

ALASKA STATE LEGISLATURE
SENATE STATE AFFAIRS STANDING COMMITTEE

January 28, 2016

9:01 a.m.

MEMBERS PRESENT

Senator Bill Stoltze, Chair
Senator John Coghill, Vice Chair
Senator Charlie Huggins
Senator Lesil McGuire
Senator Bill Wielechowski

MEMBERS ABSENT

All members present

COMMITTEE CALENDAR

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."

- HEARD & HELD

PREVIOUS COMMITTEE ACTION

BILL: SB 128

SHORT TITLE: PERM. FUND: DEPOSITS; DIVIDEND; EARNINGS

SPONSOR(s): RULES BY REQUEST OF THE GOVERNOR

01/19/16	(S)	READ THE FIRST TIME - REFERRALS
01/19/16	(S)	STA, FIN
01/26/16	(S)	STA AT 9:00 AM BUTROVICH 205
01/26/16	(S)	Heard & Held
01/26/16	(S)	MINUTE(STA)
01/28/16	(S)	STA AT 9:00 AM BUTROVICH 205

WITNESS REGISTER

RANDALL HOFFBECK, Commissioner
Alaska Department of Revenue

Juneau, Alaska

POSITION STATEMENT: Provided an overview of SB 128.

CRAIG RICHARDS, Attorney General

Alaska Department of Law

Juneau, Alaska

POSITION STATEMENT: Presented information on SB 128.

ACTION NARRATIVE

[9:01:20 AM](#)

CHAIR BILL STOLTZE called the Senate State Affairs Standing Committee meeting to order at 9:01 a.m. Present at the call to order were Senators McGuire, Huggins, Coghill, Wielechowski, and Chair Stoltz.

SB 128-PERM. FUND: DEPOSITS; DIVIDEND; EARNINGS

[9:01:44 AM](#)

CHAIR STOLTZE announced the consideration of SB 128.

[9:02:27 AM](#)

RANDALL HOFFBECK, Commissioner, Alaska Department of Revenue, set forth that the Alaska Permanent Fund Protection Act (APFPA) is the component of SB 128 that allows the state to maximize the efficiency of its existing wealth in helping to fund government going forward. He related that in June, statewide meetings were held to discuss the fiscal situation with Alaskans, to inform and listen to them. He said Director Pat Pitney and he held over 50-statewide meetings and discussed standard-type government solutions to the fiscal problem such as: new taxes, cutting expenditures, and new wealth.

He said that there have been ongoing discussions related to how to use the state's wealth, such as leveraging within the Permanent Fund which led to the conclusion that using standard processes could lead to fiscal stability, but it could not remove the volatility out of the budgeting process. He specified that using only new-wealth methods, the volatility could be removed, but there was not enough wealth to do it by itself because the state's savings were not sufficient. He set forth that the two plans coalesced into the plan before the committee today.

[9:05:44 AM](#)

CHAIR STOLTZE pointed out that the Governor's proposed expenditure reductions were modest and the plan appears to focus more on new revenue. He asked if the current budget proposal was the right size and sustainable.

COMMISSIONER HOFFBECK said APFPA works and gets to a sustainable budget; however, he specified that "it is written in pencil" and the Governor was willing to talk about the balance between spending cuts and new revenues in a discussion with the Legislature.

9:07:44 AM

He addressed "The New Sustainable Alaska Plan," beginning with APFPA, which is the focus of SB 128. He said the fund would be able to generate about \$3.3 billion toward resolving the state's fiscal issue. He detailed that if the revenue from existing taxes, fees and earnings on savings is added to that, the total is about \$4.285 billion. Last year's starting budget, minus one-time savings, was about \$5.2 billion, which leaves about a billion dollars to make up.

CHAIR STOLTZE asked if there would be a commitment to making cuts in the budget process in order to solve the billion dollar deficit.

COMMISSIONER HOFFBECK replied that the Governor would be actively engaged with the leadership in both the House and the Senate to work toward a compromise.

SENATOR MCGUIRE asserted that she termed Chair Stoltze's questions relevant because the public wants to know if the plan maintains the current size of government. She opined that the plan will be to stabilize the economy, but leave enough room for a dialogue about the size and cost of government. She noted that Wyoming was an example of a state with a budget half the size of Alaska's. She stated that people want to know that cuts are being made before their Permanent Fund dividend (PFD) is lessened.

