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Office of the President

TO MEMBERS OF THE COMMITTEE ON LONG RANGE PLANNING:

<u>DISCUSSION ITEM</u>

For Meeting of November 19, 2014

UPDATE ON LONG RANGE FINANCIAL PLAN

EXECUTIVE SUMMARY

The Regents will be presented with an update of the University's long-range budget model. The model provides a tool for looking at the University's long-term funding needs and the combination of resources needed to address those needs. Based on modest assumptions regarding UC's principal cost drivers and revenue sources, the model shows that the University can meet its longer term funding needs with a combination of four percent annual increases in State support as provided in the Governor's multi-year funding plan, further aggressive efficiency efforts, development of alternative revenues, including nonresident supplemental tuition, and, in the absence of additional State support, moderate annual tuition and fee increases of five percent.

BACKGROUND

The long-term budget model was originally developed in 2011 and its findings presented to the Regents when the State was in the throes of the fiscal crisis and the University was reeling from a series of deep cuts in its State budget. The model was intended as a tool to help identify and project the University's major cost drivers over a number of years, taking a longer-term view of the University's funding needs beyond that provided in the annual budget plan. The model has been updated a couple times, most recently in the last year to recognize evolving cost drivers, revenue opportunities, and the prospect of constrained funding.

The Governor's multi-year funding plan for the University has offered the opportunity for more stable funding, a welcome change after years of dramatic swings in State support. Predictable funding is critical to a research university like UC where many budgetary decisions, such as hiring faculty and building facilities, involve long-term resource commitments. However, while the Governor's plan provides a mechanism for cost-adjusting the portion of UC's core budget supported by State funds, it provides no mechanism for cost-adjusting nearly half of the core budget supported by tuition and fees. As a result, the Governor's plan to provide annual increases of four percent in State support would, by itself, effectively limit increases to UC's core funds to less than two percent (1.7 percent in 2015-16), below the level of inflation.

Historically, the State has reinvested in the University after reducing support during cycles of economic downturn. The Governor's multi-year funding plan represents a striking departure from that historical practice. Without reinvestment by the State during times when the economy is robust and the State budget strong, the University loses its opportunity to rebuild its base budget and thus becomes more fiscally vulnerable with the onset of the next economic downturn. The immediate challenge is that the Governor's plan is not sufficient to meet the University's basic mandatory costs, let alone cover other high priority needs essential to the basic operating of a major research university. It is against this backdrop that recent long-range financial planning has been undertaken.

Recognizing that the University must stabilize its financial future by aligning resources with programs, long-range financial planning has been guided by several strategic priorities. These include the following:

- **Investment in Academic Programs.** Preserving the institution for future generations of Californians requires renewed investment in the University's core academic programs. The President has made investment in academic quality a top priority of the University. This investment includes restoring faculty ranks, reducing the faculty salary lag, increasing graduate student support, enhancing undergraduate instructional support, renewing and modernizing the University's information technology infrastructure, and closing the salary gap for staff.

- **Improving Performance Outcome Measures.** The State has called on the University to establish challenging goals for improving performance outcomes, such as graduation rates and time-to-degree, and to achieve such goals without additional resources beyond those provided in the Governor's multi-year funding plan. By nearly all standard measures, the University has already achieved very high performance outcomes compared to other selective institutions with similar student populations. In its long-term financial planning, the University recognizes that additional resources are essential if it is to achieve further gains in key performance measures and, at the same time, maintain current levels of student diversity. Given the large numbers of educationally disadvantaged students the University enrolls and the special impediments these students face, it is unlikely the University could maintain current performance levels, let alone improve those levels, by redirecting resources from within the limited funding provided in the Governor's multi-year funding plan. Ensuring that adequate resources are available to do so is part of long-term financial planning.

- **Tuition and Fee Stabilization Plan.** One of the President's top priorities has been to implement a tuition and financial aid plan that will reduce volatility in tuition levels, provide students and their families with a clear understanding of what it will cost to attend the University over five years, preserve access and affordability, and generate sufficient revenue combined with State support to meet the minimal funding needed to sustain the University. With tuition now comprising more of the core budget than State support, a multi-year tuition plan that provides stable and moderate increases over a multi-year period allows the University to address cost increases that would not be addressed under the Governor's plan alone. Modeling of the University's long-term funding needs demonstrates that no sustainable funding plan is possible without tuition increases, or equivalent additional State funding, to enhance the currently proposed levels of State support.

- **Long-Range Enrollment Plan.** At a time when State funding does not cover the University's basic mandatory costs, it is essential that the University's instructional programs are appropriately aligned with available resources. While the University seeks to maintain its commitment to the Master Plan to offer admission to all eligible California residents, the budget plan is built on the premise that the University cannot continue to take students without resources to educate those students at the level of quality expected of the University. A systemwide enrollment plan will help ensure that there is appropriate alignment between resources and enrollment levels. The University expects to have a plan in place for 2015-16. With a combination of moderate and predictable tuition increases and four percent base adjustments in State support, the University's long-term financial planning assumes modest annual growth in Californian resident enrollment sufficient to meet the University's commitment under the Master Plan and help meet state workforce needs.

