

Future Capital Asset Funding Options for FE Colleges

Final Report
30 June 2009



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Executive summary

Introduction

PricewaterhouseCoopers LLP (“PwC”) was appointed by the Learning and Skills Council (“LSC”) to consider options for attracting additional private sector funding into the FE sector to support capital investment.

In undertaking this work we have, over a three week period, engaged with a range of stakeholders including:

- Representatives of colleges (including Association of Colleges and 157 Group representatives);
- The LSC;
- Regional Development Agencies;
- The Local Government Association
- The Department for Business Innovation and Skills
- The Department of Children Schools and Families; and
- Lenders (and potential lenders) to the FE sector.

Our team has also reviewed FE sector financial information provided by the LSC.

Issues and Observations

Our work highlighted a number of factors that are likely to impact on the FE sector’s potential to attract additional private sector funding. The work also captured a range of ideas and suggestions from a selection of colleges as to how their abilities to fund capital investment might be eased. Key issues and observations are covered in more detail in the body of the report, and are summarised under the following themes:

- **The Status Quo** - Colleges current borrow privately via one to one arrangements with banks, based on the best deal an individual college can agree.

The analysis included at section 2 highlights that total long-term borrowing in the sector at the end of 07/08 amounted to almost £0.9bn.

- **Financial Position** - The sector wide financial analysis highlights that **potential for more efficient borrowing and a greater scale of borrowing may exist.**

The highlighted cash balances and investments in the sector of nearly £1.5bn, exceed the total long term borrowings of FE colleges. Whilst this is a simplistic analysis it does raise the question of whether cash assets and borrowings could be managed more effectively across the sector?

The attitudes and views of individual colleges vary greatly as to the level of debt they feel comfortable in managing and the scale to which they would be prepared to gear up. Conclusions drawn from sector wide analysis should be considered in this context.

Private Funding - There is **strong appetite from prospective lenders**, such as banks and insurance companies, in the FE sector and it is perceived to be an attractive credit risk.

College views - We engaged with a range of college representatives who were keen to participate in the debate about future funding options for the sector. Views were shared both on a sector wide basis but also by individual colleges. In that regard, it is apparent that the respective interests of the FE sector and those of individual colleges need to be considered as they may not be directly aligned. For example, a large city based college with a high quality estate and a healthy financial situation may have the capacity to borrow substantial additional private finance yet the greatest need may lie with a smaller college that does not have the capacity to manage additional borrowing.

The Colleges highlighted a range of further issues that could improve their ability to fund capital investment, summarised under the following themes:

- Finance and Funding
- Use of Assets
- Efficiency Savings
- Donations and sponsorship

- Greater recognition of the value of FE (including stronger local working).

Further details on these areas are included at section 4.

Conclusions and Recommendations

Based on our work, we believe that there is potential to raise private debt more efficiently across the sector, to increase the amount of debt raised and to make better use of the debt / cash already in the sector.

Our conclusions are based on the high level work undertaken, and will require further work to confirm the viability of individual proposals, but could be considered for implementation in line with time frames as follows:

Short Term

Issue - The FE sector currently negotiates private finance on a one to one basis between college and banks. Across the sector this borrowing amounts to almost £1bn.

Proposal - A more co-ordinated approach across the sector could realise a number of benefits including, efficiencies (in terms of time and resources), improved funding terms (through enhanced buying power) and attraction of new entrants to the sector (which in turn may further improve competition).

Timetable - Circa three months to undertake detailed analysis (to confirm potential) and to put in place a “standard FE Sector term sheet”.

Medium Term

Issue At a sector level, there appears to be an imbalance between colleges with some carrying large cash balances whilst others have substantial long term borrowings. Whilst there will be underlying reasons for each colleges needs, the respective figures – £1.1bn cash reserves versus £ 0.9bn of long term borrowings – suggest potential inefficiencies across the sector.

Proposal - A lending vehicle is established for the sector that would allow those colleges with cash deposits to attract better rates than available in the market, whilst enabling other colleges to borrow at similarly improved rates. This proposal has the potential to make real savings across the sector (in terms of interest paid to third parties) and allows for additional public monies to be retained within the education sector.

Timetable - We have set out a six month timetable to allow quantification of potential benefits, investigation of regulatory issues and (subject to those regulatory barriers) implementation.

Longer Term

Issue The above proposals seek to support individual colleges as soon as possible. In the longer term, increased funding certainty and efficiency may be achieved if a FE sector funding vehicle could be established which raises funds collectively on behalf of the sector (as opposed to the 1:1 arrangements currently in operation).

