

ALASKA STATE LEGISLATURE
HOUSE LABOR AND COMMERCE STANDING COMMITTEE

February 17, 2016

3:30 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. 268

"An Act relating to the dividends from the Alaska Industrial Development and Export Authority; relating to the meaning of 'mark-to-market fair value,' 'net income,' 'project or development,' and 'unrestricted net income' for purposes of the Alaska Industrial Development and Export Authority; and providing for an effective date."

- HEARD & HELD

PREVIOUS COMMITTEE ACTION

BILL: HB 268

SHORT TITLE: AIDEA:DIVIDEND TO STATE;INCOME;VALUATION

SPONSOR(S): RULES BY REQUEST OF THE GOVERNOR

01/20/16	(H)	READ THE FIRST TIME - REFERRALS
01/20/16	(H)	L&C, FIN
02/17/16	(H)	L&C AT 3:15 PM BARNES 124

WITNESS REGISTER

MICHAEL E. LAMB, Chief Financial Officer
Alaska Industrial Development and Export Authority
Department of Commerce, Community & Economic Development
Anchorage, Alaska

POSITION STATEMENT: Provided a PowerPoint presentation entitled, "Alaska's Development Finance Authority Proposed Changes to AIDEA Dividend Statutes HB 268/SB 149," and answered questions.

GENE THERRIAULT, Deputy Director for Energy Policy Development
Alaska Energy Authority/Alaska Industrial Development and Export Authority
Department of Commerce, Community & Economic Development
Anchorage, Alaska

POSITION STATEMENT: Answered questions during the hearing on HB 268.

ACTION NARRATIVE

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CHAIR KURT OLSON called the House Labor and Commerce Standing Committee meeting to order at 3:30 p.m. Representatives Olson, Tilton, Hughes, Josephson, and Kito were present at the call to order. Representatives LeDoux and Colver arrived as the meeting was in progress.

HB 268-AIDEA:DIVIDEND TO STATE;INCOME;VALUATION

[Contains discussion of SB 149]

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CHAIR OLSON announced that the only order of business would be HOUSE BILL NO. 268, "An Act relating to the dividends from the Alaska Industrial Development and Export Authority; relating to the meaning of 'mark-to-market fair value,' 'net income,' 'project or development,' and 'unrestricted net income' for purposes of the Alaska Industrial Development and Export Authority; and providing for an effective date."

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MICHAEL E. LAMB, Chief Financial Officer, Alaska Industrial Development and Export Authority, Department of Commerce, Community & Economic Development, provided a PowerPoint presentation entitled, "Alaska's Development Finance Authority Proposed Changes to AIDEA Dividend Statutes HB 268/SB 149." Mr. Lamb said his presentation would address AIDEA's dividend history, goal, statutory language, and two problems that have been revealed by annual audits, both of which are corrected by the language of the bill [slide 2]. Mr. Lamb explained that

AIDEA's dividend program covers three years; slide 3 illustrated that the year ending 6/30/95 was the first year of actual results of operations of which the dividend is based. During the three years of the dividend program, the first year is the operation, the second year is the audit, and the third year the dividend is paid. The first dividend was \$15 million payable in fiscal year 1997 (FY97). Further shown was that AIDEA has paid about \$380 million to the state, and the state's capitalization was about \$332 million. Slide 4 stated AIDEA's goal: share with the state - through an annual dividend that is stable and more predictable - the financial benefits of AIDEA's actual results of operations. Slide 5 displayed pertinent language excerpted from Sec. 44.88.088. Payment of Dividend to State. Slide 6 displayed "Dividend Calculation Stack Visual" as follows: dividend to the state; based on statutorily defined net income; based on audited statements of revenues, expenses, and changes in net position; audit must include market value; generally accepted accounting principles (GAAP); and adopt applicable governmental accounting standards board (GASB). Mr. Lamb said the additional information inserted in the red box is related to the changes in HB 268/SB 149, which would remove market value adjustments and/or write-down, or loss, entries in the calculation of the dividend.

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MR. LAMB continued, noting there are three types of financial transactions: real transactions that actually occurred, such as booking what was paid for an asset; estimates and allocations, such as booking depreciation and amortization expenses; and market value adjustments, which didn't really happen and are what AIDEA seeks to remove [slide 7].

