



Susan Combs
Texas Comptroller of Public Accounts

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February 15, 2007

The Honorable Rick Perry, Governor
The Honorable David Dewhurst, Lieutenant Governor
The Honorable Thomas R. Craddick, Speaker of the House

Gentlemen:

For some time, I have been concerned about the financial status of the Texas Guaranteed Tuition Plan (Plan). As you know, this program is administered by the Texas Prepaid Higher Education Tuition Board, of which I am the statutory chair. Upon taking office in January, I immediately asked a group of experts outside state government to review the Plan and provide me with an analysis. This group includes financial professionals who volunteered their services to the state at no cost, and for that, the State of Texas owes them a debt of gratitude. More information on these professionals is enclosed.

The advisory group spent the past month reviewing the condition of the Plan and has written an extensive report detailing their findings, which I am enclosing.

The Plan had previously estimated that the program could be \$683 million dollars short of meeting its obligations by 2029. The advisory group reviewed the variables used in that estimate, and believes the assumptions do not represent a likely outcome. Based on their analysis, they believe that the Plan will more likely be short somewhere between \$1.74 billion and \$3.31 billion by 2029.

Any estimate of the Plan's future shortfall is heavily dependent on a number of variables, including projected rate of return on the fund assets, projected tuition increases, projected rates at which beneficiaries use their contracts and projected cancellation rates. The advisory group modified each of these variables based on the experience of their collective years in business. The enclosed report fully explains their concerns with the existing variables and their rationale for adjusting them. Finally, the group produced a set of outcome figures for optimistic, most likely and pessimistic scenarios. Numbers for each outcome scenario are also in their report.

While no one can accurately predict the future performance of the Plan with absolute certainty, I believe these estimates are sobering. To that end, I look forward to working with each of your offices on this important issue.

Sincerely,



Susan Combs

Enclosures

February 15, 2007

Ms. Susan Combs
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Madame Comptroller:

On January 4, 2007, you asked that we undertake an extensive review of the Texas Guaranteed Tuition Plan so that we might advise you on its current financial condition and the potential merits of reopening the Plan to new participants. As part of our review, we evaluated:

- (1) The Plan's current obligations,
- (2) Its projected schedule for paying these benefits,
- (3) Its investment strategy and projected returns over time, and
- (4) The assumptions underlying all of the foregoing.

We also interviewed representatives of both consulting firms retained by the Plan, New England Pension Consultants (NEPC) and Buck Consulting (Buck). As part of our review, Buck also prepared several scenario analyses to measure the effect of changes on the Plan's underlying assumptions.

It is important to note that Buck is not responsible for validating any of the assumptions provided to it by either us or the Plan's Board. Rather, its job is to model outcomes for the Plan that incorporate those assumptions it is provided.

For purposes of full disclosure, all members of this advisory board are citizens of the State of Texas. None currently conduct any business with the Comptroller's office. Two of our members, however, currently serve as CEO's of wealth management companies that have a small number of clients who are Plan participants. The conclusions and recommendations in this report reflect the advisory board members' personal views and not necessarily those of their employers.

Our review found that the Plan's current projected deficit of \$683 million in 2029 understates the magnitude of the State's unfunded obligations and is based on overly optimistic and unsupportable assumptions. While no one can predict the Plan's current shortfall with exact precision, our best estimate is that the deficit will instead range somewhere between \$1.742 billion and \$3.127 billion by 2029.

Additionally, we strongly recommend that the Plan not be reopened to new participants. The current Plan design is flawed and reopening it would not solve its existing problems. It would instead likely greatly increase the State's unfunded obligations over time.

1. Current Financial Condition of the Texas Guaranteed Tuition Plan

The 2006 Annual Report of the Plan states that it currently has a \$110 million deficit. However, this number reflects an actuarial "present value" calculation of the plan's deficit. The actual size of the projected shortfall is \$683 million in 2029 (the full results of this projection are shown in Appendix A). The Plan also is projected to run out of money in 2020.

It is important to remember that the actuarial calculation effectively assumes that the Plan will receive an immediate infusion of \$110 million in assets (such as might be appropriated by the Legislature) and that all of the Plan's other assumptions are correct, including an 8.25% nominal annual return on the newly found monies as well as the remainder of the Plan's other assets over the next twenty-three (23) years.

While using an actuarial calculation may be technically correct and appropriate for reporting purposes, it can be somewhat misleading as to the potential magnitude of the problem should the Plan not receive an immediate infusion of money and/or if its projected returns are less than expected. In our view, a more representative picture of the Plan's true financial condition is one that simply reflects the total ultimate shortfall and is not predicated on assumed infusion of new assets or investment returns.

Far more problematic, a close examination of the 2006 Annual Report suggests that the Plan relies on several other assumptions that are also overly optimistic and/or unsupportable and that the Plan's likely shortfall will be significantly greater than \$683 million in 2029. In particular:

A. Asset Return Assumption

The Plan's projections assume an 8.25% annual nominal return on its assets over the next twenty-three (23) years. Meeting this goal will depend on the returns of various asset classes and, more importantly, its asset allocation over time within those asset classes.

Historical return data suggest that the larger the Plan's exposure to more volatile asset classes such as equity securities, the more likely it will achieve higher returns over the long term and have a greater chance of meeting its return objectives. At the same time, however, the Plan's ability to invest in such asset classes is constrained over time by its need for liquidity to pay its obligations.

Equity returns are far more volatile than bonds and thus the value of such securities is at significant risk should one be forced to liquidate during a downturn in the equity markets. Consequently, when the Plan begins to pay out larger and larger

percentages of its assets, its asset allocation will have to begin to shift from one that is mostly equities to one that is mostly bonds. This shift will in turn significantly lower the Plan's return on its investments.

In our review of the Plan's financial condition, we were surprised to learn that no such adjustment to its asset allocation was contemplated as part of its projections. We also learned that both NEPC (the consulting firm advising the Plan on investments) and Buck (the firm advising on forecasting its obligations over time) concur with our assessment that the Plan's asset allocation will have to shift over time to a substantially greater weighting in fixed income than equities and that this shift will significantly lower its investment returns from its currently projected average annual nominal level of 8.25%.

