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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 the financial forecasts for the period 2013-14 to 2016-17, as submitted by higher education institutions to HEFCE in December 2013 and July 2014.

Financial health of the higher education sector

2013-14 to 2016-17 forecasts

HIGHER EDUCATION FUNDING COUNCIL FOR ENGLAND

Financial health of the higher education sector: 2013-14 to 2016-17 forecasts

To	Heads of HEFCE-funded higher education institutions
Of interest to those responsible for	Audit, Estates, Finance, Governance, Management, Planning
Reference	2014/26
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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 HEFCE-funded higher education sector in England. The analysis covers the financial forecasts for the period 2013-14 to 2016-17, based on information submitted by higher education institutions (HEIs) to HEFCE in July 2014.

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 2014 ('Financial health of the higher education sector: 2012-13 financial results and 2013-14 forecasts', HEFCE 2014/02).

Context

3. The analysis provided in this report is based on financial forecasts submitted by HEIs. The accuracy and reliability of these forecasts depends on the assumptions and strategies adopted by individual HEIs in response to the latest higher education reforms and current prevailing market conditions. The sector is not assuming, within its financial forecasts, any significant changes in public funding within the period to 2016-17.

Key points

4. The financial results for the higher education sector in 2012-13 showed a sound position overall. However, the sector-wide picture encompassed a wide range of financial results across institutions.

5. The latest forecasts for 2013-14 indicate that, while total income is expected to rise, increases in staff costs and other operating expenses will cause projected surpluses to fall from £943 million in 2012-13 (3.9 per cent of income) to £769 million (3.0 per cent of income). Cash flow from operating activities and liquidity levels is also expected to be lower, at 7.5 per cent of total income and 114 days respectively (compared with 8.3 per cent and 123 days reported in 2012-13).

6. Overall, the projections indicate that the sector will be financially stable in the forecast period. While discretionary reserves are projected to increase each year to 2016-17, when compared with total income the sector is forecasting lower operating surpluses in the forecast period than have been reported in the preceding three years. The sector also expects its liquid funds to fall from £7.4 billion as at 31 July 2013 to £5.5 billion as at 31 July 2017, and at the same time expects borrowing to increase from £6.2 billion at the end of July 2013 to £8.3 billion by the end of July 2017. This trend is not sustainable in the long term.

7. Although liquidity is not a concern for most HEIs at this time, strong liquidity is necessary to efficiently manage the potential increased volatility and unpredictability of the new funding system and the increasingly competitive home and overseas markets. We will continue to monitor liquidity levels in the sector to assess whether HEIs can maintain sufficient cash levels to manage their risks effectively.

8. The sector is planning to invest over £15.2 billion in infrastructure projects during the next four years, an average annual investment of £3,811 million. This is nearly 50 per cent higher than the previous four-year average (2009-10 to 2012-13).

9. These investments will be partially funded by public capital funding for teaching and research, which is expected to increase from £420 million in 2013-14 to £440 million in 2014-15. However, current public capital funding is now significantly lower than historical levels, requiring institutions to deploy more of their own resources or raise finance through external borrowing to maintain and enhance their estates. This places greater pressure on HEIs to generate higher surpluses to remain sustainable.

10. In 2013-14, forecasts showed that the sector required £1,703 million from its own cash reserves (equivalent to 6.7 per cent of total income) to help fund the capital expenditure plans for that year. This was affordable as long as forecasts and income levels were achieved. However, financial projections for 2014-15 to 2016-17 show that cash inflows from operating activities will not be sufficient to fund the major capital investments planned for those years, The sector is therefore forecasting increased borrowing and greater utilisation of its cash reserves.

11. It is also important to recognise that the forecasts assume that the capital markets will continue to have confidence in the sector, which depends upon their risk assessments of the sector and individual HEIs. Strong surpluses, liquidity and sound regulation are required to achieve this. Without it significant elements of the investment programme are at risk.

12. Following the Government’s announcement in 2013 that 30,000 additional student places would be available in academic year 2014-15, student number projections show only a marginal increase in full-time undergraduate numbers (across all years of study) in 2014-15. Greater increases are expected in 2015-16 and 2016-17, reflecting the removal of the student number control from 2015-16, although institutional projections across the forecast period vary a great deal.

13. Projections show that the sector expects numbers of overseas (non-European Union) students to grow between 4.8 and 5.8 per cent per year over next four years, with overseas fee income projected to rise from £2,997 million in 2012-13 (12.3 per cent of total income) to £4,176 million in 2016-17 (14.3 per cent of total income). The latter represents an average annual increase of 8.6 per cent over the forecast period.

14. Overseas student data published by HESA earlier in the year indicated a slowdown in the growth of international full-time undergraduate entrant numbers in 2012-13 which, if it were to continue, would increase the risk of HEIs not delivering the level of growth projected in these forecasts. This would have a significant adverse impact on the sector's income and surplus projections.

15. Given the current economic environment, the sector is increasingly focused on getting value for money from public funds, and (for the benefit of students) from tuition fees. As part of our annual accountability process, we ask institutions to submit value for money reports to us showing how they make the best use of available resources. Our analysis of the data from these reports indicates that the sector has made an estimated cumulative saving of £716 million over the last two academic years. This provides evidence that the sector is continuing to deliver substantial value-for-money savings that help to support its current financial position. These will be particularly important given the staff cost and pension pressures currently faced by the sector.

16. The affordability of future pension costs is a key issue for HEIs, with the sector facing considerable uncertainty over the value of its pension scheme deficits, and the level of pension contributions required to ensure the financial sustainability of these schemes.

17. There continues to be a wide variation in the financial performance of institutions across the sector in the forecast period. The sector continues to operate on fine margins, with projected operating surpluses ranging between 2.4 and 3.4 per cent of total income in the forecast period. This means that even small changes can have a material impact on financial performance. Despite the small margins, the short-term viability of institutions is not a concern presently, and 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, although these are reliant on institutions achieving home and overseas student recruitment targets and on the level of public funding not deteriorating.

18. Analysis of the sector's latest Transparent Approach to Costing reporting shows that, in the medium to long term, some institutions will need to generate larger surpluses to make progress towards covering the full economic costs of their activities and maintaining sustainability. Overall, the sector reported a sustainability gap (difference between the value of the economic adjustments and the sector operating surplus) of £869 million in 2012-13: this represents a deterioration against the position in 2011-12, when the sustainability gap was £726 million.

19. While the sector has shown itself to be adaptable in coping with change, there continue to be some significant challenges and risks for the future. These include the sector's capacity to generate enough financial headroom to sustain the investment in infrastructure and student services necessary to respond to increasing domestic and overseas competition. To sustain the required investment in its infrastructure, the sector will need to generate higher surpluses in the longer term. It is worth noting that all HEIs are charities, and therefore any surplus generated will be reinvested into the HEI for the benefit of its students and other stakeholders.

20. Increased uncertainty over future government funding, student recruitment levels (following the removal of the student number control) and the vulnerability of overseas student income will also require institutions to aim for higher surpluses in future. This uncertainty is likely

to lead to greater volatility of forecasting and a widening of differences in financial performance between institutions.

Action required

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

Summary and headline information

22. This report provides an overview and analysis of the financial health of the HEFCE-funded higher education sector in England. This does not include Further Education Colleges or alternative providers of higher education.

23. The data used in this paper come from two main sources. All data up to and including 2012-13 are from the Higher Education Statistics Agency's Finance Statistics Record, which higher education institutions (HEIs) complete each year. Data covering the forecast period 2013-14 to 2016-17 are from HEIs' financial forecasts, submitted to HEFCE in July 2014. All financial information is presented in academic 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 2014[1].

24. 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. Our analysis of these forecasts is included in this report.

25. We have also included aggregate sector data from the 2012-13 Transparent Approach to Costing (TRAC) returns submitted by institutions earlier in the year.

26. Table 1 provides the key headline data from the financial information submitted by HEIs in July 2014. Further detail and analysis of the sector's financial performance in 2012-13 can be found in 'Financial health of the higher education sector: 2012-13 financial results and 2013-14 forecasts' (HEFCE 2014/02)[2].

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

[2] Available online at www.hefce.ac.uk/pubs/year/2014/201402/

Table 1: Summary of key financial indicators

	Actual		Forecast			
	2011-12	**2012-13**	**2013-14**	**2014-15**	**2015-16**	**2016-17**
Total income	£23,277M	£24,320M	£25,435M	£26,857M	£28,030M	£29,194M
Operating surplus as % of total income	£972M 4.2%	£943M 3.9%	£769M 3.0%	£649M 2.4%	£841M 3.0%	£980M 3.4%
Historical cost surplus as % of total income	£1,138M 4.9%	£1,208M 5.0%	£986M 3.9%	£899M 3.3%	£1,080M 3.9%	£1,184M 4.1%
TRAC sustainability deficit*	(£726M)	(£869M)	n/a	n/a	n/a	n/a
Cash flow from operating activities as % of total income	8.1%	8.3%	7.5%	7.0%	8.1%	8.4%
Net liquidity as number of days' expenditure	118	123	114	95	85	77
External borrowings as % of total income	23.5%	25.6%	26.7%	28.2%	28.9%	28.4%
Discretionary reserves excluding FRS17[†], as % of total income	56.0%	61.8%	63.6%	64.4%	66.0%	67.9%

[*] Only actual information collected.

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

Assessing future financial sustainability

27. 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.

28. Overall, up to the end of the forecast period, the forecasts indicate that the sector is likely to remain financially sustainable, though institutions will need to continue to seek greater surpluses to fund the investment in infrastructure necessary to support a high-quality student experience, and to remain sustainable in the medium term.

29. In preparing their financial statements and forecasts, institutions identified a number of risks that could adversely affect their financial performance and sustainability. The most significant risk areas relate to:

- student recruitment
- tuition fee pricing
- pension deficit and affordability
- international strategy and compliance with visa regulations
- research quality
- research income
- public spending cuts
- estates adequacy and capital programme management
- staff recruitment
- information technology, systems and business continuity.

30. The accuracy of the forecasts depends on the assumptions made by HEIs and the extent to which they have taken the risks above into account, as well as the strategies they have adopted in response to the latest higher education reforms, which include the changes to the student number control system. Uncertainties over such unknown factors as future student recruitment (home and overseas), public funding levels and pension costs will inevitably reduce the reliability of HEIs' forecasts. Another likely consequence is greater volatility of forecasts and financial performance than in the past.

31. It is important to note that HEIs continue to undertake their own scenario planning and sensitivity analysis, to assist them in developing their financial forecasts. 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 impacts of the recent changes to the student number control, overseas recruitment levels, the availability of public funding, and pay and pensions pressures.

