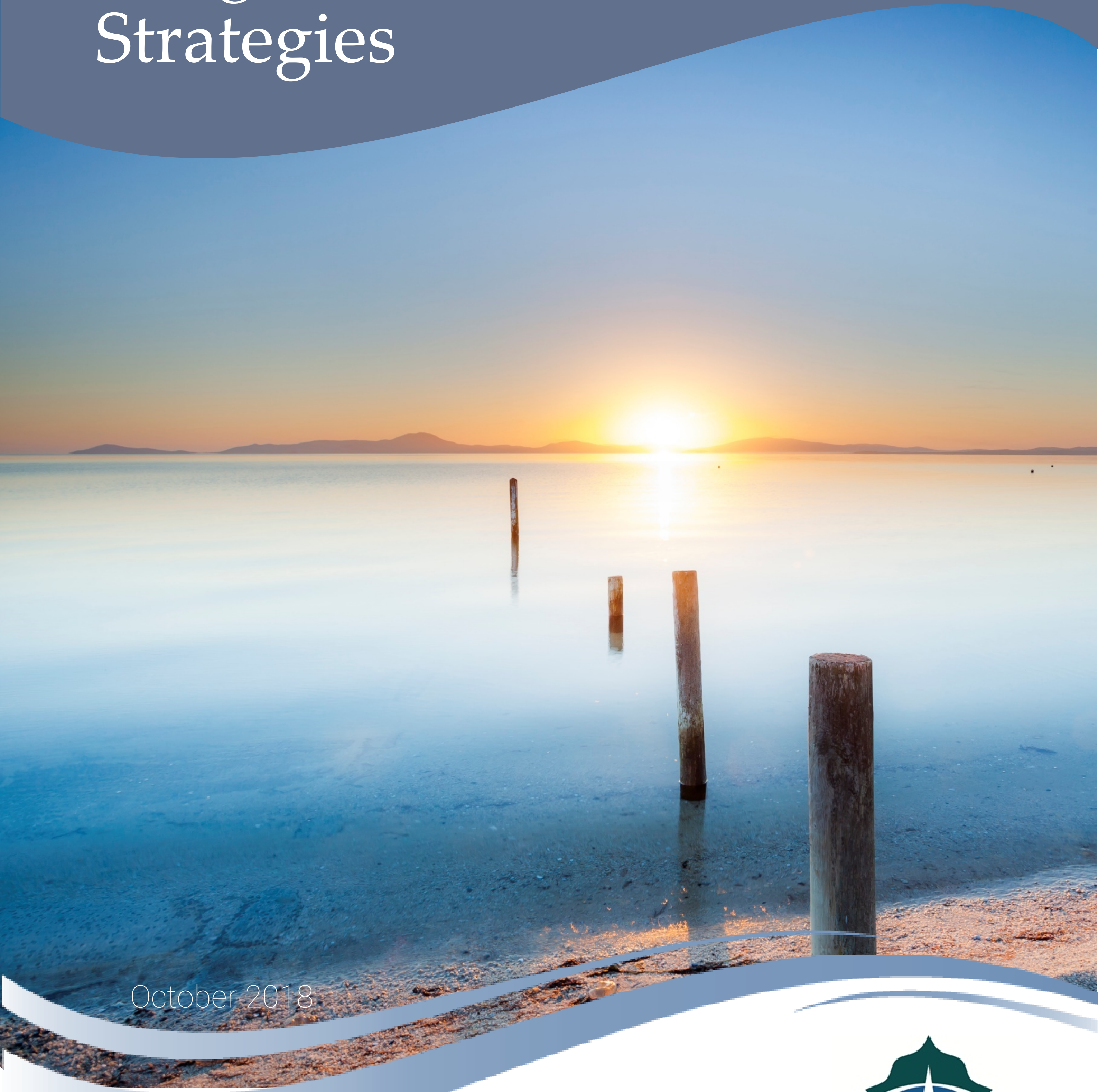
SOUTH GIPPSLAND SHIRE COUNCIL

Long Term Financial Strategies



October 2018

South Gippsland Shire Council

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Executive Summary

Council first developed a series of financial strategies prior to the development of the 2003/04 budget. Long Term Financial Strategies provide strategic guidance in developing Annual Budget's and Long Term Financial Plans. Since 2002/03, its overall financial performance has systematically and progressively improved over most years despite facing several financial challenges including:

- Significant operating losses and high debt in 2003;
- Global financial crisis in 2008/09;
- Unfunded superannuation funding calls in 2003, 2010 and 2013;
- Commonwealth government freezing the level of financial assistance grant provided to local government for 3 years to 2016/17; and
- State Government introducing rate capping in 2016/17 which sets out the maximum percentages by which councils may increase rates in a year.

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 a reasonable degree of stability in the level of rates burden;
- Ensuring decisions are made and actions taken with regard to their financial effects on future generations; and
- Accurate and timely disclosure of financial information.

The financial strategies are reviewed on an annual basis and are listed below. There have been no changes made to any of the financial strategies.

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 1.25 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 the end of a 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 1.25**
- **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 than 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 considers 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. Any services that undergo service level review process which have non statutory fees and charges will have those fees and charges identified to reflect their level of community benefit which clearly articulates the basis for the fee or charge relative to the service being provided.

17. 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 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 2018/19 Annual Budget process.

2018/19 Original Budget	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28	2028/29	2029/30	2030/31	2031/32	2032/33
Financial performance															
Underlying result	-4.47%	6.44%	7.62%	6.70%	7.21%	7.04%	6.79%	6.52%	6.11%	6.03%	5.77%	5.78%	5.97%	5.45%	7.2%
Underlying Working Capital	1.32	1.42	1.53	1.34	1.45	1.61	1.91	1.72	1.85	1.77	1.80	1.92	1.88	1.72	1.86
Funding capacity															
Self-financing	17.64%	32.82%	29.39%	27.36%	29.61%	27.15%	27.61%	29.41%	26.96%	26.19%	25.69%	25.63%	26.03%	25.73%	27.42%
Sustainability Index	208%	201%	155%	161%	139%	140%	132%	135%	122%	164%	146%	134%	137%	139%	137%
Borrowing capacity															
Indebtedness	3.80%	3.85%	3.88%	3.92%	3.95%	3.99%	4.03%	4.07%	4.11%	4.14%	4.18%	4.22%	4.23%	4.24%	4.35%
Total Debt as a % of Rate revenue	7.88%	0.00%	0.00%	0.00%	0.00%	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	0.22%	0.08%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%

Note: Ratios coloured green denote low risk, yellow medium risk and red either short term / immediate sustainability concerns.

