

MINUTES
SENATE FINANCE COMMITTEE
March 29, 2004
9:04 AM

TAPES

SFC-04 # 60, Side A
SFC 04 # 60, Side B
SFC 04 # 61, Side A

CALL TO ORDER

Co-Chair Gary Wilken convened the meeting at approximately 9:04 AM.

PRESENT

Senator Gary Wilken, Co-Chair
Senator Lyda Green, Co-Chair
Senator Con Bunde, Vice Chair
Senator Fred Dyson
Senator Ben Stevens
Senator Donny Olson
Senator Lyman Hoffman

Also Attending: SENATOR BERT STEDMAN; BILL ROLFZEN, State Revenue Sharing, Municipal Assistance, National Forest Receipts, Fish Tax, PILT, Division of Community Advocacy, Department of Community and Economic Development; EDDIE JEANS, Manager, School Finance and Facilities Section, Education Support Services, Department of Education and Early Development; ROB CARPENTER, Fiscal Analyst, Division of Legislative Finance; PHELAN STRAUBE, staff to Senator B. Stevens;

Attending via Teleconference: From an offnet location: JOHN BOLLING, City Administrator, City of Craig; RON ERICKSON, School Superintendent, Craig School Board; DOC WATERMAN, School Board President, Craig School District; DOUG RHODES, Principal, Craig High School; KEN DUCKETT, Executive Director, United Southeast Alaska Gillnetters

SUMMARY INFORMATION

SB 328-NATIONAL FOREST INCOME PROGRAM/DCED REGS

The Committee heard from the sponsor, the Department of Community

and Economic Development, and representatives of the City of Craig and the Craig School District. An amendment was adopted and the bill was reported from Committee.

SB 322-SALMON ENHANCEMENT TAX

The Committee heard from the sponsor and an industry representative. The bill was reported from Committee.

SB 326-PERMANENT FUND INVESTMENTS

The Committee heard from the Permanent Fund Corporation and the bill was reported from Committee.

SB 374-PERMANENT FUND INCOME DISTRIBUTION

The Committee heard from the sponsor and the Division of Legislative Finance. The bill was held in Committee.

SJR 3-CONST AM: APPROPRIATION/SPENDING LIMIT

This bill was scheduled but not heard.

#SB328

SPONSOR SUBSTITUTE FOR SENATE BILL NO. 328

"An Act relating to the national forest income program in the Department of Community and Economic Development and to the authority of the department to adopt regulations; making conforming amendments; and providing for an effective date."

This was the second hearing for this bill in the Senate Finance Committee.

Co-Chair Wilken stated this bill, "provides the Department of Community and Economic Development with the necessary authority to adopt regulations necessary to implement a federal program commonly known as national forest receipts."

Co-Chair Wilkin referenced an amendment made to the bill when last heard by the Senate Finance Committee. Amendment #1 adjusted the average daily membership requirement to apply only to children physically residing in the school districts receiving a share of the national forest income program.

SENATOR BERT STEDMAN testified that he has been in contact with representatives of the City of Craig and the Craig School Board and

received their financial calculations. The representatives expressed concerns about the funding cuts, especially concerning the Craig City School District and the limited amount of time it would have to adjust to the reduced funding.

Co-Chair Wilken stated that an effective date, if agreed upon, should be specified for the provisions of Amendment #1.

Senator Stedman informed that his earlier intention was to suggest an effective date of July 1, 2005, but recent input from the Department of Community and Economic Development indicates that an immediate effective date would not change funding.

BILL ROLFZEN, State Revenue Sharing, Municipal Assistance, National Forest Receipts, Fish Tax, PILT, Division of Community Advocacy, Department of Community and Economic Development, testified that Section 1(m), added to the bill in the amendment, would impact the Craig City School District's funding for the FY 05 school year were it given a July 1, 2004 effective date. Similarly, a July 1, 2005 effective date would affect the District's funding for the FY 06 school year.

Co-Chair Wilken asserted that an effective date of July 1, 2005 would be appropriate.

Mr. Rolfzen affirmed.

Senator Stedman agreed.

Amendment #2: This conceptual amendment provides that AS 41.15.180(m) has an effective date of July 1, 2005.

Co-Chair Wilken moved for adoption.

There was no objection and the amendment was ADOPTED.

