Minutes*

Senate Committee on Finance and Planning
Tuesday, February 22, 2005
2:30 – 4:15
238A Morrill Hall

Present: Charles Campbell (chair), Rose Blixt, Arthur Erdman, Daniel Feeney, Steve Fitzgerald, Lincoln Kallsen, Thomas Klein, Joseph Konstan, Michael Korth, Richard Pfutzenreuter, Charles Speaks, Kate VandenBosch, Michael Volna, Warren Warwick

Absent: Calvin Alexander, Kendal Beer, David Chapman, Scott Fine, Seth Haskell, Joshua Jacobsen, Ian McMillan, Kathleen O'Brien, Diane Parker, Terry Roe, Thomas Stinson, Alfred Sullivan, Susan Van Voorhis

Guests: Associate Vice President Steve Cawley (Office of Information Technology); Senior Vice President and Provost E. Thomas Sullivan

[In these minutes: (1) annual capital financing and debt management report; (2) annual financial report; (3) update on the new financial system; (4) update on strategic planning]

1. Annual Capital Financing and Debt Management Report

Professor Campbell convened the meeting at 2:30 and turned first to Vice President Pfutzenreuter for a discussion of the Annual Capital Financing and Debt Management Report.

Mr. Pfutzenreuter distributed copies of a set of slides that had been used to make this report to the Board of Regents in December and turned to a page that contained a histogram with the University's projected debt levels for the next 36 years (assuming no additional debt is incurred). The total debt is about $726 million. The weighted average cost of capital is 4.4%; the average life of the debt is 11.2 years, and 93% of the debt is at a fixed rate. The University has debt at a low interest rate and short life, Mr. Pfutzenreuter told the Committee. As a matter of policy the University sells debt for 20 years, but it structures the P&I payments to pay it off faster in order to recycle the debt.

Mr. Pfutzenreuter reviewed the University's credit ratings from Moody's (Aa2) and Standard and Poor's (AA). These are excellent ratings, he said, and the University has had them for quite awhile. He also reviewed the factors that go into a credit rating for a university; they include student demand, financial statement analysis, state support, and management analysis. Debt capacity is not fixed or a function of ratios but depends on a lot of other assessments by the rating agencies.

Professor Speaks inquired if any of the top-30 research universities are rated only "adequate" or worse. Mr. Pfutzenreuter said that only two public institutions (Texas and Michigan) are rated AAA; most of the University's peers are in the excellent category, like Minnesota.

Mr. Pfutzenreuter reviewed quickly a few more complicated analyses of the credit rating and noted the charts comparing Minnesota with some of its peers. There is nothing going on in any of the

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analyses, he said, that suggest the University will go down in its overall ratings—or that it will go up. The rating agencies are very pleased with the University's position.

How much would state support have to decline in order to drive the University's ratings down, Professor Campbell asked. That factor is balanced by high student demand and the fact that tuition, in the view of rating agencies, has not gone "off the chart," Mr. Pfutzenreuter said. They see the University's market position as very good and will be pleased to see that the University may get back some of the state funding it lost.

In response to questions from Professor Erdman, Mr. Pfutzenreuter explained that even though California high debt per student (a negative factor in ratings), the total resources in the California system overshadow all else. The "resources" category includes all that the University earns—the income on its financial statement—although it probably does not include money from the Foundation. The agencies do look at Foundation numbers when looking at debt capacity. Mr. Volna explained that if the Foundation assets increase, that is a future gain for the University, but it only receives $X million per year from the Foundation.

Professor Speaks asked what would happen if the University's rating dropped from excellent to good—and what likelihood is there that that will happen. Mr. Pfutzenreuter said that interest rates are so compressed right now that a drop from excellent to good (that is, a drop of one step on the scale) would have little effect on the interest rate the University would have to pay on debt. He said he sees no evidence that the University's rating will drop. There is no concern on the part of the agencies about the increased debt that will be required by the University's capital plan.

