

ALASKA LEGISLATURE COMMITTEE FILES, 2003-2004

8672

11359 SENATE STATE AFFAIRS

used in the production of corn-ethanol. We use both approaches in our analysis.

The energy balance issue first surfaced in the mid-1970s when ethanol began to receive attention as a gasoline extender. Studies during that time that analyzed the energy benefits of substituting ethanol for gasoline generally concluded that the net energy value (NEV, defined as energy content of ethanol minus fossil energy used to produce ethanol) of corn ethanol was slightly negative (Ethanol Study Committee, 1979; Chambers et al., 1979). In the late 1980s, the U.S. desire to reduce air pollution placed ethanol in the spotlight once again and energy balance studies resurfaced. About the same time, studies estimating the emissions of greenhouse gases from ethanol began to appear in the literature (DeLuchi, 1991; Ho, 1989; Marland and Turhollow, 1990). Although these studies focused on estimating the greenhouse gases associated with ethanol relative to gasoline, some of these studies also reported the NEV of ethanol. However, there was a considerable amount of variation in the findings of these reports. This wide variation relates to various assumptions about farm production and ethanol conversion. Furthermore, the various researchers used data from different time periods. Studies using older data tended to overestimate energy use because

ethanol manufacturing and farm production technologies have become increasingly energy efficient over time. To make matters worse, it is often difficult to determine why results differ from study to study because the reports often lack certain details on their calculation procedures. The purpose of this paper is to identify the methodological differences creating the inconsistencies among study results and provide a more consistent estimate for the NEV of corn ethanol.

Table 1 shows the wide variation in the NEV estimates of several studies. Some studies use lower heating values (LHV) for measuring energy and others use higher heating values (HHV). Higher heating value, also called gross heating value, is the standard heat of combustion referenced to water in combustion exhaust as liquid water. Lower heating value, also called net heat of combustion, is the standard heat of combustion referenced to water in combustion exhaust as water vapor. In other words, the difference between HHV and LHV is the energy associated with condensation of the water vapor in the combustion products. Although these two methods can produce slightly different results, either approach can be used. However, once a method is chosen, it should be used consistently throughout the study for all energy calculations.



Table 1—Energy input assumptions of corn-ethanol studies

| Study/year | Corn yield | Nitrogen fertilizer application rate | Nitrogen fertilizer production | Corn ethanol conversion rate | Ethanol conversion process | Total ¹ energy use | Coproducts ¹ energy credits | Net ¹ energy value |
|-----------------------------------|----------------|--------------------------------------|--------------------------------|------------------------------|----------------------------|-------------------------------|--|-------------------------------|
| | <i>Bu/acre</i> | <i>lb/acre</i> | <i>Btu/lb</i> | <i>gal/bu</i> | <i>Btu/gal</i> | <i>Btu/gal</i> | <i>Btu/gal</i> | <i>Btu/gal</i> |
| Pimentel (1991) | 110 | 136 | 37,551 | 2.50 | 73,687 | 131,017 (LHV) | 21,500 | -33,517 |
| Pimentel (2001) | 127 | 129 | 33,547 | 2.50 | 75,118 | 131,062 (LHV) | 21,500 | -33,562 |
| Keeney and DeLuca (1992) | 119 | 135 | 37,958 | 2.56 | 48,470 | 91,196 (LHV) | 8,078 | -8,438 |
| Marland and Turhollow (1990) | 119 | 127 | 31,135 | 2.50 | 50,105 | 73,934 (HHV) | 8,127 | 18,154 |
| Lorenz and Morris (1995) | 120 | 123 | 27,605 | 2.55 | 53,956 | 81,090 (HHV) | 27,579 | 30,589 |
| Ho (1989) | 90 | NR | NR | NR | 57,000 | 90,000 (LHV) | 10,500 | -4,000 |
| Wang et al. (1999) | 125 | 131 | 21,092 | 2.55 | 40,850 | 68,450 (LHV) | 14,950 | 22,500 |
| Agri. and Agri-Food Canada (1999) | 116 | 125 | NR | 2.69 | 50,415 | 68,450 (LHV) | 14,055 | 29,826 |
| Shapouri et al. (1995) | 122 | 125 | 22,159 | 2.53 | 53,277 | 82,824 (HHV) | 15,056 | 16,193 |
| This study (2002) | 125 | 129 | 18,392 | 2.66 | 51,779 | 77,228 (HHV) | 14,372 | 21,105 |

NR: Not reported

LHV: Low heat value = 76,000 Btu per gallon of ethanol. Keeney and DeLuca used 74,680 Btu per gallon of ethanol.

HHV: High heat value = 83,961 Btu per gallon of ethanol. Lorenz and Morris used 84,100 Btu per gallon of ethanol.

¹ The midpoint or average is used when studies report a range of values.

Conclusions

We conclude that the NEV of corn-ethanol is positive when fertilizers are produced by modern processing plants, corn is converted in modern ethanol facilities, and farmers achieve average corn yields. Our NEV estimate of over 21,000 Btu per gallon could be considered conservative, since it was derived using the replacement method for valuing coproducts, and it does not include energy credits for plants that sell carbon dioxide. Corn ethanol is energy efficient, as indicated by an energy ratio of 1.34; that is, for every Btu dedicated to producing ethanol there is a 34-percent energy gain. Furthermore, producing ethanol from domestic corn stocks achieves a net gain in a more desirable form of energy, which helps the United States to reduce its dependence on imported oil. Ethanol production utilizes abundant domestic energy feedstocks, such as coal and natural gas, to convert corn into a premium liquid fuel. Only about 17 percent of the energy used to produce ethanol comes from liquid fuels, such as gasoline and diesel fuel. For every 1 Btu of liquid fuel used to produce ethanol, there is a 6.34 Btu gain.

When looking at past NEV studies, it appears that energy requirements for producing a gallon of ethanol are falling over time. One of the primary factors for this increase in energy efficiency is the increase in U.S. corn yields. When ethanol first emerged as a gasoline extender in the 1970s, corn yield was averaging about 90 bushels per acre. This study used 1995-97 average corn yield of 125 bushels per acre, which is about 39 percent greater than the yields of the 1970s. Corn yields continue to rise in the United States—the average corn yield per acre for the past 3 years (1999-2001) was about 135 bushels per acre. If the 1999-2001 average corn yield were used in this analysis, the total energy used to produce a bushel of corn would decline by more than 4,200 Btu. As corn yields increase over time, we can expect the energy balance of corn ethanol to increase, as well. Other major factors causing this increase in energy efficiency are related to the energy-saving technologies adopted by ethanol producers and manufacturers of fertilizers and other farm inputs. Higher energy costs will likely continue to provide incentives for these industries to become more energy efficient, which will continue to push the NEV of corn ethanol higher.

SJR

17

SENATE COMMITTEE REPORT
First Committee of Referral

DATE: 4/14/03

FURTHER:

Date of 5-Day Notice: 4/17/03
(in accordance with Uniform Rule 23)

DATE TURNED
IN TO OFFICE: 4/20/03

State Affairs Committee considered SENATE JOINT RESOLUTION NO. 17

SJR 17 ALASKA-YUKON INTERGOV RELATIONS ACCORD

Relating to the Alaska-Yukon Intergovernmental Relations Accord, to annual legislative exchanges, and to continuing intergovernmental work on matters of joint concern and mutual interest.

and recommends:

be replaced with _____ CS _____ (_____)

adopt previous _____ CS _____ (_____)

attached amendment(s)

adopt Letter of Intent by _____ Committee

further referral to _____ Committee

Senate Bill:

same title

new title

House Bill:

same title

technical title

new: SCR # _____

NEW FISCAL NOTE(S):

| Department | Date | Fiscal | Zero | FN# |
|------------|---------|--------|------|-----|
| STA | 4/17/03 | | ✓ | 1 |
| | | | | |
| | | | | |
| | | | | |
| | | | | |

PREVIOUS FISCAL NOTE(S):

| Department | Date | Fiscal | Zero | FN# |
|------------|------|--------|------|-----|
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| | | | | |

APPROPRIATION - no fiscal note

| SIGNATURES AND RECOMMENDATIONS: | DO PASS | DO NOT PASS | NO REC | AMEND |
|---------------------------------|---------|-------------|--------|-------|
| <i>John J. Coakley</i> | ✓ | | | |
| <i>Paul Ryan</i> | ✓ | | | |
| | | | | |
| | | | | |
| | | | | |
| CHAIR: <i>[Signature]</i> | | | | |

FISCAL NOTE

STATE OF ALASKA
2003 LEGISLATIVE SESSION

Fiscal Note Number: _____
 Bill Version: SJR 17
 (S) Publish Date: _____

Revision Date/Time (Note if correction): _____ Dept. Affected: _____
 Title Alaska-Yukon Intergovernmental BRU _____
Relations Accord Component _____
 Sponsor Senator Olson _____
 Requester Senate State Affairs Committee Component No. _____

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

| OPERATING EXPENDITURES | FY 2004 | FY 2005 | FY 2006 | FY 2007 | FY 2008 | FY 2009 |
|------------------------|------------|------------|------------|------------|------------|------------|
| Personal Services | | | | | | |
| Travel | | | | | | |
| Contractual | | | | | | |
| Supplies | | | | | | |
| Equipment | | | | | | |
| Land & Structures | | | | | | |
| Grants & Claims | | | | | | |
| Miscellaneous | | | | | | |
| TOTAL OPERATING | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |

| | | | | | | |
|-----------------------------|--|--|--|--|--|--|
| CAPITAL EXPENDITURES | | | | | | |
|-----------------------------|--|--|--|--|--|--|

| | | | | | | |
|-------------------------------|--|--|--|--|--|--|
| CHANGE IN REVENUES () | | | | | | |
|-------------------------------|--|--|--|--|--|--|

FUND SOURCE (Thousands of Dollars)

| | | | | | | |
|---|------------|------------|------------|------------|------------|------------|
| 1002 Federal Receipts | | | | | | |
| 1003 GF Match | | | | | | |
| 1004 GF | | | | | | |
| 1005 GF/Program Receipts | | | | | | |
| 1037 GF/Mental Health | | | | | | |
| Other (Specify Type--Do not abbreviate) | | | | | | |
| TOTAL | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |

Estimate of any current year (FY2003) cost: 0.0
 Mark this box (X) if funding for this bill is included in the Governor's FY 2004 budget proposal:

POSITIONS

| | | | | | | |
|-----------|--|--|--|--|--|--|
| Full-time | | | | | | |
| Part-time | | | | | | |
| Temporary | | | | | | |

ANALYSIS: (Attach a separate page if necessary)

Prepared by: SENATE STATE AFFAIRS COMMITTEE Phone 465-4522
 Division _____ Date/Time 4/17/03 12:54 PM
 Approved by: Senator Gary Stevens, Chair Date 4/17/2003
 Agency _____

(Revised 9/2002 OMB)

Alaska State Legislature

Out of Session:
PO Box 531
Golovin, Alaska 99762
(907) 443-5599

In Session:
State Capitol, Suite 510
Juneau, Alaska 99801-1182
(800) 597-3707
(907) 465-3707
(907) 465-4821 Fax

SENATOR DONALD C. OLSON

Sponsor Statement

DISTRICT T

Alakanuk
Ambler
Anaktuvuk Pass
Atkasuk
Barrow
Brevig Mission
Browerville
Buckland
Chevak
Deering
Diomedes
Elim
Emmonak
Gambell
Golovin
Hooper Bay
Kaktovik
Kiana
Kivalina
Kobuk
Kotlik
Kotzebue
Koyuk
Mountain Village
Noatak
Nome
Noorvik
Nuiqsut
Nunam Iqua
Pilot Station
Pitka's Point
Point Hope
Point Lay
Savoonga
Scammon Bay
Selawik
Shaktolik
Shishmaref
Shungnak
St. Mary's
St. Michael
Stebbins
Teller
Unalakleet
Wainwright
Wales
White Mountain

SJR 17, Alaska-Yukon Intergovernmental Relations Accord

SJR 17 is a resolution supporting the extension of the Alaska-Yukon Intergovernmental Relations Accord. This accord is set to expire on September 8, 2003.

The State of Alaska and the Yukon Territory of Canada share not only a long common boarder but also a connected history of resource development and pre contact ethnography. In the past, Alaska and the Yukon Territory have enjoyed mutual prosperity from joint efforts in mineral exploration and development. We co-manage important fish and game resources that trans-migrate our boundaries.

With the pending gas pipeline and other matters of potential resource use, exploration and development, it is essential for Alaska and the Yukon Territory to work cooperatively together for the wise use and benefit of our bountiful resources.

This year I attended the annual legislative exchange with our Yukon colleagues in Whitehorse. The meetings and discussions that ensued underscore the importance of continuing the Alaska-Yukon Intergovernmental Relations Accord for our future economic growth and well being.

I respectfully urge your favorable consideration of this resolution.

SJR

18

SENATE COMMITTEE REPORT

First Committee of Referral

DATE: 4/17/03

FURTHER: Judiciary
Finance

Date of 5-Day Notice: 4/24/03
(in accordance with Uniform Rule 23)

DATE TURNED
IN TO OFFICE: 5/7/03

State Affairs Committee considered SENATE JOINT RESOLUTION NO. 18

SJR 18 CONST. AM: PF APPROPS/INFLATION-PROOFING

Proposing amendments to the Constitution of the State of Alaska relating to limiting appropriations from and inflation-proofing the Alaska permanent fund by establishing a percent of market value spending limit.

and recommends:

- be replaced with _____ CS SJR 18 (STA)
- adopt previous _____ CS _____ (_____)
- attached amendment(s)
- adopt Letter of Intent by _____ Committee
- further referral to _____ Committee

Senate Bill:

- same title
- new title

House Bill:

- same title
- technical title
- new: SCR # _____

NEW FISCAL NOTE(S):

| Department | Date | Fiscal | Zero | FN# |
|------------|----------------|-------------------------------------|-------------------------------------|----------|
| <u>OOG</u> | <u>4/24/03</u> | <input checked="" type="checkbox"/> | | <u>1</u> |
| <u>DOR</u> | <u>4/29/03</u> | | <input checked="" type="checkbox"/> | <u>2</u> |
| | | | | |
| | | | | |

PREVIOUS FISCAL NOTE(S):

| Department | Date | Fiscal | Zero | FN# |
|------------|------|--------|------|-----|
| | | | | |
| | | | | |
| | | | | |
| | | | | |

APPROPRIATION - no fiscal note

| SIGNATURES AND RECOMMENDATIONS: | DO PASS | DO NOT PASS | NO REC | AMEND |
|---------------------------------|-------------------------------------|-------------|-------------------------------------|-------|
| <u>[Signature]</u> | | | <input checked="" type="checkbox"/> | |
| <u>[Signature]</u> | | | <input checked="" type="checkbox"/> | |
| <u>[Signature]</u> | <input checked="" type="checkbox"/> | | | |
| | | | | |
| | | | | |
| CHAIR: <u>[Signature]</u> | | | <input checked="" type="checkbox"/> | |

23-LS1007D
Cook
5/6/03

CS FOR SENATE JOINT RESOLUTION NO. 18()
IN THE LEGISLATURE OF THE STATE OF ALASKA
TWENTY-THIRD LEGISLATURE - FIRST SESSION

BY

Offered:
Referred:

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

A RESOLUTION

1 Proposing amendments to the Constitution of the State of Alaska relating to and limiting
2 appropriations from the Alaska permanent fund based on an averaged percent of the
3 fund market value to protect the fund from inflation and assure that the real value of
4 the fund will be preserved over the long term.

