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Office of the President

TO MEMBERS OF THE COMMITTEE ON FINANCE:

ACTION ITEM

For Meeting of November 19, 2014

APPROVAL OF UNIVERSITY OF CALIFORNIA 2015-16 BUDGET FOR CURRENT OPERATIONS

EXECUTIVE SUMMARY

The Regents are being asked to approve the University of California budget plan for 2015-16.

The last seven years have presented the University with unprecedented fiscal challenges. Five years of global recession followed by slow, though steady, economic recovery have led the University to adopt stringent cutbacks, aggressive strategies for seeking alternative revenue sources, and new ways of doing business. Many of the changes the University implemented in response to budget shortfalls have been positive, efficiency-building actions. However, many of the actions the University has taken to address shortfalls are unsustainable in the long run if the University is to maintain its stature as a world-class research university training the workforce needed for California's knowledge-based economy.

After the passage of Proposition 30 in November 2012, the Governor committed to a multi-year funding plan that promised to provide stability in State funding for both UC and the California State University over a four-year period. Specifically, the plan proposed base budget adjustments of five percent in 2013-14 and 2014-15 and four percent in 2015-16 and 2016-17, but made this funding contingent upon no tuition and fee increases for the four-year period. While Proposition 30 was good for the State's budget, it did not solve UC's budget gap.

The University received the promised funding from the State in 2013-14 and 2014-15. And, at the request of the Governor, tuition and fees at the University have remained flat for three consecutive years. Unfortunately, the amount of State funding provided under the multi-year plan has been insufficient, on its own, to achieve the University's highest priorities – increasing access for eligible California students, ensuring the highest quality in students' educational experience while at UC, and meeting budgetary needs, such as mandatory cost increases. While the State funds provide a four percent base budget adjustment against the total State funds UC receives, when valued against the University's total core funds for educating students, it amounts to a 1.7 percent adjustment – lower than the rate of inflation and inadequate to fund even mandatory cost increases, let alone other high-priority needs such as enrollment growth and maintaining educational facilities.

The University remains strongly committed to the three pillars of its success – affordability, access, and excellence. Maintaining the commitment to all three requires sufficient resources, including funds needed for investment in efforts that directly affect the quality of the education UC's students receive. This will require a renewed partnership among the State, the University, and its students and their families.

The University's budget plan for 2015-16 assumes sufficient revenue to fund mandatory cost increases such as health benefit increases and increases required by collective bargaining agreements, other high-priority needs such as projected enrollment growth and compensation for faculty and staff, and an investment in quality initiatives such as graduate student support and hiring more faculty. The budget plan reflects the University's best estimate of what is needed in 2015-16 to maintain access and excellence while ensuring that a UC education is affordable.

Revenue assumptions include the four percent base budget adjustment from the State, a modest five percent increase in mandatory systemwide student tuition and fees – or equivalent State funds if the Governor and the Legislature wish to avoid a tuition increase in 2015-16 – and aggressive projections of savings from efficiencies and alternative revenues as part of the University's continuing efforts to "bend the cost curve" with internal solutions for its budget needs.

The tuition and fee stability plan is critical to the success of the University's budget plan and to the future of the State of California. Only with adequate resources can the University assure the students who have worked hard to attend the University that its doors remain open to all who are qualified and wish to enroll. The University is proposing a multi-year tuition plan that will help students and their families to plan for college expenses over the next five years, assuming the State continues to fund its commitment. The plan provides stability, predictability, and funds to enroll more students. Financial uncertainty – for students and their families and for the University's ten campuses – would be greatly reduced, and all involved would be in a position to make better decisions and plan for the future.

RECOMMENDATION

The President of the University recommends that the Committee on Finance recommend to the Regents that the budget plan included in the document, *2015-16 Budget for Current Operations*, and shown in Attachment 1, be approved.

BACKGROUND

The *2015-16 Budget for Current Operations* provides the basis for the recommendation that the 2015-16 budget plan for current operations be approved. Executive Vice President Brostrom and Vice President Lenz will make a detailed presentation on the proposed budget for current operations.

Proposed 2015-16 Operating Budget Plan

Overview of Current-Year Budget

Operating revenue, estimated at $26.9 billion in 2014-15, 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 $6.9 billion in 2014-15, these funds represent 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 $2.99 billion in 2014-15, including $194 million related to debt service for State-funded capital projects. Historically, State General Funds were by far the largest single source of support for the University. Following dramatic cuts in State support for the University and its students, however, funding from student tuition and fees exceeded the amount received from the State in 2011-12 for the first time in the University's history. In 2014-15, revenue from Tuition, the Student Services Fee, and Professional Degree Supplemental Tuition – the three types of student tuition and fee revenue in UC's core funds category – total $3.1 billion, making student tuition and fees 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 is based on the best estimates of funding available from each of these sources.