32. HEFCE institutional teams, in their regular engagement with HEIs, will continue to discuss the actions being taken by the sector to mitigate adverse impacts.

33. We also assess financial sustainability through our analysis of the sector's TRAC reporting, the results of which are summarised below.

Transparent Approach to Costing return 2012-13

34. The TRAC return is a continuing requirement for UK HEIs following the Government's 1998 comprehensive spending review (and subsequent spending reviews), and a condition of the enhanced funding awarded to the sector in those reviews. It was established as an approach to identifying the full economic costing of all activities, to improve accountability for the use of public funds and to inform institutional decision-making.

35. The TRAC return is based on the financial statements and allows for two adjustments to reflect the sustainable position of an institution. The modifications are an 'infrastructure adjustment', to account for the true capital costs to an institution of maintaining the asset base, and the 'return for financing and investment', to account for the costs of financing long-term capital and investment. In 2012-13, the infrastructure adjustment represents 3.1 per cent of expenditure and the return for financing and investment represents 5.0 per cent of expenditure.

36. For 2012-13, the sector reported a sustainability gap (difference between the value of the economic adjustments and the sector operating surplus) of £869 million, a deterioration against the position in 2011-12, when the sustainability gap was £726 million. When compared with total expenditure, the difference between the target sustainability surplus and the actual surplus increased to 3.8 per cent in 2012-13 from 3.3 per cent in 2011-12. The results are summarised in Table 2 below.

Table 2: TRAC summary 2011-12 and 2012-13

	2011-12	**2012-13**
Target sustainability surplus to cover long run costs (full economic costs)	£1,761M	£1, 876M
as % of total expenditure	7.9%	8.1%
Actual surplus*	£1,035M	£1,007M
as % of total expenditure	4.6%	4.3%
Gap between target and actual surplus	**(£726M)**	**(£869M)**
as % of total expenditure	**3.3%**	**3.8%**

***** This figure is different from the surplus reported in the annual financial statements because of adjustments in respect of joint ventures, minority interests and endowments in the TRAC returns.

37. The actual surplus achieved in 2012-13 was 53.7 per cent of the target sustainability surplus, compared with 58.8 per cent in 2011-12.

38. When comparing income with costs, the TRAC data for 2012-13 show that the sector recovered 96.5 per cent of the full costs across all of its activities. The greatest sustainability gap related to research activities, where the recovery of the full costs of research was only 75.5 per cent of research income in 2012-13.

39. In the medium to long term, some institutions will need to generate larger surpluses to make progress towards covering the full economic costs of their activities and maintaining sustainability. This is particularly important given the present and future economic conditions.

Forecast performance in 2013-14

40. The financial forecasts show that operating surpluses at sector level are expected to fall from £943 million (3.9 per cent of income) as reported in 2012-13, to £769 million (3.0 per cent of income) in 2013-14. This is despite the sector projecting total income to rise by 4.6 per cent, from £24,320 million in 2012-13 to £25,435 million in 2013-14.

41. Cash flow from operating activities is also expected to be lower, at 7.5 per cent of total income compared with 8.3 per cent of income in 2012-13, as are liquidity levels, which are projected to be equivalent to 114 days of expenditure (compared with 123 days in 2012-13).

42. While the financial position at sector level is expected to be weaker than 2012-13, the latest forecasts show that the sector expects to deliver a stronger financial performance than was anticipated in December 2013.

43. Total income is now expected to be £98 million higher than projected in the earlier forecasts. Taken together with lower expenditure projections, this will increase operating surpluses by £222 million. The most significant expenditure savings come from staff costs, which are expected to be £181 million less than predicted in December 2013.

44. While the majority of institutions are predicting better financial outturns in 2013-14 compared with the December 2013 forecasts, 35 institutions are forecasting a decline in their operating performance compared with their earlier predictions. Of these, five institutions are forecasting greater operating deficits in 2013-14, and three are forecasting operating deficits where they had originally expected to achieve small surpluses or break even. The reasons for the decline in forecast operating positions referred to above vary among institutions, but largely relate to student under-recruitment and higher-than-anticipated staff costs or other operating costs.

45. Overall, the financial outturn for 2013-14 looks manageable for all institutions.

Forecast performance in 2014-15 to 2016-17

46. The forecasts for this period show that the sector is projecting expenditure to rise at a faster rate than income, causing surpluses to fall again in 2014-15. Thereafter, surplus levels and cash flow from operating activities are expected to rise, although liquidity levels are projected to fall in 2015-16 and 2016-17.

47. The following sections look at different aspects of the financial forecasts submitted by institutions, for the whole period to 2016-17:

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

Income

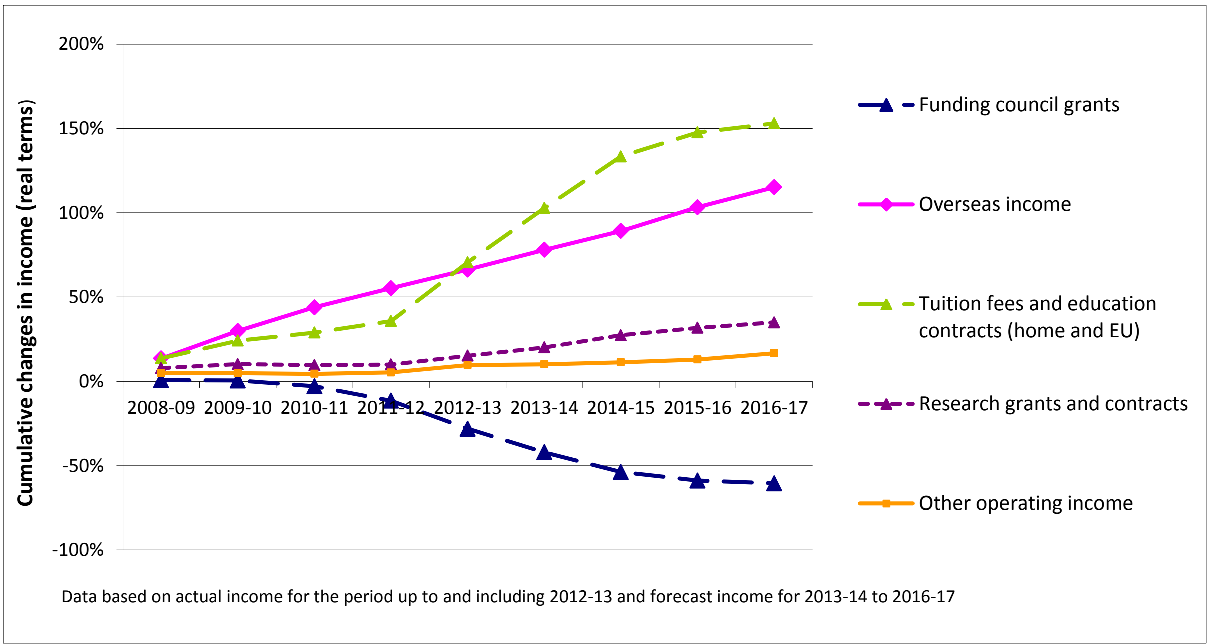
48. At sector level, total income is forecast to rise each year in the forecast period; by 5.6 per cent (cash terms) in 2014-15, and by a further 4.4 per cent and 4.1 percent in 2015-16 and 2016-17 respectively. By 2016-17, the vast majority of students will fall under the new funding arrangements. Table 3 provides a breakdown of the income levels forecast.

Table 3: Breakdown of forecast income levels (cash terms)

£M	2012-13 actual	2013-14 forecast	2014-15 forecast	2015-16 forecast	2016-17 forecast
Funding council grants	5,505	4,516	3,675	3,326	3,256
Overseas (non-EU) fee income	2,997	3,268	3,543	3,873	4,176
Tuition fees and education contracts (home and EU)	7,145	8,654	10,160	10,964	11,415
Research grants and contracts	3,872	4,115	4,449	4,683	4,888
Other operating income	4,564	4,669	4,813	4,969	5,229
Endowment income and interest	237	213	216	216	230
Total income	**23,277**	**25,435**	**26,857**	**28,030**	**29,194**

49. While Table 2 shows projected changes in cash terms, Figure 1 shows the cumulative actual and projected changes in income (excluding endowment income) in real terms since 2008-09. This illustrates the 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 2008-09 to 2016-17



50. These latest forecasts show that the sector is expecting HEFCE grant funding for teaching to fall by an average of 22.1 per cent per year in the period 2012-13 to 2016-17, whereas fee income from full-time undergraduate home and EU students is expected to increase by an average of 16.7 per cent per year in the same period. In real terms, additional tuition fee

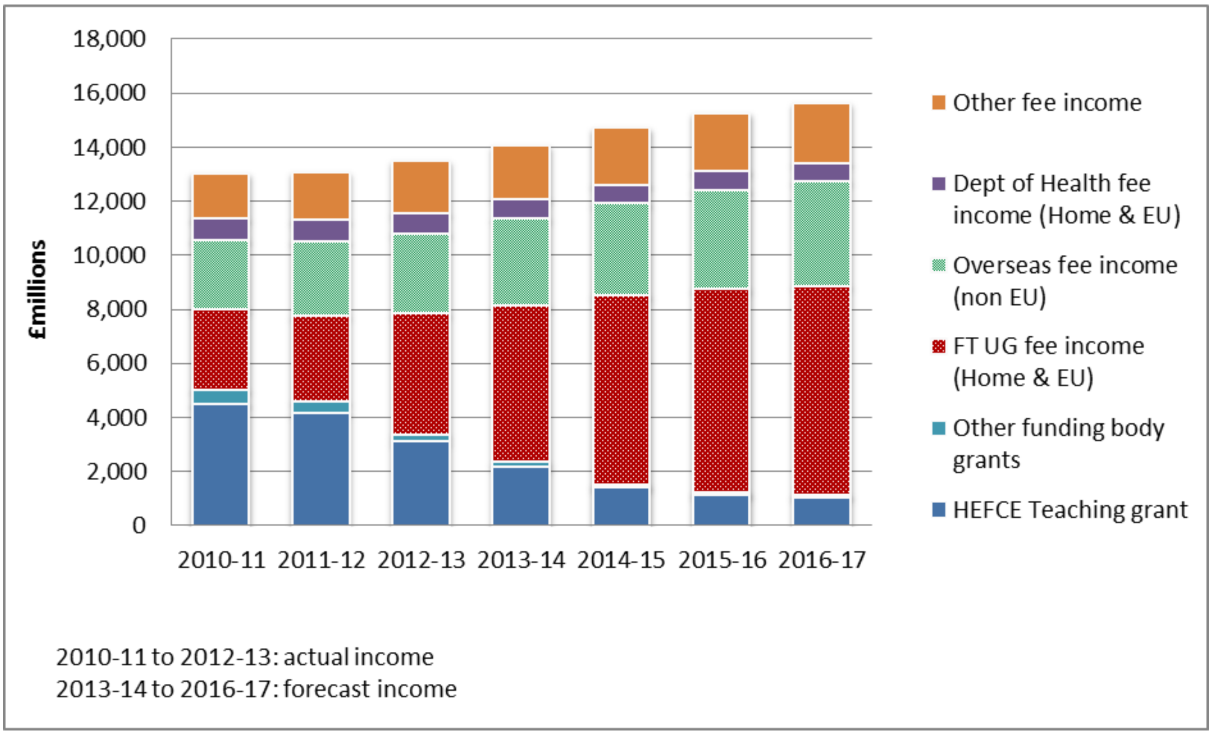
income from full-time undergraduate home and EU students exceeds the fall in HEFCE teaching grant by £1,186 million (comparing 2016-17 with 2012-13), partly due to an increase in student numbers.