- **Nonresident Student Enrollment.** The University's long-term financial planning assumes that campuses will continue to increase nonresident enrollment to help backfill operating budget shortfalls and enhance funding needed to maintain the quality of instructional programs for all students. Nonresident supplemental tuition has been a critical alternative revenue source as campuses have struggled to maintain their academic programs in the face of declining State support and has allowed campuses to help preserve quality for all students. The University is committed to ensuring that continued growth of nonresident students will not hamper its ability to accommodate qualified California residents who wish to attend – as long as the California enrollment is sufficiently funded.

- **Deferred and Ongoing Building Maintenance**. The University can no longer delay funding of critical deferred maintenance. Operation and maintenance of plant is one of the first areas of campus budgets to be reduced during fiscally challenging times. The State eliminated the last remaining funding for deferred maintenance in the University's operating budget in 2002. During the last twelve years, budget cuts have reduced funding for campus facilities while the backlog of high-priority deferred maintenance has grown dramatically. The long-term financial plan includes multi-year funding of deferred maintenance and a modest increase in ongoing building maintenance for existing UC facilities.

- **Capital Program Funding**. Trailer bill language of the 2013-14 Budget Act (AB 94) authorized the University, subject to certain approval and reporting requirements, to use State operating funds to support a small capital program. In the absence of other State funding to address the University's capital needs, the 2013 language allows the University to address critical capital needs, including significant seismic and other life safety, capital renewal, modernization, and high priority programmatic needs, including the build-out of the Merced campus to allow the campus to continue expanding enrollments to meet its 2020 development goals. Supporting a modest capital program is a strategic priority for the University, though funding such a program from the operating budget requires redirection of already constrained operating budget resources.

The challenge facing the University is how to build a sustainable long-term financial plan, one that provides the resources necessary to protect past State investment in the University and ensure that the institution continues to flourish for the benefit of future generations of Californians at a time when, despite a rebounding State economy, funding provided by the State is not adequate to cover the University's basic funding needs.

A sustainable financial plan must identify the minimal resources necessary to ensure not only that the University can continue to provide access to *all* eligible resident California students but also that it is able to deliver a high-quality education to all of its students during a period when the institution is serving an ever greater cross-section of the State's diverse population. Failure to preserve the institution's tradition of excellence at a time when more Californians from across the socioeconomic spectrum seek the opportunity to attend UC would be a tragic departure from the State's commitment to ensure access to excellence for *all* qualified students.

ASSUMPTIONS FOR LONG-RANGE BUDGET MODELING

Modeling of UC's principal cost drivers and funding solutions reaffirms the fact that there are no "magic bullets" or simple solutions to meeting the University's long-term funding needs, and that the University must rely on its own resources to cover a greater share of its long-term funding needs. As such, in modeling UC's long-range funding needs, it has been assumed that the University will continue to pursue aggressive efforts to increase operational efficiencies and alternative revenue sources, such as increased philanthropy and liquidity management. Even under the most optimistic assumptions about the University's capacity to make further efficiency gains and increase alternative revenues, however, modeling of UC's cost drivers and revenue options demonstrates that these internal solutions alone cannot close the funding gap over the next five years. Efficiencies and alternative revenues can contribute – albeit substantially – to meeting the University's funding needs; however, the University cannot cut its way to excellence. Without other revenue sources, the University cannot sustain the levels of access, affordability, and quality that have long been the hallmark of the UC experience.

In its long-range financial modeling, the University has looked carefully at what the basic cost drivers are of the institution and what resources are available to cover those costs. The focus has been on what resources are required for sustaining the University into the future. In this context, "sustaining" means that the University secures a basic level of resources needed to (1) maintain the quality of the University's core instructional programs; (2) allow the University, as requested by the State, to improve its already high outcomes on critical performance measures, such as graduation rates and time to degree; and (3) exercise responsible stewardship of the University's physical infrastructure that houses and supports the University's vast array of instructional, research, and public service programs. That is, the University's long range financial planning has not been driven by extravagant expectations of future funding; rather it has been undertaken for the purpose of identifying what the basic funding requirements are to preserve the stature and quality of the institution. The modeling of UC's long-term funding needs is conservative for at least three reasons: first, it is based on modest assumptions about what the principal cost drivers are that the University must address; second, it's based on aggressive assumptions about how much of the major costs can be addressed through the University's own efficiency initiatives and alternative revenues; and third, where investment in the academic program has been identified as necessary, that investment will be amortized over many years.

