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Office of the President

TO MEMBERS OF THE COMMITTEE ON FINANCE:

ACTION ITEM

For Meeting of November 14, 2012 Powerpoint presentation

STATUS OF 2012-13 BUDGET AND APPROVAL OF UNIVERSITY OF CALIFORNIA 2013-14 BUDGETS FOR CURRENT OPERATIONS AND FOR STATE CAPITAL IMPROVEMENTS

EXECUTIVE SUMMARY

The *2013-14 Budget for Current Operations Summary and Detail* and the *2012-22 Capital Financial Plan* included in the Regents' November meeting packet provide the basis for approval of the operating budget plan and State-funded capital plan for 2013-14.

The proposed budget plan for current operations is based on an assumption that Proposition 30, the Governor's revenue-raising initiative on the November 2012 ballot, is approved by the voters and implemented. Building on the promise of support by the Governor for a new multi-year funding agreement with the University, the plan calls for an increase of $584.3 million from a combination of State funds, UC General Funds, and student tuition and fee revenue if additional State revenue is not available. The plan also assumes increased revenue from alternative revenue sources associated with debt restructuring, asset management, increased efficiencies, and other sources.

Funds will be used to stabilize support for the University's basic operations so that mandatory cost increases are funded in the budget year. In addition, funds from alternative revenue sources will help initiate the first phase of a multi-year plan to reinvest in the quality of the University's academic program.

The 2013-14 State-funded capital outlay plan calls for a total of $788.5 million in State capital outlay funds, which would allow 39 major capital projects to complete preliminary plans, working drawings, and/or construction. Of these, 12 would design or construct new facilities for a value of $432.7 million, and 17 projects would renovate existing facilities or improve campus infrastructure for a value of $133.9 million. One project for $4.2 million would equip a building already under construction. The 2013-14 program also includes projects to address seismic and life safety deficiencies for a value of $217.7 million.

RECOMMENDATION

The President recommends that:

(1) The Committee on Finance recommend to the Regents that the budget plan included in the document, *2013-14 Budget for Current Operations,* be approved.

(2) The Committee on Finance concur with the recommendation of the Committee on Grounds and Buildings that the 2013-14 Budget for State Capital Improvements be approved.

BACKGROUND

The *2013-14 Budget for Current Operations Summary and Detail* provides the basis for the recommendation that the 2013-14 budget plan for current operations be approved. The *2012-22 Capital Financial Plan* provides the basis for approval of the State-funded capital plan for 2013-14. Vice President Lenz will make a detailed presentation on the proposed budget for both current operations and State-funded capital outlay.

Proposed 2013-14 Operating Budget Plan

Overview of Current-Year Budget

Operating revenue, estimated at $24.1 billion in 2012-13, funds the University's core mission programs of teaching, research, and public service, as well as a wide range of other activities, including teaching hospitals, the Lawrence Berkeley National Laboratory, University Extension, housing and dining services, and sponsored research.

The University's "core funds," comprised of State General Funds, UC General Funds, and student tuition and fee revenue, provide permanent support for core mission and support activities, including faculty salaries and benefits, academic and administrative support, student services, operation and maintenance of plant, and student financial aid. Totaling $6.2 billion in 2012-13, these funds represent nearly 26 percent of the University's total budget. Much of the focus of the University's strategic budget process and negotiation with the State is dedicated to the uses of these fund sources.

The State portion of the University's core funds totals approximately $2.378 billion in 2012-13. For the first time, beginning in 2011-12, funds from student tuition and fees exceeded the amount received from the State. In 2012-13, revenue from mandatory student tuition and fees totals just under $3 billion and currently is the largest single fund source providing core support for the University.

Other sources of funds include federal research funds, teaching hospital revenue, private gifts and endowments, and income from self-supporting enterprises. Use of these funds is restricted, which means they generally cannot be used to support activities other than those for which they are designated. But such funds help augment and complement the University's core activities of instruction and research, providing support functions, public service to the state and its people, and a rich social, cultural, and learning environment on UC campuses. The University's annual budget plan is based on the best estimates of funding available from each of these sources.

Context for Development of the 2013-14 Budget Plan

The volatility of the State's economy in recent years is well-depicted in the University's recent budgets. The historical backdrop for the 2013-14 plan is the unprecedented disinvestment by the State over a multi-year period during one of the worst recessions California has ever faced.

