

Office of the President

TO MEMBERS OF THE COMMITTEE ON FINANCE:

ACTION ITEM

For Meeting of November 14, 2013

APPROVAL OF UNIVERSITY OF CALIFORNIA 2014-15 BUDGET FOR CURRENT OPERATIONS AND 2013-14 AND 2014-15 BUDGETS FOR STATE CAPITAL IMPROVEMENTS

EXECUTIVE SUMMARY

In this item, the Regents are being asked to take three actions:

- approval of the operating budget plan for 2014-15;
- approval of the capital finance plan for the current year, 2013-14, an action that is necessary because of the revised capital funding process adopted by the Legislature in the 2013-14 budget package; and
- approval of the capital finance plan for 2014-15.

With the passage of Proposition 30 in November 2012, an improving state economy, and the State's success in addressing a vast and seemingly intransigent structural budget deficit, the University faces the prospect of a stable State funding environment for the first time in five years. The University's operating budget plan for 2014-15 reflects the need not only to address its ongoing mandatory costs, but also to begin reinvesting in the quality of core instruction and research programs.

The Governor has proposed a multi-year funding plan that provides a five percent base budget adjustment in 2014-15, but makes that funding contingent on the University imposing no tuition and fee increases in 2014-15 and the following two years. While the Governor's proposal establishes a framework for more predictable State funding for UC, it provides no mechanism for the University to cost adjust half of its core budget. The \$142.2 million in State funds proposed as a base budget adjustment will not cover the University's mandatory costs in 2014-15, let alone other high-priority costs, including any reinvestment in academic excellence. The University's budget plan for 2014-15 acknowledges the need for alternative fund sources, efficiencies, and additional State funds above the base budget adjustment the Governor has proposed. All told, the plan proposes a total of \$383.1 million in increased revenues for 2014-15, matched by a proposed \$383.1 million in expenditure increases.

With regard to State-funded capital outlay projects for 2013-14, the 2013-14 Budget Act appropriated funding for the Merced Science and Engineering Building 2 equipment phase and the Scripps Institution of Oceanography Nimitz Marine Facility Berthing Wharf and Pier Replacement at UCSD, funded from General Obligation bonds, as well as the Classroom and Academic Office Building at Merced, to be financed under the new State capital process adopted in the 2013-14 budget package. The appropriated projects totaled \$54 million. The University submitted a list to the Department of Finance for seven additional projects for funding in 2013-14 totaling \$87 million, consistent with the requirements of the new State capital funding process; these seven projects plus the projects previously appropriated total \$141.5 million.

A proposed list of projects totaling approximately \$202.8 million was submitted to the State in August 2013 for the 2014-15 fiscal year. Of the ten proposed projects, four projects would respond to seismic life-safety needs; three projects would provide infrastructure improvements; one project would equip a building already under construction; one modernizes an Agriculture and Natural Resources facility; and one is a new building at the Santa Cruz campus to house the Ecology and Evolutionary Biology program, one of the most impacted programs on the campus.

RECOMMENDATION

The President recommends that:

- (1) The Committee on Finance recommend to the Regents that the budget plan included in the document, *2014-15 Budget for Current Operations*, and shown in Attachment 1, be approved.
- (2) The Committee on Finance concur with the recommendation of the Committee on Grounds and Buildings that the 2013-14 Budget for State Capital Improvements (Attachment 2) be approved.
- (3) The Committee on Finance concur with the recommendation of the Committee on Grounds and Buildings that the 2014-15 Budget for State Capital Improvements (Attachment 3) be approved.

BACKGROUND

The *2014-15 Budget for Current Operations Summary and Detail* (Attachment 4) provides the basis for the recommendation that the 2014-15 budget plan for current operations be approved. The capital finance plan adopted by the Board of Regents at the November 2012 meeting provides the basis for approving the projects proposed for financing in 2013-14. The *2013-23 Capital Financial Plan* provides the basis for approval of the State-funded capital plan for 2014-15. Executive Vice President Brostrom and Vice President Lenz will make a detailed presentation on the proposed budgets for current operations for 2014-15 and State-funded capital outlay for 2013-14 and 2014-15.

