

HOUSE FINANCE COMMITTEE
January 28, 2016
9:03 a.m.

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CALL TO ORDER

Co-Chair Thompson called the House Finance Committee meeting to order at 9:03 a.m.

MEMBERS PRESENT

Representative Mark Neuman, Co-Chair
Representative Steve Thompson, Co-Chair
Representative Dan Saddler, Vice-Chair
Representative Bryce Edgmon
Representative Les Gara
Representative Lynn Gattis
Representative David Guttenberg
Representative Scott Kawasaki
Representative Cathy Munoz
Representative Lance Pruitt
Representative Tammie Wilson

MEMBERS ABSENT

None

ALSO PRESENT

Jerry Burnett, Deputy Commissioner, Treasury Division, Department of Revenue; Malan Rietveld, Managing Director, Rietveld Consultancy Inc.; Representative Cathy Tilton; Representative Jim Colver.

SUMMARY

PRESENTATION: SOVEREIGN WEALTH FUNDS & RULE-BASED RESOURCE REVENUE MANAGEMENT: GLOBAL TRENDS, CHALLENGES AND BEST PRACTICES BY MALAN RIETVELD, MANAGING DIRECTOR, RIETVELD CONSULTANCY, INC.

Co-Chair Thompson reviewed the agenda for the day. The committee would be hearing a presentation on sovereign wealth funds by Malan Rietveld. Mr. Rietveld was a fellow

of the Center for International Development within the Kennedy School of Government at Harvard University. He was also the director of Kalytix Partners. Mr. Rietveld has worked around the world assisting countries in creating sovereign funds that help create a permanent source of income. The presentation would not address any bills but would provide the committee with information regarding sovereign wealth funds and the pros and cons of establishing these endowment funds. He asked committee members to hold their questions until Mr. Rietveld has completed his presentation unless the question directly related to understanding the material being presented.

^PRESENTATION: SOVEREIGN WEALTH FUNDS & RULE-BASED RESOURCE REVENUE MANAGEMENT: GLOBAL TRENDS, CHALLENGES AND BEST PRACTICES BY MALAN RIETVELD, MANAGING DIRECTOR, RIETVELD CONSULTANCY, INC.

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JERRY BURNETT, DEPUTY COMMISSIONER, TREASURY DIVISION, DEPARTMENT OF REVENUE, introduced Malan Rietveld. He reported that Mr. Rietveld came to Alaska, gave a presentation to the administration on sovereign wealth funds and rule-based management. The administration invited him back to speak to the legislature. He thanked Mr. Rietveld for being present and turned to him to begin his presentation.

Representative Thompson indicated that Representative Pruitt had joined the meeting.

MALAN RIETVELD, MANAGING DIRECTOR, RIETVELD CONSULTANCY INC., provided his history working on sovereign wealth funds (SWFs). He was a trained economist and worked for 10 years on issues concerning sovereign wealth fund management. The term "Sovereign Wealth Fund" was coined about 10 years ago. He noted the funds had been in existence for much longer than the name. He had worked on issues related to SWFs and resource-rich jurisdictions, countries, states, and provinces around the world from the Middle East to Norway to a number of US state funds. He was also doing his PhD on the subject, which was nearly complete.

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Mr. Rietveld introduced the PowerPoint presentation: "Managing natural resource funds: global trends and practices" (copy on file). He began with providing a context of the growth of SWFs in recent decades. He pointed to slide 1: "The growth of new SWFs" which contained a map of the world and the areas in which SWFs were operating. He noted that the red highlighted areas were the locations of the largest SWFs. There was a number of large funds in the Middle East in Abu Dhabi, Saudi Arabia, Kuwait, and Qatar. He thought the great amount of economic and political diversity in the funds was striking. He would address the significant differences shortly in terms of the size of the funds relative to the domestic economy and relative to the size of the budget and the government spending needs.

Mr. Rietveld believed it was useful to consider that within the world of SWFs there were a few different kinds of funds. He would emphasize three types of funds. The first instance was stabilization funds, which was particularly relevant to countries that funded themselves mainly through natural resources subject to tremendous volatility. The function of a stabilization fund was to provide support in stabilizing government spending. Consequently, the funds typically held liquid assets that were available on short notice for stabilization purposes. The second group were outright savings funds. The point of the funds was to accumulate savings. They typically invested in more diversified portfolios with greater risk orientation in exchange for higher expected returns. The defining characteristic was that they did not typically have drawdowns. The idea was to accumulate assets for the future either for a specific earmarked purpose. For example, the SWFs in Australia and New Zealand were required to meet a pension liability by 2030 and 2035 respectively. Again, the SWFs defining characteristics included the accumulation of funds and the compounding of earnings without sustainable draws or the provision of annual income.

Mr. Rietveld stated the third and largest most interesting group was investment income funds. The funds invest similarly to savings funds but they provided an annual flow based on a variety of different mechanisms unlike savings funds. They were important in the context of resource-rich countries and jurisdictions because they provided an alternative source of revenue to government in addition to revenues funded by natural resources. Essentially all North American permanent funds operated as investment income

funds. The only exception was the recently established North Dakota fund, which was acting as savings fund. However, the intention was to transform it into an income fund within the next 5 to 10 years. Simply put, North Dakota was still accumulating assets with the intention to draw on the assets in a sustainable manner down the road. He mentioned that it was interesting that all of the SWFs in the world really were the Texas funds. Texas had the Texas Permanent Schools Fund, the oldest, and the Texas Permanent University Fund, which managed assets earned on state land that belonged to the two respective systems. Their investment incomes were used to fund the school and university systems, which had been founded in the 1850s.

Mr. Rietveld did not want any confusion around why sub-national jurisdictions used the word sovereign. All working definitions of SWFs would include funds like the Alaska Permanent Fund, the Wyoming Permanent Fund, and others. The idea of sovereign meant that ultimately the funds were managed by a government in trust by the citizens and for the benefit of the citizens. He felt very comfortable thinking of the Alaska Permanent Fund as a sovereign wealth fund.

