



AGENDA APPENDIX
Council Meeting
Wednesday 17 December 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.7 LONG TERM FINANCIAL STRATEGIES

Appendix 1 – Long Term Financial Strategies



*SOUTH GIPPSLAND
SHIRE COUNCIL*

Long Term Financial Strategies

(17 December 2014)

Table of Contents

Executive Summary	3
Background information	8
The financial challenge.....	8
External strategic considerations.....	9
Internal strategic considerations.....	9
Format of strategy discussions and usage of graphs	11
Financial Strategies.....	12
1. Comprehensive Income Statement (Operating Result) & (Underlying Operating Result)	12
2. Balance Sheet.....	17
3. Statement of Changes in Equity	21
4. Cash Flow Statement.....	26
5. Cash Flows from Operating Activities	30
(Service Delivery)	30
6. Cash Flows from Investing Activities	36
(Infrastructure Strategy Capital Works)	36
7. Cash Flows from Financing Activities	43
(Borrowing Strategy)	43
8. Fees and Charges.....	50
9. Rating strategy	52
Appendices.....	56
Appendix A – Original financial strategies	56
Appendix B – Previous year’s financial strategies	58
Appendix C – Financial performance indicators	60

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 two years significantly changed. This is primarily due to the end of the mining investment boom. Forward taxation revenue estimates from the mining industry have been materially revised down. Also, the manufacturing industry in Australia has been impacted from the decision of major car manufacturers to cease producing cars in Australia. This has significant mid to long term structural reform implications for the Australian economy.

The Federal Government is 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. This has and will have a flow on impact for the local government sector. This is evidenced by the Federal Government’s decision to freeze indexation on financial assistance grants to local government for three years to 2016/17.

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. The mandatory Local Government Performance Reporting Framework was introduced by the State Government commencing 2014/15. This reporting framework focuses 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;
- Unfunded superannuation funding calls made in 2003, 2010 and 2013; and
- Commonwealth government freezing the level of financial assistance grant provided to local government for 3 years to 2016/17.

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 was as a result of repaying portion of the defined benefit superannuation funding call liability 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. Longer term projections indicate that Council will again be considered a low risk.

The financial sustainability of Council's 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 that assesses the financial integrity of the budgeted financial statements in the Long Term Financial Plan that was adopted by Council as part of the 2014/15 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. Longer term, the projections are very sound.

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.

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 the strategic objectives of the Council, strategies for achieving the objectives and strategic indicators for monitoring the achievement of the objectives.

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.

Financial plans not only have to be 'sustainable', they also have to be financially 'affordable' for the ratepayers and community.

From an internal management perspective, the greatest challenge Council faces is defining its service level requirements and funding them in a financially 'sustainable' and 'affordable' manner. Council has to be mindful of the preparedness and affordability of its ratepayers to pay rates and charges for a given level of services. 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.

The Long Term Financial Plan seeks to efficiently and equitably accommodate ongoing funding requirements of existing and new or enhanced levels of service. The Long Term Financial Strategies provide strategic guidance in developing Annual Budget's, 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.

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 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, Loan Reserve excepted.**
- 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, upgrade and expansion capital work proposals in the first four years of the Long Term Financial Plan 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 #6 has been refined to remove reference to allocating equivalent to the average interest earned to the General Reserve when it is financially viable to do so. Also, transfers equivalent to the average interest earned will be made to all reserves, Loan reserve excepted.
- Strategy #11 has been refined to align the asset expenditure types as described in the Local Government (Planning and Reporting) Regulations 2014 as well as clarify which years that are expected to include detailed lifecycle costs.

All the remaining financial strategies remain unchanged.

The balance of this paper is divided into three sections:

- The first section 'Background Information' describes Council's financial challenges including external and internal strategic considerations.
- 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 describes each financial performance indicator.

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'.

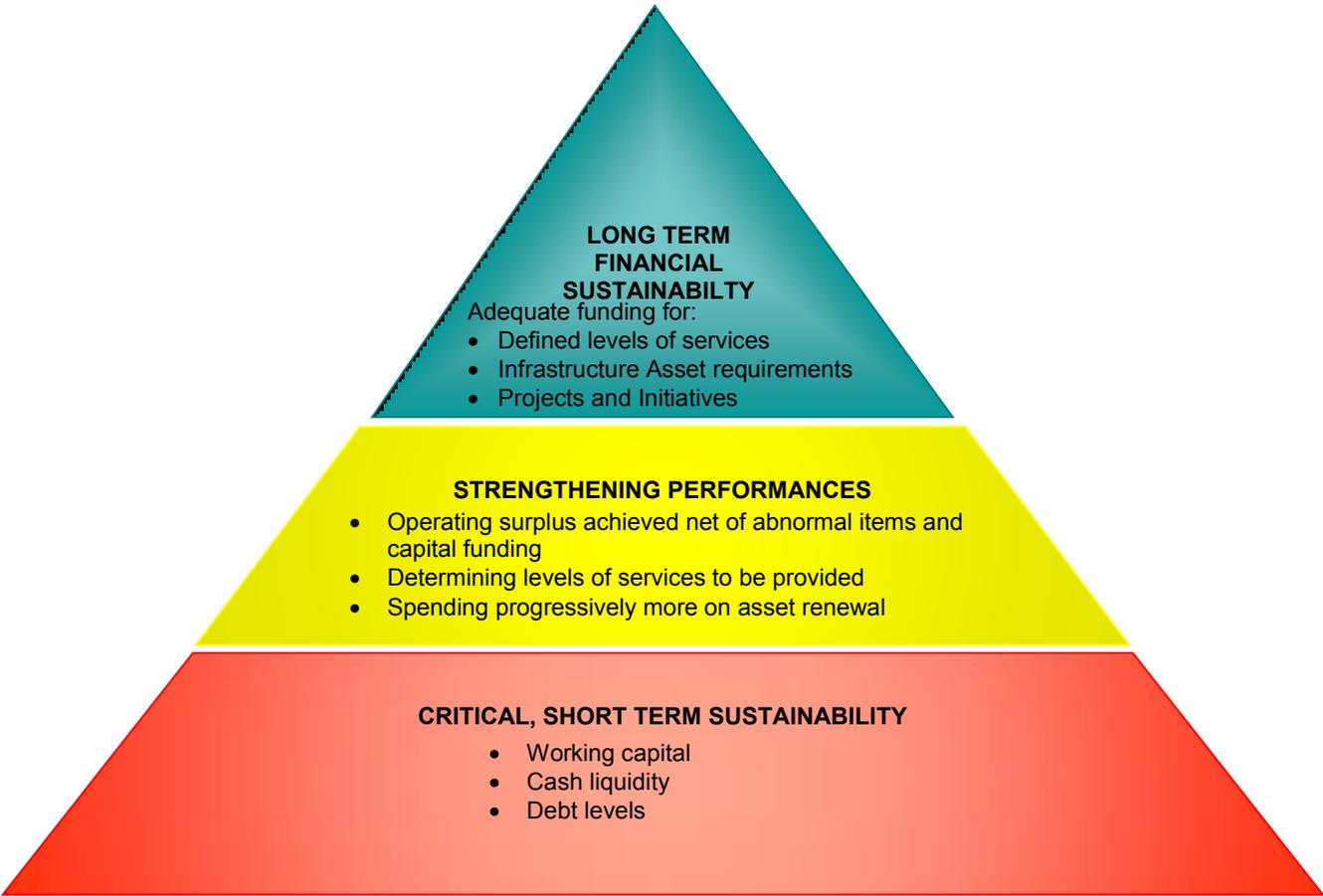
BACKGROUND INFORMATION

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 objective has to be structurally sound before attempting to progress up to the next tier. 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 updating service level and asset management funding requirements into annual and longer term budgeted financial statements, adhere to the financial strategies. The resulting financial plan should then be structurally sound that can be validated by reference to key financial performance indicators.

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

The Australian economic landscape has in the last two years significantly changed. This is primarily due to the end of the mining investment boom. Forward taxation revenue estimates from the mining industry have been materially revised down. Also, the manufacturing industry in Australia has been impacted from the decision of major car manufacturers to cease producing cars in Australia. This has significant mid to long term structural reform implications for the Australian economy.

In coming years it is anticipated that Australia will experience a positive but relatively flat profiled economic flow on from the Asian economies, in particular China and India.

