

ALASKA LEGISLATURE COMMITTEE FILES 2001-2002 8672

10685 SENATE STATE AFFAIRS

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Senator Gene Therriault, Chairman  
Senate State Affairs Committee  
Capitol Building, Room 121  
Juneau, Alaska 99801

February 21, 2002

Chairman and Members of Senate State Affairs,

My name is Jay Hogan, my wife and I live at 10741 Horizon Drive in Juneau Alaska and I am here today representing no one other than myself. For the record let me stipulate that at an earlier time, it would never have occurred to me to appear before any committee of the Alaska Legislature in opposition to a measure introduced by the Legislative Budget and Audit Committee!

In January 1970, Governor Keith Miller requested introduction of three measures to establish a "resources permanent fund". In a transmittal letter, Governor Miller stated, the "objective is to assure maximum long-term growth [of the fund] while providing an annually increasing source of income to the general fund." The two bills in the package passed the Senate but failed to move in the House. The third, a Constitutional amendment, made five percent of permanent fund market value annually available for "appropriation for general purposes"; this resolution failed to pass the Senate.

In March 1975, prompted by public concern over the disappearance of the \$900 million North Slope lease bonus, 36 Members of the House co-sponsored HB 324 establishing the "Alaska mineral lease bonus permanent fund". Fund principal was to be "invested in perpetuity"; fund income could be, "appropriated to provide funding for operating or capital expenditures for loan or grant programs" eligible for funding under the law. The Legislature passed this statutory permanent fund only to have it vetoed by Governor Jay Hammond as an "unconstitutional dedication of revenue".

In January of 1976, Governor Hammond submitted a sponsor substitute for HJR 39, his 1975 end-of-Session "fix" for the dedicated revenue problem. The substitute was a Constitutional amendment establishing the Alaska Permanent Fund. In his transmittal letter Governor Hammond emphasized, "The income of the fund would be deposited into the general fund without any permanent fund restrictions." The Resolution as introduced read; "All income from the permanent fund shall be deposited in the general fund." House Finance added, "unless otherwise provided by law" completing the sentence as it stands today, unchanged from 1976.

Mike Bradner, Speaker of the House in 1975-76, wrote in the March 1988 Juneau Report:  
"The constitutional action creating the fund was also "not about" a lot of things. It was not about dividends, investment policy, unreserved income, and in fact, did not even attempt to tell Alaskans "when" and under "what" circumstances the proceeds of the fund might one day accrue to future Alaskans.

Discussion over the Permanent Fund often takes on a biblical connotation. But amidst all this rhetoric, the simple foundation of the Fund is embraced in the two

previously stated commandments – *to preserve a portion of current oil income, and to preserve it as a future “trust”.*

All the rest of the development of the Alaska Permanent Fund is essentially left to statutory construction. Future Legislatures through general law, as opposed to constitutional law, were left to fill in the details of the Fund. These details included creation of the Alaska Permanent Fund Corporation, the rules of “inflation-proofing” (injecting some Fund earnings into the principal to account for inflation), creation of the dividend program, investment policy, and so on. These details were to be created, and to be changed as need be, by future generations of lawmakers.

What the lawmakers of 1976, in creating the Fund, were trying to avoid was “playing god”. They did not want to try to foretell the future – to dictate future policy. As much as possible, commensurate with the basic task of creating the fund, the architects of the Fund did not want to tie the hands of future generations of lawmakers.”

On average, SJR 13 would reduce by one third the amount of Permanent Fund income annually available for appropriation by the Alaska Legislature. Currently the Legislature appropriates that “third” as shown in the following appropriation from Chapter 60, SLA 2001:

“Sec. 8. ALASKA PERMANENT FUND CORPORATION. (a) . . .

(b) After money is transferred to the dividend fund under (a) of this section, the amount calculated under AS 37.13.145 to offset the effect of inflation on the principal of the Alaska permanent fund is appropriated from the earnings reserve account (AS 37.13.145) to the principal of the Alaska permanent fund.

The 2001 Permanent Fund Corporation Annual Report gives credit to the long running success of this method of appropriation for inflation proofing. On close inspection, the caption for the inflation graphic on page 17 reads, “Inflation has eroded the purchasing power of \$1.00 in 1982 to 48 cents in 2001 . . . — but inflation-proofing has maintained the Fund’s real value”.

Unlike most other state permanent funds, the Alaska Permanent Fund has been inflation proofed for the past 20 Years. Largely “under reported” throughout the 26-year history of the Alaska Permanent Fund is the part played by the Alaska Legislature in increasing Fund principal. Relegated to the “Notes to Financial Statements” on page 38 of the Permanent Fund Corporation’s Annual Report 2001, the principal balance of the Fund at June 30, 2001, was listed by source:

Dedicated State revenues	\$7,070,741,000
Appropriations from the State	6,885,906,000
Inflation-proofing	6,929,350,000
Settlement earnings	161,582,000
Total Principal	\$21,047,579,000

The Constitutional provision dedicating 25% of certain mineral revenues to the Permanent Fund produced a \$7.1 billion Fund principal as of June 30, 2001. But, with the numerous special Legislative appropriations and 12 years of Legislative appropriations

for inflation proofing, the Legislature has nearly tripled Fund principal over that funded by the Constitutional dedication of revenue.

The Permanent Fund Corporation Board of Trustees proposal contained in SJR 13 and HJR 15 would repeal existing Legislative authority to appropriate Permanent Fund income established 25 years ago. With the State's Constitutional Budget Reserve Fund approaching "empty" and increased national/state concern with internal security matters, does this Legislature really want to repeal the existing authority to use all Permanent Fund earnings for what ever purpose this, or any future Legislature, determines to be the best public use at the time?

If the existing flexibility to appropriate earnings is to be changed, I would suggest that discussion and resolution of the part Permanent Fund earnings/payout are to play in the annual State budget should run concurrently with deliberation of the Trustees' proposed amendment to imbed inflation proofing of the Permanent Fund in the Constitution. If the 2002 Legislative Session is not the time for deliberation and resolution of the statutory use of all Permanent Fund earnings/payout, consideration of the Trustee's amendment should be postponed to a time when all Permanent Fund earnings/payout can be allocated by statute. The existing statutory system of annual appropriations for, "the amount calculated under AS 37.13.145 to offset the effect of inflation on the principal of the Alaska permanent fund" has done the job well, and can continue to do so.

Thank you very much for providing this opportunity to appear before the Senate State Affairs Committee.

Jay Hogan  
PO Box 21073  
Juneau, Alaska 99802

## THE ALASKA PERMANENT FUND – PERMANENT FOR WHAT PURPOSE?

During the 1976 Legislative Session, four Alaska daily newspapers editorialized on the proposed fund, some more than once.

Anchorage Daily News – Place a check on state spending . . . offer loans to businessmen, builders and fishermen . . . “Most importantly, the permanent fund addresses that day when the oil runs out.”

Fairbanks Daily News-Miner – “What could be more exciting than the prospect of true economic stability for Alaska?” . . . much like a savings account . . . the interest derived would be used to sustain certain state programs that would benefit all Alaskans. . . fund a viable agricultural industry . . . loans to Alaskans to build their own homes . . . boat loans to revitalize a depleted fishing industry . . . and avoid careless state spending.

Southeast Alaska Empire – “What happens if, when Prudhoe runs dry, there isn’t another massive oil strike on state land?” . . . if there is no contingency fund, state government will lead Alaska back to the boom and bust economy we’ve been in since 1867.

Anchorage Times – There are reasons aplenty to set aside some oil income rather than “spend them in an orgy of pork barrel raids on the treasury” . . . “However, sealing up a share of the revenue in a bank account . . . has drawbacks” . . . others suggest reducing state debt, reducing or eliminating the state income tax, or revenue sharing to reduce or eliminate local property taxes.

The Alaska State Chamber of Commerce prepared the 1976 Official Election Pamphlet statement in favor of the Permanent Fund proposition. It read in part:

“Just as a wise and prudent family sets aside money in a savings account for the future, so should Alaska’s state government set aside a rainy day fund to benefit this and future generations of Alaskans. . . .

Today, as the result of anticipated oil and gas revenues, Alaska stands on the brink of unprecedented prosperity. No one, but no one, argues that these non-renewable resources will last but for a few decades. Similarly, no one should fail to recognize that in those years ahead the cost of state government will continue to spiral upwards. Now is the time to ask ourselves the question: ‘when the oil and gas is depleted, where will the funds to feed our giant government come from?’ The answer is: the ‘Permanent Fund’.”

October 22, 1976, an Anchorage Daily News article summed up diverse opinion:

“Nobody knows exactly how the fund will be used; that decision will be made by legislative action in the future. Although the fund is protected against certain kinds of usage, its precise organization and management have been left flexible by designers. . . .

There have been many proposals for possible fund uses. They range from paying direct dividends to Alaskans to using the money to underwrite such vast projects as hydroelectric dams. But, whatever use it is put to, the permanent fund money would have to be a money-maker. Politicians could spend the interest, but never the principle.”

Two days later, in a lengthy article the Anchorage Times detailed diversity:

“Those promoting the permanent fund, including Gov. Jay Hammond, see it as a way of providing development capital to diversify the state’s economy, strengthen

renewable resources – such as fisheries, timber and tourism – and make possible large projects such as dams, which couldn't otherwise be financed.

They also view it as a savings account, to keep some of the state's income from oil and gas out of the general fund so it can't be spent. They point to the \$900 million the state received from the 1969 Prudhoe Bay lease sale, which now is nearly all spent.

Others see the fund as a source of loans for community development, such as home mortgages, small business loans; for power development, ports, utilities, roads, or health, education or social needs, such as day care centers.

Malone [Rep. Hugh Malone, D-Kenai] said the fund could go for all three of those uses. The legislature would decide what per cent of the fund would go to each use.

Other options include reinvesting the earnings in the permanent fund, pledging the earnings as security for state and local bonds, additional revenue sharing, letting earnings flow into the general fund, lower state income taxes, or return dividends as tax credits."

Thus informed, Alaskans went to the polls and voted almost 2 to 1 for the constitutional amendment establishing the Alaska Permanent Fund.

# LEGAL SERVICES

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## MEMORANDUM

February 12, 2001

**SUBJECT:** Alaska Permanent Fund (Work Order No. 22-LS0534\C)

**TO:** Senator Gene Therriault, Chair  
Legislative Budget and Audit Committee  
Attn: Heather Brakes

**FROM:** Tamara Brandt Cook  
Director 

You ask for my observations on this draft resolution proposing an amendment to the state constitution dealing with the permanent fund. The title does not reflect the contents of the resolution and, because a joint resolution is supposed to be treated like a bill under the Uniform Rules, normally the title is drafted to reflect the contents. However, because Art. II, sec. 13 only applies to bills, the title defect in this situation is only a procedural and not a constitutional problem. Likewise, a new subsection is normally added as a new bill section and the material is not underlined. The way subsection (b) has been added does not conform to the Legislative Drafting Manual, but will not be fatal to the validity of the resolution if it is adopted by the legislature and approved by the voters.

Substantively, I observe that it makes little sense to retain the distinction between principal and income in subsection (a), since appropriations allowed under subsection (b) are based on averaged market value of the fund and no longer on income generated by the fund. Furthermore, by retaining the distinction between principal and interest, the provision that addresses permanent fund investments applies only to investments of principal. There is no constitutional requirement that interest retained in the fund also "be used only for those income-producing investments specifically designated by law as eligible for permanent fund investments." This seems a bit puzzling, but the legislature can address the investment of interest by law, so the approach probably does not create any great problem.

Subsection (b) is not as clear as might be desirable, but I think it can be applied. However, from my conversation with Mr. Jim Kelly, I gather that it is expected that only income of the fund will be available for appropriation. If this is the intended result, it has not been achieved. That is to say, if fund income is low for a period of years, it will be mathematically possible for an appropriation to be made based on the average of the market values formula that includes some fund principal. Perhaps, this possibility is so remote as not to be a serious problem.

Senator Gene Therriault, Chair

February 12, 2001

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I think it will be awkward for the constitutional amendment to spring into effect in the middle of a fiscal year and suggest that a July 1, 2003 effective date be added. Otherwise, for part of the year the legislature will be able to appropriate fund income, while at the end of the same year it will have access to an amount based on market value of the fund. Also, I am not sure about the status of the balance in the earnings reserve account on the day the amendment takes effect. I assume the entire balance on that day is available for appropriation under the constitutional language as it read prior to the amendment.

TBC:lmb

01-044.lmb

Wyoming has just begun to inflation proof State Permanent Funds. During the 2000 legislative session, the Wyoming State Treasurer, "was instrumental in getting legislative changes passed that authorized 'returning' a portion of income to the corpus of the permanent land funds to compensate for inflation. The amount to be returned is based on the beginning balance of each permanent land fund account multiplied by a portion of that year's inflation rate (this year that portion was 5 percent of the inflation rate). The first such transfer was made at the end of FY00 and totaled \$1,390,322." By statute, the inflation rate "multiplier" is increased 5% per year to reach "100% of the inflation rate" over a 20-year period. [Wyoming State Government Annual Report 2000, page 3.20]

Phone conversations with Treasurer's Office staff indicate that the recently enacted inflation protection statute is currently under review and that a new spending policy proposal will be placed before the Legislature during the 2002 session. The new plan would replace incremental increases in inflation proofing with the adoption of an "annual spending policy" authorizing "an amount equal to eight percent (8%) of the previous five (5) year average market value of the trust fund, [the permanent Wyoming mineral trust fund and the common school account within the permanent land fund] calculated from the first day of the fiscal year". The 8% of fund value payout would be decreased by .375% per year until fiscal year 2010 when it would reach and remain at "5% percent of the previous five (5) year average market value of [the trust fund or the school account]".

With either system, Wyoming will use a multi-year transition to reach the goal of full inflation proofing. The transition will give the State time to phase inflation proofing into the budget and time to hopefully increase the annual income from the mineral trust fund and the common school account. Stable annual income from both funds is necessary to maintain the current level of annual operating and capital programs.

## Keeping Pace With Inflation

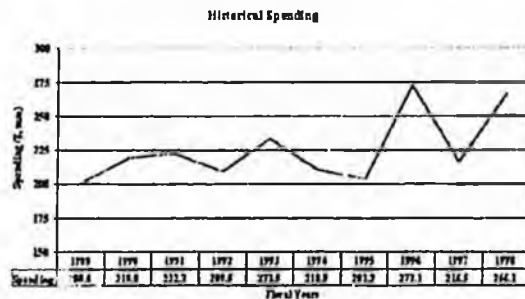
The State of Wyoming is considering changes to the investment programs implemented for the Permanent Funds that should enhance the spending and stability of spending made available from the funds and allow the Fund's assets to keep better pace with inflation.

The State Loan and Investment Board oversees the investment of the Permanent Funds. They follow an Investment Policy to guide the selection of managers and use of other service providers, set and monitor investment performance expectations, and to set asset mix policies. Every quarter the Board receives an Investment Performance Report from the State's Investment Consultant (RVK) to ensure the State's Investments are structured and performing per the requirements of the Investment Policy. A Select Committee on Capital and Investments regularly meets to become familiar with the State's Investments to review and consider any necessary legislation.

In past years, spending generated by investment earnings (income) on the Permanent Funds varied year to year directly with investment income. In addition, the State's Permanent Fund Investments were comprised primarily of bonds and cash investments which generally do not produce enough return in excess of spending to grow the assets to keep up with inflation.

The following exhibit illustrates the volatility in spending.

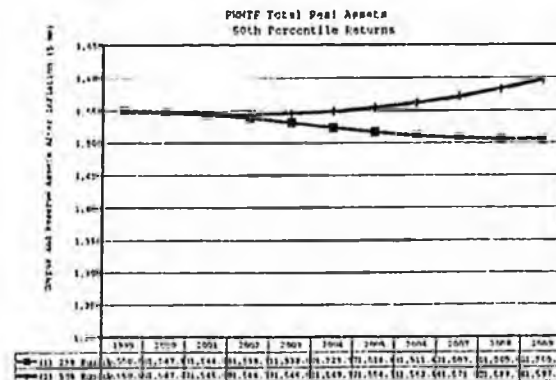
### Historical Spending



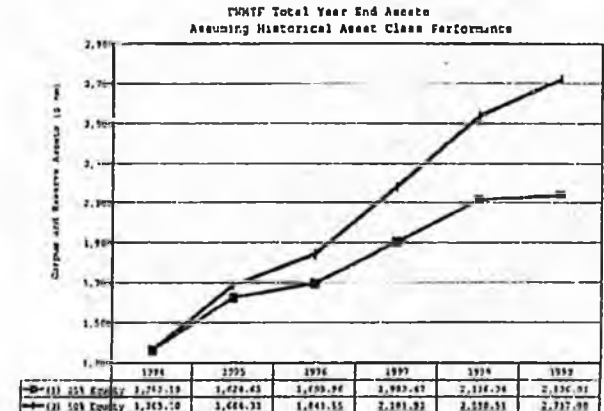
By constitutional definition funds available for spending consist of interest, income, dividend income and realized capital gains. Funds available for spending in the past have varied quite dramatically over time and have been expended instead of being used to help protect the Permanent Funds from the ravages of inflation.

In 1996 the State Land and Investment Board approved participation in stock investments for the Permanent Funds for purposes of enhancing return. The basis for doing so was grounded in the fundamental belief that stocks would outperform bonds over a long period of time. R.V. Kuhns & Associates completed an analysis for the State's Loan and Investment Board that illustrated the impact of adding stocks to the then current fixed income investments. It was assumed that stocks would offer a 9-10% return while bonds would only offer 6-6.50%. It was decided that up to 25% of the portfolio would be placed in stocks and because of the stock market's volatility, the 25% position would be achieved gradually over approximately a two-year period.

