

ALASKA LEGISLATURE COMMITTEE FILES 1901-1902 00/2

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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		99,212.69	129,212.69		129,212.69
1961	30,000.00	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	9,305,536.95
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	1,275,687.99	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

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	<u>138,554,000.00</u>	<u>197,316,818.84</u>	<u>335,870,818.84</u>	<u>365,485.83</u>	<u>335,505,333.01</u>
Remaining Liability as of 6/30/79 (St. #67)	<u>\$670,503,000.00</u>	<u>\$307,244,894.35</u>	<u>\$ 977,747,894.35</u>	<u>\$1,346,772.99</u>	<u>\$ 976,401,121.36</u>

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TABLE 1

INTEREST RATES ON BONDS
OF TWENTY YEAR OR GREATER MATURITIES

<u>YEAR</u>	<u>Aa CORPORATE</u>	<u>Aa MUNICIPALS</u>	<u>DIFFERENCE</u>
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

AND MUNICIPAL BONDS

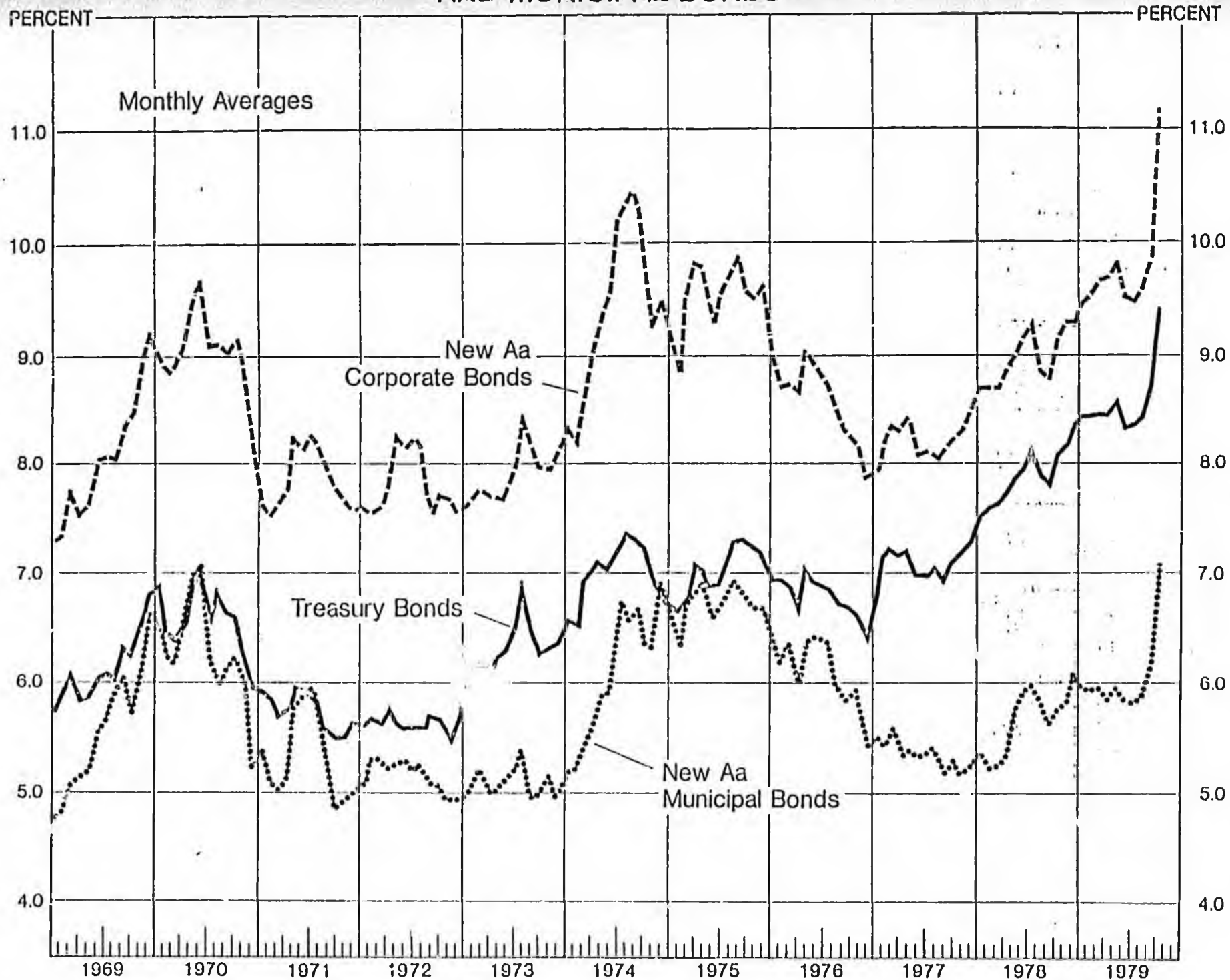


CHART 1

TABLE 2

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

<u>Maturity</u>	<u>Aaa</u>	<u>Aa</u>	<u>A</u>
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

<u>Week</u> <u>Ending</u>	<u>Municipal Bond Averages</u>		
	<u>Nuveen</u> <u>Index</u>	<u>Bond</u> <u>Buyer</u>	<u>Dow-</u> <u>Jones</u>
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)

Year	Differential Between Grades		
	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	38	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)

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

¹Charlotte DeMonte Phelps, "The Impact of Tightening Credit on Municipal Capital Expenditures in the United States," *Yale Economic Essays*, Vol. 1 (Fall 1961), p. 300. 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.

²Reuben 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.