51. Income from part-time home and EU students (at all levels of study) is projected to increase by 20.4 per cent, from £649 million in 2013-14 to £782 million in 2016-17. This is despite the sector projecting a continuing decline in part-time student numbers across the forecast period, which indicates that the growth in fee income is due to the effect of higher part-time fees.

52. Fee income from full-time home and EU postgraduate students is projected to rise 23.4 per cent, from £691 million in 2013-14 to £853 million in 2016-17.

53. Figure 2 shows a breakdown of teaching-related income received in the period 2010-11 to 2012-13 and the income projected for the period 2013-14 to 2016-17 in real terms. This shows that teaching-related income – which includes public funding and tuition fees – is expected to rise overall during the forecast period. At the same time, total student numbers (full-time equivalents) are expected to be 5.9 per cent higher in 2016-17 compared with 2012-13.

Figure 2: Breakdown of teaching-related income 2010-11 to 2012-13 (actual) and 2013-14 to 2016-17 (forecast)



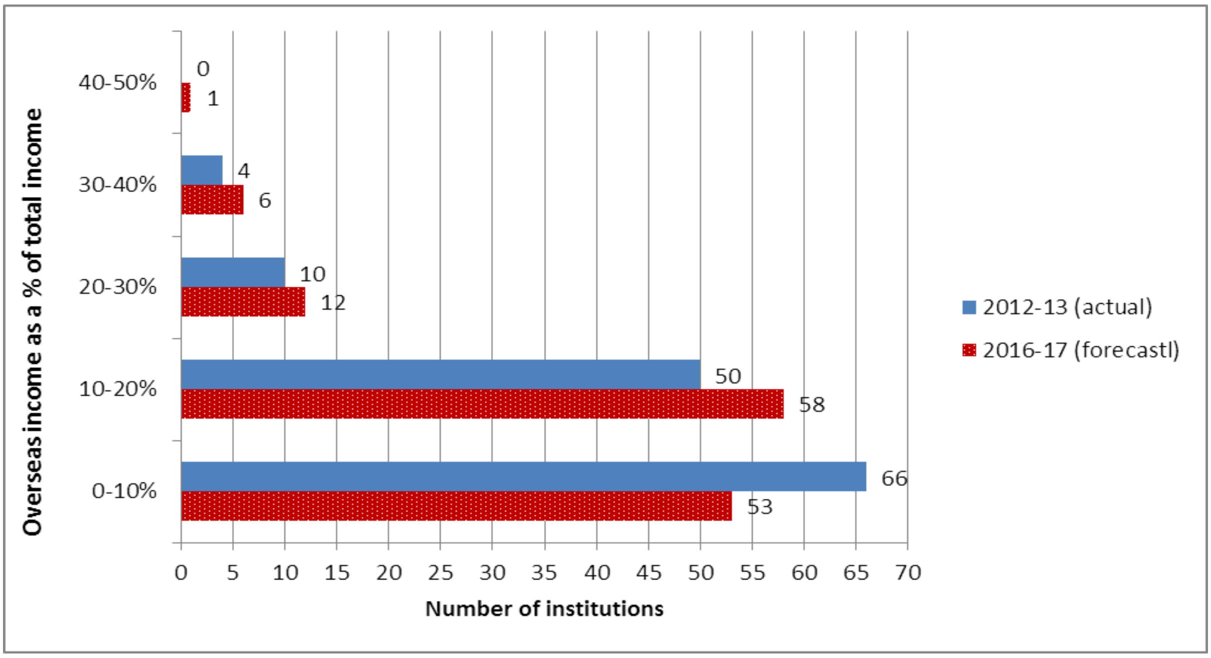
Note: ‘FT’ = ‘full-time’; ‘UG’ = ‘undergraduate’.

Overseas fee income

54. The income generated through tuition fees from international (non-EU) students in 2012-13 came to £3.0 billion (cash terms). By 2016-17, this is expected to grow to £4.2 billion.

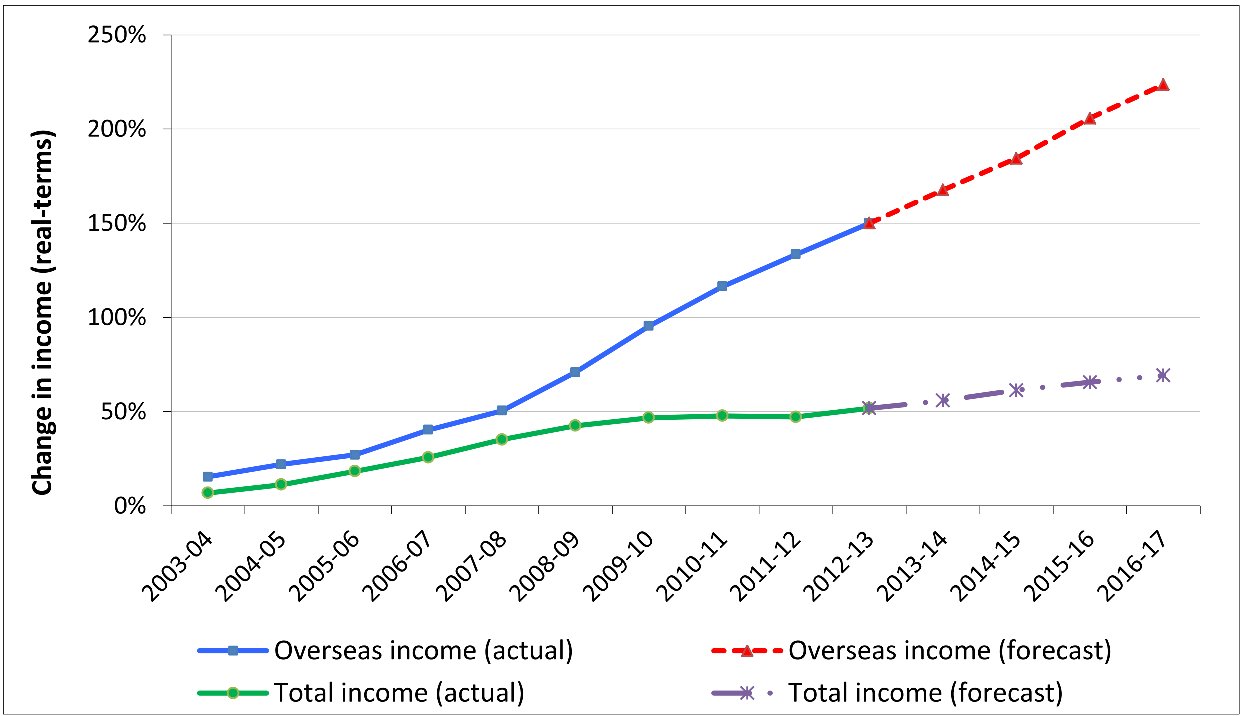
55. This represents 26.8 per cent of all tuition fee and education contract income, and 14.3 per cent of total income projected by English institutions in 2016-17. Figure 3 shows the actual and projected distribution of overseas fee income (as a percentage of total income) by institution for 2012-13 and 2016-17, demonstrating the growing reliance on this income source.

Figure 3: Distribution of overseas fee income as a percentage of total income by institution, 2012-13 versus 2016-17 forecast



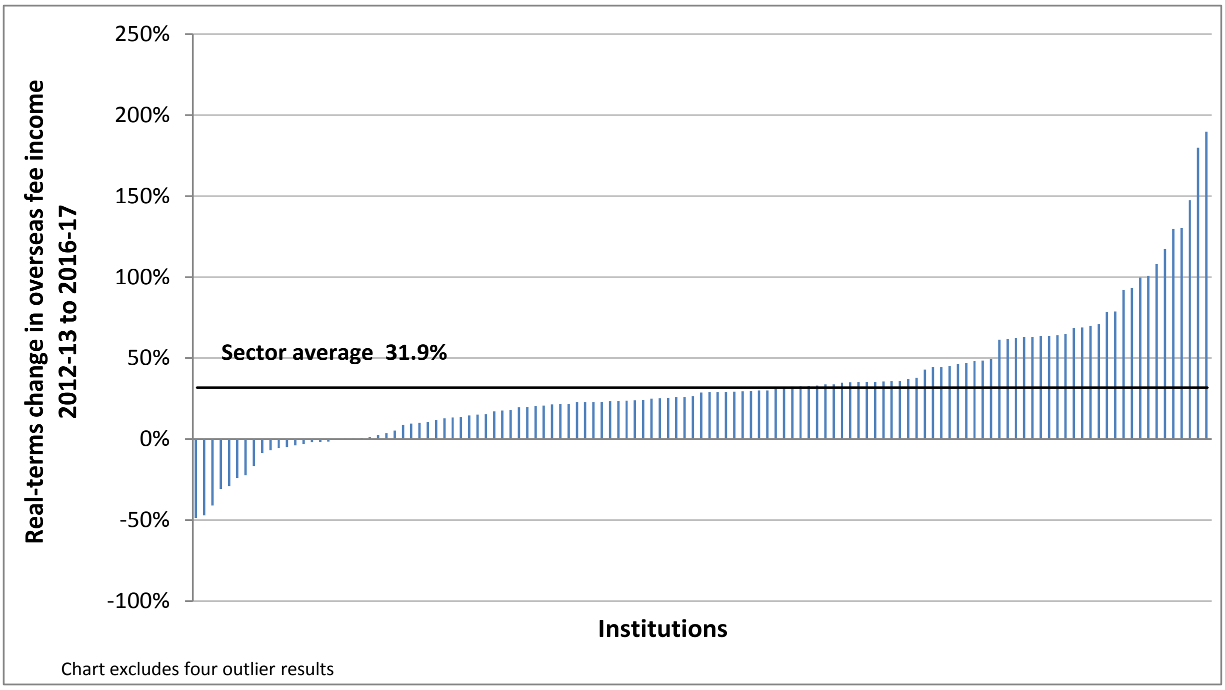
56. Figure 4 shows the percentage increase in overseas fee income compared with the percentage increase in total income (both real-terms) reported by the sector since 2002-03, together with the projected income levels for the forecast period. On average, fee income from overseas students has increased by 9.6 per cent (real-terms) per year over the last 10 years, whereas total income has increased by an average of 4.3 per cent per year over the same period.

