

HOUSE FINANCE COMMITTEE  
March 9, 2020  
1:35 p.m.

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CALL TO ORDER

Co-Chair Johnston called the House Finance Committee meeting to order at 1:35 p.m.

MEMBERS PRESENT

Representative Neal Foster, Co-Chair  
Representative Jennifer Johnston, Co-Chair  
Representative Dan Ortiz, Vice-Chair  
Representative Ben Carpenter  
Representative Andy Josephson  
Representative Gary Knopp  
Representative Bart LeBon  
Representative Kelly Merrick  
Representative Colleen Sullivan-Leonard  
Representative Cathy Tilton  
Representative Adam Wool

MEMBERS ABSENT

None

ALSO PRESENT

Mike Barnhill, Deputy Commissioner, Department of Revenue;  
Angela Rodell, Chief Executive Officer, Alaska Permanent  
Fund Corporation; Representative Mike Prax.

SUMMARY

HB 259 SUPPLEMENTAL PFD FOR 2019 RECIPIENTS

HB 259 was HEARD and HELD in committee for  
further consideration.

Co-Chair Johnston reviewed the meeting agenda.

#hb259

HOUSE BILL NO. 259

"An Act directing the commissioner of revenue to pay dividends to certain eligible individuals; and providing for an effective date."

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MIKE BARNHILL, DEPUTY COMMISSIONER, DEPARTMENT OF REVENUE, provided a PowerPoint presentation titled "HB 259 Supplemental Permanent Fund Dividend," dated March 9, 2020 (copy on file). The legislation had been introduced at the governor's request to complete the payment of the 2019 Permanent Fund Dividend (PFD) according to the statutory formula. He intended to outline the math included in the bill and discuss how the concept would be managed within the context of the Permanent Fund as an endowment.

Mr. Barnhill began on slide 2 and relayed that HB 259 would amend the uncodified law to provide for the remainder of the statutory PFD for 2019. He detailed that the Department of Revenue (DOR) had estimated in 2019 that the PFD would be \$2,910 per person. The actual PFD paid had been \$1,606 per person, which left a balance of \$1,304 per person.

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Mr. Barnhill moved to slide 3 and informed committee members that the estimate for the total aggregate cost of the supplemental PFD was \$1.88 billion. The amount was funded from \$896.5 million unrestricted general fund (UGF) and \$172.2 million from the Statutory Budget Reserve (SBR), which left a balance of \$815.9 million to pay on the statutory formula. The department estimated that just under 626,000 people would be eligible, which resulted in a supplemental PFD payment of \$1,304 per person.

Mr. Barnhill discussed eligibility on slide 4. He detailed that a person was eligible for the supplemental PFD if they had received a 2019 dividend and were eligible to receive a 2020 dividend. Under the legislation, the supplemental PFD would be paid with the 2020 dividend, subject to legislative appropriation.

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Mr. Barnhill moved to slide 5 and spoke to the rationale behind the bill. The administration had primarily proposed the legislation because of statute enacted into law in the

1980s. He detailed that the state had followed the statute calculation in payment of the PFD until several years back. In the past four years there had been a "non-structured" approach to the PFD and the governor believed in the importance of paying according to the statute. He added that there had been four years of uncertainty around how much the PFD would be, which had resulted in discussion consuming a considerable amount of time and energy in legislative budget discussions. He asserted that at some point it was necessary to get back to a structured solution to the PFD. He communicated that the governor urged the legislature to consider his proposal that adhered to the existing statutory formula.

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Mr. Barnhill advanced to slide 6 and discussed the notion that the Permanent Fund was a form of an endowment. He relayed that the state had been working over a number of years to get to a complete endowment. He highlighted the characteristics of endowments including permanent duration, protect the inflation adjusted value of the funds, preserve intergenerational equity, and limit spending to the average real return of the fund. He elaborated on the characteristics listed. One of the ways endowments achieved their purpose was to protect the inflation adjusted value of the funds deposited into the Permanent Fund/endowment, which was something the state had done since the beginning. He detailed that when there were realized gains that moved into the [Permanent Fund] Earnings Reserve Account (ERA), the legislature appropriated back an amount to compensate the principal for inflation. The primary purpose of an endowment was to preserve intergenerational equity so that each generation of beneficiaries had equal access to the benefit of the endowment, which was something that had been part of the management and experience of the Permanent Fund in Alaska.

Mr. Barnhill continued that the way endowments preserved intergenerational equity was to limit the spending from an endowment to the average real return of the fund. He noted that in SB 26 [Permanent Fund legislation passed in 2018] the legislature had adopted a spending formula, which limited spending for the first three years to 5.25 percent and 5 percent thereafter. The notion was there was an assumption the Permanent Fund would earn approximately 5 percent real return over time and as long as spending was

limited to that amount or less, it would protect the inflation adjusted value of the fund so it could be available to all generations.

