

ALASKA STATE LEGISLATURE
HOUSE SPECIAL COMMITTEE ON WAYS AND MEANS

April 22, 2003

7:07 a.m.

MEMBERS PRESENT

Representative Mike Hawker, Co-Chair
Representative Cheryll Heinze
Representative Vic Kohring
Representative Bruce Weyhrauch
Representative Peggy Wilson
Representative Carl Moses

MEMBERS ABSENT

Representative Jim Whitaker, Co-Chair
Representative Norman Rokeberg
Representative Max Gruenberg

OTHER LEGISLATORS PRESENT

Representative Ralph Samuels
Representative Paul Seaton
Representative Dan Ogg

COMMITTEE CALENDAR

HOUSE BILL NO. 271

"An Act levying and providing for the collection and administration of an excise tax on passenger vehicle rentals; and providing for an effective date."

- HEARD AND HELD

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.

- HEARD AND HELD

PREVIOUS ACTION

BILL: HB 271

SHORT TITLE: PASSENGER/RECREATIONAL VEHICLE RENTAL TAX

SPONSOR(S): REPRESENTATIVE(S)KOTT

| Jrn-Date | Jrn-Page | | Action |
|----------|----------|-----|-------------------------------------|
| 04/15/03 | 0986 | (H) | READ THE FIRST TIME - REFERRALS |
| 04/15/03 | 0986 | (H) | W&M, FIN |
| 04/22/03 | | (H) | W&M AT 7:00 AM HOUSE FINANCE 519 |

BILL: HJR 26

SHORT TITLE:CONST. AM: PF APPROPS/INFLATION-PROOFING

SPONSOR(S): RLS BY REQUEST OF LEG BUDGET & AUDIT BY REQUEST

| Jrn-Date | Jrn-Page | | Action |
|----------|----------|-----|-------------------------------------|
| 04/17/03 | 1025 | (H) | READ THE FIRST TIME - REFERRALS |
| 04/17/03 | 1025 | (H) | W&M, JUD, FIN |
| 04/22/03 | | (H) | W&M AT 7:00 AM HOUSE FINANCE 519 |

WITNESS REGISTER

REPRESENTATIVE PETE KOTT

Alaska State Legislature

Juneau, Alaska

POSITION STATEMENT: As sponsor of HB 271, testified on the purpose of the bill and answered questions from the members.

CLARK GRUENING, Vice Chair

Board of Trustees

Alaska Permanent Fund Corporation

Juneau, Alaska

POSITION STATEMENT: Testified in support of HJR 26 and answered questions from the members.

ROBERT STORER, Executive Director

Alaska Permanent Fund Corporation

Juneau, Alaska

POSITION STATEMENT: Testified in support of HJR 26 and answered questions from the members.

ROBERT BARTHOLOMEW, Chief Operating Officer

Alaska Permanent Fund Corporation

Juneau, Alaska

POSITION STATEMENT: Testified in support of HJR 26 and answered questions from the members.

ACTION NARRATIVE

TAPE 03-10, SIDE A

Number 0001

CO-CHAIR MIKE HAWKER called the House Special Committee on Ways and Means meeting to order at 7:00 a.m. Members present at the call to order were Representatives Hawker, Heinze, Kohring, Weyhrauch, Wilson, and Moses. Also present were Representatives Samuels, Ogg, and Seaton.

HB 271-PASSENGER VEHICLE RENTAL TAX

CO-CHAIR HAWKER announced that the first order of business would be HOUSE BILL NO. 271, "An Act levying and providing for the collection and administration of an excise tax on passenger vehicle rentals; and providing for an effective date."

Number 0110

REPRESENTATIVE PETE KOTT, Alaska State Legislature, sponsor of HB 271, testified on the purpose of the bill and answered questions from the members. He explained that HB 271 is a fairly simple mechanism which calls for the establishment of a statewide car rental tax of 15 percent on all vehicles that are rented for a period of less than 90 days.

Number 0217

REPRESENTATIVE WEYHRAUCH moved to adopt the proposed committee substitute (CS) for HB 271, Version 23-LS0936\H, Kurtz, 4/16/03, as the working document. There being no objection, Version H was before the committee.

Number 0238

REPRESENTATIVE KOTT explained that the major change in the proposed CS is the exemption for recreational vehicles (RVs). The rationale behind this exemption is that the last increase in the rental tax in the Anchorage area, [resulted in] three rental companies going out of business. He pointed out that with the price of a rental for an RV at \$150 per day, there would be a \$20-plus increase in cost at a 15 percent rate. He commented that he believes that may be somewhat excessive. Although there is no conclusive evidence that the increase in rental tax caused the businesses to fail, there may be some merit to that [argument].

REPRESENTATIVE KOTT told the members that this proposal came about at the suggestion of the administration. He pointed out that if this increase were to go into effect [the tax] would still be lower than the state of Washington's. Alaska is tied for the 47th [lowest] place in terms of car rental taxes. He told members that tomorrow during public testimony the members will hear from companies that a tax will run them out of business. However, he recalled traveling in Seattle, and while he did not like the tax, there was no other option. Furthermore, it did not stop the companies from doing business. In most cases there would be a \$4-5 increase at the 15 percent level. Of course, that would depend on the type of vehicle being rented. Representative Kott commented that this tax mirrors what has been done in Anchorage through an ordinance. This measure would raise slightly over \$5 million the first year, and \$7 million the second year. The amount would increase as tourism increases. He noted that government employees are exempted from the tax.

