New South Wales
Treasury Corporation

Newcastle City Council

Financial Assessment and Benchmarking Report

4 October 2012

Prepared by NSW Treasury Corporation as part of the Local Infrastructure Renewal Scheme

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 as part of the Local Infrastructure Renewal Scheme (LIRS) announced by the NSW Government.

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 within prudent risk parameters and the limits of its financial projections.

The report has been prepared for Newcastle City Council, the LIRS Assessment Panel and the DLG. TCorp shall not be liable to Newcastle City 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.

New South Wales
Treasury Corporation

Index

New South Wales
Treasury Corporation

Section 1 Executive Summary

This report provides an independent assessment of Newcastle City Council's (the Council) financial capacity and its ability to undertake additional borrowings. 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.

The report is primarily focused on the financial capacity of the Council to undertake additional borrowings as part of the Local Infrastructure Renewal Scheme (LIRS).

Council has made two applications for the Newcastle City Hall Façade Repairs, Clock Tower project for $7.5m and the Merewether Ocean Baths Promenade and Pump House Renewal project for $2.5m.

TCorp's approach has been to:

- Review the most recent three years of Council's consolidated financial results
- Conduct a detailed review of the Council's 10 year financial forecasts. The review of the financial forecasts focused on the particular Council fund that was undertaking the proposed debt commitment. As the Council operates only one fund we focused our review on this General Fund.

When analysing Council's performance over the review period we make the following observations:

- While the Council has incurred operating deficits (excluding grants and contributions for capital purposes), Council's underlying operating performance (measured using EBITDA) has marginally improved from $19.6m in 2009 to $21.1m in 2011
- Council has had sound liquidity as indicated by an Unrestricted Current Ratio above the benchmark in all three years
- Council's fiscal flexibility is sufficient as indicated by an Own Sourced Operating Revenue Ratio above the benchmark in all three years
- Council's total borrowings have increased from $38.7m in 2009 to $53.4m in 2011
- Council's ability to service further additional borrowings is reducing with the increasing debt service costs reducing Council's DSCR and Interest Cover Ratio

Council's reported Infrastructure Backlog of $112.8m in 2011 represents 12.3% of its infrastructure asset value of $918.5m. Other observations include:

- Unlike the majority of councils, Buildings and Other Structures are the largest backlog category at 75.6% of the backlog in 2011
- Over the last three years Council has averaged close to benchmark for its capital investment program, but its expenditure on maintenance has been consistently below required levels
- Since 2010, Council has commenced an expanded capital investment program and has secured approval to a permanent SRV increase of 5% (in addition to the rate peg increase of 3.6%) commencing in the 2013 financial year to fund the rehabilitation and upgrade of nine civic projects that should assist reducing the backlog

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

- The LTFP assumes the level of services and operations as 'business as usual' apart from the additional revenue and expenditure related to the nine civic capital projects identified as part of the successful SRV
- Council are forecasting operating deficits each year when capital grants and contributions are excluded and these deficits are forecast to grow from $9.7m in 2012 to $46.6m in 2022
- The liquidity position will reduce over the period and will likely result in Council becoming illiquid if they continue with the scheduled capital expenditure program due to reducing current assets and increasing current liabilities
- Council are proposing to borrow $92.2m over the 10 year period on top of the $10.0m LIRS facilities
- Overall the key assumptions within the financial forecasts are considered to be reasonable

In our view, the Council has the capacity to undertake the combined additional borrowings of $10.0m for the LIRS project. This is based on the following analysis:

- While we recommend that Council is approved for the LIRS subsidy the scheduled capital program and additional borrowings of $92.2m between 2014 and 2022 do not currently appear manageable when the current levels of services are maintained, unless revenues are increased and/or expenses reduced.
- The newly elected Council should review the LTFP and capital program so that suitable actions are taken to ensure Council's long term sustainability

In respect of the Benchmarking analysis TCorp has compared the Council's key ratios with other councils in DLG Group 5. The 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's DSCR and Interest Cover Ratio are below the group average and in the medium term Council's forecast ratios fall marginally to be around benchmark
- Council was in a sound liquidity position which on average is above the group's average liquidity level
- Council's performance in terms of its Building and Infrastructure Asset Renewal Ratio and Infrastructure Backlog are well below benchmarks and the group averages

New South Wales
Treasury Corporation

Section 2 Introduction

2.1: Purpose of Report

This report provides the Council with an independent assessment of their financial capacity and performance measured against a peer group of councils which will complement their internal due diligence, and the IP&R system of the Council and the DLG.

The report is to be provided to the LIRS Assessment Panel for its use in considering applications received under the LIRS.

The key areas focused on are:

- The financial capacity of the Council to undertake additional borrowings
- 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 three 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 particular Council fund that was undertaking the proposed debt commitment. For example where a project is being funded from the General fund we focussed our review on the General fund
- Identify significant changes to future financial forecasts from existing financial performance and highlight risks associated with such forecasts
- 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
- Conduct a high level review of the Council's IP&R documents for factors which could impact the Council's financial capacity and performance

In undertaking its work, TCorp relied on:

- Council's audited financial statements (2008/09 to 2010/11)
- Council's financial forecast model
- Council's IP&R documents
- Discussions with Council officers
- Council's submissions to the DLG as part of their LIRS application
- Other publicly available information such as information published on the IPART website

Benchmark Ratios

In conducting our review of the Councils' financial performance and forecasts 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
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

Newcastle City Council LGA	
Locality and Size	
Locality	Hunter
Area	187 km^2
DLG Group No.	5
Demographics	
Population	148,535
% under 20	23%
% between 18 and 59	56%
% over 60	21%
Expected population in 2021	165,600
Operations	
Number of employees (FTE)	926
Annual revenue	$227.7m
Infrastructure	
Roads	7.5m m^2
Bridges	260
Infrastructure backlog value	$112.8m
Total infrastructure value	$918.5m

Newcastle City Council Local Government Area (LGA) is located in the Hunter region on the coast, approximately two hours north of Sydney. The City of Newcastle is classified as the seventh largest in Australia and the second largest in NSW.

The City has a strong industrial heritage with the city founded on coal mining and its harbour remains the largest coal exporting harbour in the world. The Port of Newcastle remains the economic and trade centre for the Hunter Region along with much of northern NSW however over the last 20 years the city has seen transitional change and now has a diverse economy rich in history, arts and culture. The two largest employers are now the Hunter New England Area Health Service and the University of Newcastle highlighting the city's strengths in knowledge and human service industries.

Within Council's infrastructure, property, plant and equipment (IPP&E) assets as at 30 June 2011 there were:

- $613.5m of roads, bridges and footpaths
- $181.2m of specialised buildings
- $98.0m of stormwater drainage
- $25.1m of other structures
- $20.0m of depreciable land improvements
- $0.7m of non specialised buildings

2.4: LIRS Application

Council has made two LIRS applications:

Project 1: Merewether Baths Project

Description: The upgrade of the baths is to be achieved through the resurfacing of promenades around the pools, modifying and upgrading the pumping system, circulation systems and the installation of access ramps.

Amount of loan facility: $2.5m

Term of loan facility: 10 years

Project 2: Newcastle City Hall Clock Tower Project

Description: The project plans repairs to the Newcastle City Clock Tower via structural treatment along with sandstone removal and replacement.

Amount of loan facility: $7.5m

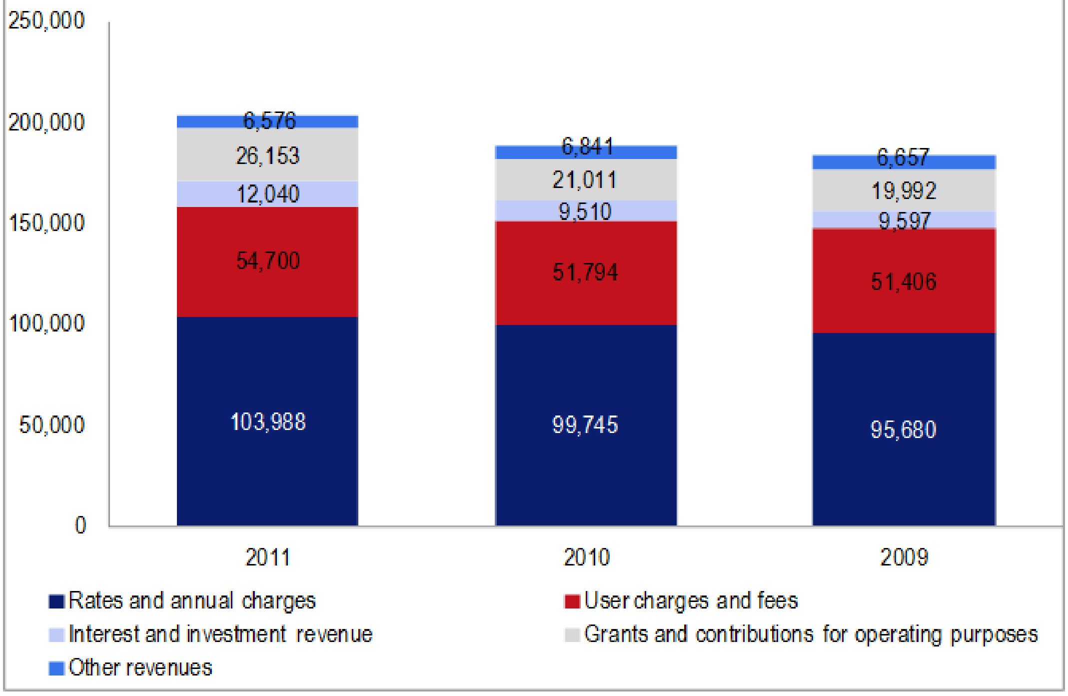
Term of loan facility: 10 years

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 2010/11 ($'000s)