Mr. Barnhill continued to address slide 6. He reported that over the decades the Permanent Fund had been in existence, Alaska tended to spend less than the real return of the fund. There were some years the state had spent more, but because those years were fewer than the years where Alaska spent less than the real return, the fund had grown in real terms over time.

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Mr. Barnhill moved to a table on slide 7 that showed historical Permanent Fund spending compared to the real return of the fund. He noted that the information was relevant for two purposes: 1) the governor was proposing to spend additional amounts in FY 21 from the Permanent Fund and 2) the Alaska Permanent Fund Corporation (APFC) board had issued a resolution the previous week suggesting that the real return portion of the distribution percentage be revisited periodically in order to determine whether spending was less than, equal to, or in excess.

Mr. Barnhill highlighted that the table included return, inflation, and spending data from APFC. He pointed to the top row representing 1998 that showed a gross return for the Permanent Fund of 16.35 percent, inflation according to the CPI-U [Consumer Price Index for all Urban Consumers] deflator of 1.7 percent, and a real return of 14.67 percent (gross return minus inflation). He noted that investment management fees could also be subtracted from the gross return, but for the simplicity's sake it had been excluded in the table. He relayed that if the SB 26 paradigm were applied going back in time, the lagging five-year return for the purposes of FY 2000 (the five years ending FY 98) would have been 9.95 percent. Under endowment principles, as long as spending was under 9.95 percent, the inflation adjusted value of the fund would not be eroded; likewise, if spending exceeded 9.95 percent, the fund would begin to erode. In 2000, the amount distributed from the Permanent Fund was \$1.175 billion or 6.3 percent of the lagging five-year market value. He explained that because spending had been below the real return, the real return had been retained and the Permanent Fund had grown in real terms because there had been no erosion of market value.

Mr. Barnhill moved down the table and highlighted that there were years where the lagging five-year real return had declined due to the market. He highlighted column 7 showing the lagging five-year real return. He referenced FY 05 and pointed out that the lagging return had gone down to under 1 percent. In FY 05, \$559 million had been appropriated, which was close to 3 percent of the lagging five-year market value. There had been an erosion of real return that year, which was to be expected with a static distribution formula. He explained that for all of the years with the static dividend formula, funding had been appropriated pursuant to the formula, which was irrespective of the real returns.

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Mr. Barnhill continued that going forward there was a static distribution formula of 5 percent. There would be years where the lagging five-year real return was higher and years where it was lower. He explained that fundamentally, the trustees were asking the legislature to pay attention to what happens in the lagging five-year real return and the distribution categories. He explained that if there were more years where the number was positive (where the distribution was less than the real return), the real value of the Permanent Fund would grow. The goal was to maintain or grow in order to protect an endowment.

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Mr. Barnhill looked at the fourth row from the bottom of slide 7 showing FY 19 - the Permanent Fund had earned 6.32 percent with inflation of 1.65 percent, resulting in a real return of 4.67 percent. The lagging five-year real return average in FY 19 was 5.59 percent. Under SB 26 they were appropriating 5.25 percent of the lagging market value or \$3.1 billion. He highlighted that the number was less, meaning that value was not being eroded. He moved to the second row from the bottom showing totals with the \$815 million for the supplemental PFD. He pointed out that the Permanent Fund distribution went from \$3.1 billion to a proposed distribution of \$3.9 billion, which increased the percentage of the five-year market value to 6.64 percent, leading to a negative real return. He noted that the occurrence was not unprecedented and had happened many times in the past. He explained it was a product of having a static distribution formula and varying real returns. The

point was, it was necessary to monitor when the real return was less than the amount distributed. He stated that in the case of the supplemental for 2019 it would be slightly less.

Co-Chair Johnston recognized Representative Mike Prax in the audience.

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Representative Wool looked at the 2019 distribution of \$3.09 billion in the column titled "Amt PF Distribution." He asked if the number reflected the 5.25 percent of market value (POMV) draw.

Mr. Barnhill replied affirmatively.

Representative Wool looked at the same column pre-SB 26 and surmised the number would be the amount calculated by the statutory dividend formula.

Mr. Barnhill directed attention to the 2016 row to see pre-SB 26 numbers. The distribution of \$803.4 million was the statutory dividend plus other amounts distributed for the Department of Law and Department of Corrections. He elaborated that the five years ending in 2017 created the calculation for FY 19. In 2017, the calculation for FY 19 had appropriated \$2.7 billion or approximately 5.25 percent of the lagging five-year market value of the Permanent Fund. The three years reflecting SB 26 were FY 19, 20, and 21 with a distribution amount of approximately 5.25 percent.

