



Financial Sustainability Program

Information Paper 8

Long-term Financial Plans

September, 2006



Introduction

When setting the annual budget, a Council is exposed to financial risk over the longer term if little regard is given to both revenue and expense implications beyond the budget period. Long-term financial planning is arguably more critical for Councils than many other organisations. All Councils have very large stocks of assets relative to their revenue base. A high proportion of these assets are reaching the stage where they will require upgrading or replacing in the foreseeable future. In addition Councils face continuing expectations and pressures to augment service levels and keep rate rises to moderate levels.

Many Councils have recognised the need for long-term financial planning and its importance was reaffirmed in the findings and recommendations of the Independent Inquiry into the Financial Sustainability of Local Government. For these reasons the LGA (with the support of Councils) supported legislative reforms passed by the South Australian Parliament in 2005 which require all Councils to prepare Long-term Financial Plans (LTFPs) as part of their suite of Strategic Management Plans (SMPs).

This information paper is one of a number being developed as part of the LGA's Financial Sustainability Program. It is designed to provide an overview of the value and nature of long-term financial planning in supporting financial sustainability.

Recent amendments to the Local Government Act will require Councils to develop and adopt LTFPs covering a period of at least 10 years along with Infrastructure and Asset Management Plans (I&s) also covering a period of at least 10 years. There is clearly a direct link between the development and implementation of these plans which will both form part of Councils' SMPs. The relevant amendments are expected to come into operation in early 2007.

This paper should be read in conjunction with the information papers on Financial Sustainability which highlight the increasing demands on Councils and the importance of efficiently managing the delivery of services. Information papers have been, or will soon be, prepared on the following topics:

- Financial Sustainability
- An Overview of Audit Mechanisms
- Audit Committees
- Scope of External Audits - Audit Specification
- Efficiency & Economy Audits
- Infrastructure and Asset Management (Policy and Planning)
- Service Delivery Framework including the Role of Shared Services
- Long-term Financial Plans
- Governance in Local Government
- Financial Governance and Management
- Revenue and Funding Policies
- A New Approach to Standards in Local Government
- A New Approach to State-Local Resourcing
- Depreciation
- Local Government Financial Indicators
- Debt Management
- An Approach to Assessing Financial Sustainability for Local Government

A number of manuals, guidelines, templates, technical definitions, codes, standards and similar documents supporting this series of information papers are also being prepared by the LGA to provide practical assistance to Councils.

For an update on which information papers have now been completed or information about other documents and activities, including briefing and training sessions, please visit our website at: www.lga.sa.gov.au/goto/fsp.

What does a LTFP do?

The purpose of a Council's LTFP is to express, in financial terms, the activities that it proposes to undertake over the medium to longer term to achieve its stated objectives. It is similar to, but usually less detailed than, the annual budget. Just like the budget, it is a guide for future action although its preparation requires the Council to think about not just one year but the longer-term impact of revenue and expenditure proposals. The aggregation of future intended outlays and anticipated revenues enables the accumulating overall financial implications to be readily identified and, if warranted, proposed future activities to be revised.

Operating without a LTFP is like driving a car at night in the country at the open-road speed limit without the car's lights on 'high-beam'. You can see the road immediately ahead but not far enough into the distance to be able to anticipate and respond quickly to needed turns in direction. A driver might get by in familiar surroundings but will be unprepared to appropriately respond to hazards that would have been recognised if the car's lights and the driver's eyes had been set on a longer-distance horizon.

The preparation of a LTFP generates improved information to guide decisions about the mix and timing of outlays on operating activities and additional assets and the funding implications of these. Without a soundly based LTFP a Council and its management team will have insufficient data to determine sustainable service levels and affordable asset stockholding strategies, appropriate revenue targets or optimal treasury management.