The 'Underlying Result' compares recurrent income and recurrent expenditure. The underlying result is forecast to be in the yellow zone in 2018/19 as a result of bringing to account 50% Victoria Grants Commission allocation for 2018/19 in the prior financial year (2017/18) because it was received in June 2018. For the six financial years in the forward plan, the underlying result trends into and remains in the green zone.

The 'Underlying Working Capital' ratio assesses Balance Sheet strength and in particular Council's ability to pay existing liabilities. In the forward plan the ratio remains in the green zone.

The 'Self Financing' indicator compares net operating cash flows to underlying revenue and capital grants. It is forecast to be in the yellow zone in 2018/19, again due to timing of grant payments, and moves to the green zone for all the forward budgets.

The 'Sustainability Indicator' assesses asset renewal and upgrade expenditure spend over a period of time. The indicator is in the green zone for 2018/19 and for all forward budgets. It is worth noting that there are no asset renewal primary funding gaps for all major asset classes over the 15 year Long Term Financial Plan. There are adequate funds for recurrent cost requirements for all major asset classes for the current defined service levels as documented in Asset Management Plans.

The three borrowing capacity indicators, 'Indebtedness', 'Total Debt as a percentage of Rate Revenue' and 'Debt Servicing Costs as a percentage of Total Revenue' are forecast to be in the green zone for 2018/19 and all the forward budgets. Due to the inherent strength of the Balance Sheet, Council has borrowing capacity in the forward years if it wishes to consider funding additional capital upgrade or extension projects.

Council's strategic intent will need to be identified and reflected in the Long Term Financial Plan during the development of the forthcoming 2019/20 Annual budget. It is important that the annual and longer term budgeted financial statements are financially sustainable.

The financial sustainability of Council's budgeted financial statements in the Long Term Financial Plan will be assessed by a series of key financial performance indicators as discussed above.

Overall, the underlying principles and fundamental direction of the Long Term Financial Strategies remains consistent with the original ones adopted in 2003. These are documented in Appendix 'A' of this report.

Background information

Principles of Sound Financial Management

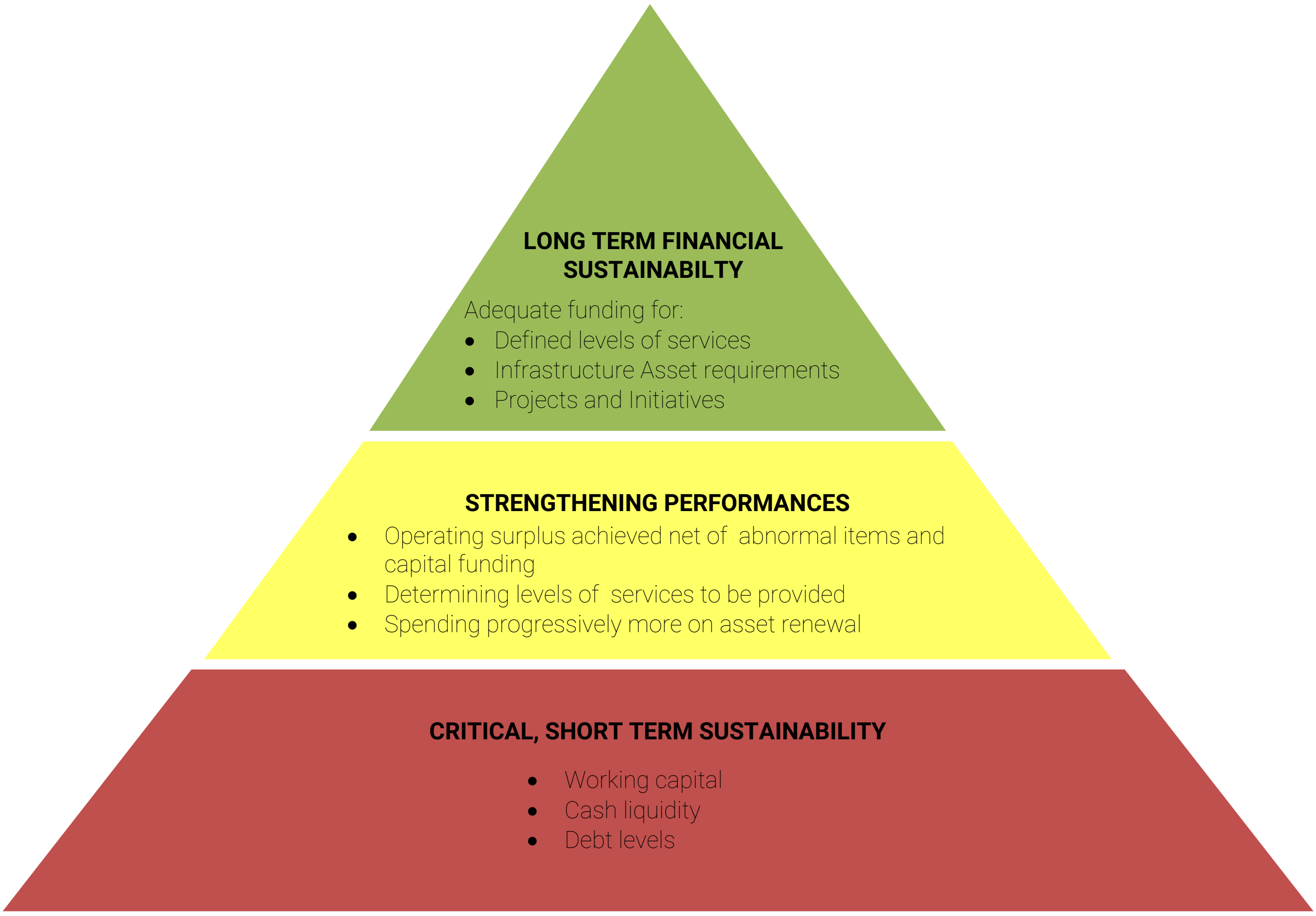
Council is required by the Local Government Act 1989 to implement the principles of sound financial management. These principles are that a Council must:

a) Manage financial risks faced by the Council prudently, having regard to economic circumstances;
b) Pursue spending and rating policies that are consistent with a reasonable degree of stability in the level of the rates burden;
c) Ensure that decisions are made and actions are taken having regard to their financial effects on future generations;
d) Ensure full, accurate and timely disclosure of financial information relating to the Council.

The risks referred to in a) above include risks relating to:

a) The level of Council debt;
b) The commercial or entrepreneurial activities of the Council;
c) The management and maintenance of assets;
d) The management of current and future liabilities;
e) Changes in the structure of the rates and charges base.

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.



Long Term 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 and this 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 and minimising its financial risks. It is a critical component of responsible financial management.

Linkages to strategic planning documents.

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 in a rate-capped environment.

