The Regents of the University of California

COMMITTEE ON FINANCE
January 15, 1998

The Committee on Finance met on the above date at UCSF-Laurel Heights, San Francisco.

Members present: Regents Atkinson, Bagley, Brophy, Davis, Johnson, Khachigian, Lee, Levin, McClymond, and Sayles; Advisory members Miura and Willmon

In attendance: Regents Chandler, Davies, Gonzales, Hotchkis, Leach, Montoya, Ochoa, Parsky, Preuss, and Soderquist, Faculty Representatives Dorr and Weiss, Secretary Trivette, General Counsel Holst, Treasurer Small Provost King, Senior Vice President Kennedy, Vice Presidents Darling, Gomes, Gurtner, and Hopper, Chancellors Berdahl, Carnesale, Debas, Dynes, Greenwood, Orbach, Vanderhoef, Wilkening, and Yang, and Recording Secretary Nietfeld

The meeting convened at 2:15 p.m. with Committee Chair Brophy presiding.

1. **CONSENT AGENDA**

A. ***Amendment of the Budget for Capital Improvements and the Capital Improvement Program***

The President recommended that the Committee concur with the recommendation of the Committee on Grounds and Buildings that the 1997-98 Budget for Capital Improvements and the 1997-2000 Capital Improvement Program be amended to include San Francisco: B. Mission Bay Off-Site Building 1A and Santa Barbara: A. San Rafael Student Housing Addition.

Upon motion duly made and seconded, the Committee approved the President's recommendation and voted to present it to the Board.

2. **AUTHORIZATION OF AGREEMENT WITH THE CALIFORNIA VIRTUAL UNIVERSITY FOUNDATION**

The President recommended that the University join with other postsecondary educational institutions in California to form the California Virtual University Foundation as a California public benefit corporation.

Vice Provost Tomlinson-Keasey recalled that at the November meeting she described for the Committee the goals of the California Virtual University (CVU), which is a cooperative effort by California's higher education institutions to provide web-based electronic access to existing technologically-mediated classes, courses, and programs offered by those institutions. It will provide a comprehensive catalog of all distance education courses, programs and other educational content, and services of member institutions. The mission of the California Virtual University is to bring the best of California higher education to full- and part-time students in California, in the United States, and throughout the world. Because of the enormous size of California's higher education system, the CVU has the potential to offer a large and diverse pool of courses and programs and is expected to offer thousands of classes by the fifth year of operation.

At present, a State task force, the CVU Design Team, is responsible for developing and operating the CVU. This task force was created by Executive Order of Governor Wilson in April 1997; the order expires on August 1, 1998. Incorporation of the CVU as a foundation is necessary to create a management entity that will continue the operation of the CVU and enable it to seek and receive funding from gifts and grants. Once established, the CVU Foundation Board would become responsible for the management of the CVU. The CVU will provide an additional marketing tool for UC's online and distance education programs and enhance access to UC's educational offerings, particularly for working professionals and adults interested in career development.

A business plan for the CVU was developed in consultation with the firm of KPMG Peat Marwick. The CVU itself will be a minimal operation financially, requiring only revenues sufficient to support the operation of the catalog and related services; the bulk of the revenues from distance education will accrue to the provider campuses. To date, financial and in-kind support for the CVU Design Team has been provided by State of California departments and agencies and by participating colleges and universities. The CVU is now seeking a total of $750,000 in corporate sponsor support and another $500,000 in educational foundation support. With this support, the California Virtual University expects to cover its costs in its first two years of operation. The balance of the operating revenues will come through strategic business partnerships with online book services and one or more career counseling services. In addition, the CVU catalog will offer as a service to its visitors the opportunity to be contacted by any of the corporate sponsors regarding job opportunities, primarily in the technology industry.

The CVU Design Team currently operates a "transitional catalog" on the World Wide Web containing links to the online catalogs of distance education courses and programs of 64 California-based colleges and universities accredited by the Western Association of Schools and Colleges. This site, which has been open to the public since mid-September 1997, received over 100,000 visitors in its first eight weeks. This transitional catalog also offers visitors automatic updates, via electronic mail, whenever a new course or program that matches their areas of interest is offered by a member campus. More than 2,000 visitors have registered with the CVU Design Team to receive automatic updates of new courses in specified subjects.

In the next phase, a pilot will be developed to test the program, and a full production catalog is scheduled to go online in the spring of 1998. It will allow a visitor simultaneously to search all courses and programs at any one campus or group of campuses and will provide links to campus web sites. Potential students will be able to connect directly to the campus for application, enrollment, or additional information. The catalog will include courses and programs from all segments of California higher education, both regular and extension, and will be automatically updated with new offerings.

Other institutions involved in this venture are the California State University system, the California Community Colleges, and independent institutions including Stanford University and the University of Southern California. All are represented on the Design Team and will participate in the CVU Foundation. Subject to Regental approval, University Counsel will assist in taking the necessary steps for incorporation of the CVU Foundation.

Upon motion duly made and seconded, the Committee approved the President's recommendation and voted to present it to the Board.

3. **EXTERNAL FINANCING FOR SAN RAFAEL STUDENT HOUSING ADDITION, SANTA BARBARA CAMPUS**

The President recommended that, subject to amendment of the Budget for Capital Improvements and the Capital Improvement Program to include the San Rafael Housing addition, Santa Barbara campus:

(1) Funding for the San Rafael Student Housing Addition, Santa Barbara campus, be approved as follows:

External financing	$42,000,000
University of California Housing System Net Revenue Fund	3,000,000
Total	$45,000,000

(2) The Treasurer be authorized to obtain external financing not to exceed $42 million to finance the construction of the San Rafael Student Housing Addition, Santa Barbara campus, subject to the following conditions:

a. Interest only, based on the amount drawn down, shall be paid on the outstanding balance during the construction period;

b. As long as the debt is outstanding, University of California Housing System fees for the Santa Barbara campus shall be established at levels sufficient to meet all requirements of the University of California Housing System Indenture and to provide excess net revenues sufficient to pay the debt service and to meet the related requirements of the proposed financing; and

c. The general credit of The Regents shall not be pledged.

(3) The Officers of The Regents be authorized to provide certification that interest paid by The Regents is excluded from gross income for purposes of federal income taxation under existing law.

(4) The Officers of The Regents be authorized to execute all documents necessary in connection with the above.

The Committee was informed that the San Rafael Student Housing Addition consists of three interconnected components: the construction of an 800-bed student housing complex and associated student support facilities, an addition to the adjacent Carrillo Commons, and life safety and building code corrections and renovation of Carrillo Commons.

New Student Housing

Freshmen enrollments drive the demand for on-campus housing at the Santa Barbara campus. While overall campus enrollments dropped in the early 1990s, the number of freshmen enrolling increased. For fall 1997, approximately 7,600 applications for admission were received, and the resulting wait list was more than 2,000 students. In response to record freshmen enrollment and demand for on-campus housing, 75 new freshmen were tripled-up in rooms designed for double occupancy. The campus has also begun engaging private sector landlords in an effort to secure the necessary housing to satisfy students' increasing demand for affordable student housing until more campus housing can be constructed.

The campus' 1990 Long Range Development Plan calls for a total of 6,069 beds to meet the goal of housing 30 percent of all students in University owned or controlled facilities. This goal is based on a total enrollment of 20,000 students. Currently, the campus is able to house approximately 22 percent of its students with a total student housing inventory of 4,069 beds located in six on-campus residence halls and five off-campus apartment complexes. The on-campus residence halls have the capacity to accommodate 2,668 students and are used primarily for freshmen and sophomores. The five apartment complexes house approximately 1,401 family and/or single graduate and undergraduate students. No new on-campus student residence halls have been constructed since 1968. With the San Rafael Student Housing Addition, the campus bed space inventory level will increase to 4,869, providing housing to 24 percent of the students.

The project proposes two types of housing, resident houses and suite housing. Suite housing will consist of clusters with shared bathrooms and a mix of single and double occupancy bedrooms in addition to a shared study room, lounge, and laundry facilities. Resident houses will be nearly identical to suite housing with the addition of shared kitchen facilities to provide students with an option for more independent-style living. The project will accommodate 400 students in each of the two housing types.

