

HOUSE FINANCE COMMITTEE
April 13, 2016
1:40 p.m.

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CALL TO ORDER

Co-Chair Thompson called the House Finance Committee meeting to order at 1:40 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

Angela Rodell, Executive Director, Alaska Permanent Fund Corporation; Craig Richards, Attorney General, Department of Law; Randall Hoffbeck, Commissioner, Department of Revenue.

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 day. He explained that the meeting would be divided into 2 parts. The first part would be a question and answer period with

Ms. Angela Rodell, the Executive Director of the Alaska Permanent Fund Corporation (APFC). In the second half of the meeting, members would be hearing from the administration on modeling. Attorney General Richards and Emma Pokon from the Department of Law would be sharing a presentation.

#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."

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ANGELA RODELL, EXECUTIVE DIRECTOR, ALASKA PERMANENT FUND CORPORATION, informed the committee that she was available to answer any questions from members. She had no prepared remarks.

Representative Munoz asked if the targeted rate of return of 6.9 percent was realistic. Ms. Rodell explained that 6.9 percent was forecasted based on current expectations calculated by the PF consultant, Callan Associates. She reported that the board of trustees had a targeted real return rate in place of 5 percent without an inflation assumption. She thought that unless the mandate changed APFC would continue without different policy direction. The Alaska Permanent Fund Corporation would continue to construct asset allocations that achieved a 5 percent real return for the fund.

Representative Munoz asked if Ms. Rodell was concerned with the model that used a rate of return of 6.9 percent. Ms. Rodell was concerned with expectations and wanted to make sure they were managed. The corporation did not control the market; the market would perform the way it performed. Looking at FY 16, which started July 1, 2015, the state's return for the fiscal year through the previous day was 0.4 percent. The corporation had started to recover from its many losses taken in December, January, and February when the market performed poorly. She reported that the equity market had taken a substantial hit. She did not mind the

challenge of trying to hit the 6.9 percent target rate but there was a possibility that in some years 6.9 percent might not be reached. She emphasized that it was just a forecasted number.

Representative Munoz asked how a lower rate than 5 percent would affect the ability to inflation proof the fund. Ms. Rodell was not sure she understood Representative Munoz's question.

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Representative Munoz wondered if inflation proofing was included in the model or if the fund was inflation proofed sufficiently. Ms. Rodell relayed that when inflation proofing was put into statute the fund could only invest in fixed income assets. In order to preserve the purchasing power of the fund inflation proofing was adopted in statute. Overtime the list was expanded and lifted. The board of trustees had an asset allocation that targeted everything in the investment spectrum. She reported that 80 percent of the portfolio was naturally inflation proofed by the type of assets invested. It could be argued that inflation proofing was not as important as it was in the past because so many investments naturally built inflation into their valuation. However, inflation proofing had been one of the mechanisms the state used to continue to build and grow the corpus of the Permanent Fund (PF). As soon as any value over the cost was recognized and received, it was moved into the earnings reserve account (ERA) to be available for appropriation. She stressed that if the state wanted to see the corpus continue to grow, it would need to place some of the gain into the fund. The way it had been done in the past was through inflation proofing presently totaling \$16 billion.

Co-Chair Neuman noted that the legislature was looking at moving the management of the Constitutional Budget Reserve (CBR) to APFC for investment. He asked how the change would work and what the investment return might be. Ms. Rodell highlighted that there were specific limitations in statute defining how the CBR could be invested and the amount of allowable risk. The statutes reflected the state had historically relied on the CBR for cash flow assistance when there were revenue shortfalls. She suggested that if the statutory limitations were not removed, the corporation would have the same limitations on making investments as

the Department of Revenue did currently. If the restrictions were lifted and APFC was allowed to invest similarly to the Alaska PF, it would also be similar to how APFC invested the Alaska Mental Health Trust Authority dollars. They would receive a share of the same returns that the fund and the ERA received.

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Co-Chair Neuman thought that generally APFC made prudent investment decisions. He asked if the same sideboards would be used in investing the CBR. Ms. Rodell responded in the affirmative.

Co-Chair Neuman commented that some of the estimates of the ERA would be about 6.0 percent. He wondered if it was a practical number. Ms. Rodell responded that if the state planned to draw on the CBR in the next few years, the number might be too high. The statutory constraints currently in place required that if the fund was to be used within 5 years it had to stay in fixed income and liquid assets, the returns of which well below 6.0 percent presently.

Representative Kawasaki asked about Callan Associates' prediction of 6.9 percent. He relayed that their report, based on a 10-year forecast, showed the rate of return prediction falling between 6.56 and 7.2 percent. Year-to-date, the return rate was -3.72 percent. He restated Ms. Rodell's conservative estimate of 5 percent. He wondered if the legislature was receiving information that she thought was wise. He had been hearing that the information might not be coming directly from the PF.

Ms. Rodell clarified that 5 percent was a real return without an inflation assumption attached. Assuming inflation was going to be 2 percent, the nominal return would need to be 7 percent to reach a 5 percent real return. Callan's numbers included an inflation assumption. The challenge with forecasting markets was that it resulted in a forecast. Although Callan had tremendous access to research, they reported missing their target every time. If perfect information were available, everyone's jobs would be much simpler. She concluded that the forecasted numbers needed to be taken with a grain of salt. Her response to Representative Munoz was that in looking at 6.9 percent there was an equal chance of going above or below the

number. She emphasized that in the following years she would be starting at .4 percent. She thought it was unlikely 6.9 percent would be reached for FY 16.

