

UNIVERSITY OF CALIFORNIA, ACADEMIC SENATE

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Chair of the Assembly and the Academic Council
Faculty Representative to the Board of Regents
University of California
1111 Franklin Street, 12th Floor
Oakland, California 94607-5200

May 6, 2010

PRESIDENT YUDOF
UNIVERSITY OF CALIFORNIA

Re: Report on UC's Indirect Cost Recovery Practices

Dear Mark:

At its meeting on April 28, the Academic Council unanimously endorsed the recommendations of a joint UCORP-UCPB report on the University's indirect cost recovery practices. The report recommends that UC review its current ICR model and make changes to it, including negotiating higher rates with federal agencies, reexamining the University's waiver policy for other funding sources, and increasing efficiencies.

I believe that you will find this report to be valuable. Please do not hesitate to contact me if you have any questions.

Sincerely,

A handwritten signature in black ink, appearing to read 'Henry C. Powell'.

Henry C. Powell, Chair
Academic Council

Copy: Academic Council
Martha Winnacker, Academic Senate Executive Director

Encl.



UNIVERSITY COMMITTEE ON RESEARCH POLICY (UCORP)

Greg Miller, Chair

grgmiller@ucdavis.edu

UNIVERSITY COMMITTEE ON PLANNING AND BUDGET (UCPB)

Peter Krapp, Chair

krapp@uci.edu

Assembly of the Academic Senate

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April 2, 2010

**HARRY POWELL, CHAIR
ACADEMIC COUNCIL**

RE: UCORP-UCPB joint subcommittee on Indirect Cost Recovery

Dear Harry,

The University Committees on Planning and Budget and Research Policy (UCPB and UCORP, respectively) have worked together this year through a joint subcommittee to re-investigate UC's indirect cost recovery (ICR) practices, the third such Senate investigation this decade. We conclude, as did our predecessors, that ICR practices are perennially confusing because they are habitually obscured and each new committee membership must re-educate itself about cumbersome and technically challenging bureaucratic processes. Clear ICR accounting and explanations would serve both faculty and administrators well.

We found that ICR funds are increasingly important to the UC budget, and that they are increasingly spread thin. When UC is unable to recover the true costs of research, it strains other funding sources and the campus community.

We recommend renewing efforts to raise UC's negotiated rates, revisiting UC's waiver policy, and examining ways to increase efficiencies. We ask that the Academic Council endorse these recommendations and forward them to the President for adoption.

Sincerely,

Greg Miller, Chair
UCORP

Peter Krapp, Chair
UCPB

cc: UCORP
UCPB

Martha Winnacker, Executive Director, Systemwide Academic Senate

Encl.

Report of the 2009-2010 Joint UCORP-UCPB Committees on Indirect Cost Recovery

April 2010

According to the 1960 California Master Plan for Education, UC is designated “the State's primary academic research institution”. Research is one of UC’s hallmarks, and one of its greatest benefits to the state. But conducting research costs the University a considerable amount of money. In addition to direct costs of each project, these include real and necessary expenses not attributable to any one project. They include laboratory space and utilities (heating, lighting, water, ventilation), hazardous waste disposal, campus security and fire protection, libraries, radiation safety, occupational safety, disaster preparedness, liability insurance, compliance with rules and laws, and administrative services. Thus Indirect Cost Recovery (ICR) is a topic at the heart of our university: it touches on the general ledger, payroll, space planning, plant assets, debt management, equipment management, research support, environmental health and safety, janitorial services, books, etc. Research comprises about 25% of the UC budget. Each year, UC spends \$5.2 billion on research and recovers about \$700 million in ICR. Though ICR is a considerable source of funding, long-term reductions in state support had deleterious effects on UC's research mission, forcing it to cover from operating funds a growing share of its facilities and administrative costs related to research. In its periodic observation of ICR, the Academic Senate has grown uneasy with the gap between funds available to support research facilities and administration, and actual indirect costs of research. UCPB also notes a simultaneous increase in reliance on ICR funds to support activities that are associated less with research. Thus it is crucial to establish a better understanding of a) how reimbursements for overhead are generated and allocated, and b) the true cost of research at UC.