Parking to accommodate the student housing has been estimated at 400 spaces. Approximately 80 spaces will be constructed on-site for short-term purposes such as service, handicap access, and temporary loading and unloading. Resident student parking is proposed in the new Harder Stadium Lot (479-space capacity) which will become restricted to resident student parking upon completion of the Campus Parking Structure 1 in winter 1999.

Carrillo Commons Addition

The project will include the expansion of the existing food service operations at Carrillo Commons to accommodate the increased student population using the dining facilities associated with the new housing. Also to be enlarged are associated kitchen, bakery, food preparation, serving, storage, and loading dock areas.

Carrillo Commons Life Safety and Code Corrections

The project also includes seismic strengthening, installation of fire sprinklers, asbestos and lead abatement, ADA improvements and upgrades to the building's utility system, including fire alarm and security system.

Financial Feasibility

The total project cost, estimated at $45 million, is to be funded from a combination of external financing and UCHS Net Revenues. Based on a debt of $42 million at 7 percent interest amortized over 27 years, the average annual debt service is $3,504,000 and annual operating expenses are estimated at $3,268,000, for a total annual expense of $6,772,000. Repayment of the debt will be from student rents generated by the addition and from existing UCHS undergraduate residence hall bed spaces at the Santa Barbara campus. Rates for the San Rafael Housing Addition will be $6,990 per year for the first full year of occupancy, 2001-02.

Upon motion duly made and seconded, the Committee approved the President's recommendation and voted to present it to the Board.

4. **DEVELOPMENT OF THE UCSF MISSION BAY CAMPUS SITE**

Regent Davies noted for the record that he would not participate in the discussion due to a previously-disclosed conflict of interest. Regent Ochoa noted for the record that he would not participate in the discussion because one of the parties is a client of his law firm.

Chancellor Debas introduced Mr. Robert Burke, a member of the Board of Directors of the Bay Area Life Sciences Alliance (BALSA), noting that Mr. Burke's pro bono work on behalf of the San Francisco campus had been instrumental in obtaining the gift of land from Catellus Development Corporation.

Chancellor Debas recalled that in May 1997 The Regents authorized the acceptance of the real property which will comprise the Mission Bay campus as a contribution from Catellus. Since that time, the campus has been working closely with the Office of the President, with the vigorous support of BALSA, to determine how best to define the San Francisco campus' relationship with BALSA in order to maximize its benefit to UCSF. The Chancellor recalled that Mr. Don Fisher, Chairman and founder of The Gap, Inc., had addressed the Regents at the November 1997 meeting, when he described how he joined with a group of local business leaders in 1996 to create BALSA, which is a 501(c)(3) nonprofit public benefit corporation. BALSA is a single-purpose entity created specifically for the development of a life sciences campus in San Francisco. BALSA represents a unique combination of individuals with the enthusiasm, motivation, expertise, and resources which can bring significant benefits to UCSF's efforts with respect to Mission Bay.

The development of facilities in the City and County of San Francisco is an extremely complex endeavor. Through its membership and executive staff the BALSA board has available sophisticated knowledge in real estate development, the development of biomedical research facilities, and expertise in developing facilities in San Francisco.

In order to fulfill BALSA's purpose, the BALSA board members have over the past year undertaken the following:

- Devoted substantial time and resources in facilitating the agreement between Catellus and the University for the conveyance of the Mission Bay campus to the University (the Catellus contribution agreement).

- Given their volunteer time at frequent board meetings and at discussions on the development strategy for the Mission Bay Campus.

- Contributed major financial resources to this endeavor at no cost to the University. The BALSA board has hired a staff headed by Clifford Graves, the former executive director of the San Francisco Redevelopment Authority and prior Chief Administrative Officer in San Diego County and retained consultants to support the effort to evaluate the Mission Bay campus.

- As a donation to the University, sponsored an international contest to select the master planning firm for the Mission Bay campus.

- Offered, as individuals, to participate in designing the fundraising campaign for the Mission Bay campus.

The BALSA members share the campus' vision for the Mission Bay campus as an institution with state-of-the art laboratories and facilities that will attract the world's greatest researchers, with substantial adjacent land available to attract major life-science companies in much the same way as Stanford University was the catalyst for the Silicon Valley. The faculty are close to formulating recommendations as to which academic programs should be located at Mission Bay. The project will have enormous value to the campus, the University, the Bay Area, and ultimately to the public who looks to the University for scientific discovery and economic opportunity.

UCSF/BALSA Collaboration

The University has a unique opportunity to facilitate the promotion, fundraising, master planning, and development of the Mission Bay campus by involving BALSA in a coordinated UCSF/BALSA collaboration.

From the outset, both the University and BALSA have acknowledged that the objectives of this collaboration must be to support, benefit, and further the scientific and educational purposes of UCSF. Both parties recognize that these objectives can be fulfilled only by ensuring that the planning and development of the Mission Bay campus is efficient, integrated, cost-effective, and consistent with the social, economic, and urban design interests of the City and County of San Francisco. In furtherance of these objectives, it is proposed that the activities of the collaboration be broad-based and include all activities which are necessary and appropriate for the planning and development of the Mission Bay campus. These activities could include the following:

- Assist with the implementation of the terms of the Catellus contribution agreement for the conveyance of the Mission Bay campus to the University

- Manage in cooperation with the University the preparation of the Mission Bay campus master plan within the framework of the UCSF Long Range Development Plan and the Catellus contribution agreement.

- Develop for review by The Regents, the University systemwide administration, and BALSA strategic long-range financing options for the development of the Mission Bay campus.

- Provide support for, and complement on an ongoing basis, the UCSF Foundation’s fundraising program. It has been agreed that major fundraising for the Mission Bay campus will be handled by and through the UCSF Foundation. However, several members of the BALSA board have volunteered to help design aspects of the next UCSF capital campaign, which will be devoted to Mission Bay.

- Collaborate with, support, and facilitate UCSF's governmental and community relations efforts, including supporting UCSF and The Regents in their ongoing communication with Catellus and the City of San Francisco with respect to issues arising under the Catellus contribution agreement and the development of the Mission Bay campus and surrounding areas.

- Promote the Mission Bay campus to third-party research organizations whose presence and involvement at Mission Bay would enhance the academic mission of UCSF and work with UCSF and these organizations to secure the necessary facilities at the Mission Bay campus.

- When requested to do so by the University, manage the design, construction, and/or financing of buildings at the Mission Bay campus.

- Lease or sell to the University, or other entities approved by the University, buildings developed at the Mission Bay campus.

- When directed by the University, develop and implement property management programs for the Mission Bay campus.

<u>Principles Governing The Relationship</u>

Chancellor Debas emphasized that BALSA and the University believe that the development of the Mission Bay campus could be enhanced by a more formal relationship that would be developed under the following principles:

- All strategic decisions with respect to the planning and development of the Mission Bay campus will remain within the control of the University, and there will be no dilution of Regental involvement and oversight.

- Both the University and BALSA will provide resources to the collaboration to ensure its effectiveness. It is proposed that BALSA would provide initial working capital, financial support for the master plan developed by Machado & Silvetti, and ongoing staff support. The University would not be required to provide working capital.

- The primary objective of the relationship must be to benefit UCSF, and no third party, including BALSA, may obtain economic or development advantages. Under appropriate circumstances, to be agreed upon by both the University and BALSA, BALSA may be reimbursed its direct expenses attributable to the development of specific projects in the event BALSA does not provide charitable donations.

- The relationship must encourage and foster the donation of third-party financial support for the development of the Mission Bay campus.

- The relationship should be long-term, perhaps twenty or thirty years, in order for it to fulfill its objectives, but provision should be made for termination of the relationship in the event it is not effectively fulfilling its objectives.

- The relationship's organization and management must be flexible in order that its broad-ranging mission may be achieved effectively.

- There must be full financial and performance accountability to the University.

Based on today’s discussion, the administration intends to return to The Regents in March for authorization to formalize the relationship between BALSA and the University.

Proposed Structure - Contractual Arrangement or New Legal Entity

General Counsel Holst reported that, as discussions between BALSA and the University have progressed, attention has been directed to the question of establishing the most appropriate structure so that the objectives and the principles of the relationship can be achieved and are appropriately reflected.

