

ALASKA STATE LEGISLATURE
HOUSE SPECIAL COMMITTEE ON WAYS AND MEANS

April 25, 2003

7:13 a.m.

MEMBERS PRESENT

Representative Mike Hawker, Co-Chair
Representative Jim Whitaker, Co-Chair
Representative Cheryll Heinze
Representative Vic Kohring
Representative Norman Rokeberg
Representative Bruce Weyhrauch
Representative Peggy Wilson
Representative Max Gruenberg
Representative Carl Moses

MEMBERS ABSENT

All members present

OTHER LEGISLATORS PRESENT

Representative Dan Ogg
Representative Ralph Samuels
Representative Paul Seaton

COMMITTEE CALENDAR

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: HJR 26

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

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

Jrn-Date	Jrn-Page		Action
04/17/03	1025	(H)	READ THE FIRST TIME - REFERRALS
04/17/03	1025	(H)	W&M, JUD, FIN

04/17/03	1025	(H)	REFERRED TO WAYS & MEANS
04/22/03		(H)	W&M AT 7:00 AM HOUSE FINANCE 519
04/22/03		(H)	Heard & Held MINUTE(W&M)
04/24/03		(H)	W&M AT 7:00 AM HOUSE FINANCE 519
04/24/03		(H)	Heard & Held MINUTE(W&M)
04/25/03		(H)	W&M AT 7:00 AM HOUSE FINANCE 519

WITNESS REGISTER

MARC LANGLAND, Chair, President, and CEO
Northrim Bank;
former trustee
Alaska Permanent Fund Corporation
Anchorage, 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.

RON LORENSEN, Attorney at Law
Simpson, Tillinghast, Sorensen, and Longenbaugh
Juneau, Alaska
POSITION STATEMENT: As counsel to the Alaska Permanent Fund
Corporation, testified in support of HJR 26 and answered
questions from the members.

ACTION NARRATIVE

TAPE 03-14, SIDE A
Number 0001

CO-CHAIR JIM WHITAKER called the House Special Committee on Ways
and Means meeting to order at 7:13 a.m. Representatives Hawker,
Whitaker, Heinze, Kohring, Weyhrauch, Wilson, Gruenberg, and
Moses were present at the call to order. Representative
Rokeberg arrived as the meeting was in progress.
Representatives Ogg, Seaton, and Samuels were also present.

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

Number 0157

CO-CHAIR WHITAKER announced that the first 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.

Number 0209

MARC LANGLAND, Chair, President, and CEO, Northrim Bank; former trustee, Alaska Permanent Fund Corporation, testified in support of HJR 26 and answered questions from the members. He told the members that because of his experience with the Alaska Permanent Fund Corporation [Board of Trustees], he would like to comment on the endowment process and let members know that he favors moving in that direction. In [moving toward an endowment process] there will be a steady flow of cash and a predictable flow of revenues to the state versus the current system, he explained. He pointed out that this would take politics out of process of managing the fund and remove the temptation on the part of the legislature to use inflation-proofing dollars instead of putting the money back into the fund. Mr. Langland noted that when he was a trustee there was not the same pressure on the fund as there is now with respect to producing earnings. He explained that there is an opportunity under the current system for decisions to be made that would create more or less cash earnings for the fund such as taking appreciation and assets as a profit to create new cash or take losses. He said sometimes those decisions could be influenced by politics and pressures to influence the flow of cash. Although he said he is not sure that has ever happened, it could occur. The [endowment] approach would allow trustees to provide better management of the assets of the fund by making decisions based on long-term proper asset allocation and [base] decisions on whether to take profits from an index fund or not, without the influence of political pressure to create cash. Mr. Langland recalled that during the last election he heard a number of people discuss the notion of not inflation-proofing the fund, and using that cash to close the budget gap; thereby, not impacting the dividend. The aforementioned is a good example of how, in times of stress, politics could influence the overall integrity of the fund by not inflation-proofing it.

Number 0636

MR. LANGLAND said that in the future the pressure to create revenues and use earnings from the fund to fill the [budget] gap will be great. He reiterated that the endowment idea would produce a predictable flow of cash no matter what happens in a more volatile stock market and unpredictable economic situations. The endowment would also provide the legislature with better knowledge on how to manage the state's fiscal issues, he said. He asked the members to consider that the state is facing very unpredictable revenue sources from the price of oil. In managing a business it is important to mitigate the volatility of the revenue stream, he explained. Under the current system, oil revenues are unpredictable and volatile and financial markets are also unpredictable and volatile; however, with an endowment method at least one-half of the revenue stream for the state will be off of the volatile list and make [the fund] more predictable. Mr. Langland summarized his comments by saying that from the standpoint of managing government revenues and being able to use those funds for government, it is in the [best interest] of the state and its citizens to understand what the permanent fund can produce on a regular basis when the fund is not influenced by political pressure. Mr. Langland urged members to pass HJR 26.

Number 0908

REPRESENTATIVE GRUENBERG asked Mr. Langland if he read Mike Doogan's column where he criticized this approach [to managing the fund].

MR. LANGLAND replied that he does not read [Mr.] Doogan's column.

REPRESENTATIVE GRUENBERG commented that Mr. Doogan raised some interesting issues with respect to this [method of management]. One issue he raised is the assumption that there will be an 8 percent return. Mr. Doogan asked what will happen if there is not that rate of return, since the fund is not earning 8 percent now. Representative Gruenberg asked Mr. Langland to respond to Mr. Doogan's question.

