

**ALASKA STATE LEGISLATURE**  
**SENATE STATE AFFAIRS STANDING COMMITTEE**

February 2, 2016  
9:00 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

PRESENTATION CONTINUED FROM 1/26/16: Making Appropriations from the Permanent Fund/Permanent Fund Dividend

-HEARD

**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

01/28/16 (S) Heard & Held  
01/28/16 (S) MINUTE(STA)  
02/02/16 (S) STA AT 9:00 AM BUTROVICH 205

#### **WITNESS REGISTER**

RANDALL HOFFBECK, Commissioner  
Alaska Department of Revenue  
Juneau, Alaska

**POSITION STATEMENT:** Provided information and answered questions regarding SB 128.

WILLIAM MILKS, Assistant Attorney General  
Alaska Department of Law  
Juneau, Alaska

**POSITION STATEMENT:** Provided information and answered questions regarding SB 128.

#### **ACTION NARRATIVE**

9:00:37 AM

**CHAIR BILL STOLTZE** called the Senate State Affairs Standing Committee meeting to order at 9:00 a.m. Present at the call to order were Senators Wielechowski, Coghill, and Chair Stoltze.

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

9:01:10 AM

CHAIR STOLTZE announced the consideration of SB 128 and the continued presentation from the administration about "Making Appropriations from the Permanent Fund/Permanent Fund Dividend."

9:02:01 AM

RANDALL HOFFBECK, Commissioner, Alaska Department of Revenue, Juneau, Alaska, reviewed how the "draw" is calculated in the petroleum model from the Department of Revenue (DOR). He specified that in the petroleum model, the oil price forecast is based on the mean value from probabilistic distribution and inputs a range of prices for each year, but uses only a single price, "the median," from the forecasting session. Oil production volumes are based on forecasts depicted in the Fall-2015 Revenue Sources Book. He specified that production volumes do not take into account undeveloped fields, are conservative, and use the shortcut model from DOR.

COMMISSIONER HOFFBECK explained that the "draw" would be calculated by using an annuity-like fixed payment to the general fund. He noted that the starting balance is \$55 billion. He detailed that there are "inflows" each year, such as investment income, 100 percent of production taxes, and 100 percent of royalties, both from the petroleum model. He added that there are also "outflows" such as expenses, the dividend, and the fixed draw that is taken out of the system until 2020 at which point in time the draw begins to inflate going forward.

CHAIR STOLTZE requested that more information be provided regarding when the draw inflates.

COMMISSIONER HOFFBECK clarified that not inflating the draw until 2020 stabilizes expenditures.

He said the \$3.3 billion draw can be sustained as an annuity from the state's financial and petroleum wealth. He pointed out that the 2040 balance would look like the 2016 balance, plus inflation.

[9:05:44 AM](#)

He turned to the subject of creating durability in the model. He said the model starts with a target balance of four times the prior draw and transfers \$3 billion from the Constitutional Budget Reserve (CBR) as part of the starting balance of \$11.6 billion the first year. He noted that the FY 16 income was included.

He stressed that the Permanent Fund itself is not large enough to sustain the draw without the ability to work with the inflows during the life of the modeling. He explained that if the earnings reserve is at the target balance, then 100 percent of production taxes and 50 percent of royalties are deposited into the corpus of the fund, which then builds in strength. The other 50 percent of royalties is deposited into the earnings reserve. He detailed that if the earnings reserve is under the target balance, then up to 100 percent of production taxes and 75 percent of royalties are deposited directly into the earnings reserve in order to build up the size of the earnings reserve. He specified that the only part that would flow into the corpus would be the mandated 25 percent of royalties. If the earnings reserve exceeds the target, the excess would be transferred back to the corpus.

[9:08:05 AM](#)

SENATOR COGHILL asked that Commissioner Hoffbeck explain the math regarding the draw from the earnings reserve when a dividend is paid as well.

