

HOUSE FINANCE COMMITTEE
February 22, 2016
1:34 p.m.

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CALL TO ORDER

Co-Chair Thompson called the House Finance Committee meeting to order at 1:34 p.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

David Teal, Director, Legislative Finance Division;
Representative Lora Reinbold; Representative Louis Stutes,
Representative Matt Claman; Representative Adam Wool;
Senator Lesil McGuire.

SUMMARY

HB 224 PERM FUND: INCOME; DISTRIBUTION; PFD

HB 224 was HEARD and HELD in committee for further consideration.

HB 245 PERM. FUND: DEPOSITS; DIVIDEND; EARNINGS

HB 245 was HEARD and HELD in committee for further consideration.

HB 303 PERM FUND: EARNINGS, DEPOSITS, ACCOUNTS

HB 303 was HEARD and HELD in committee for further consideration.

PRESENTATION: FLOW CHARTS & MODELING: LEGISLATIVE FINANCE DIVISION

#hb224

#hb245

#hb303

SPONSOR SUBSTITUTE FOR HOUSE BILL NO. 224

"An Act relating to income of the Alaska permanent fund; relating to the disposition of income of the Alaska permanent fund; establishing and relating to the distribution account; relating to the calculation of permanent fund dividends; relating to the dividend fund; and providing for an effective date."

HOUSE BILL NO. 245

"An Act relating to the Alaska permanent fund; relating to appropriations to the dividend fund; relating to income of the Alaska permanent fund; relating to the earnings reserve account; relating to the Alaska permanent fund dividend; making conforming amendments; and providing for an effective date."

HOUSE BILL NO. 303

"An Act relating to the Alaska Permanent Fund Corporation, the earnings of the Alaska permanent fund, and the earnings reserve account; relating to the mental health trust fund; relating to deposits into the dividend fund; and providing for an effective date."

Co-Chair Thompson reviewed the meeting for the day.

^PRESENTATION: FLOW CHARTS & MODELING: LEGISLATIVE FINANCE DIVISION

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DAVID TEAL, DIRECTOR, LEGISLATIVE FINANCE DIVISION, introduced the PowerPoint Presentation: "A Comparison of

Plans to Re-Plumb Alaska's Cash Flow." He indicated that the Legislative Finance Division (LFD) prepared models of the fiscal plans. He believed that modeling was the best method for comparison between plans which allowed for evaluation of projected deficits, dividends, and reserve balances. However, understanding each plan individually was necessary for comparison. Cash flow models helped illustrate where money flowed, identified "decision points," and underlined the "trade-offs inherent in the decisions." He explained that the following slides depicted the cash flow for each fiscal plan but did not include the account balances.

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Mr. Teal turned to the cash flow diagram on slide 2: titled "Current Cash Flow." He explained that the Permanent Fund (PF) was divided into two accounts: the principal and the Earnings Reserve Account (ERA). He noted that the accounts were separate from the General Fund (GF) and funds from both accounts were not used for government expenditures. Earnings from investments from the PF and the ERA itself accumulated in the ERA. Dividends were the first priority based on a five year moving average, which were based on investment earnings and were not connected to the fiscal health of the state. He added that dividend distribution was guided by statute. He pointed to the fiscal loop between the PF principal and the ERA where the statutory net income flowed from the principal into the ERA and inflation proofing money looped back. Inflation proofing occurred annually and was outlined in statute. He turned to the general fund which was comprised of revenues from production tax, royalties, and other "less volatile revenue" derived from taxes and fees. He reported that currently the state revenues were roughly \$800 million in royalties, \$200 million in production tax, and \$800 million in less volatile revenues totaling \$1.8 million. He explained that when oil prices were high revenue increased and any surplus was deposited into reserve accounts: the Constitutional Budget Account (CBR) and the Statutory Budget Reserve (SBR). Conversely, when revenue was low deficits were filled by reserve funds. He qualified that although the system had worked for 25 years it was dysfunctional in a low production, low price environment due to the fact that reserves were being drawn without being replenished. The model indicated that reserves would be exhausted by FY 2019. He relayed that the following 5

slides depicted how the governor's Permanent Fund Protection Act (PFPA) changed the "fiscal plumbing."

