

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

March 7, 2019

3:32 p.m.

MEMBERS PRESENT

Senator Mike Shower, Chair
Senator John Coghill, Vice Chair
Senator Lora Reinbold
Senator Peter Micciche
Senator Scott Kawasaki

MEMBERS ABSENT

All members present

COMMITTEE CALENDAR

SENATE BILL NO. 23

"An Act making special appropriations from the earnings reserve account for the payment of permanent fund dividends; and providing for an effective date."

- HEARD & HELD

SENATE BILL NO. 24

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

- HEARD & HELD

SENATE CONCURRENT RESOLUTION NO. 1

Proposing an amendment to the Uniform Rules of the Alaska State Legislature relating to the appearance of measures on the daily calendar after the ninetieth day of the regular session.

- SCHEDULED BUT NOT HEARD

PREVIOUS COMMITTEE ACTION

BILL: SB 23

SHORT TITLE: APPROP:SUPP. PAYMENTS OF PRIOR YEARS' PFD

SPONSOR(S): RULES BY REQUEST OF THE GOVERNOR

01/16/19 (S) READ THE FIRST TIME - REFERRALS
 01/16/19 (S) STA, FIN
 02/05/19 (S) STA AT 3:30 PM BUTROVICH 205
 02/05/19 (S) Heard & Held
 02/05/19 (S) MINUTE(STA)
 02/26/19 (S) STA AT 3:30 PM BUTROVICH 205
 02/26/19 (S) Heard & Held
 02/26/19 (S) MINUTE(STA)
 02/28/19 (S) STA AT 3:30 PM BUTROVICH 205
 02/28/19 (S) Heard & Held
 02/28/19 (S) MINUTE(STA)
 03/05/19 (S) STA AT 3:30 PM BUTROVICH 205
 03/05/19 (S) Heard & Held
 03/05/19 (S) MINUTE(STA)
 03/07/19 (S) STA AT 3:30 PM BUTROVICH 205

BILL: SB 24

SHORT TITLE: PFD SUPPLEMENTAL PAYMENTS

SPONSOR(s): RULES BY REQUEST OF THE GOVERNOR

01/16/19 (S) READ THE FIRST TIME - REFERRALS
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 03/05/19 (S) MINUTE(STA)
 03/07/19 (S) STA AT 3:30 PM BUTROVICH 205

WITNESS REGISTER

EDWARD KING, Chief Economist
 Office of Management and Budget
 Office of the Governor
 Juneau Alaska

POSITION STATEMENT: During the discussion of SB 23 and SB 24, presented a PowerPoint titled, "SB 23 and the Fiscal Health of the ERA."

BRUCE TANGEMAN, Commissioner Designee
Department of Revenue
Anchorage, Alaska

POSITION STATEMENT: During the discussion of SB 23 and SB 24, provided information related to PowerPoint titled, "SB 23 and the Fiscal Health of the ERA."

ACTION NARRATIVE

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CHAIR MIKE SHOWER called the Senate State Affairs Standing Committee meeting to order at 3:32 p.m. Present at the call to order were Senators Kawasaki, Reinbold, Micciche, and Chair Shower. Senator Coghill arrived as the meeting was in progress.

SB 23-APPROP:SUPP. PAYMENTS OF PRIOR YEARS' PFD **SB 24-PFD SUPPLEMENTAL PAYMENTS**

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CHAIR SHOWER announced the consideration of SENATE BILL NO. 23 "An Act making special appropriations from the earnings reserve account for the payment of permanent fund dividends; and providing for an effective date." and SENATE BILL 24 "An Act directing the Department of Revenue to pay dividends to certain eligible individuals; and providing for an effective date."

He encouraged the public to send written comments to senate.state.affairs@akleg.gov. He welcomed Mr. King and Commissioner Designee Tangeman to the witness table.

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EDWARD KING, Chief Economist, Office of Management and Budget, Office of the Governor, Juneau, stated that the purpose of the presentation was to respond to questions the committee asked during the last several hearings. The first question was how does the forecast relate to historic performance. He directed attention to the graphic on slide 3 that shows how the permanent fund balance and the percentage return of the permanent fund has changed over time.