9:10:42 AM

COMMISSIONER HOFFBECK agreed and noted that after talking to people around the state, the price of admission to talking about any other budget plans was "additional cuts." He asserted that people are not convinced that the government is delivering services as efficiently as it can; however, they also said they liked the services the government was delivering.

CHAIR STOLTZE added that people from all walks of life should be included in the discussion.

[9:12:18 AM](#)

SENATOR HUGGINS stated that he agreed with Senator McGuire. He asserted that the Legislature and the governor should work together to decide on the appropriate level of cuts. He referred to a poll of his constituents who said they want the budget cut before their PFD.

SENATOR WIELECHOWSKI agreed that figuring out the appropriate budget size was important. He said his constituents are asking where the promised oil production is and noted that SB 21 was enacted three years ago. He highlighted the oil production decline which is having a dramatic impact on the state's revenue and asked that the administration focus more effort on the promised oil production.

[9:15:26 AM](#)

COMMISSIONER HOFFBECK disclosed that he heard similar concerns across the state. He described that after the "New Sustainable Alaska Plan" is in place, Alaska will still have the lowest taxes in the nation. He asserted that the state will continue to have a dividend, grow its savings, provide essential savings and have money to invest in future resource development.

He set forth that the three components of APFPA were as follows:

- Creates a sustainable draw from the earnings reserve,
- Minimizes oil price volatility on the general fund,
- Adjusts the dividend.

CHAIR STOLTZE asked if the dividend will be in a more volatile position.

COMMISSIONER HOFFBECK replied that there would be discussion of the dividend in the presentation.

[9:17:44 AM](#)

CRAIG RICHARDS, Attorney General, Alaska Department of Law, said he would be defining the state's financial problem, discussing the impacts that oil volatility has on Alaska's finances and the options the administration examined in developing the APFPA.

CHAIR STOLTZE requested that the committee have a discussion on the conflicting legal opinions.

ATTORNEY GENERAL RICHARDS replied that Mr. Milks would address the conflicting legal opinions at the end of the presentation.

He organized the discussion of the state's financial problem into three categories: short-term, medium-term, and long-term. He said the short-term problem is that the drop in oil prices has resulted in large budget gaps. The medium-term problem is that the state's savings will be spent in about four years. If left uncorrected, the budget hole will damage Alaska's economy. Dividends payments will be unsustainable under the status quo.

[9:20:56 AM](#)

He said the discussions of the fiscal problem by the Department of Revenue, the Department of Law, and the Governor's Office led to the question about what is causing the problem of boom-and-bust cycles in Alaska. The conclusion was that Alaska's long-term problems are caused by the state's undiversified budget that is highly dependent on petroleum revenues, by the declining trend in North Slope petroleum production, and by the cyclicity of petroleum prices creating an unstable state budget and economy.

[9:23:13 AM](#)

He showed three graphics that highlight the state's budget problems due to: general fund revenue volatility, declining revenue, disappearing savings, and potential need for withdrawals from the PFD earnings reserve. He showed the state budget's high level of correlation with the unrestricted petroleum revenue and spending. The APFPA attempts to break the pattern of high spending when oil revenues are high and cuts when they are low and to get off the boom-and-bust cycle.

[9:27:49 AM](#)

CHAIR STOLTZE remarked about a concern regarding the eradication of the Constitutional Budget Reserve (CBR) Fund.

COMMISSIONER HOFFBECK replied that the enemy of fiscal responsibility is no plan. He said the state's plan up to now was to save 25 percent of its wealth by putting royalties into the Permanent Fund, which has grown to \$50 billion. Any excess earnings were put into the CBR for use during volatile times. He concluded that the plan was to chase oil prices up and down. The mindset in the proposed plan is to take the volatility out of the entire system. The issue with the CBR is spending money without a plan to sustain government's capabilities going forward. He stressed that there is more stability in the cash flow if the money is not subjected to a three-quarter vote.

[9:31:42 AM](#)

COMMISSIONER HOFFBECK said in response to Chair Stoltze, the administration is not trying to side step the constitution and there would be a vote by the Legislature as provided for in the constitution. He asserted that the goal is to stabilize cash flow.