Co-Chair Johnston asked if it was 1998 when the five-year lookback averaging started for the dividend calculation.

Mr. Barnhill replied it had been 2017.

Co-Chair Johnston clarified that she was not asking about the POMV.

Mr. Barnhill asked if Co-Chair Johnston was speaking about the one-year lag in paying the PFD.

Co-Chair Johnston replied in the affirmative. She asked if it had started in 1998.

Mr. Barnhill believed it had started in 2017 when the one-year lag had been shortened.

Co-Chair Johnston clarified she was speaking about the dividend formula. She did not believe the five-year lagging average had started at the beginning of the PFD program.

Mr. Barnhill responded that it was 21 percent of the five-year sum of statutory net income. He did not recall when the 21 percent had been instituted. He noted that 21 percent was functionally a five-year average. He thought it was in the 1980s, but he would follow up.

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Co-Chair Johnston summarized her understanding of the information provided by Mr. Barnhill. She asked for verification that instead of the 4.69 percent distribution listed for 2019, the supplemental PFD would result in a distribution of 5.93 percent.

Mr. Barnhill answered that he was saying two things. He began with what he identified to be the first and most important. He explained that when there was a static distribution formula (Alaska had a static distribution formula since the beginning as set in statute and the limitation of 5 percent of the lagging five-year market value had been added on) it was important to compare the results over time to the real return earned by the Permanent Fund. He noted that real return equaled gross return minus inflation. He elaborated that it was necessary to compare the data to confirm that over periods of time, the amount being distributed (in terms of the POMV) was equal to or less than the real return, otherwise the inflation adjusted value would begin to erode. The information was functionally what the APFC board resolution had specified in the previous week.

Mr. Barnhill relayed that the second part was how HB 259 impacted spending from the Permanent Fund in terms of impact to real return (as shown in the last row on slide 7). He noted that the lagging five-year market value of the fund went from 5.25 percent to 6.64 percent. Compared to the lagging five-year real return, it was 1 percent over the lagging five-year return. He stated it was not without precedent in the history of the Permanent Fund - there had been multiple years where spending had exceeded the lagging

five-year real return. He concluded that the issue was something to watch.

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Co-Chair Johnston added that when looking at the fund over years, the distribution formula was static, but the reason it was leveled out over five years was to determine whether the fund had the capacity to grow.

Mr. Barnhill agreed. He continued that as long as the state wanted to avoid the erosion of the fund value, it should always spend equal to or less than the real return over time.

Representative Wool referenced that Mr. Barnhill had stated it was without precedent...

Mr. Barnhill stressed that [he had stated] it was not without precedent.

Representative Wool corrected his statement. He clarified that Mr. Barnhill had stated it was not without precedent to have the percent real return retained in the negative. He pointed out that the difference [from the negative number shown for 2019 with a supplemental PFD] was that other times the number had been negative, the draw on the Permanent Fund had not also been used to fund state services. In other words, state services had been paid for by oil, whereas, starting in 2019, the Permanent Fund draw was being used for other things. He reasoned there were other pressures on the draw besides just paying Permanent Fund checks.

Mr. Barnhill replied that the point was valid with respect to going forward under an SB 26 paradigm. The department anticipated that the level of spending from the Permanent Fund would increase in percentage terms. He referenced the column labeled "% Lagging 5 yr MV Distributed" and highlighted that in the early 2000s the number ranged from 2 to 4 percent and in the past three years the number was 5.25 percent. The department anticipated that going forward the number would be 5 percent under SB 26. The important takeaway was that there would be years under the SB 26 paradigm where the lagging five-year real return was less than 5 percent. He explained it was what the board was asking the legislature to pay attention to.

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Representative LeBon asked if HB 259 proposed to fund the \$816 million from the CBR or ERA.

Mr. Barnhill answered, "ERA."

Vice-Chair Ortiz stated that a supplemental PFD would cost \$816 million. He calculated that with a real rate of return at 5.59 percent, the opportunity cost of lost earnings for the future of the fund would be \$45 million (if a draw was taken in the current year and the funds were taken out of return possibilities). He asked if his calculation was accurate.

Mr. Barnhill had not calculated the opportunity costs. He stated that the point was interesting. He returned to the overarching purpose of an endowment to preserve the inflation adjusted value of the fund over time in order to protect intergenerational equity. He pointed to the table on slide 7 and highlighted that there were years where the state spent more on a five-year lagging average than the real return, yet the real value of the fund had grown over time because there was a built-in discipline in the formula. As long as it could be demonstrated that the real value of the fund was growing over time, the overarching objective of the endowment was achieved. He noted that it was always possible to make the point that spending \$1 out of an endowment would mean there would be \$1 plus interest less to spend in the future, but that was not the question asked in the context of an endowment. He stated the prudent question was whether the future had the same access to the principal inflation adjusted value over time. He stated that it would be the case as long as the real value was maintained or grew.

