

**1/23/09
PRINCIPLES
OF THE
PERMANENT
FUND
PRINCIPAL**

<target><bill></bill><subject>1-23-09 PRINCIPLES OF THE
PERMANENT FUND
PRINCIPAL</subject><comm>HFIN26</comm></target>

Alaska State Legislature
HOUSE FINANCE COMMITTEE

Agenda
1:30 PM

Friday, January 23, 2009

The Principles of the Permanent Fund Principal

- GE Greg Erickson, Economist *Rep*
- Pg Pat Galvin, Commissioner, Department of Revenue *Sen*
- JB Jerry Burnett, Deputy Commissioner, Treasury Division, Department of Revenue *COMS*

Available for questions:

Mike Burns, Executive Director, Permanent Fund Corporation, Department of Revenue *Law*

Mike ~~Bar~~ Barnhill, *ass. stant* Attorney General

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Handwritten notes:
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Erickson
+ Associates
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How the PFD Came to be at Risk

By

Gregg Erickson

1976 amendment to Alaska's Constitution:

- "At least twenty-five percent of all mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payments and bonuses received by the State shall be placed in a permanent fund, the principal of which shall be used only for those income-producing investments specifically designated by law as eligible for permanent fund investments. ..."
- —Article IX, Section 15 [Effective February 21, 1977].

Orange County Debacle

- “The new rule arises in part out of the losses incurred in 1993 by the government of Orange County. Managers of county investments were able to avoid showing the declining market value of bad investments because they were not required to show the loss on the county-owned fund’s income statement. Accounting experts believe that requiring unrealized gains and losses to be reported will help provide early warning of such investment problems.”
- —“APFC asks for legal opinion on status of income, principal,” *Alaska Budget Report*, February 17, 1999

GASB 31

- “Governmental entities, including governmental external investment pools, should report investments at fair value in the balance sheet. ... Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.”

- —“Summary of Statement No. 31, Accounting and Financial Reporting for Certain Investments and for External Investment Pools,” Government Accounting Standards Board, March 1997

1999 Request for Legal Opinion

- “The Alaska Permanent Fund Corporation has asked the national law firm of Morrison and Forrester to prepare a legal opinion on whether the governor’s proposal in HB 90 to remove \$4 billion from the permanent fund would invade the principal of the fund.
- “ ... Communications Director Jim Kelly told the Senate State Affairs Committee that a legal opinion had been requested. The issue arose in the context of ... testimony on ... a bill by Sens. Jerry Ward and Rick Halford to transfer ... the fund’s earnings reserve to the principal.”
- — “APFC asks for legal opinion on status of income, principal,” *Alaska Budget Report*, February 17, 1999

1999 Legal Opinion

- “Attorneys from Morrison and Foerster say Gov. Tony Knowles’ proposal to take \$4 billion from the permanent fund won’t violate the Alaska Constitution. But a formula in state law that is used to calculate income available for dividends (or other purposes) should be changed to avoid a possible conflict-of-laws situation that could occur under new accounting interpretations, the lawyers said in a March 3 opinion. —
- — “Lawyers OK \$4 billion transfer from earnings reserve to CBR,” *Alaska Budget Report*, March 10, 1999

The 2002 Crisis, Part 1

- “For a few days in July a falling stock market shaved \$399.9 million off the principal of the permanent fund. The erosion of principal, the first such event in the fund’s 25-year history, reached its deepest point on July 23, culminating a slide that took the fund’s reserves from a comfortable \$8.6 billion in the spring of 2000 to a negative value in July.”
- —“Fund recovers after market slide eats \$400 million hole in principal,” *Alaska Budget Report*, September 17, 2002.

The 2002 Crisis, Part 2

- “Later in July rising market values erased the deficit, but the issues raised by the episode remain, including
 - “• worries that fund’s constitutional structure is more vulnerable to meltdown than officials had ever realized,
 - “• unsettling legal questions about APFC’s authority to transfer money to the state government when reserves drop into the red, and
 - “• increased doubt over whether the fund will be able to meet its dividend and inflation-proofing obligations in 2003.”
- —“Fund recovers after market slide eats \$400 million hole in principal,” *Alaska Budget Report*, September 17, 2002.

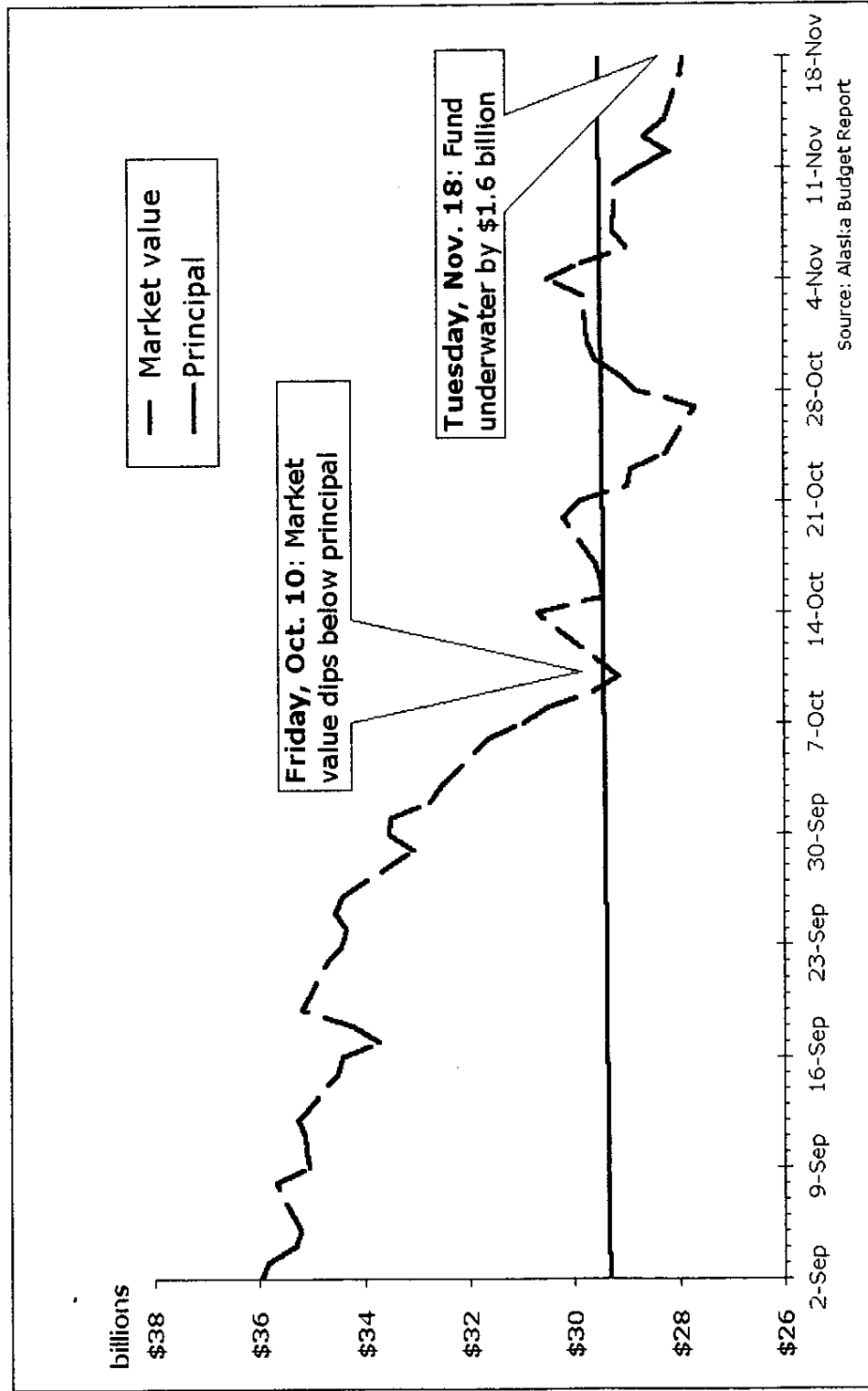
Renkes' Opinion and POMV

- “Only through a constitutional amendment, like that currently proposed by the corporation trustees establishing a payout limit of 5 percent of the total fund value, can the rate of dedication be increased and the deposit of income available for distribution be limited. Absent such an amendment, the full amount of income, made up of the realized gains and losses, is available for expenditure.”
- —Renkes 2003 opinion AG file 663-03-0153

Renkes' Legal Opinion, Part 2

- “There is no basis for expanding the concept of principal by creating a notational number that serves as a limitation on the deposit of income for distribution purposes.”
- —Renkes 2003 opinion AG file 663-03-0153
- “Rep. Eric Croft of Anchorage says he is still pondering a lawsuit to challenge Attorney General Gregg Renkes’ opinion that unrealized gains shouldn’t be considered ‘available for appropriation.’”
- —“What do Democrats really want,” *Alaska Budget Report*, December 33, 2003.

Investment losses of 2008-2009



APFC October 23 letter to OMB

- “Erosion of the supposedly permanent principal has stimulated Alaska Permanent Fund Corporation (APFC) officials to seek guidance from the Palin administration on the appropriateness of continuing to draw money from the fund to pay their own salaries and other corporation expenses. ... ‘In times of extreme market volatility with downward trends, as is the current case questions arise regarding the Permanent Fund’s ability to make cash payments for items such as its operating budget,’ wrote APFC executive director Mike Burns ... in an October 23 memorandum to OMB Director Karen Rehfeld.”
- —“Fund recovers after market slide eats \$400 million hole in principal,” *Alaska Budget Report*, September 17, 2008.

OMB's Reply to Burns

- “A consultation with the Department of Law regarding the corporation’s current circumstances affirms APFC’s interpretation that the [APFC] operating budget should be paid from the positive cash flow in order to meet the FY09 appropriated budget.”
- —OMB Director Karen Rehfeld, Memorandum to APFC Executive Director Mike Burns, November 5, 2008

Current Status

- Principal exceeds market value: fund is \$1.6 billion under water.
- \$1.1 billion needed on June 30 to pay PFD
- \$3.9 billion in realize earnings “reserve” account, but ...
 - ◆ fund investments must grow by about \$2.7 billion (\$1.6 billion + \$1.1 billion) to avoid threat of court intervention.

Options

- Take no action.
 - ◆ Hope markets rise as in 2002.
 - ◆ Hope nobody sues.
 - ◆ If dividends are blocked, deal with economic consequences separately.
 - ◆ Try to find consensus on a POMV amendment for that can win voter approval in 2010.
- Adopt backstop plan.
 - ◆ Pay PFD (all or part) out of CBR, AHFC equity, or other sources.
 - ◆ Hope markets rise before June 30, 2010.
 - ◆ Try to find consensus on a POMV amendment for that can win voter approval in 2010.

Professional History

Economist and journalist Gregg Erickson, was raised in Anchorage. In 1966 he joined the University of Alaska's Institute of Social and Economic Research as a resources economist. In 1972 he left Alaska to take an appointment as a research fellow with Resources for the Future, a Washington, D.C., think-tank.

Erickson's work at RFF on energy economics led to appointment in 1973 to the staff of what is now the U.S. Senate Energy Committee.

In 1976, Mr. Erickson returned to Alaska, becoming director of research for the Alaska Legislature. In 1984 he joined the Alaska Office of the Governor, where he served as senior economist under Governors Bill Sheffield and Steve Cowper. Following the Exxon Valdez oil spill in 1989, he was selected to direct the state's oil spill impact assessment and restoration efforts.

In 1991, Erickson left state government and opened Erickson & Associates, an economic consulting firm, and in the same year founded the *Alaska Budget Report*, a weekly legislative newsletter. He remains affiliated with the newsletter as editor-at-large.

He is co-author of *Mineral Policy and the Public Lands*, editor of two other books, and the author of more than 150 articles, papers and monographs on Alaska economics, public finance and fiscal policy issues. He frequently testifies as an economic expert in state and federal courts in Alaska, and writes a syndicated newspaper column appearing every two weeks in Alaska's largest newspapers.

Erickson is president of the Juneau Symphony Foundation. He is a long-time director of the New York-based Robert Schalkenbach Foundation and has served four terms as the foundation's treasurer. He currently chairs the foundation's Employee Pension Trust. He is married, has four grown children, and three grandchildren.

State of Alaska
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FOR IMMEDIATE RELEASE: June 20, 2003

Alaska Attorney General Issues Opinion Clarifying Permanent Fund Accounting Procedures

(Juneau) – Attorney General Gregg Renkes today released an opinion clarifying that the Alaska Permanent Fund Corporation should only consider realized investment income in calculating the amount available for dividends and inflation-proofing.

After a thorough review of Alaska statutory and case law, the attorney general determined that existing law requires only realized income from investments should be used for expenditures and the calculation of income. Alaska law (AS 37.13.140) is explicit that net income shall be computed “excluding any unrealized gains or losses.” Moreover, this is consistent with what the generally accepted accounting principles were prior to 1997, when unrealized gain or loss was not a part of the income determination.

The Permanent Fund Board of Trustees requested the opinion from the attorney general in order to resolve an apparent inconsistency between that law and revised accounting principles, the attorney general said.

“We hope this opinion will resolve the ambiguity created by differences between our law and standard accounting practices regarding the treatment of unrealized gains and losses,” Renkes said. “This is important because it could affect the amount of money available for Permanent Fund dividends and will affect the calculations the funds necessary for inflation-proofing.”

Alaska law requires the corporation to transfer funds from the Fund’s earnings reserve account at the end of each fiscal year to distribute dividend checks and inflation-proof the principal. While the Alaska Legislature this year made the necessary appropriations authorizing each transfer, declining stock and financial markets had raised concerns that the earnings reserve account would not be big enough to cover those appropriations.

These concerns were exacerbated by an apparent conflict between state law and changes in the Generally Accepted Accounting Principles (GAAP) regarding calculation of the balance of the earnings reserve account, the attorney general said.

(MORE)

Attorney General - Permanent Fund earnings - June 20, 2003 – Page 2

State law holds that only realized earnings (i.e., the gains and losses from the sale of investments, bond interest, stock dividends, and rental property income) were recorded as income in the earnings reserve account. However, 1998 changes to the GAAP required the Permanent Fund Corporation to record the Fund's readily marketable investments at current fair value in its financial statements. In other words, all unrealized earnings (i.e., the difference between market value and the original cost of assets held in the fund) were required to be included in determining Fund income for accounting purposes.

"This inconsistency resulted in large differences between net income as calculated under Alaska law, and net income as calculated using the new generally accepted accounting principles," Renkes said. "The Permanent Fund Trustees looked to us to resolve that inconsistency in their March 14 request for an opinion."

"Although financial markets have significantly rebounded over the past several months, it was imperative that these issues be addressed today," said Renkes. "By clarifying these standards, we ensure that the earnings reported by the Permanent Fund are an accurate representation of its value. It is important that the public and the trustees understand the correct application of the law and that the corporation's financial statements properly inform the public."

As of June 30, 2002 the Permanent Fund recorded net assets totaling \$23.5 billion. Of that total, \$21.8 billion was principal. Since 1982, \$7.5 billion of permanent fund income has been added to principal for inflation-proofing, through June 30, 2002. In addition to the constitutionally and statutorily mandated dedicated revenues, the legislature has made special appropriations to the permanent fund totaling \$6.9 billion. In FY04 the Legislature appropriated an additional amount to principal which could not be determined as of the date of this opinion.

* The Permanent Fund Corporation will announce the amount of this year's dividends on June 30, 2003.

