

THE UNIVERSITY OF MICHIGAN
REGENTS COMMUNICATION

ITEM FOR INFORMATION

Subject: FY 2014 response to the Budget Development Letter from the
Michigan State Budget Office

Background:

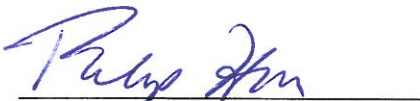
In past years, the university's annual budget request to the state was submitted to the Board of Regents for approval before submitting the request to the State Budget Office.

This year, the State Budget Office changed the process. In late October, all the universities were informed that a formal budget request would not be solicited.

Instead, universities were to respond in a letter with an assessment of the current year's performance funding metrics and suggestions for modification that could be considered in the development of the state's fiscal 2014 budget recommendation. In addition, the budget office specifically asked for details about efforts to control costs in fiscal 2013 and the university plans for new cost control initiatives in fiscal year 2014 and beyond.

As this year's request was not in the form of a substantive budget request, and given the condensed timing to meet the deadline, we responded with a letter on November 16, 2012, as requested, and provide herein as an item for information.

Respectfully submitted,



Philip J. Hanlon
Provost and Executive Vice President
for Academic Affairs

December 13, 2012

Attachment

MARY SUE COLEMAN
PRESIDENT



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November 16, 2012

Mr. John E. Nixon
State Budget Director
State of Michigan
State Budget Office
111 South Capitol
Post Office Box 30026
Lansing, Michigan 48909

Dear Mr. Nixon:

I am responding to your invitation to provide information to the state in support of the fiscal year 2014 budget development process for the University of Michigan – Ann Arbor. In this letter you will find our suggestions on formula funding as well as details of our continuing efforts to contain costs. We have also included information on affordability and on our initiatives for regional economic impact.

We will continue to strive for a budget that strongly supports our core commitments to academic excellence and student affordability, including continuation of our longstanding policy to meet the full demonstrated financial need of all in-state undergraduate students. As careful stewards of public resources we remain focused on and dedicated to prudent and responsible financial planning.

The University of Michigan – Ann Arbor operates in an extremely competitive environment for faculty, students, staff, and research dollars. We recognize the significant efforts the state has made in dealing with uncertain financial circumstances that require hard decisions and thoughtful prioritization of resources. We are appreciative of the recent modest increase in our state appropriation and would like to stress how important it will be to retain this increase as base funding for fiscal year 2014, with additional base increases aimed at achieving the Business Leaders for Michigan's (BLM) funding goal of once again becoming a top ten state in higher education funding over the long term. Like the BLM, we believe that strategic investment in higher education is essential to the future vitality of the state and its economy.

Funding Formula Suggestions

Last year's performance funding model was the result of consultation with many individuals and organizations and eventual compromise. With every new model, understanding the incentives and the outcomes are important. That wisdom should be applied to refine and improve the model so it may better achieve its aims.

Our budget letter last year included the following comments; we believe they are still relevant a year later:

"Formula funding models often favor standardization at the lowest common denominator, ignore economies of scale, and make flawed assumptions about costs being consistent between institutions. They can provide disincentives to excellence and can steer institutions towards uniformity and away from diversity. We believe strongly that the diversity of scope and mission seen among the state's fifteen public universities is invaluable; it is what enables our universities to meet the state's critical goals for higher education. A formula that undercuts the important differences amongst the public universities will harm rather than help the state."

The five components of the performance funding model highlight important areas of effective, efficient and innovative universities: degree production in critical skills areas and in total degrees awarded, on-time graduation percentages, cost conscious use of resources, and the creation of new knowledge through research that spurs economic development.

We believe, however, that the model falls short in several important aspects. First, and most critical, it resulted in one-time allocations rather than base funding. Consistency is the hallmark of prudent budget planning and it is exceptionally difficult to plan for and offer ongoing academic programs without consistent funding. Re-shuffling one-time funding over multiple years means that new initiatives and improvements cannot be introduced and sustained. Thus, we would urge that the formula-based component of the higher education allocation be provided as base funding rather than as one-time support going forward.