Proposed 2014-15 Operating Budget Plan

Overview of Current-Year Budget

Operating revenue, estimated at \$25.6 billion in 2013-14, funds the University's core mission programs of teaching, research, and public service, as well as a wide range of other activities, including teaching hospitals, the Lawrence Berkeley National Laboratory, University Extension, housing and dining services, and sponsored research.

The University's "core funds," comprised of State General Funds, UC General Funds, and student tuition and fee revenue, provide permanent support for core mission and support activities, including faculty salaries and benefits, academic and administrative support, student services, operation and maintenance of plant, and student financial aid. Totaling \$6.6 billion in 2013-14, these funds represent 26 percent of the University's total budget. Much of the focus of the University's strategic budget process and negotiation with the State is dedicated to the uses of these fund sources.

The State portion of the University's core funds totals approximately \$2.64 billion¹ in 2013-14. Historically, State General Funds have been by far the largest single source of support for the University; however, beginning in 2011-12, funds from student tuition and fees have exceeded the amount received from the State. In 2013-14, revenue from Tuition, the Student Services Fee, and Professional Degree Supplemental Tuition – the three types of student tuition and fee revenue in UC's core funds category – total \$3.03 billion, making student tuition and fees the largest single fund source providing core support for the University.

Other sources of funds include federal research funds, teaching hospital revenue, private gifts and endowments, and income from self-supporting enterprises. Use of these funds is restricted, which means they generally cannot be used to support activities other than those for which they are designated. But such funds help augment and complement the University's core activities of instruction and research, providing support functions, public service to the state and its people, and a rich social, cultural, and learning environment on UC campuses. The University's annual budget is based on the best estimates of funding available from each of these sources.

Context for Development of the 2014-15 Budget Plan

One year ago, the possible failure of Proposition 30 threatened a potentially devastating outcome for the University. Defeat of the Governor's revenue-raising initiative would have triggered an immediate \$250 million mid-year reduction in State support for UC, on top of nearly \$1 billion in cuts to UC's State-funded budget over the previous three years. With further deep cuts and the prospect of a disabled State unable to reinvest for years, the University would have faced stark choices that could have fundamentally recast the nature of the institution and severely curtailed its ability to serve the state and its citizens.

¹ Excludes \$200.4 million in State General Funds in UC's base budget for General Obligation bond debt service. This funding is paid directly by the State and is not available for UC's operating needs.

In 2013-14, the University finds itself in a very different situation. Proposition 30 was successful at the polls, and with the submission of the 2013-14 State budget to the Legislature in January 2013, the Governor effectively completed his two-year effort to close the State's structural budget gap. The Governor's highest budget priority for 2013-14 is education, as reflected in his funding recommendations for K-12, the California Community Colleges, the California State University (CSU), and the University of California. For UC and CSU, these recommendations are embodied in a multi-year funding plan that promises to provide some level of State funding stability for both university systems over the next four years. For UC, the Governor's multi-year funding plan proposes base budget adjustments of five percent in 2013-14 and 2014-15 and four percent in 2015-16 and 2016-17 – but makes this funding contingent on no tuition and fee increases for the four-year period.

In that context, the 2013-14 core funds budget for the University offers improved State funding and other positive changes. The new State funds provided for UC's operating budget in 2013-14 (\$256.5 million) are a welcome departure from past years' base budget cuts. However, they are sufficient to fund only the cost increases on the State-funded portion of the budget – which is now less than half of the total core funds. These cost increases include employer contributions to the University's retirement program, faculty merit increases, health and welfare benefit increases, non-salary price increases, and other compensation increases (most staff have only had one other general salary increase in six years). The University has committed to avoiding a tuition increase in 2013-14; thus, another source of funds must be identified to support cost-increase funding for the largest portion of the core-funded budget.

