

SENATE FINANCE COMMITTEE
March 21, 2016
9:07 a.m.

9:07:29 AM

CALL TO ORDER

Co-Chair MacKinnon called the Senate Finance Committee meeting to order at 9:07 a.m.

MEMBERS PRESENT

Senator Anna MacKinnon, Co-Chair
Senator Pete Kelly, Co-Chair
Senator Peter Micciche, Vice-Chair
Senator Click Bishop
Senator Mike Dunleavy
Senator Lyman Hoffman
Senator Donny Olson

MEMBERS ABSENT

None

ALSO PRESENT

Randall Hoffbeck, Commissioner, Department of Revenue; Craig Richards, Attorney General, Department of Law; Bill Milks, Assistant Attorney General, Department of Law; Erin Shine, Staff, Senator Anna MacKinnon.

PRESENT VIA TELECONFERENCE

SUMMARY

SB 1 REGULATION OF SMOKING

CSSSB 1(FIN) was REPORTED out of committee with a "do pass" recommendation and with one new zero fiscal note by the Department of Administration; one new zero fiscal note by the Department of Commerce, Community and Economic Development; one new zero fiscal note by the Alaska Judicial System; one new zero fiscal note by Department of

Environmental Conservation; one new zero fiscal note by the Department of Health and Social Services; and six new zero fiscal notes by the Department of Transportation and Public Facilities.

SB 128 PERM. FUND: DEPOSITS; DIVIDEND; EARNINGS

SB 128 was HEARD and HELD in committee for further consideration.

#sb128

SENATE BILL NO. 128

"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."

[9:08:44 AM](#)

RANDALL HOFFBECK, COMMISSIONER, DEPARTMENT OF REVENUE, introduced himself and his support staff. He expressed appreciation for the opportunity to present the bill to the committee.

[9:09:57 AM](#)

Commissioner Hoffbeck began the presentation, "Alaska Permanent Fund Protection Act," (copy on file). He presented Slide 2, "Overview":

- Defining the Problem
- Fiscal Policy for Oil Economies
- Analysis of Options APFPA Summary
 - Defining "Sustainable"
 - How to Handle the Draw
 - How to Handle the Volatility
 - How to Handle the Dividend
- APFPA Sectional Analysis

Commissioner Hoffbeck believed that the bill attempted to solve the subtleties of the state's fiscal problems.

[9:10:36 AM](#)

Commissioner Hoffbeck presented Slide 4, "Defining the Problem":

- Short-Term:
 - Drop in oil prices has resulted in large budget gaps
- Medium-Term:
 - State savings will be spent in about 4 years
 - Uncorrected, state budget hole will damage Alaska's economy
 - Dividend payments are unsustainable under the status quo
- Long-Term:
 - State's undiversified budget is highly dependent on petroleum revenues
 - There has been a declining trend in North Slope petroleum production
 - Cyclicalities in petroleum prices creates an unstable state budget and economy

[9:11:04 AM](#)

Commissioner Hoffbeck discussed Slide 5, "Short-Term Problem," which depicted a bar graph entitled "Alaska's Unrestricted General Fund Revenue." He remarked that the slide depicted the petroleum and non-petroleum revenues of the unrestricted general fund (UGF).

[9:12:04 AM](#)

Commissioner Hoffbeck remarked that the UGF revenues were primarily driven by petroleum revenue, which made them volatile. He pointed out the variance between 2012 and 2016. In 2012, the state had approximately \$9.5 billion in UGF to use for funding government services; conversely in 2016, the projected revenue was \$1.3 billion: an \$8 billion decline in a 4-year period of time. He noted that the decline had created a budget shortfall, regardless of mitigating factors such as savings and budget cuts. He lamented that the state faced a substantial revenue shortfall of approximately \$4 billion.

[9:13:46 AM](#)

Commissioner Hoffbeck turned to Slide 6, "Medium-Term Problem," which plotted the state budget, in nominal billions; by existing revenue; short-term savings (CBR&SBR); and withdrawals from permanent funds earnings. He said that although during times of smaller deficits the state had been able to bridge the shortfall by spending savings, state savings would not last to cover the \$4 billion deficit. He relayed that if no adjustments were made under the current scenario, the state would spend down the CBR by 2018; the earnings reserve would be depleted by 2021. He discussed the benefits of not spending down state savings during the current time of fiscal crisis; the first benefit being the fiscal certainty that savings provided, and secondly, that the savings could be a primary driver in the state's long-term sustainable income. He summarized that the goal was to balance the budget and create a long-term sustainable plan, while preserving savings.

[9:15:19 AM](#)

Commissioner Hoffbeck moved to Slide 7, "Long-Term Problem," which showed a line graph illustrating the volatility of a government funded primarily by a commodity based asset. He pointed out to the committee that government spending had tracked with the amount of money available for expenditure. He relayed that the bill was an attempt to take the volatility out of the budgeting process, which he believed would benefit the state's economy in the long-term.

[9:16:26 AM](#)

Senator Dunleavy believed that the discussion was about the state's operating budget having grown with revenue, but not dropped correspondingly, he queried whether the budget could be reduced from current levels in order to align with current revenues.

Commissioner Hoffbeck thought there were several dynamics at work; the budget had been relatively flat for 20 years, which had put stress on government services and infrastructure, and had deferred other expenses. He said that the administration had worked to trim the budget, as well as the House and Senate Finance Committees. He lamented that inflation, raising medical costs, and higher employee costs had kept the state from reducing the budget to lower levels.

[9:18:54 AM](#)

Senator Dunleavy asked whether the possibility of new revenues would keep legislators and the administration from significantly cutting the current budget.

Commissioner Hoffbeck did not believe that the possibility of new revenues would psychologically trick lawmakers or the executive branch from seeking meaningful budget cuts. He felt that it would be hard work to get to a long-term, balanced, sustainable budget even using the permanent funds earnings.

[9:20:03 AM](#)

Senator Dunleavy shared that Alaska enjoyed a smaller population and an economic boom in the mid-1980s.

[9:20:22 AM](#)

Senator Bishop stressed the importance of reigning in deferred maintenance in order to cut capital budget spending. He expressed distain for deferred maintenance as a liability.