A LTFP, just like the annual budget, should be developed in an iterative way. If a draft version shows that the proposed activities will have a detrimental effect on a Council's financial sustainability over time, then proposed outlays need to be reduced or deferred or additional revenue identified. A LTFP showing a very sound ongoing financial position would allow a Council to consider raising service levels or introducing additional activities to further satisfy community wants and needs or reducing future proposed rates and charges.

What does legislation require?

The Local Government Act was amended in 2005 as a result of the passage of the Local Government (Financial Management and Rating) Amendment Act 2005. These amendments, when they come into operation (expected to be in early 2007), will require a Council to have strategic management plans which must address:

- the sustainability of its financial performance and position;
- the maintenance, replacement or development needs for infrastructure within its area;
- proposals with respect to debt levels; and,
- identification of any anticipated or predicted changes that will have a significant effect upon the costs of the Council's activities/operations.

Councils will be specifically required to develop and adopt a LTFP covering a period of at least 10 years but Councils that wish can prepare a LTFP for a longer period.

Councils will be required to undertake a review of their LTFPs as soon as practicable after the adoption of their annual business plans. In this regard it is important to note that there will be an express statutory obligation on Councils' CEOs to report, as part of the annual review of the LTFP,

on the sustainability of their Council's long term financial performance and position, having taken into account the annual business plan and SMPs.

The Act does not specify the format of Councils' full budget documents allowing flexibility for formatting best suited to local circumstances. Regulations do require the publication of summary budget information in certain formats consistent with Australian Accounting Standards including, in particular, the clear disclosure of Councils' budgeted operating results for the period. No prescription currently exists as to the format of a LTFP.

It is possible that regulations will be prescribed requiring the publication in Councils' LTFPs of summary financial information, similar to that required of annual budgets, for each year of the planning period. Even if this does not occur it is probable, following planned consultations, that Local Government will favour the adoption of a summary template that would facilitate the reporting on, and comprehension of, Councils' key LTFP financial data. The LGA is developing a standard format for LTFPs to be made available shortly to all Councils.

Relevant provisions of the Local Government Act (incorporating the amendments) are included at Attachment 1.

What should a LTFP include?

A LTFP should specify and take account of:

- expected expenses and capital outlays for each year of the plan;
- expected revenues for each year and their source;
- any variations in net debt required as a result of expected cash flow needs;
- performance measures to enable assessment of the Council's financial sustainability over the period of the plan;
- other documents in the Council's suite of SMPs, and in particular its I&
- assumptions that have been used in the development of the LTFP including any proposed variations to service standards that underlie expenditure plans;
- sensitivity analyses performed, which highlight the factors or assumptions most likely to affect long-term financial sustainability.

The above matters are discussed in more detail in the balance of this paper.

The first year of the LTFP should be consistent with the current annual budget. The content of the LTFP may become progressively less detailed in subsequent years with an emphasis on:

- ensuring that proposed aggregate revenue and projected operating expenses can accommodate discretionary new capital expenditure and necessary asset replacement; and,
- proposed variations in the range and level of services provided to operate within acceptable limits of overall financial sustainability.

The starting point for the development of the following year's budget should then be the data set out in the year 2 of the LTFP. Significant variations that are made in finalising that budget need to be fed back into the next update of the LTFP, including any implications for subsequent years.

What should be the financial performance targets of a LTFP?

Councils need to develop targets or target ranges for financial performance. The LGA's Information Paper on Local Government Financial Indicators (soon to be released) provides further information to assist in this regard.

The LTFP should include tabular and graphical information showing a year by year analysis of the Council's projected financial performance. This should include a comparison of projected performance against targets set by the Council and other Local Government benchmark comparisons as appropriate.

A LTFP that shows an aggregate operating deficit over the projected 10 year period would suggest that the proposals included in the plan, if acted upon, would result in the Council operating in a financially unsustainable manner over the period. A forecast that projects a deteriorating operating result would highlight that the planned trend level of expenses relative to revenue is unsustainable. If the annual operating deficit is improving over time it may indicate that the Council is proposing to take incremental steps to improve its financial sustainability.

