

**MINUTES**  
**SENATE FINANCE COMMITTEE**  
**March 3, 2006**  
**9:06 a.m.**

**CALL TO ORDER**

Co-Chair Lyda Green convened the meeting at approximately [9:06:05 AM](#).

**PRESENT**

Senator Lyda Green, Co-Chair  
Senator Gary Wilken, Co-Chair  
Senator Fred Dyson  
Senator Bert Stedman  
Senator Lyman Hoffman

**Also Attending:** CHERYL FRASCA, Director, Office of Management and Budget, Office of the Governor; DEVEN MITCHELL, Debt Manager, Treasury Division, Department of Revenue

**Attending via Teleconference:** From an offnet site: DAN FAUSKE, Vice President, Northern Tobacco Securitization Corporation and CEO/Executive Director, Alaska Housing Finance Corporation, Department of Revenue

**SUMMARY INFORMATION**

SB 243-TOBACCO REV. FOR UNIV. & CORR. FACILITIES

The Committee heard from the Office of Management and Budget, Office of the Governor, the Department of Revenue, and the Alaska Housing Finance Corporation. The bill was held in Committee.

#sb243

SENATE BILL NO. 243

"An Act relating to the financing of construction, major maintenance, and renovation of facilities for the University of Alaska; relating to the financing of construction of a correctional facility; authorizing the commissioner of revenue to sell the right to receive a

portion of the anticipated revenue from a tobacco litigation settlement to the Northern Tobacco Securitization Corporation, with the proceeds of that sale to finance construction, major maintenance, and renovation of facilities for the University of Alaska and to finance the construction of a correctional facility; providing for the establishment of funds for deposit of those proceeds; authorizing the issuance of bonds by the Northern Tobacco Securitization Corporation for the purpose of acquiring the right to receive a portion of anticipated revenue from a tobacco litigation settlement; and providing for an effective date."

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

CHERYL FRASCA, Director, Office of Management and Budget, Office of the Governor informed the Committee that during the developmental phase of Governor Frank Murkowski's FY 2007 budget in the Fall of 2005, the Department of Revenue suggested refinancing the State's tobacco bonds, which were first issued by the Alaska Legislature in the year 2000 to support State capital projects. Tobacco bonds are repaid by the annual payments the State receives from the four tobacco manufacturers as the result of the Tobacco Master Settlement Agreement (MSA).

Ms. Frasca noted that the history of the tobacco bonds is depicted in the Office of Management and Budget handout titled "Tobacco Bond Refinancing Fact Sheet" [copy on file]. The Department of Revenue's initial fall 2005 projection anticipated proceeds amounting to approximately \$80,000,000. The Governor's FY 07 budget proposed to utilize \$90,000,000 of anticipated tobacco bond proceeds to finance University of Alaska (University) capital projects. She reminded that the proceeds of the first tobacco bond package funded school, university, and port and harbor construction projects.

Ms. Frasca communicated that the University projects to be funded by the tobacco bonds are described in Section 1 of the bill. "The technical part of how this actually works is" that the projects are also listed in the Governor's FY 07 capital budget with the tobacco bond proceeds being identified as the funding source.

Ms. Frasca continued that in January 2006, the Department of Revenue advised the Administration that the MSA bond proceeds might approach \$180,000,000. The Administration therefore, expanded the scope of the MSA-funded capital projects to include the construction of the Matanuska-Susitna Valley (Mat-Su) correctional facility, as specified in Sec. 4 of the bill.

Ms. Frasca impressed upon the Committee that the Administration had endeavored to find alternate funding for the correctional facility "in terms of the lease purchase options prescribed in" the original authorization (SB 65). The \$90,000,000 additional MSA revenue could be utilized to either fund the Mat-Su jail or other projects, or "however the Committee should recommend".

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Senator Dyson asked the amount of MSA bond revenues anticipated beyond the \$89,250,000 designated for University projects.

Ms. Frasca communicated that another \$90,000,000 could be forthcoming from the MSA bond proceeds.

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DEVEN MITCHELL, Debt Manager, Treasury Division, Department of Revenue characterized the revenue projections from the MSA bonds as "being a moving target as far as how much value can be generated from the sale of this asset." The primary "drivers" of this situation are "moving interest rates" and "the MSA itself, "which is adjusted by inflation as well as" by tobacco product consumption. "A number of variables go into the equation."

