

March 2013/04

Issues paper

This report is for information

This report provides an overview of the financial health of the higher education sector in England. The analysis covers financial results for the academic year 2011-12 and forecasts for 2012-13, as submitted to HEFCE in December 2012.

Financial health of the higher education sector

2011-12 financial results and 2012-13 forecasts

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To	Heads of HEFCE-funded higher education institutions
Of interest to those responsible for	Audit, Estates, Finance, Governance, Management, Planning
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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 of the financial health of the higher education sector in England. The analysis covers financial results for the academic year 2011-12 and forecasts for 2012-13, as submitted to HEFCE in December 2012.
2. The report is being published to provide universities and higher education colleges with feedback on their financial performance in 2011-12 and their estimates for 2012-13, before they submit their updated financial forecasts in July 2013 (as requested in 'Annual accountability returns 2012', HEFCE 2012/23). The analysis also provides other stakeholders with information about the current financial health of the sector.

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. Following consultation with the sector, through the British Universities Finance Directors Group, we made the decision to continue with dual submission dates for the financial forecast data and financial commentaries. This year's financial forecast data (in the form of material updates to the 2012-13 forecasts and forecast data for the academic years 2013-14 to 2015-16) and financial sustainability commentaries are due to be returned to HEFCE in July 2013.
5. The financial results for the sector in 2011-12 are sound overall, and stronger than projected by the sector in June 2012, but not as strong as the results reported for 2010-11. The improvement in the financial outturn when compared with projected performance may be due to prudent forecasting, which is a pattern we have seen in previous years. Overall the sector reported sound surplus levels, good cash balances and healthy reserve levels, despite the fall in public funding which saw its first real-terms fall in total income since financial information was

first collected across the whole sector in 1994-95. It should be noted that there continue to be significant variations in the financial performance of individual institutions across the sector. The improvement in surpluses relative to the earlier forecast position provides some evidence that the sector made good efficiency savings during the year. The most significant of these savings related to staff costs, which fell in real terms for a second consecutive year in 2011-12.

6. In terms of student recruitment in 2012-13, recent analysis of Higher Education Students Early Statistics (HESES) data indicates that numbers of full-time undergraduate entrants will be about 9 per cent below student number control limits for 2012-13, with much of this shortfall being attributable to fewer students in the 2011 UCAS application cycle deferring entry until 2012-13. However, the sector's financial forecasts show that the most significant fall is expected in the part-time undergraduate group, where numbers are expected to fall by 14 per cent across all years of study.

7. The projected financial results for 2012-13 indicate that the sector will remain in sound financial health overall, although the reductions in public teaching grant funding, shortfalls in student recruitment and projected increases in expenditure will cause surpluses to reduce sharply.

8. Capital expenditure in 2011-12 totalled £2,353 million, which was less than originally forecast. However in 2012-13 the sector is projecting an increase in capital expenditure to £3,142 million. This is despite reductions in public capital funding which have seen HEFCE capital grant funding falling from an average of £825 million per annum over the period 2008-11 to £299 million in 2011-12 (a reduction of 64 per cent).

9. Given the reductions in public capital grants, the sector is now funding a significantly higher proportion of capital expenditure from internal cash reserves or through other sources to help maintain the quality of infrastructure. In 2012-13, forecasts show that the sector requires £1,499 million from its own cash reserves, equivalent to 6 per cent of total income, to help fund the capital investment planned for that year. Some institutions will need to increase surpluses in future years above current levels to ensure that the quality of the infrastructure in the higher education sector does not deteriorate, which would harm its long-term sustainability.

10. Based on the revised financial forecasts for 2012-13, no institutions are close to the risk of insolvency. This is supported by independent institutional audits and the sector's own projected continuation of positive cash in-flows and healthy cash-backed reserves. Strong liquidity is necessary for HEIs efficiently to manage the potential increased volatility and unpredictability of the new funding system and the increasing competition from international higher education institutions.

11. We will publish an update on the financial health of the sector in the autumn, when we have received and analysed all HEIs' financial forecasts for the period 2013-14 to 2015-16.

Action required

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

Overview

13. Higher education institutions (HEIs) in England are required to send us their annual accountability returns at two points during the year. These returns form a significant part of the way in which HEIs can demonstrate accountability for the public funds distributed to them.

14. We primarily use the information collected to:

- confirm the use of HEFCE funds for the purposes intended, including compliance with the Financial Memorandum¹
- form a basis for discussion with institutions about their progress in key areas, their priorities for strategic development, and their current and future performance (including financial sustainability)
- largely determine our risk assessments for each institution
- identify trends across the sector and advise the Secretary of State for Business, Innovation and Skills on its needs and development
- monitor HEIs' reporting of information relating to their charitable status, in accordance with our role as a principal regulator under the terms of the Charities Act 2006.

15. The annual accountability returns are also a key element of HEFCE's institutional assurance and risk framework. They complement our cycle of assurance reviews and data audits to provide a coherent regulatory approach to HEIs. The various accountability returns that HEIs submit to HEFCE provide assurance to all investors and to the community that each institution serves.

16. As with last year, the submission of annual accountability returns and the accountability review process are being undertaken in two stages.

17. This report provides an overview on the financial health of the sector as assessed in the first stage, and will provide universities and higher education colleges with feedback on their financial performance in the academic year 2011-12 and original estimates for 2012-13, before they submit their updated financial forecasts in July 2013. The analysis also provides stakeholders with information about the current financial health of the sector.

18. The data used in this report come from two main sources. All 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. Information covering the period 2011-12 to 2012-13 is from HEIs' financial returns submitted to us². Some comparisons are made to the financial results and forecast data submitted to us in June 2012. All financial information is presented in academic

¹ For further information see 'Model Financial Memorandum between HEFCE and institutions: Terms and conditions for payment of HEFCE grants to higher education institutions' (HEFCE 2010/19). All HEFCE publications are available at www.hefce.ac.uk/pubs/

² The financial results and forecasts data used in this report exclude Leeds College of Music, which transferred to the further education sector on 1 August 2011. References to previous years (prior to 2010-11) include the financial data for this institution.

years (ending 31 July). For references to real-terms changes in performance we have used HM Treasury's gross domestic product deflator, announced in December 2012.³

Summary and headline information

19. Table 1 provides a summary of the key financial results for 2010-11 and 2011-12 and shows the forecast performance in 2012-13.