[9:21:37 AM](#)

Vice-Chair Micciche referred to a research paper from Institute of Social and Economic Research (ISER), published in 1992, which was written at the time of a \$2.5 million operating budget. He noted that the legislature had cut the operating budget by 35 percent over the past 3 years. He believed that the price of oil would recover in the future. He thought that it was important to remain fiscally frugal when crafting future budgets.

Commissioner Hoffbeck responded that the state needed to adopt a rules based system for use of earnings.

[9:23:39 AM](#)

Vice-Chair Micciche referred to Page 2 of the ISER report, which listed five checklist items for fiscal strategy: cut spending, use permanent fund earnings, encourage economic development, levy taxes, and conserve and invest windfalls.

[9:24:12 AM](#)

Senator Olson referred to Slide 7. He wondered whether the unfunded liability from the early 2000s was reflected in the current numbers.

Commissioner Hoffbeck responded that any money that had been spent to cover deficits would appear as spending.

Senator Olson understood that the predicted liability was not reflected in the presentation.

Commissioner Hoffbeck replied that the spending on the liability was reflected in the presentation, and that long-term liability payments had been modeled in the governor's plan.

[9:25:03 AM](#)

Co-Chair MacKinnon noted that the state continued to retain long-term pension liability of upwards of a billion dollars, which contributed to the state's economic volatility. She said that the governor's original proposal included the use of pension obligation bonds to manage the liability, and the Senate had been working to lower that reoccurring operating cost.

Co-Chair MacKinnon welcomed Co-Chair Kelly to the table.

[9:25:52 AM](#)

Commissioner Hoffbeck presented Slide 8, "Why the Permanent Fund?":

- Other pieces of the plan provide millions, the Fund can sustainably contribute billions
- Placing petroleum revenues in the Permanent Fund is the cleanest way to address oil price volatility
- There is no solution without Permanent Fund earnings and adjusting the dividend

Commissioner Hoffbeck opined the challenge of impressing upon the public the magnitude of a billion physical dollars, and how difficult it was to achieve savings in the billions.

[9:26:58 AM](#)

Commissioner Hoffbeck discussed Slide 9, "Why the Permanent Fund?":

"Of all the fiscal options for closing the deficit, only saving less of Permanent Fund earnings . . . would have no short-run economic impacts."

Economic Impacts of Alaska Fiscal Options: Draft Report
Gunnar Knapp, Mouhcine Guettabi, and Matthew Berman
Institute of Social and Economic Research (March 2016).

Commissioner Hoffbeck added that because of the sustainable draw that anticipated high and low years of revenue; the Permanent Fund Protection Act was the only solution that could deal with current low price volatility without breaking the rules based structure set up for spending.

[9:27:58 AM](#)

Commissioner Hoffbeck turned to Slide 10:

DELAY WILL . . .

- Reduce the sustainable draw
- Risks a downgrade of Alaska's credit rating
- Damage the economy

Commissioner Hoffbeck relayed that the uncertainty of how the state would resolve the fiscal crisis was a component considered by the private sector in investment strategies.

[9:29:15 AM](#)

Senator Dunleavy whether the state's economy would be damaged by the current fiscal climate.

Commissioner Hoffbeck did not think that there was any way to avoid some damage to the economy, considering the current level of oil prices and the impact of that on both the private and public sectors.

[9:29:39 AM](#)

Commissioner Hoffbeck showed Slide 11, "Lower Sustainable Draw."

Commissioner Hoffbeck hypothesized that if \$1 billion were left unresolved in FY16, the sustainable draw going forward would be \$100 million less. The \$100 million went throughout the life of the state's finance, which would mean more cuts, or more revenues, in order to balance.

[9:30:21 AM](#)

Co-Chair MacKinnon requested an analysis on how the \$100 million figure had been determined, the interest rate assumed on the \$1 billion and where it was located, was it staying in the constitutional budget reserve or the earnings reserve account. She felt that the figure was high for an opportunity loss cost.

Commissioner Hoffbeck agreed to provide the information.

[9:30:43 AM](#)

Commissioner Hoffbeck moved to Slide 12, "Cost of a Downgrade":

"The state sold \$135 million of general obligation bonds yesterday [03/09/16], its first sale in almost a year. Tax-exempt securities maturing in August of 2035 sold at a top yield of 2.9 percent, about 0.35 percentage point higher than the benchmark securities due in 20 years. That gap is four times wider than what the state paid when it last sold debt in March of 2015."

-Bloomberg News

Commissioner Hoffbeck opined that the state had already seen the costs of a downgrade.

[9:31:20 AM](#)

Commissioner Hoffbeck showed Slide 13, "Damage to Alaska's Economy":

- Lower sustainable draw from financial assets requires
 - o More taxes
 - o Less government spending (services and jobs)
- Degraded confidence and less private sector investment

- Direct impacts on Alaskans
 - o Job Market
 - o Home Values

Commissioner Hoffbeck stressed that any decisions that the legislature made would have long-term effects on the people of Alaska.

[9:32:09 AM](#)

Co-Chair MacKinnon queried whether the committee was interested having the Department of Labor and Workforce Development (DOL) speak to the governor's veto of oil tax credits in the FY 16 budget and how it affected unemployment in the state. She expressed concern with the information on the slide. She revealed that she had suffered from real estate economic instability in the late 1980's.

Members nodded in the affirmative.

[9:32:58 AM](#)

Senator Bishop requested that Neal Fried, research and analysis staff for DOL, represent the department before the committee.

[9:33:07 AM](#)

Vice-Chair Micciche lamented the huge home value impacts on municipalities that resulted from economic downturns. He felt that municipalities were bearing increasing weight due to the fiscal climate of the state.

Co-Chair MacKinnon wondered whether DOL had any data detailing how Alaskans spent their permanent fund dividends.

[9:34:20 AM](#)

Co-Chair MacKinnon wondered whether the committee was interested in hearing from the Alaska Realtors Association on the home value issue.

Co-Chair Kelly suggested the Chair of the Alaska Board of Realtors.

Co-Chair MacKinnon believed that a conversation with a state assessor could shed some light on the issue.

[9:35:34 AM](#)

Senator Dunleavy thought that a similar conversation should occur concerning the depressed energy costs for the average Alaskan.