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,
10 Except as appropriated under (b) of this section, money in the permanent fund [,
11 THE PRINCIPAL OF WHICH] shall be used only for those income-producing
12 investments specifically designated by law as eligible for permanent fund investments.
13 [ALL INCOME FROM THE PERMANENT FUND SHALL BE DEPOSITED IN
14 THE GENERAL FUND UNLESS OTHERWISE PROVIDED BY LAW.]

15 * Sec. 2. Article IX, sec. 15, Constitution of the State of Alaska, is amended by adding a

1 new subsection to read:

2 (b) To protect the permanent fund from the effects of inflation and thereby
3 assure that the real value of the permanent fund will be preserved over the long term,
4 appropriations from the permanent fund for a fiscal year may not exceed five percent
5 of the average of the market values of the fund on June 30 for the first five of the six
6 fiscal years immediately preceding that fiscal year.

7 * Sec. 3. Article XV, Constitution of the State of Alaska, is amended by adding a new
8 section to read:

9 Section 30. Transition. On the effective date of the 2004 amendment relating
10 to the Alaska Permanent Fund (art. IX, sec. 15), the unencumbered, unappropriated
11 balance of the earnings reserve account established under AS 37.13.145(a) is added to
12 the balance in the Alaska Permanent Fund.

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

I am an enthusiastic supporter of a 5 POMV payout because it constitutionally inflation-proofs the entire permanent fund. Right now, only the principal is inflation-proofed, and that is done by statute, and after the dividend program is funded.

The second reason I support 5 POMV is that it sets a spending limit. Under the current distribution methodology, the legislature may appropriate the entire earnings reserve account. 5 POMV forces us to resist the temptation to appropriate too much money when the fund is flush, yet makes distributions available in lean years.

Third, an annual payout based on market value is compatible with the fund's diversified portfolio that is managed, in conformance to industry standards, for long-term value over short-term gain. The current distribution method, based on income, was appropriate 20 years ago when the fund was invested primarily in bonds. A 5% payout is generally recognized by large fund managers as the highest sustainable payout, beyond which the real value of the fund would diminish over time. This approach protects the value of the fund and provides a limited, predictable, and sustainable revenue stream.

The permanent fund trustees combined the fund's principal and income in one pot of money to make 5 POMV work effectively. Segregating the principal interferes with value-management goals by exerting pressure to produce short-term income for dividends or other distributions during periods of poor performance. Segregating the principal also tempts the legislature to provide for a greater than 5% payout when the earnings reserve account is flush, as in HJR 1. This is just what POMV is designed to avoid.

How the legislature chooses to divide the payout is an important question. 5 POMV is a management tool, not a distribution plan. However, the two are intrinsically linked. The use of the payout should not be set in the constitution because this is an appropriation issue better left to the legislative process. Alaska Statutes 37.13.140 and 37.13.145 relating to permanent fund income and income distribution must be amended to conform to 5 POMV because they will no longer apply as written. I urge you to establish a comparable dividend formula when you change

these statutes. 5 POMV is too valuable an asset to risk voter rejection by threatening their dividend checks.

For modeling purposes, we assume an 8% total return, 3% inflation, and a 5% real return. Under the existing statutes, 50% of the income available for distribution, or 4%, goes to the dividend program. Inflation-proofing then takes 3% of the total return, leaving 1% for other legislative appropriation, which has never been touched. For this distribution to work under POMV, 80% of the 5% payout must be allocated to the dividend program to provide a comparable amount of money. Inflation-proofing of 3% has already been accounted for by establishing a 5% payout limit, leaving 20% of the payout for other legislative appropriation, which is the same as the 1% under the existing distribution statutes. 50% of the money available for distribution after inflation-proofing cannot provide the same amount for dividends as 50% of the money available for distribution before inflation-proofing. 50% of 8 translates to 80% of 5.

It is time to move forward on a fiscal plan. This constitutional amendment combined with a change to the statutes securing 80% of the annual payout for dividends is a critical step. It is a three-way win. The permanent fund gets a better management framework, the legislature gets a predictable revenue stream, and the people keep their dividend formula.

Thank you.

Mary Griswold

Homer

Methods to determine funds available for appropriation:

Five key differences between the Status quo and the proposed Percent of Market Value (P.O.M.V.)

A presentation by the Alaska Permanent Fund Corporation
to the House Ways and Means Committee

April 21, 2003

Note: This presentation supports the changes proposed in SJA 18.



Five key differences between the status quo and POMV

1. POMV offers constitutional inflation-proofing protection of the entire Fund. The status quo statutorily inflation-proofs Fund principal.
2. POMV is a spending limit. It limits funds available for appropriations to real income over time. Under the status quo, the entire earnings reserve may be appropriated.
3. During volatile markets, POMV offers greatly improved stability in year-to-year amounts available for appropriation as compared to the status quo.



Differences between the status quo and POMV

4. POMV is compatible with the Fund's diversified, long-term investment strategy of achieving a 5% real rate of return over time. The status quo was designed a quarter century ago for a Fund invested 100% in bonds.
5. Predictable annual appropriations are provided under POMV. Under the status quo, it is not known whether funds will be available for appropriation in any given year.





Alaska Permanent Fund Corporation
HJR 26 - Financial projection comparison of the Alaska Permanent Fund
under status quo versus POMV spending limit, beginning in FY05.

\$ millions

| Status Quo | -----projected----- | | | | | | | | | | |
|--|---------------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|
| | FY03 | FY04 | FY05 | FY06 | FY07 | FY08 | FY09 | FY10 | FY11 | FY12 | FY13 |
| Total Return | -3.42% | 7.38% | 7.60% | 7.60% | 7.60% | 7.60% | 7.60% | 7.60% | 7.60% | 7.60% | 7.60% |
| Principal - end of year (after payouts) | 22,348 | 23,268 | 24,149 | 25,057 | 25,988 | 26,937 | 27,910 | 28,899 | 29,899 | 30,918 | 31,956 |
| Realized earnings reserve (after payouts) | 633 | 398 | 648 | 1,102 | 1,581 | 2,028 | 2,446 | 2,886 | 3,358 | 3,865 | 4,487 |
| Unrealized earnings reserve | (632) | 118 | 610 | 960 | 1,232 | 1,468 | 1,708 | 1,929 | 2,135 | 2,332 | 2,434 |
| Total earnings reserve - end of year (after payouts) | 0 | 516 | 1,258 | 2,062 | 2,813 | 3,496 | 4,154 | 4,816 | 5,493 | 6,197 | 6,921 |
| Total Market Value End of Year (after payouts) | <u>22,348</u> | <u>23,784</u> | <u>25,407</u> | <u>27,118</u> | <u>28,801</u> | <u>30,433</u> | <u>32,065</u> | <u>33,715</u> | <u>35,392</u> | <u>37,115</u> | <u>38,876</u> |
| Annual net income | (851) | 1,620 | 1,775 | 1,897 | 2,026 | 2,152 | 2,275 | 2,397 | 2,521 | 2,647 | 2,776 |
| Dividend (lump sum) - Status Quo | 686 | 510 | 409 | 442 | 597 | 766 | 887 | 979 | 1,059 | 1,131 | 1,209 |
| Transfer status quo Inflation-proofing (ER to principal) | 102 | 590 | 612 | 635 | 659 | 683 | 707 | 732 | 758 | 783 | 810 |

| POMV - 5% (beginning in FY05) | -----projected 5% POMV beginning in FY05----- | | | | | | | | | | |
|---|---|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|
| | FY03 | FY04 | FY05 | FY06 | FY07 | FY08 | FY09 | FY10 | FY11 | FY12 | FY13 |
| Total Return | | | 7.60% | 7.60% | 7.60% | 7.60% | 7.60% | 7.60% | 7.60% | 7.60% | 7.60% |
| Total Market Value End of Year (after payouts) | | <u>23,784</u> | <u>24,581</u> | <u>25,429</u> | <u>26,307</u> | <u>27,186</u> | <u>28,078</u> | <u>28,978</u> | <u>29,881</u> | <u>30,795</u> | <u>31,717</u> |
| Annual net income | | | 1,775 | 1,834 | 1,898 | 1,963 | 2,028 | 2,094 | 2,161 | 2,228 | 2,295 |
| POMV Payout available for appropriation in lump sum | | | 1,235 | 1,243 | 1,274 | 1,329 | 1,380 | 1,426 | 1,473 | 1,520 | 1,568 |
| 5 year average market value | | | 24,706 | 24,854 | 25,480 | 26,576 | 27,608 | 28,526 | 29,463 | 30,409 | 31,363 |

Assumptions: Callan Associates 2003 Capital Market Assumptions, APFC 2003 asset allocation, Spring 2003 revenue forecast, financial statements through 3/31/03. All payouts are assumed to happen at fiscal year end, all dollar values in millions.



Alaska Permanent Fund Corporation

Calculation of annual effective rates of 5% POMV spending limit
\$ millions

| | <u>FY05</u> | <u>FY06</u> | <u>FY07</u> | <u>FY08</u> | <u>FY09</u> | <u>FY10</u> | <u>FY11</u> | <u>FY12</u> | <u>FY13</u> |
|--|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Payout based on 5 year moving average | 1,235 | 1,243 | 1,274 | 1,329 | 1,380 | 1,426 | 1,473 | 1,520 | 1,568 |
| Ending market value (after payout) | 24,581 | 25,429 | 26,307 | 27,186 | 28,078 | 28,978 | 29,881 | 30,795 | 31,717 |
| Ending market value (pre payout) | 25,816 | 26,672 | 27,581 | 28,515 | 29,458 | 30,404 | 31,354 | 32,315 | 33,285 |
| Effective payout rate * | 4.78% | 4.66% | 4.62% | 4.66% | 4.69% | 4.69% | 4.70% | 4.71% | 4.71% |
| | <u>FY05</u> | <u>FY06</u> | <u>FY07</u> | <u>FY08</u> | <u>FY09</u> | <u>FY10</u> | <u>FY11</u> | <u>FY12</u> | <u>FY13</u> |
| Payout based on 5 year moving average | 1,235 | 1,243 | 1,274 | 1,329 | 1,380 | 1,426 | 1,473 | 1,520 | 1,568 |
| less APFC costs to manage the Fund | 38 | 39 | 41 | 42 | 43 | 44 | 46 | 47 | 49 |
| 5% available for spending after deducting APFC costs | 1,197 | 1,203 | 1,233 | 1,287 | 1,337 | 1,382 | 1,427 | 1,473 | 1,520 |
| Effective rate after deducting APFC costs * | 4.64% | 4.51% | 4.47% | 4.51% | 4.54% | 4.55% | 4.55% | 4.56% | 4.57% |
| APFC costs to manage the Fund in % | 0.16% | 0.16% | 0.16% | 0.16% | 0.16% | 0.16% | 0.16% | 0.16% | 0.16% |

* Note: The effective rate is defined as the payout over the ending market value of the Fund (pre-payout) expressed as a percentage.

23-LS1006Y
Cook
4/29/03

CS FOR HOUSE JOINT RESOLUTION NO. 26()
IN THE LEGISLATURE OF THE STATE OF ALASKA
TWENTY-THIRD LEGISLATURE - FIRST SESSION

BY

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 relating to and limiting**
2 **appropriations from the Alaska permanent fund based on an averaged percent of the**
3 **fund market value to protect the fund from inflation and ensure that the real value of**
4 **the fund is preserved.**

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.
10 **Except as appropriated under in (b) of this section, money in the permanent fund**
11 **[, THE PRINCIPAL OF WHICH]** shall be used only for those income-producing
12 investments specifically designated by law as eligible for permanent fund investments.
13 **[ALL INCOME FROM THE PERMANENT FUND SHALL BE DEPOSITED IN**
14 **THE GENERAL FUND UNLESS OTHERWISE PROVIDED BY LAW.]**

15 *** Sec. 2. Article IX, sec. 15, Constitution of the State of Alaska, is amended by adding a**

1 new subsection to read:

2 (b) To protect the permanent fund from the effects of inflation and thereby
3 assure that the real value of the permanent fund will be preserved, appropriations from
4 the permanent fund for a fiscal year may not exceed five percent of the average of the
5 market values of the fund on June 30 for the first five of the six fiscal years
6 immediately preceding that fiscal year.

7 * **Sec. 3.** Article XV, Constitution of the State of Alaska, is amended by adding a new
8 section to read:

9 **Section 30. Transition.** On the effective date of the 2004 amendment relating
10 to the Alaska Permanent Fund (art. IX, sec. 15), the unencumbered, unappropriated
11 balance of the earnings reserve account established under AS 37.13.145(a) is added to
12 the balance in the Alaska Permanent Fund.

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

LEGISLATIVE BUDGET & AUDIT COMMITTEE

REPRESENTATIVE RALPH SAMUELS, CHAIR

Sponsor Statement for SJR 18

Senate Joint Resolution 26 proposes changing Alaska's Constitution to require inflation proofing of the entire Permanent Fund and to limit the payouts from the fund. This resolution was introduced at the request of the Permanent Fund Corporation's Board of Trustees.

Many large endowments and public funds use a system known as "percent of market value" payouts, or POMV, to provide payouts while still protecting both the principal and earnings of a fund. POMV limits payouts to a set percentage of the fund's market value, often 5 percent. This has shown to be the maximum sustainable payout rate that will still maintain a fund's real value over time.

However, under current law only the principal of the Permanent Fund is protected and inflation-proofed. The earnings reserve account is not considered part of the principal, is not inflation-proofed and is open to appropriation. In addition, payouts are computed as a portion of the Fund's earnings. This means that if the Fund were to have little or no earnings in a single year, a payout for dividends or other State spending would not be allowed.

Moving to a POMV system and adding the earnings reserve to the Fund would not only provide inflation proofing of the entire fund, but would provide a more reliable and predictable payout each year, regardless of the Fund's performance in an individual year. This would make it more likely that the State could continue the Permanent Fund Dividend program in the future, an outcome that is heartily supported by many Alaskans.