Figure 4: Real-terms increase in total income and overseas fee income (cumulative increases since base year of 2002-03)



57. The sector is projecting a real-terms rise in overseas income of 31.9 per cent (comparing 2016-17 with 2012-13), equivalent to an average annual increase of 6.7 per cent, although this disguises significant variation in the assumptions used by institutions in predicting their future overseas income levels. Figure 5 shows the variation between different institutions' predictions for this period.

Figure 5: Forecast real-terms change in overseas fee income between 2012-13 and 2016-17



Student recruitment

58. Because a large proportion of the sector's income depends on the number of students recruited, institutions are asked to send us their student number projections for each of the forecast periods (2013-14 to 2016-17). These forecasts show total projected student numbers for all years of study broken down by mode and level of study.

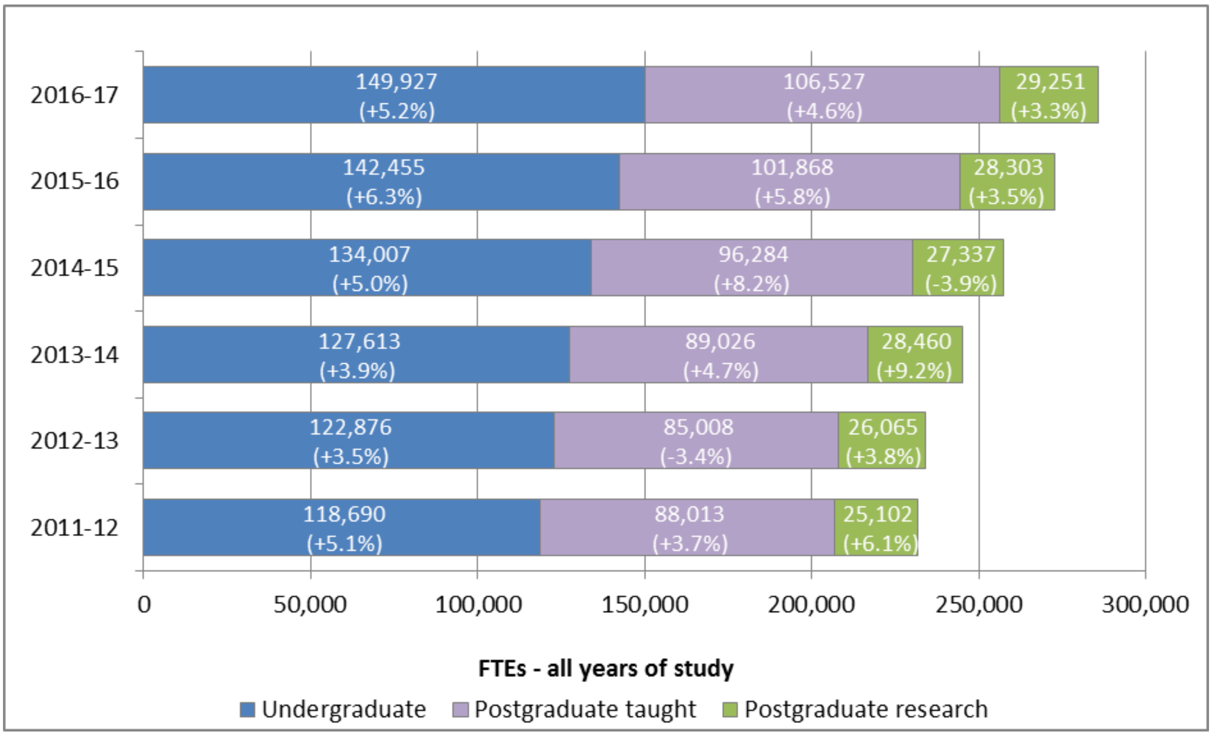
59. Further analysis of student number projections for overseas (non-EU) and Home and EU students follows.

Overseas

60. The projections for overseas (non-EU) student numbers show that the number of non-EU students studying at English institutions (for all years of study) is expected to rise between 4.8 and 5.8 per cent per year between 2013-14 and 2016-17.

61. Figure 6 shows the total number of full and part-time overseas students (expressed as full-time equivalents) either reported or projected by the sector for the period 2011-12 to 2016-17, together with the percentage change in numbers compared with previous years.

Figure 6: Overseas (non-EU) student numbers 2011-12 to 2016-17



62. While total non-EU student numbers are expected to rise, forecasts show that the sector is expecting part-time non-EU students numbers to fall in 2013-14 and 2014-15 (by 7.1 per cent and 1.6 per cent respectively). Thereafter, part-time student numbers are expected to increase, by 11.5 per cent between 2014-15 and 2016-17.

63. Overseas student data published by the Higher Education Statistics Agency in February 2014 indicated a slowdown in the growth of international full-time undergraduate entrants in 2012-13 which, if it were to continue, would increase the risk of HEIs not achieving their fee income growth targets[3]. This would have a significant adverse impact on the sector's income and surplus projections.

Home and EU

64. Following the Government's announcement in 2013 of 30,000 additional student places in the academic year 2014-15, student number projections show only a marginal increase in full-time undergraduate numbers (across all years of study) in 2014-15. This could indicate that the sector remains cautious about student recruitment, or that institutions are managing more constrained growth this year, although there is a great deal of variability between institutional projections. Greater increases are expected in 2015-16 and 2016-17, reflecting the removal of the student number control from 2015-16.

65. At an aggregate level, full-time home and EU undergraduate student numbers (across all years of study) are expected to rise by 5.5 per cent by the end of the forecast period (comparing 2016-17 with 2012-13).

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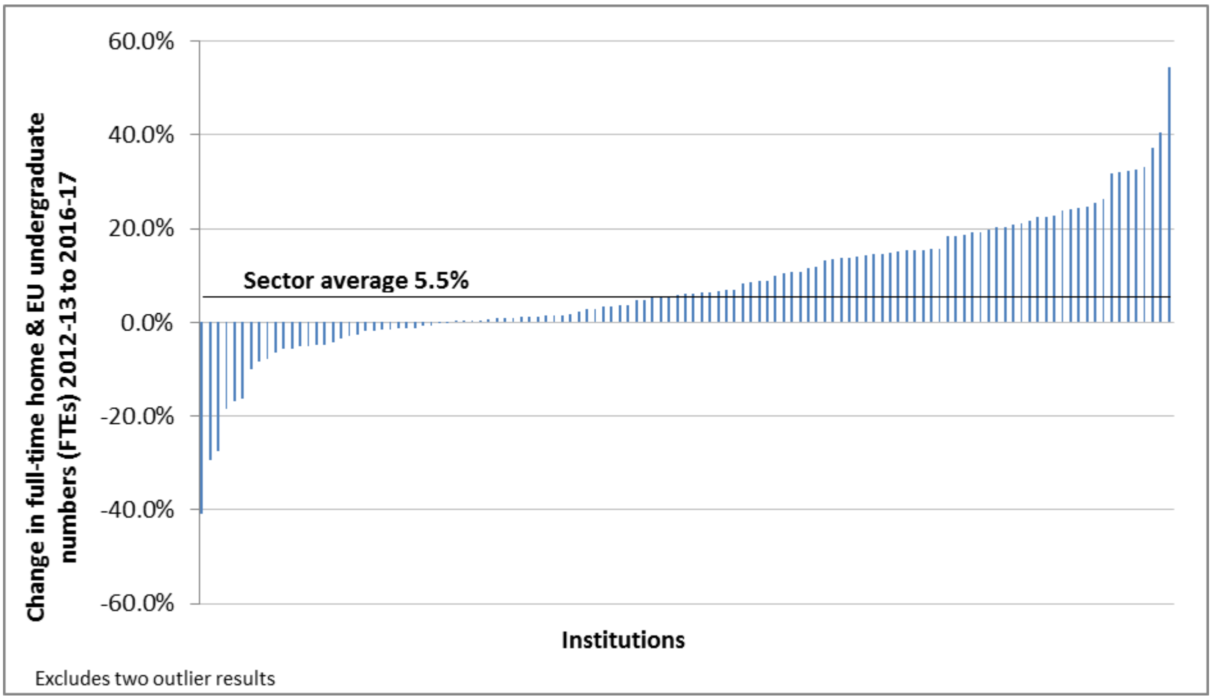
[3] HESA student data can be found at https://www.hesa.ac.uk/pubs/students.

66. Figure 7 shows the forecast changes in full-time home and EU undergraduate student numbers (expressed as full-time equivalents (FTEs)) between 2012-13 and 2016-17, for all institutions and across all years of study. This shows the variation in assumptions used by institutions in developing their financial forecasts.

