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14 May 2013

LIRS Round Two Assessment Panel
Division of Local Government
Department of Premier & Cabinet
Locked Bag 3015,
Nowra NSW 2541

Dear Assessment Panel,

**Financial Assessment for the Local Infrastructure Renewal Scheme (LIRS) Round Two**

This letter is provided to the Assessment Panel for its consideration of Greater Taree City Council's (the Council) LIRS Round Two application. It is primarily focused on the Council's financial capacity to undertake the additional borrowing proposed. This letter should be read in conjunction with the attached appendices including the disclaimer.

Council has made one application for the 2013/14 Infrastructure Backlog Road Reconstruction Program. The proposed $2.0m loan is for a term of 10 years with a fixed rate of 5.47% p.a. This year's program is part of the Council's wider initiative to reduce its road assets Infrastructure Backlog. Funding for this initiative has come from state and federal grant funding, and LIRS Round 1 subsidy for its $6.5m loan.

TCorp's approach has been to:

- Review the most recent four years of Council's consolidated financial results. This follows on from the work TCorp previously conducted for the LIRS Round One assessment process.
- Conduct a review of the Council's 10 year financial forecasts using their Long Term Financial Plan (LTFP). The review of the financial forecasts focused on the particular Council fund that is undertaking the proposed debt commitment. As the Council operates only one fund we focused our review on this General Fund.

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
- Council's submissions to the DLG as part of their LIRS application
- Other publicly available information such as information published on the IPART website

In our view, the Council has the capacity to undertake the additional borrowings of $2.0m for the LIRS project provided it addresses its forecast liquidity issue. This is based on the following analysis:

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- Council's historical and forecast DSCR and Interest Cover Ratio indicate its ability to service its existing debt commitments. They are expected to be above benchmark for most of the forecast years.
- However, its Unrestricted Current Ratio is forecast to be significantly below benchmark and it is forecast to be below 1.0x in the short term. In order to ensure additional borrowings does not jeopardise its liquidity position, Council has confirmed to TCorp that it will put in place safeguards to prevent financial distress and ensure Council can continue to meet its day to day expenses. Safeguards include phasing of budgets and cash flow management, and reduction in planned capital works. Council should continue to look to improve its liquidity position.

Further information about the analysis conducted for the Council are included in Appendix 1 and 2. A list of terms is provided in Appendix 3.

Please contact me if you require any further information.

Yours sincerely
New South Wales Treasury Corporation

Kevin Pugh
Senior Manager Corporate Finance

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# Appendix 1

Historical Financial Indicators

| Indicators | Year ended 30 June | | | |
|---|---|---|---|---|
| | 2012 | 2011 | 2010 | 2009 |
| Operating performance | | | | |
| Operating result (exc. capital grants and contributions) | (15,480) | (23,275) | (7,386) | (5,151) |
| EBITDA ($'000s) | 18,284 | 10,319 | 6,919 | 8,642 |
| Operating ratio | (27.6%) | (48.6%) | (17.2%) | (12.4%) |
| Own source operating revenue ratio | 56.5% | 60.9% | 56.9% | 53.8% |
| Liquidity | | | | |
| Unrestricted current ratio | 1.58x | 1.28x | 1.88x | 1.86x |
| Debt servicing capacity | | | | |
| Interest cover ratio | 10.91x | 6.27x | 4.48x | 6.45x |
| Debt service cover ratio | 4.64x | 1.08x | 1.70x | 2.48x |

The key observations from the ratios above are:

- Council has reported operating deficits in each year of the review period. Its operating result was at its lowest in 2011 due to a substantial increase in depreciation expense following Asset Revaluations. The 2012 results improved due to decreased employee expenses, lower materials and contracts expenses and higher operating grants from the prepayment of the Financial Assistance Grant (FAG)
- The Unrestricted Current Ratio was above benchmark in three of the review years and above 1.00x in all years. This suggests that Council had sufficient liquidity
- The Interest Cover Ratio was above benchmark in all review years and the DSCR was above benchmark in 2012. This indicates that Council had the ability to service its debt. The DSCR fell in 2011 as a result of increased principal repayments to refinance existing loans at reduced interest rates. This was prudent financial management and is not seen as an area of concern
- As at 30 June 2012, Council had $24.3m of borrowings which represents 4.7% of its Net Assets

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Forecast Financial Indicators

TCorp assessed the copy of the LTFP provided from Council which included the LIRS project, the proposed associated borrowings and borrowing costs excluding the LIRS interest subsidy. Based on the LTFP, the key forecast financial indicators are:

Figure 1 - DSCR for General Fund

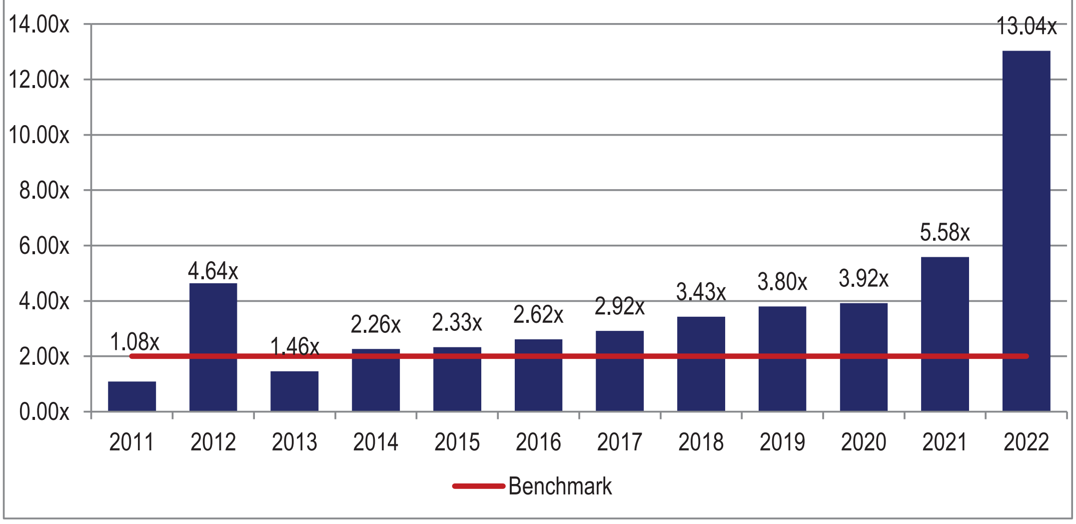



Figure 2 - Interest Cover Ratio for General Fund

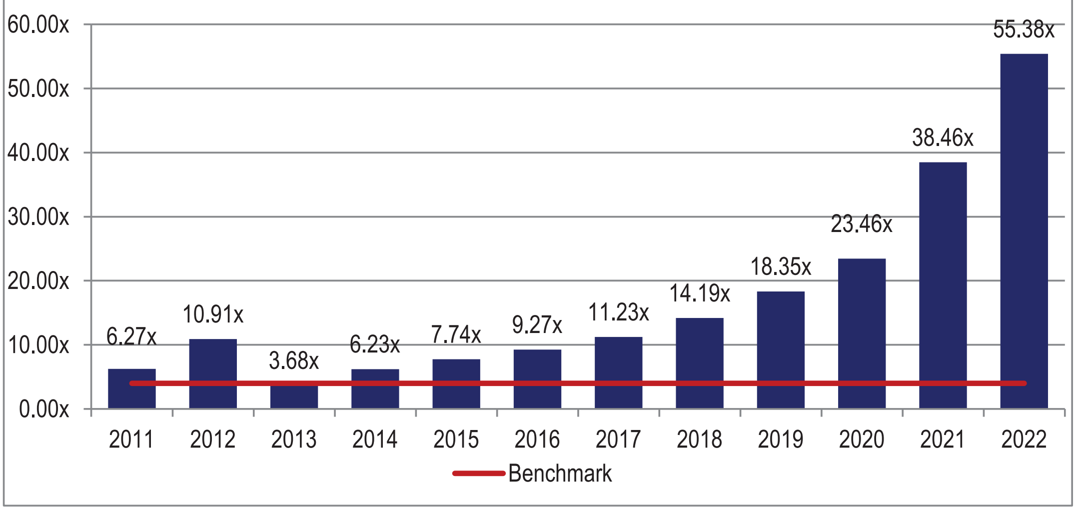
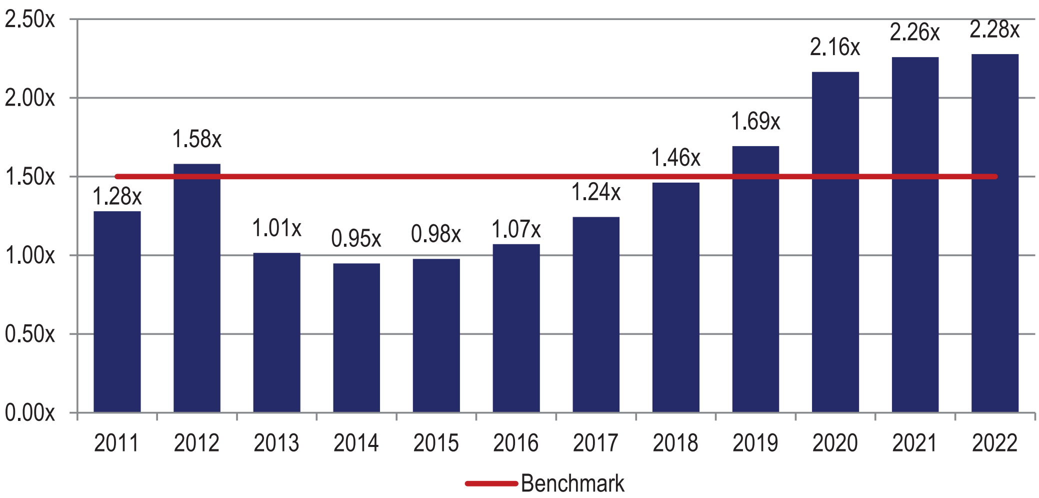


Figure 3 - Unrestricted Current Ratio for General Fund




The key observations from the graphs above are:

- Council's DSCR and Interest Cover Ratio are above benchmark for all forecast years except for 2013 due to the lower EBITDA in that year. The lower EBITDA in 2013 is a result of higher employee costs and, materials and contracts cost. These costs are expected to reduce in future years due to expenditure review measures implemented in the 2013 financial year but the full year effect of these measures will not be seen until 2014. Forecast improvement in EBITDA leads to an increase in the DSCR and Interest Cover Ratio
- Council's forecast Unrestricted Current Ratio is below benchmark until 2019 and in particular, below 1.0x in 2014 and 2015. This is an issue that Council is aware of and is looking at ways to address. Council's aim is to maintain a level of unrestricted cash to cover approximately eight weeks of operational expenditure. Adherence to this minimum unrestricted cash level is vital to ensure Council has the capacity to pay its operating expenses and service debt payments without disruptions to Council operations
- Based on its forecast DSCR and Interest Cover Ratio from 2014, Council should be able service its existing debt of $6.5m from LIRS Round 1 plus the proposed LIRS Round 2 loan. However, given that its forecast liquidity is significantly below benchmark, Council needs to have safeguards in place to ensure it does not face liquidity issues. Its liquidity position needs to be closely monitored and initiatives to improve this situation should be immediately put in place. Council may face liquidity issues if challenged with any unforseen financial shocks
- Council has the option to borrow internally from restricted funds (subject to external approvals) and suspend capital projects should it face liquidity issues. Council has also considered introducing an Environmental Levy which can fund environmental projects currently funded by general revenue

Review of Financial Forecasts

Councils have used their own assumptions in developing their forecasts. The key observations and risks from the LTFP are:

- Council has forecast that the expenditure savings made in the 2013 financial year will have a full impact in the 2014 financial year. This is considered reasonable given that the effect of the savings is already reflected in the 2013 year to date figures when compared to budget The 2013 budget operating results is adversely impacted by redundancy payments as a result of the transfer of the aquatic centre and a swimming pool to private contract management.
- After the initial reduction in costs in 2014, Council expenses are assumed to increase at a steady rate which is considered reasonable
- Rates and annual charges revenue is expected to increase by 3.2% p.a. in line with the historical rate peg
- User fees and charges revenue is assumed to increase by an average of 4.5% p.a. which is optimistic compared to historical trends and benchmarks
- Operating grants and contributions is assumed to decrease in 2013 after the prepayment of FAG in 2012 and is forecast to increase at an average rate of 1.6% p.a.
- Depreciation expense is static throughout the forecast period which is potentially underestimating this expense but the non-cash nature of depreciation will not impact EBITDA and, the Debt Service Cover Ratio and Interest Cover Ratio
- All assumptions used in this model are considered reasonable except for the depreciation expense issue outlined above

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## Appendix 2 Ratio Explanations

Debt Service Cover Ratio (DSCR)

Benchmark = Greater than 2.0x

$$Ratio = \frac{\textit{Operating results before interest and depreciation (EBITDA)}}{\textit{Principal repayments (from the statement of cash flows) + borrowing interest costs (from the income statement)}}$$

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

Interest Cover Ratio

Benchmark = Greater than 4.0x

$$Ratio = \frac{\textit{Operating results before interest and depreciation (EBITDA)}}{\textit{Borrowing interest costs (from the income statement)}}$$

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%

$$Ratio = \frac{\textit{Operating revenue excluding capital grants and contributions – operating expenses}}{\textit{Operating revenue excluding capital grants and contributions}}$$

This ratio measures a Council's achievement of containing operating expenditure within operating revenue. It is important to distinguish that this ratio is focussing on operating performance and hence capital grants and contributions are excluded.

TCorp has made some standard adjustments to some Council's operating revenue and expenses 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).

Own Source Operating Revenue Ratio

Benchmark = Greater than 60%

$$\textit{Ratio} = \frac{\textit{Rates, utilities and charges}}{\textit{Total operating revenue (inclusive of capital grants and contributions)}}$$

This ratio measures 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

$$\textit{Ratio} = \frac{\textit{Current assets less all external restrictions}}{\textit{Current liabilities less specific purpose liabilities}}$$

Restrictions placed on various funding sources (e.g. Section 94 developer contributions, RMS contributions) complicate the traditional current ratio used to assess liquidity of businesses as cash allocated to specific projects is 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 short term obligations as they fall due.

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## Appendix 3 Glossary

| Term | Explanations |
|---|---|
| Asset Revaluations | In assessing the financial sustainability of NSW councils, IPART found that not all councils reported assets at fair value. In a circular to all councils in March 2009, 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.<br>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.<br>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.<br>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. |
| 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.<br>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. |

| | |
|---|---|
| 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.<br>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.<br>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.<br>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 SRVs that a council may apply for:<br>• a single year variation (section 508(2)), or<br>• a multi-year variation for between two to seven years (section 508A).<br>The applications are reviewed and approved by IPART. |

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## Disclaimer

This Report has been prepared by TCorp in accordance with the appointment of TCorp by the DLG. The Report has been prepared to assist the DLG and the Assessment Panel considering the applications for the Local Infrastructure Renewal Scheme (Round 2).

The Report has been prepared based on information provided to TCorp by DLG, each Local Council and from publicly available sources. 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 Councils all of which may negatively impact the financial capability of the Councils. 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.

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# Greater Taree City Council

## Financial Assessment and Benchmarking Report

3 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 letter of 22 December 2011. 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 Greater Taree City Council, the LIRS Assessment Panel and the DLG. TCorp shall not be liable to Greater Taree 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.

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## Index

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# Section 1 Executive Summary

This report provides an independent assessment of Greater Taree 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 one LIRS application for $6.5m for road reconstruction.

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 Greater Taree City operates only one fund we focused our review on this General Fund

Overall, the review has found that the Council has been well managed over the review period based on the following observations:

- While the Council has incurred operating deficits (excluding grants and contributions for capital purposes), Council's underlying operating results (measured using EBITDA) have improved marginally from $8.9m in 2009 to $9.3m in 2011
- The Council was granted a 10% SRV over three years, starting from 2010/11. This will improve their revenue strength and own sourced revenue capacity
- Approximately 61% of the Council's revenue base is derived from own sourced revenue (annual charges, and user charges and fees). This has improved from previous years due to the introduction of the SRV. Whilst 61% is not a high level, Council can rely upon these revenue streams on an ongoing basis for financial flexibility
- Costs appear to have been well managed. The organisational restructuring in 2010 resulted in increased employee costs that year as a result of employee termination expenses, however the restructure should help to constrain costs in future years

The Council reported $274.2m of infrastructure backlog in 2011, with an infrastructure asset value of $483.7m. This is an extremely large backlog compared to other NSW councils and in particular, when compared to Councils of similar size. Other observations include:

- The Council's infrastructure backlog is on an upward trend, and of such a large scale, it is unrealistic to expect that it can be significantly reduced through Council's own resources
- Council expect the backlog to grow by $20.0m p.a.
- Council has been unable to fund the required maintenance amount on the backlog in two of the last three years
- A significant portion of the backlog (92%) is related to roads

The key observations from our review of Council's 10 year forecasts are:

- Council's financial forecast is in real dollars in accordance to long term financial planning guidelines they took from the Australian Centre of Excellence for Local Government. Whilst not explicit, DLG's Integrated Planning and Reporting Manual states that Council's need to consider and make assumptions about the following areas: demographics of the LGA, economic forecasts, inflation forecasts, and interest rate movements amongst other matters. We would expect Council's approach to include the impacts of inflation
  The problem with analysing forecasts in real dollars is in situations where revenues and expenses are not increasing at the same or similar rate. For example, in the case of Greater Taree, revenues over the past three years have increased 14.3%, whilst expenses have increased 54.1%. If this disparity in growth rates is projected over the 10 year financial forecast period, Council's financial results can be expected to be considerably worse than the position shown
- The forecast shows deficit positions are expected in all 10 years when capital grants and contributions are excluded. This is Council's weakest forecast ratio and highlights that over the longer term Council faces financial sustainability issues. Council's current SRV expires in 2013, and while revenues remain flat from that point onwards, expenditure is forecast to fall, resulting in a slightly improving, but still below benchmark operating deficits. Our discussions with Council officers confirm that they have recognised the unsustainability of their current financial forecasts over the long term, and accept that they will have to be adjusted, either through increased revenue or expenditure cuts. Strategies to resolve this forecast position need to be developed and actioned in the short to medium term
- Overall, Council's level of fiscal flexibility is sound as own sourced revenue is maintained at levels above 65%
- The future capital program is highly dependent on the receipt of funds from state and federal capital grants for an exceptional amount of $37m in 2013. Capital grants and contributions are forecasted to amount to under $4m for every other year over the forecast, which is reasonably consistent with historical numbers
- Council has to balance meeting liquidity benchmarks with the poor state of its infrastructure (particularly roads), and have elected to use all available funds to improve a rapidly declining infrastructure network. However, as noted above, Council does not have sufficient resources in the foreseeable future to make any significant reduction in their infrastructure backlog and it is more likely that the backlog will continue to increase

Despite these negatives, in our view, the Council has the capacity to undertake the combined additional borrowings of $6.5m for the LIRS project. This is based on the following analysis:

- The DSCR remains above the benchmark of 2.00x in the 10 year forecast
- The Interest Cover Ratio is well above the benchmark of 4.00x in the 10 year forecast

In respect of the Benchmarking analysis, TCorp has compared the Council's key ratios, on a consolidated basis, with other councils in DLG group 4. The key observations are:

- Council's financial flexibility, as indicated by the Operating Ratio and Own Source Operating Revenue Ratio, is below the group's average
- Council was in an adequate liquidity position which on average is below the group's average liquidity level
- Council is more heavily geared than its peers but its DSCR and Interest Cover Ratio are forecast to be at or above benchmark, respectively, over the medium term
- Council has a comparatively high level of Infrastructure Backlog which is not being adequately addressed by its asset renewal and maintenance works

# 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. Please see the benchmark ratio table below
- 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. Council operate a General Fund only
- 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. 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 | > 1.5x |
| Own Source Operating Revenue Ratio | > 60.0% |
| Debt Service Cover Ratio (DSCR) | > 2.0x |
| Interest Cover Ratio | > 4.0x |
| Infrastructure Backlog Ratio | < 0.02x |
| Asset Maintenance Ratio | > 1.0x |
| Building and infrastructure asset renewal ratio | > 1.0x |
| Capital Expenditure Ratio | > 1.1x |

## 2.3: Overview of the Local Government Area

| Greater Taree City Council LGA | |
|---|---|
| Locality and Size | |
| Locality | Mid North Coast |
| Area | 3,753km² |
| DLG Group No. | 4 |
| Demographics | |
| Population | 49,453 |
| % under 18 | 25% |
| % between 18 and 59 | 49% |
| % over 60 | 26% |
| Estimated population 2031 | 68,454 |
| Operations | |
| Number of employees (FTE) | 237 |
| Annual revenue | $47.8m |
| Infrastructure | |
| Roads | 1,690 km |
| Timber bridges | 105 |
| Infrastructure backlog value | $274.2m |
| Total infrastructure value | $483.7m |

The Greater Taree City Local Government Area (LGA) covers 3,753 square kilometres, stretching from Johns River in the north to Wang Wauk River in the south and up to 100 kilometres to the western hinterland. The area takes in a 50 kilometre coastal strip from Hallidays Point in the south to Crowdy Bay in the north.

Some of the key demographic trends of the LGA include:

- An increase in the over 60's of more than double the state average
- Difficulty retaining and attracting 15-24 year olds
- Increase in the dependence on migration to top-up "natural" population decline

With just over 24,000 rate payers the Council has a sizable infrastructure to manage. There are 740 km of sealed roads and 950 km of unsealed roads. Putting further demands on council resources are over 240 parks and reserves, six swimming pools and five libraries.

## 2.4: LIRS Application

Council has made one LIRS application.

Project : Road reconstruction

Description: 8.75km of road reconstruction on 6 local roads across the LGA. The selected roads for inclusion in the current program are identified in Council's 2012/2014 capital works program, which are drawn from Council's infrastructure backlog assessment.

Amount of loan facility: $6.5m

Term of loan facility: 10 years

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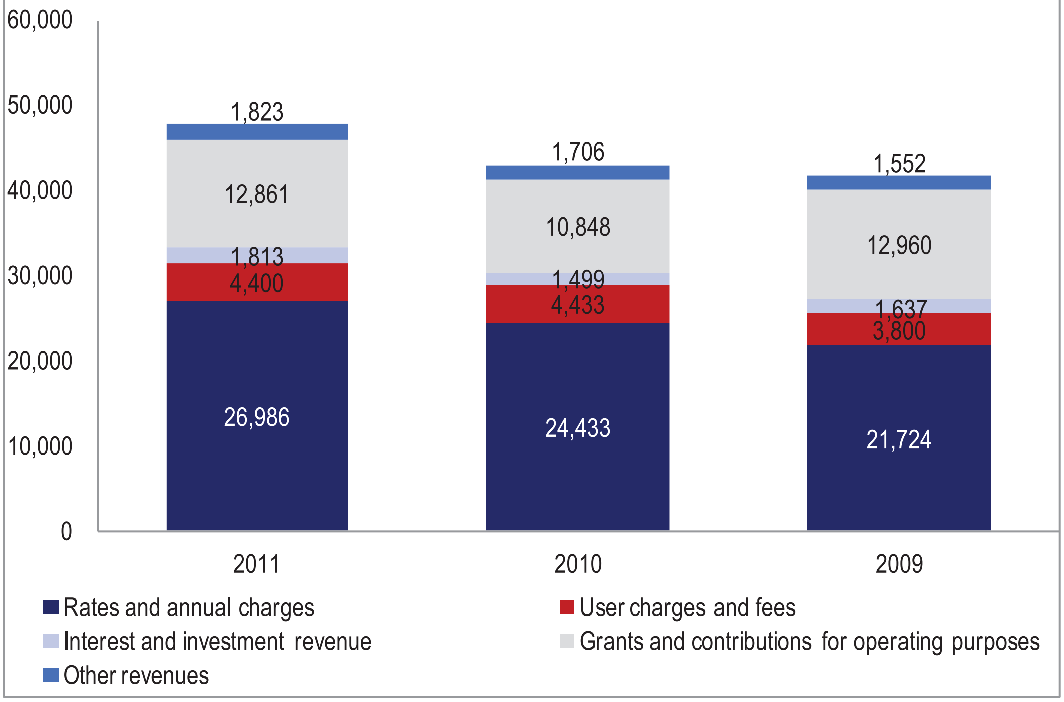
## Section 3 Review of Financial Performance and Position

In reviewing the financial performance of the Council, TCorp has based its review on the annual audited consolidated 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 income for the Council. Rates and annual charges have increased year on year with the introduction of a three year SRV of 10% p.a. which was brought in at the start of the 2011 financial year providing a larger increase than is usual. The SRV was granted to begin priority repair work on infrastructure throughout the LGA and to help prevent the infrastructure backlog from becoming larger.
- User fees and charges increased by 16% between 2009 and 2011 mainly due to increased waste disposal tipping fees.
- After rates and annual charges, grants and contributions for operating purposes is the second largest income stream. With such a large LGA, limited numbers of rate payers, and limited opportunities for generating other revenues, Council is heavily reliant on this income stream.

