AGENDA APPENDIX

Council Meeting

Wednesday 26 February 2014

AGENDA ITEM FOR SEPARATE DISTRIBUTION TO COUNCILLORS AND EXECUTIVE LEADERSHIP TEAM DUE TO DOCUMENT SIZE.

THE ITEM IS ACCESSIBLE VIA THE COUNCIL WEBSITE OR BY CONTACTING COUNCIL ON 03 5662 9200.

E.12 <u>2014/15 FINANCIAL STRATEGY</u>

Appendix 1 – 2014/15 Financial Strategy

SOUTH GIPPSLAND
SHIRE COUNCIL

2014/15 Financial Strategy

Council meeting (26 February 2014)

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EXECUTIVE SUMMARY

For the most part of the last decade, Australia experienced relatively prosperous economic circumstances compared to the rest of the world. This translated into both federal and state governments producing surplus outcomes and grants flowing through to local government. Even with the advent of the global financial crisis in 2008, councils 'financially benefited' by receiving stimulus funding.

The Australian economic landscape has in the last year significantly changed. Forward taxation revenue estimates from the mining industry have been significantly revised down. In the coming years it is anticipated that Australia will experience a positive but relatively flat profiled economic flow on from the Asian economies economic recovery, in particular China and India. The United States of America is experiencing what could be best described as a fragile economic recovery. There still remains a real risk that the less stable economies which include United States of America and some European nations may have a relapse with negative flow on impacts to the rest of the world.

Both the federal and state governments are expecting to experience a tight fiscal environment for a number of years. This is a significant contrast to what had occurred for the most part of the last decade.

The message being conveyed to the local government sector is that the state local relationship is now moving to an evidence based performance management phase. This is evidenced by the introduction of the mandatory Local Government Performance Reporting Framework that is to be introduced in 2014/15. This reporting framework will focus on service performance, financial performance and sustainability of all Victorian councils.

Council first developed a series of financial strategies prior to the development of the 2003/04 budget. Since then, its overall financial performance has systematically and progressively improved over most years despite having to at times face considerable financial challenges including dealing with:

- Significant operating losses and high debt in 2003;
- Global financial crisis in 2008; and
- Unfunded superannuation funding calls made in 2003, 2010 and 2013.

2012/13 presented as a particularly challenging year for Council. Council was encumbered by a significant unfunded superannuation funding call, received reduced Victoria Grants Commission funding and incurred other unavoidable cost events. As a result of these cost events the integrity of the Long Term Financial Plan was compromised particularly impacting on Council's working capital ratio.

A disciplined strategic management approach was implemented by Council during the 2013/14 Annual Budget process to restore the longer term financial credibility of Council's Long Term Financial Plan. Council focused its attention to produce underlying operating results and strengthen its underlying working capital position.

The financial sustainability of the budgeted financial statements in the Long Term Financial Plan is assessed by a series of key financial performance indicators. The indicators used are not dissimilar to what the Victoria Auditor General uses to assess the financial viability of all Victorian Councils.

The table below shows a series of key performance indicators to assess the financial integrity of the budgeted financial statements in the Long Term Financial Plan that was adopted by Council as part of the 2013/14 Annual Budget process.

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28
Financial performance															
Underlying result	-9.70%	4.37%	4.95%	6.93%	7.47%	8.01%	8.16%	8.94%	9.34%	22.87%	10.30%	10.67%	11.46%	12.10%	12.88%
Underlying Working Capital	1.44	1.31	1.33	1.46	1.76	1.78	2.18	1.70	1.48	2.16	1.78	1.92	2.35	2.50	2.38
Funding capacity															
Self-financing	16.99%	29.49%	26.94%	30.19%	29.08%	30.12%	30.47%	32.16%	32.86%	33.32%	34.81%	35.17%	35.91%	36.45%	37.10%
Sustainability Index	133%	159%	138%	115%	103%	107%	123%	161%	106%	175%	165%	95%	129%	149%	167%
Borrowing capacity															
Indebtedness	8.27%	6.58%	5.14%	3.74%	2.41%	1.19%	1.26%	1.33%	1.40%	1.23%	1.54%	1.60%	1.67%	1.73%	1.78%
Total Debt as a % of Rate revenue	10.35%	8.17%	6.35%	4.60%	2.96%	1.44%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Debt servicing costs as a % of Total revenue	0.37%	0.28%	0.24%	0.18%	0.13%	0.08%	0.03%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%

Note: Ratios coloured red indicate either short term / immediate sustainability concerns, yellow denotes medium risk and green low risk. The underlying working capital position is expected to gradually strengthen over the following four years and achieve its strategic target range by 2017/18.

The Victorian Auditor General's report on the results of the 2012/13 Audits considered South Gippsland as a medium risk for financial sustainability concerns. This is as a result of repaying portion of the defined benefit superannuation funding call liability in 2011/12 which affected its self-financing ratio. The payment was due to be made in 2013/14. The actual payment was made earlier to take advantage of an early payment discount offer. In the previous 2011/12 South Gippsland was rated a low risk. Longer term projections indicate that Council will again be considered a low risk.

From an internal management perspective, the greatest challenge Council faces is defining its service level requirements and funding them in a financially sustainable manner. This has been an ongoing challenge for some years, not only for South Gippsland, but the local government industry.

Council in 2013/14 established a Financial Sustainability Steering Committee that has undertaken Service Reviews for all Council departments. From this exercise it is now proceeding to implement a rolling program of detailed service reviews. Any financial ramifications from these reviews will be updated into the Long Term Financial Plan.

Council's long term planning documents such as its Community Plans, Vision Statements and associated Service Strategies drive the legislatively required Council Plan. The Council Plan covers a four year period and as such is considered a medium term planning document. It describes objectives, key strategies to achieve the objectives and includes performance measures and targets.

The Annual Business Plans and Asset Management Plans are informed by the Council Plan. The service level requirements described in Annual Business Plans also drive the development of Asset Management Plans.

These plans drive the annual and longer term Budgets for South Gippsland. The funding requirements are captured and collated in budgeted financial statements. These budgeted statements cover differing periods including the:

- Annual Budget - 1 year;
- Strategic Resource Plan - 4 years; and
- Long Term Financial Plan - 15 years.

It is important that the annual and longer term budgeted financial statements are financially sustainable. Council has a legislative obligation to implement the principles of sound financial management. Obligations include:

- Managing financial risks prudently having regard to economic circumstances;
- Providing reasonable degree of stability in the level of rates burden;
- Ensuring decisions are made and actions taken having regard to their financial effects on future generations; and
- Accurate and timely disclosure of financial information.

The Long Term Financial Plan seeks to efficiently and equitably accommodate ongoing funding requirements of existing and new or enhanced levels of service. The Financial Strategies provide strategic guidance in developing the 2014/15 Annual Budget, four year Strategic Resource Plan and the 15 year Long Term Financial Plan.

The financial strategies are reviewed on an annual basis and are listed below.

<u>Financial Strategies</u>

1 Target consistent underlying surpluses that provide sufficient funds for both recurrent service level and asset renewal and upgrade requirements.

2 Target the Balance Sheet having at least a 1.5 to 1 underlying working capital ratio in the Long Term Financial Plan.

3 Transfers to discretionary reserves will only be included in the Annual Budget if matched by an equivalent budgeted underlying surplus in the Income Statement to preserve the accumulated surplus position of Council.

4 Material favourable budget variations realised at year's end in a given financial year will be allocated to a general reserve (unless required to finance projects deemed as 'unavoidable') that can be used as a funding source for future one off, unexpected or unavoidable costs.

5 Annual transfers of equivalent to 1.0% of rate income are made to the general reserve.

6 Annual transfers equivalent to the average interest earned on investments during the financial year are made to all reserves (General Reserve excepted) and to the General Reserve in later years when it is financially viable to do.

7 Budgeted underlying cash at the end of each year shall be measured by referencing it against the underlying working capital ratio in the Long Term Financial Plan.

8 Service level funding gaps will be identified and classified as primary or secondary in nature to clearly distinguish the cash flow requirements of maintaining existing service levels (primary gaps) and for service level enhancements (secondary gaps)

9 A series of key financial performance indicators, with appropriate threshold targets, will be utilised to strategically analyse the financial integrity of the Plan. These include:

- **underlying working capital ratio – greater than 1.5**
- **underlying result – greater than 0.0**
- **financial sustainability indicator – greater than 95%**
- **self-financing greater than 20%**
- **indebtedness – less than 40%**
- **total debt as a % of rate revenue – less than 60%**
- **debt service costs as a % of total revenue – less 5%**

10 The amount of asset renewal funding required to maintain specified service levels as documented in asset management plans will be updated into the Long Term Financial Plan, subject to the available resource requirements, to ensure that the financial integrity of the plan is not compromised

11 Any new capital work (capital extension) proposals must include a lifecycle cost evaluation that identifies the asset's construction, maintenance and operating cash flow requirements as well as the depreciation impact.

12 Capital income must only be utilised as a funding source for capital or 'one off' expenditure requirements.

13 Council consider borrowing for new capital projects only when consistent underlying operating surplus results are being achieved.

14 For borrowings to be considered, projects must have had a full lifecycle cost analysis undertaken, proving that future cash inflows will exceed the cash outlays, or alternatively that the additional costs are quantified in the Long Term Financial Plan and the integrity of the financial strategies are not compromised.

15 Where reasonably possible, fees and charges are increased by the same general rates increase until full cost recovery is achieved for direct service provision. Any fees that are not increased in line with the planned rate rise be clearly identified and documented for Council's consideration.

16 Council consider the most appropriate rating strategy to provide adequate funds to:

- **achieve sustainable underlying surpluses;**
- **achieve sustainable cash flows; and**
- **fund capital renewal projects;**

in both the Annual Budget and Long Term Financial Plan to support defined service and infrastructure asset requirements.

The changes made to strategies include:

- Strategy # 5 has been refined to remove reference to increasing the annual transfer to the General Reserve from 0.5% to 1.0% of rate income - Long Term Financial Plan is now able to accommodate the annual transfers being increased to the strategic target of 1%.
- Strategy # 6 has been refined to remove reference to specific reserves

All the remaining financial strategies remain unchanged.

The balance of this paper is divided into three sections.

- The first section 'Background Information' provides some background information on the local government industry and strategic financial management practices.
- The second section 'Financial Strategies' is a detailed discussion of each financial strategy
- The third section 'Appendices' include additional information such as past strategies and further back ground information / foreshadowed adjustments to some strategies.

Overall, the underlying principles and fundamental thrust of the Financial Strategies remains unchanged from the original ones adopted in 2003. These are documented in Appendix 'A' at the back of this report. The previous year's financial strategies are documented in Appendix 'B'.

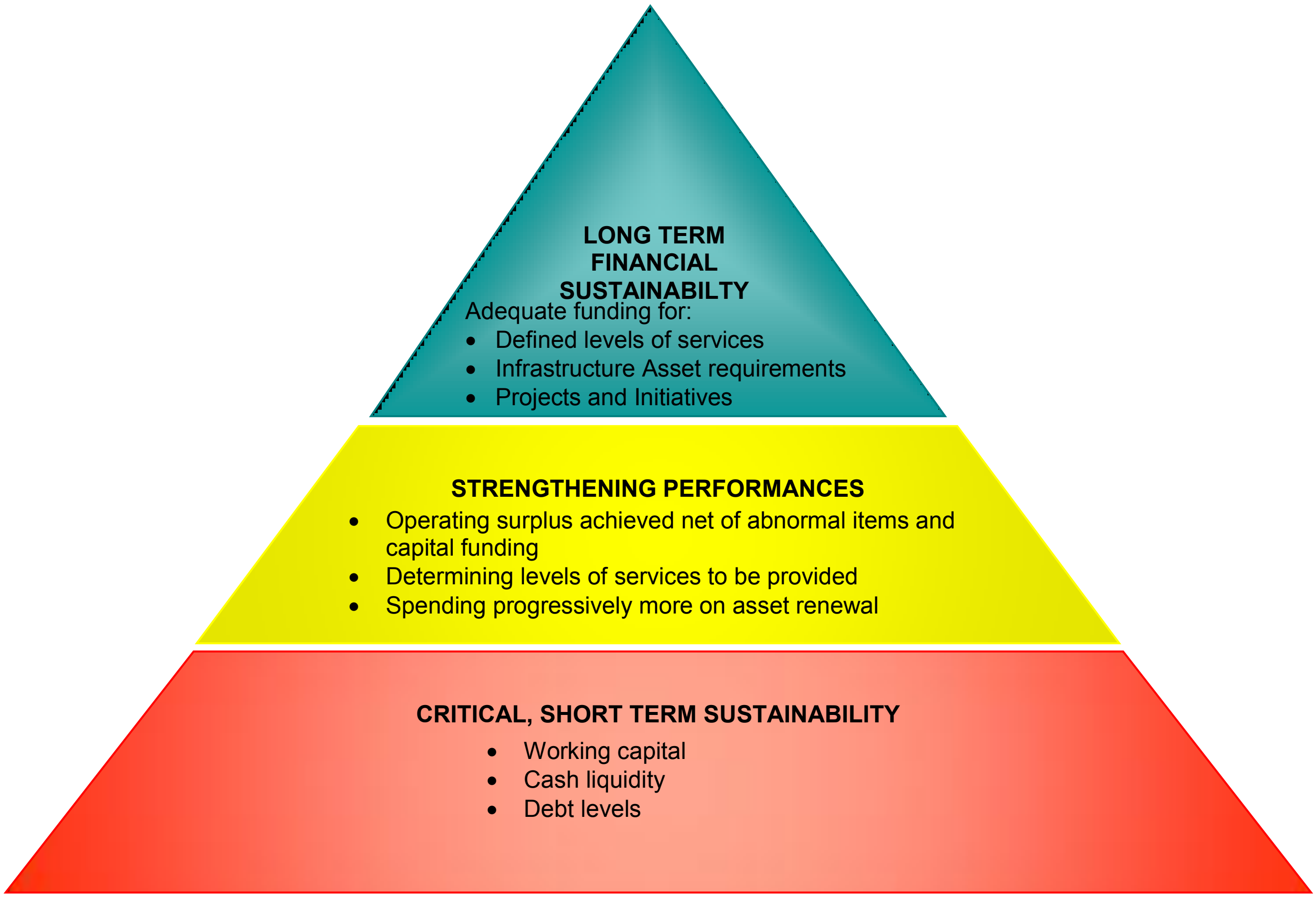
Background information

The financial challenge

Sound financial management is summarised diagrammatically below. It contains a series of tiered financial objectives. It can be likened to climbing a mountain or building a pyramid. Careful planning and discipline is required in order to get to the top. The foundation or the 1st tier objectives has to be structurally sound before attempting to progress up to the next tier of the pyramid. There are no shortcuts.

Financial strategies provide a financial framework (the business rules) to reference against when preparing both annual and longer term financial plans. Business rules influence business behaviour. The logic is simple; when service level and asset management funding requirements are being updated into annual and longer term budgeted financial statements, adhere to the financial strategies and the resulting financial plan with be structurally sound.

This way Council can achieve its affordable service level objectives, while maintaining its financial sustainability. It is a critical component of responsible financial management practice.



External strategic considerations

Council in the previous 2012/13 financial year experienced a series of cost pressures including a substantial unfunded superannuation call, reduced grants and reduced interest in investments.

As a result of all these unfavourable cost events the integrity of the Long Term Financial Plan was compromised.

This necessitated Council during the 2013/14 budget process revisiting the first tier financial objectives to address and restore the underlying working capital position. Council had to take on some debt as part of this process.

The Australian economic landscape has in the last year significantly changed. Forward taxation revenue estimates from the mining industry have been significantly revised down. In the coming years it is anticipated that Australia will experience a positive but relatively flat profiled economic flow on from the Asian economies economic recovery, in particular China and India. The United States of America is experiencing what could be best described as a fragile economic recovery. There still remains a real risk that the less stable economies which include United States of America and some European nations may have a relapse with negative flow on impacts to the rest of the world.

Both the Federal and State governments are expecting to experience a tight fiscal environment for a number of years. This is a significant contrast to what had occurred for the most part of the last decade.

It is now apparent that the Federal government is expecting to produce a series of deficit results for the following few years. This tightened fiscal environment will have flow on implications to the level of grant funding that Victorian councils can expect to receive from both State and Federal governments.

Internal strategic considerations

The Long Term Financial Plan in the early years dictated funding levels for services, service levels and associated asset management plan funding requirements. As debt and financial performances were brought under control, the resulting favourable flow on financial benefits were 'trend lined' in forward budgeted financial statements. Increasing levels of funding sources were reflected in forward budgets.

The intention was that service and asset management plans would in future articulate and dictate actual funding requirements and take over driving the Long Term Financial Plan.

Because a strategic approach to financial planning and management is now approaching its 12th year Council has credible and objective data that demonstrates that in most years it has adhered with its strategies from a pure financial management perspective. Council over the years progressed from actually achieving its first tier financial objectives and began addressing second tier financial objectives.

From an internal management perspective, the greatest challenge Council faces is defining its service level requirements and funding them in a financially sustainable manner. This has been an ongoing challenge for some years, not only for South Gippsland, but the local government industry.

The challenge of defining and performance managing services is a state wide concern across most Victorian councils. The Victorian Auditor General for some years now has expressed concern about the reliability of performance reporting on service delivery. He stated that most councils lacked information about the quality of council services, the outcomes being achieved and how these related to council's strategic objectives.

This implies that councils have been producing inadequate service plans for some years. The Minister for Local Government has mandated that a performance reporting framework will be developed and will be compulsory for councils for the 2014/15 financial year.

Council in 2013/14 established a Financial Sustainability Steering Committee that has undertaken internal Service Reviews for all Council departments. From this exercise it is now proceeding to implement a rolling program of detailed service reviews. Any financial ramifications from these reviews will be updated into the Long Term Financial Plan.

This exercise complements the critical component of 2nd tier challenge. That is, quantifying the existing service requirements and the associated long term cash flow requirements for those services and associated asset funding requirements.

Council also has to be mindful of the preparedness and affordability of it ratepayers to pay rates and charges for a given level of services.

The current position is to have service needs drive the funding requirements in the financial plan which is tempered by assessments of what are maximum levels of permissible rate rises in current and forward budgets in the Long Term Financial Plan.

The objective is for Council to consolidate its position in this 2nd tier and then embark on addressing the 3rd tier challenge to achieve long term financial sustainability. That is, having sufficient funds for a defined level of services, infrastructure asset management requirements and for projects and initiatives documented in a financially sustainable Long Term Financial Plan.

Format of strategy discussions and usage of graphs

Each financial strategy is discussed in the following pages. They are grouped and referenced to the budgeted financial statements.

Where appropriate, further information can be sourced from the appendices on particular strategies.

This enables the reader to gain further understanding of the financial principles and/or fundamentals that relate to the strategy being discussed, including foreshadowed refinements to existing strategies that could be considered in later years.

Both the 'Infrastructure Asset Management' and 'Borrowings' sections have significant financial ramifications and associated risks. For these reasons, further expanded commentary and discussion is provided in the Appendix F on both topics.

Wherever possible graphs are utilised to help illustrate or explain financial intent of specific strategies. The purpose of the graphs are to give the reader of the report a 'user friendly' feel for longer term trends of various key performance indicators.

The graphs in this document draw on information from budgeted financial statements in Council's Long Term Financial Plan. The data used in the 'current plan' is information from the month ending 31 October 2013.

Due to the number of years that Council has been producing strategic Long Term Financial Plans, the number of lines on some of the graphs may appear somewhat busy. The graphs include past years financial plan data, actual financial results as well as the current Long Term Financial Plan.

They serve to clearly demonstrate an important point. That is, to show the consistency and parity between the plans over a number of years. For reasons of practicality, only the past 5 years previous financial plans are shown on the graphs, despite strategic plans being prepared now for 11 years.

Additional graphs with less busy data are also provided to assist the reader in evaluating financial performances. These provide the actual financial performances achieved over a period of time relative to the 'current plan' that is benchmarked against the average of the past five years plans (rather than each individual year) and the average of the past 10 years plans.