REPRESENTATIVE JOSEPHSON asked for an example to illustrate market value adjustments.

MR. LAMB explained components of the first dividend problem [slide 9]:

- the dividend payment is a cash-based transaction and in the third year AIDEA writes a check to the state - if market value adjustments are factored in, AIDEA is paying the state for operations that did not have revenues, or the state does not receive dividends on unrealized losses
- over time, GASB continues to make changes to GAAP
- GAAP-based income is derived from results of operations plus market value entries

- as a result, AIDEA's net income swings and the state's dividend swings

MR. LAMB described four adjustments to AIDEA's financial activities that are required by GASB [slide 10]. As a means to explain the problem, he provided an analogy of AIDEA as a U.S. taxpayer and how GASB Statements No. 31, 68, 72, and 75 would affect a taxpayer's income tax return [slides 11-23].

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REPRESENTATIVE LEDOUX asked for the purpose of GASB standards.

MR. LAMB recalled that GASB Statement No. 31 originated over 20 years ago after the treasurer in Orange County, California, pooled money for several cities and when "the market actually turned," their assets lost liquidity. In further response to Representative LeDoux, he said the treasurer probably did not buy junk bonds because when investing at the government level, officers strive for safety first, then liquidity and yield. Due to changes in the market, the investments lost value and they were liquidated at a loss. Therefore, government agencies now want to know the current market value of securities, and GASB Statement No. 31 requires AIDEA to establish a market value of all of its securities on the last day of its fiscal year.

REPRESENTATIVE LEDOUX questioned whether this information would show in a financial statement.

MR. LAMB explained that most transactions in a financial statement are historic-based on real transactions; financial statements show what really happened but will not reflect billions of dollars' worth of investments, and if there are no real transactions, their sale value is unknown. So, GASB Statement No. 31 requires AIDEA to act like it sold its whole portfolio of marketable securities to determine an unrealized gain or loss.

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REPRESENTATIVE KITO observed that AIDEA statutes allow AIDEA to pay a dividend of between 25 percent and 50 percent, therefore, AIDEA has flexibility to level the payment to the state, and there is already a means to accommodate for items accounted for under the GASB accounting rules. He gave an example of a dividend that is

paid for an investment that realizes a loss in the following year. He suggested that the proposed legislation may result in more money coming to the state over a longer period of time, or less, or the same amount; in fact, it is a small amount of money, when considering the billions of dollars of debt. Representative Kito said, "I'm not quite sure why this is necessary and what it is actually trying to accomplish."

MR. LAMB that the AIDEA board of directors has flexibility in setting the dividend; historically, the amount is 50 percent. However, it is difficult to determine whether the dividend will create a problem for AIDEA in the future. Currently, AIDEA has investment policies that require AIDEA to have two years' worth of operating cash available; as CFO, he said his job is to be risk-adverse with public money, especially related to marketable securities. The proposed legislation will eliminate "swings," and another component is to have cash available to pay the dividend when due; also, he said he was unsure about marketable securities that are externally managed, and are "constantly" being bought and sold. Mr. Lamb cautioned that AIDEA does not have control, and remarked:

The basic question of, "In the end does it even out?" I don't know the answer to that. And in fact, when there was a changeover in one of the external managers, they sold a lot of the portfolio, and there was actually to, [because] they wanted different types of investments, and there were losses and so that will never level itself out. ... We're not in a buy and hold scenario.

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REPRESENTATIVE KITO expressed his concern that making the proposed change may establish a varied number of higher dividends paid to the state, over a long period, which would put too much pressure on AIDEA's liquid cash.

MR. LAMB said he sought these changes to stabilize the dividend and comport with GASB. He said he was unsure whether AIDEA will be better off in the future; however, the relationship between AIDEA and the state is perpetual and calculating dividends is ongoing. Furthermore, the second problem addressed by the proposed legislation is related to AIDEA's investment in projects, and to avoid paying a dividend penalty for investing in a project. As CFO, he opined that this is the right and fair

thing to do in order for AIDEA to share in operations with the state, promote economic activity, and be self-sustaining.

REPRESENTATIVE HUGHES inquired as to whether AIDEA has determined how the proposed changes would have affected dividends that were paid in past years.

