

SENATE FINANCE COMMITTEE
February 8, 2008
9:19 a.m.

CALL TO ORDER

Co-Chair Stedman called the Senate Finance Committee meeting to order at [9:19:09 AM](#).

MEMBERS PRESENT

Senator Lyman Hoffman, Co-Chair
Senator Bert Stedman, Co-Chair
Senator Kim Elton
Senator Donny Olson
Senator Joe Thomas
Senator Fred Dyson

MEMBERS ABSENT

Senator Charlie Huggins, Vice-Chair

ALSO PRESENT

Darwin Peterson, Staff, Senator Bert Stedman; Brian Andrews, Deputy Commissioner, Treasury Division, Department of Revenue; Representative Mike Hawker; Mike Eberhardt, Division of Parks, Department of Natural Resources; Gary Miller, Juneau State Parks Advisory Board

PRESENT VIA TELECONFERENCE

Judith McQuerry, Ketchikan; Taralee Alcock, Librarian, Petersburg; Julie Hursey, Petersburg; Melinda Hofstad, Petersburg

SUMMARY

SB 119 "An Act establishing a grant program to support public school libraries."

CSSB 119(FIN) was REPORTED out of Committee with a "do pass" recommendation and with a new zero fiscal note by the Department of Education and Early Development.

SB 57 "An Act relating to hunting in marine park units of the Alaska state park system, amending the area within designated marine park units of the Alaska state park system, and adding marine park units to the Alaska state park system."

CSSB 57(RES) was REPORTED out of Committee with a "no recommendation", with a new fiscal note by the

Department of Natural Resources, and with a new zero fiscal note by the Department of Fish and Game.

CSHB 13(FIN)

"An Act relating to prepayments of accrued actuarial liabilities of government retirement systems; relating to the Alaska Municipal Bond Bank Authority, the Alaska Housing Finance Corporation, and the state bond committee; establishing the Alaska Pension Obligation Bond Corporation; permitting the Alaska Municipal Bond Bank Authority or a subsidiary of the authority, a subsidiary of the Alaska Housing Finance Corporation, the state bond committee, and the Alaska Pension Obligation Bond Corporation to assist state and municipal governmental employers by issuing bonds, notes, commercial paper, or other obligations to enable the governmental employers to prepay all or a portion of the governmental employers' shares of the unfunded accrued actuarial liabilities of retirement systems; authorizing a governmental employer to issue obligations to prepay all or a portion of the governmental employer's shares of the unfunded accrued actuarial liabilities of retirement systems and to enter into a lease or other contractual agreement with a trustee, the Alaska Municipal Bond Bank Authority or a subsidiary of the authority, a subsidiary of the Alaska Housing Finance Corporation, the state bond committee, or the Alaska Pension Obligation Bond Corporation in connection with the issuance of obligations for that purpose, and relating to those obligations; relating to revision of the employer contribution rate in connection with financed prepayment of unfunded accrued actuarial liabilities of government retirement systems; and providing for an effective date."

CSHB 13(FIN) was heard and HELD in Committee for further consideration.

[9:19:24 AM](#)

SENATE BILL NO. 119

"An Act establishing a grant program to support public school libraries."

[A previous motion to adopt CSHB 119(FIN), version C, was withdrawn.]

Senator Olson MOVED to ADOPT CSSB 119(FIN), labeled 25-LS0749\M, Mischel, 2/5/08.

Co-Chair Stedman OBJECTED for discussion purposes.

[9:23:00 AM](#)

DARWIN PETERSON, STAFF, SENATOR BERT STEDMAN, explained that the current version of the bill changes Section 1, the library construction and major expansion matching grant program part of the bill, from having the Department of Education administrating the grant to the Department of Commerce, Community and Economic Development. The Board of Education is no longer involved in adopting the regulations.

The major expansion is now defined as an expansion to increase the square footage of a structure by not less than 30 percent. On page 2, line 3, eligibility requirements are outlined. A library has to be publically owned and operated and located in a community with a population of less than 10,000 persons. Local communities must now provide a match of 20 percent or more. The state can contribute no more than 50 percent. Private donors would pick up the rest.

