New South Wales
Treasury Corporation

Gloucester Shire Council

Financial Assessment, Sustainability and Benchmarking Report

19 March 2013

Prepared by NSW Treasury Corporation for Gloucester Shire Council, the Division of Local Government and the Independent Local Government Review Panel.

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Disclaimer

This report has been prepared by New South Wales Treasury Corporation (TCorp) in accordance with the appointment of TCorp by the Division of Local Government (DLG) as detailed in TCorp's letters of 22 December 2011 and 28 May 2012. The report has been prepared to assist the DLG and the Independent Local Government Review Panel in its consideration of the Sustainability of each local government area in NSW.

The report has been prepared based on information provided to TCorp as set out in Section 2.2 of this report. TCorp has relied on this information and has not verified or audited the accuracy, reliability or currency of the information provided to it for the purpose of preparation of the report. TCorp and its directors, officers and employees make no representation as to the accuracy, reliability or completeness of the information contained in the report.

In addition, TCorp does not warrant or guarantee the outcomes or projections contained in this report. The projections and outcomes contained in the report do not necessarily take into consideration the commercial risks, various external factors or the possibility of poor performance by the Council all of which may negatively impact the financial capability and sustainability of the Council. The TCorp report focuses on whether the Council has reasonable capacity, based on the information provided to TCorp, to take on additional borrowings, and Council's future Sustainability, within prudent risk parameters and the limits of its financial projections.

The report has been prepared for Gloucester Shire Council, the DLG and the Independent Local Government Review Panel. TCorp shall not be liable to Gloucester Shire Council or have any liability to any third party under the law of contract, tort and the principles of restitution or unjust enrichment or otherwise for any loss, expense or damage which may arise from or be incurred or suffered as a result of reliance on anything contained in this report.

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Section 1 Executive Summary

This report provides an independent assessment of Gloucester Shire Council's (the Council) financial capacity and its future Sustainability. The analysis is based on a review of the historical performance, current financial position, and long term financial forecasts. It also benchmarks the Council against its peers using key ratios.

TCorp's approach has been to:

- Review the most recent four years of Council's consolidated financial results
- Conduct a detailed review of the Council's 10 year financial forecasts, with a particular focus on a council's General Fund. Where a council operates a Water or other Fund the financial capacity of these other Funds may be reviewed where considered necessary.

Council's financial position has been deteriorating over the review period, and has been further impacted on a consolidated basis by the transfer of its water and sewer assets to Midcoast Water in 2012. Council has been unable to achieve operating surpluses when capital grants and contributions are excluded during the review period and the deficits have grown year on year. Some other observations include:

- Council's underlying operating performance, as measured by EBITDA, has decreased to $1.8m in 2012 following the transfer of the water and sewer assets, from $2.2m in 2009
- Council's liquidity has remained adequate to meet their short term liabilities throughout the review period however they have been below the 1.50x benchmark in the past three years indicating limited flexibility
- Within the General Fund alone, Council has increased borrowings from $2.5m in 2009 to $3.6m in 2012 due to an interest free loan received from the NSW Treasury in 2010, to construct 51 residential lots for sale
- Council's Own Source Operating Revenue Ratio has been below the benchmark in each year indicating Council's reliance on grants and contributions
- Council experienced large increases in wages and salaries costs in 2010 and 2011 before they decreased in 2012 following the water and sewer asset transfer
- Council has a low reserve for leave entitlements that will need to be funded in future years

The Council reported $32.6m of Infrastructure Backlog in 2012 which represents 30.2% of its infrastructure asset value of $108.0m. Other observations include:

- The Backlog has reduced from $54.3m in 2009, partly due to the transfer of the water and sewer assets that had a combined backlog total of $23.0m in 2011
- Council has been unable to meet the benchmark for the Asset Maintenance Ratio, Building and Infrastructure Asset Renewal Ratio, and Capital Expenditure Ratio in the past two years and this will lead to an increase in the Backlog if these trends are not reversed

The key observations from our review of Council's 10 year forecasts for its General Fund are:

- Operating deficits are projected to remain and increase over the forecast period under the 'Status Quo' scenario

- Council has modelled three alternative SRV scenarios of varying amounts to indicate the financial benefit of Council receiving an approved SRV application
- Council has listed a summary of strategic actions that cover various options to raise revenues, provide efficiencies and reduce expenses
- Council's liquidity is projected to continue to be adequate but with limited flexibility with a forecast Unrestricted Current Ratio below the 1.50x benchmark in each year

In our view, if Council is successful with one of the possible SRV applications then they may have the capacity to undertake additional borrowings. Until the details of any approved SRV's are available it is not considered prudent to recommend any additional borrowings.

In respect of the long term Sustainability of the Council our key observations are:

- Based on Council's LTFP, Council has forecast increasing operating deficits which is Unsustainable. The current service levels cannot be maintained with the existing revenue and expense base.
- The current forecast LTFP will likely lead to a deterioration of Council's asset base
- It is important that Council reviews all the possible options to raise revenues and decrease expenses in order to improve their future financial position
- Council should continue to explore the viability of a SRV application that will increase rates revenue to assist the objective of becoming financially Sustainable in the long term
- Council needs to follow the summary of strategic actions within the LTFP to enable them to explore the most suitable way to become Sustainable in the long term
- Council has limited financial reserves and does not have sufficient resources to withstand any significant unforeseen financial events

In respect of our benchmarking analysis we have compared the Council's key ratios with other councils in DLG group 10. Our key observations are:

- Council's financial flexibility as indicated by the Operating Ratio and Own Source Operating Revenue Ratio is generally below the group's average
- Council has relatively less capacity to utilise further borrowings than the group average as it has lower DSCR and Interest Cover Ratio
- Council has been in an adequate liquidity position but has been below the group average liquidity level and has limited liquidity compared to its peers
- Council's Asset Maintenance Ratio and Capital Expenditure Ratio are lower than the group average and also has a comparatively high level of Infrastructure Backlog

Section 2 Introduction

2.1: Purpose of Report

This report provides the Council with an independent assessment of their financial capacity, Sustainability and performance measured against a peer group of councils. It will complement Council's internal due diligence, the IP&R system of the Council and the DLG, together with the work being undertaken by the Independent Local Government Review Panel.

The report is to be provided to the DLG and the Independent Local Government Review Panel.

The key areas focused on are:

- The financial capacity of the Council
- The long term Sustainability of the Council
- The financial performance of the Council in comparison to a range of similar councils and measured against prudent benchmarks

2.2: Scope and Methodology

TCorp's approach was to:

- Review the most recent four years of the Council's consolidated audited accounts using financial ratio analysis. In undertaking the ratio analysis TCorp has utilised ratio's substantially consistent with those used by Queensland Treasury Corporation (QTC) initially in its review of Queensland Local Government (2008), and subsequently updated in 2011
- Conduct a detailed review of the Council's 10 year financial forecasts including a review of the key assumptions that underpin the financial forecasts. The review of the financial forecasts focused on the Council's General Fund
- Identify significant changes to future financial forecasts from existing financial performance and highlight risks associated with such forecasts, including those that could impact Council's Sustainability
- Conduct a benchmark review of a Council's performance against its peer group
- Prepare a report that provides an overview of the Council's existing and forecast financial position and its capacity to meet increased debt commitments and achieve long term Sustainability
- Conduct a high level review of the Council's IP&R documents for factors which could impact the Council's financial capacity, performance and Sustainability

In undertaking its work, TCorp relied on:

- Council's audited financial statements (2008/09 to 2011/12)
- Council's financial forecast model
- Council's IP&R documents
- Discussions with Council officers
- Other publicly available information such as information published on the IPART website

In completing the report, TCorp worked closely with Council management to analyse and understand the information gathered. The Council was given a draft copy of the report for their review and comment. Based on our discussions with Council:

- Council agrees with the findings of the report and has acknowledged TCorp's comments

Definition of Sustainability

In conducting our reviews, TCorp has relied upon the following definition of sustainability to provide guidance:

"A local government will be financially sustainable over the long term when it is able to generate sufficient funds to provide the levels of service and infrastructure agreed with its community."

Benchmark Ratios

In conducting our review of the Councils' financial performance, forecasts and Sustainability we have measured performance against a set of benchmarks. These benchmarks are listed below. Benchmarks do not necessarily represent a pass or fail in respect of any particular area. One-off projects or events can impact a council's performance against a benchmark for a short period. Other factors such as the trends in results against the benchmarks are critical as well as the overall performance against all the benchmarks.

As councils can have significant differences in their size and population densities, it is important to note that one benchmark does not fit all. For example, the Cash Expense Ratio should be greater for smaller councils than larger councils as a protection against variation in performance and financial shocks. Therefore these benchmarks are intended as a guide to performance.

The Glossary attached to this report explains how each ratio is calculated.

Ratio	Benchmark
Operating Ratio	> (4.0%)
Cash Expense Ratio	> 3.0 months
Unrestricted Current Ratio	> 1.50x
Own Source Operating Revenue Ratio	> 60.0%
Debt Service Cover Ratio (DSCR)	> 2.00x
Interest Cover Ratio	> 4.00x
Building and Infrastructure Backlog Ratio	< 0.02x
Asset Maintenance Ratio	> 1.00x
Building and Infrastructure Asset Renewal Ratio	> 1.00x
Capital Expenditure Ratio	> 1.10x

2.3: Overview of the Local Government Area

Gloucester Shire Council	
Locality and Size	
Locality	Hunter
Area	2,952 km²
DLG Group No.	10
Demographics	
Population	4,877
% under 20	22%
% between 20 and 59	43%
% over 60	35%
Expected population in 2021	5,100
Operations	
Number of employees (FTE)	86
Annual revenue	$11.7m
Infrastructure	
Roads	774 km
Bridges	179
Infrastructure backlog value	$32.6m
Total infrastructure value	$108.0m

Gloucester Shire Council Local Government Area (LGA) is located in the North-East of the Hunter Region, approximately 262km north of Sydney or a three hour drive.

The main population centre is the town of Gloucester, with five rural villages at Stratford, Barrington, Craven, Bundook and Copeland. The demographic mix is similar to most regional centres, with a higher than state average number of older residents.

Beef and dairy farming, and other horticultural activities account for 50% of local business and 20% of local jobs.