Number 1043

MR. LANGLAND replied that in looking at the permanent fund it is important to look at it as a long-term asset. The statistical data on a long-term basis [reflects that] an 8 percent return is a reasonable expectation through various economic cycles with

the proper asset allocation of the fund. Although there will be times when real returns are less than 8 percent, there will also be times that the return will be more than that. Mr. Langland pointed out that it is very difficult to predict the future and that is why it is very important to think prospectively. Unfortunately, the political arena does not look at the long term and [Mr. Doogan's] comment is a very good example of why the endowment and payout formula is so important.

CO-CHAIR WHITAKER told the members that he does not want [Mr. Doogan's] column to be the subject matter of the committee's discussion.

Number 1302

CO-CHAIR HAWKER commented that across [the state] there are criticisms [voiced] with respect to making changes [to the permanent fund]. There is [a perception] that the current structure of permanent fund is absolutely the best and only structure in which it should be organized. He asked Mr. Langland what years he served on the Alaska Permanent Fund Board of Trustees.

MR. LANGLAND replied that he served from 1986 through 1990. The 1990's were very big years and the real rate of return was about 4 percent.

CO-CHAIR HAWKER asked if the trustees were looking at a change in the methodology at that time.

MR. LANGLAND replied that the biggest issue he recalls was the requirement that dividend calculations were the first call on the earnings versus inflation-proofing. The trustees tried to get the legislature to look at switching that order, although they were not able to achieve it. Another important issue that was being discussed was the change from 50 percent to 25 percent on new oil revenues. Mr. Langland pointed out that there has been a change in the definitions in accounting principles which makes the current system more complicated. He commented that at that time [1986-1990] there was no political pressure to use earnings from the fund to close the budget gap.

Number 1550

CO-CHAIR HAWKER asked if Mr. Langland believes the legislature is being too reactive in considering this as a tool in addressing the fiscal gap. He asked if, as a financial

professional and economist, this [change] would make sense to Mr. Langland if he were still a trustee on the board.

MR. LANGLAND replied that he absolutely would support [HJR 26]. He explained that when he was on the board there was a lot of index fund management instead of individual managers for the stock portfolio. The markets were good then and the fund accumulated hundreds of millions of dollars in appreciated stock values. Mr. Langland told the members that the [board] had the opportunity to directly influence the size of the dividend over time by taking the profits and turning them into cash which would have created larger payouts of dividends. Tremendous political pressure could have resulted in influenced decisions, he commented. Mr. Langland told the members that [the fund] took profits for the right reason and it had nothing to do with dividends. As the appointments of the trustees are politicized, it is a big concern that they [may] feel pressure [to increase] earnings when there is the opportunity to change how much cash flows into the state coffers for dividends or operations [of state government]. At the time he was a trustee, Mr. Langland said he did not like it and believed it would be a major problem in future. He reiterated that he does not believe the legislature is being over reactive because this method is a very sound, long-range plan. The prudence of this concept is defensible and understandable to both institutional investors throughout the country and recipients of cash that flows out of different types of endowments, he said.

Number 1846

CO-CHAIR HAWKER referred to Mr. Langland's earlier comments on the importance of maintaining a mechanism to inflation-proof the fund. He asked if he would clarify his conclusion that the proposed method would institutionalize inflation-proofing of the fund. Would it in fact, result in the preservation of capital, or does the ultimate mechanism result in an erosion of capital, he asked.

MR. LANGLAND replied that there is no absolute answer to that question. It all depends on the time [period in which] the market is looked at, and what the payout formula percentage is. He recalled a study that was done on inflation-proofing while he was on the board. The trustees looked at every method, and there was no conclusion about what [would be the] absolute right way to protect the principal of the fund from inflation. Because there is no absolute answer, he suggested looking at how most people address this issue. The endowment method is

certainly a proven way that addresses the issues, although it is not perfect and does not totally inflation-proof the fund at any given time because it depends on the payout percentage that is used. If taking a conservative [approach], the payout should be less than 5 [percent]. If there is a desire to take an aggressive approach, then the payout would be more than 5 [percent], he said. The current system is totally subjective because no one has any idea what real inflation is and inflation-proofing is totally subject to the discretion of legislature, which creates more risk to the principal in the long run. However, the endowment theory, provided the legislature does not get carried away with the payout percentage, [would provide stability]. Mr. Langland stated that a 5 percent [payout] is about right or a little above the average [of other endowment payouts].

Number 2159

CO-CHAIR HAWKER noted that Mr. Langland's perspective on the 5 percent payout factor as the key to the success of this model is an issue he would like to discuss further. It is important that capital is preserved and not eroded, he said. Co-Chair Hawker asked for Mr. Langland's opinion on the 5 percent payout factor and the [constitutional] amendment. For the record he stated that [HJR 26] has language that states the payout would not exceed 5 percent, rather than a definitive 5 percent. Co-Chair Hawker emphasized that he believes it is important to ensure the long-term value of the fund.

Number 2310

MR. LANGLAND replied that statistical information is readily available on the long-term average of inflation. Many of the studies that he has seen say inflation has been around 3.1 percent since about 1926, and real returns are generally in the 3 to 4 percent range. If earnings are in the 7 to 8 percent range on an average basis, the fund would be in good shape, he said. Mr. Langland explained that on a long-term basis stocks generally produce about a 9 percent return, and bonds [produce] about a 3.5 to 4.5 percent [return]. He commented that a 5 percent payout over the long term is probably a very good number, but he emphasized that he would not be in favor of any number in excess of 5 percent. On a short-term basis, 5 percent will probably be excessive, but he stressed the importance of structuring this [endowment] as a long-term concept. Mr. Langland commented that no one can predict with any degree of certainty, beyond a couple of years, [what earnings will be].