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Vice-Chair Ortiz referenced the third goal of the plan to ensure intergenerational equity into the future. He highlighted that continuing to pay the statutory PFD amount would mean consistently overdrawing the SB 26 statute that specified 5 percent. He thought they would be sacrificing the equity into the future because they would be consistently drawing more from the account than what SB 26 called for.

Mr. Barnhill replied that they did not know whether the statutory formula would consistently overdraw. He explained that what the formula would show was not available until the year in which the statutory PFD pursuant to the formula was appropriated. Primarily because the formula was driven by APFC investment managers. He elaborated that money moved to the ERA when managers decide to liquidate a portfolio and realize a gain. He noted it changed and could be a fairly volatile decision making process. He detailed that the process was based on the performance of certain portfolios and cash flows. He stressed that under the SB 26 paradigm with a 5 percent distribution there may be years in which the lagging five-year real return was less than 5 percent, irrespective of how the dividend was calculated. He stated that APFC was trying to impress upon all of the stakeholders that the static formula could deliver distributions in a single year that exceeded the five-year real return. He stated that the situation would not be the end of the world, it had occurred previously within the past 20 years, nevertheless the real value of the fund had grown because of spending discipline; however, it was something to be aware of going forward.

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Representative Sullivan-Leonard shared that she did not have a background in accounting, but she did like to look at how legislation was formed and how the legislature followed the law. She asked if the administration had followed statute in 2018 to make reductions to the PFD.

Mr. Barnhill asked for clarification.

Representative Sullivan-Leonard elaborated on her question. She stated that the previous Walker administration had made reductions to the PFD distribution. For example, the administration had chosen to have \$792 million in 2017 and \$683 million in 2018 remain in the ERA. She asked if the previous administration had followed statute in making the decision to keep the funds in the ERA.

Mr. Barnhill answered that under the previous administration when there had been reductions to the PFD that did not comply with the statutory formula, it had been within the legislature's purview to not appropriate. He explained that the funds that had not been appropriated

stayed in the ERA. He noted that slide 9 showed the amount retained by virtue of not being paid in the form of the PFD and the amounts that had been earned since that time. There had been a \$792 million reduction to the PFD in 2017 and a \$683 million reduction in 2018. The amounts had earned \$363 million since that time, leaving \$1.8 billion still in the Permanent Fund earning money.

Representative Sullivan-Leonard reasoned that if the legislature followed state statute, HB 259 was appropriate for a PFD distribution.

Mr. Barnhill responded that it was a policy matter and the Dunleavy administration believed that as long as there was a statutory formula, it should be followed by the legislature.

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Co-Chair Johnston discussed that the original ballot measure pertaining to the Permanent Fund was for earnings to go to the General Fund. She noted that 50 percent of the money went to a dividend and 50 percent remained in the fund, meaning no money had gone into the General Fund. In some respects, it was similar to what Representative Sullivan-Leonard had discussed, where the state actually left its earnings in the fund to grow.

Mr. Barnhill explained the legacy statutory calculation. There was 25 percent of the five-year realized or statutory net income that went into the ERA. He detailed that inflation proofing came out of the ERA and was deposited into the principal of the fund in order to insulate the principal from inflation. He continued that 50 percent of the five-year statutory net income average went into the dividend fund. The residual remained in the ERA and had grown to be quite large.

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Co-Chair Johnston believed the ERA contained approximately \$17 billion, which had come from oil income. She added there had been some appropriations into the corpus from the ERA from some of the savings (of the 50 percent that the state did not take). She asked for verification that there had been a large amount of growth in the fund because the state had not taken the income.

Mr. Barnhill answered that the real value of the Permanent Fund had grown in real terms over time because the state had not consistently appropriated up to the real return of the fund. He highlighted the column titled "% Real Return Retained" on slide 7 and pointed out that there were years where a considerable amount had been retained and the fund had grown as a result.

Representative Josephson was confused by the administration's position. He looked at the column showing the percent of lagging five-year market value distributed [slide 7] and noted that Mr. Barnhill had highlighted that the numbers reflecting SB 26 were some of the larger in the column. He observed that to find comparable numbers it required going back to the 1999 timeframe. He referenced an article in the Anchorage Daily News (ADN) just before Christmas titled "Alaska Permanent Fund spending may be unsustainable, corporation warns." He remarked that part of what he heard Mr. Barnhill saying was that the 5.25 percent may be too large according to APFC, but the administration wanted to spend more. He was having difficulty reconciling the two things.

