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December 10, 2015

Director Michael Cohen
Department of Finance
915 L Street
Sacramento, California 95814

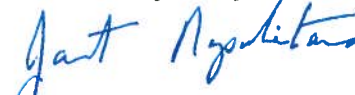
The Honorable Mark Leno
Chair, Joint Legislative Budget Committee
1020 N Street, Room 553
Sacramento, California 95814

Dear Director Cohen and Senator Leno:

Pursuant to Item 6440-001-0001, Provision 2.3, of the 2015 Budget Act (AB 93, Chapter 10, Statutes of 2015), enclosed is the University of California's report to the Legislature on *Legally Allowable Funds for Education*.

If you have any questions regarding this report, Associate Vice President Debora Obley would be pleased to speak with you. She can be reached by telephone at (510) 987-9112, or by email at Debora.Obley@ucop.edu.

Yours very truly,


Janet Napolitano
President

Enclosure

cc: Senate Budget and Fiscal Review
The Honorable Marty Block, Chair
Senate Budget and Fiscal Review Subcommittee #1
(Attn: Ms. Anita Lee)
(Attn: Ms. Cheryl Black)
The Honorable Kevin McCarty, Chair
Assembly Budget Subcommittee #2
(Attn: Mr. Mark Martin)
(Attn: Ms. Amy Rutschow)
Ms. Peggy Collins, Joint Legislative Budget Committee
Ms. Amy Leach, Office of the Chief Clerk of the Assembly
Mr. Jim Lasky, Legislative Counsel Bureau
Mr. E. Dotson Wilson, Chief Clerk of the Assembly
Mr. Daniel Alvarez, Secretary of the Senate
Mr. Michael Cohen, Department of Finance

Mr. Christian Osmena, Department of Finance
Ms. Tina McGee, Legislative Analyst's Office
Mr. Mac Taylor, Legislative Analyst's Office
Mr. Jason Constantouros, Legislative Analyst's Office
Provost and Executive Vice President Aimée Dorr
Executive Vice President and Chief Financial Officer Nathan Brostrom
Senior Vice President Nelson Peacock
Associate Vice President Debora Obley
Associate Vice President Steve Juarez
Executive Director Jenny Kao
Executive Director Kieran Flaherty
Director David Alcocer
Manager Bruce Kennedy
Executive Advisor Marsha Sato

Legally Allowable Funds for Education

Legislative Report

December 2015



UNIVERSITY *of* CALIFORNIA

**University of California
Legally Allowable Funds for Education
Legislative Report**

Introduction

This report responds to the State Budget Act of 2015 (SB 97, Chapter 11, An Act to Amend the Budget Act of 2015, Item 6440-001-0001, Provision 2.3) which provides:

No Later than December 10, 2015, the Regents of the University of California shall report to the Director of Finance and, in conformity with Section 9795 of the Government Code, to the Legislature, all of the following:

- (a) All university fund sources legally allowable to support costs for undergraduate, graduate academic, and graduate professional education.
- (b) The factors the university considers to determine which funds to use for educational activities and how much of those funds to use.
- (c) The sources of the funds included in the calculation of expenditures reported pursuant to Section 92670 of the Education Code.

Context

The partnership between the University and the State is built on an enduring commitment to protect and sustain access, affordability, and quality for future generations of Californians. In furtherance of its teaching, research and public service mission, the University enterprise will generate an estimated \$28.5 billion in 2015-16 from a wide range of revenue sources for support of the University's operations. With these funds, the University not only provides instruction for more than 253,000 undergraduate, graduate academic, and graduate professional students, but also manages an extensive research enterprise, five academic medical centers, three national laboratories, housing and dining services, libraries and museums, and develops academic preparation programs for California high school students, among other functions.

In response to AB 94, the 2013 budget trailer bill for higher education (now codified in Education Code 92670), the University produced a report that identifies expenditures by level of student, as well as by science, technology, engineering, and mathematics (STEM) fields and health sciences. The University traditionally has received its funding on an average basis and does not delineate spending by level of student or by discipline, making it difficult to report expenditures by those categories. Nevertheless, UC developed a methodology to address the challenge presented by the fact that the University's accounting and information systems do not readily allow for the disaggregation of educational expenditures as requested by AB 94.

