

HOUSE FINANCE COMMITTEE
April 12, 2016
5:06 p.m.

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CALL TO ORDER

Co-Chair Thompson called the House Finance Committee meeting to order at 5:06 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

Jane Pierson, Staff, Representative Steve Thompson; David Teal, Director, Legislative Finance Division.

SUMMARY

HB 245 PERM. FUND:DEPOSITS;DIVIDEND;EARNINGS

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

Co-Chair Thompson reviewed the agenda for the meeting.

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#hb245
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."

Co-Chair Neuman MOVED to ADOPT the proposed committee substitute for HB 245 (FIN), Work Draft (29-GH2859\E). There being NO OBJECTION, it was so ordered.

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JANE PIERSON, STAFF, REPRESENTATIVE STEVE THOMPSON, relayed the sectional analysis by reading from a prepared statement:

Sec. 1. Provides for a three year reevaluation of the use of the earnings of the Alaska permanent fund.

Sec. 2. Amerada Hess income no longer flows to the Capital Income Fund. Segregation of Amerada Hess is no longer legally required; associated language is repealed in sec 13.

Sec. 3. Dedicated deposits of royalties to the Permanent Fund are reduced from the current 25/50 split in old/new leases to the constitutional minimum 25 percent

Sec. 4.

(a) Requires the Alaska Permanent Fund Corporation to determine the net income of the earnings reserve account as the income is realized and received.

(b) Defines the Percent of Market Value payout as 5.25 percent of the average year-end market value of the Permanent Fund and Earnings Reserve Account for the first five of the most recently completed six fiscal years. The payout may not exceed the year-end balance of the earnings reserve account for the fiscal year just ended.

Sec. 5 AS 37.13.145 is the Disposition of Income of the Permanent Fund statute

- a. (Unchanged) Establishes the ERA and identifies the ERA as holding earnings of the PF and ERA.
- b. (Repealed) dividends based on statutory net income.
- c. (Repealed) inflation proofing.
- d. (Repealed) segregation of Amerada Hess.
- e. (New) The legislature may annually appropriate the POMV payout from the ERA to the general fund.

Sec. 6. Dividends are comprised of 20 percent of the 5.25 percent PMOV outlined in Sec. 4(b), and 20 percent of the prior year's royalties, excludes those dedicated to the Permanent Fund or School Fund (25.5 percent are dedicated)

Sec. 7. Mental Health Trust Fund may not be included in the computation of the available income available for distribution under the PMOV.

Sec. 8. Makes computation of the Mental Health Trust Fund income consistent with computation of other Permanent Fund Income.

Sec. 9. Transfer of money to the Dividend Fund requires an appropriation

Sec. 10. The amount of each Permanent Fund Dividend for fiscal years 2017, 2018 and 2019 shall be \$1,000.

Sec. 11. Conforms to Sec. 9, which moves money to the Dividend Fund by appropriation

Sec. 12. Once the money is in the Dividend Fund, the Department of Revenue shall annually pay dividends without further appropriation

Sec. 13. Repeals language relating to the former dividend calculation, inflation proofing calculation, and Amerada Hess language

Sec. 14. Repeals Sec. 10 - \$1,000 dividend in three years.

Sec. 15. The Commissioner of Revenue and the Alaska Permanent Fund Corporation may adopt regulations, policies and procedures to implement this Act.

Sec. 16. Retroactivity clause.

Sec. 17. Immediate effective date for sections 15 and 16

Sec. 18. Effective date of July 1, 2016

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AT EASE

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RECONVENED

Co-Chair Thompson invited Mr. Teal to walk the committee through the bill.

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DAVID TEAL, DIRECTOR, LEGISLATIVE FINANCE DIVISION, referred to the 4 page handout (copy on file) titled: "LFD Fiscal Model." He reported that the first page containing four graphs was the status quo if nothing was changed. He pointed to the graph on the lower left side titled "Budget Reserves" that depicted vanishing reserves after FY 2021. He drew attention to the chart in the upper left corner. He reported that expenditures were represented as a black line and revenue was portrayed by bars. The blue portion represented forecasted combined revenue, the orange bar represented draws from the Constitutional Budget Reserve (CBR), and the red represented the draws from the Earnings Reserve Account (ERA); both accounts were used to fill the budget deficit. The white space after FY 22 under the expenditure line represented depleted reserves. He expounded that the state could not maintain the level of

spending in order to function and the Permanent Fund Dividend (PFD) would not continue to be paid out.