COMMISSIONER HOFFBECK replied that the dividend, after the transfer, would determine which direction the monies would flow at the start of the next year.

SENATOR COGHILL summarized his understanding of the process.

[9:09:23 AM](#)

SENATOR HUGGINS joined the committee meeting.

COMMISSIONER HOFFBECK reported on the durability of the earnings reserve because of the annuity model. He asserted that there would be robust earnings-reserve cash inflows and no chance of it going to zero during the life of the modeling. He reviewed the cash inflows: \$3 billion transfer from CBR, statutory net income, and petroleum revenue. He said there would also be long-lead adjustment opportunities such as the 4-to-1 coverage ratio, which provides coverage between the four-year periodic review period, the periodic review itself, robust modeling by staff and the McKenzie and Company, and sufficient time to react to issues.

SENATOR COGHILL asked whether the modeling is embedded in SB 128.

COMMISSIONER HOFFBECK answered that modeling won't be embedded in the bill, but would be presented to the Legislature.

SENATOR COGHILL said the principles of modeling are important.

COMMISSIONER HOFFBECK replied that he agreed. He said there would be a standardized review that matches the modeling so there is no opportunity to skew the data in the review period.

CHAIR STOLTZE commented on the possibility of a constitutional amendment to define it and noted that the administration's consultant suggested that the constitutional amendment was the preferable route.

[9:12:11 AM](#)

SENATOR COGHILL requested clarification of the CBR transfer process and the possible need for a constitutional change or an annual vote.

COMMISSIONER HOFFBECK said he sees the \$3 billion transfer as a one-time event. He noted that Mr. Milks could talk more about it.

CHAIR STOLTZE explained that the CBR was established when voters approved a constitutional amendment in 1990. He specified that SB 128 would take the constitutionally protected money and put it into a straight majority spending account.

[9:13:48 AM](#)

COMMISSIONER HOFFBECK clarified that SB 128 would move the monies into either the Permanent Fund earnings reserve or the statutory budget reserve and would not dismantle the CBR because there would still be monies that flow into it from legal settlements and audits on an annual basis. He added that there is also a potential to leave some money in the CBR for unexpected events that might occur.

CHAIR STOLTZE opined that the legal requirement is that it is repaid when it is borrowed. He said under the governor's plan, it would permanently exit that requirement. He asked how Commissioner Hoffbeck sees it being repaid.

COMMISSIONER HOFFBECK deferred to Mr. Milks to answer.

CHAIR STOLTZE called the strategy political and not legal.

COMMISSIONER HOFFBECK said there is an underlying legal argument about what has to be swept back into the CRB versus what can be kept into the earnings reserve. The bill does not intend to change the repayment structure; there would still be a sweep of funds back to the CBR after any given year to repay the debt. The legislation does not see the earnings reserve as a sweepable fund.

CHAIR STOLTZE he pointed out that the appropriation can be done by a simple majority.

COMMISSIONER HOFFBECK agreed.

SENATOR WIELECHOWSKI noted dueling legal opinions and said he expects to see a lawsuit. He asked what the legal ramifications of a lawsuit might be regarding this issue.

[9:16:20 AM](#)

SENATOR MCGUIRE joined the committee meeting.

9:16:45 AM

WILLIAM MILKS, Assistant Attorney General, Alaska Department of Law, summarized the issue as the question whether or not the earnings reserve would be subject to a sweep. He provided background on the four parts of the CBR: A, B, C, and D.

He said part A identifies monies that go into the CBR, such as settlements of disputes over royalties and related litigation. The other three parts (B, C, and D) talk about how the legislature can appropriate from the CBR, such as by majority vote, three-quarters vote, and by payback (sweep) into the CBR. The latter is what is being discussed as it relates to SB 128.