Context for Development of the 2015-16 Budget Plan

The passage of Proposition 30 in November 2012 marked a major turning point for the State. After years of devastating budget cuts, the Governor was able to close the State's chronic structural budget gap and begin once again to move the State forward economically. The Governor committed to a multi-year funding plan that promised to provide State funding stability for both UC and the California State University over a four-year period. Specifically, the plan proposed base budget adjustments of five percent in 2013-14 and 2014-15 and four percent in 2015-16 and 2016-17 – but made this funding contingent upon no tuition and fee increases for the four-year period.

At the request of the Governor, tuition and fees at the University have remained flat for three consecutive years. Unfortunately, the amount of State funding provided under the multi-year plan has been insufficient, on its own, to achieve the University's highest priorities – increasing access for eligible California students, maintaining its robust financial aid program, ensuring the highest quality in students' educational experience while at UC, and meeting budgetary needs, such as mandatory cost increases. The University requires funding to pay for cost adjustments associated with the entire core-funded budget – not just a portion of it.

In 2014-15, the University requested additional State funds, above the base budget adjustment, for the State's share of the employer contribution to the retirement system and for enrollment as a way of helping address the shortfall that is associated with the lack of cost adjustment funding available when the fund source supporting more than half of the base budget is held flat. However, these requests were not funded.

As a result, the University is once again in the position of having to make significant budget cuts and redirecting internal resources to fund required costs. These efforts do not begin to address the University's priority to increase access for California students. While the University's budget plan includes assumptions about continued savings from efficiencies and development of alternative revenue sources, the budget gap created from an insufficient base budget adjustment is much greater than the University can cover through these cost-saving measures. This is unsustainable as a permanent approach to planning and budgeting – the University requires sufficient resources to fund the basic costs of operation and cannot continue year after year cutting more programs in order to make ends meet.

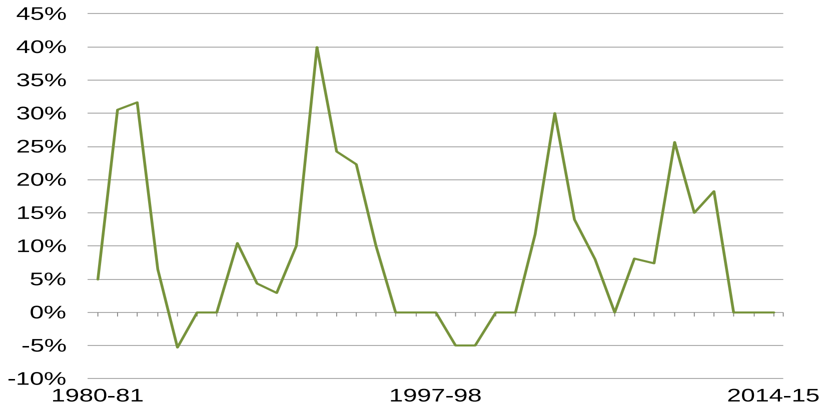
The University's Stabilization Plan for Tuition and Financial Aid

Upon taking office more than a year ago, President Napolitano promised the University community and the State that she would develop a new plan for addressing the unpredictability students and their parents have faced due to the volatility in tuition. In bad financial times, tuition and fees have increased dramatically and suddenly. In better financial times, tuition and fees have been flat (or even reduced, as in two years during the late 1990s). Display 1 illustrates the volatility of the University's tuition and fees over time.

The University strongly believes that a steady, reliable tuition plan that keeps tuition and fee levels as low as possible while providing the predictability students and their families need to plan is needed at this time.

The principles of the University's plan include a commitment to multi-year tuition levels, calibrated for each year, which will allow prospective students and their families to calculate the cost to them of a UC education – before they accept admission to a UC campus. The plan also provides necessary funding to serve at least 5,000 more California students, and to maintain UC's robust financial aid program so that more than half of UC California undergraduate students and their families will have the increase covered by grants and scholarships. Tuition

Display 1: Year-to-Year Percentage Change in Mandatory Charges Since 1980 (Not Adjusted for Inflation)



UC's tuition levels have been subject to chronic volatility, reflecting that tuition increases have closely mirrored the State's fiscal condition. Tuition has increased to offset State budget cuts.

levels will be set with the intent of making a UC education as affordable and accessible as possible, while still protecting the quality of that education. To strike this balance will require ongoing, robust efforts to control administrative costs and reform educational delivery models – to the benefit of both the University and its students. Prospective students can base any decision to attend a UC campus on better financial information regarding both tuition costs and aid opportunities. Achieving this will require UC to enhance its already expansive outreach programs into California high schools and community colleges, as well as to improve its communications efforts signficantly. Delivery of this tuition model will require support from the State and all UC stakeholders.