For example, stocks did not produce dividends in the 1990s; however, currently there is pressure for stocks to produce dividends. On a historical basis stocks have returned 4 to 5 percent over the long term in dividends, he said. There is a major shift right now in how income comes in stocks versus the importance of appreciation in value in the 1990s.

MR. LANGLAND pointed out that there are many issues that are important in the management of the fund. It is extremely important that a trustee can focus on the long term when making [investment] decisions [because the impact of those choices] will allow for the proper allocation of assets to protect the fund. Mr. Langland summarized his comments by saying that stability is very important when managing funds like this. He stated that the process currently in place creates instability, which increases risk, both in asset allocation and ultimately in inflation.

Number 2698

CO-CHAIR HAWKER commented that Mr. Langland touched on capital erosion; however, the fund has had years when there have been earnings in excess of the 5 percent level. He asked Mr. Langland if he is comfortable that this mechanism would keep the earnings "off the table" in good years.

MR. LANGLAND responded that he is comfortable with this legislation because, as an endowment, it provides that there would only be a 5 percent payout of the current market value of the fund. Asset allocations are moved around depending on a lot of different factors, he said, and that is the key to producing revenues that are less volatile in the long term. The aforementioned is one of the most important parts to consider in how this piece of legislation [could benefit the] management of the fund. Mr. Langland stated that he could not over-emphasize how important that is because the way volatility is reduced in a fund is through the proper allocation of those assets. That is the most critical and positive element for the management of the fund and preservation of capital. He explained that allocation of assets refers to the different kinds of stocks in the portfolio, [how much is invested] in bonds, how much [is invested] in international funds, and how much in real estate, et cetera.

Number 2926

REPRESENTATIVE WEYHRAUCH asked him if his reference to preservation of capital actually meant to protect the fund from inflation and ensure that the real value of the permanent fund is preserved.

MR. LANGLAND replied that is the correct interpretation.

Number 3011

REPRESENTATIVE WEYHRAUCH asked if Mr. Langland, as a banker and former trustee of the fund, believes this amendment [HJR 26] would provide certainty of dividend calculations.

MR. LANGLAND prefaced his comments by saying that he has a prejudice [concerning dividends]. He explained that he does not look at the fund and the way it is managed with any [thought] to dividends. He acknowledged that politically that does not go over well; however, he said he does not believe that [dividends] should be the focus. The focus should be on a predictable revenue stream that the legislature can use for whatever purpose is deemed necessary. He opined that [dividends] will not be an issue for very long because he believes it will be necessary to use the money for state government. He emphasized that he would not look at this resolution [based] on how it may or may not affect dividends and pointed out that this resolution would give a more predictable annual source of cash and that could be interpreted to help the dividend.

REPRESENTATIVE WEYHRAUCH highlighted that the resolution talks about protecting the fund from inflation and ensuring the real value of the permanent fund. He asked how Mr. Langland defines real value.

Number 3211

MR. LANGLAND commented that it is a loose term. He said he relates it to inflation in the sense of real value and the ability to properly allocate the assets of the fund to protect and reduce the volatility of the fund over the long term. He stated that he does not believe there is any way anyone can say that there is a formula or process that will absolutely protect the real value of the fund or real principal of the fund. Mr. Langland said that he believes this piece of legislation would clear up a lot of these definitions and eliminate a lot of the misconceptions and misinterpretations of terms. He urged the members to focus on what this legislation does or does not do for the preservation [of the fund].

Number 3404

REPRESENTATIVE WEYHRAUCH commented that in public forums questions such as these come up. He said he appreciates Mr. Langland's insight, as it will assist him in intelligently answering questions from the public. Representative Weyhrauch surmised that Mr. Langland views this resolution as a provision to improve the administration of the fund and thus improves the flow of permanent fund earnings to the state general fund. He asked if that is an accurate summary [of his views].

MR. LANGLAND replied that he is exactly right.

REPRESENTATIVE WEYHRAUCH went on to say that this legislation would help the legislature to provide appropriations for permanent fund dividends, if the legislature makes that policy choice, and to help close fiscal gap.

MR. LANGLAND responded that is correct.

Number 3516

CO-CHAIR WHITAKER noted that as a banker Mr. Langland has a huge stake in the economy. He asked what will happen in the larger economic picture if the legislature does not take action such as that prescribed by HJR 26.

MR. LANGLAND explained that he has been active in trying to persuade the legislature and the administration to face up to the fiscal crisis and deal with it earlier rather than later. He said the argument that he puts forth is there would be less impact on the economy if action is taken sooner to ease into a transition from no responsibility on the part of citizens to one in which citizens gradually become responsible for funding state government. He said he is unsure whether that action would include using part of the earnings and lowering the dividends [to fund] state government or some sort of tax system in which individuals would participate.

MR. LANGLAND expressed concern that the legislature might wait until [the state] runs out of money in the Constitutional Budget Reserve Fund (CBR) and then take dividends totally off the table and/or impose very large taxes. He said in either of those [scenarios] there will be a negative impact on the economy. There is no way that the state can get through this knot hole without having a negative impact on the state's economy.