The University is fortunate to have the benefit of a new change in how debt service funding for capital outlay is being handled at the State level. With the shift of General Obligation Bond debt service to the University's base budget, all State-funded debt service for capital outlay is now contained in the University's base budget. This will be important for base budget increases in the coming years. Moreover, the State Lease Revenue bond debt has been shifted off the State's balance sheet and onto the University's (General Obligation Bond debt service cannot be shifted from the State). The University refinanced the Lease Revenue bond debt in September 2013 – and by doing so reduced the annual debt service by \$100 million for ten years and by \$17 million for the subsequent seven years. Thus, about \$100 million of the \$221.4 million in UC's base budget that would have been otherwise used to cover the State's debt service payments is now available to help cover operating costs in 2013-14. The Legislature adopted budget trailer bill language requiring that the savings be used to address the University of California Retirement Plan (UCRP) unfunded liability. Because these are one-time funds, this will temporarily alleviate pressure on the University's operating budget and can help mitigate the fact that there is no source of funding identified for the cost increases associated with the tuition-funded portion of the University's core operating budget.

The Budget Plan for 2014-15

The University's budget plan for 2014-15, presented in Attachment 1, reflects the need to address not only its ongoing mandatory costs, but also to begin reinvesting in the quality of core instruction and research programs while continuing to protect access and affordability. In its budget planning, the University has recognized that stabilizing UC's fiscal foundation requires a

combination of moderate increases in State funding, aggressive cost reductions and efficiency improvements that leverage UC's economies of scale, and the active pursuit of alternative revenues so that the level of tuition for California students is as low as possible, and so that unpredictable and volatile changes in tuition can be avoided. Built from these elements, a stable fiscal foundation will allow UC to make the long-term investments needed to sustain its stature as a world-class university, as well as to provide its faculty, students, and employees with a more certain future.

Summary of Proposed Increases in Revenue

The University's plan calls for proposed new expenditures in core operating funds by achieving increases in revenue from State funds and non-State sources (UC General Funds, as well as alternative revenue sources and cost savings) totaling \$383.1 million, a 5.8 percent increase over the current core-funded base budget.

State General Funds. The University's 2014-15 budget plan calls for a moderate base budget adjustment consistent with the Governor's multi-year funding proposal.

As noted above, the Governor's proposal also calls for no increase in tuition and fees in 2014-15. To help meet the University's mandatory and high-priority costs in the absence of a tuition and fee increase, the University's budget plan requests additional State funding to address the University's employer contribution to the retirement plan and funding to support modest enrollment growth.

The plan calls for \$267.1 million in new State General Funds, including:

- \$142.2 million from a five percent base budget adjustment, consistent with the Governor's multi-year funding plan;
- \$4 million for reimbursement of annuitant health benefit costs;
- \$64.1 million for the State's share of the University's contribution to the retirement system;
- \$21.8 million for enrollment growth of one percent to allow the University to continue to meet its Master Plan commitment; and
- \$35 million to help fund reinvestment in academic quality.

UC General Funds. Most campuses have sought to expand nonresident enrollment. The budget plan proposes \$26 million in new revenue (after netting out instructional costs associated with these students) from Nonresident Supplemental Tuition associated with a projected increase in nonresident enrollment of 2,000 students.

Despite the University's recent success in renegotiating higher rates, federal indirect cost recovery from federal research contracts and grants is expected to decline as a result of sequestration and other changes in federal funding for research, though these declines are expected to be partially offset by increases in higher federal indirect cost rates negotiated by several campuses with the federal government and some increases in funding from non-federal

resources. Thus, no increase in indirect cost recovery revenue is shown in the 2014-15 budget plan.