1. Comprehensive Income Statement (Operating Result) & (Underlying Operating Result)

Existing Strategy

Target consistent underlying surpluses that provide sufficient funds for both recurrent service level and asset renewal and upgrade requirements.

Revised Strategy (no change)

1 Target consistent underlying surpluses that provide sufficient funds for both recurrent service level and asset renewal and upgrade requirements.

The Comprehensive Income Statement is the first of the four key financial statements.

There are three bottom lines' that can be evaluated from this one financial statement. They include the:-

- Comprehensive result;
- Operating result; and the
- Underlying operating result

Comprehensive result

The Comprehensive result as reported in the Income Statement includes not only all associated income and expenditure for a given period but also net asset revaluation increments. These increments can be a material amount when certain classes of assets are periodically subject to revaluation.

For example, the net asset revaluation increment in 2012/13 was nil. The net asset revaluation increment in the prior 2011/12 financial year was $34 million which included the Roads and Streets asset class revaluation adjustments. This provides distorted financial results from one year to the next.

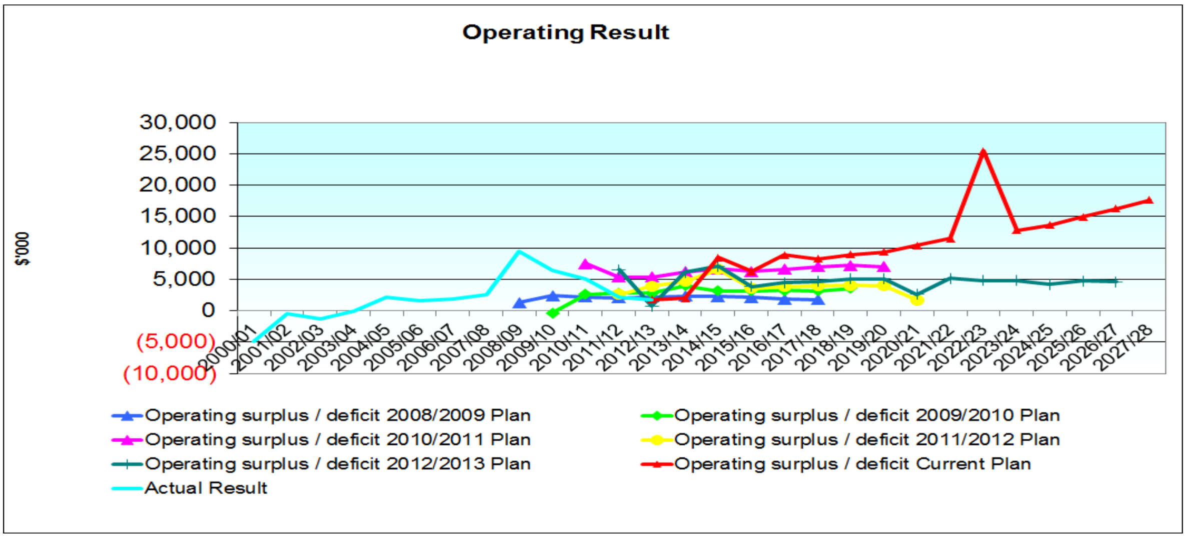
Operating result

The operating result (profit and loss) excludes net revaluation increments and is a more relevant figure to consider for strategic financial planning purposes.

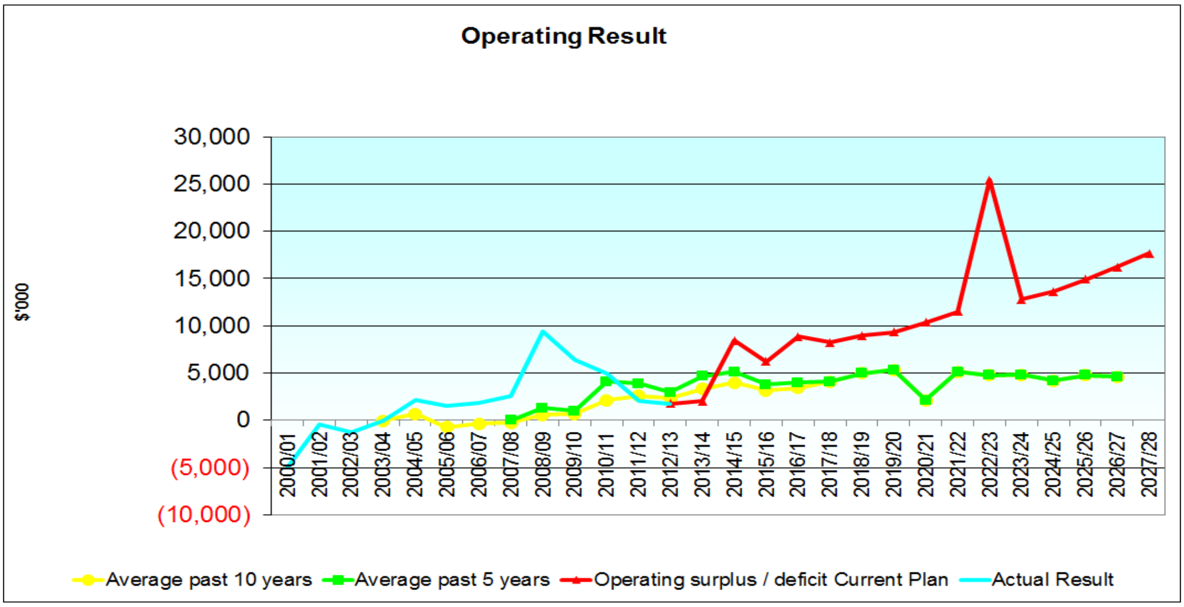
To be able to provide a given level of recurrent services, (which includes some services that are significantly dependent on infrastructure asset such as transport) it is important to achieve consistent surplus operating results on a yearly basis.

The operating result has a direct impact on the equity or net worth of Council. A surplus result contributes to the net worth of Council, whilst a deficit result reduces the net worth.

The graph below shows actual operating results achieved since 2000/01 and budgeted operating results for the current financial year and a number of previous years. The light blue line shows actual financial results from 2000/01 through to 2012/13. The red line is the current budget forecasts. The other coloured lines depict the previous 5 years financial plans.



The second graph aggregates the previous years' plans. The yellow line shows the aggregate for the past 10 years' financial plans and the green line the past 5 years financial plans. The light blue line (actual financial results) and red line (current financial plan) are exactly the same as the first graph.



South Gippsland Shire Council had for a number of years produced a series of deficit operating results, which consequently reduced its overall net worth. The graphs clearly show the strategic intent over the past years was to progressively improve its operating result and that Council has been successful in doing so with the exception of the last few years where the actual operating results have trended down.

Council in the 2013/14 Annual Budget process actively addressed this issue. The very favourable forward projections are due to a combination of the compounding impact of rate rise and supplementary rate income projections, as well as increased budget projections for developer contributions.

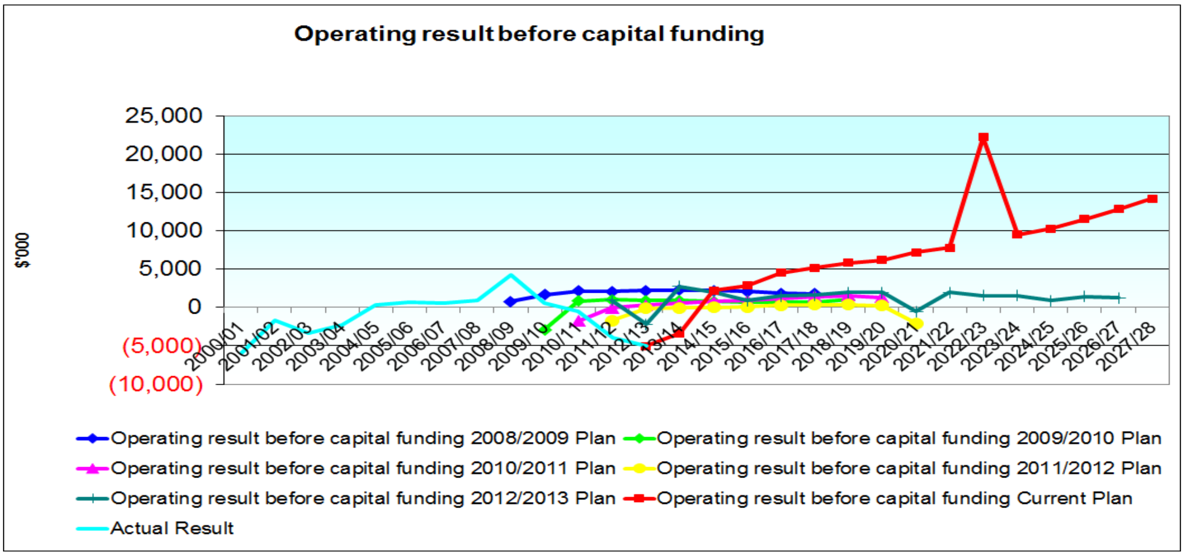
The ambitious developer contributions provide a funding source for a similarly ambitious increase in capital works program expenditure in the forward years. The spike in 2022/23 is attributable to expecting to receive $13.28m Special Charge Income for a major roads and drainage project. The developer contributions and the special rates income are classified as recurrent income sources. The increased capital expenditure program is highly dependent on the income streams.

Capital income funding sources from grants and gifted assets are recognised in the Income Statement. This has the tendency to make operating results look stronger than they actually are. The reason is that capital income is reflected in the Income Statement whereas the matching capital expenditure is not. It is costed to the Balance Sheet.

<u>Underlying operating result</u>

Underlying operating results ignore and do not include capital grant income sources. It is sometimes referred to as the 'operating result before capital funding'. It shows a direct correlation between the recurrent income and recurrent expenditure streams. The 'underlying result' is a far more relevant strategic financial performance indicator than the 'headline' or 'bottom line result'. The current financial strategy is still very relevant.

The graph below show actual operating results before capital grant funding achieved since 2000/01 and budgeted operating results before capital funding for the current financial year and a number of previous years. The light blue line shows actual financial results from 2000/01 through to 2012/13. The red line is the current budget forecasts. The other coloured lines depict previous 5 years financial plans.



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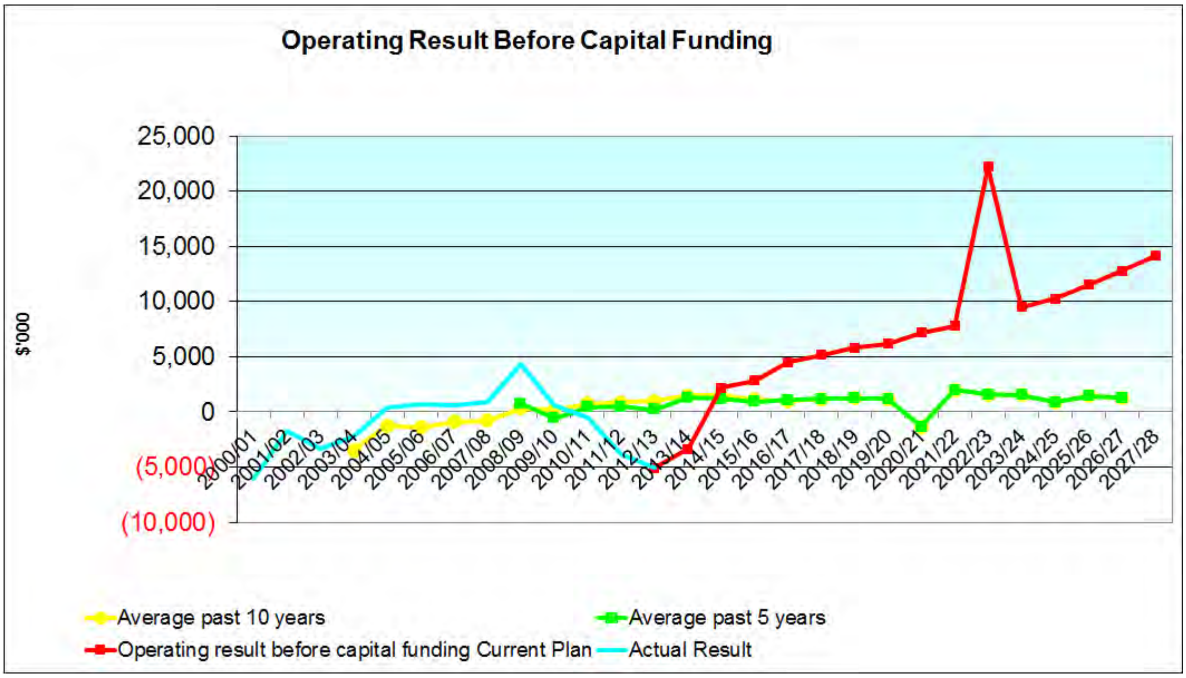


It is evident that Council over the years had been producing underlying deficit outcomes and has only recently begun to produce underlying surplus results. The spike and dip between 2008/09 and 2009/10 is due to accounting standard requirement to recognise income in advance. Again, the last few years showed a concerning downward trend in underlying operating results. Increased cost pressures did not have matching increased funding streams.

The forward graphs show that this situation is now being strategically addressed.

The rather dramatic improvement relative to previous financial plans is largely attributable to increased developer contributions projections. The spike in 2022/23 is when Council expects to receive $13.28m Special Charge Income for a major roads and drainage project. As mentioned previously, the increased capital expenditure program is highly dependent on both these income streams.

Appendix F contains further discussion on operating results including foreshadowing future refinements to associated strategies.

<u>Revised Strategy (no change)</u>

1 Target consistent underlying surpluses that provide sufficient funds for both recurrent service level and asset renewal and upgrade requirements.

2. Balance Sheet

Existing Strategy

Target the Balance Sheet having at least a 1.5 to 1 underlying working capital ratio in the Long Term Financial Plan.

Revised Strategy (no change)

2 Target the Balance Sheet having at least a 1.5 to 1 underlying working capital ratio in the Long Term Financial Plan.

The Balance Sheet is the second of the four key financial statements. The Balance Sheet discloses the net worth (equity) of an organisation at a given point in time. The operating result in the Income Statement is for a given period and has a direct impact on the net worth of an organisation.

The assets and liabilities in the Balance Sheet are broken down into ‘current’ and ‘non-current’ components. Current assets and liabilities are highly liquid and readily convertible to cash. They are not impacted upon by the periodic revaluations of infrastructure assets and gifted asset adjustments. Non-current assets and liabilities are not readily convertible to cash.

The relationship between current assets and current liabilities is used to assess Council’s capability to meet is current commitments. This ratio is known as the ‘working capital ratio’ and is one of several ratios that have to be disclosed in the annual financial statements. It is also one of the key indicators used by the Australian Loan Council when assessing loan applications from Victorian councils. The Victorian Auditor General’s Office (VAGO) also uses it to assess the financial viability of local government. It is critical that the ratio always be positive in that current assets must always exceed current liabilities.

It is strategically important to maintain a positive working capital ratio at all times. When the Long Term Financial Plan is prepared, one would not want to see the ratio fall below 1 to 1 at any point. This would mean that Council may not have enough cash funds to pay its creditors.

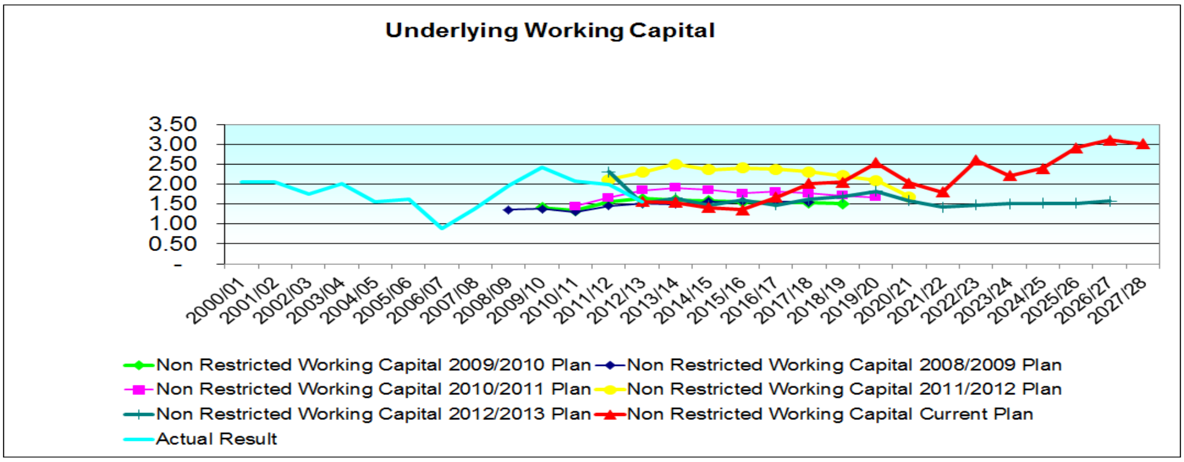
A strengthening working capital ratio indicates that Council is building up some financial capacity to deal with unexpected or unforseen unavoidable situations and other strategic opportunities that arise from time to time. The financial capacity or savings can also be quarantined to internal reserves.

Council has a number of cash backed internal reserves that are expected to grow over the coming years. The inclusion of the cash backed reserves has a positive but somewhat distorting impact on the working capital ratio. The internal reserves represent funds that have been set aside for specific requirements.

In 2008/09 Council reached a financial maturity where it considered it appropriate to shift its strategic focus to identifying and analysing its underlying working capital ratio. The financial strategy was revised accordingly. The underlying working capital ratio excludes funds that have been set aside to internal reserves. Funds set aside in internal reserves are restricted assets. This compliments the underlying operating result strategy. The ratio was set at 1.5 to 1. This provides a degree of flexibility to be able to both prudently and strategically manage unexpected events and opportunities that occur from time to time.

The underlying working capital ratio is a very stable financial performance indicator. It provides an opportunity to ensure that funds are released in a financially responsible manner for recurrent operational and primary funding gap requirements in forward financial plans.

The graph below shows actual underlying working capital ratios for the current financial year and a number of previous years. The light blue line shows actual financial results from 2000/01 through to 2012/13. The red line is the current financial plan forecasts. The other coloured lines depict previous 5 years financial plans.



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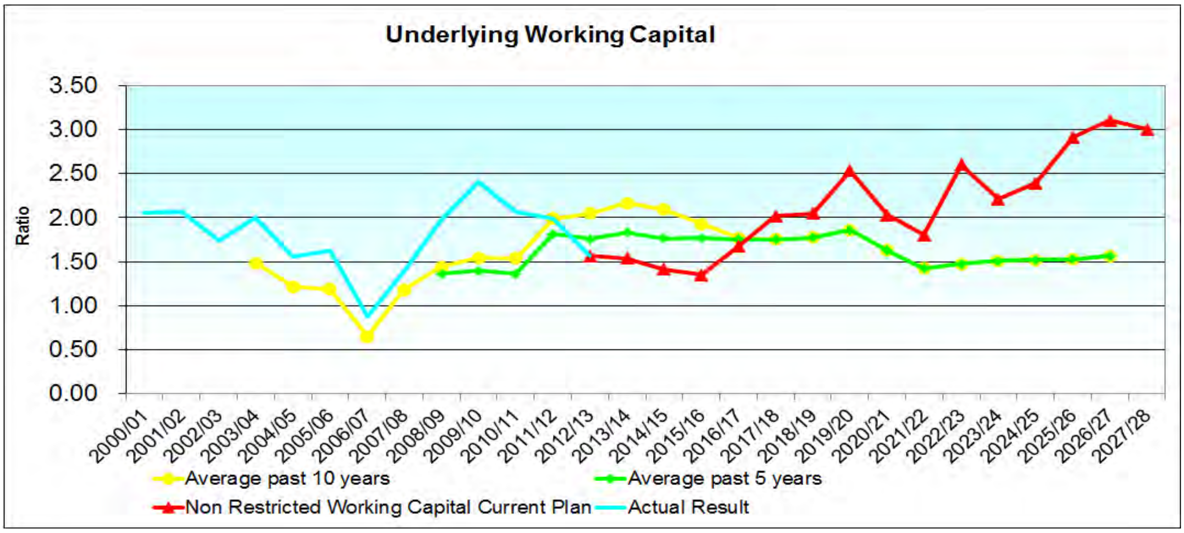


The unfavourable cost pressures identified in the immediate preceding years have had considerable implications on the underlying working capital ratio.