Table 1 Summary of key financial indicators

	Actual		Forecast
	2010-11	2011-12	2012-13
Total income	£22,933M	£23,277M	£23,920M
Operating surplus	£1,061M	£974M	£381M
as % of total income	4.6%	4.2%	1.6%
Historical cost surplus	£1,307M	£1,138M	£617M
as % of total income	5.7%	4.9%	2.6%
Cash flow from operating activities as % of total income	9.2%	8.1%	5.0%
Net liquidity as number of days' expenditure	109	118	101
External borrowings as % of total income	21.9%	23.6%	25.8%
Discretionary reserves excluding FRS17 [†] as % of total income	51.0%	56.0%	57.5%

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

Financial performance

20. The financial results for the higher education sector in 2011-12 are sound overall and stronger than those projected by the sector in June 2012, but not as strong as the results reported for 2010-11. Overall, the sector reported good surpluses, large cash balances and healthy reserve levels. However, as in previous years, the sector-wide picture encompasses a wide range of results between institutions. The key messages from the analysis of the 2011-12 annual accounts are included in the following section.

³ We have used the latest Gross Domestic Product deflators published by HM Treasury. The figures used were released on 21 December 2012, and can be found at: www.hm-treasury.gov.uk/data_gdp_index.htm

Income

21. Total income increased by £344 million (1.5 per cent) to £23,277 million during 2011-12, with the fall in funding council grants (£515 million) being offset by the rise of £623 million in income from total tuition fees (including from international students). This was the year before the new fee levels came into effect, and the rise in fee income is mainly due to an increase in the number of students starting studies in that year. Table 2 provides a breakdown of sector income for the last two years and the percentage change in income streams.

Table 2 Breakdown of total income

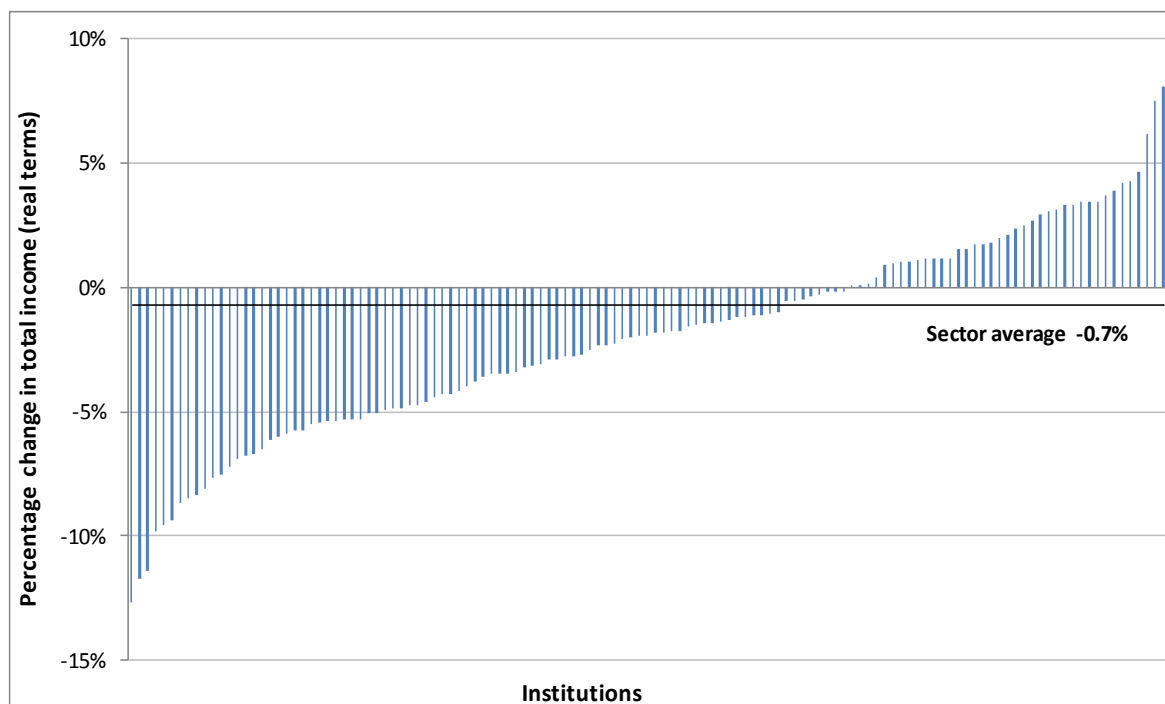
	2010-11	2011-12	% change
Funding council grants	£7,205M	£6,690M	-7.1%
Overseas fee income	£2,513M	£2,747M	9.3%
Tuition fees and education contracts (Home and European Union)	£5,235M	£5,624M	7.4%
Research grants and contracts	£3,564M	£3,645M	2.3%
Other operating income	£4,220M	£4,335M	2.7%
Endowment income and interest	£196M	£236M	20.7%
Total income	£22,933M	£23,277M	1.5%

22. Although overall sector income increased in 2011-12, 60 HEIs recorded actual cash reductions in income, a much higher figure than in previous years (for instance 23 HEIs in 2010-11).

23. In real terms, total income fell by 0.7 per cent in 2011-12. This is the first time total income has fallen, in real terms, since financial information was first collected across the whole sector in 1994-95.

24. Within the sector, 88 HEIs recorded real-terms reductions in income compared with 50 HEIs in 2010-11. These reductions were primarily due to the lower levels of HEFCE funding, but in a minority of cases the reductions result from other factors, such as a fall in income from research grants and contracts, or in other operating income. Figure 1 shows the wide variation in performance across the sector.

Figure 1 Real-terms percentage changes in total income (2010-11 to 2011-12)



25. In cash terms, total tuition fee income increased by £623 million in 2011-12, equivalent to an 8 per cent increase upon 2010-11 levels. Table 3 provides a breakdown of tuition fee income for 2011-12 compared with 2010-11.