The Federal Government is 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 will 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

This is evidenced by the Federal Government's decision to freeze indexation on financial assistance grants to local government for three years to 2016/17. The 2014/15 Annual Budget process had to allow for the Federal Government's decision to freeze indexation on financial assistance grants to local government for three years to 2016/17. As a result, Council will receive \$1.5 million less over 5 years, \$3.9 million less over 10 years and \$6.5 million less over 15 years.

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. The mandatory Local Government Performance Reporting Framework was introduced by the State Government commencing 2014/15. This reporting framework focuses on service performance, financial performance and sustainability of all Victorian councils.

Internal strategic considerations

The Long Term Financial Plan that was first developed in 2003/04 and the following few years dictated funding levels available for services 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 for service level and asset management requirements 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 13th 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's Long Term Financial Plan is financially sustainable. Council over the years progressed from actually achieving its first tier financial objective and began addressing second tier financial objective. It is now in a position to also begin to establish footholds in the third tier objective, particularly in relation to identifying specific level of service requirements.

That is having sufficient funds for a defined level of services, infrastructure asset management requirements and for projects and initiatives proposals.

Financial plans not only have to be 'sustainable', they also have to be financially 'affordable' for the ratepayers and community.

From an internal management perspective, the greatest challenge Council faces is defining its service level requirements and funding them in both a financially 'sustainable' and 'affordable' manner. Council has to be mindful of the preparedness and 'affordability' of its ratepayers to pay rates and charges for a given level of services. 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 internal Service Reviews for all Council departments. From this exercise it is now proceeding to implement a rolling program of investigating the process of shared services and services levels for all departments. Any financial ramifications from these reviews will be updated into the Long Term Financial Plan. Any productivity savings identified throughout the year will be quarantined and strategically considered in the annual budget process. In 2013/14 Council identified \$138,000 recurrent productivity savings.

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.

Reduced grant funds from external sources will put even further pressure on relying on rate income to fund its service level requirements. Coming years may require a shift in strategic thinking to assess what levels of services can be provided for a given maximum rate rise.

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.

Wherever possible graphs are utilised to help illustrate or explain the 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 August 2014.

For reasons of practicality, only the past 5 years previous financial plans are shown on the graphs, despite strategic plans being prepared now for 12 years. They serve to clearly demonstrate an important point. That is, to show the consistency and parity between the plans over a number of years. The graphs also include past years financial plan data, actual financial results as well as the current Long Term Financial Plan.

Due to the number of years that Council has been producing strategic Long Term Financial Plans, it would be impractical to show any more than the five previous years.

Additional graphs with less busy data are also provided to assist the reader in evaluating financial performances and forward plans. 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.

FINANCIAL STRATEGIES ---

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 2013/14 was \$17.08 million which included the roads, streets, kerb & channel, land, buildings and drainage asset class revaluation adjustments. The net asset revaluation increment in the prior 2012/13 financial year was \$nil. This provides distorted financial results from one year to the next.

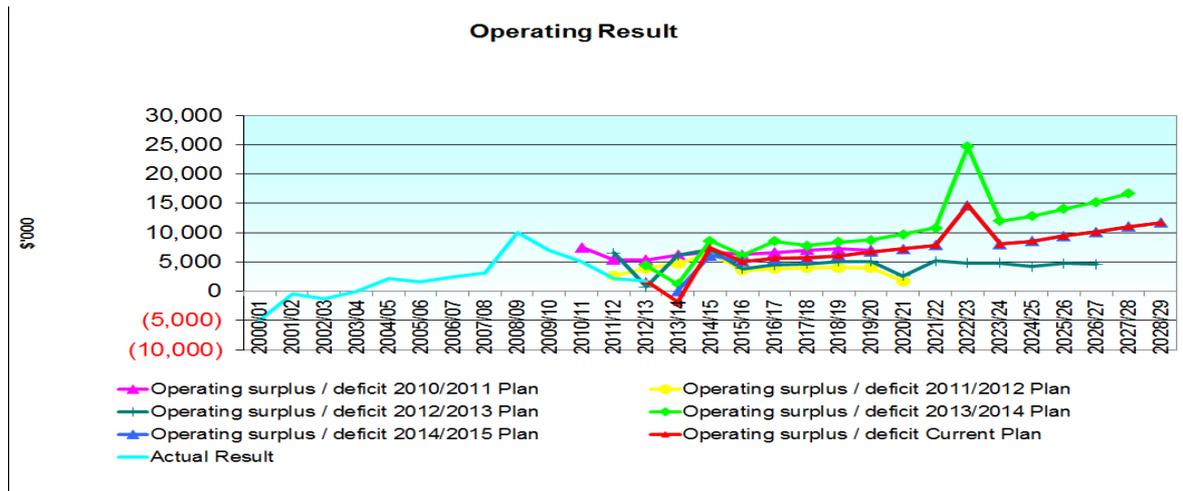
Operating result

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

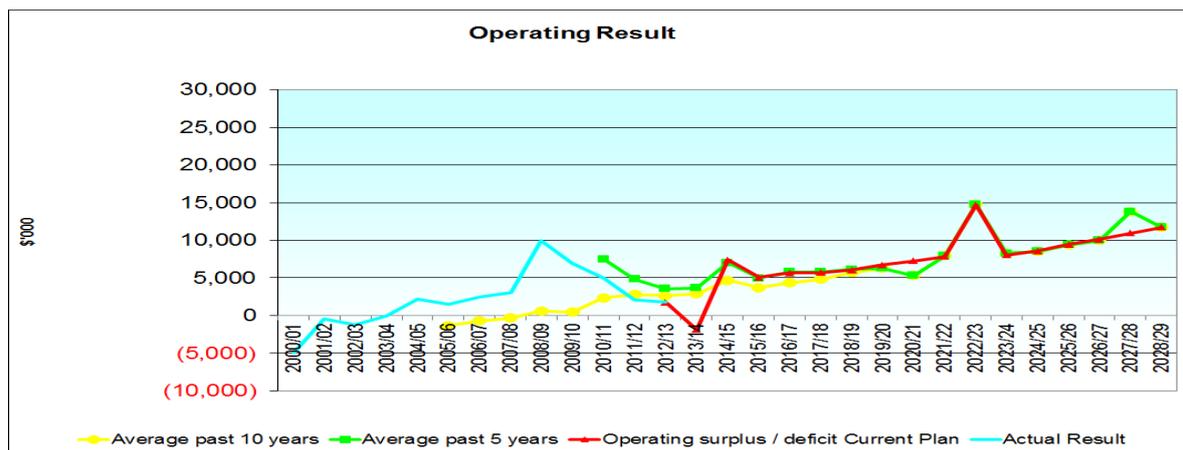
To be able to provide a given level of recurrent services, (which includes some services that are significantly dependent on infrastructure asset such as transport) it is important to achieve consistent surplus operating results on a yearly basis. Surpluses create a funding source for 'recurrent' capital works renewal requirements.

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 2013/14. The red line shows 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. Council has been successful in doing so with the exception of the last few years where the actual operating results have trended down. This reflects the tightening fiscal environment that Council has had to

operate within. The dip in 2013/14 and spike in 2014/15 is as a result of timing differences associated in receiving income.

The favourable forward projections are due to the compounding impact of rate rises 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 increased capital expenditure program is highly dependent on the income streams. The developer contributions and associated capital works program will be reviewed during the forthcoming 2015/16 capital works review process.