The strengthening underlying operating performances have a flow on impact on the underlying working capital ratio. The short term outcome is that the strategic integrity of the ratio will be restored by 2017/18 and in later years that we will have significant financial capacity. Longer term the projections look very favourable but they should be viewed with caution.

The management processes for underlying working capital ratio targets in financial plans requires:

- if the ratio in later years exceeds the target ratio, adopt a do nothing approach. The detailed recalibration of the plan's underlying working capital ratio would normally occur when the 'current financial plan' is being reviewed and formulated into a 'formal financial plan' that Council then considers and adopts annually; or
- if the ratio shows a trend tapering down away from the target, then an immediate review and consideration of corrective actions to arrest the decline would be required.

In later years it would be strategically appropriate to review the ratio target when funding gaps (both primary and secondary) have been clearly identified, Council is comfortable with its mix of recurrent services and associated levels and annual pools of funds for discretionary one /off type projects are established.

In the interim, having some financial capacity in the Balance Sheet can be strategically advantageous. It provides a degree of flexibility to be able to both prudently and strategically manage unexpected events and opportunities that occur from time to time. It reduces the likelihood of having to make reactive decisions to other spending programs in order to restore financial sustainability.

Revised Strategy (no change)

2 Target the Balance Sheet having at least a 1.5 to 1 underlying working capital ratio in the Long Term Financial Plan.

3. Statement of Changes in Equity

Existing Strategies

Transfers to discretionary reserves will only be included in the Annual Budget if matched by an equivalent budgeted underlying surplus in the Income Statement to preserve the accumulated surplus position of Council.

Material favourable budget variations realised at year's end in a given financial year will be allocated to a general reserve (unless required to finance projects deemed as 'unavoidable') that can be used as a funding source for future one off, unexpected or unavoidable costs.

Annual transfers of equivalent to 0.5% of rate income be made to the general reserve and to target increasing the annual transfer to be equivalent to 1% of rate income to the general reserve in the later years of the Long Term Financial Plan.

Annual transfers equivalent to the average interest earned on investments during the financial year be made to the following reserves; - Public Open Space, Car Parking, Corner Inlet Seawall Drainage and Henry Road Nyora Reserve and to the General Reserve in later years when it is financially viable to do.

Revised Strategies (Amendments made to strategy 5 and 6. No change to the other strategies)

3 Transfers to discretionary reserves will only be included in the Annual Budget if matched by an equivalent budgeted underlying surplus in the Income Statement to preserve the accumulated surplus position of Council.

4 Material favourable budget variations realised at year's end in a given financial year will be allocated to a general reserve (unless required to finance projects deemed as 'unavoidable') that can be used as a funding source for future one off, unexpected or unavoidable costs.

5 Annual transfers of equivalent to 1.0% of rate income are made to the general reserve.

6 Annual transfers equivalent to the average interest earned on investments during the financial year are made to all reserves (General Reserve excepted) and to the General Reserve in later years when it is financially viable to do.

The Statement of Changes in Equity is the third of the four key financial statements. It discloses the net worth of Council.

The equity in the Balance Sheet is a simple calculation, what you own (assets) less what you owe (liabilities), is what you are worth (equity).

Equity can be further broken down into:

- Accumulated Surplus;
- Asset Revaluation Reserve;
- Statutory Reserves; and
- Other Discretionary Reserves.

The Accumulated Surplus is affected by the operating result plus transfers to and from reserves as allowed for in the Annual Budget.

The Asset Revaluation Reserve reflects the revaluation increments that are costed to the infrastructure assets in the non-current section of the Balance Sheet. Periodic revaluation adjustments are required to recognise the increase in current replacement cost of those assets. These adjustments are commonly referred to as a book entry and there is no cash impact.

Statutory Reserves represent the monetary value that has been accumulated as income within the Income Statement for statutory contributions such as the Public Open Space Reserve. In some future period this reserve can be utilised to provide funding for specific projects.

Transfers to Statutory Reserves have to be made irrespective of what the operating result is, and further, have to be applied (transferred out of reserve) to fund specific capital projects at some later point in time. These funds are held in cash backed reserves.

The Other Discretionary Reserves represent the monetary value that has been accumulated within the Council to meet specified anticipated future needs and other specific projects. Council's discretionary reserves consist of:-

- General Reserve;
- Caravan Park Reserve;
- Corner Inlet Seawall Drainage Reserve; and
- Henry's Road Nyora Reserve.

Ideally, an underlying surplus result equivalent to the proposed transfer from the Income Statement is required in order to fund any 'transfers to reserves'. Otherwise, the real effect is a deterioration of the accumulated surpluses in the equity section of the Balance Sheet.

In other words, there is no point transferring monies to a reserve to fund some future expenditure unless it is funded by an underlying operating surplus in the Income Statement. The first of the financial strategies dealing with reserves specifically support the notion of ensuring transfers to internal reserves are appropriately funded and cash backed.

The second strategy dealing with internal reserves addresses transferring favourable year end variations to a General Reserve. Originally the strategy was to quarantine and transfer favourable budget variations over $100,000 to the General Reserve. The strategy in 2009 was further refined to transfer all favourable year end variations to the General Reserve.

The third strategy advocates making annual allocations to a General Reserve. This strategy has also been refined over the years. In 2010 Council agreed to transfer equivalent of 0.5% of annual rate revenue to the General Reserve on an annual basis, gradually increasing to 1% in the later years of the financial plan (from 2013/14 onwards). This ratified what had been foreshadowed in previous Financial Strategy documents. It also confirmed Council's decision that it made when it resolved to purchase the Carinos building at its special meeting on 21 July 2010.

The only financial risk with this approach of establishing and allocating funds to the General Reserve is that either an unavoidable event / and or a special project need will not eventuate in future years. If this was the case, it means that Council had accumulated funds into a reserve for no worthwhile purpose. This is highly unlikely situation.

Over the past years this strategy has proved to be of considerable value. It has provided funding for unexpected unfunded superannuation calls and strategic asset purchases. Unfortunately the General reserve funds were exhausted in 2013/14 when they were required for the unfunded superannuation call that was due and payable on 1 July 2013. It is appropriate to continue with this strategy to accommodate similar events in the future. A minor revision to this strategy is required to remove reference to increasing the annual transfer from 0.5% to 1.0% of rate income.

The fourth strategy deals with annual interest top ups equivalent to the average interest earned on investments during the financial year being made to the following reserves:-

- Corner Inlet Seawall Drainage Reserve;
- Henry's Road Nyora Reserve;
- Car Park Reserve; and
- Public Open Space Reserve.

A refinement was made in 2013 to extend income to the General Reserve when it is financially viable to do so in later years. This complements the strategic intent of the two preceding strategies. An interest transfer to the General Reserve is financially viable from 2015/16.

A further minor refinement is proposed to this strategy to make the wording more succinct by removing reference to specific reserves.

Appendix F contains further discussion on Statement of Changes in Equity including foreshadowing future refinements to associated strategies.

Revised Strategies (Amendments made to strategy 5 and 6. No change to the other strategies)

3 Transfers to discretionary reserves will only be included in the Annual Budget if matched by an equivalent budgeted underlying surplus in the Income Statement to preserve the accumulated surplus position of Council.

4 Material favourable budget variations realised at year's end in a given financial year will be allocated to a general reserve (unless required to finance projects deemed as 'unavoidable') that can be used as a funding source for future one off, unexpected or unavoidable costs.

5 Annual transfers of equivalent to 1.0% of rate income are made to the general reserve.

6 Annual transfers equivalent to the average interest earned on investments during the financial year are made to all reserves (General Reserve excepted) and to the General Reserve in later years when it is financially viable to do.

Summary of changes / refinements made Strategy # 5 has been refined to remove reference to increasing the annual transfer to the General Reserve from 0.5% to 1.0% of rate income:- Long Term Financial Plan is now able to accommodate the annual transfers being increased to the strategic target of 1%. Strategy # 6 has been refined to remove reference to specific reserves

4. Cash Flow Statement

Existing Strategy

Budgeted underlying cash at the end of each year shall be measured by referencing it against the underlying working capital ratio in the Long Term Financial Plan.

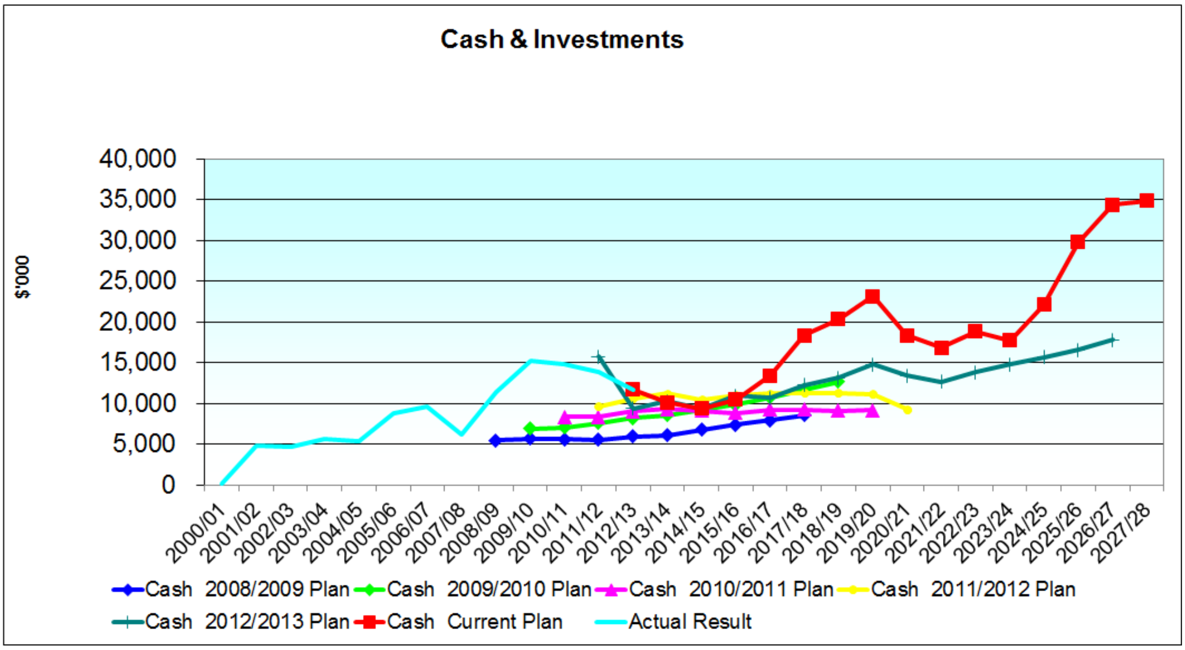
Revised Strategy (no change)

7 Budgeted underlying cash at the end of each year shall be measured by referencing it against the underlying working capital ratio in the Long Term Financial Plan.

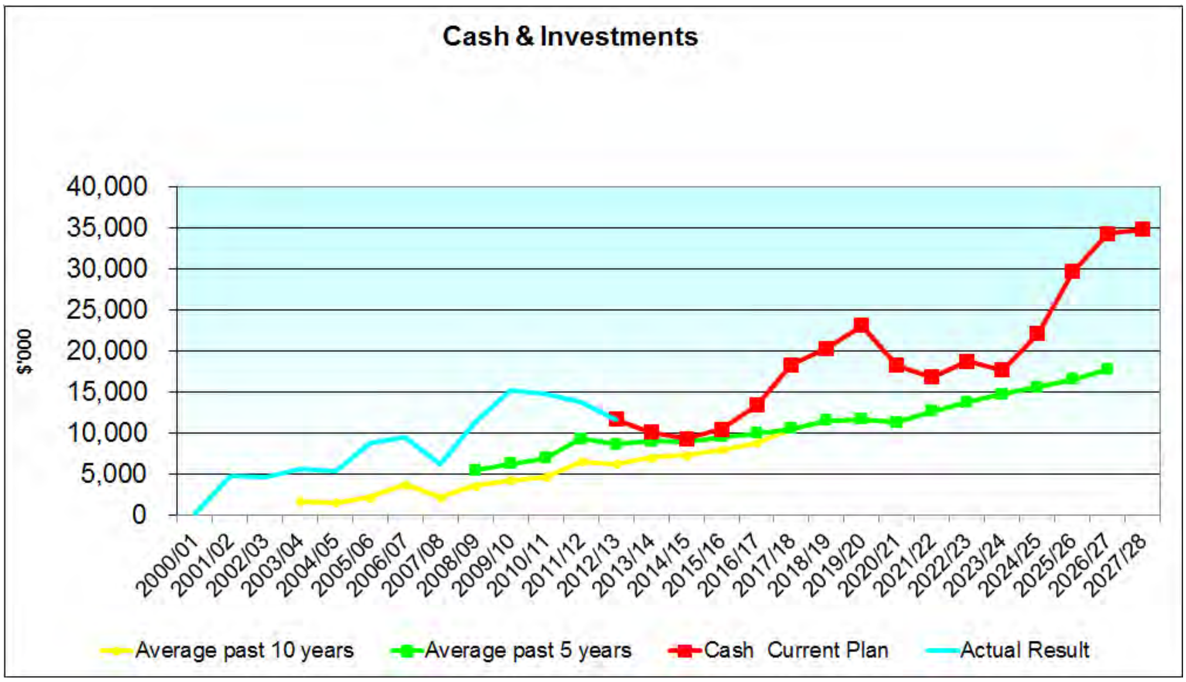
The Cash Flow statement is the final of the four key financial statements.

The Cash Flow Statement concentrates specifically on the cash or liquidity position of Council. It is important that Council does not ever become insolvent. Council must remain Cash Flow positive so it can pay for its expenses.

The graph below shows the cash position for the current financial year and a number of previous years. The light blue line shows actual financial results from 2000/01 through to 2012/13. The red line is the current financial plan forecasts. The other coloured lines depict previous 5 years financial plans.



The graph on the following page aggregates the previous year plans. The yellow line shows the aggregate for the past 10 years' financial plans and the green line the past 5 years financial plans. The light blue line (actual financial results) and red line (current financial plan) are exactly the same as the first graph.

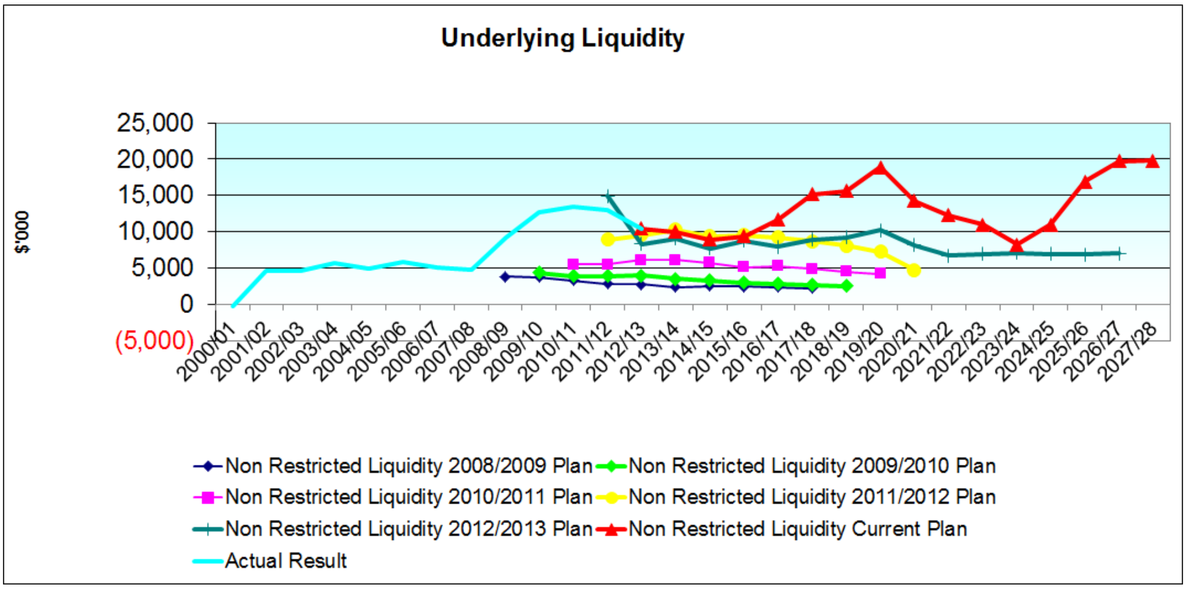


The significant strengthening of underlying operating results in the forward budgets has a favourable longer term impact on Council's cash and investment position. The mid-term projection addresses the gradual downward trend of cash that had been occurring in the immediate preceding years. The longer term projections look very favourable but they should be viewed with caution. They are some years away and are very much dependent upon Council receiving significant levels of increased income.

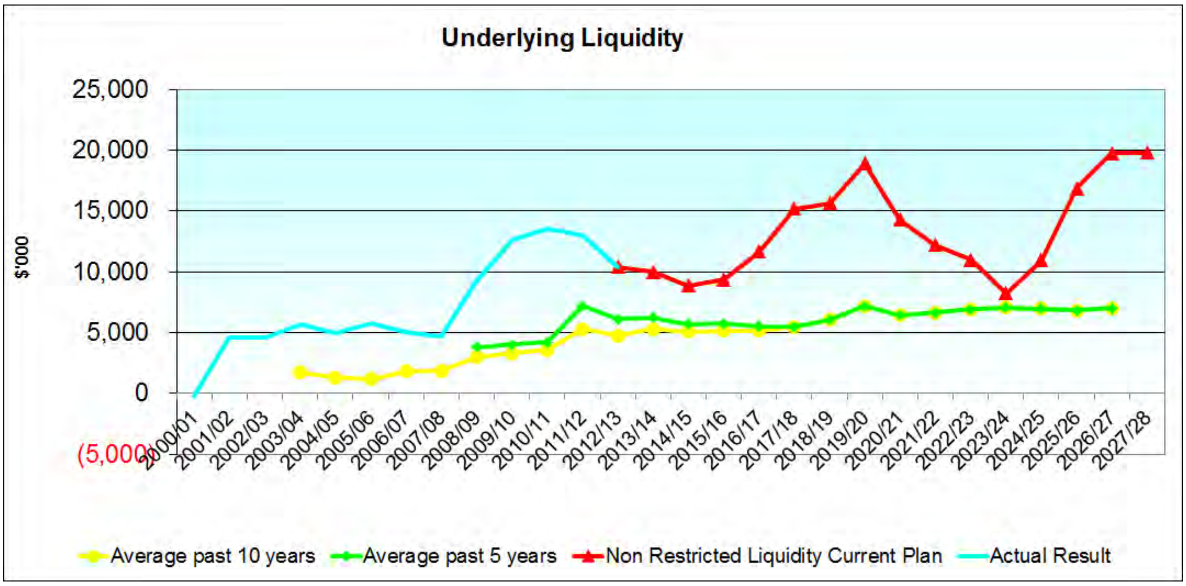
Underlying cash position

When analysing cash, it is prudent to back out the amounts that have been allocated to various internal reserves to arrive at the underlying or unencumbered cash position of Council. The funds allocated to reserves are 'restricted assets' and cannot be utilised for recurrent operational purposes. This figure then complements the underlying working capital ratio.

The graph on the following page shows actual underlying cash position for the current financial year and a number of previous years. The light blue line shows actual financial results from 2000/01 through to 2012/13. The red line is the current financial plan forecasts. The other coloured lines depict previous 5 years financial plans.



The second graph aggregates the previous year plans. The yellow line shows the aggregate for the past 10 years' financial plans and the green line the past 5 years financial plans. The light blue line (actual financial results) and red line (current financial plan) are exactly the same as the first graph.