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Mr. Teal advanced to slide 3: "1. Change Royalty Percentage (PFPA)." He reported the first change portrayed the state "harvesting" money from the ERA, which reduced the savings. Currently 30 percent of the royalties flowed into the PF principal, which was comprised of 25 percent of the royalties from old leases (prior to 1980) and 50 percent from new leases. He noted that revenue from new field oil was so much smaller than from the legacy fields that it averaged 5 percent. Under the PFPA, 25 percent of all field's royalties would flow into the PF principal. The 5 percent was added to the royalties that flowed into the GF (69.5 percent to 74.5 percent).

Representative Gara asked whether the governor was proposing not depositing the revenues from new oil into the PF principal. Mr. Teal answered in the negative because the second change proposed under PFPA rerouted both royalties and production taxes from the GF into the ERA. He explained that 25 percent of the royalties was the constitutional minimum deposit into the PF. The deposit was statutorily changed to include 50 percent of the revenue from oil fields developed after 1980.

Vice-Chair Saddler asked whether inflation proofing the PF principal account was accomplished with funds withdrawn from the ERA. Mr. Teal responded in the affirmative. He clarified that a small amount of ERA money did flow into the GF, which was expended on the Permanent Fund Division operations. In addition, approximately \$8 million was divided between the Department of Law (DOL), the Department of Revenue (DOR), and the Department of Natural Resources (DNR) for activities related to increasing money into the PF.

Co-Chair Thompson recognized former Representative Bill Thomas in the audience.

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Representative Kawasaki asked whether the small withdraws from the ERA was historical. Mr. Teal replied that the precedent went back to the late 1990's as part of GF

spending reduction measures. Representative Kawasaki wondered whether reducing the PF royalty deposit from 30 percent to 25 percent significantly altered the PF principal and if LFD performed modeling in regards to the change. Mr. Teal argued that the reduction was not very material relatively. He remarked that when compared to inflation proofing that amounted to approximately \$1 billion, the roughly \$50 million (5 percent of the current year's royalties of \$1 billion) was "dwarfed."

Co-Chair Thompson recognized Representative Matt Claman in the audience.

In response to remarks by Representative Gara, Mr. Teal clarified that 5 percent of the royalties were redirected which was roughly \$50 million.

Mr. Teal turned to slide 4: "2. Re-Route Taxes and Royalties to ERA (PFPA)." He indicated that the second change proposed by the PFPA redirected the 74.5 percent of the royalties from the GF into the ERA. Currently approximately \$1 billion would move into the ERA and the same amount would be withdrawn from the ERA into the GF and called the "Sustainable Draw." He scrolled to slide 5: "3. Add Sustainable Draw from ERA (PFPA)." He offered that the Sustainable Draw was statutorily set at \$3.3 billion and could be adjusted downward if oil revenues or interest rates were not able to maintain the real value of the PF and could be adjusted upward by inflation. He related that in dollar terms the change reduced GF revenue by \$1 billion and replaced it with a \$3.3 billion Sustainable Draw totaling a net gain of \$2.3 billion.

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Mr. Teal continued to slide 6: "4. Change Inflation Proofing to an "Overflow" Mechanism (PFPA)." He stated that the fourth change was the altering the annual inflation proofing mechanism to an overflow mechanism. The bill's inflation proofing was predicated on an overflow or surplus of 4 times the Sustainable Draw amount. He discussed the differing view points on inflation proofing. He observed that the goal of the plan was to "maintain the real market value" of the sum of the principal and ERA accounts and that it did not matter which account inflation proofing was deposited into.

Co-Chair Thompson recognized Representative Laura Reinbold and Representative Wool in the audience.

Representative Wilson asked whether the Sustainable Draw was a figure or a formula. Mr. Teal offered that the Sustainable Draw was a "fixed" draw and did not randomly change. The governor had a "module in the model" that determined the Sustainable Draw. The model had projected the total cash inflow and determined that the amount could be annuitized at \$3.3 billion per year in perpetuity. The module also included an inflation proofing adjustment. The Sustainable Draw increased with the adjustment. In addition, there was a review provision to decrease the draw.

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Representative Kawasaki asked whether the Sustainable Draw amount was sustainable. Mr. Teal answered that under the "current set of assumptions" the draw was sustainable but it was "highly sensitive" to interest rates and oil prices; i.e., the methods the portfolio was replenished. He related that the bill contained a provision for review every 4 years and could be adjusted downward if "the real value of the PF and ERA was not keeping pace with inflation." Representative Kawasaki asked whether Mr. Teal modeled the best and worst case scenarios. Mr. Teal answered in the affirmative and stated that he would address the models later in the presentation.

