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operating budgeting process to inform such policy decisions. Certainly some particular expenditures will have benefits outweighing any arbitrage earnings.

Other Opportunity Costs of Cash for Projects

ayments o ndividuals

To the extent cash left on the table from bonding for capital projects is used for cash payments to individuals or investment in other than the money and bond markets, the arbitrage argument may still be valid.

Certainly, if an individual receives a cash payment, he can invest it at the higher taxable market rates and thus earn the arbitrage on his own account. Of course, he may spend it instead; though presumably he is judging his present consumption to have greater utility than possible future consumption augmented even at market rates of interest.

Where this alternative really falls short in relation to state arbitrage with payment of the earnings to individuals is the federal tax bite that would be taken out of principal if it is given to individuals. Instead, the money could be loaned to individuals at the tax-exempt cost to the state and in that way retain the arbitrage argument's validity; this, of course, removes the possibility of expenditure of the principal by individuals.

evelopment rojects

The arbitrage argument can certainly be enhanced if the state or individuals with state loans can make investments which yield even greater returns than the money and bond markets. If these are development projects in Alaska, there may be other benefits besides a higher rate of return. The state's fiscal position may be benefited, its bond ratings possibly improved, etc., from the expanded tax base if inmigration is not pronounced or state budgets do not swell as a result. Incomes and employment will increase, hopefully for the long-run if the project is economically viable. Of course, there is always a danger that the state will be providing consumption disguised as investment.

Bonding During Periods of High Interest Rates

One final consideration as to whether to bond or pay cash would be the possibility of avoiding bonding during periods of high interest rates. Referring to Chart 1 again, one can see that municipal bonds' interest rates have varied from 5% to 7% during the 1970's. Thus, paying cash would save at most 2% based on recent experience, while foregoing the opportunity to earn 3% to 4% in arbitrage. Moreover, careful timing of actual bond sales by the administration may help

keep interest cost down. Lags in the political process would make it difficult to attempt to take advantage of swings in interest rates from the legislative end of things anyway.

Revenue Bonds

The discussion heretofore of cash vs. bonding as a financing method for capital projects is for the most part applicable to general obligation and revenue bonds. However, paying cash or using general obligation bonds where a revenue bond can be used results in a shifting of the costs of benefits for a particular group from that group to the general populace and is usually judged to be unacceptable.

If the equity considerations are not overriding, general obligation bonds are certainly cheaper than revenue bonds; recent sales have had a .7% to 1.[illegible] advantage over revenue bonds. Of course, siginficant increases in indebtedness on account of this would eventually have adverse effects on interest costs on all new GOB's. Regardless of equity considerations, revenue bonds would still offer arbitrage opportunities whether the cash alternative has state funds or user income as its source. Any shift away from revenue bonding might necessitate review of the policy for user charges and accrued surpluses.

2. WHAT ARE THE PRO'S AND CON'S OF PAYING OFF OUR PRESENT DEBT SERVICE?

Equity — Given the short maturity structure of our present debt, the equity situation would not be much changed by paying it off since either way it appears that it will be oil revenues, not individual taxpayer dollars, that will be used to pay it off.

Arbitrage — By not paying it off, the state can in theory continue to earn arbitrage. However, this depends on to what alternative use the potential bond redemption funds are put as discussed under question 1; if they are spent on budget items there is no arbitrage.

Effect on Bond Ratings — As discussed in the John Nuveen & Co. letter and also the attached April 3, 1978 White Weld letter, Alaska compares unfavorably against the traditional yardsticks used to rate bonds, i.e. debt per capita, debt as a percent of personal income, etc. Paying off our debt would dramatically improve our statistics, including the one deemed most relevant in our case, debt service as a percent of general fund revenues.

However, this action would do nothing to overcome the lack of diversification in the economy and the almost complete dependence of state revenues on a single source, Prudhoe Bay. Besides, there is no assurance that in following years bond authorizations might not be sought which would put indebtedness back at traditional levels. Thus, paying off existing indebtedness might lessen interest costs on future issues and possibly improve the state's bond ratings if the redemption is seen as part of a long-range policy of fiscal restraint and convincingly documented in long-range capital budget plans.

Potential savings vs. arbitrage

However, as indicated in Tables 3 and 4, the maximum reduction in interest costs should the state be upgraded to the highest rating (Aaa) would normally be no more than thirty basis points or .3%. This would be one-tenth the amount that could be earned, 3%, in arbitrage if the funds were invested instead of used to pay off the bonds. Thus, paying off $680 million in outstanding debt would require the issuance of $6.8 billion in new debt for interest savings to make up the lost arbitrage. Undoubtedly, our interest differential would be erased long before that level of indebtedness was reached. Although some improvement could also be expected in rates and ratings for other Alaska municipals which track somewhat with the state, this method of paying off indebtedness would still not be an attractive investment, but would be a method of budgetary restraint.

An alternative

An alternative that would possibly be a good investment though not absorb as much funds is to pay off the tail end of the state's debt service, i.e. the longer maturity bonds. Sterling Gallagher of Nuveen & Co. estimates that possibly $100 million so spent would have almost the same impact as paying off all indebtedness.

3. WHAT ARE THE PRO'S AND CON'S OF PAYING OFF PRESENT MUNICIPAL DEBT?

arbitrage

Considering the state as a whole, the arguments here are the same as for question 2. The potential arbitrage from retaining indebtedness is almost as great since the Municipal Bond Bank Authority carries an A rating, only slightly below the state's. Of course, looking at it solely from the municipalities point of view, payoff is desirable since the cash comes from the state, not the municipality. This would be an expenditure from the state's point of view, whereas paying off its own liabilities does not change its net worth.

nterest osts

The improvement in interest costs should be about the same magnitude as that for the state, thus putting the amount of new debt required to realize savings in interests costs equivalent to the foregone arbitrage at odds with the idea of reduced levels of indebtedness to secure better interest rates. Again though, paying off the tail end maturities might be a good investment.

quity

Any such program to payoff municipal debt would not benefit individuals in unorganized areas or municipalities with no debt. If the proposal is a blanket payoff of 100% of outstanding debt, some municipalities will benefit more than others, even on a per capita basis. "Alaska Taxable 1979" indicates that municipal debt per capita varies from $120 to $26,751 Payoff of equal amounts on a per capital basis would be more equitable than payoff of all or a percentage of total indebtedness.

unicipal pending

There would be no assurance that municipalities would pass on the savings in debt service to taxpayers rather than increasing other budget expenditures. Direct payments or credits to taxpayers might be superior in this regard. If a municipal debt redemption program is to be considered, it might also be appropriate to consider ceilings on municipal indebtedness.

4. AT WHAT LEVEL SHOULD WE BOND FOR CAPITAL IMPROVEMENTS? BY WHAT LOGIC?

ecommended evels

The John Nuveen & Co. letter suggests $175 to $225 million per year, which would be $350 to $450 million in authorizations this session. The Governor reputedly will insist on no more that $300 million in authorizations this session because of concerns that the rising level of debt service will leave little room for increases in other operating items within his long-range budget growth ceilings. The possibility of stretching out maturities based on improved revenue projections might permit the Governor to increase debt and debt service and still meet his budget growth objectives. Authorizations in the 1978 session totaled $275 million exclusive of the $966 million new capital bond issue.

tandards

According to the White Weld memo, debt service could be as high as 16% of general fund revenue before the state would experience significant interest penalties. In the judgment of John E. Petersen, Director of the Government Finance Research Center of the Municipal Finance Officers Association (MFOA), as quoted in his book, The Rating Game, "a ratio of ten percent is felt to be the separation between better and lesser creditworthiness, fifteen percent warrants concern, and it should never exceed twenty to twenty-five percent."

Potential Levels

Ten percent of the $3,052.2 million estimated as FY 80 unrestricted revenue in the Department of Revenue's "Revenue Sources" would be $300 million in debt service. $300 million a year in debt service over a ten year period would amortize $2,252.3 million at 6% interest. Thus, the state could theoretically increase its current total indebtedness of $680 million several times over, this session, if future bonding were to be cut back considerably.

Market Limits

In reality, the market limits are more likely determined "by intangible, psychological, perhaps even irrational factors and attitudes" according to the Nuveen letter, which further states that "no one can accurately predict what level of debt will trigger a reaction leading to a negative shift in market sentiment". (Should it be desired Legislative Finance can readily run long-range computer projections of debt service in relation to revenues based on a given pattern of bond authorizations.)

It appears there are no ready-made rules for the level of debt; by the above standard the state has tremendous unused capacity -- by other standards such as debt per capita there is no excess capacity. The state can always find the limits by testing the water. Needless to say, budgetary restraint and sound management of the state's portfolio will increase its debt capacity in relation to a given level of revenues.

UPDATE

5. WHAT IS OUR PRESENT MUNICIPAL DEBT?

As of July 1, 1979 the general obligation bond debt of municipalities was $768,508,903.

ADDENDUM

You may note that in our letter to Nuveen we wondered if a guarantee fund for general obligation bonds would improve interest costs or ratings. Nuveen felt it would raise more questions than it would be worth.

STATE OF ALASKA

GENERAL OBLIGATION BONDS
Debt Service by Fiscal Years
June 30, 1979

Fiscal Year	Principal	Interest	Total Debt Service To Maturity	Redemption Reserve	Net Cash Required By Fiscal Year
1959	$	$ 65,635.00	$ 65,635.00	$	$ 65,635.00
1960	30,000.00	99,212.69	129,212.69		129,212.69
1961	93,000.00	90,650.75	183,650.75		183,650.75
1962	311,000.00	737,998.50	1,048,998.50		1,048,998.50
1963	566,000.00	856,632.00	1,422,632.00		1,422,632.00
1964	587,000.00	1,299,202.50	1,886,202.50		1,886,202.50
1965	877,000.00	1,353,038.00	2,230,038.00		2,230,038.00
1966	1,202,000.00	1,307,483.50	2,509,483.50		2,509,483.50
1967	1,248,000.00	1,477,588.50	2,725,588.50		2,725,588.50
1968	1,778,000.00	2,877,017.05	4,655,017.05		4,655,017.05
1969	3,761,000.00	4,058,305.75	7,819,305.75	9,000.00	7,810,305.75
1970	3,770,000.00	5,535,721.95	9,305,721.95	85.00	9,305,636.95
1971	7,971,000.00	7,330,703.05	15,301,703.05		15,301,703.05
1972	9,705,000.00	9,793,394.20	19,498,394.20		19,498,394.20
1973	11,365,000.00	12,146,937.95	23,511,937.95		23,511,937.95
1974	12,352,000.00	14,029,974.80	26,381,974.80		26,381,974.80
1975	13,018,000.00	17,126,040.40	30,144,040.40		30,144,040.40
1976	12,500,000.00	22,615,109.85	35,115,109.85	10,924.13	35,104,185.72
1977	12,915,000.00	28,968,934.75	41,883,934.75	24,689.87	41,859,244.88
1978	18,795,000.00	31,233,034.75	50,028,034.75	92,852.08	49,935,182.67
1979	25,710,000.00	34,314,202.90	60,024,202.90	228,019.75	59,796,183.15
1980	38,780,000.00	36,292,273.50	75,072,273.50	1,276,687.99	73,795,585.51
1981	43,045,000.00	34,743,607.70	77,788,607.70		77,788,607.70
1982	46,265,000.00	32,187,781.50	78,452,781.50		78,452,781.50
1983	46,500,000.00	29,531,922.80	76,031,922.80		76,031,922.80
1984	46,945,000.00	26,922,165.35	73,867,165.35		73,867,165.35
1985	46,830,000.00	24,322,860.40	71,152,860.40		71,152,860.40
1986	48,235,000.00	21,714,763.60	69,949,763.60		69,949,763.60
1987	47,350,000.00	19,118,221.25	66,468,221.25	3,050.00	66,465,171.25
1988	47,665,000.00	16,532,505.00	64,197,505.00	66,950.00	64,130,555.00

STATE OF ALASKA

GENERAL OBLIGATION BONDS
Debt Service by Fiscal Years
June 30, 1979

Fiscal Year	Principal	Interest	Total Debt Service To Maturity	Redemption Reserve	Net Cash Required By Fiscal Year
1989	42,717,000.00	13,894,721.25	56,611,721.25		56,611,721.25
1990	34,550,000.00	11,746,590.00	46,296,590.00		46,296,590.00
1991	28,989,000.00	9,958,430.00	38,947,430.00		38,947,430.00
1992	29,849,000.00	8,303,425.00	38,152,425.00		38,152,425.00
1993	25,063,000.00	6,656,987.50	31,719,987.50		31,719,987.50
1994	20,598,000.00	5,219,975.00	25,817,975.00		25,817,975.00
1995	19,096,000.00	3,987,625.00	23,083,625.00		23,083,625.00
1996	18,610,000.00	2,864,412.50	21,474,412.50		21,474,412.50
1997	14,865,000.00	1,800,419.75	16,665,419.75		16,665,419.75
1998	13,380,000.00	1,008,194.75	14,388,194.75		14,388,194.75
1999	$ 8,640,000.00	$ 368,931.25	$ 9,008,931.25	$	$ 9,008,931.25
2000	2,531,000.00	69,081.25	2,600,081.25		2,600,081.25
Totals	$809,057,000.00	$504,561,713.19	$1,313,618,713.19	$1,712,258.82	$1,311,906,454.37
Paid as of 6/30/79	138,554,000.00	197,316,818.84	335,870,818.84	365,485.83	335,505,333.01
Remaining Liability as of 6/30/79 (St. #67)	$670,503,000.00	$307,244,894.35	$ 977,747,894.35	$1,346,772.99	$ 976,401,121.36

TABLE 1

INTEREST RATES ON BONDS
OF TWENTY YEAR OR GREATER MATURITIES

YEAR	Aa CORPORATE	Aa MUNICIPALS	DIFFERENCE
1979	9.77	6.00	3.77
1978	8.98	5.65	3.33
1977	8.20	5.34	2.86
1976	8.59	6.09	2.50
1975	9.51	6.70	2.81
		Five-year Average	3.05

