



Senate Finance Committee

Interim Report

January 2009

SENATE FINANCE COMMITTEE

80th Legislature

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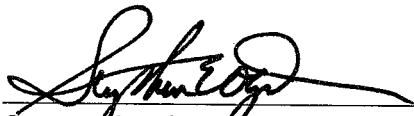
January 7, 2009

The Honorable David Dewhurst
Lieutenant Governor of the State of Texas
Capitol Building, Room 2E.13
Austin, Texas 78701

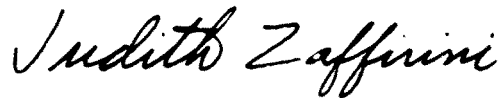
Dear Governor Dewhurst:

The Senate Finance Committee is pleased to submit its final interim report with recommendations for consideration by the 81st Legislature in preparation for the regular session.


Respectfully submitted,



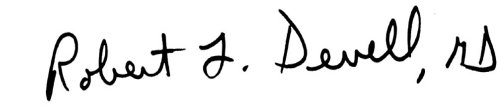
Senator Stephen E. Ogden, Chair



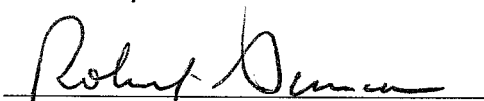
Senator Judith Zaffirini, Vice-Chair



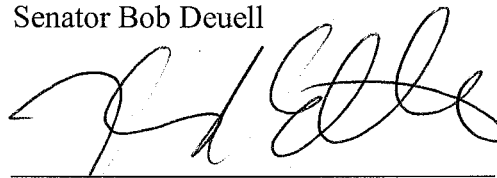
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Senator Robert Duncan



Senator Kevin Eltife



Senator Troy Fraser



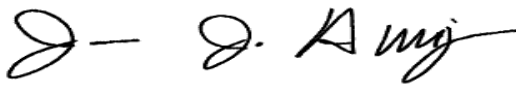
Senator Chris Harris



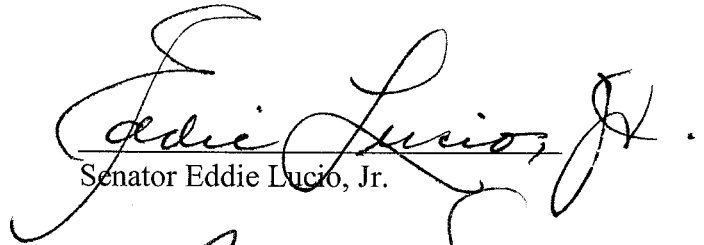
The Honorable David Dewhurst

January 7, 2009

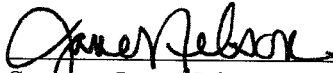
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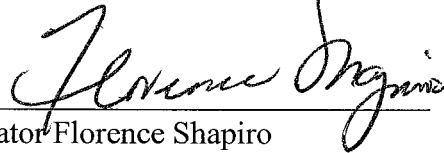
Senator Juan "Chuy" Hinojosa



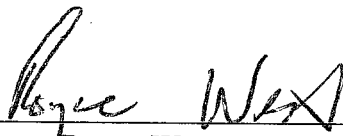
Senator Eddie Lucio, Jr.



Senator Jane Nelson



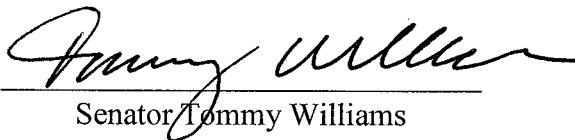
Senator Florence Shapiro



Senator Royce West

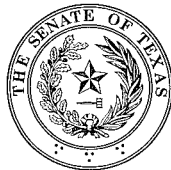


Senator John Whitmire



Senator Tommy Williams

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January 7, 2009

The Honorable Steve Ogden, Chairman
Senate Finance Committee
Capitol Building
Austin, Texas 78701

Dear Senator Ogden:

It has been a pleasure working with you and your staff this interim as we conducted the interim charges of the Senate Finance Committee. I appreciate the many hours spent taking testimony and compiling the interim report. Please accept this letter for inclusion in the report.

I would like to state my opposition to the recommendation to establish a transportation finance corporation. I firmly believe that borrowing money from the state's pension or other state investment funds for infrastructure projects does nothing but create more leverage in the system. Our transportation funding challenges are best solved long term by putting more equity into the funds used by the Texas Department of Transportation. If we are going to borrow money to help alleviate the funding shortfall at TxDOT, this is best done as we have done in the past by the State of Texas issuing bonds. It appears to me that the State can issue bonds at a much lower rate than the rate of return we would be expected to pay the pension funds.

Finally, I believe that borrowing money from the pension funds could create a conflict of interest.

I commend you for your leadership and look forward to further discussions in the upcoming Legislative Session.

Sincerely,

A handwritten signature in black ink that reads "Kevin P. Eltife".

Kevin P. Eltife
State Senator

cc: Senate Finance Committee Members
KPE/cv



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**Interim Report on
Revised Franchise Tax
Health Care Tax Credits**

EXECUTIVE SUMMARY

During the 80th interim, the Senate Finance Committee held a hearing to evaluate the effectiveness of existing state tax incentives that encourage employers to provide health coverage to their employees. The committee recommends that the Legislature consider changing the current revised franchise tax health care deduction for small businesses to a tax credit to attempt to increase the number of employees covered by health care insurance. Properly designed, it may be possible for a health care tax credit program to result in a relatively small cost to the state, if part of the cost of the tax credit is offset by a reduction in state payments for uninsured/unreimbursed healthcare. The Legislature should also investigate whether some or all of the cost of the credits may be offset by technical changes to the franchise tax.

SUMMARY OF RECOMMENDATION FOR THE 81st LEGISLATURE

The committee recommends that the Legislature consider changing the current revised franchise tax health care deduction for small businesses to a tax credit to attempt to increase the number of employees covered by health care insurance.

PROCEDURAL BACKGROUND

The Senate Finance Committee was charged with conducting a thorough and detailed study of the following issue and preparing recommendation to address problems or issue that are indentified. The Committee met in accordance with the following interim charge:

Evaluate the effectiveness of existing state tax incentives that encourage employers to provide health coverage to their employees, including tax incentives under the revised state business tax, and make recommendations for additional deductions or credits that increase the number of employees covered by health care insurance.

The Committee met pursuant to the aforementioned interim charge in a public hearing in Austin, Texas on August 19, 2008, to consider invited testimony provided by the Texas Comptroller's Office and Texas Department of Insurance. The Committee solicited public testimony on the interim charge in a public hearing in Austin, Texas on August 19, 2008. The Committee extends its appreciation to those who participated in the hearing and assisted with or made presentations before the Committee.

OVERVIEW

Texas has the highest uninsured rate in the nation. According to 2006 data, the latest data available from the Texas Department of Insurance (TDI), almost 6 million Texans--roughly one-quarter of the state's population--do not have health insurance. This is substantially higher than the national average, which is around 16%.¹

The cost of providing health care for the uninsured is transferred to those who have health insurance, through higher health insurance premium costs, and to taxpayers, who pay for uncompensated care in public hospitals and other public programs.² It is estimated that the uninsured increase the cost of private insurance in Texas by 13%--\$550 annually for single coverage and \$1,551 annually for family coverage. Moreover, the cost is rising. By 2010, premiums in Texas are expected to be 14.4% higher--\$922

¹ "Texas Health Insurance Market - Insuring the Uninsured," Presentation to Senate Finance, August 19, 2008, by Diane Longley, Director, Research and Analysis, Life, Health, and Licensing, Texas Department of Insurance.