Again, the longer term projections look very favourable but they should be viewed with caution. They are some years away and are very much dependent upon Council receiving significant levels of increased income.

The financial process to manage cash involves benchmarking the underlying cash position against the underlying working capital ratio. This is because the underlying working capital ratio is inherently far more stable than the liquidity ratio and is referred to more often in longer term planning considerations. This is reflected in the current strategy.

It is not only vital that the Council maintains a positive underlying working capital ratio, it must also pay particular attention to its underlying cash / liquidity position in current and forward budgets.

The Cash Flow Statement is broken down into three categories, these being:

- Operating activities;
- Investing activities; and
- Financing activities.

Operating activities correlate directly back to the Income Statement. It not only takes into consideration the budgeted cash inflow and outflows for a given period but is impacted by cash movements in the Balance Sheet for the same period. The net cash provided by the operating activities provide a funding source for investing activities (capital works) and financing activities (paying back borrowings).

The best practice guidelines for budgets strongly emphasise that councils focus on the availability of cash and investments when determining what funds are available for budgetary purposes as opposed to the traditional rates determination budget. The revisions made in 2003 to the Local Government Act removed reference to rate determination budgets and now mandates a legislative requirement that budgets be prepared taking into consideration the key financial statements.

Despite the inherent volatility of cash, it is important that continuous evaluations are made on the projected cash flows for current and future years. A fundamental objective is to project what the Council's liquidity will be during and at the end of a given year, but also for future years.

Revised Strategy (no change)

7 Budgeted underlying cash at the end of each year shall be measured by referencing it against the underlying working capital ratio in the Long Term Financial Plan.

Cash Flows from Operating Activities

(Service Delivery)

Existing Strategies

Service level funding gaps will be identified and classified as primary or secondary in nature to clearly distinguish the cash flow requirements of maintaining existing service levels (primary gaps) and for service level enhancements (secondary gaps)

A series of key financial performance indicators, with appropriate threshold targets, will be utilised to strategically analyse the financial integrity of the Plan. These include:

- **underlying working capital ratio – greater than 1.5**
- **underlying result – greater than 0.0**
- **financial sustainability indicator – greater than 95%**
- **self-financing greater than 20%**
- **indebtedness – less than 40%**
- **total debt as a % of rate revenue – less than 60%**
- **debt service costs as a % of total revenue – less 5%**

Revised Strategies (no change)

8 Service level funding gaps will be identified and classified as primary or secondary in nature to clearly distinguish the cash flow requirements of maintaining existing service levels (primary gaps) and for service level enhancements (secondary gaps)

9 A series of key financial performance indicators, with appropriate threshold targets, will be utilised to strategically analyse the financial integrity of the Plan. These include:

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- **debt service costs as a % of total revenue – less 5%**

Service levels

Service levels and discretionary fund requirements have a direct impact on the net cash flow provided by operating activities in annual and longer term budgets.

Council, through its Council Plan and Annual Business Plans needs to determine what services and what service levels are appropriate for its community. There are some services that are mandatory, whilst others are discretionary. Some services attract various levels of income from grants, fees or charges, or other government agencies. Any shortfall between expenditure and income sources for Council services is funded via rates.

For some years the actual identification of services and quantifying funding gaps has been the most important strategic financial challenge that Council faces and needs to address. When quality and reliable costs are identified, the Long Term Financial Plan can analyse the financial implications and model different financial bridging scenarios.

The concept of identifying funding gaps and then strategically planning to bridge them over a period of time is a very important consideration. In 2008 a new strategy was developed that emphasised the importance of identifying, quantifying and distinguishing between primary and secondary funding gaps for infrastructure assets.

In 2009 the strategy was further refined to ensure the importance of distinguishing between primary and secondary funding gaps for all services that Council provide, rather than just having an infrastructure centric perspective. That is not to suggest that the identification of such funding gaps for infrastructure assets is any less important. Due to the large portfolio of infrastructure assets, the potential cost implications will always be considerable.

Infrastructure assets solely exist and are required for some services. It is important that the infrastructure assets follow on from service level requirements and not be the other way around.

Funding gaps can exist for particular services as well as for infrastructure assets. Service level funding gaps tend to have recurrent cost implications in forward budgets. Infrastructure gaps in contrast tend to have more of a varying cost impact over a number of years.

The important strategic shift was to acknowledge and recognise that service level requirements ultimately should drive financial resource requirements of asset management plans. Funding gaps, irrespective of whether they are service or asset related, need to be identified and then strategically bridged.

Council in 2013/14 has established a Financial Sustainability Steering Committee that has reviewed Service Summaries for all Council departments. From this exercise it is now proceeding to implement a rolling program of investigating the process of shared services, changes in service levels for all departments.

<u>Financial Performance Indicators</u>

Council has a legislative requirement to implement the principles of sound financial management. It is important to minimise financial risk and generate enough income to fund recurrent operational requirements as well as asset renewal requirements and financing activities both now and in future years.

It is of no coincidence that the Victorian Auditor General Office (VAGO) has recommended in its 2008 Local Government Performance Reporting paper that councils use a series of financial performance, funding and borrowing capacity indicators to set and assess financial performance and sustainability of Victorian councils. VAGO recommended that councils use these indicators as a financial Key Strategic Activity (KSA). The KSA is set during the annual budget process, reported on in the audited Performance Statements and included in the Annual Report.

All key inquiries into local government financial sustainability including those by PricewaterhouseCoopers, Access Economics, Queensland Treasury Corporation and Municipal Association of Victoria assessed the financial sustainability of councils by applying very similar range of financial indicators.

Council had been using very similar performance indicators for a number of years prior to the VAGO report, to not only assess the annual performance but also the financial integrity of forward budgeted financial statements in the Long Term Financial Plan. Council can and does have the ability to set some additional and in some instances more sophisticated performance measures. The underlying operating, working capital and sustainability performance indicators are examples of technically more sound indicators that Council uses.

The KSA's and associated threshold targets that Council currently uses include:

Financial Performance Ratio	Target / thresholds		
	Green	Yellow	Red
• Underlying result	> 0%	(-10%)	(>-10%)
• Underlying working capital ratio	>1.50	1.0	<1.0
• Self-financing	>20%	10%	<10%
• Sustainability Indicator	>100%	90%	80%
• Indebtedness	<40%	60%	>60%
• Debt as % of rate revenue	<60%	100%	>100%
• Debt service cost relative to revenue	<5%	10%	>10%

The performance indicators are described in more detail in Appendix 'C' at the back of this report.

Guidance is drawn from both VAGO and the Australia Loan Council in setting thresholds and tolerances for the key financial performance ratios.

The Minister for Local Government has mandated that a performance reporting framework will be developed and will be compulsory for councils for the 2014/15 financial year.

Councils have been issued on several occasions draft indicators and the opportunity to provide feedback. As excepted the draft financial performance and sustainable capacity performance indicators used are not dissimilar our current key financial performance indicators and to what the Victoria Auditor General uses to assess the financial viability of all Victorian Councils.

The only material difference being that the Local Government Performance Reporting Framework 'liquidity indicator' includes internal reserves as discretionary cash whereas Council's underlying working capital ratio expressly excludes it. This has been raised as a concern by a number of Councils including South Gippsland.

There are a number of concerns having to include internal reserves in the proposed liquidity indicator including:

- It distorts (flatters) the ratio
- The ratio will inherently become volatile due to expected movements up and down in the reserves over the forward years
- It ignores the fact the that the strategic management practices and accounting entries for internal and statutory reserves are identical (statutory funded reserves are not included in the liquidity ratio)

A further submission has been made to Local Government Victoria asking them to reconsider the merits of not including internal reserves in the liquidity ratio.

It is also interesting to note that some years ago Council realigned its sustainability index calculations to align with the VAGO index. The proposed Local Government Performance Reporting Framework sustainability index aligns with index that Council had some years ago prior to it being realigned to the VAGO index.

It is anticipated that VAGO will be reviewing their current suite of financial sustainability indicators in the coming year. It is proposed that when both Local Government Victoria and VAGO indicators stabilise that Council then review its current suite of financial performance indicators.

The ratios, targets and thresholds established in the setting of the 2013/14 Annual Budget and the Long Term Financial Plan are shown below.

2013/14 Original Budget	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28
Financial performance															
Underlying result	-9.70%	4.37%	4.95%	6.93%	7.47%	8.01%	8.16%	8.94%	9.34%	22.87%	10.30%	10.67%	11.46%	12.10%	12.9%
Underlying Working Capital	1.44	1.31	1.33	1.46	1.76	1.78	2.18	1.70	1.48	2.16	1.78	1.92	2.35	2.50	2.38
Funding capacity															
Self-financing	16.99%	29.49%	26.94%	30.19%	29.08%	30.12%	30.47%	32.16%	32.86%	33.32%	34.81%	35.17%	35.91%	36.45%	37.10%
Sustainability Index	133%	159%	138%	115%	103%	107%	123%	161%	106%	175%	165%	95%	129%	149%	167%
Borrowing capacity															
Indebtedness	8.27%	6.58%	5.14%	3.74%	2.41%	1.19%	1.26%	1.33%	1.40%	1.23%	1.54%	1.60%	1.67%	1.73%	1.78%
Total Debt as a % of Rate revenue	10.35%	8.17%	6.35%	4.60%	2.96%	1.44%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Debt servicing costs as a % of Total revenue	0.37%	0.28%	0.24%	0.18%	0.13%	0.08%	0.03%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%

The table below shows the budgeted financial statements in the financial plan as at October 2013. The impact of the strengthening underlying operating result on the underlying working capital ratio in current and forward budget projections is evident.

Current Budget	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28
Financial performance															
Underlying result	-6.33%	3.99%	5.04%	7.39%	8.12%	8.68%	8.81%	9.62%	10.00%	23.26%	11.00%	11.35%	12.13%	12.84%	13.55%
Underlying Working Capital	1.53	1.41	1.35	1.67	2.02	2.05	2.54	2.03	1.80	2.60	2.21	2.39	2.91	3.11	3.00
Funding capacity															
Self-financing	17.63%	29.59%	27.28%	29.47%	29.45%	30.48%	30.80%	32.51%	33.17%	33.59%	35.10%	35.44%	36.18%	36.72%	37.36%
Sustainability Index	141%	151%	134%	106%	103%	107%	122%	160%	106%	176%	164%	94%	129%	150%	166%
Borrowing capacity															
Indebtedness	9.81%	8.01%	4.99%	3.62%	2.33%	1.13%	1.21%	1.27%	1.35%	1.18%	1.48%	1.55%	1.61%	1.67%	1.73%
Total Debt as a % of Rate revenue	10.35%	8.17%	6.35%	4.60%	2.96%	1.44%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Debt servicing costs as a % of Total revenue	0.34%	0.28%	0.24%	0.17%	0.13%	0.07%	0.03%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%

The key financial performance indicators serve as very important lead indicators. They can show future years' financial ramifications of decisions that are made during the year or from uncontrollable cost events that may occur throughout a financial year.

Appendix F contains further discussion on Operating Activities and Financial Performance Indicators.

Revised Strategies (no change)

8 Service level funding gaps will be identified and classified as primary or secondary in nature to clearly distinguish the cash flow requirements of maintaining existing service levels (primary gaps) and for service level enhancements (secondary gaps)

9 A series of key financial performance indicators, with appropriate threshold targets, will be utilised to strategically analyse the financial integrity of the Plan. These include:

- **underlying working capital ratio – greater than 1.5**
- **underlying result – greater than 0.0**
- **financial sustainability indicator – greater than 95%**
- **self-financing greater than 20%**
- **indebtedness – less than 40%**
- **total debt as a % of rate revenue – less than 60%**
- **debt service costs as a % of total revenue – less 5%**

Cash Flows From Investing Activities (Infrastructure Strategy Capital Works)

Existing Strategies

The amount of asset renewal funding required to maintain specified service levels as documented in asset management plans will be updated into the Long Term Financial Plan, subject to the available resource requirements, to ensure that the financial integrity of the plan is not compromised.

Any new capital work (capital extension) proposals must include a lifecycle cost evaluation that identifies the asset's construction, maintenance and operating cash flow requirements as well as the depreciation impact.

Capital income must only be utilised as a funding source for capital or 'one off' expenditure requirements.

Revised Strategies (No change)

10 The amount of asset renewal funding required to maintain specified service levels as documented in asset management plans will be updated into the Long Term Financial Plan, subject to the available resource requirements, to ensure that the financial integrity of the plan is not compromised.

11 Any new capital work (capital extension) proposals must include a lifecycle cost evaluation that identifies the asset's construction, maintenance and operating cash flow requirements as well as the depreciation impact.

12 Capital income must only be utilised as a funding source for capital or 'one off' expenditure requirements.

Background

Council's portfolio of property, plant and infrastructure assets current replacement cost in the Balance Sheet is in excess of $500 million. The vast majority of assets do not generate a revenue stream for Council. The assets are required in order to provide a variety of services to its community. Council is obligated to maintain and periodically replace the assets in order for them to continue to provide defined levels of service to its community.

The annual operating revenue generated by Council each year is just over $50 million. This revenue stream is disproportionally small relative to the value of assets in the Balance Sheet. The mix of services provided by local government, the associated infrastructure asset requirements and in relative terms low income streams, presents a financial management challenge that is unique to the local government industry.

The sustainability indicator

In previous years there was an absence of asset management plans for each major class of infrastructure assets. The plans did not reliably identify and quantify primary funding gaps in current and future years (from a lifecycle perspective) back to individual assets or class of assets. As a consequence, a financial strategy was developed in 2003/04 that focused on providing and prioritising increasing levels of funding for capital renewal works.

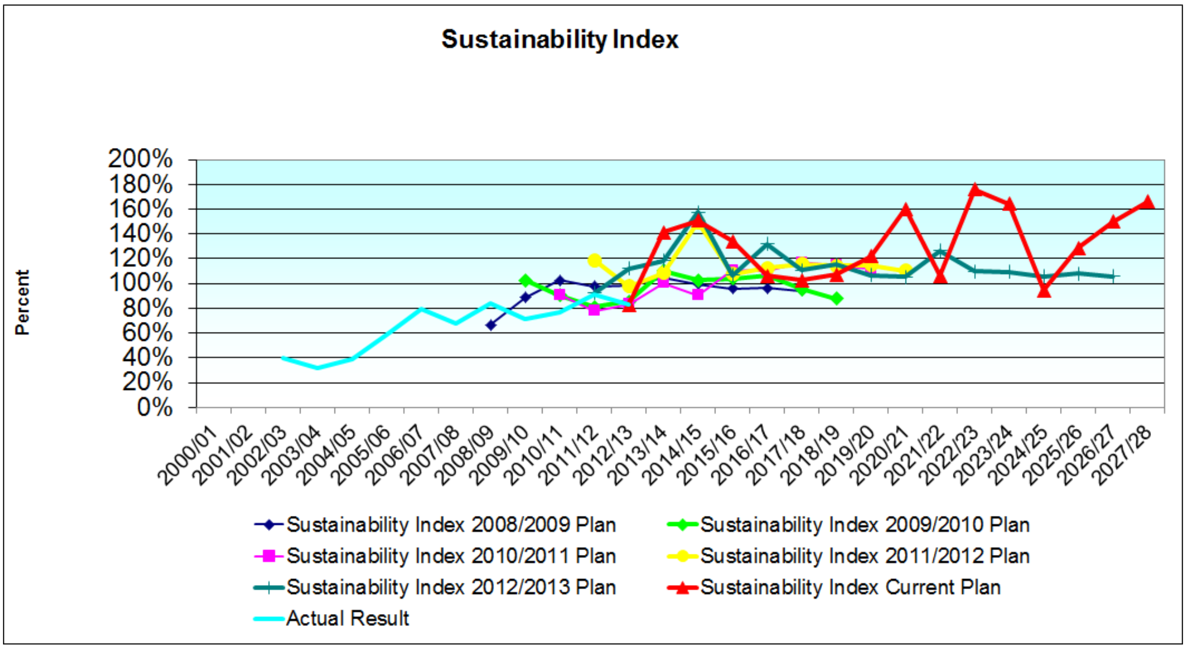
The strategy's 'spend effort' was expressed in a calculation called 'sustainability indicator'. This sustainability indicator assessed the amount spent in renewing the asset on an annual basis and compared it to the proportion of the total asset value consumed (equivalent to the annual depreciation charge which is currently calculated on straight line basis). If the amount spent on renewing assets was increased progressively each year, the effect would be that the sustainability indicator index would increase. That would be considered a positive outcome.

From 2003/04 to 2010/11 Council's sustainability indicator focussed on assessing 'renewal' expenditure effort on assets. Council in prior years spent disproportionately small amounts on renewing existing assets. The financial strategy impact on forward capital programs' capital renewal spend effort was substantial. The sustainability indicator improved from a very low 32% in 2003/04 and has gradually increased to be close to 100% in subsequent years.

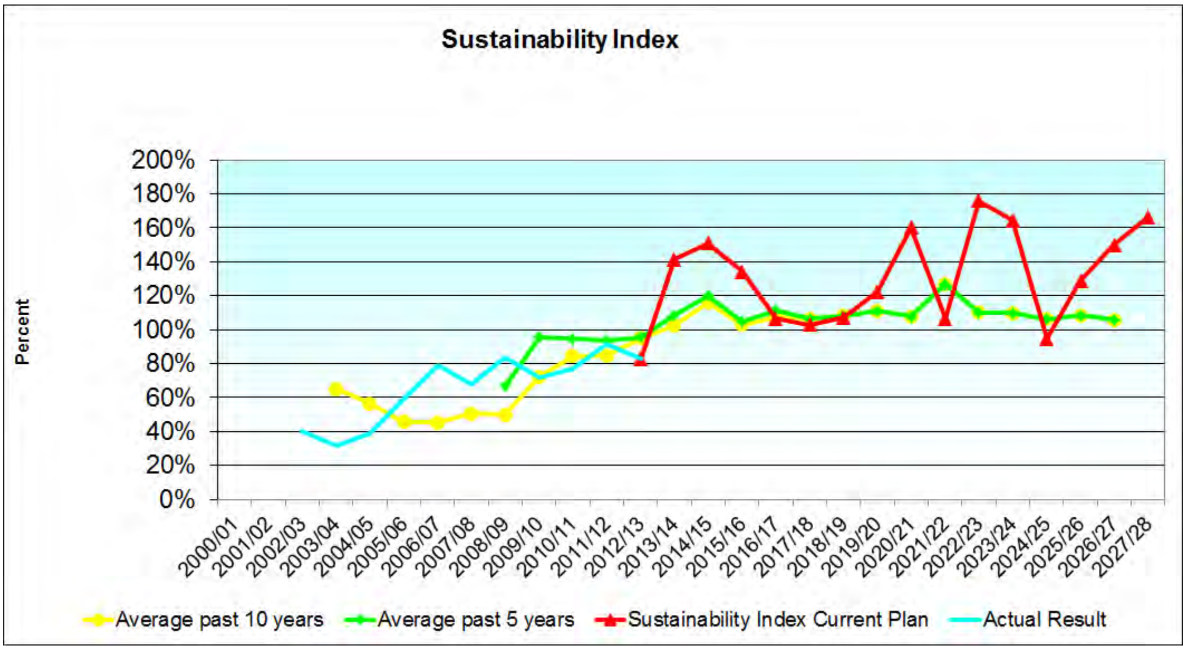
The Victorian Auditor General Office (VAGO) had for a number or years compared the rate of expenditure on infrastructure 'renewal' 'upgrade' and 'extension' works with annual depreciation charges. For 2008/09 financial audits VAGO introduced a more targeted indicator that measures the 'renewal' and 'upgrade' expenditure with the annual depreciation charge. It focused on capital expenditure on existing assets and ignored expenditure on new assets. It did not purport to identify the renewal gap. Its purpose is to assess spend effort on existing assets over a long term period.