Source: November 1979 Treasury Bulletin

AVERAGE YIELDS OF LONG-TERM BONDS

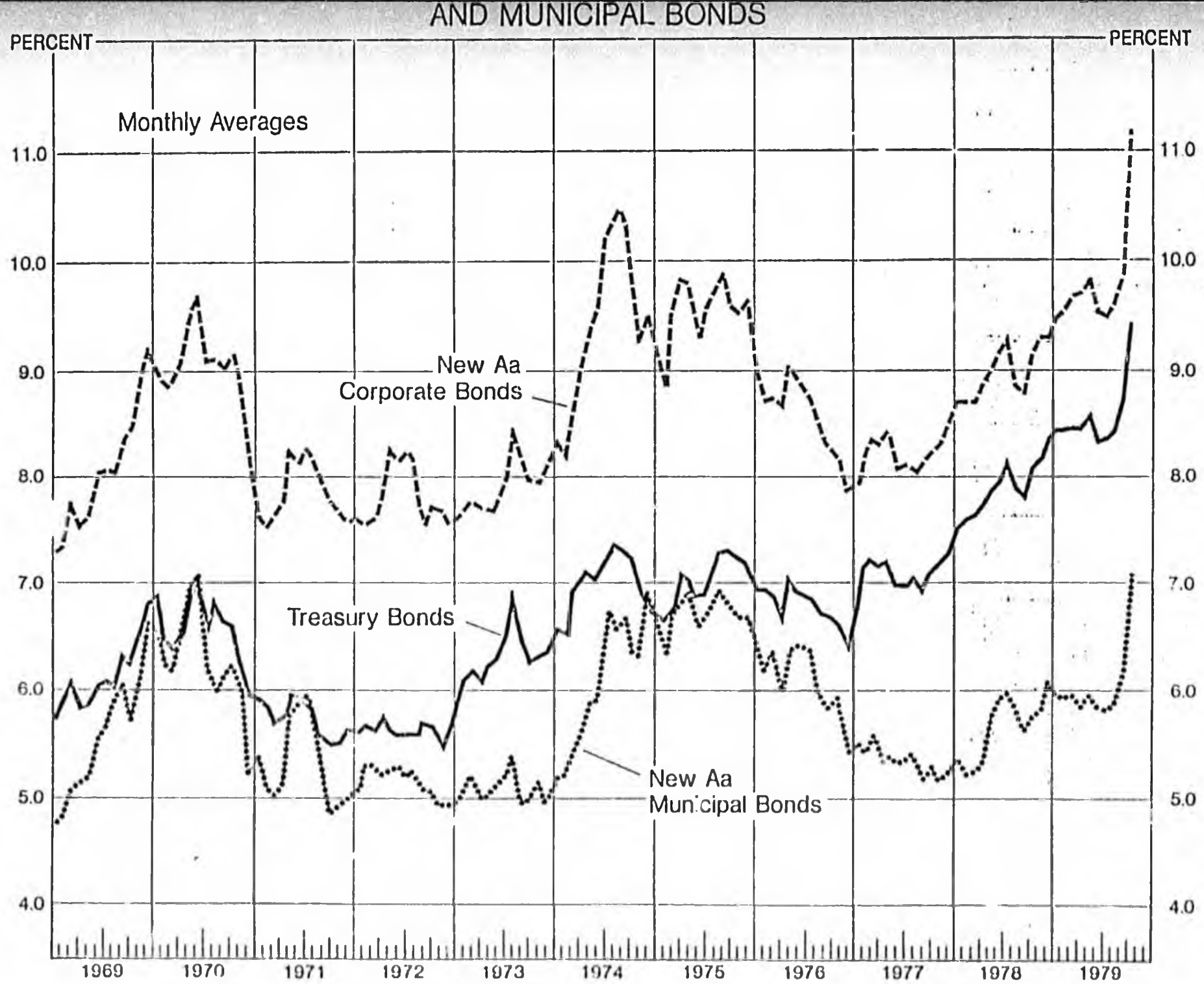

CHART 1

TABLE 2

REPRESENTATIVE TAX-EXEMPT YIELDS
(Based on major new issue offerings
for week ending December 14, 1979)

Maturity	Aaa	Aa	A
1980	6.00	6.10	6.20
1981	6.00	6.10	6.20
1982	6.00	6.10	6.20
1983	6.00	6.10	6.25
1984	6.00	6.10	6.25
1985	6.00	6.10	6.30
1986	6.00	6.10	6.30
1987	6.00	6.10	6.35
1988	6.05	6.10	6.35
1989	6.10	6.15	6.35
1994	6.35	6.45	6.60
1999	6.60	6.75	6.85

	Municipal Bond Averages		
Week Ending	Nuveen Index	Bond Buyer	Dow-Jones
November 23	7.99	7.38	7.76
November 30	7.92	7.26	7.63
December 7	7.78	7.17	7.53
December 14	7.86	7.26	7.62

JOHN NUVEEN & CO INCORPORATED

TABLE 3

DIFFERENCES BETWEEN ANNUAL AVERAGES OF YIELDS ON 20-YEAR, GENERAL OBLIGATION BONDS, BY RATING
(Basis Points)

	Differential Between Grades		
Year	Aa minus Aaa	A minus Aaa	Baa minus Aaa
1945	25	58	79
1950	19	54	75
1955	14	47	96
1956	21	50	99
1957	22	65	105
1958	22	59	92
1959	14	50	81
1960	16	51	82
1961	14	34	61
1962	11	25	52
1963	8	20	43
1964	7	19	42
1965	7	19	40
1966	9	25	49
1967	10	26	55
1968	10	31	63
1969	13	37	62
1970	26	47	63
1971	28	53	67
1972	15	34	52

Source: Moody's Series: Annual average of monthly differences.

TABLE 4

INTEREST COST DIFFERENTIALS AMONG RATING CLASSES
(Basis Points)

	Study (Period)		
Differential Between Grades	Phelps[1] (1957–58)	Kessel[2] (1959–67)	Petersen[3] (1964–1971)
Aaa-Aa	21	15	13
Aa-A	33	21	19
A-Baa	39	25	30
Baa-Ba	—	—	35
Item:			
Aaa-Baa	87	61	62

[1]Charlotte DeMonte Phelps, "The Impact of Tightening Credit on Municipal Capital Expenditures in the United States," *Yale Economic Essays*, Vol. 1 (Fall 1961), p. 306. In Phelps's equation, interest cost differentials between rating classes vary in proportion to the Federal Government's long-term bond rate. The figures above were calculated upon the assumption that the long-term bond rate was 3 percent.

[2]Reuben A. Kessel, "A Study of the Effects of Competition in the Tax-Exempt Bond Market," *Journal of Political Economy* (Sept. 1971). Instead of using the net interest cost of the issue as the dependent variable in his equation, Kessel used the difference between the twenty-year reoffering yield and White's Yield of 100. Standard & Poor's ratings were used instead of Moody's. Kessel's data sample included more than 9000 bond issues that appeared between 1959 and 1967, with virtually complete coverage of competitively offered issues that were larger than $1,000,000.

[3]John E. Petersen, "A Note on the Determinants of Municipal Bond Net Interest Costs" (unpublished), 1972. See summary of study at end of this chapter.

SOURCE: The Rating Game, John E. Petersen, Kraus Reprint, New York, 1974

M E M O R A N D U M

DATE: November 14, 1979

TO: The Honorable Terry Gardiner
Speaker of the House

FROM: J. H. Hogan, Director
Legislative Finance Division

SUBJ: Financial Questions

This Memo is a preliminary response to your questions given to me several weeks ago. Some of the answers are based on information from documents that will be updated. As I mentioned earlier, I will provide you with current information as it becomes available.

1. What is our present state debt? The outstanding Alaska general obligation bond debt as of April 10, 1979 (the date of the last general obligation bond sale) is $1,038,276,089.

2. What is our present municipal debt? As of January 1979 the general obligation bond debt of municipalities was $545,227,664. ("Alaska Taxable" will be republished in January 1980, and new figures will be available then.)

3. What is our present annual debt service? The current year's general obligation bond debt service is $82.2 million and the amount for FY 81 is estimated at $77.9 million.

4. What are the pro's and con's of paying cash or bonding for capital improvements?
5. What are the pro's and con's of paying off our present debt service?
6. What are the pro's and con's of paying off present municipal debt?

Milt Barker is preparing an analysis of these questions. We have also written the state's bond counsel and the state's financial advisor regarding certain questions on this subject. Milt will incorporate these responses in his Memo.

7. At what level should we bond for capital improvements? By what logic? Since Alaska currently has a level of general obligation bond indebtedness that exceeds the normal measures or standards applied to other states, we cannot use "traditional yard-sticks" to answer this question. The question of whether or not to bond is an economic and political question. The economic portion will be discussed in Milt's Memo.

   If the Legislature were looking for a rule of thumb for bonding, perhaps the best one that comes to mind would be limiting the use of general obligation bonds to fund new program starts; for example, new schools, new armories, new fish hatcheries and new state buildings could continue to be funded by the general obligation bond route. In this way you would have "public approval" for new capital program starts. Repairs and maintenance could be funded from cash appropriation sources; for example, highway repairs, ferry system repairs, airport repairs and building repairs could be funded from general appropriations under the assumption that once the public has approved a new capital project, the Legislature can presume they want their investment maintained and repaired so that the facility can continue to provide adequate public use or service.

8. How much capital improvement funds could we actually spend in a single year with our present level of state government? The answer to this question is difficult because it is hard to separate administrative/organizational problems from policy decisions not to spend. The enclosed letter from the Chairman of the Budget and Audit Committee to the Governor sets out the Committee's concern with the apparent lack of effort to complete bond projects already approved by the Legislature. Other research by our office indicates that of the 408 capital projects approved by the Legislature last Session in the General Appropriations Act, 302 have h had no expenditure from the accounts as of October 1. (The capital projects portion of the budget took effect on June 2, 1979.) Looking at it another way, of the $192 million appropriated in the capital budget, only $11 million had actually been spent by October 1. This next Session the Legislature might wish to hold hearings in an effort to determine whether policy decisions not to spend are responsible for this, or organizational overload of various state agencies.

9. What federal funds are projected to be available in the next two years? What are the matching requirements of state funds? The enclosed copy of "Dateline Washington", a National Conference of State Legislatures publication, contains one of several recent

articles which indicate that the President and the Federal Government intend to reduce Federal expenditures on State grant programs in future budgets. In addition to this general pattern of reduced spending o on state programs, we can expect that wherever possible Federal agencies will chip away at Alaska's entitlements due to Alaska's very strong financial position. For arguments sake, let's assume continued Federal funding at the current year budget level, approximately $254 million. The matching requirements vary from program to program. For new grants that are received in mid-budget year, they can be 100% of the funding requirements. Current programs range down from there to 90%/10%, 75%/25%, 50%/50%, to an eventual phase out where the program becomes entirely State funding.

enclosures

JHH:bf

October 15, 1979

John Nuveen & Co. Incorporated
209 South La Salle Street
Chicago, Illinois 60604

In preparation for the upcoming session, legislative leaders have requested that we gather certain information for their review prior to the session. As the State's financial advisor, I would appreciate your response to the following questions:

1. What is the average spread in interest rates between tax-exempt municipal bonds of Alaska's rating and the typical investments of Alaska's general fund, i.e., corporate and U.S. Treasury securities, bank CD's, bankers' acceptances, etc.?

2. What level of G.O. bodding can Alaska achieve without altering its ratings or adversely affecting its interest rates?

3. What greater level could be achieved without wiping out the spread between our tax-exempt rate and taxable rates?

4. What rules of thumb can be used in judging the amount of bonds that can be issued without adverse consequences? The 8% or 16% debt service in relation to general fund revenues mentioned in the White, Weld & Co. memo? (copy attached)

5. How much could our tax-exempt rate be reduced by depositing up to 15% or whatever the IRS arbitrage limit is in a G.O. Debt Guarantee Fund?

Sincerely,

J. H. Hogan, Director
Legislative Finance Division

JHH:pw
Enclosure

January 2, 1980

Tony Dean
John Nuveen & Co.
209 South LaSalle Street
Chicago, Illinois 60604

Dear Tony:

As we discussed on the phone, our office would appreciate your comments on the following questions:

1. Should the state bond or pay cash for future capital improvements?

2. Could retirement of all or part of Alaska's outstanding indebtedness improve its credit rating?

3. Is there a more efficient way to improve our credit rating than paying off existing debt such as municipal bond insurance, the G.O. debt guarantee fund mentioned in our letter of October 15, or some other means?

Yours truly,

Milt Barker

Milt Barker
Fiscal Analyst

MB:bf

nuveen

John Nuveen & Co. Incorporated 209 South LaSalle Street, Chicago, Illinois 60604 (312) 621-3000

December 31, 1979

J. H. Hogan
Director
Legislative Finance Division
The Alaska Legislature
Pouch "WF"
State Capitol
Juneau, Alaska 99811

Dear Mr. Hogan:

This letter responds to your request dated October 15th that in our capacity as financial advisor to the State we respond to a series of questions regarding Alaska's capacity to issue general obligation debt. To simplify the presentation, I have restated the original questions, occasionally combining questions, and then provided our response.

1. What is the average spread in interest rates between tax-exempt municipal bonds of Alaska's rating and the typical investment of Alaska's General Fund, i.e. Corporate and U.S. Treasury Securities, Bank C.D.'s, Bankers' Acceptances, etc.?

   The approximate $680 million of outstanding Alaska general obligation bonds have an estimated average yield of 5.30% and General Fund balances are currently invested in a variety of short term money market instruments to return a yield of approximately 10.2%. When the most recent series of bonds were issued on April 10, 1979, $60 million in par value were sold for a net interest cost of 5.5920%. The bonds had an average life of 5 years, 9 months and yields on comparable maturities of U.S. Government Securities at that time were approximately 9.25%. The net spread at the time of the April sale of 3.66% is typical of the 3 to 5 percentage points which usually separates yields on comparable maturities of Alaska's G.O. Bonds and Federal Securities.

2. What level of G.O. bonding can Alaska achieve without altering its ratings or adversely affecting its interest rates?

   What rules of thumb can be used in judging the amount of bonds that can be issued without adverse consequences; the 8% or 16% debt service in relation to General Fund revenues mentioned in the White Weld & Company memo?

In the last decade Alaska's standing as a borrower in the tax-exempt markets has steadily improved. Recognition of this fact has been reflected in the improvement in ratings which occurred in 1974 and 1975. For investors this has been an enviable situation since their investments have experienced steady appreciation with the growing credit quality of the State.

Dramatic increases in natural resource production, most notably petroleum and natural gas, have been key features of this steady growth in market acceptance. Other factors have included population growth and economic diversification. On the negative side, the rating agencies perceive Alaska to have a heavy debt load on a per capita basis and as a per cent of personal income. In addition, the State is expected to have a continuing and substantial need to borrow over the immediate future. Operating expenses for state government have risen dramatically in the last decade. While there has been a move to diversify Alaska's economy, the State still is heavily dependent on petroleum revenues which are subject to short term interruption and long term uncertainty.

The general obligation debt of the State is currently rated "A1" by Moody's and A+ by Standard and Poors. An upgrade to AA by either agency would enhance the marketability of the State's debt and lower the average interest cost. In addition, other state agencies and major local issuers would be likely to receive improved ratings following assignment of a "AA" to the State. In fact, several months after the last upgrade for the State, ratings for 12 Alaska municipalities were also revised upward. Achieving the "AA" will almost surely require the State to moderate growth in General Fund expenditure and to enact legislation providing financially sound management of the Permanent Fund.

By the standard criteria for financial analysis, Alaska ranks below the other states and to a significant extent, it is relying on a single major source of revenue. Consequently, the market perception of Alaska is colored by intangible, psychological, perhaps even irrational factors and attitudes. In the recent past the market has been positive in its judgments regarding Alaska, but no one can accurately predict what level of debt will trigger a reaction leading to a negative shift in market sentiment.

In the last ten years, the annual general obligation borrowing of the State has grown from $24.4 million in 1970 to $100 million in the most recent 12 months. Maturities have been keyed to the expected life of Prudhoe Bay petroleum revenues. Each bond sale has been characterized by healthy bidding interest by at least 4 different syndicates. In view of the continuing improvements in state revenue, the momentum of a steadily improving credit it would be possible to consider annual issuance of $175 to $225 million over the next few years. Each bond sale will provide additional insights regarding the continuing growth of the State's debt capacity.

3. What greater level of G.O. borrowing could be achieved without wiping out the spread between the State's tax-exempt rate and taxable rates?

While in theory it would appear possible to trade much higher yields for increased borrowing, in practice there are institutional and psychological constraints which limit the growth of the State's indebtedness. The reaction of rating agencies, investors, underwriters and the financial press will begin to narrow the market for the State's general obligation debt, eventually leading to a situation similar to that of New York City, in which the market is closed to Alaska, regardless of the yield it is prepared to pay.