Number 0634

CO-CHAIR HAWKER clarified Representative Kott's statement on government employee exemptions by saying that exemptions are only in effect when government employees are on government business. The proposed 15 percent [sales tax] is just above the mean and medium of rates across the country [as illustrated in the chart in the bill packet]. Co-Chair Hawker asked if the proceeds would be placed in a separate account in the general fund where they may be used for tourism development and highway maintenance.

Number 0744

REPRESENTATIVE KOTT responded to Co-Chair Hawker's comments by saying that a State of Alaska employee ID card must be presented when renting a vehicle while on state business. Use of ID cards is on an honor system, he said. Representative Kott explained that while funds could not be dedicated, the money raised would be placed in a specific account within the general fund. There could be some intent language or a statement on the record that these funds should be used for the maintenance of roads, and development of the tourism industry through marketing. He pointed out that 80 percent of the tax will be paid by non-Alaskans. He asked the members to think about the last time they rented a car in Alaska. Usually, it is when traveling on business or when the car is in the shop and an insurance company

pays for the rental. He asked the members to recall the last time they rented a car and had to pay for it.

CO-CHAIR HAWKER commented that he has rented vehicles in most of the 50 states in the last five years, and he had noticed the lack of taxes on vehicle rentals in Alaska.

Number 0926

REPRESENTATIVE KOTT noted that some communities such as Anchorage, Fairbanks, Juneau, and Kenai already have a form of tax in place.

Number 0954

REPRESENTATIVE WEYHRAUCH said he assumes the tax would not include RVs because they fall outside the definition of a passenger vehicle. He surmised that Alaska is in 47th place with respect to car rental taxes because local taxes are already in place.

REPRESENTATIVE KOTT responded that he is correct.

REPRESENTATIVE WEYHRAUCH said that many people rent cars in Alaska and then drive to Canada or outside, where they turn the car in. How does the sales tax apply in these cases, he asked.

REPRESENTATIVE KOTT replied that the point of origin where the vehicle was rented establishes the tax rate. For example, if an individual rented a car in Alaska, drove it to Los Angeles and turned it in a week later, the individual would be charged seven days of tax at the Alaska rate. He reiterated that it is the point of origin that determines the tax.

REPRESENTATIVE WEYHRAUCH noted that the dealer would pay the tax to state.

CO-CHAIR HAWKER noted for the record that Representative Ogg has joined the committee.

Number 1130

REPRESENTATIVE HEINZE asked if the car rental tax for individuals coming into the city from the Bush for medical reasons could be exempted.

REPRESENTATIVE KOTT responded that there is always a way to address special exemptions if there is the will to do it. Often times those individuals who travel for medical attention are having the tab picked up.

REPRESENTATIVE HEINZE replied that she knows there are a lot of folks coming into the city from the Bush for medical attention; however, she said she cannot imagine that their tab would be picked up.

REPRESENTATIVE KOTT explained that he knows that the BIA [Bureau of Indian Affairs] has a contract that provides for individuals who come from the Bush for medical treatment to be housed and provides for shuttle service to and from the place where they receive treatment. He said that [if an exemption were provided for] individuals who may or may not be receiving medical treatment, it would open the door for the possibility of inappropriate activity.

Number 1341

REPRESENTATIVE KOHRING said he disagrees with Representative Kott and asked how this legislation would benefit the economy of Alaska. He opined that taxes are more of a strain to an economy rather than something that will benefit an economy in terms of contributing to growth. Benefits from tourists in terms of the money spent in hotels, restaurants, gas stations, gift shops, and grocery stores offset loss of revenue that might be gained by a tax of this nature, he said.

Number 1509

REPRESENTATIVE KOTT acknowledged that it is unusual [for him] to be advocating for a tax bill, since he has spent the last 10 years advocating against taxes. However, he believes it is time to face reality. He said he is trying to do that in the least painful way possible. This is one way to impose a small tax on Alaskans who may rent a car, although in most cases, Alaskan's will not be affected. Representative Kott stated he does not believe there will be any loss of tourism as a consequence of implementing this tax. Tourists who come to Alaska rent vehicles, recreate, and participate in various activities, which provide revenue for tourism operators or restaurants. The state does not impose any tax on tourist at this point. Although there may be an indirect relationship with respect to corporate income tax, there is no direct tax. He said there is no negative impact to local small businesses or restaurateurs.

In fact, with this legislation the state would receive a small amount of money, \$5-10 million, which could be used to offset some of the damage to roads and parks by tourism. Certainly, part of the money could be set aside for tourism marketing. It is important to reinject some of that money to attract more tourists.

Number 1838

CO-CHAIR HAWKER pointed out that this bill does not apply to commercial motor vehicles [as defined in AS 28.41.100] or RVs.

Number 1930

REPRESENTATIVE WEYHRAUCH responded that the definition of a commercial motor vehicle as described in Alaska Statute 28.41.100 means:

A motor vehicle or a combination of a motor vehicle and one or more other motor vehicles used to transport passengers and property, used upon a land or vehicular highway, and that has a gross vehicle weight or combination weight rating greater than 26,000 pounds designed to transport more than 15 passengers including the driver or is used in the transportation of materials found by the U.S. Secretary of Transportation to be hazardous, except that the following vehicles meeting of the criteria, that he just mentioned in (a) and (c) of the paragraph are not commercial vehicles, emergency or fire equipment necessary for preservation of life or property, farm vehicles controlled or operated by a farmer, used to transport agricultural products, farm machinery, or farm supplies, not used in the operation of common or contract motor carrier, or RVs (recreation vehicles) used for the purposes other than commercial purposes.