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STATE OF ALASKA

FRANK H. MURKOWSKI,
GOVERNOR

DEPARTMENT OF LAW

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June 18, 2003

Eric Wohlforth, Chair
Board of Trustees
Alaska Permanent Fund Corporation
P.O. Box 110410
Juneau, Alaska 99811-0410

Re: Questions Concerning the Accounting for Principal and Income
of the Alaska Permanent Fund
AG File No. 663-03-0153.

Dear Mr. Wohlforth:

This letter responds to a request from the Alaska Permanent Fund Corporation (the corporation) for an opinion interpreting the provisions of article IX, section 15, of the Alaska Constitution and implementing statutes. Particularly, the APFC trustees ask if their current policies correctly determine net income available for appropriation and the limitations, if any, properly placed upon the expenditure of income from the earnings reserve account.

Introduction

At the end of each fiscal year, AS 37.13.145(b) directs the corporation to transfer to the dividend fund established under AS 43.23.045 an amount that is equal to 50 percent of the "income available for distribution" under AS 37.13.140. In addition, AS 37.13.145(c) directs the corporation to transfer to the principal of the Alaska permanent fund an amount "sufficient to offset the effect of inflation" on the principal ("inflation-proofing"). These transfers are to be made from the permanent fund's

Eric Wohlforth, Chair, APFC Board of Trustees
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earnings reserve account established by AS 37.13.145(a). Separate appropriations authorizing those transfers for the current fiscal year (ending June 30, 2003) were approved by the legislature in the FY 2003 operating budget (sec. 10, ch. 94, SLA 2002).

Although the necessary appropriations for the transfer of money to pay permanent fund dividends and inflation-proofing in 2003 are enacted, possible declines in the financial markets can cause some uncertainty whether there will be a balance available for expenditure from the earnings reserve account to cover the amounts appropriated. The question arises for two related reasons. First, there is an apparent inconsistency between the provisions of AS 37.13.140 and AS 37.13.145, both adopted in the 1980's, and the accounting requirements of GASB 31,¹ which became effective in 1998, regarding how to determine the size of the earnings reserve account from which money may be transferred. Second, although the constitutional provision that created the permanent fund² has always been viewed as providing "protection" for the principal, the

¹ "GASB 31" is shorthand for Statement No. 31 of the Governmental Accounting Standards Board, Accounting and Financial Reporting for Certain Investments and for External Investment Pools.

² Section 15, article IX of the Alaska Constitution provides:

Section 15. Alaska Permanent Fund. At least twenty-five per cent of all mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payments and bonuses received by the State shall be placed in a permanent fund, the principal of which shall be used only for those income-producing investments specifically designated by law as eligible for permanent fund investments. All income from the permanent fund shall be deposited in the general fund unless otherwise provided by law.

nature and extent of that protection are unclear. Accordingly, the corporation requested an opinion from this office to assist in determining how much is available for expenditure from the earnings reserve account to finance the 2003 appropriations for dividends and inflation-proofing.³

Questions presented:

Is the corporation's current policy that only realized income of the permanent fund is available for expenditure under AS 37.13.145 correct? If not, how should the amount available for expenditure from the permanent fund under AS 37.13.145 be determined?

Short answer: We believe that the corporation's policy that only realized earnings are available for expenditure is correct.

Is the corporation's current practice that both realized and unrealized income of the permanent fund should be taken into account in determining the amount that is available for appropriation correct? If not, how should the amount available for appropriation from the permanent fund be determined?

Short Answer: We believe that it would not be correct to compute the amount available for distribution by using unrealized gains and losses to determine

³ Since it is clear under both AS 37.13.145 and the appropriations for permanent fund dividends and inflation-proofing that funding of the PFD appropriation has priority and must be fully paid before any amount is transferred for inflation-proofing, you did not request our advice on whether or how those two transfers should be prioritized or allocated.

income. Existing law clearly provides that only realized gains and losses are allocated to income and are thus available for distribution. Under the relevant constitutional provision, what is not principal is income; therefore any gain or loss not expressly allocated to income must be allocated to principal.

Do the constitution and statutes require that income of the fund may not be appropriated when doing so would bring the total value of the permanent fund including all unrealized gains and losses below the sum of the amounts deposited or appropriated to principal? If not, are there any other limitations with respect to the use of principal that are applicable in determining the amount that is available for expenditure or appropriation from the permanent fund?

Short Answer: We believe that principal is the total value of all deposits and appropriations adjusted for unrealized gains and losses that should properly be allocated to principal. There is no doubt that the principal of the permanent fund cannot be deposited in the general fund and must only be used for income producing investments. However, if unrealized gains and losses are allocated to principal, by definition there is no invasion or misuse of principal if only statutory income, realized gains, is deposited in the earnings reserve fund and available for appropriation.

Before we explain how we arrived at the answers set out above, it is necessary to consider the history of the permanent fund amendment and the actions of the legislature and the corporation to implement the amendment.

Legislative History Relevant to the Questions Presented.

1. Prior to Adoption of the Amendment.

The legislature passed the permanent fund amendment in the form of HJR 39 which was ratified by the voters at the 1976 general election. The effective date of the amendment was February 21, 1977.⁴ The amendment was introduced by Governor Hammond.⁵ The legislative history of consideration of the resolution is primarily devoted to the amount and kind of revenue to be dedicated to the permanent fund. The governor first proposed a 10 percent dedication of mineral revenues but later supported an increase to at least 25 percent.

⁴ The ballot summary read as follows:

This proposal would amend Article IX, Section 7 (Dedicated Funds) and add a new section to Article IX, Section 15 (Alaska Permanent Fund) of the Alaska Constitution. It would establish a constitutional permanent fund into which at least 25 percent of all mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payment and bonuses received by the State would be paid. The principal of the fund would be used only for income producing investments permitted by law. The income from the fund would be deposited in the State's General Fund and be available for appropriation for the State unless law provided otherwise.

1976 Ballot Proposition No. 2.

⁵ The resolution was introduced in January, 1976 as a sponsor substitute for the initial version of HJR 39, introduced by the governor the previous June, which had only proposed amending the dedicated funds provision of article IX, section 7 of the Alaska Constitution to permit the dedication of the proceeds of mineral lease bonuses. The sponsor substitute proposed adding a new section 15 to article IX to create a permanent fund by dedicating 10 percent of nonrenewable resource revenue. The resolution substituted by the governor also expressly provided that the legislature could make additional contributions to the fund. 1976 House J. at 39-40.

In a joint report of the House Judiciary and Finance Committees, the chairmen explained that the principal would be used only for income-producing investments that the legislature could change from time to time to meet the needs of the state. They explained that the effective date of the amendment was delayed somewhat to permit the legislature to provide by law for an investment structure for the fund. Finally, they explained that it was their intent to give future legislatures the maximum flexibility in using permanent fund earnings, ranging from adding to principal to paying out a dividend to residents.⁶

In supporting materials provided at the time of consideration by standing legislative committees, it appeared that the governor intended that the permanent fund could be used to invest in economic development projects with a long term net economic benefit.⁷ This same view was repeated after adoption of the resolution when various proponents took their case to the voters.⁸ Although the voters were told that it was up to the legislature to shape the permanent fund, it was explained that the "income producing"

⁶ Joint Chairmen's Report on CS SSHJR 39, 1976 House J. at 684.

⁷ 1976 House and Senate J. Supp. (fiscal note comments dated January 12, 1976).

⁸ Anchorage Daily News editorial, October 26, 1976 ("a percentage of the fund would go for direct use by Alaskans - for loans to businessmen, fishermen and builders.") The permanent fund was described as a "tool whereby Alaska can take some of today's mineral wealth and prepare for the future by investing in the development of human and material resources that will remain productive for many generations" *Quoting* Revenue Commissioner Sterling Gallagher.

requirement gave the state broad latitude and that local bonds could be purchased as a means of financing instate development.⁹ The Revenue Commissioner reported

I hear public support for the fund from three sectors, . . . from those who favor a savings account approach, those who want it used to provide assistance in community development and those who want it to provide economic diversity in the state. . . . [A] major goal [is] the strengthening of the state's economic base by investing in renewable resources and by policies which would reduce seasonality of employment.¹⁰

The voters were told that "the income from the fund will be available for general appropriation by the legislature but the principal of the fund may not be touched."¹¹ The permanent fund was described as "a lasting savings account."¹²

The object is to prevent future legislatures from doing what previous legislatures did with the \$900 million bonanza received by the state from the sale of Prudhoe Bay leases in 1969. That gigantic sum ran through the legislators' fingers like water, to the alarm of many who had pleaded at the time that the \$900 million be invested, the principal preserved and the state spend only that money derived from interest.¹³

There is fairly strong evidence that the voters were aware that the legislature would have a role in providing the details for administration of the permanent

⁹ Anchorage Times, October 24, 1976 ("Lawmakers Would Shape Permanent Fund").

¹⁰ Anchorage Times, October 14, 1976 ("Panel Mulls Permanent Fund").

¹¹ Anchorage Times, October 27, 1976 ("Governor's Point of View").

¹² Anchorage Daily News, October 24, 1976 (editorial, "Its Permanent").

¹³ Anchorage Times, October 24, 1976 (editorial, "No Easy Choice").

fund. Whether the fund was to be a savings account or a development bank was not resolved by the legislature until four years after adoption of the amendment.

2. Post Adoption

A. Legal Opinions

After the amendment took effect, the attorney general was asked to interpret its meaning for various purposes. Set out below are opinions discussing aspects of the permanent fund that are relevant to our consideration of the corporation's accounting practices.

In August of 1977, the attorney general answered whether money appropriated to permanent fund principal in excess of the amount required by the constitution is irretrievable. The attorney general confirmed that once money was deposited in principal by any means, it could not be removed without further amendment of the constitution.¹⁴ The attorney general advised that the constitution's restriction on the use of fund principal is an implied restriction against the withdrawal of appropriated principal.¹⁵ The attorney general speculated that the legislature probably could not condition appropriations to principal on the ability to withdraw at a future date or to

¹⁴ 1977 Inf. Op. Att'y Gen. (Aug. 31; 663-78-0106).

¹⁵ See also 1986 Inf. Op. Att'y Gen. (Mar. 6; no file number); 1987 Inf. Op. Att'y Gen. (Feb. 12; 663-87-0356).

specify that such amounts would not be considered principal. The attorney general observed that the permanent fund was a "peculiar -- perhaps unique -- quasi-trust."

In September of 1977, the attorney general again interpreted the amendment to determine whether the legislature was required to enact legislation which takes inflation into consideration in the management and investment of fund principal.¹⁶ In this opinion, the attorney general restated the conclusion that the permanent fund was a trust or quasi-trust. This was based on a prediction that "the Alaska Supreme Court will follow a previously exhibited tendency to impose trust-like duties on the state's management of its patrimony" and the amendment "is extremely similar to the classic spendthrift trust both in its roots and causes and in its establishment"

The attorney general also concluded that the legislature acts as a trustee which must prudently exercise any duty in relation to administration of the permanent fund. In this regard, the legislature was advised that its power was not plenary but limited by the constitution and implied trust concepts. This office advised that there was no legal requirement that inflation be taken into account in statutes enacted to implement the permanent fund. The legislature was advised that the foregoing interpretation cannot be considered settled until the supreme court rules on the matter. However, the

¹⁶ 1977 Inf. Op. Att'y Gen. (Sept. 16; 663-78-0107).

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legislature was advised that it could resolve the question of status by making or treating the permanent fund as a trust.

In 1999, the attorney general contracted for an opinion from outside counsel on behalf of the board of trustees to advise on the possible transfer of permanent fund principal to the Constitutional Budget Reserve Fund (CBR). Morrison & Foerster Opinion, March 3, 1999. The advice was sought to assist the state in determining whether a proposed transfer of a portion of the permanent fund's assets to the CBR would involve an expenditure of principal. Similar to earlier legal opinions on the subject, Morrison & Foerster concluded that the permanent fund is not a true public or private trust fund. However, after rejecting the notion that the fund is a trust, the opinion resorts to trust law to support conclusions concerning the possibility of spending principal as a consequence of the transfer of principal to the CBR. Counsel observed that the board of trustees had a fiduciary obligation imposed by statute to preserve principal and to manage fund assets as prudent investors.

Morrison & Foerster accepted without comment the corporation's assumptions regarding principal. Under the corporation's longstanding practice, "principal" is reported as a notational number that changes only with further contributions to the fund - it does not fluctuate with changes in the market value of the

investments purchased with principal.¹⁷ Counsel interpreted AS 37.13.140 as inconsistent with the principal and income allocation rules usually applicable to trusts. They determined that, after the adoption of GASB 31, an invasion of principal would occur if the amount paid out exceeded the balance of the earnings reserve account which, under GASB 31, would include both realized and unrealized gains and losses. It would not occur where, after a distribution, the balance of that fund turned negative. The critical difference, according to that opinion, is between an action of the trustees and the natural fluctuation of the investment markets. The opinion suggests that unrealized losses could not force an invasion of principal. Morrison & Foerster Op. at p. 16, n.7.

At the time of the opinion, the permanent fund was enjoying the benefits of a sustained period of capital appreciation which was accounted for in the earnings reserve. This fact permitted Morrison & Foerster to conclude that, because the fund's GASB 31 earnings reserve account was then substantially in excess of that amount, a \$4 billion transfer of assets was possible to accomplish without "invading principal."

B. Principal and Income Accounting Practices

Next we consider the past principal and income accounting practices applied to the permanent fund and the sources from which those practices were derived.

¹⁷ These contributions have included one-time legislative appropriations to the permanent fund of both income and general fund revenues and the annual inflation-proofing amounts, as well as the natural resource revenues dedicated under the constitutional provision.

These practices show that differing interpretations of principal and income prevailed under previous versions of the fund's enabling statutes.

For the period 1977 - 1980, the permanent fund was under the interim management of the Department of Revenue while legislation was pending to create the corporation. The fund was invested primarily in debt instruments with a fixed rate of return. Ch. 6, SLA 1977. In 1980, legislation was enacted providing for the management of the permanent fund by a public corporation within the Department of Revenue, managed by a board of trustees. Ch. 18, SLA 1980. This legislation modified the rate of dedication to the permanent fund from 25% to 50% of revenue received by the state from mineral leases issued after December 1, 1979, or, in the case of bonuses, after February 15, 1980. The 1980 legislation only authorized the corporation to invest in certain fixed return instruments.¹⁸ Under this statute, income was defined to be the interest earned on investments and any realized gains or losses were to be allocated to principal.¹⁹

¹⁸ The corporation was given authority to place funds in direct obligations of the United States Treasury, federal agency securities, certificates of deposit, high-grade corporate bonds, quality short-term investments, and federally guaranteed loans. The fund was directed to give preference to Alaska investments as long as they met the standards of quality set out in law. Specifically, deposits could be made in Alaska banks, mutual savings banks, savings and loan associations, and credit unions. Residential real estate (owner occupied single family dwellings, duplexes, and condominiums) could also be purchased if the mortgage was privately insured by a company doing business in Alaska.

¹⁹ This legislation was accompanied by a free conference committee report in which the joint committee chairmen explained "[t]he fund is designed to be a trust which focuses on the
(continued...)