SENATOR MCGUIRE opined that moving the CBR into a statutory place is an interesting philosophical discussion. She referred to a legal opinion pointing to possible challenges about other monies being put into the Earnings Reserve Account (ERA).

[9:34:21 AM](#)

COMMISSIONER HOFFBECK explained that the plan works whether the money resides in the ERA or the CBR, as long as the investment process is similar in both places. He said the issue is that when it is in the CBR, there is a little less certainty on the annual draw because it is subject to the three-quarter vote. He said it is not a fatal flaw if the money gets swept back into the CBR.

CHAIR STOLTZE said he is trying to understand the mechanics of the plan.

COMMISSIONER HOFFBECK deferred to the Department of Law to address Senator McGuire's question.

ATTORNEY GENERAL RICHARDS specified that Mr. Milks would address that question. He echoed the idea that the Department of Law believes that the CBR sweep is not necessary, but even if it is, it is not fatal to the plan.

He turned to the long term problem the administration is trying to address; addressing the high correlation between state spending and petroleum revenues, which becomes less and less feasible over time. Under declining oil production there is less volatility to capture in the up years and the world of oil prices is going to become more volatile.

[9:37:11 AM](#)

He addressed the subject of the commodities roller coaster and highlighted a study by the International Monetary Fund from October of 2015. The study was on commodity-based economies and showed that Alaska is not alone or unique in its budget challenges. It is different than the Lower 48 states, but

similar to many national governments with a high level of dependence on one economy, such as oil or minerals.

ATTORNEY GENERAL RICHARDS said the study looked at 85 economies over three decades and found that government spending in commodity-based economies tends to move up and down with commodity revenue. He detailed that the study concluded that pro-cyclical government spending stunts economic growth and a stabilizing fiscal policy has the inverse effect, increasing the GDP growth by 0.3 percent annually.

[9:39:54 AM](#)

He showed break-even oil prices for various oil regimes. He revealed that Alaska's break-even oil price is at \$109, which compares to Russia and Saudi Arabia, but not to Norway or Kuwait who have a much lower break-even price and, therefore, more sustainable economies.

He concluded that well-managed petroleum economies have done one of two things: enacted broad-based tax measures that make the amount of petroleum revenue to the total budget small enough that it lessens the volatility, or use sovereign-wealth assets to smooth the volatility; examples of those who have broad-based tax measures are Canada, Australia, and Norway, all who had well-developed economies well before petroleum wealth came online. Alaska is similar to a Middle Eastern or African country in that it does not have the economic base to sustain revenues once gained from oil. He suggested looking at economies such as Abu Dhabi and Kuwait who use sovereign-wealth assets.

[9:42:05 AM](#)

CHAIR STOLTZE asked how the administration is looking at oil prices.

ATTORNEY GENERAL RICHARDS said he does not know, and even the Department of Revenue's forecast is a straight line similar to the current oil price. He expected a whole spectrum of oil prices in the future, if history repeats itself.

COMMISSIONER HOFFBECK added that his view is similar. The official position is that volatility within oil prices will increase. He noted that shale oil has relatively low expenditures to bring product on quickly at a price point of \$60 to \$80, which may put a ceiling on the projections, but could also easily flood the market and depress the price. He suggested that the long term, real price may be \$50 to \$70 with a lot of volatility.

[9:44:51 AM](#)

CHAIR STOLTZE asked how long term.

COMMISSIONER HOFFBECK replied three to ten years.

SENATOR WIELECHOWSKI asked if all projections are predicated on the idea that oil production will continue to decline. He questioned where the new production is that the industry promised.

COMMISSIONER HOFFBECK noted the administration's forecasts are based on meetings with the oil industry. He said he could not address the broader question about promised production.

ATTORNEY GENERAL RICHARDS added that the department's forecasts are fairly conservative and relate to the status quo; they don't project substantial new events, such as opening new fields. The status quo is a declining oil base. He said the Department of Natural Resources and others are optimistic that there is "some to good" probability that there will be "new things happening."

[9:47:38 AM](#)

COMMISSIONER HOFFBECK pointed out that even at \$55 to \$60 oil, the state would need 1.6 billion barrels-a-day to balance the budget. The status quo is at 500,000 barrels a day. He spoke of a discovery in the Colville Delta similar in size to Alpine and Kuparuk in the 100 to 200 barrel-a-day range; five fields that size would be needed to get to a balanced budget.

