

**Guidelines for
Implementing Total Management Planning**

Financial Management

OVERVIEW

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LIST OF ACRONYMS

COAG	Council of Australian Governments
DIP	Department of Infrastructure and Planning (formerly Department of Local Government and Planning DLGP)
EPP (Water)	Environmental Protection (Water) Policy 2009
GDP	gross domestic product
KPI	key performance indicator
NCP	National Competition Policy
DERM	Department of Environment and Resource Management
QCA	Queensland Competition Authority
SWOT	strengths, weaknesses, opportunities, threats
TMP	Total Management Plan
WSAA	Water Services Association of Australia
WSP	Water Service Provider

1 INTRODUCTION

The Queensland Water Industry manages over \$20 billion in water service infrastructure assets (Qld Commission of Audit Report, June 1996, Chapters 12 and 14) (Reference 1). An estimated \$800 million is spent annually on the maintenance and operation of the network. Much of this asset base is earning a minimal (or negative) rate of return. In the case of the rural water industry alone, the net result of the negative rate of return is a loss to the state of between \$150 million and \$200 million per annum. With such massive investment in the industry, sound financial planning and management of WSPs is a key priority. In the urban context \$10 000–\$15 000 worth of water supply and sewerage infrastructure exists for each household. Each year approximately \$200–\$400 million of water-related infrastructure is developed by the public or private sector.

The Financial Management Overview and Implementation Guide will help Queensland Water Service Provider (WSP) organisations to focus on achieving financial sustainability of maintaining and improving the quality of their services. Total management planning will provide the framework within which a financial management strategy is developed. This strategy will encourage best practice by WSPs as well as helping them to meet their commercial and statutory obligations (particularly consistency with COAG and NCP policy initiatives).

Smaller WSPs often have limited resources and are more constrained in achieving these aims than larger, more commercially oriented WSPs. In recognition of this, a hierarchy of approaches to developing a financial management strategy has been established, to suit WSP organisations of different sizes.

These guidelines have been prepared so as to be compatible with the new legislative framework for regulation of the Queensland water industry.

2 THE ROLE OF A FINANCIAL MANAGEMENT STRATEGY

The financial management strategy comprises a Financial Management Plan and a Financial Model. The Financial Management Plan is a qualitative document that describes what capital works need to be undertaken and why; a Financial Model uses this information to create a quantitative document (i.e. forecast of revenue and expenditure).

To be effective, the financial management strategy needs to:

- give effect to strategies identified in the Corporate and Operational Plans, and the TMP Business Management Plan;
- demonstrate the long-term viability of the organisation;
- be integrated with the organisation's broader financial management planning;
- be an iterative process (i.e. regularly reviewed and revised);
- comply with legislative and administrative requirements (including QCA, DERM and DIP); and
- provide mechanisms for effective monitoring and review.

3 WHO SHOULD DEVELOP A FINANCIAL MANAGEMENT PLAN?

The Financial Management Implementation Guide applies to all organisations that provide a water supply or sewerage. Essentially this includes the following Queensland WSPs:

- rural water supply boards;
- urban water supply boards;
- state government departments and other agencies;
- local governments;
- joint local governments;
- Aboriginal community councils;
- Torres Strait Island community councils; and
- non-government entities.

The Implementation Guide is intended to apply primarily to the provision of services for:

- urban and rural potable water supply;
- irrigation water supply; and
- sewerage.

However, the principles outlined should in general be applicable to the provision of any other category of water services.

4 ROLE OF FINANCIAL MANAGEMENT

An increasing focus on efficiency and financial accountability has brought financial management issues to the forefront for management of both large and small WSPs. This trend has been supported by increasing competition for capital, and is having a profound effect on the water industry.

Financial management is a process of assessing the organisation's current and projected financial performance in a manner that provides meaningful information for planning, performance measurement, internal control and corporate management.

The purpose of developing a Financial Management Plan is to provide a single point of reference for a range of statutory and management information without further contributing to the reporting burden of WSPs.

The Financial Management Implementation Guide has been designed to facilitate and encourage the development of a comprehensive financial management strategy by providing an outline of the defined outputs from the process. This means that there is no set reporting format, and WSPs may use existing reports and information to meet the range of outputs required. This output-based reporting provides some flexibility for each individual WSP to develop their financial management strategy to an appropriate level and in a manner that suits their organisation.

