Fit for the Future Improvement Proposal

Attachment 1

Financial Strategy

Council Report - 28 February 2012

Subject 11.1.1 Financial Strategy - Some Preliminary Thoughts (9661530)

To the Mayor and Councillors

Division: **General Manager's Division**
Department: **Executive Services**

Manager: Michael Willis - General Manager
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Summary

The Council's 2011-2021 Resourcing Strategy makes it plain that while its present financial position is sound, its long term projection is not. At page 39 it states:

"…if we continue to operate on current practices, the financial future of the Council is not sustainable. As such, corrective action is required that delivers a long term and sustainable financial future."

Quite clearly, if the Council wishes to maintain its current sound financial position, it cannot continue with all its current practices. This report:

- Highlights the key financial trends over the next 10 years, based on the continuation of current practises.
- Suggests a number of strategies to improve those trends.
- Proposes a number of actions to implement those strategies.

Background

1. <u>Introduction</u>

After a long period of managerial and structural stability, it was inevitable that the appointment of a new General Manager would bring with it a period of transition and change.

On my arrival, quite some time was spent analysing organisational performance along with the challenges it faced. In an early statement, staff was advised that the initial approach to change would follow three broad priorities:

- Reviewing our organisational structure
- Having a better budgeting process
- A more detailed approach to capital works programming

There then followed an intensive staff consultation and deliberation process on the staffing structure (under the banner of 'Reshaping the Organisation'), that concluded with the approval of a new three Directorate structure by the Council on 5 July 2011. Following a number of senior staff retirements, three new Directors were appointed as well as three new Group Managers. With the near completion of that process, greater attention is now being focused on the other two priorities listed above.

There were a number of significant changes to the 2011/12 Budget process. The most important was its integration into the Integrated Planning and Reporting (IPR) process, and in particular, the Shellharbour Community Plan and its component parts of:

- Resourcing Strategy
- Four year Delivery Program
- Annual Operational Plan

In addition, a significant change was made to the 2011/12 budget process with the decision for capital expenditure to be funded from a mix of reserves, capital grants and loans, but not operational income. This had the effect of allowing greater resources to be placed into asset maintenance and renewal expenditure.

A more comprehensive approach has been taken to the preparation of the 2012/13 Budget, with greater attention being paid to:

- Group Business Plans (an innovation)
- Detailed analysis of past expenditure trends
- Project completion; carry forwards; and capital works programming

In addition, work was begun on developing a Financial Strategy for the Council.

Coincidentally, staff were approached by the NSW Department of Premier and Cabinet, Division of Local Government (DLG) seeking discussions on its concerns relating to:

- Operating deficits over the last five years.
- Shortfalls in required asset maintenance expenditure
- Projected continuing deficits for the next 10 years

These took place on 19 January 2012, and this report is largely based on a presentation and accompanying paper provided at that meeting. As noted in the summary, this report sets out;

- The key financial trends over the next 10 years.
- Strategies to improve those trends
- Actions to implement those strategies

2. <u>The Council's Projected Financial Position</u>

This is detailed in the Shellharbour City Council Resourcing Strategy 2011-2021. Set out below is a selected extract of that data to illustrate some of the key trends at work.

2.1 <u>Consolidated Income Statement 2011/12 - 2020/21</u>

Over the next 10 years based on current policies and practices, the following changes are projected:

- Operational income + 37%
- Rates and annual charges + 45%
- User fees and charges +37%
- Operational expenses + 30%
- Employee costs +37%
- Borrowing costs will remain negligible

The overall impact of those changes is that the Council's net operating result before grants and capital will be in deficit in each year, resulting in a marked decline in the Council's financial position: a clearly unsustainable position.

2.2 Balance Sheet

Three things stand out in Council's current projected Balance Sheet.

1. Equity will decline from $605M to $544M (10%)
2. Borrowings will be zero for each of the projected 10 years
3. Infrastructure value will decline from $545M to $487M (11%)

2.3 Cash Flows

During the 10 year period, cash flows will be stable, resulting in an increase in cash from $6.7M to $7.4M (10.5%)

The 10 year plan does not show much movement in these cash and cash equivalents as they represent funds required for working capital purposes. Any increase or reduction in cash will be reflected in the level of investments which fluctuate significantly from year to year based on predicted cash usage.

2.4 Capital Works

In the 10 year period, these are projected to be in the order of $67M or $6.7M each year on average.