Within Council's Infrastructure, Property, Plant and Equipment (IPP&E) at 30 June 2012 there was:

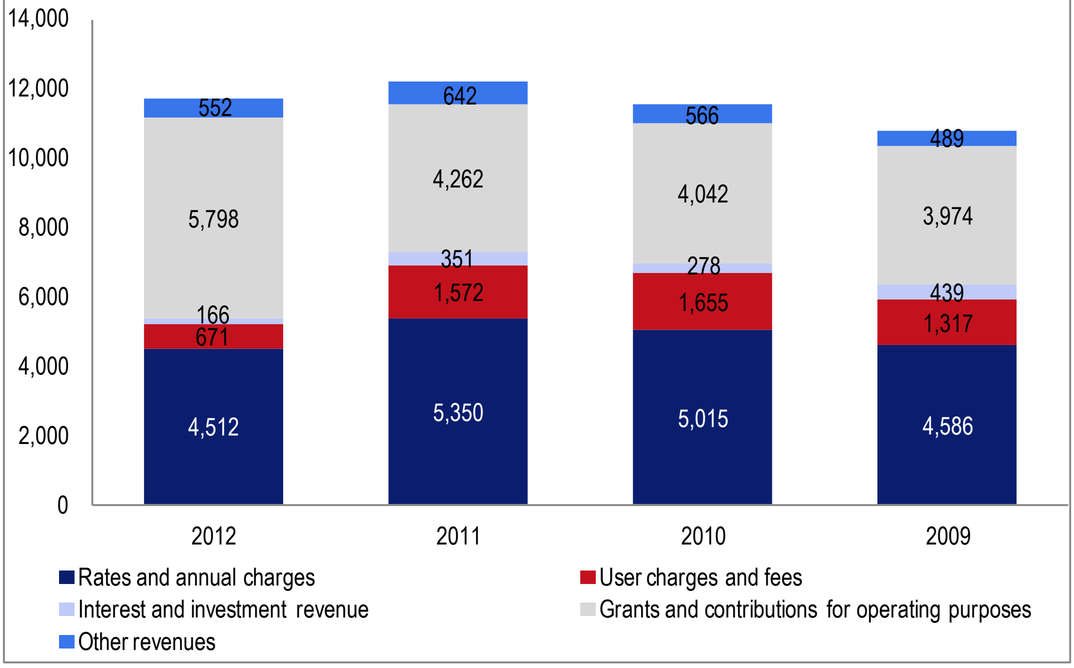
- $92.0m of roads, bridges and footpaths
- $5.9m of non specialised buildings
- $3.8m of specialised buildings
- $3.7m of other structures
- $2.7m of stormwater drainage

Section 3 Review of Financial Performance and Position

In reviewing the financial performance of the Council, TCorp has based its review on the annual audited accounts of the Council unless otherwise stated.

3.1: Revenue

Figure 1 - Revenue Sources for 2008/09 to 2011/12 ($'000s)



Key Observations

- Total operating revenues have increased by $0.9m (8.3%) over the review period to $13.2m in 2012. The relatively small increase is due to Council having to transfer their water and sewer assets to Midcoast Water on 1 July 2011 which led to reduced revenue in 2012. Council reported a book loss from discontinued operations of $23.5m in relation to this transfer however as this was a one-off transaction, it has been excluded from the figures for the purpose of our analysis. The book loss included a $2.0m net cash outflow and a loss of $20.8m in relation to the IPP&E assets.
- Rates and annual charges have decreased to their lowest total in 2012, again due to the loss of water and sewer related revenues. Of the $4.5m, farmland ordinary rates are the largest category totalling $1.7m.
- User charges and fees have also decreased to their lowest in 2012 due to the loss of the water and sewerage user fee revenues that generated $0.8m in 2011.
- Operating grants and contributions have increased over the review period and by 36.0% in 2012, due to the advance payment of half the 2013 Financial Assistance Grant and increased special purpose transport grants that together increased grant revenue by $1.1m. There was also a $0.4m contribution in relation to roads and carparks.

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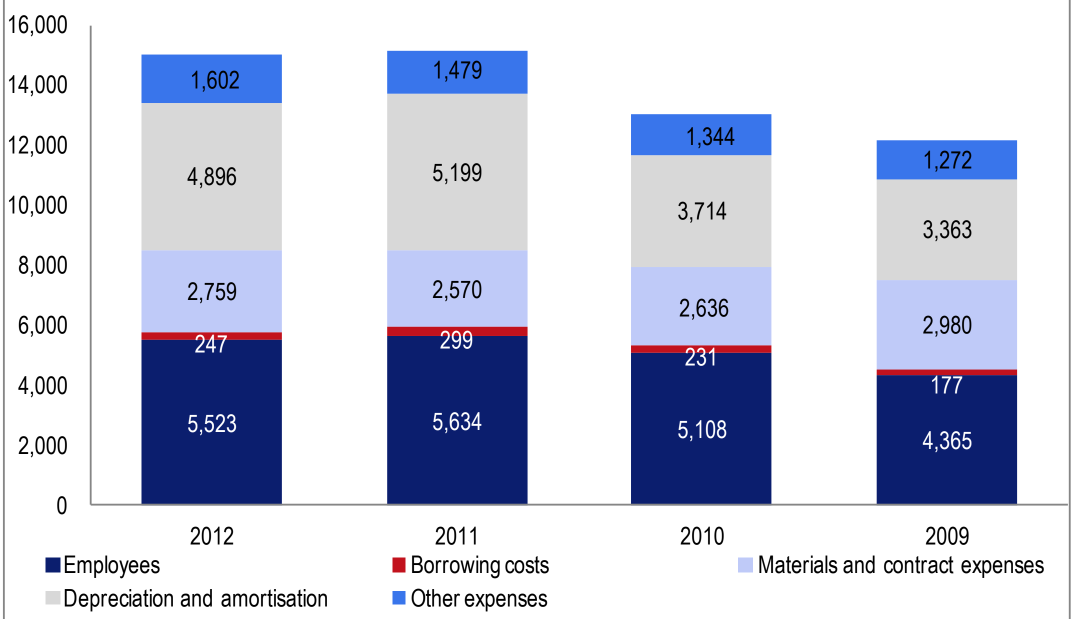
3.2: Expenses

Figure 2 - Expenses for 2008/09 to 2011/12 ($'000s)



Key Observations

- Total operating expenses have increased by $2.9m (23.6%) over the review period to $15.0m in 2012.
- Employee costs increased by over 10% p.a. in 2010 and 2011 however the transfer of the water and sewer assets has seen a 2.0% decrease in 2012. The 2011 increase was due to an increase in employee numbers, salary increments and employee leave entitlements (ELE). The 2010 increases were also due to salary increments and higher ELE. Council has a low ELE reserve equal to 12% of all leave entitlements while the average DLG Group 10 Council has in excess of 30%. Council needs to build this reserve in the coming years to meet the payouts due to older employees. FTE employee numbers reduced by 5 to 86 in 2012, the same number as in 2009 with three of these employees leaving due to the transfer of water and sewer assets.
- Materials and contract expenses have decreased over the period. In 2009 there was a $0.5m expense in relation to the upgrade of the Bucketts Way road. The increase in 2012 was in relation to raw materials and consumables as Council completed flood damage works to their road assets.
- Depreciation expense has increased by 45.6% between 2009 and 2012 despite the $0.4m decrease in 2012. The large increase of $1.5m in 2011 occurred following the Asset Revaluations that increased the annual depreciation of roads, bridges and footpaths to $3.2m from $1.6m in 2010.
- Other expenses have been on an upward trend each year with insurance, rural fire service costs and waste levies the largest expenses of $0.3m each in 2012. The waste levy increased by $0.2m in 2012.

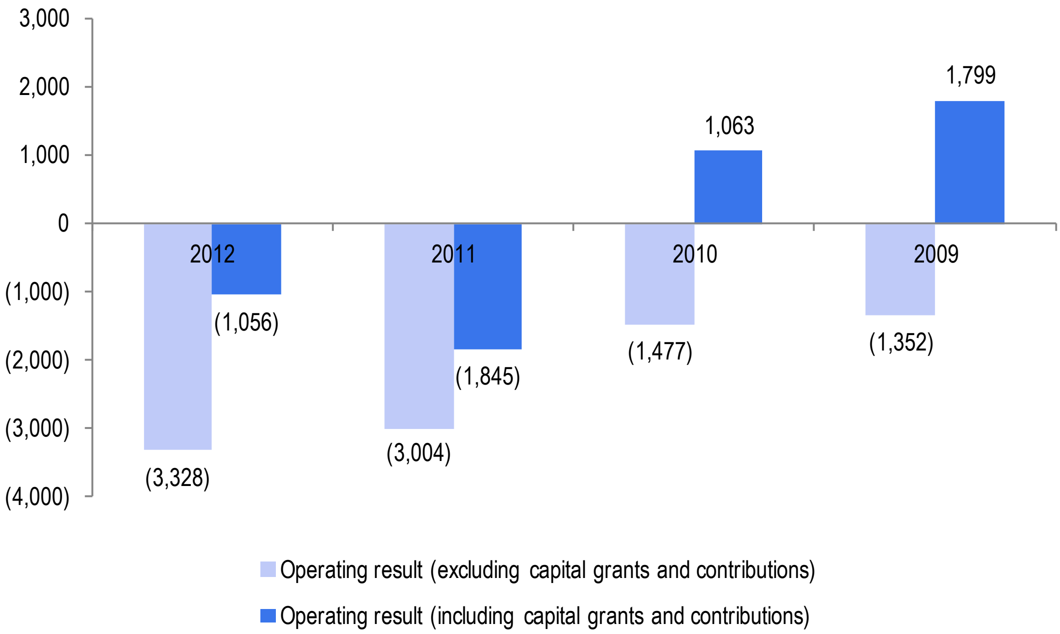
3.3: Operating Results

TCorp has made some standard adjustments to focus the analysis on core operating council results. Grants and contributions for capital purposes, realised and unrealised gains on investments and other assets are excluded, as well as one-off items which Council have no control over (e.g. impairments).

TCorp believes that the exclusion of these items will assist in normalising the measurement of key performance indicators, and the measurement of Council's performance against its peers.

All items excluded from the income statement and further historical financial information is detailed in Appendix A.

Figure 3 - Operating Results for 2008/09 to 2011/12 ($'000s)



Key Observations

- Council has posted increasing operating deficits when capital grants and contributions are excluded.
- Council expenses include a non-cash depreciation expense, ($4.9m in 2012), which has increased by $1.5m over the past four years following the Asset Revaluations process, contributing to the worsening results in 2011 and 2012. Whilst the non cash nature of depreciation can favourably impact on ratios such as EBITDA that focus on cash, depreciation is an important expense as it represents the allocation of the value of an asset over its useful life.
- The 2012 operating deficit has been further impacted by the transfer of Council's water and sewer assets to Midcoast Water that has resulted in a larger decrease in revenues compared to expenses, contributing to the largest deficit position in 2012.