4. How much could our tax-exempt rate be reduced by depositing up to 15% or whatever the IRS arbitrage limit is in a G.O. debt Guarantee Fund?

A reserve fund as contemplated in the question would have a negligible impact on the State's cost of borrowing. A reserve fund is usually associated with revenue bond issues and incorporating it in a G.O. issue would probably raise more questions about what weakness it was meant to correct as opposed to what strength it was supposed to contribute. For a $100 million issue, arbitrage earnings in excess of the cost of borrowing the reserve would be less than 3% of annual debt service.

If you have additional questions or need further information, don't hesitate to call me. I and several of my colleagues will be with Sterling Gallagher in our Juneau office during the week of January 7 through 11. At that time I would be available to meet with you and your staff.

Sincerely,

JOHN NUVEEN & CO., INCORPORATED

Anthony T. Dean
Assistant Vice President

ATD:Lmc

cc: Thomas K. Williams
Commissioner of Revenue

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THEODORE P. SWICK
FIRST VICE PRESIDENT
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CABLE ADDRESS-"WHITEWELD"

April 3, 1978

Report To
Alaska House and Senate Finance
Committees on Relocation of the
State Capital

In accordance with our contract with the State of Alaska Legislative Budget and Audit Committee on behalf of the House and Senate Finance Committees, we herein submit our report on financial questions arising from the plan for relocation of the Alaska State Capital. The report comments (I) specifically on the "Impact on State Bonding Capacity and Annual State Budget" (Impact Report), prepared for the Alaska Capital Site Planning Commission and (II) in a more general way on large capital raising programs and the demands of investors in considering lending funds to such programs in the form of purchasing bonds.

I. The Impact Report addresses itself to: "(1) the impact upon the State's capacity to issue bonds for purposes other than the new capital; (2) the ability of the State to fund the cash requirements of the Financing Plan from General Fund revenues and (3) the impact upon the marketability of all tax-exempt debt issued by Alaskan issuers".

In making our comments we have not attempted to evaluate the assumptions clearly enumerated in the Impact Report. We accept these assumptions as reasonable, particularly, the inflation rate of 8% used throughout and the "Base Case" economic development report by the University of Alaska regarding the growth rates for General Fund revenues, both petroleum related and non-petroleum related, population, income, economic development, etc.

(1) Bonding Capacity

The bonding capacity of any issuer is measured by its ability to sell bonds at reasonable rates and its ability to have access to the market when the need to borrow exists. The Impact Report states

that after examination of traditional indices of credit worthiness and bonding capacity any judgement is highly subjective. We are in full agreement with this observation and also point out that when these traditonal indices are applied to Alaska and its divisions of local government the picture for Alaska is bleak. However, the rating agencies, the bond underwriting community and, to a lesser degree, the investors in tax-exempt bonds have rightly recognized that Alaska must be evaluated on its own because of its special characteristics which makes it distinct from its forty-nine sister states.

There is no doubt that credit ratings placed on issues by the rating agencies have a tremendous impact on the costs of raising capital funds. The rating agencies in a general sense, and rightfully so, depend to a large degree on comparisons, medians, relationships, etc., in comparing one issuer to another. In applying this criteria of creditworthiness to Alaska and its municipalities, Alaska comes out badly in practically every category. Nevertheless, there are many examples where analysis and independent investigations by investment bankers and investors have led to investment decisions which have caused bond issues to be sold at less cost than similarly rated credits because of the strengths peculiar to the issuer.

Security analysts in evaluating Alaska, after recognizing the special problems such as its brief history as a State, its widely scattered and small population, its high costs of practically everything and its limited economic development, perceive its strengths, as represented by such things as its vast natural resources, oil, gas, coal, minerals, timber and fish, the private capital represented by the Native Corporations, State Fiscal Affairs, such as the creation of the Permanent Fund and the prospect of an expanding broad based economy with due regard for the quality of life, as insuring a bright future for the State. Nothing intrigues an investor more than lending to a government which is improving its credit position and so have his investment grow in relative value as time goes by.

The Impact Report places its principal measurement of bonding capacity on the ratio of annual debt service for all projected State needs, both related to the capital move and other needs, and projected General Fund revenues. We agree that this is a valuable and useful index, but do not agree with setting an 8% limit on the ratio of debt service to General Fund revenues. We can see this ratio as high as 16% without having an appreciable effect on the cost of raising funds in the capital market at reasonable rates when it is needed.

(2) Ability to meet cash requirements

The "business" of government at the state level is easily simplified to embrace three general areas of activity. They are education, transportation and what can be summarized as "social services" which would include such activities as health care, protection, justice and development of natural resources. As the Impact Report illustrates, even if the cost of the capital move as measured as a percentage of general fund revenues substantially exceeds 8%, said costs are minor compared to the three principal activities of state government.

(3) Marketability

As stated in the Impact Report, there is a volume restraint on investors based on an issuers location in a state or region. However, in the past five to ten years there are numerous examples where seemingly unmanagable amounts of bonds have been marketed without cost penalty by issuers for a single huge project or by issuers located in a limited geograpohic region. One of the earliest was an issue of $1.6 billion voted in the early 1960's in California to finance the "Feather River Water Project". At that time the underwriting community scoffed at the huge program and predicted it couldn't be financed except at a large penalty in terms of cost of borrowing. However, the project was financed successfully at no penalty in cost and as the project neared completion was able to raise additional capital by issuing revenue bonds for final completion and some expansions. Another more recent example was the authorization for the Municipal Electric Authority of Georgia to issue $2 billion bonds, over a period of years, to finance the Authorities ownership share in large electric generating projects, jointly with other owners, to serve 47 towns in Georgia with a combined population approximately the same as the population of Alaska. This authorization is being sold periodically now with great success in terms of borrowing costs. The Washington Water and Power Supply System is in a financing cycle and will eventually have outstanding approximately $7 billion in debt. Again the program continues successfully. Similar results were accomplished last year when City of Atlanta decided to finance a major airport expansion by issuing all the bonds at one time in the form of a $300 million issue.

A slightly different circumstance with equally successful results occurred when three major issuers in Nebraska, Nebraska Public Power District, Omaha Public Power District and Lincoln,

Nebraska Electric Authority all announced and sold large issues totalling some $300 million in a brief four week period. There are many other successes of this kind which are being financed at favorable borrowing costs and which are not having any adverse effect on the borrowing costs of other issuers in the same state or region.

The expansion of the amount of tax-exempt bonds being offered each year and the ability of the market place to absorb them at reasonable costs to the borrower has been dramatic in the last five years and well conceived and aggressively marketed "over-sized" issues and projects have been readily absorbed by the market place. It is not our intent to imply that there is no limit to the ability of the market to absorb at reasonable borrowing costs any and all potential bond issues. The discipline of the market will be selective in evaluating the economic need, the proper purpose, the ability and willingness to pay, the state and region basic economics, etc., and projects not meeting the tests will be penalized or ignored. There is a limit which can't be quantified, but we are of the opinion that the financial needs of the capital move combined with the projected need for borrowing by the State and its subdivision of government, based on the circumstances peculiar to Alaska can be met by the bond market at reasonable borrowing costs at the times the funds are needed.

II. Large capital raising programs

As discussed briefly above, major funding programs involving hundreds of millions and often billions of bonds are being successfully financed today. The key is a well planned, extensive and aggressive marketing program. Prior to the marketing program itself being initiated, project costs should be determined and announced publically in terms of both today's costs and inflated costs to cover an extensive construction time table. When financing by general obligation debt to be authorized by public vote, the entire bonding program should be voted upon by the constituants. They should be completely informed as to total costs as well as bonding requirements. Put the whole plan out in the open and right up front so that the public support is based on facts.

Investors will make judgements to lend funds to a project through the purchase of bonds when they can make an analysis that goes far beyond the mere citing of economic statistics and traditional ratios. Areas for examination include such things as the willingness to pay in addition to the ability to pay, the quality

of leadership and abilities of those entrusted with management of the financial affairs of the issuer, the need for the project, both from an economic and social point of view and the support of the people of the impacted area, (the business and banking community, the academic community and the public interest groups, including environmentalists). The marketing program will demonstrate public support, a determination to initiate and complete the project and the ability and resources to accomplish the task.

Such a marketing program includes a "road-show" of State officials, banking and business leaders, legislative and administration representatives holding high office telling the story of Alaska and the project to be financed at a series of meetings in the chief financial centers of the lower 48.

The principal sources of investment capital to purchase tax-exempt bonds are institutions (casualty insurance companies), banks, (commercial banks for their own investment needs and trust banks for their managed funds), tax-exempt mutual funds and unit trusts and individual investors. Each of these groups can be reached by the marketing program which will be orchestrated to telling the Alaska story from several points of view including Chamber of Commerce type promotional material, economic and financial facts, administration, legislative, business and public support and a clear demonstration that the program will fill a real need and that the issuer has the determination, resources and support to make it work.

In summary, it is our opinion that the State of Alaska, through the issuance of General Obligation bonds and the allocation of General Fund revenues, can finance the proposed Capital Move, as contemplated in the Financing Plan for the New Capital City of Alaska as discussed in the addendum thereto, "Impact on State Bonding Capacity and Annual State Budgets", in a timely manner at reasonable rates. This can be accomplished without increasing the cost of borrowing of the State and other issuers for non-capital move purposes and without causing General Fund revenues for all State needs being overwhelmed by the Capital Move requirements.

Significant unique characteristics of Alaska will be perceived to require analysis as to creditworthiness outside the traditionally used investment criteria. These characteristics will more than over come the low stature Alaska achieves by the traditional evaluation techniques.

Investors can be attracted to lend capital to large projects by complete and factual up-front disclosure of dollar requirements, by the demonstration of public support by obtaining voter approval of not only bonding requirements, but all costs, and by an extensive marketing program structured to demonstrate not only the ability, but the willingness to complete the project and repay the borrowed costs of its creation.

Theodore P. Swick

October 15, 1979

C. Richard Walker
Orrick, Herrington, Rowley & Sutcliffe
600 Montgomery Street
San Francisco, California 94111

In preparation for the upcoming session, legislative leaders have requested that we gather certain information for their review prior to the session. As the State's bond counsel, I would appreciate your responses to the following questions:

1. How much could be placed in a General Obligation Debt Guarantee Fund subject to IRS arbitrage limits?

2. Will the State have a possible arbitrage problem with the IRS if it continues to issue tax-exempt debt while building up a massive general fund surplus?

Sincerely,

J. H. Hogan, Director
Legislative Finance Division

JHH:pw

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October 30, 1979

Mr. J. H. Hogan
Director
Legislative Finance Division
State of Alaska
Pouch WF, State Capitol
Juneau, Alaska 99811

Dear Mr. Hogan:

In response to the questions in your letter of October 15:

1. This question will need considerably more elaboration before I can answer it with any reasonable assurance. I am not sure whether the suggested fund is to be used to guaranty debt service on general obligation bonds of the State or debt service on general obligation bonds of local governments in the State. I do not know the source of the moneys to be put into the fund, but I assume that those moneys will not come from any proceeds of bonds. On that basis, I do not think that a proper interpretation of the Internal Revenue Code would result in any arbitrage yield restrictions on the fund, because the applicable Code provision relates to the use of the proceeds of bonds.

However, the Internal Revenue Service has stretched and distorted the term "proceeds" in the Treasury Regulations and rulings thereunder. The result appears to be that, if the State deposits moneys from any source into a fund to be used to pay the debt service on general obligation bonds of the State or on general obligation bonds of local governments, or which fund is pledged as security for any such debt service, the Internal Revenue Service would consider the fund to be "proceeds" subject to arbitrage yield restrictions. This is indicated by Rev. Rul. 78-302 and Rev. Rul. 78-348, a copy of which is enclosed.

Even on this basis, the establishment of the fund probably could not affect the tax status of interest on bonds issued before the fund is established or before it was expected

to be established. Moreover, if the amount in the fund considered allocable to bonds hereafter issued, together with any other amounts chargeable under arbitrage rules to the "minor portion" of the proceeds of those bonds which is not subject to arbitrage limitations, do not aggregate more than 15% of the face amount of those bonds, the investment of the fund should not be subject to arbitrage yield restrictions.

The foregoing is all subject to further qualifications and complexities, but I think there is no point in pursuing them here. If you can give me a complete description of the workings of the proposed fund, I will try to give you a more definitive answer as to the federal income tax results. If there is any special need or desire for such a fund, I might suggest requesting a ruling from the Internal Revenue Service as to their treatment of the specific facts, and possibly an appeal from that ruling to the Tax Court in the quite possible event that we consider the ruling to be contrary to the law.

In any event, I am somewhat mystified as to the purpose of or need for the proposed fund, particularly if it is to relate to general obligation bonds of the State.

2. The issuance of bonds by the State in the presence of a "massive general fund surplus" should not result in taxability of the interest on the bonds, and it surely would not. This conclusion appears to be supported by Rev. Rul. 78-302 (enclosed). However, your phrasing of the question in terms of "a possible arbitrage problem with the IRS" prompts me to note that the IRS has gone so far in its pursuit of "arbitrage" that I would not be entirely surprised at anything that organization might contend.

In connection with all of the foregoing, I urge you and others in the State government to support the bill sponsored by the Municipal Finance Officers Association and about to be introduced in Congress to cure problems like these and to prevent further excesses.

Sincerely yours,

C. Richard Walker

Enclosure

income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Section 1.451-2 of the regulations provides, in pertinent part, as follows:

> (a) *General rule.* Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. • • •

If a life insurance policy provides that proceeds will be paid to the beneficiary of record upon receipt of due proof of death, and the insurance company determines in good faith that such a policy is payable (whether that determination is based on facts and circumstances indicating death or on a presumption of death under applicable state law), then the proceeds will be an amount paid by reason of death of the insured for purposes of section 101(a)(1) of the Code. Compare Rev. Rul. 76-468, 1976-2 C.B. 202, which states that for purposes of sections 2(a)(3), 112, 692, 6013, and 7508, the date of death of a member of the Armed Forces or a civilian employee, reported as missing in action or a prisoner of war and later declared to have been killed in action, is the Secretarial determination date of death, unless a later actual date of death is subsequently established. Rev. Rul. 76-468 refers to the Secretarial determination date of death as the date of death determined under 37 U.S.C. section 555 or 556. Rev. Rul. 76-468 is clarified so that any reference therein to the Secretarial determination date of death instead refers to the date on which the determination of death is made under those sections.

HOLDING

The payment of life insurance proceeds to *A* in 1977 is fully excludable from *A*'s gross income under the provisions of section 101(a)(1) of the Code. However, if *A* had deferred claiming the death benefit payment until a later year, any portion of the payment attributable to accumulated interest would be includible in *A*'s gross income under the provisions of sections 61(a)(4) and 101(c). Pursuant to section 1.451-2(a) of the regulations, the interest would be includible in the taxable year accumulated to the extent that *A* could have drawn upon it if *A* had submitted a claim for the proceeds.

See section 101(d) of the Code and the regulations thereunder with respect to computing the exclusion for proceeds held by an insurer under an agreement provided for in the life insurance contract, and paid other than as a single sum at a date later than death.

See section 2042 of the Code and the regulations thereunder with respect to the inclusion of the proceeds of life insurance in the value of a decedent's gross estate. For purposes of the federal estate tax, the date of death is the Secretarial determination date of death unless a later actual date of death is established.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 76-468 is clarified.