Even with up to 25% of the assets invested in equities, RVK advised that the real value of assets would never increase with the current spending policy. The next graph illustrates the expected growth in the Permanent Fund assets after accounting for inflation. The exhibit shows changes in assets given the current equity maximums of 25% and 50% equity. All of the scenarios assume maintaining spending at current levels plus an additional \$20 million. The graph demonstrates that if the projected spending is maintained, the value of the assets will fall in real terms except if approximately 50% of the assets are placed in equities. For simplicity, the Permanent Mineral Trust Fund is represented. Similar results can also be found for the Common School Fund.



If the State had implemented these changes 5 years ago, Permanent Fund Assets would currently be much larger.



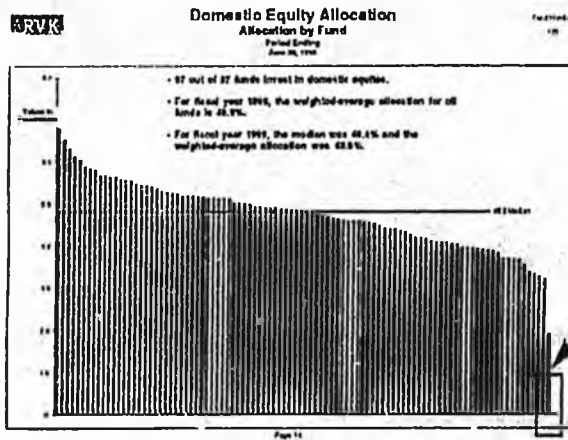
The current investment environment has produced challenges in supporting spending at current levels due to the general decrease in interest rates that has occurred in the last decade. In addition, dividend income has decreased for the average stock levels of 1.0% and 1.5%.

Facing the challenges of maintaining/increasing spending and the desire to inflation proof the Permanent Fund assets; the State is considering making a change to increase the 25% equity to approximately 50%. Because the stock market has been historically volatile, R.V. Kuhns and Associates pointed out that in some years it may be possible that the amount planned for spending may not be earned by the portfolio.

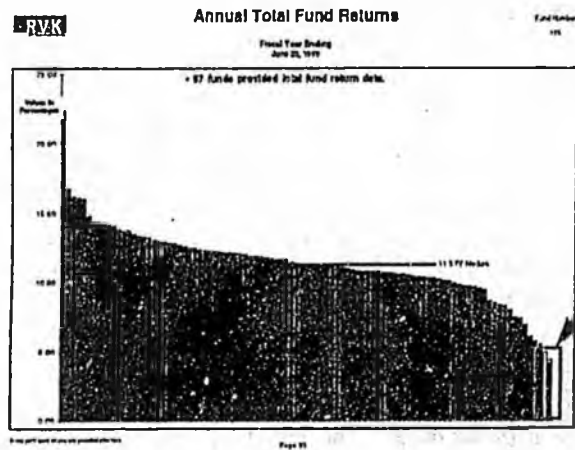
In light of this and the Constitutional requirement to disallow invasion of the corpus or spend unrealized losses, a reserve account will be established for each Permanent Fund. These reserve accounts will be used to "bank" actual returns in excess of spending policy for purposes of supplementing more lean years when investment income is insufficient to meet spending targets.

If the reserve accounts reach a size nearing a large proportion of a year's spending target, any excess above that level will revert to the principal base.

The proposed new equity level of 50% for the Permanent Funds closely resemble the mix of investments of other long-term oriented portfolios. An example within the state is the Wyoming State Retirement Fund, which has a current stock exposure of approximately 57%. In the following exhibit the State's current investment program is listed as one of the equity markets of a universe of large public funds. The State's equity allocation is represented in yellow (highlighted in blue).



The next exhibit demonstrates that having a greater equity exposure benefited the universe funds' investment returns last year. The State's annual return is represented in yellow, 2nd bar from the right indicated by the blue arrow.



In another universe comparison, the Permanent Funds current equity participation is also very small compared to a national collection of endowments and foundations. As of June 30, 1999, the average fund had an equity allocation of 63% compared to less than 10% for the State.

House Bill 21 has been drafted to allow Permanent Fund assets to grow. It is expected that the change in the investment program will enable the goals of increased spending to help address the projected shortfall in the next biennium.

With these goals in mind, it is highly recommended that the spending policy House Bill 21 be passed to assist The State of Wyoming meet its current and future fiscal needs.

## THE STATE OF WYOMING

### Permanent Fund Spending Policy



**ANNUAL REPORT  
of the Treasurer**

**of the  
State of Wyoming**



For the Period  
July 1, 2000 through June 30, 2001

*Cynthia M. Lummis, State Treasurer*  
*Sharon Garland, Deputy State Treasurer*  
*Glenn Shaffer, Chief Investment Officer*

**INCOME EARNINGS RECOGNIZED ON INVESTMENTS**  
**During Fiscal Year 2001**

	<u>REGULAR INVESTMENT INCOME</u>	<u>CASH POOL INTEREST 07/01 - 06/30</u>	<u>TOTAL INVESTMENT INCOME RECEIVED</u>
Water Development	\$6,954,082.27	\$325,460.14	\$7,279,542.41
Worker's Compensation	17,099,416.66	5,006,026.68	\$22,105,443.34
Tobacco Settlement Trust Fund	1,606,993.77	160,751.51	\$1,767,745.28
Miners' Hospital Permanent Land Fund	0.00	1,313,113.78	\$1,313,113.78
Public Buildings @ Cap Permanent Land Fund *	0.00	31,399.23	\$31,399.23
Fish Hatchery Permanent Land Fund	0.00	12,144.00	\$12,144.00
Common School Permanent Land Fund	53,661,578.00	5,906,992.19	\$59,568,570.19
Common School II	0.00	289,101.40	\$289,101.40
D.D. & B. Permanent Land Fund *	0.00	38,409.01	\$38,409.01
Carey Act Permanent Land Fund *	0.00	13,621.29	\$13,621.29
Omnibus Permanent Land Fund *	0.00	222,099.17	\$222,099.17
State Hospital Permanent Land Fund *	0.00	61,201.60	\$61,201.60
State Training School Permanent Land Fund *	0.00	14,111.42	\$14,111.42
Penitentiary Permanent Land Fund *	0.00	76,156.96	\$86,156.96
Agriculture College Permanent Land Fund	0.00	312,604.29	\$312,604.29
University Permanent Land Fund	0.00	785,987.70	\$785,987.70
Permanent Mineral Trust Fund	91,480,232.74	9,965,840.49	\$101,446,073.23
Other Funds	0.00	71,212,415.65	\$71,212,415.65
	<u>\$170,802,303.44</u>	<u>\$95,757,436.51</u>	<u>\$266,559,739.95</u>
<u>Total Income - Treasurer's Investments</u>		<u>\$166,559,739.95</u>	

Note: Realized yield for all state investments is 6.20% for FY01. This is an approximation based on income recognized versus end-of-month investments at current amortized cost, and includes investment managers but excludes WYO-STAR.

\* All or a portion of the investment income from these funds ultimately goes to the General Fund and is included in the \$30,046,858.48 General Fund Income.

**INVESTMENT ACCOUNT BALANCES**  
**As Of June 30, 2001**

<u>FUND/ACCOUNT NAME</u>	<u>CASH &amp; RECEIVABLES</u>	<u>INVESTMENTS</u>	<u>NET DISC/PERM PURCHASED</u>	<u>ACCOUNT BALANCE (Corpus)</u>
Miner's Hospital	\$22,991,625.14			\$22,991,625.14
Public Buildings At Capitol	75,405.45			75,405.45
Fish Hatchery	218,235.96			218,235.96
Common School	165,166,812.69 *	\$760,379,527.04 ***		925,546,339.73
Common School II	5,000,000.00			5,000,000.00
D.D. & B. Asylum	671,097.20			671,097.20
Carey Act	335,130.33			335,130.33
Omnibus	1,506,753.39			1,506,753.39
State Hospital	986,726.80			986,726.80
State Training School	301,044.60			301,044.60
Penitentiary	658,754.46			658,754.46
Agricultural College	5,489,106.54			5,489,106.54
University	13,671,032.56			13,671,032.56
<b>Subtotal-Permanent Land Fund</b>	<b>217,071,725.12</b>	<b>760,379,527.04</b>		<b>977,451,252.16</b>
Mineral Trust Fund	282,423,892.59	1,557,268,027.92 ***	(\$26,195.73)	1,839,665,724.78
Tobacco Settlement Fund	973,071.85	33,995,548.79		34,968,620.64
<b>Subtotal-All Permanent Funds</b>	<b>500,468,689.56</b>	<b>2,351,643,103.75</b>	<b>(26,195.73)</b>	<b>2,852,085,597.58</b>
Worker's Compensation	71,107,981.29	284,262,140.15 ***		355,370,121.44
Water Development	90,599,797.02 **	65,587,938.54 ***		156,187,735.56
<b>TOTAL</b>	<b>\$662,176,467.87</b>	<b>\$2,701,493,182.44</b>	<b>(\$26,195.73)</b>	<b>\$3,363,643,454.58</b>

\* Does not include debt service deposit (\$57,984,859.00).

\*\* Includes loans receivable.

\*\*\* All or a portion of these funds are now invested by Investment Managers, rather than directly invested by the State Treasurer.

"Cash and Receivables" is actually included with, and part of, the State Agency Pool investments. This investment Pool represents the cash balance of all funds and accounts for which specific investments have not been made. The State Agency Pool investments are not summarized in this report.

**PERMANENT WYOMING MINERAL TRUST FUND: CORPUS**

	<u>JUNE 30, 2000</u> <u>CORPUS BALANCE</u>	<u>REVENUE</u>	<u>JUNE 30, 2001</u> <u>CORPUS BALANCE</u>
Beginning Balance	\$1,629,332,131.71		
Severance Tax			
Coal		\$16,499,375.51	
Stripper Oil		2,995,108.83	
Oil		16,833,866.22	
Gas		71,344,950.01	
Condensate-Gas		1,485,710.03	
Tertiary-Oil		1,173,694.43	
Wildcat-Oil		888.04	
From General Fund per 2001 Ch 139 Sec300(h)		<u>100,000,000.00</u>	
<b>TOTAL REVENUE ADDED TO CORPUS</b>		<u><u>\$210,333,593.07</u></u>	
			<u>\$1,839,665,724.78</u>

**THE UNIVERSITY OF TEXAS SYSTEM**



**AVAILABLE UNIVERSITY FUND**

**Report to the Legislature and Governor  
Pursuant to Rider No. 4 to Available University Fund  
Appropriations  
S. B. 1, 77<sup>th</sup> Legislature, Regular Session, Page III-71**

December 2001

## **B. AVAILABLE UNIVERSITY FUND**

### **1. RATIONALE FOR DISTRIBUTION FROM PERMANENT UNIVERSITY FUND**

The Texas Constitution, as amended in November 1999 by adoption of Proposition 17, defines the Available University Fund (AUF) as consisting of distributions from the total return on all investment assets of the Permanent University Fund (PUF). The U. T. System Board of Regents adopted a policy at its November 11, 1999, meeting designed to provide the AUF with a stable and predictable stream of distributions over time, as well as to maintain the purchasing power of both the PUF assets and AUF distributions.

The amendment contained in Proposition 17 limits the discretion of the U. T. System Board of Regents to determine the amount of PUF distributions in any given year by stipulating that annual distributions cannot exceed 7% of the average market value of PUF investments. Also, distributions cannot increase year to year if the purchasing power of PUF investments has not been preserved over rolling 10-year periods.

The only exception would be to pay annual debt service on PUF bonds.

The Board of Directors of the University of Texas Investment Management Company (UTIMCO) recommended, and the U. T. System Board of Regents approved, total distributions of \$338,433,636 and \$317,081,112 from the PUF to the AUF for the fiscal years ending August 31, 2002 and 2001, respectively. The fiscal year 2002 distribution is equal to 4.5% of the average market value of PUF assets for the trailing 12 fiscal quarters ended February 28, 2001, as illustrated in Appendix A. The distribution rate of 4.5% satisfies the limitations in the Constitution. On August 9, 2001, the U. T. System Board of Regents set the distribution rate for fiscal year 2003 and beyond at 4.75%.

The PUF distribution for fiscal year 2002 represents a 6.7% increase over the distribution for the fiscal year 2001. Money credited to the AUF is administered by the State Comptroller and, along with other funds of the State, is invested in accordance with State law.

**Table 1**

<b>THE UNIVERSITY OF TEXAS SYSTEM AVAILABLE UNIVERSITY FUND FY 2000 - FY 2004</b>		
	<b>Actual FY 2000</b>	<b>Actual FY 2001</b>
<b>Income and PUF Distributions</b>		
Divisible with Texas A&M University		
Investment Income and Distributions	\$ 297,562,712	\$ 317,081,112
Surface & Other Income	6,173,996	9,265,625
Expenses of Revenue Bearing Properties	<u>(2,719,540)</u>	<u>--</u>
<b>Net Divisible Income and Distributions</b>	<b>301,017,168</b>	<b>326,346,737</b>
Less: A&M Share (1/3)	<u>(100,339,056)</u>	<u>(108,782,245)</u>
U. T. Share (2/3)	200,678,112	217,564,492
AUF Interest Income	<u>10,034,605</u>	<u>12,381,690</u>
<b>Income and Distributions Available to U. T.</b>	<b><u>210,712,717</u></b>	<b><u>229,946,182</u></b>
<b>Transfers/Expenditures</b>		
Debt Service on PUF Bonds	(132,470,830)	(60,743,924)
U. T. System Administration:		
Administration	(19,759,754)	(24,841,384)
Information Technology & Distance Education	(2,742,142)	(4,348,003)
U. T. Austin:		
Excellence	(88,727,618)	(102,500,000)
System-Wide Technology & Telecommunications	(1,060,000)	(1,060,000)
Building Revenue Bond Reimbursement	(3,385,007)	(3,391,581)
National Center for Educational Accountability	--	--
Sandia National Laboratories Project	<u>--</u>	<u>--</u>
<b>Total Transfers</b>	<b><u>(248,145,351)</u></b>	<b><u>(196,884,892)</u></b>
<b>Net Surplus/(Deficit)</b>	<b><u>\$ (37,432,634)</u></b>	<b><u>\$ 33,061,290</u></b>

Note: FY 2002 Budget and FY 2003-4 Projections are subject to change due to market conditions and unforeseen emergencies or opportunities.

Source: U. T. System Administration Financial Statements, Annual Operating Budget, and projections from the U. T. System Office of Finance.

## **PERMANENT UNIVERSITY FUND**

### **Beneficiaries of the Fund**

The Permanent University Fund (PUF) is a public endowment contributing to the support of institutions of The University of Texas System (UT System) and the Texas A&M University System (A&M System). The Constitution of 1876 established the PUF through the appropriation of land grants previously given to The University of Texas plus one million acres. Additional land grants to the PUF were completed in 1883 with the contribution of another one million acres. Today the PUF contains 2.1 million acres located in 24 counties primarily in West Texas.

### **Responsibility and Management of the Fund**

The State Constitution vests fiduciary responsibility for the PUF with the Board of Regents of The University of Texas System. The Board has entered into a contract with a nonprofit corporation, The University of Texas Investment Management Company (UTIMCO), for UTIMCO to invest funds under the control and management of the Board. UTIMCO may not engage in any business other than investing funds designated by the Board under the contract. Specific investment decisions are handled by the investment staff as well as unaffiliated investment managers who are employed from time to time.

### **Investment Objectives**

The primary investment objective shall be to preserve the purchasing power of PUF assets and annual distributions by earning an average annual total return after inflation of 5.5% over rolling ten-year periods or longer. The PUF's success in meeting its objectives depends upon its ability to generate high returns in periods of low inflation that will offset lower returns generated in years when the capital markets underperform the rate of inflation.

The secondary fund objective is to generate a fund return in excess of the Policy Portfolio benchmark over rolling five-year periods or longer. The Policy Portfolio benchmark will be established by UTIMCO and will be comprised of a blend of asset class indices weighted to reflect Fund asset allocation policy targets.

### **Market Value and Book Value of the PUF**

On December 31, 2001, the market value and book value of the PUF was \$7.2 billion and \$7.4 billion, respectively, exclusive of land acreage.

## PERMANENT UNIVERSITY FUND

**Comparison Summary of Investment in Securities, at Value**  
*August 31, 2001 and 2000*  
*(in thousands)*

	2001	2000
<b>Equity Securities</b>		
Domestic Common Stock	\$ 1,516,996	\$ 1,639,643
Index Funds	1,380,116	1,802,004
Commingled Investments	1,169,366	1,164,205
Limited Partnerships	1,020,811	1,123,614
Foreign Common Stock	227,378	316,210
Other	4,373	10,993
<b>Total Equity Securities</b>	<b>5,319,040</b>	<b>6,056,669</b>
<b>Debt Securities</b>		
U.S. Government Obligations (Direct and Guaranteed)	390,017	529,467
U.S. Government Agencies (Non-Guaranteed)	529,902	326,067
Foreign Government and Provincial Obligations (U.S. Dollar Denominated)	5,397	6,709
Foreign Government and Provincial Obligations (Non-U.S. Dollar Denominated)	109,296	67,141
Municipal and County Bonds	27,844	26,376
Corporate Bonds	504,326	529,309
Foreign Corporate Bonds	20,248	23,202
Commingled Investment	23,281	-
Commercial Paper	5,000	2,601
Other	7,771	7,771
<b>Total Debt Securities</b>	<b>1,623,082</b>	<b>1,518,643</b>
<b>Preferred Stock</b>		
Domestic Preferred Stock	13,120	12,325
Foreign Preferred Stock	1,305	4,060
<b>Total Preferred Stock</b>	<b>14,425</b>	<b>16,385</b>
<b>Convertible Securities</b>	<b>3,709</b>	<b>-</b>
<b>Cash and Cash Equivalents</b>		
Money Markets and Cash Held at State Treasury	887,575	1,039,885
<b>Total Investment in Securities</b>	<b>\$ 7,847,831</b>	<b>\$ 8,631,582</b>

*The accompanying notes are an integral  
part of these financial statements.*

## PERMANENT UNIVERSITY FUND

### *Notes to Financial Statements*

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#### Note 1 Organization

(A) The Permanent University Fund (PUF) is a state endowment contributing to the support of eligible institutions of The University of Texas System (U.T. System) and the Texas A&M University System (TAMU System). The PUF was established in the Texas Constitution of 1876 through the appropriation of land grants previously given to the University of Texas plus one million acres. Additional land grants to the PUF were completed in 1883 with the contribution of another one million acres. Today, the PUF contains over 2.1 million acres of land located in 24 counties primarily in West Texas (PUF Lands).