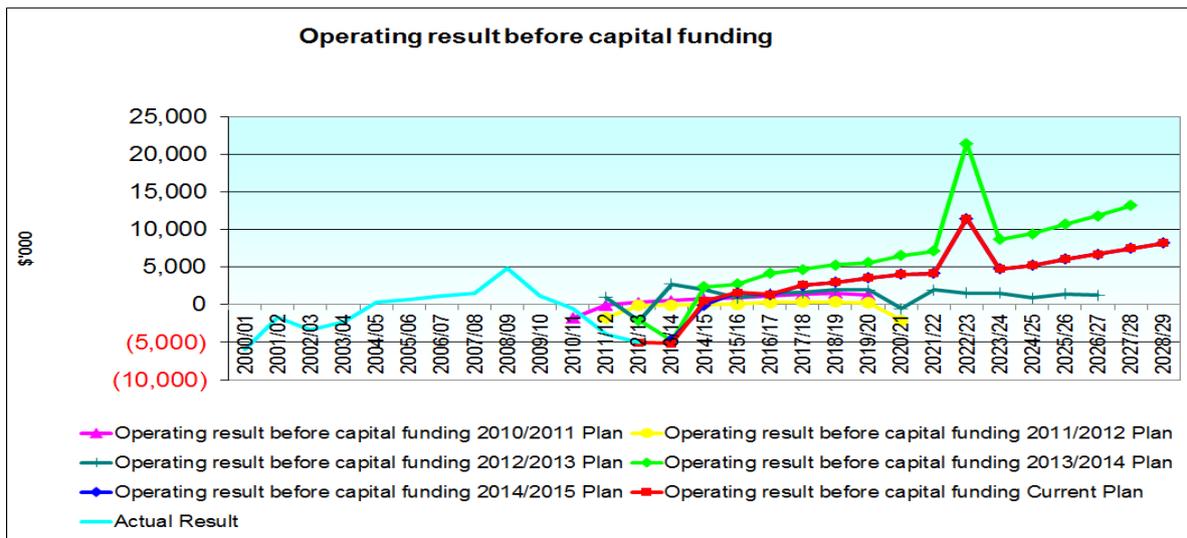
The spike in 2022/23 is attributable to expecting to receive \$7.15m Special Charge Income for a major roads and drainage project.

Underlying operating result

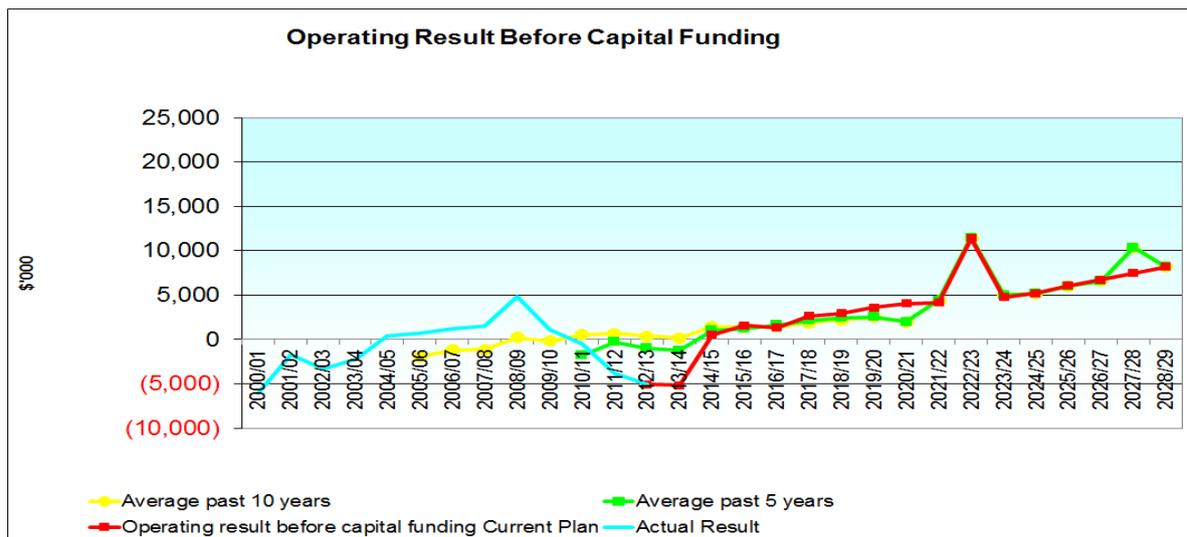
Capital income funding sources from grants, capital cash contributions and gifted assets are recognised in the Income Statement. This has the tendency to make operating results look stronger than they actually are. The reason is that capital income is reflected in the Income Statement whereas the matching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

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 following graph shows 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 2013/14. The red line shows the current budget 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.



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 improvement in forward years budgets relative to previous financial plans is largely attributable to the compounding impact of supplementary rate income projections.

The spike in 2022/23 is when Council expects to receive \$7.15m 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. If this income is not realised, the project will not proceed.

Revised Strategy (no change)

- 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 contributions of non monetary assets (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 its 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 which gives it the ability to deal with unexpected or unforeseen unavoidable situations and other strategic opportunities that present from time to time. The financial capacity or savings can also be quarantined to internal reserves as a restricted asset.

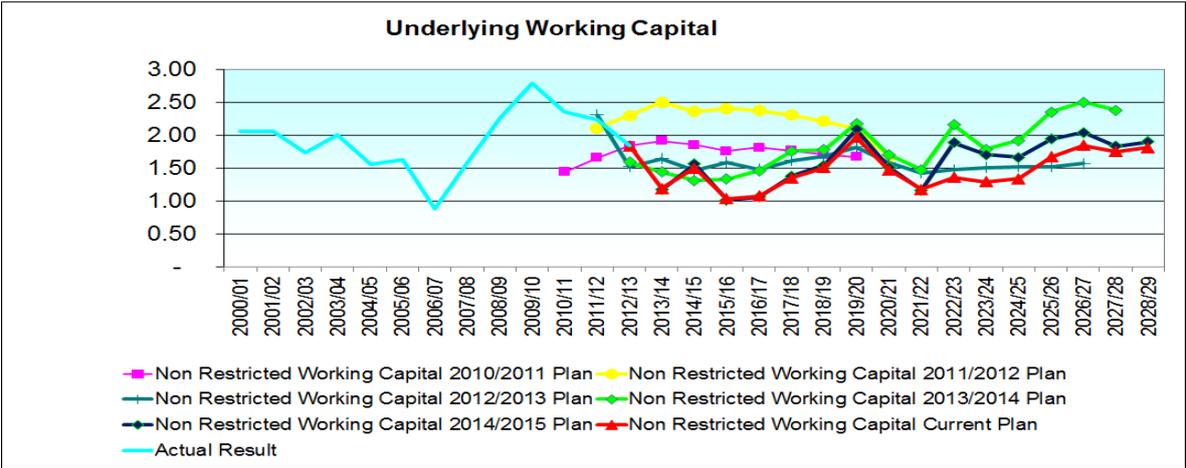
Council has a number of cash backed internal reserves that are expected to grow over the coming years. The inclusion of the cash backed reserves has a positive but somewhat distorting impact on the working capital ratio. The internal reserves represent funds that have been set aside for specific requirements.

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 underlying working capital ratio excludes funds that have been set aside to internal reserves. Funds set aside in internal reserves are restricted assets. The financial strategy was revised accordingly.

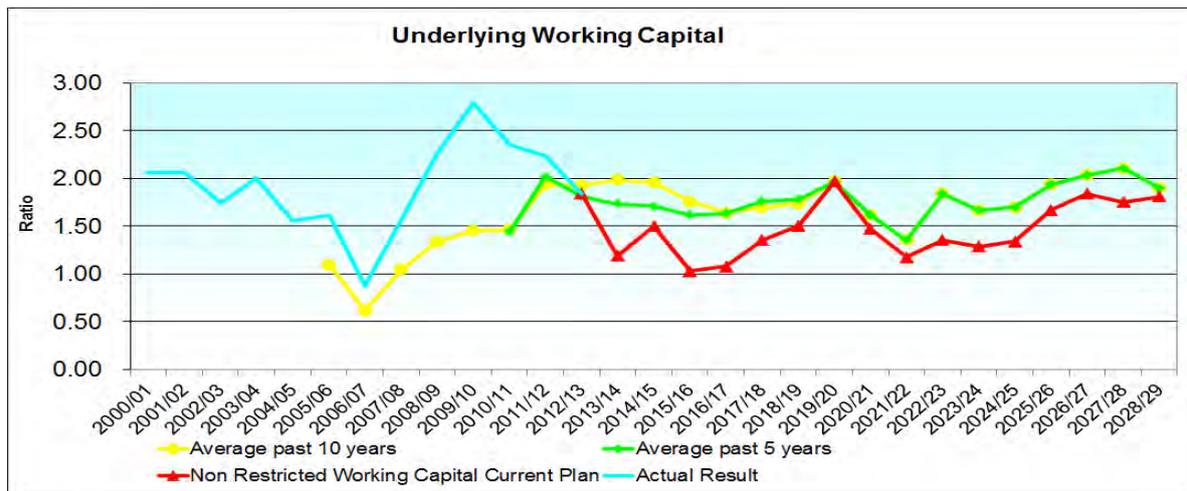
This compliments the underlying operating result strategy. The ratio was set at 1.5 to 1. This provides a degree of flexibility to be able to both prudently and strategically manage unexpected events and opportunities that occur from time to time.