Making these changes in the Constitution, rather than in Alaska Statutes adds an additional layer of protection to the fund because the Constitution can only be changed with a vote of the people.

If passed, SJR 18 would place an initiative on the next statewide election ballot that would propose the following three changes to Alaska's Constitution:

- Remove the provision that "all income be deposited in the general fund unless otherwise provided by law"
- Add a provision that would not allow appropriations from the Fund to exceed 5 percent of the average market value of the Fund over five years
- Add a provision that would consider the money in the earnings reserve account to be part of the Permanent Fund

Email: Representative_Ralph_Samuels@legis.state.ak.us

Session: Alaska State Capitol, Juneau, Alaska 99801-1182 • Phone: (907) 465-2095 Fax: (907) 465-3810
Interim: 716 W. 4th Ave., Anchorage, Alaska 99501-2133 • Phone: (907) 269-0240 Fax: (907) 269-0242

ALASKA PERMANENT FUND CORPORATION

RESOLUTION OF THE BOARD OF TRUSTEES OF THE
ALASKA PERMANENT FUND CORPORATION RELATING TO A
CONSTITUTIONAL AMENDMENT LIMITING APPROPRIATIONS FROM
AND INFLATION-PROOFING THE ALASKA PERMANENT FUND
BY ESTABLISHING A PERCENT OF MARKET VALUE SPENDING LIMIT

RESOLUTION 03-05

Preserving the real value of the money deposited into the Alaska Permanent Fund ("Fund") over the long term has been a public policy priority of the Board of Trustees ("Board") since the original Board was appointed over 20 years ago. In response to the Board's concerns in 1982 about the effects of inflation on the value of the Fund, the legislature adopted statutory inflation-proofing that same year. That change has successfully protected (by statute) the principal of the Fund for the past 20 years. After several years of review, the Board believes it is now time for the People of Alaska to make another decision that would: 1) constitutionally protect the current purchasing power of the whole Fund (both principal and income) against inflation; and 2) improve the rules governing distributions from the Fund.

To accomplish these goals, the Board has examined the use by various large endowment and public funds of a formula approach to establish appropriate limits on the size of payouts from those funds. This formula approach, generally referred to as a "percent of market value" ("POMV") spending limit, is applied by those funds in a manner that assures that, on average, only *real* income of a fund (i.e. income *net of inflation*) can be spent, thereby assuring that the real value of the contributions paid into the fund will not be touched. Because a POMV spending limit would provide for distributions from the Fund that are

predictable and limited, the Board believes that its use is in the best interest of the Fund and of the people of the State of Alaska.

The Board further believes that the best way to implement a POMV spending limit methodology for determining a level of distributions from the Fund that is predictable and limited is to amend the constitutional provision that established the Fund (Article IX, section 15 of the Alaska Constitution). Providing for a POMV spending limit in this manner would assure all Alaskans that the real value of the contributions to the Fund will be preserved for all time.

At the Board's request, APFC staff has presented a draft constitutional amendment for further discussion by the Board which, if adopted by the people of the State of Alaska, would provide for the following:

1. an annual limit on appropriations from the Fund of up to five percent of the total market value of the Fund, averaged over a period of five years;
2. using a five year period that allows the legislature and the governor to know before a fiscal year begins the exact amount that will be available for distribution from the Fund;
3. Fund income is part of the Fund, rather than being subject to appropriation by the legislature, as currently provided;
4. assures that the current statutory earnings reserve account established by AS 37.13.145 becomes part of the Fund when the constitutional amendment takes effect; and
5. the current references to "principal" and "income" are removed, as POMV ensures protection of the principal over the long-term through a constitutional spending limit.

The Board believes that this approach effectively balances the goal of providing for an annual distribution from the Fund that is predictable and limited with the long-term goal of protecting the real value of contributions to the Fund.

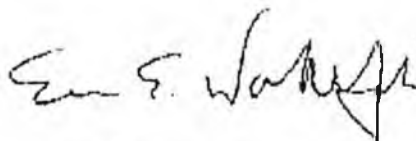
In addition, the Board believes strongly that implementing a POMV spending limit approach by constitutional amendment is such an important public policy goal that proposals for incorporating any other amendments to Article IX, section 15 which might in any way either lessen the chances of approval of such an amendment by the voters or undermine the legal status of the Fund should be rejected by the legislature.

Finally, the Board recognizes that implementation of a POMV spending limit methodology by constitutional amendment may necessitate changes to existing statutes that deal with the formula for determining and distributing the amount of the Fund that may be spent each year, including, but not necessarily limited to, payment of Permanent Fund Dividends and inflation-proofing the Fund. In anticipation of voter approval of a constitutional amendment providing for a POMV spending limit, the Board is hopeful that the legislature and the governor will work together to develop appropriate legislation to harmonize existing statutory provisions with the operation of the amendment and/or to adopt such new statutes as they may consider desirable. In this regard, the Board and APFC staff stand ready to provide any information or other assistance that may be helpful.

NOW, THEREFORE, BE IT RESOLVED by the Board of Trustees that the legislature of the State of Alaska, in consultation with the governor and the Board, are urged to consider and approve the proposal (dated 4/14/03) for a constitutional amendment that would implement a POMV spending limit mechanism that would provide an annual distribution from the Fund that is predictable and limited.

BE IT FURTHER RESOLVED by the Board of Trustees that the proposal for such an amendment be limited solely to implementation of the foregoing goal.

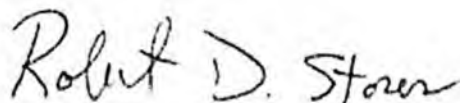
PASSED AND APPROVED by the Board of Trustees of the Alaska Permanent Fund Corporation this 14th day of April 2003.



Eric E. Wohlforth

Chair, Board of Trustees

ATTEST:



Robert D. Storer, Corporate Secretary

**Testimony before the
House Special Committee on Ways & Means
Clark S. Gruening
April 22, 2003**

Note: This testimony was for HJR 26, which is the companion bill for SJR 18.

Mr. Chairman and members of the House Special Committee on Ways & Means, thank you for the opportunity to discuss with you HJR 26, a proposed constitutional amendment for inflation-proofing the Alaska Permanent Fund.

Before speaking to how this proposal changes the way the Permanent Fund is inflation-proofed, I'd like to make some brief comments about how the Board came to recommend this change.

For 23 of the Fund's 27 years of existence, the APFC has been governed by a six-member Board of Trustees. Protecting the Fund against inflation has been the highest public policy goal of the Trustees since the original Board was appointed in 1980. The first Board testified to the legislature that the greatest threat to the permanence of the Fund is inflation. In response, the legislature adopted statutory inflation-proofing in 1982.

In more recent years, the Board has examined the use by various large endowments and public funds of a formula approach to determine the method and size of payouts from these funds. This approach is generally referred to as "percentage of market value" payouts or "POMV" for short.

The purpose of placing this formula in the state constitution is to protect the long-term real value of the Fund and to provide consistent and predictable distributions for the long-term. After considerable review and discussion, the Board recommended in February of 2001, a constitutional change in the form of

HJR 15 and SJR 13 which received committee hearings but did not come to the floor for a vote.

As in the prior proposal, the language in HJR 26 provides a spending limit on what can be currently spent or, in legislative parlance, appropriated. The existing constitutional language establishing the Alaska Permanent Fund only prohibits the appropriation of principal. In other words, anything but "principal" is income and can be spent.

Since the first Board of Trustees, 23 years ago, the Permanent Fund corporation has calculated principal as a notational number that simply equals the sum of the constitutionally mandated 25 percent of mineral deposits and the non-mandated (or voluntary) deposits the legislature has chosen to make. Principal does not vary or move up or down with the market.

Unlike the present statutory provision for inflation-proofing, HJR 26 provides for inflation-proofing of the entire Fund. But clearly, one of the most important reasons to support the proposal is that it would maximize distributions over the long term by establishing a percent of market value spending limit. By eliminating the distinction between principal and income, this proposal would also avoid the situation where market volatility on the down side prevents any distribution from the fund for any purpose, whether for dividends or anything else.

This is significant because since 1982, Alaska's fiscal picture has changed dramatically. The Alaska Permanent Fund can be reasonably expected to produce more future state revenue than any single Alaska resource -- more than oil or natural gas, more than fishing or any other natural resource.

Whatever future decisions are made by the legislature or the voters regarding the use of Fund earnings, the five percent payout of market value limit will assure complete and protected inflation-proofing while providing predictable and sustainable distributions over the long term.

In managing Alaska's fishery stocks, the only sensible choice is to avoid taking too much of any fish stock so that, over the long term, the harvest is maximized. Of course, over-harvesting can reap short-term rewards of more fish, but the inevitable result is, at best, fewer fish, and at worst, permanent impairment or destruction of a fisheries stock. The same is true for managing distributions from a large investment fund like the Alaska Permanent Fund.

I want to close by emphasizing two key points regarding the Board's proposed constitutional amendment. The first point is that if Alaska is going to have a Fund that is truly permanent, we must take those steps necessary to ensure permanence. This means investing for future generations as well as current generations. This will require commitment to basic principles of long-term investing.

But the critical flip side of a sound long-term investment strategy is a sound, sustainable, and predictable distribution plan – a plan that will sustain and provide benefits to each generation of Alaskans.

The second and last point I want to leave you with is that if the Permanent Fund is going to continue to serve each generation of Alaskans it has to be able to make distributions so that current generations receive some benefit while not

"over harvesting" the fund so that there is little or nothing left for future generations.

We all want to avoid, at all costs, defaulting to the position where the Constitutional Budget Reserve (or "CBR") is today. Within the next three to four years, the CBR is destined for extinction. As the investment horizon of the CBR steadily shortens, it will be necessary to keep the assets of the CBR in very short-term and less-profitable investments.

I believe that as the day of the CBR's demise grows near, the Trustees and staff of the Fund may have to seriously consider a shorter investment horizon for a significant portion of the Fund.

So, whether we liken the Alaska Permanent Fund to a resource industry like Alaska's fisheries, one thing is clear: the Alaska Permanent Fund can continue to import significant new money into our state year after year.

Properly invested and protected, the Alaska Permanent Fund will successfully convert the non-renewable petroleum wealth of our State into a permanent and substantial stream of revenue for generations after the last barrel of oil has been pumped.

Legislative passage and voter approval of the Board's proposed amendment would protect the ability of the Fund to be managed for the long-term and to continue to pour money into the Alaska economy over the long-term.

The proposed constitutional change before you in the form of HJR 26 is more compatible with the Fund's diversified, long-term investment strategy of achieving a five percent real rate of return over time. The present constitutional

language was designed over a quarter century ago for a Fund that was invested 100 percent in bonds.

I believe that succeeding generations will rightly view this proposed amendment with the same degree of appreciation and admiration as the original one Alaskans overwhelmingly approved 27 years ago. The Trustees believe that this proposal for complete and protected inflation-proofing makes ultimate good sense for Alaska's Permanent Fund and for Alaska's future.

FISCAL NOTE

STATE OF ALASKA
2003 LEGISLATIVE SESSION

Fiscal Note Number: _____
 Bill Version: SJR18
 () Publish Date: _____

Revision Date/Time (Note if correction): _____ Dept. Affected: Revenue
 Title Constitutional Amendment: BRU Permanent Fund Corp
Permanent Fund Appropriations Component Permanent Fund Corp
 Sponsor Senate Rules
 Requester Senate State Affairs Component No. 109

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

| OPERATING EXPENDITURES | FY 2004 | FY 2005 | FY 2006 | FY 2007 | FY 2008 | FY 2009 |
|------------------------|------------|------------|------------|------------|------------|------------|
| Personal Services | | | | | | |
| Travel | | | | | | |
| Contractual | | | | | | |
| Supplies | | | | | | |
| Equipment | | | | | | |
| Land & Structures | | | | | | |
| Grants & Claims | | | | | | |
| Miscellaneous | | | | | | |
| TOTAL OPERATING | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |

| | | | | | | |
|-----------------------------|--|--|--|--|--|--|
| CAPITAL EXPENDITURES | | | | | | |
|-----------------------------|--|--|--|--|--|--|

| | | | | | | |
|-------------------------------|--|--|--|--|--|--|
| CHANGE IN REVENUES () | | | | | | |
|-------------------------------|--|--|--|--|--|--|

FUND SOURCE (Thousands of Dollars)

| | | | | | | |
|---|------------|------------|------------|------------|------------|------------|
| 1002 Federal Receipts | | | | | | |
| 1003 GF Match | | | | | | |
| 1004 GF | | | | | | |
| 1005 GF/Program Receipts | | | | | | |
| 1037 GF/Mental Health | | | | | | |
| Other (Specify Type--Do not abbreviate) | | | | | | |
| TOTAL | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |

Estimate of any current year (FY2003) cost: 0.0
 Check this box (X) if funding for this bill is included in the Governor's FY 2004 budget proposal:

POSITIONS

| | | | | | | |
|-----------|--|--|--|--|--|--|
| Full-time | | | | | | |
| Part-time | | | | | | |
| Temporary | | | | | | |

ANALYSIS: (Attach a separate page if necessary)

SJR 18 would ask voters in the next general election whether to approve a constitutional amendment that would limit annual appropriations to no more than 5% of the average year-end market value of the Fund for the preceding five years.

SJR 18 would not affect the budgeted costs to manage and invest the Permanent Fund, nor would it change the amount of income earned by Permanent Fund investments.

See the attached schedule for financial projections of the Fund comparing the "Status Quo" to a 5% POMV spending limit.

Prepared by: Robert D. Storer, Executive Director Phone (907)465-2047
 Division Alaska Permanent Fund Corporation Date/Time 4/25/03 5:00 PM
 Approved by: William Corbus, Commissioner Date 4/29/2003
 Agency Department of Revenue



Alaska Permanent Fund Corporation
 SJR 18 - Financial projection comparison of the Alaska Permanent Fund
 under status quo versus POMV spending limit, beginning in FY05.