When asked why any such assumption was not incorporated in the Plan's calculations, NEPC indicated that it had "never been asked" to conduct any such analysis. Instead, in order to arrive at a projected rate of return, NEPC took asset class return estimates for two periods (seven-year projections and thirty-year projections) and simply interpolated them. The resulting analysis failed to include the necessary shift in asset allocations that will have to occur and which will substantially lower the Plan's overall return from its currently projected level.

It is difficult to precisely determine how this inevitable shift in the Plan's asset allocation will impact its overall return because any such adjustment will cause a chain reaction of other effects. More specifically, the resulting lower returns from a change in the asset allocation will in turn accelerate the point at which the benefits paid in a particular year become a substantial portion of the Plan's assets. This in turn will force the Plan to shift more assets into bonds at an earlier date. As it shifts further assets into bonds, the Plan's projected returns will decline even more and consequently accelerate the point at which it will need liquidity and so on.

The end point of this cycle is entirely dependent upon how well various asset classes perform over time. Predicting these returns is certainly more of an art than science. If one relies on the historical returns of various asset classes (as calculated by Ibbotson), the Plan will need to begin changing its allocation within seven to eight years or otherwise be subjected to extraordinary risk.

This change and other subsequent and resulting changes will cause the Plan's estimated return to fall significantly. In our estimation it will lower the Plan's overall annual return from its currently projected nominal rate of 8.25% to somewhere between 6% and 7%. Keeping the remainder of the Plan's current assumptions constant, such a decrease in returns would increase the Plan's ultimate deficit (currently projected to be \$683 million in 2029) to \$1.27 billion to \$1.58 billion.

As grim as this prognosis might appear, we are extremely concerned that it could prove to be too optimistic given the Plan's liability structure and the current

valuations in the financial markets. More specifically, all of the Plan's investment projection assumptions are based on long-term trends in the capital markets. However, relying on long-term trends only works if one has the capacity to take a very long-term horizon to investing.

Due to its liability structure, the Plan lacks this ability unless it generates returns over the near term on par with its overall projected return. Should only sub-optimal returns be achieved instead, the Plan's resulting smaller level of assets (relative to its stream of projected benefit payments) will further hasten the point at which it will need to begin to shift its asset allocation to less volatile and lower returning asset classes.

What particularly concerns us is that the financial markets appear in many ways to be approaching relative high points — the Dow is at a record level, credit spreads on high yield bonds are near record lows, and cap rates on real estate investments are likewise near record lows. While no one can accurately predict what the financial markets will do tomorrow, much less over the next five years, historically when several asset classes are near or at relative high points, the risk of a substantial correction increases.

Many of the most accomplished prognosticators of the financial markets have begun to forecast a potentially prolonged period of lower-than-historical returns for several asset classes. Luminaries such as Peter Bernstein, Bob Arnott, Jeremy Siegel and Gary Shilling have all raised such concerns.

Consequently should there be a significant market correction within the next five years, the resulting lower-than-expected near-term return on the Plan's assets might strip away its ability to take even a medium-term horizon to investing its assets. Instead, at a date far sooner than currently forecast, it would need to pay out benefits that are a significant percentage of its assets. The resulting spiral — of shifting to lower yielding asset classes to ensure sufficient liquidity which in turn lowers the return of the portfolio and therefore forces it to begin its asset allocation shift earlier and so on — will substantially lower the Plan's overall return and significantly increase the size of its deficit.

Although it is impossible to precisely predict how much this would change the Plan's outcomes, some of the scenarios that we reviewed suggest that such an event could result in an overall average nominal annual return for the Plan's investments as low as 5%. Should this be the outcome, the Plan might run out of money in as little as eight to nine years and its shortfall would balloon dramatically.

B. Tuition Inflation Assumptions

The Plan's outcome is highly dependent upon the rate at which tuition will increase at Texas colleges and universities over the next twenty years. Its projections assume an average annual increase of 7.5%. The bases for this assumption are that

nationally tuition is expected to rise about this amount on average and that Texas schools on average are now slightly more costly than their counterparts in other states.

This assumption is problematic because the two factors it is tied to (national tuition inflation trends and the relative cost of going to Texas schools) overlook the premium that residents of Texas must pay to attend college in another state or a private school. Currently, average annual tuition and fees to attend a Texas state college or university is \$5,332.

By comparison, nonresidents of Oklahoma currently pay \$14,683 per year to attend the University of Oklahoma. Tuition and fees for nonresident students at the University of Florida are \$17,860 per year (more than three times the average cost of attending a state school in Texas). The corresponding tuition and fees for nonresidents of Colorado to attend the University of Colorado is \$23,539 per year (more than four times what it costs to attend a Texas state school).

Private university and college costs are likewise substantially higher than those of the state schools of Texas. According to the College Board, the average tuition and fees to attend a private college in the United States is \$22,218 per year. Thus, although tuition at Texas's state colleges and universities may rise significantly faster than that of schools in other states or at private universities over the next twenty years, the relative cost of going to a State school will still be lower than the alternatives.

In reality, the chief determinants of what students will have to pay to attend a Texas college or university will be (1) the level of demand for higher education within the State and (2) the level of funding that the legislature will provide to these institutions over time. Data provided by the Coordinating Board of Higher Education suggests that demand for higher education within the State will increase substantially in the near future. It currently projects that there will be 1.29 million college students by 2015 or an increase of nearly 27% over the next eight years.

Additionally, the Coordinating Board's forecast was made prior to recent Congressional action to increase federal subsidies for college education that lower the cost of student loans. Should this legislation become law, however, the demand for higher education in Texas will likely increase at an even higher rate than is currently projected.