LTFPs in the context of strategic planning

Linkages between plans

The Local Government Act requires Councils to have a suite of up to date documents that collectively form their SMPs. At the simplest level Councils must have a Strategic Plan (SP), a LTFP and an I&.

It is critical that a Council's SP, LTFP and I& are all consistent. Expenses and capital outlays associated with both existing and new infrastructure and other assets as projected in the LTFP must reflect the activities proposed in the I&. Initiatives proposed in both the LTFP and I& must be appropriate for the pursuit of the Council's objectives and aspired outcomes as stated in its SP.

Community consultation

SMPs need to not only reflect community wants and needs but also what can be afforded without detriment to the Council's longer-term financial sustainability. Community input is vital if a Council is to achieve the best results from the development of its SMPs.

The Local Government Act simply says that:

"a council must adopt a process or processes to ensure that members of the public are given a reasonable opportunity to be involved in the development and review of its strategic management plans" [Section 122 (6)].

How this happens is up to each individual Council. A Council could, for example, consult on the specific development and annual review of its LTFP at the same time as it undertakes community consultation on its annual business plan. Even if it chooses to do these consultations separately, processes followed in consulting on the annual business plan are likely to be relevant for consulting on the LTFP, given the common themes in both.

Roles and responsibilities

Without LTFPs Councils are at risk of taking on additional services without careful consideration of the implications for their financial sustainability.

Even where a Council considers a service to be needed it does not automatically follow that the Council should take responsibility for the provision of this service itself. As part of its strategic planning considerations a Council should be clear about those activities/services for which it should take responsibility and those where it should instead advocate for another sphere of

government or entity to provide the service. Careful, strategic thinking by Councils in determining their roles and responsibilities can have a significant impact on their overall financial sustainability.

The LGA's Information Paper 7: Service Delivery Framework Including the Role of Shared Services (available at www.lga.sa.gov.au/goto/fsp) includes information on the various service delivery models that are available to Councils.

Infrastructure and Asset Management Plans

Councils' activities are typically far more asset-intensive than those of the other spheres of government. Many of their assets also have very long lives. Asset maintenance, rehabilitation and replacement are critical issues for Councils. For these reasons the Local Government Act requires Councils to prepare an I& and these are required to cover a period of at least 10 years.

Long-term financial sustainability, ensuring an optimal balance between service levels and revenue needs, depends crucially on strategic decisions by Councils on:

- the overall level and quality of asset stockholdings;
- the acquisition and specification of new assets; and,
- the timing of asset disposal, rehabilitation or replacement.

having regard to not only initial capital, but also ongoing operating costs. Councils need to plan long-term and ensure that funds are made available to maintain assets as required so that they achieve their full intended service life and total asset lifecycle costs are minimised.

Various studies have previously demonstrated that many Councils are not spending optimally on asset management. Often the initial capital cost of an asset is only a very small part of the total costs associated with owning, operating and maintaining it over its lifetime.

An I& should attempt to predict new and renewal infrastructure needs to meet future community service expectations and the expected associated maintenance costs based on expert technical assessment. Costs identified in a draft I& need to be fed into a draft LTFP to ensure projected investments can be accommodated without detriment to a Council's financial sustainability. If cuts need to be made to the I& then deletion or deferral of additional new assets is the most likely source of these savings. Reductions in well-developed proposals for replacement and maintenance of required assets are unlikely to be cost-effective. Savings are likely to be short-term with subsequent higher maintenance costs later and will therefore impact negatively on a Council's financial sustainability.

For more discussion on Councils' role in infrastructure and asset management please refer to the LGA's Information Paper 6: Infrastructure and Asset Management (Policy and Planning) which is available from the LGA's web site at www.lga.sa.gov.au/goto/fsp.