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Representative Kawasaki thought the information was important for the committee to hear. He noted that the current assumed asset allocation (17 percent US equity, 24 non-US equity, etc.) was of significance. Ms. Rodell had also mentioned policy changes coming from the legislature in terms of the 6.9 percent rate. He wondered if she could speak more on the subject of what could be done.

Ms. Rodell responded that there were specific directions to preserve purchasing power to maximize income in APFC statutes. There was specific direction given to the fund to ensure that the fund was available for current and future generations of Alaskans. The associated portion of the APFC statutes was not being amended in any way by any of the bills presented. The message that APFC was taking away was to continue doing what it had always done until the corporation was directed through statute to do something different. She added that the corporation was not going to do anything differently to meet the 6.9 percent mark. She had not seen anything about 6.9 percent in statute or in the proposed bill. She reiterated that the corporation had not been directed or seen anything in the current legislation to change the way it was doing business.

Representative Kawasaki asked if Ms. Rodell would change the way in which the corporation operated if the legislature wanted to change the statutes surrounding the PF to maximize the return. Ms. Rodell replied that to some degree she would. She furthered that obtaining a maximum return was different from maximizing income. It would change to a degree and would be the subject of a long conversation with the board of trustees in terms of how to achieve maximum returns. Additional risk assumptions would likely have to be taken that might not be acceptable. The Alaska Permanent Fund Corporation tried to balance the need for income with the need for measured risk.

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Vice-Chair Saddler asked if HB 245 raised any concerns as to whether the PF status under the Internal Revenue Service

(IRS) was tax-free. He wondered if the legislature should have any concerns. Ms. Rodell replied in the negative. She thought the bill would potentially make the state's arguments with the IRS more straight forward.

Vice-Chair Saddler asked about the significance of the change in Section 4 specifying the definition of net income and outlining when the income was realized and received. Ms. Rodell reported she had spoken with the staff of the chairs in both bodies about the language. The Alaska Permanent Fund Corporation preferred that the language be changed back to the language currently in statute. The corporation was concerned about how the action would be interpreted by auditors. She suggested that it was much cleaner to keep the current language as it existed in statute based on the historical opinions on realized income.

Vice-Chair Saddler wanted to have a better understanding of the potential issues the auditors might take up. Mr. Rodell replied that when the PF was created the constitutional amendment creating the fund stated that income "shall go" to the GF. At the time, under generally accepted accounting principles, income was only realized income. Subsequent to that time, GAP changed the definition of income to include realized income, unrealized income, and losses. The Alaska Permanent Fund Corporation had to get a number of legal opinions from the attorney general to determine what it could and could not recognize in the ERA. The auditors relied on the legal interpretations when auditing the fund to ensure that the state was booking income correctly and getting a clean audit opinion. Potential confusion was created in changing the language about what it meant to be received. Under GAP, income was recognized not when it was received, hence why there was unrealized income. The idea was that once the income was received it would be available for appropriation. Under GAP, income was unrealized and realized. She reemphasized that the PF Corporation would prefer to leave the language alone to prevent any confusion.

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Vice-Chair Saddler noted there was a section on the charts from the Legislative Finance Division (LFD) that talked about the percent of the investment return realized. He also asked about the absorption of the Amerada Hess fund

into the corpus or the earnings reserve account (he could not remember which account) and whether they created any concerns for her regarding legal, accounting, or management issues. Ms. Rodell responded in the negative. She thought that absorbing the Amerada Hess fund would make things cleaner for many people.

Vice-Chair Saddler referred to the first section of the bill where it talked about a 3-year reevaluation clause. He wondered if it raised any concerns for Ms. Rodell regarding the durability of the new regime. He asked if she had any comment on that section of the bill. Ms. Rodell responded in the negative. Her expectation was that she would be before the legislature every year to discuss the earnings and the performance of the PF fund. She suspected that there would be a significant amount of ongoing review of the fund. She did not have any problems with the language.

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Representative Edgmon referred to the models presented in the previous day. He wanted to discuss inflation proofing. Three of the four models the committee had were predicated on a 6.9 percent investment return and the fourth was based on a return of 7.45 percent. He note that the inflation rate built into the models was 2.25 percent. He referred to her comment that a 6.9 percent return might be ambitious. Based on that comment, he asked her to speak to the potential difficulties of inflation proofing the fund going forward.

Ms. Rodell stated that if a 2.25 percent inflation assumption was removed from a 6.9 percent return rate about 4.7 percent would be left and would fall under the targeted real return of 5 percent. She offered that the challenge was recognizing reality versus forecasted numbers. The state would do its best to achieve its targeted percentage return under current market conditions. However, the legislature could appropriate inflation proofing. The corporation could also seek an inflation proofing appropriation if it was integral to the corpus of the fund. For instance, if the fund earnings were significantly higher than anticipated they could be placed into the corpus. She thought there would be ongoing discussions when the annual evaluations were completed.

Representative Edgmon talked about half of the funds for the PFD being tied to royalty payments under the proposed legislation. In essence, the legislature would be redirecting some of the volatility to the funding of the PFD. The dividend would be based on annual royalty, the price of oil, and production. He invited her to discuss the change and whether someone on the street should be worried their PFD was being placed in front of traffic versus being funded by the fund itself.

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Ms. Rodell thought it was an interesting debate about where the PFD was tied - tied to the fund versus tied to royalties. She relayed that payments over the previous 4 years - dividends paid since 2011 - there had been great volatility in the dividend because of market volatility affecting the fund. She was unclear whether individuals would experience new or different volatility, having already experienced it in the past. The feedback for the prior PFC Director and as the previous DOR Commissioner people understood the volatility and understood that there were market losses resulting in lower dividends. She reported that 2 years prior the dividend was less than \$1000 and in the previous year, it was up to \$2000, a huge swing. She suspected that the dividend amount might be smaller but steadier with a portion of the payment coming from royalties. The Alaska Permanent Fund Corporation did not run any models on the dividend and was not responsible for the dividend program itself other than making one transfer annually.

