

ALASKA STATE LEGISLATURE
SENATE JUDICIARY STANDING COMMITTEE
ANCHORAGE LIO
October 30, 2003
7:07 p.m.

MEMBERS PRESENT

Senator Ralph Seekins, Chair
Senator Scott Ogan, Vice Chair
Senator Hollis French

MEMBERS ABSENT

Senator Gene Therriault
Senator Johnny Ellis

OTHER LEGISLATORS PRESENT

Senator John Cowdery
Representative Mike Hawker

COMMITTEE CALENDAR

SENATE JOINT RESOLUTION NO. 18

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

HEARD AND HELD

SENATE JOINT RESOLUTION NO. 19

Proposing amendments to the Constitution of the State of Alaska relating to the Alaska permanent fund.

HEARD AND HELD

PREVIOUS ACTION

SJR 18 - See State Affairs minutes dated 5/1/03 and 5/6/03 and Judiciary minutes dated 5/15/03, 6/26/03, 10/28/03, and 10/29/03

SJR 19 - See State Affairs minutes dated 5/13/03 and Judiciary minutes dated 5/17/03, 6/26/03, 10/28/03, and 10/29/03

WITNESS REGISTER

John Kiernan

No address provided

POSITION STATEMENT: Testified on SJR 18 and SJR 19

Sharman Haley

No address provided

POSITION STATEMENT: Posed questions on POMV

ACTION NARRATIVE

TAPE 03-59, SIDE A

SJR 18-CONST. AM: PF APPROPS/INFLATION-PROOFING

SJR 19-CONST. AM: PERMANENT FUND INCOME

CHAIR RALPH SEEKINS called the Senate Judiciary Standing Committee meeting to order at 7:07 p.m. Judiciary members present were Senators French, Ogan and Seekins. Senator Cowdery and Representative Hawker were also present.

He recognized John Kiernan who was present to testify and informed him that Mr. Bob Storer from the Alaska Permanent Fund Corporation would give an overview of the POMV (Percent of Market Value).

BOB STORER from the Alaska Corporation (APFC) Board of Trustees explained that both SJR 18 and HJR 26 propose a constitutional amendment, which they refer to as "the 5 percent solution." Multiple boards have determined that this is a superior way of insuring that all generations benefit equally from the permanent fund.

He referred to the slides on page two of the PowerPoint presentation to show the four year change in the realized income account and the reserved account, which includes principal and unrealized gains. He pointed out that the principal is protected in the constitution and cannot be touched without a vote of the people. In contrast, realized income, which is actualized profit from the sale of an asset and interest from bonds and dividends income, may be appropriated.

He explained POMV is a formula that limits the spending of the fund and is based on the total market value of the fund. They suggest setting a percentage that is based on the expected difference between the total investment return and the rate of inflation. The Legislature has always appropriated the impact of inflation into the fund principal and the payout is the excess return. The board maintains there is a superior method, which

would be to limit the amount that can be appropriated in any given time to the real or excess earnings of the fund and the affects of inflation would remain in the fund.

Historically, inflation has been three percent and over time they believe they are able to earn about eight percent so a five percent appropriation is reasonable and what they are suggesting for appropriation. Justification for this change may be found in looking at data from the last ten years because it shows returns during the bull market as well as the recent results when the market performed poorly. Over the previous wildly fluctuating ten year period, the fund earned 7.8 percent and inflation was just 2.5 percent, which made it possible to achieve a real return of 5.3 percent. Looking forward, they believe they can continue to do the same.

He then referred to the slide showing the asset allocation shift. In the late 1970s and early 1980s, the fund was invested exclusively in fixed income instruments and most income was realized from cash flow. As the fund matured, emphasis shifted from income producing assets to asset appreciation to produce income. Recognizing contemporary investment standards, they believe a superior methodology would be to limit the payout of the total market value of the fund, which would also capture the appreciation of equities.