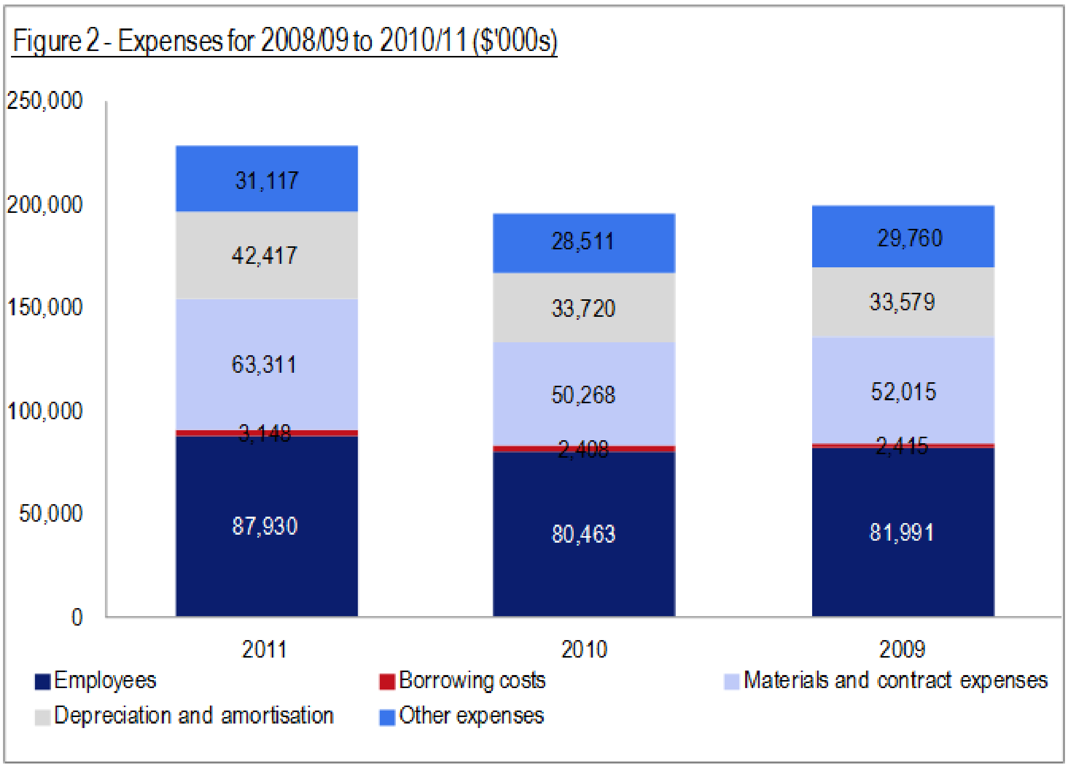


Key Observations

- Rates and annual charges are the main source of revenue for the Council being 51.1% of total revenue in 2011. Rates and annual charges have increased by 4.2% p.a. between 2009 and 2011.
- The maximum allowable rate increase was 3.5% in 2010 and 2.6% in 2011 with the additional revenue attributable to an increase in the number of assessments and increases in valuations. There was also an 11.9% increase in domestic waste management charges which increased total rates and annual charges.
- User fees and charges have increased by 5.6% in 2011 after remaining static in 2010. The main sources of fee revenue in 2011 are tipping fees at $17.6m and Newcastle Airport revenue at $10.3m. These increased by $1.0m and $1.6m respectively in 2011.
- Interest revenue excluding realised revaluation reserves increased to $12.0m in 2011, an increase of 25.5% since 2009 due to higher average interest rates and a $30.9m increase in cash holdings.
- Other revenue of $6.6m in 2011 includes parking fines of $2.4m and rental income from investment and other properties of $2.6m.

- Grants and contributions for operating purposes have increased by 30.8% over the period from 2009 to 2011. In 2011, operating grants and contributions increased by $5.1m largely due to a once off Natural Disaster Grant of $3.3m and an increase of $1.0m in the general purpose Financial Assistance Grant provided by the Federal Government.

3.2: Expenses



Key Observations

- Employee costs are the largest expense being 38.6% of total expenses in 2011. Employee costs increased 9.3% in 2011 despite a decline in employee headcount from 938 to 926 driven by a rise in salaries and wages of $3.6m, workers compensation insurance of $1.8m, employee leave entitlements of $1.4m and superannuation of $0.8m.
- Materials and contracts expenses have increased by 21.7% from 2009 to 2011 driven by the 2011 increase of $11.1m in raw materials and consumables largely attributable to the Major Asset Preservation Program (MAPP) initiated in that year. The MAPP consists of 630 projects covering roads, buildings and structures and the environment with a total project expenditure of $28.5m.
- Depreciation increased by 25.8% in 2011 following the Asset Revaluations. The increase in road, bridges and footpath infrastructure asset depreciation amounted to $7.5m.

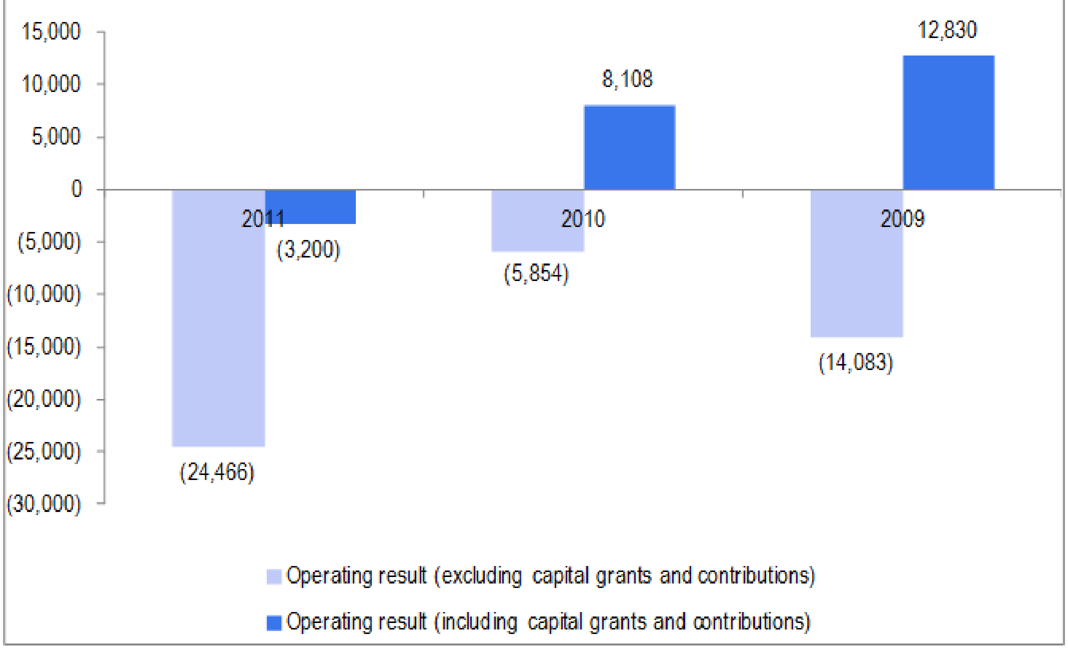
3.3: Operating Results

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 2010/11 ($'000s)



Key Observations

- Council's net operating result excluding capital grants and contributions has been in deficit over the last three years. The largest deficit in 2011 was due to a 16.7% increase in operating expenses against a 7.7% rise in operating revenue.
- The increase in operating expenses was driven by increases in materials and contract expenses as part of the MAPP, increased employee costs and the higher depreciation charges.
- Council expenses include a non-cash depreciation expense, ($42.4m in 2011), which has increased by $8.8m over the past three years following the Asset Revaluations process. 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.