Mr. Teal advanced to slide 7: "5. Change Dividend Source and Calculation (PFPA)." He explained that the source of the dividend changed from a percentage of a 5 year moving average to 50 percent of the previous year's royalties and altered both the source and the amount. The PF was based on a completed fiscal year in order to determine the dividend. He summarized that 74.5 percent of royalties flowed into the ERA, 24.5 percent remained, and 50 percent of the previous year's royalties was distributed via the dividend fund.

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Co-Chair Neuman asked Mr. Teal to further discuss placing production taxes and royalties directly into the ERA and the ability to withdraw money from the ERA. Mr. Teal responded that the model worked by reducing volatility,

which involved switching cash flows from the GF to the ERA. He shared that concerns about the legality of the plan existed. He relayed that the attorney general testified that he would argue in favor of the legality of the "sweepability" of the ERA. The Legislative Legal staff argued that depositing royalties, production tax, and CBR into the ERA changed the "character" of the account and questioned the legality of the plan. He revealed that the CBR sweep into the ERA was a onetime event and was not illustrated on the diagram. The ERA was exempt from the sweep of funds into the CBR in the years that the state carried a liability to the CBR due to the fact that the ERA only contained PF earnings. Therefore, the legal staff concluded that a legal issue occurred with the sweep of funds from the ERA. He understood that the motivation of the plan was "stability" which was only achieved through moving the volatile revenue sources from the GF to the ERA and replacing it with a steady fixed draw; resulting in the elimination of volatility. He was unsure why the plan included the CBR draw into the ERA; he offered that it could be interpreted as a way to avoid a super majority vote. He suspected that the move was due to the higher earnings the ERA garnered. He underscored that the higher earnings was not the difference in interest each account earned; the CBR earned 1 percent and the ERA's anticipated earnings were 6.9 percent. Earnings in the ERA were spendable and CBR earnings were only spendable with a super majority vote. He voiced that the increase on the rate of return of 7 percent on \$7 billion was over \$400 million "and not an insignificant amount of money." He believed that the matter was a "legalistic argument" and that it was "not worth getting into the weeds." He advised that the easiest solution was to move the CBR, royalties, and production tax in a type of "holding tank" comprised of the CBR, ERA, and principal and compute the draw based on the sum of the accounts. Consequently, it was not required to physically move the funds; it was only necessary to define the pool of money. He thought the legal issues were solvable.

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Vice-Chair Saddler understood that the CBR draws were required to be replenished. He asked what the balance of the CBR was. Mr. Teal responded that the CBR was the highest that it had ever been. He stated that the question vis-à-vis when payback was required remained. He explained

that the repayments were "ratcheted." The state had a liability to the CBR for any type of withdrawal and an annual sweep into the CBR occurred until the amount was repaid.

Representative Gara referred to the governor's plan and the \$3.3 billion draw. He discerned that the PFPA was "more comprehensive" and ultimately wanted to produce a \$4.5 billion annual draw. He asked how much the governor's plan was reduced if the entire package including revenue raising measures was not adopted. Mr. Teal replied that the question was answerable through a model he had available that allowed for the calculation of different variables. He agreed that the governor's plan "was not merely changing cash flow." He reminded the committee that cash flow alterations, cuts, or revenue by itself was not sufficient to close the deficit and a combination of all three were most likely required. He indicated that the governor's full plan demonstrated his cognizance of the situation.

Mr. Teal continued to discuss issues regarding the PFPA. He remarked on the inflexibility of the plan. Hypothetically, if the state currently gained an extra \$4 billion in production tax and royalties, the entire amount was spendable. He noted that a price of \$110 per gallon of oil was necessary to generate \$4 billion under the PFPA. The windfall would be deposited into the ERA and the Sustainable Draw remained \$3.3 billion without a provision to increase the amount. A provision allowing an upward adjustment of the Sustainable Draw granted the legislature the flexibility to spend only a portion of the windfall prorated out over years and also save a desired amount. He worried that the inherent rigidity would create a situation where the legislature broke the rules in a windfall year by spending above the Sustainable Draw. He suggested that in a rule based system, the rules should be revised to allow upward or downward adjustments to the draw. He communicated that the PFPA relied heavily on long term projects which made it vulnerable to changes in interest rates and oil prices. He warned that a Sustainable Draw did not equal a sustainable budget. He calculated that even if the draw was accurately predicted it did not fill the deficit, which was closer to \$3.8 billion and diverted \$1 billion. The restructuring alone did not fill the budget deficit. He reiterated that the governor was aware of the situation; therefore, added revenue measures and spending reductions.