Co-Chair MacKinnon thought that an economist could provide insight on disposable income increasing for average Alaskans as energy costs went down at a greater degree in rural Alaska than urban areas. She said that rural Alaska bought in bulk tanks and could be sustaining higher costs.

Senator Dunleavy referred to an older ISER study that could be referenced on the matter.

[9:36:33 AM](#)

Senator Bishop thought the University of Alaska could provide further economic research at no cost to the state.

Co-Chair MacKinnon clarified that she was not proposing any studies, and was interested only in reaching out to Alaskans who had information to share that might shed light on Alaska's economic future.

[9:37:04 AM](#)

CRAIG RICHARDS, ATTORNEY GENERAL, DEPARTMENT OF LAW, referred to Slide 15, "Government Spending and the Economy":

- The Commodities Roller Coaster - the International Monetary Fund studied 85 economies over 3 decades
- Government spending in commodity-based economies tends to move up and down with commodity revenue
- Pro-cyclical government spending stunts economic growth
- Stabilizing fiscal policy has the inverse effect, increasing GDP growth by 0.3% annually

Mr. Richards explained that the state was not unique to other states; Alaska suffers the problems of an undiversified, commodity based economy.

9:39:08 AM

Mr. Richards turned to Slide 16, "Break-Even Oil Price":

- A widely used rule-of-thumb measure of the oil price required to balance the government budget in any given year
 - o Options for petroleum states to bring down break-even oil prices are generally Diversify revenues through other types of taxation
 - o Use sovereign wealth assets

- Alaska: \$109

Mr. Richards noted that the break-even oil price for the nine other petroleum states were listed on the right hand side of the slide; Alaska rested between Russia and Saudi Arabia in terms of the need to have about \$110 p/bbl oil in order to balance the budget.

9:40:19 AM

Mr. Richards discussed Slide 17, "Oil: Break-Even Price and Share of Revenue," which graphed the oil price required to balance the budget on one axis, and oil's percentage share of total government revenue on the other. He said that the blue and yellow bubble son the slide depicted classes of oil economies that had successfully diversified their governmental revenues away from high commodity price independence. He noted that the numbers were from 2013 and represented a high commodity price environment. He stated that currently the state had a high break-even oil price, and the total share of governmental revenue relative to other sources of revenue was highly dependent on oil. The chart put Alaska up with Saudi Arabia and other Middle Eastern oil economies that had not successfully diversified. He noted that the blue bubble, which contained Wyoming, Alberta, and Norway, had successfully been able to become independent of commodity revenue by adopting broad based taxation so that they were not totally dependent on oil. He related that those economies had the advantage of taxation options, which Alaska did not. He noted that the yellow circle had economies more comparable to Alaska, and those economies used sovereign wealth fund assets to create a fiscal plan that allowed for the diversification of total

governmental revenues by using savings in a way that made them less dependent year-to-year on financial assets.

[9:42:40 AM](#)

Vice-Chair Micciche queried why the economies in the yellow bubble did not move to the blue bubble once revenues were realized by the state.

Mr. Richards replied that the red arrow on the chart could indicate a state moving to the bubble on the left. He said that he did not know why the red arrow did not slope toward the lower oil price required to balance the budget. He felt that the slide was illustrative of the point that the state could diversify its income stream by using financial savings in a way that took some of the volatility out of the year-to-year dependence on oil prices.

[9:43:54 AM](#)

Co-Chair MacKinnon referred to Slide 16. She felt that presenters before the committee always chose best case scenarios to represent their agenda.

Mr. Richards believed that the information that the administration was putting forward was the best information to offer in order to get to a solution.

Co-Chair MacKinnon referred to Slide 17. She contended that the taxation in Norway was between 50 to 75 percent, and their sovereign wealth fund did not contribute to the people of Norway. She noted that Alberta and Wyoming also taxed their residents. She wondered whether the states in the yellow bubble taxed their people, or employed complete sovereign wealth.

Mr. Richards responded that he was not in possession of exact numbers, but thought that those represented in the yellow bubble relied primarily on petroleum revenues and sovereign wealth funds, and blue bubble indicated states that had broad based taxation that differed from solely financial savings. He noted that all three of the economies in the blue bubble had permanent funds. He understood that Norway did not spend its petroleum revenues, but deposited them in an account approximated at 1 trillion, and used a 4 percent of market value approach.

Co-Chair MacKinnon recalled a conversation with a consultant that had asserted that Alaska was in a better wealth position than Norway.

Mr. Richards clarified that Alaska was displayed in the graphic with a break-even oil price of \$110 p/bbl, and was not in an enviable position from the income statement side. He said that Alaska had a high level of oil price dependence and needed high oil prices in order to be in the black. He relayed that the state was in the opposite situation in term of total financial savings. Alaska had \$55 or \$60 billion in unencumbered financial assets and a \$5 billion dollar budget; meaning that the state had 12 times financial savings than annual spending, which put the state at the highest level of sovereign wealth savings, to total governmental expenditure in the world. He stressed that used intelligently, the state had the opportunity to take an immense financial base and use it to bring down a bad income statement.

[9:47:52 AM](#)

Co-Chair Kelly agreed with Mr. Richards regarding the goal of getting off the "commodities rollercoaster". He spoke to Keynesian economics and how they applied to the state's budget. He shared that following those various theories made him uncomfortable. He felt that taxation was not the only way to diversify an economy, but was a way to diversify government revenue. He believed that changes that were more favorable to the private sector, and not Keynesian economics, would be better for the state. He contended that once the administration decided that the goal was to take care of government, government spending would increase. He felt that the administration's goal was to continue to feed government spending.

[9:50:59 AM](#)

Mr. Richards observed that by discussing Keynesian economics he had not intended to broaden economic policy. He suggested that in times of down economies, if the government had extra money to spend on capital budgets, perhaps it would be better to spend more in order to flatten out the economy. He agreed that there was a distinction between growing the economy and growing governmental revenue; however, the way to get off the commodity price roller coaster was to go for broad based

taxation, to use sovereign wealth assets, or a combination of the two. He asserted that Alaska's ability to use financial savings was greater than the ability to tax residents.