Co-Chair Wilken referred a document titled "Department of Education and Early Development, Prepared on 3/24/04: Forest Receipt/Altered Statewide Correspondence ADM" [copy on file] which informs that six of 381.75 correspondence students in the Craig City School District reside within the District. He then referenced a second spreadsheet titled, "Department of Education and Early Development, Prepared 3/11/04, Correspondence History FY99-FY05 Projected" [copy on file] which shows considerable growth in the Craig City School District's PACE correspondence program.

Senator Dyson requested a repeat of Mr. Rolfzen's earlier testimony

Mr. Rolfzen presented his earlier testimony.

Senator Dyson communicated that this legislation would ensure that the City of Craig would receive forest receipts for the correspondence students who reside within the Craig City School District.

Mr. Rolfzen confirmed.

Senator Dyson clarified that under Amendment #1 the City of Craig would not receive forest receipts for correspondence students who do not reside within the District.

Mr. Rolfzen affirmed.

JOHN BOLLING, City Administrator, City of Craig, testified via teleconference from an offnet location in Craig to express appreciation for the adoption of the effective date. He requested that any correspondent student residing within the Tongass National Forest be eligible for forest receipts.

Senator Stedman interpreted Mr. Bolling's request to amend Amendment #1 to include all students living within the Tongass and Chugiak National Forests.

Senator Dyson understood that the request asked that all students residing within the national forest be eligible for the forest receipt funding even if enrolled in a correspondence school headquartered outside the boundaries of the national forest.

Senator Stedman explained that a school must be located within a national forest to receive forest receipts.

Senator Dyson clarified that Mr. Bolling's request does not encompass students receiving their education from an institution located outside the national forest.

Senator Stedman affirmed.

RON ERICKSON, School Superintendent, Craig School Board, testified via teleconference from an offnet location in Craig about recent impacts of budget reductions and the "devastation" that additional reductions would have on the district without the adoption of Amendment #2. He also reiterated Mr. Bolling's request and urged the consideration of providing forest receipts for those students residing within the Tongass National Forest.

Co-Chair Wilken asked if the correspondence students actually

reside in the Craig City School District.

Mr. Erickson answered no, that many correspondence students reside in other communities in the Tongass National Forest such as Ketchikan and would not otherwise be eligible for timber receipts because they are not enrolled in the Ketchikan School District, or any other school system.

Co-Chair Wilken requested further clarification.

EDDIE JEANS, Manager, School Finance and Facilities Section, Education Support Services, Department of Education and Early Development, explained that the City of Craig is serving 215.9 students who reside in the Ketchikan Gateway Borough. Mr. Bolling and Mr. Erickson are asking that the City of Craig receive forest receipts for those 215.9 students because they reside within the Tongass National Forest.

Co-Chair Wilken expressed his understanding of the request.

Senator Dyson understood Mr. Bolling and Mr. Erickson are requesting timber receipt funding for students enrolled in the Craig City School District and who also reside in the Tongass National Forest.

Mr. Jeans affirmed this assessment.

Senator Dyson asked the amount of forest receipts received per student.

Mr. Jeans was unsure and deferred to Mr. Rolfzen.

Senator Dyson asked how the 0.9 per student figure is calculated.

Mr. Jeans explained the fraction represents a student who was enrolled for a portion of the school year.

Mr. Rolfzen informed that in FY 04 the forest receipt amount per student is approximately \$1,000.

DOC WATERMAN, School Board President, Craig City School District, testified via teleconference from an offnet location in Craig that the purpose of the federal forest receipts program is to provide education to students residing in the Tongass National Forest. If the Craig City School District is the only district providing education to a student living in the Tongass National Forest, Craig should be eligible to receive the receipts allocated to that student.

DOUG RHODES, Principal, Craig High School, testified via teleconference from an offnet location in Craig to support earlier testimony from the City of Craig and the Craig City School District.

Senator Dyson offered a motion to report SS SB 328, 23-LS1620\H from Committee, as amended, with accompanying fiscal note and individual recommendations.

There was no objection and CS SS SB 328 (FIN) MOVED from Committee with zero fiscal note #1 from the Department of Community and Economic Development.

#SB322

SENATE BILL NO. 322

"An Act relating to the rate of the salmon enhancement tax."

This was the second hearing for this bill in the Senate Finance Committee.

Co-Chair Wilken stated this bill "authorizes the regional aquaculture associations who hold elections to change the tax rate for the salmon enhancement tax."

Senator B. Stevens reinforced that the changes proposed in this bill are optional and are intended to provide options to reduce debt burden.