Beyond that, three of the five metrics (six-year graduation rate, total degree completions and institutional support as a percentage of core expenditures) require continual improvement in order to receive the maximum level of funding. This approach ignores the high level of attainment that some institutions already enjoy and the ceiling effect that is thereby created. For instance, at the University of Michigan – Ann Arbor, our six-year graduation rate is currently 90.5 percent. The university may achieve incremental improvement, but gains will be modest. To address this problem, we recommend that performance funding be awarded to universities that either show improvement or have achieved a high targeted attainment level for these metrics.

Another serious shortcoming of the current model is that it completely ignores the sizeable population of graduate students that contribute to the state's workforce. These individuals graduate to fill professional positions in the fields of medicine, dentistry, law, business, public health, social work and engineering, as well as contributing to the sciences, social sciences, and the arts and humanities. The University of Michigan – Ann Arbor conferred a total of 5,660 graduate degrees in fiscal year 2012, and these were unrecognized in the performance metrics.

The model makes Carnegie classification comparisons among public institutions, and we support this approach as public institutions are at a disadvantage when private institutions are included, because overall enrollment at private institutions is typically less while the resources they have available are considerably more.

We believe an appropriate tuition level is a decision best left to the individual boards governing each institution. Those board members are in the best position to know the appropriate level of tuition for their institutions. While we acknowledge about one quarter of last year's funding was related to university decisions on tuition increases we would strongly prefer that tuition decisions be left to the institution and allow state funding to be dedicated to the performance components.

Cost Containment Efforts

For nearly a decade we have engaged in aggressive cost containment efforts. In two phases, we achieved general fund recurring expenditure reductions and cost avoidance of more than \$235 million. Phase 1 was implemented between fiscal years 2004 and 2009; Phase 2 between fiscal years 2010 and 2012. As we have described in previous budget letters, we have focused on seven key areas: purchasing, energy efficiency, health benefits strategies, leveraging information technology, enhanced use of other revenue sources, greater productivity of staff, and more efficient utilization of space and facilities. In seeking efficiencies, we adhere to the following principles:

- Protect and invest in our core educational and research missions
- Remain competitive for the best faculty/staff/students
- Leverage our size and scale
- Maintain high quality essential services
- Eliminate duplicate and lower priority activities
- Shift costs from the general fund to other funding sources, where appropriate
- Avoid short-term reductions that will raise costs or undercut quality in the long-term
- Introduce centralization and greater sharing of resources in cases where this will result in higher quality services and/or more effective use of high quality facilities

- Consider insourcing and outsourcing, when it leads to improvements in service or lowers costs
- Take advantage of advanced technologies to achieve efficiency of operations

These principles have led us to pursue a broad range of cost containment initiatives in our operational areas. For instance, we have controlled energy consumption and corresponding costs through the installation of new campus systems, retrofitting existing facilities to achieve efficiencies, advanced energy purchases, and programs that encourage behavior change in our faculty, staff, and students. We have chosen to self-insure in select areas, including health programs and investment opportunities with insurance reserves. We have aligned our benefit offerings with the market and ensured appropriate levels of cost sharing with employees, who now pay on average 30 percent of health care costs.

We are now entering a new phase of our efforts (Phase 3), targeting an additional \$120 million in recurring revenue enhancements and/or general fund reductions by 2017, through additional cost containment, an emphasis on philanthropy for key priorities, and development of alternative revenue sources, as shown in Figure 1. To achieve this new goal we will need to look deeper into the academic enterprise for efficiency opportunities, but we will continue to make every effort to protect the excellence of the educational experience as we make reductions.