[9:52:01 AM](#)

Co-Chair Kelly encouraged Mr. Richards and Commissioner Hoffbeck to separate what the administration was attempting to do using sovereign wealth, from the discussion on taxing Alaskans.

Mr. Richards replied that he appreciated the advice.

[9:52:19 AM](#)

Senator Dunleavy spoke to Slide 17. He noted that without government spending there would be no economy in Alaska. He felt that a government that provided basic services, separate from the economy, should be explored.

[9:54:04 AM](#)

Co-Chair MacKinnon considered a discussion on economic structures in differing political regimes.

Senator Dunleavy pondered government support of the economy and social dislocation.

[9:54:45 AM](#)

Mr. Richards observed that moving from the yellow bubble to the blue bubble would require getting off the commodity rollercoaster by diversifying the economy. He asserted that in order to grow an economy that was not petroleum revenue or governmental spending based, the state needed to provide stability for economic growth in other sectors.

[9:55:36 AM](#)

Senator Dunleavy noted that the bill could solve the state's revenue issue, but would not solve the issue of economic diversification.

[9:56:22 AM](#)

Mr. Richards referred to the International Monetary Fund paper on Slide 15. He explained that until the state could control the fluctuation in the economy, caused by oil price dependence, it was hard to diversify into other sectors. He stated that the state could not diversify without first stabilizing the economy.

[9:57:00 AM](#)

Vice-Chair Micciche thought that the current fiscal crisis left Alaska exposed; oil constituted 90 percent of the state's revenue. He said that the states in the blue bubbles had additional revenue streams after oil monies. He felt that of the governments in the country that were responsibly operated, Alaska was the international outlier. He said that he, "did not want to be Norway" but admitted that something needed to be done to address the current fiscal situation.

[9:58:40 AM](#)

Senator Bishop pointed out that the cost for Saudi Arabia to increase the flow of crude oil was \$12 to \$14 p/bbl. He thought that, due to commodity prices, Norway would make a draw for the first time on their sovereign wealth fund.

Mr. Richards informed the committee that an expert would be brought before the committee to discuss the nuances of the different countries on the slide.

[9:59:46 AM](#)

Mr. Richards looked at Slide 19, "Rule-Based Framework." He stated that there was a correlation between unrestricted general fund spending and prior year petroleum collations. He added that the state had a habit of making spending projections based on prior year total revenues. He furthered that the permanent fund operated within a rules based framework which allowed for dividends to be paid out of the earnings reserve, inflation proofing back to the corpus, and saving the remainder. He shared that the rules based framework had never been violated. He admitted that the state did not have incredible discipline when it came to saving money from year-to-year in unrestricted budgeting, but that the legislature had displayed unrelenting discipline regarding the fund. He observed that the reason was not solely because the permanent fund was

Constitutionalized; the rules-based framework was based in statute and could have been violated by a vote of the majority, yet the custom in Alaska had been not to do so for a variety of reasons. He said that the administration hoped to duplicate the way in which the rules-based framework worked in a manner that met the current fiscal reality in a logical way.

[10:02:22 AM](#)

Co-Chair MacKinnon queried whether the double dividend of 2008 had been inside the rules-based framework.

Mr. Richards understood that the second dividend of 2008 had come out of the general fund.

Co-Chair MacKinnon pointed out that a substantial amount of money had been sent out to Alaskans.

Mr. Richards replied yes, and without altering the rules-based framework of the permanent fund.

Co-Chair MacKinnon whether the legislature had saved and paid back all CBR withdrawals since 2007.

Mr. Richards replied in the affirmative.

Co-Chair MacKinnon reiterated that the legislature had repaid all funds that had been previously borrowed from the CBR.

Mr. Richards replied, again, in the affirmative.

[10:03:33 AM](#)

Senator Olson asked whether or states with a similar sovereign wealth fund gave out a dividend to their residence.

Mr. Richards believed that Wyoming used its earnings for their broad based education system, Alabama used their earnings for its road system, and Texas used their permanent fund earnings for their road system.

[10:04:30 AM](#)

Senator Olson asserted that much of the public had advised legislators to leave the permanent fund alone while seeking solutions to the fiscal problems of the state.

Commissioner Hoffbeck believed that there had been a shift in the public's perception of using the permanent fund earnings. He said that the administration had worked to educate the public on what would be the proper way to use the funds earnings.

[10:05:58 AM](#)

Senator Dunleavy reported that Finland was contemplating giving each of its citizens \$10,000, in an effort to spur private sector activity.

[10:06:37 AM](#)

Senator Olson said that there had been talks in the past of giving every Alaskan resident a \$25,000 one-time dividend.

Mr. Richards looked at Slide 20, "APFPA," which offered a breakdown of how the act would work:

- **Volatile petroleum revenues** to the Permanent Fund
- **\$3.3 billion** draw to the General Fund
- **Dividends**
50% royalties

Mr. Richards said that the bill would place oil production taxes and royalties in the permanent fund, draw out of the permanent fund the fixed amount of \$3.3 billion to be deposited into the general fund yearly, and it would change the dividend pay-out calculation to equal 50 percent of royalties.

Co-Chair MacKinnon asked whether the dividend would be drawn out of the corpus of the fund, or the earnings reserve account (ERA).

Mr. Richards stated that, constitutionally, 25 percent of royalties went to the corpus of the fund, all statutory net income traveled from the corpus and into the earnings reserve. The corpus of the fund was not constitutionally available for expenditure, but the earnings reserve was

available by a majority vote. He concluded that, barring a constitutional amendment, all plans to use permanent fund earnings, or other permanent fund assets, had to be expenditures out of the ERA - including the payment of dividends.

[10:09:05 AM](#)

Co-Chair MacKinnon clarified that the 25 percent constitutionally required went into the corpus, and the remaining 74.5 percent went into the ERA to be managed similarly.

Mr. Richards replied in the affirmative.

Co-Chair MacKinnon noted that the remaining .5 percent was placed in the Mental Health Trust fund.

Mr. Richards answered in the affirmative.

Co-Chair MacKinnon added that the deposit was a federal requirement.

Mr. Richards understood that putting the .5 percent into the Mental Health Trust fund had been a result of litigation. He could not recall if it had been on the state or federal level.