KEN DUCKETT, Executive Director, United Southeast Alaska Gillnetters, testified via teleconference from an offnet location that the current fishery tax system works well and therefore this legislation is unnecessary. Fishermen in his area are not interested in a situation whereby an additional assessment could be imposed on their income. He referenced his letter to the Committee outlining this position dated March 28, 2004 [copy on file].

Senator B. Stevens offered a motion to report the bill from Committee with individual recommendations and accompanying fiscal note.

Without objection SB 322, 23-LH1421\H, MOVED from Committee with fiscal note #1 from the Department of Revenue in an indeterminate amount.

#SB326

CS FOR SENATE BILL NO. 326(STA)

"An Act relating to investments of Alaska Permanent Fund assets; and providing for an effective date."

This was the first hearing for this bill in the Senate Finance Committee.

Co-Chair Wilken stated this bill, offered by the Senate Rules Committee by Request of the Division of Legislative Audit, "modifies the investment guidelines for the Alaska Permanent Fund."

BOB STORER, Executive Director, Alaska Permanent Fund Corporation, testified that whereas most public funds merely follow the prudent investor rule to make their asset allocation decisions, the Permanent Fund is additionally guided by a statutory list, which dictates criteria for the types of investments that could be made. This legislation is requesting increased flexibility in the management of the fund for two reasons. First, in the near future the Fund would reach its statutory limitations, forcing it to sell assets based solely on these restrictions. Second, this flexibility could be utilized to develop a future management tool.

Mr. Storer gave a Power Point presentation as follows.

1
Alaska Permanent Fund
Senate Finance Committee
Senate Bill 326
Investment Flexibility

2
Summary of Fund's statute changes
1980 - SB 161, Sponsored by Sen. Tim Kelly, Sen. George Hohman, Sen. Mike Colletta, and Sen. John Sacket
SB 161 created the Alaska Permanent Fund Corporation to manage the Permanent Fund and started the existing statutory list of allowed investments. This list extended beyond the Fund's initial investment limitation of Treasury bonds to include corporate bonds, certificate of deposits and bankers acceptances. The list initially allowed the Permanent Fund to invest in shares of savings and loans associations, but this provision has since been removed.
1982 - SB 684, sponsored by Gov. Jay Hammond
SB 684 allowed the Permanent Fund to invest in common

stocks, partial ownership of real estate properties (not to exceed 40%), loans for commercial real estate and deposits of US dollars held overseas.

1989 - HB 69, Sponsored by Gov. Steve Cowper
HB 69 gave the APFC authority to invest in non-domestic (International) stocks and bonds.

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Summary of statute changes (cont.)

1992 - SB 39, sponsored by the Senate Finance Committee
SB 39 gave the APFC authority to invest in A rated corporate bonds to a maximum of 5%. Prior to this change, the Fund could only be invested in bonds rated AA or higher.

1994 - HB 373, sponsored by Legislative Budget and Audit Committee

HB 373 allowed the fund to own up to 100% in real estate properties worth less than \$150 million, and up to 67% in properties worth greater than \$150 million.

1996 - HB 525, sponsored by the House Finance Committee
HB 525 gave the APFC authority to invest in corporate bonds rated BBB or higher.

1999 - HB 156, sponsored by the Legislative Budget and Audit Committee

HB 156 allowed the Fund to leverage real estate investments and increased asset allocation limit for stocks to 55% of the total market value of the Fund. HB 156 also created the "basket clause" that allows up to 5% of the Fund to be invested in alternative investments or to be applied to existing asset allocations to expand their limits. In addition, HB 156 allowed the Permanent Fund to be the sole owner of any real estate property, regardless of value.

Mr. Storer responded to criticism that increasing the flexibility of the Fund would be too risky, by emphasizing that the Fund's prudent use of the basket clause must be considered. The Fund has only now begun to utilize the basket clause provisions established five years ago.

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Fund's historical asset allocation

[This graph demonstrates the percent of funds allocated to: U.S. Fixed Income, U.S. stocks, Non-U.S. Fixed Income, Non-U.S. stocks and Real estate, between the years 1978 and 2002.]

Mr. Storer emphasized the changes in the asset allocation of the

Permanent Fund as it was "given the ability to invest in expanded legislative authority". He emphasized the judicious nature of the Permanent Fund in expanding investments.

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Benefits of proposed changes

- Investment flexibility
- Increased returns
- Increased diversification

Mr. Storer qualified that the Fund needs increased investment flexibility to enable future administrators of the Fund to meet the needs of the dynamic investment management industry. Additionally, increasing the Fund's investment flexibility would make a five-percent real rate of return more probable. Increased investment flexibility does not necessarily translate into increased risk, but rather into greater diversification. Investing in diverse investment classes actually reduces risk. Mr. Storer added that, "risk is measured not by losing money, but by the volatility of returns from year to year."