3.4: Financial Management Indicators

Performance Indicators	Year ended 30 June			
	2012	2011	2010	2009
EBITDA ($'000s)	1,815	2,494	2,468	2,188
Operating Ratio	(28.4%)	(24.7%)	(12.8%)	(12.5%)
Interest Cover Ratio	7.35x	8.34x	10.68x	12.36x
Debt Service Cover Ratio (DSCR)	4.34x	5.94x	8.04x	9.90x
Unrestricted Current Ratio	1.12x	1.10x	1.30x	1.56x
Own Source Operating Revenue Ratio	37.1%	51.9%	47.3%	42.3%
Cash Expense Ratio	0.0 months	1.1 months	3.0 months	1.6 months
Net assets ($'000s)	267,920	292,528	292,747	108,022

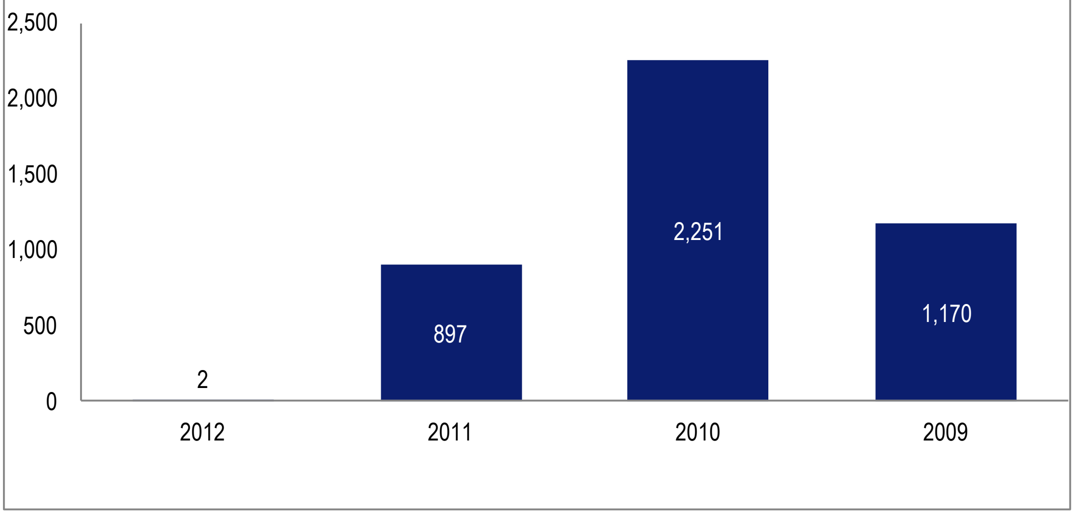
Key Observations

- Council's underlying operating performance, as measured by EBITDA, was on a slight upward trend until 2011 and has again been impacted from the water and sewer asset transfer that has reduced revenues and subsequently EBITDA in 2012.
- The Operating Ratio has been below the negative 4% benchmark in each year and is moving further away from the benchmark, indicating that Council will face Sustainability issues if they are unable to reverse this trend and achieve a break even position in the future.
- Council's DSCR and Interest Cover Ratio have both been on a downward trend although Council's credit metrics remain above the respective benchmarks. The general downward trend indicates that Council's capacity to utilise further borrowings has been reducing each year.
- Council has $3.6m of outstanding borrowings at 30 June 2012, an increase from $2.5m in 2009. This increase occurred due to the receipt of a 10 year $1.2m interest-free loan in 2010 from NSW Treasury to assist a $2.6m residential subdivision development that has created 51 allotments in 2011. The average sale price per plot is approximately $90,000 with Council selling 10 recently after a low level of demand initially.
- Council's Unrestricted Current Ratio has been below the 1.50x benchmark in the past three years but has remained above 1.00x, enabling Council to meet all short term liabilities when due. The low ratio indicates Council could face liquidity issues in the future if they were faced with any adverse financial events.
- The Own Source Operating Revenue Ratio has been below the 60% benchmark in each year and has reduced to the lowest result in 2012 due to the loss of rates and user charges associated with the Water and Sewer Funds.
- The Cash Expense Ratio has been below the 3.0 months benchmark in three of the four years and has decreased significantly in 2012 with over $2m in cash being transferred with the water and sewer operations. Council has minimal cash and cash equivalents in 2012 with the majority of funds held in current investments.
- Council's Net Assets have increased over the review period due to the Asset Revaluations. In 2010 Council revalued their infrastructure assets (including non-depreciable bulk earthworks) which added $183.7m.

- When the Asset Revaluations are excluded there has been a $3.3m increase in the IPP&E asset base over the three year period, compared to the written down value of disposed assets and depreciation.

3.5: Statement of Cashflows

Figure 4 - Cash and Cash Equivalents for 2008/09 to 2011/12 ($'000s)



Key Observations

- Council's cash and cash equivalents have decreased over the four year period and are only marginally above zero. The majority of Council's funds remained in term deposit accounts classified under current investments.
- Overall cash, cash equivalents, and investments have decreased from $5.8m in 2009 to $1.8m in 2012. Of the $1.8m, $1.4m is externally restricted, $0.3m is internally restricted and $0.1m is unrestricted.
- The investments portfolio of $1.8m consists entirely of current term deposits.
- The level of cash and investments along with the Unrestricted Current Ratio above highlight that while Council has had sufficient liquidity historically, there is little flexibility if unforeseen financial events occur.

3.6: Capital Expenditure

The following section predominantly relies on information obtained from Special Schedules 7 and 8 that accompany the annual financial statements. These figures are unaudited and are therefore Council's estimated figures.

3.6(a): Infrastructure Backlog

Figure 5 - Infrastructure Backlog for 2008/09 to 2011/12($'000s)

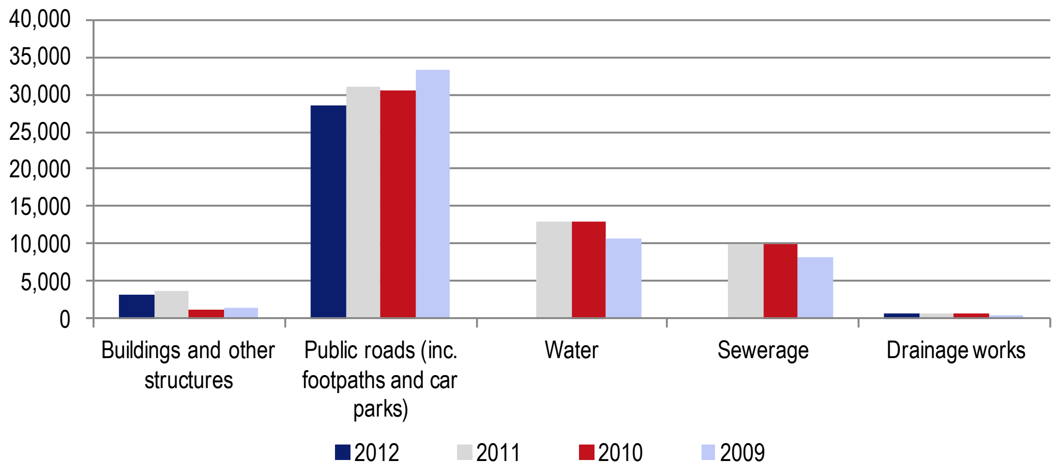
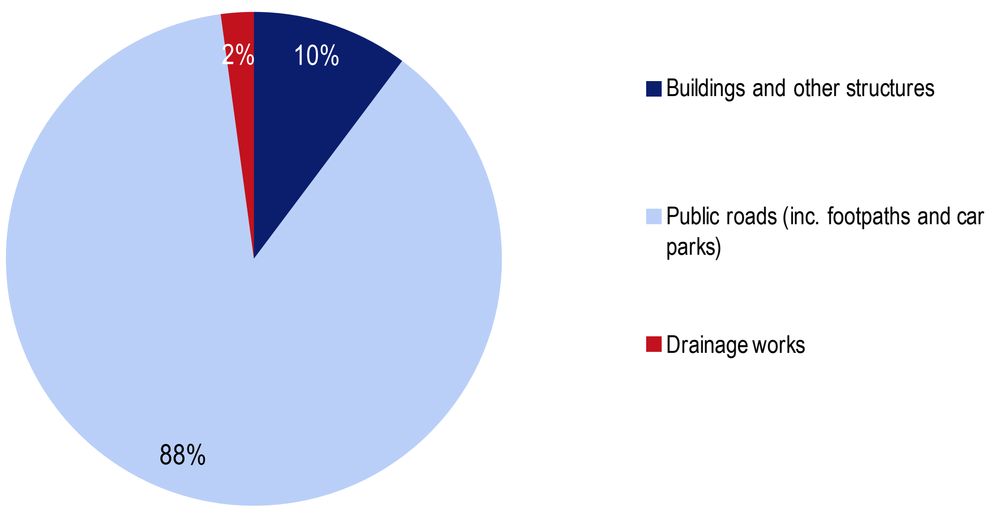


Figure 6 - Infrastructure Backlog Composition for 2011/12



Council's Infrastructure Backlog has decreased to $32.6m in 2012 from $54.3m in 2009. The decrease coincides with the transfer of water and sewer assets in 2012 that had a combined backlog total of $23.0m in 2011.

Public road assets are the dominant asset category, with a backlog of $28.6m in 2012, reduced from $33.4m in 2009.

3.6(b): Infrastructure Status

Infrastructure Status	Year ended 30 June			
	2012	2011	2010	2009
Bring to satisfactory standard ($'000s)	32,586	58,467	55,517	54,345
Required annual maintenance ($'000s)	3,341	4,279	6,066	6,136
Actual annual maintenance ($'000s)	2,387	2,915	2,743	2,623
Total value of infrastructure assets ($'000s)	107,977	128,715	128,604	93,546
Total assets ($'000s)	275,483	300,283	300,791	113,384
Building and Infrastructure Backlog Ratio	0.30x	0.45x	0.43x	0.58x
Asset Maintenance Ratio	0.71x	0.68x	0.45x	0.43x
Building and Infrastructure Renewals Ratio	0.91x	0.49x	1.00x	1.28x
Capital Expenditure Ratio	0.67x	1.01x	1.49x	1.90x

The Building and Infrastructure Backlog Ratio has reduced over the period, both due to the reducing Infrastructure Backlog total as detailed in 3.6(a) and the Asset Revaluations that increased the total value of infrastructure assets.

The Asset Maintenance Ratio has remained below the 1.00x benchmark in each year although it is on an upward trend. This indicates that Council has not invested enough to be able to maintain the operating standard of their assets.

The Building and Infrastructure Renewals Ratio has been below the 1.00x benchmark in the last two years however the 2012 figure has increased from the 2011 low. Council needs to achieve the benchmark so that they are renewing assets back to a satisfactory standard and not impacting further on the Infrastructure Backlog.

Council's Capital Expenditure Ratio, which takes into account assets which improve performance or capacity, has been on a downward trend and was below the 1.10x benchmark in 2011 and 2012. This offset the previous two years when Council was above benchmark. If the trend of the last two years continues it is likely that Council's Net Assets will deteriorate in quality over time, again impacting the Infrastructure Backlog.

3.6(c): Capital Program

The following figures are sourced from the Council's Annual Financial Statements at Special Schedule No. 8 and are not audited. New capital works are major non-recurrent projects.

