

Office of the President

TO THE REGENTS OF THE UNIVERSITY OF CALIFORNIA:

DISCUSSION ITEM

For Meeting of March 15, 2018

OVERVIEW OF THE COST STRUCTURE FOR THE UNIVERSITY OF CALIFORNIA

EXECUTIVE SUMMARY

This presentation to the full Board is intended to provide an overview of the University's cost structure, with particular emphasis on factors that most directly affect the University's core academic activities.

UC served over 90,000 more students in its State-supported programs in 2016-17 than it did in 2000-01 – an increase of 54 percent. This increase far outpaced growth in total available resources from core funds (6.1 percent in inflation-adjusted dollars) during the same period. The resulting decline of \$11,068 in available resources per student has forced changes in the University's cost structure over time and underlies many of the challenges related to the student-faculty ratio, demand for student advising and other services, and critical infrastructure needs that UC campuses face today.

Like other major research universities, the majority of the University's operating expenses are related to recruiting and retaining a highly skilled workforce, which is critical to the services that the University provides to its students and to the state. In recent years, this workforce has not kept pace with enrollment – either among faculty or general campus staff. This reflects positive increases in productivity along with some trends that have not benefited students (e.g., a higher student-faculty ratio). In other expenditure categories, the University is building on its success in reducing costs through systemwide strategic sourcing, spend analytics, and contract and supplier management.

UC continues to introduce reforms to help students graduate sooner and at a lower cost – for example, by streamlining upper-division major requirements, reducing the number of upper-division credits required for graduation in popular majors, prioritizing funding for online instruction to address bottleneck courses, and creating new transfer pathways.

Even with these efforts, cost increases in certain expense categories are unavoidable if the University is to provide students, faculty, and staff with the resources they need to be successful and to continue the University's tradition of providing a world-class educational experience to a student body that is more socioeconomically diverse than ever before.

BACKGROUND

Components of the University's Operating Budget

The University's operating revenues, estimated to be \$34.5 billion in 2017-18, support its tripartite mission of teaching, research, and public service, as well as a wide range of activities in support of these responsibilities, including teaching hospitals, the Lawrence Berkeley National Laboratory, University Extension, housing and dining services, and other functions. The revenue components of the University's budget are varied:

- **Core funds**, consisting of State General Funds, UC General Funds, and student tuition and fees, provide permanent funding for UC's core mission and support activities, including faculty salaries and benefits, academic and administrative support, student services, operation and maintenance of plant, and financial aid.
- **Teaching hospital revenue**, including patient care service revenue from private health plans, Medi-Cal, and Medicare, and other operating revenues, which provide funding to support medical centers, clinical operations, research, and faculty at the schools of medicine.
- **Sales and services revenues** directly support auxiliary enterprises such as housing and dining services, parking facilities, and bookstores; University Extension; and other complementary activities such as museums, theaters, conferences, and publishing.
- **Government contracts and grants** provide direct support for specific research endeavors, student financial support, and other programs.
- **Private support**, including Regents' endowment payouts; transfers from campus foundations; and other private gifts, grants, and contracts, funds a broad range of activities typically restricted by the donor or contracting party. Private support comes from alumni and friends of the University, foundations, corporations, and through collaboration with other universities.
- **Other sources** include indirect cost recovery funds from research contracts and grants, patent royalty income, and management fees for Department of Energy labs.

Core funds, totaling over \$8 billion in 2017-18, comprise only about one-fourth of the University's overall expenditures; however, they support the operational infrastructure needed for the success of other programs in the \$34.5 billion enterprise, such as medical centers and organized research. Moreover, since many other revenue sources may be highly restricted (e.g., government contracts and grants or private support) or are needed to sustain the operating unit that generates them (e.g., medical centers or student housing), much of the focus of UC's strategic budget process and negotiation with the State is dedicated to the levels and use of core funds sources.

Available funding from the University's core fund sources – State General Funds, tuition and fees, and UC General Funds – declined by 31.2 percent on a per-student basis between 2000-01 and 2016-17 in constant dollars, as illustrated in Display 1.