The biggest unknown in forecasting how fast tuition costs will rise in Texas is the level of funding the legislature will appropriate to its colleges and universities. The calculus of what tuition will be is fairly simple. It equals the total costs of the institution, less a combination of State (and some federal) funding, revenues produced by each school's endowment and any ancillary revenues the school might be able to generate.

Of these funding sources, the largest is State appropriations. For example, 36.6% of Texas A&M's funding is provided by the Legislature. By contrast, tuition and fees generate only 19% of its revenue.

As these schools' enrollments increase, they will have to expand infrastructure, add professors and broaden their administrative support structure, all of which will cost a great deal of money at a time the State will be facing a host of other challenges. The challenge of balancing different priorities has even led to public policy discussions of shifting to a concept of "State-assisted" schools instead of "State-funded" in Texas.

While it is clear that no one can predict how all of these factors will play out over time and how much tuition costs will have to rise as a result, we believe that, in the aggregate, they point to a strong likelihood that the State's tuition costs might rise faster than the projected national average.

What is problematic is that only a slightly higher rate of tuition inflation will have an immense impact on the financial condition of the Plan. For example, should tuition increase by 8.5% per year instead of the projected 7.5% per year (assuming all other current assumptions of the Plan remain constant), the size of the Plan's deficit would increase to \$1.529 billion by 2029.

C. Assumptions Regarding the Consumption of Benefits by Plan Participants

Another key assumption underpinning the Plan's projected deficit is the rate at which participants will utilize their benefits. As noted in the 2005 Annual Report, the Plan assumes that participants on average will start college at age 18 and use their benefits on a schedule tied to the type of contract purchased. The current projections assume that, on average: five-year contracts will be consumed evenly over five years, four-year contracts will be used within five years (with 90% of the benefits consumed in the first four), three-year contracts will be used within four years (with 90% of the benefits consumed in the first three years), two-year contracts will be consumed within three years (with 90% of the benefits used in the first two years), and one-year contracts will be consumed within two years (with 90% of the benefits used in the first year).

What is extremely problematic about these assumptions is that the timing of the use of benefits is at the sole discretion of the Plan participant. Thus, the Plan has no certainty as to when it will have to actually pay out its obligations.

To be sure, the Plan does have a sunset provision that requires benefits to be consumed by age 28, but under certain circumstances, the use of benefits may be deferred. For example, should participants elect to go into the military, they may defer using their benefits until the completion of their service. Although unlikely, it is possible that a beneficiary could defer his or her benefits for decades while in

military service and then pass them on to a family member, leaving the State's obligation in place far beyond 2029.

Regardless, the fact that most participants may pick within a ten-year window as to when to utilize their benefits creates a potential negative investment arbitrage for the Plan. More specifically, if a substantial portion of Plan participants elect to start college at age 19 or 20 or later (instead of at 18) and/or on average take eighteen months longer after commencing college to consume their benefits than currently forecasted, the cost of paying these obligations could be significantly higher than projected.

The source of this higher cost is the Plan's obligation to pay the full cost of tuition and fees at the point the benefit is used; it is not tied to the age of the individual participant. Assuming that tuition continues to rise at a high rate (i.e., higher than the returns from less volatile assets such as short term bonds), then the longer it takes someone to consume their benefits the higher the ultimate cost will be to the Plan.

However, at the same time (and as described above in section A. Asset Return Assumption) as the Plan approaches the point at which participants have the right to begin consuming their benefits at a rate that is a significant percentage of the Plan's assets, it will have to shift its allocation to less volatile asset classes so that it will have sufficient liquidity to meet its obligations. As noted earlier, this shift will significantly lower the Plan's investment return, and the combination of higher-than-projected costs and lower-than-anticipated returns could significantly increase the size of the Plan's shortfall.

Another way to look at this problem is that the Plan is effectively providing an option to each of its participants: the option to decide when to actually use the benefits. The cost of having provided this option is particularly difficult to determine because no one can accurately forecast how a very small sample of Texas's population (the Plan's participants) will act over the next twenty years.

What is clear, however, is that this option has the potential to be very costly. For example, at our request Buck conducted a series of analyses of different rates of consumption of benefits and different overall investment returns for the Plan. If all other current assumptions of the Plan remained constant but instead the average time period across which plan benefits were consumed expanded about 12 to 18 months longer than currently projected and this delay lowered the Plan's overall return by only .75% per year, the Plan's current deficit would increase to \$1.359 billion by 2029 or \$676 million more than currently projected.

However, if instead on average participants start college at age 19 and take five to six years to consume their benefits and if this much longer payout horizon lowered the Plan's average return to only 6.5%, the deficit would increase to a staggering \$1.963 billion by 2029.

Again, while it is impossible to precisely measure what all of this will cost the Plan, recent statistics collected by the Texas Higher Education Coordinating Board on the time period most students require to complete their degrees found that only 20% to 25% of all new college students in 2000 (the most recently available data) completed their degrees in four years. Only 47% finished within five years and only 55% graduated within six.

D. Contract Cancellation Assumption

Also built into the Plan's current projections is an assumed rate of contract cancellations; that is, current participants elect to voluntarily leave the Plan and, depending on the participant's age, receive some contractually determined settlement. The projections assume that cancellation rates vary by tenure in the Plan (i.e., newer participants are more likely to cancel than ones who have been in the Plan for many years) and by the type of contract purchased (i.e., participants who have fully paid their obligations to the Plan are less likely to cancel than those who still owe money). The rates used are based on "national averages" for other states' guaranteed tuition plans.

A closer examination of the Plan's current cancellation assumptions, however, suggests that they are unrealistic and cause the Plan's current shortfall to be understated.

At first glance, using a national average to predict cancellation rates may seem appropriate, but it ignores that the economics of canceling a contract are substantially different for participants in the Texas Guaranteed Tuition Plan than in plans offered by some other states. For other guaranteed tuition plans, participants who cancel their contracts receive only their principal and some nominal rate of interest, regardless of when they might cancel. With our State's Plan, participants who leave prior to their 18th birthday receive only their principal paid to date, less an administrative fee. If the same individuals wait until their 18th birthday to cancel, they would instead receive in cash the full amount of the benefits as if they had elected to attend a state college or university.

