

Managing Capital Investments

Volume 3: Capital Investment Plan
Financing the Capital Investment Plan

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ISBN

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Preface

The original Local Government Financial Management (LGFM) series was conceived in the mid-nineteen nineties in Lucenec, in Eastern Slovakia. The United States Agency for International Development (USAID), through a contract with the International City/County Management Association (ICMA), had initiated a local government capacity building programme in Slovakia and financial management was one of the areas targeted for development.

When the City of Lucenec was approached as a potential recipient of technical assistance for the specific purpose of developing a capital improvement budget, they were grateful but not impressed. They saw the need for financial management assistance for the local government and others in Slovakia in much broader terms. Working with a group of dedicated local finance officers in Slovakia, ICMA assembled a small team of LGFM consultants. Together they produced the initial fourteen handbooks in this series.

Over time, the series spread quickly to other counties in the central and eastern European region and beyond. Funding for the adaptation and translation of the materials came from a variety of sources, including The World Bank and private foundations.

While UN-HABITAT had contributed to the initiation of the series, their involvement in the development and dissemination up to this point had been minimal. Nevertheless, they recognised the series' potential for worldwide use. But, they needed to be updated to reflect new ideas in LGFM and revised to make them more user friendly as they crossed national borders and language differences. Among other things, the initial series was based on Slovak laws, regulations, and experience, which varied significantly from those in other countries. UNHABITAT commissioned a written user survey and convened a small group of experts to help determine how best to carry out the revisionist task. The expert group included the Slovak initiators and others who had used the materials in various countries around the world.

While the initial edition of these materials was directed to Slovak local government finance officers, this edition is intended for a much larger audience. It includes not just finance officers but all local government financial management personnel as well as chief executive officers, department heads, elected officials whom we refer to as policy makers, and others in local governments worldwide who might find them useful. National government departments that have oversight responsibility for local finances should also find them useful as should those educational institutions preparing students for jobs within local governments. And, of course, the audience includes financial management trainers and training managers. In other words, this series is aimed at a worldwide mix of training providers and training users.

Kay Spearman
Principal Author

Acknowledgments

The preparation of this revised and updated version of the Local Government Financial Management (LGFM) Series has drawn upon the professionalism and expertise of many persons and institutions.

First, we would like to acknowledge the various authors, both of the original series and the current revision, of each respective chapter in the series. **Introduction and Trainer's Guide** written by Fred Fisher. **Chp 1: Policy Making.** Essay rewritten and expanded by Kay Spearman. Exercises rewritten by Kay Spearman and Fred Fisher. Original essay by Jack Matzer. Original exercises by David Tees. **Chp 2: Financial Planning.** Essay rewritten and expanded by Kay Spearman. Exercises rewritten by Kay Spearman and Fred Fisher. Original essay by Winston Evans. Original exercises by David Tees. **Chp 3: Citizen Participation.** Essay rewritten and expanded by Kay Spearman. Exercises rewritten by Kay Spearman and Fred Fisher. Original essay by Winston Evans. Original exercises by David Tees. **Chp 4: Evaluating Financial Condition.** Original essay by Sanford Groves and Maureen Valente. Published by International City/County Management Association (1990 Washington DC). Exercises by Kay Spearman and Fred Fisher. **Chp 5: Operating Budget.** Essay rewritten and expanded by Kay Spearman. Exercises rewritten by Kay Spearman and Fred Fisher. Original essay by Kay Spearman. Original exercises by David Tees. **Chp 6: Financing the Operating Budget.** Essay rewritten and expanded by Kay Spearman. Exercises rewritten by Kay Spearman and Fred Fisher. Based on original essays by Winston Evans, Kay Spearman and Maureen Valente. Original exercises by David Tees. **Chp 7: Capital Investment Planning.** Essay rewritten and expanded by Kay Spearman. Exercises rewritten by Kay Spearman and Fred Fisher. Based on original essays by Jack Matzer and Allistar Law. Original exercises by David Tees. **Chp 8: Financing the Capital Investment Plan.** Essay rewritten and expanded by Kay Spearman. Exercises rewritten by Kay Spearman and Fred Fisher. Based on portions of original essays by Jack Matzer, Winston Evans and Allistar Law. Original exercises by David Tees. **Chp 9: Accounting.** Essay rewritten and expanded by Kay Spearman. Exercises rewritten by Kay Spearman and Fred Fisher. Based on portions of original essays by Jack Matzer, Winston Evans and Kay Spearman. Original exercises by David Tees. **Chp 10: Performance Measures.** Essay rewritten and expanded by Kay Spearman. Exercises rewritten by Kay Spearman and Fred Fisher. Original essay by Jack Matzer. Original exercises by David Tees. **Chp 11: Asset Management.** Written by Kay Spearman. Exercises by Kay Spearman and Fred Fisher. **Chp 12: Procurement.** Essay rewritten and expanded by Kay Spearman. Exercises rewritten by Kay Spearman and Fred Fisher. Based on original essays by Allistar Law. Original exercises by David Tees.

We also appreciate the participants of the User Survey that was carried out on the original LGFM Series. Their experiences and insights were instrumental in identifying gaps and shortcomings in the original series and thus shaping the content of the current series.

We recognise the input of the participants of the Expert Group Meeting (EGM) held in Kenya in early October 2002. Based on the findings of the User Survey, the EGM made recommendations for major changes, resulting in a more comprehensive, user-friendly and up-to-date series. In particular, we appreciate Fred Fisher of IDIOM, USA and Kay Spearman of Spearman, Welch & Associates, Inc., USA who were the principal facilitators of the EGM and who were both deeply involved in the production of the original series. We equally appreciate the expert input of the other participants, namely, Deborah Welch of Spearman, Welch & Associates, Inc., USA, Luba Vavrova of Local Government Assistance Centre, Slovakia, Eva Balazova of the City of Lucenec, Slovakia, Kristina Creosteanu of Partners Romania Foundation for Local Development, Romania, Galina Kurlyandskaya of Center for Fiscal Policy, Russia, Gangadhar Jha of the National Institute of Urban Affairs, India, Mudite Priede of the Union of Local and Regional Governments of Latvia, Latvia, Bulat Karibjanov of the Local Government Initiative, Kazakhstan, Jack Mbugua of the Nairobi City Council, Kenya, Justus Mika of the City of Gweru, Zimbabwe, Billow Abdi of the Ministry of Local Government, Kenya and Liibaan Hussein of the Burao Water Agency, Somalia.

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Rafael Tuts
Chief, Training and Capacity Building Branch
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How to Use This Series

This chapter and others in the series can be used in many ways by a variety of local government (LG) officials and officers, as well as those who want to provide training and consulting services to LGs and related organisations. To support this mix of potential users, each chapter, with the exception of the *Trainer's Guide*, includes two distinct parts. Part One includes a discussion of concepts, principles, and strategies associated with the specific topic covered in the chapter. Basic information is provided first. In the more technical chapters (*Accounting*, *Procurement*, *Financing the Operating Budget*, *Operating Budget* and *Financing the Capital Investment Plan*), Part One is divided into Basic and Advanced Concepts so that the reader or trainer can pick the most appropriate place to begin. Part One is supposed to have something for everyone—meet the needs of developing, developed, centralized, and decentralized countries. To meet this requirement, many of the chapters are divided into Basic and Advanced concepts. Our idea was that the Basic concepts would be for persons who had little or no understanding of the topic and the Advanced concepts were for those who already had a foundation. If we have erred in this balance, it has been to provide more basic information than advanced.

Part Two includes training or management tools that are primarily designed to support group learning. However, many of the exercises in Part Two can also be used to support self-study and, with some adaptation, can be turned into financial management tools to use on the job. Also, the ***Learning Applications*** provided in Part One can be easily modified for group exercises. In other words, this series is designed to be used in a variety of ways to meet the LG financial management learning needs of many audiences.

PART ONE: CONCEPTS, PRINCIPLES AND STRATEGIES

Part One of each chapter is designed to meet two needs. First, it has been written to encourage self learning by LG finance managers, their staff, elected officials, chief executive officers and department heads of LGs, and others who need to know more about specific functions important to LG financial management. To enhance the self-learning process we have inserted ***Learning Application*** exercises where we encourage you to stop for a moment and reflect on what you have been reading as it relates to your own work experience. Each learning application exercise is prefaced by a small box listing the four most important roles and responsibilities associated with LG financial management: the elected official; the chief executive officer (CEO); the finance manager; and the operating department managers. Readers are encouraged to use these reflective moments to think about the issues covered by the *Learning Application* from their own experience and perspective as elected or appointed officials.

Of course, readers are welcome to stop anytime to reflect on what they have read in terms of their own experience, so these are just friendly reminders of the importance of the financial management concepts, principles and strategies that have just been covered in the text. We also encourage readers to check out the training tools in Part Two of each chapter. Many lend themselves to individual learning moments as well.

The Part One essays are also designed to provide trainers, consultants, researchers, and others with in-depth information and ideas about specific roles, responsibilities and processes within LG financial management systems. While these essays are important resources for those who are developing group learning (training) programmes for their LG constituents, they can also be valuable resource guides for central government officials who may be responsible for monitoring LG financial transactions, or providing technical assistance to LGs.

PART TWO: THE MANAGEMENT TOOLS

The Part Two components in each of these chapters are targeted primarily to those individuals who are designing and conducting group-learning experiences in LG financial management. While the main recipients of the training will be LG officers who have financial management responsibilities, many of the chapter materials can also be tailored to work just as effectively with elected officials, chief executive officers (CEOs), operating department heads—such as public works, and others such as staff members of LG associations and public service research organisations.

Another feature of the tools in Part Two is the built-in encouragement for participants to incorporate their own work experiences as part of the learning event. We believe that professionals can and do learn a great deal from each other when given the opportunity. Since most of the tools are based on an interactive approach to learning, these value-added opportunities are not just available but encouraged.

While the training tools in each of the chapters have been organised in a sequence that could be used effectively in a workshop situation, trainers are encouraged to be creative in designing group-learning experiences based on these materials. For example, you can reorganise the various tools in each of the chapters, use some of your own designs, alter those we have included in the chapters so they are more suited for your learning audience, or even find something in a different chapter that might work better given your style of training and the participants' learning needs. ***And don't ignore the various Learning Application exercises that are included in Part One as potentially valuable training tools.*** We have highlighted this statement to draw your attention to this added-value reserve of group learning opportunities.

Finally, we want to remind the practitioners of LG financial management that a number of the tools we have included in the Part Two sections of these chapters can also be adapted for use as management tools. For example, they might be used to help develop policy positions for consideration by your governing body, or help a team of mid-managers to sharpen their skills in developing performance measures, or assist financial clerks to redesign the flow of financial documents within their work units.

A WORD ABOUT TERMINOLOGY

One of the challenges we have faced in developing this set of materials is the wide range of terms that are used in different parts of the world to describe LGs and the key roles associated with LG financial management. For example, LGs are called cities, towns, townships, counties, boroughs, regions, and other things depending on the country where they reside. Equally challenging are the names that are attached to the officials and officers. For example, elected officials are known as elected officials, legislators, councillors, supervisors, board members, or commissioners, to name some of the more common titles.

To reduce the potential for confusion among the readers and users of these chapters, we have decided to be consistent in our use of the most common terms that occur frequently through these chapters. In addition, we have included glossaries of technical terms to help users develop a common frame of reference about various financial processes when working together. Equally important, those who are given the task of **translating these chapters** into other languages can only be effective in this important task if there is consistency in the use of the more commonly used terms. We have highlighted the need for **translators** because they are unique users of these manuals and often come to the translating task with a limited knowledge of the technical aspects of financial management.

SEEKING COMMON GROUND AMONG KEY TERMS, WORDS, AND PHRASES

In the *Learning Application* exercises in Part One of each chapter we have identified four key LG roles that correspond to those individuals whom we consider to be the most important clients of these learning materials. They are: elected officials, chief executive officers (CEOs), finance managers, and department heads. Since these roles are given different names in LGs around the world, we have listed a few of the variations in the following discussion. Hopefully, this will clarify just who is included when we talk about elected officials, CEOs, finance managers, and department heads. We have also included a few more terms that can be problematic in writing for LG audiences.

Elected officials: We use this term to identify those individuals who are chosen, hopefully through a democratic election process, to represent the citizens of their respective LGs in the legislative/governing process. They are also referred to in different parts of the world as: ***policy makers,***^o ***legislators, councillors, supervisors, commissioners,*** and ***board members.*** You may also know them under some other name or term.

Chief executive officer (CEO): This term is used in these chapters to identify the individual who has the sole responsibility for making overall management or executive decisions that affect the whole LG organisation. The CEO position is complicated since it can be filled by either an elected official, i.e., a mayor, or an appointed official, i.e., a city manager. We don't make this distinction in our use of the term CEO. As just stated, the CEO might also hold one of the following titles depending on the country, local laws or tradition: ***mayor; chief administrative officer; city, township,***

town, borough or county manager; general manager, town clerk, or even *commissioner* if the executive powers are shared among several elected officials.

Finance manager: This term is used to identify those individuals within LGs who have significant financial responsibilities on a day-to-day basis. Since we want more than just the chief finance officer to use these chapters, we are deliberately including anyone within the LG who has supervisory responsibilities within the financial management domain. Depending on the location, these individuals might be known as: chief finance officer; director of finance; finance director; accounts manager; chief auditor; controller; and no doubt many more names or terms. We want all those individuals who have finance responsibilities in their LGs to benefit professionally from using these materials.

Department head: We believe the responsibilities for financial management in any LG do not end with those who occupy the roles just outlined. Their success in managing the financial affairs of the LG is also dependent on those individuals who manage the staff and operational units of their respective LGs. Since this term encompasses many different titles, often associated with the mandate of the operating department, we offer only a few as descriptive of who we have in mind. They might be: highway superintendent; water plant manager; director of human services; head nurse; chief mechanic; case work supervisor, or so on.

In addition to the four terms that are used most frequently in the chapters, translators and other users will benefit from what we mean by some other commonly used words or phrases. For example:

Governing or elected body: This is the collection of individuals elected to represent the citizens of your LG as policy makers, decision makers, and community leaders. Depending on where you are in the world, they might be known as the: *legislative body or council; political body; city, town, village, or county council; local parliament; board of commissioners; policy making body*; or some other name.

Local government (LG): LGs are called all sorts of things: *cities, towns, counties, municipalities, parishes, townships, villages, boroughs, regional governments*, and we suspect many other things, but hopefully, you get the picture. Usually, the common element is that they are the lowest self-governing unit of government in the country.

Executive branch: You might come across this term in these chapters, so here is what we had in mind. The executive branch of LG consists of all those departments that operate under the general management of the CEO, whether or not that individual is elected by the citizens, or appointed by the elected body, or some other appointing power.

Legislative branch: This branch of LG consists of the elected officials and their staff members if they have any. Supposedly, they are the *policy makers*, but that term is muddled since many people in LGs have a role in making policies, whether legitimately or through default. (If this statement raises your curiosity, we recommend you go immediately to *Financial Policy Making* and discover how this happens.)

Citizens: These are all of the residents of the LG, including women, and low-income persons. We also use the term community interchangeably. While we recognize different cultures may place a lower value or no value on the input of women and low-income persons in decision-making, our use of the term “citizen” throughout the

series is that it includes ALL residents of the LG and that women and low-income persons have an equal place at the decision-making table.

Annual budget: This is such a common term that we suspect many of you are shaking your head in wonderment. However, it does come in for some confusion and it is important to understand what the *annual budget* means in these discussions. The annual budget, as discussed in these chapters, is both the operating budget and the one-year capital budget based on the multi-year capital investment or improvement programme.

Capital investment plan: Sometimes called the *capital improvement programme*, or mistakenly the *capital budget*. That's why we made the distinction above. The capital budget is the one-year increment of all those long-term investment costs that is folded into the annual budget.

Hopefully, this lead-in to each of the chapters on how to use these materials will help in appreciating some of the subtle differences in who the clients are for the series and how they are referred to around the world.

There are additional resources for this series on the UN-Habitat website at <http://www.unchs.org/default.asp>.

Introduction

A BIT OF HISTORY

This Local Government Financial Management (LGFM) training series has a short but rich history. We believe it's worth relating to you for several reasons. First, many individuals and organisations contributed to its development, and now its redevelopment. They deserve to be recognised. Second, the redevelopment of the series was largely demand driven. Financial management and training professionals who saw the original set of chapters wanted them for use in their own countries. Consequently, they transported the old series across national borders from Slovakia to their own countries and ultimately created a demand for this new version. Finally, there are some lessons to be learned from the "redevelopment" of the original Slovak version of these training materials.

The original series was conceived in the mid-nineteen nineties in the office of Eva Balazova, the Finance Director of a small city, Lucenec, in Eastern Slovakia. The United States Agency for International Development (USAID), through a contract with the International City/County Management Association (ICMA), had initiated a local government capacity building programme in Slovakia and financial management was one of the areas targeted for development. The focus of the USAID assistance to Slovakia's local governments was initially the budget process; more specifically, the capital improvement budgeting process. Under the old centralised socialist approach to local governance there was no need for a capital budget. But the emergence of local self governments in Slovakia established the need for many new administrative and financial systems. Eva Balazova and her colleagues were sitting on a powder keg of potential change in how local governments could, and would, operate in the future.

When the City of Lucenec was approached as a potential recipient of technical assistance for the specific purpose of developing a capital improvement budget, Eva was grateful but not impressed. She saw the need for financial management assistance for her local government and others in Slovakia in much broader terms. Essentially, Eva was telling those who came with external assistance that the development needs for local government financial management were much more complex than just capital budgeting. Eva's insights and tenacity prevailed. Working through Eva and a cadre of other dedicated local finance officers in Slovakia, ICMA assembled a small team of LGFM consultants. Together they produced the initial series of these chapters.

End of story? Not quite. Word spread in the region that these training materials had been developed and had even been designed to make adaptation by other countries easier. For whatever reasons, neither USAID nor ICMA put the fourteen LGFM manuals on their websites so they could be accessed by others outside of

Slovakia. Fortunately, a small women-owned firm in Texas did. Kay Spearman, one of two principals of that private company and a member of the original ICMA technical assistance team who worked with the Slovak finance officers, became the linking pin. Once available, the series spread quickly to other counties in the central and eastern European region and beyond. Funding for the adaptation and translation of the materials came from a variety of sources, including The World Bank and private foundations.

While UN-HABITAT had contributed to the initiation of the series, their involvement in the development and dissemination up to this point had been minimal. Nevertheless, they recognised the series' potential for worldwide use. But, they needed to be updated to reflect new ideas in LGFM and revised to make them more user friendly as they crossed national borders and language differences. Among other things, the initial series was based on Slovak laws, regulations, and experience which varied significantly from those in other countries.¹ Not to be deterred, UN-HABITAT received permission from USAID to revise and republish the series. They commissioned a written user survey and convened a small group of experts to help determine how best to carry out the revisionist task. The expert group included the Slovak initiators and others who had used the materials in various countries around the world.

While it's a fascinating story of how international technical assistance often unfolds, there are a few lessons to be learned for those who will be using the new series.

1. Never under-estimate your own ability to make a difference.
2. Always challenge those who think they know more about what your training and development needs are than you do.
3. Never hesitate to step into a void that others may have created, regardless of their motives.
4. Be willing to take risks in adapting what was not invented in your own back yard.
5. Don't hesitate to help others even though there may not be anything in it for you at the time, or ever.
6. And remember, training and development is individual and organisation capacity building at its best when it is demand driven. Demand it for you, your colleagues, and your institutions.

OVERVIEW OF THE SERIES

With that short history lesson out of the way, it's time to look at what else you can expect from this chapter and the rest of the series. Among other things, you will learn about:

¹ UN-HABITAT has produced other region-specific manuals e.g. UNCHS (1991) *Training Manual on Urban Local Government for English-speaking East and Southern African Countries* and UNCHS (1991) *Training Manual on Urban Local Government Finance for South Asian Countries*.

- Why this set of training materials was developed in the first place and how it has changed.
- The expanded audience of potential users.
- Good governance principles and how they relate to LGFM.
- A revamped conceptual framework that more accurately reflects financial management reality.
- What each volume in the series will cover.
- How to get the most from the series.
- How not to be overwhelmed as either a trainer or user of this series.

COMPARING THE ORIGINAL SLOVAKIA LGFM SERIES WITH THIS SERIES

We want to share with you the original reasons for developing this series of local government financial management chapters. We also want to see if these initial reasons are still valid; if not, why not; and what we plan to do about it. There were at least three good reasons why this series was originally written.

First was the fundamental importance of financial management for the economic health and stability of local self-government in Slovakia and other countries. The effective management of any local government's financial affairs ranks among its most important functions. How well this function is carried out depends in large measure on knowledge of the discipline, ability to perform effectively, and ethical conduct of the finance manager.

This assumption still seems valid with one exception. It's not just the ethical conduct of the finance officer that is important. It's the ethical conduct of all local government employees, the elected governing body, and those they interact with in the community and beyond. Local government corruption almost always involves individuals and organisations outside the official local government family. Consequently effective, ethical LGFM involves more than just the finance manager.

Second was the concern that training materials for training finance managers had been developed in a piecemeal fashion. While many training components related to an efficient finance management system existed at the time, it would be difficult and probably impossible to integrate them into a coherent whole. A comprehensive approach to the development and packaging of materials was needed to help finance officers recognize and appreciate the scope and complexity of a fully functioning financial management system.

This assumption is still valid although we now see the importance of this series for more than just the development of the finance manager as was mentioned in the initial assumption. Very few development agencies or training institutions have taken as comprehensive an approach to developing a LGFM training curriculum as that taken in Slovakia in the mid-nineteen nineties. Nevertheless, the original series left room for considerable improvement. For example, the original version was based on topics, not the interrelated functions of LGFM. This is one of the key changes in this edition of the series. The new conceptual framework is designed to make the series more user-friendly and help users appreciate the interrelated and systemic nature of many of the LGFM functions. We will get into this later when we discuss the conceptual frame

work for this series. The other key change is to emphasize how LGFM concepts and practices are fundamental to implementing the widely accepted principles of good governance.

Third was the absence of a systematic LGFM professional development delivery system that relies on local training resources rather than outside expertise. Such a system would provide training materials in a format designed to facilitate local use by local trainers with no additional technical assistance required after initial field tests and training of trainers.

This assumption is still valid and this new series will, hopefully, make the delivery of the training just that much easier. In this regard, we have cleansed the series of its Slovak examples and bias recognising the need to make it a global resource. We have also expanded the learning audience to include more than just the finance manager.

The original series was designed with all these considerations in mind. It provided a comprehensive perspective on financial management by addressing the basic functions and skills required. It also adhered to the learning needs of the Slovak local government finance officers as they were defined at the time which was, of course, what the series was intended to accomplish. The curriculum design also mirrored earlier UN-HABITAT training packages, such as the Local Elected Leadership series, by providing concepts, principles, and strategies in Part 1 and workshop training designs in Part 2 of each discrete chapter.

As the Slovak finance officers used the original series of handbooks, they discovered that the topical sequencing of the materials was not particularly functional. Nor did the design of training based on the content of individual handbooks provide for optimum learning experiences. There was just too much inter-connectedness and overlap of the various topics to present them in their original format. So, the Slovak financial officers and trainers experimented by reorganising the content of the individual handbooks to mirror the reality of their work environment. When UN-HABITAT convened the experts to provide guidance in developing the new edition, the Slovak experience in experimenting with the content and design of the original series proved extremely valuable. We appreciate their contribution in helping to make a good training product just that more effective.

But, there was another experience of the Slovak finance officers group that needs to be mentioned as a spin off of their involvement in developing the series and using it as part of their profession's development in Slovakia. These finance officers, and they happened to be mostly women, saw an opportunity to influence the direction and the quality of local government financial policies and management practices at the national level of governance. To do this, they needed to be organised so they created the Association of Municipal Finance Officers of Slovakia. This professional association continues to be a driving force in helping define the role of local government finances as an integral part of the nation building process in that country. Never underestimate the importance of training as an integral part of larger institution and nation building strategies.

THE EXPANDED AUDIENCE OF USERS

While the initial edition of these materials was directed to Slovak local government finance officers, this edition is intended for a much larger audience. It includes not just finance officers but all local government financial management personnel as well as chief executive officers, department heads, elected officials whom we refer to as policy makers, and others in local governments worldwide who might find them useful. National government departments that have oversight responsibility for local finances should also find them useful as should those educational institutions preparing students for jobs within local governments. And, of course, the audience includes financial management trainers and training managers. In other words, these volumes are aimed at a world-wide mix of training providers and training users.

This expanded audience, however, has made the adaptation of these materials difficult. It initially looked like they would either have to be so general that they would be of no use to anyone, or so comprehensive in scope that nobody would be able to lift them, let alone use them. In wrestling with this dilemma, we decided to put the main responsibility for determining what to use in each volume and/or chapter, and how to use it, in the hands of the training managers and trainers. Given this fundamental decision, we want to direct the following comments to these individuals. While the following comments might be more appropriate for the Trainer's Guide, they are also important for finance officers, elected officials and others to hear. Thus, we have decided to put them in this Introduction chapter in hope that all training providers and users would read them. In addition, we have provided this Introduction, How to Use the Series, and the Trainer's Guide at the front of each volume so that each volume "stands alone," with all of the information provided in one place.

HOW TO MANAGE THIS MASS OF MATERIALS

Here are several ideas on how to make the use of these volumes more manageable and productive for you and your training clients. If you are a potential training client and listening in on this conversation, these ideas should also help you oversee and monitor your training supplier's performance.

- Know who your training audience will be and match what your training offers with their learning needs. There is nothing more devious in the training world than the trainer defining the client's needs in terms of what the trainer can deliver.
- One of your best marketing and delivery tools as a trainer is to talk to members of your potential target group to learn what they think would be most useful, based on their needs at the time. For example, the development of the original series resulted from a comprehensive survey of key local government officials in Slovakia. The survey included not just the finance officers but mayors who also performed as chief executive officers, members of governing bodies, and the directors of operating agencies. Each role had their special needs in terms of financial management and many of these needs were general to all the roles.

- Think seriously about providing a training programme for senior local government finance officers in your country that includes all the volumes. This is obviously a heavy commitment on the part of trainers and finance officers but essential. It also means you will need to spread the training out over a longer time period. If you want to get the attention of these finance officers but not their attendance, schedule the programme during the budget preparation season.
- Since many finance officers may be concerned about making a long term time commitment, start with those modules that they believe are most important from their point of view. Also think about creating a certificate programme for those who successfully complete training in all volumes in the series. Some kind of official recognition for completing the series will be a good incentive to most professionals.
- As for those elected officials, several briefings using the chapters from Financial Policy Making, Financial Planning, and Citizen Participation in Volume 1, before the budget preparation cycle begins would be useful. Hopefully it would get them thinking about some of the longer term issues in terms of financial management. Follow this with sessions from the chapter on Financing the Operating Budget from Volume 2, before those budget hearings begin. In other words, target the training to their needs.
- Department heads could benefit from sessions on the Operating Budget, Financial Planning, and Performance Measures. These chapters are contained in Volumes 2, 1, and 4 respectively.
- Target those officers who have specialised responsibilities. For example, are there purchasing agents in the larger local governments? If so, schedule sessions using the chapter on Procurement in Volume 4. In some countries, the Procurement chapter might even become one of the study guides for developing national legislation that provides guidelines for local governments. If there are local finance clerks who have responsibilities for asset management, the Asset Management chapter in Volume 4 offers the concepts and training designs to meet their needs.
- Think about briefing sessions on the full scope of LGFM for specific local government teams of elected officials, managers and key financial personnel. One of the best times to do this is just before the budget cycle begins. This way they all get the big picture. It's also a good time to learn about specific training needs. For example, the governing body might have been talking about involving citizens more directly in the budgeting process. Or, they might be faced with some major capital expenditures and need more knowledge and skills on their options in undertaking long term investments in public infrastructure.
- In other words, be creative in cultivating the potentials for using this rich storehouse of learning materials with a wide range of local government audiences.

With these opportunities in mind, here are four important clues on how to use these volumes successfully.

1. Don't panic by their size and comprehensiveness. Remember the old joke about how to eat an elephant? As the joke goes, one bite at a time.
2. Figure out who your training audiences are and give them an opportunity to tell you what they need in the way of training. Remember, your potential audiences for LGFM training are both many and significant. We've only touched on the most obvious in the examples just given.
3. Design the training based on these needs and the knowledge and skill levels of your specific audience.
4. Finally, select from these volumes only what is needed to meet the needs of your specific learning audience. The worst thing you can do is to overwhelm them with either too much stuff or the wrong kind of stuff. We've highlighted what we think might be advanced principles and practices in each of the manuals but the judgement call is really yours as a trainer. And, your judgement about what to include in each training design should be based on the roles and responsibilities of your participants, their learning needs, and their general level of sophistication as a group.

LGFM AND GOOD GOVERNANCE

One of the shortcomings of the original series of chapters was the absence of any explicit attention to the principles of good governance that have become standards in the past decade to define the performance of local governments worldwide. While these principles were implicit in many of the concepts and strategies in specific chapters in the original version, we will make them much more explicit in this edition. Since the good governance principles vary a bit from one official proclamation to another, we will start by presenting two versions and then tie them to financial management as the operating framework for achieving these principles.

In UN-HABITAT's Global Campaign on Urban Governance², these principles are defined as:

- **Sustainability** in all dimensions of local development;
- **Subsidiarity** of authority and resources to the closest appropriate level consistent with efficient and cost-effective delivery of services;
- **Equity** of access to decision-making processes and the basic necessities of community life;
- **Efficiency** in the delivery of public services and in promoting local economic development;
- **Transparency³ and Accountability** of decision-makers and all stakeholders;
- **Civic Engagement and Citizenship** with all citizens participating in and contributing to the common good; and

² For more information on the Global Campaign on Urban Governance, visit <http://www.un-habitat.org/campaigns/governance//>. See also UN-HABITAT (2003) *Tools to Support Participatory Urban Decision-Making*.

³ See UN-HABITAT (2004) *Tools to Support Transparency in Local Governance* for further information.

- **Security** of individuals and their living environment.

For a slightly different look at governance, we turn to The United Nations Economic and Social Commission for Asia and the Pacific (ESCAP). Their interpretation of good governance has eight characteristics:

1. It promotes and encourages participation including that of children.
2. It requires respect for the law and the full protection of human rights.
3. It involves transparency in decision making, and information is freely available and easily understandable to all.
4. It is responsive, implementing decisions and meeting needs within a reasonable time frame.
5. It is consensus-oriented, involving the mediation of different interests in society and sensitivity towards the relative influence of different actors including the poorest and most marginalised.
6. It promotes equity and inclusiveness, such that all members of society feel that they have a stake in that society.
7. It means that processes and institutions produce effective results that meet the needs of society while making the most efficient use of resources and promoting sustainability.
8. It is founded upon accountability, not only of governmental institutions, but also of private sector and civil society organisations.

As you can see, there isn't total agreement even within the larger UN community about what constitutes good governance principles. Nevertheless, most institutions that promote these principles agree that governance is much bigger than just government. The Global Campaign says that governance includes government, the private sector, and civil society.

ESCAP's definition of governance embraces just about every organised entity as well as individual citizens. For example, they include governments, NGOs, the private sector, the media, grassroots organisations, and more. To simplify our task of relating good governance to LGFM, we will take what we believe to be the most important principles in the two UN statements and provide some examples of what they might look like in practice.

- **Rule of law:** This principle is central to LGFM. For example, the budgeting process is established by law, even determining when elected and appointed officials must do what by when. Procurement standards and accounting procedures are often established by law and the development of financial policies by local governing bodies is also an act of law making, albeit local. Local government corruption is more often than not based on financial transactions that violate the rule of law.
- **Transparency:** This principle cuts across a variety of LGFM functions and responsibilities including financial policy making and planning, budget hearings and postings, financial audits, and the involvement of citizens in the full range of financial management activities.

- **Accountability:** This presumably is what the budget process is all about. It holds elected and appointed officials accountable by stating how public funds will be spent. Programme and financial audits should determine if public officials were accountable in their implementation of the budget.
- **Participation and civic engagement:** One of the current hot topics on the international circuit is participatory budgeting. The days when financial management was confined to the backrooms of city hall has passed.
- **Equity and inclusiveness:** These principles, when implemented, assure that financial decisions are made in the best interests of all citizens not just the privileged few. They cut across such financial functions as budgeting, procurement, financial policy making and planning, and the development of performance measures that focus on issues of equity and inclusiveness.
- **Subsidiarity:** This rather daunting term describes the process of determining how best to deliver services in efficient and effective ways. It may mean contracting out services to the private sector, or subsidising NGOs to perform certain services. These decisions cut across financial policy making and planning, the need to establish performance and accountability measures, the budgeting process, and a host of other LGFM activities.
- **Effectiveness and efficiency:** Financial management is really all about these two fundamental principles. Peter Drucker, the management icon, says “Effectiveness is doing the right things” and “Efficiency is doing things right.” Budget decisions should sort out the right things to spend public funds on and the management of the expenditure of those funds and resources should assure that it’s done right. These two principles should be your financial management mantra.
- **Sustainability:** We complete this principled look at LGFM by including UN-HABITAT’s principle # One in their Global Campaign on Urban Governance: sustainability in all dimensions of local development. This covers a myriad of financial decisions: from making certain that maintenance of public buildings, infrastructure and equipment is covered in the annual budget, to long range financial planning of community programmes so their sustainability can be assured.

As you can see, LGFM is a very principled role and responsibility. Keep these good governance principles in mind as you use these training materials for your own professional development and the development of your local government organisation and community.

A NEW CONCEPTUAL MAP TO NAVIGATE BY

We mentioned earlier that the original version of these materials took a topic by topic, or function by function, look at the financial management roles and responsibilities associated with local government and the broader definition of governance. The original version included fifteen handbooks: Introduction; Accounting as a Management Tool; Financial Policy Making; Financial Planning; Operating Budget; Capital

Programming; Debt Management; Cash Management; Revenue Maximisation; Cost Containment; Procurement; Performance Measures; Construction Cost Management; Citizen Participation; and Grants Management.

When the Expert Group Meeting of LGFM users was convened by UN-HABITAT in Kenya to determine the content and format of the new edition of these materials, the members were challenged by the experience and insights of the Slovakia finance officers. Not only had they helped develop the original series, they also had experience using the materials to train other finance officers in their country and the region. Again, Eva Balazova proved to be the key person in helping to take this series to a new level of anticipated performance. After many variations of how to reorganise and revitalise the LGFM series for worldwide use, the team of experts agreed on the following strategy.

1. The short-term operating budget and long-term capital investment plans are the engines that drive local government financial management: The two chapters from the original series that covered these topics remain and are expanded to include materials from other manuals in the original series. In this series they are: Volume 2, Chapter 5, *Operating Budget of* and Volume 3, Chapter 7, *Capital Investment Plan*.
2. In each of these two major LGFM functions there are financing requirements that need to be addressed separately, thus we have two new chapters in this series that are, in a sense, companion learning tools; Volume 2, Chapter 6. *Financing the Operating Budget*, and Volume 3, Chapter 8. *Financing the Capital Investment Plan*.
3. Several of the financial management functions covered in the original series are integral to the operating budget and capital investment planning processes and are incorporated into the chapters covering these topics and their companion chapters that deal with their financing. These functions include: Debt Management; Cash Management; Revenue Maximisation; Cost Containment; Construction Costs; and Grants Management. In other words, the materials covered in these original chapters are now integrated into Volume 2, Chapters 5 and 6, and Volume 3, Chapters 7 and 8.
4. Three new chapters were recommended by the expert team and they are included in this series. They are: *Trainer's Guide*, which is included in all four volumes; *Evaluating Financial Condition*, Volume 1, Chapter 4, and *Asset Management*, Volume 4, Chapter 11.
5. The remaining chapters in this series, which mostly represent cross cutting competencies, are updated and expanded versions of handbooks in the original series. They are: Chapter 1. *Introduction*, which is in all four volumes, Volume 1 includes Chapters 3, *Financial Policy Making*;, Chapter 4. *Financial Planning* and Chapter 5. *Citizen Participation*. Volume 4 includes Chapters 9, *Accounting*, 10, *Performance Measures* and 12 *Procurement*.

We hope this provides a mental picture of how this set of training and management volumes/chapters evolved from the original series. Of course, there are many

ways to slice this complicated set of competencies, functions, and responsibilities within LGFM and we suspect that a few of you are already saying, “Well, the next time they are updated I think they should” We do to but in the meantime we hope you find this new series a bit more easy to use as trainers and public officials responsible for LGFM in your communities.

VOLUME CONTENTS

The contents of the remaining LGFM volumes and chapters are summarised below to give you a brief idea of what to expect from each.

VOLUME 1: CREATING A FINANCIAL FRAMEWORK

INTRODUCTION

TRAINER’S GUIDE

This chapter is designed to help trainers and other key individuals use these materials in a variety of situations with a wide range of participants. It covers the adaptation and possible translation challenges of making the chapters more user friendly in the context of their use and the planning process of developing and delivering effective training. Clues will be included on how to design and deliver interactive learning experiences based on the input of concepts and strategies from the chapters and participant experiences in their application within local governments. The materials can and should be adapted by trainers to meet the learning needs of their clients and ways to do this will be provided. Various training design techniques will be covered, such as how to write a critical incident, case study and role play situation. Finally, there are ideas on how to evaluate training and its impact.

CHAPTER 1: FINANCIAL POLICY MAKING

This chapter examines ways that formal, written financial policies are developed and implemented at the local government level. We will provide a definition of financial policy and describe the benefits to a local government that establishes and uses sound financial policies. We will delineate the basic steps to take in identifying, proposing, adopting, and implementing financial policies. We will also discuss various obstacles to the financial policy making process.

CHAPTER 2: FINANCIAL PLANNING

This chapter will examine ways that financial planning can be developed and implemented in local governments (LGs). The focus of the chapter is primarily on one aspect of financial planning—medium-term financial forecasting of revenues and ex-

penditures. We will provide a definition of forecasting and relate it to good governance, citizens, performance measures, and financial policies. We will also describe the benefits that accrue to LG when implementing a financial forecasting process, considerations for organizing the process, types, and methods of forecasts. Included in the discussion will be obstacles, limitations, and risks inherent in developing a financial forecasting process.

CHAPTER 3: CITIZEN PARTICIPATION

This chapter examines ways that citizens interact with their local governments (LGs). We provide a definition of citizen participation and describe the benefits to a local government that establishes and uses citizen participation policies and techniques. We discuss obstacles to the use of these policies. We provide ten steps to involving citizen participation in resolving an issue. Finally, we provide a compendium of techniques that can be used by local governments to involve citizens in a timely and constructive way in the development and implementation of public programs.

This chapter is written for LG officials, managers, and policy makers. It does not attempt to provide a citizen's point of view towards dealing with LGs. Because some reviewers indicated an interest in Participatory Monitoring which focuses on citizens monitoring the LG, Appendix B: World Bank Information on Participatory Monitoring has been added to the chapter.

CHAPTER 4: EVALUATING FINANCIAL CONDITION

This chapter focuses on identifying, measuring and analysing various financial and demographic factors that affect a local government's financial condition. The financial data needed for the analyses is taken from the local government's financial records. Managers can use the information to: better understand the local government's financial condition, the forces that affect it, and the obstacles associated with measuring it; identify existing and emerging financial problems; and, develop actions to remedy these problems.

VOLUME 2: MANAGING THE OPERATING BUDGET

INTRODUCTION

TRAINER'S GUIDE

CHAPTER 5: OPERATING BUDGET

This chapter is divided into basic and advanced sections. This basic section describes how to design and implement an operating budget system for LGs. It defines operating budget terms, explores concepts, and examines the benefits and potential obstacles associated with establishing and using a system. It provides a 12-step

process for preparing, reviewing, adopting and monitoring the operating budget. The advanced section provides information on cost containment, various management analysis techniques and awarding grants within the LG community.

This chapter deals with budgeting matters in general and does not apply or take into account each individual country's laws or regulations. LGs are responsible for making local decisions, including compliance with any applicable laws, statutes, decrees or regulations.

CHAPTER 6: FINANCING THE OPERATING BUDGET

The concept of “financing the operating budget” combines many functions across the local government (LG) organization. It involves estimating revenues (covered in the Financial Planning chapter), cash budgeting, revenue billing and collections, investing idle or excess cash, setting prices and user fees and the day-to-day monitoring of all of these functions to ensure that sufficient monies are available in the bank to actually pay for the day-to-day operations of the LG—the operating budget. It is important that all of these separate but very interrelated functions are considered when developing policies, procedures and making decisions about the LG programs and services.

This chapter examines how you can use the revenue structure, cash management, internal controls, the accounting system, revenue billing, and collections, investing idle cash, and cash budgeting to assure that the revenues needed to fund the operating budget are available when needed.

VOLUME 3: MANAGING CAPITAL INVESTMENTS

INTRODUCTION

TRAINER'S GUIDE

CHAPTER 7: CAPITAL INVESTMENT PLAN

This chapter is divided in basic and advanced sections. The basic section will describe how to design and implement a capital investment planning and budgeting system at the local level of government. We will define capital investment planning terminology and examine the benefits and potential obstacles associated with establishing a system. We will also discuss the steps involved in preparing, reviewing, adopting, and monitoring a capital investment plan and budget, including an extensive section on actually constructing facilities. The advanced section includes an introduction to value management and real estate analysis.

CHAPTER 8: FINANCING THE CAPITAL INVESTMENT PLAN

It seems that most policy makers and staff are familiar with putting together the capital investment plan—holding public hearings and putting a plan together that will move the LG towards the policy maker’s vision of the future. Unfortunately, few have taken the time to understand the equally important function of financing the capital investment plan. Decisions made about it have a much longer-term effect than those made about the operating budget—they may affect several future generations of citizens.

This chapter examines how the financing for the investment plan is developed and implemented. We will provide definitions of debt management and other related terms. We will also review the benefits of instituting a debt management program, identify and provide examples of policies that should be developed, and discuss the legal environment surrounding the use of debt. We will address types of financing, methods for selecting credit instruments and the mechanics for obtaining financing, as well as a review of credit analysis, disclosure requirements and administration of the debt.

VOLUME 4: MANAGING PERFORMANCE

INTRODUCTION

TRAINER’S GUIDE

CHAPTER 9: ACCOUNTING

This chapter is divided into basic and advanced sections. The basic section includes background information on basic concepts and definitions of accounting, the importance of accounting and good governance, accounting standards, the accounting cycle, and types of accounting. It also includes policies, obstacles and benefits to accounting. There is a section on management accounting and various costing techniques. The advanced section includes information on computer technology, modernizing the accounting system, accounting manuals, fund accounting, utility funds, depreciation, and advanced financial and budgetary reporting.

CHAPTER 10: PERFORMANCE MEASURES

This chapter examines the development and implementation of performance measurement at the local level of government. We will define performance measurement and describe the benefits to a local government that uses it to improve the odds of success in achieving its service goals. We will also discuss the steps involved in setting up a performance measurement system and obstacles that may be encountered along the way.

CHAPTER 11: ASSET MANAGEMENT

This chapter examines how you can use asset management as an effective management tool. We define the term assets, as it is used in this chapter, asset management systems, and plans and describe the benefits of using asset management to better plan capital investments and achieve service delivery goals.

The best place to start developing an asset management plan is with the basics. According to the World Bank, these include:

- Developing basic asset inventories including surplus real property,
- Documenting asset operation and maintenance processes,
- Developing primary asset information systems,
- Preparing basic asset management plans, and
- Developing staff skills and governing body awareness.

We have structured the book to provide information on these basic components from two perspectives. The first deals with the assets that are used to provide day-to-day services to the citizens of the LG. The second recognizes that some countries are in a decentralization process where the central government is giving LGs responsibility for assets for which they have not previously been responsible. For those local governments that may be in the second category, we have provided a section on Surplus Real Property since it represents a different challenge than working with the assets used to provide ongoing services. However, this chapter does not deal with managing apartment or housing units.

CHAPTER 12: PROCUREMENT

This chapter is divided into a basic and advanced sections. The basic section examines the process of procurement in local government with emphasis on procurement planning, legal procedures for the acquisition of goods, services and public facilities, and details of procurement administration. It also includes policies, benefits and obstacles in the procurement process. Steps for a comprehensive procurement process for goods, services and public works are also included. The advanced section deals with construction contract administration, store operations, procurement and e-Government, and procurement and economic development issues.

USING THE SERIES

We have designed the series described above to be used by a variety of individuals and institutions. Obvious among these are the trainers and training institutions on the supply side of training and finance officers on the demand side. But, we see the potential users as many more as alluded to earlier. We hope that chief executive officers (CEO) and department heads in local government will use them along with staff members of municipal associations. There should be interest likewise on the part of community NGOs that are hoping to see citizens get more involved in the budgeting processes of their local governments. And community colleges and other educational

institutions that are preparing entry level public financial management professionals for future employment could easily integrate many of these chapters into their curriculum.

For those mainstream users like finance trainers and finance management professionals we offer the following ideas. Use these chapters:

1. As self-study guides. We hope policy makers, CEOs, department heads, and a range of financial management personnel from local governments will be inclined to pick up these chapters and read them. To add value to the reading we have interspersed each essay with Learning Application tasks. With each of the short application tasks, we have identified in a call-out box who might best benefit from undertaking each of these tasks. Of course, we encourage all users to pause from the reading to critically assess what they have been reading in relation to their own financial management responsibilities and challenges.
2. As workshop learning guides. We anticipate that these chapters will become the basis for a wide range of learning experiences for local government elected and appointed officials. As we mentioned earlier, there are many ways to organise these materials to meet a variety of learning needs within the broad local government community. For example, if you are operating as a trainer or manage a public sector-oriented training institute, think about the following options:
 - A ten-day workshop that includes approximately a half day on each of the substantive topics;
 - A five-day workshop that covers fully three or four of the topics included in the series based on the assessed interest of finance managers in a particular region of the country;
 - Twelve workshops, each one to one and one-half day in length, covering all of the topics;
 - A three-hour program in conjunction with an annual conference of local finance officers that deals with the most important aspects of one particularly high-interest topic in the series.
 - A presentation at the annual meeting of the national association of local governments on the advantages of supporting LGFM training for key local government elected and appointed officials.
 - Teaming up with a formal educational institution to offer a certificate programme based on the series, or to integrate selected materials into their degree programme in public administration, with you being an adjunct instructor who delivers the education modules.

In addition to the options mentioned, there are other ways to use these materials. For example, think about meeting with an interested group of finance officers from the same region every Friday afternoon for several weeks to hold discussions on several of the topics. Rather than give you any more ideas, we suggest you do a bit of brainstorming for other ideas by completing the following Learning Application exercise. By the way, these interludes in your reading are identified by the term just

used, Learning Application. You will find them throughout the texts of Part One of each of the chapters. Trainers have also found them to be useful as learning exercises for workshops and other structured learning events. Just modify them to meet your specific training design needs and add them to your training toolkits.

LEARNING APPLICATION

Take a few moments and jot down some ideas about how these chapters might be used in your country to support the further professional development of your public officials and institutions.

Of these ideas, which ones do you think are the most important?

What can you do personally to help support these ideas so they become real?

PART TWO: MANAGEMENT TOOLS

PURPOSE

The materials included in this overview are designed to be used by the trainer to initiate a series of workshops on financial management. In other words, they are intended to serve as an introduction when several of the topics on financial management are to be covered during the same workshop series. On the other hand, they can be adapted to supplement the content of a program devoted to just one topic. Either way, they are intended to get the training off to a successful start by helping participants get acquainted with each other, providing them with information on workshop content, and letting them experience the type of interaction to be used throughout the workshop series.

While we have stressed in Part One of this chapter and in the Trainer's Guide the importance of adapting these materials to meet the needs of your training participants, we want to reemphasize it again. Many of the exercises can be changed to meet the needs of various audiences with differing levels of knowledge and experience in financial management. Don't hesitate to adapt them to meet the learning needs of your participants.

CONTENTS

A brief description of each learning activity is shown below with an approximation of the amount of time required. If you wish to change the order, to omit something, or to add training material of your own, feel free to do so. In addition, use your judgment and experience about the time needed to complete the tasks involved in the exercises. While we have attempted to judge the times it might take to carry out a group task, for example, it will vary from group to group. Adapt to the learning needs of your participants in these workshops and you will be successful.

0. 1 WARM-UP EXERCISE: GETTING ACQUAINTED

Introductions should be made to acquaint participants with each other and the training staff, let them know what will be expected of them, and help them to feel more comfortable in the learning environment. (15 - 60 minutes)

0.2 EXERCISE: ASSESSING KNOWLEDGE AND EXPERIENCE

Participants individually assess their level of knowledge and experience in relation to a list of financial management topics, and compare results in small groups. (60 - 75 minutes)

0.3 EXERCISE: IDENTIFYING FINANCIAL RESPONSIBILITIES

An alternative to the preceding exercise. Participants work in small groups to identify and compile lists of financial management responsibilities and rate the responsibilities on challenge and the need for training. (60 minutes)

0.1 WARM-UP EXERCISE: GET ACQUAINTED

TIME REQUIRED:

15 - 60 minutes

PURPOSE

This exercise is to help participants get to know each other and the trainer, let them know what will be expected of them, and cause them to feel more comfortable in the learning environment.

PROCESS

After welcoming remarks by the host agency representative and a short description of program objectives, scheduling and logistics, give a brief personal introduction and invite participants to get acquainted. Here are some alternative ways to organize the get-acquainted exercise.

Self-introductions —Ask participants to say a few things about themselves such as their names, the local governments they represent, the number of years they have served as finance officer or some other position, and why they have chosen to take part in this workshop or workshop series.

Paired introductions—Ask participants to pair up to get acquainted, to gather some personal/ professional data on one another, and then, in turn, for each participant to introduce his or her partner to the group.

Small group mixer—Have participants write on a card the name of the finance management area in which they would most like to be more skillful. Since many of the participants may not be aware of the topics to be covered by the training, you may have to make a list of them on newsprint or a blackboard before starting the exercise.

After participants have completed the task, ask them to get up and wander around the training room until they locate another participant with a similar need. After a few minutes, have participants who are interested in the same area of financial management to join together in small groups to discuss what they would like to know or be able to do better about that area. Ask for volunteers from the various groups to introduce their group's members and report on their group's results.

0.2 EXERCISE: ASSESSING KNOWLEDGE AND EXPERIENCE

TIME REQUIRED:

60 - 75 minutes

PURPOSE

This exercise is to help participants relate their own professional experience to the various financial management topics included in the workshop series.

(Note: If participants have not read the essay at the beginning of this chapter and are not familiar with the topics included in the series, substitute Exercise 1.3 for this one.)

PROCESS

Using a questionnaire like the one shown on the next two pages, ask participants to provide some information about their own performance and the performance of their respective local government organizations in relation to various topics.

When participants have completed the task individually, ask them to share their responses in small groups. Suggest that a recorder in each small group make a list of the responses and tabulate them to identify the patterns (i.e., which topics are most often mentioned in response to items in the two boxes).

After about 30 minutes of small group discussion, reconvene the participants. Ask for a summary report from each small group. Encourage a discussion of similarities and differences in small group results.

Assessment of Financial Management Knowledge and Experience: A Questionnaire

INSTRUCTIONS

Read the descriptions of functions performed by local governments in conducting their financial management responsibilities that are presented in Table 1. After you have read each of the functions, fill in the information as requested in the boxes in Tables 2 and 3.

Table 1. Description of Financial Management Functions

Accounting	Provides the basic concepts of accounting and reporting for LGs.
Asset Management	Provides a method for identifying and managing the assets of a LG.
Capital Investment Plan	Examines the process of planning for the financing of future physical development needs to ensure that construction priorities and schedules are coordinated with the availability of needed financial resources.
Citizen Participation	Provides a guide for local government officials in their efforts to involve citizens in a timely and constructive way in the development and implementation of public programs.
Evaluating Financial Condition	Provides a illustrative set of indicators to be used in evaluating a LG's financing condition.
Financial Planning	Examines in depth the process by which local governments anticipate their future financial needs using a variety of planning and forecasting methods.
Financial Policy Making	Explores the nature of financial policy and how policies are formulated and used systematically by local governments to guide and direct their financial affairs.
Financing the Capital Investment Plan	Describes the short and long-term financing portion of the capital investment plan.
Financing the Operating Budget	Describes the revenue and short-term financing portion of the annual operating budget. Also includes cash budgeting and investment of excess.
Operating Budget	Concentrates on the annual operating budget and its use as a primary tool for financial planning and management as well as for estimating annual income and controlling expenditures.
Performance Measures	Describes the use of performance measures to determine if and how well the intended purposes of local government are being achieved and how to set up a performance measurement system.
Procurement	Reviews in detail the lawful, efficient and ethical procurement of goods and services by a local government including a step-by-step tour of the public procurement cycle.

With respect to my own management performance, I would rate the finance functions described in Table 1 as follows:

Table 2

My Performance	Function
The function in which I do the best is:	_____
The function in which I am least successful is:	_____
The function that is the most challenging for me is:	_____
The function that is the least challenging for me is:	_____
The three functions in which I want training the most are:	_____

With respect to my local government’s performance, I would rate the finance functions described in Table 1 as follows:

Table 3

My Local Government’s Performance	Functions
The three functions in which my local government performs best are:	_____

The three functions in which my local government performs the least successfully are:	_____

Worksheet—Financial Functions: Challenges and Training Needs

INSTRUCTIONS

In Column 1, on the left side of the worksheet, make a list of 10 important financial functions performed by the local governments represented by members of your small group. After completing the list, agree as a group on five of the functions on the list as the ones that are the most challenging for the local governments represented. Indicate your group’s choices by blackening the appropriate five circles in Column 2. Then, agree as a group on five functions from the list as the ones in which training is needed the most by finance officers representing the local governments. Indicate your group’s choices for training by blackening the appropriate five circles in Column 3.

Column 1	Column 2	Column 3
Finance Function	Most Challenging	Training Needed
1. _____	0	0
2. _____	0	0
3. _____	0	0
4. _____	0	0
5. _____	0	0
6. _____	0	0
7. _____	0	0
8. _____	0	0
9. _____	0	0
10. _____	0	0

0.3 EXERCISE: IDENTIFYING FINANCIAL RESPONSIBILITIES

TIME REQUIRED:

About 60 minutes

PURPOSE:

This exercise is to help participants identify the various individuals or roles that perform important functions within local government's financial management process. The intent is to increase awareness of the interrelated nature of the various functions and the importance of team work in carrying out these functions. This is an exercise that can be used with participant groups that include policy makers (elected officials), CEOs, and department heads as well as financial officers.

PROCESS:

Divide the participants into small groups of five to seven and give each participant a copy of the list of FM functions from Exercise 1.2; Table 1. Ask each group to discuss who within the local government family of individuals, departments, boards, and commissions (such as the elected body or the planning commission) need to be involved in each of the twelve functions on the list. Out of the list for each function ask them to identify who does or should take the lead responsibility. Tell them they have about 30 minutes to come up with their responses.

This could get a little messy since many individuals, departments, and various boards and commissions need to be consulted or involved in many if not most of these functions. Remind the participants that the intent is to better understand the complexity of most LGFM functions. Ask each group to record their responses on flip chart paper so they can report on their findings in the following plenary session.

Don't hesitate to add any additional tasks to this exercise that you feel would be useful in helping the participants get a better understanding of the full range of functions within LGFM. For example, you might ask them to identify the roles that citizens should play, if any, in each of these functions.

Trainer's Guide

INTRODUCTION

When the Expert Group met in Kenya to plan this series of training and management materials the members agreed that the utility of the series would be enhanced by including a trainer's guide. While trainers will be the primary users of this guide, there are others that will also find it useful. For example, we have included a few notes for those who might be concerned about translating them into another language or perhaps adapting them to be more congruent with national laws and financing practices. We also see finance managers and other local government managers as potential users of this guide, particularly if they want to have an influence on the quality of training that is being provided for their employees. If your country has an association of finance officers, chief executive officers, or governing bodies, or is thinking about starting one, this guide might be useful. In other words, its potential users go beyond just those in the trainer role. We have tried to write it with this expanded audience in mind. We believe it's important to put training into a much broader context than just designing a learning event for a group of local government officials.

We will start our discussion in a moment by explaining what we mean by this. From there we will look at some of the challenges of adapting, and where necessary, translating the series into another language. We will also discuss some issues involved in planning and sustaining a successful local government financial management (LGFM) training programme. These aspects of training cover a range of training management tasks from doing a training needs assessment, to training trainers, and evaluating the impact of the training investment.

Finally, we will get to the trainer's concerns about how to use these materials to enhance their performance as learning facilitators. We will look at how to design successful learning interventions and how to carry them out successfully. It's one thing to design a successful training programme. It's another to conduct it successfully. In covering these aspects of the training trade, we will provide some clues about various kinds of learning tools such as case studies, role plays, and the use of instruments. We will also talk about the art of facilitating effective learning.

PRE-PLANNING CHECKLIST

Before sending out workshop announcements for LGFM training, it will be helpful to do a bit of preplanning to assure that you get the most from your efforts. To help

you do this we collected a few questions you need to ask yourself and others. Don't hesitate to add to the list as you engage in this preplanning planning.

- Who will be your primary training target group? Local government finance directors? Finance department staff members? Operating department heads? Local elected officials? Central government or provincial officials with local government oversight responsibilities? A mix of these possibilities?
- What are the potential numbers of training participants you might be able to attract from each of those target groups you want to serve?
- Have you thought about doing a training needs assessment of these potential training participants? If so, do you know how you will conduct the assessment?
- What will be the potential market for a training programme that involves the full series?
- Is there a pre-service training potential for this type of training?
- Have you thought about the potential of addressing good governance principles through special workshops for both local government and civil society participants based on the content of this series?

These are the kinds of marketing questions you need to be asking yourself and others before sending out the training announcement. They also get to the questions of what is feasible in terms of time commitments on the part of the participants you hope to attract to your training. Offering a training programme that involves the entire series is ideal for senior finance officers but may present some financial and time constraints. There are several ways to overcome these constraints and they probably involve partnerships. For example,

- Can you partner with another organisation or individuals to plan and deliver the training? Is there a professional association of finance officers, chief executives or governing bodies that would be a likely partner? Or a national association of local governments?
- Are there funding possibilities to help underwrite the cost of the training? International development agencies? Foundations? Professional or trade associations that are concerned about the quality of local government management?
- Have you thought about educational institutions that might want to offer this type of training as part of their continuing education programmes? They have the incentive of being able to offer a certificate or other credential that could enhance the careers of those who complete the series successfully.
- Have you taken time to get acquainted with the entire series with the intent of deciding how you might use selected ones to meet specific training audience learning needs? For example, elected officials? Or, auditors? Department heads of local government operating agencies?

These materials offer a wide array of marketing and partnering potentials. It will be helpful to spend some time thinking about these potentials before making any firm decisions about how you want to use these materials. We mentioned the potential of conducting training needs assessments (TNA) earlier. We believe they are important to help you and your training colleagues determine not only what to offer in terms of training content but also how to work within the time and other constraints your potential training clients might encounter in participating in the training. TNAs can also be important marketing tools. They help those who might need the training to better understand their needs and to help you in return explore some ways to overcome the constraints of participating in the training.

The next set of questions to ask involves the logistics of getting ready to offer the training.

- Will the materials have to be translated into the local language? If so, how will you arrange to have this done? And, how will you pay for the translation? We suspect you have had lots of experience in this process and know the pitfalls to be avoided. Nevertheless, we will make a few comments later about how to make this part of the planning process less troublesome.
- Will you need to adapt the materials to accommodate accounting or budgetary regulations, local legislation, management arrangements, or other peculiarities that might create resistance from the potential training audiences? We have tried to make the volumes as general as possible to minimise adaptation problems while not making them so general that they are useless. If you don't have to translate them into a local language you may be able to handle any essential adaptations with addenda to each chapter that are printed separately and inexpensively.
- Will you need to train trainers to conduct the training? If so, how will you conduct this training? Who will pay for this training?

There are many other questions you will need to be asking as you begin planning to use these materials. Don't hesitate to ask them. Better now than saying later, "Why didn't I think of that when I was considering the use of this series?"

TEN WAYS TO FAIL AS YOU USE THESE MATERIALS

One of the members of the Expert Group who helped to shape the content and format of these materials suggested we include a short discussion of how you can fail in using these materials. It comes from an earlier version of the Local Elected Leadership series also published by UN-HABITAT¹. With a few adaptations to the source document here are some contrary thoughts on how to fail.

1 UNCHS (Habitat) (1995) Local Governance Manuals: Training for Elected Leadership Series. Set of 13 volumes.

1. Don't bother to discuss the training with any finance officers before they come to your first workshop on this series. After all, you're the training expert, and they are just your training clients.
2. Plan to hold the training in places that are convenient for you and your training team. Don't worry about the training participants. They all have big travel budgets. If they don't, it's their own fault since they put together the budget.
3. The same goes when you hold the training. Your clients should be able to adjust their schedules if they are really interested in the training. And, don't let their excuse that it's "budget time" bother you.
4. Don't waste time checking out the training venue before the workshop begins. Everyone knows it's the content of the training that counts.
5. UN-HABITAT training materials are always so complete that there is no need to check them out before the workshop.
6. Stick to lectures and guest speakers as much as you can and don't bother with small group exercises and other stuff. They waste a lot of time and take up too much space.
7. If you feel you must use exercises, just go with the ones in the chapters. Start with the first and go through them in sequence until time runs out.
8. Don't bother to make changes in the exercises in the chapters. Obviously, the authors knew what they were doing or UN-HABITAT wouldn't have hired them.
9. Always go with the time the authors suggested in the exercises. Even if the participants are really into learning, don't hesitate to shut them off when the time the authors said the exercise should take runs out.
10. Don't bother with evaluations or follow up. Those finance officers are the kind who will call you if they have any questions or want more training.

These comments sound familiar. Sure, we've all known trainers who operated this way. Did you notice the past tense of that last statement? Hopefully they are no longer conducting training!

ADAPTING AND TRANSLATING THE SERIES

We mentioned briefly in the introduction some concerns about the possible translation and adaptation of the LGFM series for use in your country. Given the importance of these potential tasks, we want to share some lessons learned in preparing other training materials for local use.

The tasks of *adapting* and *translating* these materials will depend on a number of circumstances. If the training is to be conducted in your country in English and you have a cadre of seasoned trainers who are adept at modifying training materials to meet their needs, you may be able to use the series as published. Or, you might feel that new materials are needed to more accurately reflect the legal, cultural, political or managerial approaches to financial management in your country. If this is the case, you might want to produce a supplement for use by trainers and others.

For example, it might include different approaches to financial management tasks like oversight or procurement that are different in your country and need to be highlighted in the training; adaptation or abandonment of training tools that are not appropriate or otherwise acceptable to the potential participants of training; and development of new training and management tools that would be more user friendly and acceptable to your training clientele. We encourage these additions and changes.

If you need to translate the chapters into your local language, the tasks become more complex. Before you do anything, you should check with UN-HABITAT to see if any other institution or group has translated the series into your language. If they haven't, consider doing both an adaptation and translation if those who review the original text believe it will be necessary or desirable. The adaptation could include, for example, local case studies, role plays, and critical incidents, and changes of examples in the text to make them more country specific.

The following are some guidelines you might want to consider if you need to undertake adaptation and translation.

- Don't hesitate to make changes in the text and other important features in the materials.

While there are often rules and regulations that warn you not to copy, change, or otherwise mutilate someone else's published documents, they don't apply when working with this series of training materials. One reason UN-HABITAT training materials have been so successful is the freedom that users have to make them more compatible with their own circumstances.

In one country where one of the authors worked, he thought he had been clear about their right to make necessary and useful changes in the text. Only after the in-country version was translated and published in the local language did he discover that few, if any, changes had been made in crucial parts of the materials. Don't assume the permission to alter the materials has been clearly communicated. Even if it is clear to all concerned, don't assume the adaptation of even the most basic materials, such as case studies and role plays, has taken place.

- Assemble a small team of potential users, trainers, language specialists, and other key stakeholders to help with the adaptation and translation.

The task of adapting and translating these materials should not be left to one person although one person should have responsibility for pulling together the insights and inputs of others to produce the final product.

The selection of this team is important and might on rare occasions be problematic. For example, you will need one or two highly respected finance officers to serve on this team who are open to the need for training and understand the importance of introducing new concepts, principles and strategies into the management of financial responsibilities at the local level. Not only should they be familiar and skilled in LGFM principles and practices within your country, they will also provide a reality check on the use of these materials in their work environment. Their task will be to assure that the financial management concepts and strategies are either

compatible with local legislation and practice or represent improved approaches to current practices. In selecting these individuals, it is important to identify those who are open to change and willing to support new ways of doing things.

Include if possible one or two finance officers who also have training experience with adult education principles and strategies. They should also have a commitment to experiential learning, i.e., *learning by doing*. Let them know before they commit to working with your team that they will be responsible for helping to revise role plays, critical incidents, and case situations based on their own field experience and input from other members of the adaptation team.

Having a linguistics specialist on the team, in addition to the translator, may be important. For example, there may be certain words that are problematic even in the same language.

- Agree on some basic ground rules for working together as a team before you begin the adaptation and translation process.

For example, how will your team handle disagreements and differences of opinion about what to adapt and why? Be clear about each team member's role and responsibilities. Establish objectives, expected outputs and outcomes, and realistic time tables for reaching key milestones.

- If you are translating the materials into another language, hire the best translator available and don't allow that person to work in a vacuum.

The translation process is too important and difficult to be carried out without supportive interaction with a small bilingual team of trainers and finance specialists who are responsible for reading the translations and giving constructive feedback. We had an instructive experience when working with a two-language team in the development of the initial set of these materials. Much of the dialogue about how to translate certain technical terms took place between two continents and sometimes the interactions were, well, amusing. As some of the technical terms went from one language to another and then back again to the originating language, the initiator of the discussion often could not recognize the concept that was being discussed. Never underestimate the difficulty and importance of the adaptation and translation processes.

- Share the wealth of your experience and labour with others.

The translation of these learning materials can be a difficult, costly, and time-consuming venture so think about how you can share your final products and experience with others who communicate in the same language. If there is a regional language that is dominant, such as Spanish in Latin America, you may want to encourage joint production to optimize your production investments.

LEARNING APPLICATION

Adapting and, if necessary, translating the financial management series will be among the first and most important actions you will take once the decision has been made to use these materials. Stop for a moment and reflect on how you and others will undertake this responsibility. Jot down your thoughts on what kinds of adaptations might be needed to make this series of training materials more acceptable and useful in your country and culture; some of the key persons to be involved in adapting and translating; and how best to get this part of the process underway.

