

ALASKA STATE LEGISLATURE
SENATE STATE AFFAIRS STANDING COMMITTEE

February 7, 2017

3:30 p.m.

MEMBERS PRESENT

Senator Mike Dunleavy, Chair
Senator David Wilson
Senator Cathy Giessel
Senator John Coghill
Senator Dennis Egan

MEMBERS ABSENT

All members present

COMMITTEE CALENDAR

SENATE BILL NO. 26

"An Act relating to the Alaska Permanent Fund Corporation, the earnings of the Alaska permanent fund, and the earnings reserve account; relating to the mental health trust fund; relating to deposits into the dividend fund; relating to the calculation of permanent fund dividends; relating to unrestricted state revenue available for appropriation; and providing for an effective date."

- HEARD & HELD

PREVIOUS COMMITTEE ACTION

BILL: SB 26

SHORT TITLE: APPROP LIMIT & PER FUND:DIVIDEND;EARNINGS

SPONSOR(S): RULES BY REQUEST OF THE GOVERNOR

01/18/17	(S)	READ THE FIRST TIME - REFERRALS
01/18/17	(S)	STA, FIN
02/07/17	(S)	STA AT 3:30 PM BUTROVICH 205

WITNESS REGISTER

EMMA POKON, Assistant Attorney General
Civil Division

Alaska Department of Law
Juneau, Alaska

POSITION STATEMENT: Announced questions regarding SB 26.

RANDALL HOFFBECK, Commissioner
Alaska Department of Revenue
Juneau, Alaska

POSITION STATEMENT: Provided an overview of SB 26.

ACTION NARRATIVE

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CHAIR MIKE DUNLEAVY called the Senate State Affairs Standing Committee meeting to order at 3:30 p.m. Present at the call to order were Senators Wilson, Giessel, Egan, and Chair Dunleavy.

SB 26-PERM. FUND: DEPOSITS; DIVIDEND; EARNINGS

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CHAIR DUNLEAVY announced the consideration of SB 26.

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EMMA POKON, Assistant Attorney General, Alaska Department of Law, Juneau, Alaska, introduced herself and offered to answer questions regarding SB 26.

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RANDALL HOFFBECK, Commissioner, Alaska Department of Revenue, Juneau, Alaska, addressed Emma Pokon's presence at the meeting. He said typically someone from the Department of Law does not sit next to him during a bill presentation, but Ms. Pokon has been involved with the development of SB 26 as well as coordinating the bill's modeling. He said Ms. Pokon is intimately involved with the details of the bill.

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He explained that there are two-main purposes of the Permanent Fund Protection Act (PFPA) that sets up the following:

1. Framework for sustainable withdrawals from the earnings reserve account (ERA).
2. Sustainable dividend formula.

He said both are needed to be accounted for in the final plan. He explained that the bill is "numbers driven" with a

significant public-overlay as it relates to the Permanent Fund Dividend (PFD).

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COMMISSIONER HOFFBECK explained that the "problem" is a combination of the following issues:

1. Low oil revenues,
2. Persistent deficit,
3. Diminished budget reserves.

He explained that the low-oil revenues have been a constant since late 2014. He opined that "low" may be a misnomer because current oil prices may be the new norm so that current revenues is the baseline to be looked at going forward regarding what is possible for government expenditures and services that can be provided.

He revealed that \$103 per-barrel oil pricing would be required to balance the current budget. He noted that the current price for oil is approximately \$55 per barrel. He pointed out that no one is forecasting future-oil prices to be above \$60 to \$70 per barrel. He detailed that approximately 500,000 barrels of oil is flowing through the Trans-Alaska Pipeline System and approximately 1.5 million barrels-per-day would be needed to balance the budget at \$60 per-barrel oil. He set forth that current oil prices and production levels puts the state in a situation where something other than oil price or production rebound must be looked at. He added that the Alaska's diminished budget reserves that have been used over the past several years to fund the gap between revenues versus expenditures for the last few years have been greatly diminished.

He said to provide a perspective to the low-oil revenues, from 2005 to 2014 over 90 percent of the Alaska's unrestricted general fund (UGF) revenues came from petroleum revenues, primarily from the severance tax and royalties. He added that between 2012 and 2015, oil revenue fell by 88 percent, \$7.8 billion in revenue. He summarized that Alaska has lost approximately 80 percent of its revenues, overall.