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Potential questions

- Too much risk?
- How will the Board of Trustees use this flexibility?
- Derivatives?

Mr. Storer reiterated the traditional judiciousness of the Permanent Fund. Considering other public funds, the increased investment flexibility proposed in this legislation would be a conservative structure.

Mr. Storer continued by giving some specific examples of the Fund's possible implementation of this legislation.

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Permanent Fund asset allocation

[This bar graph demonstrates the percentage of the Fund that was, or would be invested in: Traditional asset classes, Basket clause-stocks, Basket clause-private equities, and Basket clause-hedge funds, on the following dates: 12/31/03, 6/30/04, 12/31/04 and 6/30/05]

Mr. Storer stated that recently, because of the appreciation in the equity market, the Fund has begun utilizing the basket clause. The Fund would soon implement two more strategies, which fall under the basket clause: a hedge fund strategy, and a diversified portfolio

referred to as private equities. Within a few years, the Fund's five-percent of alternative investments allowed for in the basket clause would be exhausted.

Co-Chair Wilken asked if all Permanent Fund managers have access to the provisions of the basket clause.

Mr. Storer replied that not all of the managers have access to the basket clause. Specific managers are granted the authority to use the provisions of the clause based on resolutions, statutes and individual contracts.

Senator Bunde asked how the Permanent Fund would have been affected if the hedge fund and private equities strategies that are proposed for 2005, were enacted in 1995.

Mr. Storer responded that higher returns would have been realized if the proposed allocations were implemented in 1995; however, if they were enacted in 2000 the private equity portion would not have done well and the hedge fund portion would have "added superior returns".

Senator Bunde inquired as to how the Permanent Fund's investment portfolio would have been affected as a whole, given the scenario.

Mr. Storer speculated that given the bear market, the overall result would have been similar to what is currently being achieved by those investment strategies.

Senator B. Stevens asked for a clear interpretation of the bar graph on slide seven titled, "Permanent Fund asset allocation".

Mr. Storer clarified that the bar graph represents the existing investment authority of the Fund.

Senator B. Stevens asked if requiring a five-percent limit in each investment class, and considering certain alternative investment strategies are appreciating in value, is forcing the Fund to utilize realized earnings to remain within the five-percent limit.

Mr. Storer affirmed and elaborated that the Fund would be forced to liquidize securities and take the realized gains if the five-percent limit was approached.

Senator B. Stevens suggested that if the percentage limit was increased to 10 percent, and distribution guidelines were retained, the need to use realized earnings would diminish. As a result the realized earnings would not grow at the rate they are currently.

Mr. Storer qualified that during this period the Fund's other investments would also be realizing earnings, especially private equities. The amount of realized earnings would be significant, although less than if forced liquidation were required. Under the expanded clause, the realized earnings would likely be equal to or greater than the current basket clause.

Senator B. Stevens asked if the investment status quo were maintained and the basket clause increased, whether the potential for realized earnings would diminish.

Mr. Storer predicted realized earnings would increase over the long term: a period of five or more years.

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Mr. Storer continued that in the in near term, if the basket clause were expanded, he would expect realized earnings to be the same or higher than current earnings. The differences would be attributed to market performance and Fund policy not dictated by statute.

Senator B. Stevens remarked that every managed fund has imposed limitations on investment classes and when those limits are reached the fund is forced to realize earnings. Possible reductions in realized earnings due to an extended basket clause would be incidental under the Percent of Market Value (POMV) pay out plan, but the possible reduction in realized earnings could significantly affect the current pay out method.

Mr. Storer informed that when the Fund develops asset allocation a target allocation is established for each asset class. Restrictions are then created to avoid a high-turnover environment, which would result in high transaction costs. He informed that policy currently imposes these bans and that this legislation would make the bans statutory.

Senator B. Stevens asked if these provisions are not already statutory.

Mr. Storer replied that statutory provisions have always existed; however, the Fund is nearing the limitations for the first time in its history.

Senator Hoffman clarified that allowing the Fund administrators to alternatively invest 10 percent of the assets of the Fund would

translate into making accessible \$2.8 billion. He recalled dialog on this legislation in the Senate State Affairs Committee in conjunction with the Board of Trustees' other recommendation that the Fund be managed under a POMV system. He expressed concern that when dependent upon a certain income source, higher risk investment options are not taken. He used the example of a retirement investment fund that is invested in higher risk ventures when the worker is younger and transitions to lower risk investments as the worker nears retirement. If the POMV plan were implemented, dependence on the Fund's earnings would gradually increase suggesting investment in lower risk ventures.