Co-Chair MacKinnon asked Ms. Mills, in the gallery, whether the case had been on the federal level.

Ms. Mills replied yes.

[10:10:11 AM](#)

Senator Bishop asked whether the plan changed in any way the investment strategy of the permanent fund board.

Mr. Richards answered in the negative. He added that if the state drew from the ERA on an annual basis under any of the proposed plans, the board would need to manage for additional liquidity.

[10:11:12 AM](#)

Senator Bishop theorized that the \$3.3 billion draw might not be available in certain future years. He suggested that

the budget could be short funded in the future, regardless of which plan is implemented.

Mr. Richards explained that the plan would take the constitutionally required 25 percent of the royalties and placed them into the corpus. Then, approximately 75 percent of the royalties would be deposited into the ERA, as well as all production taxes. The other cash flowing into the ERA would be considered statutory net income, which creates an income stream into the ERA. Three things would come from the ERA: 50 percent of royalties to pay dividends, the \$3.3 billion draw for the General Fund, and when the earnings reserve reached a balance of 4 times the annual payout of \$3.3 billion any extra would be placed into the corpus and would be constitutionally protected.

Mr. Richards addressed the assertion that the plan ran a substantial risk of failure. He said that the issue would be whether the ERA had a sufficient enough balance to instill confidence even during bad market years. He relayed that the small chance that the ERA would not be available for the \$3.3 billion draw would exist under any plan; the current plan had been designed to reduce the chance of shortfall to a very high degree. He thought that the Callen and Associates estimations were high, and shared that the administration had adjusted for chance by establishing the target of amassing 4 times the balance of the annual draw into the ERA, and by creating the periodic review. The review entailed that every four years the balance of the ERA would be assessed in order to decide whether the system needed adjustment. He relayed that four years had been chosen because every four years there would be four times the amount of payment in the ERA. He said that the plan was made more robust by the proposal of \$3 billion from the CBR into the ERA. He pointed out to the committee that the \$3 billion would not be required in order for the plan to work, but offered a higher level of confidence that the ERA would be large enough to accommodate bad market years.

[10:16:16 AM](#)

Co-Chair MacKinnon stated that she would be meeting with the Executive Director of the permanent fund board. She summarized that the asset allocation would remain the same with the board managing the fund.

Mr. Richards could not speak to the accuracy of the summarization. He said that he had requested that Angela Rodell, Executive Director, Alaska Permanent Fund Corporation brief the trustees on the issue. He was not aware of whether or not there was an expectation that the asset allocation would change if additional petroleum revenues were placed in the fund.

[10:16:58 AM](#)

Co-Chair Kelly understood that the 25-30 percent failure rate had been calculated using the assumption of a higher level return from the permanent fund and an old oil revenue forecast.

Mr. Richards replied in the affirmative. He added that the new spring 2016 forecast put out by the department used a new petroleum projection. He revealed that for the plan under the bill the forecasted revenues did not particularly matter. He related that the permanent fund analysis may have down stated return assumptions. He shared that a future meeting with the board would reveal more on the matter.

[10:17:51 AM](#)

Co-Chair Kelly thought that the failure rate might increase as the to-date numbers changed.

Mr. Richards replied that if assumed petroleum revenues and return assumptions were lowered, the probability of failure would increase.

[10:18:08 AM](#)

Co-Chair MacKinnon spoke to the assumptions used in the crafting of the plan. She wondered whether the actuaries had assumed for lost opportunity cost due to the changes in the per-year cash draw and the need for higher liquidity on an annual basis.

Mr. Richards relayed that the administration had examined the issue and had concluded that it was irrelevant. He shared that the administration believed that it could "go long" with other financial assets that were currently held "short". He thought that there would be some modeling affect, but that the remaining balance of the CBR was

short, and not long, which suggested that the total amounts would be similar.

[10:18:56 AM](#)

Co-Chair MacKinnon referred to a previous slide which had indicated \$100 million on \$1 billion worth of opportunity cost lost. She said that if a \$3.3 billion draw were to be taken annually, there would be between \$0 and \$100 million worth of opportunity cost lost on assets sitting in more fixed reserves.

Mr. Richards responded that because of the way the cash flow was structured he could not estimate the magnitude of opportunity cost lost.

[10:19:44 AM](#)

Mr. Richards showed Slide 21, "Defining 'Sustainable'":

- Protect the Corpus
- Earnings Reserve Durability
- Inflation Proofing
 - Maintain the real value of the Permanent Fund
 - Transfers to the Corpus

Mr. Richards believed that it was important to have a meaningful definition for "sustainable" when determining at what level to draw from the fund. He relayed that from the administration's point of view in order to equitably preserve the state's financial assets over time, the amount drawn down should not reduce the inflation adjusted value of the fund, and examining the durability of the ERA to assure for sustainability.

[10:20:49 AM](#)

Mr. Richards turned to Slide 22, "How to Handle the Draw":

- Status quo framework
 - Sustainable draw \approx \$2.4 billion
 - Funds to the general fund = \$2.4 billion - dividend (\$1.4 billion in FY16)
- APFPA framework
 - Sustainable draw = \$3.3 billion or 6% POMV

- o Separate cash flow allocated to the dividend

POMV

- Draw self-adjusts
 - o Lower chance of depletion
 - o Less fund growth potential
- Year-to-year budget volatility*

Fixed

- Draw does not self-adjust
 - o Greater chance of depletion
 - o Greater fund growth potential
- Stable Budget

*Volatility may be reduced, but not eliminated, with use of smoothing rule such as 5- year averaging

Mr. Richards explained that the administration had determined that placing petroleum revenues in the forms of royalty and production taxes into the permanent fund, as proposed by SB 128, the sustainable draw would be \$3.3 billion; alternatively; a 6 percent of market value draw (POMV). He relayed that the stability of a fixed draw to the general fund made more sense than a POMV draw. He said that a draw a 6 POMV could be done, and was mathematically equal to the \$3.3 billion draw, it was a matter of determining which had the higher level of variability. The administration had determined that the volatility should be kept in the permanent fund and not be allowed to flow through to the governmental share of revenues. He added that both POMV and a fixed draw were plausible plans with fairly equal risks and benefits.