Proposal - Two potential routes to establish sector wide funds have been put forward, with a debt based approach (rather than a traditional PFI model) identified as more likely to provide early impact.

If the LSC invests up to £50million of contingency funding, a total fund of £0.5bn might be established across the sector. We recommend further work is done to consider how this can be done most effectively, for example:

- A long term fund (say debt over 20-25 years) repayable from future college surpluses; or
- A shorter term construction finance facility (over say 3-5 years) that enables funding for construction, which could be re-financed at a later date. This may be of interest in a current climate where long term finance is relatively expensive.

Timetable - A 12 month indicative timetable has been set out for this approach.

Next Steps

The potential success and impact of measures such as those highlighted in this report – both private sector funding and other issues - will depend on the engagement and willingness of both the college sector and the funders to participate going forward.

Our work highlighted a willingness and desire from colleges, public sector stakeholders and private funders to looking at new approaches that could help the sector to fund investment in the future.

We therefore believe that the establishment of a dedicated “Funding Task Force” or cross FE sector team could help to drive forward this agenda. It would allow the sector to explore a broad manifesto of funding ideas and to quickly focus on implementation and making a difference. We propose that such a group could be mandated to

consider both:

- Private funding options; and
- Other funding options (efficiency, assets, links to local government etc);

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1 Scope of our report

PricewaterhouseCoopers LLP (“PwC”) was engaged by the Learning and Skills Council to consider how additional private sector finances might be accessed to support additional capital investment into the FE sector.

Our work has been undertaken over a three week period and has been informed by:

- Financial information provided by the LSC (based on 07/08 returns)
- Discussions with stakeholders including representatives of
 - Association of Colleges
 - 157 Group
 - LSC
 - RDAs

- Local Government Association
- Department of Business Innovation and Skills
- Department of Children Schools and Families
- Meetings and discussions with private sector funders (including banks and pension funds)
- A review of private funding models in other sectors (eg Water, Health)

In undertaking our work we have not sought to check the validity of the information or views provided to us. The conclusions and recommendations for future funding options are therefore high level options for further consideration.

The full scope of work is attached at Appendix 1.

2 Financial snapshot

The following provides a snapshot of financial information provided by the LSC for the FE sector. The information summaries key financial data from the 2007/08 financial year. This information has been reviewed at a high level to gain a view of the financial position for both the FE sector.

Key Financial data – FE Sector

Based on a review of 361 college financial returns (07/08)

- 61% are in accounting surplus (average £550k)
- 39% are in accounting deficit (average £1,057k)
- Overall average accounting deficit of £78k (includes average depreciation charge of £1.4m)
- Average cash generated of circa £1.3m per college p.a.
- Total cash balances of £1,122m in sector
- Total investments of £343m
- Total long term borrowings of £861m (12% of income)

We have also completed the same review for the 141 colleges covering the 150 outstanding projects to assess whether their high level financial position is consistent with that of the sector.

Key Financial data – Colleges covering 150 outstanding projects

Based on a review of 141 college financial returns (07/08)

- 52% are in accounting surplus (average £623k)
- 48% are in accounting deficit (average £1,470k)
- Overall average accounting deficit of £372k (includes average depreciation charge for the sector of £1.6m)
- Average cash generated of £1m per college p.a.
- Cash balances of £438m in colleges
- Investments of £56m
- Long term borrowings of £316m (10% of income)

Key points to note:

The FE Sector

- The financial health of colleges varies greatly from college to college. Differences are driven by many factors including;
 - Type of college;
 - Size and location;
 - History (including beneficiaries, condition of estate)
 - Management and approach to generating new income streams.
- Approx 3 in 5 colleges reported surpluses in 07/08 with 2 in 5 reporting deficits. The average deficits reported (£1.05m) are virtually double the average surpluses (£0.55m).
- Colleges are on average cash generative producing circa £1.3m per annum. At an individual college level this picture is distorted with some colleges achieving larger cash generation and others reporting deficits.
- Almost 1.5bn of cash and investment assets were reported at the end of 07/08. This figure exceeds long term borrowings by more than 50%. While much of this cash will be utilised for working capital or earmarked for capital programmes, it raises the question of whether cash could be used more efficiently across the sector.
- Total long term borrowings equate to 12% of income which is

well below the maximum sector rate of 40%.