Representative Gara asked about the charts that characterized FY 16 and wondered whether the numbers represented the balance at year's end or during the year. Mr. Teal responded that they were all year-end balances.

Mr. Teal related that the purpose of the first page was to show that the state had a problem; the state did not have sufficient revenues to address expenditures in the future. The bill attempted to address the issue. He turned to the second page of graphs that modeled the legislation. He turned to the data assumptions depicted between the graphs. He noted that all of the graphs were based on the spring forecast. He highlighted that the operating budget growth was held at zero with \$247 million in reductions, \$30 million in Community Assistance, and \$185 million in Capital Budget spending. He skipped to the data containing the Permanent Fund (PF) Variables that assumed 6.9 percent investment return, in the blue shaded area the Point of Market Value (POMV) payout was 5.25 percent, and the dividends were 20 percent of the 5.25 percent POMV payout and 20 percent of prior year royalties. He added that the dividend had a floor of \$1000 and were set at \$1000 for FY 17, 18, and 19. He pointed to the data under Revenue Variables and reported that Tax Credit Reform was set at the numbers in the House Resources committee version of the bill. The figures on lower left listed the reserve balance at \$10.4 billion, the deficit was \$624 million [in FY 25] and the reserves lasted 17 years. The table on right forecasted the PFD real value at 97 percent and the effective payout of 4.9 percent while the nominal payout was 5.25 percent. He mentioned that the only difference between page 2 and page 3 was that page 3 data was based on the House Finance Committee version numbers for tax credit reform. He indicated that dividends and the PF changed only slightly. The only difference was the projected reserve change to \$11.9 billion [FY 25] under the House Finance Committee version roughly \$1.5 billion less than the House Resources version. He examined page 4 and commented that the figures were the same except for the difference in investment return reported at 7.45 percent. He detailed that the data was based on the Callan Associates (advisors to the PF) memo from December 24, 2015. He quoted from the memo as follows:

"The most salient impacts of the revision are reductions in the median projected 10 year annualized total return from 7.8 percent versus 7.45 percent."

Mr. Teal deduced that based on the 7.45 percent figure and all other variables remaining the same as page 3, the primary difference resulted in the reserves lasting longer because more earnings were realized on the PF and ERA. He pointed to the table on the lower right showing the real value of the PF at 102 percent in FY 25.

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Co-Chair Thompson asked Mr. Teal to explain the middle column listing the CBR earnings at 6 percent. Mr. Teal answered that the CBR was currently earning one to two percent. He delineated that the governor's solution was to move the CBR into the ERA. The two funds were not legally required to be physically combined. The CBR could be more aggressively invested, if the draws were substantially lower, and could be managed by either the Department of Revenue (DOR) or the Alaska Permanent Fund Corporation (APFC). The assumption was set at 6 percent but the actual rate was unknown. Co-Chair Thompson thought the rate was definitely higher than the current rate of CBR earnings. Mr. Teal responded in the affirmative.

Co-Chair Neuman referred to top left graph on page 4 depicting the Undesignated General Fund (UGF) Revenue/Budget in millions and noted that the budget was shown at nearly \$5 billion. He asked whether any significant changes would result in a budget reduced to a \$4.5 billion or \$4.4 billion range. Mr. Teal answered in the affirmative. He added that any reduction in expenditure reduced the revenue gap, which was filled through draws from the CBR. A balanced budget eliminated draws on the CBR and strengthened reserves.

Co-Chair Neuman noticed that the fiscal note analysis reported a \$2000 dividend. He suggested that if the dividend was reduced to \$1000 a savings of \$700 million would result. He wondered whether, with the addition of \$300 million in cuts, \$1 billion in reductions affected the calculations significantly. Mr. Teal answered affirmatively. He pointed to the table on the lower left that depicted the deficit in the out years at approximately \$350 million and estimated that the deficit would be

eliminated and the reserves would grow. The amount in reductions each year for ten years totaled an impact of \$2 billion.

Co-Chair Thompson asked whether taxes were included in his calculations on page 4. Mr. Teal affirmed that taxes were not included. Co-Chair Thompson wondered whether the inclusion of taxes would increase the savings. Mr. Teal responded that reductions in spending and increased taxes had the same result; both closed the deficit and saved reserves.