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Representative Wilson stated that under the plan, money to refund the CBR was unavailable unless less volatile revenue increased and wondered whether her assessment was correct. Mr. Teal explained that the statement was correct. He explained that any windfall oil revenue was deposited directly into the ERA without a provision to repay the CBR.

Representative Gara believed that any plan adopted that only included restructuring the PF as a revenue measure was "completely imbalanced." He relayed that in the first year the governor promised a \$1000 dividend but in future years the dividend would be less. He wondered what the future dividend amounts were at oil price ranges of \$30 to \$70 per barrel. Mr. Teal answered that roughly 50 percent of royalties would pay \$500 million and calculated on a per-capita basis that the dividend amounted to \$750. At \$30 dollar per barrel oil dividends dropped to approximately \$400. He recommended consulting the LFD model for more accurate information.

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Representative Edgmon asked whether LFD modeled depositing production tax directly into the PF principle or if the Sustainable Draw was too heavily dependent on the annual production tax flowing into the ERA in order to make the draw sustainable. Mr. Teal responded that LFD had not modeled his scenario but knew the answer. He detailed that production tax was currently low but projected to be \$1 billion. If the tax was deposited into the principal the Sustainable Draw was at risk. The tax was not spendable in the corpus and the money was needed in the ERA to ensure the Sustainable Draw amount. He added that in years with low earnings the reserves were necessary for the Sustainable Draw. Representative Edgmon stated that he lacked expertise in sovereign wealth funds but deduced that most sovereign wealth funds would deposit production tax into the principal. He thought it was a fundamental difference between the PFPA and sovereign wealth funds. Mr. Teal responded that the state was in an unusual situation with the PF; the corpus was not spendable. He expounded that most sovereign wealth funds were designed as an endowment comprised of one spendable account. In Alaska, a constitutional amendment was required to spend the principal.

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Representative Edgmon added that most sovereign wealth funds did not pay dividends and was another significant difference. Mr. Teal affirmed the statement. He voiced that no other sovereign wealth fund paid dividends. The PF could be turned into a sovereign wealth fund or endowment with a constitutional change.

Vice-Chair Saddler referred to the AKLNG project and relayed that the project "envisioned" a portion of gas royalties and gas production tax to help fund the cost of the project and noted that was in conflict with the governor's plan. The royalties and taxes were deposited into the ERA and draws were limited to the Sustainable Draw amount. He asked what would happen if the state had to make a cash call for AKLNG. Mr. Teal reminded Vice-Chair Saddler that royalties were meant for dividends under the PFPA so the pledged royalties reduced the Permanent Fund Dividend (PFD). Vice-Chair Saddler wondered when the CBR would be totally empty. Mr. Teal deferred to the models later in the presentation.

Mr. Teal turned to slide 8: "Current Cash Flow." He advanced to slide 9: "1. Change Royalty Percentage (SB 114 /HB 303)" and discussed the cash flow for the fiscal plan contained in the legislation. He remarked that the first change was identical to slide 3 under the PFPA. He highlighted slide 10: "2. Add POMV Payout (SB 114/ HB 303)." The second change did not redirect the royalties and production tax out of the GF into the ERA. The second change was considered a Point of Market Value (POMV) payout. He elaborated that the volatile revenue stayed in the GF and was not as stable as the PFPA. The draw from the ERA was variable and was a percent of balance that changed over time. Mr. Teal pointed to slide 11: "3. Remove Inflation Proofing (SB 114/HB 303)." He indicated that the third change removed the annual inflation proofing mechanism and did not include a provision in the legislation. However, inflation proofing theoretically did happen when the earnings were in excess of the payout rate. The excess earnings accumulated in the ERA and could be appropriated to the corpus. He deemed that inflation proofing was "ad hoc" rather than through rules.

