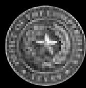
SPECIAL EDITION



FISCAL NOTES

AN EXAMINATION OF THE STATE'S OBLIGATIONS AND THE POLICY OPTIONS THAT COULD MITIGATE THEIR EFFECT ON STATE FINANCES.

A REVIEW OF THE TEXAS ECONOMY FROM THE OFFICE OF **GLENN HEGAR**, TEXAS COMPTROLLER OF PUBLIC ACCOUNTS

TEXAS STATE GOVERNMENT AND LONG-TERM OBLIGATIONS

The Texas economy is more broad-based than it was 30 years ago, when it relied much more heavily on the oil and gas sector, and thus is much more resilient in the face of periodic economic downturns. Even so, Texas state government faces certain significant, long-term financial challenges.

As the 2017 legislative session crafts the next state budget under tight budgetary constraints, policymakers should remain aware of these lingering long-term obligations, which could damage the state's credit rating and limit the amount of revenue available for general spending.

In December 2016, Comptroller Glenn Hegar identified four such obligations in a letter to state leaders:

- state employee pension funding;
- health care coverage for retired public school employees and their dependents (TRS-Care);
- the Texas Guaranteed Tuition Plan, a state-sponsored prepaid tuition plan; and
- deferred maintenance for state buildings.

These obligations differ in size, scope and urgency, but the potential consequences are similar: the longer the state waits to address them, the greater their ultimate costs will be. This report examines these obligations as well as policy options that could mitigate their effect on state finances. ■

I. STATE EMPLOYEE PENSION FUNDING

Texas' state and local government pension funds have more than 2 million members in 93 different plans. The Employees Retirement System (ERS) manages three funds for different groups of public employees: ERS for most state employees; the Law Enforcement and Custodial Officers Supplemental Retirement Fund (LECOS); and the Judicial Retirement System Plan Two (JRS II). The main ERS fund includes most state employees and all LECOS members, serving more than 185,000 active participants in all.[1]

Like most states, ERS still offers *defined benefit plans* (DBPs), which guarantee specific amounts of monthly income upon retirement. Although both state agencies and their employees contribute to the pension fund, the investment risk is with the state as plan provider. (With defined *contribution* plans such as 401ks, by contrast, employers generally contribute a specific amount to employee retirement but have no further obligation to manage the funds.)

In 2016, 85 percent of all U.S. state and local government employees had access to a DBP, and 88 percent of those employees participated.[2]

When a pension plan's obligations exceed its assets, it is considered to have an *unfunded liability*. Unfunded pension liabilities have become a major concern for state and local governments across the U.S.

In the Great Recession, many government pension systems' *unfunded actuarial accrued liability (UAAL)* — the amount needed to meet all their future obligations — rose dramatically due to lower investment returns or even losses. Consequently, dozens of government entities saw their credit ratings fall due to rising UAALs,

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A Message from the Comptroller

Last December, I sent a letter to Governor Abbott and the legislative leadership outlining some long-term challenges to our state's financial health — obligations that, in the absence of action, can only be expected to become more expensive, ultimately endangering our budget and our state's credit rating.

Since legislators are grappling with preparing the budget for the next biennium, I thought it would be useful to provide more background on the issues highlighted in my December letter.

As a former legislator, I know only too well the difficulties that can come with the budget process, as lawmakers attempt to reconcile thousands of competing needs. The hot-button demands of the next two years always seem more important than issues that can be allowed to slide for "just one more session."

Unfortunately, delaying action on some of our long-term obligations will only cost us more over time, much like compounding interest on a loan.

In this special report, we examine four of these obligations: state employee pension funding; the TRS-Care program, which provides health care coverage for retired public school employees and their dependents; the Texas Guaranteed Tuition Plan, a state-sponsored prepaid tuition plan; and our ever-growing backlog of deferred maintenance projects for state buildings.

These issues vary in scope, timing and severity, but they all represent obligations the state will have to address, sooner or later — and later will cost us a lot more. We discuss various existing proposals for coping with each of the long-term obligations individually, as well as the option of investing a portion of Treasury balances to raise revenue to address these issues.

I hope this report will provide some much-needed context on our long-term obligations and spur some consideration of them as budget negotiations continue.

As always, my office is ready to assist the Legislature with these and other important financial questions.

GLENN HEGAR
Texas Comptroller of Public Accounts

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including Dallas, Houston and the state of Illinois; the cities of Stockton, California, and Detroit, Michigan, declared bankruptcy due in part to unmet pension obligations.

While the obligations of Dallas and Houston won't affect Texas' state government balance sheet or the state's credit rating, both the Moody's and Standard & Poor's (S&P) rating agencies have warned Texas its credit rating could be in jeopardy if the state's own pension liability isn't addressed adequately.[3]

ERS doesn't meet certain pension standards, but Texas still receives AAA-stable ratings. These ratings reflect expectations that the state's leadership will:

- maintain budget and cash management discipline;
- address potential future budget gaps in a timely manner; and
- maintain sustainable UAAL levels by making the necessary contributions.[4]

A pension plan's average *funded ratio* — the ratio of its assets to its liabilities — is one measure of a plan's health. Traditionally, a pension fund was considered "sound" at 80 percent or more, but other factors such as the size of the fund's obligation, its funding policies and investment strategy all matter as well.[5] As of August 2016, ERS had a funded ratio of 75.2 percent, down from 76.3 percent a year before (**Exhibit 1**).[6]

CHALLENGES FACING ERS

Several factors are making the ERS pension fund's viability uncertain, including:

- *unrealistic assumptions about investment returns*. ERS assumes an 8.0 percent annual investment return but saw a gain of less than 0.5 percent in fiscal 2015 and 5.3 percent in fiscal 2016.[7] This is a common problem; the national average assumed return for state pension programs was 7.5 percent in fiscal 2016, while the median actual return was 0.52 percent.[8]

  Averaging good and bad years over time shows ERS' average compound return was 7.7 percent during the last five years, 5.8 percent for the last 10 years and 7.4 percent for the last 25 years.[9] These averages give a more accurate picture of ERS performance over time, but note that none meet the 8 percent assumption.

