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Office of the President

TO MEMBERS OF THE COMMITTEE ON FINANCE:

DISCUSSION ITEM

For Meeting of September 18, 2013

DISCUSSION OF THE 2014-15 BUDGET

EXECUTIVE SUMMARY

The 2013-14 fiscal year marks the end of a half-decade of base budget cuts and extreme fiscal volatility. In fact, over the last 13 years (taking into account the fiscal downturn that began in 2001-02), the University has experienced only four years in which it did not address significant budgetary shortfalls. With the State's economy improving, passage of Proposition 30 last November, and the Governor's success in addressing what has been for more than a decade a large and intransigent structural State budget gap, 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 ($256.4 million) are a welcome departure from past years' base budget cuts. However, the University's budgetary challenges remain significant. Campuses are still contending with budget reductions that have occurred in recent years and the new funding provided in 2013-14 falls short of the amount needed just to keep even with inflation and other cost increases. The 2014-15 fiscal year is likely to be difficult as well, and perhaps more challenging than the current year.

The September Board meeting will include a discussion of the issues under consideration for the 2014-15 budget. Key expenditure issues will be discussed at the meeting and are presented in this item, i.e., funding for mandatory cost increases, other high priority budget items, and spending on UC's "Reinvestment in Quality" initiatives. This item also discusses challenges related to fund sources, such as the Governor's request for no tuition increases through 2016-17; the funding of UC's retirement plan (UCRP); declines in indirect cost recovery revenue; revenue generated by nonresident students; and UC's planned renewal of its request for Proposition 39 funding to help address energy efficiency and climate solutions to reduce its carbon footprint. In addition, the item introduces the new State-funded capital outlay process to be used for directing a portion of the University's new State General Fund base budget for capital outlay projects. A proposed budget plan for 2014-15 will be brought before the Board for approval in November.

BACKGROUND

The University's core funds budget – the funds used to support the basic educational mission of the University – consists of State General Funds, revenue from mandatory systemwide tuition and fees, and UC General Funds (which include Nonresident Supplemental Tuition, portions of indirect cost recovery, application fee revenue, and a variety of other revenue sources). Core funds comprise only about one-fourth of the University's overall expenditures; however, they form the basis – i.e., fund the infrastructure – from which all other activities included in the $24 billion enterprise stem. As a result, they are critical to the overall success of the University.

In recent years, State funds have been declining and tuition and fee revenue has been increasing to the point where the largest single source of revenue supporting the University's basic mission is now no longer State funds, but tuition and student fee revenue. This tuition and fee revenue is projected to be $3.03 billion in 2013-14.

2013-14 State Budget Outcome

In 2013-14, the overall State-funded budget for UC will increase from $2.377 billion to $2.844 billion; however, $400 million of that total is debt service related to capital outlay and is not available for operating budget purposes. About half of the increase in UC's State General Fund allocation for 2013-14, or $256.4 million, is available for unrestricted distribution to the operating budget. Consistent with the 2012-13 Budget Act, the budget for 2013-14 includes $125 million to buy out the planned tuition and fee increase from 2012-13. For 2013-14, the budget also provides $125.1 million for a five percent base budget adjustment, of which $10 million is to be used to advance online education (to support, in particular, courses that can be accessed across UC campuses), $15 million is to be directed to the UC Riverside School of Medicine, and $3.6 million is to be used to fund the debt service for a $45 million Classroom and Academic Office Building at the Merced campus. The budget also provides $6.4 million for annuitant health benefit costs and a $10.2 million adjustment for lease revenue bond payments. In addition, the budget shifts $200.4 million of State General Obligation Bond debt service to the University's base. With this shift, the University will benefit from future base budget adjustments.

The State funds provided in 2013-14 ($256.4 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, the largest portion of the core-funded budget will receive no cost increase funding in the current year.

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. All State-funded debt service for capital outlay – both that related to general obligation bonds and to lease revenue bonds – is now contained in the University's base budget. As indicated above, this will be important for base budget increases in the coming years. Moreover, the State lease revenue bond debt is being shifted off the State's balance sheet and onto the University's, which will allow UC to restructure the debt and save an estimated $80 million in 2013-14. This is temporary savings, available for possibly ten years or more, depending on how the debt is restructured. The Legislature adopted budget trailer bill language requiring that the savings be used to address the University's 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.