² "Special Report-The Uninsured: A Hidden Burden on Texas Employers and Communities," April 2005, Carol Keeton Strayhorn, Texas Comptroller. <http://www.window.state.tx.us/specialrpt/uninsured05/96-1128.pdf> (page 1).

annually for single coverage and \$2,786 annually for family coverage--due to uncompensated care.³

According to the data presented by TDI, low-income and moderate-income Texans are less likely to have health insurance provided by their employers. Almost 60% of the uninsured in Texas have an income that is below 200 percent of the federal poverty (currently \$42,400 for a family of four). Of the uninsured adult population, more than two-thirds are employed.

Additionally, small businesses are less likely to provide health coverage to their employees: 58% of uninsured adults are employed by firms with less than 100 employees. However, a substantial number of uninsured adults are employed by large firms. In 2006, 23% were employed by firms with more than 1,000 employees. Most large firms in Texas offer health insurance to their employees, while only 34% of small firms do so. Employers report several reasons for not providing health coverage for their employees: cost, participation requirements, inability to offer multiple plans, rate stability, and underwriting or rate variability due to employee demographics.

Texas currently provides several tax incentive programs to encourage employers to offer health care to their employees. In 2001, the Texas Legislature approved House Bill 1200 (Texas Economic Development Act, Chapter 313, Property Tax Code), which provides qualifying taxpayers a property tax benefit. In 2003, the Legislature approved Senate Bill 10, which exempts insurance premiums associated with a health group cooperative from the gross premium tax. And in 2007, the Legislature approved House

³ "Texas Health Care Reform Proposal" sent to The Honorable Michael Leavitt, Secretary of Health and Human Services, Washington D.C. by the Honorable Rick Perry, Office of the Governor, December 5, 2007. http://www.hhs.state.tx.us/medicaid/ConceptPaper_DRAFT.pdf (page 3).

Bill 3928, which provides a bonus Franchise Tax deduction to certain employers offering health coverage to their employees for the first time.

Current Incentives

1. Texas Economic Development Act

Description: In exchange for an appraised value limitation and tax credit, a property owner must agree to create a specific number of qualifying jobs and build or install specific types of property of a certain value. Qualifying jobs must be covered by a group health benefit plan that pays 80% the employee's premium.

Evaluation: The primary goal of the program is to encourage businesses to make large-scale capital investment and create high-paying jobs. The requirement for health coverage is secondary to that goal. While the requirement ensures that these new jobs have coverage, it does not reduce the number of existing jobs without coverage. Decisions regarding which businesses benefit are made by school districts, not the state. The state, however, picks up the cost of the value limitation and tax credits through the school funding system.

2. Health Group Cooperatives

Description: S.B. 10 (78th Leg. 2003(R)) allows employers to establish health group cooperatives for the purchase of employer health benefit plans for their employees and dependents. A health carrier issuing coverage to a health group cooperative is exempt from the 1.75% gross premiums tax for premiums to provide the coverage.

Evaluation: The gross premiums tax exemption results in a small reduction in the cost of health coverage for participating employers.

3. Revised Franchise Tax

Description: A small employer that chooses to deduct compensation from its computed margin, and did not offer health care coverage to its employees in the preceding year, is eligible to receive a bonus deduction of 50% of the cost of the health care benefits for the first year the health care coverage is offered and a deduction of 25% of the cost in the second year.

Evaluation: The Comptroller's office has not yet identified the number of small firms taking advantage of this new deduction. The initial impression is that the tax benefit is not substantial enough to induce small firms that do not currently offer health insurance to do so. Since the franchise tax rate is 0.7% or less, the tax benefit the employer would actually receive is small relative to the cost of health

insurance premiums. By the same token, this incentive appears to have a very low cost to the state in terms of lost franchise tax revenue.

At last count, nearly 25% of Texas residents lacked health insurance. Many of the uninsured are employees of businesses that do not provide health insurance to their employees. One proposal to increase the number of Texans with health insurance is to expand the current franchise tax incentive for employers who offer health insurance to their employees.

With respect to general business tax incentives, some states offer participating employers a *tax credit*, rather than a *tax deduction*. A tax credit is a direct offset against the firm's tax liability; a tax deduction is a subtraction from the tax base to which the tax rate is applied. The difference can be substantial. A \$1,000 credit reduces the firm's tax liability by \$1,000. A \$1,000 deduction, on the other hand, reduces the firm's tax liability by \$7 at a tax rate of 0.7%.

An employer is more likely to provide health coverage to employees if the employer receives a financial benefit for doing so. The more substantial the tax credit, of course, the more effective it will be at motivating employers to provide coverage. A tax benefit based on the number of employees actually enrolled in a qualifying health insurance program would provide a direct incentive to the firm to increase the number of covered employees. The policy goal of the tax credit should be to increase the number of insured individuals, not to reward firms that already provide coverage.

There is, however, an inherent tension in the tax credit approach. Although increasing health insurance coverage for Texans is good public policy and reduces the need for more taxpayer funding of uninsured/unreimbursed health care, the fairness of the

business tax could be undermined by large tax credits for selected businesses. Additionally, such tax credits could have a significant fiscal impact on the state's revenue stream. Limiting the cost of credits could be achieved by limiting the period of time in which an employer may claim the credit, by requiring that the business enroll a high percentage of the firm's employees to qualify, or by establishing in law a maximum cost of tax credits that may be granted in a fiscal year.

RECOMMENDATION

The Committee recommends that the Legislature consider changing the current revised franchise tax health care *tax deduction* to a *tax credit*. Properly designed, it may be possible for a health care tax credit program to result in a relatively small cost to the state, if part of the cost of the tax credit is offset by a reduction in state payments for uninsured/unreimbursed healthcare. Thus, it would be helpful to decision-makers to have a dynamic fiscal analysis to determine the net cost of the tax credits, taking into account any savings to state programs. The Legislature may also want to investigate whether some or all of the cost of the credits may be offset by technical changes to the franchise tax.

**Joint Interim Report with Health and Human
Services on Medicaid Provider Rate
Reimbursement Methodologies,
Hospital Reimbursement and
Uncompensated Care**

EXECUTIVE SUMMARY

Health and human services expenditures continue to be among the largest drivers in our biennial state budget. For the 2008-09 biennium, appropriations total \$53.0 billion in All Funds or 31.6 percent of all state appropriations, including \$21.4 billion in General Revenue Funds and General Revenue-Dedicated Funds. The various components of the Medicaid program account for \$15.4 billion in General Revenue funding for the 2008-2009 biennium. On an All Funds basis, Medicaid accounts for \$39.6 billion, which is 75 percent of the Article II budget and 24 percent of the total state budget. The Senate Finance Committee in conjunction with the Senate Health and Human Services Committee were given a specific charge related to health care cost-related issues.

The report is divided into two chapters:

- Chapter 1: Uncompensated Care/Hospital Financing/Medicaid Reform
- Chapter 2: Medicaid Rates Reimbursement Methodologies

SUMMARY OF RECOMMENDATION FOR THE 81st LEGISLATURE

1. Participating hospitals should be required to submit audited data to be eligible for Disproportionate-Share Hospital (DSH) & Upper Payment Limit (UPL) reimbursement. Via rider or statute, HHSC should be provided the authority to withhold payment for a participating hospital's failure to comply with reporting requirements.
2. HHSC should implement a simpler and standardized reporting methodology to calculate uncompensated care.
3. The Centers for Medicare & Medicaid Services (CMS) diagnosis related groups (DRGs) should be expanded to an "all patient" system for use in Medicaid to better measure severity of illness and differences in population to more accurately reflect a patient's needs.

4. Before any future rate increases are considered or approved, the Legislature and HHSC must understand how previous rate increases were implemented and what measurable results were obtained.