\$ millions

| Status Quo | -----projected----- | | | | | | | | | | |
|--|---------------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|
| | FY03 | FY04 | FY05 | FY06 | FY07 | FY08 | FY09 | FY10 | FY11 | FY12 | FY13 |
| Total Return | -3.42% | 7.38% | 7.60% | 7.60% | 7.60% | 7.60% | 7.60% | 7.60% | 7.60% | 7.60% | 7.60% |
| Principal - end of year (after payouts) | 22,348 | 23,268 | 24,149 | 25,057 | 25,988 | 26,937 | 27,910 | 28,899 | 29,899 | 30,918 | 31,956 |
| Realized earnings reserve (after payouts) | 633 | 398 | 648 | 1,102 | 1,581 | 2,028 | 2,446 | 2,886 | 3,358 | 3,865 | 4,487 |
| Unrealized earnings reserve | (632) | 118 | 610 | 960 | 1,232 | 1,468 | 1,708 | 1,929 | 2,135 | 2,332 | 2,434 |
| Total earnings reserve - end of year (after payouts) | 0 | 516 | 1,258 | 2,062 | 2,813 | 3,496 | 4,154 | 4,816 | 5,493 | 6,197 | 6,921 |
| Total Market Value End of Year (after payouts) | <u>22,349</u> | <u>23,784</u> | <u>25,407</u> | <u>27,118</u> | <u>28,801</u> | <u>30,433</u> | <u>32,065</u> | <u>33,715</u> | <u>35,392</u> | <u>37,115</u> | <u>38,876</u> |
| Annual net income | (851) | 1,620 | 1,775 | 1,897 | 2,026 | 2,152 | 2,275 | 2,397 | 2,521 | 2,647 | 2,776 |
| Dividend (lump sum) - Status Quo | 686 * | 510 | 409 | 442 | 597 | 766 | 887 | 979 | 1,059 | 1,131 | 1,209 |
| Transfer status quo inflation-proofing (ER to principal) | 102 | 590 | 612 | 635 | 659 | 683 | 707 | 732 | 758 | 783 | 810 |

* The APFC FY03 projected dividend, paid to Alaska citizens in October, 2003 is subject to available earnings reserve. The volatility in the stock market has taken earnings reserve to zero or below several times this fiscal year. If the earnings reserve balance is zero or negative on 6/30/03, no dividend distribution will be paid to the Department of Revenue.

| POMV - 5% (beginning in FY05) | -----projected 5% POMV beginning in FY05----- | | | | | | | | | | |
|---|---|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|
| | FY03 | FY04 | FY05 | FY06 | FY07 | FY08 | FY09 | FY10 | FY11 | FY12 | FY13 |
| Total Return | | | 7.60% | 7.60% | 7.60% | 7.60% | 7.60% | 7.60% | 7.60% | 7.60% | 7.60% |
| Total Market Value End of Year (after payouts) | | <u>23,784</u> | <u>24,581</u> | <u>25,429</u> | <u>26,307</u> | <u>27,186</u> | <u>28,078</u> | <u>28,978</u> | <u>29,881</u> | <u>30,795</u> | <u>31,717</u> |
| Annual net income | | | 1,775 | 1,834 | 1,898 | 1,963 | 2,028 | 2,094 | 2,161 | 2,228 | 2,295 |
| POMV Payout available for appropriation in lump sum | | | 1,235 | 1,243 | 1,274 | 1,329 | 1,380 | 1,426 | 1,473 | 1,520 | 1,568 |
| 5 year average market value | | | 24,706 | 24,854 | 25,480 | 26,576 | 27,608 | 28,526 | 29,463 | 30,409 | 31,363 |

Assumptions: Callan Associates 2003 Capital Market Assumptions, APFC 2003 asset allocation, Spring 2003 revenue forecast, financial statements through 3/31/03. All payouts are assumed to happen at fiscal year end, all dollar values in millions.

SJR

19

SENATE COMMITTEE REPORT

First Committee of Referral

DATE: 5/2/03

FURTHER: Judiciary
Finance

Date of 5-Day Notice: 24 Hour Rule in Effect
(in accordance with Uniform Rule 23)

DATE TURNED
IN TO OFFICE: 5/14/03

State Affairs Committee considered SENATE JOINT RESOLUTION NO. 19

SJR 19 CONST. AM: PERMANENT FUND INCOME

Proposing amendments to the Constitution of the State of Alaska relating to the Alaska permanent fund.

and recommends:

be replaced with _____ CS _____ (_____)

adopt previous _____ CS _____ (_____)

attached amendment(s)

adopt Letter of Intent by _____ Committee

further referral to _____ Committee

Senate Bill:

same title

new title

House Bill:

same title

technical title

new: SCR # _____

NEW FISCAL NOTE(S):

| Department | Date | Fiscal | Zero | FN# |
|------------|---------|--------|------|-----|
| DOR | 5/14/03 | | ✓ | 1 |
| COV | 5/14/03 | ✓ | | 2 |
| | | | | |
| | | | | |

PREVIOUS FISCAL NOTE(S):

| Department | Date | Fiscal | Zero | FN# |
|------------|------|--------|------|-----|
| | | | | |
| | | | | |
| | | | | |
| | | | | |

APPROPRIATION - no fiscal note

| SIGNATURES AND RECOMMENDATIONS: | Do PASS | Do NOT PASS | NO REC | AMEND |
|---------------------------------|---------|-------------|--------|-------|
| <i>John J. Bowdler</i> | | | ✓ | |
| <i>[Signature]</i> | | | ✓ | |
| <i>[Signature]</i> | ✓ | | | |
| | | | | |
| | | | | |
| CHAIR: <i>[Signature]</i> | | | ✓ | |

FISCAL NOTE

STATE OF ALASKA
2003 LEGISLATIVE SESSION

Fiscal Note Number: _____
 Bill Version: SJR19
 () Publish Date: _____

Revision Date/Time (Note if correction): _____ Dept. Affected: Revenue
 Title Constitutional Amendment: BRU Permanent Fund Corp
Permanent Fund Income Component Permanent Fund Corp
 Sponsor Senator Lincoln
 Requester Senate State Affairs Component No. 109

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

| OPERATING EXPENDITURES | FY 2004 | FY 2005 | FY 2006 | FY 2007 | FY 2008 | FY 2009 |
|------------------------|------------|------------|------------|------------|------------|------------|
| Personal Services | | | | | | |
| Travel | | | | | | |
| Contractual | | | | | | |
| Supplies | | | | | | |
| Equipment | | | | | | |
| Land & Structures | | | | | | |
| Grants & Claims | | | | | | |
| Miscellaneous | | | | | | |
| TOTAL OPERATING | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |

| | | | | | | |
|-----------------------------|--|--|--|--|--|--|
| CAPITAL EXPENDITURES | | | | | | |
|-----------------------------|--|--|--|--|--|--|

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|-------------------------------|--|--|--|--|--|--|
| CHANGE IN REVENUES () | | | | | | |
|-------------------------------|--|--|--|--|--|--|

FUND SOURCE (Thousands of Dollars)

| | | | | | | |
|---|------------|------------|------------|------------|------------|------------|
| 1002 Federal Receipts | | | | | | |
| 1003 GF Match | | | | | | |
| 1004 GF | | | | | | |
| 1005 GF/Program Receipts | | | | | | |
| 1037 GF/Mental Health | | | | | | |
| Other (Specify Type--Do not abbreviate) | | | | | | |
| TOTAL | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |

Estimate of any current year (FY2003) cost: 0.0
 Check this box (X) if funding for this bill is included in the Governor's FY 2004 budget proposal:

POSITIONS

| | | | | | | |
|-----------|--|--|--|--|--|--|
| Full-time | | | | | | |
| Part-time | | | | | | |
| Temporary | | | | | | |

ANALYSIS: (Attach a separate page if necessary)

SJR19 would ask voters in the next general election whether to approve a constitutional amendment that would require distributions from the Permanent Fund earnings reserve be as provided in the existing statutes for determining the annual amount available for appropriation and the amount of the dividend.

SJR19 would not affect the budgeted costs to manage and invest the Permanent Fund, nor would it change the amount of income earned by Permanent Fund investments.

Prepared by: Robert D. Storer, Executive Director Phone (907)465-2047
 Division Alaska Permanent Fund Corporation Date/Time 5/12/03 3:00 PM
 Approved by: Larry Persily, Deputy Commissioner Date mm/dd/yr
 Agency Department of Revenue

FISCAL NOTE

STATE OF ALASKA
2003 LEGISLATIVE SESSION

Fiscal Note Number: _____
 Bill Version: SJR19
 () Publish Date: _____

Revision Date/Time (Note if correction): _____ Dept. Affected: Office of the Governor
 Title Constitutional Amendment relating to BRU Elections
the Alaska permanent fund Component Elections
 Sponsor Senator Lincoln
 Requester Senate State Affairs Component No. 21

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

| OPERATING EXPENDITURES | FY 2004 | FY 2005 | FY 2006 | FY 2007 | FY 2008 | FY 2009 |
|------------------------|------------|------------|------------|------------|------------|------------|
| Personal Services | | | | | | |
| Travel | | | | | | |
| Contractual | | 1.5 | | | | |
| Supplies | | | | | | |
| Equipment | | | | | | |
| Land & Structures | | | | | | |
| Grants & Claims | | | | | | |
| Miscellaneous | | | | | | |
| TOTAL OPERATING | 0.0 | 1.5 | 0.0 | 0.0 | 0.0 | 0.0 |

| | | | | | | |
|-----------------------------|--|--|--|--|--|--|
| CAPITAL EXPENDITURES | | | | | | |
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|-------------------------------|--|--|--|--|--|--|
| CHANGE IN REVENUES () | | | | | | |
|-------------------------------|--|--|--|--|--|--|

FUND SOURCE (Thousands of Dollars)

| | | | | | | |
|---|------------|------------|------------|------------|------------|------------|
| 1002 Federal Receipts | | | | | | |
| 1003 GF Match | | | | | | |
| 1004 GF | | 1.5 | | | | |
| 1005 GF/Program Receipts | | | | | | |
| 1037 GF/Mental Health | | | | | | |
| Other (Specify Type--Do not abbreviate) | | | | | | |
| TOTAL | 0.0 | 1.5 | 0.0 | 0.0 | 0.0 | 0.0 |

Estimate of any current year (FY2003) cost: 0.0
 Mark this box (X) if funding for this bill is included in the Governor's FY 2004 budget proposal:

POSITIONS

| | | | | | | |
|-----------|--|--|--|--|--|--|
| Full-time | | | | | | |
| Part-time | | | | | | |
| Temporary | | | | | | |

ANALYSIS: *(Attach a separate page if necessary)*
 This figure includes the cost of providing information about this issue in the Official Election Pamphlet, as required by AS 15.58. If this measure requires the printing of an 8-1/2 by 18 inch ballot, the cost will increase by \$22.0.

Prepared by: Lauri Allred Phone 465-5347
 Division: Division of Elections Date/Time 5/12/03 10:10 AM
 Approved by: Laura A. Glaiser, Director Date 5/12/2003
 Agency: Office of the Lt. Governor, Division of Elections

LEGAL SERVICES

DIVISION OF LEGAL AND RESEARCH SERVICES
LEGISLATIVE AFFAIRS AGENCY
STATE OF ALASKA

(907) 465-3867 or 465-2450
FAX (907) 465-2029
Mail Stop 3101

State Capitol
Juneau, Alaska 99801-1182
Deliveries to: 129 6th St., Rm. 329

MEMORANDUM

May 13, 2003

SUBJECT: Disposition of Permanent Fund Income; sectional summary
(SJR 19)

TO: Senator Georgiana Lincoln
Attn: Sara Boario

FROM: Tamara Brandt Cook
Director *TBC*

Sec. 1. Amends the state constitution by requiring income of the permanent fund to be placed in the earnings reserve account and distributed as provided for under three statutes as they read on July 1, 2002. The statutes are: AS 37.13.140, income of the permanent fund; AS 37.13.145, disposition of that income; and AS 43.23.025, amount of dividend.

Sec. 2. Adds a new subsection to the state constitution providing that AS 37.13.140, AS 37.13.145, AS 43.23.025, and provisions of law referred to in those sections as they read on July 1, 2002, remain in effect unless amended or repealed with the change ratified by a majority of the voters voting on the question. Also provides that money may be appropriated from the earnings reserve account only as authorized under AS 37.13.145(b), transfers for dividends, and AS 37.13.145(c), transfers to permanent fund principal for inflation proofing, as those statutes read on July 1, 2002. Money appropriated for other uses must be ratified by a majority of the voters voting on the question.

Sec. 3. Suspends the amendments under secs. 1 and 2 of the resolution on the date of a determination by the IRS that the permanent fund is subject to taxation. The suspension terminates on the date the amendments are repealed or 180 days after a nonappealable judgment by a federal court deciding the fund is not subject to taxation as a result of the amendments. The amendments are repealed 180 days after the date of a nonappealable judgment that the fund is subject to taxation.

Sec. 4. Directs the amendments proposed by this resolution to be submitted to the voters at the general election to be held in 2004.

TBC:mdr
03.115.mdr

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Alaska State Legislature

Please enter into the record my testimony to the Senate State Affairs Committee on SJR 19 / Constitutional Amend.: Permanent Fund Income. Date: May 13, 2003

ALASKA VOTERS ORGANIZATION RESOLUTION 2003-10

A Resolution to the 23rd Alaska State Legislature in SUPPORT OF SJR 19, which authorizes an election to decide if the voters of Alaska wish to approve a Constitutional Amendment, that will protect the Permanent Fund Dividend program.

WHEREAS, most candidates elected in November 2002 promised they would not touch the Permanent Fund, without a vote of the people; and

WHEREAS, the Legislature and Governor are proposing appropriations from the Permanent Fund earnings, which is in opposition to the intent of the 1999 advisory vote and election promises made during the 2002 election campaign; and

WHEREAS, the legislature has failed to recognize the direct correlation between increased state spending and reduced oil royalty payments being the underlying reason for the growing budget deficit; and

WHEREAS, the legislature has continued to fund our state government at an unsustainable level, by making annual withdrawals from the Constitutional Budget Reserve; and

WHEREAS, the legislature continues to deplete our Constitutional Budget Reserve and has failed to submit any plan to repay this "rainy day account", as required by the Alaska Constitution; and

WHEREAS, the annual Permanent Fund Dividend has become a huge economic engine most business owners and Alaskan citizens rely on each winter; and

WHEREAS, 83% of voters in the 1999 special advisory election clearly said they could spend their dividend better than the government and rejected the option of legislative appropriation of the Permanent Fund earnings; and

WHEREAS SJR 19 would insure that the fund's principle remains protected through inflation proofing; and

WHEREAS, if approved by the legislature, SJR 19 will put the question of whether the Permanent Fund Dividend program should be Constitutionally protected on the ballot for all citizens of Alaska to vote on; and

| | | | | | |
|-------------------|--------------------|---------|--------------|------------|--------|
| Post-It® Fax Note | 7671 | Date | 5/13/03 | # of pages | 1 of 2 |
| To | Matic | From | Mila McBride | | |
| Co./Dept | Rep. Chris' office | Co. | AK Voters | | |
| Phone # | | Phone # | | | |
| Fax # | 1 907 465 4411 | Fax # | 776 5444 | | |


WHEREAS SJR 19 would give the legislature much needed direction to solve the most serious problem currently facing our state;

NOW, THEREFORE, BE IT RESOLVED by the Alaska Voters Organization, Board of Directors, that SJR 19 be approved by the 23rd Legislature and put on the ballot for a vote of the people; and be it

FURTHER RESOLVED that the legislature should prioritize spending and make the necessary cuts required to obtain a government of the size and cost that Alaska can afford, without negatively impacting those citizens most at risk;

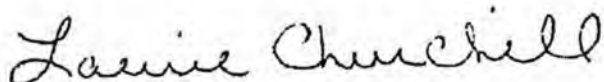
Adopted by the Alaska Voters Organization Board of Directors; this 6th day of May 2003.

