ASSUMPTIONS FOR A MULTI-YEAR BUDGET MODEL

UC projects that by 2015-16 it will face a shortfall of $2.5 billion in funding needed to support its core operations, barring any actions to reduce costs or raise revenue from the State and other sources. This projection is based on a series of assumptions about "cost drivers," which are those items that will require funding in the future and for which there is no other identified source of funds. These cost drivers have been discussed in great detail in prior Board meetings and are summarized in Section I below.

The University projects that $1 billion of the projected shortfall will be addressed through actions already underway to reduce or avoid costs and generate new revenue. These, too, have been discussed in prior Board meetings and are summarized below in Section II.

I. Cost Drivers

Enrollment and Instructional Programs

UC has long accepted its obligation, as a land-grant institution and in accordance with the Master Plan for Higher Education, to provide a quality education to all eligible California resident undergraduate students who wish to attend. This commitment was most recently underscored in the Compact with Governor Schwarzenegger, which included an expectation of enrollment growth of about 2.5 percent annually through 2010-11 as growth in the number of high school graduates peaked. Funding for this growth was provided during the first three years of what was intended to be a six-year Compact.

In addition, the University planned to rebalance the proportions of graduate and undergraduate students enrolled to better meet state workforce needs, particularly in the health science disciplines. The University was planning for continued growth in graduate and professional enrollments after 2010-11, when demographic projections indicate there would be a significantly slower rate of growth in undergraduates.

The State's most recent fiscal crisis has dramatically altered UC's enrollment planning. The State was unable to provide funding for enrollment growth that occurred during 2008-09 and 2009-10. As a result, in 2009-10, UC enrolled more than 15,000 FTE students for whom the State had not provided enrollment growth funding.

In response to the State's inability to provide the resources necessary to support enrollment demand, the University took steps to curtail enrollment growth. UC reduced the number of new California resident freshmen by more than 2,000 students in 2009-10 and by 2,850 during 2010-11 and 2011-12 as a means of slowing enrollment growth. During these years, fewer students were admitted to the campus or campuses of their choice and more applications were sent to the referral pool for accommodation, primarily at Merced. As a result, students had fewer UC campus choices and, in some cases, chose to pursue their education at other institutions.

The freshman reductions were partially offset by a planned increase of more than 1,000 California Community College (CCC) transfer students. The University took this action in order to preserve the transfer option in difficult economic times.

In 2010-11, the State budget provided enrollment growth funding of $51.3 million to support 5,121 FTE students at UC. Even with these new resources, during 2010-11, the University enrolled more than 11,000 FTE students for whom the State has not provided funding. Estimates indicate that enrollment of California residents remained stable for 2011-12, and thus the University continues to enroll more than 11,000 students for whom the State has never provided funding. However, the extraordinary reduction in State support during 2011-12 effectively means that more than 24,600 California residents are enrolled for whom the State is not providing support.

Accommodating enrollment without sufficient resources (as student tuition and fees do not cover the cost of instruction) means that new and existing students alike are affected by the lack of resources needed to support a high quality academic experience. Though campuses are employing a variety of measures to deal with the budget shortfall – dramatically slowing the hiring of permanent faculty, narrowing course offerings, increasing class sizes, curtailing library hours, and reducing support services for students – these are negatively impacting what has historically been an educational program characterized by excellence and opportunity.

During a budget crisis, such steps are necessary. But these actions are not sustainable over a long period of time if the quality of the University is to be preserved. Revenue from student tuition and fees has helped, but it has been insufficient to fully address the loss of State funding. While access is important, the University cannot indefinitely accommodate larger numbers of students without adequate resources to provide them a UC-caliber education. The dilution of State funding over larger numbers of students results in a lower quality experience for all students.

In order to protect access while ensuring the viability of academic programs, the proposed plan includes modest levels of growth in California residents over the next several years. Under the multi-year plan, this growth would be funded through a combination of increases in both State support and student tuition (or by higher tuition alone if the State is unable to contribute), as well as funding redirected from other sources through administrative efficiencies.

For modeling purposes, the cost of general campus enrollment growth is assumed to be $18,300 per student in 2012-13, growing at a rate of three percent annually over the multi-year plan. This amount is based on the cost to hire new faculty at a student-faculty ratio of 18.7:1 and maintain levels of service for instructional support, libraries, student services, and facilities operation and maintenance. Through 2015-16, enrollment growth costs are expected to total $170 million.

In addition to general campus enrollment growth, in recent years the University has engaged in efforts to expand enrollments and program offerings in medicine and nursing, including the development of a new medical school at the Riverside campus in response to the state's critical need for more healthcare professionals. As with general campus enrollment growth, under a multi-year plan, health sciences program expansion would be funded from increases in both State support and student tuition, or by higher tuition alone if the State is unable to contribute.

Retirement Plan Contributions and Retiree Health Benefits.