PROCEDURAL BACKGROUND

The Senate Finance Committee and Senate Health and Human Services Committee (the Committees) were charged with conducting a thorough and detailed study of the following issue, including state and federal requirements, and preparing recommendations to address problems or issues that were identified. The Committees met in accordance with the following interim charge:

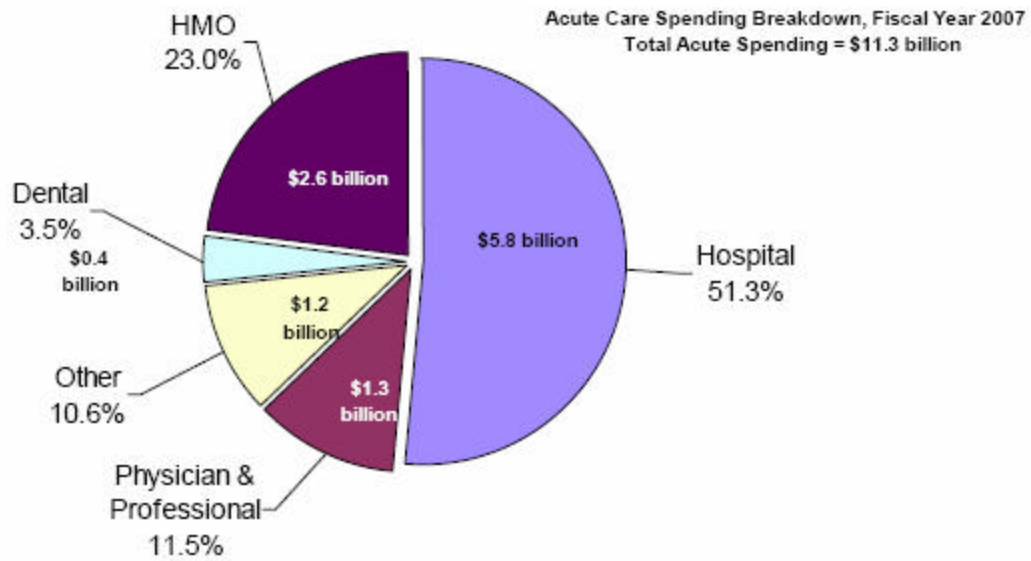
Review Medicaid provider reimbursement rate methodologies, including the impact of factors such as infrastructure concerns, federal minimum wage changes, and cost reports. Study the impact on access to care, quality of care, and value, and make recommendations for legislative changes, taking into account rate increases contained in the current budget.

The Committees met pursuant to the aforementioned interim charge in a public hearing in Austin, Texas on September 16, 2008, to consider invited testimony provided by HHSC and solicited public testimony. The Committee extends its thanks to those who participated in the hearing and assisted with or made presentations before the Committees.

CHAPTER 1: UNCOMPENSATED CARE/HOSPITAL FINANCING

BACKGROUND

Health and human services are a significant and growing portion of the Texas state budget with health care funding intertwined into numerous programs. Appropriations for the health and human services functions for the 2008-09 biennium total \$53.0 billion in All Funds or 31.6 percent of all state appropriations and in turn, Medicaid spending accounts for a large portion of all spending in Texas.



The 80th Legislature recognized the complexities of hospital uncompensated care and directed HHSC via Senate Bill 10 and through HHSC Rider 44 to convene a hospital industry work group to study and advise HHSC on options to improve uncompensated care reporting, with the goal of streamlining definitions of uncompensated care.

The workgroup determined that the individual program definitions of uncompensated care were too unique to each program for a single definition to be workable in all cases. Instead, an overarching definition and methodology could clarify hospital uncompensated care reporting. This methodology should also account for offsetting funding sources provided by the legislature and federal and local governments and measure the residual impact of uncompensated care on hospital costs.

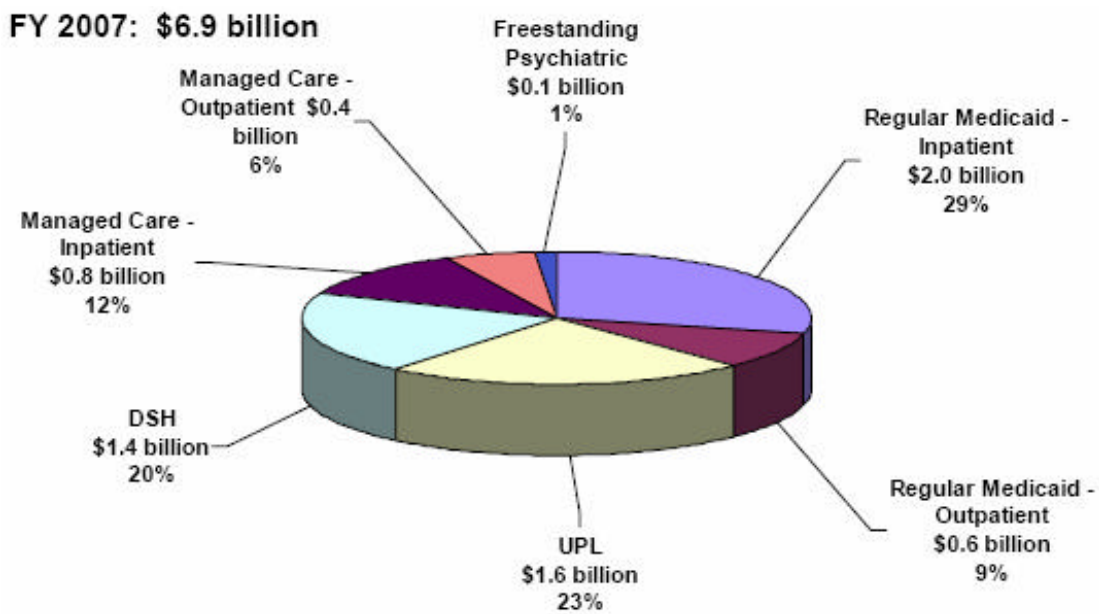
Also of particular interest is hospital financing. Payments to hospitals for inpatient services are based on diagnosis related groups (DRGs). A DRG is comprised of a standard dollar amount (SDA) multiplied by a relative weight. The SDA is in effect a

base rate that is unique to each hospital based on its costs. The relative weights are a measurement of severity of illness for the patients receiving treatment. Outpatient payments to hospitals are calculated differently. Hospitals are provided a defined percentage of their allowable costs. High volume providers are reimbursed at 84.48 percent of their allowable costs while other hospitals are reimbursed at 80.30 percent of their allowable costs.

Effective October 1, 2007, CMS adopted a Medicare Severity-Diagnosis Related Groups (MS-DRG) classification system for the Medicare inpatient prospective payment program. Under this prospective payment program, hospitals are encouraged to use more cost-efficient medical care and are paid a pre-determined rate for each Medicare/Medicaid admission. HHSC also adopted the new MS-DRG listings for the state's Medicaid inpatient prospective payment system effective October 1, 2007. The previous version of the Medicare DRG listing had about 540 relative weights. The new MS-DRG has 745 relative weights. CMS and HHSC adopted this expanded listing of weights to better recognize the severity of illness among patients whose care is reimbursed by the prospective payment system. This expansion focused more on the types of care provided to the older Medicare population, rather than the pregnant women and children who are the bulk of the clients in the Medicaid program. Even with this expanded number of DRG's, there are limitations on the completeness of this list since CMS based its system on the costs of its older, Medicare population. HHSC is considering an "all patient" DRG methodology which will more appropriately categorize hospital costs for the Medicaid population (which is predominately infants and children with relatively few older adults).

Changing to an “all patient” DRG system for the Medicaid population will allow hospital reimbursement to be more appropriate to the actual hospital cost for serving Medicaid patients. A more accurate DRG system also paves the way for incorporating more quality data into payment systems, such as the use of present on admissions indicators.