PUF Lands produce two streams of income: mineral and surface. Mineral income is contributed to the PUF and surface income is distributed to the Available University Fund (AUF). The investments of the PUF are managed by The University of Texas Investment Management Company (UTIMCO). The PUF Lands are managed by U.T. System administration.

(B) Amendments to the Texas Constitution were approved by voters in a statewide election held on November 2, 1999. The amendments were effective November 29, 1999, and allow for a) distributions to the Available University Fund (AUF) from the "total return" on PUF investments, including income return as well as capital gains (realized and unrealized) and (b) the payment of PUF expenses from PUF assets. Before the effective date of the amendments, the constitutional provisions governing the PUF prohibited the expenditure of corpus, and consequently, gains and losses on sales of securities remained in the PUF. Conversely, the Texas Constitution mandated that all dividend and interest income be distributed to the AUF on an accrual basis. The amendments directed the Board of Regents of U.T. System to establish a distribution policy that provides stable, inflation adjusted annual distributions to the AUF and preserves the real value of the PUF investments over the long term. Accordingly, distributions to the AUF in any given fiscal year are now subject to the following: (1) A minimum amount equal to the amount needed to pay debt service on PUF bonds; (2) No increase from the preceding year (except as necessary to pay debt service on PUF bonds) unless the purchasing power of PUF investments for any rolling 10-year period has been preserved; (3) A maximum amount equal to seven percent of the average net fair market value of PUF assets in any fiscal year, except as necessary to pay debt service on PUF bonds. The PUF distribution to the AUF for the year ending August 31, 2002, in the amount of \$338,433,636 was paid September 4, 2001.

(C) The accompanying financial statements report the investment in securities of the PUF, including the assets, liabilities and investment income. Beginning November 29, 1999, expenses related to the PUF's investments and PUF Lands are also included in accordance with the constitutional amendments. The PUF Lands are not included in this report.

These financial statements follow the form and content of investment company financial statements and related disclosures in accordance with accounting principles generally accepted in the United States of America. The principles followed will differ from the principles applied in governmental and fund accounting. The Schedule of Changes in Cost of Investments and Investment Income has been prepared for the purpose of complying with the reporting requirement of Section 66.05 of the Texas Education Code.

The annual combined financial statements of U.T. System are prepared in accordance with Texas Comptroller of Public Accounts' Annual Financial Reporting Requirements and include information related to the PUF. The accompanying financial statements may differ in presentation from

REAL PER CAPITA APPROPRIATIONS, FISCAL 1979-2000

Fiscal Year	July 1 Alaska Population	June Anchorage CPI-U	General Fund Operating Appropriations			General Fund Total Appropriations			Permanent Fund Program Appropriations	
			Operating (millions)	Per Capita Operating	Real Per Capita Operating (FY 1999 \$)	Total (millions)	Per Capita Total	Real Per Capita Total (FY 1999 \$)	PFD Program Cost (millions)	Real Per Capita Total Plus PFD (FY 1999 \$)
1979	413,700	73.9	803	1,942	3,844	1,083	2,617	5,179		5,179
1980	419,800	81.7	924	2,200	3,939	1,160	2,764	4,948		4,948
1981	434,300	89.0	1,314	3,024	4,970	2,587	5,957	9,789		9,789
1982	464,300	95.6	1,661	3,576	5,472	3,445	7,420	11,353		11,353
1983	499,100	97.8	1,829	3,664	5,479	2,848	5,706	8,533	219	9,189
1984	524,000	102.7	1,868	3,565	5,076	3,087	5,891	8,390	175	8,865
1985	543,900	104.7	2,005	3,686	5,149	3,662	6,733	9,405	217	9,963
1986	550,700	108.3	1,998	3,628	4,900	2,832	5,142	6,944	303	7,687
1987	541,300	108.3	1,715	3,169	4,280	2,398	4,430	5,982	391	6,958
1988	535,000	108.4	1,789	3,344	4,512	2,255	4,216	5,688	424	6,757
1989	538,900	110.9	1,975	3,664	4,832	2,379	4,414	5,821	460	6,947
1990	553,171	116.9	2,009	3,632	4,544	2,441	4,413	5,522	482	6,612
1991	569,063	123.3	2,167	3,809	4,518	2,555	4,490	5,326	491	6,349
1992	586,684	127.3	2,195	3,742	4,299	2,772	4,724	5,428	488	6,383
1993	596,808	131.5	2,197	3,682	4,095	2,705	4,532	5,041	525	6,019
1994	600,765	134.3	2,248	3,742	4,075	3,201	5,328	5,803	558	6,814
1995	601,646	138.2	2,242	3,726	3,943	2,470	4,106	4,345	565	5,339
1996	604,966	141.8	2,192	3,623	3,737	2,419	3,999	4,125	643	5,221
1997	609,311	144.1	2,206	3,621	3,675	2,432	3,991	4,051	749	5,299
1998	621,400	146.3	2,169	3,491	3,491	2,355	3,790	3,790	893	5,227
1999	633,729	148.9	2,172	3,427	3,367	2,324	3,667	3,602	999	5,151
2000	646,302	151.6	2,200	3,404	3,285	2,304	3,565	3,440	1,078	5,049

Population estimates from Department of Labor as of July 1 (beginning of each fiscal year).

Population for FY 99 and FY 2000 estimated by OMB.

Inflation assumptions for FY 99 and FY 2000 taken from DOR Revenue Sources book (reference case).

FY 2000 spending based on Governor's proposed budget and March Permanent Fund projections.

Total Appropriations do not include special PF appropriations.

OMB/BP

5/1/01 16:07

Brad Pierce



# LAWS OF ALASKA

1980

Source

SCS CSHB 509 (Rules)

Chapter No.

35

Chapter 35

## AN ACT

Making a special appropriation to the Alaska permanent fund; and providing for an effective date.

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

THE ACT FOLLOWS ON PAGE 1, LINE 9

Approved by the Governor: May 21, 1980  
Actual Effective Date: July 1, 1980

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## AN ACT

Making a special appropriation to the Alaska permanent fund; and providing for an effective date.

\* Section 1. The sum of \$900,000,000 is appropriated from the general fund to the Alaska permanent fund (art. IX, sec. 15, Constitution of the State of Alaska).

\* Sec. 2. Beginning July 1, 1980, the commissioner of revenue shall make monthly deposits to the Alaska permanent fund of the appropriation made by this Act. A monthly deposit to the Alaska permanent fund shall be in an amount determined by the commissioner of revenue to be in excess of the general fund revenues necessary to finance state government operation for the month in which the deposit is made.

\* Sec. 3. This Act takes effect July 1, 1980.



# LAWS OF ALASKA

1981

Source

FCCSHB 1

Chapter No.

61

## AN ACT

Making a special appropriation to the Alaska permanent fund, and making appropriations to the Department of Administration and the Department of Community and Regional Affairs for aid to municipalities and unincorporated communities; and providing for an effective date.

\* Section 1. The sum of \$1,800,000,000 is appropriated from the general fund to the Alaska permanent fund (art. IX, sec. 15, Constitution of the State of Alaska, AS 37.13.010).

\* Sec. 2. Beginning July 1, 1981, the commissioner of revenue shall make monthly deposits to the Alaska permanent fund of the appropriation made by sec. 1 of this Act. A monthly deposit to the Alaska permanent fund shall be in an amount determined by the commissioner of revenue to be in excess of the general fund revenues necessary to finance state government operation for the month in which the deposit is made.

\* Sec. 3. The sum of \$380,000,000 is appropriated from the general fund to the Department of Administration for payment of entitlements to qualified municipalities for the fiscal year ending June 30, 1982, in accordance with legislation authorizing the payments.

\* Sec. 4. The sum of \$24,987,000 is appropriated from the general fund to the Department of Community and Regional Affairs for payment of entitlements to unincorporated communities in the unorganized borough for the fiscal year ending June 30, 1982, in accordance with legislation authorizing

-1-

FCCSHB 1

## Chapter 61

1 the payments.

2 \* Sec. 5. The sum of \$73,800 is appropriated from the general fund to  
3 the Department of Administration for costs of administering the entitlements  
4 for which an appropriation is made by sec. 3 of this Act.

5 \* Sec. 6. The sum of \$252,800 is appropriated from the general fund to  
6 the Department of Community and Regional Affairs for costs of administering  
7 the entitlements for which an appropriation is made by sec. 4 of this Act.

8 \* Sec. 7. The appropriation made by sec. 1 of this Act is not a one-year  
9 appropriation and it does not lapse under AS 37.25.010.

10 \* Sec. 8. This Act takes effect on the effective date of a version of  
11 Senate Bill No. 168 entitled "An Act relating to state assistance for  
12 municipalities and unincorporated communities; and providing for an effective  
13 date."

-2-

FCCSHB 1



**Alaska Permanent Fund Corporation**

P.O. Box 25500 Juneau, Alaska 99802-5500

(907) 465-2047

**MEMORANDUM**

**DATE:** April 11, 2001

**TO:** Senator Gene Therriault, Chair  
Senate State Affairs Committee

**FROM:** Robert D. Storer, *RS*  
Executive Director

**SUBJECT:** Senate Joint Resolution 15 - Permanent Fund  
Constitutional Inflation-Proofing Amendment

This is to request a hearing at your earliest convenience on Senate Joint Resolution 13, "Proposing amendments to the Constitution of the State of Alaska relating to inflation-proofing the permanent fund."

SJR 15 accomplishes inflation-proofing by constitutionally limiting the annual payout of Fund income to no more than 5 percent of the Fund's five-year average market value. This amount comprises all of the Fund's expected "real," i.e., inflation-adjusted, income. For example, the Board's current asset allocation is designed to earn 8.25 percent annually and inflation is expected to average 3.25 percent. By retaining that difference between what is earned and what is paid out, the purchasing power of the Permanent Fund is fully protected against inflation.

The Board is unanimous in its support for this proposal. They believe its benefits are compelling:

1. Provides constitutional protection against inflation for the total Permanent Fund, thereby more effectively safeguarding the Fund and increasing the amount protected.

Senate Joint Resolution 13

April 11, 2001

Page 2

2. Establishes a limit on annual distributions which helps ensure that the Fund will continue to grow in perpetuity in both nominal and real, inflation-adjusted dollars.
3. Maximizes the total amount of Fund income which can be paid out in the future, at least as compared to higher payout rates, and provides for intergenerational equity by striking a fine balance between short-term and long-term distributions.
4. Beginning in 2003, makes available \$175-\$300 million per year, depending on the Fund's market value, for purposes other than inflation-proofing and dividends. This amount will grow over time as the Fund grows.
5. Uses the percent of market value (POMV) payout methodology which smoothes volatility, treats realized and unrealized income equally as investment return, and is consistent with generally accepted accounting principles and modern endowment practice.
6. Lets lawmakers know in advance, within a relatively narrow range, how much Fund income will be available for appropriation each year.

In short, the Trustees believe SJR 13 serves the best interests of the Fund and the people of Alaska, and we request an opportunity this session to begin discussing with the members of your Committee the very important issues addressed in this resolution.

Thank you for your consideration.

# **Trustees Request Your Support for Constitutional Inflation-Proofing of the Permanent Fund**

**Clark Gruening, Chair Board of Trustees  
Jim Kelly, Director of Communications**

**Alaska Permanent Fund Corporation**

**Senate State Affairs Committee  
April 26, 2001**

[www.apfc.org](http://www.apfc.org)

Alaska Permanent Fund Corporation



## **Board of Trustees unanimously supports HJR 15/SJR 13**



**Why is it important and  
why should Alaskans support it?**

Alaska Permanent Fund Corporation



**"Inflation is like a thief in the night."**



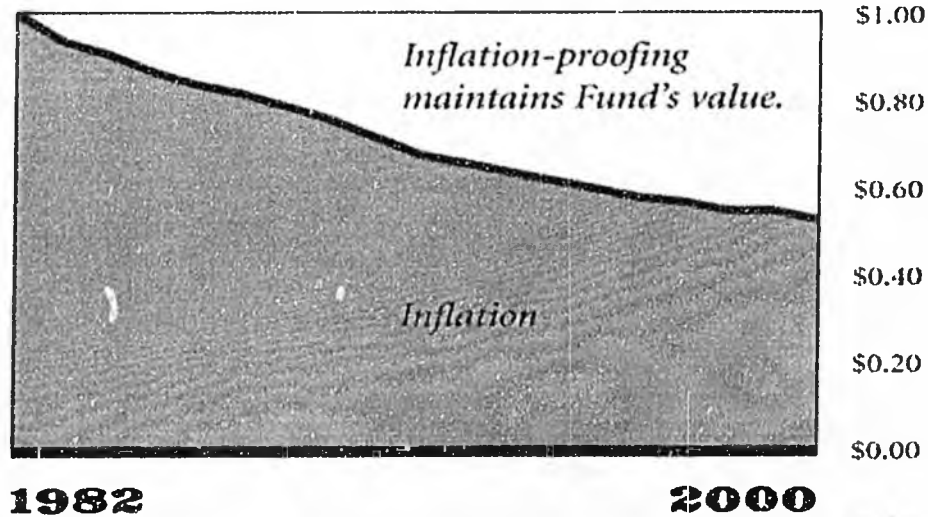
**Elmer Rasmuson**

First chair, Permanent Fund Board of Trustees

Alaska Permanent Fund Corporation



**Inflation erodes value of dollar**



Alaska Permanent Fund Corporation





# General Election November 5, 2002

**Section 15. Alaska Permanent Fund.** (a) At least twenty-five per cent of all mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payments and bonuses received by the State shall be placed in a permanent fund, the principal of which shall be used only for those income-producing investments specifically designated by law as eligible for permanent fund investments. All income from the permanent fund shall be deposited in the permanent [GENERAL] fund [UNLESS OTHERWISE PROVIDED BY LAW].

(b) For any fiscal year, appropriations from the permanent fund shall be limited to five percent of the average of the year-end market values of the permanent fund for the last five fiscal years, including the fiscal year just ended. No other appropriations from the permanent fund may be made.

Yes [] No []

Alaska Permanent Fund Corporation



## What is POMV?

Percent Of Market Value = Total investment return

8.25% x \$28 billion = \$2.3 billion

Percent Of Market Value = Retain for inflation-proofing

3.25% x \$28 billion = \$0.9 billion

Percent Of Market Value = Payout of Fund income

5.00% x \$28 billion = \$1.4 billion

Alaska Permanent Fund Corporation



## **Benefits of POMV**

- 1. Preserves** the Fund's purchasing power
- 2. Maximizes** distributions over the long-term
- 3. Minimizes** fluctuations in annual payouts

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Alaska Permanent Fund Corporation



## **Why limit the payout to 5%?**

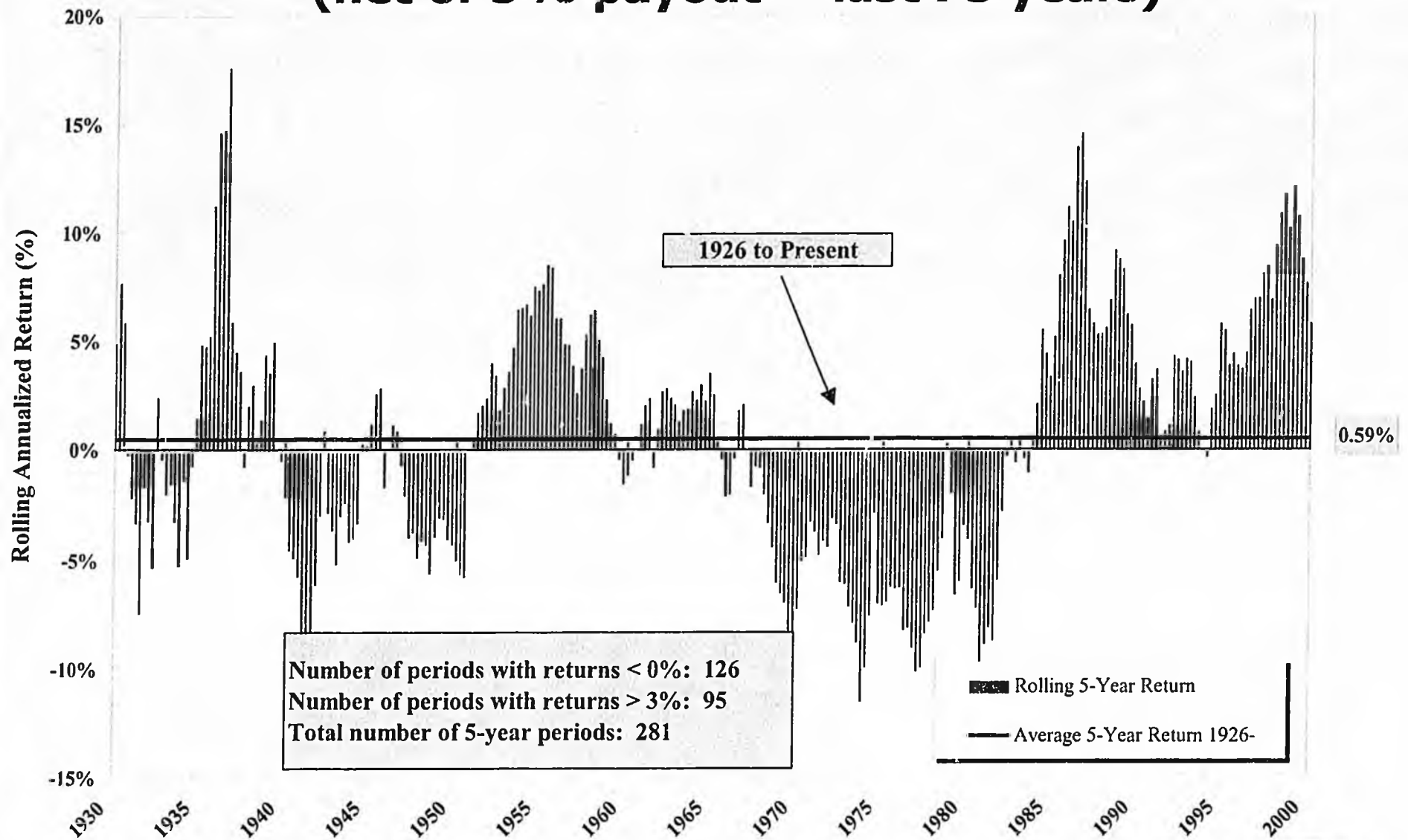
- 5% real rate of return is at the high end of what is achievable for the Permanent Fund
- 5% is the maximum sustainable payout rate that still maintains the Fund's real value
- 5% allows greater distributions over time than a higher payout
- 5% is what the majority of endowments pay out