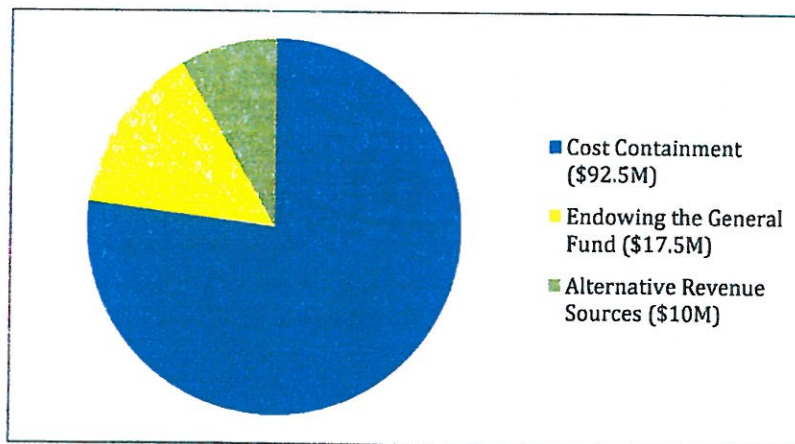


Fig. 1: Phase 3 General Fund Reduction Plan, Targeting \$120M (FY2013-2017)

As a first step in Phase 3, we have identified and implemented recurring reductions and reallocations of more than \$30 million this year (fiscal year 2013), as shown in Figure 2. We have restructured departments leading to decreases in administrative services costs; implemented strategic sources for computers, office supplies, and janitorial supplies;

consolidated staff and deployed inventory control in our facilities operations; and put in place a range of other cost-cutting steps, such as reducing travel expenditures, extending equipment replacement cycles, consolidating leases, and eliminating certain programs and workshops.

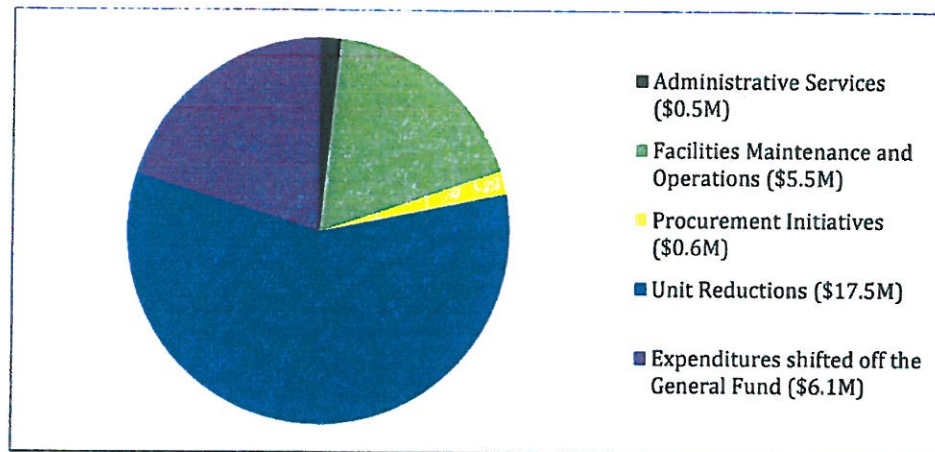


Fig. 2: General Funds Reductions Implemented in FY2013, \$30M

Moving forward, we are currently implementing a major initiative to rationalize, remove redundancy from, and thus lower the costs of our IT services across campus. This initiative will be implemented over multiple years, with the initial projects rolled out in fiscal years 2013-2015 and focused on a consolidation of desktop, network, server, storage, security, and helpdesk support into a single organization.

A second major initiative is in the area of administrative services. A detailed study of our provisioning of human resources and financial operations services identified the potential for increased efficiency through consolidation of many activities in a shared services organization, which we are now working to design. We will also continue to expand our strategic sourcing program.

Working to achieve this level of cost containment has been both difficult and disruptive, but also necessary for us to achieve our central goals:

- offering excellent, innovative educational programs that enable our students' long-term success and ensure the value of their education;
- attracting and retaining world-class faculty on the Ann Arbor campus; and
- providing a high level of financial aid to our students so that a University of Michigan education remains accessible.

Mr. John E. Nixon
Page Six
November 16, 2012

Consistently cutting and reallocating at a level higher than our rate of new investment will ultimately have a negative impact on the quality of the institution, but we are committed to doing everything we can to operate as efficiently as possible.

