

Paying for Space

A Brief Framing the Issues and Opportunities in
Capital Finance for Higher Education in California

Based on extensive analysis done by Patrick J. Lenz

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A COMPLEX CHALLENGE

The capital financing needs for the public institutions in California are immense and overwhelming, and neither the state nor the institutions have a coherent plan for addressing them. The current ad hoc and episodic approach to funding may be the best that can be done under the current circumstances, but without a better approach, the situation will only continue to deteriorate.

The state has to protect its substantial, 100-year investment in public facilities for higher education. A systematic approach to paying for renovations, repairs, and deferred maintenance is needed, beginning with decisions about revenue sources and ways to establish funding priorities. Plans also must be made for increasing capacity to accommodate rising enrollment demand for higher education.

In the pages that follow, we explore the diverse and interrelated facets of the California higher education capital finance challenge.

1 Fund allocations for capital outlay are inconsistent, uneven, and unclear.

The state planning and policy process for capital finance has been ad hoc, largely driven by changes in revenue availability, and the policies for setting priorities among different types of expenditures are inconsistent and uneven. Around the time of the enactment of the Master Plan for Higher Education, the state paid for capital outlay for higher education and for other state functions on a pay-as-you-go basis, supported by general funds. Funding was provided for construction of dormitories, research space, land acquisition, and instructional facilities. Construction funds routinely included funding for initial equipment for new buildings, as well as necessary campus infrastructures (roads, water, electrical systems) associated with new construction. Over time, the funding sources changed from state general funds to dedicated special funds for capital outlay, and increasingly to bond financing (both general obligation and lease-revenue bonds). The rules about what could be funded by state funds versus bond finances, federal grants, or private funds have shifted over time, as have the parameters for defining issues such as whether equipment funding “counts” within capital outlay or should be funded via operating revenues.

The state has made numerous attempts to discipline the capital planning and allocation process through different iterations of capital outlay planning policies. The most recent state policy for capital financing was codified in the California Infrastructure Planning Act, authorized by AB 1473, Hertzberg (Chapter 606, Statutes of 1999). The law provided a framework for a comprehensive approach to infrastructure capital planning, to include new, rehabilitated, modernized, improved, or renovated infrastructure requests by all state entities, including instructional and instructional support facilities for California Community Colleges (CCC), California State University (CSU), and University of California (UC). The comprehensive approach also drew from all potential revenue sources for infrastructure projects, including state general funds, special funds, general obligation bonds, lease-

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revenue bonds, or other state funding options. The first five-year infrastructure plan submitted in the spring of 2002 identified \$56 billion for all state agencies and, of this amount, it identified \$5.4 billion for priorities in public higher education.

In June 2015, the legislature enacted Senate Bill No. 81 to allow UC to restructure its capital debt and to give it greater flexibility to use operating support for debt service and other capital expenses. At the time, the outstanding lease-revenue debt obligation for UC was about \$2.5 billion. While this debt was technically a state obligation, rating agencies counted it as part of UC’s debt obligation. The legislation transferred the debt to UC and gave the institution the ability to use up to 15% of its operating budget to pay for capital costs, including debt service. The restructuring allowed the university to achieve nearly \$1 billion in savings over ten years, which was redirected to pay for the growing costs of employer contributions to the retirement system. Companion legislation to allow similar debt restructuring for CSU was implemented the following year as part of the 2014-15 state budget. Both systems therefore now have the costs of capital debt service as an additional obligation for operating funds.

The debt restructuring legislation also provided for a streamlined capital facilities approval process for higher education, to allow UC and CSU to sidestep the time-consuming and expensive post-hoc approval of capital projects by the State Public Works Board. However, the streamlined process, while accepted by the institutions, was seen as a basis for excluding UC and CSU from inclusion in future state general obligation or lease-revenue bond sales. The most recent 2017 California Five-Year Infrastructure Plan is proposing \$43 billion for statewide capital projects. Because of the interpretation about eligibility that followed the debt restructuring plan, funding needs for UC and CSU have been excluded from current statewide infrastructure planning.

