

**ALASKA STATE LEGISLATURE**  
**SENATE JUDICIARY STANDING COMMITTEE**

February 9, 2004

8:12 a.m.

TAPE(S) 04-4&5

**MEMBERS PRESENT**

Senator Ralph Seekins, Chair  
Senator Gene Therriault  
Senator Hollis French

**MEMBERS ABSENT**

Senator Scott Ogan, Vice Chair  
Senator Johnny Ellis

**COMMITTEE CALENDAR**

SENATE BILL NO. 300

"An Act relating to an attorney's lien, to court actions, and to other proceedings where attorneys are employed."

HEARD AND HELD

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**

BILL: SB 300

SHORT TITLE: ATTORNEY'S LIEN

SENATOR(S): STEDMAN

02/06/04 (S) READ THE FIRST TIME - REFERRALS

02/06/04 (S) JUD, FIN

BILL: SJR 18

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

SENATOR(s): RLS BY REQUEST OF LEG BUDGET & AUDIT BY REQUEST

04/17/03 (S) READ THE FIRST TIME - REFERRALS  
04/17/03 (S) STA, JUD, FIN  
05/01/03 (S) STA AT 3:30 PM BELTZ 211  
05/01/03 (S) Heard & Held  
05/01/03 (S) MINUTE(STA)  
05/06/03 (S) STA AT 3:30 PM BELTZ 211  
05/06/03 (S) Moved CSSJR 18(STA) Out of Committee  
05/06/03 (S) MINUTE(STA)  
05/07/03 (S) STA RPT CS 1DP 3NR NEW TITLE  
05/07/03 (S) NR: STEVENS G, DYSON, GUESS;  
05/07/03 (S) DP: COWDERY  
05/13/03 (S) JUD AT 8:00 AM BELTZ 211  
05/13/03 (S) Scheduled But Not Heard  
05/14/03 (S) JUD AT 0:00 AM BELTZ 211  
05/14/03 (S) -- Meeting Postponed to 5/15/03 --  
05/15/03 (S) JUD AT 8:45 AM BELTZ 211  
05/15/03 (S) -- Meeting Rescheduled from 5/14/03 --  
10/28/03 (S) JUD AT 7:00 PM Kenai  
10/28/03 (S) CONST. AM: PERMANENT FUND INCOME  
10/29/03 (S) JUD AT 7:00 PM Mat-Su LIO  
10/29/03 (S) CONST. AM: PERMANENT FUND INCOME  
10/30/03 (S) JUD AT 7:00 PM Anch LIO  
10/30/03 (S) CONST. AM: PERMANENT FUND INCOME  
01/21/04 (S) JUD AT 8:00 AM BELTZ 211  
01/21/04 (S) -- Meeting Canceled --

BILL: SJR 19

SHORT TITLE: CONST. AM: PERMANENT FUND INCOME

SENATOR(s): LINCOLN, Ellis

05/02/03 (S) READ THE FIRST TIME - REFERRALS  
05/02/03 (S) STA, JUD, FIN  
05/13/03 (S) STA AT 3:30 PM BELTZ 211  
05/13/03 (S) Moved Out of Committee  
05/13/03 (S) MINUTE(STA)  
05/14/03 (S) STA RPT 1DP 3NR  
05/14/03 (S) NR: STEVENS G, COWDERY, DYSON;  
05/14/03 (S) DP: GUESS  
05/16/03 (S) JUD AT 1:00 PM BELTZ 211  
05/16/03 (S) Scheduled But Not Heard  
05/17/03 (S) JUD AT 10:00 AM BELTZ 211  
05/17/03 (S) Heard & Held  
05/17/03 (S) MINUTE(JUD)

10/28/03 (S) JUD AT 7:00 PM Kenai  
10/29/03 (S) JUD AT 7:00 PM Mat-Su LIO  
10/30/03 (S) JUD AT 7:00 PM Anch LIO  
01/21/04 (S) JUD AT 8:00 AM BELTZ 211  
01/21/04 (S) -- Meeting Canceled --

**WITNESS REGISTER**

Senator Bert Stedman  
Alaska State Capitol  
Juneau, AK 99801-1182  
**POSITION STATEMENT:** Sponsor of SB 300

Mr. William Schendell, Attorney  
Fairbanks, AK  
**POSITION STATEMENT:** Supports SB 300

Mr. Ken Covell, Attorney  
Fairbanks, AK  
**POSITION STATEMENT:** Supports SB 300

Ms. Jo Kuchle, Attorney  
Fairbanks, AK  
**POSITION STATEMENT:** Supports SB 300

Mr. Kevin Walsh, CPA  
Fairbanks, AK  
**POSITION STATEMENT:** Supports SB 300

Mr. Robert Storer  
Executive Director  
Alaska Permanent Fund Corporation  
PO Box 25500  
Juneau, AK 99802-5500  
**POSITION STATEMENT:** Answered questions regarding SJR 18

Representative Eric Croft  
Alaska State Capitol  
Juneau, AK 99801-1182  
**POSITION STATEMENT:** Presented SJR 19 for Senator Lincoln

Mr. Mark Stopha  
Staff to Senator Lincoln  
Alaska State Capitol  
Juneau, AK 99801-1182  
**POSITION STATEMENT:** Available to answer questions about SJR 19

Mr. Roger Gay  
Big Lake, AK 99652

**POSITION STATEMENT:** Opposed to inflation proofing the permanent fund

Mr. Gary Hanthorn  
Wasilla, AK 99654

**POSITION STATEMENT:** Supports keeping the permanent fund dividend program

**ACTION NARRATIVE**

**TAPE 04-4, SIDE A**

**CHAIR RALPH SEEKINS** called the Senate Judiciary Standing Committee meeting to order at 8:12 a.m. Senators Therriault, French and Chair Seekins were present. He announced that Senators Ellis and Ogan would not be attending the meeting today. The first order of business to come before the committee was SB 300.

^#SB 300

**SB 300-ATTORNEY'S LIEN**

SENATOR BERT STEDMAN, prime sponsor of SB 300, told members that SB 300 is a housekeeping measure to avoid double taxation. He explained that when court settlements are awarded, the prevailing party must pay income tax on phantom income - the gross amount of the award even though part of that income is paid to the party's attorney. The attorney must then pay tax on the income received, resulting in double taxation. The structure of the system in the State of Oregon differs so that if the proper documents are filed, the court settlement is paid to the attorney who, after retaining attorney fees, pays the remainder to the client, thereby avoiding double taxation. Attorneys have structured trust accounts to hold court settlements, so this mechanism would pose no danger to the client.

8:16 a.m.

SENATOR HOLLIS FRENCH asked for an example to illustrate the double taxation problem.

SENATOR STEDMAN said a wrongfully damaged plaintiff might be awarded \$10,000. The plaintiff would have to claim income of \$10,000 and pay tax on that amount, \$2,000 if the plaintiff's tax bracket was 20 percent. The plaintiff must also pay 30

percent of the \$10,000 for attorney fees, equaling 3,000. Then, the attorney must pay tax on his fee of \$3,000. SB 300 will avoid double taxation by paying the attorney off the top, so that the plaintiff would claim gross revenue of \$7,000.

SENATOR FRENCH surmised that two parties would be paying income tax on the \$3,000.

SENATOR STEDMAN said that is correct. He said there is no way an attorney could avoid paying taxes on his or her fees, so SB 300 will not affect the attorney. It will, however, have a big impact on the citizen who must pay tax on the attorney fees.

SENATOR GENE THERRIAULT asked if the way to avoid double taxation is to have the attorney file the proper lien paperwork so that the jury award becomes the property of the attorney. Then, once the attorney's lien is paid, the remainder is paid to the client via contract.

SENATOR STEDMAN said that is correct and that the client would pay taxes on the actual amount paid to him or her. He clarified that the award funds paid to the attorney would be protected by a litany of regulations to provide safety for the client.