³John E. Petersen, "A Note on the Determinants of Municipal Bond Net Interest Costs" (unpublished), 1972.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

MEMORANDUM

DATE: November 14, 1979

TO: The Honorable Terry Gardiner
Speaker of the House

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

SUBJ: *JEH*
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 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 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. bidding 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
Fiscal Analyst

MB:bf

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, Banks' 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?

J. H. Hogan, Director
December 31, 1979
Page Two

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.

J. E. Hogan, Director
December 31, 1979
Page Four

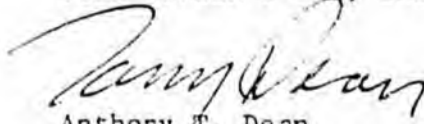
4. How much could our tax-exempt rate be reduced by depositing up to 15% or whatever the IRS arbitrage limit is in a G.O. debt Guarantee Fund?

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

WHITE, WELLS & CO.
INCORPORATED

ONE LIBERTY PLAZA
91 LIBERTY STREET, NEW YORK, N. Y. 10006

THEODORE P. SWICK
FIRST VICE PRESIDENT
212/288-2153

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 traditional 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 geographic 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 constituents. 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 administrative 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 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 overcome 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

JRH: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 obli-
gation 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

ORRICK, HERRINGTON, ROWLEY & SUTCLIFFE

Mr. J. H. Hogan
State of Alaska
October 30, 1979
Page Two

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

Section 101

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 obligation that

are not used directly for the payment of principal or interest.

Rev. Rul. 78-302¹

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

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.

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 in-

clude 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.

HOLDINGS

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. 78-348¹

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 20 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 substituted as an alternative to issuing the bond. 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. 1968). 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.



Alaska State Legislature

Senate

Committee on State Affairs
Chairman Vic Fiskner

of February 19 and 21, 1981
Pouch V
State Capitol
Juneau, Alaska 99801

Official Business
February 20, 1980

REPORT ON COMMITTEE HEARINGS
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

And, related issues of state fiscal policy, and financial management, and economic development

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 occurred 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

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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)
	<u>\$905 million</u>

SB 21 & 68 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 minimal \$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

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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.

List of Witnesses and Participants

*Committee +
Sen Rodey
Rep Clocksin*

BILL #	ITEM	DOLLAR AMOUNT
Governor Freeman, HB 1	Permanent Fund	\$ 1.8 billion
Randolph, HB 24	Personal Loans	1.0 billion
Ferguson, SB 33 Moss, HB 85	Education Endowment	5.0 billion *
Kerttula, SB 26	Power Project Fund	4.6 billion **
Governor	Bond Defeasance (Colletta, SB 13, \$290 million)	905 million
Fischer, SB 159	Knik Arm Crossing	1.1 billion
Governor SB 141	Fisheries Revolving Fund	100 million
Governor	Municipal Assistance	133 million
Governor, SB 67	Cash Distribution of Oil Bonuses	77 million
Governor	Housing Assistance (Total Loan Programs, \$400 million)	289 million
Governor	Rainy Day & Litigation Escrow	650 million
Governor	Operating Budget (Total: 2.2 billion)	1.8 billion
		17.45 billion

* of which 4.0 billion is in future years' appropriation

** of which 3.0 billion is in future years' appropriation

10.45 billion
this year

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 artificial 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

Yrs	PERMANENT FUND		BUDGET GROWTH	
	I. \$2 Billion at 11% compounded	II. \$4 Billion at 11% compounded	III. \$2 Billion - at 11% rate of increase	IV. \$2 Billion - at 15% rate of increase
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



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 \$239,712,500.
(4) Projects start/debt occurred 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)
	<u>\$905 million</u>

SB 21 & 68 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 minimal \$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.



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.

J. H. Hogan, Director
December 31, 1979
Page Four

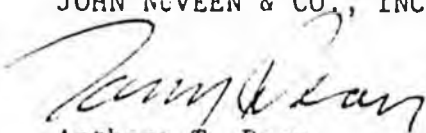
4. How much could our tax-exempt rate be reduced by depositing up to 15% or whatever the IRS arbitrage limit is in a G.O. debt Guarantee Fund?

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

STATE OF ALASKA

THE LEGISLATURE

BUDGET AND AUDIT COMMITTEE

FINANCE DIVISION
POUCH WF-STATE CAPITOL
JUNEAU, ALASKA 99811
PHONE: (907) 465-3795

MEMORANDUM

TO: Hon. Leo Schaeffer
House Finance Committee

DATE: February 6, 1980

FROM: Milt Barker ^{MB}
Fiscal Analyst

SUBJ: Paying off State Bonds

Outstanding state general obligation bonds of \$670,503,000 could be paid off with an appropriation of \$546 million according to item 2 of the attached letter from John Nuveen & Co., the state's financial advisor.

The prefunding approach suggested by Nuveen would not cost the state any lost interest as would paying off the bonds immediately. In other words, the state hangs on to its cash, invests it at taxable rates, say 10%, while continuing to pay off bonds at only 6% or so, thus earning a net of 4% interest which it would not earn if the bonds were simply paid off.

Yet, the prefunding approach does assure bondholders of being paid off. This has two effects. One, existing bonds would immediately get improved ratings; the state would not benefit on this account but the bondholders would as there would be an immediate increase in the value of their bonds should they wish to sell them. Sterling Gallagher of Nuveen & Co. has suggested the state try to capture some of the increase in bond prices that would occur by making the prefunding contingent on bondholder turning in their existing bonds in exchange for new bonds with a lesser coupon or interest rate. We could split the difference of the price increase with them.