Alternative Revenue Sources. The 2014-15 budget plan assumes \$90 million in alternative revenue, specifically:

- \$35 million from asset management strategies, such as the transfer of Short Term Investment Pool funds to the Total Return Investment Pool;
- \$30 million from additional savings achieved through new systemwide procurement contracts; and
- \$25 million from new models of philanthropic giving.

These initiatives continue the University's practice of resolving a portion of its funding needs through internal actions to reduce costs, promote efficiencies, and generate new revenue.

Key Elements of the Expenditure Plan

The 2014-15 budget plan proposes \$383.1 million in expenditure increases for 2014-15. These increases fall into three categories of costs: mandatory costs, high-priority costs, and costs associated with reinvesting in academic quality.

Mandatory Costs. Mandatory costs are unavoidable increases which must be funded. For the 2014-15 budget plan, mandatory costs total \$168.1 million and include the following:

- \$73 million to support new employer contributions to UC's retirement plan. These costs are associated with another two percent increase in the employer contribution rate, from 12 percent in 2013-14 to 14 percent in 2014-15;
- \$20.3 million in employee health benefit costs to fund an overall increase of five percent in health benefit plans;
- \$4 million in retiree health benefit costs needed to provide funding for UC retiree health benefit cost increases equivalent to that being provided to other State employees;
- \$16.3 million in compensation costs in 2014-15 related to contractual wage increases per collective bargaining agreements;
- \$30 million to continue the academic merit program, critical to retaining high-quality faculty; and
- \$24.5 million in non-salary price increases, representing a two percent increase over the prior year plus \$8 million for expected increases in electricity and natural gas costs above inflation.

High-Priority Costs. High-priority costs are ultimately discretionary, but they are essential to the ongoing operation of a major research university of UC's stature. The 2014-15 budget plan includes \$165 million in high-priority costs:

- \$117.2 million to cover three percent compensation increases for represented and non-represented employees. This total excludes the salaries of represented staff whose 2014-15 salaries are already committed to under existing collective bargaining agreements;

- \$21.8 million to address the costs of one percent enrollment growth, or about 2,180 students;
- \$11 million to address critical deferred maintenance; and
- \$15 million to support a modest capital improvements program.

Reinvestment in Academic Quality. Reinvestment in academic quality initiatives is a third category of costs focused on critical elements of the core academic programs that have been particularly affected by the budget cuts in recent years. Recognizing that immediate reinvestment in program quality is constrained by the current fiscal environment, the reinvestment plan is anticipated to extend over a number of years with the expectation that more resources will become available in future years. The plan is focused on addressing several well-established and closely watched measures of academic program quality, described below.

- Reducing the student-faculty ratio. Delays in faculty hiring and unfilled vacancies have dramatically increased the student-faculty ratio. The University's long-term goal is to return to the budgeted level of 18.7:1.
- Supporting startup costs for new faculty. As campuses begin to hire faculty once again, both to replace those who have retired or separated and to address quality issues, one of the major challenges they face is the cost of startup packages for new faculty. Startup costs include renovation of laboratory space, equipment, graduate student support, and other costs that are necessary for new faculty to establish their research projects.
- Reducing faculty and staff salary gaps. Faculty salaries lagged the market by 11.2 percent in 2012-13; there is a similar disparity in staff salaries. As the University's budget stabilizes, closing this gap is a high priority as the University competes for the best faculty and staff.
- Augmenting graduate student support. Graduate education and research at the University have long fueled California's innovation and economic development, helping establish California as one of the ten largest economies in the world. The strength of UC's graduate programs is a key factor in attracting and retaining the highest-quality faculty. The University must ensure that the amount and duration of graduate student support remains competitive.
- Enhancing undergraduate instructional support. Investments are needed in instructional technology, libraries, instructional equipment replacement, and building maintenance, all critical to the quality of the academic program.