- *inadequate contributions*. Texas Government Code §815.403 requires the state to make annual contributions to the ERS pension fund equal to 7.4 percent of the total compensation received by all ERS members in that year. Yet the state failed to meet this requirement in all but two years from 1988 through 2013.[10] By one estimate, this cost the ERS pension fund more than $1.1 billion in contributions between 1991 and 2011 alone.[11]

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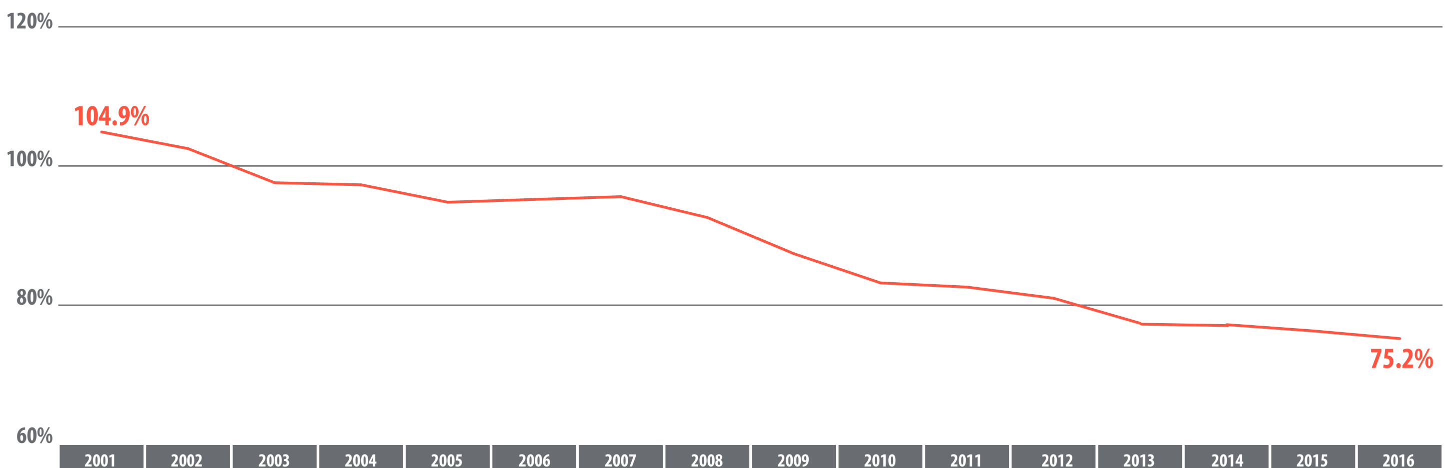
EXHIBIT 1

FUNDED RATIO HISTORY OF ERS PENSION PLAN



Source: Employees Retirement System of Texas

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The state also generally fails to make actuarially sound contributions (ASC) —that is, the level of contributions needed to fund the cost of future benefits and amortize (or gradually eliminate) the UAAL over a finite period.[12] Texas' contributions to the ERS fund have fallen below the ASC level each year since 2004.[13]

- *demographic pressures*. Longer life expectancies are increasing fiscal pressure on pension systems. The average U.S. life expectancy was 69.7 in 1960 and 78.7 in 2010.[14]
- *fewer contributing members*. In 2013, the ERS fund had 27 percent fewer contributing state employees than in 1995. A smaller contributor pool also affects returns on investment.
- *early retirements*. Law enforcement and custodial officers, who represent 30 percent of the ERS population, are allowed to retire earlier, leaving fewer contributions and more lifespan to draw benefits.[15]

PRIOR LEGISLATION

Since 2009, several state laws have attempted to address the ERS pension fund's rising UAAL by increasing employee contributions, raising the retirement age and making other adjustments (**Exhibit 2**).[16] S&P called changes made in 2015 in particular a "meaningful step toward constraining the future liability."[17]

POLICY OPTIONS

Any change to government pension plans can involve significant challenges and may have unforeseen consequences. Before pursuing any significant change, a cost-benefit analysis should be conducted to fully understand how Texas' pension funds and contributions would be affected.