Two possible structures have been examined, a contractual arrangement between the parties or the establishment of a new legal entity between the parties, either in the form of a nonprofit corporation or a limited liability company formed for nonprofit purposes. As the analysis has developed, three key disadvantages have been identified with respect to a contractual arrangement. First, contractual arrangements (such as general partnership joint ventures) are less commonly used for long-range, comprehensive planning and development activities contemplated by the collaboration between the University and BALSA because the introduction of the limited liability company under California law has provided a more convenient and flexible vehicle. Generally, contractual arrangements are more appropriately employed with respect to specific projects or specific services, such as construction management services. Second, a contractual arrangement may not offer the University appropriate protection from liabilities which may be created by BALSA in its activities in planning and developing the Mission Bay campus. A contractual arrangement may be construed as a general partnership, in which case the University could have general partner liability for the acts of BALSA, or it is possible that BALSA would be held to be the agent of the University. As BALSA is a corporate entity with minimal capitalization, in either case the University would likely bear responsibility for any obligations created by BALSA. Formation of a separate limited liability entity will better protect the University from these risks. Finally, it is likely that individual contractual arrangements on a building by building basis will not be as effective in fostering third party donations for the Mission Bay campus as a corporate structure.

Limited Liability Company or Nonprofit Corporation

Mr. Holst explained that the limited liability company and the nonprofit corporation share many similarities. Both are sanctioned and governed by statutory authority under the California Corporations Code and provide limited liability protection to their members, in this case the University and BALSA. In addition, the purposes of a limited liability company may be restricted to nonprofit purposes and, accordingly, both the nonprofit corporation and the limited liability company may qualify as 501(c)(3) entities for federal income tax purposes to ensure the tax deductibility of donations to the entity. The nonprofit purpose, in the case of both the nonprofit corporation and the limited liability company, would be to support, benefit, and further the scientific and educational purposes of UCSF by facilitating the consummation of the development of the Mission Bay campus.

Despite substantial similarities, the limited liability company offers two significant advantages over the nonprofit corporation. The limited liability company offers greater flexibility in the management structure and is subject to fewer corporate formalities.

With respect to management structure, the nonprofit corporation is required by statute to constitute a board of directors. In the case of a limited liability company, certain management responsibilities may be vested in one member or in an individual or group of individuals. Although day-to-day management may be shared with BALSA, it is proposed that the operating agreement would require University approval of all significant decisions with respect to the planning and development of the Mission Bay campus and would provide a mechanism for the University to initiate and require the company to undertake specific activities.

With respect to corporate formalities, the limited liability company is burdened with fewer legal requirements, which would enable the University and BALSA to craft the terms of the operating agreement to meet the specific requirements of the University with respect to the Mission Bay campus.

Key Provisions of a Limited Liability Company Operating Agreement

Mr. Holst continued that the formation and organization of a limited liability company are governed by the Articles of Organization, which are filed with the Secretary of State, and an operating agreement executed by the members of the company. The key provisions of the operating agreement would be as follows. Both BALSA and the University would make capital contributions to the company. BALSA's capital contribution could consist of (a) cash required for working capital, (b) BALSA's financial support for the master plan developed by Machado & Silvetti, and (c) ongoing staff support to the company, at a level to be agreed upon by the University and BALSA. The University's capital contribution could consist of a groundlease of portions of the Mission Bay Campus and ongoing staff support to the company, at a level to be agreed upon by BALSA and the University.

In order to ensure that the company's activities effectively benefit UCSF and that the University is empowered to make all critical decisions, the company would be structured so that all strategic decision-making with respect to the planning and development of the Mission Bay campus would remain with the University. For example, if the company intended to take an action which, if taken by the University would require the approval of The Regents or the President, then the company would not be able to take such action without the approval of the University as a member of the company.

However, as the relationship with BALSA evolves, and the performance of the company is established and the company is providing demonstrable benefits to the University and the community, the administration could return to the President and The Regents with requests, where appropriate and consistent with all laws and University policies, for further approvals so that the company could undertake substantial development activities with respect to individual buildings.

Subject to the substantial involvement and control of the University, the present discussion between the University and BALSA contemplates that the day-to-day management of the company could reside in BALSA, as the managing member of the company. It is proposed that BALSA may be removed as the managing member at any time at the direction of the University.

Except with respect to liquid assets provided by BALSA which have not been previously designated in furtherance of the company's purposes, it is proposed that the University may direct the company to distribute specified assets to the University during the operation of the company or upon dissolution. Donor provided assets would be distributed consistent with donor intent. It is proposed that all operating cash and donor contributions be invested in the Short Term Investment Pool or other University endowment pools as appropriate.

Although both BALSA and the University believe that the collaboration should be long-term and significant, the governing documents of the company would provide that either party, on notice to the other party, may withdraw from the company. If the University elected to withdraw from the company, the company would be dissolved. However, if BALSA elected to withdraw from the company the University could, at its option, continue the existence of the company. The governing documents of the company will provide that neither the University nor BALSA would transfer its interest in the company without the consent of the other party.

Land Contribution

Chancellor Debas reported that due diligence on the land contribution is proceeding, and Catellus will be issuing the project EIR for its land surrounding the Mission Bay campus shortly. In order to assure that the University's initial projects can proceed into design and construction in a timely manner regardless of delays in the processing of the Catellus EIR and approvals which are related to conditions precedent to the Mission Bay campus contribution, the parties are working on the possible early conveyance of the southernmost two blocks within the 26-acre First Contribution Parcel. A Second Contribution Parcel of 17 acres which completes the Mission Bay campus will be conveyed by Catellus and the City of San Francisco. These two blocks, which comprise approximately seven acres, will accommodate development of the first several buildings at the Mission Bay campus. Such early contribution would be accepted only following successful completion of the University's due diligence and receipt of appropriate assurances from Catellus and the City that the balance of the Mission Bay campus would ultimately be contributed in a manner that would facilitate the continuing development of the entire 43-acre campus.

At the conclusion of the presentation, Chancellor Debas introduced Professor Zack Hall, Associate Dean for Research, School of Medicine, and Chair of the Academic Implementation Planning Committee, which is responsible for defining the academic program at Mission Bay. Also in attendance were BALSA members Mr. Joe Larson and Mr. Clifford Graves and BALSA's legal counsel, Mr. Robert Thompson.

Regent Leach supported the creation of a long-term relationship with BALSA due to the ongoing nature of the project. He reported that he had discussed with Mr. Burke the fact that management of the limited liability company would reside with BALSA and had raised the question of whether its direction could be shared by the University. He suggested that such an arrangement would be in the best interests of the University and that the Committee should approve such an arrangement when the matter comes before it as an action item.

Regent Soderquist was concerned about potential conflicts of interest involving BALSA board members and their ownership of property in the Mission Bay area. He asked how the LLC would be structured to ensure that future BALSA members did not benefit from their association. Chancellor Debas reported that the campus had received disclosure statements from the members of the BALSA board of directors and that at present there is no conflict of interest.

General Counsel Holst recalled that the approach that the Regents took when the tenth campus site was under consideration called for a level of disclosure on the part of Regents above and beyond that called for by the Political Reform Act in order to provide complete satisfaction that no conflicts would arise. He suggested that a similar arrangement might respond to Regent Soderquist's concerns.

Regent Levin observed that it was unusual for an entity to be formed to act as a manager of University business. She noted that the University had taken great care in the steps it had taken to create UCSF-Stanford Health Care and cautioned the need to pay similar attention to detail in the negotiations with BALSA. She stressed that direction should come from the Board of Regents.

In response to a question from Regent Brophy, General Counsel Holst stated that the managing authority of the LLC was subject to agreement between the parties. The limited liability company provides a full range of opportunity to pursue whatever direction the parties determine to be in their best interests. He confirmed for Regent Brophy that one possibility would be that one party would be able to act without the consent of the other. Regent Brophy believed that such an arrangement would not be in either of the parties' best interests.