Figure 7: Forecast change in full-time home and EU undergraduate student numbers between 2012-13 and 2016-17

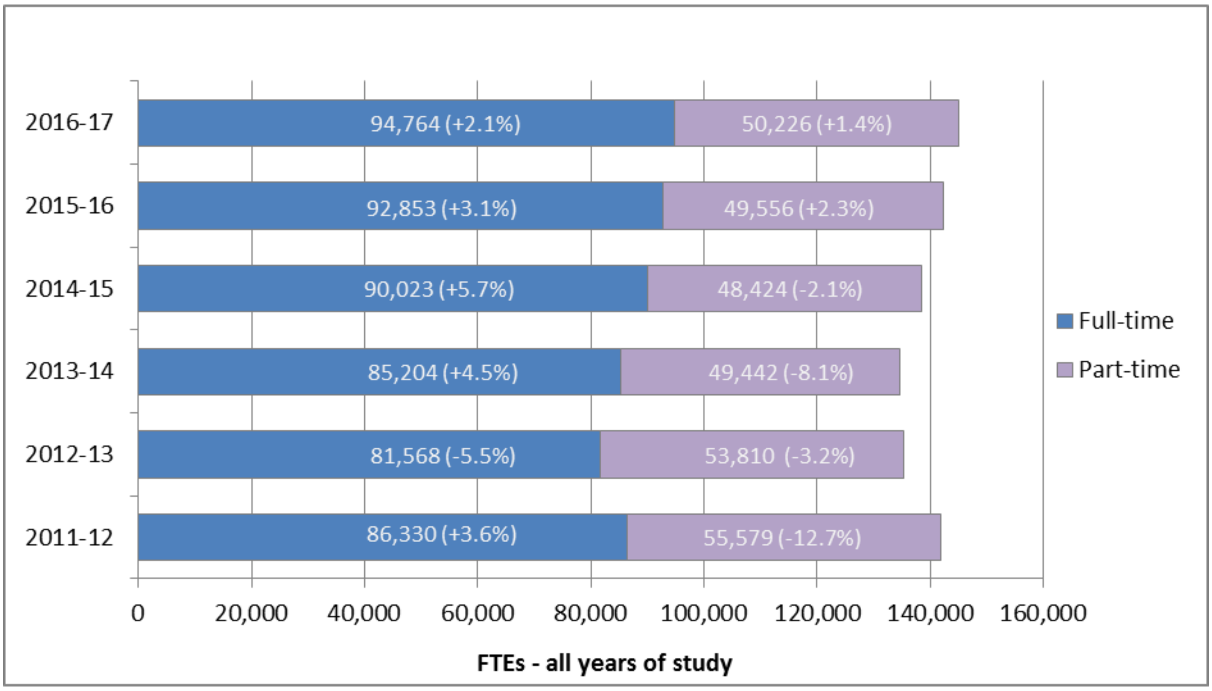


67. Despite an increase in full-time numbers, the sector expects the decline in part-time undergraduate student numbers to continue across the forecast period. In particular, the sector expects these numbers to fall by 10.2 per cent in 2013-14, followed by a further falls of between 2.2 and 4.5 per cent per year across the remainder of the forecast period.

68. Full-time home and EU postgraduate taught student numbers are expected to rise by 4.5 per cent in 2013-14, followed by increases of between 2.1 and 5.7 per cent per year between 2014-15 and 2016-17. By contrast, part-time home and EU postgraduate taught student numbers are expected to fall by 8.1 per cent and 2.1 per cent in 2013-14 and 2014-15 respectively, before rising in the following two years. It is yet to be seen whether these forecasts will be achievable, however, as the impact of the 2012 undergraduate education reforms on the take-up of postgraduate education will not be known until 2015 at the earliest, when the first students who have paid higher fees at undergraduate level begin to apply.

69. Figure 8 shows the number of full and part-time postgraduate taught students for all years of study (expressed as full-time equivalents) the sector reported in 2011-12 and 2012-13, as well as the student numbers the sector projected for the period 2013-14 to 2016-17. The percentage change in student numbers compared with previous years is also shown.

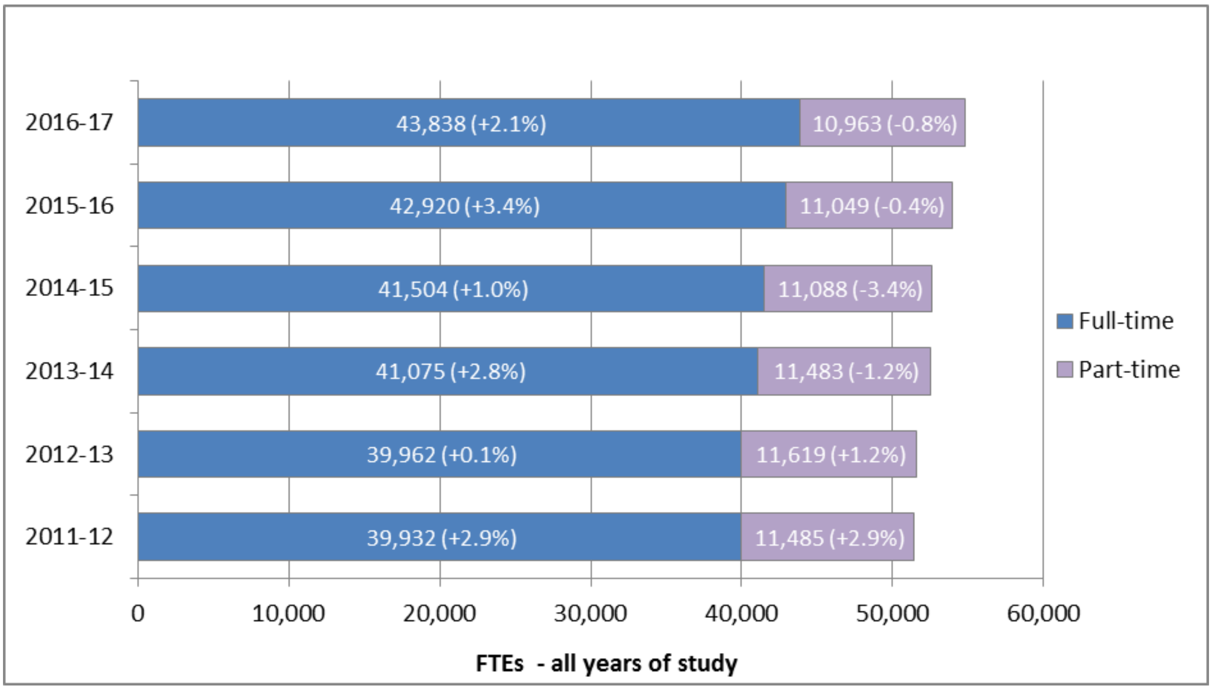
Figure 8: Postgraduate taught home and EU student numbers 2011-12 to 2016-17



70. Projections for postgraduate research study show that the sector is expecting full-time student numbers to increase by 2.8 per cent in 2013-14, followed by rises of between 1.0 per cent and 3.4 per cent per year from 2014-15 to 2016-17. In contrast, part-time postgraduate research student numbers are expected to fall between 0.4 per cent and 3.4 per cent per year in the forecast period, with total student numbers expected to be 5.6 per cent lower in 2016-17 compared with 2012-13.

71. Figure 9 shows the number of full and part-time postgraduate research students (expressed as full-time equivalents) either reported or projected by the sector for the period 2011-12 to 2016-17, together with the percentage change in numbers compared with previous years.

Figure 9: Postgraduate research home and EU taught student numbers 2011-12 to 2016-17



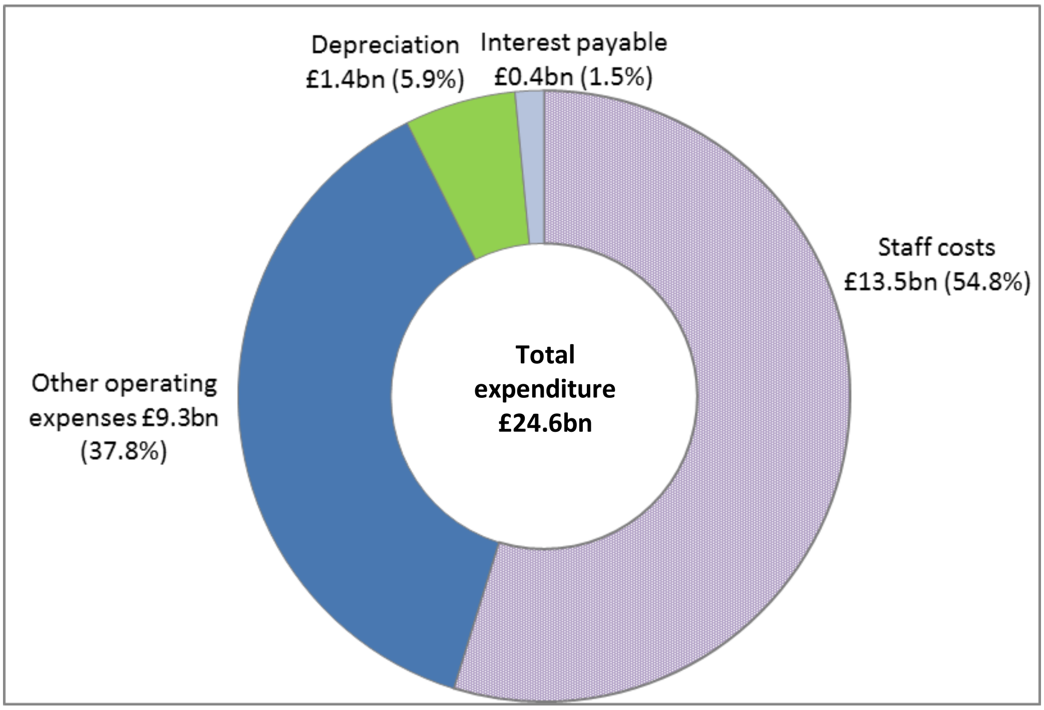
72. Final numbers of home and EU student new entrants in 2014-15 will not be known until the HEFCE aggregate student number surveys are available later this year. However, the interim UCAS figures published in September 2014 revealed an overall 4 per cent increase in acceptances to English institutions compared with this time last year[4].

Expenditure

73. Forecasts for 2013-14 show that the sector is projecting a rise in expenditure of 5.7 per cent, compared with the level reported in 2012-13. Figure 10 shows the breakdown of projected expenditure (in cash terms) in 2013-14.

[4] See: 'Interim assessment of UCAS acceptances 2014-15' on the UCAS web-site at www.ucas.com/news-events/news/2014/four-cent-rise-uk-and-eu-students-starting-university-and-college-courses

Figure 10: Forecast expenditure by type 2013-14

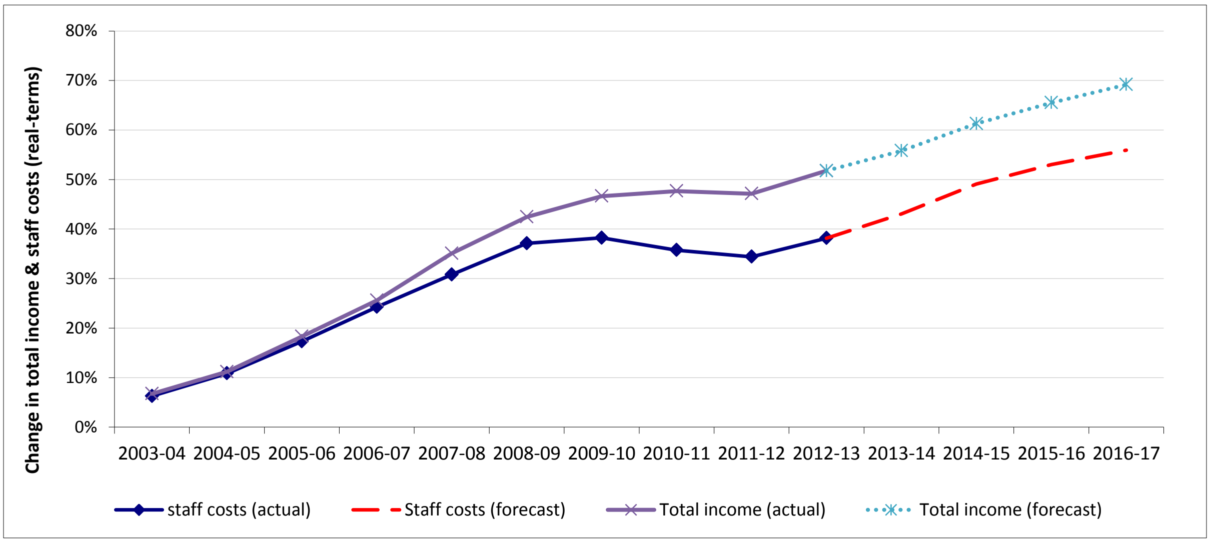


74. The sector's biggest expenditure is staff costs, which in 2012-13 totalled £12,753 million, equivalent to 52.4 per cent of total income. The latest forecasts show that the sector is expecting staff costs to rise by 5.5 per cent, to £13,453 million in 2013-14.