Appendix A of the Implementation Guide provides an indication of the extent of information required in the development of a Financial Management Plan for WSPs of various sizes.

The overall financial management strategy should address the range of outputs discussed in Section 2.4 of the Implementation Guide.

The financial model

At the heart of the financial strategy will be a Financial Model. Financial modelling will quantify the impact of the organisation's financial objectives and demonstrate (in dollar terms) the commercial performance of the organisation over time.

The Financial Model should be developed on an output basis. Two Financial Models (basic and advanced) have been developed to suit organisations at each development level. However, WSPs may use their own financial models, provided that they address the outputs listed in Section 2.4 of the Implementation Guide.

4.1 What is driving financial management?

The need for accurate and effective financial management planning arises from changes in the operation of the water industry. The forces driving the need for improved financial management among WSPs include the following:

Customer pressures

Consumers (both large and small) are increasingly demanding efficiencies in the management of WSPs, reflected in 'reasonable' prices for services.

Downstream industry drivers

The outputs of the water industry are key inputs to a range of businesses. It is therefore important to ensure that efficiency and productivity of the water industry meet best practice. These businesses (several of which are competing in a global market and provide local employment opportunities) need to ensure that their inputs are priced as efficiently as possible.

The COAG/NCP reform agenda

The COAG reform agenda (Reference 2) applied a timetable for reform of the water industry. The supporting industry commission report (Reference 3) identified that reform of the water industry would contribute up to \$465m per year in National Gross Domestic Product (GDP). Commonwealth and State funding arrangements underpin this reform agenda.

The impact of the COAG/NCP reform agenda is reflected in the following key initiatives:

- introduction of full cost pricing;
- adoption of consumption-based pricing regimes (two-part tariff);
- increased transparency, through removal or identification of cross-subsidies that are not consistent with efficient and effective service provision;
- identification of community service obligations where service deliverers are required to provide water services to customers at less than full cost; and
- earning a real rate of return on assets.

The Queensland Competition Authority (QCA) role in overseeing prices

The Queensland Competition Authority has a role in overseeing issues of competitive neutrality, monopoly prices and third party access as they apply to the water industry. This role is established in legislation and is reflected in the *Statement of Regulatory Pricing Principles for the Water Sector* (Reference 4).

Legislative requirements

These include compliance with State legislation and administrative standards such as:

- *Financial Administration and Audit Act 1997*;
- Local Government Finance Standard 1994;
- Financial Management Standard 1994;
- agency-specific information including the *Local Government Act 1993* (e.g. commercialisation, application of two-part tariff);
- compliance with Accounting Standards (particularly AAS27, AAS4, AAS10) (References 5, 6 & 7); and
- guidelines from State Government departments (e.g. Treasury, DERM, DIP) (References 8, 9, 10, 11 & 12).

4.2 Benefits of financial management

Billions of dollars are invested in the State's water infrastructure and millions are spent each year by WSPs in operating and maintaining these assets. Improvements in financial planning management, therefore, can significantly affect both local and State economies.

Effective financial management has the following beneficial outcomes:

- The business remains viable in the short, medium and long term;
- Customers get value for money;
- Statutory requirements are met; and
- Managers have financial information (costs, KPIs, etc.) to allow them to manage the business more effectively and efficiently in the short term and the long term.

These outcomes are achieved by:

- identifying the need for future infrastructure investment (capital works) and potential sources of funding for it (e.g. reserves, debt, subsidies), thus allowing the business to plan its future capital requirements;
- assessing whether sufficient revenue is being generated to meet long-term financial obligations;
- communicating effectively with the board of management; and
- highlighting changes in the cash position, profitability and size of the business over time.

4.3 Risks associated with inadequate financial management

A lack of adequate financial management and planning can compromise a business’s ability to meet its long-term obligations. The more significant potential risks include:

- sudden significant increases in charges due to unforeseen expenditure;
- non-compliance with financial obligations;
- inability to fund necessary capital works;
- inability of commercialised or corporatised entities to pay agreed dividends to the owner;
- changes in subsidy rates; and
- significant reduction in the number of customers (revenue base).

Developing a comprehensive financial management strategy will help WSPs to identify and overcome financial risks that could affect the business’s viability.

5 FINANCIAL MANAGEMENT WITHIN THE TMP CONTEXT

Financial management is recognised as a key result area for purposes of total management planning, as discussed in the TMP Concept document and shown in Figure 1. Figure 2 illustrates the relationship between the financial management and other key result areas within the Total Management Plan.

