The Regents of the University of California

COMMITTEE ON FINANCE
February 19, 1998

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

Present: Regents Atkinson, Bagley, Brophy, Connerly, Johnson, Khachigian, Lee, Levin, McClymond, and Sayles; Advisory members Miura and Willmon

In attendance: Regents Chandler, Davies, Gonzales, Hotchkis, Leach, Montoya, Nakashima, 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 Broome, Darling, Gomes, Gurtner, Hershman, and Hopper, Chancellors Berdahl, Carnesale, Dynes, Greenwood, Orbach, Vanderhoef, and Yang, Vice Chancellor Bainton representing Chancellor Debas, and Recording Secretary Bryan

The meeting convened at 1:45 p.m. with Committee Chair Brophy presiding.

EXTERNAL FINANCING FOR THE 1998-99 UNIVERSITYWIDE DEFERRED MAINTENANCE AND FACILITIES RENEWAL PROGRAM

The President recommended that:

A. Funding for the 1998-99 Universitywide Deferred Maintenance and Facilities Renewal Program be approved in an amount not to exceed $66 million.

B. The Treasurer be authorized to obtain external financing in an amount not to exceed $66 million to finance the Universitywide Deferred Maintenance and Facilities Renewal Program, subject to the following conditions:

   (1) Annual debt service shall not exceed $6 million.

   (2) Repayment of the debt shall be from nonresident tuition income.

   (3) The general credit of The Regents shall not be pledged.

C. 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.

D. The Officers of The Regents be authorized to execute all documents in connection with the above.

Vice President Hershman and Director Heinecke discussed in detail the scope of the University's deferred maintenance and facilities renewal problems and a financial plan to alleviate them. The Committee was informed that, as described in the 1998-99 Regents Budget for Current Operations approved in November 1997, one of the casualties of the budget reductions of the early 1990s was the University's physical plant. These cuts followed years of insufficient funding for ongoing as well as deferred maintenance. As a result, the University is faced with maintenance and facilities problems that cannot be adequately addressed with existing resources.

These problems fall into three major categories: ongoing maintenance, facilities renewal, and deferred maintenance. Authorization to finance up to $66 million in deferred maintenance and facilities renewal projects will be a start to addressing the enormous backlog of work that needs to be accomplished in facilities that house programs eligible for State maintenance funding.

Ongoing Maintenance

The 1998-99 Regents' Budget for Current Operations includes an increase of $6 million to the base budget for annual building maintenance, above and beyond that required to fund new space. This increase builds on the current year State funding increase of $7.5 million, consistent with the concept endorsed by the Legislature to develop a multi-year plan to fully fund ongoing building maintenance. However, building maintenance has been underfunded for some time, based on State-recognized workload standards. Even with this two years of additional funding, building maintenance will remain underfunded by about $50 million annually. This deficit means that the funds being provided are only 60 percent of what the University needs.

Facilities Renewal

The University constructs buildings and infrastructure systems to last 50 to 100 years. However, some systems in buildings, or components of those systems, need to be replaced or renewed more often. Normal use inevitably causes wear and tear on building systems, causing them to wear out, and they must be replaced, regardless of how well they are maintained. Heating, ventilation, and air conditioning systems, elevator control systems, and roofs are a few examples of these systems, and normally, these systems would have useful lives of 25-30 years. If funding for proper and timely annual maintenance is not available, the useful life of these systems is shortened. Infrastructure that constitutes the major support systems for the campuses include items such as electrical and water distribution systems, roads, sidewalks, and bridges. These are extensive, complex systems that are costly to maintain or replace.

Facilities renewal is a program systematically and predictably to replace or renew components of buildings and infrastructure to extend the useful life of facilities. Until now, the University has not specifically budgeted annually for this category of expense. Many such projects have gone unfunded until they become emergencies. When they are funded, it can be as a part of ongoing maintenance, the deferred maintenance program, or as part of a major capital improvement project which renews building systems at the same time that programmaticallydriven renovations are being made. The development of a budget model is under way to help to identify annual funding needs for facilities renewal.

Deferred Maintenance

The following list was included in the 1998-99 Regents' Budget, which displays the history of the deferred maintenance backlog for State-maintained facilities and infrastructure. The figures are based on annual submissions from campuses which list individual projects by priority category. There are a number of factors that have contributed to this backlog, including underfunding of ongoing maintenance, the age of the physical plant, the lack of funding for facilities renewal, and the lack of permanently budgeted funds to help reduce the deferred maintenance backlog. The deferred maintenance backlog for 1996-97 was in excess of $500 million. It now exceeds $600 million.

Deferred maintenance projects are categorized according to the following priorities, consistent with an agreement with the Department of Finance and the Legislature:

Priority 1: Currently Critical. These projects require immediate action to return a facility to normal operation, stop accelerated deterioration, or correct a cited safety hazard. The systemwide backlog for Priority 1 deferred maintenance projects currently exceeds $300 million.

Priority 2: Potentially Critical. These projects will become critical within a year if not corrected expeditiously. Situations in this category include intermittent interruptions, rapid deterioration, and potential safety hazards. The systemwide backlog for Priority 2 deferred maintenance projects currently exceeds $200 million.