75. Overall, as a percentage of total income, staff costs are expected to remain relatively stable; between 52.9 and 53.3 per cent of total income throughout the forecast period, compared with 52.4 per cent in 2012-13 and a high of 58.1 per cent in 2000-01.

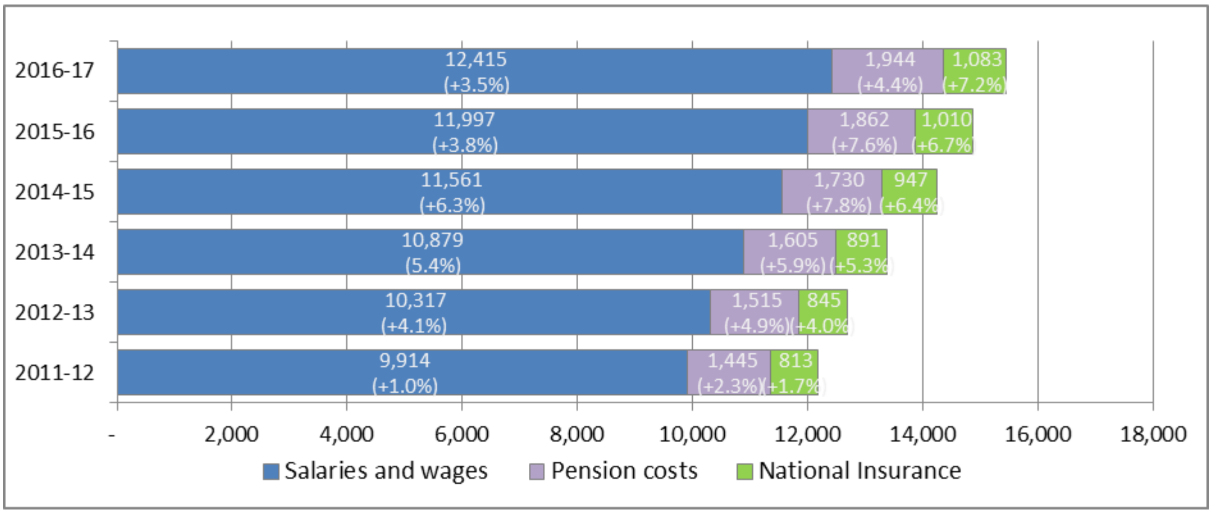
76. Figure 11 compares the level of real-terms increases in total income and staff costs over the past 10 years, plus what the sector is forecasting to happen over the next four years. It shows that the projected cumulative increase in staff costs will continue to be lower than the cumulative increase in total income in the forecast period.

Figure 11: Real-terms increases in total income and staff costs (cumulative since base year of 2002-03)



77. Figure 12 shows the amounts of staff costs (in cash terms) and the breakdown between salaries and wages, pension costs and employer national insurance contributions for the period 2011-12 to 2012-13 and forecast for 2013-14 to 2016-17, together with the percentage increases upon previous years.

Figure 12: Changes and breakdown of staff costs 2011-12 to 2016-17



78. The projected rise in staff costs over the forecast period is caused by a combination of increasing pay and rising staff numbers. Forecasts show that staff numbers will be 6.2 per cent higher in 2016-17 than in 2012-13.

79. Annual pay costs per employee are forecast to rise between 1.0 and 2.4 per cent per year (in real-terms) in the period from 2013-14 to 2016-17, following a period of curtailment between 2009-10 and 2011-12.

80. The highest percentage rises relate to pension costs and national insurance contributions. In real terms, average pension costs and national insurance contributions (per employee) are expected rise between 1.2 per cent and 5.2 per cent per year.

81. Although HEIs have attempted to include pension cost rises in their forecasts, there continues to be much uncertainty and volatility over the value of, and hence the level of pension contributions required to fund, the sector's pension scheme deficits. The latest pension scheme valuations indicate that HEIs could face substantial increases in their future pension contribution rates, and there is a risk that these may not be fully reflected in the sector's financial forecasts as summarised in this report.

82. The sector is forecasting other operating expenditure to rise between 2.2 per cent and 6.1 per cent per year (cash terms) in the period 2013-14 to 2016-17, with the greatest rises expected in 2013-14 and 2014-15. Depreciation and interest payable are expected to increase at a faster rate, with the former rising between 4.7 per cent and 9.8 per cent per year, and the latter between 4.2 per cent and 8.3 per cent per year (cash terms) in the same period. These increases reflect the sector's rising investment in physical infrastructure and increasing levels of external borrowing.

83. Given the current economic environment, and the staff cost and pension pressures described above, the sector is increasingly focused on getting value for money from public funds, and (for the benefit of students) from tuition fees. As part of our annual accountability process, we ask institutions to submit value for money reports to us showing how they make the best use of available resources.

84. These reports set out details of the value for money activities that institutions have carried out over the course of the year, and the resultant savings. These savings can be categorised as cost savings, efficiency savings or income generation measures. The nature and content of the value for money reports vary, and they are not submitted by all institutions. However, with some assumptions, we can extrapolate the reported savings across the English higher education sector as a whole. This approach yields estimated annual savings for the sector of £235 million for 2012-13 and £481 million for 2011-12, giving an estimated cumulative total of £716 million in savings across the two years.

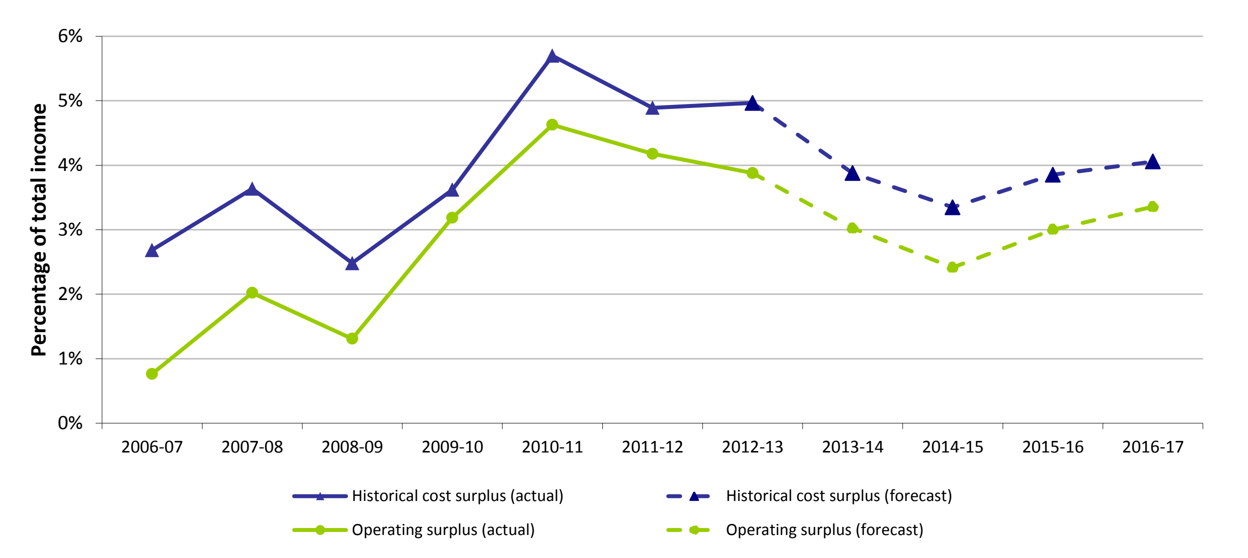
85. While the lack of standard reporting mechanisms for the reports mean that year-to-year figures do not lend themselves to direct comparison, this shows that the sector continues to deliver substantial value for money savings that help to support its current financial performance.

Surpluses

86. 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 3.0 per cent of total income in 2013-14 to 2.4 per cent of total income in 2014-15. Thereafter surpluses are expected to rise, to 3.0 per cent of total income in 2015-16 and 3.4 per cent of total income in 2016-17. On a historical-cost basis the average level of surpluses is projected to be between 3.3 per cent and 4.1 per cent of total income over the forecast period. Historical-cost surpluses are expected to follow a similar pattern to operating surpluses, falling in 2013-14 and 2014-15 but recovering from 2015-16.

87. Figure 13 shows the actual and expected operating and historical cost surpluses for the forecast period. The larger difference between the operating and historical position forecast in the year 2013-14 is partly accounted for by exceptional items of £102 million. Many of these exceptional items relate to capital receipts following disposal of assets.

