

HOUSE FINANCE COMMITTEE

January 23, 2009

1:35 p.m.

CALL TO ORDER

Co-Chair Hawker called the House Finance Committee meeting to order at [1:35:54 PM](#).

MEMBERS PRESENT

Representative Mike Hawker, Co-Chair
Representative Bill Stoltze, Co-Chair
Representative Bill Thomas Jr., Vice-Chair
Representative Allan Austerman
Representative Harry Crawford
Representative Anna Fairclough
Representative Richard Foster
Representative Les Gara
Representative Reggie Joule
Representative Mike Kelly
Representative Woodie Salmon

MEMBERS ABSENT

None

ALSO PRESENT

Representative Mike Doogan; Senator Con Bunde; Senator Joe Paskvan; Gregg Erickson, Economic Consultant, Erickson & Associates; Pat Galvin, Commissioner, Department of Revenue; Jerry Burnett, Director, Division of Administrative Services, Department of Revenue; Mike Burns, Executive Director, Permanent Fund Corporation, Department of Revenue; Michael Barnhill, Assistant Attorney General, Department of Law.

PRESENT VIA TELECONFERENCE

NONE

SUMMARY

^The Principles of the Permanent Fund Principal

Overview: The Principles of the Permanent Fund Principal

[1:38:17 PM](#)

CO-CHAIR HAWKER queried the process that results in the Revenue Sourcebook numbers that the state uses to project revenue for the coming year. The Revenue Sourcebook applies to the remainder of the current fiscal year ending June 30, 2009, and to the fiscal year of July 1, 2009 through June 30, 2010. He questioned whether the recent dramatic change in the world economy was cause for review of current projections for FY09 and FY10.

PAT GALVIN, COMMISSIONER, DEPARTMENT OF REVENUE responded that an FY09 interim revenue forecast associated with the supplemental budget would be provided in a week. He confirmed that the price of oil is currently lower than the price used for projections in the fall. The number used for forward price projection would be in the low \$50s, which was expected to create a shortfall of over a billion dollars. He assured the committee that he would provide more information as the exact dollars were known.

[1:41:25 PM](#)

Commissioner Galvin expressed concern about spending more than was coming in. He reiterated that the FY09 numbers used to project the FY10 numbers have dropped significantly. He elaborated on the fluctuation in oil prices over the last few months.

[1:43:05 PM](#)

Commissioner Galvin thought that the numbers would be lower for the fall forecast.

Co-Chair Hawker explained that a significant budget surplus or budget deficit would affect budget decisions. Commissioner Galvin stated that he would provide as much information, in a timely manner, as he could.

Representative Kelly advised using the lower numbers.

[1:45:44 PM](#)

Commissioner Galvin voiced that the Office of Management and Budget (OMB) was working with DOR and were aware of the drop in the revenue forecast. Co-Chair Hawker explained

that OMB director Karen Rehfeld would come before the committee soon to answer further questions.

Representative Gara asked for clarification as to why the FY09 budget has a potential \$1 billion deficit but \$5 billion in savings. He questioned Commissioner Galvin's definition of the word "deficit".

Commissioner Galvin noted that there was a revenue shortfall of over \$1 billion dollars, not a deficit. He mentioned other funds that could be considered savings accounts. The budget can be rolled together from year to year. It can be confusing understanding what funds are located where.

[1:48:31 PM](#)

Co-Chair Hawker summarized that "shortfall" means that the state simply has not saved as much as it planned. The state will have saved \$4 billion instead of \$5 billion.

Commissioner Galvin concurred. He elaborated that a revenue estimate is given in order to create a budget and that the numbers are subject to change. The FY09 budget had designated \$1 billion for the constitutional budget reserve (CBR), automatically resulting in \$1 billion less income for the state.

[1:50:35 PM](#)

Commissioner Galvin admitted that using the word "deficit" may confuse the public when the state may be putting money into savings at the end of the year.

Representative Gara asked that the administration not use the word deficit when presenting to the public if there was no real deficit as the public understands the definition of the word. He expressed that it affects the public's mood to hear the word. Co-Chair Hawker agreed that clarification between "deficit" and "shortfall" should be made for public understanding.