Council's existing strategy was revised in 2010 to also include 'upgrade expenditure' in the sustainability ratio to have alignment with the VAGO indicator. Ironically the proposed Local Government Performance Reporting Framework 'Asset Renewal' indicator only includes asset renewal expenditure in the measures computation. The intention is not to revert back to original indicator, but rather wait and see whether VAGO and the Department of Transport, Planning and Local Infrastructure review and align their indicators so that there are no differences.

The graph on the following page shows actual sustainability indicator for the current financial year and a number of previous years. The light blue line shows actual financial results from 2000/01 through to 2012/13. The red line is the current financial plan forecasts. The other coloured lines depict previous 5 years financial plans.

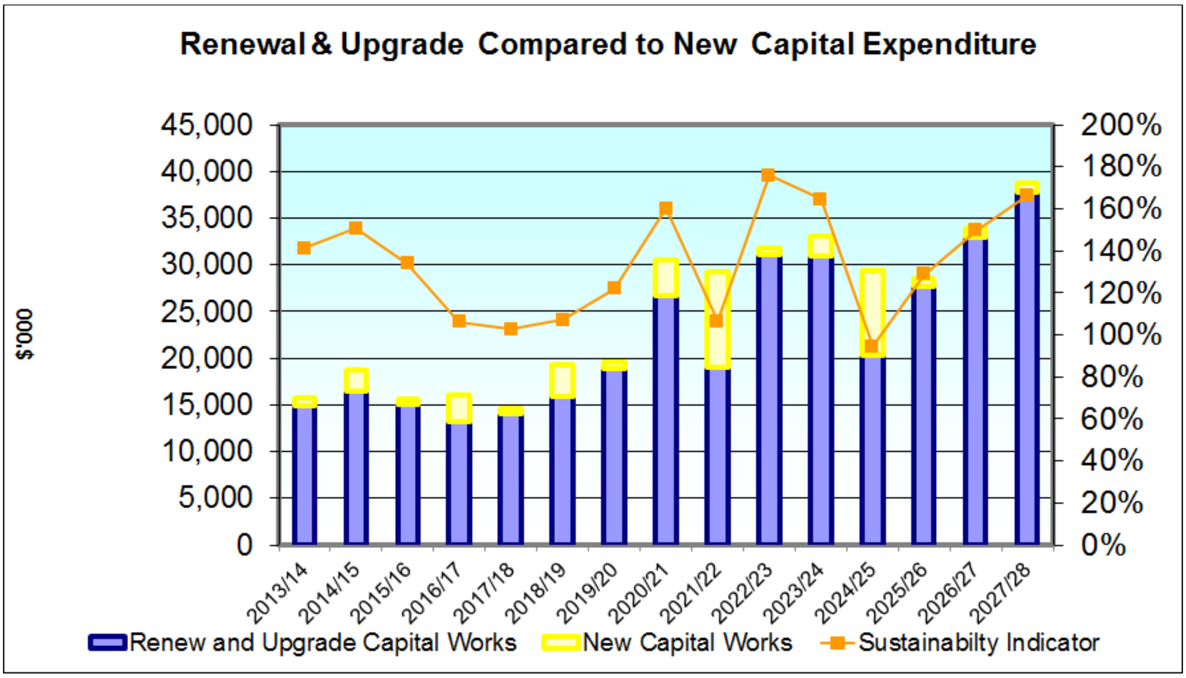


The second graph aggregates the previous year plans. The yellow line shows the aggregate for the past 10 years' financial plans and the green line the past 5 years financial plans. The light blue line (actual financial results) and red line (current financial plan) are exactly the same as the first graph.



The sustainability index graphs above clearly demonstrate the strategic and actual effort that has taken place over the past years in prioritising funds to capital renewal projects. The capital expenditure budgets in the later years are highly dependent upon developer contribution income streams.

The graph on the following page clearly shows significantly increasing funds being released to capital works in the coming years and how it has been prioritised to renewal projects. Importantly, this is all self-funded and is sustainable over the longer term. The objective now is to begin quantifying exactly how much is required, and when, for asset management purposes.



The sustainability indicator is a financial trend indicator and does not purport to quantify actual funding gaps. It makes for a very poor proxy if used as a measure to identify funding gaps.

In the absence of more sophisticated capital expenditure modelling that identifies and distinguishes between primary and secondary funding gaps, the sustainability index was relevant in that it showed positive or negative trends in regard to expenditure effort that was being applied to renewing Council's infrastructure assets.

The original financial strategy stated that a sustainability index value trending towards or in fact exceeding 95% was a desirable strategic objective. Reaching 100% did not in any way at all imply that infrastructure gaps have been bridged, however it is useful in assessing spend effort.

Since 2013/14 Council has prepared Asset Management Plans for all its asset classes. The strategy was revised to emphasise the importance of asset management funding needs driving the funding requirements in the Long Term Financial Plan. The increased funding requirements still need to be responsibly funded.

Capital income and strategic asset management

It is also worth strategically considering and managing any capital income that may arise from asset sales. Capital income streams are 'one off' in nature and therefore should only be utilised as a funding source for capital type or 'one off' expenditure requirements irrespective as to whether this cost is expensed in the Income Statement or capitalised to the Balance Sheet.

Capital income should never be used as a funding source for recurrent expenditure requirements. This principle is easy to apply when developing strategic Long Term Financial.

It is also easy to apply during the financial year. Any unexpected capital income realised throughout a given financial year would provide a one off financial capacity. The funding may be strategically considered:

- As a funding source for some immediate capital works / major project initiative that arises throughout the course of the year; or
- As a funding source for the following or future years capital works considerations (by transferring the sale income to a specific asset sale reserve during the current year and releasing it in following year/s).

Appendix F contains further discussion on Investing Activities including foreshadowing future refinements to associated strategies.

Revised Strategies (No change)

10 The amount of asset renewal funding required to maintain specified service levels as documented in asset management plans will be updated into the Long Term Financial Plan, subject to the available resource requirements, to ensure that the financial integrity of the plan is not compromised

11 Any new capital work (capital extension) proposals must include a lifecycle cost evaluation that identifies the asset's construction, maintenance and operating cash flow requirements as well as the depreciation impact.

12 Capital income must only be utilised as a funding source for capital or 'one off' expenditure requirements.

Cash Flows From Financing Activities (Borrowing Strategy)

Existing Strategies

Council consider borrowing for new capital projects only when consistent underlying operating surplus results are being achieved.

For borrowings to be considered, projects must have had a full lifecycle cost analysis undertaken, proving that future cash inflows will exceed the cash outlays, or alternatively that the additional costs are quantified in the Long Term Financial Plan and the integrity of the financial strategies are not compromised.

Revised Strategies (no change)

13 Council consider borrowing for new capital projects only when consistent underlying operating surplus results are being achieved.

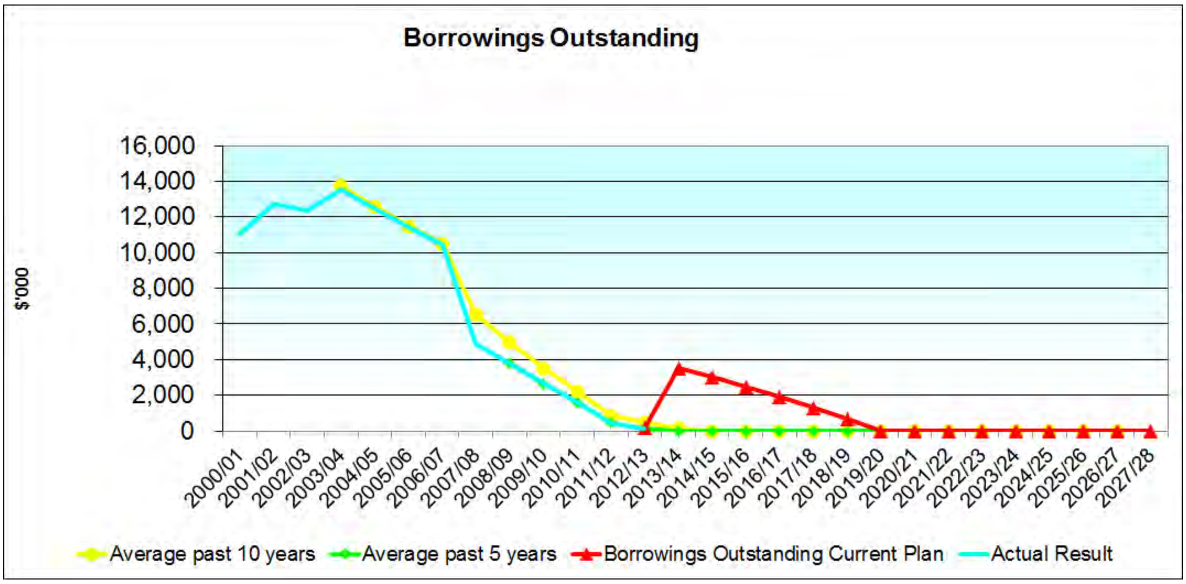
14 For borrowings to be considered, projects must have had a full lifecycle cost analysis undertaken, proving that future cash inflows will exceed the cash outlays, or alternatively that the additional costs are quantified in the Long Term Financial Plan and the integrity of the financial strategies are not compromised.

Cash flows from 'financing activities' in the Cash Flow Statement summarise cash flows specifically related to borrowing funds and the repayment thereof.

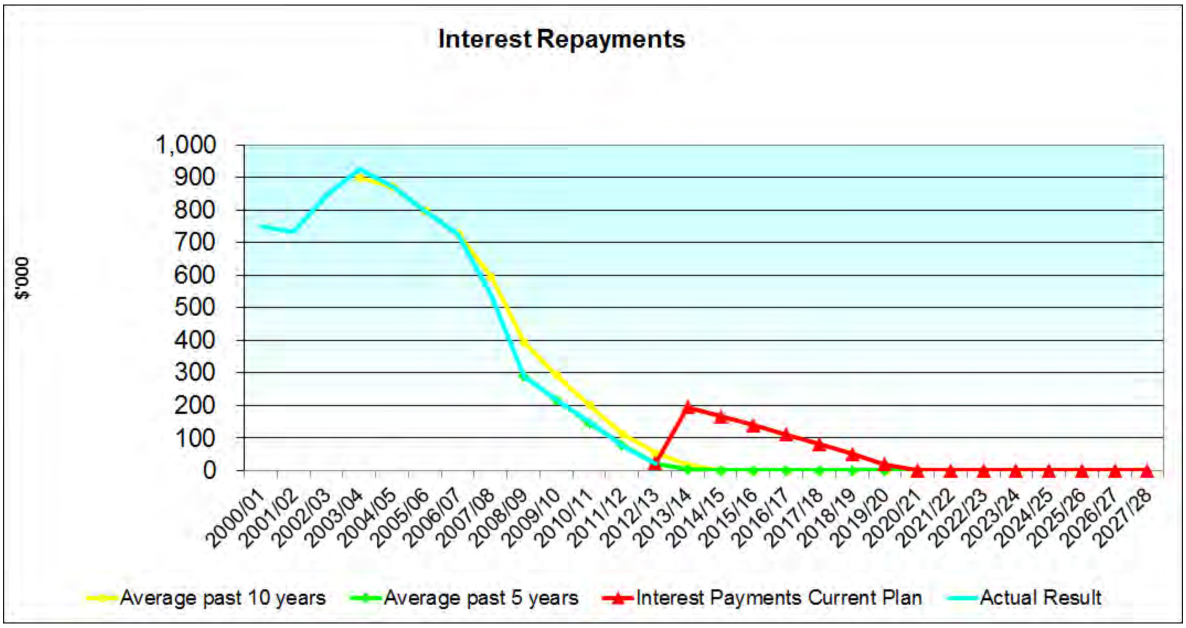
Since council amalgamations in 1994 through to 2003/04 Council had borrowed for a variety of reasons, including financing relatively large infrastructure projects as well as paying superannuation liabilities. In 2003/04 Council's outstanding borrowings peaked at $13.5 million. At the same time, it had been incurring significant operating losses and had been doing so for a number of preceding years. In 2004/05 Council began a phase of debt reduction. At 30 June 2013, South Gippsland Shire Council had outstanding borrowings of $135,000.

Council in 2013/14 had to borrow $4.0 million to fund its $4.6 million unfunded superannuation obligations that was payable 1 July 2013.

The graph below on the following page shows borrowings outstanding for a number of previous years. The light blue line shows actual financial results from 2000/01 through to 2012/13. The red line is the current financial plan forecasts. The yellow line shows the aggregate for the past 10 years financial plans and the green line the past 5 years financial plans.



The graph below shows interest payments for a number of previous years. The light blue line shows actual financial results from 2000/01 through to 2012/13. The red line is the current financial plan forecasts. The yellow line shows the aggregate for the past 10 years' financial plans and the green line the past 5 years financial plans.



Although borrowings give an instant injection of cash to fund major projects, the other side of the equation is that the borrowings have to be paid back over a period of time as well as the associated interest or financing costs. These financial obligations are reflected in a number of the budgeted financial statements that span a number of years.

The first being the Income Statement where the finance or interest costs is recorded. The interest gradually tapers down over the life of the loan.

The Cash Flow Statement would show a very consistent cash outflow impact of having to pay back both the principal amount borrowed and also the finance cost over the life of the loan.

In the Balance Sheet, the majority of the loan outstanding would be classified as a non-current liability in the early years so the impact on the underlying working capital ratio will be minimal. Over the life of the loan as more principal amounts are committed to be paid back, they would be reclassified as current liabilities. This presents as a gradual increasing pressure on the working capital ratio.

Unless the Long Term Financial Plan is also amended to reflect either recurrent savings or increased income streams over the same period as a financial offset for new borrowing considerations, the financial strain will be adversely reflected in all the key financial performance indicators.

It is very important that all the financial ramifications of borrowings which impact on the Long Term Financial Plan and the associated key financial performance indicators are well understood.

Council's existing strategies in relation to borrowings remain relevant. The first strategy ensures that Council does not repeat the mistakes that were made in previous years. The second strategy ensures that a proper business evaluation process is undertaken when considering borrowing for major works.

These borrowing strategies are further complimented by other financial strategies. Council's current strategy of quarantining material year end favourable outcomes to an internal futures reserve is a complementary cost containment strategy to the existing loan strategy. As is the other strategy, that allocates annual top up allocations to the General Reserve.

By following these strategies Council has demonstrated that it take a very disciplined approach to financing projects from borrowings by minimising, as much as possible, the future finance costs associated with borrowed funds. The easy but financially expensive alternative is having a borrowing strategy that is driven by prudential threshold levels.

Appendix F contains further discussion on Financing Activities.

Revised Strategies (no change)

13 Council consider borrowing for new capital projects only when consistent underlying operating surplus results are being achieved.

14 For borrowings to be considered, projects must have had a full lifecycle cost analysis undertaken, proving that future cash inflows will exceed the cash outlays, or alternatively that the additional costs are quantified in the Long Term Financial Plan and the integrity of the financial strategies are not compromised.

5. Fees and Charges

Existing strategy

Where reasonably possible, fees and charges are increased by the same general rates and charges increase until full cost recovery is achieved for direct service provision. Any fees that are not increased in line with the planned rate rise be clearly identified and documented for Council consideration.

Revised Strategy (no change)

15 Where reasonably possible, fees and charges are increased by the same general rates increase until full cost recovery is achieved for direct service provision. Any fees that are not increased in line with the planned rate rise be clearly identified and documented for Council's consideration.

When a service is being provided and the income recovered from the fees and charges is less than the expenses incurred in providing the service, the short fall invariably has to be paid by someone. Any net cost between fees paid and direct costs incurred in providing a particular service is inevitably financed through rate income.

A widely accepted public sector pricing principle is that fees and charges should be set at a level that recovers the full cost of providing the services unless there is an overriding policy or imperative in favour of subsidisation.

Due to the nature of some services, it may be considered not appropriate to pursue a full user pays system. This could be for reasons where there is some particular health and / or social benefit being provided.

Other fees may be impractical to attempt to have full cost recovery on, for example some leisure activities that may have a perceived community benefit or are fixed by external parties and cannot be altered by councils. Other considerations could be reviewing parity of fees being charged for similar services in neighbouring councils.

At the very least, wherever reasonably possible to do so, fees and charges need to be reviewed taking into consideration CPI movements as well as program costs associated with providing particular services. Further to this, cost recovery wherever possible should be considered as part of the fees and charges review process.

It is considered from a ratepayer's perspective that fees and charges are revenue supplements that specifically benefit the individuals receiving these services. The payment of fees and charges therefore ought to reduce the rate burden to the broader community. If fees and charges do not keep pace with increases in the cost of service provision, or if the fees are set only partially to recover costs, then the cost burden can fall back on all ratepayers.

From a service user's viewpoint, the fee or charge acts as a price signal about the cost and value of resources used to provide the service they receive.

Council in 2013/14 originally wanted to establish a committee to review Fees and charges for all services. This review has now been incorporated into being part of the individual departments' service review process being conducted by Council.

The current strategy acknowledges the reality that for most service providers that it would have been a challenge to go much beyond identifying direct costs associated with service provision, let alone objectively identifying indirect costs and overheads.

The strategy also relies on the assumption that most fees and charges are significantly less than the direct costs incurred in providing this service. As a result most fees by default (statutory fees excepted) increase by the annual rise. Fees and charges generally speaking therefore increase greater than the costs associated with the service delivery. Funding gaps as a result are gradually being bridged.

In coming years as Departments analyse and clearly document services standards it would be appropriate to develop a more sophisticated approach to setting and reviewing fees and charges. Systems would have to be developed to capture direct costs as well as indirect costs associated with service delivery. The Victorian Auditor General's report on Fees and Charges in 2010 considered that the MAV Overheads Model – Manual an appropriate tool to assist councils to allocate indirect costs to services.

The fees and charges increases would be dependent on the type of service being provided. The strategy for fees and charges would also have to be refined accordingly.

Revised Strategy (no change)

15 Where reasonably possible, fees and charges are increased by the same general rates increase until full cost recovery is achieved for direct service provision. Any fees that are not increased in line with the planned rate rise be clearly identified and documented for Council's consideration.

6. Rating strategy

Existing Strategy

Council consider the most appropriate rating strategy to provide adequate funds to:

- **achieve sustainable underlying surpluses;**
- **achieve sustainable cash flows; and**
- **fund capital renewal projects;**

in both the Annual Budget and Long Term Financial Plan to support defined service and infrastructure asset requirements.

Revised Strategy (no change)

16 Council consider the most appropriate rating strategy to provide adequate funds to:

- **achieve sustainable underlying surpluses;**
- **achieve sustainable cash flows; and**
- **fund capital renewal projects;**

in both the Annual Budget and Long Term Financial Plan to support defined service and infrastructure asset requirements.

The overall rating strategy needs to consider the following parameters:

- To maintain equity within South Gippsland Shire Council's rating system;
- Progressively increase funding for asset renewal to approximately equate the wear, tear and obsolescence on existing assets (bridge the primary funding gap);
- Balance revenue streams associated with its program budget that specifically allocates resources for the achievement of outcomes identified in Annual Department Business Plans;
- Provide an adequate level of funding in future years to enable a sustainable level of services and service levels to be delivered to the community (Secondary funding gaps identified and bridged); and
- The Financial Strategies, Plan and associated key financial performance indicators are not compromised.

The Local Government Act stipulates that councils must ensure that decisions are made and actions taken having regard to their financial effects on future generations. This means that spending and rating policies must be consistent, with a reasonable degree of stability in the level of rate burden. These principals of sound financial management are required to be reflected in the Strategic Resource Plan.

It is evident that over the past 11 years successive Council's exercised considerable constraint in its financial management processes. In the absence of having sophisticated business plans for services and asset management:

- Council moved from a high borrowing large rural Council to having the lowest outstanding borrowings;
- The annual rate rises have been consistently below the average rate rises for large rural councils (for 9 of the 11 years); and
- The financial performances have generally improved at a greater rate relative to other large rural councils.