Representative Guttenberg suggested that if something went wrong with the modeling Ms. Rodell would feel some heat regardless of her actions or the success of the fund. He wondered if she had concerns with the bill or the modeling. Ms. Rodell struggled to answer the question because it was difficult to know where and how the heat would be applied. She thought that it was the nature of the beast. Her plan sitting before the committee in the present was to be able to explain what the corporation was doing and why. The legislature might not like her responses, but the fund was known globally for its transparency and was often commended on its translucence. She thought it was the best counter to any heat the corporation might receive. The potential heat could result from spending the earnings reserve account faster than the corporation could earn money due to low

market conditions for extended periods. The fact that there were provisions of a 3-year review and that the legislature had the power of appropriation gave her comfort. He indicated he would address his questions regarding modeling with the Department of Revenue.

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Co-Chair Neuman referred to a letter dated December 24, 2015 that suggested an earnings target of 7.5 percent (or 7.45 percent) for the PF in a deterministic model. He asked if she agreed with the percentage rate using that particular model. Ms. Rodell was uncomfortable using that high of a number. She understood modeling, and deterministic and probabilistic models and the risks incorporated into such models. However, her individual personal experience was that no matter how well modeling was done it was inaccurate most of the time. She was uncomfortable with that high of a return.

Co-Chair Neuman asked her to propose a conservative number or goal. Ms. Rodell relayed that she kept her focus on the real return of 5 percent. In looking at the current year's inflation of 0.12 percent, the nominal return would be just over 5 percent. If the inflation rate was 2.25 percent, she would be looking at 7.25 percent. She was most comfortable with the targeted real return assumption that had been executed and resolved by the board of trustees rather than what the potential might be even though capital market indicators predicted certain returns over a 10-year period.

Co-Chair Neuman was looking for a suggested modeling number. He would rather use more conservative numbers in modeling. Ms. Rodell was uncomfortable with providing an exact number outside of 5 percent.

Vice-Chair Saddler asked her to provide circumstances that would justify limiting the PF appropriation capping the total amount of the earnings reserve balance. He asked if an automatic limit on the dividend distribution, based on the balance would kick in after several years of poor returns. Ms. Rodell responded in the Affirmative.

Vice-Chair Saddler asked if she had seen the model with inflation proofing included. He mentioned that the charts he had seen were reflective of nominal numbers. Ms. Rodell

had not seen the model run with real target returns as opposed to nominal target returns.

Co-Chair Thompson thanked Ms. Rodell for her testimony.

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CRAIG RICHARDS, ATTORNEY GENERAL, DEPARTMENT OF LAW, made himself available to the committee for questions. He referenced a letter handed out regarding the administration's comments on the proposed committee substitute (CS). He relayed that he would be walking through the short PowerPoint presentation from the Department of Revenue on some modeling results and would discuss the major points in the letter. He wondered if the chair was agreeable to his agenda.

Co-Chair Thompson encouraged Attorney General Richards to continue.

Attorney General Richards introduced the PowerPoint Presentation: "Analysis for House Finance CS for HB 245 by Department of Revenue's Economic Research Group 4/12/2016." He explained that the first few slides condensed what the bill did and what assumptions were used in the modeling. He confirmed that the administration had modeled what was in the bill. The modeling included the dividend payout calculation using a 5.25 percent payout rate. He relayed the conclusions from the Department of Revenue in three senses. The first was what the dividend would look like over time under the modeling in the bill. The second was what the value of the PF itself look like over time. The third was what he revenue stream going to the general fund over time look like. He thought the conclusions were relatively similar to what the Legislative Finance Division (LFD) came up with as expected with the assumptions. In particular, the assumption he thought had the most controversy around it in relation to the bill was what return assumption was used.

Attorney General Richards continued that the information presented the previous day had two return assumptions: one at 6.9 percent total geometric returns and one at 7.45 percent. He relayed that the administration had used, and would continue to use 6.9 percent because one of the major things the state asked McKinsey and Company, a private consulting firm, to provide its best opinion as to what

return assumption should be used. He reported that the company had spent several weeks going through the different options, forecasts, historical data, and the different models of returns and return assumptions used by the Department of Revenue and Callan Associates. McKinsey and Company concluded that the best available information to use for modeling purposes was Callan Associates' 10-year forecast in its deterministic model at 6.9 percent. He relayed that using 7.45 percent was not recommended by experts who evaluated the problem for the administration.

Attorney General Richards scrolled to slide 6: "HB 245 CS at 5.25 percent POMV Per Person Dividend Size." He reported that when DOR modeled the dividend using the 6.9 percent total return, the dividend stayed flat at about \$1000 at the mean. He highlighted the yellow and blue bars where they intersected. The intersection represented the fiftieth percentile outcome; the average outcome for each of the years represented in the chart. In reference to the blue bar, he relayed that there was a 25 percent chance that the outcome would be above the average to the top of the blue bar. There was also about a 25 percent chance that the outcome would go all the way to the top line above the blue bar. Similarly, there was a 50 chance that the outcome would go in the yellow box and the line below the yellow box. He explained that the reason there was so much variability was that even though 6.9 percent was the mean on the returns it would vary widely over time with the stock market potentially the stock market performing in a number of different ways. He remarked that it was a long way of saying the mean expectation of DOR was that the PFD would be about \$1000 flat overtime under the proposed committee substitute. He noted that the committee substitute met the governor's targets.