He noted that current oil prices and production are higher than what was forecasted for 2017. He revealed that an annual average-oil price that increases by a dollar is worth approximately \$30 million in revenue and 10,000 barrels of additional annual production equates to approximately \$20 million in revenue.

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SENATOR COGHILL joined the committee meeting.

CHAIR DUNLEAVY asked what is anticipated for the state's revenue from oil production.

COMMISSIONER HOFFBECK detailed that the average oil price is \$48.82, approximately \$2 more than forecasted that equates to \$60 million more in revenue. He said production is at 515,000 barrels-per-day which is 25,000 more than forecasted that equates to an additional \$50 million. He summarized that total revenue would be approximately \$1.5 billion.

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He addressed the state's deficit spending and noted that even though expenditures have been reduced by 44 percent over the last five years, expenditures do not match the 80-percent loss in revenue. He remarked that the state will run out of savings long before the deficit gap is closed and real changes need to be made. He informed that the forecasted combined balance from the Statutory Budget Reserve (SBR) and Constitutional Budget Reserve (CBR) is \$4.6 billion for June 30, 2017. He noted that the fall forecast is projecting more revenue for the next fiscal year.

He detailed that with no structural changes, the state would be down to \$2.1 billion by the end of the next fiscal year. He declared that \$2.1 billion is not enough to fund another year's deficit if nothing is done to fix the issue. He informed that the state needs to retain some money within the CBR for emergency expenditures and budget interruptions. He asserted that some liquidity is needed to make the state's fiscal plan work. He detailed that the Department of Revenue (DOR) borrows against the CBR during the fiscal year in order to meet expenditures. He said the borrowing allows DOR a liquidity bank that is used with the general-fund expenditures and the hope is to avoid the Alaska Permanent Fund Corporation (APFC) from having to modify their investment portfolio and carry the liquidity on their books.

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He asserted that the big issue is once the CBR and SBR are gone, the only place to turn would be the permanent fund if the state has an ongoing structural deficit. He said the PFPA comes into place as a way to efficiently and effectively use the permanent

fund while maintaining government services and a sustainable dividend.

COMMISSIONER HOFFBECK addressed the permanent fund's structure to provide an understanding between the ERA, the permanent fund's principal, and the segregation within the principal between the corpus and unrealized gains. He detailed FY2016 data on the permanent fund as follows:

- Permanent fund's principal: \$44.2 billion.
- Permanent fund's corpus within the principal: \$39.4 billion.
- Permanent fund's unrealized gains that the corpus has achieved but not realized: \$4.7 billion.
- ERA balance: \$8.6 billion.

He reiterated that the permanent fund's corpus is the protected portion of the fund that cannot be spent on anything whatsoever. He added that the \$4.7 billion in unrealized gains will eventually be realized and flow within the ERA.

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He addressed how the money flows in and out of the permanent fund's "corpus" as follows:

- Money in:
 - Mineral royalties:
 - At least 25 percent deposited into the corpus,
 - Currently depositing 30 percent of all mineral royalties.
 - Inflation proofing.
- Money out is prohibited.

He addressed the ERA's money flow as follows:

- Money in:
 - Investment income:
 - Statutory net income (SNI) from the principal, also known as realized gains:
 - Money from dividends,
 - Maturation of fixed-income investments,
 - Real estate,
 - Royalties,
 - Equities that are sold,
 - Private equity distributions
 - "Things that generate cash."

- Money out:
 - Inflation proofing the corpus;
 - Dividends, approximately 50 percent of the SNI.

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COMMISSIONER HOFFBECK disclosed that the permanent fund's annual-net income far exceeds the amount of money generated from oil-and-gas taxes as well as from royalties. He said the state is looking long term at \$60 plus-or-minus oil prices with 500,000 barrels-a-day as the maximum ceiling moving forward with nothing on the horizon that is ever going to change. He asserted that the state's financial assets now are Alaska's greatest resource that will generate more revenue for funding government services than oil and gas is going forward in the future. He noted that the state crossed over the "crossover point" in 2015, a moment in time that was envisioned when the permanent fund was set up. He set forth that the permanent fund is the new future for state funding.

He asserted that the "problem" is spending continues without a plan where additional revenue sources are not generated with oil, gas and other revenues remaining at current levels. He said the "no plan" scenario would mean the Legislature spends the CBR to zero and the ERA would be depleted by FY2022 or FY2023. He informed that a depleted ERA would mean the state is "off of the fiscal cliff in freefall" as well as not having money to pay the PFD from the ERA.