Do unsecured bonds (such as might be issued for a stadium) affect the University's rating, Professor Campbell asked? The rating agencies like the stadium proposal because it targets new revenue streams to pay the debt, Mr. Pfutzenreuter said—it will increase both debt and revenue. They do NOT like such proposals when there is no funding plan. There has been talk about not having the full faith and credit of the University behind stadium bonds, Professor Konstan recalled, so if revenues are not adequate, payment of the debt could be at risk. That might mean the University will have to pay a higher interest rate but the arrangement protects the core of the University. Is that still an option? It is, Mr. Pfutzenreuter said. The Board of Regents has established two categories of debt, core debt and subsidiary debt with a revenue stream. The two together still affect the University's credit rating and debt capacity.

Is it possible to identify the weighted dollar value of a change in the credit rating, Professor Konstan asked? If the University were to issue debt for a stadium, which debt knocked down the credit rating, would it be possible to attach the increased cost of University debt to the project? Mr. Pfutzenreuter said he could model such a proposal but he would not know what assumptions to use. Linking it to a percent change in rates would be arbitrary, Mr. Pfutzenreuter said. Mr. Volna added that when interest rates are compressed there is only a miniscule difference between ratings; it would not be worth the extra effort to get into the top ranking and a slight drop would have almost no effect. It would not be worth the work the University would have to do in order to climb from the excellent to the exceptional category. It would be possible, Mr. Pfutzenreuter said, if the University paid off its existing debt and took on no more—but that must be compared with what the University would get if it built a new research building or something else. It would not be worth trying to improve the rating, he concluded. And the University would take a beating politically and reputationally if it let the rating drop.

Professor Campbell thanked Mr. Pfutzenreuter for his presentation.

2. Annual Financial Report

Mr. Volna next reviewed the University's Annual Financial Report. 2004 was an excellent year for the University financially, he said. Finances are not the only way to look at the University, he cautioned, it is only one piece of the picture, but it ties to the institution's ability to fund construction, debt, and so on.

The University saw a net increase in assets of $239 million. That does not mean there was additional money to spend but it does reflect the fact that tuition revenue was up (by $59 million) and operating expenses were down (by almost $20 million). Of the $239 million increase in assets, $93 million was in unrealized investment gains; another $63 million was in grant funding. Other revenue and expense changes reduced the gain by $48 million, resulting in the total of $239 million.

Professor Konstan expressed surprise that expenses only increased by $48 million. That seems low, he said; what happened? Why weren't expenses up $200 million? If grant revenues go up, expenses go up along with them; tuition increases are related to salary increases. Mr. Volna pointed out that there was a salary freeze.

Mr. Klein asked for an estimate of the respective amounts of realized and unrealized gains; Mr. Volna promised to provide the information.

If the University's assets increased by $239 million, Professor Speaks asked, what is the argument with the Governor and legislature that the University is in trouble and needs an increased appropriation? Mr. Volna said the Board of Regents asked the same question. One reason for the increase was that investment returns—where they aim to get 8-9%--were almost 20% last year. That, however, can't be predicted or banked on. Expenses went down, just as the University promised they would. In the case of tuition, Mr. Kallsen noted, the increases were both in volume and rate. Professor Konstan said that the message is that the University was planful, and decided to defer money for raises until it had the cash in hand (from tuition increases) rather than start spending it in the first year of the biennium (when the revenue was more uncertain). That suggests that the University expects to use up those assets in fiscal 2005 (which was the plan) and may well see negative asset growth as that money is spent. The snapshot makes it look like the University has money, but this was planned and is an artifact of looking at things in the middle of the biennium rather than at the end.

When the University goes through a cut of $185 million, one expects the reductions in expenses to be gradual, Mr. Volna said. It is not possible to make cuts of that magnitude quickly in an organization this complex. No one expected expenses to drop as fast as they did—a corporation probably could not react as fast as the University did. If the University had acted more slowly, the asset numbers would have looked different.