CO-CHAIR HAWKER commented that [the definition] did include vehicles used to transport either passengers or property. The gross vehicle weight limit of 26,000 pounds appears to be the key requirement.

REPRESENTATIVE KOTT commented that a bus could be exempted from the tax.

Number 2112

REPRESENTATIVE WILSON noted that the definition mentions a 15-passenger vehicle. Would the definition include a 12-passenger van, she asked.

Number 2153

CO-CHAIR HAWKER commented that the statutes define a 15-passenger van [as a commercial vehicle]. He said his own experience in renting 12- and 15-passenger vans, which are comparable to the one-ton Budget or U-Haul vans, is if there are seats in them, they are considered a 15-passenger van, while those without seats are considered a cargo van.

Number 2213

REPRESENTATIVE WILSON pointed out that some schools drive cheerleaders to events in 12-passenger vans. She said she has no idea whether these vans meet the weight requirement.

REPRESENTATIVE HEINZE asked if there is any forward thinking about how these funds could be funneled back into tourism marketing. She pointed out that these taxes are mainly tourism user fees.

Number 2311

REPRESENTATIVE KOTT commented that she made a correct assessment regarding forward thinking. The funds cannot be dedicated directly into a specific arena unless there is a constitutional amendment authorizing dedicated funds. Representative Kott reiterated his earlier comments that intent language can be included in the bill that would suggest that the legislature wants a percentage of the proceeds which are generated from this excise tax to go toward some other method of doing business in the state of Alaska. He stated that he believes it would be a good thing to include intent language for "tourism marketing" in the bill. Representative Kott told the members that he cannot promise any money raised from this excise tax will ever end up in tourism marketing.

Number 2416

REPRESENTATIVE HEINZE explained that those in the tourism industry will be on the outside watching these user fees [accumulate]. How can the tourism industry get an answer about more funds for tourism marketing, she asked. How will the

[Department] of Community and Economic Development will be affected.

REPRESENTATIVE KOTT pointed to the fiscal note and said that the details are comprehensive. He commented that there are entities in the tourism field that are cognizant of this bill and other measures that will generate money from non-Alaskans, whether they are working on the North Slope or visiting as a tourist. Representative Kott said that at some point the state will have to provide some level of support for the tourism industry. There will be a request for dollars for marketing activities because without marketing, the industry will become stagnate. For example, after [the terrorist attacks of September 11, 2001] Las Vegas [as a tourism destination] was on the decline; however, the city opted to spend \$14 million for marketing. Las Vegas is one of few cities that showed a marked increase in tourism to their city. There is a nexus between marketing and the number of tourists who visit a specific city. Representative Kott commented that he would not have expected Las Vegas to do so well considering the fact that large properties would be targets for terrorism.

Number 2722

REPRESENTATIVE KOHRING reminded the members of contributions made by tourists to the economy. If the primary justification for this tax is to raise dollars for marketing and road maintenance, it would be interesting to know what the administration has in the way of quantifying the costs, he commented. Representative Kohring opined that there has been negligible cost to the state on wear and tear of the highways and use of public facilities by tourists. He said he would like to hear from the administration regarding what costs this tax would try to offset.

Number 2844

CO-CHAIR HAWKER announced that there will be public hearings tomorrow on HB 271. He told the members that as the session grows short and the workload is heavy, he wants to keep moving forward as quickly as possible. With that in mind, he announced that anyone who would like to raise concerns or propose amendments to the bill should provide them to the committee today, so they can be considered tomorrow before and after public hearings.

REPRESENTATIVE KOTT cautioned the members who might propose a change in the definition of commercial vehicles or exemptions to be aware of the potential conflict a change might have in municipalities and the confusion that might follow with rental car companies. He pointed out that HB 271 has basically extracted language and regulations [that are currently used to avoid unnecessary confusion].

[HB 271 was held over.]

HJR 26-CONST. AM: PF APPROPS/INFLATION-PROOFING

Number 3041

CO-CHAIR HAWKER announced that the final order of business would be 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 HAWKER explained that HJR 26 was submitted by the House Rules Standing Committee at the request of the Legislative Budget and Audit Committee by request of the Alaska Permanent Fund [Corporation].

Number 3147

CLARK GRUENING, Vice Chair, Board of Trustees, Alaska Permanent Fund Corporation, testified in support of HJR 26 and answered questions from the members. He told members that HJR 26, which is a proposed constitutional amendment, is a different way to inflation proof, protect, and enhance the Alaska permanent fund. Mr. Gruening explained that for 23 of the fund's 27 years of existence, the permanent fund has been governed by a six-member board of trustees. Protecting the fund against inflation has been the highest public policy goal of the trustees since the first board was appointed in 1980, he commented. The first board testified to the legislature at that time that the greatest threat to the permanent fund and to its permanence was inflation. In response to that testimony, the legislature adopted a statutory inflation-proofing methodology in 1982 which is in use today.

MR. GRUENING said in more recent years, the board has examined the use, by large endowments and public funds, of a formula approach to determine the method and size of payouts from these funds. This approach is generally referred to as percent of market value payouts or POMV. The purpose of placing this

formula in the state constitution is to protect the long-term real value of the fund and to provide consistent and predictable distributions for the long term. After considerable review and discussion the board recommended in February 2001, to the last legislature, a constitutional change in the form of SJR 13 and 15. He explained that both measures received hearings but did not come to the floor for a vote. As in the prior proposal, the language in HJR 26 provides a spending limit on what can be currently spent or in legislative parlance, appropriated. The existing constitutional language establishing the permanent fund only prohibits the appropriation of principal. In other words, anything but the principal is income and can be spent, he stated. Since the first board of trustees, 23 years ago, the permanent fund has calculated the principal as a notational number. It simply equals the sum of the constitutionally mandated 25 percent of mineral revenues and non-mandated or voluntary deposits the legislature has chosen to make. He noted that the legislature has made appropriations to two-thirds of what is now calculated as principal.