Mr. Storer replied that when developing a portfolio, an investment time horizon, risk tolerance, and expected returns are considered in order to ensure a sufficient cash flow. He noted that unlike a retirement fund, an endowment fund with a POMV method is not managed for eventual liquidation of assets but rather the real income is used to supply a predictable cash flow. The POMV plan would insure the long-term viability of a fund. If the Fund's earnings were eventually used to fund both dividends and State government, its investment portfolio must be restructured to maintain multiple cash flows. He spoke to the advantages of investment flexibilities to enhance the Fund's ability to provide revenue.

Senator Bunde referenced Senator B. Stevens' earlier comment that the current payout system forces sale of high performing investments resulting in realized gains. If this legislation were adopted under the current payout system, dividends would likely be higher. However, if both this legislation and the POMV plan were adopted, fluctuation of dividend amounts would decrease. He cautioned against forcing poor management decisions to increase dividend amounts, warning that the future value of the Fund would be jeopardized. He was undecided on the matter.

Senator B. Stevens spoke to Senator Hoffman's point, expressing agreement with Senator Hoffman's example of the management of a "finite pool" of capital. However, Senator B. Stevens emphasized that the Permanent Fund is not a finite capital fund because it receives royalty payments and statutory inflation proofing funds.

Co-Chair Wilken asked the witness to comment on Senator Bunde's statement.

Mr. Storer responded that the current pay out methodology is based on a five year moving average of realized income. To date, the income from the Fund has been used for three purposes: dividend payments, special appropriations to the principal of the Fund, and

inflation proofing of the Fund. More realized income translates to a greater pool of money available for distribution. Due to the current strict formula for distribution, any program that accelerates realized income would produce a larger dividend.

Senator Olson introduced members of the Kotzebue High School Leadership Program who were attending the meeting.

Co-Chair Green recalled that adoption of the basket clause was discussed extensively during 1998 and 1999, with some parties viewing the provision with skepticism and others "with a great deal of faith". Through those discussions she came to realize that placing a ceiling within a system creates constraints on choices leading to success. The State expects the Permanent Fund's Trustees to have the ability to invest "widely and deeply". Constraints diminish that ability and at times force the Fund's Trustees to compromise the profitability of the Fund. The dividend should not be the focus of discussion when considering this legislation, but rather the two clear objectives that are stated in the Alaska Permanent Fund Corporation's "Sponsor statement for SB 326" [copy on file].

Mr. Storer agreed. He assured that the Corporation has been judicious in exercising the authority granted to it by the legislature. At no time in past discussions with the legislature has the dividend been the focus. The goals of this legislation remain twofold: to insert housekeeping legislation to express the need and intent of the basket clause and to increase the basket clause from five to 15 percent. Senator Stedman made a motion, supported by the Permanent Fund's Board of Trustees, to reduce the limit to 10 percent, which would provide the Permanent Fund Corporation with flexibility in the next few years. The Trustees' eventual alternative investment goal remains 15 percent.

Co-Chair Wilken questioned the language in Section 1, amending AS 37.13.120 (e), which states that the Corporation could "borrow money if the borrowing is without recourse to the corporation and the fund." He asked if this language would allow the Corporation to not repay loans.

Mr. Storer replied that the Corporation could not pledge the principal of the Fund. The Corporation only has a small amount of leverage to borrow from within its real estate portfolio, approximately 15 percent of assets. The Fund operates subsidiaries as limited liability corporations and collection on loans made to these subsidiaries could not access the Permanent Fund.

Co-Chair Wilken noted the delay in publication of the Producer

Pricing Index for January and February 2004 and asked whether the Trustees have discussed this.

Mr. Storer responded that the matter has not been discussed in detail. He informed that the Producer Pricing Index figures for December 2003 are being studied extensively as they will be used to determine the level of inflation proofing.

Co-Chair Wilken commented that this information affects inflation and interest rates.

Mr. Storer relayed that inflation appears to be rising, but very slowly.

Senator Hoffman asked if the Board of Trustees considered the State's future dependency on the Fund when crafting the proposed legislation.

Mr. Storer answered, "absolutely". The Trustees' strategy is to focus on investment diversification, which will enhance the Fund's ability to meet the State's future needs.