TEXAS’ MEDICAID RELATED HOSPITAL PAYMENTS (ALL FUNDS)



DSH/UPL

In addition to the regular payments for inpatient and outpatient care, the Medicaid program provides the supplemental payment options. Two of the largest of these are the Disproportionate Share Hospital (DSH) program and the Upper Payment Limit (UPL) program. The DSH program is a Medicaid supplemental payment program for hospitals that qualify for participation based on the disproportionate number of Medicaid days and/or uninsured days provided. The DSH program reimburses qualifying hospitals for the amount of their inpatient Medicaid shortfall costs (which are Medicaid costs not

reimbursed by the Medicaid DRG program) and the uncompensated care costs they have incurred for providing care to uninsured Texans. In the allocation of DSH payments, the current formula pays state hospitals first for their actual costs of uncompensated care and then, depending on the amount of DSH remaining, allocates the remainder of the federal DSH funds to all other qualifying hospitals. In 2008, the total amount of DSH funds available for allocation was approximately \$1.5 billion.

Another supplemental payment program, the UPL program is intended to reimburse participating hospitals the difference between what Medicare would have paid for each Medicaid patient and what Medicaid actually did pay. This program is composed of three separate hospital classes: State Hospitals, Public Hospitals and Private Hospitals. Each class calculates its own UPL and a hospital cannot be in more than one class. Hospitals do not have to participate in the DSH program to be able to participate in the UPL program; however, the formula used to calculate the payment to a hospital that does participate in DSH is different than what is used to calculate the UPL payment for a hospital not in the DSH program.

As is the case for the DSH program, state hospitals fund the state share of their full UPL payments with GR funds, while public hospitals use Intergovernmental Transfers (IGTs) for their state match. The private UPL program is unique in that private hospitals are unable to provide a match that is allowable under CMS rules. In order for a private hospital to participate in the UPL program, a public hospital is required to put up the state match using allowable tax funds to do so. This matching requirement leads to the need for a private hospital to negotiate an “affiliated agreement” with the public hospital providing the state match. The Private UPL program was temporarily on hold

during the interim as CMS reviewed the permissibility of some non-federal matching funds. Private UPL program payments were restored beginning in August 2008 and will total \$575 million in All Funds for this year alone.

Nearly \$3 billion is paid to hospitals each year via the DSH and UPL programs. This makes up about half of total Medicaid funding provided to hospitals. These programs that were initially intended as supplements and funding enhancements now almost match traditional payments. However, there is very little accountability on how the funds are spent since the payments are not associated with specific patients or services.

The Texas Medicaid waiver request called for in SB 10, submitted in April 2008 and revised in October of 2008, outlines a large series of health care reforms that are intended to assist more people with insurance, reduce reliance on high-cost emergency room visits for basic care, and make it easier for working individuals to buy into employer-sponsored health coverage.

Approval of the waiver would protect funding for our safety-net hospitals, establish greater transparency in the reporting of uncompensated care expenses, and support local efforts to reduce uncompensated care. The Medicaid Reform waiver, if granted, could serve to protect the allotment of UPL funds to Texas and to perhaps allow for the development of a more cost effective vehicle for providing care. Chronic illnesses such as diabetes, asthma and heart disease often are not treated in a proper manner. The result is overcrowded emergency rooms, rapidly growing uncompensated care charges, higher private insurance premiums for insured Texans and their employers, and poor health outcomes for many. If the federal government does not approve the Medicaid

Reform waiver, the state should still move forward with efforts to more effectively and efficiently use DSH funds. Funds should not simply be distributed to non-state DSH hospitals via the traditional formula, but instead be leveraged to support disease management programs, for example.

Regardless of the adoption of federal waiver, participating hospitals should be required to submit audited data to be eligible for these DSH & UPL payments. Via rider or statute, HHSC should be provided the authority to withhold payment for failure to comply with reporting requirements. Currently, most observers believe the state cannot address its problems of the uninsured unless we reform the Texas health care system at its base. With Texas' Medicaid waiver request, the state is seeking to break this cycle.

RECOMMENDATIONS

The Senate Committee on Finance and the Senate Health and Human Services Committees recommend that the 81st Legislature consider taking appropriate action to effectuate the following in regard to Uncompensated Care and Hospital Financing:

1. Participating hospitals should be required to submit audited data to be eligible for Disproportionate-Share Hospital (DSH) & Upper Payment Limit (UPL) reimbursement. Via rider or statute, HHSC should be provided the authority to withhold payment for participating hospitals failure to comply with reporting requirements.
2. HHSC should implement a simpler and standardized reporting methodology to calculate uncompensated care.
3. The Centers for Medicare & Medicaid Services (CMS) diagnosis related groups (DRGs) should be expanded to an "all patient" system for use in Medicaid to better measure severity of illness and differences in population to more accurately reflect a patient's needs.

CHAPTER 2: MEDICAID RATE REIMBURSEMENT METHODOLOGY

BACKGROUND

The joint hearing also included an overview of the Health and Human Services Commission (HHSC) Medicaid rate setting responsibilities. HHSC develops more than 157,000 different rates, primarily for the Medicaid program. Of these, 360 rates are for health maintenance organizations (HMOs), 955 are for nursing facilities, 28,000 for school health and related services, 473 for inpatient hospital standard dollar amounts and 745 for inpatient hospitals diagnostic related groups, 112,592 for physicians and other professionals, 1,991 for durable medical equipment, and 2,773 are for Texas Health Steps providers.⁴ There are several major methodologies under which most of these reimbursement mechanisms can be grouped, [SFC presentation 9/16/2008, page 9]. Managed care rates are actuarially based. This includes programs such as STAR, PACE and CHIP. Other rates are cost report based, or prospective. These include nursing facilities, community care, rehabilitation services and foster care. Another methodology is cost based reimbursement. This includes children's hospitals, state schools, the state lab, outpatient hospital services, and school and health related services (SHARS).

In some cases, the state does not directly determine the rate methodology. Several major rate categories are influenced by federal Medicare policy. These include hospital diagnosis related groups (DRGs), ambulance providers, and durable medical equipment. Furthermore, the Centers for Medicare and Medicaid Services (CMS) mandate the methodology for the rate calculation. These include rates for hospice (both nursing facility and in-home), federally qualified health centers (FQHCs), and rural

⁴ Consolidated Budget, page 64.

health clinics. In general, most Medicaid services had rate increases effective September 1, 2007.

RATE INCREASES RECENTLY DONE BY THE LEGISLATURE

Providers	2002-2003	2004-2005	2006-2007	2008-2009
Hospitals - Inpatient	9/01/01 fully rebased acute care hospitals	9/1/03 rate decrease 2.5% 9/1/04 rate decrease of 5% (Implementation of UPL program begins in 2004)	9/1/06 rate decrease related to SSI patients in 8 specific Managed Care Organizations Service Delivery Areas 8%	Subject to Medicaid Reform Waiver approval - \$150 million (increases offset 5% rate decrease)
Hospitals - Outpatient	0%	9/1/03 rate decrease 2.5%	0%	9/1/07 rate restoration 2.5%
Federally Qualified Health Centers (FQHC)	1/1/02 rate increase 3.8% 1/1/03 rate increase 4.5%	1/1/04 rate increase 4.4% 1/1/05 rate increase 4.8%	1/1/06 rate increase 4.3% 1/1/07 rate increase 3.6%	1/1/08 rate increase 3.3% 1/1/09 rate increase MEI + 1.5%
Rural Health Clinics (RHC)	1/1/02 rate increase 2.3% 1/1/03 rate increase 3.0%	1/1/04 rate increase 2.9% 1/1/05 rate increase 3.1%	1/1/06 rate increase 2.8% 1/1/07 rate increase 2.1%	1/1/08 rate increase 1.8% 1/1/09 rate increase MEI
Ambulance Providers	0%	9/1/03 rate decrease 2.5%	0%	9/1/07 rate increase and rate restoration of 55.5%
Physicians and Certain Other Practitioners:				
<i>Children**</i>	0%	9/1/03 rate decrease 2.5%	0%	9/1/07 rate increase and rate restoration of 27.5%
<i>Adults</i>	0%	9/1/03 rate decrease 2.5%	0%	9/1/07 rate increase and rate restoration of 12.5%
Dentists**	1/1/02 rate increase of 13.5%	9/1/03 rate decrease 2.5%	0%	9/1/07 rate increase and rate restoration of 52.5%
Vendor Drug (Dispensing Fee)	0%	9/1/03 rate decrease 2.5%	0%	9/1/07 rate increase and rate restoration of 44.8%