MR. GRUENING explained that the principal does not vary with the market. Under the present statutory provision inflation proofing is only on the principal, unlike HJR 26 which would provide inflation proofing of the entire fund. He stated that one of the most important reasons to support the proposal is that it would maximize distributions over the long term by establishing a percent of market value limit, and also eliminate the distinction between principal and income. This proposal would avoid the situation where market volatility on the downside prevents any distribution from the permanent fund for any purpose, whether it is dividends or anything else. Mr. Gruening told the members that this is significant because since 1982, as the members are well aware, Alaska's fiscal picture has changed dramatically. The Alaska permanent fund can be expected to produce more future revenue than any other Alaska resource including oil, natural gas, fishing, tourism, mining, or anything else, he said. Whatever future decisions are made by the legislature or the voters regarding the use of permanent fund earnings, the 5 percent payout of market value limit will assure complete and protected inflation-proofing while providing predictable and sustainable distributions over the long term.

Number 3640

MR. GRUENING used the analogy of managing fisheries stocks when the only sensible choice is to avoid taking too much of the fish stock so that over the long term the harvest is maximized. Of

course, he said, over harvesting can reap short-term rewards of more fish and more money, but the inevitable result, at best, is fewer fish, less money, and at worst, permanent impairment or destruction of the fisheries stock. He said the same is true for managing distributions from a large investment fund, like the Alaska permanent fund. If Alaska is going to have a fund that is truly permanent, it is important to take those steps to ensure permanence. This means investing for future generations as well as current generations. This will require a commitment to basic principles of long-term investment. He explained that the critical flip side of a sound long-term investment strategy is a sound, sustainable, and predictable distribution plan; a plan that will sustain and provide benefits to each generation of Alaskans.

MR. GRUENING commented that he believes everyone wants to avoid defaulting to the position where the Constitutional Budget Reserve (CBR) is today. Within the next three to four years the CBR is destined for extinction, he predicted. As the investment horizon of the CBR steadily shortens, it will be necessary to keep the investments in very short term, and less profitable investments. As the day the CBR's demise grows near, the trustees and staff will have to also consider a shorter-term investment horizon for a significant portion of the fund. However, one thing is clear and that is that the permanent fund can continue to import significant sums of money into Alaska, year after year after year. If properly invested and protected the permanent fund will successfully convert nonrenewal petroleum wealth into Alaska for a permanent and substantial stream of revenue for generations after the last barrel of oil has been pumped. Mr. Gruening said that legislative passage and voter approval of HJR 26 would protect the ability of the fund to be managed for the long term and would continue to pour money into the Alaskan economy over the long term.

Number 3941

MR. GRUENING concluded his testimony by telling the committee that the proposed constitutional change in HJR 26 is much more compatible with the funds diversified long-term investment strategy with a 5 percent real rate of return over time. The present constitutional language was designed over 25 years ago for a fund that was 100 percent invested in bonds. Mr. Gruening said he believes that succeeding generations of Alaskans will view this amendment with the same degree of appreciation as the original one approved 27 years ago. The trustees believe that this proposal for complete and protected inflation-proofing

makes ultimate good sense for the Alaska permanent fund and Alaska's future.

Number 4025

ROBERT STORER, Executive Director, Alaska Permanent Fund Corporation, testified in support of HJR 26 and answered question by the members. He told the members there are five key issues that he believes are very important in this legislation. The first issue of HJR 26 is a new method of memorializing and inflation-proofing the fund in the constitution. He explained that at the moment inflation-proofing is in statute and it is done after the dividend [distribution]. It is important to note that in the past the legislature has always had the money available to inflation proof the fund. Mr. Storer said he believes it is important to ensure that all generations are treated equally and that the purchasing power of the permanent fund is maintained over time.

MR. STORER explained that HJR 26 includes a spending limit which means that no more than 5 percent of the moving average of the fund [can be appropriated]. There has been discussion about spending limits and making more money available during the "bear" markets. However, he said he believes it is very important to create discipline during the bull markets. What has occurred is that endowments and foundations have incurred spending patterns that they could not meet because they were extrapolating a bull market and higher payouts. He emphasized that this resolution would create a spending limit on the upside so that it ensures there will be continuity over time during both bear and bull markets. This change would provide greater stability during volatile markets; since all markets are volatile all the time, it is a question of magnitude. This payout methodology creates greater stability than the current methodology that is in statutes.

Number 4318

MR. STORER said, for example, if the members were to look forward [from now] to FY 06, the rate of change on what is available for distribution, would be an increase in the first year [2004] of 35 percent, the following year [2005] 16 percent, and the next year [2006] 18 percent. The POMV would be 2.5 percent growth to 4 percent greater predictability. He explained that if the members looked at the bull market that ended in March of 2000, the dividend payout was [based on] what was available for the dividends which were growing

substantially; however, now what is available is dropping in equal magnitude. He pointed out that the [dividend] went from \$1,963 to \$1,541. If markets hold, there will be a \$1,000 distribution this year. The change would provide greater stability and predictability.