MR. LAMB said no. He added that that information is not material to the swings in the market today, and remaining is the problem of insufficient cash on hand for paying dividends. He restated his intent to remove volatile market swings and stressed the need to address the impacts of GASB Statement No. 68 - on the pension obligation - and the unknown impacts of GASB Statement No. 72.

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REPRESENTATIVE HUGHES asked how the proposed changes would affect dividends over the next five years.

MR. LAMB said he did not know. He said he expected that for 2016, if market conditions continue as they are and without a change to statute, AIDEA will have an unrealized loss and a reduced dividend to the state. In further response to Representative Hughes, he said more information in this regard will be provided later in the presentation.

REPRESENTATIVE LEDOUX noted that AIDEA is owned by the state; without GASB, how would the legislature know AIDEA is not in a position similar to that of the public entity in Orange County.

MR. LAMB reminded the committee the statutory language requires an audit based on GAAP and GASB, and which requires a certified public accountant opine that the financial statement is correct. Part of Mr. Lamb's responsibility as a state financial manager, is to represent that the value of AIDEA's assets are true and correct, and this statement is validated by the audit.

REPRESENTATIVE LEDOUX asked whether the Orange County entities were audited.

MR. LAMB pointed out that GASB Statement No. 31 was not in effect at that time. He restated the requirements of GASB Statement No. 31.

REPRESENTATIVE LEDOUX surmised that as far as income tax reporting, AIDEA would not use GASB Statement No. 31, but AIDEA

would continue to use GASB Statement No. 31 for financial statements.

MR. LAMB said right.

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GENE THERRIAULT, Deputy Director for Energy Policy Development, Alaska Energy Authority/Alaska Industrial Development and Export Authority, Department of Commerce, Community & Economic Development, clarified that for purposes of the audited financial statement, AIDEA would continue to apply all of the GAAP and GASB rules; however, as policy makers, legislators determine upon what the dividend paid to the state would be based, and at that point market value evaluations would be "backed out."

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REPRESENTATIVE HUGHES asked for the original intent of the legislation as currently written.

MR. LAMB said that GASB Statement No. 31 was not in effect at that time and since then, three more market value adjusting entries have been added. There are two questions: (1) what AIDEA should report on an audited financial statement; (2) what AIDEA should share with the state in the form of a dividend.

MR. LAMB, in response to Chair Olson, said he did not serve on the Alaska Retirement Management Board (ARMB), Department of Revenue. He discussed the impacts of GASB 31, GASB Statement No. 67 (GASB 67), and GASB Statement No. 68 (GASB 68) to a retirement fund.

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MR. LAMB returned to slide 14, which illustrated the effect of GASB 31, and proceeded through slide 23, which illustrated the effects of GASB Statement Numbers 68 (GASB 68), 75 (GASB 75), and 72 (GASB 72). He said any of the tax analogies could go in any direction, considering pension and retirement obligations, which is why he wants to take these factors out of the AIDEA dividend to the state. Mr. Lamb opined that the dividend should not be based on the foregoing non-cash transactions. Slide 21 was a graph that illustrated the impact of GASB 31 on AIDEA net income. The green line represented audited numbers, and in FY 98 - the first fiscal year impacted by GASB 31 - net income went

from about \$45 million of income from actual activities, to \$52 million, after adding in income that AIDEA really didn't get as required by GASB, and the dividend was based on 25 percent to 50 percent of \$52 million, which included revenue AIDEA really didn't earn. Whether the state has received more or less in dividends after the effect of GASB is unknown. All the areas above the green line were areas where AIDEA would pay dividends on more than it had earned, and all the areas below the green line were areas where AIDEA could have paid more to the state. Whether the state has received more or less in dividends after the effect of GASB is unknown. Slide 22 was a chart which illustrated dividend trend information for 2012/2013 through 2014/2015. Mr. Lamb pointed out that the operating revenues and operating expenses are stable; however, there are huge swings in unrealized gains/losses. For example, in 2012 there was an unrealized gain of \$7.14 million, and one year later there was an unrealized loss of almost \$22 million, which adds up to a variance of almost \$29 million in two years. He provided further examples. Slide 23 illustrated the final tax return analogy. Mr. Lamb stressed that HB 268 and SB 149 would "take out those [unrealized gains and losses], act like you don't have to do them."