Employer Contributions to the Retirement Plan. Due to the significant under-funding of the UC Retirement Plan (UCRP), contributions to UCRP restarted in April 2010 at rates of four percent for employer contributions and two percent for employee contributions. In September 2010, the Regents approved increases to both the employer and employee contributions for 2011-12 and 2012-13. Employer contributions rose from four percent to seven percent for 2011-12 and will rise to ten percent for 2012-13. Employee contributions rose from two percent to 3.5 percent for 2011-12 and will rise to five percent for 2012-13. Employer contributions are expected to continue to rise by two percent annually through at least 2015-16.

In December 2010, the Regents took further action to make changes to retirement plan benefits that will reduce long-term costs. Most significantly, the Regents approved the establishment of a new tier of pension benefits applicable to employees hired on or after July 1, 2013, which would increase the early retirement age from 50 to 55, but retain many of the features of the current plan.

In 2011-12, the University is contributing $211 million from core fund sources and $356 million from other sources to UCRP. To date, the State has provided no funding for UCRP contributions. As employer contribution rates rise over the next several years, UC contributions are expected to rise to at least $581 million from core funds and $847 million from other sources. The State's share, based on State and student tuition and fee-funded employees, is projected to be $182 million in 2012-13 and will rise to $489 million in 2015-16. If the State is unable to provide funding for contributions to UCRP, the University will need to increase student tuition to cover the growing cost.

Annuitant Health Benefits. In addition, UC provides medical and dental benefits for more than 50,000 eligible retirees and their dependents. Unlike the UCRP, UC retiree health benefits are currently funded on a pay-as-you-go basis – that is, from current operating funds rather than from a trust account. In 2011-12, the cost to the University for retiree health benefits is $255 million. This amount is projected to increase significantly over the next several years, as both health benefit premiums and the number of annuitants rise rapidly. The University requests that the State continue its practice of funding its share of cost increases for retiree health benefits, which in 2012-13 is projected to be $10.5 million.

Because accumulated future retiree health benefits costs are not pre-funded, UC has an unfunded liability for retiree health representing the cost of benefits accrued to date by current faculty, staff, and retirees based on past service. In December 2010, in order to reduce long-term costs and the unfunded liability for retiree health, the Regents approved changes to retiree health benefits. Changes included reductions in the University's aggregate annual contribution to the Retiree Health Program to a floor of 70 percent, a new eligibility formula for all employees hired on or after July 1, 2013 and for existing employees with fewer than five years of service credit or whose age plus service credits is less than 50 as of June 30, 2013. Including the future cost savings resulting from these changes, the retiree health liability is estimated to be $13.4 billion as of July 1, 2011, and is projected to grow to $16.1 billion in 2014. For retiree health benefits, the multi-year plan includes increased costs of $40 million by 2015-16.

Normal Cost Increases.

Compensation. Compensation for faculty and staff employees remains a critical issue for the University. During 2008-09, 2009-10, and 2010-11, faculty and non-represented staff received no general salary increases, and in 2009-10 were subject to furloughs that reduced salaries by four to ten percent depending on salary level. Due to the lack of a stable salary increase program, salary levels for both faculty and staff at many levels have fallen significantly behind market. The re-establishment of employee retirement contributions and increases in contribution rates are further hampering UC's efforts to remain competitive.

The multi-year plan includes annual compensation cost increases of three percent for both represented and non-represented staff, as well as the regular academic merit salary increase program, totaling $533 million by 2015-16. While compensation likely will continue to lag substantially behind the market, three percent increases are critical to retain and recruit the faculty and staff needed to maintain UC's continued quality and competitiveness as a teaching and research university, especially after three years without range adjustments. The three percent increases are not expected to reduce the current lag in UC salaries, but should keep the lag from growing beyond a point from which future restoration would be very difficult.

Actual salary and benefit actions for University employees may be subject to notice, meeting-and-conferring, and/or consulting requirements for represented employees under the Higher Education Employer-Employee Relations Act.

Employer Contributions to Employee Health and Welfare Benefits. Employee health benefit costs are rising at a rapid rate (ten percent for calendar year 2010), much more than the five percent rate of growth anticipated when the Compact was developed in 2004-05. Thus, funds received during the early years of the Compact for employee benefit costs fell far short of what was actually needed. No State funds were provided for this purpose in 2008-09 or 2009-10, yet costs continued to rise, dramatically exacerbating an already difficult problem. Campuses have been forced to redirect funds from existing programs to address these cost increases – beyond the redirections necessary to absorb base budget cuts.

In addition, employees have been required to bear a larger responsibility for the rising costs of these benefits, partially offsetting earlier salary increases. In 2002-03, the University instituted a progressive medical premium rate structure (based on full-time salary rates) designed to help offset the impact of medical plan premiums on lower-paid employees. Although UC pays approximately 87 percent of monthly medical premiums for employees on an aggregate basis, the University has made a strategic decision to cover an even larger portion of the premium for those in the lower salary brackets.