In other words, there is a significant financial incentive for current participants to delay canceling their contracts until they turn 18. For example, if a family that had purchased a four-year public college contract in 2002 at the birth of their child elected to cancel the contract today, the family would get back only \$15,131 less an administrative fee. If instead the family waits the 13 years until the child turns 18 to cancel (and the Plan's current inflation assumptions are correct), it would instead receive more than \$51,000, or almost three-and-a-half times more. Further, provided the family uses the funds to pay for their children's education, the entire gain on the investment would be tax-free.

The Plan's currently projected deficit relies heavily on a relatively high assumed rate of contract cancellations of participants who are not yet 18. According to an

analysis conducted for us by Buck, if all participants wait until they are 18 to cancel their contracts and all of the Plan's other assumptions remained constant, the shortfall would increase by 2029 to \$818 million.

While some participants may be economically irrational and depart the Plan prematurely, it is unrealistic to assume that a large number of individuals will voluntarily surrender so much value.

E. Combined Effect of Changes to Several Current Assumptions

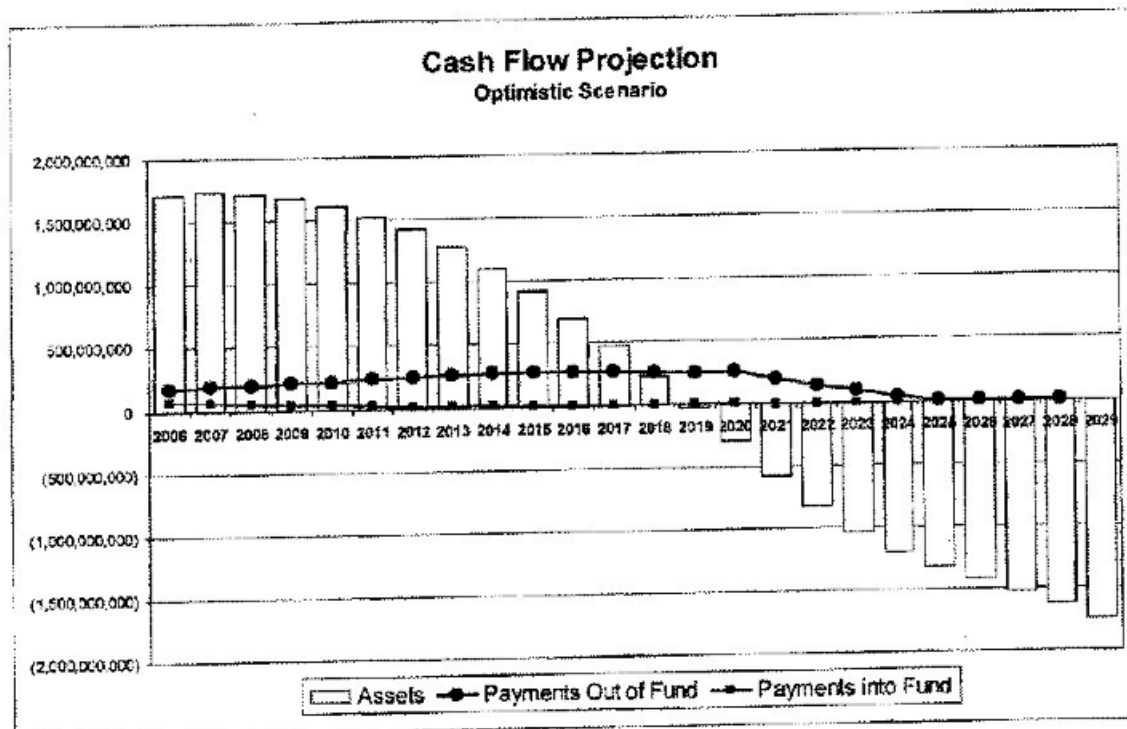
As noted earlier, even small changes to any one of these four previous sets of assumptions will significantly impact the size of the Plan's deficit. Our biggest concern is the likelihood that several of the Plan's assumptions are overly optimistic. Combined they could create a potentially enormous unfunded liability for the State.

To measure how these variables might interact, we developed a range of potential outcomes for each. We then asked Buck to conduct three additional scenario analyses using numbers taken from each of these ranges.

The *Optimistic* scenario considers those assumptions within each range that are most favorable to the Plan. The *Pessimistic* scenario considers those assumptions within each range that will most increase the Plan's projected shortfall. The third scenario (*Likely*) considers those assumptions that fall between the extremes of the *Pessimistic* and *Optimistic* scenarios.

It is important to reemphasize, however, that no one can predict any of these variables with certainty.

For the *Optimistic* scenario we assumed that the Plan's investments would generate a 7% average annual nominal return and that tuition would increase 8% per year on average. We also assumed that the contract cancellation rate would be only 50% of what is currently forecasted and participants would consume benefits in accordance with the currently forecasted schedule. Under this scenario, the Plan's deficit will increase to \$1.742 billion by 2029 (or more than two and a half times greater than its current projection). As shown below, the Plan would run out of money in 2018. The full results of this scenario are illustrated in Appendix B.