Capital Program ($'000s)	Year ended 30 June			
	2012	**2011**	**2010**	**2009**
New capital works	1,218	3,580	3,443	4,213
Replacement/refurbishment of existing assets	0	0	0	0
Total	**1,218**	**3,580**	**3,443**	**4,213**

- Council's major capital works program during 2011 and 2012 included: $1.6m spent on regional road upgrades
- $1.3m spent on road sealing extensions
- $1.2m spent on plant and equipment
- $0.8m spent on bridge replacements
- $0.7m spent on unsealed road upgrades
- $0.7m spent on new urban roads

3.7: Specific Risks to Council

- Mining expansion. Council has stated that increased interest in the extraction of coal seam gas is currently occurring. This provides both an opportunity and risk as while Council may be able to increase their rates revenues, the offset is that infrastructure will have to manage the increased heavy vehicles utilising the road network while any environmental impact also needs to be considered and monitored.
- Reliance on grants and contributions from State and Federal Government. Council have to rely heavily on these external sources of funding due to their low rate base and population numbers, and large geographical area. Any reduction in the level of assistance would have substantial impacts on Council's operations.
- Ageing workforce. Approximately 67% of Council's employees are 45 or over and the 25 to 35 age group are underrepresented, creating challenges in relation to succession planning. There is also gender imbalance within the workforce with only 28% female employees and none represented at executive management level. Council recognises that an organisation wide training program and an established learning and development strategy do not currently exist, although guidelines have been prepared for management to facilitate training requests.

Section 4 Review of Financial Forecasts

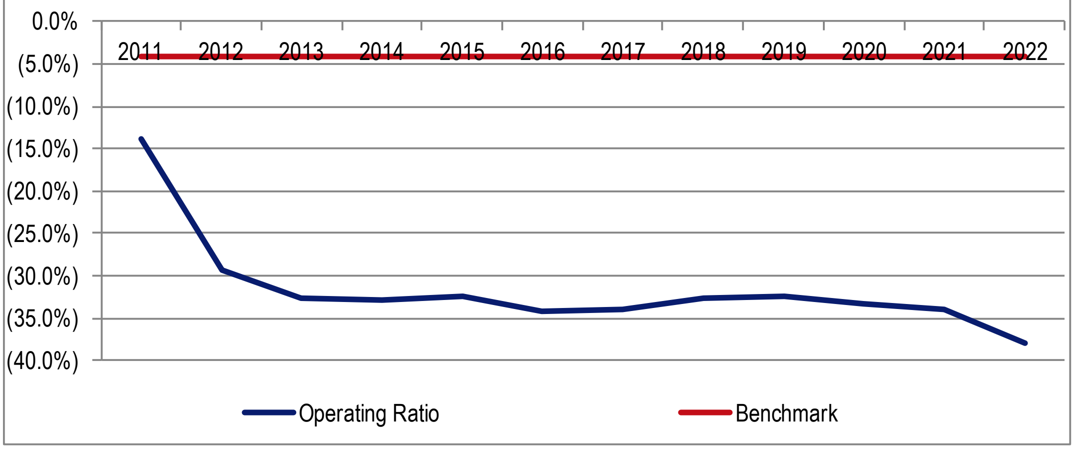
The financial forecast model shows the projected financial statements and assumptions for the next 10 years for Council's General Fund.

Council's LTFP forecast has a 'Status Quo' base case scenario that forecasts the position if current operating conditions were to continue. Three further scenarios with varying proposed SRVs have been completed that indicate how the operating position will be improved if the SRVs were approved and implemented in 2015. The three SRVs model the annual rate increase at 18.5%, 14.0% and 9.9% (all inclusive of the rate peg), for seven consecutive years from 2015 to 2021.

As these SRVs are only possibilities at this stage, our analysis has focussed on the Status Quo scenario.

4.1: Operating Results

Figure 7- Operating Ratio for General Fund

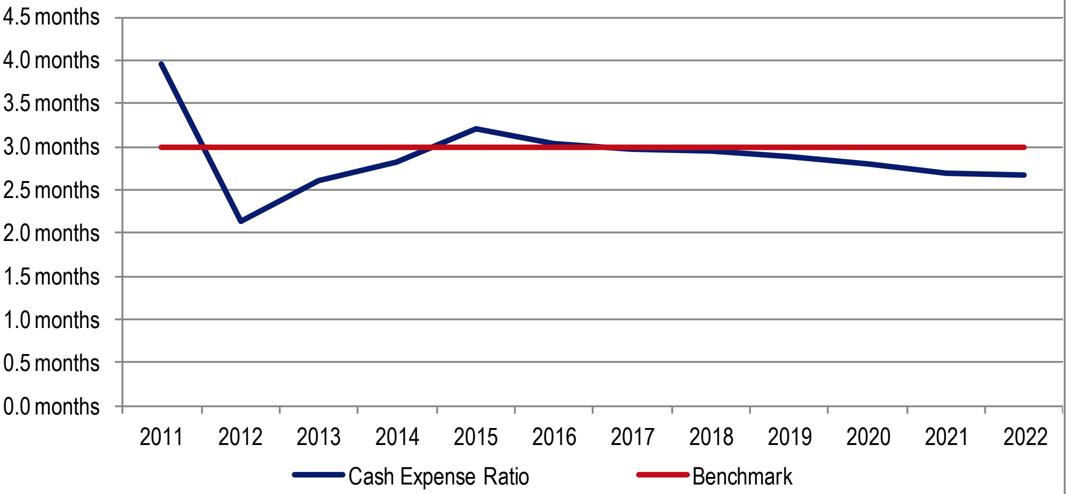


The Operating Ratio is projected to continue to deteriorate with Council's revenue base not able to meet all existing and forecast expenses. The deficits will continue to grow and forecast to be at $5.0m in 2022, equating to an Operating Ratio deficit of negative 38.0%.

4.2: Financial Management Indicators

Liquidity Ratios

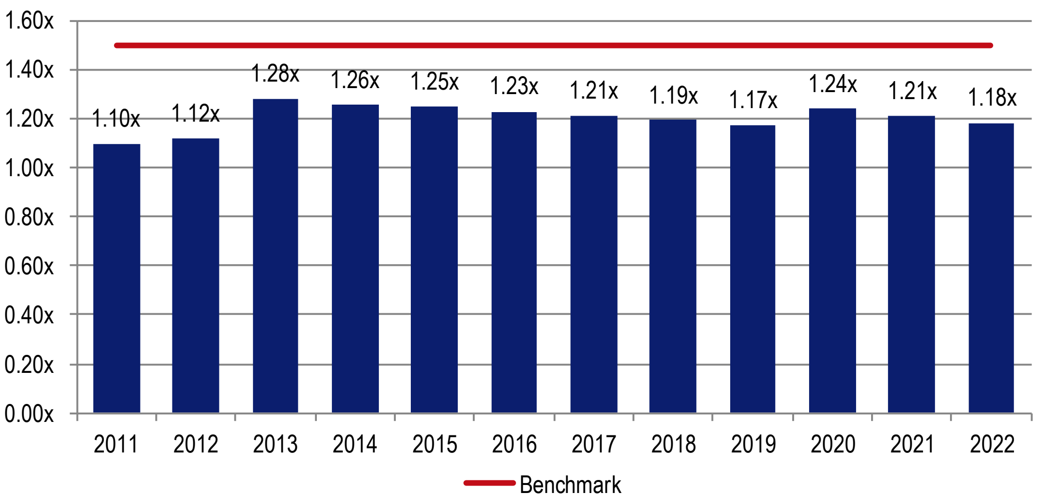
Figure 8 - Cash Expense Ratio for General Fund inc. current investments



Council's Cash Expense Ratio is zero in each year because Council invests most of its funds in deposits. Current investments have been included in the Cash Expense Ratio calculation to indicate a more realistic liquidity position. Council has forecast the combined total to remain static at $2.5m from 2015 onwards, an increase from $1.8m in 2012.

The ratio with current investments remains close to the benchmark in each year although is on a marginal downward trend from 2015 as Council's Operating Ratio declines each year.

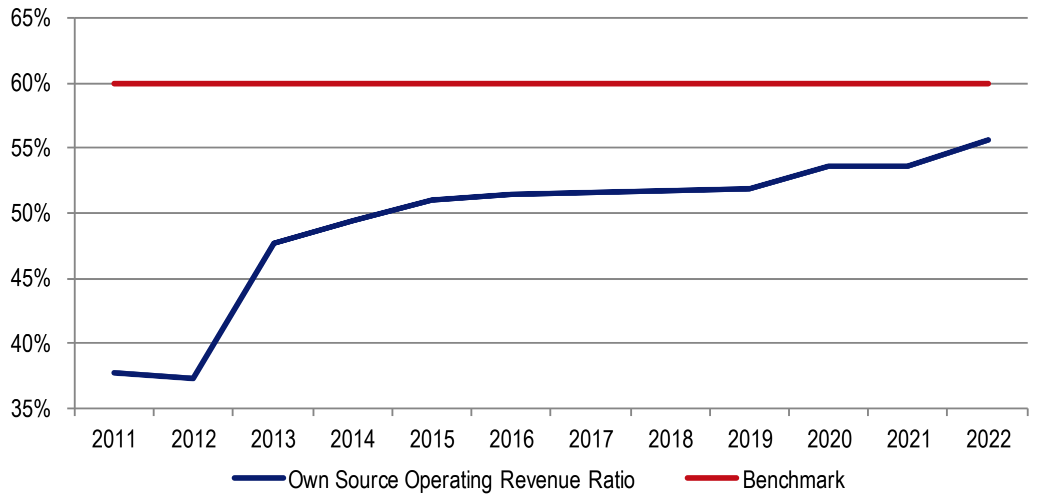
Figure 9 - Unrestricted Current Ratio for General Fund



The projected Unrestricted Current Ratio is forecast to remain below the benchmark through the forecast period indicating Council will have to continue to prudently manage their cash and that any substantive adverse financial events may lead to Council experiencing liquidity issues.

Fiscal Flexibility Ratios

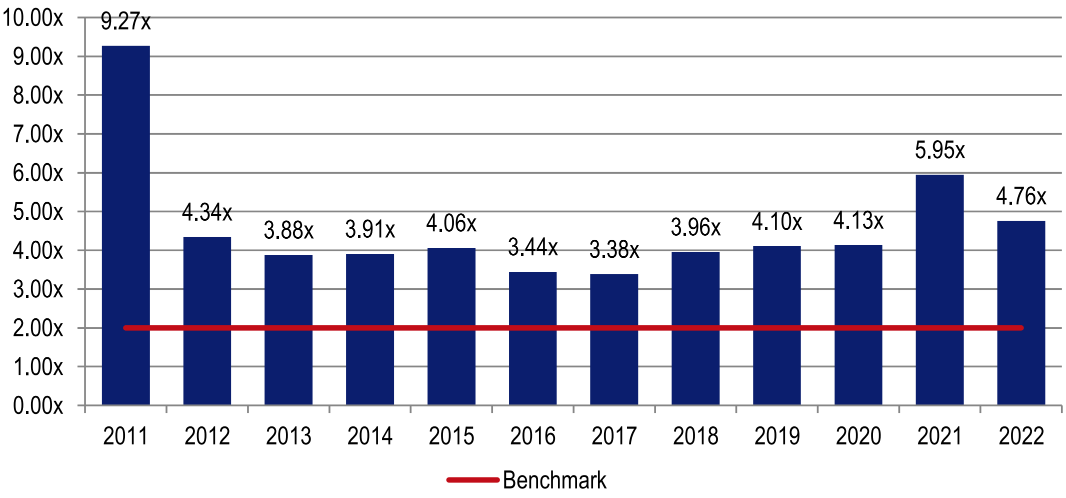
Figure 10 - Own Source Operating Revenue Ratio for General Fund



Council's Own Source Operating Revenue Ratio is projected to increase from the historical results but not sufficiently to reach the benchmark, highlighting Council's ongoing reliance on grants and contributions from State and Federal Government.

