The Regents of the University of California

FINANCE AND CAPITAL STRATEGIES COMMITTEE
June 21, 2017

A special meeting of the Finance and Capital Strategies Committee was held on the above date by teleconference at the following locations: Carnesale Commons, Palisades Room, Los Angeles campus; 1111 Franklin Street, Lobby 1, Oakland; 1130 K Street, Suite 340, Sacramento; Student Center, Aliso Beach A, Irvine campus.

Members present:	Regents Elliott, Kieffer, Makarechian, Schroeder, Sherman, and Zettel; Ex officio member Napolitano; Advisory member White; Chancellors Blumenthal and Hawgood; Staff Advisor Richmond
In attendance:	Regents Anguiano, De La Peña, Ortiz Oakley, and Park, Regent-designate Mancia, Faculty Representative Chalfant, Secretary and Chief of Staff Shaw, Executive Vice President and Chief Financial Officer Brostrom, Executive Vice President and Chief Operating Officer Nava, Deputy General Counsel Nosowsky, and Recording Secretary Johns

The meeting convened at 3:00 p.m. with Committee Chair Makarechian presiding. He explained that notice had been given in compliance with the Bylaws and Standing Orders for a special meeting of the Finance and Capital Strategies Committee.

1. **PUBLIC COMMENT**

There were no speakers wishing to address the Committee.

2. **REVIEW OF FISCAL YEAR 2017-18 BUDGET FOR OFFICE OF THE PRESIDENT**

[Background material was provided to Regents in advance of the meeting, and a copy is on file in the Office of the Secretary and Chief of Staff.]

President Napolitano began the discussion by recalling that the Regents had approved the 2017-18 budget for the Office of the President (UCOP) at the May meeting, contingent on further review by the Finance and Capital Strategies Committee. She expressed concern about a provision in the State budget bill that would create a separate line item appropriation for UCOP. The State budget bill, approved by the State Senate and Assembly on June 15, would replace funding from two campus assessments, the general campus assessment and the UCPath assessment, with a separate line item appropriation of State General Fund monies. While this provision would not reduce the amount of General Fund support for UCOP or UCPath in this fiscal year, it would require UCOP to change its allocation model to ensure that campuses are treated fairly. President Napolitano warned that this might set a negative precedent for future years. She stated the University's conviction that the Board of Regents, not the State Legislature, is the appropriate entity to oversee the UCOP budget. The University would work with the Legislature and the Governor to restore the UCOP budget to its rightful place the following year. UCOP staff had been working on implementation of the 33 recommendations for UCOP made by the State Auditor. Many of these recommendations require analysis and study, and so the deadlines for implementing them were not until April 2018 or later. In the meantime, UCOP was endeavoring to present the UCOP budget in a clearer manner. President Napolitano reflected on the complexity of the UCOP budget.

Executive Vice President and Chief Operating Officer Nava reminded the Committee that the UCOP budget had been presented at the May Regents meeting in the form of two budgets. One, the Central and Administrative Services budget, totaled $388.8 million, while the other, the Systemwide Academic and Public Service Programs budget, totaled $424.7 million. The programs funded by the Systemwide Academic and Public Service Programs budget are managed primarily by the Academic Affairs division of UCOP. Roughly 43 percent or $352 million of the total UCOP budget passes through UCOP directly to grant recipients on the campuses.

Regent Kieffer drew attention to the fact that the UCOP budget is different from the amount the University requests from the State for the UCOP budget. Ms. Nava responded that UCOP has 300 fund sources, including State and federal funds. UCOP allocates these funds to various programs. Some funding supports UC’s systemwide public service mission, some supports UC’s research mission, and some funding is required for the general operations of the University, such as UC’s retirement and benefit programs.

Ms. Nava presented a chart showing fiscal year 2017-18 UCOP funding sources, usually divided into the categories of restricted versus unrestricted funds. Restricted funds totaled $410.9 million in this budget. Unrestricted funds come primarily from the general assessment to the campuses, the UCPath assessment, as well as endowment and gift funds. Restricted funds included almost $130 million in State funds and about $38 million in federal funds for research programs. Close to $50 million in restricted funds was dedicated to retirement program administration and $42 million to administration of UC’s investment portfolio. Approximately $125 million in external revenues came from tuition, patent royalties, and self-supporting programs, while a category titled “other restricted” funds, $27.2 million, came from endowments and gifts, cost recovery, and bond management fees. The Central and Administrative Services portion of the UCOP budget was funded mostly by campus assessments.