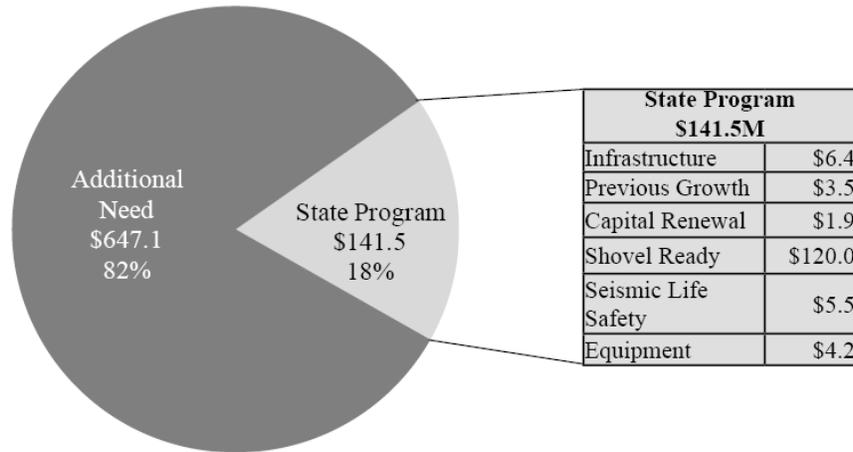
Proposed 2013-14 Budget for State Capital Improvements

The *2013-14 Budget Act* appropriated General Obligation bond funding for Merced's Science and Engineering Building 2 equipment phase and the Scripps Institution of Oceanography Nimitz Marine Facility Berthing Wharf and Pier Replacement at UCSD. In addition, the final budget package included an expectation that State funds provided for UC's base budget adjustment be used to support the Classroom and Academic Office Building at Merced. Funding for these projects totals \$54 million.

The State adopted legislation in 2013-14, Assembly Bill No. 94, Chapter 50, Section 8 (AB 94), which adds, among other provisions, sections 92495 et seq. to the Education Code. The

provisions required that the University submit any additional 2013-14 capital outlay projects by August 1, 2013 to the Joint Legislative Budget Committee and the Department of Finance. The University submitted seven additional projects totaling \$87 million; these seven projects plus the

Display 1: 2013-14 State Capital Outlay



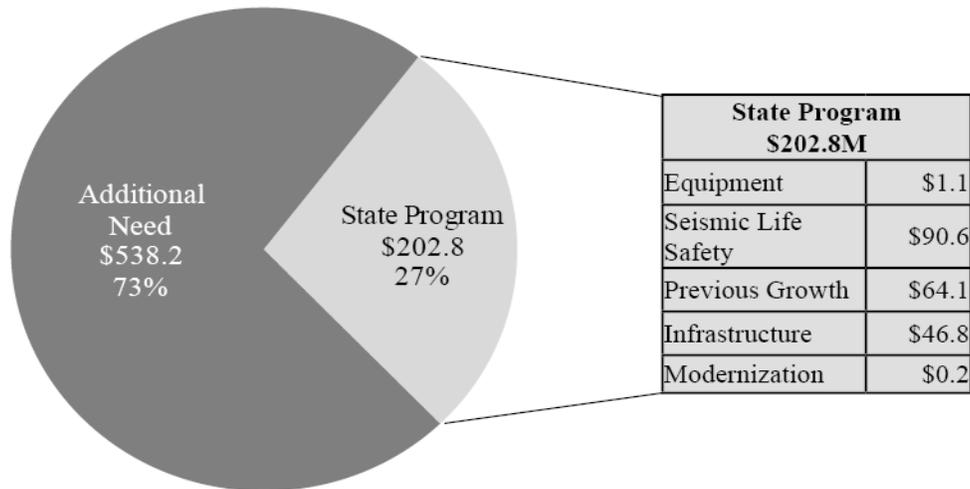
projects previously appropriated total \$141.5 million. As shown in Display 1 above, this proposal represents only 18 percent of the University’s total funding need of \$788.6 million for State-eligible capital improvement projects. A listing of the *2013-14 Budget for State Capital Improvements* may be found in Attachment 2.