He explained that one Alaska Supreme Court case analyzed the CBR on the question of what is available for appropriation and how it can be appropriated. Regarding the payback provision, the court decision, "Hickel vs. Cowper," concluded that there is a difference between the language used in the constitution between "B and C, and D." The decision was clear for D, the "payback provision," that what must be paid back are monies in the general fund available at the end of the succeeding fiscal year. The court was clear that it was "general fund only," not monies in other funds, and it used the earnings reserve account as a specific example; it said the entire earnings reserve account is available by the legislature to appropriate, but the payback provision is restricted to funds in the general fund.

He discussed the current situation where an appropriation bill transfers monies from the CBR to the earnings reserve account and the question whether the earnings reserve account is subject to payback or sweep. He said Department of Law's (DOL) analysis is that it is not subject to payback or sweep, based on the plain language of the constitution, as "Hickel vs. Cowper" has informed us. He maintained that SB 128 does not change the statute and does not change the fact that the earnings reserve account is not in the general fund. The provision still exists that funds in the general fund would be subject to a sweep and the earnings reserve would not.

He said the argument has been raised that if the nature of the earnings reserve is changed so it can be used for general government expenditures and monies will be added to it, that it is possible the court will change its mind. He pointed out that existing law is that it is not subject to payback; however, a court could decide to change that. He said DOL does not view the earnings reserve as a dedicated account.

[9:23:22 AM](#)

MR. MILKS said the first point that has been raised is that the monies would be used for general government expenditures and DOL does not think that would change the analysis. The second point is that monies will be appropriated into it, so it is not just going to be an account comprised only of income from the Permanent Fund. He admitted that both points are true, but he questioned whether they were meaningful differences. He pointed out that the legislature in the past has appropriated from the CBR and general fund to other accounts, such as Power Cost Equalization funds and pension funds.

He concluded that DOL is comfortable with its analysis.

[9:25:20 AM](#)

CHAIR STOLTZE noted a potential problem mentioned by the Office of Budget and Management and the need for a constitutional "fix." He questioned the definition of "fix." He argued that the earnings reserve has been treated like a general fund in several ways. He said he hoped to see the past legal decisions related to this issue.

[9:28:33 AM](#)

SENATOR WIELECHOWSKI opined that the issue of the "sweep" is one issue and Mr. Milks has a different opinion than the Legislature's counsel has. He said the other issue was on the fact that money is being deposited into the Permanent Fund and quoted from the Legislature's counsel as follows:

The attorney general has in the past concluded that once money is deposited into the Permanent Fund, the money may only be used for income producing investments and the Legislature may not, even if the deposits exceeded the constitutional requirement and were made with the intent that they be retrievable, transfer the money out of the Permanent Fund.

He noted that the Legislature's counsel sites a 1977 AG opinion and compared the situation to today's situation.

CHAIR STOLTZE added that there were inquiries by past administration and individual legislators about the process of re-appropriations. He said he wished to have a discussion on that topic.

SENATOR WIELECHOWSKI requested Mr. Milks' opinion of that decision.

MR. MILKS stated that when money is appropriated into the principal of the corpus of the Permanent Fund it is irretrievable. The difference in SB 128 is that it provides for appropriating money into the earnings reserve account, a separate statutory account comprised only of income of the Permanent Fund. In "Hickel vs. Cowper," the Alaska Supreme Court identified that the earnings reserve account is open for appropriation, so the Legislature can do so.

[9:31:04 AM](#)

SENATOR WIELECHOWSKI stated that he thought Mr. Milks' interpretation was a fair; however, it is the opposite of legislative counsel's interpretation. He said it is about balancing risk going forward. He voiced concern that SB 128 could be found unconstitutional at a later date after budgets have been passed and suggested that a government shutdown could occur.

MR. MILKS surmised that the outcome of such a challenge would be to have the additional funds paid back to the CBR. He asserted that the whole budget would not be deemed unconstitutional.

SENATOR WIELECHOWSKI stated that there are two points: the issue of the "sweep," and the issue of irretrievable funds from the Permanent Fund.