Development of the 2014-15 Budget

As noted earlier, the State's economy is improving and the structural deficit that has plagued the State's budget for more than a decade has been largely addressed. With the successful passage of Proposition 30, the Governor proposed a multi-year funding plan for UC (and the California State University) in his January budget proposal for 2013-14. His proposal called for five percent base budget increases in 2013-14 and 2014-15 and four percent base budget increases in 2015-16 and 2016-17. He also called for no tuition increases as a condition of receiving the base budget adjustments. The budget for 2014-15 will be developed in the context of the Governor's multi-year plan.

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Expenditure Issues

Key expenditure issues to be considered in the development of the 2014-15 budget plan are outlined below.

Funding for Mandatory Cost Increases. The primary drivers of increased costs in the University's budget include the following:

- continuing ramp-up of employer contributions to the University's retirement program to secure the financial viability of the plan – the employer contribution will increase from 12 percent to 14 percent beginning July 1, 2014;
- funding annuitant health benefit increases, consistent with how other State employees are funded;
- maintaining the academic merit program, a critical activity for retaining high-performing faculty;
- funding compensation increases already approved as part of the collective bargaining process;
- preserving the quality of employee and retiree health benefits programs while striving to contain cost increases; and
- keeping pace with inflationary costs for instructional equipment, technology, library materials, purchased utilities, and other non-salary items.

These are unavoidable costs that must be funded. In the past, the lack of funds for these items has contributed significantly to the University's budget shortfall.

Other High Priority Budget Items. There are several budgetary areas that are critical to the

University's ability to operate efficiently and effectively and thus, while discretionary rather than mandatory, are extremely important to address. These include:

- compensation increases for faculty and non-represented staff in order to prevent further erosion of market competitiveness of UC salaries;
- support for modest enrollment growth to accommodate all eligible California resident undergraduates who wish to attend, as well as more properly balance the proportion of graduate students to undergraduate students, to better respond to both institutional and workforce needs;
- addressing deferred maintenance and capital renewal, which have not received systematic regular funding for more than a decade, which in turn is placing many of the University's physical assets in jeopardy of becoming unable to support critical core programs; and
- expanding and renewing essential infrastructure and facilities, and maintaining progress on seismic and other life-safety improvements.

Reinvestment in Quality. The University has identified a number of areas that traditionally have been key to maintaining quality and excellence, including reducing the student-faculty ratio, providing funds for start-up costs associated with hiring new faculty, reducing the salary gap for faculty and staff, increasing graduate student support, and enhancing undergraduate instructional support. These are all areas that are critically underfunded, and when they are adequately funded they make a profound contribution to the quality of the education UC students receive. It is the University's long-term plan to make investments in these areas to restore levels of quality.

Revenue Challenges

In terms of funding for planned expenditures, there are many challenges to be faced in 2014-15. Planning for the 2014-15 budget will assume the five percent base budget adjustment from State funds will be approved; this adjustment is expected to yield approximately $142 million. However, several other issues related to fund sources remain, including the following:

- ***Governor's "No Tuition Increase" Request.*** As noted earlier, the Governor has stated that his multi-year funding proposal is predicated on the notion that there would be no tuition increases in any of the years covered by the plan. The University's previous long-term budget model assumed tuition increases that would provide dollars equivalent to a net five percent increase (after financial aid is accounted for). In 2013-14, this would have yielded $130 million. The 2013-14 year is the second year in a row of no tuition increase, although the two years are being treated very differently by the State – the shortfall that would have resulted from the first tuition increase, in 2012-13, was replaced with State revenue. If no tuition increases are to be implemented in 2014-15, then another source of funds will need to be identified to cover the cost increases expected on tuition-funded programs. As mentioned earlier, revenue from tuition and fees is the largest single source of funds supporting the University's core operations. A way to fund cost adjustments for this major portion of the budget must be resolved if there is to be no increase in student charges.

  Regarding tuition increases, it is essential to note that the University's outstanding financial aid program, combined with the Cal Grant program and other aid programs, would alleviate the burden of tuition increases for many students. In 2012-13, grant and scholarship assistance fully covered mandatory systemwide tuition and fees for over half of California resident undergraduates. In addition, the Middle Class Scholarship Program sponsored by Speaker Pérez will provide new funds to many California families that had not previously qualified for financial aid. The program will effectively reduce net tuition at UC by 40 percent for those families with annual incomes of up to $100,000 and by ten percent for those with incomes up to $150,000. The program will be phased in over four years, beginning in 2014-15.