Priority 3: Necessary, Not Yet Critical. These projects include conditions requiring reasonably prompt attention to preclude predictable deterioration or potential down time and the associated damage or higher costs if deferred further. The systemwide backlog for Priority 3 deferred maintenance projects currently exceeds $100 million.

Permanent, annual State funding allocations for deferred maintenance ended in 1993 with the budget cuts. Prior to this, State funding of nearly $20 million per year was being provided. Since that time, the State pledged to pay debt service on a two-year State-funded deferred maintenance program totaling $50 million from bonds. The University has provided some one-time funding, between $7 million and $20 million annually, principally funded from excess UC and General Fund income available for reallocation at year end.

Funding for deferred maintenance has been sporadic and one-time in nature. There is no permanent source of funds dedicated to reducing the deferred maintenance backlog, and there are only limited funds in the capital budget to address the routine renewal of building and infrastructure systems. As a result, only the most critical deferred maintenance needs have been addressed; the backlog remains, and continues to grow.

The University's Proposal

It is essential that the University have sufficient funding to address facilities renewal needs in a prospective way, as well as to eliminate the deferred maintenance backlog. Given this substantial need for funding at a time when State funds are insufficient for these purposes, UC is proposing to use University long-term financing for deferred maintenance and facilities renewal projects. This proposal has been discussed with and agreed to by the Department of Finance. The basic tenets of the proposal are as follows:

- University financing would be issued each year over a period of at least five years to fund Priority 1 deferred maintenance and facilities renewal projects with a minimum useful life of 15 years.

- The source of funds to be pledged and used for repayment of the debt would be nonresident tuition income.

- The amount of funding to be provided for debt service on an annual basis would be limited to no more than 5 percent of the annual increase in UC and State general funds.

- The amount of funding to be provided for project costs on an annual basis would be influenced by current interest rates at the time of financing, which would determine the amount of principal which a specific debt service payment could support.

In 1998-99, a maximum of $6 million would be used to pay debt service for the first increment of the multi-year program. This level of debt service is expected to finance between $57 million and $66 million of debt, assuming a 15-year amortization; the amount of principal to be financed will depend on the interest rate at the time of financing. This program of financing is expected to continue for at least five years, with an additional $50 million to $65 million to be financed each year. A specific proposal for the level of debt service and principal to be financed would be brought to the Board of Regents for approval annually.

If this program is implemented as planned, it is anticipated that $250 to $325 million will have been made available over a five-year period, through 2002-03, for deferred maintenance and facilities renewal projects. This is expected to have a significant impact on reducing the Priority 1 backlog of deferred maintenance projects, as well as to fund many facilities renewal projects. Given the large backlog of deferred maintenance projects, it is intended that the first year of funding will concentrate almost exclusively on funding deferred maintenance.

It is anticipated that this financing program will be augmented as temporary funds, such as excess UC and General Fund income, become available.

Financial Feasibility

The amount available for debt service for the Deferred Maintenance and Facilities Renewal Program would be limited to no more than 5 percent of the annual increase in the UC and State general fund operating budget. For the 1998-99 budget year, the University would use no more than $6 million for debt service. Depending on interest rates at the time of financing, it is estimated that between $57 million and $66 million would be available for project costs.

Nonresident tuition is proposed as the repayment source. The increase in 1998-99 budgeted income over 1997-98 budgeted income is $11 million, contrasted to the $6 million to be used for debt service. It is anticipated that about $6 million per year would be available for debt service in future years; this is a conservative estimate assuming moderate increases in fees and enrollments over the next several years.

Regent Leach asked how construction costs can best be managed to ensure that the financial program will cover the maximum amount of work. Senior Vice President Kennedy reported that value engineering techniques are applied to construction planning in an effort to ensure that only essential elements are included in new facilities. Regent Leach explained that he was interested in knowing objective standards on the cost of deferred maintenance at academic institutions or in the commercial market to reassure himself that the University was getting the best possible value in carrying out deferred maintenance. Director Heinecke responded that the University has a multiple-year program with a target for each year, the predictability of which helps the campuses to design projects effectively. Giving the campuses reasonable targets encourages the careful examination of each project. Any savings from capital projects may be used for other purposes.

Although Regent Preuss agreed that using nonresident tuition was a source of funding and repayment was necessary in this case, he discouraged pursuing similar financial arrangements to address future needs.

Regent Sayles advocated bidding projects by the system rather than individual campuses in order to achieve savings.

Regent Johnson noted that the amount of deferred maintenance at the Berkeley campus amounts to about 25 percent of the systemwide backlog. She asked whether there were any possibility of taking money out of the capital budget to use for deferred maintenance. Vice President Hershman responded that the Department of Finance does not encourage the use of State bond money for that purpose. It is hoped that there will be enough money in the next five-year period to pay for the deferred maintenance projects that are in the highest category, but he agreed that the problem of insufficient funds is going to continue as lesser deferred maintenance priorities move up the scale.

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

The meeting adjourned at 2:30 p.m.

Attest:

Secretary