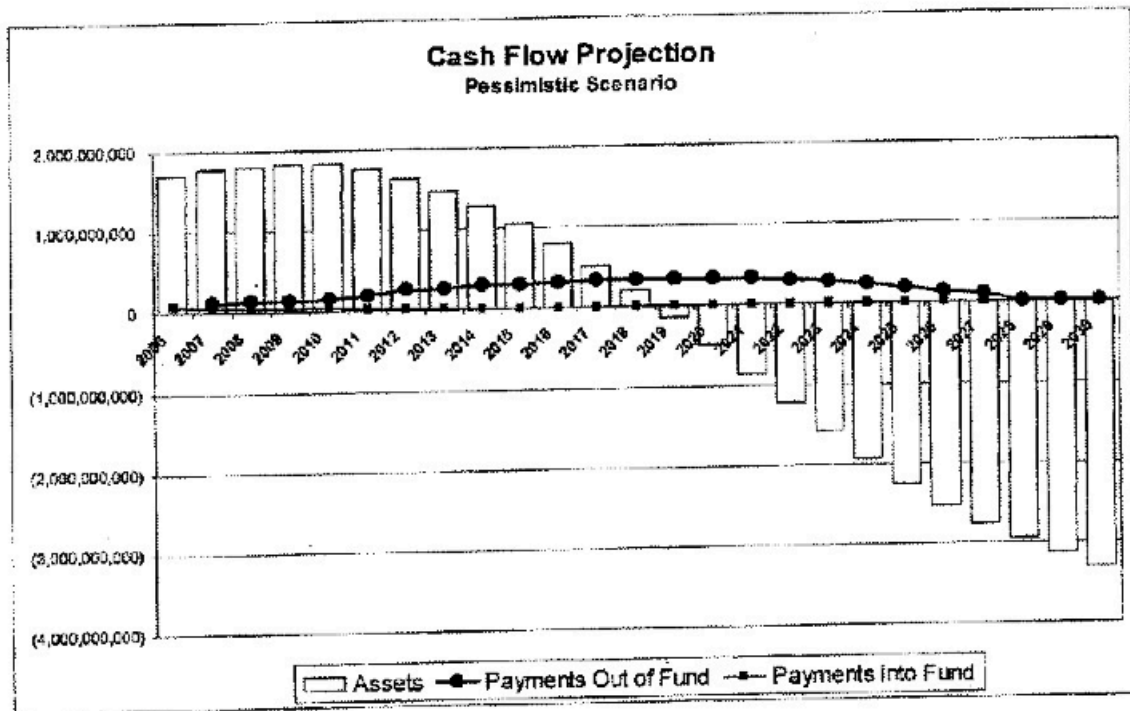


For the *Pessimistic* scenario we assumed that the Plan's investments would generate a 6% average annual nominal return and that tuition would increase 8.5% per year on average. We also assumed that the contract cancellation rate would be only 20% of what is currently forecasted. This scenario also assumed that participants would consume benefits according to the following schedule:

Benefit Utilization Schedule 1

Type of Contract	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8
5-Year	10%	10%	10%	10%	15%	15%	15%	15%
4-Year	10%	10%	15%	15%	15%	15%	20%	
3-Year	10%	10%	15%	20%	20%	25%		
2-Year	10%	15%	20%	25%	30%			
1-Year	20%	25%	25%	30%				

Under the *Pessimistic* scenario, the Plan's shortfall in 2029 will total \$3.127 billion (or more than four and a half times greater than currently projected). As shown below, the Plan will run out of money in 2018. The full results of this scenario are presented in Appendix C.

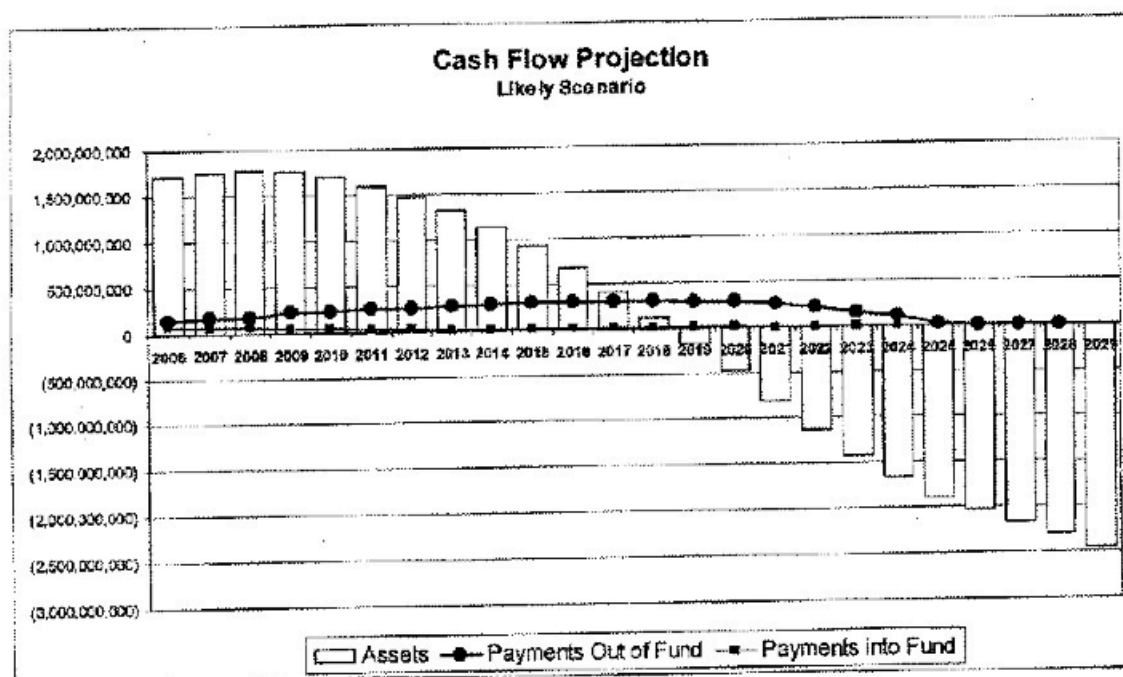


For the *Likely* scenario we assumed that the Plan's investments would generate a 6.5% average annual nominal return and that tuition would increase 8.25% per year on average. We also assumed that the contract cancellation rate would be only 33% of what is currently forecasted. We also assumed that participants would take on average about a year longer to consume benefits according to the following schedule:

Benefit Utilization Schedule 2

Type of Contract	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8
5-Year	15%	15%	15%	15%	20%	20%		
4-Year	15%	15%	20%	20%	30%			
3-Year	15%	15%	20%	25%	25%			
2-Year	15%	20%	30%	35%				
1-Year	30%	35%	35%					

Under the *Likely* scenario, the Plan's projected shortfall in 2029 will increase to \$2.45 billion. It will also exhaust its assets in 2018. Complete results from the *Likely* scenario can be found in Appendix D.