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Mr. Rietveld discussed the chart on slide 2: "The growth of new SWFs." He relayed that the chart showed the growth of SWFs by periods. There were three interesting periods in Texas and New Mexico in the 19th century. At the inception of statehood, they created funds to help fund government priorities. Funds were established in the 70s and 80s, in response to the commodity price boom of the 70s and production increases. The Middle Eastern funds had typically been established in the oil shocks period of the 70s. The Alaska Permanent Fund was created in 1976 as was the Alberta Heritage [Savings Trust] Fund and a number of North American state permanent funds. More recently since 2000, there had been a real proliferation of funds. The concept was essentially catching on and had been tried and tested as a sensible and prudent way to manage volatile and depleting (in most instances) natural resource assets and income. He added that the overwhelming majority of SWFs were created by the proceeds from natural resources. There were also funds, particularly in Asia, that were funded by other forms of government surpluses and government revenue such as privatization proceeds, foreign exchange reserve

accumulation related to exchange rate policies, and other surpluses. He noted that the majority of funds (75 percent to 80 percent of assets) were held by countries that funded them through natural resource revenues.

Mr. Rietveld advanced to slide 3: "Major global trends: the context." He framed three distinct eras that he saw in how SWFs had historically evolved. The first group was what he called SWFs 1.0. In the case of the first permanent funds and what happened in the 70s in the Middle East and the North American permanent funds the emphasis was on the simple process of creating a fund, a major step. It required getting the legal foundations established and installing a discipline where the state or government would not spend all revenues but was going to put it aside in a structure with its own legal identity. Consequently, the investment model for these kind of funds was very simple: Cash balances were maintained without a significant amount of attention paid to the fund's investment styles and the use of the funds. The idea behind a fund was to try to insulate a share of revenues from the budget process. Often they came because of a political compromise. One of the more interesting examples was the State of Wyoming. In 1976, there were proponents of a higher severance tax on production. Members of the legislature and the governor were concerned that if the increase in severance taxes came to pass all of the additional revenue would be spent. As a compromise, the Wyoming Permanent Fund was created so that the excess revenues would flow to the permanent fund to be spent over successive generations rather than immediately. If the money had been spent immediately, it would have likely been destabilizing to the state.

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Mr. Rietveld scrolled to slide 4: "Major global trends: the context." He reported that around the turn of the century there was a shift to what he referred to as SWFs 2.0 when a number of things happened. There was a significant increase in the number of funds and a significant growth in the size of the assets managed by the funds because of increasing revenues to fund them and healthy financial returns. There was also an emergence of non-resource based SWFs particularly in Asia, China, and Korea. Singapore had funds earlier but theirs had increased significantly during this period. The Sovereign Wealth Fund model became mainstream around the Asian financial crisis in 1998 until 2014. It

became standard advice for the international monetary fund, for example, in advising countries that were resource dependent and resource rich as a way to manage fiscal affairs. It led to the creation of the International Forum of Sovereign Wealth Funds eight years previously. The group was a convening body for all the international funds. The Alaska Permanent Fund was an active member of the forum and met at least once annually. It was a place to discuss ideas and share best practices. The group had come up with a list of 24 general governance principles and practices of which the Alaska Permanent Fund was in full compliance as a global leader of good SWF practices. He added that around the same period there was greater political consensus concerning the purpose of the funds. Countries that had the funds imbedded in their constitution had less of an issue. In the Middle East, there was a break from the historical tendency to dip into the funds without any principle and rule behind it. Countries gradually began to understand that the funds were there for a particular purpose and for the long-term. Finally, there was significant growth in media attention, policy analysis, and academic research devoted to SWFs.

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Mr. Rietveld skipped to slide 6: "SWFs 3.0: Adjusting to new fiscal realities." He contended that the collapsing oil prices especially since late 2014 was heralding in the new era of SWFs 3.0. He would briefly run through what the key issues were presently. He thought it would frame the discussion in House Finance. It would give members the sense that Alaska was by no means alone in confronting the issues. He believed the most important issue presently for resource-based countries given the most recent drop in oil prices was to consider the savings mechanism as well as paying greater attention to thinking about the sustainable and sensible approach to using investment income, to using earmarked pools of assets. Accumulated in good times to help support spending and economic stability in tough times. He was seeing the replacement of what he called old rules of thumb that worked quite well in a rising tide. The simple process for saving assets was shifting to a more sophisticated set of policies combining a savings rule with a sensible spending rule. He thought Norway, Abu Dhabi, and Chile were three examples of countries that were already there. The majority of resourced-based SWFs were getting there. All three of the countries operated in different

contexts and different degrees of resource dependence. In broad strokes, they were at the vanguard of countries and governments that had already moved in the same direction. As people thought through appropriate combinations of savings and spending rules, the focus in the first instance was to avoid a depletion of funds in tough times for commodity producers. He suggested it would be less of an issue if an entity's principle was constitutionally protected. For many countries, it was not the case. They had to take action to ensure that the fund's capital and assets were protected. Once that was achieved, the real objective for commodity dependent countries was to decouple spending from the underlying commodity cycle. The real question was what role could SWFs and the spending rules around SWFs play in breaking the historical cycle that many countries and jurisdictions suffer from where spending tended to track oil prices and oil revenue. He stated that an ebbing tide had revealed that some people had been swimming naked. He elaborated that essentially, as commodity prices were rising there was a significant interest in the SWF model because it was working well. As the tide ebbed, there were some elements, particularly on the spending side, that needed further work to improve spending and savings policies making them more robust through the commodity cycle.