3.4: Financial Management Indicators

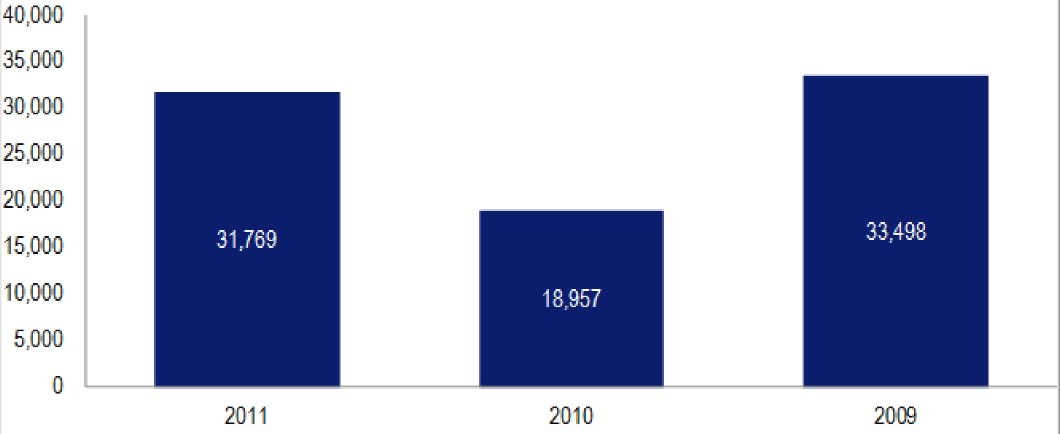
Performance Indicators	Year ended 30 June		
	2011	2010	2009
EBITDA ($'000s)	21,099	29,659	19,566
Operating Ratio	(12.0%)	(3.4%)	(7.6%)
Interest Cover Ratio	6.70x	12.32x	9.07x
Debt Service Cover Ratio	3.18x	5.45x	5.24x
Unrestricted Current Ratio	2.88x	2.99x	2.43x
Own Source Operating Revenue Ratio	70.6%	74.7%	70.0%
Cash Expense Ratio	2.1 months	1.4 months	2.5 months
Net assets ($'000s)	1,400,991	1,734,589	1,565,452

Key Observations

- EBITDA, a measure of Council's underlying performance, increased marginally between 2009 and 2011 after a strong result in 2010. The 2010 result was due to a combination of increased revenues (3.0%) and a reduction in expenses of 2.2% whereas the 2011 result was impacted by increased revenues of 7.7% being offset by a 16.7% increase in expenses. The $20.5m increase in employee costs, and material and contract expenses were the main drivers of the increased expenses.
- In 2011, the Interest Cover Ratio and the DSCR remain above benchmark indicating the Council has flexibility in regard to carrying further debt although this flexibility is reducing due to increased levels of debt.
- Council's total borrowing shows an increasing trend rising from $38.7m in 2009 to $53.4m in 2011, representing 3.8% of net assets.
- The Unrestricted Current Ratio has remained well above the target level of 1.50x over the last three years indicating the Council has had sound liquidity.
- Council's Own Source Operating Revenue Ratio is above the 60.0% benchmark by a minimum of 10.0% over the three years indicating that Council has a sufficient level of fiscal flexibility.
- The Cash Expense Ratio is below the benchmark in all three years however Council utilises the majority of their funds in term deposits and FRNs classified under current investments.
- Net assets declined from $1,734.6m in 2010 to $1,401.0m in 2011 due to the Asset Revaluations that resulted in revaluation decrements of $375.1m in community land, and $20.6m decline in other structures (this was slightly offset by an increase in Council's heritage collection by $51.3m). Asset values had increased in 2010 from 2009 by $153.5m from the revaluation of road, bridge, footpath and drainage infrastructure assets.
- When the Asset Revaluations are excluded, there has been marginal rise in the IPP&E asset base of $8.4m across the three year period.

3.5: Statement of Cashflows

Figure 4 - Cash and Cash Equivalents for 2008/09 to 2010/11 ($000s)



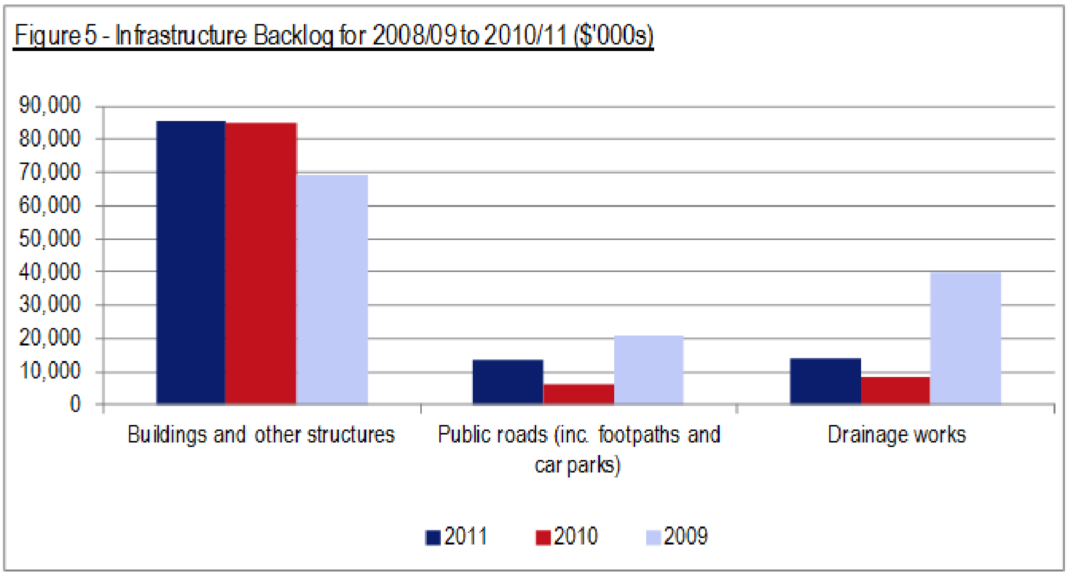
Key Observations

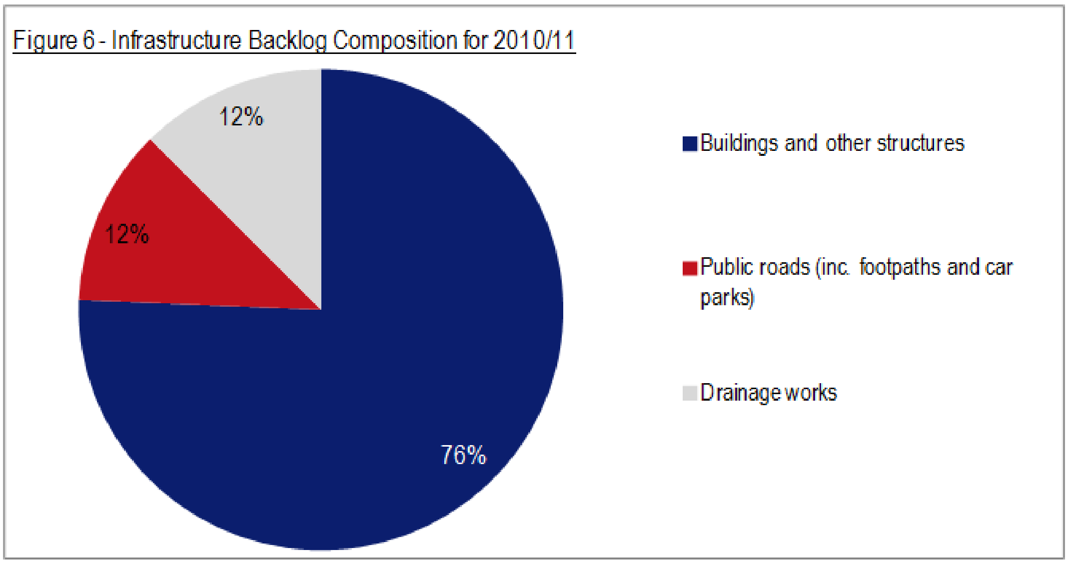
- Cash and cash equivalents are at similar levels in 2009 and 2011. The reduction in 2010 was due to the increase in the purchase of investments in that year.
- Overall cash and cash equivalents, and investments have increased over the three years from $155.6m in 2009 to $186.5m in 2011. Of the $186.5m, $34.6m is externally restricted, $144.4m is internally restricted and $7.5m is unrestricted.
- Within the current investments of $65.9m, $33.5m is in current term deposits, $19.0m in FRNs, $6.0m in bonds, $4.0m in negotiable certificates of deposit and $3.4m in CDOs. Council has already written the value of the CDOs down and the original value of these CDOs were significantly higher than the book value stated. Council hope to recover the maturing CDOs at the written down book value as a minimum.
- The non-current investments of $88.8m comprise $41.3m in bonds, $20.0m in term deposits, $17.5m in floating rate notes and $10.0m in negotiable certificates of deposit.
- The levels of cash and cash equivalents, and current investments combined, together with the Unrestricted Current Ratio above the benchmark highlights an adequate liquidity position with Council likely to have the capacity to manage most irregular financial events that may impact the Council's cash position.

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**





The Council's Infrastructure Backlog has reduced overall in the past three years with a decline in 2010 before a smaller increase in 2011. Overall the Infrastructure Backlog has reduced to $112.7m in 2011 from $129.8m in 2009 due to a reduction in both drainage works and public roads backlog.

The reduction in the backlog was predominantly due to the Asset Revaluations in 2010 that increased the value of road and drainage infrastructure assets while also providing a more accurate analysis of the quality of these assets.

Buildings and structures continue to make up the majority of the infrastructure backlog at $85.3m of the total backlog in 2011. This is dissimilar to the majority of Councils where public roads are the dominant category of asset causing the backlog.