Table 3 Breakdown of tuition fee income

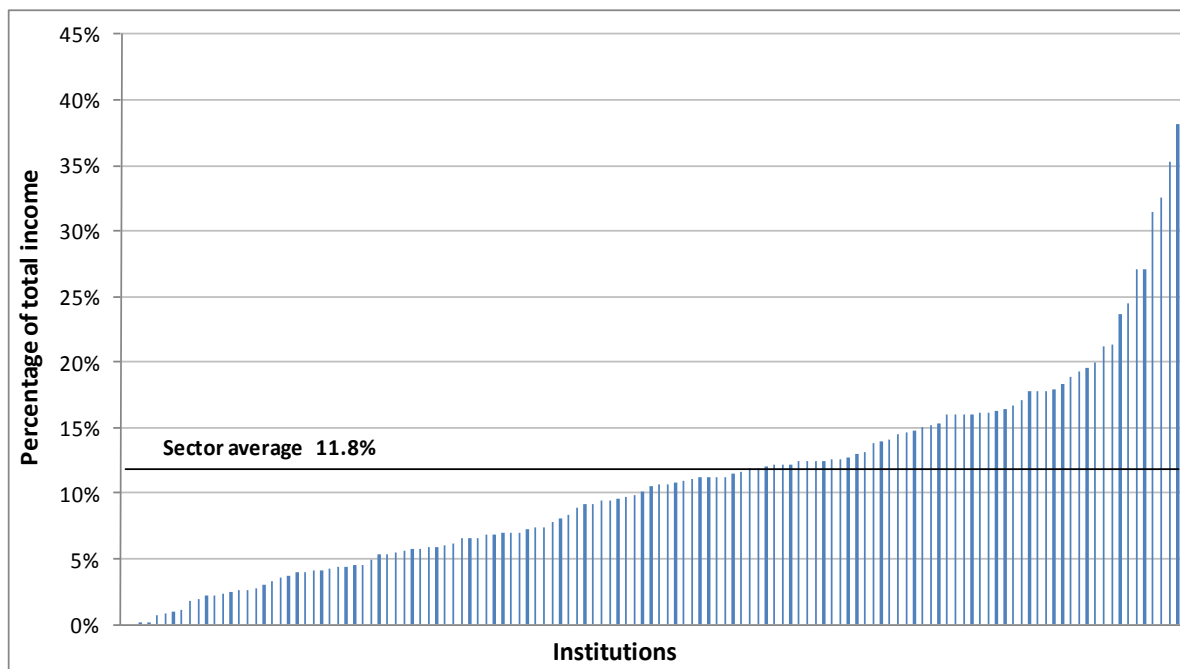
	2010-11	2011-12	% increase
FT UG (home and EU)	£2,859M	£3,113M	8.9%
FT PG (home and EU)	£544M	£575M	5.8%
PT (home and EU)	£536M	£558M	4.0%
Health (home and EU)	£746M	£760M	1.8%
Overseas	£2,513M	£2,747M	9.3%
Other	£550	£618M	12.5%
Total fee income	£7,748M	£8,371M	8.0%

Note: FT – full-time; PT – part-time; UG – undergraduate; PG – postgraduate; EU – European Union.

26. As in previous years, Table 3 shows that there has been continued growth in fee income from overseas students in 2011-12. Since 2000-01 this income stream has more than doubled in real terms, and at the end of 2011-12 it accounted for 11.8 per cent of the sector's total income.

27. Dependence on this income source varies between institutions, ranging from 0 per cent to 38.2 per cent of total income. As in previous years, the 20 institutions recording the highest income from overseas fees account for nearly 50 per cent of the sector's total income from this source. However, the number of institutions reporting a greater reliance on this source of income is growing, with 10 institutions reporting overseas income of over 20 per cent of total income in 2011-12, compared with four institutions in 2008-09. Figure 2 shows the distribution in 2011-12.

Figure 2 Overseas fee income as percentage of total income (2011-12)

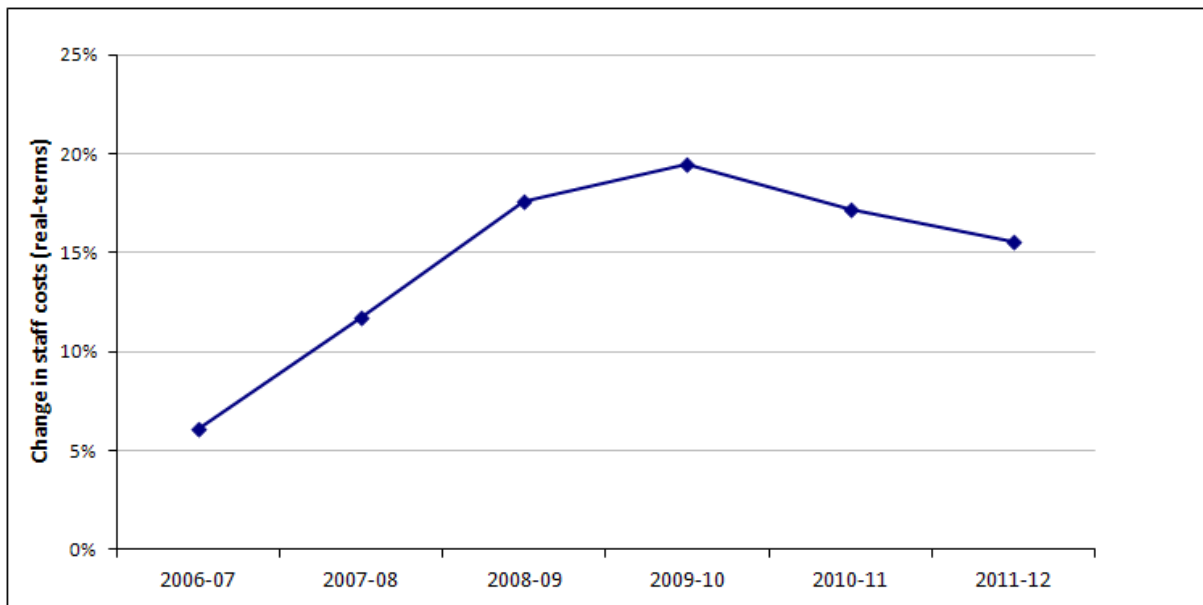


Expenditure

28. In 2011-12 total expenditure increased by 2.0 per cent in cash terms, compared with the increase of 2.5 per cent forecast in June 2012. The sector's biggest expenditure continues to be staff costs, which totalled £12,241 million in 2011-12, equivalent to 52.6 per cent of total income. There has been a trend for staff costs expressed as a percentage of total income to reduce, since a high of 58.1 per cent in 2000-01.

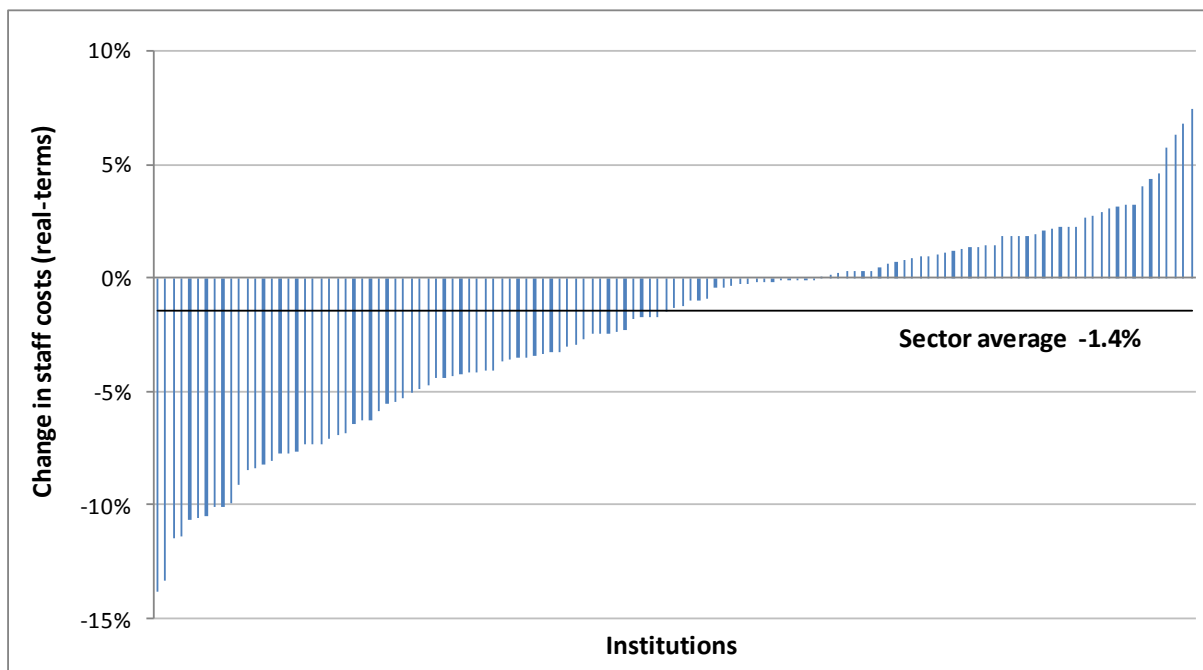
29. In real terms, staff costs have fallen for a second consecutive year. This follows a period of significant growth in staff costs. Figure 3 shows the cumulative change in real-terms staff costs since 2005-06. The reduction of 1.4 per cent in 2011-12 was the third time staff costs have reduced, in real terms, since financial information was first collected across the whole sector.

