November 2012/30

Issues paper

This report is for information

This report provides an overview on the financial health of the higher education sector in England. The analysis covers the financial forecasts for the period 2011-12 to 2014-15, as submitted by higher education institutions to HEFCE in December 2011 and June 2012.

Financial health of the higher education sector

2011-12 to 2014-15 forecasts

HIGHER EDUCATION FUNDING COUNCIL FOR ENGLAND

Financial health of the higher education sector

2011-12 to 2014-15 forecasts

To	Heads of HEFCE-funded higher education institutions
Of interest to those responsible for	Audit, Estates, Finance, Governance, Management, Planning
Reference	2012/**30**
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Enquiries to	HEFCE assurance consultants or assurance advisers Contact details for HEFCE staff are at www.hefce.ac.uk/whatwedo/reg/assurance/contacts/

Executive summary

Purpose

1. This report provides an overview on the financial health of the higher education sector in England. The analysis covers the financial forecasts for the period 2011-12 to 2014-15, as submitted by higher education institutions to HEFCE in December 2011 and June 2012.

2. The report is being published to provide universities and higher education colleges with feedback on the sector's projected financial performance. The analysis also provides other stakeholders with information about the sector's current and future financial health. It supersedes our previous analysis published in March 2012 ('Financial health of the higher education sector: 2010-11 financial results and 2011-12 forecasts', HEFCE 2012/05[1]).

Key points

3. Higher education institutions (HEIs) in England are required to send us their annual accountability returns in December each year. These returns form a significant part of the way in which HEIs can demonstrate accountability for the public funds distributed to them. The accountability returns enable HEFCE to reassess HEIs' overall risk assessments and to ensure that HEIs are meeting their accountability responsibilities.

4. For this year's annual accountability returns we deferred the submission of financial forecast data (relating to the academic years 2012-13 to 2014-15) and financial sustainability commentaries until June 2012. The decision to defer submission was taken due to the degree of uncertainty in the higher education sector about, among other things, student number limits, future HEFCE funding and student recruitment in the new fee regime. While not eliminating all of the uncertainty, we considered that deferral would enable institutions to produce more reliable forecast information in June 2012 for both HEFCE and internal use, because by then institutions would have known the outcomes of the HEFCE grant letter from the Department for Business,

[1] All HEFCE publications are available at www.hefce.ac.uk/pubs.

Innovation and Skills (BIS) and would have a better indication of student demand in 2012-13. A consultation on our future teaching funding methodology was also under way at that time.

5. As well as submitting forecasts for the period 2012-13 to 2014-15, we requested that institutions send us any material updates to their 2011-12 forecasts. All institutions took the opportunity to send us updated forecasts for 2011-12.

6. As previously reported, the overall financial results for the sector in 2010-11 showed a stronger financial position than previous years. The projected sector performance in 2011-12 is not as strong as the results for 2010-11, but is significantly better than forecast by institutions in December 2011. This improvement in projected performance may be due to greater certainty of outcomes and prudent forecasting earlier in the financial year. Given that the latest forecasts have been submitted so close to the financial year-end, it would be reasonable to assume that these projections provide a reliable indicator of the financial outturn for the sector in 2011-12.

7. The overall financial results projected by the sector in the remainder of the forecast period (2012-13 to 2014-15) are sound overall though this is heavily dependent on the sector achieving its student recruitment targets. It is too early to say what the effects of the funding reforms on students and institutions will be. However, information we have received from UCAS and HEIs indicates that student demand is lower in 2012-13 than forecast by the sector and that some institutions are experiencing some pressures on student recruitment, suggesting that enrolments will be down by more than planned. This increases the risk that financial performance for these institutions will be poorer than forecast. We currently do not know whether the reduction in enrolments is a one-off or permanent, and this will be carefully monitored over the coming year.

8. In 2012-13 forecasts show the first major fall in public grant funding which is countered by a significant increase in fee income from home and European Union (EU) students. This comes at a time when the sector is projecting increases in expenditure, and when many institutions are planning to invest substantial sums into their capital programmes to make the necessary improvements in their estates. The effect of this is a sharp reduction in surpluses and a fall in cash levels. Thereafter, surpluses and cash flow from operating activities are expected to rise. Some of this rise is attributed to the continued strong growth in fee income from non-EU students.

9. There is a risk that the widely reported revocation of the London Metropolitan University Tier 4 licence could affect the UK's reputation and lead to a decline in overseas applications. Universities UK and the Government are aware of this risk, and are taking action to promote UK higher education abroad. It is too early to predict whether there will be a reduction in demand in future, but fees from overseas students are a significant source of income for many HEIs so this is an important issue for the sector.

10. In terms of short-term viability, the forecasts show that the sector is in a sound surplus position overall. However in an increasingly competitive environment and with reductions in public capital funding, some institutions will need to increase surpluses even beyond those currently achieved to finance future capital investment and maintain their long-term sustainability. If surpluses do not increase there is a risk that the quality of the infrastructure in the higher education sector will reduce, which will harm its long-term sustainability.

11. Based on the financial forecasts no institutions are presently close to the risk of insolvency. This is supported by independent going-concern opinions of institutions' external auditors and the projected continuation of positive cash in-flows and healthy cash-backed reserves. Strong liquidity is necessary for HEIs to efficiently manage the potential increased volatility and unpredictability of the new funding system and the increasing competition from international higher education institutions.

12. The sector has, over recent years, shown that it can deliver efficiencies. For example it has reduced its cost base with pay costs being curtailed after a period of strong growth. These efficiency measures have helped support the current financial performance of the sector. It will be important for the sector to maintain this efficiency drive in order to deliver a long-term sustainable future.

13. The financial forecasts submitted by the sector in June 2012 may not have been able to include assumptions about the medium-term effects of the UK economy. There continues to be a risk that future public funding of higher education could be constrained if the overall economic climate does not improve.

Action required

14. No action is required: this report is for information.

Summary and headline information

15. The overall financial results for the higher education sector in 2010-11, which we reported on in March, showed a stronger financial position than previous years. The sector reported healthy surpluses, strong cash balances and reasonable reserve levels.

16. The projected sector performance in 2011-12 is, as anticipated, not as strong as the results for 2010-11, but is significantly better than forecast by institutions in December 2011. This improvement in projected performance may be due to greater certainty of outcomes and prudent forecasting earlier in the financial year. Given that the latest forecasts have been submitted close to the financial year-end, it would be reasonable to assume that these projections provide a reliable indicator of the financial outturn for the sector in 2011-12.

17. Sector income is now expected to be £370 million higher than predicted in the December 2011 forecasts which, together with additional expenditure savings, results in operating surpluses of £719 million compared to the earlier forecast of £270 million. Average sector cash levels are also expected to remain strong at 104 days in 2011-12, where they had originally been expected to dip. This improvement in liquidity indicates that many institutions have been building cash reserves ahead of public funding reductions and potential increases in income volatility from 2012-13.

18. The projected financial performance for the sector in the remainder of the forecast period (2012-13 to 2014-15) is sound overall. In 2012-13 forecasts show the first major fall in public funding, which is countered by a significant increase in fee income from home and EU students. This comes at a time when the sector is projecting increases in expenditure and when many institutions are planning to invest substantial sums into their capital programmes. The effect of this is a sharp fall in surpluses and cash levels. Thereafter, surpluses and cash flow from operating activities are expected to rise.

19. The sector continues to forecast slower growth in expenditure with projected staff costs of between 53.0 and 53.9 per cent of total income in the forecast period, compared to a high of 58.1 per cent in 2000-01. Pay costs are expected to remain low, with the sector projecting average annual pay costs per employee to rise by 0.5 per cent (real-terms) between 2010-11 and 2014-15.

20. Despite the reductions in public capital funding, the sector continues to project significant levels of capital investment throughout the forecast period. To achieve this, institutions are expecting to finance much higher proportions of capital investment by internal cash than has been seen in the past. In the short term this is affordable due to the cash reserves held by the sector. However some institutions will need to generate increased levels of surplus even beyond those currently achieved in order to sustain this level of investment and maintain their long-term sustainability.

21. One of the key risks to future financial sustainability reported by institutions as part of HEFCE's last annual accountability review was an unexpected fall in student recruitment and retention caused by the Government's new fee proposals. While final student numbers will not be known until later in the autumn, UCAS data[2] as at 20 September 2012 indicate that, at sector

[2] UCAS data can be found at: www.ucas.com/about_us/media_enquiries/media_releases/2012/20121409

level, demand for 2012-13 is expected to be lower than has been projected by institutions in their forecasts. HEFCE discussions with institutions also suggest that some HEIs are experiencing student recruitment difficulties and that enrolments will be down by more than planned, which may necessitate these institutions to revisit their financial forecasts. HEFCE will continue to discuss with HEIs the actions being taken to mitigate any adverse impacts on their forecasts.