Planned Capital Works detailed in the resourcing strategy's long term financial plan over the 10 year period totals $84 million. This does not include the 10 year asset renewal and replacement program, which is predominantly made up of Council's annual plant replacement program and totals $47 million.

The asset renewal ratio is projected to decline over the 10 year period from 0.28 to 0.13 (where 1.00 represents annual asset renewal expenditure equalling the annual rate of asset consumption (via depreciation), and 0.00 represents no replacement of annual asset consumption). The ratio takes into account capital expenditure on assets but not maintenance expenditure. Further work needs to take place on the distinction between these two classifications.

So, what's wrong with this picture? There are three key concerns.

First and foremost, no organisation can sustain continual operating losses without having a severe effect on its assets, and the goods and services it supplies.

Second, given that the City is continuing to grow at a relatively high rate, it is unrealistic to continue to exclude loan financing from the mix of funding required for capital spending.

Third, there is inadequate financial capacity to renew and maintain existing infrastructure and assets (which is projected to more than halve from its already quite low levels of replacement).

3. Some Strategies

What can the Council do to mitigate those apparent trends? A number of strategies should be adopted by the Council to ensure its future financial sustainability.

3.1 Recurring income must exceed recurring expenditure

It is difficult to discern this from our current financial reporting. This is because our budgets contain (as one would expect) significant items of one-off expenditure. In addition, there are a large number of budgeting changes that occur as the financial year progresses that can have the effect of obscuring whether or not recurring income is exceeding recurring expenditure.

The last five to seven years has seen our day to day or recurrent expenditure growing at a faster pace than our recurrent income. If they are brought closer in line this will flow on to assisting in bring our annual operating result to a balanced position.

A close to neutral result for our operating result will be extremely difficult to achieve. Our operating results before capital the past two years have been a $3.7 million deficit in 2011 and $4.3 million in 2010. The phasing in over the last five years of recording our infrastructure assets at fair value rather than the previous historical cost method, has greatly improved our balance sheet position, with over $380 million being added to its value.

Unfortunately, this has also led to higher depreciation expenses which hit our operating statement. Depreciation costs increased from $12 million in 2010 to $16 million in 2011. The only reason our operating result for 2011 was superior to 2010 was the $4.7 million inclusion of income for the part sale of Lamerton Crescent.

Ongoing operating deficits can only be eliminated if this strategy is strictly applied, difficult in all though that it will be to achieve.

3.2 Each of the Council's service delivery activities is to be cost and quality competitive

No one would argue that our services should be provided at high cost and low quality. The question therefore is, 'cost and quality competitive to what?' That can be answered in two different ways.

- For services that are uniquely local government (such as libraries), how do our residents rate them and how do these services compare to those provided by other councils?

- For services that are provided by the Council but could be supplied by the market, two questions should be asked:

  1. Is the quality of the service we provide, comparable to what is available in the market place?

  2. Is its cost at the median of what is available in the market place, i.e. neither expensive nor cheap, but more or less in the middle?

The essence of this approach is to establish a comparative approach (rather than a contestable or contracting-out one) to benchmark the appropriate levels of cost and quality, for each of the Council's service delivery activities.

The answers to these two questions will generate further thinking about ways to improve quality and cost of service levels.

This approach is in keeping with the recommendation in the Resourcing Strategy for "a formal service review for all operations…" (p.40)

3.3 Asset renewal must have a higher priority than the creation of new assets, all things being equal

Such a strategy is to be followed in a relative rather than absolute sense. Given that Shellharbour is a growing city, asset renewal cannot always be put ahead of new capital investment. Rather, what it does mean is that, all things being equal, asset renewal will receive a higher priority than capital development. Application of this strategy will lead the Council (in time) to be able to better maintain and sustain what it has previously built.

The adoption of our Integrated Planning documents in June last year for the first time included the data from our Asset Management Plans. Condition ratings were used to indicate the current state of our assets, which in turn gave an overview of both their current state, as well as implied priorities for renewal expenditure.

This was our first attempt at compiling this sort of information. Further iterations will improve the quality of that information which will in turn be reflected in the cost of renewals. From experience, better quality of information will be reflected in lower valuations of the assets, and lower costs of renewal.

As indicated earlier, one challenge we have in this area is the classification of asset renewal capital expenditure versus asset maintenance expenditure. Our Resourcing Strategy defines asset renewal as expenditure that does not increase the design capacity but restores, rehabilitates, replaces or renews an existing asset. Asset maintenance is defined as on-going work that is necessary to keep assets operating. It includes cyclic maintenance which involves the replacement of higher valued components of assets.