Mr. Mitchell stressed that, currently, the financial market is favorable in regards to the issuance of these bonds. There was a period of time from 2002 through 2004 in which the issuance of tobacco bonds required the "pledging of additional security" due to "uncertainty from the market's prospective." Recent favorable [unspecified] Court decisions have benefited market conditions. This is substantiated by the fact that the MSA bond revenue projections have increased from fall 2005 estimates of \$100,000,000 to current projections of approximately \$180,000,000. The fact that the situation would "continue to evolve" is one of the reasons the bill was drafted in an "open-ended" manner; in that it could allow "secondary funding" to be

available to fund projects beyond the ones specified in the bill.

Senator Dyson asked the total capital cost projections for the Mat-Su Correctional Facility.

Co-Chair Green replied that the project would cost approximately \$130,000,000.

Senator Dyson asked whether any other funds have been identified for the project.

Co-Chair Green noted, "a group of folks are working" on the financing of the project. That effort is separate from this proposal.

Senator Dyson asked when the construction might begin.

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Ms. Frasca responded that the desire would be to start site preparation this summer. The project could take approximately two years to complete. She affirmed Co-Chair Green's comment that separate financing options are being investigated. SB 65, which was adopted two years ago, allowed the option of "a lease/purchase relationship between the State and the Mat-Su Borough" to be considered. A number of financing options are being "explored" with the Alaska Housing Finance Corporation (AHFC), the Mat-Su Borough, and the Department of Revenue. "The best deal" for the State and for the Mat-Su Borough is being sought.

Senator Dyson asked how this project might reduce the number of prisoners being housed out-of-State.

Ms. Frasca declared that the plan is to bring all Alaska prisoners "home". The \$30,000,000 being spent to house prisoners outside of Alaska could then be used to support the Mat-Su Borough facility. It is currently anticipated that, with the out-of-State prisoners and other sentenced felons, the proposed facility would be at 100 percent capacity when opened. "That's the good news and the bad news."

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Co-Chair Wilken voiced surprise that a prison construction project within the State might actually occur. While noting his support of the project, he inquired as to whether research would attest that "that's the right thing to do".

Co-Chair Green reminded the Committee that SB 65 authorized construction of the prison.

Co-Chair Wilken could not recall whether language in SB 65 authorized the construction of a prison. Continuing, he asked whether an analysis of the costs of constructing the prison had been conducted. The cost per bed at the Kenai prison exceeds \$90 per day whereas the per-bed cost to house Alaska inmates in Arizona is approximately \$50. Thus, he questioned the impact on the general fund that would be incurred by bringing out-of-State prisoners back to Alaska to serve their sentences.

Co-Chair Wilken also asked whether the size of the proposed Mat-Su prison would affect other communities; specifically whether inmates might be moved from one community's prison "to populate" a prison somewhere else. An analysis should be conducted to determine whether the construction of a new prison facility would be substantiated. He would approve of it were "it to pencil out".

Co-Chair Green recalled SB 65 including limits on the costs per day of a new prison over 25-year period. The bill also specified the amount per prisoner per day that could be spent. Approval of SB 65 authorized the Commissioner of the Department of Corrections and the Commissioner of Department of Administration to work with the Administration. SB 65 also allowed Mat-Su or Fairbanks North Star Borough representatives to work with the State to further the endeavor. "The key to this whole thing was local participation." SB 65 approved the construction of a new prison. The tremendous amount of "scrutiny" the provisions of SB 65 have undergone has delayed prison construction.

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Co-Chair Wilken requested an analysis be conducted regarding the cost of constructing a prison in the State. He could support the endeavor were that cost comparison "neutral or slightly negative".

Co-Chair Wilken was pleased to see University capital projects included in the Governor's FY 2007 budget. While he was not initially familiar with the MSA bonding mechanism, he had a "sense of what it was". The details of the budget specified a \$55,000,000 grant to the University of Alaska Anchorage (UAA) campus for an integrated science building; however, there was disappointment that the Vicks Building on the University of Alaska Fairbanks (UAF) campus was not included. Thus he requested that facility be included in the discussion were additional MSA revenues forthcoming. This would "elevate" the efforts being undertaken at UAF in a manner similar to the UAA effort.

Senator Hoffman informed the Committee that he has been in communication with the Administration regarding the on-going need for a prison facility in Bethel. This has been the State's "number one needed correctional facility" for at least four years. He recalled working with Co-Chair Green on SB 65. The areas discussed to house a new prison facility included Bethel, Fairbanks, and the Mat-Su Valley. The discussion at the time centered upon the fact the State did not desire to undertake "the debt of the facility"; "those communities needed to work and use SB 65 as authorization for payment for the construction of correctional facilities". It is a "big challenge to get those communities to agree to go into debt for correctional facilities on behalf of the State of Alaska, even though the State would be backing" the bonds or another funding mechanism through which to reimburse them.