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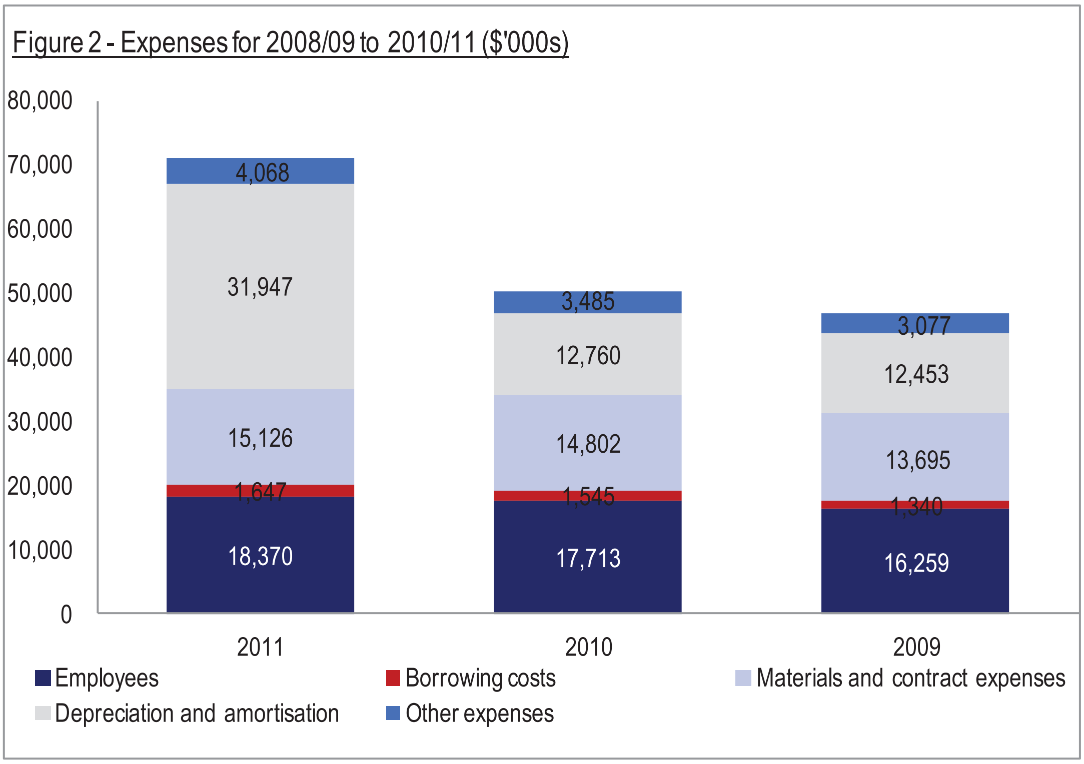
## 3.2: Expenses




Key Observations

- Employee expenses rose for the third consecutive year to $18.4m. While increasing 3.7% in 2011, 2010 saw increases of 8.9% due termination payments to staff following an organisational restructuring, and superannuation payments to the defined benefit scheme almost doubling.
- Materials and contracts costs have increased between 2009 and 2011 mainly due to increased waste management contract charges.
- The Asset Revaluation process resulted in the value of Council's roads, bridges and footpaths being increased and the value of community land decreasing. This revaluation process saw the value of infrastructure increase by $199.7m, and the value of community land fall by $135.6m, resulting in an increase in net assets.
- The rise in other expenses has been driven by the introduction of a waste levy in 2010 by the NSW govt. The waste levy has been offset by increased waste disposal fees.

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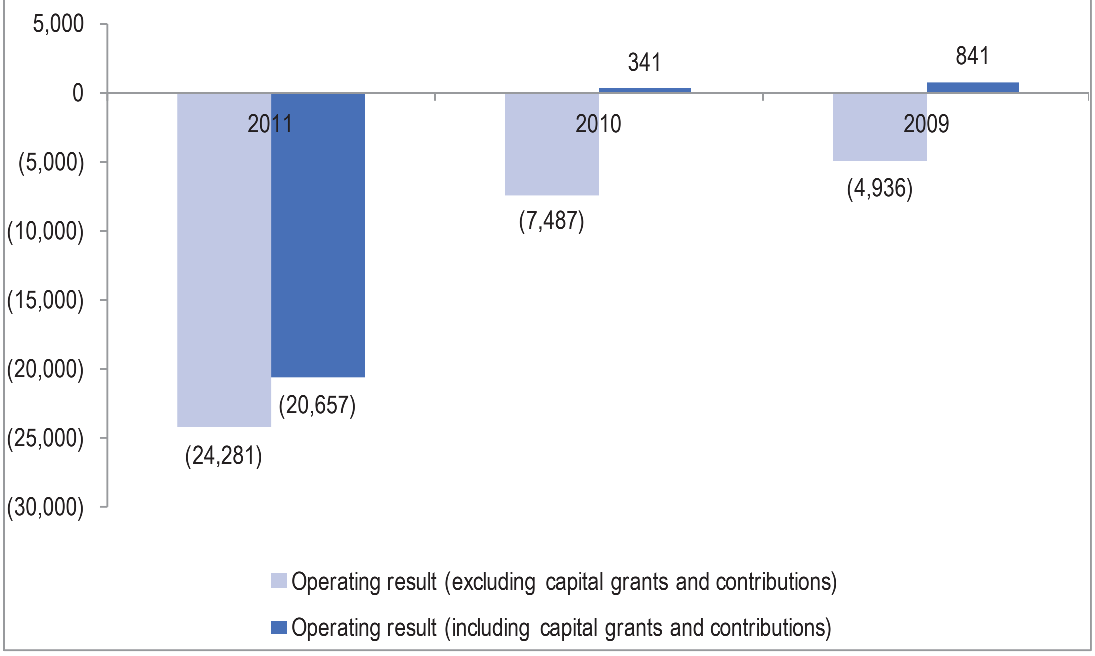
## 3.3: Operating Results

TCorp has made some standard adjustments to focus the analysis on core operating council results. These adjustments relate to grants and contributions for capital purposes, realised and unrealised gains on financial investments, 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 are detailed in Appendix A.

Figure 3 - Operating Results for 2008/09 to 2010/11 ($'000s)




Key Observations

- Council has consistently posted net operating deficits excluding capital grants and contributions. The deficit increased in 2011 due to higher depreciation charges.
- Council expenses include a large non-cash depreciation expense ($31.9m in 2011), which has increased substantially 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 ($'000's) | 9,313 | 6,818 | 8,857 |
| Operating Ratio | (50.7%) | (17.4%) | (11.8%) |
| Interest Cover Ratio | 5.65x | 4.41x | 6.61x |
| Debt Service Cover Ratio | 0.98x | 1.68x | 2.54x |
| Unrestricted Current Ratio | 1.28x | 1.88x | 1.86x |
| Net Assets ($'000's) | 529,215 | 491,663 | 491,322 |

Key Observations

- Council's EBITDA grew between 2009 and 2011. It fell in 2010 due to increases in revenue not matching increased costs such as employee termination costs.
- The DSCR has been below the benchmark of 2.00x over the past 2 years.
- The lower DSCR in 2011 was the result of increased principal repayments in 2011. Scheduled to repay $2.8 m in 2011, the council increased repayments by $5m to $7.8 m to refinance existing loans at reduced interest rates. This was prudent financial management and is not seen as an area of concern.
- The Operating Ratio has deteriorated in 2011 due to the increased depreciation.
- The Unrestricted Current Ratio fell below benchmark of 1.50x in 2011, indicating liquidity is becoming more of a concern. Due to the introduction of the SRV, and to promote goodwill in the community, Council are keen to spend as much as possible on the road infrastructure, however this does adversely impact the liquidly indicators in the process.
- Net Assets have increased by over $37.9m between 2009 and 2011 due to the Asset Revaluations in 2010 that increased the value of roads, bridges, drainage infrastructure, but substantially reduced the value of community land assets.
- When the Asset Revaluations are excluded, the underlying trend in all three years has been a decline in the IPP&E asset base with asset purchases being less than the combined value of disposed assets and annual depreciation. Over the 3 years this amounted to a $17m decrease in IPP&E assets.
- Council has total borrowings of $21.5m. This is comparable to a number of other councils, with the total debt at 4.1% of Net Assets.

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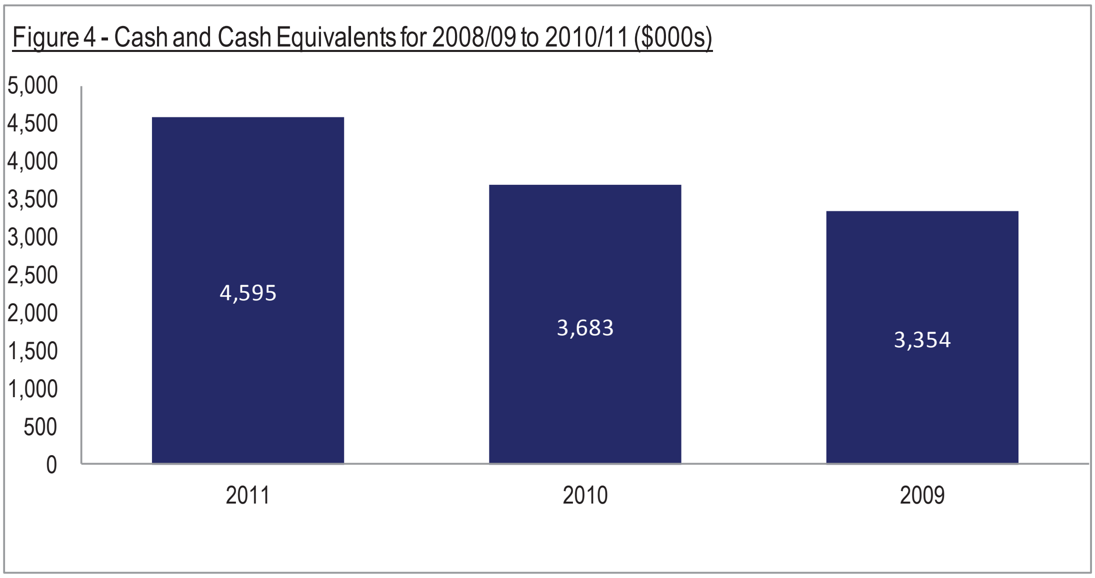
## 3.5: Statement of Cashflows




Key Observations

- Council's net position in cash and equivalents increased in 2011, primarily due to a reduction in the purchase of IPP&E. Whilst this position is not consistent with Council's desire to spend more on roads, we are advised by Council that this is because of the need to carry forward amounts as a result of wet weather and flooding.
- In total, the Council has cash and investments of $32.6 in 2011 of which $24.6m is externally restricted, $3.5m is internally restricted, and $4.6m is unrestricted.
- Within its investments portfolio Council had non-current deposits amounting to $28.0m.
- Overall the cash balances along with the Unrestricted Current Ratio suggest the Council was comfortable in meeting day to day obligations up until 2011 when the Unrestricted Current Ratio fell below the benchmark. Council forecast that they do not expect to meet the DLG benchmark of 1.5x for the lifetime of the forecast indicating they do not put a high priority on meeting this benchmark. Council management have indicated to TCorp that this benchmark is important to them, but it requires commitment by elected officials to reduce expenditure.

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### 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.

| Capital Program ($'000's) | Year ended 30 June | | |
|---|---|---|---|
| | **2011** | **2010** | **2009** |
| New capital works | 1,771 | 9,760 | 2,743 |
| Replacement/refurbishment of existing assets | 10,104 | 7,191 | 12,925 |
| **Total** | 11,875 | 16,951 | 15,668 |

The majority of the capital budget is tied up in replacement and refurbishment of existing assets. New projects will generally have a lower priority with such a large infrastructure network to maintain. Any cut in grants and contributions would have an immediate effect on the capital works program and the infrastructure backlog.

### 3.6(a): Infrastructure Backlog

Figure 5 - Infrastructure Backlog for 2008/09 to 20010/11 ($'000's)

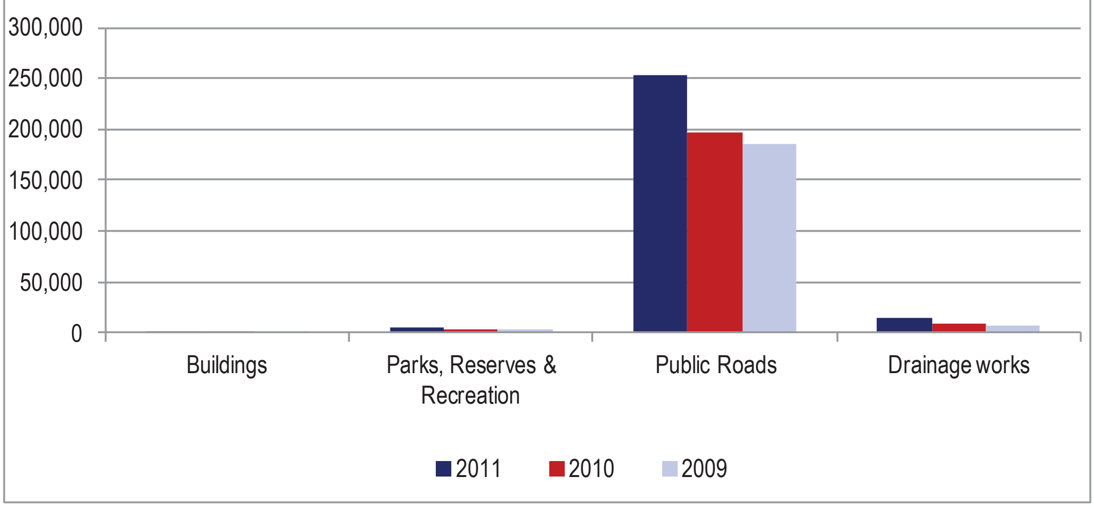
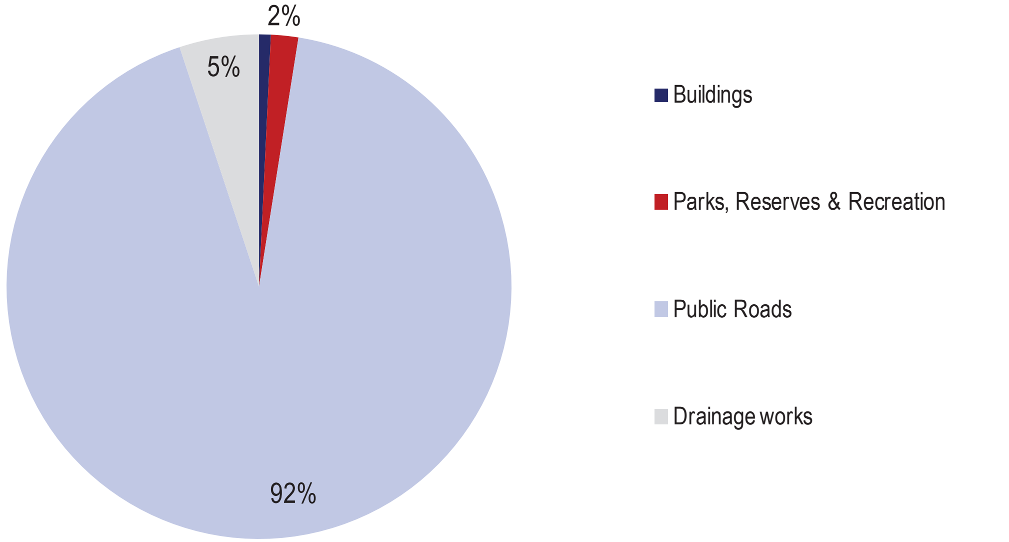


Figure 6 - Infrastructure Backlog Composition for 2010/11




The Council reported a $274.2m backlog in 2011 up from a reported backlog of $197.7m in 2009. With such an extensive road network to maintain it is no surprise to see that the backlog is 92% road related. Council maintain that "the infrastructure backlog is likely understated and has been exacerbated by natural disaster and an inadequate response to natural disasters by the state". The current level of infrastructure backlog requires significantly increased levels of maintenance to ensure assets can be operated at appropriate standards.

Council do not feel that it is realistic to expect that the backlog can be reduced to a lower level, giving a conservative estimate that it will grow by $20.0m p.a.

### 3.6(b): Infrastructure Status

| Infrastructure Status | Year ended 30 June | | |
|---|---|---|---|
| | 2011 | 2010 | 2009 |
| Bring to satisfactory standard ($'000's) | 274,213 | 212,929 | 197,744 |
| Required annual maintenance ($'000's) | 19,694 | 14,359 | 12,369 |
| Actual annual maintenance ($'000's) | 10,035 | 14,364 | 10,981 |
| Total value infrastructure assets ($'000's) | 483,726 | 322,955 | 320,184 |
| Total assets ($'000's) | 568,257 | 525,074 | 520,563 |
| Infrastructure Backlog Ratio | 0.57x | 0.66x | 0.62x |
| Asset Maintenance Ratio | 0.51x | 1.00x | 0.89x |
| Building and Infrastructure Asset Renewal Ratio | 0.12x | 0.69x | 0.91x |
| Capital Expenditure Ratio | 0.31x | 1.23x | 1.18x |

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Council has a large Infrastructure Backlog ratio of 0.51x compared to many councils which have ratios of between 0.05x and 0.20x. The Infrastructure Backlog Ratio decreased in 2011 due to the revaluation process increasing the value of the infrastructure at a greater rate than the increase in the value of the backlog. However the backlog increased in real terms.

Both the Building and Infrastructure Asset Renewal Ratio, Asset Maintenance Ratio, and the Capital Expenditure Ratio are not meeting the benchmarks and indicate that Council did not spend enough on asset renewal and asset maintenance in 2011.

### 3.6(c): Capital Program

Some of the capital works undertaken by Council in the last year are set out in the following table.

| Funding | Infrastructure | Timeline |
|---|---|---|
| $2.24m | Reconstruction of Gloucester Road | Completed July 2011 |
| $1.4m | Reconstruction of a 1.3km section of Wingham Road | Due for completion October 2011 |
| $800,000 | Reconstruction works on Queen Street North | Commenced |
| $178,000 | CBD beautification works | Commenced |

**Additional Road Works planned for early 2012**

| Funding | Infrastructure | Timeline |
|---|---|---|
| $1.5m | Cowper St, Taree | Started February 2012 |
| $400,000 | Blackhead Rd | Started February 2012 |
| $1.2m | Stevenson St, Taree | Started February 2012 |

### 3.7: Specific Risks to Council

- Environmental and natural disasters. Greater Taree is subject to the impacts of climate change and sea level rises as it has over 50km of coastline. The LGA has had two Natural Disaster Declarations since 2009 due to flooding. Council's management of this risk is substantially reliant on being able to receive both state and federal funding under various "natural disaster" funds.
- Council recognised impairments of $19.2m in 2011 due to floods. Current advice from RMS is that $8.3m of the $19.2m claim has been assessed and $2.3m has been approved. Approximately $3m is under question by RMS and $7m is subject to a geotechnical investigation as it relates to land slip damage. A shortfall in the impairment reimbursement of more than $10m is probable according to Council. Council has no means of funding this

shortfall other than deferring other capital works and hence further increasing its infrastructure backlog.

- Council has provided guarantees to community organisations and sporting bodies, amounting to $371,500 at 30 June 2011. Failure of any of these community bodies could adversely impact Council's finances.
- The infrastructure backlog is causing increased community concern and reaction. Provision of access, bus services, student's school attendance, and capacity for primary production transportation have all been questioned due to the state of the infrastructure.

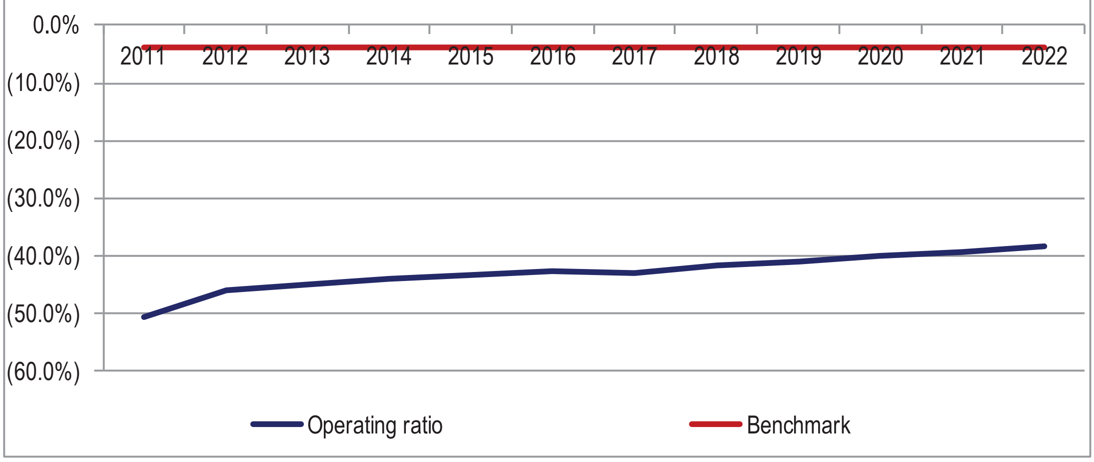
## Section 4 Review of Financial Forecasts

The financial model shows the projected financial statements and assumptions for the next 10 years. The model includes the combined $6.5m of loans applied for under LIRS but without any subsidy.

Council operate just one General Fund covering all activities.

### 4.1: Operating Results

Figure 7 - Operating Ratio




The results show significant deficit positions are expected each year when capital grants and contributions are excluded. The increased depreciation charges following the Asset Revaluations are impacting on this ratio.

The operating deficit is forecast to gradually improve ever so slightly as operating expenses are forecast to decrease due to reduced borrowing costs.

However these forecasts indicate Council will face sustainability issues in the future unless additional revenue sources are found, services are cut, or other expenses are able to be reduced.

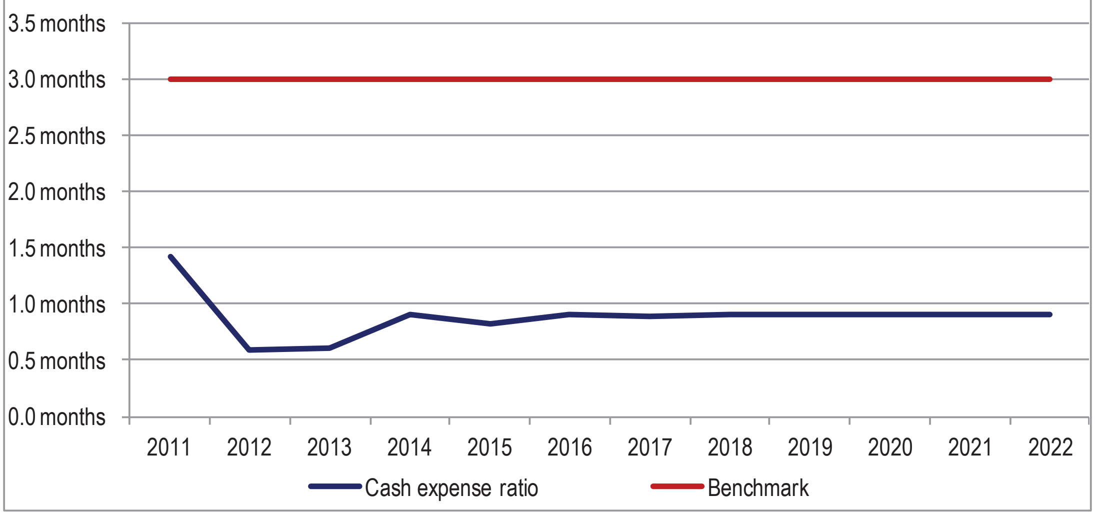
In discussions with Council officers, they have indicated that Council has cut administration and operating costs. Council say that future operating costs are dependent of a reduction in service levels as all avenues for current efficiency savings have been exhausted. This will be a matter for the new Council in September 2012.