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Mr. Rietveld advanced to slide 7: "SWFs 3.0: Adjusting to new fiscal realities." He continued that in going into the SWF era of adjusting to new fiscal realities for commodity producers there were three groups of countries. Group A were countries that never saved enough initially. Despite the uninterrupted rise in commodity prices between 2004 and 2014, (2009 was an exception) countries like Venezuela and Nigeria were unable to save in a boom period to help them in the current environment. He reported they were hurting and in trouble. Group B, including Russia and Saudi Arabia had managed to achieve some savings in the prior decade. However, in the absence of sustainable rule-based spending policies they were presently drawing down and depleting their assets rapidly. He would discuss Saudi Arabia later in the presentation as a cautionary tale. The group Alaska wanted to associate itself with, Group C, was reforming or considering the appropriateness of saving and spending rules. Abu Dhabi, Kuwait, Norway, Chili, and potentially Saudi Arabia were in Group C or were moving in that

direction. He suggested that despite all of the pressure on the SWF model, the framework was attractive for countries. He had counted 17 countries that had drawn legislation to create SWFs, particularly countries that had discovered natural resources in the past decade. It was also under consideration in a number of additional countries.

Mr. Rietveld pointed to the pie charts on slide 9: "Oil's % of revenue & fiscal break-even price." He wanted to provide a context of where he saw Alaska relative to other countries that had significant resource revenues and SWFs. He noted that the horizontal axis showed the share of government revenue from oil. It was a measure of the government's and the budget's dependence on oil. He referred to the vertical axis. He wondered what kind of oil prices were necessary to balance the books if the spending patterns of recent years were maintained given production volumes. The two matrices indicated Alaska being in uncomfortable territory - it was highly dependent on oil revenue to fund government. He reported that 80 percent of government revenues came from oil. In good years with high oil prices, the number could rise to 90 percent or higher. There was another group including the Canadian province of Alberta, the State of Wyoming, and Norway that found themselves in a less pressured situation to the extent they had significant revenues outside of the oil sector and the commodity sector. Typically, these countries had high tax rates with income taxes, corporate taxes, and additional revenues to fall back on when oil and commodity prices declined.

Mr. Rietveld continued that of the Middle Eastern group a number of countries that were part of the grey grouping (Abu Dhabi, Qatar, and Kuwait) were able to cope and balance their budgets despite their high levels of oil dependence. He explained that these countries had moved toward the full embrace of the SWF model. They were using their income and the sustainable amount of draw that they could get from their SWF assets to supplement the budget in times of low oil prices. He relayed that Abu Dhabi, Qatar, and Kuwait could balance their budget without significant cuts to spending levels - oil prices being around \$45 per barrel to \$60 per barrel. The red line showed that if Alaska would similarly follow the trend towards the full embrace of the SWF model it would move to a similar position. In fact, he claimed that in all probability Alaska would be able to balance its budget at an even lower

oil price than its Middle Eastern counterparts. He would provide additional info shortly.

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Mr. Rietveld reviewed the bar graph on slide 10: "SWF assets under management." He explained that the chart showed the size of assets under management in US dollar billions for a number of SWF countries. Clearly, Alaska's was relatively small compared to other countries. He noted that the chart showed Norway having \$820 billion in assets.

Mr. Rietveld continued to slide 11: "Size of assets relative to budget." In terms of Alaska's fiscal position, he suggested scaling Alaska's pool of assets relative to its budget. The numbers at the top of the chart indicated the number of times the budget could be covered if the accumulated assets were divided by the size of the budget. According to the matrix, Alaska was the wealthiest country in terms of its assets; its assets could cover almost 11 times the budget. Even some of the most established SWF countries were nowhere near the position that Alaska was in. They were somewhere over halfway as wealthy if the SWF was scaled relative to the size of their budgets.

Mr. Rietveld scrolled to slide 12: "Notional sustainable draw as a % of budget." He posed the question that if 4.5 percent was applied as a sustainable amount to draw from the assets, how big would the draw be relative to the size of the budget. He reported that the amount of a sustainable draw of 4.5 on assets would equal roughly half of Alaska's budget. For the other countries represented, the numbers were under 30 percent. The chart illustrated the extent of Alaska's wealth in terms of accumulated assets.

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Mr. Rietveld turned to slide 13: "Alaskan strengths and weaknesses." He reviewed Alaska's strength and weaknesses relative to other countries that were resource dependent and had SWFs. He considered a number of fiscal indicators including the outlook for raising non-oil revenues, the production outlook, and the governance and management structures around the actual assets. In terms of the size of savings relative to the budget and government spending needs, he opined that Alaska's position was particularly strong. By his calculations, Alaska's was the strongest of

all resource dependent jurisdictions in the world. His largest concern was the amount of money available under the current system as accessible buffers. He understood Alaska had various funds that were available to support the budget in tough times. However, the amount of years of coverage of budget spending currently accessible in the structures was nowhere near what some of the Middle Eastern funds had provisioned. He noted that Abu Dhabi and Qatar were able to draw on assets to tide them over for the following 5 or 6 years and up to 10 years if they were to make some spending cuts. Alaska's system did not have the same accessible buffers. One of Alaska's big weaknesses was its large fiscal dependence on oil, which limited its ability to raise non-oil revenues compared to other areas. He pointed out the significant benefit of Alaska having a savings rule in its constitution. He only placed one tick in the box because Alaska did not have a spending rule in place appropriate for government spending needs in conjunction with a savings rule.

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Co-Chair Neuman mentioned the state's investment in a large diameter gas pipeline. He asked Mr. Rietveld to comment on whether the project was a strength or weakness for the state.

Mr. Rietveld responded that further down on the slide he had the potential for production increases. He noted that there was a great deal of uncertainty around how many assets were under the ground. His assessment was based on data used in a model that was utilized to consider the SWF plan numbers. The baseline assumption on the model was one of declining revenues. It was possible that there could be a significant and highly beneficial increase in production for Alaska in the future. He would explain what would happen to the SWF model if it occurred. He understood there was significant potential for increases in production and resource revenues relative to the baseline assumption.