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Mr. Teal discussed slide 12: "4. Change Dividend Source and Calculation (SB 114/HB 303)." He announced that dividends were higher than those generated from the PFPA because the full 74.5 percent of the previous year's royalties that flowed into the general fund were used for dividends. The GF was used due to the year time lag. He pointed to slide 13: "PFPA vs. SB 114/HB 303" and stated that the diagram compared the two bills. He noted that the PFPA was represented by blue lines and SB 114 and HB 303 was presented in red and that black represented the same provisions. He explained that both plans maintained the 0.5 percent of royalty's distribution into the Public School Trust Fund and changed to the 25 percent royalty into the PF principal. The royalties and production tax percentages were the same but under the PFPA they flowed into the ERA and under SB 114/HB 303 they remained in the GF. He commented that the governor placed a high value to the stability of the GF. Directing the money into the ERA allowed a fixed draw for the PFPA versus a variable draw under SB 111/HB 303. The amount of the draw changed but not the 5 percent POMV. He believed that the difference in inflation proofing was a policy choice and not a "conceptual difference. Inflation proofing could be added to the POMV plan as a provision in the bill. The divided change between the plans was a policy choice rather than a technical change. He believed that the two plans were "conceptually close" except for the legal issues regarding "contaminating the ERA" with outside funds. He concluded that the only "significant difference" was the degree of stability.

Representative Edgmon thought that the PFPA offered a "better opportunity to grow more" than the POMV concept. He wanted to better understand how the governor's claim that his plan offered greater opportunity for the PF corpus to grow.

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Mr. Teal agreed that the PF corpus would be larger under the governor's plan because the Production tax was deposited into the ERA. He related that the corpus may grow more under the governor's plan, because more funds were necessary to sustain the \$3.3 billion annual draw. If oil was less than \$85 per barrel, than the Sustainable Draw would be larger. If oil was greater than \$85 per barrel, SB 114/HB 303 plan would result in a larger revenue source for

the GF. He furthered that "which plan would pay more, depended upon oil prices."

Representative Wilson asked what money could travel from the GF into the CBR under SB 114/HB 303. Mr. Teal confirmed that he left out the arrow on slide 13. He explained that under SB 114/HB 303 a surplus could build in the GF. If there was high revenue coming from production tax and the POMV that was higher than expenditures the surplus was available for spending or saving in the CBR.

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Co-Chair Thompson interjected that the surplus in the GF had potential to "grow government." Mr. Teal agreed. He suggested that it was important to consider the point that the PFPA offered more stability in the fixed draw. He referred to slide 14:

"PFPA vs. POMV: Which is Better?"

1. A fixed draw is highly dependent on actually attaining the projected rates of return and projected oil revenue.
2. Those projections look forward 20 years--hence the need for review of sustainability of the draw.
3. We are not very good at projecting rates of return, and even worse at projecting oil revenue.
4. POMV looks backwards 5 years and the payout is based on actual events rather than on projections.
5. Ask yourself this question: Is your hindsight better than your foresight?
6. Lest that question appears to be one-sided, note that POMV fails the stability test--if royalties and production tax revenue jump \$4b and fill the deficit without the need for a payout, the payout still occurs and there would be a tendency, or at least a possibility, of spending the windfall.
7. Is there a hybrid that offers the comfort of hindsight offered by POMV and the stability of PFPA?

Mr. Teal suggested limiting the payout from POMV when it was not required that removed the primary difference between the two plans. He indicated that at that point they became very similar bills.

Co-Chair Thompson recognized Senator Lesil McGuire and Representative Liz Vasquez in the audience.

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Representative Wilson wondered whether there was a mechanism that could also limit spending in either plan. Mr. Teal responded that the legislature could include a provision that limited the draw in some way for SB 114/HB 303. The PFFPA Sustainable Draw provided a limit by mandating a fixed draw.

Representative Kawasaki returned to slide 13. He asked whether HB 303 had a material impact on the PF principle without specific inflation proofing. Mr. Teal reiterated that he viewed inflation proofing as a policy decision that could be easily accomplished. He observed that a number of ways existed to build inflation proofing into any of the plans. He noted the tradeoff was between protecting the PF and maintaining a sufficient balance to make the spending draw. Representative Kawasaki agreed that the issue was a policy discussion. He relayed that historically the state had inflation proofed in the amount of \$17 billion. He worried that the corpus would not grow without inflation proofing. Mr. Teal offered that the principle cannot be spent. The issue was how much each plan deposited into the principle. The constitution mandated 25 percent of royalties as a minimum and did not require inflation proofing. He mentioned that inflation proofing was added years later. He thought that the argument went both ways. One could argue the issue in terms of the "real value of the sum of both accounts" (ERA and principle) where the inflation proofing money remained in the ERA and was not moved.