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At ease.

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CHAIR DUNLEAVY called the committee back to order.

COMMISSIONER HOFFBECK addressed why the permanent fund should be used. He specified that the current UGF budget is \$4.2 billion, revenues of about \$1.4 billion, leaving the state with approximately a \$2.8 billion budget gap.

He reviewed the potential tools outside of the permanent fund to close the budget gap as follows:

- Motor-fuels tax increase:
 - \$100 million.
- Other broad-based tax:
 - \$600 million.

- Corporate-income tax:
 - \$100 million.
- Oil tax credit reform:
 - \$100 million.
- Maximum cuts proposed by the Senate (over three years):
 - \$750 million.
- PFPA (net dividend):
 - \$1.9 billion.

COMMISSIONER HOFFBECK said excluding the PFPA, the total proposed revenues and cuts equal approximately \$1.65 billion, leaving approximately \$1 billion to \$1.2 billion short of a total solution. He set forth that there really is only one asset that the state has that is capable of closing the budget gap and that is the permanent fund. He asserted that approximately \$1.9 billion will be generated by the PFPA for government services.

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At ease.

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CHAIR DUNLEAVY called the committee back to order.

COMMISSIONER HOFFBECK said the other question addresses whether the PFPA is the proper use of the permanent fund for government expenditures. He mentioned that there has been a lot of discussions about interpreting the statutes, what the legislative intent was, the memory of the folks that were involved with the permanent fund, a lot of "Hammond quotes" floating around, and a lot of public perception. He revealed that the administration actually went back to what was on the ballot proposition that people voted on. He detailed Ballot Proposition No. 2 on establishing the permanent fund as follows:

This proposal, if approved, would amend the Constitution of the State of Alaska by ... establish[ing] a constitutional permanent fund into which at least 25 percent of all [mineral royalties] received by the State would be paid. The principal of the fund would be used only for income-producing investments permitted by law and the income from the fund would be deposited in the general fund of the State and be available to be appropriated for expenditure by the State unless otherwise provided by law.

COMMISSIONER HOFFBECK pointed out that there is an odd understanding in the constitution for expenditures because ballot proposition's noted expenditure phrase does not show up in the constitution, which creates an odd understanding of what the purpose was.

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He set forth that the permanent fund should be used in a systematic and rules-based fashion that actually achieves the goals of funding government services while still protecting the corpus of the fund and paying a dividend. He specified that there are five ways of judging the sufficiency of a plan as to whether the plan achieves the goal of a sustainable and durable use of the permanent fund:

1. Long term,
2. Sustainable,
3. Rule-based,
4. Stabilizing,
5. Maximize the use of the permanent fund earnings.

He detailed the need for a long-term plan as follows:

- The fund is meant to provide for all generations of Alaskans.
- As North Slope production declines, the fund's earnings will be increasingly important to sustaining public services.
- Unlike petroleum, Alaska's financial reserves can be a renewable resource.
- Like petroleum, investment earnings can be highly variable.

He addressed the need for planned "sustainability" as follows:

- Maintain or grow the real (inflation-adjusted) value of the permanent fund.
- Provide for a dividend.
- Ensure ERA "durability" where the ERA holds enough to bridge years of low earnings.

He specified that ERA "durability" is a critical issue, particularly in light of discussions about purposely leaving a structural deficit in the budget. He said he understands the logic behind a structural deficit where downward pressure is created on the budget; however, a secondary pressure is created that may be greater than the pressure on the budget and that is

the pressure to spend unscheduled expenditures out of the ERA. He opined that a scenario occurs where the ERA is tapped into when the budget has not been cut enough and there are not enough revenues. He said tapping into the ERA with unscheduled expenditures starts to deplete the ERA and makes the plan less durable.

COMMISSIONER HOFFBECK revealed that when DOR modeled out a full-fiscal plan so that uncertainty is taken out, a 1.12-percent failure rate occurred; however, if uncertainty is left in where strictly a permanent fund "only" plan with no other changes, the failure rate is approximately 45 percent. He summarized that the structural deficit is a critical piece that needs to be closed.

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CHAIR DUNLEAVY noted that the current model has been used for decades and was supposed to be long term. He asked what has changed that makes the current model outdated.