The underlying working capital ratio is a very stable financial performance indicator. It ensures that funds are released in a financially responsible manner for recurrent operational and asset funding 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 2012/14. The red line shows 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 spike in the recent years' actual underlying working capital ratio is largely due to timing differences of receiving income and incurring expenses between different financial years. The downward trend in underlying operating results in the immediate preceding years' has had a considerable adverse impact on the underlying working capital ratio going forward for a few years.

The forward budgets in the Long Term Financial Plan show this strategic concern being addressed. Strengthening underlying operating performances have positive 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 Council will have progressively increasing levels of financial capacity. Longer term the projections look favourable but they should be viewed with caution. Council's current position is to plan to provide strategic capacity for major works in future years.

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 and Council is comfortable with its mix of recurrent services.

It is worth noting that the Victoria Auditor General Office state that ratios between 1 and 1.5 to 1 require caution with cash flows because issues may arise in being able to meet obligations. Ratios in excess of 1.5 to 1 should not present issues.

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 1.0% of rate income are made to the general reserve.

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.

Revised Strategies (Amendment made to strategy 6)

- 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, Loan Reserve excepted.**

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 impacted 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 are considered 'restricted assets' and consist of:-

- General Reserve;
- Caravan Park Reserve;
- Corner Inlet Seawall Drainage Reserve;
- Accommodation Reserve; and
- Loan 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 Long Term 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 fourth strategy deals with annual interest top ups equivalent to the average interest earned on investments during the financial year being made to the reserves.

A refinement was made in 2013 to extend interest 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 and is reflected in the current Long Term Financial Plan.

Minor amendments are proposed for this strategy. The first is to remove reference to allocating equivalent to the average interest earned to the General Reserve when it is financially viable to do so. Secondly, the only reserve not to have transfers equivalent to the average interest earned on investments made to it is the Loan Reserve. The rationale being that specific annual 'lump sum' allocations are made to the Loan Reserve on an annual basis to ensure that when the loan becomes payable there is the exact monies on hand in the cash backed reserve.

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

Unfortunately in coming years future funding calls are anticipated. The Australian Prudential Regulation Authority (APRA) introduced a new Prudential Standard (SPS 160) for assessing funding requirements of defined benefit plans. The key impacts of this new standard include:

- The Vested Benefits Index (VBI) is the only relevant measure;
- VBI will be measured quarterly; and
- Unfunded liabilities must be paid within three years.

Simply, the VBI measures the market value of assets in a defined benefit portfolio against the benefits that members would have been entitled to if they had resigned on the same day.

If the VBI is below the minimum required level, a restoration plan is required to restore the VBI within the next three years. If the funding does not improve as expected, additional contributions may be required within this three year period.

As markets fluctuate, Victorian councils have been advised that there is a possibility of more frequent, but smaller, unfunded liabilities arising.

This emphasises the importance to strategically replenish the General Reserve as soon as is reasonably possible to do so. Council estimates that it would have \$707,000 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.

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 a highly unlikely situation.

Planning ahead

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

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%). If Council had some financial capacity in the later years of the Long Term Financial Plan the term of the loan could be further reduced, further minimising its finance costs.

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 back up its General Reserve.

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 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.

Revised Strategies (Amendment made to strategy 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, Loan Reserve excepted.**

<p>Summary of changes / refinements made Strategy # 6 has been refined to remove reference to allocating equivalent to the average interest earned to the General Reserve when it is financially viable to do so. Also, transfers equivalent to the average interest earned will be made to all reserves, Loan reserve excepted.</p>
--

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.

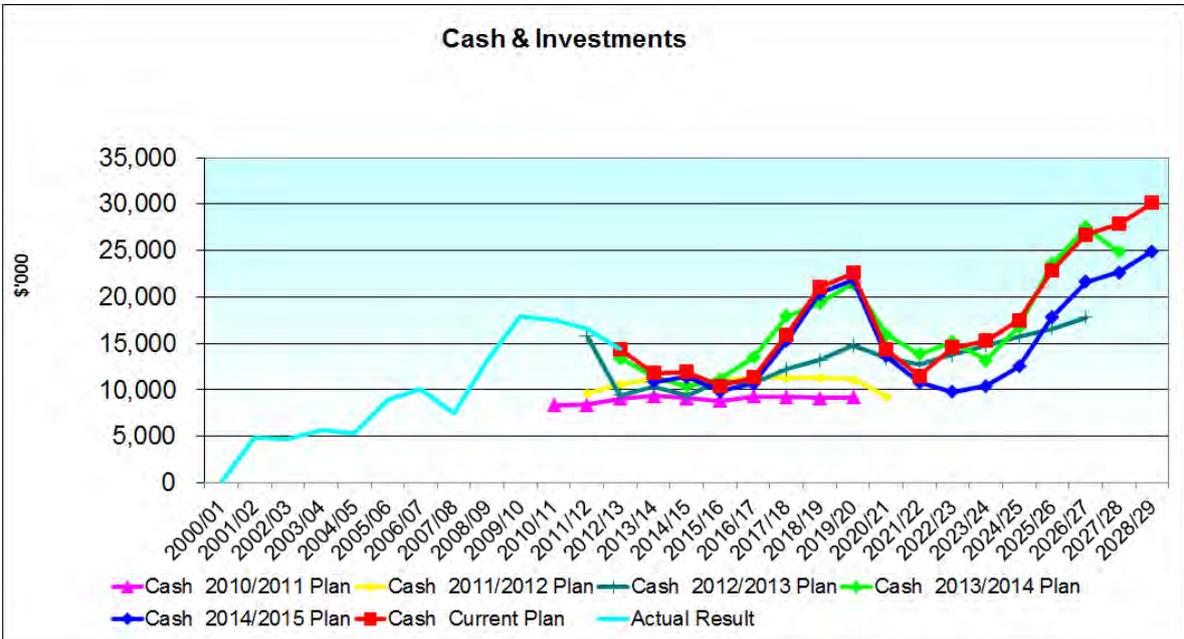
Revised Strategy (no change)

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.

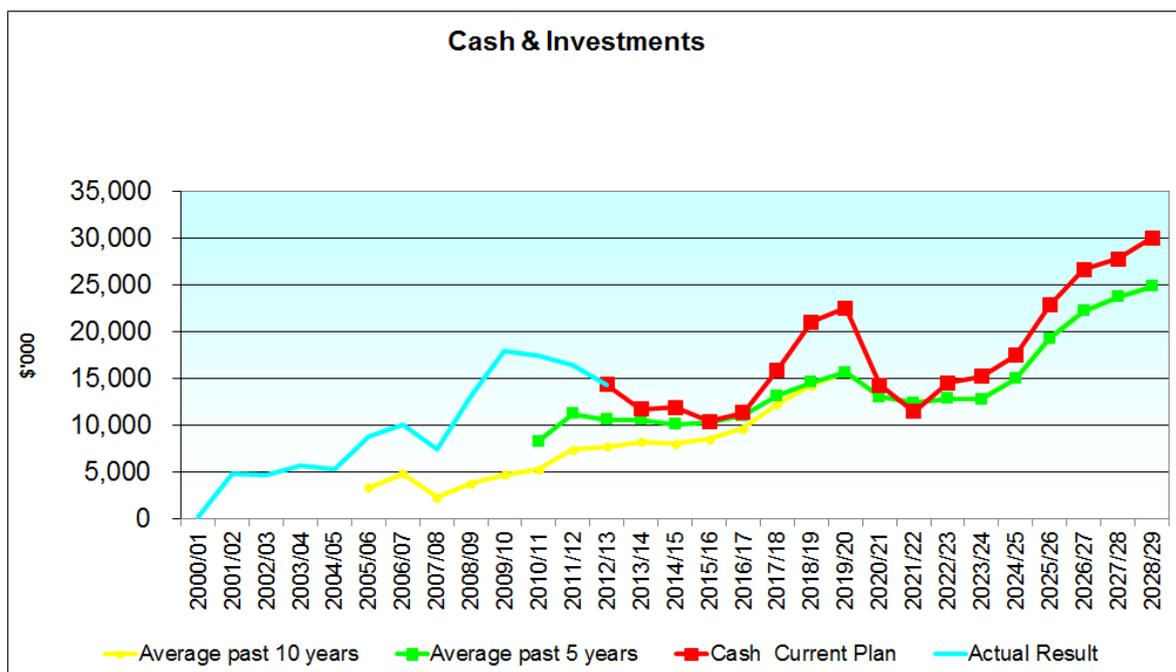
The Cash Flow statement is the final of the four key financial statements.