Colleges covering the 150 outstanding projects

- The percentage of colleges in surplus is less than the average for the sector. across the sector, but the average surplus is greater than the sector;
- Whilst the average surplus achieved is slightly higher than the quantum of the sector average surplus, the average deficit is almost 40% bigger than compared to the sector average.
- The average deficit for the 141 colleges is 3.7 times that of the sector
- The deficits are based on accounting deficits which include approximately £1.6m per annum on depreciation (non-cash charges). The cash generated by this group of colleges is on average £100k less per annum per college than the sector average.
- The level of cash balances is consistent with the level for the FE sector; but these colleges do not have the same level of investments as a proportion of the whole sector.
- The level of borrowings is consistent with the sector at 10% of total income.
- The size of the colleges is across all sizes of colleges. In fact approximately 50% of the large and very large colleges have outstanding schemes.

3 Potential Funding Options

The FE College sector is a major borrower of money from the external banking markets - £0.9bn aggregate long-term borrowings across the sector in financial year 2007/08. In most instances this borrowing has been secured in a piecemeal fashion, on a college by college basis. In the course of our work to date, we have considered the opportunities that might exist to bring a more co-ordinated sector wide approach to the raising of non-grant based funding, with a view to harnessing the buying power of the sector as a whole and in so doing, securing better value for money from external markets and more efficiency from the surplus funds in the internal market.

Recognising that as well as there being a need to identify some immediate actions that could be taken to address the most pressing issues, there is also an opportunity to put in place a longer term structural change to how the sector finances its capital programmes. In this context, we have tried to identify both immediate and longer term options for consideration by the LSC and the sector at large. A brief summary of each of these strategies is set out below together with suggested next steps for further development of the ideas.

Short Term “Wins”

Proposal:

As highlighted above, the sector as a whole currently borrows almost £1bn from the commercial debt markets. These borrowings

have been secured by individual colleges negotiating directly with the providers of the finance and as such, there will almost certainly be a wide disparity in the terms secured by one college from another and there will have been considerable duplication of effort by borrowers and lenders alike.

It is possible that a more co-ordinated sector wide approach, with support from a central body, could generate not only efficiencies, in terms of time and resource, in the process of securing the debt but also better underlying funding terms through the enhanced negotiating power that a sector wide approach would bring. In addition, a co-ordinated approach might attract new lenders into the market who may not currently consider the sector as attractive due to the fragmented nature of the borrowers. New entrants of course would generate new competition and potentially more competitive pricing behaviours from existing players.

Next Steps:

- establishment of a central review team to perform the exercise (composition of team to be discussed);
- detailed analysis of the existing borrowing arrangements held by each college (or a selection of colleges if the preference is to identify an appropriate first wave);

- detailed analysis of the actual borrowing requirements, existing and proposed, of the colleges (this would most likely be done in conjunction with a review of the proposed capital programmes);
- review of the processes currently adopted by colleges for securing external debt;
- engagement with lenders to explore the appetite for standard terms and conditions that would be applied, with only minor borrower specific amendment, to the sector as a whole;
- assuming lender appetite for the proposition, commence development of outline terms and conditions to identify potential gains over existing arrangements; and
- prepare a short report for the LSC, detailing findings and recommending a course of action.

Timeframe:

We would envisage the above process taking no more than 4-6 weeks assuming ready access to the information and individuals required. Depending upon the internal approval processes of the lenders involved, a further 3-5 weeks may be required to put in place a “standard FE College sector termsheet” ready for deployment to live projects.

This standard terms sheet would create comparability of lending terms and support colleges in securing financing at competitive rates in the prevailing market conditions

Assuming general support for the proposition from both borrowers and lenders, it is not inconceivable that such a structure could be up

and running within 3 months.

Medium Term

Proposal:

From the analysis we have conducted of the financial information made available to us, it is clear that an imbalance currently exists when looking at the sector as a whole: on the one hand there are a number of colleges who carry large cash balances from year to year; whilst on the other hand, a number of colleges have entered into arrangements to borrow money from the external funding markets. The most striking aspect of this situation is the respective numbers - £1.1bn of cash reserves versus £0.9bn of long term borrowings¹.

At a very simplistic level, if looking at the sector as a whole, it is borrowing money from banks at approximately 6% to then give that money back to the banks in the form of deposits which receive interest at something less than this borrowing rate i.e. negative arbitrage. Whilst this is clearly a very simplistic analysis, it does beg the question: could better use be made of existing resources by re-directing the surpluses that currently exist in the sector towards those colleges that have borrowing requirements?

In other words, would it be possible to establish an internal lending vehicle for the sector, whereby those colleges with surpluses that they do not immediately require could “deposit” into the *FE Bank*

¹ Based on the financial year 2007/08 figures for 361 college returns.

and those colleges with funding requirements could “borrow” the money from the *FE Bank*. For both circumstances it is possible that better rates could be achieved than are currently on offer from the commercial banking market.