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FACILITY ASSETS IN PUBLIC POSTSECONDARY EDUCATION IN CALIFORNIA	
California Community Colleges	113 campuses
	72 off-campus centers
	5,720 buildings
	72 million gross square feet
California State University	23 campuses
	8 off-campus centers
	2,133 buildings
	87 million gross square feet
University of California	10 campuses
	5,970 buildings
	133 million gross square feet

2 The historic separation of operating and capital budgets may be contributing to the funding problems.

Capital outlay finance has historically been largely a separate process from the operating budget, both in terms of revenues and in the budget review and approval process. Financial analysts have argued for many years that the separation of capital and operating costs understates the true costs associated with higher education, by between 15% to 25% on average.¹ The rationale for the separate process in the public sector largely stems from the distinct lifecycle of capital costs, which typically span 30 years or more, and are episodic and project-specific (associated with acquiring lands, building new buildings, and building redesign or renovation) rather than ongoing.

Yet the distinctions between capital and operating expenses are more blurred than they were in the 1960s and 1970s when capital outlay was dominated by new building. Today's capital needs are more likely to include technology costs, infrastructure, seismic maintenance, and repair as contrasted to building. Over the years, revenue sources have shifted away from state general funds or special funds to bond financing, putting more pressure on operating budgets for debt service, which legally is treated as the first priority for spending. The very nature of capital financing has also changed, away from single-use facilities dictated by funding sources (such as instructional buildings that are separate from libraries, administrative buildings, student support structures, or residence halls) in the direction of mixed-use facilities that better serve student needs. Capital costs also have increased because of the chronic budget cutting of maintenance costs, which have come to be treated as a discretionary spending area, and as such the first in line for reductions during times of fiscal stringency.

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As California considers ways to address financing issues for public higher education, the time may have come for looking at both capital and operating needs more holistically, through an integrated planning and budgeting process. The habits of work that have grown up around old ways of doing business would have to change to allow that to happen.

3 Capital funding needs in higher education are enormous and growing.

Current assessments of capital funding needs in California show huge and growing costs, some urgent. Failure to address these needs will hurt the quality of the instructional and research programs, erode the value of the investment that has been made by the state over the last hundred years, and expose the state and the institutions to liabilities for failure to address health and life safety issues as well as code violations. A process is needed to rationalize priorities between, for instance, deferred maintenance, health and life safety issues, renovation and renewal, and construction of new space. What follows below is an educated estimate of the level and type of need.

¹ See Gordon Winston, "A Guide to Measuring College Costs." Williams Project on the Economics of Higher Education, January 1998, DP-46, available at <http://sites.williams.edu/wpehe/files/2011/06/DP-46.pdf>.

Community Colleges Needs

California Community Colleges have estimated a \$20.1 billion capital facility need as part of a plan spanning the 2017-18 through 2021-22 fiscal years. Of this amount, \$8.8 billion is needed for construction of new facilities to accommodate enrollment growth and \$11.3 billion for modernization of existing facilities. The CCC Five-Year Capital Outlay Plan is based on estimated fall enrollment of 1.7 million students in 2017-18, growing to an enrollment of 1.9 million in 2021-22—an increase of approximately 145,000 students. The CCC capital plan additionally estimates a need for \$200 million annually for deferred maintenance.

California State University Needs

California State University has identified approximately \$12.5 billion in capital facility projects spanning the 2017-18 through 2021-22 fiscal years. The plan identifies \$7.4 billion in academic projects and \$5.1 billion in self-support facilities. The age of CSU's buildings is typically 30 years or older (similar to that of UC buildings, see below), with critical seismic, fire-life-safety, ADA, infrastructure, and modernization issues. Based on the campus data, the CSU system should be spending on average about \$143 million per year to replace systems that are reaching the end of their useful life, and should spend an additional \$166 million to address the estimated renewal backlog, for a total \$309 million per year. CSU additionally projects that enrollments will increase an average of 3,600 full-time students between 2017 and 2020. If recent transfer reform legislation has its expected effect, new transfer enrollments will also increase, putting additional pressure on capacity. CSU tentatively has identified a deferred maintenance backlog of approximately \$2.6 billion, a figure which is growing annually by another \$143 million.