Now, I would like to turn to two topics that I want to continue to emphasize, even though they were not included in your request. Both constitute a sizable amount of work that we are also committed to performing at a very high level.

Affordability

U-M has protected its commitment to keep a high-quality Michigan education accessible to academically qualified Michigan students, regardless of family income – even while state funding has dropped precipitously on a per student basis (see Fig. 3). U-M meets 100 percent of demonstrated need for all admitted in-state undergraduate students. This assures prospective students that if they are admitted, they can afford to attend the university.

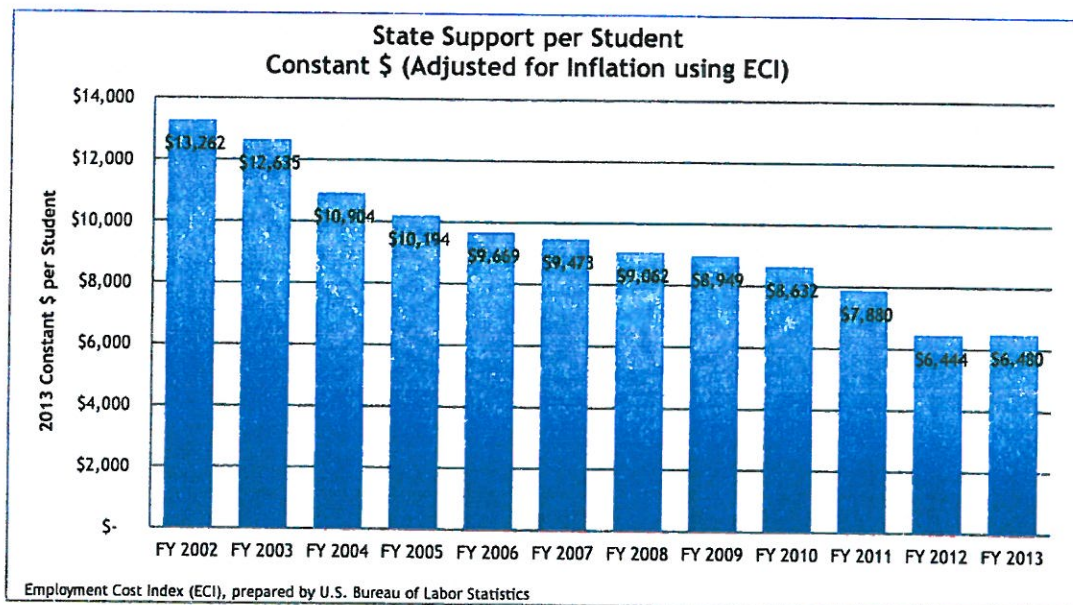


Fig. 3: Decline in State Support per Student

Last year, U-M assisted in-state undergraduate students and their families by packaging more than \$110 million in grants and scholarships. This total includes \$84.3 million from U-M sources, \$18.4 million from federal sources, \$6 million from private sources, and \$2.3 million from the state of Michigan. The typical Michigan student with a family income less than \$20,000 had all of his or her costs covered—for tuition, room and board, textbooks, and incidental—and needed no loan. Typical packages for middle-income families included need-based loans in the range of \$2,600 to \$4,100 for the current year.

Continued investments in financial aid by U-M means that Michigan students with need have actually seen decreases in their loan burden, as shown in Fig. 4. Today, it costs less for the typical undergraduate from a Michigan family with low to moderate income to attend U-M than it did in 2004.

U-M has been a leader in constraining growth in net price: The Department of Education's recent report on College Affordability shows that U-M's net price change was lower than 567 of 650 institutions in the public four-year category.