[10:23:14 AM](#)

Vice-Chair Micciche stated that the modeling on the draw suggested an assumption of a commodity price, and therefore an eventual production tax improvement. He probed the administration's modeling on the expectations for production taxes.

Mr. Richards stated that the distinction between the way that DOR did oil price modeling in the Permanent Fund Protection Act, and the way it was presented in the Revenue Forecast was that DOR used probabilistic modeling, which projected a large range of values and assigned a percentage chance across those values of possible oil prices. He

relayed that probabilistic modeling was important when looking at petroleum revenues because of the progressive nature of the tax.

[10:25:03 AM](#)

Co-Chair MacKinnon queried the purpose of the restructuring effort. She felt that the projected draw would support the current status quo funding for state government, rather than putting the draw into the general fund in order to pay the state's bills.

Mr. Richards replied that he would speak to the issue further in the presentation.

Co-Chair MacKinnon thought a 6 percent rate of return was ambitious for a sovereign wealth model; other POMV's across the nation, and globally, were set at a rate of 4.25 percent.

Mr. Richards stated that the 6 percent was higher than the more traditional approach was due to the fact that the state would place petroleum revenue into the permanent fund. The incoming cash flows would be greater than what was earned solely on financial assets, which would allow for a larger take of the total value.

[10:26:52 AM](#)

Senator Hoffman wondered whether the funds could be kept in the ERA until the success of the plan was proven, and then make the percentage change, with caution, in the future.

Mr. Richards did not think time would make a great deal of difference. He spoke to the issue of growing the assets before spending them in the earnings reserve, he shared that the system had been designed to meet current needs, at a sustainable level.

Senator Hoffman expressed concern that if the state were to be successful and have additional funds that were targeted to go back into the corpus, those funds could never be taken out again. He asked how stable the dividend would be under the legislation.

Mr. Richards stated that under the bill, the dividend would be 50 percent of the royalties. He said that the dividend

would not be stable in the sense that it would be subjected to oil price volatility and changes in production forecasting. He clarified that the way in which the dividend was drawn was interchangeable between different restructuring plans, the governor's plan only changes the sustainable draw amount. Whatever dividend formulation the legislature chose, the draw would be adjusted accordingly.

[10:29:57 AM](#)

Vice-Chair Micciche maintained his request for information concerning the assumptions and failure rate.

Mr. Richards stated that the information was all already public. He stressed that, although the department had changed its deterministic price forecast, did not change its probabilistic modeling or assumption. He offered to write a letter that explained the matter to the senator.

[10:30:40 AM](#)

Mr. Richards turned to Slide 23, "How to Handle the Draw." The slide depicted a hypothetical world in 2002, when the state had adopted POMV, the yellow represented what the permanent fund would have contributed after dividends. He said that the slide demonstrated that moving to a traditional POMV did not address the state's economic volatility; it layered the earnings of the state's financial assets onto already volatile petroleum revenues. He warned that in high years, that could compound pro-cyclical spending by putting unneeded money into the general fund.

[10:31:55 AM](#)

Mr. Richards discussed Slide 24, "How to Handle Volatility":

STATUTORY NET INCOME (SNI) VOLATILITY

- Option 1:
 - o SNI placed in earnings reserve
 - o Formulaic draw (e.g., fixed draw or POMV)

- Option 2: constitutional amendment allowing pure POMV

PETROLEUM REVENUE VOLATILITY

- Option 1:
 - Royalties and production taxes placed in earnings reserve
 - Formulaic draw (e.g., fixed draw or POMV)

- Option 2:
 - Revenue limit
 - Reduce POMV draw as petroleum revenues in general fund go up

- Option 3:
 - Spending or appropriation limit not linked to earnings
 - Difficult to have a dependable rule

[10:32:57 AM](#)

Co-Chair MacKinnon about the hope of the CBR being reimbursed.

Mr. Richards replied that under the bill repayment to the CBR would need to come from revenues other than petroleum production taxes, royalties, and permanent fund earnings; those three earnings would not be used to pay back the CBR. The CBR would be paid back through other forms of taxation, royalty settlements, and other types of future income.

[10:34:10 AM](#)

Senator Bishop commented that the legislature would not be limited in creating a payment plan back to the CBR.

Co-Chair MacKinnon agreed, but was bothered by the statement that taxes would be collected in order to pay back the money borrowed from the CBR.

Mr. Richards alleged that the plan would treat the two major sources of volatile petroleum revenue the same as earnings from the permanent fund. He directed the committee's attention to Option 1 on the slide, stating that the option treated the volatility of the two sources of petroleum revenues the same way that earnings were treated - by housing the income in the earnings reserve, and then drawing them down based on POMV or a fixed draw.

[10:36:40 AM](#)

Mr. Richards turned to Slide 26, "Calculating the Draw - Annuity Payment to the General Fund":

Starting Balance = \$55 billion (\$45B in corpus;
\$7B in earnings reserve account; \$3B from CBR)

+ Inflows =

Investment income
100% production taxes
100% royalties

- Outflows =

Expenses
Dividend
Draw (inflation increase delayed until 2020)

= End-of-Year Balance

... \$3.3 billion annuity from financial and
petroleum wealth
(2040 Balance = 2016 Balance + Inflation)

[10:39:07 AM](#)

Senator Hoffman asked whether the \$3 billion draw from the CBR would require a three-quarter vote.

Mr. Richards understood that the vote would still be required. He shared that the plan did not need the \$3 billion draw in order to work, but that the draw increased the success of the plan.

[10:39:35 AM](#)

Co-Chair Kelly considered the \$3.3 billion as a mechanism to ensure the permanent fund retained its value.

Mr. Richards concurred. He furthered that a larger draw could result in an estimated value of the fund that would not grow with inflation.

Co-Chair MacKinnon interjected that there was greater durability in the ERA if an addition \$3 billion were to be added, because then there would be 4X the cash call.

Mr. Richards replied in the affirmative.

[10:40:25 AM](#)

Senator Bishop asked whether the failure rate increased without the \$3 billion deposit into the ERA.

Mr. Richards replied that he could provide the information at a later date.