Vice-Chair Saddler asked about the effect of inflation on the models set at 2.25 percent. He cited Section 6 of the bill that recalculated the dividend at one-fifth of the POMV stream and one-fifth of the prior year's royalties. He understood that inflation proofing was built into the corpus of the PF with the POMV plan. He wondered to what degree the PFD was protected against inflation. Mr. Teal responded that as the PF and ERA balance grew the payout grew and a constant percentage of the payout went to dividends. He surmised that the dividends were protected from inflation in the same manner as the full payout and the PF was.

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Vice-Chair Saddler asked about inflation proofing in the royalty stream into the Permanent Fund. He did not see how they were covered. Mr. Teal answered that to the extent that oil prices reflected inflation the royalty portion would also be inflation proofed. However, royalties did not "necessarily" have the same inflation proofing protection as production declined. Vice-Chair Saddler asked for clarification on the "percent realized" listing under Permanent Fund Variables on the handout. Mr. Teal stated that realized earning went into the ERA and unrealized earnings affect market value but were not cash until they were realized. He delineated that the model differentiated between the PF total investment rate at 7.45 percent of which 75 percent was realized and the remainder was unrealized, which increased the market value but not the cash in hand.

Representative Gara asked whether Mr. Teal spoke with the permanent fund managers to determine whether they planned to aggressively invest the CBR knowing that a smaller

portion was being spent each year. Mr. Teal answered in the negative but planned to engage in the discussions. He relayed that currently the CBR was managed by the Department of Revenue (DOR). The department invested in liquid assets when the reserves were being drawn. He was trying to find a way to get a better return on the CBR. Representative Gara asked whether the bill contained a provision authorizing the PFD to manage the CBR and if it was necessary. Mr. Teal replied in the negative and did not think that management of the fund mattered. He thought that the issue of investment parameters was more important.

Co-Chair Thompson mentioned that the attorney general was in the audience and available for questions.

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Representative Gara asked about the bottom right hand chart on page 4 that denoted different colors for status quo, governor's plan, custom plan, SB 114, and HB 224. He wondered why only two colors were represented on the chart. Mr. Teal responded that the only data included was the status quo and the option with a "yes" value, otherwise the chart was "too busy." Representative Gara asked whether the chart represented the status quo compared to the "custom plan" which was the current version of the bill. Mr. Teal replied affirmatively. Representative Gara asked whether savings were still realized in ten years if the dividend was set at \$1500. Mr. Teal answered in the affirmative. He indicated that a \$1000 dividend equated to \$700 million per year and when increased by 50 percent would equate to an estimated additional \$300 million in expenditure; therefore a \$1500 cap on the dividend by FY 25 reduced the reserve balance by roughly \$2.5 billion.

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Vice-Chair Saddler pointed to "cost variables" on the data that contained a targeted cut of \$257 million. He asked whether that was projected for each year. Mr. Teal responded that included the cut in FY 2017 and maintained the same level of cuts in the out years. Vice-Chair Saddler asked why the specific number was included. Mr. Teal relayed that the number was based on the changes made on the current operating and capital budgets in both the House and Senate. Vice-Chair Saddler asked whether the Amerada Hess case [Alaska v. Amerada Hess et al., officially known

as State v. Amerada Hess et al. (1JU-77-877)] had any implication in the equations. Mr. Teal replied that the Amerada Hess case represented the "fenced off portion of the Permanent Fund" and amounted to \$425 million. He explained that the legal case mandated that the money earned on it could not be used to pay dividends of roughly \$21 million per year. The earnings were deposited into the Capital Income Fund and was typically spent on items in the capital budget. The extra earnings would become part of the POMV payout. Vice-Chair Saddler asked whether the money was always available for spending. Mr. Teal stated that the funds were not available until about 5 years prior. He delineated that the legislature continued to inflation proof the portion of the Amerada Hess money and it continued to grow until 5 years ago and began using the earnings in the capital budget. The net effect on the current legislation was zero because the money was not fenced off or identified as Amerada Hess anymore due to the expiration of the legal mandate.