The University is also specifically concerned about the effect of the Governor's "No Tuition Increase" request on programs that charge Professional Degree Supplemental Tuition (PDST). Over many years UC's professional programs have experienced funding shortfalls, in large part due to decreases in State funding, as well as the rapid increase of mandatory costs. PDST increases will allow UC's professional programs to fund cost adjustments and prevent a precipitous erosion of quality of these programs.

- ***UCRP.*** As noted below, the University resumed contributions to the retirement plan, UCRP, in April 2010. Employer contributions are funded from the source of funds supporting the employees working for each program. All fund sources have been contributing their share to the plan since 2010, with the exception of the State, which has contributed only a small portion of its share since contributions resumed. For other State agencies, however, including for the California State University (CSU) system, the State makes contributions each year for the cost of the program. In 2012-13, the CSU has $438 million in its base budget from the State for this purpose. In the current year, the Governor's original budget proposal in January proposed five percent base budget adjustments for both UC and CSU, but the funding necessary for CSU's retirement program was already largely in its base budget. Because UC is still ramping up its contributions to UCRP, more than one-half of the base budget adjustment proposed for UC would have had to be directed to UCRP. Fortunately, the final budget package included the debt restructuring proposal that allowed this year's UCRP contribution to come from those savings, permitting the full five percent base budget adjustment to be used for other pressing operating budget needs. There is currently no such alternative source identified for 2014-15 for this purpose. UC is proposing that the State provide funds for its share of the employer contribution above the funds provided in the five percent base budget adjustment to treat UC's budget similarly to CSU's. Otherwise, about one-half of the five percent base budget adjustment that UC is expecting in 2014-15 would need to be directed to this purpose.

- ***Indirect Cost Recovery.*** The budget plan for 2014-15 will need to include an acknowledgement that indirect cost recovery (ICR) revenue is declining. Federal funding for research contracts and grants is expected to decline significantly – perhaps by $200 million to $250 million – due to sequestration and flattening research budgets. It is estimated the decline in ICR will be in the range of $40 million to $50 million, or approximately seven percent, despite the fact that more favorable ICR rates are now beginning to be reflected in federal contracts and grants. The loss in volume of contracts and grants outweighs the gains made from implementing more favorable rates.

- ***Nonresident Enrollment.*** Campuses are expected to continue to enroll larger numbers of nonresident students. While no increase in Nonresident Supplemental Tuition is planned, it is expected that increasing numbers of national and international students will be evident on all general campuses except Merced. These students are not replacing funded California residents. UC's priority continues to be access for eligible California residents for whom the State has provided funding. However, nonresident students help prepare all students to effectively live and work in an increasingly global marketplace. Moreover, the total tuition they pay significantly exceeds the cost of their education, providing extra revenue that improves education for all students and enables campuses to maintain and increase enrollment for California resident students. Systemwide, nonresident undergraduate enrollment represented only nine percent of the undergraduate population in 2012-13, whereas over 30 percent of undergraduates at the University of Michigan and the University of Virginia are nonresidents.

- ***Proposition 39 Funding.*** In addition to the items above, the University intends to renew its request for Proposition 39 funding to help address energy efficiency and climate solutions to reduce its carbon footprint. The University is actively working to reach carbon neutrality and has been deeply engaged in climate solutions planning for several years. Many initiatives are already under way and are producing a demonstrated track record of delivering cost-effective energy projects and programs. As such, the University is uniquely positioned to leverage State funds available for energy initiatives (Proposition 39 State Energy Funds and/or Cap and Trade funds) to reduce its carbon footprint and energy consumption through a portfolio of projects that can be implemented immediately as well as over the longer term, all while creating high-quality jobs for Californians. Initiatives include extension of the Statewide Energy Partnership programs to non-participating campuses, initiation of deep energy efficiency projects that fall outside the scope of the Statewide Energy Program, construction of a 40 MW solar project to be located on the Merced campus, development of biogas facilities, and development of rooftop solar projects. Ultimately, UC's energy efficiency and climate change strategies are expected to deliver an estimated $80 million a year in energy cost savings and eliminate nearly half a billion metric tons of greenhouse gases.

Executive Vice President Brostrom and Vice President Lenz will make an oral presentation to the Board on options and considerations being discussed as part of the development of the 2014-15 budget. In addition, each of the expenditure issues is discussed in the attachment to this item.

(Attachment: Additional Information about Expenditure Issues) - below

ATTACHMENT

Expenditure Issues: Additional Information

Each of the expenditure issues involved in developing the 2014-15 budget for the University is discussed in more detail below.