DISPLAY 1: Change in Available Resources from State General Funds and Student Tuition/Fees

	2016-17	2000-01	
		Adj. for Inflation	Not Adj. for Inflation
State General Funds - Permanent (\$M)	\$3,306	\$5,000	\$3,192
Tuition/Student Services Fee	\$3,151	\$940	\$600
Professional Degree Fees	\$315	\$68	\$44
UC General Funds	\$1,418	\$581	\$371
	\$8,190	\$6,590	\$4,206
Resources Unavailable for Current Operations (\$M)			
Financial Aid	(\$966)	(\$337)	(\$215)
Lease revenue / GO Bond payments	(\$344)	(\$168)	(\$107)
UCRP Contributions	(\$424)		
	(\$1,735)	(\$505)	(\$323)
Available Resources (\$M)	\$6,455	\$6,084	\$3,883
Number of Students Enrolled (FTE)	263,957	171,270	171,270
Available Resources per Student (\$)	\$24,456	\$35,524	\$22,674
\$ Change since 2000-01	(\$11,068)		
% Change	-31.2%		

While the amount of *gross* revenue from these sources increased over time, the *net available resources per student* declined by \$11,068 per student because of several factors.

- First, UC expenditures on financial aid increased from \$337 million to \$996 million in constant dollars between 2000-01 and 2016-17. This investment shielded many UC students from the impact of tuition increases that occurred in the late 2000s due to State funding cuts during the recession years and provided additional aid to help students cover costs such as housing, food, and books. But it also resulted in less revenue available to meet other critical parts of the University's operating budget such as faculty hiring, academic support, student services, and addressing an aging infrastructure.
- In addition, over \$300 million of the University's State General Fund appropriation is dedicated to debt service for outstanding General Obligation and former State Lease Revenue bonds. This amount grew substantially in 2013-14 when \$200.4 million was added to the University's base budget for debt service on outstanding General Obligation bonds that had previously been paid directly by the State outside of the University's annual State General Fund appropriation. Although this increased the University's

General Fund appropriation, it also shifted the responsibility to repay those bonds to the University's operating budget.

- Employer contributions to the UC Retirement Plan (UCRP) also increased during this period. UC restarted employer contributions to UCRP in April, 2010. In order to secure the financial viability of the plan, the rate of employer contributions rose quickly over a six-year period until it reached 14 percent of compensation in 2014-15. This put an enormous strain on campus budgets, particularly because the restart of contributions occurred at the same time as dramatic cuts were made to the University's State appropriation because of the Great Recession.
- Lastly – and most important – UC served over 90,000 more students in its State-supported programs in 2016-17 than it did in 2000-01 – an increase of 54 percent. This increase far outpaced growth in total available resources from core funds, which increased by only 6.1 percent in constant dollars during the same period.

The resulting decline of \$11,068 in available resources per student has forced changes in the University's cost structure over time and underlies many of the challenges related to the student-faculty ratio, demand for student advising and other services, and critical infrastructure needs that UC campuses face today.

Major Components of the University's Cost Structure for Core-Funded Operations

Primary drivers of the University's cost structure for core-funded operations are described below.

Personnel-Driven Expenses for Faculty, Staff, and Retirees

- *Contractually Committed Compensation.*

Salary increases for represented employees are governed by collective bargaining agreements with each represented bargaining unit. When projecting future cost increases for represented employees, the University considers contractually committed increases that are already in place as well as estimated increases for contracts that will be subject to negotiation within the upcoming year. These costs have generally grown at a faster rate than inflation and or compensation increases for non-represented employees.

- *Faculty Merit Program.*

The University has maintained the faculty merit program each year – even through years of fiscal crisis – because of its importance to the quality of the University. Faculty are generally eligible to be considered every two to three years for a merit increase, which is intended to reward them for excellent teaching and research, as well as fulfillment of their public service mission. This program requires a rigorous peer review process before a merit increase is awarded.

- *Startup Costs for New Faculty.*

As campuses hire new faculty, they are faced with the need to cover the associated startup costs. These may include renovation of laboratory space; equipment; graduate student, postdoctoral scholar, and technical staff support; and other costs necessary for new faculty to establish their research teams and to become productive members of the University community. In some disciplines – especially health sciences, life sciences, physical sciences, and engineering – startup costs frequently exceed \$1 million per faculty member. Since UC's top candidates have multiple job prospects and UC is in competition for these hires, candidates make decisions based in part on UC's ability to support their research efforts.

- *Compensation for Nonrepresented Faculty and Staff.*

The University regularly compares its faculty salaries with those of eight peer institutions to evaluate its market position. At the start of the last decade, UC's faculty salaries were on par with the market. In contrast, UC's faculty salaries were 8.4 percent below market in 2016-17, placing UC at a competitive disadvantage relative to other institutions in recruiting and retaining top talent. Staff salaries present a similar competitive challenge. While market salaries over the past ten years have been increasing at approximately three percent per year, UC staff salary increases have not kept pace and averaged about two percent annually. To ensure that UC is able to recruit and retain faculty and prevent further growth in salary lags for both faculty and staff, the University must continue to support regular and predictable compensation increases.