The library collection grant has been changed in subsection (c), line 24, to say that if there is not enough money appropriated, it goes to the highest ranking eligible grantee. If there is too much money appropriated, it goes back into the general fund.

[9:26:13 AM](#)

Mr. Peterson described the change on page 3, lines 23 - 25, which was in response to Senator Elton's concern that schools may use the money to supplant their responsibility. The library collection grants may not be used to supplant school district library expenditures.

Co-Chair Hoffman asked about the criteria to rank applicants. Mr. Peterson replied that the criteria will be developed by the Department of Commerce, Community and Economic Development through regulations.

Senator Olson referred to the eligibility section of the bill and asked if some libraries are being excluded. Mr. Peterson replied that the grant is for construction and major expansion of publically owned libraries, not for school libraries. He said the title was changed to reflect that. Part of the bill deals with public school library collection grants and part of the bill deals with construction grants for public libraries in small communities.

[9:27:59 AM](#)

Co-Chair Stedman WITHDREW his objection to adopt version M of SB 119. There being NO further OBJECTION, it was so ordered.

[9:28:25 AM](#)

JUDITH MCQUERRY, KETCHIKAN, testified in support of SB 119. She asked why there was a population limit of 10,000 for communities. She thought the community of Ketchikan would not qualify for the grant, however, the municipality of Ketchikan would. Co-Chair Stedman clarified that the city of Ketchikan would qualify for the grant program with a population of 7,622. Smaller communities would apply and be ranked, and then the legislature would approve a block of funds. Large populations such as Juneau with 30,000 would not qualify.

[9:31:06 AM](#)

TARALEE ALCOCK, LIBRARIAN, PETERSBURG, testified in support of the bill. She addressed Section 1, library construction and major expansion matching grant program. She described the need for a new library in Petersburg as urgent. She noted that financial support by the community was essential.

JULIE HURSEY, PETERSBURG, testified in support of SB 119, especially the state matching fund component. She detailed plans for a new Petersburg library.

[9:34:57 AM](#)

MELINDA HOFSTAD, PETERSBURG, testified in support of SB 119. She spoke of the diligent work of a local community group toward building a new library in Petersburg. She praised the local librarian and shared statistics about library usage. She mentioned local fundraising efforts for a new library.

[9:38:04 AM](#)

Senator Thomas commented that the definitions of "community" and "on-going maintenance" should be clarified. Co-Chair Stedman explained that the issues of on-going maintenance and fiscal capability would be addressed in department regulations. He pointed out that the bill is going forward without the funding in it, but regulations would be written.

Mr. Peterson spoke of researching the definition of "community". Legislative Legal Services explained that the term is used throughout statutes and is an all-encompassing term that includes towns, cities, and boroughs. Senator Thomas asked if a community could be just an area that has existed for a long time. Mr. Peterson said the community

does not have to be organized. The provision in the CS states that the community would have to provide a 20 percent matching grant, which would eliminate very small communities.

Senator Dyson asked if a community defined by federal law would qualify. Mr. Peterson replied that it would. For example, the community of Metlakatla would qualify. Senator Dyson asked if tribes and villages would. Mr. Peterson replied that they would also qualify. Senator Dyson inquired if a community not recognized by state law, but recognized under federal law, would qualify. Mr. Peterson said if a community is not recognized by state law it would not qualify. He offered to research the subject further with the drafter of the bill.

[9:42:57 AM](#)

Senator Olson MOVED to REPORT CSHB 119(FIN) out of Committee with individual recommendations and the accompanying fiscal note. There being NO OBJECTION, it was so ordered.

CSSB 119(FIN) was REPORTED out of Committee with a "do pass" recommendation and with new zero fiscal note by the Department of Education and Early Development.

[9:44:24 AM](#)

SENATE BILL NO. 57

"An Act relating to hunting in marine park units of the Alaska state park system, amending the area within designated marine park units of the Alaska state park system, and adding marine park units to the Alaska state park system."

Senator Elton, sponsor, highlighted SB 57. The bill adds 14 islands adjacent to Juneau and to the existing Marine Parks. They range from Lincoln Island in the north to Portland Island in the south. The islands are frequented by locals and Southeast Alaska residents and are used for many purposes. The islands are an integral part of the tourism economy. It is expected that outdoor groups, especially the Territorial Sportsmen, will add amenities to the park system.