Mandatory Cost Increases. The University faces a continuing challenge of achieving adequate support for rising mandatory costs. These are costs that must be paid regardless of the availability of new funds to pay them. In 2014-15, it is estimated these costs will total approximately $155 million, although estimates are still being developed. These costs include:

- Increases in Contributions to the UC Retirement System. In April 2010, employer and employee contributions to UCRP were reinstated at four percent and two percent, respectively. Since that time, contributions from the employer have risen three percent for two years and by two percent in each year thereafter, and from the employee 1.5 percent each year. In 2013-14, the employer contribution is 12 percent and the employee contribution is 6.5 percent. Approval to increase the employer contribution to 14 percent beginning July 1, 2014 was approved at the July 2013 Board meeting. Employee contributions will increase to eight percent (subject to collective bargaining for represented employees). The cost of the proposed change in the employer contribution for programs supported from core funds will be approximately $73 million, while the total cost for all University programs will be $225 million.

- Faculty Merit Program. The University has maintained the faculty merit program each year through the fiscal crisis, despite the devastating budget shortfall it faced, because of the importance of this program to the quality of the University. Faculty are generally eligible every 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 is a true merit-based program, requiring a rigorous peer review process before a merit salary increase is awarded. The cost of the faculty merit program is estimated to be $30 million in 2014-15.

- Retiree Health Benefits. In 2013-14, more than 54,200 UC retirees and beneficiaries receive health benefits at an estimated cost to the University of $263 million. The University annually requests funds from the State equivalent to the per-employee funding provided for other State employees for the increased number of annuitants expected in the coming year. Currently, UC estimates this will require $6 million in 2014-15.

- Health and Welfare Benefits for Faculty and Staff. In previous years, health and welfare benefit costs for employees were rising rapidly, typically between 8.5 percent and 11 percent. Through aggressive negotiations with providers and a redesign of the plan portfolio, the University curbed this tide in 2013-14, keeping the rise in these costs to four to five percent – one of the “out-of-the-box” solutions developed to address the budget shortfall. The University estimates an increase in 2014-15 of approximately five percent at a cost of $20.3 million.

- Keeping Pace with Inflation. To maintain the quality of the instructional program and all support activities, the University must regularly replace, upgrade, or purchase new non-salary items such as instructional equipment and library materials. 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. It is estimated that a two percent rise in inflation will cost $16.7 million in 2014-15, plus an additional $8 million projected for higher energy costs.

Other High Priority Budget Items. While not mandatory, the cost drivers in this category are a necessary part of doing the business of a world-class higher education institution.

- Compensation for Academic and Staff Employees. Recent cuts to the University's budget have resulted in significant disparities in faculty and staff salaries compared to the market. In 2012-13, UC faculty salaries lagged the market by 11.2 percent, and there is a similar or greater problem with respect to staff salaries in most workforce categories. The University is deeply concerned about the widening gap between funds available for compensation and the resources needed to fund competitive salaries. The most recent study of UC's total compensation program indicates that in general, average UC salaries are significantly below the market median, but the total compensation package, including salaries and health and welfare benefits for employees as well as post-employment benefits (pension and retiree health), are close to market.

  Changes in the costs and structure of the University's employee benefits programs will intensify pressure for salary increases over the next several years. Employee contributions to the retirement program total 6.5 percent of pay in 2013-14 and will rise to eight percent in 2014-15, which will have a further impact on employee take-home pay. In addition, inflationary cost increases in health and welfare benefits will likely require that employees pay an increased amount in medical insurance premiums. Although the benefits provided by UC are an important component of the packages offered to candidates, the salary component itself must be competitive to attract and retain high-quality faculty and staff employees if the University is to retain its preeminent stature.

  To ensure that UC is able to recruit and retain faculty and avoid further growth in salary lags for both faculty and staff, the University must develop a stable, predictable program for compensation increases. In 2014-15, the University is considering a general salary increase of three percent for faculty and staff. Actual salary and benefit actions for represented employees are subject to notice, meeting-and-conferring, and/or consulting requirements under the Higher Education Employer-Employee Relations Act.

- Enrollment Growth. UC has long accepted its obligation, as a land-grant institution and in accordance with the California Master Plan for Higher Education, to provide a high-quality education to all eligible California resident undergraduate students who wish to attend. In addition, the University has planned to rebalance the proportions of graduate and undergraduate students to better meet state workforce needs, particularly in the health science disciplines, as well as institutional needs. University projections indicated that enrollment growth of about one percent per year through this decade would accomplish these goals.