The University's proposal is discussed in more detail in *Approval of Long-Term Stability Plan for Tuition and Financial Aid*, item L3, to be considered by the Committee on Long Range Planning at the November meeting.

The Budget Plan for 2015-16

The University's budget plan for 2015-16, presented in Attachment 1, reflects the need to address not only its ongoing mandatory costs, but also to begin again to invest in the quality of core instruction and research programs while continuing to protect access and affordability. In its budget planning, the University has recognized that stabilizing UC's fiscal foundation requires a combination of moderate increases in State funding, aggressive cost reductions and efficiency improvements that leverage UC's economies of scale, and the active pursuit of alternative revenues so that the level of tuition for California students is as low as possible, and so that unpredictable and volatile changes in tuition can be avoided. It also requires that the University continue to develop new methods for delivering instruction, such as online education, to support UC's teaching mission and carefully explore to what extent new technologies can help reduce costs while enhancing instructional effectiveness and furthering efforts to improve performance outcomes of an increasingly diverse student body. Built from these elements, a stable fiscal foundation will allow UC to make the long-term investments needed to sustain its stature as a world-class university, as well as to provide its faculty, students, and employees with a more certain future.

Summary of Proposed Increases in Revenue

The University's plan calls for proposed new expenditures in core operating funds by achieving increases in revenue from State funds, tuition and fees, and non-State sources (UC General Funds, as well as alternative revenue sources and cost savings) totaling $459 million, a 6.6 percent increase over the current core-funded base budget.

State General Funds. The University's 2015-16 budget plan calls for a moderate base budget adjustment of four percent, or $119.5 million, consistent with the Governor's multi-year funding proposal. This four percent increase is equivalent to a 1.7 percent increase in UC's core educational funding.

Tuition and Fee Revenue. The plan also calls for $97.7 million in revenue (net of financial aid) from a $612, or five percent increase, in mandatory systemwide student fees. The University would continue its practice of committing 33 percent of new revenue to financial aid for needy undergraduate students and 50 percent to financial aid for graduate students. In addition, the budget includes $30.2 million in new revenue from tuition and fees associated with enrollment growth. This would make available $127.7 million for operating budget purposes. However, if the State provides funding to avoid or lower the tuition and fee increase in 2015-16, the President would be authorized to eliminate the increase or implement a lower increase. Finally, the budget plan also anticipates $8.7 million (net of financial aid) in revenue associated with increases in Professional Degree Supplemental Tuition.

UC General Funds. In the absence of adequate State funding support, most campuses have sought to expand nonresident enrollment. Nonresident undergraduates each pay about $23,000 more than California residents, generating more revenue to provide course offerings, help mitigate against rising student-faculty ratios, and enhance the educational experience of all students. The budget plan proposes $50 million in new revenue from a five percent increase in Nonresident Supplemental Tuition as well as a projected increase in nonresident enrollment of 2,000 students (after netting out instructional costs associated with these students). This increase in nonresident enrollment will be in addition to the enrollment of California resident students planned for 2015-16. The University continues to place a high priority on maintaining its commitment to California to enroll all eligible high school graduates who wish to attend. Enrollment of nonresident students assists in maintaining the quality of academic programs, providing much-needed revenue in a time of constrained resources. Nonresident students also add to the cultural and intellectual diversity of the campuses, benefitting all students who attend UC.

Despite the University's recent success in renegotiating higher rates, federal indirect cost recovery from federal research contracts and grants has declined as a result of sequestration and other changes in federal funding for research, though these declines are expected to be partially offset by increases in higher federal indirect cost rates negotiated by several campuses with the federal government and some increases in funding from non-federal resources. Thus, no increase in indirect cost recovery revenue is projected in the 2015-16 budget plan.

Alternative Revenue Sources. The 2015-16 budget plan assumes $80 million in alternative revenue, specifically:

- $40 million from asset management strategies, such as the transfer of Short Term Investment Pool funds to the Total Return Investment Pool;
- $20 million from additional savings achieved through new systemwide procurement contracts; and
- $20 million from new models of philanthropic giving.

These initiatives continue the University's practice of resolving a portion of its funding needs through internal actions to reduce costs, promote efficiencies, and generate new revenue.