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 2013/14. The red line shows 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.

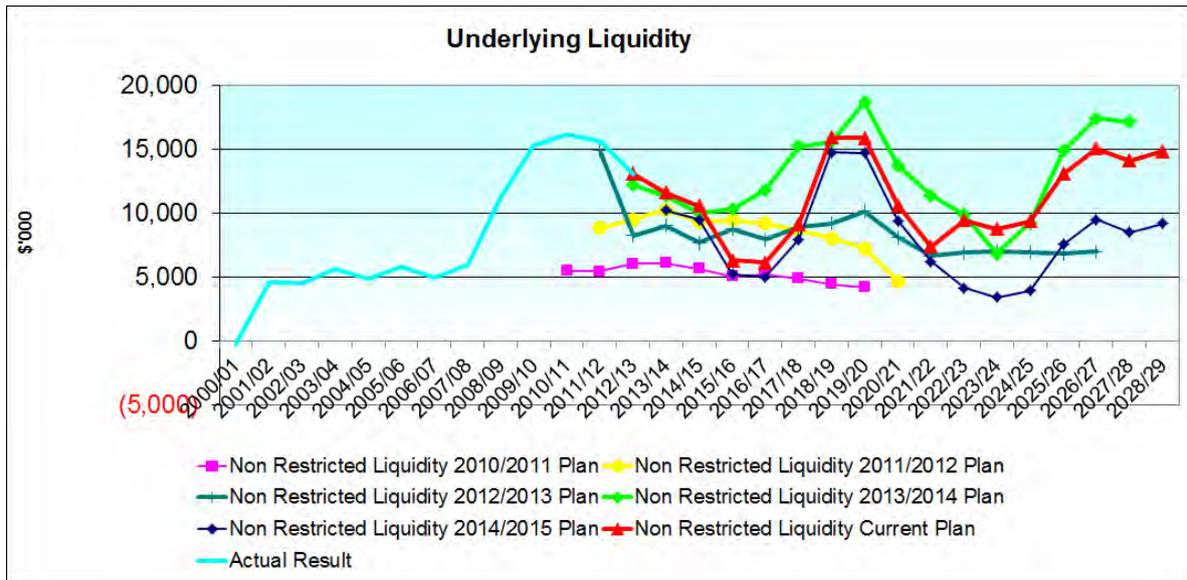


The strengthening of underlying operating results in the forward budgets has a favourable longer term impact on Council's cash and investment position. The mid-term projection addresses the gradual downward trend of cash that had been occurring in the immediate preceding years. The longer term projections 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 developer contribution income.

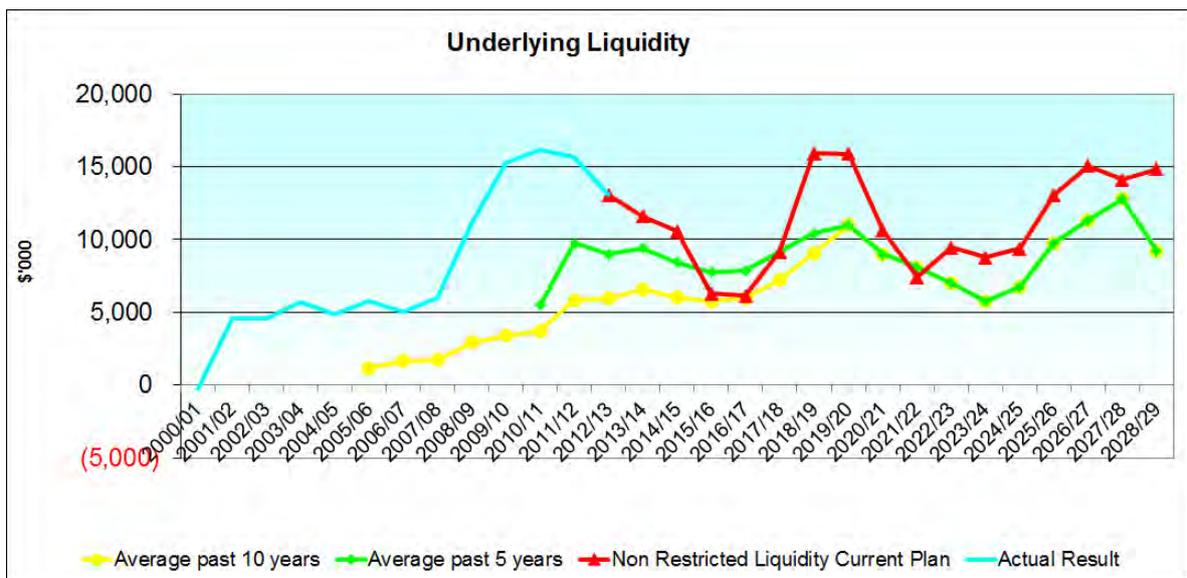
Underlying cash position

When analysing cash, it is prudent to back out the amounts that have been allocated to various internal reserves and trust fund liabilities 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 trust fund liabilities are monies held on behalf and repayable to third parties.

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 2013/14. The red line shows 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 longer term projections look favourable. 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 inflows 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 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. 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.

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.**

5. 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:

- 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%

Service levels

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

Council, through its Council Plan and Annual Business Plans determines 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. 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 faced and needed to address.

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 being infrastructure centric. 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.

It is important to note that infrastructure assets solely exist and are required for some services. 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.

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.

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 and service levels for all departments.

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.

Reduced grant funds from external sources will put even further pressure on relying on rate income to funds its service level requirements. Coming years may require a shift in strategic thinking to assess what levels of services can be provided for a given maximum rate rise.

Financial Performance Indicators

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.

The Victorian Auditor General Office (VAGO) 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 their financial performance and sustainability. VAGO use a series of financial sustainability indicators when assessing and reporting on councils' financial viability in its annual report on Local Government audit results to Parliament.

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 and working capital performance indicators are examples of technically more sound indicators that Council uses.

The financial performance indicators 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 VAGO, Local Government Victoria and the Australia Loan Council in setting thresholds and tolerances for the key financial performance ratios.

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.

A mandatory Local Government Performance Framework has been introduced by the State Government in 2014/15. The Financial Performance Indicators are detailed in the Local Government (Planning and Reporting) Regulations 2014 and disclosed in the 2014/15 Annual Budget document.

Interestingly there are some variations between some of the financial performance indicators that VAGO, Local Government Victoria (LGV) and South Gippsland use.

These include:

Underlying result: - measurement of recurrent income and expenditure costs.

- VAGO's indicator backs out contributions of non-monetary assets and net gain /loss on asset disposals;
- LGV's indicator backs out contributions of non-monetary assets, non-recurrent capital grants and capital cash contributions;
- South Gippsland's indicator backs out contributions of non-monetary assets and all capital grants.

Backing out all capital funding irrespective of it being recurrent or one off provides a better (and more stable) match of recurrent income to recurrent expenses. There is merit to also include backing out capital cash contributions. The underlying result financial performance indicator for the current and future years has been altered accordingly. The impact on the indicator result is not material, it is however more technically correct in matching recurrent operating income to recurrent expenditure.

Sustainability index:- measurement of expenditure incurred renewing existing assets compared to annual depreciation costs.

- VAGO's indicator includes capital renewal and upgrade expenditure in its index calculation;
- LGV's indicator includes capital renewal expenditure in its index calculation;
- South Gippsland's indicator includes capital renewal expenditure in its index calculation.

It is interesting to note that some years ago Council realigned its sustainability index calculations to align with the VAGO index. The LGV index aligns with index that Council had some years ago prior to it being realigned to the VAGO index! There again is merit to consider changing back the indicator so as to not include upgrade expenditure. This would provide a more pure and stable form of expenditure effort over a period of time.

It is also worth noting that LGV has no less than 18 financial performance and sustainability indicators that Victorian councils have to report on annually. Along with the other 53 service performance indicators there is a real risk that many councils will view the performance reporting framework as a compliance exercise rather than as a strategic driving exercise.

It will however provide useful data for the State Government to assess councils by in coming years. It will also enable South Gippsland to self-assess and benchmark itself against other large rural councils.

VAGO's and South Gippsland have six and seven financial performance indicators respectively. These indicators are specific to both driving and analysing the financial integrity of budgeted and actual key financial statement performance.