[1:52:31 PM](#)

GREGG ERICKSON, ECONOMIC CONSULTANT, ERICKSON & ASSOCIATES, and founder of the Alaska Budget Report introduced a

PowerPoint presentation, "How the Permanent Fund Dividend (PFD) Came to be at Risk" (Copy on File).

1:56:18 PM

Mr. Erickson went over Slide 2, "1976 Amendment to Alaska's Constitution":

At least twenty-five percent of all mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payments and bonuses received by the state shall be placed in a permanent fund, the principal of which shall be used only for those income-producing investments specifically designated by law as eligible for permanent fund investments.

(Article IX, Section 15 (Effective February 21, 1977).)

Mr. Erickson cautioned misinterpretation of the 1976 amendment. At the time the amendment was made he believed that the Permanent Fund was meant to be income producing and permanent.

Mr. Erickson continued with "Orange County Debacle" (Slide 3):

The new rule arises in part out of the losses incurred in 1993 by the government of Orange County. Managers of county investments were able to avoid showing the declining market value of bad investments because they were not required to show the loss on the county-owned fund's income statement. Accounting experts believe that requiring unrealized gains and losses to be reported will help provide early warning of such investment problems.

("Alaska Permanent Fund Corporation (APFC) asks for legal opinion on status of income, principal," Alaska Budget Report, February 17, 1999)

Mr. Erickson pointed out that the Alaska Supplemental Benefits System had placed money in Orange County's Guaranteed Investment/Insurance Contracts. The contracts were not guaranteed. The value of the contracts was declining, yet dividends continued to be paid out. Orange

County and subsequently the state of Alaska lost a lot of money. The Corporation therefore instigated the new rule.

Mr. Erickson continued with "Government Accounting Standards Board (GASB)31" (Slide 4):

Governmental entities, including governmental external investment pools, should report investments at fair value in the balance sheet.

Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

("Summary of Statement No. 31, Accounting and Financial Reporting for Certain Investments and for External Investment Pools," Government Accounting Standards Board, March 1997)

Mr. Erickson recounted that GASB 31 presented a problem for the Alaska Permanent Fund because its accounting practices in determining dividends were comparable to Orange County. This was not an issue when the fund was heavily invested in bonds, but into the 1990s the Fund was invested mainly in equities. Equities are less stable. The fear was that Alaska might find itself in a position like Orange County because the value of the assets was in danger of becoming less than the value of the principal. The value of the principal is determined by adding up all the money the legislature by appropriation or constitutional dedication had put into the fund since its conception in 1977. He disclosed that the current principal is \$29 billion.

[2:02:29 PM](#)

Mr. Erickson took his definition of principal from the "1999 Request for Legal Opinion" (Slide 5):

The Alaska Permanent Fund Corporation (APFC) has asked the national law firm of Morrison and Forrester to prepare a legal opinion on whether the governor's proposal in House Bill 90 to remove \$4 billion from the permanent fund would invade the principal of the fund.

...Communications Director Jim Kelly told the Senate State Affairs Committee that a legal opinion had been

requested. The issue arose in the context of...testimony on...a bill by Sens. Jerry Ward and Rick Halford to transfer...the fund's earnings reserve to the principal.

("APFC asks for legal opinion on status of income principal," Alaska Budget Report, February 17, 1999.)

Mr. Erickson recalled that in 1999 the PFD had a huge budget reserve. The Knowles administration wanted to transfer the reserves to the CBR. The Knowles administration and the Department of Law contracted Morrison & Foerster LLP to determine the legality of the Knowles plan. Morrison & Foerster found in favor of the plan but discovered that the dividend formula had to be changed in order to avoid a conflict with the Constitution of Alaska (see "1999 letter Morrison and Foerster," Copy on File).

Mr. Erickson turned to "1999 Legal Opinion" (slide 6):

Attorneys from Morrison and Foster say Gov. Tony Knowles' proposal to take \$4 billion from the permanent fund won't violate the Alaska Constitution. But a formula in state law that is used to calculate income available for dividends (or other purposes) should be changed to avoid a possible conflict-of-laws situation that could occur under new accounting interpretations, the lawyers said in a March 3 opinion.