## 4.2: Financial Management Indicators

The financial management indicators are linked to the utilisation of debt in early years and improve over time as the amortising debt reduces and operating deficits also improve. However the liquidity indicators suggest Council have left themselves in a marginally liquid position albeit below benchmark for the lifetime of the forecast.

Liquidity Ratios

Figure 8 - Cash Expense Ratio




The Cash Expense Ratio indicates that Council operate with little room for flexibility in regard to liquidity. This ratio is already below benchmark, and is not forecast to improve. However, this ratio does not take into account Council's level of investments. When investments are considered, this shows that Council will not actually face liquidity issues, and remain above the benchmark for the life of the forecast.

Figure 9 - Cash Expense Ratio (Including Current Investments)

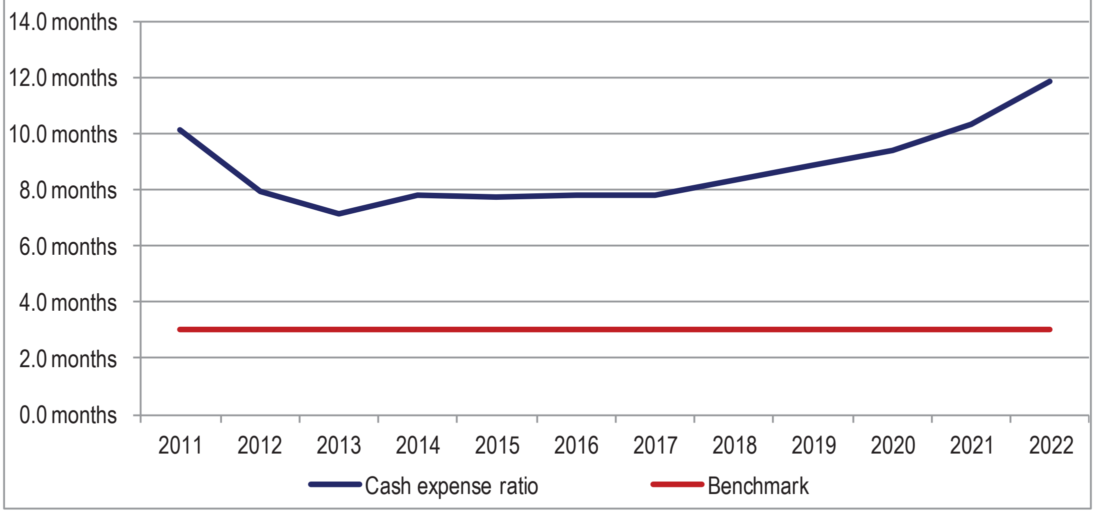
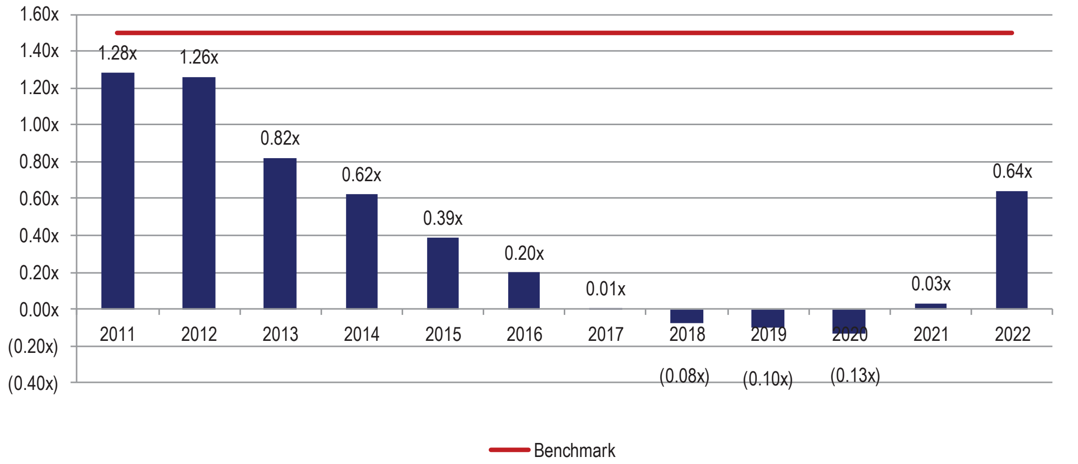


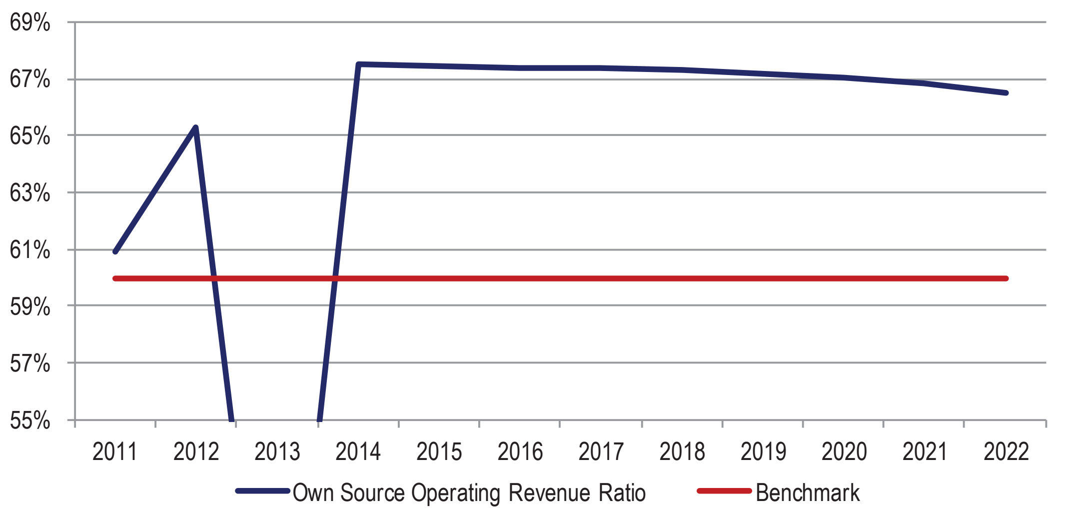
Figure 10 - Unrestricted Current Ratio



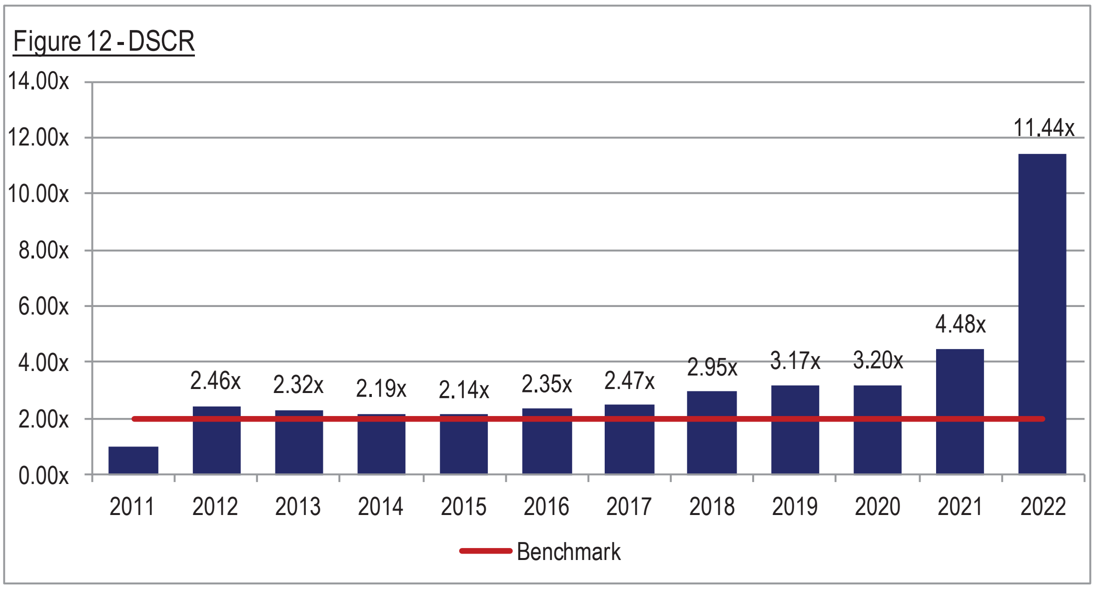

The Unrestricted Current Ratio is at the lowest position in 2020 however it is below the IPART benchmark figure of 1.5x for each year of the forecast. These forecast results are below the historical ratio performance therefore it appears that Council have been prudent when forecasting these figures. As discussed in section 3.4, Council prioritise road improvements ahead of meeting liquidity benchmarks.

Fiscal Flexibility Ratios

Figure 11 - Own Source Operating Revenue Ratio

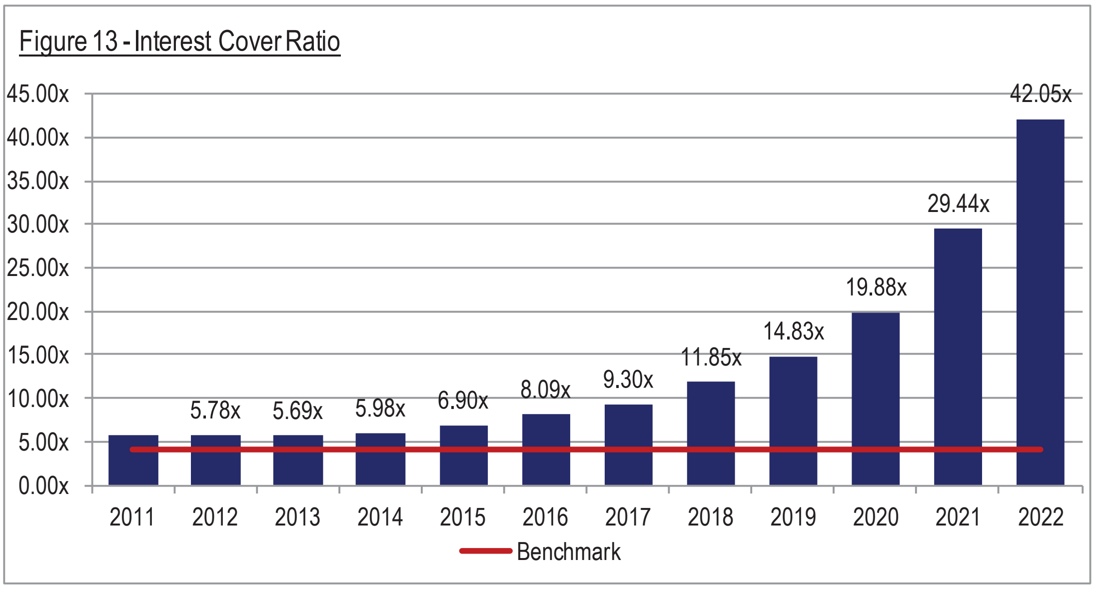



The Own Source Operating Revenue Ratio shows a strong result with Council's net rates, utilities and charges remaining over 65% against the 60% benchmark figure of total revenue. The one exception to this is 2013, due to forecast capital grants of $37.8m.




The DSCR is above the benchmark of 2.00x for the 10 years of the forecast. This indicates that the Council has the capacity to manage the additional debt cost that the LIRS application relates to.

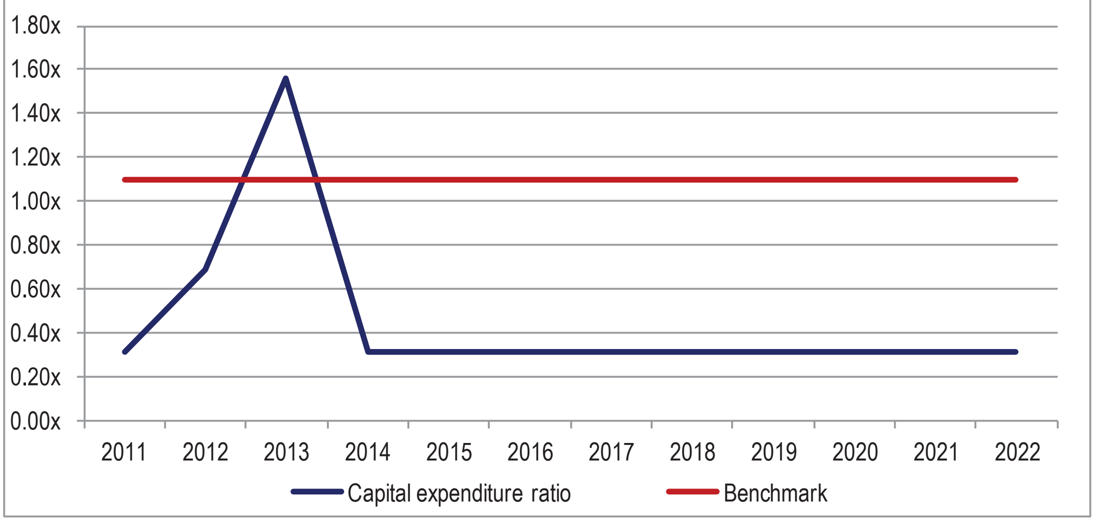
This also corresponds with Council having a relatively moderate level of borrowings. The improving ratio over time is due to an increasing EBITDA and a decrease in debt service costs over time as Council pays down its debt.




The Interest Cover Ratio, similarly to the DSCR, shows the Council has sufficient capacity to service scheduled debt commitments, including the LIRS loan. There is capacity to service further debt interest costs before the Council's ratio decreases to the 4.00x benchmark.

## 4.3: Capital Expenditure

Figure 14 - Capital Expenditure Ratio




The Capital Expenditure Ratio shows a large spike in 2013 followed by Council forecasting the ratio being significantly below the benchmark in nine out of 10 years. The total deficit for capital expenditure versus depreciation across the 10 year period amounts to $185.8m in nominal terms.

Capital expenditure is boosted by forecast capital grant income of $37m in 2013. Due to the injection of works nominated under the SRV, state funded projects, and federally funded projects, Council will undertake the capital works programs including:

- $6m reconstruction of Marlee and Duffs Bridges
- $8m in federal funds on the Bucketts Way
- $9m in federal funds on Gloucester Road, Manning Point Road and Old Bar Road
- $3.1m in federal funds on Dickenson and Dyers Crossing Bridges
- $2m in state funds on The Lakes Way
- $5m in state funds on Wallanbah and Avalon Roads
- $6.5m in SRV funds on Manning Point Road, Saltwater Road, Lobban Road, Murray Road and Pulteney Street
- $1m in SRV funds on a gravel road resheet program and
- $1m in roads to recovery federal funds on resheeting Glenwarrin, Bunyah, Bobin Creek and Cedar Party unsealed roads

### 4.4: Financial Model Assumption Review

The Council 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 benchmarks for annual increases in the various revenue and expenditure items. Any material differences from these benchmarks should be explained through the LTFP.

TCorp 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 2013 financial year will be 3.6%. Beyond 2013 TCorp has assessed a general benchmark for rate and an annual charge to be an increase by mid-range LGCI annual increases of 3%
- Interest and investment revenue: annual return of 5%
- All other revenue items: the estimated annual CPI increase of 2.5%
- Employee costs: 3.5% (estimated CPI+1%)
- All other expenses: the estimated annual CPI increase of 2.5%

Key Observations and Risks:

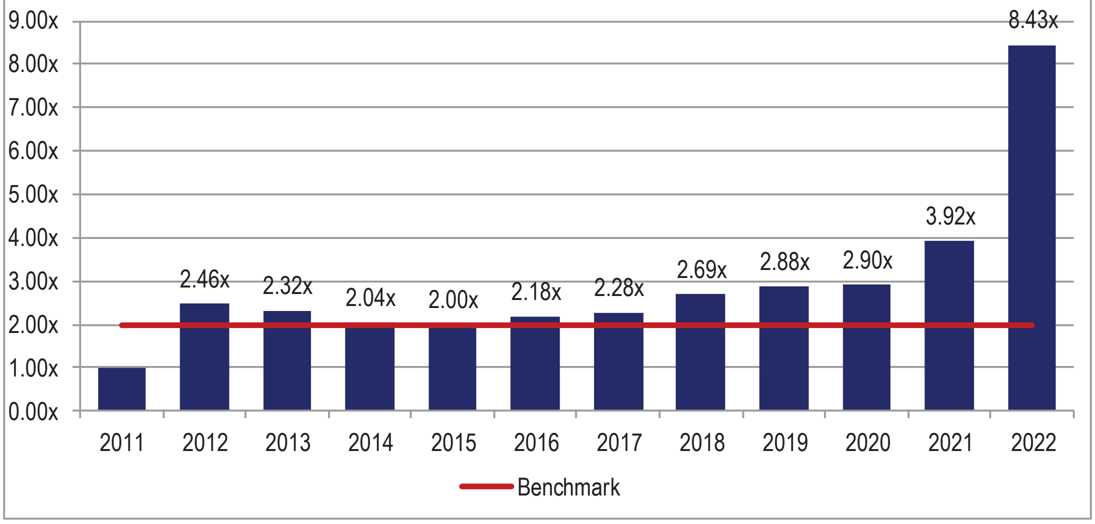
- The LTFP assumes that current service levels will remain unchanged
- In forecasting their results, Council have used "Long Term Financial Planning Practice Note 6" by The Institute of Public Works Engineering Australia, and the Australian Centre of Excellence for Local Government (January 2012). This approach forecasts all revenues and costs in real dollars
- The underfunding of capital works versus forecast depreciation, results in a shrinking assets base with Net Assets expected to decline from $529.8m to $355.8m by 2022
- Council are forecasting flat income streams with no growth. Whilst this appears to be inconsistent with the forecast population growth for the area, Council maintain that there has been no growth in population that impacts on revenue in recent years and development statistics are flat lining. Based on current information they believe it is prudent to not include growth in the long term financial plan although they will continue to review that position annually.
- From our discussions with Council officers, we understand, Council has no prospects for other commercial opportunities to raise revenues that are material
- Expenditure is forecast to fall as loans are paid off and borrowing costs reduce. Efficiencies will continue to be pursued but are not expected to deliver any significant achievable savings. Council say that no decisions have been made to reduce services
- Council's capital program is highly dependent on $37m in state and federal funding due to be received in 2012/13. Discussions with Council officers indicate that they expect this funding to be forthcoming with some certainty due to strong political representation
- Council's forecasts are at risk from natural disasters. The LGA has had two Natural Disaster Declarations since 2009 due to floods

Council's approach to forecasting is fundamentally different to TCorp's due to Council's use of real dollars. Whilst some of the assumptions made in arriving at the forecasts may be reasonable, we are unable to confirm the reasonableness of the forecasts until we are provided with detailed plans on proposed cost reduction action plans.

### 4.5: Borrowing Capacity

Subject to the issues raised in section 4.4, when analysing the financial capacity of Council we believe the Council could be able to incorporate additional loan funding in addition to the LIRS loan facilities. However due to Council's marginal liquidity position we would not recommend adding more debt in addition to the LIRS borrowings. Some comments and observations:

Figure 15 - DSCR




- Based on a benchmark of DSCR>2.00x, Council could borrow $2.9m in addition to the $6.5m borrowings proposed under LIRS in 2013
- The DSCR is at its lowest position in 2015 and capacity increases over the life of the forecast
- The DSCR is at its highest in 2022 due to much lower principal repayments
- This scenario has been calculated by basing borrowing capacity on a 10 year amortising loan
- The ratio improves in the latter years of the forecast as despite the flat revenue, expenditure is forecast to decrease, resulting in higher EBITDA

## Section 5 Benchmarking and Comparisons with Other Councils

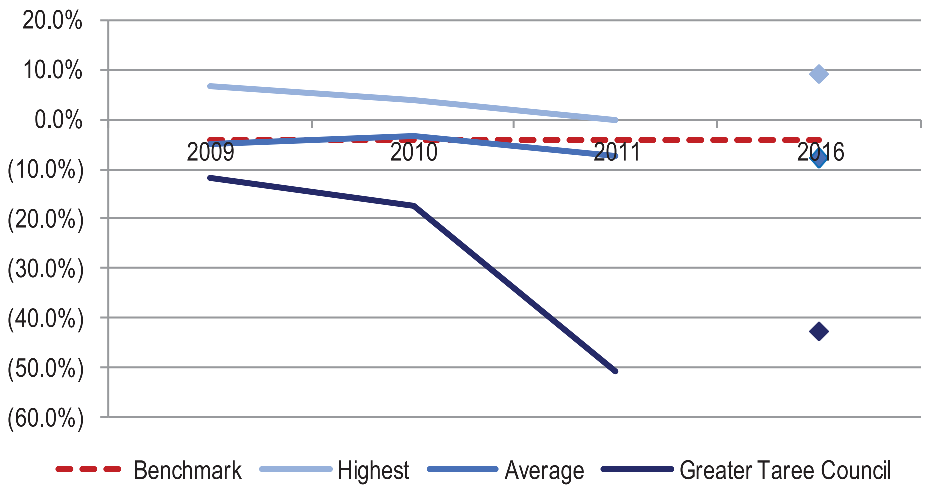
As discussed in Section 2 of this report, each council's performance has been assessed against ten key benchmark ratios. The benchmarking assessment has been conducted on a consolidated basis (that is, for councils that operate more than one fund, the results of all funds are included). This section of the report compares the Council's performance with its peers in the same DLG Group. The Council is in DLG Group 4. There are 32 councils in this group and at the time of preparing this report, we have data for 19 of these councils.

In Figure 16 to Figure 22, 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 23 to 25 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.

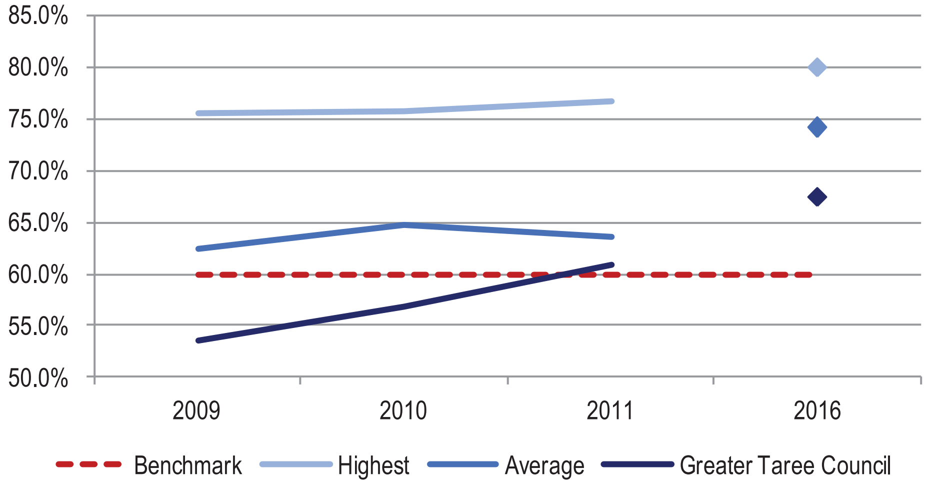
Financial Flexibility

Figure 16 - Operating Ratio Comparison




Council's Operating Ratio was below average in the past three years. Council experienced a decline in operating results in 2011, due to increased depreciation expense. The decline was greater than that experienced by other councils in the group. The results are forecast to remain well below benchmark and the group's average over the medium term.