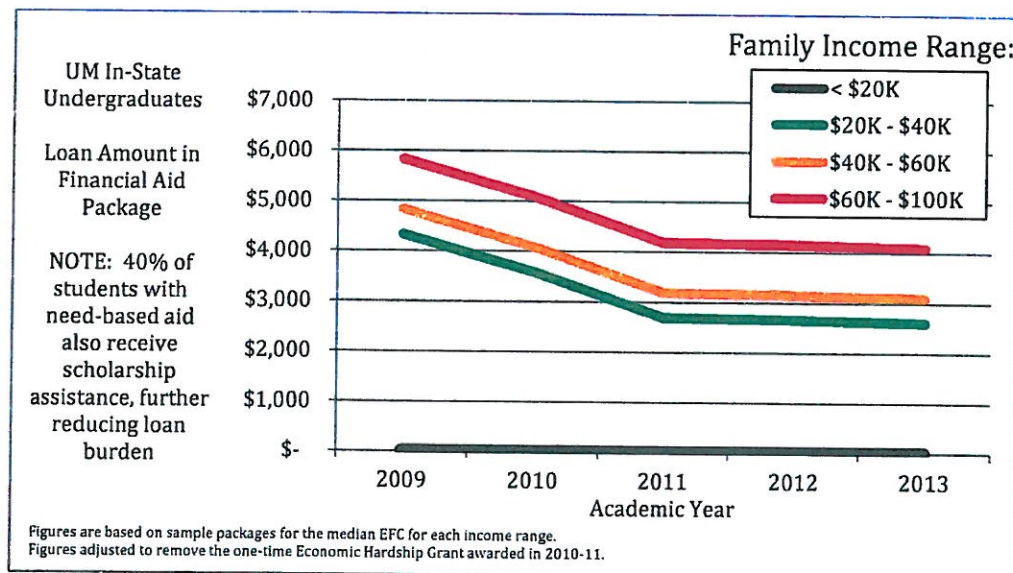


Fig. 4: Packaged Loans for Michigan Students

Growth and Regional Economic Impact

Economic development is a key part of the University of Michigan's public mission, and a direct result of maintaining a high quality academic enterprise. The university's reservoir of talent and ideas sustains an ecosystem for innovation aimed at economic transformation and growth for the region and the nation. "Great ideas change everything" is the theme of the University of Michigan's Entrepreneurship and Innovation website, www.innovate.umich.edu, where these efforts are compiled.

As part of its commitment to economic development, the university is embracing and strengthening its relationships among academia, industry, and government. Through business engagement, technology transfer, industry partnerships, student internships, entrepreneurship and community assistance, the university is continuing to put resources toward addressing our region's economic challenges. Over the last year, the university took several new steps to facilitate partnering for economic development.

With the support of U-M and other universities, this region is poised to become a major industrial cluster that will define and spearhead the next generation of American advanced manufacturing not only in transportation, but also in renewable energy, chemicals, pharmaceuticals, and other areas where manufacturing expertise is a key to success. U-M is one of six universities involved in the Advanced Manufacturing Partnership (AMP), a national working group advising the White House. U-M hosted a regional meeting of the group last December.

In March, the university launched the Michigan Investment in New Technology Startups (MINTS) program, which will provide up to \$25 million from the university's endowment over the next 10 years to help nurture venture funded start-up companies based on technology developed in U-M laboratories.

The Michigan Research Advantage IP Program, also announced in March, offers our major industrial partners the opportunity to negotiate terms for ownership of intellectual property at the outset of a long-term research program, instead of after the IP has been created. This program, which lowers the barriers to creating university-industry research partnerships, is part of a broader Michigan Research Advantage Program aimed at facilitating ties to industry.

Just five years ago, U-M launched the Business Engagement Center (BEC) as a "front door" for companies seeking access to university expertise and other resources. Along with its affiliated offices in the College of Engineering and the Medical School, and at the Flint and Dearborn campuses, the BEC now maintains relationships with more than 1,000 companies. Nearly 200 new companies contact the BEC each year. This year, the university took a lead role in

Mr. John E. Nixon
Page Nine
November 16, 2012

establishing a state-wide network aimed at connecting six Michigan universities with industry, funded by the Strategic Fund-Michigan Economic Development Corporation, and called the Michigan Corporate Relations Network.