22. While the picture for student recruitment in 2012-13 will become increasingly clear in the coming months, 2012-13 may well not provide a reliable guide to recruitment in subsequent years. The last time a major system change was introduced (2006-07), recruitment in the first year was subsequently found to be aberrant. We will continue to monitor the impact of the reforms on the availability of provision across subjects, as well as the longer-term impacts on graduate outcomes and social mobility. We expect to publish our first report on the impact of the reforms in spring 2013.

23. In terms of non-EU income, the sector is projecting an average real-terms increase in fee income of 24.5 per cent over the forecast period. However this disguises a significant variation in assumptions used by institutions in predicting their future overseas income levels.

24. It is too early to predict how the new Tier 4 visa regime introduced by the UK Border Agency (UKBA) during 2011-12 will affect the recruitment and retention of international students in the medium term. However, there is a significant risk that the new immigration restrictions, as well as the UKBA's decision in August to revoke London Metropolitan University's Tier 4 licence to sponsor students from outside the EU, will have caused some reputational damage to the UK which could result in a slowdown of international student recruitment that is not reflected in institutional forecasts. At present the sector is forecasting significant growth in fee income from international students but these forecasts were prepared before the UKBA decision to revoke London Metropolitan University's licence was announced.

25. The sector continues to operate on very fine margins, which means that even small changes can have a material impact on its financial performance. Despite the small margins, the short-term viability of institutions is not a concern at this point in time. There continues to be wide variation in the financial performance and health of institutions within the sector. However, positive cash in-flows and healthy cash-backed reserves mean that institutions are unlikely to face solvency concerns in the short term.

26. Uncertainties over future student recruitment, both home and overseas, and over how the new funding system will operate in the medium term (2013-14 and 2014-15) could result in increased volatility of forecasts and financial performance than has been seen in the past. As the impact of these factors become clearer, we will re-assess the financial prospects of institutions.

27. The remainder of this report comprises an analysis of the financial forecasts for the period 2011-12 to 2014-15. The focus is on the financial health of the whole higher education sector in England. Each institution has been sent benchmarking data in relation to its 2010-11 financial performance and forecast position up to 2014-15.

28. The data used in this paper come from two main sources.

a. Data up to and including 2010-11 are from the Higher Education Statistics Agency's Finance Statistics Record, which is completed by all institutions each year.

b. Data covering the forecast period 2011-12 to 2014-15 are from HEIs' 2011 financial results and forecasts submitted to HEFCE. All financial information is presented in academic years (years ending 31 July). For references to real-terms changes in performance we have used HM Treasury's gross domestic product deflator announced in June 2012[3].

29. Table 1 provides the key headline data from the financial information submitted by HEIs in June 2012. Further detail and analysis of the sector's financial performance in 2010-11 can be found in 'Financial health of the higher education sector: 2010-11 financial results and 2011-12 forecasts', HEFCE 2012/05[4]).

Table 1 Summary of key financial indicators

	Actual		**Forecast**			
	2009-10	**2010-11**	**2011-12**	**2012-13**	**2013-14**	**2014-15**
Total income	£22,221M	£22,933M	£23,119M	£24,072M	£25,005M	£26,002M
Operating surplus as % of total income	£708M 3.2%	£1,061M 4.6%	£719M 3.1%	£431M 1.8%	£649M 2.6%	£875M 3.4%
Historical cost surplus as % of total income	£805M 3.6%	£1,307M 5.7%	£933M 4.0%	£701M 2.9%	£824M 3.3%	£1,028M 4.0%
Cash flow from operating activities as % of total income	8.3%	9.2%	6.2%	5.8%	6.5%	7.9%
Net liquidity as number of days' expenditure	98	109	104	88	81	79
External borrowings as % of total income	21.1%	21.9%	23.5%	24.4%	25.1%	24.6%
Discretionary reserves exc. FRS17[†], as % of total income	46.0%	51.0%	55.2%	56.4%	58.0%	60.1%

[†] FRS17 is the financial reporting standard on retirement benefits.

Assessing future financial sustainability

30. As in previous years, the forecasts show that the sector-wide picture encompasses a wide range of projected financial results between institutions. The main financial strength of the sector remains in a small number of institutions.

31. Overall, up to the end of the forecast period the forecasts indicate that the sector is likely to remain financially sustainable, though some institutions will need to generate better financial

[3] See www.hm-treasury.gov.uk/data_gdp_index.htm

[4] All HEFCE publications are available at www.hefce.ac.uk/pubs

results to remain sustainable in the medium term and to make the necessary capital investments in their estates.

32. In preparing their financial forecasts, institutions have identified a number of risks to the forecasts' accuracy and their financial performance.

Key risks

33. HEIs have identified the following key risks to the sector's financial sustainability:

- fall in student recruitment and retention in an increasingly competitive market
- failure to manage student number controls
- further unanticipated public spending cuts
- failure to effectively manage changes to the timing of cash payments from public funding bodies (including payments from the Student Loans Company)
- failure to effectively manage major capital investment programmes and their financial impacts
- rise in the cost of borrowing
- failure to achieve growth in overseas fee income
- a rise in staff and pension costs above forecast levels
- changes to visa regulations resulting in reduced overseas student demand
- failure to comply with UKBA requirements resulting in removal of ability to sponsor non-EU students.

34. The accuracy of the forecasts depends on what assumptions have been made by HEIs and to what extent they have taken the risks above into account. On top of that the uncertainties over future student recruitment both home and overseas, together with the uncertainties about the effects of the UK economy and how the new funding system will operate in the medium term, are unknown factors that will inevitably reduce the reliability of HEIs' forecasts. Another likely consequence is greater volatility of forecasts and financial performance than has been seen in the past.

35. There continues to be a risk that future public funding of higher education could be constrained if the overall economic climate does not improve.

36. It is important to note that HEIs continue to undertaken their own scenario planning and sensitivity analysis to assist them in developing their financial forecasts. As we move to the new funding environment, we encourage institutions to continue to assess the potential impacts of future changes on their operations and, where necessary, to identify mitigating actions. This scenario planning will need to consider potential changes in student demand, availability of public funding, and pay and pensions pressures. HEFCE institutional teams, in their regular engagement with HEIs, will continue to discuss the actions being taken by the sector to mitigate adverse impacts.

Forecast performance in 2011-12

37. Due to the uncertainty over the future funding climate we gave institutions an option to defer forecast information for the period 2012-13 to 2014-15 from December 2011 until June 2012. (See 'Annual accountability returns 2011', HEFCE 2011/28, and 'Annual accountability return requirements', HEFCE Circular letter 10/2012.)

38. All institutions submitting forecast data to us in June 2012 also provided revised forecast information for 2011-12. This is the first year of transition to the new funding environment, and the financial forecasts, at sector level, show a stronger financial position than that anticipated in December 2011.

39. Total income is expected to be £370 million higher than forecast in December 2011 which, together with additional expenditure savings, results in operating surpluses of £719 million (compared to the earlier forecast of £270 million). The most significant expenditure savings come from staff costs, which are expected to be £216 million (1.7 per cent) less than predicted in December 2011. This more than offsets the expected increase in 'other operating expenses' (£151 million). The fall in staff costs may be due to institutions returning more cautious forecasts about the results of their cost-reduction programmes earlier in the financial year.

40. Cash flow from operating activities is expected to be 6.2 per cent of total income (against the earlier forecast of 4.5 per cent). Cash (liquidity) levels are expected to remain strong at 104 days, much higher than forecast in December 2011 (which was 88 days).

41. While the majority of institutions are now predicting better financial outturns in 2011-12, 20 institutions are forecasting a decline in their operating performance compared to their earlier predictions. Of these, 7 are forecasting greater operating deficits in 2011-12 than forecast in December 2011, and 3 are forecasting operating deficits where they had originally expected small operating surpluses.

42. Overall the financial outturn for 2011-12 looks manageable for the vast majority of institutions. However, we will continue to monitor the medium-term prospects of institutions as the impacts of the new funding system become apparent.

Forecast performance in 2012-13 to 2014-15

43. 2012-13 is the first year of the funding reforms. The forecasts for this year show the first major fall in public funding, which is countered by a significant increase in fee income from home and EU students. This comes at a time when the sector is projecting increases in expenditure and when many institutions are planning to continue to invest substantial, but necessary, sums into their capital programmes. As a result, surpluses and cash levels are expected to fall in 2012-13 before rising again in 2013-14 as the new funding arrangements become established and fee income is projected to rise further. Some of this rise is attributed to continued strong growth in fee income from non-EU students.

44. It is too early to say what the effects of the funding reforms on students and institutions will be on home and EU student numbers in the forecast period. However, latest UCAS data[5]

[5] UCAS data can be found at: www.ucas.com/about_us/media_enquiries/media_releases/2012/20121409

indicate that in 2012-13, overall demand will be down, and lower than the level projected by the sector in these forecasts. Our discussions with HEIs also suggest that some institutions are experiencing some student recruitment difficulties indicating that enrolments will be down by more than planned, which may result in a poorer financial performance than forecast.