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, the four-year Strategic Resource Plan and the 15-year Long Term Financial Plan.

Format of strategy discussions and usage of graphs

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

Wherever possible graphs are utilised to help illustrate or explain the financial intent of specific strategies. The purpose of the graphs is to provide 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 2017.

The graphs not only include the current Long Term Financial Plan but also actual financial results achieved since 2003/04, the average of the past five years plans and the average of the past 10 years plans.

Financial Strategies

A. Comprehensive Income Statement

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

Existing Strategy - ***no change recommended***

The Comprehensive Income Statement is the first of the four key financial statements. The results in the Income Statement are for a given period of time (12 month period: 1 July – 30 June) and have a direct impact on the net worth of an organisation.

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/decrements. These asset revaluations can be material when certain asset classes are periodically subject to revaluation.

For example, in 2017/18, a change in valuation methodology for infrastructure assets resulted in a net asset revaluation decrement of $6.5M. The net asset revaluation change in the prior 2016/17 financial year was nil, whereas the revaluation in 2015/16 resulted in an increment of $29.4M. This provides distorted financial results from one year to the next.

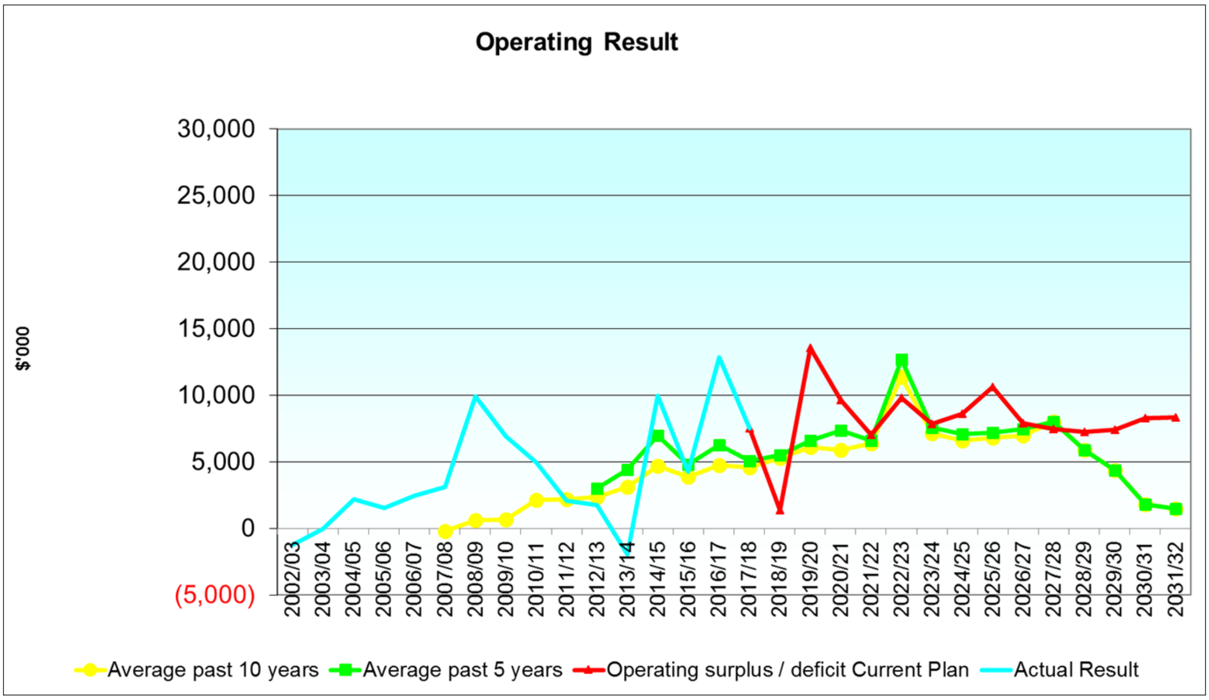
Operating result

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

To be able to provide a given level of recurrent services, 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 2002/03 and aggregates of previous years' plans. The light blue line shows actual financial results from 2002/03 through to 2017/18 and the red line shows the current budget forecasts. The yellow line shows the aggregate for the past 10 years' financial plans and the green line the past 5 years financial plans.



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 the operating result.

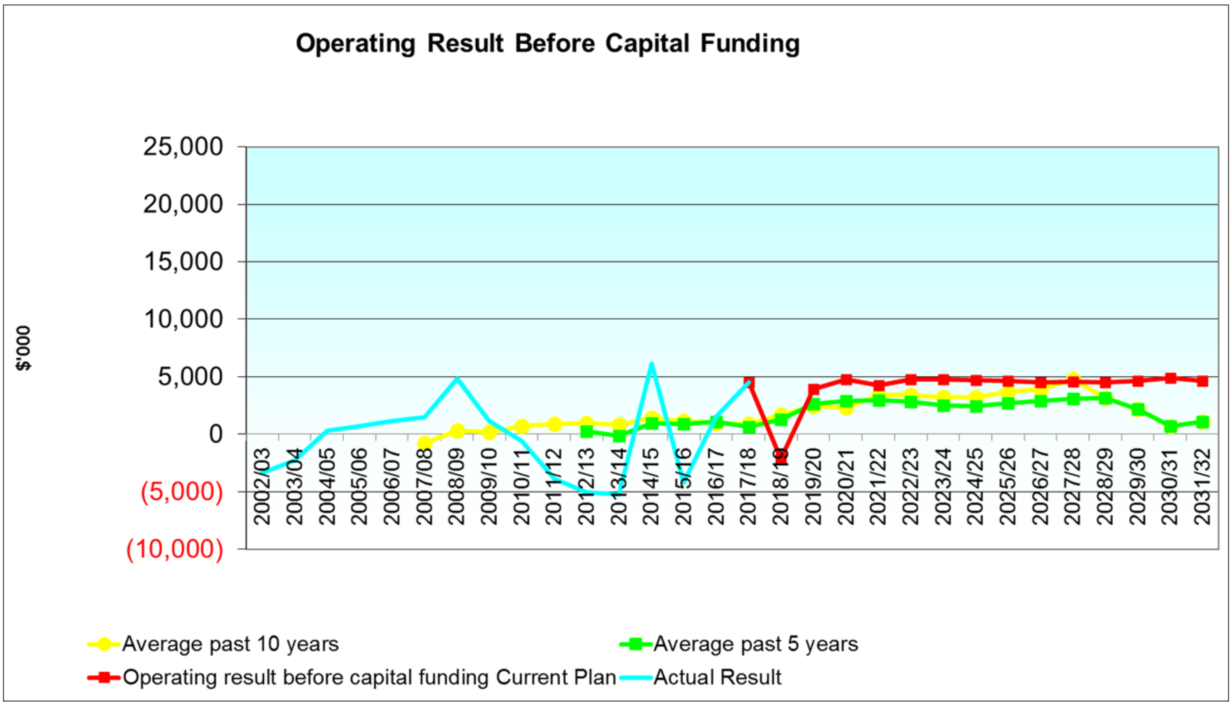
In the later years of the plan the projected operating result has a gradual flattening trend. This is due to the longer term impact of restricted rates revenue being generated as a result of rate capping.