The impetus for this update and summary of earlier Senate reports on ICR comes from a continuing dissatisfaction among faculty with respect to the opacity of the process by which ICR is generated and distributed, coupled with a sense that research infrastructure is not being supported effectively. The net recovery of indirect costs is well below the actual overall cost of supporting research at UC (see appendix). The lack of transparency in the allocation processes on the campuses is partly due to the fact that every grant is different and places different demands on institutional resources. During 2007-08, the University Committee on Research Policy (UCORP) initiated an ICR investigation recommended by the previous UCORP and approved by the 2006-07 Academic Council. To this end, UCORP agreed with the University Committee on Planning and Budget (UCPB) to create a joint subcommittee.

However, the 2007-08 joint subcommittee of UCORP and UCPB was unable to complete its report; although ICR funds are categorized according to formula, the data provided were neither comprehensive nor conclusive. After the work of that prior joint subcommittee stalled, annual reports for both committees

recommended that ICR be taken up again. The present overview is the result of collaboration between UCORP and UCPB during 2009-10.

Indirect Cost Recovery

UC Core Funds come mainly from the state legislature (State General Fund), educational fees, and the general fund component of indirect cost recovery; the last category comprises reimbursements by research sponsors for expenses known as indirect cost, overhead, or facilities and administrative cost (F&A). Federal research sponsorship obeys rules laid out in the Office of Management and Budget Circular OMB A-21, *Cost Principles for Educational Institutions*.¹ Financial basis for ICR is a set of audited data for nine cost pools in two categories: facilities (buildings and improvements, interest, equipment, operations and maintenance, and library) and administration (general, departmental, sponsored projects, and student services). The latter category is capped: regardless of actual cost, the four administrative pools together cannot collect more than 26 cents of ICR for every dollar of direct grant costs.

After the federal government, universities themselves are the second leading sponsor of research conducted on their campuses, funding a share that equals the combined total of state, industry, foundation, and other non-federal support. Within UC, federal ICR follows a path that varies somewhat on a campus-by-campus basis. In 1990, the state approved legislation authored by Senator John Garamendi, authorizing the use of indirect cost reimbursements for the construction and maintenance of certain research facilities; “Garamendi Funds” service bonds used to build research infrastructure. The remaining funds are distributed according to a formula established by UCOP and the campuses in the 1990's. Approximately 20% of the federal ICR remaining is classified as Off-the-top Funds (OTT), to be used mainly for proposal and financial support services. Another 35% is classified as Opportunity Funds (OF) and the remaining 44% is classified as UC General Funds (referred to in some older documents as Offset to State Support). UCOP retains 6% of some of the funds classified as OTT, OF, and/or UC General Funds. ICR on state grants and contracts follows varied pathways, and in general is assessed at a lower rate than that for federal grants. At the Chancellor, Provost, Dean and Department levels on campus, some ICR is retained for infrastructure use and some is passed on. Uses of ICR include commonly used infrastructure, services, and equipment; recruitment and retention, especially start-up expenses; cost-sharing and operating costs for multi-disciplinary units; and supporting the research infrastructure with accounting, human and animal review, telephones, and other expenses "unallowable" on direct costs. The history of indirect costs over the past decades has been one of increasing decentralization, with control of these funds delegated from OP to

¹ <http://www.whitehouse.gov/omb/rewrite/circulars/a021/a021.html>

the campuses, and from central campus administration to divisions or departments. How recovery is distributed is a matter not of Federal regulations or accounting, but of campus governance.

It strains other funding sources when UC is unable to recover the true costs of research. This leaves UC with a limited number of unappealing options: refusing to accept research awards that require significant institutional subsidy, deterioration of research facilities as the risk becomes too great to invest institutional funds, a substandard compliance environment if UC cannot afford to pay for mandated compliance costs, and increases in tuition rates to cover costs that have been shifted to the institution. Due to the long-term decline in state contributions, per-student support from State General Funds dropped in real dollars (corrected for inflation) during a time of considerable enrollment growth. At the same time, UC student fees rose, but not enough to close the gap. Because a significant fraction of federal ICR is placed in the UC General Fund pool, some of the increase in UC General Fund spending on a per student basis is attributable to ICR; at the same time, however, the cost for grant administration and research facilities has also continued to grow. In short, ICR funds are increasingly important to the UC budget, and they are increasingly spread thin.

Without transparent accounting throughout UC, it is difficult to evaluate how much ICR funds actually support the research enterprise, or how this number may change over time (in real dollars or as a fraction of ICR). The previous UCORP-UCPB subcommittee set out to test two hypotheses. Given that UC student population has grown considerably in recent years, in times of large reductions in per-student funding provided by the state, one possibility is that some ICR funds are being used to make up for reductions in state support of UC's non-research mission. An alternative interpretation is that ICR is actually insufficient to cover the true F&A costs of research. These hypotheses are not incompatible; the present report will try to clarify as much as is possible with the limited resources of the Academic Senate.