Proposed 2014-15 Budget for State Capital Improvements

The *2014-15 Budget for State Capital Improvements*, presented in Attachment 3, proposes a total request of \$202.8 million in State capital outlay funds to allow ten major capital projects to complete preliminary plans, working drawings, construction, and/or equipment. UC’s proposal for 2014-15 focuses on critical infrastructure priorities and seismic life-safety needs. Within the proposal, four projects would address seismic life-safety needs (\$90.6 million), three projects would provide infrastructure improvements (\$46.8 million), one project would support modernization (\$0.2 million), and one project would accommodate previous growth (\$64.1 million). Additionally, the University is requesting \$1.1 million to equip a building currently in construction. This proposal has been submitted to the State of California in compliance with legislative reporting requirements.

As shown in Display 2 (next page), this proposal represents only 27 percent of the University’s total funding need of \$741 million for State-eligible capital improvements projects in 2014-15.

Display 2: 2014-15 State Capital Outlay



Funding needs for State-eligible academic and support functions are estimated to be more than \$750 million per year over the next five years. This estimate does include the costs of addressing the University’s serious capital renewal problems resulting from continuing shortfalls in operations funding or the costs associated with program changes.

The University maintains a continuing commitment to pursue gifts and other potential sources to supplement State funding for construction. The University has capital needs for student life and auxiliary programs that do not qualify as State-supportable and therefore must be addressed only with non-State resources. In this context, the University has intensified its efforts to make the most efficient use of existing facilities, to carefully define and analyze facility needs, to evaluate competing needs and non-construction alternatives and set priorities that maximize the value of available funds, and to continually improve management of project design and construction.

(Attachments 1 and 2 below; **Budget for Current Operations**)

2014-15 BUDGET PROPOSAL (Dollars in Millions)**2013-14 OPERATING BUDGET**

State General Funds	\$ 2,844.4
Less General Obligation Bond Debt Service	200.4
State General Funds (excluding GO Bond Debt Service)	<u>\$ 2,644.0</u>
Total Core Funds (State General Funds, Student Tuition and Fee Revenue, and UC General Funds)	\$ 6,600.0

PROPOSED INCREASES IN REVENUE***State General Funds (as proposed in Governor's multi-year plan)***

2014-15 Base Budget Adjustment (5%)	\$ 142.2
Annuitant Health Benefits	4.0
Subtotal	<u>\$ 146.2</u>

Additional State General Funds

State Share of UCRP	\$ 64.1
1% Enrollment Growth	21.8
Reinvestment in Academic Quality	35.0
Subtotal	<u>\$ 120.9</u>

UC General Funds

Nonresident Supplemental Tuition (related to new enrollment)	\$ 26.0 ¹
Indirect Cost Recovery	- ²
Subtotal	<u>\$ 26.0</u>

Alternative Revenues/Cost Savings

Asset Management (STIP to TRIP)	\$ 35.0
Systemwide Contracts	30.0
Philanthropy	25.0
Subtotal	<u>\$ 90.0</u>

TOTAL NEW REVENUE AVAILABLE FOR 2014-15 **\$ 383.1**

PROPOSED INCREASES IN EXPENDITURES***Mandatory Costs***

Retirement Contributions	\$ 73.0
Employee Health Benefits	20.3
Annuitant Health Benefits	4.0
Contractually Committed Compensation	16.3
Academic Merit Increases	30.0
Non-salary Price Increases	24.5
Subtotal	<u>\$ 168.1</u>

High-Priority Costs

Compensation Increases (3% all employees)	\$ 117.2 ³
1% Enrollment Growth	21.8
Deferred Maintenance	11.0
High-Priority Capital Needs	15.0
Subtotal	<u>\$ 165.0</u>