Referring to Regent Levin's comments, Chancellor Debas suggested that the proposal LLC should not be compared with the UCSF-Stanford merger because in that case The Regents had ceded some authority to the new board of directors. Mr. Burke confirmed that the members of BALSA had never conceived that they would have the authority to take an action that was contrary to the interests of the University. He reported that the draft LLC agreement contains a long list of actions which can be approved only by The Regents or the Chancellor. In addition, the authority to terminate BALSA's involvement with the project will reside with The Regents.

Regent Davis supported the full disclosure of any potential conflicts of interest both as exist at present and in the future. Mr. Burke reiterated the point made by Chancellor Debas that each member of BALSA had been asked to complete a form in which they were required to disclose any companies or properties in which they have an interest that could be materially impacted by the transaction. He added that the BALSA members would make any additional disclosures that the Regents might request because they do not seek any personal benefit from their relationship with the University. Regent Brophy stressed that such an obligation would exist with respect to future investments.

Regent Khachigian expressed her appreciation to BALSA, without which the conveyance of property would not have occurred, and asked why, given the provision that BALSA would have no authority to act without the consent of the Chancellor or The Regents, there was the need for the LLC. Mr. Burke responded that BALSA has brought and will continue to bring to the Mission Bay project resources that would not traditionally be available to the University. Regent Leach recalled that the University has entered into various arrangements with other entities in the past to accomplish certain projects, such as the Keck Telescope in Hawaii. In the case of the development of the Mission Bay campus, which will continue for twenty or thirty years, Mr. Leach believed that the limited liability company described by General Counsel Holst would be the most effective way to proceed. He pointed out that both parties would have the ability to terminate the agreement at any time.

5. **REPORT ON THE 1998-99 GOVERNOR'S BUDGET**

President Atkinson reported that the Governor has honored, for the fourth consecutive year, the compact with higher education. The budget provides the University with an eight percent increase in State general funds, as well as funding for several high priorities. The Governor's Budget provides the University with sufficient State general funds to avoid increasing student fees for a fourth consecutive year. In addition, the Governor has provided funding to offset the five percent reduction in general fees for California undergraduate residents provided for in Assembly Bill 1318. In addition to fully funding the expenditure plan approved by The Regents in November, the Governor has chosen to provide funding for two initiatives that continue to recognize the University's role with respect to the State's economy.

The Governor's Budget provides the University with an augmentation to fund enrollment in electrical engineering and computer science programs. In response, the administration is working with the Engineering Advisory Council and the campuses to develop a plan to phase in a forty percent increase in enrollment in these disciplines over a period of eight years. The Budget also proposes to provide an additional $5 million, beyond the compact, to expand the successful Industry-University Cooperative Research Program. With this, and industry matching funds, there will be at least $30 million per year to continue funding for biotechnology research and to move into several new fields, including digital media, semiconductor manufacturing, information technology, and communications. These are all areas of significant economic importance to California. These augmentations are critical to the State's continued economic growth and represent a wise investment by the State. The Budget also provides the following:

- $5 million to help pay for the start-up of academic programs and planning for the tenth campus in Merced. This increment is one of the major elements needed in order to proceed with the development of a tenth campus.

- $5 million to help expand outreach efforts. This brings the State's commitment of new funding for outreach to $7 million. With the additional funding to be provided by

> the Office of the President, the total of new State and University funds for outreach will reach $12 million in 1998-99. Major efforts will be devoted to implementation of the recommendations of the Outreach Task Force report as the University seeks new paths to diversity and to promote student achievement, especially among students with disadvantaged backgrounds. In addition, matching funds will be sought from the K-12 schools, as well as private and federal funds, to help reach the goal of $60 million for outreach programs over the next several years.

The President expressed concern, however, that the Governor's Budget reduces State funding by $12.2 million for the California Subject Matter Projects, which are programs to improve teacher training in a variety of areas. These are intersegmental programs involving the California State University which have historically been funded through the K-12 budget.

President Atkinson observed that, with the funding levels proposed in the Governor's Budget, the promise of an affordable, accessible and high-quality university education which was made to past generations of Californians is being kept and renewed. This budget assures that for the near term the University of California can maintain the excellence of its programs, continue to offer a place at a UC campus to all eligible California high school graduates seeking admission, and provide the classes that students need to graduate in a timely fashion.

Mr. Atkinson pointed out that the Governor has reiterated his commitment to work with the University to develop a new compact to ensure continued fiscal stability. The Budget includes a set of principles the Governor believes should be encompassed in a new compact with higher education. These principles build upon the current compact and the provisions of AB 1415, which was approved by the Legislature. The administration is encouraged by the principles and will use them to continue a dialogue regarding the need for a long-term funding policy to maintain access to a high-quality and affordable public higher education system in California.

The President then called upon Associate Vice President Hershman to provide details of the Governor's Budget. Mr. Hershman reported that General Fund revenues and expenditures are expected to increase by about 4.5 percent over 1997-98, and the Budget provides for a reserve of nearly $300 million. The Governor's Budget continues to predict continued economic growth for 1998-99, although at a slower pace than in 1997-98, and moderate inflation.

With respect to revenues, the Budget reflects agreements made with the Legislature regarding tax relief. No new tax reductions are proposed, but the Budget does recognize the second increment of a three-year plan to reduce personal and business income taxes. By the year 2000, when the plan is fully phased in, the cost of the tax relief previously agreed to with the Legislature will exceed $1 billion.

With respect to proposed budgets for specific agencies, Mr. Hershman reported that about two-thirds of the increase in State general funds is used to fund education. For K-12, the combination of State general funds and local property tax revenues results in a total funding increase of 4.5 percent. This provides K-12 with sufficient revenue to fund enrollment growth, a modest cost-of-living adjustment in line with inflation, and several initiatives including the Governor's proposal to lengthen the school year to 180 days. Community colleges will receive a total increase of 6.8 percent, which will fund enrollment growth, provide a cost-of-living adjustment consistent with inflation, and fund a major new initiative called Partnership for Excellence. In return for funding, the Partnership for Excellence holds local community college districts accountable for specific outcomes, including improvement of the transfer function. For CSU, the Governor's budget provides an 8.6 percent increase, including funding for the compact, a buy out of a 10 percent fee increase, the 5 percent fee reduction, as well as full funding of enrollment. The budget provides the Student Aid Commission with an increase of 8.5 percent, which is essentially continuation funding for previously approved increases in the number of CalGrant awards and award levels.

The Governor's Budget also includes an infrastructure initiative that proposes to place $7 billion in general obligation bonds on the ballot in 1998. Included are $2 billion for K-12, $1 billion for higher education, $1.4 billion for new prisons, and $2 billion for parks, water, and other resources. The remainder would be used for a series of infrastructure projects and the development of an "infrastructure bank." If the voters approve the entire $7 billion, the State's debt as a percentage of the general fund budget will reach about 6 percent in 2000-01.

Mr. Hershman called the Committee's attention to a table presenting an overview of the proposed increase in State general funds for the University. Under the Governor's proposed budget, the University will receive an eight percent increase in State general funds, which includes the following:

- $83.5 million in funding under the compact (a four percent increase)
- $9.5 million to restore the undesignated budget cut included in the 1997-98 Budget
- $39.5 million to avoid an increase in general student fees
- $22.5 million to pay for a five percent fee reduction for California undergraduate resident students
- Funding for unavoidable costs, which includes an additional $2 million for the debt service related to revenue bonds and $4.8 million for increased annuitant health and dental benefits.

The Budget provides the University with $5 million to expand academic outreach programs. The University is committed to promoting student achievement, especially among students in disadvantaged circumstances, and to achieving a diversified student body. Additional funding levels of $60 million will be required over the next several years to meet these commitments. With this $5 million in additional State funding added to the previous $2 million provided by the State, the State's added contribution totals $7 million. President Atkinson plans to increase UC's contribution from $3 million to $5 million, bringing the total of State and UC funds to $12 million in 1998-99.

As noted by President Atkinson, the Governor's Budget allocates $5 million for academic programs and planning for the Merced campus, which will bring total State funding for the tenth campus to $10 million. This provides the core funding needed for the campus. The remaining operating funds will come from normal funding related to enrollment growth. In 1998-99, the funds will be used to support a variety of planning activities, including initial site studies, joint infrastructure and community planning, preparation of a long-range development plan and the associated environmental impact report, further delineation of the academic program that will form the basis for planning initial campus facilities, and costs associated with expanding academic programs in the San Joaquin Valley prior to opening a tenth campus.