Council has devised the Major Asset Preservation Program and have been directing increased funds into this strategy with the focus of improving Council assets and reducing the Infrastructure Backlog. Council hope to continue this strategy in future years

3.6(b): Infrastructure Status

Infrastructure Status	Year ended 30 June		
	2011	**2010**	**2009**
Bring to satisfactory standard ($'000s)	112,753	99,216	129,848
Required annual maintenance ($'000s)	44,805	43,500	39,749
Actual annual maintenance ($'000s)	34,691	27,256	27,622
Total value of infrastructure assets ($'000s)	918,464	956,101	751,898
Total assets ($'000s)	1,521,109	1,841,707	1,665,991
Building and Infrastructure Backlog Ratio	0.12x	0.10x	0.17x
Asset Maintenance Ratio	0.77x	0.63x	0.69x
Building and Infrastructure Renewals Ratio	0.16x	0.12x	0.07x
Capital Expenditure Ratio	1.16x	0.90x	1.15x

The Buildings and Infrastructure Backlog Ratio has improved since 2009 however remains lower than the benchmark in 2011. The improvement is due to both the decrease in the Infrastructure Backlog and a rise in the value of total infrastructure assets due to the Asset Revaluations.

The Asset Maintenance Ratio has improved since 2009 although it remains below the 1.00x benchmark. If Council is unable to improve this ratio above benchmark then their assets will deteriorate and increase the Infrastructure Backlog.

The Building and Infrastructure Asset Renewal Ratio is also far below benchmark although it has been improving since 2009. This indicates that buildings and infrastructure are not being renewed to their equivalent capacity. However this ratio does not take into account capital expenditure that increases capacity or performance.

The Capital Expenditure Ratio has been above benchmark in both 2009 and 2011. Over the past three years this ratio has averaged 1.07x and indicates that the Council is expanding their Net Assets to manage the growth of the LGA and the related increase in demand for assets and services.

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		
	2011	2010	2009
New capital works	46,000	42,000	1,000
Replacement/refurbishment of existing assets	0	0	0
Total	**46,000**	**42,000**	**1,000**

Some of the capital works undertaken by Council in the last three years have been:

- Development and construction of the new Newcastle Museum ($23.5m)
- Redevelopment of the No 2 Sportsground ($7.2m)
- Coastal Revitalisation MasterPlan ($5m)
- Wallsend Park skate facility
- Newcomen Street retaining wall
- Replacement of the Stockton beach tourist park cabins
- Newcastle ocean baths restoration

3.7: Specific Risks to Council

- Environmental disasters / Climate change and sea level rise. Approximately 70 per cent of land in the Council's Local Government Area (LGA) is natural, pre-existing floodplains with the probability that one in three properties may be affected by flooding in the future. In September 2009 Council began work on a City-Wide Floodplain Risk Management Plan to examine options to reduce and manage the extensive flood risks in the LGA.
- Increased population. Council is forecasting a large increase in population over the next 20 years and The Lower Hunter Regional Strategy in conjunction with Planning NSW has identified the requirement for 20,500 additional dwellings over this period. This will place pressure on existing infrastructure and services which Council has identified within their Community Strategic Plan.
- Ageing population. Council has an ageing population with almost 16% of residents over 65 years of age. An ageing population, as with population growth, places pressure on existing infrastructure and services, with consideration required for future service requirements that may have implications in terms of future service provision.
- Major Asset Preservation Program. Council has developed the MAPP to improve the quality of their infrastructure assets and reduce the Infrastructure Backlog. While this is a positive initiative it appears to be impacting on the operational performance of Council and increasing operating deficit positions. Council need to operate in a responsible manner to achieve the balancing act of improving both their operating performance and capital expenditure.

Section 4 Review of Financial Forecasts

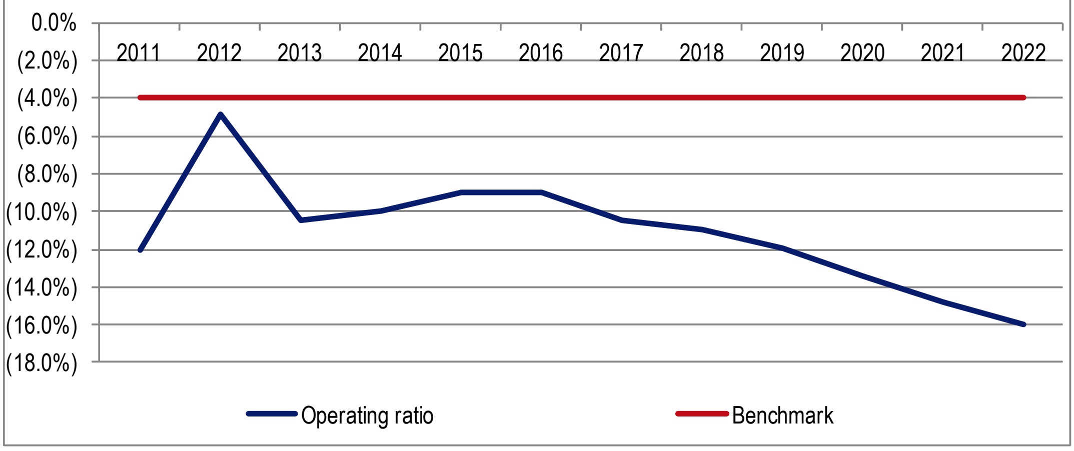
The financial forecast model shows the projected financial statements and assumptions for the next 10 years. The model includes the two LIRS loans of $10.0m in total without any LIRS subsidy.

Council completed two scenarios in their 2012 LTFP, one on a 'business as usual' basis and the second including a one year SRV of 5.0% above the rate peg to be permanently retained in the revenue base. This SRV is specifically related to nine civic capital expenditure projects with all additional funds being utilised for these specific schemes. IPART approved this SRV in June 2012 therefore this is the scenario that our analysis is focused upon.

As Council only operates a General Fund we have focused our financial analysis solely upon this Fund.

4.1: Operating Results

Figure 7 - Operating Ratio



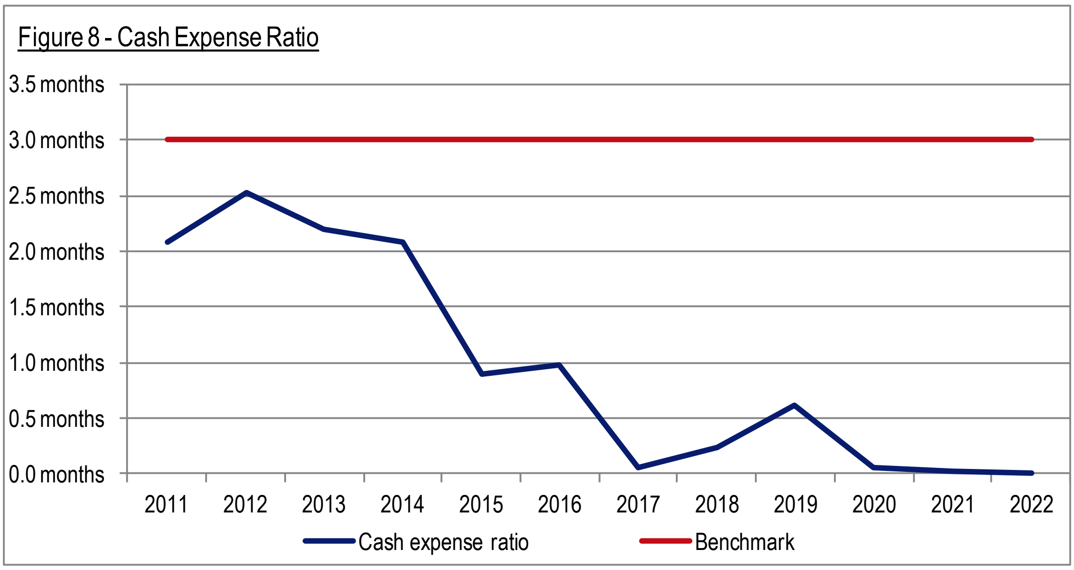
Council has forecast operating deficits in each year of the forecast with the Operating Ratio improving to a deficit of $9.7m (4.9%) in 2012 before declining with deficits around 10.0% for four years to 2016. From this point the deficits are forecast to grow in each year to $46.6m (16.0%) in 2022.

This Operating Ratio trend will impact on Council's long term financial sustainability and will need to be addressed and options developed to improve operating performance. Council management is well aware of this issue and will discuss options with the incoming Council and through their community consultation process.

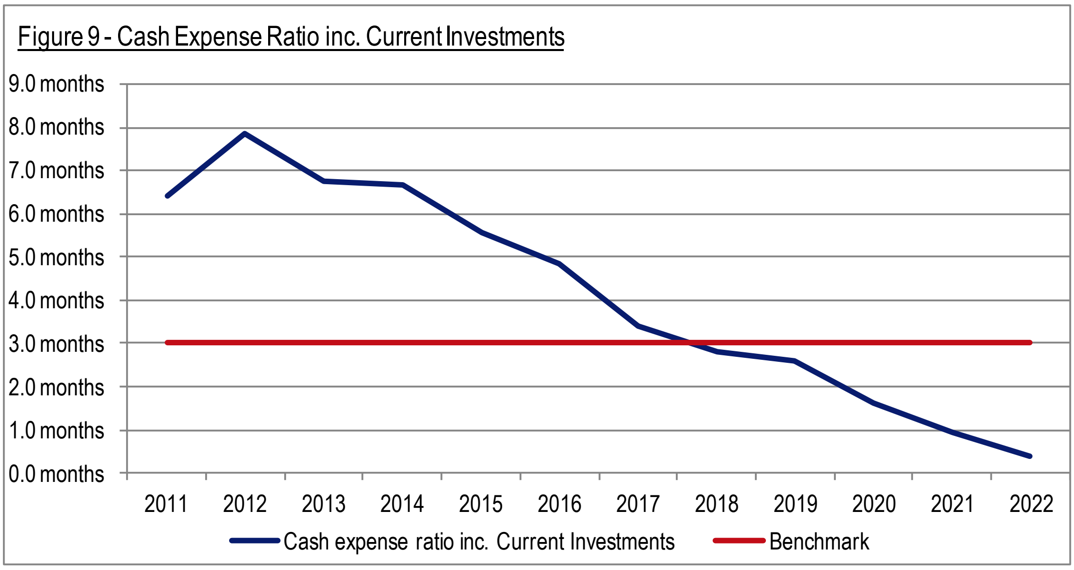
These operating deficits occur despite Council being granted a one-year SRV of 5.0% in 2013 above the rate peg to be permanently retained in the revenue base as mentioned above.