MR. MILKS reiterated that the reference is talking about a period in time when there was no earnings reserve account established by statute. He added that the Alaska Supreme Court has already said the earnings reserve account is available for appropriation. He asserted that the plan does not envision placing money into the corpus or the principal of the Permanent Fund and then removing it.

SENATOR WIELECHOWSKI restated that he is asking what impacts the state would incur if the Department of Law is not correct in its interpretation. He opined that all appropriations made under this method are unconstitutional.

[9:34:49 AM](#)

MR. MILKS repeated that if the court were to change its mind, all additional monies put into the earnings reserve account would have to be returned to the CBR.

COMMISSIONER HOFFBECK opined that having the monies "swept" and put back into the CBR is not a fatal flaw to the plan; however,

it does mean that part of the revenues on an annual basis are going to have to come from the CBR, which creates some uncertainty and volatility in the \$3.3 billion draw because it will require a three-quarters vote.

CHAIR STOLTZE opined that the court system can be political.

[9:37:05 AM](#)

SENATOR COGHILL stated that he thought there was agreement that money going into the corpus of the Permanent Fund stays there. He said the CBR is available with a three-quarters vote and the earnings stay within the CBR. He believed that using the earnings reserve was appropriate, but adding the CBR to it will probably require an annual three-quarters vote appropriation. He said the political pressure of this policy matter is great and it comes down to a policy call.

CHAIR STOLTZE pointed out that part D says a loan is taken and not an appropriation.

SENATOR COGHILL added that the approaches to the Permanent Fund versus the CBR are very different.

[9:39:16 AM](#)

SENATOR WIELECHOWSKI noted that from a policy perspective, SB 128 is a huge change with constitutional issues. He opined that a simpler method would be to appropriate the money from the earnings reserve every time it is needed. He questioned why not use the simple route.

COMMISSIONER HOFFBECK answered that the change creates the greatest amount of stability in the draw. He reiterated that not being able to move the CBR is not a fatal flaw and have to do it just out of the earnings reserve.

CHAIR STOLTZE commented that misunderstanding or confusion just fuels skepticism.

[9:41:44 AM](#)

COMMISSIONER HOFFBECK specified that the goal is to have a rules-based systematic approach for using earnings and not just have a random appropriation on an annual basis to fill a void from other incomes.

SENATOR MCGUIRE asked for clarification that new monies from royalties placed in the CBR would not be subject to the "sweep."

9:43:18 AM

COMMISSIONER HOFFBECK replied that based on the attorney general's opinion, they are not subject to the "sweep."

SENATOR MCGUIRE asked Commissioner Hoffbeck to confirm that only the CBR portion itself is subject to the "sweep."

COMMISSIONER HOFFBECK replied that the administration did not think the CBR portion was subject to the "sweep," either.

SENATOR MCGUIRE voiced concern about an attempt to grow the corpus in order to create stability for the government by putting in new royalties, etc. She maintained that SB 128 sets up a potential problem for instability of the state budget. She opined that "the entire thing is potentially sweepable." She said the goal is to look for stability and to eliminate volatility, so the differing opinions need to be resolved.

COMMISSIONER HOFFBECK answered that the administration agrees and is willing to continue the conversation.

9:45:50 AM

He turned to the subject of the new dividend process and how the concerns of volatility and value relate to it. He showed a graph of the historic value of dividends and said that they have always been volatile. He point out that dividends have fluctuated between \$300 and \$2100 based on stock market returns. He suggested that the governor's plan will not increase the volatility of the dividend, but will decrease it to some extent. He noted that the graph also shows that there is no set value or base value of the dividend.

SENATOR MCGUIRE noted the importance of understanding the variation in value of the dividend. She said lawmakers have a political challenge in that the dividend has recently been high. She agreed that there is volatility built into the structure and there would be volatility in a percent of market value (POMV) plan and in plans that are royalty based.

9:49:51 AM

COMMISSIONER HOFFBECK reviewed the formula the dividend is based on. He said the formula was a political negotiation at the time it was established. He detailed that the dividend consists of the annualized average of the last five years of statutory net income, divided in half, and transferred to the dividend fund where, after adjustments, the fund is divided by the number of recipients.