COMMISSIONER HOFFBECK explained that the biggest reason is simply that never before has the state needed to use the ERA for something other than paying the dividend and inflation proofing the permanent fund. He set forth that the state has reached a life-cycle point with its oil-and-gas revenues that the permanent fund needs to be used at its maximum capacity to fund government services. He reiterated that there is no other solution that can get the state to the "finish line."

CHAIR DUNLEAVY asked why DOR used their own modeling rather than the APFC's modeling. He pointed out that the APFC has managed the permanent fund for decades.

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COMMISSIONER HOFFBECK replied that the APFC just models their return scenarios going forward whereas DOR modeled the state's entire budgetary process and the demands that will be made on the available revenues. He set forth that DOR is comfortable with its modeling as well as the modeling that the APFC does. He noted that DOR works with the APFC regularly.

CHAIR DUNLEAVY pointed out that APFC's modeling is totally different from what DOR's modeling is showing where the ERA runs out in 2022.

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COMMISSIONER HOFFBECK addressed the need for a rule-based plan for savings, spending, and dividends as follows:

- Withdrawals occur under a set of statutory rules.
- Designed to protect the fund and guard against unsustainable uses.
- International best practice.

COMMISSIONER HOFFBECK pointed out examples of rule-based frameworks used for other sovereign wealth funds as follows:

- Singapore developed a proprietary model that projects 20-year returns where the government may spend 50 percent of the annualized 20-year expected returns.
- Kazakhstan uses a fixed-annual draw of \$8 billion which may be adjusted by 15 percent, but the draw is reduced if the fund balance is less than 20 percent of the GDP.
- Norway limits withdrawals to 4 percent, but withdrawals are allowed over 4 percent in limited circumstances with parliamentary resolution.

He summarized that there is no one perfect way to structure a sovereign-wealth fund, but a fund is structured based on the needs of the particular entity and what other resources they have available. He said DOR believes that the structure they put forward has been carefully modeled and is the best model for using the permanent fund resources for funding government services. He pointed out that the governor has said the PFPA is "written in pencil" and the administration is happy to take a look at better ideas. He noted that the previous year the Senate State Affairs Committee had taken the administration's permanent fund plan with a \$3.3 billion fixed draw where everything flowed through the permanent fund and substituted it with a percentage of market value (POMV) plan with draw limits. He noted that this year's plan is essentially the same bill that passed the Senate last year, SB 128, with a couple of modifications.

He addressed the need for a "stabilizing" plan as follows:

- Over the long term, economies that experience repeated ups and downs grow slower than stable economies.
- Because commodity prices are volatile, economies dominated by a single-commodity industry experience more pronounced cycles.
- Government spending that follows the same cycle amplifies the damaging effect.

COMMISSIONER HOFFBECK said for budgetary purposes the state needs to know what their revenues are going to be.

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He addressed the need for a plan that maximizes the use of the permanent fund earnings as follows:

- Other proposed new revenues and cuts could reduce the deficit by millions, the fund can sustainably contribute billions.
- Withdrawing too much is unsustainable and risks damaging the fund.
- Withdrawing too little limits future options for full-fiscal solutions.

He summarized that the state's biggest resource should be maximized and as many of the "other decisions" as possible should be eliminated.

SENATOR WILSON asked what Commissioner Hoffbeck meant by "eliminating other decisions."

COMMISSIONER HOFFBECK replied that the budget gap requires either new revenue sources or very significant cuts in expenditures, both of which have a significant impact on the economy, individuals and businesses. He set forth that maximizing the permanent fund can protect Alaska's fragile economy by limiting new taxes and cuts to government expenditures. He asserted that using the earnings from the permanent fund is the only solution that injects new money into the system.

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He explained that SB 26 is a slimmed down version of the bill (SB 128) that passed the Senate last year. He revealed that SB 128 was heavily vetted in 2016 with 39 hearings between the Senate State Affairs, Senate Finance and House Finance committees. He added that 63 hearings and 7-public hearings occurred last year on various permanent fund bills. He noted that Senator McGuire's bill, SB 114, ultimately became the core to SB 26 by incorporating the POMV process. He said the administration felt that the plan that passed the Senate was solid and the bill was worth bringing back this year.

He set forth that SB 26 is the same as the CS for SB 128, but without the following provisions:

- CBR management:
 - Moving from DOR to APFC.
 - DOR is more equipped to deal with cash management and liquidity issues for the permanent fund earnings on a daily basis.
- APFC procurement:
 - Does not have a real purpose in the bill.
- Secondary savings rule.
 - Not part of the crux of the plan and has its own momentum in separate bills.

