

**ALASKA STATE LEGISLATURE
HOUSE LABOR AND COMMERCE STANDING COMMITTEE**

February 18, 2015

3:29 p.m.

MEMBERS PRESENT

Representative Kurt Olson, Chair
Representative Shelley Hughes, Vice Chair
Representative Jim Colver
Representative Gabrielle LeDoux
Representative Cathy Tilton
Representative Andy Josephson
Representative Sam Kito

MEMBERS ABSENT

Representative Mike Chenault (alternate)

COMMITTEE CALENDAR

HOUSE BILL NO. 86

"An Act relating to investment of the power cost equalization endowment fund; and providing for an effective date."

- HEARD & HELD

PREVIOUS COMMITTEE ACTION

BILL: HB 86

SHORT TITLE: PCE ENDOWMENT FUND INVESTMENT

SPONSOR(s): RULES BY REQUEST OF THE GOVERNOR

01/30/15	(H)	READ THE FIRST TIME - REFERRALS
01/30/15	(H)	L&C, FIN
02/18/15	(H)	L&C AT 3:15 PM BARNES 124

WITNESS REGISTER

JERRY BURNETT, Deputy Commissioner
Office of the Commissioner
Department of Revenue (DOR)
Juneau, Alaska

POSITION STATEMENT: Testified during the discussion of HB 86.

PAMELA LEARY, Director, Treasury Division
Department of Revenue (DOR)

Juneau, Alaska

POSITION STATEMENT: Answered questions and presented a PowerPoint on the Power Cost Equalization Endowment Fund Investment during the discussion of HB 86.

GARY BADER, Chief Investment Officer
Treasury Division
Department of Revenue
Juneau, Alaska

POSITION STATEMENT: Answered questions and presented a PowerPoint on the Power Cost Equalization Endowment Fund Investment during the discussion of HB 86.

ACTION NARRATIVE

[3:29:28 PM](#)

CHAIR KURT OLSON called the House Labor and Commerce Standing Committee meeting to order at 3:29 p.m. Representatives Colver, Kito, Josephson, Tilton, Hughes and Olson were present at the call to order. Representatives LeDoux arrived as the meeting was in progress.

HB 86-PCE ENDOWMENT FUND INVESTMENT

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CHAIR OLSON announced that the only order of business would be HOUSE BILL NO. 86, "An Act relating to investment of the power cost equalization endowment fund; and providing for an effective date."

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JERRY BURNETT, Deputy Commissioner, Office of the Commissioner, Department of Revenue, stated that HB 86 is a very important bill. He stated that Pam Leary, Director, Treasury Division; and Gary Bader, the state's Chief Investment Officer will present the bill.

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PAMELA LEARY, Director, Treasury Division, Department of Revenue (DOR), offered to provide a brief history of the fund, present the bill, and discuss any considerations.

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MS. LEARY stated that the original Power Cost Equalization Endowment Fund was established in 2000. Its purpose is to fund the Power Cost Equalization (PCE) & Rural Electric Capitalization Fund and to reimburse the costs associated with managing the fund [slide 2]. She said that 7 percent of the monthly average market value of the fund for the previous three fiscal years may be appropriated annually. The Department of Revenue, Treasury Division provides the Alaska Energy Authority (AEA) with that figure annually. She provided a brief history, such that the PCE Endowment Fund was established by a \$100 million appropriation from the Constitutional Budget Reserve, along with \$89.6 million from proceeds of the sale of the four dam pool hydroelectric project, and two additional appropriations: \$182.7 in 2007, and \$400 million in 2012. The current balance of the PCE Endowment Fund is \$950.7 million [slide 1].

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MS. LEARY directed attention to HB 86 to Section 1 of the bill that does two important things [slide 3]. First, it removes the stated nominal return target of at least 7 percent from the statute, which will allow the commissioner of the Department of Revenue (DOR) to invest the fund in the manner that can meet the objectives of the fund. It would also provide the commissioner the ability invest in less risky investments when it is prudent to do so, but still meet the financial needs of the fund itself. She pointed out that there is a zero fiscal note associated with HB 86 since it will not require additional funds to continue the work.

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GARY BADER, Chief Investment Officer, Treasury Division, Department of Revenue (DOR), stated that the goal is to achieve the best return for the least amount of risk. The current statutes direct the Commissioner of Revenue to attempt to earn 7 percent each year without regard to risk.