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Representative Kawasaki wanted the PF to remain a "permanent fund." He felt that without inflation proofing in SB 114/HB 303 the fund was not "permanent anymore."

Vice-Chair Saddler referred to slide 14 and pointed to points 6 and 7. He liked that failure was defined as collecting more money than expected. He commented that the bills were not designed to fix every aspect of the fiscal plan and that a spending cap currently existed in statute. He relayed that the cap was \$2.5 billion plus population and inflation.

Representative Gara understood the bulk of Mr. Teal's presentation. He was unclear about the dividend. He referred to Mr. Teal's remarks regarding the revenue generated in SB 114/HB 303 was slightly larger than the PFPA. He asked how that was possible when the reduction in the dividend was larger in the governor's bill. Mr. Teal deferred to the models.

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Mr. Teal examined slide 15: "HB 224 Cash Flow." He reported that HB 224 incorporated spending limits in the plan and contained a "strong rules based system." He characterized the plan as a "waterfall approach." The bill set forth a number of rules in statute. He explained that the statutory net income flowed from the PF principle into the ERA that happened in all plans. The other plans priority was to pay a dividend. The first priority of HB 224 was to pay a 4.5 percent POMV and fill a deficit. The entire payout could pay a deficit. If the payout filled the deficit, some of the surplus could be used for dividends. He expounded that dividend payouts of \$250 up to \$2000 depended on reserve balances. He viewed the plan's philosophy as paying dividends based on the long term fiscal health of the state measured by reserve balances. The plan offered very strong protection to the treasury and filled the deficit at the expense of the dividend. He maintained that whether to amend the plan to ensure dividend distribution was a policy call. He continued that once dividends were paid any remaining funds were deposited into the CBR until repayment was reached. After the obligation to the CBR was reached, the excess was distributed into the Statutory Budget Reserve (SBR). He relayed that if all funds were used to achieve the payout, the deficit was filled from the CBR.

Representative Gara relayed that Representative Hawker stated the plan raised approximately \$2.4 billion in POMV payout. He noted that a dividend would not be issued in deficit situations and a dividend would be eliminated with

implementation of income taxes in HB 224. Mr. Teal responded that there was a significant amount of policy embedded in the bill and any of the other plans as well. All of the payouts were passed on a five year moving average. HB 303's POMV was basically 5 percent based on the balance three years ago. He delineated that in essence the effective payout was approximately two tenths of a percentage point below 5 percent or 4.8 percent that was inflation proofing the fund. The HB 224 plan with a 4.5 percent payout seemed less than a 5 percent payout; however, more money accumulated in the fund. In the long run a 4.5 percent payout could be a higher payout than 5 percent. The higher balance made more earnings. The lower payout rate favored future generations over the current generation and was therefore, intergenerational.

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Representative Wilson referred to the HB 224's POMV of 4.5 percent and deduced that in the future the dividend would come back or grow larger due to the growth of the ERA. Mr. Teal agreed. He recapped that the growth in the ERA due to a lower payout would eventually spill into dividends. The dividends would not grow until deficits were filled and overflow was distributed into the CBR to pay higher dividends.

Representative Gara believed that under HB 224 it was very difficult to achieve enough overflow to deposit into dividends. Mr. Teal agreed with the statement.

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Representative Edgmon pointed out that an arrow on slide 15 could be placed from the CBR to the dividend box, since the money could be used to pay a higher dividend amount. He noted that the model required \$1 billion in reductions in order to work. He asked whether an alternative to any of the three plans existed in order to achieve a sustainable budget. Mr. Teal stated that when LFD modeled it could only model rules. Many variables existed including using the CBR to enhance dividends. He remarked that the clear intent of HB 224 was designed to prioritize filling deficits. Representative Edgmon wanted to know what the "opportunity costs" were between all three of the models if budget action was not taken by the legislature in the current year. Mr. Teal remarked that the model indicated that HB