There are clearly a number of issues that would need further investigation to ascertain the viability of this proposition, not least the vires of inter college lending but there does appear, on the face of it, to be an untapped source of funding which could potentially help alleviate the current shortfall in funding for the capital programme.

Next Steps:

- identify the quantum and source of current surplus reserves;
- Identify quantum of recurring annual surplus;
- ascertain how much of the current surplus reserves are not already earmarked for future uses in the next, say 3-5 years;
- investigate the regulatory position to ascertain whether or not the establishment of an FE sector *Bank* / inter college lending would be deemed vires under current statutes governing the sector;
- consider accounting treatment issues
- consider how the lending vehicle might be structured and managed: who would assess borrowing applications? what criteria would applications be assessed against? Who would monitor the loans? etc

Timeframe:

We would envisage the above process taking somewhere in the region of 3-4 months to fully investigate and develop into a working model. Assuming there are no complex regulatory barriers to the concept being developed, it is not inconceivable that such a structure could be up and running within 6 months or less.

Long Term Sector Wide Capital Asset Funding Programme

Proposal:

With the size of the capital programme budget deficit that currently exists within the FE college sector, it is unlikely that the options set out above and the other initiatives discussed elsewhere in this paper will be sufficient to meet the overall capital funding requirement of the sector over the next 3-5 years. Most of the options considered so far in the paper fall into the category of *micro* level actions where the gains, whilst possibly able to be delivered relatively quickly, are mainly incremental, internally driven and of relatively low financial value when compared to the size of the capital funding shortfall that pertains at present. With the cuts to public sector spending plans recently announced by the Government, it is unlikely that a public sector funded solution to the shortfall will be available in the near future.

Consequently, we have sought to consider how a private sector based solution might be developed, with the aim of raising sufficient funds, as quickly as possible, to provide the level of financial resource required to address the capital asset renewal needs of the sector. Unfortunately, there are few, if any, examples from other sectors of similar *macro* level approach being applied to the introduction of private finance to the funding of public infrastructure

assets. The most common methodology has been to embark upon a series of PPP/PFI type projects where each individual project raises its own finance on a stand alone basis, and, whilst there may be an element of central co-ordination involved, this has tended to focus on programme timetables and standardisation of legal documentation and not central finance raising.

Therefore, to a large extent the proposition envisaged here is breaking new ground in terms of the financing of a sector wide infrastructure programme in the public sector, but in doing so, it draws on structures that have been commonly used in the private sector e.g. the Artesian funding framework used in the water industry which allowed multiple water companies ease of access to capital markets funding under a single framework. This approach facilitated both large and small fund raising ventures and the provision of finance at competitive pricing – this offers clear parallels with the FE college sector where the financing requirements differ greatly from college to college and much time and resource could be tied up in negotiating individual funding agreements.

A key area in which a framework structure for the FE college sector is likely to differ from corporate structures such as the Artesian facility is in the provision of risk capital funding to sit alongside the senior debt. The Artesian facility provided to the water sector was to all intents and purposes normal corporate lending against the cashflows and assets of the borrowers (notwithstanding the role of the monoline assurers) and did not require the water companies to commit equity alongside the debt. It is probable that to replicate such a facility in the FE college sector there would require to be an element of risk capital provided to insulate the senior debt from repayment shortfalls.

There are two potential routes to market that could be considered for providing this equity cushion in a *framework funding* structure for the FE college sector: one would be to adopt the PFI methodology common in many other sectors whereby private developers (usually contractors, service providers and/or investment funds) provide the risk capital or equity strip of finance, normally in the region of 10% of the overall funding requirement, with senior debt finance (from banking and capital markets) picking up the other 90%. This is a tried and tested method for infrastructure programmes where the debt is procured on an “*as you go*” basis as each project within the programme comes to market. However, it has not been tested where the debt is raised up front for an entire programme of projects which will take place over a 3-5 year period. That is not to say that such an approach would not be acceptable to the debt markets but in the current climate, where liquidity and capital are in short supply, banks might prefer something more tangible by way of commitment from the public sector sponsor.

An alternative approach to the traditional PFI methodology, might be to use the £50m contingency fund that the LSC currently has as a *pump-priming* or *seed funding* equity strip against which senior debt from the commercial market could be raised (using the 90:10 approach of the PFI market this could facilitate up to £450m of private sector investment). As well as emphasising the commitment of the public sector to delivering the programme and providing the *first loss* risk capital that funders would look for, it would also remove the costliest element of financing associated with PFI procurements, namely private sector equity and potentially deliver the added benefit of ensuring 100% of any future refinancing gains remain within the public sector.