The Legislature’s budget proposal included a modification to UCOP funding that would replace the general and UCPath assessments to the campuses with a direct State appropriation. The general campus assessment for 2017-18 had been set at $312.4 million, the same as the prior year. The State was proposing that these funds be replaced by a $296.4 million appropriation to fund UCOP. This left a $16 million difference; Ms. Nava explained that this funding is traditionally held at the campuses for campus programs and is treated as a credit back to the campuses. These funds would remain at the campuses and would not be funded through this direct appropriation. The

Legislature also appropriated $52.4 million for UCPath. The University's assessment to the campuses for UCPath had been based on the number of W-2 forms issued for each campus. The State budget package also envisioned an enrollment increase of 1,500 students. UC would share in the expense of funding this new enrollment. By December 2017, the State Department of Finance, the Legislature, and UC would identify State funds to be permanently redirected to support UC enrollment growth. This plan would come to the Regents for review.

Ms. Nava then discussed the State Auditor's recommendations related to UCOP administrative expenditures. Eighteen of these recommendations were budget-related. The most significant area of work to be undertaken by UCOP through April 2018 was the review of fund restrictions. UCOP was already at work evaluating documentation related to fund restrictions, purposes, and allowable uses. As part of the implementation of the State Auditor's recommendations, UCOP would move toward multi-year budgeting and was at work on the development of a reserve policy; Ms. Nava anticipated that this policy would be presented to the Board later in the current fiscal year. UCOP was also reviewing its programs and initiatives. All this work was scheduled to occur over the next three years.

In order to reflect the $16 million difference mentioned earlier, the total UCOP budget proposal amount had been reduced from $813 million to $797.5 million. Ms. Nava presented a chart showing this amount and comparing it with budgeted expenses for fiscal year 2016-17 and projected actuals for June 30, 2017. The difference between the proposed budget for 2017-18 and actuals was $149.5 million. Ninety percent of the overall budget increase was due to three factors: $78 million in new State research funds from Proposition 56 for tobacco-related disease research; a $32.3 million increase in funding for the UCPath Center to allow pilot deployments at UCLA, UC Merced, and UC Riverside in December 2017; and $37.7 million in one-time salary and non-salary savings achieved during the fiscal year. One-time savings based on vacancies and lags in hiring experienced over the course of the year must be built back into the budget. The UCOP vacancy rate is about 15 percent, and the budget included a vacancy factor to address this.

Ms. Nava presented charts showing the general trend for campus assessments over several years. The campus assessment was held flat for this fiscal year, and the campus assessment as a percentage of UC's total revenue had been declining. She concluded by recalling that UCOP had made a commitment to review systemwide initiatives and programs by March 2018 and enumerated some of the activities that fall into this category: longstanding programs, shorter-term programs that represent responses to emerging issues, and temporary budget line items. UCOP agreed that the State Auditor's recommendations about evaluating these programs had merit. Ms. Nava anticipated that as a result of this review, a recommendation might come forward to the Regents that as UCOP initiates new programs, these programs are automatically scheduled to end after a certain term, such as five years, and that there be a process for reauthorization of programs.

Committee Chair Makarechian requested more thorough definition and distinction of restricted versus unrestricted funds, and presentation of different kinds of restricted funds, over some of which UCOP might have control. Ms. Nava responded that this request was part of the work UCOP was carrying out in response to the State Audit report. UCOP would clarify the nature of the restriction for all restricted funds. Committee Chair Makarechian further requested a more detailed explanation of the vacancy factor and the reasons for funding environmental mitigation measures for UC Merced wetlands through UCOP.

Regent Park asked how one-time salary and other savings were being deployed. Ms. Nava responded that the UCOP budget recognized $25.4 million in one-time salary savings that occurred in the 2016-17 budget; these savings were being built back into the 2017-18 budget because positions had been filled. UCOP was including a vacancy factor in the budget, $7.8 million, because there would always be some open positions. This number would be refined over the coming years as UCOP budgeting became more sophisticated.

Regent Park asked if UCOP would deploy one-time savings for one-time purposes. Ms. Nava responded that the differential transitions to the reserve balance.

Regent Park asked if UCOP were developing a policy for the reserve balance, and if the reserve funds would not be deployed in the budget until policy was decided upon. Ms. Nava responded in the affirmative. UCOP anticipated that it would close the fiscal year with uncommitted reserves of approximately $30 million; UCOP projected that by the end of the 2017-18 budget year those reserves would be reduced to about $16 million. One issue to be addressed in the reserve policy would be a method to determine the appropriate reserve level and a mechanism to fund reserves. Executive Vice President and Chief Financial Officer Brostrom added that UCOP was considering an annual process by which, if all reserves are filled, any funds left over become the beginning balance for the next budget year.

Regent Zettel expressed concern about proposed reductions to the President's Postdoctoral Fellowship Program and emphasized the importance of this program. Ms. Nava referred to the $16 million mentioned earlier that would be left out of the direct State appropriation to UCOP. A component of this $16 million, $1.2 million, was dedicated to the Postdoctoral Fellowship Program. While this does not reside in the UCOP budget, one could presume that the campuses would continue to fund this program. UCOP would work with the campuses to ensure that they have the means to support programs not included in the direct State appropriation.