SENATOR THERRIAULT asked if SB 300 passes, the plaintiff in the previous example would receive \$7,000 and the attorney would receive \$3,000, while under the current system, the plaintiff would only receive \$5,000.

SENATOR STEDMAN said that is correct.

SENATOR FRENCH asked if any damage award would go directly to the attorney.

SENATOR STEDMAN said yes, if the attorney has filed the proper liens, and the attorney would disburse the funds directly to the client. The plaintiff would then claim only the income received from the attorney, not the gross amount.

SENATOR FRENCH noted letters of support from attorneys in members' files but asked if Senator Stedman has heard from any plaintiffs who are concerned that attorneys might sit on their money for too long.

CHAIR SEEKINS said that witnesses were available to testify and might be able to answer that question. He took public testimony.

MR. WILLIAM SCHENDEL, an attorney who has practiced in Fairbanks for about 30 years, told members that the issue behind SB 300 is double taxation and is one of the biggest problems that has faced both employers and employees over the last five years. In essence, the plaintiff is taxed on the attorney fees that the plaintiff does not receive. The consequence of that system is that the plaintiff is prompted to try to recover more from the defendant, typically the employer, and that drives up the cost of settlements. SB 300 will do away with double taxation so that the plaintiff is only taxed on the net award.

MS. JO KUCHLE, a Fairbanks attorney for 17 years, told members that regarding the trust account issue, the funds do not always flow through the trust account; sometimes the funds are paid directly to the prevailing party. She said under the current scheme this issue not only arises with settlements, it can occur with judgments or in any case in which the prevailing party has won damages and pays attorney fees. She pointed out:

This has been primarily the result of rulings by the Ninth Circuit Court of Appeals, which has basically determined that for federal tax purposes, the fee award, though it goes directly to the taxpayer and the taxpayer has to pay the attorney, gets taxed entirely to the taxpayer. They carved out an exception in Oregon on Oregon's lien law. That's why the group before you has requested, and we're very pleased that Senator Stedman has introduced this bill, to correct this disparity with Oregon taxpayers and that all taxpayers really in the Ninth Circuit - all states in the Ninth Circuit are affected by this taxpayer [indisc.].

MR. KEN COVELL, a Fairbanks attorney for 18 years, told members he focuses on personal injury and employment law, and that he is concerned that in civil rights actions, a plaintiff will receive nominal damages of \$1. However, attorney fees are often \$100,000. These cases are often very important and involve racial discrimination. It is conceivable that a plaintiff could receive a \$1 award but have a \$30,000 tax liability because of the \$100,000 attorney fee. He pointed out that clients often take on such cases at great emotional and personal risk. Therefore, if an attorney has to tell that client he or she is liable for an additional \$30,000 tax, clients will not pursue important cases. SB 300 would put the citizens of Alaska on equal footing with citizens of various other states. He repeated

that the current system creates a disincentive for clients to pursue important issues.

MR. KEVIN WALSH, a certified public accountant in Fairbanks for 25 years, thanked members for considering SB 300. He said this issue is near and dear to him as he runs into this problem in his tax practice and must advise potential plaintiffs. It creates different classes of taxpayers and affects opportunities that people have to correct injustices changes based on tax advice. He considers that to be wrong and looks to SB 300 for resolution. He said this issue is based on federal income tax law, which is based on taxing the owner of income. A recent Supreme Court decision basically said, "tax the fruit of the tree to the tree from which it falls." This lien law is based on establishing property rights - who owned the case and who owned what right under the case. Current federal tax law says the entire case belongs to the plaintiff; therefore all amounts flowing from that case are taxable to the plaintiff. He explained:

Then, if the plaintiff is allowed a deduction for the amount of the attorney fees that they pay, then they end up [indisc.] income tax only on the net amount. This is absolutely true for any business that is successful in a suit. Businesses report the entire damage amount as income, deduct all of the attorney fees. They only pay income tax on the net amount. People that are injured in a personal injury situation don't pay taxes at all. This is not an issue for them. So it boils down to the only people impacted on this are the employees. Employees who bring suit against their employers for whatever reason and end up successful, end up having to report the entire amount of the attorney fees and their own award as income. They are then allowed a deduction for the amount that they pay the attorneys.

Unfortunately the deduction is limited to two separate distinct events: one, it is only allowed as a miscellaneous itemized deduction and limited to the amount that exceeds 2 percent of their adjusted gross income.... Unfortunately, the alternative minimum tax, which if you have - is a parallel tax system that was established many years ago to make sure that the rich paid at least a minimum tax every year, the consequence of that tax is that no miscellaneous itemized deductions of any type are allowed for

purposes of computing that tax and then the tax rate is 25, 28 percent applied to the net income coming from that.

So let me give you a real live example coming out of our practice. We had a public interest litigant, an employee who was [indisc.]. They sued successfully. They received approximately \$105,000. Their attorney's fees were \$100,000 and that was understood to be part of the award. In other words, their net amount was about \$5,000. They ended up with a tax bill associated with that of approximately \$30,000. In other words, understand, they got to keep \$5,000 and had the obligation to pay \$30[,000], so by taking corrective action through the judicial system to get a court to correct an employer's egregious behavior, they had to reach in their pocket and take out approximately \$25,000. I consider that to be a miscarriage of justice.

MR. WALSH gave other examples and said that the origin of this situation is based on property law in Alabama, Michigan and Oregon. The court reviewed it and found the attorneys in those cases had a sufficient property right in their piece of that case so that income was taxed to them and not to the taxpayers. The Alaska Supreme Court has reviewed this issue and said the person receiving the award "gets the shaft." He said Alaska's law should be changed so that a public interest litigant is not penalized. He noted the Supreme Court has had several opportunities to correct the disparity between the circuit court and has basically said it does not care. Similarly, Congress has had the opportunity to take this matter up several times but declined to do so. He encouraged the Legislature to take action.

8:37 a.m.

CHAIR SEEKINS asked, "As I understand it, this lien exists until it is satisfied and only affects the previously agreed upon fees. Is that correct?"

MR. COVELL said that is correct.

CHAIR SEEKINS asked if SB 300 passes, the prevailing party would pay taxes only on the award less the attorney fees.

MR. COVELL agreed.

CHAIR SEEKINS asked if SB 300 will correct the current disparity.

MR. COVELL said it would.

CHAIR SEEKINS asked if it would have any fiscal impact on the State of Alaska.

MR. COVELL said it would not.

SENATOR THERRIAULT asked if attorney fees and the costs of a case are categorized separately and whether they would be treated the same way.

MR. COVELL said he believes so; nothing would change in regard to cost.

CHAIR SEEKINS said as is the common practice of the committee, he would hold the bill for a second hearing to see if anyone else wants to comment. He said he believes SB 300 is good public policy and thanked all participants.

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^#SJR18

[The following is a verbatim transcript.]

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

CHAIR RALPH SEEKINS: Okay, next we're going to move on to our second item, which is CSSJR 18[STA]. We're looking at version [H]. A little bit of history on this bill - we have had public hearings across the state. We had public hearings this summer in Fairbanks; we had public hearings in Kenai, in Mat-Su and in Anchorage. Today is our last opportunity for public hearings on this particular bill and then for any questions from the members that are present. Do we have anyone who would like to testify today on CSSJR 18? I see Mr. Storer is here from the [Alaska] Permanent Fund [Corporation] and I think the members pretty much understand what the proposal is here. Is there anything that you would wish to add to what you guys have testified on already four times across the state?

MR. ROBERT STORER, EXECUTIVE DIRECTOR, ALASKA PERMANENT FUND CORPORATION: Thank you Mr. Chair. We're prepared to answer any questions that you may have.