45. We will continue to monitor the impact of the funding reforms on the financial prospects of institutions. In the meantime, the following sections look at different aspects of the financial forecasts submitted by institutions, for the whole period to 2014-15:

- income
- overseas income
- student recruitment
- expenditure
- surpluses
- liquidity and cash flow
- capital expenditure and borrowing
- reserves.

Income

46. At sector level, total income is forecast to rise by 4.1 per cent (cash terms) in 2012-13, 3.9 per cent in 2013-14, and a further 4.0 per cent in 2014-15. These rises reflect the expected increases in tuition fee income. Table 2 provides a breakdown of the income levels forecast.

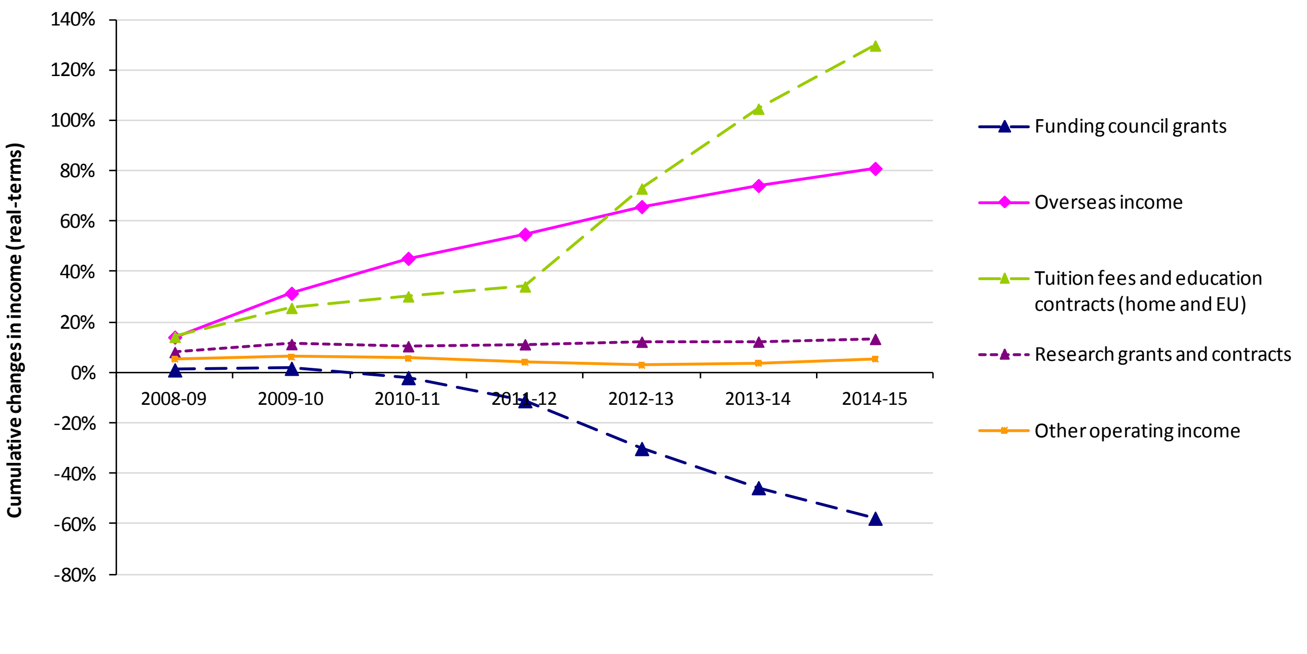
Table 2 Breakdown of forecast income levels (cash terms)

£M	**2010-11 actual**	**2011-12 forecast**	**2012-13 forecast**	**2013-14 forecast**	**2014-15 forecast**
Funding council grants	7,205	6,694	5,405	4,311	3,436
Overseas (non-EU) fee income	2,513	2,745	3,016	3,248	3,459
Tuition fees and education contracts (home and EU)	5,235	5,527	7,313	8,867	10,201
Research grants and contracts	3,564	3,678	3,810	3,906	4,043
Other operating income	4,220	4,263	4,324	4,468	4,654
Endowment income and interest	196	211	204	205	209
Total income	**22,933**	**23,119**	**24,072**	**25,005**	**26,002**

47. Within the forecasts for funding council grants, institutions are expecting HEFCE funding for teaching to fall by £1.1 billion in 2012-13, with further reductions in funding of £1 billion and £816 million in 2013-14 and 2014-15 respectively. These projections appear reasonable given what the Government has announced so far about future funding of the sector. While Table 2 shows projected changes in cash terms, Figure 1 shows the cumulative real-terms actual and projected changes in income since 2007-08 (excluding endowment income). This illustrates the

sharp fall in funding council grants over the period, which is countered by significant growth in fee income from home and EU students.

Figure 1 Cumulative real-terms actual and projected changes in income since 2007-08

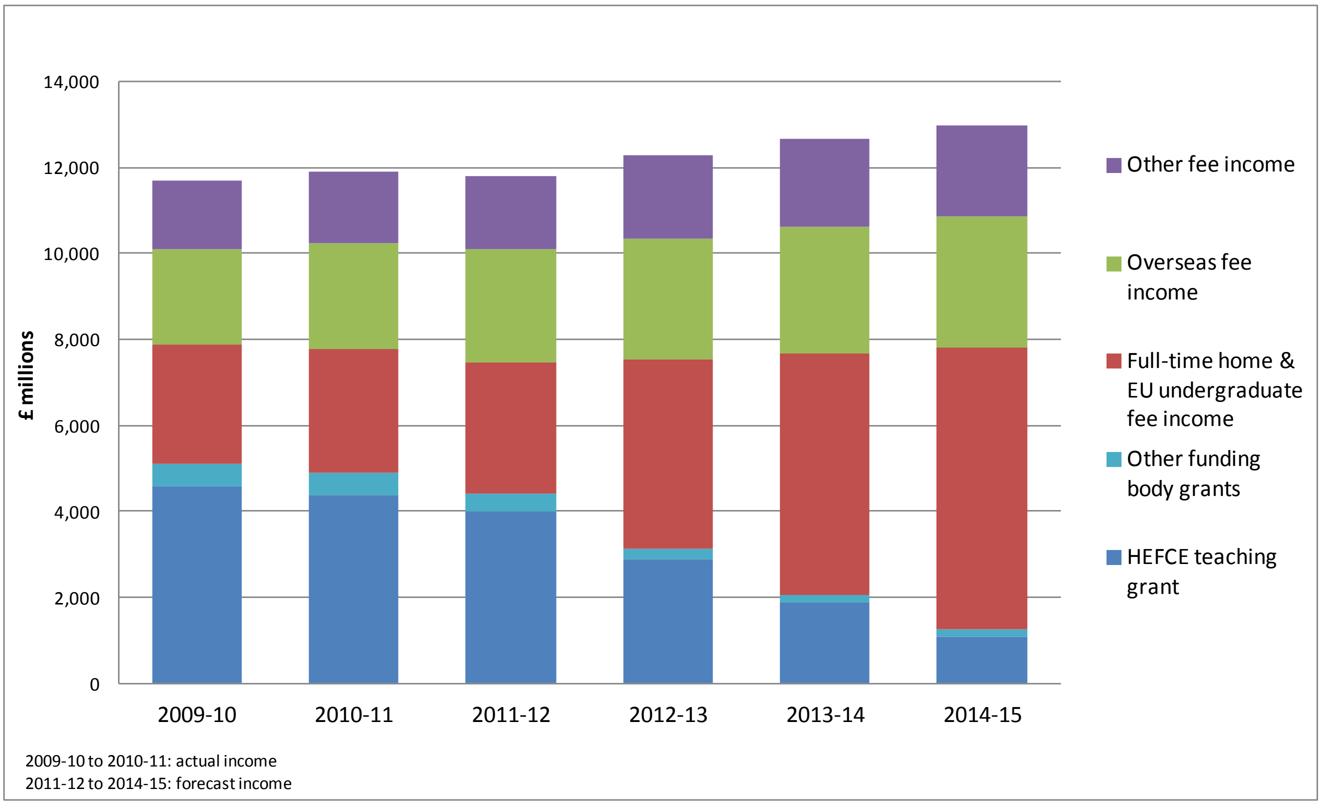


Data based on actual income for the period up to and including 2010-11 and forecast income for the period 2011-12 to 2014-15

48. In 2012-13 fee income from full-time home and EU undergraduates is expected to increase by £1.5 billion (48.5 per cent), with further increases of £1.4 billion (30.2 per cent) expected in 2013-14 and £1.2 billion (19.8 per cent) in 2014-15 (cash terms). Income from part-time and postgraduate fees is forecast to increase in cash terms over the forecast period, by 60.8 per cent and 49.9 per cent respectively.

49. Figure 2 shows a breakdown of teaching-related income (real terms) received in 2009-10 and 2010-11 and the income projected for the period 2011-12 to 2014-15 (in real terms and based on institutional forecasts). It shows that, overall, teaching-related income – which includes public funding and tuition fees – is expected to rise over the forecast period.