Another aspect of the structure that might differ from that used in the corporate sector is the tenor of the debt. Again, using the Artesian framework as an example, the initial bank debt was borrowed on a relatively short-term basis and was then re-financed in the capital markets with the benefit of a financial guarantee, known as a “wrap”, from one of the triple-A rated monoline assurance companies. The monolines were one of the first casualties of the crisis that still affects the international financial markets and have been largely out of the market since the early part of 2008. Consequently, the ability of borrowers to access the very fine pricing that comes with “wrapped” bond issues has disappeared, leaving only the far more expensive “unwrapped” market as an option. Therefore, at this point in time, it may be necessary to consider an exclusively bank debt funding structure for the FE college sector funding vehicle. This might be achieved in one of two ways:

- (i) Enter into a long-term loan of say 20-25 years, with repayment being effected by the annual surpluses generated by the borrowing colleges over that period of time. By way of an example, if the sector as a whole was to borrow £250m; over a timeframe of 20 years; at an interest rate of 7% (broadly consistent with current market rates); then the annual debt service to fully repay that loan would be in the order of £23.5m per annum on a straightforward annuity basis. This compares to a current annual cash generated by the sector as a whole (which must also service existing borrowings and allocations for future capital) of circa £400m.
- (ii) As an alternative to locking into long term finance at the outset, a shorter term construction finance facility of say

3-5 years could be a more attractive option, particularly in the current climate where long-term bank debt is relatively expensive and the accelerated repayment provisions that many banks require may not be conducive to the sector. Such an approach would involve a re-financing of the debt, at the expiry of the construction finance facility, with longer term finance and is attractive to lenders who are wary of the greater risks associated with the construction phase of projects.

This might present sufficient time for the return to the market of “wrapped” bonds, the development of more competitive “unwrapped” bond structures or at least a softening of the current pricing and aggressive repayment structures associated with long-term bank debt. Alternatively, it could present an opportunity to introduce one of the newer sources of long-term finance that are starting to emerge such as insurance company funds e.g. the Norwich Union Infrastructure Fund which has invested in health and education sector projects, or indeed Local Authority Pension Funds which are being looked at very closely as a potential provider of long term debt to the public infrastructure market.

Moreover, if the current surpluses held in the sector were available to fund or part-fund the construction finance facility, then this could present a very attractive proposition to the market.

From our discussions with a number of lending institutions including those banks already active in the sector, banks with experience of lending to PFI programmes, the EIB and alternative lenders such as

insurance companies, it is clear that there is a strong appetite for the FE college sector and that it is regarded as an attractive credit risk. Against this back drop, and notwithstanding the issues highlighted above, there is cause for cautious optimism regarding the potential to establish a *framework funding* structure to assist in the delivery of the capital asset programme in the FE college sector.

Next Steps:

- formally engage with lenders from all parts of the debt community to ascertain their interest in and obtain feedback on the proposal;
- start to identify what the key terms and structural requirements of the lenders would be;
- identify form of public sector involvement – finance, people;
- develop the principles by which individual projects would access the funding;
- identify legal documentation structures/requirements;
- discuss with rating agencies what might be required to achieve investment grade rating if this is important to lenders;
- develop principles of governance/management of the vehicle;
- accounting treatment (inc balance sheet issues)

- consider what scope exists to reduce individual project costs through standardised approaches e.g. funder due diligence

Timeframe:

The concept of a *framework funding* structure has been considered previously for public sector infrastructure programmes e.g. Church of England Schools, Building Schools for the Future, NHS Lift but to date it has proved difficult to implement. There have been varying reasons for this which may or may not apply to the FE college sector, but it should be recognised that the development of this type of approach is likely to take some time. We would envisage the dialogue/structuring phase with the likely providers of framework financing to require somewhere in the region of 6-9 months to complete. Thereafter, the internal approval processes of both the public sector and potential funders could take up to a further 3 months to finalise such that it is likely that it would be in the order of 12 months before the vehicle was ready for roll-out into live projects.

4 Views from the Stakeholders

We consulted with various stakeholders in the sector, including AoC, 157 Group, LSC representatives, RDAs, LGA, DCSF and DBIS. Key themes that emerged from these consultations included:

Finance and funding

During the consultation, a number of themes emerged around issues of finance and funding:

- **Certainty of Funding** – There was a perception that the current uncertainty around future funding levels is making it difficult to forecast future income and consequently borrow monies at preferential rates. The move to a demand led system has exacerbated the current uncertainty and made colleges even more cautious about investing. Examples were provided where colleges have income on 3 year agreements, but feel it too risky to “gear up” on the back of such contracts.
- **VAT** – The consultation raised the issue that the current VAT system is disadvantageous for colleges when compared to schools. Colleges feel that their primary business activity needs to be redefined in order that they can build the buildings they need to deliver the service required, without having to pay what they see as an excessive VAT burden. The current rules state that if a building is used less than 90% for LSC grant funded activity; all costs are subject to VAT.