Senator Bunde suggested that under the current payout system the Board of Trustees could be pressured into selling assets to increase realized earnings, and consequently, a greater dividend. He asked the witness if this scenario is feasible. Further, he inquired if the proposed legislation would prohibit such exploitation by a future Board of Trustees.

Mr. Storer acknowledged that a Board of Trustees could affect realized gains either for good reason or artificially, and stated that such a probability exists whether or not this legislation is implemented.

Co-Chair Green offered a motion to report the bill from Committee with individual recommendations and accompanying fiscal note.

There was no objection and CS SB 326 (STA) MOVED from Committee with zero fiscal note #1 from the Department of Revenue.

#SB374

SENATE BILL NO. 374

"An Act relating to calculation of the amount to offset the effect of inflation on the principal of the Alaska permanent fund, and to transfers of money from the earnings reserve account; and providing for an effective date."

This was the first hearing for this bill in the Senate Finance Committee.

Co-Chair Wilken stated this bill, sponsored by Senator B. Stevens, "establishes a mechanism to repay the Constitutional Budget Reserve (CBR) after Permanent Fund dividends and inflation proofing and maintaining a \$250 million balance in the earnings reserve account, any excess moneys are transferred to the CBR. In addition, Senate Bill 374, new deposits from natural resources [deposited] into the corpus of the Permanent Fund are considered when calculating the amount needed to inflation proof."

Senator B. Stevens testified this legislation would maintain the current dividend payout calculation, and ensure dividend payouts as the first priority of distribution of earnings of the Permanent Fund, as has occurred since the year 1980. This bill would amend statutes pertaining to the procedures for inflation proofing. The existing inflation proofing calculation takes the market value of the Permanent Fund and multiplies it by the average of two years' Consumer Price Index figures. The product would be transferred from the Permanent Fund's earnings reserve account to the principal of the Permanent Fund. The proposed method would deduct annual royalty deposits from the inflation proofing calculated amount. This method guarantees that inflation-proofing requirements are met and also provides a "baseline balance" in the earnings reserve account. Over the history of the earnings reserve account the legislature has made approximately six modifications to the balance, and in each instance at least \$100 million was retained. This balance consistently provided for "ample" dividends. This legislation would require a conservative minimum balance in the earnings reserve account of \$250 million allowing for the account's first priority, annual dividend distribution, to be achieved.

Senator B. Stevens continued that this legislation proposes the balance of the earnings reserve account after dividends, inflation proofing, and less the \$250 million balance, be deposited into the Constitutional Budget Reserve (CBR) fund. The balance swept into the CBR would serve to repay the debt incurred by withdrawals made from that fund to balance the State budget. If the deposits into the CBR eventually come to equal withdrawals, then the proposed statues will be repealed and the original statutes reinstated.

Senator B. Stevens expressed that the intent of this legislation is to repay the CBR when excess funds remain in the earnings reserve account, thus "maintaining the life of the Constitutional Budget Reserve".

Senator Bunde noted this legislation would provide repayment to the CBR until the existing debt is settled. This bill would not provide a long-term solution to restoring the CBR because future withdrawals could be made.

Senator B. Stevens explained that once deposits into the fund equal the amount of withdrawals, the repayment plan proposed in this legislation would cease. However, he remarked that future legislatures would have the ability to make appropriations from the Constitutional Budget Reserve. While in affect, this legislation would provide the ability to repay funds withdrawn from the CBR in the past and in the future.

Senator Bunde characterized this proposal as a revolving line of credit the legislature would provide itself. This plan would "bridge our [State legislatures'] current problems" and meet the criteria of a long-range fiscal plan to fund State services.

Senator B. Stevens restated that the objective of this legislation would be to provide a long-range plan to replenish the CBR. The future use of the CBR would be determined by future legislatures.

Co-Chair Wilken commented that the proposal to include royalty income in the inflation-proofing amount is a major component of this legislation.

Senator B. Stevens stated this legislation is comprised of two major components, one being the method used to meet the obligation of inflation proofing the Permanent Fund. The other major component is a minimum balance requirement for the earnings reserve account and the allowance of a transfer of funds into the CBR. If a State savings account is to be kept, it should be within the CBR, not the earnings reserve account.

ROB CARPENTER, Fiscal Analyst, Division of Legislative Finance, testified that the projections included in the series of spreadsheets prepared by the Legislative Finance Division dated 3/22/2004 9:32 am [copy on file] were conservative at Senator B. Stevens' request. The data on the spreadsheet titled "Model Concept/Parameters" assumes a general fund budget growth rate of two-percent from FY 05, a three-percent rate of inflation, population figures from the Department of Labor and Workforce Development and information relating to the Permanent Fund from the Permanent Fund Corporation monthly models.