Proposed policy options to improve the ERS pension fund's finances include:

- *raising member and/or state contributions*. Increasing member contributions would improve the fund's financial health, but wouldn't be popular with enrollees. ERS member rates

EXHIBIT 2

SIGNIFICANT LEGISLATIVE ACTIONS FOR ERS PENSIONS, 2009-2015

SESSION / BILL	ACTION	AFFECTED EMPLOYEES
81st – 2009 / HB 2559	Employee contributions increased by 0.5 percent to 6.5 percent	All employees
	Eligibility for retirement annuity rules changed from 60 years old with five years of service to 65 with 10 years of service, or five years of service if the employee meets the Rule of 80	Employees hired on or after Sept. 1, 2009
	Final average salary (FAS) increased from the average of the prior three years to four years	Employees hired on or after Sept. 1, 2009
83rd – 2013 / SB 1459	FAS increased to the average of the prior five years	Employees hired on or after Sept. 1, 2013
	Healthcare insurance premium contribution now based on years of service	Employees with less than five years of service credit on or before Sept. 1, 2014
	Unused sick and vacation leave can no longer be used to meet retirement eligibility	Employees hired on or after Sept. 1, 2013
	Employees who retire before age 62 will have their annuity reduced by 5 percent annually for each year below that age	Employees hired on or after Sept. 1, 2013
	Employer contribution increased to 7.5 percent starting in fiscal 2014	
	Each state agency to make a 0.5 percent contribution	
	Employee contributions to increase in increments from 6.5 percent to 7.5 percent by 2017	All employees
84th – 2015 / HB 9	State and member contributions both increased to 9.5 percent starting in fiscal 2016	All employees
	Employees given a 2.5 percent across-the-board pay raise to offset member contribution increase from 6.9 percent to 9.5 percent	All employees
	90-day membership waiting period for new hires eliminated	All new hires as of Sept. 1, 2015

Source: Employees Retirement System of Texas; Texas Department of Criminal Justice; Texas House of Representatives; and Texas Legislature online

are already above the national average, at 9.5 percent versus 6 percent. State rates are below the national average, at 10 percent versus 11.5 percent, but Article 16, Sec. 67(b)(3) of the Texas Constitution caps the state contribution at 10 percent.[18] A constitutional change would be necessary unless the governor, following the constitutional provision, declares an emergency, in which case "the legislature may appropriate such additional sums as are actuarially determined to be required to fund benefits authorized by law." Thus, increasing the state's contribution would require the governor to declare an emergency or the Texas Constitution to be amended.

- *making a one-time payment to the pension fund from general revenue or the Economic Stabilization Fund*. In the absence of further plan changes or major economic disruption, a payment of $1 billion would reduce the plan's total obligations by $8.3 billion and fully fund it by 2041. A $4 billion payment would reduce obligations by $17.5 billion and fully fund the plan by 2028.[19] A one-time payment would allow the funds to be invested at higher returns, lessen the need for changes to plan design and benefit structures and decrease the UAAL — but it wouldn't prevent the UAAL from rising again in subsequent years if the state doesn't meet the ASC.[20]
- *selling pension obligation bonds*. In 2015, Kansas issued general obligation (GO) bonds to defray the cost of its employee pension systems, while bills supporting similar moves failed in Kentucky and Colorado.[21] While this can be a viable option when interest rates are low, increased market exposure and required repayment schedules can make them risky. For this reason, the Government Finance Officers Association does not recommend the use of pension bonds.[22]
- *reducing benefits offered to current and/or future hires*. This broad category of options includes increasing the retirement age; raising the number of years worked to become eligible for a pension; or reducing the multiplier that determines the size of the annuity.

  Such options could reduce the UAAL over time, but reducing plan benefits is always controversial and can spur legal challenges, as seen recently in Rhode Island, where a benefit reduction led to several years of mediation and litigation.[23]

  In addition, significant benefit changes could cause high-performing workers to seek employment elsewhere, reducing the overall quality of the workforce, or cause a "rush to retirement" among those at or near retirement age, reducing contributions and damaging the plan's solvency.[24]
- *changing the plan to a defined contribution or hybrid plan*. Supporters of defined contribution plans (DCPs) say they can give retirees more at retirement, and point to problems with DBPs such as higher costs, lack of personal control over investments, difficulties in transferring the plan to other employers and other inherent characteristics, such as the employer's responsibility to maintain required fund balances regardless of market performance.[25]

  Some research suggests otherwise, however. The state governments of Minnesota, California and New York each considered switching to DCPs and found that DBPs can cost less and achieve higher returns.[26]

  Hybrid plans typically include mandatory contributions to both a DBP and a DCP, distributing the risk between employee and employer. The DBP portion provides a guaranteed monthly annuity while the DCP portion gives employees some control over their investment portfolios.

  Because DCP contributions are invested separately from those for the DBP, employees may forego some earnings, since DBP pools focus on long-term assets that may yield higher returns over time. DCPs, therefore, need more funds to achieve the same level of benefit as a DBP.[27]

  Hybrids, moreover, allow employees to leave their employer and take the DCP contributions with them, unlike DBP investments. Critics say this incentivizes employees to leave instead of staying for the long-term benefits offered by DBPs. ■

II. TEACHER RETIREMENT SYSTEM — TRS-CARE

The Teacher Retirement System of Texas (TRS) administers two health benefit programs: one for current public school employees and their dependents, the Texas School Employees Uniform Group Health Coverage Program (TRS-ActiveCare); and one for retirees and their dependents, the Texas Public School Retired Employees Group Benefits Program (TRS-Care). This overview addresses TRS-Care only.

TRS-Care is a self-funded program, established in 1985 through Chapter 1575 of the Texas Insurance Code.[28] As of August 31, 2016, the TRS-Care program covered about 261,500 retirees, dependents and surviving spouses. Aetna administers the health plan while Express Scripts administers the pharmacy benefit.[29]

TRS-Care faces a large and growing shortfall. In the absence of supplemental appropriations or changes to the plan's design, retiree premiums could triple starting on September 1, 2017. [30]

TRS-CARE SOLVENCY ISSUES

TRS-Care funding is linked to active public school and charter school employee payrolls and not to actual health care costs. Rising costs, an increasing retiree population and a contribution system that hasn't changed in more than a decade have led to an ongoing funding shortfall. In 2015 alone, the Legislature contributed $768.1 million in supplementary appropriations to cover this funding gap.