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CHAIR DUNLEAVY asked if he believes that the change in the bill will get the bill passed.

COMMISSIONER HOFFBECK replied that the administration is essentially giving back the bill that the Senate passed last year. He pointed out that the House has the same issues associated with addressing broad-based taxes as well as oil-and-gas credit reform first. He pointed out a need for a "clean bill" as follows:

What we are hoping to do is pass as clean a bill to the House as we possibly can and try to take as much of that noise out of the discussion. We've been pushing hard with them to say we think we need clean bills and we need to deal with these issues on their merits, but obviously we don't control what the House will do, we are hopeful.

He detailed that the PFPA outlines a long-term plan with three formulas as follows:

1. Sustainable draw formula:
 - 5.25 POMV,
 - Draw limit.
2. Sustainable dividend formula:
 - 20-percent of UGF royalties,
 - 20-percent of POMV draw.
3. Adjust deposits to corpus:
 - Reduce royalty deposits to the constitutionally mandated 25 percent,
 - Change inflation-proofing transfers.

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COMMISSIONER HOFFBECK addressed how money will flow under SB 26 as follows:

- Mineral royalties:
 - Continue to go directly into the corpus of the fund at the 25-percent mandated by the constitution.
- Principal (corpus):
 - Statutory net income (SNI) would flow out of the principal (corpus) into the ERA.
- ERA:
 - Monies from the ERA would flow into the general fund.
- General fund:
 - 20/20 formula used to move money into the dividend fund.

He pointed out that one big difference is the dividend's money route would now flow through the general fund. He added that another difference is planned inflation proofing where money from the ERA is fed back into the corpus when the ERA reaches four times the annual draw rather than through legislative appropriation.

He addressed the POMV draw as follows:

- 5.25 percent of the average fund value in the first 5 or the last 6 years to assist with the budget process and APFC with investing.
- Example draw calculation:
 - Average fund value for FY2012 through FY2017 equals: \$48.1 billion.
 - 5.25 percent of \$48.1 billion equals a \$2.5 billion draw.
 - Effective POMV from the \$2.5 billion draw for FY2017 of \$53.6 billion equals 4.7 percent.

He detailed that as long as the permanent fund is growing, using the "back average" of 5.25 percent results in the effective POMV of 4.7 percent, a percentage that is substantially less than the 5.25 percent against the current year's value of the fund. He pointed out that the 5.25 percent back-average would be in line with this year's estimate return for the permanent fund return of 6.95 percent, less 2.25 percent for inflation that equals 4.7 percent.

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SENATOR WILSON asked Commissioner Hoffbeck why a more moderate withdrawal rate that is less than 5.25 percent be considered if the idea is to protect and have sustainability.

COMMISSIONER HOFFBECK explained that the intent is to maximize the use of the asset and "not leave money on the table" that necessitates more cuts and more taxes. He admitted that the model was "cranked" to squeeze as much out of the permanent fund earnings as possible. He revealed that there is a three-year review in the plan to make sure the fund is not being overdrawn and noted that the percentage can always be adjusted.

SENATOR WILSON remarked that he questioned the aggressive 5.25-percent POMV and noted Commissioner Hoffbeck's overly-optimistic modeling that did not take into account a once-a-decade market situation that would require draws on the ERA.

COMMISSIONER HOFFBECK replied that DOR's modeling takes into account various swings that could potentially occur during the 24-year modeling period. He explained that the modeling showed that even with the 5.25 percent draw, the failure rate to grow the fund and make the payments was only 1.25 percent. He reiterated that the administration believes the 5.25 percent draw is sustainable.

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He addressed the 5.25-percent POMV-draw formula with UGF revenue and oil prices. He explained that the draw by itself would not stabilize UGF revenue because revenue continues to vary with oil prices. He said an additional step was needed to stabilize cash flows and noted that the Senate State Affairs Committee during the previous year developed a draw-limit that is imposed when UGF production tax and royalties exceeds \$1.2 billion. He detailed that once the \$1.2 billion threshold is exceeded, the POMV draw is reduced by a dollar for every dollar collected in production taxes and royalties. He said the end result is spending would level off at \$1.2 billion plus the ERA draw.

He specified that the draw limit does not apply to the portion for the dividends. He emphasized that any reductions in the draw does not impact the size of the dividend because the dividend calculation is always against the 5.25 percent maximum, not the reduced draw that will occur from additional oil-and-gas taxes.