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Attorney General Richards pointed to there being more upside in the dividend over time than there was downside. In other words, the chance of the dividend amount being higher was more likely based on two components. The first component of the dividend was that it would be based on a POMV. Due to the expectation of the fund value growing over time, the dividend would also grow for one half of the component. The other half of the component was the royalty component, which was likely to be larger than it was presently because of low oil prices. Currently, 20 percent

of royalties was a relatively conservative number compared to what it would be if oil prices increased significantly. In response to Representative Edgmon's question about whether the proposed dividend formulation more or less volatile than the current one, the administration had not modeled it. He would ask someone from DOR to look at it. He suspected it would be less volatile than the current dividend. He explained that by basing the dividend on the POMV versus on the earnings, the number was much less volatile.

Attorney General Richards turned to slide 7: "HB 245 CS @ 5.25 percent POMV Total EOY Fund Balance." He suggested that if the 6.9 percent return assumption was used, the 5.25 percent POMV draw was too aggressive if the goal was to maintain the real value of the fund. He conveyed that on an inflation adjusted basis the 5.25 percent would degrade the purchasing power of the fund over time in the median case. He emphasized that he stated "the median case." It was possible that things would change substantially and the fund would grow considerably. Conversely, things could change negatively such that the stock market could perform poorly and the fund could shrink substantially. The chart showed a range of what the fund might look like. He noted that the mean value of the fund under a 5.25 percent draw was projected not to meet up with inflation. However, there was still much more of an upside in growth than there was a downside due to interest turning compound over time. If there were a good series of runs, there would be a compounded growth effect.

Attorney General Richards turned to slide 8: "HB 245 CS @ 5.25 percent POMV: Net Payout to GF plus Production Taxes and Royalties not dedicated to the PF or Dividend." He explained that with a basis of 6.9 percent total returns the administration did not believe the growth of the PF would be equal to inflation. It also meant that the amount of money that went to government would decrease over time. He concluded that by degrading the value of the fund in real terms, it would also degrade the value of the cash flow that went to the government over time.

Attorney General Richards mentioned there were other things worth looking at in terms of modeling that would be provided in the following couple of days. Some items included looking at how the modeling would work with

certain revenue limits and at volatility in relation to the current dividend.

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Representative Edgmon commented that if he were to take what Attorney General Richards presented at face value, it contradicted what the director of APFC had told the committee earlier about rate of returns. However, he knew it was more complicated. He asked if the model encompassed in HB 245 was based on a 6.9 percent rate of return. He wondered if the number captured the variability with oil production and oil prices and therefore, provided more comfort to rising above the 5 percent the Ms. Rodell had stated she was more comfortable with based on her own experiences. Attorney General Richards indicated that the board had set a real rate of return expectation of 5 percent - the return not counting inflation. The total return rate of 6.9 percent included both the real return component and the inflation return component. If the real return target was 5 percent and inflation was anticipated to be 2.25 percent then the total return expectation would be 7.25 percent. If 2.25 percent was a reasonable inflation estimate then the 6.9 percent total return that Callan Associates used was more conservative than the board's real expectation.

Representative Edgmon was grappling with the question of variability of oil price and oil production. He was concerned with the performance of the endowment fund. Attorney General Richards relayed that the modeling being reviewed did not account for the variability of oil prices because the current CS did not deal with volatility, as the administration would suggest was appropriate. He noted he would be making some recommendations on how to amend the CS to handle volatility. That modeling would include oil prices. He noted, however, that under the constitution 25 percent of royalties were going to the corpus under any plan. The modeling took into account oil prices as it influenced the 25 percent of the constitutional royalty influx into the corpus.

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Attorney General Richards reported that the administration was pleased with the committee substitute. He commented that it was a well thought out and well-designed bill that

adopted an approach that the administration could support. He suggested there had been a great collaboration. One of pieces of the bill that the administration wanted to highlight that made sense was talking about a sustainability target in the same kind of way that the state should maintain, at a minimum, the real value of the fund over time. One of the governor's core goals was that the value of the PF not be degraded. The administration thought that the original Alaska Permanent Fund Protection Act (APFPA) had proposed drawing a fixed amount of \$3.33 billion versus a POMV. The administration had indicated from the beginning that the POMV was a great approach that worked. He thought adopting a POMV approach was very reasonable. The governor was in support of the royalties being tied to the dividend. He thought it made sense to have Alaskans rewarded when the state's natural resource economy was doing well. As Alaska did well and the budget did, the dividend would go up. On the other hand, the administration recognized that there was utility and value in having the people of Alaska staying connected to the direct performance of the fund itself. The dividend calculation achieved both. It tied people to the success of Alaska's resource economy and it tied people to the success of the PF. In terms of the absolute amount of the dividend, the governor has said that a dividend of around \$1000 was an appropriate amount. The specific calculation in the bill was projected to provide.

Attorney General Richards reported that another item in the committee substitute that made sense was to repeal the Emerita Hess provisions. They were an artifice of old litigation and were not necessary legally or from an accounting perspective. He thought the administration would support a statutory change that would allow the CBR to be invested more long-term to achieve higher returns. He noted the administration would likely pass on some technical comments regarding the language of the bill, which would not be substantive. (Attorney General Richards referred to a letter addressed to Co-Chair Thompson dated April 13, 2016 - Copy on File).