Figure 2 Breakdown of teaching-related income 2009-10 to 2010-11 actual and 2011-12 to 2014-15 forecast

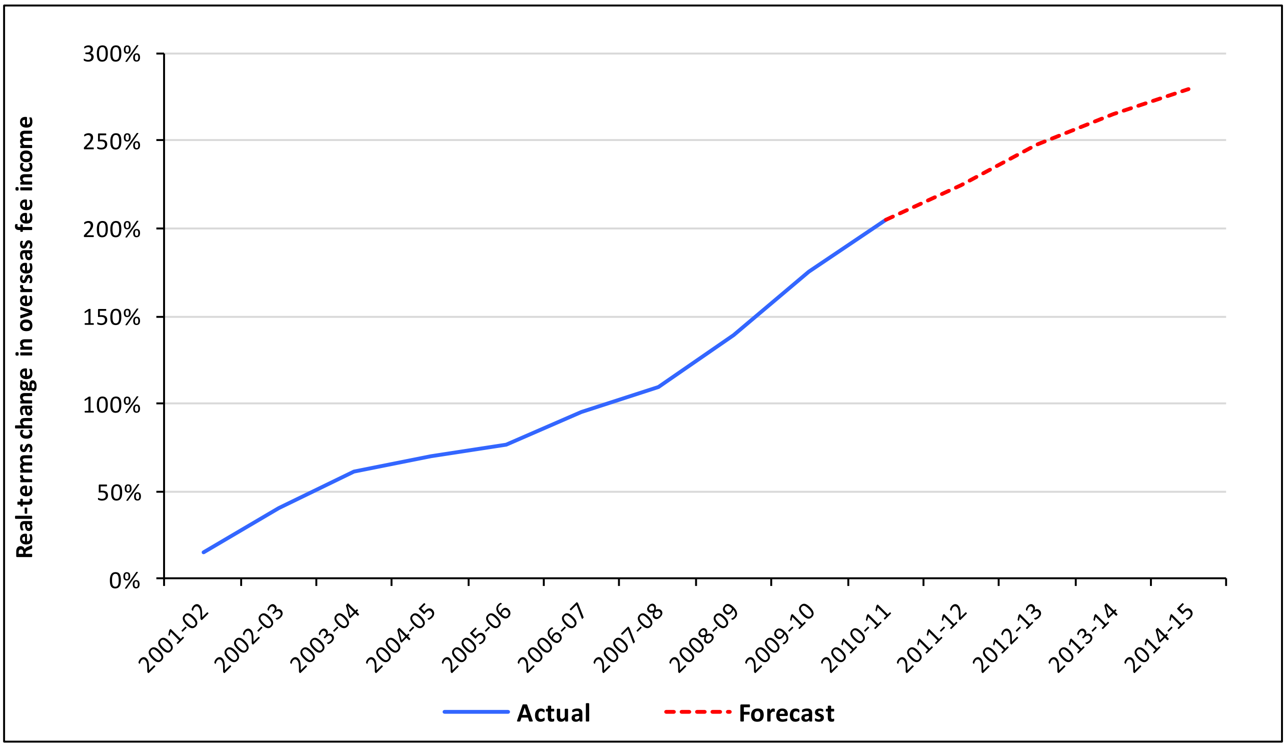


Overseas income

50. As in previous years, the sector is expecting overseas (non-EU) student numbers to increase over the forecast period. On average, fee income from overseas students has increased by 11.4 per cent (real terms) per year over the last nine years. In cash terms, the sector is expecting overseas fee income to rise 37.6 per cent from £2,513 million in 2010-11 to £3,459 million by 2014-15.

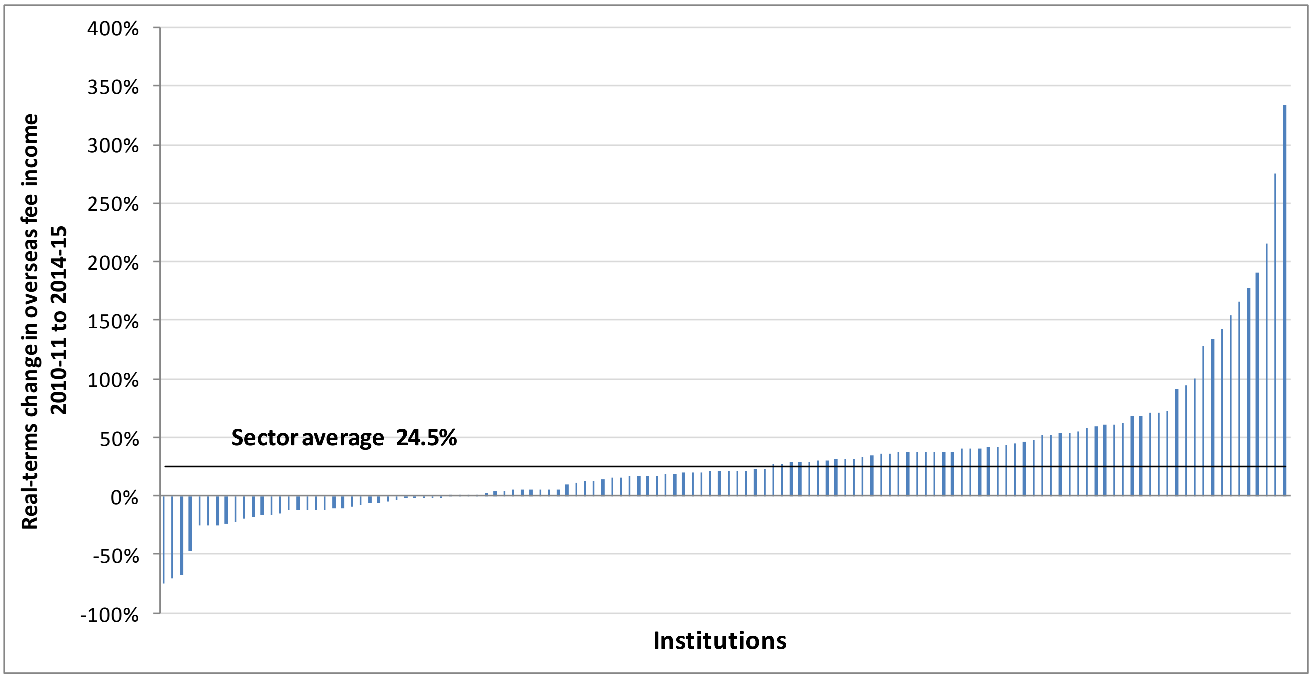
51. Figure 3 shows the real-terms percentage increase in overseas fee income reported by the sector since 2001-02, together with the projected overseas fee income for the forecast period. This shows that the sector is expecting a continuation of real-terms increases in overseas income over the forecast period.

Figure 3 Real-terms increase in overseas fee income 2001-02 to 2014-15



52. Sector forecasts predict an average real-terms increase in fee income for international students of 24.5 per cent (2014-15 compared to 2010-11). However this disguises the significant variation in assumptions used by institutions in predicting their future overseas income levels. Figure 4 shows the variation between different institutions' predictions.

Figure 4 Real-terms change in overseas fee income between 2014-15 forecast and 2010-11 actual



53.	It is too early to predict how the new Tier 4 visa regime introduced by the UKBA during 2011-12 will affect the recruitment and retention of international students in the medium term. However, there is a significant risk that these new immigration restrictions, as well the UKBA's decision in August to revoke London Metropolitan University's licence to sponsor students from outside the EU, will have caused some reputational damage to the UK. This could result in a slowdown of international student recruitment that is not reflected in institutional forecasts.