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At ease

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CHAIR SHOWER reconvened the meeting.

MR. KING turned to slide 4, "Alaska Permanent Fund Corporation History and Projection." He explained that he translated the numbers from slide 3 into an excel spreadsheet and added the projections and statutory net income going forward. The idea is to show how the projection compares to the historic performance. He highlighted that the projections appear to be within the range of historic performance.

MR. KING said the fund generates revenue two ways. First, is from income streams such as dividends on stock, lease payments from buildings, and bond interest from fixed income assets. These are realized earnings that go directly into the earnings reserve and can be appropriated by the legislature. Second, the fund generates revenues from the purchase of assets that are sold for more than the purchase price. For example, an asset that is purchased for \$100 million and appreciates to \$120 million on the marketplace is booked as an unrealized gain until the asset is sold. When the fund sells the asset, \$100 million returns to the principal account and the \$20 million appreciated amount goes to the earnings reserve.

Responding to a question from the chair, Mr. King explained that the accounting return is the change in the total fund value, including the realized and unrealized gains. For example, a \$100 million asset that is now worth \$120 and has generated \$5 million in income is worth \$125 million - \$5 million in regularized income and \$20 million in unrealized gains. The increase in total value is 25 percent and the statutory return is 5 percent. If the asset earns zero income the next year and is sold for \$120 million, the realized earnings are \$20 million. The fund made 20 percent on the investment last year and it was realized this year. He said that's the difference between accounting returns and statutory returns.

MR. KING related that the three components of the fund include \$40 billion in principal funds, about \$7 billion in unrealized gains, and about \$17 billion in realized gains that is sitting in the earnings reserve.

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SENATOR REINBOLD said it would helpful to know the mean and if there are things on the state, national, or international horizon that may affect the investments in the future. She also asked him to comment on a presentation that was given this last weekend that talked about the effect that taking the PFD will

have on the earnings reserve and education funding in the next X number of years.

MR. KING deferred the first question to next slide. To the second question, he said when you're talking about the fund health it's tempting to say the balance is X and forget about the unrealized gains that will eventually go into the balance of the earnings reserve. The DOR models calculate the income and realization and how those realizations move, he said.

CHAIR SHOWER asked for a layman's explanation of the way the \$4 billion in earnings are calculated.

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MR. KING first provided an explanation of different asset classes and how the different assets generate income, how the fund transitions between assets, the five-year conversion rate to roll over an asset, and when unrealized gains are converted to realized gains. He subsequently explained that about \$1.8 billion of the earnings come from income from interest, dividends, and rents. The rest of the earnings are projected to be \$2.1 billion for a total of just under \$4 billion. He noted that the FY2019 projected earnings will be updated next week and will reflect the poor stock performance in October and November. Nevertheless, he still believes the total earnings will be in the \$3 billion to \$4 billion range for FY2019.

SENATOR MICCICHE asked him to talk about the billions of dollars it would cost to sell [the assets with unrealized gains] for a statutory return.

MR. KING responded that part of portfolio management is to convert assets and the conversion ratio is normally in the 4-5 year range. He cited the example of buying a house and living in it for 5 years before cashing out the equity and buying another house. He asked Senator Micciche to clarify the question.

SENATOR MICCICHE said he was trying to help the public understand why unrealized gains are beneficial in the long term for the earnings of the fund.

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BRUCE TANGEMAN, Commissioner Designee, Department of Revenue, Anchorage, responded that the Permanent Fund Corporation is tasked with growing the permanent fund and providing a certain amount of liquidity for state government through the Senate Bill 26 POMV (percent of market value) calculation. This gave the

corporation more stability because they know their liquidity needs and are able to deploy more assets into the market than the last few years when the POMV was only under debate.

CHAIR SHOWER asked for a simple explanation.

COMMISSIONER DESIGNEE TANGEMAN said the permanent fund balance dropped to about \$60.4 billion by the end of December [2019] and it's recovered to about \$65 billion. "So you see some of the swings where just a couple months can really drive it down, but it can recover quite well, too, now that it's a pretty large corpus." he said.