Representative Wilson wanted to understand better why citizens would favor benefiting when oil prices increased and not benefiting when oil prices decreased. Government already benefited because the state had its highest years when oil was over \$100 per barrel. The state already experienced large spending years. Currently, things were

reversed and the state had to come into check. Alaskan residents would benefit from the PFD but at present, the state wanted to change the game. She asked if the attorney general saw an issue. Attorney General Richards responded that he did not see an issue. He understood that having the dividend system tied to the earnings was really a system designed to incent Alaskans to protect the fund, which included not spending the fund and encouraging its growth. He did not believe there was anything inappropriate about tying the dividend to the natural resource economy currently or in the future. He thought either was rationale and that a policy decision was required. He suggested policy makers needed to consider what made sense in terms of incenting and rewarding Alaskans going forward.

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Representative Wilson commented that the attorney general had obviously not gone door-to-door. She stressed that it would be very difficult to explain to constituents the state taking their money when the price of oil was high and changing the rules. Currently, the price of oil was low and it did not appear that it would rebound. She suggested that instead of reducing its spending, the state was going to take what belonged to the people. She asserted that the bill sought to fill the gap using a different formula. The model showed the public contributing indefinitely while the state continued to spend. She opined that she would have a tough time selling the plan to her constituents.

Attorney General Richards responded that there were two parts to the conversation. The first part had to do with what formulaic method to use to calculate the dividend. He thought it would reflect the volatility in the dividend. The other part of the conversation was about the size of the dividend. His answer was that it was rational to change the method of calculating the dividend. He claimed that in moving to a POMV it was not possible to do an earnings-based dividend, as it did not make sense. He remarked that Representative Wilson's question went to not just how the dividend was calculated but also how much the dividend should be.

Representative Wilson clarified that she was uncomfortable in deciding the amount of the dividend. She did not want to choose a random number to fill the state's gap. It was the people's money. She wondered how to justify picking a

number. Attorney General Richards answered that from the administration's point of view the state had a system that was unsustainable. The governor believed that in order to move to a sustainable system, the state would need to press down evenly. He had tried to balance reducing the dividend, increasing revenue measures, reducing oil and gas tax credits, and introducing spending cuts. He tried to design a system that spread the pain. Reducing the dividend was a necessary component because of its magnitude. In order to protect the dividend in the future there needed to be a plan that reduced the cost of the system and increased revenues. As Mr. Teal has stated before, without a plan the state would be broke by FY 21.

Representative Wilson responded that the only reason Alaska would be broke was if the state continued to spend at the same level as it did presently. She mentioned hearing from Mr. Keithly earlier in the day and Mr. Goldsmith previously that there was another path to a sustainable budget. It was suggested that the state use a portion of the ER and some of the other state savings. However, the state had to save money for the plan to work. She asked if the administration's plan had triggers such as oil prices going up placing a limit on the amount government could spend. Attorney General Richards asked to postpone the answer to her question. He would be covering it later in the slide. Representative Wilson agreed to wait.

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Attorney General Richards reported having reviewed what the administration considered positive aspects of the committee substitute. The administration would provide some suggested small technical amendments. However, the administration identified three aspects of the bill that could be improved. First, the administration thought 5.2 percent was slightly too aggressive in the current form of the bill. He relayed that a POMV percentage of 4.9 or less would meet the sustainability requirement.

Attorney General Richards' second point was that the administration believed it was good policy and appropriate to have an inflation proofing mechanism in place. He explained that in the current system all of the realized gains came out of the corpus of the PF into the ER. By statute, an amount dedicated to inflation proofing was placed back into the corpus of the fund. He suggested that

without a system, not necessarily the present system, the growth in the PF over time would occur in the ER rather than in the corpus. The administration believed it was appropriate to have a durable earnings reserve that was large enough to be able to make the sustainable draws that would be expected of it. Any excess funds would return to the corpus to protect the principle and the corpus of the fund, which would grow over time for future Alaskans.

Attorney General Richards continued that the original bill recommended getting rid of the existing inflation proofing mechanism. However, it added a provision stipulating that once the ER got four times larger than the current year expected draw, anything in the ER above that amount - about \$10 billion in the proposed bill - would be transferred back to the corpus. It provided for a type of inflation proofing that grew the corpus over time but left the state with a durable ER. He further explained that Mr. Teal and Mr. Dell talked about the change in the nature of allocations and PF investments. The change included moving away from investment bonds to holding stocks, real estate, and private equity; things that appreciated in value, but were not recognized as income right away. Eventually, over time the state would realize its gain on all of the assets when they were sold. The occurrence of capital appreciation in investments currently reflected in the corpus upon sale would go to the ER. If the state was going to have the ER continue to grow, and maintain its size over time there had to be some mechanism that would allow money to go back from the ER to the corpus. Otherwise, the ER would experience the growth over time and the corpus would not. He concluded that it was better policy to protect generationally the money by having the growth in the corpus rather than the ER.

Representative Pruitt asked how long it would take to get to the \$10 billion figure. Attorney General Richards responded that he had not seen the modeling for the current CS. However, under the original proposal the best estimate was about 4 years. If things turned out better, like the stock market jumping significantly, it would only take a couple of years. The same applied if oil revenues jumped up. In boom times, it was a way of capturing the excess and transferring it to the corpus.

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Representative Munoz asked if it was a combination of having a larger draw from the CBR into the corpus of the account, thus generating more revenue. Attorney General Richards responded affirmatively. The governor's original proposal in the APFPA was to take \$3 billion from the CBR and place it in the ERA. By doing so, it allowed the state to invest the \$3 billion for a longer period to get better returns and increasing the state's sustainable take. It also buttressed the size of the ER to make it stronger. He relayed the governor's plan was not necessary, but it provided a higher degree of confidence. Under the committee substitute, because the draws were smaller, it made it less necessary to do so. Having a \$3 billion-transfer was favorable, but it was not necessary to have a durable ER.