PLANNING FOR TRAINING IMPLEMENTATION

There are so many tasks associated with planning a successful training programme. For example, how do you get organised to conduct LGFM training? Who can, or will, be your sponsors? How do you market the training and follow-up activities? How do you build the trainer capacity to do this type of training if it doesn't exist? And how will you measure the impact of this training on the individual, the organisation and its various operations, and the community?

To help you sort through these many tasks, we are going to start with a technique that should serve you well in a number of situations. We borrow it from the consulting profession, but it works equally well in the training business and other entrepreneurial ventures. What we are about to discuss is called, among other things, *Contracting with your client*. This is not a legal contract; rather, it's a psychological contract. The concept and strategy has a rich history in the helping professions like consulting, training, and coaching, to name a few. Moreover, it's a great management tool and an effective tool for trainers and finance managers to use as well in conduct-

ing their business. As a trainer, think about how you can use this process as part of your LGFM training offerings.

BUILDING EFFECTIVE WORKING RELATIONSHIPS

Ed Schein wrote an important book called *Organizational Psychology* (Englewood Cliffs, NJ: Prentice-Hall, 1965, p.11.) In that book he took the concept of the “social contract” and gave it an organisational spin. Here’s what he had to say at the time.

The notion of a psychological contract implies that the individual has a variety of expectations of the organisation and that the organisation has a variety of expectations about him. These expectations not only cover how much work is to be performed for how much pay, but also the whole pattern of rights, privileges, and obligations between the worker and organisation.

If you substitute *training manager* for the individual and *training client* for the organisation, then you can easily see how this concept applies. Schein’s definition also relates to many of the issues involved of putting together an operating budget in a local government organisation.

Design Learning (DL) has described what is involved in setting the psychological contract between two people or entities better than any we have seen. The elements DL believes are important to cover in an initial meeting between the training manager and client are these:

- **Personal Acknowledgement.** This is the first exchange of information and feelings between the training manager and the training client. The goal is to make contact and to establish a working relationship. For example, express your appreciation for the opportunity to meet. If the client initiated the contact, then this is a good time to learn why the client decided to get in touch. If you as the training manager initiated the contact, then you might want to say why you wanted to meet and how the contact was made.
- **Communicating and Understanding the Situation.** Talk about the role of the finance official and the challenges inherent in this important community role. If you initiated the discussion, talk a bit about financial management training and what it involves. If the client has reservations about getting involved, this is the time to understand what they are and to discuss them.
- **Client Wants and Needs.** Understand why the client might want to get involved in financial management training, what their expectations are about such training, and why they think it could be an important investment for their department and organisation. If you have initiated this conversation, then it’s important to help the client express what he or she can offer to help make the training effective. It may be financial, logistical, even symbolic such as endorsing the programme. Discuss the client’s

concerns about costs, schedules, and the format of the training and other issues that might be associated with planning and implementing the training.

- **Training Manager's Wants and Offers.** Be clear about what you will need from the client to make the training successful and what you can bring to the training relationship. This can include such issues as the numbers of trainees you think you need to conduct a successful training programme, how the training will be delivered, the quality of the trainers, possible venues, the time commitment required, what the training content and process will be, and other "wants and offers" you have that will factor into this being a successful working relationship.
- **Closing the Conversation.** If you have reached an agreement to go ahead with the training, summarize the key points of the agreement and talk about next steps. Most initial discussions about your offer of financial management training will probably not result in a firm commitment immediately, so you will need to talk about follow-up steps. Otherwise, you may have wasted your time and theirs. Make plans to meet again within the near future to move toward a firm commitment. If this is not the right person or group to work with to initiate elected leadership training, then determine who is and ask if the person you are talking to can help make the contact.

What we have just covered is a process of establishing a working relationship with your training client. It is also a process you might want to work into a training session with finance officers to help them develop better working relations with department heads, the chief administrative officer, and elected officials in developing the annual budget.

SOME THOUGHTS ON FINDING SPONSORS AND CLIENTS

Sponsors of your local government financial management training efforts come in two basic types: those that provide monetary or other concrete kinds of support; and those who lend their name and prestige, and even clout, to support local government training.

Your concrete support list should include the usual grant giving institutions, i.e., bi-lateral and multi-lateral development institutions, foundations, private organisations, national and international NGOs that want to support local government capacity building initiatives, and more. If you have an association of local governments or several associations that represent local governments in your country, they may also be sources of direct support if they believe that financial management training can benefit their mission. The same is true of professional associations. The central government may give funds to support training, or they may be able to help introduce you to third parties they know who would be interested in supporting your training initiatives.

Some of the same sponsors you thought might be able to provide monetary or other direct support might also be able to lend moral support by endorsing your

financial management training efforts or by providing entrée to key stakeholders. Think about conducting a stakeholder analysis to identify potential direct and indirect sponsors. You could do the same to identify potential clients for the training. By stakeholder, we mean any person, group, or organisation that has an interest, pro or con, and would be affected in any way by financial management training at the local governance level and the consequences of such training. As you can see, even the planning of elected leadership training can cut both ways.

THE SPONSORSHIP-FUNDING DILEMMA

Before we go any further, it is essential to talk about the longer-term funding trap that is often associated with many of the kinds of sponsors we just mentioned. Many services and programmes often die on the vine once the sponsor's financial support is discontinued. Given this reality, you need to develop a strategy for sustaining the training after the donor or sponsor leaves town and to plan that strategy before you accept their money.

Here are some suggestions. Develop a sliding scale of participant training fees. As the acceptance and popularity of financial management training grows, you can increase the fees without suffering serious decreases in enrolment. Make sure you build as much of the developmental costs as possible, i.e. materials, translations, training of trainers, into any initiating grant or contribution. If you don't, you may be forced to increase costs later on to recoup these costs. In one country, regional training centres are supported by local governments through a modest membership fee based on population. In turn, the local governments are represented on the centre's policy board and get discounted and often free registrations to attend training programmes.

A POTENTIALLY DIVERSE CLIENTELE

It is easy to define the "clients" of financial management training too narrowly, i.e. as only individual finance officers attending short workshops. As a trainer, training manager, head of a professional association of local government officials, or an elected official concerned about the quality of your local government's financial management you need to think "outside the box" (the box being the traditional way of handling things!) in terms of ways these learning materials can be used. Here are just a few ideas.

- Involve local elected officials, the local policy makers, in LGFM training by focusing on their need to understand the big picture regarding their local government's financial management responsibilities. If there are national meetings of local elected officials, get on their programme to make a short presentation on the potential benefits of supporting LGFM training, not just for their finance officers but other key stakeholders including themselves. The conceptual framework used to put this new series together and the various components is a good place to begin such a presentation.

Follow this with a summary of the kinds of short training sessions you can provide elected officials. For example: a one day session on the various components of an effective and efficient financial management process for their local government; a half day briefing on the operating budget and the financing of this budget timed to happen just before they will be getting the budget from their administrators; a similar briefing on capital programming for those local governments that are establishing a capital programme or faced with major infrastructure expenditures; a similar briefing on assess management and evaluating the financial conditions of their local governments is another possible one-half day training opportunity; and, of course, special sessions on financial planning and policy making and citizen participation in the financial management of their governments are important elected official roles and responsibilities that can benefit from training. As we said, think outside the box in exploiting these materials for your benefit and those who can benefit from training.

- We assume that you already are planning a series of workshops for senior local government finance officers, but don't forget their subordinates who might want to enhance their opportunities to make a career of LGFM. This series, as mentioned before, provides a solid foundation for developing a certificate programme in conjunction with an educational institution, such as a community college or an association serving financial institutions or finance officers.
- Most countries have national government agencies that have oversight responsibilities over local government finances. Professionals in these departments could benefit from training in areas like evaluating financial conditions, asset management, and performance measures.
- One of the co-authors of this series has successfully combined key elected and appointed policy makers with finance officers in one day financial management workshops in Indonesia. She and her local colleagues covered the concepts, principles and strategies of certain topics in morning sessions involving a mix of these participants. In the afternoon, they held skill development workshops for technical and professional staff members on the same topics.

This series is a potential gold mine of opportunities for creative and entrepreneurial trainers and training managers.

MARKETING FINANCIAL MANAGEMENT TRAINING

The potential use of these materials will benefit from creative marketing on your part. While every country has its own values and behaviours regarding marketing, it will be up to each country team to decide what will be most effective in promoting this new training opportunity. Based on our experience and that of others who have carried out successful marketing initiatives, here are some ideas for you to consider.

- Get information out to as many media sources as possible about the financial management series and how you plan to use it. Raise awareness about the need for this kind of training, opportunities for attending such training, and the benefits to be realized. Think about addressing those audiences who are themselves concerned about improving the quality of local governance. These include service clubs, chambers of commerce, and others you are familiar with in your country that support the development of local governments.
- Contact key elected leaders who are trend setters and influential with their colleagues and ask them to help you mobilize support for financial management training. If corruption is a problem in local governments in your country, for example, emphasize the importance of this training. Work with public officials and civic leaders who have expressed concern about the need to curb corruption in local governments.
- If you have one or more local government associations or associations of local government professionals, get them involved in your marketing efforts. If there is no association of local government finance officers, help start one. If there is one, get them involved in your marketing initiatives. If they have a newsletter or journal, get an interview with the editor and provide them with a short article describing the series and how it can help them meet their association's goals and objectives.
- Get invited to their annual meeting or other membership meetings. Offer to make presentations to both explain the series and to solicit interest in follow-up training. Conduct short demonstration training events based on the series.
- Work with trainers and training organisations who have established working relationships with local government and other public and civic institutions. Of course, they may be your competitors. If this is the case, try to figure out how to collaborate so it's a win-win situation for everyone concerned.
- Hold information and demonstration workshops on a sub-regional basis within your country. Often potential training participants expect training to be a series of dull lectures. This series is designed to help you conduct practical, skill oriented, and interactive learning events. Short demonstration workshops can win over those who have had negative experiences with academic-oriented training. It also helps if you can offer these introductory workshops at no cost to the participants. Consider it an investment, an expected cost of launching a new programme.
- Conduct periodic or targeted training needs assessments of local financial management officers and others focusing in part on various roles and responsibilities of potential training participants. Share the results with those who have been assessed and with other key decision makers.
- Once your programme has a sufficient number of graduates, conduct impact assessment evaluations to learn how participants have used their new knowledge and skills to be more effective in carrying out their roles and responsibilities. Use this data and personal testimonies from key par-

ticipants to market new programmes. Also, use the evaluation feedback to strengthen your financial management training initiatives.

- If your region doesn't already have an organisation devoted to building the capacity of other institutions that have the responsibility for local government capacity building, consider creating one. With support from the Local Government and Public Service Reform Initiative of the Open Society Institute in Hungary, Partners Romania Foundation for Local Development (FPDL) has conducted a very successful regional program for capacity building in governance and local government development for central and eastern European countries. They conduct training of trainer programmes based on new materials like this series and provide other on-going support initiatives to trainers and training institutions in the region. FPDL's yearly steering committee meeting involving users of the program assess progress, share ideas and materials, and recommend new initiatives for future support based on their collective needs.

To summarize, raise awareness about the potential benefits of LGFM training in every way possible. If your potential clients for this training don't know what is available, it's hard for them to be motivated to take advantage of it. Hold demonstration workshops at municipal association and other likely meetings. Take your show on the road by offering short one-half or full-day demonstration workshops wherever there is a cluster of potential clients. Join forces with key stakeholders who are concerned with good governance in your country and develop a strategy that involves financial management training as a major component. Create a training capacity building programme and train trainers. Mobilise these trainers to help in the marketing of your programme. Organise it so it's in everybody's self-interest. Carry out impact assessments with participants when they return home from the training. Use the results from these assessments to improve your programme and promote future programmes through personal testimonies from past participants and concrete examples of the training's impact on local government performance.

With this "pep talk" under your belt, it's time to move on to another key component in preparing for training implementation: training trainers.

PREPARING A CADRE OF TRAINERS

Your potential pool of trainers for this financial management series is considerably less than what might be available for a less technical series on leadership or interpersonal skills, for example. Given this potential constraint, it will be important to forge a relationship with a few local government financial managers or individuals with knowledge and skills who you believe will make competent trainers. If there is an association of local finance officers in your country or region, this may be the first place to begin the search for your human resource needs.

Our preference for developing a cadre of trainers is to conduct a training of trainers (TOT) in-country even though the initial market for such training might seem small. The rationale is simple. A TOT is one of the best ways to field test the adapted or translated series. It is also an effective way to identify those potential

trainers you will want to work with initially in your LGFM training programme. It is important to recognise that everyone who completes a TOT workshop will not become a trainer. Nevertheless, they may become boosters for your programme. Assuming you agree with our rationale, here are some ideas about mounting that TOT.

- It's important to have a small team of competent trainers to train other trainers. Our experience in conducting TOTs suggests that a two person team is sufficient to conduct an effective TOT with this training series. But there are no hard and fast rules on how many to include on the TOT training team. Whatever the number, they need an in-depth knowledge about financial management and what's in the manuals, and confidence in their ability and skills to conduct experiential learning events. "Experiential" means interactive, knowledge enhancing, skill-based learning experiences that tap the needs, personal attributes, and experiences of the participants. It is also important for these trainers to be willing to take risks in their designs and training delivery and to be willing to experience occasional failure.
- The quality and number of TOT participants are also important ingredients for achieving TOT success. Before we talk about the quality of your TOT participants, let's talk about numbers. Your TOT for these materials probably should be limited to between eight and sixteen. Many of the training of trainer workshops we are familiar with have organised participants into four person teams who then become responsible for designing and delivering training modules to a group of finance officers on the second week of the TOT. You may be constrained in the numbers you can recruit for your initial TOT because of the requirement that they have knowledge, skills and experience in local government financial management. In terms of recruiting participants for your initial TOT, here are some lessons we've learned over the years.
 - o It helps if the TOT participants come from organisations that will support their efforts to participate in financial management workshops once the TOT is completed.
 - o Opportunities for success in launching and sustaining LGFM training programmes are enhanced if the participants come as teams who can work together after the training.
 - o Requiring previous training experience doesn't seem to be an important factor in the success of TOT participants, although it helps to have mentoring relationships in the initial stages of their development as trainers.
 - o When you are fortunate to recruit individuals who have a financial management background and training experience, it is important for them to come to the experience with an open and willing attitude to engage in new learning. The training materials and approach may be quite different from those they have used in the past.

- The tools in each of the manuals are designed to be modified at the trainer's discretion. We encourage trainers to tinker with them, to improve upon them, and on occasion, to take only the core design idea and construct their own learning experience around it. In the TOT part of your programme, encourage your participants to incorporate their own ideas based on the needs of their training clients.
- While there are many ways to design TOT workshops, we are partial to one that is about two weeks long. During the initial week, participants work in teams to design a day or more of training based on the materials in the series. The second week these teams of two to four participants conduct one or more days of training to a group of finance officers with minimal assistance from the TOT training staff. In other words, the TOT participants conduct training work sessions with real live experienced participants. Since this particular TOT design has worked remarkably well in many parts of the world we are confident in recommending it.

As stated before, don't expect every participant to become a competent and successful trainer of elected officials based on a two-week TOT. Nor should you be too concerned about the initial quality of the training your TOT participants deliver when they return home based on such a short TOT experience. We have learned over the years that it is better to have trainers from the same country or culture working with local officials, even though they might not be polished trainers, than some outside trainer with long experience. Trainers graduating from your TOT programme will have another advantage. They will be working with materials that are user-friendly.

ASSESSING IMPACT

While it's impossible to cover all the details about planning for implementation of your LGFM programme in this short User's Guide, we want to mention one more planning detail we think is important. It's the importance of assessing the impact of the training on individual learning and behaviour as well as the impact in the organisations where the participants are carrying out their financial management responsibilities. For example, what will be the impact of the training on improved systems of budgeting, introduction of capital programming, the use of performance measures, asset management systems, better procurement procedures, and more?

The importance of collecting data about the impact of training on organisation and community performance, such as participatory budgeting practices, is very important to your ability to sustain your LGFM training. However, determining how you will measure the impact of your training needs to be determined before you conduct the training, otherwise there are few benchmarks against which you can measure success. To learn more about impact assessments, contact UN-HABITAT for a copy of their *Manual for Evaluating Training's Impact on Human Settlements*.

TRAINING DESIGN AND DELIVERY

Training design and delivery includes a lot of planning tasks although they are different from those we just discussed. In the following discussion you will find an overall checklist of some key design and delivery factors to keep in mind; a look at some logistical factors to consider, such as time, venue and equipment; the importance of adaptation and creativity in using these materials; the art of writing learning objectives; and, how to design learning events that will keep your clients coming back.

There are many factors to consider in designing and delivering effective, efficient, and engaging learning experiences. The following checklist targets some of the more important ones. It is followed by more in-depth discussions about each. By the way, *effectiveness* has to do with providing training experiences for your clients that meet your client's immediate and short-term learning needs. *Efficiency* is how you deliver the training. *Engaging* is the process of involving your participants through sharing their ideas, life experiences, and visions about the future.

- Effective, efficient and engaging training is driven by purpose. Your ability to write clear and concise objective statements that describe what you plan to accomplish during the learning experience is the most important design task you will undertake.
- The quality of your learning events will be determined in large measure by the time and energy you invest in adapting these materials to fit the situational context of your participants.
- Complete learning events involve the infusion of new knowledge, ideas and insights and the opportunities for participants to process and apply these infusions based on their individual and collective experiences and needs.

The most insightful learning design can be sabotaged by external factors. Fortunately, most of these externalities are within your control, but they need to be managed.

Since the need to cope with the last set of factors often precedes efforts to sit down and design the training event, let's look at them first.

MANAGING THE EXTERNAL FACTORS

It's impossible to design and deliver an effective training programme without taking into consideration many of the external factors that will often determine just how successful you will be when you begin the training. While most of these may be obvious to many of you, they are still worthy of review.

EXPECTATIONS

To the extent possible, narrow the expectation gap between you as the trainer and the workshop participants. Your workshops are more likely to be effective if the par-

ticipants know ahead of time what they will be learning and the process to be used to facilitate their learning. This can be important if your intended audience is likely to have experienced only lecture-oriented training in the past. You might also consider developing a training calendar that can be provided to client organisations such as municipal associations, so they can announce when workshops on various topics will be available, their length, and location.

We encourage you to negotiate a mutually agreed-upon contract with potential training clients. These clients might be a cluster of local governments, an association of local governments, or even an educational institution that wants to broaden their services to local governments. Individual training contracts allow the trainer and the client organisation to be much more explicit about training content and scheduling. In any case, it is important that information on training content and approaches is specified beforehand so that participants know the learning opportunities being made available to them.

DURATION AND TIMING

The number of workshops to be conducted, their duration, and the sequencing and timing of training exercises depend on a number of considerations. If you can schedule the training as a single programme (e.g., one or two weeks in length) involving participants from many organisations, you will have considerable control over content and schedule. A series of 2 or 3-day workshops designed to cover the entire series presents a different design and scheduling problem. Since the materials provide lots of optional learning exercises for each of the subjects covered in the series, there is a substantial amount of design freedom built into their use. Be particularly careful to include enough time for participants to process the information being covered in every exercise or workshop fully before moving on to the next. Build reflective time into the overall design so that individuals and small groups can informally explore in more depth the issues and topics being covered.

LOCATION AND PHYSICAL FACILITIES

It is important to create an environment that supports learning, one that removes participants from everyday distractions and encourages them to think and act in new and different ways. Some of the worst training venues are those associated with the everyday work activities of the participants. Some of the best locations have been somewhat remote and rustic settings. These kinds of environments seem to foster a greater willingness to be open and to take risks in their interactions with others.

The physical facilities are also important. Look for workshop venues that offer privacy, have movable furniture, and provide enough space for several small groups to meet concurrently. Auditoriums and large, open buildings are usually not flexible enough and lack the intimacy needed for effective interaction. It is also important to arrange things so that participants are not interrupted by non-participants, telephone calls, or other annoyances during training sessions.

EQUIPMENT AND TRAINING AIDS

Be sure that you have access to materials and equipment that can be transported easily or can be supplied by the training venue. Essential items include flipcharts, easels, numerous pads and markers, and an overhead projector or other audio-visual equipment that is compatible with your needs and expectations. If you plan to use power point presentations, check to see that everything is in good working order and have contingency plans when something malfunctions. Our experience tells us that anything that can go wrong will and at the last moment. Prepare participant hand-out materials including instruments, questionnaires, checklists, and worksheets in advance and make provisions to have access to photocopy equipment or service at the training site.

NUMBERS OF PARTICIPANTS

We discussed earlier the number of participants we believe optimum for training trainers. While we won't be dogmatic about the number of finance officers or other public officials you can involve in LGFM training, we think there are some good guidelines to consider. Groups of 16 to 24 are just about ideal for one or two trainers to facilitate. These numbers also lend themselves to small group work sessions of four, six or eight members each. If you begin to include more than twenty four, although we realize this number is arbitrary, it makes the experience less intimate, more impersonal, and cuts down on the time that each member of the group has to contribute to the interaction. Unfortunately, these decisions are often determined by funding constraints.

We've covered only a few of the important external factors that can influence the quality of the learning experience you will be designing and delivering for the benefit of others. While there are obviously many more, we don't want to deprive you of the opportunity to discover them yourself as you initiate your LGFM training programmes.

KNOW WHAT YOU WANT TO ACCOMPLISH AND STATE IT CLEARLY

As we said earlier, effective, efficient and engaging training is driven by purpose. Your ability to write clear and concise objective statements that describe what you plan to accomplish during the learning experience is the most important design task you will undertake. Here are some thoughts about how to do this and maybe even a few that are unconventional.

The best roadmap for guiding you to successful learning experiences is a clear statement of your overall goal and objectives. If you are able to state these clearly, you have increased your chances of success immeasurably. Now writing learning goals and objectives can be dull, deadly business. We don't know a trainer who enjoys doing it. And yet it has to be done. The old adage, "If you don't know where you are

going, you probably won't know when you get there," applies to learning design. It's not a very attractive alternative for either you or your workshop participants.

We are using two terms, *goal* and *objective*, to describe aspects of your learning roadmap. The *goal* we see as the accomplishment of the overall expectations you hope to fulfil with your participants as a result of the learning experience. It's the super-ordinate objective you hope to achieve, a statement of the big learning picture. *Objectives* are sub-goals, or statements of those things you want to accomplish through specific learning experiences during the workshop.

Many training textbooks recommend writing objectives in the following way: *By the end of the training, participants will be able to demonstrate their ability to write a policy statement*, or some other concrete task. This implies that we are going to be testing them in some way to make sure they can do it. This strikes us as being a bit too academic. Given this, we will reveal our own bias about this onerous training-design task, but not before making it clear that you should feel free to write learning objectives in any way that you feel clearly states what you plan to accomplish in the workshop.

We often write learning objectives based on what it is possible to accomplish through experiential learning. This includes:

1. increased knowledge and understanding;
2. new or improved skills, either technical or relational;
3. new or altered attitudes and values; and
4. creative acts.

The first two are standard learning objectives associated with knowledge and skill-based training. The next two are harder to defend. Let's look at the third one on attitudes and values. Some still argue that you can't change these personal attributes through training. We disagree. Take, for example, someone who believes strongly that citizens should not be involved in the local government budgeting process. Now that's an attitude, but it might also be a value that this person believes in. Through a learning experience, this person begins to understand the importance of citizen participation. Beyond the workshop, this person demonstrates this new attitude and value by supporting a move to involve citizens in local budgeting decisions.

There is no question that helping others alter their attitudes and values is a difficult learning objective to accomplish, but often it is the cutting edge of important community changes. Don't shy away from these more emotionally charged learning opportunities.

Regarding the fourth objective, "creative acts," it's more curious than difficult. What if you ask participants to develop an action plan as part of your learning objectives or outcomes? It hardly fits in the first three categories, so we invented a fourth.

The ultimate learning outcome is, of course, behavioural change. If local government officials and others do not change their behaviour as a result of learning new concepts or strategies, acquiring new or improved skills, or even changing a few attitudes and values in a learning experience, then the training investment is lost.

Another important distinction to keep in mind when designing learning programmes is the difference between *outputs* and *outcomes*. For example, when partici-

pants demonstrate that they know how to develop financial strategies to assure that basic local government services can be provided to low income neighbourhoods, this is an “output.” They have learned how to develop such delivery strategies during a workshop. When they go back to the organisation and lead the charge to implement their strategy, based on the knowledge and skills gained in the workshop, it is an “outcome.”

ENGAGE IN ADAPTATION AND CREATIVITY

You need to take advantage of the opportunities in your immediate working environment to make these materials and the training you will be conducting as relevant, timely, and client-centred as possible. Here are a few guidelines to train by:

1. If you decide to use a case study, role play, simulation, or any other tool from any of these materials in your training programmes, adapt it to meet your needs and the learning needs of your participants. Change names, locations, circumstances, and anything else that says, “Not invented here!”
2. Talk to some finance officers or other practitioners before you sit down to finalise your workshop design. Ask them if they have any interesting experiences that might relate to the topics you plan to cover. If so, check to see if you can incorporate them into your design.
3. Whenever possible, exploit your participant’s experiences in the financial management competencies you are covering in the workshop. Use these experiences to create new learning exercises, or to modify those in the materials. For example, you can create a role play right on the spot based on something that might be bothering many in the workshop. Or you can have a participant describe a particularly difficult situation that he or she is experiencing and break the others up into small discussion groups to determine what they might do in this situation.
4. Look in Part One section of each chapter, the *Concepts, Principles, and Strategies* part, for clues to develop your own exercises. For example, many of the Learning Application exercises are ready-made to be turned into workshop learning experiences.
5. Don’t be afraid to deviate from your workshop design or agenda when you see an opportunity for significant learning emerging out of the dialogue and energy that has been created by your participants.

DESIGNING LEARNING EVENTS

If you are able to decide with clarity what you want to accomplish during a workshop, seminar, or some other kind of planned learning event, you have cleared the first and most important training hurdle. We are, of course, assuming that you have also arrived at these conclusions in consultation with your client(s) and their training needs and transformed your ideas into written statements of purpose, goals, and objectives

that are concise, understandable and doable. If so, then the next step is to figure out how to accomplish them within the time allotted. This is the training design part of the puzzle.

As we said in our overview comments leading into this discussion on training design and delivery, effective, efficient and engaging learning events involve three interrelated activities: 1) the infusion of new knowledge, ideas, and insights; 2) the opportunities for participants to process these infusions, based on their individual and collective experiences; and 3) the application of what they have learned to their individual, work team and organisational needs and opportunities. Complete learning designs should, whenever possible, include a mix of input, processing and application.

The first two of these interrelated components are common to most experiential training designs. We provide new ideas, information, concepts and strategies as input, and we design some kind of interactive experience so participants can process the new input. The third, *application*, is less frequently used mostly because it is more difficult to design into training, or so it seems. Application is evident when we have participants complete an action plan design a new revenue reporting form in a financial management workshop, or develop a list of stakeholders who might be important to consider in carrying out a community development project.

The most important thing to remember about these three interrelated components is their complete flexibility. You can start with any one of the components and move to the other two in whatever sequence you want. While it is fairly common to provide a lecture, for example, and follow it with some kind of exercise to process the content of the lecture, it is less common to start with an exercise and then insert the lecture. When you realize you can start with any one of the three components and move to the other two in whatever sequence you choose, you have one of the most important value-added dividends of experiential learning at your command². Before we move on to training implementation, we want to share with you the workshop template that Eva Balazova, the godmother of these materials, uses in designing her learning events. The overall framework includes:

1. The aims and objectives of the workshop;
2. The timeframe and agenda which spell out in detail what the participants can expect from one session to another; and
3. Lessons learned during the experience, back home planning, and evaluation.

Within the overall framework Eva designs around the following agenda:

1. Welcoming statement and introductions of staff and participants;
2. Learning aims and objective: what she and her staff plan to accomplish;
3. Information about the programme and logistics;
4. Ice breaker or energiser, depending on which seems most appropriate given the group;
5. First learning block includes cognitive input from the chapter being covered, i.e. lecturette, guided discussion, interactive presentation using visual aids;

6. Second learning block includes use of experiential materials from the tools or from her experience as a trainer, i.e., case study, role play, assessment instruments, problem solving exercise;
7. Based on the length of the workshop and the maturity of the group in the subject matter Steps 5 and 6 would be repeated; and
8. The completion of the workshop experience includes a participant look at lessons learned, preparation of personal plans by participants to indicate how they plan to use lessons learned back in their organisation, and workshop evaluation.

We believe this template is an effective one to use in designing experiential learning experiences for professionals. Of course, it's up to each individual trainer to arrive at a process that works best based on experience and results. As the expert group reminded us on more than one occasion these materials need to be *descriptive* and not *prescriptive*.

IMPLEMENTING TRAINING DESIGNS

Each of the volumes in the *Local Government Financial Management* series consists of exercises and activities developed and sequenced to provide a comprehensive learning experience for your participants. They include role plays, case studies, simulations, instruments, and other learning opportunities that can be arranged in various combinations. These are designed to help participants make sense out of the concepts and ideas being presented in Part One of the chapter.

The exercises we have included in the chapters are all structured in about the same way although the subject matter from chapter to chapter is different. For example:

- Each exercise begins with a general statement of the objective to be achieved and an estimate of the time required. While staying within the recommended time frame is recommended, don't be a slave to it. Use your judgment. If the exercise has sparked lively and important discussions don't cut it off by saying, "Sorry, but we've scheduled a role play, and we need to get on with it." That's an example of the trainer meeting his or her needs and not the needs of the participants and is very dysfunctional. If it takes longer to complete an exercise than scheduled, you can either make up the time elsewhere in the workshop or discuss with the participants the need to add a bit more time to the schedule.
- Following the objective and suggested timeframe we have provided a step-by-step set of instructions on how to conduct the learning event. We call this the *process*. Occasionally, the process will include variations or alternatives for your consideration particularly if the exercise is to be used with participants who work together and may be interested in improving their team performance. A time estimate may be provided for various steps in the process.

- The process description is often followed by worksheets to be either read or written on by participants. Typical worksheets include cases, role-play situations and role descriptions, instruments to be completed, questions to be answered by small groups, and other participant-involving things. Hopefully the instructions on these worksheets are clear and easy for participants to read. If not, change them to meet your needs. All worksheets included in the chapters are designed and intended for mass duplication.

Each chapter includes an example of a warm-up exercise. Warm-ups are the means by which you begin moving participants from the known to the unknown and start the process of getting them acquainted as early into the workshop as possible with others, the learning process, and you. We haven't included different warm-up exercises in each of the chapters since most trainers and many of the participants have their own favourite exercises they like to use. Don't hesitate to involve your participants in providing and conducting their own warm-up exercises and energisers.

Many of the exercises in this series are designed to involve discussions and group problem solving on specific aspects of financial management. The intent of these exercises is to help workshop participants gain a working knowledge of a useful idea, strategy or process and at the same time some experience in using the new knowledge. For example, participants are introduced to brainstorming in one of the manuals, one of the common methods for generating ideas to solve a problem or make a decision. In another chapter participants are encouraged to use *force field analysis* as an analytical aid in planning ways to remove obstacles to the attainment of an operational goal. Many of the chapters include exercises that have general applicability to more than just the topic being discussed. Given this, you might want to get acquainted with what is available in all of them before designing workshops on specific aspects of financial management.

A number of the training tools are designed to build on participant-contributed situations or problems. Working in small task groups, they are asked to analyse the situation and suggest courses of action to be reported on during a plenary session. In other suggested workshop designs, there are problem-solving activities supported by worksheets. These are intended to be completed by participants working in small groups as an aid to analysis and for later reporting. Worksheets are useful for at least two reasons: they provide a record of small group reactions to the assigned tasks, and they give participants written record of their small group's results to take home with them.

At the completion of each workshop design is a skill-transfer exercise. The intent is to help participants begin the transition back to the "real world" of participating elected officials. It is important that participants begin making definite plans for trying out or changing certain aspects of their performance responsibilities. These plans are more effective if they are made in writing, realistically critiqued, and shared openly with other participants.

We have been talking about the tools in each of the chapters as though they are also workshop designs. They are, and they are not. They are because they include a sequence of training exercises that can be selected to conduct a workshop based on the substantive material covered in Part One of each chapter. They are also sequenced to help you develop a learning rhythm in your workshops.

However, we never intended that you should use all the exercises in one workshop, nor to adhere rigorously to the sequence in which they are presented. In this respect they are not workshop designs. Use your imagination, and your design knowledge, skills, and experience to develop a workshop design that will work for you and your participants.

FACILITATING SUCCESSFUL SMALL GROUP LEARNING ACTIVITIES

With the possibility that we are repeating ourselves on some of these issues, we will nevertheless press on with some clues about how to work with small groups. We will focus on three aspects of managing small group learning: giving instructions, monitoring their progress or lack thereof, and helping them to report out and process what they have learned.

GIVING INSTRUCTIONS

Most experts on giving instructions agree on one thing: begin the instruction by giving participants a rationale for the task or exercise. When participants know *why* they are being asked to do something, they will be far more interested in learning *how*. Beginning with this expert-driven mandate, giving good instructions can be viewed as a simple, four-step process.

- Introduce the exercise by giving a rationale. This should include the objective of the exercise and anything else you might add to help participants see the importance of the exercise from their point of view.
- Explain the task. Describe what participants will be doing. Usually the task of a small group is to produce a product. Use active verbs to describe the product such as, “list the three most important...” or “describe an incident in which you were involved that...” Make the transition from the rationale for the task to the explanation as smoothly as possible.
- Specify the context. It is important for participants to know who they will be working with, under what conditions, and how long. The context of the exercise spells out how they will be accomplishing the task.
- Reporting. Let them know that they will be asked to report out to the larger group the results of their small group discussions. The purpose is not just to explain what happened but to advance the process of learning. Reporting allows participants to share their experiences with one another, hopefully enabling them to expand, integrate and generalize learning from their individual or small group experiences. Ask them to decide on who will represent them in this reporting process before they begin their discussions.

MONITORING SMALL GROUP ACTIVITIES

When participants are busy carrying out the tasks you have assigned them, you need to be busy keeping track of how their work is progressing. We call this monitoring. Monitoring is important for two reasons:

- It gives you feedback on how well participants know what they are supposed to be doing and how committed they are to the task. If you sense confusion, misdirection, or misinterpretation in a group, you may need to restate the task, perhaps by paraphrasing the original instructions or augmenting them with an example.
- It helps you to adjust the time needed for the task. Even the most carefully designed small group exercise will require some adjustments in the amount of time it takes to complete certain tasks. Each participant group is different. Therefore, your concern should be with assuring the small groups enough time to gain the most learning value for its members.

When you have given small groups their instructions, stand quietly and wait until they have convened and have gotten underway on the task. After a few minutes, circulate to find out how things are going. Enter the work area quietly being careful not to interrupt. If you are asked questions, and you usually will be, answer them briefly. If one small group's questions suggest there may be confusion in the other groups, then interrupt the others and re-phrase appropriate parts of the task for all of them.

As groups proceed with the task, there are several aspects of their activities you should be aware of and intervene in if it seems necessary to help them be more productive:

- Is the physical space and seating conducive to participation by all the members, or are some participants isolated?
- Are there changes in the noise level in the group? These changes may indicate that a group has finished its task, just getting down to work, or perhaps confused about the task. In any event, you need to check it out.
- Do participants seem to be working on the task, or are they engaged in idle conversation? If participants are discussing matters unrelated to the task, they may be finished, or they may be avoiding the task. Check it out.

Based on the task given and the time remaining, are participants behind, ahead, or on schedule? If time is running out but participants are still working intently, it may be more desirable to give them more time. When you notice that some groups are finished and others are not, you might offer a time check, "You have two minutes left," for example.

FACILITATING THE REPORTING PROCESS

By reporting, we do not mean a detailed, “this is what we did during our meeting” recital. Rather, the term “reporting” is intended to mean an opportunity to share the most important observations and conclusions of the time spent by a small group on a task.

Logistics are an important aspect of facilitating small group reporting. What group will report when, and who will represent them? What kind of reports will be expected-- on newsprint, orally with no visuals, or by power point? One of the authors worked on a training programme in one of the Pacific Rim nations where every group was expected to make computer-assisted reports.

Time is also an issue in reporting and it needs to be managed. For example, you can have each group report two or three items from its list rather than report every item. Another approach to reporting is to have each small group examine and report on a different aspect of the same topic. Finally, where small groups have been working on the same task and some kind of synthesis or consensus is needed, a polling procedure can be used. For example, have each small group place its recommendations on a sheet of newsprint which is posted for all to see. When all the sheets are posted and reviewed, comparisons can be made, differences noted, and confusing entries clarified.

Three skills are required to facilitate the reporting process effectively:

- Asking initiating and clarifying questions. To help initiate and clarify group reports, you need to be able to ask direct, but not leading, questions. These should be open-ended questions usually beginning with what, when, where, how, or why such as, “What are the implications of this method given your role as a finance manager?”
- Paraphrasing. This is important to be sure you are actually hearing what the participant meant you to hear. Your objective is to assure the participant that you are listening and that you are eager to know if you have heard correctly. For example, if someone reports that, “*Elected officials have difficulty adopting the budgets we prepare for them,*” you might paraphrase or restate what you heard for clarification by saying, “*You mean elected officials know they have the responsibility to adopt the budget but often find it difficult because of conflicting priorities.*”
- Summarizing. While paraphrasing is meant to mirror the meaning with a change of words, summarizing is to synthesize or condense a report to its essentials. The intent, once again, is to test for understanding. Efforts by a trainer to summarize or reduce information to its essentials might begin with phrases like:

“In other words “

“If I understand what you are saying, you mean....”

“In summary, then, you feel...”

SOME THINGS TO CONSIDER IN USING TRAINING TOOLS

While the training exercises in each of the chapters provide some of the important tools needed to construct a series of elected leadership workshops, they still need the skills of the master builder to apply them with success. Here are a few ideas on how to work with these tools more effectively.

BE FLEXIBLE

Flexibility in working with the training materials and the participants may be the most important and often most difficult skill to develop as a trainer. While most of the exercises in the chapters can probably be conducted without a lot of modification, we don't recommend it. There are many reasons for this. You might experience time constraints that will require you to "cut and fit" the exercise to fit the time available. The participants may have different expectations from those assumed when the exercise you want to use was developed. There may be something about the exercise that just doesn't feel right in the culture in which you are working. Your participants may have actually raced ahead of you in discovering something that is important to them, and they want to talk about it in more depth. It's important to be flexible, to seize the opportunity of the moment.

ENRICH THE CONTENT

While we have tried to provide enough content materials in Part I of each of the chapters to get you through most workshops, we encourage you to enrich the content with local examples, new concepts or strategies that you might have discovered, or even evidence that refutes what we have written about so eloquently. The world of local government financial management is changing rapidly, and whatever we write today may be out of sync with tomorrow's reality. As you prepare for each workshop, enrich the content with current examples and new ideas that build upon, or even refute, the concepts, principles, and strategies we have provided.

There is another content enrichment opportunity that is available in every experiential learning experience that yearns to be tapped at any given moment. That's the experience, wisdom, and ideas of the participants. While we have included a number of different approaches to collecting and evoking information and ideas from your participants in the various chapters, we encourage you to invent your own. One of the most successful techniques we have found to get a lot of ideas out quickly and organize them into some logical framework is to use large index cards. Have the participants respond on these cards with their ideas, ask them to attach them to a blank wall with paper tape and then rearrange them into logical categories for processing.

There are, of course, many ways to tap the experience of participants to add to the content of each workshop. These include developing instant case studies or critical incidents based on their experience rather than using ones that have been included in the chapters; asking participants to take various positions in a role play that reflects a situation they might be struggling with in their own communities; or creating an instant simulation based on the needs of the participants. For example,

the simulation might involve a budget hearing where citizens have, for the first time, been given the opportunity to participate in the deliberations.

PROVIDING BALANCE AND RHYTHM

Designing workshops is a bit like writing a musical score. You need to take into consideration things like sequencing events, balancing your instruments and their impact on the overall production, and assuring that the rhythm doesn't bore either the audience or the conductor(s). For example, the arrangement of exercises and presentation should proceed naturally from the more known to the less known, from the less complex to the more complex, from the less interactive to the more interactive. Every component of the workshop should contribute to the attainment of workshop goals. Even the refreshment breaks, meals, and free times should be placed strategically.

And don't forget those ice-breakers, energisers, and openers that are so important to group growth and on-going maintenance. They serve the needs of those who join together to learn and implement what they are learning. Since some of us get these tools confused with each other, it might be useful to describe them and how they differ.

Icebreakers and openers have a lot in common, but also some differences. Icebreakers are relatively subject-free activities whereas openers are often related to the content of the workshop. Icebreakers are typically used when workshop participants don't know each other. They are designed to help members get acquainted and become more comfortable as learning partners. Openers, on the other hand, are tools to help participants ease into the subject matter. They tend to set the stage for interactive learning; help the group, including the facilitator, avoid abrupt starts; and generally help the participants get comfortable with the content material. An opener may be as simple as asking the participants to share in pairs what they think is meant by "asset management" when that particular topic is introduced.

The other type of climate-building and group-maintenance exercise is the energiser. Typically, it's a fun event to get the group's collective energy level up when the group seems to have hit a slump. Don't hesitate to use these group "environmental tools" to open your workshops, to help everyone get acquainted, and to infuse a bit of adrenalin into the learning community when it's fuel tank seems to be on empty. If you want to learn more about these tools, check with your training colleagues or get on the internet and surf for ideas. If these two options fail, just ask your participants to lend a hand. Our experience it that most groups have individuals who are skilled in running these types of exercises and enjoy the opportunity to become involved.

PROCESS THE WHAT, WHY, AND HOW OF LEARNING

Polly Berends, in writing about how we learn, said, "Everything that happens to you is your teacher. The secret is to learn to sit at the feet of your own life and be taught by it." To paraphrase Polly's metaphor about self-learning, everything that happens in a workshop is important. The secret is to keep on top of the *what*, the *why* and the *how* of your learning design and process them. Processing is simply an activity that is designed to encourage your participants to plan, reflect, analyse, describe, and com-

municate throughout the learning experience. These are the events that encourage the transfer of learning from the workshop environment to the real-world working life of your participants. Here are some processing techniques to consider:

- Use observers to report on the process or outcome of an exercise.
- Ask participants to serve as consultants to one another to stimulate thinking and problem solving.
- Divide participants into several smaller groups for rapid processing of new ideas and information and provide for reports and summary discussions.
- Leave time for participants to reflect on what they have been learning and doing.
- Encourage back-home application by having participants develop written plans about what they plan to do to apply what they have learned to their roles and responsibilities as elected officials.

ENCOURAGE PARTICIPATION BUT DON'T OVERDO IT

While an important trainer role is to stimulate participants to exercise more freedom in thought and action, it is important not to force any activity that might cause them to feel threatened or intimidated. This is particularly true if people are attending a workshop involuntarily or with strong reservations. Be sensitive to the feelings and needs of all participants. Don't expect your participants to involve themselves with equal enthusiasm in every single activity.

CELEBRATE OPPORTUNITIES TO LEARN

Every significant learning experience is a cause for celebration. While you will need to determine what is "significant" based on your experience and the norms of your situation, we tend to think that a week or more of training deserves some kind of celebratory event. It may be a closing luncheon, the handing out of certificates of participation, a group photograph, or something more significant depending on the time and personal commitment of your participants. If you have a large number of officials participating in the full series of workshops, you might consider holding one large celebration or reunion once a year. This could provide publicity for your program and also an opportunity to make it more elaborate.

HAVE FUN!

We came across a French proverb while writing this part of the Trainer's Guide that sums up one of the most important qualities of a learning experience. The most wasted of all days is the day when we have not laughed. Think about your own experiences as a trainer or participant and the ones you have treasured and remembered. So, have fun knowing that laughter in the midst of learning is a no-cost, value-added commodity.

LEARNING APPLICATION

While training is the accepted strategy throughout the world for workforce development, it's expensive. A good return on your training investment is assured when (1) the training addresses real performance discrepancies and skill needs; (2) the training is competently designed and delivered by experienced trainers; and (3) those who have attended the training apply their new knowledge and skills to improve work performance. All of these factors must be present for training to meet the expectations of those who invest in it. But it is the third that is the most problematic. Unless those who are trained make the effort to use what is learned to correct discrepancies or to modify or change their behaviour, the investment is lost. Here are some thoughts on what you might do to help participants apply what they learned when they return home from your workshop.

Sharing experiences. The opening session of any skill based workshop is not too soon to raise the importance of how the participants will apply their new-found knowledge and skills when they return home. If this is one of a series of open enrolment workshops on the various roles and competencies, you might ask if any participants have attended earlier workshops on the series. If so, invite them to share their experiences in applying what they learned. This sharing technique can provide continuity and remind other participants that it is important to think about how they will apply what they will be learning to challenges in their local leadership role.

Learning objectives. It is important to include near the start of any organised learning experience a discussion of the objectives you hope to achieve as a group. However, it's not so common to ask participants to develop their own set of learning objectives based on the workshop content and design. We suggest you do. Have them write their own learning objectives and remind them that they will be asked to return to them at the end of the workshop when they prepare an action plan based on what they plan to do when they return home.

Action Planning. In each of the chapters we have included a Learning Application Plan worksheet. We encourage you to have each participant complete this form, or one of your choice as a trainer, before the workshop closes. It's an important way to help participants reflect on what they have learned and how they plan to use what they have learned for their own continuing professional development and the development of their organisation.

BASIC TRAINING TOOLS

While the chapters offer enough training materials to help you design and deliver a full-scale local government financial management training programme, we decided to supplement these with a few basic tools of the trade. Think of these learning components as parts from which you can design and build an experiential learning event. They are largely interchangeable although their success depends on a number of environmental variables. For example, the number of participants you are working with, the time you have available, the mix of participants, and most importantly, what you hope to achieve. Start with your learning objectives and your learning audience and

then decide which of these might be helpful in constructing a winning workshop design.

PRESENTATIONS

Trainers who believe in andragogy, a fancy term for adult education, and experiential learning, which translates roughly into learning-by-doing, are usually horrified to even mention the word lecture in the company of other trainers. Instead we use such terms as *lecturette*, *guided discussion*, and yes, *presentations*. However, there are lots of opportunities when it is both appropriate and essential to present ideas, concepts, strategies, data, and other cognitive stuff to achieve your learning objectives even in the most interactive training experience. Following are a few ideas to help you make presentations that will keep your participants from snoring.

Presentations are useful for explaining new concepts and subject-matter details and to stimulate critical thinking. Used in conjunction with other learning methods, presentations help workshop participants become better informed, involved, and comfortable with learning new things.

Presentations are more than just a way of delivering information. You can use them at the start of a workshop to establish a proper learning climate, promote interest in learning, and reduce participant anxiety. You may present information spontaneously at any point in the workshop to stimulate thought, introduce exercises, clarify or interpret a new concept, or test for comprehension. Finally, you can take advantage of presentations at the conclusion of a workshop to summarize important lessons learned and encourage learning transfer.

Many trainers see the presentation only as a form of information delivery. Viewed from a broader perspective, the presentation is an opportunity for the trainer to get a group of participants involved in their own learning. This is more likely to happen when a presentation includes planned or spontaneous participant-involvement techniques sometimes referred to in the chapters as *guided discussions*. Here are a few clues on how to engage your participants in your presentation:

1. Ask participants to think about and discuss situations in their own work experiences that illustrate a concept you have just introduced to them as a way of helping them see its practical application to their own work.
2. Ask participants to answer questions about material just covered or restate in their own words what they just heard you say as a comprehension check before going on to new material.
3. Give participants a handout that covers some aspect of the material being presented orally and include some blank spaces in the handout for their use in writing down their own interpretations or possible job applications of the material being discussed.
4. Most important, use visual materials to supplement your oral presentations, i.e., flipcharts, chalkboards, overheads, and, if available, computer-assisted materials. These help to keep participants awake, lengthen their attention span, increase the retention of new information, and lessen the chance of your being misunderstood.

In summary, successful presentations are planned with four considerations in mind.

- They are brief, focused on a few key ideas and packaged to deliver information in “bite-sized” chunks.
- They are designed to include provocative beginnings, convincing middles, and strong endings.
- They give participants ample opportunity through question and answer techniques to demonstrate their comprehension, and to compare viewpoints and experiences with the trainer and other participants.
- They respond to the needs of participants to experience multiple ways of accessing information and ideas.

DISCUSSIONS

Discussion is any interaction between two or more people on a topic of mutual interest. The types of discussion used in this series are of two kinds depending on the trainer’s role. In those that are trainer-guided, the trainer takes an active and direct part in guiding and directing the discussion. In what is sometimes called a structured discussion, you will be letting participants manage their own deliberations.

In the trainer-guided discussion, the objective is to encourage participants to think about, relate to, and internalize new ideas related to a particular topic. While usually planned as a way of processing case-study data, role-playing experiences, or other exercises, such discussions may occur spontaneously during a presentation or near the close of a workshop. How productive they are will depend on how experienced you are with the question-and-answer method and your knowledge of the subject.

In a structured discussion, the objective is to engage participants in idea generation or problem solving relative to an assigned topic and to demonstrate the value of teamwork — interdependence. You need little subject-matter expertise to initiate a structured discussion. Normally, you will divide the participant group into several small groups of about equal size and assign the same or different tasks to each group. After tasks are assigned, a period of time is allowed for the small groups to discuss the task. You might want to give instructions to the small groups about appointing a leader, a reporter, and a timekeeper. At the end of the discussion phase, small groups are asked to come back together and to report their findings, sometimes written on flipchart paper which can be taped to a wall of the training room.

Sometimes, the focus of small group discussions is on the process of working together as well as the product of the group effort. There is much learning value in exploring relationships or patterns of interaction among participants as they work together to solve a problem, decide on a course of action, or carry out some other task. You might decide to select one or two participants to be observers. Ask them to monitor the process of interaction among participants as they work together on tasks. Assure that this is being done with the knowledge and consent of other group

members. Their final task is to feed back their observations and conclusions to the group when it has finished work on its assigned task.

In summary, the discussion method can stimulate participant involvement in the learning process. Trainer-guided discussions are of value principally in stimulating logical thinking. However, subject-matter expertise is required if you plan to lead such a discussion. Structured discussions, on the other hand, help participants to become self-reliant, to develop team thinking and approaches, and to be less dependent on the trainer. Your role in discussions of this kind shifts to coach and interpreter. Through mutual exploration, struggle, and discovery, participants in small groups gain insight and the satisfaction that comes from having attained these insights.

CASE STUDIES AND CRITICAL INCIDENTS

Under this heading we will discuss two types of exercises that are used in this series: (a) the longer traditional *case study* used in many professional schools and (b) an abbreviated version of the case study called the *critical incident*.

TRADITIONAL CASE STUDIES

The case study is an actual or contrived situation, the facts from which may lead to conclusions or decisions that can be generalised to circumstances experienced by those taking part in the exercise. Put another way, a case study is a story with a lesson. Cases used in training can take many forms. They may be quite long, complex, and detailed. Or they may be short and fairly straightforward similar to the one-to-three page variety found in the series.

The case method assumes group discussion. The well constructed case stimulates participants to analyse and offer opinions about (a) who was to blame, (b) what caused a person to behave as he or she did, and (c) what should have been done to prevent or remedy the situation. The more important contributions of the case method to training include:

- Discouraging participants from making snap judgements about people and behaviour.
- Discouraging a search for the one “best answer.”
- Illustrating how the same set of events can be perceived differently by people with similar backgrounds.
- Encouraging workshop participants to discuss things with each other and to experience the broadening value of interaction.
- Emphasising the value of practical thinking.

CRITICAL INCIDENTS

Closely related to case studies, critical incidents are brief, written descriptions of situations that are familiar to the workshop participants. They can come from several sources: (a) the workshop participants themselves; (b) participants in earlier workshops; (c) anecdotal information collected by the trainer through interviews and

surveys; (d) secondary source material such as journals, books, and manuals on the topic; and (e) the trainer's fertile imagination. When preparing a critical incident for use in a workshop, there are several design ideas to keep in mind:

- Keep them short—several sentences are usually enough—and simple so they be read and understood quickly by workshop participants.
- Because incidents are short, they need to be tied directly to the workshop objectives.
- Include enough detail about the problem to emphasise the point of the incident.

When asked to write a critical incident, participants are instructed to think of a difficult situation related to the training topic. They should describe the situation briefly, state who was involved in it, and the role they played. Depending on how the incident is to be used, participants might be asked later to explain what was done about the situation and the resulting consequences.

A critical incident can be as simple as a participant saying,

The mayor has been turning in travel, lodging and meal expenses that are far in excess of those allowed in the city's regulations. In fact, it looks like he is using these otherwise legitimate expenses to run his private business on the side. As the city's newly appointed finance director I'm concerned about the consequences of this for the city, the mayor, and, of course, my job. I raised the issue with him a month or so ago and he vehemently denied any wrong doing and told me to mind my own business. When I mentioned this to my assistant who had been with the city for several years, he told me that the previous finance director had been fired for confronting the mayor about his expenses and that I needed to be careful. I've only been in the job for about six months and can't afford to get fired. What should I do?

ROLE PLAYING

Role playing involves asking workshop participants to assume parts of real or imaginary persons, to carry out conversations, and to behave as if they were these individuals. The intent is to give participants the chance to practice new behaviours believed appropriate for their work roles and to experience the effect of behaving this way on themselves and on others who are playing related roles. It is generally believed that on-the-job application of new behaviours increases to the extent that people are willing to try out and evaluate the new behaviours under supervised training conditions. Few training methods offer more effective ways to encourage experimentation with new behaviours than role playing.

To provide the context in which role playing can achieve significant participant learning, couple it with the case study or critical incident method. After reading and discussing a case study or critical incident, invite participants to step into the roles of the individuals featured in the situation. Realism is enhanced when detailed role descriptions are developed for each of the role players.

If an individual is resisting the opportunity to become involved in a role play, it is better not to push them into participating. It is up to the trainer to establish the tone for role playing. Provide firm direction when moving a group into role playing by establishing ground rules and the boundaries of good taste. Bring the role play to a close when it begins to lose its realism and learning value.

Here are some useful steps to take in setting up and directing a role play.

- Introduce the setting for the role play and the people who will be represented in the various roles. If names are not given, encourage role players to use their own names or provide them with suitable names for the roles they will be playing.
- Identify participants to play the various parts. Coach them until you are satisfied they understand the “point of view” represented by each part. Participants may be asked to volunteer for roles, or you may attempt to volunteer them for roles in a good-natured way.
- Ask participants who play roles to comment on what they have learned from the experience.
- Ask other participants to give critical feedback to the role players.

In summary, role playing is a highly interactive, participant-centred activity that, combined with the case-study method, can yield the benefits of both. When case situations, critical incidents, and role descriptions closely represent real-life conditions, role playing can have a significant impact on the participants’ ability to learn new behaviour.

SIMULATIONS

Simulations are like role plays, but bigger. They are often simplified models of a process that is to be learned. Through simulation, workshop participants can experience what it is like to take part in the process and can experience their own behaviours relative to it in a safe environment. They help the participants learn while avoiding many of the risks associated with real-life experimentation.

Simulations are sometimes used to involve participants in organising physical objects to study how they make decisions. One example is to create small teams that are asked to compete against each other on the construction of a tower within designated time and resource constraints. The intent is to examine questions of planning, organisation, and the assumption of leadership within newly-formed teams. Another example of simulation is something called an in-basket exercise. Individual participants are asked to make quick decisions as a newly-appointed manager on how to delegate or otherwise dispose of a stack of correspondence left behind by a previous manager. The intent of this kind of simulation is to investigate how an individual sets priorities, delegates authority, and generally manages time.

As with role plays and case studies, simulations garner their learning value from the authenticity of the situations and the degree of realism provided by participants taking part. What has been said earlier in the guide about setting up the situation and being sure everyone knows what he or she is supposed to be doing applies equally to your trainer role in producing successful simulations.

In summary, simulations are workshop representations of situations participants are likely to be confronted with in their real-life roles. They allow participants to practice new ways of doing things and learn more about their own behaviour in role-relevant situations with a minimum of personal or professional risk.

INSTRUMENTS

An instrument is any device that contains questions or statements relative to an area of interest to which participants respond. Instruments are versatile. They can include questionnaires, checklists, inventories, and other non-clinical measuring devices. Normally, instruments focus on a particular subject about which workshop participants have an interest in learning. They produce a set of data for participants to study, either individually or in small groups or both. Often these instruments are designed to help participants discover more about their own beliefs, values, and behaviours and provide data on the norms of a larger population. Most participants, when confronted with their own data, are inclined to alter aspects of their future behaviour so they can be more effective.

There is a major distinction between just having participants complete an instrument and using it properly. The value of these learning aids is increased measurably when you apply the following steps.

STEP 1: ADMINISTRATION

Distribute the instrument, read the instructions to participants, ask for questions of clarification only, and instruct them to complete the instrument. Monitor the time carefully and encourage participants to help others if they are having problems in completing it. Expect some individuals to take longer than others.

STEP 2: THEORY INPUT

When participants have completed the instrument, discuss the theory underling the instrument and what it measures.

STEP 3: SCORING

Based on the way the instrument is designed, ask participants to score their responses. Sometimes instruments have a built-in scoring mechanism. At other times, it may be necessary to read out the answers and to give other instructions, e.g., how to combine scores. Since some scoring instructions can be difficult, we suggest you take the instrument yourself and become familiar with all aspects of it before trying it out on others. This is even more important if you devised the instrument yourself.

STEP 4: INTERPRETATION

It is generally effective to have participants post their scores on chart paper for others to see. Small groups are often formed to discuss their scores. Special attention should be given to the meaning of low and high scores and discrepancies between

actual and estimated scores, if estimating is done. Participants may be asked if they were surprised by their scores or other participant's scores.

In summary, instruments are used to derive information directly from the experience of workshop participants themselves. Owing to the personal nature of the feedback, instruments can be an effective method for helping participants learn more about specific behaviours and the impact these behaviours have on others. While we have included a number of instruments in the series, we encourage you to develop your own based on the needs of your participants and your own interests in expanding your training design knowledge and skills.

LEARNING APPLICATION

Speaking of *Learning applications* don't forget that each of the chapters includes a number of these efforts to encourage the reader to stop and reflect on what they have just read. These interludes in the Part One text of each chapter have the potential to be very effective training design and learning tools. Don't overlook their potential as you design workshops and learning experiences for your clients. Now, back to this specific opportunity to apply what you have just learned about the design of training programmes and experiences.

In an effort to better understand the many ideas that we have presented on developing effective training programmes for your constituents, we suggest you jot down five to ten of the most important lessons you have learned from this Guide that will help you become better prepared to offer this LGFM series.

Now, take the best of these ideas and describe how you plan to put it into operation in planning and designing your next financial management workshop.

IN CONCLUSION

The secret of being a competent and successful training manager or trainer is not measured by how many guides like this you may have read. It's measured by what others do with what they have learned from you and the learning experiences you have made available to them.

For example, about twelve years ago one of the authors conducted a three-week programme on the topic of managing change in Hungary. There were twenty-seven participants in that workshop but only one responded immediately to the potential of trying to manage changes back home. It was the early 1990s and Ana Vasilache was from Romania, a country that was undergoing significant political, social and economic changes. With new ideas on how to change things and a whole lot of tenacity and courage, Ana began to develop a regional training and capacity building programme to serve local governments and non-governmental organisations in her country and others in the region.

In the twelve years since that workshop on Managing Change, she and her Romanian colleagues established an organisation that has trained over 10,000 participants from 35 countries on four continents. Moreover, their training has included twenty-one national training of trainer (TOT) programmes involving 230 trainers. By the most conservative multiplier the number of officials consequently trained by the graduates of these TOT programmes far exceeded 100,000 at the time this was being written. She attributes the genesis of her success in large part to what she learned in that initial workshop, i.e. concepts, strategies and skills in experiential learning and change management.

As the author recalls the initial workshop that sparked this flurry of training opportunities in Romania and beyond, he admits that he has no verifiable data on the success of the other twenty-six graduates. If we assume that twenty-six of the twenty-seven participants in that change management workshop did very little to apply what they had learned, can we make the outrageous assumption that the workshop was successful? Or, was it a dismal failure? You decide.

We believe there is a lesson or two or more in this short parable. First, never underestimate the influence you can have as a trainer using chapters like the one you are reading. Second, don't expect every training programme you conduct to be 100% successful. You can't control nor dictate the impact that others will have from what they have learned in workshops that you conduct. Training of Trainer (TOT) workshops are notorious for the dropout rate among those who attend. Very few participants in a Training of Trainers programme will become accomplished and dedicated trainers. Not to worry. It only takes one trainer in a TOT who is dedicated to cloning herself to keep the propagation going.

Finally, be encouraged by the success that Ana and her colleagues have experienced and don't be discouraged by short term workshop results. Most external

evaluators would consider a programme like the one in Hungary a dismal failure. After all, the percentage of participants who went forth and actually “managed change” in their organisations and communities appeared to be miniscule. It probably was a dismal failure and waste of funds from conventional measures of success. Unless, you consider the consequences of the one participant who went home and turned her learning into a phenomenal success story that has spanned four continents. Social, political and economic revolutions often start not from the masses but from a few individuals who recognize the power of an idea whose time has come.

In closing this guide we want to go from *inspiration* to *perspiration*. In other words, we want to put you to work. The following worksheet is to help you and your colleagues begin to plan the application of these learning materials in your own country, region or community. Good luck and think outside the box. Ana Vasilache did and was one of seven persons world-wide honoured in 2000 by UN-HABITAT for their contributions to good governance.

Never doubt that a small group of thoughtful, committed citizens can change the world. Indeed, it's the only thing that ever has.

Anthropologist Margaret Mead

PLANNING FOR SUCCESS

The following questions are designed to help you think through how you will put this series of Local Government Financial Management (LGFM) opportunities into action. We suggest that this is a task best accomplished by a few dedicated stakeholders involving not only those who will take the primary responsibility for providing the training but also those who will benefit from the training. Thus the first set of queries to consider. By the way, these questions may not follow your own sense of what the planning logic should be. Given this, don't hesitate to alter the sequence, add your own, or drop some of the tasks we are suggesting. Also to conserve space we have not left enough room after some of the questions to provide adequate answers. Given this, we suggest you plan to use a flip chart to record your answers, preferably working through the questions with one or two other colleagues who will make up the core of your planning team.

THE PLANNING TEAM

1. About how many persons will be on your planning team? ____
2. What expertise and points of view will they represent? For example: potential trainers? If so, who? _____; Finance officers? _____; Representatives of other potential client groups? _____; Potential sponsors of training: _____; Potential funding sources? _____; Language specialists, if necessary? _____; Others? _____.

THE POTENTIAL CLIENTELE OF THE TRAINING:

In each of the following client possibilities, not only think about whether you want to target them, but try to estimate the potential numbers of training participants in each of the categories mentioned. Just check those you want to target and provide a guess-timate of the numbers. This part of the planning will provide a sense of the potential there might be for the training given out-of-the-box thinking and marketing.

1. Senior local government finance officers? ____; #s? ____
2. Staff members of finance departments? ____; #s? ____
3. Operating department heads, i.e. public works, fire protection, library?
____ #s? ____
4. Local elected officials? ____ #s? ____ Members of specific committees of the governing body, i.e. finance or oversight committees? ____ #s? ____
5. State government officials with local government oversight responsibilities? ____ #s? ____
6. Pre-public service students who want to work with local governments?
____ #s? ____
7. Citizens, i.e. those who might serve on citizen boards or committees to help plan and manage the budget? ____ #s ____
8. Others? ____ #s ____.
9. Speaking of potential clients, do you plan to conduct any training need assessments? If so, with whom? ____; And how? ____
10. Now, go back to each of the potential client groups and think about what chapters would be most appropriate for each category of training participant. For example, senior finance officers should ultimately be trained in all the chapters. Elected officials might need to concentrate on topics like operating budgets and their financing, evaluating financial conditions, and a few others with an overview on all of the chapters.

MATERIALS AND TRAINER PREPARATION

1. Will the series have to be translated into a local language? ____ If so, how will you undertake this task? ____
2. Who will pay for the translation? ____ And, the printing in the local language? ____
3. How will you monitor the integrity and accuracy of the translation? ____
4. If translation is not necessary, do you see the need to adapt the materials for local use? ____ If so, what does this mean? ____ How do you plan to carry out these adaptations? ____
5. Who do you plan to work with to accomplish these adaptations? ____ How will you compensate those who do the adaptations? ____
6. What other questions do you need answers to regarding the preparation of the materials for local or national use? ____
7. Who do you plan to use to conduct the LGFM training? ____

8. How will you prepare them as trainers who both understand the content of the materials and the experiential learning process? ____
9. Will you conduct a training of trainers (TOT) to develop a small cadre of trainers who can undertake the initial series of training events? ____ If so, how do you plan to organise and staff such a programme? ____
10. How will you recruit the participants for the TOT? ____ What will be your criteria for selection of these participants? ____
11. How will you finance the cost of the TOT? ____

PARTNERSHIPS, FUNDING, AND OTHER NECESSITIES

1. Do you plan to partner with other organisations or individuals to plan and conduct the training? ____ If so, who are they, and what will they contribute to the endeavour? ____
2. How do you plan to fund the training of LGFM participants? ____ How will you organise these potential funding possibilities? ____ What are the possibilities of sustaining each of these funding options? ____ What is your strategy for sustaining the LGFM training over time? ____
3. How do you plan to market the training? ____
4. What kinds of evaluations do you plan to use to assess the quality of the training experiences associated with LGFM training? ____ How do you plan to assess the impact of the training within the participant's work setting? ____
5. What is the first thing you plan to do to put this plan into action? ____

There are no doubt many more questions to be asked and answered before you begin to spend time and money on launching a new programme of local government financial management training. We hope this volley of queries has helped to begin the dialogue toward action. We encourage you to add to this list of questions as you go down the road toward training implementation. The more you can define the *what*, *who*, *why*, *where*, *when*, and *how* dimensions of this new venture before you even

Capital Investment Plan

PART ONE: CONCEPTS, PRINCIPLES, AND STRATEGIES

SUMMARY

This chapter is divided in basic and advanced sections. The basic section will describe how to design and implement a capital investment planning and budgeting system at the local level of government. We will define capital investment planning terminology and examine the benefits and potential obstacles associated with establishing a system. We will also discuss the steps involved in preparing, reviewing, adopting, and monitoring a capital investment plan and budget, including an extensive section on actually constructing facilities. The advanced section includes an introduction to value management and real estate analysis.