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Alaska Permanent Fund Corporation



# Rolling 5-year real return for 60% stock/40% bond mix (net of 5% payout -- last 75 years)



**SOURCE: Callan Associates, Inc.**

**CPI 1926-2000: 3.3%**

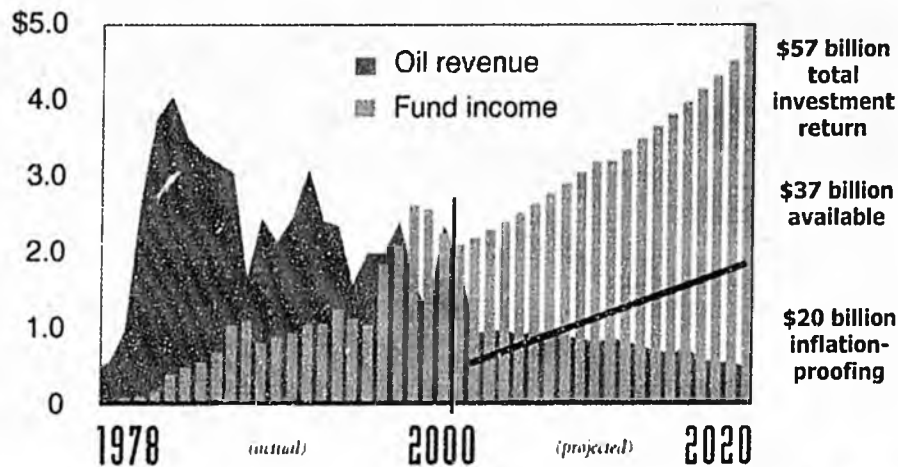
Alaska Permanent Fund Corporation



## Fund statutory net income vs. state oil revenue

(Dollars in billions)

**5% POMV**



Alaska Permanent Fund Corporation

## How is this different from the status quo?

- Constitution vs. statutes
- Total Fund vs. principal only
- Limits withdrawals from the Fund – currently all of the earnings reserve is available for appropriation

Alaska Permanent Fund Corporation

## Keep it permanent

### 5 percent limit protects Alaska Permanent Fund

Big and long, Alaska's leaders have been paid dividends of the Alaska Permanent Fund in any measure, the Permanent Fund is a success. The fund is now worth \$24 billion. Alaska residents last year received individual checks of \$1,362 as their share of the state's wealth. The fund's principal has the protection of the Alaska Constitution.

And we still have the language of that law -- we haven't decided yet what, other than dividends, we want the Permanent Fund to do for us.

But most Alaska leaders agree they want the fund to last. The only thing we'll let the board of trustees adjust is to limit the payments of the Permanent Fund to a percent of a five year average of its year end market value.

The proposal would require a constitutional amendment, meaning two-thirds of each house of the Alaska Legislature would have to agree to put it on the 2007 general election ballot. Then a majority of voters would have to approve it.

This is a good idea.

Why?

Jim Kelly, communications director of the Permanent Fund, gives three reasons.

- The fund keeps Alaska's treasury safe. Fund managers now come on its earnings ranging at about 2.5 percent. With a five percent maximum pay out, inflation is protected because it would be at least 1.5 percent. So the fund will continue to grow in real value.

- Maximize income five percent. It is more with what most economists pay out, but, particularly with the five-year average, it is more realistic to keep the fund growing. Over time, a larger five-year average will make that a period target.

- Maximize dividends from year to year. If we allow the five-year average to have a perspective in the return formula, and give the state a better idea of just how much money the fund will provide from year to year.

- The 5 percent rule won't affect the dividend check, which already is calculated using a five-year average that is more realistic. If the percent is more than enough to cover the dividend payment, the current formula, historically, dividends have met the state a little less than 5 percent of the fund's value.

Trustee Clark Geringer said the 5 percent limit in the "best way to regulate the Permanent Fund is permanent."

The 5 percent rule has no other advantages. It doesn't affect the current dividend formula, and while increasing the fund against inflation with the force of the state constitution, the fund would have a projected \$175 billion (\$20 billion) in earnings available for state spending. This amount could be used to help cover the state's spending shortfall. That dividend amount is projected, but guaranteed -- the proposed constitutional amendment puts inflation protection and dividends first -- but the national proposals for ways to acquire state spending and revenue have included some use of Permanent Fund earnings along with other revenue and resources.

Whether or not the Legislature would decide to use better earnings that way, the proposed constitutional amendment would mean that Alaska can come to having the fund's protection system in place. This would guarantee a growing fund -- even Alaska's oil is being used as well as those of us who live here.

Anchorage Daily News editorial,  
April 17, 2001

# Public will decide!

Alaska Permanent Fund Corporation



## Five myths about how the Permanent Fund works

1. It is possible to be precise about how much total investment return the Fund will produce in the future.
2. The distribution policy which has worked well for the last 20 years will work well for the next 20 years.
3. Any change can be made to the current use of Fund income without affecting the PFD.
4. The Permanent Fund is big enough to be all things for all people.
5. Permanent Fund dividends always go up.

Alaska Permanent Fund Corporation





Alaska Permanent Fund Corporation  
P.O. Box 25500 Juneau, Alaska 99802-5500  
(907) 465-2047

## MEMORANDUM

**DATE:** April 11, 2001

**TO:** Senator Gene Therriault, Chair  
Senate State Affairs Committee

**FROM:** Robert D. Storer, *RDS*  
Executive Director

**SUBJECT:** Senate Joint Resolution 15 - Permanent Fund  
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The Board is unanimous in its support for this proposal. They believe its benefits are compelling:

1. Provides constitutional protection against inflation for the total Permanent Fund, thereby more effectively safeguarding the Fund and increasing the amount protected.

Senate Joint Resolution 13

April 11, 2001

Page 2

2. Establishes a limit on annual distributions which helps ensure that the Fund will continue to grow in perpetuity in both nominal and real, inflation-adjusted dollars.
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In short, the Trustees believe SJR 13 serves the best interests of the Fund and the people of Alaska, and we request an opportunity this session to begin discussing with the members of your Committee the very important issues addressed in this resolution.

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Senate Joint Resolution 13

April 11, 2001

Page 2

2. Establishes a limit on annual distributions which helps ensure that the Fund will continue to grow in perpetuity in both nominal and real, inflation-adjusted dollars.
3. Maximizes the total amount of Fund income which can be paid out in the future, at least as compared to higher payout rates, and provides for intergenerational equity by striking a fine balance between short-term and long-term distributions.
4. Beginning in 2003, makes available \$175-\$300 million per year, depending on the Fund's market value, for purposes other than inflation-proofing and dividends. This amount will grow over time as the Fund grows.
5. Uses the percent of market value (POMV) payout methodology which smoothes volatility, treats realized and unrealized income equally as investment return, and is consistent with generally accepted accounting principles and modern endowment practice.
6. Lets lawmakers know in advance, within a relatively narrow range, how much Fund income will be available for appropriation each year.

In short, the Trustees believe SJR 13 serves the best interests of the Fund and the people of Alaska, and we request an opportunity this session to begin discussing with the members of your Committee the very important issues addressed in this resolution.

Thank you for your consideration.



Alaska Department  
of Natural Resources

For illustration purposes only.

State of Alaska  
State Lands  
on the North Slope

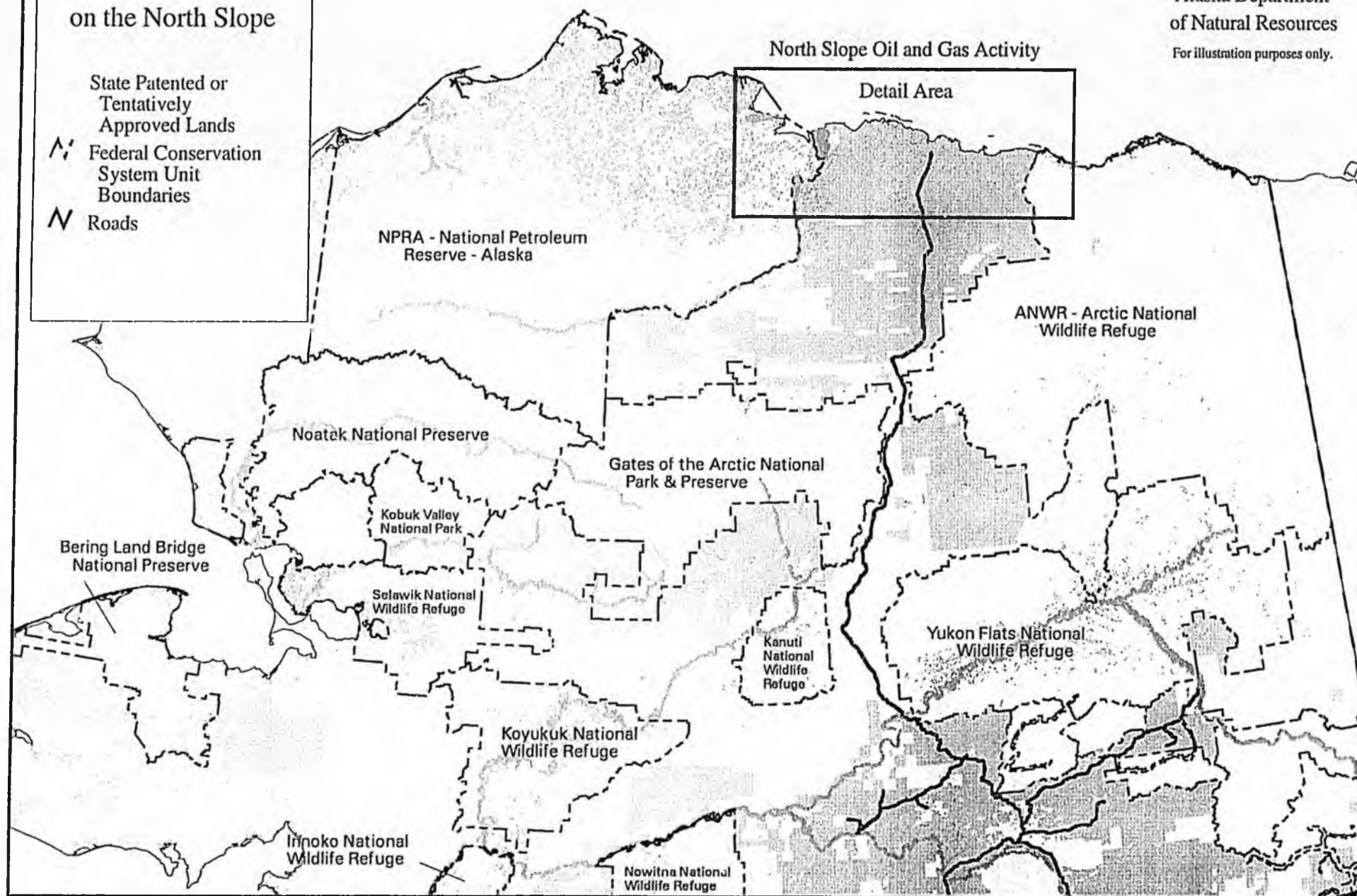
State Patented or  
Tentatively  
Approved Lands

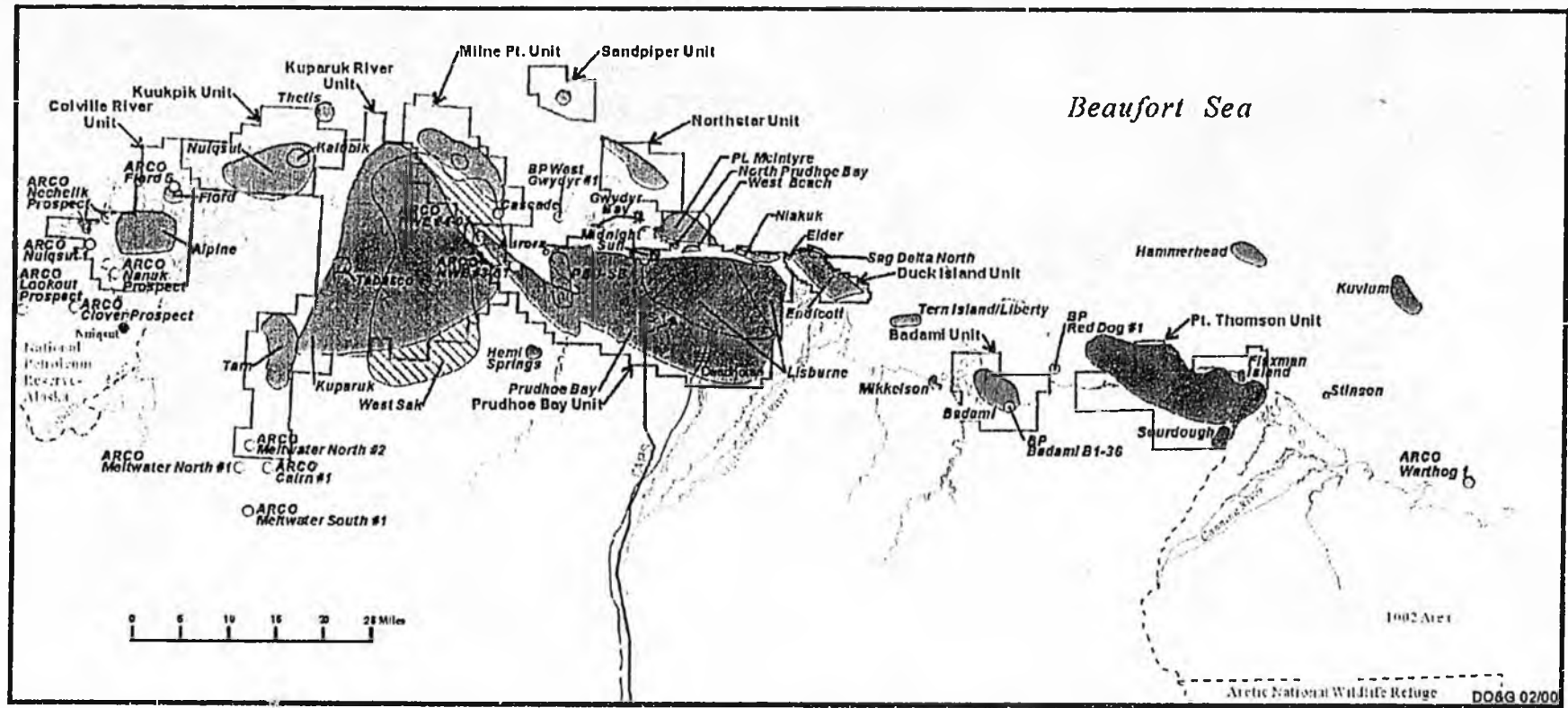
⚡ Federal Conservation  
System Unit  
Boundaries

⚡ Roads

North Slope Oil and Gas Activity

Detail Area






<http://www.dog.dnr.state.ak.us/oil>

## North Slope Oil and Gas Activity February 2000

**Map Legend**

- Units
- Oil Field / Accumulation
- Selected Wells
- Proposed / Active Wells



# State Trust Land Map



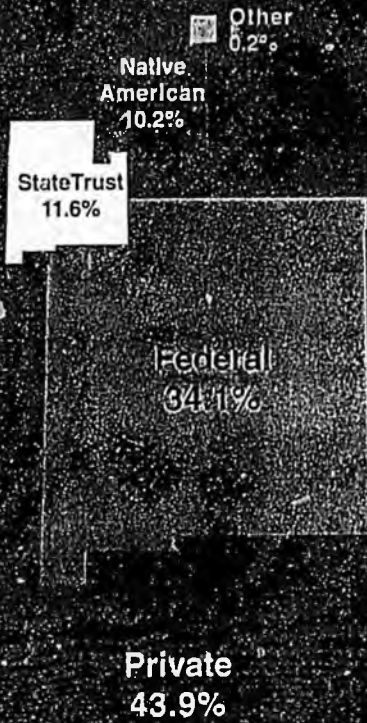
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Land Ownership by  
 County  
 Township  
 Section

# New Mexico Land Ownership

77,666,400  
 Total Acres







Alaska Department  
of Natural Resources

For illustration purposes only.