Attorney General Richards mentioned that over the previous 6 months the administration had talked about the issue of volatility. In particular, he noted volatility associated with the state's three major sources of cash flow including earnings of the PF, production taxes, and royalties. The plan managed the volatility associated with the earnings of the PF by adopting a POMV approach. The state would not spend the earnings every year, but rather a proxy for the earnings, which was a percentage of the market value - a steady number. The governor's plan had proposed applying a similar approach to production taxes and royalties by placing those cash flow streams into the earnings reserve account and spending a fixed amount every year. He suggested that with this approach when oil prices were high, the state would save more. Conversely, when oil prices were low, the state would spend more. The administration thought it was a good approach and worked with a POMV. Whereas, the governor's plan stated that \$3.3 billion was a sustainable amount if petroleum revenues were placed in the ERA. The petroleum revenues could still be placed in the ERA and the POMV draw could be increased. It was another way of having a steady cash flow coming out of the PF to fund government while harnessing the volatility of the three cash flow systems. The economic modeling showed the sustainable POMV percentage at roughly 6.5 percent if production taxes and royalties were placed into the ERA.

Attorney General Richards reported that another approach the administration supported was the revenue limit that resulted from an amendment to SB 114 [Legislation introduced in 2015 - Short Title: PERM FUND: EARNINGS,

DEPOSITS, ACCOUNTS] out of the Senate State Affairs Committee. He explained that if oil prices rebounded, then to the extent they rebounded the state would not be drawing from its financial assets. It was another logical way of handling the real problem of volatility. The problem with volatility was twofold. First, state revenues jumped up and down, which propagated government growth in good years and significant government shrinkage in bad years. He surmised that the revenue limit adopted by the Senate State Affairs Committee addressed the issue. It also addressed the other piece of volatility, which was a pure POMV. In the committee substitute, the state would be able to turn on the PF faucet to move money into the GF. If oil prices were to rebound, the state could potentially build budgets not only on high oil prices but also on large draws from the PF. It would be akin to doubling down on oil price volatility. In the next period of oil price collapse, the government would have built a larger and more unsustainable budget than without PF revenues being accessible. He concluded that the governor thought the inflation piece and the volatility piece (the lack of a revenue limit) could be improved substantially.

Representative Thompson welcomed Commissioner Hoffbeck to the meeting.

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Attorney General Richards addressed the issue of a rule-based system around a revenue limit. He noted that Mr. Teal had mentioned the previous day that a revenue limit was not necessary because funding was subject to appropriation. Mr. Teal had indicated that the rules could be changed by the legislature, although he was uncertain they were necessary. Instead, Mr. Teal offered that everything could be handled by a yearly appropriation.

Attorney General Richards pointed to a chart titled "Long-Term Problem" from the Alaska Permanent Fund Protection Act: Defining the Problem (one-page handout from a previous presentation - labeled page 10). He offered that the chart demonstrated the state's unrestricted budget graphed against unrestricted petroleum revenues. It showed a high statistical correlation to the amount the state spent and the amount of petroleum revenues that were collected in the prior year. He furthered that when petroleum levels were high, the state spent a significant amount of money. He

continued that when petroleum revenues were low the state spent less money. It was an extremely high statistical correlation. He furthered without a rules-based system it was likely the legislature would spend the petroleum revenues available if history repeated itself. He suggested comparing his handout to the history of the PF. He thought members could see the value of a rules-based revenue limit. In roughly 35 plus years, the legislature had never broken a rule regarding the PF. The state had inflation proofed, paid dividends, and kept from spending the ER, all of which could be done by a majority vote by appropriation. He claimed where a rule-based system was not in place, there was an extremely high tendency to spend money. In a rules-based system, there was incredible discipline in following the rules. He furthered that when a system needed to be changed, if there was a rules-based revenue limit the discussion would not be about taking money out of the PF but about changing the rules in a sustainable manner. He surmised that by having the rules in place the topic of ad hoc spending would be avoided. He advised that the state would want to avoid ad hoc spending with its financial savings and sovereign wealth funds because it would prevent the state from growing its savings over time in a sustainable system.

Representative Wilson asked if there had been any modeling done with the entire package. She indicated that the bills were being heard separately. She did not have a picture of the impact of a total package. She wondered if the department had done modeling for different groups in different demographics. She wanted to have a bigger picture of the impacts of the total plan.

RANDALL HOFFBECK, COMMISSIONER, DEPARTMENT OF REVENUE, replied that the department had not done a model of the cumulative impact of the various components on an individual taxpayer. The department had modeled it in aggregate. Gunnar Knapp had done the modeling and presented it to the committee. The department had not drilled down to the level Representative Wilson queried, such as a particular fisherman in a certain community.

Representative Wilson asked how long it would take to produce a model. Commissioner Hoffbeck thought some kind of modeling could be done with a selection of six proxy individuals in the state with a certain occupation.

Representative Wilson stated that the legislature kept hearing about being fair to everyone in the state and sharing the pain. She wanted to have a better understanding of the full impact of what was being proposed. She thought more people would leave the state. She did not have a grasp of how everything that was on the table would affect people's choices to stay in Alaska or leave the state, especially those folks in areas with higher energy costs. Commissioner Hoffbeck could produce a model, but thought there was a much larger picture to consider. There would be an impact if the state cut an amount from the budget, a certain number of people lost their jobs, people left the state, and house prices dropped. He could provide a simple model but it would be very difficult to model fully how the changes would affect an individual in the state. Everything the state did would have some impact whether it reduced its expenditures or increased its revenues.

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Representative Wilson understood the commissioner's point. She thought private businesses were already doing it. She was concerned with taxes stacking up. She commented that it [the plan] would have a huge impact: it would not only impact a family's income, but would also affect Alaskan communities. She was trying to measure the different items in the last few days [of the legislative session].