224 worked without reductions as large as stated by Representative Edgmon. Representative Edgmon understood that if the legislature did not adopt a fiscal plan in the current fiscal year, up to \$150 million in investments would be lost. He wondered what the "opportunity costs" would be for the other plans if the legislature failed to act. Mr. Teal affirmed that an opportunity cost applied to any of the fiscal plans if no action was taken in the current fiscal year and was similar for all plans. He ascertained that the PFPA was expected to gain larger returns due to the consolidation of reserve accounts. He suggested investing the CBR at higher rates than the current 1 percent, assuming that the legislature would adopt any one of the fiscal plans avoiding reliance on the CBR to fill the deficit. Adoption of a plan significantly reduced the draw on the CBR and allowed the balance to accrue more earnings over years. He delineated that the long-term investment portion of the CBR was eliminated due to the anticipated reliance on the reserve to fill budgetary needs.

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Vice-Chair Saddler deduced that there "were a couple of places" where the governor's plans contained opportunity costs. The governor assumed that if a fiscal plan was not adopted and the CBR used for the budget the investment earnings would be lost. He thought that the second factor was the lost "investment horizon" with short-term investing. He wondered whether the opportunity cost would be the same for all plans that maintained CBR investment in the short-term. Mr. Teal replied in the affirmative.

Representative Gara announced that the provision regarding elimination of the dividend with the implementation of an income tax was found on page 4 of HB 224. Mr. Teal explained that HB 224 clearly established the notion that the dividend was a government expenditure that competed with other government expenditures. In addition, all windfall revenue would be available for spending. It appeared that the POMV payout acted as a spending limit because the payout was limited to the amount of the deficit but the legislature could spend more. The lack of spending constraints inherent in the bill currently existed. He emphasized that any rules that limited spending for any of the plans cannot "truly control spending." He contended that the lack of spending constraint was therefore, not a

"weakness" in the plan. The plan was more volatile than the PFPA and SB 114/HB 303 due to the fact that all revenue continued to flow into the general fund. Lack of oil revenue was first absorbed by reduction or elimination of dividends in HB 224 and then employing reserves, which was common in all plans. He summarized that HB 224 was similar to SB 114/HB 303 in the manner GF revenue was enhanced via a payout from earnings but did not shift volatility. The major differences were not prioritizing dividend payout and varied the dividends amount on the long-term health of reserves rather than royalty revenue in the short-term. Dividends would not increase if oil prices spiked.

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Representative Guttenberg wanted to see all of the mechanisms embedded in the plans in the models.

Vice-Chair Saddler believed that HB 224 "rationalized cash flow" by making the dividend a "regular part of state spending" and linked the dividend to spending. He thought the plan made more "net sense" from an accounting viewpoint.

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Co-Chair Neuman asked whether the public could weigh in on how the legislature spent money. He felt that if the legislature had to use dividends to pay for government the public should have an "opportunity" to determine how their dividend was spent. He thought that departments could adjust its budgets to accommodate the plan. He was looking for new options to help persuade public opinion. Mr. Teal thought HB 224 was a good option and clearly connected the dividend to the budget process. He voiced that currently "money appeared to fall out of the sky" eventhough the dividend was appropriated. The dividend was a government check similar to any other government check. The dividend competed with every GF expenditure. He discerned that once the public understood the connection they will weigh in on budgetary items. He cautioned to "be careful what you ask for."

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Co-Chair Neuman declared that none of the plans created "new money." He was thinking of a program similar to the

PFD "Pick, Click, and Give" program except that citizens would choose the state agency and dedicate their dividend amount to fund a program such as K-12 education. Mr. Teal responded that "he was thinking in more general terms" and thought something like that" was possible.