Underlying operating result (operating result before capital funding)

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, with capital income reflected in the Income Statement whereas the matching capital expenditure 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 graph below shows actual operating results before capital grant funding achieved since 2002/03 and the aggregates of previous years' plans. The light blue line shows actual financial results from 2002/03 through to 2017/18 and the red line shows the current budget forecasts. The yellow line shows the aggregate for the past 10 years' financial plans and the green line the past 5 years financial plans.



Over the years Council had been producing underlying deficit outcomes prior to beginning to produce underlying surplus results.

The years between 2008/09 and 2013/14 showed a downward trend in underlying operating results. Increased cost pressures did not have matching increased funding streams. The spike and dip between 2014/15 and 2018/19 are due to an accounting standard requirement to recognise income in advance, with timing of receipt of operating grants impacting these results.

B. Balance Sheet

2. Target the Balance Sheet having at least a 1.25 to 1 underlying working capital ratio in the Long Term Financial Plan.

Existing Strategy - ***no change recommended***

The Balance Sheet is the second of the four key financial statements and discloses the net worth (equity) of an organisation at a given point in time (30 June).

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 and are expected to be held by the organisation for a period of at least 12 months.

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

It is strategically important to maintain a positive working capital ratio at all times. A ratio below 1 to 1 at any point would mean that Council may not have enough cash funds to pay its immediate debts. A strengthening working capital ratio indicates that Council is building financial capacity which gives it the ability to deal with unexpected or unforeseen 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.

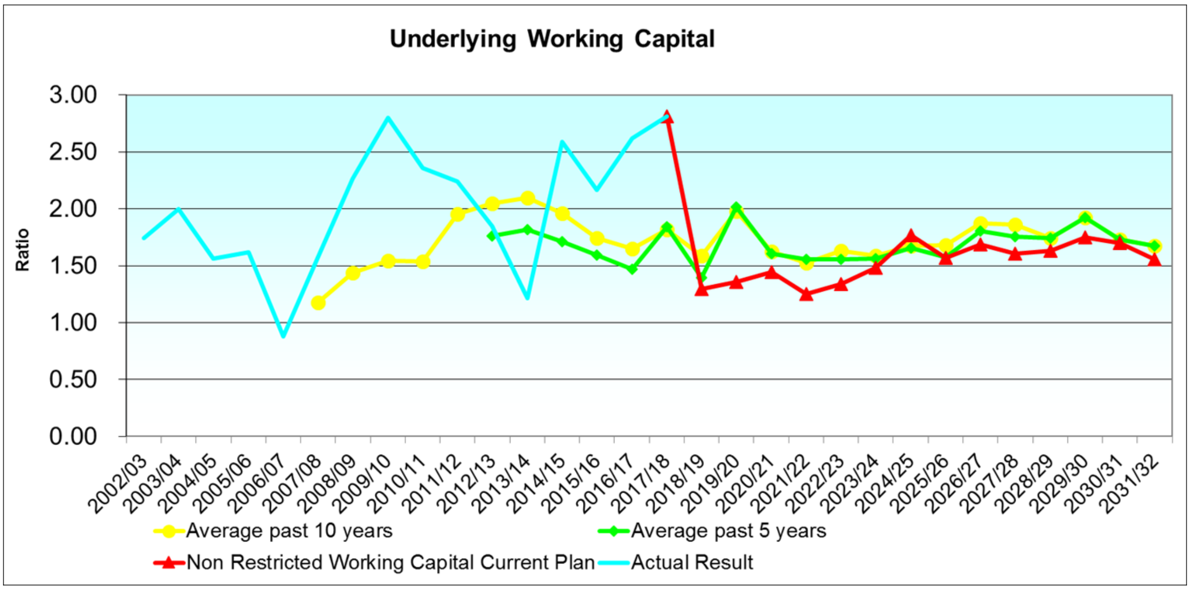
Council has a number of cash backed internal reserves that are expected to grow over the coming years. The inclusion of the cash backed reserves has a positive but somewhat distorting impact on the working capital ratio. The internal reserves represent funds that have been set aside for specific requirements.

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 originally set at 1.5 to 1. This provided a degree of flexibility to be able to both prudently and strategically manage unexpected events and opportunities that occur from time to time.

In December 2015 the ratio was revised to 1.25 to 1. This had the effect of a 'one off' freeing up of financial capacity. Longer term having a lower threshold does mean that Council has somewhat less strategic flexibility to accommodate unforeseen strategic opportunities or unavoidable cost events that may arise.

The graph below shows actual underlying working capital ratios achieved since 2002/03 and aggregates of previous years' plans. The light blue line shows actual financial results from

2002/03 through to 2017/18 and red line shows the current budget 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 spikes in the recent years' actual underlying working capital ratio (notably 2009/10, 2014/15, 2016/17 and 2017/18) are largely due to timing differences of receiving income and incurring expenses between different financial years.

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.

The underlying working capital ratio is a relatively stable financial performance indicator. It ensures that funds are released in a financially responsible manner for recurrent operational and asset funding requirements in forward budgets.

The current underlying working capital ratio projections in the mid to later years of the plan are generally weaker than the previous plans. The ratio is impacted by a combination of the gradual projected downward trend of underlying operating results in the mid to later years as a result of the introduction of rate capping in 2016/17 and significant capital funding requirements for capital works programs in the mid years of the plan.

The management process for underlying working capital ratio targets in financial plans is:

- 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 from the target, then an immediate review and consideration of corrective actions to arrest the decline would be required.

C. Statement of Changes in Equity

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 the end of 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.

Existing Strategies - ***no change recommended***

The Statement of Changes in Equity is the third of the four key financial statements. It represents 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 costs of those assets. These adjustments are commonly referred to as a 'book entry' as 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 for 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 comprise:

- General Reserve;
- Caravan Park Reserve;
- Venus Bay Surf Life Saving Club Reserve;
- Corner Inlet Seawall Drainage Reserve; and
- Loan Reserve

Ideally, an underlying operating 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.

The first of the financial strategies dealing with reserves specifically supports 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).

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 was financially viable to do so in later years. This complemented the strategic intent of the two preceding strategies. An interest transfer to the General Reserve was financially viable from 2015/16 and was reflected in the Long Term Financial Plan that was prepared as part of the 2014/15 Budget process.