Senator Elton reported that the bill was developed in consultation with the Division of Parks, Juneau Parks and Recreation Advisory Committee, the Juneau State Parks Advisory Committee, local tourism companies, and the City and Borough of Juneau. It excludes private landholdings but protects private landholdings already on the islands. The bill is supported by CBJ, Territorial Sportsmen, Goldbelt Native Corporation, Anytime Charters, Juneau State Parks

Advisory Board, Southeast Alaska Land Trust, and Southeast Alaska Conservation Council. Senator Elton noted that in the previous committee a 10-fathom bathymetric line was added in order to protect areas adjacent to the Marine Park. The bill says that the commissioner cannot prohibit hunting and fishing in the Marine Park.

[9:49:09 AM](#)

Senator Olson asked if trapping is allowed. Senator Elton referred to Section 2 to show that trapping cannot be prohibited. Senator Olson asked if commercial fishing is included in the section. Senator Elton said it was.

Co-Chair Stedman commented that 10 fathoms was selected because it is easy to see on all electronic charts.

Co-Chair Hoffman asked how many acres the park encompasses. Senator Elton deferred to the Department of Natural Resources.

[9:50:48 AM](#)

MIKE EBERHARDT, DIVISION OF PARKS, DEPARTMENT OF NATURAL RESOURCES, replied that he does not know the total acreage of the Marine Park. He thought there was approximately 1,500 acres of land. Senator Stedman requested more information, broken down by land and water.

Senator Olson asked how much of the park was on private land. Mr. Eberhardt replied that there were only three private landowners and they have been contacted. Senator Olson asked if they are supportive. Mr. Eberhardt said they have not voiced opposition.

Co-Chair Stedman asked if the three private parcels have waterfront access. Mr. Eberhardt replied that they do. Senator Elton noted a letter of support from one of the landowners.

Senator Dyson assumed that the property rights of the landholders are not diminished. Mr. Eberhardt said that is correct.

[9:54:39 AM](#)

GARY MILLER, JUNEAU STATE PARKS ADVISORY BOARD, reported that the park consists of 12.1 square miles of land and 11.5 square miles of water, which would be somewhat reduced by the 10-fathom boundary. Co-Chair Stedman asked if most of the land is on Shelter and Lincoln Islands. Mr. Miller said yes and added that hunting and trapping are available on both islands.

[9:56:32 AM](#)

Senator Elton MOVED to CSSB 57(FIN) out of Committee with individual recommendations and the accompanying fiscal notes. There being NO OBJECTION, it was so ordered.

CSSB 57(RES) was REPORTED out of Committee with a "no recommendation" and with a new fiscal note by the Department of Natural Resources, and with a new zero fiscal note by Department of Fish and Game.

[9:57:07 AM](#)

At-ease

[10:01:38 AM](#)

CS FOR HOUSE BILL NO. 13(FIN)

"An Act relating to prepayments of accrued actuarial liabilities of government retirement systems; relating to the Alaska Municipal Bond Bank Authority, the Alaska Housing Finance Corporation, and the state bond committee; establishing the Alaska Pension Obligation Bond Corporation; permitting the Alaska Municipal Bond Bank Authority or a subsidiary of the authority, a subsidiary of the Alaska Housing Finance Corporation, the state bond committee, and the Alaska Pension Obligation Bond Corporation to assist state and municipal governmental employers by issuing bonds, notes, commercial paper, or other obligations to enable the governmental employers to prepay all or a portion of the governmental employers' shares of the unfunded accrued actuarial liabilities of retirement systems; authorizing a governmental employer to issue obligations to prepay all or a portion of the governmental employer's shares of the unfunded accrued actuarial liabilities of retirement systems and to enter into a lease or other contractual agreement with a trustee, the Alaska Municipal Bond Bank Authority or a subsidiary of the authority, a subsidiary of the Alaska Housing Finance Corporation, the state bond committee, or the Alaska Pension Obligation Bond Corporation in connection with the issuance of obligations for that purpose, and relating to those obligations; relating to revision of the employer contribution rate in connection with financed prepayment of unfunded accrued actuarial liabilities of government retirement systems; and providing for an effective date."