[10:41:09 AM](#)

Vice-Chair Micciche wondered whether there was a plan for "smoothing" on the dividend on a five-year running average.

[10:41:58 AM](#)

Commissioner Hoffbeck presented Slide 28, "How to Handle the Dividend." He emphasized that the dividend was volatile, and was a formula based calculation that varied from year to year.

[10:42:27 AM](#)

Commissioner Hoffbeck turned to Slide 29, "How to Handle the Dividend":

- Earnings Dividend (current formula): half of statutory net income (SNI)
- Royalties Dividend: connects Alaskans to the economy
- POMV Dividend: based on Fund market value, not SNI
- CBR Dividend: based on CBR balance; rewards Alaskans for Legislature maximizing stabilization account
- \$1,000 Flat: ~ \$650 million, reduces the sustainable draw
- Mixed Formula: combination of different ideas

[10:43:12 AM](#)

Commissioner Hoffbeck discussed Slide 30, "How to Handle the Dividend":

- Dividend formula should connect Alaskans to the economy and the fund
- Certain draw and dividend combinations do not work well

- o POMV draw & earnings dividend
 - o Volatile dividend formula (i.e. royalty dividend) and floor
- Dividend formula tied to the balance of stabilization funds (i.e., CBR) runs risk of politicizing rule-based dividend payout formula

[10:43:42 AM](#)

BILL MILKS, ASSISTANT ATTORNEY GENERAL, DEPARTMENT OF LAW, discussed Slide 32, "Alaska Permanent Fund Protection Act":

Section 1: Revenue to the Corpus
 Section 2: Defines "target balance"
 Section 3: Conforming Amendment
 Section 4: ERA transfer to Dividend Fund
 Section 5: ERA transfer to Corpus
 Section 6: Revenue to the ERA, Draw, and Periodic Review
 Section 7: Conforming Amendment
 Section 8: Conforming Amendment
 Section 9: \$1,000/person dividend in 2016
 Section 10: Effective July 1, 2016

Mr. Milks discussed the sectional analysis (copy on file):

Section 1 - Revenues to the Corpus

Section 1 amends AS 37.13.010(a) to increase the petroleum revenues directed to the corpus of the permanent fund, subject to a redirection mechanism that ensures the earnings reserve account is not degraded.

- o Production Taxes: 100% of production taxes are directed to the corpus
 - Currently, these funds go to the general fund
 - Requires an appropriation
- o Mineral Royalties: 49.5% of all mineral royalties are directed to the corpus
 - Constitutionally mandated 25% (no change)

- An additional 24.5% (an increase from 5%)
- Redirection Mechanism: if needed to maintain the target balance (see Sections 2 and 6), some petroleum revenue may be redirected to the earnings reserve account
- Removes distinction between old and new leases

Section 2 - Target Balance of the Earnings Reserve Account

Section 2 adds subsection (d) to AS 37.13.010, which cross-references AS 37.13.145(1) (see Section 6), setting the target balance at equal to four times the prior year's sustainable draw.

Section 3 - Conforming Amendment

Section 3 is a conforming amendment to AS 37.13.140 that removes the calculation of "income available for distribution" because (1) the term relates to the current dividend formula, which would change (see Section 4), and (2) other revenues, including production taxes and royalties, may also be available in the earnings reserve account.

[10:46:38 AM](#)

Mr. Milks addressed Section 4:

Section 4 - Transfers from the Earnings Reserve Account to the Dividend Fund

Section 4 amends AS 37.13.145(b) to change the calculation of the annual dividend.

- Changes the amount transferred from earnings reserve account to the dividend fund to 50% of the prior year royalties instead of approximately 50% of realized investment earnings
- Changes timing of the transfer from the end of the fiscal year to the beginning

[10:47:17 AM](#)

Mr. Milks addressed Section 5:

Section 5 - Transfers from the Earnings Reserve Account to the Corpus

Section 5 amends AS 37.13.145(c) to change the timing and amount of transfers from the earnings reserve account to the corpus.

- Changes amount transferred to the corpus from the amount necessary to inflation proof the corpus to funds in earnings reserve account exceeding the "target balance"
- Changes timing of the transfer from every year to when excess funds are available
- Flexible inflation proofing and a presumption of savings
 - o Over time, these transfers inflation proof the corpus
 - o Transferred funds may exceed the amount needed for inflation proofing
 - o The flexibility in timing improves the durability of the earnings reserve account and protects the corpus

[10:47:47 AM](#)

Mr. Milks discussed Section 6:

Section 6 - Revenues to the Earnings Reserve Account and the Sustainable Draw to the General Fund

Section 6 adds subsections (e) to (l) to AS 37.13.145 to direct some petroleum revenues to the earnings reserve account and establish the endowment transfer to the general fund.

- **Redirection Mechanism:** Subsections (e) and (f) mirror the redirection provisions in Section 1. Specifically, if needed to maintain the target balance, up to 100% of production taxes and 24.5% of royalties that are otherwise deposited in the corpus may be redirected to the earnings reserve account.
 - o Durability of the earnings reserve account: making these petroleum revenues available to the earnings reserve account helps ensure it

is not depleted if there are several consecutive years of low petroleum revenue and low investment income

- o Protects the corpus: depleting the earnings reserve account would put the corpus at risk as the state searches for additional funds to pay for government
- o Savings: establishes a presumption of saving excess revenue in the corpus when possible
- **Dividend Royalties:** Subsection (g) provides that funds for the dividend (50% of royalties) gather in the earnings reserve account until they are transferred to the dividend fund under Section 4.
 - o Retains the connection between the dividend and the permanent fund.
 - o Helps with cash flow, particularly in first few years.
 - o Establishes the cash flow pathways in the first year and minimizes departures from the permanent framework.
- **Sustainable Draw:** Subsections (h) and (i) provide for the annual endowment transfer from the earnings reserve account to the general fund.
 - o \$3.3 billion fixed-draw
 - o Maximum amount
 - o Adjusted for inflation beginning in FY 2020
 - o Flexible transfer timing allows the Treasury and the Alaska Permanent Fund Corporation to work out a practical and efficient system based on cash flow needs and investment practices
- Appropriation
 - o Framework relies on legislature partnering with the executive
 - o The Alaska legislature has a long history of following a rule-based policy for the earnings reserve account
- **Periodic Review:** Subsections (j) and (k) provide for a periodic sufficiency of assets review and adjustments to the draw amount.
 - o The Commissioner of Revenue, in consultation with the Alaska Permanent Fund Corporation,

conducts a review of the state's financial assets and forecasts and may recommend adjusting the draw amount

- o Scheduled: 2017, 2020, then every 4 years
 - o Formulaic: the periodic review uses the same approach and variables used to calculate the initial draw

 - o Protects the permanent fund: the periodic review ensures that, in light of experience, Alaska remains on a sustainable fiscal course

 - o Collaborative: the review is provided to the legislature

 - o Transparent: all supporting material - data, modeling, etc. - must be made available to the public in its native file format (except for confidential taxpayer information which may be provided in aggregated form)
- Subsection (1) defines "sustainable draw amount" and "target balance."