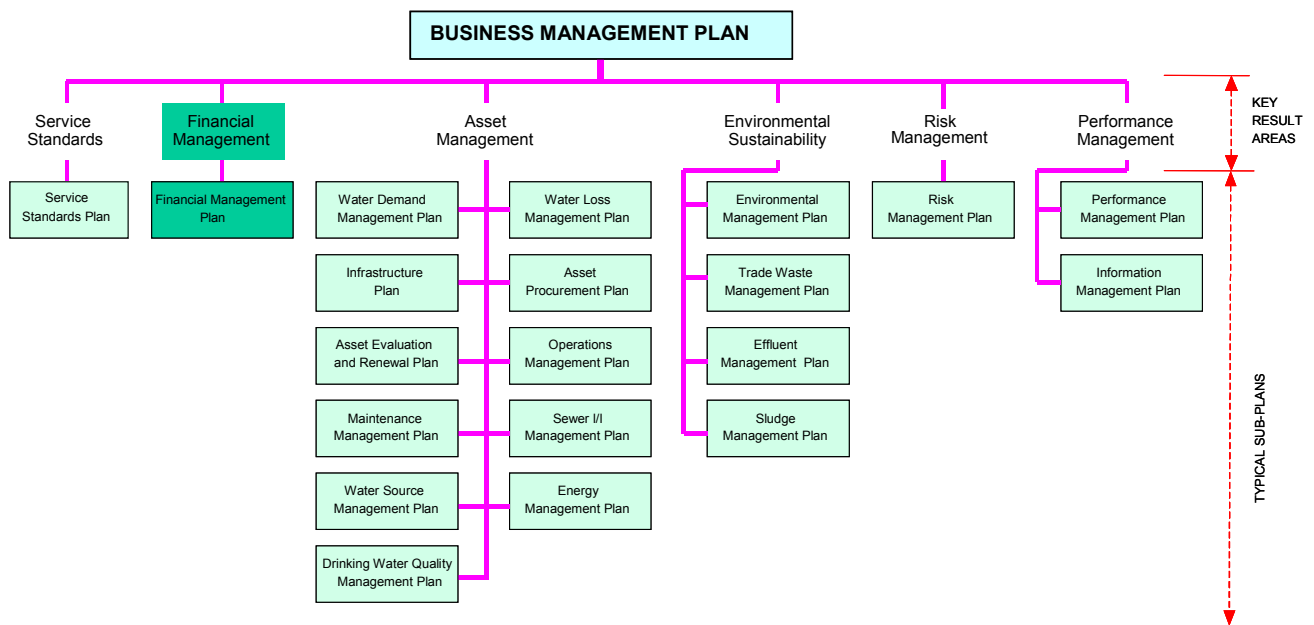


Figure 1: Financial Management in the TMP context

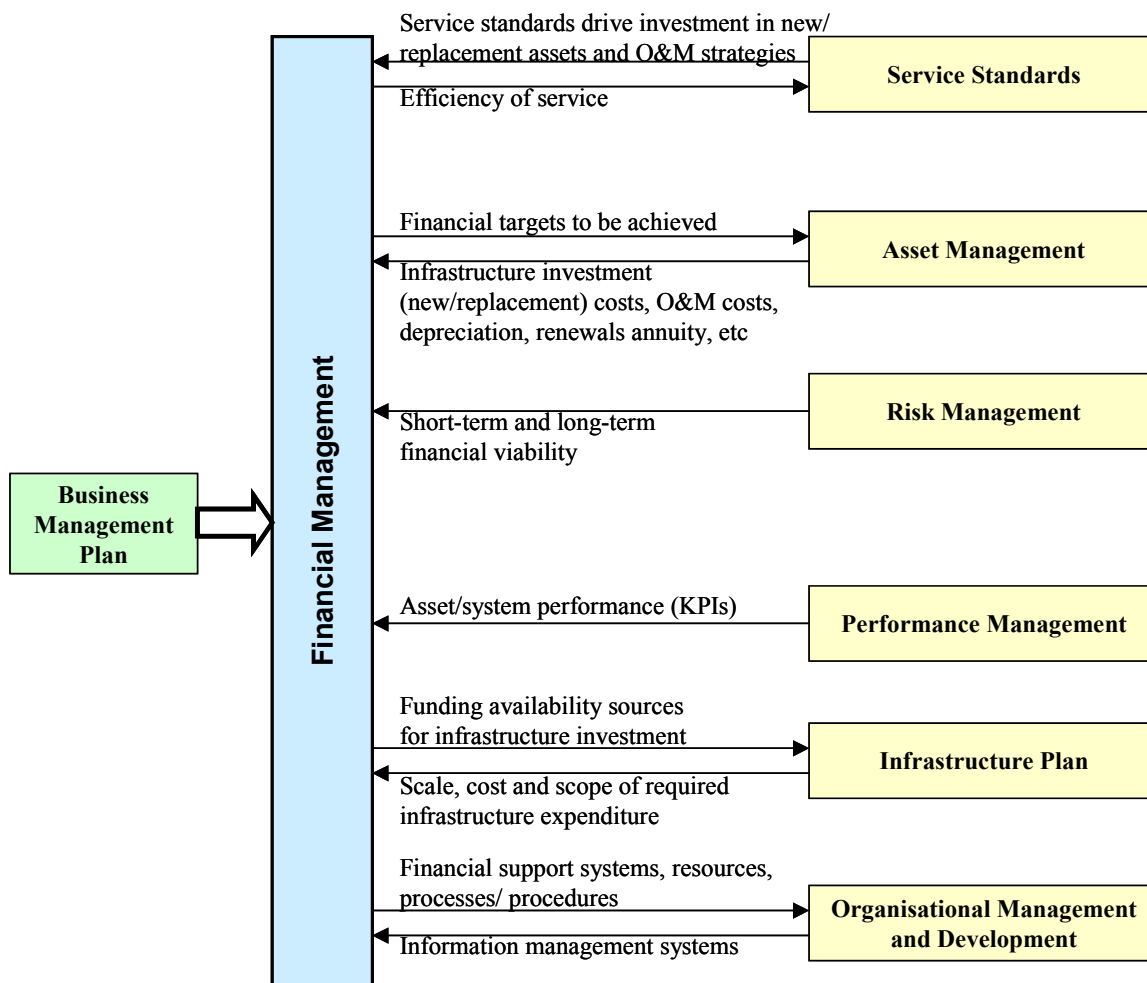


FIGURE 2: Relationship between Financial Management and other key result areas

The **Financial Management Plan** itself is the qualitative component of the financial management strategy. The plan identifies and presents in a succinct manner:

- the strategic direction for financial management, including goals, objectives, strategies, key performance indicators and action plans.
- external issues impacting on the WSP's financial management (e.g. COAG/NCP);
- current status of financial management:
- revenues and cost projections;
- results of financial modelling (discussion and graphical outputs); and
- broad SWOT analysis.

Another key element of the financial management strategy is the development of a 10- to 20-year **Financial Model**. Essentially, the model is the 'engine room' for the whole Total Management Plan. The Financial Model is a decision tool which effectively quantifies how the business will meet its obligations, particularly in respect of:

- funding infrastructure investment (capital works) and recurrent expenditure to meet desired customer service standards;
- meeting regulatory requirements;
- meeting financial obligations to owners/shareholders; and
- assessing the impact of potential risk factors (refer 4.3 above).

The relationship between the Financial Management Plan and Financial Model is illustrated in Figure 3.