He addressed modeling for the UGF revenue and oil prices with the POMV draw and draw limit. He noted that once oil prices hit the \$75 to \$80 range, a reduction in the POMV draw will start to

occur as oil-and-gas royalties and taxes start to rise, essentially shutting off the ERA draw when oil-and-gas taxes are sufficient to cover the budget. He asserted that the draw limit addresses the issue of super-heating government spending when the POMV is layered on top of increased revenue without a limit.

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CHAIR DUNLEAVY pointed out that constitutionally, the CBR has to be replenished. He asked how the CBR will be replenished.

COMMISSIONER HOFFBECK replied that any monies left over at the end of the year that are available for appropriation are deposited or "swept" back into the CBR; the ERA has been an exception to that, the money residing in the ERA has not been "sweepable." He pointed out that there is nothing that would prevent the Legislature from moving money. He noted that there's one thing that automatically happens and that is once you get greater than the four-times-draw money flows back into the corpus of the permanent fund.

CHAIR DUNLEAVY asked to confirm that movement into the ERA is not into the general fund and not subject to the "sweep."

COMMISSIONER HOFFBECK answered correct. He pointed out that once a point is reached where the draw is completely shut off from the ERA, there is nothing that stops a continued draw from the oil-and-gas revenue for expenditures. He said there has been some discussion whether the continued draw from oil-and-gas revenue needs to be shut down or not, but there is also the argument that there will be some pent-up need for capital and maintenance programs.

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CHAIR DUNLEAVY asked if spending can keep increasing from oil revenue or a broad-based tax once oil revenue hits a certain amount and the "spigot" from the permanent fund is reduced.

COMMISSIONER HOFFBECK answered yes. He noted that one of the criticisms was that a relatively flat profile for government spending would be required.

CHAIR DUNLEAVY asserted that the continued spending issue in SB 26 is one of the reasons why the Senate is contemplating an appropriation limit. He said he is interested to see where the administration falls on the appropriation-limit concept. He set forth that an appropriation limit would keep the possible added

revenues and the growth of government tighter. He noted that any added revenues could be diverted to the CBR.

COMMISSIONER HOFFBECK explained that the bill has a formula for a sustainable-dividend draw. He detailed that SB 26 has a \$1,000 per person guarantee for the first two years of the plan. After the first two years the dividend draw would be 20 percent of the UGF royalties, plus 20 percent of the 5.25-percent POMV draw. He disclosed that the dividend draw is expected to stay around \$1,000 per person into the future. He specified that having the dividend based on a 20/20 draw from the UGF royalties and permanent fund earnings tends to stabilize the dividend over time. He added that the 20/20-dividend draw also tied Alaskans to the state's overall economic health.

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He addressed inflation-proofing transfers and noted that AS 37.13.145(c) currently provides for an annual inflation-proofing transfers from the ERA to the corpus of the fund. He said although the ERA needs to have a sufficient balance to meet the draw each year, the bill's feedback-loop provides the ability to inflation proof the corpus as well. He detailed that when the balance in the ERA reaches four times the annual draw, then the additional revenue flows back into the corpus of the fund to inflation proof the fund.

SENATOR WILSON asked what would occur if the scenario that Commissioner Hoffbeck described does not occur and the permanent fund is not inflation proofed.

COMMISSIONER HOFFBECK concurred that there would be an issue where permanent fund's corpus may not be inflation proofed. He opined that the fund itself would likely continue to grow at a sufficient rate with the 5.25-percent draw. He specified that the gains would be realized either in the ERA or in the unrealized gains piece, but not in the protected part of the fund's corpus with the feedback-loop occurring.

CHAIR DUNLEAVY noted that the bill caps the dividend at \$1,000. He asked what the government's take could range.

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COMMISSIONER HOFFBECK replied that the government's take would be approximately \$1.9 billion at the fund's current size. He added that the government's take would increase as the fund grew. He noted that the dividend is not capped and added that the dividend will grow if the permanent fund grows because the

dividend is tied to the POMV draw. He summarized that the bill will start with \$700 million for the dividend and \$1.9 billion for government services.

CHAIR DUNLEAVY asked to confirm that the government take will always be larger than the dividend.

COMMISSIONER HOFFBECK answered yes.

SENATOR WILSON reiterated that the dividend is set at \$1,000 for the first two-years and then based on the 20/20 formula that Commissioner Hoffbeck explained. He asked what would occur if a governor continued to set the dividend at \$1,000 and vetoed the remaining portion.