However, how serious that impact will be depends on the legislature's approach to closing the [fiscal] gap, which will be closed because constitutionally the legislature is required to balance the budget. One argument he opposes is to take inflation-proofing dollars and use those [funds to balance the budget]. In this case the dividend would still be paid out. The danger he sees [with the legislature failing to] close the gap is that it will affect people coming into the state or people already here who are trying to expand their businesses. For example, if a businessperson coming into Alaska knows that there is a billion dollar [fiscal] gap, it would be clear that there will be taxes and it will have an impact in some way. Mr. Langland cautioned that this is a dangerous situation that is easy to keep putting off because the legislature has the cash to deal with the deficit, but it is a very dangerous process economically. Phasing in [a method of closing the budget gap] would provide a smoother transition with less impact on the economy. He urged the members to let citizens make adjustment personally. Mr. Langland summarized his comments by saying he understands the political realities that the members must face, but leadership [should not] take polls, and going to the vote of the people is not a very practical way to close the [fiscal] gap.

Number 4046

CO-CHAIR WHITAKER asked if the budget is not balanced, where will that path lead us. He surmised that [if the budget is not balanced] economic growth will be stifled and in combination with the shock or reality that must be faced when the CBR is gone [will lead the state to an economic crisis].

MR. LANGLAND agreed that is the path [the state] is on. He said he is not very hopeful that the administration and the legislature will provide a transition [in addressing this problem]. Politically it will be necessary to do a combination of major reductions in the permanent fund [dividends] and have taxes to fill the gap. Mr. Langland commented that a combination of these two steps would be less of an impact on each citizen, although there will be some impact to the economy. He emphasized that he does not see these steps as having a devastating impact at all. In some cases, he said he believes it will be positive for the state to have more participation in government [from its citizens]. Mr. Langland commented that he does not see this as a big negative. Although there will be issues that will have to be worked thorough, Alaska has a strong enough economy to weather this [storm] without any major

disruptions. However, he cautioned that it may be necessary to offer some help on the social side to bridge the gap. Still, Mr. Langland said he believes this is very manageable and he is optimistic.

Number 4342

CO-CHAIR HAWKER said that this constitutional amendment [HJR 26] envisions merging the earnings reserve and the principal of the Alaska permanent fund. Most politicians and economists have conditioned people to be very protective of the corpus of the fund. He asked Mr. Langland if he believes it is appropriate to merge these two aspects of the fund. In doing this will the state end up with a result that is consistent with preserving the long-term value of the fund, he asked.

MR. LANGLAND replied the he thinks it is [appropriate]. He explained that the way the fund works now there is a need for a depository for those times when there is more cash available than what the formula needs. The reserve account has been used to pull off cash in those years when the formula does not work and it is short of cash. Once the legislature goes to the payout formula, there will be no need for the reserve account; it goes away. He said he thinks, from a prudent standpoint, that merging the reserve account into the principal of the fund, rather than taking it off the table and using it for other governmental purposes, would be viewed in a more positive light politically; philosophically it is the prudent thing to do.

Number 4554

CO-CHAIR WHITAKER asked if this would facilitate asset management and the implementation of those points addressed earlier which would mitigate the volatility of the fund.

MR. LANGLAND replied that it would.

TAPE 03-14, SIDE B

Number 4526

CO-CHAIR HAWKER moved to adopt the proposed committee substitute (CS) for HJR 26, Version 23-LS1006\H, Cook, 4/23/03, as the working document. There being no objection, it was so ordered.

CO-CHAIR HAWKER noted a [typographical] error on page 2: the reference to Version A should actually be to Version H.

Number 4437

RON LORENSEN, Attorney at Law, Simpson, Tillinghast, Sorensen, and Longenbaugh, speaking as outside counsel to the Alaska Permanent Fund Corporation, testified in support of HJR 26 and answered questions from the members.

REPRESENTATIVE WEYHRAUCH asked about the language on page 2, line 2, Section 2(b), which says, "Money should not be appropriated from the permanent fund." He asked why the words "should not" were used, instead of "will not."

MR. LORENSEN explained that the change in the draft was suggested by Tamara Cook, Director, Legal and Research Services. He recalled that Ms. Cook was concerned that as drafted and presented in the original version of HJR 26, the first and second sentences of subsection (b) setup separate and independent standards for appropriations from the permanent fund. She was concerned that might create some confusion and legal issues in the future. Therefore, Ms. Cook drafted the first sentence basically as a predicate statement to the second [sentence], he said. Mr. Lorensen noted that while he has not talked to Ms. Cook directly, that is his understanding of the change and it makes sense to him when he read it in that context.

Number 4247

REPRESENTATIVE WEYHRAUCH agreed that it does makes sense, especially since the second sentence begins with the word "therefore." Representative Weyhrauch said that he had never seen a sentence in the constitution start with the word "therefore" which [makes] it almost a statement of policy or intent.

MR. LORENSEN reiterated that Ms. Cook is, in this case, using the first sentence as a predicate or policy statement, as to the goal of limitations of payouts and the word "therefore" is used as the transition into the limitation language.

Number 4136

REPRESENTATIVE WEYHRAUCH commented that changing the word "should" to the word "will" would remove the need for the use of the word "therefore".

MR. LORENSEN asked the members to compare the original version of HJR 26. He pointed out that it said "money may not be appropriated" in the first sentence so the word "therefore" was not in the second sentence.