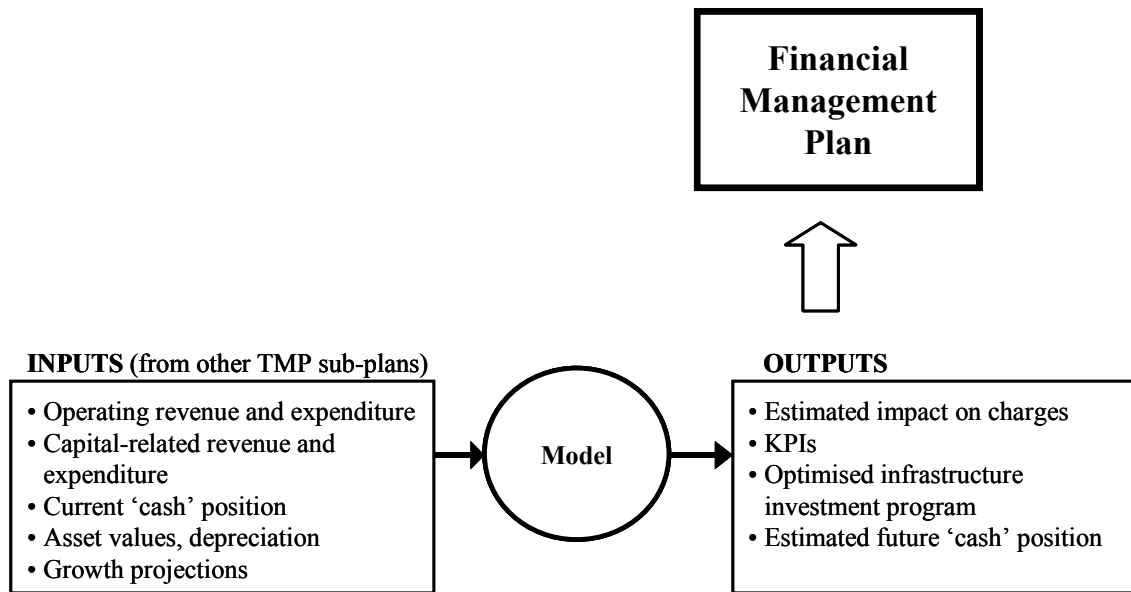


FIGURE 3: The relationship between the Financial Management Plan and the Financial Model

The processes for development of a Financial Management Plan and Financial Model are set out in greater detail in the Financial Management Implementation Guide.

Three different development levels for the preparation of a Financial Management Plan are proposed, in recognition of the different needs of WSPs of various sizes. Three levels of financial modelling would support these. A brief outline of the scope of the Financial Management Plan at each development level is provided in the Financial Management Implementation Guide. The highest level will apply to the larger entities and will include adjustments associated with operating a commercialised business; the intermediate standard will be a slightly simpler model. The lowest standard will be a very simple model aimed at meeting the requirements of small local governments and rural water boards, which may have comparatively few issues in water service provision and limited resources.

6 RELATIONSHIP WITH OTHER DOCUMENTATION

The financial management strategy is a key part of an organisation's management and planning functions. To be effective, the Financial Management Plan must be developed in context with the organisation's established strategic direction. That is, the content (and perhaps structure) of the Financial Management Plan needs to support or reflect the organisation's Corporate Plan, Total Management Plan and Operational Plan.

The Corporate Plan provides the WSP with the authority to carry out its functions, and provides a general strategic direction for the organisation. The Total Management Plan converts the long-range strategic objectives contained within the Corporate Plan into specific actions over a defined (1- to 3-year) timeframe. The Operational Plan is an annual plan which identifies the short-term management priorities. Together, these documents provide the total framework for the operation of the WSP. The Financial Management Plan will use the information provided by these documents to develop both short-term and long-term financial goals.

In addition, the financial impact of all other TMP key result areas will be reflected in the Financial Management Plan. In particular, the Service Standards key result area will act as a primary driver of annual operations and maintenance expenses and associated revenue (i.e. higher or lower customer service standards may result in higher or lower expenses). The Asset Management key result area will include an outline of proposed capital works (Infrastructure Plan sub-plan), which inevitably has a significant impact on the financial performance of a WSP. The financial impact of the other key result areas also needs to be considered: environmental sustainability (i.e. benefit/cost of new initiatives); risk management (i.e. potential for significant variance in revenues/expenses); and organisational development (e.g. cost of reforms and targeted benefit of change).

The relationship between the Financial Management Plan and other documentation is illustrated in Figure 4.