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MR. THERRIAULT said the policy question the proposed legislation poses to legislators is as follows:

Do you want the AIDEA dividend to be based on real cash transactions, or do you want them to be, that number, to be swung by these, these paper transactions? ... The solution for this first problem is that those things would just be backed out, still would all be followed for the GASB compliance, GAAP compliance, but when it came time for calculation of the actual dividend, those non-cash things would be backed out.

REPRESENTATIVE HUGHES inquired as to whether the AIDEA board supports the legislation, and the time of the origin of the proposed legislation.

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MR. LAMB answered that during the FY 2015 audit, sometime in July, he talked to the AIDEA executive director, and the board, and suggested there should be legislative statutory changes. He

assured the committee the board is aware of, and supports, the proposed legislation. He pointed out AIDEA's mission is employment, financing, to generate income, and to be self-sustaining. In addition, it is important for AIDEA's income to be stable and predictable when it approaches rating agencies for bonds and financing, and he characterized the changes as "the right thing to do ... a fair thing to do." Mr. Lamb turned to the second problem, the dividend penalty effect adjusting entries, which he said is a complex problem. He said the problem is again leading to more or less net income - upon which the dividend is based - and depending on the circumstances, which may or may not affect the dividend. Although this problem does not arise frequently, he urged for changes to address both problems. For a variety of reasons, AIDEA may decide to stop work on a project and remove the asset from its balance sheet, which reduces net income, and could have a dividend penalty effect [slide 25]. He described a hypothetical project to illustrate the potential effect of an adjustment to a state funded investment, or to a federally funded project, which resulted in a \$13.2 million loss to the state [slide 26].

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REPRESENTATIVE LEDOUX questioned whether the amount taken off the balance sheet was ever an asset on the balance sheet.

MR. LAMB said yes, the amount was an asset. In the hypothetical example, the state gave AIDEA \$8.8 million to invest in a project and the funds were converted to pay for preliminary work to be used in the future for the project. He said, "So you keep it on the books, on the balance sheet - it has future value." Mr. Lamb gave another example.

REPRESENTATIVE LEDOUX asked:

If you put it on the balance sheet as an asset and then it turns out not to be an asset, then wouldn't it make sense to write it off ... and put it down as a loss because now it is a loss?

MR. LAMB said yes, although, the next question is whether that affects the dividend. He returned attention to slide 26 and restated the circumstances of the illustrated hypothetical project. He stressed that AIDEA's revolving funds were not invested in the asset: the state or the federal government provided the funds, the funds were used, and then written down which reduced the net income, and thereby reduced the dividend

to the state. He advised that this should not be part of the dividend calculation.

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REPRESENTATIVE LEDOUX questioned whether the initial \$8.8 million to AIDEA from the state was part of the dividend calculation.

MR. LAMB said "it actually gets removed." He added:

Otherwise what would happen is, the state would give us money, it would show up as a revenue, and then we would have to give you 25 to 50 percent of it back, so you wouldn't have money to do the project. So it comes out - what's missing is the other side of that.

MR. TERRIAULT pointed out that in the example, the funds were a GF appropriation or a federal grant, outside of AIDEA's normal revenue stream. When a project is written off, there is a question of whether that transaction should impact the dividend to the state that comes from AIDEA's normal operations. He added:

And the suggestion is that no, those were funds that were outside the normal course of AIDEA's utilization of its income stream and so it should not impact the calculation of the dividend.

MR. LAMB presented slide 27 which was a graph of the impact of GASB 31 to the state's dividend on the same hypothetical project. Slides 28 and 29 presented an additional hypothetical investment to show the reverse impact when a project is sold at a loss. Slides 31-33 displayed the statutory language changes included in HB 268 and SB 149. He highlighted that the substance of the changes sought to correct both "problem number one" and "problem number two" are in Section 1, paragraphs (2) and (3) of the bill, which define "mark-to-market fair value" and "net income." He summarized, noting that the proposed statutory change achieves the following [slide 33]:

- removes the "market value" entries that impact the dividend and which will stabilize the dividend
- connects the actual payment of a dividend to actual revenue earned
- removes the dividend penalty

- aligns statutory language to the fact that the dividend is a cash-based transaction, and brings the language current with GASB statutes

[HB 268 was held over.]

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ADJOURNMENT

There being no further business before the committee, the House Labor and Commerce Standing Committee meeting was adjourned at 4:52 p.m.