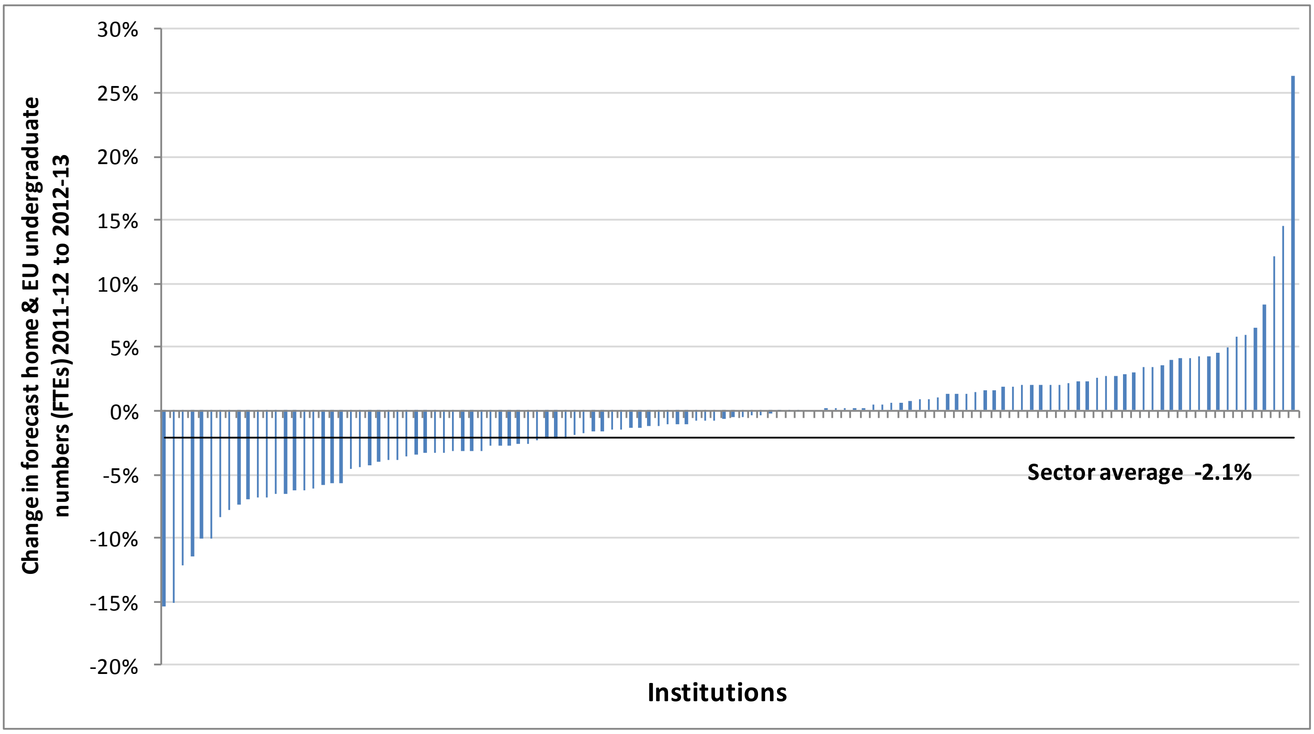
54.	Universities UK and the Government are aware of this risk, and are taking action to promote UK higher education abroad. We will continue to monitor and assess the impact of the new visa regime at sector and institutional level.

Student recruitment

55.	Given that a large proportion of the sector's income depends on the number of students recruited, we ask institutions to support their financial projections with information on the forecast number of students.

56.	In 2012-13, these forecasts show that, at an aggregate level, home and EU undergraduate student numbers are expected to fall by an average of 2.1 per cent. Figure 5 shows the forecast changes in home and EU undergraduate student numbers (both full time, and part time expressed as full-time equivalents) between 2011-12 and 2012-13 for all institutions.

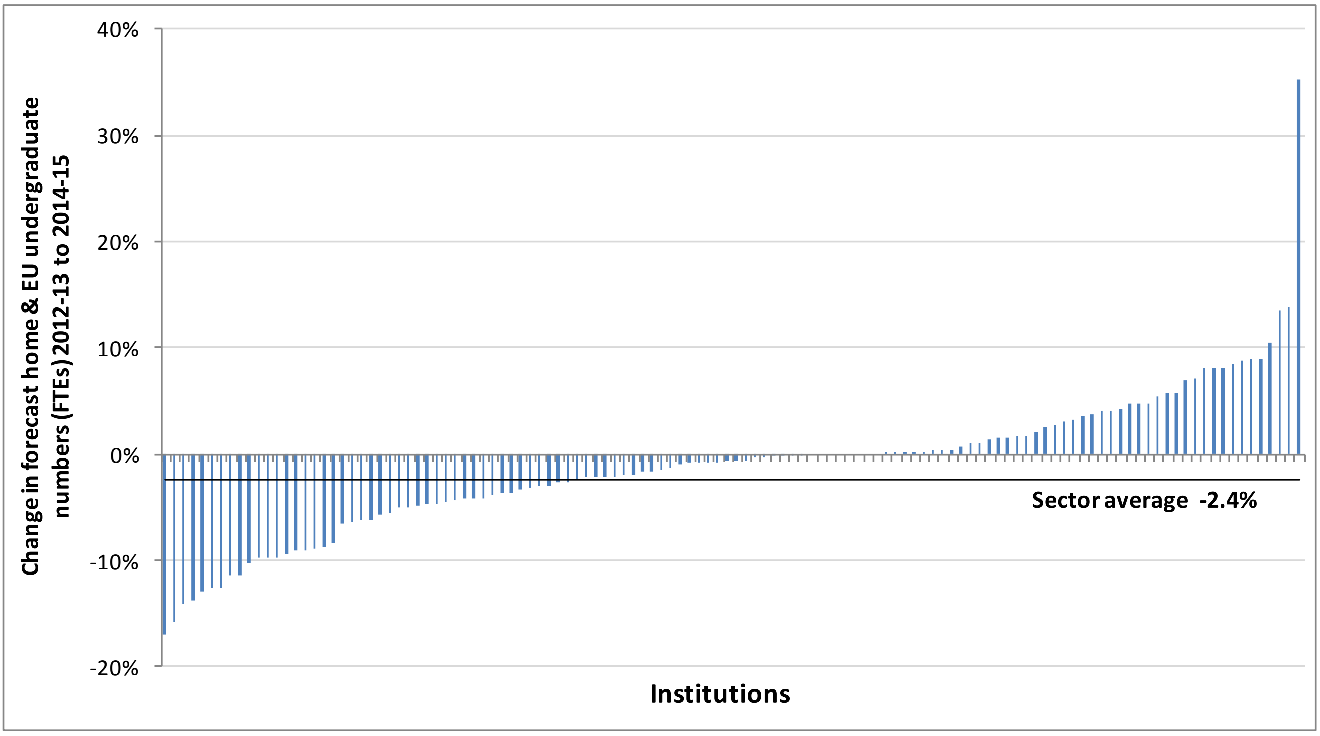
Figure 5 Forecast changes in home and EU undergraduate student numbers between 2011-12 and 2012-13



57.	The majority of institutions (54 per cent) are expecting numbers of home and EU full-time undergraduate students to fall in 2012-13, and a further 6 per cent of institutions forecast no change in student numbers in this period. The remaining 40 per cent are forecasting increases in student numbers, including three institutions that forecast increases of over 10 per cent.

58. In 2013-14 and 2014-15, institutional forecasts show that home and EU undergraduate student numbers are expected to fall by an average of 1.2 per cent per year. Figure 6 shows the forecast changes in home and EU undergraduate student numbers (full time and part time) between 2012-13 and 2014-15 for all institutions.

Figure 6 Forecast changes in home and EU undergraduate student numbers between 2012-13 and 2014-15



59. Home and EU postgraduate taught student numbers (full-time and part-time) are expected to marginally increase over the period 2011-12 to 2014-15, with increases averaging between 0.2 per cent and 1.9 per cent per year. In the same period, part-time undergraduate numbers are forecast to fall between 0.5 per cent and 9.0 per cent per year, with the greatest fall in numbers expected in 2012-13. Overseas student numbers (full-time and part-time) are expected to rise between 4.0 per cent and 6.7 per cent each year in the forecast period.

60. While final student numbers for 2012-13 will not be known until the results of clearing are available, current indications are that enrolments will be down by more than projected by some institutions, and this will require these institutions to revisit their financial forecasts. It is unclear whether the reduced demand reflects an increasing unwillingness of students to accept alternatives in clearing; a tightening of the overall supply/demand balance; or an increase in the time taken to resolve the clearing process as a result of the more critical and complex nature of the decisions facing institutions and students.

61. While the picture for 2012-13 student recruitment will become increasingly clear in the coming months, 2012-13 may well not provide a reliable guide to recruitment in subsequent years. The last time a major system change was introduced (2006-07), recruitment in the first year was subsequently found to be aberrant.

62. We are in close contact with UCAS and receive regular updates on the progress of clearing. We continue to monitor the impact on the financial forecasts and discuss with institutions the actions being taken to mitigate adverse impacts.