("Lawyers OK \$4 billion transfer from earnings reserve to CBR," Alaska Budget Report, March 10, 1999.)

[2:06:30 PM](#)

Mr. Erickson continued with "The 2002 Crisis, Part 1" (Slide 7):

For a few days in July a falling stock market shaved \$399.9 million off the principal of the permanent fund. The erosion of principal, the first such event in the fund's 25-year history, reached its deepest point on July 23, culminating a slide that took the fund's reserves from a comfortable \$8.6 billion in the spring of 2000 to a negative value in July.

("Fund recovers after market slide eats \$400 million hole in principal." Alaska Budget Report, September 17, 2002.)

Mr. Erickson explained that this was the first time the value of the fund had fallen below its principal. Because of the fallen numbers there was concern within the APFC that dividends would be paid out by invading the principal.

Mr. Erickson continued with "The 2002 Crisis, Part 2" (slide 8):

Later in July rising market values erased the deficit, but the issues raised by the episode remain, including;

1. worries that the fund's constitutional structure is more vulnerable to meltdown than officials had ever realized,
2. unsettling legal questions about APFC's authority to transfer money to the state government when reserve drops into the red, and
3. increased doubt over whether the fund will be able to meet its dividend and inflation-proofing obligations in 2003.

("Fund recovers after market slide eats \$400 million hole in principal." Alaska Budget Report, September 17, 2002.)

Mr. Erickson shared that due to this situation, APFC and the Murkowski administration agreed it would be best to abandon the concept of principal and embrace the idea of Percent of Market Value (POMV) to eliminate ambiguity.

[2:10:39 PM](#)

Representative Gara queried the difference between the earnings reserve and the Permanent Fund Principal. He wondered if money is taken from the earnings reserve to keep the principal intact when there is more in the earnings reserve than in the principal. Mr. Erickson responded that before 2003 the money came out of the reserves. He discussed the difference between realized and unrealized reserves.

Representative Gara asked if the monies were separately invested. Mr. Erickson answered that investments were pooled. Presently the practice of the fund is to allocate unrealized gains and losses to the principal.

[2:13:49 PM](#)

Mr. Erickson explained that the Murkowski administration inquired of Attorney General Renkes an opinion concerning the idea of a POMV payout from the fund.

Mr. Erickson cited "Renkes Opinion and POMV (Percent of Market Value)" Slide 9:

Only through a constitutional amendment, like that currently proposed by the corporation trustees establishing a payout limit of 5 percent of the total fund value, can the rate of dedication be increased and the deposit of income available for distribution be limited. Absent such an amendment, the full amount of income, made up of the realized gains and losses, is available for expenditure.

(Renkes 2003 opinion AG file 663-03-0153.)

[2:14:54 PM](#)

Mr. Erickson interpreted from the Renkes Legal Opinion that the notion of the principal does not limit the ability to spend as long as realized earnings are in hand.

Mr. Erickson continued with "Renkes' Legal Opinion, Part 2" (slide 10):

There is no basis for expanding the concept of principal by creating a notational number that serves as a limitation on the deposit of income for distribution purposes.

(Renkes 2003 opinion AG file 663-03-0153.)

Rep. Eric Croft of Anchorage says he is still pondering a lawsuit to challenge Attorney General Gregg Renkes' opinion that unrealized gains shouldn't be considered 'available for appropriation'.

("What do Democrats really want," Alaska Budget Report, December 23, 2003.)

Mr. Erickson declared that the concept of POMV was less antiquated than the idea of principal. He furthered that the Renkes Opinion would not have been a problem had the POMV been approved. He explained that POMV cannot be reached without revisiting how the PFD is calculated. The POMV annual payout compromise set forth by Hollis French in 2003 was resisted by the Murkowski administration. Mr. Erickson felt that was the reason the POMV plan eventually failed in the Senate.

[2:18:19 PM](#)

Mr. Erickson discussed "Investment losses of 2008-2009" (Slide 11). He revealed that on Friday, October 10, 2008 the PFD dropped below principal for a second time.