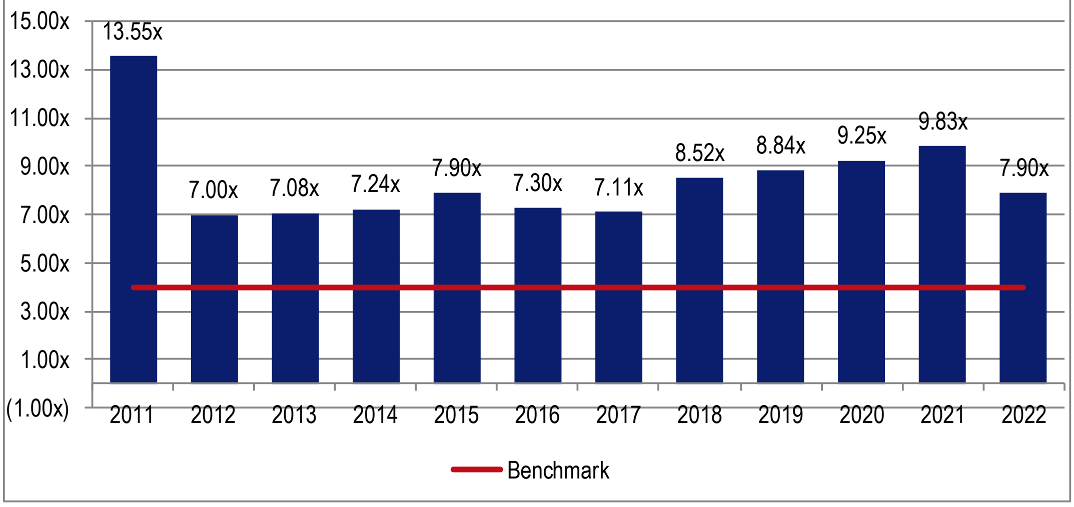
The increase is forecast to occur due to reduced operating and capital grants and contributions during the forecast period. The reduction in the operating grants and contributions is partly due to the timing of the Financial Assistance Grants regularising over the period.

Figure 11 - DSCR for General Fund



The DSCR is projected to remain above the benchmark in each year of the forecast period. Council has projected that they will utilise additional borrowings of $1.8m across the forecast period against total repayments of $2.2m. The majority of the borrowings are to be utilised for bridge renewal works.

Figure 12 - Interest Cover Ratio for General Fund

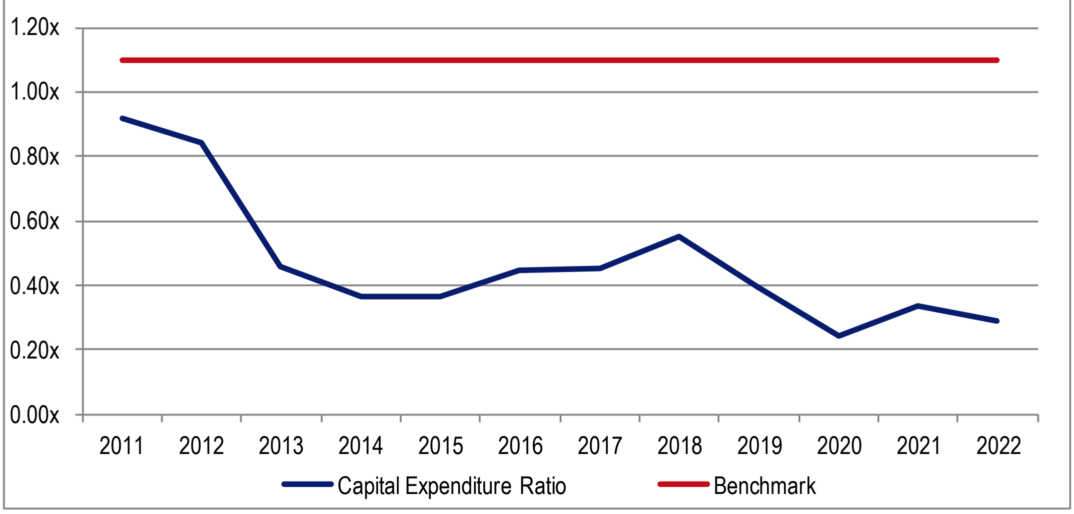


The Interest Cover Ratio is also forecast to remain above the benchmark for the full forecast period.

This indicates that Council will be in a position to service their outstanding borrowings.

4.3: Capital Expenditure

Figure 13 - Capital Expenditure Ratio for General Fund



The Capital Expenditure Ratio is projected to deteriorate further below the benchmark over the forecast period to a low of 0.24x in 2020.

The cumulative capital expenditure on IPP&E is $21.8m over the forecast period against the cumulative depreciation of $56.6m, indicating a decreasing Net Asset position, and it being likely that the quality of Council's assets will be impacted along with an increasing Infrastructure Backlog.

4.4: Financial Model Assumption Review

Councils have used their own assumptions in developing their forecasts.

In order to evaluate the validity of the Council's forecast model, TCorp has compared the model assumptions versus TCorp's benchmarks for annual increases in the various revenue and expenditure items. Any material differences from these benchmarks should be explained through the LTFP.

TCorp's benchmarks:

- Rates and annual charges: TCorp notes that the LGCI increased by 3.4% in the year to September 2011, and in December 2011, IPART announced that the rate peg to apply in the 2012/13 financial year will be 3.6%. Beyond 2013 TCorp has assessed a general benchmark for rates and annual charges to increase by mid-range LGCI annual increases of 3.0%
- Interest and investment revenue: annual return of 5.0%
- All other revenue items: the estimated annual CPI increase of 2.5%
- Employee costs: 3.5% (estimated CPI+1.0%)
- All other expenses: the estimated annual CPI increase of 2.5%

<u>Key Observations and Risks</u>

- Current service levels are maintained throughout the forecast period in all scenarios within the LTFP.
- The LTFP clearly highlights the current financial position of Council and the possible options that Council can explore in order to improve their position.
- The LTFP states Council is aware that they are financially unsustainable over the long term if the Status Quo scenario is experienced, with the operating deficits compounding the Infrastructure Backlog.
- Within the LTFP, a summary of strategic actions has been compiled that are options to assist improving Council's operating position as they aim to be Sustainable over the long term.
- The three SRV scenarios incorporate a significant level of rate increases with the 18.5% and 14.0% scenarios more than doubling the projected annual rates revenue received during the 10 year forecast period.
- Rates and annual charges are forecast to increase by 9.3% in 2013 and then between 3.4% p.a. and 4.5%p.a. for the remaining years. The 9.3% increase occurs because the 2012 figure is net of pensioner rebates whereas the forecast figure includes this total.
- Employee expenses are forecast to vary between a 2.5% decrease in 2015 to a 5.4% increase in 2016. This is in comparison to larger historic increases of a minimum 7.6% p.a. during the review period. With Council needing to increase the ELE provision during the coming years TCorp is of the opinion that the forecast for employee expenses is optimistic.
- Noting the points above, Council's underlying assumptions are deemed reasonable with the majority of revenue and expense categories forecast to increase each year between 1.0% and 3.0% with a CPI of 2.5% utilised, apart for construction costs that are forecast at 5.0% p.a. in line with the current Construction Price Index.

4.5: Borrowing Capacity

In our view, if Council is successful with one of the possible SRV applications then they may have the capacity to undertake additional borrowings in excess of those included in the current LTFP. Until the details of any approved SRV's are available it is not considered prudent to recommend any additional borrowings.

4.6: Sustainability

TCorp believes Council is in an Unsustainable financial position if current operating conditions continue. Council has reported an operating deficit in each of the past four years when capital grants and contributions are excluded and has forecast a deteriorating position each year of the forecast period.

Council's LTFP indicates their awareness of the current position and that they are considering all possibilities to raise additional revenues and/or reduce expenses to enable the continuation of the current levels of service to the community. The process of applying for a SRV is one of the options that will assist Council to try to reverse the declining operating results.

While the transfer of Council's water and sewer assets to Midcoast Water negatively impacted some ratios in 2012, Council has stated that they believe that over the long term, the transfer will not have a negative impact on Council's operating performance within the General Fund.

In considering the longer term financial Sustainability of the Council we make the following comments:

- Council's 'Status Quo' scenario highlights operating deficits will continue and are likely to increase, making it impossible for Council to maintain the current service levels and their asset maintenance and renewals funding at an acceptable level
- Council's forecast capital expenditure remains below the required levels and is forecast to decrease to well below the level required to maintain the quality of Council's asset base
- Council has limited financial reserves and does not have sufficient resources to withstand any significant unforeseen financial events
- If a SRV application is approved, it may not be likely to generate sufficient additional revenues to improve Council's operating results to a Sustainable position and further options to raise revenues and/or reduce expenses will be utilised as detailed within the LTFP
- It is important that Council is able to control their employee expenses because if these increase at the levels experienced in 2010 and 2011 it will impact Council as they try to reach a Sustainable operating position

Section 5 Benchmarking and Comparisons with Other Councils

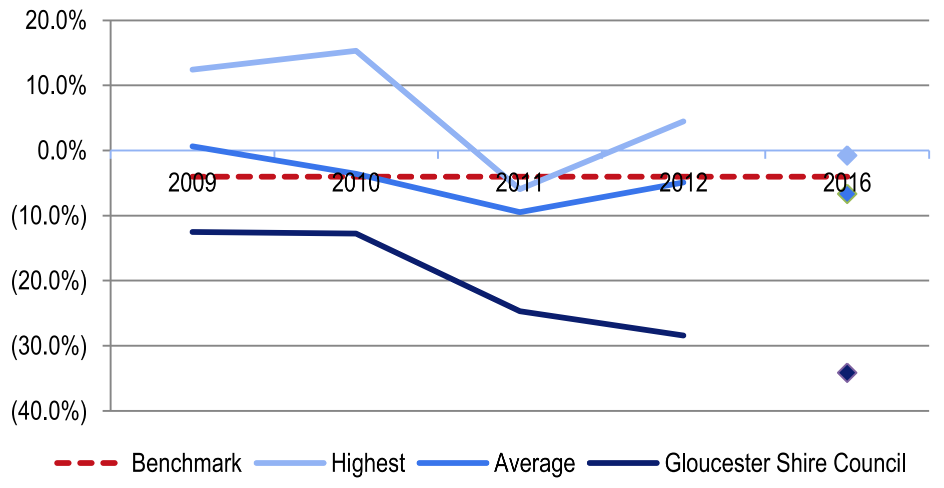
Each council's performance has been assessed against ten key benchmark ratios. The benchmarking assessment has been conducted on a consolidated basis for councils operating more than one fund. This section of the report compares the Council's performance with its peers in the same DLG Group. The Council is in DLG Group 10. There are 25 councils in this group and at the time of preparing this report, we have data for all of these councils.