2. Reopening the Plan to new participants

The Sunset Commission (as well as several individual members of the Legislature) asked you to evaluate the merits of reopening the Plan to new participants. Their interest in potentially doing so stems from two reasons: (1) the Plan is widely popular and many of their constituents have expressed a strong desire to participate, and (2) several people have suggested that reopening the Plan would help reduce its deficit by allowing it to more efficiently invest its assets. The premise is that should the Plan reopen, it would receive ongoing cash flow from participants every year that would allow it to avoid the problem described earlier in section 1.A. above.

This cash flow could be used to pay the near-term obligations of the Plan, allowing a greater percentage of its remaining assets to be invested in higher returning, more volatile asset classes, such as equity securities. With a greater percentage of its assets invested this way, the Plan's overall return could achieve its currently projected level of 8.25%.

Leaving aside the issue of the popularity of the Plan (which is undisputed), there are several reasons why reopening the Plan does not make sense. While it is correct that using cash flow from the sale of new contracts to pay maturing obligations would enhance its ability to invest using a longer term horizon and thus achieve better returns for a period of time, this strategy both ignores the short option position that the Plan's

structure has created (as described in 1.B. above) and does not address the Plan's current shortfall.

Because existing participants have the option of deciding when to use their benefits, investing the Plan's assets effectively would still be very difficult even if it continued to receive new cash flows annually. The Plan would still be required to pay out benefits under an uncertain schedule and thus be forced to keep a more than optimal amount of its assets in short-term, low returning asset classes. Under such circumstances, the Plan would still have difficulty achieving its overall return goal of 8.25%.

To be sure, the Plan might also accept an enormous number of new participants so that the near-term cash flow generated from the sale of contracts could potentially provide it with sufficient liquidity and allow it to achieve this return level over time. However, any such strategy would have to be predicated on attracting continually increasing numbers of new participants. Eventually the laws of large numbers will make such an approach unsustainable and the Plan will have to pay the cost of allowing participants to decide (within a 10-year window) when to use their benefits. But at this point the cost could be orders of magnitude greater than it is today.

More importantly, adopting this approach does nothing to solve its existing deficit. Although the Plan is using the new cash flows to pay short-term obligations so that it can invest its existing assets on a more long-term basis, it is at the same time accruing obligations to the new participants that are compounding at the rate at which tuition is increasing. Thus, instead this strategy only postpones the day of reckoning, and any delay will only make the problem much bigger.

Further, the only way in which reopening the Plan would address the current shortfall would be to impose on new participants a significant surcharge (the size of which would be dependent upon the number of new participants, contracts purchased and the payment plans selected) relative to the benefits provided. Determining the correct surcharge would be very difficult, given the many assumptions involved in such a calculation.

It also assumes that there are thousands of people who are prepared to substantially overpay for a future benefit. This is especially hard to accept since several other alternatives (such as investing in one of many available state-sponsored 529 plans) would surely provide a better perceived return on investment.

This strategy also raises a host of public policy questions. *Is it appropriate to effectively tax new participants in order to correct the Plan's previous missteps?* Clearly only the least financially sophisticated members of the State's population (or those who cannot afford to get sophisticated advice) would be the most likely participants under this new structure. *Is it not the duty of the State to protect its citizens from being unfairly led into overpaying for a benefit or service?* Additionally, *is it proper that the State take advantage of some of its citizenry's inability to fully understand and evaluate investment alternatives?*

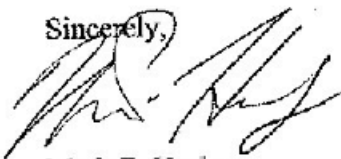
Lastly and most importantly, the reasons that have been offered for reopening the Plan ignore its most fundamental problem: Because it is impossible to precisely predict how fast the cost of Texas college tuition will rise in the future, it is likewise impossible to correctly price the cost of entry to new participants. Consequently, reopening the Plan increases the risk that its ultimate shortfall will mushroom in size.

It is for all of these reasons that we strongly recommend that the Texas Guaranteed Tuition Plan not be reopened to new participants.

3. Alternatives Available to the State

Unfortunately, the State has very limited options available to address the Plan's shortfall. The Legislature can appropriate additional funds to fill the gap today; the Legislature can appropriate a much larger amount of funding in the future; or the Legislature can effectively cut a substantial amount of its future funding the State universities and colleges by requiring them to allow Plan participants to attend their institutions at a discounted rate.¹ What is certain, however, is that the longer it takes the Legislature to act, the greater the ultimate cost will be to the taxpayers of the State of Texas.

Sincerely,



Mark P. Hurley

Chairman

Comptroller's Advisory Board for the Texas Guaranteed Tuition Plan

¹ The State already requires universities with tuition rates higher than the weighted average to absorb a portion of the cost: in 2005, Texas state universities waived more than \$10.5 million in tuition and fees from Plan participants. This mandate on the State's universities is already incorporated into our assumptions.