Mr. Erickson "APFC's October 23 letter to OMB" (slide 12):

Erosion of the supposedly permanent principal has stimulated Alaska Permanent Fund Corporation (APFC) officials to seek guidance from the Palin administration on the appropriateness of continuing to draw money from the fund to pay their own salaries and other corporation expenses. ...'In times of extreme market volatility with downward trends, as in the current case, questions arise regarding the Permanent Fund's ability to make cash payments *for items such as its operating budget,*' wrote APFC executive director Mike Burns...in an October 23 memorandum to OMB Director Karen Rehfeld.

("Fund recovers after market slide eats \$400 million hole in principal," Alaska Budget Report, September 17, 2002.)

Mr. Erickson pointed out that the Permanent Fund is \$1.1 billion below the principal. He stressed that if the fund remains below principal there will not be enough in the reserves to pay the dividend without further erosion of the principal.

[2:23:04 PM](#)

Mr. Erickson highlighted "OMB's reply to Mr. Burns" (Slide 13):

A consultation with the Department of Law regarding the corporation's current circumstances affirms APFC's interpretation that the APFC operating budget should be paid from the positive cash flow in order to meet the FY09 appropriated budget.

(OMB Director Karen Rehfeld, Memorandum to APFC Executive Director Mike Burns, November 5, 2008.)

[2:24:47 PM](#)

Mr. Erickson "Current Status" (Slide 14):

- Principal exceeds market value: fund is 1.6 billion underwater.
- \$1.1 billion needed on June 30 to pay PFD
- \$3.9 billion in realize earnings "reserve" account, but...fund investments must grow by about \$2.7 billion (1.6 billion + \$1.1 billion) to avoid threat of court intervention.

Mr. Erickson concluded his presentation with "Options" (Slide 15):

1. Take no action
 - Hope markets rise as in 2002.
 - Hope nobody sues.
 - If dividends are blocked, deal with economic consequences separately.
 - Try to find consensus on a POMV amendment that can win voter approval in 2010.
2. Adopt backstop plan.
 - Pay PFD (all or part) out of CBR, Alaska Housing and Finance Corporation (AHFC) equity, or other sources.
 - Hope markets rise before June 30, 2010.
 - Try to find consensus on a POMV amendment that can win voter approval in 2010.

[2:27:33 PM](#)

Co-Chair Hawker asked about protection of the principle under the Alaska Constitution. He asked how a dividend can legally be paid if principal of the fund can be used only for investments as stated in the constitution, and the current value of the principal is less than the amount of money deposited into it. Mr. Erickson answered that the question should be answered by the Department of Law (LAW).

Representative Crawford understood that this year there was a possibility that there would not be money available for the PFD. He wanted to know what happens to the money in the fund if dividends are not paid out. Mr. Erickson responded that if the court blocked the transfer of money from the permanent fund to the dividend fund, or put conditions on transfer that had the same effect, the money would stay in the permanent fund.

Representative Gara did not understand how the fund could have principle that is worth more than the market value. Mr. Erickson answered that the definition of principal as Representative Gara understood it in this situation differs from that of Attorney General Renkes as laid out in his 2003 legal opinion.

Representative Gara asked if there was a definition of the word principal in the constitution. Mr. Gregg asserted the word was used but not defined. Representative Gara asked if there was another definition of the word other than Attorney General Renkes' opinion. Mr. Erickson answered that it was interpreted in the 1999 Morrison & Foerster opinion and that opinion held the opposite view of Renkes' opinion.

MICHAEL BARNHILL, ASSISTANT ATTORNEY GENERAL, DEPARTMENT OF LAW, pointed out that there is valid appropriation in place to pay out the 2009 dividend. He stressed the 2009 dividend must be paid out by law. Co-Chair Hawker added that although the value of the fund is less than the money that has been deposited into it, money can still be taken out in order to pay dividends.

Mr. Barnhill responded that Mr. Erickson's presentation was premised upon a definition of principal without basis in the state constitution or statutes. If there is no definition of principal in the constitution, it is necessary to turn to the statutes. The applicable statutes are AS.37.13.140 and AS.37.13.145, which stipulate that

income is to be deposited into the earnings reserve when it is received. He referred to Article 9, Section 15 of the Alaska constitution, which requires that income from the permanent fund be deposited into the general fund unless otherwise provided by law. In order for the income to be income it has to be realized and cannot be unrealized. Language in the statutes also says that net income of the fund shall be calculated under general accounting principles excluding unrealized gains and losses. Principle must be everything that income is not and can rise and fall.