Providers	2002-2003	2004-2005	2006-2007	2008-2009
Nursing Facilities	9/1/01 rate increase of 8.8%	9/1/03 rate decrease of 1.75%	1/1/06 rate increase of 11.75%	9/1/07 rate increase of 3% 9/1/08 rate increase of 5%
Community Care - DADS (CBA, PHC, DAHS, CLASS, etc.)	9/1/01 rate increase varies from .04% to 2.2%	9/1/03 rate decrease of 1.1%	9/1/05 rate restoration increase of 1.10% 8/1/07 minimum wage increase - varies from 0% to 1.79%	9/1/07 rate increase - varies from 1.79% to 6.06% 8/1/08 minimum wage increase - varies from 2.45% to 14.29% 8/1/09 minimum wage increase - not yet determined
Community Care - DADS (HCS, TxHmL)	9/1/01 varies from rate decrease of 4.4% to rate increase of 3.23% depending on service	9/1/03 rate decrease of 1.1%	6/1/07 rate restoration increase of 1.1%	9/1/07 rate increase of 5%
Community Intermediate Care Facility for Persons with Mental Retardation (ICF/MR)	9/1/01 and 11/1/01 rate increase - varies from 10% to 13%	9/1/03 rate decrease of 1.75%	6/1/07 rate restoration increase of 1.75%	9/1/07 rate increase of 7.5%
Foster Care	9/1/01 rate increase of 3% 9/1/02 rate increase of 2%	9/1/03 rate decrease of 3.1%	9/1/05 rate increase of 2.78%	9/1/07 rate increase of 4.3%

OTHER ISSUES FOR THE 81ST SESSION

In the event the legislature approves increased funds for provider rates, state agencies responsible for the designated programs will, in most cases, utilize stakeholder groups and other methods to determine reimbursement for each type of procedure. Rate increases can be targeted by appropriations rider and the legislature can review and modify instructions based on impact, fairness, or any other basis.

RECOMMENDATIONS

The Senate Committee on Finance and the Senate Health and Human Services Committees recommend that the 81st Legislature consider taking appropriate action to effectuate the following in regard to Medicaid Rate Reimbursement Methodology:

1. Before any future increases are approved, the Legislature and HHSC must understand how previous rate increases were implemented and what measurable results were obtained.

**Interim Report on
Statewide Transportation Financing**

EXECUTIVE SUMMARY

Over the past decade, the Texas Department of Transportation (TxDOT) has experienced a record increase in funding to build and maintain Texas roads. TxDOT estimates that \$11 billion is spent on Texas roads by federal, state, and local governments each year.⁵

However, TxDOT's estimated need for new state construction projects exceeds the future capacity of existing annual deposits to State Highway Fund 6. There are additional pressures on state funding as well. For example, federal funding rescissions from the largest federal transportation grant, the SAFETEA-LU, have totaled \$705 million dollars over three years.⁶ Since 2002, construction costs have increased 62%, leaving the state with considerably decreased purchasing power. These increases may flatten out with the current economic conditions.

The Joint Interim Report on Funding Allocation and Project Funding Reductions at the Texas Department of Transportation to the 80th Legislature highlighted the disparity of TxDOT's budget and the department's bill pattern in the General Appropriations Act (GAA). According to the report, "TxDOT advised that it is not possible for the amounts listed in the 12 categories [of The Unified Transportation Program, UTP] to be added together to match the level of funds appropriated in the various GAA strategies for several reasons. First, the amounts listed in the UTP categories are programming amounts (anticipated contract award amounts), while the

⁵ Legislative Budget Board. *Highway Funding Primer*. (p. 1).

⁶ *Ibid.* (p. 13).

amounts in the GAA are for expenditures over time.”⁷ Without coordinating the budget systems of the GAA and TxDOT’s UTP, the Texas Legislature cannot make informed decisions about future transportation funding. Due to the tenuous nature of state and federal funding for the state highway system, the Texas Legislature needs a clearer picture of the state's true and prioritized transportation needs in order to accurately address transportation funding. New funding mechanisms, as well as reduced reliance upon pay-as-you-go financing have altered the system of financing state highways. Therefore, new methods of tracking the department’s expenditures and debt obligations must be available in the General Appropriations Act.

SUMMARY OF RECOMMENDATIONS TO THE 81ST LEGISLATURE

1. Improve overall accountability in transportation funding by aligning the TxDOT appropriation bill pattern in the GAA with TxDOT’s internal budgeting procedures.
 - a. Restructure the Transportation Bill Pattern in the GAA to include the appropriation line items of past, current and future contracts for planning, construction and maintenance.
 - b. Restructure the bill pattern to include specific bond debt service items.
2. Amend Rider 3, Transfer Authority, to include a written approval requirement from the Legislative Budget Board.
3. Focus the use of State Highway Fund monies on state highway construction and maintenance.
4. Standardize rider language and rules to create a uniform reporting system for TxDOT.
5. Increase the enforcement of reporting requirements.

⁷ Senate Committee on Finance. Interim Charge Recommendations to the 80th Legislature. *Joint Interim Report on Funding Allocation and Project Funding Reductions at the Texas Department of Transportation*. January 2007. (p. 65/IV-6).

PROCEDURAL BACKGROUND

The Senate Committees on Finance and Transportation and Homeland Security were charged with conducting a thorough and detailed study of the following issues and exploring options to address identified problems. The Committees met in accordance with the following interim charges:

1. Study and review state and local options for expanding transportation funding and explore options to reduce diversions of Fund 6 revenue. (Joint charge with Senate Committee on Transportation and Homeland Security)

2. Study and make recommendations relating to whether the Texas Department of Transportation is in compliance with Transportation Code §201.109, Revenue Enhancement, and whether the Texas Department of Transportation is using the funding sources provided by the legislature, including, but not limited to, General Obligation, Fund 6 and Mobility Fund bonds, to build new roads. (Joint charge with Senate Committee on Transportation and Homeland Security)

The Committees met pursuant to the aforementioned interim charges in a public hearing in Austin, Texas, on February 5, 2008, to consider invited testimony provided by the Legislative Budget Board, the State Auditor's Office, and Texas Department of Transportation Commissioners and staff.

The Committee members extend their appreciation to those who participated in the hearing and assisted with or made presentations before the Committees.

OVERVIEW

Shortly after the 80th Legislature adjourned, TxDOT announced it would be reducing the amount of new construction contracts let because it did not have sufficient funds to support its existing construction plan. The Texas Legislature and the public were surprised to learn of the funding crisis so soon after the session because the amount of total dollars appropriated to TxDOT was at an all-time high.

After the announcement, TxDOT officials met with members of the Senate Committee on Transportation and Homeland Security and the Senate Committee on Finance to discuss the funding problem. TxDOT expressed concern over federal rescissions, inflationary pressures, reduced demand for gas, and therefore, income to the fund, as well as increased construction costs. These problems, however, should have been apparent to both TxDOT and the legislature when the budget was deliberated during the 80th legislative session. The legislature was perplexed as to how the agency had run out of construction funds so soon after its recent budget requests were substantially funded in the previous legislative session.

Over time the legislature has listened to TxDOT's request for flexibility in funding mechanisms, the need for new income sources, and the agency's complaints regarding non-highway related uses of State Highway Fund 6 money. To its credit, the legislature and the public responded to the agency's need for more money by offering new construction bond availability, committing more money sources to the Texas Mobility Fund, and adding new payment delivery methods for local financing options.

Going forward, TxDOT needs to regain the trust of the public and the legislature. The department can begin to do so by working with the legislature to ensure the GAA has a strong relationship with the agency's operating budget. The Senate Finance Committee believes changes to the General Appropriations Act will increase transparency in the Transportation Bill Pattern.