Appendix A

Present Value of Assets and Liabilities
2006 Annual Report

August 31 of Year	Present Value of Future Benefit and Expenses	Value of Assets and Present Value of Future Collections	Surplus of Assets Over Liabilities
2006	2,098,825,348	1,986,488,275	(110,337,073)
2007	2,087,384,843	1,967,944,962	(119,439,881)
2008	2,053,901,479	1,924,807,808	(129,293,671)
2009	2,014,038,520	1,874,078,121	(139,960,399)
2010	1,957,727,946	1,808,220,814	(151,507,132)
2011	1,890,834,437	1,726,827,966	(164,006,470)
2012	1,804,898,950	1,627,361,946	(177,537,004)
2013	1,698,712,410	1,508,528,603	(192,183,807)
2014	1,571,349,668	1,363,310,697	(208,038,971)
2015	1,428,950,822	1,203,748,635	(225,202,186)
2016	1,272,090,081	1,028,308,695	(243,781,367)
2017	1,106,736,849	842,843,519	(263,893,329)
2018	933,928,063	648,263,534	(285,664,529)
2019	755,132,878	445,901,025	(309,231,853)
2020	573,818,143	239,074,662	(334,743,481)
2021	376,840,134	14,480,316	(362,359,818)
2022	222,712,633	-169,541,869	(392,254,503)
2023	107,686,489	-316,929,010	(424,615,499)
2024	33,282,260	-426,364,017	(459,646,278)
2025	282,880	-497,284,216	(497,567,096)
2026	133,411	-538,482,970	(538,616,381)
2027	34,488	-583,017,745	(583,052,233)
2028	1,591	-631,152,450	(631,154,042)
2029	0	-683,224,250	(683,224,250)

Appendix B

Financial Projection
Optimistic Scenario
All Dollars In Millions

Benefit Payments Schedule: Current Plan
Contract Cancellation Rate: 50% of Current Assumption
Asset Return Rates: 7%
Tuition Cost Inflation: 8%
Operating Costs: \$32/contract + CPI

Fiscal Year Ending	Payments	Expense	Cash Flow	Present Value of Future Benefit and Expense	Value of Assets and Present Value of Future Collections	Surplus of Assets over Liabilities
2006				2,370.4	2,002.9	(367.5)
2007	789	187.0	(91.2)	2,360.2	1,967.0	(393.2)
2008	57.9	191.1	(133.2)	2,323.8	1,903.1	(420.7)
2009	47.7	197.0	(149.3)	2,278.7	1,828.5	(450.2)
2010	41.9	212.0	(170.0)	2,214.6	1,732.9	(481.7)
2011	35.3	219.4	(184.0)	2,138.1	1,622.8	(515.4)
2012	28.6	234.3	(205.7)	2,040.7	1,489.2	(551.5)
2013	20.9	248.9	(228.1)	1,920.9	1,330.8	(590.1)
2014	15.1	263.0	(247.9)	1,777.8	1,146.4	(631.4)
2015	12.9	269.5	(256.6)	1,618.0	942.4	(675.6)
2016	10.9	274.3	(263.4)	1,441.8	719.0	(722.9)
2017	8.9	272.0	(263.1)	1,255.8	482.4	(773.5)
2018	6.9	267.9	(261.0)	1,061.0	233.4	(827.6)
2019	5.0	261.8	(256.8)	859.1	(26.4)	(885.5)
2020	3.3	251.6	(248.3)	653.8	(293.7)	(947.5)
2021	1.7	255.1	(253.4)	430.4	(583.5)	(1,013.8)
2022	0.0	194.8	(194.8)	254.9	(829.9)	(1,084.8)
2023	0.0	141.5	(141.5)	123.5	(1,037.2)	(1,180.8)
2024	0.0	89.0	(89.0)	38.2	(1,203.8)	(1,242.0)
2025	0.0	38.5	(38.5)	0.3	(1,328.6)	(1,328.9)
2026	0.0	0.2	(0.2)	0.1	(1,421.8)	(1,422.0)
2027	0.0	0.1	(0.1)	0.0	(1,521.5)	(1,521.5)
2028	0.0	0.0	0.0	0.0	(1,628.0)	(1,628.0)
2029	0.0	0.0	0.0	0.0	(1,742.0)	(1,742.0)

Appendix C

Financial Projection
Pessimistic Scenario
All Dollars In Millions

Benefit Payments Schedule: Benefit Utilization Schedule 1
Contract Cancellation Rate: 20% of Current Assumption
Asset Return Rates 6%
Tuition Cost Inflation 8.5%
Operating Costs \$32/contract + CPI

Fiscal Year Ending	Payments	Expense	Cash Flow	Present Value of Future Benefit and Expense	Value of Assets and Present Value of Future Collections	Surplus of Assets over Liabilities
2006				2,834.8	2,016.0	(818.7)
2007	76.4	113.0	(36.6)	2,856.5	2,018.7	(867.9)
2008	58.5	125.6	(67.2)	2,762.4	1,996.9	(765.5)
2009	48.2	125.2	(77.0)	2,645.7	1,979.8	(665.9)
2010	42.6	153.8	(111.3)	2,510.5	1,936.0	(574.5)
2011	35.9	194.4	(158.6)	2,349.2	1,849.8	(499.5)
2012	29.1	255.4	(226.4)	2,149.3	1,696.2	(453.2)
2013	21.3	268.6	(247.3)	1,951.0	1,519.8	(431.3)
2014	15.4	288.2	(272.8)	1,750.3	1,312.0	(438.3)
2015	13.1	301.2	(288.1)	1,552.4	1,078.5	(473.8)
2016	11.1	316.8	(305.7)	1,356.0	814.9	(541.1)
2017	9.1	328.0	(318.9)	1,164.1	523.5	(640.6)
2018	7.1	335.8	(328.7)	978.9	206.1	(772.7)
2019	5.2	337.9	(332.8)	803.0	(133.0)	(936.0)
2020	3.4	333.2	(329.8)	639.4	(488.2)	(1,127.6)
2021	1.8	329.2	(327.4)	486.9	(861.3)	(1,348.2)
2022	0.0	305.0	(305.0)	353.6	(1,232.4)	(1,586.1)
2023	0.0	278.4	(278.4)	238.8	(1,597.9)	(1,836.8)
2024	0.0	234.1	(234.1)	147.8	(1,939.0)	(2,086.8)
2025	0.0	186.7	(186.7)	79.3	(2,250.9)	(2,330.1)
2026	0.0	132.4	(132.4)	33.4	(2,524.6)	(2,556.0)
2027	0.0	89.2	(89.2)	4.3	(2,769.5)	(2,773.8)
2028	0.0	13.8	(13.8)	0.1	(2,950.1)	(2,950.2)
2029	0.0	0.2	(0.2)	0.0	(3,127.2)	(3,127.3)