Ms. Frasca affirmed that SB 65 "did set up a lease finance partnership with a local government".

Senator Hoffman asked therefore whether this MSA bond funding mechanism would be available to fund other correctional facilities, as discussed during the development of SB 65.

Co-Chair Green communicated that when she initially read this MSA bond proposal, she had contacted Ms. Frasca and the Administration to declare that the proposal to fund the Mat-Su prison would "not work", as attested by the fact that both Senator Hoffman and Co-Chair Wilken are questioning the proposal. The discussion "about the prison, about the financing, and how's that to be done" were previously addressed in SB 65. Therefore, she would be willing to remove the Mat-Su prison language from the bill immediately.

Senator Hoffman did not desire that to occur.

Co-Chair Green reiterated that her initial reaction was "this will not work for financing the prison", because doing so would open "it up to a whole new review of prison construction. We've had that conversation and we passed that Legislation."

Senator Hoffman concurred.

Co-Chair Green declared that this funding mechanism would "not be used for the Mat-Su prison".

Senator Hoffman clarified that rather than his interest to be "to support or not support this; my interest is to follow through and implement the intent of SB 65". One component of the rehabilitation process is to house Alaskan prisoners as close to their community as possible. That is the reason he has endeavored to promote the construction of the correctional facility in Bethel. Rather than his remarks to be interpreted as an attempt to remove the funding for the Mat-Su prison, they should be viewed as an effort to address identified needs of State.

Senator Hoffman recalled the original MSA bond life as being 15 years. To that point, he asked the justification of extending the State's indebtedness another 15 years.

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Mr. Mitchell responded that the original bills did not authorize leveraging "the revenue streams for a certain period of time. They offered a sale in exchange for value ... 40 percent was sold in 2000 and then an additional 40 percent of the revenue stream was sold in 2001. ... That was sold in an exchange for a dollar amount identified by the Legislature. That commitment is in force until the obligations that Northern Tobacco Securitization Corporation sold to obtain that money are paid off".

Mr. Mitchell continued that the proposal in this bill does not differ from the previous legislation. "It's an additional sale of that same 80 percent that we've already seen sales on, that do obligate it for a period of time into the future. This is a further obligation into the future."

Mr. Mitchell noted that the original structure "required a minimal debt service schedule that was 30 years in term. But there was an expected final maturity in the 15-year range."

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Senator Hoffman opined that there is "a vast difference" in the proposal "if you are talking about indebting the State for 15 years verses 30 years. The difference is twice as long."

Mr. Mitchell agreed, "there could be a distinction based on term". However, his position is that "the fundamental issue about what you're considering the sale of the asset is the same".

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Co-Chair Green asked whether the increase from the original proceeds forecast of \$90,000,000 to \$180,000,000 was the result of "changing the length of time".

Mr. Mitchell affirmed that the increase would change the length of time. The MSA settlement revenue stream "is considered an asset" ... "that flows in over a number of years". The time it would take for that revenue stream to repay \$90,000,000 would be "a much shorter term" than the time that would be required to repay \$180,000,000.

Mr. Mitchell reiterated that the Department of Revenue's "analysis of this opportunity" specified "that there was no market for these types of securities a year and half ago." Today, as the result of "low interest rates" and a "favorable environment in which to enter the market", the State has the "opportunity to maximize revenues today from a revenue stream, an asset, that could go away." It is possible "that the MSA might not exist into the future. By selling it, you transfer that risk to investors. That's one of the key points that you should be aware of when you're considering whether or not you do want to sell it for a period of ten" or twenty years. The State might receive more value by selling this revenue stream for 20 years, as it might only exist for another ten years.

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Senator Stedman asked for "a justification" as to why the State would "securitize these when we are in a position of revenues in excess of our expenditures, and why are we not keeping some of these things on the sideline until such time that that's reversed, and we have a deficit type issue and we're trying to come up with ways to drive capital projects and we're short of funds."

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Mr. Mitchell responded that "several reasons" supporting the proposal are specified in the aforementioned Fact Sheet. This is a "point in time" market opportunity to sell this security. Since this opportunity has not always existed, the opportunity might dissipate were the decision made to wait.