State of Alaska  
State Lands  
on the North Slope

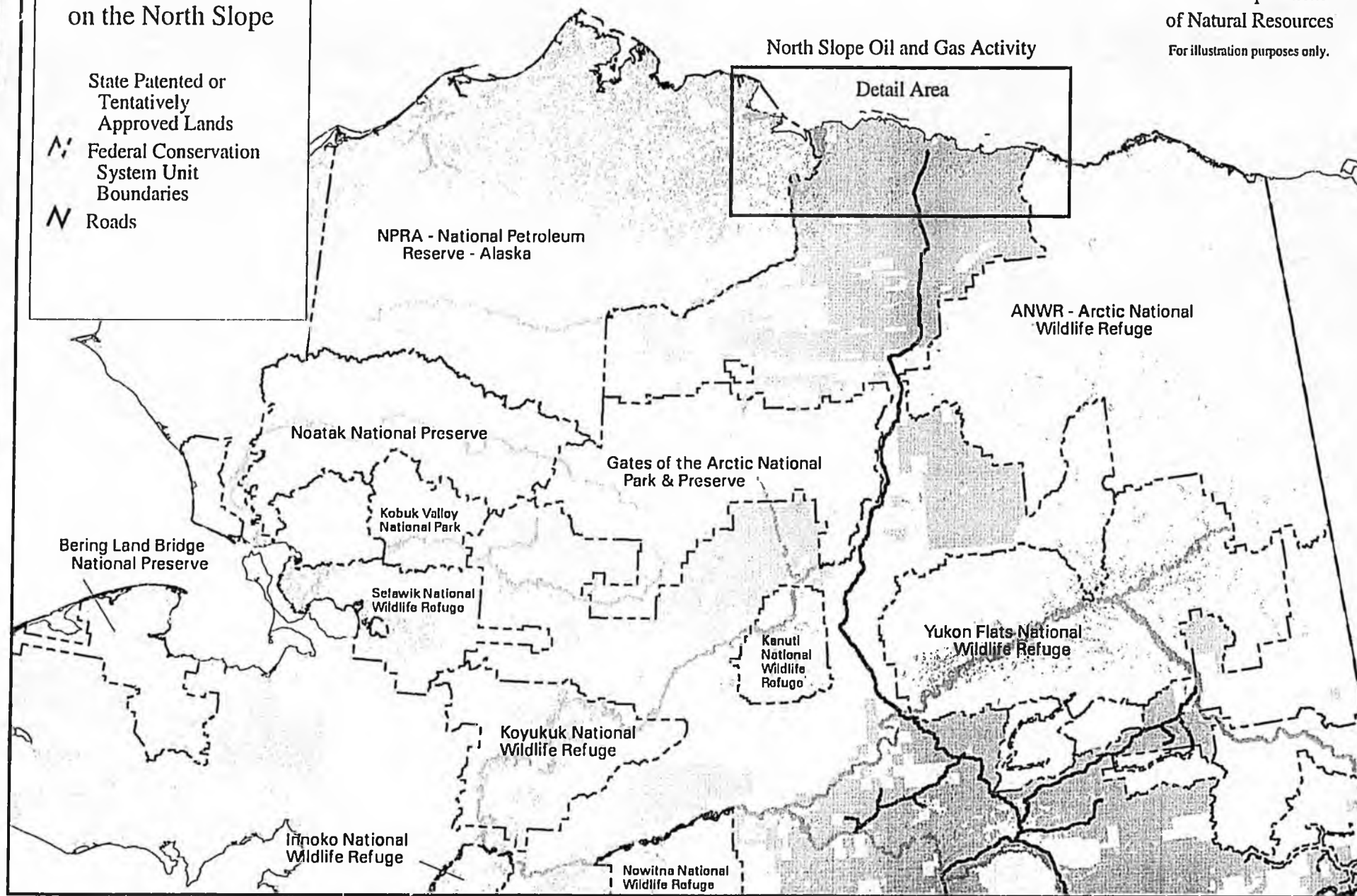
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Approved Lands

 Federal Conservation  
System Unit  
Boundaries

 Roads

North Slope Oil and Gas Activity

Detail Area





Alaska Department  
of Natural Resources

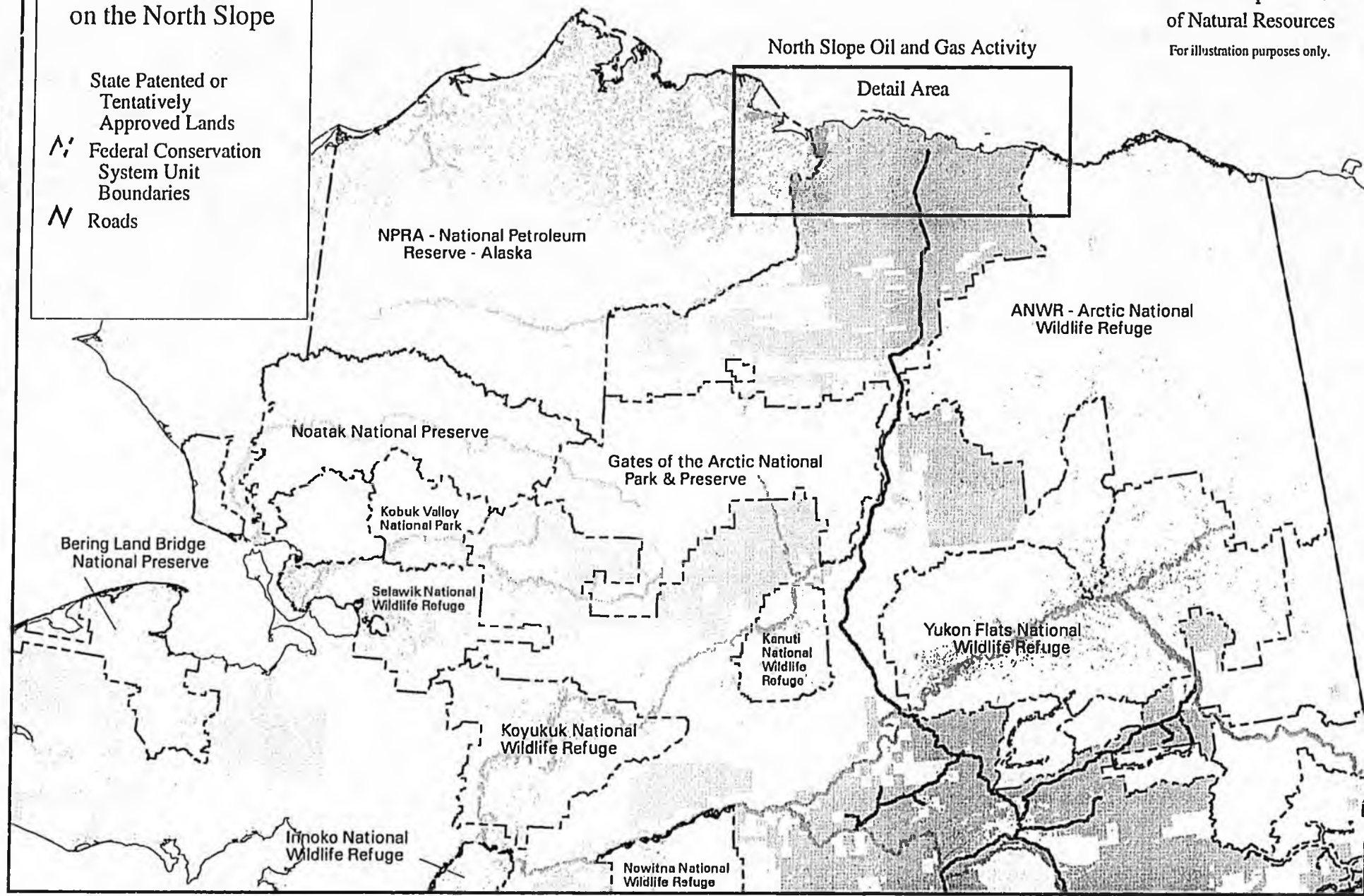
For illustration purposes only.

State of Alaska  
State Lands  
on the North Slope

- State Patented or Tentatively Approved Lands
- ∧ Federal Conservation System Unit Boundaries
- ∧ Roads


North Slope Oil and Gas Activity


Detail Area



State of Alaska  
State Lands  
on the North Slope

State Patented or  
Tentatively  
Approved Lands

 Federal Conservation  
System Unit  
Boundaries

 Roads



Alaska Department  
of Natural Resources

For illustration purposes only.

North Slope Oil and Gas Activity

Detail Area

NPRA - National Petroleum  
Reserve - Alaska

ANWR - Arctic National  
Wildlife Refuge

Noatak National Preserve

Gates of the Arctic National  
Park & Preserve

Bering Land Bridge  
National Preserve

Kobuk Valley  
National Park

Selawik National  
Wildlife Refuge

Kenai  
National  
Wildlife  
Refuge

Yukon Flats National  
Wildlife Refuge

Koyukuk National  
Wildlife Refuge

Inupoko National  
Wildlife Refuge

Nowitna National  
Wildlife Refuge

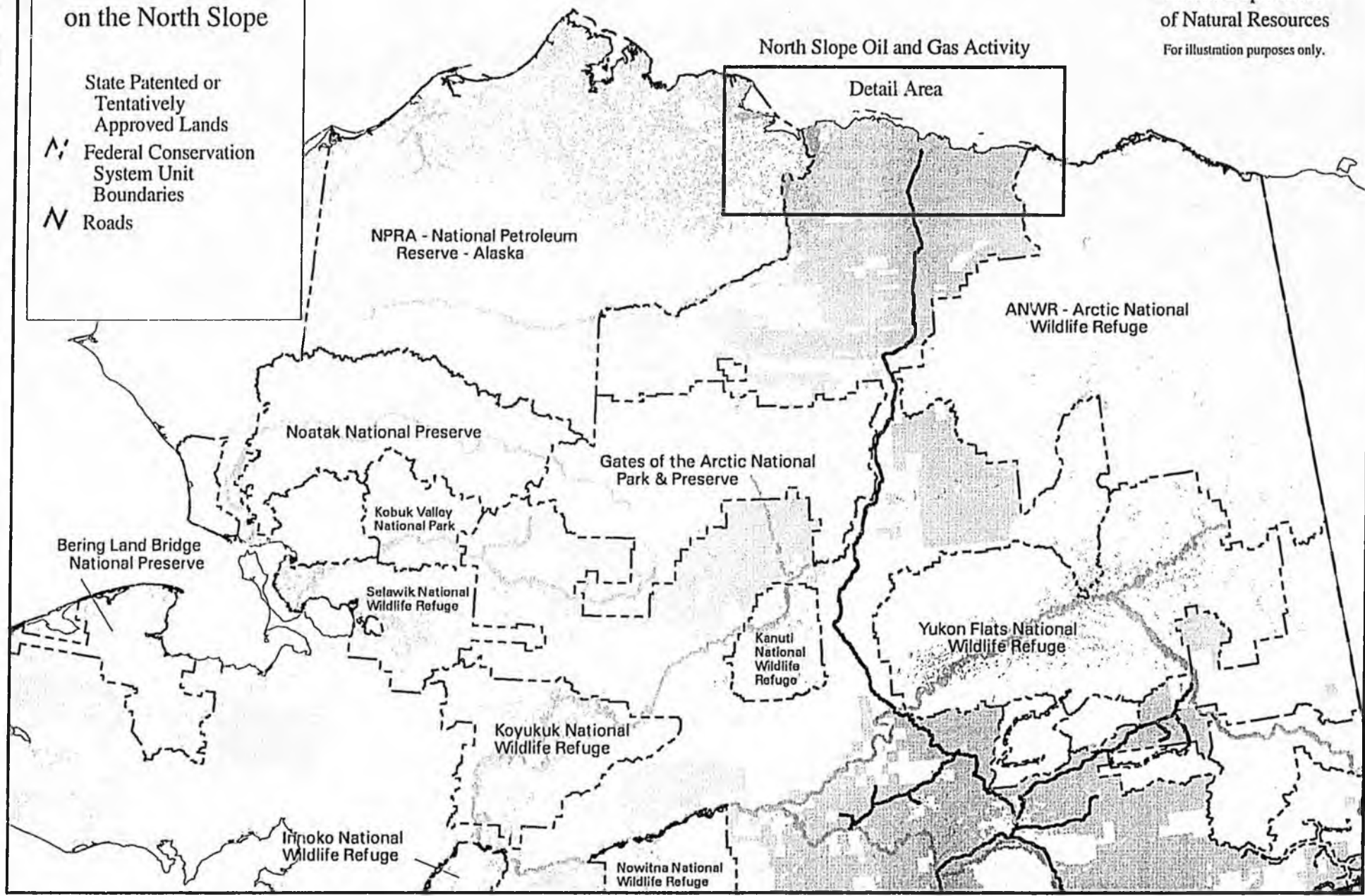
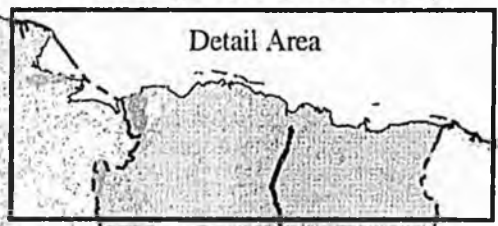


Alaska Department  
of Natural Resources  
For illustration purposes only.

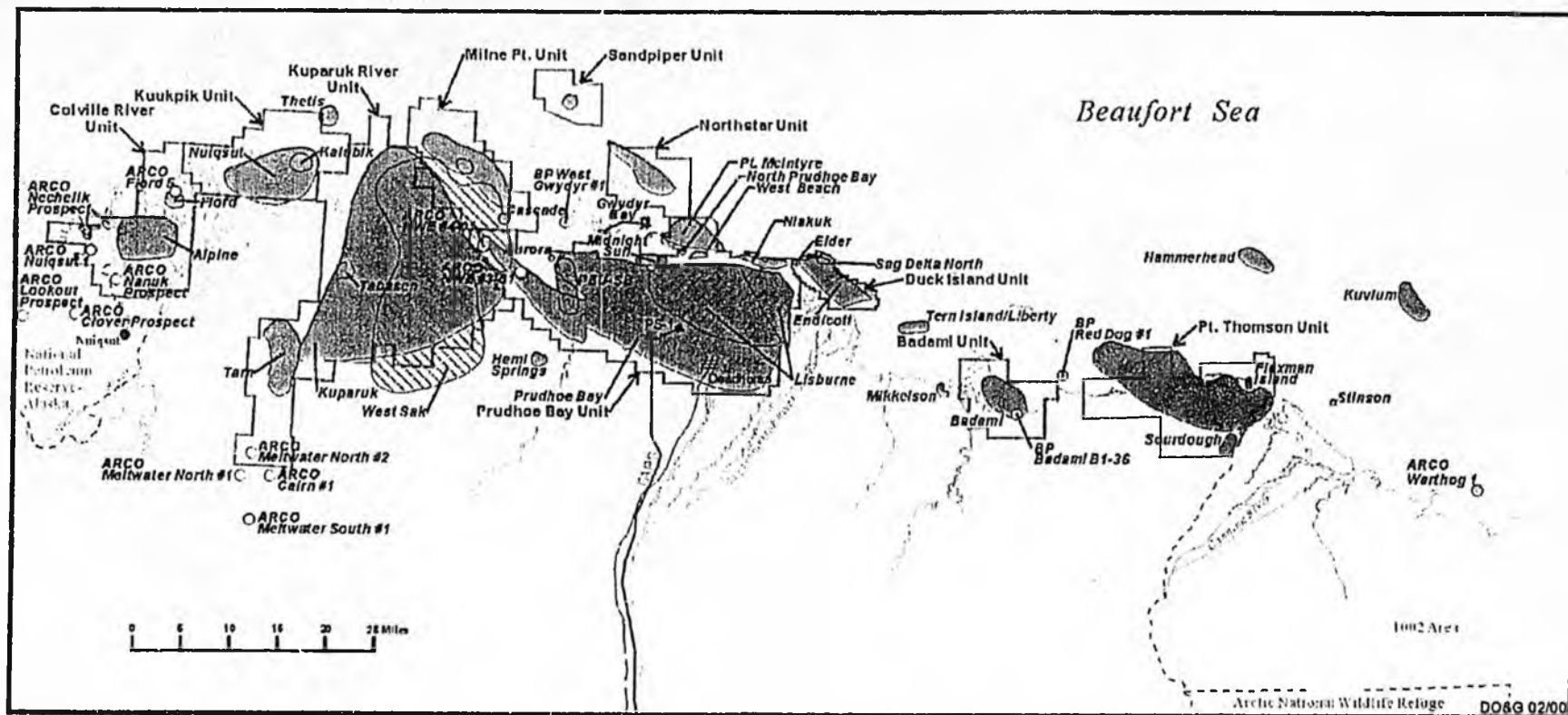
State of Alaska  
State Lands  
on the North Slope

- State Patented or Tentatively Approved Lands
- Federal Conservation System Unit Boundaries
- Roads