INTRODUCTION

We recognize that basic or introductory concepts are relative—depending upon your background and frame of reference for both finance, capital investments and local government. Users of this material will range from those who have no knowledge of capital investment principles or concepts to those who have a very sophisticated understanding. The following are our ideas of what represents the most fundamental principles and concepts needed to understand capital investment planning at a beginning level.

INTERRELATIONSHIPS BETWEEN CHAPTERS IN THE SERIES

The following matrix shows the interrelationships between the *Capital Investment Plan* and other chapters in the series.

	Capital Investment Plan
<i>Introduction</i>	The <i>Introduction</i> provides the framework for using the entire series.

Trainer's Guide	Provides guidelines for using the chapters to provide training.
Financial Policy Making	Financial policy making provides the framework for the capital investment planning process.
Financial Planning	Financial planning prioritizes and projects LG revenues and expenditures. It identifies capital investment needs at a high level. The capital investment planning process refines and carries out the planning at a specific project by project level.
Citizen Participation	Capital investments such as infrastructure (streets, clinics, traffic lights, water systems, etc.) are the foundation for the essential services that the LG provides to its citizens. Citizen participation in the capital investment planning process ensures that citizens have input into the priority setting and decision making regarding capital investments.
Evaluating Financial Condition	A LG's investment in capital investments may be a primary reason for citizens and industry or businesses being in the LG. Unwise decisions regarding capital investment planning may result in these groups deciding to leave the LG which, in turn, may reduce the tax base or revenues from these groups, which, in turn, may worsen the LG's financial condition.
Operating Budget	The annual budget is made up of the operating budget (day-to-day operations) and the capital budget (the amount to be paid out in the current fiscal year for multi-year building, road or other infrastructure projects or very expensive equipment such as fire trucks. The chapters <i>Operating Budget</i> and <i>Financing the Operating Budget</i> focus on aspects of day-to-day operational budgets as opposed to the multi-year focus of the <i>Capital Investment Planning</i> chapter.
Financing the Operating Budget	The annual budget is made up of the operating budget (day-to-day operations) and the capital budget (the amount to be paid out in the current fiscal year for multi-year building, road or other infrastructure projects or very expensive equipment such as fire trucks. The chapters <i>Operating Budget</i> and <i>Financing the Operating Budget</i> focus on aspects of day-to-day operational budgets as opposed to the multi-year focus of the <i>Capital Investment Planning</i> chapter.
Financing the Capital Investment Plan	<i>Financing the Capital Investment Plan</i> chapter focuses on the revenue side of the capital investment plan.
Accounting	Capital investment planning (budgeting) is a plan. Accounting documents how the funds were actually spent.
Performance Measures	Performance measures help the LG ensure that the capital investment planning process is as efficient and effective and accomplishing the goals of the LG.
Asset Management	Capital investment planning is the plan to acquire or build assets such as streets, water systems, clinics, etc. Once built, asset management focuses on utilizing each asset to its best advantage for the LG.
Procurement	The procurement process is the primary method for acquiring or building capital investments.

BASIC CONCEPTS AND DEFINITIONS

Capital investment planning and budgeting terminology can be confusing. Definitions differ among countries due to central government laws and may even differ among LGs within a country. To help minimize the confusion the following terms and definitions will be used in this chapter.

Appropriation—Legal authorizations granted by the governing body to make expenditures and incur obligations for specific purposes; they usually are limited in amount and time to be expended.

Back-door financing—Secretive, illicit or indirect means of providing financing.

Benefit assessments—A compulsory tax or service charge made against certain properties to defray all or part of the cost of a specific capital investment or service deemed to benefit primarily those properties.

Borrowing capacity—The maximum amount or number than can be borrowed.

Brainstorming—A group technique for solving problems, generating ideas, stimulating, creative thinking, by unrestrained, spontaneous participation in discussion.

Capital budget—The capital budget covers projects included in the first year of the capital investment plan. It may be incorporated in the operating budget or adopted as a separate budget. In the capital budget, the LG appropriates funds for projects to be undertaken during the current budget year. Each year, the first year of the capital investment plan becomes the capital budget.

Capital expenditures—See capital investments.

Capital investment project—Also called capital project in this chapter. A major non-recurring, tangible, fixed asset of significant value with a useful life of more than one year. The specifics of value and life expectancy are frequently determined by central government regulation. Each LG should establish its own rules for defining capital investment projects based on local needs and legal requirements. Here are some examples of capital investment projects:

- New and expanded facilities such as buildings, parks, roads, water and sewer systems, street lighting, and a landfill.
- Rehabilitation or replacement of existing facilities such as streets, buildings, parks, street lighting, and water and sewer systems.
- Equipment for public improvements when they are first constructed such as furniture, office equipment, or playground equipment.
- Major equipment—which is expensive and has a relatively long life—such as fire trucks, garbage trucks, and construction equipment. Many times equipment with a useful life of less than five years or which is small in size, and difficult to control, such as portable radios, are excluded from the definition. Another common exclusion is equipment such as furniture and police vehicles that are replaced annually in approximately the same quantity.
- Repairs to existing facilities such as building repairs including new roofs and major electrical, plumbing and heating repairs. Establishing rules for repairs can be difficult. A total unit cut-off such as US \$2500, US \$5,000 or US \$10,000 simplifies the definition, but other criteria can be used

including the extent to which repairs add value, prolong the useful life, or entail major structural or mechanical change. However, these criteria are hard to quantify.

- The cost of engineering, architectural and feasibility studies associated with new facilities or major renovations.
- The acquisition of land or buildings.

Capital investments—Expenditures made for capital investment projects. Also called capital expenditures in some countries.

Capital investment plan—(CIP)—A multiyear (usually 5 - 6 year) plan of capital investment projects listed in priority order by year with anticipated beginning and completion dates, annual estimated costs and proposed methods of financing. Annually, the plan is reviewed, revised, and projected one additional year.

Capital program—See capital investment plan.

Creditworthiness—The general eligibility of a person, company, or LG to borrow money.

Debt capacity—Ability to repay loans or other debts as measured by creditors who judge an applicant's ability to repay a loan based on assets and income, and assign a certain capacity to pay off debt; if a LG has many credit lines available, even if there are no outstanding balances, that is still using up the LG's debt capacity.

Debt service—The cost of principal and interest on borrowed money for a given year or series of years according to a predetermined payment schedule.

Deferred maintenance—Not performing (deferring) maintenance at the time it should have been, or was scheduled to be, performed; maintenance in this context means more than routine preventative maintenance and repairs; it also includes replacement of parts, periodic road resurfacing and other activities needed to maintain the fixed asset at its originally contemplated serviceability for its originally estimated life.

Dollar value cut-off—An arbitrary method, based on the anticipated cost of the proposed capital investment project, for determining whether the project will be included in the capital investment plan and capital budget. This term often relates to LG size and financial resources. Projects with a value above the cut-off are included in the capital investment plan and capital budget. Those below the cut-off are treated as operating budget expenditures. To be placed in the capital budget, typically the project cost requires special attention and has a significant impact on the financial condition of the LG. A small LG may decide to use a value cut-off of US \$2,500. Medium size LGs may use a cut-off of US \$10,000. Large LGs may use a cut-off of US \$50,000 or US \$100,000.

Fixed assets—Property of a long-term character that is owned by the LG and intended to continue to be held or used for public purposes, such as land, buildings, and equipment.

Infrastructure—Public facilities such as streets, bridges, buildings, parks, water and sewer systems, and street lighting.

Life cycle costing—A system that tracks and accumulates the actual costs attributed to an asset from its original design or purchase to its disposition. This includes: the time involved to complete the project, the people needed (number, expertise and so on), the degree of difficulty involved, availability of money or other resources, the

amount of maintenance needed, and the money that must be expended and kept in reserve. Also called “cradle to grave” or “womb to tomb.”

Life expectancy—The expected useful life of an asset from the date placed in service to the projected retirement date.

Nominal group method—A structured interaction technique that encourages input from all group members and provides for anonymous voting on priorities.

Operating budget—Plan for current year expenditures and the proposed means of financing them; it is the primary means by which most of the financing, acquisition, spending, and service delivery activities of a LG are controlled.

Pay-as-you-go—A principle or practice of paying for goods and services when they are purchased or built rather than relying on credit (e.g., loans or bonds).

Pay-as-you-use—A principle or practice of paying for goods and services as they are used over time by using credit (e.g., loans or bonds). This method matches the benefit of the use of the asset, such as a street, bridge, or building with the repayment of the debt for that asset.

Reserves—Generally an amount appropriated or allowed in anticipation of possible future events such as a “Reserve for Contingencies.”

Return on investment—A measure of the earning power of assets. It is commonly used to evaluate effectiveness and efficiency.

Value engineering—A systematic approach to optimizing the value of a facility. In the value engineering process, a group of objective technical specialists, who have not been associated with a design, break the project down into major components, agree on the functions of each, and then propose alternatives to the existing designated components to perform the same function; it is not a design check or review, but a re-engineering process which challenges established designs or paradigms.

WHY ESTABLISH CAPITAL INVESTMENT PROJECTS AND A CAPITAL BUDGET SEPARATE FROM THE OPERATING BUDGET?

There are several important reasons for separating the capital budget from the operating budget:

- First, capital investment projects require multi-year expenditures because they are expensive and may take more than one year to design and construct.
- Second, capital investment projects often involve multiple sources of financing such as current funds, debt, reserves, and grants that must be accounted for separately.
- Third, capital investment projects have future operating budget impact, which requires careful planning.
- Finally, financial resources for capital investment projects are limited and therefore must be considered and allocated in a systematic manner.

DECENTRALIZATION AND LG CAPITAL INVESTMENT PLANNING

In a decentralized country, governing bodies usually define capital investment policies. In countries going through decentralization, this function may still be at the central government level. Policies and decisions made at the central government level will be based on central government priorities—not LG priorities. One of the significant milestones of approving a CIP based on LG priorities is that the governing body establishes its own policy and direction for providing services to its citizens. The governing body is responsible for providing maximum possible satisfaction of public service needs within existing resources.

In some countries undergoing decentralization, small capital projects—based on LG priorities—are beginning to be funded by own source revenues. So, focus your attention on where you can have an impact. If the central government is still deciding most capital investment projects, you will need to use their forms, policies, and procedures. But, if your LG has begun to develop and implement some of your own CIP priorities, use the principles and concepts found in this chapter, where possible, to provide guidance for these projects.

DECISION MAKING PROCESS FOR THE CAPITAL INVESTMENT PLAN (CIP)

The CEO, governing body members, department heads, citizens, and interest group representatives should all participate in capital investment planning decision making. The goal of CIP participation is to allow potentially contradictory demands on limited resources to be expressed and resolved rather than suppressed or ignored, while at the same time ensuring that conflict does not overwhelm the process or render decision making impossible. Following are suggested roles and responsibilities.

The chief executive officer (CEO)—normally is responsible for carrying out the following CIP tasks:

- Preparing the draft capital investment plan to be reviewed by the governing body;
- Explaining the current and projected financial status of the LG;
- Implementing the CIP as approved by the governing body; and,
- Monitoring and reporting on the status of the CIP throughout the budget year.

The CEO may choose to delegate some of these tasks to other staff members such as the budget officer. CEOs should provide overall guidance to the CIP process by identifying any issues to be addressed and identifying other expectations that should be met in the CIP preparation process.

The CEO's active involvement in the CIP process is important because there are inevitably conflicts among the goals the CIP process is intended to achieve. It is part of the CEO's job to facilitate setting priorities when goals clash. For example, the goal of making the CIP more open and interesting may increase the level of conflict and delay decisions. Creating more opportunities for citizen participation may subject

the governing body to a barrage of contradictory advice that may, in turn, give way to deep conflicts within the community and on the governing body. The CEO's role is to navigate through these conflicting wants and help the governing body achieve consensus on a CIP.

Budget/ Planning officer—Assuming that most budgetary tasks will be delegated by the CEO to either the budget or planning officer (we will use the term “CIP officer” to refer to the person who has primary responsibility for the CIP), that person and their staff have key roles to play in the CIP process. The role usually takes one of the following forms:

- Coordinator of the CIP and capital budgeting process—The CIP officer may play a limited role in the process as coordinator of CIP-related documents. In this role, the CIP officer does not evaluate the requirements presented by the different departments, submits no suggestions, and does not attempt to match financing with capital projects. The role is to provide for the adherence to the CIP-related schedules, for accurate and complete CIP-related documents presented in a uniform and intelligible format. Some of the following duties may be delegated to their staff members:
 - Setting up the CIP calendar.
 - Drafting CIP-related forms and worksheets.
 - Assisting departments in formulating their project performance indicators.
 - Compiling instructions for department heads to guide them in filling out CIP-related forms.
 - Controlling the accuracy and completeness of CIP-related forms submitted by department heads..
 - Identifying sources of financing,
 - Coordinating CIP activities including timing and planning of meetings.
- Guidance of the CIP and capital budgeting process—In this role, the CIP officer and staff, in addition to coordination, have some analytical and control functions, such as
 - Conducting citizen hearings for input into the CIP process.
 - Developing instructions for departments concerning CIP priorities and providing any assumptions to be considered in CIP development.
 - Reviewing department requests to ensure adherence to guidelines.
 - Setting CIP objectives including any restrictions.
 - Matching CIP requests with potential sources of financing.
 - Preparing recommendations for governing body members.

- Control of the CIP and capital budgeting process—The third role is direct control of and responsibility for tasks related to CIP and capital budget implementation. In this role the CIP officer and staff will be:
 - o Conducting citizen hearings for input into the CIP process.
 - Coordinating with the finance officer on securing financing for the capital budget and CIP.
 - Ensuring that departments do not exceed project authorization. This is accomplished through regular monitoring of capital project expenditures.
 - Reviewing requirements for transfer of funds between capital projects.
 - Developing and updating capital budgeting process procedures.
 - Providing progress reports on CIP and capital budget implementation for the CEO and the governing body.
 - Monitoring capital project activities to prevent negative developments.

Department heads (service managers)—The department heads are normally responsible for carrying out the actual capital investment projects. Their responsibilities include:

- Preparing draft capital investment projects to be reviewed by the governing body,
- Explaining the purpose of each proposed project at citizen hearings and for the governing body,
- Identifying/ recommending potential financing sources to the finance manager and CEO,
- Implementing the CIP as approved by the governing body and,
- Monitoring and reporting on the status of the CIP throughout the budget year.

The department head may choose to delegate some of these tasks to other staff members. The department heads should support the CEO by identifying technical issues that should be considered in the CIP preparation process.

Governing body (policy makers)—Early in the CIP preparation process, policy makers should help set priorities among goals and inform management of their preferences on allocation issues. Governing body members may not always be willing to set policy or interested in doing so, but they should be given the opportunity.

The appointed staff should create the best possible conditions for the mayor and governing body to make policy. Staff should help frame the policy issues and, where appropriate, make recommendations on preferred policy alternatives. Framing makes it less difficult for the governing body to make decisions. More politically divisive issues are best reserved to the governing body, with staff providing objective analyses of the merits of each alternative.

The budget, finance, or planning offices may frame some issues, especially those dealing with financing recommendations or CIP format, and make recommendations in those areas.

Citizens, community, NGOs—The public should play a substantial role throughout the capital investment planning process. It is especially important, however, to involve citizens when community priorities are being developed and to seek their opinions on key decisions related to taxation and expenditures. In practice in many countries, however, public involvement in CIP making is superficial and undertaken only to satisfy legal requirements.

There are three typical concerns expressed by LG officials about citizen participation in the CIP preparation process:

- Elected officials do not want to raise expectations they cannot satisfy. Thus, many LGs resist greater public involvement because they fear citizens' expectations for spending will be unrealistic. There also may be fear that the costs of responding to the public's wish list will be unbearable to the community as a whole or to wealthier taxpayers.
- A second reason for resisting public involvement in capital investment planning is that different areas of the community may want different or even contradictory plans, leaving policy makers in the difficult position of not knowing how much of what to deliver to whom.
- A third argument raised by local officials is that citizens are simply not interested in participating and that trying to involve them is time consuming and frustrating.

Although there is some basis for these concerns, all of them can be addressed in ways that will allow policy makers to benefit from citizen participation. Strategic planning sessions, focus groups, neighbourhood councils, citizen budget commissions, and capital budget committees are all ways of involving the public in the CIP process before final approval. Once the CIP is final, the CEO can make press presentations and take the CIP proposal on the road, presenting it to meetings of civic groups, service clubs, and neighbourhood and homeowners associations. Another chapter in this series, *Citizen Participation*¹, provides excellent suggestions for getting citizens involved in the budgeting process.

LEARNING APPLICATION

In the first Learning Application in each of the chapters in this series we will be reminding the reader about how to get the most from each of these exercises. First, there is a box identifying the four key LG roles that most readers represent. These are Policy Makers (elected officials), CEOs (Chief Executive Officers such as mayors, city managers, etc.), Finance Managers (the chief finance official in the LG), and Department Heads (those individuals who are responsible for the management of specific LG departments such as public works, planning, and human resources). Second, we will indicate in the box those readers we believe will benefit most from completing the learning application task. Finally, when more than one official is listed, we see this as an opportunity for these individuals to get together and compare their responses. These

Learning Application *opportunities can also be modified to become training exercises for group learning. So, our advice is to make the most of these reflective interludes in the text.*

POLICY MAKER _X_ CEO _X_ FINANCE MANAGER _X_ DEPARTMENT HEAD _X_

Consider, for a moment, the capital investment planning roles played by officials in your own LG. In what ways are they similar to the role descriptions presented here?

In what ways are they different?

If you could change the ways capital investment planning tasks are assigned within your LG, what would you change?

LINKS BETWEEN STRATEGIC PLANNING AND THE CAPITAL INVESTMENT PLAN AND CAPITAL BUDGET

Strategic planning is both a process and a product. As a process it uses organization and environmental analysis to identify internal and external strengths, weaknesses, opportunities, and threats that will shape an organization’s future direction. This information is then used to formulate strategic alternatives over the next ten to fifteen years. A strategic planning exercise typically creates layers of goals, objectives, and strategies that provide a target path for the operations of an organization. In LG, strategic planning typically involves the governing body in a systemic process that seeks to establish a new direction for the organization and thus overcome the

traditional incremental decision-making. The product is a plan that establishes the organization's future strategic direction. That direction must ultimately be reflected in the capital investment plan and capital budget. While the capital investment plan and budget has always been a choice between different revenue sources and capital investment expenditures, in the future the capital investment plan and capital budget must reflect strategic choices. Capital plans and budgets can be used to implement strategic plans, in effect, as strategic financing plans to stimulate economic development. On the other hand, the lack of strategic financing planning may, by default, constrain development, local planning, and investments.

ETHICAL STANDARDS, CORRUPTION AND PROCUREMENT² IN THE CAPITAL BUDGETING PROCESS

In many countries, corruption, collusive practices, and outside influence have become accepted norms of operation when awarding contracts for capital investment projects. It is important that your citizens are comfortable with your LG's procurement process—especially in capital investment projects. The procurement system is the primary method for implementing the capital budget, which in turn is the method for implementing community priorities. If you have an open procurement process, citizens will normally not be that concerned with the procurement system. If your procurement process is not as open, the citizens may have questions about the integrity of the system.

WHY SHOULD CITIZENS BE CONCERNED ABOUT PROCUREMENT IN THE CAPITAL INVESTMENT PLANNING PROCESS?

The process by which a LG decides from whom it will obtain goods, services, or construction has important economic and political consequences. From an economic perspective, the design of the procurement process directly affects the efficiency with which an organization spends tax dollars. The more efficient the procurement process, the more goods and services can be purchased at a given level of funding.

The procurement process also has important political consequences. Each procurement transaction places money from the collective coffer into a vendor's private account. Consequently, procurement presents an opportunity for government officials with the power to influence the procurement process to reward individuals and firms who have supported them in the past, or to curry favour with individuals and groups they hope will support them in the future. Similarly, a firm seeking to obtain a government contract has an incentive to maximize its economic return on political contributions by targeting county officials who can influence the procurement process.

If your country has an effective civil society structure in place, it's highly likely that there is also a National Chapter of Transparency International (www.transparency.org). Enlist their support to help provide an effective monitoring role – directly or through expert consultants – thus assuring greater transparency and credibility for your procurement process.

A government may also, either in addition to the involvement of civil society, or possibly in its place, adopt a policy of total transparency of the bidding, bid evaluation, award selection and contracting process, through outright publication of all the critical documents or by giving easy access to relevant documents and information to any interested party. The website above provides several examples of this type of document.

As a way of encouraging interested citizens or vendors to provide suggestions or complaints regarding your procurement system, consider the following ideas:

- Put a suggestion box in the procurement office premises to encourage suggestions from concerned or other interested parties.
- Make arrangements for the analysis of and implementation of feasible suggestions on a routine basis.
- Designate someone to respond to the suggestions and complaints received. Complaints should be studied and addressed as soon as possible. Responses to complaints should be made public.

THE CONCEPT OF VALUE

It is sometimes difficult to understand, or even define, the concept of “good value,” especially in the context of capital investment projects. The following analogy may help:

When we decide to purchase an article—it could be clothing, a car, or even a home—we typically decide upon our specifications, consult our financial advisor to determine what we can afford, and then finally match specifications and financial means to set our budget. Then we go out into the marketplace to make our acquisition.

If we can obtain our article as specified for less than our budget, then we have obtained “good value”—sometimes we refer to this as a “bargain.” If, on the other hand, we have to pay more money than we wished, or have to accept lower specifications, we have obtained “poor value,” and sometimes consider that we have been cheated.

Although that was a simple example, the general principle exists for capital investment projects, and it must be stressed that good value will only be obtained if careful attention is given to each of the project cycle phases, and each investment decision optimizes functional requirements, quality expectations, and financial capability.

Consider the following:

- Inadequate or poor planning will result in a project that does not satisfy real needs.
- Incomplete design will result in higher than expected construction costs.
- Inferior materials must be replaced at faster than planned intervals and create additional and unplanned costs.
- If the building does not reflect its intended use, the operational costs may be higher than necessary.

- Inclusion of hazardous materials in the construction may make disposal costs very expensive.

THE CONCEPT OF LIFE CYCLE COSTING

Until comparatively recently, in almost every country throughout the world, government agencies responsible for the provision of facilities, accounted for their cost under two separate and quite distinct categories.

- Initial or capital cost of the building, and
- Operating and maintaining the building.

Little or no consideration was given to the inter-relationship between these two cost categories, and the standard practice was, and in many cases still is, to construct the building with the lowest possible capital cost using competitive tendering. Those who were to occupy and maintain the building inherited the consequences of this practice and were thereafter responsible for finding sufficient monies from a separate budget—the operating budget—to adequately operate the building throughout its useful life.

There are obviously many arguments both for and against this practice. However, there has been a growing awareness of the need to examine the total costs of a building over its life and to evaluate the costs and benefits of investing in building systems and materials that will ultimately reduce the operating costs. This has been particularly true in relation to reducing the cost of energy consumption.

Life cycle costing, therefore, is a method of examining the total costs of a building or design over its entire life. In order to do this; it is necessary to take into consideration the following cost categories:

- Capital costs—land, construction, furniture and equipment, design fees and all associated costs.
- Finance costs—land acquisition, construction finance, and finance charges during occupancy.
- Operating costs—energy, insurance, cleaning, management, and administration.
- Maintenance, replacement, and alteration costs—all associated costs.
- Residual or salvage values—resale value, related costs such as the costs and charges associated with demolition and site clearance.

Note that in carrying out a life cycle cost study, it may not always be appropriate, or necessary, to include each of the five categories identified above. This will be particularly true, for example, when evaluating the life cycle costs of several building systems, when finance costs may not have any particular relevance.

We recommend five steps in the life cycle costing process. These are:

Five Steps in Life Cycle Costing

- Identification and quantification of all costs associated with each option being studied.
- Summation of all costs for each time period for each option.
- Discounting of all costs—adjusted to their present value by applying a discount rate to make the comparison of the various options possible and meaningful. This is necessary because each option may have costs that occur at different times throughout its life cycle.
- Comparison of costs of each option.
- Selection of the most desirable option.

Standard life cycle costing formulae—The following standard formulae are used in completing life cycle costing calculations. Although we provide the formulas here, the actual calculations are available in finance textbooks that are published in most countries. It is easier to use the tables.

Present Value of 1 unit of your country's currency—This is the present value of a future accumulated amount, where:

A = the accumulated amount
 I = the interest (as a decimal)
 n = number of years
 $= A \times 1 / (1 + I)^n$

Compound Interest—This is the future accumulated value of an initial capital, where:

P = Principal (initial capital)
 I = the interest rate (as a decimal)
 N = Number of years
 $= P \times (1 + I)^n$

Sinking Fund—This is the sum of money to be put aside each year to cover a future known expenditure, where:

A = the accumulated amount
 I = the interest rate (as a decimal)
 N = the number of years
 $= A \times I / (1 + I)^n - 1$

Loan Repayment—This is the annual repayment over a loan's life, where:

P = principal (amount of the loan)
 I = interest rate (as a decimal)
 N = number of years (of the loan)
 $= P \times (1 + I)^n \times I / (1 + I)^n - 1$

Present Value of 1 unit of your country's currency—This is the present value of an annual expenditure to take place over "n" number of years, where:

R = payments due at the end of each period (usually one year)
 I = the interest rate (as a decimal)
 N = number of years
 $= R [1 - (1 + I)^{-n}] / I$

Inflation Adjustment—This is the discount rate to be applied, which takes inflation into account, where:

T = the actual discount rate (usually the current bank rate)
 F = the inflation rate
 $= (1 + t) / (1 + f) - 1$

(Note: to obtain a percentage, the result from the formula, the number has to be multiplied by 100)

Again, it should be noted that it is not always necessary to calculate all the formula referred to in this section. Published present value and discount tables are usually available, from which all of the factors can be derived.

Sample life cycle cost study

Two heating systems have been designed for a building, and it is desired to make an evaluation of each one to determine which would represent the best investment over the life of the building. The life of the building is expected to be 60 years, and capital was borrowed at an annual rate of 8 %. The estimated costs are as follows:

	OPTION A	OPTION B
Installation cost	\$250,000	\$350,000
Builders work in connection with installation	\$60,000	\$20,000
Life of wearing parts on the installation	20 years (Note this will occur twice for Option A)	30 years
Cost of renewing wearing parts	\$ 150,000	\$200,000
Annual maintenance work	\$5,000	\$2,500
Annual fuel costs	\$12,000	\$7,000
Annual cost of attendant	\$5,000	\$ N/A

The net present values can now be calculated, using factors available in published discount tables.

OPTION A

Initial cost of installation (capital cost)	\$ 250,000
Associated builders work (capital cost)	\$ 60,000
Present value of renewing wearing parts in 20 years (first replacement) \$ 150,000 x 0.2145 (from discount tables)	\$ 32,180
Present value of renewing wearing parts (40 years, second replacement) \$ 150,000 x 0.0460 (from discount tables)	\$ 6,900
Present value of \$ 22,000 per annum (maintenance, fuel and attendance) for 60 years. \$ 22,000 x 12.377 (from discount tables)	<u>\$ 272,294</u>
TOTAL Net present value (NPV)	\$ 621,374

OPTION B

Initial cost of installation (capital cost)	\$ 350,000
Associated builders work (capital cost)	\$ 20,000

Present value of renewing wearing parts in 30 years (first replacement) $\$ 200,00 \times 0.0994$	\$ 19,880
Present value \$ 9,500 per annum (maintenance and fuel) for 60 years $\$ 9,500 \times 12.377$ (from discount tables)	<u>\$ 117,581</u>
TOTAL Net present value (NPV)	\$ 507,461

It can be seen from this study that although the initial costs of Option A were actually lower than those in Option B, the evaluation of all the associated costs over their useful life demonstrated that Option B was actually the most economical solution. This resulted from recognizing from the life cycle study that the cheaper initial cost of Option A, was outweighed by the need to replace the wearing parts twice in its useful life as opposed to only once in the case of Option B. In addition, Option B clearly had better fuel efficiency, also critically affecting the long-term cost.

The foregoing example demonstrates that life cycle costing can be an effective cost management tool. It should be recognized however, that all the difficulties inherent in cost estimating are intrinsic in life cycle costing. These include the difficulty in accurately forecasting likely costs, and the estimated life of a building system or material. In addition, accurate feed back in operating and maintenance costs are sometimes difficult to obtain. Never the less, life cycle cost analysis is a valuable tool which can, and should, be used at all levels of the decision making process.

POLICIES

Clearly defined and written policies: 1) guide the process, 2) facilitate planning and objective setting, 3) establish parameters for identifying and prioritizing projects and financing options and 4) provide staff direction. The CEO, governing body, and staff need to be involved in the formulation of capital policies. Additional information on financial policies can be found in another chapter in this series, *Financial Policy Making*.³ Examples of policy issues requiring attention are:

- Definition of capital investment projects
- Period covered by the capital plan
- Designation of organizational responsibility for plan preparation
- Methods of financing capital investment projects
- Criteria for prioritizing projects
- Percentage of general operating revenues to be earmarked for capital investments
- Assessment of the future operating costs of capital investment projects
- Borrowing limits
- Methods and timing of citizen participation
- Maintenance and replacement policies

Examples of Capital Policies

- A six year capital investment plan will be prepared and updated annually.
- Capital investment project financed through borrowing will be financed for a period not to exceed the useful life of the project.
- Approximately six percent of general operating revenues will be allocated for capital investment.
- Physical assets will be maintained at a level adequate to protect the capital investment and to minimize future maintenance and replacement costs.
- The future operating costs of all capital investment projects will be determined.
- A seven person citizen's advisory committee will be appointed to review project requests and make recommendations.
- The capital investment plan will be adopted annually by the governing body.
- The finance department will be responsible for coordinating the capital investment process.
- One time revenues, revenue from the sale of property and a percentage of operating surplus will be earmarked for capital investment projects.
- Capital investment and equipment replacement reserves will be established.
- On all debt financed projects a down payment of ten percent of total project cost will be made from current revenues.

LEARNING APPLICATION

POLICY MAKER _X_ CEO _X_ FINANCE MANAGER _X_ DEPARTMENT HEAD _X_

Prepare a list of capital policies that you believe would be appropriate for your LG. What is your rationale for each of the policies?

Capital policies

Rationale

BENEFITS

There are a number of benefits resulting from capital investment planning and capital budgeting.

Serves as a major tool for linking planning and budgeting systems. This includes the physical development of a LG’s urban development, strategic planning, transportation, parks and recreation, solid waste, water, sewer and other plans. It provides a process that coordinates both physical and financial planning. It also relates public facilities to other public agency and private development plans. And, it facilitates integration with the operating budget.

Focuses attention on community objectives and financial capabilities. It provides the opportunity for community input at multiple points in the capital investment planning process. It aids in prioritizing current and future capital needs, and helps to balance identified needs with the LG’s ability to pay. It provides the opportunity to keep the public informed about capital needs, projects, and assists in building public support. It allows the LG to show its commitment to several projects over a long period.

Coordinates the activities of other public and private agencies. The CIP process provides a central process to guide in project planning, scheduling, financing, and construction thereby reducing duplication, conflict, and costs.

Allows time for careful planning in the initial steps of the CIP and encourages administration that is more efficient so that land can be acquired in advance and costly mistakes avoided. This can be a very important benefit if the purchase of land is involved in the CIP.

Demonstrates good administration. This enhances the perception of the LG’s creditworthiness and ensures financial stability by helping to control tax rates, avoiding unanticipated borrowing and maximizing alternative financing options. The CIP process also identifies the most efficient and economical means of financing capital investment projects and increases opportunities for obtaining funding from higher levels of governments and private sources.

LEARNING APPLICATION

POLICY MAKER_X_ CEO_X_ FINANCE MANAGER_X_ DEPARTMENT HEAD_X_

We have identified several benefits of using a capital investment planning and budgeting process. Take a moment and list the benefits that you believe your LG would gain from such a comprehensive process.

OBSTACLES, LIMITATIONS, RISKS AND OTHER CONSIDERATIONS

Capital investment planning and capital budgeting can be difficult and time consuming. Expect to encounter obstacles as you implement the system. These obstacles will consist of political resistance, staff resistance and information barriers.

Political resistance—Elected officials resist capital investment planning for several reasons. They may contend it introduces excessive rigidity into policy making because plans for projects become solidified and are difficult to change. Elected officials may fear that it raises unrealistic public expectations, which cannot be met because of limited funding. Many officials believe it is not practical to plan more than one or two years into the future or beyond their term of office. They may fear that too much information on the extent of deterioration and deferred maintenance can harm them politically or cause credit problems.

Some believe that since only limited funds are available it is meaningless to go through the effort. Others are concerned that the staff will manipulate the need and funding data and neglect to accurately gauge the operating budget impact. Elected officials may be concerned that the scheduling of one project may precipitate the need for another. Many question the ability of citizens to understand the technical data. Finally, they contend that constantly changing central government legislation inhibits their ability to plan future capital investments.

There are several ways to limit or overcome these obstacles. Involve elected officials early and in all phases of designing the capital investment planning and capital budgeting system. Encourage them to adopt capital policies that reflect their values. Assure them of adequate project oversight. Provide them with a comprehensive analysis of financial condition and funding sources. Conduct citizen surveys to generate information on citizen concerns and priorities. Point out that acceptance of the multi-year capital investment plan does not commit them to financing other than the first year capital budget. Continually provide information on the benefits of capital investment planning and refine the process to meet changing conditions and needs.

Staff resistance—Staff will often object to capital investment planning because they feel it takes an inordinate amount of time and effort. They may believe the priority setting process is vague and ambiguous. The staff frequently cites the lack of elected official and top management commitment to the process. There is a belief that elected officials will not adhere to the plan and give overriding consideration to political factors. Staff feels that there is little support for low visibility projects such as water, sewer and waste disposal sites. Experience has shown staff that maintenance is the first thing to be deferred.

A major staff concern is the fear of micro-management by elected officials and the loss of flexibility. The staff is concerned that elected officials will place excessive information demands and controls on them. Often they complain about the lack of

project accounting and funding information. Finally, they may believe they will not be given adequate resources to do the job and that the process is merely a worthless exercise. Staff may point to a reluctance to provide funds for staff to experiment with new capital technology. These obstacles can be ameliorated by a firm commitment of top management and elected official support and the provision of adequate resources.

Involve staff in all aspects of the process including the design of the priority setting system. Provide adequate training and technical support. Encourage the staff to recommend funding opportunities. Provide them with the necessary accounting and information systems. Allow them sufficient flexibility to manage the projects by providing funds for contingencies and broad funding authority.

Information barriers—Inadequate information is a major obstacle. Condition data is frequently limited. Work order systems may not be available to accumulate repair costs. Information on complaints and service interruptions may not be tracked and analyzed. Funds may not be made available for the use of condition assessment technology. Project cost and funding information may not be available. Computerized maintenance management systems may not exist to accumulate condition and cost information and to effectively schedule repairs and maintenance. Research on the application of new infrastructure technology may be limited. Adequate information on financial condition and potential funding sources is often unavailable. Finally, it is difficult to quantify the benefits of many projects.

These obstacles can be addressed by recognizing the importance of supporting the development of adequate information systems. Install automated maintenance management and work order systems. Track complaints and service interruptions. Employ technology and a variety of condition assessment techniques. Undertake financial condition analysis and develop comparative data on capital financing sources. Install a project accounting system.

LEARNING APPLICATION

POLICY MAKER _X_ CEO _X_ FINANCE MANAGER _X_ DEPARTMENT HEAD _X_

Prepare a list of obstacles you believe will be encountered in the installation of or already encounter in the capital investment planning and budgeting in your community. What can be done to overcome them?

THE CAPITAL INVESTMENT PROJECT CYCLE PHASES

Capital investment planning and budgeting is a dynamic process that involves several phases. The complexity of the process depends on the law, extent of central government regulations and LG size, organizational structure, staff capability and financial condition. Each phase identifies the steps we recommend that your LG consider for implementing the capital investment planning and budgeting process. At various points in the following text we use the design and construction of a building as an example.

PHASE 1: ORGANIZING

This phase covers Steps 1, 2, and 3 and is used to organize the process and establish a framework in which to identify, cost out, review approve and see through to completion a capital investment project. This capital investment project may be building a fire station, street or bridge, or renovating a water treatment plant or purchasing a fire engine. The process that is established must allow for the variety of capital projects that your LG needs.

STEP 1: DETERMINE THE ORGANIZATIONAL STRUCTURE AND PROCESS

The first step in setting up a capital investment plan and capital budget system is to establish an organizational structure to oversee the process. Central coordination and oversight are necessary to ensure an efficient process and compliance with policies and guidelines.

Typically, the capital investment plan and budget are prepared under the direction of the CEO on the basis of project requests submitted by the operating departments. The CEO recommends a plan and budget to the governing body that has responsibility for adoption and appropriation of funds. Respective roles of the CEO and the governing body and the selected organizational structure will depend on local circumstances including the size and form of LG.

One organizational approach is to assign administrative responsibility to the CEO's, planning, finance, budget or public works staff. The designated unit or individual would be responsible for coordinating the steps in the capital investment planning and budgeting process and providing technical assistance.

Another organizational option is the creation of a capital investment plan committee consisting of major players in the process such as department managers, elected officials and citizens. The committee reviews project requests, conducts public hearing, assigns priorities, and recommends a plan and budget to the CEO. Some LGs use their planning board or commission as a coordinating committee. Other LGs establish a citizens' capital investment plan committee to provide public input into the process. If the committee approach is selected, it is essential to provide for adequate staff support.

Criteria to Assist in the Selection of the Most Effective Organizational Structure for a LG

The unit should have:

- _____ Sufficient time to devote to the process.
- _____ Adequate trained staff to provide technical assistance.
- _____ Authority to obtain compliance with policies, guidelines, and schedules.
- _____ A long-range perspective and ability to balance diverse interests and points of view.
- _____ Collaboration skills to obtain the cooperation of the operating and support agencies.
- _____ Ability to foster citizen participation
- _____ Communication skills.
- _____ Credibility with the governing body and ability to facilitate its continuous involvement in the process.

STEP 2: ESTABLISH POLICIES

A discussion and adoption of capital policies should precede the initiation of the capital investment planning process. Policies will guide the process, facilitate planning and objective setting and establish parameters for identifying and prioritizing projects and financing options, and provide the LG staff with direction.

STEP 3: DEVELOP FORMS AND INSTRUCTIONS

The capital investment coordinating staff should prepare a calendar, forms and instructions. Dates for each step of the process are listed on the calendar, which keeps the process on schedule by informing all parties of deadlines. If possible, capital investment planning should be scheduled to begin and end prior to the operating budget cycle in order to avoid an excessive staff workload and provide adequate time for review. Initiating capital investment planning several months before the operating budget cycle provides valuable information on the potential effect of capital investment projects on the operating budget. In addition, adequate time is provided for governing body review and public hearing before it must focus on the operating budget.

Standard forms and instructions are essential to an effective capital investment planning process because they ensure uniform and complete information required to evaluate, prioritize and schedule project requests. Each LG will need to create forms that meet its own requirements. Basic forms include a project request form and summary forms.

Project request forms are used to collect detailed information on each proposed project. Pertinent project information includes: department, project name, location, description, purpose (new, continuing or modified project), justification of need, costs, expenditures by year, status of planning and engineering, construction data, operating costs, effect on revenue, relationship to other projects, conformance to lo-

cal plans, recommended financing, priority number and rationale. Following are 2 sample project request forms.

Sample Project Request Form from Lucenec, Slovakia

Supporting Material for Capital Budget Development									
Investment Project for the Year _____	Date _____								
Request for investment project no. _____	Commission at the Town Hall _____								
Town Hall, Department _____	Budget section _____								
1. Project description A. Project name: B. Description: C. Location: D. Purpose: E. A project request was/was not submitted covering this project last year.									
2. Need A. Who will derive the greatest benefit from this facility? - citizens - commercial - industrial B. What will be the scope of services provided by this facility? - regional - community - neighbourhood C. Comment on the needs to be met by this project.									
3. Costs A. Approximate total cost B. Which costs are covered by the municipal budget?									
4. Proposed expenditures by years (what are the possibilities for phasing, to how many phases and in what cost) <table style="width: 100%; border: none;"> <tr> <td style="width: 50%;">Prior</td> <td style="width: 50%;">4th</td> </tr> <tr> <td>1st</td> <td>5th</td> </tr> <tr> <td>2nd</td> <td>6th</td> </tr> <tr> <td>3rd</td> <td>Later</td> </tr> </table>		Prior	4 th	1 st	5 th	2 nd	6 th	3 rd	Later
Prior	4 th								
1 st	5 th								
2 nd	6 th								
3 rd	Later								
5. Construction data									
6. Estimated effect of completed project on municipal budget <table style="width: 100%; border: none;"> <tr> <td style="width: 50%;">Revenue</td> <td style="width: 50%;">Operating expenses:</td> </tr> </table>		Revenue	Operating expenses:						
Revenue	Operating expenses:								
7. Related to other projects - Project name - How related									

<p>8. Priority</p> <p>A. What priority number does your group assign to this project among those being requested at this time?</p> <p>B. What are your reasons for the hierarchy of priorities in this project? (give a brief rationale)</p>									
<p>9. Recommended financing</p> <table> <tr> <td>- Own resources</td> <td>- Subsidies</td> </tr> <tr> <td>- Pool funding</td> <td>- Loan</td> </tr> <tr> <td>- State fund</td> <td>- Bonds</td> </tr> <tr> <td>- Other</td> <td></td> </tr> </table>		- Own resources	- Subsidies	- Pool funding	- Loan	- State fund	- Bonds	- Other	
- Own resources	- Subsidies								
- Pool funding	- Loan								
- State fund	- Bonds								
- Other									

The following contains a U.S. sample project request form.

Capital investment project request form

19__ to 19__

Department _____

Dept. Project No. _____

Division _____

Date_____

Department Priority No. _____

1. Project description

A. Project Name _____

B. Description: _____

C. Location _____

D. Purpose: _____

E. A project request _____ was _____ was not submitted covering this project last year.

2. Need (√ appropriate one)

A. Who will derive the greatest benefit from this facility?

_____ general citizenry _____ commercial _____ industrial

B. What will be the scope of services provided by this facility?

_____ county-wide _____ community _____ neighbourhood

C. Comment on the needs to be met by this project.

D. How are needs currently being met?

3. Cost

A. Approximate total cost

\$_____

B. Cost already incurred

\$_____

C. Balance

\$_____

D. Detailed cost estimates

1. Planning

a. Engineering

\$_____

b. Architectural

\$_____

Total

\$_____

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2. Land

a. Site already acquired \$ _____

b. Site to be acquired \$ _____

c. Area required (acres) \$ _____

d. Estimated cost \$ _____

3. Construction

1. Estimated cost \$ _____

4. Equipment and furnishings

a. Equipment \$ _____

b. Furnishings \$ _____

c. Other \$ _____

Total \$ _____

TOTAL COST \$ _____

4. Proposed Expenditures by Years

Prior	\$ _____	4 th	\$ _____
1 st	\$ _____	5 th	\$ _____
2 nd	\$ _____	6 th	\$ _____
3 rd	\$ _____	Later	\$ _____

5. Construction Data

A. Estimated construction period _____ months.

B. Proposed manner of construction (3 appropriate one):

Contract _____ Force account _____

Other _____ (Describe):

C. Status of plans and specifications (3 appropriate one);

_____ Plans not needed

_____ Nothing done except this report

_____ Preliminary engineering estimate received

_____ Surveys complete

_____ Survey in process

_____ Sketches in process

_____ Sketches complete

_____ Plans and specifications in preparation

_____ Plans and specifications complete

6. Estimated Effect of Completed project on Operating Budgets of This Department

A. Increased revenue	\$ _____
B. Decreased operating expenses	\$ _____
C. Number of new personnel positions	_____
D. Additional salary costs	\$ _____
E. Additional other expenses	\$ _____
Net Effect on Operating Budget	\$ _____

7. Estimated Effect of This project on Operating Budget of Other Departments

Departments affected: General effect on their budget:

Comments:

8. Related to other projects (✓ appropriate one):

A. Of this department ____Yes ____No

Name of project: _____ How related: _____

B. Of other departments ____Yes ____No

Department: _____ Name of project: _____

How related: _____

9. Priority

A. What priority number does your department assign to this project among those being requested at this time? _____

B. What are your reasons for attaching this priority rating to this project?

10. Recommended financing (✓ appropriate one):

_____ Federal Aid _____ Capital investment fund

_____ State Aid _____ Bonds

_____ Special Assessments _____ Other

_____ Current Revenue

Comments:

In some cases, a separate form is used to gather information on equipment. Examples of relevant equipment information are name, description, purpose (new or replacement), proposed use, form of acquisition (purchase, lease), number of units requested, gross and net cost, trade-in value, number of similar units in inventory, useful life, information on equipment to be replaced (make, age, condition, repair costs and recommended disposition-trade-in, salvage, sale, use by another agency).

Summary forms list projects by department, priority, plan year, type of project (water, parks, streets, buildings, equipment), funding source and fund. Summarized information relates to the project name, total cost, estimated operating budget impact, amounts previously authorized, amounts requested for each of the plan years and for future years and sources of financing by plan year. The plan summary information brings together into one place the full proposals of the submitting agency.

Detailed instructions for completing the forms and samples of completed forms should accompany the forms. They also can be presented in a manual. The capital investment plan staff should provide training on how to prepare the forms and provide continuing technical assistance. Pilot testing of the forms and instructions will

help to identify and correct problems. Continuing review and fine tuning of the forms and instructions are necessary to maintain their effectiveness.

PHASE 2: PLANNING

The planning phase is the most important phase in the capital investment planning process. It includes steps 4, 5, 6, and 7. It is the opportunity for LG officials and the community to come together and establish priorities for the LG's future capital investments. This is also the phase that evaluates the current needs of the community and looks at the LG's financial capacity.

STEP 4: GET CITIZEN INPUT

Communities are made up of citizens and should reflect their vision of what the community should be. It is very important to get citizen input into the capital investment planning process. The chapter on *Citizen Participation* provides a number of ways to involve citizens. It is important that citizens understand upfront that there will be an objective method to determining the priority of the different, competing capital projects. It seems that there is never enough money to fund all proposed capital investment projects in a LG. So, to ensure that community aspirations are achieved, we recommend that the priority-setting process include the following elements:

- Establishes selection and evaluative criteria.
- Assigns values to each criterion.
- Compares projects against the criteria.
- Rates the projects.
- Lists the projects in priority order.

There is more information on priority setting in Step 10.

STEP 5: ASSESS CAPITAL NEEDS

Most LGs have capital needs that exceed their financial resources. Therefore, it is important that they develop a sound information base for identifying capital needs. The information base will assist in:

- Identifying and prioritizing capital needs.
- Selecting the best maintenance, repair, replace or abandonment strategy.
- Minimizing the effects and costs of deferred maintenance.
- Evaluating alternative methods to meet capital needs.
- Assessing financial options.
- Reducing service interruptions and complaints.
- Improving financial reporting.
- Controlling capital costs.

Local officials should focus on capital needs and problems rather than specific projects. Some basic questions to ask are:

- What is the nature of the need or problem?
- What are the causes?
- Who is affected?
- What is the scope of the need or problem?
- When does it occur?
- What are some alternative ways of resolving it?
- What are the consequences of doing nothing?

Comprehensive master plan

It is particularly important in the public sector that all capital construction investments are part of a comprehensive development plan. Among other things, this will encourage the particular agency to plan for the future not only in terms of physical development, but also in terms of its investment plan and capital requirements. Typically, the master plan will be prepared by sector—health, education, etc.,—and once approved, it must be reviewed at regular intervals to ensure that the parameters have not changed. If there have been significant changes, the master plan must be adjusted, and the capital investment requirements adjusted accordingly.

Information to answer these questions is available from a number of sources including 1) inventory and condition assessment information, 2) planning studies, 3) service standards information, and 4) citizen surveys.

Inventory and condition assessment information—Capital asset inventory information consists of a description of the asset (road, park, fire engine), location, age, physical dimensions, construction method and type of materials, condition, repair history and costs, proposed date for replacement, replacement costs, operating cost and type and extent of use. Maps, diagrams and photos help in identification. Geographic information systems and other software are available for mapping the location of assets.

Inventories may be done by staff or contract. The process takes time and is costly. Continual updating is necessary. Inventory information can be obtained from engineering, architectural, insurance and property records. Other methods are visual inspection and knowledgeable employees.

The condition of capital assets is affected by age, climate, soil conditions, use, construction methods and materials, and maintenance practices. Condition information is critical to determining need. Methods of condition assessment are visual inspection, engineering analysis, repair analysis and complaint and service interruption analysis.

- Visual inspection—Staff or consultants inspect facilities using industry standards and other criteria. Inspections are aided by common definitions, checklists, forms, and rating scales such as:
 - Very good, good, fair, poor, very poor
 - Not severe, severe, very severe

- No problem, limited problem, widespread problem or hazard
- Visual inspection is subjective and requires guidelines, training, and careful monitoring. Streets are inspected for surface distress such as cracking, potholes, and bumps. Parks and recreation facilities are inspected for broken equipment, ball fields, tennis courts, and green areas in poor condition and building damage. Sidewalks are inspected for cracks, rises, holes, and root invasion. Building evaluations identify structural, electrical, plumbing and mechanical system problems. There are firms who specialize in conducting pavement, building, and other infrastructure evaluations. Their reports identify deficiencies, corrective action, costs and establish priorities. In addition, they will train employees to perform inspections.
- Engineering Analysis—Engineering technology is available for condition assessment. In the case of streets, mechanical devices measure ride quality, dynaflect equipment measures the effect of loads on the pavement, and core sample testing equipment is used to measure the condition of pavement material. TV cameras, hydrogen sulfide measures, smoke and dye testing, thermography, and flow monitoring devices are used to determine the condition of sewers. Sonic leak detectors, TV cameras, thermography, pressure tests, water quality tests and the measurement of unaccounted for water aid in evaluating the condition of water systems. Core samples, infrared and ultra sound equipment are employed to assess bridge conditions. The technology is costly but offers a valuable tool for documenting need.
 - Repair Analysis—Information on the nature, frequency, and cost of repairs greatly facilitates condition assessment. A work order system that describes repairs and their costs is required. High unit costs and frequent repairs highlight the existence of a problem. Repair information also aids in the evaluation of different maintenance and repair strategies. Plotting of repairs by pins on a map can quickly point out problem areas. Automated maintenance management systems are available to track and analyze repair frequency and cost as well as scheduling preventative maintenance.
 - Complaint and Service Interruption Analysis—Tracking and analyzing complaints and service interruptions is an effective low cost method of obtaining condition information. Data on downtime, breaks, leaks, sewer backups, potholes, low water pressure, building problems, street congestion, broken playground equipment and inoperable street lights help to document capital needs and problems. Violations relating to water and wastewater quality, landfill contamination, incinerator pollution and other environment problems can be used to identify potential capital needs. The condition assessment methods used by your LG will depend on your size, budget, and availability of information and staff. Every effort should be made to improve the quality of your condition information since it will enhance your ability to identify and document capital needs.
 - Planning studies—Physical development, economic development, redevelopment, strategic, transportation, pavement management, water, sewer,

solid waste and parks and recreation plans are a rich source of information on future capital needs.

These plans include demographic, land use, traffic, condition, housing, economic, development, use, demand, and other information critical to identifying capital needs.

- Service standard information—Central government, industry, professional association, and other standards are another useful source of information for determining capital needs. Examples of such standards are hectares or acres of park land per 100 residents, building space standards, street lighting, water, and wastewater treatment standards.
- Citizen surveys—Citizen surveys are effective in measuring citizen expectations relating to capital needs and methods of paying for them. For example, a survey may reveal that citizens place a higher priority on sidewalk repairs than street repairs and prefer to pay for capital investment projects through **benefit assessments**. Surveys are a means of identifying the level of support and opposition to different projects. Many LGs have found citizen surveys assist greatly in the capital decision making process.

STEP 6: CONDUCT ANY NEEDED STUDIES FOR POTENTIAL CONSTRUCTION PROJECTS

Construction projects may require additional information before proposing them as capital investment projects.

ENVIRONMENTAL IMPACT STUDY

All legal requirements for environmental impact studies must be fulfilled concurrently with the development of the master plan. In addition to identifying important environmental conditions that need to be resolved, all associated costs must be calculated and included in the project budget.

PRE-PLANNING / SPACE ANALYSIS STUDY

This study has three essential components:

- A statement of need. (What will be the use / function of the building, and how much space is required?)
- A statement of quality. (What should be the planned life, and what special characteristics must the building have?)
- A statement of time. (When will the building be required?)

It is the combination of these three components that will dictate the ultimate capital cost of the project.

STATEMENT OF NEED

The general requirement for the project should have already been established within the framework of the comprehensive master plan.

The specific need, or function, which the building is required to fulfil, should therefore have been established. The statement of need study, however, should help the master planning decision progress from the general to the specific, and derive the actual space and functional requirements for the project. Since this is a pre-approval planning study, there will be a degree of uncertainty at this stage, but it is essential that sufficiently accurate parameters be set to permit a reasonably accurate budget to be established for the project.

If the functional requirements have been justified and approved, the actual space needs can be calculated. At this stage they will be generic in nature, and typically would be described in the Study, using one of the following categories, as appropriate:

- Number of hospital beds
- Number of classrooms / students per classroom
- Persons per hectare / persons per housing unit
- Number of parking spaces
- Number of cells per prison
- M2 office / retail space
- Daily / weekly flow / filtration plant
- KW capacity of generating station

STATEMENT OF QUALITY

It is essential to define the desired quality of the project right at the outset. This is important because there are many different perceptions of quality, and when undefined, expectations can vary substantially.

For example, consider the options available if need for transportation was defined only as “a car,” without any further qualifying statement. There is just not enough information to provide parameters. This is equally true of buildings, and great care must be taken in defining the appropriate quality level for the planned project.

The level of quality achievable will obviously be closely related to the funds available for a project, so at the pre-planning stage, it may only be possible to make a general statement of expected quality, which would be consistent with the anticipated funds available.

Quality may be described in a variety of different ways. For example:

- “Institutional” implies a long life building with high quality finishes.
- “Industrial” assumes factory type components and finishes.
- Housing may be described as “luxury” or “residential.”
- Offices may be categorized by grade “A,” “B,” or “C.”
- By defining a cost range “EU 1,000 - EU 1,500 per square metre.”

Sometimes quality is expressed in other, more subtle, ways. For example:

- By indicating the desired life of the building. For example, “10” versus “50” years.
- By stipulating the required return on the investment. Sensitivity analysis may then be used to determine the price range of the project.
 - By reference to location. For example, an office building in a LG centre may have different quality characteristics than one in a suburban setting.

The importance of realistically establishing the most appropriate quality level at this stage cannot be emphasized strongly enough. Not getting it right may result in a badly needed function not being fulfilled on the apparent grounds that it is unaffordable, when in reality it was the lack of, or poor definition of, the realistic quality that doomed the project.

It is for this reason that many building authorities throughout the world are employing value management techniques at this very early stage in the project life cycle. The principles of value management are discussed later in this hand book.

Time is Money!

In the United States of America, for example, it can take seven to eight years for a Federal Government building to progress from the Statement of Need to occupation of the building. Cost inflation, whether 2% or 12% per year, will obviously have a substantial impact on the ultimate cost of the project. Clearly, this cost must be planned for, and a realistic assessment of the overall time schedule must be included in the pre-planning studies.

STATEMENT OF TIME

The saying “time is money” is a truism in the development business. At the planning stage, therefore, it is of fundamental importance to recognize, and budget for, the realistic period of time between planning and realization of the project.

The planning schedule must include allowances for the following activities:

- Site acquisition,
- Planning approvals,
- Design and tendering for construction,
- Obtaining building permits,
- Construction,
- Obtaining occupancy permits, and
- Building fit out and tenant occupancy.

Once all these activities have been evaluated, and times allocated to each of them, the statement of time can be assembled.

LEARNING APPLICATION

POLICY MAKER _X_ CEO _X_ FINANCE MANAGER _X_ DEPARTMENT HEAD _X_

Identify two capital needs in your community. What information is available to help you document the needs? What additional information should your community develop?

STEP 7: ANALYZE FINANCIAL CAPACITY

Early in the capital investment planning process, an analysis should be made of your LG's financial condition and capacity to finance future capital investment projects. The chapters *Financial Planning*⁵ and *Evaluating Financial Condition*⁶ provide extensive information about evaluating financial capacity.

Prepare and discuss the analysis before the preparation of project requests so that the information can be used by the elected officials to prepare policies and guidelines to be followed by those developing the requests. Schedule an elected official workshop to discuss the analysis along with economic and non-economic trends, a target of available capital funds and preferred methods of financing. The establishment of fiscal parameters by the policy makers ensures a more rational approach to the preparation of project requests in recognition of available capital resources. As a minimum, a financial analysis should involve the following:

- A three to five year analysis of own source revenues by major source, expenditures, operating and capital reserves and surplus or deficits.
- A three to five year projection of future own source recurring revenues, expenditures, reserves and surplus.
- A analysis of current and future debt capacity, debt service and overlapping debt of other LGs supported by the same tax base.
- An analysis of per capita debt, debt as a percentage of revenues, and debt service as a percentage of the budget.
- An analysis of lease obligations.
- An analysis of potential future changes in central government funding.
- An analysis of potential capital investment funding sources.

Questions to ask in conducting the analysis are:

- What are the trends of expenditures, revenues, and surplus?
- Why are the trends occurring?
- What is the current amount of outstanding debt?
- How much borrowing capacity is available?
- How dependent is the LG on one-time revenues and central government funding?
- What is the level of current debt service?
- What is the potential for new sources of capital investment funds?
- How much will be available for capital investment financing?
- How can you improve your LG's financial condition?

Use charts and graphs to illustrate the information and narrative explanations of trends. Additional information on revenue forecasting is found in the series chapter, *Financial Planning*.

PHASE 3: PREPARE PRELIMINARY CAPITAL INVESTMENT PLAN

This phase includes steps 8, 9, 10, 11 and 12. This phase takes the results from the planning phase and begins to prepare a preliminary plan to be presented to the governing body. The priorities used in this process should be based on the organization and community input from Phase 1 and with the planning from Phase 2. It is important that the preliminary plan reflect the priorities of the community.

STEP 8: PREPARE PROJECT REQUESTS

Department and agency staff are responsible for preparing project requests in accordance with the forms, instructions and guidelines issued by the capital investment plan staff. Examples of typical project information requested have been discussed in the forms and instructions section. Here we will focus on the justification, cost, and financing parts of the project request.

PROJECT JUSTIFICATION

In justifying a project request, it is important to furnish accurate, objective and supportable information. Both tangible and intangible benefits should be discussed. Comment on the technical, financial, political, economic, environmental, and administrative feasibility of the project. Support the request with condition, planning, citizen survey, service standard, regulatory compliance, demographic, and other data. Ask tough questions about the request and identify potential sources of support and opposition. A checklist of useful information for inclusion in project justifications follows.

Checklist of project justification information

_____	Explain the basis of the cost estimates and if they are preliminary or final.
_____	Need or problem addressed by project.
_____	Extent to which the project meets need or solves problem.
_____	Number of people or area benefiting (LG wide, neighbourhood, or community).
_____	Specific benefits to be derived.
_____	Volume of work, services, or clients to be served.
_____	Relationship to other projects.
_____	Savings produced.
_____	Revenue generated.
_____	Availability of outside funding.
_____	Time restrictions on funding availability.
_____	Extent of economic development stimulated and jobs created.
_____	Positive and negative environmental consequences.
_____	Comparison of current and proposed operating and maintenance costs.
_____	Cost recovery opportunities.
_____	Consistency with community plans and capital policies.
_____	Length of time to plan and construct.
_____	Level of public or interest group support or opposition.
_____	Other alternatives considered and reasons for rejection.
_____	Consequences of deferring the project.
_____	Operating and maintenance costs.

PROJECT COSTS

All project costs should be estimated including:

- Feasibility and planning studies,
- Engineering and architectural,
- Land acquisition,
- Demolition,
- Construction and construction management,
- Contingency,
- Site improvements,
- Equipment and furnishings, and
- Debt service.

FINANCING

Although the finance staff should provide recommendations on capital financing alternatives, it is beneficial for those preparing project requests to recommend financing sources. Frequently they possess information on financing sources not otherwise available. Be as specific as possible about the proposed method and if it is a viable

option. Discuss its strengths and weaknesses and if it requires further investigation.

ECONOMIC ANALYSIS

Some projects, such as utility projects, may require an economic analysis, others will not. The purpose of the economic analysis is to assemble all the likely costs associated with the planned project, and either evaluate them against the likely revenues, or calculate the funding requirements over a predetermined period of time. For example, a LG utility authority may use it to establish the need and timing of a bond issue to finance the project. Also, a utility—like a private enterprise—may use the study to calculate the potential return on their investment. Irrespective of what type of organization prepares the economic analysis, the content is similar and should contain all or most of the following items. The outcome of this study will vary depending upon the type of organization that is preparing it. Typically, costs are categorized under three classes:

Hard costs will include the following:

- Acquisition of land,
- Cost of construction, and
- Cost of furniture and equipment.

Soft costs will include the following:

- Project management,
- Architectural and engineering design,
- Legal costs,
- Accounting costs,
- Marketing costs,
- Insurance,
- Interest on borrowed money,
- Taxes (if appropriate), and
- Building permits and utility connections.

Note that this list is not necessarily exhaustive. There may be other items of cost, which will necessarily be incurred, and must therefore be included in the economic analysis.

Operating costs will normally include the following:

- The cost of energy / utilities,
- Maintenance and cleaning,
- Normal repairs and replacements, and
- Other function-related costs / supplies, etc.

CONTINGENCIES

In addition, it is also prudent to include allowances for costs that cannot easily be identified or quantified at this stage. These are usually described as contingencies, and they typically fall into several categories:

Planning and design contingencies—these provide for changes in the scope of the project that may arise during the planning and design phases.

Construction contingencies—these provide for unknown and unforeseen conditions that may occur during construction.

Project contingencies—these will reflect the level of confidence in the preparation of the economic analysis.

Contingencies are normally expressed as a percentage of the estimated cost of the specific category. The following is a list of typical percentages:

- Planning and design contingencies: 7 - 10% of the estimated construction costs.
- Construction contingencies: 3 - 5% of the estimated construction costs.
- Project contingencies: 10 - 15% of the total estimated costs.

CAPITAL PROJECT BUDGET PREPARATION

There are three elements of a budget that must always be satisfied:

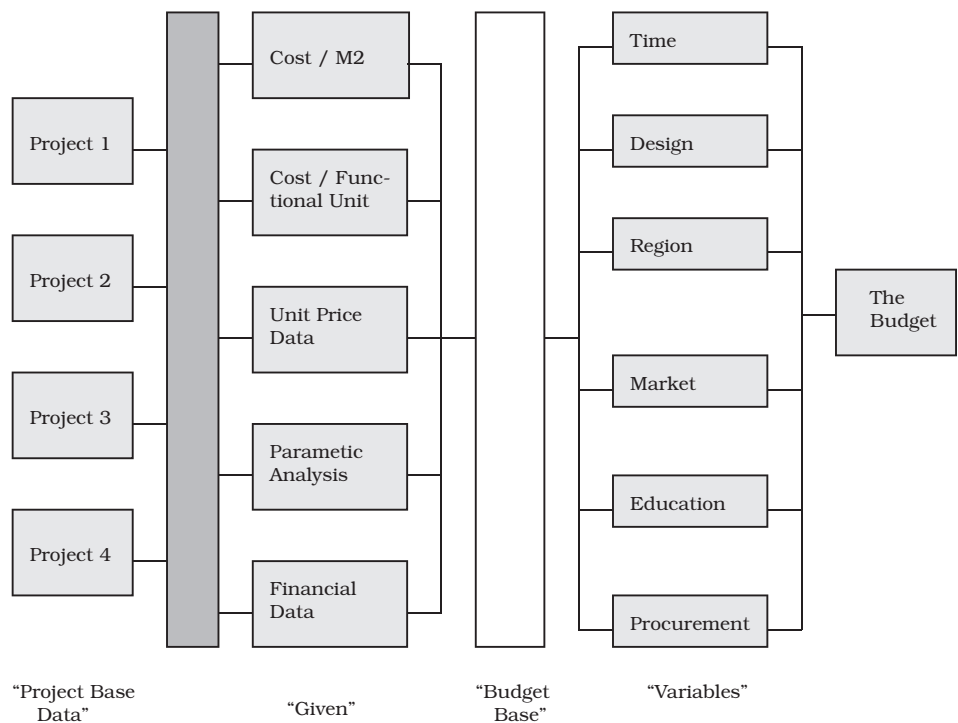
- It must be **realistic** (the amount of money to be designated for the project must be sufficient to meet all the requirements).
- It must be **achievable** (there must be confidence that not only is the budget sufficient, but that funds can be made available to make the acquisition).
- It must be **comprehensive** (all potential items of cost must be included).

Although these three tenets may, at first sight, appear obvious and simplistic, studies carried out throughout the world into the root causes of projects that have suffered from severe financial problems, have invariably uncovered budgets that were ill-conceived from the beginning, and had not given intelligent consideration to some, or all, of these basic elements.

In addition, a well-developed budget must provide a realistic balance between the functional requirements of the project, the defined quality, and the funds available. While this may be thought of as a compromise, it should not be one where there is perceived disadvantage, but one, which is seen as a challenge to be met.

The challenge is for the owner of the project to communicate the precise functional requirements to the designer, and for the designer to translate them into an accurate set of contract documents for the builder to implement. This is described as the “Eternal Triangle of Building.”

Budget Preparation from Data Bank Information



CAPITAL BUDGET PREPARATION USING HISTORICAL COST DATA

The development and maintenance of a historical construction cost database is an essential tool to help in the preparation of accurate budgets. Following is a graphic representation of the flow of information from a historical cost database into the creation of a budget for a new project.

The “project base data” column represents the cost database itself. Projects 1 - 4 are similar building types (schools, for example) that have previously been stored in the data bank, and therefore provide a reliable set of data from which to start.