In 2014 two further minor amendments were made to this strategy. The first was 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 amount on hand in the cash backed reserve.

Further discussion

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 fund $4.62 million unfunded superannuation call in 2013

Unfortunately, in coming years future superannuation 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 has $1.7M in its General Reserve at 30 June 2018, an increase of $0.4M from 30 June 2017.

Council can strategically consider taking advantage of its underlying financial strength and internal reserves by strategically utilising the reserves to fund special project requirements in future years rather than undertaking borrowings.

D. Cash Flow Statement

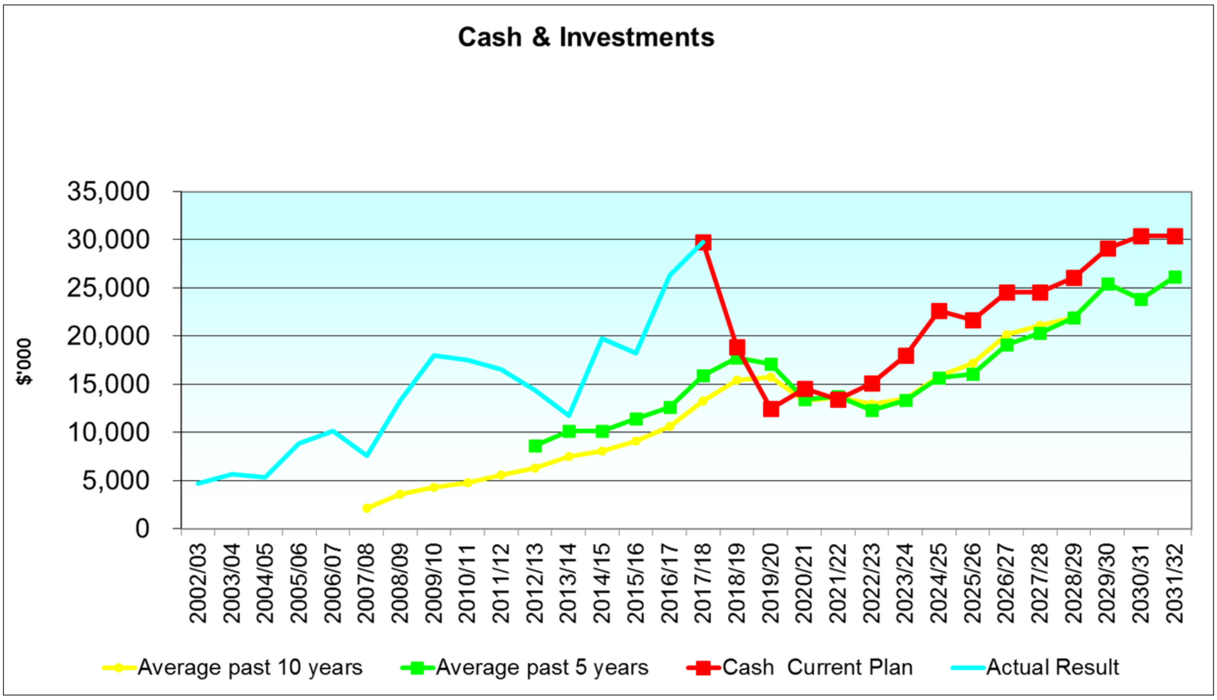
7. Budgeted underlying cash at the end of each year shall be measured by referencing it against the underlying working capital ratio in the Long Term Financial Plan.

Existing Strategy - ***no change recommended***

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 its expenses and debts.

The graph below shows the cash position achieved since 2002/03 and aggregates of previous years' plans. The light blue line shows actual financial results from 2002/03 through to 2017/18 and red line shows the current budget forecasts. The yellow line shows the aggregate for the past 10 years' financial plans and the green line the past 5 years financial plans.

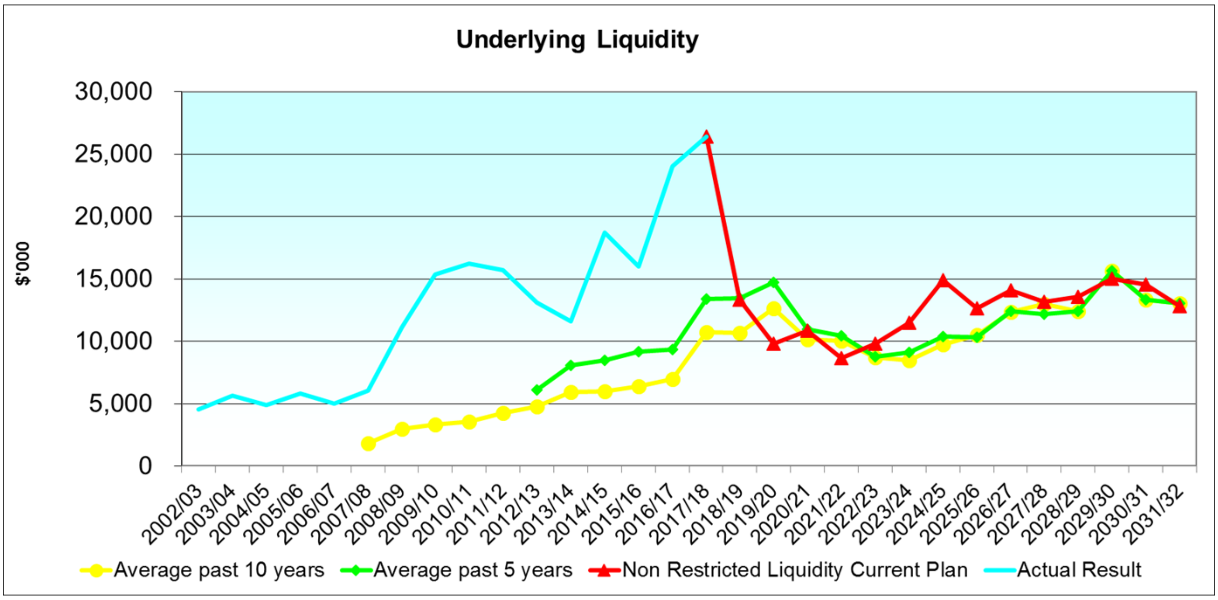


The longer term cash & investments projections are generally stronger than in previous plans. The forecasts are impacted by a significant capital funding requirements in 2018/19 and 2019/20 and then a flattening in the level of capital works budgeted into future plans.

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. The trust fund liabilities are monies held on behalf of Council and repayable to third parties. This underlying cash position figure then complements the underlying working capital ratio.