SENATOR HUGGINS commented that a trait of a reasonable plan includes bands of assumptions as well as the inclusion of known data. He asserted that the administration is tasked with synchronizing their assumptions and data.

COMMISSIONER HOFFBECK noted that an analysis has been run looking at the impacts of potential returns on gas-line investments and associated costs.

SENATOR HUGGINS requested to see the analysis Commissioner Hoffbeck referred to.

[9:51:33 AM](#)

SENATOR MCGUIRE concurred with Senator Huggins. She stated that the idea of a sovereign-wealth fund or endowment in order to stabilize Alaska's economy is absolutely right. She said the broader questions concern production and new revenues from

developments and the gas line. She requested information on how to protect on the upside. She also said the gas-line plan must be shared with the Legislature and explained as to how it fits into the governor's financial plan. She suggested that there are many other opportunities that will fit into the plan.

9:54:59 AM

ATTORNEY GENERAL RICHARDS said the administration has already been working on the exercise of what more optimistic petroleum outcomes would look like in terms of a royalty-based dividend and in terms of the governor's financial plan and the state's long-term fiscal health. He offered to present the information to the Legislature.

SENATOR HUGGINS asked if the state's partnership in the gas line is 25 percent.

COMMISSIONER HOFFBECK answered yes.

ATTORNEY GENERAL RICHARDS noted that the partnership is subject to the royalty-in-kind finding that the Alaska Department of Natural Resources makes.

SENATOR HUGGINS opined that Alaskans need to understand how the Permanent Fund might be used as a solution.

9:58:39 AM

ATTORNEY GENERAL RICHARDS highlighted a quote regarding the Permanent Fund from Governor Hammond, "I wanted to transform oil wells pumping oil for a finite period into money wells pumping money for infinity." He said the administration wants to figure out a way to optimize the pumping of the money for infinity.

He related that the administration also wants to spend the Permanent Fund earnings sustainably by preserving an appropriate amount of wealth across generations going forward and using financial assets to sustain a level of government that could also be maintained equitably across generations. He defined "sustainable" as protecting the constitutionally protected corpus, making sure the earning reserve has durability, and includes inflation proofing.

CHAIR STOLTZE asked if inflation proofing would require an appropriation or would be part of the fund management.

ATTORNEY GENERAL RICHARDS replied that Chair Stoltze's question would be answered in a moment. He explained that the cash flows

in APFPA are very similar to what they are now. Under the existing model, the Permanent Fund corpus produces statutory-net income to the earnings reserve, and out of the earning reserve inflation proofing goes back to the corpus and dividends come out. Over time, to the extent that dividend payments and inflation proofing is less than the statutory net income, the earnings reserve grows. Roughly, 30 percent of royalties are currently going into the Permanent Fund.

ATTORNEY GENERAL RICHARDS explained that APFPA changes the "plumbing" slightly by putting all of the royalties and production taxes into the Permanent Fund. Out of the corpus of the Permanent Fund comes the same statutory net income that goes to the earnings reserve. He added that out of the earnings reserve comes the dividend payment, which is 50 percent of last year's royalties, and a steady-state \$3.3 billion to the general fund.

[10:02:40 AM](#)

CHAIR STOLTZE requested that Attorney General Richards clarify what goes into the "corpus."

ATTORNEY GENERAL RICHARDS explained that there still is a mechanism for inflation-proofing in the model. The state needs to be confident that the earnings reserve has enough money that it can meet its cash calls, which includes the dividend payout and the \$3.3 billion to the general fund. He said, "We change inflation-proofing that exists now by eliminating that provision, but instead, we have a provision that, when the earnings reserve is greater than four times the \$3.3 billion payout, everything extra in the earnings reserve goes back into the corpus." Rather than an annual inflation-proofing, there is a delayed inflation-proofing mechanism that occurs over time.

[10:04:01 AM](#)

SENATOR WIELECHOWSKI referred to the fall forecast and said he is, "Trying to model those numbers." He asked if 75 percent of the \$650-million mineral royalties in 2016 would be put into the earnings reserve.