Appendix D
Financial Projection
Likely Scenario
All Dollars In Millions

<i>Benefit Payments Schedule:</i>	Benefit Utilization Schedule 2
<i>Contract Cancellation Rate:</i>	33% of Current Assumption
<i>Asset Return Rates</i>	6.5%
<i>Tuition Cost Inflation</i>	8.25%
<i>Operating Costs</i>	\$32/contract + CPI

Fiscal Year Ending	Payments	Expense	Cash Flow	Present Value of Future Benefit and Expense	Value of Assets and Present Value of Future Collections	Surplus of Assets over Liabilities
2006				2,585.1	2,009.6	(575.5)
2007	76.2	131.8	(55.6)	2,614.6	2,001.7	(612.9)
2008	58.2	155.9	(97.7)	2,620.7	1,968.0	(652.7)
2009	48.0	165.7	(117.7)	2,616.9	1,921.8	(695.2)
2010	42.2	221.6	(179.3)	2,554.1	1,813.8	(740.3)
2011	35.6	227.6	(192.0)	2,480.8	1,692.4	(788.5)
2012	28.8	245.9	(217.1)	2,383.6	1,543.9	(839.7)
2013	21.1	257.7	(236.6)	2,267.7	1,373.4	(894.3)
2014	15.3	274.1	(258.8)	2,126.9	1,174.5	(952.4)
2015	13.0	287.7	(274.7)	1,962.7	948.4	(1,014.3)
2016	11.1	300.3	(289.2)	1,774.8	694.4	(1,080.3)
2017	9.0	303.4	(294.4)	1,571.1	420.6	(1,150.5)
2018	7.0	300.7	(293.7)	1,357.1	131.8	(1,225.3)
2019	5.1	290.8	(285.7)	1,139.6	(165.3)	(1,304.9)
2020	3.3	286.3	(283.0)	912.7	(477.0)	(1,389.7)
2021	1.8	287.5	(285.7)	669.8	(810.2)	(1,480.1)
2022	0.0	248.6	(248.6)	452.1	(1,124.2)	(1,576.3)
2023	0.0	209.1	(209.1)	261.6	(1,417.1)	(1,678.7)
2024	0.0	151.7	(151.7)	119.1	(1,668.7)	(1,787.8)
2025	0.0	106.6	(106.6)	14.9	(1,889.2)	(1,904.1)
2026	0.0	14.7	(14.7)	0.3	(2,027.5)	(2,027.8)
2027	0.0	0.2	(0.2)	0.1	(2,159.5)	(2,159.6)
2028	0.0	0.1	(0.1)	0.0	(2,300.0)	(2,300.0)
2029	0.0	0.0	0.0	0.0	(2,449.5)	(2,449.5)

Comptroller's Advisory Board for the Texas Guaranteed Tuition Plan

Mark P. Hurley

Hurley is the President and CEO of Fiduciary Network, LLC a network of fee-only advisory businesses. Prior founding that company, he was Chairman and CEO of Undiscovered Managers, LLC, a mutual company he founded in 1998 and sold to J.P. Morgan/Chase in 2003. Before starting Undiscovered Managers, Hurley was a Managing Director at Merrill Lynch and Co. and a Vice President at Goldman, Sachs & Co. He also served from 1990-1992 in the Bush Administration at the Office of Thrift Supervision, the bureau of the Department of Treasury responsible for regulating the nation's savings and loans. He is a graduate of the United States Military Academy at West Point and received an M.B.A. from the Stanford Graduate School of Business.

Mark Trieb, FSA

Trieb is the Managing Principal of the Southern Region of Milliman's Employee Benefits Practice. He is an expert in the design, implementation, communication, funding and outsourced administration of a wide range of retirement benefit programs including traditional pension plans, hybrid pension plans, 401(k) plans, ESOPs and non-qualified plans. Trieb served on Milliman's Board of Directors from 1992-1996 and was the firm's National Practice Director of Retirement Plans from 1993-1996. He received a B.A., *summa cum laude*, from the University of Texas and an M.B.A. from the University of Texas Graduate School of Business.

Janet Briaud, CFP

Briaud is the President of Briaud Financial Planning a \$400 million financial advisory business in College Station, Texas. She is a member of the National Association of Personal Financial Advisors (NAPFA), and served as the president of that organization from 1992 to 1993. She is also a member of Financial Planner Association (FPA) and serves on the TIAA Cref Advisory Board. She has also been included in *Worth's* "Top Financial Advisor" list since 1994, *Medical Economics* "Best Financial Advisors" since 1998, and *Bloomberg's* "Top Wealth Managers" since 2002.

Deena Katz, CFP

Katz is an Associate Professor at Texas Tech University. She previously served as President of Evensky & Katz, a \$500 million, fee-only financial advisory business. She has authored six books and numerous professional articles in the field of financial planning. Katz also served as editor-in-chief of the *Journal of Retirement Planning* from 2000 – 2002 and as a member of the CFP board in 1998. She is an internationally recognized expert on financial advisory business practice management and long-term health care planning and has consulted to numerous advisory and financial planning practices. She has been selected by *Medical Economics* and *Worth* as one of the country's top financial advisors on several occasions. Katz is a graduate of Adrian College and was awarded a Doctor of Humane Letters from that institution in 2001.

David Diesslin, CFP

Diesslin is the CEO of Diesslin & Associates, a \$450mm fee-only financial advisory business in Fort Worth, Texas. He has served as Chairman of the Board of Governors of the Certified Financial Planner Board of Standards and as Chairman and President of the National Association of Personal Financial Advisors. He also has served on the Schwab Institutional Advisory Board and is Administrator for the American National Standards Institute where he has helped develop global financial planning criteria. Diesslin has been recognized on numerous occasions as one of the country's top financial planners by *Worth*, *Medical Economics* and *Money* and by the Consumers' Research Council. He has also been a contributor to several books in the field of financial planning. He is a graduate of Indiana University and received an M.B.A. from the University of Dallas.