The “Givens” column represents the type of cost data that should be available, in any, or all, of the categories listed, and derived as follows:

- Cost / M2—This is the total cost of the building divided by the gross area of the building. *Example:* Standard office building - 18,000 Euro / M2.
- Cost / Functional Unit—This is the total cost of the building divided by an appropriate functional unit. *Example:* Elementary School Building - 9,000,000 Euro per classroom.
- Unit Price Data—This is the cost of major building materials or systems in place. *Example:* Cast in place concrete - _____ Euro / M3. Structural steel - _____ Euro / ton.
- Parametric Analysis—This is the total cost of the building, or building system, divided by an appropriate parameter, typically used where type a and b above are not suitable. *Example:* Air conditioning system - _____ Euro / ton of chilling. General site development - _____ Euro / hectare.
- Financial Data—This is essentially any other data that may be in the database, in the absence of a, b, c, or d above. Typically, it will be less precise, and may be very general in nature. *Example:* From newspaper article - “500 unit housing development to cost EU _____ billion.”

The initial step in the budget preparation can now take place. This will be achieved by multiplying the appropriate “given factor” by its matching cost (a worked example follows).

The “Budget Base” column must now be adjusted to take into consideration all the impact of all the variables, as follows.

Note that this is a critical stage in budget preparation and the one where most errors occur, because of failure to closely review and adjust for all of the variable factors.

The “Variables” column is used as follows:

- The “time” variable allows the database to be adjusted to present time (if it has not been already). For example, the database number may be as of December, 2007, and the budget is being developed in December, 2008. It would be necessary to add one year of cost escalation to the database number. The “design” variable allows for any necessary adjustments for higher or lower building quality from that contained in the database.
- The “region” variable provides a means of adjusting the database cost for projects in other LGs, which may have a higher or lower level of costs.
- For example, if the database is set for Bratislava, Slovakia a project in the High Tatras will most likely have higher costs because of more expensive transport costs and limited seasonal working times.

- The “market” variable allows for an assessment of the likely market conditions at the time the tender documents are to be issued. As a rule, prices will be higher when the market is saturated with projects, and will tend to be lower when there are not many projects being solicited, and contractor workloads are diminishing.
- The “escalation” variable must take into account the overall time schedule for the project, from the time the budget is being assembled through to the completion date. The calculation should be based upon the current national inflation rates, projected forward to cover future years.
- The “procurement” variable should be used only if the procurement type is likely to have an effect on the pricing of the project. While the preferred method of procurement should always be open competitive tendering, sometimes other methods must be used. For example, the database number might be adjusted if the proposed method of procurement was necessarily by sole source or direct procurement.

ASSEMBLING A CAPITAL INVESTMENT PROJECT BUDGET—A WORKED EXAMPLE

Since this LGFM series of training manuals was initially developed in Slovakia, with the direct involvement of a number of key finance directors from the larger cities, we were able to develop a historical cost data base from their experience. The following represents an example of how they used historical cost data to look at the possible costs of a new high school building for the second largest city in Slovakia, Kocise at the time. As you can see, the database contains standardized records of the actual costs of completed projects, based upon the final amounts paid to the contractors at that time. It was converted to a common baseline: in this example, all costs were converted to the country’s capital city, prices. Whenever a project is completed, the data must be collected and added to the bank of information. The maintenance of a database of this nature will provide LGs with reliable and up-to-date cost information from which to develop a budget for a specific project.

Worked example

Objective—To provide sufficient documentation for a government agency to request funding from an appropriate authority.

Requirements—The proposed project should include the following:

- Statement of Need
- Justification
- Statement of Quality
- Realistic Budget
- Schedule

The project—Proposed new High School in Kosice, Slovakia

- Area: 18,500 M2 general teaching
- Site area: 4 hectares
- Parking: 40 cars (staff parking only)

Justification

- Existing school does not comply with new building and safety codes.
- New facility is required to accommodate future population growth.

Quality Statement

- Plan for 50-year life.
- Materials and construction quality to be durable and hard wearing.

Schedule—School must be ready for occupation by September, 2010.

Republic of Slovakia Construction Cost Database

High Schools

Base City: Bratislava

Base Year: 2007

SCHOOL	COST / M2
1	31,650
2	37,800
3	33,300
4	35,900
5	33,260
6	<u>29,500</u>
Average	33,568 SK / M 2

Database Note: Although all schools were similar in size, they were constructed of pre-fabricated materials, which had a life limited to about 15 years.

Site Development Base City: Bratislava Base Year: 1997

General site development, sidewalks, paths, access roads, drainage, utilities, landscaping, etc.

Average cost per hectare SK 3,000,000.00.

Car Parking Base City: Bratislava Base Year: 1997

Surface parking, paved and lined
SK 180,000.00 per parking space

Budget Development (Preparation Date: December 2008)

a. Base construction Cost ("Givens")		
Teaching area 18,500 m2 x SK 33,568.00		SK 621,008,000
Site development 2 hectares x SK3, 000,000.00		SK 6,000,000
Car parking 40 spaces x SK 180,000		SK 7,200,000
Total Base construction Cost		SK 634,208,000
b. Variables		
b.1 Time December 1997 - December 1998		
Annual inflation rate: 8%		<u>SK 5,078,736</u>
		SK 639,286,736
b.2 Design		
Increase in building quality, say, 15% (from panellized construction)		<u>SK 95,893,010</u>
		<u>SK 735, 179,746</u>
b.3 Region		
Kosice from Bratislava base, x 1.08=		<u>SK 793,994,125</u>
b.4 Market		
Market conditions expected to be very competitive x 0.95=		<u>SK 754,294,418</u>
b.5 Escalation		
Estimated construction start date: April, 1999		
Estimated construction period: 16 months		
Mid-point construction: November, 1999		
Escalation calculation period:		
December, 1997 – November, 1999 - 24 months		
Annual predicted inflation rate - 8%		
Total escalation 16% x 1.16		<u>SK 874,981,524</u>
b.6 Procurement		
It is proposed to use open competitive tendering for this project.		
No adjustment necessary.		
PROPOSED CONSTRUCTION BUDGET		<u>SK 874,981,524</u>

Capital Investment Project Budget Summary

Construction Budget		SK 874,981,524
Construction Contingency	3%	26,249,524
Design Fees	6%	52,498,891
Project Management	3%	26,249,524
Construction Administration	3%	26,249,524
Furniture and Equipment (allowance)		60,000,000
		SK 1,066,228,750
Project Contingency	10 %	SK 106,622,875
TOTAL PROJECT BUDGET		SK 1,172,851,625

LEARNING APPLICATION

POLICY MAKER _X_ CEO _X_ FINANCE MANAGER _X_ DEPARTMENT HEAD _X_

Does your LG use an historical database in preparing capital budgets? If not, what obstacles do you see to using a historical database? How would your LG overcome those obstacles?

STEP 9: REVIEW CAPITAL INVESTMENT PROJECT REQUESTS

After project requests are prepared, they are reviewed for completeness and accuracy. Project request review is coordinated by the capital investment plan staff in cooperation with planning, finance, engineering, and architectural staff specialists. Sometimes outside technical experts participate in the review. The preparation of checklists and review criteria assists in expediting and simplifying the review. Project review provides an opportunity to clarify and request additional information. Field visits and department hearings are also useful components of the review process. Here we will identify four types of review: 1) administrative, 2) planning, 3) engineering/architectural and 4) financial. Each LG will need to develop a review process consistent with its size and resources. Following is a checklist of questions to facilitate each type of review.

Checklist for Administrative Review

_____	Have all required forms been completed?
_____	Is the information complete and accurate?
_____	Are all mathematical calculations accurate?
_____	Have the projects been categorized as one of the following: carried forward-no change; modified as to nature or cost; changed as to scheduling; submitted in a prior year but not scheduled; first time projects?
_____	Have the summary forms been verified against individual project forms?
_____	Do the projects meet the adopted eligibility definitions?
_____	Is project need identified and supported with appropriate data?
_____	Are the justification and priority sections well documented?
_____	Does the project have a positive or negative impact on other projects?
_____	Is the project in conformance with adopted capital policies and work plans?

- _____ Is the project required by law, court action or other levels of government?
- _____ What is the level of political, citizen and interest group support or opposition?
- _____ How does the project relate to the results of citizen surveys?
- _____ Have alternative ways of meeting the need or solving the problem been evaluated?
- _____ Are there the negative impacts of the project (environmental, relocation, economic, nuisance, etc.?)
- _____ Are the location and land requirements adequate?
- _____ What are the consequences of not undertaking the project?

Checklist for Planning Review

- _____ Does the project conform to development and other plans (strategic, parks and recreation, transportation, solid waste, water, sewer)?
- _____ Is the demographic, land use, traffic, housing, economic base and other information supporting the request accurate?
- _____ What is the impact of the project on economic development and neighbourhood preservation?
- _____ What is the environmental impact?

Checklist for Financial Review

- _____ Are the financing recommendations accurate and feasible?
- _____ What other funding options are available?
- _____ Are the direct and indirect operating and maintenance cost projections accurate and realistic?
- _____ Have all capital costs been identified?
- _____ What affect does the project have on revenues?
- _____ Have estimated cost savings been verified?
- _____ Is the project eligible for *debt financing*?
- _____ What is the impact on the tax rate?
- _____ Is cash flow sufficient to finance the project?
- _____ What fiscal impact does the project have on other projects?

Checklist for Engineering and Architectural Review

- _____ Is the project design adequate?
- _____ Have design alternatives been considered?
- _____ Have value engineering and life cycle costing been considered?
- _____ What is the status of the project (planning, design, engineering, construction)?
- _____ Are the specifications adequate?
- _____ Are the cost estimates accurate and reasonable?

- _____ Is the project operationally feasible?
- _____ Is the proposed scheduling realistic?
- _____ Have alternative approaches been considered (repair, rehabilitate, replace, abandon)?
- _____ What is the extent of potential service interruption?

LEARNING APPLICATION

POLICY MAKER _X_ CEO _X_ FINANCE MANAGER _X_ DEPARTMENT HEAD _X_

Identify who should be involved in reviewing proposed capital investment projects in your community and prepare a checklist of factors that should be considered.

STEP 10: PRIORITIZE PROJECT REQUESTS

The most demanding and difficult aspect of project review is the prioritization and selection of projects. Usually funds are not available to finance all needed capital investment projects. Consequently, local officials must make hard choices among competing projects. Too often such decisions are based on intuition and subjective judgment rather than an explicit set of evaluation criteria. In Phases 1 and 2, A more effective and formal evaluation process:

- Establishes selection and evaluative criteria.
- Assigns values to each criterion.
- Compares projects against the criteria.
- Rates the projects.
- Lists the projects in priority order.

The project evaluation and prioritization process is made more objective and rational by the development of predetermined and clearly defined criteria. Everyone involved in priority setting and selection including staff, citizens, the CEO, and the governing body should participate in defining the selection criteria. Public hearings and citizen surveys are often used to provide citizen input into the formulation of selection criteria. Evaluation criteria should be established before the preparation

of project requests in order to provide guidance to those drafting the requests. No evaluation system is perfect. Not all criteria will apply to every project.

Characteristics of Sound Criteria

- Simple and clearly defined.
- Understood by the users.
- Relevant to community goals and capital policies.
- Measurable and supported by reliable, relevant information.
- Identify critical and non critical projects.
- Apply to a wide divergence of projects.
- Consider major consequences of a project.
- Practical in terms of costs, time and application.

Good judgment, common sense, and political considerations will continue to play an important role in establishing criteria. Obstacles to developing useful criteria consist of cost, time, availability of information, values, intangible benefits, the danger of information overload and fear of compromising the political process.

Nevertheless, carefully prepared criteria will help to sharpen distinctions between projects, narrow the range of disagreement, and provide for discussion. It is critical that project selection be supported by reliable, accurate, and relevant information.

Several priority setting approaches are available: 1) single standard; 2) prioritization by categories based on values; and 3) multiple criteria involving weighting and scoring.

SINGLE STANDARD / CRITERIA

This approach uses a single standard such as **return on investment** or availability of financing to evaluate projects. Projects that have short investment payback periods or can be financed by other than local funds receive high priorities.

PRIORITIZATION BY CATEGORY BASED ON VALUES

Each project is placed into one of a small number of rating categories based on urgency and community values. Examples of categories include mandatory, urgent, essential, necessary, desirable, acceptable, and deferrable. This type of system generally does not prioritize projects within each category but points can be assigned and projects ranked. The table below is an example of prioritization by category.

Prioritization by Category

Mandatory

- Projects mandated by law, regulation, or court order.

Urgent/Essential—includes projects which:

- Remedy a condition dangerous to health, safety, or property.
- Corrects a major deficiency.
- Completes or makes fully usable a major improvement.
- Provides facilities for a critically needed service.
- Timing and funding are not flexible.

Desirable—includes projects which:

- Conserves or improves existing facilities.
- Replaces functionally obsolete or deteriorated facilities.
- Reduces operating and maintenance costs.
- Raises service standards.
- Attracts new development.
- Needed now but funding is flexible.

Acceptable—includes projects which:

- Prevent substandard service.
- Provides a new service.
- Enhances public convenience and comfort.
- Reduce overcrowding.
- Raise facilities to optimum level.
- Funding and timing are flexible.

Deferrable—includes projects which:

- Can be postponed to a later date.
- Need additional planning and analysis.
- Duplicate other public or private projects.
- Have limited benefits or adverse effects.

MULTIPLE CRITERIA

This approach uses multiple criteria for evaluating projects in order to balance diverse and competing values and needs. Examples of criteria include fiscal, health, safety, economic, environmental, operating budget and political impact. Numeric weights of 1 to 10 may be assigned to each criterion according to their importance and LG values such as:

Health and safety	7.0
Fiscal impact	6.5
Economic impact	5.5
Environmental impact	5.5
Budget impact	7.0

Within each criterion project are numerically rated and scored:

Major impact	6–10 points
Minor impact	1–5 points
No/negative impact ...	0 points

For each criterion, the score is multiplied by the criterion weight to reach a total score. An overall score is then calculated for each project by totalling all the criteria scores. Try to be as specific as possible in defining and assigning points to the criterion. For example, under fiscal impact the highest number of points could be assigned to a project that leverages private funds 3:1. Projects that benefit the entire community could be assigned a higher rating than those benefiting only one neighbourhood. The following table is an example of multiple criteria and their definitions.

Multiple Criteria for Priority Setting

- **Legal impact**—Considers the extent to which the project is mandated by law or regulations of a higher level of government such as water pollution regulations pertaining to a landfill site.
- **Health and safety impact**—Considers the extent to which a project corrects hazardous conditions relating to health, life, or property or prevents a critical breakdown of an essential facility.
- **Fiscal impact**—Considers capital, operating and maintenance costs, return on investment, alternative sources of financing, potential for leveraging local funds, revenue increases or decreases, cost recovery, cost savings and effect on tax base.
- **Economic impact**—Considers the extent to which a project stimulates economic development and creates jobs.
- **Community impact**—Considers the extent to which the project benefits the entire community or neighbourhood, meets the special needs of the low income, aged, minorities, or handicapped and contributes to neighbourhood preservation, stabilization and revitalization.
- **Environmental impact**—considers the extent to which the project protects the environment and conserves resources such as energy, water and open space.
- **Political impact**—Considers the extent of community support or opposition and elected official's perceptions and needs.
- **Aesthetic and cultural impact**—Considers the extent to which the project enhances the community aesthetically and culturally such as providing works of art and cultural facilities.

Operational impact—Considers:

- Quality and timeliness of the request
 - Priority assigned by the department
 - Extent to which the facility will be used
 - Useful life
 - Productivity increases
 - If project is on an approved replacement schedule
 - Application of technology
 - Implementation of approved plans and policies
- **Service delivery impact**—Considers the extent to which the project causes disruption and inconvenience such as relocation, rerouting of traffic or temporary cessation of water or sewer service.
 - **Risk impact**—Considers the extent of risk and uncertainty associated with the project such as effect of new technology, uncertain benefits or design problems.

- **Interjurisdictional and intrajurisdictional impact**—Considers the relationship of the project to other public and private projects in terms of scheduling, financing and construction benefits.
- **Consequences of deferring**—Considers the costs and negative consequences of deferring the project such as inflation, construction cost increases, loss of financing or detrimental reduction in level of service.

Each LG will need to identify the criteria and weights most suitable to its needs. Multiple criteria systems can be burdensome and time consuming. Some LGs have abandoned applying points and weights because of the time required. They have, however, continued to use clearly defined criteria to aid those involved in setting priorities. A sound factual basis for priority setting is essential. Evaluative criteria development is a trial and error process requiring continual testing and refinement. A simple system installed gradually is the best approach. Initially the criteria will prove useful in strengthening the preparation of project justifications.

Priority setting can be simplified by excluding certain projects from intense scrutiny such as:

- Projects which alleviate an emergency.
- Small or marginal projects.
- Projects involved in litigation.
- Projects with a high level of community and political support.
- Poorly conceived projects requiring further analysis.
- High cost projects when only limited funds are available.
- Projects included on an approved replacement schedule.
- Legally mandated projects.

When project priorities are determined by a committee consideration should be given to using group interaction techniques such as the ***nominal group method*** and ***brainstorming***. Nominal grouping is a structured interaction technique that encourages input from all group members and provides for anonymous voting on priorities.

LEARNING APPLICATION

POLICY MAKER _X_ CEO _X_ FINANCE MANAGER _X_ DEPARTMENT HEAD _X_

Using the previous information, design a priority setting system for your LG. What criteria would be most appropriate?

STEP 11: EVALUATE FINANCING OPTIONS.

Capital investment planning requires the identification and evaluation of alternative sources of financing. The chapter, *Financing the Capital Investment Plan*⁷, contains an extensive discussion of financing options.

Examples of common capital financing options include: current funds, reserves, surplus, debt, central government grants and subsidies, sale of assets, user fees, leasing, development fees, benefit assessments, public private partnerships and donations. Frequently, many combinations are used. Selection of the most appropriate source or sources of financing is complicated by the number and variety of available options, changes in central government laws, volatile debt markets and the constant development of new, complex creative financing sources. For these reasons the finance staff should prepare an analysis of the key features and advantages and disadvantages of each type of capital financing. Every effort needs to be made to identify and evaluate all available sources. Each LG will need to identify and evaluate the capital financing options available to it. Information on options can be obtained from the statutes, ministries of finance, financial consultants, professional associations, and other LGs. Department heads are often aware of sources of financing for projects related to their operations.

LEARNING APPLICATION

POLICY MAKER _X_	CEO _X_	FINANCE MANAGER _X_	DEPARTMENT HEAD _X_
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Make a list of capital financing sources used in your community. What are some of their advantages and disadvantages? What other sources should your community consider?

STEP 12: DRAFT CAPITAL INVESTMENT PLAN AND CAPITAL BUDGET DOCUMENTS

After the CEO finalizes the recommended capital investment plan and budget a capital investment plan and budget document is prepared for submission to the governing body. The plan and budget may be combined in one document or two separate documents. In some countries, the plan and budget are incorporated into the operating budget. Typical components of the document are: 1) capital investment plan message or transmittal letter, 2) summary schedules, and 3) detailed project information.

TRANSMITTAL LETTER

The plan message or transmittal letter presents an overview in narrative form. Examples of topics discussed include:

- Key issues and trends that have influenced the plan and budget such as mandates, financial condition and condition assessments
- Description of the process and glossary of terms
- Statement of capital policies
- Factors considered in setting priorities
- Percentage of projects by priority category
- Results of citizen survey
- Highlights of projects in capital budget
- Financing sources including percentage by source, new sources and constraints
- Status of current year budget projects
- Impact on the operating budget
- Outstanding and projected debt, debt capacity, debt service and impact of debt on tax rate
- Changes from previous plan including dropped projects, delayed projects, new projects, modified projects and accelerated projects
- Project distribution by purpose, fund and year
- Unmet needs and scope of deferred maintenance

SUMMARY SCHEDULES

Project summary schedules are prepared by department, purpose, fund, priority, and financing source. Debt and debt service schedules are also provided.

DETAILED PROJECT INFORMATION

This section provides detailed information on each project including description, department, fund, project costs, operating and maintenance costs, sources of financing and requirements by year. Maps are useful to show location. Photographs, diagrams, schematics, and other graphic material can be used to illustrate projects. Following is an US example of a detailed project format. Many LGs prepare a citizen's oriented document that is simple, brief, and free of technical jargon and makes effective use of narrative and graphics.

PHASE 4: APPROVAL

This phase includes Steps 13 and 14 and is very important in that it gives the citizens the opportunity to participate and give additional input before decisions are finalized by the governing body.

STEP 13: CITIZEN REVIEW OF THE PROPOSED CAPITAL INVESTMENT PLAN AND BUDGET

The governing body should be given adequate time to review the capital investment plan and capital budget. Their review may include public hearings and staff workshops. Workshops and study sessions offer an informal setting for discussing the project proposals with staff members. Site visits also serve as a valuable educational tool. Citizen participation in the capital investment planning process can take several forms. Citizen surveys may be conducted to obtain citizen input. A citizen's committee may be appointed to review project requests and make recommendations. Citizens may be appointed along with staff to a capital investment plan committee. Community or neighbourhood councils may recommend projects. Public hearings offer another means of obtaining citizen input. When citizens participate in the process, they develop a better appreciation of the challenges facing local officials and of the tradeoffs involved. Additional information on methods of citizen participation can be found in a chapter in this series on *Citizen Participation*.

STEP 14: GOVERNING BODY ADOPTION OF THE CAPITAL INVESTMENT PLAN AND CAPITAL BUDGET

After completing its review, the governing body should adopt the capital investment plan and capital budget to demonstrate its commitment to the plan and to confirm its policy regarding the community's approach to meeting its future capital needs. Adoption of the plan is not a binding commitment to fund other than the first year. Some governing bodies object to formally adopting the plan because they believe it restricts their policy making authority and flexibility. They may decide to approve

it in principle or merely accept it. Acceptance is not binding on the governing body. Instead, it may only adopt the one-year capital budget and appropriate funds. Failure to adopt the plan does not reduce its value. It serves as an effective planning and management tool. Moreover, it keeps the governing body informed on capital needs and helps them respond to citizen inquiries about the status of projects.

PHASE 5: IMPLEMENTATION

Adoption of the capital budget does not complete the process. This phase includes Steps 15 and 16. A system must be established and used for planning, controlling, and monitoring the managerial and fiscal aspects of projects. Such a system is comprised of design, schedule, cost, quality, change order and document controls. Project financing has to be arranged and implemented.

Project timing and staging is important and should follow a few simple rules:

- Provide adequate time for preparing plans and specifications and arranging financing.
- Designate project management responsibility.
- Stage projects to take maximum advantage of alternative financing opportunities.
- Combine and coordinate projects to maximize cost savings and minimize inconvenience and disruptions.
- Monitor and control projects with timely, complete and accurate progress reports.

Managing the cost of construction is certainly not a new challenge, but it seems to be one that continues to accompany development in both the public and private sectors. The challenge is worldwide, but countries in a transition economy face an even greater problem. It will take several years of development in a market driven economy to create accurate records of the real costs of public facilities. This database in turn will provide the necessary information to help authorities create realistic budgets, which will be the basis for planning capital investments. In addition, since there must be a major change in management of public works projects from previous regimes, it may be necessary to establish new procedures to manage the costs of public works projects.

STEP 15: ESTABLISH PROJECT MANAGEMENT

Project management responsibility should be designated to an in-house project manager or a contract project management firm. Vigilant monitoring of design and construction are crucial to controlling scheduling and costs. Computerized construction management systems are a valuable aid in tracking and controlling projects. Project control logs show a description of the project, its status and such key events as plan approval, bid approval, ground breaking and construction phases.

Direct special attention to the selection of the most appropriate construction contract. Lump sum, guaranteed maximum price, construction management, design/build and turnkey contracts have distinct advantages and disadvantages. Additional information on contracting is found in a chapter in this series on *Procurement*. Written procedures are the best method of ensuring proper project implementation and scheduling.

QUALITY ASSURANCE

Inspection and testing assures compliance with construction and equipment specifications. On large construction projects consider assigning a resident engineer to oversee the contractors and maintain quality control. Regular materials testing and frequent inspection of construction help to prevent the use of inferior materials or shortcut methods which can be dangerous, costly and reduce the quality and life of the project.

PROJECT SCHEDULING

Keeping a project schedule is important for controlling costs and maintaining credibility. Scheduling techniques are as simple as bar charts or as complex as network-based schedules such as the critical path method or plan evaluation review technique. Network techniques are usually computerized and track activities cost, time, and interrelationships.

STEP 16: CHOOSE A PROJECT DELIVERY SYSTEM

A project delivery **system** is the path the project follows from inception to completion, and incorporates the organizational and contractual relationships associated with it. It will also include the procurement method selected by the LG.

Selecting the most appropriate delivery system is important because there are costs and benefits associated with each system. Selecting the best system can effectively save unnecessary costs and time, and therefore contribute to the overall effective use of the funds to be invested.

It should be understood that in the USA for example, project delivery systems have evolved over many years, changing to meet new circumstances and economic conditions. There is little doubt that this will continue to happen, but there are several generic models that form the basis of all systems world-wide:

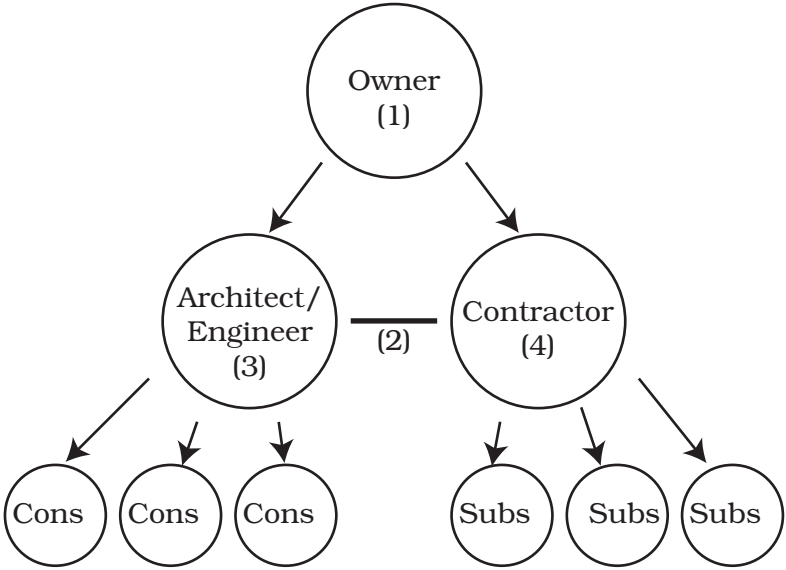
- **Traditional**—a sequential process where the project is fully designed, issued for tender, and then, built.
- **Construction management**—a variety of options where a construction manager will take the lead role in completing the project.
- **Design / build**—a method where one entity takes full responsibility for the design and construction of the project. Turnkey contracts also fall into this category.

Each of these generic types has its own set of contractual requirements, which, in turn, have an effect upon the procurement method and associated tender documentation.

TRADITIONAL DESIGN/ TENDER / BUILD

This is the most commonly used delivery system associated with open competitive tendering. It is essentially the base methodology from which all other delivery systems have evolved. The table below shows the organizational structure for this system.

Traditional design/tender/build



Note that:

1. The owner (LG) holds contracts with architect and contractor.
2. The architect acts as agent of owner to implement construction contract.
3. The architect holds contracts with his consultant – owner has no direct contracted relationship with them.
4. The contractor holds all sub-contracts. The owner has no contractual relationship with them and architect has no direct communication with sub-contractors.

Note that in this case, the owner, or LG, holds separate contracts with the architect / engineer, and the contractor. The architect / engineer and the contractor will hold separate sub-contracts with their consultants and sub-contractors respectively. Note that the owner does not, and should not, have any direct contractual link with these sub-contractors.

Note also that although the architect / engineer has no direct contract relationship with the contractor; he is empowered under his contract to act as the agent of the owner in administering the contract.

In this form, the owner must take two separate procurement actions. The first will be to hire the architect / engineer, and the second will be to select the contractor.

An essential feature of this method is that it is based upon the premise that all contract documentation (drawings, specifications etc..) will be complete before tender action is taken.

This method allows the greatest flexibility for open competition, but it also takes the longest time, and for that reason, may result in higher overall costs than some of the other delivery systems.

CONSTRUCTION MANAGEMENT SYSTEMS

Construction management systems fall into two basic categories:

1. Where the construction manager assumes all the financial and schedule risk, (usually described as CM “at risk”)
2. Where the construction manager provides professional services for a fee, and does not assume any of the financial or schedule risk, (usually described as CM “for a fee”).

CM “at risk” contracts also have two forms:

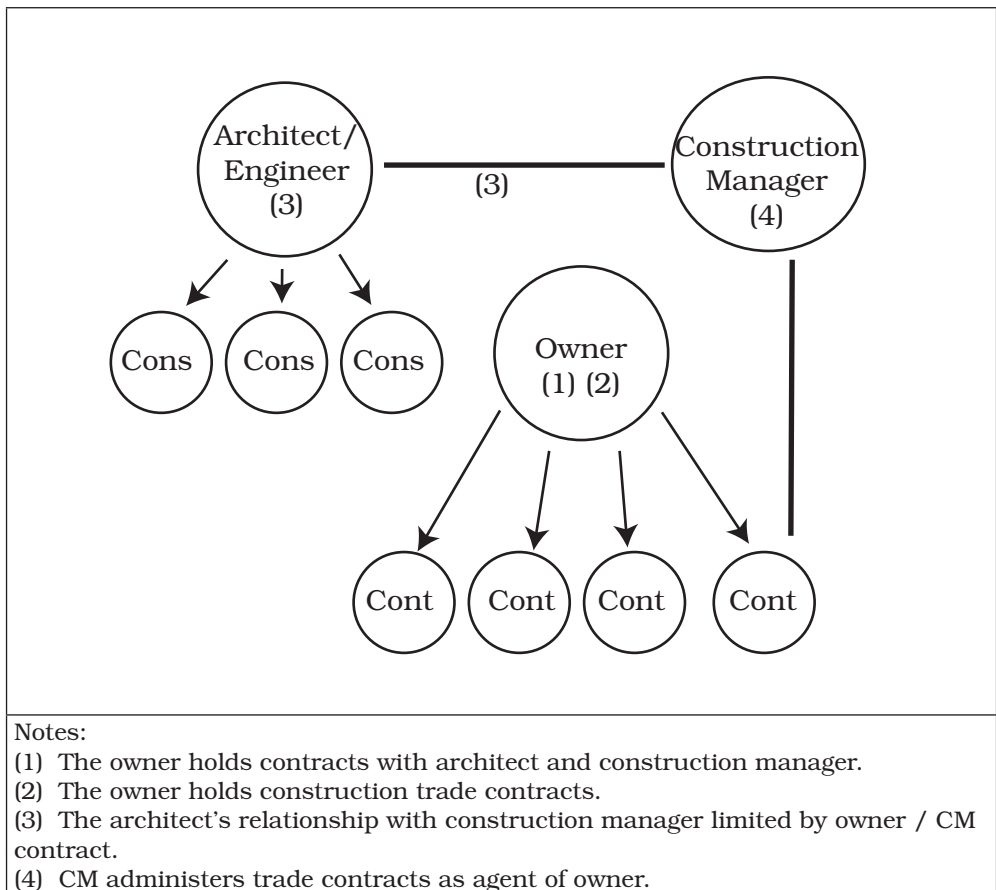
1. Where the CM holds the contracts with the various contractors, or,
2. Where the owner or LG, holds all the contracts.

Construction management “at risk”

Competent construction contractors who have the bonding and financial capacity to assume risk typically carry out these types of contracts. The construction manager (CM) is usually paid a fee in addition to the costs of construction, and the amount will be based upon the services the CM will provide. It is quite common for the CM to provide pre-construction services such as estimating, constructability reviews of the architect’s designs, etc., as part of his service. Fees are dependent upon the size of the project, and the amount of risk to be assumed by the CM. Where the risk is low (for example, when all the construction contracts have been awarded, and the contract amount is established), the fee would be in the range of 3% - 5% of the cost of construction. If the risk is high, for example if the CM is to provide a “guaranteed maximum price” (GMP) before any of the construction contracts has been

awarded, the fee will be higher, in the 5% - 10% range. In addition, and as part of the overall construction cost, the CM will be paid for all staff allocated to the project.

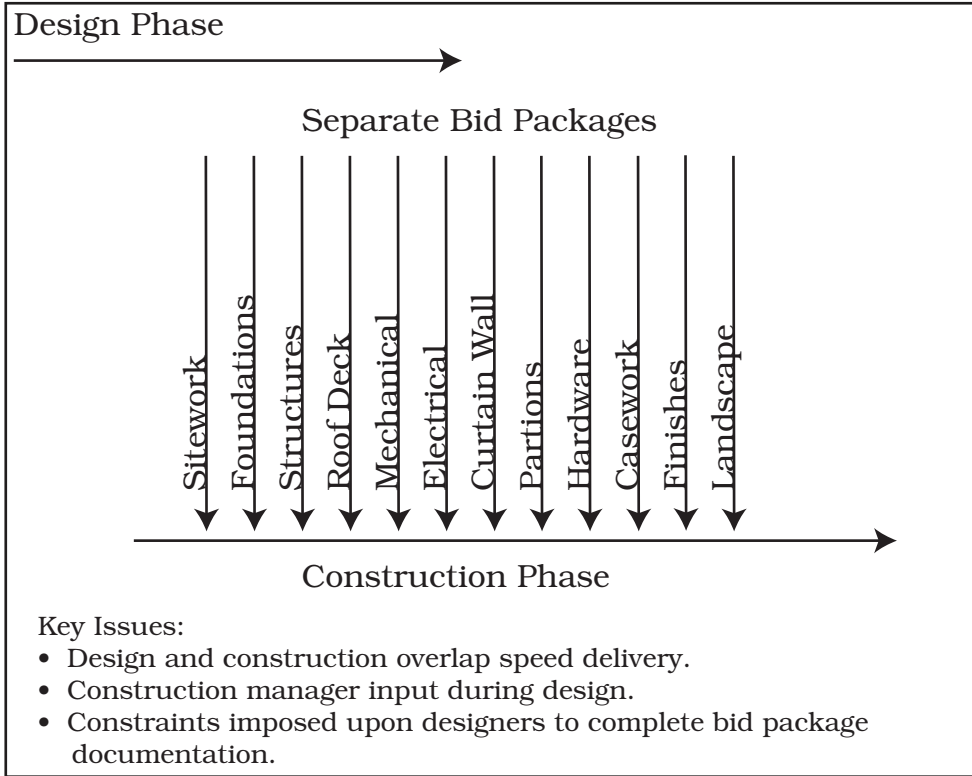
Owner/architect/construction manager organization



*(A **guaranteed maximum price GMP** contract, is one where the contract price is agreed with the CM prior to the completion of all the drawings and specifications, and cannot be exceeded without the written authority of the owner.)*

One advantage of this type of organization is that the CM can provide the GMP well in advance of the completion of the design, thus permitting an early start to construction. This is called "phased construction," and is illustrated below. **Phased construction** cuts down the overall project time, by overlapping design and construction. In this way, particularly in times of high inflation, the overall project cost may be reduced substantially.

Phased Construction



Construction management for “a fee”

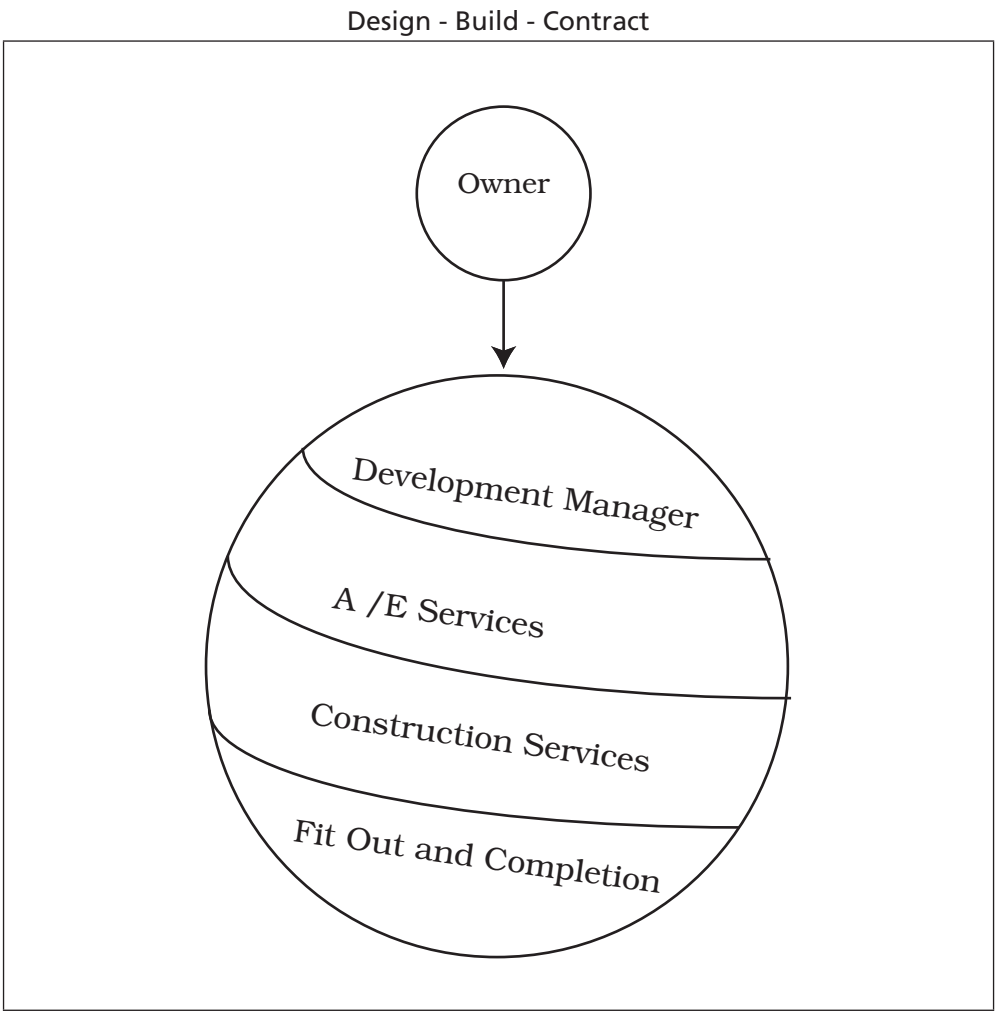
In this contractual form, a professional service contract exists between the construction manager and the LG. The construction manager assumes no fiduciary risk, but has a professional obligation to ensure that the project is completed on time and within the budget. In this case, the title “construction manager” is interchangeable with “project manager,” and either may be used. The CM will provide pre-construction services, developing budgets, monitoring the design, preparing estimates, and preparing the overall schedule for the project. During construction, the CM will be responsible for monitoring the contractor’s performance in terms of cost, time, and quality.

Compensation for these services is normally in the range of 3% - 5% of the construction cost, typically dependent upon the range of services provided, and the size of the project. This professional fee will cover the cost of all staff allocated to the project, and the consulting firm’s overhead and profit.

DESIGN / BUILD CONTRACTS

This organizational form of contracting has increased in popularity over recent years. It has the advantage of “one stop shopping,” since the LG only enters into one single

contract, and the design / builder assumes the entire risk from the beginning to the end of the project. The following table graphically depicts this type of organization.



One of the major advantages of this form is that it may substantially reduce the overall time to complete the project. It is estimated in the USA that it can save as much as one year on a typical government project. Obviously, this will have associated cost savings; total cost savings are estimated to be as much as 15% - 25 % in the overall project cost.

Depending on the nature of the project, the leader of the design / build team will be either a Developer, or a construction contractor. In either case, the leader must have the financial capacity to assume the fiduciary risk. It is unlikely that the Designer, in his normal business role, would have sufficient capital or, more importantly, the capacity to obtain the level of performance securities and guarantees that are necessary in this type of contract.

Typically, design / build teams will be formed to respond to a specific project, although in the USA and other Western countries, a few firms specializing in design / build contracts are now emerging as viable business entities.

Although there are many obvious advantages to this type of delivery system, it must also be understood that there are also quite different types of risk associated with it. For example, in order to provide the LG with a realistic price and time schedule, the design / builder must have a very precise and carefully drafted statement of requirements. Many LGs do not have the technical capacity to provide this and must hire a consultant to provide this service. This is a cost, which must also be taken into consideration. In addition, the Designer does not fulfil his traditional role of representing the LG, and being a member of the Development team, must comply with the overall requirements of the Development manager.

It is therefore important for the LG to have a stronger management team in place to ensure cost, quality, and schedule compliance, than would be necessary in other forms of delivery systems.

PHASE 6: DESIGN

This phase is Step 17 in the process. It may involve the use of consultants, and it is of particular importance that the consultants are provided with detailed descriptions of the actual requirements for the project, functionally, physically, and financially. It is unfortunately true that in the majority of cases where projects have suffered from severe financial, and schedule problems, the root cause has been lack of clarity between functional requirements, quality expectations, and financial capability.

Designers must be given sufficient time to prepare accurate and comprehensive tendering (bidding) documents. The documents are the basis of a competitive procurement action that will result in the selection of a construction contractor, and mark the commencement of the next phase.

During this phase, all the drawings, specifications, and other documentation necessary to define the project in sufficient detail for the construction contractor to eventually build it, will be assembled. It is a progressive process that starts with a statement of the LGs' requirements, and finishes with a set of tender documents, which will be used for the procurement of the construction contractor.

This is a critical stage with regard to cost management, and there are several important controls that must be put in place in order to ensure that the project is designed within the limitations of the funds available for it.

In order to exert these controls, it is necessary for the LG to identify the responsibilities and obligations with regard to cost management, for all members of the project team. This should be achieved contractually, as far as the design team is concerned, and should be defined within the framework of internal management procedures in the LG's own organization.

WHAT ARE THE PRINCIPLE RESPONSIBILITIES OF THE LG AND THE DESIGN TEAM?

The Local Government—has three primary responsibilities with regard to cost management:

- Develop a realistic, achievable, and comprehensive budget.

- Ensure that the design team is provided with all the details of the budget, and its related functional, quality, and schedule requirements.
- Establish strict cost management controls to be followed throughout the Design and construction Phases.

The design team—has one very clear responsibility with regard to Cost management:

- To design a project that can be achieved within the stated budget, and meet the LG's goals with regard to function and quality.*HOW ARE THESE RESPONSIBILITIES AND OBLIGATIONS ACHIEVED?*

The LG

The budget—The preparation of the budget has been discussed in the planning phase. The LG should take the opportunity to re-evaluate the original budget, and confirm that it is still valid, before providing it to the design team. Once confirmed, it should be fixed, and no changes to any of its components permitted without written approval.

The design team obligation—The LG must ensure that there is a contractual obligation placed upon the design team to develop a project design that will meet the budget. It must be recognized however, that there are sometimes circumstances that occur which will result, for example in higher than anticipated tenders, and which are beyond the control of the design team. Notwithstanding, there should be appropriate contract language in the services contract between the LG and the design team, which places a primary responsibility upon the design team to take all professional steps to ensure that the project is designed to meet the budget.

Typical Services Contract Language Follows:

- "The estimated construction budget is EU _____million."
- The design team will be required to develop a project, which can be achieved within this budget. Full details of its content will be provided to the design team as a separate document.
- In the event that tenders are received which exceed this award amount by more than 10%, then the design team will be required to carry out such re-design as is necessary to meet the contract budget limitation, at no additional cost to the LG.
- It is recognized that neither the Design team or the LG has control over the cost of labour, materials, equipment costs or energy, or the rate of inflation or over-competitive tendering, or market conditions, and that in that respect, it cannot warrant that tenders will not vary from the stated budget."
- The overall effect of such a contract clause is to impose a requirement on the design team to develop a project, which is strictly within the functional, and quality requirements. Any major deviation from these which causes higher than anticipated tenders will result on a requirement to re-design at their own cost.

Cost Controls—A rigorous set of procedures must be instituted within the LG to ensure that throughout all stages of the design, the integrity of the construction

cost budget is being maintained. This will be achieved by requiring the design team to make regular submittals to the LG, which will demonstrate that all the functional quality and cost constraints of the contract are being met. Typically, there should be at least three submittals, during the design phase, each of which must include estimates of the likely construction cost. These usually occur at the beginning of the design, after the preliminary studies have been completed (sometimes described as the Concept Phase); at the stage when the design has been completed, but before the detailed construction drawings have been completed (sometimes described as the Design Development Phase); and at the completion of the construction drawings and specification, prior to requesting tenders (sometimes referred to as the construction Documents Phase). This requirement should also be written into the contract between the LG and the design team, and the language should include the level of detail of the estimates of construction cost at each submittal.

The LG must carefully review all the submittals, and provide the design team with comments as appropriate. The design team should not be allowed to proceed to the next stage of design without the written authority of the LG.

In the event the LG does not have the technical capability in-house to carry out this function, then it may be necessary to hire a consultant to ensure that this important task is effectively completed.

At the conclusion of the design phase, the LG must have a “government estimate,” which will become the base line for the evaluation of the tenders received from the construction contractors. Obviously, this government estimate must be in line with the original budget, adjusted only in accordance with any changes that may have been authorized during the design phase.

The government estimate must remain strictly confidential to the LG, and should be disclosed only **after** the bid tenders are opened.

The design team

Contract Obligations—The primary obligation of the design team is to meet the requirements of the contract, in terms of the stated function, quality, and cost limitations. Although this may seem a relatively simple responsibility, in practice, the LG needs to ensure that the designers are, in fact complying. It is regrettably not uncommon for a building to be designed with simple deviations which were contrary to the stated requirements, but which were not recognized by the LG during the design phase, and which resulted in higher than expected tender prices. Some typical examples follow:

- **Excess area**—This is one of the greatest “offenders.” The project must be planned to meet as precisely as possible, the statement of area requirements. Without thoughtful planning, and careful attention to the schedule of required accommodation, it is very easy to over-run the space limitations by 10% - 15 %, which, in turn, reflects in a similar cost overrun.
- **Excessive building geometry**—The external “skin” of a building is one of its most expensive elements. Therefore minimizing its area is of significant importance in controlling the overall cost of the project. Irregular

shapes or excessive indentations to the building plan should be carefully analyzed, and either justified or discouraged.

- Use of non-traditional building methods—Although the use of innovative building methods that may actually save money should obviously never be discouraged, careful attention must be paid to the use of local skills and materials. Sometimes ignoring local traditions can result in increased costs. For example, in areas where bricks are manufactured, and where there is a long history of high quality brick laying, it can be expensive to introduce alternative materials where the trade skills also have to be imported, at higher than average wage rates.
- Excessive design features—Try to avoid conflicts between art and architecture. There can be a natural tendency to express design in terms of special features or appendages, which may be of no functional value, and contribute to unnecessary additional cost. Reaching a balance between function and design is always important—it should never be forgotten that many of the architecturally outstanding buildings in the world are significant in their simplicity.
- Outdated specifications—Specifications should be kept current with changes in materials and building techniques. It is quite normal for design organizations to maintain standard specification documents, but unless they are kept up to date with current trends, there is a possibility that older, less efficient, and even out of date materials and building methods may be specified, which are typically more expensive.

•
Procedures and Submittals—There are typically three major phases of design. They may have different names in different countries, but they are essentially the same in practice. As a minimum, the LG should review the status of the project at the end of each phase. In larger projects, there should be an intermediate review during the final phase. In each case, the submittal should be accompanied by an estimate of the expected construction cost based upon the current level of design. The following is a list of typical documentation for each Phase:

Phase one: Concept design

- Functional analysis diagrams - these portray how the various functions of the building will relate to one another (sometimes referred to as “blocking and stacking”).
- Building footprint and massing studies - these will indicate the building plan options and its overall proposed shape and height.
- Basic floor plans.
- Preliminary elevations.
- Outline specifications.
- Site plan.
- Estimate of construction cost.

Phase two: Design development

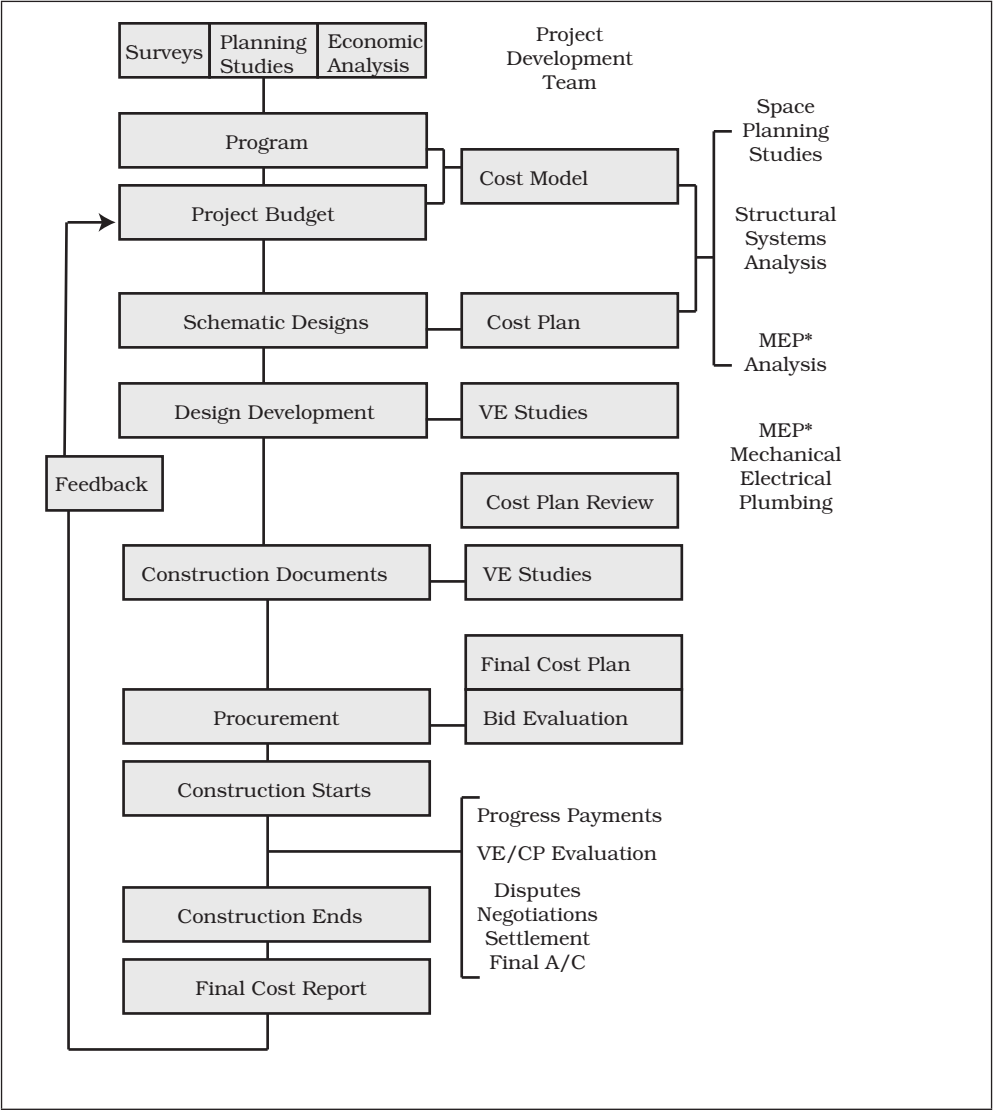
- Floor plans.
- Elevations.
- Sections through the building.
- Foundation and structural design.
- Basic mechanical, electrical, and plumbing layout.
- Material selections.
- Specifications.
- Detailed site plan.
- Estimate of construction cost.

Phase three: Construction documents

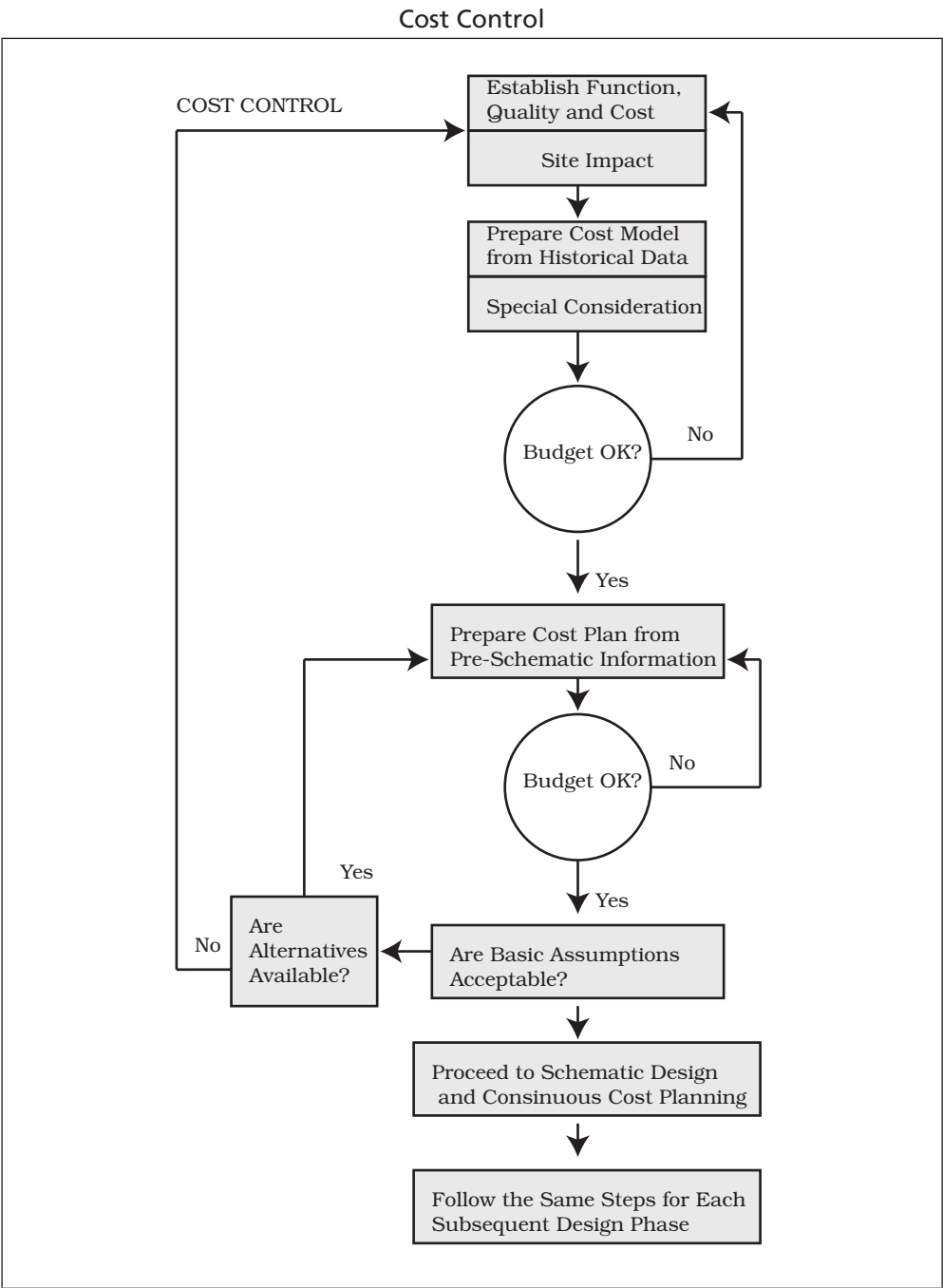
- Final floor plans.
- Elevations.
- Building sections.
- Construction details.
- Structural details.
- Mechanical drawings.
- Electrical drawings.
- Plumbing and fire protection drawings.
- Final specifications.
- Final site drawings.
- Contractual arrangements, conditions of contract, etc.
- Bills of quantities.
- Detailed estimate of construction cost.

The diagram “The Building Delivery System—Cost Management Process,” illustrates cost management as a dynamic process throughout the life of a project.

Building Diagram Delivery System—Cost Management Process



The table, “Cost Control,” shows how at each phase of the design process, the impact of design decisions taken should be tested against the budget. Only if the integrity of the budget is maintained should the design team be authorized to proceed to the next phase.



A **cost model** is a representation of the anticipated distribution of the cost of a building throughout all of its elements, and it is based upon the historical analyses

of similar completed projects. A cost model should be developed by the design team and derived from the budget provided by the LG. A **building element** is a logical functional component of the building, which can be separately defined and allocated its portion of the overall cost. A typical list of building elements is as follows:

- Foundations
- Substructure
- Superstructure
- Exterior Closure
- Roofing
- Interior construction
- Conveying Systems
- Mechanical Systems
- Electrical Systems
- General Conditions and profit
- Equipment

A detailed listing and comparison of four international descriptions of building elements is shown in the following table.

UNIFORMAT General Services Administration (GSA) USA	CANADIAN INSTITUTE OF QUANTITY SURVEYORS (CIOS)	THE ROYAL INSTITUTION OF CHARTERED SURVEYORS (RICS- UK)	CONSTRUCTION ECONOMICS EUROPEAN COMMITTEE (CEEC)
FOUNDATIONS <ul style="list-style-type: none"> • Standard foundations • Special foundations 	SUBSTRUCTURE <ul style="list-style-type: none"> • Normal foundation • Basement excavation & landfill • Special foundations 	SUBSTRUCTURE SUPERSTRUCTURE <ul style="list-style-type: none"> • Frame • Upper floors • Roof • Stairs • External walls • Windows & exterior doors • Interior walls & interior partitions • Interior doors 	SUBSTRUCTURE / SUPERSTRUCTURE <ul style="list-style-type: none"> • Frame • External walls • Internal walls • Floors • Roofs • Stairs • Windows & exit doors • Internal doors
SUBSTRUCTURE <ul style="list-style-type: none"> • Slab on grade • Basement excavation • Basement walls 	STRUCTURE <ul style="list-style-type: none"> • Lower floor construction • Upper floor construction • Roof construction 	INTERNAL FINISHES <ul style="list-style-type: none"> • Wall finishes • Floor finishes • Ceiling finishes 	FINISHES <ul style="list-style-type: none"> • Internal wall finishes • External wall finishes • Ceiling finishes

SUPERSTRUCTURE <ul style="list-style-type: none"> • Floor construction • Roof construction • Stair construction 	EXTERIOR CLADDING <ul style="list-style-type: none"> • Roof finishes • Walls below ground floor • Walls above ground floor • Windows • Exterior doors & screens 	FITTINGS & FURNITURE <ul style="list-style-type: none"> • Fittings & furnishings 	EQUIPMENT & FURNISHINGS SERVICES <ul style="list-style-type: none"> • Plumbing • Heating • Ventilation & air conditioning • Internal drainage • Electrics • Communications • Lifts, escalators • Protective installations • Miscellaneous services inst.
EXTERIOR CLOSURE <ul style="list-style-type: none"> • Exterior walls • Exterior doors & windows 	INTERIOR PARTITIONS & DOORS <ul style="list-style-type: none"> • Permanent partitions & doors • Movable partitions & doors 	SERVICES <ul style="list-style-type: none"> • Sanitary appliances • Services equipment • Disposal installations • Water installations • Heat source • Space heating & air treatment • Ventilation systems • Electrical installation • Gas installation • Life & conveyor installation • Protective installations • Communication installations • Special installations • Builders work in connection with services • Builders profit & attendance on services 	EXTERNAL SITE WORKS <ul style="list-style-type: none"> • Site preparation • Site enclosure • Site fittings • Site services • Site buildings • Hard and soft landscaping
ROOFING INTERIOR CONSTRUCTION <ul style="list-style-type: none"> • Partitions • Interior finishes • Specialities 	VERTICAL MOVEMENT <ul style="list-style-type: none"> • Stairs • Elevators & escalators 	EXTERNAL WORKS <ul style="list-style-type: none"> • Site works • Drainage • External services • Minor building work 	

CONVEYING SYSTEMS <ul style="list-style-type: none"> • MECHANICAL Plumbing • HVAC • Fire protection • Special mechanical systems 	INTERIOR FINISHES <ul style="list-style-type: none"> • Floor finishes • Ceiling finishes • Wall finishes 		
ELECTRICAL <ul style="list-style-type: none"> • Distribution • Lighting & power • Special electrical systems 	FITTINGS & EQUIPMENT <ul style="list-style-type: none"> • Fittings & fixtures • Equipment 		
GENERAL CONDITIONS & PROFIT EQUIPMENT <ul style="list-style-type: none"> • Fixed and movable • Furnishings • Special construction 	SERVICES <ul style="list-style-type: none"> • Electrical • Plumbing & drainage • Heating, ventilation & air conditioning 		
SITE WORK <ul style="list-style-type: none"> • Site preparation • Site improvements • Site utilities • Off-site work 	SITE DEVELOPMENT <ul style="list-style-type: none"> • General • Services • Alterations • Demolitions 		
	OVERHEAD & PROFIT <ul style="list-style-type: none"> • Site overhead • Head office overhead and profit 		

Historical construction cost database—is a library of information derived from completed construction projects. The database should preferably be established on a central government basis to give it greater depth and usefulness. Completed projects should be analyzed in sufficient detail to provide consistent cost information, which can be used, for evaluating future projects and establishing realistic budgets. The most important features of a database are that the information stored is derived from the final costs of completed projects, and that the project costs are analyzed consistently. The simplest form of analysis is to use a building element format as described above.

Cost plan—is the progressive development of the cost model. It sets the design to cost targets for each of the building elements and is the basis of all future decision making to ensure compatibility of design alternatives with the budget. The cost plan should be prepared by the design team at the outset of the project, and should be amended as the project moves through the design phases. As has been suggested, the cost plan should be used to test the cost impact of design decisions—alternates

can be considered and either accepted or rejected based on maintaining the overall integrity of the budget.

A cost plan should always be considered “predictive”—providing answers to the question: “What If...?” (Example. “What will be the impact on the budget if I use a glass curtain wall system instead of masonry?”)

Parametric estimates—are those developed from the analyses of the total costs of identifiable parameters, or functions, of a project. The following is a sample of typical parametric costs:

- A wastewater treatment plant may treat “x” litres of water per hour. Dividing the total cost of a completed wastewater treatment plant by the number of litres treated per hour will derive its parametric cost. (“Y” Euros per litre / hour).
- It requires “x” tons of chiller capacity to cool a building of a specific gross area. Dividing the total cost of the cooling system by the number of tons will derive its parametric cost. (“Y” Euros per tons of cooling).
- The total cost of a school divided by the number of pupils will give another parametric cost. (“Y” Euros per pupil).

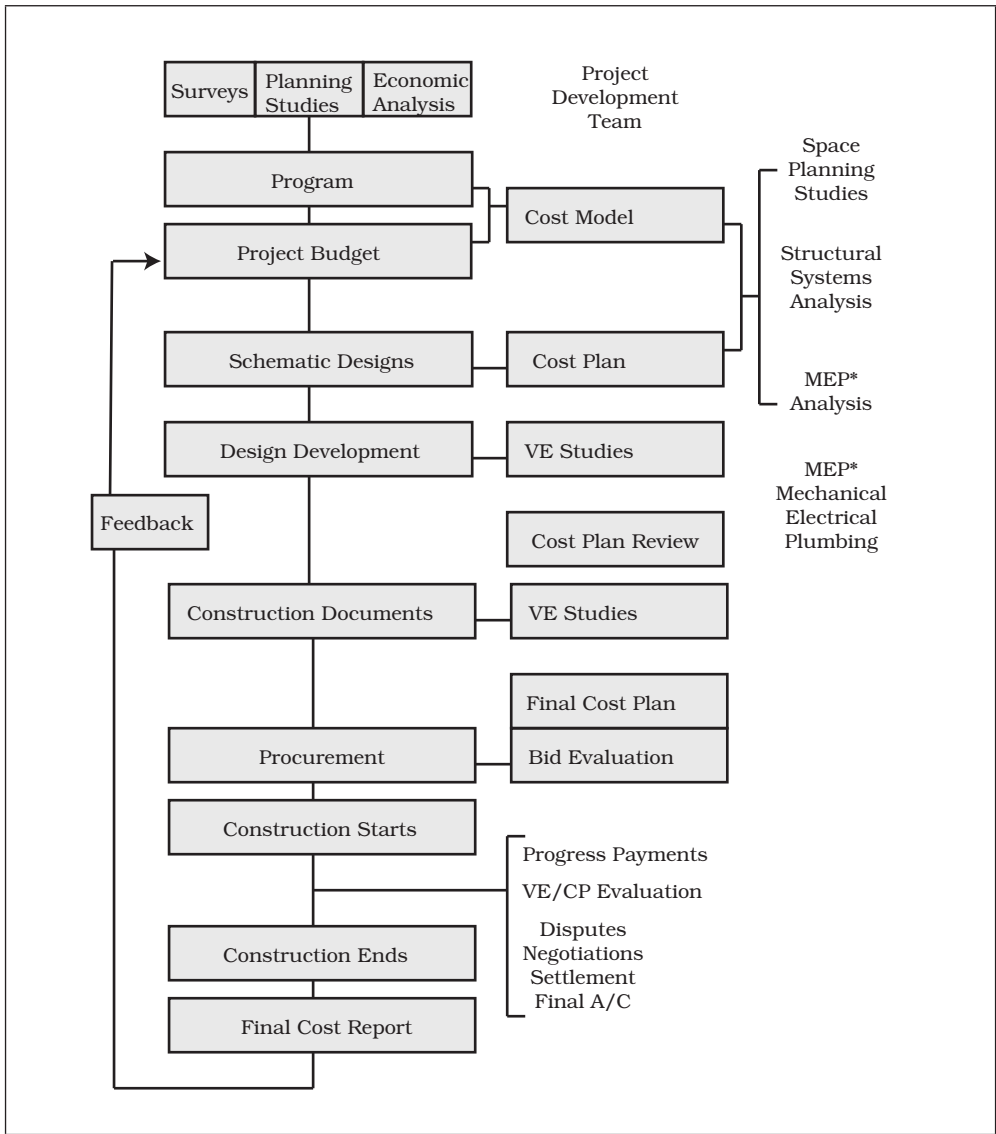
Cost estimate—is derived from a definitive design that has been documented on drawings and specifications. The estimate will be prepared from current labour and material prices, anticipated productivity, and will include the cost of all plant and machinery, management, taxes, etc. Estimates should always follow a consistent format, and is an essential component of the process of cost planning.

Cost estimates should always be considered “reactive”—providing answers to the question: “How much will this cost?”

Design contingencies—should always be included in the cost plan, to provide flexibility to the designer throughout the design of the specific project. This contingency will allow for variations from the average situation from which the cost model was derived. Typically, the design contingency will start at 10% of the construction cost, and will decrease at each successive phase of design, recognizing that as the design of the project becomes more developed, the cost estimates will be more accurate. At the end of design phase, and just before tenders being invited, the design contingency should only be 1% - 2%.

Cost planning process—Cost planning is an important process within the capital investment planning process. Refer again to the following graphic as you read the following steps.