The second effect of prefunding would be to improve the ratings for any future bonds the state issues. Here, the state would get the full benefit of the effect. However, as the attached tables indicate the maximum reduction in the interest rates would normally be no more than thirty basis points or .3%. This is based on the state going from its present A1 or A+ rating to Aaa. On \$100 million of bonds with an average 5 year maturity, this would thus save the state at most \$1,080,000 in interest costs over the life of the bonds.

Sterling Gallagher has also suggested that prefunding only the later maturities of the bonds could have the same effect on the interest cost to the state of future bond issues. In other words, the state's revenues on Prudhoe Bay production in the near-term would provide maximum security for bonds while prefunding

Hon. Leo Schaeffer
February 6, 1980
Page Two

would serve the same function after Prudhoe begins to decline. Mr. Gallagher estimates only \$100 million in prefunding would be required to prefund the tail end of outstanding state GOB's.

If you wish to seriously consider an appropriation for prefunding, we should request a legal opinion from state bond counsel as to whether such prefunding would cause any IRS arbitrage problems. In other words, the guarantee fund established by prefunding could result in the IRS finding that the prefunded bonds are arbitrage bonds and taking away the federal income tax exemption allowed on interest received by the bondholders. This would have no direct cost to the state, but the bondholders would undoubtedly prefer that prefunding not be done in that case.

In the attached letter from Orrick, Herrington, the state's bond counsel, a preliminary judgment is made that "establishment of the fund (prefunding account) probably could not affect the tax status of interest on bonds issued before the fund is established".

MB:kw

January 21, 1980

Milt Barker
Fiscal Analyst
Alaska State Legislature
Budget and Audit Committee
Finance Division
Pouch WF - State Capitol
Juneau, Alaska 99811

Dear Milt:

This letter responds to the questions posed in your letter of January 2 regarding policies affecting management of the State's debt.

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

In today's tax-exempt market, Alaska can borrow funds at interest rates ranging from 6.20% to 7.1% depending on maturities. Currently, the State can invest surplus revenues in a variety of high quality money market instruments at yields of 10 to 13% or more. So long as Alaska continues to pursue a policy of prudent growth in its outstanding indebtedness, it can and should continue to benefit from the favorable interest rate differential that exists between the rate at which it borrows and the rate at which it can invest. The credit standing of the State is not so much affected by the means chosen to finance capital improvements as it would be by the magnitude of capital improvement programs in relation to the State's long-term sources of revenue.

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

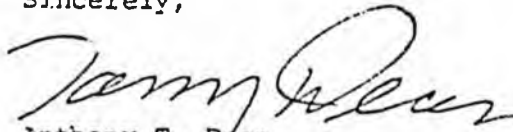
Alaska's outstanding general obligation debt of approximately \$670-million could be prefunded by the creation of a special investment account, the principal and interest of which would be used exclusively to meet interest and principal payments on the debt. A deposit of \$546-million to be invested in appropriate U.S. Government Securities at today's market yields would generate sufficient cash to meet principal and interest on the \$670-million outstanding general obligation debt. This deposit is \$124-million less than the cost of simply paying off the debt. Whether the State prefunds the debt or

Milt Barker
January 21, 1980
Page Three

those to be derived from a prefunding of the State's general obligation debt. In addition, the credit standing and debt capacity of local governments in Alaska would be substantially improved. During my visit to Juneau this week, we will assemble the data necessary to provide a preliminary estimate of the cost and potential financial advantage to be derived from a prefunding of the outstanding school debt.

I look forward to an opportunity to meet with you later this week.

Sincerely,



Anthony T. Dean
Assistant Vice President

ATD:lw

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

Year	Differential Between Grades		
	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	57

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

TABLE 4

INTEREST COST DIFFERENTIALS AMONG RATING CLASSES
(basis Points)

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

¹Charlotte DeMonte Phelps, "The Impact of Tightening Credit on Municipal Capital Expenditures in the United States," *Yale Economic Essays*, Vol. 1 (Fall 1961), p. 370. 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.

²Reuben 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 receding 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.

³John 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

ORRICK, HERRINGTON, ROWLEY & SUTCLIFFE

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WILLIAM L. HOISINGTON
THOMAS R. SHEARER, JR.
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M. PETER LILLEVAND
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RICHARD E. V. HARRIS
G. RUP EDWARDS
RAYMOND G. ELLS
STEVEN A. BRIGGS
JOHN F. SEEGAL

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

ORRICK, HERRINGTON, ROWLEY & SUTCLIFFE

Mr. J. H. Hogan
State of Alaska
October 30, 1979
Page Two

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 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

Section 101

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. 78-302¹

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.

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 in-

clude 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. 78-348¹

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. 1968). 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.

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

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. bidding 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?

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
Fiscal Analyst

MB:bf

THE LEGISLATURE OF THE STATE OF ALASKA
TWELFTH LEGISLATURE

SB 296, 297

FISCAL NOTE

I. REQUEST

Bill/Resolution No. SENATE BILL NO. 296 & 297

Title Prohibiting the sale of certain general obligation (GO) bonds, special appropriation
Request for GO bonds that have been authorized but not Date 3/17/81

issued and for defeasance of outstanding GO bonds.