Arguably, the issue is not that ICR accounting is too complex. UC gathers information on ICR in order to enter into periodic negotiations with the federal government, so there is reliable, quantitative information available. The University must also be prepared for financial audit of its research activities at any time. Indeed, every Principal Investigator (with assistance from a team of financial analysts) tracks both direct and indirect research expenditures. Thus it is possible to do so with all of UC's ICR expenditures in the General Fund and Opportunity Fund categories.

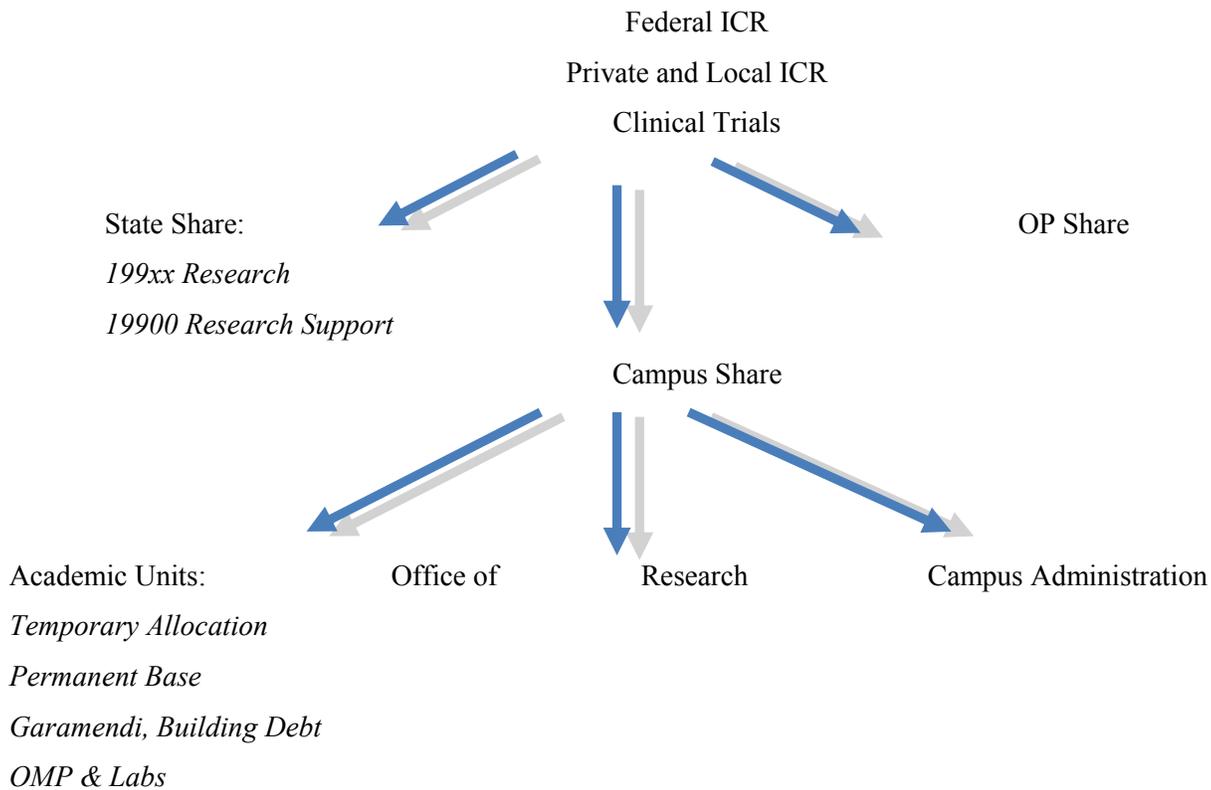
Maintaining a high degree of flexibility in the use of ICR funds may have had some short-term benefits, but this policy may place the UC research enterprise at risk over the long term. ICR is reimbursement for costs after they are incurred. Increasing ICR income implies associated increases in costs related to conducting research rather than a net gain in revenue. The university gains flexibility by putting ICR into the General Funds and Opportunity Funds categories, without tracking their use, but using

any of these funds for non-research purposes reduces the availability of ICR to support the research for which it was obtained. As prior Academic Senate reports noted, this contributes to the continued deterioration of the environment for conducting research at UC. Moreover, if UC continues to build facilities, then more of any given revenue stream, certainly including ICR, goes to cover debt, which means less ICR can go to support other facilities and administration costs, forcing academic departments to get state funds from their Deans to pay for F&A. Deans do this, for example, by not filling approved and allocated faculty lines so as to redeploy the cash equivalent.