Number 4435

MR. STORER reaffirmed Mr. Gruening's comments that the 5 percent payout is consistent with long-term objectives. He said that in examining the history and projected future assets, allocation and statutory limitations will allow the Alaska permanent fund to achieve a 5 percent real rate of return, which is 5 percent in excess of inflation over time. As was noted, 26 years ago the Alaska permanent fund was established and it was a world of fixed income securities, lower volatility, and higher cash payouts, and that is what the current methodology is. Mr. Storer said that the statutes served the fund well during that period, but investment management has changed and he believes that these changes [proposed in HJR 26] would move the fund to a more consistent approach.

MR. STORER said his final point is that the changes will provide predictability of annual appropriations under the POMV. He pointed out that under the status quo it is not known if there will be funds available for appropriation in any given year. Mr. Storer commented that the fund uses a 5 percent moving average of realized income. At the end of May, the fund will have four years and 11 months left, and beyond that he would not be able to say because of the magnitude of volatility that has been experienced. He cautioned that there still is a 10 percent chance that there will be no dividend. It really depends on how the markets behave over time. Mr. Storer offered to answer questions from the members.

Number 4642

ROBERT BARTHOLOMEW, Chief Operating Officer, Alaska Permanent Fund Corporation, testified in support of HJR 26 and answered questions from the committee.

TAPE 03-10, SIDE B

MR. BARTHOLOMEW told the members he would like to go through the financial schedules and then review the resolution to highlight suggested changes to the constitution. The first schedule, titled "HJR 26 Financial projection [comparison of the Alaska

permanent fund]," is on page 4 of the handout. He asked the members to look at FY 03 column and go down to the "Dividend (lump sum) - Status Quo," which is the distribution or what would be paid out for the dividend in FY 03, which is \$686 million. He explained that [the corporation] will not know with even one day left of the fiscal year if there will be any money for the payout of the permanent fund dividend. If the markets go well, there will be a payout of \$686 million for the dividend; if there is a bad market for a week at the end of the fiscal year, given the way the rules work, the payout could be zero.

MR. BARTHOLOMEW noted that whether there is an effort to build a budget or an economy that has dividends, or whatever the legislature chooses to do with the distribution of the permanent fund, there is a significant risk. With the constitutional amendment, he said, there is an assured payout every year. He said that it is important to note that under the "status quo," all numbers that are shown being paid out of the permanent fund each year are the dividends, then funds are transferred from the earnings reserve [account] to the principal for inflation proofing. It is assumed that there will be no other distribution because that is the way the permanent fund has been used for the past 10-15 years. Mr. Bartholomew commented that whether that is the way it would work in the future is speculative.

Number 4301

MR. BARTHOLOMEW asked the members to look at the lower part of the schedule on the POMV where it shows the market value after payout. This schedule assumes that the whole 5 percent would be distributed from the permanent fund, and the market value over time will be much smaller, he said. If under POMV, only the dividend was paid out which has happened over time, the numbers would be exactly the same. This schedule shows the differences if the permanent fund were to be used for another purpose, it will change what is available.

MR. BARTHOLOMEW pointed out that under Status Quo, lines 2-4 give a picture of the earnings reserve [account] as it is set up today. He asked the members to note that if they look out over time the earnings reserve [account] grows if there is only the payout of the dividend, which happened in FY 02. The permanent fund earnings reserve [account] had \$6.5 billion, which is available for appropriation by the legislature. The trustees cannot manage for a large distribution if they do not know what

the legislature will do with it. With the 5 percent spending limit the trustees know that the most that will come out in any one year is 5 percent. The [fund managers] will be more comfortable with that asset allocation of long-term investments because there would not be a risk of large sums of money, that may be sitting in long-term investments, such as stocks that are in a down market. If the plan is to take a lot of money out of the permanent fund, it is important not to be invested in long-term investments. Mr. Bartholomew summarized his comments by saying that the schedule is designed to give the members an idea of what the numbers look like and what the permanent fund produces in income each year and what will be available.

Number 4118

MR. BARTHOLOMEW directed attention to page 5, titled "Calculation of annual effective rates of 5% POMV spending limit." This schedule points out that a 5 percent payout, as stated by the executive director, is an aggressive payout rate. It is at the high end of what statutory limitations for investments would allow the permanent fund to return over time. He noted that the [trustees] are comfortable using a 5 percent payout. There are two issues in this schedule that reduce the effective rate or what is really being paid out. Normally, capital markets grow every year. For example, today the Alaska permanent fund has \$23 billion. If it grows for the next five years, then there will be an average that may vary from \$23 to \$26 billion. The average of those five years will be \$24.5 billion. The fund will take 5 percent of that five year average and that is what is available [for payouts].

Number 3939

MR. BARTHOLOMEW went on to say that for example, in FY 08 the fund is [projected to be] \$26 billion, what is actually being paid out of the total market value of the fund that year is less than 5 percent. The first blue line across the spreadsheet shows that the actual effective rate is closer to 4.7 percent which is a built in cushion to ensure that the fund does not overspend the sustainable yield from the permanent fund. The second half of that schedule points out the rate of payout after deducting the costs for the Alaska permanent fund. Currently, when calculating income or what is available for distribution that is determined after paying the operating budget of the Alaska Permanent Fund Corporation. Right now the [operating budget] is roughly \$35-\$40 million per year. The way the constitutional amendment [HJR 26] is written the permanent fund

[Corporation's] operating budget would come out of that 5 percent limit, he told members. So this further reduces what is being paid out after covering the costs of investing and managing the funds. So again, this would mean there would be a 4.5 percent effective payout rate. This [constitutional amendment] would ensure that there is a bigger cushion and the risk of overspending is diminished.