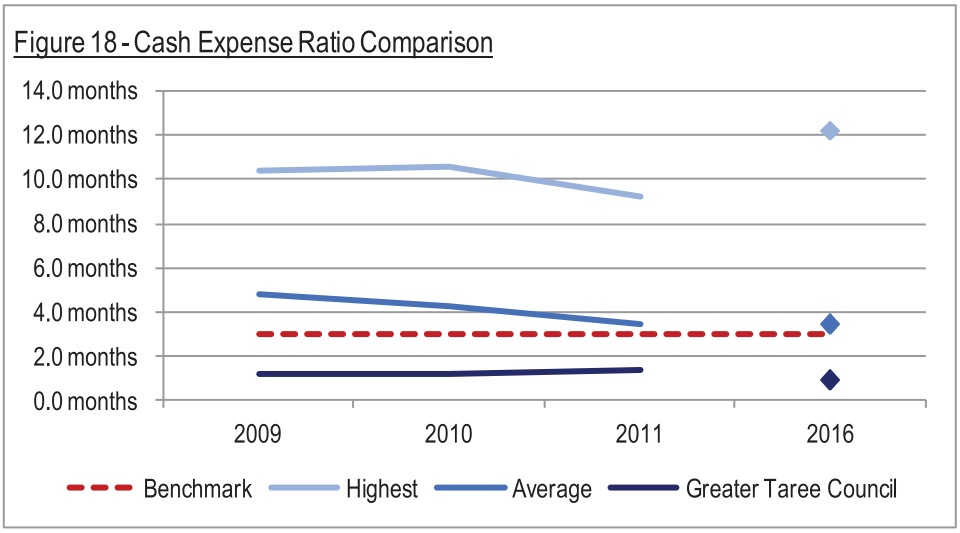
Figure 17 - Own Source Operating Revenue Ratio Comparison

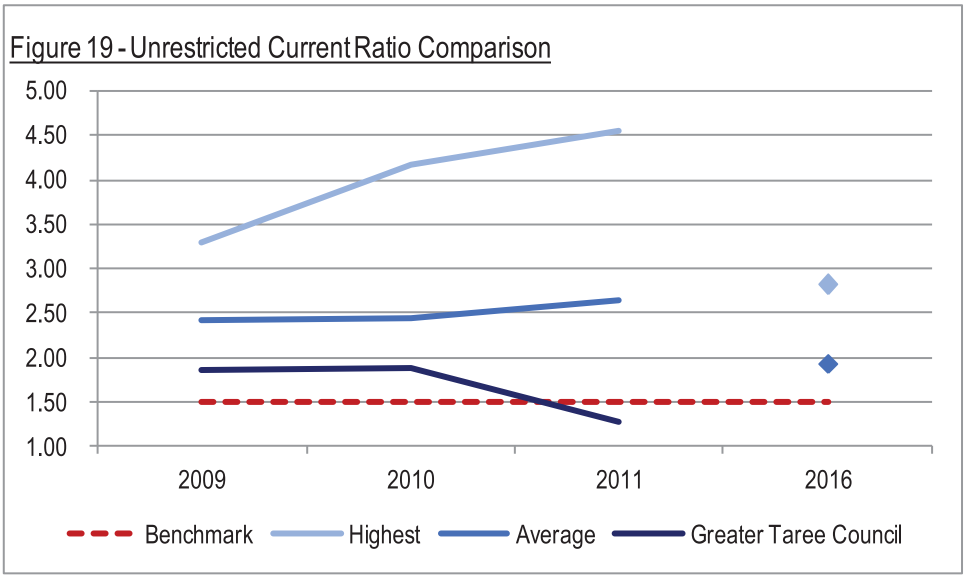



Council's Own Source Operating Ratio was below the group average in the past three years and below benchmark in 2009-2010. However, Council's fiscal flexibility is improving and is forecast to improve further in the medium term.

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

Liquidity




Council's Cash Expense Ratio is below the group's average and the benchmark in the past three years, and is expected to remain so over the medium term.

Council's Unrestricted Current Ratio is also below average in the past three years, and fell below benchmark in 2011. Consistent with other councils in the group, Council's ability to meet its liabilities is forecast to deteriorate in the medium term.

Overall, Council's liquidity is forecast to remain adequate.

Debt Servicing

Figure 20 - Debt Service Cover Ratio Comparison

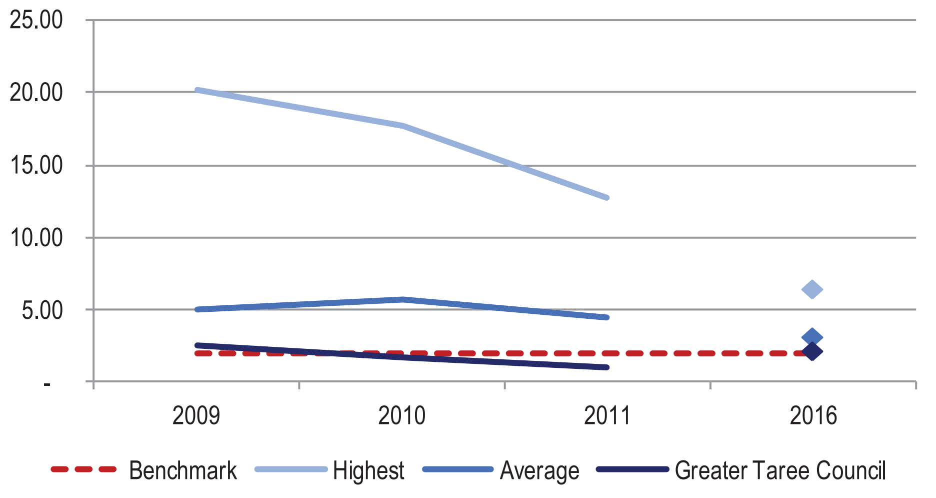
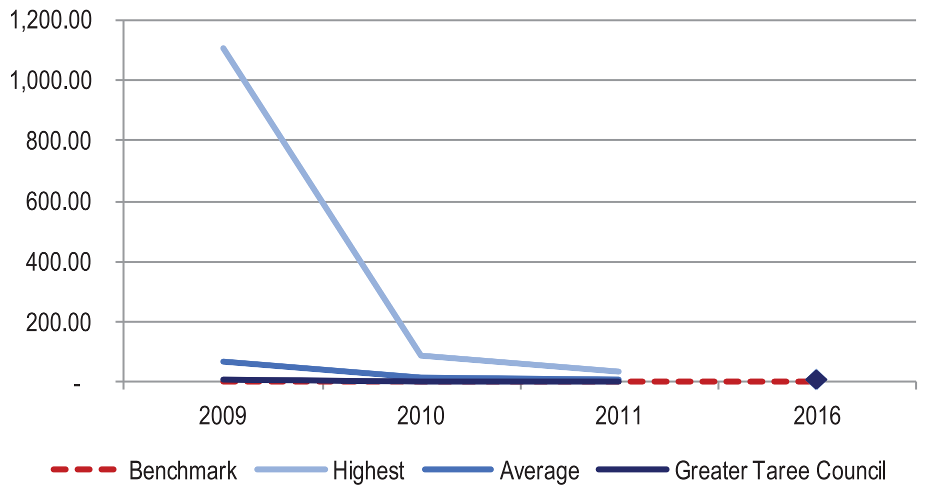



Figure 21 - Interest Cover Ratio Comparison




Over the review period, Council was below the group's average DSCR and Interest Cover Ratio. Council has remained around benchmark over the same period.

Overall, Council is forecast to improve its debt servicing over the medium term to sufficient levels.

## Asset Renewal and Capital Works

Figure 22 - Capital Expenditure Ratio Comparison

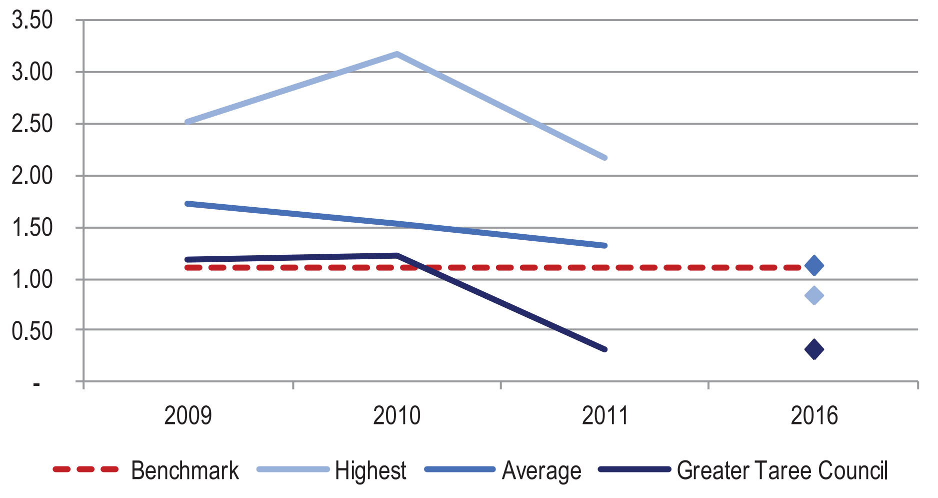



Figure 23 - Asset Maintenance Ratio Comparison

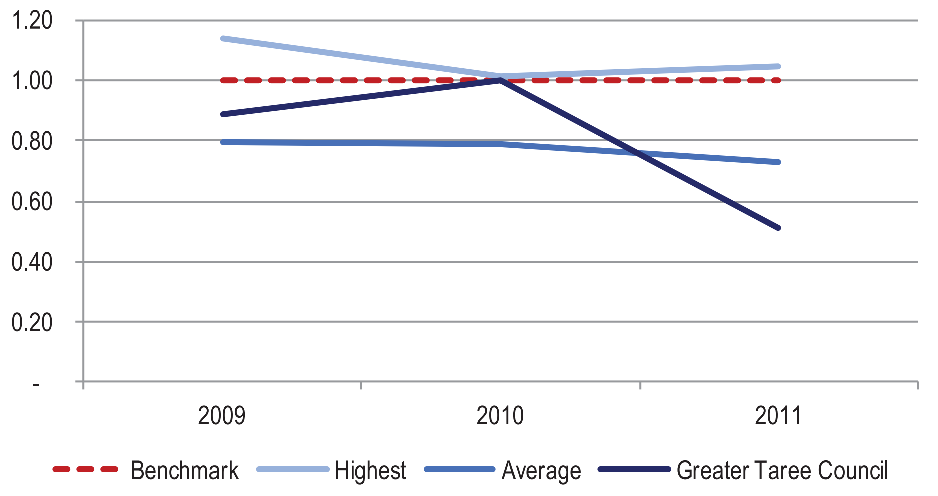


Figure 24- Infrastructure Backlog Ratio Comparison

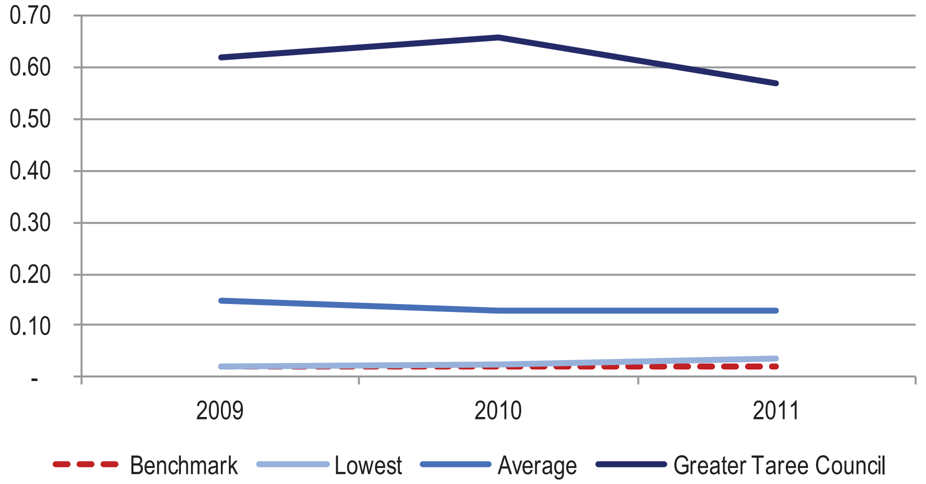
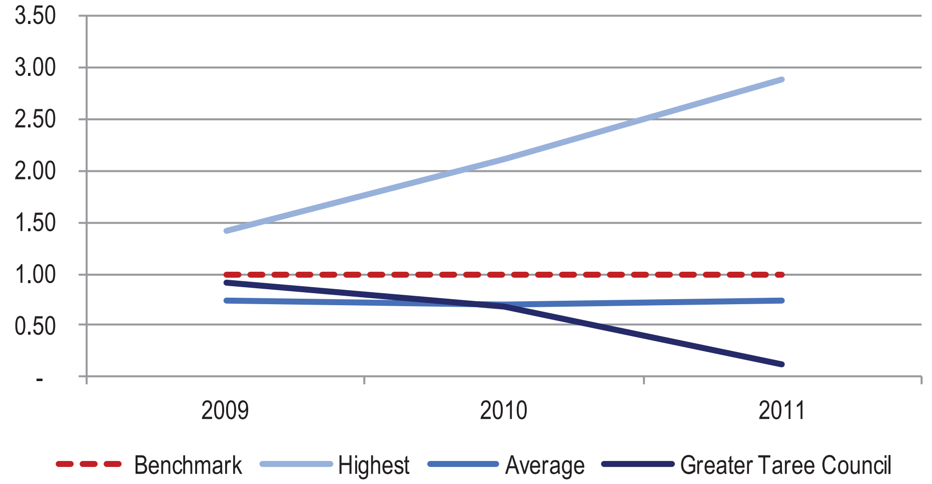



Figure 25 - Building and Infrastructure Asset Renewal Ratio




Council's Capital Expenditure Ratio remained below the group's average in the past three years and dipped below benchmark in 2011. It is forecast to remain well below benchmark over the medium term.

Council's Asset Maintenance Ratio has fluctuated over the review period, falling sharply in 2011 to below benchmark and group average, implying that Council is not spending a sufficient amount on asset maintenance. This is also the case for asset renewal expenditure.

Council has a much higher Infrastructure Backlog than benchmark and the average council in the group.

Overall, Council's asset renewal and capital works are insufficient to stop the infrastructure backlog from growing.

## 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 in a satisfactory financial position in the short to medium term in terms of their operating performance. However, clearly Council has insufficient financial resources to meet its future capital expenditure requirements or to address its infrastructure backlog.

Both past performance and the financial forecasts support our findings that Council has sufficient financial capacity to service the additional borrowings proposed under its LIRS application.

We base our recommendation on the following key points:

- Council has sufficient financial capacity to repay the additional $6.5m debt highlighted by a DSCR and Interest Cover Ratio above the benchmarks in all 10 years of its financial forecast
- Council has maintained control of expenses in the past three years, especially employee costs where other councils have seen considerable increases
- Council has a moderate level of borrowings at $21.5m, only 4.1% of net assets
- Council have been proactive in estimating and achieving efficiencies as evidenced by the organisational review in 2010

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

- Operating deficit results excluding capital grants and contributions are forecast to remain for the 10 year forecast period. These operating deficit results are all substantially below the benchmark target of (4%). This is a significant issue that could impact the long term financial sustainability of the Council. We recommend Council considers its options for improving its performance in this area, either by further and on-going cost controls, or securing new or additional revenue, such as an additional SRV in future years
- Council's infrastructure backlog is already 0.57x of its infrastructure assets and estimated to be growing by over $20m p.a. This backlog is clearly unsustainable and a problem that Council will be unable to address without significant external funding support
- Council have the difficult task of balancing sufficient liquidity, with spending as much as possible on an already daunting infrastructure backlog. We believe that Council should, in the short to medium term focus on developing strategies to resolve this long term forecast position

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Treasury Corporation

## Appendix A Historical Financial Information Tables

Table 1- Income Statement

| Income Statement ($'000's) | Year ended 30 June | | | % annual change | |
|---|---|---|---|---|---|
| | 2011 | 2010 | 2009 | 2011 | 2010 |
| **Revenue** | | | | | |
| Rates and annual charges | 26,986 | 24,433 | 21,724 | 10.4% | 12.5% |
| User charges and fees | 4,400 | 4,433 | 3,800 | (0.7%) | 16.7% |
| Interest and investment revenue | 1,813 | 1,499 | 1,637 | 20.9% | (8.4%) |
| Grants and contributions for operating purposes | 12,861 | 10,848 | 12,960 | 18.6% | (16.3%) |
| Other revenues | 1,823 | 1,706 | 1,552 | 6.9% | 9.9% |
| Net gain from disposal of assets | 0 | 0 | 215 | N/A | N/A |
| **Total revenue** | **47,883** | **42,919** | **41,888** | **11.6%** | **2.5%** |
| **Expenses** | | | | | |
| Employees | 18,370 | 17,713 | 16,259 | 3.7% | 8.9% |
| Borrowing costs | 1,647 | 1,545 | 1,340 | 6.6% | 15.3% |
| Materials and contract expenses | 15,126 | 14,802 | 13,695 | 2.2% | 8.1% |
| Depreciation and amortisation | 31,947 | 12,760 | 12,453 | 150.4% | 2.5% |
| Other expenses | 4,068 | 3,485 | 3,077 | 16.7% | 13.3% |
| Net losses from disposal of assets | 1,006 | 101 | 0 | 896.0% | N/A |
| **Total expenses** | **72,164** | **50,406** | **46,824** | **43.2%** | **7.6%** |
| **Operating result (excluding capital grants and contributions)** | **(24,281)** | **(7,487)** | **(4,936)** | **(224.3%)** | **(51.7%)** |
| **Operating result (including capital grants and contributions)** | **(20,657)** | **341** | **841** | **(6157.8%)** | **59.5%** |

Table 2 - Items excluded from Income Statement

| Excluded items ($'000) | | | |
|---|---|---|---|
| | 2011 | 2010 | 2009 |
| Grants and contributions for capital purposes | 3,624 | 7,828 | 5,777 |
| Impairments | 19,248 | 0 | 0 |

Table 3 - Balance Sheet

| Balance Sheet ($'000's) | Year Ended 30 June | | | % annual change | |
|---|---|---|---|---|---|
| | 2011 | 2010 | 2009 | 2011 | 2010 |
| **Current assets** | | | | | |
| Cash and equivalents | 4,595 | 3,683 | 3,354 | 24.8% | 9.8% |
| Investments | 28,000 | 26,000 | 25,000 | 7.7% | 4.0% |
| Receivables | 6,607 | 3,545 | 3,220 | 86.4% | 10.1% |
| Inventories | 670 | 667 | 702 | 0.4% | (5.0%) |
| Other | 655 | 68 | 169 | 863.2% | (59.8%) |
| Total current assets | 40,527 | 33,963 | 32,445 | 19.3% | 4.7% |
| **Non-current assets** | | | | | |
| Receivables | 142 | 164 | 147 | (13.4%) | 11.6% |
| Inventories | 12 | 12 | 12 | 0.0% | 0.0% |
| Infrastructure, property, plant & equipment | 527,576 | 490,935 | 487,959 | 7.5% | 0.6% |
| Total non-current assets | 527,730 | 491,111 | 488,118 | 7.5% | 0.6% |
| **Total assets** | **568,257** | **525,074** | **520,563** | **8.2%** | **0.9%** |
| **Current liabilities** | | | | | |
| Payables | 6,759 | 4,148 | 3,508 | 62.9% | 18.2% |
| Borrowings | 2,263 | 2,820 | 2,249 | (19.8%) | 25.4% |
| Provisions | 4,810 | 4,589 | 4,875 | 4.8% | (5.9%) |
| Total current liabilities | 13,832 | 11,557 | 10,632 | 19.7% | 8.7% |
| **Non-current liabilities** | | | | | |
| Borrowings | 19,282 | 17,007 | 14,195 | 13.4% | 19.8% |
| Provisions | 5,928 | 4,847 | 4,414 | 22.3% | 9.8% |
| Total non-current liabilities | 25,210 | 21,854 | 18,609 | 15.4% | 17.4% |
| **Total liabilities** | **39,042** | **33,411** | **29,241** | **16.9%** | **14.3%** |
| **Net assets** | **529,215** | **491,663** | **491,322** | **7.6%** | **0.1%** |

Table 4-Cashflow

| Cash Flow Statement ($'000's) | Year ended 30 June | | |
|---|---|---|---|
| | **2011** | **2010** | **2009** |
| Cash flows from operating activities | 10,192 | 10,008 | 13,731 |
| Cash flows from investing activities | (10,998) | (13,062) | (10,134) |
| Proceeds from borrowings and advances | 9,600 | 5,900 | 1,150 |
| Repayment of borrowings and advances | (7,882) | (2,517) | (2,143) |
| Cash flows from financing activities | 1,718 | 3,383 | (993) |
| **Net increase/(decrease) in cash and equivalents** | **912** | **329** | **2,604** |
| Cash and equivalents | 4,595 | 3,683 | 3,354 |

New South Wales
Treasury Corporation

# 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 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

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.

# Review of TCorp's Report *'Financial Sustainability of the NSW Local Government Sector'*

Final Report 3 October 2014

John Comrie
JAC Comrie Pty Ltd

## Contents

## 1. Introduction

The New South Wales Treasury Corporation (TCorp) April 2013 report, *'Financial Sustainability of the New South Wales Local Government Sector',* (TCorp report), was informed by its detailed assessment of each council's own published financial reports.[1] Based on its analysis, TCorp gave at that time approximately 75% of councils a moderate or better financial sustainability rating and 25% a weak or worse rating.[2] It also looked at councils' forward financial projections and concluded that without a change in their financial strategies the financial sustainability outlook rating was positive for only 3% of councils, neutral for 49% and negative for the remainder.[3] It suggested that if nothing changed 48% of councils could have a weak or worse rating within 3 years.[4] TCorp also emphasised that the local government sector had been reporting that it had significant asset renewal backlog needs.

Many councils expressed concern at the rating TCorp attached to their financial sustainability. Local Government New South Wales, (LGNSW), recently engaged Mr John Comrie to undertake a review of the TCorp report and in particular to provide an evaluation of the basis by which TCorp assessed the financial sustainability ratings and outlooks of NSW councils.[5]

## 2. Basis of TCorp's Ratings of Councils

TCorp developed the following definition of financial sustainability in local government:

> *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.*

TCorp based its assessments on the audited financial statements and other publicly available financial information prepared by councils. It looked not only at 2011/12 financial reports but those for the previous three years too (and attached a greater weighting to

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[1] The TCorp report and those it prepared for each individual council are available at http://www.olg.nsw.gov.au/strengthening-local-government/local-government-reform/TCORP-financial-assessments

[2] See TCorp Report Table 1.

[3] See TCorp Report Table 2.

[4] TCorp's analysis focussed primarily on councils' 'General fund'. It did not explicitly consider financial matters relating to councils' 'water' or 'sewerage' funds (bit did have regard to any significant matters) and neither does this report.

[5] John Comrie operates a consultancy, JAC Comrie Pty Ltd, specialising in local government financial sustainability matters. He conducts training courses and has written much of the guidance material on this and related topics for the South Australian Local Government Association, the Institute of Public Works Engineering Australasia (IPWEA) and the Australian Centre of Excellence for Local Government (ACELG). Further details regarding his experience are available at www.jaccomrie.gov.au.

more recent financial information). It also examined councils' forward financial projections reported in their adopted long-term financial plans. It thus focussed on trend data and its assessments were therefore not materially affected by abnormal one-off events. It also spent time with each council discussing the council's data (and made adjustments in its analyses for any errors or omissions that may have been detected). It also invited each council to review its draft assessment and associated report before finalising its work.

TCorp's assessment of each council's financial sustainability outlook and rating was based on scores that were generated for 10 indicators the results for which were calculated from each council's data. Some indicators were given a higher weighting than others. A value was attached to the score a generated for each indicator based on whether it met TCorp's benchmark score and if not how close it was to the benchmark.

A rating was then attached to each council's overall weighted score in the range; Very Strong, Strong, Sound, Moderate, Weak, Very Weak and Distressed. A Moderate rating was considered to be the minimum acceptable level to be assessed as financially sustainable. To achieve a 'Moderate' rating a council effectively needed to achieve performance at levels at or near the benchmark target scores for each of TCorp's 10 indicators.[6] TCorp also generated an 'Outlook' rating (Positive, Neutral or Negative) for each council based on its forward projections and an assessment of the assumptions and availability and reliability of data that underpinned those projections. TCorp's definitions for its various financial sustainability rating categories and outlook classifications are included in Appendix I.

TCorp noted (p.36) '*that for many Councils, there is still much work to be done in upgrading their IP&R* (Integrated Planning and Reporting) *documentation and their 10 year LTFP* (long-term financial plan). *As this occurs, it may be that some of the Negative Outlooks would be removed'.* It also highlighted in various parts of its report that work was ongoing by councils to improve the reliability of accounting data such as depreciation estimates and forecasts of renewal needs. There is still considerable work to do in this regard but if the same review was undertaken today with available updated information then some and possibly many councils would be likely to receive more favourable results. Updated information for others though could generate less favourable ratings and outlooks.

[6] It should not be assumed that a rating above 'moderate' should necessarily be aspired to. Depending on the needs and circumstances of a council and its community a 'moderate' rating may be perfectly acceptable. In fact a 'very strong' rating could indicate a council is generating or is forecast to generate more revenue relative to the range and level of services provided than is absolutely necessary.