Mr. Mitchell stressed that the combination of "a favorable market", low interest rates, and the uncertainty of the continuance of this MSA revenue stream going forward, should be considered.

Mr. Mitchell stated that, regardless of whether Alaska or another state might sell tobacco bonds, all MSA credits are based on payments from tobacco producers. Some of the producers might "go bankrupt or have other problems based on laws that are passed", such as a community in another state's recent decision to prohibit the smoking of tobacco products on its streets. Continuance of such a trend could affect future MSA credit payments. While recent court rulings have been favorable, the possibility does exist that the courts could award large settlements against tobacco producers that could put them out of business. These are "the fundamental reasons" supporting this proposal.

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Senator Stedman opined that these conditions would be known to any prospective bond purchaser and "would be reflected in the price they are willing to pay". He referred back to previous comments about the timing of this proposal, as it relates to the overall status of the State's finances.

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Senator Stedman referred to language in the bill's title, page 1 line 7, which specifies that the proceeds of this sale would be used to finance University capital needs and to construct "a" correctional facility. "That's what this bill does. It creates a funding source for construction of 'a'" correctional facility. The issue of whether or not one should be constructed is a separate consideration.

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Co-Chair Green responded that the bill's title would also be amended were the decision made to eliminate the correctional facility language specified in Section 4 of the bill. The issue of how to fund a correctional facility in the State has been extensively discussed, and the Administration "was thinking outside the box" in regards to utilizing this funding mechanism in this manner. Her initial reaction to utilizing this funding source for the correctional facility was, "this violates Senate Bill 65 because the borough has to be involved with the financing scheme. This takes the borough out of it." SB 65 required local government participation in the project in the form of land, financing, or planning. That must be part of the equation before a facility could be built. Bethel and Fairbanks could participate in this manner. Thus, Section 4 was "an inappropriate inclusion" in this bill.

Ms. Frasca vehemently agreed. Co-Chair Green was correct with her interpretation of the intent of SB 65.

Ms. Frasca explained that when the Department of Revenue presented this MSA funding mechanism opportunity to the State, the Administration focused on enhancing University projects. She acknowledged Co-Chair Wilken's position that one University project had been overlooked. The Administration understood the Legislature would weigh in on how the proceeds should be utilized. She also affirmed Co-Chair Green's immediate response to the inclusion of the correctional facility in the proposal.

Senator Dyson asked the State's discount rate obligation associated with this proposal.

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Mr. Mitchell replied that the discount rate would be "market driven". He acknowledged Senator Dyson and Senator Stedman's

concerns by assuring that "generally, the Department of Revenue isn't a huge advocate for the use of debt, especially when we might be in a period of time when we are experiencing a surplus". However, this particular opportunity "makes sense" at "this point in time". Both Senator Stedman and Senator Dyson are "on point" in regards to the discount rate. Because "this isn't a general obligation type issue" ... "there are going to be higher interest rates." While reiterating that the interest rate would be market driven, he noted that "in the past, the interest rate relationship to a State supported type obligation or general obligation type obligation would be something in the range of 85 basis points". This would amount to approximately three-quarters of a percent higher interest rates than could be "achieved through an issuance that would pledge State credit and ... wouldn't transfer the uncertainty of future payments to investors".

Senator Dyson opined that the "most compelling argument is the transfer of risk." He assumed that the Northern Tobacco Securitization Corporation (NTSC) would not be involved in this issuance were they not anticipating making money "over the long haul". They must consider this "a good investment for them."

Mr. Mitchell clarified that NTSC, which is a subsidiary of the Alaska Housing Finance Corporation (AHFC) in the Department of Revenue, would be the issuer of the bonds. While there is a fairly narrow market for such bonds, there are a few large institutional buyers whose asset allocations allow them to assume the risk. These buyers have successfully made money through these types of purchases.

Senator Dyson asked their expected rate of return; specifically whether they might make three or four percent.

Mr. Mitchell was uncertain to the actual return, but assumed that it would be "above market rates, verses a comparatively rated State security". He did not view the return the buyers might receive as being "excessive" in light of the risk accompanying that return.

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Senator Bunde stated that while the "State does need infrastructure", this proposal of "using the money up front" would come at "a substantial price". "Alaska is like the lottery

winner; you can get \$30,000,000 if you take it out over 30 years or you can get \$10,000,000 if you take it out all at once." The State might receive "ten cents on the dollar by selling this future income." He opined that the buyers would be getting a good deal, but the State would not.

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Senator Stedman did not consider 85 basis points as being "a very large default risk premium"; therefore, he determined there must not be a huge default issue.