Regent Zettel asked about a slated reduction of approximately $11.8 million for the California Institutes for Science and Innovation and about the status of the Puente Program, one of the UC's Student Academic Preparation and Educational Partnerships. Ms. Nava responded that these reductions were in the same category as that for the President's Postdoctoral Fellowship Program. The University's assumption was that the campuses would fund these programs directly.

Regent Ortiz Oakley referred to the assessment to the campuses. He asked how UCOP surveys the campuses to determine whether the level of service UCOP provides to the campuses is adequate or not, a question that had arisen during the State audit. Ms. Nava responded that UCOP was implementing a campus budget committee, to be called the Executive Budget Committee, including representatives from all the campuses, provosts and vice chancellors, Academic Senate members, and the Provost, the Chief Financial Officer, and the Chief Operating Officer. This group would help to develop the UCOP budget and provide input on implementation of the State Auditor's recommendations. Feedback from this committee would improve the setting of priorities. Mr. Brostrom added that individual divisions within UCOP carry out annual assessments of campus satisfaction.

Regent Ortiz Oakley remarked that the present time was an opportune moment to ensure that these lines of communication are robust and that campuses can provide their opinion on the services that UCOP provides. He asked how UCOP measures the effectiveness of its programs and initiatives and how UCOP would make funding decisions about programs in the future. Ms. Nava responded that this was a major component of the work UCOP was doing in implementing the State Auditor's recommendations. Criteria for programs and initiatives were being refined and would be brought to the Regents for discussion. Provost Dorr noted that background materials for the discussion included the Report of the Portfolio Review Group, a review of UC's systemwide research portfolio. The University had also recently examined all programs in the Student Academic Preparation and Educational Partnerships. She underscored that the division of Academic Affairs and all divisions at UCOP were seeking to establish a reasonable level of review and a time frame for every program as criteria for determining which programs to maintain, expand, or end.

Regent Ortiz Oakley stated that it was important that the Regents have options available to make these decisions. The clearer the choices that the Regents can make, the more support they can provide to UCOP. Mr. Brostrom remarked that this question would become particularly relevant in the fall. The State was providing $5 million in new funding for graduate enrollment, but no new funding for undergraduate enrollment. UCOP would be reviewing its programs and initiatives to determine if some funds would be better spent on enrollment growth. The decision about this would come to the Regents.

Regent Ortiz Oakley stated his view that the actions taken by the Legislature and the Governor regarding UC's budget were alarming. It was troubling that this could and did happen and it was an indication of a breakdown in communications between UCOP and Sacramento. Individuals whom the University usually relies on did not step forward to defend the University in this instance. The University should seek to understand this outcome in order to prevent outcomes like this in the future. He expressed the hope that in a year's time the University would have gained the trust of the Legislature and the Governor and that UC would not be scrambling to repair its relationship with the State government. Committee Chair Makarechian stated his view that all the Regents were alarmed by the State's action.

Faculty Representative White related that the Academic Senate was dismayed by this breakdown in communications. Of the unintended consequences of the State budget bill, the one of greatest concern to the Academic Senate was the direct allocation of State funds that would normally support campuses and other State-funded programs to solely support UCOP. This would create enormous internal logistical problems. Mr. White opined that the State could not have intended the campuses and their core teaching mission to be diminished in this manner; this must have been an unintended oversight. He hoped that there was some way this action could be delayed or that a "clean-up" bill could address this matter in the current year, and a better mechanism worked out. Instead of the cost of operating UCOP being spread among all fund sources, all ancillary operations, this support would come only from the smaller portion of the budget that is provided by the State. It would be a difficult task in the coming year to protect the State-supported core teaching functions of the University. UC would clearly need to reapportion funding streams among the campuses and within each campus. There would have to be rebalancing to ensure that campus departments are supported as they were previously and that the support comes from ancillary operations that would no longer be taxed to support UCOP, so that the core teaching mission remains unaffected and unharmed. This would be an enormous systemwide and campus problem, even a problem within departments.

Regent Sherman asked if the financial figures presented included retiree health and pension obligations. Mr. Brostrom responded that these obligations were included on a cash basis, but not on an accrual basis.

Regent Sherman asked about the magnitude of the non-cash obligation for retiree health benefits. Mr. Brostrom responded that systemwide retiree health benefit costs on a pay-as-you-go basis were $300 million, or one percent of UC's overall budget. However, due to new Governmental Accounting Standards Board requirements, this had become a $21 billion liability. This liability was not included in the budget presentations for UCOP and the campuses.