Mr. Barnhill replied that he was primarily saying it was important to monitor the average lagging real return and the amount spent (the percentage of the average five-year market value). In the past, spending compared to real return had been very positive (and in some years the number had been negative). He explained that the issue would persist irrespective of HB 259. He stated that in future years the real return may drop below 5 percent, while the hope was the real return would increase over the 5 percent mark in future years. With respect to the proposal in HB 259, he was trying to place it in the context of how to manage an endowment. Managing an endowment required paying constant attention to the real return and the spending with respect to the real return - whether the real value was being added to or subtracted from.

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Representative Josephson highlighted that when the legislature had selected the 5.25 percent that went down to 5 percent after several years [under SB 26], it had been done with the knowledge there would be good and bad years, which was the reason a balance had been struck. He thought

he heard Mr. Barnhill saying the balance was too conservative.

Mr. Barnhill clarified that it was not what he was saying. His point was the need to keep an eye on the issue.

Co-Chair Johnston stated that DOR was responsible for going to bonding agencies and arguing the state's case. She wondered how DOR would argue the state's rating to agencies. She asked how the administration would address the additional draw and how it would impact the state's bond ratings.

Mr. Barnhill replied that he would show the agencies the table [on slide 7] to provide context. The administration would also like to make the case there had been a structural fiscal deficit for several years that the administration was attempting to work through step by step. The effort involved replacing the state's legacy fiscal structure that called the state to pay for certain things per statute; however, there were limited revenues. He elaborated that SB 26 had been the first step in terms of imposing a discipline on draws from the Permanent Fund. Another important structural change under discussion was whether there should be a change to the PFD formula. Additionally, there was a need to look at structural revenues and spending. The department would communicate the challenge and explain the state's progress on the path towards rebuilding Alaska's fiscal structure when it met with ratings agencies in New York.

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Co-Chair Johnston referenced a conversation she and Mr. Barnhill had regarding the CBR and the fact that a minimum required cushion for cash management had yet to be determined. She recalled that Mr. Barnhill had basically inferred that they could not currently look at the CBR for that purpose because it had been used as revenue [to help fund the budget]. She was concerned that the governor's proposal appeared to draw the CBR down to \$400 million or \$500 million in combination with an increased draw from the ERA. She was pleased to know that DOR believed a [fiscal] structure was needed and that it was the goal. However, she noted that the department would go to New York and tell ratings agencies the state did not quite have structure in place, a given number of money had been used, and the state

may need to use the ERA as its backup fund for cash management. She thought the scenario may mean that the DOR representative would have to be an exceptional salesperson.

Mr. Barnhill replied that he would try. He continued that unfortunately the state had faced some severe challenges to its legacy fiscal structure. He believed the more conversations they had with the legislature about how to replace the legacy structure with a new fiscal structure that worked in the modern revenue climate, the better. He noted that the issues took time - democracy was not neat and pretty, but messy. He reasoned that as long as some forward progress was made annually towards solving the issues, there would be better stories to tell ratings agencies in New York. He believed progress was being made. He recognized that in the midst of economic issues in the state and worldwide it was difficult to see the progress. He highlighted that having the discussions showed progress. He continued that it was progress if the parties could agree on the importance of having the discussion about new revenue structures, fiscal structures, new structures with respect to appropriation limits, and possibly tax structures.

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Co-Chair Johnston was pleased that Mr. Barnhill was suggesting the topic the committee would spend the week discussing was time worthwhile spent.

Mr. Barnhill replied, "It is."

Co-Chair Johnston stated her only concern was that progress had been made, but the appropriation under HB 259 may result in two steps back. She noted they had not yet discussed the fiscal note.

Mr. Barnhill stated there was one fiscal note [OMB Component Number 981] from the Permanent Fund Dividend Division. He believed the cost of reprogramming was about \$12,000, which he characterized as a "steal."

Co-Chair Johnston remarked that the fiscal note was basically to ensure that everyone who received the supplemental PFD was eligible.

Mr. Barnhill affirmed.

Representative Wool referenced Mr. Barnhill's statements that it was necessary to keep an eye on the amount distributed versus the amount of five-year lagging earnings and if the number was negative - which it would be - it was important to continue to keep watch. He had been present for discussions leading up to the passage of SB 26. He recalled discussions with APFC where the legislature had been told the draw could be 5.25 percent for several years and 5 percent thereafter (knowing there would be some plus and some minus years). He noted that financial advisors would say that a draw of around 4 percent was sustainable for the long-term for sovereign wealth funds and endowments. He noted that Alaska's fund had only been a sovereign wealth fund for several years. He referred to the ADN article mentioned previously [by Representative Josephson] suggesting the APFC board may have some concerns. He asked if the APFC board believed 5 percent may be too high and should be reconsidered. He highlighted that the administration was simultaneously proposing to increase the draw above 5.25 percent. He was trying to reconcile the two things.