Commercialization of university research is creating jobs and improving the quality of life for the residents of Michigan. Here and across the globe, more U-M technologies were licensed to companies in 2012 than ever before. U-M Tech Transfer created 123 licensing agreements with industry, including 11 new start-up ventures. Researchers reported 368 new inventions in fiscal year 2012, another record high, demonstrating the broadened participation of U-M faculty in tech transfer activities. Eleven new startup ventures, eight of which are headquartered in Michigan, were launched in fiscal year 2012 with the guidance and resources of Tech Transfer's Venture Center. The Venture Center, a one-stop hub for entrepreneurs and investors looking for startup opportunities based on U-M research, has launched 98 new companies in the last ten years, an average of one every five weeks. The university also reported that 101 U.S patents were issued in fiscal year 2012, and \$13.4 million in licensing royalties were received, providing funds to reinvest in research and innovation. The Venture Center opened an Accelerator on the North Campus Research Center (NCRC) campus to provide world-class lab and office space. Here our faculty can start their own companies while accessing expert help in being successful. Less than two years old, the Accelerator is at capacity, with 18 companies based on technology developed by faculty from five U-M schools.

This fall, the first students enrolled in an innovative professional master's degree in entrepreneurship developed by the College of Engineering and the Ross School of Business. With more business content than a typical master of engineering and more startup content than a typical MBA, it educates students on forming and managing high-growth potential, scalable businesses. The Zell Entrepreneurship and Law program is preparing law students to serve both start-up and existing entrepreneurial businesses and is establishing a clinic to provide free legal advice to student entrepreneurs across campus.

Partnering with other universities, industries, governments and foundations is another way that U-M is leveraging its efforts in economic development. Founded in 2006, the University Research Corridor is a collaboration of Wayne State University, Michigan State University, and the University of Michigan to strengthen the role the state's top research universities play in helping transform the state's economy through their educational and research programs.

The University of Michigan also administers and leads the fundraising for a state-wide consortium of public universities to promote regional economic development and entrepreneurship, called the Michigan Initiative for Innovation and Entrepreneurship (MIIE). Funding from the Michigan Economic Development Corporation, as well as Mott, Dow and NEI foundations, matched with resources and funding from universities and private businesses, has fueled six MIIE award cycles. Some \$5.38 million has been granted to 105 projects at 13 universities to commercialize research and encourage public and private collaboration in

Mr. John E. Nixon
Page Ten
November 16, 2012

Michigan. MIIE expands on the success of the Michigan Universities Commercialization Initiative (MUCI), funded by the state, which in its first ten years distributed more than \$8.1 million to tech transfer projects, which led to over \$401 million in follow-on funding. MUCI and MIIE together have fostered 62 start-ups.

The breadth and depth of the university's research portfolio, with record research expenditures of \$1.27 billion in fiscal year 2012, is the foundation of our economic impact in our state and beyond. It yields hundreds of ideas and thousands of graduates annually who contribute to economic development. In a move designed to fast-track more research from the lab to the real world, U-M was named one of two new nodes of the National Science Foundation's Innovation Corps program, designed to train scientists and engineers how to extend their focus beyond basic research and toward practical applications that have value in the marketplace.

Conclusion

Over the past decade, we have relied heavily on internal reallocation and cost containment to mitigate the effects of rising costs and the simultaneous reduction in state support. The environment for recruiting and retaining faculty remains fiercely competitive, the needs of our student body continue to grow, and we must continue to ensure that qualified students of all economic backgrounds are able to attend the university.

Maintaining our position as one of the best educational and research institutions in the world is essential. It is critical to our ability to continue supporting the state's economic transformation and recovery, and to our ability to ensure that our students leave the University of Michigan with the knowledge and skills they need to succeed and become leaders in the 21st century. Strategic investment in higher education is essential to the future vitality of the state and its economy, and we hope that the state will partner with us to work towards a bright future.

Sincerely,

A handwritten signature in dark ink, reading "Mary Sue Coleman". The signature is fluid and cursive, with a long horizontal line extending to the left from the first letter "M".

Mary Sue Coleman
President

MSC/RPF/plk