Signed:



Mike McBride,
Board President

Attest:



Laurie Churchill,
Board Secretary

Alaska Voters Organization
PO Box 2016
Kenai, Alaska
99611-2016

(907) 776-8008
akvoters@gci.net
www.akvoters.org



Alaska Permanent Fund Corporation

Status quo dividend payout as a percent of the five year average market value (pre-payout)
\$ millions

| | <u>FY03</u> | <u>FY04</u> | <u>FY05</u> | <u>FY06</u> | <u>FY07</u> | <u>FY08</u> | <u>FY09</u> | <u>FY10</u> | <u>FY11</u> | <u>FY12</u> | <u>FY13</u> | <u>FY14</u> | <u>FY15</u> |
|--|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Dividend (lump sum transfer) - status quo formula | 686 | 510 | 409 | 442 | 597 | 766 | 887 | 979 | 1,059 | 1,131 | 1,209 | 1,252 | 1,293 |
| 5 year average market average (pre-payout) | 25,458 | 25,081 | 24,706 | 25,032 | 26,021 | 27,654 | 29,385 | 31,161 | 32,939 | 34,708 | 36,486 | 38,289 | 40,137 |
| Dividend (lump sum) % of 5 year moving average | 2.69% | 2.03% | 1.66% | 1.77% | 2.29% | 2.77% | 3.02% | 3.14% | 3.21% | 3.26% | 3.31% | 3.27% | 3.22% |
| Per Capita Dividend | \$1,120 | \$820 | \$640 | \$690 | \$950 | \$1,220 | \$1,420 | \$1,560 | \$1,680 | \$1,790 | \$1,910 | \$1,970 | \$2,020 |

*per capita dividend in dollars, rounded to the nearest \$10

Status quo - MOMA volatility model projections as of 12/31/02

Updated with March 03 Financial Statements, and Spring oil forecast out to 2015, Callan 2003 Capital Market assumptions.

Estimated return 7.60% beginning in FY05, realized return, varies from 1.36 in FY03 to a high of 7.33 in FY13



Alaska Permanent Fund Corporation

5% payout of five year average market value, dividend status quo, residual of 5% paid out for public services
\$ millions

| | <u>FY03</u> | <u>FY04</u> | <u>FY05</u> | <u>FY06</u> | <u>FY07</u> | <u>FY08</u> | <u>FY09</u> | <u>FY10</u> | <u>FY11</u> | <u>FY12</u> | <u>FY13</u> | <u>FY14</u> | <u>FY15</u> |
|---|-------------|-------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Dividend (lump sum transfer) - status quo formula | 686 | 510 | 409 | 438 | 583 | 736 | 836 | 902 | 954 | 998 | 1,047 | 1,065 | 1,080 |
| Residual of 5% paid out for public services | 0 | 0 | 826 | 805 | 691 | 593 | 545 | 524 | 519 | 522 | 522 | 551 | 585 |
| Total Payout | 686 | 510 | 1,235 | 1,243 | 1,274 | 1,329 | 1,380 | 1,426 | 1,473 | 1,520 | 1,568 | 1,616 | 1,665 |
| 5 year average market average (pre-payout) | 25,458 | 25,081 | 24,706 | 24,854 | 25,480 | 26,576 | 27,608 | 28,526 | 29,463 | 30,409 | 31,363 | 32,324 | 33,294 |
| Dividend as a % of 5 year moving average | 2.69% | 2.03% | 1.66% | 1.76% | 2.29% | 2.77% | 3.03% | 3.16% | 3.24% | 3.28% | 3.34% | 3.29% | 3.24% |
| Residual as a % of 5 year moving average | 0.0% | 0.0% | 3.34% | 3.24% | 2.71% | 2.23% | 1.97% | 1.84% | 1.76% | 1.72% | 1.66% | 1.71% | 1.76% |
| Total payout of 5 year moving average | 2.7% | 2.0% | 5.00% | 5.00% | 5.00% | 5.00% | 5.00% | 5.00% | 5.00% | 5.00% | 5.00% | 5.00% | 5.00% |
| Per Capita Dividend * | \$1,120 | \$820 | \$640 | \$690 | \$920 | \$1,170 | \$1,330 | \$1,430 | \$1,510 | \$1,580 | \$1,650 | \$1,670 | \$1,680 |

*per capita dividend in dollars, rounded to the nearest \$10

POMV - payout 5%, status quo dividend, residual to public services (inflation-proofing stays in ER)

Status quo - MOMA volatility model projections as of 12/31/02

Updated with Mar 03 Financial Statements, and Spring oil forecast out to 2015, Callan 2003 Capital Market assumptions.

Estimated return 7.60% beginning in FY05, realized return, varies from 1.36 in FY03 to a high of 7.33 in FY13

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ATTORNEYS AT LAW

SAN FRANCISCO
LOS ANGELES
SACRAMENTO
ORANGE COUNTY
PALM ALTO
WALNUT CREEK
DENVER

2000 PENNSYLVANIA AVENUE, NW
WASHINGTON, D.C. 20006-1448
TELEPHONE (202) 887-1500
TELEFACSIMILE (202) 887-0763

NEW YORK
WASHINGTON, D.C.
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BRUSSELS
HONG KONG
SINGAPORE
TOKYO

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
Civil Division
P.O. Box 110300
Juneau, AK 99811-0300

Re: Alaska Permanent fund Corporation

RECEIVED

APR 21 1998

SIMPSON, THORNTON, EAST,
SORENSEN & LORENSEN

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.

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II. Constitutional Immunity

The 1988 Report concluded that the constitutional doctrine of implied intergovernmental tax immunity had been so narrowly interpreted over the years that it was unlikely to provide a reliable basis for arguing that any income received by a state was immune from federal taxation should Congress choose to impose such taxation. At one time, the constitutional doctrine of intergovernmental tax immunity held that, as a matter of constitutional relationship between the federal government and the states, the federal government may not tax the sovereign states. This doctrine has been so eroded over the years that it is difficult to determine what its remaining scope might be.

During our previous consideration of this issue, the Supreme Court decided *South Carolina v. Baker*, 485 U.S. 505 (1988), which held (among other rulings) that the doctrine of intergovernmental immunity did not bar a nondiscriminatory federal tax on interest earned by holders of state government-issued bonds ("[T]he States have never enjoyed immunity from all federal taxes considered to be 'on' a State."). Although that case did not deal with a federal attempt to tax a state or state instrumentality, but rather a state attempt to deal with a tax on bondholders, the Court offered a sweeping analysis of the doctrine of intergovernmental tax immunity, a discussion which might be characterized as dicta. Although the Court never addressed the question of the "extent to which, if any, States are currently immune from direct federal taxation," 485 U.S. at 523 n. 14, the decision includes the often-quoted caveats that "at least some state activities have always been subject to direct federal taxation", 485 U.S. at 523 n.14, and "at least some nondiscriminatory federal taxes can be collected directly from the States even though a parallel state tax could not be collected directly from the Federal Government." 485 U.S. at 523.³

We concluded that *South Carolina*, read in conjunction with the Court's expansive reading of the commerce clause in *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (1985), suggested that the Court recognized few restraints on the federal commerce or taxing powers over state activities. Nevertheless, we believed that the Court was likely to conclude that there was a limited set of core powers of sovereignty that would remain immune from the federal taxing power, such as state tax revenues, but that there was less comfort that the Court would not approve a

³ The Court defined "directly" with respect to a state tax on the federal government as "when the levy falls on the United States itself, or on an agency or instrumentality so closely connected to the government that the two cannot realistically be viewed as separate entities ..." and indicated that the same definition applied to a federal tax on a state. 485 U.S. at 523.

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III. Federal Taxation Does Not Reach Income Earned by an Integral Part of a State

We previously contended that the strongest argument was that the Fund and the APFC were an "integral part" of the state, and thus wholly outside the federal tax code. That is, the IRS has consistently taken the position that the federal income tax law does not impose income tax on income earned directly by a State or an entity that is an "integral part" of a State absent a specific statutory provision.

This is a separate argument from the constitutional doctrine of intergovernmental immunities, which is premised on the constitutional relationship between the federal government and the states.

In contrast, the "integral part" argument assumes that, if Congress so chose, it might be empowered to tax the states directly, but that careful review of the income tax laws reveals that Congress has not attempted to do so. At its most developed, the "integral part" theory argues that any congressional imposition of tax must be clear and unequivocal. The Internal Revenue Code expressly taxes corporations, but does not expressly tax states or political subdivisions, and there is no evidence that Congress ever intended the code to apply to states. The IRS had developed this theory in several precedential published rulings as well as numerous nonprecedential administrative interpretations and internal memoranda. See Report, at 27-39.⁵

gas production on Indian reservations by non-Indian lessees, Cotton Petroleum Corp. v. New Mexico, 490 U.S. 163 (1988) (describing the intergovernmental immunities doctrine as "thoroughly repudiated" by modern case law"); and whether state use taxes on bankruptcy sale proceeds unduly burden the processes of the federal bankruptcy court, California v. Sierra Summit, Inc., 490 U.S. 844 (1989).

⁵ See the Report, at footnotes 26 and 30, for a discussion of the varying forms of IRS interpretations and rulings, and their precedential weight. In this letter, we have included discussion of many Private Letter Rulings (PLR) which are written advice provided to taxpayers who submit written requests for rulings on specific legal issues based upon a specific set of facts. Under section 6110(j)(3), such private letter rulings are directed only at the taxpayer that requested the ruling and may not be used or cited as precedent. Since the IRS has substantially reduced its output of published guidance and no longer produces even general counsel memoranda (discussed at footnote 30 of the report), private rulings are a valuable window into the developing position of the IRS, particularly in areas such as this which are rarely the subject of published guidance and even more rarely litigated. Although nonprecedential, private letter rulings also can provide a basis for seeking a similar interpretation by the IRS with respect to similar fact patterns.

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subject to laws governing the conduct of state agencies, e.g., open records law, open meetings laws, and FOIA. The attorney general provided legal counsel.

An important factor was the source of funds — the entire assets of the MET consisted of actuarially-determined amounts paid by parents under pre-paid tuition contracts. MET was to invest the funds and guaranteed the college tuition of beneficiaries at some time in the future. The act expressly provided that the funds were to be used solely for the purposes of the trust and could not be used by the state for any other purposes. The assets of MET were not considered state money or state revenues, and were not subject to payment of full faith and credit obligations of the state (although the appellate court later determined that the reason for this may have been to give the trust broader investment powers than it otherwise would have). Another important factor was the destination of funds, which were to be paid out to beneficiaries. Moreover, upon dissolution, the assets would not go to the state but would be distributed pro rata to the investors, although state could claim any actuarially determined excess. The state was not legally obligated to make up any shortfall in funding, although it was authorized to do so.

The MET funds were segregated from state funds, although they could be pooled with state funds for investment purposes. Apparently, state treasury department employees actually handled the investments. The bank trust accounts were in the name of the state treasurer, with the state as agent for the trust. MET made an annual accounting to the state governor and legislature. Annual audits were conducted by the state auditor general. Fund payments were paid out through state warrants. Trust income was exempted from state taxes.

During our work on the 1988 Report, the IRS issued a private letter ruling rejecting the exempt status of the MET. PLR 8825027 (March 29, 1988). The IRS discussed the "integral part" theory only briefly, concluding that MET was not an integral part of the state. The key factors mentioned in the IRS ruling were that it was created as a corporation to operate independently from the state; the trustees' decisions could not be overridden by any state agency; the funds were not derived from the state, were not subject to the claims of the state's creditors, and were not considered state funds; the state could not loan, transfer, or use MET funds for any purpose; and the MET funds could be used only for the tuition payment or refunds to investors.

Michigan then filed returns and sued for a refund of the taxes paid. In the District Court, the parties stipulated the facts and filed cross motions for summary judgement. The District Court denied the refund claim, determining as a matter of law that the MET was subject to federal taxation. *Michigan v. United States*, 802 F. Supp. 120 (W.D. Mich. 1992). Michigan raised, and the court addressed, several possible

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Unfortunately, the 6th Circuit's decision is so over-inclusive in its argument and use of analogous legal tests that it is somewhat muddled, and to some extent confuses, rather than clarifies, the appropriate legal standard under the "integral part" theory. The 6th Circuit seemed to feel that it had to conclude that the MET was not only an instrumentality but also a political subdivision in order to conclude that it was an integral part of the state. The Court determined that the statutory description of the MET as a "public body corporate and politic" rendered it a state instrumentality. 40 F.3d at 818. The Court relied on an Advisory Opinion of the Supreme Court of Michigan that the grant of corporate powers to a state agency rendered it a "quasi-corporation" but that the agency nevertheless "remains an instrumentality of the State." *Id.* (quoting Advisory Opinion re Constitutionality of PA 1966, 380 Mich. 554, 575, 158 N.W. 2d 416, 425 (1968)).

The Court then reviewed the case law regarding whether an entity is a political subdivision or part of a state for tax purposes, concluding that the standard was whether the entity had been created by state authorities, acting within their constitutional powers, and had been delegated the right to exercise a part of the state's sovereign power for the purposes of carrying out state functions. The treasury regulations defined "political subdivision" as a division of the state which either is a municipal corporation or has been delegated the right to exercise part of the sovereign powers of the state. The Court concluded that the contractual obligations of the MET were no less than those of other entities determined by the courts to be political subdivisions, and that the contracting powers delegated to the MET empowered it to exercise essential governmental functions on behalf of the state. *Id.* at 825.⁷

Citing prior authorities⁸, the Court focused less on the creation and powers of the entity rather than its purposes, finding that the "real criterion" was whether the activities

⁷ Not surprisingly, this aspect of the Court's decision has been criticized as confused and inconsistent with the authorities relating to political subdivisions, primarily on the grounds that MET was not granted sovereign powers.

