The Meister Controversy

How Student Fees are Connected to UC Construction Projects

(9 pages with links to 26 background documents)

by Charles Schwartz, UC Berkeley, March 22, 2010

Student Fee revenues are put at risk, through the General Revenue Bonds program, to support construction projects throughout the University of California (UC); and top UC officials appear stubbornly negligent regarding their oversight responsibilities. When we asked whether students' Educational Fees have ever been spent to pay for campus construction projects the official answer came in two contradictory parts:
a) To the best of our knowledge, there has never been such an occasion.
b) The University does not record the data needed to answer that question.
This is an intricate story that is summarized and reviewed here with links to the full documentation.

Summary of Information Gathered

The General Revenue Bond (GRB) program is the major vehicle through which UC raises external financing for capital (construction) projects on the campuses of the University, excluding the Medical Centers. Instead of having each construction project financed by an individual bond, with debt service pledged from that particular revenue stream, this arrangement pledges all revenues from a very large pool. The main motivation for this aggregation of funding pledges is that it increases the University's overall debt capacity and it also lowers the interest rate that would be paid on each individual bond. There is currently $5.852 Billion in such GRB obligations outstanding.

Every major construction project is first approved by The Regents with a primary source of revenue designated as responsible for all debt service (payment of interest and principal on the bonds). However, when packaged and sold as a General Revenue Bond, The Regents provide an Indenture, which pledges that a large stream of UC revenues will be available to insure timely debt service even if that primary source should prove inadequate. Student Fees and Tuition constitute the largest component of that General Revenue. At the close of the last fiscal year, this General Revenue pool of funds amounted to $7.049 Billion, and the largest component came from Student Tuition and Fees, at $2.665 Billion. (In the prospectus for one recent bond issue, I could find no reference to any primary source of payment, only the General Revenues themselves are designated as guaranteeing timely payment of interest and principal; and student fees are most prominently listed among those revenues. See excerpts on page 9 of this paper.)

University officials have stated, at various times in this controversy, that:
(a) UC policy forbids use of Educational Fees for the payment on such bonds.
(b) Educational Fees are not being used for that purpose.
(c) Educational Fees are merely pledged as a backup for the primary source.
(d) Educational Fees have never been used as substitute payment for such bonds.
(e) There is no need for an audit of this system.
(f) There is no need for routine reporting of debt service coverage data.
(g) There is no UC oversight of potential defaults by the primary sources.

Background

In telling this story I rely on a number of documents that have been gathered. These are listed in the Index at the end of this paper, where you may access the documents through electronic links. In this text I shall quote (by "…" or indentation) or paraphrase the most relevant excerpts, with a reference such as [MC1] to the full document in that Index.

Major construction projects – for classrooms, dormitories, research buildings, medical centers, athletic facilities, etc. – if not entirely paid for by state funds or by private donations, are generally financed through borrowing, typically through the issuing of bonds sold in the name of The Regents of the University of California. It used to be that construction bonds were issued for each individual project, or perhaps a group of related projects; but in 2003 The Regents reorganized that entire process by creating two large funding pools: one for all five of the UC Medical Centers and another – called General Revenue – for all other campus-based construction projects. The motivation for this was to enlarge the University's overall debt capacity and to lower the interest rates that would be paid out. [MC1]

This plan, approved by The Regents at their meeting in July 2003, assigned to the General Revenue pool all unrestricted incomes (aside from the Medical Centers' revenues) except for state appropriations. At that time the total amount of the General Revenue pool (for FY 2002) was $3.977 Billion, and the largest single component was listed as Student Tuition and Fees, at $1.299 Billion. [MC1a]

(In the Minutes of that July 16, 2003, regents' meeting one reads [MC1b]:
"Mr. Charles Schwartz, UCB Professor Emeritus, spoke in opposition to Committee on Finance Item 504. *Authorization to Establish Indenture for General Revenue Bonds to Finance and Refinance Debt for UC Projects*, believing that what seemed simply a technical change was a swindle that would direct the revenue stream provided by tuition and student fees toward financing construction projects.")

According to the most recent official report we learn that, "As of November 30, 2009, the University had approximately $10.4 billion (excluding State Public Works Board debt) in debt outstanding." General Revenue Bonds accounted for $5.852 Billion of that and Medical Center Pooled Revenue Bonds accounted for $1.039 Billion. [MC2] Elsewhere one learns that for FY 2009 the overall General Revenues amounted to $7.049 Billion, with Student Tuition and Fees being the largest component at $2.665 Billion. [MC3]

The latest report to The Regents - Annual Report on Debt Capital for FY 2009 [MC2] - has this statement of policy (on page 10), which is most pertinent to the present inquiry.