POMV would provide for a permissible legislative payout from the permanent fund in each year of five percent of market value, averaged over a five year period. Under the current scenario, actual earned income from the fund is available for legislative appropriation. The Board of Trustees supports a solution that is up to five percent of market value. They believe that will conserve the fund for future generations and maintain the ability to pay out monies for current generations.

POMV protects the fund by eliminating the distinction between principal and earnings. With regard to the concern that there could be an invasion of principal, he pointed out that four years ago about 25 percent of the fund was earnings that could have been appropriated. If that amount had been appropriated, there would have been nothing available for payout. This limit imposes discipline so there wouldn't be overspending in a bull market, which he believes to be critically important in protecting principal.

He explained the chart on current formula payouts for 1998, 2000 and 2003 takes the total realized income for the last five years

multiplies it by .21 percent and divides by two. Applying the current formula out to 2005 and using a mid-case scenario, there would be less available for the dividend and not enough to meet inflation proofing.

In comparison, the POMV simply takes the market value of the fund at the end of five years, average the five years and take five percent. He referred to the chart to show that there is less volatility using this formula.

He then explained the chart showing realized income versus market value. In 1996, realized income increased by 80 percent, but it dropped by that same amount in 2001 and 2002 showing the volatility in the current formula. Predictability and stability of payout is important and the current formula shows higher volatility. He emphasized this by reminding members that the board repeatedly warned of the possibility of no payout earlier in the year.

People sometimes ask which method would have the greater payout over time and they say that ultimately, it's the same, but POMV smoothes the payouts to higher lows and lower highs. In addition, POMV eliminates any question that the asset allocations are based on anything other than investment management decisions. Under the current method, actions will affect the dividend.

JOHN KIERNAN testified as a private citizen and noted that several years ago 83 percent of the Alaskans that voted indicated they did not want the dividend touched and now the Legislature is going after the permanent fund itself. He said:

When we have BP taking 65 percent of the profits of oil, the federal government gets 35 percent corporation tax, Alaska gets about 3 percent and with what the federal government gets it makes up 35 percent and then the other 65 percent of the profits go to BP - of oil. And oil is the big money in this state. We fought the war of 1776.... to get the British out of America, but they're taking our money in oil money out of here, to London. So okay, I can invest in BP and share some of that profit, that's great, but I understand from a letter I've gotten hold of... that says 'At statehood a major portion of our private property mineral rights were negotiated away. We property owners were told that the state would manage our mineral rights for the benefit of all. We

would receive a dividend, much like a stock dividend to compensate us for the loss of this significant right.' She then says, 'Hands off my dividend!' among other things. She says, 'Now unrestrained state spending threatens the dividend and the proposed, highly promoted, POMV is not the answer. Alaska spends more than twice as much as any other state per person." If that be the case, you guys know more about that than I do and I can only take from what she has written here and this was in the Alaska Digest Email News on 10/23/03, which was just a few days ago. If that is the case, then the state has committed itself to taking care of those mineral rights and paying a dividend to the public. Okay, we have a permanent fund that does that, but what the public are concerned about is that they said no, don't touch the dividend, but now they're looking at going after the fund itself. Five percent of the fund sounds okay, but if the fund is not earning money at all. If we hit a real depression, and do we still continue to pay out five percent of the fund even in a really depressing situation? That would cause the fund to disappear if the depression lasted a long time. I agree five percent, five into 100 is 20 years, but okay, in rough calculations it would take a long time for it to disappear.

Okay, then I read another problem. Why is Alaska being ripped off? Most oil exporting countries go to great lengths to keep their tax policies secret. However, a great deal of information about OPEC member Nigeria's oil tax policy can be found at a certain email address which I've got written down here. Doing business in Nigeria, when you reach the page, do a word search and find petroleum profits tax is payable at the tax rate of 85 percent for all companies. And 85 percent rate is the norm for all OPEC countries.... [They] all pay those taxes. A complete list of companies that pay those taxes can be found at another email address. If 85 percent does not stop major oil company involvement in Nigeria, what is our Governor or our Legislature doing about our pitiful, miniscule tax rates here in Alaska? Why are we giving away our resource wealth, but are attempting to raid the permanent fund dividend.