Section 103.—Interest on Certain Governmental Obligations

Arbitrage bonds; fund established for indirect payment of principal or interest. Examples illustrate whether the arbitrage yield restrictions of section 103(c) of the Code apply to amounts accumulated in funds established in connection with the issuance of local government obligations that are not used directly for the payment of principal or interest.

Rev. Rul. 78-302 [1]

ISSUE

Will amounts accumulated in certain funds be subject to arbitrage yield restrictions?

FACTS

Situation 1.

Authority *A* proposes to issue dormitory revenue refunding bonds. The refunding bonds will mature serially over 20 years. The proceeds of the refunding bonds will be deposited in an escrow fund to secure payment of the prior issue and to defease the lien of the prior issue on revenues of the authority. A portion of *A*'s dormitory revenues will be deposited in a "reserve fund." Amounts in the "reserve fund" will be pledged as security for the bonds.

Situation 2.

City *B* proposes to issue $5.5 million of 33-year sewer revenue bonds. Two and a half million dollars of the revenue bonds will mature serially over the first 30 years. In addition, $1 million of term bonds will mature in each of the last three years.

B's sewer revenue will be used as follows (in order of priority):

(1) to pay operating expenses,

(2) to pay all debt service on the revenue bonds, and

(3) to make deposits in a "renewal fund."

B covenants to maintain sewer rates high enough to pay all necessary operating expenses and to make all scheduled payments of debt service and all scheduled deposits in the "renewal fund." However, it would be impracticable for *B* to raise sewer rates high enough to meet the balloon payments due in years 31-33 solely out of revenues.

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[1] Also released as News Release IR-2018 dated July 30, 1978.

The "renewal fund" is not pledged as security for the revenue bonds. Moreover, amounts held in the "renewal fund" can in no event be used directly to pay principal or interest on the revenue bonds. However, *B*'s use of the "renewal fund" is restricted by covenants contained in the indenture for the revenue bonds. In particular, *B* is required to invest the "renewal fund" in Treasury bonds that will mature approximately 30-33 years after the revenue bonds are issued. Further, *B* will have only one practicable way to meet the balloon payments due in years 31-33. It will have to use the "renewal fund" to pay necessary operating expenses during these years. This will enable *B* to meet the balloon payments out of current sewer revenues.

Pending use, the amounts in the "renewal fund" will be invested at a yield that is materially higher than the yield on the sewer revenue bonds. Moreover, these amounts will at times exceed 15 percent of the original proceeds of the bonds.

Situation 3.

City *C* proposes to issue $10 million of general obligation bonds. While the bonds are outstanding, *C* will deposit a portion of its tax revenues in a separate "investment fund." The investment fund will be established and maintained at *C*'s discretion solely to enhance *C*'s general credit rating. It will not be specially pledged as security for the general obligation bonds, and *C*'s use of the "investment fund" will in no way be restricted by covenants contained in the bond indenture. Further, *C* does not reasonably expect to use amounts in the "investment fund" (directly or indirectly) to pay principal or interest on the general obligation bonds.

LAW AND ANALYSIS

Section 103(a)(1) of the Internal Revenue Code of 1954 provides that gross income generally does not include interest on obligations of a state or a political subdivision thereof.

Section 103(c)(1) of the Code provides that, with certain minor exceptions, the interest on an arbitrage bond is not excludable from gross income.

Section 103(c)(2) of the Code provides that the term "arbitrage bond" means any obligation all or a major portion (more than 15 percent) of the proceeds of which are reasonably expected to be used directly or indirectly (A) to acquire securities or obligations that may be expected to produce a yield over the term of the governmental issue that is materially higher than the yield on such issue; or (B) to replace funds that were used directly or indirectly to acquire securities or obligations described in (A).

Section 1.103-13(g)(2) of the proposed Income Tax Regulations published in the Federal Register on May 8, 1978 (43 FR 19675), provides that amounts accumulated in a sinking fund for an issue are treated as proceeds of the issue. Section 1.103-13(g)(3) provides that the term "sinking fund" includes a debt service fund, or any similar fund, to the extent that the issuer reasonably expects to use the fund to pay principal or interest on the issue. With certain exceptions, subparagraphs (2) and (3) apply to bonds sold after May 2, 1978.

In Situation 1, the "reserve fund" will be pledged as security for the bonds. Therefore, the "reserve fund" will be treated as a sinking fund, and amounts accumulated in the "reserve fund" will be treated as bond proceeds.

In Situation 2, the specific amounts accumulated in the "renewal fund" will be used to pay operating expenses rather than to pay principal or interest on the bonds. However, *B* will use amounts held in the "renewal fund" to replace sewer revenues, and will use the sewer revenues thus freed up to pay principal or interest. Therefore, the amounts accumulated in the "renewal fund" will be used indirectly to pay principal or interest on the bonds. Consequently, the "renewal fund" will be treated as a sinking fund, and the amounts accumulated in the "renewal fund" will be treated as bond proceeds.

However, in Situation 3, *C* will not use the "investment fund" (directly or indirectly) to pay principal or interest on the general obligation bonds. Accordingly, the "investment fund" will not be treated as a sinking fund, and amounts accumulated in the fund will not be treated as bond proceeds.

HOLDING

Amounts accumulated in the "reserve fund" in Situation 1 and in the "renewal fund" in Situation 2 will be subject to arbitrage yield restrictions as provided by section 103(c) of the Code. Because these amounts will be invested at a materially higher yield, the bonds will be arbitrage bonds and interest received by the bondholders will not be excluded from their gross incomes under section 103(a)(1). On the other hand, amounts accumulated in the "investment fund" in Situation 3 will not be subject to arbitrage yield restrictions.

Arbitrage bonds; third party securities pledged as collateral. Examples illustrate whether the arbitrage yield restrictions of section 103(c) of the Code apply to securities pledged by a third party as collateral for state or local government obligations.

Rev. Rul. 78-348 [1]

ISSUE

Will certain securities pledged as collateral for municipal bonds be subject to arbitrage yield restrictions?

[1] Also released as News Release IR-2028, dated August 23, 1978.

FACTS

Situation 1.

State *A* proposes to sell $1 million of general obligation bonds, the proceeds of which will be loaned to Corporation *B*, a nonprofit corporation, that will use the proceeds to construct a hospital. In addition, *B* owns a federally insured mortgage note worth $1 million that will be pledged as collateral for the bonds. Under the terms of the pledge, the bondholders are reasonably assured that this collateral will be available if needed to pay debt service, even if *A* and *B* encounter financial difficulties. The yield on the mortgage note will be materially higher than the yield on the bonds.

Situation 2.

County *C*, a political subdivision of State *D*, proposes to sell $50 million of general obligation bonds. *C* will use the bond proceeds to finance the construction of various county buildings. Taxes and other revenues will be used to retire the bonds serially over 25 years.

D has a surplus fund that will be invested in Treasury bonds. Certain Treasury bonds worth $50 million will be pledged as collateral for *C*'s bonds. Under the terms of the pledge, *D* cannot dispose of any of the Treasury bonds while *C*'s bonds are outstanding (except to pay holders of the bonds in the case of default). Thus, the bondholders are reasonably assured that this collateral will be available if needed to pay debt service, even if *C* or *D* encounter financial difficulties. However, *D* does not reasonably expect to use the Treasury bonds (or interest thereon) directly or indirectly to pay debt service (payment of principal or interest) on *C*'s bonds. The yield on the Treasury bonds will be materially higher than the yield on *C*'s bonds.

LAW AND ANALYSIS

Section 103(c)(2) of the Internal Revenue Code of 1954 provides that the term "arbitrage bond" means any obligation all or a major portion (more than 15 percent) of the proceeds of which are reasonably expected to be used directly or indirectly (A) to acquire securities or obligations that may be expected to produce a yield over the term of the governmental issue that is materially higher than the yield on such issue; or (B) to replace funds that were used directly or indirectly to acquire securities or obligations described in (A).

Section 103(c)(2)(B) of the Code applies to an issue of obligations if the proceeds are used to replace funds invested in securities having a yield that is materially higher than the yield on the obligations. This section does not apply in every case in which the higher-yielding securities could have been liquidated as an alternative to issuing the bonds. However, the requisite nexus or sufficiently direct relationship between the bonds and the higher-yielding securities does exist where the securities are pledged as collateral for the bonds. An issuer that borrows to invest in higher-yielding securities and one that borrows against such securities already owned are in virtually the same economic position. Compare section 265(2) relating to interest paid to earn tax-exempt income, and see especially section 3.03 of Rev. Proc. 72-18, 1972-1 C.B. 740, citing *Wisconsin Cheeseman v. United States*, 338 F.2d 420 (7th Cir. 1963). The same principles apply when the higher-yielding securities pledged are held by any third party who will substantially benefit from the bond issuance.

For purposes of section 103(c)(2)(B) of the Code, a pledge of collateral need not be cast in a particular legal form. Thus, for example, the bondholders need not take actual or constructive possession of the collateral. However, there must be a reasonable assurance that the collateral will be available if needed to pay debt service, even if the issuer encounters financial difficulties. Thus, for example, an arrangement will not have the effect of a pledge of collateral if the issuer has discretion to defeat the "pledge" merely by liquidating the "collateral" and disposing of the proceeds.

In both Situations 1 and 2, securities (the federally insured mortgage note and the $50 million of Treasury bonds) are pledged as collateral for municipal bonds. Moreover, the yield on these securities is materially higher than the yield on the municipal bonds. Therefore, all or a major portion of the proceeds of the proposed bonds are reasonably expected to be used directly or indirectly to replace funds that were used to acquire securities at a materially higher yield.

HOLDING

The securities to be pledged as collateral for the proposed bonds described in Situations 1 and 2 will be subject to the arbitrage yield restrictions as provided by section 103(c) of the Code. Because the securities pledged as collateral will produce a yield materially higher than the yield on the bonds, the bonds (in both Situations 1 and 2) will be arbitrage bonds and the interest received by bondholders will not be excludable from their gross income under section 103(a)(1). Further, in Situation 1, the hospital bonds will be arbitrage bonds even if they are issued to finance the construction of a for-profit hospital.

Arbitrage bonds; funds established in connection with local government obligations. Examples illustrate whether the arbitrage yield restrictions of section 103(c) of the Code apply to amounts accumulated in certain funds established in connection with the issuance of local government obligations; Rev. Rul. 78-302 clarified.

PLEASE NOTE: THE PRECEDING PAGES WERE TREATED AS A UNIT IN THE ORIGINAL DOCUMENT.

PLEASE NOTE: THE FOLLOWING PAGES WERE TREATED AS A UNIT IN THE ORIGINAL DOCUMENT

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1981

Alaska Association of Realtors Statement of Legislative Policy

PREAMBLE

Under all is the land. Upon its wise utilization and widely allocated ownership depend the survival and growth of free institutions and of our civilization. The Alaska Association of REALTORS recognizes that the interest of our State and it's citizens requires the highest and best use of the land and the widest distribution of land ownership. They require the creation of adequate housing, the building of functioning cities, the development of productive industries and farms, and the preservation of a healthful environment.

In furtherance of these needs and desires, the Alaska Association of REALTORS, by action of its membership meeting in convention at Juneau, Alaska, in September, 1980, has adopted a Statement of Legislative Policy as a guideline for evaluation of legislation pending before the 1981 session of the Alaska State Legislature. Said Statement of Legislative Policy is as follows.

Permanent Fund Legislation

We believe that monies invested in the Permanent Fund should be primarily invested in the State of Alaska for the purpose of improving the economic well being of the State and the standard of living and life styles of its citizens. We specifically oppose the current policy of investing the majority of the fund outside Alaska.

Where possible, existing financial institutions should be utilized to originate and service loans from the Permanent Fund.

We believe that the earnings from such investments should be reinvested in the same manner as the original principal.

Stimulation of the Economy

We favor expedited capital expenditures on projects already approved in bond elections by the citizens of the State of Alaska, or approved by the Alaska State Legislature, and the immediate funding of other projects with long-term economic benefits.

We oppose short-term economic stimulation through programs such as increased unemployment compensation which have no long-term economic benefit.

We support use of State funds including money from the Permanent Fund for business loans, and loans for agricultural, fishing, tourism, and natural resource development.

Tax Relief

We favor tax relief which will benefit and encourage private property ownership, and economic development.

Business Loans

We support expansion of the current business loan program to include loans for purchase of inventory and equipment and/or establishing working capital. Pledges of inventory, equipment, accounts receivable, and other business assets should be accepted as acceptable collateral.

The current business loan program should be

expanded to include loans for purchase, construction and remodeling of real properties such as: apartments, office buildings, commercial buildings and industrial buildings held for rental purposes. The program should also be expanded to include loans for land development.

Mortgage Financing

We support continuation of the long-term program established for the Alaska Housing Finance Corporation by the 1980 Legislature and feel it should be supplemented through the use of Permanent Fund monies and unappropriated surplus monies. We feel that the Legislature should now address refinement and imrovement of the current program with specific attention to:

1. The program should be expanded to include owner occupied 3 and 4 unit dwellings similar to the financing programs available through the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation.

2. Loans should be allowed for refinancing of existing high interest loans under the same criteria used for new loans.

3. In transactions where existing loans at reasonable interest rates can be assumed, Alaska Housing Finance Corporation should be allowed to make second or junior mortgages for the difference between the assumed mortgage and the program's loan limits. Such second or junior mortgages should also be available for home improvement loans.

4. The program should be expanded beyond the Federal National Mortgage Association limits to allow loans equal to 80% of the value on higher priced homes.

5. The program should be expanded to allow for interim construction loans at times when interest rates through conventional sources become so high as to be a detriment to new construction.

We support establishment of a Veterans Loan Program funded by the General Obligation Bonds similar to the program now in effect in the state of Oregon.

Land and Property Use

We oppose all restrictions on the use of real property which are not clearly necessary for the protection of health and safety, to protect the rights of other property, or to protect the environment from serious degradation. The benefits of any regulations on real property use, must be such that they clearly outweigh any negative, economic impact on the property, its owners, or the community in general, and such benefits must clearly outweigh the disadvantage of infringement on private use of such real property.

Disposition of State Lands

We support a program for transfer of State lands to private ownership in an orderly manner which will not economically disrupt existing private ownership. All subdivision and development of State lands for disposition to private ownership should be subject to the same laws and regulations applicable to private developers and private sales of such property. Such property should not be disposed of at a cost less than the greater of its development costs or fair market value as determined by independent appraisal.

Tenant/Owner Legislation

We oppose any form of rent control.

We support legislation which provides for equity and fairness in the relationship between owners and tenants.

Occupancy of Real Property by State Agencies

We support the use of existing space for occupancy by State agencies in communities where there exists an adequate supply of vacant space, as opposed to construction of new structures for such occupancy.

Testimony of Robert B. Flint
of
Wohlforth & Flint, State Bond Counsel
on S. B. 13 Before the
Senate Committee on State Affairs
Alaska State Legislature

Mr. Chairman and members of the Committee on State Affairs, I am Robert B. Flint, a partner in the law firm of Wohlforth & Flint, Bond Counsel to the State Bond Committee. I appreciate the invitation extended to our firm to testify on S. B. 13 which would appropriate general fund money for the capital projects approved at the 1980 bond election. Since the State currently enjoys a large cash surplus a number of advocates have urged a cessation of general obligation bonding for capital improvements and the pursuit of a cash only policy. My remarks today are confined to an analysis of this position and of S. B. 13 from a financial point of view. I recognize that there are considerations other than financial that need to be taken into account, but such political or policy questions are beyond our firm's role as Bond Counsel and legal advisor to the State Bond Committee.