CO-CHAIR HAWKER told Mr. Bartholomew that he appreciates the succinctness and clarity of the first schedule.

CO-CHAIR HAWKER commented that he received 30 e-mails today expressing the view that the only purpose of the permanent fund is to pay dividends to individual Alaskans. He asked how the permanent fund Board responds to those folks.

Number 3656

MR. GRUENING responded that this board, like prior boards, has avoided getting involved in recommending what the legislature should do with income from the fund. However, as a legislator who helped craft the original language, and who was there when it was approved by the legislature and the voters, he said, a majority of the members did not see this fund as strictly a fund to pay dividends. At that time, then-Governor Hammond had an idea of what to do with dividends, but it was really envisioned as a way to conserve this one-time wealth for future generations. How those benefits would flow were not determined by us, but many could foresee that when the oil wealth was gone, this could help replace some of that [revenue] and serve to help support services to which the public had become accustomed. He emphasized that his comments are made not as a trustee or on behalf of the permanent fund Board, but as a legislator who was there in the beginning. Mr. Gruening added that the fund was all things to all people. A lot of people saw it doing many things. The two major thoughts were to conserve wealth and help provide for some of the load when oil revenue was not there.

Number 3450

CO-CHAIR HAWKER stated for the record that his intention was not to ask Mr. Gruening to take a position for the board. He said he appreciates hearing Mr. Gruening's institutional experience and understands that his comments are based on his personal experience and not as a trustee of the board. Co-Chair Hawker noted that the board has not taken a position on the disposition of the funds. He asked Mr. Gruening if he believed the

disposition of the funds is the providence of the legislature rather than the providence of the permanent fund Board if it is not established in any constitutional dictate.

MR. GRUENING responded that is correct.

Number 3416

MR. BARTHOLOMEW pointed out that the statutes that are on the books today have been there since 1982. These statutes set out the formula which directs that the annual appropriation from the permanent fund be based on the realized income, which then directs 50 percent of that income to be allocated to the dividends. The second step that is required is to inflation proof the fund out of what is available [after the dividend distribution]. He told the members that for the last 20 years the permanent fund has only allocated 50 percent of the available annual distribution to the dividend program even though there have been residual funds after paying the dividend and inflation-proofing the fund. Mr. Bartholomew reiterated that there has been money available for other uses.

MR. BARTHOLOMEW explained that the history that the fund could be available for other uses goes back to when the fund was small and people were not use to the dividend. Those statutes have not changed. The expression of the legislature 20 years ago, however, was to not make the whole amount available [for distribution].

Number 3251

CO-CHAIR HAWKER said he would like to follow up on the spreadsheet [titled HJR 26 - Financial projection comparison of the Alaska permanent fund on page 4]. He commented that there is a trend. In looking all the way out to the projected FY 2013 numbers, which is a 10-year consequence of what is being considered, the schedule is predicated on a total return estimate of 7.6 percent to the future. He acknowledged that it is a premise that is subject to debate; however he said he would use these figures for the purposes of discussion. Lines 2-4, which are the earnings reserve accumulations in this model, shows an accumulation of \$6.9 billion in the earnings reserve on a market value basis. Co-Chair Hawker noted that Mr. Bartholomew said that the fund currently pays out one-half of the earnings of the fund in dividends and the other half is being internalized into the fund. He asked if the other one-

half that is being internalized corresponds to the accumulation of the earnings reserve.

Number 3128

MR. BARTHOLOMEW replied that it does [correspond to the accumulation of the earnings reserve]. What this model projects is what the fund will earn. It is the [projected] median return that the fund's consultants have said the capital markets should produce over the long term. He pointed out that the 7.6 percent is the total return; the current assumption for inflation for the next five years is 2.6 percent; and the difference between those two [figures] is 5 percent. If the fund is earning 5 percent and only paying out the dividends, around 2 percent of the fund would be needed for the dividend for the next few years. Mr. Bartholomew explained that what is accumulating in the earnings reserve is the excess earnings that have not been spent, and are believed to be available on a sustainable basis. What has happened in the past 10-15 years is that there has been more saved for future generations than has been spent on current years. He told the members that the 5 percent [spending limit] is research and analysis' best estimate regarding the best way to balance the fund between current and future [needs]. As the earnings reserve grows it means more money is being saved for the future and less money is being spent from what is available currently.

Number 2955

CO-CHAIR HAWKER clarified that the \$6.9 billion in FY 13 [Total earnings reserve - end of year (after payouts)] represents the continued discipline of savings and spending only for either dividends or inflation-proofing, not spending for any public purpose that portion of projected earnings that is not used for either dividends or inflation proofing.

MR. BARTHOLOMEW responded that is correct.

CO-CHAIR HAWKER noted that FY 13 [line 1 under the heading of POMV - 5% (beginning in FY 05)] the Total Market Value End of Year (after payouts) is \$31.7 [billion], and the Total Market Value in FY 13 under the current Status Quo heading is \$38.8 [billion]. He asked if the difference of \$7 [billion more under the Status Quo option] is a result of the accumulated savings discipline of not having used those earnings that were reinternationalized into the fund.

MR. BARTHOLOMEW responded that it is exactly right.

CO-CHAIR HAWKER reemphasized Mr. Bartholomew's point that it is the legislature's prerogative to use the full 5 percent for public purposes in whatever manner is appropriate.