In 1982, legislation was enacted making four amendments bearing on the corporation's accounting practices: (1) the authorized list of investments was expanded to include equities; (2) the concept of "net income" was established which included gain or appreciation in value determined by generally accepted accounting principles, excluding unrealized gains or losses; (3) a portion of each year's permanent fund income was targeted for reinvestment back into the fund to offset inflation; and (4) a valid permanent fund dividend program was established. Ch. 81, SLA 1982; ch. 102, SLA 1982.²⁰

During the interim management period of 1977 - 1980, and after creation of the corporation until 1982, the accounting practices applied to the permanent fund distinguished between income and appreciation in the value of investments. For the first two accounting cycles of the corporation (1980 - 1982), income of the fund was defined as "the interest received in a year." Sec. 5, ch. 18, SLA 1980. For the entire period 1977 - 1982 during which the fund was limited to fixed income investments, appreciation

safety of principal first and the maximization of earnings second." 1980 Senate J. at 671. It was intended that the fund would be held to a more restrictive list of investments than other fiduciary trusts.

²⁰ The authorized list of investments has since been expanded at least four more times by the legislature: in 1989 to include investments in non-U.S. securities; in 1992 to include A-rated corporate bonds; in 1994 to expand permissible real estate investments; and in 1999 to make a variety of adjustments to the authorized list, to authorize up to 5% of the fund to be invested in other prudent investments not specifically included in the list, and to increase the allocation limit placed on equity investments.

in value ("gain") was credited to principal, interest was credited to income.²¹ However, if losses exceeded gains, interest was to be transferred to principal in an effort to cover some of the loss. Former AS 37.13.130 (repealed 1982); former 15 AAC 137.060 (repealed 7/12/92).

In 1982 after the fund was authorized to invest in equities, income was defined to include realized gain representing appreciation in value. Under then-applicable generally accepted accounting principles ("GAAP"), only realized gains (and losses) of the fund were recorded as income in the earnings reserve account established under AS 37.13.145. This former GAAP approach was consistent with the statutory requirement of AS 37.13.140 (in effect since 1982) for determining fund "net income" (from which the amount of the annual dividend transfer is then computed), which specifically excluded unrealized gains and losses from the determination.²²

²¹ According to annual financial statements of the permanent fund, realized gain was credited to principal for fiscal years 1980 and 1981. When the permanent fund was under Department of Revenue management, income was deposited in the general fund. After the corporation was created, statutes called for income to be deposited in an undistributed income account.

²² There were actually some minor differences in determining "net income" between the methods called for by GAAP pre-GASB 31 and by AS 37.13.140, but those differences did not affect the underlying requirement of each that only *realized* gains and losses be taken into account. The drafters of sec. 140 were aware of the potential that GAAP and state law might some day be inconsistent. In his transmittal letter, Governor Hammond made clear his intent that the statutory method for computing income should prevail over generally accepted accounting principles. Letter from Gov. Jay Hammond, regarding Sponsor Substitute for Senate Bill 684, 1982 Senate J. at 494, 496 (March 9, 1982).

Eric Wohlforth, Chair, APFC Board of Trustees
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This consistency in treatment ended with the implementation of GASB 31 in 1997. Under GASB 31, the corporation is required to record as revenue in its financial statements the permanent fund's readily marketable investments at current fair value. The corporation has interpreted this change in GAAP as requiring all unrealized market appreciation and depreciation (unrealized gains and losses) to be included in determining income for accounting purposes, potentially resulting in large differences between GAAP net income and "net income" under AS 37.13.140. As a result, the corporation now has two different ways to report income. The first method is to report realized income, as called for by the definition of "net income" under AS 37.13.140, to determine how much is available for distribution. The other method is to apply the GAAP definition and include both realized and unrealized gains and losses to determine net income for financial reporting purposes. Depending on the situation, the corporation applies both approaches in its financial statements. The inherent conflict between these two approaches is at the heart of the request for this opinion.

In late 2001, the audit committee of the corporation considered an issue paper prepared by APFC staff which discussed the policy for determining the amount available for expenditure to pay the dividend and inflation-proofing transfers provided for under AS 37.13.145. The issue paper did not resolve the matter, but recommended the trustees seek a legal opinion from the Department of Law. While the subject was briefly discussed by the trustees, they did not pursue an opinion from the Department of Law at

that time. In the absence of an attorney general's opinion, the corporation has applied a conservative "invasion test" under which realized income may not be spent if doing so causes the total value of the permanent fund and the earnings reserve account to fall below the historic dollar amount ("notational principal") contributed to principal from all sources. Although this limitation is not specifically addressed in the statutes, it was presumably applied in order to "protect" past contributions to principal from diminishment and has been subsumed in the corporation's accounting practices.

Notwithstanding this conservative "invasion test," there have been instances in the past when distributed earnings were more than offset by unrealized losses. These distributions to the state general fund occurred in fiscal years 1978 and 1979 and would have amounted to an expenditure of principal under the corporation's "invasion test." This is apparently why, beginning in 2001, the corporation and corporate counsel recommended obtaining a legal review of corporate accounting policy by this office.

For fiscal year 2002, there was enough realized income accumulated in the earnings reserve account and in excess of "notational principal" to fully pay the 2002 dividend and inflation-proofing distributions without having to apply the limitation regarding invasion of principal. However, given the current investment allocation of the fund, a sustained downward trend in financial markets could result in the total market value of the permanent fund at the end of a fiscal year totaling less than the sum of the

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amount attributed to "notational principal," plus the amount of realized income in the earnings reserve account. If total market value of the permanent fund is less than the sum of those two figures, then current corporation accounting practices would limit the amount available for expenditure under AS 37.13.145 to the amount (if any) by which the total market value of the permanent fund on the last day of that fiscal year, including the earnings reserve, exceeds "notational principal" (the sum of all dedications and appropriations to the principal of the fund over time).

Discussion

At the outset we observe that the permanent fund has not yet experienced market conditions that required the trustees to apply an "invasion test" to limit appropriations from the earnings reserve. It appears, though, that the possibility of this happening caused the trustees to request this opinion. Notwithstanding the apparent lack of immediacy, this opinion is as appropriate and necessary now as it was in 2001 when staff and counsel first recommended it. It is important that the public and the trustees understand the correct application of the law and that the corporation's financial statements properly inform the public. It now appears that the financial condition of the fund and earnings reserve, barring some unforeseen and extraordinary financial event at the end of the fiscal year, will again not test the application of the concepts discussed here. Clearer opinions no doubt result when the law is not looked at through the fog of a looming crisis.

While the permanent fund is not a trust, we resort in part to trust principles to answer the corporation's questions, the central issue of which turns on construction of AS 37.13.140, defining income for purposes of the permanent fund corporation. The terms of every trust are governed by the governing document, statutes, court decision, and general trust principles. In the case of the permanent fund, the governing document is the Alaska Constitution and valid implementing statutes. In arriving at the correct interpretation of sec. 140, we will attempt insofar as possible to harmonize the provisions of that statute with trust principles.²³ However, if there is a conflict, existing law must prevail. An added complication is that the provisions of AS 37.13.140 can be read to be ambiguous regarding the treatment of unrealized gains and losses on assets of the permanent fund. We must determine whether unrealized gain or loss is an element of principal or income. This allocation is important for determining how much is available for distribution in a given year.

All who have considered the legal character of the permanent fund agree that it is not a trust. It is a constitutionally dedicated fund, the principal of which must be invested in income producing assets. However, each analysis inevitably turned to trust principles to support the advice given. Early in the life of the fund, this office advised the legislature that it was not obligated to protect the fund from inflation, but that it could

²³ We have located no case law in Alaska applying trust principles relevant to the questions presented.

undertake that responsibility and make clear that the fund will be operated according to trust concepts. We also advised that the legislature is a trustee when it provides for the administration of the permanent fund. This means that the legislature may be limited in its lawmaking power when it provides meaning to terms and concepts applicable to the permanent fund.

It appears that the legislature intended to act consistent with the advice of this office when it first enacted statutes to implement the permanent fund amendment. In a free conference committee report, the chairmen declared the permanent fund is "... designed to be a trust which focuses on the safety of principal first and the maximization of earnings second."²⁴ The corporation has also done its part to interpret both the constitution and the statutes. The corporation made specific the legislature's direction through various resolutions and policies. The corporation's powers to interpret and make specific the constitution are important. However, because we are interpreting the constitution and enabling statutes, it is not likely that a court will accord deference to interpretations by either the legislature or the corporation.²⁵

²⁴ 1980 Senate J. at 671 (Senate and House J. Supp. No. 7).

²⁵ In *Hickel v. Cowper*, 874 P.2d 922 (Alaska 1995), the Alaska Supreme Court declared that matters of constitutional construction are reviewed *de novo*. The court will determine what the constitution actually means and will approach this task as a question of law which requires the exercise of independent judgment. 874 P.2d at 926.

The constitution uses the terms "principal" and "income" in establishing the permanent fund. As a limited exception to the general constitutional prohibition on dedicated funds, the constitutional amendment creating the permanent fund is explicit in that only principal must remain dedicated for investment and that income should be made available for appropriation from the general fund. This requirement by implication prevents appropriation of principal but does not further define principal or income. It clearly does not require that principal be preserved in the manner contemplated by the "invasion test" or in any way subjugate the availability of "income" for expenditure to the dedication of "principal" to income producing investments.

Consistent with the constitutional dedication of fund principal to one purpose, income producing investment, the legislature has declared a general purpose to provide safety for principal and legislative committees have, in a non-binding way, expressed intent that principal must be preserved. Relying in part on this expression of intent, the corporation interpreted the constitution and enabling statutes to require that principal be recorded at the dollar amount historically deposited by dedication and appropriation without any diminishment for gain or loss on investments. However, in doing so it appears that the corporation failed to consider the potential effect on the constitutional requirement that income be made available for appropriation.

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explained above, the amendment was promoted by some as a savings account that would serve as a form of development bank to help diversify an economy that was too dependent on non-renewable resource revenues. There was also a clearly stated purpose to dedicate oil revenue and prevent expenditure of the dedicated amounts. The amendment expressly provided that income is to be deposited in the general fund or other legislatively authorized purpose. After the amendment was adopted, the legislature abandoned the development bank approach in favor of an investment fund managed by a public corporation authorized to make conservative fixed income investments.²⁶

At the time the permanent fund amendment was adopted in 1976, trust law traditionally allocated gain and loss on equity securities to principal rather than income.

The proceeds of the sale of trust property are ordinarily to be treated as trust principal, even though they include profit in excess of cost price or inventory value. Losses on such sales fall on trust principal. The rule should govern sales of corporate stock where there is a gain in value due to undistributed earnings.

Bogert on Trusts, sec. 120 (6th ed. 1987). As recently as 1984, the legislature chose to adopt traditional allocation rules for common trusts.²⁷

There has been a movement among the trustees of endowment trusts to change traditional allocation rules to permit investment in equity securities. This

²⁶ See discussion of legislative history set out in 1994 Inf. Op. Att'y Gen. (Sept. 23; 663-94-0207).

²⁷ 1984 House and Senate J. Supp. No. 21; see also AS 13.18.020(b) and 13.38.050.

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approach would authorize a trustee to consider capital gain as part of the total return, enabling distributions to beneficiaries without being restricted by whether the returns are accounting income or value appreciation. A uniform act was proposed in 1972 to permit trustees to allocate both realized and unrealized capital appreciation to income for distribution purposes.²⁸ The uniform act is the law in 46 states and the District of Columbia. The UMIFA contains an impairment rule very similar to the "invasion test" contemplated by the corporation. Realized and unrealized gains are offset to determine if the historic dollar amount of contributions to principal will be impaired by a planned distribution. Sec. 2 UMIFA. However, the uniform act is not the law in Alaska. Aside from the difference between the permanent fund and an endowment trust, the uniform act differs from existing law by permitting distributions based on unrealized appreciation. State law charts a different course for the permanent fund by not allowing such a distribution. For that reason, it is not appropriate to apply the impairment rule of the uniform act. When the legislature expanded authority for investments to include equity

²⁸ Uniform Management of Institutional Funds Act, 7A U.L.A. 316 (West Supp. 1997) (UMIFA).

securities, it added a definition of income. AS 37.13.140 provides in pertinent part:

Net income of the fund shall be computed annually as of the last day of the fiscal year in accordance with generally accepted accounting principles, excluding any unrealized gains or losses.

(Emphasis added.) This hybrid definition of income is intended to "to allow the maximum use of disposable income." AS 37.13.020(3). By making clear that "gain" is to be an element of income, the definition of income was expanded to include capital appreciation, but it plainly prevented any distribution of unrealized gain. Section 140 does not explain the accounting treatment for unrealized gains and losses other than to provide that this form of appreciation or loss is to be excluded from the determination of income.

The limitation of income to that which is realized appears to be consistent with the text of both the constitution and statute. The constitution provides the income "shall be deposited in the general fund." Alaska Const., art. IX, sec. 15. The statute provides: "[I]ncome from the [permanent] fund shall be deposited by the corporation into the [earnings reserve] account as soon as it is received." AS 37.13.145(a). When interpreting these words, a court will attempt to discover the plain meaning and purpose of the provision.

Because of our concern for interpreting the constitution as the people ratified it, we generally are reluctant to construe abstrusely any constitutional term that has a plain ordinary meaning. Rather, absent some signs that the term at issue has acquired a peculiar meaning by statutory definition or judicial construction, we defer to the meaning the people themselves probably placed on the provision. Normally, such deference to

the intent of the people requires: "[a]dherence to the common understanding of words."²⁹

The words "deposit" and "received" convey a meaning that income is to be in hand, or realized.³⁰ By applying these common meanings there is no conflict between sections 140, 145, and the permanent fund amendment.

Section 140 defines income with reference to generally accepted accounting standards. Before 1997, these standards did not include unrealized gain or loss in the determination of income. These unrealized values were permitted to be reported in notes at the foot of an agency's financial statements. After 1997, accounting principles changed to require the depiction of investment income as the net increase or decrease in fair value. Fair value is what a willing buyer would pay for the security in an arm's length transaction and necessarily includes unrealized gain or loss on the valuation date of a security held in the corporation's portfolio. Para. 22, GASB 31. This change reflected a concern that the disclosure of fair value in the notes may not have allowed financial statement users to be sufficiently aware of the potential effect of investment gains and losses. Appendix A to GASB 31. Even though GASB 31 requires fair value

²⁹ *Citizens Coalition for Tort Reform, Inc. v. McAlpine*, 810 P.2d 162, 169 (Alaska 1991) (citations omitted).

³⁰ "Deposit" means to "place, cache, or entrust", while "receive" means to "take possession or delivery." Webster's Third International Dictionary.

reporting, the National Council on Governmental Accounting recognized that state law requiring other methods for the computation of income governs when there is a conflict.³¹

The restrictive definition of income set out in AS 37.13.140 embodies a policy instituted by the legislature to allow distributions to be made from the appreciated value of investments in equity securities. However, the legislature permitted appreciation to be considered income only if it is realized. Unrealized capital appreciation is not expressly allocated to either principal or income by section 140. As recounted in our discussion of the accounting practices set out above, realized appreciation was allocated to the principal of the permanent fund until the corporation was authorized to invest in equity securities. It is unclear whether unrealized appreciation was allocated at all, but we presume it would have been allocated to principal as well. We find no evidence that the legislature intended to alter the traditional allocation rules as to unrealized gain or loss. Therefore, we decline to attribute a legislative intent to allocate unrealized appreciation to income for any purpose, including the use of unrealized losses to determine whether there has been an invasion of principal. We believe that this policy is not authorized and could possibly upset the balance in the accounting for principal and income. The better interpretation is to give a consistent meaning to the exclusion of unrealized appreciation

³¹ "Conflicts between legal provisions and GAAP do not require maintaining two accounting systems. Rather, the accounting system may be maintained on a legal-compliance basis, but should include sufficient additional records to permit GAAP based reporting."