Various questions were addressed to Mr. Volna about the information on some of the slides, copies of which he had distributed. Does the University receive capital project funds when it spends the money? The University does not record it as revenue until it is eligible to draw it from the state; it is like sponsored projects money: it is earmarked and can't be drawn until it is spent. Is depreciation charged? Or if not, do property, plant, and equipment go to zero value the next year? These items are depreciated over time. Auxiliary units set aside funds for depreciation because they are expected to pay for buildings in the future. Only 20% of the University's expenses are identified for research. That seems odd, since the University also spends state funds on research; is this a result of the accounting system or is research being under-counted? It is not; there are national standards on how to identify expenses, standards that the University follows. What about faculty salaries—are they counted one-half for teaching and one-half for research? That depends on effort. What about non-sponsored departmental research? That depends on how a department codes expenditures in CUFS accounts. The History Department, for example, might not receive a lot of external grant funding but the History faculty certainly do research and they are paid by O&M funds; is there work coded as research? That depends entirely on how the department sets up accounts.

Professor Campbell thanked Mr. Volna for this report, and continued the discussion with him on the next item.

3. Update on the New Financial System

Mr. Volna distributed copies of slides providing information on the new financial system. He reviewed the goals of the system, the phases in which it has been and is being implemented, and the plans for achieving full implementation by July 1, 2007.

Professor Speaks asked if the new system is being funded entirely by the enterprise tax. Part of it is being funded that way, Mr. Volna said. Mr. Cawley reported that part of it is being funded by an O&M allocation to his office. Professor Speaks asked if they anticipated the enterprise tax would increase. They do not, Mr. Volna said; they have modeled how long the enterprise tax will have to be continued to pay off the cost, but there has been no whisper of increasing the tax. What is the tax based on, Professor Speaks asked? If on salaries, the revenues from the tax will go up even if the rate does not because salaries will increase. For example, the 10% increase in graduate student pay will mean a 10% increase in the tax revenues from those salaries. Ms. Blixt affirmed that the tax is on active salaries paid the previous month. So the decision on increasing graduate student salaries will hit departments twice, Professor Speaks observed—they must pay students 10% more plus pay a higher enterprise tax.

Professor Campbell asked if funds for the new system are included in the biennial request. Mr. Volna said they are but he did not know if the University would receive the money. Presumably there will be no need for internal taxes for this purpose if the system were to be paid for by state funds, Professor Campbell commented. Mr. Volna said the state has been interested in the project.

Professor Konstan said he thought the project was going along well. He asked if the fundamental concepts in the new system are different. Some are, Mr. Volna said. What is the schedule for training time in 2007-08, Professor Konstan asked? Mr. Volna said he could not say at this point but that training has been part of the project from the very beginning. He said they expect that departments will do more training for this system than they did for CUFS. How flexible is the system if there is a change in federal policies, Professor Konstan asked? For example, there are NIH funding modules that do not have restrictions. Mr. Volna said he could not speak to that particular example but the chart of accounts system capability will be much more robust than it has been with CUFS.

Professor Campbell thanked Mr. Volna for the presentation.

4. Update on Strategic Planning

Professor Campbell next welcomed Provost Sullivan to the meeting to provide an update on strategic planning.

Provost Sullivan reported that the strategic plan has been presented to the Board of Regents and was received enthusiastically. There will be a final resolution at the March Board meeting to accept or approve the plan. The second stage is that the President has appointed two task forces, one on the academic side (of which he serves as chair) and one on the administrative side (which is chaired by Vice President O'Brien and Executive Associate Vice President Sullivan). The latter will be looking at efficiencies and economies that the University can achieve, and it is expected that any savings will be reinvested in the academic side. The President will have the reports from the two task forces by March 21; the month after that will be used for consultation. The final recommendations will go to the Board of Regents in May and June—while the University and the legislature are still in session. The process will be entirely transparent, he said.