Funding strategy

Funding sources

An integral part of developing a LTFP is determining proposed funding sources and amounts to meet projected outlays. Councils need to determine an appropriate mix of rates, fees and charges, grants revenue and borrowings having regard to both cashflow needs and long-term financial sustainability.

The funding strategy needs to weigh up whether:

- today's ratepayers pay more or less than the cost of providing today's services to them and the consequential implications for future ratepayers? and,

- the best balance between funding from direct users of specific services (fees and charges) and broader public beneficiaries (general rates)?

The LTFP also needs to consider the implications for financial sustainability of any increase in net interest costs from increasing net financial liabilities (eg by running down financial assets or raising debt) to meet asset acquisition funding needs.

Rating considerations

A Council's rate revenue expectations (arising from forecast movements in the number of rateable properties) and proposals (any intended variation in average rates payable for all or some classes of ratepayers) are a crucial consideration in the final content of, and overall financial sustainability forecast by, the LTFP.

A Council may identify and determine as a result of rate revenue deliberations in the preparation of the LTFP that a review of the structure of its rating strategies is warranted. This could include:

- consideration of equity and capacity to pay by the community overall and different sections within it;
- benchmark comparisons of rating levels with other Councils as appropriate;
- analysis of the potential to reduce or increase reliance on rates through a variation in revenue from other sources such as user charges;
- assessment of the impact on rate revenue from projected land use and demographic change;
- consideration of changes in rating policies, eg introduction of fixed charges, service rates or targeted rate relief.

Treasury management

The preparation of a LTFP is likely to help Councils determine whether their existing (explicit, or in their absence, implicit) treasury (including debt) management policies and practices could be improved.

Modern approaches to treasury management that are consistent with accrual accounting concepts, clearly highlight that considerable savings can be made through an holistic focus on funds management compared with undertaking separate or specific borrowings to finance particular projects or assets and quarantining existing financial assets in separate special purpose accounts. This topic is considered in more detail in the LGA's Information Paper on Debt Management (soon to be released).

For the purposes of this paper it is sufficient to note that in developing a LTFP, the use of accumulated financial assets and debt can be identified as an important funding source.

While it is clearly desirable that debt levels be as low as possible (subject to intergenerational equity considerations and all other things being equal), soundly managed borrowings are an important and appropriate financing option available to Councils to help fund their ongoing infrastructure requirements. Councils must make debt policy decisions in the context of their overall financial management and service delivery decisions.

There are two distinct aspects of a Council's treasury management:

- a strategy covering the level of a Council's debt over the planning cycle; and
- a strategy to minimise a Council's net interest costs over time in a risk averse manner.

The LTFP is a key financial management tool to optimise a Council's treasury management strategy. It needs to clearly highlight anticipated movements in annual cash flows linking movements in a Council's level of borrowings and financial assets over the planning period.

Sensitivity analysis

A Council's finalised LTFP should outline the optimum balance of prioritised services that it considers can be funded within acceptable revenue raising proposals based on carefully considered assumptions and community consultation while ensuring its long term financial sustainability.

When preparing its LTFP a Council needs to undertake sensitivity analyses to assess the impact of variations in underlying assumptions. For example small variations over time in the expected growth in the number/percentage of new properties in the Council area may have a very significant impact on the Council's projected aggregate rate revenue and hence its financial capacity and financial sustainability over the planning period.

Ultimately a LTFP must be based on best assumptions but a Council should be mindful of the probabilities and risks associated with these assumptions in its decision making. Assumptions need to be reconsidered, and if necessary updated, in the annual review of the LTFP.

What are the issues for Councils?

Councils have very large stocks of long-lived assets. In many cases these will require substantial upgrading or replacement within a 10 year period. Community demands for better and additional Local Government services continue to grow. Councils have very limited revenue sources and unlike other spheres of government lack access to a growth tax. Many people in the community are resistant to higher property rates and other spheres of government are reluctant to provide increased grants to Councils.