Figure 3 Cumulative real-terms change in staff costs since 2005-06



30. This overall reduction in staff costs in 2011-12 was caused by a real-terms reduction in the average pay costs of employees, together with a small decrease in the total number of employees in the sector. The overall reduction in staff costs across the sector masks considerable variation between institutions. Figure 4 shows the distribution of changes in staff costs across the sector from 2010-10 to 2011-12.

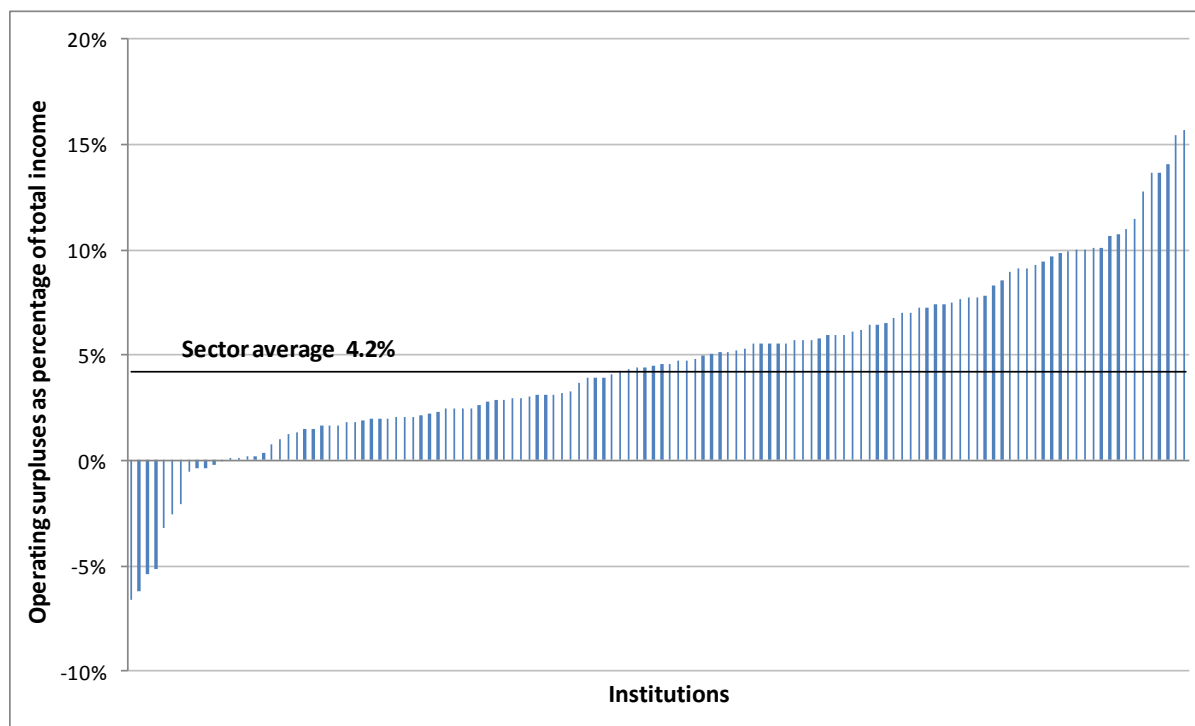
Figure 4 Real-terms percentage changes in staff costs from (2010-11 to 2011-12)



Surpluses

31. The sector's operating surplus (that is, its total income less its total expenditure before any exceptional items) fell over the year from £1,061 million to £974 million (4.2 per cent of total income). Within the sector, 12 institutions reported operating deficits in 2011-12, compared with nine in 2010-11. Figure 5 shows the level of operating surpluses as a percentage of total income reported by institutions in 2011-12.

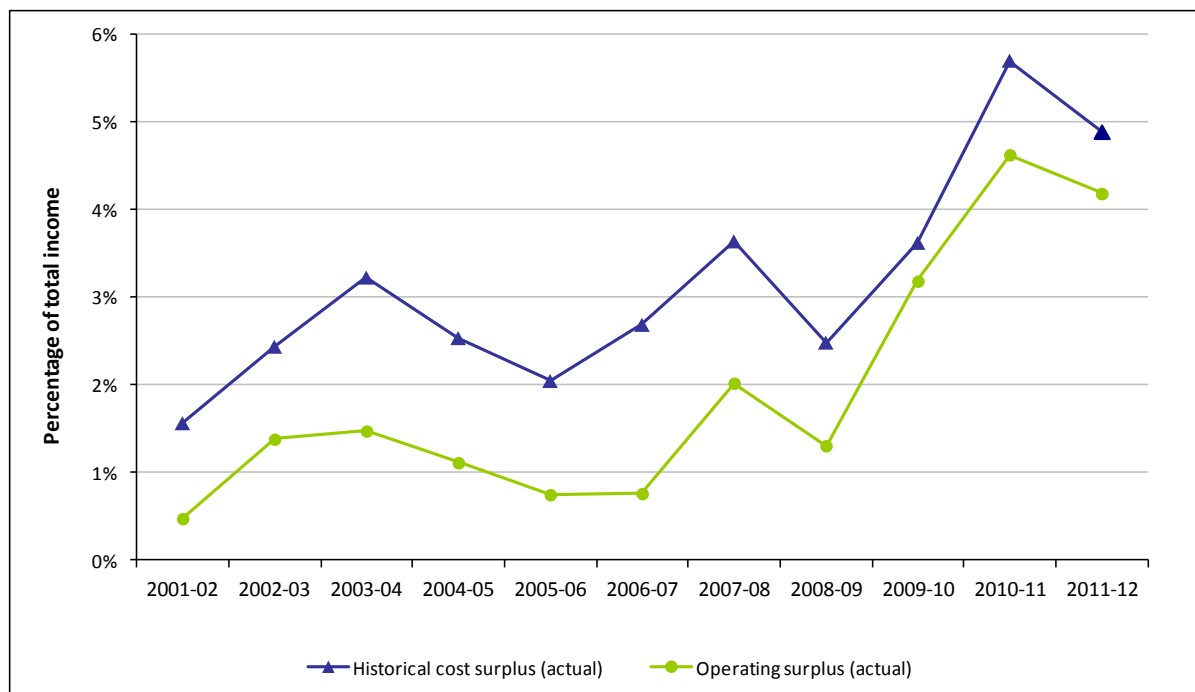
Figure 5 Operating surpluses as a percentage of total income (2011-12)



