



**INDIGO SHIRE COUNCIL  
OFFICE CONSOLIDATION PROJECT  
FUNDING STRATEGY**

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## **Executive Summary**

### ***Introduction***

Indigo Shire Council (“Indigo”) resolved in August 2008 to pursue the Office Consolidation Project (“Project”). Amongst other things, Council Officers are to provide a full and detailed funding strategy to Council for consideration in October 2008.

We have been requested to examine the Project and prepare the detailed funding strategy having regard to the financial position of Indigo. This report presents the findings arising from a financial sustainability assessment and an analysis of the funding options for formulating the funding strategy.

### ***Financial Sustainability Assessment***

Indigo could be financially stressed if it were to undertake more major projects without substantial rate increases because of the following:

- It does not have much discretionary cash or equivalent holdings.
- It has only a head room of \$1.7M for new borrowings before breaching the best practice limit of 60% of total rates and charges.
- Of the recurring surplus of \$3M, revenue from private works had contributed \$4M (50% of rates and charges), which is not as “risk free” as rates and charges.
- Another \$2M-\$3M was required from one-off fund, primarily from grants and contributions that were tied to capital works, to pay for the capital works and loan repayments.
- Although spending on capital works of \$4M-\$5M is comparable to the depreciation charge; Indigo would be stretched to have the financial capacity to maintain its infrastructure without capital works specific grants and contributions.

### ***Funding Strategy***

There are clear benefits of consolidating the existing offices, but the total amount of potential benefit may not be sufficient to justify the cost of \$8M.

Indigo would be exposed if the Project was to go ahead with the option of borrowing \$8M. Indigo may find LGV reluctant to approve the application for new borrowing as this would place its borrowing/rate revenue ratio above 100%.

The Project could only be viable by a combination of the following risk mitigation measures:

- Reducing the building cost to \$5M or below
- Consider using PPP arrangements to mitigate the potential of cost blow-out
- Adopting a strategy of accelerating the loan repayments in the first five years by making the rate increase higher with a view to reducing the debt/rate revenue ratio to the best practice level of 60%
- Making representation to LGV on the new borrowing that is required for funding the Project, and the measures for reducing the debt/rate revenue ratio.

### ***Qualifications and Declarations***

In conducting the financial sustainability assessment and preparing the funding strategy, all source information was provided by Indigo. The reliability and accuracy of the findings is limited to the accuracy of the source information on which the report is based, and the assumption made as detailed in the report.

The review was conducted by way of enquiries, interviewing senior staff members of Indigo, analysing information made available to C Kwong & Associates and data provided or extracted from the various accounting records and computer systems.

We believe, on reasonable grounds, that the information and documents provided are reliable, complete and not misleading. We have no reasons to believe that any material facts have been withheld. The comments and recommendations in this report are drawn in good faith and without any known conflict of interest. Accordingly, we disclaim any reliance on this report if used for any purpose other than for which it was specifically prepared.

## Detailed Report

### ***Background***

Indigo Shire ("Indigo") was formed in 1994 through the amalgamation of the Shire of Rutherglen and parts of the Shires of Beechworth, Chiltern and Yackandandah as part of the Local Government reform. The reform oversaw the amalgamation of 212 municipalities into 77. For Indigo, it includes the towns of Beechworth, Chiltern, Rutherglen, Yackandandah and Tangambalanga. The original four shires had a combined total area of 2,953 sq km and a total population of 15,640. The new Indigo Shire has a total area of 2,016 sq km and a total population of 14,500.

Subsequent to the formation of Indigo, the Commissioners determined that Indigo would operate from the following four offices:

- Main Shire office at Beechworth
- Shire Operations office at Yackandandah
- Service Centre at Chiltern in conjunction with WAW Credit Union
- Service Centre at Rutherglen in conjunction with the Library

One of the feasibility reports on the Project indicated that there are 235 employees of which 79 are office based:

Council Support and CEO	4
Corporate Services	17
Finance	6
Asset and Operations	18
Environment & Development	14
Health and Well-Being	16
Economics and Tourism	4
	<hr/>
	79
	<hr/>

About 50 employees are currently located at the Yackandandah office.