ATTORNEY GENERAL RICHARDS answered yes.

SENATOR WIELECHOWSKI asked if 100 percent of the \$172-million production taxes also goes into the Earnings Reserve and then the dividend is calculated by dividing by two.

ATTORNEY GENERAL RICHARDS corrected that only the royalties are divided by two.

SENATOR WIELECHOWSKI asked if the dividend is calculated based on only the royalties.

ATTORNEY GENERAL RICHARDS answered yes.

SENATOR WIELECHOWSKI asked if the royalties were roughly \$500 million would half of that goes to dividends.

ATTORNEY GENERAL RICHARDS answered yes.

SENATOR WIELECHOWSKI divided \$250 million by 750,000 Alaskans to get a total of \$300 to \$400 for a dividend.

COMMISSIONER HOFFBECK clarified that the 50 percent number was of the total royalties. If oil prices remain at \$30 per barrel, the dividend will be low.

SENATOR WIELECHOWSKI asked if under the 2016 forecast, the dividend would have been about \$300 to \$500.

COMMISSIONER HOFFBECK answered yes.

SENATOR COGHILL voiced concern about shifting risk to the Permanent Fund to stabilize government. He asserted that there has to be a balance.

CHAIR STOLTZE opined that the questions from the committee were educational and not confrontational.

SENATOR MCGUIRE agreed with Senator Coghill. She opined that there has to be a conversation with the public on the state's cash flow. She pointed out that if royalties are connected to the PFD check, a new chapter is created in Alaska where the PFD absorbs the risk, the amount of government take will be lowered and it will be less stable. She remarked that there are four versions of using the state's wealth to fund government that all treat the PFD differently.

[10:09:14 AM](#)

ATTORNEY GENERAL RICHARDS said both the governor's proposal and Senator McGuire's proposal can accommodate any number of ways to calculate the dividend, but there are consequences that must be considered depending on the amount of money that would go to the

general fund versus to dividends and the timing of those cash flows.

SENATOR COGHILL remarked that discussions on the level of services the state should provide and on how the state's sovereign wealth will be used to stabilize government will be rough.

[10:12:36 AM](#)

ATTORNEY GENERAL RICHARDS discussed how the state has historically had a fiscal rule for saving 30 percent of royalties, but there has been no fiscal rule for spending out of the Permanent Fund. In researching fiscal rules for how to spend, the economic research group and the administration looked at two ways to do so. One method is to consider the percentage of market value (POMV), which is sustainable and will protect the value of the fund. The other method is what the APFPA does, the fixed method that treats the savings as an annuity.

He highlighted the attributes and risks of a POMV versus a fixed draw. The amount that comes out of the POMV fund self-adjusts and the risk lies with the state budget. With a fixed draw, the risk lies with the PFD and provides stability for the budget. He added that the governor's plan builds in a periodic-review mechanism as well.

He showed a graph of year-to-year budget volatility under both schemes, which showed more volatility in the budget under POMV and less volatility in the budget under a fixed draw. He stated that the Governor's plan maintains that the state should use its sovereign wealth assets to buffet volatility by putting petroleum revenues into them and then drawing out a percentage or fixed draw.

He stressed that the math calculations for POMV get very complicated and a periodic review is needed for the amount of the POMV draw. He cautioned that the POMV method needs to be done on the value of Permanent Fund assets, less debt.

[10:17:47 AM](#)

He set forth that the Governor's plan is the better one because the POMV plan, "Gets you most of the way there on a rule-based framework," but it does not address the long-term problem of oil-price volatility; it adds revenue, but does not address volatility and works when oil prices are low, but not when oil prices are high.

[10:19:16 AM](#)

CHAIR STOLTZE suggested that a revenue/spending limit mechanism be included. He asked if Attorney General Richards was amenable to his suggestion.

ATTORNEY GENERAL RICHARDS offered to look at Chair Stoltze's suggestion.

CHAIR STOLTZE opined that Alaskans would be amenable to his proposal.

ATTORNEY GENERAL RICHARDS replied that volatility could be addressed in a number of ways: spending limits; endowment draw rules; or as in the Governor's plan, an annuity concept.

SENATOR MCGUIRE voiced appreciation for the discussion. She said she has considered a range in SB 114 that would be subject to annual review by a board of financial experts. She agreed with building in safety measures. She stated that she thought the annuity concept would work.