University of California Needs

Almost 60% of University of California state-supportable space is more than 30 years old, with most of these building having been built between 1950 and 1980. The University of California estimates \$14.6 billion in facility needs, extending from the 2016-17 fiscal year over the subsequent five years. UC will need approximately \$7.6 billion for general campus and educational facilities, \$4.2 billion to support non-instructional auxiliary facilities including student housing, dining services, parking structures, and faculty housing, as well as \$2.8 billion for UC medical centers. These estimates do not include needed space to accommodate additional enrollments. UC expects California undergraduate enrollment increases of 10,000 between 2017 and 2020. Slightly less than half of those students are planned to be accommodated at UC Merced. It is not known what proportion of the remaining 5,000 new students can be accommodated without additional space. UC additionally estimates a deferred maintenance backlog of between \$3.2 and \$5 billion.

4 Deferred maintenance needs are growing as ongoing maintenance is being cut.

Funding of deferred maintenance has been a budgetary football over many years, kicked between capital and operating budgets largely in response to revenue availability. Various approaches have been tried, including appropriating ongoing revenue in the base budget as part of the annual state budget process, providing one-time funding, requiring state funds to be matched with institutional funds, and funding deferred maintenance as part of debt through general obligation bonds or lease-revenue bonds. Meanwhile, operating fund budgets have cut funding for ongoing maintenance, and the list of deferred needs continues to grow. Governor Jerry Brown and the current Department of Finance have fairly recently begun to provide funding for deferred maintenance on a one-time basis. This is part of their budget strategy to avoid increasing base funding from revenues they believe are particularly susceptible to fluctuations in funding. This is arguably good budget policy, as it discourages unsustainable growth in base budgeting. It has yet to provide a reliable or sufficient source of revenue to meet the huge backlog of deferred maintenance needs.

Funding for operations and maintenance of the physical plant (OMP) has a similar history to that for deferred maintenance. The definition of maintenance and operations differs between UC, CSU, and CCC, although these institutions might argue that their overall funding needs are similar. At one time, the state funded OMP according to clear standards governing use of space which dictated the assignable square feet (ASF) that would be eligible for state support for different functions. The line item for OMP disappeared when the state shifted to funding compacts for higher education. OMP funding has consistently been more vulnerable to funding cuts during budget crises, which has inevitably led to increases in deferred maintenance.

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5 Undergraduate enrollments will grow, with no plan as to how they will be accommodated, or whether new capacity space should even be an option.

The demand for undergraduate enrollment is increasing, and the state has no explicit plans for accommodating these students, including guidelines for determining whether new capacity space will be needed, or where it might be needed. Both UC and CSU have experienced a huge increase in undergraduate enrollment demand, well above what might be predicted based on high school enrollments alone. Both systems have also seen an increase in the number of students who are denied admission. It is not known how many of the turn-downs were caused because of insufficient operating budget support (to hire necessary staff to manage increased workload) or how many campuses have simply run out of space for accommodating more students.

The capital costs to build new capacity space are increasingly prohibitive, particularly in urban areas (including the Bay Area, Los Angeles/Fullerton/Long Beach, and San Diego), which are experiencing the greatest surge in demand. While several of the campuses could potentially handle more students, some (UCLA is the prime example) have run out of space unless they build up rather than out. Clearly more must be done to increase space capacity and efficiency in higher education, including alternative approaches to expansion, such as through year-round operation and technology, as well as cross-sector space sharing with other education institutions, local government, or private partners. A number of

institutions have been successful in using public-private partnerships and other joint ventures to expand capacity. In addition to expanded capacity, some of these collaborative initiatives have the added benefit of fostering stronger cross-sector partnerships to improve student success. The final section of this briefing document provides further detail on specific collaborations of this nature.

6 Federal infrastructure financing may pose some potential for revenues.

The federal government may again become a viable source of revenue for infrastructure financing to help pay for capital costs. This has happened in the recent past, through the American Recovery and Reinvestment Act (ARRA) enacted during President Obama's first term as a federal response to the deep recession.

President Trump has indicated that federal support for infrastructure will once again become a priority in his administration. There may be long odds against such an eventuality, still it would behoove California to be ready to advocate for its fair share of any such funding initiative. Even if higher education is not included in state capital planning, leadership should take care to be sure that it is appropriately included in any potential advocacy for federal financing.