## **Financial Sustainability Assessment**

### **Assessment Approach & Method**

The assessment was based on the audited accounts of Indigo for 2005-06, 2006-07 and 2007-08. We analysed the past financial positions and performance of Indigo in order to ascertain whether Indigo would be financially stressed in its operations, and whether it has the financial strengths to take on major projects including the office consolidation project (“Project”).

### **Findings & Observations**

#### FINANCIAL POSITION

In summary, the audited accounts revealed the following financial indicators that are relevant to the Project:

	<b>30<sup>th</sup> June 06</b> <b>(\$'000)</b>	<b>30<sup>th</sup> June 07</b> <b>(\$'000)</b>	<b>30<sup>th</sup> June 08</b> <b>(\$'000)</b>
Cash Holdings	2,968	3,204	4,085
Restricted	(3,150)	(2,698)	(3,262)
Discretionary Cash	(182)	506	823
Borrowings	4,111	3,872	3,214
Best practice borrowing limit (60% of rates)	4,233 (60% of 7,055)	4,577 (60% of 7,628)	4,963 (60% of 8,272)

The key financial indicators that are relevant to the Project indicated that:

- Indigo does not have much cash or equivalent holdings at its discretion.
- Indigo has only a head room of \$1.7M only for new borrowings before breaching the best practice limit of 60% of total rates and charges.
- The level of borrowing is trending downwards over the past 3 years.

We have further reviewed the properties in the asset register and found none that is surplus to the need of the operations.

FINANCIAL PERFORMANCE

The audited accounts also revealed the following financial performance results:

	<u>2005-06</u> <u>(\$'000)</u>	<u>2006-07</u> <u>(\$'000)</u>	<u>2007-08</u> <u>(\$'000)</u>
Total Revenue	22,250	21,535	21,586
Total Expenses	22,125	20,326	20,283
Subtotal	125	1,209	1,303
Net gain (loss) on asset disposal	187	5	(11)
Surplus/(Deficit)	312	1,214	1,292

The audited accounts had included non cash items including depreciation charges, debts written off and written down value of asset sold.

The operating capacity of Indigo may be better understood if the audited accounts are dissected into recurring and one-off components after adjusting for the non cash items.

In general, the recurring component would provide an indication of the size of surplus the Shire could generate annually.

Together with the one-off fund, the recurring surplus would finance the capital works and loan repayments.

Having determined the recurring surplus, assessing the financial sustainability of Indigo would entail establishing:

- a) The reliability of the source and amount of the one-off funds available to supplement the recurring surplus;
- b) The amount spent on capital works (from the cash flow statement) comparing to the annual depreciation charge; and
- c) The annual repayment amount on the outstanding loan principal (from the cash flow statement).

It should be noted that the size of recurring surplus is related to the number of services provided and whether they are provided in a cost effective manner.

The tables in the following pages provide summary of results from dissecting the audited accounts of the past three financial years. It should be noted that the amounts of net gain (loss) on asset disposal have been re-composed into proceeds from sales (grouped under other revenue) and written down value of asset sold (grouped under other expenses) to facilitate the elimination of non-cash amounts. This should have no impact on the calculation of surplus (deficit) for the year.