Also included are $1 million to help develop courses for the California Virtual University, which is a collaborative effort among California's public and private universities to help serve the educational needs of California students and employers by enhancing the range and quality of courses available on-line, and $3.4 million to fund several efforts including $400,000 as matching funds to continue the support of the International Thermonuclear Experimental Reactor (ITER) project on the San Diego campus, $1.5 million for the UC Arts Bridge Program, and $1.5 million for the UC Teaching Internships for Mathematics and Science.

Mr. Hershman reiterated President Atkinson's concern about the reduction of $12.2 million in the University's budget to fund the California Subject Matter Projects. He recalled that historically these projects were funded by Proposition 98 funds in the State Department of Education's budget. In 1996, consistent with a settlement agreement between the California Teachers Association and the State Department of Finance regarding the use of Proposition 98 funds, funding for these programs was transferred to the University's budget, and additional general funds were provided to support them. The University hopes that funding for these important programs will be restored.

The Governor's Budget includes $151 million in general obligation bonds for capital outlay which is proposed to be funded by a general obligation bond measure on the 1998 ballot. The University's five-year capital outlay plan calls for increased State funding from $150 million in 1998-99 to $250 million by 2002. The University, in cooperation with CSU and the community colleges, had requested the Governor's support for a multi-year commitment to place general obligation bond measures on the ballot over several election cycles as well as a higher level of bond funding. Each segment believes it needs $250 million a year in State general obligation bonds in order to meet life-safety needs, modernize existing facilities, and accommodate enrollment growth.

Associate Vice President Hershman outlined the actions which The Regents will be asked to take related to the budget, beginning with the reduction of mandatory systemwide fees for California undergraduate resident students by five percent and approval of the 4.5 percent increase in nonresident tuition. In February the President will recommend that the Board take action to authorize long-term financing for deferred maintenance and facilities renewal projects, consistent with the Regents' and Governor's Budgets. At the same time there will be a presentation on deferred maintenance and facilities renewal as requested at the October meeting.

Finally, once the Legislature and the Governor finish their work on the Budget, the administration will ask for approval of a revised budget plan for 1998-99.

Mr. Hershman then turned to the issue of long-term funding for public higher education. As President Atkinson indicated in his remarks, the Governor has included a set of principles that essentially constitute his proposal for a renewed compact. The Governor has pledged his commitment to work with the administration to develop a new compact to provide adequate resources to maintain quality and meet the projected enrollment demand associated with "Tidal Wave II," including an adequate level of funding for capital outlay. In return, the Governor expects that the University will emphasize growth in engineering and computer science-related programs as well as continue its commitments to improve productivity, improve undergraduate education, maintain competitive faculty salaries, improve the transferability of courses among segments, increase intersegmental cooperation, increase public-private partnerships, and maintain the efficient use of existing campuses and facilities. These principles are generally consistent with the principles included in AB 1415 and previously approved by the Legislature, and they form the basis for continuing discussions which may lead to an early agreement on funding for higher education.

Regent Lee asked why the President was recommending an increase in nonresident tuition in light of increased funding for the University in the Governor's Budget. Mr. Hershman explained that State policy requires the University to charge out-of-state and foreign students the full cost of instruction. If the comparison eight institutions charge less than full cost, in order to remain competitive the University must charge fees in line with the comparison institutions. Regent Lee pointed out that over the last two years the University has increased nonresident tuition by 16 percent.

In response to a question from Regent Leach regarding funding for outreach programs, President Atkinson recalled that the Outreach Task Force had estimated that the University was spending between $60 million and $100 million on activities related to outreach and to K-12. The task force recommended that the University increase that base amount by another $60 million. The President noted that the University would need to seek multiple sources for this additional funding, which will be the responsibility of Senior Associate to the President Pister. In addition, as described by Associate Vice President Hershman, the University and the State will provide increased funding for this effort. Last year the University received an increase of $2 million for outreach in its State budget, which was augmented by $3 million by the Office of the President. In 1998-99, that amount will be augmented by an additional $5 million from the State and $2 million from the Office of the President. This combined funding of $12 million is moving toward the goal of $60 million over the next several years.

Regent Johnson noted that the administration had estimated an over-enrollment of about 3,000 students for 1998-99, which represents a real problem for the University. The ongoing deterioration of the faculty to student ratio undermines the quality of the University of California. Mr. Hershman related that when he met with the Director of Finance he had conveyed this important message. Faculty Representative Weiss commented that the faculty would agree with the concerns raised by Regent Johnson.

6. **PROPOSED REDUCTION IN EDUCATIONAL FEE FOR RESIDENT UNDERGRADUATE STUDENTS FOR 1998-99**

The President recommended that, effective with the fall term 1998, the Educational Fee be reduced by $190, from $3,086 to $2,896 per year for resident undergraduate students only.

It was recalled that no recommendation regarding changes in student fee levels was included in the 1998-99 Regents' Budget because of actions taken by the Governor and the Legislature in each of the last three years to buy out proposed student fee increases and due to the Legislature's approval of Assembly Bill 1318. Section 66025(a) of AB 1318 provides that:

> Systemwide fees charged to resident undergraduate students at the University of California and the California State University shall be reduced for the 1998-99 fiscal year by 5 percent below the level charged during the 1997-98 fiscal year, and the systemwide fees charged to those students for the 1999-2000 fiscal year shall be the same as the systemwide fees established for those students for the 1998-99 fiscal year. Systemwide fees charged to resident graduate students and resident students pursuing a course of study leading to a professional degree at the University of California and the California State University for each of 1998-99 and 1999-2000 fiscal years shall be established at the same level as established for those resident students for the 1997-98 fiscal year.

Contingent upon The Regents' approval of the fee reduction, the bill appropriates funds for the University to cover the loss of revenue resulting from the fee reduction for 1998-99. The 1998-99 Governor's Budget includes sufficient general funds for the University to avoid an increase in mandatory systemwide student fees as specified in the compact with higher education and, consistent with the provisions of AB 1318, funds to offset the loss of revenue associated with the five percent reduction in mandatory systemwide student fees.

Consistent with the proposed Governor's Budget, a reduction of $190 (five percent of the total systemwide fees for 1997-98) in the Educational Fee for resident undergraduate students is recommended for 1998-99. With the proposed reduction, the Educational Fee will be $2,896 for resident undergraduate students. The Educational Fee will remain at $3,086, the 1997-98 level, for nonresident undergraduate students and for graduate and professional school students for 1998-99. All students will continue to pay the University Registration Fee and miscellaneous campus fees. The average of all mandatory systemwide and campus-based fees for 1998-99 for resident undergraduate students is projected to be $4,022.

With the proposed reduction, total fees for resident undergraduate students for 1998-99 will be about $1,080 below the projected average of fees charged at the University's four public salary comparison institutions. Currently, the University's resident fees for graduate and professional school students are lower than the average of tuition and fees charged to resident students at the four public salary comparison institutions used for fee comparison purposes and should remain below the average for 1998-99.

Regent Davis recalled that he had sponsored AB 1318 because he was concerned about the rising costs of higher education. It was his hope that the Board would approve the President's recommendation unanimously because it is of substantial benefit to the University. He also hoped that the action by the State of California and the University in reducing fees would have a tempering influence on other colleges and universities throughout the country.

Regent Soderquist pointed out that the professional schools had counted on the planned fee increases, which are now disallowed for two years, and asked whether the Legislature had intended to freeze these particular fees. Associate Vice President Hershman believed that the intention of the Legislature was clearly that these professional fees be frozen. In order to raise fees, the University would have to ask the Legislature for permission to do so, which could be difficult given the views in the Legislature with respect to student fees. Regent Soderquist suggested that a bill be drafted which would allow for fee increases in certain professional schools. Regent Davis believed that such an action would diminish the credibility of the University, noting that it was the clear intention of the Legislature in its deliberations that AB 1318 apply to all fees. Regent Montoya stated her support for Regent Soderquist's position with respect to professional fees.