Senator Hoffman asked the reason why the spreadsheet listed a negative growth rate for FY 04.

Mr. Carpenter explained this rate reflects the reduction in general fund spending between the FY 03 to FY 04 enacted budgets.

Co-Chair Wilken asked for clarification on the "Model Concept/Parameters" spreadsheet data, and using FY 05 as an example. He asked if the formula used in the "Statutory Net Income" column was the same formula used in the "Statutory Net Income" column of the spreadsheet titled "Alaska Permanent Fund Financial Projections 2004-2014 as of December 31, 2003" issued by the Permanent Fund Corporation [copy on file].

Mr. Carpenter replied that yes, the two columns were referring to the same concept. He added that the information on the series of spreadsheets was based on the January 2004 monthly financials, and did not take into account the February 2004 monthly financials.

Senator B. Stevens pointed out that the monthly financial projections fluctuate significantly.

Co-Chair Wilken asked the definition of "MV".

Mr. Carpenter responded "MV" is an acronym for "market value".

Co-Chair Wilken clarified that the data referenced on the "Model Concept/Parameters" spreadsheet represents a "snapshot in time".

Mr. Carpenter outlined the data in the spreadsheet included in the packet prepared by the Legislative Finance Division titled "Status Quo", using FY 05 as an example. He proceeded to detail the information in the FY 05 column of this spreadsheet.

Senator Dyson asked for a definition of the phrase "reserved ending balance".

Senator B. Stevens referenced the "Reserved Fund Balance" versus "Unreserved Fund Balance" sections of the "Alaska Permanent Fund, Financial Projections 2004-2014" spreadsheet. The unreserved fund balance includes the earnings reserve account, and the reserved fund balance consists of the Permanent Fund's unrealized gains and the dedicated principal of the Fund, which includes deposits, inflation proofing and realized gains.

Mr. Carpenter continued to detail the FY 05 data in the "Status Quo" spreadsheet.

Co-Chair Wilken asked which figures were used to derive the Permanent Fund's FY 05 market value ending balance of \$29.443 billion.

Mr. Carpenter answered that the market value ending balance is the sum of the Fund's principal ending balance, accumulated unrealized earnings and the ending balance of the earnings reserve account.

Co-Chair Wilken clarified that the ending balance of the earnings reserve account reflects the balance after dividend distribution, inflation proofing, and potential withdrawals to compensate for the State's fiscal gap.

Senator B. Stevens referred to the "Status Quo" spreadsheet in pointing out that the ending balance of the CBR would be zero in FY 07 because withdrawals would exceed the balance. Following the exhaustion of the CBR, the spreadsheet assumes that the earnings reserve account would be the only resource available to fill the State's fiscal gap. The projection predicts that the earnings reserve account would reach a zero balance in FY 11.

Co-Chair Green asked if the projections included in the status quo model are based on hypothetical evaluations of the actual price of oil rather than outdated forecasts.

Senator B. Stevens answered no.

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Senator B. Stevens clarified, using the spreadsheet included in the packet provided by the Legislative Finance Division titled "Model", that the projected unrestricted general fund revenue amounts for FY 03, FY 04 and FY 05 are derived from the adjusted fall forecast oil prices and current production levels. Beginning in FY 06 the general fund revenue projection assumes a rate of \$22 per barrel of oil under current production levels.

Senator Bunde understood the status quo model demonstrates that, after the CBR Fund is depleted and funds are appropriated from the earnings reserve account to balance the State budget, adequate funding remains in the earnings reserve account to issue dividends and inflation proof the Permanent Fund.

Senator B. Stevens affirmed and added that dividend payouts and inflation proofing are required statutorily.

Mr. Carpenter and Senator B. Stevens then outlined the spreadsheet titled "Model", which assumes the implementation of this legislation.

Senator B. Stevens explained that beginning in FY 05 the "Model" spreadsheet demonstrates that transfers from the earnings reserve account into the CBR are visible in the CBR ending balance. The primary dissimilarity in the balance of the earnings reserve account between the "Status Quo" and "Model" spreadsheets is the amount "swept" into the Permanent Fund for inflation proofing: in FY 05 the "Status Quo" spreadsheet reflects a transfer of \$712 million whereas the "Model" spreadsheet reflects a transfer of \$460 million. The divergence exists because in the "Model" spreadsheet the Permanent Fund's dedicated revenue, consisting of royalty deposits, is counted towards the inflation proofing calculation. Thus, the inflation proofing calculation of \$712 million is arrived at by adding the Fund's dedicated revenue in FY 05, \$252 million, to the inflation proofing transfer from the earnings reserve account: \$460 million.