	<b>2005-06 (\$'000)</b>	<b>Audited</b>	<b>Non Cash</b>	<b>One-Off</b>	<b>Recurring</b>
<b>Revenue</b>	Rates & Charges	7,055	0	0	7,055
	Grants	8,607	0	(3,799)	4,808
	Fees & Fines	1,118	0	0	1,118
	Private works	4,312	0	0	4,312
	Contributions	730	0	(730)	0
	Others	1,087	0	(659)	428
			<u>22,909</u>	<u>0</u>	<u>(5,188)</u>
<b>Expenses</b>	Employee costs	7,789	0	0	7,789
	Mat & Services	6,295	0	(1,750)	4,545
	Private works	1,532	0	0	1,532
	Depreciation	3,604	(3,604)	0	0
	Finance costs	220	0	0	220
	Others	3,157	(472)	(581)	2,104
			<u>22,597</u>	<u>(4,076)</u>	<u>(2,331)</u>
Surplus/(Deficit)	312	4,076	(2,857)	1,531	
					<u>1,531</u>
					<u>2,857</u>
					<u>(4,006)</u>
					<u>(578)</u>
					<u>(196)</u>
					<u>(196)</u>
					<u>(196)</u>
	<b>2006-07 (\$'000)</b>	<b>Audited</b>	<b>Non Cash</b>	<b>One-Off</b>	<b>Recurring</b>
<b>Revenue</b>	Rates & Charges	7,628	0	0	7,628
	Grants	7,264	0	(2,690)	4,574
	Fees & Fines	1,234	0	0	1,234
	Private works	3,806	0	0	3,806
	Contributions	1,123	0	(1,123)	0
	Others	969	0	(489)	480
			<u>22,024</u>	<u>0</u>	<u>(4,302)</u>
<b>Expenses</b>	Employee costs	7,398	0	0	7,398
	Mat & Services	4,581	0	(371)	4,210
	Private works	1,308	0	0	1,308
	Depreciation	4,230	(4,230)	0	0
	Finance costs	234	0	0	234
	Others	3,059	(532)	(609)	1,918
			<u>20,810</u>	<u>(4,762)</u>	<u>(980)</u>
Surplus/(Deficit)	1,214	4,762	(3,322)	2,654	
					<u>2,654</u>
					<u>3,323</u>
					<u>(5,442)</u>
					<u>(680)</u>
					<u>(145)</u>
					<u>(145)</u>

	2007-08 (\$'000)	Audited	Non Cash	One-Off	Recurring
Revenue	Rates & Charges	8,272	0	0	8,272
	Grants	6,429	0	(1,454)	4,975
	Fees & Fines	1,299	0	0	1,299
	Private works	3,919	0	0	3,919
	Contributions	1,023	0	(1,023)	0
	Others	726	0	(82)	644
		<u>21,668</u>	<u>0</u>	<u>(2,559)</u>	<u>19,109</u>
Expenses	Employee costs	7,515	0	0	7,515
	Mat & Services	4,219	0	0	4,219
	Private works	1,476	0	0	1,476
	Depreciation	4,443	(4,443)	0	0
	Finance costs	223	0	0	223
	Others	2,500	(94)	(532)	1,874
		<u>20,376</u>	<u>(4,537)</u>	<u>(532)</u>	<u>15,307</u>
	Surplus/(Deficit)	<u>1,292</u>	<u>4,537</u>	<u>(2,027)</u>	<u>3,802</u>
	Recurring Surplus				3,802
	One-off Fund				2,027
	Capital works from cash flow statement				(4,279)
	Loan Repaid from cash flow statement				(658)
					<u>892</u>
			Cash Surplus		<u>892</u>

The analysis indicated that:

- Indigo had generated a recurring surplus of approximately \$3M in the last two year, hence could reasonably expect to have \$3M annually available from the operations.
- A large proportion of the revenue (\$4M or 50% of rates and charges) came from private works, which is not as “risk free” as rates and charges.
- Another \$2M-\$3M is required from one-off fund, primarily from grants and contributions, to pay for the capital works and loan repayments.
- As most of the one-off revenue came from grants and contributions, they would be tied to capital works
- Capital works of \$4M-\$5M is comparable to the depreciation charge. An independent assessment was made in early 2008 and confirmed that the level of capital expenditure is adequate to maintain the infrastructure of Indigo.
- The corollary is that without the grants and contributions, Indigo could be stretched to have the financial capacity to maintain its infrastructure,

## Conclusion

Indigo would be financially stressed if it were to undertake more major projects without substantial rate increases because of the following:

- It does not have much discretionary cash or equivalent holdings.
- It has only a head room of \$1.7M for new borrowings before reaching the best practice limit of 60% of total rates and charges.
- Of the recurring surplus of \$3M, revenue from private works had contributed \$4M (50% of rates and charges), which is not as “risk free” as rates and charges.
- Another \$2M-\$3M was required from one-off fund, primarily from grants and contributions that were tied to capital works, to pay for the capital works and loan repayments.
- Although spending on capital works of \$4M-\$5M is comparable to the depreciation charge; Indigo would be stretched to have the financial capacity to maintain its infrastructure without capital works specific grants and contributions.