Mr. Rietveld continued to elaborate on slide 13. He had placed question marks under the short-term and long-term potential for raising non-oil revenues through taxation. He thought the Alaskan economic base was relatively small to achieve massive gains through taxation and it was a policy issue for the legislature to decide. It was not obvious to him that there was significant potential to offset the drop

in commodity revenues with other forms of revenue. He had three thoughts about the current management of Alaska's assets. There was no doubt that the governance structure including the institutional rules, the independence, and the competence of the Alaska Permanent Fund Corporation (APFC) was of the standard worldwide. It was an example that many countries sought to emulate. He continued that the investment style pursued by APFC, relative to what was expected, was appropriate. He added that under a SWF model there would not be a great need for significant changes in the portfolio or the mandate of the fund. On the operational side, he thought there was scope for increasing the internal capacity of APFC with the support of the legislature and the public. Currently the corporation made heavy use of external managers. He thought there was potential to bring some of the management in-house. His final point was that there could be significant benefits by bolstering the operational and internal capacity of APFC.

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Representative Guttenberg asked him to expand on information regarding the last line on the slide "Support for fund staffing needs."

Mr. Rietveld responded that he checked the "dislike" box twice because in comparison to other funds, the managers of larger funds such as the Norwegian SWF managed by a separate entity had figured out a way to hire and retain the best staff. Typically, in the world of finance it could cost a significant amount of money. It had historically been an obstacle for many SWF to justify and explain the staffing needs of the management institution. He made the case that the state would achieve savings in the end by allowing the APFC to fulfill its real staffing needs.

Representative Guttenberg thought it was something significant to consider.

Mr. Rietveld had spoken about the SWF model and the two critical qualifiers around the model were sustainable and rule-based. He would speak about the critical elements of the rule-based sustainable SWF model.

Vice-Chair Saddler had the sense that the SWF was just a savings function. He thought that it set certain types of funds apart from the volatility dampening or stabilization

and the investment income model. He thought he was using SWF to imply the second two. He believed that the pure savings, which might still be with the Alaska Permanent Fund, was outside of the definition of a sovereign wealth fund. He asked Mr. Rietveld for his thoughts.

Mr. Rietveld agreed with his argument. In general, things like investment capacity were much more applicable to savings and investment income funds with more complex portfolios. The investment process and requirements for a stabilization fund were simpler. He made his remarks about support for staffing needs in relation to investment income funds and savings funds. He believed that stabilization funds were different beasts in terms of staffing needs.

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Vice-Chair Saddler clarified that the first definition of a savings fund had implied no spending mechanisms. He did not presume the legislature would be changing the PF.

Mr. Rietveld suggested that the Permanent Fund in its current form was both a savings fund and an investment income fund to the extent that it funded the PF dividend. In the proposals being discussed, the question was whether the PF moved more in the direction of an investment income fund more than currently. Vice Chair Saddler was correct that it was in between the two.

Mr. Rietveld continued to Slide 15: "What are resource-based SWFs really about?" He invited the committee to consider the most important functions performed by resource-based SWFs. He relayed that Adam Smith, the father of economics, described mining as the most disadvantageous lottery in the world. He might as well have been talking about commodities in general. Uncertainty had always accompanied commodity wealth and commodity income. The first function of resource-based SWFs was savings - transforming a depleting asset and depleting income stream from finite natural resources into a permanent one. The savings would potentially provide a stream of income completely separated from the commodity revenue. Sovereign wealth funds could provide macro-economic and fiscal stability. The idea was to separate the budget process from the fluctuation of commodity revenues and focus on the accumulation of those commodity revenues in a financial

portfolio applying standard financial approaches based on the size of the portfolio. It was important to answer the question as to the sustainable amount of the assets that could be spent by the state without depleting the corpus.

Mr. Rietveld discussed that the second function of a SWF was that the state could completely decouple the budget process from the underlying commodity revenues. Alaska would be able to move away from a "boom-bust" cycle where spending tracked commodity prices and revenues, and fiscal policy destabilized the state's economy. The use of a SWF was not magically making volatility disappear from the system. Instead, volatility was being held in a place that proponents of the SWF model felt that was more appropriate. Currently, with the absence of the SWF model the volatility resided on the revenue and spending side of the state's fiscal affairs. Whereas, in the SWF model, the volatility was transferred to the fund's level while spending and the sustainable draw from the SWF was considerably more stable and potentially very stable. The third purpose was a more negative function. In the history of boom-bust economics of resource-based economies, there was a tendency in boom periods to overspend, make wasteful investments and deploy boom-time commodity windfalls in economically inefficient sectors and putting them to economically inefficient uses. All economies were subject to absorptive capacity constraints. In other words, there was a defined labor pool, a limited number of ports for importing capital into the state, and a limit to how much windfall the state could absorb sensibly and efficiently. He suggested that in using the SWF model the windfall would go into the SWF, the level of the fund would rise, and the windfall would be spent over a longer period, ameliorating some of the capacity constraint.

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Representative Wilson remarked that the PF was already essentially, what Mr. Rietveld was saying it was. The difference was the state had chosen not to spend its reserves. She thought the reason the topic was being discussed was that the legislature was contemplating a change in how the state provided a dividend to the people of Alaska. She believed the state already had a fund in place and wondered what she was missing.

Mr. Rietveld thought what was being discussed was a fully-fledged embrace of the SWF model than what was currently in place. First, the model dictated the greatest share of revenues going into the fund. Currently, it was constitutionally mandated that 25 percent of royalties went into the fund and had historically been 30 percent. Under a SWF model, a greater share of revenues would go into the fund rather than the direct budgeting process. Second, a greater share of sustainable draw or investment income from the fund would be available for spending. The proposal was to change the magnitude of resource revenue and income that came out of the system. It operated in a similar way but a greater share of revenue would go into the PF and a larger sustainable draw would come out of the fund.

Representative Thompson remarked that there would be a more detailed discussion on the topic in the following week.

Representative Wilson wanted to understand the difference between what Alaska already had in place and what was being proposed using the SWF model. It seemed to her that whether the state used the current model or the one Mr. Rietveld was proposing the state would end up with the same amount of revenue. She wanted to understand the changes being suggested.