32. On a historical cost basis⁴ the sector recorded a surplus of £1,138 million (4.9 per cent of total income), which again is significantly ahead of the average over the past 10 years (where the average was 3.2 per cent). The large difference between the operating and historical position in 2011-12 is partly accounted for by exceptional items (for example profit or loss from the sale of properties or exceptional restructuring) totalling £21 million. Figure 6 shows the level of operating and historical cost surpluses as percentage of total income since 2001-02.

⁴ Historical cost surplus (or deficit) is derived by adjusting for the difference between historical cost depreciation and the actual depreciation charged on revalued assets, and net gains realised on the disposal of revalued assets. Institutions may use either historical cost or revaluation to value their assets and the different bases of valuation will alter the operating results, so the historical cost surplus or deficit provides greater consistency for comparing results between institutions.

Figure 6 Operating and historical cost surpluses as percentage of total income (2001-02 to 2011-12)



Liquidity and borrowings

33. At the end of 2011-12 the sector had net liquidity⁵ of £6,775 million, equivalent to 118 days' expenditure, the highest level on record. This is higher than the level forecast in June 2012 (104 days) and the level reported at the end of 2010-11, which was 109 days.

34. The increase in liquidity indicates that the sector has continued to build its cash reserves ahead of the funding reforms in 2012-13. This may have been a temporary increase as capital expenditure is forecast to increase sharply in 2012-13. Capital expenditure totalled £2,353 million in 2011-12 which was £249 million (9.6 per cent) lower than forecast by the sector in June 2012. Liquidity is also higher than originally projected as surpluses and borrowings increased. Only five institutions had liquidity of less than 20 days (compared to nine institutions in 2009-10).

35. Liquidity was also much higher than borrowings, which rose from £5,029 million to £5,490 million, equivalent to 23.6 per cent of income. At the end of July 2012 the sector had another £1,661 million of financing agreed with lenders but not drawn down. Between August and October the sector drew down £915 million of this borrowing.

36. Interest payments and other finance costs rose by 3.7 per cent in 2011-12 (compared with a fall of 16.2 per cent in 2010-11). The sector's annualised servicing costs rose to 2.4 per cent of income in 2011-12 (compared with 2.1 per cent in 2010-11).

⁵ Net liquidity is equal to current asset investments plus bank and cash balances less bank overdrafts. The indicator is also expressed as the number of days' operating expenditure covered by the net liquidity.

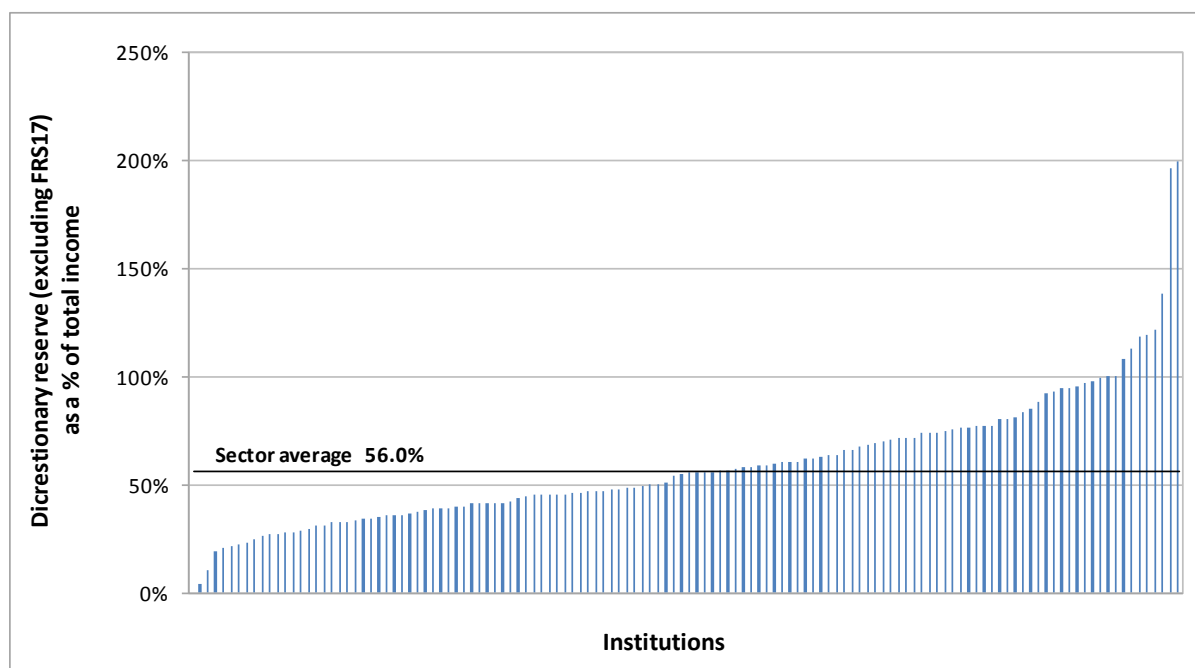
Reserves

37. Discretionary reserves⁶ at the end of 2011-12 totalled £8,966 million, after taking into account the impact of the financial reporting standard on retirement benefits (FRS 17). This reporting standard requires pension scheme surpluses or deficits to be included in the balance sheet, but not those of the Universities Superannuation Scheme since this is a multi-employer scheme that is unable accurately to identify assets and liabilities of individual HEIs. It came into effect from 2005-06, and can make comparisons with previous years more difficult. Without FRS 17 the sector would have reserves of £13,033 million, equivalent to 56 per cent of total income.

38. Total pension scheme deficits increased by £1,029 million to £4,066 million, which reduced reserves to 38.5 per cent of income. In the main, the funding position of sector pensions has deteriorated because of market conditions underlying the financial assumptions on which pension scheme liabilities are calculated under FRS 17. The discount rate applied to pension liabilities is based on bond yields which have reduced during the year; the lower discount rate has the effect of increasing the present value of scheme liabilities.