Upon motion duly made and seconded, the Committee approved the President's recommendation and voted to present it to the Board.

7. **PROPOSED INCREASE IN NONRESIDENT TUITION FOR 1998-99**

The President recommended that, effective with the fall term 1998, the nonresident tuition fee be increased by $400, from $8,984 per year to $9,384 per year.

The Committee was informed that, consistent with State policy, an increase in nonresident tuition is proposed as part of the 1998-99 Regents' Budget. It is recommended that a 4.5 percent increase in nonresident tuition be approved. Total fees paid by nonresident students will not be affected by the provisions of Assembly Bill 1318. In addition to paying nonresident tuition, out-of-state students also must pay the Educational Fee, the University Registration Fee, miscellaneous campus fees and, if applicable, the Fee for Students in Selected Professional Schools. The proposed increase in nonresident tuition is included in the 1998-99 Governor's Budget. This increase will generate about $5 million in new revenue. Combined with revised nonresident enrollment projections, an increase of about $11 million in nonresident tuition is projected for 1998-99.

With the proposed increase, the University's 1998-99 charges for nonresident undergraduate and graduate students are higher than the State-funded marginal cost of instruction and less than the projected average of tuition and fees charged at other public institutions. For nonresident undergraduate students, the University's fees are about $460 less than the average of tuition and fees charged to nonresident undergraduate students at the four public salary comparison institutions used for fee comparison purposes. For nonresident graduate students, the University's fees are about $230 less than the average of tuition and fees charged to nonresident graduate students at the comparison institutions.

Regent Preuss asked whether it was appropriate, given the views of the Legislature with respect to student fees, to increase the fees for nonresident students. He pointed out that increased fees were a particular burden for foreign students who are precluded from attaining residency. Increasing nonresident tuition will discourage foreign students from coming to UC campuses. Regent Preuss pointed to the large number of professionals working in Silicon Valley who were educated in the United States and decided to remain. He stated his intention to vote “no” when the recommendation comes before the Board of Regents.

Regent Brophy noted that the University’s cost to educate a foreign student is higher than the nonresident tuition which the University charges and thus the University is subsidizing the foreign governments that support these students. It was his understanding that more students are choosing to return to their home countries rather than remaining in the United States than was the case in the past.

In response to a question from Regent Lee, Mr. Hershman stated that about 12,000 students pay nonresident tuition. Regent Lee pointed out that many leaders of Asian countries were educated at the University of California, which is of benefit to the University and the State. Regent Lee moved that the President’s recommendation be tabled and that no vote be taken until the University’s budget is finalized. The motion was duly seconded. The motion was put to a vote and failed.

In response to a question from Regent Leach regarding financial aid, Mr. Hershman reported that out-of-state students are eligible to receive financial aid from the University.

Regent Davies commented that while he was opposed to the decrease in student fees because he was an advocate of the high fee-high aid model, the State had clearly expressed its wishes with respect to student fees. It would be unwise for the University to defy the Governor and the Legislature.

Regent-designate Miura agreed with Regent Lee’s observations, noting that Asian alumni are generous in their support of the University system. She believed that increasing fees for foreign students would send the wrong message.

Regent Davis recalled that when Chancellor Tien was at Berkeley that campus raised more money from Asia than any other American university. He suggested that the University should demonstrate its sensitivity to the problems of foreign students and asked that the President report to the Regents on what financial aid programs are not available to nonresident students.

Regent Johnson stated that it was her understanding that some of the additional revenue would be used to fund deferred maintenance, which presently totals $500 million.

Upon motion duly made and seconded, the Committee approved the President’s recommendation and voted to present it to the Board, Regents Atkinson, Brophy, Johnson, Levin, McClymond, and Sayles voting “aye” (6), and Regent Davis and Lee voting “no” (2).

8. **UNIVERSITY OF CALIFORNIA RETIREMENT PLAN--ANNUAL ACTUARIAL VALUATION REPORT**

The President recommended that The Regents adopt and ratify the Consulting Actuary's opinion and statement of financial condition of the University of California Retirement Plan as of July 1, 1997, as reported in conformance with actuarial reporting requirements under §6059(b) of the Internal Revenue Code of 1986, as amended.

Senior Vice President Kennedy stated that, prior to presenting the results of the recent actuarial study, he would provide some statistics about the employees covered under the UC Retirement Plan and some demographic data. All of the data are as of July 1, 1997. The number of active members is 93,382, with a covered payroll of $4.76 billion. The average age and service of the active member is 43 years, with 9.4 years of service. The University has 30,101 retired members currently receiving benefits from the system with a payout of $586 million annually. The average age of retirees is 68 years and, on average, they have been retired eight years. Most of the members continue to retire at around age sixty. There are 13,646 inactive members who have terminated their employment and are eligible to retire and receive their benefits any time after reaching age fifty.

Vice President Kennedy explained that three main components are needed as input to determine the liabilities under the University's defined benefit retirement plan. These include the demographics of UCRP's membership, the benefit provisions of the Plan, and the assumptions that are used. There are two types of assumptions: demographic--such as mortality, turnover, and retirement age; and economic--the interest rate, inflation, and salary increases. The Plan's current economic assumptions are a 7.5 percent interest rate, a 4 percent inflation rate, and a 5.4 percent salary increase that is a combination of inflation and merit based increases. Because the liabilities of the plan are long-term liabilities, it is necessary to have assumptions that are viewed as being reasonable over the same period of time. Mr. Kennedy observed that each year the administration reviews these assumptions. From time to time, appropriate changes have been recommended to the Board of Regents. The last changes were in 1994. While there has been low inflation and considerable growth in Plan assets over the past few years, these economic assumptions must be considered over a long period of time. The administration will continue to review these assumptions each year and also look to other large public and private plans for comparisons.

Mr. Kennedy reported that, as of July 1, 1997, the actuarial value of the Plan's assets was $22.9 billion compared with an actuarial accrued liability of $19.3 billion, which translates into a funded percentage of 119 percent. Because of this favorable funded position, there is no contribution requirement for this plan year from either the employees or the University as the employer. The Plan has enjoyed a zero contribution requirement since November 1990, but it is important to note that the liabilities of the Plan are expected to grow at a faster rate than the assets, and in time there will be a need to restart contributions. To that end, the administration has been working on a contribution strategy study that will be brought to the Regents later in the year. The purpose of the study is to have a plan in place for the resumption of both member and University contributions when certain conditions are realized.

Vice President Kennedy then called upon the University's actuary, Ms. Catherine Cole of Towers Perrin, to present additional information from this year's actuarial valuation.

Ms. Cole explained that, in accordance with statutory disclosure requirements applicable to tax qualified defined benefit pension plans, Towers Perrin, the Plan's Consulting Actuary, has performed a comprehensive actuarial valuation for UCRP as of July 1, 1997. The report is applicable to the 1997-98 Plan year. The actuary's statement shows the value of UCRP assets is sufficient to maintain a zero percent payroll employer contribution rate. This recommendation is in line with the full funding liability described in §412(c)(7)(A) of the Internal Revenue Code of 1986, as amended, which was adopted by The Regents in 1990. Under the policy the University will suspend contributions when the smaller of market value or actuarial value of Plan assets exceeds the lesser of the actuarial accrued liability or 150 percent of the current liability.

At the fiscal year end, June 30, 1997, the net asset value of UCRP, after subtracting benefit claims currently payable and other current payables of the Plan, was $29,120,811,000, compared to $23,737,287,000 as of the beginning of the Plan fiscal year. During the 1996-97 fiscal year the Plan experienced a 25.8 percent investment return of the market value of Plan assets. Dividend and interest income of $872 million exceeded benefit and expense payments of $650 million. This increase in surplus reflects the outstanding investment performance during the 1996-97 Plan year. Since the June 30, 1997 valuation, market value of Plan assets has increased 3.97 percent for the first quarter of the fiscal year.