CHAIR SEEKINS: We'll hold you to stand by for any questions. Is there anyone on-line that would like to testify on this bill? [No response.] Anyone in the audience that would like to testify on CSSJR 18? [No response.] Mr. Storer, perhaps you could take the chair in case we do have any questions from members of the committee? Anyone signed up Mr. Hove? [No one signed up.] At this point, we're going to close public testimony on this CS for SJR 18. Public testimony is closed. Questions from the members - any questions, comments? Here's our opportunity to ask the expert as to what the formula that they originated from the trustees of the permanent fund is in this resolution that we're considering today. Senator Therriault?

SENATOR THERRIAULT: Mr. Storer, I know one of the concerns that has come up is that with the allowable up to five percent draw, there could be some erosion of the principal in a down investment market or climate. I know that you have run some models historically looking back to see [indisc.] toss around some different ideas of how we could prevent that from happening. I'm wondering if you could just go over that?

MR. STORER: Thank you, Mr. Chair. I'm Bob Storer, the Executive Director of the Alaska Permanent Fund Corporation. Senator Therriault, I have handouts from two views if I could ask that those be distributed? We take the longer term view so the first thing we looked at was what was the real rate of return based on a 10-year rolling average of the history of the fund. And if you look at that, you'll see that in all time periods - I should describe the chart - zero and above is the excess return - earnings of the fund above inflation so zero and below would incorporate inflation. This is zero and above is the real rate of return of the permanent fund. And then we've driven a red line through the 5 percent real rate of return because, of course, that's our proposed constitutional amendment.

You'll see on a rolling 10-year period, during all time frames, we have been able to achieve a 5 percent real rate of return and that includes the most recent period where we experienced not only very high rates of return in the bull market but a 3-year bear market as well. In fact, we earned a 5.3 percent real rate of return for that 10-year period and you'll see it's trending back and we've extrapolated what we think we'll earn through this whole fiscal year.

So that's one way of looking at it. But many people have said well what happens, you've got - it's on a rolling 5-year rate of return, so what happens if you look at a 5-year rolling rate of

return perspective and you'll see I've also provided a graph for you on that as well. And you'll note that in virtually all periods we have earned an excess rate of return of 5 percent real, with the exception of most recent history when we had the 3-year bear market and you'll see that over those 5-year observations most recently, we still were able to achieve a real rate of return, albeit below 5 percent, slightly above probably about 1 percent, etcetera. Now it's trending upwards because the returns have been so good over that period. This chart highlights what I believe is the importance of the POMV, which is limiting or creating the discipline to not overspend in the good years. If you look at that chart, by not overspending, and the legislature did not, they created the cushion, the reserves that actually would allow us to meet, or allow decision makers to meet, the payments in the down years. So I think this chart illustrates, in my mind, the importance of the discipline in the good years to create a reserve for the down years.

CHAIR SEEKINS: Go ahead Senator Therriault.

SENATOR THERRIAULT: Just so I can make sure I understand this - so the zero line incorporates covering inflation?

MR. STORER: Correct.

CHAIR SEEKINS: Senator French?

SENATOR HOLLIS FRENCH: Mr. Storer, I had a conversation with Mr. Bartholomew this summer and I explained my chief reservation about this proposal and that is in the same area that I think Senator Therriault was just asking about and that is the inflation proofing. The quarterly report you guys mailed out to me at my home late in the summer, early September, showed that the annualized 5-year return for the years ending June 30, 2003, that is going back 5 years from there, the total fund returned 3.39 percent. That's the kind of scenario I guess that most - at least I am concerned about, that we could go into a time that we're not making a lot of money and we're taking this 5 percent out and you start to claw into the fund. I think that really sort of highlights one of the difficulties in the proposal, and that is that if you really believe you can take out 5 percent regularly, after inflation proofing, and if one of the chief selling points of the model is that it provides a predictable payout, that is somewhat undercut by the idea that, well, you don't have to take that 5 percent in bad years. I think that's one of the faults, if you will, in the premise of the POMV is that you're going to have this predictable 5 percent payout

except in bad years when you don't do that. Once I think you go to telling folks you're going to have a 5 percent payout, it's going to be very, very difficult to take something less than 5 percent. So I guess my concern is that in bad years, in years where you get a 3.39 percent annualized return, you haven't made your 5 percent and you haven't inflation proofed either. That strikes me as clawing into the principal of the fund.

CHAIR SEEKINS: Let me ask a couple of questions so that we can take a look at this when we talk about this. You know I've been a used car salesman for a long time. What's the present market value of the fund, roughly?

MR. STORER: It's in excess of \$27 billion right now.

CHAIR SEEKINS: Okay, so we've got 27 billion. What's the principal of the fund?

MR. STORER: That's - I was afraid you were going to ask me that. I've been traveling so much but I think it's about \$22.5 billion.

CHAIR SEEKINS: So with that in mind, we've got \$4.5 billion in market value that exceeds the current principal value of the fund?

MR. STORER: Um-hum.

CHAIR SEEKINS: So we'd have to have a couple of really bad years before we started eating into the principal if we started now with a 5 percent payout - is that correct?

MR. STORER: That is correct.

CHAIR SEEKINS: So there's a cushion already there that exists because of the discipline of the legislature in the past and so we should not confuse market value as principal - am I correct there Mr. Storer?

MR. STORER: I think that's an important issue. I think you've - in my mind, I'd like to address a couple of things there. Everywhere I've seen in the United States over the last - as a result of the bear market, is everyone got caught overspending. Not everyone, but I can cite you example after example of overspending in the good years - they got caught up in the bull market mania. I believe the best way - this is what I believe personally, I believe it strongly - the best way to protect the

principal is to create the discipline not to overspend. If I add some responses to Senator French's comments, I've thought about that a lot over the summer because I know it's important not just to you but to many people, and my response has always been as it relates to the POMV, and again I send you to the 10-year period, which says that in fact, we have been able to achieve that goal but we well may not in the future.

The problem exists under the current system as well and we can't forget that. So then it becomes each system has a set of decisions or parameters around it based on the statutes, or the guidelines, or what matters. You are correct, if decision makers wished in a low real rate of return period to distribute 5 percent, we say the stability, the predictability - it's there or it's not there. Under the current system, and you know we have varying scenarios, we had a real rate of return there - what happens if we get a negative real rate of return? Under the current system, depending, you have the same problems but you can also hit that principal and theoretically go several years without any payment at all. Then you've got this 22 - 27 billion dollar fund that does nothing until the market value goes back above. And so it's a decision. It's an important decision. One gives you the flexibility. The other, in a really bad scenario, you wait or you change the Constitution to eliminate principal then. So the problem doesn't go away in either way. It just manifests itself in a slightly different way.

CHAIR SEEKINS: And so, I see - as you know I was on the Permanent Fund Board of Trustees and I can see all kinds of different scenarios where even the current system could be used to actually spend into the principal by selling losers and other different ways to be able to do that to produce revenue into - well it wouldn't produce revenue but we could actually spend into the principal at this time. Is that correct?

MR. STORER: If you - on the current, you can take income - if realized income is available you can distribute that. So if you had realized income and then unrealized losses, you could pay out and then the value of the fund would be below principal, as an example.

CHAIR SEEKINS: What do we do with rents and royalties? Where do we classify those?

MR. STORER: Those are realized income.

CHAIR SEEKINS: So we could be losing in the market and not sell it because that's unrealized losses.

MR. STORER: That is correct.

CHAIR SEEKINS: And be bringing in rents and royalties that we call realized income and that goes to distribution even though we're losing our shirt in the markets?

MR. STORER: Under the current system that's correct, Mr. Chairman. And the other question in all of this is, under the current system is would inflation proofing continue or not. It always has in the past through the statutory process.

CHAIR SEEKINS: I always ask the question on that - if I was looking at my own family, you know, the question I ask is would I inflation proof it if I couldn't feed my kids? Easy decision but if I look at this then, if I understand my math was wrong as I look at it, \$27 billion market fund - market value, \$22.5 [billion] principal - that's \$4.5 billion between principal and market value. If we were taking 5 percent of that market value now, it would take us three years to get down to principal?