Prior to 1982, UC negotiated and used a single system-wide overhead rate; after that year, rates have developed differently at each UC campus – e.g. in 1985, UCB charged 45.6%, UCD 39%, UCSF 32.6%, etc. – for a UC average of 42.2% (median 43%). By 2002, the average in UC was 50.1% (UCD was at 48.5%, UCB at 51.2%, UCSF at 50.5%). UC campuses currently charge between 50% and 55%. As an example, look at federal cost recovery: Once Garamendi funds are taken off the top, OP splits about 20%, returning 94% to campus and keeping 6% of the 20%. The remaining 80% are split as 55% general funds (i.e. 44% of total) and 45% opportunity funds (i.e. 36% of total). The opportunity funds are again taxed 6% by OP. Each campus gets to keep all of its clinical trial recovery dollars. But with private and local government recovery, a campus receives a base allocation plus an inflation rate; OP keeps an amount set in 1995-1996, when it initiated a policy to distribute all incremental overhead to campuses.

At the school level, take the example of a school that generates, in a given year, \$8m in indirect cost recovery. Of that, \$4.2 come back to campus, \$3.8 go to UCOP and state. UCOP takes \$1.5m, the state takes \$2.3m. The state funds come back as 199xx funds (\$1.5m) and as research-admin 19900 funds (\$800k). Garamendi debt subtracted from the campus allocation is \$45k, leaving a bit more than \$4.1m, minus debt service and leases of \$1.5m. The remaining \$2.65m are divided between school (\$1.3m) and campus (\$1.35m), and the latter share largely benefits startup funds for hires. At first glance, this may look like the school is not getting a lot: but consider that the Garamendi debt, debt service and leasing, the substantial start-up funds for faculty research, and the return of funds to the school (for its own administrative efforts in grants and in labs) in sum amount to \$10.25m, or actually more of a benefit than the school can claim a direct responsibility for in that year. In addition, it is important for all faculty members to understand that the considerable start-up costs and laboratory expenses are amortized only over many years, or even decades, due to low actual recovery rates and due to the fact that mandatory expenses such as building debt and utilities tend to consume the bulk of ICR. In order to achieve this goal, both UCORP and UCPB also wish to renew the call for improved transparency in ICR, at both OP and Campus levels.

Overhead Recovery Allocation and Distribution



Funding Research Excellence

UC has no legal obligation to spend *indirect cost recovery* dollars on research; they are reimbursements for facilities and administrative expenses. This is one reason why ICR funds are so highly valued: once UCOP takes its share and a campus subtracts Garamendi and Off-the-Top funds, the remaining ICR funds (Opportunity Funds and General Funds) are fungible. Slightly different ICR rates are determined within UC on a per-campus basis, negotiated periodically with representatives of the federal government. Campuses routinely argue for ICR rates that are 10-20% higher than agreed upon by federal representatives. Regulatory compliance and other factors made research increasingly expensive. UC's negotiated federal ICR rate brings UC less overhead than is needed to support the associated research. Actual indirect cost recovery from all research sponsors is closer to 25% than the actual negotiated rates on each campus – a dramatic shortfall, as true costs appear to be in the 65-70% range. This gap applies not only because the net overhead recovery rate is insufficient to cover real facilities and administrative costs; UC also increased support deficits as research programs continue to grow, for even at full recovery rates the actual indirect

cost of research is not covered. That remains true even if every penny of ICR were used exclusively in support of research. Long-term reductions in state support made this accumulating deficit larger.

Increasing private research sponsorship is a highly ambiguous response to the problem. UC's comparatively low ICR rate is framed by the assumption that the state provides a sizeable subsidy to its public university, though corporations do not provide that subsidy. Federal ICR rates are a ceiling for private grants and contracts; corporate sponsors negotiate lower overhead rates. Indeed, given the competition for research funding, UC may see itself forced to accept lower overhead rates to stay competitive in a race to the bottom for private sponsorship of research. This negative spiral may explain why an increasing share of UC research support is declared as gift rather than as grant or contract, subject only to flat-tax foundation fees but not to appropriate overhead assessments (5% or 10% rather than around 1/3 of total support granted). If state resources are being diverted from teaching and other campus needs to development offices in the hope of bringing private funds to campus and to manage complex projects, then accepting research sponsorship that covers little or no share of the associated effort in administration, space, equipment, and utilities, will continue to take more resources from the UC budget than it brings in.