Requested by Senate State Affairs & Resources Committees

II. FISCAL DETAIL

Agency Affected Department of Revenue, State Bond Committee

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) ALL FIGURES IN MILLIONS OF DOLLARS

(1) GENERAL FUND	1,336.9					
(2) Debt Service Cost Reduction	(97.8)	(94.6)	(91.7)	(88.3)	(86.3)	
(3) Defeasance Savings	(155.7)					
(4) Opp. Cost Post 5/78 Issued	8.4	9.6	11.0	12.1	13.4	
(5) Opp. Cost New Debt Not Issued	8.0	17.6	23.4	27.2	30.9	
(6) PV Opp. Cost of Defeasance	8.9	16.4	22.8	28.0	32.7	

POSITIONS

FULL TIME						
PART TIME						
TEMPORARY						

(1) Appropriated funds to "cash-out" all remaining authorized but unissued bonds, defeasance of all outstanding/issued GO bonds. Defeasance portion based on interest rates in effect second week of March, 1981.

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

- (2) This is the annual debt service related to the \$718.2 (6/1/81) in bonds that would be due in the years indicated. The cash flow of the escrow set aside makes these payments when they become due.
- (3) The savings in principal due to investments allowed on escrow set aside as part of defeasance.
- (4) Opportunity cost related to the post-May 1978 outstanding debt as this debt is subject to defeasance at a restricted yield basically equal to the rate paid on the bonds.
- (5) Opportunity cost of not using the favorable low interest rate obtainable on issuing GO bonds for new projects; rather, using all cash up front.
- (6) Because debt service payments can be made later with "cheaper dollars" this is the Present Value difference due to early payment of annual debt service.

THE AMOUNT REQUIRED FOR DEFEASANCE IS BASED UPON INTEREST RATES AVAILABLE AT THE TIME THE TRANSACTION TAKES PLACE. ACCORDINGLY, FOR EACH 10% DROP IN INTEREST RATES, THE AMOUNT NECESSARY FOR DEFEASANCE GOES UP APPROX. 6.7%.

IV. DATE _____ PREPARED BY Anselm C. Staack, Treasury Comptroller

March 30, 1981

AGENCY Dept. of Revenue/Treasury Division

Original: Legislative Finance

PHONE 465-2351

cc: Budget and Management

Prime Sponsor (First Legislator Named)

Anselm C. Staack

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

Your file only

STATE AFFAIRS Thursday February 19th

✓ Tom Williams -- Commissioner of Revenue

Greg Erickson - Economist (~~1/19/72~~)

✓ Jim Rhode

✓ _____ Gov's office

• Pat Rodev

✓ Geo Rogers

• Sterling Gallaghan

ANCHORAGE — SAT

✓ Bob FLINT

State Affairs Saturday 21st

✓ John Havelock

? Tom Fink

• Bob Pennv

AKPIRG

Resource Development Council for Alaska

Coalition for Economic Justice

✓ Harold Pomerov

Joe Jcsevhsen

• Wallv Hickel

✓ Jim Rhode

• Elmer Rasmusson

Willie Henselv

✓ Scott Goldsmith ISER (Lee Gorsuch) ✓

✓ ANCH. NEWS

✓ ANCH. TIMES

2/19/81

SB-13

C: pay cash for projects - speed implem - jobs

Tom Williams - loans from gen'l fd can be used to build stack

- ① bonds - low interest, tax exempt, good rating
 | gen'l fund - invest @ higher rates.
- ② → could repaid borrowing good for 50 cred. rating.
- ③ - if continue to bond I will have high rating when ^{may} need in '90s
- ④ when wealthy, people like to lend us.
 have alternative

? what is diff betw. AA & AAA

Defeating bonds.

Defeatance of school bonds

def. amt.	562m	570 - (net savings)
	466.5m	466.5
	1028m	
	128m	
	<u>900m</u>	

1,030

+ 1,800m PF

Local sch debt as of Jan 80 350m
 - ~~1100~~ approx \$250-270m

2/21/81

Robert Flint

- borrowing increases amt of feds avail. for expenditure

Comm. North. - oppose PF appropriation.

x lock up money

- infrastructure - RR, ports, highway, energy

All investment fund - a few weeks

John Havlock

Public vote on major projects

Legrolling

Multi-year budget for cap improv.

PF - savings account

Pomeroy - if put in \$26 now to PF,
will be \$66 in 20 yrs

x throw \$ at debt

PF growth.

Can't have badly based econ.

Jamie Fisher

few people, educational efforts

→ teleconference

2/21/81 - 2

Jamie - socioeconomic impact of state investment

Lee Cassard - PF

SB68 what rel do const requiremnt? % etc.

25% vs 75%

Strategy - lack of

Fiscal policy, state spending

long-term investment strategy
- goals, strategy, fiscal policy

Scott Goldsmith - SB13

- economist → arbitrage

- ~~not what will suffer~~

- not at expense of profitable investments

- distributional effect - today's people pay for benefit to people in future.

- but long-term bonds would still have to be paid off at time when it may not be available

PF - proper rate of accumulation?

Purduee - one time inheritance.

\$806 - in 1980 \$

- real rate of return \$1.63 @ 2% - would spend this amount perpetually

Kentain - Alaskaize PF investment policy/strategy

Dustin Stanch	9:32 - 10:00	
Robert Flint	10:10 - 10:25	Nuwan
Mark Roberts	10:25 - 10:45	Common North
John Hancock	10:45 - 10:57	
Harold Conway	10:58 - 11:15	
Jim Wade	11:17 - 11:20	
Jamie Fisher	11:21 - 11:28	
Lee Conner	11:29 - 11:38	
Scott Caldwell	11:40 - 11:53	
Ken Cain	11:54 -	

3) Milt Barker

6.199 - ill-liquid assets.