A November 2016 report by the Joint Committee to Study TRS Health Benefit Plans projects the TRS-Care shortfall at $1.3 to $1.5 billion for the 2018-2019 biennium, and $4 to $6 billion for the following biennium.[31]

FUNDING

TRS-Care receives state general revenue contributions equal to 1 percent of the salaries of all active public education employees. In addition to these contributions, TRS-Care is funded by retiree premiums as well as contributions from active public education employees and local school districts. The active public education employee contribution rate is 0.65 percent of payroll, while school districts contribute 0.55 percent of payroll.

At its creation in 1985, TRS-Care was expected to remain solvent for just 10 years, with the understanding that additional funding or benefit changes would be necessary to maintain the plan. Its funding formula hasn't changed since 2005, however, and hasn't kept pace with plan costs, requiring periodic supplemental appropriations.[32]

In 2003, for instance, the Legislature appropriated $516 million from the Texas Economic Stabilization Fund to cover a TRS-Care shortfall. More recently, the Legislature made supplemental appropriations to TRS-Care in fiscal 2013, 2014 and 2015 (**Exhibit 3**).

EXHIBIT 3

FUNDING SOURCES FOR TRS-CARE, FISCAL 2015

CONTRIBUTION SOURCE	DESCRIPTION	FISCAL 2015 REVENUE
Retirees	Plan premiums	$369,066,459
State Appropriation	1.0 percent of salaries of all active public education employees	304,917,343
State Supplemental Appropriation	One-time appropriation to maintain TRS-Care viability	768,100,754
School Districts	0.55 percent of payroll	179,157,485
Active Employees	0.65 percent of payroll	198,196,273
Other	Federal subsidies; investment income; employer surcharge	201,816,846
TOTAL		**$2,021,255,160**

Source: Joint Interim Committee to Study TRS Health Benefit Plans

COST DRIVERS

Major causes of TRS-Care shortfalls include:

- *pharmacy costs*. Prescription drugs accounted for about 45 percent of claims (net of rebates) in fiscal 2015. Costs for patented, costly "specialty" drugs rose by about 30 percent in fiscal 2015, compared to a 13 percent increase for non-specialty drugs.
- *emergency room costs*. From fiscal 2011 to 2015, the number of emergency room visits by TRS-Care members rose by 13 percent, from 227 to 256 per 1,000 members. Members aged 70 and older have the highest rate of emergency room use.
- *chronic conditions*. Individuals with claims for more than $150,000 were the primary cost driver for TRS-Care in fiscal 2015. Of these members, 71 percent had complications stemming from chronic diseases such as heart disease, diabetes, hepatitis, arthritis and other long-lasting

conditions. High-cost claimants represented more than half of the 9 percent in total cost growth for TRS-Care in 2015.

- *growing population*. Since fiscal 2011, the TRS-Care population has risen by 3 to 6 percent annually. From fiscal 2011 to 2015, the number of members under age 65 who were ineligible for Medicare rose by 11 percent, from 71,071 to 78,858. Participants under age 65 have the highest medical costs because TRS-Care is the primary payer for their medical expenses until they become eligible for Medicare. In fiscal 2015, 88 percent or $65 million of the increase in medical claims for TRS-Care's self-funded plan was generated by enrollees under age 65.[33]

JOINT COMMITTEE PLAN OPTIONS

The 2015 Legislature created the Joint Committee to Study TRS Health Benefit Plans to examine the sustainability of TRS-Care and affordability of TRS-ActiveCare and present its findings before the beginning of the 2017 legislative session.

The committee's November 2016 report offered a series of proposals for TRS-Care, based on the assumptions that current state, school district and active employee contributions would not increase and participant costs would rise. These include:

- *Health Reimbursement Accounts*. Retirees ineligible for Medicare would receive $400 each month in a Health Reimbursement Account to be used to purchase health insurance or for any medically eligible expense.
- *High Deductible (HD) Plan*. The HD plan would provide non-Medicare-eligible retirees with a high-deductible plan similar to the current TRS-Care 1 (for catastrophic coverage). The plan would have a $4,000 in-network deductible. Estimated retiree-only plan costs for a participant would be about $430 monthly.
- *Medicare Advantage Plan*. This plan would be the *only* one available to Medicare-eligible retirees through TRS-Care. Medicare-eligible retirees would be expected to enroll in Medicare Advantage and Medicare Part D for prescription drug benefits. The plan would have a $500 deductible. Estimated retiree-only plan costs to the participant would be about $146 monthly. All current TRS health care options for Medicare-eligible retirees would be eliminated, including TRS-Care 1 (catastrophic coverage) currently offered for retirees only at no cost to the participant.[34] ■

III. TEXAS GUARANTEED TUITION PLAN

The Texas Guaranteed Tuition Plan, formerly called the Texas Tomorrow Fund, is a prepaid tuition plan created in May 1995 and opened for enrollment in 1996. Texas voters approved a constitutional amendment in 1997 that guarantees the plan's benefits with the full faith and credit of the state.[35]

Fund participants could select contracts for public junior colleges, public universities or private colleges and universities and purchase them in a lump sum or through installments to lock in current tuition rates for the beneficiary's later use. The plan pays a different hourly reimbursement rate for each contract type.[36]

The plan stopped accepting new contracts when the Texas Legislature deregulated tuition in 2003, in anticipation of significantly higher tuition rates. In all, the plan sold 158,442 contracts prior to closure. Today, it has about 60,000 active contracts.