North Slope Oil and Gas Activity

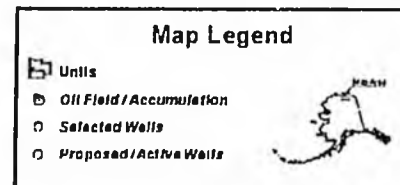


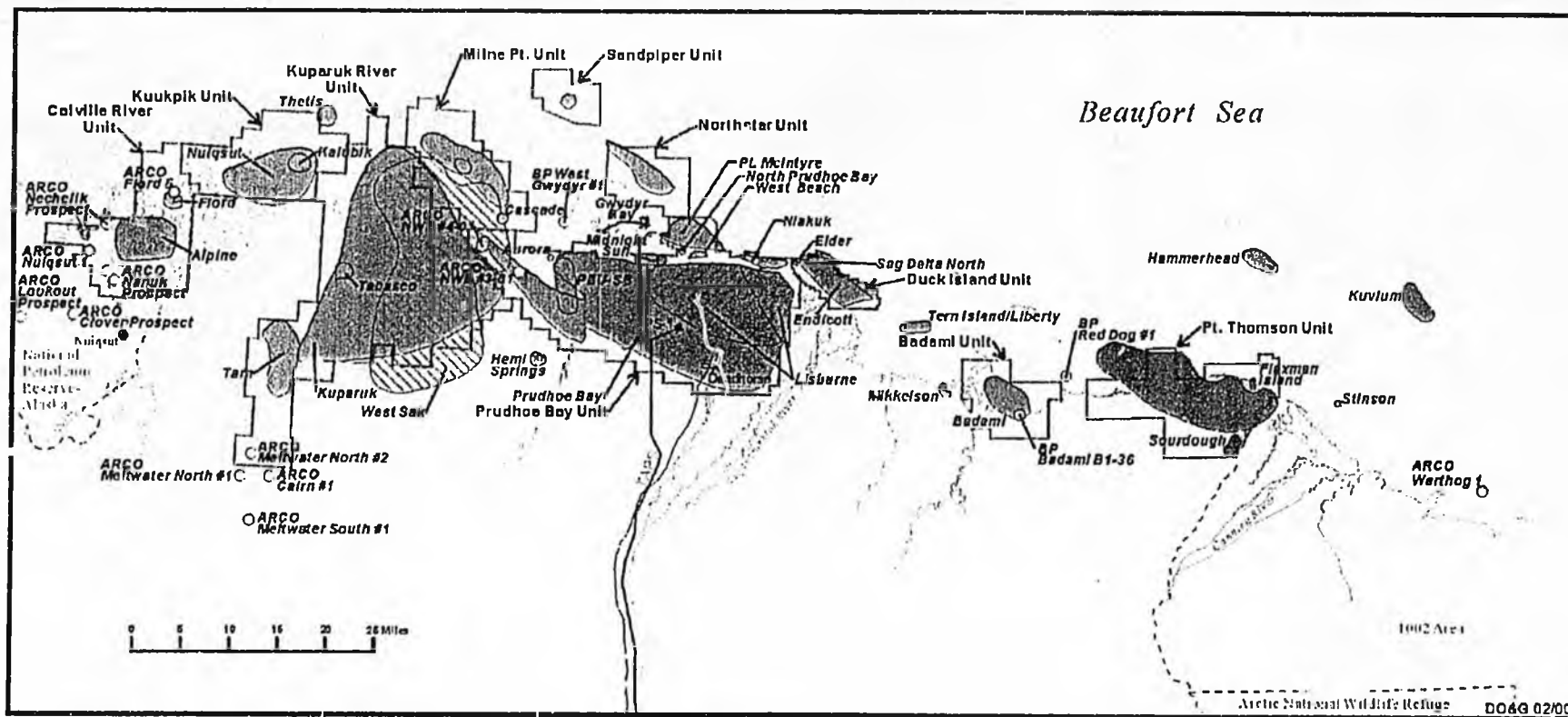




<http://www.dog.dnr.state.ak.us/oil>

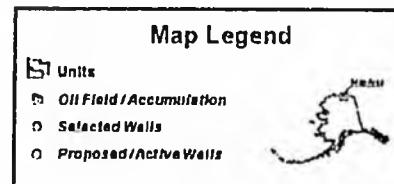
## North Slope Oil and Gas Activity February 2000



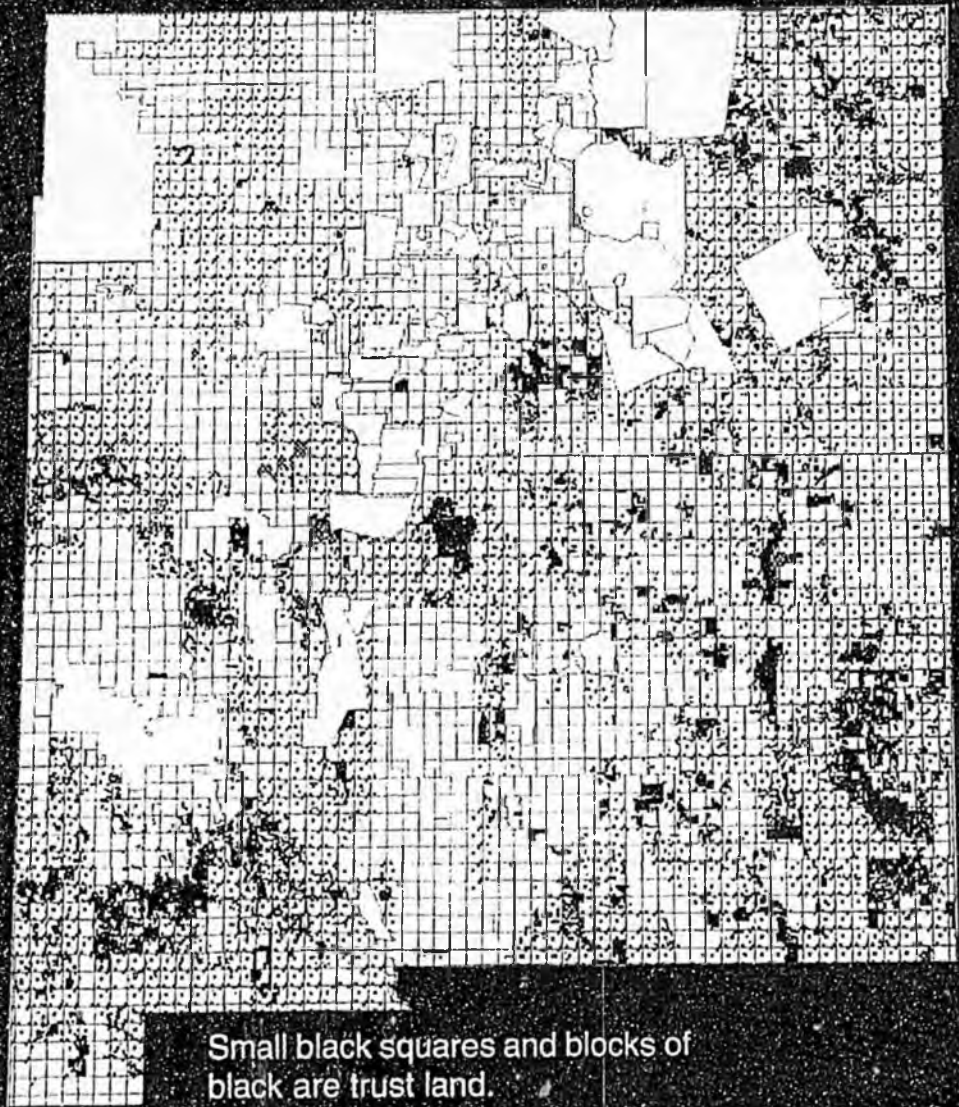


<http://www.dog.dnr.state.ak.us/oil>

## North Slope Oil and Gas Activity February 2000



# State Trust Land Map



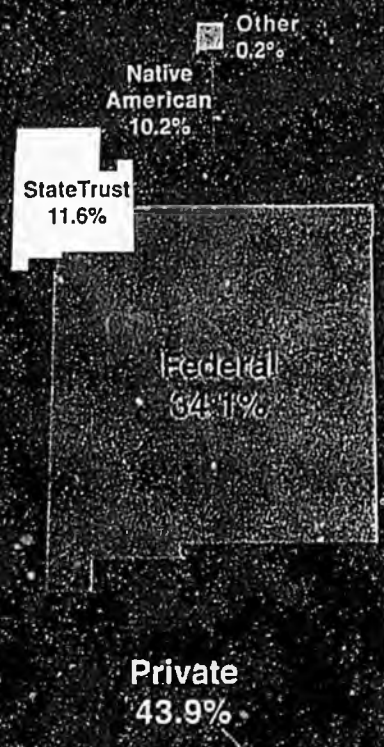
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30	29	28	27	26	25
31	32	33	34	35	36

Land Ownership by Township  
 as of Dec. 31, 1999  
 (Total: 1,000,000)

# New Mexico Land Ownership

77,666,400  
 Total Acres



# State Trust Land Map



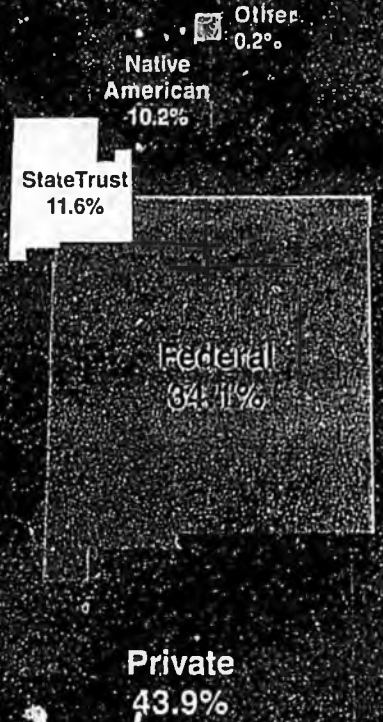
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30	29	28	27	26	25
31	32	33	34	35	36

Land Ownership by  
Township  
Township  
Township

# New Mexico Land Ownership

77,666,400  
Total Acres



# State Trust Land Map



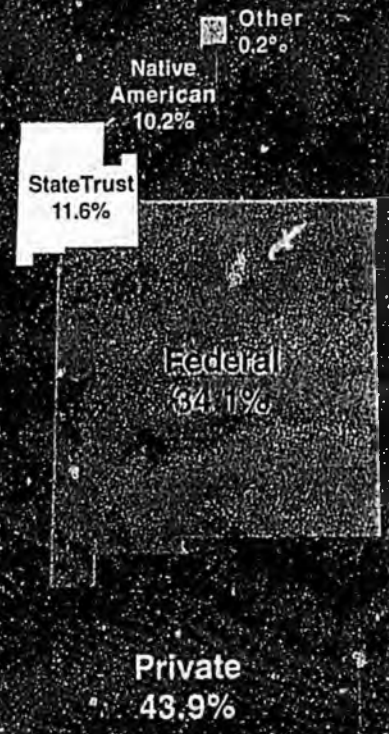
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30	29	28	27	26	25
31	32	33	34	35	36

Land Use Ownership  
 1997-2000  
 by county  
 and land use type

# New Mexico Land Ownership

77,666,400  
 Total Acres



# State Trust Land Map



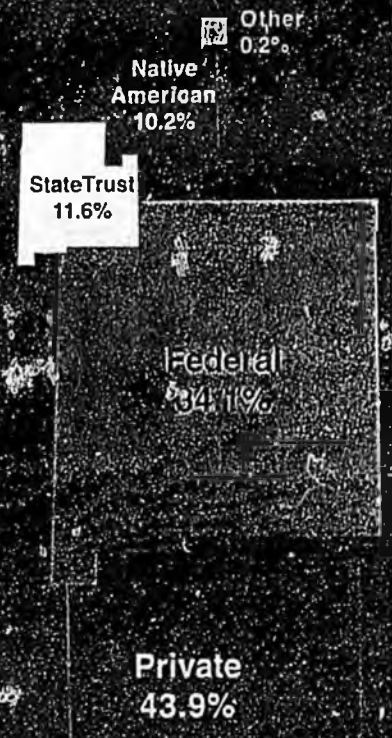
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19	20	21	22	23	24
30	29	28	27	26	25
31	32	33	34	35	36

Land ownership by  
county

# New Mexico Land Ownership

77,666,400  
Total Acres



## Percent of Market Value—talking points

Analysis of proposals affecting the Permanent Fund boil down to three questions

1. What happens to the Earnings Reserve account?
2. What happens to PFDs?
3. What happens to the fiscal gap?

The answers are not as simple as the questions because the words everyone uses to describe their plans are very slippery and the questions (like the plans) are several layers deep. Back to the questions.

### 1. What happens to the Earnings Reserve Account (ERA)?

Be concerned about:

- Future flows—does income go anywhere other than the reserve account?
- The Balance—does it remain available to replenish the CBR or for other appropriations?
- Inflation proofing—transfers to principal are off-limit forever. Are we putting in too much? Too little? It shouldn't matter whether inflation proofing is by statute or by constitution as long as the ERA *can* support the transfers and the legislature *does* support transfers.

The key point is that *any* reduction in Permanent Fund balance (including the ERA) reduces future earnings, which reduces future dividends.

### 2. What happens to PFDs?

Be concerned about:

The formula vs. money-in-pocket—retaining the current formula is no guarantee that dividends won't change. Back to the key point from #1. The current formula *will* reduce dividends if money is diverted from the sum of Permanent Fund balance and ERA balance.

### 3. What happens to the fiscal gap?

Dividends, inflation proofing and surplus earnings in the ERA are “off budget” in that they do not affect the fiscal gap. Under virtually any proposal, dividends and inflation proofing will remain off budget.

Earnings not used for dividends and inflation proofing can affect the fiscal gap if the surplus earnings are considered general fund revenue.

## The "Simple" Proposal by the Permanent Fund

The constitutional amendment appears simple when compared to versions of HB 411 (last year's bill). The appearance of simplicity is primarily because the constitutional amendment simply adopts a percent of market value (POMV) payout without describing what happens to the payout stream.

Although the bill appears simple, here are some points to consider:

### 1. What happens to the Earnings Reserve Account (ERA)?

- Future flows—Permanent Fund income would be deposited in the Permanent Fund instead of the general fund. This has huge implications.
- The Balance—the ERA is no longer available as budget reserves because the only money that can flow from the Permanent Fund is the 5% annual payout. The ERA cannot be used to reload the CBR or otherwise fill the fiscal gap.
- Inflation proofing—earnings remaining after the payout can be considered inflation proofing. No appropriation is necessary. Expect inflation proofing to be considerably more than under the current system because
  - the entire account will be inflation proofed and
  - any "extra" earnings beyond the payout remain in the Permanent Fund as inflation proofing.

### 2. What happens to PFDs?

Although the bill is silent, PFDs *will* be affected by the bill. If we retain the current formula for computing dividends, there are two possibilities

The 5% payout *is less than* the current formula would pay—dividends decline. (This is unlikely—annual dividends take only about 4% of the market value, or 80% of the 5% payout.)

- The 5% payout *exceeds* what the current system pays out as dividends—dividends are not immediately affected, but decline over time because earnings decline as the balance declines due to the higher payout.

If we replace the current formula, dividends would not necessarily decline in the near future. Some money from the 5% payout would be available to prop up dividends.

### 4. What happens to the fiscal gap?

- The impact on the fiscal gap depends on how much of the payout goes to the general fund and how much to dividends.
- Earnings not used for dividends would reduce the fiscal gap.
- If the entire payout went to dividends, PFDs would increase by about 25%. This would, of course, leave no money to close the fiscal gap.

If inflation is higher than expected, the "up to five percent" clause becomes interesting. There may be some pressure to appropriate less than 5% if it meant less than full inflation proofing. This would leave less payout to reduce the gap.

There are two additional issues raised by the proposed bill

1. Is 5% an appropriate payout rate?
2. What is the impact of basing the payout on a five-year moving average?

A five percent payout is specified because 5% is the projected long-term real rate of return (real return means "after adjusting for inflation"). Just accept the rate as the best estimate. But realize that the rate and the moving average are closely linked.

The 5% rate of return applies to earnings on the *current* balance, while the 5% payout is based on an *average* balance. For a fund that constantly increases because of royalty deposits and inflation proofing, more years in the average translates to a lower average balance. (e.g., the 10-year average balance is \$18 billion, the 5-year average is \$23 billion and the current balance is \$27 billion).

Using a moving average gives a more stable payout, but it makes the effective payout rate lower as well. A 5% payout on a 5-year average balance is equivalent to a 4.3% payout on the current balance. The difference between the 4.3% payout and the 8.25% rate of return remains in the Permanent Fund, so that inflation proofing is close to 4% rather than the 3.25% required to cover actual inflation.

The result:

- the payout is not as aggressive as the Permanent Fund implies,
- the fund is "over inflation proofed,"
- some money (.3% or \$100 million) remains in the general fund to help close the fiscal gap, and
- PFDs fall slightly over time because money is transferred from the Permanent Fund to the general fund.

The payout rate and the balance to which it applies are a philosophical debate. A shorter averaging period or a higher effective payout rate would transfer more money to the general fund. Remember that any money transferred to the general fund reduces future dividends.

Board of Trustees

Final

Monthly Management Report - December 31, 2001



*Consolidated Assets - Dollars in millions. APF assets equal 98.3% of total assets. Each manager's cash is reflected in their respective accounts. Unaudited market values provided by BoNY. Returns for periods greater than one year are annualized. Monthly real estate, fund benchmark and total fund returns are calculated internally. All other returns are provided by Callan Associates, Inc.*

Section 1: Fixed Income & Equity Performance

	12/31/2001 Market Value	Return as of 12/31/2001						Return as of
		Current Month	Last 3 Months	Fiscal Y-T-D	Calendar Y-T-D	Last 12 Months	Last 3 Years	9/30/2001 Last 5 Years
<b>FUND SUMMARY</b>								
Alaska CDs	\$ 30.0	0.29%	0.95%	1.97%	4.54%	4.54%	5.07%	5.40%
Domestic Fixed Income	8,537.1	-0.49%	0.26%	4.61%	8.45%	8.45%	5.35%	7.67%
Non-Domestic Fixed Income	624.0	-2.14%	-1.79%	2.88%	0.51%	0.51%	-0.01%	
Domestic Equities	9,338.3	1.90%	12.67%	-5.48%	-10.84%	-10.84%	-0.33%	8.43%
Non-Domestic Equities	4,178.2	1.61%	9.40%	-7.49%	-18.44%	-18.44%	-2.10%	2.22%
Real Estate <sup>1</sup>	2,697.7	1.41%	3.11%	4.82%	11.33%	11.33%	11.92%	11.67%
<b>Total Fund</b>	<b>\$ 25,405.3</b>	<b>0.88%</b>	<b>6.18%</b>	<b>-0.02%</b>	<b>-1.65%</b>	<b>-1.65%</b>	<b>2.52%</b>	<b>7.71%</b>
<b>Total Fund Return Benchmark</b>		<b>0.43%</b>	<b>5.72%</b>	<b>-1.31%</b>	<b>-3.70%</b>	<b>-3.70%</b>	<b>2.25%</b>	<b>7.78%</b>

22-LS0568\A  
Cook  
1/31/02

CS FOR HOUSE JOINT RESOLUTION NO. 15(JUD)  
IN THE LEGISLATURE OF THE STATE OF ALASKA  
TWENTY-SECOND LEGISLATURE - SECOND SESSION

BY THE HOUSE JUDICIARY COMMITTEE

Offered:  
Referred:

Sponsor(s): HOUSE RULES COMMITTEE BY REQUEST OF THE LEGISLATIVE BUDGET AND AUDIT COMMITTEE

A RESOLUTION

1 Proposing amendments to the Constitution of the State of Alaska requiring income of  
2 the permanent fund to be deposited into the permanent fund and limiting  
3 appropriations from the permanent fund to six percent of the year-end market values of  
4 the fund for the last five fiscal years.