> While from an external capital markets perspective the University is viewed as a single entity that finances on a consolidated, systemwide basis, internally each project's financial feasibility is assessed on an individual basis. Each campus demonstrates affordability and is expected to maintain certain net debt service coverage from available revenues. Internal financial discipline dictates that the University identify a repayment source for each financing demonstrating sufficient cashflow for debt service.

This concept of <u>a primary source of revenue for debt service on each individual project</u> is key to understanding the Meister controversy. The whole General Revenue pool, so it appears from these documents, is merely a backup (collateral) in the case of a default by that primary revenue source.

This arrangement is delineated in a presentation, "Strategic Uses of Debt", made by the University's Executive Vice President (EVP) and Chief Financial Officer, Peter J. Taylor, to the UC Committee on Planning and Budget on October 6, 2009. [MC4] On page 6 we read:

> Repayment sources must be in accordance with Regent approval and bond indentures. •Student tuition and fees •Indirect cost recovery •Sales and Services -Educational activities •Sales and Services -Auxiliary enterprises •Unrestricted investment income •Other
>
> Each external financing request must identify a specific fund source to be pledged to repay the obligation.

As an example, we note the recent (September 2009) approval by The Regents of plans for two projects supporting the Intercollegiate Athletics program on the Berkeley campus. [MC20] External financing in the amount of $321 million was approved for the improvements of Memorial Stadium and another $136 million for construction of the Student Athlete High Performance Center. These bonds are to be paid off over a 30 year period, with a total cost of over $1 billion. The Regents' approval was based upon the designation that the "Athletics program gross revenues" was the pledged source of repayment.

Meister Speaks and UC Officials Respond

Bob Meister is a Professor of Political and Social Thought at UC Santa Cruz; he is also President of the Council of UC Faculty Associations. He discovered this arrangement of the General Revenue Bonds, with their pledge of using other funds, especially student fees, to back up debt obligations on many University construction projects; and he wrote an article about this, titled, "They Pledged Your Tuition (An Open Letter to UC Students)," on his organization's web site, http://keepcaliforniaspromise.org/ on October 11, 2009. [MC5]

The most provocative element of his writing was the suggestion that rapid increases in student fees were being promoted by UC's top officials for the purpose, in part, of supporting expanded construction activity. This got a heated reaction from the top.

On October 16 UC President Mark Yudof was interviewed by campus newspaper reporters and spoke about Meister's allegations. (As transcribed and published by the Daily Californian on October 19. [MC6])

> Q: … UCSC Professor Bob Meister has, like, written this piece, I don't know if you have heard of it, it's called "They Pledged Your Tuition: An Open Letter to UC Students."
>
> A: It is totally untrue, by the way. …

> It is untrue because we are not allowed to use student fees to pay bonded indebtedness.
> …
> He took two numbers that, you know, that we had pledged toward debt and when the fees were going up. [inaudible] It's just untrue. We're not allowed to use fees for that purpose. The fees are used for operating expenses of the university. The reason we made these pledges, cause it will lower-if you pledge the whole campuses as opposed to just the residence hall, or whatever, it lowers the interest rate which means students pay less for their dorm rooms and the like. It's just not true, flat-out not true; misinformation. …

EVP Taylor gave a somewhat more measured reaction in [MC9] and in his Op-Ed piece dated October 30. [MC11] The following two excerpts are most specific.

> The educational fee – equivalent to tuition – supports university operations, including instruction and support activities. It's counted as general revenue. But, while general revenue is pledged as security for bonds, educational fees ***are not used*** to pay debt service on our bonds.
> …
> Before we sell bonds, we require that an internal source of repayment be identified for each campus project. The primary sources of debt repayment for general revenue bonds are housing, parking and other auxiliaries, approximately 43 percent; indirect cost recovery (grants and contracts), approximately 35 percent; registration fees and student-approved fees that are not educational fees, approximately 10 percent. The remainder comes from a diverse mix of funds, including leasing income and extension fees.

To understand this one must note the University's Student Fee Policy, established by The Regents in 1994 and most recently amended in 2005. [MC22] It defines uses of the Educational Fee as follows:

> In addition to funding programs and services supported by the Educational Fee (such as student financial aid and related programs, admissions, registration, administration, libraries, and operation and maintenance of plant), income generated by the Educational Fee may be used for general support of the University's operating budget. Revenue from the Educational Fee may be used to fund all costs related to instruction, including faculty salaries.