COMMISSIONER HOFFBECK answered that the funds would be moved into the general fund and then would be available for any purposes.

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He said a review would occur after three years to take a look and make sure everything is actually working and make adjustments if needed. He pointed out that the bill has an immediate effective date and could be applied during the current FY2017 budget year. He added that a quirky accounting "thing" would occur where the bill changes forward-funding appropriations from previous fiscal years to appropriations that occur in the same fiscal year.

He summarized about the PFFA as follows:

- Sustainably provides billions to the general fund when needed.
- Preserves the dividend program.
- Stabilizes the budget for the state as well as providing confidence to investors in the state's future.

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He addressed the bill's sectional analysis as follows:

Section 1:

Framework for the three-year review.

Section 2:

Reduces the royalties to just the 25-percent constitutional payment into the principal of the fund.

Section 4:

POMV and draw-limit formulas.

Section 6:

Appropriation for the earnings reserve for the general fund and principal plus the four-time draw component.

Section 7:

20/20-dividend formula.

Section 10:

\$1,000 dividend in calendar years 2017 and 2018.

Section 13:

Repeal language for the CBR sub-account which restricts the way investments can be in the CBR. The language is the same as the language in the bill that passed the Senate last year.

Section 15:

Immediate effective date.

SENATOR WILSON noted that Commissioner Hoffbeck commented earlier during his presentation that the government portion of the draw would always be higher than the dividend's portion. He asked which portion would be prioritized in a "short" year.

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COMMISSIONER HOFFBECK explained that with the structure of the four-times-draw from the ERA, there will be years where the statutory-net income is less than the payout and there will be years when the statutory-net income is greater than the payout; however, over time the two would even out. He pointed out that sustained-low returns over three or four years would be needed in order to deplete the ERA. He revealed that the financial markets have never had three or more consecutive years of down markets.

SENATOR WILSON said the bill's title that references "protection" bothers him. He noted that Commissioner Hoffbeck stated that the permanent fund currently works fine, but then claimed that government's only viable solution for the budget is to use the permanent fund. He asked who the bill protects the permanent fund from.

COMMISSIONER HOFFBECK replied that the new economic reality is the state is looking at insufficient oil-and-gas revenues to fund government services going forward. He asserted that the new

reality is not a short-term deal. He set forth that the bill would protect the permanent fund's integrity, not from an individual or entity, but from the reality that the state is about to burn through the last of its savings. He asserted that the next step in proceeding with an ad hoc draw against the ERA is probably the greatest potential for jeopardizing the permanent fund.

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SENATOR WILSON remarked that the bill actually protects the ERA and the bill's title seems a little misleading in identifying the permanent fund rather than the ERA.

COMMISSIONER HOFFBECK replied that by definition the permanent fund is a combination of the corpus, the unrealized gains within the principal, and the ERA.

CHAIR DUNLEAVY asked Commissioner Hoffbeck to provide his definition of the dividend.

COMMISSIONER HOFFBECK answered as follows:

The dividend is that portion of the earnings from the investments of the permanent fund that are shared with the citizens of the state of Alaska.

CHAIR DUNLEAVY asked Commissioner Hoffbeck if he viewed the permanent fund as welfare.

COMMISSIONER HOFFBECK answered no.

CHAIR DUNLEAVY asked if he viewed the dividend as a way for citizens to partake in the royalty concept that citizens were denied by the Statehood Act in the Alaska Constitution.

COMMISSIONER HOFFBECK replied as follows:

I see it as what the ballot initiative said in the constitutional amendment which is that it was to reserve money for the future, for government expenditures was the fund itself. There's nothing incorporated within the fund itself that talks about it being a share of the royalties. So I think the construct that the dividend is a share of the royalty I think is probably imposing something on the permanent fund itself that was never there in its original structure. I think people saw it not so much

as a share of the royalty wealth as it was a way to preserve some of the money, the wealth in high years for the future years when we did not have as much money.

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CHAIR DUNLEAVY asked if he was addressing the dividend.

COMMISSIONER HOFFBECK replied as follows:

The fund itself and the dividend is a piece of the fund. There was nothing in the arguments and discussions in creating the fund itself about being a way to preserve a royalty for the citizens; it is an argument that has developed after the fund was developed versus something that I think is imbedded in the fund itself.

CHAIR DUNLEAVY asked if he views the dividend as welfare.