Of all contracts sold, 94 percent were public university or "senior" contracts. Since 2003, these have paid an hourly reimbursement rate based on the weighted average amount of tuition (WAT) and school-wide required fees for a semester hour at all Texas public four-year colleges and universities. Texas institutions above the WAT must waive the difference between the amount paid by the plan and the actual tuition and required fees, if greater. (Large universities such as the University of Texas and Texas A&M waive millions of these dollars each semester.)

The Texas Prepaid Higher Education Tuition Board invests contract payments and uses the payments and interest earnings to pay college tuition and required fees for enrollees. The program has proven to be a significant benefit for participating students and their families, as the average cost of tuition and fees at Texas public colleges and universities has more than doubled since the program began.[37]

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CURRENT STATUS

The Texas Guaranteed Tuition Plan's contract payments and earnings have failed to keep pace with tuition inflation. The plan had a projected unfunded liability of $617.2 million as of August 31, 2016, a 15.3 percent increase from the previous year. An actuary hired by the Texas Prepaid Higher Education Tuition Board projected that the plan would experience a cash shortfall as early as fiscal 2019; an additional $87.7 million in general revenue funding provided in 2015 pushed the projected shortfall date into fiscal 2020.[38]

Since the program has a constitutional funding guarantee, any shortfall automatically triggers a draw on general revenue. Texas could save as much as $58 million by taking action to fully resolve the Texas Tomorrow Fund's unfunded liability before the end of fiscal 2017.

PLAN CHALLENGES

Several of the actuarial assumptions used in setting prices for the plan's contracts didn't pan out. Tuition rose more than expected, while the fund's investments returned less than expected.

Furthermore, a provision of the program allows contract owners to cancel mature, paid-in-full contracts for a refund — when, for instance, a beneficiary did not attend college as expected, or received scholarships or other financial assistance that made the contract unnecessary — based on the *current* hourly reimbursement rate for their contract type, including earnings based on tuition inflation over the life of the contract. As of Dec. 31, 2016, refunds for cancelled contracts included nearly $227 million in earnings in addition to the amount originally paid for the hours.[39]

In 2009, the Texas Prepaid Higher Education Tuition Board considered a rule change to limit refunds to the amount contract holders *paid in*, less administrative fees, rather than basing them on the hourly reimbursement rate in effect at the time of cancellation.[40] Numerous contract owners expressed concern over this potential rule change to their legislative representatives, however, and it never took effect.[41]

OTHER STATES

Texas isn't the only state to experience difficulties with prepaid tuition plans. Although 20 states once offered such plans, only 12 states have plans still open for new enrollment today — Alaska, Florida, Illinois, Maryland, Massachusetts, Michigan, Mississippi, Nevada, Pennsylvania, Texas (through a new prepaid tuition plan, the Texas Tuition Promise Fund, discussed below), Virginia and Washington. The Private College 529 Plan, an independent prepaid tuition plan, is also open for new enrollment.[42]

Most state prepaid tuition plans, like Texas', overestimated investment gains while underestimating tuition increases. These plans suffered during the Great Recession, and 12 states closed plans to new enrollment — Alabama, Colorado, Kentucky, Michigan (its first plan), New Mexico, Ohio, South Carolina, Tennessee, Texas (its first plan), West Virginia, Wisconsin and Wyoming. Alabama's plan closed to new enrollment in 2009, leaving contract holders with partial payments. Colorado's plan shuttered in 2013, offering contract holders a 5.5 percent return on their payments. West Virginia's plan closed to new enrollment in 2003 and is backed by the state's Unclaimed Property Fund.[43]

POLICY OPTIONS

In October 2016, Sherman Actuarial Services, LLC, analyzed the Texas Guaranteed Tuition Plan at the request of the Legislative Budget Board, offering the following estimates and funding options (**Exhibit 4**).[44] Note that potential savings increase with the amounts the 2017 Legislature appropriates to cover the plan's expected needs.

- In the absence of additional appropriations, the actuary estimates the plan's available cash for benefits will be depleted in March 2020, requiring an annual general revenue draw for plan benefits and expenses ("pay as you go") until 2038, when all contracts are expected to be fulfilled, for a total projected cost of $693.9 million.
- If the Legislature appropriates $100 million to the fund in September 2017, the actuary expects the plan to remain funded until September 2020, requiring pay-as-you-go general revenue thereafter, for a total cost to the state of $687.7 million and a projected savings of nearly $6.2 million.

- If the Legislature appropriates half of the total liability, $317.7 million, in September 2017, the plan will remain funded until March 2022, requiring a total cost to the state of $672 million and producing a projected savings of $21.9 million.
- If the Legislature appropriates $400 million in September 2017, the plan will remain funded until March 2023, for a total cost to the state of $664.3 million in general revenue and producing a projected savings of nearly $29.6 million.
- If the Legislature appropriates the total liability of $635.5 million in September 2017, the plan will remain funded until the estimated end of the plan in 2038, for an estimated savings of $58.4 million.

TEXAS TUITION PROMISE FUND

In 2008, Texas opened a new prepaid tuition plan, the Texas Tuition Promise Fund. This plan differs from its predecessor in important ways: it is structured so it will never pay institutions more in benefits than the amount contributed by purchasers for tuition units, plus or minus net earnings or losses on those contributions; and it isn't guaranteed by the full faith and credit of the state, although Texas public colleges and universities must accept the amount transferred by the plan as payment in full for tuition and required fees for the hours covered by the units. ■

EXHIBIT 4

TEXAS GUARANTEED TUITION PLAN FUNDING OPTIONS

Source: Sherman Actuarial Services, LLC

IV. DEFERRED MAINTENANCE FOR STATE-OWNED FACILITIES

State governments throughout the U.S. are facing growing backlogs of deferred maintenance due to reduced funding during the Great Recession, and Texas is no exception.

