HOUSE RESEARCH ORGANIZATION bill analysis 5/3/1999

HJR 58
Junell, Cuellar
(CSHJR 58 by Junell)

SUBJECT: Permanent University Fund (PUF) investments and distributions

COMMITTEE: Appropriations — committee substitute recommended

VOTE: 19 ayes — Junell, West, Coleman, Cuellar, Farrar, Giddings, Glaze, Gutierrez, Hartnett, Heflin, Janek, Luna, McReynolds, Mowery, Pickett, Pitts, Puente, S. Turner, Van de Putte

0 nays

8 absent — Delisi, Eiland, Flores, Gallego, Hochberg, P. Moreno, Staples, Tillery

WITNESSES: For — None

Against — None

On — Grover Campbell, University of Houston System Board of Regents; William Cunningham, University of Texas System; Sam Kirkpatrick, University of Texas at San Antonio; Tom Loeffler, University of Texas System; Ricardo Romo, University of Texas at San Antonio; Tony Sanchez, University of Texas Board of Regents; Barry Thompson, Texas A&M University System; Robert Witt, University of Texas at Arlington

BACKGROUND: The Texas Constitution established the Permanent University Fund (PUF), which is a public endowment based on 2.1 million dedicated acres of university land. The University of Texas Board of Regents is responsible for investing mineral receipts, such as oil and gas royalties, from the university lands, using the prudent person standard. Dividends, interest and other income from the PUF, plus surface income from the university lands, are distributed annually to the Available University Fund (AUF). Capital gains from PUF investments are retained as part of the corpus of the funds.

After subtracting the amount required to manage the PUF, one-third of the AUF is distributed to the Texas A&M University (TAMU) System and two-thirds to the University of Texas (UT) System. The AUF is used first to pay interest and dividends on PUF-backed bonds. The TAMU institutions whose bonds are backed by the PUF are: TAMU College Station, Prairie View A&M

University, Tarleton State University, TAMU Health Science Center, and TAMU service agencies. The UT System institutions using PUF-backed bonds are UT Austin, UT Arlington, UT Dallas, UT El Paso, UT Permian Basin, UT San Antonio, UT Tyler, UT Institute of Texan Cultures in San Antonio, and all UT medical units and health science centers. Six Texas A&M service agencies and 17 institutions of higher education within TAMU System and UT System finance capital improvement bonds with the AUF. Each system receiving funds must pay any obligations on capital bonds and notes pledged against the PUF's earnings.

The remainder of the AUF is used for system administration for the UT and TAMU systems and for "excellence" funding for UT Austin, TAMU College Station, and Prairie View A&M. The projected disbursement to the AUF for fiscal 2000 is $252.3 million.

DIGEST: CSHJR 58 would change the method of making disbursements to the AUF from the PUF and revise PUF investment policy.

Available University Fund. CSHJR 58 would amend Art. 7, sec. 18 to allow the UT board to determine PUF distributions to the AUF based on the total return on all PUF assets, including capital gains, rather than only dividends, interest, and other income. It would require annual distributions from the PUF to the AUF in any fiscal year:

- to cover at least the amount needed to pay monies due on bonds and notes pledged against the PUF's earnings;
- to provide a stable and predictable stream of annual distributions to the AUF and to maintain over time the purchasing power of PUF investments;
- to preserve the purchasing power of the PUF investments in any rolling 10-year period; and
- not to exceed 7 percent of the average net fair market value of PUF investment assets, except as necessary to pay principal and interest due on PUF bonds and notes.

The expenses of managing PUF land and investments would be paid by the PUF.

PUF Authorized Investments. CSHJR 58 would amend Art. 7, sec. 11b to allow the UT System board of regents to invest the PUF by using the prudent investor standard, considering the fund's total investments rather than a single investment. It would replace the prudent person standard that bars speculation and focuses on the permanent disposition of the fund, considering probable income as well as probable safety of the capital.

Current Obligations Guarantee. CSHJR 58 would add a temporary subsection to the Texas Constitution to guarantee any bonds or notes issued against the PUF's earnings prior to these proposed amendments. It would mandate that distributions from the PUF to the AUF at least equal the monies due on bonds and notes issued prior to January 1, 2000. This provision would expire January 1, 2030.