39. As reported in previous years, the aggregate sector financial position masks a significant spread of financial strength, with a concentration of large discretionary reserves in a small number of universities. Figure 7 shows the spread of reserves (excluding FRS 17) as a percentage of total income, reported as at 31 July 2012.

Figure 7 Discretionary reserves as percentage of total income (2011-12)



Cash flow

40. Cash flow from operating activities totalled £1,896 million in 2011-12, which compares favourably with the forecasts provided in June 2012 (£1,423 million). The level of cash flow in 2011-12 was equivalent to 8.1 per cent of total income, a drop from the 9.2 per cent reported for

⁶ Discretionary reserves are equal to expendable endowments plus general reserves from the balance sheet.

2010-11. The sector has been increasing its cash flow gradually each year since 2004-05, which is a positive indicator of solvency and is particularly important given the changes in funding arrangements from 2012-13.

Financial forecast for 2012-13

41. Overall, the projected results for 2012-13 indicate that the sector will remain in sound financial health. In broad terms, the latest forecasts for 2012-13 are not materially different from those submitted in June 2012. The key messages from the analysis of the latest projections for 2012-13 are included in the following section.

Income

42. The sector is forecasting an increase in total income of 2.8 per cent to £23,920 million in 2012-13. This is marginally lower than the income projected in June 2012 which was £24,072 million. Table 4 provides a breakdown of the income levels forecast and compares these with actual income received in 2011-12.

Table 4 Breakdown of income levels (cash terms)

	2011-12 Actual	2012-13 Forecast	% change
Funding council grants	£6,690M	£5,427M	-18.9%
Overseas fee income	£2,747M	£2,934M	+6.8%
Tuition fees and education contracts (Home and European Union)	£5,624M	£7,185M	+27.8%
Research grants and contracts	£3,645M	£3,805M	+4.4%
Other operating income	£4,335M	£4,345M	+0.2%
Endowment income and interest	£236M	£223M	-5.5%
Total income	£23,277M	£23,920M	+2.8%

43. Following changes to the Government's approach to funding teaching in higher education, from 2012-13, HEFCE teaching grants will reduce for students starting studies from September 2012. At the same time, tuition fees for students have increased to compensate for the reduction in grant funding.

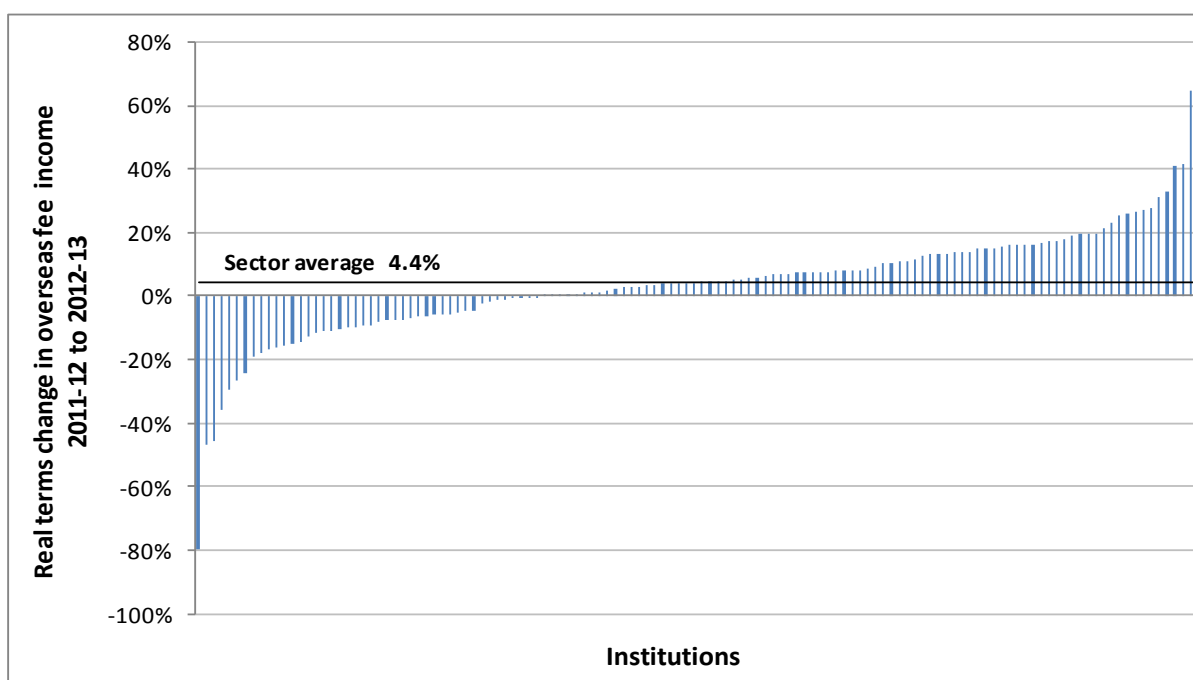
44. Overall, the sector is expecting funding council grants⁷ to fall by 18.9 per cent in 2012-13. This reduction will be offset by a rise in tuition fees and education contracts for home and European Union (EU) students of 27.8 per cent. In real terms, combined income from these two categories is expected to rise by 0.1 per cent.

⁷ This will include HEFCE, the Skills Funding Agency and the Training and Development Agency for Schools.

45. Forecasts for overseas (non-EU) fee income show that the sector is predicting a rise of 6.8 per cent in 2012-13, compared with the rise of 9.9 per cent forecast in June 2012. This reduction in the forecast levels may indicate that some institutions have responded to concerns about the impact of the latest changes in visa regulations on the overseas student market.

46. As in previous years, there remains a large degree of variation in the assumptions used by institutions in their overseas forecasts, with 19 institutions expecting overseas fee income to rise by over 20 per cent in 2012-13 and 37 institutions expecting it to fall. The variation in assumptions is demonstrated in Figure 8; this shows the real-terms changes in overseas income forecast by institutions in 2012-13.