- *UC Retirement Plan.*

The UCRP provides pension benefits for more than 59,000 retirees and survivors and has more than 126,000 active employee members as of July 1, 2017. The University has a fiduciary responsibility to ensure that the UCRP is adequately funded, which requires annual contributions to the plan from both the University and employees.

- *Employee Health Benefits.*

The University has taken a series of steps in recent years to control costs related to employee health benefits. These include self-funding the University's preferred provider organization (PPO) plans and leveraging UC's captive insurance company, Fiat Lux, to reinsure the plans; providing incentives for employees to seek care at UC medical centers through a tiered benefit structure; and continuing the University's successful Family Member Eligibility Verification Review program for health benefits. The University's 2018-19 budget plan incorporates a four percent increase in employee health benefits, well below the expected cost increases of five to six percent in 2017 reported by other large employers in recent surveys.

- *Retiree Health Benefits.*

In 2017-18, more than 63,000 UC retirees and beneficiaries are eligible to receive or are receiving an estimated \$315 million in health benefits paid for by the University. The State had historically provided funding to the University equivalent to the per-employee funding provided for other State employees for the increased number of annuitants expected in the coming year. In the 2014-15 budget, the State stopped funding these costs separately, adding them to the expenditures to be covered within the base budget increase provided under the Governor's multi-year funding plan.

Needs Related to Capital

- *Deferred Maintenance.*

The University's current deferred maintenance need is estimated to exceed \$8 billion, over \$4 billion of which is eligible for State support. As University facilities deteriorate, the threat of a significant building or infrastructure failure grows – a failure that could place students, faculty, and other staff at risk, cause extensive damage to facilities and other property, destroy years of research, or disrupt instructional and other core mission activities for an extended period of time.

- *Capital Improvements.*

The University continues to face a growing backlog of capital projects, including but not limited to classrooms, offices, laboratories, seismic improvements, and affordable student housing. The State process introduced by AB 94 allows the University to address its highest-priority capital needs until a new General Obligation bond can be brought before California voters. To utilize this mechanism, however, the University must set aside sufficient revenue from other parts of its operating budget. The University has intensified its efforts to make the most efficient use of existing facilities, to carefully define and analyze facility needs, to prioritize needs that maximize the value provided by available funds, and to continually improve management of project design and construction.

Enrollment Growth

- *Marginal Cost of Enrollment Growth.*

Enrollment growth results in higher institutional expenditures in several categories of the University's operating budget including faculty hiring, academic support, student services, and instructional equipment. The University's budget plan includes an estimated marginal cost for enrollment growth that incorporates these elements and is based upon a methodology negotiated over time with the State. For 2018-19, the projected marginal cost of enrollment growth (to be covered by a combination of State support and student tuition and fees) is approximately \$18,900 per student, excluding financial aid.

Cost Drivers Related to Student Success

- *Improving the Student-Faculty Ratio.*

The University's student-faculty ratio ballooned during the recent fiscal crisis and stands currently at 21:1 – well above the ratio previously agreed upon with the State of 18.7:1. To put this gap in perspective, reducing the student-faculty ratio by 1.0 point is estimated to cost between \$200 million and \$250 million dollars. Consequently, improving the student-faculty ratio requires a sustained effort over the course of many years.

- *Graduate Student Support.*

Graduate education and research at the University fuel California's innovation and economic development, helping establish California as the sixth largest economy in the world. The strength of UC's graduate programs is also a key factor in attracting and retaining high-quality faculty. To maintain that strength, the University must ensure that the amount and duration of graduate student support are competitive.

- *Student Financial Aid.*

The University and the State continue to dedicate extraordinary levels of resources toward need-based financial aid in order to keep the University financially accessible to all academically eligible students, regardless of their financial resources. The University sets aside one-third of all new undergraduate tuition revenue to strengthen its own institutional aid program – which is a critical investment in student access, but which also reduces the amount of tuition revenue available to support other parts of the University's operating budget.

- *Improved Access to Student Mental Health Services.*

UC campuses are continuing to hire student mental health counselors and other staff in order to improve students' access to mental health services, consistent with the high priority that the Regents and students have placed on this issue in recent years.

Other Cost Drivers

- To preserve the quality of the instructional program and support activities, the University must regularly replace, upgrade, or purchase new instructional equipment, library materials, and other non-salary items, which are subject to inflation. The University must also purchase utilities to provide energy to its facilities. In addition to campus-level efforts to control costs, the University has taken steps to leverage its size and scale to reduce costs through systemwide strategic sourcing, spend analytics, and contract and supplier management. These programs have also generated revenue for the campuses from early pay discounts, e-commerce incentives, and other negotiated efficiency incentives.