(continued . . .)

or loss in section 140 and account for such gains and losses as an element of principal where it has traditionally been allocated.

In our opinion, authority to invest in equity securities does not imply that unrealized gain or loss becomes an element of income for any purpose. The legislature can establish allocation rules for common trusts under its plenary law-making powers. *See Bogert on Trusts and Trustees*, sec. 816 (2nd ed. rev.) (but the best criterion for making [allocation] decisions is the practical treatment of the topic by the courts or the legislature.) We believe that the legislature established such a criterion when it enacted section 140.

Under article IX, section 15 of the Alaska Constitution and the relevant implementing statutes, there is no basis for expanding the concept of principal by creating a notational number that serves as a limitation on the deposit of income for distribution purposes. Once dedicated or appropriated, the principal in the permanent fund is used only for income producing investments the value of which rise and fall in corporation financial statements as unrealized gains and losses dictate. Only through a constitutional amendment, like that currently proposed by the corporation trustees establishing a payout limit of 5 percent of the total fund value, can the rate of dedication be increased and the deposit of income available for distribution be limited. Absent such an amendment, the

Para. 13, National Council on Governmental Accounting Statement No. 1 (Governmental Accounting and Financial Reporting Principles, issued March 1979).

full amount of income, made up of the realized gains and losses, is available for expenditure. It is up to the legislature, as it has done in the past, to appropriate excess permanent fund income to principal.³² A corporate practice cannot operate to prevent the legislature from exercising discretion over the disposition of income.

Finally, we anticipate some will claim that our reading of the constitution and statutes serves to permit a silent invasion of principal when the permanent fund is carrying a large unrealized loss on its books. Realized income does not lose its character as income even if it were offset by unrealized capital losses. There simply is no basis in the history of the amendment or the enabling statutes for a liberal interpretation that

³² As of June 30, 2002 the permanent fund recorded net assets totaling \$23.5 billion. Of that total, \$21.8 billion was principal. Since 1982, \$7.5 billion of permanent fund income has been added to principal for inflation-proofing, through June 30, 2002. In addition to the constitutionally and statutorily mandated dedicated revenues, the legislature has made special appropriations to the permanent fund totaling \$6.9 billion. The amount and sources of these appropriations are set out below:

Permanent Fund Special Appropriations (amounts in millions)		
<u>Year</u>	<u>Amount</u>	<u>Source</u>
FY 81-85	\$2,700	Surplus Oil Revenues
FY 87	1,264	Earnings Reserve Account
FY 96	1,842	Earnings Reserve Account
FY 97	803	Earnings Reserve Account
FY 00	250	Earnings Reserve Account

In FY 03 the legislature appropriated an additional amount to principal which could not be determined as of the date of this opinion.

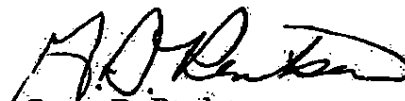
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would expand the scope of the dedicated fund by foreclosing expenditure of traditional accounting or statutorily defined income. To do so would do violence to the plain meaning of the constitution and section 140 which require that income be determined by realized gains and losses and be available for expenditure.

The constitutionally required dedication of principal is more than satisfied by the prudent investing practices of the corporation in statutorily approved investments and the generous inflation-proofing and contributions to principal appropriated by the legislature. We decline to read into either the constitution or the statutes a broader exception to the general prohibition on dedicated funds than can be justified by the plain meaning of article IX, section 15 of the Alaska Constitution and relevant implementing statutory provisions and the history leading to the adoption or enactment of these provisions.

Sincerely,


Gregg D. Renkes
Attorney General

GDR:JLB:jn

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March 3, 1999

Privileged and Confidential

Eric Wohlforth
Chair, Board of Trustees
Alaska Permanent Fund Corporation
P.O. Box 25500
Juneau, Alaska 99802-5500

Re: Transfer of Securities Pursuant to the Proposed Appropriation of \$4
Billion of Permanent Fund Income to the Constitutional Budget
Reserve Fund

Dear Mr. Wohlforth:

On behalf of the Board of Trustees of Alaska Permanent Fund Corporation ("APFC") you have requested our opinion on three questions regarding the transfer of securities from the Alaska Permanent Fund (the "Permanent Fund" or the "Fund") to the Constitutional Budget Reserve Fund to implement a proposed \$4 billion appropriation of income from the Fund by the Governor and Legislature.

Question One: What is the proper definition of principal in the Permanent Fund, and does the plan to identify securities for transfer described in the accompanying memorandum (the "Discussion") in any way involve the expenditure of principal which is prohibited by the Constitution?

Answer: Principal in the Alaska Permanent Fund is an amount equal to the amounts contributed to the Fund by constitutional dedication, statutory dedication, and appropriation. The amount representing the excess of total assets, less total liabilities, over principal are credited to the earnings reserve account. Accordingly, the plan to identify securities for transfer does not involve the prohibited expenditure of principal provided that at the time of transfer the value of the securities transferred does not exceed the amount then credited to the earnings reserve account in the Permanent Fund as determined under generally accepted accounting principles.

Question Two: Is there anything in the Constitution or the enabling act that would conflict with or prevent the plan described in the Discussion from being implemented as presently conceived?

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Answer: No, provided that the proposed legislation described in the Discussion amends the statute to direct that the earnings reserve account shall be determined pursuant to generally accepted accounting principles, amends the net income provision to clarify that it pertains only to the computation of income available for distribution, and directs that the amount of principal remaining in the Permanent Fund be maintained inviolate.

Question Three: What fiduciary obligations are imposed upon the Board of Trustees of the APFC ("Board") when they undertake to identify specific securities within the portfolio of the Permanent Fund for transfer?

Answer: Although not trustees of a true trust, the Board will be subject to the duties of judgment and care imposed by the prudent investor rule — here imposed by statute — whenever they select securities to sell and reinvest. The magnitude of the proposed transaction may impose greater restrictions on their flexibility than would be imposed by the ordinary turnover of a smaller percentage of securities within the portfolio. The proposed alternative method of transferring an across the board "slice" of the Permanent Fund's assets in the form of a unit interest in the commingled investment pool would preserve the existing diversification and asset allocation. Their duty to incur only reasonable expenses would appear to be well served by the proposed in-kind transfer, absent other conflicting considerations. The Board's constitutional duty to preserve principal is not impaired, provided the legislation requiring the transfer directs that principal is not to be impaired by the transfer. The Board's fiduciary duties to the other entities whose funds it administers are essentially limited to those of an investment manager — to follow the statutory prudent investor rule and to account for the principal and income in accordance with the governing statutes of each entity.

In rendering this opinion and responding to your inquiries, we have considered such facts and circumstances as you, the Commissioner of Revenue, the Chief Financial Officer, and others within the staff of the APFC have made available to us that describe the pending legislation, as well as the existing accounting methodologies utilized by the Permanent Fund as described in a memorandum prepared by the Chief Financial Officer of the APFC. We have also relied on discussions with, and a memorandum describing, the Permanent Fund's outside accountant KPMG's accounting analysis of the proposed transaction. Both memoranda are attached to this letter. We have also considered such law as we deemed appropriate and have made assumptions as stated in the Discussion. We have relied primarily on secondary sources for legislative or constitutional history materials due to the apparent lack of original documents. Our review of the books and records of the APFC has been limited to the 1997 and 1998 Annual Reports. This opinion is based upon and subject to those facts and circumstances supplied to us and

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the considerations and assumptions reflected in the Discussion. Unless otherwise defined herein, capitalized terms shall have the meaning contained in the Discussion.

This opinion has been reviewed by the Office of the Attorney General of the State of Alaska and it concurs in our conclusions. This letter responds only to the specific questions asked, and should not be relied upon for opinions on issues that were not specifically requested. This opinion is provided solely for the use of the Board of Trustees of AFPC and may be distributed only as it shall direct.

Very truly yours,


Morrison & Foerster LLP

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DISCUSSION

Discussion appears under the following headings:

- I. Background 5
- II. Constitutional Duty to Protect Principal 5
- III. Character of Fund — Not a True Trust 6
- IV. Relevant Fiduciary Principles 8
- V. Definition of "Principal" 10
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- VII. Impact of a Transfer on Principal 16
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- IX. Limited Fiduciary Duties Analyzed 19
 - A. Prudence in Investing 19
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I. Background

You have informed us that Governor Tony Knowles proposes to appropriate \$4 billion from the income of the Alaska Permanent Fund (the "Permanent Fund" or "Fund"), Alaska Const. art. IX, 15, to the Constitutional Budget Reserve Fund, Alaska Const. art. IX, 17. The size of the proposed transfer would necessitate taking amounts equivalent to both realized and unrealized income from the earnings reserve account as it is determined under generally accepted accounting principles. Moreover, the actual sale of securities in order to realize up to \$4 billion in cash proceeds to transfer would entail large transaction costs. Accordingly, it has been proposed that investments of the Permanent Fund not be sold in order to realize income, but that specific securities equivalent in value up to the amount of income appropriated be identified and transferred in kind to the Constitutional Budget Reserve Fund. Under these circumstances, questions have arisen as to whether the existing constitutional and statutory framework would permit such an in-kind transfer.

II. Constitutional Duty to Protect Principal

In anticipation of a great wave of revenue from Alaska's oil resources and with a historical recognition of the boom and bust nature of natural resource exploitation, the Constitution of the State of Alaska was amended by public referendum in 1976 to dedicate a portion of the State's natural resource revenues to the Alaska Permanent Fund. That same constitutional mandate required that the principal of the fund "shall be used only for income-producing investments specifically designated by law as eligible for permanent fund investments." Alaska Const. art. IX, 15. However, "[a]ll income from the permanent fund shall be deposited in the general fund unless otherwise provided by law." *Id.* This section has been interpreted to safeguard the principal of the fund by removing it from the power of legislative appropriation. Williams v. Zobel, 619 P.2d 448, 453 (Alaska 1980) ("the constitutional provision establishing the fund places the principal of the fund beyond the Legislature's appropriation power, which can be exercised only over earnings derived from the fund"), *rev'd on different grounds*, 457 U.S. 55 (1982).

The constitutional and legislative history are replete with discussions of the meaning and intent of a "permanent" fund. The consensus appears to have been that the principal could never be touched, but was to be invested in perpetuity. As a result, moneys dedicated or appropriated to the Permanent Fund cannot be withdrawn. See Helgath & Bibb, The Alaska Permanent Fund; Legislative History Intent and Operations (Alaska State Senate, January 1986) at 30-33.

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III. Character of Fund — Not a True Trust.

As a predicate to our analysis, the legal status and character of the Permanent Fund must be established. Upon analysis, we conclude that the Permanent Fund does not have the fundamental characteristics of a true private or public trust fund.

First, the Constitution does not actually create a trust. Rather, the enumerated state revenues are placed in a dedicated fund called a permanent fund. This constitutional provision is an express exception to another constitutional provision which prohibits the dedication of state proceeds "to any special purpose, except as provided in section 15 of this article [the Permanent Fund]". Alaska Const. art. IX, §7. And indeed, no specific trust purposes are enumerated—rather, all income is to be deposited into the state's general fund to be expended as the legislature sees fit. Alaska Const. art. IX, 15.

Moreover, simply calling the Board "trustees" does not create a trust. "It is not enough, however, that a statute purports to create a trust: A state cannot magically transform ordinary agents, contractors, or sellers into fiduciaries by the simple incantation of the terms "trust" or "fiduciary." See *In re Khai Tran*, 151 F.3d 339, 342 (5th Cir. 1998).

In this case, the trustees are not designated as trustees of a trust fund but rather constitute the Board of a public corporation created under a statutory charter, AS 37.13.040, and required by the Constitution to be closely tied to the executive branch. See Alaska Const. art. III, §22. Indeed, the Alaska Attorney General has frequently issued legal opinions that the APFC is a state agency, and that its Board officers and employees are subject to the same laws and immunity as other state officials. See, e.g., 1982 Op. (Inf.) Atty. Gen. Alaska, File No. 366-269-83 (Dec. 2, 1983).

Despite the obligation to take care when handling the Fund's investments in order to preserve the safety of capital as well as produce income, AS 37.13.120, "all income" from the Fund is specifically made subject to disposition "by law," and hence is subject to appropriation by the Legislature.

In this instance, the Constitution mandates that the Fund produce income not for beneficiaries of the Fund but for the "general fund" of the State of Alaska or for such other purposes as the Legislature shall direct. Thus, unlike a trust, the Board does not manage Fund assets for beneficiaries, present and future. Rather, it manages the Fund to generate income for distribution as the Legislature, not the Board, directs. Because the disposition of income is subject to the control of the Legislature, which may choose to either distribute it (favoring current recipients) or add it to principal for reinvestment (favoring future generations), the balance between the interests of current and future

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generations is determined by the Legislature, not the Board. Because the determination of the distribution of income is constitutionally reserved to the Legislature, the Alaska Permanent Fund, at least with regard to the disposition of income, is more properly characterized as an investment fund rather than a classical trust fund.

Consequently, the "trustees" of the Permanent Fund do not have the customary trustee's obligations to balance the investments of the trust so as to avoid overgeneration of income for current beneficiaries at the expense of future beneficiaries. The trustees of a classical trust would be required to invest and distribute income in such a manner as to balance the needs of present and future beneficiaries. See *Restatement (Second) of Trusts* 183 cmt. a (duty to deal impartially with the beneficiaries of a trust whether they are entitled to their interests "simultaneously or successively") and §232 (duty to the successive beneficiaries to act "with due regard to their respective interests"); 3A *Fletcher, Scott on Trusts* (4th ed. 1998) §232 at 5-7.

Because the Constitution leaves the distribution of income to subsequent direction by law, the Fund differs from a true trust that creates a class or classes of beneficiaries with a legally enforceable entitlement to income. If a true trust with regard to income had been created in a legal sense, its ascertainable beneficiaries (a necessary component of any trust, see *Restatement (Second) of Trusts* 112 (1959) ("Definite Beneficiary Necessary")) would have enforceable legal rights against the trust and a legal entitlement to their dividends. However, both Alaska and federal courts have rejected any such notion of absolute entitlement. In *Exxon Corp. v. Heinze*, 792 F. Supp. 72,75 (D. Alaska 1992), the court stated that "The right to a dividend is a matter of legislative grace, not entitlement." The Court observed that no individual owns an interest, or has a cause of action to protect his expectancy regarding future dividends. See also *Underwood v. State*, 881 P.2d 322, 327 & n.7 (Alaska 1994) (no Alaskan has a vested right to a dividend, which is a creature of the Legislature and can be abolished at any time); *Beattie v. United States*, 635 F. Supp. 481, 491 (D. Alaska 1986), *aff'd sub nom. Griesen v. United States*, 831 F.2d 916 (9th Cir. 1987), *cert. denied*, 485 U.S. 1006 (1988) ("The people do not 'own' the natural resources nor the proceeds from the same nor the Alaska Permanent Fund. . . . In adopting their constitution, the people of the State of Alaska have very clearly constituted the State as owner of the natural resources which give rise to the fund [Permanent Fund] in question."); *State v. Anthony*, 810 P.2d 155, 158 (Alaska 1991). Indeed, the IRS has ruled that current distributions, *i.e.*, dividend payments, are not distributions of Permanent Fund income, but rather are distributions of State funds. Rev. Rul. 90-56, 1990-2 C.B. 103 (1990).