In the current environment, with limited new funding and growing cost pressures, it is expected that some of the increases in cost will continue to be borne by most employees. The University will continue to review its total compensation program to ensure that all elements move toward being more competitive in the market.

In keeping with the rapid rise of benefits rates over the last several years, the multi-year plan assumes annual employer contribution increases of seven percent for employee health benefits, totaling $114 million by 2015-16.

Capital Renewal. Over the next decade, UC's projected capital renewal costs are expected to increase significantly as mechanical and other systems in buildings constructed 25 to 40 years ago reach or surpass the end of their useful life. The proposed plan assumes an investment of $100 million by 2015-16.

Other Non-salary Cost Increases. To maintain the quality of the instructional program and all support activities, the University must regularly replace, upgrade, or purchase new instructional equipment, library materials, and other non-salary items. The University must also purchase utilities to provide energy to its facilities. Just as costs for salaries and benefits for employees rise, the University's non-salary spending is affected by inflation. Costs of goods and services employed for education generally rise faster than the typical basket of goods and services used to measure inflation. In addition, since 1999-00, prices of electricity and natural gas have risen by over 120 percent, resulting in significant cost increases for UC campuses despite significant energy efficiency efforts that have limited consumption to modest increases. Even with the efficiency improvements described earlier, without State funding to support cost increases the University must redirect funds from existing resources to offset the impact of inflation and maintain the University's purchasing power.

The long-term model assumes no increase in purchased utility costs for two years followed by $6 million annual increases thereafter to capture the anticipated costs of an increasing amount of renewable power in the State's energy portfolio. Other non-salary items are assumed to increase three percent annually beginning in 2012-13. The non-salary cost increases will total $204 million by 2015-16.

II. *Alternative Revenues and Cost Reductions*

The multi-year plan assumes that the University will address about $1.0 billion of the projected $2.5 billion in costs in 2015-16 through aggressive operational efficiency initiatives and enhanced revenues. These baseline assumptions are ambitious and will require a sustained commitment across the University to carry out efficiency programs and to pursue opportunities to enhance revenues from other sources. Even if the identified operating efficiencies are implemented and revenue enhancements are secured over the next few years, a $1.5 billion budget gap will remain in 2015-16.

Systemwide Efficiencies and Reductions at the Office of the President. The multi-year plan assumes savings of $100 million annually over five years, with two-thirds of these savings, or $335 million in total, accruing to core fund sources by 2015-16. The plan also assumes a further reduction to the Office of the President in 2011-12, generating additional savings of $50 million.

Other Cost Reductions. Also assumed are $30 million of reductions to earmarked programs in 2011-12 and 2012-13. These are primarily research and public service programs that had been funded in the past by augmentations from the Legislature outside the priorities of the University and without the benefit of peer review.

Philanthropy. The multi-year plan assumes an additional $1 billion in new endowments that will yield $50 million annually in unrestricted or more flexible payouts. Overall, of UC's estimated $10 billion endowment only about eight percent is unrestricted. Of the campus endowments, significantly less is unrestricted. This additional revenue will require a considerable expansion of UC's fundraising efforts, as well as efforts to request the elimination of endowment restrictions from donors.

Research Cost Recovery. The multi-year plan assumes that the University will increase indirect cost recovery (ICR) by $30 million above current levels in each of the following four years. Increasing federal ICR rates to levels comparable to private institutions represents a prodigiously aggressive approach to increasing revenue from this funding source. Additional opportunities to improve cost recovery could come from reductions in ICR waivers for private contracts and grants.

Nonresident Enrollment Increases. The multi-year plan includes ten percent annual growth in nonresident undergraduates (approximately 860 students per year), yielding $92 million in additional revenue, net of instructional costs, in 2015-16. Over the past ten years, only about five to seven percent of UC's undergraduates have been nonresidents, as compared to many other public universities across the country that enroll as much as a third of their students from out of state. Systemwide undergraduate nonresident enrollment was capped by the Regents at ten percent in December 2010; while nonresident undergraduate enrollment has increased over the past two years, there is still considerable room within the cap for nonresident growth at the undergraduate level. The international stature of UC campuses suggests potential for nonresident growth, and campuses are indeed pursuing strategies to increase nonresident enrollments with evidence of success. Since 2008-09, nonresident freshman enrollment has risen 58 percent.

Professional Degree Supplemental Tuition Increases. The multi-year plan assumes revenue increases from tuition increases and expansion of professional degree programs (both State-supported and self-supporting) equivalent to eight percent annual increases in professional degree supplemental tuition revenue, totaling $60 million in 2015-16.

Financial Aid. The multi-year plan assumes $50 million annually in enhanced financial aid from corporate sponsored scholarship and other sources that would free tuition revenue to support operations.

Tuition Revenue from Enrollment Growth. In addition, new enrollment will generate revenue from tuition and fees, totaling nearly $80 million net of financial aid that will partially offset the costs of enrollment growth.