## **Office Consolidation Funding Strategy**

### **Project Cost Estimate**

The cost estimates for building a new office at various sites have been prepared by two consultants in 2008, and they were as follow:

#### NO 42 ARCHITECT

The consultant has estimated that the office building would cost approximately \$5M. Estimates for various sites are as follows:

<u>Town</u>	<u>Site</u>	<u>\$'000</u>
<b>Beechworth</b>	Old Hospital	5,125
	Tennis Court	5,093
	Oven Hospital	4,568
<b>Chiltern</b>	Hume Highway	4,901
	Police Paddock	4,646
<b>Yackandandah</b>	Combining Existing Offices	5,398

#### SUTER

The consultant has estimated that the office building would cost approximately \$7M. Estimates for various sites are as follows:

<u>Town</u>	<u>\$'000</u>
<b>Beechworth</b>	6,612
<b>Chiltern</b>	7,172
<b>Yackandandah</b>	7,268

Clearly, both cost estimates were made during the “conceptualization” phase of the Project, and would not have the benefits of a detailed design of the office building for each site. Although Suter has factored some cost escalation into the estimates, the risk of cost escalation would remain high during the detailed design and construction phases based on experience. State Government has been adopting the private public partnership (“PPP”) approach to mitigate (transfer) such risks in recent years.

For the purpose of this analysis, the cost estimate of \$8M is adopted.

## Business Case

The Suter report prepared in June 2008 estimated that the potential annual savings could amount to \$309,000:

– Annual operational cost savings from utilities (energy & fuel etc)	\$6,750
– Annual savings from increased efficiencies (office travelling)	\$265,264
– Annual rental payment savings from the Beechworth office	\$37,000
Total	<u>\$309,014</u>

The net present value (“NPV”) of cash flow arising from an annual savings of \$300,000 over 30 years using a discount rate of 8% is \$3.38M. Ideally, the cost of the new office should not exceed this amount if the Project is to be “justified” on financial terms alone. There would be other non financial benefits.

The potential annual savings may occur in the form of cash saving which could be utilized for loan repayments, or in the form of time saving which can be utilized for service improvement.

Council Officers have reviewed the estimates, and conservatively estimated that the potential cash savings would be \$133,500:

– Staffing cost reduction from obviating travel between Yackandandah & Beechworth	\$59,000
– Vehicles and running costs reduction from minimizing travel between Yackandandah & Beechworth	\$20,000
– IT link between Yackandandah & Beechworth (I have left out savings from office equipment as experience would indicate otherwise)	\$15,000
– Savings in power, gas and building maintenance services	\$21,000
– Income from lease rental from Beechworth offices	\$18,500
	<u>\$133,500</u>

The NPV of an annual savings of \$133,500 over 30 years using a discount rate of 8% is \$1.5M.

Extrapolating the two estimates, the NPV of the potential annual cost savings would be \$2.5M (or \$220,000 pa). This is well short of the estimated \$8M required for the new office building.

Whilst it is common sense to consolidate the existing offices, there needs to be a lot of intangible and non financial benefits arising from the consolidation including improved internal communication and customer services to justify the cost of \$8M.

## Project Funding Analysis

The financial sustainability assessment has concluded that Indigo cannot fund the Project by:

- Drawing discretionary cash holdings
- Selling buildings that are surplus to the needs of the Shire
- Allocating excess recurring surplus

New borrowing is the main remaining option, assuming that Local Government Victoria (“LGV”) would approve.

New borrowing requires additional recurring surplus to service the loan interest and repay the loan principal. The following table provides a summary of impact on rate increase for a new borrowing of \$8M:

Loan @10%	Term (year)	Annual Payment (\$'000) (principal & interest)	Equivalent Rate Increase (\$8.272M)
\$8M	15	1,052	12.7%
	20	940	11.5%
	25	881	10.6%

Naturally, the level of rate increase could be reduced by taking into account the following sources:

- a) Potential annual savings arising from the consolidation (\$220,000);
- b) Funding some capital work projects by external sources including grants and contributions instead of by recurring surplus (estimated feasible to “refinance” up to \$250,000 annually); or
- c) Further identifying duplicated staff positions after consolidation.

Source c) will not be considered in this analysis as a lot more impact analysis would need to be carried out.