Likewise, there is no class of remainder beneficiaries who ultimately would receive the principal of the trust. In contrast, under a private trust, "[a]lmost every trustee finds that the trust terms require him to pay or apply income to or for a

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temporary beneficiary, and to distribute principal to one or more beneficiaries prior to or upon termination of the trust." G. Bogert, Trusts and Trustees, (rev. 2d ed.) Ch. 39, §816, at p. 339. The constitutional history plainly indicates that the Permanent Fund was to be exactly that — *permanent*. "Unlike most trusts, the principal may not be reached whatever, either now or in the future. No one has a future right to principal." Helgath & Bibb, The Alaska Permanent Fund: Legislative History, Intent, and Operations (Alaska State Senate, January 1986), at 32 (quoting State of Alaska Department of Law Letter to Representative Clark Grucning (Aug. 31, 1977)).

These facts, which distinguish the Permanent Fund from a true trust, are reinforced when considering other public trusts, each of which imposes duties on the trustees not only to manage the fund, but also to distribute the income to specified classes of beneficiaries. The state statutes reflect that the Alaska Legislature has either established or has inherited from Congress legislative authority over legal trust funds in other contexts. See, e.g., Public School Trust Fund, AS 37.14.110-37.14.170; Alaska Children's Trust, AS 37.14.200-37.14.270; Mental Health Trust, AS 37.14.001-37.14.099. When it was intended that such state funds have a more traditional trust character, they were designated trust funds with duties to identifiable beneficiaries. For example, the enabling act for the Mental Health Trust specifies that the trust has beneficiaries, and charges the trustees with duties towards the beneficiaries. AS 37.14.007(b).

We conclude therefore that the Permanent Fund is an investment fund, not a true trust fund.¹ Indeed, to a great extent it is *sui generis*, and not readily susceptible to analogies or traditional concepts. Compare Beattie v. United States, 635 F. Supp. 481 (D. Alaska 1986), *aff'd sub nom. Griescen v. United States*, 831 F.2d 916 (9th Cir. 1987), *cert. denied*, 485 U.S. 1006 (1988).

IV. Relevant Fiduciary Principles

¹ We note that in 1997 the Government Accounting Standards Board circulated an Exposure Draft of "Basic Financial Statements — and Management's Discussion and Analysis — for State and Local Governments", which would require reporting from dual perspectives at both the entity-wide perspective and at the fund perspective. These financial reporting standards would define a new type of fund, Permanent Funds. These funds would consist of certain funds previously classified as Nonexpendable Trust Funds. This category would be included in the proprietary fund category, although such Permanent Funds presented at the fund perspective level would be presented in the entity-wide financial statements as governmental activities. The Permanent Fund category would include funds that are legally restricted to the extent that only earnings and not principal may be used for purposes that support the reporting government's programs (i.e., for the benefit of the public).

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Despite the foregoing, trust law has some relevance to interpreting the statutory and constitutional obligations of the Permanent Fund. The Legislature has imposed certain statutory fiduciary obligations upon the Fund that are rooted in trust law. See *Restatement (Second) of Trusts* §2, cmt. b (1959) ("Fiduciary Relation") (limiting the duty of a fiduciary to act for the benefit of another "within the scope of the relation"); *SEC v. Chenery Corp.*, 318 U.S. 80, 85-86, 63 S Ct. 454, 458, 87 L. Ed. 626, 632 (1942) (opinion of Frankfurter, J.) ("To say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?"); A. Scott, "The Fiduciary Principle," 37 Calif. L. Rev. 541 (1949) ("Some fiduciary relationships are undoubtedly more intense than others. The greater the independent authority to be exercised by the fiduciary, the greater the scope of his fiduciary duty.")

In this instance, the Board's fiduciary duties are provided by statute, which specifically imposes the prudent investor rule on the Board, admonishing it to "exercise the judgment and care under the circumstances then prevailing that an institutional investor of ordinary prudence, discretion, and intelligence exercises in the management of large investments entrusted to it not in regard to speculation but in regard to the permanent disposition of funds, considering the probable safety of capital as well as probable income." AS 37.13.120.

Here, the fiduciary duty of the Board is limited to preservation of principal and money management; the Governor and Legislature are in charge of distribution of income. This Board is obligated to manage the investments of the principal by the prudent investor rule, a rule traditionally applicable to trusts. It is charged with a paramount duty to preserve principal, again a fundamental trust law concept.

We believe that in analyzing the questions presented here, a Court would look to the plain language of the Constitution and implementing legislation, their purpose and intent, the decisional law of the state, and to the past practice of the responsible administrative agencies. See G. Bogert, *Trusts and Trustees*, (rev. 2d ed.) §816 at p. 340 ("the best criterion for making decisions [as to what is principal] is the practical treatment of the topic by the courts or legislatures.") And secondarily, when faced with the duty to interpret the applicable provisions of law absent controlling statutory or constitutional guidance, the Alaska courts also will look to basic trust law principles for analogies to guide their rulings.

A fundamental rule of trust law is that a trustee has such powers as are specifically conferred by the terms of the trust. The expression "terms of the trust" is here used in the broad sense, *Restatement (Second) of Trusts* 186, and frequently

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includes statutory terms such as the prudent investor rule. A basic rule of trust construction is that the courts will interpret the trust documents in such a way as to implement the intent of the creator of the trust. Similarly, when the courts come to interpret and apply legislation, they construe legislation in accord with the legislative purposes. By either standard, the primary focus will be to determine what was intended. The statutory and constitutional provisions — the “terms of the trust” — will govern over general default rules of trust law, which will be applied only where the terms are silent. With these distinctions in mind, we turn to the relevant sections of the Alaska Constitution and the Alaska statutes.

V. Definition of “Principal”

The starting point for a definition of principal is the fundamental distinction between principal and income. Trust law divides the assets of a trust between the mutually exclusive categories of principal and income. Black's Law Dictionary (5th ed. 1979) defines “principal” as “property as opposed to income. The term is often used to designate the corpus of a trust.” The Revised Uniform Principal and Income Act (“RUPIA”), which Alaska has adopted for *private trusts*, defines principal as: “The property that has been set aside by the owner or the person legally empowered so that it is held in trust eventually to be delivered to a remainderman while the return or use of the principal is in the meantime taken or accumulated for an income beneficiary.” AS 13.38.020(b). By contrast, income is defined as: “The return in money or property derived from the use of principal, including” AS 13.38.020(a). Even in private trusts, however, the terms of the trust may override the classic treatment of principal and interest by specific direction. AS 13.38.020(a); see *Restatement (Second) of Trusts* §§232-233.

Neither the Alaska Constitution, the statutes, nor the decided cases announce a comprehensive definition of the “principal” of the Permanent Fund, although they prescribe that certain amounts be dedicated or allocated to the Fund's principal. The statutes have defined “income” in different ways at various times which provides some guidance because what is income is not principal and what is not principal must be income. For the reasons stated below, we believe that a coherent definition of principal nevertheless may be derived from the Alaska Constitution and statutes, which is supported by analogy from trust law.

The drafters of the Constitutional clause that established the Permanent Fund had an overriding concern with the preservation of principal for the production of income for future generations. See Free Conf. Comm. Rept. for SB 161, p.1 (May 4, 1979). This duty was recognized by the Legislature when it enacted provisions to inflation-proof the principal of the fund, and is recognized by the Trustees themselves in managing their

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investments. Alaska Permanent Fund Corporation, 1997 Annual Report, p. 1. Classically, the principal of a trust, or its "corpus," is the amount set aside to fund the trust when it is first created or "settled." Extending this principle to the Permanent Fund, the principal of the Fund clearly includes the amounts constitutionally dedicated to the Fund, that is, at least twenty-five percent of:

- mineral lease rentals,
- royalties,
- royalty sale proceeds, and
- federal mineral revenue sharing payments and bonuses.

Alaska Const. art. IX, 15.

In addition, such additional funds as the Legislature has directed to the Fund also constitute its principal. By statute, the Legislature has increased the constitutionally dedicated amounts from certain mineral leases to fifty percent of the enumerated revenues. AS 37.10.010. The Legislature also has enacted provisions further dedicating amounts for inflation-proofing pursuant to the statute, AS 37.13.145 (c), and transferring settlement earnings to principal, AS 37.13.145(d). And from time to time, the Legislature has appropriated additional amounts specifically to principal. See AS 37.13.010(a)(3). See, e.g., 1983 Op. Atty. Gen. Alaska No. 234 (Sept. 23, 1983) (discussing inflation proofing — reflects consistent legislative view that principal is limited to monthly deposits of these enumerated revenues plus specific appropriations to principal).

This definition of principal is consistent also with the core concepts of trust law. The principal of a private trust would be the amount that the settler of a trust set aside for the future.

In a private trust, however, some portion of earnings also would be directed to principal absent specific direction from the trust document. For example, the Restatement of Trusts and the Uniform Act provide definitions of how profits, gains, dividends and interest should be allocated between principal and income. By implication, these authorities prescribe what increments of profit from investments shall be added to principal. For example, unless otherwise provided by the terms of a private trust, realized capital gains would be added back to the principal of the trust. This allocation is necessary in the private trust context because of the need to balance the interests of current and remainder beneficiaries.

The governing law for the Permanent Fund, however, does not look to private trust law principles for guidance, but rather establishes a different treatment for gains,

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whether realized or unrealized.² First, under the Constitution, all income from the Permanent Fund is directed to the general fund of Alaska and is not added back to principal unless the Legislature directs otherwise. Alaska Const. art. IX 15. Indeed, the Constitution expressly directs that principal be used "only for income-producing investments", Alaska Const. Art. IX, 15: it does not require that any portion of it be used for principal-producing investments. The legislative history of the constitutional Permanent Fund provision indicates that the legislative intent behind the constitutional mandate depositing all income into the general fund was to give "future legislatures the maximum flexibility in using the fund's earnings—ranging from adding to fund principal to paying out a dividend...." Joint Comm. Rept. on HJR 39, 1976 House Journal, p. 635.

The history of legislative direction and control over gains and losses further supports the conclusion that they are allocable to income. The statutory scheme does not rely on traditional trust definitions of income or principal, but rather focuses on whether a particular inflow of money is to be considered "net income" under generally accepted accounting principles. AS 37.13.140. Thus under the statute, a capital gain of the Permanent Fund is allocated to income, not to principal. AS 37.13.140. Consequently, the Legislature's definitions of income reinforce the conclusion that principal consists exclusively of the constitutionally and statutorily-mandated sums plus additional legislative appropriations.

A related question is whether principal of the Permanent Fund consists of an identified, specific set of assets. We believe not. The sums set aside for the Permanent

² We believe a court would recognize that when the Legislature intended to incorporate specific provisions of private trust law, it chose precise language to do so. For example, other state trust funds have provisions that require that realized revenues, depending on their character as gains, losses, interest or dividends, are allocated to either principal, which must be preserved, or income which may be expended by the legislature for any public purpose. To illustrate, the enabling act for the Mental Health Trust expressly provides that principal and income are to be determined according to the guidelines applicable to private trusts. AS 37.14.031(d), citing AS 13.38 (the Revised Uniform Principal and Income Act). The governing statutes for the Public School Trust Fund, the Alaska Children's Trust, and the Alaska Heritage Endowment Fund all expressly provide that (1) income does not include capital gains or losses realized on principal, and (2) capital gains or losses realized on the principal shall be retained in the respective trust funds perpetually for investment as additions to principal. AS 37.14.110(c)(Public School Trust Fund); AS 37.14.240(a) (Alaska Children's Trust); AS 37.14.530(a) (Alaska Heritage Endowment Fund). In contrast, the Permanent Fund enabling act, as amended by the legislature, defines net income to include all realized income (regardless of its character as gain, dividend or interest), and excludes only *unrealized* gains or losses. AS 37.13.140.

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Fund are cash revenues from identified resources and activities, which are invested in income-producing investments. This is not like a public land trust, for example, where the principal consists of specifically identifiable or tangible assets. Cash, by definition, is fungible — one dollar has no different character than any other dollar. The Permanent Fund principal cannot be traced to specific investments separate and apart from the investments representing reinvested earnings. Thus principal is an aggregate amount, consisting of the sum of all constitutional dedications, statutory transfers from income, and legislative appropriations. So long as the Permanent Fund records and separately accounts for these sums, the amount of principal has been identified. However, principal is not specifically identified to particular assets.

VI. The Meaning of Income

To answer the question of whether and when an invasion of principal could occur, we must consider the definition of income. The first statutory definition of income was found in section 37.13.140 ("Income") and its companion provision, section 37.13.130 ("Gains and Losses"). Income was then defined as "interest received in a year." Under section 37.13.130, the net gains from the sale of securities were to be added to principal, which was intended to help offset the effects of inflation. Free Conf. Comm. Rept. for SB161, p.2 (May 4, 1979).³ It also provided that an amount equal to net losses from such sales should be deducted from income and added to principal, which was intended to protect the principal from erosion. *Id.* No specific legislative direction of such net gains to principal would have been necessary or possible if net gains were not otherwise included in income, and hence subject to legislative control.

Section 37.13.130 was repealed in 1982. At that time, section 37.13.140 was amended. Although the Section is titled "Income," it begins by discussing "Net Income." It does not define net income but directs that it be computed annually "in accordance with generally accepted accounting principles, excluding any unrealized gains or losses."⁴ Section 37.13.145, titled "Disposition of Income," also does not define income directly, but rather provides that "Income from the fund shall be deposited by the corporation into the [earnings reserve] account as soon as it is received."

³ This language reflects the Permanent Fund's statutory investment limitations. At the time, the Board lacked the power to invest in equities; the securities in question presumably would be bonds and other interest bearing investments such as mortgages.

⁴ A later amendment clarified that income from the earnings reserve account is also included within income. 1992 SLA Ch. 134, §19.

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Section 37.13.140 references generally accepted accounting principles for the determination of net income. At the time section 37.13.140 was first adopted, generally accepted accounting principles did not recognize unrealized gains or losses in income. In 1997, the Governmental Accounting Standards Board ("GASB") adopted Statement No. 31 ("GASB 31"). That standard requires that unrealized gains (or losses) be taken into account in determining net income. Consistent with the adoption of GASB 31, the Permanent Fund for reporting purposes now periodically marks to market its investment portfolio and reflects unrealized gains and losses in its statement of revenues and expenses.

The statutory reference to the definition of net income provided by generally accepted accounting principles, in turn, poses several interpretative issues: First, is there a difference between income and net income for statutory purposes? Second, given the change over time in generally accepted accounting principles ("GAAP"), has the statutory language become internally inconsistent or can it be reconciled with GAAP?

Is there a viable distinction between "income" and "net income" for purposes of section 37.13.140 or section 37.13.145 or both? Standard accounting texts recognize the concepts of gross and net income; income, however, can be one or the other depending upon the context. Gross income, however, is income before expenses, i.e. is equivalent to gross revenues. Net income, in turn, is defined to be what is generally conceived of as profit. One standard accounting text defines net income as "the net increase in net assets (owners' equity) of the firm, assuming no new capital contributions by the owners or dividend distributions by the business." Williams, Stanga, Holder, *Intermediate Accounting* (1984). Thus, net income as typically understood for accounting purposes is consistent with the broader GASB 31 definition although not consistent with the definition of section 37.13.140.