The graph below shows actual underlying cash position achieved since 2002/03 and aggregates of previous years' plans. The light blue line shows actual financial results from 2002/03 through to 2017/18 and red line shows the current budget forecasts. The yellow line shows the aggregate for the past 10 years' financial plans and the green line the past 5 years financial plans.



As discussed immediately above for cash and investments and for the same reasons, the longer term underlying liquidity position of Council is generally stronger than the previous plans.

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 important that 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.

E. Cash Flows from Operating Activities (Service Delivery)

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 1.25**
- **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 than 5%**

Existing Strategies - ***no change recommended***

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 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 provides

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.

Reduced grant funds from external sources have put even further pressure on relying on rate income to fund its service level requirements. The introduction of rate capping from 2016/17 necessitated 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 financial performance indicators and associated threshold targets that Council uses include:

Financial Performance Ratio	Target / thresholds		
	Green	Yellow	Red
• Underlying result	> 0%	(-10%)	(>-10%)
• Underlying working capital ratio	>1.25	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 'B' 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.

A mandatory Local Government Performance Framework was 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 2015/16 Annual Budget document.

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, capital cash contributions, special charge scheme income for capital projects 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.

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 and upgrade expenditure in its index calculation.

The ratios, targets and thresholds established in the setting of the 2018/19 Annual Budget and the Long Term Financial Plan are shown below.

2018/19 Original Budget	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28	2028/29	2029/30	2030/31	2031/32	2032/33
Financial performance															
Underlying result	-4.47%	6.44%	7.62%	6.70%	7.21%	7.04%	6.79%	6.52%	6.11%	6.03%	5.77%	5.78%	5.97%	5.45%	7.2%
Underlying Working Capital	1.32	1.42	1.53	1.34	1.45	1.61	1.91	1.72	1.85	1.77	1.80	1.92	1.88	1.72	1.86
Funding capacity															
Self-financing	17.64%	32.82%	29.39%	27.36%	29.61%	27.15%	27.61%	29.41%	26.96%	26.19%	25.69%	25.63%	26.03%	25.73%	27.42%
Sustainability Index	208%	201%	155%	161%	139%	140%	132%	135%	122%	164%	146%	134%	137%	139%	137%
Borrowing capacity															
Indebtedness	3.80%	3.85%	3.88%	3.92%	3.95%	3.99%	4.03%	4.07%	4.11%	4.14%	4.18%	4.22%	4.23%	4.24%	4.35%
Total Debt as a % of Rate revenue	7.88%	0.00%	0.00%	0.00%	0.00%	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	0.22%	0.08%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%

The table immediately below shows the budgeted financial statements in the financial plan as at August 2018. Budget adjustments were made for 2018/19 to take into account budgets that were carried forward form the previous 2017/18 financial year for capital works and grant funded programs that had not been completed by 30 June.

Current budget	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28	2028/29	2029/30	2030/31	2031/32	2032/33
Financial performance															
Underlying result	-3.49%	6.13%	7.33%	6.44%	6.98%	6.84%	6.62%	6.37%	5.99%	5.94%	5.70%	5.73%	5.95%	5.45%	7.47%
Underlying Working Capital	1.46	1.58	1.67	1.46	1.55	1.70	2.01	1.80	1.92	1.83	1.86	1.99	1.94	1.78	1.94
Funding capacity															
Self-financing	17.38%	32.55%	29.12%	27.12%	29.40%	26.96%	27.45%	29.28%	26.86%	26.11%	25.62%	25.59%	26.02%	25.74%	27.66%
Sustainability Index	213%	201%	155%	161%	139%	140%	132%	135%	122%	164%	146%	134%	137%	139%	137%
Borrowing capacity															
Indebtedness	4.46%	4.50%	4.51%	4.54%	4.55%	4.58%	4.60%	4.62%	4.66%	4.68%	4.70%	4.72%	4.72%	4.72%	4.81%
Total Debt as a % of Rate revenue	7.88%	0.00%	0.00%	0.00%	0.00%	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	0.22%	0.08%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%

The majority of indicators remain within strategic thresholds targets. Underlying result is marginally stronger than the original The key financial performance indicators serve as very important lead indicators.

F. Cash Flows from Investing Activities (Capital Works)

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.

Existing Strategies - ***no change recommended***

Background

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

The annual operating revenue generated by Council each year is over $60 million. This revenue stream is disproportionally small relative to the value of assets in the Balance Sheet. The mix of services provided by local government, the associated infrastructure asset requirements and in relative terms low income streams, present a financial management challenge that is unique to the local government sector.

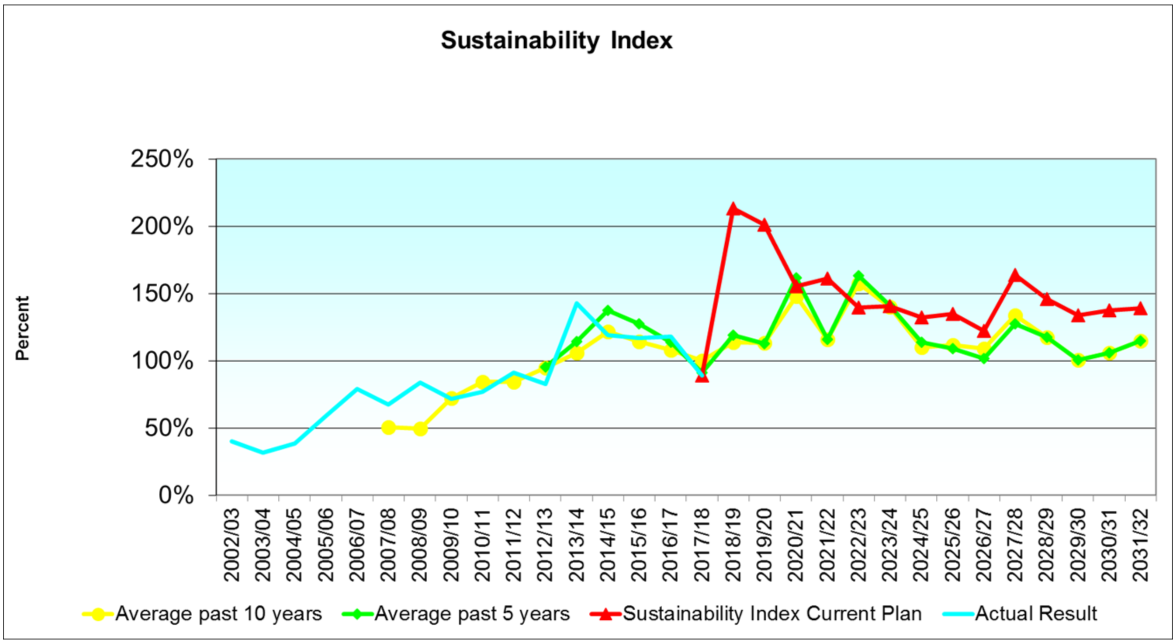
The sustainability indicator

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 increased progressively each year, the effect would be that the sustainability indicator index would increase. That would be considered a positive outcome.