4.2: Financial Management Indicators

Liquidity Ratios



The Cash Expense Ratio is below the benchmark in each year and the downward trend highlights how Council's cash and cash equivalents are forecast to reduce over the period from $35.0m in 2012 to $0.1m in 2022. Historically Council has utilised the majority of their funds in current investments.



When current investments are included there is still a sharp downward trend with the combined cash and investments reducing from $109.1m in 2012 to $8.9m in 2022.

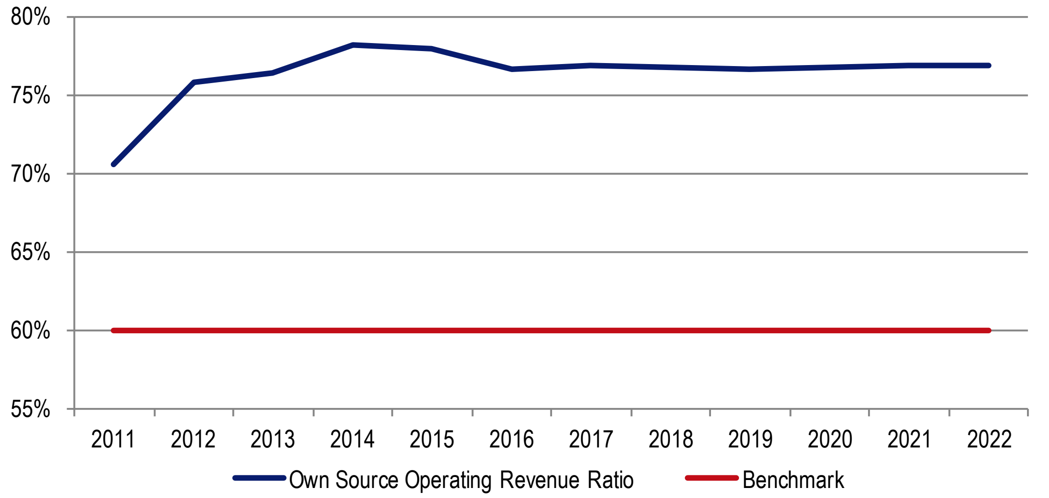
Council has been unable to calculate the Unrestricted Current Ratio at this time, however it is likely that this will also show a negative trend due to the fact that in 2012 Council has $126.9m of current assets against $48.3m of current liabilities, whereas by 2022 Council is forecast to have $32.4m of current assets against $91.1m of current liabilities.

New South Wales
Treasury Corporation

This position along with the Cash Expense Ratio indicates that Council are likely to become illiquid over the 10 year forecast period if the currently scheduled capital expenditure program is not amended or other revenue increases or expense reductions not secured.

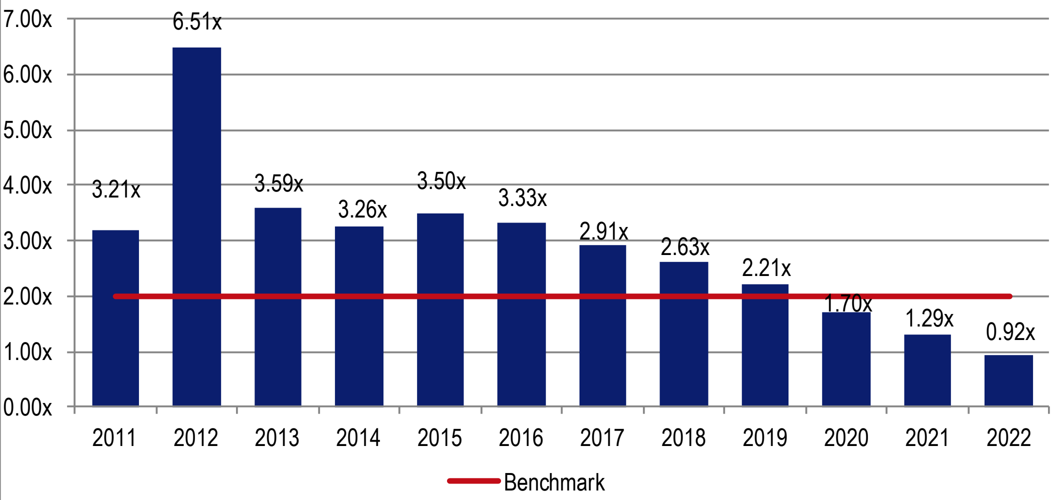
Fiscal Flexibility Ratios

Figure 10 - Own Source Operating Revenue Ratio



Council has forecast their Own Source Operating Revenue Ratio to be above 75.0% for the full forecast period against historical ratio results nearer to 70.0%. The forecast ratios are higher than the historical ratios due to lower capital grants and contributions being forecast. This skews the ratio upwards.

Figure 11 - DSCR



The DSCR is forecast to remain above the benchmark in each year until 2020 but by 2022 it is below 1.00x indicating that Council will not be able to service their borrowings in this year.

The cumulative borrowings forecast to be utilised between 2013 and 2022 is $102.2m, with $10.0m new borrowings added in each year apart from 2014 when $12.2m is added. This increases the annual principal repayments from $2.2m in 2013 to $4.6m in 2022 while Council's EBITDA reduces from a high of $32.8m in 2012 to a low of $9.9m in 2022. These inverse trends are the reason for the decline in the ratio over the forecast period.

The Interest Cover Ratio follows a similar trend to the DSCR but falls below the benchmark a year

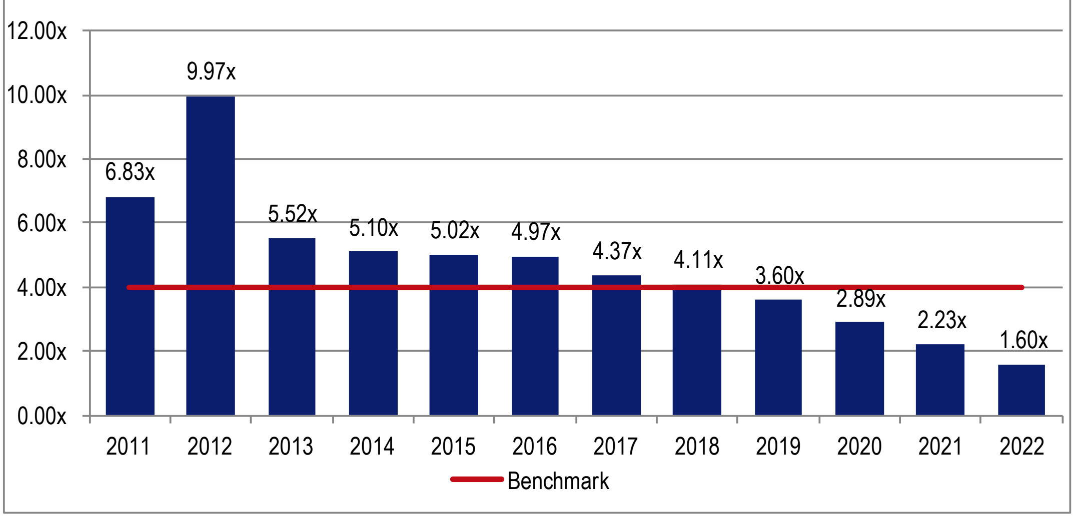


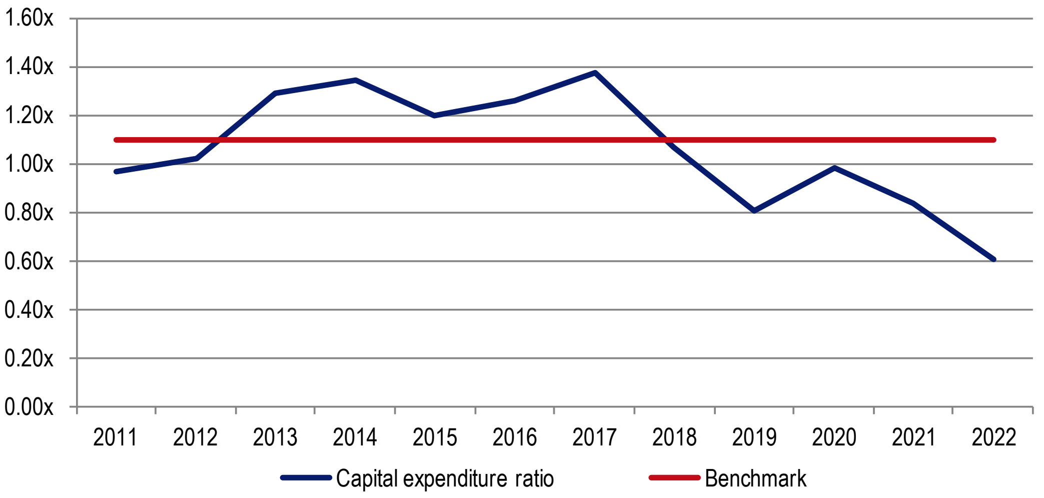
Figure 12 - Interest Cover Ratio

earlier in 2019, with interest costs increasing from $3.3m in 2012 to $6.2m in 2022.