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Representative Edgmon asked Mr. Teal to discuss page 2 (House Resources Committee version) versus page 3 (House Finance Committee version). He noted that both versions set the rate of return on the permanent fund at 6.9 percent. The reserves in FY 25 were \$11.9 billion versus the House Resources Committee version in FY 25 that showed reserves of \$10.4 billion. He remarked that the graphs did not look a "whole lot different" and he asked for an explanation. Mr. Teal agreed that the graphs looked similar. He added that part of the problem with modeling was a \$500 million change could be lost. Representative Edgmon cited Section 14 of the bill that repealed the dividend in 2020. He asked for clarification. Mr. Teal indicated that the \$1000 guaranteed dividend was being repealed and replaced by the amount calculated by the bill's formula, which amounted to approximately \$1000.

Co-Chair Thompson added that the blue bar on the bottom left showed the amount of reserves remaining. He reported that reserves lasted 17 years with the House Resources Committee version and 28 years in the House Finance Committee version.

Representative Edgmon cited the inflation proofing rate of 2.25 percent included in the data and asked whether

inflation proofing was eliminated in the legislation. Mr. Teal answered that the bill eliminated inflation proofing specified in statute. The proposed inflation proofing was the difference between the earnings and the payout.

Representative Gara suggested that there would be a significant change depending on the version of the oil tax credit bill that was adopted. He asked how long savings would last if the governor's original version figures of a savings of approximately \$250 million per year were used in the model. Mr. Teal did not remember the number. He remembered that the governor's proposal had significant fiscal impacts and the reserve lines went "upward." The out years were included to provide perspective and were not a guarantee.

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Vice-Chair Saddler inquired whether all of the figures were real numbers. Mr. Teal responded in the negative. He added that the numbers were all nominal. Vice-Chair Saddler deduced that the bill's plan to fill the deficit, extend the CBR and ERA included reduced payout of the PFD, increased interest on the PF corpus, ended statutory inflation proofing, and instituted the 5.25 percent POMV draw. He asked for confirmation of his summation. Mr. Teal answered in the affirmative.

Representative Gara asked that if the reserves rose, would the CBR last over a ten year period and whether the balance would decline. Mr. Teal answered that the CBR would maintain a positive balance due to the reduction of the draws on the CBR. Representative Gara asked whether the reserves remained "steady." Mr. Teal responded that the CBR balance remained higher than shown and the ERA would also increase. He elaborated that the result was based on new revenues or less expenditures through the tax credit bill, which reduced the deficit and the draw on reserves. He spoke to the House Finance Committee version of the bill and reported that the deficits were smaller and the CBR maintained a positive balance through FY 25. He added that in the House Resource Committee version the state's deficit was over \$600 million in FY 25 but fell over \$200 million per year under the House Finance Committee version. Smaller deficits mean less impact on reserves resulting in higher reserve balances. The governor's version used less of the CBR and was roughly \$4 billion.

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Vice-Chair Saddler referred to page 4 and noted that the model assumed a flat budget. He relayed that other models reported 1.5 percent budget growth. He wondered how the budget growth and inflation impacted the model. He asked whether the bill assumed a large deposit from the CBR into the corpus. Mr. Teal replied in the negative and added that the bill assumed the CBR was invested more aggressively. Vice-Chair Saddler referred to the lower left chart on page 4 and noted that the reserve balance "tipped upward. He wondered whether the bill included a "reserve threshold where the money cascaded someplace else in the model." Mr. Teal responded in the negative. He indicated that the governor's bill mandated that if the ERA was more than 4 times the draw, the excess earnings were placed into the corpus. He informed the committee that he left the provision out of the model considering that the legislature had the authority to do what it wanted with the excess. He mentioned that "from the model perspective... it was all just money sitting in a reserve." Vice-Chair Saddler restated that the dividend, predicated on investment returns and the price of oil, automatically included inflation proofing and was flat in all of the models at \$1000. He assumed the amount would decrease by 2.25 percent compounded due to inflation. He requested comment. Mr. Teal replied that "that was driven to some extent by population growth." He referred to the page 4 figures on the lower right that projected PF growth of \$10 billion by FY 25 to \$65 billion. He concluded that the PF was maintaining its real value and the constant 5.25 percent ensured that the payout was larger and larger over time. He interpreted flat dividends as a combination of growing dividends due to the POMV, declining dividends due to royalties, and declining dividends due to population growth that in combination resulted in a flat line. Vice-Chair Saddler asked whether population growth estimates were built into the models. Mr. Teal replied in the affirmative and added that population was growing by 1.3 percent.