It's not a bad solution to our financial dilemma, but it's not going to help the people, this taking away the permanent fund from the people. The oil companies should be paying more in taxes than just three percent to Alaska and five percent to the federal government and then walking away with 65 percent. That's my thinking.

I hear you in that you say that the five percent would be a steady form of income. And then how expensive would be another matter, but it would be a steady form of income and even in bad times it would take it over 20 years for the fund to be wiped out completely. Usually bad times only last about a year and then we're back to the good times again. So I see your point, it's possibly a good thing to do. But you have to sell it to the people and yes, that 83 percent said no, don't touch the dividend so you've got to sell it to the people.

I would say that if the people saw that their dividends were going to continue and if all the oil revenue was put into the fund for investment, not just put into state coffers for spending, but all of the oil revenue and all of the revenue from everywhere was put into the fund for investment and then only payout five percent, you might convince some people then. But [not] to just take five percent of the fund and add it to the general fund.

SENATOR COWDERY noted that when he homesteaded in 1954 it was clear that he didn't have any subsurface rights and he had no problem with that.

He recalled that the first lease sale was about \$900 million and royalty rates were set at about 12.5 percent. He asked Mr. Kiernan how he would change the formula.

MR. KIERNAN asked about the length of the leases.

CHAIR SEEKINS said, "In perpetuity."

MR. KIERNAN expressed surprise.

CHAIR SEEKINS explained that if a company leases a piece of property for oil extraction, they pay a royalty and harvest the resource until it is not longer there. Their profit comes after

they have paid royalties. He pointed out the company isn't paying just three percent; they've already paid at least 12.5 percent in royalties.

SENATOR COWDERY added that the royalty on some fields has been as high as 50 percent.

CHAIR SEEKINS stated there was no agreement at statehood regarding sacrificing subsurface mineral rights for a dividend.

MR. KIERNAN acknowledged that his source might be incorrect then asked about mineral rights on leasehold property.

CHAIR SEEKINS said the agreement has already been made and it can't be altered.

REPRESENTATIVE HAWKER noted that Section 6 of the Statehood Act gave all of the fundamental resource wealth to Alaska. The first line clearly delineates the purpose for which that wealth was given, which was to develop Alaska's community infrastructure.

CHAIR SEEKINS added that the federal government held that wealth in trust for the people of the future state.

SENATOR OGAN suggested returning the discussion to the POMV.

CHIAR SEEKINS agreed.

SENATOR COWDERY said an agreement is an agreement and the state signed the agreement. People were very pleased when the oil companies arrived.

SENATOR FRENCH referred to the third bullet point on the POMV solution and noted that protecting the fund by constitutional inflation proofing is there by implication only.

MR. STORER agreed it was there by implication.

SENATOR FRENCH said that if there were a year where the return on the fund was five percent and the Legislature decided to spend the five percent then there wouldn't be any inflation proofing that year.

MR. STORER said they use the term "over time" to say that you will succeed in earning a five year return over inflation. He said, "You're correct, it is implied; the residual remains with the fund."

They did a study on rolling tenures and found there was never a ten year period in which less than five percent was earned. This includes the recent three year bear market. Looking at shorter time horizons there is no question there have been periods when that goal wasn't achieved, but with the long-term discipline you will achieve the goal he said.

SENATOR FRENCH asked what it is about the current structure of the fund that jeopardizes future generations receiving a dividend.

MR. STORER replied that's a good question because to date the Legislature has appropriated for inflation proofing and at times they have appropriated additional revenue into principal. However, there is no way to predict whether or not that would be the case with future Legislatures. Currently statute requires the dividend come first followed by inflation proofing. By memorializing this in the constitution, it has a more powerful effect on inflation proofing and if they are correct, the purchasing power will be maintained and all generations would benefit equally.