Given the above it is imperative that Councils have well-developed LTFPs to help guide decision making and protect their future financial sustainability. The commencement of recent legislation is expected to require the process of developing and adopting such plans to commence in early 2007.

LTFPs need not be detailed and complex. It is necessary though that they are consistent with Councils' strategic objectives and take into account prioritised needs, including those identified in their I&s (the process of developing and adopting such plans is expected to be required to commence in early 2007).

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Attachment 1: Local Government Act Provisions Relating to Long term Financial Plans

Section 122 provides that:

- (1) A Council must develop and adopt plans (which may take various forms) for the management of its area, to be called collectively the **strategic management plans**, which—
 - (a) identify the Council's objectives for the area over a specified period (**the relevant period**), and provide a clear indication of—
 - (i) the extent to which the Council has participated with other Councils, and with State and national governments, in setting public policy objectives, and the extent to which the Council's objectives are related to regional, State and national objectives;
 - (ii) the extent to which the Council has given consideration to regional, State and national objectives and strategies which are relevant to the economic, social, physical and environmental development and management of its area;
 - (iii) the extent to which the Council intends to co-ordinate with State and national governments in the planning and delivery of services in which there is a common interest; and
 - (b) identify the principal activities that the Council intends to undertake to achieve its objectives;
 - (c) estimate the revenues and expenses of the Council over the relevant period;
 - (d) state the measures (financial and non-financial) that are to be used to monitor and assess the performance of the Council over the relevant period;
 - (e) describe the relationship between the Council's objectives and activities, and its rating policy under this Act;
 - (f) identify the means by which its activities are to be carried out, with particular reference to its policies on contracts and tenders under this Act;
 - (g) address issues associated with arranging its affairs so as to separate its regulatory activities from its other activities, so far as this is reasonable to do so; and
 - (h) make provision for the regular review of the charters, activities and plans of any subsidiary of the Council.
- (1a) A Council must, in conjunction with the plans required under subsection (1), develop and adopt—
 - (a) a long-term financial plan for a period of at least 10 years; and
 - (b) an infrastructure and asset management plan, relating to the management and development of infrastructure and major assets by the Council for a period of at least 10 years;

(and these plans will also be taken to form part of the Council's strategic management plans).
- (2) Strategic management plans—
 - (a) should (as far as practicable) be consistent with the Planning Strategy and the Development Plan or Plans for the Council's area, and with other relevant statutory policies and plans; and

- (b) must comply with any requirement prescribed by the regulations.
- (3) In addition to the requirements of subsection (2), a Council must, in formulating its strategic management plans, have regard to—
 - (a) the Council's roles and responsibilities under this or any other Act; and
 - (b) the Council's objectives for its area.
- (4) A Council may review its strategic management plans under this section at any time but must—
 - (a) undertake a review of—
 - (i) its long-term financial plan; and
 - (ii) any other elements of its strategic management plans prescribed by regulations for the purposes of this paragraph,

As soon as practicable after adopting the Council's annual business plan for a particular financial year; and
 - (b) in any event, undertake a comprehensive review of its strategic management plans within 2 years after each general election of the Council.
- (4a) A Council must, for the purposes of a review under subsection (4), take into account—
 - (a) in relation to a review under subsection (4)(a)(i)—a report from the chief executive officer on the sustainability of the Council's long-term financial performance and position taking into account the provisions of the Council's annual business plan and strategic management plans; and
 - (b) insofar as may be relevant—any other material prescribed by the regulations.
- (5) A council may amend its strategic management plans or adopt new plans.
- (6) A council must adopt a process or processes to ensure that members of the public are given a reasonable opportunity to be involved in the development and review of its strategic management plans.
- (7) A council must ensure that copies of its strategic management plans under this section are available for inspection (without charge) and purchase (on payment of a fee fixed by the council) by the public at the principal office of the council.
- (8) A council must, for the purposes of this section, specifically declare which plans will constitute the strategic management plans of the council.