THE TRANSPORTATION BILL PATTERN

Reporting requirements have lagged in response to recent legislative changes such as additional contract flexibility and new finance tools. The legislature must be privy to

key information concerning new construction projects in order to make informed decisions about future funding. If transportation funding is needed, the Department of Transportation has a responsibility to properly communicate with the legislature through clear documentation.

TxDOT must make a habit of updating the Legislative Budget Board and Governor's Office with regularly refreshed lists of prioritized projects—including those with forecasts lasting beyond the next biennium. When the legislature has a clear picture of the state's true needs based on priority, it can fund those projects properly and willingly. TxDOT must demonstrate to the legislature exactly how contracts are funded over time in order to illustrate how rising construction costs, inflation, and population growth affect road construction costs. In addition, new methods of financing such as contracts, bond program status, and current monies appropriated to past projects must be delineated in the GAA.

Recommendation #1

Restructure the Transportation Bill Pattern in the General Appropriations Act.

The Senate Finance Committee recommends amending the appropriations bill to reflect two general additions. First, the GAA must single out all past, present and future contractual funding within the first three strategies of the Transportation Bill Pattern. Strategy 1, Transportation Planning, should continue to include contracted planning and design as a subset. Strategy 2, Transportation Construction, should contain a.) Existing Highway Contract Payments, b.) New Highway Contract Payments, and c.) Construction Grants and Services. Strategy 3, Maintenance and Preservation, should include a.) Existing Maintenance Contract Payments, b.) New Maintenance Contract Payments, and

c.) Routine Maintenance Contracts. These new additions will illustrate which funds are tied to existing contracts as well as funds dedicated to new construction projects.

Secondly, appropriation line items should be added for all bond debt service payments. These line items would require an additional strategy, Bond Debt Service. This strategy would include funding for General Obligation Bonds, State Highway Fund Bonds, Texas Mobility Fund Bonds, and Other Debt Service Payments. By isolating debt service in the Transportation Bill Pattern, the legislature will be better equipped to monitor the cost of bond payments over time.

The refined bill pattern would highlight the commitment to fund new construction projects by breaking out how much State Highway Fund 6 monies are spent continuing payments for committed projects and how much debt service is being paid. Appendix A of this report enumerates all recommended changes to the Transportation Bill Pattern.

TRANSFER AUTHORITY

One contributing factor to the confusion surrounding the funding shortfall lies in transferability provisions found in Rider 3 of the transportation budget. The General Appropriations Act (GAA) requires little accountability, explanation, or legislative input with regard to TxDOT initiated transfers. The current Transfer Authority Rider appears below.

3. Transfer Authority. The Department of Transportation is hereby authorized to transfer appropriations from any Strategy into Strategy C.1.1, Contracted Maintenance, Strategy A.1.2, Contracted Planning and Design, Strategy A.1.3, Right-of-Way Acquisition, and Strategy B.1.1, Transportation Construction. In addition, funds may be transferred between Strategies, except that no funds may be transferred out of Strategies C.1.1, Contracted Maintenance, or A.1.2, Contracted Planning and Design, Strategy A.1.3, Right-of-Way Acquisition, or B.1.1, Transportation Construction, except for transfers made between those Strategies.

The Department of Transportation shall submit to the Legislative Budget Board, in the format prescribed by the Legislative Budget Board, an annual report of transfers made

under the authority of this rider no later than 10 days after September 1 of each fiscal year.

The transfer provisions in Rider 3 allow for a loophole around the accountability and clarity of the first recommendation. Regardless of the reason behind the \$1.1 billion shortfall, the existence of the Transfer Authority Rider exacerbated perceptions of the department's lack of financial transparency and accountability. Essentially, the department overestimated the amount of construction funding available, and made commitments to projects through the local Metropolitan Planning Organization planning schedule in excess of \$1 billion. Rather than admitting this oversight to the legislature, the department issued a notification to district engineers instructing them to cut recently committed construction funding. Adding to the legislature's misgivings regarding the fund shortage were the available funds for maintenance projects. The current authority for unfettered transfers led some lawmakers to believe that new construction funds had been reassigned to maintenance projects.

Due to the obscurity created by the current Transfer Authority rider, the Senate Finance Committee recommends revising its provisions to seek LBB approval before transfers. Revisions will serve to minimize confusion about how funds are spent.

Recommendation #2

Revise the Transfer Authority Rider

If the decision is made to add more descriptive line items to TxDOT's budget pattern, the following rider would replace the current Transfer Authority rider. The existing rider allows TxDOT to make transfers at its own discretion; only an annual report is required. This revised rider would require prior Legislative Budget Board approval before any transfers are made. Without the rider, TxDOT would be subject to

Art IX, Sec. 14.01., which would allow TxDOT to transfer up to 12.5% from one appropriation line item to another without seeking such approval.

3. Transfer Authority. The Department of Transportation ~~is hereby authorized to~~ may transfer appropriations from any Strategy into Strategy C.1.1, ~~Contracted Existing~~ Maintenance Contract Payments, Strategy C.1.2, New Maintenance Contract Payments, Strategy A.1.2, Contracted Planning and Design, Strategy A.1.3, Right-of-Way Acquisition, and Strategy B.1.1, ~~Transportation Construction~~ Existing Highway Contract Payments, Strategy B.1.2, New Highway Contract Payments only after the department submits a report to the Legislative Budget Board, in the format prescribed by the Legislative Budget Board, that provides information regarding the impact of the transfers on transportation projects and 2012-2013 appropriation needs; and the Legislative Budget Board issues a written approval.

In addition, subject to approval, funds may be transferred between Strategies, except that no funds may be transferred out of Strategy C.1.1, ~~Contracted Existing~~ Maintenance Contract Payments, Strategy C.1.2, New Maintenance Contract Payments, Strategy A.1.2, Contracted Planning and Design, Strategy A.1.3, Right-of-Way Acquisition, and Strategy B.1.1, ~~Transportation Construction~~ Existing Highway Contract Payments, Strategy B.1.2, New Highway Contract Payments, except for transfers made between those Strategies.

~~The Department of Transportation shall submit to the Legislative Budget Board, in the format prescribed by the Legislative Budget Board, an annual report of transfers made under the authority of this rider no later than 10 days after September 1 of each fiscal year.~~

THE STATE HIGHWAY FUND

Instead of using all of the tools the legislature previously made available to the Texas Department of Transportation, the agency delayed action in issuing Proposition 14 bonds and expressed concern about the new funding strategy. The primary reason for this concern rests in the agency's many misgivings about the State Highway Fund's sustainability.

TxDOT initially did not want to issue new bonds out of concern for paying for the bond's debt service through the State Highway Fund 6. The department and local planning authorities have expressed apprehension regarding their perception of numerous unrelated expenditures from Fund 6. TxDOT failed to acknowledge that the legislature

addressed this concern by appropriating \$300 million of General Revenue funds to offset the cost of TxDOT's debt service on these bonds in the 2008-2009 GAA. In August 2008, Texas Governor Rick Perry, Lieutenant Governor David Dewhurst, and Speaker of the House Tom Craddick advised TxDOT Chairwoman Deirdre Delisi to take advantage of the Proposition 14 bonds and immediately issue \$1.5 billion of the bonds.⁸ Finally, in late August 2008, the TxDOT Commission voted to let \$1.5 billion of new contracts related to the Proposition 14 capacity.⁹

Local communities and transportation planning regions are being told that the construction project funding cuts experienced in 2007 were the result of funding “diversions.” However, few people are aware the State Highway Fund comprised only 33% of the total transportation budget in the 2008-09 biennium. In fiscal years 2008-09, \$5.3 billion of the \$6.6 billion of the State Highway Fund was spent on construction and

Constitutional Uses of the State Highway Fund

"...all net revenues...[of taxes and fees on]...motor fuels and lubricants...shall be used for the sole purpose of acquiring rights-of-way, constructing, maintaining, and policing such public roadways, and for the administration of such laws as may be prescribed by the legislature pertaining to the supervision of traffic and safety on such roads...."