Reinvestment in Academic Quality

Reduce Student-Faculty Ratio	TBD
Support Startup Costs for New Faculty	TBD
Reduce Faculty Salary Gap	TBD
Reduce Staff Salary Gap	TBD
Increase Graduate Student Support	TBD
Enhance Undergraduate Instructional Support	TBD
Subtotal	<u>\$ 50.0</u>

TOTAL EXPENDITURES COVERED BY AVAILABLE REVENUES **\$ 383.1**

Notes:

1. Assumes revenue from nonresident enrollment growth of 2,000 undergraduate students, net of instructional costs.
2. Assumes no change in 2013-14 levels of indirect cost recovery.
3. Represents a 3% overall compensation increase less 2014-15 increases already committed to under existing collective bargaining agreements.

2013-14 BUDGET FOR STATE CAPITAL IMPROVEMENTS (\$000s)
CCCI 6077

CRITERIA	CAMPUS	PROJECT	PHASE	2013-14 REQUEST	FUTURE STATE FUNDS	NON- STATE FUNDS
Shovel Ready	MC	Classroom & Academic Office Building	C	\$ 45,144	\$ 4,079	
Equipment	MC	Science & Engineering Building 2	E	4,220		
Infrastructure	SD	SIO Nimitz Marine Facility Berthing Wharf	C	5,000		\$ 20,053
TOTAL APPROPRIATED				\$ 54,364	\$ 4,079	\$ 20,053
Capital Renewal	ANR	Ext Centers Renewal & Improvements	PWC	1,850		200
Seismic/Life Safety	DV	Walker Hall Renewal & Seismic Corrections	PW	2,731	28,081	
Shovel Ready	LA	CHS Seismic Correction & Fire Life Safety	C	48,349		
Infrastructure	MC	Central Plant/Telecomm Reliability Upgrade	PW	1,400	15,000	
Seismic/Life Safety	SF	Clinical Sciences Building Seismic Retrofit	W	2,800	21,735	66,933
Shovel Ready	SF	Academic Support Facility	C	26,505		7,395
Previous Growth	SC	Coastal Biology Building	W	3,530	64,443	3,985
TOTAL PROPOSED				\$ 87,165	\$ 129,259	\$ 82,319
TOTAL STATE PROGRAM				\$ 141,529	\$133,338	\$102,372

Note: The State adopted legislation in 2013-14, Assembly Bill No. 94, Chapter 50, Section 8 (AB 94), which adds, among other provisions, sections 92495 et seq. to the Education Code. AB 94 required that the University submit its *2013-14 State Capital Outlay* request by August 1, 2013. The University submitted seven additional projects totaling \$87 million; these plus the projects previously approved total \$141.5 million.

2014-15 BUDGET FOR STATE CAPITAL IMPROVEMENTS (\$000s)
CCCI 6151

CRITERIA	CAMPUS	PROJECT	PHASE	2014-15 REQUEST	FUTURE STATE FUNDS	NON- STATE FUNDS
Modernization	ANR	Intermountain Research Extension Center	PW	\$ 200	\$ 1,786	\$ 100
Seismic/Life Safety	DV	Walker Hall Renewal & Seismic Corrections	C	27,917	509	
Seismic/Life Safety	DV	Chemistry Seismic & Life Safety	PW	3,482	30,418	
Equipment	IR	Business Unit 2	E	1,094		3,281
Infrastructure	IR	Primary Electrical Improvements Step 4	DC	19,462		
Infrastructure	MC	Central Plant/Telecomm Reliability Upgrade	C	15,183		
Seismic/Life Safety	SD	Campus Life/Safety Improvements	WD	49,010		
Infrastructure	SB	Infrastructure Renewal Phase 1	C	12,136		
Previous Growth	SC	Coastal Biology Building	C	64,127	1,100	
Seismic/Life Safety	SC	Life Safety Upgrades	PWC	10,201		
TOTAL STATE PROGRAM				\$ 202,812	\$ 33,813	\$ 3,381