Regent Sherman asked if this presentation was significantly understating the UCOP budget by not including this liability. Mr. Brostrom responded that the budget was presented correctly on a cash basis, but not including all actuarial liabilities. Regent Sherman asked for an estimate of the UCOP budget if these items were included. Mr. Brostrom responded that UCOP would be in a substantially negative financial position.

Regent Sherman stated his view that the University was in effect underfunding the UCOP budget by not including a liability that UC would incur at some point. Mr. Brostrom responded that this liability is not passed on to the campuses but is reflected in the University's financial statements.

Chancellor Hawgood referred to the $16 million that would be left out of the direct State appropriation. He asked if this $16 million difference was defined in the budget as associated with specific programs, or if it was a coincidence that these programs amounted to $16 million. Director Eva Goode responded that this amount was based on data from the auditors. When UCOP charges the campuses for the assessment, UCOP would not charge for that $16 million; it is an offset. Chancellor Hawgood asked if UC had been receiving this money as an offset but would now no longer receive it. Mr. Brostrom responded that UC would still receive this funding, but that it would be directed to the campuses instead of flowing through the UCOP budget.

Chancellor Hawgood asked about new revenues for tobacco-related disease research and for the patent litigation program. He asked if these were increases to the base budget or one-time monies. Ms. Nava responded that the patent litigation increase was a permanent budget allocation. With regard to tobacco-related disease research funding, Ms. Goode explained that this was ongoing funding; the University was projecting that it would receive this on an annual basis, although the amount might change slightly.

Chancellor Blumenthal cautioned that the effect of using State funding to entirely fund UCOP would be a decrease in the amount of State money that would flow to the campuses. Unless something were done to rectify this situation, it would have an especially adverse effect on campuses like UC Santa Cruz that are more dependent on State funds than other campuses. It also happened that these campuses have the largest numbers of students from underrepresented groups and from poorer socioeconomic backgrounds. He stated his view that this was an unintended consequence of the legislative allocation of the UCOP budget.

Committee Chair Makarechian asked if the University could do something to rectify this situation. President Napolitano responded that UC would undertake some internal rebalancing to take this into account.

Staff Advisor Richmond expressed concern about how implementation of the State Auditor’s recommendations might affect staff recognition, retirement, and professional development programs, and possible differential impact on staff at UCOP versus staff at the campuses.

Regent Schroeder asked if the 15 percent vacancy factor was an average for the last few years. Ms. Nava responded that UCOP accounting for the current year was not yet complete. The vacancy rate for UCOP might decrease slightly from this number. Over the past three to four years, it had ranged from 15 to 17 percent. An average vacancy factor for higher education institutions is 12.8 percent.

Regent Kieffer expressed approval of UCOP’s response to the State Auditor’s report and recommendations. He reflected on the complexity of UCOP funding. While there are about 300 funding sources, it might be possible to gain an overview of 50 to 100 of them. He observed that the taxing of campuses was a relatively recent development in the history of UC. Mr. Brostrom explained that this practice began around 2011; earlier these funds had come from the State General Fund.

Regent Kieffer stated that it was wrong to view UCOP as a service office for the campuses; UCOP is the head of the ten-campus system. Over time it had evolved to take on these service functions. The UC system was organized differently than the California Community Colleges or other university systems with centers of administration. He described the Legislature's action as separating the head of the system from the body, and stressed that there would be unintended consequences if this situation remained in effect. He hoped that this situation would not remain in effect for more than a year.

Committee Chair Makarechian reflected that the terms "assessment" or "tax" to the campuses were misleading; this might more accurately be described as an allocation of overhead expenses. If the University is seen in corporate terms, with the campuses like corporate divisions, UCOP has the right to collect overhead.

Regent Kieffer stated that it is helpful for the Regents to receive several months' advance notice regarding significant issues. President Napolitano agreed that such an overview would be helpful. Ms. Nava reminded the Committee that UCOP would be presenting its budget to actuals on a quarterly basis. This would be an opportunity for the Regents to review the budget process.

Regent Park remarked that there was now an opportunity to improve communications with Sacramento and improve the State government's understanding of the UCOP budget. She referred to Appendices III and V in the background materials. Appendix III included a list of "Systemwide Academic and Public Service Programs," while Appendix V listed "Systemwide Initiatives and Programs," but the lists were not identical. She requested clarification. Ms. Nava responded that Appendix III presented budget details broken down by UCOP divisions, showing how monies would be allocated. The list in Appendix V had been generated by the State audit; it did not reflect UCOP's categorizations for its programs and initiatives or how UCOP would present this information. UCOP was now undertaking work that would help clarify, explain, and define programs and initiatives, and make this information more transparent.

The meeting adjourned at 4:15 p.m.

Attest:

Secretary and Chief of Staff