These 10 financial sustainability indicators applied by TCorp in its analyses were grouped in four categories. Details of the categories, their weighting in the overall rating and each indicator are listed below.

***Financial flexibility (35%)***

*i). operating ratio (17.5%)*

*ii). own source operating revenue ratio (17.5%)*

***Liquidity (20%)***

*iii). cash expense ratio (10%)*

*iv). unrestricted current ratio (10%)*

***Debt servicing (10%)***

*v). debt service cover ratio (7.5%)*

*vi). interest cover ratio (2.5%)*

***Asset renewal and capital works (35%)***

*vii). infrastructure backlog ratio (10%)*

*viii). asset maintenance ratio (7.5%)*

*ix). building and infrastructure renewals ratio (7.5%)*

*x). capital expenditure ratio (10%)*

Given that more weighting was assigned to some indicators than others in assessing overall performance, a council's rating depended more on how well it scored for some particular indicators compared with others. Further details regarding the basis of calculating the indicator score and the benchmark score for each indicator are provided in Section 3 and in more detail in Appendix II.

## 3. Assessment of TCorp Methodology

I am very comfortable with TCorp's definition of what financial sustainability should be interpreted to mean in a local government context and of its approach of focussing on recent financial data (including forward financial projections) produced by councils and giving consideration to the availability of evidence to support the reliability of that information. I am also supportive of its general conclusions regarding the financial sustainability of the NSW local government sector and especially its associated recommendations. This is so even though I am not convinced that all indicators it has applied and the basis of their calculation  or the weighting they have been assigned in its analysis are optimal for this purpose.

My reservations regarding aspects of the TCorp methodology stems primarily from the fact that TCorp has scored councils using indicators that in some instances are more appropriate for financial assessment of entities operating in the business world. I accept that it is important that councils operate efficiently and in many respects in a business-like manner. However I do not see local government as an industry but as a sphere of government and believe that indicators used to assess the financial sustainability of councils should be more consistent with those applied to assess state governments' financial circumstances and capacity. I agree that particular attention also needs to be given to the asset management responsibilities and capacities of councils also but am not convinced that the methodology applied by TCorp is optimal in the circumstances.

It is important that tools and measures that are used to assess the financial circumstances and capacity of an entity have regard to its operating environment and in particular the reliability of its future income streams and the nature of service level responsibilities. Governments for example typically have more reliable income streams than individuals and private sector businesses. They have taxing and charging powers and such revenue can be increased subject to political and longer-term economic considerations. They also have at least some discretion over the range and level of services provided and are generally able to borrow more (and more cost-effectively) than corporates because there is less risk for lenders of not being repaid.

Local governments in NSW have some (but not full) control over their revenues and service level outlays. It is also noteworthy that they have more control over their net financial inflows and outlays than the state and federal governments.[7] Local governments' costs are heavily influenced by the provision and ongoing maintenance and renewal of long-lived assets (typically infrastructure and to a lesser extent buildings). Their outlay needs associated with provision of service from such assets can vary significantly between periods. This may be so even if service provision and population and properties served remain relatively constant over time, e.g. because there will be peaks and troughs in asset renewal needs between periods.

My views regarding TCorp's indicators are outlined below. The reasons why I am nevertheless comfortable with its general findings and recommended ways forward are documented in Section 4 of this report.

[7] Councils on average generate far more own source revenue than state governments. The income and outlays of both the state and federal governments are also far more sensitive to changes in economic conditions than is the case for local governments.

### i). Operating Ratio

This ratio measured the annual cost of as council's current ongoing service provision (i.e. its operating expenses) relative to operating revenue (excluding capital grants and contributions). A council's score for this ratio measured relative to TCorp's benchmark of 'Better than negative 4%' was given a weighting of 17.5% in its overall assessment.

I am a strong advocate for this indicator and argue that generally speaking a council should base its capital expenditure, service level and revenue raising decisions on achieving a modest (say typically up to 10%) underlying (i.e. net of material abnormal revenues and expenses) operating surplus ratio (net of capital revenue, i.e. revenue required to be spent on acquisition of assets) on an ongoing basis (including in its long-term financial plan forward projections). If this can be achieved then a council's service levels would always be sustainable and it would have the capacity to renew and replace assets as required (even if that necessitated raising additional debt at times and repaying it in subsequent periods). I emphasise several times in this report the importance of a council ensuring its service levels are affordable over time. By affordable I mean that a council can maintain achievement of an appropriate operating surplus target.

Given the above I would argue for the operating ratio to be given a much higher weighting in an assessment of councils' financial sustainability that the 17.5% allocated in TCorp's assessments (say at least 50%). I would also argue for a higher benchmark than 'Better than negative 4%' (say usually to at least a breakeven result). During discussions with TCorp representatives they pointed out that if it had used a higher weighting for this ratio more councils would have received more adverse overall assessments. TCorp for example notes that in 2012 only one third of councils (50) reported an operating surplus but that 52% had an operating result of better than negative 4%.[8]

An arguable weakness of this indicator is that depreciation represents a very large proportion of the total operating expenses of councils on average. The reported level of a council's depreciation expenses can therefore have a big bearing on its operating result and can be difficult to reliably estimate. This estimate is nevertheless far too important to disregard. Councils' services are asset intensive. Recognition of the cost of asset consumption is a critical component of assessment of councils' financial and service level sustainability. The key therefore is to ensure that auditors and management teams pay careful consideration to the basis of their councils' annual estimates of depreciation expenses and that councils generally aim for modest (but not excessive) underlying annual operating surpluses over the medium term. Such a strategy (rather than a breakeven result) would help offset the risk that past estimates of annual asset depreciation may have been understated.

[8] See TCorp p.7 and p.40.

**ii). Own Source Operating Revenue Ratio**

This ratio measures the extent of a council's reliance on external funding sources. It is calculated by expressing a council's rates, utilities and charges revenue for a period as a ratio of its total operating revenue (inclusive of capital grants and contributions) for the same period.

I see merit in this type of indicator but would argue for refinements. First of all I suggest that consideration should be given to including financial assistance grants revenue in the numerator (or at least having an additional indicator that included such that was given equal weighting with this one). Such revenue is in the main a reliable source of revenue for local governments (despite the Commonwealth's decision to hold the quantum constant in nominal values over the three years following 2013/14). For many rural councils with small populations financial assistance grants are a major source of revenue that they should comfortably rely on in planning affordability of future proposed works and services. (I would not make the same arguments in relation to Roads to Recovery or other grants which unlike FAGs would not require legislative change for their availability to be discontinued or annual quantum reduced). The basis of distribution of the available FAGs pool is such that councils with greatest needs for FAGs receive a higher share.

Secondly I question the inclusion rather than exclusion of capital revenues in the denominator. Such revenues can be both significant relative to other operating revenue and lumpy over time. I'd claim the circumstances of two councils that had the same score for this indicator but where one had significant capital revenues and the other didn't were not identical. This is notwithstanding the fact that receipt of capital revenues will generally consequentially lead to higher operating costs for a council in future. (A large share of capital revenues is from developer contributions and development will lead to future higher operating revenues too.)

TCorp suggests that this measure is an indicator of a council's 'fiscal flexibility'. I accept it is an indicator of to what extent it has influence over its annual revenue quantum and that such information has some value in this regard. Given the nature of councils' operating environment and service delivery responsibilities I'm not convinced though that significant 'financial flexibility' is a critical consideration.

A council's score for this indicator measured against TCorp's benchmark of 60% was given a weighting of 17.5% in determining its overall assessment. I believe this indicator (modified as discussed above or not) should not be attached as great a weighting in assessing financial sustainability as the Operating Ratio.

**iii). Cash Expense Cover Ratio**
This ratio, the score for which was given a weighting of 10%, measured a council's cash and cash equivalents at year end relative to its average monthly outlays for the year. It thus was an indicator of the number of months a council could continue paying for its immediate expenses without additional cash inflow.

The score for such an indicator can be an important consideration for a private sector entity (or others interested in its performance and capacity). Uncertainty may exist for such entities regarding future revenue streams and capacity to borrow at short-notice to meet cashflow needs. By comparison most local governments' future revenue inflows are relatively reliable and future expenditure outflows reasonably predictable. Most would also be able to borrow at short notice if unforeseen circumstances arose (and could establish such facilities as a safeguard in advance of any such financing needs).

There is an opportunity cost from holding cash and cash equivalents (including term-deposits) in excess of immediate cashflow needs. My ACELG Working Paper on the role and use of debt argues that councils should adopt treasury management practices that generally reasonably minimise their cash holdings to reduce net interest costs and interest rate risk exposure (e.g. by repaying debt (and ensuring a significant share of their debt is structured in a way so that this can occur) and by deferring an otherwise need to raise debt).

NSW councils current treasury management practices are far from optimal but are generally consistent with guidance instructions that have traditionally been in place. In the circumstances I can understand why TCorp made use of the Cash Expense Cover Ratio indicator in its analyses. I would not though recommend its use in future and would instead encourage assessment of performance relative to treasury management approaches applicable to the circumstances of the local government environment.

**iv). Unrestricted Current Ratio**
Councils' score for this ratio relative to TCorp's benchmark of 'greater than 1.5' attracted a weighting of 10% in a council's overall assessment. It was calculated by comparing a council's current assets (net of monies with external restrictions on their use) with its current liabilities (net of specific purpose liabilities).

The current ratio is a commonly used liquidity ratio applied in the private sector to assess an entity's ability to meet short term obligations as they fall due. TCorp made refinements to the usual basis of calculating that indicator to take account of the fact that councils often hold significant monies that can only be applied for specific purposes and cannot be used to meet other outlay needs. Regardless of these adjustments, and as highlighted in iii) above, I question the merit of applying liquidity and debt servicing indicators to financial assessments in the local government sector given the differences in operating circumstances.

TCorp’s benchmark for this indicator favours councils holding a large (i.e. a conservative level) of unrestricted current assets. I would argue many councils would be better served in future by targeting a considerably lower unrestricted current ratio score than the TCorp benchmark. This could in many instances reduce both a council’s net interest costs and interest rate risk exposure. Before implementing such a strategy a council should establish sound treasury management policy frameworks relative to their circumstances and ensure that they have complementary levels of knowledge and understanding by responsible staff.

**v). Debt Service Cover Ratio (DSCR)**

This ratio was given a weighting of 7.5% in each council’s overall assessment. It measured a council’s operating result before interest and depreciation (effectively approximately net operating cash inflow) relative to repayments of debt (principal amounts) and interest costs on debt.

This ratio is commonly used in the private sector to assess the capacity of a borrower to take on and repay borrowings. The fact that local governments’ service responsibilities are very asset intensive and that their ongoing revenue streams are typically more reliable and expenditure needs reasonably predictable means it will often be appropriate for councils to carry large stocks of borrowings (In order to finance asset acquisition and then equitably fund associated costs over time from taxes and charges on service recipients). As such a council could possibly appropriately have a higher level of debt (and a lower debt service cover ratio score) than what may be warranted for entities in various private sector industries.

TCorp applied a benchmark of ‘greater than 2 times’ in assessing councils’ performance for this indicator. All other things being equal this meant that a council that repaid debt more quickly (as I would advocate it should if it had cashflow capacity available) would receive a lower score than one that repaid it less quickly. This is because the former council would incur higher principal repayments (albeit over a lesser number of periods) and the denominator in its scoring for the indicator would therefore be larger.

My preference would be for councils to base service level decisions on long-run affordability and generally borrow only when cashflow needs warrant and for borrowings to be structured in ways that allow repayment arrangements to minimise net interest costs and interest rate risk exposure. Structuring loan repayment arrangements to achieve a higher DSCR score could in fact add to a council’s net interest costs and interest rate exposure risks.

**vi). Interest Cover Ratio**

This ratio, the score for which was given a weighting of only 2.5%, is intended to provide an indication of the extent to which a council can service its interest bearing debt and take on additional borrowings. Its calculation was based on a council’s operating result before interest and depreciation for a period relative to interest costs from borrowings for the same period.

TCorp indicated in discussions that its benchmark of 'Greater than 4.0x' for assessing councils' performance is commonly applied in the private sector. For reasons highlighted elsewhere (see e.g. item v) above in this section) I question the merit of applying liquidity and debt servicing indicators to financial assessments in the local government sector given the differences in operating circumstances.

The circumstances of some councils are that they could and should appropriately carry more net debt (e.g. often those that need to meet infrastructure upgrade costs associated with growth) compared with others. Such councils may therefore be warranted in having a lower interest cover ratio result than others.

**vii). Infrastructure Backlog Ratio**

This ratio identified a council's reported asset renewal backlog relative to the total reported value of its depreciable buildings and infrastructure. A council's score for this indicator was given a weighting of 10% in calculating its overall assessment.

In calculating a council's score, TCorp based the council's asset renewal backlog on its reported Special Schedule 7 forecast of the estimated cost to bring assets it was responsible for up to a satisfactory condition. The basis of information reported in that document is quite variable between councils. Special Schedule 7 is unaudited and interpretations as to what is needed and what constitutes satisfactory condition are necessarily subjective. Answers to this question will depend on the willingness of service recipients to pay (and also whether there is a perception of the possibility of grants from others to fund such expenditure) and consideration by a council of its community's other needs and priorities.

My report for the Independent Panel last year highlighted concerns with the basis of the reporting requirements of Special Schedule 7 and reliability of reported data. TCorp in its report also highlighted concerns with the reliability of data and consistency between councils as to the basis of reported backlogs. I also suggested in my report for the Independent Panel that many councils have considerable capacity to address reported asset management backlog needs by taking on additional debt but appear unwilling to do so suggesting either a lack of confidence in reported 'needs' (and/or an unwarranted fear of debt).[9]

I appreciate that there is considerable ongoing work being undertaken by councils to refine the reliability and basis of their asset renewal backlogs. Some councils have reported very significant revisions of their estimates post the finalisation of the TCorp report. Even with these refinements it will always remain problematic to compare one council's reported backlog quantum with that of another or to add all councils' figures and arrive at an

[9] See in particular Sections 3.3 and 3.4 of 'Roadmap to Financial Sustainability for Local Governments in NSW'.

estimated renewal backlog for the sector. The point at which an asset should be renewed is not definitive. It will depend to a large degree on the circumstances and subjective preferences of individual councils.

Rather than focus on the content of Special Schedule 7 in evaluating asset management needs a better approach would be to consider the content of councils' asset management plans (I acknowledge that the reliability of data therein is often still being refined). Such plans should be of course consistent with a council's long-term financial plan and therefore the achievement of their financial targets (thus forcing councils to wrestle with and make judgement calls in preparation of these documents regarding trade-off choices between service level preferences and service recipients' willingness and capacity to pay).

**viii). Asset Maintenance Ratio**

This ratio, the score for which was given a weighting of 7.5% in each council's overall assessment, measured actual asset maintenance expenditure relative to the asset maintenance expenditure for the period that the council deemed was warranted in its Special Schedule 7 report.

In theory I have no argument with the indicator or its assigned weighting. Councils need to make service level (and therefore asset maintenance level) decisions that are consistent with likely long-run revenue availability (which will to varying degrees depend on a council's capacity and willingness to generate own source revenue). A ratio of less than one may mean:

a) Available revenue is less than is needed to accommodate justified maintenance levels for a given preferred level of service. If so (and assuming this is the projected ongoing scenario) then a council needs to act to either generate more revenue or accept a lower level of service (and lower associated maintenance costs); and/or,

b) Available revenue is adequate to accommodate justified maintenance levels for a given preferred level of service but the council has chosen (implicitly or explicitly) to spend a lower amount on maintenance. That is, whether it realises it or not it has effectively decided that it prefers to utilise available funds in other ways – if so reported warranted maintenance expenditure is not in fact consistent with a council's preferences.

A council always needs to ensure that actual and future planned maintenance levels are consistent with warranted maintenance levels. It can do this by ensuring its asset management plans are based on preferred and affordable service levels and annual expenditure budgets are generally consistent with asset management plans.

Some people sometimes claim that it would be cost-effective but unaffordable to spend more on maintenance. This makes no sense. A council may be financially challenged but if it would really save money over time by spending more on maintenance now it should do so –

even if it needed to borrow additional money. In reality what they often mean is that a council's existing budget decision-making process has not delivered asset maintenance funding levels consistent with what such individuals prefer.

It is clear that there is a high degree of variability in the Special Schedule 7 reported needs of councils. This is likely to be so even for councils in similar circumstances. This often reflects differences in viewpoints of 'needs' between councils. Reported 'needs' should be based on long-run affordable service levels and if they are not then it is hard to make any conclusions regarding relative asset maintenance performance of councils. Differences in scores generated between councils for the asset maintenance ratio indicator will reflect this variability in the basis of reported Special Schedule 7 maintenance 'needs'.

**ix). Building and Infrastructure Renewals Ratio**

This ratio measured asset renewal expenditure relative to the recorded annual depreciation expense for the same classes of assets (i.e. buildings and infrastructure). Each council's score was given a weighting of 7.5% in its overall assessment.

Intuitively it seems reasonable to assume that this ratio score should be about 100% as that would mean that infrastructure asset renewal expenditure over any particular period of one or more years was approximately offsetting the decline associated with age and use in the service potential of existing assets. In practice though there may be good grounds why a ratio of substantially more or less than 100% is more appropriate.

The weighted average life of local governments' stock of depreciable assets is typically very long (often 40 years or more). Annual average asset renewal needs for classes of assets like stormwater drainage, road pavements and buildings are unlikely to be constant over time. They are likely to be periods of peaks and troughs. Rather than spend an amount on asset renewal each period consistent with annual depreciation, a council would be better advised to undertake asset renewal in accordance with levels and timing outlined in a soundly based asset management plan.

An indicator comparing asset renewal with depreciation can prove a useful guide of performance for individual classes of assets that have a significant stock of items and that have relatively short lives (e.g. plant and sheeted roads) or for councils that do not have material levels of long-lived assets (e.g. rural councils with large sheeted road networks).

South Australian councils were required to report asset renewal relative to depreciation for several years but results proved generally an inconclusive indicator of warranted performance. Now that SA councils have had several years' experience with asset management planning they are instead required to report (in their budgets, financial statements and long-term financial plans) asset renewal expenditure levels relative to asset management plan identified renewal needs for the same period.

**x). Capital Expenditure Ratio**

This ratio measured a council's annual capital expenditure relative to its annual depreciation for the same period. Each council's score was given a weighting of 10% in its overall assessment.

TCorp suggested that the indicator measures the extent to which a council is expanding its asset base (and used as a benchmark a score of 'greater than 1.1'). I accept that low ongoing scores for this indicator may indicate an under-investment in service providing capital works but such a conclusion will not always be valid. A higher score is likely to be far more warranted and appropriate for some councils (e.g. possibly those that are rapidly growing) than others (e.g. possibly those with a relatively stable or declining population and an asset stock in generally good condition and with a long weighted average useful life).

The fact that the numerator doesn't distinguish between expenditure on new additional assets and renewal of existing assets is also problematic. As highlighted previously expenditure on new assets has a much greater impact on long-run costs than renewal outlays. Furthermore warranted asset renewal can vary significantly between years, particularly for councils with a larger share of long-lived assets relative to classes with shorter useful lives.

Acquiring new additional depreciable assets adds to long-run operating costs. A council that has financial sustainability challenges will quite possibly be adding to those challenges rather than helping to address them by spending on new capital works. It seems potentially anomalous therefore to assume a higher score for such an indicator suggests greater financial sustainability.

In the private sector a firm will of course only invest in additional capital works if it helps it improve its long-term financial performance. The indicator therefore is likely to have more applicability in that context. Local governments have multiple objectives. Acquiring new assets may help meet some strategic social objectives but also adversely impact on financial ones. Their financial objectives are not about maximising long-run profits but instead more about efficiently providing affordable services and equitably generating revenue to pay for them.

## 4. General Discussion regarding financial sustainability indicators

I have expressed in Section 3 concerns and reservations regarding either the suitability, basis of measurement, weighting and/or benchmark targets (to varying degrees) for each of the indicators applied by TCorp in its assessment of the financial sustainability of NSW councils. Despite this I am comfortable with its overall findings regarding the sector. Its assessment of the reported circumstances is broadly consistent with the one I have formed from various work I have undertaken in recent years.[10] Simplistically this congruence of our assessments can be reconciled as follows:

a) I would give much greater weighting to the underlying operating result of councils which would drag down the overall assessment ratings,

b) I would assign less weight to reported asset management needs and performance and anticipate that this would improve the collective assessed ratings of councils, and

c) I would also assign less weight to liquidity and debt servicing considerations. The impact on overall assessments of this is less clear and would vary between councils.

Even though my assessment for the collective grouping of councils would I anticipate be similar to TCorp's our assessment of individual councils may well be different. Given that I would place more emphasis on some factors and less on others it is likely that I would rate some councils more highly and others less so.

I also believe that many councils (but certainly not all) could potentially be in a better position than the data TCorp necessarily used in its assessments suggests (or certainly can become so over time). It is still relatively early days in terms of councils developing and working with asset management and long-term financial plans and in refining estimates of asset renewal needs and warranted and affordable service levels. My experience (from leading various related training courses throughout NSW) suggests that there is still considerable inconsistency within and across councils regarding the recording and interpretation of asset management and financial data. Progress is being made though in improving data and its interpretation and appropriate responses. Intuitively for example I think it is more likely that councils on average have in the past been overstating rather than understating estimates of annual depreciation and asset renewal backlogs. (It is not uncommon for councils to have in service assets that they have already fully depreciated).

I agree with TCorp that most councils will need to improve their financial performance over time. I am also though of the view that most NSW councils with appropriate guidance and encouragement will be able, with incremental changes in policy settings, to make significant improvement in their financial sustainability over the medium term relative to the assessments and outlooks determined by TCorp in 2013.

In all Australian jurisdictions councils are now required, or at least strongly encouraged, to disclose results for specified financial sustainability indicators in their annual financial statements and long-term financial plans. There is reasonable (but not uniform) consistency in promotion of some particular indicators (and even for these there are some slight

[10] In particular work for the Independent Panel and ACELG listed in the references.

differences in their basis of calculation) but most states also encourage publication of others not widely applied elsewhere.

ACELG and IPWEA's Practice Note 6, Long-term Financial Planning (which I authored) encourages attention on just three indicators in order to maintain a clear and simple focus in strategic financial decision-making.[11] The three indicators are the :

i). Operating Surplus Ratio (same as the (Operating ratio described at item viii) of Section 3),

ii). Asset Renewal Funding Ratio (actual renewal expenditure relative to asset management plan identified needed renewal outlays for the same period),

iii). Net Financial Liabilities Ratio (debt and other financial liabilities less financial assets all expressed as a ratio of operating revenue (exclusive of capital revenue)).

Practice Note 6 suggests that the key to financial sustainability is ensuring a council sets own source operating revenues and service levels such that it will maintain a small operating surplus (including in its future projections) whilst also addressing asset renewal needs as required. In order to achieve these targets it may be necessary for many councils to carry more debt than they have traditionally been comfortable with so doing. My ACELG Debt Paper argues that if councils have reliable financial data and commit to strategies that help them achieve satisfactory targets for their operating surplus ratio and asset renewal funding ratio then they should not fear making greater use of debt.

There has been in-principle interest between jurisdictions in agreeing on a standard set of core financial sustainability related indicators for all local governments across Australia to report against. No significant objections have been raised to the proposal but local priorities in individual jurisdictions have meant that it has not yet been actively pursued to finalisation. The three ACELG and IPWEA recommended indicators are suitable prime financial sustainability indicators for application by NSW councils (or at least can become so over time). Having regard to the current level of reliability of some financial and asset management information and traditional guidance, understandings and practices I acknowledge that there is still some way to go before these indicators would be sufficient by themselves for sound financial sustainable strategy setting by all councils.

From discussions I had with TCorp I believe it may have refined its thinking regarding appropriate financial sustainability indicators and targets as a result of the work it did in preparing its 2013 report and in considering applications by councils for subsidised borrowings through the NSW Government's Local Infrastructure Renewal Scheme.