MR. BADER directed attention to slide 4, to the 2015 Capital Market Expectations - Return and Risk. This shows the capital market assumptions provided to the Alaska Retirement Management Board by Callan and Associations. He directed attention to the top third bracket of the investment asset classes or equity investment classes and three columns over to the column entitled "1-year Arithmetic" return, which shows high rates of return if

one considers the return will be the mathematical average over several years, or the mean average. The column entitled "Projected Risk, Standard Deviation" means that two-thirds of the time the returns to the fund will be plus or minus the standard deviation. Thus, when viewing broad domestic equity, a "1-year arithmetic return" means that the fund would earn 9.15 percent over a 10-year expectation plus or minus 19 percent [using the standard deviation]. Therefore, it is possible to lose 10 percent during two-thirds of the time, but during other times the percentage could be far more or far less. The aforementioned standard deviation affects the geometric return. The column entitled, "10-year Geometric Projected Return," is a term that means when there is a volatility of returns, the actual amount one could expect to gain would be something less than the arithmetic return. It is always true, he said. For example, an initial \$100 investment with an expectation of [zero] percent on average and a standard deviation of 50 percent, could increase to \$150, but if 50 percent of the investment was lost the next year, the initial investment would be reduced to \$75. Thus, while the arithmetic average was zero, the actual return would be far less than zero. This means that how funds are invested matters a lot, in terms of how investments are made, and the department's goal is to eliminate as much risk as possible.

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MR. BADER stated by looking down the column of possible investment returns and viewing the arithmetic column, that in order to earn 7 percent, nearly 80-90 percent of investments would need be in equities, since investing in fixed income with returns of 2 and 3 percent would average down the investment considerably. Thus, an attempt to earn 7 percent has a tendency to force the commissioner to take a far more risky path than he/she might otherwise choose. He highlighted that the stock market has gone up six years in a row, which is unprecedented, noting it has never gone up seven years in a row. Although he hoped it will continue to improve this year, the potential exists for the market to go down and passage of this bill will allow the DOR's commissioner to adjust asset allocations of the market conditions and risk, but still attempt to earn an investment return of 7 percent over time.

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CHAIR OLSON asked what will happen if the market "tanks" and with returns of 2-3 percent. He further asked whether the state

will make up the difference in order to fund the PCE Endowment Fund at 7 percent.

MR. BADER answered that the legislature could appropriate the [7 percent] amount to the PCE, but there isn't any requirement to do so, but the PCE Endowment Fund "lives" on its own returns.

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REPRESENTATIVE LEDOUX related her understanding that the term "nominal return" typically means nothing, but it doesn't sound like that is what is being discussed since HB 86 [removes the language] that specifically stated 7 percent nominal return. She asked for further clarification on the term "nominal return."

MR. BADER answered that "nominal return" is a term of finance and means the real rate of return plus inflation.

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REPRESENTATIVE LEDOUX asked how long the state has been investing the PCE Endowment Fund.

MS. LEARY answered that it has been 14 years and it was established in 2000.

REPRESENTATIVE LEDOUX asked whether the fund has always attempted to reach the 7 percent rate of return.

MS. LEARY answered yes.

REPRESENTATIVE LEDOUX asked whether the fund has lost or gained revenue.

MS. LEARY answered that it has fluctuated, and the returns have been negative in some years and positive in others. She reported that the last five years the returns have been 14 percent.

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MR. BADER added that when the statute was written interest rates were higher than they are today so fixed income investments could earn 7 percent, plus equity investments also made the 7 percent return an attainable goal; however, under the current

low interest rates 10 year [investments] are earning less than a 3 percent return, which prompts the need for this bill.

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CHAIR OLSON asked for the average annual nominal return in the past 14 years.

MS. LEARY offered to provide the figures. She stated that she has actual returns for each year, but not the complete average.

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REPRESENTATIVE JOSEPHSON asked for further clarification on the growth rate and whether it has grown 14 percent in five years or per annum.

MS. LEARY answered that the return has been 14 percent per annum.

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REPRESENTATIVE HUGHES, referring to slide 2, understood that 7 percent of the monthly average market value of the fund for the previous three fiscal years may be appropriated [to the PCE Endowment Fund]. She asked whether that has occurred. She further asked whether the legislature would need to adjust the amount under the bill. For example, if the state will be earning less than anticipated, it may need to lower the percentage of appropriation to the PCE Endowment Fund.

MS. LEARY answered that she does not have the historical figures for the past 14 years; however, she said the FY 16 budget appropriation is less than 7 percent, but a little more than 5 percent. She offered to review and provide the prior appropriations to the committee. She said that one of the factors for the target return of 7 percent is to consider the use of the fund, the cash flow, and expectations. She clarified that from the investment perspective the Department of Revenue is more concerned about setting the target and eliminating any undue potential risk associated by setting the rate too high, which could increase risk in certain environments.

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REPRESENTATIVE HUGHES asked whether the 7 percent that may be appropriated [to the Power Cost Equalization Endowment Fund] is set in statute.

MS. LEARY answered yes; that the calculation that the DOR provides to the Alaska Energy Authority (AES) is 7 percent of the 3-year fiscal year monthly average.

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CHAIR OLSON held public testimony open on HB 86.

[HB 86 was held over.]

[3:45:12 PM](#)

ADJOURNMENT

There being no further business before the committee, the House Labor and Commerce Standing Committee meeting was adjourned at 3:45 p.m.