MR. BARTHOLOMEW replied that they chose a scenario to model which would show the full effect of the 5 percent. He noted that he believed that was the most that could be taken [from the fund].

Number 2743

CO-CHAIR HAWKER asked if using the 5 percent POMV payout option, with the continued current statutory concept regarding how much is paid in individual dividends, which is 50 percent of payout right off the top, would mean the payout will be one-half of the \$1.235 billion in FY 05, which is the POMV payout available for appropriation in lump sum.

MR. BARTHOLOMEW responded that there is a difference between the two methods. If using the second method, which is the payout of the POMV method, and there would be a continuation of the 20-year history of making one-half of what is annually available allocated to the dividend, then that line which says [POMV Payout] available for appropriation in lump sum would be split 50-50 and that is how much money would be allocated.

Number 2617

CO-CHAIR HAWKER compared the status quo or the current payout structure with the POMV methodology. Under the POMV methodology, he said, approximately one-half of \$1.2 billion is roughly \$600 million, which would be \$200 million greater than the current projected dividend under the status quo of \$400 million. He noted that these results are in the trailing years of a declining market, with 5-year averaging the dividends will continue to drop precipitously. Co-Chair Hawker compared FY 06 and FY 07, noting that FY 07 is at a breakeven point. What is prudent in managing future revenue streams in a period of rising markets, he asked.

Number 2427

MR. BARTHOLOMEW explained that what has happened is that the dividend got up to almost \$2,000. If the formula remains as it is today that will drop down to \$700 or \$800 in a year or two.

That is a huge fluctuation that hits the economy or wherever the legislature chooses to use the earnings. He told the members that [the corporation] would recommend changing that payout method so the dividend does not go so high in the good years and not drop down drastically in the down years.

CO-CHAIR HAWKER commented that is the fundamental premise of the POMV method which enforces savings in periods of rising and good markets and keeps the legislature's hands off of those earnings, but makes an element of those earnings available in declining years.

Number 2326

REPRESENTATIVE WILSON observed that what has been currently done in paying out 50 percent in dividends and saving the other 50 percent for future generations, has resulted in the loss of those funds.

Number 2244

MR. BARTHOLOMEW responded that what has happened is that part [of the funds] have been paid out in dividends, and part have been transferred from the earnings reserve to the principal for inflation-proofing the fund. Part was lost in the decline in the stock markets. He said that it is true to say that [some] of the funds have been lost, but that is also reflected in capital markets. The funds were there in 2000 and if a guru could predict the markets, the funds could have been removed from the permanent fund, but the investment professionals would caution against thinking cherry picking at the top [of the market] can be done and then re-enter the market when it is low. The markets go up and down, and therefore he recommended a distribution method that stays in the middle and does not run up.

MR. STORER commented that one-third of the principal of the permanent fund is special appropriations. So prior legislators have invoked a discipline, by virtue of taking that larger earnings reserve and moving it into the principal, so all the funds have not been dissipated away.

Number 2109

REPRESENTATIVE WILSON said that when comparing the two options, it appears to her that the POMV at the 5 percent option, which the permanent fund Board is suggesting, really gives more

security and predictability for the future of the fund. She noted that it also allows the legislature to appropriate some of the other 50 percent and still ensure that the fund will continue to grow.

MR. STORER agreed with Representative Wilson. He commented that this option would create discipline and predictability that allows informed decisions to be made.

Number 2012

REPRESENTATIVE HEINZE asked Mr. Gruening to address a hypothetical question. Assuming there is a year where the funds in the capital markets are low and the inflation rate is high, under this [constitutional] amendment does the legislature have the flexibility to add more into [the fund] for inflation proofing.

Number 1929

MR. GRUENING commented that he will address the legislative portion of the question and Mr. Storer will answer the market situation Representative Heinze envisions. He told the members that the legislature always has the power of appropriation and could decide to appropriate more money to the fund. Nothing in HJR 26 would prevent that.

MR. STORER reiterated that the [resolution] would implement a 5 percent spending limit. The legislature is not required to use all 5 percent, and can use less if deemed appropriate. Historically, inflation has been about 3.1 percent so it not only invokes a discipline on the payout, but invokes a discipline on what [is required for] inflation [-proofing]. The current inflation rate is about 2 percent. The permanent fund's consultants think inflation over the next five years will be about 2.6 percent. He commented that they recognize that some years inflation will be higher than the 3 [percent] and some years lower. He emphasized that they expect to earn 5 percent real income in excess of inflation.

Number 1800

REPRESENTATIVE HEINZE asked if there is another national endowment that calculates its payouts the way the permanent fund does.

MR. STORER responded that the permanent fund did a study, and what is being proposed is currently used for approximately 70 percent of the endowments and foundations. [Endowments and foundations] use the methodology of payout of the moving average of their funds. He told the members that what is being proposed is consistent with the way most endowment funds move forward. Mr. Storer commented that he is not aware of any example of a fund that uses the 5 percent moving average of realized income.

Number 1704

CO-CHAIR HAWKER said that over the years there have been many references in reports and documents by the permanent fund on research done with respect to other large endowments and managed funds. He asked if there is a report or summary study on that work which would be available to the public.

MR. STORER replied that some of that information is in the trustees' paper, but there are also two surveys, one from Greenwich Associates and one from NACUBO [National Association of College and University Business Officers]. He told the members that they would be glad to provide copies of the studies.