Mr. Mitchell responded that, "the bonds that were previously issued received investment grade ratings". There is uncertainty in the future as evidenced by the market dissipating in the past several years. While the market has had a recent "resurgence", the market is narrow; there are only a few large institutions willing to consider these types of bonds. "Time will tell ... whether the 85 basis points was a good or bad deal".

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Co-Chair Wilken understood that "the MSA is not backed by the full faith and credit of the United States government".

Mr. Mitchell affirmed.

[9:42:39 AM](#)

DAN FAUSKE, Vice President, Northern Tobacco Securitization Corporation, and CEO/Executive Director, Alaska Housing Finance Corporation, Department of Revenue, testified via teleconference from an offnet site and informed the Committee that AHFC had established NTSC with the "blessing" of the Legislature. NTSC is "a corporation that is solely responsible for this debt"; thus neither the State nor AHFC would incur this debt. "The reward for that was the cash upfront and the ability to use that money". The original two bond issuances provided approximately \$300,000,000 to the State. "The investor was rewarded in the sense that by eliminating any risk or any pledge with your moral or general obligation of the State of AHFC, the bonds were issued at a higher rate." Alaska was one of the first states to issue tobacco bonds, and the returns were "successful." While the State was sued in State Superior Court on the premise that the bond issuance "was like pledging future tax revenues", the

judge viewed the money as "a windfall to the State and would not be viewed in the same light as [indiscernible] tax or severance tax revenue."

Mr. Fauske shared this information in order to demonstrate the difficulty in "analyzing the cost of these ... because they don't compare favorably on paper to any other kind of issuance that a state or an agency such as AHFC would normally issue. They are truly a unique market."

Mr. Fauske affirmed that the market for this type of issuance has improved recently. A recent lower court ruling in Chicago, Illinois that awarded a \$12 billion dollar verdict against a major tobacco company was overruled. Since that time, there has been resurgence in this market.

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Mr. Fauske stated that the tobacco industry has been "successful in making their MSA payments" nationwide. 80 percent of the proceeds generated from the initial MSA bonds were used to support rural schools. The balance was used to service the bond debt and to support a smoking cessation program that included television advertising campaigns and public information.

Mr. Fauske stated that, were this legislation approved, NTSC "would be the issuer and the State would be the recipient of the proceeds". The original bond issuance was structured with a 25 year term, "with an anticipated payout on the bonds of 15". "A turbo provision ... was incorporated into that sale to maximize the exposure time that was out there in anticipation that the MSA payments would be in excess of what the bond requirements were". That has occurred.

Mr. Fauske echoed the Department of Revenue's assertion that this is an opportunity that would benefit the State, particularly since the structure is in place. This proposal would also "protect the State". The Committee's determination would, therefore, be dependent on whether there is currently a need for this money. He reiterated that the uniqueness of this structure makes it difficult to compare to other bond issuances.

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Senator Dyson asked whether, aside from "the risk reduction factor", there is a determination of "the net present value of the funding that we are foregoing".

Mr. Fauske responded that the anticipated proceeds could amount to \$280,000,000. The downside value has not been calculated.

Senator Dyson would appreciate the receipt of that information.

Co-Chair Green agreed that that information would be beneficial to the discussion.

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Senator Stedman asked the intent of this hearing.

Co-Chair Green expressed that this was an "introductory" hearing on the bill. It's scheduling was influenced by the fact that both Ms. Frasca and Mr. Fauske were available to address it.

Senator Stedman would appreciate a hearing being scheduled in which the Committee could hold a policy discussion regarding State debt. It could be argued that the State has been "building up some debt over the last several years". To that point, he suggested that efforts should be made to eliminate some State debt over the next few years.

Co-Chair Green agreed that that is an important part of the discussion.

Ms. Frasca assured that protecting the State's bond rating has been a priority of this Administration, particularly in consideration of the endeavor to further a gas pipeline project. At the same time, the desire is for the Committee to consider the "unique opportunity" provided by the MSA. This "unusual debt instrument" could be used in place of State general funds, which are traditionally the fund source for University projects the Administration proposes.

Co-Chair Green stated that the bill would be HELD in order to allow for further discussion.

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Co-Chair Green reminded the Committee of the following morning's joint meeting with the Senate Resources Committee for a presentation from Legislative consultants on the proposed oil and gas tax legislation.

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**ADJOURNMENT**

Co-Chair Lyda Green adjourned the meeting at [9:51:27 AM](#).