SENATOR FRENCH said that since the fund moved away from a bond strategy into equities it seems less likely that the dividend payout would be too much under the current structure. He used Microsoft stock as an example. It pays no dividends, but the value of the stock has risen considerably. If the permanent fund were to have a lot of this stock, the size of the fund would increase, but there wouldn't be any realized earnings until the stock was sold. Under current methodology, none of the appreciation would be available for distribution as a dividend or inflation proofing or any other use unless the stock was sold.

MR. STORER said,

"You brought up an excellent point and it goes back to another point I touched on briefly....

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7:52 p.m.

...is almost given away, it's one half of a percent is what we pay for the management of that. And there is virtually no turn over unless a stock enters or is removed from the dividend. So what happens is, on that portfolio, you get a dividend, but there is virtually

no change and so what would happen in that portfolio absent activity, would be it would appreciate theoretically. Your Microsoft keeps appreciating and there are only paper profits, yet the value of the fund is increasing rather dramatically. The other half of the portfolio - we use active managers. We use active managers to diversify the risk and you expect them to add some incremental value above the index. Otherwise why would you do that? Those managers are active all the time and in fact when they buy Microsoft their discipline actually is different.... Many of them own it, but they tend to own a limited amount in the portfolio. When that Microsoft stock goes up, and you've got five percent of the portfolio, they sell. So now you've got only three percent of the portfolio. So they're selling the profits.

The other decision that they make is they may like Intel better than Microsoft for whatever reason so they may sell all the Microsoft because they think they can earn more in Intel. The problem becomes that we have a balance. What if - I know one state whose domestic portfolio is exclusively passive. If we did, there would be virtually no dividend whatsoever unless you made non-investment arbitrary decisions to harvest the profits. Which brings the second question. What do you do with the money? So, there are potentially arbitrary and non-investment decisions that can come out of these kinds of things. That's the beauty of limiting to the value of the market value of the fund. That way you're capturing some of that appreciation, but no more than would be in excess of inflation. So it eliminates the ambiguity other than it's a pure investment decision.

CHAIR SEEKINS referred to the chart showing realized income versus market value and asked if the change in value in 1996 resulted from a management decision or a Board of Trustees decision because they wanted to increase the dividend payout.

MR. STORER advised he didn't participate in those discussions, but he believes the debate stemmed from fact that assets were increasing dramatically in the raging bull market and there was concern that future generations would benefit from the bull market more than the current generation. At that time the board made the decision to take profits in the passive portfolio, which had the effect of increasing the dividend.

CHAIR SEEKINS stated this decision was made without legislative consultation for the purpose of increasing the dividend.

MR. STORER replied the payout would be the same ultimately, but there was an arbitrary decision with regard to when.

SENATOR FRENCH asked if this was the permanent fund.

MR. STORER said it was. He pointed to the spike in 1996 and advised that was during the bull market so there was profit taking, but there was also a specific decision made by the Board of Trustees to take profits in the passive portfolio.

SENATOR COWDERY questioned how close we came to having no dividend.

MR. STORER said that according to their studies, there was a ten percent chance there would be no dividend in 2003. Things changed in the last quarter of the fiscal year and they earned about ten percent. "But if that was the first quarter there would have been about a ten percent probability of no dividend under the existing formula."

SENATOR COWDERY questioned, "On the existing formulas, if it had stayed that way for two or three more quarters before it turned?"

MR. STORER quipped, "Another executive director would be making this presentation."

SENATOR COWDERY asked if the fund plummeted \$4 or 5 billion during the slump.

MR. STORER said it wasn't that much, but it was dramatic. At fiscal year end, the earnings reserve was \$1.6 billion and around mid July [2002] that money was gone. By July 24 it was back up, but the volatility lasted for about a six month period. That year, [2002] the fund had the worst quarter in the history of the fund. That quarter was -7.5 percent, but for the fiscal year the fund earned about 5.5 percent. During the latter part of that calendar year, the value of the fund was less than the principal about three times. That includes the unrealized losses.

SENATOR COWDERY asked if it was correct that the dividend would have been about the same if the POMV had been in place during that time.