5 BE IT RESOLVED BY THE LEGISLATURE OF THE STATE OF ALASKA:

6 \* Section 1. Article IX, sec. 15, Constitution of the State of Alaska, is amended to read:

7 Section 15. Alaska Permanent Fund. (a) At least twenty-five per cent of all  
8 mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing  
9 payments and bonuses received by the State shall be placed in a permanent fund, the  
10 principal of which shall be used only for those income-producing investments  
11 specifically designated by law as eligible for permanent fund investments. All income  
12 from the permanent fund shall be deposited in the permanent [GENERAL] fund  
13 [UNLESS OTHERWISE PROVIDED BY LAW].

14 (b) For any fiscal year, appropriations from the permanent fund shall be  
15 limited to six percent of the average of the year-end market values of the

1 permanent fund for the last five fiscal years, including the fiscal year just ended.

2 No other appropriations from the permanent fund may be made.

3 \* Sec. 2. The amendments proposed by this resolution shall be placed before the voters of  
4 the state at the next general election in conformity with art. XIII, sec. 1, Constitution of the  
5 State of Alaska, and the election laws of the state.



## Alaska Permanent Fund Corporation

P.O. Box 25500 Juneau, AK 99802-5500

Telephone (907) 465-2047

Facsimile (907) 586-2057

### MEMORANDUM

**DATE:** November 23, 2001

**TO:** Jesse Kiehl  
Chief of Staff to Senator Kim Elton

**FROM:** Jim Kelly  
Director of Communications

**SUBJECT:** APFC forecasts of residual income available  
assuming an annual 5 percent payout of the Fund's  
five-year average market value

You have asked whether the projections regarding residual income presented in the spreadsheet titled "Alaska Permanent Fund Corporation Hypothetical Look Backwards at the Effects of SJR 13," are still valid.

The short answer is that the numbers presented in the spreadsheet were never intended to be valid as projections going forward because, as indicated in the April 1, 2001 memorandum which accompanied that spreadsheet,

"The spreadsheet overstates the amount of income available for distribution because it does not show the effect of actually paying out the residual income available under the 5 percent limit;"

However, there was one projection in that memorandum which was valid then and remains valid today:

"The APFC believes that the amount of residual income available will likely be in the range of \$175 - 300 million per year."

There are three points to keep in mind regarding this projection:

1. Expenditure of that \$175 - 300 million would not place inflation-proofing in jeopardy; the Fund would still be able to retain sufficient income over time to provide long-term protection of the total Fund's purchasing power.
2. Any appropriations out of the Fund, in addition to dividends per existing statutes, would cause dividends to decline relative to the status quo.
3. This range of represents the APFC's most informed estimate of likely outcomes over the next ten years - taking volatility of investment returns into consideration.

**Why the APFC thinks it is important to take volatility into consideration.** In recent years, the APFC has moved away from providing forecasts which focus on individual numbers and instead has preferred to talk in terms of ranges of likely outcomes. This shift recognizes that it is not only impossible to produce reliably accurate single point-in-time numbers for future years, it is misleading to indicate that any of us can assess the impacts of future events such as financial market performance with "laser-guided precision."

With that cautionary note, there are two fundamental principles - one relating to investment policy and one to spending policy - with which one can assess the soundness of any proposed change to the current use of Fund income.

- Time greatly reduces - but does not eliminate - the volatility in annual returns. That is why from an **investment policy** perspective, asset allocation, diversification, disciplined rebalancing and long term time horizon are all key elements of a successful investment program. In this regard, the important question to ask is, "**Does a particular proposal have a neutral, a positive or an adverse effect on the Board's investment strategy?**"
- From a **spending policy** perspective, the best way to moderate the impact of volatility is averaging. So, for example in the case of the Alaska Permanent Fund, which - with its 53 percent target allocation to equities - has a one-in-four chance of a negative total Fund return in any given year, averaging returns over five years reduces the likelihood of a negative return to one-in-twenty. This moderation of the impact of volatility provides a valuable cushion to ensure stability of distributions. In this

Jesse Kiehl  
November 23, 2001  
Page 3

regard, the important question to ask is, "Does a particular proposal enhance or diminish the Fund's ability to produce a sustainable and stable income stream (after inflation) to benefit current and future generations?"

I hope this is responsive. If you have any further questions, please let me know.



## Alaska Permanent Fund Corporation

P.O. Box 25500 Juneau, AK 99802-5500

Telephone (907) 465-2047

Facsimile (907) 586-2057

### MEMORANDUM

**DATE:** January 7, 2002

**TO:** Melanie Lesh,  
Aide to Representative Bill Hudson

**FROM:** Jim Kelly  
Director of Communications

**SUBJECT:** *"What would happen if the Permanent Fund's earnings reserve account (ERA) were called upon by the legislature to effectively replace the CBRF as the source for funding the budget gap when the CBRF runs out?"*

The Department of Revenue estimates that the CBRF will be depleted late in calendar 2004 and thus will be unavailable to fund the expected \$1.099 billion budget gap in FY 05. Based on the APFC's current projections, the Fund's ERA most likely would be sufficient in FY 05 to fund the budget gap that year and pay dividends per current formula. However, there is a chance that the ERA itself could be depleted by that date in the event of continued negative investment returns between now and then.

The full answer depends on whether the Board-proposed percent of market value (POMV) payout limitation has been placed in the constitution by the time the legislature needs to use the Permanent Fund for the state budget.

**If the constitutional amendment has been passed.** The APFC's analysis of the constitutional amendment proposed under HJR 15/SJR 13 indicates that the Permanent Fund is likely to be able to produce earnings to support an annual payout of five percent of the five-year average market value of the Fund. That is

estimated at from \$1.2 billion to \$1.4 billion per year in inflation-adjusted 2001 dollars. That payout would be for all purposes approved by the legislature, including the dividend and the general government budget. If you assume no change in the present dividend statute, which is based on realized income rather than market value, some \$175 million to \$300 million would be available each year for budget purposes other than the dividend. These estimated ranges are narrow because of the five-year smoothing built in to the payout proposal.

That constitutional amendment would protect the Permanent Fund. If the statutes that specify other limits on spending from the ERA conflicted with the legislature's needs, they could be amended or repealed without posing a risk to the Fund.

**If the constitutional amendment has not been passed**, however, there would be two very large differences. First, the amount available for the legislature to appropriate each year would vary much more widely. Instead of a range of \$1.2 to \$1.4 billion, it could be as little as a few hundred million to well over \$2 billion. Second, all the existing, specific limits on the ERA would have to be maintained, as would the inflation-proofing statute, in order to protect the Permanent Fund against invasion of principal and against inflation.

To illustrate the first point, consider the following numbers:

First, note the current projected June 30, 2002 balance in the realized ERA, after dividends and inflation-proofing: \$1.9 billion.

Second, note the annual swings in statutory net income over the past four years plus 2002 projected:

1998	\$2.6 billion
1999	\$2.5
2000	\$2.2
2001	\$1.2
2002	\$1.2

Third, note the annual "Net Change" in the realized ERA for the same period:

1998	\$1,282 million
1999	\$1,201
2000	\$382
2001	- \$588
2002	- \$471

Response to Rep. Hudson's question

January 7, 2002

Page 3

The first number, \$1.9 billion, is the beginning size of the cushion in the realized ERA. When that is gone, or nearly gone, the legislature would be completely subject to the wide variability demonstrated by the second set of numbers in terms of appropriations for all purposes. The third set of numbers shows what is left for funding the budget gap after paying dividends and inflation-proofing.

In short, the Fund - even with the POMV limitation - is just not large enough to be all things to all people. Although it gains increased stability with the POMV limitation, the Fund cannot continue to pay dividends per the existing statutory formula, retain sufficient earnings for inflation-proofing and completely fund the fiscal gap. If asked to do too much, instead of a Permanent Fund, you would have a temporary fund.

Here's another perspective on what would happen if the ERA were to be treated as the "new" CBRF and no structural changes were made to the Fund nor any new state revenues established:

First, future Fund earnings would begin to diminish as: (a) the Fund's growth is reversed due to unsustainably large payouts from the ERA, and (b) the Fund earns a lower rate of return as the Trustees shorten the Fund's investment horizon to reflect the increased annual distributions. Then, as the ERA begins to shrink in size, it becomes vulnerable to an extended period of low or negative investment returns, high inflation, and/or low oil prices, and eventually - and perhaps quite suddenly -- is completely dissipated, leaving no income at all for inflation-proofing, dividends or the budget gap. That is the nightmare scenario.

That is how Alaska's fiscal situation goes from bad to much, much worse.

Board of Trustees

Final

# Monthly Management Report - December 31, 2001



*Consolidated Assets - Dollars in millions. APF assets equal 98.3% of total assets. Each manager's cash is reported in their respective accounts. Unaudited market values provided by BoNY. Returns for periods greater than one year are annualized. Monthly real estate, fund benchmark and total fund returns are calculated internally. All other returns are provided by Callan Associates, Inc.*

## Section 1: Fixed Income & Equity Performance

	12/31/2001 Market Value	Return as of 12/31/2001						Return as of 9/30/2001 Last 5 Years
		Current Month	Last 3 Months	Fiscal Y-T-D	Calendar Y-T-D	Last 12 Months	Last 3 Years	
<b>FUND SUMMARY</b>								
Alaska CDs	\$ 30.0	0.29%	0.95%	1.97%	4.54%	4.54%	5.07%	5.40%
Domestic Fixed Income	8,537.1	-0.49%	0.26%	4.61%	8.45%	8.45%	5.35%	7.67%
Non-Domestic Fixed Income	624.0	-2.14%	-1.79%	2.88%	0.51%	0.51%	-0.01%	
Domestic Equities	8,338.3	1.90%	12.67%	-5.46%	-10.84%	-10.84%	-0.33%	8.43%
Non-Domestic Equities	4,178.2	1.61%	9.40%	-7.49%	-18.44%	-18.44%	-2.10%	2.22%
Real Estate <sup>1</sup>	2,697.7	1.41%	3.11%	4.82%	11.33%	11.33%	11.92%	11.67%
<b>Total Fund</b>	<b>\$ 25,405.3</b>	<b>0.88%</b>	<b>6.18%</b>	<b>-0.02%</b>	<b>-1.65%</b>	<b>-1.65%</b>	<b>2.52%</b>	<b>7.71%</b>
<b>Total Fund Return Benchmark</b>		<b>0.43%</b>	<b>5.72%</b>	<b>-1.31%</b>	<b>-3.70%</b>	<b>-3.70%</b>	<b>2.25%</b>	<b>7.78%</b>

# Alaska State Legislature

SENATOR  
GENE THERRIAULT

Mailing Address:  
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Fairbanks, Alaska 99701  
(907) 488-0857  
Fax: (907) 488-4271



Senate

While in session  
State Capitol  
Juneau, Alaska  
99801-1182  
(907) 465-4797  
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Senate District Q

Date: 4/30/01

Number of Pages including cover: 3

To: Gregg Erickson / ABR  
Fax: 586-1987  
From: Joe Balash

Re: per your request. call if you  
have any other questions.

Memorandum

To: Sen. Gene T. Carriault  
From: Joe Balash, State Affairs Committee Aide  
Date: 1/27/01  
Subject: APFC Trustees' proposed constitutional amendment

---

You have asked for my thoughts on the APFC Board of Trustees' proposed constitutional amendment. In particular, you asked about what other steps would be required to carry out this proposal. I have included a brief description of what the language does, what questions it raises in my mind, and where able to, my answers to those questions.

The proposed language does two things. First, it takes the existing section of the Constitution establishing the permanent fund and changes the disposition of the earnings of the fund. Currently, the constitution reads "all income from the permanent fund shall be deposited in the general fund unless otherwise provided by law." The existing law puts all income in the earnings reserve. Within the earnings reserve are the realized and unrealized earnings. The PFD formula is based upon the realized earnings of the fund. The proposed amendment would change this set-up by depositing all income from the permanent fund in the permanent fund. The significance is that the permanent fund is off-limits from spending; if all income from the fund is going to be deposited back into the fund, there will have to be additional changes made to the constitution if the PFD program is going to be maintained. Which leads to the other 'half' of the proposal.

The second part of the proposal would add another paragraph to Article IX, section 15 to state:

“(b) For any fiscal year, an appropriation from the permanent fund to the general fund shall be limited to five percent of the average of the year-end market values of the permanent fund for the last five fiscal years, including the fiscal year just ended. No other appropriations from the permanent fund may be made.”

This would be quite a change from existing interpretations/opinions on how the permanent fund may be used. This language allows the principal to be spent, but limits that spending to 5% of the five-year rolling average of the fund's market value (about \$1.24 billion in FY02). This is a big departure from the way people have been looking at the Permanent Fund for some time now. If such a change is going to be made, the repercussions need to be fully explored with an eye toward the long-range use of the fund. Also, the public's perception of what is being proposed will be critically important since they will be voting on the measure.

The constitutional amendment proposed by the APFC Board of Trustees raises some interesting questions about the future of the Permanent Fund and the state's fiscal policy. They break down into three broad categories: (1) is this really a measure to protect the Permanent Fund from inflation? (2) what are the other pieces that make this work mechanically? and (3) what happens to the PFD program?

**Question 1: Is this really a measure to protect the fund from inflation?**

The title of the resolution drafted by the APFC Trustees reads, "Proposing amendments to the Constitution of the State of Alaska relating to inflation-proofing the permanent fund." Not to suggest that the Board of Trustees is somehow disingenuous, but the change proposed here, if adopted, will drive additional changes that ultimately can determine Alaska's course of fiscal policy for some time. And the manner in which they suggest the fund be inflation-proofed is not *really* inflation-proofing per se.

The Trustees propose managing the fund on a "percent of market value" (POMV) basis. It is slightly different from what the Legislature proposed in 1999 in that the language is permissive rather than explicit. The All-Alaska Plan would have created a revenue stream that would be paid out every fiscal year. This language appears to allow a revenue stream to be paid out, but does not require one. Instead, it allows the Legislature to make a limited appropriation each year. This does not explicitly inflation-proof the fund. Rather than insuring that a defined pot of money, the principal, be increased according to the CPI so that the pot has the same value at the end of the fiscal year that it had at the beginning of the fiscal year, this approach limits the amount of the fund that can be "spent". Basically, this is supposed to prevent the fund from being "overspent".

While it is certainly true that over the long-term, limiting spending to something less than 5% will protect the integrity of the fund, it does not guarantee that the fund will not lose value in a given year. The first year that total returns do not equal inflation plus the appropriation made to the general fund, observers will point out that the fund lost value. The public needs to understand that there should be a long-term view taken when looking at the fund.

**Question 2: What are the other pieces that make this work mechanically?**

Overall, the language appears to be aimed at a long-term goal/view for how the fund should be used. However, there are some steps that will have to be taken between what we have now and what is proposed. First, is the earnings reserve going to be rolled into what we now consider the principal? If so, that can be accomplished with two steps—making an appropriation from the earnings reserve to the principal and then repealing the statutes establishing the earnings reserve. There would be some timing issues to work out, though. If for example, the amendment were on the ballot in 2004, the appropriation would have to be made after the appropriations for FY2004's dividends and inflation-proofing and the statutes would probably have to be repealed effective June 30/July 1, 2005. Which raises additional timing questions. Would the same legislature that put the amendment forward pass these additional pieces of law contingent upon the amendment's passage? Or would the task fall to the next legislature? There could be some trickiness here similar to what the legislature encountered in 1999—lay everything out so the public knows what will be happening or hold back a little so as not to make it appear as a done deal (thereby incurring their wrath in that same general election).

If the earnings reserve is not going to be rolled into the rest of the fund, what is to be done with it? This is somewhat important since the reserve accounts for something close to 23% of the entire fund's current value and would affect the availability of funds in the future. Since I don't think that the Trustees intend to keep the earnings reserve separate, I haven't spent a lot of time thinking about the potential down-side.

### **Question 3: What becomes of the PFD?**

This question has bedeviled every plan proposed to this point that I am aware of. It is certainly important to the public since it will impact them quite directly. Since the current PFD formula is based on realized earnings, it would become useless under a "percent of market value" (POMV) method. In all likelihood, the PFD pool would be based on a given percentage of the fund's market value. However, this, too, would require statutory changes—which again raises questions of timing similar to those mentioned above. Also, would this appropriation be the full 5% of the rolling average allowed by the Trustees? If not, there would almost certainly be a drop in the value of the PFD checks. Would everything be on the table and contingent upon the adoption of the amendment by the voters?

There is an additional "problem" created by the new language. The section that allows for "spending" up to 5% of the permanent fund in a given fiscal year appears to require that the appropriation only be made to the general fund. If this is the case, and PFDs continue to be paid, then PFD growth will impact the state's bottom line. Is it the Trustees' intent to have PFDs compete with all other GF spending by the Legislature? A lot of effort has been made to differentiate between GF and all other spending, including PFDs. This would most definitely blur that line. In addition, if PFDs are competing with other GF funding one has to consider the possibility that the judiciary may be tempted to infringe on the Legislature's appropriation power. Decisions will be forthcoming in the next 18 months that may give a better idea of whether this is likely or not (GRF/Medicaid for abortions, *Kasayulie*).