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SPACE-SAVING SOLUTIONS

In this section, we identify “alternative” practices designed to increase the capacity and efficiency of higher education spaces across California.

Public-Private Partnerships and Joint Ventures

The option of public-private partnership (P3) projects or joint venture collaboration is not a new concept to higher education, but may be underutilized between the public higher education segments, private universities, and municipalities. Generally, the P3 process is designed primarily for facility projects that will generate income from land or campus facilities associated with retail space. One of the major concerns in approving the P3 option is the increased cost of development, which may be 10% higher than the more traditional method of funding capital facility projects. However, at times the critical need to move forward with new campus construction or expansion to address enrollment growth or other campus facility needs may outweigh the additional cost of waiting until a more traditional funding mechanism is available. Joint venture collaborations have allowed for shared cost in facility construction, ownership, and operations and are viewed as a creative pathway to providing upper division access and university degrees for CCC students. More could be done to encourage such collaborations, by both the systems and the state.

UC Merced 2020

One of the largest P3 projects being constructed today is the Merced 2020 project, a \$1.3 billion venture to construct the necessary facilities that will expand campus enrollment of approximately 6,850 full-time students to 10,000 full-time students by the year 2020. The UC Merced campus officially opened in the fall of 2005 to 875 students and 60 faculty members as the first new UC campus in 40 years. The Merced 2020 project envisions an expansion of the existing Merced campus with new mixed-use facility development that integrates students, faculty, and staff into a sustainable living and learning environment.

UC’s 2016-26 Capital Financial Plan consists of 19 P3 projects, including the Merced 2020 Project which represents UC’s largest public-private partnership with a developer responsible to design, build, finance, operate, and maintain facilities at the Merced campus. The project will expand the campus by 790,000 assignable square feet of academic, administrative, research, recreational, student housing, and student services facilities to support enrollment growth. The developer will act as the design and construction contractor, provide debt and equity financing, and operate and maintain major building systems for 35 years. The UC Board of Regents has approved external financing of \$600 million for this project with another \$590 million being financed by the project developer. At this point, no state bond financing is supporting this project, although UC is relying on State General Fund monies to pay a portion of the debt service.

UC Davis, West Village Campus

In January 2012, UC Davis, in collaboration with the Los Rios Community College District (LRCCD), opened the first permanent community college facility on a UC campus. The West Village Implementation Plan was approved by the UC Board of Regents in November of 2006 as a mixed-use community that included student, faculty, and staff housing along with commercial services to be implemented in three phases. Phase 1 consisted of a two-story building of approximately 20,000 gross square feet that included classroom and administrative spaces for LRCCD faculty, staff, and students. The UC Regents approved a 65-year ground lease to the LRCCD for all three phases of the plan and the LRCCD used its general bond revenue for construction of the facilities as part of the joint-facilities financing for this project.

UC Davis and LRCCD formed a partnership and initiated an academic program collaboration that proved extremely beneficial to both UC and CCC students. West Village offers courses in English composition, chemistry, history, art, and mathematics, to name a few, that are available to both university and community college students. The LRCCD continues to have a presence at UC Davis by offering transfer-level courses that support the opportunity for “simultaneous enrollment” for UC Davis students, allowing them access to high-demand courses where on-campus demand exceeds capacity. UC Davis and LRCCD also coordinate course schedules to offer less commonly taught courses, such as foreign languages including Farsi, Tagalog, and Vietnamese. Additionally, LRCCD students are permitted access to the UC Davis campus library and college events, allowing community college students to experience UC Davis campus life.

San Jose State University, Dr. Martin Luther King, Jr. Library

One of the most creative and successful P3 CSU projects culminated in the 2003 opening of the Dr. Martin Luther King, Jr. Library, a facility jointly developed, owned, and operated by San Jose State University and the City of San Jose. This joint venture was originally proposed as a 465,000 gross square foot library where the university would be allocated just over two-thirds of the space and the city, the remaining one-third. Of the \$171 million initial cost, the university proposed to fund \$101 million and the city would fund \$70 million. This unique collaboration between the San Jose State University and the City of San Jose has won numerous awards for partnering to provide library services to campus students, faculty, and staff along with the general public. Located in downtown San Jose on university property, the Dr. Martin Luther King, Jr. Library is easily accessible and provides an ideal solution to meet the library services needs of both the city and the university.