From 2003/04 to 2010/11 Council's sustainability indicator focussed on assessing 'renewal' expenditure effort on assets. 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.

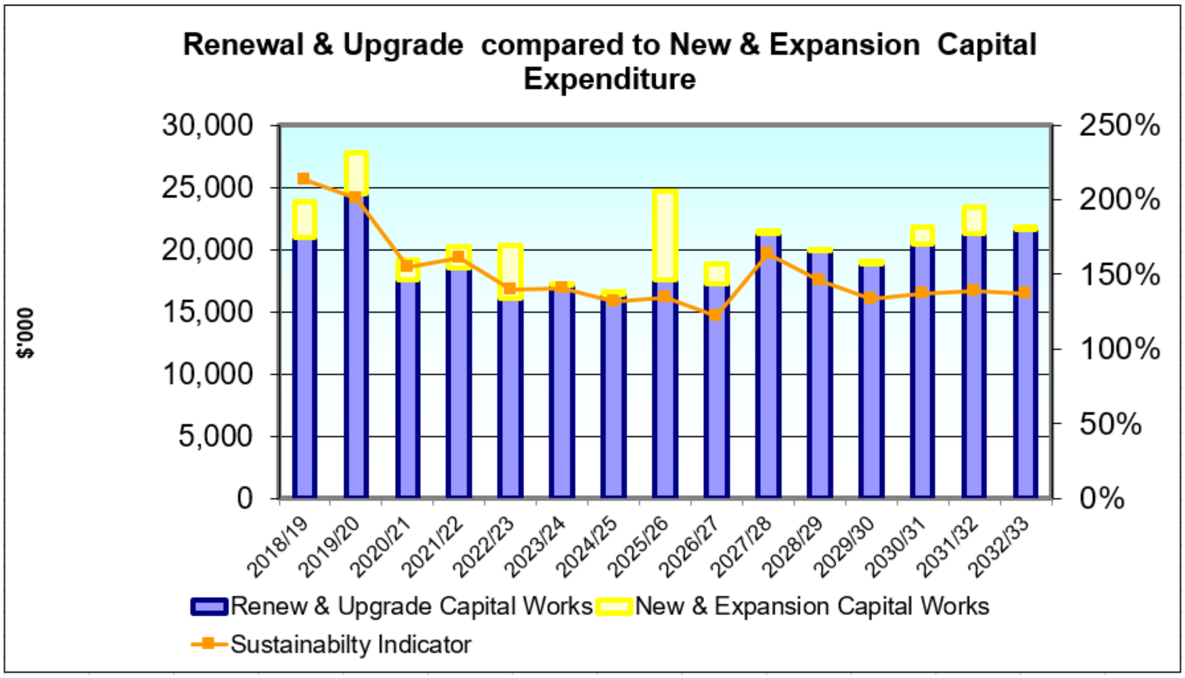
Council's existing strategy was revised in 2010 to also include 'upgrade expenditure' in the sustainability ratio to have alignment with the VAGO indicator.

The graph below shows actual operating results achieved since 2002/03 and aggregates of previous years' plans. The light blue line shows actual financial results from 2002/03 through to 2017/18 and red line shows the current budget 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 sustainability index graph above clearly demonstrates 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 below clearly show the level of funds being released to capital works in the coming years and how this 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 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 aligns with Council Plan objectives.

Asset expenditure budgets for '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.

Planning ahead

There is a flat lining of the capital expenditure budgets requirements in the later years of the Long Term Financial Plan. It would not be unreasonable to assume that in coming years there may be some upward rather than downward pressure on capex funding requirements.

It would also 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 could 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 third 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. The financial implications of the introduction of rate capping from 2016/17 and onwards must also be carefully considered.

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.

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 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.

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

G. Cash Flows from Financing Activities (Borrowing Strategy)

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.

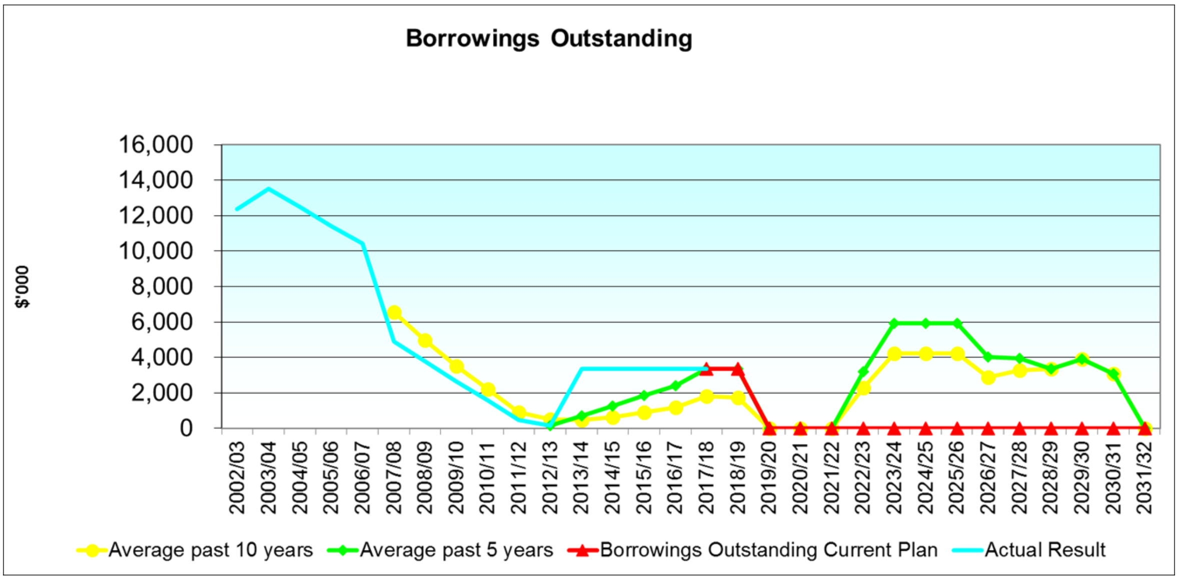
*Existing Strategies - **no change recommended***