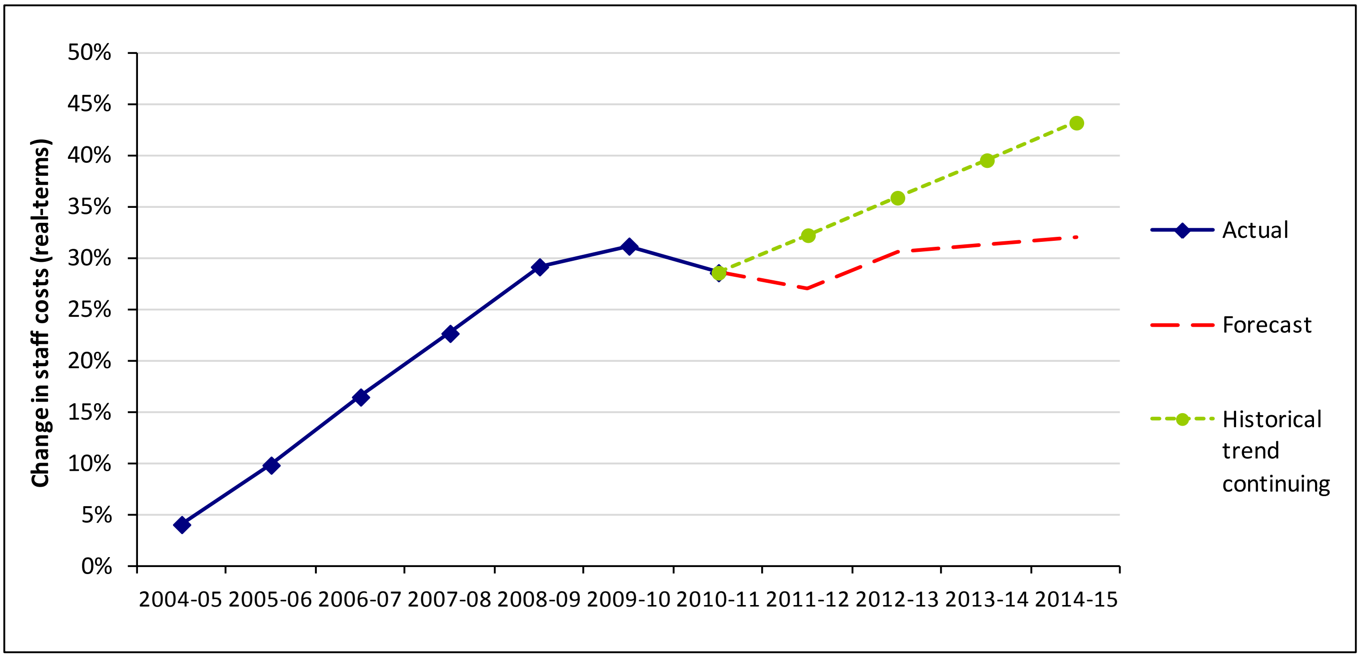
Expenditure

63. Overall, the sector continues to forecast slower growth in expenditure. The exception is 2012-13, when expenditure is expected to rise by 5.6 per cent over the previous year (cash terms).

64. The sector's biggest expenditure is staff costs, which in 2010-11 totalled £12,144 million, equivalent to 53.0 per cent of total income. Although staff costs increased by 0.7 per cent during that year this increase was significantly lower than the average annual increase since 2003-04, which was 6.2 per cent per year (cash terms). Total staff costs for future years are expected to rise between 1.2 per cent and 5.5 per cent (cash terms), with the largest rise expected in 2012-13. In real-terms, average annual pay costs of employees are expected to rise by 0.5 per cent in the period 2011-12 to 2014-15.

65. Figure 7 shows the level of real-terms increases in staff costs over the past seven years, plus what the sector is forecasting to happen over the next four years. It shows that the sector is expecting much lower increases in staff costs than the historical trend. This is consistent with other sectors in the economy.

Figure 7 Real-terms increases in staff costs (cumulative increase since base year of 2003-04)



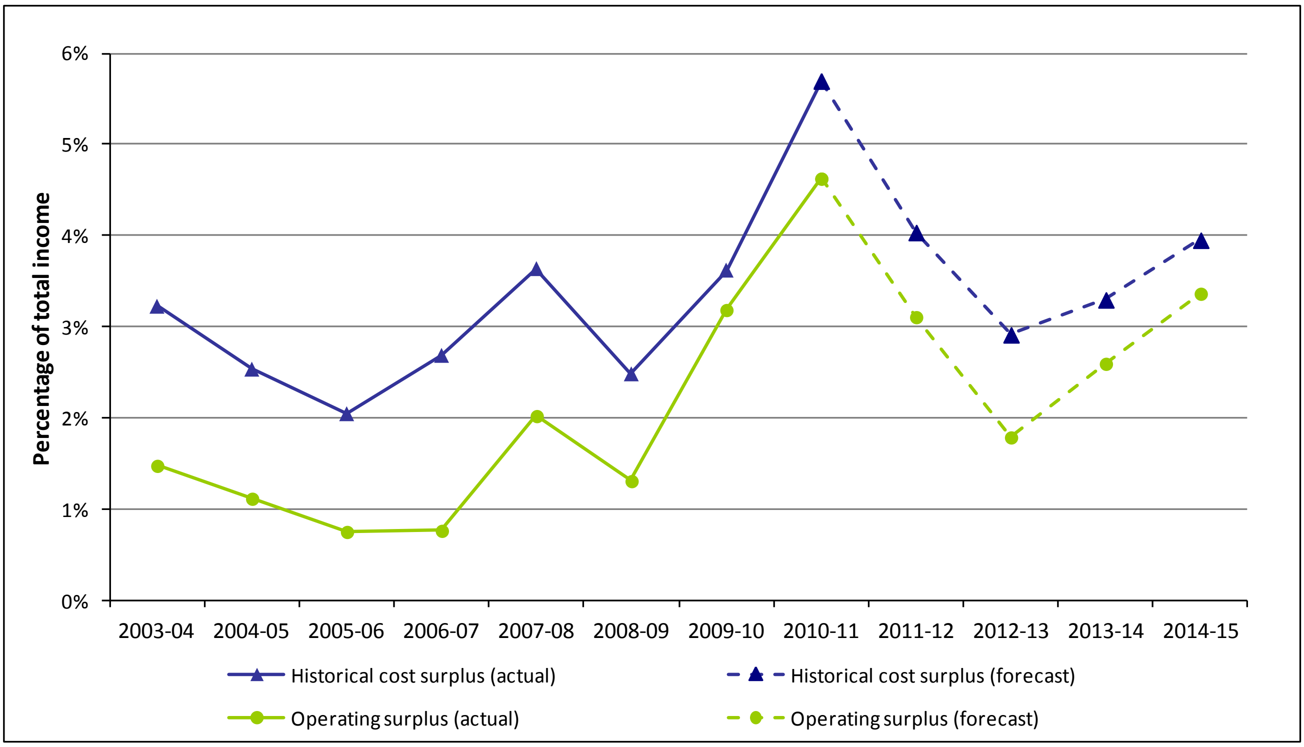
66. The sector is forecasting other operating expenditure to rise between 2.6 per cent and 5.4 per cent (cash terms) per year in the period 2011-12 to 2014-15. Depreciation and interest payable are expected to increase at a faster rate, with depreciation rising between 3.9 per cent and 6.2 per cent per year, and interest payable rising between 1.5 per cent and 8.4 per cent (cash terms) per year in the same period. As with staff costs, the largest rises are expected in 2012-13.

Surpluses

67. The forecasts indicate that, at an operating level (that is, total income less total expenditure, before any exceptional items), the sector expects surpluses to fall from 3.1 per cent of total income in 2011-12 to 1.8 per cent of total income in 2012-13. This fall in surpluses is mainly due to the rise in staff costs forecast by the sector for 2012-13. Thereafter surpluses are expected to rise as fee income increases at a greater rate than reductions in teaching grants. On a historical cost basis the average level of surpluses expected over the forecast period is 3.6 per cent of total income. Historical cost surpluses are expected to follow a similar pattern to operating surpluses, falling in 2012-13 but then recovering from 2013-14.

68. Figure 8 shows the actual and expected operating and historical cost surpluses for the forecast period. The large difference between the operating and historical position forecast in the year 2012-13 are partly accounted for by exceptional items (for example profit or loss from the sale of properties) of £116 million. Although the exceptional items do not substantially distort the analysis of the sector's financial performance, £83 million of the £116 million was accounted for by two institutions expecting substantial capital sums after granting long term leases in respect of their halls of residence.

Figure 8 Operating and historical cost surpluses 2003-04 to 2014-15



Liquidity and cash flow

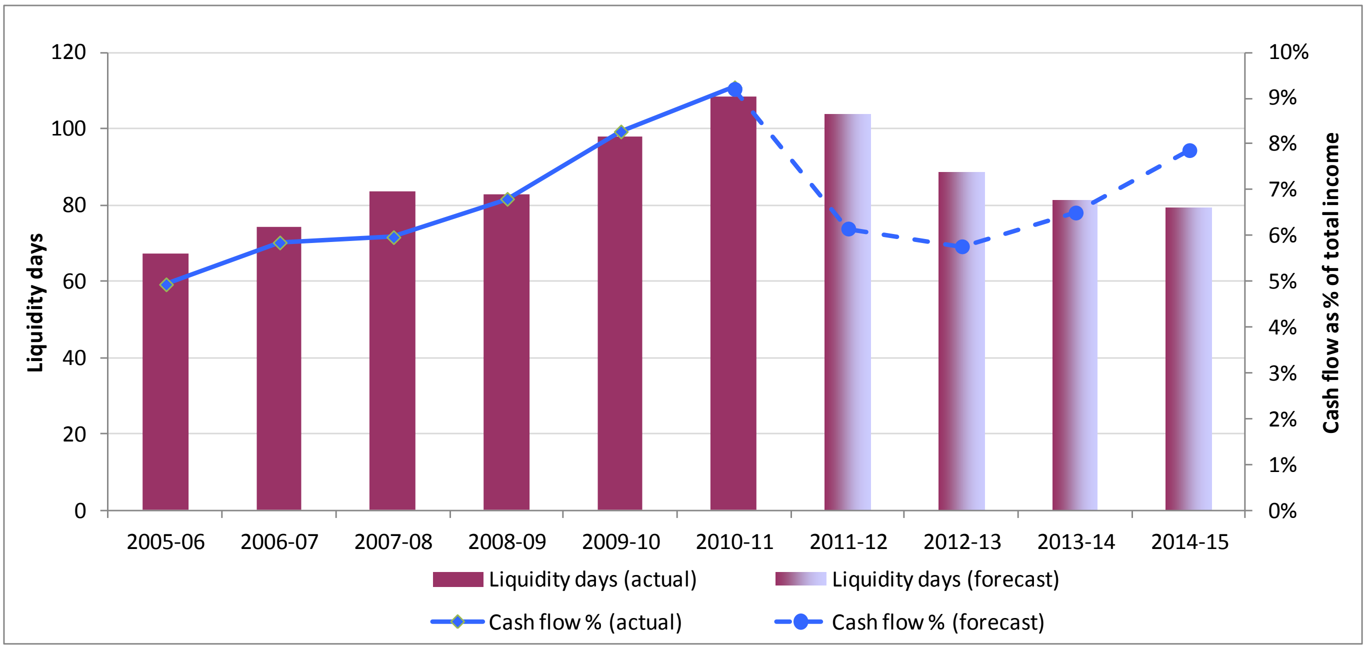
69. The level of liquidity days (that is, the number of days that liquidity covers expenditure) reported for the sector in 2010-11 was the highest on record. This is expected to fall over the forecast period, though remaining at a satisfactory level throughout.