Representative Gara recapped the difference between what the state was currently doing and what Representative Wilson proposed. In addition to revenue used for state spending, a certain amount would be dedicated to a fund that would generate additional revenue. It would become an endowment fund. In other words, revenue would be divided into two pools: one pool would go directly into the budget and another would go into a fund that generated investment revenue. The sovereign wealth fund proposal was to shift a significant amount into a SWF to generate investment revenues that would be used to supplement annual revenue. He asked if he was correct.

Mr. Rietveld responded in the affirmative. He clarified that the SWF model was not his proposal; he was a strong proponent. He acknowledged Representative Gara's description was correct. The most important additional benefit the state would receive from transferring a greater share of revenues into the fund and a greater share of investment income out of the fund was stability and breaking the cycle of spending. The sustainable draw was a

stable concept. Whereas, spending 70 percent to 75 percent of oil revenues (practiced historically) it created a significant volatility in spending. The critical distinction of what was being proposed was that the SWF model would change the magnitude of investment income to fund government and would transfer volatility from the budget process to the SWF structure.

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Mr. Rietveld moved to slide 16: "Oil to equities." He offered that another way of thinking about the SWF concept was what the Norwegians had described as transforming oil to equities. He noted that financial assets and financial portfolios were subject to risk and volatility. However, in looking at historical data and patterns financial assets had higher returns and lower levels of volatility than oil. Therefore, it could be argued, from a financial standpoint, that it was advantageous to transform subsoil assets and revenues derived from subsoil assets into financial ones.

Mr. Rietveld explained slide 17: "Oil to equities: what would you rather hold?" He pointed out that the chart reflected a period from 1928 to 2010. The dark blue line at the top represented the growth of the value of stocks. He noted that the vertical axis went from 10 to 100 to 1,000. He concluded that stocks had generated considerably higher returns historically than oil represented by the light blue line and bonds [in yellow] and money markets [in green]. He highlighted the volatility of the oil line on the chart. Essentially, oil returns were very similar to bond and money market returns but at a much greater volatility if a state was holding all of its wealth in the form of oil.

Mr. Rietveld scrolled to slide 18: "Oil to equities: what would you rather hold?" He relayed that the Norwegians used a measure referred to as "Value at Risk" to quantify the risk to the value of their petroleum under the ground. The higher the bar on the chart, the more the value was at risk of the asset under the ground. Although they had an \$850 billion financial endowment, the assets were considerably less at risk than if it was held in oil and less at risk than the petroleum that they held under the ground. At every opportunity, the Norwegians tried to transfer their oil wealth and oil income into financial wealth and financial income.

Mr. Rietveld turned to Slide 19: "Key elements of a rule-based SWF model." He emphasized the importance of the process operated by way of rules - both a savings rule and a spending rule. He elaborated that in the absence of rules, even with the best intentions, the tendency was for those intentions to break down in tough times and to abandon an implicit rule. He thought a savings rule was worthy to deliberate. He suggested considering what percentage of revenue to transfer to the SWF. If there were different sub funds such as a stabilization fund and an income fund, it would be important to think about the rules that govern the flows between the funds. In terms of spending, it depended on the fund's purpose. For instance, the fund could be in place to provide short-term stability to the budget or, it could be in place to replace the source of funding for government through investment income. He restated the importance of considering rules on the savings side, which he thought were largely in place with Alaska's constitutional protection of a minimum. However, he recommended that the proposed changes to the spending rules needed to be properly vetted ensuring that the mechanisms were rule-based.

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Mr. Rietveld discussed Slide 20: "Why have a rule?" He relayed his thoughts on the benefits of having a rule. He surmised that like all rules, the idea was to constrain the discretion of policy makers, legislators, and governments. He suggested that memories tended to be short in oil rich jurisdictions that were subject to historical boom-bust periods. He added that because of the fiscal pain commodity producers were currently experiencing, the tendency was to do catch-up spending once prices recovered. If countries were able to save some of the "boom," it would be much easier to manage any downfalls. Alaska had accumulated assets because of the prudence of legislation and the prudence of previous legislatures that insured the occurrence of inflation proofing and sticking to the rules in place.

Mr. Rietveld spoke of the limitations of human ability to forecast oil prices and revenues. Academic studies showed that it was impossible to forecast them accurately. In the absence of a rule, forming a budget was entirely unpredictable. In contrast, a rule would prevent spending if oil prices were higher than expected. The excess

revenues would go into the SWF. Once the value of the assets increased, the state could adjust the rule through a periodic review and adjust the sustainable draw. It was unreasonable to think the state could accurately forecast oil prices and form a stable and sustainable budget on it.

Mr. Rietveld emphasized the importance of rules being symmetric or counter-cyclical. In other words, it was important that the rules applied to both commodity booms and busts. Otherwise, there was a tendency to save in a boom period and to act freely in a bust period. It was very important that the rules were binding for boom and bust periods.

Another attractive feature of having a rule in place and being able to communicate the rule clearly was expectation management for medium to long-term fiscal policy. He thought it applied to ratings agencies, businesses and investors, and the public. Ratings agencies that assessed the credit worthiness of Alaska would take comfort from a long-term plan embedded with a set of rules. Historically assessors of credit worthiness looked favorably on a rule-based system. It was also important to manage the expectations of businesses. It was his understanding that businesses in Alaska were asking for a plan that provided fiscal stability before deciding to increase long-term investment in the state. He suggested that having a rule-based system in place and being able to communicate the long-term plan would be useful in managing expectations of businesses and investors. He asserted that the public would also benefit in their own financial planning, savings, and through their most important assets, typically their home values. There was a historical correlation between oil prices, oil revenues, government spending, and home values in Alaska. He concluded that a rule-based system that embedded stability would help households and the public to manage their own fiscal affairs.

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Representative Edgmon asked him to explain why the legislature should enact the model as soon as possible rather than waiting.

Representative Thompson added, "The urgency why."