This is distinctly different from the Policy for use of the University Registration Fee, which may be used to support "operating and capital expenses", which benefit students and are complementary to, but not a part of, the instructional program. Thus we see explicit authorization for the use of Registration Fees for construction projects (capital expenses); and the absence of any such authorization for the use of Educational Fees is interpreted by the President and his staff as prohibition of such usage. (This year Registration Fees account for $196 Million and Educational Fees account for $1,631 Million in gross revenues.)

The alert reader will notice a contradiction in the official information displayed above. How can they *pledge* to use Educational Fees in payment of General Revenue Bonds, when The Regents' own policy on Student Fees *prohibits* such expenditure? This very question was voiced by

Professor Meister, speaking to the Regents' Committee on Audit on October 28. [MC10]. No University official, as far as I am aware, has even tried to answer that question.

On that same occasion, Professor Meister also called for an audit of the GRB program to find out if there had ever been any use of Educational Fees for payment of debt service. That request was summarily dismissed by EVP Taylor in his October 30 piece. [MC11]

Schwartz Inquiries

After seeing the paper by Meister and the rapid responses from top UC officials, I began a series of inquiries aimed at clarifying specific aspects of this GRB story. My direct appeals to regents and an exchange of letters with EVP Taylor are contained in the indexed documents and I will here summarize the exchanges.

A standard way of monitoring debt obligations for any enterprise is to look at the "debt service coverage ratio." Take the annual net revenues (gross revenues minus expenditures) and divide that by the amount you are scheduled to pay out in interest and principal on your debts this year. If that ratio is less than 1.0, you are in deep trouble; if it is several multiples of 1.0 you are looking very healthy. For their routine oversight of the five Medical Centers, the UC Regents receive a quarterly status report, which includes, on its first page of data, "debt service coverage" ratios for each one of the individual medical Centers, for the current year-to-date and also the previous one. [MC17] This provides an early warning system in case any one of those businesses gets into financial difficulty that might impact the others.

Why is there no similar reporting – of debt service coverage ratios - for the General Revenue Bonds? If any one of the primary sources was about to fail its debt service obligations, this puts the other revenue sources in jeopardy; and so responsible officials ought to be alert to this problem. This was the subject of my first inquiry addressed to regents [MC7]. The reply I got, from two Vice Presidents [MC8], simply avoided that question and instead went on about how the General Revenue arrangement makes UC look good to the bond market.

Here are the subsequent exchanges with Executive Vice President Taylor.

S. Has there ever been an occasion, under the GRB program, when something other than the original primary source had to be used to provide substitute debt service payments? [MC12]
T. To the best of our knowledge, there has never been such an occasion. [MC14]

S. If such an event were to arise in the future, what is the established process to manage that situation and what reporting mechanism, within the University, is entailed? [MC12]
T. "Charlie, it's hard to speculate about a speculative question. Suffice it to say that we would work with the individual campus in question… Indeed, of the many things about UC that keep me up at night worrying, this is not one of them." [MC14] (In other words, there is no established procedure and there is no reporting mechanism.)

S. I suggest that you ask The Regents to create an appropriate oversight mechanism, and also an early warning system, such as listing detailed debt service coverage ratios in the annual debt

capital report. [MC15]
T. In response, you should be aware that the UC system strictly adheres to the requirements of Rule 15(c) 2-12 of the Securities and Exchange Commission. Attached is a page from one of our offering documents, which describes our disclosure requirements if any one of eleven "significant events" were to occur. [MC16] (This is about disclosures to the bond market and does not at all address the concerns I had identified, which are internal to the University.)

I then made a formal request, under the California Public Records Act, for data showing debt service coverage ratios for each of the outstanding projects under the GRB program. I cited a letter from Taylor to Meister in which he mentioned some such ratios for individual campuses. [MC13] The response I got made it official that there are no such records. [MC21] Here is the precise explanation given.

> The University does not record individual tabulations of each project's debt service coverage. This is because revenues generated by said projects are not the only revenues that can be pledged toward the projects and counted toward a debt service coverage calculation.

This seems to say: All the General Revenue funds (including all student fees) are considered to be in one big pot and we don't care which portion of the money is used to pay off the bonds.

My latest reproach to the regents on this topic was delivered to their Committee on Grounds and Buildings on January 19, 2010. [MC18]

Open Questions and Suggestions

The issue that generated the most heat, between Meister and UCOP, is the suggestion that University officials raise student fees in order to expand their construction projects. This is a question of motives, which I see no way of answering.