SENATOR MICCICHE said it might be easier to understand the difference between realized and unrealized gains by talking about the purchase and sale of a house. If you buy a house for \$200,000 and it's now worth \$400,000, the difference is an unrealized gain that has no spendable value. If you borrow against the difference in equity or you sell the house, the gain is realized.

MR. KING agreed with the explanation.

He added that slide 4 is intended to illustrate that the accounting return is much more volatile than the statutory return. The chart shows that over the life of the fund the accounting return (gold bars) has a high of 25 percent and a low of -18 percent, whereas the statutory return (green bars) is much less volatile. For example, \$10 billion in gains or losses in one year includes appreciated or depreciated assets that are not realized until the asset is sold. Those gains and losses do not sit in the earnings reserve. Until the assets are sold, and the gains and losses are realized, they do not affect the earnings reserve. He said he believes that the only reason to calculate the less volatile statutory return is to calculate the PFD.

CHAIR SHOWER offered an analogy with [Warren] Buffet's comment that he didn't lose any money when the stock market crashed because he didn't sell anything.

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MR. KING pointed out that 2009 was the worst financial correction in the 40-year history of the fund. The accounting return was -18 percent and the statutory return was -9 percent.

He turned to slide 5 that illustrates the frequency distribution of historic accounting returns. He pointed out that 90 percent of the time fund returns have run between -3 percent and 20 percent. Over 40 years the returns were in excess of 20.5 percent just two times and less than -3 percent just two times. The fund has returned between 10 percent and 15 percent most often and between 5 percent and 10 percent the next most often. The simple average of the returns is 9.665 percent. The standard deviation, which shows the range of volatility, is 7.872 percent. That means that over time the permanent fund has performed phenomenally well, he said.

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SENATOR REINBOLD asked if he believes the returns over the next 5 years will average 5 percent.

MR. KING replied the expectation in the marketplace is that a correction is going to happen. Most advisors are suggesting returns over the next 5 years in the 6 percent to 7 percent range. He warned that while nobody knows when the correction will occur, more money is lost in the stock market by trying to predict when a correction will happen than is made in any other way. He said the corporation is doing what it can to prepare and that's why the projected return is 6.55 percent.

SENATOR MICCICHE noted that over the long term, even before the 1929 depression, the market return has been fairly consistent. He questioned the wisdom of a sovereign adjusting for the short term and asked if it's like trying to time an unpredictable market.

MR. KING deferred to the commissioner.

COMMISSIONER DESIGNEE TANGEMAN said he didn't believe huge corrections are being made at the permanent fund regarding the percent of liquidity, what is set aside, and what is in fixed income and private equities. The goal continues to be to grow the fund, albeit with the knowledge that ups and downs are coming.

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SENATOR COGHILL joined the committee.

CHAIR SHOWER asked if the board plans to readjust its strategy now that the POMV model has been adopted.

COMMISSIONER DESIGNEE TANGEMAN replied he didn't believe the strategy would change, but they now have a better idea about how much cash can be deployed into the existing asset allocations. He highlighted that the \$3 billion POMV is a fairly small amount compared to \$65 billion fund.

MR. KING turned to the graphic on slide 6, "APFC Returns" that illustrates the change in value of a \$100 investment based on APFC historic returns. He clarified that the historic and projected means are geometric, not arithmetic. To illustrate the geometric calculation he provided an example of a \$100 investment that returns 50 percent the first year. \$150 is in the account at the end of the year. The next year the asset experiences a 50 percent loss or half of \$150. The geometric mean shows \$75 in the account at the end of 2 years, which is a negative 25 percent return or negative 12.5 percent a year. The arithmetic mean for the same example would show \$100 in the account at the end of 2 years, or zero return. The \$50 gain the first year is offset by the \$50 loss the second year leaving a zero return.

CHAIR SHOWER described the corporation projections as somewhat conservative.