Senator B. Stevens clarified the amount of the transfer from the earnings reserve account to the CBR in FY 05. He pointed out that the balance of the CBR fund increases from FY 04 to FY 05, but reduces after FY 05 until FY 12.

Senator Dyson referenced discussions and arguments made that the Permanent Fund is currently double inflation proofed because the value of the Fund's assets naturally increase with inflation, and, in addition, money is transferred from the earnings reserve account to compensate for inflation. He stated that this legislation would not address this argument because it continues to inflation proof the Fund using the current calculation.

Senator B. Stevens replied that under the proposed model the Fund continues to be inflation proofed at the required amount; however, by applying dedicated revenue towards the inflation calculation amount, the actual inflation proofing deposit would be reduced.

Senator B. Stevens next explained the spreadsheet included in the packet prepared by the Legislative Finance Division titled "Output - Status Quo vs Model". According to the February 2004 Consumer Price Index the rate of inflation in the State for 2004 was 2.15 percent. The inflation proofing calculation for the Permanent Fund for FY 05 assumes an inflation rate of 4.2 percent. Thus, assuming the FY 05 inflation rate is comparable to the FY 04 rate, the Permanent Fund will be inflation proofed at approximately double the rate of inflation. In addition, referring to Senator Dyson's comments, the value of the Fund's assets naturally increases with inflation. Therefore, it is arguable that the Permanent Fund is actually being inflation proofed at three times the rate of inflation. Under this legislation only the principal of the Fund

would be inflation proofed as required by statute.

Senator Dyson restated the inflation proofing method this legislation would implement.

Senator Dyson addressed the discrepancies in the subtraction of percentages in the "Effective Inflation Proofing" section of the "Output - Status Quo vs Model" spreadsheet.

Mr. Carpenter specified the discrepancies are from a "rounding error" in the spreadsheet computer program.

Senator Bunde asked, assuming this legislation is implemented, if the fiscal gap would be zero until FY 12 at which time the CBR would be fully funded and no longer used to fund fiscal shortfalls.

Senator B. Stevens corrected that no fiscal gap is represented in the "Output - Status Quo vs Model" spreadsheet until FY 12 because the CBR would be used to fill any fiscal gap until then. The CBR would be drained as of FY 12.

Senator Bunde commented that this legislation does not prevent the CBR from being exhausted, but rather delays the process.

PHELAN STRAUBE, staff to Senator B. Stevens, affirmed that the model representing this legislation utilizes the assumption that the average price of oil is \$22 per barrel and that no new oil sources are developed. The model also assumes that no new taxes are imposed.

Senator B. Stevens furthered that the model assumes that the State's only means of satisfying the fiscal gap would be the CBR. The model also presumes an actual growth rate in the budget.

Senator Hoffman noted that in the "Output - Status Quo vs Model" spreadsheet the status quo projects the market value of the Permanent Fund in FY 14 at \$40.2 billion, whereas the model projects a market value that is approximately \$2.25 billion less. He asked what the dividends would be under both the status quo and model projections.

Senator B. Stevens replied that appropriations to the Permanent Fund would begin to decline in FY 06 under both the status quo and the model projections. The dividend would continue to grow under the model, but not as rapidly as under the status quo. Despite efforts to accurately project realized earnings, actual amounts are the result of management decisions for the Fund and could not be precisely forecasted.

Co-Chair Wilken requested a chart detailing the dividend transfers from the earnings reserve account, as listed on line 26 of the "Model" spreadsheet.

Senator B. Stevens referred to the "Output - Status Quo vs Model" spreadsheet, specifically the "Per Capita Dividends" section, in highlighting the comparison between the dividend transfer in the status quo and model projections.

Co-Chair Green asked if this legislation would increase scrutiny of funds available to balance the State budget by reclassifying funding. She suggested the reclassification would require a three-quarters majority vote of the legislature to appropriate funds rather than the current simple majority vote requirement.

Senator B. Stevens affirmed.

Co-Chair Wilken ordered the bill HELD in Committee.

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ADJOURNMENT

Co-Chair Gary Wilken adjourned the meeting at 10:59 AM