Co-Chair Hawker stated that the original concept of the permanent fund was make investments that would produce income. A netting requirement was necessary if losses were being produced and only income could be moved.

[2:38:08 PM](#)

Mr. Barnhill divulged that when the fund was established there were three viewpoints on how it should be used:

1. social welfare programs
2. economic development
3. savings

Mr. Barnhill added that income producing investments by definition leave out social welfare programs. He pointed out that investments are never guaranteed. The income producing investments in the fund have lost value.

Representative Crawford asked if the principle is permanent.

Mr. Barnhill replied that money could not be appropriated from the principal but could be appropriated from the earnings reserve. The value of the principal could go to zero but that that would be a result of the market going down.

Co-Chair Hawker opined that if the market value was going down dividends should not be paid in order to protect the principal. Representative Crawford added that it would seem that this made the permanent fund not so permanent.

Mr. Barnhill reiterated that the state constitution protects the principal from appropriation.

[2:42:43 PM](#)

Co-Chair Hawker asked could the question be remedied if income going into the permanent fund earnings reserve, which is managed by the principal, had been left going into the general fund, which can be appropriated from. Mr. Erickson qualified that would solve some legal issues but would not be consistent with his understanding if the 1976 constitutional amendment.

Mr. Barnhill thought that had all of the income from the permanent fund been deposited into the general fund the value of the fund would currently be \$12 or \$13 billion. He surmised the notional value that Mr. Erickson spoke of is a product of inflation-proofing. That means taking some permanent fund income that is in the earnings reserve and dedicating it back to the principal. Co-Chair Hawker communicated that the notional value had been a judgmental decision made by the legislative body to make deposits to the permanent fund principal as well as the 25 percent that is constitutionally mandated.

SENATOR CON BUNDE asked if the legislature should appropriate from the earning reserve back into the corpus of the fund to make it whole. Mr. Erickson replied that it would be an option.

MIKE BURNS, EXECUTIVE DIRECTOR, PERMANENT FUND CORPORATION, DEPARTMENT OF REVENUE, addressed an earlier question regarding whether the fund could disappear through continually accessing the earnings reserve. He warned that there was less than \$4 billion in the earnings reserve, and if the country's financial situation continued to deteriorate, the earnings reserve would dissolve itself long before the fund.

[2:47:18 PM](#)

Mr. Burns stated that APFC accounting has operated under the Renkes Opinion for six years and in the interim period their auditors have approved of APFC financial statements using the opinion. He added that the auditors give deference, not reverence, in the legal opinion handed down by Renkes. Co-Chair Hawker communicated that it is an example statutory accounting versus General Accepted Accounting Principles (GAAP). He parlayed that statutory

accounting principles, however different from GAAP, comply with the legal authority.

[2:49:12 PM](#)

Mr. Burns deferred to Co-Chair Hawker's interpretation but wanted to add that if issue had been taken with the opinion it would have been noted in a footnote or management letter.

REPRESENTATIVE MIKE DOOGAN commented on Mr. Barnhill's statement about the use of the PFD as an economic development and savings vehicle and not to pay for social programs. Mr. Barnhill retorted that was correct and had been in the 2003 opinion. Representative Doogan disagreed. He informed the committee that he was the aide to the House permanent fund committee that wrote the permanent fund bill. After three years of debate the question of using the permanent fund as an economic vehicle was answered in the negative. He felt that it would behoove Mr. Barnhill to review the history of the fund.

Co-Chair Hawker concurred with Representative Doogan. He reminded the committee that the PFD was designed to be an ongoing source of revenue.

[2:53:32 PM](#)

AT EASE

[2:54:04 PM](#)

RECONVENED

Co-Chair Hawker stated that the question of the definition of principal and how it determines the pay out of the dividend needed to be resolved sooner rather than later. He pointed out that although LAW has currently determined that there is no danger to the legal authority to have a PFD for 2009, there are still serious intellectual questions to interpret.

[2:56:02 PM](#)

#

ADJOURNMENT

The meeting was adjourned at 2:56 PM.