MR. KING responded that his interpretation is that at some point in the next 5-10 years, the corporation expects a significant negative return. He cautioned against interpreting the graph to mean that the geometric mean will be 6.55 percent every year for the next 10 years.

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MR. KING addressed Senator Micciche's question about how the fund performs under various spending assumptions. He reminded the committee that during the first hearing he talked about what the 6.55 percent return looks over time using the assumption that the legislature follows all the existing laws. Under that scenario, passing SB 23 does not significantly affect the fund's risk exposure. He said Senator Micciche appropriately asked what the ERA balance would look like under different spending assumptions, with and without SB 23. The chart on slide 8 shows what happens to the fund if the legislature does not follow the POMV and covers the deficits with unstructured draws from the ERA.

The gold line represents the fund performance over time with a \$3 billion UGF budget and the dotted gold line represents the same assumption with SB 23 in place. The \$2 billion difference

reflects the amount coming out of the fund and distributed to the people. The green line represents a \$3.5 billion UGF budget and the green dotted line represents that budget with SB 23 in place. The next two scenarios represent a \$4 billion UGF budget and a \$4.5 billion UGF budget, with and without SB 23 in place. The \$1 billion and \$1.5 billion overdrafts illustrate how quickly the earnings reserve account is depleted and that it is accelerated with the passing of SB 23.

SENATOR MICCICHE said he assumes the chart uses the 6.55 percent earnings.

MR. KING said yes.

SENATOR MICCICHE mentioned the modeling he did that looked at UGF going down instead of up and highlighted the danger if: 1) spending is higher than projected and the earnings reserve is relied on to make up the difference; and 2) being unable to get a 3/4 vote on the CBR, which puts more pressure on the earnings reserve. He said the smallest reduction in the budget he looked at was \$300 million and that depletes the fund by 2027 or 2028. He urged people to think about the fact that unstructured draws or additional spending depletes the ERA earlier, which will also complicate the payment of any dividends. He asked Mr. Tangeman if he disagreed.

COMMISSIONER DESIGNEE TANGEMAN replied, "We can all agree that the full budget, the full dividend, and the full backpay creates a problem."

SENATOR MICCICHE asked if the assumptions on slide 8 include a 2.25 growth rate for inflation.

MR. KING said that's correct.

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SENATOR COGHILL asked if the \$3 billion UGF and \$3.5 billion UGF spending assumptions include the full dividend payment.

MR. KING replied the dividend payment is in addition to those numbers.

SENATOR COGHILL commented that he would need to factor that in.

CHAIR SHOWER asked Mr. King to expand the explanation.

MR. KING replied some people wonder whether the permanent fund payments are considered unrestricted general fund payments. The question was whether or not the \$3 billion UGF spending assumption includes the PFD payment. The answer is that the PFD payment is in addition to the \$3 billion.

SENATOR KAWASAKI asked if the \$3 billion UGF spending assumption includes [the POMV draw under] Senate Bill 26.

MR. KING replied he turned off the POMV calculation in this scenario to show how the health of the fund is affected by overdrafts.

SENATOR KAWASAKI asked what the anticipated POMV draw is this year under Senate Bill 26.

MR. KING replied it's about \$2.9 billion.

SENATOR KAWASAKI referred to the Fall 2018 Revenue Forecast and asked if he agrees that under the Senate Bill 26 scenario, the POMV draw will be between \$3 billion and \$3.8 billion for the next ten years.

COMMISSIONER DESIGNEE TAGAMENT said that's correct.

SENATOR KAWASAKI asked if the graph demonstrates that the earnings reserve balance is constantly drawn down.

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MR. KING clarified that the gold bar represents the legislature's desire to spend \$3 billion UGF when there is \$2.2 billion in UGF revenue and a draw from the ERA makes up the difference. There's room to do that in the current structure under the POMV, he said, but not in a \$4.5 UGF scenario. He reiterated that the graphic looks at the health of the fund under the different scenarios without factoring in the POMV.

CHAIR SHOWER asked how he would respond to the people who ask why it wouldn't work to start with Governor Walker's \$4.8 billion budget.