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

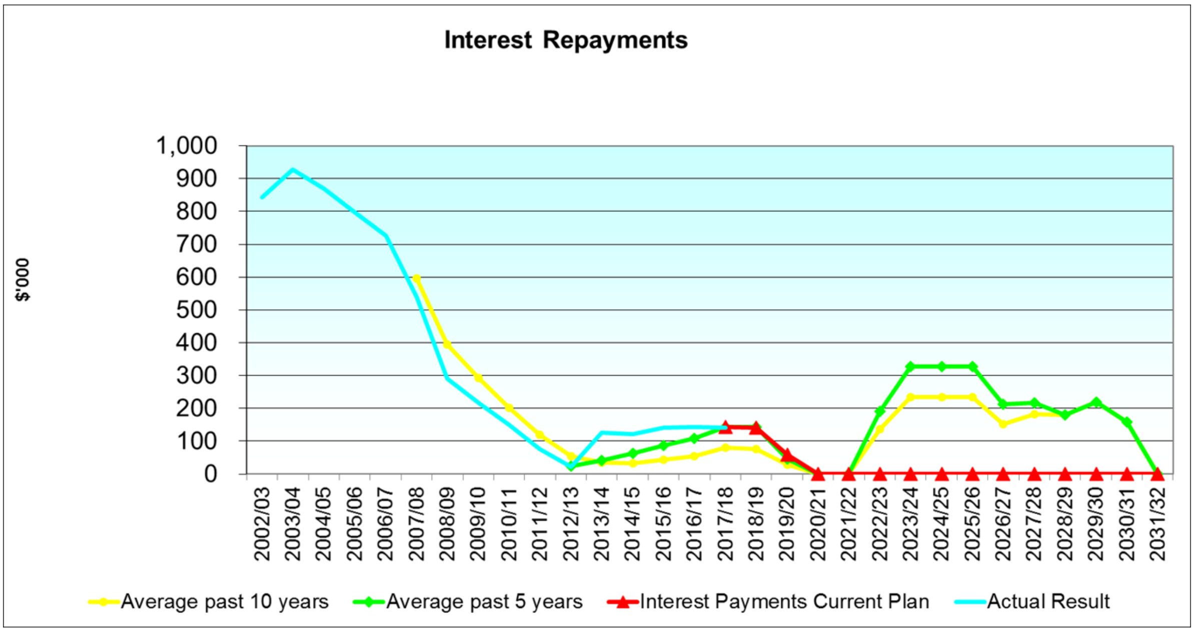
Since council amalgamations in 1994 through to 2003/04 Council had borrowed for a variety of reasons, including financing relatively large infrastructure projects as well as paying superannuation liabilities. In 2003/04 Council's outstanding borrowings peaked at $13.5 million. At the same time, it had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

In 2013/14 Council had to borrow $4.0 million to fund its $4.6 million unfunded superannuation obligations that was payable 1 July 2013. At 30 June 2018, Council had outstanding borrowings of $3.35 million, which are anticipated to be repaid in early FY2020. An internal reserve has been established 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 the current financial year and a number of previous years. The light blue line shows actual financial results from 2002/03 through to 2017/18. The red line shows the current financial plan forecasts. The other coloured lines depict previous 5 years financial plans.



The graph below shows interest payments for the current financial year and a number of previous years. The light blue line shows actual financial results from 2003/04 through to 2016/17. The red line shows the current financial plan forecasts. The other coloured lines depict previous 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 charge 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 would 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. This is a particularly important consideration in a rate capping environment which puts a ceiling on how much revenue can be raised from rates and charges.

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

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

These borrowing strategies are further complemented 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 more 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

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 is worthy of consideration. Commercial ventures that provide monetary returns are typically financed by long term borrowings.

The reality is that there are not many 'capital intensive' services that councils provide that generate recurrent income streams. Councils 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 have a negative cost impact on 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 $12 million in most years. 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.

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 four million dollars per year. They are currently self-funded.

Council could consider undertaking additional works over and above what it currently has 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.

Fortunately, Council currently has low debt and has financial capacity to be able to borrow. It has the financial capacity to accommodate borrowing funds in the earlier years of its current Long Term Financial Plan and would not have to consider further increasing its rates and charges.

The critical issues that need to be considered are the preparedness of ratepayers to fund the pay back of borrowings over a number of years and Council complying with the rate capping environment.

Borrowings should only 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.

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 in the future 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.

H. Fees and Charges

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. Any services that undergo service level review processes and which have non statutory fees and charges will have those fees and charges identified to reflect their level of community benefit which clearly articulates the basis for the fee or charge relative to the service being provided.

Existing Strategies - ***no change recommended***

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 financed. 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 inappropriate 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.

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.

I. Rating strategy

17. Council considers 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.

Existing Strategy - ***no change recommended***

The overall rating strategy needs to consider the following parameters:

- To maintain equity within South Gippsland Shire Council's rating system;
- Provide adequate funding for asset renewal to approximately equate the wear, tear and obsolescence on existing assets (including bridging any primary funding gaps);
- 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 Long Term Financial Strategies, Plan and associated key financial performance indicators are not compromised.

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 entire local government sector.

The determination of what level of rates and charges revenue is required is 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. All Victorian councils from 2016/17 and onwards have to take into consideration and comply with rate capping requirements. This effectively places a ceiling on the level of rates and charges that a council can raise in any given year. From 2016/17 onwards, rate capping effectively will determine what level of funding is available for service requirements.

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.

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.

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 is evidenced by key financial performance indictors not being compromised in the forward budgets of the Long Term Financial Plan. In order to be able to achieve this, it may be necessary to consider:

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

Conclusion

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 enable 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 reviewed and no changes are recommended. This reflects the growing maturity and financial stability of this organisation in relation to strategic long term financial management practices.

Appendices

Appendix A – Original financial strategies

Listed below are the 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 – 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	> 1.25	Low risk of financial sustainability concerns
Yellow	1.0 - 1.25	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.

<u>Borrowing capacity</u>

Indebtedness

Non-current liabilities / own sourced revenue

Non-current liabilities as per Balance Sheet
Own sourced revenue does not include capital grants

Measures ability to cover long term liabilities from own revenue

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

Total Debt as a % of Rate revenue

Total Debt as a % of Rate revenue

Includes current and non-current liabilities in Balance Sheet
Rate income as per Income Statement

Measures level of rate income relative to total debt

Indicator	Range	Comment
Green	<60%	Reasonable reliance on rate revenue to fund debt.
Yellow	60%-100%	Undesirable reliance on rate revenue to fund debt.
Red	>100%	Unsustainable reliance on rate revenue to fund debt.

Debt servicing costs as a % of Total revenue

Debt servicing costs as a % of Total revenue

Borrowing cost expenses as per Income Statement
Total revenue in Income Statement not including donated assets and gain/ loss on asset disposals

Measures portion of revenue committed to fund debt finance costs

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

Red	>10%	Unsustainable reliance on proportion of total revenue to fund debt finance costs.

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