MR. STORER: If we didn't earn anything.

CHAIR SEEKINS: If we didn't earn anything, so there's a cushion that's there and I don't think a lot of people in the state understand that that cushion exists because they only think in terms of the market value, not the principal value.

MR. STORER: At one time, Mr. Chair, 25 percent of the fund was either realized income or unrealized gains, in about 1999, early 2000.

CHAIR SEEKINS: Okay. Senator French?

SENATOR FRENCH: But my understanding is when you enact the POMV, you eradicate that difference. As soon as you enact POMV, you stop thinking about principal and earnings. You make one big pot of money, and it's going to be about \$27 billion and from that day forward, Alaskans are going to regard that as their permanent fund and they're not going to differentiate between what it's earned and what it hasn't earned. And I think from that day forward, we're going to have to give them some reasonable and, I think, explicit promise of inflation proofing. If these models hold true, then for us to write inflation proofing in the Constitution is no risk at all to the fiscal

stability of the state. But, if I can finish, I have concerns about whether this model is going to hold true over the long run. We haven't seen a crushing period of inflation for some time now, not since the late '70s and early '80s. The first president I ever voted for was Jimmy Carter. Then I moved to Alaska and found out what a bad idea that was from many Alaskans' point of view. And during that time period, there was terrible, terrible inflation and I think, given the federal deficits that are being run up here in this country, the largest ever in the history of the nation, sooner or later the bond market is going to have to react to that and I think interest rates are going to have to go up. And so I'm just concerned that unless we put some positive guarantee of inflation proofing on paper - because in your system, inflation proofing is implicit and I'd like to make it explicit. I guess that's my chief concern.

MR. STORER: Mr. Chair, first off I've looked at a lot of scenarios and the worst case scenario, in either case I believe, is, I'll call it hyper-inflation. We can handle rising inflation to some degree but if we revisit the '70s - the '70s, like the Depression, were the two very singular events. Can they happen again? Of course they can happen. That's the worst-case scenario under either scenario. It seems to be, well, if it happens, it's not in the foreseeable future. But the one thing I want - a couple of elected officials have asked me to provide statutory guidance, statutory insight that essentially addresses precisely what you're talking about - about memorializing the guidance by statute.

CHAIR SEEKINS: And I understand that. In fact, I would support that. Go ahead, Senator Therriault.

SENATOR THERRIAULT: If we got into a situation like the '70s with staggering inflation, under the current system we have a big problem too.

MR. STORER: That's the worst-case scenario, there's no question about it. For a long time I've run models just trying to find what is the worst-case scenario. It gets postponed for a few years but you would have a big issue in terms of maintaining purchasing power and, at least historically, you would see low returns in bonds and equities during that period as well.

SENATOR THERRIAULT: So the current system has not only the instability of the dividend roller coaster, but it's more

susceptible to hyperinflation and the erosion that would accrue to the fund?

MR. STORER: I believe it is. I believe it is because of that line that it is principal that you cannot go below and there would be - the question was - it becomes would inflation proofing be abandoned in that scenario? I personally find it hard to believe it would not be because the only way you could access income, or the first line would be to abandon inflation proofing so you're no longer maintaining your purchasing power anyway.

SENATOR THERRIAULT: Mr. Chairman, it is true, as far as the wording here, Section 3 is a one time deposit of \$4.5 billion that the legislature would be putting before the people and the people would vote on [whether] that \$4.5 billion deposit from the earnings reserve would go into the principal, establishing a new level for principal. So I just wanted to clarify that. But, with regards to the 5 percent draw, the language says you may take up to - it may not exceed 5 percent. It doesn't say thou shalt take 5 percent each year. And, in fact, because you've got 4 or 5-year averaging, you are actually drawing off less than 5 percent. It's more like 4.75 or 4.8. Is that correct? Because you've got a growing fund - you've got new resources that are going in, you've got inflation proofing going in, so when you take the 5-year average of a growing fund, it's actually less than 5 percent of that year's market value.

MR. STORER: Through the chair, that's absolutely correct. If you look at the snapshot of the payout versus the ending value of the fund, it looks more like around 4 and three-quarters percent.

SENATOR THERRIAULT: So we look back on the history. The 10-year history shows that from a 10-year look back that we could have paid the 5 percent and if we want additional protection, we can consider statutory language or if somebody wants to propose or come up with a way sensibly to put it into the Constitution, you could have language that says if you get into a situation where you're going to dip down below that line, then you put the brakes on and your allowable draw is even less.

CHAIR SEEKINS: I think it's very easy for us - I always - what I hear now - people say is well, it could erode the principal, we could be dipping into the principal and that's why I wanted to make it very clear that there's a \$4.5 billion buffer from where the fund is now until we get to the principal. So that, in my

mind, kind of satisfies that argument. And secondly, you know, I'm concerned about the faults of the current system where our growing fund causes us to overspend. We can exceed that 5 percent if we wanted to in overspending and how we do it, including inflation proofing - inflation proofing appreciating assets, which sometimes doesn't make that much sense to me unless somebody else is willing to do it for me, but, when I look at the current method, and if I try to characterize - let me ask you a question. How many investment funds and investment managers are just looking ... [END OF SIDE A].

**TAPE 04-4, SIDE B**

CHAIR SEEKINS: ... current method of handling endowment funds?

MR. STORER: Mr. Chair, the answer is not many because there are already - rushing to our methodology?

CHAIR SEEKINS: Yes, our current methodology.

MR. STORER: 85 percent of the endowments, the universities use some variant of what we're proposing. I'm not sure that I'm aware of any entity that still lives off the concept of realized income. Even accounting standards changed in the mid-'90s to recognize that appreciation is income as well.

CHAIR SEEKINS: So we're not thinking up something new and a lot of other financial minds have said how can we best preserve our endowment without, you know, over the long term eroding it to nothing? And a percent of market value methodology is what they have found to be the best way to do that. Am I correct?

MR. STORER: That is correct and there's many examples in Alaska that have adopted the percentage of market value payout as well.

CHAIR SEEKINS: For example?

MR. STORER: For example Anchorage. I was just talking to Senator Stedman - Sitka. I know the University of Alaska at Fairbanks - the foundation for years in Alaska has that methodology.

CHAIR SEEKINS: The City of Fairbanks.

MR. STORER: The City of Fairbanks has one. Bob Bartholomew in our office, the chief operating officer, was just in Barrow and he said that they've adopted the POMV as well. I'm not sure whether Valdez has or not.

CHAIR SEEKINS: Okay. Senator Therriault?

SENATOR THERRIAULT: Bob, you're a fiduciary for the permanent fund so you understand the fiduciary duty or obligation. Do you think it would be fair to characterize that if we had POMV, and you proposed to go to our current system, would you be subjecting yourself to possible litigation for breaking your fiduciary obligation - taking us to a system that is more subject to the ups and downs of the markets and more subject to the dangers of high inflation?

MR. STORER: I'm sorry - if we?

CHAIR SEEKINS: If we...

SENATOR THERRIAULT: The POMV.

CHAIR SEEKINS: If we had the POMV.

SENATOR THERRIAULT: And you were proposing that we go to the system that we have currently, which is more of a roller coaster and more subject to inflation, would you possibly be setting yourself up for a claim that you have broken your fiduciary obligation?

MR. STORER: One of the keys in a fiduciary is showing a process to make an informed decision. So if I was trying to convert us back, I would - within that obligation would be to show you a process that why - to give you an informed decision and I don't think I would be breaking my fiduciary responsibility. I think it would be a real challenge though, to convert from a POMV to realized income when you realize there's so many complexities in terms of our equity portfolio structure and the appreciation of those assets.