Council needs to be aware that the current Long Term Financial Plan, which was first introduced as part of the 2003/04 budget, sets out a series of proposed rate rises. It is of great importance that during the budget process that Council consider the existing 'proposed' rate rise not only for 2014/15 but for the following 14 years.

In past years the Long Term Financial Plan generally set the funding parameters for the business planning process. It reflected a very prudent financial approach being taken by Council to minimise financial risk.

In coming years as the business planning process matures it is expected that the funding needs of the community which are reflected in Department Business Plans will take over driving the Financial Plan. This would include the expectation that service needs would have a more influencing role in determining the forthcoming and future financial year's rate rises.

Some caution is required when service level requirements become the driver of financial plans. Council's ability to provide required services in a financial sustainability manner must be tempered with the relative capacity of its community to pay rates and charges.

The key financial performance indicators are used to strategically analyse the financial integrity of the resulting Annual Budget and Long Term Financial Plan. If there is a perception that rate rises are becoming a matter of some burden, this may necessitate reviewing service level priorities and deferring / reducing services.

In contrast Council could take a rate rise ceiling approach to determine what services are to be provided to its community. That is, reverting to the Long Term Financial Plan taking over driving and determining service level requirements. Again, some caution is required when using this approach. The community may demand that some additional or higher level services be provided than what is currently is affordable. This may necessitate increasing the level of rate rise over and above the current ceiling threshold that is documented in the Long Term Financial Plan.

In both approaches a common theme is to continually review service level provision to ensure that it is being provided in a cost efficient and effective manner.

Revised Strategy (no change)

16 Council consider the most appropriate rating strategy to provide adequate funds to:

- **achieve sustainable underlying surpluses;**
- **achieve sustainable cash flows; and**
- **fund capital renewal projects;**

in both the Annual Budget and Long Term Financial Plan to support defined service and infrastructure asset requirements.

Conclusion

Why have financial strategies? Council has a legislative obligation to implement the principles of good financial management. Good governance advocates that Council needs to be transparent with its strategic financial planning processes.

Financial strategies and the resultant Annual Budget and Long Term Financial Plans are essential to ensure Council can sustainably manage its limited resources within an environment of changing and unlimited demands. A Financial Strategy enables both Annual Budgets and Long Term Financial Plans to both deliver on longer term Council Plan objectives in a financially sustainable manner.

The previous strategies addressed issues raised by a variety of stakeholders including:

- The Executive Director for Local Government Services;
- The Minister for Local Government;
- The Auditor General;
- Municipal Inspector of Local Government; and
- Councillors.

The financial strategies presented in this report have been refined to reflect the growing maturity of this organisation in relation to strategic long term financial management.

Financial Strategies ensure that the resulting annual and longer term budgets in the Long Term Financial Plan are financially sustainable.

Planning to reach and achieve the 3rd tier summit of the 'financial pyramid' can become a reality in coming years if Council continues to exercise financial discipline in its maturing service and asset management planning and delivery. Strategic financial management is an ongoing discipline.

APPENDICES

Appendix A – Original financial strategies

Listed below are the actual financial strategies adopted by Council at its meeting in April 2003.

1. **That council adopt the budgeted statement of financial performance (profit and loss Statement) as being an integral part of the budget setting process of South Gippsland Shire for current and forward budgets.**

2. **That South Gippsland Shire Council aim to achieve a breakeven operating result in the statement of financial performance within 5 financial years (2007/08).**

3. **That Council adopt the budgeted statement of financial position (balance sheet) as being an integral part of the budget setting process of South Gippsland Shire for current and forward budgets.**

4. **That the working capital ratio of South Gippsland Shire Council in proposed budgets and forward financial plans be targeted not to fall below 2 to 1.**

5. **That budgeted transfers to reserves be matched by an equivalent budgeted surplus in the statement of financial performance so as to preserve the accumulated surplus position of the Council (particularly after Strategy 1 has been achieved).**

6. **That Council adopt the budgeted statement of cash flows as being an integral part of the budget setting process of South Gippsland Shire for current and forward budgets.**

7. **That the budgeted 'cash at the end of year' position be targeted to be within the range of $1.0 million to $1.5 million in annual and forward financial plans pending further detailed analysis of budgeted cash inflows and outflows.**

8. **That capital expenditure on asset renewal projects (and upgrades that have a significant renewal component) be given priority over capital expenditure on new assets until the sustainability index consistently exceeds 95%.**

9. **That the detailed 10 year capital works program be reflected in Councils current and forward budgets.**

10. **That the detailed 10 year Plant replacement program be reflected in Councils current and forward budgets.**

11. That Council take appropriate action to reduce its total debt to below 65% of Rate revenue within the next 4 financial years (2007/2008).

12. That any new projects that require loan funding be considered only if the projects will have proven cash flows in future periods to 'repay' the cash outlays required in the initial periods and / or that the capital evaluation guidelines be used to evaluate costing impacts on the forward budgets.

13. That Council consider borrowing for new capital works (Leisure Centre stage 2 excepted) only after at minimum breakeven operating results are achieved in statements of financial performance.

14. That Council use the program budget to identify specific resource for achieving outcomes identified in service plans and requirements Annual business plans, which in turn will show the rate impact (cost) of providing services and outcomes.

15. The rate revenue required figure be determined by analysing the program budget together with the budgeted statement of financial performance, the statement of cash flows as well as the statement of changes in equity.

16. That Council consider the most appropriate rating strategy to provide adequate funds to:

- **Achieve a breakeven operating result in statement of financial performances,**
- **Achieve a sustainable cash flow,**
- **Fund capital renewal and appropriate upgrade projects,**

in both the annual budget and in the long term financial plan.

17. That Council consider the most appropriate fees and charges strategy so that adequate funds are recovered to offset operational expenses in annual and future budgets.

Appendix B – Previous year's financial strategies

Listed below are the actual financial strategies adopted by Council at its meeting on 27 March 2013.

2013/14 Financial Strategies

1 Target consistent underlying surpluses that provide sufficient funds for both recurrent service level and asset renewal and upgrade requirements.

2 Target the Balance Sheet having at least a 1.5 to 1 underlying working capital ratio in the Long Term Financial Plan.

3 Transfers to discretionary reserves will only be included in the Annual Budget if matched by an equivalent budgeted underlying surplus in the Income Statement to preserve the accumulated surplus position of Council.

4 Material favourable budget variations realised at year's end in a given financial year will be allocated to a general reserve (unless required to finance projects deemed as 'unavoidable') that can be used as a funding source for future one off, unexpected or unavoidable costs.

5 Annual transfers of equivalent to 0.5% of rate income be made to the general reserve and to target increasing the annual transfer to be equivalent to 1% of rate income to the general reserve in the later years of the Long Term Financial Plan.

6 Annual transfers equivalent to the average interest earned on investments during the financial year be made to the following reserves; - Public Open Space, Car Parking, Corner Inlet Seawall Drainage and Henry Road Nyora Reserve and to the General Reserve in later years when it is financially viable to do so.

7 Budgeted underlying cash at the end of each year shall be measured by referencing it against the underlying working capital ratio in the Long Term Financial Plan.

8 Service level funding gaps will be identified and classified as primary or secondary in nature to clearly distinguish the cash flow requirements of maintaining existing service levels (primary gaps) and for service level enhancements (secondary gaps).

9 A series of key financial performance indicators, with appropriate threshold targets, will be utilised to strategically analyse the financial integrity of the Plan. These include:

- **underlying working capital ratio – greater than 1.5**
- **underlying result – greater than 0.0**
- **financial sustainability indicator – greater than 95%**
- **self-financing greater than 20%**

- **indebtedness – less than 40%**
- **total debt as a % of rate revenue – less than 60%**
- **debt service costs as a % of total revenue – less 5%**

10 The amount of asset renewal funding required to maintain specified service levels as documented in asset management plans will be updated into the Long Term Financial Plan subject to the available resource requirements to ensure that the financial integrity of the plan is not compromised.

11 Any new capital work (capital extension) proposals must include a lifecycle cost evaluation that identifies the asset's construction, maintenance and operating cash flow requirements as well as the depreciation impact.

12 Capital income must only be utilised as a funding source for capital or 'one off' expenditure requirements

13 Council consider borrowing for new capital projects only when consistent underlying operating surplus results are being achieved.

14 For borrowings to be considered, projects must have had a full lifecycle cost analysis undertaken, proving that future cash inflows will exceed the cash outlays, or alternatively that the additional costs are quantified in the Long Term Financial Plan and the integrity of the financial strategies are not compromised.

15 Where reasonably possible, fees and charges are increased by the same general rates increase until full cost recovery is achieved for direct service provision. Any fees that are not increased in line with the planned rate rise be clearly identified and documented for Council's consideration

16 Council consider the most appropriate rating strategy to provide adequate funds to:

- **achieve sustainable underlying surpluses;**

- **achieve sustainable cash flows; and**

- **fund capital renewal projects;**

in both the Annual Budget and Long Term Financial Plan to support defined service and infrastructure asset requirements

Appendix C – Financial performance indicators

<u>Financial performance</u>

Underlying Working Capital

Current assets / Current liabilities

Current assets as per Balance Sheet

Current liabilities as per Balance Sheet

Measures ability to pay existing liabilities

Indicator	Range	Comment
Green	> 1.5	Low risk of financial sustainability concerns
Yellow	1.0 - 1.5	Caution with cash flow as issues could arise with meeting obligations as they fall due.
Red	<1	Immediate sustainability issues with insufficient current assets to cover liabilities.

Underlying result

Adjusted net surplus / underlying revenue

Adjusted net surplus is underlying revenue less expenses.

Underlying revenue does not include one off and developer contributions. capital grants and net gain / loss on disposal of assets.

Measures strength of financial result

Indicator	Range	Comment
Green	>0	Low risk of financial sustainability concerns.
Yellow	0-(10)%	Risk of long term run down of cash reserves and inability to fund asset renewals.
Red	> (-10%)	Insufficient revenue to fund operations and asset renewal.

<u>Funding capacity</u>

Self-financing

Net operating cash flows / underlying revenue

Net operating cash flows as per Cash Flow Statement

Underlying revenue does not include one off and developer contributions, capital grants and net gain / loss on disposal of assets.

Measures ability to self-fund asset replacement

Indicator	Range	Comment
Green	>20%	Generating enough cash from operations to fund assets.
Yellow	10% - 20%	May not be generating sufficient cash from operations to fund new assets
Red	<10%	Insufficient funds from operations to fund new assets and renewals.

Sustainability Index

Capital spend / Depreciation

Capital spend as per Cash Flow Statement

Depreciation as per Income Statement.

Measures level of spending on assets

Indicator	**Range**	**Comment**
Green	>100%	Low risk of insufficient spending on asset renewal.
Yellow	90%-100%	May indicate that spending on asset renewals is insufficient
Red	<90%	Spending on asset renewals has not kept pace with consumption of assets.

At best this is a poor ad hoc asset spend indicator. It is useful in that it assesses financial 'spend effort' over a period of time.

Ideally this should in time be replaced by ratio analysis of Written Down Value to replacement value when credible consumption based depreciation is introduced.

<u>Borrowing capacity</u>

Indebtedness

Non-current liabilities / own sourced revenue

Non-current liabilities as per Balance Sheet

Own sourced revenue does not include capital grants

Measures ability to cover long term liabilities from own revenue

Indicator	**Range**	**Comment**
Green	<40%	No concern over the ability to repay debt from own source revenue.
Yellow	40%-60%	Some concern over the ability to repay debt from own source revenue.
Red	>60%	Potential long term concern over the ability to repay debt levels from own source revenues.

Total Debt as a % of Rate revenue

Total Debt as a % of Rate revenue

Includes current and non-current liabilities in Balance Sheet

Rate income as per Income Statement

Measures level of rate income relative to total debt

Indicator	**Range**	**Comment**
Green	<60%	Reasonable reliance on rate revenue to fund debt.
Yellow	40%-60%	Undesirable reliance on rate revenue to fund debt.
Red	>60%	Unsustainable reliance on rate revenue to fund debt.

Debt servicing costs as a % of Total revenue

Debt servicing costs as a % of Total revenue

Borrowing cost expenses as per Income Statement

Total revenue in Income Statement not including donated assets and gain/ loss on asset disposals

Measures portion of revenue committed to fund debt finance costs

Indicator	**Range**	**Comment**
Green	<5%	Reasonable proportion of total revenue to fund debt finance costs.
Yellow	5%-10%	Undesirable reliance on proportion of total revenue to fund debt finance costs.
Red	>10%	Unsustainable reliance on proportion of total revenue to fund debt finance costs.

The performance indicators are not dissimilar to the Victoria Auditor General Office’s financial sustainably indicators that it uses to assess all Victorian Councils.

Appendix D – Local Government Industry and Strategic Financial Plans

The local government industry in Victoria until the last decade had traditionally taken a relatively isolated or annual centric approach to business planning and the associated budgeting processes. The focus had been by and large to ignore what happened in the past, determine priorities for the upcoming financial year, set an annual budget and not give too much thought to future years implications, or at the very best, prepare token extrapolated forward financial plans / budgets. These approaches are not good business practice.

The reason that this occurred historically is that the legislative requirements of the former Local Government Act 1958 and the accompanying Municipal Accounting Regulations were remiss in their approach to business planning and management practices. Particularly, when benchmarked against normal commercial practices. The annual rate determination budgeting process and fund accounting reporting was unique to local government. As the words implied it was an annual centric process.

The standard commercial approach to developing annual and longer term financial plans is commonly referred to as '3 way budgeting methodology'. It involves producing budgeted key financial documents. These are the Income Statement, Statement of Cash Flows and the Balance Sheet. From these, 'what if' financial scenarios can be modelled, as well as be performance managed via a series of key financial performance indicators.

Even when in 1992 the legislation was amended to require the industry to report its financial results as per Australian Accounting Standards Board (AASB) requirements, a significant number of councils continued to develop business plans and budgets using the rate determination method of budgeting. This quasi cash type of budgeting methodology had no relationship to the financial statements that were produced at year-end. This dysfunctional approach to business planning and reporting continued for many years.

It was not until 11 years later in 2003 that the Local Government Act 1989 was further amended, which forced all Victorian Councils to produce budgets in a format that mirrored how the financial statements looked at year-end. The legislation changes also compelled councils to produce forward or longer term 4 year budgets (Strategic Resource Plans) in the same format.

This anomaly of preparing budgets in one format and financial statements in another format was not just confined to Victorian Local Government. It has been acknowledged to be a national concern.

In March 2007 the Local Government and Planning Ministers' Council (LGPMC) agreed, among other things, to a nationally consistent approach to financial planning and reporting for local government. The National Framework for Financial Planning and Reporting focused on local government's financial management at both strategic and operational levels.

The framework requires the presentation of annual and long term strategic financial plan that are readily comparable to audited financial statements.

In 2009 the Australian Infrastructure Financial Management Guidelines stated that a long term financial plan needs to be underpinned by a clear financial strategy with measurable financial targets.

In 2010 both the Municipal Association of Victoria ‘Step program’ and the Australian Centre for Excellence for Local Government (ACELG) advocated that Local Government should develop robust long term financial plans that are underpinned by clear financial strategies and measurable financial targets. They also advocated that all councils should produce at a minimum, 10 year long term financial plans. The Institute of Public Works Engineering Australia, a consortium member of ACELG, also endorses this approach. At this point a majority of councils still only produce the legislatively required 4 year budgets.

South Gippsland Shire Council has been producing 10 year Financial Plans since 2003/04. Council commenced producing a 15 year Financial Plan in 2012/13. Good financial management requires a strategic approach that exceeds basic compliance requirements.

The Minister for Local Government in 2012 advised councils that a performance reporting framework would be developed and be compulsory for councils for the 2014/15 financial year. All councils have been issued with draft Local Government Performance Reporting Framework indictors. There are in excess of 90 indicators that analyse service performance, financial performance and sustainability.

South Gippsland Shire Council is one of few Victorian councils that develop and adopt financial strategies in an open and transparent manner prior to the development of its Annual Budget and Long Term Financial Plan. The Financial Strategies are considered and adopted in an open Council meeting and the adopted document is available on Council’s Web site.

Because South Gippsland Shire Council has taken a strategic approach with its financial management planning processes for a number of years, it now has a wealth of financial data to utilise to further enhance its strategic financial planning processes and overall financial accountability. Council can:

- benchmark its current financial plans against adopted financial plans from previous years; and
- assess actual financial performance achieved over the years against the current and previous years financial plans.

These comparative financial assessments are disclosed in a number of graphs in this Financial Strategies paper, the Annual Budget and Long Term Financial Plan.

Appendix E - Financial Strategies relationship to the Council Plan, Operational Plans and Financial Plans

Council Plan objectives drive Department Business (Service) Plans and their associated funding requirements. Department Business (Service) Plans in turn drive Asset Management Plan's cash flow requirements. Together the financial implications of both Department Business (Service) Plans and Asset Management Plan's should then drive the Annual Budget and Long Term Financial Plan.

It is important that the financial implications of existing service and asset management requirements are both credible and easy to understand. The current and future years funding requirements are updated into annual and longer term financial statements. These cost requirements have a direct impact on funding decisions that are made in the annual budget process.

Each financial strategy discussed in the body of this report has a fundamental influence on both the annual and longer term budgeted financial statements and therefore the associated key financial performance indicators. This informs stakeholders and other interested parties what the annual and longer term financial direction of Council is. Financial plans must be able to demonstrate that Council has in place principles of sound financial management practice.

The Financial Strategies are referenced to a range of key financial performance indicators that source information from the budgeted annual and long term financial statements. The financial statements include the:-

- Income statement;
- Balance sheet;
- Equity statement; and
- Statement of cash flows.

The annual and longer term budgeted financial statements and associated financial performance indicators provide important and transparent benchmarks to validate Council's objective of being financial sustainability in the medium to longer term.

Some of the performance indicators are 'trend line orientated' whilst others are 'target orientated'. When service levels and associated funding requirements are more adequately defined and have accurate cash flow projections, the financial performance indicators will progressively become more target orientated.

Similarly, at year-end, the Council's financial performance is measured by undertaking an objective business assessment by reference to the key performance indicators of the actual financial performance achieved relative to the adopted Annual Budget and Long Term Financial Plan.

The Victoria Auditor General Office (VAGO) has for some years used a series of performance indicators to assess the financial sustainability of all Victorian Councils. South Gippsland's financial performance indicators currently align with VAGO.

The Minister for Local Government has advised Councils that a performance reporting framework will be developed and be compulsory for councils for the 2014/15 financial year. All councils have been issued with draft Local Government Performance Reporting Framework indictors. There are in excess of 90 indicators that analyse service performance, financial performance and sustainability.

It is expected that in coming years the Department of Transport, Planning and Local Infrastructure and VAGO will review and align key financial performance indicators. When this occurs the intention will be to review and align South Gippsland's key indicators with the industry standard indicators.

Appendix F – Financial Strategies – Additional information / foreshadowed refinements.

Comprehensive Income Statement

History

In 2007 the strategy for the Comprehensive Income Statement was modified to target achieving underlying surplus results. The original strategy was simply to target achieving a surplus result (which included capital income).

An additional strategy was introduced in 2008/09 that modified the disclosure of information in the budgeted Income Statement. The underlying result in the Annual Budget, Strategic Resource Plan and Long Term Financial Plan is now clearly disclosed in the Standard Income Statement, rather than having to manually calculate it. This alternative financial reporting format is endorsed in the Best Practice Guide for reporting local government budgets in Victoria issued by the Institute of Chartered Accountants. The strategy was fully implemented in 2008/09.

In 2010 the strategy was further refined so the focus shifted to achieving sufficient levels of underlying surpluses (as opposed to ever increasing surpluses) in order to fund existing service level requirements.

Ironically, if there was a funding gap for a recurrent service and it was financially bridged in the financial plan, the underlying surplus could possibly stay the same (Increased expenditure offset by increased income) or could even reduce (if there was no offset income identified).