COMMISSIONER HOFFBECK answered that he does not view the dividend as welfare.

CHAIR DUNLEAVY stated that SB 26 will be held in committee for future consideration. He asked if he had any parting thoughts.

COMMISSIONER HOFFBECK thanked Chair Dunleavy for the opportunity to present the bill. He set forth that the administration views the bill as a solid way to use the permanent fund.

SENATOR COGHILL suggested that a graphic representation be provided where both the status quo in keeping the permanent fund dividend formula the way it is and the PFPA's dividend formula be juxtaposed to one another on a graph.

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COMMISSIONER HOFFBECK noted that several graphs have been provided to the committee that shows what Senator Coghill referred to.

SENATOR COGHILL opined that the intent was to try and smooth out the dividend's volatility, but using the ERA was not considered for government; however, the government takes a bigger and bigger chunk. He pointed out that government currently has the right to appropriate from the ERA and asked what the impact to the dividend formula would be if government appropriated out of the ERA.

SENATOR COGHILL noted that people in his district inquire why government doesn't just use the ERA and leave the dividend alone. He pointed out that taking money out of the ERA has a huge impact on the dividend based on cash available. He opined that continued work must be done to figure out the methodology. He said he did not know if the Senate will buy in again or if the House will buy into the proposal as well.

He said he listened to the other approach which is based on a clean-endowment model. He admitted that the clean-endowment model is tempting in addition to having perpetuity; however, the model delivers a whole lot less value to the state and forces the Legislature to deal with harder decisions. He summarized that the Legislature has to eventually figure out how to come up with \$1.9 billion.

CHAIR DUNLEAVY addressed modeling differences between DOR and APFC. He noted that APFC's modeling from recent months projected the following:

- FY2018: \$10.4 billion starting out in the ERA with equal appropriations for the dividend and government of \$1.5 billion.
- FY2022: Equal appropriations from the ERA for the dividend and government of \$1.8 billion.
- FY2027: Total value of the permanent fund of \$64 billion.

He pointed out that Commissioner Hoffbeck raised concerns that the ERA would actually be zeroed out by 2020 or 2022.

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COMMISSIONER HOFFBECK pointed out that APFC's 50/50-split modeling leaves a \$1.2 billion to \$1.4 billion deficit in government spending that would have to come from the ERA. He added that the APFC modeling did not include inflation proofing the permanent fund. He said DOR will work with APFC to provide a true comparison for the committee.

SENATOR WILSON inquired if the status quo in DOR's modeling means there will be no new revenue sources and no significant cuts to the budget. He asked if the administration believes that the state has the right government size with the model presented by Commissioner Hoffbeck.

COMMISSIONER HOFFBECK replied that the governor looked at the budget that included substantial cuts; however, the governor

believes that was not his vision for the state of Alaska. He said the governor's position is that he feels the solution now is additional revenues. He pointed out that the state has already cut \$3.8 billion out of the budget and it was time to start talking about the revenue side of the equation. He noted that revenue would include using the permanent fund as well as new taxes.

SENATOR WILSON specified that his question related to the DOR model that currently says the state has the right size of government and the government should stay the same without looking at other cuts or other sources of revenue outside of permanent fund earnings.

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COMMISSIONER HOFFBECK replied that one DOR model was a dividend-only solution with the budget gap filled with earnings. The second model was a full-fiscal solution with a forecast for government spending to be flat for two to three years and then growing with inflation over time.

CHAIR DUNLEAVY opined that the size of state government was actually growing. He said the Legislature has competing visions for Alaska. He set forth that there is one vision where enough cuts have been made and the legislature must rearrange the permanent fund so that government gets more, and the people get less. He opined that the first vision argues that people will get more government services, but the people will get less in their ability to spend their dividend in the way they want. He added that the first vision will continue to address taxes as well. He set forth that the second vision includes a philosophy of Alaskans wanting to keep more money in their pockets and bring down the size of government.

He remarked that his hope is the Legislature can come together within the next 60 days with a fiscal plan that everyone can live with; however, he conceded that there are some serious differences in the way Alaska should be.

CHAIR DUNLEAVY thanked Commissioner Hoffbeck for his well laid-out presentation and welcomed him back to reconcile some "numbers."

[SB 26 was held in committee for future consideration.]

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There being no further business to come before the committee,
Chair Dunleavy adjourned the Senate State Affairs Standing
Committee at 4:57 p.m.