MR. STORER said that was probably accurate. The irony is that for the next two years the dividend will probably continue to go down under POMV.

CHAIR SEEKINS asked about inflation proofing in POMV. He said he understands it's inherent to the strategy, but it's not constitutionally guaranteed.

MR. STORER agreed and added there is no constitutional guarantee inflation proofing would be exercised in any given year.

CHAIR SEEKINS said, "When it came to cutting funds for education or cutting inflation proofing, the Legislature can decide which of those they are going to do."

MR. STORER replied the same fundamental debates regarding inflation proofing could exist in the future.

CHAIR SEEKINS asked about the invasion of principal question. He remarked that he understands very well how influential the Board of Trustees can be in determining whether or not there is a dividend and how large it might be because they are able to instruct management to sell or not sell. If it was politically expedient to make sure that there was money for a dividend, the trustees could conceivably cherry pick the fund to produce realized income so funds could be available for distribution even though the principal of the fund was decreased.

MR. STORER replied that fact exists every year.

CHAIR SEEKINS said, "Even today there is no real constitutional provision that protects the principal from invasion based on different creative strategies."

MR. STORER agreed. In investment management there are an increasing number of ways to get from A to B.

CHAIR SEEKINS asked whether the POMV strategy would provide better, worse or neutral protection of fund principal.

MR. STORER opined it would unequivocally make every investment decision a pure investment management decision.

SHARMAN HALEY, an economist, asked why the projections to the end of the decade comparing the current formula with the POMV under the 50 50 scenario shows that in the short run the POMV dividend is higher, but by the end of the decade, the current formula shows a higher dividend. She questioned why they aren't more comparable.

CHAIR SEEKINS advised the 50 50 formula is not under consideration under the bill.

MR. STORER said the 50 50 formula is an example they have used and the answer goes to the stability of payout issue.

"Whereas there's less volatility in market value, you get this constant that's going to go up like that.... So over the next few years, the moving average, the amount that's available will, under the existing formula, will continue to drop. What happens and what you see are extrapolations of the median case only. What happens is that as the normalized payout goes up then you will see more profits generated in the realized income that compensates. We overshot in the bull market and we're undershooting rather significantly so we go back out. In the out years you'll see it go above a bit and what I think is that ultimately they smooth out and compress a bit.

There is an arbitrary issue in our projections that you can appreciate. We have to predict realized income. Which means we're predicting two things. We're predicting markets and we're predicting manager behavior to those markets. So we take historical turnover rates in our realized assumptions, but they are arbitrary decisions.

CHAIR SEEKINS emphasized that in considering POMV, they aren't considering any change in the way distributions are allocated. It is just a proposal for determining how much is available from the fund for distribution on an annual basis.

MR. STORER added that people do care a lot about the amount of the dividend and there is a fiscal issue. They are parallel issues, but they exist even without the POMV. He said their point isn't the spending issue; it's the management of the fund.

CHAIR SEEKINS said his point is to insulate from market and, in particular, political volatility. He pointed out that board

members serve at the pleasure of the governor and legislators do not confirm the board. When he was removed from the board, he received a letter from the governor stating he was being removed because it was doubtful that he would invest according to the governor's political philosophy. He opined it is a dangerous situation to invest according to a governor's political philosophy and it shouldn't be a possibility. In considering POMV, that is a valuable consideration.

Considering POMV by itself, it is an upgrade. The chart showing how asset allocation has changed makes it clear that an allocation and distribution upgrade is in order. The proposed formula is used by 85 percent of the major funds so it's not new or untried. He stated his personal position is that, "I would trust that the decision being made on how much to take out on an annual basis, in case of a major depression would better be made by the 60 members of the Legislature than the six political appointees on the Board of Trustees - having been one and now being on the other."

CHAIR SEEKINS announced he would hold a committee meeting on this subject during the first week of the upcoming session. If additional meetings are needed in different areas of the state he will hold them.

There being no further business to come before the committee, Chair Seekins adjourned the meeting at 8:20 p.m.