



THE UNIVERSITY of TEXAS SYSTEM
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The Honorable Jane Nelson
Chair, Texas Senate Committee on Finance
P.O. Box 12068
Austin, Texas 78711-2068

Dear Chairwoman Nelson:

In response to questions raised at the meeting of the Senate Finance Committee on January 26, Chancellor McRaven asked that I provide the following information in support of the committee's consideration of Senate Bill 1, the General Appropriations Act.

Enclosed are issue briefs that describe in detail the nature, uses, and constitutional restrictions on the Permanent University Fund (PUF) and the Available University Fund (AUF). In combination with the published 2016 annual report on the Available University Fund, also enclosed, we believe this information will address many of the issues committee members raised in that hearing in regard to the PUF and the AUF.

Of particular interest to the committee was the amount of money distributed to the AUF and the availability of the AUF to offset anticipated reductions in general revenue appropriations to institutions of the U.T. System, particularly in regard to funding special items. Because of narrow constitutional restrictions, there is very limited availability of using the AUF for these purposes; under the constitution, the U.T. System Board of Regents (U.T. System Board or Board) may not transfer money from the AUF to campuses (other than U.T. Austin) or use the AUF for operational expenses of those campuses. The only means by which U.T. System Administration may use the AUF to offset lost general revenue for those campuses is for U.T. System Administration to absorb and perform more duties for U.T. System institutions generally, which necessarily increases the size of the budget for and number of employees of U.T. System Administration.

To explain this result, we address briefly the questions we heard the committee asking:

What are the PUF and AUF?

The Texas Constitution created the PUF and prescribes its governance, investment and use. The PUF includes more than 2.1 million acres of land (known as “university lands”), mineral income from that land, and the accumulated value of investments of that income. The constitution also established the AUF, which consists of distributions from the PUF made by the U.T. System Board, and surface income, such as income from grazing leases, from university lands.

How is the PUF used?

The constitution does not permit direct expenditure of the PUF except for the expenses of managing university lands and the investments.

The constitution authorizes U.T. System and Texas A&M System to issue bonds (commonly known as “PUF bonds”) secured by the AUF. The Systems may use the bond proceeds only for construction and other specifically identified capital expenses, including acquisition of land, capital equipment, and library material. The Systems may not use PUF bond proceeds for operational expenses of either System Administration or a campus.

The PUF bonds benefit all institutions of the U.T. System and benefit the agencies and institutions of the Texas A&M System other than those eligible for the Higher Education Assistance Fund. The constitution limits the amount of U.T. System PUF bonds outstanding at any one time to an amount equal to 20% of the value of PUF investments. Thus, PUF bond capacity varies depending on investment performance and the amount of outstanding PUF bonds.

How is the amount of money distributed to the AUF determined?

The constitution provides that “The amount of any distributions to the ... [AUF] shall be determined by the board of regents of The University of Texas System” within constitutional limits. The distribution comes from the total return on PUF investments, which includes interest, dividends, and capital gains. Additionally, the AUF receives income attributable to the university lands’ surface interests.

How much discretion does the U.T. System Board have in determining the amount distributed to the AUF?

The constitution has specific limits on the Board’s discretion. The total annual distribution to the AUF may not exceed 7% of the average net fair market value of PUF investment assets. In addition,

the constitution requires that distributions provide a stable and predictable stream of income to the AUF while preserving the purchasing power of both the AUF and the PUF over the next 10 years.

Under U.T. System Regents' Rules, the Board receives an annual report showing the amount that would be distributed at a standard rate of 4.75% of the average market value of PUF investments over the preceding three years. The standard rate increases to 5% if investment returns are greater than expected.

Although the standard rates are reported to the Board, the Regents' Rule does not limit the constitutional authority of the Board to determine the distribution amount. The Board has exceeded the reported standard rate on occasion, provided that the higher distribution did not jeopardize the constitutional requirement that the Board preserve the PUF's purchasing power. The value of the PUF has continued to grow significantly net of all distributions.

How may the AUF be used?

As a constitutional fund, the Board may expend the AUF only for the purposes expressly permitted by the constitution. The constitution specifies only three purposes:

- debt service on PUF bonds
- "support and maintenance" of U.T. Austin
- "support and maintenance" of system administration.

Because of these narrow constitutional purposes, the AUF may not be used for operational expenses of U.T. System institutions other than U.T. Austin.

The Board has some discretion to determine what constitutes "support and maintenance" of "system administration." That determination is guided by the general and specific legal responsibilities of the System Administration imposed by the constitution or statute. Legal counsel and the U.T. System controller review AUF expenditures for System Administration to ensure compliance with the constitutional standards.

Because the plain language of the constitution permits the Board to expend the AUF only for support and maintenance (i.e., operations) of a single campus, U.T. Austin, any expenditure to support and maintain "system administration" must provide system-wide benefit, that is, it must benefit many, if not all, U.T. System institutions. For any AUF expenditure not part of the routine

existing operations of System Administration, the practice is for the Board to make a finding of why the expenditure of the AUF for that purpose is appropriate.

How does U.T. System allocate and use the AUF?

U.T. System Regents' Rules require that 45% of the U.T. System AUF share be allocated to U.T. Austin, subject to exceptions for availability of sufficient debt service for PUF bonds and for a minimum balance necessary for unexpected capital needs and debt service reserve. In addition to the standard share, the Board has allocated additional amounts to U.T. Austin, such as the current allocation of an additional 3% or \$25 million a year, whichever is greater, for the U.T. Austin Dell School of Medicine.

After the allocation to U.T. Austin, typically 25-30% of the remainder is necessary for debt service on PUF bonds. The constitution provides that the debt service is the first call on the AUF.

After the allocation to U.T. Austin and payment of debt service on PUF bonds, the Board allocates a portion of the remaining AUF for salaries, facilities, and other operational expenses in carrying out the responsibilities of System Administration. Those responsibilities include, for example, the oversight and coordination of institutional activities, planning and evaluation, and the provision of services such as legal and financial services.

Use of the AUF to support System Administration is a constitutional design intended to reduce reliance on general revenue for System Administration, allowing the legislature to redirect general revenue to other state priorities. This is reflected in S.B. 1, which appropriates no general revenue for System Administration operating expenses.

Money from the AUF remaining after these allocations—U.T. Austin, debt service, and System Administration—is available for additional allocations to U.T. Austin or for what have become known as “system initiatives.”

What is a “system initiative,” and may the Board redirect funding for a system initiative to campuses to offset reductions in general revenue?

“System initiative” is not a term used in general law, nor a term used or defined in Regents' Rules. The term came into use relatively recently in General Appropriations Act riders that require the Board to report system initiatives to the Legislative Budget Board (LBB), and in some cases receive

the approval of the LBB. Although not defined there, in context the term describes uses of the AUF that are distinct from pre-existing general U.T. System operations.

An activity identified as a system initiative is subject to the same constitutional restrictions on use of the AUF as any other expenditure; the expenditure is legally permissible only if it may be reasonably classified as an expenditure for the support and maintenance of System Administration. Accordingly, if a system initiative is dropped or disapproved, those AUF funds may nonetheless not be transferred to an individual campus nor used to fund a special item or other operational cost of an individual campus (other than U.T. Austin).

Thank you for the opportunity to present this information. If we may answer any additional questions for the committee or any individual member of the committee, please advise me.

With respect,



Scott C. Kelley
Executive Vice Chancellor
for Business Affairs

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