ALTERNATE OPPORTUNITY

From a financial perspective a "cash only" policy is unwise. One of the advantages of borrowing money for capital improvements as opposed to paying cash is an expansion in the availability of funds. For most state and local governments this means an ability to build projects that they could not otherwise afford. Alaska is obviously not in this position but it

does have alternative uses for its surplus cash. The State has decided as a matter of policy to set aside a portion of the nonrecurring oil wealth in a permanent fund to ensure its availability after the oil runs out. To the extent the State builds its capital improvements for cash there will be less funds available for this kind of set-aside.

There is an ascertainable cost to such a "cash only" policy since funds set aside will earn more than the cost of borrowed funds cost. The estimated earnings over and above borrowing costs for ten year bonds with level principal payments in the amount of $150 million is $33 million. If the current borrowing rate of approximately $150 million per year is assumed the lost earnings for the 25 year life of Prudhoe Bay is $825 million without allowance for compounded interest. As capital needs and costs will increase this estimate is very conservative.

Obviously such money is not needed currently but we all know that the oil will be gone within our lifetime. At the time Prudhoe runs out our savings will be needed at least to cushion the shock of transition to normal taxation and budgeting. The idea of special funds is to preserve some of the wealth for future generations. Judicious use of general obligation debt can materially assist this goal.

FISCAL OVERSIGHT

Regular entry into the municipal bond market subjects the State to the scrutiny of that market and the rating agencies. Such an exposure is a helpful aid to the self-discipline necessary even in affluent times. Moreover it builds a reputation with the market that is invaluable when

borrowing becomes necessary. Alaska has carefully built its reputation over the last 20 years starting with a Baa rating (medium grade with speculative characteristics) to Aa (high grade) this year. This effort has resulted in excellent interest rates for State borrowing. The table on Exhibit "A" shows the improvements in the state's credit. If entry into the bond market is stopped this effort will be wasted. After the oil is gone the State will simply have to start all over again. Like any private person a State must establish credit. An applicant who has never borrowed is a poorer risk than one who has. The bond market is like all bankers. The devil it knows is preferred to the saint it doesn't. It would be wise to leave a good credit rating to future generations.

FINANCIAL IMPACT

The current impact of debt service on the State budget is minimal. Only 2.9% of 1980 general fund revenues were spent on debt service. The ratio of debt to assessed valuation in 1979 was about 3%. These are low figures which will certainly decline further even if borrowing is increased. The table on Exhibit "B" shows the decline in the debt burden. There is plenty of room to continue a sensi[illegible] rowing program.

CONCLUSION

From the point of view of a technical advisor S. B. 13 is not good public policy. The cost will be substantial to the state if adopted and continued during the period of oil wealth. Continuing the present policy of a conservative use of the capital markets on the other hand has clea

benefits without any negative effects. As I stated in my opening remarks the perspective I present today is limited and is intended to provide information for your consideration. As Bond Counsel to the state, I, of course, take no position on the actual passage of S. B. 13.

EXHIBIT "A"

State G.O. Bonds

The following tabulation gives details of bonds sold since 1973:

Date of Bonds	Amount of Issue (Millions)	Maturities	Avg. Life in Years	NIC	Bond Buyer Index	Interest Cost Per Borrowed Dollar	Ratings (at the time of issuance) Moody's/S&P
Jan. 15, 1973	$ 20.0	1976-1998	15.3	5.12%	5.08%	78.2¢	Baa 1/A
June 1, 1973	27.0	1976-1998	14.8	5.10	5.10	75.6	Baa 1/A
Aug. 1, 1973	31.0	1977-1998	16.7	5.80	5.58	96.8	Baa 1/A
Sept. 1, 1974	30.0	1978-1998	15.6	6.85	6.88	107.2	A 1/A
Feb. 1, 1975	40.3	1978-1998	14.6	5.98	6.59	87.3	A 1/A+
May 1, 1975	42.0	1979-1999	15.1	6.52	6.95	98.5	A 1/A+
Oct. 1, 1975	42.9	1978-1997	12.5	6.85	7.49	85.8	A 1/A+
March 1, 1976	40.0	1978-1993	9.5	5.86	6.95	55.7	A 1/A+
July 1, 1976	40.0	1978-1993	9.5	5.80	6.87	57.3	A 1/A+
Feb. 1, 1977	40.0	1979-1988	9.5	5.08	5.90	48.3	A 1/A+
Oct. 1, 1977	40.0	1979-1988	7.0	4.50	5.50	29.3	A 1/A+
April 1, 1978	45.0	1980-1988	7.0	4.86	5.59	29.2	A 1/A+
Jan. 1, 1979	40.0	1979-1989	5.5	5.52	6.29	30.0	A 1/A+
May 1, 1979	60.0	1979-1989	5.5	5.59	6.25	32.1	A 1/A+
July 1, 1980	125.0	1981-1990	5.5	5.76	7.55	35.8	Aa/AA-

Source: John Nuveen & Co. Incorporated

EXHIBIT "B"

The schedule below compares debt service with general unrestricted revenues for the last eight fiscal years:

Fiscal Years Ending June 30	General Unrestricted Revenues (Millions)	Debt Service (Millions)	Percent Required for Debt Service
1973	$ 214.6	$23.5	10.95
1974	258.1	26.3	10.22
1975	333.6	30.1	9.03
1976	705.4	35.1	4.98
1977	877.4	41.8	4.77
1978	768.0	50.0	6.51
1979	1,117.4	60.0	5.36
1980 (est.)	2,550.0	75.1	2.95
1981 (est.)	3,808.8	—	—

Source: John Nuveen & Co. Incorporated

SENATE STATE AFFAIRS COMMITTEE HEARING

ON

1. DEPOSITS IN THE PERMANENT FUND: 2. PAYING CASH FOR CAPITAL IMPROVEMENTS

February 21, 1981

Testimony by Harold E. Pomeroy

Our future is bright if we don't spend billions and billions of dollars unproductively trying to create an artificial destiny for Alaska.

Right now we are misreading the signals.

There is popular belief that if we just do the right things we can achieve a prosperous, diversified and renewable resources economy, including renewable resource production and processing-manufacture. This means, of course, producing goods for export.

We are negligible producers of processed-manufactured goods - with few exceptions, relative to our resource production and services economy, due to far higher costs here than elsewhere - costs that cannot be cured by spending money. Where the potential for competitive position in the market is lacking, direct and indirect aid is only creating artificial viability that can last only until the money runs out.

The wrong signal is that somehow, if we just put enough money into articial viability in the direction of diversification and renewable resource processing we can turn a liability into an asset. The result is the false assumption that taxes generated out of these areas of activity will be able to make up for less oil income in the future.

The hard fact is that there is no basis whatever for believing the aggregate of all tax revenue from all sources, other than oil production will increase the approximate 1/10 of our expenditures such revenues now pay, by an appreciable amount, if at all - unless taxes are raised drastically.

Testimony, 2/21/81
Harold E. Pomeroy

Take the molybdenum mine soon to be established near Ketchikan. Though one of the largest deposits anywhere, molybdenum won't be made there; the concentrate will go Outside for processing for reasons of economy. Would we increase taxes on the plant two or three or more times in the future to make both ends meet due to less oil income?

Our future economic stability rests heavily on the reason the question has to be asked.

There will be a few individual exceptions to the revenue potential overall - plants with profits coming from huge investments and very few workers.

We can be encouraged about the future if we take the right signal from the dramatic increase in the amount of oil income from even two years ago. A Permanent Fund that generates a substantial part of future needed revenue is practical - with room also for such benefits as no personal income tax and some desirable capital improvements that are cost effective.

Our tremendous good fortune in quantity of oil money is that we can make massive early years deposits in the Permanent Fund, accumulate the interest and arrive at a total of as much as $125 billion to produce $13 billion or $14 billion in annual revenue from then on.

We should place the highest priority on action to secure as strong a financial future as possible, rather than to grab more toward a taxless society and what amounts, indirectly, to colossal price support for economic enterprise that simply isn't economically viable in the open market.

	PERMANENT FUND		BUDGET GROWTH	
	I.	II.	III.	IV.
	$2 Billion at 11% compounded	$4 Billion	$2 Billion - at 11 rate of increase	$2 Billion - at 15 rate of increase
Yrs				
5	$3.37	$6.74	$3.37	$4.02
10	$5.68	$11.36	$5.68	$8.09
15	$9.57	$19.14	$9.57	$16.27
20	$16.12	$32.29	$16.12	$32.73

I. At the end of 20 years the $16.12 would produce $1.67 billion yearly - from then on.

III. The $1.67 billion would not go very far toward funding the $16.12 billion budget. The 11% rate of increase may not be enough for inflation and population growth and would allow zero for real growth.

IV. At 15% growth, $120 billion in the Permanent Fund would produce about $13 billion in earnings revenue toward the $32.73 billion budget

February 21, 1981

Harold E. Pomeroy

PLEASE NOTE: THE PRECEDING PAGES WERE TREATED AS A UNIT IN THE ORIGINAL DOCUMENT.

WORK DRAFT WORK DRAFT WORK DRAFT

Alaska State Legislature

Senate

Committee on State Affairs
Chairman Vic Fischer

Pouch V
State Capitol
Juneau, Alaska 99811

Official Business
February 20, 1980

SENATE STATE AFFAIRS COMMITTEE REPORT

ON

SB 13 "An Act making special appropriations for capital improvements for which general obligation bonds were approved by the voters at the 1980 general election; and providing for an effective date."

SB 21 "An Act making a special appropriation to the Alaska Permanent Fund; and providing for an effective date." ($1,500,000,000)

SB 68 "An Act making a special appropriation to the Alaska Permanent Fund; and providing for an effective date." ($1,800,000,000)

BILL SUMMARY

SB 13 This bill would use a general fund appropriation to pay for these capital improvements rather than issue General Obligation (G.O.) Bonds. The opportunity cost assumes the State would either invest its own money, if bonds would have been sold, or if spent on other projects, etc., that project has an implicit rate of return equal to what the State could have gotten by investment.

Assumptions:
(1) A 12% earnings rate on invested funds or project.
(2) An 8% interest rate on cost of debt.
(3) If debt were issued it would be as follows (in millions) FY'82-$100, FY'83-$150, FY'84'$39, 712; Total issued $289,712,500.
(4) Projects start/debt occured at beginning of each period.
(5) Not discounted for present value.

SB 21 This bill would make an appropriation from the general fund to the Alaska Permanent Fund in the amount $1,500,000,000.

SB 68 This bill would make an appropriation from the general fund to the Alaska Permanent Fund in the amount $1,800,000,000.

BACKGROUND

SB 13 The classical argument of economics can be made in the case of SB 13. When a government, any government needs to make capital outlays for needed projects and cash is not readily available, then that government issues bonds to pay for the capital. This is the normal way of building roads, schools, etc. What happens when there is a surplus of cash on hand? Do you still issue bonds or do you use the cash you have? A sound case for the concept behind SB 13 can be made. The State of Alaska, because of Prudhoe Bay, has a ready supply of cash. The choice then becomes whether or not the state

through the Dept. of Revenue should issue general obligation bonds or use available cash. What is not obvious about paying cash for the November 1980 authorized but unissued G.O. bonds, is that there are over $100 million Pre-1978 authorized but unissued bonds that need to be included in this general fund appropriation. (See statistics at end of summary.)

Another concept of classical economics is one of defeasance. Through a special defeasing [escrow] account, the state could create a monetary approach that would pay off the entire state debt. This account managed by a special bond counselor would invest in the taxable bond market [12% interest] while paying off the incurred debt in the tax-exempt bond market [8% interest]. The potential is there at the moment to erase Alaska's debt [$720 million] with a cash account of [$570 million]. One may ask why not make the investments directly out of the general fund and not set up a special account. It has become clear that the Alaska Legislature has the ability to spend all the money before it no matter the amount. This special [escrow] account would set this money aside for a specific purpose: to pay the state debt.

With continuing pressure from our Washington delegation assuring us that the mood in the "lower 48" is becoming increasingly jealous of our resource wealth, this would be one way of "putting our house in order." We would be showing our responsiveness to the nation's financial community by giving a clear signal that we were doing "first things first." We pay off our debts before we borrow money for other purposes.

If we were to create this "defeasing escrow account," it would preclude us from going to the bond market for a period (minimum) of 18 months due to IRS regulations. That is why this concept goes hand in hand with substituting cash for all authorized but unissued general obligation bonds. The next time we would be eligible to go to the bond market would be (roughly) after the 1982 general election.

The Hammond Administration approves of the defeasing concept if, there are several if's, but the principal one being that it does not affect the $1,800,000,000 contribution to the Alaska Permanent Fund (SB 68). If the money is just going to be spent to continue growth in state government then he would certainly favor defeasing.

Defease $720 million of outstanding G.O. bonds	$570 million
Cash out all authorized but unissued bonds	463 million
Delete FY'82 debt service	(128 million)
	$905 million

<u>SB 21 & 68</u> These bills have almost identical wording, the only difference being the actual dollar amount. Sen. Rodey's bill would transfer $1,500,000,000 to the Alaska Permanent Fund; the Governor's bill would transfer $1,800,000,000.

Governor Hammond believes that it is appropriate that Alaska set aside this amount this year of its oil wealth so that its earning can provide an increased income stream for the benefit of all Alaskans. The Legislature determined that dividends should be worth a <u>minimal</u> $50 each. This contribution will provide sufficient earnings to meet that commitment without having to borrow from the general fund. Should the state not make such provisions, our legal case may

be weakened.

The Permanent Fund Board of Trustees have not taken a stand on this and other issues concerning the "Fund's" plan for the future. Instead, they are planning a series of seminars to examine all alternatives and to establish long range as well as short-term planning for the Alaska Permanent Fund.

Alaska State Legislature

Senate

Committee on State Affairs

Official Business

Pouch V
State Capitol
Juneau, Alaska 99811

Feb. 21, 1981 Captain Cook

9:00 am Anchorage

MEMBERS PRESENT: SENATOR FISCHER, CHAIR
SENATOR BRADLEY
SENATOR COLLETTA

VISITING: SENATOR RODEY
REP. CLOCKSIN

AGENDA: SENATE BILL 13 "An Act making special appropriations for capital improvement projects for which general obligation bonds were approved by the voters at the 1980 general election; and providing for an effective date."

SENATE BILL 21 "An Act making a special appropriation to the Alaska permanent fund; and providing for an effective date."

SENATE BILL 68 "An Act making a special appropriation to the Alaska Permanent Fund; and providing for an effective date."

Chairman Fischer called the meeting to order, introducing the three pieces of legislation on the agenda. He pointed out that what is presently referred to as "surplus funds" in the state of Alaska is in fact not surplus at all, because many needs of the state have not been met. When those statewide needs have been met, then what money is left over will constitute a surplus.

Senator Colletta stressed the importance of continuity in successful money management; the process of politics, he said, often fails to reflect such continuity. He further stated that the idea behind SB 13 does not present an ongoing policy; rather it is a one time event to get those projects approved by the voters in the last general election started quickly.

Senator Bradley commented that "it takes money to make money".