Baseline Expenditure Assumptions of the Long-Range Budget Model

For modeling the University's funding requirements over the next five years, between 2015-16 and 2019-20, the following assumptions have been used to establish the baseline case:

- Annual growth of resident students of one percent through the five-year planning period. This assumes that the University will increase its undergraduate resident enrollment by 5,000 students, as well as direct some funding to cover the costs of additional graduate students and enrolled students for whom the State has never provided funding;

- Growth in academic staff of one percent and growth of non-academic staff by 0.5 percent;

- Employer contributions to the University's retirement system will remain at the current 14 percent of compensation during the modeling period;

- Average annual increase of seven percent in health benefit costs for employees and retirees;

- Annual non-salary price increase of two percent, with an additional four percent above inflation for energy-related purchased utility costs in each year;

- $32 million annually thereafter to continue the academic merit program, a program critical to retaining high-quality faculty;

- Three percent compensation annual increases for all staff (including represented and non-represented academic and non-academic staff). The latest faculty total compensation study concluded that UC's faculty salaries are 12 percent behind market. In the past, the University has been able to hire and retain faculty in part because of the strong benefits packages the University offered even as the University's comparative salary position lagged. As the University has reduced benefits packages for both academic and non-academic staff, the salary lag threatens to become a bigger obstacle for the University's recruitment and retention effort.

- $55 million of permanent deferred maintenance funding in 2015-16 and increasing to $100 million in the following years. As discussed above, addressing the deterioration of campus buildings and supporting infrastructure is a high priority of the President. With no support from the State for deferred maintenance over the last twelve years, the University can no longer delay in directing resources to address critical deferred maintenance needs.

- $13.9 million in 2015-16 and $15 million annually thereafter from the operating budget to support a modest capital program, consistent with the provisions set forth in AB 94 trailer bill language.

- As noted above, $60 million in 2015-16 and $50 million a year for investment in critical elements of the academic program that have suffered as a result of recent cuts. These include improving the student-faculty ratio; funding for startup packages for new faculty (a major obstacle for many campuses seeking to hire new faculty); augmenting graduate student support to ensure that the level of support offered by UC is sufficient to attract the best graduate students; enhancing undergraduate instructional support (including instructional technology, libraries, instructional equipment replacement, and building maintenance); and reducing faculty and staff salary gaps.

Modeling Assumptions Related to UC Efficiencies and Alternative Revenues

The base case revenue and expenditure assumptions resulted in significant funding gaps in each year. It became apparent more aggressive measures are necessary to generate efficiencies, savings, and alternative revenues and achieve a balanced budget. In modeling the additional efficiency improvements and alternative revenues that the University will generate over the next five years, the following assumptions were made:

- Consistent with enrollment levels proposed in the Three-Year Financial Sustainability Plan to be submitted to the State, growth of undergraduate nonresident enrollment of 2,000 in 2015-16, 1,800 in 2016-17, and 1,500 in 2017-18;

- Five percent increases in undergraduate nonresident supplemental tuition in each year of the modeling period;

- $20 million in 2015-16 and $25 million in each following year of increased revenue available for operating budget purposes from philanthropy. This assumes that UC will continue to increase its philanthropic support, but also implement new strategies to increase flexibility of these funds. The new endowed chair initiative is an example of one such new strategies;

- $40 million of revenue generated from liquidity management in 2015-16 and an additional $15 million in 2016-17 that would be available for operating budget purposes;

- An additional $20 million in 2015-16 from the strategic sourcing initiative, which is intended to save money by centralizing procurement of common goods and materials at a lower cost;

- Federal indirect cost recovery will remain flat in 2015-16 and in subsequent years. Although many campuses have experienced some softening in federal research funding due to sequestration and other changes in the way federal research funding is awarded, these declines have been partially offset by higher cost recovery rates recently renegotiated by a number of campuses.

- The baseline case assumes one percent growth of core-funded academic staff and 0.5 percent growth of core-funded non-academic staff. The balanced budget scenario assumes UC will maintain non-academic staff at current levels. No staff growth will be challenging since many campuses, particularly the smaller ones (which are more dependent on State support), have cut non-academic staff to a point that may be unsustainable given regulatory compliance risks and basic operating needs.

- Increases of seven percent annually for health benefit costs are assumed in the baseline case. For the balanced budget scenario, it has been assumed that UC will hold these cost increases to no more than six percent in 2015-16 and five percent in each of the following years. Given strong cost pressures in the health care industry, this assumption will require continued vigilance on the part of the University in constraining costs.

Based on these further efficiencies and alternative revenues, the model projects that the University can address over a third of its funding needs over the next five years. It should be emphasized, as indicated above, that the assumed levels of savings and new revenue are ambitious and will require aggressive efforts on the part of the University to achieve.

Findings of the Long Range Financial Modeling

The Regents will be shown how the University can meet its five-year funding requirements from a combination of aggressive efforts to control costs through further efficiency improvements, increased revenue from alternative sources (including nonresident tuition), State funding increases of four percent each year, and five percent tuition increases as provided in the Stabilization Plan for Tuition and Financial Aid, or equivalent additional State support.