Sources of Funds

The University has five major sources of funds:

- 1) Medical Centers, which comprise 28.9% of fund sources;
- 2) Sales and Services, which comprise 22.3% of total fund sources;
- 3) Government Contracts and Grants, which comprise 14.3% of total fund sources;

- 4) Private Support, which comprises 7.3%;
- 5) Core Funds, which comprise 25.8% of total funds sources, can be further broken down into the following three categories:
 - a. Tuition and fees (11.4% of total fund sources);
 - b. State general funds (10.4% of total fund sources);
 - c. UC general funds, which includes nonresident supplemental tuition (4% of total fund sources).
- 6) Other, which is a small category (1.8%) of miscellaneous revenue sources such as contract and grant administration funds and the Department of Energy management fee.

Section A. All University fund sources legally allowable to support costs for undergraduate, graduate academic and graduate professional education.

Simply said, all University fund sources that are not otherwise restricted as to use by the provider of the revenue are “legally allowable” to support educational costs. Nonetheless, other considerations place practical constraints on the extent to which funds currently used for purposes other than education may be redirected for educational expenses. Each fund source serves a purpose. In some instances, redirecting funds from the purpose it is currently serving to support education could raise the cost of providing those services or eliminate the service, with impacts for the students, staff, and faculty that currently make use of it. For example, if parking lot revenue were diverted to other uses, the cost of parking for faculty and students could rise in order to ensure sufficient funds for the operation and maintenance of the parking facility. The University’s Expenditures for Instruction report, discussed later in this report, demonstrates the considerable extent to which UC does leverage other fund sources (non-core funds) to help support its instructional mission.

Below is a discussion of each major fund category and how funds may or may not be deployed for educational costs.

1. Medical Centers. The University operates five medical centers which also serve as centers of research and teaching hospitals. Revenues generated at the Medical Centers fall into three broad categories: patient services revenues (such as reimbursement from government sponsored healthcare programs and private insurance for inpatient and outpatient care); other operating revenues unrelated to direct patient care (such as parking); and non-operating revenues (for example, interest income). The vast majority of the revenues generated by the teaching hospitals are from private healthcare plans (about 60% of revenues generated from patient services) and government-sponsored programs including Medi-Cal/Medicare programs (about 38% of revenues generated from patient services). Payments from California counties to certain hospitals that provide care to indigent adults account for approximately 3% of total University medical center revenues and are dedicated for reimbursement of patient care. These revenues are used to support the ongoing needs, both capital and operating, of the medical centers; some revenues generated at the medical centers are used to support academic instruction for graduate academic and graduate professional students as described below.

Although there is no prohibition in law related to how the hospitals can expend reimbursements, the reimbursement is intended to compensate for services provided by the hospitals. The medical centers must maintain an operating margin sufficient to cover debt, provide working capital, purchase state-of-the-art patient care equipment, invest in infrastructure (including necessary life-safety and seismic updates required by state and federal

law and regulation), provide sufficient resources for educating students, and meet the mission of caring for the state's most vulnerable patients. Moreover, it is important to maintain the connection between costs and reimbursement – for example, if it were evident that the hospitals did not need this reimbursement revenue to cover its costs, there would be a negative impact on the amount providers are willing to reimburse the University.

The Medical Centers do provide resources to the Schools of Medicine. Services purchased from the Schools of Medicine include physician services that benefit the Medical Centers, such as emergency room coverage, physicians providing medical direction to the Medical Centers, the Medical Centers' allocation of malpractice insurance, clinical research, faculty practice plans, as well as other payments made to support various programs.

Two types of Medicare payments provided to teaching hospitals, Graduate Medical Education (GME) and Indirect Medical Education (IME), are used for graduate professional education, i.e., medical education.