Representative Pruitt remarked that the models made many assumptions. He stated that if the spring 2016 forecast was correct it meant that Saudi Arabia no longer existed; therefore, he believed the forecast was incorrect. He did not see a revenue cap that prevented the state from ending up back in the same position if the price of oil rose and spending increased. He asked if a spending cap or something like it was included in the bill, it helped manage the growth in government and prevent up and down spending and

deficit cycles. Mr. Teal answered in the negative; including a limit was "an easy amendment." He did not believe that any limits worked very well because limits or caps were rules that could be broken by the legislature. He spoke to the fact that if the price of oil spiked the legislature can spend the excess. He felt that it was difficult to devise a cap that granted flexibility for spending while providing a strong enough rule. He noted that the governor favored a cap.

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Representative Pruitt was concerned about turning on the tap from the PF to pay for government. He believed that the legislature was going to increase spending and "did not follow the rules." He strongly favored including a spending cap rule. He stated that it was necessary to give the public assurance that the legislature was not going to increase spending with permanent fund money and break the public's trust.

Representative Wilson asked whether an oil trigger was included in the bill; if oil rebounded the funds from the Permanent Fund were no longer used. Mr. Teal replied in the negative. He continued that regarding dividends, as oil prices rise royalties increased and as royalties increased the dividend increased. He pointed to Representative Pruitt's remarks that if the state did not need the revenue from the POMV payout why make it available. He thought that "the rule would make the legislature discuss breaking the rule." The discussion may be helpful, but he reminded the committee that the POMV payout was subject to appropriation. He felt that the discussion should center on how much discretion the legislature should have to spend available funds with or without rules. He illuminated that the governor's comparison of the bill assumed that if there was a revenue spike, all of the money was spent. His model assumed any surplus revenue was saved and others argued that an oil price spike was not expected. Representative Wilson surmised that the percentages did not really matter significantly because the bill held the PF payout to \$1000 as well as the floor.

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Mr. Teal replied that the bill set the dividend at \$1,000 in FY 17 through FY 19 and was then based on a formula that still produced roughly \$1,000 dividends. He added that if investment returns or oil prices were higher than projected the dividend would increase and also made the deficit disappear which made reserves go up. He voiced that higher

oil prices improved the model. Representative Wilson countered that his conclusions were true only if the money was not spent. She reasoned that a provision did not mandate that the dividend would increase and that excess revenue would be diverted to spending. Mr. Teal answered that the dividend depended on the calculation of the POMV payout. He elucidated that the dividend would increase with higher oil prices, but expenditures would not necessarily increase and the level of spending was decided by the legislature. He suggested that a revenue or expenditure limit could work if the legislature chose to follow the rule.

Representative Wilson asked whether the bill was necessary to accomplish the provisions it contained. Mr. Teal responded that everything could be accomplished through the appropriation process. He qualified that bill established a set of rules, but appropriations were not part of a plan or rule based system. Representative Wilson restated that the legislature did not always follow rules.

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Representative Edgmon stated that the models were predicated on assumptions. He articulated that the chief assumptions embedded in the models were oil production, oil prices, and investment returns. He pointed out the one constant that no other revenue stream was counted in any of the models. He wondered how assuming that no other new revenues were incorporated into the model, the bond rating agencies would view the legislature's actions. Mr. Teal recognized that he was asked to give his opinion. He thought the bond rating agencies would look at the bill as the very strong first step. However, he thought the bond rating agencies would react more favorably in combination with additional revenues and additional cuts. He noted that new revenue sources and expenditure reductions were independent actions not included in the bill. The bill set up a framework for using the ERA.

Representative Gattis stressed the importance of looking at the worst case and best case scenarios when doing the modeling. In addition, she suggested that any plan needed to include a reduction in the size of government.

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Representative Guttenberg offered that the model had to consider the things that were out of its control such as the price of oil. He wondered whether Mr. Teal had applied the worst case scenario into the model. Mr. Teal replied in the affirmative and offered to return when discussing options beyond the bill with interactive models. He explained that variables could be applied to the model.

Co-Chair Thompson thanked Mr. Teal for his presentation. He reviewed the agenda for the following morning.

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ADJOURNMENT

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The meeting was adjourned at 6:22 p.m.