Senator Rodey, while he favors a conservative banking approach characterized, in part, by participation in the bond market, expressed support for utilizing a combination of participation

in the bond market and cash appropriations; in essence, a mix of the policies now being discussed before the committee.

Rep. Clocksin supports the $1.8 billion appropriation to the permanent fund, and is keeping an open mind toward SB 13.

Anselm Staack, Comptroller, Div. of the Treasury, Dept. of Revenue, presented an overview of SB 13 and the concept of defeasance. He described how the present status of the market would allow defeasing $720 million worth of G. O. bonds with $570 million worth of cash outlays placed in a special "escrow" account. Staack stated that the Governor would introduce legislation that would defease the school debt at a cost of $275 million. He pointed out the problem of interest arbitrage and the time factor that would prohibit the state from returning to the bond market for a period of approximately two years due to IRS regulations. Finally, he made note of the fact that SB 13 ($289M) did not cover all of the authorized but unissued bonds. Such a figure would total approximately $466 million.

In response to the question, "Should the state stay in the bond market in the future?" Anselm Staack said that the state should. In response to the question, "Will defeasing affect the state's bond rating?" Staack replied that defeasing would have the potential of raising the state's bond rating, and certainly would not hurt the rating. In response to the question, "Is there a tie between the school debt and the G. O. debt?" he stated that there was none.

Senator Rodey asked whether the escrow account would be invested in government securities. Anselm Staack replied that it would. Senator Rodey expressed reservations about the state financing the national debt through this type of investment.

Anselm Staack closed his remarks with the reminder that the more money the state put into the permanent fund, the less there would be to spend on other projects.

Robert Flint, State Bond Counsel, maintains that a cash only policy is not a wise policy. He provided historical background of how the state has improved its bond rating from B-AA to AA rate. Responding to a question posed by Chairman Fischer, Flint said that SB 13 combined with defeasance would not harm the state bond rating, but the state would lose $300 million in opportunity cost by not going to the bond market. In response to the question, "Would the combination of SB 13 and defeasance improve the state's rating?" Robert Flint answered in the affirmative, stating that the market likes to know it's going to be paid. In explaining the state's bond limit, he stated that the municipal market looks more at the type of investments that state makes rather than the amount. It would approve more of sewer, water and road projects rather than domed cities and capital move projects.

Malcolm Roberts, Executive Director of Commonwealth North, opposes putting 1.5 or 1.8 billion dollars into the permanent fund. If we do this we are locking up our revenues in a restricted place. We need, Mr. Roberts maintained, to invest it on a regional basis so we can build the state infrastructure. We have to diversify: there are needs for railroads, ports, energy. This is our challenge for the future. As one faces the future one should put $1 out of $7 into investment.

Senator Rodey responded that we must be prudent with our wealth; he maintained that we should make early and sizable appropriations to the permanent fund. He added that according to Senate priorities we will put $1 in every $6.7 into ivestment.

Senator Bradley maintained that we should not put our wealth into savings, but rather put it out on the streets, into the free enterprise system.

John Havelock, testifying as a citizen, emphasized that great care must be exercised in dealing with interest arbitrage lest Alaska be penalized. He stressed the importance of planning for the future in the area of capital projects, suggesting that the voters might not have approved all of the bond issues if they had been more fully informed. Many large projects, he explained, are protected by "motherhood titles" and the people are not always sure what they are voting on. John Havelock suggested establishing a multi-year approach to capital improvements rather than the leapfrogging "wish-lists" currently used. The dimensions of the problems encountered in developing the role of the permanent fund are great: $1 billion is more than the ANCSA, greater than the original TAPS estimate and larger than the earthquake pay-off of the sixties. John Havelock's final point dealt with the way in which many large, public projects develop a momentum of their own and they outstrip fiscal analysis. It's the little jobs that create jobs for Alaskans, the big jobs that create jobs for outsiders. One cannot buy economic opportunity, one can only subsidize it.

Harold Pomeroy, testifying as a citizen, spoke of his own experiences in Alaska as a homesteader and the first Kenai Borough Mayor. He told of the attempt to build diversified economy in Southcentral Alaska and his realization that it was "not feasible". He stressed the importance of developing a long-range plan for our economic future; we must pick and choose carefully when building our infrastructure. Harold Pomeroy maintains that the high unemployment rate in Alaska may be unchangeable, that to throw money at development is irresponsible, and that having a broad diversified economy is impossible.

Jim Rhode, special assistant to the Board of Trustees of the Alaska Permanent Fund, opened his testimony with the statement that we need a broad review of oil money and the future of the permanent fund. He announced that the Board was planning a series of seminars on the permanent fund to be held in Juneau, Anchorage, and Fairbanks, and invited everyone present to take part.

James E. Fisher, testifying as a citizen, expressed his principal concern: he would like to see the public take a great interest in the hearings about the permanent fund in order to have the maximum amount of public input.

Lee Gorsuch, of the Institute of Social and Economic Research, the Anchorage School Board, and testifying also as a citizen, questioned the criteria the state was using to judge whether putting $1.8 billion in the permanent fund was too much or too little. He stated that the 25% of the royalty payments going into the permanent fund would be swamped by the 75% going into the general fund. Lee Gorsuch made a point of emphasis in questioning the actual expenditure policy of the state and how it related to the results Alaska is presently achieving. He posed the question, "What do we want Alaska to look like in twenty years?" and asked committee members to devote some thought to school endowment and higher budgets for education.

Scott Goldsmith, ISER Economist, initially responded to earlier testimony on SB 13, agreeing that the state should plan wisely; he expressed support for making positive interest arbitrage on the defeasance account. He put this in perspective by asking how long we would make payments on our large capital projects, and if we expected to be making payments on these after Prudhoe Bay runs out. What was the prospectus for future generations? Scott Goldsmith then put the Sadlerochit find in perspective by comparing it to other world scale oil discoveries. He placed an $80 billion (1981 dollars) price tag on Alaska's oil inheritence from Prudhoe Bay, and then said with a 2% real return to the state, the annuity from this inheritence was $1.6 billion per year. If the state only spent $1.6 billion, then it could spend that every year and never touch the principal. This year we have $6.6 billion, a combination of interest, principal, and earnings. If we spend $6.6 billion, we are eating into the principal. Goldsmith said it would be very hard to identify another source of revenue that might replace Prudhoe. He compared it to coal, and made an interesting observation/comparison: making the assumption that the real return on a ton of coal is $.25, how much coal would have to be mined to equal $1.6 billion per year? We would have to mine 8 billion tons of coal. We now mine 1 million tons. The Koreans want to buy 4 million tons. How much is there in the Beluga and Nenana coal fields? 4 billion tons in known reserves. We would have to mine all of these known reserves in six months to equal the annuity of our inheritence from Prudhoe Bay. Goldsmith closed by saying that the size of the "inheritence" should be kept in perspective when planning the state's future.

Ken Gain, of the Alaska Association of Realtors, said that there were a number of questions which needed to be answered before we made these large early year appropriations to the permanent fund. We have to ask ourselves, Mr. Gain stated, what that money is competing against. Anchorage is going to face a quadrupling of its heating (natural gas) costs in five years when the present contract runs out. All the cities of the state are facing housing shortages, according to Mr. Gain, (???) and he maintains that the permanent fund is "having your cake and eating it too". We must, he stated, make good, sound investments in Alaska, for the people in Alaska.

Chairman Fischer responded that the appropriation this year is part of the context for setting permanent fund policy for the next year and the year to come.

The meeting adjourned at 12:05 pm.

THE LEGISLATURE OF THE STATE OF ALASKA
TWELFTH LEGISLATURE

SB 13

FISCAL NOTE

I. REQUEST
Bill/Resolution No. SENATE BILL NO. 13
Title Making special appropriations for capital improvements for projects for which general obligation bonds were approved by the voters at the 1980 general election.
~~Requested by~~ Date 1/13/81
Requested by Senate State Affairs Committee

II. FISCAL DETAIL
Agency Affected State Bond Committee, Dept. of Revenue
Program Category Affected General Fund
BRU, Program, or Subprogram(s) Affected
(Note: If more than one budget component is affected, separate line-item amounts and funding for each component in the analysis section.)

EXPENDITURES (Thousands of Dollars)

	FY 81	FY 82	FY 83	FY 84	FY 85	FY 86
100 PERSONAL SERVICES						
200 TRAVEL						
300 CONTRACTUAL						
400 COMMODITIES						
500 EQUIPMENT						
600 LAND & STRUCTURES						
700 GRANTS, CLAIMS, ETC.						
TOTAL						

FUNDING (Thousands of Dollars) IN TERMS OF OPPORTUNITY COST

→ MILLIONS ←		4.0	10.8	14.4	16.7	19.0
GENERAL FUND						
FEDERAL FUNDS						
OTHER (Specify Fund Source)						

POSITIONS

FULL TIME						
PART TIME						
TEMPORARY						

III. ANALYSIS (See Fiscal Note Preparation Instructions, Section III)

This bill would use a general fund appropriation to pay for these capital improvements rather than issue General Obligation bonds. The opportunity cost assumes the State would either invest its own money, if bonds would have been sold, or if spent on other projects, etc., that project has an implicit rate of return equal to what the State could have gotten by investment.

Assumptions: (1) A 12% earnings rate on invested funds or project.
(2) An 8% interest rate on cost of debt.
(3) If debt were issued it would be as follows (in millions): FY 82-$100, FY 83-$150, FY 84-$39.712; Total issued $289,712,500.
(4) Projects start/debt incurred at beginning of each period.
(5) Not discounted for present value.

IV. DATE February 19, 1981 PREPARED BY Anselm C. Staack, Treasury Comptroller
AGENCY Dept. of Revenue/Treasury Division
PHONE 465-2351

Original: Legislative Finance
cc: Budget and Management
Prime Sponsor (First Legislator Named)

33-001 (Rev. 12/80)

SENATE STATE AFFAIRS COMMITTEE HEARING

ON

1. DEPOSITS IN THE PERMANENT FUND: 2. PAYING CASH FOR CAPITAL IMPROVEMENTS

February 21, 1981

Testimony by Harold E. Pomeroy

Our future is bright if we don't spend billions and billions of dollars unproductively trying to create an artificial destiny for Alaska.

Right now we are misreading the signals.

There is popular belief that if we just do the right things we can achieve a prosperous, diversified and renewable resources economy, including renewable resource production and processing-manufacture. This means, of course, producing goods for export.

We are negligible producers of processed-manufactured goods - with few exceptions, relative to our resource production and services economy, due to far higher costs here than elsewhere - costs that cannot be cured by spending money. Where the potential for competitive position in the market is lacking, direct and indirect aid is only creating artificial viability that can last only until the money runs out.

The wrong signal is that somehow, if we just put enough money into articial viability in the direction of diversification and renewable resource processing we can turn a liability into an asset. The result is the false assumption that taxes generated out of these areas of activity will be able to make up for less oil income in the future.

The hard fact is that there is no basis whatever for believing the aggregate of all tax revenue from all sources, other than oil production will increase the approximate 1/10 of our expenditures such revenues now pay, by an appreciable amount, if at all - unless taxes are raised drastically.

Testimony, 2/21/81
Harold E. Pomeroy

Take the molybdenum mine soon to be established near Ketchikan. Though one of the largest deposits anywhere, molybdenum won't be made there; the concentrate will go Outside for processing for reasons of economy. Would we increase taxes on the plant two or three or more times in the future to make both ends meet due to less oil income?

Our future economic stability rests heavily on the reason the question has to be asked.

There will be a few individual exceptions to the revenue potential overall - plants with profits coming from huge investments and very few workers.

We can be encouraged about the future if we take the right signal from the dramatic increase in the amount of oil income from even two years ago. A Permanent Fund that generates a substantial part of future needed revenue is practical - with room also for such benefits as no personal income tax and some desirable capital improvements that are cost effective.

Our tremendous good fortune in quantity of oil money is that we can make massive early years deposits in the Permanent Fund, accumulate the interest and arrive at a total of as much as $125 billion to produce $13 billion or $1.4 billion in annual revenue from then on.

We should place the highest priority on action to secure as strong a financial future as possible, rather than to grab more toward a taxless society and what amounts, indirectly, to colossal price support for economic enterprise that simply isn't economically viable in the open market.

	PERMANENT FUND		BUDGET GROWTH	
	I.	II.	III.	IV.
	$2 Billion at 11% compounded	$4 Billion	$2 Billion - at 11% rate of increase	$2 Billion - at 15% rate of increase
Yrs				
5	$3.37	$6.74	$3.37	$4.02
10	$5.68	$11.36	$5.68	$8.09
15	$9.57	$19.14	$9.57	$16.27
20	$16.12	$32.29	$16.12	$32.73

I. At the end of 20 years the $16.12 would produce $1.67 billion yearly - from then on.

III. The $1.67 billion would not go very far toward funding the $16.12 billion budget. The 11% rate of increase may not be enough for inflation and population growth and would allow zero for real growth.

IV. At 15% growth, $120 billion in the Permanent Fund would produce about $13 billion in earnings revenue toward the $32.73 billion budget

February 21, 1981

Harold E. Pomeroy

UNIVERSITY OF ALASKA
FAIRBANKS, ALASKA 99701

TO: Senator Vic Fischer

DATE: 2/25/81

Attached is my testimony before the Senate State Affairs Committee public hearing on 2/21/81. I appreciate the opportunity to appear and present testimony

Scott Goldsmith

Testimony Before Senate State Affairs Committee

of

Scott Goldsmith
Institute of Social and Economic Research

February 21, 1981

Senate Bill 13 - An act to appropriate cash from the general fund to pay for capital improvements approved by G.O. bonds in 1980.

The logic of borrowing to pay for capital projects when the state has the money to pay cash rests upon the idea of "arbitrage." That is the ability to earn money by borrowing at a low rate of return and investing the borrowed funds at a higher rate of return. When arbitrage is possible, income is maximized by borrowing to pay for capital and, in fact, any expenditure. Thus, when the state can effectively invest money at a higher return than it must pay to borrow, paying cash does not maximize state revenues.

There are, however, two considerations which could alter this conclusion in the unique situation which faces the state of Alaska.

1. The arbitrage model assumes rational behavior on the part of government. Although government is composed of rational individuals, their collective decisions on the spending of money are not always rational. In other words, money gets spent on projects which do not yield a positive return, and this is more likely to occur when the state has more money to spend.

   Thus, in analyzing whether paying cash for capital projects makes sense, you should try to determine what spending would be eliminated by such a policy. (Or if the capital project were paid for with borrowed funds, what would actually happen to the funds made available for other purchases.) If unproductive investments are curtailed, then the opportunity cost of paying cash would be zero and no income would be lost. If productive investments are curtailed, then the opportunity cost of paying cash is the lost income from arbitrage.

2. At some time, ten-to-twenty years hence, state revenues, because they are so dependent upon Prudhoe Bay oil and gas production, will be considerably smaller than today. It is unlikely that public needs will be less, however. This suggests the public spending opportunities available to the next generation will be limited relative to our own. Further restricting their options with the requirement of retiring a substantial debt may be an unfair burden. In the extreme, state revenues could fall to such a level that they would all be required for debt service, leaving nothing for schools, highway maintenance, etc. Simply put, an <u>ability to pay</u> criterion suggests paying cash for capital projects.