Figure 8 Real-terms change in overseas income (2012-13 compared to 2011-12)



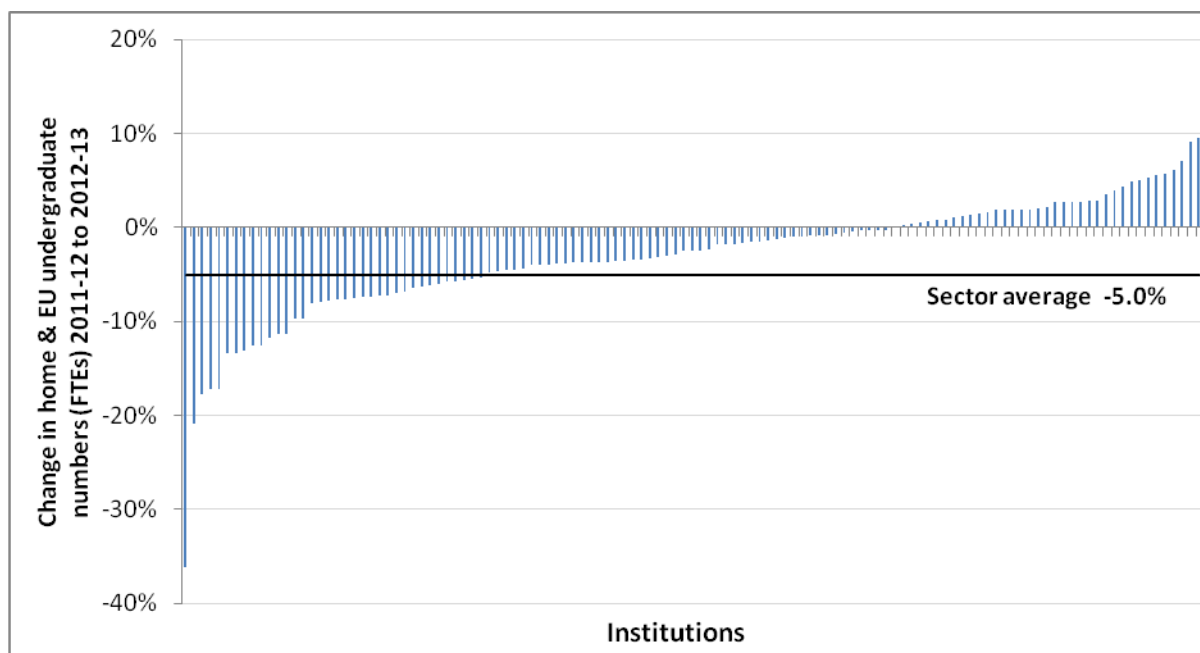
47. We will review institutions' predictions for future overseas income, and their responses to the risks arising as a result of the new visa regulations, in the next stage of our accountability process following the submission of the next forecasts due in July 2013.

Student numbers for 2012-13

48. 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 student number forecasts, expressed as full-time equivalents (FTEs).

49. In 2012-13, these forecasts show that, at an aggregate level for all years of study, home and EU undergraduate student numbers are expected to fall by an average of 5 per cent, although at institutional level there is a wide variation in forecasts. Figure 9 shows the forecast changes in home and EU undergraduate student numbers (full time and part time) for all years of study between 2011-12 and 2012-13.

Figure 9 Forecast changes in home and EU undergraduate student numbers between 2011-12 and 2012-13



50. Further analysis of these forecasts shows that the sector is expecting full-time undergraduate numbers across all years to fall by 3.5 per cent in 2012-13, compared with the fall of 0.9 per cent predicted in June 2012.

51. Much greater reductions are forecast for part-time undergraduate student numbers, with the sector expecting these to drop by 14 per cent in 2012-13 (compared with a reduction of 9 per cent in June 2012 forecast) across all years of study. This is supported by our analysis of the Higher Education Students Early Statistics (HESES) survey data, received separately from HEIs, which indicates that the most significant fall in student numbers will be experienced in the part-time undergraduate group. Overall, the sector anticipates that lost fees resulting from this recruitment shortfall will be mitigated by the increases in tuition fees charged to new students. However, some institutions with a high proportion of part-time students are likely to be disproportionately affected by this fall in demand.

52. Home and EU postgraduate taught student numbers (full-time and part-time) are expected to fall by 9.4 per cent in 2012-13, compared with the June 2012 forecast which predicted a marginal increase in numbers of 0.1 per cent. This reduction is also consistent with our analysis of the forecasts reported in the HESES survey data.

53. December 2012 was the first time HEIs have provided us with numbers of new entrants to support their financial forecasts, so we are not yet able to analyse the forecast changes in new entrants for 2012-13. However, our current analysis of HESES data indicates that numbers of full-time undergraduate entrants will be about 9 per cent below planned student number control limits for 2012-13, with much of this shortfall being attributable to fewer students in the 2011 UCAS application cycle deferring entry until 2012-13.

54. Notwithstanding the year-on-year reduction in entrant numbers in 2012-13, the reduction in full-time undergraduate numbers across all years is expected to be more muted, as students from the high intake in 2011-12 continue their studies. However, there is the prospect of a

significant dip in all-year numbers around 2014-15, as the high 2011-12 entry cohort graduate. In the longer term much will depend on the extent to which recruitment recovers from the low in 2012-13.

55. The latest UCAS data on the 2013-14 application cycle indicate that overall applications to UK institutions have risen by 3.5 per cent. Although there remains uncertainty as to how many of these applications will equate to students actually taking up places in that year, the early indications are that student recruitment should be closer to the planned numbers in 2013-14.

56. Further information relating to our analysis of student demand in 2012-13 and 2013-14 is included in our report 'Higher Education in England – changes and impacts (HEFCE 2013/03)'⁸.

57. We will continue to monitor UCAS data for early indications of recruitment issues and adverse impacts upon financial forecasts, and will assess the impact as part of our accountability review process and our dialogue with HEIs.

Expenditure

58. In 2012-13, the sector is expecting a rise in total expenditure of 5.6 per cent, equivalent to a real-terms rise of 3.2 per cent. In cash terms, 2012-13 expenditure is projected to be £105 million less than the level projected in the June 2012 forecasts.

59. The forecast real-terms rise in staff costs is also expected to be 3.2 per cent in 2012-13. This follows two consecutive years of real-terms reductions in staff costs reported for 2010-11 and 2011-12. The projected rise in 2012-13 is largely due to expected increases in staff numbers in the sector, as opposed to an increase in average real-terms staff costs, which are only expected to rise by 0.9 per cent.

60. As in previous years, at individual institutional level the predicted changes in staff costs vary, ranging from a reduction of 10.0 per cent to an increase in real terms of 16.1 per cent.

Surpluses

61. The forecasts indicate that at an operating level the sector will see a reduction in its surplus from 4.2 per cent in 2011-12 to 1.6 per cent of total income in 2012-13. This is also marginally lower than the surplus forecast for the same period in June 2012, which was 1.8 per cent.

62. On a historical cost basis the level of surplus forecast will be 2.6 per cent of total income, which is below the average over the past 10 years (3.2 per cent) and also below the level forecast in June 2012 (2.9 per cent).

Liquidity and borrowings

63. The level of liquidity in days is forecast to fall from 118 in 2011-12 to 101 in 2012-13. This is still a healthy level and much higher than the forecast submitted in June 2012, which was 88 days. Eight institutions expect to have liquidity of less than 20 days in 2012-13 (compared with five in 2011-12).