CHAIR SEEKINS: If I could reword that just a little bit then - would recommending that someone go from a percentage of market value process, similar to one that's been recommended, to the current realized income, would it be in compliance with reasonable person responsibilities? I mean you...

MR. STORER: It would be a challenge.

CHAIR SEEKINS: It would be a challenge. I'll leave it at that.

MR. STORER: But it would be - as I noted earlier, it would be inconsistent with current accounting standards. So, one of the challenges would be to say if current accounting standards recognize appreciation of the assets as earnings, then why are you saying that that doesn't matter and only realized income matters? That would be a challenge.

CHAIR SEEKINS: So if we divorce ourselves, if we separate how any distribution would be used from the process, the process is the one that's most currently adopted by major endowments, financial advisors across the nation if not the world.

MR. STORER: True, Mr. Chair. The permanent fund is about 27 years old now and if you look at our statutes - distribution, inflation proofing, they're 27 years old. We've [indisc.] additions to try and meet contemporary investment standards in there but they're 27 years old. Our realized income statutes made sense back then. I think you've all seen a slide that shows how our asset allocation has changed. I think our objective is to create a permanent fund that can meet the needs of the legislature, the citizens of Alaska, and also address contemporary investment management issues and that's what we're trying to do.

CHAIR SEEKINS: Senator French?

SENATOR FRENCH: Thank you. Call me hard headed but I'm really stuck on the inflation proofing issue and I think this chart makes my point as well as it makes yours. I'm not against modernizing the way the fund is handled, but if this model holds true, you can write into the Constitution, you must inflation proof the fund before distributing earnings and as long as you are, you know, over the last five years you would have beaten 5 percent - oh, I'm sorry - back to 1994, to the beginning of this chart, you would have beaten 5 percent every single one of those 10-year rolling averages and so you'd have exactly what you want, which is a predictable payout, and exactly what I want, which is concrete inflation proofing. Am I misunderstanding this chart?

MR. STORER: No. That chart - there'll be some point where that chart will go below the 5 percent.

SENATOR FRENCH: Sooner or later in time.

MR. STORER: Yes.

SENATOR FRENCH: It just happens.

MR. STORER: Yes. It will happen. And, if I arrived here in May of '83 and we were having this conversation, you would say Storer, you're crazy, you can't achieve it, so that's an example and all of that. The question for all of you in regards to that in my mind is predictability and stability versus that piece then, which would eliminate some of the predictability or stability of payout, wherever it goes. That's there in the discussion point. And whether - how one wants to have that decision, either have that decision taken away, have that decision by statute, or address it every year, etcetera, that's the debate. What we're proposing gives greater predictability, greater stability to the payout over time, but the potential exists that at some time you could go below what we now call principal. The other side of the coin, the benefit, is you're not going to overspend in the good years. So, in a perfect world, if it happens in this environment, you've got the cushion to where you never have to go there.

CHAIR SEEKINS: I think, as a way of comment, I think inflation proofing is important but, as I said earlier, it's not a hard decision for me - if I was going to inflation proof my if I couldn't feed my kids. I think the legislature deserves to have that kind of flexibility if we get into that kind of a situation. The state's going bankrupt and our Constitution says we must inflation proof our fund. I don't think that that's good fiduciary responsibility for the legislature to even think about that and so, in many respects, when I look, Mr. Storer, at how we inflation proof now, we're inflation proofing appreciating assets, which in many schools of thought would not be something that most people would do. Am I again fairly close to correct on that?

MR. STORER: Mr. Chair, to use the POMV you don't need to inflation proof it because you are investing in inflation proofing assets so it occurs. The problem we have is those inflation proofing assets, such as equities, can be converted into profits and then those profits can be distributed and so POMV actually does memorialize inflation proofing - the appreciation as well. The current statutes do not guarantee inflation proofing. You still have the same debate either way, which is inflation proof or make a payment.

CHAIR SEEKINS: In your estimation, for the coming fiscal year, what would inflation proofing be in total dollars?

MR. STORER: I'm going to say about 575 - I don't think it's 600 million. Inflation is a bit over 2 percent right now and the fund is such - I guess more like 500 million.

CHAIR SEEKINS: So \$500 million that we'll put into inflation proofing, regardless of what other needs the state has.

MR. STORER: Correct.

CHAIR SEEKINS: Thank you. Senator Therriault?

SENATOR THERRIAULT: Thank you. At looking at this chart I think - something that this chart also points out that - in addition to the inflation proofing we have - the legislature has continued to put excess money into the permanent fund and that's basically what the hills - the peaks are here is the retention in the fund of excess dollars above and beyond the 25 percent contribution every year above and beyond inflation. If you look back over the years, of course, we've dumped in billions and billions of dollars in just additional cash deposits too. So the allowance over a long period of time, you know, coming close to this line or slightly dipping below and then going back up, you made your extra deposits, you retained the extra value here to protect yourself against that and, you know, in addition, we could put something on the books that would limit the draw, you know put some dampers on the draw in any period that you did get below.

MR. STORER: That is correct and also the legislature, if this were the February 2000 and 25 percent of the fund was profits, the legislature displayed the discipline that we're asking for and did not overspend, did not exceed the 5 percent and that gave us the cushion to work through a very severe bear market - a 3-year bear market to where we were able to make the distributions, we were able to inflation proof. Why? Because that discipline was there, both in the special appropriations to the fund and not taking more of the earnings than is necessary, reasonable.

CHAIR SEEKINS: Senator Therriault, go ahead.

SENATOR THERRIAULT: Thank you Mr. Chairman. So with the current situation, if you are concerned about the legislature eroding the value of the fund, and we're getting into a tight revenue scenario and more and more pressure to come up with money, with that \$4.5 billion sitting out there that can be realized, that should be weighing on your mind I would think.

MR. STORER: It's available for consideration.

CHAIR SEEKINS: Mr. Storer, conceivably the legislature could establish - to answer the question, the concern about eating into the principal of the fund, which has been dedicated there and I think is defined legally - am I correct there - what the principal is?

MR. STORER: It is.

CHAIR SEEKINS: So there's a legal definition of what we consider the principal of the fund.

MR. STORER: Um-huh.

CHAIR SEEKINS: If we were to say okay, as a legislature, we could take that principal fund as of the end of the last fiscal year, we could deposit into it the royalty income that we get in from oil and natural resources. And, in addition to that, we could theoretically take an average inflation proofing over the last two or three or four - we do 2 years now, don't we?

MR. STORER: We take 1 year, Mr. Chair, but it's the rate of change between the 2 years.

CHAIR SEEKINS: We could add an inflation proofing number and establish a statutory principal number, which the legislature could use and say you can't spend below this line and still keep track of what the principal of the fund is after inflation proofing and compare that to the market value to be able to see whether or not we really are, through disbursement of the market value, eating into the principal of the fund and use that as legislative guidance.

MR. STORER: There's any number of pieces like that - using a 10-year rolling average, a 5-year RIT (ph), redefining principal in the statutes, recognizing the impact of inflation on - principal is a notational number. It's a recordkeeping number. It has nothing to do with how we manage the money so you can convert that recordkeeping number by statute. My Director of Finance, [indisc.] but that's okay, because it's one more thing to keep track of. But that's another way of doing it and then you'd have to change the statutes or address it through statutory change.

CHAIR SEEKINS: And by doing that we could provide some indication of the fiscal responsibility of the legislature to the people of the state of Alaska as we go forward.

MR. STORER: It would be a more rigorous process if that occurs.

CHAIR SEEKINS: Okay. Other questions? Hearing none, I want to thank you very much, Mr. Storer, for coming to talk with us today and we will move next - I think we're going to give the full committee the opportunity to take a look and we'll address this when everyone can be here - Senator Ellis, Senator Ogan as well. So we'll move on from SJR 18 and set it aside and go to [SJR] 19 and I see representatives here. We've got Representative Croft, welcome to the committee, and representing Senator Lincoln, if you gentlemen will put yourselves on the record, welcome to the committee and we're eager to hear your testimony.