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MR. KING pointed to the black line and explained that in that scenario the goal of the legislature is to spend \$4.5 billion in UGF expenditures. Revenue in the current year is \$2.2 billion, which leaves \$2.3 billion that needs to be paid somehow. The graphic represents what happens to the ERA if that \$2.3 billion

and the full \$1.9 billion dividend comes out of the fund. Logistically it's possible to draw \$4.2 billion from the ERA, he said, but it will eventually be depleted. When that happens, just current year returns are left to spend.

CHAIR SHOWER observed that the ERA is depleted faster with the full PFD payments.

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SENATOR MICCICHE said it's important to point out that in all four scenarios the ERA is depleted about two years earlier when the full dividend and the payback is paid as opposed to paying just the dividend and not the payback.

COMMISSIONER DESIGNEE TANGEMAN said that's correct, but the governor's complete package, which includes a significantly decreased budget, accepts SB 23 without depleting the ERA by 2030.

SENATOR MICCICHE pointed out that the \$3 billion UGF, which is fairly close to the governor's, erodes the ERA with or without a payback.

MR. KING suggested moving to the next slide to clarify the point.

COMMISSIONER DESIGNEE TANGEMAN highlighted that while the ERA balance is going down, the permanent fund corpus is up over \$100 billion.

SENATOR MICCICHE said he understands that but regardless of the permanent fund's projected growth, the ERA will erode with 6.55 percent earnings and that is the account the PFD is paid from.

MR. KING responded that part of the calculus is that every year money is transferred from the earnings reserve to the principal account, so the ERA balance is going down, but the total fund balance is not.

SENATOR MICCICHE asked if he agrees that while the permanent fund continues to grow, the ERA continues to be eroded under this scenario.

MR. KING answered that the money that is moved from the earnings reserve to the principal account for inflation proofing could remain in the ERA and you wouldn't see the decline, but the legislature could spend it.

COMMISSIONER DESIGNEE TANGEMAN clarified that the answer is yes.

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SENATOR KAWASAKI asked if the graph represents inflation-adjusted dollars.

MR. KING replied they're nominal dollars, but inflation is an important factor in protecting the principal balance. That's why money is moved to the principal account. He said slide 9 shows the fund balance increasing under the four scenarios and for the most part it's growing with the rate of inflation. The line would be just slightly inclined if the numbers were inflation proofed.

SENATOR MICCICHE asked if the fund is growing with the 6.55 percent earnings assumption as opposed to inflation.

MR. KING replied the fund does not grow from the projected 6.55 percent earnings if the legislature appropriates a full PFD and withdraws what it legally can under current law.

CHAIR SHOWER commented that it only grows from inflation proofing.

MR. KING agreed that the principal account grows with inflation.

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MR. KING turned to slides 10-13 and explained that they show three different scenarios that come out of a Monte Carlo simulation. The numbers are generated from the probability distribution the fund uses to show what the future looks like. He clarified that none are more likely to occur than the unrealistic 6.55 percent return every year for the next decade or two.

In Scenario 1, the randomly generated numbers show that over the next 10 years the accounting returns mostly fall between 5 percent and 10 percent, although the return in one year was more than 20 percent followed by a deep correction. The distribution mimics history just as DOR's probability distribution is intended to do.

On the right the green line shows that as long as the legislature limits draws to the POMV, the fund is growing. The green dotted line applies SB 23 and reflects the \$2 billion that's paid out of the fund. The black line scenario shows how

overdraws on the account change the performance and health of the fund.

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MR. KING said Scenario 2 shows a less rosy picture. In 2020 there were poor returns, an average projected return in 2021, and a deep -12 percent correction the next year. The earnings reserve is depleted in this scenario, even if the POMV is followed, but it doesn't quite run out even with SB 23. He reminded the committee that in the first hearing he said there aren't many scenarios where the earnings reserve almost runs out and SB 23 causes it to run out.

CHAIR SHOWER asked what the UGF assumption is for the different scenarios.