In Figure 14 to Figure 20, the graphs compare the historical performance of Council with the benchmark for that ratio, with the average for the Group, with the highest performance (or lowest performance in the case of the Infrastructure Backlog Ratio where a low ratio is an indicator of strong performance), and with the forecast position of the Council as at 2016 (as per Council's LTFP). Figures 21 to 23 do not include the 2016 forecast position as those numbers are not available.

Where no highest line is shown on the graph, this means that Council is the best performer in its group for that ratio. For the Interest Cover Ratio and Debt Service Cover Ratio, we have excluded from the calculations, councils with very high ratios which are a result of low debt levels that skew the ratios.

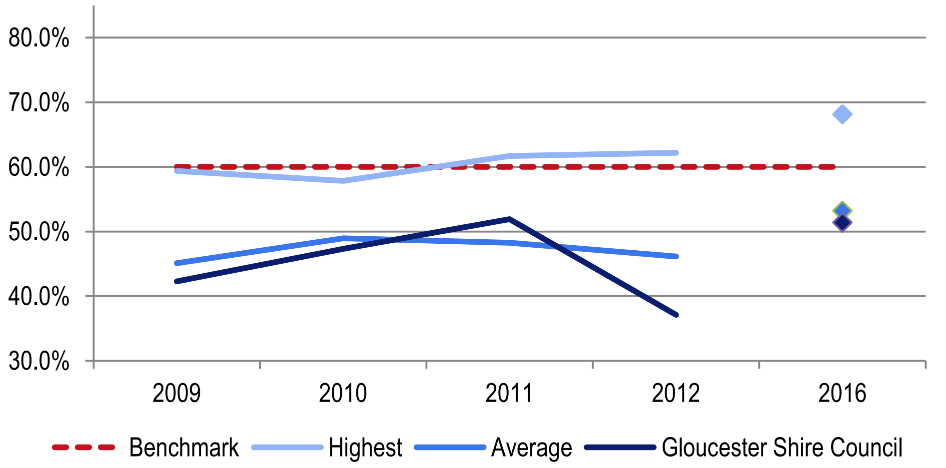
Financial Flexibility

Figure 14 - Operating Ratio Comparison



Council's Operating Ratio has been below the group average and benchmark in each year and is forecast to decline further below from both indicators

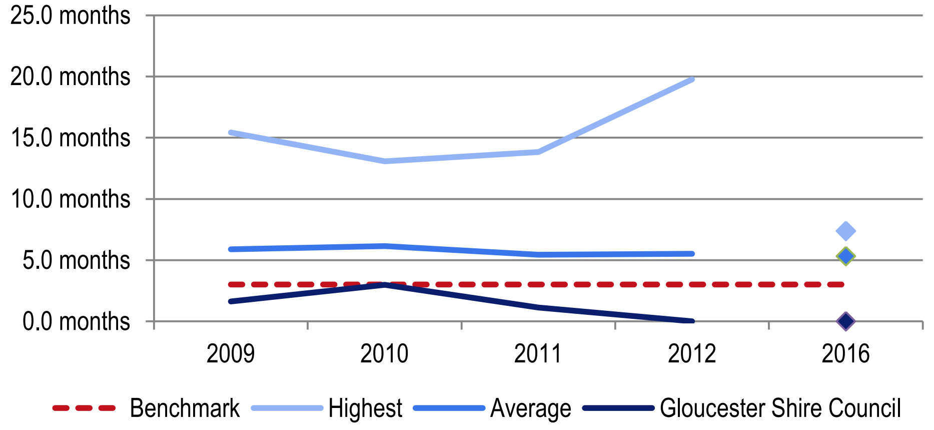
Figure 15- Own Source Operating Revenue Ratio Comparison



Council's Own Source Operating Revenue Ratio has been below the group average in three of the four years while both have been below the benchmark in each year. Council's ratio is forecast to remain below the group average and benchmark despite a projected improvement in this ratio in 2016.

Liquidity

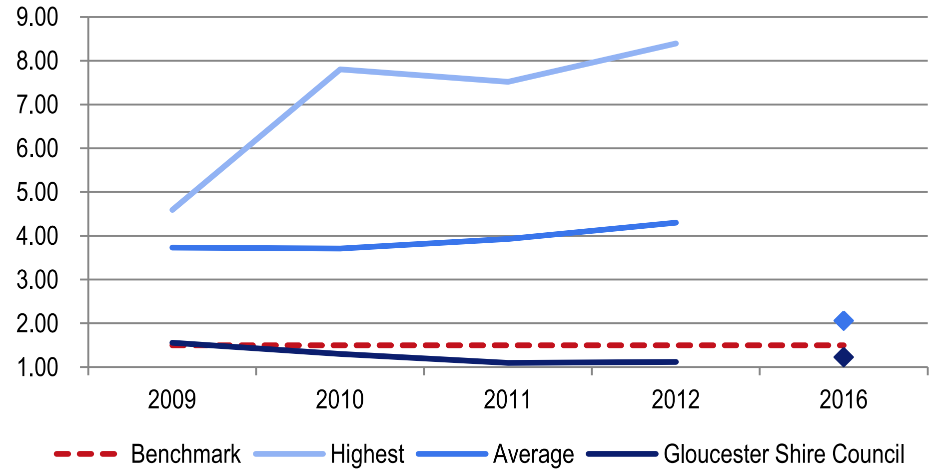
Figure 16 - Cash Expense Ratio Comparison



Council's Cash Expense Ratio has been below the group average in each year and below the benchmark in three of the four years.

Council has relatively low cash and investments but invested nearly all their funds within term deposits to maximise return. These are classified as investments and not included within this ratio.

Figure 17 - Unrestricted Current Ratio Comparison



Council's Unrestricted Current Ratio is below the group average in each year and the benchmark since 2010, and is projected to remain below both indicators in 2016.

Both liquidity ratios highlight that Council do not have as much funds as other councils to manage any unforeseen adverse financial events.

New South Wales
Treasury Corporation

Debt Servicing

Figure 18- Debt Service Cover Ratio Comparison

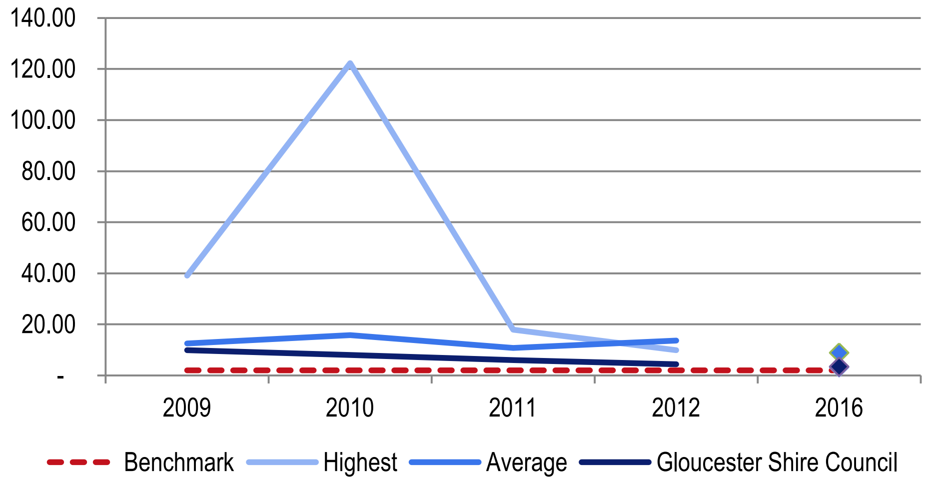
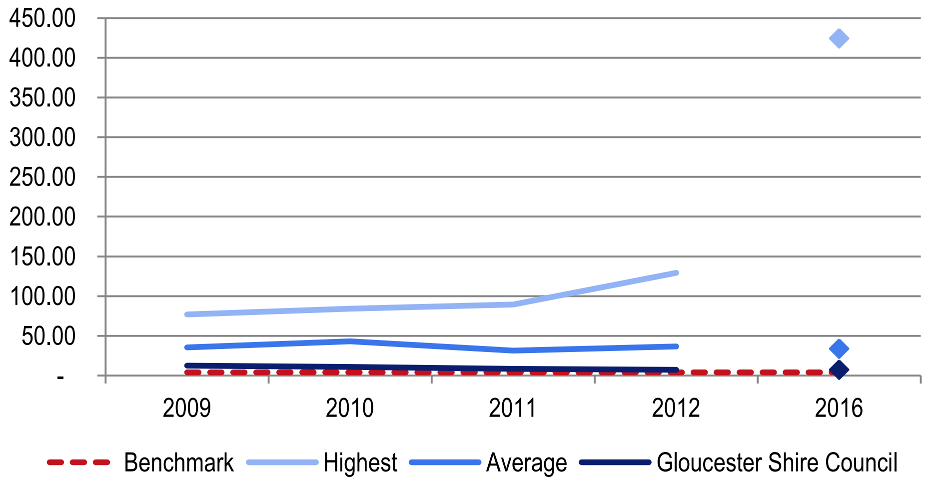
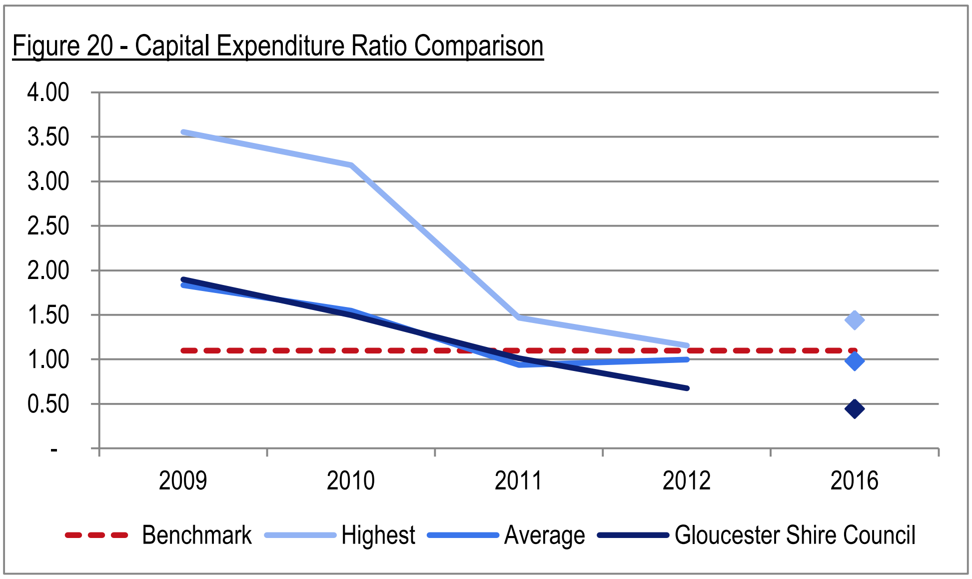


Figure 19 - Interest Cover Ratio Comparison



Council's DSCR and Interest Cover Ratio are below the group average in each year but remain above the respective benchmarks. Council's forecast position is projected to remain similar to its 2012 figures indicating Council has less capacity than its peers to utilise further borrowings.