Texas Constitution, Art. 8. Sec. 7.

maintenance related projects. Approximately \$1 billion was used to fund the Department of Public Safety (DPS), which is clearly a constitutional purpose of Fund 6 (see text box). The remaining \$305 million was appropriated to various other agencies. Non-DPS expenditures account for less than 5% of the total appropriations to the fund.¹⁰ This number is dwarfed by the total \$17.5 billion appropriated to the department over the

⁸ Gov. Rick Perry, Lt. Gov. David Dewhurst, Speaker Tom Craddick. Letter to Chairwoman Deirdre Delisi. August 19, 2008. (p. 2). Letter is attached in Appendix B.

⁹ Texas Department of Transportation. *Transportation Commission Votes to Proceed with Bond Issuance*. Press Release. August 29, 2008.

¹⁰ Senate Finance Committee conclusions based on Legislative Budget Board figures.

fiscal years of 2008-2009. Transportation advocates believe that all State Highway Fund revenues should be limited to highway construction and maintenance-related expenses and all other uses should be ended. In late August 2008, Perry, Dewhurst, and Craddick pledged to work towards implementing a plan which would end DPS funding through gas taxes and return to funding it with General Revenue.¹¹

Recommendation #3

Focus State Highway Fund monies on state highway construction and maintenance.

The Senate Finance Committee recommends replacing Fund 6 with General Revenue to pay for state functions and programs less clearly aligned with the constitutional purposes of the fund. In times of economic surplus, the legislature should consider funding constitutionally permissible programs that are not related to state highway construction and maintenance. However, the Committee strongly advises against constitutional and statutory policies which ultimately constrain the legislature's fiduciary flexibility in periods of economic volatility. Policies such as amending the Texas Constitution to reserve all State Highway Funds for the Department of Transportation may increase transportation funding for the short-term, but in the long run it will limit the legislature's financial flexibility. The legislature should not unnecessarily restrict its own funding capabilities in order to increase financial flexibility for one state agency.

REPORTING REQUIREMENTS

TxDOT has made major inroads and laudable progress in documenting state construction projects online. This is a valuable first step towards increasing transparency within the organization and towards facilitating communication with the legislature and

¹¹ Letter to Chairwoman Delisi. (p. 1).

local entities. This process also ensures timely updates in required reporting provisions within the GAA. The Senate Finance Committee appreciates the regularly updated material and encourages the department to continue this model for other reporting requirements.

Recommendations 4 & 5

4.) Standardize rider language and rules to create a uniform reporting system for TxDOT.

5.) Increase the enforcement of reporting requirements.

TxDOT, the executive branch, and the appropriate legislative authorities should be on the same page when it comes to reporting requirements. One way to serve this goal is to implement standardized reporting requirements and rider language. To avoid a misunderstanding of legislative intent, all reporting requirements need uniformity in language. Riders that require reporting should be simplified to create homogeneity and reduce confusion. For instance, notification requirements are sometimes required 10 days after discovery or in more vague standards. Unless there is a real reason for variance, this language should maintain consistency whenever possible.

For the legislature, it makes little difference to receive these reports when the content is not referenced or attached to any other data. The department needs to consider methods of labeling projects online in accordance with the Unified Transportation Program.

Likewise, the information makes very little difference when reports are tardy. Based on the department's testimony, missed deadlines seem to have contributed to a

further lapse in the discovery of TxDOT's funding crisis.¹² The agency needs to work with LBB to create consistent, simple, and non-time consuming approach to data gathering and delivery. Where possible, the reporting should reflect references to the UTP funding structure. This approach must consist of true and prioritized funding strategies for new construction as well as maintenance and right-of-ways.

The Senate Finance Committee recommends the legislature exercise authority garnered from Rider 38, Appropriations Contingent upon Reporting Requirements, if necessary. The rider states that upon TxDOT's failure to report within the prescribed time period or failure to fulfill reporting requirements, the Legislative Budget Board may request the Comptroller of Public Accounts to withhold certain appropriation authorities. The legislature must be confident that the Texas Department of Transportation will provide requested information in a timely manner.

¹² Amadeo Saenz. *Testimony before the Senate Committees on Transportation and Finance*. February 5, 2008. (p. 4).

APPENDIX A

A. TRANSPORTATION PLANNING
A.1.1. PLAN/DESIGN/MANAGE
A.1.2. CONTRACTED PLANNING AND DESIGN
A.1.3. RIGHT-OF-WAY ACQUISITION
A.1.4. STRATEGY RESEARCH
B. TRANSPORTATION CONSTRUCTION
B.1.1. TRANSPORTATION CONSTRUCTION
B.1._ EXISTING HIGHWAY CONTRACT PAYMENTS
B.1._ NEW HIGHWAY CONTRACT PAYMENTS
B.1._ CONSTRUCTION GRANTS & SERVICES
B.1.2. AVIATION SERVICES
C. MAINTENANCE AND PRES ERVATION
C.1.1. CONTRACTED MAINTENANCE
C.1._ EXISTING MAINTENANCE CONTRACTS
C.1._ NEW MAINTENANCE CONTRACTS
C.1._ ROUTINE MAINTENANCE CONTRACTS
C.1.2. ROUTINE MAINTENANCE
C.1.3. GULF WATERWAY
C.1.4. FERRY SYSTEM
D. OPTIMIZE SERVICES AND SYSTEMS
D.1.1. PUBLIC TRANSPORTATION
D.1.2. REGISTRATION AND TITLING
D.1.3. VEHICLE DEALER REGULATION
D.2.1. TRAFFIC SAFETY
D.3.1. TRAVEL INFORMATION
D.4.1. AUTOMOBILE THEFT PREVENTION
D.5.1. RAIL SAFETY
E. INDIRECT ADMINISTRATION
E.1.1. CENTRAL ADMINISTRATION
E.1.2. INFORMATION RESOURCES
E.1.3. OTHER SUPPORT SERVICES
E.1.4. REGIONAL ADMINISTRATION
F. BOND DEBT SERVICE
F.1.1. GENERAL OBLIGATION BONDS
F.1.2. STATE HIGHWAY FUND BONDS
F.1.3. TEXAS MOBILITY FUND BONDS
F.1.4. OTHER DEBT SERVICE



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August 19, 2008

Ms. Deirdre Delisi
Chairman
Texas Transportation Commission
125 East 11th Street
Austin, Texas 78701

Dear Chairman Delisi:

As you are well aware, our state faces significant transportation funding challenges. Due to a variety of factors including the steady population growth of our state, inflation in the construction industry, rescissions in the federal highway funding program, and the Texas Mobility Fund reaching its bond capacity, our ability to fund needed transportation projects in the future is limited.

Recognizing this, we, as the elected leadership of this state, have been in a consistent dialogue to identify solutions to these ongoing challenges. We have agreed to work together to implement the following solutions in the 81st Legislative Session:

- Implement a plan that sets a definitive course to end the practice of funding the Department of Public Safety (DPS) with gas taxes that are needed for road construction, and return to funding the DPS with general revenue.
- Create a Transportation Finance Corporation or similar entity that will allow public Texas-based investment funds to invest directly in Texas transportation projects that offer a potential solid long-term return.
- Pass authorizing legislation and appropriation for the Proposition 12 bonds approved by voters in the November 2007 constitutional election.

We believe these measures to be a good start to addressing the long-term challenges of financing a world-class transportation system. However, we believe the ten-year priority needs assessment you are working on will show that more is needed, and we intend to keep working toward consensus on additional solutions to further ensure that this state and its communities have access to the necessary funding tools to meet our transportation needs.