5.8 av. for appx in cash

Corp oil + gas - 9th '82 2,484m
@ 300m exxon Rainy day #700m



2/19/81 - 2

SB 68 (2.8b) SB 21 (1.5b)
Admin → NO →

⊥

Subl debt int. in PF growing
in over time

If No other
major oil

Calc of how large fund
should be in

Endowment fund to sust. future needs.
- maximum approx

Defasance of School Bonds

S

B

2

1

BILL #	ITEM	DOLLAR AMOUNT
Governor Freeman, HB 1	Permanent Fund	\$ 1.8 billion
Randolph, HB 24	Personal Loans	1.0 billion
Ferguson, SB 33 Moss, HB 85	Education Endowment	5.0 billion *
Kerttula, SB 26	Power Project Fund	4.6 billion **
Governor	Bond Defeasance (Colletta, SB 13, \$290 million)	905 million
Fischer, SB 159	Knik Arm Crossing	1.1 billion
Governor SB 141	Fisheries Revolving Fund	100 million
Governor	Municipal Assistance	133 million
Governor, SB 67	Cash Distribution of Oil Bonuses	77 million
Governor	Housing Assistance (Total Loan Programs, \$400 million)	289 million
Governor	Rainy Day & Litigation Escrow	650 million
Governor	Operating Budget (Total: 2.2 billion)	1.8 billion
		17.45 billion

* of which 4.0 billion is in future years' appropriation

** of which 3.0 billion is in future years' appropriation

=====

10.45 billion
this year

STATE OF ALASKA

THE LEGISLATURE

BUDGET AND AUDIT COMMITTEE

FINANCE DIVISION
POUCH WF-STATE CAPITOL
JUNEAU, ALASKA 99811
PHONE: (907) 465-3795

MEMORANDUM

DATE: February 5, 1981

TO: Honorable Sam Cotten
Chairman
House Finance Committee

FROM: Milt Barker, ^{MB} Fiscal Analyst
Legislative Finance Division

SUBJ: Funds Available for Appropriation

The attached Table I is a simplification of page 7 in the FY 82 Executive Budget which shows the amount of general funds available for appropriation as presented by the Governor.

However, based on the two attached legislative finance memos, the amounts in Table I could be increased as follows:

	<u>Available for Appropriation</u>	<u>Cash</u>
Table I	\$6,014.1 million	\$5,665.2 million
Decontrol	185.2	185.2
	<u>\$6,199.3</u>	<u>\$5,850.4</u>
Underestimates		
Petroleum Corporate		
Income Tax	596.0	596.0
Interest Income	<u>170.5</u>	<u>170.5</u>
	<u>\$6,965.8 million</u>	<u>\$6,616.9 million</u>

Total petroleum corporate income tax receipts through FY 82 are estimated at:

"Revenue Sources"	\$2,433.0 million
Decontrol	51.1
	<u>\$2,484.1</u>
Underestimate	596.0
	<u>\$3,080.1 million</u>

These amounts are subject to litigation.

attachment

MB:bf

TABLE I
GENERAL FUND BALANCES
(\$ MILLIONS)

	<u>Available for Appropriation</u>	<u>Cash</u>
General Fund Balance 6/30/80	\$2,221.6	\$1,438.7
<u>FY 81</u>		
Unrestricted Revenue (Net of Permanent Funds)	3,631.0	3,631.0
Appropriations	(4,793.6) ¹	(4,341.6)
Illiquid Investment	<u> </u>	<u>(18.0)</u>
General Fund Balance 6/30/81	\$1,059.0	\$ 710.1
<u>FY 82</u>		
Unrestricted Revenue (Net of Permanent Funds)	<u>\$4,955.1</u>	<u>\$4,955.1</u>
General Fund Balance (Before 1981 Session Appropriations)	\$6,014.1	\$5,665.2

Footnote:

1. Certain appropriations to AHFC, AIDA, and for fish processing loan guarantees were made from illiquid assets.

PREPARED BY:
Legislative Finance Division
February 5, 1981

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 artificial 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

Yrs	PERMANENT FUND		BUDGET GROWTH	
	I. \$2 Billion at 11% compounded	II. \$4 Billion at 11% compounded	III. \$2 Billion - at 11% rate of increase	IV. \$2 Billion - at 15% rate of increase
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

S

B

5

4

FACT SHEET

PROPOSED 1981 LEGISLATION

The Department of Military Affairs has asked the Governor to introduce one bill in the 1981 Legislation.

The bill has three parts:

The first part proposes that the reimbursement of tuition and fees for members who attend an educational, vocational or training school in Alaska be extended to retired members. This proposal is designed to provide an additional incentive to stay in the Guard until retirement and reward, in a small way, those retired members who would like to continue their education. We anticipate that no more than 15 members would take advantage of this proposal each year. The average reimbursement is \$125.00 per year per person, making the total cost of this proposal between 2 and 3 thousand dollars annually.

The second proposal is designed to protect the families of the lower rank enlisted members from a dramatic financial loss in the event of an extended State Duty period. It also ensures that members called to State Active Duty are covered by the Workman's Compensation Act. The fiscal impact of this proposal would be felt only in the event of a major disaster. The funding would come from the Governor's Emergency Fund.

The third part is identical to a bill submitted by the Governor last year and proposes a restructuring of the reenlistment bonus. A reenlistment bonus in the amount of \$3,000 will be paid for the first 6 year reenlistment only. The payments will be \$1,000 each, payable every two years. At the end of the initial reenlistment, the bonus stops. Payments would be made to the Guard members during their 6th through 12th year of total military service. This period has been determined as the "decision making" time for Guard members as to whether to stay until retirement or quit. We feel that paying this bonus during the decision years is the best possible use of a reenlistment bonus and conforms very closely to the bonus offered by the Federal Government for the active component personnel. Those members currently receiving a reenlistment bonus under AS 26.05.265 would continue to receive those bonus payments.