The Building System Cost Management Process



Step 1. Develop cost model

The LG must provide the design team with full details of the project budget. The design team should then convert that budget into a cost model based upon historical costs of projects of the same type.

For example, following is a cost comparison of elementary schools in the Boston, Mass., area of the USA. The last column shows the average cost for each element, shown both as a cost per square foot of floor area, and also as a percent (%).

A simple cost model could therefore be derived for a new school, based upon similar percentages, as follows:

Cost Comparison of Elementary Schools in the Boston, Massachusetts, USA			
Proposed New School Boston, MA USA			
AREA : 10,000 SQUARE METERS			
CONSTRUCTION COST BUDGET : \$ 10,000,000			
AVERAGE COST PER SQ. METER \$ 1,000			
COST MODEL			
ELEMENT	%TOTAL COST	ELEMENT COST \$ / M2	TOTAL COST
Foundations	2.6	26	260,000
Substructure	3.6	36	360,000
Superstructure	6.9	69	690,000
Exterior Closure	13.1	131	1,310,000
Roofing	3.6	36	360,000
Interior	18.6	186	1,860,000
Conveying Systems	0.7	7	70,000
Mechanical	17	170	1,700,000
Electrical	8.4	84	840,000
Equipment	3.4	34	340,000
Site Work	12.4	124	1,240,000
General Conditions	8.7	87	870,000
Total	100	1,000	10,000,000

This simple cost model will demonstrates how the anticipated overall cost of the building can be apportioned. More importantly, it sets target costs for each of the elements.

Step 2. Develop a cost plan

At this stage, no real design work has started, and since obviously it is to be expected that there will be differences in any specific project from the typical averages that were derived from the database, it is prudent to make some allowances in our cost plan to allow some flexibility to the Designer. This will be achieved very simply by creating a design contingency pool, typically by reducing the cost of each element in the cost model by 10 %.

This action changes the cost model to the cost plan. The cost plan then becomes a management tool for the designer, and an efficient basis for reporting the status of the project budget to the LG regularly.

The cost plan, derived from the cost model shown above, would therefore be as follows:

Cost Plan

	ELEMENT	ELEMENT COST
1	Foundations	234,000
2	Substructure	324,000
3	Superstructure	621,000
4	Exterior Closure	1,179,000
5	Roofing	324,000
6	Interior	1,674,000
7	Conveying Systems	63,000
8	Mechanical	1,530,000
9	Electrical	756,000
10	Equipment	306,000
11	Site Work	1,116,000
12	General Conditions	870,000
13	Design Contingency	<u>1,000,000</u>
	Total Cost Plan	10,000,000

Now that the cost plan has been created, the concept design phase should commence, and major design decisions may be examined and evaluated against the cost plan.

Step 3. Cost Checks

This is a dynamic process, which will continue through all phases of design. Cost checks should be carried out to determine the cost effectiveness of major design decisions. During the concept phase, for example, the process may help determine the ultimate shape of the building, or the selection of basic materials for the external walls.

The following is an example of how this cost planning technique may be used to help the designer decide on both the shape of a building, and the range of materials that could be affordable within the framework of the established budget. It is based upon the cost plan developed above:

- Proposed school building
- Cost planning example
- Exterior closure

(Note: The Wall / Floor Ratio is the mathematical relationship between the gross floor area of a building and the actual area of its outside skin. Although in geometric terms, a circle is the economic way of enclosing space, this is not always practicable in building. However, using the circle as a base line, the nearer to that formula that a building plan form takes, the more economical will be the Wall / Floor Ratio.)

Historical analyses shows that the optimum wall / floor ratios fall within the range 0.3 - 0.6

**Gross Area of Building
10,000 square meters**

Cost plan allocation external closure		\$ 1,179,000
Wall / floor ratio	0.6	0.3
External wall area (M2)	3,000	6,000
Cost target / M2 wall area	\$393	\$196.5

Typical Wall System Prices / square meter

Facing brick veneer with concrete block backing	\$150 - \$180
Pre-cast concrete	\$220 - \$300
Cast stone / Stone veneer panel	\$400 - \$600
Limestone / Granite	\$550 - \$750
Glass curtain wall system	\$250 - \$350

This cost study very clearly indicates to the designer that if the building is planned with a wall / floor ratio of 0.3, then the options available for the external skin would be a facing brick veneer with concrete block backing, a pre-cast concrete panel wall system, or a glass curtain wall system. On the other hand, if the building is planned with a 0.6 wall / floor ratio, only the facing brick system will be affordable.

The conclusions to be drawn from the study, therefore, must be that the designer must concentrate in planning a building with a wall / floor ratio with a target around 0.4 in order to permit a less restrictive selection of wall system materials.

This example may appear deceptively simple. However, it demonstrates the importance of taking into consideration all elements of planning and design from a design / cost perspective, rather from a narrower aesthetic view point, in order to avoid seriously jeopardizing the budget, and / or creating a total imbalance of cost throughout the other elements of the building.

Step 4. Continuous cost checking / estimating

This process of cost checking must continue throughout all phases of design. At the end of each design phase, the architect / engineer should make a submittal to the LG which must satisfactorily demonstrate that the project has been designed within the established budget.

The submittals will be in the form of estimates of probable construction cost, and they should always be prepared in a consistent manner, so that any differences from previous estimates can be readily identified. The level of detail of each estimate should be consistent with the level of design. As the plans and specifications are developed more fully, then it becomes possible for a progressively more accurate level of measurement and estimating to take place.

Note that as the level of detail of estimating increases, it is to be expected that the design contingency reserve will diminish, taking up differences in measurement and /or pricing from the original cost plan, but still maintaining the integrity of the budget.

It is helpful to have the “estimate of probable construction cost” accompanied with a review of the cost plan at each submittal. The cost plan summary will be a clear reference point for the LG to evaluate the status of the project and to be assured the project budget is being maintained.

The following cost plan summary example is based upon the cost model and cost plan shown previously.

Cost Plan Summary			
Cost Check Number 1			
	ELEMENT	COST PLAN	COST CHECK
1	Foundations	234,000	275,000
2	Substructure	324,000	310,000
3	Superstructure	621,000	700,000
4	Exterior closure	1,179,000	1,320,000
5	Roofing	324,000	310,000
6	Interior	1,674,000	1,575,000
7	Conveying systems	63,000	67,000
8	Mechanical	1,530,000	1,710,000
9	Electrical	756,000	720,000
10	Equipment	306,000	276,000
11	Site work	1,116,000	1,100,000
12	General conditions	870,000	870,000
13	Design contingency	1,000,000	767,000
14	Total Cost	10,000,000	10,000,000

It can be seen from this cost check that although the cost estimate of the various elements may vary from the cost plan, (and this is to be expected), by reducing the design contingency by approximately 2.5 %, the budget is still being maintained. At this stage, reducing by that amount is acceptable, and the design team should be authorized to proceed to the next phase of design.

This review and approval process should continue through all phases of design.

Step 5. The government estimate

At the completion of the final phase of design, and prior to inviting tenders, it is most important that a final, pre – tender, estimate is prepared on behalf of, or by, the LG.

This estimate has two very important functions:

- It is the final confirmation that the project has been designed within the budget (within normal estimating parameters).
- It becomes the baseline for the evaluation of the tenders to be submitted under the procurement process.

Once the estimate has been prepared, it must be treated with the utmost confidentiality, and only divulged after the tenders are opened. In the United States, and many other countries, this is called the “government estimate,” and there are strict rules pertaining to its use. They relate not only to the aspect of confidentiality, but also to prescriptive limits relating to discrepancies between the government estimate and the tenders received. For example, in the United States, if tenders received exceed the government estimate by more than 1 %, then a contract award would not normally be permitted, and it would be necessary to cancel the procurement. Only after exhaustive investigations would a new procurement action take place, and steps would have been taken to ensure that tenders should be received within acceptable margins.

Accuracy of estimates—The level of accuracy of estimates is determined by two specific factors:

- The skill and experience of the estimator
- The quality and amount of information available to the estimator

Estimates should be prepared with great care and attention to detail. Professionals in their field who are recognized experts and who have received advanced training in the specific sector of industry should therefore always prepare them. A recent study carried out by the National Academy of Sciences in the United States into the reasons for cost over-runs in the construction of Federal Buildings, established that one of the major causes was poorly prepared initial estimates (budgets). It also established that in many cases, the preparation of these important estimates had been delegated to individuals who did not have adequate experience or training. The United States government now mandates that all estimates are carried out under the direction of qualified professional estimators.

Obviously, the level of information available to the estimator will increase as the project is developed, and proceeds through each design phase. Although a competent estimator will develop techniques to overcome lack of detailed information, it is to be expected that there will be a variable degree of accuracy, sometimes described as “risk,” from the first to the last estimates. Typical, acceptable, levels of accuracy at each phase of design are as follows:

Levels of Accruacy of Estimates

Planning phase	15% - 20%
Concept design	10% - 15%
Design development	7.5% - 10%
Construction documents	5% - 7.5%
Pre – tender	5%

At the planning phase, this risk would be covered by a contingency in the development of the budget, and in all other phases, it is covered by the design contingency.

STEP 17: ENSURE FINANCIAL CONTROLS

Cost controls during the design and construction phases are essential. Especially important is a project accounting system which records, analyzes, and reports all costs. Close communication between the project manager and the finance staff is necessary for strict accounting and cash flow analysis, which facilitates timely draw downs of funds and maximizes funds available for investment. Additional information on cash management can be found in another chapter in this series on *Financing the Operating Budget*.⁸ Accounting controls are needed to be sure that payments do not exceed the level of completed work and debt requirements are met. Information on the elements of debt issuance and management are found in a series chapter on *Financing the Capital Investment Plan*.

Other methods of cost control include value engineering, life cycle costing, design-build, and change order controls. Value engineering during the design phase can reduce costs using materials that are more efficient, construction methods and technology. Improved repair and rehabilitation technology assists in extending the useful life of existing facilities and reducing maintenance costs. Life cycle costing is a technique that determines the total lifetime cost of acquiring and operating a facility or equipment. Energy efficient building design and equipment may increase the initial cost but can substantially reduce lifetime operating costs. Design/build combines responsibility for project design and construction with a single firm. Design and construction proceed simultaneously therefore permitting a project to be “fast tracked.”

Change order controls are critical to preventing change order abuses often associated with low bid contracts. Project costs can be substantially increased through change orders. A written change order procedure should provide for justification, approvals, itemization of labour and materials, tracking and penalties for abuse. Change orders and cost overruns over a specific percentage of the contract should be presented to the governing body for approval and capital budget amendments if necessary. Allocation of adequate funds for valid contingencies such, as unanticipated soil problems are sound management.

PHASE 7: CONSTRUCTION

This phase includes Steps 18 and 19 and will include the physical implementation of the project, and will incorporate the biggest non-recurrent investment in the project. It is important to carefully manage the financial expenditures. This will mean establishing an effective management team to take responsibility for quality, schedule, and cost control of actual construction.

STEP 18: CONTRACT ADMINISTRATION

CONTRACT AWARD

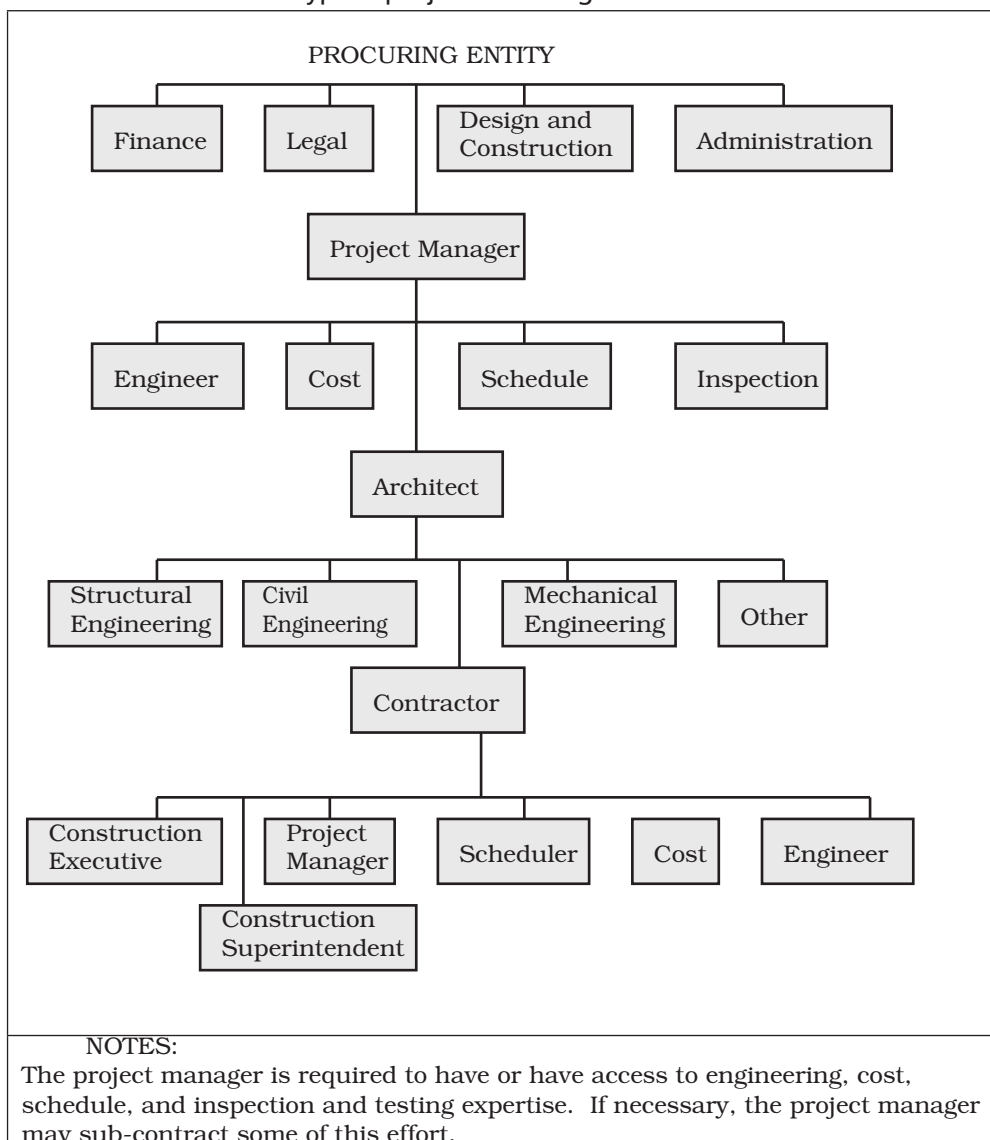
This phase will commence on the award, and signing, of a contract between the LG and the construction contractor. After the contract has been signed, the LG must issue a “notice to proceed” letter to the construction contractor, advising him of the date when the project site will officially be available to the contractor, and defining the contractual start date. It is most important that this letter is issued by the LG, and the contractor must formally acknowledge its receipt. This start date will mark the time from which contract schedule performance is measured, and from which any contract extensions, delays, or claims will be measured.

CONSTRUCTION MANAGEMENT STRUCTURES

It is essential for the LG to establish management procedures to ensure compliance with the contract in terms of performance, quality, and cost. Typically, there will be a designated project manager, who may be either an employee of the LG, or a consultant, and who will assume the overall responsibility for the management of the project. This is a key role, and it should not be diminished in any way. The project manager should have access to all necessary departments within the LG (accounting, legal, engineering, etc.), and should establish strong lines of communication to ensure that all contractual issues can be dealt with expeditiously. The construction contractor will also establish a management team, and must designate a project manager.

A typical project team organization is shown in the following table:

Typical project team organization



OBJECTIVES, ROLES, AND RESPONSIBILITIES

The following is a summary of the objectives, roles, and responsibilities of the various participants in a typical public works contract, during the construction phase:

The LG	The project manager	The construction contractor
<ul style="list-style-type: none"> Obtain a complete and useable facility. Obtain good value for the investment. 	<ul style="list-style-type: none"> Act as the representative of the LG. Ensure effective co-ordination between the LG, the Designer, and the contractor. 	<ul style="list-style-type: none"> Provide a complete and useable facility. Comply with the contract documents.

<ul style="list-style-type: none"> • Ensure the facility is completed on time and occupancy can take place on schedule. • Ensure funds are available to complete the project. • Enter into a legal and binding contract in good faith with the construction contractor. • Establish an adequate organization to administer the contract. • Make progress payments in a prompt manner. • Accept the facility on completion. 	<ul style="list-style-type: none"> • Efficiently administer the contract. • Ensure compliance with contract documents. • Interpret plans and specifications. • Establish quality control procedures. • Evaluate, certify, and process progress payments. • Process equipment, submittals, warranties, and certifications. • Ensure job safety regulations are being followed. • Resolve disputes, changed conditions, change orders. • Carry out final inspection and certify final payments. 	<ul style="list-style-type: none"> • Ensure performance guarantees in place. • Ensure quality of workmanship. • Enlist competent sub-contractors. • Submit payment requisitions in a timely manner. • Complete the project on schedule and within the budget. • Provide all warranties for equipment, materials, and workmanship. • Make a profit.
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(Note that some of the above responsibilities may be undertaken by the designer, depending on the nature of the contract).

REQUISITION / INVOICE AND PAYMENTS

Normally, the construction contractor is entitled to monthly progress payments during the term of the contract. It is also normally a provision of the contract that the contractor should receive payment from the LG within 30 days of receiving the approved requisition/invoice. A procedure must be established to ensure that the project manager and the contractor can review and approve the requisition/invoice within a time frame that will be in accordance with the LG's accounts payable cycle. Since typical contract provisions allow the contractor to receive interest on any late payments, it is in the best interest of the LG to ensure that this cycle is met.

The construction contractor should prepare a detailed requisition/invoice based upon work completed to date (this would normally also include the value of materials on site), and submit for review to the project manager by an agreed upon date. The project manager and the contractor's representative should then meet on site and physically agree the content of the requisition/invoice. Note that the project manager may refuse to pay for work not in accordance with the drawings and specifications.

RETENTION (RETAINAGE) FROM PROGRESS PAYMENTS

Under the terms of the contract, the LG will be permitted to retain a percentage of each monthly requisition to establish a fund to be drawn upon in the event that any work remains incomplete or not in accordance with the specifications at any time in the contract. This fund would allow the LG to have the work completed by another contractor or sub-contractor if necessary. Note however, that until there is such default, this money legally belongs to the contractor, and the LG must ensure that it is retained in a special account and not under any circumstances used for any other purpose.

In most contracts, the amount retained is 10% of the monthly payment. It is normal practice to reduce this to 5% after the contract is 50% complete. It is also not uncommon to further reduce the amount of the retention fund when the building has been taken over by the LG, but there still remains some finishing work to be completed. The LG has an option here to either reduce the amount to 2.5%, or to retain an amount equal to a sum in excess of the value of the work still to be completed (for example, 1.5 times the value of the work to be completed). Note that whatever arrangements are proposed by the LG, they **must** have been incorporated in the contract documents.

CHANGES IN SCOPE

A **change in scope** is a material deviation from the contract documents. Although in general changes in scope should be avoided where possible, it must be recognized that they do occur, and provision must be made in the contract to deal with them.

Only the parties to the contract may request changes in scope:

- Additions or deductions to the contract requested by the LG.
- Additions or deductions to the contract requested by the contractor.
- The reasons for the proposed changes must be clearly identified, as well as the responsible party.
-

The following table provides a sample of typical changes in scope.

Typical Changes in Scope

Reason	Example	Risk	Procedure	Remarks
Unforeseen circumstances.	Rock in foundation excavations.	LG	Issue change order to the contractor.	Funding will be covered by the construction contingency.
Additional Requirements of the LG.	Increase number of parking spaces.	LG	Issue change order to the contractor.	LG will require to provide additional funding.

Contractor requests additional payment.	Information omitted from drawings.	LG	Issue change order to the contractor.	<ul style="list-style-type: none"> • LG must agree that there was an omission. • LG may have redress against Designer.
Contractor offers reduction in contract amount.	Saving identified by Value engineering.	Contractor	Issue change order reducing contract amount.	<ul style="list-style-type: none"> • LG must agree with contractor's proposal. • Saving will make monies available for other uses. • Sometimes value engineering savings are shared between contractor and LG.

CHANGE ORDERS

A change order is the contract vehicle for acknowledging a change in scope. Each change order should be separately negotiated by the LG. Typically, the contractor should be required to submit a proposal to the LG providing details of the content of the proposed change. It should include details of the cost of all labour, materials, overhead, and profit. If the contract documents have included a bill of quantities, or a schedule of rates, the unit prices included in them should be used for calculating the change order.

Before receiving the contractor's proposal, the LG should also prepare an independent estimate, "the government estimate," as a basis for the negotiations.

On conclusion of the negotiations, a formal change order should be issued amending the contract value accordingly. A log of all changes to the contract should also be maintained.

DISPUTE RESOLUTION

The methods for resolving disputes must be included in the general conditions of the contract, and must be followed if such an occasion arises. Prominence should be given to non-judicial methods of resolution, and settling problems amicably and expeditiously. Most settlements will revolve around contract period extensions and additional financial awards.

It is imperative that accurate records are maintained by the LG, so that when a claim for additional compensation arises, there will be sufficient information available to allow the LG to make a realistic evaluation of the contractor's assertion. The project manager will be responsible for ensuring that proper records are maintained, and the following is a list of documents that will be sources of reference in dispute resolution:

- All contract documents, and time schedules,
- Meeting minutes,
- Financial reports,
- Change proposals and change orders,
- Daily weather logs,
- Daily construction inspection reports, and
- Progress photographs.

In the event a claim is made for additional compensation, the LG must receive fully documented evidence from the contractor in support of the claim; this will include reference to the relevant conditions of contract as well as any additional supportive information. No decision should be made until the claim has been carefully evaluated, including the assembly of the required information in support of the LG's viewpoint. This must include an estimate of the amount the LG is prepared to award, if any.

REMEDIES IN THE EVENT OF NON-PERFORMANCE

One of the major responsibilities of the LG is to establish a set of procedures to monitor and ensure contractual performance by the contractor. This will be achieved under the jurisdiction of the project manager, and will include regular inspection of the construction works. There are several remedies available to the LG in the event of non-performance by the contractor. **Note that all instructions must be in writing.**

- Request the defective work be corrected at the contractor's expense. If the work is corrected, the problem is solved.
- If after the number of days stipulated in the conditions of contract, the contractor has not yet corrected the defective work, the LG may choose to have another contractor come on site and perform the work in accordance with the contract requirements. In this case, the value of the defective work should be deducted from the contract amount, and any additional costs deducted from the retention fund.
- In the event of persistent non-performance, the LG has the right to terminate the contract, and invoke the terms of the performance security, in whichever form it may take.

Typically, the situation, in its worst case, will be progressive, starting with a request to correct a deficiency, and ultimately leading to a termination. Every effort should be made to avoid the worst case, however, and in any event, each stage must be carefully and accurately documented. Terminating a contract and invoking the terms of the performance security will inevitably involve complex and expensive legal proceedings, and should be avoided where possible.

SUBSTANTIAL COMPLETION

A project is usually considered substantially complete when the LG can take “beneficial occupancy” of the building. That is to say, it can be functionally used although the entire works are not yet complete.

This is an important contractual step, and should only occur after the LG has carried out a complete inspection of the project, and provided the contractor with a list of work still to be corrected or completed.

At this time, the LG may release or reduce the amount being retained from the contractor’s payments. If the limit of the retention fund was 5% of the contract amount, it may be reduced to 2.5%.

Another option is to release all the funds being retained, place a value on the work to be completed, and to retain say, 1.5 times that value, until the work is completed.

CONTRACT COMPLETION

After all contract obligations have been completed, the LG should assume final occupancy and ownership of the building. This will include the following:

- Issue a “certificate of acceptance,”
- Receipt of all warranties,
- Receipt of all manuals for equipment,
- Release of all funds due to be paid to the contractor, and
- Release of all insurance requirements under the contract.

Obviously, this is a major step in the contract, and it should be achieved expeditiously, but accurately.

This is particularly the case with regard to the release of funds to the contractor. It is essential that the final account is prepared accurately, it is equally important to make the final payment to the contractor as soon as practical after the amount has been agreed upon.

STEP 19: PROJECT REPORTING

Status reports are a crucial aspect of project implementation and oversight. The format and frequency of the reports should reflect the information needs of the users including project manager, staff, CEO, and governing body. Basic information includes: department, project name, start date, estimated completion date, percentage of completion, funding source and costs including budget and actual. Costs can be broken down by cost category such as planning, land acquisition, design, engineering, construction, and contingency. Narrative explanations of delays, cost overruns, funding and construction problems, and proposed corrective action are very important. Charts, graphs, and exception-type reports help to simplify the presentation for the CEO and governing body. Computerized data management systems are useful in tracking project status and contract requirements.

COST REPORTING

Cost status reports must be maintained, and updated at least monthly, to ensure that the LG is fully aware of the financial status of the project. A standard format should be adopted so that status reports for all current projects can be consolidated for management use. The project manager should be responsible for the preparation of the monthly report. The following is a typical format for a cost status report and a payments log:

Sample Cost Status Report

PROJECT NAME :					REFERENCE #			
CONTRACT AMOUNT:					CONTRACT PERIOD:			
PAYMENTS LOG								
	Date	Gross Value of Work	Gross Value Materials on Site	Total Gross Value	Total Retained	Net Total Value	Net Previously Certified	Amount Certified
1.	1/30	10,000	2,000	12,000	1,200	10,800	----	10,800
2.	2/28	30,000	5,000	35,000	3,500	31,500	10,800	20,700

Sample Payments Log

PROJECT NAME:				REFERENCE #		
CONTRACT AMOUNT:				CONTRACT PERIOD:		
STATUS REPORT						
	Contract Value	Adjustments To Date	Revised Contract Value	Total Paid To Date	% Revised Contract Value *	Remarks
1.	100,000	None	100,000	10,800	10.8	N/A
2.	100,000	10,000	110,000	31,500	28.6	Change Order #1

FINAL COST ANALYSIS

A post contract evaluation report should be prepared by the LG. This should include a critical evaluation of the entire project, from its inception to its completion. The report should review the proposed function and whether it has been adequately provided or not. It should also include a performance review of all the parties to the contract. This is particularly important regarding lessons that should be learned from the project, and implemented in successive projects.

An analysis of the final costs of the project must be completed, since this will provide the LG with a valuable database for future projects. This should be prepared in a standard format so that the data can be transferred into a comprehensive database for general use not only in the LG, but also throughout the country.

Every effort needs to be made to keep the public informed about the status of projects in order to maintain their support. Door hangers and visits are an effective means of notifying residents when projects will begin in their areas and the extent of disruption to be anticipated. Proper signing (posting signs at construction sites) of projects informs citizens of how their tax dollars are being spent, and can be used to give credit to other funding agencies. Project photos and status reports should be distributed through press releases and local newsletters. Open houses of facilities such as LG halls and public works facilities are a good way of promoting the benefits of capital investment projects. Additional information on public information techniques is found in the series chapter on *Citizen Participation*.

LEARNING APPLICATION

POLICY MAKER _X_ CEO _X_ FINANCE MANAGER _X_ DEPARTMENT HEAD _X_

Prepare an implementation and monitoring plan for projects in your community. Who will be responsible for monitoring? What techniques will be used?

PHASE 8: OCCUPANCY

There are two important stages in this phase. The first is the relocation stage, when plans must be made well in advance to move the prospective tenants into the building, without undue delay, and with the assurance that all the support facilities will be available immediately. This takes careful planning and budgeting. It is important that operating expenses be calculated and included in the operating budget for the year that the facility becomes operational.

Secondly, there is the long-term support of the tenants in the building to ensure that they can carry out their functional tasks effectively throughout the life of the building. This requires both operational and maintenance planning and budgeting, and adequate allocation of funds over the life of the building.

PHASE 9: DISPOSAL

Every facility should be planned with a desired useful life. Towards the end of that life, a plan should be made for its disposal. This may vary from prolonging it, by carrying out major renovations, to demolishing it to make room for a new project.

In any event, there will be a cost associated with the ultimate decision, and this must be taken into consideration in the long-term capital investment planning process.

INTERNET RESOURCES

Municipal infrastructure investment planning	http://irc.nrc-cnrc.gc.ca/uir/miip/
Perform measures and capital planning	http://irm.cit.nih.gov/itmra/perform.html
Toolkits for financing water and sewer	http://www.worldbank.org/html/fpd/water/wstoolkits/index.html

ADVANCED CONCEPTS

There are two additional concepts that should be considered in developing a capital investment plan. These are the concepts of value management or value engineering and how to analyze real estate.

AN INTRODUCTION TO VALUE MANAGEMENT AND ENGINEERING

It has been stressed throughout this chapter, that the decision to build a facility or road is a significant step for any LG, and one, which has a far-reaching impact upon the community. The prudent use of monies raised by taxes is essential, and public works projects must be perceived as having obtained good value for the money invested. Considerable time and effort goes into the preparation for a project, and the product is a valuable asset, which will affect the lives of those who use it or benefit from its output. In addition, a public works project is typically highly visible—taxpayers may have a daily reminder of a bad investment by their elected leaders.

In the private sector, value can be measured based upon the financial return on the investment. It is much more difficult to measure value in the public sector, since, typically, there is no tangible financial return from the investment. It might be said therefore, that value in the public sector could be a measure of ultimate cost, performance, aesthetics, efficiency, and transparency in procurement.

By definition therefore, **value management** would be a process, which ensures that the public works project will be completed for the lowest cost; will function effec-

tively; aesthetically reflects the principles of good design, and was procured efficiently and transparently. It is a structured approach to defining what “value” means to a client (LG) in meeting a perceived need for a project by establishing a clear consensus within the management group, about the project objectives, and how they can be achieved.

Value engineering is a systematic approach to delivering the required functions (the physical purpose of the project) at lowest cost without detriment to quality, performance, and reliability of the product or service.

It could be said that if value management is the process, value engineering is the tool.

In recent years, the concept of value management has been developed to a level where by using value management procedures, capital cost savings of between 10 % and 20 % have been achieved. In addition, and equally important, even greater savings over the life of the project can also be obtained through effective value management.

HISTORY OF VALUE ENGINEERING

Value engineering was a concept introduced by the General Electric Company of the US during World War Two. At that time, there was a shortage of many of the materials that the company had traditionally used in the manufacturing process. An engineer was assigned the task of solving this problem, and he soon realized that by challenging conventional thought, and therefore, specifications, and by examining products from the perspective of the primary function that they performed, it was possible not only to find alternative materials, but in many cases reduce the cost of a product without diminishing its desired performance. This then, was the beginning of the principles of value engineering.

PRINCIPALS OF VALUE ENGINEERING

There are essentially two basic principles. The first is the relationship between “cost” and “worth,” and the second is the examination of the “function” of a component or product.

Cost is defined, as how much we must pay to acquire something. **Worth** is the value we place on those goods or services. Although this may appear to be a very simple distinction, if we examine it closer, we will realize the truth that in any purchase if we pay more than we budgeted (which was our perceived value), then we feel we have been over-charged. On the other hand, if we pay less than we expected, we feel we have a bargain.

This concept translates readily to a construction project. The cost model is the expression of the worth of the building, system, or element. The estimate will tell us what it might cost. If the estimate is higher than our worth, or budget, then we must take steps to re-evaluate that item and find a solution that is within the budget.

FUNCTION

The determination of the primary function of an object is the second important element of value engineering. Again, this may appear to be a simple concept. It is

deceptively simple, however, and if you apply it to a construction project or its elements, it can readily be seen that this can become quite a complicated analysis. For example, what is the primary function of a window? Obviously, a window has many functions and identifying the primary function in a specific location needs careful scrutiny.

The reason for identifying the primary function is to permit an examination of the alternative methods of fulfilling that function, and assessing their costs, to determine if there is another and cheaper way of providing it. This concept can be applied to the decision to build in the first place just as well as to a specific element of the building itself.

THE BASIC QUESTIONS

The structure of a value engineering study can be summarized in a series of questions:

- What does it do?
- What does it cost?
- What is it worth?
- What else will do the job?
- What does that cost?

After these questions have been asked and answers identified, the final selection can be made, based on best value.

PARETO'S LAW

A prime objective of a value engineering study is to identify areas which appear to have high cost and low value (worth) In this case, it is important at the outset to select subjects for study that have significant impact on the total cost of the project. In this respect, the principals of Pareto's Law of Distribution can be applied—it says that in any cost centre, twenty percent of its elements will account for eighty percent of its total cost. This is remarkably consistent in construction projects, and it these elements that should be identified for value engineering study. They can be readily identified from the cost model, and review of the estimates will identify those most appropriate for study.

THE JOB PLAN

A value engineering study is usually conducted in a workshop form, and must be systematic and well organized. In order to achieve this it conforms to a well-defined job plan, which has eight phases:

PHASE 1: PROJECT SELECTION

The subject(s) for study will be identified during this phase. Note that value engineering is applicable at all phases of the project cycle, and that in general, the earlier the study is carried out, the more effective it is likely to be. Thus, the decision to build

can be a significant Value engineering study in itself, and if positive, successive studies will improve the cost efficiency of the project.

PHASE 2: INFORMATION

During this phase, gather all the pertinent information available. This will include:

- Planning and value objectives
- Cost model data
- Cost estimates
- Design and performance information
- Life cycle cost data
- Organize the workshop

PHASE 3: FUNCTIONAL ANALYSIS

Review criteria and cost estimates, and identify functions. This will include:

- Identify functions including aesthetic functions
- Classify functions
- Establish target worth
- Evaluate function / cost / worth relationship
- Refine scope of study for value improvement

PHASE 4: IDEA GENERATION

The objective of this phase is to generate as many creative ideas as possible. This should be achieved by "brainstorming" and it is important not to pre-judge any ideas, rather to encourage active participation by the team members. The team leader should write down all the ideas as they are suggested so that they can all be reviewed, or built upon, during the workshop.

PHASE 5: EVALUATION

At this stage all the ideas generated should be evaluated, criticized, and tested. It will be necessary to estimate the cost of each idea, and to determine which offers the best-cost savings potential. The process will include:

- Combining and modifying ideas
- Screening out those which do not meet criteria
- Developing evaluation criteria
- Ranking ideas
- Cost to develop idea
- Time to implement it
- Probability of implementation
- Potential benefit

PHASE 6: DEVELOPMENT

Select alternatives and prepare final recommendations for implementation this will include:

- Preparing estimates including life cycle costs where relevant
- Developing required actions
- Select first and second choices
- Develop convincing facts
- Prepare written recommendations

PHASE 7: PRESENTATION

The value engineering team will make its presentation of its findings and recommendations to the responsible authority. The initial presentation should be oral and supplemented by a concise written report.

PHASE 8: IMPLEMENTATION

Typically, this will be the joint responsibility of the value engineering team and the management of the LG. At this time they should decide which of the recommendations should be implemented, and develop a plan for doing so. Obviously, this is the most important phase and care must be taken to ensure that related factors are taken into consideration. These will include:

- How should they be implemented?
- What should be changed and in what sequence?
- Who should do it?
- How long should it take?
- Are there any deadlines?
- How much will it cost to implement?
- What are the consequences of delay?

The value engineering team—should be lead by a professional skilled in the subject. The team leader will be supported by a multi-discipline group of professionals reflecting the nature of the project. The designers should be represented at the workshop, but should not be members of the value engineering team itself.

Potential “roadblocks”—Value engineering is innovative and creative. Although it is a technique, which has the potential for saving LGs substantial sums of money and creating better investments, it is often subject to criticism and resistance. The following is a list of typical “roadblocks” which the value team will probably meet, and have to overcome

- “We have always done it this way.”
- “It will take too long.”
- “The LG has plenty of money.”
- “Why change?”
- “The plans and specifications say so.”

- “Safety is at stake.”
- “It’s never been done that way before.”
- “We have the best system already.”
- “The idea is too radical.”
- “It’s not feasible.”
- “It’s impossible,” and
- Pride of ownership/ authorship.

REAL ESTATE ANALYSIS

In countries around the world, LGs are in the position of owning real estate. To attract private capital from banks, institutional investors, or individual investors, they must be prepared to follow the same real estate analysis that would be done in the private sector. LGs must be careful to accurately value both the costs and the benefits of development.

WHAT IS REAL ESTATE INVESTMENT ANALYSIS?

Real estate investment analysis is a process of evaluating the risks and returns of a long-term investment in income-producing real estate. The “development budget” is one component of a real estate investment analysis.

The private sector investment process is driven by the financial return on investment, which is dependent upon the ability to rent or sell the property.

WHEN IS THE DEVELOPMENT BUDGET PREPARED?

Like the public sector, the development budget is estimated in advance by the developer, depending upon the demand for the property type and the financial sources available. A change in the development budget will impact the financial return to the investor, and therefore there is a need to control the budget.

WHOSE PERSPECTIVE IS IMPORTANT TO CONSIDER IN A REAL ESTATE ANALYSIS?

A supply and demand analysis of real estate services is required from two perspectives:

- Tenant’s perspective. Customer preferences for services and ability to pay for them (demand), as well as existing and competing projects (supply). Viewing the investment from the tenant’s perspective helps the investor determine the expected net income, and any variations during the period of ownership.
- Equity investor’s perspective. The equity investor must analyze the expected future income (from rental and future disposal) of the property. This analysis includes calculating the expected income, and what risk is associated with it in the future. Market analysis helps determine the relationship between value, risk, and cash flow from the investment.

WHO NEEDS TO PERFORM AN INVESTMENT ANALYSIS?

Banks, private investors and institutional investors, will require feasibility analysis to evaluate returns on their investment, and the risks associated with those returns.

WHAT IS THE INVESTMENT DECISION MAKING PROCESS?

There are five basic steps in the decision making process:

- **Step 1:** Identify goals, objectives, and constraints of the various participants in the investment process that an investment must satisfy in order to be acceptable. These will include:
 - Equity investor,
 - Mortgage lender,
 - Tenant, and
 - Government.
- **Step 2:** Analyze the overall investment environment in which the investment decision must be made:
 - The market,
 - The legal background, and
 - The socio-political situation.
- **Step 3:** Forecast the future benefits and costs (cash flows) arising from the ownership of the investment. This will include:
 - Cash flow from operation,
 - Potential gross income,
 - Effective gross income,
 - Net operating income,
 - Before tax cash flow,
 - After tax cash flow, and
 - Cash flow from reversion.
- **Step 4:** Apply criteria for decision making.
- **Step 5:** Perform discounted cash flow analysis.
- **Step 6:** Accept or reject the investment.

WHAT ARE THE STEPS IN A REAL ESTATE MARKET ANALYSIS?

There are five essential steps in a Real Estate Market Analysis:

- **Step 1:** Delineate the market area
- **Step 2:** Analyze the demographic characteristics:
 - Historical population growth

- Estimated future population growth
 - Age distribution
 - Number of households
 - Location preferences
 - Typical size of units
 - Amenities and building services provided
- **Step 3:** Consider factors influencing demand for real estate:
 - Employment trends
 - Income data
 - Economic base of the neighbourhood
 - **Step 4:** Analyze supply side of the market:
 - Building and construction market
 - Housing market trends
 - Mortgage market trends
 - Inventory of existing competition
 - **Step 5:** Investigate political and legal conditions
 - Land use planning
 - Zoning
 - Building Codes
 - LG services
 - Ecological considerations
 - Property taxes

Factors to Consider in a Real Estate Market Analysis Report

Specify research direction:

- _____ What decision is the investor trying to make?
- _____ What are the investor's goals and objectives?
- _____ Include both primary and secondary data:
- _____ Primary data helps the investor determine the tastes and preferences of the particular segment of the real estate market to which an investment is aimed. It includes investor surveys, vacancy surveys, rental rates, tenant profiles, and operating expense levels of competing investments.
- _____ Secondary data is collected for some purpose other than the immediate study. It is collected from the census bureau, trade associations, and planning agencies. Because of its more general nature, its major weakness is that it frequently does not fit the investment process very precisely.

Include and consider economic indicators: _____ Local economies are typically interdependent with regional and national economies, and some rental markets are greatly influenced by changes in economic conditions.
Explain statistics: _____ How do the statistics relate to the investment decision?
Specify supply and demand: _____ What is the market? _____ What segment of the market does the project serve? _____ How does the project compare with competing projects?
Correlate supply and demand: _____ Supply and demand factors should show expected rent levels, property values, and vacancy rates.

The investor must make a quantitative decision regarding the ability to rent the investment.

THE FINANCIAL ANALYSIS

The investor / developer will prepare a financial analysis which has three components:

- Developer's pro-forma: a one-year's analysis of income, expenses, debt service, and cash flow.
- Project budget: acquisition costs, construction costs, and associated fees.
- Five to ten year forecast of income, expenses, debt service, and cash flow.

DEVELOPMENT PRO-FORMA

The developer / investor will analyze the cash flow from operation of the stabilized year. Important calculations and ratios are:

- Net operating income—(Estimated rent per unit x number of units) - (vacancy + bad debt allowance) + miscellaneous income - operating expenses).
- Operating expenses—Expenses to the owner of the property, including management fee, utilities for common property, and property taxes.
- Debt coverage ratio—One criterion banks and other lending institutions use to estimate the maximum amount of a loan for a real estate property is the "debt coverage" ratio. The debt coverage ratio is the net operating income divided by the debt service. Typical debt coverage ratios range from 1.15 to 1.5 for large income producing properties. The ratio varies depending on the type of the project, the developer's reputation with the lender, and the lender's assessment of the risks involved in the particular project.
- Debt service—The debt service is the payment to the lending institution and includes both the interest payment and amortization (repayment) of the original loan.
- Before tax cash flow—Net operating income - debt service.
- Debt financing—This is the total loan amount and is dependent upon the length of the loan period (term), interest rate, and debt service.
- Equity requirement—Equity required = development cost - debt financing.

The development cost (project budget) must be estimated to calculate how much equity investment is required.

THE PROJECT BUDGET

The project budget has three main components.

- **Acquisition, land and land development costs**—In the case of a renovation project, (e.g., an office building or an apartment building), the project budget must include the existing building and land acquisition costs. In the case of new construction, the land cost is included in the budget. The cost of utilities (water, sewer, electricity, gas, etc.) to the site, may be paid by the LG, but often the infrastructure is paid by the developer / investor, and is called “land development costs.”
- **Construction costs**—These will be calculated in exactly the same way as previously discussed.
- **Soft costs**—These are fees for financing of the development, architecture / engineering, legal, development management, project management, marketing. These costs are typically between 15% and 50% of the project budget. They are less predictable than the construction / hard costs, and are largely influenced by the strategies of the developer / investor.
 - A. **Architecture / engineering fee**—Usually calculated as a % of the construction cost. Typical fees are in the range 4% - 6% for new construction and 6% - 10% for renovation projects, and depending on the size of the project.
 - B. **Legal fee**—Legal fees are dependent upon the complexity of the project, and can vary from 1% - 10% of the project costs.
 - C. **Project management fee**—The project manager is responsible for the day-to-day management of the project. He is the key point of contact for government officials, the architect, and the contractor. The project management fee is typically between 3% - 5% of the project costs.
 - D. **Developer fee and profit**—The development fee is a component of the budget, which should be negotiated in advance. It includes the fee and / or, profit, which are to be paid to the developer during project development, usually at project completion. This is exclusive of any proceeds which may be paid to the developer after project completion, and which are dependent upon the financial performance of the investment.
 - E. **Marketing fee**—To sell property in the U.S., brokers will receive a fee in the range of 3% - 7% of the sale price. Your country may also have this business custom.
 - F. **Financing fees**—These are the fees paid to brokers for land and building purchases before construction, and the fee paid to obtain the construction financing. Note also that construction financing usually has a higher interest rate (usually several percentage points) than the permanent financing interest rate, and is related to the higher risk involved. The financing fee can be divided into two components:

1. **Land and existing building financing**—Purchase of land is usually well in advance of construction, and therefore the financing for land (and building, if it is a renovation project) will be for a longer term than for the construction financing. Developers typically try to minimize this portion of the financing by structuring an agreement or “option” to buy the land in the future, for an established price.
2. **Construction financing**—This is based upon the construction costs, and some of the “soft” costs (usually architectural, legal, and project management fees). It is based upon the length of construction, the financing rate, and the disbursement rate of the funds. Since the timing / need for funds occurs throughout the length of the project, the entire amount is not borrowed at the outset, and the money is disbursed by the lender in phases.

CASH FLOW ANALYSES

The developer must analyze the project cash flow, to determine the proceeds available to pay back the equity investors. The cash flow for the investment will determine the return to the investors.

The cash flow analysis will comprise:

- The initial investment,
- Yearly cash flow from operations,
- Cash flow from reversion (future sale), and
- Income from reversion (sale).

One method of estimating the proceeds from a future sale of real estate is by capitalizing the net operating income:

$$\text{Value} = \text{Net Operating} / \text{Capitalization Rate.}$$

Capitalization rates can be derived by analyzing the ratio of net operating income to the value of other current transactions.

Discounted Cash Flow Models

The return on an investment in real estate may be measured as a series of cash flows plus a “reversion” at the end of the investment period, when the project is sold to someone else. Most investors use a “discounted cash flow” model as a basis for decision making. To develop a cash flow model, future cash flows need to be forecast, then discounted at the required rate of return. Discounted cash flow models recognize that a Euro today, is worth more than a Euro tomorrow. Two models are used to calculate and evaluate the discounted cash flow:

1. **Net present value (NPV) method**—When making a net present value calculation, the investor needs to select a “discount rate” equal to the minimum rate of return desired on the investment. If the calculation results in a positive net present value, the rate of return is higher than the minimum acceptable, and the investment would therefore be considered worthwhile.
2. **The internal rate of return**—The internal rate of return is the rate, which makes the present value of future cash flows equal to the initial equity investment.

Comparison of Two Investments Using the Net Present Value Method

Discount rate 16%			Initial Investment EU 18,165	
Year	Investment 1 Annual Cash Flow	Present Value	Investment 2 Annual Cash Flow	Present Value
1	900	776	2,000	1,724
2	900	669	2,000	1,486
3	700	448	2,000	1,281
4	2,000	1,105	2,000	1,105
5	1,565	745	2,000	952
6	1,543	633	2,000	821
7	2,000	708	2,000	708
8	2,637	804	2,000	610
9	2,408	633	2,000	526
10	3,515	797	2,000	453
Reversion	56,000	12,694	46,000	10,427
Totals	74,168	20,012	66,000	20,094
		(18,165)		(18,165)
	Net Present Value	1,847		1,929

It can be seen from the example above, that Investment 2 has a higher net present value, and would therefore be considered the best investment.

PART TWO: MANAGEMENT TOOLS

PURPOSE

Capital investment planning is the systematic practice of anticipating and budgeting for important infrastructure restoration, replacement or expansion consistent with the financial capabilities of a local government. A principal obligation of local self government is to provide and maintain a safe and serviceable infrastructure to support the delivery of essential public services or to generate income to pay for these services. Whether included as a part of the annual operating budget or as a separate document, the one-year capital budget of a LG is important as a planning tool for scheduling and financing essential public projects. In addition, local governments that engage in capital investment planning and budgeting are likely to have their capital fund requests viewed with greater favour by “business- minded” lending institutions.

The infrastructure of a community consists of its capital assets—roads, bridges, water systems, drainage structures, sewerage works, parks, and various public-owned buildings. As the infrastructure ages, becomes obsolete, or suffers from wear and tear, decisions must be made about the investment of public funds for its restoration or replacement. Public agencies throughout the world invest large sums of money each year in public works construction. Ineffective procedures for managing construction costs can lead to cost overruns and subject government to public criticism for what is viewed as the unwise investment of public funds. There is a universal need for improvement in managing the cost of investments in public works projects, particularly in transition countries with inadequate record keeping systems and information for realistic capital budgeting.

This workshop is intended to provide local officials with the ability to plan and recommend priorities for financing the restoration, replacement, or expansion of essential capital facilities. It is also intended to assist local government officials in establishing effective procedures for cost management throughout the construction cycle and provide them with the tools for planning and managing public work projects.

Don't forget to look back at the Learning Applications! Many of them can be easily adapted for group exercises and may be more appropriate for persons who are just being introduced to the concepts of capital investment planning.

CONTENTS

A brief description of each learning activity is shown below with an approximation of the amount of time required. If you wish to change the order, to omit something, or to add training material of your own, feel free to do so.

7.1 WARM-UP EXERCISE: ROADBLOCKS TO CREATIVITY

Participants take part in an introductory exercise that explores typical barriers to creative thinking in organizations including their own local governments. (30 minutes)

7.2 WARM-UP EXERCISE: WHICH AUTOMOBILE TO BUY

Participants consider purchase alternatives and make a decision based on a determination of the best long-term value. (20 minutes)

7.3 TRAINER PRESENTATION

Brief concept presentation based on the preceding essay that describes capital budgeting as an important planning tool for the development, preservation and restoration of essential capital facilities. (30 minutes)

7.4 EXERCISE: DEVELOPING CAPITAL BUDGET POLICIES

Participants, in small groups, write policy statements that are suitable for adoption by their local governments to guide the adoption, development, and implementation of a capital budget. (60 minutes)

7.5 EXERCISE: THE CASH FLOW DILEMMA

Participants, in groups, analyze a project with a serious cash flow deficiency to draw conclusions and propose remedies. (60 minutes)

7.6 EXERCISE: INFRASTRUCTURE CONDITION ANALYSIS

Participants explore various methods for obtaining data on the condition of the infrastructure in their communities using a checklist and tasks provided by the instructor. (90 minutes)

7.7 EXERCISE: VALUE MANAGEMENT

Participants work individually and in small groups to decide on which vendor to use for a high cost purchase using multiple criteria and matrix analysis. (180 minutes)

7.8 ROLE PLAY/CASE STUDY: BETTER ROADS FOR POSHENKO

Participants role play a situation involving finance board deliberation on project priorities for capital facility financing presented by the finance director and discuss implications of the case for their own local governments. (120 minutes)

7.9 ROLE PLAY EXERCISE: THE CHANGE ORDER REQUEST

Participants take part and observe a role play involving a dispute over a contractor's claim for a change in the scope of a road and bridge construction contract. (90 minutes)

7.10 CLOSING EXERCISE: LEARNING TRANSFER

Participants reflect individually on what they have learned and make commitments to put it to use back home after the workshop. (30 minutes)

7.1 WARM-UP EXERCISE: ROADBLOCKS TO CREATIVITY

TIME REQUIRED:

30 minutes

PURPOSE

Enable participants to recognize barriers to the introduction of new concepts or ways of doing things within local government organizations.

PROCESS

Introduce the exercise by pointing out that, in many organizations, creative thinking and new ideas are blocked by the law, local policy, custom, tradition, conventional thinking, or the organization's culture overall. Sometimes the barriers are inadvertent such as the belief that something can't be done for no other reason than it never has. Sometimes they are purposeful such as legal prohibitions or strong traditions that support existing work practices. Then, on a chart pad, write this question:

What barriers prevent our local government from being fully open to the introduction of new concepts, policies, and work practices?

In groups of five or six, ask participants to think of as many answers to this question as they can. Their responses will likely include such things as:

- National government
- The law
- Mayor
- Governing body
- Custom or tradition
- Lack of skills
- Employee resistance
- Cost

After about ten minutes, ask each group to appoint a spokesperson to identify a few of that group's barriers. After these barriers have been identified, ask each group to go through its own list and identify which of the items on the list actually are under their own control as opposed to the control of others.

Following this group activity, engage participants in a discussion using all of some of these questions:

- Were you surprised to see such a long list of barriers?
- For those items over which you have some control, what might be done to reduce them as barriers?

- For those over which you have little or no control, what might be done to alleviate or work around them?

7.2 WARM-UP EXERCISE: WHICH AUTOMOBILE TO BUY

TIME REQUIRED

20 minutes

PURPOSE

Introduce participants to the issues involved in cost control and management by engaging them in a familiar purchase decision.

PROCESS

Tell participants that getting the most value for the least cost over time is an important objective in personal planning as well as public works planning. To illustrate the principle, handout copies of the purchase problem shown on the next page.

Give participants about 10 minutes solve the problem. Ask volunteers to disclose their answers. After several volunteers have given their answers, give the correct answer: Automobile 1. Ask participants what can be learned about managing the cost of public work projects from this simple exercise. Encourage a discussion.

Which Automobile Would You Buy?

Imagine that you are about to purchase an automobile. The choices have narrowed to two automobiles that are equal in almost every respect. Your objective is to purchase the automobile that will cost you the least to own and operate over the next five years. Based on your driving experience during the last five years, you expect to put 12,000 miles per year on your next automobile. In comparing the two automobiles, you consider these facts.

Alternatives	Purchase Price	Service Cost	Fuel Expense
Automobile 1	\$ 29,500	4 year full warranty or 50,000 miles, whichever comes first; average service cost of \$150/month thereafter	20-mpg average. Automobile 1 uses premium grade fuel at a cost of \$2.50/gallon
Automobile 2	\$ 27,500	1 year full warranty; average service cost of \$130/month thereafter	25-mpg average. Automobile 2 uses medium grade fuel at a cost of \$2.30/gallon

Which of the two automobiles would be the best buy considering your purchase objective?

7.3 EXERCISE: TRAINER PRESENTATION

TIME REQUIRED

30 minutes

PURPOSE

This presentation is to provide participants with ideas and perspectives on capital investment planning and capital budgeting as a conceptual foundation for the exercises included in this workshop.

PROCESS

Prepare the presentation based on information covered by the preceding essay on capital budgeting. Emphasize the need for a policy base to support the practice of long-range capital planning and financing. Describe the various methods for compiling and maintaining information on capital facility condition as a basis for planning. And discuss priority setting and agreeing on a long-range financial plan for infrastructure improvement, replacement, or restoration.

Outlined information on note cards may help you cover the information systematically and stay on schedule. Ask questions from time to time during the presentation as a check on participant comprehension and to hold their attention. Augment the presentation with visual aids including pre-printed newsprint sheets and overhead transparencies as a further aid to comprehension.

7.4 EXERCISE: DEVELOPING CAPITAL BUDGET POLICIES

TIME REQUIRED

90 minutes

PURPOSE

This exercise is to give participants experience in identifying areas of needed policy development and skill in writing specific policy statements on the adoption, development and implementation of a capital budget appropriate for use by their respective local governments.

PROCESS

Give each participant a copy of the following worksheet. Explain that the worksheet is designed for their use to compile information on capital investment planning and budgeting policies that may have been or should be adopted by the local governments being served by participants. After this introduction, ask participants to complete the worksheet following instructions. Give participants about 30 minutes to complete the worksheet.

When participants have completed their worksheets, assign them to small groups of about five to six. Ask participants in each small group to compare individual results of the worksheet exercise and to prepare a group list of suggested policy statements that they agree would be of benefit to their local governments in preparing and implementing a capital budget. Ask each group to write the resulting policy statements on a chart pad for ease of presentation. Allow the groups about 30 minutes to complete the assignment and report back.

When all of the groups have returned, ask for reports from each group and engage participants in a discussion focused on the implications of the exercise for the adoption and use of capital budgeting policies like these by their local governments.

Worksheet – Developing Capital Budget Policies

Instructions. This worksheet includes examples of policies on capital investment planning and budgeting. The policy statements are intentionally broad and general. However, they are believed useful as formats for the design of more specifically worded policies suitable for use by the local governments with which you and your colleagues are associated. Read and discuss the first policy statement. After reading it, answer each of the questions about the policy including how it might be revised or reworded to have value as a guide for capital investment planning and budgeting by your local government. Continue in this way until you have responded to all of the policy statements on the worksheet. Complete the worksheet by indicating any other subjects for policies on capital investment planning and budgeting.

Policy Statement No. 1

Our LG will project future operating costs associated with new capital projects and will include them in long-range budget forecasts.

My government has a policy similar to this Yes ____ No ____

If “yes,” go on to Policy Statement No. 2.

If “no,” do we need such a policy? Yes ____ No ____

If “yes,” I would prefer this wording.

If “no,” my reasoning is as follows.

Policy Statement No. 2

Our LG will develop and follow multi-year maintenance and replacement schedules.

My government has a policy similar to this Yes ____ No ____

If “yes,” go on to Policy Statement No. 3.

If “no,” do we need such a policy? Yes ____ No ____

If “yes,” I would prefer this wording.

If “no,” my reasoning is as follows.

Policy Statement No. 3

Our LG will allocate ____% of its general operating fund revenues for cash capital investments.

My government has a policy similar to this Yes ____ No ____

If “yes,” go on to Policy Statement No. 4.

If “no,” do we need such a policy? Yes ____ No ____

If “yes,” I would prefer this wording.

If “no,” my reasoning is as follows.

Policy Statement No. 4

Our LG will develop a multi-year plan for capital improvement projects, update it annually, and make all capital investments in accordance with the plan.

My government has a policy similar to this Yes ____ No ____

If “yes,” go on to Policy Statement No. 5.

If “no,” do we need such a policy? Yes ____ No ____

If “yes,” I would prefer this wording.

If “no,” my reasoning is as follows.

Policy Statement No. 5

Our LG will develop criteria to evaluate and prioritize each capital project.

My government has a policy similar to this Yes ____ No ____

If “yes,” write additional policy statements in the space below.

If “no,” do we need such a policy? Yes ____ No ____

If “yes,” I would prefer this wording.

If “no,” my reasoning is as follows.

My local government has adopted or should adopt additional policies on capital investment planning and budgeting such as the following:

7.5 EXERCISE: THE CASH FLOW DILEMMA

TIME REQUIRED

60 minutes

PURPOSE

This exercise is to provide participants with practice recognizing and analyzing the implications of a cash flow deficiency for the ultimate success or failure of a project.

PROCESS

Ask participants to recall the discussion during the preceding presentation on the importance of project monitoring for contract compliance and cost control. Give each participant a sheet of paper containing a copy of the figure drawn on the next page. Explain that the figure is meant to compare “actual” with “planned” cash flow on a sizeable project over the first ninety days. The planned duration of the project is five months.

Give participants a few minutes to review the chart. When everyone appears to have completed the task, ask participants to form into several small discussion groups to answer the following questions:

1. How would you appraise the progress of this project from the information presented in the chart?
2. What are the implications of this appraisal for the ultimate success of this project?
3. What action or actions might or should have been taken and when to keep this project on schedule?

Give the small groups about 20 minutes to answer the three questions. At the end of this time, ask each group to share its answers to each of the three questions. Ask a final question to finish the exercise. What can be learned from this discussion about the role of local government in ensuring contract compliance with respect to performance, quality, and cost? Discussion.

7.6 EXERCISE: INFRASTRUCTURE CONDITION ANALYSIS

TIME REQUIRED

90 minutes

PURPOSE

To prepare participants to conduct a condition assessment of the infrastructure in their communities.

PROCESS

Give participants a copy of the *Infrastructure Condition Checklist* (next page) and ask them to complete the checklist following the instructions.

When participants have completed the checklist, divide them into small groups of five or six. Ask participants in each small group to compare their responses to the checklist and to complete the following group tasks:

Identify methods for assessing the condition of capital facilities that are being under-utilized by participating local governments and specify ways that these methods can be used more efficiently in the future.

Identify methods for assessing the condition of capital facilities that are not being used at all and determine what can be done by local governments to begin using them.

Give small groups approximately 45 minutes to complete these tasks. When they have reassembled, ask each small group for a report. Conclude with a general discussion of condition analysis and why it is an essential step in selecting priorities for the capital budget.

Infrastructure Condition Checklist

Instructions. This checklist is designed to assist you in identifying appropriate ways to assess the condition of various components of your community's infrastructure as a basis for setting priorities for improvement, restoration, or preservation. Three types of infrastructure are listed in the first column. Opposite each type are several methods of assessing its condition. The final three columns are for your use to identify if your local government either "uses now," "does not use, but should," or "does not use and can't" for each of the methods. Place the check marks where they apply for your local government for each of the three infrastructure types on the checklist. You have completed the checklist when you have checked one of the three responses for each method in each of the infrastructure-type categories.

Infrastructure Type	Condition assessment practices	We do this Now	We don't do this, but should	We don't do this and can't
1. Roads, bridges, traffic lights, culverts	Visual inspections by staff or consultants.			
	Engineering analysis and technology.			
	Repair type, cost and frequency analysis.			
	Complaint and service interruption analysis.			
	Review of capital facility planning studies.			
	Comparison with service/industry standards.			
	Data from citizen surveys.			
	Other			
2. Underground facilities (water lines, sewer lines, storm water lines)	Visual inspections by staff or consultants.			
	Engineering analysis and technology.			

3. Public building and other physical assets	Repair type, cost and frequency analysis.			
	Complaint and service interruption analysis.			
	Review of capital facility planning studies.			
	Comparison with service/industry standards.			
	Data from citizen surveys.			
	Other.			
	Visual inspections by staff or consultants.			
	Engineering analysis and technology.			
	Repair type, cost and frequency analysis.			
	Complaint and service interruption analysis.			
	Review of capital facility planning studies.			
	Comparison with service/industry standards.			
	Data from citizen surveys.			
	Other.			

7.7 EXERCISE: VALUE MANAGEMENT

TIME REQUIRED

180 minutes

PURPOSE

This exercise is to provide participants with practice in analyzing the relative value and worth of high cost acquisitions.

PROCESS

Tell participants they will be working for in small groups on a task designed to simplify the analysis of complex issues. Explain that cost is not the only consideration in many public acquisition decisions where a number of variables may be involved. Use the example of buying oranges. If price were the sole criterion, then a simple review of prices at different stores would readily identify the best buy and justify a purchase decision. If, however, such factors as shape, sweetness, ripeness, juiciness, proximity of the store, etc., are important, then a decision may take considerably more evaluation. Give each participant a copy of a handout labelled *Exhibit A*. Ask them to read the handout. Explain that the situation in the handout is meant to demonstrate the principles of matrix analysis using a simple illustration—choosing a vendor for oranges.

After reviewing the example in *Exhibit A*, give participants copies of the handouts labelled *Exhibit B*. Divide the participants into small groups and tell them to read the instructions on the front page of the exhibit and then to perform the task described. Give the small groups about ninety minutes to complete the task and to report back for a discussion of results.

After ninety minutes, participants return. Ask a representative from each group to describe the group's results and the process followed by the group in completing the task. When all groups have reported, explain that the exercise was intended to demonstrate how multiple factors associated with complex decisions and their cost implications can be managed with proper planning. Finish by asking volunteers to critique the exercise and to give examples from their own work experiences where this kind of analysis would improve project cost management.

Exhibit A

Example—The situation in this example is about choosing the best vendor as a source of oranges. A decision could be made simply enough by selecting a set of criteria, weighting the criteria (say, on a scale of 1 – 5, where 5 is the highest value) and adding up the results as shown in **Figure A**. As the figure shows, Vendor 4 represents the best buy. However, the decision was made on an overall “best buy” basis rather than a more comprehensive criteria ranking process that takes into account the greater importance of some criteria than others. Moreover, only one person was involved in making the decision thus introducing individual bias and expectancy that might skew the results in a direction not in the overall best interests of the organization.

Figure A

Vendor	A Cost	B Size	C Sweetness	D Juiciness	E Store Loc.	Total Points
1	3	4	5	4	2	18
2	4	3	4	3	1	15
3	4	4	3	3	3	17
4	3	5	3	5	3	19

In complex decisions, it is seldom desirable to depend on a single decision source. The following matrix describes a simple but effective method for group decision making by allowing each individual to weight and rank criteria and to aggregate the results into a composite group result. There are several steps involved in this process that begins with individuals working separately.

Step 1. Based on self-evaluation and preference, each individual decision maker in the example compares A (cost) with B (size) and place the letter representing the more important in the upper left hand block of the matrix (**Figure B**). Add to the block the appropriate weight factor (e.g., 1, 2, 3). The weight factor is high (3) if the decision is urgent in nature and low (1) if the decision is not urgent. In the example, size (B) is considered more important than cost (A), and the decision is moderately urgent (2). The blocks in the matrix are filled in by comparing each of the criteria with all the others – e.g., A to C (cost with sweetness); A to D (cost with juiciness), and so forth – and adding the weight factor to each.

Figure B

	B	C	D	E
A	B2	A1	D3	E2
	B	B2	B1	B2
		C	C3	E2
			D	D2
				E

Step 2. When the matrix is complete, and all the criteria have been compared, each individual adds the weight factors for each criterion (e.g., totals the values of the As (3), Bs (9), etc.) and enters the results in the “weight factor” column in **Figure C**.

Figure C

Criteria	Weight Factor	
A (Cost)	1	
B (Size)	7	
C (Sweetness)	3	
D (Juiciness)	5	
E (Vendor Location)	4	

Step 3. Now that the criteria are weighted in order of preference, the analysis shown in **Figure A** can be re-evaluated by adjusting the original scores to reflect the Weight Factor for each criterion. The result is shown in **Figure D**.

Note that in this example, although Vendor 1 still represents the best buy, based on the expressed importance of the selection criteria, it is by a substantially enhanced margin, providing a much higher level of confidence in the decision.

Figure D

Vendor	A Cost x 1	B Size x 7	C Sweet x 3	D Juice. x 5	E Loc. x 4	Total Points
1	3	28	15	20	8	74
2	4	21	12	15	4	56
3	4	28	9	15	12	68
4	3	35	9	25	12	84

When each individual has completed the ranking process as shown in Figure D, the results can be combined with the results of other individuals who are also doing the ranking to obtain a composite, group result.

Exhibit B

Instructions

Group Activity:

Step 1. Think of an example from the work experience of one of your local governments that involved deciding on the best source for a high cost acquisition. The situation should involve at least three competing vendors for the item under consideration. Use the example for the rest of this exercise.

Step 2. Having selected the high cost item and competing vendors, next choose a set of criteria by which to evaluate the suitability of each alternative source. Use the preceding example as a guide. You should agree on no less than three criteria.

Step 3. Draw a replica of **Figure 1** on a sheet of newsprint. List each vendor being evaluated by a number in the left column of the figure and identify by name the criterion you have chosen on the top row, also giving each criterion a letter designator (see the preceding example). Then, using a scale of 1 – 5, assign an appropriate weight to each criterion based on how well that vendor meets the criterion (e.g., 5 = vendor measures up extremely well; 1 = vendor measures up quite poorly). Total the weights for each criterion and enter the result in the far right column.