It is anticipated that VAGO will be reviewing their current suite of financial sustainability indicators in the coming year. When this has been completed that South Gippsland will then consider whether it is warranted to modify Council's sustainable index indicator. Early indications are that VAGO will make minimal if any modifications to their existing suite of indicators.

The ratios, targets and thresholds established in the setting of the 2014/15 Annual Budget and the Long Term Financial Plan are shown below.

2014/15 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	2028/29
Financial performance																
Underlying result	-9.02%	-0.11%	2.81%	2.19%	4.13%	4.55%	5.27%	5.67%	5.55%	13.41%	5.83%	6.07%	6.75%	7.10%	7.6%	7.9%
Underlying Working Capital	1.17	1.56	1.01	1.06	1.38	1.54	2.09	1.52	1.17	1.89	1.70	1.66	1.94	2.04	1.84	1.90
Funding capacity																
Self-financing	15.76%	24.16%	25.00%	26.08%	26.85%	27.79%	28.04%	28.87%	29.78%	25.56%	31.39%	32.19%	32.59%	33.35%	33.84%	33.74%
Sustainability Index	108%	132%	136%	102%	92%	85%	90%	158%	98%	127%	128%	91%	113%	124%	138%	130%
Borrowing capacity																
Indebtedness	2.51%	10.28%	8.21%	8.11%	7.80%	1.23%	1.31%	1.40%	1.48%	1.40%	1.64%	1.71%	1.77%	1.84%	1.91%	1.97%
Total Debt as a % of Rate revenue	9.94%	9.39%	8.88%	8.41%	7.98%	7.59%	0.00%	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	0.25%	0.23%	0.25%	0.24%	0.23%	0.22%	0.00%	0.00%	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 August 2014. 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	2028/29
Financial performance																
Underlying result	-9.82%	0.67%	2.71%	2.19%	4.13%	4.55%	5.27%	5.67%	5.55%	13.41%	5.83%	6.07%	6.75%	7.10%	7.59%	7.87%
Underlying Working Capital	1.23	1.61	1.05	1.10	1.42	1.57	2.13	1.56	1.21	1.93	1.74	1.70	1.98	2.08	1.88	1.94
Funding capacity																
Self-financing	14.74%	24.84%	24.93%	26.08%	26.85%	27.79%	28.04%	28.87%	29.78%	25.56%	31.39%	32.19%	32.59%	33.35%	33.84%	33.74%
Sustainability Index	98%	143%	136%	102%	92%	85%	90%	158%	98%	127%	128%	91%	113%	124%	138%	130%
Borrowing capacity																
Indebtedness	2.42%	10.18%	8.14%	8.02%	7.72%	1.15%	1.23%	1.33%	1.41%	1.34%	1.57%	1.65%	1.72%	1.79%	1.86%	1.92%
Total Debt as a % of Rate revenue	9.94%	9.39%	8.88%	8.41%	7.98%	7.59%	0.00%	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	0.23%	0.23%	0.25%	0.24%	0.23%	0.22%	0.00%	0.00%	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. The rolling budget adjustments show future years' financial ramifications of decisions or from uncontrollable cost events that may occur throughout a financial year.

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%**

6. 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 (Amendment made to strategy 11)

- 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, upgrade and expansion capital work proposals in the first four years of the Long Term Financial Plan 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 \$600 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 \$60 million. This revenue stream is disproportionately 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 sector.

The sustainability indicator

In the last decade 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. What was anecdotally known was that Council had not been spending enough on renewing its infrastructure 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.

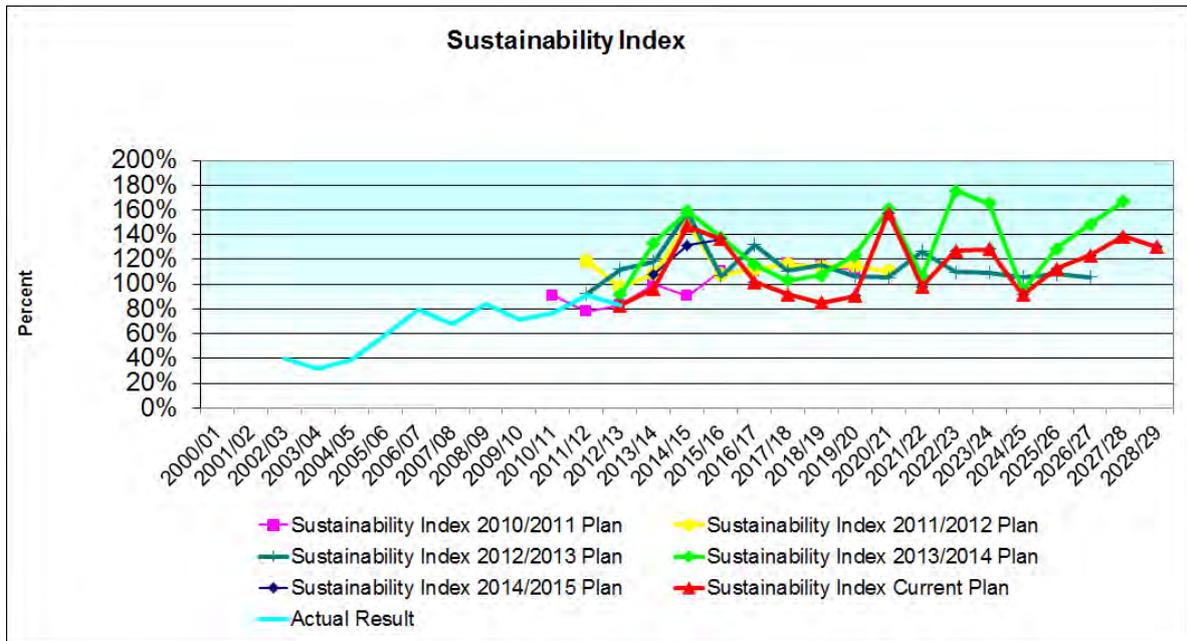
The strategy's 'spend effort' was expressed in a calculation called 'sustainability indicator'. This sustainability indicator assessed the amount spent in renewing infrastructure assets on an annual basis and compared it to the proportion of the total asset value consumed (equivalent to the annual depreciation charge). If the amount spent on renewing assets was increasing 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. In prior years Council 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.

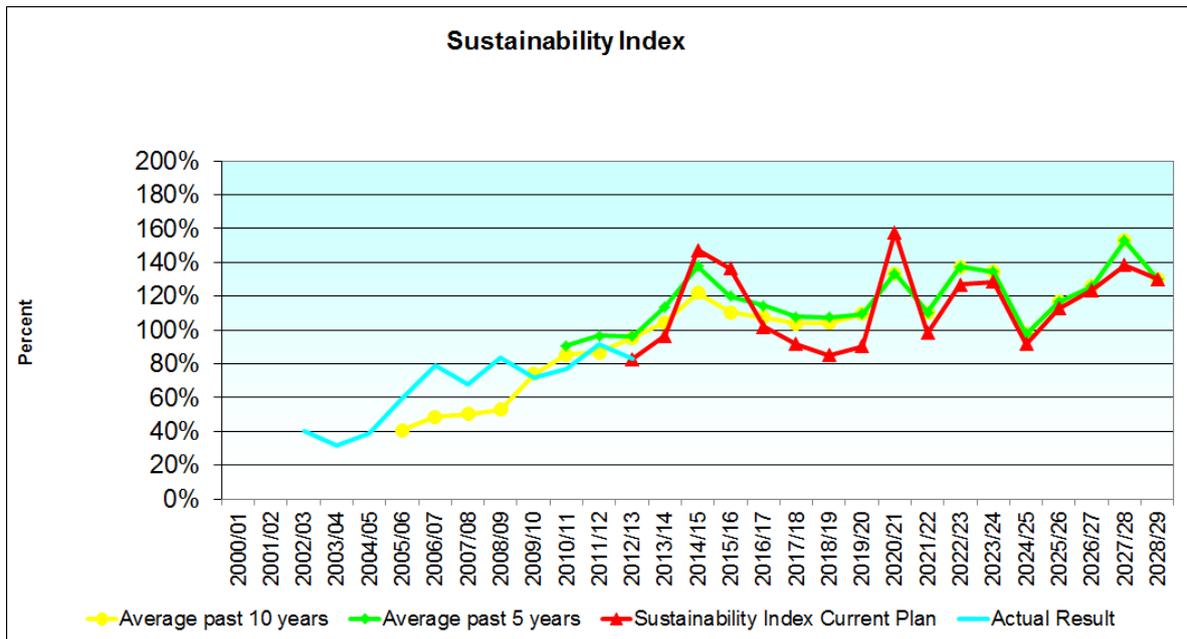
The Victorian Auditor General Office (VAGO) had for a number of years compared the rate of expenditure on infrastructure 'renewal' 'upgrade' and 'extension' works with annual depreciation charges. For 2008/09 financial audits VAGO introduced a more targeted indicator that measures the 'renewal' and 'upgrade' expenditure with the annual depreciation charge. It focused on capital expenditure on existing assets and ignored expenditure on new assets. It also 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 Local Government Performance Reporting Framework 'Asset Renewal' indicator introduced in 2014/15 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 Local Government Victoria 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 2012/14. The red line shows the current financial plan forecasts. The other coloured lines depict previous 5 years financial plans.