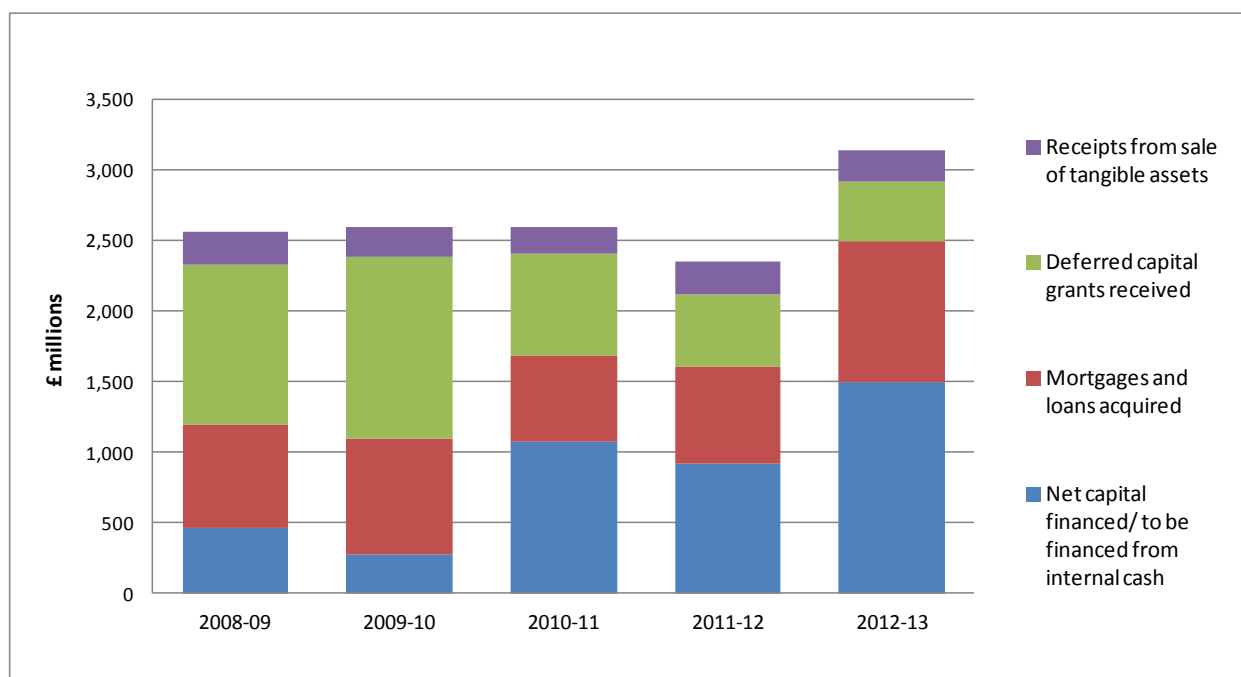
⁸ This HEFCE publication is available at www.hefce.ac.uk/about/intro/abouthighereducationinengland/impact/

64. Liquidity is forecast to fall to £6,083 million by the end of 2012-13, which is partly due to significant planned investment in infrastructure by the sector. One indicator of this is the level of capital expenditure, which the sector is forecasting will increase by £789 million to £3,142 million in 2012-13. This represents a significant increase of 33.5 per cent compared with 2011-12 levels, but may be partly explained by the shortfall in capital expenditure originally planned for 2011-12 (which was £249 million less than forecast in June 2012).

65. Since 2002 the sector has spent £22,767 million on improving its physical infrastructure, excluding general day-to-day maintenance. Figure 10 provides a breakdown of how capital expenditure was funded in the period 2008-09 to 2011-12, together with an indication of how the sector is expecting to fund its investment in infrastructure in 2012-13. This shows a diminishing level of capital grants alongside a significant increase in the level of net capital financed (or to be financed) by internal cash.

66. In 2009-10, the sector received £1,280 million in deferred capital grants and used £274 million of its own cash reserves to help fund capital expenditure. By contrast, in 2012-13 the sector is expecting to receive £417 million in deferred capital grants and projects that it will need £1,499 million of internal cash to finance its net capital requirements. This equates to 6 per cent of the sector's total income projections for 2012-13. To maintain this investment in future some institutions will need to generate higher surpluses to compensate for the reduction in public grants for capital.

Figure 10 Funding breakdown of capital expenditure 2008-09 to 2012-13



67. To help finance these investments the sector is also forecasting that borrowings will rise. By 31 July 2013, the sector is projecting that borrowings will reach £6,174 million, equivalent to 25.8 per cent of total income. This represents a rise of £684 million compared to borrowing at the end of 2011-12. The sector also has access to over £746 million of financing agreed with lenders but not yet drawn down, which suggests that the availability of financing should be less of an issue compared with 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. The increase in payments to service these borrowings (interest and capital payments) will cause a rise in 'fixed costs' which could put pressure on some institutions that fail to constrain other costs and/or increase income.

Reserves

68. Discretionary reserves are forecast to increase to £9,730 million at the end of 2012-13, after taking into account projections of the impact of FRS17, which forecasts that total pension scheme deficits will fall over the year to £4,018 million. However, uncertainty over pension deficits, which depend on actuarial assumptions, could significantly affect this figure.

69. The sector saw a substantial increase in pension liabilities during 2011-12. While these liabilities can fluctuate from year to year, there continues to be a risk that the sector's reserves could come under further pressure if pension liabilities increase, significantly impacting the financial health of the sector.

Cash flow

70. The sector is forecasting cash inflows of £1,193 million from operating activities in 2012-13, a fall of £703 million from the level reported in 2011-12. This is also less than the cash inflows projected in June 2012, which were £1,388 million.

71. These latest forecasts show that cash in-flows from operating activities will be insufficient to fund the capital expenditure plans not already financed by capital grants or borrowings. The large capital expenditure forecast in 2012-13 will therefore require close cash flow management.

Conclusion

72. The financial results for the sector in 2011-12 are sound overall, and stronger than those projected by the sector in June 2012, despite the fall in public funding which saw its first real-terms fall in total income since financial information was first collected across the whole sector.

73. The projected results for 2012-13 indicate that the sector will remain in sound financial health, although reductions in public teaching grant, shortfalls in student recruitment and projected increases in expenditure will cause surpluses to reduce sharply.

74. The sector is now funding a significantly higher proportion of capital expenditure from its own internal cash reserves following reductions in public capital funding. In 2012-13 this pressure will continue, and in future years some institutions will need to increase surpluses above projected levels otherwise there is a risk that the quality of capital infrastructure will deteriorate, with consequent threats to long-term sustainability and the student experience.

75. There continues to be a large degree of uncertainty about student demand in the short to medium term (2012-13 to 2015-16), and we will continue to monitor UCAS data for early indications of recruitment issues and adverse impacts on the financial prospects of the sector.