In a defined benefit pension plan, the employer promises employees certain benefits payable in the future. The cost of these benefits is generally funded incrementally over the career of employees as part of their total compensation package. This process involves the use of an actuarial cost method which assigns the value of promised benefits and anticipated expenses to individual plan years, as an annual cost. The Employee Retirement Income Security Act (ERISA) §3(31) specifically grants approval to six actuarial cost methods. One of these, the entry age normal cost method, has been used for the Plan for twenty years. It is the actuarial method used by seventy percent of public sector plans. The entry age method is considered a conservative actuarial cost method. Using this method of analysis, costs are distributed over the entire length of an employee's service beginning at the age of service entry and ending with the anticipated age at separation from service.

The "normal cost" of the Plan as defined under ERISA §3(28) is the annual percent of payroll which must be accrued over the total career of each employee to fully provide for future UCRP benefits, measured as of the valuation date. Under the entry age normal method, as a percentage of covered payroll, the UCRP normal cost for the 1997-98 Plan year is 13.90 percent ($662 million), up from 13.86 percent. The increase is due primarily to the aging of UCRP Active Members.

The actuarial assumptions, which presume that the Plan will continue indefinitely, are reviewed by The Regents annually. Were the Plan to terminate, different actuarial assumptions and other factors might be applicable in determining the present value of accumulated Plan benefits.

UC-PERS Early Retirement Plan

It was recalled that on October 18, 1990 The Regents approved an early retirement incentive program for University employees who were covered under the Public Employees' Retirement System (PERS) pension plan. The most tax-effective method to provide this group with a benefit generally comparable to the incentive offered to UCRP Members was to establish a "frozen" defined benefit plan under §401(a) of the Internal Revenue Code.

The UC-PERS Plan required campus and Department of Energy laboratory locations to fund their individual liabilities over no more than five years. This Plan is a standard terminal funding arrangement under a wasting trust, which, in this instance, is obligated to make fixed lifetime payments under either a single or joint-survivor benefit structure. The assets must remain in the Trust until all benefit promises have been satisfied. The assets are commingled with UCRP assets for maximum investment return without the loads, fees, or industry risk attached to an insurance contract.

In Revenue Ruling 89-87, the Internal Revenue Service clarified that a wasting trust is subject to the standard pension qualification, funding, and reporting requirements, inclusive of an actuarial review under IRC §6059. As such, the actuary reviews the Trust's fiscal position and funding status annually to assure that the UC-PERS Plan is adequately funded.

As of July 1, 1997, the net assets of the wasting trust were $63.5 million and the actuarial liability was $47.3 million. Including the present value of required future contributions, the present value of assets is 134 percent of the present value of future obligations as of July 1, 1997.

Regent Leach recalled Senior Vice President Kennedy’s statement that the liabilities of the Plan are expected to grow faster than its assets and asked what factors led to this conclusion. Ms. Cole explained that the liabilities grow at a rate of three percent of the fund assets per year, so each year that there is no contribution, the Plan must earn an additional amount over its expected rate of return, which it has over the last several years. Some time in the next forty to sixty years, the liabilities should exceed the Plan assets. Regent Leach asked whether the current assumptions were prudent. Ms. Cole believed that they were, noting that the ratio between the inflation assumption and the earnings assumption is what is important.

Senior Vice President Kennedy continued that, given the assumption that the University will continue to grow over the next decade, the number of faculty and staff will also increase, which affects the liabilities of the Plan.

Regent Parsky asked for an explanation of the relationship between the consulting actuary and the Office of the Treasurer. Ms. Cole explained that as the actuary of the Plan, she values its liabilities. The Office of the Treasurer is responsible for supplying the data on its assets. Regent Parsky suggested that it would be important for the Regents to be comfortable with the assumptions on the liability side and to make sure they understand whether or not the investments program has an appropriate mix of equity and fixed income in the portfolio. Vice President Kennedy recalled that when the assumptions were changed in 1994 there was debate on the Board as to the nature of the assumptions. It appears that the assumptions are reasonable at the present time. He reiterated the fact that these assumptions are reviewed each year by the consulting actuary, and the Treasurer participates in that review as a member of the UCRP Advisory Board.

Upon motion duly made and seconded, the Committee approved the President's recommendation and voted to present it to the Board.

9. **AMENDMENT OF THE UNIVERSITY OF CALIFORNIA TAX-DEFERRED 403(B) PLAN TO ALLOW THE ISSUANCE OF REQUIRED MINIMUM DISTRIBUTIONS TO BENEFICIARIES**

The President recommended that the University of California Tax-Deferred 403(b) Plan be amended to allow the payment of required minimum distributions to the beneficiary(ies) of deceased Participants, effective January 1, 1998.

The Committee was informed that currently the beneficiary of a 403(b) Plan Participant has nine months from the date of death of the Participant either to elect a lump- sum distribution or use the accumulations to purchase an annuity with an outside vendor. Surviving spouses, in accordance with Internal Revenue Code (IRC) provisions, have the additional option of rolling over all or a portion of the accumulations into a tax-deferred Individual Retirement Account.

The Benefits Office was asked to research allowing surviving spouses to leave Participant's accumulations in the 403(b) Plan. IRC provisions relating to the maximum period within which distributions must be made were thoroughly researched, and the program was designed to be in compliance with the provisions of the IRC.

Effective for Participant deaths on or after January 1, 1998, spousal beneficiaries meeting the necessary IRC requirements will have the option of leaving 403(b) plan accumulations on deposit indefinitely, subject to annual minimum distributions as required. Spousal beneficiaries, in instances where minimum distributions have not begun and they are not the singular primary beneficiary, will be allowed to leave monies on deposit for only four years after the Participant's date of death.

Nonspousal individual beneficiaries meeting the necessary IRC requirements will have the option of leaving 403(b) plan accumulations on deposit up to four years after the date of death, subject to annual minimum distributions as required. An exception to this rule is that an entity (trust, estate, charity, or corporation) named as a beneficiary will still be subject to the existing nine-month rule.

These amendments were endorsed by the University of California Retirement System Advisory Board at its November 4, 1997 meeting.

Upon motion duly made and seconded, the Committee approved the President's recommendation and voted to present it to the Board.

10. **AMENDMENT OF THE UNIVERSITY OF CALIFORNIA DEFINED CONTRIBUTION PLAN TO ELIMINATE CURRENT PLAN LIMIT AND CLARIFY AFTER-TAX CONTRIBUTION LIMIT**

The President recommended that:

(1) The University of California Defined Contribution Plan (DC Plan) After-Tax Account be amended to eliminate the current 10 percent Plan limit, effective January 1, 1998.

(2) Section 3.03(b) of the DC Plan document be clarified to provide that, effective January 1, 1998, maximum annual after-tax voluntary contributions of an Active Participant, together with any annual additions as defined in Internal Revenue Code §415(c), shall not exceed the §415(c) limit.

The Committee was informed that currently the DC Plan allows eligible Participants to contribute the lesser of ten percent of gross University salary or the limits prescribed in IRC §415. Under IRC §415(c), the maximum annual additions that can be contributed to a participant's account in a defined contribution plan during a limitation year is the lesser of $30,000 or 25 percent of the participant's compensation.

The ten percent limit of gross University compensation was derived from an Internal Revenue Service tax qualification rule that the aggregate amount of contributions by a participant over his or her career could not exceed ten percent of his or her compensation. This rule has been eliminated. Because the IRS tax qualification rule no longer exists, eliminating the ten percent limit would allow Participants to contribute to the DC Plan After-Tax Account in accordance with the more lenient limit prescribed in IRC §415(c).

The Benefits Office will provide worksheets to Participants to help them determine their maximum annual additions in accordance with the DC Plan contribution limit for the 1998 limitation year. To help ensure compliance with the DC Plan's provisions and regulations and the IRS Code and Regulations, staff will perform yearly monitoring of Participants' contributions to the DC Plan.

These amendments were endorsed by the University of California Retirement System Advisory Board at its November 4, 1997 meeting.

Upon motion duly made and seconded, the Committee approved the President's recommendation and voted to present it to the Board.

11. **UNIVERSITY OF CALIFORNIA FINANCIAL REPORT 1997**

Associate Vice President Broome stated her intention to review for the Committee the University's financial position and operating results for fiscal year 1997, which ended on June 30, 1997. The **University of California Annual Financial Report, 1996-97**, was mailed to the Regents in November 1997. While that report was similar in both format and organization to last year's report, major changes required by the Governmental Accounting

Standards Board (GASB) significantly changed the way in which the University presents data on retirement funds, investments, and investment activity. Because of the GASB accounting changes, the University is reporting an increase of approximately $29 billion in the prior year's fund balances.