One might argue that a distinction between income and net income is supported by the difference between the title of section 37.13.140 — "Income" — and the use of the term "net income" in the statutory language itself. We do not believe a court would favor this view. A common principle of statutory and contract interpretation is to disregard section titles. Sutherland Stat. Const. §47.14 (5th ed. 1992 & 1998 Supp.). The only reference within section 37.13.140 to "income" other than "net income" is the term "income available for distribution," defined as a percentage of net income for the last five fiscal years. This usage of "income" is not inconsistent with the usage of "net income" in that section.

Although it could also be argued that the statute adopts the determination of net income under generally accepted accounting principles, this incorporated definition must be read as modified by the plain text of section 37.13.140, which expressly

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excludes from net income unrealized gains and losses. The available legislative history suggests that the Legislature made a conscious decision to reject inclusion of unrealized gains and losses in the determination of net income for dividend purposes.³ Moreover, this reading of "net income" is consistent with the use of "income" in section 37.13.145(a) — "income" appears to be limited to that which can be "deposited . . . as soon as it is received," i.e., cash or realized income. Finally, it is inconceivable that the Legislature could allow a nongovernmental party ("GASB") the discretion to decide in the future what is net income for purposes of calculating the payment of State funds without creating a potential improper delegation of legislative power.

The inconsistency between GAAP and the statutory definition of income is further exacerbated by the discrepancy between the earnings reserve account as it is computed under generally accepted accounting principles ("the GAAP earnings reserve account") and the statutory earnings reserve account described in section 37.13.145(a). The statute establishes the earnings reserve account as a separate account in the Fund. It then states, however, that "income from the fund shall be deposited by the corporation into the account as soon as it is received." AS 37.13.145(a). The obvious implication is that the statutory earnings reserve account includes only realized income. This language made sense in an era when generally accepted accounting principles also required earnings to be realized before being treated as income and included in an earnings reserve account. However, this statutory provision is inconsistent with current generally accepted accounting principles.

Because unrealized gains and losses are now taken into income for accounting purposes, the earnings reserve account used for accounting purposes (the "GAAP earnings reserve account") contains both realized and unrealized gains and losses. That is, the GAAP earnings reserve account used for accounting purposes now contains all

³ The legislative history of the 1982 amendments to AS 37.13.140 suggests that the sponsors of the amendment were aware of the potential that such an inconsistency might develop between the statutory exclusion of unrealized gains and losses and GAAP. The Governor's transmittal letter for the amendment observes that the provision was consistent with GAAP at that time. The Governor, however, notes that "we are advised that the GAAP may be revised to allow inclusion of unrealized gains and losses while computing net income. While it is important for sound management to know the market value of the fund, this concern is satisfied by the reporting requirement of AS 37.13.170. The Board of Trustees has determined, and I concur, that since the amount of income available for distribution is fixed by statute and may not be altered by the Board, it is imperative for sound management of the Fund to ensure the exclusion of unrealized gains and losses when computing distributable income." Letter from Gov. Jay Hammond, regarding Sponsor Substitute for Senate Bill No. 684, 1982 Senate Journal 494, 496 (March 9, 1982).

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income of the Permanent Fund as that concept is defined by generally accepted accounting principles. At any point in time, then, the assets of the Fund are divided between the GAAP earnings reserve account and the principal.

VII. Impact of a Transfer on Principal

When would an invasion of principal occur? An invasion of principal would occur if a proposed pay-out from the Fund exceeded the current balance of the earnings reserve account. Past Permanent Fund dividend pay-outs have not tested this limitation because they were constrained by the limitation of section 37.13.140 against including unrealized gains and losses in income. In other words, the Permanent Fund had a cushion of retained earnings (consisting of unrealized gains and losses) that, in an accounting sense, protected it against coming close to an invasion of principal.⁶ After adoption of GASB 31, an invasion of principal would occur if the amount transferred or paid out of the earnings reserve account exceeded the balance in the account, which balance now includes both realized and unrealized gains and losses due to the operation of GASB 31.⁷

We have been advised, and we have assumed for purposes of our opinion, that the past practice of the legislature, the State, the APFC, and its accountants and outside auditors — since the inception of the Fund — has been to treat principal as a balance of the accumulated sum equal to the value of the total assets contributed to the Fund by constitutional dedication, Alaska Const. art. IX, 15, statutory dedication, AS 37.13.010, 37.13.145; *see* AS 37.13.020, and legislative appropriation. We have also been advised, and we have assumed for purposes of this opinion, that principal is not specifically attributed to any particular asset in the Fund, but is maintained as a balance amount in the Fund as a whole. Accordingly, under the present accounting methodology, the

⁶ Another protection is found in section 37.13.145(b), which provides that only 50% of the income available for distribution is transferred to the dividend fund.

⁷ A logical question occurs. What if most of the balance of the earnings reserve account were paid out and some time later the stock market suffered a major correction? In that hypothetical situation, the value of the earnings reserve account would turn negative. Would that negative balance, be offset against the principal balance and if so, would that constitute an invasion of principal? The answer is negative. An invasion of principal would occur where the Permanent Fund had attempted action to pay out more than the balance of the earnings reserve account. It would not occur where, after a payout, the balance of that fund turned negative. The critical difference is between an action of the trustees and the natural fluctuation of the investment markets. One is an action over which the trustees have control; the market fluctuation is not.

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excess of market value of total assets over principal, less total liabilities, is credited to the earnings reserve account. Accordingly, when a dividend is paid, principal always remains in the Fund and is not impaired when specific securities are sold and the entire proceeds transferred out of the earnings reserve account. So long as the value of the assets remaining in the Fund less the total liabilities at the time of the transfer is greater than the principal balance amount, the decrease in assets in the Fund caused by the transfer is balanced by a decrease in the balance attributed to the earnings reserve account, leaving the principal balance unimpaired.

Because the actual sale of securities and the transfer of the proceeds of such a sale would not result in any impairment of principal so long as the value of the remaining assets of the Fund (less total liabilities) exceed the principal balance, it is our opinion that the direct transfer of those assets at their fair market value also does not impair principal, provided that at the time of transfer the value of the securities transferred does not exceed the amount in the Permanent Fund earnings reserve account as determined under generally accepted accounting principles.

VIII. Statute Inconsistent With GAAP

The statutory framework for the Fund distinguishes the treatment given to realized and unrealized income. Section 37.13.140 provides, "Net income of the fund shall be computed annually as of the last day of the fiscal year in accordance with generally accepted accounting principles, excluding any unrealized gains or losses." For a period of time only the statutory net income consisting of net realized gains was credited to the earnings reserve account established by section 37.13.145(a), which provides, "Income from the fund shall be deposited into the [earnings reserve] account as soon as it is received. Money in the account shall be invested in [authorized] investments...." However, with the adoption of GASB 31, the chief financial officer of the APFC began valuing investments at market on a monthly basis and crediting unrealized net earnings to the balance of the earnings reserve account for financial reporting purposes. Accordingly, for financial reporting purposes, the earnings reserve account now holds both realized and unrealized net gains in the income that has been credited to it.

The statutory definition of net income in section 37.13.140 requires both adherence to generally accepted accounting principles, which requires marking assets to market value, and the exclusion of unrealized market gains and losses. This conflict creates problems with regard to whether or not the "income" of the Fund that must be deposited in the earnings reserve account, and from which the legislative appropriation shall come, should properly include unrealized gains and losses. One possible solution to the problem would be to simply sell the securities, which would convert any

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unrealized gains or losses attributable to those securities into actual realized gains credited to the earnings reserve account that could then be transferred to the Constitutional Budget Reserve Fund. The difficulty with this approach is that selling securities on the open market generates additional expenses in the form of brokerage commissions and other transaction costs. If the securities could be transferred in kind at their fair market value, the Fund would be spared the expenses associated with the sales, and hence more Fund assets would be preserved. The difficulty is that it is not clear that the "income" held in the earnings reserve account under section 37.13.145(a) properly includes the unrealized gains and losses not included in "net income" under section 37.13.140.

Because the ambiguity has been created by section 37.13.140, it may be remedied the same way — by amending the statute to conform to generally accepted accounting principles to provide that income held in the earnings reserve account shall include both realized and unrealized gains and losses.⁸ As income, the amounts in the earnings reserve account are subject to disposition as directed by statute without invading principal. Any proposed legislation should further direct that the principal shall be maintained inviolate.

If the statute is amended as described above, then a transfer of \$4 billion of securities from the Permanent Fund to the Constitutional Budget Reserve Fund can occur without either affecting the dividend or requiring the realization of the gain associated with the particular securities that are transferred. Our conclusion is premised upon not only the amendment of the statute as described above, but also the advice that we have received from the Permanent Fund's accountants ("KPMG") that this transfer would be a one time non-standard, non-recurring event, which would be treated by the accountants as a residual equity transfer and permissible under generally accepted accounting principles as such. The consequence of this transfer would be that the earnings reserve account, assuming that it had more than \$4 billion of realized and unrealized gains and losses, as well as other income, would be reduced by \$4 billion as would the assets of the Fund. We are advised by KPMG that the particular unrealized gain that, in a theoretical sense, could be identified to the transferred securities would not be realized, and thus would have no immediate impact on the dividend calculation. Any impact on future dividends would be the result of the reduced amount of investments in the Fund, as well as any limitation on future pay-outs imposed by the

Amend statute then

⁸ To maintain the legislature's intent that the dividend shall be based on a measure of distributable income that excludes unrealized gains and losses, a companion amendment to Section 37.14.140 should clarify that the calculation of net income under that section is solely for the purpose of calculating the dividend.

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decreased level of income in the earnings reserve account. The Constitutional Budget Reserve Fund would receive these securities at the fair market value on the date of transfer.

IX. Limited Fiduciary Duties Analyzed

In carrying out the proposed transfer, the Board will be subject to the same duties of prudence and care that apply whenever it selects securities to sell and reinvests; although the magnitude of the proposed transaction will impose greater restrictions on its flexibility than would be imposed by the ordinary turnover of a smaller percentage of securities within the portfolio. The duty to incur only reasonable expenses would appear to be well served by the proposed in-kind transfer, absent other conflicting considerations. The limited duty of impartiality and the duty to preserve principal are not impaired provided that the Board's acts are directed by the legislation requiring the transfer.

A. Prudence in Investing

The Board has adopted policies that pay careful attention to and comply with the concepts of diversification, asset allocation, and "total return"—the latter defined as "the realized income plus the net change in unrealized gains and losses. Realized income includes interest, dividends, real estate cash flow and realized capital gains." Alaska Permanent Fund Corporation, 1997 Annual Report, p. 3 note. The proposal does pay attention to total return, but reduces equity allocation and therefore diversification until rebuilt by future receipts and investments. However, this is a function of the fact that the unrealized gains and losses that are being transferred are due, in very large part, to appreciation in equities. The change in asset allocation is therefore a function of where the unrealized gains and losses to be transferred occur, not the consequence of a deliberate investment choice by the Board.

The Board will need to exercise care when selecting the stocks to be transferred to make sure that it has evaluated the impact of its divestiture program both on the overall risk of its portfolio, and on the investment policies that it has chosen in constructing its current equities portfolio.

We understand that one methodology under consideration as an alternative to selecting assets for transfer would be to implement the proposed transfer by transferring to the Constitutional Budget Reserve Fund a percentage across-the-board "slice" of the Permanent Fund's assets, representing \$4 billion in value. The Constitutional Budget Reserve Fund would become a unit holder in the combined funds' investment pool, similar to the interests held by the Alaska Mental Health Trust, the Alaska Science and

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Technology Foundation, and the International Trade and Business Endowment. See Discussion Part IX.D. below. This proposal would not disturb the asset allocation or diversification of the investment pool, nor would it impose unnecessary costs.

B. Duty to Minimize Expenses

A trustee must "incur only costs that are reasonable in amount and appropriate to the investment responsibility of the trusteeship." *Restatement (Third) of Trusts* §227(c)(3) (1992)(prudent investor rule). One of the clear advantages of an indexed approach to equity investments is that stock turnover is very low, thereby minimizing the losses that would otherwise occur in the form of commissions paid to brokers to execute trades. The need to sell stocks in order to generate cash proceeds to transfer decreases this advantage to the indexing investment strategy. However, the proposed direction of an in-kind transfer is clearly compatible with the duty to minimize costs, because it should substantially reduce the transaction costs that would otherwise attend the selling of a significant proportion of the Fund's equity portfolio.

C. Fiduciary Duty of Loyalty — to the State

The *Restatement (Second) of Trusts* §2, cmt. b (1957) states: "b. *Fiduciary relation*. A person in a fiduciary relation to another is under a duty to act for the benefit of the other as to matters within the scope of the relation." Here, the Board's duty is owed, not to specific beneficiaries, but to the State for which it manages the Permanent Fund in accordance with the statutes.

Here, the terms of the Constitution specifically reserve the disposition of "all income" to direction by the State "by law." Alaska Const. art. IX, 15. The removal of \$4 billion in trust assets cannot help but reduce the amount to be available in the future for dividends because the lesser amounts to be invested will, all other things being equal, result in lower absolute amounts of income realized on those investments even if the current rate of return is maintained. However, the duties of this Board do not extend to distribution of income except as directed by law. Accordingly, no duty of loyalty within the scope of the discretion given to these trustees is implicated by the transfer itself.

D. Investments Managed on Behalf of Other Entities

Separately, there may be impartiality issues vis-à-vis the other state funds that invest through the Permanent Fund that will need to be handled to make sure that whatever interests they may have are kept whole. By statute, the Alaska Mental Health Trust (AS 37.13.300, 37.14.001 - 37.14.099), the Alaska Science and Technology Foundation Endowment (AS 37.17.010 - 37.17.110), and the International Trade and

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Business Endowment (AS 37.17.440)(collectively referred to hereafter as "other funds") are invested by the APFC under the same investment authority as the Permanent Fund is managed. Alaska Permanent Fund Corporation, 1998 Annual Report, "Alaska's Future," p. 39 ("1998 Annual Report").

The assets of the other funds are commingled with the assets of the Permanent Fund for investment purposes. Earnings are separately allocated to the other funds on the basis of unit and fractional shares, which have undivided beneficial interests in the commingled assets equal to the proportion that such shares bear to the total units outstanding. Unit shares are credited to the other funds on the basis of amounts contributed to the investment pool. The following represents the other funds' shares of the commingled assets:

	6/30/1998	1997
Alaska Science and Technology Endowment Fund	\$ 129,092,000	\$ 128,565,000
Alaska Mental Health Trust Fund	299,356,000	267,553,000
International Trade and Business Endowment Fund	5,710,000	
TOTAL OF OTHER MANAGED FUNDS	\$ 434,158,000	\$ 396,118,000

It is apparent from a review of the respective enabling statutes that the APFC Board, acting only as investment manager of each of the respective funds, has only limited fiduciary responsibilities. For example, the cash principal of the Mental Health Trust Fund shall be retained perpetually in the fund for investment by the APFC under the prudent investor rule. AS 37.14.033, 37.14.035, AS 37.13.300. Net income of the fund shall be transferred to the mental health trust settlement income account at the end of each fiscal year and may be utilized only "by the Alaska Mental Health Trust Authority for purposes listed in AS 37.14.041". AS 37.13.035.