This report will explore variations within the following options and express the impact in terms of rate increase required:

- Borrowing only
- Borrowing with Risk Mitigation Measures (as would be highlighted later that adopting the above two options may expose Indigo to unacceptable risks.)

**BORROWING ONLY**

The following table provides a summary of rate increase required in order to repay a borrowing of \$8M:

Loan amount of \$8M Rate base \$8.272M	Loan Term of (years) @10%		
	15	20	25
Annual payment (\$'000)	1,052	940	881
Less potential savings (\$'000)	(220)	(220)	(220)
Net annual payment (\$'000)	832	720	661
<b>Equivalent rate increase</b>	<b>10.1%</b>	<b>8.7%</b>	<b>8.0%</b>
Less capital works “refinanced” (\$'000)	(250)	(250)	(250)
Net annual payment (\$'000)	582	470	411
<b>Equivalent rate increase</b>	<b>7.0%</b>	<b>5.7%</b>	<b>5.0%</b>

Naturally, the rate increase would be in addition to the normal increase to take into account CPI and other budgetary needs. It is envisaged that the “special increase” would be quarantined for the purpose of the Project.

**BORROWING WITH RISK MITIGATION MEASURES**

In the previous sections, we have identified that building an office for \$8M would expose Indigo to the following risks which must be mitigated:

- a) Financial stress as a result of additional annual payment required to fund the Project, with inadequate identified savings to defray the additional cost and the new loan potentially not approved by LGV.
- b) “Cost Blow-Out” on the estimated \$8M during the detailed design and construction phases which would further exacerbate the financial stress.

The following are suggestions of mitigation measures for the two risks:

**Financial Stress**

Indigo should consider having a lower cost building, say \$5M the original cost estimate. There are many known design technique for minimizing the total office space requirements (including open plan) to reduce the cost of building, or mixing commercial use of the ground floor to subsidise the annual payments (hence locating the office in a commercially preferred area would be paramount).

A borrowing of \$5M would have the following impact on rate increase:

Loan amount of \$5M Rate base \$8.272M	Loan Term of (years) @10%		
	15	20	25
Annual payment (\$'000)	657	587	551
Less potential savings (\$'000)	(220)	(220)	(220)
Net annual payment (\$'000)	437	367	331
<b>Equivalent rate increase</b>	<b>5.3%</b>	<b>4.4%</b>	<b>4.0%</b>
Less capital works “refinanced” (\$'000)	(250)	(250)	(250)
Net annual payment (\$'000)	187	117	81
<b>Equivalent rate increase</b>	<b>2.3%</b>	<b>1.4%</b>	<b>1.0%</b>

Restricting the cost of the Project to \$5M would clearly reduce the financial stress on Indigo by minimizing the size of rate increase. But it would still take the total borrowing to \$8.2M. Against a rates & charges base of \$8.272M, the debt/rate revenue ratio would be 100%, the “red territory” which could make LGV reluctant to approve the new borrowing without a plan to reduce it within an acceptable timeframe.

However, if Indigo could go to the LGV with a Council Plan which embrace a financial strategy of reducing the debt/rate revenue ratio to below 100% in five years, LGV may consider the application. One of the measures is to accelerate the initial repayment amounts in the first five years on a loan of 25 years, and reduce the repayment amounts in the latter years.

The implication of this strategic measure is that the size of the rate increase would need to be larger in order to meet the accelerated repayment plan. It is a one-off increase, and Indigo would inherit a potentially larger recurring surplus in the latter years, and wean its dependence on grants and contributions to maintain its infrastructure.

The following table illustrates how the accelerated repayment measure works:

<b>LOAN 5,000 (\$'000)</b> <b>RATE 10%</b> <b>PERIOD 25 years</b>										
P#	Start	Payment			End	Start	Payment			End
	Balance	normal	Interest	Principal	Balance		Balance	accelerate	Interest	Principal
1	5,000	551	500	51	4,949	5,000	750	500	250	4,750
2	4,949	551	495	56	4,893	4,750	750	475	275	4,475
3	4,893	551	489	62	4,831	4,475	750	448	303	4,173
4	4,831	551	483	68	4,763	4,173	750	417	333	3,840
5	4,763	551	476	75	4,689	3,840	750	384	366	3,474
6	4,689	551	469	82	4,607	3,474	408	347	61	3,413
7	4,607	551	461	90	4,516	3,413	408	341	67	3,346
8	4,516	551	452	99	4,417	3,346	408	335	73	3,273
9	4,417	551	442	109	4,307	3,273	408	327	81	3,192
10	4,307	551	431	120	4,187	3,192	408	319	89	3,104
11	4,187	551	419	132	4,055	3,104	408	310	98	3,006
12	4,055	551	405	146	3,909	3,006	408	301	107	2,899
13	3,909	551	391	160	3,749	2,899	408	290	118	2,780
14	3,749	551	375	176	3,573	2,780	408	278	130	2,650
15	3,573	551	357	194	3,380	2,650	408	265	143	2,507
16	3,380	551	338	213	3,167	2,507	408	251	157	2,350
17	3,167	551	317	234	2,932	2,350	408	235	173	2,177
18	2,932	551	293	258	2,674	2,177	408	218	190	1,987
19	2,674	551	267	284	2,391	1,987	408	199	209	1,778
20	2,391	551	239	312	2,079	1,778	408	178	230	1,547
21	2,079	551	208	343	1,736	1,547	408	155	253	1,294
22	1,736	551	174	377	1,358	1,294	408	129	279	1,016
23	1,358	551	136	415	943	1,016	408	102	306	709
24	943	551	94	457	487	709	408	71	337	372
25	487	551	49	502	(16)	372	408	37	371	1

Making an annual repayment of \$0.75M would require quarantining an one-off rate increase of 6.4% (putting aside the opportunity of refinancing some capital works by grants and contributions), as summarized in the following table:

Rate base \$8.272M	Term (years)	25
Annual payment (\$'000)		750
Less potential savings (\$'000)		(220)
Net annual payment (\$'000)		530
<b>Equivalent rate increase</b>		<b>6.4%</b>
Less capital works “refinanced” (\$'000)		(250)
Net annual payment (\$'000)		280
<b>Equivalent rate increase</b>		<b>3.4%</b>

However, after the fifth year, \$0.35M would be added to the recurring surplus to fund capital works that could not be funded by grants or contributions.

The estimated level of debt would be \$7M by the fifth year, well below the rates & charges of base which would be close to \$10M by then. It would also return Indigo close to the best practice debt/rate revenue ratio of 60%.

### Cost Blow-Out

One of the mitigation measures is to call an Expression of Interests (“EOI”) for a PPP partner to finance, build and operate the building to a value of \$5M.

Instead of paying for an architectural design, Indigo could use this process to find out what the private sector could offer a building at that price and still meet the accommodation needs of Indigo.

Under a typical PPP arrangement, Indigo would provide the land for the building and expect the building to be transferred back to Indigo after a concession period to be determined (not less than 30 years). This may become an issue for some of the locations when the land is not owned by Indigo. Naturally, the EOI should specify the office space that is necessary to provide adequate accommodation for Indigo.

The annual costs proposed by the PPP partners would be compare to the amortised cost of building it by Indigo, and the difference would indicate the level of risk premium Indigo have to pay for having a peace of mind.

Based on experience in Victoria, most of the PPP arrangements were delivered on time and on budget. It should be noted that such arrangement would require Ministerial approval.

## Conclusion and Funding Strategy

There are clear benefits of consolidating the existing offices, but the total amount of potential benefit may not be sufficient to justify the cost of \$8M.

Indigo would be exposed if the Project was to go ahead with the option of borrowing \$8M. The risks would remain even with the sale of Buller Gas to reduce the borrowing to \$4.5M. Indigo may find LGV reluctant to approve the application for new borrowing as this would place its borrowing/rate revenue ratio to well above 100%.

The Project could only be viable by a combination of the following risk mitigation measures:

- Reducing the building cost to \$5M or below
- Consider using PPP arrangement to mitigate the potential of cost blow-out
- Adopting a strategy of accelerating the loan repayments in the first five years by making the rate increase higher with a view to reducing the debt/rate revenue ratio to the best practice level of 60%
- Making representation to LGV on the new borrowing that is required for funding the Project, and the measures for reducing the debt/rate revenue ratio.