Mr. Barnhill responded that he was presenting a new lens for watching spending from the Permanent Fund. The method measured the amount spent and compared it to the real return earned. He believed it was a discipline they needed to engage in annually. He would not characterize whether 5 percent was too high or too low; it had been a balance the legislature achieved by statute - a balance that could be considered fair at the time it had been made. He explained it was necessary to pay attention over time to determine whether 5 percent was the right number. He noted there may be long periods of time where 5 percent was the perfect number and there may be economic periods where 5 percent needed adjustment because it was too high or low. Looking at the spending and return helped quickly identify whether real value was eroding or being added to. He believed that under the SB 26 paradigm there would be years where the numbers were in the negative. He remarked that hopefully there would be years where the numbers were in the positive - it was necessary to keep an eye on the data.

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Representative LeBon considered the five-year lookback on determining what percent to draw. He detailed that if the

fund was growing, the five-year lookback effectively reduced the draw to about 4.5 percent.

Mr. Barnhill pointed the column showing percent of current year market value distributed on slide 7, which showed a comparison of spending to the previous year's balance (instead of a five-year average balance). He looked at the fourth row from the bottom under the "For FY" column for FY 21 as an example and explained that the \$3.1 billion distribution ended up being 4.7 percent of \$66.3 billion (the FY 19 closing balance). He explained that in an endowment there were multiple ways of measuring and comparing. He detailed that most endowments tended to use some sort of averaging to smooth out spending, the natural volatility, and investment gains/losses over time. One check was to look at spending compared to the closing balance of the previous year to determine whether it was significantly higher or lower. He highlighted that the column labeled "% Current Yr MV Distributed" showed the percentage right at or below 5 percent (in some years the percentage was closer to 1 percent). He relayed it was another metric to gauge whether there was overspending or underspending taking place.

Mr. Barnhill moved to the impact to the FY 21 Permanent Fund draw on slide 8. The slide showed a computation of the lagging five-year average market value for the Permanent Fund of \$58.9 billion. Multiplying the figure by the [SB 26 distribution percentage] of 5.25 percent equaled a POMV draw of \$3.1 billion. The supplemental PFD of \$816 million was an additional 1.39 percent of the lagging five-year market average, which resulted in a distribution percentage of slightly over 6 percent.

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Mr. Barnhill noted they had already discussed the amounts not distributed for 2017 and 2018 PFDs (slide 9). He explained that the amounts could be considered for use on a supplemental PFD.

Co-Chair Johnston noted that the Angela Rodell, Executive Director, Alaska Permanent Fund Corporation was in the room for questions.

ANGELA RODELL, CHIEF EXECUTIVE OFFICER, ALASKA PERMANENT FUND CORPORATION, introduced herself.

Representative Wool asked if the APFC board had changed its position on whether the planned [annual] 5 percent POMV draw was sustainable. He asked if recent market activity had shaded opinion on the 5 percent draw.

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Ms. Rodell replied that the board had not changed its stance on the 5 percent draw at present. The board wanted to make it clear that there could be times in a down market where the draw could effectively be more than 5 percent, which could draw down the ERA in an unanticipated way. She continued that when APFC had talked about and testified on SB 26 and the 5.25 percent for three years stepping down to 5 percent, it was to give everyone a sense of how the POMV would work and to provide a glidepath on the dependency for the fund.

Representative Wool asked how many years were needed to have a higher view of the 5 percent POMV draw where APFC may decide the amount was too generous. He wondered if it was a 10-year perspective or less.

Ms. Rodell referenced events in the market in the past three weeks. She intuited that if the fiscal year were to end at the end of the current day, numbers would be flat for the fiscal year (she noted that private market valuations would not come in for three months). She detailed that if the trend continued into the next couple of years and made up the majority of a five-year calculation, she believed it would be necessary to stop and consider whether the draw was too high because at that point the draw would exceed earnings. She expounded that the draw would begin to eat into the fund, and it would be necessary to decide whether or not it was something that should be continued. She noted that it was possible in three years the market could be robust and bullish. She explained that "these things" would be volatile. She reported that the APFC trustees had met the previous week to reaffirm their commitment to SB 26 and to reaffirm it had always been intentional to appropriate "up to" [a given amount] and that the legislature would continue to monitor and ensure that the account was not overdrawn unexpectedly.

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Representative Wool recalled that the year 2008 had come up myriad times during the debate on SB 26. He knew there had been "a lot of activity in the last few weeks," but he did not believe it was at the 2008 level. He noted that 2008 had been a one-year event. He was trying to interpret what Ms. Rodell was saying and surmised that if a multiyear 2008 event did not occur, the system should be able to absorb volatility when considering the long-term history of the fund.