Asset Renewal and Capital Works



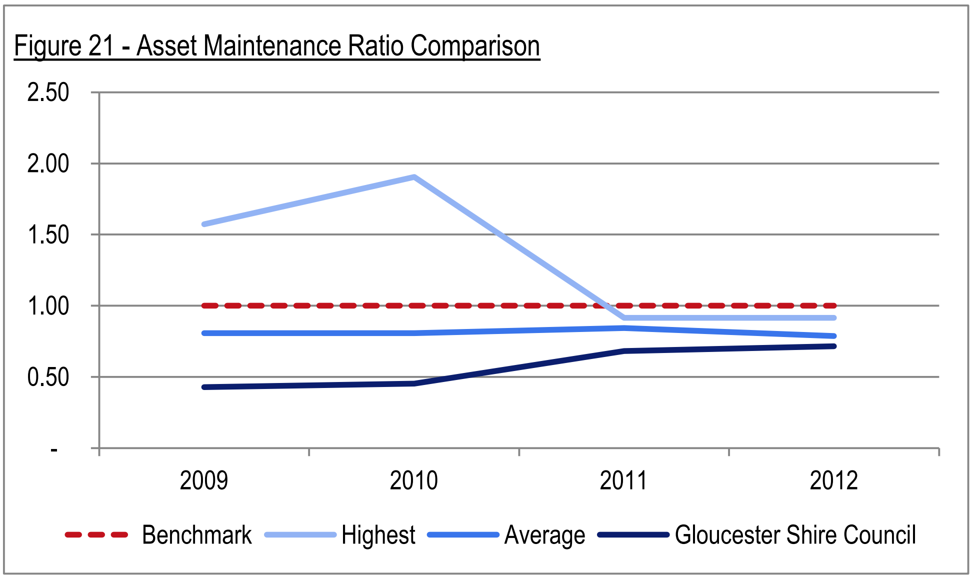


Figure 22 - Infrastructure Backlog Ratio Comparison

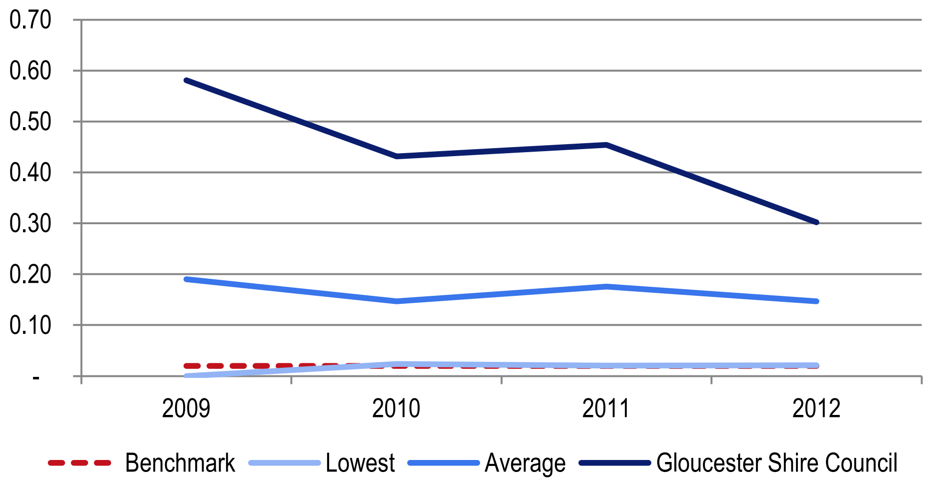
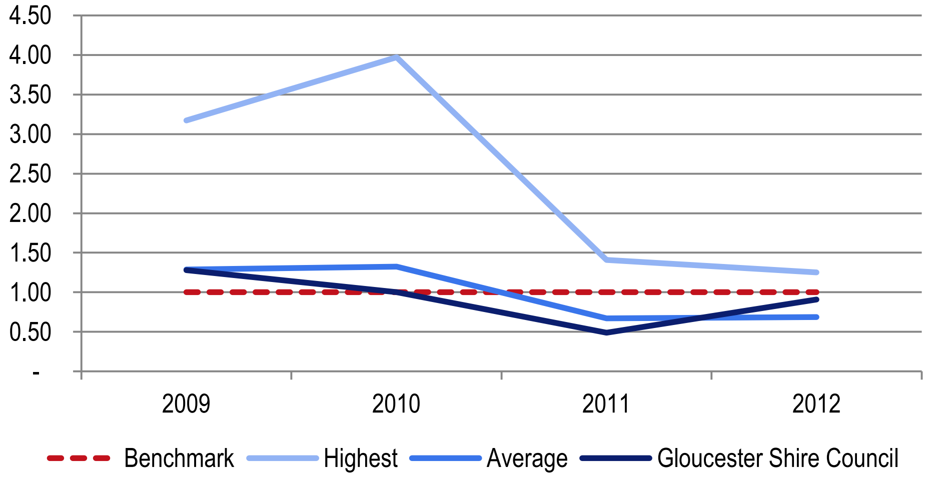


Figure 23 - Building and Infrastructure Asset Renewal Ratio



Council's Capital Expenditure Ratio has been on a downward trend, similar to the group average although the group average steadied in 2012 whereas Council's ratio continued to decrease. Council's forecast continues on the same trend and decreases further below the benchmark and group average in the medium term.

Council's Asset Maintenance Ratio has improved over the period but remains below both the group average and the benchmark.

Council's Infrastructure Backlog has decreased but remains higher than the group average and benchmark. This indicates Council has comparatively a larger Backlog value than their peers.

Council's Building and Infrastructure Asset Renewal Ratio has decreased below the benchmark in 2011 however it rebounded above the group average in 2012. The group average being below the benchmark indicates the limited capacity of councils within this group to adequately spend on asset renewals.

Section 6 Conclusion and Recommendations

Based on our review of both the historic financial information and the 10 year financial forecast within Council's LTFP we consider Council to be unsustainable. This opinion is derived from analysis of Council's 'Status Quo' scenario with current service levels to remain against the current revenue base.

We base our recommendation on the following key points:

- Council has posted increasing operating deficits over the four year review period and these are projected to worsen over the 10 year forecast period
- Council has been unable to meet the respective benchmarks for all asset related ratios in the past two years and the forecast Capital Expenditure Ratio is projected to continue to decrease further from the benchmark over the forecast period, resulting in a growing Infrastructure Backlog

However we would also recommend that the following points be considered:

- Council's management is aware of the financial position that Council is facing and is proactively exploring all the possibilities to increase revenues and cut expenses to assist the ongoing financial position
- If Council is successful in applying for a SRV then their operating performance will improve. Due to the small population within the LGA even with the approval of a SRV it will be difficult for Council to achieve an operating result that would provide a Sustainable position with a SRV alone. Other options to raise revenues and/or reduce expenses will need to be explored and implemented

New South Wales Treasury Corporation

Appendix A Historical Financial Information Tables

Table 1- Income Statement

Income Statement ($'000s)	Year ended 30 June				% annual change		
	2012	2011	2010	2009	2012	2011	2010
Revenue							
Rates and annual charges	4,512	5,350	5,015	4,586	(15.7%)	6.7%	9.4%
User charges and fees	671	1,572	1,655	1,317	(57.3%)	(5.0%)	25.7%
Interest and investment revenue	166	351	278	439	(52.7%)	26.3%	(36.7%)
Grants and contributions for operating purposes	5,798	4,262	4,042	3,974	36.0%	5.4%	1.7%
Other revenues	552	642	566	489	(14.0%)	13.4%	15.7%
Total revenue	**11,699**	**12,177**	**11,556**	**10,805**	**(3.9%)**	**5.4%**	**7.0%**
Expenses							
Employees	5,523	5,634	5,108	4,365	(2.0%)	10.3%	17.0%
Borrowing costs	247	299	231	177	(17.4%)	29.4%	30.5%
Materials and contract expenses	2,759	2,570	2,636	2,980	7.4%	(2.5%)	(11.5%)
Depreciation and amortisation	4,896	5,199	3,714	3,363	(5.8%)	40.0%	10.4%
Other expenses	1,602	1,479	1,344	1,272	8.3%	10.0%	5.7%
Total expenses	**15,027**	**15,181**	**13,033**	**12,157**	**(1.0%)**	**16.5%**	**7.2%**
Operating result	**(3,328)**	**(3,004)**	**(1,477)**	**(1,352)**	**(10.8%)**	**(103.4%)**	**(9.2%)**

Table 2 - Items excluded from Income Statement

Excluded items ($'000s)				
	2012	2011	2010	2009
Grants and contributions for capital purposes	2,272	1,159	2,540	3,151
Operating loss from discontinued operations	(23,544)	0	0	0
Interest free loan from State Government	0	551	0	0
Amortisation of discounts/premiums of interest free loan	(85)	(89)	0	0
Net gain from the disposal of assets	77	147	(26)	48

Table 3 - Balance Sheet

Balance Sheet ($'000s)	Year Ended 30 June				% annual change		
	2012	2011	2010	2009	2012	2011	2010
Current assets							
Cash and equivalents	2	897	2,251	1,170	(99.8%)	(60.2%)	92.4%
Investments	1,750	4,495	3,600	1,512	(61.1%)	24.9%	138.1%
Receivables	2,211	1,665	2,099	1,209	32.8%	(20.7%)	73.6%
Inventories	1,384	1,397	1,618	1,046	(0.9%)	(13.7%)	54.7%
Total current assets	5,347	8,454	9,568	4,937	(36.8%)	(11.6%)	93.8%
Non-current assets							
Investments	0	0	486	3,094	N/A	(100.0%)	(84.3%)
Receivables	0	0	0	61	N/A	N/A	(100.0%)
Infrastructure, property, plant & equipment	270,136	291,829	290,737	105,292	(7.4%)	0.4%	176.1%
Total non-current assets	270,136	291,829	291,223	108,447	(7.4%)	0.2%	168.5%
Total assets	**275,483**	**300,283**	**300,791**	**113,384**	**(8.3%)**	**(0.2%)**	**165.3%**
Current liabilities							
Payables	2,159	1,250	1,366	1,128	72.7%	(8.5%)	21.1%
Borrowings	261	243	471	99	7.4%	(48.4%)	375.8%
Provisions	1,166	1,587	1,277	1,238	(26.5%)	24.3%	3.2%
Total current liabilities	3,586	3,080	3,114	2,465	16.4%	(1.1%)	26.3%
Non-current liabilities							
Borrowings	3,371	4,102	4,390	2,387	(17.8%)	(6.6%)	83.9%
Provisions	606	573	540	510	5.8%	6.1%	5.9%
Total non-current liabilities	3,977	4,675	4,930	2,897	(14.9%)	(5.2%)	70.2%
Total liabilities	**7,563**	**7,755**	**8,044**	**5,362**	**(2.5%)**	**(3.6%)**	**50.0%**
Net assets	**267,920**	**292,528**	**292,747**	**108,022**	**(8.4%)**	**(0.1%)**	**171.0%**

Table 4-Cashflow

Cashflow Statement ($'000s)	Year ended 30 June			
	2012	2011	2010	2009
Cashflows from operating activities	3,018	3,969	3,286	2,490
Cashflows from investing activities	(3,201)	(5,269)	(4,580)	(3,035)
Proceeds from borrowings and advances	0	0	2,482	1,325
Repayment of borrowings and advances	(731)	(121)	(76)	(44)
Cashflows from financing activities	(731)	(121)	2,406	1,281
Net increase/(decrease) in cash and equivalents	**(914)**	**(1,421)**	**1,112**	**736**
Cash and equivalents	2	897	2,251	1,170

Appendix B Glossary

Asset Revaluations

In assessing the financial sustainability of NSW councils, IPART found that not all councils reported assets at fair value.[1] In a circular to all councils in March 2009[2], DLG required all NSW councils to revalue their infrastructure assets to recognise the fair value of these assets by the end of the 2009/10 financial year.