Figure 1

Vendor	A	B	C	D	E	Total Points
1						
2						
3						
4						
5						

Individual Activity:

Step 1. Based on personal evaluation and preference, compare criterion A with criterion B. Place the letter representing the more important in the upper left hand cell of the matrix in Figure 2. Add a weight factor (a scale of 1–3 with one being the lowest weight and three being the highest) to the letter. The magnitude of the weights should reflect how urgent it is to get the decision made - i. e., 3 = extremely urgent; 2 = somewhat urgent; and 1 = not at all urgent. Then compare A with C; A with D; and so forth always adding the appropriate weight factor. Continue until you have placed a letter and a number in each cell of the matrix.

Figure 2

	B	C	D	E
A				
B				
	C			
		D		
			E	

Step 2. When the matrix is complete, add the weight factors for each letter and total the values for criterion A, B, C, etc. Enter the sum for each letter in the column called “weight factor” to complete **Figure 3**.

Figure 3

Letter	Corresponding Criterion	Weight Factor
A		
B		
C		
D		
E		

Group Activity:

Step 1. Draw a replica of **Figure 4** on a sheet of newsprint. Total the weight factors assigned by each member of the small group for each criterion in the column labelled “Group Weight Factor.” Enter the ranking for each criterion based on the total group weights, the highest weight factor being #1.

Figure 4

Letter	Criteria	Weight Factor	Ranking
A			
B			
C			
D			
E			

Step 2. Draw a replica of **Figure 5** on a sheet of newsprint. Opposite each vendor, enter the weight assigned to each of the criteria multiplied by the weight from **Figure 1** given to that criterion for that vendor. Follow the same procedure for each of the vendors being evaluated. Then, add the weighted points for each criterion across and enter the total for each of the vendors. The vendor with the highest point score represents the “best acquisition” opportunity.

Figure 5

Vendor	A	B	C	D	E	Total Points
1						
2						
3						
4						
5						

7.8 ROLE PLAY / CASE STUDY: BETTER ROADS FOR POSHENKO

TIME REQUIRED

120 minutes

PURPOSE

Demonstrate the importance of compiling information on infrastructure condition as an objective basis for governing body decision making about priorities for capital financing.

PROCESS

Tell participants they will be taking part in a role-play/case-study exercise concerned with a finance committee of a governing body that is engaged in setting priorities for capital financing for the next three years.

Ask six participants to volunteer to take part in the exercise. Explain that three of the six will be assuming roles as members of a finance board of the governing body, one of the three being the board chairperson. A fourth participant will be the local government's finance director. The other two participants will be asked to observe the action and to complete worksheets for discussion of the process following the exercise.

Give each participant a description of the situation/task (see below); a copy of only the role each is to play and a sheet containing *Figures 1* and *2*. Give each observer a copy of all the handout materials plus the observe worksheet at the end of the exercise. Explain that the finance board's task is to act on recommendations of the finance director who has prepared a list of road reconstruction priorities for the LG's capital budget. Complicating the decision are differing opinions on the proposed priorities and one of the governing body members who each has a personal interest in getting a "pet" project included on the priority list. Give role players about 15 minutes to prepare for the exercise.

While role players are preparing for the exercise, ask participants who are not playing roles to set up the room in conference style with a couple of chairs to the side for the observers and a chart pad on an easel. Chairs for non-participants should be arranged in a circle around the conference table.

When participants are seated and ready to begin, tell them they have 20 minutes to agree on a project recommendation for District A. At the end of 20 minutes, call time and ask for reports from each of the role players on their reactions to the process and the outcome. Ask for reports from each of the observers based on information from their worksheets. Then lead a discussion of the exercise using the following or other questions of your own:

- What value was the condition analysis information in helping the board members make a decision?

- What political factor or factors complicated the decision?
- How might your own governing body make use of condition analysis information to decide on capital budget priorities?

THE SITUATION

The governing body of Poshenko earlier this year adopted a policy calling for major restoration and replacement of the municipal road system. The policy was adopted in the aftermath of a bitter governing body election during which the condition of roads in the LG was one of the principal issues.

Much of the municipal road system is more than 40 years old. Many streets, designed for small, light-weight vehicles, now are cracked, uneven, and filled with “pot holes” owing to the weight of modern trucks and busses. Nearly one-third of the municipal roads, located mostly within residential areas, have never been paved and are the source of choking, eye-watering clouds of dust every day during heavy traffic periods. When the LG undertook roadwork during the term of the last governing body, the beneficiaries were only those citizens who had contributed heavily to the campaign of the current governing body. As a result, it was not unusual to see a road crew working on a relatively trouble free section of road in front of or leading up to a structure owned by a governing body patron while ignoring an obviously hazardous or seriously deteriorated road segment nearby.

“Outrageous,” proclaimed the editor of Poshenko’s daily newspaper in a scathing editorial. Her charge led to a series of investigative reports that clearly exposed the abuse of power by the mayor and governing body. The revelatory reports were influential on local voters who removed from office the mayor and members of the governing body most closely associated with the road scandal.

The new mayor and several of the new governing body members were quick to promise major improvement to the LG’s decrepit road system based on need rather than favouritism. At a recent meeting, the governing body committed itself publicly to implement a policy to widen, as needed, replace or rehabilitate every kilometre of road within the municipal limits on a priority basis within five years. As a first step, the mayor has assigned the task of developing a street improvement plan and capital budget to the governing body finance board with the assistance and support of the finance director.

For the last three years, the finance director has been compiling data on the municipal road system in Poshenko. The data has been collected using a combination of physical inspection of road conditions, interviews with experienced road crew personnel and rigorous review of road construction/ repair records. Using a commercial software program, the director’s staff systematically has been entering width, age, condition, and usage information on road segments throughout Poshenko. Recognizing that the existence of a database on local road conditions might have been threatening to the former mayor and governing body and could have placed her job at risk, the finance director did not mention it until the new governing body was elected. She sees the database now as a valuable asset for the current finance board, useful to them in making choices among competing demands for limited construction and

maintenance funds. The finance board is meeting this evening to discuss priorities for road reconstruction to recommend for inclusion in Poshenko's capital budget for the next fiscal year. From the database, the finance director has prepared a report containing a list of road reconstruction priorities (see *Figure 1*) and selection criteria which were approved by the entire governing body two weeks before (*Figure 2*).

1

Figure 1
Poshenko LG Road Status Report
District A Road Listing

Road	From	To	Traffic cc date	Traffic Count	Total Meters	Cost (EU millions)
Adorf	Newberg	Milan	A	60	162	2.17
Adorf	Newberg	End of road	A	100	180	2.62
Braun	Tabors	Krupke	C	300	252	2.89
Braun	Freiberg	Limerick	D	600	297	9.60
Dobrin	Lurban	Lewin	B	30	135	.94
Friendland	Habana	Turnov	A	20	180	1.22
Friendland	Habana	End of road	A	60	225	2.08
Heidnau	Luchen	Platna	C	90	360	4.71
Liebau	Ledoc	Placov	B	400	369	1.88
Neratov	St. Bolos	Lysia	A	50	180	1.67

Figure 2
Criteria for Selecting Road projects

Criterion 1—The road must carry a condition code (cc) of either C (fair) or D (poor). This criterion is assurance that roads which are in the worst shape are first in line for governing body attention.

Criterion 2—The road must carry a traffic load of not less than 500 vehicles per day. This criterion qualifies roads targeted for reconstruction as sufficiently travelled to justify the cost to rebuild them.

Criterion 3—The road must not exceed 300 meters in length. This criterion is intended to spread out the available funds over as many deserving road projects as possible.

The Task

The governing body finance board is meeting to reach a decision on which road projects to recommend for financing in the first year's road reconstruction plan. The board has requested the finance director to provide road status reports on six geographic districts of the LG. From each report the board intends to select the roads which meet the three criteria for deserving road projects and to recommend as many of these for the first year's capital budget as the LG is capable of supporting financially.

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- 1 Figures 1 and 2 above were inspired by ideas published in Tees, David W. and Seidel, Andrew D. *Texas Cities in the Microcomputer Age* (Arlington, TX: The University of Texas at Arlington, 1985), pp. 47-8.

The meeting begins with an opening remark from the chairperson on the purpose for the meeting who turns the meeting over to the finance director to present the report for District A.

Role No. 1: Eva

You were appointed director of finance for Poshenko about five years ago. Trained in governmental accounting and a shrewd budget planner, you are ready and able to manage the financial affairs of the LG in an exemplary manner. You were thrilled with the recent election results. Few of the old governing body members recognized or cared about your capabilities as a financial manager. Rather, most members of the governing body, in your view, were selfish, politically motivated, and interested only in capital investments that would bring financial gain to themselves or their political benefactors.

It has been hard for you to conceal your dismay over the governing body's disdain for financial planning and particularly its indifference to the community's failing infrastructure. You are hopeful that the election will usher in a change in philosophy about long range budget planning, but you are aware that only a slim majority of the new governing body shares your interest in a more professional approach. You feel that you must continue to be cautious when making proposals on priorities for capital financing.

Role No. 2: Viktor

A long-term member of the governing body, you have earned the right to chair this prestigious finance board. You have never profited personally from any governing body decision and do not condone the actions of many of your former governing body colleagues. More of the governing body's attention, you believe, must be devoted to budget planning, and more public money must be spent to preserve or restore the LG's failing infrastructure. However, you are painfully aware that there is still sentiment on the governing body to use public funds to reach political objectives. And there is no doubt in your mind that your influence on the governing body depends on your continuing to be a moderate, taking a "let's not rock the boat" position on potentially heated issues like those facing the board today.

Role No. 3: Robert

This is your fifth term on the governing body. You have survived the challenges of the recent election despite your close association with many of the governing body members who lost seats on the governing body. From a poor family with few opportunities to achieve financial success in life, you have worked hard to rise from your humble beginnings by building a constituency of influential friends and patrons. Their continued support of you has allowed you to retain your seat on the governing body. In turn, you have repeatedly used your influence on the governing body to channel public funds to projects in which they had an interest. As a member of the finance board, you have been able to influence where public money is spent. One of your friends who lives in District A has asked you to "do what you can" to speed up the process of reconstructing a segment of road serves his factory (Braun from Tabors to Krupke). You have seen the finance director's list of District A road projects that

includes this road segment as well as the selection criteria. You are determined to have this project emerge from the discussions as the board's choice for District A.

Role No. 4: Elena

This is your first term as a member of the governing body. Your appointment to the finance board has come about because of your background as a bank officer and investment planner. You strongly support the philosophy of long-range planning for the investment of public funds in capital facilities. In fact, you were responsible for the wording of the five-year road improvement policy statement recently adopted by the governing body and have decided to support the finance director's recommendation on project priorities. You are a strong willed individual, never one to back away from a fight. However, you are politically inexperienced and lack the political adroitness possessed by your colleagues on the finance board.

Observer's Worksheet

1. What decision did the board make?

2. What influence did each of the parties have on the board's decision (Eva, Viktor, Robert, Elena)?

3. How important was the existence of a priority list and criteria on the board's decision?

7.9 ROLE PLAY EXERCISE: THE CHANGE ORDER REQUEST

TIME REQUIRED

90 minutes

PURPOSE

This exercise is to help participants gain experience making decisions that involve changing the conditions of an existing construction contract.

PROCESS

Explain that participants will be involved in a role-play exercise that involves a contractor who is asking for an adjustment in a construction contract that would increase the cost. Explain further that one group of participants will be assuming roles as members of the LG's project management team. A second group of participants will be assuming roles as members of the contractor's project team. A third group will be assigned observer roles. Describe the role-play, as a meeting between the two groups during which the contractor will argue for the change and officials of the LG will respond.

Divide the participants group so that two teams of about three to five participants each represent the contractor and municipal teams respectively and the remaining participants are assigned to observer roles. Give all participants copies of Handout No. 1, "The Situation." Give copies of Handout No. 2 to members of the group assigned to play roles in the municipal project management team and Handout No. 3 to members of the groups assigned to play roles in the contractor project team. Observers should be given copies of Handouts 4 and 5.

When all participants have a copy of the situation and their respective role sheets, assign the role playing groups to separate work areas to read their role sheets, discuss their positions and develop strategies for their meetings with one another. Suggest that each of the role playing groups select one of its members to serve as principal spokesperson for the team. Give these groups about 30 minutes to develop their positions and strategies.

While the role-playing groups are at work, rearrange the tables and chairs in the training room to resemble a conference room. Some of the observers can be recruited for this task. Set up the tables so that all members of the two teams can be seated at the table and observers can be seated in chairs behind but in easy view of the role players.

At the end of 30 minutes, ask the participants playing roles on the municipal project management team to come back to the training room and be seated at the conference table. When these officials are ready to begin, ask the participants who are playing roles on the contractor project team to come in and seat themselves at the table. Instruct both teams to get started.

After about twenty minutes, end the meeting. Ask for reactions and comments from the role players, beginning with those playing roles as members of the municipal project management team. Follow this by reactions and comments from the contractor project team role players. Finally, ask observers for their comments on the exercise with reference to their observer worksheets.

Conclude the exercise by emphasizing the importance of including language in construction contracts that provides guidance for handling changes in the scope of work. In that regard, ask participants how their municipalities handle requested changes in the scope of contract work and how situations like the one that occurred in this situation can be avoided.

Handout #1 – The situation

Two months ago, a LG entered into a construction contract to build a 30km highway. The planned construction included three bridges. The contract is for a fixed amount and includes provision for adjustment should there be an announcement from the Ministry of Finance of an increase in the price of labour and materials.

A couple of days ago, the contractor submitted a claim for the lease of a second bulldozer, which he says he overlooked in preparing his tender. This morning, the LG's project management team is meeting with representatives from the contractor to resolve the matter.

Handout #2 – LG project management team role

It has been just over two months since the contractor acknowledged receipt of the LG's "Notice to Proceed" letter on the road and bridge project. The contractor already has received its first monthly payment and a second requisition was received from the contractor for the second month's work a few days ago. In submitting its claim for the lease of another bulldozer, the contractor argues that its lease, although unforeseen when the tender was being prepared, is nonetheless legitimate and necessary to keep the project on schedule.

The LG's position, in general, is that the contractor should have known to include the additional equipment in its tender. One member of the team has openly expressed a suspicion that the contractor deliberately excluded the cost of a third lease in order to lower its bid and win the award.

Several team members believe that the contractor may request a "Change in Scope" by attempting to show that the original plans prepared by the LG were vague regarding the soil conditions and that the additional lease amount should be handled as a change order to the contractor. The LG is prepared to argue in this case that a change of scope represents a material deviation from the contract and that this situation does not justify such a change. However, the team has been cautioned by the governing body to hold the line on cost but not to threaten timely completion of the project.

Handout #3 – The contractor project team role

This is the start of your third month on the road and bridge project. Frankly, the inclusion of a second bulldozer was never considered until a few weeks ago when it became clear that the equipment would be needed to keep the project on schedule. In other words, the oversight was not intentional. Several members of the project team are worried that the LG will think the oversight was deliberate just to win the

contract. The truth is, the project was bid low because the firm has been an unsuccessful bidder on several other projects recently, and the road and bridge project was urgently needed to meet payroll.

There has been some discussion that the LG might allow the claim as a “Change in Scope” and amend the contract to include it as an unforeseen circumstance. After all, as one member of the team concludes, the LG’s plans were not as clear as they might have been about the amount of dirt and rock moving required.

You are aware that delay in finishing the project would prevent opening a new highway segment that has been waited for patiently by several large firms that depend on the public roads for moving goods to market. If necessary, you will rely on the LG’s need to get the project finished as leverage for approval of the change.

Handout #4 – The observer’s task

As an observer, your task is to observe the interaction between the two teams and to answer each of the questions on the attached observer worksheet. During the planning phase of the exercise, you will be responsible for setting up the training room in conference room fashion with representatives of the two teams seated across from each other at the conference tables. After the 20-minute discussion, be prepared to report on your observations and participate in a discussion of the implications of the exercise for a LG responsible for ensuring compliance with construction contracts in terms of performance, quality, and cost.

Handout #5 – Observer’s worksheet

What was the purpose of the meeting, how was the purpose stated and by whom?

What were the most effective arguments used by the LG to support its position?

What were the most effective arguments used by the contractor to support its position?

What degree of success was achieved in resolving the matter and how was this accomplished?

7.10 CLOSING EXERCISE: LEARNING TRANSFER

TIME REQUIRED

30-45 minutes

PURPOSE

This exercise is to help participants transfer the learning experiences of the workshop into their real-world activities as finance directors. The focus of this exercise is on raising expectations, engaging in realistic planning and making personal commitments. Most of the work is done on a personal basis with some interpersonal sharing.

PROCESS

Spend at least half an hour at the end of the workshop to focus the attention of participants on important learnings and encourage them to continue experimenting with these learnings in their management activities. Begin by giving participants about fifteen minutes to work independently on a simple learning transfer questionnaire.

When participants have completed the questionnaire, ask them to share quickly with the group two or three things they intend to do differently in their roles with respect to capital investment planning to close the workshop.

***Trainer's note.** It is generally agreed that the purpose of training is to improve the way people do things by showing them a better way. In fact, the success of a training experience can be measured by the amount of personal growth and change that takes place both during training and after the training is over. Commitments to learning and change made at the close of a workshop can help participants overcome learning resistance in themselves and in the work environment. A trainer can help learners make a successful transition from the world of learning to the world of doing through a few simple planning exercises.*

A Learning Transfer Questionnaire

Take a few minutes to reflect on capital investment planning, the new ideas you encountered in this workshop, and how you feel about them. Then, in the space below, write a sentence or two to describe something interesting you have learned about yourself during this workshop.

Based on what you have learned about yourself and the many possibilities for change presented by this workshop, what two or three things do you intend to do differently that involves capital investment planning?

1.

2.

3.

Finally, what obstacles in yourself or in your work environment do you expect to experience during your efforts to implement these changes? What will you do to remove or minimize these obstacles?

Expected Obstacle	Action to Remove It
1.	1.
2.	2.
3.	3.

Financing the Capital Investment Plan

PART ONE: CONCEPTS, PRINCIPLES, AND STRATEGIES

SUMMARY

It seems that most policy makers and staff are familiar with putting together the capital investment plan—holding public hearings and putting a plan together that will move the LG towards the policy maker's vision of the future. Unfortunately, few have taken the time to understand the equally important function of financing the capital investment plan. Decisions made about it have a much longer-term effect than those made about the operating budget—they may affect several future generations of citizens.

This chapter examines how the financing for the investment plan is developed and implemented. We will provide definitions of debt management and other related terms. We will also review the benefits of instituting a debt management program, identify and provide examples of policies that should be developed, and discuss the legal environment surrounding the use of debt. We will address types of financing, methods for selecting credit instruments and the mechanics for obtaining financing, as well as a review of credit analysis, disclosure requirements and administration of the debt.

INTERRELATIONSHIP WITH THE “FINANCING THE OPERATING BUDGET” CHAPTER

There are two chapters in the series that probably should have been one chapter but it would have been too large! Those two chapters are the “Financing” chapters: *Financing the Operating Budget* and *Financing the Capital investment plan*. The basic difference between them is the *Financing the Operating Budget* is based on the premise that LG revenues are used to finance the operating budget; while *Financing the Capital investment plan* is based on the premise that debt or borrowed monies—which are not revenues—are used to finance the capital investment plan. Therefore,

one chapter focuses on revenues, the other focuses on borrowing money. Short-term borrowing is in both chapters.

All basic cash management, investing, and cash budgeting information is in the *Financing the Operating Budget* chapter. This is fundamental information that should be understood before tackling this chapter.

INTERRELATIONSHIPS BETWEEN CHAPTERS IN THE SERIES

The following matrix shows the interrelationships between *Financing the Capital Investment Plan* and the other chapters.

	Financing the Capital Investment Plan
<i>Introduction</i>	The Introduction provides the framework for using the entire series.
<i>Trainer's Guide</i>	Provides guidelines for using the chapters to provide training.
<i>Financial Policy Making</i>	Financial policy making provides the framework for the capital investment planning process.
<i>Financial Planning</i>	Financial planning prioritizes and projects LG revenues and expenditures. It identifies capital investment needs at a high level. The capital investment planning process refines and carries out the planning at a specific project by project level.
<i>Citizen Participation</i>	Capital investments such as infrastructure (streets, clinics, traffic lights, water systems, etc.) are the foundation for the essential services that the LG provides to its citizens. Citizen participation in the capital investment planning process ensures that citizens have input into the priority setting and decision making regarding capital investments.
<i>Evaluating Financial Condition</i>	A LG's investment in capital investments may be a primary reason for citizens and industry or businesses being in the LG. Unwise decisions regarding capital investment planning may result in these groups deciding to leave the LG which, in turn, may reduce the tax base or revenues from these groups, which, in turn, may worsen the LG's financial condition.
<i>Operating Budget</i>	The annual budget is made up of the operating budget (day-to-day operations) and the capital budget (the amount to be paid out in the current fiscal year for multi-year building, road or other infrastructure projects or very expensive equipment such as fire trucks. The chapters Operating Budget and Financing the Operating Budget focus on aspects of day-to-day operational budgets as opposed to the multi-year focus of the Capital Investment Planning chapter.
<i>Financing the Operating Budget</i>	The annual budget is made up of the operating budget (day-to-day operations) and the capital budget (the amount to be paid out in the current fiscal year for multi-year building, road or other infrastructure projects or very expensive equipment such as fire trucks. The chapters Operating Budget and Financing the Operating Budget focus on aspects of day-to-day operational budgets as opposed to the multi-year focus of the Capital Investment Planning chapter.

<i>Capital Investment Plan</i>	This chapter focuses on the preparation of the expenditure side of the capital investment plan, where Financing the Capital Investment Plan chapter focuses on the revenue side of the capital investment plan.
<i>Accounting</i>	Capital investment planning (budgeting) is a plan. Accounting documents how the revenues or financing were actually received.
<i>Performance Measures</i>	Performance measures help the LG ensure that the capital investment planning process is as efficient and effective and accomplishing the goals of the LG.
<i>Asset Management</i>	Capital investment planning is the plan to acquire or build assets such as streets, water systems, clinics, etc. Once built, asset management focuses on utilizing each asset to its best advantage for the LG.
<i>Procurement</i>	The procurement process is the primary method for acquiring or building capital investments.

INTRODUCTION

We recognize that basic or introductory concepts are relative—depending upon your background and frame of reference for revenues, budgets and local government. Users of this material will range from those who have no knowledge of revenue and budget principles or concepts to those who have a very sophisticated understanding. The following are our ideas of what represents the most fundamental principles and concepts needed to understand financing the operating budget at a beginning level.

The chapter focuses on public sector financing and thus does not include private sector financing participation through mechanisms like management contracts, concessions, build-operate-transfer, etc.

BASIC CONCEPTS AND DEFINITIONS

Following are some terms with which you may be unfamiliar. Glance at them now, and then refer back to the definitions as needed. We have also defined additional words in the text as needed.

DEFINITIONS

Appropriation—An authorization made by the legislative body of a government that permits officials to incur obligations against and to make expenditures of governmental resources. Appropriations are usually made for fixed amounts and are typically granted for a one-year period.

Arbitrage—Simultaneous or nearly simultaneous purchase in one market and sale in another of a security, in order to make a profit on price differences between the two markets.

Assets—Property owned by a government that has monetary value.

Bond—A written promise to pay (debt) a specified sum of money (called principal or face value) at a specified future date (called the maturity date(s)) along with periodic interest paid at specified percentage of the principal (interest rate). Bonds are typically used for long-term debt

Callable bonds—Bonds that may be redeemed at the option of the issuer on the call date at a price equal to the call price. The specific conditions under which the bonds may be called or redeemed are identified in the bond indenture.

Capital investment plan—A plan that identifies the capital projects to be funded during the planning horizon (usually five years) The capital investment plan is updated annually, and the first year of the plan serves as the current year capital budget.

Coupon rate—The interest rate that will be paid to the bondholders. The amount of interest is determined by multiplying the coupon rate by the par value of the bond.

Credit enhancement—A guarantee provided by a third part to pay the interest and principal on a bond if the issuer is unable to make the required payment. The most common types of credit enhancements are letters of credit issued by commercial banks and issuance provided by bond insurance companies.

Debt policy—A policy that establishes the guidelines for the use of debt by an issuer. The policy covers the maximum amount of debt that can be issued, the types of debt, the purposes for which debt can be issued, and the debt maturity schedule.

Debt service—Payment of interest and repayment of principal to holders of a government's debt instruments.

Debt service payment—The sum of interest and the principal amount of bonds scheduled to mature in a given year.

Defease—The legal release of the lien of the bondholders on the assets or revenues pledged by the issuer in exchange for the pledge of cash or securities sufficient to repay the bonds.

Fixed rate bond—A bond whose coupon rate is fixed at the time the bond is sold.

Full faith and credit—A pledge of the general taxing power of a government to repay debt obligations (typically used in reference to bonds)

General obligation bond—A bond that is secured by the full faith, credit, and taxing power of the issuer. The issuer pledges to levy taxes at whatever amount is necessary to repay the bonds.

Gross underwriter spread—The difference between the sale price received by the underwriting syndicate and the amount paid by the underwriting syndicate to the issuer. The spread is usually stated as an amount per \$1000 of par value. The gross underwriter spread is the compensation earned by the underwriting syndicate for selling the bonds to investors.

Limited-tax, general obligation bond—A type of bond that is backed by revenue sources that are limited as to the sources or the maximum amount of the tax.

Maturity date—The date at which the issuer is obligated to repay the principal amount of the bond to the bondholder.

Maturity (or par, or face) value—The principal amount of a bond. The amount is used to determine the period interest payments and is repaid to the bondholder at maturity.

Maturities—The dates on which the principal matures and may be reclaimed by the holder of the debt obligation.

Original issue discount—The amount by which the maturity value of a bond exceeds the sale price at the time of issue.

Official Statement—A printed document that contains complete information about the bonds and the issuer.

Par value—See maturity value.

Put bond—A bond that the bondholder has the right to sell (or put) back to the issuer at a fixed price. The right to sell the bond back to the issuer is exercised on specific dates, usually interest payment dates.

Refunding bond issue—A bond issue in which the proceeds are used to redeem a currently outstanding bond issue. A refunding issue is usually sold to achieve an interest cost savings, that is, the interest rate on the new (refunding) bonds is lower than that on the old bonds (the bonds to be refunded).

Revenue bond—A bond issued for either project or enterprise financing, secured by the revenues generated by the facility being financed.

Sinking fund—A fund established by bond issuers, generally required in the bond indenture, that is increased through time for the purpose of retiring some of the outstanding bonds before their maturity, all zero coupon bonds at their maturity or reducing the risk of default on the bonds. The fund is generally restricted to investment in liquid securities.

Variable rate (or floating rate) bond—A bond whose coupon rate can change over the life of the bond issue. The variable rate is generally linked to the level of an interest rate index.

FINANCING THE CAPITAL INVESTMENT PLAN

Financing the capital program requires the identification and evaluation of alternative sources of financing. In many developing countries going through decentralization, there are no alternative sources of financing since 75%–90% of LG revenues are redistributions of central government revenues. In these countries, most capital investment is done by grants or loans from the central government—based on central government priorities. For countries in a decentralizing trend, we encourage you to read the following concepts and principles and begin to implement them as decentralization continues. It will be a process over time. But the more you understand about how to handle your LG's capital financing, then the better position you will be in when the time comes to be able to make LG capital investment priorities and financing decisions at the LG level.

It is difficult to write one chapter on this topic because there is such variation at where LGs are world-wide in decentralization and self-governance. Many countries do not allow LGs to borrow money from private/ commercial banks yet—they may borrow from central government or province banks or must live within their current cash flow. Realistically, implementing any major capital investments in this situation is just not feasible. Nor are these LGs allowed to issue any kind of debt such as bonds. Part of this is due to a LG financial structure that is still emerging. Decentralization takes time. So many of these concepts may be foreign and seem too far in

the future to matter at this time to many readers. Again, we encourage you to learn as much as possible about this topic and help bring about change in your country to move LGs farther along towards self-governance and setting and implementing LG priorities.

Each local government will need to identify and evaluate the capital financing options available to it. Information on options can be obtained from the statutes, ministries of finance, financial consultants, professional associations, and other local governments. Department heads are often aware of sources of financing for projects related to their operations.

Examples of common world-wide LG capital financing options include: own source revenues, transfers and shared revenues from the central/ provincial government, reserves, surplus, debt, state grants and subsidies, sale of assets, user fees, leasing, development fees, benefit assessments, public private partnerships and donations. Frequently, many combinations are used.

Selection of the most appropriate source or sources of financing is complicated by the number and variety of available options, changes in national laws, lack of own source revenues, inability to issue debt, lack of debt markets, volatile debt markets, and the constant development of new, complex creative financing sources.

For these reasons the finance staff should prepare an analysis of the key features and advantages and disadvantages of each type of capital financing available to the LG. Every effort needs to be made to identify and evaluate all available sources.

PUBLIC VERSUS PRIVATE SECTOR INVESTMENT

It is important to recognize from the outset that motives and strategies for capital investments—especially buildings—vary between the public and private sectors. Since policy makers will typically come from the private sector, they should be aware of the principal differences between the investment goals of each sector, and how these differences will affect capital investment decisions.

Clearly, the main difference between the public and private sectors is that typically, the private sector investment is creating a means of making a profit, whereas the public sector investment is fulfilling a desired need for a specific type of building. The private sector may not necessarily build a building to last—the public sector usually does.

While it is important to understand the philosophies behind each investment strategy, it is equally important to understand the effect that each investment strategy has on the development criteria used. The following table demonstrates potential substantial differences between the two sectors.

Typical Investment Criteria

Public Sector	Private Sector
Builds for the Long-term (50 – 100 Years)	Builds for the Short- to Medium-Term (7 – 25 Years)
Institutional Quality	Variable Quality
Uses Tax or Bond Funds	Uses Borrowed Funds

Long-term Stability of Investment	Geared To Profit / Return on Investment
Life Cycle Costs Important	Operational Costs May Not Have High Priority
Will Renovate to Prolong Life / Use	May Demolish and Start Again

These are not hard and fast rules, but serve primarily to identify the main differences in objectives and goals for investment. Understanding the significance of these differences is important for policy makers, and may have particular significance, for example, in the case of public / private partnerships.

There are as many examples of the longevity of public sector buildings—LG halls, water treatment plants, universities etc., as there are examples of speculative developments that have endured a very short life span. Investment motives for corporate buildings, banks, insurance company offices, etc., typically fall somewhere between the two philosophies. Typically, they will share many of the elements of the public sector criteria, and in some cases may even exceed the quality expected in public buildings.

WHY SHOULD CITIZENS CARE?

Capital investments are the infrastructure on which LGs function and to many people, the reason that LGs exist. They include: streets, bridges, irrigation ditches, traffic signals, water pumping facilities, water treatment facilities, sewer treatment facilities, health clinic buildings, hospitals, medical equipment, schools, buses, and almost all other basic elements of modern life. If citizens want to have these types of facilities and equipment, they must be paid for. In most developing countries, these basics are still being provided by the central government, contributory organizations (LG enterprises), or through grants distributed by the central government. Over time, as decentralization continues, LGs will assume more and more responsibility for providing the capital financing for these types of facilities. To do that, the LGs must have either their own revenue sources or have a revenue stream that is sufficient and consistent enough to plan and carry out the building of or purchasing of capital investments.

If the revenues are own source, then they are coming from the citizens or businesses within the LG. This means either higher taxes or user charges and fees. These additional revenues will have to come from the citizens and citizens around the world begin to care about decisions when they must pay more in taxes or fees. Hopefully, with the additional revenues that citizens and businesses will contribute, they will also participate in the planning and decision making processes that decide which capital investments will be made.

WHAT IS DEBT?

Simply stated *debt* is an obligation to pay or return something at a future date. We will use the term “debt” to generically refer to all LG debt regardless of length, type, instrument, or lender. Examples of debt are:

- Short-term and long-term loans from banks or the central government,
- **Bonds** (written promise to repay the amount borrowed (*principal*) at some specific time in the future, plus *interest* (payment for using the money over time) issued by the LG, and
- Leases made by the LG.

Debt management is the process of directing and controlling the acquisition and retirement of debt. Debt can be “acquired” by:

- Getting a loan from a bank to cover a lack of cash flow,
- Issuing LG **bonds** to build a water treatment plant, or
- Leasing specialized heavy road building machinery because it is too expensive to purchase outright.

Debt is “retired” by paying off the loan, bonds, or lease. Because of the potential long-term impact and binding commitment of future resources, debt acquisition and retirement are usually controlled with specific legal requirements, policies, and procedures.

Debt service is the cost of repaying the principal and interest on borrowed money for a given year or series of years, according to a predetermined payment schedule. For ease of reading, we will use the term “debt service” to generically refer to all types of payments whether for a bank loan, central government loan, LG **bond** or lease agreement.

WHY DO LGS HAVE DEBT?

LGs may borrow for short periods of time when there is not enough cash to meet the **operating budget** (day-to-day) expenses of providing LG services; or for long periods of time, typically to finance **capital investments** such as a land purchase, engineering design, utility relocation, construction, or equipment that has a long useful life. Long-term debt places a claim against future governmental revenues or **assets** that may reach far into the future.

PAY-AS-YOU-GO VERSUS PAY-AS-YOU-USE (DEBT)

“Pay-as-you-go” financing is useful for low cost repair and maintenance projects or the purchase of equipment with short useful lives such as radios. “Pay-as-you-use” is appropriate for capital investments with a high cost and a long useful life such as construction of LG buildings, streets and sidewalks, drainage systems, or water supply systems. Applying the equity principle, taxpayers of several generations will both benefit and pay for these types of investments if financed with long-term debt and no one generation will be unfairly burdened. Carefully planned use of current revenues, end of year surplus, or reserves for a “pay as you go” program is a positive factor because it provides a cushion for debt service payments in the event that

future revenues do not materialize. Officials should exercise caution, however, when using cash surpluses or reserves for capital projects. Significant reductions in these funds restrict the flexibility for responding to revenue downturns, or other emergencies. Most LGs should use a combination of the “pay as you go” and “pay as you use” financing.

Comparison of “Pay as You Go” and “Pay as You Use” Financing Methods

In Favour of “Pay as You Go”

- Avoids the interest cost of financing the debt; the savings can be used to expand services or reduce taxes.
- Provides greater flexibility to finance operating costs during bad economic times because there are less fixed annual debt service costs.
- Conserves debt capacity to enhance creditworthiness and thereby lessens interest costs when borrowing is really necessary.
- Provides no chance for irresponsible policy of incurring too much debt—given available resources.
- Provides a benefit for the next generation of taxpayers in the form of “paid for” infrastructure.

In Favour of “Pay as You Use” or Debt Financing

- Size and cost of the project usually limits the ability to pay from current revenues. In most cases, investments can only be financed with a “pay as you use” policy.
- Over the life of the facility, users pay as they benefit. As people move into the community, they pay their fair share of capital financing costs.
- During high inflation, the actual amounts paid in principal and interest (after discounting for inflation) can be considerably less than the present day value.

WHAT IS THE LENGTH OF DEBT?

Length of debt refers to the amount of time before the debt is repaid. Short-term debt is to be paid off in one year or less, long-term debt in over one year. Long-term debt may be further sub-divided by source and the type of security pledged. In this section, we will define each length of debt, describe its uses, discuss terms and conditions, and list some of advantages and disadvantages of each.

SHORT-TERM FINANCING

Short-term debt consists of maturity of one year or less after the date of issuance. It includes direct bank loans and others types of debt issued through general credit markets. In countries where a short-term LG debt market exists, LGs issue LG notes,

tax and revenue anticipation notes, and bond anticipation notes. Short-term debt instruments fall into two broad categories: those issued in anticipation of a specific revenue and those issued in anticipation of long-term, permanent financing.

LGs often use short-term debt as a cash management tool to meet daily, weekly or monthly expenditure requirements. It enables them to pay operating expenditures when revenue flows do not match expenditure needs. Borrowing short-term by establishing a line of credit with a bank or issuing interim cash management notes ensures that obligations are paid on time. If you use this technique, ensure that it is temporary and that expected future revenue inflows are clearly sufficient to repay amounts borrowed within a few months' time. Short-term debt that exists beyond a single fiscal year should be avoided. You should not allow short-term obligations for current expenditures to become long-term debt through annual "rolling over" of the debt into the next fiscal year.

Another use of short-term debt is to provide interim financing for long-term capital investment projects. For example, as a regular part of a capital financing program, a LG can take advantage of short-term debts historically lower interest rates to initially finance a long-term obligation while it is under construction. This use of short-term debt provides project liquidity, allows construction to start on time, and lowers overall interest costs of the project. When the project is completed, the short-term debt is converted to long-term debt. The combination of short and long-term debt reduces overall project borrowing costs.

Another example of using short-term debt as interim financing for long-term projects might occur when long-term interest rates become so high as to make financing long-term debt not feasible. To avoid a long-term commitment and high interest costs, LGs can use short-term debt to take advantage of the lower interest rates with plans to convert the short-term debt to long-term when market conditions improve. This technique can be a sign of prudent debt management; however, it may be considered less creditworthy than borrowing for cash management purposes and interim financing of capital projects because repayment of the short-term debt is contingent on the LG's ability to access the long-term debt market at a time when interest rates are lower.

What are the types/ sources of debt?

Bank or central government loans, bonds or leasing are examples of types or sources of debt.

What are examples of debt instruments?

Examples are warrants, notes, bonds, and certificates.

LONG-TERM FINANCING

Long-term debt consists of a maturity of more than one year after the date of issuance. Long-term debt is one of the best ways of financing capital investments for the following reasons. It:

- Creates a possibly self-supporting enterprise—a capital investment built with the proceeds from long-term debt can produce revenues by selling its services. It may provide sufficient revenues to pay for operation and maintenance expenses, debt service and additional capital facilities;
- Speeds up construction of facilities— funds are immediately available, capital investments can be completed faster than if they were dependent upon operating budget surpluses; and
- Shares the cost of the capital investment between current and future users—by repaying a debt or loan over the useful life of an capital facility or a piece of equipment, the cost is shared by all the users or beneficiaries during its useful life.

LGs can obtain long-term debt financing from a variety of sources such as commercial banks and savings institutions, government and international development organizations, issues of LG bonds and lease financing.

LEARNING APPLICATION

*In the first **Learning Application** in each of the chapters in this series we will be reminding the reader about how to get the most from each of these exercises. First, there is a box identifying the four key LG roles that most readers represent. These are Policy Makers (elected officials), CEOs (Chief Executive Officers such as mayors, LG managers, etc.), Finance Managers (the chief finance official in the LG), and Department Heads (those individuals who are responsible for the management of specific LG departments such as public works, planning, and human resources). Second, we will indicate in the box those readers we believe will benefit most from completing the learning application task. Finally, when more than one official is listed, we see this as an opportunity for these individuals to get together and compare their responses. These **Learning Application** opportunities can also be modified to become training exercises for group learning. So, our advice is to make the most of these reflective interludes in the text.*

POLICY MAKER _X_ CEO _X_ FINANCE MANAGER _X_ DEPARTMENT HEAD _X_

With respect to what you have read so far, now is the time to look at capital investment planning and debt management as it is practiced in your LG:

Has your LG established a capital investment plan (CIP)?

How has your LG financed its capital investment plan: by “pay as you go” or “pay as you use” financing? What percentage for each type?

What type of capital investments have been debt financed?

What legal limitations or other problems affect your debt management program?

TYPES OF SHORT-TERM FINANCING

Lenders include commercial banks, central government or other government agencies, and underwriters.

A direct bank loan is frequently the simplest and easiest way to meet short-term debt needs. Typically, negotiations are conducted between LG and bank officials with no need for public disclosure statements, external credit ratings, or advertisements. Bank loans provide flexibility in terms of the time at which money is to be taken down and repaid, as well as adjustments in amounts. Commitments can be secured to advance monies on a schedule beforehand and if circumstances change in the course of the year, the term can ordinarily be re-negotiated. Bank loans usually do not involve a cost of issuance, as do transactions such as bonds or notes sold in a general credit market. On the other hand, there may be a commitment fee.

Banks are in the business to make a profit; and while banks may view a loan to the LG as a form of civic obligation, they are obligated to charge a market rate of interest with appropriate terms for bank loans. Therefore, the LG should conduct the negotiations with the bank on a business-like basis to assure that reasonable rates

and terms are obtained. LG has an obligation to consider the terms offered by all banks, it also has an obligation to get the best rate available.

In countries with established LG debt markets, the most common short-term instruments are tax anticipation notes, revenue anticipation notes, bond anticipation notes and commercial paper.

- **Tax and revenue anticipation notes** are used for cash management purposes to even out cash flows. For example, if property tax revenues are needed earlier than the scheduled instalments provide to meet expenses, a LG issues tax anticipation notes in the general credit market to provide the cash needed and avoid a monthly cash flow deficit. These notes are repaid upon receipt of the property taxes.
- **Bond anticipation notes** are securities issued as a bridge between the start of a project and its eventual long-term financing. For example, a LG plans to sell ten-year LG bonds in six months, but needs cash now to start construction of a capital investment. The LG issues bond anticipation notes to provide the cash now rather than wait for receipt of the long-term financing. Upon receipt of the ten-year bond proceeds, the LG repays the bond anticipation notes.
- **Commercial paper** is issued similar to tax, revenue, and bond anticipation notes, except the average maturity of the paper is very short—between 30-45 days. In some countries, LG commercial paper has become a favoured instrument for purchase because of its short maturity and excellent liquidity. High demand for this instrument also contributes to the paper's interest rate being one of the lowest.

ADVANTAGES/DISADVANTAGES

The major advantages of short-term borrowing are its ability to provide liquidity to meet obligations and lower interest costs than long-term debt. The disadvantages are its temporary nature and that it must be managed prudently to avoid possible misuse. Following are some additional advantages and disadvantages for each type of short-term debt:

- Bank loans are the simplest and easiest to use and have considerable flexibility in establishing terms, few disclosure requirements, and low issuance costs. On the other hand, bank loans usually have higher rates of interest than other short-term instruments.
- Issuing notes (tax, revenue and bond anticipation) demonstrates that a LG has access to credit markets other than banks; usually produces lower rates than bank loans; and provides a benchmark for comparison of rates between the issuer and other governments to help future planning. The primary disadvantages are the increased disclosure requirements, higher cost of issuance and need for a credit rating for acceptance in the credit market. Bond anticipation notes have an additional disadvantage in that they represent a gamble that the LG will be able to access the

long-term market at lower interest rates when the bond anticipation notes mature.

- Commercial paper has all the advantages and disadvantages of notes. Additionally, commercial paper has even higher initial set-up costs and as a result requires borrowing a large amount of short-term money to be feasible—minimum of EU 50 million.) Start-up costs include: a bank letter of credit, dealer fees for re-marketing the paper, bond counsel and financial advisory fees, plus staff and on-line computer equipment and software to manage the program.

TYPES OF LONG-TERM FINANCING

COMMERCIAL BANK AND SAVINGS INSTITUTION LOANS

A common source of financing for capital investment is through loans from commercial banks and savings institutions. These institutions serve as a readily available source of funds because they are located in the community and usually have an established relationship with the LG by providing traditional banking services.

Note: In some countries commercial banks are risk averse and not readily available as a source of funding for LGs.

Since the specific terms of a bank loan will vary depending upon your LG's financial circumstances, we will generalize.

TERM

Commercial banks offer loans that are usually shorter than other loans and have a maturity of 2-5 years; foreign banks and other loan institutions may provide longer terms. The length is determined by the bank based on the purpose of the loan and bank policy. As a rule, loans that finance capital facilities or equipment should never exceed the life of the asset financed.

INTEREST RATES

The bank sets the interest rate on loans based on current market rates, length of debt, collateral, or security for the loan, and creditworthiness of the borrower. Rates can be fixed or floating. A fixed interest rate is set at the time the loan is approved and reflects financial market conditions at that time. It remains in effect during the entire term of the loan. A floating interest rate moves with market interest rates and represents a specific percentage above the general level of interest rate, such as the discount rate of the national bank of your country.

In choosing between fixed or floating rates, you must make a judgment on the future direction of interest rates. A fixed interest rate is considered advantageous if interest rates are rising since it locks in a specific rate and protects from continuing rising rates. A floating rate is more advantageous in a declining interest rate environ-

ment where the periodic resetting of the interest rate produces lower interest costs with each adjusted and hopefully lower rate.

STRUCTURE

The bank establishes the loan structure and determines how quickly the principal is repaid. Generally, they require monthly or quarterly repayments of principal and interest in equal instalments for the term of the loan that is normally referred to as the annuity method. In this method, the principal amount paid increases in each instalment while the interest amount paid decreases in each instalment. The result is a level or even instalment payment throughout the loan period. There are other variations of structure, but they are more typically used with LG bonds and therefore will be discussed in that section.

GUARANTEES OR COLLATERAL

Bank loans are normally secured by LG property or by a pledge of future revenues. There are four standard types of guarantees or collateral:

- A guarantee of all LG property e.g., real estate;
- A pledge of proportionate taxes or subsidy from the central government budget. In this situation, the LG pledges these taxes or subsidy for the loan payment and establishes a dedicated amortization fund for the sole purpose of receiving the revenues and repaying the principal and interest on the loan;
- A guarantee by future LG revenues. This method allows the bank or creditor to have local taxes or other LG revenues credited to his account at the time of their collection.
- Cash deposit or securities

Other loan provisions—Both the finance manager and legal counsel should review the entire loan agreement thoroughly to insure that all the terms are understood and in the LG's best interest. Pay close attention to provisions dealing with late payments, defaults, prepayment options, loan collateral or guarantees, and loan extension options at maturity.

GOVERNMENT AND INTERNATIONAL DEVELOPMENT PROGRAM LOANS

Another source of long-term financing are loans from central government or international development programs. These organisations offer financing to support their specific programs such as environmental protection or LG housing development. As a result, their appeal will be limited to communities that have that specific need and can meet the loan requirements. These organizations require a completed loan application to be considered. There is no guarantee that the loan will be approved. The loan process is often very competitive and only the most deserving are approved.

The terms and conditions of government and international development organization loans tend to be less rigid than commercial banks. Their objective is to assist LG long-term development needs rather than make a profit. This different orienta-

tion results in terms that are more flexible. Many times, these loans and their terms are determined by political considerations rather than rule-based financing. In such a situation there is a significant danger of creating incentives for bad performance. In many countries the government loans are on the decline or have dried up.

TERM

Government and international programs offer loans for longer terms than bank loans. These agencies tend to be more flexible in adjusting the length of the loan to meet LG needs. The length of the loan is often tied to the useful life of the asset.

INTEREST RATES

Government or international program interest rates are typically based on the government's ability to borrow money and usually this means that rates are below commercial bank rates. Fixed interest rates are common and are set based on a relationship to government interest rates.

STRUCTURE

Government and international organizations have considerable latitude to create attractive loans that range from traditional loans at market rates called "hard loans" to more flexible loans called "soft loans" that may be offered at lower interest rates, deferred repayment, exceptional length or a combination of these terms. Soft loans are usually designed for specific purposes or to make the loan affordable to the borrower. Both agencies will modify the loan structure to meet the financial needs of a community.

GUARANTEES OR COLLATERAL

Government or international organizations require that the LG provide a guarantee or provide collateral to repay the loan or equipment being financed. Often times they will take a second position behind bank loans or LG bonds. Government and international agencies are usually less interested in being repaid than in providing financing for a specific need or purpose.

OTHER LOAN PROVISIONS

The same words of caution that apply to commercial loans also apply to government and international organization loans. While the terms may be more favourable, do not skip the review process. The loan agreement should still be reviewed by both finance manager and legal counsel to insure that all the provisions of the loan are understood and in the best interest of the LG. Pay close attention to provisions dealing with late payments, defaults, prepayment options, loan collateral or guarantees, and loan extension at maturity.

The following table lists some advantages and disadvantages of commercial bank loans and government/ international development program loans.

Advantages and Disadvantages of Commercial Bank Loans and Government Loans

Commercial Bank Loans
<p>Advantages</p> <ul style="list-style-type: none"> • Provides a readily available source of financing based on existing local bank relationships. • Applying for a commercial bank loan is a relatively simple process. • Credit analysis is performed by the commercial bank. • A separate credit rating from a rating agency is not required. • Loan terms and conditions are negotiable to meet the needs of the bank and LG.
<p>Disadvantages</p> <ul style="list-style-type: none"> • Interest rates tend to be higher than other types of debt. • Security (collateral) requirements may be excessive (i.e. greatly exceed the value of the loan). • Terms and conditions of the loan are generally structured to favour the creditor.
Government/International Development Program Loans
<p>Advantages</p> <ul style="list-style-type: none"> • Provides financing for specific purposes. • Provides favourable and potentially more flexible terms of financing (interest rates, repayment terms and structures, guarantees, other loan provisions) to assist the LG.
<p>Disadvantages</p> <ul style="list-style-type: none"> • Financing is limited to a specific purpose defined by the government or international development program. • Project and financial reporting requirements may be complex and burdensome. • Decision making process is usually slow and complicated. • Loans from international organizations may have currency exchange risks that require the LG to create special reserves to protect itself from adverse currency fluctuations.

LG BONDS

Another source of financing in many countries that can be tapped to fund LG capital investments is to issue LG bonds. Issuing LG bonds through banks or through investment firms has become an increasingly important component for some countries.

PURPOSE AND TERM

Many LGs issue bonds to cover both operating deficits and fund capital investments with terms ranging from 2-5 years. In developing countries, banks are primary purchasers of LG bonds and hold them in inventory since there is usually no secondary market for LG bonds. Occasionally, a bank will participate with a private investor to purchase LG bonds.

INTEREST RATES

LG bond interest rates reflect current financial market conditions, the term and structure of the bond being issued and the creditworthiness of the LG. For these reasons, interest rates on LG bonds tend to be lower than rates for private bank loans. LGs also can choose to issue fixed or floating rate bonds with the same dilemma discussed in a commercial bank loan -- determining the future direction of interest rates.

In preparing to issue bonds, LGs traditionally take a lead role in structuring the issue to meet the LG's financing needs. Working with the financial advisor or bank, LG officials and the finance manager should consider the capacity of the LG to assume new debt, current laws and debt policies, the useful life of the investments being financed, and demand for LG bonds in developing the bond structure. LG bonds can be structured in a variety of ways. They can be structured as serial, term or combination bonds with debt level, principal level or deferred principal debt service structures. The bonds can be issued as either **general obligation bonds** requiring a tax pledge or **revenue bonds** requiring a pledge of dedicated revenue to repay the bonds. These items will be discussed in more detail later.

GUARANTEES OR COLLATERAL

Check with your country's security law to determine if the LG bonds carry an automatic guarantee of all LG property or the exact collateralization requirements. In some cases, this means that the entire value of LG property secures a relatively small LG bond-- in effect over securing the bond. For example, a LG may issue a EU 10 million bond that will have a guarantee of EU 217 million of LG property. That appears excessive.

PROCESS

Bond issues may need to be authorized by the central bank and/or by the Ministry of Finance in your country. These agencies investigate and confirm the financial information that the LGs provide. Please check with a finance expert in your country about regulations or requirements.

EVALUATION CRITERIA FOR DETERMINING TYPES OF FINANCING

In choosing a method for financing capital improvements three principles should be considered: equity, effectiveness, and efficiency.

- **Equity** or fairness means that those who benefit from a capital investment or service should pay for it. For example, a capital investment in public transit can benefit the entire community by providing affordable transportation and at the same time reduce congestion and air pollution from automobiles. It can be financed from general revenues. On the other hand, certain facilities such as water and sewer systems benefit specific users. Financing for these should be obtained from user fees.
- An **effective** financing method provides the required amount of funds when needed. For example, LGs generally have a difficult time building large-scale capital investments from own source revenues. In this case, relying on own source revenues is an ineffective financing method.

- **Efficiency** refers to the relative costs of using one financing method over another. For example, you may decide that certain financing methods or risks are too high relative to the benefit they generate. These are regarded as inefficient.

When analyzing financing alternatives, use the following evaluation criteria as a framework: legality, features of the source, adequacy of funds, community impact, economic impact, political feasibility, administrative feasibility and the basic principles.

- **Legality**—This criterion looks at who may use the option and under what conditions. Can the source be used to finance new and replacement facilities, rehabilitation, repairs and equipment? Are limits placed on its use? Is voter or state approval required? Are limits placed on the amount of funds or the life of the project financed? All impediments to its use are identified including the need for special legislation.
- **Feature of source**—This criterion examines the procedures that must be followed in establishing and using the financing option. Are public hearings required? What legislative and/or administrative action is required? Is property owner approval required? What percentage of voter approval is required? Are complicated negotiations and agreements required? Is financial flexibility insured? How is borrowing capacity and creditworthiness affected? What costs are included and excluded?
- **Adequacy of funds**—This criterion examines the extent to which the financing source is sufficient to cover all project and operating/ maintenance costs. Is it a one-time source? What costs are not covered? Is the availability dependent on matching funds or tied to spending priorities and other restrictions? Are the funds available for only a limited time? Can the funds be leveraged with other funds? An effort is made to determine if the source will produce enough funds.
- **Community impact**—This criterion looks at the impact of the option on different segments of the community such as low income, business, and industry. Does the option take ability to pay into consideration? Do the benefits received differ among segments of the community? Does the burden primarily fall on one group in the community such as new residents, established residents, property owners, or low-income households? Will those who benefit pay in relation to use?
- **Economic impact**—This criterion examines the impact of the financing source on the public and private sectors. What affect will the source have on development including land and housing costs? Will its use affect business location decisions? Will funds be drawn from the private sector? The analysis focuses on the effect of the financing source on private costs.
- **Political feasibility**—This criterion attempts to gauge the level of public support and opposition to the source. Is the source too innovative or risky? Has it been opposed in party platforms? Have voters previously defeated such proposals? What is the position of elected officials regarding the option?

- **Administrative feasibility**—This criteria looks at how simple or complex the source is to administer. What start up costs are required? How restrictive are the regulations? Is specialized staff required? How much staff time will be required? What compliance costs are involved? What administrative costs are involved? Are specialized consultants required? Emphasis is placed on identifying the cost and complexity of procedural requirements.

Following is a sample matrix that helps organize this information.

Evaluating Financing Options

Financing Types / Sources	Legality	Feature of source	Adequacy of funds	Community impact	Economic feasibility	Political feasibility	Administrative feasibility
Own source revenues							
Surpluses							
Transfers							
Shared							
Loans							
Grants/ Subsidies							
Sale of assets							
Leases							
User fees							
Notes							
Bonds							
Other							

LEARNING APPLICATION

ELECTED OFFICIAL _X_ CEO _X_ FINANCE MANAGER _X_ DEPARTMENT HEAD _X_

Make a list of capital financing sources used in your LG. Use the sources identified in the matrix above as a starting point. What are some of their advantages and disadvantages?

What other sources should your LG consider?

UNITED STATES EXAMPLES OF LONG-TERM FINANCING

In the US, a different political, economic, and legal system has created an extensive LG credit market, in which LGs finance their capital needs through the issuance of long-term debt. This market is similar to the private sector market. For comparative purposes, we will discuss the types of long-term debt instruments that LGs use in this system with the expectation that over time similar markets and instruments will evolve throughout other parts of the world. Although the discussion is based on the US, there are numerous comments throughout the section for developing countries and those interested in seeing a LG debt market in their own country.

In the US, long-term debt is traditionally divided in two major types based on the pledge of funds that secure the debt: general obligation bonds and revenue bonds.

GENERAL OBLIGATION BONDS

General obligation bonds are commonly referred to as “full faith and credit” bonds because they are based on the pledge of LG to levy the necessary taxes to pay the annual debt service.

This type of debt is further subdivided by the degree to which the full faith and credit and taxing power is limited by law:

- Unlimited general obligation bonds legally obligate a LG to levy a tax within its jurisdiction at whatever level is necessary to meet the debt service on the bonds. There are no limits to the local taxing power.
- Limited general obligation bonds have a similar obligation to levy a tax within the jurisdiction by raising the tax rate; however, a maximum rate is imposed by law. The LG has unlimited taxing power to raise the tax rate up to a maximum rate.

In either case, the debt is secured by the LG’s unconditional promise to pay the principal and interest based upon an agreed upon schedule. If the taxes are insufficient to pay the required principal and interest on the bonds at any time, the LG is legally obligated to raise the tax rate or broaden the tax base to raise the needed revenues. Failure to meet the required debt service payments results in a default on

the bonds, possibly jeopardizing the LG's ability to access the credit markets in the future.

The type of bond a LG chooses to issue to finance a long-term project depends upon the benefit it produces. If the investment produces a product or service that benefits the entire community, or specific users of the product or service or both, the investment is said to be a "public good." As a public good, it should be financed by all taxpayers and thus a general obligation bond is appropriate. Typical examples of these projects include: public safety, fire protection, streets and bridges, public parks and open space and public buildings.

REVENUE BONDS

Revenue bonds are often referred to as "limited liability" bonds. These bonds rely solely upon a LG's pledge of restricted revenues or user fees (such as service charges, tolls, admission fees, leases and rents) to guarantee the repayment of the debt. These bonds are not backed by the taxing power of the LG and as a result are usually not included within tax supported debt limitations. If the revenues are not sufficient to pay the required debt service, the LG is legally obligated to raise the revenues from the pledged revenue source by raising the fees or broadening the revenue base. Failure to raise sufficient revenues to pay the indebtedness will result in that activity being in default. There is no legal requirement to use the full faith, credit, and taxing power of the LG to pay these obligations to avoid default; however, some might argue that there is a moral obligation of the LG to pay the indebtedness to preserve the reputation of the LG in the financial markets.

In some limited situations, LGs have backed revenue bonds with a full faith and credit tax pledge to add strength to the creditworthiness of the revenue bond. These are referred to as tax-supported revenue bonds or indirect general obligation bonds. This is an appropriate use for situations where revenues are not strong or where there is a limited credit history associated with the project.

Capital investments that directly benefit a specific group of users who pay for the investment through user charges are considered to be a private or merit good. These projects are appropriate for revenue bond financing. Examples of such investments include: municipally owned airports, water and sewer systems, electric utilities, athletic and sport facilities and limited access highways.

Revenue bonds can be further subdivided into five types based on the type of investment financed:

- **Enterprise Revenue Bonds**—are LG owned activities designed, operated, and financed like a private business with the intent that it be self-supporting from user charges. Bonds issued for enterprise capital investment are solely paid for from the revenues of the enterprise. In the US, these bonds are issued for LG owned utilities such as water and sewer, gas or electric.
- **Mortgage Revenue Bonds**—These bonds finance LG owned public utilities or enterprises but are secured by a mortgage against specified properties of a LG. When the debt is primarily payable from enterprise revenues, they are classified as revenue bonds. The primary advantage of the mortgage-backed bond in the US lies in the protection it affords the creditor in case of

bankruptcy and foreclosure. This protection will vary among countries with different bankruptcy and foreclosure laws.

- **Lease Rental Bonds**—These bonds finance facilities that are leased under contract to a LG, which pays rent sufficient to pay the debt service. This type of bond has been used to finance public buildings, parks, transportation facilities, hospitals, and schools. This type of debt is frequently used to circumvent borrowing restrictions on LG powers that levy taxes to pay the debt.
- **Conduit Revenue Bonds**—These bonds finance private facilities to promote economic development, increase local employment opportunities, or achieve a social goal. Facilities are leased or funds are lent to a private business or activity. Rental or loan payments cover the debt service on the bonds. The term “conduit” refers to the fact that the sponsoring LG makes no commitment to pay or guarantee the debt, but by using this mechanism allows the business activity access to the LG market.
- **Special Purpose Bonds**—In a special purpose bond issuance, the principal and interest of the bond is paid for from a designated tax (i.e. gasoline tax, hotel bed tax, alcohol beverage tax), special purpose tax (i.e. a special purpose tax in an economic development district) or a special assessment for a specific capital investment in a designated area.

The following table lists the advantages and disadvantages of general obligation bonds and revenue bonds.

Advantages and Disadvantages of General Obligation and Revenue Bonds

General Obligation Bonds

Advantages

- Provides the strongest pledge of the LG taxing power to repay the debt and usually produces the lowest interest cost.
- Preparing for the debt issuance is a relatively simple process and less costly than other types of issuance.
- Selling debt competitively rather than negotiated usually reduces the interest cost.
- Commercial banks demand for LG bonds may create a market for bonds with shorter-term maturities (2-5 years).

Disadvantages

- Lack of a secondary market in many countries limits the attractiveness and shortens the maturities of LG bonds
- Commercial banks may limit the term of LG bonds in their portfolio to five years.
- Legal debt limitations imposed by national government limit a LG's ability to meet long-term financing needs. Reduces future borrowing capacity.
- If paid by taxes, may not align benefits to costs.
- Project costs may not be aligned to the useful life of the investment.

Revenue Bonds

Advantages

- Cost of debt is distributed more equitably to the users who benefit from the service.
- Does not absorb future borrowing capacity.

- Financing costs must be paid within the useful life of the project.
- Improved discipline in spending because revenue enterprises are obliged to meet public demands for service at reasonable costs.
- Improved operation and maintenance since bond indentures carry requirements for supervision of budget, maintenance, and other phases of management not present in general obligation bonds.

Disadvantages

- Lack of a secondary market in many countries limits the attractiveness and shortens the maturities of LG bonds
- Lack of the full faith, credit and taxing power of the LG may reduce creditworthiness. Usually receives a higher interest rate.
- More complex and as a result will have increased preparation and administration costs.
- A higher proportion of these bonds are sold through negotiation thus increasing costs.
- Defaults in enterprise revenue bonds can have adverse carry over effects in an issuer's general obligation debt credit rating.

LEASE FINANCING

Another long-term debt financing option available to meet LG investment needs is lease agreements. Leasing by US LGs has greatly increased over the years as an effective means of acquiring **assets** necessary to provide public services. This growth is due in part to a number of economic and legal factors:

- Leasing may be an alternative to LG bond financing for a major investment because interest rates in the LG loan or bond market are too high or debt limitations preclude use of debt instruments.
- Leasing enables a government to spread out the cost of equipment and capital investments over multi-year periods.
- Leasing is often a suitable and economical method of financing a capital investment that is too expensive to fund in one budget year but the investment's useful life is too short to justify the issuance of long-term debt (i.e. 10-20 years)
- A LG may need the equipment temporarily or rapid changes in technology make owning the equipment impractical.
- A fiscally distressed LG may need to replace equipment, at least temporarily, to keep public services going.

Types and uses—There are a number of different types of leases, each structured to meet specific uses or circumstances. We will discuss briefly four types of leases and their use: a true lease, a lease purchase agreement, finance lease, and a sale-leaseback. (Because leases may have varying tax consequences in different countries, please consult with legal counsel to fully understand the benefits, drawbacks, and limitations of this type of financing in your country.)

A true lease is an arrangement in which the lessee (i.e. a LG) acquires use but not ownership, of leased property, and the lease term is shorter than the asset's useful life. Depending upon tax laws, there may be benefits to the lessor of retaining

ownership such as depreciation. Offsetting these potential benefits, the lessor usually must pay income taxes on the full amount of the lease rental payments.

A lease purchase agreement is a contract that is called a lease but is in substance a purchase for which payments are made in instalments over time. The lessee acquires ownership as well as use of the leased property from the inception of the lease term and the lease typically specifies a date on which title to the property changes hands. The periodic payments established in the lease agreement are divided into principal and interest and if the lessee is a LG, the interest portion may receive favourable tax treatment depending upon income tax law. For example, in some countries interest earned on LG bonds may be taxed at 10 percent versus 25% on other types of investments. Legal counsel should be consulted to determine whether this interest could be treated similar to LG bond interest.

In countries where the LG interest is tax exempt (e.g. US), the lessors are able to charge lower interest rates on such LG leases than on other true leases of comparable risk and terms.

To avoid having this agreement classified as a debt, US LGs usually include a non-appropriation clause in the agreement. The clause allows the LG lessee to terminate, without penalty except for loss of the leased property, a lease for which funds are not appropriated beyond the current budget year. Lessors on the other hand charge a higher interest rate than for a guaranteed contract term and include a non-substitution clause that states the lessee cannot lease or purchase replacement equipment within a specified time.

A finance lease is a financing device in which the lessor is a bank, another financial institution or an investor. The LG lessee requires use of the asset over a major portion but not the entirety of its useful life. The lessee is responsible for the costs of operation and maintenance, taxes and insurance. The lease term and payments generally are structured to recoup the lessor's investment to purchase the leased property and provide a satisfactory return on investment. Broadly conceived, a finance lease may be a true lease or a lease-purchase agreement, but as the term "finance lease" is commonly used, it refers to a type of true lease.

A sale-leaseback is an arrangement in which the owner of property (e.g. LG) sells a property to a financial institution or an investor and simultaneously executes an agreement to lease the property back from the buyer. If a sale-lease back is structured as a true lease, the seller-lessee may be able to transfer the tax benefits of ownership to the buyer-lessor in return for favourable or low lease payments. If a sale-leaseback is structured as a lease purchase, the arrangement may qualify as a LG lease enabling the buyer-lessor to obtain LG interest and to pay tax at reduced rates. Of course, these transactions need to be reviewed by legal counsel to determine the tax benefits that accrue, if any.

The following table contains a list of advantages and disadvantages of lease financing.

Advantages and Disadvantages of Lease Financing

Advantages

- Provides a mechanism to replace capital equipment when revenues are inadequate.
- Provides a suitable and economically feasible alternative to bank loans and LG bond. Financing to acquire capital equipment or facilities.
- Conserves operating reserves.
- Can be structured to avoid classification as LG debt.
- Useful to spread out the cost of equipment over multiple years.
- Excellent way to obtain the use of equipment temporarily or to avoid owning equipment that will be technologically obsolete in a short time.

Disadvantages

- Higher interest cost over other similarly structured forms of financing (i.e. LG bonds and bank loans)
- Complex and potentially burdensome lease agreements
- Tax benefits of leasing may vary depending upon different country's laws on leasing

CREATIVE FINANCING TECHNIQUES

Creative financing is a term used by issuers to describe financing techniques that depart from traditional capital financing described above. LG issuers have been driven by varying market demands and economic factors to become more creative. Issuers have not created these techniques out of thin air since these are not new loan instruments, but instruments borrowed from private corporate finance. What is new is their use by LGs and the creation of additional sources of funds that did not exist previously.

The following describes three long-term creative financing techniques:

Zero coupon bonds—do not pay semi-annual interest, as do traditional LG bonds. Rather the bonds are sold at a substantial discount from the par value (face) of the bond. The investor receives the full amount of the principal at maturity. For example, a bond issued in 1997, which matures in 12 years at \$5000, may be sold at a price of \$ 1250. When the bond matures in 2009, the LG must pay the investor the bond par value \$5000 at which time the imputed interest rate of 11.89 percent is realized.