Deferred maintenance is simply the postponement of maintenance activities (such as repairs, retrofitting or replacement) for buildings, equipment and systems, due a lack of sufficient funding. Deferring maintenance is a common tactic in times of tight budgets, but a growing maintenance backlog can lead to inefficiencies, safety hazards, poor customer service and higher eventual costs.

The deferred maintenance backlog reflects the sum of past annual maintenance deficits and the continuous, compounding effect of postponement from one year to the next, similar to interest on debt. When maintenance is postponed, repair and replacement costs become higher in future years due to the accelerated deterioration of known deficiencies, the accumulation of new problems and the rising cost of facility repair and construction.

CHALLENGES

Deferred maintenance capital projects typically require four to five years to complete, while funding is requested on a biennial basis. New deficiencies can arise and the state of current deficiencies can change greatly between the development of an appropriation request and the beginning of a project. Unplanned budget spikes can result if a deferred maintenance item becomes an emergency.

RECENT LEGISLATIVE EFFORTS

Until recently, the state primarily funded deferred maintenance projects through general revenue appropriations and the issuance of general obligation bonds. Funding for unplanned, emergency projects, by contrast, usually comes from the remaining balances of recently completed projects; interest earned on bond proceeds; utility appropriation balances; and, most commonly, the diversion of funding from planned deferred maintenance projects.

The 2011 Legislature appropriated $110 million in GO bond proceeds for deferred maintenance projects, as well as $8.8 million in general revenue for debt service payments.

In 2013, the Legislature appropriated an additional $142 million in GO bond funding and $38.6 million in general revenue for deferred maintenance, as well as $11.1 million in general revenue for debt service. Smaller amounts were supplied from federal funds ($2.5 million) and the State Highway Fund (nearly $3.7 million).

The 2015 Legislature's S.B. 2004 established a plan for state facility maintenance and created a special Deferred Maintenance Fund (General Revenue-Dedicated Account 5166) within the General Revenue Fund. This fund received $387.7 million for the 2016-17 biennium.

S.B. 2004 also created a Joint Oversight Committee on Government Facilities to receive quarterly implementation status updates on funded projects by state agencies and annually report the status of these projects to the Legislature.

In all, the 2015 Legislature appropriated $445.1 million for deferred maintenance, including the $387.7 million from Account 5166 and $57.4 million in unrestricted general revenue. Of this total, the Texas Facilities Commission (TFC), which manages facilities space for more than 100 state agencies, received $240 million.

As of September 15, 2016, state agencies had reported more than 1,600 deferred maintenance projects to the committee, with a total estimated cost of $487.7 million (**Exhibit 5**).[45] About $26.8 million was expended from Account 5166 and $169.6 million was encumbered (slated for spending on specific projects), leaving a total unfunded deferred maintenance project balance of $291.3 million.

EXHIBIT 5

DEFERRED MAINTENANCE PROJECTS, FISCAL 2016 AND 2017

AGENCY	CURRENT ESTIMATED PROJECT BUDGET	FISCAL 2016 AND 2017: ENCUMBERED	FISCAL 2016 AND 2017: EXPENDED	REMAINING PROJECT BALANCE	PERCENT REMAINING
Department of Public Safety	$38,778,877	$2,162,778	$1,793,696	$34,822,402	89.8%
Texas Military Department*	19,562,500	8,931,737	943,263	9,687,500	49.5
Texas Parks and Wildlife	91,000,000	10,624,197	2,370,519	78,005,284	85.7
Texas Department of Criminal Justice	58,765,393	32,020,908	14,055,123	12,689,362	21.6
Texas Facilities Commission	217,156,348	97,731,599	5,413,721	114,011,028	52.5
Texas Department of Transportation	62,400,000	18,103,047	2,247,514	42,049,439	67.4
TOTALS	**$487,663,118**	**169,574,266**	**$26,823,836**	**$291,265,015**	**59.7%**

* Facilities of the Texas Army National Guard, Texas Air National Guard and Texas State Guard.
Source: Joint Oversight Committee on Government Facilities

POLICY OPTIONS AND CONSIDERATIONS

The most vocal stakeholders for deferred maintenance funding have been the state agencies themselves, particularly TFC. Proponents cite significant risks to operational continuity and occupant health and safety as well as the risk of significantly higher costs in the long term.

The Joint Oversight Committee on Government Facilities made the following recommendations in its October 2016 report to the Legislature:

- fund each agency's deferred maintenance baseline and exceptional budget requests as funds are deemed available;
- continue the quarterly reporting process for all agencies receiving deferred maintenance funding; and
- approve unexpended balance authority for current deferred maintenance projects funded in the 2016-17 biennium (that is, allow appropriated but unspent funds from the last biennium to be expended in the next without a new appropriation).