The NSW Government has recently announced a 'Fit For the Future' reform program. The assessment of councils as being 'fit for the future' will include their performance against six

[11] See Section 7.3 of 'Long-term Financial Planning, Practice Note 6'.

financial sustainability indicators.[12] Those indicators and their benchmarks are set out below:

a) Operating Performance Ratio with a performance benchmark of breakeven or greater over 3 years,

b) Own Source Revenue Ratio (benchmark performance of greater than 60% over 3 years),

c) Building and Infrastructure Asset Renewal Ratio (benchmark performance of greater than 100% over 3 years),

d) Infrastructure Backlog Ratio (benchmark performance of less than 2%),

e) Asset Maintenance Ratio (benchmark performance of greater than 1.0),

f) Debt Service Ratio (benchmark performance greater than 0 and less than 20% of operating revenue excluding capital grants and contributions).

It is not clear at this time how those indicators will be measured. The September 2014 IPART Report indicates that the basis of calculation of the first five may be as per items i), ii), ix), vii) and viii) respectively of Section 3 of this report. The proposed 'debt service ratio' indicator is not the same as item v) (debt service cover ratio) in Section 3. It is based on loan repayments (principal and interest for a period as a percentage of operating revenue).[13] Whether these 6 indicators will be weighted to generate an overall financial sustainability score and if so how is also not known at this time.

It would also appear that indicators iii), (cash expense ratio), iv) (unrestricted current ratio), vi) (interest cover ratio and x) (capital expenditure ratio) (as described in Section 3) will not be applied in 'fit for the future' assessments.

## 5. TCorp's overall findings and recommendations

As highlighted previously, despite some misgivings regarding TCorp's financial sustainability indicators I am supportive of its report's key findings and recommendations. I have listed below (generally in paraphrased form) some that I think are particularly noteworthy and or wished to comment on. (My comments below are generally restricted to adding to rather than repeating comments made earlier in this report.)

[12] See 'Fit for the Future, A Roadmap for Stronger, Smarter Councils' available at http://www.fitforthefuture.nsw.gov.au/sites/fftf/files/Fit-for-the-Future-A-roadmap-for-Stronger-Smarter-Councils.pdf

[13] I am not a fan of this indicator. Principal repayments are not an accrual accounting expense. I discuss my concerns regarding this indicator more fully in my ACELG Debt Paper (Comrie 2014) where this indicator is described as 'debt servicing ratio' (see e.g. p.22).

i). TCorp provided some recommendations to assist councils in improving their financial sustainability (see p.6 and p.38) These included:

   a) Sourcing additional revenue, e.g. through a Special Rating Variation,

   b) Using debt funding to assist in reducing the Infrastructure Backlog (TCorp noted (p.55 & p.59) that some councils have no debt and significant capacity to repay additional debt, yet report that they have Infrastructure Backlogs),

   c) Devising programs and strategies to contain rising costs and improve efficiencies,

   d) Refining the content of asset management and long-term financial plans and better ensure their consistency (and I would add reviewing service levels upon which they are based, including the timing of provision of new additional capital works, or the upgrade of existing assets to a higher level of service),

   e) Increasing spending on maintenance and infrastructure renewal.

ii). It emphasised the importance of councils aiming to achieve at least breakeven operating positions and developing pricing paths that help them achieve this over the medium term,

iii). TCorp highlighted that debt is underutilised and there are opportunities for it to be structured in a more cost effective manner (p.63 & p65),

iv). It also emphasised that liquidity levels are in some cases overly conservative (p.61) and that treasury management policies need to be reviewed to improve council management of liquidity (p.66). I would add that such policies would also help improve councils' use of debt. TCorp also suggested that there should be a review to consider improved use of restricted funds. In my view greater 'internal borrowing' between funds by councils if carefully managed could generate very significant overall savings and reductions in councils' interest rate risk exposure,

v). TCorp noted that reported infrastructure backlogs are not audited and require further refinement,

vi). It stressed that the provision of capital grants to build new additional assets or upgrade existing assets to higher levels of service can adversely impact on financial sustainability (p.63). I would argue that councils need to consider the impact on their overall financial sustainability and capacity to maintain existing service levels before seeking capital grants to add to their stock of assets and increase service levels,

vii). TCorp identified (see p.48) that the recognition and treatment of depreciation remains a contentious issue amongst some councils and that depreciation rates, expenses and methodologies vary widely. It suggested that further work may be warranted to provide guidance to refine such estimates. I support these findings. Asset consumption (depreciation) is a very significant component of the cost of service delivery in local government. It is as a legitimate a cost as any other a council may incur. The fact that it doesn't automatically result in a cash outlay is irrelevant. Councils should be basing their revenue raising and service level decisions on accrual accounting rather than cash accounting information. In order to be financially sustainable depreciation expenses generally need to be fully offset with revenue,[14]

viii). TCorp suggested that a review should be conducted to ensure a consistent approach to the future auditing of all councils' annual accounts. There is currently in my view some very inconsistent advice and direction being given by auditors and other external advisors to councils regarding appropriate accounting treatments for valuing and depreciating infrastructure assets. Increased guidance or sector-wide oversight is certainly worth consideration,

ix). TCorp suggested a need to enhance the capacity of councillors and their management staff as regards financial management. In my view good progress has generally been made in transitioning from a traditional short-run cash accounting mindset in decision-making but I don't disagree with TCorp's suggestion. It also recommended that increased community consultation will be needed to help improve understanding of and inform decisions regarding service level and revenue raising trade-offs. I agree with this. It will be essential for residents and ratepayers to feel that they've been listened to in order for financial sustainability improving reforms to be accepted and effectively implemented.

## 6. Case Studies

LGNSW asked that liaison take place with a small group of 3 councils in the preparation of this report and suggested Bourke, Greater Taree and Penrith. All 3 willingly agreed to assist and provided valuable input to help form and refine the content of this report. Brief comments regarding each council follow.

**i). Bourke**

Bourke was assigned a 'Weak' financial sustainability rating by TCorp in its 2013 assessment and a 'Negative' outlook.

[14] An exception for example may be where a council is satisfied that it would not be justifiable to replace significant depreciable assets in future. In such cases an adjusted lower operating result target may possibly be appropriate.

It scored adversely against TCorp's benchmarks for the following:

a) Operating ratio
b) Own source operating revenue ratio
c) Capital expenditure ratio
d) Infrastructure backlog ratio
e) Building and infrastructure renewal ratio

At the time of TCorp's review Bourke reported a significant asset renewal backlog relative to its total value of infrastructure assets and annual operating income and a forecast gradual reduction in its operating deficit over time. TCorp concluded based on available reported data that Bourke was unsustainable in the medium to long term.

What TCorp effectively meant was that Bourke's service levels appeared to be unsustainable beyond the medium term based on reported information. This scenario was predicted because Bourke's service generating assets (predominantly roads) were being reported as being consumed at a rate in excess of which they were being renewed. TCorp recognised that rural councils serving large land areas with small population bases and large road networks face greater challenges than other councils in achieving and maintaining financial sustainability.[15] TCorp suggested that Bourke needed to review its service levels to ensure that they were set based on what was optimally sustainable on an ongoing basis.

I have no disagreement with TCorp's assessment based on then available information.

TCorp's findings have proved to be a driver for Bourke to look closely at the factors that gave rise to its rating score and what it may be able to do to better meet ongoing challenges. It appreciates that the rating is not an assessment of 'how well it is doing in the circumstances' and recognises it faces more operating environment challenges than many other councils. It also now has an increased appreciation of the value of asset management and long-term financial planning and the importance of ensuring accounting data reliably reflects the value and rate of consumption of infrastructure assets.

Bourke is currently reviewing depreciation rates, expenditure capitalisation policies and asset management needs. Based on evidence to date Bourke recognises that it's previously forecast asset renewal needs and road asset useful lives were more 'aspirational' than reflective of current actual service levels. Work is ongoing but it is reasonably confident that it can maintain current service levels on an ongoing basis and that they are acceptable to its community.

[15] I have argued in my ACELG 'In our Hands' and Independent Panel 'Roadmap to Financial Sustainability' reports that whilst such councils often can and must do more to help themselves they also need additional external financial support. I have suggested that consideration should be given to providing a larger share of the existing pool of Commonwealth Financial Assistance Grants to such councils if an increase in the overall pool of available grants is not able to be secured.

### ii). Greater Taree

TCorp awarded Greater Taree City Council a 'Very Weak' financial sustainability rating and a 'Negative' outlook.

Greater Taree scored adversely against TCorp's benchmarks for the following:

a) Operating ratio
b) Capital expenditure ratio
c) Asset maintenance ratio
d) Infrastructure backlog ratio
e) Building and infrastructure renewal ratio

TCorp highlighted that in particular Greater Taree had reported a very high infrastructure renewal backlog (about 25% of the replacement cost of its stock of infrastructure assets) and had forecast large ongoing operating deficits. It also indicated that Greater Taree believed that its reported asset renewal backlog was conservative and could not realistically be reduced without additional funding.

TCorp concluded that Greater Taree was currently in a satisfactory financial position but that '*clearly Council has insufficient financial resources to meet its future capital expenditure requirements or to address its infrastructure backlog'*.[16] I would agree with that assessment if a reasonable degree of confidence could have been attached to the council's then estimates of its annual depreciation expense and outstanding asset renewal needs.

In my September 2013 'Roadmap' report for the Independent Panel I highlighted that depreciation represented about double the share of Greater Taree's total operating expenses relative to the average for all NSW councils even though the council's asset stocks were not above the average proportion (compared with income) of other councils. I indicated then that the council had initiated work to review the basis of its assumptions regarding asset useful lives, depreciation rates and asset maintenance and renewal needs. In fact considerable work had already been commenced by the council well before the TCorp review to resolve the issues of asset renewal needs and service level affordability. TCorp's assessments were not a surprise to the council.

Greater Taree's work to refine its projections and determine appropriate responses is continuing and has been assisted by the introduction in NSW of the local government Integrated Planning and Reporting framework. It is noteworthy that for the year ending 30 June 2013 Council's depreciation expense was $26 million compared with $32 million for the previous two years. Council is anticipating a further reduction of about $4 million in its recorded depreciation expense for 2013/14. Council is currently preparing for a

[16] P.33 of TCorp's Greater Taree City Council Financial Assessment and Benchmarking Report of Oct 2012.

conversation with its community regarding affordable service levels and asset renewal expenditure.

TCorp also was critical of Greater Taree for preparing its long-term financial plan in real rather than nominal values. This surprised the council because it had relied on the ACELG/IPWEA Practice Note advice recommending use of real values (the document suggests such an approach in order to aid inter-period comparisons). Providing a council adjusts individual classes of financial inputs (e.g. employee costs or rate revenue) for real movements in prices (i.e. relative to the expected general inflation rate) then a long-term financial plan will generate the same outcomes and indicator scores regardless of whether real or nominal input values are used.

**iii). Penrith**

Penrith scored a 'Weak' financial sustainability rating from TCorp in its 2013 assessment and a 'Neutral' outlook.

It scored adversely against TCorp's benchmarks (generally for most years) for the following:

a) Operating ratio
b) Cash expense ratio
c) Interest cover ratio
d) Infrastructure backlog ratio
e) Building and infrastructure renewal ratio

It is noteworthy that Penrith has well above benchmark levels of own source revenue. This suggests to me that it has considerable control over its own financial destiny. Even if depreciation expenses remained at the levels reported when TCorp undertook its assessment I would claim that Penrith has good capacity to improve its financial performance in future, e.g. by holding service levels reasonably constant and increasing its own rates and charges at an incrementally higher rate than costs over time. I would also argue that it has capacity to borrow considerably more if this was necessary to address justified asset renewal needs.

In the course of my work associated with the preparation of this report Penrith advised that it undertook a comprehensive review of its depreciation methodology post its TCorp assessment. This resulted in its depreciation expense falling from $39M to $19M in 2012/13. I am not in a position to comment on whether this estimate will prove to be a reliable long-run base but simply note that such a change would have had a very material impact on Penrith's score for several of the indicators TCorp applied in its assessment.

Penrith also advised that it felt that the basis of calculation of TCorp's cash expense ratio indicator was excessively restrictive. It is its understanding that TCorp used 'cash at bank' as the numerator for this liquidity ratio and did not allow inclusion of short-dated term deposits that Council had and was able to access with 24 hours' notice. Penrith changed its treasury management practices in order for such monies to be counted in the numerator in 2013. It also understands that from 2014 onwards term deposits will be allowed to be included in the numerator under the coding classifications applied for reporting purposes by the Office of Local Government.

As regards the unrestricted current ratio indicator, Penrith advised that it considers TCorp's benchmark is excessive and although it could easily meet the benchmark it instead conducts its treasury management affairs to achieve a lower target score that saves it money. I concur with its approach.

Penrith believes its reported asset renewal backlog is relatively small and is comfortable with its current and future planned levels of asset renewal expenditure. (This illustrates the point I've made elsewhere regarding the care needed in interpreting reported backlog levels. In some cases they reflect 'what in a perfect world would be nice to do but not now if we had to pay for it'.)

The experiences and responses of the three case study councils highlight the points that I've made earlier throughout this report that councils are still coming to grips with ensuring that their accrual accounting asset related information and their asset management data is consistent and reflective of current service levels and that this information is then used for critical decision-making. This is not surprising and consistent with experiences in other states. Councils Australia-wide traditionally focussed on short-run cash accounting information and it is only in recent years with the emphasis on accrual accounting and the requirement to regularly revalue assets and prepare asset management and long-term financial plans that the shortcomings of the traditional approach are becoming more widely recognised.

## 7. Conclusions and Summary

TCorp was entitled to rely on the data it used in its analysis but this data prepared by councils is not as robust as it could be. In particular councils are still refining their estimates as regards future asset renewal needs and ensuring that asset useful life and depreciation accounting estimates are closely correlated with actual practice and preferred, affordable service levels.

TCorp's ratings of councils has caused many of them to reflect on their accounting practices and implicit and explicit service levels, including estimates of warranted asset renewal needs. This in itself has made TCorp's work worthwhile. Elected councils, their management teams and communities and others that councils are accountable to should, indeed need to, be able to depend on the reliability of financial information produced by councils to make strategic decisions and judge performance. It is quite likely that if the TCorp review was repeated today with the same methodology but with updated financial data, that some, and possibly many, councils would be likely to receive  more favourable ratings and outlooks. Others though could receive less favourable results. There would though at least be a better appreciation by such councils of the reasons for the assessments and what the implications may be and what further actions may be warranted.

I am supportive of TCorp's general findings regarding the sector's financial sustainability and particularly its recommendations to help strengthen councils' financial performance and capacity. This is despite the fact that that I would advocate some differences in the range of financial sustainability indicators applied and in their computational basis and weighting. Such changes would result in some councils getting better and others a less favourable rating.

In my opinion some of TCorp's indicators are more appropriate for assessment of the financial worthiness of private sector entities (and in particular their worthiness to take on more debt) than for a sphere of government. Local governments generally have more reliable revenue streams, discretion regarding expenditure and stable and predictable operating environment than is typically the case for entities in the commercial business world.

I would encourage in particular a prime focus on the current and projected operating result (net of capital revenues) of councils in assessing their financial sustainability. Secondly I would also caution against assessment of asset management performance that involved comparison of asset renewal levels with depreciation. Asset renewal needs can vary significantly over time and may justifiably in any period be at levels higher or lower than depreciation. Thirdly councils generally need to make greater use of debt if they are to cost-effectively manage their service level responsibilities and equitably charge beneficiaries of these services over time. Not only should councils make greater use of debt (subject to having sound financial plans, strategies and policies in place) but they could also benefit substantially from changes in their treasury management practices. As such I would give less regard to liquidity considerations than TCorp has in its assessments.

**Acknowledgement**

I acknowledge and thank TCorp and the three case study councils, Bourke, Greater Taree and Penrith for the very valuable assistance provided by their representatives in the preparation of this report. All were not only willing to assist but genuinely interested in hearing and understanding other perspectives on the issues discussed.

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**The TCorp ratings and their definitions are listed below. (This information has been sourced from Appendix 1 of the TCorp report.)**

## FINANCIAL SUSTAINABILITY RATING

### Very Strong

- A local government with a very strong capacity to meet its financial commitments in the short, medium and long term.
- It has a record of reporting operating surpluses.
- It is highly likely to be able to manage unforseen financial shocks and any adverse changes in its business without revenue and/or expense adjustments.
- Its capacity to manage core business risks is very strong.

### Strong

- A local government with a strong capacity to meet its financial commitments in the short, medium and long term.
- It generally has a record of operating surpluses and may occasionally report minor operating deficits. It is able to address its operating deficits, manage major unforseen financial shocks and any adverse changes in its business with minor revenue and/or expense adjustments.
- The expense adjustments are likely to result in only minor changes to the range of and/or quality of services offered.
- Its capacity to manage core business risks is strong.

### Sound

- A local government with an adequate capacity to meet its financial commitments in the short, medium and long term.
- While it is likely that it may have a record of minor to moderate operating deficits, the local government is expected to regularly report operating surpluses. It is likely able to address its operating deficits, manage major unforseen financial shocks and any adverse changes in its business with minor or moderate revenue and/or expense adjustments.
- The expense adjustments are likely to result in some changes to the range of and/or quality of services offered.
- Its capacity to manage core business risks is sound.

**Moderate**

- A local government with an adequate capacity to meet its financial commitments in the short to medium term and an acceptable capacity in the long term.
- While it has some record of reporting minor to moderate operating deficits the local government may also have recently reported a significant operating deficit.
- It is likely able to address its operating deficits, manage unforseen financial shocks and any adverse changes in its business, with moderate revenue and/or expense adjustments. The expense adjustments are likely to result in a number of changes to the range of and/or quality of services offered.
- Its capacity to manage core business risks is moderate.

**Weak**

- A local government with an acceptable capacity to meet its financial commitments in the short to medium term and a limited capacity in the long term.
- It has a record of reporting moderate to significant operating deficits with a recent operating deficit being significant. It is unlikely to be able to address its operating deficits, manage unforseen financial shocks and any adverse changes in its business, without the need for significant revenue and/or expense adjustments.
- The expense adjustments would result in significant changes to the range of and/or quality of services offered.
- It may experience difficulty in managing core business risks.

**Very Weak**

- A local government with a limited capacity to meet its financial commitments in the short to medium term and a very limited capacity long term.
- It has a record of reporting significant operating deficits. It is highly unlikely to be able to address its operating deficits, manage unforseen financial shocks and any adverse changes in its business without the need for structural reform and major revenue and/or expense adjustments.
- The expense adjustments are likely to result in significant changes to the range of and/or quality of services offered and it may need the assistance from higher levels of government.
- It has difficulty in managing its core business risks.

**Distressed**

- A local government with a very limited capacity to meet its short term financial commitments and no capacity to meet its medium to long term financial commitments.
- It has a record of reporting significant operating deficits.
- To be able to address its operating deficits, meet its medium and long term obligations, manage unforseen financial shocks and any adverse changes in its business, major revenue and expense adjustments and structural reform will be required.
- The local government is unlikely to have the capacity to manage core business risks and may need assistance from higher levels of government.

## FINANCIAL SUSTAINABILITY RATING OUTLOOK

**Positive**

As a result of a foreseeable event or circumstance occurring, there is the potential for enhancement in the local government's capacity to meet its financial commitments (short and/or long term) and resulting change in its rating. However, it does not necessarily indicate that a rating change may be forthcoming.

**Neutral**

There are no known foreseeable events that would have a direct impact on the financial sustainability of the local government. It may be possible for a rating upgrade or downgrade to occur from a neutral outlook, if warranted by an event or circumstance.

**Negative**

As a result of a foreseeable event or circumstance occurring, there is the potential for deterioration in the local government's capacity to meet its financial commitments (short and/or long term) and resulting change in its rating. However, it does not necessarily indicate that a rating change may be forthcoming.

**The TCorp indicators, their basis of calculation and the weightings attached to each in arriving at a council's overall financial sustainability rating is set out below. (This information has been sourced from Appendix 2 of the TCorp report.)**

### i). 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 achievement of containing operating expenditure within operating revenue. It is important to distinguish that this ratio is focussing on operating performance and hence capital grants and contributions are excluded.

Weighting: 17.5%

### ii). 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 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.

Weighting: 17.5%

### iii). 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.

Weighting: 10%

**iv). Unrestricted Current Ratio**

Benchmark = 1.5x

*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 used to assess liquidity of businesses as cash allocated to specific projects is 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 short term obligations as they fall due.

Weighting: 10%

**v). 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 operating cash to service debt including interest, principal and lease payments

Weighting: 7.5%

**vi). Interest Cover Ratio**

Benchmark = Greater than 4.0x

*Ratio = Operating results before interest and depreciation (EBITDA) / Borrowing interest costs (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.

Weighting: 2.5%

### vii). 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.

Weighting: 10%

### viii). 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.

Weighting: 7.5%

### ix). 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.

Weighting: 7.5%

### x). 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.

Weighting: 10%

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# Great Lakes 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 Great Lakes Council, the LIRS Assessment Panel and the DLG. TCorp shall not be liable to Great Lakes 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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# Index

## Section 1 Executive Summary

This report provides an independent assessment of Great Lakes Council (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 one application for $18.0m relating to Council's Road and Bridge Rehabilitation Program.

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.

The Council has been adequately managed over the review period based on the following observations:

- The underlying operating performance (measured using EBITDA) has shown its strongest result in 2011
- The Unrestricted Current Ratio has remained above the benchmark in all three years indicating that Council had sound liquidity throughout the period.
- Council has been conducting an ongoing organisation-wide service level review that is identifying efficiencies and cost savings along with possible revenue generating opportunities
- Council has been granted an SRV of 8.0% p.a. including the rate peg for three years from 2011/12 that should assist the financial sustainability of Council by funding specific capital programs.
- Total borrowings have increased by $10.6m to $29.1m in 2011 indicating Council is utilising debt funding to manage their financial requirements

Council's reported Infrastructure Backlog of $38.5m in 2011 represents 6.6% of its infrastructure asset value of $586.3m. Other observations include:

- The Infrastructure Backlog has reduced from $59.1m in 2009, and then $73.2m in 2010 as a result of Council's improved asset management systems providing a more reliable information
- Capital expenditure has been adequate over the three years when measured by the Capital Expenditure Ratio
- Expenditure for asset maintenance and renewals has reduced over the period and has not been sufficient when compared to the Asset Maintenance Ratio and Buildings and Infrastructure Asset Renewal Ratio benchmarks.

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

- Operating deficits are forecast each year with the largest in 2013 of $7.3m (12.6%) followed by a gradual improvement through to 2022 when the deficit is $2.9m (3.6%)
- Council should not have liquidity issues as indicated by an Unrestricted Current Ratio above benchmark in every year
- Council has a cumulative shortfall of $26.9m when comparing the scheduled capital expenditure to depreciation expenses with the Capital Expenditure Ratio below benchmark from 2015 to 2022

In our view, the Council has the capacity to undertake the combined borrowings of $18.0m for the LIRS project. This is based on the following analysis:

- The DSCR is scheduled to fall below benchmark between 2013 and 2021 however the lowest ratio is 1.51x in 2016, indicating that Council will still be able to manage the associated debt commitments. The ratio also takes into account the non LIRS $20.1m additional borrowings scheduled within the forecast
- The Interest Cover Ratio remains above the benchmark in all 10 years

In respect of the Benchmarking analysis, TCorp has compared the Council's key ratios, on a consolidated basis, with other councils in DLG group 4. The key observations are:

- Council's financial flexibility, as indicated by the Operating Ratio and Own Source Operating Revenue Ratio, is generally comparable to the group's average
- Council's liquidity position is adequate and it is generally similar to the group's average
- Council is more highly leveraged than its peers. Both the DSCR and Interest Cover Ratios were adequate over the review period
- Council had an overall lower level of Infrastructure Backlog than its peers; however did not achieve the benchmark throughout the review period. While Council's asset maintenance underperformed benchmark and the group's average, its capital expenditure outperformed benchmark and was generally comparable to the group's average

# 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 focused 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

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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 | > 1.5x |
| Own Source Operating Revenue Ratio | > 60.0% |
| Debt Service Cover Ratio (DSCR) | > 2.0x |
| Interest Cover Ratio | > 4.0x |
| Infrastructure Backlog Ratio | < 0.02x |
| Asset Maintenance Ratio | > 1.0x |
| Building and Infrastructure Asset Renewal Ratio | > 1.0x |
| Capital Expenditure Ratio | > 1.1x |

## 2.3: Overview of the Local Government Area

| Great Lakes Council | |
|---|---|
| Locality and Size | |
| Locality | Hunter |
| Area | 3,373 km² |
| DLG Group No. | 4 |
| Demographics | |
| Population | 34,430 |
| % under 18 | 21% |
| % between 19 and 59 | 40% |
| % over 60 | 39% |
| Expected population 2021 | 42,900 |
| Operations | |
| Number of employees | 298 |
| Annual revenue | $65m |
| Infrastructure | |
| Roads | 1,282 km |
| Bridges | 181 |
| Infrastructure backlog value | $38.5m |
| Total infrastructure value | $586.3m |

Great Lakes Council Local Government Area (LGA) is located about three hours drive north of Sydney on the Mid-North Coast between Port Stephens in the south, Taree in the north and west to the slopes of the Great Dividing Range.