REPRESENTATIVE WEYHRAUCH asked about the language on page 2, lines 6-7, where it says "the first five of the six fiscal years" and inquired as to the significance of the 5-year period. He asked if Mr. Lorensen would clarify if this meant any five of the preceding six years, or the last five of six years. What is the purpose of selecting five years, he asked.

MR. LORENSEN said that what this calls for is a one-year look back provision. What this means is when looking back to determine the 5-year period the current fiscal year is omitted. In other words if the legislature is making an appropriation for this year, FY 04, it would mean that FY 03 is not looked at, but that the five years that ended with FY 02 would be included. He explained that this is a simpler way of saying that than the attorney's language. For example, if appropriating funds for FY 04, the legislature would look at the six years before that year, but only use the first five of those years. This would ensure certainty at the time of making the appropriation because the last year used as part of the calculation would be FY 02.

Number 4000

REPRESENTATIVE WEYHRAUCH turned to when the trustees are determining if there should be a payout on June 30th and inquired as to the timeframe being used. Is it the close of business at 5:00 p.m. [Eastern Standard Time] or midnight Alaska Time?

MR. LORENSEN replied that he believes it is the end of the business day for financial purposes which is 5:00 p.m., New York time.

ROBERT BARTHOLOMEW, Chief Operating Officer, Alaska Permanent Fund Corporation, testified in support of HJR 26 and answered questions from the members. He told the members historically when the permanent fund and the custodian bank, the Bank of New York, determine the fund value of a day they use the last closing of the markets around the world. When making calculations on June 30th, the fund will find the last closing value from all the stock markets all around the world were. For example, if in the middle of evening on June 30th the stock market in Tokyo is opening, the fund does not use an opening or

intra-day value in determining the value of the fund. It would be the last closing day that would be used for all of those different markets, he reiterated.

Number 3748

REPRESENTATIVE WEYHRAUCH asked if the funds would be appropriated to the general fund under this scheme.

MR. BARTHOLOMEW responded that the funds are subject to legislative appropriation so there is no direction in the constitution as to where those appropriations would go.

MR. BARTHOLOMEW, in response to Representative Weyhrauch, clarified that the current constitutional provision says income from the permanent fund shall be deposited in the general fund unless otherwise provided by law. However, since 1982 the statutes have provided that all income from the permanent fund shall be deposited in the permanent fund. So the funds have been retained in the permanent fund since 1982 and then appropriations have come from the earnings reserve [account] of the permanent fund and have gone to the dividend fund, which is a subfund of the general fund. In further response to Representative Weyhrauch, Mr. Bartholomew confirmed that the earnings reserve account and the earnings reserve fund are the same thing.

Number 3624

CO-CHAIR HAWKER noted that if this constitutional amendment should pass the legislature, it would be necessary to address the existing statute which would be incompatible with the mechanism within the constitution. It would require the legislature to look for broader enabling statutes to define or delineate what should be done with those distributions should they be made, he said.

MR. BARTHOLOMEW said the board's policy resolution, which is in the members' packets, recommends that the existing statutes be updated to work better with a payout of market value method. The legislature could leave the existing statutes, but it does not work very well. The existing statutes provide for a calculation of what is available for appropriation using a realized income approach, and [these statutes] do not direct where the money goes, he explained. It is the understanding of the board that there will be statutory language that implements

constitutional provisions as things work now. Mr. Bartholomew told the members that the board's recommendation and policy statement is that the legislature look at the statutes that determine what is available and write those [statutes] to work better with the payout of market value [method].

Number 3559

REPRESENTATIVE WEYHRAUCH said that the language in [sub]section (b) of this amendment indicates that the government of the State of Alaska has to ensure that the real value of the permanent fund is preserved over time. He asked if that is a correct. In response to Mr. Bartholomew's affirmative response, Representative Weyhrauch asked if this requires the legislature to ensure the value of the permanent fund reserved over time. The legislature could not appropriate out funds that would drain the permanent fund because that would be in violation of the constitution. He asked if Mr. Bartholomew agrees with his interpretation of the language.

MR. BARTHOLOMEW agreed that is his understanding of the intent language. The language is to ensure the focus is on the long-term period, and then over that long-term period, the policy statement is to preserve the real value of the permanent fund. The board of trustees or legislative members use whatever tools available to them to make a statement or an analysis to look to the preservation of the value of the fund, he said.

Number 3341

REPRESENTATIVE WEYHRAUCH commented that when the permanent fund was established and the statutory scheme was setup in 1982, the intent was to set aside money for government and keep politicians honest by investing the public through permanent fund dividends. This ensured that the public [had a] invested [interest] in the account and the legislature knew the people would be invested. There was also the intent that the funds would eventually be there for a rainy day when Alaska ran out of oil revenues, and therefore the legislature could fund government when Alaska did not have a huge revenue stream. He asked Mr. Bartholomew if that is his basic understanding of the permanent fund's origin.

Number 3257

MR. BARTHOLOMEW responded that he would go back a bit further and say that there were three major steps that led to the

current situation with the permanent fund. First, there was a constitutional amendment in 1976 that asked the citizens of the State of Alaska to set aside mineral wealth, which historically has been oil wealth. So step one had no conception of a dividend or what would be done with the earnings. [The 1976 constitutional amendment] said that the state would set aside earnings that are not needed or oil wealth that was not needed. The earnings from that oil wealth would be deposited into the general fund. He pointed out that in 1976 the earnings were fairly small, but those earnings were deposited into the general fund. In 1980, after a couple of years of debate and discussion, the dividend program came into existence. In 1982, [the constitution] was amended and that is the statutory scheme that is used today. Mr. Bartholomew turned to the legislative history of the permanent fund. Governor Hammond was the governor at the time. The statutes in place since 1982 gave a better allocated 50 percent of what is available for appropriation annually to the dividend program. Mr. Bartholomew noted that inflation-proofing has been in the statutes since 1982, and [there is no mention] about what to do with the funds available after the dividends have been paid and inflation-proofing has occurred.