Similarly, the Science and Technology Foundation Endowment shall be held and invested by the APFC subject to the prudent investor rule, but net income shall be distributed by grants under Title 37, Chapter 17 rather than by the APFC. AS 37.17.020(b). The International Trade and Business Endowment also was established within, and is administered by, the Alaska Science and Technology Foundation, AS 37.17.440(a), 37.17.010(b)(3), although it is invested by the APFC subject to the prudent investor rule. AS 37.17.440(b).

Eric Wohlforth
Chair, Board of Trustees
March 3, 1999
Page Twenty-Two

Thus, the responsibilities for operational employment of the funds and distribution to the beneficiaries rest with the trustees and directors of the respective entities, and such fiduciary responsibilities as exist for the APFC Board are limited to those existing "within the scope of the [investment] relationship." *Restatement (Second) of Trusts*, § 2, comment b (1959).

Since the funds are permissibly commingled with the other assets of the Fund for investment purposes, the Board will adequately discharge its fiduciary responsibility with respect to these funds by continuing to follow the prudent investor rule (AS 37.13.120), by maintaining impartial treatment as to each of the separate funds through the undivided beneficial interests of each of the funds in the fashion described above, and by segregating income of other funds as required by particular provisions of the particular statutes relating to each fund. The Mental Health Trust enabling act requires that "The net income of the fund shall be determined by the Alaska Permanent Fund Corporation in the same manner the corporation determines the net income of the Alaska permanent fund under AS 37.13.140," AS 37.14.031(c), and then that "net income of the fund shall be transferred by the corporation to the mental health trust settlement income account at the end of each fiscal year." AS 37.14.035(b). Similarly, the "net income from the [Alaska Science and Technology Foundation] endowment shall be distributed under AS 37.17.010 - 37.17.110 and 37.17.225," i.e., under the control of that endowment's Board of Directors to make grants or other distributions of endowment income, and "not [as] net income available for distribution under AS 37.13.140." AS 37.17.020(b) Therefore, inasmuch as the special funds require the APFC Board to account separately for the net income of each fund, the Board must do so in such a way as not to impair the income due the subsidiary fund because of the Board's substantial transfer to the Constitutional Budget Reserve Fund.

In summary on this point, apart from investing according to the prudent investor rule (imposed by statute on all assets under its management), and accounting for principal and income under the terms of the particular statutes whose funds are being administered by it, the APFC Board has no other duties under the circumstances of the proposed legislation. The proposed legislation should have no special effect on commingled funds different from its effect on the other assets held by the Board since its effect will be distributed proportionately among each and all of the funds it holds for investment.

MORRISON & FOERSTER LLP

MEMORANDUM

TO: Kathy Porterfield
FROM: Robert Loeffler
Linda Arnsbarger
Michael Toumanoff
Joseph Wyatt
DATE: March 2, 1999
RE: Summary of Feb. 24, 1999 Discussion Regarding Accounting for Fund Transfers

CC: Peter Bushre
James Baldwin

FILE: 14507/85

This is to summarize the discussion on February 24, 1999 between Kathy Porterfield, Peter Bushre, James Baldwin, Robert Loeffler, Joe Wyatt, Michael Toumanoff, and Linda Arnsbarger regarding the proposed recommendations as to the proper accounting for a fund transfer. The facts we discussed involved the possible one-time transfer of \$4 billion in cash or securities from the Alaska Permanent Fund to the Constitutional Budget Reserve Fund. We asked Kathy to discuss the accounting treatment for such a transfer. Kathy responded that her answer was premised on the fact that both are state funds, and the proposed transfer is a one-time transfer. She discussed two options with regard to transfers in general.

One, which was not discussed at length, was to reflect the transfer in the income statements, which would have an immediate and substantial impact on the dividend.

The second approach, which we understood to be the appropriate accounting treatment, was to reflect the transfer as an adjustment to retained earnings, here the earnings reserve account, which would not have an immediate impact on the dividend. We understand that the accounting literature would permit the second approach, described as a "residual equity transfer" if it is a one-time transfer between two state funds, so long as it is legal to do so.

With respect to the legal question, Kathy identified one statutory barrier to this second treatment. AS 37.13.145(a) establishes the earnings reserve account, and states that "income from the fund shall be deposited by the corporation into the account as soon as it is received." This provision literally appears to limit the earnings reserve account to realized cash income. In other words, as a matter of law, the unrealized gains are not in the earnings reserve account.

We asked Kathy to consider the following hypothetical: First, assume that AS 37.13.145 is amended to provide that the earnings reserve account is calculated in accordance with generally accepted accounting principles. Then assume that, on a one-time basis, \$4 billion in securities are transferred from the Permanent Fund to another state fund. Assume that the transferred securities have \$1 billion in unrealized gains associated with them. Assume that, prior to the transfer, the earnings reserve account is \$5 billion. Kathy agreed that the assets of the fund would be reduced by \$4 billion, and the earnings reserve account would be reduced by

MORRISON & FOERSTER LLP

the amount of \$4 billion (leaving \$1 billion in the account). The CBRF would take the securities at their market value.

In KPMO's view, under the second approach, the transfer of \$4 billion in assets with an associated \$1 billion in unrealized gain associated with the assets would not result in any realization of gain, and thus would have no immediate impact on the dividend calculation. Any impact on future dividends would be the result of the reduced amount of investments in the fund, as well as any limitation on future pay-outs imposed by the decreased level of income in the earnings reserve account.

We explored how this reduction in the earnings reserve account would follow through for statutory purposes in calculating a dividend in subsequent years. (Our concern was how, under the statutory accounting method, to ensure that the component of the transferred earnings reserve that represented transferred unrealized gains would not be double counted in determining realized gains in later years for purposes of the statutory dividend calculation.) Kathy agreed that if, in the subsequent year, the fund had \$3 billion in realized income, and the calculated income available for distribution exceeded the earnings reserve account, the amount of the dividend still could not exceed \$1 billion, or the amount in the earnings reserve account, because to pay out more would be to invade principal. In other words, \$2 billion of that year's realized income would nevertheless be unavailable for a dividend distribution in the current year.

Kathy and Peter clarified that the earnings reserve account for statutory purposes is not, by definition, the same as the earnings reserve account for accounting purposes under current GAAP. The accounting earnings reserve account represents only residual equity, not income.

We asked Kathy Porterfield and Peter Bushro to review a draft of this memorandum, dated February 24, 1999, and to let us know whether this summary accurately reflects the description they provided to us.

Kathy Porterfield has reviewed this memorandum, made revisions, and has confirmed in a telephone conversation with James Baldwin and Linda Arnsbarger on March 2, 1999 that this revised summary accurately reflects the description she provided to us.

DOL Document
#2

FISCAL PLAN AMENDMENTS

1. The governor has introduced a bill proposing to transfer \$4 billion from the earnings reserve account of the Alaska Permanent Fund to capitalize the Constitutional Budget Reserve Fund.
2. A proposal has been under consideration to make the transfer in a way that will avoid the necessity of selling a large amount in securities to raise the money.

These sales will cost the permanent fund a substantial amount in transaction fees (estimated in excess of \$20 million) owed to brokers and other securities dealers.
3. The plan involves either the transfer to the CBRF of in-kind securities worth \$4 billion, or an undivided interest in the permanent fund worth \$4 billion. Counsel to the Alaska Permanent Fund Corporation was engaged to provide independent legal advice concerning implementation of this in-kind transfer plan.
4. Legal counsel determined that a one-time, in-kind transfer could be validly implemented if certain statutory amendments were made by the legislature to make it clear that income of the permanent fund is determined exclusively by generally accepted accounting principles.
5. By establishing these principles in statute, there would be no legal questions concerning whether the appreciated value of securities owned by the permanent fund can be made available for distribution by the board of trustees as income.
6. If these amendments are enacted, legal counsel advises that a transfer of unrealized earnings of the permanent fund will not

constitute an appropriation from the principal of the permanent fund; and

that such a transfer will not violate a fiduciary duty owed by the board of trustees of the Alaska Permanent Fund.
7. The legal opinion also relies on the advice of auditors of the Alaska Permanent Fund that such a one-time transfer of \$4 billion in permanent fund income would not cause an increase in the permanent fund dividend payable in the year of the transfer.

"Draft Legislation" Document
#3

- * Section __, AS 37.13.140 is amended to read:

Sec. 37.14.140. **Income.** Net income of the fund includes income of the earnings reserve account established under AS 37.13.145. For the purpose of calculating the income available for distribution, net [NET] income of the fund shall be computed annually as of the last day of the fiscal year in accordance with generally accepted accounting principles, excluding any unrealized gains or losses. Income available for distribution equals 21 percent of the net income of the fund for the last five fiscal years, including the fiscal year just ended, but may not exceed [NET INCOME OF THE FUND FOR THE FISCAL YEAR JUST ENDED PLUS] the balance in the earnings reserve account described in AS 37.13.145.

- * Sec. __, AS 37.13.145(a) is amended to read:

(a) The earnings reserve account is established as a separate account in the fund. The balance of the earnings reserve account shall be determined according to generally accepted accounting principles. [INCOME FROM THE FUND SHALL BE DEPOSITED BY THE CORPORATION INTO THE ACCOUNT AS SOON AS IT IS RECEIVED.] Money in the account shall be invested in investments authorized under AS 37.13.120.

<http://www.adn.com/opinion/story/606388.html>

adn.com

Anchorage Daily News

Should Permanent Fund managers stick to philosophy?

GREGG ERICKSON
COMMENT

(11/29/08 22:56:03)

In late August, Sarah Palin flew off on her nine-week campaign for the nation's second-highest office. During those nine weeks the Alaska Permanent Fund lost \$8 billion, including more than \$1 billion from the supposedly untouchable principal.

Palin's absence played no role in the fund's meltdown. The fund's managers lost the state's money because of the world financial collapse. But Palin's preoccupations -- with gas pipeline issues, Troopergate and the national campaign -- may be implicated in the paralysis that has gripped managers in responding to the fund's hemorrhaging value.

The decline in fund investments has not occurred across the board. Stocks and real estate have declined most dramatically, while bonds have done relatively well. As a result, percentages of assets in several of the fund's nine asset categories have drifted far from the board's allocation targets. So far, managers have taken no steps to bring them back to where they belong. Domestic bond holdings, for instance, account for 27 percent of fund assets, way above the 19 percent target and well beyond the permissible percentage variation the board established in a July resolution. Real estate holdings are also outside the limits, though in the opposite direction.

Maintaining allocation discipline is the Holy Grail that has guided managers at the fund since the theory was first adopted there in 1983. Innovative then, the notion that diversified asset allocation is the key to successful investing is now a core tenet of investment theory as taught in finance and investment courses at graduate schools around the world.

Why have Permanent Fund managers abandoned this long-held discipline?

Author and investment manager Peter Lynch writes that when it comes to investing, "The key organ in the body is the stomach, not the brain." The way to maintain the allocation percentages is to sell assets that have done well and use the proceeds to buy more of the assets that have done poorly. Following through on that discipline in today's market requires the courage of one's convictions.

That kind of courage appears to be in short supply at Permanent Fund headquarters. Fund managers have the responsibility to maintain that discipline; they don't need to

wait for the board of trustees' blessing. In an interview last month with reporters for the Alaska Budget Report (see the newsletter's Oct. 31 issue), Michael Burns, the fund's executive director, was asked repeatedly why the oft-touted discipline appears to have been abandoned.

"We're working through it," was his most direct response.

Permanent Fund managers also worry about the political implications of continuing to draw money from the fund to cover its expenses when doing so eats into the constitutionally protected principal. The principal is the sum of the state's contributions to the Permanent Fund since its inception, whether from oil royalties, special state appropriations or inflation-proofing. As the chart shows, on Nov. 18 the fund's market value was \$1.6 billion less than the principal, putting the fund "under water." Money drawn to pay Burns' monthly \$21,416 salary or any other outlay submerges it even deeper.

If the fund is under water in June when it's time to transfer more than a billion dollars to the Department of Revenue for Permanent Fund dividends, someone could ask the courts to block the payments on grounds they would invade the principal.

Former Attorney General Gregg Renkes, in a 2003 legal opinion, wrote that the problem can be eliminated by adopting a new legal definition of "principal," but Burns is uncertain where Palin -- who styles herself as a fund protector -- might come down on that. On Oct. 23 he wrote an official memo to Palin's budget chief, Karen Rehfeld, requesting the administration's views.

So far, we see little indication that Palin or her top officials have paid much attention. In an interview late last month, Rehfeld, noting the implications for next year's Permanent Fund dividend, said Burns shouldn't expect a substantive response to come quickly.

"We have to look at that question, we have to look at inflation-proofing, all of those pieces. We're researching it now," Rehfeld said.

Patrick Galvin, Palin's revenue commissioner and one of her two representatives on the Permanent Fund's six-person board of trustees, was unaware of Burns' memo to Rehfeld until I asked him about it a week after it was sent.

The trustees have a meeting scheduled Tuesday and Wednesday in Anchorage. That's their chance to ask Burns whether managers have the courage to stick to their allocation discipline, and how he proposes to deal with a potential dividend challenge. Let's hope the trustees do ask those questions. And let's hope they get coherent answers.

Juneau economic consultant Gregg Erickson is editor-at-large of the Alaska Budget Report. E-mail, gerickso@alaska.com.

1-23-09


MEMORANDUM

STATE OF ALASKA

Office of the Governor
Office of Management and Budget
PO Box 110020
Juneau AK 99811-0020
(907) 465-4660, fax 465-3008

To: Michael Burns
Executive Director
Alaska Permanent Fund Corporation

Date: November 5, 2008

From: 
Karen J. Renfield
Director
Office of Management and Budget

Subject: APFC Operating Budget in
Declining Financial
Markets

On October 23, 2008, you requested feedback on a potential issue regarding the source of funds for the Alaska Permanent Fund Corporation's annual operating budget during times of extreme market volatility with downward trends.

As you outlined in your memorandum, state statute section 37.13.150 clearly identifies the source of corporation's operating budget as "The revenue generated by the fund's investments." A consultation with the Department of Law regarding the corporation's current circumstance affirms APFC's interpretation that the operating budget should be paid from positive cash flow in order to meet the FY09 appropriated budget.

cc: Mike Nizich, Chief of Staff
Julie Hamilton, APFC Director of Finance

Alaska Constitution

Section 9.15 - Alaska Permanent Fund.

At least twenty-five percent of all mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payments and bonuses received by the State shall be placed in a permanent fund, the principal of which shall be used only for those income-producing investments specifically designated by law as eligible for permanent fund investments. All income from the permanent fund shall be deposited in the general fund unless otherwise provided by law.

Alaska Statute

Sec. 37.13.020. Findings.

The people of the state, by constitutional amendment, have required the placement of at least 25 percent of all mineral lease rentals, royalties, royalty sale proceeds, and federal mineral revenue sharing payments and bonuses received by the state into a permanent fund. The legislature finds with respect to the fund that

- (1) the fund should provide a means of conserving a portion of the state's revenue from mineral resources to benefit all generations of Alaskans;
- (2) the fund's goal should be to maintain safety of principal while maximizing total return;
- (3) the fund should be used as a savings device managed to allow the maximum use of disposable income from the fund for purposes designated by law.

Sec. 37.13.140. Income.

Net income of the fund includes income of the earnings reserve account established under AS 37.13.145. Net income of the fund shall be computed annually as of the last day of the fiscal year in accordance with generally accepted accounting principles, excluding any unrealized gains or losses. Income available for distribution equals 21 percent of the net income of the fund for the last five fiscal years, including the fiscal year just ended, but may not exceed net income of the fund for the fiscal year just ended plus the balance in the earnings reserve account described in AS 37.13.145.