[10:21:01 AM](#)

ATTORNEY GENERAL RICHARDS said that finding a way to adjust the POMV payment up or down as needed is challenging and has not been discovered. He suggested using a period review unless the formula could be determined.

He reported that the Governor's annuity model assumes that the starting value of the Permanent Fund (on the target date) is \$55 billion and includes \$45 billion in the corpus, \$7 billion in earnings reserve, and a \$3 billion transfer from the CBR to the earnings reserve in order to ensure that the earnings reserve is large enough that there is a high probability that the state will ride out low probability, bad stock market events, even if they occur, to maintain a stable system.

He specified that the financial model assumes an inflation rate of 2.25 percent. He listed the total investment return rate over 10 years at 6.9 percent and the statutory net income at 6.01 percent.

[10:24:22 AM](#)

SENATOR WIELECHOWSKI asked if the total value of the Permanent Fund was \$49 billion and if the earnings reserve was included.

ATTORNEY GENERAL RICHARDS specified that the Permanent Fund was \$49.175 billion.

SENATOR WIELECHOWSKI asked if the Permanent Fund has dropped \$6 billion.

ATTORNEY GENERAL RICHARDS answered that the Permanent Fund has dropped \$3 billion because \$3 billion of it is the transfer from the CBR. He detailed that the end of FY 16 was used for the projected ending value.

SENATOR WIELECHOWSKI asked how another drop would affect the fund and if more would have to be pulled from the CBR.

ATTORNEY GENERAL RICHARDS replied that there are several ways to think of it and one is the raw numbers. He said reducing the total value of the fund in the annuity calculations by \$3 billion, the sustainable draw would be roughly reduced by \$100 million.

SENATOR WIELECHOWSKI asked that instead of pulling \$3.3 billion, \$3.2 billion would be pulled out.

ATTORNEY GENERAL RICHARDS concurred with Senator Wielechowski, He emphasized the importance of picking a target date. He shared details of the analysis and the predicted returns. He said he does not worry about short-term drop offs, but whether the earnings reserve is big enough to preserve the POMV model or the fixed-draw model. He set forth that the \$3-billion draw provides a cushion.

[10:27:57 AM](#)

He turned to the petroleum model and how the oil price is calculated. He said for production volumes and costs, the same forecast as the Revenue Sources Book is used. He noted that the governor's plan used the Economic Research Group for the modeling. He specified that the mean value of oil is about \$56 per barrel.

He summarized that the governor's plan makes few changes from the status quo base formula. He noted that the rules-based framework is constitutional in the form of its savings rule at 25 percent of royalties. He detailed that approximately 35 years ago the Legislature overlaid, on top of a constitutional system, a statutory system subject to change by majority vote. The statutory system did a couple of things: inflation-proofed the fund, provided for a dividend, and was developed around the idea that the Legislature does not spend the earnings reserve except for inflation-proofing and dividends; even though it only

required a majority vote not to follow the rules-based system, legislatures did through custom and expectation. He said the amazing outcome for the state has resulted in having \$49 billion in savings.

ATTORNEY GENERAL RICHARDS set forth that today, SB 128 proposes to slightly modify the rules by adding an increase of what goes into the fund from 30 percent of royalties to half of the royalties and all of the production taxes, and devise a spending rule that takes money out of the fund under a formulaic calculation meant to be sustainable for general fund spending. He opined that the governor's plan is not complex, is understandable, and is a variation of the existing plan with the added spending rule.

[10:32:53 AM](#)

CHAIR STOLTZE announced that the presentation would continue at the next meeting. He requested to hear legal opinions regarding SB 128.

ATTORNEY GENERAL RICHARDS agreed to provide them.

[10:36:47 AM](#)

CHAIR STOLTZE noted that the next referral of the bill is to the Senate Finance Committee. He disclosed that the Senate State Affairs Committee would spend several weeks on the bill and would plan to hear from the public as well. He suggested that Attorney General Richards talk to people that were architects of the Permanent Fund.

[SB 128 was held in committee.]

[10:37:25 AM](#)

There being no further business to come before the committee, Chair Stoltze adjourned the Senate State Affairs Committee at 10:37 a.m.