CO-CHAIR WHITAKER noted for the record that Representative Rokeberg had joined the meeting.

Number 3039

REPRESENTATIVE WEYHRAUCH asked Mr. Bartholomew if he believes this [HJR 26] is a dramatic departure from the original intent of the people, legislature, and the administration that setup the permanent fund.

MR. BARTHOLOMEW responded that the board of trustees does not feel this is a major change; the permanent fund has changed and matured. How the money is invested has evolved over the last 25 years, he commented. For example, the funds have evolved to be 100 percent invested in fixed income or bonds that pay interest income to the holder of the bonds whereas 20 years ago the general direction was that these bonds were to be held to maturity so there was not a lot of volatility. The legislature crafted a statutory scheme that works well in the world of bonds and fixed income. As the permanent fund has matured and more learned about the investment industry and capital markets, the legislature has granted the [Alaska Permanent Fund Corporation] through statutes the permission to invest in U.S. stocks, international stocks, international fixed income or bonds, and

real estate. How income is derived from those investments has evolved, it is not just an interest payment, he explained. As Mr. Langland testified earlier, the permanent fund now has capital appreciation in real estate and stocks which were not an issue with bonds, he said. The [board] characterizes this more as [addressing] the fund's asset investment strategy which has matured; [however,] the rules that guide the permanent fund regarding how to make use of the value have not evolved. The board has been working for the last eight or nine years to educate everyone so that a decision will be made to bring the rules up to speed and in a manner matching the fund's investment strategy. Originally, the intent was to set aside oil wealth for some future period, and the decision as to whether the state is in that future period or not is separate from how to manage the fund. Mr. Bartholomew told the members that this is purely the board's recommendation that the rules that help manage the fund need to be improved. He said he does not see that as a dramatic change in what was trying to be done in 1982.

Number 2731

REPRESENTATIVE GRUENBERG said that he always thought of the concept of the fund as a permanent fund, so that the corpus would be there permanently, but income from the fund could be used. The amendment to the constitution provides a theoretical possibility that the corpus could itself be consumed, he said. He asked if that is not a fundamental change in the purpose of the fund.

MR. BARTHOLOMEW responded that he believes it is a different perspective. He asked the members to look at the policy statement [the board submitted]. He said the board has had a lot of discussion on the issue of whether to remove the distinction between principal and income and move to where the permanent fund is one account of money. He referred to Representative Weyhrauch's earlier question as to whether the intent is still to preserve the corpus or principal [of the fund] over time. Mr. Bartholomew stated that he believes the board would say it absolutely is the intent and objective to continue to maintain the principal. He read the following sentence [from the Alaska Permanent Fund Corporation Board of Trustees Resolution 03-05, page 3, lines 1-3], which addresses the proposal to eliminate the distinction between principal and income and the overall proposal of payout of market value, which read:

The Board believes that this approach effectively balances the goal of providing for an annual distribution from the Fund that is predictable and limited with the long-term goal of protecting the real value of contributions to the Fund. [original punctuation provided]

MR. BARTHOLOMEW pointed out that the board of trustees is trying to determine the best way to protect the fund and deal with annual distributions. Some believe that if there were a \$22-\$23 billion fund it could not make a distribution for a year or two because the capital markets had taken the value below principal. There are some dynamics involved. One [dynamic] would be the effect on the economy, which is not the primary concern of the board; however, it is something that is reviewed. There is also a risk of what the public would feel if there is this fund that is providing no distribution. It is possible that there could be a move that would say that if there is a fund that is not doing anything for us let's just divvy it up. Mr. Bartholomew clarified that the board is not predicting that would happen, but that was part of the discussion and it is a risk. He told the members this is the standard method followed by major endowments and trusts, which have the same intent to preserve the initial contributions so they will be there in perpetuity while also providing a distribution. The board wants to balance those goals and protect the fund with this proposal. It is important to note, he said, that if capital markets change from what has occurred over the last 75 years and the real return or the return in excess of inflation were to be less than 5 percent over the long term, the legislature would have to look at that and decide to appropriate less than the maximum that is available.

Number 2308

REPRESENTATIVE WILSON said that currently the legislature never knows until the end of the session how much money can be distributed. However, with the change in language [on page 2, lines 6-7] means that the legislature will know in January how much money is available for distribution because the current fiscal year is not included in that calculation. This change will make it much easier for the legislature to deal with the budget. Representative Wilson asked Mr. Bartholomew if her assumptions are correct.

MR. LORENSEN replied that is correct.

Number 2157

REPRESENTATIVE OGG asked about the 5 year running average. He pointed out that the date is being set on June 30th, for each of those years. How does that change from what is presently being done, he asked. He also asked if there is more flexibility in determining a particular day that would be used for what the market value of the fund is.

MR. BARTHOLOMEW responded that the way it is now written, the permanent fund uses the end of the fiscal year, which is June 30th. This does not change anything unless the State of Alaska decided to change its fiscal year end. In that case, the amendment would lock in that date, which is different than [the way it is done now]. Mr. Bartholomew explained that from permanent fund's perspective, the constitution will now tell them to use June 30th, but the State of Alaska could still decide to change its year-end date, which he said he believes is a remote possibility. It does take away a little flexibility, but it is not really something that would have been used, he said.