The LGA is comprised of two main population centres - Forster/Tuncurry in the north and Tea Gardens/Hawks Nest to the south. In addition there are a number of towns and villages within the region, each with their own unique character, including Stroud, Bulahdelah, Coolongolook, Nabiac and Pacific Palms.

Economically the LGA has historically relied on agricultural related industry, however approximately 60% of the jobs in the LGA now relate to retail, accommodation and food services, health care and social assistance, education and training. This is due to increased retirees moving to the region and people migrating for a 'sea' or 'tree' change.

The LGA has an average growth rate of 1.1% p.a. across the five years between 2006 and 2011, below the 1.4% p.a. average for NSW LGA's.

Within Council's total infrastructure, property, plant and equipment (IPP&E) of $673.3m at 30 June 2011 there are:

- $474.2m of roads, bridges and footpaths
- $69.2m of stormwater drainage
- $26.4m of specialised buildings
- $9.2m of other structures
- $5.1m of non specialised buildings

### 2.4: LIRS Application

Council has made one LIRS application.

Project: Great Lakes Council Road and Bridge Rehabilitation Program.

Description: The program provides for the replacement of approximately 12 timber bridges with concrete at a cost of $5.0m and the rehabilitation of $13.0m of urban and rural sealed road pavements which are classified as being in poor or very poor condition within Council's Asset Management Plan.

Amount of loan facility: $18.0m to be drawn down across a three year period from 2012 to 2015.

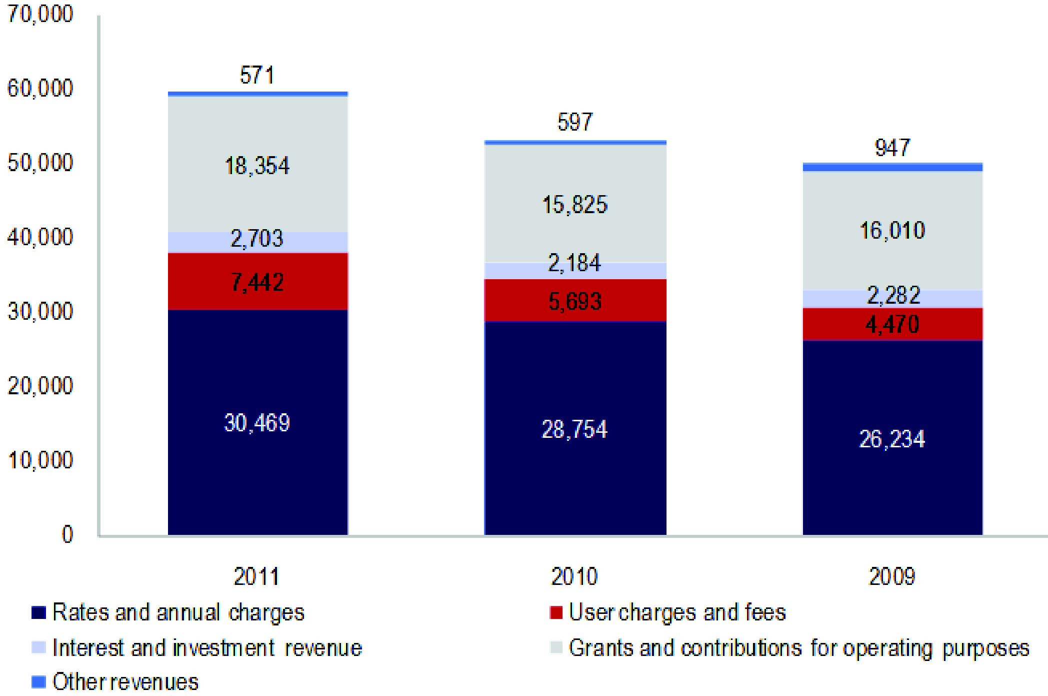
Term of loan facility: 10 years

## 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

- Operating revenues have increased by $9.6m over the period, representing an average increase of 9.6% p.a.
- Rates and annual charges have increased in each year above the rate peg equating to 8.0% p.a. The introduction of a new non-domestic waste management services charge was the main driver in 2011, while a 6% environmental special rate in place until 2014 (included in general rate revenue) and increased domestic waste management charges were responsible in 2010.
- User fees and charges have grown by $3.0m over the period when the caravan park revenue has been excluded received in 2009 and 2010. The main drivers for the $3.0m increase were domestic waste management service charges in 2010 and private works in 2011.
  The caravan parks were transferred to the Land and Property Management Authority (LPMA) as part of an ongoing State Government directive.
- Operating grants and contributions varied over the period with the 2011 increases due to increased road contributions from the RTA (now RMS) and home and community care grants. They make up 30.8% of the total operating revenue in 2011, representing a significant source of funding for Council.

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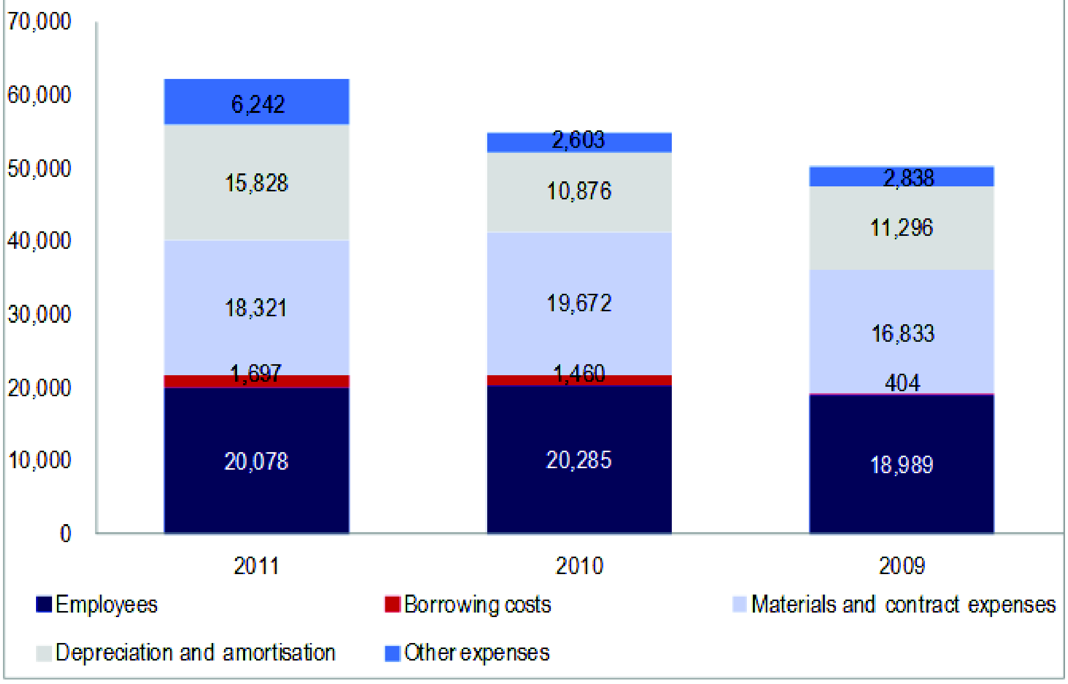
## 3.2: Expenses

Figure 2 - Expenses for 2008/09 to 2010/11 ($'000s)




Key Observations

- Operating expenses have increased by $11.8m over the period, representing an average 11.7% p.a.
- Employee expenses are the Council's largest expense and after an increase in 2010 it reduced marginally in 2011. The decrease in 2011 was due to lower workers compensation insurance premiums and Council not filling positions vacated during the year. The 2010 increase was due to higher superannuation payments of $0.5m relating to the defined benefit plan and employee leave entitlements of $0.5m. The overall increase was 5.7% across the period.
- Materials and contracts fluctuated over the period with the increase in 2010 due to additional contractor works for waste collection, road works and river environment studies. A reduction in these works in 2011 was the reason for the decrease in that year.
- Depreciation has seen the largest increase over the period of $4.5m, despite a decrease in 2010, representing a 40.0% increase from 2009. The increase relates to the Asset Revaluations that increased the value of roads, bridges, footpaths and drainage infrastructure assets and their associated depreciation.
- The increase in borrowing costs relates to Council utilising increased borrowings over the period although the 2009 figure is deflated due to a $0.7m discount adjustment for remediation liabilities.
- The other expenses in 2009 and 2010 have been adjusted downwards as this is where TCorp deducted the caravan park expenses from for these years, as there is not one specific expense category where the cumulative expenses are stated.

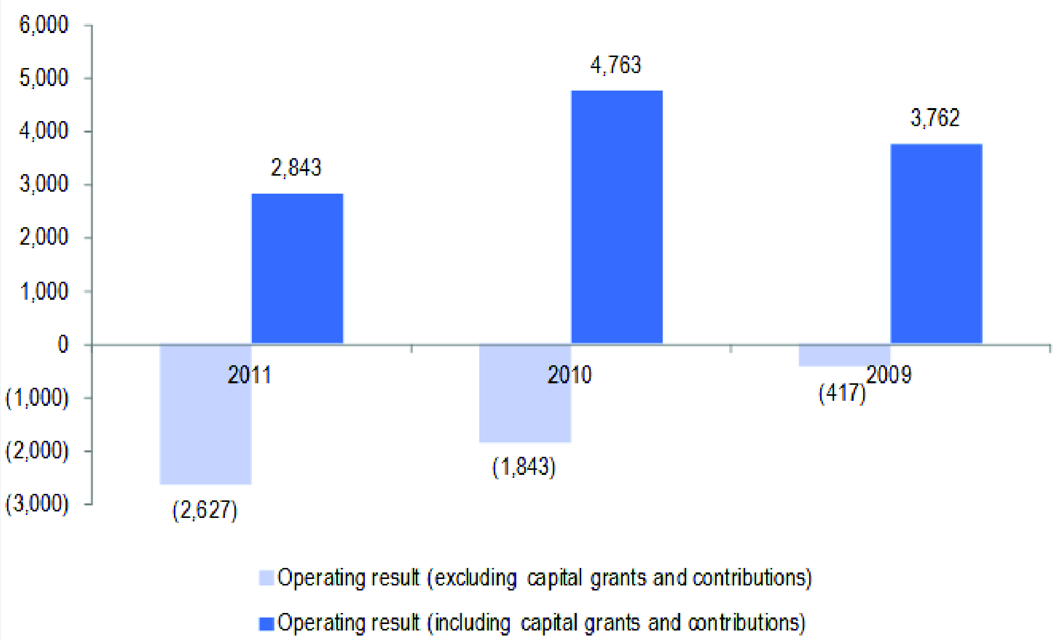
### 3.3: Operating Results

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 has posted operating deficits in all three years when capital grants and contributions are excluded. The downward trend has been due to expenses growing at a faster rate than revenues over the period.
- The $2.8m increase in materials and contract expenses in 2010, and the $5.0m increase in depreciation in 2011 are the main expense items that have driven the expense growth.
- The depreciation amounted to $15.8m in 2011, which has increased substantially 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.

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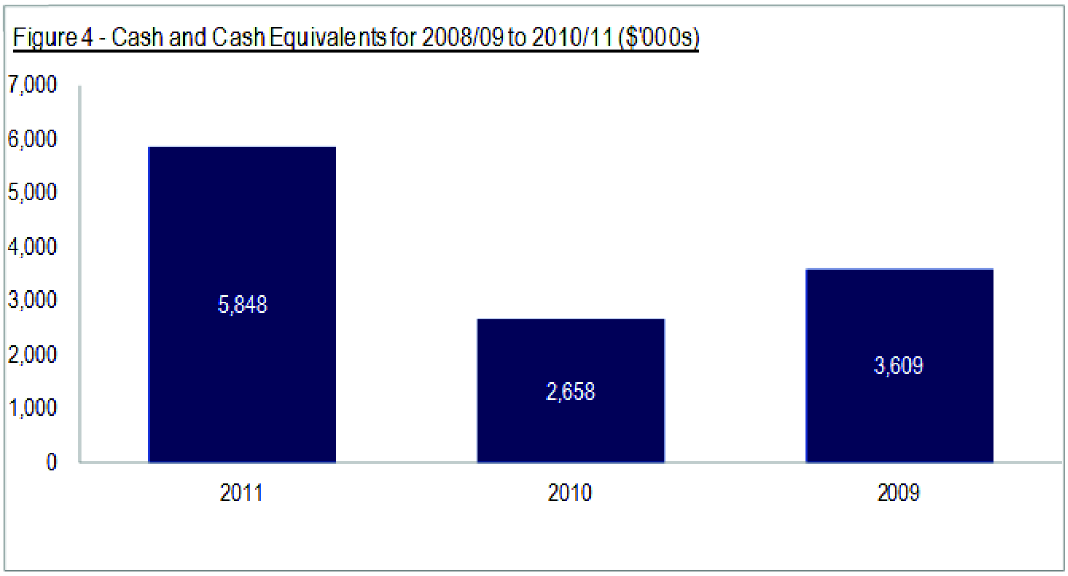
### 3.4: Financial Management Indicators

| Performance Indicators | Year ended 30 June | | |
|---|---|---|---|
| | **2011** | **2010** | **2009** |
| EBITDA ($'000s) | 14,898 | 10,493 | 11,283 |
| Operating Ratio | (4.4%) | (3.5%) | (0.8%) |
| Interest Cover Ratio | 8.78x | 7.19x | 27.93x |
| Debt Service Cover Ratio | 3.04x | 2.54x | 3.81x |
| Unrestricted Current Ratio | 2.85x | 2.84x | 2.99x |
| Cash Expense Ratio | 1.6 months | 0.7 months | 1.1 months |
| Own Source Operating Revenue Ratio | 58.3% | 57.7% | 56.7% |
| Net assets ($'000s) | 678,635 | 667,558 | 455,412 |

Key Observations

- The Operating Ratio has fallen below the benchmark in 2011 in line with the downward trend in the operating result.
- Council's underlying performance (measured using EBITDA) has also shown its strongest performance in 2011. This increase has improved the Interest Cover Ratio back over double the benchmark. The 2009 ratio was high due to the reduced interest expense in that year, relating to the $0.7m discount adjustment for remediation liabilities.
- The DSCR has remained above the benchmark for all three years, with the higher EBITDA contributing to the ratio climbing back above 3.0 times in 2011.
- Council's total debt stands at $29.1m in 2011, an increase from $18.5m in 2009. This equates to 4.3% of Net Assets in 2011. Over the three year period Council borrowed $8.1m in respect of a new land fill site and $7.0m for road infrastructure renewals and maintenance.
- The Unrestricted Current Ratio has remained above the benchmark indicating that the Council have had sufficient liquidity throughout the period.
- The Cash Expense Ratio has remained below the benchmark in all three years however Council have the majority of their current assets held in current investments. In 2011 the total of internally restricted and unrestricted cash and cash equivalents, and current investments totalled $25.4m, compared to cash and cash equivalents alone that totalled $5.8m.
- The Own Source Operating Revenue Ratio is slightly below the benchmark in all three years but is on an upward trend. This highlights that Council rely on grants and contributions to boost their total revenue.
- The increase in Net Assets relates to the Asset Revaluations with a $207.1m increase in 2010 relating to road, bridge, footpath and drainage infrastructure assets and $18.2m relating to community land and other structures in 2011.
- When the Asset Revaluations are excluded there has been a $15.6m 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




Key Observations

- Council's cash and cash equivalents have fluctuated over the period and increased to their highest level in 2011. Overall the cash and cash equivalents, and investments combined have increased across the three year period by $8.4m to $48.8m.
- Of the $48.8m, $23.4m is externally restricted, $20.3m is internally restricted and $5.1m is unrestricted.
- Within the investments portfolio of $42.9m, $35.5m is held in current deposits, $4.0m in non-current deposits, $1.5m in CDOs due to mature in 2012, $0.9m in equity linked notes, and $1.0m in longer term Negotiable Certificates of Deposits and FRNs.
- The increase in both cash and cash equivalents, and investments, along with a strong Unrestricted Current Ratio indicates that Council had sufficient liquidity to manage their day to day liabilities.

### 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 2010/11 ($'000's)

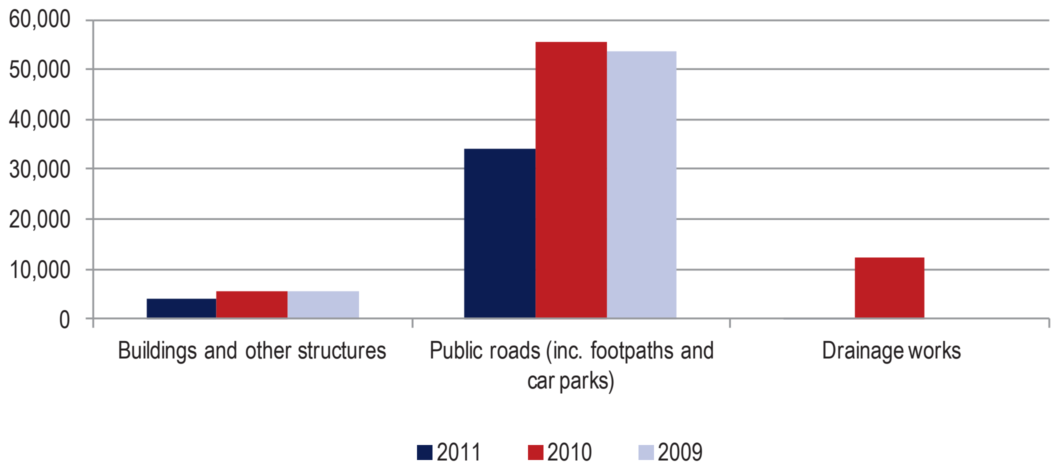
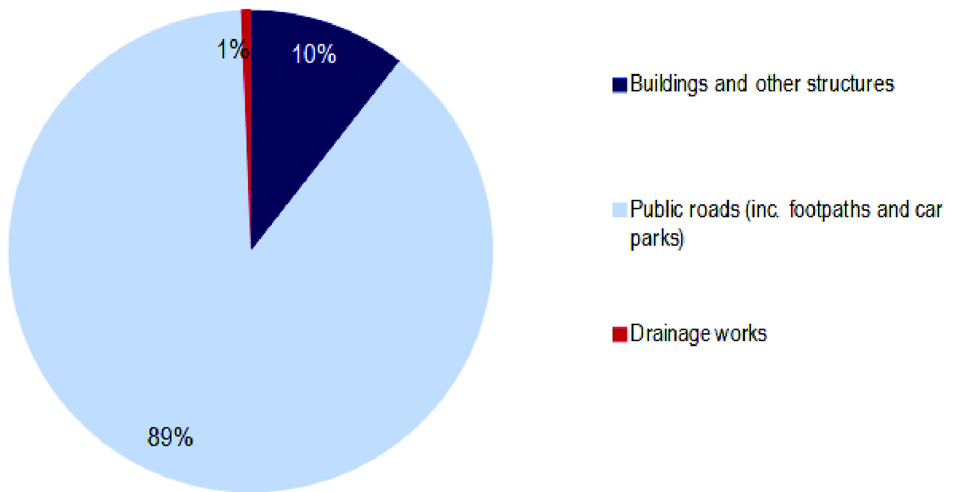



Figure 6 - Infrastructure Backlog Composition for 2010/11




The Infrastructure Backlog has fluctuated over the period and is stated at its lowest level in 2011 at $38.5m. This is a decrease from $73.2m in 2010 and is because Council have refined their revaluation process and their asset management plan.

The 2011 Infrastructure Backlog is heavily dominated by Public Roads which make up $34.2m of the total.

### 3.6(b): Infrastructure Status

| Infrastructure Status | Year ended 30 June | | |
|---|---|---|---|
| | 2011 | 2010 | 2009 |
| Bring to satisfactory standard ($'000s) | 38,469 | 73,216 | 59,137 |
| Required annual maintenance ($'000s) | 12,569 | 17,741 | 0 |
| Actual annual maintenance ($'000s) | 7,138 | 10,243 | 0 |
| Total value of infrastructure assets ($'000s) | 586,316 | 596,410 | 342,633 |
| Total assets ($'000s) | 730,119 | 711,623 | 491,887 |
| Building and Infrastructure Backlog Ratio | 0.07x | 0.12x | 0.17x |
| Asset Maintenance Ratio | 0.57x | 0.58x | N/A |
| Building and Infrastructure Renewals Ratio | 0.72x | 1.02x | 1.32x |
| Capital Expenditure Ratio | 1.41x | 1.54x | 1.28x |

The Infrastructure Backlog Ratio has been on a downward trend over the period. This positive trend is because of an increase in the value of the infrastructure assets from 2010 but also a reduction in the backlog amount in 2011.

The Asset Maintenance Ratio data was only available for 2010 and 2011 and the ratios for both years indicate that Council is not investing sufficient funds to maintain the asset base. This could impact negatively on the backlog figure in future years. The 2009 special schedules were not fully complete and is the reason for the absence of the 2009 ratio.

The Building and Infrastructure Renewals Ratio has been on a negative trend over the period and fell below the benchmark in 2011.

Council have invested adequate capital expenditure in all three years when analysing the Capital Expenditure Ratio. Over this period Council has invested $15.6m more in asset additions than the written down value of disposed assets and the depreciation of IPP&E combined.

### 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 | 7,615 | 4,792 | 0 |
| Replacement/refurbishment of existing assets | 15,533 | 12,492 | 0 |
| **Total** | **23,148** | **17,284** | **0** |

Special Schedules 7 and 8 were not completed in 2009 as this was not a compulsory requirement.

Council's 2011 capital programs included:

- Myall Way upgrade - $1.2m
- Southern Parkway, Forster - $0.8m
- Bramble Parade Wetland refurbished
- Several sections of The Lakes Way reconstructed - $2.0m
- Sandy Creek Bridge on Booral Road reconstructed - $0.6m
- Lavinia Murray Bridge at Bunyah reconstructed - $0.8m
- Drainage piped past Bulahdelah Nursing Home - $0.3m

Other programs also listed in 2011 are:

- Palms Estate water treatment devices
- Smiths Lake Recreation Ground - netball court, picnic shelters and landscaping
- Dredging of Corrie Channel
- Upgrade to community halls - Bungwahl, Hawks Nest, Coolongolook and Pacific Palms
- Clarkson Street Nabiac cycleway construction
- Clarkson Street Nabiac road rehabilitation
- Near completion of a $2.2m addition to the Aquatic Centre in Forster
- Near completion of the access road to Council's landfill at Minimbah

### 3.7: Specific Risks to Council

- Inability to reduce Infrastructure Backlog. Council have historically funded a portion of their maintenance funding through loan borrowings as their operating revenues have been limited. This impacts their ability to finance their capital expenditure and reduce the backlog. The Infrastructure Backlog will increase over time unless this trend is addressed. Council is committed to reducing their reliance on borrowings for maintenance by 10%p.a. and has evidenced that this is being achieved.
- Climate change and sea level changes. Council has a large area of coastline and a number of areas very susceptible to sea level rise. One example relates to the beach at Winda Woppa where Council has to spend approximately $0.3m p.a. to replenish the sand but the total rates received by residents in the area only amounts to $0.33m. This cost has increased from $0.1m historically. Council has established a Climate Change Co-ordination Committee to identify the impacts and develop mitigation strategies and policies.
- Ageing population. The LGA is a popular place for the 'sea and tree' retirees and by 2021 the proportion of residents over 65 is expected to be over 30%. Council is mitigating the demographic shift by amending urban design and infrastructure provision within their town planning policies to service the ageing population.
- Ageing workforce. Council had 57% of employee's aged 45 or over in 2010 and 21% aged 55 or over. Council find it difficult to implement succession planning given the size of Council whereby a clear career path is not easily identifiable within the organisational structure. This makes it hard to transfer skill knowledge as employee's get towards retirement. Retaining skilled staff is also a challenge as Council battles against other industries such as mining. The development of Council's Workforce Management Plan is focusing Council's efforts to mitigate these issues.
- Natural Resources Management. The community rated the protection of waterways as their number one priority and protection of the natural environment as the number three priority in a 2008 survey of 38 separate priorities. The preservation of the natural environment and waterways is also vital to economic output with key industries of rock oyster production and fishing, along with tourism all relying on the natural resources. Council has developed a number of plans and strategies to preserve the quality of the LGA including the environmental levy that has been in place for 11 years. This levy is due to expire in 2015 and at present Council has not had approval for this to continue.
- Unemployment – especially amongst the young. The LGA has had an unemployment rate of 9% over the three year period, one of the highest in the Hunter Region. If unemployment remains high then younger people will most probably look outside the LGA for work and may end up having to move. This will compound the problem of an ageing population over the longer term. Council face the challenge of promoting and assisting economic development while respecting the community's wishes in relation to the natural environment preservation. Council's Community Strategic Plan is focusing on this issue within the 'planning for balance' key direction.