⁸ *Commissioner v. Shamberg's Estate*, 144 F.2d 998 (2d Cir. 1944), cert. denied, 323 U.S. 792 (1945) (port authority is political subdivision even though it had no power to impose taxes or pledge the credit of the state and was not subject to debt-limiting provisions of state constitution). Critics question how MET can be a political subdivision without sovereign powers. The political subdivision argument is not likely to be strong outside the 6th Circuit, due primarily to the lack of sovereign powers. The case law is quite old that a political subdivision must have sovereign powers, defined as the power to tax, the power of eminent domain, and the power to regulate (the police power). The case cited, *Shamberg's Estate*, is the leading "political subdivision" case. It dealt with a port authority that had eminent domain and police powers, but not the power to tax -- it was held to be a political subdivision. Other political

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speculated that it could not be ruled out for the future), and concluded that, on balance, the presence of five factors led to the conclusion that it was a state instrumentality.¹⁰

The Court also distinguished *United States v. Maryland Savings-Share Insurance Corporation*, 308 F.Supp. 761 (D. Md.), *rev'd on other grounds*, 400 U.S. 4 (1970) ("*MSSIC*"), which was discussed in our Report at pages 85-90. In *MSSIC*, the Supreme Court upheld the lower court's conclusion that a nonprofit insurance corporation chartered to insure savings and loan accounts was not exempt from federal taxation as an instrumentality. The 6th Circuit pointed out that that *MSSIC* was a private corporation, organized by and for savings and loan members, with a Board largely comprised of elected directors. 40 F.3d at 827-828. In contrast, the MET was a public instrumentality, had a board appointed by the governor, and was delegated authority to contract on behalf of the state.

The court also rejected both of the government's arguments that the trust could not be an integral part of the state because its corporate form made it functionally independent and because the source and earmarking of funds made it fiscally independent. The Court determined that it was "immaterial" that the state chose to use a public corporation rather than to assign the functions to a traditional department. 40 F.3d at 828. The Court cited the example of the U.S. Postal Service as a corporate entity that did not become taxable by virtue of its corporate form. 40 F.3d at 828-29. Similarly, the Court rejected the argument that the source or earmarking of funds was determinative, again citing the example of the U.S. Postal Service, the TVA, and ports authority as examples of governmental instrumentalities that obtain funding from private sources and are earmarked for the performance of public functions that the agencies were created to perform. The Court was also critical of the government's focus

¹⁰ Critics argue that this six-factor test of "instrumentality" is irrelevant for two reasons. First, it was developed in a different context involving different law, legislative history and intent, and different requirements (ERISA and governmental plans). This argument was made by the IRS in criticizing the *MET* case in subsequent rulings. See, e.g., PLR 9809013 (Nov. 7, 1997); PLR 9706006 (Nov. 8, 1996); PLR 9627016 (April 5, 1996); PLR 9622019 (Feb. 28, 1996). The IRS's challenge is a bit disingenuous, however, since it was the IRS itself that issued a series of G.C.M.s and rulings relying on this six-factor test for purpose of section 115. See, e.g., G.C.M. 34704 (Dec. 2, 1972); G.C.M. 34502 (May 2, 1971); P.L.R. 8820030 (Feb. 16, 1988); PLR 8740015 (July 2, 1987); PLR 8650017 (Sept. 10, 1986). Second, critics argue that "instrumentality" is not synonymous with "political subdivision" or "integral part of a state", and that instrumentalities are not even certain of exemption under section 115. See, e.g., Letter to Editor from Prof. Ellen P. April, 66 Tax Notes 121 (Jan. 2, 1995) (citing *Maryland Savings-Share Insurance Corp. v. United States*, 400 U.S. 4, 7 n.2 (1970) ("*MSSIC*") and Rev. Rul. 77-261, 1977-2 C.B. 34).

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1. Florida Hurricane Catastrophe Fund

In 1995, Florida successfully obtained a private ruling which held that the Hurricane Catastrophe Fund ("CAT Fund"), a trust fund created by state law, would be considered an integral part of the state. PLR 9507037 (Nov. 4, 1994). It is described as a "trust fund under state law", *i.e.*, a separate legal entity, but it does not appear from the ruling or the state statute that it was structured as an actual trust but rather as a state fund. Participating insurers were to pay premiums into the fund, and would be reimbursed for a percentage of losses resulting from certain events. The state also imposed an assessment on a broader class of insurers, including many nonparticipants, with the revenues to be earmarked for the fund.

It appears that the state was not liable if the fund proved to be insufficient, although if that occurred, local governments could issue revenue bonds for the benefit of the fund, and the bonds would be backed by the fund's future revenues. It appears that monies in the fund were not subject to the state's creditors. The ruling does not indicate whether the fund was treated as a state account for accounting purposes, or whether there was any duty to provide financial reports or to be audited by the state. The state legislature also could appropriate funds from the fund for grants to local governments and nonprofits for preparedness programs. All assets of the fund would revert to the state upon termination of the fund. It was governed by the State Board of Administration, a three-member board comprised entirely of state officials. Operations of the fund were conducted by fund employees and contract advisors. It appears that the board was not created for the purposes of governing the fund, but rather was a pre-existing body that had been created under the state constitution to administer certain special purpose tax revenues, and also could be delegated other powers under state law.

The ruling cryptically states that "[t]he method of accounting for moneys related to certain operations does not by itself determine whether the operation is an integral part of the state or an entity separate from the state." Nothing in the ruling discusses the method of accounting for funds. It is known that the fund was very controversial and was initially rejected by the IRS. This comment may be an observation that the fund was actually a state fund, rather than an independent fund, and that that distinction alone did not resolve the issue of integral part. Certainly, past IRS rulings have found that the existence of a separate legal entity or independent entity was a determinative factor in finding that an entity was not an integral part of the state.

The ruling does rely on the state's exercise of its taxing power and "significant contribution" of monies to the fund, the state's power to appropriate monies from the fund for certain specified purposes, and the state's receipt of the assets upon dissolution as significant factors in concluding that the state has a "financial interest" in the fund. Another factor cited by the ruling was that the monies could only be used for purposes

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kept in a trust fund outside the state treasury. The fund revenues came principally from annual premiums for the policies. The fund was authorized to levy annual assessments on insurers in the state. The law also created a special mortgage recording fee to be earmarked for the fund. If the fund was insufficient to pay claims, the law also provided for increased assessments on insurers, or additional special assessments, or surcharges on hurricane policy premiums. Additionally, the law authorized creation of a bond fund within the state treasury, and authorized the commerce department to issue state debt obligations which would not be backed by the full faith and credit of the state, as well as other further revenue bonds which would be backed by the full faith and credit of the state under certain limited circumstances. The bond fund would make loans to the trust fund to support its operations. Upon dissolution of the fund, any remaining monies after settlement of any claims, would revert to the state general fund.

The ruling concluded that the state exercised significant control over the fund. All board member would be state officials or nominated by state officials and confirmed by the state senate. The initial plan of operations was subject to legislative review. It would be administered by a state department and was required to report annually to the state insurance commissioner. Employees were considered employees of a state department. The state had made a substantial financial commitment to the fund through assessing the mortgage recording fee, levying an annual assessment on insurers, providing for potential surcharges on premiums, pledging full faith and credit for certain debt obligations, and receiving the assets of the fund upon dissolution. Based on the elements of state control and financial commitment, the IRS concluded that it was an integral part of the state.

3. California Earthquake Authority

The IRS revisited the issue with the California Earthquake Authority ("CEA"), issuing, revoking, and reissuing rulings as the state amended its proposed program to satisfy the IRS. Initially, after about six months of negotiations, the IRS issued a private ruling determining that the CEA was an integral part of the state. PLR 9622019 (Feb. 28, 1996). As described in the ruling, the CEA was established by a statute which created both an agency and the fund to provide earthquake coverage. Private insurers were required to offer coverage in one of two ways — either directly, or by participating in the fund and issuing a fund policy to be administered and serviced by the private insurer. Premium rates for fund policies were subject to approval by the state and subject to public rate-making procedures.

The fund was governed by a board consisting of three voting members, all state officials, and two nonvoting members, both legislators. The board members could designate a state employee to serve in their place. The board also had an advisory panel.

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Other factors cited in the ruling were the significant government interest set forth by the state in providing assistance to its citizens and economy in the event of natural disasters of the magnitude of an earthquake. The state also had argued that this plan represented an exercise of the state's power to regulate an industry, and that the fund was as valid an exercise of state power as the regulatory alternatives.

Two months later, the IRS revoked the ruling letter for further review of the issue. Letter dated April 30, 1996, LEXIS, FEDTAX, TNT, 96 TNT 102-54. It appears that this revocation may have been prompted by the state legislature's consideration of further legislation that threatened to significantly revise the CEA.

The state then conducted an unusual high pressure campaign, seeking assistance from the White House and imposing pressure through its congressional delegation. Legislation was introduced in Congress to grant an express federal tax exemption to the CEA.

Then in June, 1996, the IRS reinstated the ruling granting exemption as an integral part of the state without discussion. PLR 9641010 (June 25, 1996) (reinstating PLR 9622019). The ruling noted that the state legislature was considering legislation affecting the fund, and warned that the IRS was not giving any opinion as to the continuing exempt status of the fund if the legislation were to be enacted.¹¹

After the California legislature further amended the statutory scheme, the state again sought a reaffirmation of the IRS's ruling. Subsequently, the IRS again issued a ruling to California, concluding that after numerous statutory changes, the CEA was an integral part of the state. PLR 9706006 (Nov. 8, 1996).

In general, the legislative amendments did not really address the issues of either state control or financial interest, which apparently were the chief concerns of the IRS. The chief purpose of the amendments appears to have been to forbid the CEA from declaring bankruptcy, to strengthen the capitalization of the fund, and to create additional "tiers" of remedy in the event that the assets of the fund proved inadequate to satisfy claims, including various additional surcharges on participating insurers. The

¹¹ Published accounts of the California Earthquake Authority tax negotiations, discussed below, and private discussions with Florida, Hawaii, and California state officials and IRS officials reveal that the IRS was very concerned about the overwhelmingly private benefit characteristics of these funds. The IRS required amendments, if necessary, to strengthen state control, to impose requirements that assets revert to the state upon dissolution (although given the nature of these funds, the possibility of remaining assets is so remote as to be meaningless), and most important, to require a significant state financial commitment.

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had its own officers and employees, and was not under the control of any state agency or any one political subdivision. PLR 9009063 (Dec. 8, 1989).¹⁴

One distinction between these rulings and other favorable rulings is that these involve public corporations, while other favorable rulings involve trusts or other entities of more nebulous legal status. It is difficult, however, to determine the significance of corporate status, especially when the IRS does not elaborate on the issue, or when the IRS eventually finds the entity to be exempt under another provision. For example, while the IRS considered corporate status to be a negative factor for MET, it apparently was not the determinative factor in concluding that it was not an integral part of the state.

Certainly, there are other rulings that conclude that a corporation can be an integral part of the state. For example, the Hawaii hurricane fund was organized as a public corporation, yet the IRS did not raise that as an issue. It would appear generally that while corporate status is a significant factor for the IRS, it may be neutralized by sufficient evidence of state control and, in the words of the IRS, "domination." See, e.g., G.C.M. 39601 (Jan. 30, 1987) (lawyer trust fund); G.C.M. 38921 (Nov. 26, 1982) (housing authority).¹⁵ Yet it is extremely difficult to predict when separate organizational structure will be determinative or what level of government control renders a separately organized entity an integral part of the state.

Also, if a corporation cannot by definition qualify as an integral part of the state due to its separate legal existence, then the same rationale should apply to a trust. Yet there are several rulings that conclude that trusts can be integral parts of a state. See Rev. Rul. 87-2, 1987-2 I.R.B. 4 (1987).

In one recent ruling, the IRS held that a trust was an integral part of the state regardless of the fact that it was created as a separate and distinct entity apart from the political subdivision. The IRS reviewed a trust set up by a municipality to pay retiree medical benefits. PLR 9809013 (Nov. 7, 1997). Although the municipality asked for a ruling under section 115, the IRS concluded that section 115 did not apply because the

¹⁴ See also PLR 8934052 (May 21, 1989) (arts commission is "corporate and politic," therefore not integral part).

¹⁵ See also PLR 8923056 (Feb. 22, 1989) (An unincorporated city economic development board was not an integral part because the board could hire its own staff who were not considered city employees. The board was created under state statute and funded by taxes, board members were appointed by the city, the city budgeted expenses, the board submitted financial reports to city, city audited the board).

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Yet another group of rulings echo the MET ruling in considering the source and/or destination of the assets and income of the entity. In 1994, the IRS held that a trust fund created by a state court to collect private contributions to pay for judges' portraits was an integral part of the state. PLR 9439008 (June 30, 1994). The funds were from private sources and there was no financial commitment on the part of the government. A key factor in the ruling, however, were that the court created the trust and controlled it through its ability to select and discharge the state employees who controlled the funds and the trust. Moreover, reflecting the IRS's interest (sometimes) in the destination of funds, the ruling was expressly made contingent on trust documents being amended to provide that any funds remaining after the purposes were met would be delivered to the government's general fund. The ruling concluded that the trust was an integral part of the state, since it was created by the court, controlled by the court officers, and upon termination, any remaining funds would go the state general fund.

In another ruling, the IRS considered a "lifeline" fund, created by the state to subsidize the utility rates of the poor, and concluded that it was an integral part of the state. The fund was created by statute, although it is unclear from the ruling what its legal status was. The funds came from a state-ordered surcharge on utility bills, and were invested until paid out to needy individuals. It was administered by a committee appointed by a state commission. No state officials served on the governing committee. The fund's budget was subject to state review, and annual reports were submitted to the legislature. If terminated, assets would be distributed as ordered by a state public utilities commission, but could not revert to private interests. The IRS concluded that the fund was an integral part of the state due to the state's control over the creation, operation, funding, and supervision of the fund. PLR 8931042 (May 8, 1989). The fact that the assets and income were paid out entirely to private individuals did not seem to merit discussion.

Another recent ruling addressed funds created by state officials from the proceeds of litigation judgments or settlements. The state created two funds to hold settlement payments received as a result of litigation by the attorney general. PLR 9733003 (May 9, 1997). A fund was created in the state treasury to hold litigation judgments or settlements, and was controlled by the treasury department. Distributions from the fund were made pursuant to court order. All income from investment of the fund was deposited in the fund. Fees were paid to the treasurer for investment and administrative services. The fund consisted of two litigation settlements, funds A and B. Settlement A was from state litigation against a trade school. The state court's order required the Attorney General to create a fund, fund A, to receive payments from the defendants for civil penalties, attorneys fees, and restitution to students of the school. In other words, the proceeds in the fund were to be paid as restitution to the individual claimants. The second fund, fund B, consisted of settlement proceeds of antitrust cases

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private benefit. It is unclear why the IRS has adopted this analysis, but it is equally clear that not only is it now a key element under section 115, there is a not insignificant likelihood that the IRS may well import it into an "integral part of the state" determination as well.