In 2007-08, before the State's fiscal crisis began, funds for UC totaled \$3.257 billion. Permanent and one-time cuts to UC's budget for 2008-09 totaled \$814.1 million, although these reductions were largely offset on a one-time basis with \$716.5 million in American Recovery and Reinvestment Act (ARRA) funds. For 2009-10, State funds totaled \$2.6 billion, reflecting permanent and one-time cuts in State funding of \$637.1 million compared to the 2007-08 budget. While the 2012-13 budget restored less than half of these cuts with \$199 million in permanent funds and \$106 million in additional ARRA funds, and provided some relief toward the University's over-enrollment (\$51.3 million for 5,121 FTE), the University's budget remained highly constrained, with worse cuts still to come. With the introduction of the Governor's Budget for 2011-12, UC faced a \$500 million reduction. This reduction was increased by \$150 million late in the budget process five months later. A trigger reduction mid-year raised the cut for 2011-12 to \$750 million. This meant that the University's budget had been reduced by nearly \$1 billion, to a base budget of \$2.271 billion, over a four-year period.

The 2012-13 budget year signaled a small, but welcome, change in that the University's budget was treated as a priority for the State. While many State programs received additional base budget cuts, the University received an augmentation of \$89.1 million toward the State's share of the employer contribution to the University's retirement plan (UCRP), \$5.2 million for annuitant health benefits, and \$11.5 million for lease revenue bond debt service. In addition, the budget includes a deferred buy-out of the planned tuition and fee increase for 2012-13; UC is to receive \$125.4 million in 2013-14 if no tuition and fee increases are implemented in 2012-13 and if the Governor's revenue-raising initiative on the November ballot is successful. The current State-funded base budget of \$2.378 billion constitutes a 4.7 percent increase over the prior year.

Cuts in State funds are not the only pressure contributing to UC's budget constraints. To help secure the financial viability of the University's retirement plan, employer and member contributions were reinstated in 2009-10, despite the lack of State support for its share of these expenses. The employer contribution has steadily increased from zero (just three years ago) to ten percent of covered pay effective 2012-13, equivalent to \$940 million against all fund sources, of which core funds are about one-third. While UC is encouraged that the State has contributed a portion of its share of employer contributions, the amount allocated for 2012-13 is far short of the \$229 million that constitutes its share. For 2013-14, the employer contributions will increase to 12 percent of covered pay and member contributions will increase to 6.5 percent of covered pay, putting further pressure on UC's operating budget and on the competitiveness of faculty and staff total remuneration. Beginning July 1, 2013, the sum of employer and member contributions will cover UCRP's normal cost.

The State budget package adopted by the Governor and the Legislature for 2012-13 resolves about $10 billion of the $15.7 billion gap identified by the Governor, primarily through cuts to Health and Human Services, Social Services, child care, Proposition 98 and other State programs. The 2012-13 State budget assumes adoption of the Governor's revenue-raising initiative (Proposition 30: *The Schools and Local Public Safety Protection Act of 2012*) on the November ballot, which would address about $5.6 billion of the gap. If the Governor's revenue-raising initiative is not adopted in the November election, the budget calls for nearly $6 billion in trigger reductions to various State agency budgets, including $250 million each to UC and the California State University.

Proposition 30 on the November 2012 Ballot – the Governor's Revenue-Raising Initiative

Proposition 30 would temporarily raise the sales tax by one quarter of one percent for four years and temporarily raise the personal income tax on the State's wealthiest taxpayers for seven years. While the funds from Proposition 30 would primarily be directed to K-12 and local public safety programs, State General Funds that would have been used for those purposes would now be freed up for programs in the discretionary part of the budget, such as the University of California. For this reason, the Regents formally endorsed and recommended passage of Proposition 30 at their July 2012 meeting.

The Governor's office has reiterated its support for reaching a multi-year agreement with the University that would call for six to 7.5 percent increases to UC's State-funded budget each year through 2016-17, along with several other provisions, contingent on implementation of Proposition 30.

If Proposition 30 is unsuccessful in November, the impact on the University's budget will be very significant. The trigger cut of $250 million would be implemented immediately. In addition, the University would not receive the $125.4 million in 2013-14 in deferred tuition and fee buy-out funding, nor would it receive the $150 million base budget adjustment expected in 2013-14 through the multi-year funding agreement – in total, a $525 million negative impact on UC's budget.

The Budget Plan for 2013-14

The University's budget proposal for 2013-14 sets the groundwork for a new multi-year plan to stabilize funding, provide a course for addressing the University's ongoing mandatory costs and recent budget cuts, and leverage new sources of revenue and cost reduction to reinvest in quality. Building on the prospect of a multi-year funding agreement with the State, the 2013-14 budget proposal seeks to begin stabilizing UC's fiscal foundation through a combination of moderate increases in State funding, as well as tuition and fees if additional State revenues are not available, aggressive cost reductions and efficiency improvements that leverage UC's economies of scale, and the active pursuit of alternative revenues. A stable fiscal foundation will allow UC to plan for the near and longer term; to make the long-term investments needed to secure its stature as a world-class university; and to provide its faculty, students, and employees with a more certain future.