70. This improvement in liquidity for 2010-11 indicates that the sector has been building its cash reserves in preparation for the changes to the funding system and increased volatility in

income levels. This may have been at the expense of capital expenditure in that year, which, at £2,591 million, was £555 million (17.6 per cent) less than projected in the April 2011 forecasts.

71. Figure 9 shows actual and forecast levels of net liquidity (expressed as liquidity days), together with the actual and forecast levels of cash flow from operating activities (as percentage of total income). This shows that the level of liquidity is forecast to reduce over the forecast period to 79 days by the end of 2014-15. Cash flow from operating activities is expected to fall over the next two years, before rising again in the 2013-14 and 2014-15 as fee income rises.

Figure 9 Net liquidity and cash flow 2005-06 to 2014-15



72. Three institutions reported negative cash flows in 2010-11, the lowest number of HEIs on record. This number is expected to rise over the next three years, with ten institutions forecasting negative cash flows in 2011-12, eleven in 2012-13 and ten in 2013-14. By 2014-15, when the transition to the new funding arrangements is substantially complete, the number of institutions predicting negative cash flows is expected to fall to five.

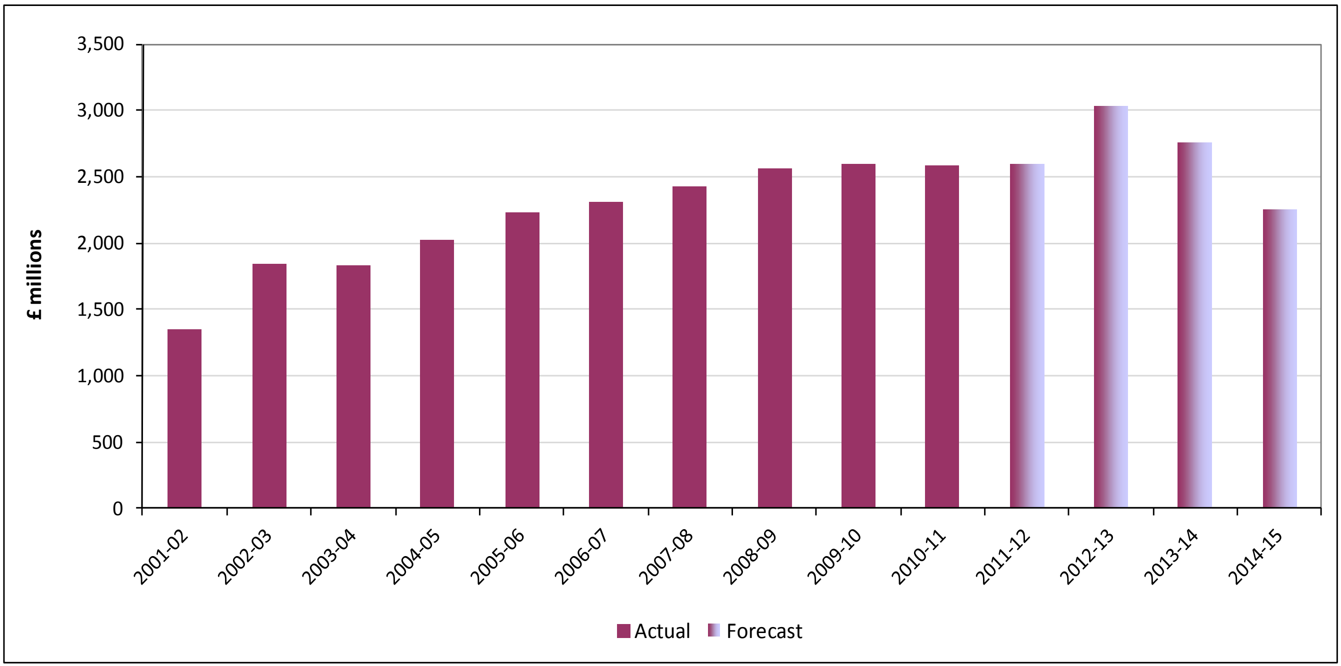
73. Only five institutions had liquidity of less than 20 days in 2010-11 (compared to nine in 2009-10) but this number is expected to rise in the forecast period to ten. Despite this, the risk of solvency problems in the sector remains low.

74. Strong liquidity is necessary for HEIs to efficiently manage the potential increased volatility and unpredictability of the new funding system and the increasingly competitive overseas markets.

Capital expenditure and borrowing

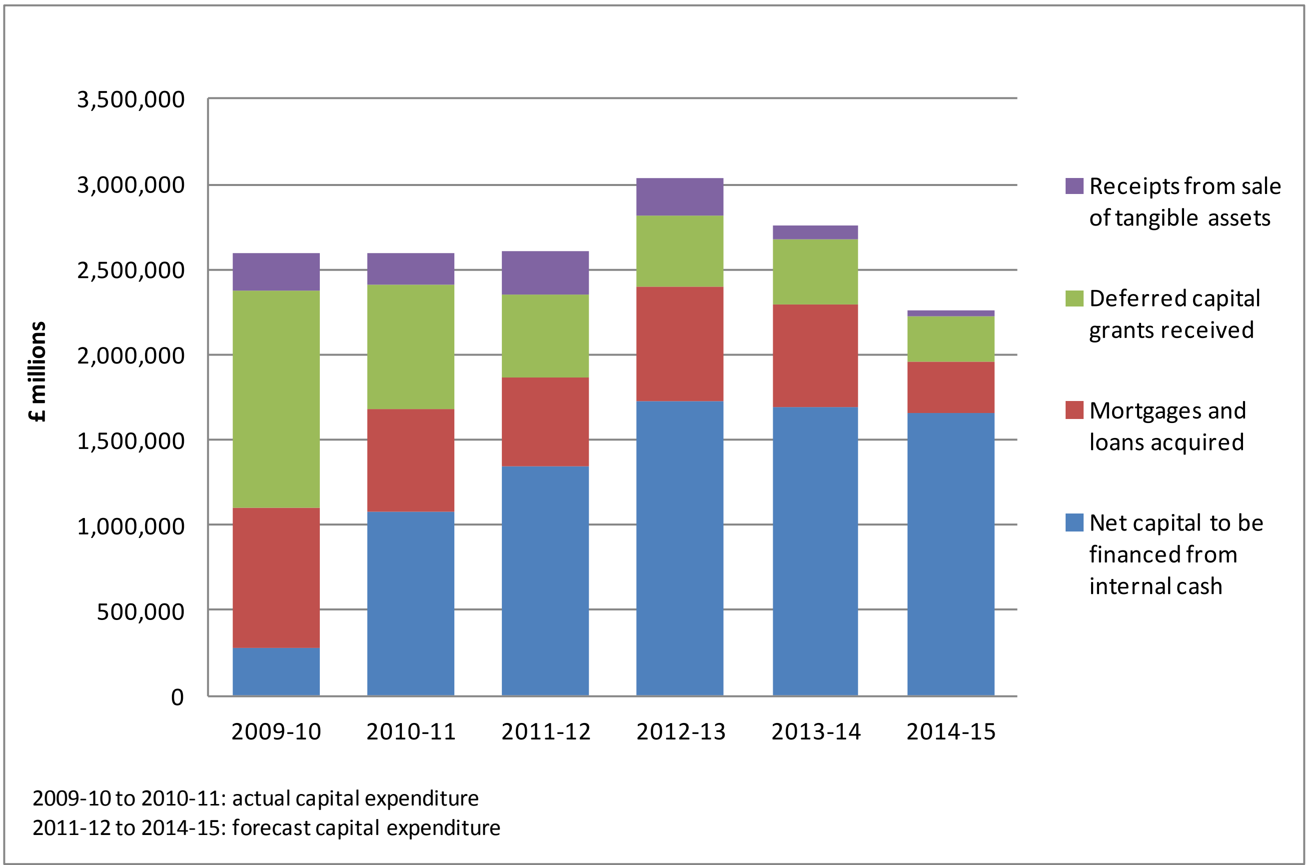
75. Since 2001 the sector has spent £21,767 million on improving its physical infrastructure, excluding expenditure on general day-to-day maintenance. Figure 10 shows the actual levels of investment over the period (payments to acquire tangible assets), together with the projected level of capital expenditure forecast by the sector.