What is the likelihood that Educational Fees will be used to pay for some construction debts in the future? Trying to estimate the magnitude of that risk is no easy task. One thing that would help is some information about past experiences with debt service performance on the campuses; and that we do not yet have. Another element is trying to rank the relative vulnerability of the several components of the General Revenue pool; and I think one can say that students' Educational Fees are the most vulnerable to being tapped.

[Q. How can you say student fees are "vulnerable" when we have $7+ billion of pledged revenue to pay $522 million of annual debt payments?

A. We are thinking about what would happen in the future if some primary source of debt payment fails and some of the General Revenues is required to fill the void. There are a total of $7 billion in the whole pool, but lets examine the major components and see which is most likely to be sacrificed for that purpose. It is not just that student fees are the largest component (at $2.665 Billion); it is a matter of internal "political" clout. The second largest component is "Sales and Services of Educational Activities" (at $1.468 billion); this is mostly revenues from clinical practice at the five medical schools. I believe the medical school faculty are a very powerful and self-protecting group, who would strongly oppose having their incomes deprived in order to pay off someone else's debt. (This was demonstrated last July, when President Yudof caved in to that pressure group and exempted this same revenue stream from the paycuts he imposed on nearly all other employees of UC.) The fourth largest component of General Revenues is "Cost Recovery from Contracts and Grants" (at $825 million); this is money greatly prized by the most active research faculty throughout the University and they would not readily agree to have it siphoned off to pay someone else's debts. What's left? "Sales and Services of Auxiliary Enterprises" (at $1.287 billion) is mostly dormitories and dining for students. So, either they get their rates increased, to pay for someone else's debt, or it goes to the general pot of student fees. That is the vulnerability I speak of.]

From the perspective of the bond market, it is clear that the pledge of student fees and the anticipation of that particular revenue stream in the future are great selling points for UC's capital programs. The latest rating of UC's bonds by Moody's [MC23] emphasizes that point.

What mechanisms are now in place to provide oversight, and advance warning, in the potential event that Educational Fees, already pledged as backup for construction projects, might actually be used for that purpose? Here we have firmly determined that there is nothing in place at the level of UCOP or The Regents.

The latest data [MC24] provided by UCOP (on March 5, 2010) shows Revenue Bonds aggregated by Campus for fiscal year 2009. The debt service ratios shown here look reasonable healthy – 1.91 on average – but this tells us nothing about the performance of the individual projects, and their own originally pledged revenue. Such composite data completely hides the very question at the center of the Meister controversy, namely, what is the role, and what is the liability of students' Educational fees?

I consider this a serious neglect of fiduciary responsibilities; and it is worse that top officials seem unwilling to consider any corrective action.

Perhaps it is possible for people to do something about this negligence on each individual campus. Concerned faculty and students could make local inquiries, find the mid-level officials whose job it is to monitor the debt service obligations for each on-campus project, and seek open disclosure of the pertinent data, such as debt service coverage ratios, on a regular basis. (Call this Transparency from Below, when there is none from Above.)

Returning to the parochial issue of the Intercollegiate Athletics facilities' projects at Berkeley: This is a topic under study by a special task force of the local Academic Senate. I note the following that may be of interest to that group. I can find no reference to the General Revenue Pool in the documents approved by The Regents for the funding. Conversely, in the GRB prospectus issued last August there is general reference to athletics facilities but no special identification of the Berkeley plans or the designation of Athletics revenues as the primary source of repayment. It is all the responsibility of General Revenues. (See pages 10, 11 of document MC19, copied on page 9 of this paper.) If it is not too late, perhaps it could be asked that these athletics projects, if they seem to carry significant financial risk, should be placed outside of the GRB pool and handled as special purpose bonds. That could raise the cost (in interest rates) but it would better respect the principle that those who reap the benefit should bear the risk – and not pass that risk off onto some innocent bystanders.

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Index of Documents re the Meister Controversy