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^#SJR 19

[The following is a verbatim transcript.]

**SJR 19-CONST. AM: PERMANENT FUND INCOME**

MR. MARK STOPHA: Good morning. For the record, my name's Mark Stoph, staff for Senator Georgiana Lincoln. She's not able to be here today. She's attending a funeral for Chief John in Copper Center and for approval of the committee chair, Representative Croft will present SJR 19 and answer any questions.

REPRESENTATIVE ERIC CROFT: And this is Representative Eric Croft from Spenard and I'm the author of the House companion of this measure, so Senator Lincoln asked me to be here to answer any questions. I've learned enough from observing the Senate over the last 8 years that sometimes the Senate wants to act and sometimes it wants to talk and I'll do whichever the Chairman wants this morning.

CHAIR SEEKINS: Mr. Croft, why don't you do what you think is best for your position at the moment and we'll hear and then we'll ask questions.

REPRESENTATIVE CROFT: Okay. The bill before you, SJR 19, protects the permanent fund dividend. It protects the inflation proofing of the fund and it provides that the earnings may not be used. It's hard to talk about this in a vacuum and

particularly in light of the discussion we've just had about percent of market value. We introduced it - the House bill over on my side and Senator Lincoln, the Senate bill, as an effort to reassure Alaskans that their dividend would always be there, and, in particular that the current fiscal structure - the current dividend structure that reflects the market performance of the fund in the dividend, we thought then and continue to think is appropriate. In addition, I think inflation proofing, and possibly we just disagree Mr. Chairman, is the most important aspect of the fund, that it provides that my children have the same buying power of the fund, have the same choices available to them that we have today. To inflation proof at less than the actual rate of inflation I believe steals from my children those very choices. I want this debate to be happening 10 years and 50 years from now on what's the proper use for the permanent fund earnings and have them have that same debate with the same effective real buying power. So, possibly we're at a situation of sort of core fundamental disagreement. This would protect a structure that has served well to provide dividends for Alaskan citizens and protect an inflation proofing that protects the actual real value of the fund and protects it by inflation proofing at the real observed actual inflation rate, not a rate we can assume.

Percent of market value, while it has certain aspects that are in its favor, certain aspects that are positive, assumes that we can guess what is going to happen over the next 100 years, assumes from the last 100 years of market performance and inflation performance, that over the average it has been 3 percent inflation over the last long extended period of time. And over that same period of time, the market has been able to perform at about 8 percent, that therefore we can, over the next 100 years, take the difference, take 5 percent. I don't know that. I think if I knew what the market performance would be over the next 100 years and knew what inflation would be over the next 100 years, that I'd be making a lot more money than I am today. I think there are a lot of people who, if I could say I know absolutely what that will be, who'd be very interested in that number. We don't know. We're talking about a period of time that was the Dow Jones Industrial Average where it was largely an American phenomenon in a pre-industrial and industrial setting. I don't know what a global DOW - as the stock markets, ours and the worlds, become more global as the economy becomes more global and becomes more high technology, I don't know whether those 8 percent returns are going to continue to exist - be lower or higher. I don't want to bet the real earning power of the fund on that experience. I don't think we know enough to

do that. I'm much more comfortable inflation proofing every year by the actual inflation that we saw. Mr. Storer, when he was up, talked about we hope we don't see the '70s again. I hope we don't either but if we take - I mean if we're going to take the percent of market value construction, that we can look back over the last 100, 80, 50 years, and say that is going to repeat itself, then we have to assume that things like the Great Depression and the '70s recession are going to happen. And when those things do happen, and you have 8 or 10 percent inflation, you continue under percent of market value to pretend that inflation was 3 percent. We have had those periods before. I think we have to assume that we will again and under a percent of market value formulation, we would be eating into the principal.

I listened to the discussion up here. I looked at yesterday the earnings reserve balance of the permanent fund. It's around \$900 million. The great \$4.5 billion you're talking about is in unrealized gains. According to the most recent AG opinion from Attorney General Renkes, that should be put into the principal. I'm not sure whether that's the right legal opinion but it is the legal opinion that the permanent fund is operating on.

CHAIR SEEKINS: I don't agree with your interpretation but we'll put it on the record for you.

REPRESENTATIVE CROFT: Okay. Individuals, I guess, can disagree on that. I've read that opinion a number of times. I disagree with whether the opinion is right legally but I believe that's what it says.

CHAIR SEEKINS: I think it's counted into principal but it doesn't require that it be deposited into principal. I mean it's counted in terms of the calculation, that's how I would portray it.

REPRESENTATIVE CROFT: You might have a brilliant career forward in the legal profession, Mr. Chairman, because that distinction evades even me.

CHAIR SEEKINS: Well, I can understand how. Please, I'm being facetious, just having some fun there.

REPRESENTATIVE CROFT: The fundamental aspect of the percent of market value that disturbs me is that presupposing what we know what inflation will be and pretending that it's that and, frankly, the portion, and you've referred to it in some of the

testimony before, that deletes the word 'principal' from our Constitution. We put it in there in the '70s. We're going to take it out. I think it would be better and a sounder fiscal policy to start by reassuring people that their dividend won't be touched, reassuring people that real inflation proofing, inflation proofing at the rate that actually occurred, will happen and that's what the bill before you does. I can see that the....

CHAIR SEEKINS: Senator Therriault has a question and if you don't object, as we go along, we like to ask questions while they're fresh in the minds of our members. Senator Therriault.

SENATOR THERRIAULT: I don't think you can guarantee those two things that you just said you want to guarantee. I believe that I tend to agree probably more - fall on the side of the spectrum with - that you're on, as far as the importance of inflation proofing. But we've just heard from Mr. Storer that we can have a situation in a down equity market but continue real estate earnings that come in that have to be paid out as a dividend that could in fact erode the principal of the permanent fund if we didn't have that buffer that we talked about. So you're desiring to have absolutely guaranteed two things that under the current situation, I don't think you can.

CHAIR SEEKINS: Please go right ahead.

REPRESENTATIVE CROFT: I listened to the entire testimony for that reason. What Mr. Storer said was that you could reach a situation where you couldn't pay out dividends and you couldn't inflation proof because you'd gotten to the bottom of the barrel. At that point, and because of market performance after that, you could have a book value of less than principal - it could be negative for a while. All that is true and what you do in that situation is you stop spending. That's the appropriate response when you've hit the bottom of your savings account and that's not what happens in percent of market value - you keep spending, in fact you keep spending at 5 percent assuming that things are happening that are not happening in the real world.

CHAIR SEEKINS: You mean the bottom of your savings account or this line below, which you should not participate. The bottom of the savings account means it's all gone to me. How did you mean that?

REPRESENTATIVE CROFT: The bottom of the checking account and maybe you still have savings that you declared you're not going to get into yet.

SENATOR THERRIAULT: It seems to me if you get down to a poor market situation, in fact we almost got to a point where we didn't have money to pay a dividend within the last year and there were bills that were introduced to pay it out of the regular state treasury because it got so close. But I think that one of the things that Mr. Storer was alluding to is you still would have real estate earnings coming in so you have income that goes into the calculation of your dividend but you have no money. The first money to go is the inflation proofing. The very thing that you said should be paramount. I agree if the permanent fund is the mechanism is to be a mechanism of taking a one-time revenue stream and making it truly multi-generational, you should put inflation proofing as your number one goal. It should be paramount to everything else but with what you're proposing here when you get into a bad situation, the first thing to go is the inflation proofing.

REPRESENTATIVE CROFT: This constitutional amendment protects inflation proofing and....

SENATOR THERRIAULT: I don't see inflation proofing in here.