### **General Conclusions**

What the Trustees have presented is not all that bad when considering all the implications. Their proposed language impacts the PFD and the general fund in very significant ways. Needless to say, this proposal goes much further than simply inflation-proofing the permanent fund. In the resolution adopted by the Trustees last December, the legislature is urged to reject all other amendments affecting the section of the constitution containing permanent fund. This would appear to mean that they would reject all other proposals—creating a formidable roadblock for competing visions of the fund, thereby framing the debate on any "Long-Term Fiscal Plan".

**Subject: SJR13**

**Date: Thu, 26 Apr 2001 18:14:57 -0800**

**From: Mary Griswold <mgrt@xyz.net>**

**To: Jim Kelly <jkelly@alaskapermfund.com>**

**CC: Joseph Balash <Joe\_Balash@legis.state.ak.us>**

April 26, 2001

Hi Jim,

I listened to your presentation at the SSTA committee meeting this afternoon. I think you made a good case for SJR13. I signed up to testify, but it turns out that Therriault lost the slip of paper with my name on it. His aide just called me to apologize and let me know that I can testify next week.

I am concerned about one concept as you presented it.

I think it is deceptive or at least confusing to say that the principal will not be eroded with a 5% payout which is further limited to the income in the earnings reserve account. I agree that the acquired principal will not be eroded, but what we really expect to maintain is the inflation-proofed principal, which IS subject to erosion because the inflation-proofing dollars are inseparable from the other dollars in the earnings reserve account.

Earlier in this process, I was concerned that the principal was not truly inflation-proofed if its inflation-proofing dollars were left in the earnings reserve account. I wanted periodic transfers from the earnings reserve to the principal in times of plenty to protect the principal in leaner days. However, because only 5% of the fund's market value may be appropriated each year, the principal is in fact fully inflation-proofed as much as market models permit. I am willing to accept the small risk that the real value of the principal of the permanent fund may be occasionally eroded in a prolonged down market. I stress that it is very important to limit the payout to no more than 5% to make this an acceptable risk.

Regarding Tamara Cook's memo of February 12, 2001, I would remove from the resolution at the end of line 7 to line 8 "the principal of" and add to the end of the sentence at line 9 "and for the purpose provided in (b)," meaning that all funds in the permanent fund shall be used only to make money and to provide for a 5% payout even if this erodes the value of the principal (which is very unlikely).

As I mentioned in an earlier e-mail, I think life would be a lot simpler if we got rid of the earnings reserve in the statutes to complement the constitutional amendment. 80% (adjustable) of the 5% would go to dividends, 20% (adjustable) would go to government. The constitution does not recognize the earnings reserve account. It was created by statute to distribute income under the current system based on earnings, but it is not necessary or even relevant for POMV distribution. It can only confuse people. I offered statutory changes to 37.13.140 and .145 (a-e) to delete it in Bill Hudson's HB35.

I plan to present some of this at next week's committee meeting if they remember me.

Mary



**Subject: SJR13**

**Date: Wed, 25 Apr 2001 20:52:29 -0800**

**From: Mary Griswold <mgrt@xyz.net>**

**To: Joseph Balash <Joe\_Balash@legis.state.ak.us>**

April 25, 2001

Dear Senator Therriault,

Thank you for scheduling a hearing on SJR13.

I enthusiastically support imposing a 5-year rolling average 5% market value payout restriction on the Permanent Fund.

The main reason I support this constitutional amendment is that it provides a better money management framework. POMV payout reduces the pressure to manage the permanent fund for return over value. Managing for value is generally considered a better fiscal approach. A 5% payout is generally recognized by large endowments as the highest sustainable payout, beyond which the real value of a fund would diminish over time.

A secondary benefit is that this methodology will provide a reasonable money stream for government if the legislature chooses to use it. Right now the money sitting in the earnings reserve account is available for legislative appropriation for purposes other than dividends, although the legislature has not ever spent it. There will be more pressure in the future for the legislature to use this money. SJR 13 will limit the amount the legislature can use to a predictable and modest amount.

It is important to recognize that our dividends are as much as they are because the legislature made special appropriations from the earnings reserve account to the principal and because it did not spend the earnings available to it. Any use of permanent fund earnings for purposes other than dividends will decrease the value of our checks because whatever is spent will not be available to earn more money. However, our dividends could be cut by much more under the current payout system than under POMV.

5 POMV payout combined with allocating 80% for dividends and 20% for government would preserve the status quo dividend formula with the understanding that the 20% transfer from the fund will reduce the fund's future income producing potential.

I believe it is time to allocate some permanent fund earnings to government and see 5 POMV payout as the best way to do that. But most importantly, I see 5 POMV payout as a better money management tool which will keep the permanent fund permanent for future generations.

Thank you for your consideration.

Mary Griswold  
Homer

The private benefit arguably represented by the dividend program continues to fall into a gray area in terms of public purpose. At one end of the spectrum are the approved disaster insurance programs. The IRS found a sufficient governmental purpose to help its citizens protect themselves against natural disasters in the wake of significant disasters with profound economic consequences for the state. The IRS may have been particularly persuaded by the suggestion that, absent such programs, the financial consequences would be borne more directly by the state. At the other end of the spectrum are the prepaid tuition programs, which the IRS characterized as private investment schemes wrapped in the state's cloak of tax exemption. It may be difficult to argue that the dividend program is more like the former than the latter.

It is an open question whether dividend payments to individuals outside the context of a higher education purpose (or some other "approved" governmental purpose) will suffice to satisfy the public purpose criterion.

Morrison & Foerster believe that as long as the income from the Fund clearly accrues to the State and no individual has a vested right in the income or assets of the Fund, the income and assets are those of the state alone, and thus not subject to federal taxation. How the state chooses to appropriate or spend its revenues should have no impact on this determination, except perhaps to further reinforce the argument that the investment activity is an integral part of the State and essential governmental function. And as long as the dividend program is implemented as a matter of legislative grace, M&F believe that it will be difficult for the IRS to argue that, having earned the income (investment being an appropriate public purpose and essential government function), it is not entirely within the discretion of the State to appropriate it as it sees fit, whether through legislative allocation or annual budget appropriations.

To the extent that the Fund, or some portion of it, becomes irreversibly dedicated to the benefit of private beneficiaries, or to the extent that the dividend program becomes an entitlement that is beyond the reach of government, then it becomes more like the prepaid tuition programs and is subject to potential challenge by the IRS as a private, rather than public investment activity.

		Alaska Permanent Fund	Michigan Education Trust	Florida Hurricane Catastrophe Fund	Hawaii Hurricane Relief Fund	California Earthquake Authority
Corporate Status		State Fund; managed by a public corporation	Public Corporation	State Fund	Public Corporation	State Agency
	Ownership of Assets	State	Investors	Reverts to the state upon termination	Reverts to the state upon dissolution	Transferred to the state upon termination
Control and Domination		Investments dictated by law; LB&A Cmte has oversight	Independent of the State; decisions could not be overridden by any agency		Initial plan of operations subject to legislative review	Initial plan of operations approved by the legislature; amendments approved by the insurance commissioner
	Board Make-up	state officials and public members confirmed by the legislature		state officials	state official and public members confirmed by the senate	state officials
	Employees	state employees		Fund employees and contract advisors	Administered by a state agency	Employees subject to state civil servant requirements
Source and Destination						
	Source	State royalties and settlements	Participants	Insurers/Participants; some nonparticipant funds	Participants + additional state funds (mortgage recording fee)	Equivalent of state premium tax collections; some seed money; sale of fund premiums
	Destination	Currently, a matter of legislative grace	private beneficiaries	revenues earmarked for the fund	insurers and the insured	insurers and the insured
IRS ruling		none requested	rejected	exempt	exempt	exempt

## Integral Part Theory

Federal taxation does not reach income earned by a state—or an integral part of a state

- Congress may tax the income of states—but must do so specifically
- Morrison & Foerster (D.C. tax attorneys) contend this is the Fund's strongest argument

What constitutes an integral part of a state? Three essential elements are reviewed:

1. Corporate Status
2. State creation; control and domination; and declaration of state purpose
3. Source and destination of program funds

No single element is determinative in and of itself.

IRS looks very closely whenever a private benefit is created. However, sufficient indicia of state control and public purpose can support integral part status, despite the existence of significant private benefit.

There is *nothing* comparable to the Permanent Fund and its dividend program. The areas where a private benefit has caused the IRS to get concerned involved mechanisms where the individuals who paid into the entity (fund, corporation, agency) were the only recipients of the private benefit. In our situation, the Fund comes only from royalties that the state already owns, plus some additional grants of general fund dollars in the early 1980s. Payments of dividends to private individuals from income of the fund does not seem to be similar to any of the other "investment schemes" that the IRS required some public purpose to justify the private benefits in question.

**Subject: Attached draft**

**Date:** Mon, 25 Mar 2002 01:34:31 -0900

**From:** Gregg Erickson <gerickso@alaska.com>

**To:** Senator\_Gene\_Therriault@legis.state.ak.us

**CC:** Joe\_Balash@legis.state.ak.us

Dear Senator Therriault:

Do you or Joe have anything to add to this story (draft attached)?

My deadline is late Tuesday. If you'd rather phone, I'm at 586-1290.

Thanks,

Gregg Erickson

--

Capital Information Group

gerickso@alaska.com

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 SJR_13_update.doc	<b>Name:</b> SJR_13_update.doc <b>Type:</b> WINWORD File (application/msword) <b>Encoding:</b> base64
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# DRAFT

## PERMANENT FUND

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### Therriault to push adding PFD to trustees' PF amendment

House State Affairs Chair Gene Therriault says he doesn't buy the argument that making the permanent fund dividend program a part of the Alaska Constitution will threaten the fund's tax exempt status, and the North Pole senator says he wants to move forward with an independent legal analysis of a plan to add the dividends provision to a constitutional amendment being pushed by trustees of the Alaska Permanent Fund Corporation.

SJR 13, the trustees' constitutional amendment proposal, would require all permanent fund income to be returned to the fund, and limit annual appropriations from the fund to 5 percent of the fund's market value, a level trustees say will ensure full inflation-proofing. Therriault's plan is to add provisions mandating that a certain percentage of any money withdrawn from the fund be paid as dividends directly to Alaska residents. The Legislature would not be required to pay dividends if no money was taken from the fund.

At a March 21 hearing on SJR 13, Therriault provided members with copies of legal opinions prepared for APFC by the national law firm of Morrison & Foerster [see **Lawyers say feds unlikely to tax permanent fund**, *ALASKA BUDGET REPORT*, November 4, 1998]. He noted that APFC witnesses cited the opinions in February as the basis for their conclusion that the federal government would likely try to tax the fund's earnings if the dividend program were made a part of the state Constitution [see **APFC lawyer warns senators against putting dividend in Constitution**, *ALASKA BUDGET REPORT*, February 27, 2002]. He also

"I read through them and I understand the trustee's concern," said Therriault. "There is a potential tax problem." But Therriault said his reading of the opinions suggests that there are ways to minimize any legal risk. He asked Joe Balash of his staff to summarize the legal issues.

Balash said Congress has the right to tax the income of states, but must specifically exercise this right, and has so far not done so. Based on this doctrine, courts have generally held that activities and funds that are an "integral part" of a state government are exempt from taxation. The question then becomes: Is the institution being considered for taxation an integral part of a state? Three factors are considered:

- Legal status, whether incorporated as part of a state or separately,
- The degree of state control or domination of the institution, and
- The source and destination of the money or other assets of institution.

No single element is determinative on its own, Balash said, but applying the tests to the permanent fund doesn't suggest vulnerability to federal taxation, even assuming a constitutional requirement that dividends share in any payout.

The Alaska Permanent Fund Corporation is a state-owned corporation with a separate legal existence, but its officers are all state employees. Moreover, the corporation doesn't own the fund: it remains the property of the state government, a point the APFC has emphasized in its recent annual reports. The "legal status" provides a strong argument for exemption.

On the issue of "control or domination" Balash said there is no question that the fund is under the state's power and command. APFC is not allowed to spend money except as the Legislature appropriates, and the Legislative Budget and Audit Committee has statutory legislative oversight of its activities. State law, Balash noted, defines what kind of investments are permissible and the distribution of the proceeds.

Balash said the Internal Revenue Service has increasingly focused on the last test: where the money comes from, and where it goes. Permanent fund dividend payments could easily be considered a private benefit, a factor that would tend to concern the IRS, but money coming into the fund clearly is not from private sources, indicating that the arrangement would be of less concern to the IRS. "It is only individuals investing their money, then earning a [tax-sheltered] return, and then getting a benefit back that really caused the concern to the IRS."

Balash painted a far different picture than the committee received from APFC officials. Speaking to the committee on February 21, Juneau attorney Ron Lorensen, under contract to assist the fund, said that creating a private interest in the fund, such as making dividends mandatory, would make the entire fund taxable. "It's not worth risking." Even if only "a little" of the fund's earnings were dedicated to dividends, "it all becomes susceptible as soon as the Legislature gives up control over any portion of it."

Citing legal advice from Lorensen and the national law firm of Morrison & Foerster, APFC Executive Director Robert Storer said at the February hearing that the corporation opposes a constitutional amendment guaranteeing the dividend.

Therriault made it clear at the March 21 hearing that he has reached a different conclusion, and that his approach to putting the dividends into the Constitution—as a fixed percentage of any money the Legislature decides to use from the fund—would not mandate an annual dividend as some earlier proposals [see **Ogan PF dividend amendment moves despite tax worry**, *ALASKA BUDGET REPORT*, April 12, 2000, and **Trustees' amendment spawns confusion**, May 2, 2001].

"Under the proposed percent of market value methodology [as proposed by the trustees], if there is to be a draw from the permanent fund, it must be limited to 5 percent. That's permissive—it doesn't dictate that you have to take a draw." Making the dividends a fixed percentage of any draw doesn't force the Legislature to take any money out of the fund. He claimed that the option would always open

for other uses of any money left in the fund because citizens could always change the Alaska Constitution.

Therriault said he is comfortable now that the state would prevail if the dividend program were linked to the percentage-of-market-value (POMV) limit being pushed by the APFC's trustees, and assuming that the Legislature would have full discretion to set the amount of the draw, up to POMV limit.

"It is almost a siam-dunk in our favor," he said, citing recent IRS rulings on the taxability of disaster funds established by Hawaii, Florida and California. "When you compare with these disaster funds, we've got a lot stronger case."

Therriault said the state already is using some permanent fund earnings for state government functions, and presumably would continue to do so, even if dividends were constitutionally mandated as a share of any money drawn from the fund. He said that also strengthens the state's case.

So what is the next step for SJR 13?

"I wanted to have this discussion to bring you up to speed, give you my interpretation, give you an opportunity to digest it, and see if you come to the same conclusion," Therriault said, indicating that he hopes the committee will take some final action on SJR 13 sometime in the next two weeks."

Therriault noted that the possibility of taking a holiday from inflation-proofing is under discussion in the House. "I'm not sure that the Senate would ever agree to not inflation-proofing, taking a holiday from inflation proofing, or taking a 7 or 8 percent draw from the overall value of the fund."

Sources say Therriault will bring the matter up in the Senate Majority Caucus to be held ASK LOREN WHEN??.

On March 22 in the House, the day after the Senate hearing, Democrat Harry Crawford, joined by Democrat Eric Croft, introduced a constitutional amendment resolution that embodies the Therriault proposal. Sponsor substitute for HJR 14 would establish the POMV scheme as proposed by the APFC trustees, but require that "At least fifty percent of the amount appropriated ... during a fiscal year shall be used during that same fiscal year for a program of dividend payments to state residents established by law."

The Crawford-Croft resolution contains a repealer provision that would wipe out the dividend mandate if the courts give a final judgment that the fund is subject to federal taxes. As originally introduced last year, Crawford's HJR 14 would have restructured the constitutional budget reserve.

ASK CRAWFORD WHERE HE GOT THE IDEA.

**MORRISON & FOERSTER LLP**

SAN FRANCISCO  
LOS ANGELES  
SACRAMENTO  
ORANGE COUNTY  
HAWAII  
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April 7, 1998

Writer's Direct Dial Number  
202-887-1598

By Overnight Delivery

Mr. James L. Baldwin  
Assistant Attorney General  
Alaska Department of Law  
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P.O. Box 110300  
Juneau, AK 99811-0300

**RECEIVED**

APR 21 1998

SIMPSON, THORNTON & EAST,  
SORENSEN & LORENSEN

Re: Alaska Permanent Fund Corporation

Dear Jim:

You have requested an update of the Report ("Report") that we provided to the Alaska Permanent Fund Corporation ("APFC") approximately 10 years ago, regarding the question whether the Fund and APFC are subject to federal taxation. I have reviewed the cases and rulings that have been issued since 1988, as well as the statutory amendments made to Title 37, chapter 13 of the Alaska Statutes, Attorney General opinions, and the recent annual reports. This letter summarizes and discusses the legal developments relating to the central legal arguments addressed in our previous report. We assume for purposes of this letter that the factual description of the Alaska Permanent Fund ("Fund") and the APFC contained in the Report are still applicable, apart from the legislative amendments which substituted references to the fund for references to the APFC, and other changes discussed below at page 32.

**I. Executive Summary**

As before, we believe that there are three primary arguments supporting the position that the income of the Fund and the APFC are not subject to federal taxation.

First, it might be argued that the constitutional doctrine of implied immunity of state instrumentalities from federal taxation applies. As we concluded before, this doctrine has been so narrowly construed that it offers only questionable protection. The few legal developments under this doctrine have only reinforced our previous conclusion.