- **Funding Levels** - The consultation raised the issue of funding rates in comparison with the schools sector. It is clear that colleges often receive a lower level of funding per pupil than their opposite organisation in the schools or school sixth form sectors. It was noted that this funding disparity has existed for a number of years.
- **Public Works Loan Board and the European Investment Bank** – Colleges were unsure as to why they are unable to access funding from these institutions but it was generally agreed that both are routes that should be explored.

Private Finance Initiatives

PFI and PPP are traditionally not popular within the FE sector but there is an increasing recognition that schemes must be considered given the current situation. The following issues were noted with regard to PFI:

- **Prohibitive returns** – Colleges who have explored the idea of a PFI link up have been quoted figures of around 6-7% in terms of the total desired return on investment. It is generally felt that borrowing at this level of return rate is not sustainable.
- **Cautious governance** – Many college boards are unwilling to engage in any form of build and lease arrangement as they feel that the college would be risking their future viability in return for a short term benefit.

- **Hidden costs** – There is a perception of high hidden costs in PFI deals, based on experiences from local partner schools who have engaged on PFI deals. When these costs are combined with the return rates on investment it was felt that the real rate of return could be as high as 10-11%. This is a burden of debt that colleges are currently unwilling to accept.

Use of Assets

The sector is in possession of estates with a net book value of circa £6.7bn against which potential investment could be leveraged. The current level of estate ownership is still felt to be high with many colleges owning multiple satellite sites which are used for community and outreach teaching.

The potential options for consideration were felt to be:

- **Land swap** - It is possible that many colleges would consider a position of “land swap” deals with local partners which would allow them to take ownership of sites in the locations that they need, this could reduce the future cost of capital projects and allow a “zero” cost land acquisition deal, subject to tax implications.
- **Co-location with other public partners** – Colleges felt this is an avenue worth exploring given the increasing propensity for partners in health, police and the Local Authority sector building community based centres for delivery. It is also possible that many of the current community based delivery centres could be developed alongside partners as part of the “place making” agenda.
- **Loans** – Many colleges have the potential to leverage additional loans against their estates. The average level of debt in the college sector is approximately 12% of income with the LSC setting a maximum ceiling of 40%. It is clear that many colleges could sustain a higher level of debt in order to acquire monies which could be used to finance the sector, however this option presents a number of issues:
 - Many colleges would break existing covenants were they to acquire new debt; (examples cited included interest rates of 1-3% rising to 6-7%).
 - Whilst the LSC ceiling of 40% is based on a theoretical affordability position that LSC believe colleges could sustain, many colleges feel that this figure is too high. Uncertainty around the future funding of colleges, the political support for underwriting colleges and a lack of future capital funding, many colleges felt uncertain of their ability to service increased debt.
- **Sale** – the sector holds felt it had few assets which could be sold in the current climate. Many buildings have been sold in recent years in order to provide funding for the college development. Colleges felt much of the easily disposable surplus estate has been divested. Where there are assets which could be sold, the current market conditions mean that often they are unable to attract a viable bid.
- **Joint ventures** - Some colleges own revenue generating companies through joint ventures and other finance vehicles which could be sold to raise capital but would need specialist advice as to how best to approach the market.

- **Flexible space** – Some colleges are increasingly looking to find flexible property solutions so that their estates can grow and shrink in line with demand, particularly where large contractual income is involved. This is seen as an option in some locations where 3-5 year space can be leased.

Efficiency Savings

The stakeholder consultation brought out the view that colleges have not exploited opportunities to deliver efficiencies through collaborative working. It was considered possible to achieve reductions in the following ways:

- **Merger** – The LSC is currently reviewing the framework for college mergers with a view to a potential change. There is a general sense of nervousness within the wider education sector that many colleges are merging in order to gain a competitive advantage, rather than the more traditional reasons of poor quality and or finances in one of both parties concerned. Despite this nervousness, there is a recognition that mergers could provide the answer to efficiency savings. The merger experience of Sutton-Coldfield college was cited as having provided saving of an estimated £3 million per-year.
- **Shared services** – There has been limited consideration to the use of shared services within the FE sector but it is an area which could lead to considerable benefit. For instance, it is possible for colleges in close proximity of each other to make better use of technology in order to benefit from shared service efficiency savings. It is also possible to work with local partners to share functions such as marketing, HR and IT support, bringing major financial savings.