RICHARD KOUNTREE
MIL AFFRS

January 12, 1981

President of the Senate
Alaska State Legislature
Pouch V
Juneau, AK 99811

Dear Mr. President:

Under the authority of art. III, sec. 18, of the Alaska Constitution, I am transmitting a bill relating to pay and benefits for members of the Alaska National Guard and Naval Militia. The bill would increase benefits for education, active service pay, workers' compensation, and the reenlistment bonus.

Section 1 of the bill would authorize a sorely-needed change in the pay for members called to active service in an emergency. Under existing law enlisted members of the National Guard in the lower pay grades and their families would suffer grave hardship if the members were called away from their regular employment to active service at very low pay. The section sets a minimum daily compensation which will help insure that a member's family will have enough money while the member is away on active service. The minimum compensation will increase with an increase in the Consumer Price Index for Anchorage, Alaska.

Sections 2 and 3 of the bill would provide for coverage of members of the National Guard under the Workers' Compensation Act while they are on active service in an emergency.

Section 5 of the bill would amend the provision which establishes the reenlistment bonus to provide for three lump sum payments of \$1,000 instead of the more numerous but smaller payments provided under existing law. Those members of the National Guard who are receiving a bonus under existing law would continue to receive that bonus and would not receive the reenlistment bonus that is proposed in this bill.

Section 6 of the bill would extend the education benefits currently available to retired members. Under the current law, only active members may claim this benefit.

Sincerely,

S/JS H

Jay S. Hammond
Governor

THE LEGISLATURE OF THE STATE OF ALASKA
TWELFTH LEGISLATURE

FISCAL NOTE

I. REQUEST

Bill/Resolution No. SB 54
 Title An Act relating to the Alaska National Guard and Naval Militia
 Requested by the Department of Military Affairs Date 06 Feb 1981

II. FISCAL DETAIL

Agency Affected Department of Military Affairs
 Program Category Affected Public Protection
 BRU, Program, or Subprogram(s) Affected Military Preparedness
 (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	0	5.0	5.0	335.0	202.0	459.0
200 TRAVEL						
300 CONTRACTUAL						
400 COMMODITIES						
500 EQUIPMENT						
600 LAND & STRUCTURES						
700 GRANTS, CLAIMS, ETC.						
TOTAL						

FUNDING (Thousands of Dollars)

	FY 81	FY 82	FY 83	FY 84	FY 85	FY 86
GENERAL FUND						
FEDERAL FUNDS						
OTHER (Specify Fund Source)						

POSITIONS

	FY 81	FY 82	FY 83	FY 84	FY 85	FY 86
FULL TIME						
PART TIME						
TEMPORARY						

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

Sections 1 - 3 have no budget impact except in the event of a disaster. This funding is received from the Governor's Emergency Fund.

Section 5 will require expenditures of \$330.0 in FY 84, \$197.0 in FY 85, and \$454.0 in FY 86. Beginning FY 87, the expenditures will decrease each year as current (1980-81) members drawing the old bonus payment will begin to retire or leave the Guard for other reasons. As these older members retire or drop out, the new program will have completed paying 33 1/3% of the new members. Attached to this fiscal note is a break down of the payments to be paid FY 84-87.

Section 6 extends reimbursement of tuition to retired members. About 15 retired members would use this benefit. The average reimbursement is \$125.00 for active members. Shown above as \$5,000 each year.

IV. DATE 06 Feb 1981 PREPARED BY LTC Henry A. Compton
 AGENCY Department of Military Affairs
 Original: Legislative Finance PHONE 465-4601 - Juneau
 cc: Budget and Management 243-0656 - Juneau
 Prime Sponsor (First Legislator Named)

REENLISTMENT BONUS

ARMY GUARD @ 60% RETENTION

FY 82	304 ETS 182 Reups	Pay in 84 \$182,000.
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FY 83	175 ETS 105 Reups	Pay in 85 \$105,000.
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AIR GUARD @ 74% RETENTION

FY 82	200 ETS 148 Reups	Pay in 84 \$148,000.
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FY 83	127 ETS 92 Reups	Pay in 85 \$ 92,000.
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ARMY GUARD @ 60% RETENTION

FY 84	159 ETS 92 Reups	Pay in 86 \$ 92,000.
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FY 85	175 ETS 105 Reups	Pay in 87 \$105,000.
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AIR GUARD @ 74% RETENTION

FY 84	42 ETS 32 Reups	Pay in 86 \$ 32,000.
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FY 85	1 ETS 1 Reup	Pay in 87 \$ 1,000
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TOTALS PAY IN:

FY 84	\$182,000. <u>148,000.</u>	Army Guard Air Guard
	\$330,000.	

FY 85	\$105,000. <u>92,000.</u>	Army Guard Air Guard
	\$197,000.	

TOTALS PAY IN:

FY 86	\$330,000. <u>124,000.</u>	(2d Pmt from 34) (1st Pmt from 84)
	\$454,000.	

FY 87	\$197,000. <u>106,000.</u>	(2d Pmt from 85) (1st Pmt from 85)
	\$303,000.	

FACT SHEET

PROPOSED 1981 LEGISLATION

SB 54

The Department of Military Affairs has asked the Governor to introduce one bill in the 1981 Legislation.

The bill has three parts; in nine sections and is now known as SB 54.

The first three sections are designed to protect the families of lower rank enlisted members from a dramatic financial loss in the event of an extended State Duty period. It also ensures that members called to State Active Duty are covered by the Workman's Compensation Act. The fiscal impact of this proposal would be felt only in the event of a major disaster. The funding would come from the Governor's Emergency Fund.