Ms. Rodell answered that it was designed to stay as long as they remained at the amount agreed upon - 5.25 percent in FY 20 and 5 percent in FY 21. She appreciated the analysis done in the presentation and she would be curious to see how it would all shake out by the end of session in terms of a total amount for FY 21 and what a 5 percent draw would look like for FY 22 at the end of the year.

Representative Josephson had considered a press account from five days back on warnings issued by APFC. He noted that the corporation had described concerns both in extremely bad markets and extremely good markets. He asked Ms. Rodell to elaborate on the latter in more detail.

Ms. Rodell replied that in extremely good markets it was necessary to sell gains to rebalance on a regular basis - she noted it had occurred a couple of times in the statutory net income numbers. She elaborated that as the market went up and up, the corporation sold stocks and realized gains, which was moved into statutory net income and became part of the earnings calculation. In a time period of robust bull markets there could be a situation where the dividend calculation took all of the POMV because of the way the calculations worked in terms of realizing earnings versus merely growth in the market value.

Ms. Rodell reported that one of the things the APFC board had looked at two weeks earlier at its board meeting was how the two calculations could be contradictory. The calculations were contradictory when there was a market that required rebalancing on a much more frequent basis. She elaborated that down markets required rebalancing away from cash (buying low) in order to increase the public equity asset allocation to its regular level. Whereas, in high performing markets it was necessary to rebalance because growth was occurring too fast and it was necessary to sell out and realize gains. There were a couple of

different scenarios where the events took place and it highlighted the differentiation between the earnings calculation and the market value calculation.

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Representative Josephson stated his takeaway from the discussion was that SB 26 had been a compromise and he inferred there could be a more sophisticated, nuanced bill that accounted for some of the variables.

Ms. Rodell agreed. She detailed that the paper published by the trustees in early January recognized that endowments had looked at prudent spend rules, which took a percentage of the previous year's spend along with the percent of market value to recognize what was taking place year over year and limit the potential growth under a POMV or earnings calculation. There were hybrid approaches. To the credit of the legislature and state, the appropriation of the POMV had occurred two consecutive years and discussion was occurring for the third year. She explained that adhering to the statute had been helpful from an investment planning perspective.

Co-Chair Foster asked for the current value of the ERA.

Ms. Rodell replied that as of December 31, 2019 the ERA balance was approximately \$10.1 billion of unencumbered amounts (the numbers included the private market valuations for the first quarter and were the most robust). She detailed that reserved amounts included \$3.1 billion for FY 21, \$4 billion that had been appropriated and would move over at the end of the fiscal year in June, and \$600 million in inflation proofing (all of the funds excluding the \$3.1 billion had been included in FY 20 bills) for a total of approximately \$8 billion. Adding the \$8 billion to the unencumbered balance of \$10.1 billion resulted in a total balance of about \$18 billion as of December 31.

Co-Chair Foster considered the figures that resulted in [an unencumbered balance of] a little over \$10 billion. He stated that recently there had been a news report about the decrease in the Permanent Fund size due to the current Coronavirus and shrinking global markets. He asked if the decrease was about \$2.8 billion.

Ms. Rodell confirmed there had been a decrease of about \$2.8 billion to the total Permanent Fund over a seven-day period. On December 31, the fund total had been about \$66.982 billion. As of market close the previous Friday, the total fund value was about \$65.426 billion, a decrease of about \$1.556 billion since December 31, which would be spread pro rata between the fund principal and ERA.

Co-Chair Foster asked for verification that the loss was only realized in the ERA when losses were realized (when investments with losses were sold).

Ms. Rodell agreed.

Co-Chair Foster recognized that the loss could increase if markets fell further. He surmised that currently there was a loss of about \$1.5 billion that could be realized in the ERA. He remarked that the loss would bring the [unencumbered ERA balance] down to \$9 billion. He continued that taking an additional draw of \$816 million for the supplemental PFD would take the balance down to just over \$8 billion. He highlighted that APFC had recently included two recommendations in a resolution. He elaborated that the resolution recommended looking at constitutionally combining the entire fund to include both the corpus and ERA or setting up an internal statutory rule specifying that a balance of at least four times the draw would be maintained in the ERA. The current draw was \$3 billion, which equaled \$12 billion when multiplied by four. He highlighted that the [\$8 billion] balance would be far short of the \$12 billion. He asked Ms. Rodell how concerning the issue was.

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Ms. Rodell believed Co-Chair Foster was asking how APFC would view drawing down the ERA to a point where it may only have a two or three times balance. She shared that the challenge with the ERA was that it acted as the buffer in many ways to the performance of the fund. She elaborated that it had room to absorb volatility and provide the \$3.1 billion for the FY 21 transfer. The concern was about drawing the ERA down to a point where it could no longer act as a buffer and a negative balance occurred. She continued that there were only losses when they were realized; therefore, arguably there could be a negative balance in the ERA and because the money was still

invested, the valuation was negative. Under the scenario, she questioned where they would come up with the \$3.1 billion for FY 22 and how the situation would be managed and reconciled.