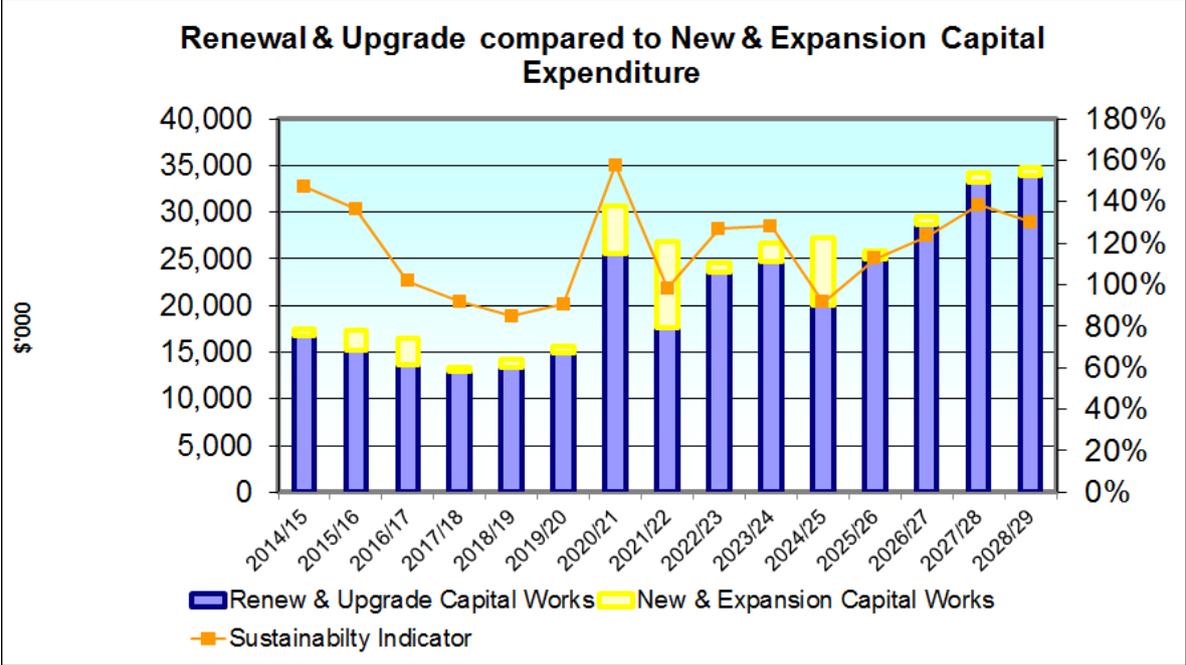
The second graph aggregates the previous year plans. The yellow line shows the aggregate for the past 10 years' financial plans and the green line the past 5 years financial plans. The light blue line (actual financial results) and red line (current financial plan) are exactly the same as the first graph.



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 bar chart and 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.

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. It is still retained as a key financial performance indicator.

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

South Gippsland is fortunate that there are no asset renewal primary funding gaps for all major classes of assets. There are adequate funds allocated in the Long Term Financial Plan for recurrent cost requirements for all major asset classes current defined service levels as documented in Asset Management Plans.

The second strategy states that any such expenditure proposal must include a lifecycle cost evaluation. This includes identifying the assets construction, maintenance and operating cash flow requirements as well as the depreciation impact.

Asset expenditure on 'new' or 'expansion' assets should be expected to be identified to specific jobs over a four year period and be supported by a business case that details lifecycle cost requirements and align with Council Plan objectives.

Asset expenditure budgets on 'new' or 'expansion assets in the following 5 to 15 years can either be:

- Identified to specific jobs supported by a summary business case that references back to a Council Plan strategic objective; or
- Have non-specific pools of 'funding capacity' allocated if it is seen to be supporting longer term Council Plan Strategic objectives.

The rationale for providing funding capacity in later years of financial plans is that major project proposals that run into many millions and in some instances 10's of millions of dollars tend to have long lead times. It is not unusual for the larger projects to have a 5 to 10 year lead time.

Council has taken a position that it more likely than not wishes to have the capacity to undertake major works in future years. The strategic message being that it more likely than not it will undertake major works in future years and wishes to minimise future finance costs of borrowing funds.

This also provides some strategic flexibility to consider 'new' project proposals over and above what is in the current Long Term Financial Plan and minimise the costs and as a result the overall rate burden.

Following on from the example provided earlier (*page 24 – Statement of Changes in Equity– Planning ahead*):- Recapping, 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%).

Further, if Council had some financial capacity in the later years of the Long Term Financial Plan the term of the loan could be further reduced, further minimising its finance costs. For example if the term of the loan could be reduced to say 5 years instead of 10 years, the finance cost would be further reduced by \$843,000.

This strategy has been refined to provide further clarity lifecycle cost requirements as well as align the asset expenditure types ('new', 'upgrade' and 'expansion' with the asset expenditure types as described in the Local Government (Planning and Reporting) Regulations 2014.

Planning ahead

It would not be unreasonable to assume that the community might wish to have additional and / or higher levels of service than is currently being provided. This being the case it would effectively create a 'secondary funding gap' that will 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.

Council would have to consider the financial implications of undertaking additional expenditure over and above what has been currently allowed for in the Long Term Financial Plan.

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. Consideration is required of unlimited demands versus Council's limited financial resources and the opportunity cost of borrowing funds that will eventually need to be repaid.

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.

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.

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 Plans.

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).

Council's existing strategy in relation to utilising capital income for capital or 'one off' expenditure requirements remains intact.

Revised Strategies (Amendment made to strategy 11. No change to the other strategies)

- 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, upgrade and expansion capital work proposals in the first four years of the Long Term Financial Plan 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.**

Summary of changes / refinements made
 Strategy # 11 has been refined to align the asset expenditure types as described in the Local Government (Planning and Reporting) Regulations 2014 as well as clarify which years that are expected to include detailed lifecycle costs.

7. 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.

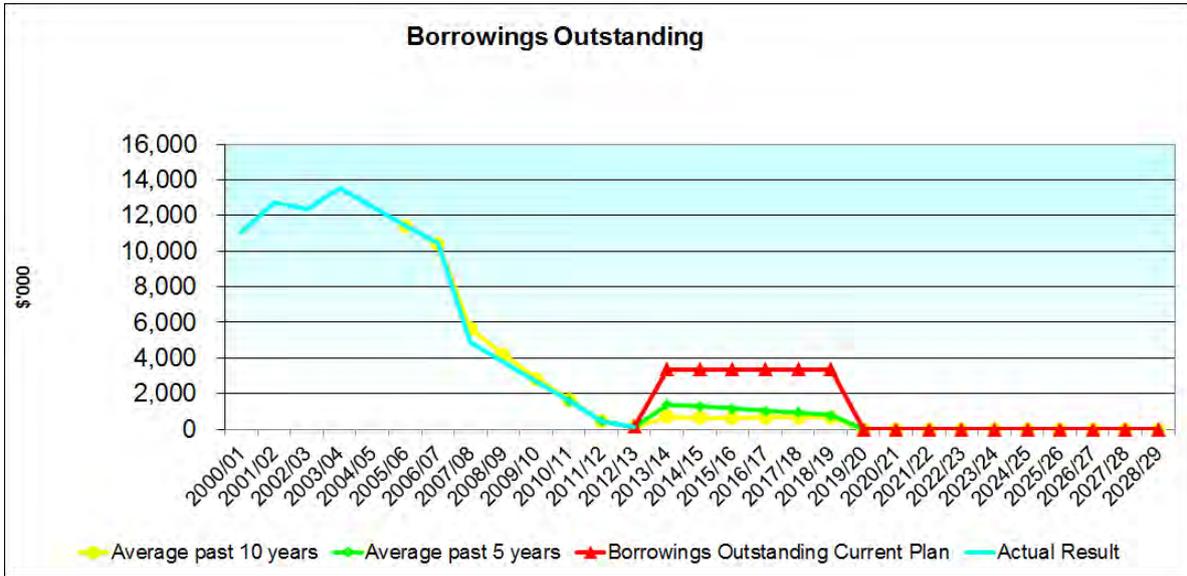
Since council amalgamations in 1994 through to 2003/04 Council had borrowed for a variety of reasons, including financing relatively large infrastructure projects as well as paying superannuation liabilities. In 2003/04 Council's outstanding borrowings peaked at \$13.5 million. At the same time, it had 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, 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. At 30 June 2014, Council had outstanding borrowings of \$3.35 million.