Section 5 is identical to a bill submitted by the Governor last year and proposes a restructuring of the reenlistment bonus. A reenlistment bonus in the amount of \$3,000 will be paid for the first 6 year reenlistment only. The payments will be \$1,000 each, payable every two years. At the end of the initial reenlistment, the bonus stops. Payments would be made to the Guard members during their 6th through 12th year of total military service. This period has been determined as the "decision making" time for Guard members as to whether to stay until retirement or quit. We feel that paying this bonus during the decision years is the best possible use of a reenlistment bonus and conforms very closely to the bonus offered by the Federal Government for the active component personnel. Those members currently receiving a reenlistment bonus under AS 26.05.265 would continue to receive those bonus payments.

Section 6 proposes that the reimbursement of tuition and fees for members who attend an educational, vocational or training school in Alaska be extended to retired members. This proposal is designed to provide an additional incentive to stay in the Guard until retirement and reward, in a small way, those retired members who would like to continue their education. We anticipate that no more than 15 members would take advantage of this proposal each year. The average reimbursement is \$125.00 per year per person, making the total cost of this proposal between 2 and 3 thousand dollars annually.

Sections 7 through 9 are administrative in nature.

Analysis of state funded benefits the Alaska National Guard and Naval Militia now enjoy:

RETIREMENT SYSTEM

Current law passed in the last session of the legislature provides for a retirement payment of \$100.00 for every month served in the Alaska National Guard or Naval Militia provided the retiree has a total of 20 years of service a minimum of five of which as a member of the guard

TUITION REIMBURSEMENT

The State of Alaska will pay an amount equal to 50% of all tuition and required fees paid by the member to schools in Alaska. The schools include all technical vocational or educational institutions. Eligibility requirements are, that the guard member attend 90% of all scheduled drills and 15 days of annual training each year. This eligibility is certified by the unit commander.

REENLISTMENT BONUS

Current statute provides that the state will pay the equivalent of 10 days base pay at the rank held upon satisfactory completion of a members initial enlistment who reenlists or extends that enlistment for any period of time. Average reenlistment bonus payment is approximately \$350.00. Our proposal in SB 54 changes this to a \$3,000 payment for the initial six year reenlistment after the completion of the initial contract.

VETERANS BENEFITS

Members of the Alaska National Guard and Naval Militia who have served five or more years with the Alaska National Guard or Naval Militia obtain veterans status for procurement of state loans.

NATIONAL GUARD LOSSES 1980

TOTAL LOSSES 110

DROP OUTS AT ETS 76

Of 76 lost, 52 dropped out during "Decision Making" period, or 68.4% could be saved by a larger reenlistment payment that can be used by the family group. In most cases the family makes the decision to leave or stay in the Guard.

THE LEGISLATURE OF THE STATE OF ALASKA
TWELFTH LEGISLATURE

FISCAL NOTE

I. REQUEST

Bill/Resolution No. AB 54
Title An Act relating to the Alaska National Guard and Naval Militia
Requested by _____ Date 6 Oct 1980

II. FISCAL DETAIL

Agency Affected Department of Military Affairs
Program Category Affected Public Protection
BRU, Program, or Subprogram(s) Affected Military Preparedness
(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	5.0	5.0	335.	202.0	459.0	308.0
200 TRAVEL						
300 CONTRACTUAL						
400 COMMODITIES						
500 EQUIPMENT						
600 LAND & STRUCTURES						
700 GRANTS, CLAIMS, ETC.						

TOTAL

FUNDING (Thousands of Dollars)

GENERAL FUND						
FEDERAL FUNDS						
OTHER (Specify Fund Source)						

POSITIONS

No Additional Positions

FULL TIME						
PART TIME						
TEMPORARY						

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

Section 1 extends reimbursement of tuition to retired members. About 50 retired members would use this benefit. The average reimbursement is \$75.00 for active members. This will cost \$3,770 per year. Shown above as \$5,000 each year.

Sections 2-5 have no budget impact except in the event of a disaster. The per day cost per person would increase from \$45 to \$70.00 depending on the location. This funding is received from the Governor's Emergency Fund.

Section 5 will require expenditures of \$330.0 in FY 84, \$197.0 in FY 85, \$454.0 in FY 86 and \$303.0 in FY 87. Beginning FY 88, the expenditures will decrease each year as current (1980-81) members drawing the old bonus payment will begin to retire and leave the Guard for other reasons. As these older members retire or drop out, the new program will have completed paying 33 1/3% of the new members. Attached to this fiscal note is a break down of the payments to be paid FY 84-87.

IV. DATE 06 Oct 1980

PREPARED BY ^{For} LTC Hank Compton
AGENCY Department of Military Affairs
PHONE 465-4601 - Juneau
243-0656 - Anchorage

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

Introduced: 1/13/81
Referred: State Affairs and
Finance

1 IN THE SENATE

BY THE RULES COMMITTEE BY
REQUEST OF THE GOVERNOR

2 SENATE BILL NO. 54

3 IN THE LEGISLATURE OF THE STATE OF ALASKA

4 TWELFTH LEGISLATURE - FIRST SESSION

5 A BILL

6 For an Act entitled: "An Act relating to the Alaska National Guard and
7 Naval Militia; and providing for an effective date."