College of the Canyons, University Center

The University Center at College of the Canyons is a creative joint venture collaboration providing an overwhelming benefit to CCC students who desire to pursue upper-division and graduate level education beyond their CCC experience. The initial concept was to offer higher educational opportunities that otherwise might not be available to residents of the Santa Clarita Valley by partnering with universities that can offer four-year degrees. The facility is a 110,000 square foot center with 23 smart classrooms, two computer laboratories, six meeting rooms, and a lecture hall.

Partnering university institutions include CSU Northridge, Brandman University, CSU Bakersfield, La Verne University, and National Universities. College of the Canyons also offers TEACH program

(an undergraduate program that prepares future teachers) professional teaching workshops and seminars to assist students taking the California Basic Educational Skills Test (CBEST). Representatives from partnering university institutions collaborate with College of the Canyons counselors and advisors to ensure effective student educational planning and the transferability of lower division coursework. Students who complete the coursework with satisfactory grades and meet the admission requirements of partnering institutions are given priority admission and registration. This joint venture collaborative and academic delivery approach has the potential for better managing future overall capital construction costs and facility needs while at the same time providing CCC students with access to upper division courses, improved transfer rates, and university degrees.

Year-Round Operations

California has periodically looked at ways to encourage greater use of existing facilities as one way to accommodate increased demand without adding new buildings. Recommendations to expand use of year-round operations began to surface in California even before the Master Plan for Higher Education was adopted in the 1960s. In 1955, a document titled “Restudy of the Needs of California Higher Education,” by T. R. McConnell, T. C. Holy, and H. H. Semans, outlined the early concept associated with the highest and best use of classroom facilities. The subsequent master plan supported this concept with a recommendation that all public and private higher education institutions offer summer programs equivalent to one quarter of a year. In addition, the master plan called for a study on the merits of trimester and four-quarter plans for year-round use of public and private higher education facilities. By 1962, the University of California began planning campus conversions for year-round operations.

By 1962, the University of California began planning campus conversions for year-round operations. Eventually, both UC and the CSU began to expand summer course offerings.

The anticipation of year-round operations led to a series of financial assumptions relative to the cost of increasing classroom availability to serve growing student enrollment versus the need to build more classroom facilities. The first such estimate was offered in February 1964 by the Coordinating Council for Higher Education that concluded the adoption of year-round operations would increase operating costs for the university and state colleges between 1967 and 1975 by \$109.7 million (in 1963 constant dollars), but that capital outlay savings in the same period would amount to \$177.2 million, for a net savings of \$67.5 million. Eventually, both UC and the CSU began to expand summer course offerings that were self-supporting, as opposed to tapping into the full-time enrollment funding from the State General Fund for fall, winter, and spring semesters/quarters. However, a major concern with this initial approach was that self-supporting fees charged in the summer were higher than fees charge in the other academic terms.

By the late 1990s, the state embraced the benefit of summer sessions by investing state general funds at the same “marginal cost” rate as provided for the other academic terms to the UC and CSU. In 2000, the legislature enacted AB 2409 (Migden) stating UC and CSU must charge the same fee rate for summer as they would for fall, winter, and spring, creating a consistent year-round fee policy. As part of the 2001-02 budget, the state provided \$33.1 million to UC and CSU to convert three UC campuses and four CSU campuses to year-round enrollment. A review of year-round enrollment and student

participation rates in summer enrollment from 2000 to 2005 showed mixed results. While UC summer enrollment doubled during this time, enrollment in the CSU actually declined, causing concerns regarding the state's investment and incentive with this approach. However, there was continuing support by the state and the institutions for expanding and investing in year-round operations at UC and CSU campuses.

In the 2016 budget, Governor Brown proposed three initiatives to the UC budget to increase summer enrollment through an alternative pricing model. The intent of the initiatives was to provide students with a greater personal financial incentive to take courses during the summer term at three piloted UC campuses (Berkeley, Irvine, and San Diego). To incentivize summer enrollment, UC Berkeley offered a student loan program; UC Irvine offered a fee cap, with no charge to students taking greater than 8 units; and UC San Diego offered students summer housing at a lower cost. The effort of these initiatives proved successful, as UC summer enrollment increased by 638 full-time equivalents over the prior year at the three piloted campuses.