Zero coupon bonds appeal to LG issuers because of the reduced administrative cost of not issuing semi-annual interest payments and because interest on the bonds is not paid until maturity. At that time, the present value of the expense is much less than if periodic interest payments had been made through the life of the bond. Investors like zero coupon bonds because they are able to lock in a fixed interest rate and avoid some interest rate risk. On the other side, LG issuers must increase the size of a zero bond issue because they are sold at a discount to produce the amount of proceeds needed to fund the capital investment. This difference between the discount price and par value may be difficult to explain to the average taxpayer. Also the deferral of interest payments can cause problems because of the size of the one time payment due at maturity; therefore, LGs should establish a **sinking fund** to eliminate the problem of not having sufficient funds to retire the debt at maturity.

Put option bonds—are a way that issuers can attract investors to purchase LG debt when interest rates are volatile and potentially lower their interest cost. A put

option entitles the bondholder to return the bond to the issuer at some future date before the bond's maturity date. There are two kinds of put options:

- In a ***window put***, the investor can exercise the option once during a specific period on a specific date or week.
- An ***anniversary put*** gives the investor the option of returning the bond to the issuer periodically once every year.

Investors view bonds with put options as short-term debt, and as a result, the interest rates are lower than long-term debt. From the LG issuer's standpoint, the possibility that a bond would be returned before its maturity date is a real risk. The issuer can reduce that risk by purchasing insurance in the form of a bank letter of credit. This guarantees the investor that there will be sufficient funds available to repay the bond if the put option is exercised.

The major advantages of the put option bond are the potential for lower interest cost, and if the bond is put back to the LG, it is redeemed at par. Normally, if the issuer exercises an option to call a bond before the maturity date, a premium is required above the par value. The disadvantages of the put option are the cost of the letter of credit and the risk that the LG might have to use it.

Variable Rate Bonds or Notes—are viewed as short-term debt because they are issued without a single fixed interest rate. The interest rate is tied to an index that reflects the general level of interest rates. This type of instrument provides the LG issuer a means to access the market at a lower cost than other short-term debt. Investors are generally willing to accept a lower return from a variable security that considerably reduces their market risk.

Variable rate notes generally have a ***demand feature***. This feature gives the investor the option to tender the bonds back to the issuer if the interest rate on the bonds is unacceptable. Demand options are very similar to put options discussed above. The uncertainty that faces issuers is compensated for by lower interest costs than would be necessary with a fixed-term bond.

The key to successful variable rate issue is the index rate to which the security's interest is pegged. LG officials must exercise caution in the selection of this index, because it determines the total issue interest costs. A variety of indexes can be used such as a weekly, monthly, or annual average of the rates of other short-term notes or bonds. To attract investors, the index must closely follow trends in other competing investments of similar risk and maturity. However, the closer the index follows fluctuations in interest rates, the more uncertain the total costs of the issue will be. If the issuer attempts to restrict the issue from interest rate fluctuations, it may result in the demand feature being exercised more often and thus increase the borrowers' total interest cost.

Finance managers should familiarize themselves with the different types of financing available to address capital investment needs as well as the advantages and disadvantages of each so that an appropriate decision can be made which is in the best interest of the LG.

STEPS FOR CREDIT ANALYSIS OF THE LG

A LG issuer's credit quality is one of the most important determinants of the interest rate paid on a debt. The stronger the issuer's perceived credit, the lower the interest rate that banks will offer to make a loan or investors will require to purchase the bonds and the lower the interest cost to the LG. In this section, we will review the factors that are considered in evaluating a LG's creditworthiness.

The objective of credit analysis is to determine the willingness and the ability of the LG issuer to make full and timely payment of all loan obligations or debt service requirements. One of the first things that a LG should do when considering a debt issue is to perform a credit analysis of the LG. We discuss how the LG can do that analysis in this section. We will also review how a credit analysis is performed by two types of private firms: an underwriter or bank purchasing a debt issue or making a loan, or a rating agency evaluating the LG 's credit for investors.

LG officials can employ an analytical methodology to assist them in making sound financial management decisions regarding the use of debt to finance capital investments. The methodology addresses two basic questions: how much *can* a LG borrow and how much *should* a LG borrow?

To determine how much a LG *can* borrow, the finance manager first calculates the current and projected net operating results of the LG. This is the difference between recurring revenues (local taxes and fees, rents from LG property etc.) and non-investment expenditures. An operating surplus is the amount available to pay the maturing principal and interest payment on any new debt. It determines the maximum amount a LG can borrow. If this initial calculation produces a deficit or no surplus, the LG has no capacity to borrow and should strive to improve their financial condition to produce surplus revenues for future debt issuance.

While the net operating surplus can provide information on how much a LG can borrow, a LG must assess the risks it faces to determine how much it should borrow. The next steps of the methodology use an analysis of financial performance indicators to determine whether the LG is in a strong or weak financial condition. Past and projected trend in those indicators can show whether that condition is improving or deteriorating. The methodology uses three alternative scenarios, a base case, worst case, and best case to look at the impact of small changes in the assumptions about future revenues and expenditures on the financial condition of the LG. These entire elements taken together provide an assessment of the level of risk. The degree of risk can help a LG determine how much it should borrow. Generally, a LG will want to borrow less if the risks are high and more if they are low. Following is a more detailed description of each step:

STEP 1: PREPARE AN STATEMENT OF THE LG'S OPERATING SURPLUS (OR NET OPERATING RESULTS)

To calculate the net operating results, take total revenues and then separate recurring revenues (taxes and fees, shared national taxes, transfers, rents, etc.) from non-recurring revenues (those only authorized for one year or that are one time revenues i.e. sales of property) and divides total expenditures the same way by separating investment expenditures from the recurring operating expenditures. The *net operat-*

ing results are determined by subtracting the non-investment expenditures (operating expenditures) from the recurring revenues. This will produce a **net operating surplus** when recurring revenues are greater than operating expenditures or a **net operating deficit** when operating expenditures are greater than recurring revenues.

LGs that are considering borrowing money must provide for payment of the principal and interest from the surplus operating funds over the life of the debt. Since the LG will be making payments each year until it has repaid the debt fully, the conservative and prudent approach is to plan on using only recurring revenues to make the payments.

If the LG has a net operating deficit (no net recurring surplus revenues), the LG should not consider borrowing any money until it has taken steps to identify and address the causes of the problem. If a LG has a current net operating surplus, it can consider borrowing. The amount it can borrow however, will depend on not only on a surplus in the current year but that trend continuing into the future. The LG must forecast its future operating results since payments of debt service will extend several years into the future.

STEP 2: PREPARE A BASE CASE SCENARIO

A base case scenario covers the period for the next five years and forecasts each recurring revenue and non-investment expense over that period. You should refer to the chapter on *Financial Planning* to review the different ways to forecast revenues and expenditures. In forecasting, when in doubt use a conservative assumption that leads to a lower revenue or higher expenditure estimate. This will tend to underestimate the net operating results. It is the most prudent approach on which to base the first estimate about how much a LG can borrow.

Subtracting forecasted non-investment expenditures from forecasted recurring revenues shows the net operating surplus (or deficit) in future years. If there are other repayments of outstanding loans or other debt that the LG is obligated to cover, add these as a separate line and show an adjusted net operating surplus.

If the current and all future years show a net operating surplus, then a LG can consider entering into debt. *The smallest surplus in any of the years will determine the maximum amount the LG can count on to pay debt services at a constant level during the entire period of the forecast.* A useful way to express this amount is a percent of recurring revenues. For example, the projected maximum debt service is estimated to be 5%, 10%, or 15% of recurring revenues. This is the **debt service ratio** that is often used to describe how much a LG can or should borrow.

By applying an assumed interest rate and the number of years to repay the debt, you can convert the projected debt service amount to a principal amount of the loan or bond issue. That will show how much the LG can borrow. The following table shows what a base case format might look like.

Forecast Revenues and Expenditures 2xx6-2x11—Base Case Scenario Format

	Years					
	2xx6	2xx7	2xx8	2xx9	2x10	2x11
	Actual	Estimate	Estimate	Estimate	Estimate	Estimate
REVENUES (recurring)						
Tax revenues						
Revenues from business activities						
Administrative and other fees						
Other revenues						
Transfers						
Grants						
Total Revenues						
EXPENDITURES (non-investment)						
Personnel						
Supplies						
Services						
Debt service (existing)						
Total Expenditures						
Current Net Operating Surplus/ (Deficit)						
Obligations from existing debt (including accrued liabilities)						
Adjusted Net Operating Surplus/ (Deficit)						
Net Surplus Available for Debt Service as % of Total Revenues						

STEP 3: DEVELOP FINANCIAL PERFORMANCE INDICATORS

The indicators are used in the credit finance analysis methodology to help determine how much a LG *should* borrow. We use seven categories of indicators in this methodology. An analysis of the indicators highlights the financial strengths and weakness of the LG. You should refer to the *Evaluating Financial Condition*¹ chapter for a complete description of the development of these indicators. Only a brief description is included in this essay.

- **Revenues**—These indicators are designed to help you understand the structure of revenues—general and recurring—that are important to the analysis of how much a LG can borrow. A key issue is to what extent does the LG have control over the future level of its revenues. (i.e. to what extent are decisions made by the central or higher levels of government) If a large share of recurring revenues falls into this category, the LG has little control over its future recurring revenues. The mere fact that the LG is dependent upon others' decisions is an element of risk.
- **Expenditures**—These indicators look at the relationship of operating versus capital investment expenditures, the level of expenditures relative to population and number of employees and which departments, agencies, or contributory organizations actually incur the expenditures. The critical issues are the degree to which the LG relies upon contributory organizations to deliver services. The assumption is that there is less control over expenditures of such an organization and hence higher risk.
- **Net operating results**—This indicator shows the amount available to fund new expenditures including new debt, which is fundamental to answering the question of how much a LG can borrow.
- **Actual to budget**—These indicators look at the ratio of initial and final budget projections to actual results. They show the degree of accuracy of budget plans. These indicators help understand how well a LG can plan and manage its finances over time.
- **Relative growth**—These indicators show how the change in revenues compares to the change in expenditures overtime. Just because a LG has a surplus in the current year does not guarantee that it will continue in the future. The key issue is whether the growth of operating expenditures is matched by growth in recurring revenues. Faster growing expenditures will eventually lead to a deficit particularly if revenue growth decreases. Conversely, faster revenue growth will produce or maintain a future-operating surplus.
- **Debt Service**—These indicators monitor debt and the ability of the LG to meet its debt service obligations. These indicators are most useful when used with the preceding indicators. The lower the percentage of debt service to recurring revenues and current assets such as cash, the better. Conversely, the higher the ratio of debt service to revenue and current assets, the greater the burden to the LG of meeting the payment on its outstanding debt repayments. A LG with lower risk levels and stronger performance in the other categories, such as net operating results and structure of recurring revenues, can probably afford a higher level of debt service.
- **Liquidity and Outstanding Debt**—The liquidity indicator shows the nature and amount of resources immediately available to a LG to cover its current obligations, including debt service. The outstanding debt indicator looks at the structure and amount of long-term debt—those greater than one year. While these are basic indicators, the data is not usually consistently available from LG balance sheets to be a reliable indicator.

STEP 4: USE THE FINANCIAL INDICATORS IN STEP 3 TO ASSESS THE RISKS

The *first* step in the risk assessment is to determine the current financial condition status of the LG at the current time. For each of the key indicators, there may be an established benchmark for LGs in your country. By comparing the value of the indicator against the benchmark, a LG can assess whether its status is strong, acceptable, or weak. For example purposes we will use the benchmarks established in the US. One of the indicators looked at the ratio of operating expenditures to recurring revenues. If the ratio of a LG is less than .95, this is considered strong in the US. More than 1.00 is weak. Anything in between is acceptable.

The *second* step in the risk assessment is to look at the trends in the LG's indicators over time. Gather data for the indicators for at least the last three years. Develop the indicators to determine if the situation is improving, stable or deteriorating. Some values or scores vary without any apparent pattern and produce an erratic trend. The more years you can go back the easier it will be to determine a trend.

The *final* step in the risk assessment is to combine the status and trend scores to form a judgment of the level of risk: This is expressed as high or low risk. Thus for each indicator, there are three scores:

- Status: strong, acceptable, weak
- Trend: improving, deteriorating, stable, erratic
- Risk: high, low

Taking the information that you have developed, you need to interpret the results. Indicators with strong status results and improving trends results can be put in the lowest risk category. Low risk means the LG may wish to borrow the total amount or substantially the amount that it can borrow from the net operating results analysis. On the other hand, weak status results and deteriorating trend results represents the highest risk category resulting in the conclusion that the LG should borrow far less of that amount. There are many scenarios that the LG may face, including the times the risk assessment will range between high and low. Examples of this range of risk assessment along with a guideline for “Should Borrow?” follow:

Status	Trend	Risk	Should Borrow?
Strong	Improving	Lowest	Most
Strong	Stable	Low	More
Strong	Erratic	Unclear	Not clear
Acceptable	Improving	Low	More
Strong	Deteriorating	Low	Less
Acceptable	Deteriorating	High	Less
Weak	Improving	High	Less
Weak	Stable	High	Less
Weak	Erratic	Unclear	Not clear
Weak	Deteriorating	Highest	Least

Any given LG will score better on some indicators than on others. It also will have patterns of scores in each of the categories of indicators. LG officials need to

look at the sum of results of the risk assessment to form a global judgment about how much the LG should borrow.

STEP 5: PERFORM A SENSITIVITY ANALYSIS

This looks at the impact of new revenue and expenditure assumptions on the net operating results calculated in the base case projection. In the base case, you made assumptions about the future. You may have felt that you were being too optimistic or too pessimistic. This analysis shows you how to develop a series of “what if” scenarios in which you are able to vary those assumptions. The results of the sensitivity analysis are the final steps in determining how much the LG *should* borrow.

The *first* step is to prepare a “best case” projection. This is the one in which you use the most optimistic assumptions about the future. This may include more aggressive revenue assumptions and/or more conservative spending patterns. The most practical way to think of this is to express future revenues and expenditures as a percent of those estimated in the base case. For example, you could express revenues as 105% of base case revenues and expenditures as 90% of base case expenditures. This would produce a scenario in which future net operating results are higher.

The *next* step is to prepare a “worst case” scenario. This is the most pessimistic set of assumptions that may include more aggressive expenditure assumptions and/or more conservative revenue patterns. For example, you can estimate revenues at 95% of the base case and expenditures at 103% of the base case. The scenario should produce the lowest future net operating results.

The most useful sensitivity analysis will be the one that relies on relatively small changes in the assumptions for both the best case and worse case scenarios.

The sensitivity analysis allows a LG to view the extent to which changes in revenue and expenditure assumptions affects its financial condition. It allows a LG to see how sensitive a slight change in one or more of the assumptions from the base case scenario can affect the financial condition and change the net operating results or the risk assessment. As a general rule, the more sensitivity to change, the higher the risk to borrow, conversely the less sensitivity to change, the lower the risk to borrow.

CREDIT ANALYSIS BY COMMERCIAL BANKS

A bank that makes a loan or plans to bid on LG bonds as an underwriter, conducts its own credit analysis of the LG before approving a loan or participating in a bond sale. The outcome of that analysis is reflected in the interest rate of the loan or price bid for the bonds and the interest cost paid by the LG. If possible, obtain the factors used in your country’s bank’s credit analysis. Some banks may consider them proprietary and will not disclose them. But, it never hurts to ask!

CREDIT ANALYSIS BY RATING AGENCIES

A LG’s creditworthiness may be analyzed by firms called **rating agencies** who are engaged in the business of evaluating the debt issued by corporations, central governments, provincial and state governments, and LGs. These agencies review a LG’s creditworthiness before the sale of LG bonds and assign a credit rating to the LG

bond. The higher the rating, the lower the interest costs that will have to be paid on the bonds. Two major US firms now provide this service for a number of countries world-wide: Moody's Investors Service and Standard and Poor's Corporation. Your country may have its own rating agencies. Local investment specialists and banks should be able to help you determine if they are available or not.

As an example, the US firms use a 3-letter classification system. Long-term bonds of the highest quality are rated "Aaa" by Moody's and "AAA" by Standard and Poor's. Issues rated below "Baa" by Moody's and below "BBB" by Standard and Poor's are considered below investment grade. A separate set of ratings is used for short-term notes. Following are the Moody's Investors Service and Standard and Poor's long-term debt rating definitions respectively.

Long-term Debt Rating Definitions used by Moody's Investor Services

LG Rating Definitions

- Bonds that are rated **Aaa** are judged to be of the best quality. They carry the smallest degree of investment risk and are generally referred to as "gilt edge." Interest payments are protected by a large or by an exceptionally stable margin and principal is secure. While the various protective elements are likely to change, such changes as can be visualized are most unlikely to impair the fundamentally strong position of such issues.
- Bonds that are rated **Aa** are judged to be of high quality by all standards. Together with the **Aaa** group, they comprise what are generally known as high-grade bonds. They are rated lower than the best bonds because margins of protection may not be as large as in **Aaa** securities or fluctuations of protective elements may be of greater amplitude or there may be other elements present which make the long-term risks appear somewhat larger than in **Aaa**.
- Bonds that are rated **A** possess many favourable investment attributes and are to be considered as upper-medium-grade obligations. Factors giving security to principal and interest are considered adequate, but elements may be present which suggest a susceptibility to impairment some time in the future.
- Bonds that are rated **Baa** are considered as medium-grade obligations; i.e. they are neither highly protected nor poorly secured. Interest payments and principal security appear adequate for the present but certain protective elements may be lacking or may be characteristically unreliable over any great length of time. Such bonds lack outstanding investment characteristics and, in fact, have speculative characteristics as well.
- Bonds that are rated **Ba** are judged to have speculative elements; their future cannot be considered as well assured. Often the protection of interest and principal payments may be very moderate, and thereby not well safeguarded during both good and bad times over the future. Uncertainty of position characterizes bonds in this class.
- Bonds that rated **B** generally lack characteristics of the desirable investment. Assurance of interest and principal payment or maintenance of other terms of the contract over any long period of time may be small.
- Bonds that are rated **Caa** are of poor standing. Such issues may be in default or there may be present elements of danger with respect to principal or interest.
- Bonds that are rated **Ca** represent obligations that are speculative in a high degree. Such issues are often in default or have other marked shortcomings.
- Bonds that are rated **C** are the lowest rated class of bonds, and issues so rated can be regarded as having extremely poor prospects of ever attaining any real investment standing.

- Bonds for which the security depends upon the completion of some act or the fulfilment of some condition are rated conditionally. These are bonds secured by: (a) earnings of projects under construction, (b) earnings of projects unseasoned in operating experience, (c) rentals which begin when facilities are completed, or (d) payments to which some other limiting condition attaches. Parenthetical rating denotes probable credit stature upon completion of construction or elimination of basis of condition.
- The bonds in the **Aa, A, Baa, Ba** and **B**, groups which Moody's believes possesses the strongest investment attributes are designated by the symbols **Aa1, A1, Baa1, Ba1** and **Ba1**.

Long-term Debt Rating Definitions used by Standard and Poor's

LG Rating Definitions

Investment Grade

- **AAA** Debt rated "AAA" has the highest rating assigned by S&P. Capacity to pay interest and repay principal is extremely strong.
- **AA** Debt rated "AA" has a very strong capacity to pay interest and repay principal and differs from the highest rates issues only in small degree.
- **A** Debt rated "A" has a strong capacity to pay interest and repay principal although it is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than debt in higher rated categories.
- **BBB** Debt rated "BBB" is regarded as having an adequate capacity to pay interest and repay principal. Whereas it normally exhibits adequate protection parameters, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity to pay interest and repay principal for debt in this category than in higher rated categories.

Speculative grade

- Debt rated "BB," "B," "CCC," "CC" or "C" is regarded as having predominantly speculative characteristics with respect to capacity to pay interest and repay principal. "BB" indicates the least degree of speculation and "C" the highest. While such debt will likely have some quality and protective characteristics, these are outweighed by large uncertainties or major risk exposures to adverse conditions.
- **BB** Debt rated "BB" has less near term vulnerability to default than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions that could lead to inadequate capacity to meet timely interest and principal payments. The "BB" rating category is also used for debt subordinated to senior debt that is assigned an actual or implied "BBB-" rating.
- **B** Debt rated "B" has a greater vulnerability to default, but currently has the capacity to meet interest payments and principal repayments. Adverse business, financial or economic conditions will likely impair capacity or willingness to pay interest and repay principal. The "B" rating category also is used for debt subordinated to senior debt that is assigned an actual or implied "BB" or "BB-" rating.
- **CCC** Debt rated "CCC" has a current identifiable vulnerability to default, and is dependent upon favourable business, financial, and economic conditions to meet timely payment of interest and repayment of principal. In the event of adverse business, financial, or economic conditions, it is not likely to have the capacity to pay interest and repay principal. The "CCC" rating category also is used for debt subordinated to senior debt that is assigned an actual or implied "B" or "B-" rating.
- **CC** Debt rated "CC" typically is applied to debt subordinated to senior debt that is assigned an actual or implied "CCC" debt rating.

- **C** The rating “C” typically is applied to debt subordinated to senior debt that is assigned an actual or implied “CCC” debt rating. The “C” rating may be used to cover a situation where a bankruptcy petition has been filed, but debt service payments are continued.
- **CI** Debt rated “CI” is reserved for income bonds on which no interest is being paid.
- **D** Debt rated “D” is in payment default. The “D” rating category is used when interest payments or principal payments are not made on the date due even if the applicable grace period has not expired, unless S&P believes that such payments will be made during the grace period. The “D” rating also will be used upon the filing of a bankruptcy petition if debt service payments are jeopardized.
- **Plus (+) or minus (-)** The ratings from “AA” to “CCC” may be modified by the addition of a plus or minus sign to show relative standing within the major rating categories.

Typically, the rating process works like this. A LG issuer applies for a rating a couple of weeks before the sale of bonds from one or more of the rating agencies. They usually pay a fee for the service. The LG also submits specific information for analysis with their application for a rating. This information can be included in the official statement or submitted as supplemental material. A rating agency analyst evaluates the information and asks follow-up questions of local officials. When satisfied with the information presented, the analyst makes a recommendation to the ratings committee of the rating agency. The rating committee acts upon the recommendation and assigns a rating to the issue. After the initial rating of the bond, the rating agency periodically reviews the credit of the LG until the bonds are paid off.

INTERNATIONAL CREDIT RATING

Standard and Poor’s has identified specific criteria that it considers in its international credit analysis. One of the first criteria is an assessment of country risk. Standard and Poor’s has a policy that requires that they determine the creditworthiness of the sovereign (central) government first before they rate any LG’s debt. The sovereign rating for foreign and local currency debt represents the upper limit or rating ceiling for any LG in that country. The reason for this policy is that the central government has a wide range of power and resources that render its credit standing superior to that of any other debtor in the country. Also with regard to foreign currency debt, the central government has first claim on foreign exchange reserves to service external debt obligations. It also has the power to tax and print national currency.

In addition to country risk assessment, Standard and Poor’s credit analysis is based on an assessment of a wide range of political, economic, and financial factors. Standard and Poor’s information requirements for assessing these factors are divided into five broad areas for analysis: economic structure and growth potential, intergovernmental relations, administrative systems and controls, budgetary performance and fiscal flexibility and debt and financing requirements. These areas are described in more detail in the following table.

Standard and Poor's Information Requirements for Regional and LGs

Economic structure and growth potential

- Demographic characteristics: historical and projected figures for population size, natural growth rates vs. immigration and age distribution.
- Status of infrastructure and future needs: transportation, schools, hospitals, housing, basic utilities, and other.
- Structure of local economy in terms of output and employment by economic sector (e.g. agriculture, mining, manufacturing, construction, trade, private services and government services).
- List of major employers, including 10 largest non-government employers; information on these entities' employment trends, profitability, and investment plans.
- Level and trends of per capita or household income.
- Measures of growth and prosperity of the local economy; trends in gross domestic product, employment, unemployment, retail sales, investment (construction spending, building permits, housing starts, etc.), new business start-ups and real estate values.
- Projections for major local economic indicators.

Intergovernmental relations

- Service responsibilities, distinguishing mandatory from discretionary and capital from on-going. Ability of higher levels of government to download expenditure responsibilities without commensurate revenues.
- Taxing authority including types of taxes and whether they are shared with other levels of government.
- Transfer to and from other levels of government, including the method of determination and frequency of modification.
- Authority to borrow and for what purposes.

Administrative systems and controls

- LGs' legal limitation, if any and procedures for debt issuance, tax increases, budget approval, and the making of loans and investments.
- Structure and composition of legislative and executive branches; stability of political environment.
- Labour relations, wage settlement process, and capacity to cut staff under legal and contractual arrangements.
- Overview of budget forecasting and monitoring systems, including expenditure controls and revenue collection procedures.
- Description of accounting practices and their impact on budget and financial statements.

Budgetary performance and fiscal flexibility

- Revenue composition and trends, breaking out transfer receipts by point of origin (e.g. intergovernmental or from public enterprises), own-source taxes by type, fees, and interest and dividend earnings.
- Measures of local tax burden, its trend over time, and comparisons to neighbouring local authorities.

Practical capacity to increase taxes and fees.

- Composition of and trends in expenditure, including a breakdown between capital and current spending. Also the composition of spending by functional category (e.g. education, health, etc.) and by economic category (e.g. wages, interest, etc.).
- Analysis of significant budget variances over the last three years.
- Recent and projected trends in the balance on current operations.

Debt and financing requirements

- Capital budget and projections, including composition and details on any major investment programs.
- Identification of significant reserve accounts and their use.
- Review of liquidity policies and cash management systems.
- Historical and projected gross and net financing requirements, including borrowing from, and lending to third parties.
- Direct debt and debt of enterprises owned or supported by the local authority.
- Overlapping debt of other governmental bodies sharing the same tax base.
- Financial performance and projected investment and borrowing plans of enterprises owned or supported by the local authority. Systems of control over these enterprises.
- Evaluation of other significant contingent liabilities, such as employee pension funds.

Credit analysis and bond ratings are used by investors as a substitute for or an enhancement of their own research. The credit ratings are very important to LG officials as they affect investor attitudes about the risk associated with the bonds and hence the total cost of the borrowing.

After a rating is assigned, the LG should make every effort to maintain a good relationship with the analyst and the rating agency. Here are some suggestions for staying on good terms with the rating agencies.

- Keep them informed of financial and other developments that affect the outstanding bond rating.
- Send them copies of the annual budget, audited financial reports and other financial reports.
- Maintain periodic contact to inform them of upcoming developments.

The most useful approach to applying credit analysis is to perform a self-assessment of your LG using the methodology described in this section. This way you will know how much your LG *can* and *should* borrow and the strengths and weaknesses of its finances. This self-assessment prepares you for the difficult questions that will be asked by banks, underwriters, and investors if you plan to obtain a loan or issue LG bonds.

LEGAL ISSUES

Borrowing must comply with legal requirements from the central government and local laws. Before borrowing money, determine any restrictions on: the amount of debt that can be incurred, types of debt, maturity dates, and the process to be followed.

Constitutional provisions or statutory laws are the most common means of limiting LG's ability to borrow money. These laws are usually targeted at tax-supported obligations because the debt is secured by a pledge of tax revenues. There may be a limit on the percentage or type of assets that can be pledged. It is prudent financial management to limit the ability to pledge future revenues or LG assets through borrowing. Following are some examples of legal debt limitations:

- Debt service payments on tax-supported obligations in a fiscal year shall not exceed 15 percent of the general operating revenues.
- At least 10 percent of the cost of capital investments shall be paid from current general revenues in any given fiscal year.
- At least 25 percent of the principal on any loan or bond issue shall be retired within five years after the debt is acquired or issued.
- Outstanding debt of a LG shall not exceed 15 percent of the total market value of property in the LG available for taxation. (Note: This may not be applicable to LGs in countries unless property taxes are based on market values rather than area.)
- The interest rate on a LG debt issue or loan shall not exceed 20 percent.
- The maximum maturity of a LG bond issue shall not exceed 30 years.

If legal debt limitations have not been established, then local officials should establish them through locally adopted ordinances or policy statements.

STEPS TO SHORT-TERM BORROWING—WHEN AND HOW MUCH?

If borrowing short-term, consider two questions: when and how much? These decisions rest on an assessment of current circumstances, projected needs, and the opportunity for arbitrage. **Arbitrage** is the profit derived from the more or less simultaneous purchase of a security in one credit market and sale in a different market. In this case, it is borrowing money from the bank at one rate and investing the proceeds temporarily at a higher rate.

STEP 1: ASSESS THE CURRENT CIRCUMSTANCES

- Develop a cash flow budget determines the cash needs for the budget year. It shows all anticipated revenues and disbursements for a period of time—usually one year. Carefully examine each major revenue source and disbursement category on a monthly or weekly basis using at least three years of actual historical experience to construct the cash budget. It identifies when a deficit cash flow occurs and the estimated amounts of cash necessary to correct the situation. For a detailed explanation of how to construct a cash flow budget, refer to *Financing the Operating Budget*², another chapter in this series.
- Analyze the cash budget and modify it. The original projection produces a one year forecast of revenues and disbursements, but it's based on historical averages that smooth out year to year variations. However, significant variations can be expected in any one year. Anticipate yearly variations and build in some flexibility, by using conservative revenue estimates and liberal disbursement patterns. Also provide a reserve element to avoid returning to the bank or credit market for additional funds. Going back is likely to produce an adverse impact on your LG's credibility.

STEP 2: DEVELOP A PLAN

Take the modified cash budget and develop a plan to create flexibility in disbursements. The crudest form of flexibility is to simply delay payment to vendors. However, this is usually short sighted and very costly. It costs the LG its reputation to pay suppliers/contractors late, reduces the number willing to do business with the LG, and those that do, raise prices to take delays into account. Look at each type of disbursement and identify any that can be delayed without incurring penalties.

STEP 3: DETERMINE HOW MUCH TO BORROW

Consider two approaches. In the first, you borrow money based on the cash flow budget schedule. The bank advances loans and is repaid as promptly as cash flow permits. This minimizes the amount of short-term debt outstanding and pays the smallest amount of interest. In the second approach, you borrow the total amount of money needed to cover the projected deficits and reserve for the entire year. A portion of the money can be invested for longer periods and therefore is able to earn interest. The earned interest can be used to reduce the total cost of the transaction and if the re-investment interest rate is higher than the loan rate, actually earn a profit.

STEP 4: MAINTAIN RELATIONS WITH THE BANK

With a loan outstanding, the bank loan agreement will require the LG to provide the bank with annual reports on the financial condition of the LG and certify adherence to the loan provisions. After reviewing these reports, the bank may require more frequent reporting. At a minimum, local officials should provide the lending bank with an annual budget, debt repayment plans, audited financial reports and long-term financial plans. It also would be a good idea for the finance manager to periodically visit the bank lending officer to discuss the status of the LG's finances and to personally keep the bank abreast of other prospective financial developments.

STEPS TO ISSUING DEBT

If borrowing long-term the same two questions about *when* and *how much* from the short-term section should be asked. But there are a number of additional questions to be answered and decisions to be made—issuing long-term debt is more complicated. Also, with issuing long-term debt, your LG may choose to hire some external advisors to help with the process.

EXTERNAL ADVISORS FOR ISSUING DEBT

We will describe the role of the key external players and the services they provide in the debt issuance process and also offer some suggestions on how to select and compensate them.

The **financial advisor** assists the LG issuer in completing the borrowing transaction. However, the better way is to retain the financial advisor before the development of the capital investment plan. In this way, the financial advisor can assist the LG in developing alternatives for financing the capital program, as well as, in planning the related debt issuance.

In the selection of a financial advisor, the principal criterion should be the qualification of the individual(s) who will advise the LG, as well as, the qualifications and resources of the firm. The selection process should require each firm to identify the individual being assigned to the project and their experience. There should also be some assurance that no replacement will be assigned without the consent of the issuer. The key benefit to the issuer will be working with an individual who has the knowledge and experience with the type of issues being considered by the LG.

The financial advisor's scope of services varies based upon the needs of the LG, capacity of the LG to provide some of these services with existing staff, the type of sale: competitive or negotiated and the complexity of the transaction. Generally, a financial advisor provides the following services to the LG:

- Reviews the LG debt structure and financial resources to determine borrowing capacity for current and future capital financing requirements.
- Helps the LG evaluate alternative funding sources for capital investments.
- Assists in the development of financial management criteria to determine whether borrowing is appropriate, reviews borrowing alternatives, and provides an analysis of the each financing method for a given project.
- Assists the LG in the selection of other members of the advisory team by reviewing the request for proposal and sitting on the selection committee.
- Cooperates with bond counsel in developing documents related to the debt issuance.
- Establishes the timing of the debt issuance in consultation with the issuer and bond counsel (and underwriter in a negotiated sale).
- Prepares a debt issuance schedule that establishes the responsibilities and deadlines for each member of the advisor team.
- Coordinates the development of the issuance structure, including the terms (i.e. maturity schedule, interest pay dates, and call dates) and conditions of the issue.
- Advises the issuer (and the underwriter in a negotiated sale) on disclosure issues including the preliminary **official statement**.
- Prepares, in conjunction with bond counsel and the issuer, an official statement, notice of sale and bid form and distributes them to all prospective underwriters and investors.
- Works with bond counsel to ensure that the legal requirements are met.
- For competitive sales, attends the bid openings and verifies the accuracy of the bids submitted.
- For negotiated sales, works closely with the LG issuer and the underwriter to establish an initial pricing, monitors the order activity and assists with any re-pricing of the obligations.

- Makes a recommendation to the issuer concerning the acceptance or rejection of the bid or offer to purchase.
- Assists bond counsel with development of closing documents.
- Prepares a post sale memorandum that compares the results of the debt issuance with comparable issues in the market at approximately the same time.

Financial advisory services are typically available through underwriting firms, commercial banks and independent firms, which have no affiliation with an underwriting firm. The LG should select a financial advisory firm through a competitive process after soliciting proposals from all qualified firms based on criteria established by the LG. The LG should establish a selection process that is clear, open, and objective.

The LG should prepare a *request for proposal* (RFP) to solicit responses from investment banking firms, commercial banks and independent firms to provide financial advisory services. A financial advisory request for proposal should include:

- A discussion of the firm's understanding of the LG's financing needs and the firm's ability to provide the requested scope of services.
- Identification and qualifications of the individuals who will provide advisory services (and a back up individual).
- Experience of the individuals with the type of transactions that the LG plans to issue.
- A commitment of these individuals by the firm to the LG during the life of the contract.
- The basis on which the financial advisor will be compensated.
- References from at least three other LG clients who have retained the firm and the individuals for similar transactions.

Regardless of the type of firm selected, the firm must have the full confidence of the LG. In this regard, the ability of the financial advisor to provide an objective and informed review of all aspects of the transaction is an essential qualification.

The financial advisor's compensation usually is structured on an hourly or fixed fee basis or as a percentage of the amount of debt issued. However, LG issuers should be cautious about compensating a financial advisory firm on a percentage or per bond basis for the following reasons. First, the payment on a per bond issued does not reflect the amount of work a firm may have to undertake to complete the transaction for the issuer. Second, the method provides a potential incentive to the advisor to advocate the issuance of bonds whether or not this financing method is the most advantageous for the issuer.

For example, in a LG bond issuance, the percentage method is expressed as an amount per \$1000 bond (US). Therefore, a \$10 million bond sale results in a \$10,000 financial advisory fee if a \$1.00 per \$1000 bond issued is charged. In the percentage method, the financial advisor would receive \$10,000 regardless of actual work done. Payment on an hourly or fixed fee basis eliminates this potential conflict of interest.

In this section, we often refer to the need to prepare a request for proposal. To assist you in that task, we have included guidelines for preparing a proposal in the following table.

Guidelines for Preparing an RFP

A **Request for Proposal (RFP)** is a document prepared by the LG that outlines a specific scope of work that needs to be accomplished and requests professional firms (such as engineering, legal, accounting, financial advisor, underwriters or banks etc.) to respond to the proposal by describing their qualifications and experience to provide the desired services and a schedule of fees. The LG selects the “best qualified” firm to perform the work rather than the firm offering the lowest price.

The following guidelines are offered to help LGs prepare a Request for Proposal:

1. Define the services needed by the LG in clear, precise language. By clearly describing the scope of work needed, responding firms will be able to determine what services are needed and emphasize the qualifications and experience that they have to meet the LG’s needs.
2. Include in the request for information only items that will be used to evaluate responses
3. Identify and describe the criteria that will be used to select the best proposal
4. Make the selection criteria as objective as possible
5. Assemble a selection committee to review the proposals and interview the firms. Ensure that the committee has a clear understanding of the desired services.
6. Be cautious of using elected officials on the selection committee. The selection process may be undermined if any of the committee members receive financial support from a competing firm or otherwise would appear to benefit politically from a firm’s selection.
7. Provide each firm sufficient time to prepare a response to the Request for Proposal. (Be aware of holidays)
8. Establish a deadline (date, time and place) for receipt of the proposal by the LG and adhere to it.
9. After the selection committee reviews all the proposals, develop a list of the 2 or 3 firms that have submitted the best proposal based on objective criteria.
10. Interview the firms on this short list. Require the attendance of the key personnel listed in the proposal.
11. Ask each of the firms to make a short presentation about the firm’s qualification and then have each firm respond to a set of the same questions. These questions should address the most important items in the proposal. This will provide an opportunity to compare responses directly and match the response to the government’s requirements.

BOND COUNSEL

The **bond counsel** is an attorney who specializes in LG bond and securities law. The bond counsel’s role is to advise LG officials concerning the issuer’s com-

pliance with the constitution, central government laws, and local ordinances and resolutions. The primary responsibility of bond counsel is to certify that the LG has the legal authority to issue the debt. In countries where LG bonds are exempt from income taxation, the bond counsel also certifies that the securities qualify for tax exemption based on existing law. The opinion of bond counsel on the prospective issue assures the investor that the issue complies with all legal requirements and reduces the investor's risk that the contract will be unenforceable or that the interest is not tax exempt.

The bond counsel provides specialized legal services to assist the LG issue LG securities. If a specialist in LG debt is not available, LG should rely upon the traditional legal counsel in these matters. Bond or legal counsel usually provides the following services:

- Determines whether the LG has the legal authority to issue bonds or other debt instruments based on existing constitutional, central government law and local ordinances and limitations.
- Ensures local ordinance authority is consistent with constitutional requirements and limitations.
- Prepares legal documents for debt issuance, such as the bond ordinance or loan agreement, which describes the debt, the security, or guarantees for the debt and any other legal instruments needed to authorize the issuance of debt.
- Ensures the bonds or loans are within applicable debt limitations.
- Ensures the applicable tax rate or debt service limitation is observed.
- Reviews the official statement or loan/lease application to make certain that the legal information is correct and that no material information has been omitted.
- Examines the proceedings of the governing body providing for the debt issuance to ensure that the debt will be issued legally.
- Ensures that a competitive sale is advertised properly or that an underwriter in a negotiated sale is selected properly.
- Determines whether the tender (bid) accepted is legally acceptable in a competitive sale.
- Responds to questions from underwriters, investors, trustees, paying agents and others regarding the debt issuance before delivery.
- If there are favourable tax benefits to LG debt issuance, prepares an unqualified opinion regarding the tax benefit nature of the issuance (if applicable in your country).

LG officials should consider including items from this list of services in developing the scope of work to select a bond counsel to assist the LG with the debt issuance.

When selecting bond counsel, LG officials should be primarily concerned with the strength of the firm's reputation in the area of LG securities law. Issuers' and investors' confidence in the bond counsel opinion is directly related to the firm's experience. A source of attorneys specializing in this area of law can be obtained from commercial banks, financial advisors, or underwriters involved in LG financing.

LGs should prepare a request for proposal to solicit proposals from law firms that provide these specialized services. A bond counsel request for proposal should include:

- A discussion of the firm's understanding of the LG's debt financing needs and the firm's ability to provide the requested scope of services.
- Identification and qualifications of the individuals who will provide bond counsel services (and a back up individual).
- Experience of the individuals with the type of transactions that the LG plans to issue.
- A commitment of these individuals by the firm to the LG during the life of the contract.
- The basis on which the bond counsel will be compensated.
- A list of LGs currently under contract for bond counsel services.
- References from at least three other LG clients who have retained the firm and the individuals for similar transactions.

LGs compensate bond counsel in one of three ways: 1) a fixed fee-not to exceed a specified amount; 2) an hourly fee with the bond counsel providing an estimate of work hours; or 3) a percentage of the bonds sold usually expressed as an amount per \$1000 of bonds issued. In selecting bond counsel, local officials should consider the complexity of the issue, the risk involved in the transaction and the amount of work required to complete the transaction. As has been mentioned previously, it is considerably difficult to judge these factors if the bond counsel is compensated on an amount per bond basis since the amount of bond issued is not always a good measure of the difficulty of the transaction.

UNDERWRITER

In a LG debt issuance, the role of the **underwriter** (sometimes called banker's role) is to provide a market for the LG by purchasing debt instruments from LG issuers and then reselling them to other investors or holding them for their own portfolio.

The underwriter provides different services to the issuer depending upon the type of LG debt issuance. In a competitive bond sale, underwriters compete against each other for the right to purchase the LG issue. The underwriter determines their bid by reviewing the pricing of comparable issues, discussing the sale with potential investors, assessing the competition for the bonds and comparing the issue to other issues that are coming to market at the same time. The underwriter submitting the best bid (lowest interest cost) on the day of the sale is awarded the bonds. To insure a competitive bid at current market prices, underwriters submit bids just before the time established for bid opening.

In a negotiated bond sale, the LG selects the underwriter ahead of time. This allows the underwriter to discuss the bond issuance in advance with the issuer and potential investors and to develop a structure that meets the needs of the investor and is cost effective for the LG. By designating the underwriter, the LG reduces the time normally needed to sell LG bonds and enables the underwriter to be in a better position to sell bonds based on current market conditions. The underwriter deter-

mines the final purchase price of the bonds after negotiating between the LG issuer and the potential investor. LG officials approve the transaction by signing a bond purchase agreement.

The selection process for an underwriter is different depending upon the nature of the transaction. Obviously, in a competitive transaction, the low interest cost bid determines the underwriter. There is little additional work needed in this process. Also, each transaction could produce a different underwriter based upon the best bidder on any specific date.

In a negotiated transaction, the LG should conduct a selection process much like that described for financial advisors and bond counsel. To select an underwriter. The LG should prepare a request for proposal and send it to interested commercial and investment banks. The request for proposal should solicit information about the firm's experience and financial capacity to underwrite the debt issuance. The request should include the following:

- A discussion of the firm's understanding of the LG's debt financing needs and the firm's ability to provide the requested scope of services.
- Identification and qualifications of the individuals who will provide underwriting services (and back-up individuals).
- Experience of the firm and individuals with the type of debt transactions that the LG plans to issue.
- Financial capacity of the firm to underwrite the transaction.
- The length of the contract: a single issue or a fixed time period (3-5 years).
- On what basis the underwriter will be compensated.
- History of the firm's underwriting for the past three years for similar transactions.
- References from at least three other LG clients who have retained the firm and the individuals for similar transactions.

The selection of an underwriter should be based on the experience and qualifications of the firm and individuals involved in the transaction, the proposed structure of the issuance, and the cost of the issuance.

Compensation for underwriters also differs depending upon the type of transaction. In a competitive transaction, the underwriter is compensated from either buying the bonds at discount or from buying them at par and re-offering them at a premium. In a negotiated transaction, the underwriter receives a gross spread or discount that is a percentage of the face amount of the bonds and is often expressed in an amount per \$1000 bond (such as 1% or \$10.00 per bond).

PAYING AGENT/REGISTRAR/TRUSTEE

The role of the *paying agent* is to maintain the debt service deposit received from the LG and to pay the principal and interest on LG bonds when due. Financial institutions, such as banks, usually provide this service for LG bonds. However bank and government loans and leases, the lending institution generally handles their own loan servicing.

Paying agent/registrar duties are frequently combined with the trustee in the case of limited obligation bonds where a trust indenture is required. The trustee's role has taken on a greater importance with the increased use of revenue security and complicated relationships and responsibilities found in certain transactions. The trustee, even though hired by the issuer, has a fiduciary responsibility to protect the interest of the investors and to oversee a range of responsibilities including: ensuring adherence to covenants, disbursing bond proceeds, managing the investment of unspent bond funds, processing call provisions, and making purchases of bonds in the open market with surplus funds.

A LG should select the paying agent /registrar/trustee by competitive bid with the lowest cost provider meeting the specification being awarded the bid. Compensation to the paying agent/registrar is based on a one time set up fee and an annual administrative fee to cover the cost of maintaining the bond ownership records and transferring principal and interest payments to bondholders.

OTHER SPECIALISTS

The complexity of the debt transaction may require the hiring of other financial and technical specialists. Auditors may be needed to provide audit reports (often referred to as comfort letters) on revenue generating activities or issuance of additional bonds. For example, in some revenue bond covenants, there may be a requirement that before additional bonds can be issued certain minimum debt service coverage tests be met. An independent auditor would conduct the coverage test and certify to its accuracy. Consulting engineers may be required to conduct engineering and market feasibility studies to determine the revenue generating capacity of a new facility. These reports provide independent confirmation of the project's necessity and the likelihood that sufficient revenues will be generated to repay the debt. Lastly, the LG may need a **credit enhancement** to issue debt. This instrument, supplied by a financial institution selected by the issuer, provides additional protection to the creditors by providing credit backing with an insurance policy or letter of credit.

LEARNING APPLICATION

POLICY MAKER _X_ CEO _X_ FINANCE MANAGER _X_ DEPARTMENT HEAD _X_

With respect to what you have read so far, has your LG ever used external advisors to issue debt? If yes, how would you describe the experience?

If your LG has never used external advisors, what concerns do you have with using external advisors?

INVOLVING POTENTIAL INVESTORS

Transparency in the process for financing capital investments is equally as important as transparency in financing the operating budget. However, potential investors will insist on transparency when issuing debt is involved. The lack of transparency can directly affect the interest rates that the LG will have to pay for debt. Following are some of the traditional ways that LGs have kept investors informed.

DISCLOSURE

Disclosure is defined as all the materials prepared by a LG issuer that describe the proposed debt issuance, the security pledged to repay the debt, and the supporting information related to the issuer willingness and ability to repay the debt when due. From an investors' point of view, disclosure is all the information that they need to understand the risk and make an informed investment decision. From a banker's point of view making a loan, disclosure is the same except that the information is held confidentially and not publicly disclosed

The type of document used to disclose information to the bank or investors varies depending upon who needs the information, the type of debt (loan or bonds) and the requirements of the lenders, underwriters, or investors. As a rule, the more public the issuance the greater the disclosure requirement.

LGs issuing LG bonds to investors and the public have significant disclosure requirements. The most important document that discloses this information in one place is the preliminary **official statement** prepared by the LG issuer. This document summarizes the proposed debt issue, describes the security pledged to guarantee the debt repayment, and relevant information regarding the creditworthiness of the LG. An outline of an official statement is shown below.

The preliminary official statement is very important in the debt issuance process because it provides underwriters a way to evaluate LG creditworthiness in preparing a bid for the securities, and to market the bonds to prospective investors. In many cases, investors will only have the preliminary official statement on which to make an investment decision. To ensure that all pertinent information is disclosed

to investors, LGs often include summaries or extracts of other source documents such as audits, financial statements, feasibility studies, and bond indentures in the preliminary official statement.

Outline of an Official Statement

- Cover page describing key feature of the securities
- Introduction to the official statement
- Description of the securities being offered
- Description of the credit enhancements (if applicable)
- Description of the issuer (and conduit issuers, if applicable)
- Debt Structure
- Basic documentation (includes a description of pertinent bond covenants)
- Financial information
- Miscellaneous items

Because the scope and content of disclosure materials can vary from country to country, LG issuers should work closely with their bank, financial advisor and bond counsel to prepare the required documentation.

After the sale/purchase of the bonds, the LG has additional information that must be included in preparing the final official statement. This additional information includes the *coupon rates* of interest on the bonds, the prices, or re-offering yields, whether a *credit enhancement* was utilized (and if so, the identity and a description of the provider) and other information that was not known before the sale.

Generally, the information disclosed in the preliminary official statement about the LG, the security pledged and overall creditworthiness does not change prior to printing the final official statement; however, should there be a change, the LG must include this new or revised information in the final official statement. In these cases, the assistance of bond counsel and financial advisor will be invaluable.

Since the official statement is the primary means of disclosure, its distribution is very important. The preliminary official statement is usually distributed by the financial advisor for competitive sales to ensure wide spread market distribution and increase the number of bidders. In a negotiated sale, the distribution of the preliminary official statement is handled by the issuers selected underwriter to market the debt issue to participants in the underwriting syndicate and potential investors. Once the sale/purchase is finalized, the underwriter determines the number of copies needed to meet their marketing program to investors and syndicate members. The financial advisory normally handles the printing and distribution of the preliminary and final official statements.

Once the transaction is completed, the LG issuer should make an effort to continually disclose information to the public, investors, and rating agencies on their financial condition and creditworthiness. This can be as easy as providing copies of the auditor's opinion, annual financial statement and budget to the underwriters or a bank involved in the borrowing transaction, and of course, the rating agencies, if applicable.

OFFICIAL STATEMENT

Preparing an official statement is unique to the issuance of LG bonds that will be re-offered for sale to investors and the public. However, the actions of a LG to gather

information about the LG finances and the debt issuance which are included in the official statement are very similar to that required to process a bank or government loan or lease financing. To obtain a loan, a LG prepares and submits an application and supporting documentation to the lending organization to provide assurance of the willingness and ability of the LG to repay the loan. The bank, government or international organization uses the information determine if the application meets their underwriting criteria and the degree of risk which determines the interest rate and collateral or security guarantees. The major difference between the official statement and the loan application is that the official statement becomes the bond offering document provided to each investor and the public and is very comprehensive. On the other hand, the loan application is generally not public and not as detailed and comprehensive. With that comparison in mind, we will discuss preparing an official statement.

The LG issuer should prepare an official statement in sufficient time before the sale date to give investors and underwriters ample opportunity to review it, analyze the financial condition of the issuer and prepare pricing on the issue. The LG issuer should also ensure that the official statement is complete and accurate. They should also consult the financial advisor and bond counsel for the specific information that should be disclosed in the official statement to meet both legal requirements and underwriter and investor needs.

Generally, are a myriad of requirements that dictate what should be included in official statements. Bond defaults of some prominent American LGs have contributed to the need to increase disclosure on behalf of US LGs. In other parts of the world, these requirements do not exist, so the question is: in the absence of stated requirements, what is appropriate to prepare and disclose in an official statement? The underwriter and investors will be the persons that a LG issuer will have to satisfy. At a minimum, the LG issuer should prepare:

- A description of the security being pledged for repayment of the debt (either a revenue or LG assets).
- A statement of the LG's financial condition.
- The structure of the bond issue.
- The risks inherent in the owning the bonds.
- The legal issues relevant to the issue and any special tax status of the debt.

Underwriters and banks may request additional information. Local officials would be wise to prepare the following information ahead of time to ensure that they are aware of what the information portrays. The information items include:

- Total LG debt outstanding.
- Value of LG assets currently pledged to outstanding debt.
- Value of remaining LG assets not pledged to debt.
- Debt per capita.
- Tax or revenue collection history.
- Tax rate history.
- Changes in financial condition of the LG.
- Population and income trends.

- Actual value of the property in the jurisdiction.
- Operating revenues.
- Tax rate and debt service limits.
- Accounting policies.
- Principal taxpayers.
- Current assets and liabilities.
- Value of fixed assets.

In a competitive sale, the official statement and notice of sale (discussed in the next section) are prepared and distributed to prospective bidders for the bonds before the sale. These documents are the basis for underwriters to submit bids for the bonds. Once the sale is final, the financial advisor or issuer provides the winning bidder with an addendum reflecting any changes to the official statement and with the bidder's coupon interest rates on the bonds.

In a negotiated sale, the preliminary official statement is used by the underwriter to obtain investor interest before establishing the interest rates or offering prices. A notice printed on the cover states that the preliminary official statement does not constitute an offer to sell or a solicitation of an offer to buy securities.

NOTICE TO SALE

In addition to the official statement, the LG issuer and financial advisor should prepare a notice of sale to accompany the official statement. The notice of sale is the issuer's official notice of intention to sell a bond issue by competitive bid. The notice of sale must be advertised before the bid opening date in accordance with central government and/or local laws. Advertising and publication requirements differ from country to country and possibly between LGs, so LG officials should determine what requirements apply to them. The requirements range from posting the notice of sale on local sign boards and advertising in local newspapers to publishing the notice in newspapers or specific financial trade publications with a national circulation.

The Notice of Sale should contain at least the following information:

- Total par value of bonds to be sold.
- Maturity dates of the bonds.
- Call provisions, if any.
- Maximum interest rate permitted.
- Minimum bid permitted.
- Time, date and location to submit bids.
- Basis on which the bond sale will be awarded.
- Constraints on the bids (i.e. spread between coupon interest rates).
- Size of good faith deposit.
- Name of bond counsel.
- Name of financial advisor.
- Name of the person to contact for further information.

The financial advisor usually assumes responsibility for distributing the Notice of Sale (including the official statement) to underwriters and prospective investors in

a competitive sale. The financial advisor's goal is market the bonds to underwriters and potential investors to stimulate interest in the issue and increase the number of underwriting firms who will bid for the bonds. Hopefully, with increased competition, the issuer receives a lower interest rate on the bonds.

METHODS FOR ISSUING DEBT

There are three primary methods used for issuing debt.

1. PRIVATE PLACEMENT

Private placement is the one least often used. In a **private placement**, the LG issuer deals directly with a bank or investor, and the debt is not offered for sale to the public. A LG uses this method in situations where the terms must be specifically tailored to an issuer's needs, a complex transaction is envisioned or the issuer has unusual circumstances, such as a prior default on a debt issuance.

2. COMPETITIVE BID

In a **competitive bid**, the LG issuer solicits bids from underwriting firms to purchase its debt and awards the bid to the bank, underwriter, or syndicate with the lowest interest cost. In determining the lowest interest cost, LGs select one of two ways to calculate the interest cost of the bids: the net interest cost (NIC) or the true interest cost. The method of tabulating the bids is included in the official statement

The net interest cost method is the traditional method used for LG bonds and represents an average interest rate on a bond issue. This method provides a quick calculation. The net interest method is calculated as follows:

$$\text{Net Interest Cost} = \frac{(\text{Total coupon interest} + \text{bond discount}) \text{ (or - bond premium)}}{\text{Total Bond Years}} *$$

*_Total Bond Years = the par value of each bond for a specific maturity times the number of years to that bond's maturity.

The net interest cost method has one major drawback; it does not consider the time value of money. The true interest cost method takes the time value of money into account in its calculations. For this reason, it is considered a more effective interest cost calculation. To account for the time value of money, this method gives greater weight to earlier debt payments and discounts the value of future payments. A computer is necessary because this method must be calculated using an iterative trial and error algorithm; in addition, because many bond issues are in serial form, numerous cash flows must be valued.

In a competitive sale, the LG issuer assumes responsibility for preparing the issuance documents, structuring the issue, obtaining a credit evaluation, determining the need for **credit enhancements** and all other requirements needed to issue the bonds before the sale. Generally, the financial advisor assists with this task.

To compare competing loan or lease payment schedules, an acceptable method uses present value analysis to compare cash flows. Present value calculation takes the time value of money into account.

The present value of a future sum of money can be determined from the following equation:

$$PV = FV_n \frac{1}{(1 + i)^n}$$

Where FV_n = the future value of the investment at the end of n years
 n = the number of years until the payment will be received
 i = the opportunity or discount rate
 PV = the present value of the future sum of money

To aid in the calculation of present values, tables have been compiled for values of $1 / [(1+i)^n]$ and are available in most finance textbooks. Apply the formula to each annual cash flow, determine that year's present value, and sum each year's present value to arrive at a total present value of the year's cash flow. There are computer programs that include present value analysis programs to make this calculation easier. Your financial advisor should be able to assist you in making these calculations and comparisons.

The following table lists the advantages and disadvantages of competitively bidding LG bonds:

Selling Bonds by Competitive Bid

Advantages	
•	Provides an incentive for underwriters to submit their best bid, resulting in the lowest interest costs given market conditions.
•	Is viewed as a fairer method of selecting an underwriter.
•	Helps keep underwriter's costs (gross underwriter spreads) low due to competition.
Disadvantages	
•	Is relatively inflexible to respond to changing market conditions.
•	Eliminates the issuer's control in determining which underwriting firm is selected and how bonds are distributed among investors.
•	May encourage underwriters to build a "risk premium" into the bids thereby increasing the overall interest cost because underwriters have no assurance that they will be selected as underwriter and the potential volatile nature of the bond market.

3. NEGOTIATED SALE

In a negotiated sale, the LG issuer and the financial advisor select the underwriter early in the process before the terms of the debt issuance are set. Once selected, the underwriter assists the issuer in all tasks necessary to prepare for the issuance. The issuer negotiates a purchase price for the bonds at the time the bonds are sold.

The following table lists the advantages and disadvantages of selling bonds by negotiation.

Selling Bonds by Negotiation

Advantages

- Saves the LG issuer time and expense because the underwriter does most of the work associated with the bond issuance.
- Increases the issuer's and underwriter's flexibility to structure the debt to respond to changing market conditions or to meet investors' needs.
- Provides the issuer with more control over the composition of the underwriting syndicate and distribution of the bonds within the syndicate.
- Reduces the time it takes an issuer and underwriter to bring a sale to market and permits the underwriter to better time the sale of the securities to respond to changes in market conditions.
- Increases the time an underwriter has to conduct pre-sale marketing to assess investor demand; this might be helpful for an issuer's initial offering or a complex sale from an established issuer.

Disadvantages

- Increases the issuer's difficulty to ensure that the prices reflect current market conditions.
- May increase the opportunity for an issuer to be criticized for favouritism if a particular bank is chosen to underwrite or purchase the bonds.
- Reduces the issuer's ability to determine what the underwriter's gross spread is because of the number of services provided in a negotiated sale by the underwriter.

CONSIDERATIONS IN CHOOSING THE METHOD

A LG should choose a method of issuing debt after considering a number of factors related to the nature of the issue, the issuer, and the current bond market. These factors include the size and complexity of the debt issue, the credit quality of the issuer, the investor's familiarity with the debt, and market conditions. The size of the issue influences both the level of investor demand and the market's ability to absorb the issue. Issues that are too small may not attract sufficient bidding interest—yet very large issues may not be easily absorbed by the market. Thus, unusually large or small issues may benefit from a negotiated transaction.

A LG debt issue that contains complex or an unusual debt structure may require the underwriter to educate the investor about an issue's features and would benefit from a negotiated transaction. Similarly, an issuer that wants to respond to changing or unstable market conditions should also opt for a negotiated transaction to retain flexibility on setting the sale date.

A LG that plans to issue traditionally structured debt and be in the market on a regular basis (i.e. annually) should sell bonds competitively. Traditionally structured debt is easily understood by investors, and a LG that sells bonds frequently is known by investors because they are in the market on a regular basis. Both situations reduce the need to educate the investor on the issuer and negotiate a purchase price.

A LG that achieves a high quality credit rating and issues debt frequently should sell bonds competitively. Since investors demand high quality issues and generally know more about these issuers, there is less need for marketing the issue and specialized negotiation. Therefore, a high quality, frequent issuer will benefit from a competitive bid method of selling bonds.

PAYING INTEREST

Most LGs prefer to issue debt that has a fixed interest rate. That means that the interest rate paid to investors is set at the time of the original sale and is not subject to change before maturity. Fixed rate debt relieves the LG of any concern that rates on the debt will change over time and increase beyond their ability to pay.

SERIAL AND TERM DEBT

There are three types of fixed rate debt: serial, term and a combination of serial and term. A **serial debt** structure provides for a portion of the issue's par value to mature (or be paid off) each year. For example, if a LG issued 5 million in bonds over a fifteen-year period, a serial structure would require that a portion of the bond principal mature each year. An example of a serial bond structure is shown in the following table. Since the serial structure has principal amounts maturing in each year, the outstanding indebtedness declines each year increasing capacity for future debt and so does the interest paid on the outstanding indebtedness.

A **term debt** structure provides for the entire or a large part of the par value of the debt coming due on a single maturity date. For example, if a LG issued 5 million in LG bonds with a single maturity date in fifteen years, the structure would be referred to as a term bond. The LG would pay interest only in the intervening years and that interest would be calculated each year based on the 5 million in bonds outstanding. The principal amount would be paid off in one lump sum at maturity. See the following table for an example of a term debt structure.

The serial and term debt structures may be combined. For example, a serial bond structure may be used for the first 15 years and a term bond added at year 20. This larger maturity at the end of an issue is often attractive to specific investors. The LG issuer pays interest periodically at the coupon interest rate on both the serial and term bonds associated with each maturity. The term bond also requires the LG create a sinking fund to provide funding for the redemption of the term bond principal. **Sinking funds** are a method for the LG to set aside a specified amount of money annually to reduce the amount of money that would otherwise have to be raised in one year to redeem the term bond at maturity. See the following table for an example of a combined structure.

Regardless of the type of structure selected, LG should always match the structure to the life of the project. The final maturity should closely match the useful life of the project being constructed or renovated. A LG should never be in a position to be paying for a capital asset that is no longer being used. The type of debt structure selected should also be checked to ensure that it complies with any debt management policies. For example, a policy that requires rapid retirement of principal, an average bond maturity below 10 years or the lowest interest cost is calling for serial type of debt structure.

Serial, Term and Combined Structure Options for a 5 Million Debt Issuance

Maturity Year	Maturity Amounts		
	Serial Debt	Term Debt	Serial and Term Combined
1998	250,000		162,500
1999	255,000		167,500
2000	265,000		172,500
2001	275,000		180,000
2002	285,000		187,500
2003	297,500		195,000
2004	310,000		202,500
2005	322,500		212,500
2006	337,500		220,000
2007	355,000		232,500
2008	370,000		242,500
2009	390,000		255,000
2010	407,500		267,500
2011	430,000		280,000
2012	450,000		295,000
/			
2017		5,000,000	1,727,500
Total	5,000,000	5,000,000	5,000,000

FIXED RATE DEBT SERVICE STRUCTURES

LG issuers establish debt service structures in one of two ways: level principal and level debt. There are also two variations on these two structures.

Level Principal Debt Structure—In a level principal debt structure, a LG issuer would pay equal amounts of the par value of the debt each year. For example, if a LG issued a 20 million par value serial bond, for 20 years with level principal, the LG would retire 1/20 of the par value or 1 million each year. When interest is added to this structure, the total annual debt service requirements are highest in the first year and decline in each following year.

Level Debt Service Structure—In a level debt service structure, a LG would pay an equal amount of debt service each year, including principal and interest payments. In a level debt structure, the amount of principal gradually increases over the life of the debt in proportion to decreases in the interest cost so that the combined total is equal for the life of the debt for each year.

Each of these two debt structures has advantages and disadvantages. The level principal structure produces the fastest pay off of the debt (restores debt issuance capacity quickly) and the lowest overall interest cost. However, its high first year debt service cost can be troublesome for LGs. The debt level structure solves the high first year debt service cost by making equal debt service payments, but it has higher total interest costs and a slower payoff of the indebtedness. Given this situation, a LG should select the structure that best meets their specific needs.

Graduated Principal Structure—In a graduated principal structure, a LG issuer reduces the size of the principal payment in the early years to reduce the overall debt service payment and shifts the principal payments to later years. This is often done to finance revenue generating facilities that when completed will produce revenues to retire the debt. The graduated principal structure allows the LG issuer to better match the repayment of the debt to the revenues available. This structure gives the LG issuer an opportunity to complete construction of the project and establish a record of operations.

LG officials should note that this structure is more complex than the others described above and as a result, may be more difficult to obtain. To effectively issue debt with this type of structure, a feasibility study of the revenue-generating project may be needed to support the shift of the principal to later years to ensure that future revenue streams will be sufficient to repay the higher debt service at that time. Also the slower repayment schedule will increase the total interest cost of the issue.

Deferred Principal—The last debt structure a LG issuer might want to consider is a deferral of all principal for a period of years. LGs use this structure to limit the debt service during construction of a project. Once the project is complete, the facility can generate revenues to repay the debt. Also, in projects that use deferred principal, it is also common to incorporate capitalized interest into the project financing. By **capitalized interest**, we mean that the issuer sells additional bonds to pay for the interest during the period of construction and until the project is complete and generating revenues. LG officials should note that this structure increases both the amount of money borrowed and the total debt service.

VARIABLE RATE DEBT

Variable rate debt provides an alternative to fixed rate debt for LG issuers. This type of debt can benefit issuer and investor alike: the issuer takes advantage of lower interest rates in very short maturities and the investor protects a return on investment in an inflating economy. The most common maturities are seven days and 30 days, but the issuer can have an option of setting various maturities up to one year.

Variable rate debt works this way. On the maturity date, the holder of the variable rate bond is given an option, to present the bond for payment or accept a new maturity date and rate of interest. If the bond is presented for payment, the LG's remarketing agent (a commercial bank or underwriter) must identify new investors to buy the bond. If the agent finds a buyer, the bonds are reissued at the new maturity date and a new interest rate. However, if the remarketing agent is unable to find a buyer, the variable bond issuer must have a financial institution that will provide funds to satisfy the former holder of the bond. Issuers normally purchase a letter of credit to provide this liquidity.

LG officials should be cautious in the use of variable rate debt due to the two risks. First, there is market risk that there will not be a market (a new buyer) for the issuer's variable rate debt on a specific maturity date. This would mean that the letter of credit would have to be drawn upon, and it usually has a less favourable rate than the variable rate debt. The second risk is **interest rate risk**. If interest rates rise, the LG will pay higher interest cost on its debt issuance, and this action could jeopardize the LG's ability to pay the debt service.

The selection of a maturity schedule should reflect the revenue stream pledged to retire the debt. In selecting a maturity schedule, the LG issuer should be aware of the availability of the revenues to retire the debt. If the debt is paid from tax revenues, the issuer may have more flexibility in the selection of a maturity schedule. If the debt is paid from specific revenue and paying the debt is dependent upon the revenue generating facility being completed, the issuer must consider that fact in selecting a maturity schedule.

PAYING DEBT OFF EARLY—CALL PROVISIONS

One of the last items to be considered by a LG issuer in structuring the debt is whether or not to include a call provision. A call provision allows the LG to redeem the LG bond at a date earlier than the scheduled maturity date. Callable bonds can be either mandatory or optional.