Co-Chair Stedman commented that the bill has an immense magnitude in dollars and is one of the tools to facilitate cash flow for the unfunded liability. He referred to a book

called "Pension Obligation Bonds and Other Post-Employment Benefits" by Roger Davis. He referred to the presentation by the Department of Revenue (DOR). He also referred to documents from the PEW Center on the States, "Promises with a Price", and a fact sheet regarding other states' retiree benefit obligations. There is also a handout from Standard and Poor's RatingsDirect, "Time May Be Ripe For A POB Revival". (All copies are on file.)

[10:05:49 AM](#)

REPRESENTATIVE MIKE HAWKER, SPONSOR, explained that HB 13 deals with the unfunded liability related to the Public Employee Retirement System (PERS) and the Teacher Retirement System (TRS), due to insufficient assets to cover liabilities. About \$8.5 billion is needed to cover the unfunded liabilities. The retirement obligation to those trusts is a requirement fixed in the state constitution. HB 13 provides a mechanism by which to pay off the liability through the use of the capital markets financial leverage.

Representative Hawker compared the debt to a mortgage on a house, which accrues interest. The pension liabilities also accrue interest, of sorts. The device offered in the bill would empower the political subdivision to refinance these pension funds by going into the international capital markets, borrowing money at a low rate of interest, and investing it. He explained how the state saves on the arbitrage. There are many federal restrictions, but this method is federally sanctioned.

[10:11:03 AM](#)

Representative Hawker emphasized that the bill is an empowerment bill. It allows the municipal authorities to engage in Pension Obligation Bonds (POBs) to help reduce debt. He pointed out that the state has qualified financial advisors. He highly recommended the Orrick (Roger Davis) book.

[10:14:09 AM](#)

BRIAN ANDREWS, DEPUTY COMMISSIONER, TREASURY DIVISION, DEPARTMENT OF REVENUE, testified on HB 13 using a handout entitled "Pension Obligation Bonds" (copy on file.) He referred to page one of the handout to define what Pension Obligation Bonds (POBs) are. He explained that POBs replaces one form of debt with another form of debt that carries a lower interest rate cost, similar to refinancing the mortgage on a house. They are issued by a state or local government. The greater the investment arbitrage, the better off the state will be in achieving a lower contribution rate to the state's pension plans. POBs have been an increasingly popular and successful way for state and

local governments to accomplish financial goals. Since 1955, six states and over 234 local governments have issued POBs totaling in excess of \$40 billion. In the mid-90's Anchorage issued a POB.

Mr. Andrews turned to page 2, a map of the U.S. which depicts states that have issued POBs. Illinois holds the record for the largest POB, in 2003, worth \$10 billion. He noted that Connecticut would be issuing a POB in the next couple weeks.

[10:17:55 AM](#)

Mr. Andrews addressed the question, "Why Should We Consider Issuing POBs?" found on page 3. Some of the benefits of POBs are interest rate savings, a positive arbitrage potential, and the fact that they are not generally viewed as adding to the debt burden of the state government issuer.

Mr. Andrews emphasized that POBs are not a golden bullet, but rather a financial tool - page 4.

Mr. Andrews discussed page 5, "Alaska Pension Bill/Unfunded Actuarial Accrued Liability (UAAL) in 2006". The unfunded liability is a bill that the pension systems are giving to the state and local governments, which totals \$8.6 billion. Co-Chair Stedman asked for a definition of PERS and TRS. Mr. Andrews defined those terms.

Mr. Andrews continued to explain page 6, "Paying the Bill/UAAL". One of the options is to pay with cash; another option is to pay with a loan at 8.25 percent over 25 years. The question is whether a POB can reduce the cost to less than 8.25 percent.

[10:20:27 AM](#)

Mr. Andrews reported on the "Funding Status Overview" on page 7. He reviewed the funding status for PERS and TRS as of June 30, 2006, according to the actuarial report.