Mr. Rietveld responded that he looked at the money available under the current system to plug the short-term deficit. He saw that there was coverage available for two or three years. He believed Alaska had the tools and assets at the legislature's disposal to fund the deficit more sustainably. In answer to Representative Edgmon's question, the state would draw down on the limited buffer of available funds. The risk was that if the legislature kicked the can down the road the system would be at greater risk and the SWF model would require roughly four times the annual budget-spending amount in a cash reserve structure. The state would have to replenish the fund if it were to run down further in the current year. There would be a concern around the willingness of policy makers and legislators to deplete reserve buffers further at a time of pressing fiscal issues.

Representative Edgmon would follow up with additional questions later.

Representative Gattis was thinking about the spending aspect. She remarked that the state had historically brought programs back during boom periods. She thought there was merit to having a budget, like having a household budget. She believed a person had to save for a rainy day. She liked the aspect of limiting state spending when there was money and saving it for a rainy day.

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Mr. Rietveld surmised the state was calculating its financial wealth and changing the mindset of the people who formulated and approved the budget to a concept of a sustainable annuity like a household that lived on a financial endowment. A person thought about a sustainable level of spending given their financial wealth. They did not deviate from their budget; they knew their budget and planned accordingly.

Mr. Rietveld detailed Slide 22: "Existing approaches to rules." He cited that there were three types of savings rules. The first rule was to save a fixed percentage of either some or all commodity revenues. Alaska constitutionally mandated depositing 25 percent of royalties into savings; however, in practice, the percentage had been 30 percent. Another rule was to have a moving average of either revenues or prices. If, in any

fiscal year, the state exceed the moving average, it would be required to place the exceeded portion into savings. The third savings rule was to have a reference price of \$75 per barrel of oil. If prices were \$90 per barrel then the percentage difference would be calculated and put into savings. They were simple rule-of-thumb savings measures. He qualified that it was better to have the three savings rules than to not have any. There were potential problems with only having the three rules in place. He elaborated that there was a pro-cyclicality of a fixed percentage savings if a stabilizing spending rule was not in place to offset it. It meant that even in the toughest times the fixed percentage would need to be transferred the fixed percentage to the savings pool. Some people might say that it made more sense to save in grim times and find a way to reduce savings in tough times. The problem with a reference price was determining who set the reference price and the appropriateness of the price. A few years prior \$100 price might have seemed appropriate. Presently, it did not appear that oil prices would return to \$100 per barrel any time soon. He suggested that from a governance and policy perspective it was very difficult to know who would determine the reference price. The rule-of-thumb measures on their own were good rules for accumulating assets. However, they were not particularly useful in combining the spending and savings decisions into one unified framework, especially one that provided stability to spending.

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Mr. Rietveld continued to Slide 23: "A fiscal rule for resource-based SWFs." He advised making some conceptual departures when considering a complete rule-based fiscal framework that had both spending a savings rules. He encouraged members to move away from thinking of the budget first then savings as an afterthought. In the SWF model, a much greater share of assets flowed first to the SWF and then out of the SWF in the form of a sustainable investment income. Changing the piping was essential. He highlighted that the first place of resource revenue went into the SWF. By doing so, the fund and the level of assets held in the fund was the place in the fiscal system where the burden of adjustment to volatility took place rather than in the budget itself. The concept applied as much to booms as it did to busts. In boom periods, the burden of adjustment would happen in the SWF. The Sovereign Wealth Funds would rise rather than spending. In bust periods, SWF assets

might decline rather than spending. The Sovereign Wealth Fund became the volatile element.

Mr. Rietveld explained that by adopting the SWF model the state would achieve the goal of decoupling spending decisions and the budget process from the underlying volatility of commodity revenue. The concept was that by transforming oil wealth into financial wealth and assessing a sustainable draw on that financial wealth, the amount would become the achievable and sustainable amount of spending. It would be completely uncorrelated to what was actually happening with oil prices and oil commodities in the previous or current year. His final point was that if production increased significantly in the state and commodity revenues exceeded current baseline expectations, the spending increase would spread out over a number of years because of a higher level of the SWF and through periodic reassessments of the sustainable draw size. He added that it was equally important to remember that if revenue decreased an adjustment to the draw size would take place. Spending would also have to adjust down over time. The burden would be spread over time through the level of the SWFs.

Co-Chair Thompson made the comment that the price of oil was frequently talked about but he thought Alaska also had to be cognitive of declining production. The price of oil could sharply increase, but less production would affect the state.

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Representative Wilson asked about a spending level amount provided at the end of December each year. She used \$3 billion as an example asking if the legislature's job would remain to decide how to spend those funds. The only adjustment the state would have if the spending level amount decreased would be to pass taxes that would go back into the SWF with the hope of the spending level increasing the following year.

Mr. Rietveld answered that Representative Wilson had provided an accurate description of what would happen. He added that a prudent and popular approach worldwide would not be to make the assessment annually, but perhaps every four years. The review would check the essential components of the model and the assumptions guiding it were still in

place. He thought four years was too long and one year was too short. Another suggestion was to make periodic assessments in conjunction with the periodic assessments of the Permanent Fund. The Alaska Permanent Fund Corporation could make the assessment at the same time or shortly before reviewing the central elements of the fiscal rule and fiscal framework in order to get APFC's input and an explanation for why it believed the assumed target return was still achievable.

Co-Chair Thompson assumed that with a certain amount of earnings there would be a set draw amount each year. The state would have four times the amount set aside and conduct a review every two or four years.

Mr. Rietveld responded in the positive.

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Representative Wilson mentioned having savings in addition to revenues. She wondered if the money to appropriate would be a calculation. There would be a limited amount to allocate because there was no other source to tap for funding. In other words, everything would go through the SWF. She asked if that was how the plan worked.

Mr. Rietveld indicated that Representative Wilson was correct.

Vice-Chair Saddler mentioned that some people wanted to close the barn door when the horse was gone saying that the state should have a spending cap or hard other rule. He wondered if the SWF had a mechanism to manage an increase annually or to have a hard spending cap or any other rules.

Mr. Rietveld responded that there were other rules and spending caps that could be applied in varying degrees. He thought for a commodity dependent jurisdiction the SWF was a tried and tested model. Legislation could be introduced to put a budget cap on the fund. He believed that in the SWF model the number was based on an assessment of what was sustainable investment income.