Both the DSCR and Interest Cover Ratio results indicate that Council do not have the capacity to manage the proposed $102.2m of borrowings over the forecast period based on Council's current forecasts.

4.3: Capital Expenditure

Figure 13 - Capital Expenditure Ratio



Council's Capital Expenditure Ratio is above the benchmark in the first five years of the forecast period between 2013 and 2017 before deteriorating to a low of 0.61x in 2022.

This is because annual forecast capital expenditure declines from $60.9m in 2017 to $30.5m in 2022. Over the 10 year period the cumulative capital expenditure of $475.4m is below than the cumulative benchmark figure of $493.1m.

This is likely to result in the quality of Council's assets deteriorating and the Infrastructure Backlog growing, during a period when the population is expected to grow and additional demand on infrastructure and services will occur.

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>

- The LTFP assumes the level of services and operations as 'business as usual' apart from the additional revenue and expenditure related to the nine civic capital projects identified as part of the successful SRV
- Other operating revenues are forecast to increase by 15.3% and 32.5% in 2015 and 2016.
- Materials and contracts are forecast to increase by 51.0% in 2013 and by 8.0% in each year from 2016 to 2022. Council has stated that the 2012 adopted budget figure was under budgeted and that the increase from 2013 onwards reflects the projected cost increases more accurately.
- Other operating expenses are forecast to increase by 17.2% in 2013, predominantly due to the increased waste levy and then increase between 2.0% and 7.2% in the remaining year through to 2022
- Council has reclassified the waste levy into other expenses as opposed to materials and contracts where it had historically been accounted for.
- Council's total cash and investments are forecast to decrease from $184.4m in 2012 to $23.0m in 2022
- To assist the funding of the nine civic capital projects relating to the SRV funding, Council are forecasting to sell underutilised or redundant assets at a value of $45.2m that are included within the cumulative asset sales of $68.2m within the forecast. This includes two of the three parking stations that Council own, with the sale of these completing in the 2013 financial year.
- Overall the key assumptions within the financial forecasts are considered to be reasonable, although it is noted that the outcome of these assumptions is a deteriorating financial position for Council.

4.5: Borrowing Capacity

When analysing the financial capacity of the Council we believe Council will not be able to incorporate all of the additional loan funding included in Council's LTFP, in addition to the LIRS loan facilities. Some comments and observations are:

- Based on a benchmark of DSCR>2.00x, Council are forecast to reduce below the 2.00x benchmark in 2020 and below 1.00x in 2022. This indicates that the $92.2m scheduled to be utilised between 2014 and 2022 is larger than Council are reasonably able to manage.
- It appears Council will face liquidity issues over the period with their cash and investments diminishing over the forecast period
- It therefore appears that Council will need to revise their scheduled capital program so that they remain liquid and are able to meet all short term liabilities

Section 5 Benchmarking and Comparisons with Other Councils

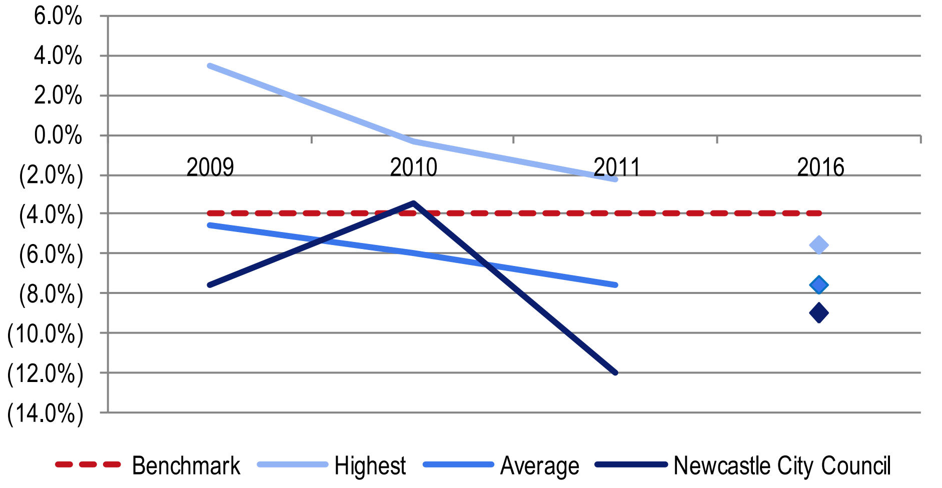
As discussed in section 2 of this report, each council's performance has been assessed against ten key benchmark ratios. This section of the report compares the Council's performance with its peers in the same DLG Group. The Council is in DLG Group 5 and there are six councils in this group.

In Figure 15 to Figure 21, 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 22 to 24 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.

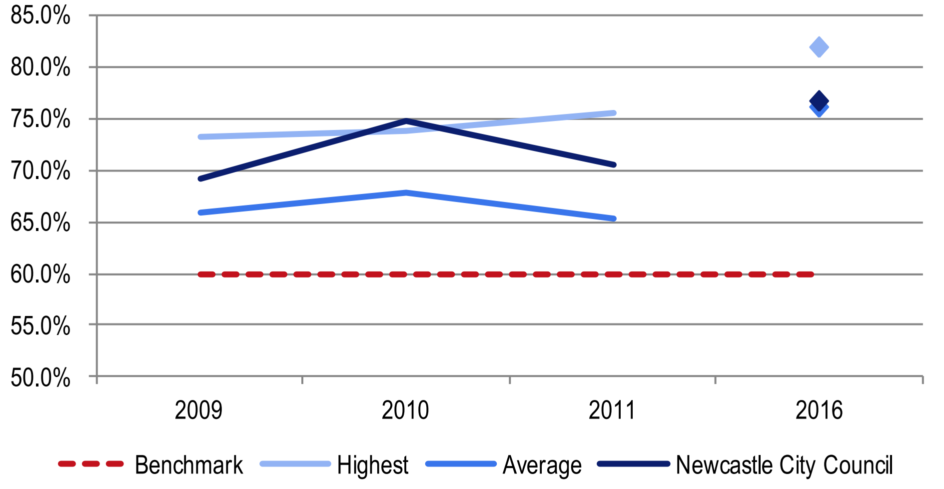
Financial Flexibility

Figure 14 - Operating Ratio Comparison



Council's Operating Ratio was below the benchmark and group average in two of the past three years. Consistent with other councils in the group, it experienced a decline in operating results in 2011 due to increased depreciation expense. The results are forecast to improve in the medium term but remain below the benchmark (and deteriorate significantly post 2016).

Figure 15 - Own Source Operating Revenue Ratio Comparison



Council's Own Source Operating Revenue Ratio was above the group average and the benchmark. The ratio is forecast to improve further in the medium term in line with the group average.

Overall, Council's financial flexibility is below the group's average.