REPRESENTATIVE CROFT: The statutes that we put into the Constitution that we say - AS 37.13.140, .145, and 23.025 - 13.145 is the inflation proofing statute and then when we add Section 2 that says that you can't amend them as they were effective on 2002, that says dividend....

SENATOR THERRIAULT: What happens when we get into a situation where we don't have the money under the current system to pay them both. Which one gets paid?

REPRESENTATIVE CROFT: What you should do when you reach the end of your principal and you get down - and principal just means a number below which we don't want to fall, below which we want to stop doing business as usual, and in this system you do stop. I mean I can't protect....

CHAIR SEEKINS: In which system - the 19?

REPRESENTATIVE CROFT: The current system protected constitutionally as SJR 19 would do. I can't guarantee you market performance that will always allow us a dividend and

inflation proofing. Nobody can. I can, though, write a system that says we will do that each year and when we hit the principal number that we don't want to fall below, we've got to stop. You have no question in my opinion, and you wait for the markets to rebound. And then when you do, you pay those back. You start paying dividends again and you pay back the inflation at the real amount. Percent of market value would continue through that entire time, pretending we could pay out 5 percent, eroding principal and continuing to operate as though there was something normal about that.

CHAIR SEEKINS: Percent of market value does not mandate a 5 percent payout. It limits it to 5 percent based on the fiscal responsibility of the legislature. Senator Therriault?

SENATOR THERRIAULT: Thank you Mr. Chairman and I think language can be, as we discussed earlier, developed that would prevent that from happening. But you say we've got the current dividend payout system and we've got inflation proofing. When money gets tight, which one gets paid? Is it prorated between the two? If you only got enough money to pay a portion, which one gets paid - inflation proofing or a dividend under this language? Which one takes precedent?

REPRESENTATIVE CROFT: Right. Under the current structure and under the structure we incorporate here in SJR 19, if you get down to that point, you keep dividends. It's a calculation that you and I have been through.

SENATOR THERRIAULT: Right - you keep dividends. So inflation proofing, the very thing that you said to be paramount, is now secondary.

REPRESENTATIVE CROFT: It's secondary to dividends and superior to everything else.

SENATOR THERRIAULT: It's secondary to dividends and, for myself, that's a problem. Another question. In addition, Section 2 on page 2, lines 5 through 8, you talk about an allowance for an appropriation, above and beyond B and C sections, that I guess would just be a majority vote of the legislature and then ratification of the state voters and that would come out of the earnings reserve. So you are allowing for spending here in addition to the dividends and the inflation proofing.

REPRESENTATIVE CROFT: Well, through the chair, Senator Therriault, we saw that as a protection. Of course they could

spend now but this would require that the people approve any spending out of the earnings reserve.

SENATOR THERRIAULT: The people that year. So with pressure on the budget, and the public demand for dividends, where do you think the dollars are going to go? Is it going to go to inflation proofing?

REPRESENTATIVE CROFT: Well, and that became the final sort of point in the discussion here before, the idea that we, the people or we, the legislature, would fail in our commitment on inflation proofing. I happen to think inflation proofing is very popular publicly and I think it should be. I hope it still is in this legislature. I think keeping the earning power for our future generations will win politically but the provision you're talking about doesn't have to do with either. It has to do with putting another protection against getting into the earnings reserve and that government use of the earnings reserve is, in the long run, as big a threat to inflation proofing as dividends as the market - government getting in and taking substantial amounts of the earnings reserve is what drives you to the very situations you were talking about, of having no money and how do we choose between dividend and inflation proofing. We wanted to set one more protection to make sure that earnings reserve stayed healthy and it wasn't used for government. If the people say that they want to, that's their choice but we not do it ourselves.

CHAIR SEEKINS: Go ahead, Senator Therriault.

SENATOR THERRIAULT: Mr. Chairman, this mechanism by just enshrining the statutes, which we've also had testimony that says we're 27 years down the track. We've changed our investment strategy and now we're trying to freeze these statutes that haven't kept pace with the means by which we generate revenue. It just seems that to suggest that this is a better way, when clearly you get into a situation where you don't have enough money so you're going to have to pick between dividends and inflation proofing, you could have an appropriation because of budgetary pressure that could also take precedence over inflation proofing, leaving nothing for inflation proofing. I think with a segment of the state population, the inflation proofing is very important, but we've also got a transient section of the state population that carrying forward the purchasing value for the next generation, they don't care a bit. I've heard from - I have one constituent that I just had to agree to disagree with and he said you know nobody looked out

for my generation so let the next generation look out for themselves. I completely disagree with that and I think that truly we should go toward something that really does guarantee that we preserve the purchasing power. And although POMV might not be 100 percent, it sure seems like it's a whole lot better than what we've currently got.

CHAIR SEEKINS: And we'll go to Senator French next but purchasing power that doesn't meet needs is useless.

REPRESENTATIVE CROFT: Doesn't meet? Sorry Mr. Chairman?

CHAIR SEEKINS: Purchasing power that doesn't meet any need is useless. What are we trying to preserve purchasing power for future generations if we can't feed our kids today and that's where you and I probably basically philosophically disagree. I'd feed my kids before I'd inflation proof my savings account. So that's not a hard decision for me in that case. When I look at projected shortfalls in general fund versus expenditures, you know, we're shooting for a number around \$400 million and we're going to put \$500 million first into inflation proofing. How do people want to spend their money? Do they want to spend it to inflation proof and then we tax them and take it away from them? There are a lot of questions there that become very debatable when the reality hits the pocketbook and so I'm not so sure how people would react. I know how my wife would react if I said baby, we're going to put the money in our savings account and you don't have anything to go buy groceries to feed the kids and grandkids. There'd be a revolution in the house. So, sometimes the legislature has to live up to its fiscal responsibility without undue restraint and I think they've got a good track record of doing that. I haven't been here as long as you, but the track record has been good. It's been admirable and I think to some respect anything that we do that unduly limits the ability for the legislature to act in a fiscally responsible manner in the face of uncertainties, as you mentioned are surely going to come, puts us in a position where if we don't know, why do we want to eliminate the ability for the legislature to respond appropriately? That's where I get into problems. Senator French?

9:37 a.m.

SENATOR FRENCH: I think one of the remarkable things about the current set of statutes is the degree to which the public kind of gets how the system works. When the dividend went from \$1,900 just a few years ago down to \$1,000 this year, none of my

constituents were squealing about, you know, some kind of terrible inequity in the system. They understood that it was just a down market year and I think that's one of the difficulties with POMV that proponents haven't quite come to grips with that somehow POMV implies stability, that you will have this money paid out every year irrespective of the market's performance and yet there's sort of that little language that says you can go up to 5 percent as if there were going to be years when we wouldn't do that.

CHAIR SEEKINS: Well we did that in 1996, Senator French.

SENATOR FRENCH: I was almost finished.

CHAIR SEEKINS: Go ahead.

SENATOR FRENCH: So I guess the point I was trying to make was that there's some real good value in maintaining something very much like the current statutes because of the degree to which the public understands that sometimes there [are] going to be years when you just don't get a dividend because the market just didn't provide one. So I think that's - I just think that's worthy of making note of.

CHAIR SEEKINS: I have no problem with that but we did - in our current system, we did, I would call it, hyper-inflate the dividend in 1996. The decision was made by the Board of Trustees that the current generation should, this was the rationale, the current generation needed to get more from the permanent fund than it was getting through the regular distribution system, the dividend system. So, investment management companies were told to go sell stocks to bring in realized income to be able to put more cash into the dividend for the current generation. Now whether that was the real reason or not is debatable, but that was the rationale that was used. It was done. We had additional income that came in that peaked and then went right back in terms of realized income and so, sometimes, it isn't just market variability that affects the dividend under the current system, Senator French, it's also political variability. Senator Therriault?