In 2015, then-Texas State Senator Kevin Eltife, a member of the Joint Oversight Committee on Government Facilities, proposed creating a state "escrow account" specifically to accumulate funds for deferred and regular maintenance issues as they arise.[46]

V. CREDIT RATINGS AND LONG-TERM OBLIGATIONS

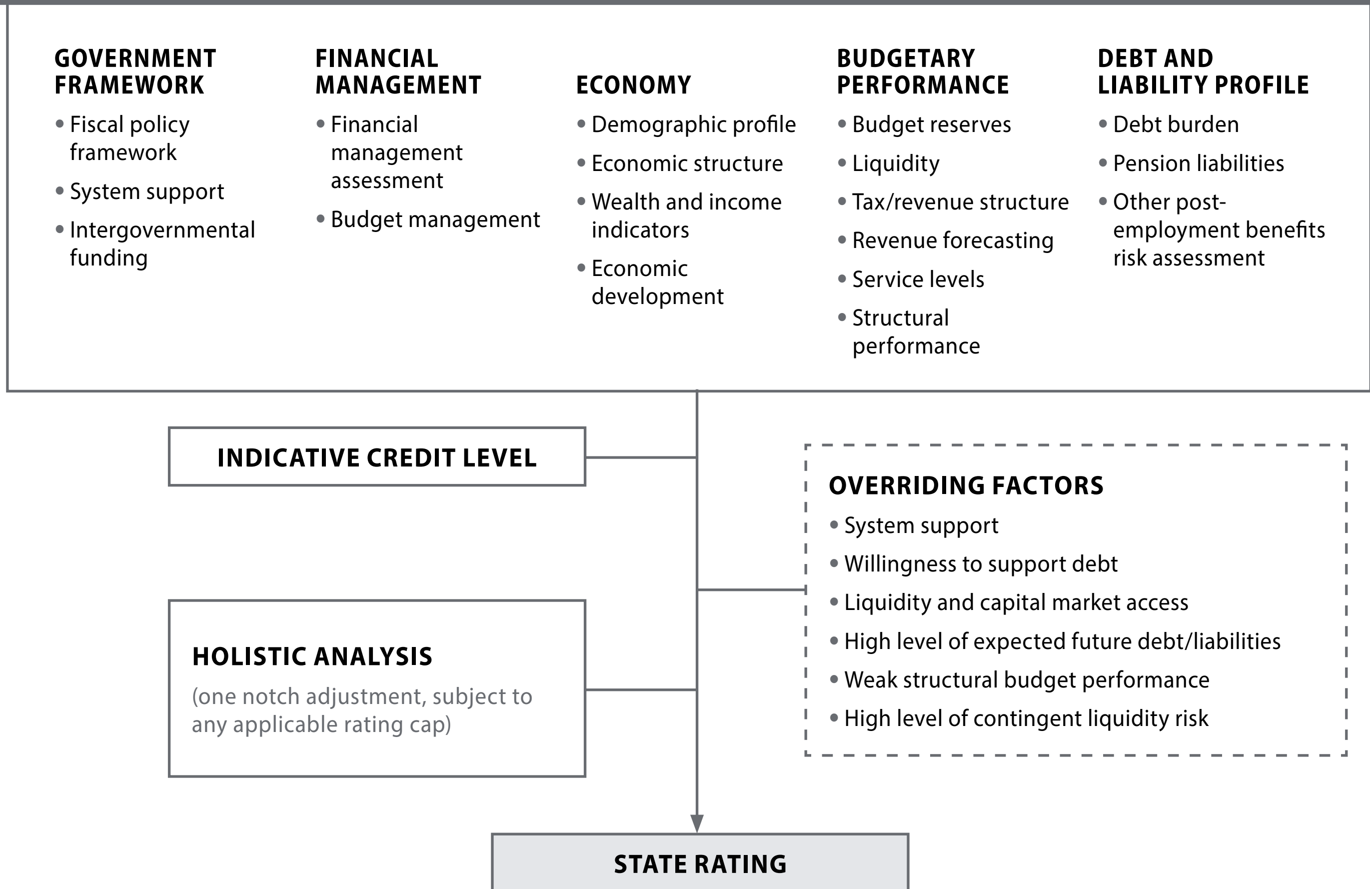
Poor management of the state's long-term debt obligations could cause a downgrade of the state's credit rating, resulting in increased borrowing costs and decreased investor confidence.

While Texas has received the highest possible credit rating from Moody's and S&P (Aaa-stable since 2012 and AAA since 2013, respectively), unfunded pension liabilities have earned Texas declining debt scores in recent years.

Credit rating agencies are private, independent companies. Their ratings represent an estimation of the state's ability and willingness to meet its financial obligations. The ratings have both qualitative and quantitative elements and are developed by teams of specialists who evaluate a state's creditworthiness using budget documents, audited financial reports, economic data and relevant official statements.

Texas has been highly rated due to its above-average population growth, well-developed infrastructure and trade networks, large and diverse economic base, financial reserves and strong financial management and budgetary practices. Weaknesses noted by rating agencies include the continuing importance of the volatile energy industry to the state's economic base and large shortfalls in employee pension contributions.

EXHIBIT 6



Source: Standard and Poor's Financial Services LLC

Exhibit 6 displays S&P's criteria for evaluating state debt as one part of its state credit rating. The company's "overriding factors" contain some elements applicable to the long-term debt obligations, including pension systems. If analysts determine that a state has these overriding factors, they can be used to justify a downgrade of a state's credit rating.

The "debt and liability profile" portion of the criteria examines how debt service and other long-term liabilities spending are prioritized. The criteria evaluate how these obligations may affect operating costs and budgets as well as future tax streams and other revenue sources. The pension component also considers changes in assets and liabilities, funded ratios, funding discipline and unfunded pension liabilities.