8 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

9 * Section 1. AS 26.05.260(b) is amended to read:

10 (b) Members of the Alaska National Guard and Alaska Naval Militia
11 are entitled to receive, for each day of active service under AS 26.-
12 05.070, [COMMISSIONED AND WARRANT OFFICERS FOR STATE SERVICES ACTUALLY
13 PERFORMED ARE ENTITLED TO RECEIVE] pay and allowances equal to those
14 provided by federal laws and regulations for members of equivalent [COM-
15 MISSIONED AND WARRANT OFFICERS OF THE SAME] grades of the United States
16 armed forces, however, no member will receive less than \$65 per day for
17 active service performed during the fiscal year ending June 30, 1982.
18 For fiscal years beginning after June 30, 1982, the minimum payment of
19 \$65 shall be increased one percent for each percent increase in the con-
20 sumer price index of Anchorage, Alaska, as determined by the United
21 States Department of Labor, Bureau of Labor Statistics, not to exceed an
22 annual increase of 10 percent. The increase, if any, takes effect not
23 more than 30 days after the release of the consumer price index. The
24 consumer price index which is published immediately after July 1, 1981
25 is the reference base index [ARMY OR AIR FORCE].

26 * Sec. 2. AS 26.05.260(d) is repealed and reenacted to read:

27 (d) A member of the Alaska National Guard or Alaska Naval Mili-
28 tia who, while on active service under ; 26.05.070 and lawfully per-
29 forming his or her duties, including transit to and from his or her

1 home of record, suffers a disability is entitled to all compensation and
2 benefits available under the Alaska Workers' Compensation Act (AS 23.-
3 30).

4 * Sec. 3. AS 26.05.260(e) is repealed and reenacted to read:

5 (e) If a member of the Alaska National Guard or Alaska Naval Mil-
6 itia dies as a result of a disability suffered while on active service
7 under AS 26.05.070 and while lawfully performing his or her duties, in-
8 cluding transit to and from his or her home of record, death benefits
9 shall be paid to the persons in the amounts specified in AS 23.30.215.

10 * Sec. 4. AS 26.05.260 is amended by adding a new subsection to read:

11 (h) In this section, "member" means an active commissioned or
12 warrant officer or enlisted man or woman in the Alaska National Guard
13 or Alaska Naval Militia.

14 * Sec. 5. AS 26.05.265 is amended to read:

15 Sec. 26.05.265. REENLISTMENT BONUS. (a) A bonus shall be paid
16 to an enlisted [A] person who, at the his or her enlistment is com-
17 pleted, reenlists or extends an enlistment in the Alaska National Guard
18 or the Alaska Naval Militia for six years. The bonus is \$3,000 payable
19 in the amount of \$1,000 at the satisfactory completion of the second
20 year of reenlistment or extension, \$1,000 at the satisfactory comple-
21 tion of the fourth year, and \$1,000 at the satisfactory completion of
22 the sixth year [A SUM EQUAL TO 10 DAYS OF BASIC PAY FOR EACH YEAR HE
23 REENLISTS OR EXTENDS HIS ENLISTMENT, COMPUTED ACCORDING TO A MEMBER'S
24 GRADE AT THE END OF EACH QUALIFYING YEAR AND PAYABLE AT THAT TIME.
25 PAYMENT OF A BONUS IS CONTINGENT UPON THE MEMBER SATISFACTORILY PARTI-
26 CIPATING IN UNIT TRAINING ACTIVITIES FOR THE YEAR FOR WHICH PAYMENT IS
27 TO BE MADE].

28 (b) An enlisted person who has a break in service of more than 30
29 days forfeits his or her eligibility for a reenlistment bonus.

MW-5 yrs
Service

* Sec. 6. AS 26.05.296(a) is amended to read:

(a) To the extent funds are available, the adjutant general shall authorize the payment of not more than 50 percent of the cost of tuition and required fees for each active or retired [MALE OR FEMALE] member of the Alaska National Guard or the Alaska Naval Militia who attends an educational, vocational, or technical training school in Alaska. Payments authorized under this section continue so long as the active member participates satisfactorily in unit training activities or a retired member is on the retired list and pursues the course of study in a manner acceptable to the school.

* Sec. 7. TRANSITION. AS 26.05.265 as amended in sec. 5 of this Act does not apply to persons who reenlisted or extended an enlistment in the Alaska National Guard or the Alaska Naval Militia before July 1, 1981.

* Sec. 8. AS 26.05.260(c), (f), and (g) are repealed.

* Sec. 9. This Act takes effect July 1, 1981.

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ARMY GUARD @ 60% RETENTION

FY 82	304 ETS 182 Reups	Pay in 84 \$182,000.
FY 83	175 ETS 105 Reups	Pay in 85 \$105,000.

End of term of service

AIR GUARD @ 74% RETENTION

FY 82	200 ETS 148 Reups	Pay in 84 \$148,000.
FY 83	127 ETS 92 Reups	Pay in 85 \$ 92,000.

ARMY GUARD @ 60% RETENTION

FY 84	159 ETS 92 Reups	Pay in 86 \$ 92,000.
FY 85	175 ETS 105 Reups	Pay in 87 \$105,000.

AIR GUARD @ 74% RETENTION

FY 84	42 ETS 32 Reups	Pay in 86 \$ 32,000.
FY 85	1 ETS 1 Reup	Pay in 87 \$ 1,000

TOTALS PAY IN:

FY 84	\$182,000. <u>148,000.</u>	Army Guard Air Guard
	\$330,000.	
FY 85	\$105,000. <u>92,000.</u>	Army Guard Air Guard
	\$197,000.	

TOTALS PAY IN:

FY 86	\$330,000. (2d Pmt from 84) <u>124,000. (1st Pmt from 84)</u>	
	\$454,000.	
FY 87	\$197,000. (2d Pmt from 85) <u>106,000. (1st Pmt from 85)</u>	
	\$303,000.	