Governmental Accounting Standards Board

The UC Retirement System fund net assets are now recorded as a fund balance in the University's Balance Sheet, whereas previously they were classified as a liability. The Retirement Plan operating activity is now included in the Statement of Changes in Funds Balances.

The second accounting change relates to the securities lending program, which provides additional investment income to the University. The activities of this program are now reported in the financial statements, whereas this activity was previously disclosed in the Annual Report footnotes. In addition, this year's financial statements report all investments at fair-market value. Previously, investments owned by the Retirement System funds were reported at their fair-market value, and other investments were reported at the original cost.

1997 Current Fund Revenues, Expenditures, and Other Changes

Ms. Broome discussed the operations of the University which are presented in the Statement of Current Fund Revenues, Expenditures, and Other Changes. These current funds record the primary operating activity as distinguished from other funds which record either the holding of long-term assets or financing activities. Her comments focused on the University's current fund activities, excluding the Department of Energy laboratories. In 1997, the University recorded total revenues of $11.6 billion. For financial statement presentation, the University is required to report the Laboratory revenues and expenditures in the financial statements. Because more than $2.5 billion related to the DOE laboratories, slightly more than $9 billion was University revenue.

On the expenditures side, the University recorded $11.1 billion of expenses and other changes. Of this amount, $2.5 billion was attributable to the DOE laboratories. Of the remaining $8.6 billion, over $6 billion was spent for educational and general purposes, nearly $2 billion in the medical centers, and over $500 million for auxiliary services. The net result was an increase of approximately $450 million in current fund equity for the year. This compares to a $23 million increase last year, indicating that in fiscal year 1997 the University significantly strengthened its financial position through current operating results.

1997 Current Operating Revenues

Ms. Broome reported that current operating revenues of $9 billion increased 7.1 percent from last year, representing $600 million. Funding from the State of California increased by 7.5 percent ($146 million). Private gifts, grants, and contracts grew by 13.5 percent ($61 million). This growth in private funding reflects increased fundraising efforts by the campuses. However, it reflects only a portion of the private funding for the University because a major portion of gifts are raised and reported by the University's nine campus foundations. Investment income, including endowment income, increased by over 12.5 percent, primarily as a result of the net revenue growth which was invested in the Short Term Investment Pool throughout the year.

The increase of over ten percent ($200 million) in medical center revenue is due to a variety of factors. There was an increase in patient revenues as a result of increased admissions and outpatient visits. Medi-Cal disproportionate share payments for San Diego, Irvine, and Davis increased by over $60 million. These medical centers also received a one-time secondary supplemental payment of $30 million. In addition, $50 million of Medi-Cal Medical Education funds were received by all five medical centers under a new program in 1997. The growth of over nine percent ($60 million) reported in educational activities is primarily related to the Faculty Medical Practice Plans.

A growth in student tuition and fees of 5.7 percent ($54 million) is attributable to higher enrollment, a nine percent increase in nonresident tuition, and the phasing in of professional school fees assessed to students in graduate programs of dentistry, medicine, veterinary medicine, business/management, and law.

1997 Current Operating Expenditures

Associate Vice President Broome reported that the University's operating expenses of $8.7 billion grew by $310 million, representing a 3.7 percent increase. Instruction, which includes academic salaries and other expenditures related to UC's instructional programs, including summer session and University Extension, increased by 6.1 percent ($111 million). The major portion of this growth is attributable to faculty salary adjustments which reflect the University's continued effort to regain a competitive position with other institutions in order to maintain the quality of its teaching and research programs.

Medical center expenditures increased by just under five percent ($91 million), largely due to increased admissions and salary adjustments. Expense increases were partially offset as a result of cost containment programs at Irvine and San Diego.

The growth in research spending of 4.5 percent ($70 million) is related primarily to increased funding from State appropriations for breast cancer and tobacco research and in federal and private sources for research in a variety of academic disciplines. Currently, three campuses are in the top ten in the nation in terms of research funds received from the federal government.

Institutional support expenditures, which include various current expenditures of the University of a general character, such as central administrative offices and fiscal operations, decreased by over 6 percent ($31 million). Salary increases and investments for systems and technology were offset by a reduction in self-insurance costs. A significant portion of insurance costs last year were nonrecurring in nature and were classified in this category.

1997 Sources and Uses of Current Funds

Ms. Broome explained that, with respect to revenue, the University's sources of funds are fairly diversified. State funds provide 23 percent of the cash inflows, and 11 percent is provided from student tuition and fees. State support and student tuition and fees are the core components of the funding that support the instructional mission of the University. Gifts, grants, and contracts provide 22 percent of funds. These dollars provide opportunities for students to participate in basic research alongside some of the most prominent researchers in the country. Medical centers provide 24 percent of the funds and support the University health science programs. Educational activities account for 8 percent of revenue while auxiliary enterprises, which include student housing, food service, and parking operations, provide 6 percent. Other sources, including royalties from patents and sales of publications, provide 6 percent of revenue.

With respect to expenses, 51 percent of the University's expenditures are for direct faculty and staff salaries and 9 percent are for employee benefits. Student financial aid accounts for 5 percent of expenditures. Debt service and other mandatory transfers account for another 3 percent. About 4 percent of expenditures were made to purchase equipment.

The "All Others" category includes expenditures that individually represent a smaller percentage of 1 to 2 percent but collectively add up to 28 percent. This category includes expenditures for such items as supplies and materials, services, communications, utilities, and travel.

Comparison of Operating Revenues, 1987-1997

In 1987, State appropriations accounted for 38 percent of revenues versus 23 percent for the past year. State funding has become a smaller percentage of total operating revenue as a result of budget cuts in the early 1990s and the emphasis by the University on other revenue sources. The decline in State funding required the University to make some fundamental changes in the way it operated. Expense reductions were a large part of those changes. Another was strategic shifts in revenue sources. Student tuition and fees now comprise 11 percent of revenues versus 7 percent ten years ago. The growth in gifts and grants from 20 percent to 22 percent is largely due to increased emphasis on private giving by the campuses.

Medical center revenues have shown a fairly significant increase, from 18 percent to 24 percent, as a result of increased patient revenues, the addition of two hospitals, and special programs. In 1987, there were no disproportionate share programs, which were initiated in the early 1990s. In 1997, the University recorded over $150 million in revenue from these various programs.

Comparison of Operating Expenditures 1987-1997

The budget categories of support services, academic, student, and institutional have declined to 22 percent from 25 percent in 1987. Instruction expenditures declined from 27 percent to 23 percent due to faculty retirements and reduced salaries and merit adjustments. Medical center spending has grown from 19 percent to 23 percent in order to support the growth in hospital operations. Research expenditures have increased slightly, from 18 percent to 19 percent, largely due to the overall growth in contracts and grants.

Financial Position - Fund Balances - 1996/1997

Ms. Broome concluded her presentation with a description of the University's financial position, which looks at the strength of the balance sheet and growth in fund equity. Over the past year the fund equity increased from $42.9 billion to over $50 billion, an increase of $7.7 billion. Current fund equity increased by $449 million this year to nearly $2.5 billion, while loan fund equity increased by $9 million to $297 million. Loan funds primarily represent loans to students from both federal and University programs. Endowment funds balances grew by $562 million to nearly $3.2 billion, primarily due to net appreciation in the fair value of investments of $528 million and private gifts of $27 million. The University's equity in its Plant investment grew by over $500 million this past year to over $10.9 billion. This increase is primarily due to a number of capital projects, including equipment purchases and library expenditures. After the retirement system, the majority of the University's fund equity is attributable to the physical plant. UCRS is now included in the University's equity.

UCRS funds equity grew by $6.2 billion this year primarily from realized and unrealized gains of $5.6 billion to $33.7 billion, and UCRS now makes up approximately two-thirds of the University's total equity.

The meeting adjourned at 4:40 p.m.

Attest:

Secretary