Sec. 37.13.145. Disposition of income.

(a) The earnings reserve account is established as a separate account in the fund. Income from the fund shall be deposited by the corporation into the account as soon as it is received. Money in the account shall be invested in investments authorized under AS 37.13.120.

(b) At the end of each fiscal year, the corporation shall transfer from the earnings reserve account to the dividend fund established under AS 43.23.045, 50 percent of the income available for distribution under AS 37.13.140.

(c) After the transfer under (b) of this section, the corporation shall transfer from the earnings reserve account to the principal of the fund an amount sufficient to offset the effect of inflation on principal of the fund during that fiscal year. However, none of the amount transferred shall be applied to increase the value of that portion of the principal attributed to the settlement of State v. Amerada Hess, et al., 1JU-77-847 Civ. (Superior Court, First Judicial District) on July 1, 2004. The corporation shall calculate the amount to transfer to the principal under this subsection by

(1) computing the average of the monthly United States Consumer Price Index for all urban consumers for each of the two previous calendar years;

(2) computing the percentage change between the first and second calendar year average; and

(3) applying that rate to the value of the principal of the fund on the last day of the fiscal year just ended, including that portion of the principal attributed to the settlement of State v. Amerada Hess, et al., 1JU-77-847 Civ. (Superior Court, First Judicial District).

(d) Notwithstanding (b) of this section, income earned on money awarded in or received as a result of State v. Amerada Hess, et al., 1JU-77-847 Civ. (Superior Court, First Judicial District), including settlement, summary judgment, or adjustment to a royalty-in-kind contract that is tied to the outcome of this case, or interest earned on the money, or on the earnings of the money shall be treated in the same manner as other income of the Alaska permanent fund, except that it is not available for distribution to the dividend fund or for transfers to the principal under (c) of this section, and shall be annually deposited into the Alaska capital income fund (AS 37.05.565).

ALASKA PERMANENT FUND**Balance Sheets**

Unaudited (millions of dollars)	November 30, 2008	June 30, 2008
Assets		
Cash and temporary investments	\$ 565.9	819.9
Receivables, prepaid expenses and other assets	325.5	1,089.3
Investments —		
Marketable debt securities	8,173.3	9,706.4
Preferred and common stock	12,860.7	19,936.0
Real estate	3,225.3	3,514.1
Alternative investments	2,942.5	3,088.0
Alaska certificates of deposit	232.2	237.2
Total investments	<u>27,434.0</u>	<u>36,481.7</u>
TOTAL ASSETS	\$ 28,325.4	38,390.9
Liabilities		
Accounts payable	\$ 178.2	998.9
Securities sold short at market value	125.4	184.9
Income distributable to the State of Alaska	0.0	1,326.2
TOTAL LIABILITIES	<u>303.6</u>	<u>2,510.0</u>
Fund Balances		
Reserved — principal:		
Contributions and appropriations	29,553.9	29,148.9
Unrealized appreciation (depreciation) on invested assets	(5,675.4)	1,763.3
Total reserved	<u>23,878.5</u>	<u>30,912.2</u>
Unreserved:		
Realized earnings	<u>4,143.3</u>	<u>4,968.7</u>
TOTAL FUND BALANCES	<u>28,021.8</u>	<u>35,880.9</u>
TOTAL LIABILITIES AND FUND BALANCES	\$ 28,325.4	38,390.9

ALASKA PERMANENT FUND

**Statements of Revenues, Expenditures and Changes
in Fund Balances**

Unaudited (millions of dollars)	Month ended November 30, 2008	Five months ended November 30, 2008	Fiscal year-end actual June 30, 2008
Revenues			
Interest	\$ 37.3	186.4	549.5
Dividends	31.3	148.6	457.7
Real estate and other income	0.4	78.2	195.1
Total interest, dividends, real estate and other income	<u>69.0</u>	<u>413.2</u>	<u>1,202.3</u>
Net increase (decrease) in the fair value of investments			
Marketable debt securities	86.3	(698.9)	228.5
Preferred and common stock	(1,035.0)	(7,251.4)	(2,631.2)
Real estate	(87.0)	(331.3)	(176.6)
Alternative investments	(145.6)	(398.0)	97.7
Forward exchange contracts and futures	(3.1)	47.0	(95.1)
Currency	0.3	(13.0)	(4.2)
Total net increase (decrease) in investments	<u>(1,184.1)</u>	<u>(8,645.6)</u>	<u>(2,580.9)</u>
TOTAL REVENUES	<u>(1,115.1)</u>	<u>(8,232.4)</u>	<u>(1,378.6)</u>
Expenditures			
Operating expenditures	(4.7)	(29.1)	(78.4)
Other legislative appropriations	0.0	(2.6)	(6.3)
TOTAL EXPENDITURES	<u>(4.7)</u>	<u>(31.7)</u>	<u>(84.7)</u>
EXCESS (DEFICIENCY) OF REVENUE OVER EXPENDITURES	<u>\$ (1,119.8)</u>	<u>(8,264.1)</u>	<u>(1,463.3)</u>
Other Financing Sources (Uses)			
Transfers in	79.5	405.0	844.3
Transfers out	0.0	0.0	(1,326.2)
NET CHANGE IN FUND BALANCES	<u>(1,040.3)</u>	<u>(7,859.1)</u>	<u>(1,945.2)</u>
Fund Balances			
Beginning of period	<u>29,062.1</u>	<u>35,880.9</u>	<u>37,826.1</u>
End of period	<u>\$ 28,021.8</u>	<u>28,021.8</u>	<u>35,880.9</u>

Statutory Income Calculation

Excess (Deficiency) of revenues over expenditures	(1,119.8)	(8,264.1)	(1,463.3)
Adjustments to bring net income to statutory net income:			
Unrealized (gain) loss	893.3	7,438.6	4,434.4
Alaska Capital Income Fund realized earnings	0.0	0.0	(33.0)
STATUTORY NET INCOME (LOSS)	<u>\$ (226.5)</u>	<u>(825.5)</u>	<u>2,938.1</u>

ALASKA PERMANENT FUND

Receivables and Payables

Unaudited (millions of dollars)	November 30, 2008
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Accounts Receivable

Interest Receivable	\$ 90.2
Dividends Receivable	40.1
Pending Sales Fixed Income	6.4
Pending Sales Equities	40.1
Pending Sales Alternative Investments	0.0
Foreign Exchange Contracts Receivable	28.3
State Dedicated Revenues Receivable	116.8
Pending Sales Real Estate/REITs	3.6
Prepaid and Other Receivables	0.0
TOTAL RECEIVABLES	<u>\$ 325.5</u>

Accounts Payable

Accrued Operating Payables	\$ 16.1
Pending Purchase Fixed Income	94.6
Pending Purchase Equities	65.9
Pending Purchase Real Estate/REITs	1.6
Foreign Exchange Contracts Payable	0.0
TOTAL PAYABLES	<u>\$ 178.2</u>



ALASKA PERMANENT FUND FUND FINANCIAL HISTORY & PROJECTIONS as of November 30, 2008

Projections will extend ten years, and are based on best available information (\$ in millions)

FY	Reserved Fund Balance - Principal										Unreserved Fund Balance										TOTAL FUND FY-End Balance
	FY-Begin Balance	Appropriations	Dedicated Revenues	Inflation Proofing	Contributions	FY-End Balance	Net Change	Unrealized Gain (Loss)	FY-End Balance	Reserve Balance	Acct. Net Income	Statutory Net Income	Dividends	Inflation Proofing	Gain / Other	Realized Earnings	FY-End Balance				
77-00	0	7,039	6,731	6,244	20,014	3,529	(2,146)	3,529	23,543	25,800	23,433	9,005	1,113	274	2,972	2,972	26,515				
01	20,014	8	339	586	21,047	1,953	(878)	1,953	22,430	23,433	1,998	4	686	4	(588)	2,384	24,814				
02	21,047	(23)	258	602	21,884	505	(671)	505	22,389	23,433	257	5	602	5	(1,248)	1,136	23,525				
03	21,884	354	398	352	22,988	601	1,106	601	24,094	23,433	355	0	691	0	(1,035)	352	24,194				
04	22,988	(339)	353	524	23,526	1,909	859	1,909	25,541	23,433	502	0	170	0	759	859	27,400				
05	23,526	0	480	641	24,647	859	3,874	859	28,522	23,433	1,754	27	641	27	561	1,440	29,962				
06	24,647	0	601	856	26,104	347	4,221	347	30,325	23,433	3,072	37	856	37	1,145	2,585	32,910				
07	26,104	0	532	860	27,497	1,977	6,198	1,977	33,694	23,433	5,448	42	860	42	1,547	4,132	37,826				
08	27,497	0	844	808	29,149	(4,434)	1,753	(4,434)	30,912	23,433	2,938	33	808	33	837	4,969	35,881				
10%	29,149	0	724	1,180	31,052	(2,936)	1,172	(2,936)	29,880	23,433	994	13	1,180	13	(1,425)	3,544	33,424				
25%	29,149	0	724	1,180	31,052	(1,272)	491	(1,272)	31,544	23,433	1,206	15	1,180	15	(1,235)	3,733	35,276				
Mid	29,149	0	724	1,180	31,052	1,377	3,140	1,377	34,193	23,433	1,435	18	1,180	18	(1,031)	3,938	38,131				
25%	29,149	0	724	1,180	31,052	3,570	5,333	3,570	38,386	23,433	1,711	21	1,180	21	(784)	4,185	40,570				
10%	31,052	0	659	872	32,584	1,173	4,313	1,173	36,897	23,433	3,006	21	872	21	(228)	3,710	40,607				
11	32,584	0	630	956	34,137	1,248	5,562	1,248	39,699	23,433	3,202	21	914	21	(167)	3,543	43,242				
12	34,137	0	630	956	35,723	1,328	6,890	1,328	42,613	23,433	3,412	21	956	21	(14)	3,529	46,142				
13	35,723	0	619	989	37,341	1,417	8,307	1,417	45,648	23,433	3,642	21	989	21	213	3,742	49,389				
14	37,341	0	591	1,043	38,975	1,515	9,822	1,515	48,797	23,433	3,900	21	1,043	21	231	3,972	52,770				
15	38,975	0	618	1,089	40,682	1,619	11,441	1,619	52,123	23,433	4,170	21	1,089	21	278	4,248	56,371				
16	40,682	0	620	1,136	42,437	1,729	13,170	1,729	55,908	23,433	4,457	21	1,136	21	325	4,574	60,181				
17	42,437	0	620	1,184	44,242	1,845	15,015	1,845	59,257	23,433	4,761	21	1,184	21	377	4,951	64,208				
18	44,242	0	674	1,235	46,151	1,969	16,944	1,969	63,134	23,433	5,064	21	1,235	21	432	5,383	68,518				
19	46,151	0	671	1,288	48,109	2,100	19,084	2,100	67,193	23,433	5,428	21	1,288	21	493	5,876	73,069				
Cumulative Totals																					
Proj. for 2009-2019	0	7,064	11,896			17,321					26,341	13,538	11,896	230	967						

Notes related to financial history and projections FY1977 - FY2019
 (1) Appropriations include special general fund, realized earnings, and other miscellaneous appropriation transfers into principal
 (2) Dedicated State Revenues in current and future fiscal years is based on the Fall 2008 Department of Revenue forecast
 (3) Accounting net income is based on United States Generally Accepted Accounting Principles (GAAP). Statutory net income is accounting net income, excluding any unrealized gains and losses on investments.
 (4) FY05 and forward, Amerasia Hess, et al. settlement earnings are transferred to Alaska Capital Income Fund per AS 37.13.145(d)
 (5) FY03 Senate Bill 100 transferred \$354 million from realized earnings to principal. FY04 Senate Bill 283 defined that appropriation as pre-FY04 inflation proofing, so it was moved from appropriations to inflation proofing, along with the balance of \$170 necessary to fully inflation proof the Fund.
 (6) \$15 million in settlement earnings remained in appropriations per AS 37.13.145(d).
 (7) Current year returns are based on 2008 Callan capital market assumptions. A range of possible returns illustrates shows different outcomes across various market scenarios.
 (8) Future returns are based on 2008 Callan capital market assumptions and median expected returns (the mid case). Actual results will vary

Assumptions:	Total Return - Inflation-Total Real Return	Statutory Return
10%	FY 2008 -5.08%	3.95%
25%	FY 2009 0.10%	3.95%
Mid	FY 2008 8.05%	3.95%
25%	FY 2009 14.87%	3.95%
10%	FY 2009 22.43%	3.95%
FY 2010-2019	8.05%	2.75%
		5.30%
		5.00%

Income year-to-date as of November 30, 2008	
Interest, dividends, real estate & other income	\$ 413.2
Realized gains (losses) on the sale of invested assets	(1,207.0)
Less operating exp / Legis. appropriation	(31.7)
Less AK Capital Inc. Fund committed realized earnings	-
Statutory net income (loss)	\$ (825.5)
FY09 Statutory net income	
Statutory net income (loss)	\$ (825.5)
Unrealized gains (losses) on invested assets	(7,438.6)
AK Capital Income Fund committed realized earnings	-
Accounting (GAAP) net income (loss)	\$ (8,264.1)

PERFORMANCE SUMMARY (preliminary as of November 30, 2008)									
Alaska CDs	Domestic Fixed Income	Non-Domestic Fixed Income	Domestic Equities	Non-Domestic Equities	Global Equities	Real Estate	Absolute Return	Total Fund	Fund Benchmark Return
Current Month	0.12%	1.22%	-8.05%	-6.95%	-6.38%	-2.43%	-3.28%	-3.80%	-3.80%
Last 3 Months	0.41%	-5.73%	-31.29%	-38.34%	-34.14%	-6.71%	-20.85%	-20.77%	-20.77%
Last 12 Months	2.00%	-4.68%	-30.40%	-43.55%	-37.10%	-13.60%	-26.72%	-27.02%	-27.02%
Fiscal Y-T-D	0.73%	-5.36%	-1.39%	-43.55%	-37.10%	-13.60%	-22.39%	-22.62%	-22.62%
Calendar Y-T-D	2.34%	-4.51%	-37.72%	-49.03%	-43.62%	-17.46%	-26.72%	-27.44%	-27.44%
Last 3 Years	4.08%	2.32%	-9.07%	-7.18%	5.72%	0.86%	-2.76%	-2.83%	-2.83%
Last 5 Years	3.35%	2.80%	-1.25%	-2.30%	12.27%	2.62%			

**2009 HOUSE FINANCE
COMMITTEE ATTENDANCE**

DATE: 1/23/08

Circle Meeting Chair: Hawker Stoltze

MEMBER PRESENT ABSENT

RF	REP. FOSTER	/	
AA	REP. AUSTERMAN	/	
MK	REP. KELLY	/	
AF	REP. FAIRCLOUGH	/	
MH	CO-CHAIR HAWKER	/	
BS	CO-CHAIR STOLTZE	/	
BT	VICE-CHAIR THOMAS	/	
LG	REP. GARA	/	
HC	REP. CRAWFORD	/	
WS	REP. SALMON	/	
RJ	REP. JOULE	/	

Pg Pat Galvin
 GE Greg Wickson
 3b Jenny Burnnet
 rep. Pash
 Rep Doogan.

Barnhill-DOL
 Sen Burde
 R. Stoefter