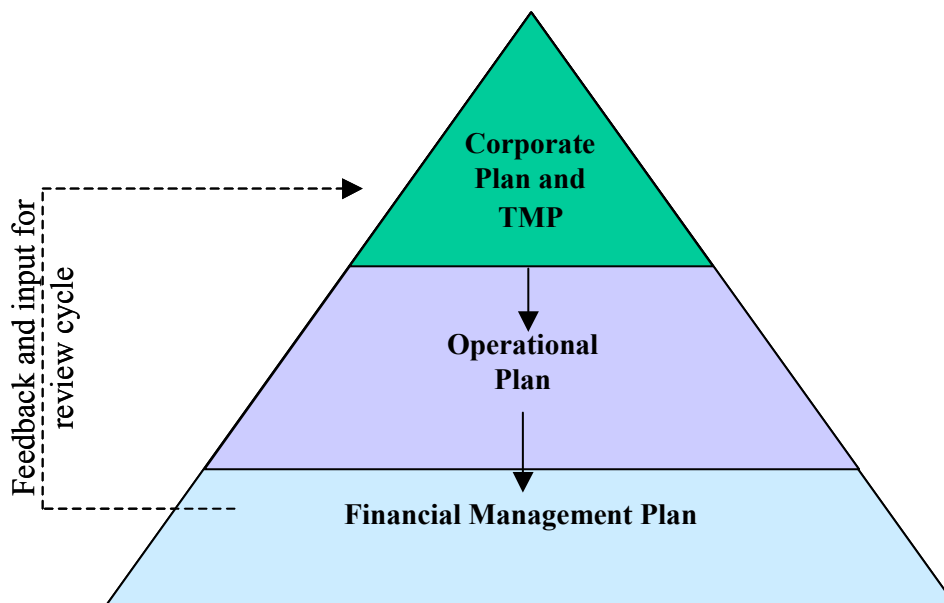


FIGURE 4: Documentation hierarchy

Other reference documentation

One of the key objectives in developing a WSP’s financial management strategy is to utilise the range of existing documentation already developed by the State, professional or other authorities which provide guidance on how activities may be undertaken (refer ‘References’). Wherever possible, the Financial Management Plan should make reference to such appropriate documentation including:

- Australian Accounting Standards (particularly AAS27, AAS4 and AAS10) (References 5,6 &7);
- Queensland Government’s full cost pricing Guidelines (Reference 8);
- QCA’s principles of water pricing (Reference 4);
- state and national comparative information (References 13, 14 & 15);
- sources of KPIs used in water service management (financial and non-financial) (References 14 & 15);
- Treasury guidelines on private infrastructure funding (Reference 10);
- Departmental Guidelines on two-part tariffs, taxation equivalents, asset valuation methodology (References 8, 9, 10, 11 & 12); and
- Discussion papers, guidelines and reports on the implementation of water industry reforms (References 16, 17, 18 & 19).

7 REGULATORY FRAMEWORK FOR FINANCIAL MANAGEMENT

Financial management of WSPs is the subject of a range of legislative obligations. The impact of key legislation and statutory requirements are outlined below.

Water Supply (Safety and Reliability) Act 2008

The *Water Supply (Safety and Reliability) Act 2008* seeks to ensure that WSPs, as monopoly service providers, implement appropriate systems and processes for ensuring the reliability and supply of an essential service. The Act is largely performance-based rather than prescriptive. Under this legislation, the development and implementation of financial management in Queensland will be subject to a degree of regulation by DERM.

Local Government Finance Standard (1994) (Part 5) and Financial Management Standard (1997)

These standards set out detailed requirements for budgets, including a requirement that budgets be prepared on an accrual basis.

The DIP Local Governing Bodies' Capital Works Subsidy Scheme

This scheme provides subsidies of up to 40% (50% in certain circumstances) on capital works for water supply and sewerage. To be eligible for full subsidies for capital works, DERM requires 10-year financial projections to be updated on an annual basis (minimum requirements are detailed in the Financial Management Implementation Guide).

Local Government Act 1993

Amendments to the *Local Government Act 1993* now specify that those WSPs which qualify for Type 1 or Type 2 business activities must:

- identify water supply and sewerage services as significant business activities within their budgets;
- undertake a public benefit assessment to determine the costs and benefits of reforming the water and sewerage businesses and adopt a timetable for implementation of reforms;
- implement full cost pricing plus commercialisation reforms to Type 1 or 2 business activities;
- fully attribute all costs to these activities (including depreciation and estimates equivalent to government taxes and debt guarantee fees); and
- evaluate the cost-effectiveness of introducing two-part tariffs (including the necessary costs of installing or refurbishing water meters);

Sustainable Planning Act 2009

Some local government currently levy up-front capital charges ('developer contributions' or 'infrastructure charges') to fund future water and sewerage infrastructure. Under the *Sustainable Planning Act 2009* those local governments that wish to continue this practice must have a complying Infrastructure Charges Plan by 30 March 2003. Up-front charges are only one way of charging for infrastructure, and not necessarily the most efficient in economic terms. For this reason, the Act requires that a local government proposing to impose infrastructure charges must justify doing so and explain why alternative approaches or combinations of approaches were not adopted. This is a major departure from the 'developer contributions' approach under the former legislation.

The Queensland Competition Authority

This authority (as a statutory regulator in Queensland) may have its powers extended to cover overseeing costs of local government significant business activities.

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