Vice-Chair Saddler commented that a global change in economic conditions that proved 4.5 percent was no longer sustainable could trigger the necessity to reassess the model or change the rule.

Co-Chair Thompson remarked that the state would still be able to make up the differences through taxes or other means.

Representative Kawasaki asked about a separate account in which funds could be deposited prior to being appropriated. He noted having to have four times the amount in the earnings reserve to make a SWF plan work.

Co-Chair Thompson remarked that the topic would be discussed in the future.

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Co-Chair Neuman opined that the biggest impediment to Mr. Rietveld's SWF model was politics. He remarked that the stock market was declining and that there could be a drawdown of the reserves. He understood that the model required approximately four years of reserves for potential downturns in the economy. He estimated the amount to be about \$13 billion. He thought the problem would be in the stresses in government. The public had certain wants and needs, which he attributed to the growth in spending. He wondered if the state was better off keeping politics out of the mix and staying away from using the PF to fund government. He argued that the PF should focus on funding the endowment fund. He asked if he was accurate.

Mr. Rietveld agreed that if the state adopted the SWF framework it would be important to make sure APFC continued to make investment decisions based purely on financial objectives. It would have a clearly articulated return target visible to the public and to legislators. It would be critical for the PF team to be left alone to pursue prudent investment decisions to achieve the target.

Co-Chair Neuman was concerned with keeping politics out of the scenario. He mentioned that currently there were members of the governor's cabinet that sat on the PF board. He asked Mr. Rietveld if he thought it was better not to have any person from a government agency sitting on the PF board to avoid political influence.

Mr. Rietveld did not see a categorical problem with the composition of the APFC board. It seemed to be in keeping

with what the best SWFs did worldwide to have a range of people represented on the board. He mentioned that APFC had extremely high levels of transparency in place under which they operated. The corporation also operated under high levels of accountability, which he thought, offset the risk of undue political intervention. He did not have a problem with the make-up and added that it was well governed and well managed.

Co-Chair Neuman asked about reducing the risk of political interference.

Mr. Rietveld answered that he was unable to provide a "yes" or "no" answer to his question. He stated, "It works."

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Vice-Chair Saddler asked if it was usual for a SWF to transform itself from one model to another such as from a stabilization model to a pure savings or to an investment. He thought it was asking a lot to put away money rather than responding to legitimate needs of people to spend it. He wondered how often people could be asked to change a model.

Mr. Rietveld stated that there was not a SWF in existence, around more than five years, that had not changed. The most obvious change for funds was to transition from being a pure savings fund to being an investment income fund. It was a very prevalent and widespread pattern. There were also changes in the balance between stabilization purposes and income purposes. He indicated changes were very common.

Representative Guttenberg stated that the state had two major assets: money in the bank and oil in the ground. He remarked that the SWF liked the SWF. He thought the two assets should flow into the SWF rather than other revenue sources such as gasoline, alcohol, and tobacco taxes. He asked if using the other sources of revenue was part of the model.

Mr. Rietveld responded that both things happened. He clarified that some countries and jurisdictions ran all revenues through the SWF. The most important thing the legislature could do conceptually was to put the volatile revenues into the SWF. If there were other sources of revenue that were more stable, more predictable, and more

sustainable, he did not necessarily see why they would have to run through the fund. The most important thing was to put the volatile and potentially declining revenue source into the SWF.

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Representative Pruitt asked about the timing of changing from a savings to an income fund. He suggested that if the state had changed the model in the last downturn when the PF was about \$28 billion, it would not have grown to its current amount. He wondered if the state was deciding to switch the model and limiting the eventual opportunity to grow the fund even more than 48 percent of government spending. He asked about the timing of the change. He thought it was an important part of the discussion. He asked if the state was knee jerking to a crisis.

Mr. Rietveld thought the assessment was based on there being a current crisis due to oil prices. He noted that the SWF was one way to address the fiscal issues in a prudent manner. He did not see a downside to implementing the model because if oil revenues did recover, revenues would still flow into the SWF and allow for greater government spending. It would be spread over several decades. The fund would appreciate through additional oil revenues. Government revenue would respond but the response would be spread out over several years, decades or potentially into perpetuity. He thought it was an opportune time to apply the model especially since the state had accumulated a nice pool of assets. The state was in a position to implement a policy where it could make use of a sustainable draw.

Representative Gattis asked if the state was putting all of its eggs in one basket, the stock market basket. She was concerned with the market crashing.

Mr. Rietveld suggested she was right that the state's portfolio would be subject to volatility. His observation was that the PFs asset allocation was highly diversified. The goal was to achieve diversification benefits including assets that were uncorrelated. It was not to say that all volatility would be eliminated. However, he believed (as indicated in the slides pertaining to Norway) financial assets had historically provided a better return at lower risk than oil. He concluded that the state would be moving eggs from one basket to a bigger basket that was less

fragile based on historic data. His second point was that the state had to deal with the fact that it had its wealth in oil and financial wealth. He believed oil was more volatile than financial assets. However, the state did not have personal income taxes, unlike Norway with a personal income tax of 55 percent. He opined that the baseline for Alaska would be to transform as much oil wealth and income into financial wealth and income.

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Mr. Rietveld skipped to slide 27: "Saudi Arabian report." He noted the work he had done on Saudi Arabia. It was an illustrative case of what could happen in the absence of rule-based policies. Saudi Arabia was the world's largest oil producer, which was potentially being challenged by Russia and the United States presently. It had the cheapest oil and a century or more of subsoil oil revenues at the lowest extraction price. Prior to the oil price collapse Saudi Arabia had about \$850 billion in accumulated assets. It seemed that not much could go wrong for Saudi Arabia from a fiscal perspective. However, the absence of rules caused a significant amount of ruin.