Texas has received a gradually declining score in Standard & Poor's debt and liability profile since 2014. Possible scores range from one to four, with one being the strongest; Texas moved from a 2.1 in 2013 to a 2.7 in 2016. S&P assigned this score in response to contributions below the actuarially determined annual contribution, a "trend that could put the rating under pressure."[47] Furthermore, the agency notes that Texas' pension funding policy is set in law as a percentage of payroll, making future payments below the actuarially determined contribution rate very likely.

Moody's debt criteria assess relative debt burdens and debt affordability, the state's debt structure and its capacity to meet long-term debt obligations, including unfunded pension liabilities (**Exhibit 7**). The pension component of the debt profile measures the total unfunded liability of state pension plans as a percent of state revenues. Analysts assign scores in this category

based on this ratio (Aaa = less than 25 percent, Aa1 = 25-40 percent, Aa2 = 40-80 percent, etc.)

Moody's analysts also consider pension governance and management, contribution decisions and pension liability calculation mechanisms in their formulation of scores in this component of the profile. Moody's also may move a rating up or down based on an "additional debt factor," significantly strong or weak pension characteristics not reflected in the profile.

A June 2016 Moody's analysis stated that Texas' record of below-actuarial-level contributions are driving rising pension costs.[48] While Moody's credits Texas with successful pension reforms in 2013 and 2015, and a higher-than-national-average ratio of active employees to retirees, an October 2016 report by the company notes that Texas has one of the nation's largest pension shortfalls due to continued underfunding.

In 2016, Moody's introduced a "treading-water" metric that measures whether pension liabilities rose, fell or remained static in a fiscal year. Moody's found Texas was considerably below the treading-water benchmark in 2015.[49]

In the last few years, most states have enacted some type of pension reform. Still, several have seen their credit ratings downgraded due to pension underfunding, including Kentucky, New Jersey, Kansas and Illinois. Pension shortfalls in Dallas and Houston captured attention recently, prompting credit rating downgrades and concern that the downgrades will put negative pressure on the state's economy as a whole. Moody's has cautioned that Texas local governments, with their own troubled pension systems, are contributing to growing concern about state government's pension liabilities.[50]

Credit rating criteria don't address deferred maintenance issues directly but such costs are eventually reflected in the state's financials and could negatively affect the state's ratings for financial management and governance. Standard & Poor's overriding factors could be triggered by deferred maintenance, particularly the criteria evaluating financial best practices, flexibility and governance, among other elements. A poor rating on the overriding criteria can trigger a downgrade.

The Texas Tomorrow Fund is perhaps the least visible of the long-term debt obligations discussed in this report. While the ratings agencies criteria do not speak specifically to guaranteed tuition plans, it's a general revenue pledge and a long-term obligation of the state. Shoring up the program's finances would send a strong message to rating agencies that Texas intends to meet all its obligations. ■

EXHIBIT 7

MOODY'S STATE RATING METHODOLOGY

BROAD RATING FACTORS	FACTOR WEIGHTING	RATING SUB-FACTORS	SUB-FACTOR WEIGHTING
Economy	20%	Income	10%
		Industrial Diversity	5%
		Employment Volatility	5%
Governance	30%	Financial Best Practices	15%
		Financial Flexibility/Constitutional Constraints	15%
Finances	30%	Revenues	10%
		Balances and Reserves	10%
		Liquidity	10%
Debt	20%	Bonded Debt	10%
		Adjusted Net Pension Liabilities	10%
TOTAL	**100%**	**TOTAL**	**100%**

Source: Moody's Investors Service, Inc.

VI. INVESTING TO ADDRESS LONG-TERM OBLIGATIONS

As we've seen in this special report, Texas' long-term obligations *must* be addressed, but most of the available strategies — raising member contributions, reducing benefits and increasing state debt, for example — create their own problems and may be unpalatable for many policymakers. And in tight budget times such as these, using general revenue to quickly mitigate these obligations often isn't feasible.

One option is to set aside some state Treasury balances to address long-term obligations, either by creating a new permanent fund or by reserving a portion of the existing Economic Stabilization Fund (ESF, or "rainy day fund"), to function much like an endowment, creating investment earnings to address long-term obligations. Texas already has many permanent funds, including the Permanent School Fund, which produces earnings to fund public education, and the Permanent University Fund, which supports public higher education.

This approach would differ from a one-time ESF expenditure in that the goal would be to generate earnings for annual spending, leaving the corpus of the fund untouched.

The investment objectives would be to provide predictable, stable funding from earnings; ensure that the inflation-adjusted value of this funding is maintained over time; and to preserve the inflation-adjusted value of the principal, after distributions and fund expenses.

Seven states (Alaska, Montana, New Mexico, North Dakota, Utah, West Virginia and Wyoming) currently use an approach similar to this, making long-term investments with severance tax revenue. Such funds provide a more consistent revenue stream than volatile tax revenues from oil, gas and other natural resources. Most of these states, however, appropriate some fund earnings to general revenue, and four allow withdrawals from the principal, which can seriously damage their long-term revenue potential.[51]

If it adopts this approach, the Texas Legislature would develop guidelines for the fund's purpose, its initial funding and the amounts available for appropriation. Lawmakers would prioritize needs to be addressed by the fund, such as deferred maintenance, pensions or other long-term obligations.

One potential way to increase this investment balance would be to lower the cap on the ESF and dedicate any revenue above the cap for this purpose.

This could provide a permanent, additional stream of income to help address long-term debt obligations without increasing taxes. Taking positive action to further address the state's long-term obligations, moreover, would benefit Texas' standing with credit agencies. ■

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