Representative Munoz returned to the rules-based system and the importance of having rules pertaining to spending. She wondered if the POMV approach was a rules-based system. If it was not, she wondered what the state would need to recalculate the spending amount to put the rules into place in the current legislation. Attorney General Richards replied that the POMV was definitely a rules-based system. He asserted that the bill did not contain all of the rules he thought it needed. The committee substitute had a rule for how much could be drawn from the PF. He remarked it was a good rule, but perhaps slightly too high. It had a rule for how dividends were paid and rules for how the PF was managed consistent with existing rules. They were all part of a rules-based framework. He expounded that it lacked a rule to address a revenue limit in the volatility issues. He was not suggesting that it was not a rules-based framework. However, it left out one of the necessary rules for the framework to be robust that did not result in the

state just spending PF earnings if oil prices increased to previous levels.

Representative Edgmon asked Mr. Teal the previous day about how Alaska would stand with the rating agencies. He noted the governor and members of his cabinet meeting with the rating agencies on the East Coast. He wondered how the plan being proposed stacked up with the rating agencies in terms of Alaska getting its fiscal house in order if the legislature did not include other sources of new revenue such as income, fishing, or mining taxes. He wondered how the legislation would be received back East. Commissioner Hoffbeck stated that the bond rating agencies were in favor of the state using its earnings reserves. However, they would negatively view the state leaving a large structural deficit in which it continued to draw down savings. He thought the state needed to close its deficit with the revenue packages before the bond rating agencies would view the plan as sustainable over the long-term. He reported a comment offered by Moodys. There was a discussion about the downgrade from AAA to AA+. He had shown how using the earnings reserves would stabilize the state. Moodys was unsure that using just the earnings reserves would create a stable enough fiscal environment for the state.

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Representative Edgmon indicated that it had just been mentioned that the three largest sources of revenues to the state included production tax, royalties, and the earnings from the PF. If current oil prices stayed within the current low realm, \$50 to \$60 into the future, the state would not have production tax revenue or would have a very limited amount the way SB 21 [Oil tax legislation passed in 2013] was structured. The question was how it impacted modeling. He was aware the commissioner could not provide the exact results, but it seemed to him that it played a substantial role if the variables he had just described stayed in place going into perpetuity. He thought 2040 was perpetuity. He wanted the commissioner to provide a bigger picture view. Commissioner Hoffbeck affirmed that if the state had sustained low oil prices in the \$40 range the state would build a credit liability. If the price of oil ranged from \$50 to \$60, the state would no longer build a net operating loss liability with the producers. Depending upon what the legislature decided on the oil and gas tax credit reform it would make sense to model whether the

state would have a tail of liability. It would become another component against the oil price in production until it was paid off. The department modeled the current price points and did not anticipate a major shift. If the price remained at low levels for 4 or 5 years, the department would need to remodel. Hence, there was a systematic review in the plan.

Representative Gara relayed that historically POMVs used a 4.5 percent payout. He understood that most trust funds did not have a royalty as well. He thought royalties allowed for an aggressive payout. He asked if he was accurate. Attorney General Richards replied that he was correct. He added that if an average lagging number were used, the percentage would be slightly higher because of averaging in the lower value from 5 years prior with the current value. If only the current value was used as the percent, then 4.5 percent was the accepted number. However, if an average were used, then a slightly higher percentage would be used.

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Representative Gara wondered about the potential for a higher dividend payout. He thought that under the governor's plan the payout percentage allowed for a dividend. He asked about royalties adding to the percentage of the PF at \$30, \$40, or \$50 per barrel of oil. He remarked that most trust funds did not have an extra income stream such as a royalty. Alaska was somewhat different because it had royalties that offset the worry of eating into the principle of the PF. Attorney General Richards responded that 25 percent of royalties equaled approximately \$200 million.

Vice-Chair Gara wondered if \$200 million was about 1.5 percent. Attorney General Richards responded that \$200 million divided by \$50 billion equaled about .4 percent of the value of the PF. He added that it was \$200 million every year. If the state treated it like an annuity, the value of an annuity would be roughly \$2 billion.

Representative Gara asked if it was safe to move the POMV payout rate higher than 5.25 percent to achieve the desired revenue and a better dividend. Attorney General Richards replied that as the bill was currently constructed, a percentage rate of 5.25 was considered a little aggressive. He explained that the POMV percentage would not change, but

the relative amount that went to government versus dividend checks would change through adjusting the POMV percentage as drafted in the CS. He reiterated that one of the two revenue limits that the administration supported would change the POMV sustainable percentage.

Representative Gara referred to raising the dividend payout from \$1000 to \$1500, which he thought would cost about \$350 million. Commissioner Hoffbeck responded in the affirmative.

Representative Gara discussed the variability of oil prices. He stated that one of the reasons the model being presented in the CS was more flexible than the governor's model was because of a relief valve being present in case oil prices rose. The governor's model had much more money going towards the principal. He asked if there was an objection to moving the PFD to \$1500 the first year, then revisiting the amount to judge if it was sustainable the following year under the proposed plan. Commissioner Hoffbeck stated that the reason for the \$1000 figure had to do with the underlying math. If \$500 were added to the dividend, it would take away \$350 million from monies available for other expenditures.

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Representative Gara advised that he was asking questions while not yet being in support of the proposed plan. He relayed that it would be difficult to tell the public there was a balanced plan without an oil tax credit reform bill. He mentioned a number of wealthy individuals had expressed not needing their PFD. He reported that unclaimed PFDs were spread amongst other applicants as the current practice. He asked if there was a way for Alaskans to decline their dividend having the funds go back to the ERA. He wondered if the administration would consider such an option so that individuals could opt out of the dividend and grow the ERA.