MR. KING replied the spending assumption for the ad hoc draws is \$4.8 billion in FY19 and it grows with inflation and population. He pointed out that trying to fund that size budget and getting these returns causes the earnings reserve to run out faster under SB 23. However, the principal of the fund continues to earn money, so the earnings reserve starts to recover in this scenario. Thus it's hard to say what failure means, he said. Is it failure at any point, at the end, because of SB 23, or some other factor?

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MR. KING turned to Scenario 3 that beats the fund's projections nearly every year through 2029 and grows to over 40 billion. With SB 23 the fund grows to about \$37 billion. If the full FY19 budget is funded in this scenario, the fund balance stays flat.

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SENATOR MICCICHE expressed appreciation for the information and commented that it's clear that if everything goes fine with SB 23 and SB 24, then everything will be fine. However, everything won't be fine without reductions. He said it's helpful to take it to that basic level to understand why the bills are receiving such careful evaluation. He asked if that is a fair statement.

MR. KING replied that's a very fair statement. He added that DOR runs the Monte Carlo simulations to see how often one scenario comes up versus another and to understand what the risk looks like. But it's clear that withdrawing more money than is currently allowed increases the likelihood of a bad outcome.

SENATOR COGHILL commented on the importance of the assumptions, the POMV, and inflation proofing, all of which he would take into account.

COMMISSIONER DESIGNEE TANGEMAN said this administration has chosen to limit risk by starting with the available revenues and building the budget from there. Starting with the FY19 budget and allowing it to run increases the risk profile and reduces the options over the coming years.

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MR. KING explained that an assumption he built into the model was that the legislature would follow the law. However, that might not be a good assumption if the ERA balance runs low and the legislature decides to prolong the balance of the fund by not inflation proofing the fund or not paying a full PFD. He acknowledged that the legislature could also prolong the balance by asking the corporation to sell an unrealized gain. The legislature has that prerogative, but that will impact the fund, he said.

SENATOR COGHILL expressed appreciation for the reminder.

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CHAIR SHOWER commented that the committee spent an hour to say, "It depends." He asked if he was wrong.

MR. KING replied you're not wrong.

CHAIR SHOWER said there really aren't a lot of options between reducing the dividend or reducing spending or adopting some type of tax. What happens next depends, he said.

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MR. KING said the last two slides address questions that come up frequently when the payback is discussed. He clarified that the governor views the money in the fund as excess to what the fund value should be. From that perspective, these would not be losses, he said, they'd be returns to normal.

He said many people have asked what impact SB 23 would have on the future POMV. The answer is that removing money from the fund results in it earning less and the balance gets smaller. "Five percent of a smaller number is a smaller number." The chart on slide 15 shows how that plays out. The full effect isn't seen for a few years because of the five-year averaging, but it

eventually stabilizes and the POMV calculation is \$130 million less than it would have been if the money was left in the fund.

MR. KING turned to slide 16 that shows the impact of SB 23 on the PFD. The additional payments the next three years reduce the balance which means that dividends will be lower thereafter. He noted that the breakeven point for receiving the back pay comes after 30 years.

SENATOR MICCICHE added, "For context, you're talking about a Department of Public "Safetyish" difference on the POMV draw." He pointed out that the numbers on slide 16 can also vary dramatically in the scenario of continuous budget growth and unstructured draws. He continued, "We're going to do what we can. We've got a challenging mix in the legislature. This can vary dramatically because that impact can hit much earlier and cause somewhat dramatic reductions. This can vary dramatically because that impact can hit much earlier and cause somewhat dramatic reductions or the elimination of the dividend much earlier than when you start seeing the impact in this chart. So again, if everything goes well, this will be great. If everything doesn't it will have a fairly dramatic impacts on future dividends as well as will every other aspect of the state economy."

MR. KING responded that the numbers on slide 16 are an average of the infinite number of possible futures. He thanked Senator Micciche for the comments and said he agrees.

CHAIR SHOWER commented that life is a risk. He thanked the presenters.

He held SB 23 and SB 24 in committee.

[4:40:53 PM](#)

There being no further business to come before the committee, Chair Shower adjourned the Senate State Affairs Standing Committee meeting at 4:40 pm.