**Joint Interim Report with State Affairs
State Investment Policies**

EXECUTIVE SUMMARY

During the 80th interim, the Senate Committees on Finance and State Affairs studied a variety of issues surrounding the major state investment funds in Texas. Upon study, the Committees found that a single investment policy for all the funds would not be feasible but made three recommendations they felt would benefit the State.

SUMMARY OF RECOMMENDATIONS FOR THE 81st LEGISLATURE

1. Add Value at Risk to the reporting requirements in the LBB "Report on major Investment Funds" (Government Code Chapter 322, Section 322.014(b)).
2. Establish a Transportation Finance Corporation.
3. Increase the oversight authority of the Pension Review Board and the Office of the Attorney General to require that ethics and investment policies be submitted to each for review and comment prior to adoption or amendment.

PROCEDURAL BACKGROUND

The Senate Committee on Finance and Senate State Affairs Committee (Committees) were charged with conducting a thorough and detailed study of the following issue and preparing recommendations to address problems or issues that are identified. The Committee met in accordance with the following interim charge:

Study the feasibility and the advisability of establishing an investment policy that is consistent across all state trust funds, including the trust funds of the Employees Retirement System, the Teacher Retirement System, the Permanent University Fund, and the Permanent School Fund. Identify best investment policies for state trust funds. Examine recent portfolio diversification strategies and the effect they have on long-term fund performance. The recommendations should consider what is an acceptable rate of return, an acceptable degree of risk, the appropriateness of certain investments.

The Committees held a public hearing in Austin, Texas, on March 25, 2008, to consider invited and public testimony. Invited testimony was provided by the Legislative

Budget Board, the Office of Attorney General, the Texas Legislative Council, the Pension Review Board, the National Association of State Retirement Administrators, the Texas Department of Transportation, UBS Investment Bank, Citigroup, the Employees Retirement System (ERS), the Teacher Retirement System (TRS), the University of Texas Investment Management Company on behalf of the Permanent University Fund (PUF), the University of Texas System, the General Land Office, the Permanent School Fund (PSF), the Comptroller of Public Accounts, and the Texas Treasury Safekeeping Trust Company.

DISCUSSION

The testimony from the invited panelist and subsequent comments from the members of the Committees identified three main topics of concern: risk, infrastructure and fiduciary duty. This report will focus on the four major funds in Texas: ERS, TRS, PUF and PSF, referred to as the "Funds". Additional detail on the funds can be found in the Legislative Budget Board's report on these funds.¹³

RISK

The financial markets are affected by many different types of risk. They include credit risk, liquidity risk, market risk, and political risk, to mention a few. While the various types of risk are evaluated when determining the appropriateness of investment in a specific market sector or asset, downside market risk is the dominant concern. Simply put, downside market risk is the chance that the investment or asset will lose value over time.

The governing boards of the individual Funds have established processes for evaluating and quantifying risk. These processes allow each board to establish

¹³ http://www.lbb.state.tx.us/Investment_Funds/AnnualReport_MajorStateFunds_0508.pdf

appropriate risk parameters for their entire portfolio, as well as for individual asset classes. The primary factor considered in setting these parameters are downside market risk tolerance and rate of return. In assessing risk tolerance, the Funds must consider the overall purpose of the fund and beneficiaries for whom it was established.

While the processes used by the Funds to establish its risk parameters and investment policies are fundamentally similar, it does not appear feasible to implement a statewide investment policy. However, reporting the potential downside risk and the actuarial assumptions used in determining the investment policy would improve the State's ability to better evaluate investments the Funds have deemed appropriate.

From testimony provided, risk cannot be quantified by a single measure. However, a widely accepted measurement for downside market risk is Value at Risk (VaR). VaR is defined as "the loss that will be incurred in the event of an extreme adverse price change with some given, typically low, probability."¹⁴ This measurement provides, within a certain probability, the expected market loss of an asset given past volatility of the asset's value. VaR should be added to the reporting requirements currently set out in Government Code Chapter 322, SECTION 1, Section 322.014(b).

INFRASTRUCTURE

Currently, each of the Funds have the authority to invest in infrastructure-based assets and have been exploring these types of assets. Two of the four Funds have together made \$700 million worth of commitments to invest in infrastructure-based assets. The infrastructure assets class includes toll roads, airports, water plants, etc. Testimony was provided to the Committees that focused primarily on public toll roads.

¹⁴ Investments by Bodie, Kane, Marcos 7th Edition (G-13).

The typical structure of a toll road project provides multiple opportunities for investment depending on the risk/return being sought. Investors have the option of buying tax exempt debt or debt on the open bond markets. Investors could also take an equity position in the project. A common equity position would cover the amount of the project that cannot be bonded due to debt coverage ratios.

An investor who takes a debt position in a project is provided a fixed return over a specified period of time. Revenues from the project are paid to these investors first. An investor who takes an equity position is not guaranteed a fixed return. However, with this higher risk position an opportunity for greater return also exists. For those with an equity position, returns are determined, like other equities, by returning any profit or excess revenue from the project to the investor on a pro rata basis.

Opportunities exist for the Funds to take both debt and equity position in these types of projects. It is unlikely a debt position will be attractive to the Funds due to the tax exempt status of the Funds. Additionally, the State lacks a structure that would allow the Funds to invest in an equity position in these projects in Texas. A Transportation Finance Corporation would serve as the vehicle to facilitate this type of investment opportunity.

It is not the intention of the Committees to suggest that the Funds be required to invest in such a corporation; rather, the goal is to provide another investment opportunity for the Funds to review and determine if the project fits their portfolio goals.

FIDUCIARY DUTY

The governing boards of the Funds serve a fiduciary role which requires them to perform their duties for the exclusive benefit of the Fund's members. The Texas

Constitution requires the four investment Funds to follow the exclusive benefit rule and the prudent investor standard.¹⁵ While the rule and standard are similar for each of the Funds, the Funds have the discretion to individually interpret the rule and standard to reflect the purpose and mission of their Fund.

In addition, the Federal Government requires pension funds to comply with the Employee Retirement Income Security Act (ERISA). The Federal Department of Labor describes ERISA as an act that "protects your plan's assets by requiring that those persons or entities who exercise discretionary control or authority over plan management or plan assets, have discretionary authority or responsibility for the administration of a plan, or provide investment advice to a plan for compensation or have any authority or responsibility to do so are subject to fiduciary responsibilities."¹⁶

Additionally, the Federal Department of Labor indicates "the primary responsibility of fiduciaries is to run the plan solely in the interest of participants and beneficiaries and for the exclusive purpose of providing benefits and paying plan expenses. Fiduciaries must act prudently and must diversify the plan's investments in order to minimize the risk of large losses. In addition, they must follow the terms of plan documents to the extent that the plan terms are consistent with ERISA. They also must avoid conflicts of interest. In other words, they may not engage in transactions on behalf of the plan that benefit parties related to the plan, such as other fiduciaries, services providers, or the plan sponsor."

¹⁵ Article 16, Section 67, Texas Constitution, Article 7 Section 5 & 11b

¹⁶ <http://www.dol.gov/dol/topic/health-plans/fiduciaryresp.htm>

In light of the recent developments in the financial markets and the previous increases in investment authority, additional oversight may be necessary to guarantee that fiduciary duty is being upheld to the highest standard. Additional oversight could focus on conflicts of interest, ethics policies, actuarial assumptions, governance and transparency.

RECOMMENDATIONS

The Senate Committees on Finance and State Affairs report the following to the 81st Legislature to consider taking appropriate action on the following in regard to state investment policies.

1. Add Value at Risk to the reporting requirements in the LBB "Report on major Investment Funds" (Government Code Chapter 322, Section 322.014(b)).
2. Establish a Transportation Finance Corporation.
3. Increase the oversight authority of the Pension Review Board and the Office of the Attorney General to require that ethics and investment policies be submitted to each for review and comment prior to adoption or amendment.