Ballot Wording. The proposal would be presented to the voters at an election on November 2, 1999. The ballot proposal would read: "The constitutional amendment relating to the investment of the permanent university fund and the distribution from the permanent university fund to the available university fund."

SUPPORTERS SAY:

The purpose of CSHJR 58 is to modernize the investment and spending principles of the PUF and the AUF. The Legislative Budget Board's fiscal note conservatively estimates that CSHJR 58 would allow distributions to the AUF to increase $33.6 million in fiscal 2000 and up to $49.75 million by fiscal 2004.

Current provisions of the Texas Constitution inhibit the ability of the PUF to preserve its purchasing power. The Texas Constitution mandates the distribution of all interest and dividend income to the AUF and prohibits the distribution of realized and unrealized gains. These constitutional provisions reflect an era when fixed rate bonds were the only eligible investment, and mineral income, not investment appreciation, was the source of income growth. Today, these provisions are incompatible with university endowment policies that restrict distributions to the average total investment return after inflation.

The Constitution's income-based distribution policy divorces distributions from the total investment return earned on endowment assets and often contributes to financial disequilibrium. Such was the case during the 1980s when income should have been reinvested and during the 1990s when gains should have been distributed to preserve purchasing power. CSHJR 58 would level out the spending pattern and ensure that the PUF continues to grow and benefit future Texans.

The total return investment strategy in CSHJR 58 is endorsed by management professionals and the various universities comprising the higher education coalition. More than 94 percent of higher education institutions use the proposed total return strategy for endowment fund investments. In 1996, the state auditor issued a report concluding that constitutional restrictions imposed on the use of capital gains and ordinary investment income of the Permanent University Fund impairs the ability of the board to optimize its long-term performance. The auditor noted that a constitutional amendment eliminating those restrictions would provide more flexibility in attempting to maximize long-term growth in both corpus and the distribution from the fund.

CSHJR 58 would ensure that distributions of capital gains from the PUF to the AUF would be done prudently by including several conditions that would have to met before any distribution could be made. First, the distribution would have to cover principal and interest on outstanding obligations used for capital expenditures at UT and TAMU institutions. Second, a stable and predictable stream of annual distributions would have to be preserved and the purchasing power of PUF investments would have to be maintained over any rolling 10-year period. Finally, no annual distribution could exceed 7 percent of the average net fair market value of PUF investment assets, except to cover the amount due on the bonds. These limitations would prevent the investment corpus of the PUF from being undermined but would allow investment gains to be used to benefit the UT and TAMU campuses.

The additional revenue from increased distributions could be used to help make up for capital funding inequities between institutions in the PUF and the Higher Education Fund (HEF) — the permanent endowment fund for non-PUF institutions. For example, the UT System estimates about $25 million per year is needed to bring its capital projects funding, per square foot, up to par with HEF institutions.

Since 1986, when new schools were added to the PUF, 45 percent of PUF bonds issued have been to benefit those schools. However, due to AUF income limitations, no PUF construction bonds have been issued for UT schools since 1992. Excellence funding for UT Austin from the AUF has remained constant since 1986, but has declined 26 percent when adjusted for inflation. The total return distribution system authorized by CSHJR 58 would help make up for some of that shortfall.

OPPONENTS SAY:

While CSHJR 58 would improve the investment and distribution strategies used for the PUF schools in the UT and TAMU systems, it would not solve the inequities in higher education funding. All Texas schools do not benefit from the PUF. Even within the PUF certain institutions are restricted to capital improvement revenue while others may use PUF revenue for educational excellence. The Legislature should take this opportunity to truly equalize funding for all of Texas' institutions.

While CSHJR 58 would provide protections and conditions for distributing capital gains to the AUF, capital gains should be reinvested in the fund. A conservative investor should err on the side of preserving the corpus of the endowment. The only way to absolutely assure that practice is to reinvest capital gains while distributing only income and dividends.

NOTES:

The original version would have transferred several PUF institutions to the Higher Education Fund. It would have outlined procedures to transfer six UT institutions and one A&M institution and the continued payment of PUF bonds issued for those institutions.