COMMISSIONER HOFFBECK shared the Alaska Permanent Fund Corporation's resolution in 2003 as follows:

The Board recognizes that a POMV spending limit methodology may necessitate changes to the Permanent Fund Dividends.

He pointed out that the formula will change when the earnings are used for anything other than paying for dividends and inflation proofing, as proposed by several bills.

[9:51:43 AM](#)

SENATOR WIELECHOWSKI stated that the governor's proposal assumes the return on the Permanent Fund will be between 6.5 percent and 7.5 percent. He asked if the present dividend formula was kept, would the dividend's value be closer to \$1,000 or \$2,000.

COMMISSIONER HOFFBECK replied that if there was a flat return, the dividend would stay closer to \$2,000. He pointed out that the reality was in 2016 the 6.5 percent return will be missed by about 10 percent in addition to the Permanent Fund having negative earnings for the year. He said there will be downward pressure on the dividend.

SENATOR WIELECHOWSKI asked if the earnings reserve ever loses money. He noted that the earnings reserve is invested just like the regular corpus.

COMMISSIONER HOFFBECK answered correct.

SENATOR WIELECHOWSKI provided an example of \$7 billion in the earnings reserve with a loss of 10 percent in the corpus and inquired if that meant a loss of \$700 million in the earnings reserve.

COMMISSIONER HOFFBECK answered yes.

SENATOR WIELECHOWSKI asked whether about \$1 billion of the \$7 billion is spent for inflation proofing.

COMMISSIONER HOFFBECK said yes.

SENATOR WIELECHOWSKI asked if there is inflation proofing in the governor's plan.

COMMISSIONER HOFFBECK answered that the inflation proofing is in the modeling and varies by year. He said the fund would grow at the rate of inflation over time.

9:53:59 AM

SENATOR WIELECHOWSKI addressed the governor's plan as follows:

If we were just to look at the actual plan today. So you've got \$7 billion in the earnings reserve, you are taking \$3.3 billion draw, you've got inflation proofing of roughly \$1 billion, that's \$4.3 billion, you've got another \$1 billion for dividends, that's \$5.3 billion, and you've just lost \$700 million. So you've got a \$1 billion cushion and you've got \$1 billion in the earnings reserve?

COMMISSIONER HOFFBECK replied as follows:

Because under this plan there would not be a direct inflation-proofing payment, that \$1 billion would go away. Certainly under our plan, the governor is guaranteeing a \$1,000 dividend, so that's more like \$700 million for the dividend. So essentially you would be drawing out the \$3.3 billion draw plus the \$700 million dividend, so about \$4 billion from that \$7 billion, plus you would have whatever inflows occur; because it is under statutory net-income, there will still be inflows into the fund even in years where we lose.

SENATOR WIELECHOWSKI asked if inflows are things like dividends.

COMMISSIONER HOFFBECK answered yes and added that inflows would include "rents and royalties."

SENATOR WIELECHOWSKI reviewed his calculations and asked what would happen if the stock market had a bad year and there was nothing left in the earnings reserve.

9:55:50 AM

COMMISSIONER HOFFBECK explained that under the plan when the balance is below a four-times draw, all of the petroleum production tax and royalties would also flow into the earnings reserve, as well as the Permanent Fund statutory income.

SENATOR WIELECHOWSKI asked if there was \$150 million in production taxes this year.

COMMISSIONER HOFFBECK replied that there was more in royalties. He stressed the need to make the initial \$3.3 billion deposit into the CBR to provide stability in the early years.

CHAIR STOLTZE expressed that he would be interested to see the governor's CBR strategy.

[9:57:17 AM](#)

SENATOR HUGGINS commented that his constituents are concerned about spending state money on budget consultants.

COMMISSIONER HOFFBECK replied that Senator Huggins' point was taken.