The California Community Colleges have been very aggressive with summer enrollment, alternative scheduling, and maximizing year-round facility use. In the 2014-15 fiscal year, 643,000 community college students attended summer sessions, generating approximately 108,000 full-time equivalents, or 20.9% of the average full-time enrollment achieved during the fall and spring terms. An additional 198,000 students, or 33,000 full-time equivalents, attended winter session. In 1996-97, the CCCs offered an average 271 days of instruction for the 113 colleges, a figure that grew to 294 days by the 2015-16 fiscal year. The duration of each academic term is left to the discretion of each individual district. The average fall and spring term session for a community college district is 18 weeks, and generally summer sessions are offered to students in two six-week sessions. The California Community Colleges Chancellor's Office applies a term factor for summer full-time equivalents based on the average six-week session in summer, versus the average 18-week session in the fall or spring terms.

Technology and Online Education

California Community Colleges

The 2013-14 state budget provided the CCCs with \$16.9 million to offer more online courses and increase the matriculation of students using technology. Similar to the UC and CSU budget augmentations, the focus of this funding was to provide students access to high-demand courses, particularly those critical to degree completion.

In the 2017-18 Five-Year Capital Outlay Plan, the CCCs reported that the 2013-14 enrollment in distance education courses had increased to 11.2%, or approximately 132,000 full-time equivalents, over the prior academic year. Based on the continuing growth in alternative academic course offerings, there is an assumption of reduced demand by 3,151,000 assignable square feet that future facilities need to meet enrollment demand. The CCC Chancellor's Office believes the increase in the use of technology for instructional delivery will become a critical cost incentive for campuses as part of its planning process for future capital projects while saving the cost of new classroom facilities.

California State University

The CSU offers online, hybrid, and instructional courses at all 23 campuses. In the 2013-14 academic year, this translated into 118 online degree programs that graduated 4,320 students and an additional 76 hybrid courses that graduated 1,045 more students. The 2013-14 state budget also included \$10 million for CSU to develop additional online coursework to provide greater access to more students, particularly with respect to CSU courses with the highest student demand.

University of California

All 10 UC campuses offer fully online courses and programs to undergraduate and graduate students to enhance learning opportunities, strengthen teaching and learning, and provide increased access to the courses students need to graduate. Prior to launching a system-wide initiative in 2013 to increase online education, UC offered approximately 2,600 online courses totaling over 90,000 student enrollments. Most of these online courses and enrollments were associated with certificate and/or other extension programs, and were not typically designed or offered for credit toward graduation to UC undergraduate students. The 2013-14 state budget provided UC with \$10 million in annual funding for online education. UC initiated the Innovative Learning Technology Initiative (ILTI) to provide students with online courses to meet more flexible and innovative learning opportunities that count toward degree requirements. These funds support the development of online and hybrid courses, campus and system-wide infrastructure, cross-campus course instruction, and evaluation and accountability efforts.

About College Futures Foundation

College Futures Foundation works with partners throughout California to increase bachelor's degree attainment among low-income students and others who are underrepresented in higher education. The Foundation operates on the belief that every qualified student in California should have the opportunity to succeed in college and it recognizes that creating a vibrant future for our state requires awarding more bachelor's degrees to broader populations of students. Established in 2005 as a private foundation, College Futures supports work in three areas: improving student transitions toward degree completion; developing and strengthening partnerships across institutions, systems, and regions to drive increases in bachelor's degree attainment; and reducing gaps between policy and practice to advance student access to and success in college.

Visit us online at www.collegefutures.org

About the Higher Education Finance Reform Initiative

Hundreds of thousands of our students who would benefit from a bachelor's degree are being left out because the system for financing our public universities in California isn't working. College Futures Foundation began examining the issue of higher education finance reform because we could not ignore what has become a major obstacle in the path to success for this and future generations of California students, for our higher education institutions, and for our own work. Addressing this challenge will be difficult, but it is possible. We must start by building a shared understanding between public policymakers and higher education leaders of the problem as well as practical ways to solve it.

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