The proposed 2013-14 budget plan assumes passage and implementation of the Governor's revenue-raising initiative. Whether the initiative passes or fails, however, the University is committed to securing a path to fiscal stability and pursuing a course that focuses on sustaining the quality of its instructional programs.

Summary of Proposed Increases

The University's plan calls for proposed new expenditures in core operating funds by achieving increases in revenue from State funds and non-State sources (UC General Funds, as well as student tuition and fees if additional State revenue is not available) totaling $584.3 million, a 9.4 percent increase over the current core-funded base budget. In addition, changes are proposed to other funds that support functions other than the core operating budget, as outlined below.

State General Funds. State General Funds are proposed as follows:

- $125.4 million associated with the deferred buy-out of planned tuition and fee increases in 2012-13;
- $150.2 million representing a six percent budget adjustment to the University's State General Fund base; and
- $15 million for planning and start-up for the new medical school at the Riverside campus.

Additional State General Funds or Revenue from Student Tuition and Fee Increases. Given the large share of operational costs currently funded from student tuition and fees, annual revenue increases from either additional State General Funds or from tuition and fees are necessary for the University to help cover cost increases in the University's operating budget. The 2013-14 budget plan assumes $126.5 million from either additional State General Funds or from an increase in student tuition and fees (net of financial aid).

If the State is unable to provide funding to avoid increases in mandatory systemwide charges for 2013-14, the University would plan to increase mandatory systemwide tuition and student fees by an amount sufficient to generate $126.5 million, net of financial aid, to support core operating budget needs.

The University's budget plan calls for increases in Professional Degree Supplemental Tuition (PDST) levels ranging from zero percent to 35 percent (up to $3,256), depending on the campus and program. The increases in PDST levels are proposed for approval in a separate item, F3, *Approval of Professional Degree Supplemental Tuition Levels for 2013-14*, for the November meeting. Net of financial aid, PDST increases are expected to generate $13.3 million annually to support the instructional programs and maintain quality in professional school programs.

UC General Funds. UC General Funds are expected to increase through modest growth in indirect cost recovery on research contracts and grants and additional Nonresident Supplemental

Tuition income due to increases in enrollment of nonresident students. The budget plan projects an increase of $26.4 million from these sources. Due to the already high level of tuition and fees paid by nonresident students, no increase in Nonresident Supplemental Tuition is proposed.

Alternative Revenues to Fund Quality Reinvestment. At the September 2012 Regents' Retreat, the Regents were presented with an expansive list of new ideas for enhancing revenues and reducing costs in addition to those already being implemented under Working Smarter and other initiatives under way. Most of the proposed strategies are not expected to generate significant revenue in the short term, but offer opportunities in 2014-15 and subsequent years. The University will continue to pursue these and other options as it moves to stabilize funding over the longer term. In the meantime, the 2013-14 plan assumes $80 million of new revenue from the restructuring of State lease revenue bond debt, $20 million from asset management strategies (i.e., moving Short Term Investment Pool funds to the Total Return Investment Pool), and $20 million from procurement savings through new systemwide contracts.

Other Funds. Changes projected for 2013-14 in major fund sources supporting non-core operating functions of the budget include the following:

- Private Giving and Endowment Earnings – projected to increase by three percent;
- Federal Contracts and Grants – projected to remain flat;
- Auxiliaries – projected to increase by 2.5 percent; and
- Teaching Hospitals – projected to increase by 7.5 percent

Key Elements of the Expenditure Plan

Each of the proposed expenditure items is discussed in detail in the attached documents. The plan proposes $584.3 million in expenditure increases for 2013-14. These increases consist of the following:

- $22.4 million to cover enrollment growth of one percent above current funded levels, or about 2,100 students, including continued expansion of the Merced campus and addressing unfunded enrollment of California residents and in the health sciences. The funding is based on a marginal cost of $10,000 for all students and supplemental funding for health sciences students;
- $13.3 million, net of financial aid, for supporting instructional programs and maintaining quality in professional school programs;
- $15.0 million to support planning and start-up activities for the UC Riverside medical school;
- $77.2 million to support new employer contribution costs for UC's retirement plan associated with moving to a 12 percent employer contribution rate in 2013-14;
- $11.4 million in employee health benefit costs to fund an increase of approximately 3.5 percent in health benefit plans overall, or one-half the amount that had originally been planned. This represents one of the University's aggressive alternative strategies for reducing costs, as discussed at the September Regents' retreat;

- $6.4 million in retiree health benefit costs needed to provide funding for UC retiree health benefit cost increases equivalent to that being provided to other State employees;
- $30 million to continue the faculty merit program, critical for retaining high quality faculty;
- $100.2 million to cover three percent increases in merit-based compensation for represented and non-represented employees. Salaries for represented employees are subject to notice, meeting and conferring, and/or consulting requirements under the Higher Education Employer-Employee Relations Act (HEERA);
- $37.2 million in continuation costs to cover the second half of a three percent mid-year salary increase to be implemented in 2012-13 if the Governor's revenue-raising initiative passes;
- $23.7 million in non-salary price increases, representing a two percent increase over the prior year plus an additional $8 million for rising electricity and natural gas costs; and
- $25 million for deferred maintenance and capital renewal to address the deterioration of the University's aging facilities.