Mr. Andrews discussed "Interest Rate Savings" - page 8. IF a bond transaction was issued this week, it would be at about 5.25 percent. He cautioned that credit markets are in an unstable state. The difference between 8.25 and 5.25 over twenty-five years is \$323 million in savings on \$1 billion, or \$23 million annually.

Mr. Andrews explained the "Interest Rate History" on page 9. The interest rate is very low, the lowest since the mid-60's. Page 10 deals with "Treasury Rates Still Historically Attractive".

[10:23:44 AM](#)

Mr. Andrews turned to the topic of arbitrage and the "Historical Investment Returns of State Pension Plans (PERS)" on page 11 and 12. The average return from 1992 to 2007 is 9.67 percent. The numbers from 2003 and up have been very attractive. He discussed the risk, which is usually measured by volatility, a measurement of standard deviation. The level of volatility is low. The numbers are very similar for TRS because the portfolio is similar.

Mr. Andrews turned to page 13, "Long Term Target Asset Allocation". The ARM Board reviews the asset allocations each year with the help of the financial advisor, Callan Associates, Inc. The median return is 8.05 percent with a standard deviation of 12.27 percent.

[10:26:05 AM](#)

Mr. Andrews discussed the third reason for going to POBs, credit neutrality. He explained "Credit Rating Consideration" on page 14. He summarized that POBs are not considered new debt. Rating agencies like to talk about unfunded liabilities as being a soft liability, which allows for some flexibility. A POB transaction turns a soft liability into a hard liability. He argued that unfunded liabilities are really hard liabilities because they are set in constitution. He recalled a case, the State v. Duncan that agreed with the interpretation that unfunded liabilities are hard liabilities. He opined that treating the unfunded liabilities as hard liabilities brings fiscal stability to the process.

[10:28:07 AM](#)

Mr. Andrews turned to page 15, "Prudently Structured, POBs are Ratings Neutral". He pointed out that the funding level rating agencies like to look at is around 80 percent. Overfunding above 80 percent is somewhat risky. Ratios below 80 percent are a potential negative.

Mr. Andrews explained, on page 16, the three types of risks: investment, political, and market. He turned to page 17 - "Investment Risk Analysis". As long as those bond-funded assets earn more than 5.25 percent, there is a positive effect; anything under that percentage fails to cover the cost of the bond. Page 18 depicts "Investment Risks (PERS)". The graph shows the various scenarios by year since 1992 if POBs had been issued. For 14 out of 16 years the issuance of POBs would have resulted in a gain to the pension plan. It highlights one of the risks of having a negative scenario, such as in 2000 and in 2001.

[10:31:37 AM](#)

Co-Chair Stedman asked for more information about cash flow impacts in various environments. The 90's had a very strong equity market. 2002 and 2001 were negative environments. Mr. Andrews agreed to provide more information. He spoke of bull markets and bear markets as examples.

[10:33:14 AM](#)

Mr. Andrews addressed page 20, "UAAL vs. POB Financial Success". He summarized that as long as the bond-funded assets make more than 5.25 percent, the state is better off for having borrowed. If the assets earn less than 8.25 percent, the unfunded liability goes up. Even if those assets earn more than 8.25 percent, the unfunded liability can increase due to actuarial and/or accounting changes.

Senator Thomas asked about the charts on pages 18 and 19 and the change in the estimated cost of borrowing column. He wondered if the percentages are actuals. Mr. Andrews replied that each year stands by itself. He gave examples from various years. Co-Chair Stedman asked if that was before or after transaction costs. Mr. Andrews said that included transaction fees. In 2007, the rate would have been around 5.75 percent. He noted that these figures are for fiscal years.

[10:36:59 AM](#)

Mr. Andrews turned to page 21, "Investment Return Forecast", a Monte Carlo simulation that takes historical returns and scrambles them and tries to determine what the return of a portfolio would be. In a conservative scenario - 70/30 - the return was greater than 5.25 percent, but included a risk.

Co-Chair Stedman referred to page 18 and a reference to if POBs had been implemented last year on June 30. He requested more information. Mr. Andrews corrected that it would have been in June of 2006, with a return of 18.9 percent.

Representative Hawker spoke of this proposed transaction as having a high degree of confidence that, over the life of the transaction, works to the state's benefit. He explained how the Monte Carlo simulation documents the possibilities. He said this POB proposal has a high degree of confidence due to the fortuitous time of low interest rates. He cautioned not to try to time a transaction with the market.