Figure 10 Capital expenditure 2001-02 to 2014-15



76. Figure 11 provides a breakdown of how capital expenditure was funded in 2009-10 and 2010-11, together with an indication of how the sector is expecting to fund its capital investment plans for the period 2011-12 to 2014-15 (based on institutional forecast data). This shows a diminishing level of capital grants alongside an increase in the level of net capital to be financed by internal cash. To achieve this increased internal cash institutions will need to generate higher surpluses than before, to compensate for the reduction in public grants for capital expenditure.

Figure 11 Funding breakdown of capital expenditure 2009-10 to 2014-15



77. Despite large sums of capital expenditure in recent years, Estate Management Statistics (EMS) show that as at 31 July 2011, many institutions still had large amounts of non-residential space in poor condition, with the sector reporting a backlog of under-investment of £2,714 million.

78. In an increasingly competitive environment, and with reduced levels of capital funding, institutions will need to generate surpluses and operating cash inflows to finance future investment in facilities sufficient to attract both home and international students. However looking at the latest sector forecasts, cash inflows from operating activities for 2012-13 and 2013-14 will not be sufficient to fund capital expenditure plans not already financed by capital grants or borrowings. In the short term this level of capital investment is affordable due to the cash reserves held by the sector; however investment in infrastructure will not be able to continue at this level unless institutions generate increased surpluses.

79. If surpluses do not increase there is a risk that the quality of the infrastructure in the higher education sector will reduce, which will harm its long-term sustainability. We will continue to monitor the actions being taken by HEIs to manage their capital investment plans and the quality of their estate.

80. In terms of borrowing, institutional forecasts show that the sector expects its borrowings to rise to £6,409 million by the end of 2014-15, which is £1,380 million more than at 31 July 2011. Given that the sector already has access to over £924 million of additional financing agreed with lenders but not yet all drawn down, availability of financing should be less of an issue compared to other sectors. However, changes in the banking market have meant that lenders are reducing

the period of loans and requiring more restrictive covenants, as well as introducing higher rates of interest.

81. Compared to total income, the level of borrowing has remained relatively stable, fluctuating between 18.4 and 21.9 per cent since 2001 (although the overall trend is an increase). In 2010-11, the level of borrowing increased to 21.9 per cent of total income; this is projected to rise further over the next four years to a high of 24.6 per cent by the end of 2014-15.

82. As borrowing rises in the sector, interest payments are expected to increase, from £333 million in 2010-11 to £405 million in 2014-15. The increase in payments to service borrowing costs (interest and capital payments) will be affordable as long as income and cash projections are as currently forecast. However, this rise in 'fixed costs' could put pressure on any institution that fails to constrain other costs and/or increase income.

Reserves

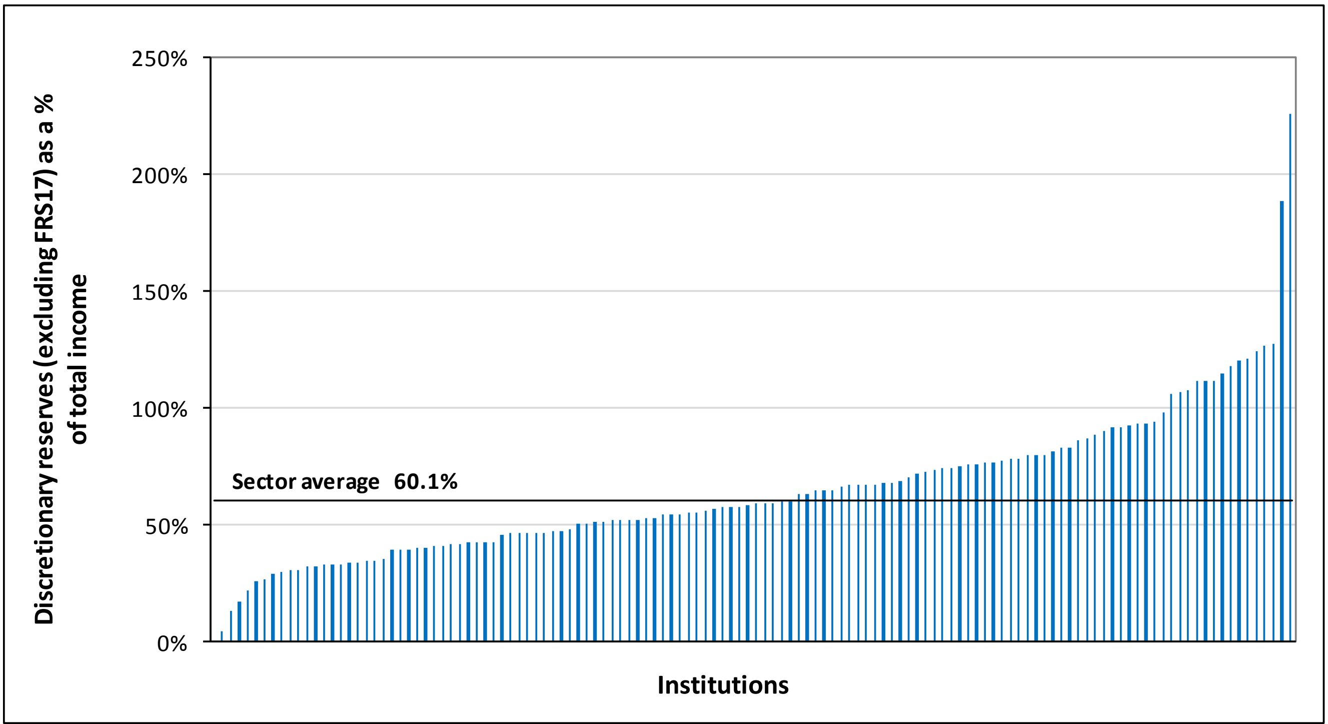
83. At the end of 2010-11 reserves totalled £8,656 million, after taking into account the impact of the financial reporting standard on retirement benefits (FRS17). This reporting standard, which requires pension scheme surpluses or deficits to be included in the balance sheet (but not those of multi-employer schemes such as the Universities Superannuation Scheme), makes comparisons with previous years more difficult. Without FRS17 the sector would have reserves of £11,694 million at the end of 2010-11, equivalent to 51.0 per cent of total income. Including all pension scheme deficits of £3,038 million though reduced the reserves to 37.7 per cent of income.

84. Discretionary reserves are forecast to increase each year in the forecast period as the sector continues to generate surpluses. By the end of 2014-15, the sector expects to have built reserves (including FRS17) of £12,576 million. However, uncertainty over pension deficits, which depend on actuarial assumptions, could significantly affect this figure.

85. As in previous years the sector is not forecasting any material changes in the pension liabilities on its balance sheets. This is an understandable position, due to the inherent difficulty in forecasting pension assets and liabilities, but there is a risk that the sector reserves could come under further pressure if pension liabilities increase. Given the expected reduction in discount rates there is a high likelihood that pension liabilities will increase in 2011-12.

86. Although reserves are strong overall, the aggregate sector position masks a significant spread of financial strength: there is a concentration of large discretionary reserves in a small number of universities. Although this concentration is forecast to continue, six more institutions are expecting to report reserves higher than the sector average in 2014-15 compared to 2010-11. Figure 12 shows the forecast level of discretionary reserves (excluding FRS17) as a percentage of total income for all institutions in 2014-15.

Figure 12 Forecast discretionary reserves (excluding FRS17) as a percentage of total income 2014-15



Conclusion

87. Overall, the financial results for the higher education sector in 2010-11 showed a stronger financial position than previous years. The projected sector performance in 2011-12, the last year before the start of the new funding environment, is not as strong as 2010-11, but is significantly better than forecast by institutions in December 2011.

88. The projected performance for the sector in the remainder of the forecast period (2012-13 to 2014-15) is sound overall. However, given the reductions in public capital funding, some HEIs will need to increase surpluses to finance future capital investment and maintain their long-term sustainability.

89. The main risk identified by the sector last year was an unexpected reduction in student demand. At a sector level the immediate risk of a significant fall in student numbers in 2012-13 has not crystallised. However latest UCAS data suggest that some institutions may have fewer full-time undergraduate students starting studies in 2012-13, and this may require these institutions to revisit their financial forecasts and future financial strategy.

90. There continues to be a large degree of uncertainty about how the new system will operate in the medium term (2013-14 and 2014-15), in particular with regards to the policy of controlling student numbers. This, together with other uncertainties, means that we will need to re-assess the future financial prospects of the sector once the potential impacts become clear.