The academic task force is focusing on three areas, Provost Sullivan said.

-- the design of the University: if it has the right academic clusters to be in the top three public research universities

-- admissions: how the University recruits, admits, enrolls, advises students, and including its use of financial aid, in order to achieve better retention and graduation rates; they are looking at University-wide experiences that would enhance the student experience and performance on outcomes

-- faculty culture: does it have the right culture to identify, recruit, hire, reward, and retain the very best faculty to achieve the University-wide goal? This includes compensation, benefits, prizes, endowed chairs, and so on.

All three of these items involve looking at the whole University. This will be an ongoing work in progress, Provost Sullivan said, a multi-year process that they hope their successors continue to look at. They cannot accept the status quo if the University is to achieve its goal.

Professor Konstan said this is a challenging task, and more challenging because there is no answer to the question of how the University does things. There could be 87 faculty cultures at the University. If one includes the recruitment, retention, and funding of graduate students, there may be over 100 cultures. The question is how to dip below the level of the dean to identify what happens in departments. One will not see that in college-level reports. How will that be done? What they will try to do, Provost Sullivan responded, is instill a sense of urgency about implementing the strategic values and make the point day to day. He will do this through the compact process—the strategic plan is being applied to the compact process and colleges need to respond to it. He said he hoped it will be applied at the department level. The rhetoric and theory must be applied in day-to-day practice. He said he knows that observation will not be 100% but the organizational culture must change.

It boils down to five action strategies, the Provost said: recruiting and retaining strong students, recruiting and retaining strong faculty, looking at the organizational culture and changes that must be made to accompany the goals, a communications strategy (if there is not communication both internally and externally, a lot will be lost), and how to manage the infrastructure as a platform for human capital. The University must work on all five simultaneously or it will not be successful.

Professor VandenBosch said that the academic clusters will generate the most anxiety; once announced, what mechanism will there be for feedback? They are still working on that, Provost Sullivan said, and the feedback will take place after March 21, once the President has decided which of the recommendations from the task forces he will accept. The exchange of information will be two-way in the consultation process before the final recommendations go to the Board of Regents.

Professor Erdman noted that a number of things are going on simultaneously, including the compact process and the strategic planning effort. How independent are they and are the task forces receiving information about them. Provost Sullivan said that decisions will be aligned—the biennial request, the capital request, the budget, and so on. The strategic planning process will include all decisions that must be made. The academic task force is making decisions at a different level from the colleges, Professor Erdman observed, and it could be that colleges are moving ahead on plans and decisions that may turn out to be contrary to the recommendations of the two task forces. At present everything is at the conceptual level in that academic task force, Provost Sullivan said. He goes across meetings and serves as the conduit between groups.

As a research university, the University aspires to be among the top three public institutions in the world, so one would expect to see more overtly stated about research in the plan, Professor Campbell said. The whole theme of the document is research, Provost Sullivan said. He believes that research bubbles up from the faculty and the University must be careful about identifying research from the top down.

What will it take to get state-level buy in, Professor Konstan asked? Seeing the articles in the paper, it appears the view is that the University should not be a top-ranked institution if it means "my kid can't go there." Legislators seem to say that the state can't afford a top-ranked university and one that is good enough will do. Good enough is not good enough, Provost Sullivan said. The legislator has thwarted efforts to save money by closing or changing in the past, Professor Konstan said; can the institution make changes without state buy-in? The Committee discussed this issue with the Provost, who concluded that the University will fall behind if it does not move forward, and it must have the resolve to do so. Modesty and humbleness are desirable personal attributes but they are not good for a university.

Professor Campbell thanked the Provost for joining the meeting.

Professor VandenBosch reported that she and Professor Roe have been appointed to the administrative strategic planning task force as a result of inquiries by the Faculty Consultative Committee.

Professor Campbell adjourned the meeting at 4:15.

-- Gary Engstrand

University of Minnesota