Figure 13: Operating and historical cost surpluses 2006-07 to 2016-17

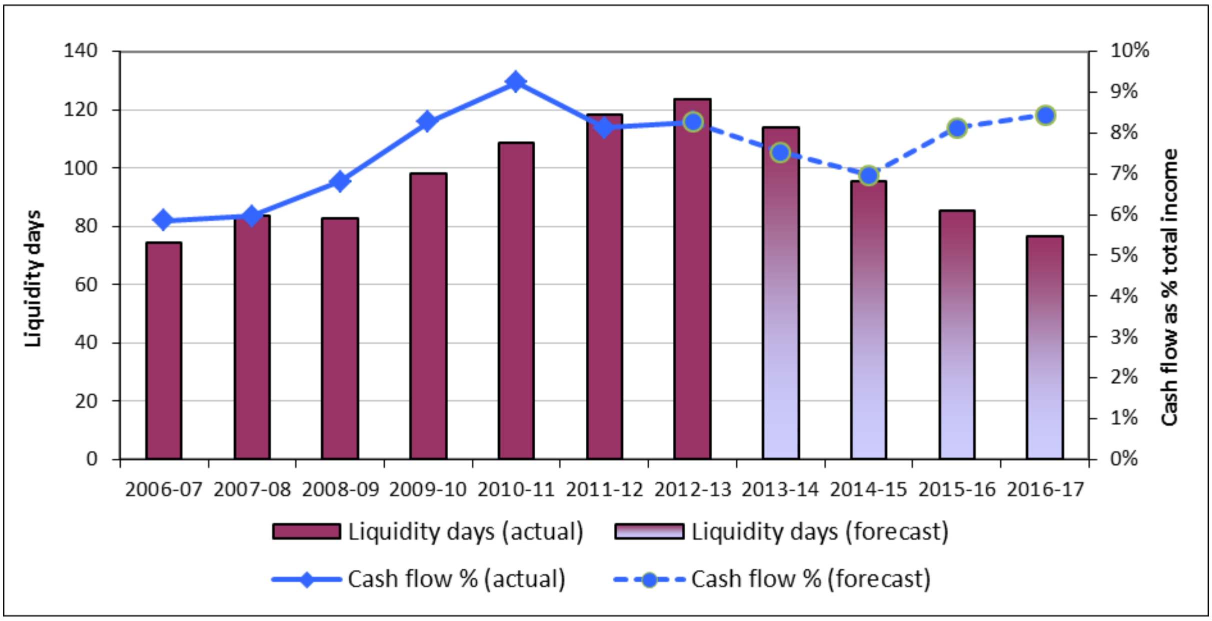


Liquidity and cash flow

88. The level of liquidity (that is, the number of days for which liquidity would cover expenditure) reported for the sector in 2012-13 was 123 days, the highest on record. However, the sector expects liquidity to fall to 114 days in 2013-14, and further in the remainder of the forecast period, to reach 77 days by the end of 2016-17 (the lowest level since 2006-07). This coincides with a rise in the level of borrowing, which is expected to reach record levels by the end of 2016-17.

89. Figure 14 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, whereas cash flow from operating activities is expected to fall in 2013-14 and 2015-16, before rising again in 2015-16 and 2016-17.

Figure 14: Net liquidity and cash flow 2006-07 to 2016-17



90. The number of institutions reporting negative cash flows in 2012-13 was 11. This number of institutions is expected to fall to 10 in 2013-14, and is projected to range between four and nine in the remainder of the forecast period.

91. Only six institutions had liquidity of less than 20 days in 2012-13 (compared with five institutions in 2011-12). Although this number is expected to rise to nine in the forecast period, the risk of solvency problems in the sector remains low.

92. While liquidity is not a concern at this time, strong liquidity is necessary for HEIs to efficiently manage the potential increased volatility and unpredictability of the new funding system and the increasingly competitive markets. We will continue to monitor liquidity levels in the sector, to ensure that HEIs can maintain sufficient cash levels to manage their risks effectively and to finance investment in infrastructure.

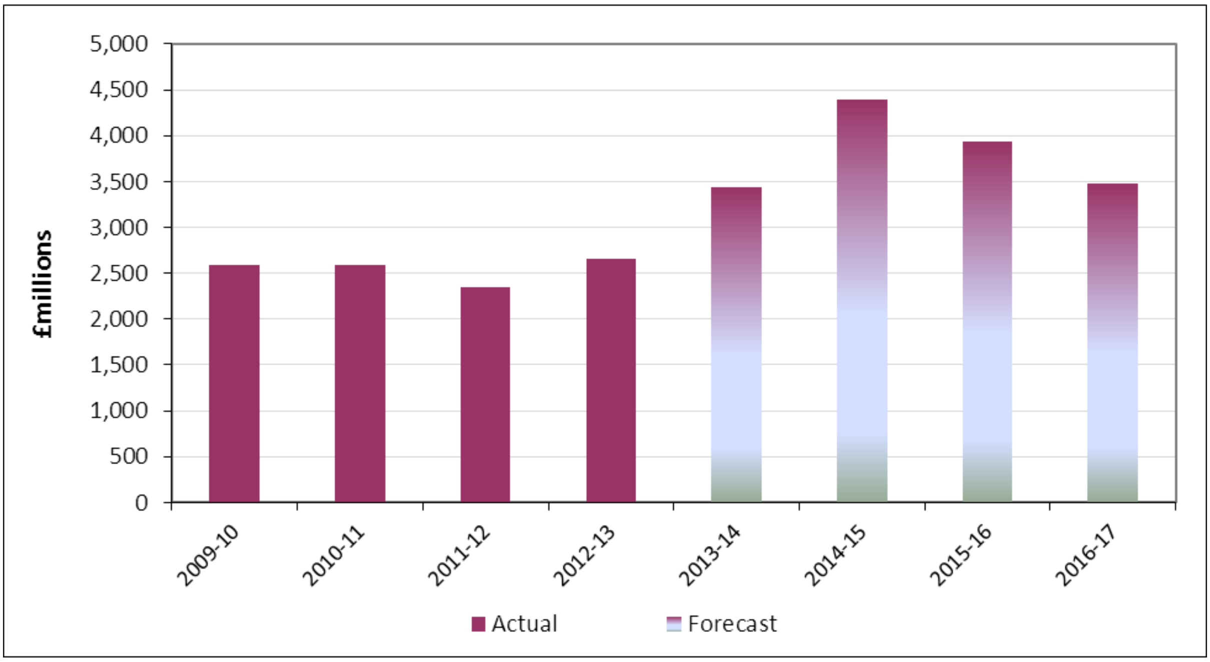
Capital expenditure and borrowing

93. Since 2002 the sector has spent £25,420 million on improving its physical infrastructure, excluding expenditure on general day-to-day maintenance. Although this is a significant level of investment, Estate Management Statistics data show that on 31 July 2013 many institutions still had large amounts of non-residential space in poor condition, with the sector reporting a backlog of under-investment of £3,327 million[5] (an increase of 18.8 per cent compared with the backlog of £2,800 million on 31 July 2012).

[5] These data are sourced from the Estates Management Record for 2012-13 (collected by HESA) and represent the maintenance costs required to upgrade non-residential buildings to a condition that is sound, operationally safe and exhibiting only minor deterioration.

94. Figure 15 shows the actual levels of investment (payments to acquire tangible assets) over the period 2009-10 to 2012-13, together with the projected level of capital expenditure forecast by the sector from 2013-14 to 2016-17.

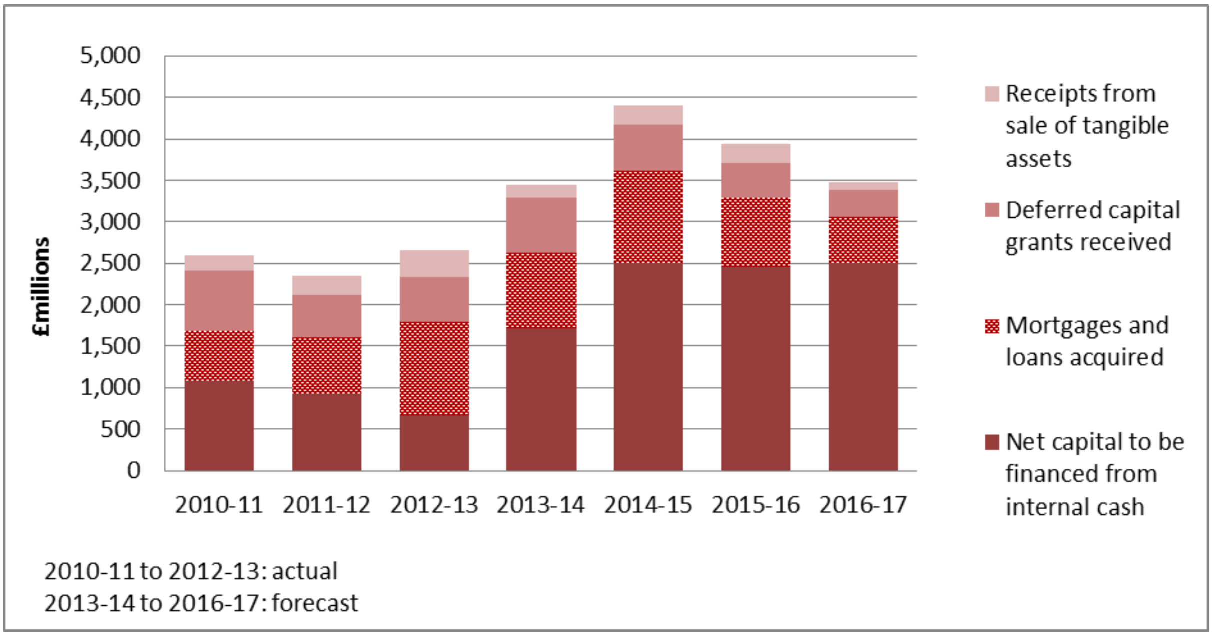
Figure 15: Capital expenditure 2009-10 to 2016-17



95. These latest forecasts show that the sector is projecting capital expenditure of £3,439 million in 2013-14, which, although lower than forecast in December 2013, is 29.5 per cent higher than the level reported for 2012-13. High levels of capital expenditure are also expected over the next three years, averaging £3,935 million per annum (2014-15 to 2016-17).

96. Figure 16 provides a breakdown of how capital expenditure was funded from 2010-11 to 2012-13, with an indication of how the sector expects to fund its capital investment plans for the period 2013-14 to 2016-17 (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, particularly from 2014-15 onwards. The sector will need surpluses to achieve this.

Figure 16: Funding breakdown of capital expenditure 2010-11 to 2016-17



97. Cash inflows from operating activities projected by the sector for 2013-14 are sufficient to finance any expenditure plans not financed by capital grants or borrowings. However, the large expenditure forecast in the next three years will require close cash flow management, particularly in 2014-15 as forecasts indicate that the sector requires £626 million from its own cash reserves (in excess of the projected surpluses and cash inflows) to fund the capital expenditure shortfall for that year. In the absence of alternative financing, this will result in a fall in the sector's projected cash levels (from £2,839 million to £2,213 million) at the end of July 2015, and cause liquidity levels to fall from 95 to 86 days.

98. The historical capital forecasting trends indicate that actual expenditure may be lower than projected for this period, but there is growing awareness in the sector of the need to increase the level of investment in infrastructure in order to attract new students, particularly in the increasingly competitive environment.