Collateralised Debt Obligation (CDO)

CDOs are structured financial securities that banks use to repackage individual loans into a product that can be sold to investors on the secondary market.

In 2007 concerns were heightened in relation to the decline in the "sub-prime" mortgage market in the USA and possible exposure of some NSW councils, holding CDOs and other structured investment products, to losses.

In order to clarify the exposure of NSW councils to any losses, a review was conducted by the DLG with representatives from the Department of Premier and Cabinet and NSW Treasury.

A revised Ministerial investment Order was released by the DLG on 18 August 2008 in response to the review, suspending investments in CDOs, with transitional provisions to provide for existing investments.

Division of Local Government (DLG)

DLG is a division of the NSW Department of Premier and Cabinet and is responsible for local government across NSW. DLG's organisational purpose is "to strengthen the local government sector" and its organisational outcome is "successful councils engaging and supporting their communities". Operating within several strategic objectives DLG has a policy, legislative, investigative and program focus in matters ranging from local government finance, infrastructure, governance, performance, collaboration and community engagement. DLG strives to work collaboratively with the local government sector and is the key adviser to the NSW Government on local government matters.

Depreciation of Infrastructure Assets

Linked to the asset revaluations process stated above, IPART's analysis of case study councils found that this revaluation process resulted in sharp increases in the value of some council's assets. In some cases this has led to significantly higher depreciation charges, and will contribute to higher reported operating deficits.

[1] IPART "Revenue Framework for Local Government" December 2009 p.83

[2] DLG "Recognition of certain assets at fair value" March 2009

EBITDA

EBITDA is an acronym for “earnings before interest, taxes, depreciation, and amortisation”. It is often used to measure the cash earnings that can be used to pay interest and repay principal.

Grants and Contributions for Capital Purposes

Councils receive various capital grants and contributions that are nearly always 100% specific in nature. Due to the fact that they are specifically allocated in respect of capital expenditure they are excluded from the operational result for a council in TCorp’s analysis of a council’s financial position.

Grants and Contributions for Operating Purposes

General purpose grants are distributed through the NSW Local Government Grants Commission. When distributing the general component each council receives a minimum amount, which would be the amount if 30% of all funds were allocated on a per capita basis. When distributing the other 70%, the Grants Commission attempts to assess the extent of relative disadvantage between councils. The approach taken considers cost disadvantage in the provision of services on the one hand and an assessment of revenue raising capacity on the other.

Councils also receive specific operating grants for one-off specific projects that are distributed to be spent directly on the project that the funding was allocated to.

Independent Commission Against Corruption (ICAC)

ICAC was established by the NSW Government in 1989 in response to growing community concern about the integrity of public administration in NSW.

The jurisdiction of the ICAC extends to all NSW public sector agencies (except the NSW Police Force) and employees, including government departments, local councils, members of Parliament, ministers, the judiciary and the governor. The ICAC's jurisdiction also extends to those performing public official functions.

Independent Pricing and Regulatory Tribunal (IPART)

IPART has four main functions relating to the 152 local councils in NSW. Each year, IPART determines the rate peg, or the allowable annual increase in general income for councils. They also review and determine council applications for increases in general income above the rate peg, known as “Special Rate Variations”. They approve increases in council minimum rates. They also review council development contributions plans that propose contribution levels that exceed caps set by the Government.

Infrastructure Backlog

Infrastructure backlog is defined as the estimated cost to bring infrastructure, building, other structures and depreciable land improvements to a satisfactory standard, measured at a particular point in time. It is unaudited and stated within Special Schedule 7 that accompanies the council’s audited annual financial statements.

Integrated Planning and Reporting (IP&R) Framework

As part of the NSW Government's commitment to a strong and sustainable local government system, the *Local Government Amendment (Planning and Reporting) Act 2009* was assented on 1 October 2009. From this legislative reform the IP&R framework was devised to replace the former Management Plan and Social Plan with an integrated framework. It also includes a new requirement to prepare a long-term Community Strategic Plan and Resourcing Strategy. The other essential elements of the new framework are a Long-Term Financial Plan (LTFP), Operational Plan and Delivery Program and an Asset Management Plan.

Local Government Cost Index (LGCI)

The LGCI is a measure of movements in the unit costs incurred by NSW councils for ordinary council activities funded from general rate revenue. The LGCI is designed to measure how much the price of a fixed "basket" of inputs acquired by councils in a given period compares with the price of the same set of inputs in the base period. The LGCI is measured by IPART.

Net Assets

Net Assets is measured as total assets less total liabilities. The Asset Revaluations over the past years have resulted in a high level of volatility in many councils' Net Assets figure. Consequently, in the short term the value of Net Assets is not necessarily an informative indicator of performance. In the medium to long term however, this is a key indicator of a council's capacity to add value to its operations. Over time, Net Assets should increase at least in line with inflation plus an allowance for increased population and/or improved or increased services. Declining Net Assets is a key indicator of the council's assets not being able to sustain ongoing operations.

Roads and Maritime Services (RMS)

The NSW State Government agency with responsibility for roads and maritime services, formerly the Roads and Traffic Authority (RTA).

Section 64 Contribution

Development Servicing Plans (DSPs) are made under the provisions of Section 64 of the Local Government Act 1993 and Sections 305 to 307 of the Water Management Act 2000.

DSPs outline the developer charges applicable to developments for Water, Sewer and Stormwater within each Local Government Area.

Section 94 Contribution

Section 94 of the Environmental Planning and Assessment Act 1979 allows councils to collect contributions from the development of land in order to help meet the additional demand for community and open space facilities generated by that development.

It is a monetary contribution levied on developers at the development application stage to help pay for additional community facilities and/or infrastructure such as provision of libraries; community facilities; open space; roads; drainage; and the provision of car parking in commercial areas.

The contribution is determined based on a formula which should be contained in each council's Section 94 Contribution Plan, which also identifies the basis for levying the contributions and the works to be undertaken with the funds raised.

Special Rate Variation (SRV)

A SRV allows councils to increase general income above the rate peg, under the provisions of the Local Government Act 1993. There are two types of special rate variations that a council may apply for:

- a single year variation (section 508(2)) or
- a multi-year variation for between two to seven years (section 508A).

The applications are reviewed and approved by IPART.

Sustainability

A local government will be financially sustainable over the long term when it is able to generate sufficient funds to provide the levels of service and infrastructure agreed with its community

Ratio Explanations

Asset Maintenance Ratio

Benchmark = Greater than 1.0x

Ratio = actual asset maintenance / required asset maintenance

This ratio compares actual versus required annual asset maintenance, as detailed in Special Schedule 7. A ratio of above 1.0x indicates that the council is investing enough funds within the year to stop the infrastructure backlog from growing.

Building and Infrastructure Renewals Ratio

Benchmark = Greater than 1.0x

Ratio = Asset renewals / depreciation of building and infrastructure assets

This ratio compares the proportion spent on infrastructure asset renewals and the asset's deterioration measured by its accounting depreciation. Asset renewal represents the replacement or refurbishment of existing assets to an equivalent capacity or performance as opposed to the acquisition of new assets or the refurbishment of old assets that increase capacity or performance.

Cash Expense Cover Ratio

Benchmark = Greater than 3.0 months

Ratio = current year's cash and cash equivalents / (total expenses – depreciation – interest costs)*12

This liquidity ratio indicates the number of months a council can continue paying for its immediate expenses without additional cash inflow.

Capital Expenditure Ratio

Benchmark = Greater than 1.1x

Ratio = annual capital expenditure / annual depreciation

This indicates the extent to which a council is forecasting to expand its asset base with capital expenditure spent on both new assets, and replacement and renewal of existing assets.

Debt Service Cover Ratio (DSCR)

Benchmark = Greater than 2.0x

Ratio = operating results before interest and depreciation (EBITDA) / principal repayments (from the statement of cash flows) + borrowing interest costs (from the income statement)

This ratio measures the availability of cash to service debt including interest, principal and lease payments

Building and Infrastructure Backlog Ratio

Benchmark = Less than 0.02x

Ratio = estimated cost to bring assets to a satisfactory condition (from Special Schedule 7) / total infrastructure assets (from Special Schedule 7)

This ratio shows what proportion the backlog is against total value of a council's infrastructure.

Interest Cover Ratio

Benchmark = Greater than 4.0x

Ratio = EBITDA / interest expense (from the income statement)

This ratio indicates the extent to which a council can service its interest bearing debt and take on additional borrowings. It measures the burden of the current interest expense upon a council's operating cash.

Operating Ratio

Benchmark = Better than negative 4%

Ratio = (operating revenue excluding capital grants and contributions – operating expenses) / operating revenue excluding capital grants and contributions

This ratio measures a council's ability to contain operating expenditure within operating revenue.

Own Source Operating Revenue Ratio

Benchmark = Greater than 60%

Ratio = rates, utilities and charges / total operating revenue (inclusive of capital grants and contributions)

This ratio measures the level of a council's fiscal flexibility. It is the degree of reliance on external funding sources such as operating grants and contributions. A council's financial flexibility improves the higher the level of its own source revenue.

Unrestricted Current Ratio

Benchmark = 1.5x (taken from the IPART December 2009 Revenue Framework for Local Government report)

Ratio = Current assets less all external restrictions / current liabilities less specific purpose liabilities

Restrictions placed on various funding sources (e.g. Section 94 developer contributions, RMS contributions) complicate the traditional current ratio because cash allocated to specific projects are restricted and cannot be used to meet a council's other operating and borrowing costs. The Unrestricted Current Ratio is specific to local government and is designed to represent a council's ability to meet debt payments as they fall due.