MC1 http://socrates.berkeley.edu/~schwrtz/MC/MC1.pdf The Regents establish General Revenue Indenture, July 2003
MC1a http://socrates.berkeley.edu/~schwrtz/MC/MC1a.pdf General Revenues detailed 2002
MC1b http://socrates.berkeley.edu/~schwrtz/MC/MC1b.pdf Minutes of Public Comments July 2003
MC2 http://socrates.berkeley.edu/~schwrtz/MC/MC2.pdf Debt Capital Report, November 2009
MC3 http://socrates.berkeley.edu/~schwrtz/MC/MC3,pdf General Revenues detailed 2009
MC4 http://socrates.berkeley.edu/~schwrtz/MC/MC4.pdf Taylor presentation to UCPB 10/2/09
MC5 http://socrates.berkeley.edu/~schwrtz/MC/MC5.pdf Meister, "They Pledged Your Tuition (An Open Letter to UC Students)" 10/11/09
MC6 http://socrates.berkeley.edu/~schwrtz/MC/MC6.pdf Yudof interview 10/16/09
MC7 http://socrates.berkeley.edu/~schwrtz/MC/MC7.pdf Schwartz letter to Regents 10/15/09
MC8 http://socrates.berkeley.edu/~schwrtz/MC/MC8.pdf Taylor & Brostrom letter to Schwartz 10/19/09
MC9 http://socrates.berkeley.edu/~schwrtz/MC/MC9.pdf Taylor & Lenz press release 10/20/09
MC10 http://socrates.berkeley.edu/~schwrtz/MC/MC10.pdf Committee on Audit meeting 10/28/09: statements by Schwartz, Meister, Rosen
MC11 http://socrates.berkeley.edu/~schwrtz/MC/MC11.pdf Taylor Op-Ed 10/30/09
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MC17 http://socrates.berkeley.edu/~schwrtz/MC/MC17.pdf Medical Centers quarterly report September 2009
MC18 http://socrates.berkeley.edu/~schwrtz/MC/MC18.pdf Schwartz statement to regents G&B 1/19/10
MC19 http://socrates.berkeley.edu/~schwrtz/MC/MC19.pdf Offering of General Revenue Bonds August 2009 (See excerpts on page 9 of this paper.)
MC20 http://socrates.berkeley.edu/~schwrtz/MC/MC20.pdf Regents G&B on UCB Athletics facilities September 2009
MC21 http://socrates.berkeley.edu/~schwrtz/MC/MC21.pdf Formal request for records from UCOP January 2010
MC22 http://socrates.berkeley.edu/~schwrtz/MC/MC22.pdf Regents' Student Fee Policy
MC23 http://socrates.berkeley.edu/~schwrtz/MC/MC23.pdf November 19, 2009, Report by Moody's on their bond rating for The Regents of the University of California
MC24 http://socrates.berkeley.edu/~schwrtz/MC/MC24.pdf Systemwide Summary of Revenue Bonds by Campus FY 2009

Key excerpts from the August 19, 2009, Offering of $1.323 Billion in General Revenue Bonds by The Regents of the University of California:

Page 10:

PLAN OF FINANCE

Financing for New Projects

The proceeds of the 2009 Bonds will be used to finance or refinance all or a portion of approximately 70 projects on all ten campuses of the University of California (the "2009 Projects"). The 2009 Projects are generally described as new facilities, expansion or renovation of existing facilities for student housing, faculty housing, student centers, recreation and events facilities, research facilities, facilities renewal projects, intercollegiate athletic facilities, certain seismic retrofitting improvements, infrastructure projects and certain academic, administrative and other facilities of the University. Pursuant to the Indenture, The Regents may use proceeds of the 2009 Bonds to finance or refinance all or a portion of additional projects authorized by The Regents after the 2009 Bonds have been issued.

Page 11:

SECURITY FOR THE BONDS

Pledge; Definition of General Revenues. The Bonds are secured by a pledge of General Revenues, the proceeds of the Bonds and any other amounts held in any fund or account (excluding the Rebate Fund) established pursuant to the Indenture. As defined in the Indenture, General Revenues consist of certain operating and non-operating revenues of the University as reported in the University's Annual Financial Report, including (i) gross student tuition and fees; (ii) facilities and administrative cost recovery from contracts and grants; (iii) net sales and service revenues from educational and auxiliary enterprise activities; (iv) other net operating revenues; (v) certain other non-operating revenues, including unrestricted investment income; and (vi) any other revenues as may be designated as General Revenues from time to time by a Certificate of The Regents delivered to the Trustee, but excluding (a) appropriations from the State of California (except as permitted under Section 28 of the State Budget Act or other legislative action); (b) moneys which are restricted as to expenditure by a granting agency or donor; (c) gross revenues of the University Medical Centers; (d) management fees resulting from the contracts for management of the United States Department of Energy Laboratories; and (e) any revenues which may be excluded from General Revenues from time to time by a Certificate of The Regents delivered to the Trustee. See "APPENDIX C – SUMMARY OF CERTAIN PROVISIONS OF THE INDENTURE AND THE CONTINUING DISCLOSURE AGREEMENT – THE INDENTURE – Definitions."