Number 2008

REPRESENTATIVE OGG posed a situation in which the permanent fund had the flexibility to look at the market last year and see that it was going down and determine a good day to end the fiscal year as long as it was before June 30. He asked if that kind of flexibility existed last year.

MR. BARTHOLOMEW responded that there are bylaws and other corporate documents that currently say the permanent fund fiscal year [ends] on June 30. He told the members that he never heard any discussion about using that tool to change what is available. It is not something that could have been done on the short term, he said. There are rules that require public notice to change the bylaws. The notice must be at least one meeting ahead of time. It would take many months to effect a change, he said. Theoretically, it is possible, but the fund has been set on using that consistent fiscal year end. Furthermore, there are contracts based on those dates. Therefore, many things set in motion that would make it very difficult to change the date from June 30 without a very long process.

REPRESENTATIVE OGG commented that there really was not much flexibility.

MR. BARTHOLOMEW agreed that there is very limited flexibility. It would have taken two to three months to change the date and the timeframes. Theoretically, there is some [flexibility], but for practical purposes there is not, he said.

Number 1745

REPRESENTATIVE SAMUELS asked if any other endowments [distribute funds the way the permanent fund] does now.

MR. BARTHOLOMEW answered that 70-80 percent of the endowments of public funds that are out there use a concept based on total market value of fund rather than realized income. The executive director testified earlier this week that in his 25 years in the industry, he is not aware of any other funds that use the payout formula that is currently used by the permanent fund. The formula was written specifically for the fund 20 years ago. He told members the amendment is an accepted payout method; however, the one currently used is unique to the permanent fund.

REPRESENTATIVE SAMUELS recalled that Mr. Langland testified that this method is a common sense [approach] and that the crux of the resolution was whether the legislature picked 4 percent or 5 percent. How did the trustees determine 5 percent [as the payout], he asked.

MR. BARTHOLOMEW replied that the trustees looked at it in many ways, but the primary driver of the 5 percent is that over time the board has [developed] a policy statement [which strives for] the real rate of return that they are trying to achieve [through] investment [allocations]. The [rate of return] started out at 3 percent and has worked its way up to 4 and 5 percent. He pointed out that for many years the permanent fund used asset allocations specifying the fund would have 55 percent in equities, 37 percent into bonds, and 10 percent in real estate. The fund works with a consultant who looks at the capital markets, looks at the five-year projections, and runs a calculation. That calculation says, given how the fund has allocated the assets the expected earnings over a five-year period will be a 5 percent rate of return. Mr. Bartholomew said some people questioned why there is a policy statement that says the earnings should be at least 4 percent, while an asset allocation policy that [projects] 5 percent was adopted. The response has been that it gives the fund some leeway. The 5 percent payout statement is an effort to make the policy statement consistent with the asset allocation policy the fund has adopted. There has been a little bit of uncertainty, he

said, because the statutes are general in saying the permanent fund should maximize its return while protecting the principal. The professional markets have been used to come up with that 5 percent [figure]. The 5 POMV statement [makes it clear] to the board that there is more than just its understanding of how [much] the permanent fund should be earning or how much risk the permanent fund should take. It would be a state policy, that is boarder than the board of trustees, he remarked.

Number 1344

REPRESENTATIVE SAMUELS commented that the trustees have no opinion on the legislature's appropriation of available funds under the old system, and would have no opinion under the new system. He asked if that is a correct assumption. Representative Samuels noted that yesterday there was testimony that this amendment to the constitution is really a raid on the fund. In truth, the legislature could choose not to fund the dividend now or under the new system, or fund it under either system. That issue does not change, he surmised.

MR. BARTHOLOMEW responded that this amendment does not change the legislature's ability to spend the earnings in any way they deem appropriate. This is not a change to the way funds are currently appropriated, he said. However, inflation-proofing is only done through appropriation by the legislature, so there is the option to appropriate money to inflation-proof or to protect the real value of the fund. Under this proposal the fund would prioritize inflation-proofing as the number one priority because there is an effort to retain inflation-proofing in the fund, cover the effects of inflation, and then provide a distribution, he explained. So the amendment does change the priority of how inflation-proofing is handled and that would no longer be an option [for the legislature] because the [fund] would be automatically [inflation proofed].

MR. BARTHOLOMEW told the members that the only problem the trustees have had with the distribution or payout of the permanent fund is regarding [how] to improve its ability to manage investments in long-term assets [which would be possible] if there were some constraints or understanding of what the draw would be. Over the last five years the legislature has had the ability to take up to \$6.5 billion out of the permanent fund at any time, he pointed out. He recalled that there was discussion many years ago about taking a large sum of the earnings reserve, \$4 billion, and setting up another fund for education or government. It is a little bit unnerving for the board of

trustees to say that they have adopted this long-term asset allocation, and invested in assets that should only be invested in if they will be held for five, seven, or eight years. The [trustees] questioned whether they should be invested in those ways. This proposal says that the fund needs a more predictable and limited distribution, so the board can better manage the fund. He explained that with this amendment the board knows what can be put into long-term assets that cannot be drawn out except up to five percent per year. Mr. Bartholomew summarized that it is important that there be a more stable and predictable payout because it matches how the [trustees] have invested the fund. The board of trustees' responsibility ends at this point and they do not take a position on how the payouts are distributed.