Liquidity

Figure 16 - Cash Expense Ratio Comparison

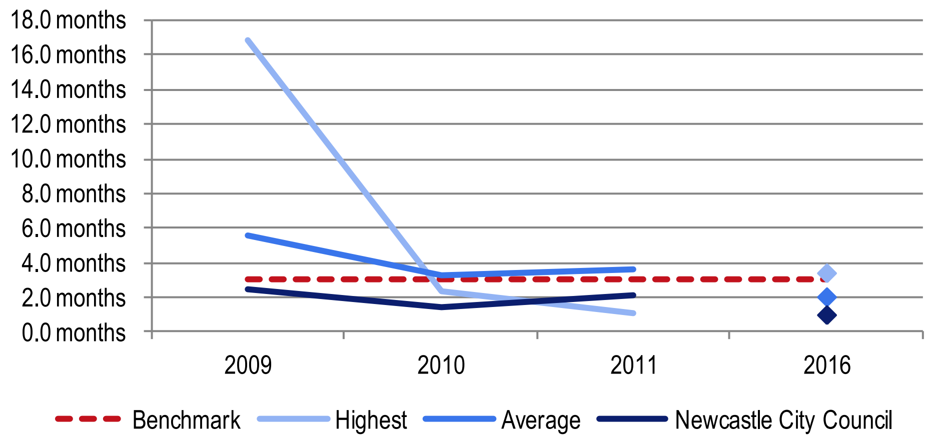
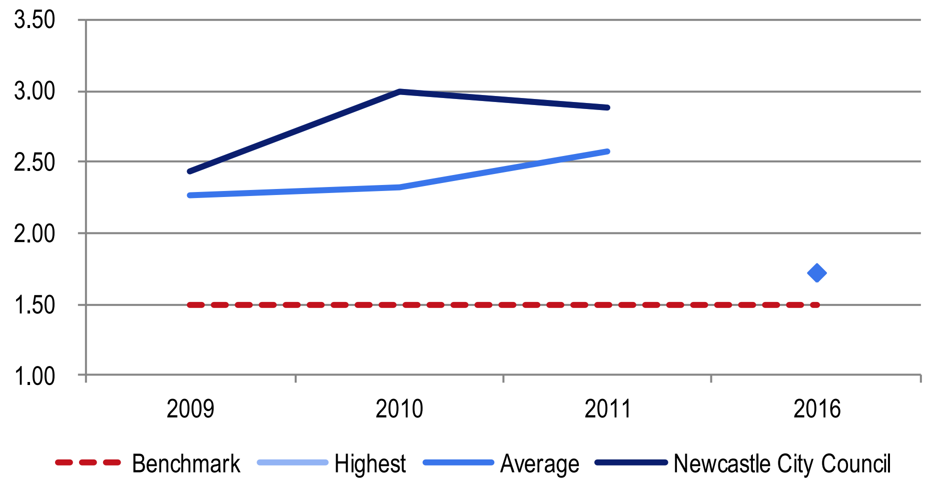
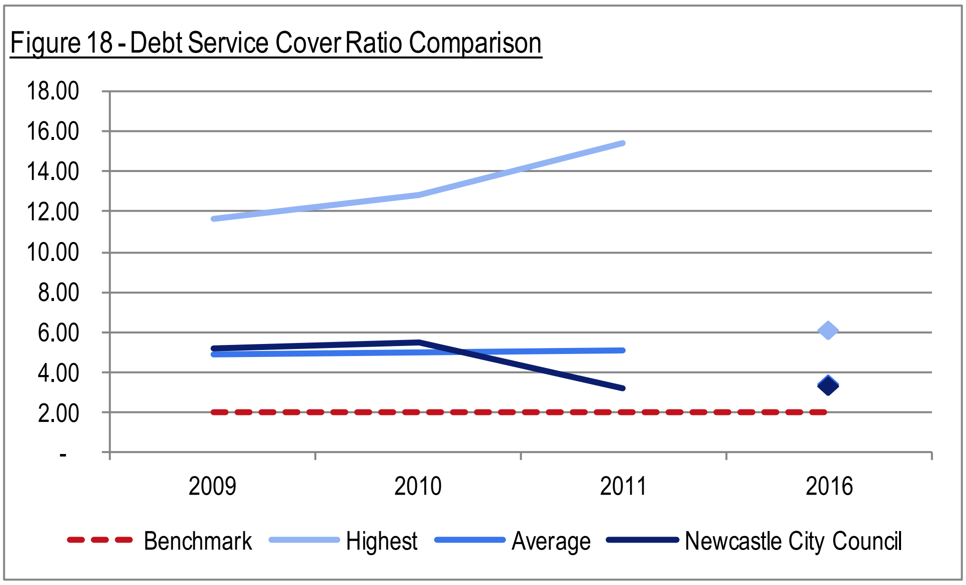


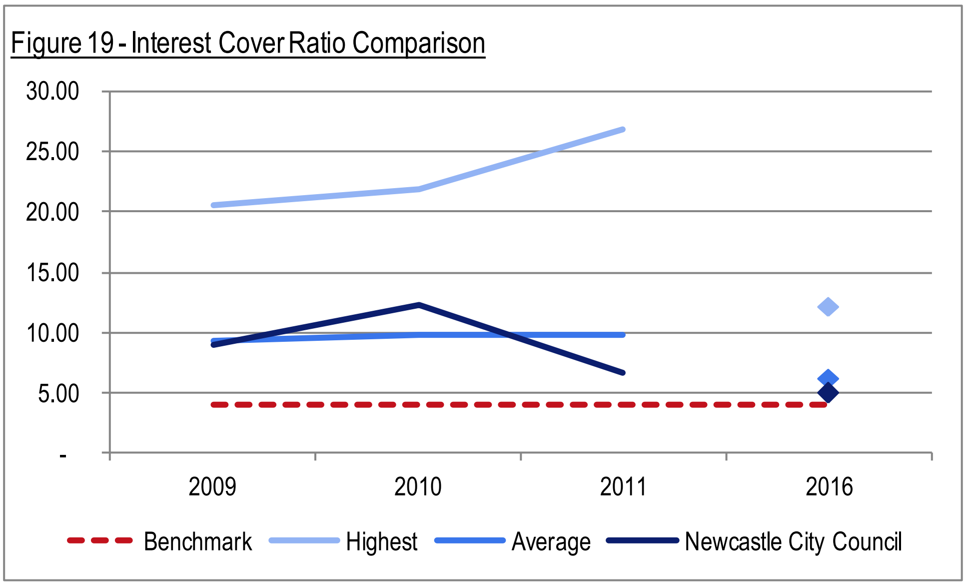
Figure 17 - Unrestricted Current Ratio Comparison



On average over the past three years, the Council's liquidity position has been sound. Council has the highest Unrestricted Current Ratio in the group though they have not provided a forecast Unrestricted Current Ratio.

Debt Servicing





Over the review period, Council was above benchmark in respect of its DSCR and Interest Cover Ratio's but these ratios are forecast to marginally deteriorate in the medium term to be close to the benchmark.