- a. GME. Medicare also provides teaching hospital with payments. GME helps to pay for the direct medical costs of providing medical education to the approximately 4,470 graduate medical education students at UC and for direct programmatic costs allowable under Medicare, such as salary and benefits for medical residents.
 - b. IME. IME payments are provided to teaching hospitals for some of the indirect costs associated with medical education, such as the extra demands placed on medical centers as a result of teaching activity.
2. Sales and Services. A variety of self-supporting enterprises other than the medical centers also generate revenue, including 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. Funds generated by these enterprises are used to ensure they remain self-sustaining, which is a challenge because they often operate in a market driven environment with the same—or more—cost and revenue pressures as their private sector competitors. There is no legal prohibition on those funds being used to support other activities, but the expenditures of revenues from these activities are restricted by the University to ensure that they are used to support the activities that generate the revenues and ensure the services are of a quality commensurate with the associated costs charged to consumers of these services. In addition, the revenues for services like housing, dining, bookstores, and many other University-operated auxiliaries come largely from UC students: raising prices to generate additional revenue would increase the costs students must pay.

One area of self-support that does contribute directly to education is Self-Supporting Graduate Professional Degree Programs (SSGPDPs). Campuses now operate approximately 60 programs that provide alternative pathways to graduate professional degrees for academically qualified students. The programs serve a varied student body, including, but not limited to, full-time working professionals, international students seeking professional training in the United States, and students seeking a professional degree that is not provided by one of the University's State-supported professional degree programs. SSGPDPs complement the University's State-supported professional degree programs by allowing the University to serve additional students in order to meet State workforce needs. Self-supporting programs receive no State support and must generate sufficient revenue to cover program costs, including, but not limited to, faculty

instructional costs, program support costs, student services costs, and overhead. Since fees for these programs are set at market rates and programs are financially sustainable, any excess funds generated by these programs are available to support UC's core academic mission.

3. Government Contract and Grants. Federal, state, and local governments directly fund specific research programs, as well as graduate student financial support. These funds are used as described in the contract or grant and cannot be redirected to fund other programs. Nevertheless, these grants often provide support critical to graduate students, including payment of their tuition and fees as well as stipends for their subsistence.
4. Private Support. Endowment earnings, grants from campus foundations, and other private gifts, grants, and contracts fund a broad range of activities. These funds are typically restricted in the way they can be expended by the donor or contracting party – over 97% of all gifts and grants are restricted as to use. The portion that is unrestricted is targeted for support of critical areas of the budget that are underfunded. In fact, the University's budget plan for the last several years has included a component calling for increased unrestricted philanthropy to help meet core budget needs. The 2016-17 budget and the three-year sustainability plan adopted by the Regents in November also anticipate an increase in unrestricted philanthropy.
5. Core funds. Core funds total \$7.3 billion in 2015-16, accounting for almost 26% of the University's \$28.5 billion budget. Core funds are primarily used as permanent funding for , student services, operation and maintenance of plant, faculty salaries and benefits, academic and administrative support, and student financial aid. Core funds are comprised of State General Funds (\$2.9 billion – this excludes General Obligation bond debt service that is not available for general operating budget purposes), student tuition and fee revenue (\$3.2 billion), and UC General Funds (\$1.1 billion). The latter category includes Nonresident Supplemental Tuition revenue, cost recovery funds from research contracts and grants, patent royalty income, and interest earned on General Fund balances.

Note: Revenue from the DOE National Laboratory Management Fee, a portion of contract and grant administration funds, and the portions of federal indirect cost recovery and patent revenue that, by agreement with the State, are not included as part of Core Funds are categorized as "other sources."

Section B. The factors the University considers to determine which funds to use for educational activities and how much of those funds to use.

The University is driven by its mission of teaching, research, and public service in alignment with the State's Master Plan for Higher Education. The University therefore devotes resources provided by the State and students – core funds – to strive to meet all aspects of its mission as it relates to access, affordability, and quality. As stated above, funds restricted by the provider of the revenue are not available for education unless specifically stated. In instances where those funds, such as philanthropy, are specifically dedicated for academic purposes, they are used in that manner.