The shift in strategic thinking is one of gradually moving away from a 'trend line' financial management approach to a financially more mature 'service target' management approach. The refined strategy confirms the shifting focus to the importance of identifying the specific cash flow requirements of existing services and asset renewal requirements.

The cash flow funding requirements of recurrent services and in particular asset replacement needs should dictate the level of underlying surplus required to be generated.

Further discussion

Financial strategies explicitly ignore the initial financial impact of non-operational events or periodic adjustments brought to account in the Comprehensive Income Statement. The budgeted financial statements do however take into consideration the secondary or indirect cost impact of these actions.

Examples of such events include contributions of non-monetary assets (gifted assets such as roads, kerb & channel and footpaths) by developers and periodic revaluations of infrastructure assets, which are both brought to account in the Balance Sheet and the Comprehensive Income Statement.

These events however do have several secondary flow on effects on the Income Statement in following years which need to be accounted for and strategically managed.

For example, every time a periodic asset revaluation review process is undertaken on a class of asset, the increased carrying value of the assets would initially have a significant impact on the Comprehensive Income Statement and the non current assets in the Balance Sheet.

The secondary impact is that the depreciation cost that is expensed annually to the Comprehensive Income Statement would also increase in the following years. This places increasing recurrent pressure on the underlying operating result. Gifted assets from developers have the same financial implications.

It is important to take into account the ‘inflationary pressure’ that current cost accounting has on increasing asset values and, in particular, the pressure on the underlying result in the Income Statement through increasing depreciation costs. This type of cost has to be strategically considered and reflected in Long Term Financial Plans.

This problem has been compounded for Victorian local councils due to volatility in depreciation charges brought to account over the years. Varying approaches have been taken in valuing infrastructure assets and estimating remaining useful lives, and South Gippsland Shire Council is no different.

The key variables that impact on depreciation expenditure are replacement cost calculations, the condition assessments and anticipated asset lives. Changes in methodology can translate to significantly different depreciation costs being recognised and brought to account in financial statements. It is expected that in future years as asset management practices improve for infrastructure assets, this will translate to more stable, credible and consistent financial data being recorded in financial reports and plans.

Council intends to progress from calculating depreciation from a straight line basis to a more sophisticated consumption based model based on actual asset conditions for infrastructure assets. Asset conditions are assessed on regular basis and re-valued based on the remaining useful life of the asset. Remaining useful life is calculated by from the adopted asset deterioration curve and current condition. This would disclose more accurately the consumption of service potential embodied in assets in the Income Statement more accurately. In turn, this would enable more credible financial modelling to be undertaken in future years’ financial plans.

Engineering Services Directorate estimates that it will be in a position to progress asset management systems to a point of being doing such calculations no sooner than 2018/19.

Future strategic considerations

Aiming to achieve consistently improving underlying surpluses over the past few years has been a credible objective. To move away from a trend line management approach to try and establish some sort of ceiling or targeted results is a credible next step. The question that needs to be considered is what level of underlying surplus ought to be targeted in the longer term?

The answer to this question will be determined by a number of factors.

First of all it is important to note that the concept of identifying funding gaps is applicable across all services that Council provides, not just capital dependent services. Funding gaps are the difference between what the cash flow requirements are to deliver a particular service and what has been allowed for in the Long Term Financial Plan.

This requires the accurate documentation of the current services, in particular the level of service that is expected to be provided and the quantification of the associated cash flow requirements.

Similarly, any funding requirements for all major classes of infrastructure assets required to maintain existing specified levels of service provision, need to be quantified. The magnitude and timing of expected cash outflows is of considerable interest and importance.

South Gippsland is fortunate that there are no asset renewal primary funding gaps for all major classes of assets. There currently are adequate funds for recurrent cost requirements for all major asset classes for the current defined service levels as documented in Asset Management Plans. There are however funding pressures looming in respect of increasing construction costs particularly for the road network.

Quantifying all current service levels and associated funding requirements and in particular any primary funding gaps, then developing bridging strategies, are a core 2nd tier financial pyramid challenge.

When funding gaps has been identified and documented, a determination needs to be made as to what is an acceptable timeframe to bridge the funding gap.

Determining timeframes will be tempered by the community’s perception of affordability and preparedness to pay. In the longer term if a community wants to maintain having a particular level of service being provided, it must also be prepared to pay for it. The preparedness to pay for services will be tempered by the net disposable community income of ratepayers which is their capacity to pay.

It would also be reasonable to assume that the community might wish to have additional and / or higher levels of service than is currently being provided. This effectively creates a ‘secondary funding gap’ that will also need to be quantified and then bridged. Depending on the service level requirements, this may have both recurrent and capital funding implications. This is a 3rd tier financial pyramid challenge.

Borrowing funds for new major capital works can and should be considered. This spreads the cost impact over a number of years. However it is important to note that not only the borrowings but the accompanying interest costs have to be paid back. This is the balancing point for considering unlimited demands versus Council’s limited financial resources and the opportunity cost of borrowing funds that will eventually need to be repaid.

To put this in some sort of perspective the South Gippsland community has consistently indicated in annual Local Government Community Satisfaction Surveys (conducted by the Department of Planning and Community Development since 1998) that:

- Rate rises are too high;
- The community members do not know what they get for their rates and charges; and
- They do not get enough for their money.

in relation to questions about the financial management performance of this Council.

It is not unreasonable for the community to expect to know what services are being provided, the associated costs are, and to have some form of assurance that they are getting provided with value for money services from Council.

Council in 2013/14 has established a Financial Sustainability Steering Committee that has reviewed Service Summaries for all Council departments. From this exercise it is now proceeding to implement a rolling program of investigating the process of shared services, changes in service levels for all departments.

The provision of service levels in coming years may have to be tempered by the community’s preparedness to pay for same. Establishing a ceiling of sorts for future years rate rises could force Council to prioritise services. Lower priority services may not receive funding.

Statement of Changes in Equity

Further discussion

By progressively increasing the value of the General Reserve over the years, has provided more opportunity to strategically utilise funds if and when required.

Over the years the General Reserve funds have been utilised to provide funding for:

- $1.16 million unfunded superannuation call in 2003;
- $4.50 million interest only loan that became payable 2008;
- $0.87 million unfunded superannuation call in 2010;
- $0.70 million to help fund Carinos complex purchase in 2010;
- $0.80 million to help partially fund $4.62 million unfunded superannuation call in 2013

Council was advised in late 2011 that the likely funding call in the forthcoming 31 December 2011 actuarial investigation of its defined benefits superannuation obligations would most probably exceed the preceding $0.87 million call made in 2010. Council strategically planned for this situation by putting aside and earmarking funds in a General Reserve and building up additional financial capacity in its Balance Sheet. Council potentially could have accommodated a call in the vicinity of $1 – 1.5 million.

The $4.62 million was substantially above the previous $0.87 million call. This was payable 1 July 2013. Unfortunately this and other unavoidable cost events have had a significant detrimental impact on Council's working capital ratio, compromising its long term financial sustainability.

As at 30 June 2013 Council only had $486,000 in its General Reserve. All available General Reserve funds ($803,000) are being utilised to apply against the $4.62 million unfunded super call in 2013/14.

Unfortunately in coming years a future funding call is anticipated. The next actuarial review is due on 31 December 2014. This review may be brought forward to 30 June 2014. If a further funding call was made it would payable in 2015/16. It is hoped that the call will be significantly less than the previous one. It emphasises the importance to strategically replenish the General Reserve as soon as is reasonably possible to do so. Council estimates that it would have $723,000 in its General Reserve by the 2015/16 financial year.

This approach complements a recommendation made by the MAV Defined Benefit Taskforce December 2012 report that councils make provision within their accounts for potential future calls.

To further complement the existing strategy of allocating annual transfers to the General Reserve a refinement has been made to the strategy that allocates transfers equivalent to average interest earned on investments. It now includes making additional transfers equivalent to the average interest earned on investments to the General Reserve (effective from 2015/16).

Future strategic considerations

Council after it has restored its underlying working capital needs to seriously consider taking advantage of its growing underlying financial strength and allocate funds to internal reserves and then to strategically utilise them.

In future years, if and when the reserve funds are required to be applied to either an unexpected unavoidable one off cost event or major capital upgrade or extension project, this would present an immediate saving or reduction of finance costs associated with any borrowing requirements.

For example, if Council had accumulated a cash backed General Reserve amounting to $4.0 million dollars and it required $10 million capital funds for a major project, it would only have to borrow $6.0 million dollars. Being able to self finance to the value of $4 million would immediately save approaching $1.09 million in financing costs (if loan taken over 10 years at 5.0%).

At the same time, the strategy could and should then be altered to redirect the annual allocations that were being made to the General Reserve and utilise as a funding source for future years' loan redemption obligations. This would minimise the potential pressure on requiring an unfavourable spike in rate rises in future years' budgets to fund the repayment of borrowings. Once the loan commitments were under control the funds could again be redirected to building up reserves.

This building up and then releasing financial capacity from the reserves reflects the growing strategic financial maturity and discipline of this organisation. Ironically, this exact management approach was taken in 2003/04 in relation to partitioning funds to offset against long term debt. Council literally saved close to $2 million in finance costs. Significant further savings were also made when funding calls were made for superannuation in 2003 ($1.16 million funding call) and in 2010 ($0.87 million funding call).

This strategic 'next step' must however take into consideration the prevailing economic conditions and Councils and indeed the ratepayers' preparedness to save and pay for future needs. To achieve future cost effective outcomes require both financial discipline and commitment from all key stakeholders in preceding years.

Financial discipline being exercised consistently over a number of years is a hallmark of a mature organisation.

Operating Activities

Further discussion

To maintain predetermined service levels, one must consider all associated cash flow requirements associated with providing the services. This includes the cyclical operational and maintenance costs as well as the periodic capital renewal costs for services that are infrastructure asset dependent. This is sometimes referred to as life cycle costing analysis. This not only has to be affordable on an annual basis, but also on a longer term basis.

It is therefore paramount that Department Business Plans developed for the forthcoming years specifically focus on defining and documenting all service level and associated cash flow funding requirements. This includes infrastructure asset management requirements as well as funding allocation requirements for discretionary and / or new services and capital expansion projects. This would enable the financial implications to be strategically assessed and ultimately be funded in a financially sustainable manner.

In the absence of a structured approach being followed, the budget tends to become the default driver of Council Services. This of course is not a desirable outcome, unless it is desired to undertake an exercise of cost containment by rationalising services and service levels.

Discretionary fund requirements for one off projects are also a practical reality that has financial impacts on annual and future years' operating cash flow. In the development of the 2011/12 Annual Budget and Long Term Financial Plan pools of funds were earmarked in current and forward budgets for discretionary and one off project proposals. Unfortunately all available funds in current and forward years were subsequently utilised to fund a variety of service and project initiatives identified in the 2012/13 budget process. There are no pools of funds in the forward budgets for discretionary and one off project proposals.

Council needs to ensure that a robust process is used to prioritise what projects receive discretionary funding in a given year. It is highly desirable that these items be strategically linked back to the Council Plan.

Financial performance Indicators

Background

The key financial performance indicators serve as very important lead indicators. They can show future years' financial ramifications of decisions that are made during the year or from uncontrollable cost events that may occur throughout a financial year.

Key financial performance indicators should not become a strategic obsession. Rather, they provide a 'what if' look at future financial scenarios based on current year decision making processes. Their main purpose is to give technical clarity to the financial information that is contained in the budgeted financial statements in the Long Term Financial Plan. They enable management an opportunity to identify and then strategically address any issues of concern.

They are useful for analysing the likely financial implications of major project proposals that occur throughout the year. The process involves modelling and analysing financial implications of project proposals using 'what if' financial modelling scenarios into the Long Term Financial Plan. It enables Council to make fully informed financial decisions.

This approach accords with the recommendations made in the Victoria Auditor General's Office 2011 performance audit on 'Business Planning for Major Capital Works and Recurrent Services in Local Government'.

The challenge is to sustainably fund a given level of services and discretionary expenditure as well as preserving Council's existing assets in a financially responsible manner now and in future years. Responsible financial management would be evidenced by key financial performance indictors not being compromised in the forward budgets of the Long Term Financial Plan. In order to be able to achieve this, it may be necessary to consider:

- Reducing or eliminating existing services;
- Review funding levels provided for discretionary one off type projects including capital expansion projects;
- Reducing costs wherever possible (efficiency);
- Attract more grant funds;
- Responsibly manage borrowings;
- Increase fees and other charges; and
- Increase rates and charges.

<u>Further discussion</u>

It is important that Council consider and then determine what services and service levels it believes the community needs (which may differ from what they define as levels they want), document these, and then deliver the outcomes in a cost efficient and effective manner.

The 2011 Victorian Auditor General Office performance audit on 'Business Planning for Major Capital Works and Recurrent Services in Local Government' was critical about councils ability to formulate business plans for all major services, with measurable objectives clearly aligned to their Council Plans.

The Local Government Performance Reporting Frameworks Direction paper issued in December 2012 was very critical about the quality of reporting by councils on the services that they provide to ratepayers. The draft Local Government performance Reporting Framework Indicator Workbook issued to all councils in 2013 has over 90 performance indicators measuring service performance, financial performance and sustainability of councils

There is also an emerging trend that funds from the Federal Government in particular will in future years be targeted to organisations that can demonstrate that they are efficient and effective service providers. This is a significant shift from the previous criteria that provided money on a 'needs basis'.

In future years, being able to demonstrate that Council is a cost efficient service provider will play a significant role in attracting increased levels of grant funding.

Investing Activities

Background

Council prior to 2003/04 would have been briefed and presented with various long term capital expenditure programs for roads, bridges, property, parks, plant and the like. Unfortunately, they were never 'costed' or incorporated into any long term financial plans. No real distinctions or cost analysis was made between capital expansion and capital renewal works. They were stand-alone documents and in many instances, the costs shown bared no relationship to the available funds. Rather than being a capital works program, it would have been more accurate to refer to them as a capital works 'wish list'.

Capital Budgets and the Long Term Financial Plan

In 2003/04 Council began to prepare strategic Long Term Financial Plans that incorporated the long term capital works program. The budgets for all capital works in annual and longer term budgets since 2003/04 are now categorised into the following:

- Renewals ('replacing the road');
- Upgrades ('making the road wider'); and
- Extensions ('making the road longer')

and are included in the 15 year period in the Long Term Financial Plan.

The Department of Planning and Community Development require councils to submit 15 year forward projections for their annual asset management performance measures survey. Similarly the Institute of Public Works Engineers Australia 'Australian Infrastructure Financial Management Guidelines' advocate calculating up to 20 year cash flow projections for capital works portfolios.

As asset management plans become more sophisticated with their lifecycle costing models the Long Term Financial Plan can be, if required, extended to a 20 or even a 25 year plan.

Service plan requirements need to drive asset management plan cash flow requirements. Future years' capital funding requirements in financial plans have a direct impact on funding decisions that are made in the annual budget process.

Stable capital works programs lend themselves to being a cost effective way of doing business. It gives Departments more certainty when organising resources to allocate to projects that go beyond the boundaries of a given financial year. For example, projects can be designed one year and then built the following year. The efficient and effective use of resources over a period transcends financial years.

Having the 15 year capital works program incorporated into the Long Term Financial Plan has some other benefits. It makes the financial 'cause and effect' of any changes proposed more transparent. For instance, if a new project (irrespective of whether it is avoidable, non avoidable, low or high priority) gets approved during the financial year and doesn't have a matching funding stream, the financial impact on the budgeted financial statements can easily be seen.

If a new project gets included, something must either come out, be deferred or additional funds sourced. Otherwise, the key financial performance indicators would reflect the unfavourable cost impact in the Long Term Financial Plan. This promotes a disciplined, transparent and sustainable approach to infrastructure asset management.

<u>Asset Management and the MAV STEP Program.</u>

South Gippsland Shire Council joined the MAV STEP Asset Management Program in 2003. The core objective of the program is to be able to provide sustainable local government infrastructure.

The asset renewal modelling exercises conducted in the MAV STEP program confirmed that Victorian councils were not allocating sufficient resources to asset renewal works. Councils' were found to be inadvertently compounding the funding gap challenge by allocating much needed 'renewal funds' to expanding their asset base.

South Gippsland Shire Council fortunately has for some years now strategically acknowledged the importance of prioritising funds to renewal of its infrastructure asset portfolio.

It must be noted that the identified funding gaps from the modelling exercises that have been undertaken as part of the STEP program has a degree of volatility. Over the years there have been and continue to be significant differences between Victorians councils on their assessment of unit cost rates, asset lives and intervention points, all of which have a material impact on what is calculated to be the renewal funding gap. As a result, the funding gap has varied considerably between the years that it has been calculated.

Funding gaps in the STEP program are determined by calculating renewing assets on the worst assets renewed first basis. It is generally accepted that this methodology is rather simplistic and not necessarily the most cost efficient way to manage assets. In the absence of more sophisticated asset funding gap modelling, the information provided still has strategic merit. At the very least, it supports the proposition that existing levels of expenditure on asset renewals was not adequate.

In September 2012 the Council was advised by STEP consultants that they were well placed to achieve core maturity in asset management by December 2012 and were well ahead of all other Gippsland Shires and among the top 10 in Victoria. All

Council's civil assets are now populated in the Conquest asset register and linked to GIS. These include roads, footpaths, kerbs, bridges, drains, pits, pipes and parks furniture.

Council continues to participate in the MAV STEP program. The next stage of the program is known as the Broadened STEP program, which focuses on quantifying service level requirements and involving the community more in an associated consultation processes.

It is planned to integrate these outcomes with service level modelling and produce improved Roads and Buildings Infrastructure Service Plans. This complements Council's commitment to the National Asset Management Assessment Framework.

<u>Victorian Auditor General's Office performance audit</u>

The Victorian Auditor General's Office performance audit on 'Business Planning for Major Capital Works and Recurrent Services in Local Government' in 2011 was critical of Council's business planning practices for major capital works. The report recommended that Council:

- Develop business cases for proposed investments in major capital works to demonstrate they are soundly based and that they support the achievement of the Council's service delivery objectives;
- Rigorously analyse service need, value for money, cost, and financial sustainability against defined standards consistent with Best Value Principles to inform investments in recurrent services.

The existing strategy that advocates lifecycle cost evaluation methodology for capital project proposals is compatible with the above recommendations.

It is important that the organisation embraces a service centric asset management culture and that infrastructure assets are maintained in a strategic, financially responsible and accountable manner.

<u>Asset management plans and infrastructure funding requirements and gaps.</u>

Funding requirements for assets are very much dependent upon the service level requirements of the community and where the assets are in their lifecycle. It is important to identify how much funding is required and when it is required. Assets nearing the end of their economic life will require a specific amount of funding at a certain point in time when they need to be replaced.

It is not only important to identify periodic asset replacement costs, but the recurrent operational maintenance costs of assets also need to be considered. Together, these costs are commonly referred to as life cycle costs.

Any shortfall between what funding is required and what has been allowed for in budgets is a funding gap.

Funding gaps can be financially expressed as the difference between what the asset lifecycle cash flow requirements are, and the actual amount that has been allowed / allocated in current and forward budgets.

A primary funding gap is when there are not enough funds available to continue to provide a predetermined existing level of service in current and / or future years. This means that the infrastructure assets required to provide a defined level of service will in fact deteriorate over a period of time and subsequently the service levels being provided will also reduce. Deferring rehabilitating or renewing assets to later years can be very costly.

South Gippsland is fortunate that there are no asset renewal primary funding gaps for all major classes of assets. There currently are adequate funds for recurrent cost requirements for all major asset classes for the current defined service levels as documented in Asset Management Plans. There are however funding pressures looming in respect of increasing construction costs particularly for the road network.

A secondary funding gap exists when the existing defined service level being provided is deemed to be inadequate and a higher level of service is desired by Council and ratepayers. This situation can occur irrespective of whether there already exists a primary funding gap for the existing service level requirements of a particular asset or asset class.

The challenge is to over a period of time identify and financially bridge the funding gaps.