CO-CHAIR HAWKER replied that he would appreciate receiving copies of these studies. He turned to the trustees' document, volume 7, which is about a year old now, and addresses prior proposals and legislation. He asked if the premises and presentation in that document are still fairly applicable to the current situation.

MR. STORER said that he still believes the document is applicable with the exception of one thought. At the time the document was created the earnings reserve was so large that no one thought that it was necessary to change the distinction of principle. However, now the corporation believes it is not in the best interest of the long-term management of the fund for predictability, et cetera.

Number 1516

REPRESENTATIVE SAMUELS asked Mr. Storer if he said that none of the other large endowments use a rolling average.

MR. STORER responded that about 70 percent of large endowments and foundations use a rolling average. Some use five years and

others use seven years. However, [these rolling averages] are not of realized gains.

REPRESENTATIVE SAMUELS asked if our current formula, which is a five-year average of cash flow income, is used by any existing funds or endowments.

MR. BARTHOLOMEW said no.

Number 1441

REPRESENTATIVE SAMUELS asked how the 5 percent [spending limit] compared with other endowments: large, middle of the road, or conservative.

MR. STORER responded that the [5 percent] figure would be considered the middle of road. He said they found 4.5 percent to 5.5 percent for the more aggressive funds which are invested in more volatile assets, publicly traded stocks, private equity, market venture capital will tend to have a higher payout. Furthermore, this is consistent with our long-term objectives regarding how the fund is managed.

Number 1347

CO-CHAIR HAWKER recalled Mr. Storer's earlier observation that no one does it quite like the permanent fund. Co-Chair Hawker asked if he was referring to the measurement only on realized market gains and losses rather than a full market value calculation which includes unrealized gains and losses.

MR. STORER responded that is correct.

Number 1250

MR. BARTHOLOMEW, upon the committee's agreement, began reviewing HJR 26. He turned attention to Section 1, page 1, of the resolution and specified that the bold print is what will be inserted into constitution. This [language] gives reference to the spending limit that is established in Section 2. The first addition is just to add into the text that how the legislature uses the money will be addressed in Section 2. On line 10, the word "principal" is removed from the constitution. He reiterated the executive director's statement that it is believed that the permanent fund will be protected and that the corpus and principal of the permanent fund will be protected through a spending limit versus the limitation of principal in

the constitution. Lines 12-13 remove language that has been in the constitution since 1976, when the original amendment was passed. [The original amendment] stated that all earnings and all earnings and income from the permanent fund would be deposited into the general fund unless otherwise directed by law. That language is deleted with the intent that all the income of the permanent fund will remain in the permanent fund subject to Section 2. In other words, the income will now be part of the permanent fund.

Number 1056

MR. BARTHOLOMEW responded to Co-Chair Hawker's comment that this section does take the income away from the appropriation [process]. On page 2, Section 2, the first [two lines] add language to explain that the objective of the spending limit is to make sure only the real income is appropriated. That is the income that is earned in addition to inflation. The [next lines, lines 4-6] set the actual spending limit and the protection of the permanent fund through the limit to real income of 5 percent of the 5-year average.

MR. BARTHOLOMEW pointed out that the legislature is now working on the FY 04 budget with a month to go with the legislative session, and there is no idea what will be available from the permanent fund. This language, says the permanent fund will go back one extra year, so in essence the five-year average is going to be for the fiscal year that is already over. So when the legislature comes to town in January, there will not be any speculation with regard to what is available. The permanent fund will have computed all the numbers, done the five-year average, and will say X number of dollars will be available if necessary.

Number 0913

MR. BARTHOLOMEW explained that in Section 3 there is some transitional language. There was some concern when the proposal was brought forward for a constitutional amendment two years ago that the current earnings reserve was not part of the permanent fund and there could be an argument to leave the earnings reserve in the general fund. The Senate State Affairs and Senate Judiciary Committees, and the Legislative Legal and Research Services director felt that by adding this transitional language it would clarify that the earnings of the permanent fund that are accumulated at the time the resolution is voted on by the people would be part of permanent fund. He commented

that the Board of Trustees supports the idea that the earnings reserve would be a part of the permanent fund. Section 4, talks about the fact that this would go to a vote of the people in November 2004, he said.

Number 0805

CO-CHAIR HAWKER asked if the model includes any provision for new principal investment from on-going oil and gas state resource revenues or is this a status quo model based on the existing investment.

MR. STORER replied that the model does anticipates future contributions for mineral leasing.

MR. BARTHOLOMEW explained that the model is based on the current Department of Revenue forecast. It is not based on any new fields that are not in production today. It is based on the known and expected production from the existing oil fields.

CO-CHAIR HAWKER clarified that it is not based on any new fields that could be brought on line. Is it also based on the current statute which has the calendar division between old fields and new fields for the 25-50 [split, which refers to a change in the amount of money the State of Alaska receives from new oil leases].

Number 0704

REPRESENTATIVE WILSON commented that she really appreciates the provision in Section 2 (b), lines 4-5, which eliminates the guess work and provides the legislature with solid numbers.

REPRESENTATIVE HEINZE asked what the rate of change means.

Number 0618

MR. STORER responded that when he mentioned the rate of change he was talking about distribution. It is the percentage change from one year to another. For example, two years ago the dividend was \$1,963; last year it was \$1,541, and that rate of change is about a 25 percent drop.

CO-CHAIR HAWKER announced that is the end of testimony today and that there will be more hearings on HJR 26.

[HJR 26 was held over.]

ADJOURNMENT

There being no further business before the committee, the House Special Committee on Ways and Means meeting was adjourned at 8:38 a.m.