D. Summary Regarding Integral Part Theory

Overall, we believe that these developments have helped to further elucidate the courts' and the IRS's rationale under the integral part theory in ways that generally are favorable to the fund and the APFC. The MET decision is particularly generous, as are the disaster fund rulings.

Ten years after the Report, the fact that APFC is structured as a corporation continues to give some cause for concern. Commentators have argued that the use of a separate entity, such as a corporation or a trust, must preclude integral part status, and must be analyzed under section 115. This does not seem to be the IRS position, however. Although the rulings of the last 10 years continue to be inconsistent on this point, it appears that, given sufficient indicia of control and financial commitment by the state, a corporation or trust is not automatically precluded from being an integral part of the state.

In this case, the assets and income are not those of the corporation, but rather belong to the State. As a matter of statute, APFC is simply the manager of the Fund assets. This has been reinforced through the 1992 amendment of section 37.13.030 which now plainly clarifies that the assets are managed and invested by APFC, rather than "allocated to" APFC. Similarly, the annual report clearly reports income and assets as those of the Fund, and not the corporation.

Certainly, it would appear that - apart from the corporate structure issue - state creation, control and domination, and declaration of state purpose are essential factors. Similarly, the MET and disaster fund rulings seem to teach that some not significant part of the assets must come from the state, and that it must have some financial risk in the enterprise. The IRS's MET ruling reflects the IRS's evolving but erratic interest in the destination of funds as well although this did not appear to concern the 6th Circuit.

A comparison of MET with the Alaska Permanent Fund and APFC is both instructive and reassuring. The key characteristic of the MET and similar prepaid tuition programs, which gives pause to the IRS and, we suspect to any court, is the source and destination of the program funds at issue. The MET may have had all the appearances of being a part of the state, but it was still wholly a private activity conducted by private investors for the benefit of private beneficiaries. The state

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skeptical of its reliance on the political subdivision cases in particular, or its apparent finding that "instrumentality" status is sufficient for exemption under the "integral part" theory.

Although it is difficult to reconcile the IRS's continuing hostility to prepaid tuition plans, which the IRS labels as private investment schemes that seek improperly benefit from the state's exemption, with its generous position on disaster insurance programs, a key distinguishing factor is the element of the state's financial commitment to the enterprise. The IRS insisted that the disaster programs include a significant level of state financial commitment as a source of funds, such as through contributions of funds, earmarking of certain tax or fee revenues, or allowing certain debt obligations to be backed by the state's full faith and credit. In the case of the Fund, it is an essential distinction that the assets clearly are those of the State.

IV. Section 115 Exclusion From Income

The previous Report concluded that the Fund might alternatively claim exclusion of income under section 115, although that position was not entirely free from doubt.¹⁷ Section 115 requires: (1) that the income of an instrumentality be derived from an essential governmental function, and (2) that the income accrue to the State. We noted that the few judicial authorities did not clearly support this argument, yet the IRS appeared to be more liberal than the courts in applying section 115 in the ruling context, particularly with respect to finding "accrual" of income by the State. Since 1988, section 115 has been discussed on only one reported case, *Michigan v. United States*, 802 F.Supp. at 120, described above, which was reversed by the appellate court without discussion of section 115. The IRS has issued one precedential ruling and approximately 170 nonprecedential rulings in this area.

A. Michigan Educational Trust

In *Michigan v. United States*, the state made the alternative argument that the MET's income was excluded from gross income under section 115. In the private ruling, the IRS did not discuss the essential governmental function prong of the statutory test, concluding rather that the accrual requirement was not met because the income served private interests that were more than incidental to the public interest. PLR 8825027 (March 29, 1988). The MET provided direct economic benefits only to

¹⁷ Section 115 and "integral part" theory are not merely alternative arguments. The distinction has important consequences — if the income were excludible under section 115, APFC would be required to file tax returns.

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Rev. Rul. 90-74 illustrates the typical ruling. The political subdivisions agree to create a pooled self-insurance entity, which could be a corporation. See, e.g., PLR 9646026 (Aug. 20, 1996); PLR 9101005 (Sept. 1, 1990).¹⁸ In some cases, the pooling entity was created or authorized by state statute. This did not appear to be a necessary factor, although it supported the finding of essential government function. Each participating body authorized participation in the entity. The board was elected by the member political subdivisions, and controlled the entity. Typically, the state treasurer managed the fund, although this was not the case in all the rulings. Each member contributed funds from general revenues based on actuarial risk determinations. The entity received investment income. The entity reimbursed members for casualty losses. In the event of dissolution, assets would be distributed to member political subdivisions. The rulings held that the investment of funds was a necessary incident of the power of governmental entities to raise revenue and meet expenses. The rulings also concluded that insuring political subdivisions against risk arising from governmental activities also was a governmental obligation. The rulings determined that risk pooling (rather than purchasing commercial insurance) fulfilled the obligations of the political subdivisions to protect their financial integrity. A universal requirement was that no private interests participated in or benefited from the operation of the entities. The IRS concluded that the entities performed an essential governmental function. Regarding the accrual requirement, the rulings observed that, since income was used to reimburse losses incurred by the participating political subdivisions or to reduce their annual fees, and did not benefit private interests, and since assets would be distributed to members upon dissolution, the income accrued to a political subdivision. Any private benefit to employees (i.e., payment of claims) from insuring against these risks was incidental to the public benefit.

C. Section 115 Rulings

Since 1988, the IRS has issued over 170 private rulings under section 115, triple the number during the previous decade. These rulings generally look to *Maryland Savings Share Insurance Corp. v. United States*, 308 F. Supp. 761 (D. Md.), *rev'd on other grounds*, 400 U.S. 4 (1970) ("MSSIC") and Rev. Rul. 77-261, 1977-2 C.B. 45 for guidance.

¹⁸ Apparently, even if these self-insurance entities are not organized as separate corporations, they are treated as such by the IRS (absent exclusion under section 115) because unincorporated entities primarily involved in insurance activities are taxable as corporations. Rev. Rul. 83-132, 1983-2 C.B. 270.

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were school district employees. The board held legal title to cash and other property contributed by the members. The board could enter into contracts for administrative and custodial services. The investment goals were safety, liquidity, and return on investment. The income could not accrue to a private party. Upon dissolution, assets would be distributed to the members.

The IRS concluded that "[t]he investment of positive cash balances by a state or political subdivision thereof in order to receive some yield on the funds until they are needed to meet expenses is a necessary incident of the power of the state or political subdivision to collect taxes and other revenues for use in meeting governmental expenses." Therefore the fund performed an essential government function. Since no part of it accrued to any private party, members could redeem their interest at any time except during emergency situations, and the dissolution clause provided that the assets returned to members. The IRS held that the income accrued to a state or political subdivision. The fund was a wholly-owned instrumentality of the political subdivisions, and its income was excluded under section 115.

This approval of governmental investment activities as essential governmental functions has been criticized by some commentators who favor restricting state exemption from federal taxation. It also potentially creates some tensions with the IRS position on programs like the prepaid tuition programs, where the IRS takes the position that it is not an essential governmental function for the government to lend its own exempt status to the investment activity of individual investors. The IRS faces this difficulty particularly in reviewing programs in which the state indirectly conducts investment activity on behalf of individual beneficiaries.

2. Litigation Settlement Funds

As discussed above, several rulings address funds created by state officials from the proceeds of litigation judgments or settlements. In one case, a state created two funds to hold settlement payments received as a result of litigation by the attorney general. PLR 9733003 (May 9, 1997). Settlement A was from state litigation against a trade school; the proceeds in fund A were paid as restitution to the individual claimants who were former students of the school. The second fund, fund B, consisted of settlement proceeds of antitrust cases in federal court brought by the state as *parens patriae* for its residents. The plaintiff class members who were to receive the settlement proceeds in fund B were the state and municipalities.

The IRS seemed to conclude without discussion that the funds were an essential governmental function. Applying the accrual test, however, the IRS determined that only the income of fund B was excluded from gross income under section 115, since

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D. Summary of Section 115

It is clear from the rulings that the IRS adopts a very broad view that an "essential governmental function" is whatever the state legislative says it is. Most rulings quote Rev. Rul. 77-261, which stated the premise that "it may be assumed that Congress did not desire it any way to restrict a state's participation in enterprises that might be useful in carrying out those projects desirable from the standpoint of the state government which, on a broad consideration of the question, may be the function of the sovereign to conduct." *See, e.g.*, PLR 9669634 (Dec. 1, 1995).

For purposes of the accrual test, the IRS has long looked to the destination of the funds and more particularly, looks for benefits to private individuals, which apparently is fatal under section 115 (although apparently not under the "integral part" theory, under the *MET* decision and disaster fund rulings). Certainly in the *MET* ruling, the IRS made its decision based on a private benefit analysis without any actual discussion of accrual. This seems to reflect a trend toward emphasizing a concern with benefits to private individuals over the historical understanding of the accrual test (which required that the income must accrue in a technical sense). *See* Rev. Rul. 90-74. To some extent the IRS appears to use the private beneficiary test as a separate requirement from the accrual test, rather than a part of it, *see, e.g.*, PLR 8825027 (*MET*). On the other hand, there are numerous rulings in which the IRS has granted section 115 exclusion to governmental pension plans, which exclusively pay benefits to individuals. *See, e.g.*, G.C.M. 34704 (Dec. 2, 1971); PLR 8825027 (July 2, 1988). The IRS has not explained how it distinguishes pension plans from prepaid tuition plans in terms of the applicable criteria. One possible explanation is that the rulings also appear to reflect a trend toward examining whether the activity benefits the government financially by relieving it of some present or future financial obligation, which can have the effect of permitting private benefit which is considered "incidental" to the public benefit, resulting in an even more generous application of section 115.

Although there is no authority for this argument, it may be possible to argue under section 115 that any income that does not benefit private parties (*i.e.*, is not transferred to the dividend fund) should be excluded under section 115. We find no rulings addressing whether income can be allocated in this fashion, although the *MET* ruling determined that the payments by the state and investors into the fund were excludible, presumably as some form of "capital" contribution. Section 115 does not purport to characterize all of the income of an entity as taxable or excluded from gross income. Rather it provides that "gross income does not include" income of a certain character. Arguable, income that in fact accrues to the state should be excludible, even if the income that ultimately benefits private persons might not be.

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VI. Conclusion and Recommendations

We continue to recommend that the State take the position that the Fund and APFC are integral parts of the state, and thus not subject to federal taxation, relying on the authorities cited in our prior Report and the MET decision. We recommend that section 115 be presented as an alternative basis for exclusion of income from federal taxation, relying on the authorities cited previously and Rev. Rul. 90-74.

The many rulings issued by the IRS, while not authoritative, are nevertheless instructive. It is clear that many of the factors discussed in rulings relating to legislative purposes, governmental function, and state control are present in the Fund and APFC. See Report at 45-64, 104, 122-25. The recent rulings reinforce the importance of these indicia of state creation, control and domination. While we would reiterate our preference that the Fund be managed by an agency rather than a corporation, the statutory amendments and other changes in the APFC's mode of doing business have done much to relieve this concern. The several rulings granting integral part status to corporations also indicate that although this may be an important threshold consideration for the IRS, it does not appear to be determinative given sufficient evidence of state control and financial commitment.

We continue to be concerned about the potential perception of the dividend fund program as an improper private benefit, particularly in light of the wide-ranging discussion about the future of the Fund and the dividend program. While private benefit has always been an element of the accrual test under section 115, it increasingly appears to be an important criterion of independent significance. The rulings suggest that private benefit is simply impermissible under section 115, other than that incidental to the public purpose (e.g., payment of state employee insurance claims under a pooled insurance program). It is unclear to what extent the income of the Fund, although it clearly accrues to the State, might be considered to ultimately benefit private beneficiaries.

The developments of the last ten years also have revealed the surprising extent to which this concern with private benefit seems to be influencing the IRS' interpretation of the "integral part" theory. Since that theory has been developed in only one case, MET, which the IRS rejects, the IRS presently is to a great extent in a position to interpret "integral part of a state" as it chooses, constrained only by its own prior (and reversible) rulings. On the other hand, the disaster fund rulings seem clearly to suggest that private benefit is not a bar to an entity being characterized as an integral part of the state. In cases where there is significant private benefit, the IRS appears to be willing to overlook it if there is not only sufficient evidence of public purpose and state control, but also a significant state financial commitment such that the assets of the state are at risk in the enterprise. Although this focus on the state's financial commitment does not

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State Capitol
Juneau, Alaska 99801-1182

(907) 465-3732
Toll Free: 1-888-461-3732
Fax (907) 465-2652

E-mail: Senator_Georgianna_Lincoln@legis.state.ak.us

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SPONSOR STATEMENT SJR 19
Permanent Fund Dividend Protection Act

SJR 19 proposes a constitutional amendment that would give constitutional protection to the dividend program of the Alaska Permanent Fund. It ensures the Permanent Fund Dividend will endure.

This resolution is a reiteration of the popular initiative proposed by former Governor Jay Hammond late last year. SJR 19 would require a majority vote by Alaskans before the Legislature could spend any of the Permanent Fund earnings that currently go to the dividend or to inflation proof the fund.

The Resolution would also maintain the distribution formulas used to calculate the dividend that were in place on July 1, 2002. This will further guarantee the Permanent Fund Dividend Program will remain intact.

It has been said that permanently protecting the dividend program might make the fund susceptible to federal taxation. Section 3 of SJR 19 will immediately repeal Sections 1 and 2 if the IRS determines the fund is taxable.

The Permanent Fund dividend represents approximately one-eighth of Alaska's economy, and is the most direct link between the people of Alaska and the resources they own. With the ongoing budget deficit, it is in the interest of Alaskans to constitutionally protect our dividend on which many people depend and with which they contribute to a healthy economy.

Hyder
Kake
Kaltag
Kasaan
Katalla
Kenicott
Kenny Lake
Klawock
Klukwan
Koyukuk
Labouchere Bay
Lake Minchumina
Lime Village
Livengood
Long Island
Mankomen Lake
Manley Hot Springs
Marshall
McCarthy
McGrath
Medfra
Metlakatla
Mentasta
Minto
Nabesna
Naukati Bay
Nenana
Nikolai
Northway
Nulato
Ophir
Point Baker
Polk Inlet
Port Alice
Port Protection
Rampart
Red Devil
Ruby
Russian Mission
Shageluk
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Stony River
Strelna
Tahotna
Tanneross
Tanana
Tatitlek
Tazlina
Telida
Tenakee Springs
Tetlin Junction
Tok
Tonsina
Tyonek
Utopia Creek
Venetie
View Cove
Waterfall
Whale Pass
Wiseman
Yukutat



MAY 19 2003

Alaska State Legislature

Please enter into the record my testimony to the ___Senate State Affairs (committee name)

on _____SJR19 _____, dated 051303

I would like the following message to be added as written testimony to SJR 19.