- **Outsourcing** – Most colleges have many internal functions which are used to support the management of their business. As with the private sector, it is possible that outsourcing business functions could reduce overheads.

Donations and Sponsorship

Colleges have always been able to attract funding from external donations and there are a number of potential areas which arose in the consultation exercise:

- **Private benefactors** – It is felt that for private benefactors to be attracted in the current climate there would need to be an additional incentive from the government. If a tax incentive could be given for the donation of private monies into the college sector, it is likely that donations could be sourced. Many colleges are already in discussions with individuals. Colleges cited examples of the environmental arena and with the British Film industry where this incentive that has been used to great effect.
- **Corporate Responsibility** – Funding for the corporate responsibility agenda has increased dramatically in the last decade and is an area which could be targeted within the FE sector. Companies are keen to be associated with successful community organisations and schemes which bring benefit to society as a whole. It was felt colleges could leverage their position as the heart of the community, their prime city centre locations and their heavy footfall, to make them an attractive proposition to companies looking to invest in socially responsible endeavours.

Greater Recognition of the value of FE

One message that came out from the consultations is that opportunities exist to join up at a local delivery level and make savings. Part of the barrier cited was a lack of understanding of the benefits of the FE colleges (at worst) or simply an inability to join up local agenda.

For example, a new mixed use development with employment and residential space would be more attractive with a college facility on site. Yet the experience of those in the consultation were that no college present had benefited from a Council's S106 planning obligation to a developer and, in fact, some had been subjected to obligations themselves rather than being viewed as a key piece of social infrastructure.

As part of the consultation, PwC fed back the college views to the LSC, DCSF, several RDAs, the LGA and DBIS, with the following key messages emerging;

- **Future Capital Funding** – it is unlikely that the government will be increasing the capital funding levels in the next 5 years. The current figure of £300 million is under review and it is possible that this figure will see further reductions as the sector is pushed to find its own funding. The need for new approaches therefore

remains a priority for the sector.

- **Structural Funds** – There is a willingness from the RDAs to help the colleges within their area. The issue with structural fund allocations is that many RDAs have moved to a position of theme based allocations with some opting for issues such as low carbon and others moving towards a social outcome based model. The RDAs are keen to be involved in further conversations on this issue and prefer a route which leads to a more sustainable and flexible model for the future. It is unclear as to the scale of the potential opportunities that might arise if both structural funding priorities and timelines could be aligned with college needs.
- **Local Authority Funding** – The LGA was keen to stress that their members see a clear need to help local colleges where they possibly can. Whilst there is little free capital in the Local Authority arena, there is a keen sense that there is much that can be done to help through partnering of the local authorities and colleges.

We see this as a key area where future synergies might be explored, particularly given the increasing responsibilities that Local Authorities have for social and economic development and their increased responsibility for learning for up to 18 year olds.

5 Conclusions and Recommendations

Our work has highlighted a range of potential measures that collectively could be considered the basis for a “FE funding manifesto”. The options highlighted include both options to access additional private funding as well as other ideas focussed on improving the impact of existing funding e.g. efficiency gains or greater linkages with the delivery with other local services (e.g. libraries or police).

The potential impact of any of these funding options will depend on the engagement and willingness of the colleges and funders alike.

Our work highlighted a willingness and desire from both colleges and funders to look at new ways of funding and to do so in a positive manner.

We therefore believe that establishment of a dedicated “FE Funding Task Force” would be widely supported to drive this agenda forward. It could allow the sector to:

- Implement short term wins (e.g. standardised lending terms);
- Explore and develop medium and longer term private funding options; and
- Identify and take forward other initiatives to improve funding to the sector e.g. efficiency via use of technology, closer links to local authority etc.

Potential next steps that could be addressed in taking forward a FE Funding Manifesto and developing a Funding Task Force are set out below:

Potential options for inclusion in a FE “Funding Manifesto”

- Improving access to private funding; Colleges collectively have around £0.9bn in long term borrowings, but this position has been arrived at by each college going to market individually.

There are likely to be benefits to the sector and individual colleges through a coordinated approach to the market that could include:

- improved terms of finance achieved through the use of collective bargaining, including finer pricing of debt;
- standardising debt terms sheets in the sector to reduce the costs of securing finance;
- attracting new players to the market, increasing competition amongst funding providers;
- “bundling projects”, to create economies of scale at a project level and to manage funder risk;
- exploring new options and mechanisms for the sector.

- Creating an internal funding market. This could allow colleges with surplus cash to achieve a high rate of return on savings and other colleges to secure lending at rates below the open market. If successful this could help to retain additional funding within the education sector.
- Access additional value in recognition of colleges' role in the community (by aligning to local authority economic and social development objectives). Our work to date has highlighted the complimentary nature of colleges with the objectives of LAs and RDAs. Both the LGA and RDAs recognise the benefits that colleges can bring to their place making and social agendas.