CHAIR STOLTZE pointed out that the committee's discussion was friendly and in good faith.

[9:59:22 AM](#)

SENATOR WIELECHOWSKI asked if the dividend calculation is 50 percent of the net royalties and is not based on the production tax.

COMMISSIONER HOFFBECK answered correct.

SENATOR WIELECHOWSKI calculated that the 2016 fall forecast was \$650 million in royalties, divided by two equals \$325 million being available.

COMMISSIONER HOFFBECK answered correct.

SENATOR WIELECHOWSKI continued that the \$325 million would equate to a \$500 dividend.

COMMISSIONER HOFFBECK answered correct.

SENATOR WIELECHOWSKI said moving forward to 2017, the dividend would be approximately \$550.

COMMISSIONER HOFFBECK answered that the dividend would be approximately \$600.

SENATOR WIELECHOWSKI asked if the plan is to increase the dividend to \$1,000 every year or just in the first year or two.

COMMISSIONER HOFFBECK answered just the first year.

SENATOR WIELECHOWSKI noted that he was referring to calculations on page 29 of the Revenue Sources book.

[10:01:05 AM](#)

COMMISSIONER HOFFBECK clarified that Senator Wielechowski was referring to a table on the unrestricted part of the royalty, so an additional 25 percent or 30 percent would have to be added.

SENATOR WIELECHOWSKI asked if the table was net calculations. He requested a chart of PFD projections under the governor's plan.

COMMISSIONER HOFFBECK agreed to provide the chart he requested.

CHAIR STOLTZE stated that he appreciated Senator Wielechowski's request and agreed that the public should be informed.

SENATOR WIELECHOWSKI asked for a chart with a 6.5 percent to 7.5 percent return versus the current dividend calculations.

COMMISSIONER HOFFBECK agreed to provide the chart.

He explained that the Governor's plan is one way to calculate the dividend and is "written in pencil." He said the administration was open to other ways to calculate the dividend. He pointed out that the administration's original plan was adopted from Senator McGuire's plan, which they believed tied the dividend to the economic health of the state and made sense. He reviewed a variety of methods and reiterated that the administration was open to suggestions. He concluded that a dividend that is pro-cyclical with the economic health of the state is the goal.

[10:04:53 AM](#)

SENATOR MCGUIRE thanked Commissioner Hoffbeck for the presentation and noted that her version of the bill will be presented on Thursday. She echoed Commissioner Hoffbeck's sentiments and said the point is to get to a structure that is less volatile, more predictable, and more reflective of the state's true economic health. She stressed the importance of linking the PFD to the royalties.

CHAIR STOLTZE asked Mr. Milks to respond to the legal opinions.

[10:07:31 AM](#)

MR. MILKS related that there are over 200-legal opinions on the Permanent Fund. He said the department would pare them down to ones that are relevant to the direct issues.

CHAIR STOLTZE noted that he was especially interested in the ones that Attorney General Botelho was involved with because Mr. Botelho continues to be an advisor with the administration in some capacity and sometimes more transparent than others.

SENATOR MCGUIRE stated that the intent was to look for a thorough analysis that leads the committee as to why elements of past attorney general opinions are debunked or supported. She specified that her focus related to the "sweep issue," the viability of the new fund structure and its susceptibility from a legal challenge that destabilizes the government.

[10:09:40 AM](#)

SENATOR WIELECHOWSKI did not know if dueling attorney opinions could be resolved at the legislative level. He set forth that the court would ultimately have the final say. He said he is more concerned about the impacts to the state if the court finds the bill unconstitutional.

CHAIR STOLTZE suspected that there was not a legal opinion on a scenario that addressed the radical departure proposed in SB 128. He stated that the committee needs all of the guidance in making a decision. He noted that the public will weigh in as well.

[SB 128 was held in committee.]

[10:13:47 AM](#)

There being no further business to come before the Senate State Affairs Standing Committee, Chair Stoltze adjourned the committee at 10:13 a.m.