Key Elements of the Expenditure Plan

The 2015-16 budget plan proposes $459 million in expenditure increases for 2015-16. These increases fall into four categories of costs: mandatory costs, high-priority costs, enrollment, and costs associated with investing in academic quality.

Mandatory Costs. Mandatory costs are unavoidable increases which must be funded. For the 2015-16 budget plan, mandatory costs total $125.4 million and include the following:

- $17.6 million to support employer contributions to UC's retirement plan. These costs reflect slight growth in the number of faculty and other staff required for the academic program and modest increases in compensation for all faculty and staff;
- $27 million in employee health benefit costs to fund an overall increase of six percent in health benefit plans;
- $5.2 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;
- $15.6 million in compensation costs in 2015-16 related to contractual wage increases per collective bargaining agreements;
- $32 million to continue the academic merit program, critical to retaining high-quality faculty; and
- $28 million in non-salary price increases, representing a two percent increase over the prior year (based on the Department of Finance estimate) plus an additional four percent (or $8 million) for expected increases in electricity and natural gas costs above inflation.

Investment in Academic Quality. Investment in academic quality initiatives is a category of costs focused on critical elements of the core academic programs that have been particularly affected by the budget cuts in recent years. Recognizing that significant investment in program quality is constrained by the current fiscal environment, the 2015-16 plan includes modest investment of $60 million. Further investment is anticipated to extend over a number of years with the expectation that more resources will become available in future years. The plan is focused on addressing several well-established and closely-watched measures of academic program quality, described below.

- Reducing the student-faculty ratio. 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.
- Supporting startup costs for new faculty. As campuses begin to hire faculty once again, both to replace those who have retired or separated and to address quality issues, one of the major challenges they face is the cost of startup packages for new faculty. Startup costs include renovation of laboratory space, equipment, graduate student support, and other costs that are necessary for new faculty to establish their research projects.
- Reducing faculty and staff salary gaps. A recent study on ladder-rank faculty compensation concluded that faculty salaries lagged the market by 12 percent in 2012-13; there is a similar disparity in staff salaries. As the University's budget stabilizes, closing this gap is a high priority as the University competes for the best faculty and staff.
- Augmenting graduate student support. Graduate education and research at the University have long fueled California's innovation and economic development, helping establish California as one of the ten largest economies in the world. The strength of UC's graduate programs is a key factor in attracting and retaining the highest-quality faculty. The University must ensure that the amount and duration of graduate student support remains competitive.
- Enhancing undergraduate instructional support. Investments are needed in instructional technology, libraries, instructional equipment replacement, and building maintenance, all critical to the quality of the academic program.

California Enrollment Growth. Projections indicate that enrollment growth of about one percent per year through this decade will allow the University to continue to meet its obligations to California resident students under the Master Plan. The 2015-16 budget plan assumes that with a combination of a four percent base budget adjustment in State funding and five percent tuition increases, the University will have sufficient resources to fund enrollment growth of one percent, or 2,200 students. Assuming similar support is provided beyond 2015-16, at least 5,000 more California residents will be served under the University's proposed five-year plan. The University will continue to support enrollment growth at the Merced campus, and moderate growth in undergraduate and graduate students on the general campuses and in the health sciences.

High-Priority Costs. High-priority costs are ultimately discretionary, but they are essential to the ongoing operation of a major research university of UC's stature. The 2015-16 budget plan includes $178.7 million in high-priority costs:

- $109.8 million to cover three percent compensation increases for represented and non-represented employees. This total excludes the salaries of represented staff whose 2015-16 salaries are already committed to under existing collective bargaining agreements;

- $55 million to address critical deferred maintenance; and
- $13.9 million to support debt service for capital projects coming on line in 2015-16.

Financial Aid. In recognition of the critical role played by financial aid in enabling talented students from all socioeconomic backgrounds to attend UC, the 2015-16 budget plan includes an additional $72.9 million for this purpose. This augmentation includes:

- 33 percent of the new Tuition and Student Services Fee revenue attributable to undergraduate students;
- 50 percent of the new Tuition and Student Services Fee revenue attributable to students in graduate academic programs; and
- 33 percent of the new Tuition, Student Services Fee, and Professional Degree Supplemental Tuition (if applicable) revenue attributable to students in graduate professional degree programs.

These new resources, together with the State's continued support of the Cal Grant program, are expected to fully cover increases in mandatory systemwide charges for over 50 percent of California resident undergraduates. The resources will also allow the University to continue to enroll outstanding graduate students from a highly competitive, global pool of candidates.

Attachments:

Attachment 1: 2015-16 Budget Plan for Core Funds

Attachment 2: Budget for Current Operations