Funded Depreciation concepts

The concept of 'funded depreciation' and its relationship to bridging asset funding gaps is particular and unique to the local government industry. In fact there are varying interpretations as to what 'funded depreciation' really means.

Interpretations of 'funded depreciation' include:

- producing a bottom line operating surplus in its Income Statement would imply that an organisation has funded its depreciation (another variation is that it produced an underlying surplus);
- by allocating an amount of cash to a internal reserve that is equivalent to the annual depreciation cost has also been viewed as depreciation being funded (a form of an annuity);
- an organisation incurring capital renewal expenditure equal to or greater than the value of its annual depreciation, would also imply that it has funded its depreciation (variations being capital expenditure on renewal and upgrade works or alternatively total capital expenditure).

The varying interpretations are worth discussing because they are in fact all flawed.

Council has for a number of years consistently produced bottom line surpluses. There is considerable anecdotal opinion that during the same period Council has not allocated enough funds to asset renewal requirements. A surplus result means that Council's operating income exceeded its operating expenses in a given year. There is no meaningful correlation of surplus results to asset funding requirements. Fortunately this interpretation of funded depreciation has very little traction in the industry.

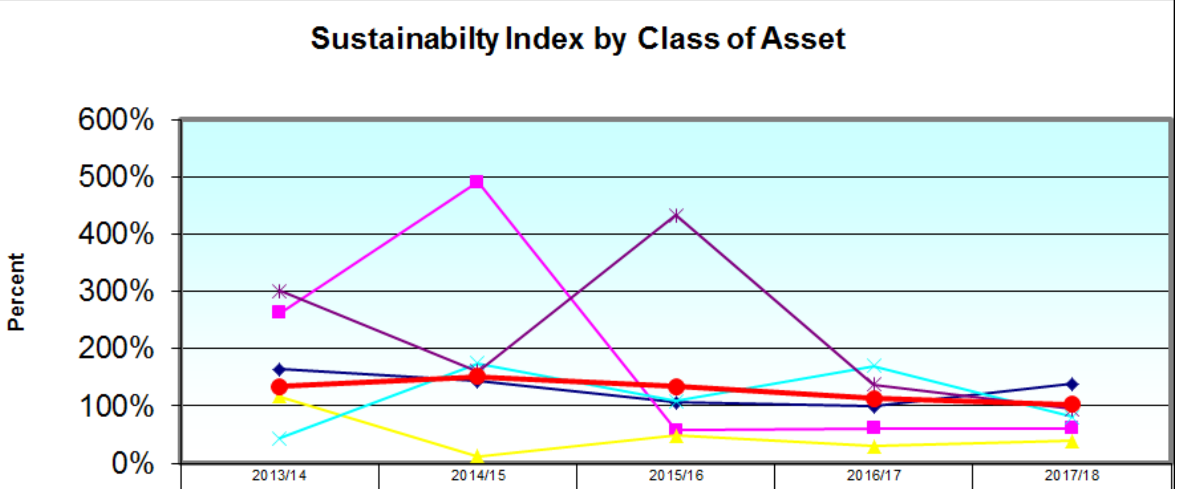
The second concept of 'funded depreciation' is undoubtedly the most interesting and flawed. There is a poorly considered view that some local government practitioners have and that is that depreciation should be 'cashed up' and transferred to an internal reserve in order to fund future asset replacement programs. The argument being that the funds gradually build up and can then be released some years later when the particular assets are required to be renewed.

If that strategy was being diligently applied, one would expect this Council to currently have in excess of $140 million in cash backed reserves! The journey to get to this point would translate to incredible funding pressures on the annual and longer term budgeting process. Fortunately again, there is very little evidence that this approach is actually being applied in the industry.

The third concept of funded depreciation is very prevalent throughout the local government industry. Practitioners have misinterpreted that if annual capital spend was consistently equal to or greater than the annual depreciation charge that depreciation was funded and that there would be no asset funding gaps. Again this concept is somewhat flawed. There is no relationship between the value an asset's service potential deteriorating to that of the specific cash outflow requirements, to replace or renew assets nearing the end of their useful serviceable life in any given year.

To a degree one of the Victorian Auditor General's financial sustainably measurements, the capital replacement (or asset sustainability) indicator which measures whether councils have been replacing assets at a rate consistent with their consumption, has been misinterpreted and promotes this view. It compares the amount spent on renewing assets to annual depreciation on a yearly basis. This indicator measures the level of 'spend effort' over a period of time. It does not and should not purport to measure or assess whether there is an adequate level of expenditure being incurred to renew assets.

The reality is that the timing of actual capital expenditure requirements bears no relationship to the asset consumption costs (expressed as depreciation). The graph below shows the sustainability index for several different classes of assets. It clearly shows how annual capital expenditure requirements for different classes of assets can vary considerably over a number of years. Asset renewal funding requirements (how much and when) should be dictated by Asset Management Plans that in turn are linked to service level requirements.



	2013/14	2014/15	2015/16	2016/17	2017/18
Roads	163%	143%	106%	99%	138%
Bridges	263%	491%	58%	60%	61%
Drains & Culverts	117%	12%	48%	29%	39%
Buildings	43%	175%	108%	170%	80%
Other Structures	301%	161%	433%	137%	95%
Total	133%	151%	134%	113%	103%

<u>Taking a balanced strategic approach to primary / secondary funding gaps</u>

It is important not to take on an obsessive approach in regard to financial strategies dealing with asset management issues, but rather a balanced approach. Primary funding gaps and associated renewal works should be merely prioritised ahead of service expansion works in a strategically balanced manner. This has actually been occurring for the past 11 years.

In addition to the pressures of just trying to maintain the existing asset portfolio that support various services / service level requirements, there will be pressure to upgrade existing assets and consider building new assets to satisfy community service level demands and needs.

This is understandable and needs to be considered and financially accommodated. The unavoidable reality however is that any new asset that is built has to be maintained and eventually replaced.

By expanding the asset base when the renewal and upgrade funding gaps for existing assets have not been bridged, will further compound the infrastructure primary funding gap dilemma (unless the new asset replaces a number of 'high cost' assets).

It is important that all additional lifecycle costs for new capital expansion project proposals are considered and financially accommodated in forward plans. That is why the financial strategy dealing with capital works encouraging lifecycle cost evaluations is still relevant and will continue to be so in future years.

Hypothetically, Council in coming years may have identified all its primary funding gaps and then strategically planned to bridge that gap in say five years. This would be reflected in both the Asset Management Plans and the Long Term Financial Plan.

If Council then considered taking on additional asset expansion works over and above what has been allowed for in the current plans, this invariably would have an impact on the bridging timelines. This would be particularly so if there were no increase in income sources to offset against the increased costs.

Inevitably, the original timeline to bridge the primary funding gap would then have to be extended out beyond the 5 year bridging plan. If this is deemed acceptable, then Council would have made a fully informed decision understanding the financial and service level ramifications.

The challenge is to find the right balance in terms of existing risk management obligations to current assets, maintaining and adequately funding existing service levels and the desire to provide the community with more or better services within a responsible and affordable long term financial framework.

The periodic review of the Council Plan is an important process that gives direction in relation to services and service level requirements.

<u>Optimised funding modelling</u>

Simple one dimensional approaches as advocated by the Municipal Association of Victoria (MAV) STEP program such as targeting to fix the worst assets first basis invariably does not lend itself to producing financially efficient outcomes. The Asset Management Diagnostic Report that was prepared in 2009 by Australian Centre for Excellence in Asset Management also confirmed that improvements could be made in capital expenditure planning practices of Council.

Now that asset management plans are fully implemented for all infrastructure asset classes and an asset management system implemented, one would expect more sophisticated optimised decision making processes to begin occurring in coming years. This would include cost benefit and least cost analysis to be undertaken for major renewal and maintenance project considerations.

This would ensure that the most cost effective means of maintaining and replacing assets is updated into the Long Term Financial Plan.

<u>Future strategic considerations</u>

In the absence of credible asset consumption data that match the degradation curves of each particular asset within a particular asset class, the writing down of the useful life of the assets to the Income Statement as depreciation cost is currently done on a straight line basis.

The straight line approach and the asset consumption approach to depreciation tend to provide significantly different financial results. Being a non cash entry it does not translate into any budget concerns from a cash management perspective. Relatively crude financially asset management trend analysis can still be undertaken, such as the sustainability index to assess ‘expenditure effort’, because the denominator (depreciation) although overstated is a relatively consistent and stable figure.

Observations made by Australian Centre for Excellence in Asset Management of councils' that use and apply straight line depreciation methodology is that the costs are generally overstated by as much as 20 percent. The cyclical round of periodic asset revaluations 'corrects' the written down values of the assets in the Balance Sheet.

Ideally it would be desirable to reflect in the financial statements the writing down of assets from an asset consumption perspective that correlates to an engineering assessed asset degradation curve for particular assets. When the asset management systems and registers are able to capture enough relevant information that can pass external audit scrutiny, the objective will be to change the accounting policy for depreciation from straight line to an asset consumption methodology.

From a strategic financial management perspective, more accurate data would enable the infrastructure assets in the Balance Sheet to be performance managed in a more sophisticated and commercially acceptable manner. Typically this involves measuring and comparing the relationships between the replacement value and the written down value of the assets over a period of time.

Council intends to progress from calculating depreciation from a straight line basis to a more sophisticated consumption based model based on actual asset conditions for infrastructure assets. Asset conditions are assessed on regular basis and re-valued based on the remaining useful life of the asset. Remaining useful life is calculated by linear interpolation between total life and current condition. This would disclose more accurately the consumption of service potential embodied in assets in the Income Statement more accurately. In turn, this would enable more credible financial modelling to be undertaken in future years' financial plans.

Financing Activities

Borrowing scenarios

Borrowing funds should only be considered in certain circumstances. Some options are briefly discussed below.

Commercial ventures

There would be nothing wrong to consider borrowing to fund any capital projects that will have proven cash flows in future periods to 'repay' the cash outlays required in the initial period including the finance costs, as well as the ongoing recurrent expenditure requirements associated with the asset.

The reality is that there are not many 'capital intensive' services that councils provide that generate good recurrent income streams, and also, local government has found that it generally can't compete effectively with private enterprise in commercial activities. The main reason is that commercial activities are not a core business of local government and Councils generally lack the expertise and professional resources to be commercially competitive. Councils also cannot avail themselves of tax effective accounting strategies that the commercial world has in respect to borrowings. Councils also have to address National Competition Policy requirements. These require increased governance and reporting requirements that can be cost prohibitive to the venture.

Capital renewal works

Extreme care is required when considering borrowing to finance 'recurrent' capital renewal projects. Currently Council self-funds capital renewal works in excess of $10 million every year. Unless it can be clearly demonstrated that there are future cost savings or efficiencies to be had that are greater than the cost of finance, it would be inappropriate to fund recurrent capital renewal programs from borrowings.

If Council, in an effort to try and reduce the annual rate burden, decided to borrow say $1 million to fund renewal works instead of self-funding this cost, the financial implications would be as follows. The total cash outflows would be reduced $127,000 per year over 10 years instead of $1 million in one year (based on borrowing $1 million at 5%). This would suggest that the rate increase in that particular year could then be reduced by $873,000 or 3%. (A 1% increase in rates equates to $290,000). This on face value would appear very appealing. It would imply that the current projected rates and charges rise for 2014/15 could be reduced from 6.25% down to 3.25%.

Unfortunately there would be some significant longer term financial ramifications that would need to be carefully considered. There would be a resulting $11 million reduced income stream generated from rates over 10 years. To maintain the integrity of the Financial Plan the previously self-funded capital works program would have to be reduced accordingly. If the objective was to provide the same level of capital renewal works, either the rates would have to be significantly increased the following year, or alternatively additional funds would have to be borrowed the following years. This is an example of the impact of borrowing $1 million in one year. If the strategy was to borrow $1 million each and every year the negative compounding impact would be quite dramatic.

Capital upgrade and extension (new) works

The Long Term Financial Plan currently shows that Council has allowed some $2 million per annum that gradually increases in forward budgets for capital upgrades and new works. They are also currently self-funded. If Council decided to borrow for capital and extension works to reduce the immediate rate burden the longer term financial ramifications would be no different to what was described above for asset renewal works.

If Council decided instead to do additional works by borrowing funds each and every year and spreading the cost burden over a number of years the longer term financial implications would be less dramatic. This proposal would still warrant careful consideration.

To fund an additional $1 million capital works each and every year (borrowing $1 million at 5% over 10 years) the rates would have to increase by approximately 0.35% each year. Council currently has low debt and therefore has plenty of financial capacity to be able to borrow.

Prudential ceilings or thresholds are commonly incorporated into local government borrowing strategies to justify borrowing funds on a cyclical type basis. This approach can be likened to setting a ‘quasi credit card limit’ on the extent of funds Council can access through borrowings. Longer term this can prove to be very counterproductive. So long as you don’t exceed the prudential limits, all is deemed to be well and strategically responsible. The reality is that South Gippsland Shire Council in 2002/03 did not exceed prudential limits but had managed to get itself into considerable financial difficulties.

If it cannot not be clearly quantified and demonstrated that the longer term financial benefits exceed the finance cost commitments over the life of the loan, a threshold approach would be likened to using a credit card facility. At best if Council adopted a strategic approach that enabled it to borrow funds to a certain level simply because it can, it may inadvertently be limiting opportunities to utilise borrowing funds for major projects that may cost many millions of dollars.

Borrowing for major projects and the concept of intergenerational equity

Borrowings should only really be considered when a large new capital project has been identified that is deemed highly desirable and beneficial. The repayments for such projects are for a prolonged period of time, so as to match the lifecycle of the project. This strategy enables the project to proceed and spreads the cost burden over a number of years.

This concept is commonly referred to as the ‘intergenerational equity’ approach. The principle is to spread the cost burden by linking payment for the asset (via debt redemption payments) to successive Council populations who are deemed to be the beneficiaries of the asset. Again, some caution is required.

Currently if Council borrowed funds over a 7 year period instead of say 3 years, the applicable interest rate would be 0.8% more expensive. The premium between a 3 year interest rate and 10 year rate is 1.3%. The major banks typically only provide maximum 10 year loans to local government. A significant number of assets have a lifespan far greater than 10 years. If Council wanted to have an extended finance arrangement (a 10 year loan with a 40% residual payment at maturity to approximate a 15 year cash flow) the premium would be 1.5% when compared to a three year term.

This intergenerational equity approach needs to be exercised with caution. The Institute of Public Works Engineering Australia financial guidelines confirm that the existence of Financial Strategies and plans helps an organisation determine how much to borrow and when. They make the point that there is no point borrowing long term for a long lived asset if the financial plan shows it has financial capacity to borrow short term.

Major projects typically have several years lead time and this should be strategically taken advantage of. Wherever it is reasonably possible to do so complementary strategies such as utilising reserve funds ought to be considered to minimise overall finance costs.

For example, if Council had accumulated a cash backed General Reserve amounting to $4.0 million dollars and it required $10 million capital funds for a major project, it would only have to borrow $6.0 million dollars. Being able to self finance to the value of $4 million would immediately save approaching $1.1 million in financing costs (if loan taken over 10 years at 5.0%).

If the financial ramifications of borrowing commitments on future years' financial plans are not fully understood there is a real risk that future generations may in fact be committed to paying expensive financing arrangements for the projects funded by previous Councils.

Council must be able to demonstrate that it can afford to responsibly borrow for major works and understand the future financial ramifications. The community must also be prepared to pay. The acid test is whether the community perceives the value of the project is equal to or exceeds the cost of the project (including the associated financing costs). If they believe it will be of value, this will be demonstrated by their preparedness to pay through their rates and charges.

Borrowing for 'new' capital works & existing asset renewal funding gaps

When considering funding capital expansion projects with borrowings, it is highly desirable that Council can with some confidence establish any primary funding gaps for its current portfolio of infrastructure assets.

If Council sometime down the track determines that it wishes to finance capital expansion projects despite the fact that it still has primary funding gaps, this will impose further cost pressures on Council. To responsibly accommodate this scenario, Council would need to financially accommodate this situation by extending the number of years in which it now wishes to bridge the renewal funding gap.

The most important strategic consideration in any capital funding scenario is that Council ensures that it fully understands the annual and longer term financial considerations when it considers any borrowing proposals.

If the above matters are not seriously considered, the short term gain from borrowing, no matter how desirable, may in fact be over shadowed by the undesirable and unavoidable longer term financial ramifications.

Further discussion

It is not coincidental that there are two specific financial strategies that Council currently has in regard to borrowings, or that such a detailed focus is presented in this proposed Financial Strategy papers.

Over the years the two biggest issues of strategic financial mismanagement within the local government sector has been in relation to:

- rate determination budgeting and
- loan borrowings.

and when considered in conjunction with each other, can and have led to particularly inappropriate funding decisions being made.

Rate determination budgeting methodology in simple terms is identifying income and expenditure sources and balancing back to a 'rates carry forward' figure. This is a quasi-mix of cash and select assets and liabilities. The focus is very much annual centric. The easiest way to make the budget balance is to increase rates, borrow, or do combination of both. Borrowing funds invariably tend to be a softer political option to take than to raise the rates.

To satisfy eligibility for borrowings, all a council had to do was satisfy a number of prudential loan ratios. It again is worthwhile being reminded that this Council up until 2003/04 did exactly that and did not breach any legislative rules. It however found itself in a very undesirable and concerning financial position.

Council had on a continual basis produced operating deficit results which clearly demonstrated that it hadn't enough operational revenue for long term sustainable operations, let alone funding borrowings for major works. The irony was that because it complied with the prudential guidelines, it could borrow and therefore did. Successive Councils had to strategically manage the financial ramifications and essentially pay the price for the poor financial decisions made several years earlier.

To its credit, Council in 2003/04 abandoned the rate determination approach to budgeting and adopted the commercially accepted three way budget methodology and has produced consistently improving financial results ever since in line with the Long Term Financial Plan.

There is always a real risk that over time improving financial results are misconstrued as good or strong financial outcomes and organisations begin to revert back to undesirable financial management. What this generally demonstrates is an organisation that is prepared only to follow strategic financial advice when experiencing dire financial circumstances and has very little other choice. As the financial circumstances improve the outcomes are misconstrued as good financial performance and strategic financial advice is considered an elective consideration. Old habits tend to resurface along with the accompanying undesirable financial consequences. When the lessons of history are not understood, heeded or ignored, the mistakes made in the past have a tendency to repeat themselves.

This is why few councils, if any, have ever reached the 3rd tier or summit of the 'financial pyramid'.

It is also worth clarifying a few issues and dispelling some myths that appear to still be prevalent in the local government industry. Some practitioners will suggest that having some borrowing liabilities in the financial statements is in fact strategically a good thing. The fact is that Council does not benefit from any tax advantages from borrowings as commercial businesses do. Tax benefits are only really relevant for some businesses undertaking certain commercial ventures.

What is also overlooked is that commercial or 'for profit' businesses invest those 'tax effective borrowings' into assets that produce an income stream, which again benefits their bottom line. The returns generated exceed the financing costs of borrowing. Councils' investments are generally in assets that provide services, not profits. Generally speaking, Council does not get tax breaks, nor does Council generate net revenue from investments.

In summary local government is better off having little debt than having a lot of debt. Having no debt is far better than having any debt. Aiming to become debt free is a desirable objective.

This is not to say that Council should not borrow in the future. It is more a question of how, why and when Council take debt on. Councils that are producing viable underlying operational results and are in a position of financial strength can and should seriously consider taking on debt to build major assets that they deem the community need. The only outstanding consideration is the community's preparedness to pay and whether they perceive the value of the project being equal to or greater than the associated cost of the project.

Loans should never be raised for operational expenses. Nor should loans be used to fund capital expenditure that is considered to be recurrent in nature such as infrastructure asset renewals. That is, unless it can be clearly shown that the cost savings in future financial years will exceed the cost of financing the loan. Loans should only fund one-off type expenses, such as major capital works projects, or an extenuating one-off event, such as an unfunded superannuation call.