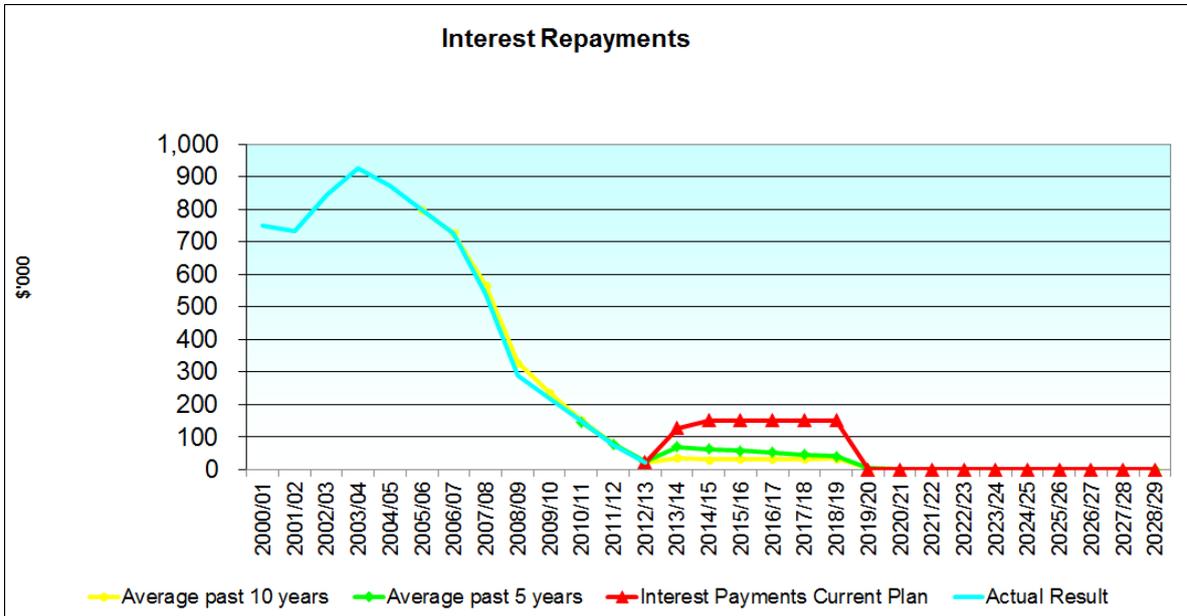
In May 2014 Council resolved to partake in a pooled borrowing vehicle named 'Local Government Funding Vehicle' to raise funding from a public bond market on behalf of participating councils. This will enable Council to refinance \$3.35 million over a 5 year basis. \$670,000 annually will be allocated to an internal reserve to ensure that Council has \$3.35 million on hand when the bond is payable in July 2019.

The graph 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 2013/14. The red line shows 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 2013/14. 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 cost in a typical principle and interest repayment loan 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 the majority of 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.

When raising funds from a public bond market, the amount raised becomes a non current liability. No repayment of principle owing is required till the end of the bond tenure. The total amount outstanding reverts to being classified as a current liability the year prior to it being payable. Analysis suggests that councils will benefit with approximately 50 to 75 basis points reduction in the interest rate when compared to a tender process undertaken with the banking sector. The reduced cash outflows when compared to a normal principal and interest payment arrangement would enable additional interest income on investments to be generated over the period of the bond.

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 has taken a much disciplined approach in considering financing requirements 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.

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. Commercial ventures that provide monetary returns are typically are financed by long term borrowings.

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 \$11 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 2.55%. (A 1% increase in rates equates to \$339,000). This on face value would appear very appealing. It would imply that the current projected rates and charges increase for 2015/16 could be reduced from 5.50% down to 2.95%.

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 new and extension works

The Long Term Financial Plan currently shows that Council has allowed expenditure in its forward budgets for capital upgrades, new and extension works that generally fluctuate between one to six million dollars per year. They are currently self-funded. If Council decided to borrow for such capital 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.

Council could consider instead undertaking additional works over and above what it has currently allowed for in its existing capital works program in the Long Term Financial Plan by borrowing funds. This would spread the cost burden over a number of years and 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. The critical issue is the preparedness of ratepayers to fund the paying back the borrowings over a number of years.

As discussed previously, Council could consider reducing the finance costs by borrowing short term if at all possible. This could be done by strategically taking into consideration any reserve fund capacity that it can avail itself to at the time the project is scheduled to commence as well as any longer term any available financial capacity that is in the later years of the financial plan.

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.

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 typically structured 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 0.6% 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.

In the commercial world borrowings are usually made for major asset acquisitions that provide a revenue stream for the business. Borrowing terms for these types of investments tend to be structured for prolonged periods of time. These types of borrowing structures provide a spread of costs against revenues over a number of years as well as tax benefits.

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 and later years financial capacity ought to be considered to minimise overall finance costs.

Referring to the previously used 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%). Again, if Council could borrow short (say 5 years) because it had financial capacity in the later years it could save an additional \$843,000 in finance costs.

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 if it has 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.

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.**

8. 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 established a committee to review Fees and charges for all services. This review was then 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 rate 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.**

9. 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.

As noted previously, the greatest challenge Council faces is defining its service level requirements and funding them in both a financially 'sustainable' and 'affordable' manner. Council has to be mindful of the preparedness and 'affordability' of its ratepayers to pay rates and charges for a given level of services. This has been an ongoing challenge for some years, not only for South Gippsland, but the local government industry.

Council has prepared a Rating Strategy 2014-2018 that changed the rating structure to achieve a more equitable distribution of the rate burden. The more significant changes include phasing out the Municipal Charge over two years, removing the costs associated with street sweeping and public litter bin collection from the waste charge, excluding lifestyle properties from the Farm differential rate, increasing the Vacant land, Commercial, Industrial and Cultural & Recreational differential rates and reducing the Farm differential rate over two years. As a result the amount of rates and charges paid by some property owners will increase whilst other property owners will experience a decrease

It is important to note that the terms of reference for the Rating Strategy specifically stated that it not consider the amount of total rates and charges revenue to be collected, nor to review cost effectiveness and efficiencies of providing Council services nor the merit or otherwise of the range of services and facilities provided by Council.

The determination of what level of rates and charges revenue is required is in fact driven by the Council Plan strategic objectives that in turn inform the Annual Business Plans and Asset Management Plans. These plans in turn drive the annual and longer term funding requirements of Council.

The funding requirements are captured and collated in budgeted financial statements in the Long Term Financial Plan. The Long Term Financial Strategies give guidance to ensure that the resulting annual and longer term budgeted financial statements are financially sustainable. The financial implications and in particular the impact on current and future rates and charges increases can then be strategically analysed.

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.

Reduced grant funds from external sources will put even further pressure on relying on rate income to funds its service level requirements. Coming years may require a shift in strategic thinking to assess what levels of services can be provided for a given maximum rate rise.

Financial plans not only have to be 'sustainable', they also have to be financially 'affordable' for the ratepayers and community.

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

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 indicators 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.

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. Long Term Financial Strategies enables both Annual Budgets and Long Term Financial Plans to both deliver on longer term Council Plan objectives in a financially sustainable manner.

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.

Long Term 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 26 March 2014.

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 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.

Appendix C – Financial performance indicators

Financial performance

Underlying Working Capital

Current assets / Current liabilities

Current assets as per Balance Sheet not including restricted assets quarantined to internal reserves

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 capital cash contributions 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.

Funding capacity

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.

Borrowing capacity

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 sustainability indicators that it uses to assess all Victorian Councils.