Asset Renewal and Capital Works

Figure 20 - Capital Expenditure Ratio Comparison

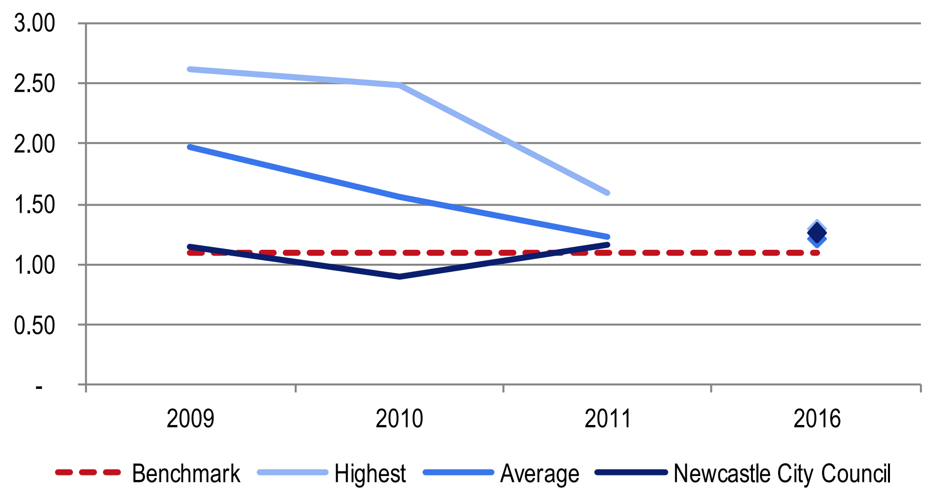


Figure 21 - Asset Maintenance Ratio Comparison

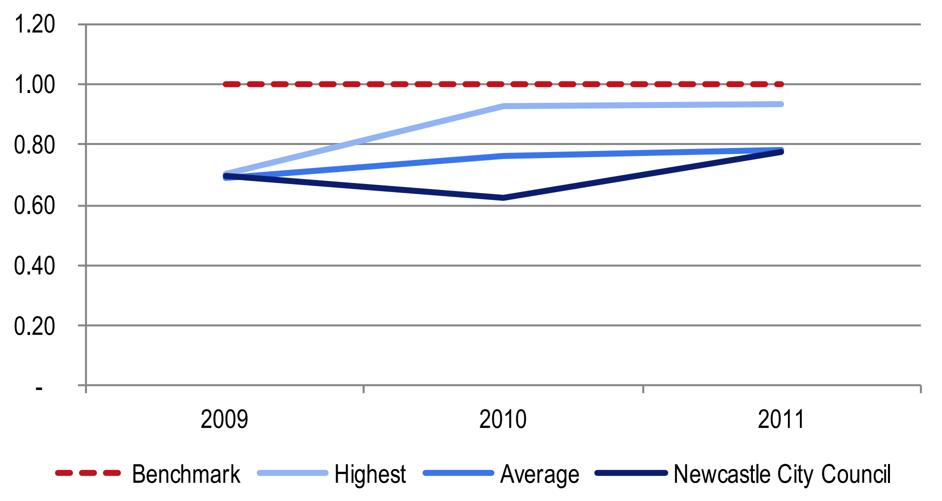


Figure 22- Infrastructure Backlog Ratio Comparison

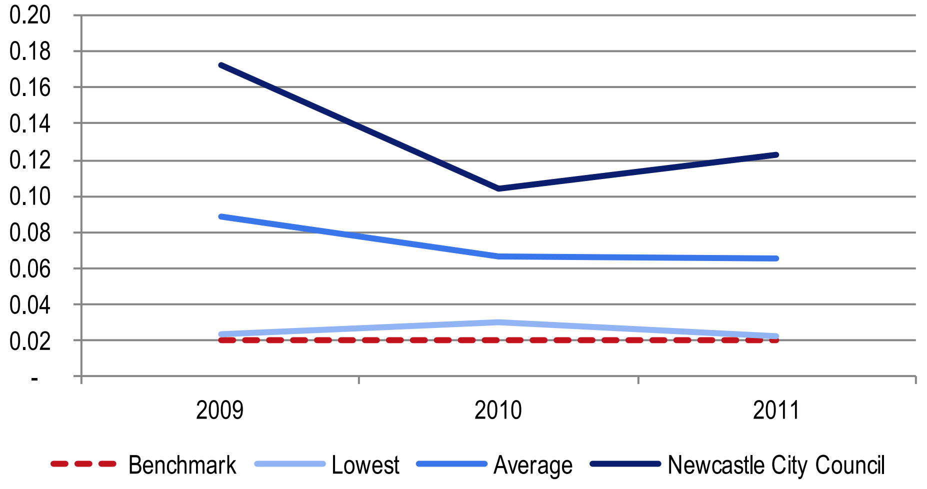
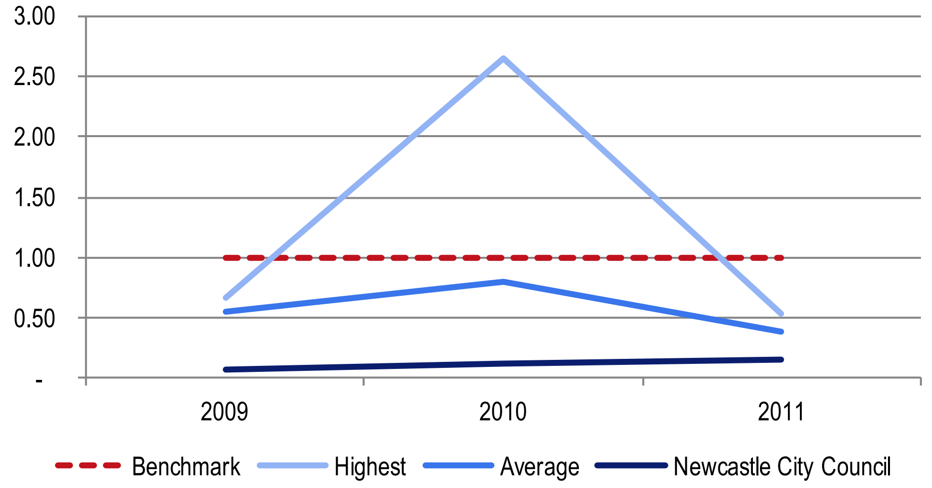


Figure 23 - Building and Infrastructure Asset Renewal Ratio



Overall, the Council has a much higher Infrastructure Backlog than other councils in the group. It is also below the group average and benchmark in terms of spending on asset maintenance. The Council's Building and Infrastructure Asset Renewal Ratio is well below the group average and benchmark. The Council's Capital Expenditure Ratio has been below the group average, though it has been around the benchmark and is forecast to remain around the benchmark in the medium term.

Overall the Council has a high Infrastructure Backlog and has spent less on building and infrastructure asset renewal and asset maintenance than required. This is likely to increase the Infrastructure Backlog further in the future if this issue is not addressed.

Section 6 Conclusion and Recommendations

Based on our review of both the historic financial information and the 10 year financial forecast within Council's long term financial plan we consider Council to be currently in a satisfactory financial position. We believe that Council has the capacity to manage the LIRS facilities therefore we recommend that they are approved for the $10.0m for the two LIRS projects. This recommendation is made subject to the points stated below.

We base our recommendation on the following key points:

- Council's DSCR and Interest Cover Ratio has remained above the benchmark in recent years indicating the capacity to manage the additional borrowings
- Council's liquidity position has been sound, as indicated by a strong Unrestricted Current Ratio
- Council's financial flexibility is adequate as highlighted by the Own Source Operating Revenue Ratio
- While Council's Infrastructure Backlog is relatively large it is predominantly buildings related and they have successfully managed to keep the roads and drainage backlog to a manageable level. Having the backlog within buildings is seen as less of a negative as these assets are saleable should Council need to undertake an asset rationalisation exercise

Council management are aware of the current position and the challenges that the Council faces in the medium to long term. This recommendation is made with the following points to be reviewed by the newly elected Council in conjunction with the management team:

- The current LTFP and capital expenditure program is likely to lead to Council becoming illiquid by 2019
- A review of the LTFP assumptions should be undertaken to identify a sustainable way forward, whether that be by identifying new revenue sources, revising service levels, or rescheduling capital expenditure and associated borrowings to ensure that all liabilities are able to be met as required
- The additional borrowings currently scheduled within the LTFP of $92.2m from 2014 to 2022, contribute to Council's potential future liquidity issues. If the liquidity issues scheduled in 2019 were addressed but the scheduled additional borrowings were still utilised then Council will not be in a position to meet the increasing repayments by 2022

Appendix A Historical Financial Information Tables

Table 1- Income Statement

Income Statement ($'000s)	Year ended 30 June			% annual change	
	2011	2010	2009	2011	2010
Revenue					
Rates and annual charges	103,988	99,745	95,680	4.3%	4.2%
User charges and fees	54,700	51,794	51,406	5.6%	0.8%
Interest and investment revenue	12,040	9,510	9,597	26.6%	(0.9%)
Grants and contributions for operating purposes	26,153	21,011	19,992	24.5%	5.1%
Other revenues	6,576	6,841	6,657	(3.9%)	2.8%
Total revenue	**203,457**	**188,901**	**183,332**	**7.7%**	**3.0%**
Employees	87,930	80,463	81,991	9.3%	(1.9%)
Borrowing costs	3,148	2,408	2,415	30.7%	(0.3%)
Materials and contract expenses	63,311	50,268	52,015	25.9%	(3.4%)
Depreciation and amortisation	42,417	33,720	33,579	25.8%	0.4%
Other expenses	31,117	28,511	29,760	9.1%	(4.2%)
Total expenses	**227,923**	**195,370**	**199,760**	**16.7%**	**(2.2%)**
Operating result	**(24,466)**	**(6,469)**	**(16,428)**	**278.2%**	**(60.6%)**

Table 2 - Items excluded from Income Statement

Excluded items ($'000s)			
	2011	2010	2009
Grants and contributions for capital purposes	21,266	13,962	26,913
Revaluation reserves realised	1,478	0	0
Net gain/(loss) from disposal of assets	1,462	6,158	(17)
Investment recoupment (Other revenues)	0	0	2,345
Fair value adjustments - investment property	0	615	0
Fair value adjustments - investments	0	0	(10,131)

Table 3 - Balance Sheet

Balance Sheet ($'000s)	Year Ended 30 June			% annual change	
	2011	**2010**	**2009**	**2011**	**2010**
Current assets					
Cash and equivalents	31,769	18,957	33,498	67.6%	(43.4%)
Investments	65,941	76,868	43,899	(14.2%)	75.1%
Receivables	15,775	16,081	15,560	(1.9%)	3.3%
Inventories	745	732	692	1.8%	5.8%
Other	395	620	450	(36.3%)	37.8%
Non-current assets classified as held for sale	4,445	830	891	435.5%	(6.8%)
Total current assets	119,070	114,088	94,990	4.4%	20.1%
Non-current assets					
Investments	88,801	84,476	78,184	5.1%	8.0%
Receivables	7,968	8,100	7,735	(1.6%)	4.7%
Infrastructure, property, plant & equipment	1,291,982	1,622,204	1,472,854	(20.4%)	10.1%
Investment property	12,815	12,815	12,200	0.0%	5.0%
Intangible Assets	451	0	0	N/A	N/A
Other	22	24	28	(8.3%)	(14.3%)
Total non-current assets	1,402,039	1,727,619	1,571,001	(18.8%)	10.0%
Total assets	**1,521,109**	**1,841,707**	**1,665,991**	**(17.4%)**	**10.5%**
Current liabilities					
Payables	24,216	18,709	15,565	29.4%	20.2%
Borrowings	2,687	3,162	2,709	(15.0%)	16.7%
Provisions	33,782	33,720	37,849	0.2%	(10.9%)
Total current liabilities	60,685	55,591	56,123	9.2%	(0.9%)
Non-current liabilities					
Borrowings	50,664	43,384	36,000	16.8%	20.5%
Provisions	8,769	8,143	8,416	7.7%	(3.2%)
Total non-current liabilities	59,433	51,527	44,416	15.3%	16.0%
Total liabilities	**120,118**	**107,118**	**100,539**	**12.1%**	**6.5%**
Net assets	**1,400,991**	**1,734,589**	**1,565,452**	**(19.2%)**	**10.8%**

Table 4-Cashflow

Cashflow Statement ($'000s)	Year ended 30 June		
	2011	**2010**	**2009**
Cashflows from operating activities	37,957	34,544	44,939
Cashflows from investing activities	(31,950)	(56,922)	(38,892)
Proceeds from borrowings and advances	10,284	10,873	7,068
Repayment of borrowings and advances	(3,479)	(3,036)	(1,765)
Cashflows from financing activities	6,805	7,837	5,303
Net increase/(decrease) in cash and equivalents	**12,812**	**(14,541)**	**11,350**
Cash and equivalents	31,769	18,957	33,498

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.

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, building, other structures and depreciable land improvement assets (from note 9a)

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.