To fulfill its core mission, the University must enroll sufficient numbers of students to meet its obligations under the Master Plan and provide them with not only education, but also other resources to succeed. Such functions related to education – financial aid programs, having sufficient faculty,

lecturers, and teaching assistants, academic counselors, staff to support and administer instructional programs – are not sufficiently funded with core funds alone. To meet its access, affordability and quality objectives, the University uses core funds and leverages other funds as required. In considering where to make expenditures, each campus is best poised to determine the optimal use of funds. Prioritization of the size and structure of instructional programs, amount and type of classroom facilities, the number of faculty and teaching assistants to accommodate course and major offerings, and academic and administrative support services for education are largely determined at the campus level. Each campus makes these decisions consistent with its own long-range academic plan.

Each campus must weigh and balance a variety of factors in deploying its resources. Legal and compliance requirements must be met, which generally take precedence over other priorities. The services funds are intended to support must be adequately operated, such as medical centers, parking structures, dining halls, etc. Health and safety of University students, staff, and faculty and the public are critical and require the University to make capital and operating expenditures across the system. While these expenditures do not directly support instructional activities they are a necessary part of the University’s educational mission. The University relies on a variety of fund sources to accomplish this, with core funds (state general fund and tuition) representing a fraction of overall expenditure in this area.

The University also has mandatory costs related to employee and retiree benefits that support the University’s mission, but may not be considered strictly related to education. The University’s practice is to make the employer share of contribution to those funds from the same fund source that the employee is paid, i.e., medical center employees are paid by medical center revenues, and so is their contribution to retirement; by the same rationale, employees funded by core funds, such as most UC faculty, have their contributions paid from core funds.

Finally, campuses must weigh and balance among remaining competing priorities, although maintaining the availability and quality of the academic program is always a priority for campuses.

Section C. The sources of the funds included in the calculation of expenditures reported pursuant to Section 92670 of the Education Code.

The sources of funds required by Section 92670 of the Education Code to be included in the calculation of expenditures for instruction are: State General Funds; tuition and fees; nonresident tuition; other UC General Funds. The University’s report also included all other funds as a separate category to demonstrate the significant leveraging that occurs because of the investment from core funds.

For the calculation related to expenditures for instruction related to general campus (undergraduate, graduate academic, and graduate professional students other than those in the health sciences), the health sciences, and STEM fields, the following sources of funds are used in the calculation:

- State General Fund reflects the annual appropriation to the University from the State’s general fund.

- Tuition and fees reflect the mandatory systemwide charges assessed to all registered undergraduate, graduate academic, and graduate professional students (except for students participating in self-supporting degree programs). These include Tuition, formerly known as the Educational Fee, that supports the basic operations of the University, the Student Services Fee which is used for services that directly benefit students outside of educational costs, and Professional Degree Supplemental Tuition which is charged to graduate students in certain specified general campus and health science disciplines.
- Nonresident tuition reflects the supplemental tuition charged to undergraduate, graduate academic, and graduate professional students in programs that receive some level of state support who are not residents of California (in addition to the mandatory systemwide tuition charged to all registered students).
- Other UC General funds refers to other funds, aside from nonresident tuition, that by agreement with the State are to be used to support the core operations of the University, such as indirect cost recovery, patent revenue, application fee revenue, among other sources.
- All other funds includes any other funds not included in any of the categories above and may include sales and services revenue (such as revenue from SSDPs, museums, theaters, conferences, and publishing); unrestricted philanthropy; government contracts and grants (which are included in the fund sources for both general campus and health sciences graduate education); private support for instruction, such as certain funds from endowment, campus foundations, and gift funds; and student fees that are not mandatory systemwide student fees but nonetheless support the education of students, such as course materials fees.

The University acknowledges the importance of prioritizing funding for its teaching mission and thus ensures that State and tuition funding leverage considerable additional resources for educating its students.