Ms. Rodell continued that because there were two accounts where the principal was protected and could not be touched at all times and the ERA was relied on for different things, the trustees' view was to request a formula driven buffer in order to recognize the cushion and have the ability to make the required payments. She stated the question for the committee was what would happen if APFC could not make a payment due to market volatility, how the situation would be viewed, and what the legislature's expectation was to deliver. She relayed it was the question APFC had struggled with because there was not clarity on the expectations of the ERA. She noted that the message had been for APFC to invest the ERA similarly and in the same assets as the fund. The question for the legislature was whether it was viewed differently now.

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Co-Chair Foster replied that it was a great question. He stated Ms. Rodell was essentially asking about the legislature's contingency plan if the existing plan failed. He believed it was something they all needed to keep in mind. He pointed out there was an additional problem related to the CBR. He detailed that with a CBR balance of \$2 billion and the governor's plan to use \$1.5 billion from the account for the PFD, the balance would be taken down to \$500 million. He highlighted that the state needed \$1 billion in the account to pay for its bills. He observed that a balance of \$500 million was far short of the recommendation. He noted that it did not factor in that oil prices were currently crashing. He stressed that the state was looking at hundreds of millions of dollars less than it had planned for. He recapped that the CBR balance could be far less than needed and an ERA balance that did not meet the minimum of what APFC believed to be prudent. He had significant concern about paying a supplemental PFD and a full PFD at present.

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Co-Chair Johnston remarked that there had been much discussion about structure during the current meeting. She

stated that paying the supplemental PFD would result in straying from the existing structure. She wondered if it made APFC's job more difficult to manage with less structure. She asked how APFC would manage the investments of the ERA if there was deviation from the structured draw.

Ms. Rodell replied that APFC could only control what it could control; it could not control the markets or what the legislature would appropriate from the ERA. The corporation was encouraging the legislature to stick with the spending amount that had been agreed upon. The corporation would manage the funds and liquidity to the best of its ability. When things started going in many different directions for valid reasons, it would make APFC's job managing the ERA challenging. She explained that APFC would likely look at what it needed to do to respond in order to deliver to the legislature's expectations.

Co-Chair Johnston asked for verification that APFC would need to maintain more liquidity than it currently had to maintain with the legislature's structured draw.

Ms. Rodell agreed. Alternatively, APFC would look at prepaying on the POMV even though it had not been appropriated. There were a number of different options to ensure APFC could focus on the long-term investment strategies it had been tasked with. Ultimately, APFC was focused on the \$49 billion in the corpus of the Permanent Fund, which was not to diminish the importance of the \$18 billion in the ERA. The corporation was driven more by the \$49 billion and how it thought about investing in perpetuity than the short-term strategies required by the ERA.

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Co-Chair Johnston remarked that the discussion had touched upon the CBR and that it operated as the cash management account for state government. She asked if Ms. Rodell believed the ERA could act as the state's cash management account if funding was reduced to an insufficient level in the CBR. She asked if a legal opinion would be required.

Ms. Rodell answered that there were a couple of ways to look at the issue. She explained that the Permanent Fund would need something to catch all of the earnings. She reported that the fund received about \$1.2 billion to \$1.5

billion in interest payments, rent payments, and in dividend payments off of dividend stocks. An account was needed to catch the funds because it became available for appropriation and was statutory net income. She considered that if there was contemplation on having one or two years of the POMV moved over to manage separately, it would be a portion or a subaccount of the ERA and not the entire fund. She believed the cash management question was best posed to DOR and the Department of Law.

Representative Wool noted that Vice-Chair Ortiz had mentioned the earning power of the \$816 million to pay past PFDs. He did not recall the number or timeframe.

Vice-Chair Ortiz answered, "\$45 million."

Representative Wool was concerned about drawing down the ERA and producing less earnings. He noted Co-Chair Foster's point that the portion of revenue from oil was experiencing serious problems in addition to the revenue from stocks. He asked if Ms. Rodell could speak to the decrease in earnings potential by drawing down the ERA in an ad hoc way.

Ms. Rodell believed the importance of the POMV had been to create a prudent spend rule on the fund. The idea was to recognize and benefit from increases in the market value and avoid overspending in years where market value was flat because there would be an averaging function. She explained that ad hoc draws from the ERA would move away from the prudent spend idea. She asked the committee to consider what the spending rule needed to be for the fund.

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HB 259 was HEARD and HELD in committee for further consideration.

Co-Chair Johnston reviewed the schedule for the following morning and amendment deadlines for HB 97 and HB 223.

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ADJOURNMENT

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The meeting was adjourned at 2:54 p.m.