[10:50:01 AM](#)

Co-Chair MacKinnon queried the reasoning behind choosing 4 years, rather than 3.

Commissioner Hoffbeck replied that the idea had been that the review would fall in the middle of each gubernatorial term.

[10:51:43 AM](#)

Mr. Milks continued to Sections 7 through 10:

Section 7 - Conforming Amendment

Section 7 is a conforming amendment to AS 37.13.300(c) isolating income of the mental health trust fund from net income available for transfer to the general fund.

Section 8 - Conforming Amendment

Section 8 is a conforming amendment to AS 43.55.080 directing production taxes to the permanent fund.

Section 9 - \$1,000 Dividends in 2016

Section 9 amends uncodified law to specify that 2016 dividend checks will be \$1,000 per person. This provision eases the transition to the new dividend formula.

Section 10 - July 1, 2016 effective date

[10:52:15 AM](#)

Mr. Milks summarized that for a very important issue, the bill was relatively straightforward.

[10:52:39 AM](#)

Mr. Richards encouraged the committee to examine Slide 33, "Rule-Based Fiscal Policy":

- Savings Rule
 - Permanent Fund SNI to earnings reserve
 - 25% of mineral royalties to corpus
 - 24.5% of royalties and 100% production taxes to earnings reserve
- Growth Rule
 - Assets grow with inflation
 - Opportunities for additional growth assigned to the corpus and dividend
- Protection Rule
 - Constitutional protection of the corpus
 - Transfers funds in excess of earnings reserve target balance to the corpus
 - Earnings reserve durability tested
- Spending Rule
 - Draw: fixed \$3.3 billion with periodic review
 - Dividend: 50% of annual mineral royalties to Alaskans
- Volatility Rule

- o Permanent Fund: SNI, 49.5% royalties 100% production tax volatility in the Permanent Fund
- o Dividend: 50% royalty volatility in dividend
- o General Fund: No SNI, royalty or production tax volatility in general fund

Commissioner Hoffbeck reiterated that modeling of the plan had been successful.

SB 128 was HEARD and HELD in committee for further consideration.

[10:53:47 AM](#)

Co-Chair MacKinnon discussed housekeeping.

[10:55:30 AM](#)

RECESSED

[1:05:06 PM](#)

RECONVENED

Co-Chair MacKinnon discussed housekeeping.

#sb1

SENATE BILL NO. 1

"An Act prohibiting smoking in certain places; relating to education on the smoking prohibition; and providing for an effective date."

[1:05:44 PM](#)

Vice-Chair Micciche MOVED to ADOPT proposed committee substitute for CSSSSB 1(FIN), Work Draft 29-LS0003\U (Martin, 3/18/16).

Co-Chair MacKinnon OBJECTED for discussion.

[1:06:13 PM](#)

ERIN SHINE, STAFF, SENATOR ANNA MACKINNON, explained that the current version incorporated the two amendments that had passed during the hearing on version V of the bill on 3/18/16. She relayed that the incorporation of Amendment 1 could be found on Page 4, lines 7 through 16, and on Page

5, lines 9 and 11. She stated that Amendment 2 had been incorporated on Page 5, lines 23 through 31. She noted that when she walked through version V at the previous hearing, she had failed to note that the effective date had been changed from 2015 to 2016.

[1:07:11 PM](#)

Co-Chair MacKinnon REMOVED her OBJECTION. There being NO further OBJECTION, it was so ordered.

[1:07:46 PM](#)

Vice-Chair Micciche pointed out that all the fiscal notes attached to the bill were zero notes. He briefly discussed the notes attached to the legislation.

[1:10:53 PM](#)

Co-Chair MacKinnon welcomed Senator Hoffman to the table.

[1:11:22 PM](#)

Vice-Chair Micciche expressed appreciation to the committee for hearing the legislation. He expounded on the point of the non-smoker's right to breathe smoke-free air. He believed that the bill would minimally affect commerce. He added that fines would be kept at a minimal level.

[1:12:26 PM](#)

Senator Dunleavy stated that he would be voting "no" on the bill. He expressed that avoided cigarette smoke in his personal life, and understood the intent of the bill. He supported smoke-free public areas. He expressed discomfort with regulating smoking for private businesses and believed that the legislation crossed over the line of government overreach.

[1:15:20 PM](#)

Vice-Chair Micciche divulged that he was initially hesitant to sponsor the legislation, for all of the reasons pointed out by Senator Dunleavy. He contended that the state regularly regulated private business for safety.

Vice-Chair Micciche MOVED to report CSSSSB 1(FIN) out of Committee with individual recommendations and the

accompanying fiscal notes. There being NO OBJECTION, it was so ordered.

CSSSSB 1(FIN) was REPORTED out of committee with a "do pass" recommendation and with one new zero fiscal note by the Department of Administration, one new zero fiscal note by the Department of Commerce, Community and Economic Development; one new zero fiscal note by the Alaska Judicial System; one new zero fiscal note by Department of Environmental Conservation; one new zero fiscal note by the Department of Health and Social Services; and six new zero fiscal notes by the Department of Transportation and Public Facilities.

1:17:12 PM

AT EASE

1:19:13 PM

RECONVENED

Co-Chair MacKinnon discussed housekeeping.

#

ADJOURNMENT

1:19:37 PM

The meeting was adjourned at 1:19 p.m.