However, State funding has not kept pace with enrollment growth – there were about 7,600 students enrolled at UC for whom the State has never provided funding. When the extraordinary reduction in State support over the last several years is accounted for, there are more than 25,000 California residents (based on a Department of Finance methodology) in 2012-13 who are not adequately supported by the State.

In view of the changing financial circumstances of UC and the State, campuses were asked to develop new long-range enrollment plans through 2020-21. Campus submittals are being analyzed now. Once agreement is reached with each campus on their individual plans, the finalized plan for the system will form the basis for enrollment planning going forward.

In the meantime, the University estimates that enrollment of California residents for 2014-15 will increase by about one percent in 2014-15, including continued enrollment growth at Merced and moderate growth in undergraduate and graduate students on the general campuses and in the health sciences. However, if sufficient funding is not identified to adequately support the budget plan, campuses may instead opt to hold enrollment of California residents steady in the coming year.

- Deferred Maintenance and Capital Renewal. The need for an ongoing commitment to funding deferred maintenance and capital renewal has never been more acute as the University's inventory of aging buildings continues to grow (nearly 60 percent of University facilities are more than 30 years old); in addition, severe cuts in operation and maintenance funding have forced campuses to reduce building maintenance services and curtail, or in some instances eliminate, preventive maintenance programs. Without reliable and predictable funding to address the highest-priority needs, campuses face an ever-increasing risk of catastrophic failure of building and infrastructure systems. The University's budget plan will include some recognition of the need to support restoration of a modest deferred maintenance program.

- Essential Infrastructure and Facilities: State-Eligible Capital Projects. As mentioned earlier, the process for funding State-eligible capital projects has changed. The State's General Obligation (GO) bond debt has been shifted to the University's base budget, and going forward the base budget increase can be used to fund or finance State-eligible capital projects. Additionally, under Debt Restructuring, the State transferred Lease Revenue Bond (LRB) debt to the University, along with the cash flow to meet the current level of debt service. The University is preparing to reissue that debt and expects to realize additional cash flow from this exercise. UC still has (approximately) a $1 billion backlog in State-eligible capital facility projects.

  Although the projects are funded by the University, these are still considered State-funded projects because of the initial source of funds. As such, there remains an associated State approval process, whereby specific project milestones are approved by the University in lieu of the State Public Works Board, as required when the State sells the bonds. The new process requires the University to submit a list of projects proposed for funding by September 1 of each year. A proposed list of projects totaling approximately $203 million was submitted to the State in August 2013 for the 2014-15 fiscal year.

State-eligible capital projects proposed for 2014-15 were drawn from previously submitted campus capital requests and priorities. The projects requested represent completion funding for projects previously approved; seismic remediation; fire and life-safety upgrades; and projects to meet enrollment growth that has already occurred.

Reinvestment in Quality Initiatives. In addition to the aforementioned cost issues, the University believes investments are needed in a variety of areas that have a direct impact on improving the quality of the University's instructional, research, and public service programs as well as the fiscal health of the system. These include:

- Improving the student-faculty ratio. Consistent with the high priority placed on maintaining the instructional program and preventing further deterioration in the student-faculty ratio, the University's 2005-06 and 2006-07 budgets included increments of $10 million each year as part of a multi-year effort to recover some of the ground lost in the instructional program during this decade. It is critical that the University return to restoring funding for instruction as quickly as possible.

- Addressing faculty and staff salary gaps. As noted earlier, faculty salaries lagged the market by 11.2 percent in 2012-13; there is a similar problem with respect to staff salaries. If the University is to remain competitive in attracting and retaining the best faculty and staff, steps to close these salary gaps must be undertaken. For several years, the Regents have acknowledged this to be one of the University's highest priorities.

- Restoring funding for academic support. Historically, the State has recognized chronic shortfalls in funding for key areas of the budget that directly affect instructional quality – instructional equipment replacement, instructional technology, libraries, and ongoing building maintenance. The previous two compacts with the Governor proposed an additional one percent per year base budget adjustment to help address these shortfalls. The University must begin reinvestments in these areas if it is to keep up with technical innovations in equipment, libraries, and instructional technology, and to address ongoing maintenance needs – all of which were chronically underfunded before the recent fiscal crisis, and now have even less funding given recent budget cuts.

- 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 Regents have identified securing adequate support for graduate students as one of their highest priorities.

- Enhancing information technology systems and infrastructure. The University of California is on the cutting edge of education, research, and development, and yet its information technology infrastructure is not keeping up. The University must make strategic investments to update its technology infrastructure to better reflect the changing times and its status as the world's finest public university system.