The classification of a particular project into either asset maintenance or asset renewal is not always obvious, but the end result is interesting.

If it is classed as maintenance expenditure, then it appears in our operating result and subsequently takes us further away from achieving an operating surplus before capital items. If it is classified as asset renewal and capitalised, it does not appear in our operating result, thus improving our position and assisting in improving our asset renewal ratio.

3.4 Capital investment (expenditure) must be financed from a mix of reserves, grants, contributions and loans, but not operational income

This particular strategy was applied in 2011/2012, which had the effect of tightening capital and 'New Items' expenditure while making additional resources available for recurrent operating expenditure, including asset maintenance.

3.5 Optimise returns from the Council's commercial holdings

The Council has a number of commercially valuable assets. These include Shell Cove, the Illawarra Regional Airport, The Links, as well as other commercial property. It is fair to say that the return from some of these assets has not been reflective of their prospective commercial value, nor have they been managed in a commercial or "businesslike" manner. Council needs to apply a more commercial perspective to the management of and returns on such assets. Optimisation of their value will require such an approach.

4. Actions

For each of the strategies identified above, a number of actions can be identified that will give effect to them.

4.1 Recurring income must exceed recurring expenditure

Actions

4.1.1 Ensure that budgets and monitoring reports are able to identify the degree to which recurring income meets and exceeds recurring expenses.

4.1.2 Aim to reduce annual operating statement deficits before capital to within 1% of annual operating expenditure by 2015/16, with continual improvement on an ongoing basis.

4.1.3 Any surpluses of unrestricted income over unrestricted expenditure are to be applied to (in order of priority)

i. One-off or extraordinary costs
ii. Unrestricted reserves

4.2 Each of the Council's service delivery activities is to be cost and quality competitive

Actions

4.2.1 Corporate Policy to catalogue and specify the services to be delivered by Shellharbour Enterprises to the community.

4.2.2 Service Level Agreements are to be negotiated between Corporate Policy and Shellharbour Enterprises, which will reflect the quantum and quality of services to be delivered and the 'price' to be paid for them.

The term "price" is of critical importance. This will either be at the market median (where this can be reasonably established), or by negotiation and agreement. Care must be taken to avoid the easy option of simply converting current cost to price.

4.2.3 Overhead costs are to be determined on a similar basis to 4.2.2 above, i.e. with reference to median indicators and by negotiation and agreement.

4.3 Asset renewal has a higher priority than capital development - all other things being equal

Actions

4.3.1 Ensure the appropriate classification of asset renewal expenditure and asset maintenance expenditure.

4.3.2 Establish annual investment targets in renewal or refurbishment of existing assets, to progressively increase the asset renewal ratio, over the next 10 years.

4.3.3 Asset renewal programmes are to be prioritised on the basis of condition ratings.

4.4 Capital investment (expenditure) to be financed from reserves, grants and contributions and loans where appropriate

Actions

4.4.1 All capital works in excess of $5,000 to be funded as above.

4.4.2 Council to establish a Debt Service Ratio.

4.4.3 Council to establish a scheduled approach to acquiring and retiring such debt.

4.5 Optimise returns from the Council's commercial property holdings

Actions

4.5.1 Complete 'soft' and 'hard' tendering of The Links by 30 June 2012.

4.5.2 Investigate the possibility of placing the assets of the Illawarra Regional Airport into a council owned entity that would operate on a commercial basis.

4.5.3 Investigate the establishment of a local wealth fund to receive the final proceeds of the Shell Cove project, with a view to the returns from such a fund being applied 50% to reinvestment in the fund, and 50% to the general revenues of the Council.

4.5.4 Establish rates of return benchmarks for all other commercial property holdings.

Conclusion

The strategies and actions set out in this report have been listed in priority order:

1. Recurring income must exceed recurring expenditure.

2. Ensure that Council's service delivery activities are cost and quality competitive.

3. Give higher priority to asset renewal over new capital development.

4. Finance new capital development from reserves, grants and contributions, and loans.

5. Maximise the Council's returns from its property assets.

The Council's most important immediate financial objective is to ensure that our operating budgets are in balance. This will provide the solid foundation upon which each of the succeeding strategies can then be built.

The significance of the approach set out in the paper is that it is a strategic one (with supporting actions) that sets an agenda for meeting the challenge identified earlier on p39 of the Resourcing Strategy, i.e. 'ensuring that immediate action is taken to deliver a long term and sustainable future'. As indicated in the attached letter, it is one that has been noted by the DLG.