Please support SJR 19.

This legislation will put an end to all the proposals to raid the Permanent Fund. The PEOPLE of Alaska have said 'NO' to such raids every time they are proposed, but it would only take ONE instance of inattention to allow the Permanent Fund to be lost. Please vote in support of SJR 19.

Your constituents WILL remember that you did.

Joann Odd
P.O. Box 39296
Ninilchik, AK 99639

MAY 19 2003



Alaska State Legislature

Please enter into the record my testimony to the Senate State Affairs Committee
committee name

Committee on SJR 19 Date, 5-13-03
bill # / subject

With all the numerous Permanent Fund bills submitted before the 23rd legislature SJR 19 is one of the best. It can save the permanent fund and not raid the fund as others will.

Please support SJR19 for the continuation of a legacy for the children of Alaska.

We must guarantee a vote by the people of Alaska before we spend any permanent fund money. After all it is the Permanent Fund not the Temporary Fund.

Signed: Malcolm G. McBride

Testifier

4 Voter household

Representing (optional)

1111 Fifth Avenue, Kenai, Alaska 99611

Address

907-283-7409 or 398-9177

Phone number



Alaska State Legislature

Please enter into the record my testimony to the Senate State Affairs Committee on SJR 19 / Constitutional Amend.: Permanent Fund Income. Date: May 13, 2003

ALASKA VOTERS ORGANIZATION RESOLUTION 2003-10

A Resolution to the 23rd Alaska State Legislature in SUPPORT OF SJR 19, which authorizes an election to decide if the voters of Alaska wish to approve a Constitutional Amendment, that will protect the Permanent Fund Dividend program.

WHEREAS, most candidates elected in November 2002 promised they would not touch the Permanent Fund, without a vote of the people; and

WHEREAS, the Legislature and Governor are proposing appropriations from the Permanent Fund earnings, which is in opposition to the intent of the 1999 advisory vote and election promises made during the 2002 election campaign; and

WHEREAS, the legislature has failed to recognize the direct correlation between increased state spending and reduced oil royalty payments being the underlying reason for the growing budget deficit; and

WHEREAS, the legislature has continued to fund our state government at an unsustainable level, by making annual withdrawals from the Constitutional Budget Reserve; and

WHEREAS, the legislature continues to deplete our Constitutional Budget Reserve and has failed to submit any plan to repay this "rainy day account", as required by the Alaska Constitution; and

WHEREAS, the annual Permanent Fund Dividend has become a huge economic engine most business owners and Alaskan citizens rely on each winter; and

WHEREAS, 83% of voters in the 1999 special advisory election clearly said they could spend their dividend better than the government and rejected the option of legislative appropriation of the Permanent Fund earnings; and

WHEREAS SJR 19 would insure that the fund's principle remains protected through inflation proofing; and

WHEREAS, if approved by the legislature, SJR 19 will put the question of whether the Permanent Fund Dividend program should be Constitutionally protected on the ballot for all citizens of Alaska to vote on; and

WHEREAS SJR 19 would give the legislature much needed direction to solve the most serious problem currently facing our state;

NOW, THEREFORE, BE IT RESOLVED by the Alaska Voters Organization, Board of Directors, that SJR 19 be approved by the 23rd Legislature and put on the ballot for a vote of the people; and be it

FURTHER RESOLVED that the legislature should prioritize spending and make the necessary cuts required to obtain a government of the size and cost that Alaska can afford, without negatively impacting those citizens most at risk;

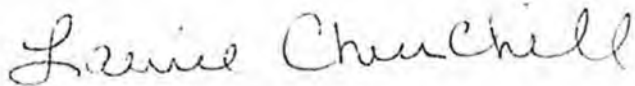
Adopted by the Alaska Voters Organization Board of Directors; this 6th day of May 2003.

Signed:



Mike McBride,
Board President

Attest:



Laurie Churchill,
Board Secretary

Alaska Voters Organization
PO Box 2016
Kenai, Alaska
99611-2016

(907) 776-8008
akvoters@uci.net
www.akvoters.org



Alaska State Legislature

Please enter into the record my testimony to the Senate State Affairs
committee name

Committee on SJR 19, dated 5/13/03
bill # / subject public hearing date

Signed: Laurie Churchill
Testifier

Representing (optional)
PO Box 7043 NIKISKI AK 99635
Address

907-776-3499
Phone number

Dear Legislators:

I am in favor of the passage of this bill because it protects the PFD and prevents it from being tapped without a vote of the citizens of Alaska. It will help to keep the permanent fund; PERMANENT After all the PDF does belong to the people so why shouldn't we have a say on how the government spends our resources.

I was very disappointed that the bill HJR3 was held up in committee because it would have required a 60%, of Alaskan voters to pass government spending. This bill lowers that figure to a 50% vote but SJR19 will at least give Alaskans a voice. I have been hearing an outcry from the mainstream Alaskan on what this government has been implementing so I recommend that if all of our legislators wish to remain in public office for another term that they remember what they promised the people when they were campaigning. No new taxes, to protect the PFD and to cut the size of government. Please remember that you were put in Juneau to serve the people of this state. I thank you for your time and I pray for a result that will accommodate the majority of the people of Alaska and not special interest groups.



Alaska State Legislature

Please enter into the record my testimony to the SJR19
committee name

Committee on STATE AFFAIRS, dated MAY 13, 2003
bill # / subject public hearing date

Signed: Petra Falkenberg
Testifier

Self
Representing (optional)

Box 3293 Kenai,
Address

(907) 283-7858
Phone number



Alaska State Legislature

Please enter into the record my testimony to the Senate State Affair Committee
committee name

Committee on SJR 19, dated MAY 13, 2003
bill #/subject public hearing date

Please PASS this legislation!

This resolution supports the will of a great majority of your Alaskan constituents.

This resolution should be passed in order to give Alaskan citizens a chance to express their will on this important issue.

Fulfill the wishes of your constituents - Quit playing politics with the PFD - Listen to the people who elected you and simply

PERMIT THE PEOPLE OF ALASKA TO EXPRESS THEIR WILL WITH A CONSTITUTIONAL AMENDMENT TO PROTECT THE PERMANENT FUNDS!

Signed:

James [Signature]
Testifier

- Self -

Representing (optional)

Po Box 7043, NIKISKI, AK 99635
Address

907-776-3481
Phone number



Alaska State Legislature

Please enter into the record my testimony to the Senate State Affairs
committee name

Committee on SJR 19, dated 05-13-03
bill # / subject public hearing date

Please pass SJR 19. We already spend 2.5-times for State government ~~as~~ per person as the next most expensive State and that is absurd. This will restrict available funds for additional and unnecessary State spending.

And the public needs the money to spend individually to enhance the general economy of the State.

There are 60 other "pots of money" which can be re-directed to general fund expenditures.

Signed: Paul M. Kime
Testifier

Representing (optional)
POB. 334 Ninilchik, Alaska
Address

907-567-4388
Phone number

SJR

20

SENATE COMMITTEE REPORT
First Committee of Referral

DATE: 5/10/03

FURTHER: Health, Education and
 Social Services

Date of 5-Day Notice: 24 hr. rule
 (in accordance with Uniform Rule 23)

DATE TURNED
 IN TO OFFICE: 5/17/03

State Affairs Committee considered SENATE JOINT RESOLUTION NO. 20

SJR 20 US COAST GUARD ROTC IN ALASKA

Relating to the establishment of Reserve Officer Training Corps programs in Alaska by the United States Coast Guard.

and recommends:

- be replaced with _____ CS SJR 20 (STA)
- adopt previous _____ CS _____ (_____)
- attached amendment(s)
- adopt Letter of Intent by _____ Committee
- further referral to _____ Committee

Senate Bill:

- same title
- new title

House Bill:

- same title
- technical title
- new: SCR # _____

NEW FISCAL NOTE(S):

| Department | Date | Fiscal | Zero | FN# |
|-------------|----------------|--------|-------------------------------------|----------|
| <u>DMVA</u> | <u>5/15/03</u> | | <input checked="" type="checkbox"/> | <u>1</u> |
| | | | | |
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PREVIOUS FISCAL NOTE(S):

| Department | Date | Fiscal | Zero | FN# |
|------------|------|--------|------|-----|
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APPROPRIATION - no fiscal note

SIGNATURES AND RECOMMENDATIONS:

| SIGNATURES AND RECOMMENDATIONS: | DO PASS | DO NOT PASS | NO REC | AMEND |
|----------------------------------|-------------------------------------|-------------|--------|-------|
| <u>John Glendey</u> | <input checked="" type="checkbox"/> | | | |
| <u>Paul Perry</u> | <input checked="" type="checkbox"/> | | | |
| <u>Charles Brown</u> | <input checked="" type="checkbox"/> | | | |
| | | | | |
| | | | | |
| CHAIR: <u>[Signature]</u> | <input checked="" type="checkbox"/> | | | |

SENATE COMMITTEE REPORT
First Committee of Referral

DATE: 5/10/03

FURTHER: Health, Education and
 Social Services

Date of 5-Day Notice: 24 hr. rule
 (in accordance with Uniform Rule 23)

DATE TURNED
 IN TO OFFICE: 5/17/03

State Affairs Committee considered SENATE JOINT RESOLUTION NO. 20

SJR 20 US COAST GUARD ROTC IN ALASKA

Relating to the establishment of Reserve Officer Training Corps programs in Alaska by the United States Coast Guard

and recommends:

be replaced with _____ CS _____ (_____)

adopt previous _____ CS _____ (_____)

attached amendment(s)

adopt Letter of Intent by _____ Committee

further referral to _____ Committee

Senate Bill:

same title

new title

House Bill:

same title

technical title

new: SCR # _____

NEW FISCAL NOTE(S):

| Department | Date | Fiscal | Zero | FN# |
|-------------|----------------|--------|-------------------------------------|----------|
| <i>DMVA</i> | <i>5/15/03</i> | | <input checked="" type="checkbox"/> | <i>1</i> |
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PREVIOUS FISCAL NOTE(S):

| Department | Date | Fiscal | Zero | FN# |
|------------|------|--------|------|-----|
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| | | | | |

APPROPRIATION - no fiscal note

SIGNATURES AND RECOMMENDATIONS:

| SIGNATURES AND RECOMMENDATIONS: | DO PASS | DO NOT PASS | NO REC | AMEND |
|----------------------------------|-------------------------------------|-------------|--------|-------|
| <i>John Glendey</i> | <input checked="" type="checkbox"/> | | | |
| <i>Paul Romo</i> | <input checked="" type="checkbox"/> | | | |
| <i>Clayton</i> | <input checked="" type="checkbox"/> | | | |
| | | | | |
| | | | | |
| CHAIR: <i>[Signature]</i> | <input checked="" type="checkbox"/> | | | |

FISCAL NOTE

STATE OF ALASKA
2003 LEGISLATIVE SESSION

Fiscal Note Number: _____
 Bill Version: SJR 20
 () Publish Date: _____

Revision Date/Time (Note if correction): _____ Dept. Affected: DMVA
 Title US Coast Guard ROTC Program BRU _____
 Component _____
 Sponsor Senator Elton Component No. _____
 Requester _____

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

| OPERATING EXPENDITURES | FY 2004 | FY 2005 | FY 2006 | FY 2007 | FY 2008 | FY 2009 |
|------------------------|------------|------------|------------|------------|------------|------------|
| Personal Services | | | | | | |
| Travel | | | | | | |
| Contractual | | | | | | |
| Supplies | | | | | | |
| Equipment | | | | | | |
| Land & Structures | | | | | | |
| Grants & Claims | | | | | | |
| Miscellaneous | | | | | | |
| TOTAL OPERATING | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |

| | | | | | | |
|-----------------------------|------------|------------|------------|------------|------------|------------|
| CAPITAL EXPENDITURES | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
|-----------------------------|------------|------------|------------|------------|------------|------------|

| | | | | | | |
|-------------------------------|--|--|--|--|--|--|
| CHANGE IN REVENUES () | | | | | | |
|-------------------------------|--|--|--|--|--|--|

FUND SOURCE (Thousands of Dollars)

| | | | | | | |
|---|------------|------------|------------|------------|------------|------------|
| 1002 Federal Receipts | | | | | | |
| 1003 GF Match | | | | | | |
| 1004 GF | | | | | | |
| 1005 GF/Program Receipts | | | | | | |
| 1037 GF/Mental Health | | | | | | |
| Other (Specify Type--Do not abbreviate) | | | | | | |
| TOTAL | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |

Estimate of any current year (FY2003) cost: 0.0

Mark this box (X) if funding for this bill is included in the Governor's FY 2004 budget proposal:

POSITIONS

| | | | | | | |
|-----------|--|--|--|--|--|--|
| Full-time | | | | | | |
| Part-time | | | | | | |
| Temporary | | | | | | |

ANALYSIS: *(Attach a separate page if necessary)*
 SJR 20 relates to the establishment of a Reserve Officer Training Corps programs in Alaska by the United States Coast Guard. This would have no fiscal impact to this Department, as it would be a Federal program. However the DMVA supports the establishment of JROTC and ROTC programs.

Prepared by: John W. Cramer
 Division: Administrative Services
 Approved by: General Craig Campbell, Commissioner
 Agency: Department of Military and Veterans Affairs.

Phone 465-4602
 Date/Time 5/15/03 11:33 AM
 Date 5/15/2003

SJR 20
Supporting Establishing Coast Guard ROTC and JROTC in Alaska

Sponsor Statement

Senate Joint Resolution 20 supports establishing a Coast Guard Reserve Officer Training Corps (ROTC) at the University of Alaska and a Junior Reserve Officer Training Corps (JROTC) at Juneau-Douglas High School and Kodiak High School.

The Coast Guard does critical work for America's coastal communities and homeland security. They save hundreds of lives each year, police Alaska's fisheries, and secure our ports and harbors. With the new security requirements after September 11, 2001, the Coast Guard's mission has expanded. This is the perfect opportunity to expand the Coast Guard's existing JROTC program in Florida to include Alaska communities with a substantial Coast Guard presence. It is also an ideal time to develop ROTC programs at the college level, enhancing opportunities at the University of Alaska and increasing training and recruitment for this branch of America's armed forces.

The Coast Guard is the primary military presence in both Kodiak and Juneau. Coast guard members are active in these communities and greatly valued. This resolution supports strengthening these ties and by doing so, both the Coast Guard and Alaska communities. I would appreciate your support.

SJR

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