One rationale for debt finance is to pay for the facility over its lifetime, such that those people pay who are actually getting the benefits as the good is consumed. In the Alaskan context, this rationale may break down because of the transient nature of the population associated with the boom-bust character of the economy, combined with the nature of the project "benefits." For example, a benefit advanced for many capital projects is the employment generated in the construction phase. This directly benefits the present population but not the population which may be here in ten-to-twenty years. The people benefiting today may leave Alaska when the boom construction jobs are all gone because state revenues cannot support them. Should they leave behind an unpaid bill in the form of annual debt service payments for those who remain in the state after the bust?

<u>Senate Bills 21 and 68</u> - An act to appropriate general fund money to the permanent fund.

State revenues from Prudhoe Bay should be viewed as a one-time inheritance. From this perspective, rules about the proportion of revenues which should be saved in the permanent fund emerge.

The unique good fortune of Alaska in its ownership of Prudhoe Bay reserves is evident from the attached Table A which compares the initial reserves in the Prudhoe Bay Field with the largest oil fields in North America and the world. At 10 billion barrels, Prudhoe Bay contains the largest reserves in North America, and only two other fields in the United States had over 2 billion barrels. A field of 100 million barrels, which would be one-hundredth as large as Prudhoe, is considered a giant and hailed as a major discovery in the United States. Consequently, the probability of the discovery of additional reserves, <u>on state land</u>, to compensate the state treasury for the eventual decline in Prudhoe Bay oil production is virtually nil.

Thus, Prudhoe Bay state resources are an inheritance, primarily in the form of oil in the ground but partly in the form of money into which some of the oil is annually transformed. This is commonly called revenues but is more properly viewed as a portion of the principal of the inheritance in monetary, rather than physical (oil in place), form.

Using current (FY 1982) estimates of the per barrel revenues from Prudhoe Bay oil as well as current estimates of recoverable oil, the present value (in 1981 dollars) of the state's inheritance is very roughly $80 billion (royalties and various taxes associated with oil production and transportation).

We can easily calculate that if that $80 billion were all invested to earn a 2 percent real rate of return, the state could withdraw $1.6 billion annually from the invested fund without reducing its value. This $1.6 billion (in 1981 dollars) would be the annual annuity which could be withdrawn every year to finance government. Such an annuity could completely finance the 1980 state budget.

This suggests that saving $1.5-to-$1.8 billion out of total revenues of $6.6 billion and spending $4.7-to-$5 billion is cutting into principal to the tune of over $2 billion. Thus, if one objective of financial planning is a sound long-term, revenue-generating base, a policy of saving $1.5-to-$1.8 billion this fiscal year in the permanent fund is inadequate.

It will, of course, be argued that the best way to ensure a stable long-term tax base is through investment in state resources. The truth is that the revenue-generating capacity of other resources does not have any possibility of providing revenues equal to the $1.6 billion annuity available through a saving and investment program of the permanent fund.

For example, consider coal. Demonstrated resources in Alaska are about 4.8 billion tons, primarily centered at the Nenana and Susitna Coal Fields (McGee and O'Connor, Mineral Resources of Alaska and the Impact of Federal Land Policies on Their Availability: Coal, Open File Report 051, DNR, USGS, 1975, p. 2).

If the state could get a 30 cent royalty on each ton of coal mined, how many tons would need to be mined annually to generate $1.6 billion from royalties? (The minimum royalty rate on state land is 5¢/ton with recent leases carrying a 30¢-35¢ royalty rate.) The answer is 5.3 billion tons. So each year, more coal would need to be mined than is currently available as reserves in order to match the $1.6 billion annuity. (The mining license tax and corporate income tax would generate some additional revenue but would not substantially alter the conclusion.) It is interesting to note that actual production of coal is presently about one million tons, or about 1/6300 the amount necessary for a tax base dependent upon coal.

TABLE A

I. LARGEST OIL FIELDS IN NORTH AMERICA

			Billion Barrels
1.	Prudhoe Bay	USA	10.014
2.	Chiapas	Mexico	6.513
3.	East Texas	USA	5.999
4.	Wilmington	USA	2.418
5.	Poza Rica	Mexico	2.028
6.	Pembina	Canada	1.742
7.	Midway Sunset	USA	1.683
8.	Yates	USA	1.600
9.	Wasson	USA	1.508
10.	Kern River	USA	1.453
11.	Panhandle	USA	1.415
12.	Swan Hills	Canada	1.315
13.	Ebano-Panuco	Mexico	1.304
14.	Sho-Vel-Tum	USA	1.300
15.	Elk Hills	USA	1.296
16.	Naranjos Cerro Azul	Mexico	1.177
17.	Huntington Beach	USA	1.076
18.	Santa Ynez	USA	1.000

II. LARGEST OIL FIELDS IN THE WORLD

1.	Burgan	Kuwait	68.900
2.	Ghawar	Saudi Arabia	60.270
3.	Safania	Saudi Arabia	17.051
4.	Kirkuk	Iraq	16.320
5.	Samotlorskoye	USSR	14.600
6.	Romashkino	USSR	14.040
7.	Rumaila	Iraq	13.935
8.	Gachsaran	Iran	11.435
9.	Marun	Iran	10.087
10.	Lagunillas	Venezuela	10.732
11.	Agha Jari	Iran	10.034
12.	Prudhoe Bay	USA	10.014

Oil and Gas Journal, August 1977, Vol. 75, No. 35, p. 102.

Alaska MUNICIPAL League

TELEPHONES
(907) 586-1325
586-6526

204 N. FRANKLIN ST.
JUNEAU, ALASKA 99801

The Alaska Conference of Mayors met in Juneau on February 5 & 6, 1981 and adopted the following provisions:

FY 81 Supplemental (SB 125). The Alaska Conference of Mayors pledged to use any supplemental funding for tax relief.

Mobile Home Financing. The Conference of Mayors urges supplemental appropriation to the Alaska Housing Finance Corporation for mobile home loans in order to ease the serious statewide housing shortage.

High Unemployment Rate. The Conference of Mayors supports state funding for capital projects in order to alleviate the serious unemployment problem in the state by providing both construction jobs and operation and maintenance jobs when the projects are completed; urges the Legislature and Governor to approve funding early enough to get projects "on the street" this construction season.

In Lieu Of Bonds. The Conference of Mayors urges speedy passage of SB 13, making direct appropriations for projects approved by voters in lieu of selling bonds; additionally supports state interim financing for municipal bonds that have been authorized by the voters but cannot be sold because of the bond market.

Permanent Fund. The Conference of Mayors urges the Legislature to create special endowments for fundamental services, such as those provided by local governments instead of increasing the Permanent Fund, in order to lessen the risk of the federal government devising methods of taking away the state's money.

School Support. The Conference of Mayors endorses the concept of 100% state funding for schools, both operating and construction.

Communities represented at those meetings include the Municipality of Anchorage, the City of Angoon, the City of Fairbanks, Fairbanks North Star Borough, the City of Haines, Haines Borough, the City of Homer, the City of Hoonah, the City and Borough of Juneau, the City of Kenai, Kenai Peninsula Borough, Kodiak Island Borough, the City of Nenana, the City of Nome, North Slope Borough, the City of Petersburg, the City of Sand Point, the City of Seldovia and the City of Wrangell.

Bill Overstreet, President
Leo Rasmussen, Vice President
George Sullivan, Secretary/Treasurer

SB

18

COMMITTEE REPORT

SENATE

1/13/81

FURTHER: Finance

Date: _____

Mr. President:

The Committee on HEALTH, EDUCATION & SOCIAL SERVICES has had SB 13

special education

under consideration and (a majority of the committee) (the committee) reports it back with the following recommendations:

[ ] do pass [ ] do not pass

[ ] do pass with attached amendments(s)

[ ] same title

[✓] replace with CS for _____ [ ] new title

and recommends _____

[ ] AND attaches a "Letter of Intent" [ ] New Fiscal Note

[ ] reports it back without recommendation

[ ] referred to the _____ Committee

MEMBERS SIGNING DO PASS

MEMBERS HAVING OTHER RECOMMENDATIONS:

CHAIRMAN

S 60 (Rev. 12/78)

As parents of an emotionally impaired child, we support HOUSE BILL NO.455, "An Act relating to state aid to school districts and regional educational attendance areas which provide instruction in special education on a year-round basis; and providing for an effective date."

We strongly feel this bill will help our son and other children with exceptional needs. We are closely involved with our son's Individual Education Program and do know that handicapped children require intense structure at school as well as home. The summer vacation period is too long for these children to go without individualized structured behavioral modification and instruction from the teaching environment.

Our goal is to mainstream these children into regular classrooms or to an environment least restrictive for the child and teacher. By having this year-round program (H.B. NO. 455), we as parents, teachers, school administrators and a healthy State of Alaska can achieve these goals sooner and better.

Very truly yours,

Jody J. Foss

Jody and Steven Foss

P.O. Box 60491
Fairbanks, Alaska 99706

cc: The Fairbanks Delegation
Mr. Joe Bielski, Director of Pupil Personnel Services
Dr. Bryce Stallard, Superintendent F.N.S. School District
Mrs. Carol Welsh, Governor's Council for the Handicapped and Gifted

refer to the board rather than the department.

Editor's note. — The repealed section derived from § 4, ch. 81, SLA 1965, and § 52, ch. 98, SLA 1966.

Sec. 14.30.347. Transportation of exceptional children. When transportation is required to be provided as part of special services, exceptional children, whenever practicable, shall be carried separately from the children attending regular classes. State reimbursement for transportation of exceptional children shall be as provided for transportation of pupils attending regular classes except that eligibility for reimbursement shall not be subject to restriction based on the minimum distance between the school and the residence of the exceptional child. (§ 1 ch 105 SLA 1966)

Sec. 14.30.350. Definitions. In §§ 180—350 of this chapter

(1) "exceptional children" means children who differ markedly from their peers to the degree that they are better served by placement in a special learning program designed to serve their particular exceptionality; these children may be identified in the following categories:

(A) "mentally retarded" includes those children of educable and trainable mind who consistently demonstrate evidence of reduced academic achievement or social behavior and whose intellectual potential indicates restriction significantly below that of their peers;

(B) "physically handicapped" includes children whose known or diagnosed physical impairments are so severe or involved that special facilities, equipment or methods are needed to make their educational program effective;

(C) "emotionally handicapped" includes children whose known or diagnosed emotional impairment is so severe or involved that special facilities, equipment or methods are needed to make their educational program effective;

(D) "children with learning disabilities" includes those who exhibit disorders in one or more of the basic learning processes involved in understanding or using expressive or receptive language and who may require special facilities, equipment or methods to make their educational program effective;

(E) "gifted" includes children having outstanding intellect, ability or creative talent; programs or services beyond the level of those ordinarily provided as regular school programs shall be submitted to the department for supplemental funding on an approved program basis.

(F) "multiple-handicapped" includes children whose known or diagnosed handicaps are determined to be any combination of (A)—(E) of this paragraph whose needs demand the provision of special facilities, equipment or methods to make their educational program effective.

(2) "special services" includes but is not limited to transportation, remedial teaching, corrective teaching, corrective health habits and the

provision of special seats, books, teaching supplies, facilities, and equipment required for the instruction of exceptional children, and includes education and training for children who cannot utilize regular classroom instruction. (§ 2 ch 120 SLA 1959; am §§ 5, 6 ch 81 SLA 1965; am §§ 13, 14 ch 144 SLA 1970)

Revisor's note (1970). — In ch. 144, SLA 1970, the revised version of AS 14.30.350 was incorrectly designated AS 14.30.351.

Article 4. Bilingual-Bicultural Education.

Section
400 Bilingual-bicultural education
410 Bilingual-bicultural education fund

Effective date of article. — Section 45, ch. 124, SLA 1975, makes this article effective on July 1, 1975

Sec. 14.30.400. Bilingual-bicultural education. City or borough district school boards and regional educational attendance area boards shall provide a bilingual-bicultural education program for each school in a city or borough school district or regional educational attendance area which is attended by at least eight pupils of limited English-speaking ability and whose primary language is other than English. A bilingual-bicultural education program shall be provided under a plan of service which has been developed in accordance with regulations adopted by the department. Nothing in this section precludes a bilingual-bicultural education program from being provided for less than eight pupils in a school. (§ 26 ch 124 SLA 1975)

Sec. 14.30.410. Bilingual-bicultural education fund. (a) There is in the Department of Education a bilingual-bicultural education fund which is an account in the general fund to receive money appropriated by the legislature for bilingual-bicultural education and to be used for bilingual-bicultural education program implementation and operation, including but not limited to the establishment of a statewide bilingual-bicultural educational center.

(b) The department shall adopt regulations for the determination of entitlement and the distribution of bilingual-bicultural funds to city and borough school districts and regional educational attendance areas and the statewide center. (§ 26 ch 124 SLA 1975)

POSITION PAPER/Department of Health & Social Services

POSITION PAPER

SENATE BILL NO. 18

"An Act relating to special education; and providing for an effective date."

Analysis

It is widely known that year around education for some handicapped students is necessary to achieve optimal development. In the absence of a developmental training program during the summer months, there is a high likelihood of regression in developmental achievements.

Historically (1961 through 1978) the Alaska Legislature funded such programs through AS 47.20 which was administered by the Department of Health & Social Services as a grant program to parent groups. In 1978 this statute was amended to emphasize the zero to three age group of exceptional children who were not addressed by the existing statutes governing special education. This amended statute is currently operating as a grant program in 15 communities on a year around basis. That amendment, however, left no statutory mechanism for local communities to adequately fund and operate summer programs for exceptional children. This bill creates a funding mechanism that will allow local education agencies to integrate summer program offerings into the individual education program for specific children.

Department's Position

In light of the above factors, the Department of Health & Social Services supports this bill.

Recommended by:

Verner Stillner, Director
Mental Health and Developmental Disabilities

Recommended by:

Deputy Director,
Division of Public Health

Date: 1/2/81

Approved by:

Date:

THE LEGISLATURE OF THE STATE OF ALASKA
ELEVENTH LEGISLATURE

FISCAL NOTE

I. REQUEST
Bill/Resolution No. SENATE BILL NO. 18
Title "An Act relating to special education; and providing for an effective date."
Requested by Commissioner's Office Date January 26, 1981

II. FISCAL DETAIL
Agency Affected Department of Health & Social Services
Program Category Affected Health/Division of Public Health
BRU, Program, or Subprogram(s) Affected
(Note: If more than one budget component is affected, separate line-item amounts and funding for each component in the analysis section.)

EXPENDITURES (Thousands of Dollars)

	FY 80	FY 81	FY 82	FY 83	FY 84	FY 85
100 PERSONAL SERVICES	0	0	0	0	0	0
200 TRAVEL	0	0	0	0	0	0
300 CONTRACTUAL	0	0	0	0	0	0
400 COMMODITIES	0	0	0	0	0	0
500 EQUIPMENT	0	0	0	0	0	0
600 LAND & STRUCTURES	0	0	0	0	0	0
700 GRANTS, CLAIMS, ETC.	0	0	0	0	0	0
TOTAL	0	0	0	0	0	0

FUNDING (Thousands of Dollars)

GENERAL FUND	0	0	0	0	0	0
FEDERAL FUNDS	0	0	0	0	0	0
OTHER (Specify Fund Source)	0	0	0	0	0	0

POSITIONS

FULL TIME	0	0	0	0	0	0
PART TIME	0	0	0	0	0	0
TEMPORARY	0	0	0	0	0	0

III. ANALYSIS (See Fiscal Note Preparation Instructions, Section III)

IV. DATE [illegible] PREPARED BY David A. Spence
AGENCY [illegible]
PHONE [illegible]

Original: Legislative Finance
cc: Budget and Management
Prime Sponsor (First Legislator Named)

33-001 (Rev. 12/79)

NEA · ALASKA

AFFILIATED WITH THE NATIONAL EDUCATION ASSOCIATION

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Deputy Executive Secretary
Anchorage Office

Dianne Anderson
Field Staff
Anchorage Office

Steve Pulkkinen
Field Staff
Anchorage Office

Mary Ann Eininger
Deputy Executive Secretary
Fairbanks Office

TO: Chairman Parr
Members of the Senate HESS Committee

FROM: NEA/Alaska

SUBJECT: Senate Bill 18:
An Act Relating to Special Education

MEMORANDUM OF SUPPORT

NEA/Alaska supports and urges passage of Senate Bill 18.