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Mr. Teal pointed to slide 16: "Decision Point." He explained that the diagram included production taxes, royalties, and less volatile taxes in boxes. He pointed to the first decision whether the revenue should be deposited into the ERA or GF, which represented a choice between the stability of a fixed draw or less stable POMV draw. He noted that both plans made the choice. The PFPA placed the money in the ERA versus the POMV plans that deposited revenues into the GF. He moved to the second choice: whether to place royalties into the PF principle. He reminded the committee that a minimum of 25 percent of royalties was deposited into the GF via mandate. The real question was whether the legislature chose to save and harvest simultaneously. He indicated that the costs were in the tens of millions of dollars. He emphasized that the next decision of payout was the first very critical decision. He indicated that the tradeoff was between favoring a "forward looking manually adjusting fixed draw that promised greater stability" or "a backward looking self-adjusting draw" offering decreased stability. A key element of the PFPA was a spending restraint under high oil prices. The POMV's weakness in spending restraints was overcome by placing a limit on the draw. The variable POMV payout rate could be adjusted (lower payout) to favor the long-term. However, in order to address short-term deficits decisions regarding how to fill the gap through reduced spending, revenue generation, or reliance on reserves were necessary. The longer the legislature waited to act the lower the reserves and the higher the risk of failure. He added that inaction drained reserve balances and diminished the choices on "the amount of payout" necessary to fill the deficit. He spoke of another critical choice: the amount and source of dividends. He noted that the interest earned on inflation proofing was spendable. However, higher dividends lead to lower reserves and a higher risk of "unfillable" deficits. Money spent on dividends was "gone." He notified the committee that higher dividends were the "critical element in determining what the reserve levels" were and the reserve level determined the risk of the plan.

He communicated that another trade off related to dividends was the amount of the dividend and its connection to the economy. He cautioned that lower dividends was better for the state treasury but not necessarily for the economy. He suggested a plan that did both; issue dividends based on a certain percentage of royalties reflecting the short-term and included a provision that increased dividends based on the long-term health of the treasury. He stressed that every decision had a "trade-off and every trade-off had a sweet spot." He stated that "deciding what to do with the money that remained after the deficit was filled and after dividends were paid was probably not worth talking about." He suggested that the legislature establish rules or leave the decisions to future legislatures.

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Mr. Teal referred to his excel spreadsheet model [The model was a real time interactive computer projected model and was not distributed as backup]. He reported that the model used the official revenue forecast data. He explained that the model assumed that any remaining deficit was first filled through the CBR and then the ERA because the money had to be produced from "somewhere" if it was budgeted. He noted that unplanned draws were shown in red. The base of the model was the current budgeting system or status quo. He pointed to the unplanned draws from the ERA in the model that occurred in FY 19 after the CBR was exhausted. The deficit was then filled with expenditures for the ERA until it vanished in FY 21 or FY 22. Earnings would continue to be spent but were not enough to cover expenditures. The only option would be to cut the budget, which currently amounted to \$2.5 billion.

Co-Chair Thompson guessed that there would be no dividend distribution at the point he just described. Mr. Teal answered in the affirmative because the system "was broken" at that point. Mr. Teal continued that there were several options including cutting inflation proofing that filled the gap until 2025. He modeled cutting dividends instead of inflation proofing when the ERA draws began. The scenario resulted in rapidly drawing down reserves and the system broke down again within two or three years. He noted that the scenarios he modeled were based on a price of \$50 per barrel of oil. He changed the model to \$30 per barrel of oil. He showed that the reserves would be exhausted, the dividends and inflation proofing would be eliminated, and

the plan would be broken by 2030. He summarized that the scenarios were the status quo options. He mentioned that many variables and choices existed with the status quo, but continuing with the status quo wasn't considered a plan.

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Mr. Teal discussed the model for the governor's plan. He illustrated what dividends were set at 50 percent of royalties, which amounted to a range of \$700 to \$900. He pointed out that under the PFPA revenues fell because the plan diverted royalties and production tax from the GF to the ERA and produced the Sustainable Draw. He demonstrated that the draws from reserves were necessary to fill the budget deficit that still remained. After the CBR vanished unplanned draws from the ERA were necessary to fill the gap. He pointed to the red bars signifying the unplanned draws. He stated that the red bars did not designate failure it indicated that the rules were being broken. He deduced that the plan failed the "real value" test due to the unplanned draws from the ERA. The unplanned draws resulted in the PF balance not growing fast enough to keep pace with inflation. He noted that the governor wanted the plan to keep pace with inflation and the model showed that it failed and therefore, failed the real value test. He showed that reducing the draw did not help and resulted in a larger unplanned draw.

Co-Chair Thompson indicated that the committee needed to wrap up and would continue at a later date.

Mr. Teal invited members and other legislators to come to his office to further discuss the model.

HB 224 was HEARD and HELD in committee for further consideration.

HB 245 was HEARD and HELD in committee for further consideration.

HB 303 was HEARD and HELD in committee for further consideration.

Co-Chair Thompson //.

ADJOURNMENT

3:36:13 PM

The meeting was adjourned at 3:36 p.m.