[10:40:56 AM](#)

Senator Elton referred to page 21 and noted it was a 25-year investment period. He assumed there was a 5.25 percent cost over that time, based upon assumptions in the market place

at the time over the life of the bonds. Mr. Andrews explained how the Monte Carlo model worked by scrambling iterations. Senator Elton said he is assuming if the bill passes, the interest rate will be predicated over the full life of the term of the bond. Mr. Andrews said that is correct.

[10:43:21 AM](#)

Co-Chair Stedman requested information about the probability of the outcome using various time periods, not just 25 years. Mr. Andrews replied that the life of the bonds is 25 years, and the shorter the time period, the more volatility there is. Over time, that is lessened and the return averages out. If the time frame is shortened to 5 or 10 years, the confidence level decreases.

Co-Chair Stedman offered to provide more data to the committee. He asked where Mr. Andrews got his data. Mr. Andrews replied that it came from the S & P 500 index. Co-Chair Stedman asked if allocations were used. Mr. Andrews reported that the 70/30, 80/20, and 90/10 allocations were used. Co-Chair Stedman said the 70 percent was from the S & P 500. He asked where the 30 percent was from. Mr. Andrews replied Lehman aggregate, an index that is used for fixed income securities with a duration of about 7 years. Mr. Andrews explained that the average maturity of the Lehman aggregate or fixed income portfolio is approximately 10 years. Co-Chair Stedman added that it is a weighted average of cash flows.

[10:47:36 AM](#)

Mr. Andrews turned to page 22, "Political Risk - Key Driver of UAAL". He explained that the unfunded liability, as reported by the state's actuary, was really created by increased health benefit costs in 2001-2003. There were also some pension plan changes that contributed to the expense. It was not the result of poor investment returns.

Mr. Andrews discussed political risk on page 23. High amounts of POB proceeds may cause the pension system to be over-funded, which could lead to political pressure calling for benefit increases that would incur new liabilities in the future.

Mr. Andrews spoke of "Market Risk" on page 24. POB proceeds cause a large amount of capital infusion into the pension system at once, and how the ARM Board invests those proceeds is critical. The success of the POB plan relies on a low cost and a positive arbitrage. When the issuance of the bonds have proceeds, it's very important that they achieve at least 5.25 percent during the first couple of years. He provided an example: If a \$100 investment drops to \$50, the

loss is 50 percent; however, to go from \$50 back to \$100 requires a 100 percent gain.

Representative Hawker related a strategy by the ARM Board to invest more conservatively in the first couple of years.

[10:51:33 AM](#)

Mr. Andrews turned to three types of public debt, page 25, "Security": general obligation bonds, obligations imposed by law, and annual appropriation bonds. HB 13 calls for annual appropriation bonds.

He explained potential savings, page 27, "Case Study (PERS)". The upper left matrix, "Employer Contribution Rates", shows a figure of 35.22 percent, which is the contribution rate that the ARM Board adopted for the unfunded liability. The matrices show the potential savings of issuing POBs or using cash to pay down the unfunded liability. He gave an example from the first matrix of a \$2 billion POB transaction moving the annual contribution rate down to 32.91 percent. That equals a savings of 2.31 percent on the annual contribution rate as depicted in the lower left column. That equates to dollars in the upper right column, which is a savings of \$38.62 million annually. Over the life of the bonds, or 25 years, that is a cumulative rate of \$544.28 million in savings, discounted out at 35 percent. That final tally is shown in the lower right column.

[10:54:15 AM](#)

Mr. Andrews summarized the "Take-aways" on page 31. He read the 4 points:

If we can earn more than the cost of POB, we are better off for issuing it.

We are in a very favorable interest rate environment - take advantage of it!

Risks associated with POB issuance are quantifiable and statistically justified by the rewards.

Doing nothing is not a viable option.

Mr. Andrews concluded that the Administration is in favor of HB 13.

CSHB 13(FIN) was heard and HELD in Committee for further consideration.

ADJOURNMENT

The meeting was adjourned at 10:54 AM.