Continuity of an educational program is an essential component of a successful school experience for children with learning disabilities. Reinforcement and repitition are basic techniques used with exceptional learners. Access to a continuing program would add significantly to the cumulative success of Alaska's handicapped children. Senate Bill 18 would provide such an opportunity.

This bill is significant in its implementation in that it is designed to make the opportunity of access to a continuing program available to all children in the state who are classified as mentally retarded, physically and mentally handicapped and multi-handicapped. NEA/Alaska eagerly supports this effort.

Finally, NEA/Alaska supports the concept that a child who would qualify for summer school instruction under this bill may have access to the services of another district or REAA in the event their home school district does not operate a summer school, as stated in AS 14.30.348 (b).

Respectfully Submitted,

Bob

Bob Manners
Executive Secretary
January 28, 1981

JAN 12 1981

1189 Nenana Street
Fairbanks, Alaska 99701
January 6, 1981

Senator Betty Fahrenkamp
Pouch V
Juneau, Alaska 99811

Dear Senator Fahrenkamp:

Enclosed is a proposed budget request for a Home Economics program within the School of Agriculture and Land Resource Management. I am not certain of the priority placed on this program by the Fairbanks Campus, but I thought this background information might assist you in your decision-making process.

SB 18

I noted in the January 5th News Miner you prefiled a bill for special education funds to provide summer schooling for these students. I would personally support this proposal. As you know, special education students need all year around school in order to receive maximum benefit from their education.

Sincerely,

Marguerite Stetson

Marguerite Stetson
Nutrition Specialist

MS/es
Enc.

SB 18 file

THE LEGISLATURE OF THE STATE OF ALASKA
ELEVENTH LEGISLATURE

FISCAL NOTE

I. REQUEST
Bill/Resolution No. Proposed 14.17.143 (2nd Revision)
Title Incremental support for year round special education (for level 4 students).
Requested by Senator Ferguson Date 4/22/80

II. FISCAL DETAIL
Agency Affected Elementary and Secondary Education
Program Category Affected Foundation Support Programs
BRU, Program, or Subprogram(s) Affected Special Education Adjustment
(Note: If more than one budget component is affected, separate line-item amounts and funding for each component in the analysis section.)

EXPENDITURES (Thousands of Dollars)

	FY 80	FY 81	FY 82	FY 83	FY 84	FY 85
100 PERSONAL SERVICES						
200 TRAVEL						
300 CONTRACTUAL						
400 COMMODITIES						
500 EQUIPMENT						
600 LAND & STRUCTURES						
700 GRANTS, CLAIMS, ETC		670.0	1842.6*	2026.8	2229.5	2452.5
TOTAL						

FUNDING (Thousands of Dollars)

GENERAL FUND		670.0	1842.6*	2026.8	2229.5	2452.5
FEDERAL FUNDS						
OTHER (Specify Fund Source)						

POSITIONS

FULL TIME	N/A					
PART TIME						
TEMPORARY						

III. ANALYSIS (See Fiscal Note Preparation Instructions, Section III)

Assumptions:
1. 25% of exceptional student FTE is level 4.
2. Districts with fewer than 3 special education F.T.E. have no level 4 students, or will not offer year-round.
3. Average I.U. value for exceptional children is $36,000.
4. Adjusting for 2, above, each remaining district will generate a fractional I.U.
5. 25% of total FTE = 1157 level 4 FTE = 100 I.U. plus 25 I.U. because of 4, above, = 141 I.U. x $36,000 = $5,076.0 x 33% = $1675.1.
6. 40% first year participation = $1675.1 x .4 = $670.0 subsequent years at 100% participation.
7. This does not provide for transportation of exceptional students required by AS 14.30.167, which is not a part of the foundation program.

* Fiscal years beginning with 1981 inflated by 10% per year.

IV. DATE 4/22/80 PREPARED BY [illegible]
AGENCY [illegible]
PHONE [illegible]

Original: Legislative Finance
cc: Budget and Management
Prime Sponsor (Last Legislator Named)

33-001 (Rev. 12/79)

Section _____ AS 14.17 is amended by adding a new section to read:

Sec. 14.17.143. INCREMENTAL SUPPORT FOR YEAR-ROUND SPECIAL EDUCATION. A school district or regional educational attendance area which provides special services for Level 4 exceptional children as defined under 14.30.350 (1)(A), (B), (C), and (F) on a year-round basis is entitled to receive, in addition to the instructional unit support provided under AS 14.17.041(f), an amount equal to 33 per cent of the instructional unit support calculated for special education under AS 14.17.041(f) which is generated by the Level 4 exceptional children in the district.

Section _____. This Act takes effect immediately.

THE LEGISLATURE OF THE STATE OF ALASKA
TWELFTH LEGISLATURE

FISCAL NOTE

I. REQUEST
Bill/Resolution No. CS SB 18
Title An Act Relating to Special Education
Requested by Senate HESS Date 2/9/81

II. FISCAL DETAIL
Agency Affected Education
Program Category Affected Elementary and Secondary
BRU, Program, or Subprogram(s) Affected Public School Foundation Support (Spec. Ed. Adjustment)
(Note: If more than one budget component is affected, separate line-item amounts and funding for each component in the analysis section.)

EXPENDITURES (Thousands of Dollars)

	FY 81	FY 82	FY 83	FY 84	FY 85	FY 86
100 PERSONAL SERVICES						
200 TRAVEL						
300 CONTRACTUAL						
400 COMMODITIES						
500 EQUIPMENT						
600 LAND & STRUCTURES						
700 GRANTS, CLAIMS, ETC.	-0-	7,209.6	7,930.6	8,723.6	9,595.9	10,555.6
TOTAL						

FUNDING (Thousands of Dollars)

GENERAL FUND	-0-	7,209.6	7,930.6	8,723.6	9,595.9	10,555.6
FEDERAL FUNDS						
OTHER (Specify Fund Source)						

POSITIONS

FULL TIME	N/A					
PART TIME						
TEMPORARY						

III. ANALYSIS (See Fiscal Note Preparation Instructions, Section III)

This estimate is based upon several assumptions:

1. Participation by all exceptional students.
2. Participation by all eligible school districts.
3. Maximum hours per day and number of days in programs offered.
4. Annual inflation of 10 percent.
5. A single fiscal year payment process.

Calculation: $\frac{50}{180}$ = 28% x FY-82 Special Education projection $25,748.5 = $7,209.6

IV. DATE 2/9/81 PREPARED BY Steve Hole
AGENCY Education
PHONE 465-2800

Original: Legislative Finance
cc: Budget and Management
Prime Sponsor (First Legislator Named)

SPECIAL EDUCATION TASK FORCE

Barbara Block, PTA

Tom Brown, AASA

Marsha Buck, GCH&G

Terry Coons, AASE

Steve Daeschner, ASD

Senator Bettye Fahrenkamp, Ak. Legislature

Sue Glocke, H&SS

Robert Greene, AASB

Mary Jo Parks, NEA-AK

Alaire Stanton, State Board

Exoffico Members

Guy Bellville, ASD

Bob Davis, DOE

Jim Elliott, DOE

Steve Hole, DOE

Bill Mahnix, DOE

District	No of Level Fours	Cost per Child
Adak	-0-	
Alaska Central Railbelt	-0-	
Alaska Gateway		
Aleutian Region		
Anchorage	837	8,149
Annette Island	1	8,000
Bering Strait	4	19,640
Bristol Bay	-0-	
Chatham		
Chugach	-0-	
Copper River	12	
Cordova City	1	8,045
Craig City	-0-	
Delta/Greely		
Dillingham		
Fairbanks	141	0
Galena City	1	22,000
Haines Borough	1	12,768
Hoonah City		
Hydaburg	1	15,120
Iditarod	-0-	
Juneau	80	13,221
Kake City		
Kenai	106	4,176
Ketchikan	57	6,780
King Cove	-0-	

District	No of Level Fours	Cost per Child
Kodiak	25	10,868
Kuspuk	2	12,500
Lake and Peninsula	5	9,800
Lower Kuskokwim	50	8,500
Lower Yukon		
Matanuska Susitna		
Menana City	-0-	
Nome City		
North Slope Borough	25	9,114
Northwest Arctic		
Pelican City	-0-	
Petersburg City	9	5,556
Pribilof	4	8,534
Sand Point	-0-	
Sitka	23	9,130
Skagway City		
Southeast Island	2	10,000
Southwest Region	3	
St. Mary's		
Unalaska	1	10,700
Valdez	90	8,897
Wrangell City	2	8,035
Yakutat City	-0-	
Yukon Flats	2	79,400
Yukon/Koyukuk	4	18,400

March 27, 1980

Ms. Bettye Fahrenkamp
Assembly Bldg. Rm. 200
Juneau, Alaska 99811

Dear Ms. Fahrenkamp:

Re: House Bill #455 Act relating to State aid to school districts and regional educational attendance areas which provide instruction in special education on a year-round basis and providing for an effective date.

With regards to the above mentioned act I would like to emphasize the importance of year-round continuous education and training of Special Education students.

I am a Junior High Shop teacher employed by the North Star Borough School District.

It must be realized that any time there is an interruption of instruction for any length of time of a student, there is a definite loss of progress.

In the case of Special Ed. students an interruption of three months creates an extremely undesirable situation.

The student will usually suffer a relapse of his formal education during the summer break. But more important is the loss the student suffers from not being with his classmates and it's environment.

Coupled with this is a 24 hour situation in the home. Many of the parents cannot cope with this continuous caretaking.

It is easily seen that this bill needs your support in passing.

Thank you,

James Kiesk

James Kiesk

[illegible]

THE LEGISLATURE OF THE STATE OF ALASKA
TWELFTH LEGISLATURE

FISCAL NOTE

I. REQUEST
Bill/Resolution No. SB 18
Title Relating to special education.
Requested by Senate HESS Date 1/23/81

II. FISCAL DETAIL
Agency Affected Education
Program Category Affected Financial Support Districts
BRU, Program, or Subprogram(s) Affected Special Education Grants
(Note: If more than one budget component is affected, separate line-item amounts and funding for each component in the analysis section.)

EXPENDITURES (Thousands of Dollars)

	FY 81	FY 82	FY 83	FY 84	FY 85	FY 86
100 PERSONAL SERVICES						
200 TRAVEL						
300 CONTRACTUAL						
400 COMMODITIES						
500 EQUIPMENT						
600 LAND & STRUCTURES						
700 GRANTS, CLAIMS, ETC.	-0-	2,000.0	2,200.0*	2,420.0	2,662.0	2,928.2
TOTAL						

FUNDING (Thousands of Dollars)

GENERAL FUND	-0-	2,000.0	2,200.0	2,420.0	2,662.0	2,928.2
FEDERAL FUNDS						
OTHER (Specify Fund Source)						

POSITIONS

FULL TIME	N/A					
PART TIME						
TEMPORARY						

III. ANALYSIS (See Fiscal Note Preparation Instructions, Section III)

Estimate based upon six week, half-time summer programs.

*Fiscal years after FY 82 inflated at 10%.

IV. DATE 1/23/81 PREPARED BY Steve Hole
AGENCY Education
PHONE 465-2800

Original: Legislative Finance
cc: Budget and Management
Prime Sponsor (First Legislator Named)

33-001 (Rev. 12/80

WITNESSES FOR
SENATE H.E.S.S. MEETINGS

SB 18 1-28-81

Name	Address/Phone	Representing
Marilyn Madden	2800	Dept of Ed
William Mulvihill	2970	Dept. of Ed
Bettye Fahrenkamp	3762	Senate
D Lopez	3100	DHES
Marianne Endicott		Parents

THE LEGISLATURE OF THE STATE OF ALASKA
ELEVENTH LEGISLATURE

FISCAL NOTE

I. REQUEST

Bill/Resolution No. Proposed 14.17.143 (2nd Revision)

Title Incremental support for year round special education (for level 4 students).

Requested by Senator Ferguson Date 4/22/80

II. FISCAL DETAIL

Agency Affected Elementary and Secondary Education

Program Category Affected Foundation Support Programs

BRU, Program, or Subprogram(s) Affected Special Education Adjustment

(Note: If more than one budget component is affected, separate line-item amounts and funding for each component in the analysis section.)

EXPENDITURES (Thousands of Dollars)

	FY 80	FY 81	FY 82	FY 83	FY 84	FY 85
100 PERSONAL SERVICES						
200 TRAVEL						
300 CONTRACTUAL						
400 COMMODITIES						
500 EQUIPMENT						
600 LAND & STRUCTURES						
700 GRANTS, CLAIMS, ETC.		670.0	1842.6*	2026.8	2229.5	2452.5
TOTAL						

FUNDING (Thousands of Dollars)

GENERAL FUND		670.0	1842.6*	2026.8	2229.5	2452.5
FEDERAL FUNDS						
OTHER (Specify Fund Source)						

POSITIONS

FULL TIME	N/A					
PART TIME						
TEMPORARY						

III. ANALYSIS (See Fiscal Note Preparation Instructions, Section III)

Assumptions:

1. 25% of exceptional student FTE is level 4.
2. Districts with fewer than 3 special education I.U. have no level 4 students, or will not offer year-round
3. Average I.U. value for exceptional children is $36,000.
4. Adjusting for 2, above, each remaining district will generate a fractional I.U.
5. 25% of total FTE = 1157 level 4 FTE = 106 I.U. plus 35 I.U. because of 4, above, = 141 I.U. x $36,000 = $5,076.0 x 33% = $1675.1.
6. 40% first year participation = $1675.1 x .4 = $670.0 subsequent years at 100% participation.
7. This does not provide for transportation of exceptional students required by AS 14.30.347, which is not a part of the foundation program.

* Fiscal years beginning with 1982 inflated by 10% per year.

IV. DATE 4/22/80 PREPARED BY [signature]

AGENCY Department of Education

PHONE 465-2800

Original Legislative Finance
cc: Budget and Management
Prime Sponsor (First Legislator Named)

11-001 (Rev. 12/79)

Section 1 AS 14.17 is amended by adding a new section to read:

Sec. 14.17.143. INCREMENTAL SUPPORT FOR YEAR-ROUND SPECIAL EDUCATION. A school district or regional educational attendance area which provides special services for Level 4 exceptional children as defined under 14.30.350 (1)(A), (B), (C), and (F) on a year-round basis is may entitled to receive, in addition to the instructional unit support provided under AS 14.17.041(f), an amount ~~equal~~ up to 33 per cent of the instructional unit support calculated for special education under AS 14.17.041(f) which is generated by the Level 4 exceptional children in the district.

Section 2. This Act takes effect immediately.

Section 3. AS 14.17.143 is repealed.

Section 4 Section 3 takes effect July 1, 1982