Mr. Rietveld turned to Slide 28: "Saudi Arabia's problems: lessons for Alaska?: Estimated Oil Price Required to Balance 2015 Budget." He reported that already Saudi Arabia needed a very high oil price, despite its massive oil production, to balance its budget. It needed an oil price in excess of \$100 per barrel based on recent years' spending. There was not a significant amount of give.

Mr. Rietveld advanced to slide 29: "Saudi Arabia's Problems: lessons for Alaska? Projected Breakeven Oil Price." He commented that the projection was for the breakeven oil price to continue rising significantly drive by demographic pressures. The country had a very young population and it made significant social welfare and subsidy payouts.

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Mr. Rietveld turned to slide 30: "Saudi Arabia's problems: lessons for Alaska? Budgeted and Actual Government Spending." He reported that a very common problem in a resource-based economy was that spending just adjusted to the increase in oil revenues as it did in Saudi Arabia. He

pointed out that the green lines represented the budgeted spending. Saudi Arabia consistently overspent the budget by 15 percent to 20 percent annually which was a way of not saving as much as should have been saved.

Mr. Rietveld continued to Slide 31: "Saudi Arabia's problems: lessons for Alaska?: Oil-Driven Cyclicity in Capital Spending." He relayed that a familiar pattern to people in Alaska was the historic correlation between oil prices (represented in blue) and capital spending (shown in green). The boom-bust cycles in capital spending were devastating given that Saudi Arabia had not sufficiently decoupled the budget process from oil price volatility.

Mr. Rietveld discussed the policy recommendations for Saudi Arabia listed on slide 32. First, he recommended adopting explicit spending and savings rules. It had happened to some extent but in an ad-hoc fashion. Because of their ad-hoc mechanism, they had drawn down on assets to the tune of \$200 billion since the oil price collapse. In some calendar months, approximately \$37 billion to \$40 billion was withdrawn. He had tried to calculate what would have happened if Saudi Arabia had implemented the rule-based framework that he proposed in the Harvard paper in 2004 or 2004. He showed that the country under-saved in the absence of a saving rule even though they went to \$850 billion. Calculations indicated they should have been at least at \$1.4 trillion, which would have put them in a much better position. Delays were costly and had been for Saudi Arabia. He also thought delaying reforms in the same direction in other jurisdictions would also be costly.

Mr. Rietveld also proposed a clearer separation of stabilization funds and investment income funds. He had given names to the funds and placed some numbers around the existing asset pools. He also suggested a governance structure for the investment management and oversight of the investment management function. It was made to fit the Saudi political realities. In general, though he would have moved it towards what Alaska had in place already in the form of the APFC.

Mr. Rietveld relayed that he had a couple of slides regarding Saudi oil policies but because they were slightly off topic, concluded with three points. First, Alaska was by no means alone in terms of adjusting to a potentially protracted era of lower commodity prices and the role that

its accumulated financial assets could play. He continued that the magnitude of savings made Alaska exceptional. It was a distinct positive for Alaska in dealing with its fiscal issues.

Mr. Rietveld relayed that at the heart and spirit of the governor's proposed plan there were two important points included. The first point was that it was critical to manage volatility better by decoupling budget spending from the underlying commodity cycle and placing volatility in the SWF. The second point was that it was critical to facilitate the transition of government funding itself through investment income derived from a financial portfolio infused with oil revenues.

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Representative Edgmon thought more stability within Alaska's economy would provide the opportunity to create a better business climate and to diversify the economy down the road. Given the recent newness of SWFs, he asked Mr. Rietveld to point to particular countries that had accomplished something similar.

Mr. Rietveld responded that boom-bust cycles and commodity dependence was a great hindrance to long-term investment in any country or any state. To the extent that the hindrance could be removed would be positive to the overall investment and business climates. He added that there was literature on the resource curse that spoke to the particular ailment referred to as the "Dutch Disease." In a commodity boom there were certain sectors booming disproportionately to the rest of the economy. Capital flooded into certain sectors such as housing and construction rather than being efficiently allocated across a broad spectrum of the economy. Countries that had used the SWF model included Norway. Norway discovered significant oil reserves in the 1970s and had been able to maintain a diversified economy because of the SWF model and not becoming fixated on the commodity cycle. He thought the same applied to Australia and to some extent Alberta, Canada. There was a tried and tested track record of jurisdictions able to diversify their economies - they were jurisdictions that had been able to remove themselves from being beholden to the commodity cycle and commodity revenues.

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Representative Pruitt commented that the discussion was not about stabilizing Alaska's economy, but rather about stabilizing government expenditures into the future. He asked if a key part was missing in the overall discussion. He thought that the legislature should be looking at certain things to ensure a diversified economy. Alaska was still not dealing with the 700 thousand people that were not directly employed by or associated with government. He wondered if the state would solve the issue of diversification with the SWF model. He thought it was important to discuss opening up the state's land to further development opportunities, which in turn could generate jobs and circulate money back into the economy. He believed it was important to consider ways other than oil to generate revenue.

Representative Thompson remarked that it sounded like a policy discussion for the legislature to have in the future.

Mr. Rietveld responded that he thought there was a deep conversation that needed to take place regarding opportunities to diversify the Alaskan economy. He argued that the SWF at least made it possible to have that conversation. If government exacerbated boom-bust cycles, it would play a very destructive role in diversifying the economy. He agreed that a separate conversation was necessary. However, he believed fiscal stability and fiscal prudence needed to happen first.

Representative Pruitt asked if it was appropriate for the legislature to avoid referring to the SWF model as a means of diversifying Alaska's economy.

Mr. Rietveld thought the appropriate way to frame the discussion was that the state would be diversifying and stabilizing its fiscal income sources rather than contributing to the diversification of the entire economy - a significant intermediate step to achieving diversification. It was imperative to make sure the fiscal footing was stable and that government fiscal policy was not a hindrance to the stability and diversification of the Alaskan economy.

Co-Chair Thompson invited additional questions and announced the agenda for the afternoon meeting.

ADJOURNMENT

[10:42:25 AM](#)

The meeting was adjourned at 10:42 a.m.