A mandatory call provision requires the issuer to call the outstanding bonds according to a schedule that is defined in the bond indenture and official statement. Term bonds are frequently subject to early call. In this case, an issuer makes annual payment in the years just before the stated maturity of the term bonds. These annual payments when added to the final maturity principal payment are sufficient to fully retire the term bonds.

An optional call provision gives the LG issuer the right to call bonds at their discretion earlier than the maturity date. To do this, the LG issuer pays a premium above the par value to exercise the option. The right to call the bonds from an investor is extremely valuable to the issuer when interest rates have declined significantly below the coupon interest rates on the previously issued, outstanding bonds. Calling bonds before their maturity date provides the basis for much of the benefit associated with refinancing debt obligations.

A LG that borrows money from a commercial bank rather than issue bonds should also include provisions in the loan agreement that preserves the right of the LG to refinance the loan without a penalty should interest rates decline below the loan rate.

PUTTING ALL THE PIECES TOGETHER

Which type of financing a LG uses depends on a number of factors. These include: the nature, size, and life of the project, existing legal authority, and financial condition of the LG.

One of the easiest ways to help with that decision is to relate the project to be financed to the types of financing that the LG has available. Three general financing options are shown in Exhibit 6, short-term debt, long-term debt, and “pay as you go.” If there is any question about your options, consult your local legal counsel.

The following table shows another ways for determining the most appropriate type of financing given a specific project characteristic in a decision matrix format.

Decision Matrix for Determining an Appropriate Financing Technique

	Then use			
If	Short-term Debt	Long-term Debt	Pay as you go	Comments
Nature of project				
Cover temporary cash flow shortage	X			Retire short-term debt within the fiscal year; do not roll over.
Interim finance capital project	X			Must have access to long-term markets to refinance short-term debt
Finance capital project		X	X	Pay as you go if access to capital markets is not available
Size of project				
Small			X	Use current revenues
Large		X		
Useful life of project				
A few months to 1 year			X	Use current revenues
1-5 years		X	X	Use current revenues for total project cost or a large down payment; and/or debt with maturity not to exceed asset's useful life
5-30 years		X		Maturity not to exceed asset's useful life

If you have decided to incur long-term debt, the next decision is to determine what type of debt will be used --commercial bank loans, government or international organization loans, LG bonds, or leasing. One of the easiest ways to make this decision is look closely at factors related to the nature of the project and debt financing transaction, and the LG's objectives regarding the debt and relate those to the type of debt that best meets those factors and criteria. The following table provides a matrix listing various factors/criteria and relates these to the most appropriate debt instruments.

Decision Matrix for Choosing Among Long-term Debt Financing Alternatives

	then use				
If	Bank Loan	Gov't Loan	LG Bond	Lease	Comments
Nature of Project					
Acquire temporary use of equipment or facility				X	True lease

Purchase equipment or construct permanent facility with a long useful life	X	X	X	X	Lease-purchase agreement
Size of Project					
Medium	X	X	X	X	
Large		X	X		
Useful Life of Project					
1-5 years	X		X	X	
6-30 years		X	X		
Flexibility in Use of Proceeds					
Specific capital investment	X	X	X	X	
Multiple capital investments	X		X		
Complexity of Transaction					
Simple	X	X			
Complicated			X	X	
Time Needed to Complete Transaction					
Short	X				
Medium			X	X	
Long		X			Depends on budget cycle
Cost of Issuance					
Low	X	X			
High			X	X	External advisors needed

If you have made a decision to issue LG bonds, you now need to decide what type of LG bond is appropriate. There are two broad categories already discussed: general obligation and revenue bonds. The following table provides a matrix to help you make the decision between these two types of bonds based upon selected criteria.

Decision Matrix for Choosing Between General Obligation and Revenue Bonded Debt

Factor/Criteria	General Obligation Bonds	Revenue Bonds
Who benefits?		
Provides direct and indirect benefits to the whole community	X	
Provides direct benefits only to users		X
Who pays?		
All taxpayers in the community	X	
Users of the facility/project		X
What secures the debt?		
Full faith, credit and taxing power of LG (unlimited)	X (unlimited tax)	
Full faith, credit and taxing power of LG (limited by a designated revenue source or maximum tax rate)	X (limited tax)	
A pledged revenue source of the facility being constructed		X

Next, consider the advantages and disadvantages of your selection as described in the earlier section. For example, if you have decided to issue revenue bonds, review the advantages and disadvantages of revenue bonds. The same if you decided to issue general obligation bonds. Lastly, consider the decision in light of your LG's capacity to repay the debt. If you are still comfortable, proceed to the next step of issuing debt.

LEARNING APPLICATION

POLICY MAKER X CEO X FINANCE MANAGER X DEPARTMENT HEAD X

We have reviewed the different types of debt that a LG might issue and some decision methods that apply to investments to determine the most appropriate type debt for your LG. Think about two or three major capital investments that will require financing in the next year and list them below. From your role unique perspective, is the use of debt appropriate in each of these cases?

Why or why not?

If debt were appropriate, what type of debt instrument would you recommend to your LG?

What characteristics of the investment support your answer?

Can you identify any other criteria that you would consider in making this decision?

STEPS FOR ISSUING DEBT

Once the decision to issue debt is made, turn your attention to preparing the debt issue. It will require the LG to assemble an advisory team, select a method for issu-

ing debt, determine the size and structure of the debt issue, prepare an official statement, prepare and publish the notice of sale, and ultimately conduct the sale and award the debt issue to the best tender (bid).

In this section, we continue to use the term “debt” to refer to all types of debt issues: bank loans, government loans, LG bonds, and lease financing. Also, while the following steps were originally designed to issue LG bonds, you can apply the information in each step to guide preparation of other debt issues such as loans. In cases where the narrative does not apply to all the various types of debt, we will try to point out those differences.

STEP 1: ASSEMBLE AN ADVISORY TEAM

One of the first decisions that LG officials should make is to assemble a group of advisors to assist the LG in issuing debt. At a minimum, the team consists of a financial advisor (a financial specialist who assists the issuer in the transaction), bond counsel (a specialist in LG securities law) and the LG issuer (usually represented by the finance manager). An underwriter is selected by the issuer as a part of this group of advisors if the debt issue is negotiated. If the debt issue is not negotiated but competitively bid, the underwriter does not join the group until the sale is consummated since the underwriter is determined by award of the sale to the best bid. There may be other specialists such as paying agent/registrar, consulting engineers and auditors depending on the nature of the transaction. The finance manager should select members of the team to reflect the complexity of the debt issuance. Obviously, preparing for a small bank loan will require fewer advisors than a complex LG bond financing.

STEP 2: SELECT A METHOD FOR ISSUING DEBT

After assembling the advisory team, you are ready to undertake the second step in the issuance process: selecting a method for issuing debt. LG issuers usually issue debt in one of three ways: competitive bid, negotiation, and private placement.

STEP 3: DETERMINE THE SIZE AND STRUCTURE OF THE DEBT ISSUE

Officials should ensure in this step that they identify all the project costs, that the financing is consistent with their debt objectives and that the debt service repayment schedule matches the available revenues.

In sizing the issue, the LG issuer must determine the amount of money needed. In determining the amount, the issuer should consider: project cost, issuance cost, and interest earnings on investment of the borrowed money. The proceeds and interest income must be sufficient to cover all the project and related costs.

In addition to project costs, the LG issuer may use the proceeds for other related issue costs. These costs will vary from project to project but might include: interest on the securities for a limited period of time (this is known as **capitalized interest**) to cover the interest cost on a project in which the project is totally dependent upon the project revenues to pay debt service or to fund a debt service reserve. A debt service reserve is required for revenue bond issues that do not have a claim on a LG taxes to pay the revenue bond debt service if revenues are insufficient. A **debt service**

reserve provides funding for at least one year of debt service. Other issuance costs may include the fees paid to the advisory team usually the financial advisor and bond counsel.

In structuring an issue, another decision to make is: what type of structure to use: serial, term or a combination, and should the debt service structure be based on a fixed interest rate or variable rate schedule. The issuer must also consider the value of including call provisions in a bond issue or refinancing provisions in a loan.

STEP 4: PREPARE AN "OFFICIAL STATEMENT"

The next step is to prepare the documents needed to market and sell the bonds. One of the most important is the official statement. The **official statement** discloses pertinent information regarding a LG's bond issuance. The official statement defines the processes related to the bond issuance and provides information that allows the underwriter and investor to price the bonds. The LG issuer and financial advisor work together to prepare the official statement.

STEP 5: PREPARE AND PUBLISH THE "NOTICE OF SALE"

This step applies primarily to the issuance of LG bonds offered for sale in the bond market. However, this step might apply to a loan package if it was being offered to all local banks to bid on. LGs should review the procurement laws and regulations to determine the need to advertise, give public notice and competitively bid loans.

STEP 6: REVIEW AND APPROVE THE DEBT ISSUE/ AWARD THE SALE OF BONDS

If the debt issue is a loan, the banks or government's proposed loan terms and conditions will be reviewed and analyzed by the financial advisory team to determine the best loan package. If there are competitive bids, the financial advisor and finance manager tabulate the bids based on the LG's offering loan criteria and recommend the LG accept the best offer. This information is subsequently presented to the governing body for approval. Upon approval, the finance manger arranges for the execution of loan agreements and transfer of loan proceeds to the LG.

If the LG is awarding the sale of bonds, on the date of sale, the LG opens the bids in a competitive sale or proposed purchase price for the bonds in a negotiated sale. The financial advisor reviews and tabulates the bids based on the criteria in the notice of sale and recommends the LG accept the best (either net interest or total interest cost) bid. This information is then presented to the LG for approval either by the LG Council or by a representative of the governing body who has authority to act on their behalf.

To advise the local officials of the bids (tenders), the financial advisor usually prepares a fact sheet about the current bond market and sale of the bonds. The fact sheet identifies the underwriter submitting the winning bid or proposal based on the criteria in the notice of sale, and the net or total interest cost bid and the interest rate. It also shows data about the current market, such as applicable bond indexes, the issuer's rates received at comparable prior sales and interest rates of other issuers selling at approximately the same time. Bond counsel prepares the bond documents and bid (tender) acceptance forms to finalize acceptance of the offer. When completed,

the bond counsel prepares a transcript of the proceedings that becomes a part of the LG records. Transcripts of the proceeding are also provided to the financial advisor, bond counsel, and paying agent.

LG officials and the finance manager should use the foregoing discussion as a guide to develop detailed procedures for debt issuance and to expand the steps as needed to meet the unique debt issue requirements of your LG.

ADMINISTRATION OF DEBT

What happens after the debt issuance is completed is almost as important as what goes into preparing for it. A LG issuer's responsibilities do not end with the debt issuance. In fact, their responsibilities actually continue for the life of the debt until the final maturity, which may be 20-30 years for long-term bonds. Administering this outstanding debt includes three important tasks: 1) investing the proceeds if transferred to LG control; 2) paying the principal and interest of the loan or bonds when due and maintaining debt records; and 3) monitoring the credit market for re-financing opportunities.

Investing the proceeds—One of the most important post-issuance tasks is to invest the proceeds upon receipt. To do this successfully, the LG should develop an investment schedule that matches the construction payment schedules for the capital projects over the next 12-18 months. The proceeds should then be invested in authorized investments until they are needed to cover project costs. LG officials should strive to maximize the return on the investment of the proceeds consistent with the need for project funding liquidity and safety of principal.

Normally, when investing LG bonds proceeds, the official statement will include extracts from the bond ordinance or trust indenture listing the type of authorized securities in which bond proceeds can be placed. Local officials should also consult central government and local laws for additional guidance on any security limitations that may be applicable. In the absence of any limitations, local officials should always place safety of the invested principal and liquidity of the security above the yield (rate of return). In investing the public's money, your primary interest is not the return on your principal but the return of your principal. For this reason, securities should be limited to those fully guaranteed as to principal and interest or if not guaranteed, then fully secured by highly liquid securities.

The issue of investing the proceeds may not apply to bank or government loans or leasing because the lending institutions may extend credit to the LG and withhold disbursement of money until the LG actually incurs the expense. The finance manager should evaluate the terms of the financing transaction before its approval to ensure that the arrangement meets the needs of the LG.

Recordkeeping—The second step in administering the outstanding debt is to set up a recordkeeping system for the LG's debt issues. The LG should establish a separate record for each debt issue. They should also maintain a full set of records as outlined below and assign responsibility to an individual for these tasks in either the finance or accounting department.

The LG issuer should establish and maintain the following records:

- **Loan and bond register**—The loan and bond register provides the basic detailed accounting record for all loan and bond issues. It is maintained until all loans, bonds, other debt instruments, and interest payments of the issue are paid.
- **Remittance advice to bank/ paying agent/ registrar**—This document specifies the exact legal name of the LG making a loan payment or issuing the deposit, the amount of bonds and interest to be paid, and the fees to the paying agent/registrar.
- **Report from the bank/ paying agent/ registrar**—At times mutually agreed between the bank/paying agent/registrar and issuer, the bank/paying agent/registrar reports on the loan payments or bonds and coupons/interest payments paid.
- **Schedules of future debt service**—These records summarize future debt service requirements until the last maturity.

While the above describes the required loan and bond records that should be maintained for debt issuance, it does not replace accounting records. The LG must also record the loan payments and deposits of bond principal and interest payments with the bank/paying agent/registrar in the LG's accounting system in accordance with established accounting rules and policies.

Monitoring for refinancing opportunities—In process of managing the LG's outstanding indebtedness, LG officials should watch for opportunities to refinance their outstanding debt. The most common reason for refinancing is to produce a debt service savings by replacing high interest rate debt with lower interest rate debt.

LG officials should establish a regular program to review the outstanding debt and increase the frequency of that review when interest rates begin to decline. In the review, officials should note the dates on which outstanding debt becomes eligible for current refunding and the dates on which there are reductions in the call premiums. Each can affect the viability of a refunding. In addition, if interest rates reach levels that would make a refinancing cost effective, the LG and financial advisor should assemble a team to begin preparations for a refinancing. This will enable the LG to respond quickly if it is able to meet or exceed its savings target. Normally, a refinancing is cost effective if a 4-5% net present value savings is achieved.

LEARNING APPLICATION

POLICY MAKER X CEO X FINANCE MANAGER X DEPARTMENT HEAD X

Because of the importance of debt as a means of financing capital investments, we suggest that you develop a strategy for reviewing your current use of debt and debt management program. From your unique role perspective, what can you do to persuade others in your LG that a strategy to review your LGs' debt situation is important?

What areas of debt management need attention? Policies? Decision making processes? Mechanics of issuance? Credit analysis? Disclosure? Or Administration? In each case, describe why.

Prepare a list of objectives that you would like to achieve in the very near future to manage your debt situation in accordance with the criteria mentioned earlier in the chapter.

POLICIES

To have an effective policy framework, your LG will need both capital investment financing and debt management policies.

CAPITAL INVESTMENT FINANCING POLICIES

Financing your capital investment plan will require a policy framework to make it all legal and to assure that good governance principles and practices are being achieved in this important financial management strategy and process. Here are some of the issues to be considered in developing this policy framework:

- Adopting an official policy and a capital investment plan—Before undertaking a long-term debt financing program, there should be an official policy that clearly identifies: types of investments or fixed assets to finance, and an adopted capital program that identifies when the investments will be built or acquired.
- Considering ALL potential financing sources—Officials should consider all potential financing sources including: operating revenues, sales of property, accumulated reserves, depreciation (reproduction or replacement fund in the case of contributory organizations), internal borrowings from non-budgetary funds, contributions from private parties (i.e. to develop infrastructure), grants or subsidies from central government funds, and financing by a supplier/contractual partner.

Utilizing external sources of revenues first—The policy should require the use of other or external sources first rather than own source revenues. This means that funding for capital projects from the central government budget or contributions from private parties would normally be used first unless there are unusual restrictions or unnecessary delays in receiving the funds. LGs experiencing rapid growth should consider having developers contribute the needed infrastructure as a condition of receiving approval of their development plans. To reduce a financing burden, some LGs may choose to privatize certain functions and facilities.

- Reviewing for equity, effectiveness, and efficiency—In choosing a method for financing capital improvements three principles should be considered: equity, effectiveness and efficiency.
- Deciding on “Pay-as-you-go” or “Pay-as-you-use” or some combination—The policy should include a method for deciding when to pay for capital investments

using current revenues or a “pay-as-you-go” basis versus using long-term financing or a “pay-as-you-use” basis.

DEBT POLICIES

Once a LG decides to borrow money, officials should adopt a formal policy to provide general direction in planning and implementing the program.

A debt policy:

- Establishes parameters for the acquisition or issuance of debt and keeps it within acceptable levels.
- Provides a basis for evaluating the impact of acquiring debt on the overall financial condition of the LG.
- Communicates to investors and citizens the importance placed on financial management as evidenced by adoption of debt policies.
- Provides parameters for the consistency and continuity required to achieve certain financial goals.

Officials need to adhere to this framework to carry out their duties and responsibilities in debt management. Since the framework serves many purposes, it should be reasonably flexible so officials can respond quickly to favourable changes in the financial market or other changing conditions without jeopardizing essential services.

The policy is developed within the framework of existing laws and based on projections of the LG’s future condition. It anticipates future financing needs and limitations that the policy imposes. Specifically it should address the following questions:

- What is the appropriate use and acceptable level of short-term debt?
- What is an acceptable level of long-term debt?
- For what purposes (types of projects) will long-term debt be used?
- When should tax supported (or asset backed) general obligation debt be used versus self-supporting revenue debt?
- What is the desired mix of “pay as you go” (current revenues) and “pay-as-you-use” (debt financing)?
- When should variable rate debt be used versus fixed rate debt?
- What maturity schedule should be used for short-term and long-term debt?

The following table contains sample policies to review as you prepare specific debt policies.

Sample Debt Policies

- The LG will try to avoid the use of short-term borrowing by establishing and maintaining adequate reserves; however, should short-term borrowing be needed for cash flow purposes, it must be repaid before the end of the fiscal year in which it was borrowed.
- Total debt service will not exceed _____ percent of the LG’s total operating revenue.
- Outstanding long-term debt will not exceed _____ per capita.

- Average maturity of loans and LG bonds will be maintained at or below ____ years.
- The LG will not use long-term debt for current expenses.
- The LG will limit long-term borrowing to capital investments that cannot be financed from current revenues.
- When the LG finances capital projects by acquiring debt, it will pay back the debt within a period not to exceed the expected useful life of the project.
- Where possible, the LG will use government loans or self-supporting debt before tax supported bonds or bank loans.
- On all debt-financed projects, the LG will make a down payment of at least ____ percent of total project cost from current revenues.
- The LG will only capitalize interest, operating and maintenance expenses for self-supporting enterprise activities and will be strictly limited to those expenses incurred before actual operation of the facility.
- The LG will follow a policy of full disclosure on every financial report and debt statement.

Debt policies provide the parameter for implementing a detailed debt financing program. LG officials should review these policies periodically to ensure its effectiveness.

BENEFITS

Establishing an effective framework for locally financing the capital investment plan basically means that your LG has effective debt management program in place. It helps preserve the LG's long-term fiscal viability. Here are specific ways it can benefit a LG:

- Establishes parameters that limit the power to borrow money and avoid potential abuses.
- Provides a way to finance capital investments within the LG's capacity to repay the loans.
- Establishes sound debt management practices that support creditworthiness.
- Saves money on interest charges by selecting appropriate debt instruments and structures.
- Improves the image of LG in the eyes of the business community and taxpayers for being fiscally responsible.

LG officials and managers must optimize the use of LG resources to efficiently and effectively implement capital investment plans for the community. Here are some additional ways that going through the process of financing the capital investment plan benefit the LG.

Improves planning and budgeting—Without proper capital investment planning, goals are achieved only by accident. Financing the CIP is an integral part of

the planning process because it provides information for decision-making. Financing is what makes the CIP possible—without financing of some sort there will be little capital investment since most LGs cannot finance a CIP out of current operating revenues.

Provides documentation and support for borrowing and credit evaluation—Financial institutions that underwrite loans to LGs view financial planning and forecasting, which are integral parts of the financing process, as a necessity.

Allows the LG to meet the community's vision—by financing the CIP, the community moves towards its vision of what the LG should be in the future.

OBSTACLES, LIMITATIONS, RISKS AND OTHER CONSIDERATIONS

You will find that developing a capital investment financing framework is not an easy task. There are many obstacles along the way.

Political and staff resistance—Expect political and staff resistance as you begin to develop a formal written capital investment financing framework—especially if you are in a country going through decentralization. Resistance will come from the other higher levels of governments especially. Some elected officials will tell you that such a process is irrelevant to the way decisions are made and that the framework, if adopted, would not be used. They will claim there are few choices about taxes and spending and that it is impossible to predict the future.

Alternatively, the governing body may have agreed that funding a capital investment plan is a top priority but then allows surplus funds to be used for projects not in the capital investment plan.

Staff members may resist the process as an infringement on their authority and claim they are more qualified to make capital investment financing decisions than elected officials do. It is common for the staff to say that LG finance—especially debt management—is a complicated subject best left to the experts. On the other hand, staff may resist by saying they are too busy with other duties to develop the process.

Time required—Developing a comprehensive capital financing framework is a time consuming process. Many countries do not give LGs the authority to issue debt or even get loans. It is not unusual to find procedures for developing and financing the capital investment plan that have not been committed to writing, that contain inconsistencies, that are incomplete or out of date, that must be pieced together from several sources, that have provisions that conflict, or that have never been formally adopted.

Lack of knowledge about concepts and practices—Another barrier exists when elected officials and staff are not familiar with LG debt and revenue structure concepts, terminology, and practices. The financial education of LG officials through reports and workshops is a vital staff responsibility. LG officials must be well informed about the LG's current practices in the area of capital investment planning and debt management along with an understanding of best practices and standards.

Few standards and benchmarks—This is particularly a problem for LGs new to the process of self-government. Previously, major financial policies may have been

prescribed by the central government. A special effort will be necessary to locate “rules of thumb” and benchmarks to guide LGs, especially in the area of debt management. Elected officials may find themselves exploring new but informative financial territory. Time will be needed for the development of comparative LG data and for individual governments to accumulate sufficient historical data to project trends.

Legal restrictions—Many countries simply do not allow LGs to have debt. These same countries usually do not allow LGs to have a very large percentage of own source revenues. There may also be a centralized planning process with most capital investment decisions and financing happening at the central government level. It will take time for decentralization to take place and for LGs to be given more authority for their self-governance.

LEARNING APPLICATION

ELECTED OFFICIAL _X_ CEO _X_ FINANCE MANAGER _X_ DEPARTMENT HEAD _X_

We have identified some but not all obstacles to developing a capital investment financing framework.

List other barriers, which you can imagine or have experienced.

What works and what does not work in overcoming obstacles?

INTERNET RESOURCES

Banks or bonds: Building a Municipal Credit Market	www.oecd.org/dataoecd/59/56/21559374.pdf
Making Cities Work: Capital Financing	http://www.makingcitieswork.org/urbanThemes/city_governance/financing_capital
Measuring LG credit risk	www.worldbank.org/html/fpd/urban/mun_fin/toolkit/tools.PDF
Funding opportunities for urban local bodies	www.ficci.com/ficci/media-room/speeches-presentations/2002/oct/oct-city-kudva.ppt
Building local credit systems	www.urban.org/PDF/credit-systems.pdf
Determinants of municipal credit quality	www.gfoa.org/services/dfl/debt/GFR-Determinants-of-Credit-Qua.pdf
Municipal finance authority of British Columbia	www.mfa.bc.ca/pdfs/cp%20rating.pdf
Financing anti-poverty policies: issuing municipal bonds and borrowing from the international credit market.	http://mirror.undp.org/switzerland/wacap/en/experiences/ahme.htm
A CASE FROM THE SOUTH: AHMEDABAD, INDIA	
Linkages Between Local Governments and Financial Markets: A Tool Kit to Developing Sub-Sovereign Credit Markets in Emerging Economies	http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2000/11/17/000094946_00110305341722/Rendered/INDEX/multi_page.txt

APPENDIX A: MOSCOW DEBT PROGRAM

<http://www.moscowdebt.ru/eng/management/concept/>

Following excerpt taken from website on December 15, 2005.

CONCEPT OF THE CITY OF MOSCOW STATE DEBT MANAGEMENT AND USE OF BORROWED FUNDS IN THE CITY BUDGET

(Approved by the Resolution of the City of Moscow Government “About the Concept of City of Moscow State Debt Management and Use of Borrowed Funds in the City Budget” No 318-PP dt. May 6th, 2003)

Content

- The main objectives of the Concept
- Legal and organisational basis for the City of Moscow state borrowing system
 - Legal basis for City of Moscow state debt management system and use of borrowed funds in the city's budget
 - Organisational basis for the City of Moscow state debt management
- Criteria for establishing the optimal (safe) level of the City of Moscow debt
- City of Moscow state debt management Strategy as a part of the general system of budgetary funds management
 - Restrictions in the City of Moscow budget policy with regard to state debt
 - Budget policy in regard to planning of the City of Moscow state debt volume and structure
 - Use of debt instruments in financial support of the City of Moscow development planning
- Effecting borrowings and operations with the City of Moscow debt
 - Operations with the City of Moscow debt
 - Efficient City of Moscow state debt management
 - Optimisation of the City of Moscow state debt structure. Management of risks related to City of Moscow state debt structure.
 - The system of a single municipal borrower
- Registration and reporting
 - State Debt Register of the City of Moscow State Debt
 - Organisation of registration of the City of Moscow state debt and the operations for attraction of loans, debt service and repayment

THE MAIN OBJECTIVES OF THE CONCEPT

Forming the budget policy in the sphere of state debt management is an integral part of the City of Moscow financial resources management system. The 1998 crisis in Russia and the current crisis in Argentina and Brazil showed that in case of non-

considered debt management policy state debt can be a source of both economical and political risks. That is why debt management problems are closely related to the problems of ensuring economic safety of federal and subfederal issuers.

At the same time the restrictions imposed by the existing legislation in regard to the volume of state debt of the subjects of the Russian Federation as well as to payments effected for debt service do not allow to fully avoid debt risks, discover and forecast the growth of the crisis tendencies in economics.

Though the importance of the task of the City of Moscow state debt management and related risks are quite evident, the term “debt management” is missing both in the federal and local (Moscow) legislation.

Within the framework of this Concept the City of Moscow state debt management is understood as the process of development and implementation of state debt management strategy with the purpose of keeping debt volume on economically safe level, minimization of debt service costs and even distribution of debt payments.

The term “State debt management” includes three interrelated aspects described hereunder:

- Budget policy as regards planning City of Moscow debt volume and structure.
- Effecting borrowings and operations with state debt aimed on optimisation of debt structure and reduction of debt service costs.
- Organisation of registration of liabilities and operations with state debt, functioning of debt repayment system.

Accordingly, the objective of this Concept is to create the mechanism of assessment and regulation of debt burden within the City of Moscow budget and development of the procedures for managing the City of Moscow state debt in the system of unique borrower.

This Concept does not cover issues related to effecting municipal borrowings.

LEGAL AND ORGANISATIONAL BASIS FOR THE CITY OF MOSCOW STATE BORROWING SYSTEM

Legal basis for the City of Moscow state debt management system and use of borrowed funds in the City's budget

Legal regulation of the issues of the City of Moscow state debt management and use of borrowed funds in the City of Moscow budget is effected within the framework of

general legal regulation of functioning of the City's budget as an integral part of the budget of the Russian Federation.

The fundamental legal document in the sphere of the City of Moscow debt origination and management is the Budgetary Code of the Russian Federation. This law determines, in particular: the types of debt obligations of the subjects of the Russian Federation, debt origination procedures, debt service and repayment as well as elements of supervision over borrowings effected by the subjects of the Federation. The most important aspect of the Budgetary Code of the Russian Federation is establishment of the general regulations for fulfillment of the budgets of the subjects of the Russian Federation, including those related to debt origination, debt service and repayment.

The issues of reflection of debt origination, debt service and repayment in the budgets of the subjects of the Russian Federation are regulated by the Federal Law No. 115-FZ "On the budget classification of the Russian Federation" dt. 15.08.1996.

The issues related to borrowings by the Subjects of the Russian Federation effected in form of state securities are regulated by the Federal Law No. 126-FZ "On characteristic features of issuance of state and municipal securities" dt. 29.06.1998 and the Resolutions of the Government of the Russian Federations issued on the basis of this law.

In general the laws of the Russian Federation create the entire legislative basis for debt origination, debt service and repayment and debt management for the subjects of the Russian Federation including the City of Moscow.

Legislative regulation of debt management issues and use of borrowed funds in the City of Moscow budget is based on the provisions of the above-mentioned federal laws. The most important part of the City of Moscow legislation are the Charter of the City of Moscow and the following laws: "On the City of Moscow Government" (No. 5 dt. 26/02/1997), "On Budget and Budget Process of the City of Moscow" (No.51 dt. 09.10.2002), "On the City of Moscow State Debt" (No.15 dt. 18.04.2001), the laws on the City of Moscow budget for each fiscal year, as well as the Resolutions of the Government of the City of Moscow "On Improvement of the System of City of Moscow State Debt Management" (No. 1020-PP dt. 13.11.2001) and "On Improvement of the System of Registration of the City of Moscow Debt" (No. 240-PP dt. 02/04/2002). The above-mentioned documents determine the process of debt origination, the degree competence of the City of Moscow authorities as regards debt management issues, forecasting and performance of the City of Moscow budget, debt origination, debt service and repayment.

LEGAL BASIS FOR THE CITY OF MOSCOW STATE DEBT MANAGEMENT SYSTEM AND USE OF BORROWED FUNDS IN THE CITY'S BUDGET

ORGANISATIONAL BASIS FOR THE CITY OF MOSCOW STATE DEBT MANAGEMENT

In accordance with the Charter of the City of Moscow and the City of Moscow Laws "On Budget and Budget Process of the City of Moscow" (No.51 dt. 09.10.2002) and "On the City of Moscow State Debt" (No.15 dt. 18.04.2001) and the City of Moscow normative documents approved on their basis, the Moscow authorities within their competence take part in the process of the City of Moscow state debt management as follows:

1. MOSCOW CITY DUMA:

- in accordance with the legislation of the Russian Federation approves the City of Moscow laws concerning the general regulations of the City of Moscow state debt management;
- every year, during the process of approval of the law on the City of Moscow budget for the appropriate fiscal year, considers the data of the Program of State Borrowings of the City of Moscow which serve as the basis for the activities of the City of Moscow Government aimed on debt management in the appropriate fiscal year;
- controls, in accordance with the legislation of the Russian Federation and the City of Moscow, the implementation of the Program of State Borrowings of the City of Moscow as an integral part of the City of Moscow law on the City of Moscow budget.

2. THE MAYOR OF MOSCOW:

- sets, in accordance with the federal and the City of Moscow laws, top priorities in the City of Moscow state debt management;
- offers for consideration by the Moscow City Duma the Draft Program of State Borrowings of the City of Moscow as an integral part of the law on the City of Moscow budget for the appropriate fiscal year.

3. THE GOVERNMENT OF THE CITY OF MOSCOW:

- organises the development of the Draft Program of State Borrowings of the City of Moscow as an integral part of the draft law on the City of Moscow budget for the appropriate fiscal year;

- organises, in accordance with the federal and the City of Moscow laws, the implementation of the Program of State Borrowings of the City of Moscow as an integral part of the City of Moscow budget;
- defines the policy of the City of Moscow state debt management for the next fiscal year and in perspective (middle-term);
- defines the structure and competence of the City of Moscow executive authorities taking part in state debt management.

4. EXECUTIVE AUTHORITIES OF THE CITY OF MOSCOW PERFORM THE FOLLOWING FUNCTIONS:

- The Department for Economic Policy and Development of the City of Moscow prepares a forecast of social and economic development of the City of Moscow for the next year and the following two years.
- The Department of Finance of the City of Moscow prepares the forecast budget of the City of Moscow and prospective financial plan for the next year and the two following years, and provides fulfillment of the budget as far as use of borrowed funds, debt repayment and state debt service is concerned.
- State Debt Committee of the City of Moscow develops Draft Program of State Borrowings of the City of Moscow on the basis of the forecast of social and economic development and prospective financial plan of the City of Moscow. It effects attraction of borrowed funds, service and repayment of the City of Moscow state debt within the framework of this Program on the principle of a unique borrower on behalf of the city.
- Other City of Moscow executive authorities perform the functions stipulated by the respective laws issued by the City Government.

CRITERIA FOR ESTABLISHING THE OPTIMAL (SAFE) LEVEL OF THE CITY OF MOSCOW DEBT

The budget code of the Russian Federation establishes the ratios of maximum limits for the amounts of state debt of a subject of the Russian Federation to the budget revenue of the fiscal year (not including financial aid from the budgets of other levels), the maximum limits of budget expenditure in the City of Moscow budget allocated for state debt service to budget expenditure of the fiscal year as well as the maximum limit of budget deficit which, in case of absence or insufficiency of internal sources of financing not related to borrowings, is covered by way of effecting new borrowings followed by increase of the total amount of state debt.

These legal documents do not establish the optimal (safe) level of debt burden because the limits are based on comparison of yearly payments for debt service and repayment to the budget revenue for only one planned year. At the same time are not taken into consideration two very important factors which have a significant meaning for establishment of the optimal (safe) level of debt burden, namely the presence in any year's budget of obligatory (non-postponed) expenditure and the distribution of

the payments related to debt service and debt repayment not only within one fiscal year but within the whole period for which the City has debt obligations.

Taking into consideration the above-mentioned, in order to achieve the optimal (safe) level of the City of Moscow state debt it is necessary to establish additional criteria in the field of development and realization of the city's debt policy, based on comparison of the forecast budget revenue to the payments due in each fiscal year.

The budget policy in the field of the City of Moscow state debt management providing the necessary level of economic safety should be based on the mechanism of securing of a certain part of budget expenditure, required for "non-stop" functioning of the city infrastructure and implementation of social programs, against the risks related to debt repayment.

To these expenditure should be referred: the current budget expenditure, including the expenditure for the City of Moscow state debt service, and, partly, the expenditure of capital character (realisation of the objectives of acquisition of equipment and major repairs of the city infrastructure). An important issue is securing the forecast amount of the above-mentioned expenditure by the forecast amount of revenue for the appropriate fiscal year. This means that the lack of financing can not be compensated from budget sources.

At the same time obligatory covering of the current expenditure and part of capital expenditure by budget revenue is still not sufficient to eliminate the risk of default on the debt obligations assumed by the city. Including into obligatory expenditure the amounts for debt repayment should be an additional condition of eliminating debt risks.

The most important condition for providing the optimal (safe) level of stat debt is strict observance of the principles of planning the City of Moscow budget, in accordance to which the amount of yearly payments for debt repayment in the current year and for the future periods should not exceed the difference between the budget revenue and the summary amount of the current budget expenditure plus the above-mentioned part of capital expenditure. This difference can be defined as "capital resource".

The issue of major importance is to make the appropriate calculations not only within the prospective financial plan (for 3 years) but for the whole period till repayment of the debt obligations assumed by the city to the moment of making the forecast. Simultaneously, the limits as stipulated in legal documents for effecting borrowings by the subjects of the Russian Federation should be observed in the prospective calculations for each year.

THE STRATEGY OF THE CITY OF MOSCOW STATE DEBT MANAGEMENT AS A PART OF THE SYSTEM OF MANAGEMENT OF BUDGET RESOURCES

THE SYSTEM OF RESTRICTIONS IN THE CITY OF MOSCOW BUDGETARY POLICY IN REGARD TO STATE DEBT

The basic factors influencing the restrictions of the city borrowing policy are:

- the norms established in the Budget Code of the Russian Federation and the City of Moscow Law “On the City of Moscow State Debt”;
- capital resource of the City of Moscow budget;
- the amount of resources available in the capital market, on the terms and conditions, in regard to cost and maturity, acceptable for the City of Moscow.

These data is the basis for assessment of debt related risks which appear with execution of the City of Moscow budget and serve for determining the amounts of borrowed funds used for financing the municipal investment programs, including acquisition of property.

The ratio: yearly payments for state debt repayment to the budget revenue for the appropriate year determines the city’s ability to meet its obligations without using the mechanisms of refinancing of debt and shows the level of financial safety in executing the budget as far as current expenditure and top priority capital expenditure is concerned.

The forecast amount of the “capital resource” of the City of Moscow budgets for the future periods establishes limitations on the city’s new borrowings, determines their structure and is taken into account in the process of their planning and execution.

The qualitative criteria establishing the limits on the amount and maturity of new debt is the ratio of yearly repaid state debt to the amount of forecast “capital resource”. At the same time the safe level of state debt is provided if the amount of yearly payments for debt repayment do not exceed the “capital resource” of the City of Moscow budget for every year within the forecast period.

The above-mentioned criteria, together with the restrictions imposed by the Budget Code and the City of Moscow Law “On the City of Moscow State Debt”, establishes the maximum limits on amount and maturity of new loans.

BUDGET POLICY AS REGARDS PLANNING OF THE VOLUME AND STRUCTURE OF BORROWINGS AND THE CITY OF MOSCOW STATE DEBT

In accordance with the established criteria planning of the volume and structure of state debt is effected as follows:

- When a forecast of social and economic development of Moscow and the draft budget for the next fiscal year and for the future periods is prepared there are calculated: the forecast revenues, current and (partly) capital expenditure of the City of Moscow budget for the period depending on maturity period of the existing state debt and planned borrowings. Basing on these calculations is established the capital resource of the City of Moscow budget for the next fiscal year as well as for forecast future budgets.
- Based on the analysis of the capital market capacity is established the available amount, possible maturity and cost of the City of Moscow debt for the next fiscal year.
- Basing on the amount of “capital resource” of the City of Moscow budget, the planned amount of capital expenditure and the amount of debt to be repaid for the next fiscal year, and taking into consideration the restrictions listed in p.4.1., is determined the required debt amount and structure and is formed the program of state borrowings of the City of Moscow for the next fiscal year.

USE OF DEBT INSTRUMENTS IN FINANCIAL SUPPORT OF THE CITY OF MOSCOW DEVELOPMENT PLANNING

State borrowings as a form of financial support of the City of Moscow are regarded as one of the sources of the city's development. Use of state borrowings can help to solve urgent investment objectives in case of shortage of financial resources in the current year, provided the forecast increase of the revenue which will serve for the City of Moscow debt repayment.

Very important is the necessity of use of debt instruments with change of the city's budget revenue caused by economic situation as well as by changes in the Russian legislation. Applied reasonably, they improve the financial provision of the City of Moscow budget and positively influence the city's further development.

In case of decrease of the City of Moscow budget revenue the decrease of “capital resource” is compensated by growth of state debt, which in its turn reduces the possibilities for future borrowings defined by the limitations on the ratio of annually repaid City of Moscow state debt to the amount of “capital resource” of the future periods.

With quick growth of the City of Moscow budget revenue the extra “capital resource” secures successive decrease of the city’s borrowings and switch to debt reduction which in its turn improves the possibilities for further borrowings defined in accordance with the ratio of annually repaid debt to the amount of “capital resource”.

Besides, use of debt instruments may be regarded as a method of efficient planning of the City of Moscow budget resources.

EFFECTING BORROWINGS AND OPERATIONS WITH THE CITY OF MOSCOW DEBT

OPERATIONS WITH THE CITY OF MOSCOW DEBT

Within the execution of the City of Moscow budget and debt management are effected the following operations with the City of Moscow debt:

- debt origination;
- debt service;
- debt repayment;
- debt repayment ahead of schedule;
- repurchase;
- use of derivatives in operations with the City of Moscow debt (percent and currency swaps, forwards and options).

These operations are effected on the basis of the provisions of the Law on the City of Moscow budget for a certain fiscal year and Resolutions of the City’s Government taking into consideration the situation in the market.

EFFICIENT MANAGEMENT OF THE CITY OF MOSCOW STATE DEBT

As the above-mentioned approach to the borrowing policy should be considered under certain conditions, namely the existing borrowing practice i.e. the debt obligations taken by the city, the issues of efficient management of state debt for ensuring the security of the City of Moscow economics and finance become very urgent.

The main objective of the system of efficient management of the City of Moscow state debt is avoiding the peaks in debt payments, saving budget funds allocated for debt service and repayment.

In the previous parts of the Concept were described the principles of the City of Moscow state debt management in the stage when forecasts are made, which are expressed in establishing additional restrictions on the amounts of middle-term borrowings.

In this part are defined the methods of efficient management of the City of Moscow state debt within the framework of execution of the budget of each year.

These methods include:

- Correction of the periods for debt origination stipulated in the Program of state borrowings of the City of Moscow for financing of the approved amount of the city's budget deficit.
- Accumulation in the City of Moscow budgetary account the resources required for debt repayment.
- Debt repayment ahead of schedule.
- Debt reduction.
- Use of derivatives.

Correction of the periods for debt origination (provided that the general terms of the budget for the current year remain unchanged) envisages that these periods are shifted to an earlier or later time as compared to the approved quarterly distribution of the borrowings. The criteria for establishing the necessity of such correction is the actual financial situation in the city i.e. actual revenue received and actual use of the allocations from the budget.

In case of temporary decrease in actual revenue as compared to the planned level, which may be followed by cancellation of financing of the approved quarterly expenditure, it may be decided to attract borrowed funds (envisaged for the following periods of the fiscal year) ahead of schedule.

In case the planned revenues are received ahead of schedule or some amount is saved from the approved amount of budget expenditure, it may be decided to shift state borrowings to a later period or to repay some part of the City of Moscow state debt ahead of schedule.

Corrections in the periods of attraction of borrowed funds may also be motivated by the situation in the financial market where decrease in expenditures for state debt service is achieved by way of changing the approved periods for attraction of borrowed funds.

Accumulation in the City of Moscow budget account of the amounts required for debt repayment is aimed in the first turn at smoothing up the "peaks" of debt repayments in the City of Moscow budget and consequent elimination of drastic decrease in financial security of the budget expenditure.

Accumulation in the City of Moscow budget account of the amounts required for timely debt repayment may take place in the year preceding the year when "peaks" of debt repayments are expected as well as during forming of the draft budget of the "peak" year.

In the year preceding the "peak" year accumulation of funds is effected from additional revenue received in the process of execution of the City of Moscow budget as well as when the amounts saved from the expenditure are not re-allocated. In case

of absence of such sources it may be decided to optimize (reduce) the amounts of financed current year expenditure.

The amounts accumulated during the current fiscal year for repayment of the City of Moscow state debt are a part of the free balance amount at the beginning of the next fiscal year and are used for repayment of this debt in the way as provided by the existing legislation.

With the purpose to avoid the appearance in the City of Moscow budget account of considerable funds not used in the current budget, i.e. their “freezing”, the periods for attraction of borrowed funds (as stipulated by the Program of state borrowings of the City of Moscow for the current year) may be changed taking into consideration the resources accumulated. It means that financing of the expenditures of the current fiscal year is effected from the funds on the budget execution account, and attraction of borrowed funds for their financing is effected within the periods maximally near the end of the year. This mechanism for regulation of accumulation of funds for debt repayment in the following fiscal year allows to save money on debt service expenditure.

Repayment of the City of Moscow debt ahead of schedule, including loans from banks, repurchase and cancellation of state securities issued by the City of Moscow is effected from additional revenue, re-allocation of funds saved on current expenditure and/or new and cheaper borrowings. Both the liabilities due in the current year and in the following fiscal year may be subject to repayment ahead of schedule. Repayment of liabilities of the following fiscal year in the form of bank loans and repayment of state securities providing removal from circulation till the date of repayment is effected in order to reduce the budget expenditure for debt service.

State debt is decreased with stabilization of the City’s financial situation due to receipt of additional revenue and optimization of approved expenditure, in the first turn by refusal from use of the above-mentioned funds for increase in expenditure not previewed during approval of the budget. Reduction of the amount of state borrowings in the current fiscal year should be regarded as one of the measures for eliminating “peaks” in future debt repayments.

The proposals with regard to expediency and necessity of measures aimed on efficient state debt management in the City of Moscow are prepared by the Department of Finance of the City of Moscow together with the Department of Economic Policy and Development of the City of Moscow and State Debt Committee of the City of Moscow.

Derivatives are used in operations with the City of Moscow liabilities with the purpose of management of risks related to operations with foreign currency, decrease of budget expenditure for state debt management, use favourable market situation for future borrowings in anticipated non-stable financial markets.

The proposals regarding use of derivatives in operations with the City of Moscow state debt are prepared by the Department of Finance of the City of Moscow together with the Department of Economic Policy and Development of the City of Moscow and State Debt Committee of the City of Moscow.

OPTIMISATION OF THE STRUCTURE OF THE CITY OF MOSCOW STATE DEBT.

MANAGEMENT OF THE RISKS RELATED TO THE STRUCTURE OF THE CITY OF MOSCOW STATE DEBT.

Management of state debt structure is effected by systematic selection of the form of borrowings which maximally satisfy the City's needs in financial resources and favour the decrease in the cost of the City of Moscow state debt at the given level of risks.

The costs for the City of Moscow state debt service are nominated in Roubles and are a value depending on the state of financial markets. Such a situation is due to loans in foreign currency and loans with "floating" rate of interest in the structure of the City of Moscow state debt as well as to unknown cost and structure of future borrowings.

The cost of the City of Moscow state debt consist of two components:

1. the forecast expenditures for state debt service;
2. possible expenditure for service of state debt in case there is a deviation in parameters of financial markets from the forecast values or as the result of operations aimed on management of state debt structure.

The expenditure for the City of Moscow state debt service for the appropriate fiscal year and in the middle-term perspective is calculated based on the Program of the City of Moscow state borrowings and the forecast level of interest and currency exchange rates. The calculated amount of expenditure for the City of Moscow state debt service is taken into consideration when the draft City of Moscow budget for the appropriate fiscal year is worked out.

The second component of the cost of the City of Moscow state debt, i.e. possible expenditure for service of state debt in case there is a deviation in parameters of financial markets from the forecast values, depends on the following risks:

- changes in interest rates;
- changes of currency exchange rates;
- changes in the accessible capacity of financial markets;

- calculation and operational risks;
- legal errors and changes in the existing Russian and foreign legislation.

Planning and performing operations for management of the City of Moscow state debt structure is effected basing on the results of the analysis of dependance of debt service costs on realisation of the above-mentioned risks.

The main operations used for optimisation of the structure of the City of Moscow debt and management of currency- and interest- related risks are:

- choice and use of alternative variants for placement and repayment of the City of Moscow liabilities;
- repurchase;
- management of the structure of the City of Moscow debt portfolio;
- use of derivatives.

THE SYSTEM OF A SINGLE MUNICIPAL BORROWER

With the purpose of centralization, regulation and specialisation of the work for attraction, service and repayment of the City of Moscow debt, in accordance with the Budgetary Code of the Russian Federation and the City of Moscow Law “On the City of Moscow State Debt” all the operations for debt attraction, debt service and repayment in the City of Moscow are effected by a single borrower which is a specialized branch of the City of Moscow executive authority - State Debt Committee of the City of Moscow.

In the process of consideration and implementation of the budget policy in the sphere of the City of Moscow state debt State Debt Committee of the City of Moscow performs the following functions:

- assesses the possible volume, maturity period and the cost of the City of Moscow state debt for every fiscal year;
- prepares, together with the Department of Economic Policy and Development of the City of Moscow and the Department of Finance of the City of Moscow, the proposals for the City of Moscow Government as regards the required volume and structure of state debt planned for use in the appropriate fiscal year for financing capital expenditure of the budget and as regards the Program of state borrowings for the appropriate fiscal year;
- prepares, together with the Department of Economic Policy and Development of the City of Moscow and the Department of Finance of the City of Moscow, the proposals for the City of Moscow Government as regards implementation of measures for effective management of the City fo Moscow state debt;

- attracts state borrowings within the approved Program of the City of Moscow state borrowings and based on the decisions taken by the City of Moscow;
- effects, as agreed with the Department of Finance of the City of Moscow, the operations for management of the structure of the City of Moscow state debt in accordance with the law on the budget for the appropriate year and the decisions taken by the City of Moscow Government;
- effects service and repayment of the City of Moscow debt.

For organising and better functioning of the market infrastructure of the system of debt attraction, service and repayment in the City of Moscow, as well as for solving technical problems related to the City of Moscow state debt management was established Specialised State Unitary Enterprise “Financial Agency of the City of Moscow” (further referred to as SSUE “MosFinAgency”). SSUE “MosFinAgency” also serves as a connection between the City of Moscow Government, represented by State Debt Committee of the City of Moscow, and financial market infrastructure. SSUE “MosFinAgency” has not its own interests in the market and its legal and organizational structure allows the City to totally control its activities.

REGISTRATION AND REPORTING

State Debt Register of the City of Moscow Debt

In accordance with the provisions of the Budgetary Code of the Russian Federation (Art. 121), the City of Moscow Law “On the City of Moscow State Debt” (Art.9, P.2) the Department of Finance of the City of Moscow keeps up the State Debt Register of the City of Moscow Debt which is a part of the whole system of registration and control of state borrowings of the Russian Federation.

Keeping up the State Debt Register of the City of Moscow Debt is effected in accordance with the regulations approved by Resolution of the City of Moscow Government dt. April 2, 2002 No, 240-PP “On improvement of the system of registration of the City of Moscow liabilities”.

PART TWO: MANAGEMENT TOOLS

PURPOSE

Financing the capital investment plan frequently leads to the management of debt. Frequently LGs must borrow money from banks or other lending institutions to meet cash flow deficits or finance capital improvements. Uneven revenue collections add to the need for and sometimes urgency of short-term borrowing. LGs must be knowledgeable about sources and methods of borrowing to assure adequate financing of necessary public services without obligating the LG to unnecessary debt and associated loan repayment obligations.

This workshop is designed to provide LG officials with a working understanding of debt management including methods for calculating local borrowing capacity, establishing a LG's "credit worthiness" and justifying a decision to incur additional debt as opposed to other available options.

Don't forget to look back at the Learning Applications! Many of them can be easily adapted for group exercises and may be more appropriate for persons who are just being introduced to the concepts of financing and budgeting.

CONTENTS

8.1 WARM-UP EXERCISE: TWO PERSPECTIVES ON BORROWING MONEY

Participants discuss the varying perceptions and expectations associated with the two ends of a loan transaction: the borrower and the lender. (30 minutes)

8.2 TRAINER PRESENTATION

Brief concept presentation based on the preceding essay that focuses on the need for debt management policy and an understanding of present value analysis and the establishment of LG credit worthiness. (30 minutes)

8.3 EXERCISE: HARD CHOICES ABOUT LONG-TERM FINANCING

Participants learn how to make accurate choices among various financing alternatives. (75 minutes)

8.4 EXERCISE: PRESENT VALUE ANALYSIS

Participants learn how to calculate the present value of money when arranging a loan or establishing the terms of a lease agreement. (90 minutes)

8.5 ROLE PLAY EXERCISE: NEGOTIATING A BANK LOAN

Participants gain insight into the thinking of bank officers about loaning money to LG organizations through a role-play exercise. (90 minutes)

8.6 EXERCISE: SKILLS TRANSFER

Participants reflect individually on what they have learned and make commitments to put it to use back home after the workshop. (30 minutes)

8.1 WARM-UP EXERCISE: TWO PERSPECTIVES ON BORROWING MONEY

TIME REQUIRED

45 minutes

PURPOSE

Understand differing perspectives on the experience of asking a friend for a *personal* loan.

PROCESS

Tell participants they will be working in two small groups for a few minutes to answer questions about a situation common to everyone: giving and receiving money. Explain the purpose of the exercise is to learn how it feels to be in the position of a borrower and in the position of a lender.

Divide the group into two parts by asking roughly one-half of the participants on the left side of the room to be *Group 1* and an equal number on the right side of the room to be *Group 2*. Ask participants to raise their hands when you call out *Group 1* and then *Group 2* to assure they know which group they are in.

Give members of *Group 1* a copy of the attachment labelled “*Group 1*” and ask each them, as a group, to answer the questions in the space provided. Then give members of *Group 2* a copy of the attachment labelled “*Group 2*” with the same instructions.

After about twenty minutes, ask a spokesperson from *Group 1* to state his or her name and LG affiliation followed by the group’s answers to the questions. Then ask the same thing of the spokesperson from *Group 2*. When the process is over, ask participants:

1. In general, what differences in perspective about the loan are reflected in the answers given by each group to the questions?
2. What is the relevance of answers given by the two groups for a LG official seeking to obtain a loan from a bank?

Group 1

If you needed money to finance an important personal project that was not affordable without help from the outside, where would you go for the money? What would you take into account in making this decision? What factors do you think a prudent lender would take into account in deciding whether or not to loan you the money?

This image shows a single sheet of white paper with horizontal blue or grey ruling lines. The lines are evenly spaced and run across the width of the page. There are approximately 20 lines visible. The paper has a slight shadow on the right side, suggesting it's resting on a surface.

Group 2

If you were asked to loan someone money for personal reasons, what would you want to know before saying *yes* or *no*. Make a list of important criteria you would use to make the decision.

This image shows a single sheet of white paper with horizontal ruling lines. The lines are evenly spaced and run across the width of the page. There are no margins, text, or other markings on the paper.

8.2 TRAINER PRESENTATION

TIME REQUIRED

60 minutes

PURPOSE

This presentation is to provide participants with ideas and perspectives on debt management as a conceptual foundation for the exercises included in this workshop.

PROCESS

Prepare the presentation based on information covered by the preceding essay on financing the capital investment plan. Emphasize the need for policies consistent with existing laws including examples and a rationale. Distinguish between long and short-term debt. Explain when each form of debt should be considered and give examples of each form. Include a description of “present value analysis” with an example and a demonstration to ensure comprehension. Review the steps for analyzing a LG’s credit worthiness and the steps used to issue new debt.

Outlined information on note cards may help you cover the information systematically and stay on schedule. Ask questions from time to time during the presentation as a check on participant comprehension and to hold their attention. Augment the presentation with visual aids including pre-printed newsprint sheets and overhead transparencies as a further aid to comprehension.

8.3 EXERCISE: HARD CHOICES ABOUT LONG-TERM FINANCING

TIME REQUIRED

75 minutes

PURPOSE

Recognizing the variety of financing choices available and which is best for which type of LG project or program.

PROCESS

Explain that this exercise is intended to assist participants in making choices among the various types of financing discussed during the workshop or other types not discussed with which they might be familiar.

Divide participants into at least three groups of five to seven participants each. Tell each group that it will be asked to develop a financing plan for a capital project that involves an appropriate form of debt repayment. Give each group a handout containing instructions for completing the task (*see the following pages*). Tell each group it has 45 minutes to complete its task and to report the results including the criteria used by the group to make its choice of debt repayment. Remind the groups that their report should include a rationale for its choice of repayment and a description of the criteria used.

Trainers note: there are three handouts, each specifying a different capital project. If there are more than three groups, it will be necessary to assign the same project to more than one group. Or, you can develop additional projects of your own if you wish each group to have a different project.

After 45 minutes, have the groups reconvene. Ask each group for a report. After the report, ask for reactions to the plan and the criteria from members of the other groups. Conclude the exercise with these and other discussion questions for participants:

Questions

1. Why is it important to be familiar with forms of indebtedness that are not commonly used in your own country?
2. How might your LG or professional association broaden the scope of debt financing methods available in your country?

Handout # 1

Your group's assignment is to recommend a debt financing plan for the following project:

The construction of a regional sanitary landfill for the disposal of solid waste (garbage and trash) by several local governments.

Before making your choice from among the alternatives presented in the instructor's presentation, develop a list of criteria to base your decision on. Be prepared to report on: 1. your decision; 2. the criteria your group used to make your decision; and 3. your rationale or justification for your debt financing recommendation.

Handout # 2

Your group's assignment is to recommend a debt financing plan for the following project:

Redevelopment of the town square including the identification and restoration of buildings with residential or commercial potential.

Before making your choice from among the alternative choices presented in the instructor's presentation, develop a list of criteria to base your decision on. Be prepared to report on: 1. your decision; 2. the criteria your group used to make your decision; and 3. your rationale or justification for your debt financing recommendation.

Handout # 3

Your group's assignment is to recommend a debt financing plan for the following project:

Enlargement of sewer collectors to use more efficiently the existing treatment capacity, and to handle additional sewerage through a tie in with a neighbouring town.

Before making your choice from among the alternatives presented in the instructor's presentation, develop a list of criteria to base your decision on. Be prepared to report on: 1. your decision; 2. the criteria your group used to make your decision; and 3. your rationale or justification for your debt financing recommendation.

8.4 EXERCISE: PRESENT VALUE ANALYSIS

TIME REQUIRED

90 minutes

PURPOSE

Understanding how to use present value calculations to evaluate the current value of a future sum of money when borrowing money or establishing the financial terms for a lease agreement.

Trainers note. At least five hand calculators and copies of the present value tables from a finance textbook from your country will be needed for participants to use during this exercise.

PROCESS

Explain that participants will be working in small groups on two tasks that involve the use of present value analysis as described in the earlier presentation. Divide participants into several groups of five to seven participants each. Give each group one calculator and a copy of the three handouts on the following pages. Use a simple demonstration like the following to give participants practice in using the tables before beginning the assigned tasks.

Assume you have received a loan proposal for 1 million to be repaid in nine years at an interest rate of 9%. Also, assume that the bank making the loan is asking for a fee of 2% up front. What is the present value of the loan? Using the present value table, locate the figure on the matrix where 09 on the vertical scale (years) intersects with 9% on the horizontal scale (interest rate). Multiply the figure (.46043) by the loan amount. To the resulting figure, add the up-front fee (20,000).

After the practice period, tell participants they are to complete the two tasks described in the handouts and return to the training room in 30 minutes prepared to report on their results.

After 30 minutes, ask the small groups to reconvene. Beginning with the first task, ask each group to identify the bank proposal the group believed was best for the LG and why. Identify areas of agreement and disagreement and explore the reasoning in each case.

Follow the same procedure with the restaurant lease. Ask each group to identify the leasing terms believed to be best for the LG and why. Again, look for areas of agreement and disagreement and explore the reasoning.

Complete the exercise by asking participants for examples of situations in their own LGs where present value analysis has been used or can be used in the future to good advantage. Encourage discussion.

Handout #1

THE SITUATION

The solid waste disposal needs of a growing population has compelled the mayor and governing body to accelerate plans for expansion of the LG's landfill. Cost estimates for the expansion to ensure full compliance with stringent environmental regulations is 18 million. The LG does not have sufficient cash reserves to finance the expansion project without obtaining outside assistance. Therefore, a decision has been made to solicit 100% financing from the local banks. Within one week, three proposals have been received.

<i>Bank A Proposal</i>	Financing of 18 million for five years at 12% interest rate plus an up-front bank fee of 3%.
<i>Bank B Proposal</i>	Financing of 18 million for six years at 10% interest rate plus an up-front bank fee of 2.5%.
<i>Bank C Proposal</i>	Financing of 18 million for seven years at 8% interest rate plus an up-front bank fee of 3.5%.

TASK

Your task as a group is to use the present value tables provided by the instructor to calculate the present value of each loan proposal and with that information and other considerations decide which proposal you would recommend to the CEO and governing body.

Handout #2

THE SITUATION

A landowner who lives in a neighbouring country decides to donate a piece of property to the LG. In a letter to the LG, the landowner states that his family, for many years, has used the property as a restaurant and stipulates, as a condition of the donation, that the property continue to be used for restaurant purposes.

In accepting the property, the LG decides to fulfil its obligation under the donation agreement by leasing the property to a restaurant operator. The LG has contacted several reputable restaurant entrepreneurs and asked each for a proposal.

The mayor and governing body members have mixed feelings about the restaurant. One view is that the restaurant could be a significant income generator for the LG if well-managed and aggressively marketed. Another view is that the LG should minimize its risk and aim at getting a modest but "safe" return on its investment. Still another is that the LG should accept any reasonable offer to shift ownership of the restaurant into private hands, assuming the price is right.

The three responsible proposals received by the LG consist of the following:

<i>Proposal A</i>	Lessee proposes to invest all of the capital needed to ready the restaurant for start up. In return, the LG would waive lease payments for a period of 24 months. In the 25 th month, the lessee would begin monthly lease payments to the LG based on 20% of the restaurant's gross receipts for five years. After five years, the lease would be subject to review and re-negotiation by the parties.
<i>Proposal B</i>	Lessee proposes that the LG pay half the estimated restaurant start-up costs of 1.5 million. Lessee, in turn, agrees to pay in 24 equal monthly instalments beginning the third month after start up of operations, a sum sufficient to repay the LG's investment in the restaurant plus 50%. In the 28 th month after start up, the lease would be subject to review and re-negotiation by the parties.
<i>Proposal C</i>	Lessee proposes to pay the LG monthly from the start of the lease the sum of 150,000 plus 25% of the gross receipts for 5 years. The LG, in turn, would pay all of the restaurant start up costs and would transfer title to the property to the lessee free and clear at the end of the fifth year.

TASK

Your task as a group is to use the present value tables provided by the instructor to calculate the present value of each lease proposal and with that information and other considerations decide which proposal you would recommend to the CEO and governing body.

8.5 ROLE PLAY EXERCISE: NEGOTIATING A BANK LOAN

TIME REQUIRED

90 minutes

PURPOSE

Understanding the differing perspectives of LG officials in need of bank financing at reasonable terms and bank officers interested in getting the maximum return on the bank's investment.

PROCESS

Tell participants they will be taking part in a role-play exercise concerned with officials of a LG making a convincing case for action by a local bank to revise the terms of a loan for financing an important public project.

Ask six participants to volunteer for the role-play exercise. Explain that half the participants will be assuming roles as LG officials who have invited loan proposals and the other half will be assuming roles as officers of a local bank that has submitted a loan proposal. Explain that participants not playing roles will be asked to develop criteria for evaluating what takes place during a meeting of LG and bank representatives at the bank as they discuss the bank's loan proposal.

Give both groups a description of the task and each group a description of the role – LG officials and bank officers – they are being asked to play (*see below*). Explain that the objective of the LG officials is to argue convincingly for a change in the terms of the bank loan proposal that would reduce the size of the LG's monthly loan payments in the early years of the loan. The LG official role description provides certain facts that can be used as "leverage" in the negotiation. Explain that the objective of the bank officers, on the other hand, is to get the best possible return on the bank's financial investment over the life of the loan with the least risk to bank owners. The bank officer role description describes what the bank wants in return for making the loan.

Give the two role-playing groups about 20 minutes to read and discuss the situation and to choose a strategy for getting what they want. Ask other participants to work together during the 20 minutes on a common set of criteria for use in evaluating what takes place during the role-play.

At the end of the twenty minutes, seat the three LG and three bank representatives at a table that simulates a conference table at the bank. Seat non-participants in a circle around the table and remind them they are to evaluate the role-play based on their criteria. Tell the two groups they have 20 minutes to present their positions and find a way to resolve their differences. At the end of 20 minutes, call time and ask observers to describe the criteria they were using to evaluate the meeting and the results of their evaluation. Ask each group of role players, in turn, to respond to the evaluation and to give their own assessment of the meeting outcome. Conclude the discussion with two closing questions:

1. What insight have you gained from the exercise about the local bank perspective in loaning money to LGs for capital projects?
2. How might this experience alter the way you and your LG deal with local banks when seeking long-term financing?

Negotiating a Bank Loan

THE SITUATION

The LG of Kubin owns several blocks of multi-story buildings containing flats that it leases by the month to working families. The flats have provided the LG with a positive cash flow for over three years. A couple of weeks ago, a devastating fire in one of the flats within a few hours destroyed an entire block of these buildings. Temporary housing has been found for several hundred families left homeless by the tragedy. A shortage of housing in Kubin has created an urgent public necessity to rebuild immediately.

Kubin is able to finance only about one-third of the estimated reconstruction cost of the flats from reserve funds and must obtain the rest from outside financing. The quickest source of financing for reconstruction of the flats is a bank loan, and LG officials have acted quickly to prepare the necessary tender documents. Only one bank has responded to the tender request and terms for the proposed loan are not satisfactory. Although negotiating the terms of a loan is not customary, LG officials have decided to request a meeting with bank officials. The request is accepted and a date has been set for the meeting.

Role # 1

BANK OFFICER

We will loan you the money you have requested. No problem. In return, however, we want the LG to use our bank from now on as sole depository for all LG funds. We also will need a guarantee or collateral – something of value we can hold as security during the payout period. It must be at least two times the value of the loan to serve as sufficient collateral.

Role # 2

LG OFFICIAL

It is our understanding that your bank is looking for space in a neighbourhood commercial area to locate a branch bank. The LG owns a building in the neighbourhood that can be remodelled for use as a branch bank. We will give the bank rent-free occupancy of this building for five years. How is that for collateral? We may have a problem with a commitment to your bank as sole depository, however. As you may know, the mayor sits on the board of a competitive bank.

8.6 CLOSING EXERCISE: LEARNING TRANSFER

TIME REQUIRED

30-45 minutes

PURPOSE

This exercise is to help participants transfer the learning experiences of the workshop into their real-world activities as finance directors. The focus of this exercise is on raising expectations, engaging in realistic planning and making personal commitments. Most of the work is done on a personal basis with some interpersonal sharing.

PROCESS

Spend at least half an hour at the end of the workshop to focus the attention of participants on important learnings and encourage them to continue experimenting with these learnings in their debt management activities. Begin by giving participants about fifteen minutes to work independently on a simple learning transfer questionnaire.

When participants have completed the questionnaire, ask them to share quickly with the group two or three things they intend to do differently in their debt management roles to close the workshop.

Trainers note. It is generally agreed that the purpose of training is to improve the way people do things by showing them a better way. In fact, the success of a training experience can be measured by the amount of personal growth and change that takes place both during training and after the training is over.

Commitments to learning and change made at the close of a workshop can help participants overcome learning resistance in themselves and in the work environment. A trainer can help learners make a successful transition from the world of learning to the world of doing through a few simple planning exercises.

A LEARNING TRANSFER QUESTIONNAIRE

Take a few minutes to reflect on the financing of the capital investment plan and debt management process, the new ideas you encountered in this workshop, and how you feel about them. Then, in the space below, write a sentence or two to describe something interesting you have learned about yourself during this workshop.

Based on what you have learned about yourself and the many possibilities for change presented by this workshop, what two or three things do you intend to do differently in your role?

1.

2.

3.

Finally, what obstacles in yourself or in your work environment do you expect to experience during your efforts to implement these changes? What will you do to remove or minimize these obstacles?

Expected Obstacle	Action to Remove It
1.	1.
2.	2.
3.	3.