Commissioner Hoffbeck suggested that Representative Gara's idea would require a statutory change, and most likely a ruling by the Internal Revenue Service (IRS) to settle tax issues. He thought there might be a tax liability if a PFD applicant was considered to be in control of the dividend funds through making a choice to direct them to the ERA.

Representative Gara asked if Commissioner Hoffbeck would look into the matter. He had considered the circumstances surrounding an employee who received a bonus but declined it. He thought the idea could result in extending the ERA. Commissioner Hoffbeck agreed to look in to the matter.

Representative Pruitt believed that Representative Gara's idea would be more difficult to implement. He thought there would be a tax liability as mentioned by Commissioner Hoffbeck. He agreed with Attorney General Richards that it was important to find an appropriate way to make sure that there were revenue limits and stability in the bill. He referred to the two options that AG Richards had discussed, and asked for more detail. Attorney General Richards stated that the idea of a rules- based revenue limit was extremely important to the administration in handling some budget problems. He furthered that the limit was a way to make sure that if oil prices recovered, the state would not increase spending to a degree and diminish the PF earnings.

Attorney General Richards addressed the two proposals mentioned by Representative Pruitt starting with the revenue limit that was put into SB 114 [Legislation proposed in 2015 - Short Title: PERM FUND: EARNINGS, DEPOSITS, ACCOUNTS] in the Senate State Affairs Committee. He prefaced his comment by informing the committee that production taxes and royalties were estimated collectively to be approximately \$800 million to \$1 billion in the future. The proposal would include accessing the PF in the short-term and building a sustainable budget plan around the petroleum revenue assumption. If revenues were greater than anticipated, the revenue limit would reduce the amount that came from the ERA above \$1 billion. If oil revenues turned out to be \$1.2 billion, the state would reduce the POMV draw by the excess \$200 million. The revenue limit would prevent a budget built upon high oil prices and PF earnings in a high oil price environment.

Representative Pruitt asked the attorney general to provide a stable dollar amount based on how the bill was currently constructed. Attorney General Richards referred back to three volatile cash flows that were being managed: production taxes, royalties, and the draw from the PF. He relayed that together the funds were expected to total about \$3.5 billion; assuming a 5 percent POMV from the PF and approximately \$1 billion in revenues from production taxes and royalties. The revenue limit of \$3.5 billion was

a baseline from the three various cash flows. As oil prices rose, the state would not use PF earnings to inject more than the \$3.5 billion into the GF.

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Representative Pruitt asked about the second option being considered. Attorney General Richards explained that option 2 (initially contained in the original version of the APFPA) combined production taxes, royalties, and earnings from the corpus of the fund into the ERA. The revenue limit would include a calculation that would determine a sustainable annual draw over time that could be supported by the three income streams. The variable cash flow streams would be leveled to come up with a sustainable amount that could be used to budget upon annually. He explained that under the PFPA, the revenue limit was originally \$3.3 billion; he commented that the math was very similar to adopting a 6.5 POMV approach. He restated that if all three income streams were housed in the ERA, the sustainable POMV would be about 6.5 percent, which would provide a steady annuity-like payment coming from the PF every year that would act as the revenue limit.

Representative Pruitt wanted to understand the benefit of moving the income streams into the ERA. He wondered if the configuration gave opportunities for the state to invest the funds in a more beneficial way than they would be otherwise. He assumed the higher rate of 6.5 percent accounted for the fact that the state would be sending more money towards the PF. Attorney General Richards stated that the sustainable POMV draw percentage (without putting more income into the PF) was calculated by DOR as approximately 4.9 percent. If royalties and production taxes or any other cash flow was put into the PF, the sustainable draw percentage on a POMV basis would rise. In the case of putting production taxes and royalties in to the PF, DOR calculated the sustainable draw percentage at about 6.5 percent. The 1.6 percent difference in what was possible to draw from the PF was a reflection of the value of the income streams.

Representative Pruitt restated his question about the value of and reasoning for moving the revenue streams into the fund. Commissioner Hoffbeck explained that there was some advantage in moving the revenues to the ERA because there would be an intermittent cash flow in the form of a monthly

payment coming in. If the funds were housed in the GF to pay for government services, not much could be done with the funds beyond short, low-return investments. Conversely, if the funds were flowing into the larger PF, the monies could go into the standard investment portfolio and be invested more aggressively.

Representative Pruitt asked if the scenario could be compared to using a checking account or money market account with a higher opportunity to make more money from the funds.

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Vice-Chair Saddler asked about the option of citizens declining a PFD. He asked how often the Department of Revenue had received checks from citizens to reduce the public debt. Commissioner Hoffbeck stated he had not seen such a check recently.

Vice-Chair Saddler asked if such an occurrence would be likely. Commissioner Hoffbeck answered that it would not be likely.

Representative Wilson spoke of a constituent that was interested in donating his PFD to help with the budget deficit. The individual had donated money to the university and then had to pay taxes on the PFD despite having donated the funds. She recounted that the constituent had written to the legislature inquiring as to how he could donate his PFD without being taxed on it.

Representative Gara emphasized that the committee was trying to find a way for individuals to donate PFD funds without being taxed, rather than engaging in arguments.

Co-Chair Thompson called a point of order and surmised that Commissioner Hoffbeck could work on the issue of a non-taxable donation of the PFD. He set the bill aside.

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

Co-Chair Thompson reviewed the agenda for the following day.

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ADJOURNMENT

3:25:16 PM

The meeting was adjourned at 3:25 p.m.