In coming months, as part of the budgeting process, the Council will be required to review its:

- Resourcing Strategy
- Four year Delivery Program
- Annual Operational Plan

As part of that process, the council will need to take account of the strategies recommended in this report, especially in respect of considering additional levels of service, alteration to income streams, along with the quantum of asset renewal and capital works expenditure.

As indicated above, this report clearly links to the Council's adopted Resourcing Strategy 2011/2021, and in particular, pages 39-40.

While the Council's current financial position is sound, unless corrective steps are taken, it will continue its current trend of medium term decline. The longer it takes to address the financial challenges outlined in this report, the greater the impact there will on the level and quality of council services.

It is far better that the Council adopts a number of strategies and actions now to arrest that trend, and minimise any impact on its organisational capacity and services to the community.

The DLG has an oversight and monitoring responsibility for the performance of local government in NSW. It has already signalled its concerns regarding the council's longer term financial projections. Failure to take the appropriate corrective action now may lead to it to make a more direct intervention at some point in the future.

It is important that the public is well informed of the Council's appreciation of its longer term financial situation and that it is taking the appropriate steps to rectify it. By doing this, the Council will be able to continue to enjoy the support it has for its current direction and levels of service. Conversely, failure to do so may only serve to foster a loss of confidence in the ability of the Council to meet the growing needs of a growing city, and the investment and development decisions that will be required to achieve that.

Consultations

Internal

Manex
Group Manager Finance
Manager Financial Services

External

NSW Department of Premier and Cabinet, Division of Local Government

Political Donations Disclosure

Not applicable

Recommendation

1. That the report be received.

2. That the Council endorse the Financial Strategies set out below:

(a) Recurring income must exceed recurring expenditure.

(b) Each of the Council's service delivery activities is to be cost and quality competitive.

(c) Asset renewal must have a higher priority than the creation of new assets, all things being equal.

(d) Capital investment (expenditure) to be financed from reserves, grants, contributions, and loans where appropriate.

(e) Optimise returns from the Council's commercial holdings.

3. That the Council endorse the Actions detailed in paragraphs 4.1-4.5 in the General Manager's report

Approved for Council's consideration: [redacted]

Attachments

1. Letter from NSW Premier & Cabinet Division of Local Government dated 27 January 2012

Attachment 1 - Letter from NSW Premier & Cabinet Division of Local Government dated 27 January 2012.

NSW GOVERNMENT | Premier & Cabinet
Division of Local Government

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SHELLHARBOUR CITY COUNCIL
Doc No
01 FEB 2012
Batch No
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Mr Michael Willis
General Manager
Shellharbour City Council
Locked Bag 155
SHELLHARBOUR CITY CENTRE NSW 2529

Dear ~~Mr Willis~~ Michael

I am writing in regard to the meeting held on 19 January 2012 with Divisional officers regarding Council's financial position.

As outlined at the meeting, the Division of Local Government reviews the financial position of all councils and county councils in New South Wales. I am advised that the review of Shellharbour City Council highlighted several concerns, including the following:

- Council has recorded operating deficits before capital grants and contributions in the last five financial years (totalling $18.5 million)
- Council's infrastructure Renewal Ratio for 2010/11 was 19.11% (benchmark 100%)
- Council's required asset maintenance spending was $8.5 million short of the required estimate for 2010/11 ($18.8 million shortfall over the last five years)
- Council's Long-Term Financial Plan forecasts further deficits for the next ten years ($97.4 million). In addition, Council was not fully funding its asset maintenance and is not replacing its assets as they are being consumed (depreciation and amortisation).

I understand that Council's short term financial position may be sound, but its long term projection is not. It was agreed that Council needs to reconsider its long term financial management projections.

It is noted that Council has identified the following initiatives to improve its financial position:

- Policy change whereby the maintenance of assets will be given priority over the replacement of assets. I note Council maintains that this will extend the life of the asset
- Capital investment to be financed by a mixture of reserves, grants and contributions and loans, thus reducing the need to use recurrent funds
- Optimise returns from Council's commercial holdings, including:
    - The Shell Cove project

    - Illawarra Regional Airport
    - The Links Golf Course (lease)
    - Review needs and options on commercial property
- Monitoring of budgets more closely
- Review pricing policies
- Review overheads.

The Division will continue to monitor Council's financial position on an ongoing basis.

I would also like to thank Council for its co-operation with the Division and the manner in which it approached the meeting.

Yours sincerely

27/1/12

Ross Woodward
Chief Executive, Local Government
A Division of the Department of Premier and Cabinet