Number 0950

REPRESENTATIVE WEYHRAUCH asked if [5 percent] is the accepted industry standard of payout.

Number 0934

MR. BARTHOLOMEW responded that the method of payout based on total market value is the most widely adopted method in industries or public funds that are established in the form of endowments to protect the corpus [of a fund]. The percentage [of payout] varies, he said.

REPRESENTATIVE ROKEBERG asked if this method is widely adopted, but not the generally accepted standard.

MR. BARTHOLOMEW responded that he did not mean to imply that this is not generally accepted, it is. It is the most used method and the industry [standard]. He clarified his statement by saying that the POMV approach is generally accepted and an industry standard.

REPRESENTATIVE ROKEBERG asked if the 5 percent payout is [generally accepted and an industry standard].

MR. BARTHOLOMEW offered to provide the members with a chart that shows how many funds are using a 5 percent [payout], how many are using more than 5 percent, and how many are using less than 5 percent. There are fewer funds using 5 percent than are using less than 5 percent.

Number 0735

REPRESENTATIVE ROKEBERG commented that last week he requested that the corporation prepare a memorandum for the committee on the current cash situation as is related to the dividend and allocation formula and also with (indisc.) regarding the potential attorney general opinion on the unrealized portion. He asked if the corporation was working on that request.

MR. BARTHOLOMEW replied that the request is being worked on in two ways. The corporation will make available to the committee the actual request that went to the attorney general's office that explains what the different perspectives are that are being reviewed. The [corporation] will also provide the committee with the updated balance of the permanent fund that is available for [appropriation] under the existing rules.

Number 0638

REPRESENTATIVE ROKEBERG told the committee he believes it is important that the members have time to debate whether adoption of this amendment will influence the appropriations investment strategy, and whether [the strategy] will be more conservative or more aggressive.

REPRESENTATIVE ROKEBERG asked Mr. Lorensen to explain the language on page 2, Section 2, subsection (b). He asked if this language was used to explain to the public the intention of the trustees in this amendment and reassure the public that the [trustees] were not going to take their money. He asked if inserting this language, particularly in Version (H), with respect to real value is a prudent position for the state to take. Representative Rokeberg added that in his opinion this [amendment] appears to be constitutionally adopting the inflation-proofing concept. He asked if that is a fair statement.

MR. LORENSEN said, in response to the first question, that the board's intent with the first sentence was to set out a policy goal that the public would be aware of at the time the constitutional amendment was being considered. He reminded members that the language has been modified somewhat due to Ms. Cook's recommendation that the language should read, "the money should not be appropriated". Mr. Lorensen told the members he does not believe the language is inappropriate for a constitutional provision.

REPRESENTATIVE ROKEBERG asked if the trustees do not wish the legislature to make a maximum draw from the fund if circumstances are such that it would diminish its real value based on inflation-proofing and growth calculations. He pointed out that there is an implicit statement [in HJR 26] that says do not [appropriate] up to 5 percent if the fund cannot afford it under these conditions. Representative Rokeberg stated that this is a concern and questioned if the trustees want to express to the public that these are their instructions to the legislature.

Number 0327

MR. LORENSEN replied that he does not know if he can characterize [what the trustees intention may or may not have been], beyond the fact that this language was inserted at the request of the board. He told the members that he does not want to guess as to what the board was trying to do. If this amendment were adopted as it is now, he said he would interpret this as a statement of a policy goal with respect to the distribution the fund.

Number 0239

CO-CHAIR WHITAKER commented that his interpretation is that it is a long-term consideration, and a long-term invasion that the legislature needs to be very cautious about.

REPRESENTATIVE ROKEBERG commented that he thinks it is important that the intent of this [language] be crystal clear so everyone understands what this language means. He said he believes this is a lawsuit waiting to happen. If the legislature took a certain action that was (indisc.) to what the intention was there could be a constitutional challenge that the legislature did not take enough or took too much. Representative Rokeberg reiterated his concern about this language.

Number 0133

REPRESENTATIVE GRUENBERG said he is concerned as to whether there is a considerable change legally from the way it was originally [written], "may not be appropriated" to "should not be appropriated." He pointed out that one is legally actionable and the other may not be. That is a big difference, he stated.

REPRESENTATIVE ROKEBERG said it is the reverse.

CO-CHAIR WHITAKER clarified that [Representative Gruenberg] meant "may" would be legally actionable, and "should" would not be legally actionable.

Number 0043

REPRESENTATIVE GRUENBERG commented that aspirational language is not placed in the constitution; that language is placed in the preamble of the constitution. Actionable language is placed in the constitution, he said. Mr. Gruenberg said he believes that it is the intent to make this language actionable.

MR. LORENSEN responded that he cannot state what the intent was.

[Not on tape, but reconstructed from the committee secretary's log notes follows.]

REPRESENTATIVE ROKEBERG commented that the word "may" is more permissive than "should".

REPRESENTATIVE GRUENBERG told the members he wants to see the language changed so that it is actionable.

REPRESENTATIVE ROKEBERG stated that he would like to see the language and intent [written] as clearly and consistently as possible. He said he is concerned about inserting language in the constitution, and cautioned that the legislature needs to understand the policy that is chosen.

REPRESENTATIVE GRUENBERG asked for Ms. Cook to work on the language of the amendment.

ADJOURNMENT

There being no further business before the committee, the House Special Committee on Ways and Means meeting was adjourned at 8:50 a.m.