SENATOR THERRIAULT: Mr. Chairman, I need to disagree with earlier comments here about people understanding the current system and the value of that. Certainly last year when there was the real potential that there would be no dividend, there was enough of a concern in this building of, number one, the shock to the citizen, the shock to the economy that there were

proposals to pay it out of the general state treasury. So I don't think the general public has any level of understanding that really, in the current system, that there's the chance that there is a zero dividend year. And certainly for those of us that know the potential impact to the state treasury, that's not something that we would invite so I'm not going to - I guess I can't agree with that line of thinking when there are other alternatives that make sure that that stream of cash that goes out into the Alaska economy is smooth and you get the by-product of guaranteeing that inflation proofing of some degree is made automatically independent of action of the legislature. I don't think that the general public understands that they can get a zero dividend year in the current system.

CHAIR SEEKINS: Right. I think that's true, too. When I was on the Board of Trustees it didn't take me very long to figure out that the Board of Trustees can play God with the permanent fund and what the dividend's going to be. And in a year where the earnings reserve was very low and you're faced with the possibility of not having the cash to inflation proof or pay a dividend, there will certainly be a tremendous amount of political pressure to maybe pick some fruit that isn't quite ripe yet in order to get the cash from realized earnings to put into the earnings reserve account when a more disciplined investment strategy would say it's not time to pick this fruit yet but we need the money. So, you know, I can see how the current system lends itself to all kinds of abuse. Senator Therriault?

SENATOR THERRIAULT: The section, for either one of the gentlemen, that allows for an appropriation for other than inflation proofing and dividends - was that language specifically left or put in here so that you could answer the legal question of whether you've still got a public purpose?

REPRESENTATIVE CROFT: Through the Chair, Senator Therriault, no, my purpose for putting it in, and I believe Senator Lincoln's was to provide another check on government getting into the earnings reserve. I think that the legal matter of whether we're a tax free status has been at least in my mind fairly well settled. The recent opinion by Attorney General Renkes that constitutionally protecting the dividend didn't threaten the tax-exempt status of the fund - in effect, if it was a public purpose when you did it statutorily, it's a public purpose when you do it constitutionally. And a lot of the case law that has come down over the last five years that buttresses that agreement or that understanding, particularly in the areas of

educational trusts, where private money comes in and the state holds it and gives it out to go to the state university, those sorts of cases have really taken that from what was a question mark and a worry for a long time - nothing is certain in life but much more of a certainty that that's not a serious question.

SENATOR THERRIAULT: Okay, well I just know from the debate over the years, it seems like if you can still point to something where there is a general public access, you have some protection from the federal court because they can say well, you're not using the money for that purpose right now but there's that possibility so it gives you a little bit of extra protection so I just wondered if that was part of the reason that you put that in there because you've got this whole Section 3 here that talks about oops, if there's an adverse tax consequence, we want this whole thing to go away. So you must feel like there is some possibility of that, otherwise you wouldn't have Section 3.

REPRESENTATIVE CROFT: True enough. And through the Chair, Senator Therriault, the House version we took it out over the last couple of months, after those opinions came down. When I talked to Senator Lincoln about it, she said that that would be a perfect question for the Judiciary Committee and up to you guys to decide. I do think the case law has come down much cleaner on the point that it is not needed. If the Judiciary Committee felt like that was their opinion, they could take it out. If they still wanted the protection, they could leave it in.

SENATOR THERRIAULT: Do you yourself think that would be prudent? I mean with the uncertainty of getting a tax ruling out of the federal courts and then us being stuck with language in the Constitution and we know it's a high hurdle to change it, would it be prudent not - to go without this protection?

REPRESENTATIVE CROFT: I was convinced enough that in my version of the bill I was comfortable pulling it out but it is a low risk, but a risk, and I really do feel like you guys can decide. As for me, after reading and re-reading the cases, not just the memo that was sent to Attorney General Renkes, but the underlying cases, I felt very confident that it was a public purpose and would not be taxable. But, we had it in there to fit your comfort level.

SENATOR THERRIAULT: Thank you.

CHAIR SEEKINS: Other questions? Senator French, did you have anything? Senator Therriault? Thank you gentlemen, if you'll stand by I do have one person who has indicated on-line that he'd like to testify and, if you don't mind, if you can just hang tough where you are so we can go into this. Is Mr. Gay - Roger Gay, at the Mat-Su LIO - Mr. Gay, are you on-line? Do we have him on-line still?

MR. ROGER GAY: Hello. Can you hear me?

CHAIR SEEKINS: Please, if you'll identify yourself for the record? Welcome to the Judiciary Committee and please proceed with your testimony.

MR. GAY: My name is Roger Gay. I live in Big Lake and I'd like to say a little something about inflation proofing. In my opinion, inflation proofing does not protect the value of the fund. It merely subjects more money to the ravages of inflation. Inflation is the result of the devaluation of our money. Every year our money is worth less, and that is why the price of goods goes up. A loaf of bread is a loaf of bread. A gallon of gas is a gallon of gas. We can make bread and gas cheaper now than at any point in history. Only the money has become less valuable. Because of the Federal Reserve System and the way our money is handled, our money has no intrinsic value. When you have a huge permanent fund being subjected to I don't know how much of a loss due to inflation, if you take that amount and dump it back into the fund, that amount then becomes subject to inflation. I'm not suggesting that we spend everything today at today's prices, which would be the best way to get the full value of our money. But the idea of taking money that has been hit by inflation and fooling yourselves into thinking that you can protect it by dumping more money into it to be ravaged by inflation just doesn't make sense. You know we're losing a lot of money to inflation because our money is not stable and if you want to inflation proof, you have to work at stabilizing the value of our money.

CHAIR SEEKINS: Senator Therriault?

SENATOR THERRIULT: I understand your point. However, to stabilize the value of our money is a national economic issue that I don't know that the State of Alaska has the power to control. But if that's a given, then that's something that's largely outside of our individual legislative control. [END OF TAPE.]

**TAPE 04-5, SIDE A**

SENATOR THERRIAULT: So should we not do that?

MR. GAY: You're not having any effect on inflation by taking more money out of the hands of whoever, whether it's the state or the people. You're not having any affect whatsoever on inflation by throwing more money into the fund under the name of inflation proofing. Inflation proofing is an oxymoron.

SENATOR THERRIAULT: Thank you.

CHAIR SEEKINS: Other questions? Seeing none, thank you Mr. Gay for being with us this morning and providing your testimony. Is anyone else on line that wishes to testify this morning? No one else? Anyone in the audience that wishes to testify on this matter this morning?

MR. GAY: I have a friend of mine that would like to make a brief comment and his name is Gary Hanthorn.

CHAIR SEEKINS: Is Gary there?

MR. GAY: Yes he is and he has a mental disability but he'd like to say a short word.

CHAIR SEEKINS: If he'll identify himself for the record, we'll be pleased to take his testimony and Mr. Hanthorn, welcome to the Judiciary Committee.

MR. HANTHORN: I'm Gary. Could you leave my permanent fund alone? It's mine.

CHAIR SEEKINS: Thank you very much, Gary. Any questions?

MR. HANTHORN: Could you tell Mr. Kohring to give me a letter because [indisc.] and he's supposed to get back to me for something about my permanent fund being left alone.

CHAIR SEEKINS: Well we can't answer for Mr. Kohring here, but you're certainly welcome to call his office. They have the number there in the LIO and I would encourage you to do that.

MR. HANTHORN: Thank you.

CHAIR SEEKINS: Thank you for testifying this morning. With that, hearing no one wishing to testify, we're going to close public

testimony on SJR 19. Are there any discussion points with members of the committee? None? Seeing none, we'll hold this over for a time when the entire committee can be here for discussion. I want to thank you gentlemen for being with us this morning. We appreciate your testimony and the lively discussion and look forward to getting in this in the next - sometime soon. With that, we have no other business before the Judiciary Committee this morning and so we'll adjourn the Judiciary Committee at this time [9:51 a.m.].

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