The opportunity exists for further exploration as to how these synergies can be translated into support for colleges. This work should be broad and consider opportunities for co-location and service delivery with the likes of libraries, leisure and other community facilities.

- Increase confidence in future income potential

We identified a clear nervousness amongst colleges to “gear up” with private sector debt beyond certain levels due to a fear as to future income levels. Fears arose from a number of aspects

- Concern of the level of provision in the sector. There was little clarity as to the size of the market being targeted by colleges and its future potential. Many did however sense over provision in the sector but were unable to quantify what this might be. The position is potentially further complicated with impending changes to the government policy on leaving ages.

- Concern as to what future government revenue budget cuts might be. A potential “double whammy” impact being highlighted as direct funding may be cut as well as funding to other departments that underpins major contracts currently delivered by a number of colleges.

- Exploring potential efficiency gains. Colleges recognise the need to manage cost bases and to make real efficiency savings. There is a recognition that potential for shared services, joint working and technology driven savings may exist.
- With potential funders develop model for a sector wide solution

On a longer term basis, the sector seeks funding certainty and the creation of a sector wide funding model, to access private funding, could be a viable option.

Development of this option will need further analysis (that considers individual college positions rather than a sector wide view) and the consideration of key implementation issues such as scale of fund, how it would be managed, accounting treatment, and risk issues.

Developing a Funding Task Force

A Funding Manifesto of this nature could be driven and delivered through the establishment of the proposed Task Force, with the following key objectives:

- Clarify long term role of the sector
- Open up new sources of income (through increased recognition of the sector's contribution to other government policy objectives)
- Support the sector to make better use and maximise value of its assets
- Support the sector to access private capital markets more efficiently, an 'Access to Finance' programme co-ordinated and managed by LSC. This programme could take on the early wins identified, allowing the Task Force to focus on medium to longer term initiatives.

Annexes

Annex 1 – Scope of Works

The work PwC has undertaken is summarised in the following scope of works:

1. Basing our work on solid foundations

In order to deliver our work efficiently and to your timetable, we recognise that we need to focus on developing new funding options as quickly as possible. We can only do this if we:

- (a) Understand the current arrangements and delivery proposals to ensure our work builds upon lessons already learnt and proposals that may have been developed to date.
- (b) Understand the future business model, nature and value of the current asset base (where possible) in order to understand the size of the challenge and the potential financing capacity offered by the FE sector's revenue streams.
- (c) Understand the existing external finance sources that colleges might currently access and whether there is scope to enhance these opportunities.
- (d) Identify potential sector wide debt market funding options which would be centrally managed as opposed to delegated to individual colleges.

2. Consider lessons from other sectors

The FE sector faces an infrastructure deficit that cannot be covered within the public sector's foreseeable budget constraints. This is a challenge that is not unique to the FE sector. We therefore propose that our work will include:

- (a) Drawing capital asset funding lessons from the wider education sector, e.g. Building Schools for the Future model.
- (b) Drawing capital asset funding lessons from other relevant sectors.

3. Identify potential short term actions to increase funding availability

There is a need for immediate action to address the infrastructure deficit the FE sector faces. We propose our work will include:

- (a) Consideration how current funding approaches might be enhanced to increase the leverage of grant funding (e.g. maximising current borrowing capacity, negotiating better terms for existing facilities through refinancings;
- (b) Highlighting potential opportunities for FE colleges to improve their investment capacity via actions at a regional/national level (e.g. co-ordinated sector-wide

borrowing leading to standardised and better external finance terms); and,

- (c) Exploring with the LSC potential opportunities at a regional or national level to better utilise current funding in the sector (e.g. inter college lending).

4. Highlight options for longer term strategic funding models to increase investment into the FE sector

We will work with you to develop a limited series of options for new public / private funding options for the FE sector. Our option development – which will have an emphasis on the attraction of private sector funding – will cover:

- (a) Structure (including geographic options e.g. college specific, regional or national)
- (b) Sources of finance

- (c) Potential funders

5. Testing Propositions

We believe that it will be vital to test any proposals with the market, internal and external, to ascertain potential interest.

6. **Report**

Provide you with a substantive report, in the form of a “funding manifesto” in substantive form by 30 June and a high level summary report conforming main recommendations and findings by 24 June that:

- (a) Sets out the lessons and ideas that could be undertaken by the LSC and FE colleges at a micro level;
- (b) Where possible, set out proposed funding options to address the investment challenges the FE sector in the long term;