The plan also assumes repayment of $60 million of Short Term Investment Pool borrowing by campuses to help bridge the budget shortfall in 2012-13.

In addition to funding these basic operating costs, the 2013-14 budget plan includes the first year of a multi-year reinvestment in the quality of the University's academic programs. The plan is focused on several well-established and closely-watched measures of academic program quality, including the following:

- <u>Reducing the student-faculty ratio</u>. Delays in faculty hiring and unfilled vacancies have dramatically increased the student-faculty ratio. The University's long-term goal is to return to the budgeted level of 18.7:1.
- <u>Increasing revenue to cover faculty start-up costs</u>. Attracting high-quality faculty requires up-front investment for research support, laboratory renovations and other support. This has become extremely challenging in the current fiscally constrained environment.
- <u>Reducing faculty and staff salary gaps</u>. Faculty salaries currently lag the average of the University's comparison institutions by 10.8 percent; there is a similar or greater problem with staff salaries in most categories. Paying competitive salaries is critical to UC's ability to recruit and retain the employees needed to secure the University's future as a preeminent research university.
- <u>Increasing graduate student support to competitive levels</u>. UC graduate support packages fall far short of the packages offered by competing institutions.
- <u>Enhancing undergraduate instructional support</u>. Investments are needed in instructional technology, libraries, instructional equipment replacement, and building maintenance, all critical to the quality of the academic program.

The proposed budget plan is attached to this item as Attachment 1.

Proposed 2013-14 State-Funded Capital Outlay Program

The *2013-14 Budget for State Capital Improvements,* presented in Attachment 2, proposes a total request of $788.5 million in State capital outlay funds, which would allow 39 major capital projects to complete preliminary plans, working drawings, and/or construction. Of these, 12 would design or construct new facilities for a value of $432.7 million, and 17 projects would renovate existing facilities or improve campus infrastructure for a value of $133.9 million. One project for $4.2 million would equip a building already under construction. The 2013-14 program also includes projects to address seismic and life safety deficiencies for a value of $217.7 million. Following approval by the Regents, the document will be submitted to the State of California in compliance with legislative reporting requirements.

The last general obligation bond approved in the State of California was the Higher Education Capital Outlay Bond of 2006, which allocated $890 million for the University of California. Subsequently, the fiscal crisis in late 2008 triggered a freeze on the Pooled Money Investment Account (PMIA) and the halt of nearly all University projects approved by the Legislature. With loans no longer available through the PMIA, these projects and all subsequent general obligation bond appropriations receive cash for expenditure only through a slow process of intermittent bond sales, as the bond market allows. This has resulted in a large backlog of approved State projects that still require funds to proceed.

The need to ensure the safety of the campus community and the urgency of renovations has compelled some campuses to take on externally financed debt to address several projects that would normally have been funded by the State, reducing the funding being requested of the State for the 2013-14 year.

The future of State capital funding for the University remains uncertain. Current fiscal and economic conditions in the State do not favor passage of a general obligation bond for capital outlay for at least another two years. The University, however, supports a scenario in which the State would commit to a four-year funding plan via an annual contribution to the University's operating budget. The University and each campus would then determine how much of their budgets should be directed toward the construction, operation, maintenance and renewal of facilities.

Funding required for State-supportable academic and support functions are estimated to average $650 million per year over the next five years. This estimate does not include the costs of addressing the University's serious deferred maintenance problems resulting from continuing shortfalls in operations funding or the costs associated with program changes.

The University maintains a continuing commitment to pursue gifts and other potential sources to supplement State funding for construction. Currently, these efforts are constrained by cuts in State operations budgets and by competing needs for the remaining resources. The University has capital needs for student life and auxiliary programs that do not qualify as State-supportable and therefore must be addressed only with non-State resources. In this context, the University has intensified its efforts to make the most efficient use of existing facilities, to carefully define and analyze facility needs, to evaluate competing needs and non-construction alternatives and set priorities that maximize the value of available funds, and to continually improve management of project design and construction.

(Attachments: One Two)