99. With significantly reduced levels of publicly funded capital grants, institutions will need to generate surpluses and operating cash inflows to finance future investment plans if they are to attract home and international students and ensure long-term sustainability. In the short term this level of capital investment is affordable given 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.

100. The reduction in cash balances, the increase in borrowings, and the increasing volatility of income streams point to an increase in financial risk. As part of the new Memorandum of assurance and accountability between HEFCE and institutions, we introduced a new approval process to assess whether increases in financial commitments by an HEI above a threshold (based on earnings before interest, tax, depreciation and amortisation) would increase the risk to its future financial sustainability, and therefore to the public and collective student interests. This new approval process came into effect on 1 August 2014.

101. Forecasts show that the sector expects its borrowings to rise by £2,069 million over the forecast period and to reach £8,290 million by the end of 2016-17. Although the sector already has access to over £675 million of additional financing agreed with lenders but not all drawn down, a significant amount of borrowing is yet to be financed.

102. The availability of finance has not been an issue for the higher education sector over recent years. The changes in the financial markets have led to lenders reducing the repayment periods on new loans, although there are positive signs that the repayment periods are increasing. The sector continues to consider different options for financial investment, including private and public bonds. The number of financial covenants attached to borrowing agreements appears to be increasing, with covenants covering both financial performance and balance sheet strength. Interest rates overall remain low for the sector, reflecting the confidence of lenders to the sector, but the spread in margins between different types of institutions has increased considerably.

103. The average level of borrowing has been rising within the sector for some time. In 2001-02, the level of borrowing was 18.4 per cent of total income; by the end of 2012-13, this had risen to 25.7 per cent. This is projected to rise further to a high of 28.9 per cent by the end of 2015-16, before falling to 28.4 per cent by the end of 2016-17.

104. As borrowing rises in the sector, interest payments are expected to increase, from £357 million in 2012-13 to £444 million in 2016-17. The increase in payments to service borrowing costs (interest and capital payments) will be affordable provided 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 or to increase income.

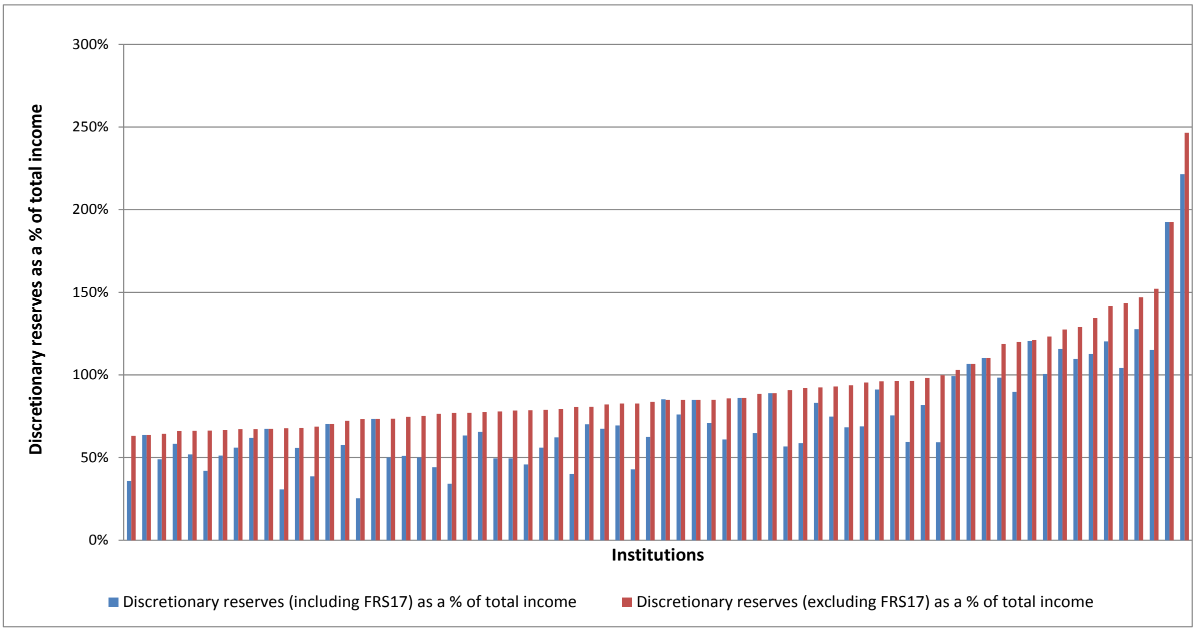
Reserves

105. At the end of 2012-13 reserves totalled £11,523 million, after taking into account the impact of the financial reporting standard on retirement benefits (FRS17). This reporting standard, which requires pension scheme surpluses and deficits to be included in the balance sheet (but not currently those of multi-employer schemes such as the Universities Superannuation Scheme (USS)), makes comparisons with previous years more difficult. Without FRS17 the sector would have reserves of £15,025 million at the end of 2012-13, equivalent to 61.8 per cent of total income; but including pension scheme deficits of £3,502 million reduces the reserves to 47.4 per cent of income.

106. Discretionary reserves are forecast to increase each year in the forecast period as the sector continues to generate surpluses. By the end of 2016-17, the sector expects to have built reserves (including FRS17) of £16,311 million. However, uncertainty over pension deficits, which depend on actuarial assumptions, could significantly increase or reduce this figure.

107. 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, and the forecasts show that this concentration is likely to continue throughout the forecast period. Figure 17 shows the forecast level of discretionary reserves, including FRS17 as a percentage of total income, compared with the forecast level of discretionary reserves excluding FRS17, for all institutions in 2016-17.

Figure 17: Comparison of forecast discretionary reserves excluding and including FRS17 as a percentage of total income 2016-17



108. As in previous years, the sector is not forecasting any material changes in the pension liabilities on its balance sheets. While this has been an understandable position in the past given the inherent difficulty in forecasting pension assets and liabilities, a new financial reporting standard, FRS102, due to be implemented from 2015-16, will require institutions to recognise liabilities relating to deficit recovery plans for multi-employer pension schemes (such as USS) in their balance sheets. These forecasts do not take into account these changes.

109. The latest USS Summary Funding Statement confirms that the estimated USS scheme deficit stood at £7.9 billion as at the end of June 2013. This compares with the last full triennial assessment, which valued the deficit at £2.9 billion as at the end of March 2011, demonstrating the significant level of volatility in these valuations. Although reserves are satisfactory overall, there is a risk that the sector reserves could be significantly overstated depending on the value of the USS deficit at the next full valuation, which commenced in March 2014.

How realistic are the sector's forecasts?

110. Historically the sector has been pessimistic in its short-term (one-year) forecasting, with the actual results always better than expected. Taking the current forecasts we have attempted to highlight the limited margins in which the sector operates. Looking at the first three areas of risk (public funding, full-time home and EU undergraduate fee income and overseas fee income), we have modelled the cumulative impact of a small (2.5 per cent) cash change in what HEIs are forecasting for each of the last three years. We have also modelled the cumulative impact of a one per cent increase in pay costs (which include pension costs). Table 4 shows the level of operating surpluses in each year under the various scenarios.

Table 4: Operating surpluses under modelled scenarios

	2014-15	2015-16	2016-17
Current forecasts	£649M 2.4%	£841M 3.0%	£980M 3.4%
Cumulative public funding reduction (2.5% per year)	£478M 1.8%	£506M 1.8%	£479M 1.6%
Cumulative reduction in full-time Home and EU undergraduate fee income (2.5% per year)	£467M 1.7%	£461M 1.6%	£391M 1.3%
Cumulative reduction in overseas fee income (2.5% per year)	£560M 2.1%	£656M 2.3%	£690M 2.3%
Cumulative increase in pay costs (1% per year)	£505M 1.9%	£549M 2.0%	£532M 1.8%
Combination of above four events	**£65M** **0.2%**	**(£352M)** **-1.3%**	**(£847M)** **-3.0%**

111. The above scenarios assume no mitigating action is taken by institutions, which is unlikely. However, Table 4 highlights the fine margins within which the sector operates, and how quickly small changes can have a material impact on the financial performance of the sector.

112. In the event of all four changes happening, the sector would be in deficit in all three years of the forecast period and, by 2016-17, the £980 million projected operating surplus would have turned into a deficit of £847 million (a fall of £1.8 billion).

113. HEIs need to generate surpluses to provide the positive cash flow to fund future investment in infrastructure, to the extent that these are not met from capital funding. The actual levels of surplus needed will vary, depending on the circumstances of individual HEIs. Overall, the sector is in a financially sustainable position in the short term, but the above analysis highlights the tight margins within which some institutions are operating.

Conclusion

114. The expected financial out-turn for 2013-14 is not as strong as 2012-13, although better than forecast in December 2013.

115. The projected performance for the sector in the remainder of the forecast period (2014-15 to 2016-17) is sound overall, with the sector forecasting continued surpluses and healthy reserve levels. However, the projected financial out-turn for the sector is weaker than the previous three years, with the sector expecting its liquid funds to diminish and its borrowing to increase to record levels – an unsustainable trajectory.

116. Strong liquidity is particularly important given the current level of uncertainty in the sector over future government funding, student recruitment levels and the vulnerability of overseas student income.

117. The value of the sector's pension scheme deficits and the contributions required to ensure the sustainability of these schemes also represent a key area of uncertainty within the sector. The latest scheme valuations indicate that HEIs could face substantial increases in their pension contribution rates, causing operating costs to rise.

118. The sector is increasingly dependent on its capacity to generate sufficient surpluses for sustained investment in infrastructure whose quality is critical to the successful delivery of quality teaching and research, to the ability of HEIs to attract and recruit new students, and to secure their long-term sustainability.

119. Institutions failing to invest sufficiently in infrastructure could find themselves in a weaker market position and at higher risk of financial instability.

120. The fiscal constraints of the last few years have made the funding environment confronting universities more challenging. In the short-to-medium term there is a continuing risk that future public funding of higher education could be constrained if the overall economic climate does not improve.

Disclaimer

121. This report, which is based on information provided by higher education institutions, has been prepared for the benefit of institutions and their stakeholders in general terms. HEFCE cannot reasonably foresee the various specific uses that may be made of this report, and therefore no responsibility is accepted for any reliance any third party may place upon it.

List of abbreviations

EU	European Union
FRS	Financial Reporting Standard
FT	Full-time
FTE	Full-time equivalent/equivalence
HEFCE	Higher Education Funding Council for England
HEI	Higher education institution
HESA	Higher Education Statistics Agency
RFI	Return for financing and investment
TRAC	Transparent Approach to Costing
UCAS	The Universities and Colleges Admissions Service
UG	Undergraduate
USS	Universities Superannuation Scheme