As a result of a number of long-standing challenges for public research universities, UC fails to recover an estimated \$600 million of ICR annually. It is not just that federally negotiated overhead rates fall short of the true costs of research. By policy, UC accepts lower rates (called class waivers) from many sponsors (other than for-profits) that have uniform policies of not paying full overhead. UC accepts "Vital Interest" waivers on a case-by-case basis when, in the judgment of the campus Vice Chancellor of Research and the UCOP Office of Research, such a waiver is in the best interests of UC. UC now waives overhead on 18% of federal grants and 72% of foundation grants. Some external agencies see the fact that they do not provide full reimbursement for indirect costs as a form of cost sharing, justified by the view that they are assisting a public university in its research mission.

This report does not depart from conventional wisdom when it suggests that UC a) reconsider its policy for approving class waivers, b) review the "vital interest" waiver policy, and c) stop automatic approval of waiver requests. The same recommendations were made by the Academic Senate in 2003 (Binion to Atkinson, August 7, 2003). That memo also requested that every campus incorporate allowable direct costs of administrative or clerical support and general supplies into proposal budgets, wherever this is not explicitly prohibited or already incorporated into indirect costs billed to sponsors (e.g. the federal government). An important goal would be to achieve an ICR rate equal to or greater than the rates at similar research universities. UC needs to make the strongest case possible to the federal government to raise the cap on the administrative component of ICR; and together with other leading research universities,

UC should work with major foundations to request that they provide funding that covers indirect costs, or allow overhead costs to be represented as direct costs of conducting research.

On some campuses, too little ICR money seems to return to PIs to cover their local share of overhead. While the main goal of this report is to foster better understanding of ICR, past Senate reports have recommended tracking ICR on each campus through the accounting system, though nobody has yet figured out how to do that efficiently, and some believe it could do more harm than good. It is clear, though, that administration at both campus and OP levels must continue to improve ICR transparency.

Furthermore, this report is not breaking new ground when it endorses a systematic inquiry into factors that contribute to driving up overhead costs. This is not merely a matter of proliferating environmental health and safety regulations. UC campuses must make a concerted effort to control expenditures on grant processing and accounting, and to create clarity about space metrics and utilities, especially since it has become clear that ICR is not sufficient to cover these expenditures. If the university cannot recover its indirect costs, it will be forced to cut services and staff, reduce research space, and trim other expenses. The university subsidizes sponsored research to an increasing extent, although fungible sources for doing so are limited.

It is important to note, however, that disciplines rely on foundation grants to different degrees. Should UC require full overhead on all sponsored research and discourage accepting foundation grants that do not cover full indirect cost, it might adversely impact research in social sciences and humanities that rely to a greater extent on foundations rather than on state or federal agencies. Universities have perverse incentives to minimize research expenditures in high-enrollment departments in the humanities and social sciences: the revenue surplus generated there from enrollments can support indirect costs in science, engineering, and medicine only if little of the surplus is absorbed by research in high-enrollment departments themselves.

The difference in ICR rates between UC and its peers and competitors is not a factor of UC's particular research mix. UC's peers have policies and practices that allow them to negotiate higher ICR rates more successfully. They have more permanent staff positions devoted to proposal development and negotiation; a high level of engagement and commitment from senior administrators; an educated and committed faculty; and they conduct careful surveys of space functions used to set a facilities rate. Some competing institutions allow departments to decide whether to waive overhead, and ask departments that do to make up the difference between the actual rate of the award and the Federal overhead rate by using departmental funds. Some competitor institutions have permanent government costing staff devoted to proposal development and negotiation; others supplement their staff by outside consultants.

By way of conclusion, UCORP and UCPB assert that UC's indirect cost recovery model must support the campus research enterprise; direct adequate recovery funds to research infrastructure such as research administration, contract & grants accounting, environmental health and safety; acknowledge overhead recovery generated by individual units; provide central funding for existing and new research opportunities and for shared facility and equipment needs; account for all debt and lease costs; and be transparent and easily understood by the campus community. Transparency at all levels of administration is critical to allay the faculty concerns that motivated this reinvestigation. Policy changes to increase ICR may be viewed as a disproportionate "tax" on performing the research mission if these rates are not visibly linked to research-related costs.