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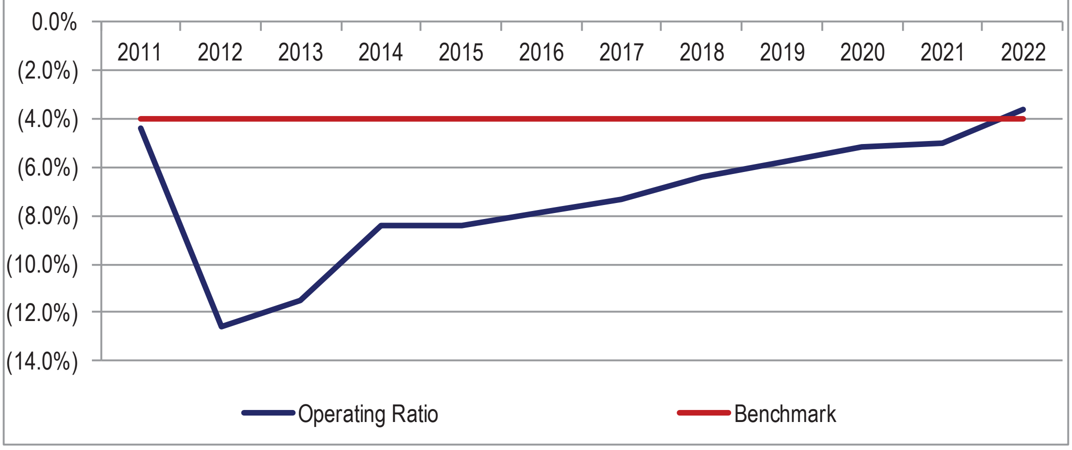
## Section 4 Review of Financial Forecasts

The financial forecast model shows the projected financial statements and assumptions for the next 10 years. The model includes the $18.0m loan with the LIRS subsidy. We have therefore made a manual adjustment to the forecast to remove the subsidy after Council provided the relevant figures.

The LIRS loan relates to the General Fund, therefore we have focused our financial analysis solely upon this Fund.

### 4.1: Operating Results

Figure 7 - Operating Ratio




Council has forecast the weakest Operating Ratio in 2012 at negative 12.6%, equating to a deficit of $7.3m.

Council was granted an SRV of 8.0% p.a. including the rate peg for three years inclusive of 2012 that should assist the financial sustainability of Council by funding specific capital programs.

Despite the SRV in 2012, Council's operating revenues decreased by $1.6m due to reduced user charges and fees, and operating grants and contributions. At the same time operating expenses increased by $3.1m, leading to the weakest performance over the forecast.

From 2012 Council is expecting the Operating Ratio to improve each year with the deficit in 2022 to be slightly better than the benchmark at negative 3.6%, or $2.9m.

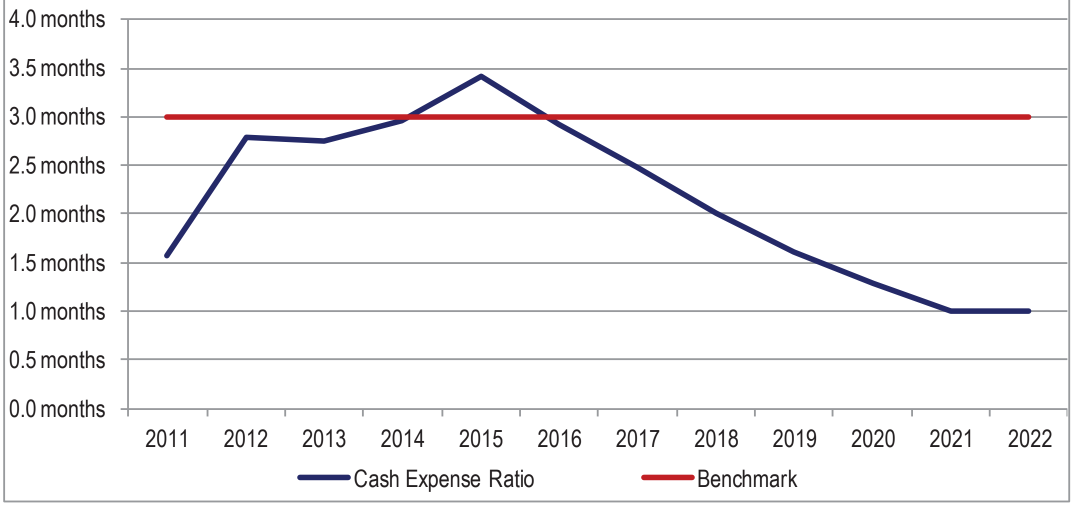
The LIRS loan is scheduled to drawn down over a three year period with $4.9m utilised in 2013, $6.6m in 2014 and $6.5m in 2015.

## 4.2: Financial Management Indicators

The financial management indicators are linked to the utilisation of debt in early years and improve over time as the amortising debt reduces and operating deficits also improve.

Liquidity Ratios

Figure 8 - Cash Expense Ratio




Council is below the benchmark in all years excluding 2015 as they proactively utilise their cash reserves in short term deposits classified under current investments. Council is forecasting their cash and equivalents to reduce from $15.0m in 2015 to $5.6m in 2022.

When current investments are included the ratio is above the benchmark in all 10 years but is on a downward trend. The figure below includes all current investments however it is to be noted that in 2011 approximately 42% of cash and cash equivalents, and current investments were externally restricted.

Figure 9 - Cash Expense Ratio inc. Current Investments

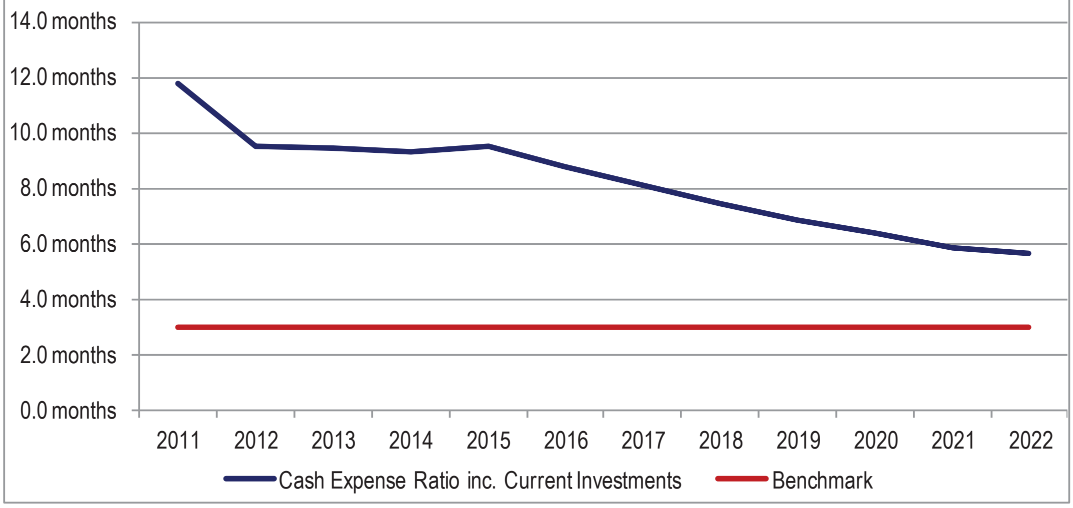
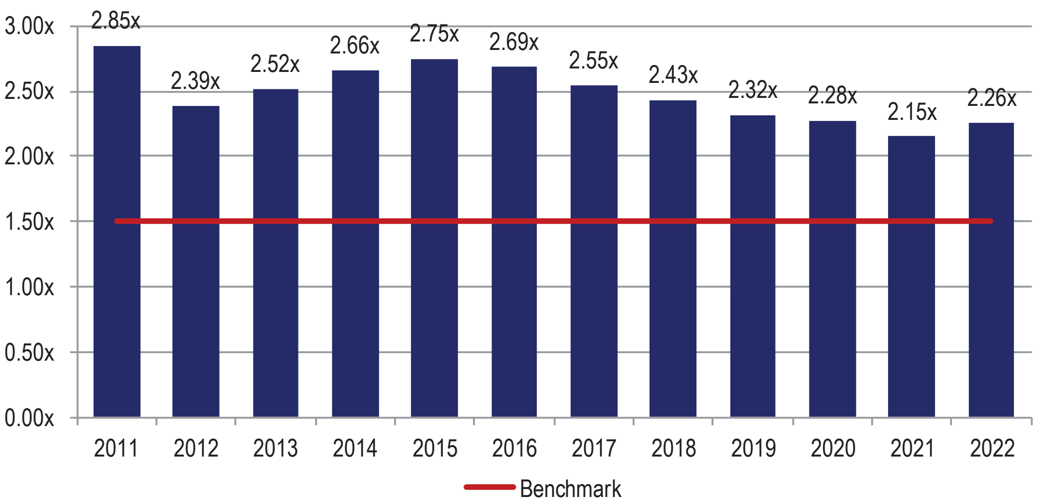


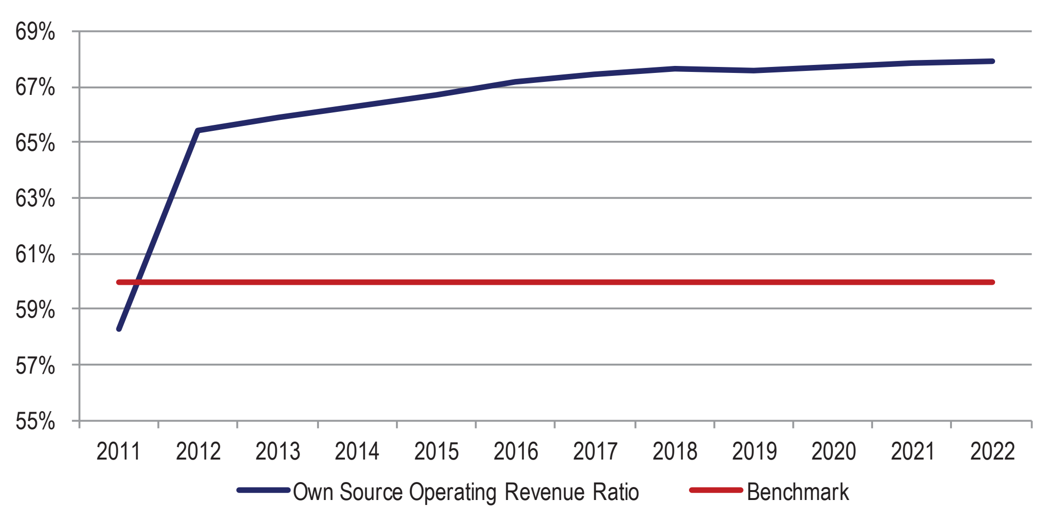
Figure 10 - Unrestricted Current Ratio



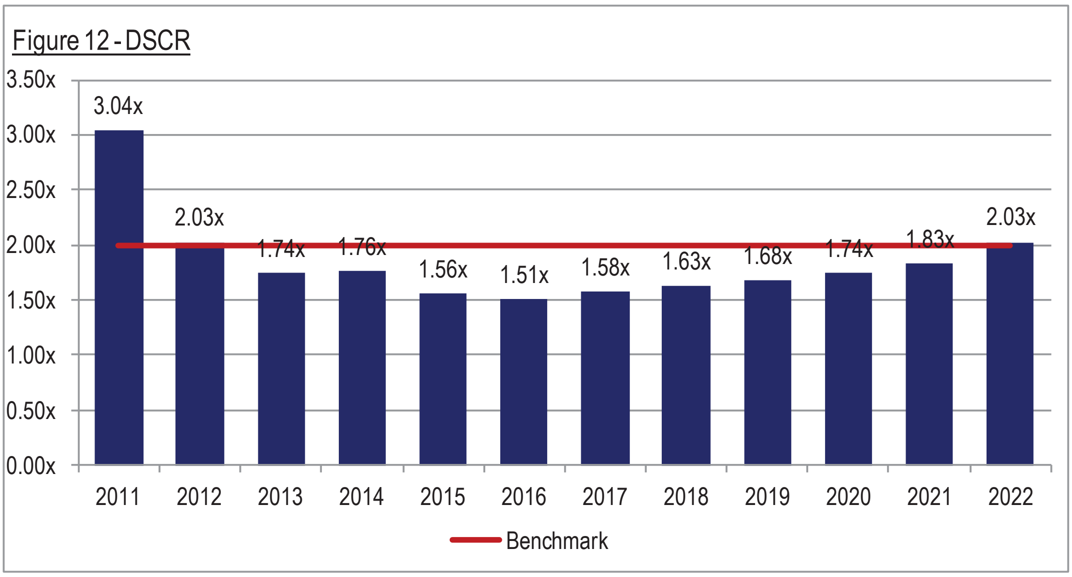

Council has forecast the Unrestricted Current Ratio to be below the historical results in all 10 years. The ratio still remains above the benchmark for every year indicating Council should not experience liquidity issues.

Fiscal Flexibility Ratios

Figure 11 - Own Source Operating Revenue Ratio

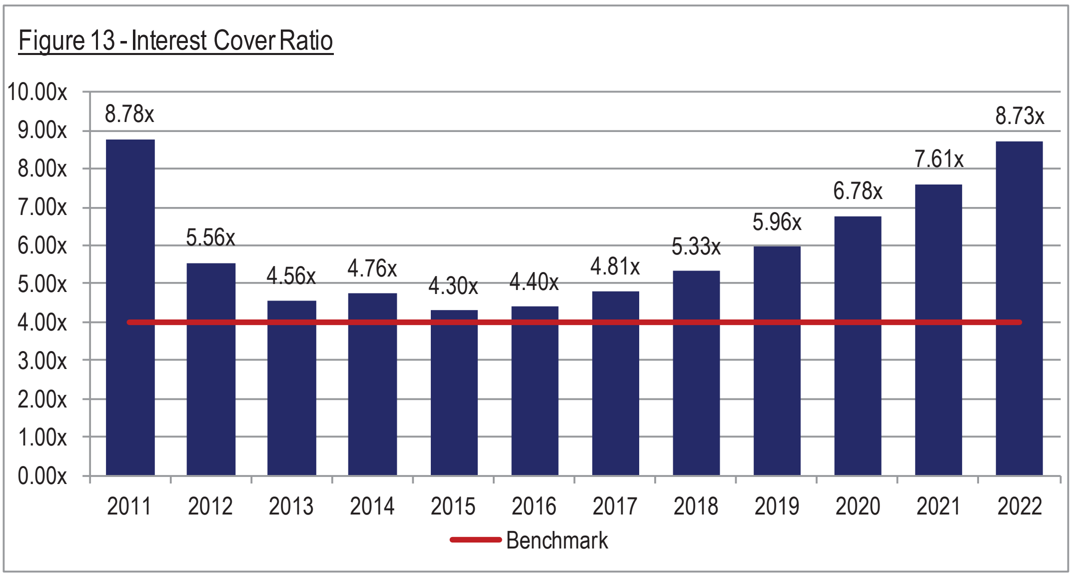



The Own Source Operating Revenue Ratio remains above the benchmark for each year of the forecast from 2012 onwards. This is in contrast the historic result being slightly below the benchmark. The ratio is rising marginally over the lifetime of the forecast due to capital grants and contributions forecast being lower than historically received. This skews the proportion of Own Source Revenue Ratio upwards.




The DSCR is forecast to be below benchmark in 2013, the first year of the LIRS project draw down, and to remain below the benchmark until 2022. In addition to the $18.0m LIRS borrowings, Council has scheduled further borrowings of $20.1m during the 10 year period.

Council's total borrowings peak at $48.7m in 2015. Council is scheduled to repay in excess of $5m in each year from 2015 therefore it appears that the majority of Council's borrowings have a 10 year term or less.




The Interest Cover Ratio decreases as the LIRS loans and the majority of the additional borrowings are utilised between 2013 and 2015 however unlike the DSCR, the ratio remains above the benchmark for the duration of the forecast and improves as the borrowings are repaid and the interest cost reduces from the high of $3.0m in 2015.

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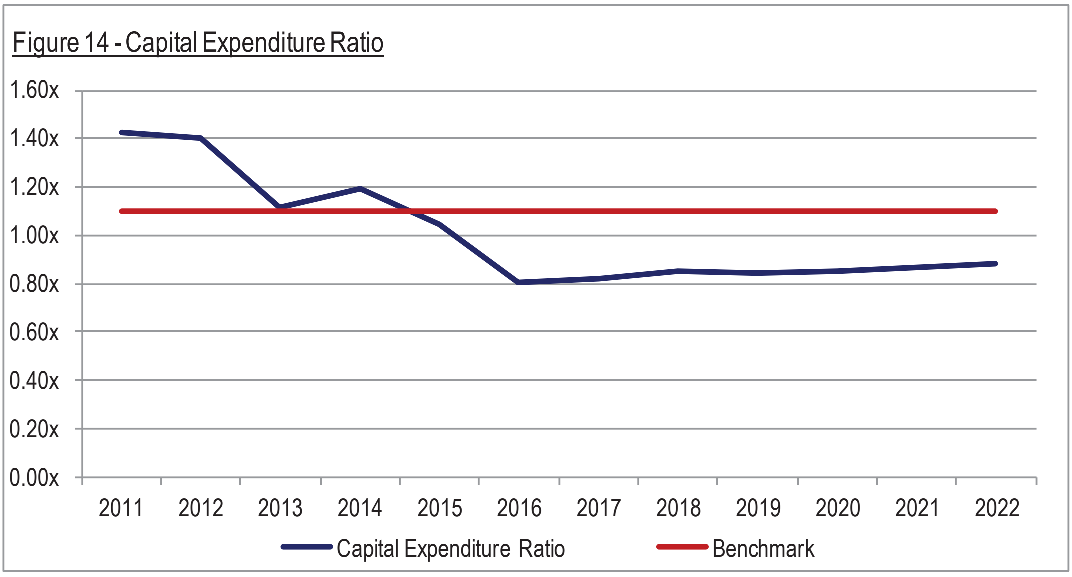
## 4.3: Capital Expenditure




While Council has historically been above the benchmark for the Capital Expenditure Ratio, the ratio is forecast to be below the benchmark from 2015 onwards. Over the forecast period from 2013 to 2022, the cumulative shortfall of capital expenditure against depreciation is $26.9m.

This shortfall will likely have an impact on the quality of Council's assets and impact the Infrastructure Backlog figure.

### 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%

Key Observations and Risks

- As part of Council's on-going organisation-wide service level review it has already revised certain services in the past however the LTFP base case was completed on the assumption that services are maintained at the current service levels over the full 10 years
- The three year SRV that was partially approved by IPART for 2012 – 2014 was to provide an additional layer of funding to improve Council's financial sustainability through a number of capital works programs
- Other revenues are forecast to more than double in 2013 to $1.3m as this is the first year when rental income will be received from the supermarket development at Tuncurry. It is then forecast to increase in 2014 by a further 36.0% as this is the first full financial year of rental income being received
- Other expenses are forecast to increase by 19.1% in 2013 and between 8.8% to 5.8% from 2014 to 2017. These increases mainly relate to the State levies for the domestic waste management program along with higher than CPI increases for water and sewerage charges as well as electricity and other levies to State Government for the Rural Fire Service and State Emergency Services but we note that some of these increases are offset by corresponding revenue increases.
- TCorp considers the majority of the assumptions behind the LTFP reasonable

### 4.5: Borrowing Capacity

When analysing the financial capacity of the Council, we believe they will not be able to incorporate additional loan funding in addition to the LIRS loan facilities of $18.0m and the scheduled $20.1m additional borrowings already included within forecast. This observation is because as indicated in Section 4.2, Council will be below the DSCR benchmark of 2.00x from 2013 to 2021.

## Section 5 Benchmarking and Comparisons with Other Councils

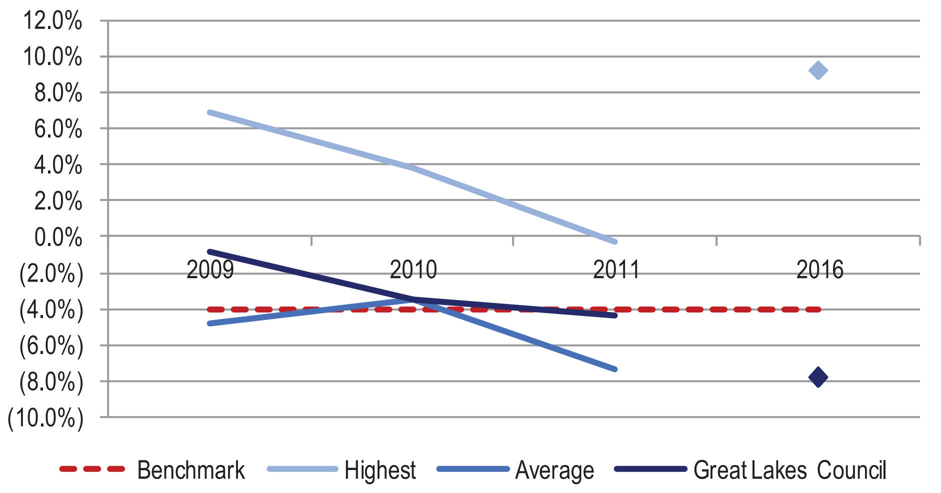
As discussed in section 2 of this report, each council's performance has been assessed against ten key benchmark ratios. The benchmarking assessment has been conducted on a consolidated basis (that is, for councils that operate more than one fund, the results of all funds are included). This section of the report compares the Council's performance with its peers in the same DLG Group. The Council is in DLG Group 4. There are 32 councils in this group and at the time of preparing this report, we have data for 19 of these councils.

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.

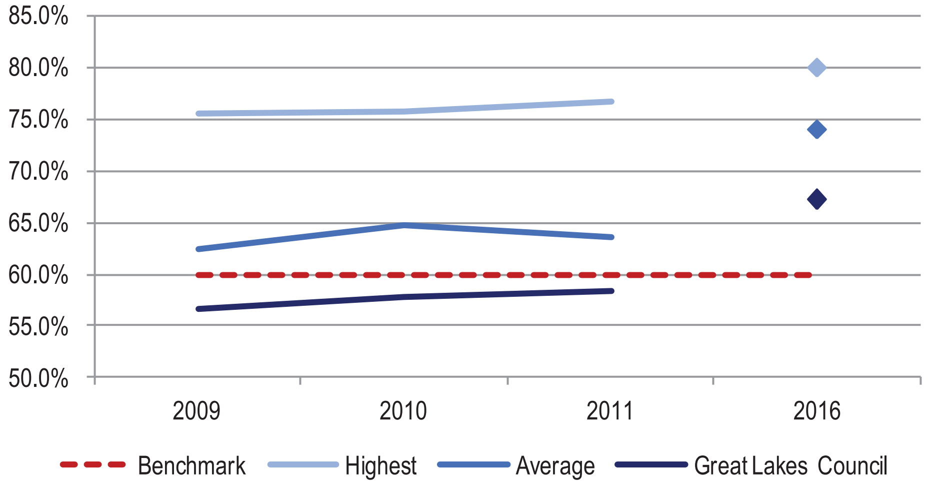
Financial Flexibility

Figure 15 - Operating Ratio Comparison




Council's Operating Ratio generally tracked the benchmark and outperformed the group's average in the past three years. However, Council's operating results are forecast to fall below benchmark over the medium term to match the average of councils in the group.

Figure 16 - Own Source Operating Revenue Ratio Comparison

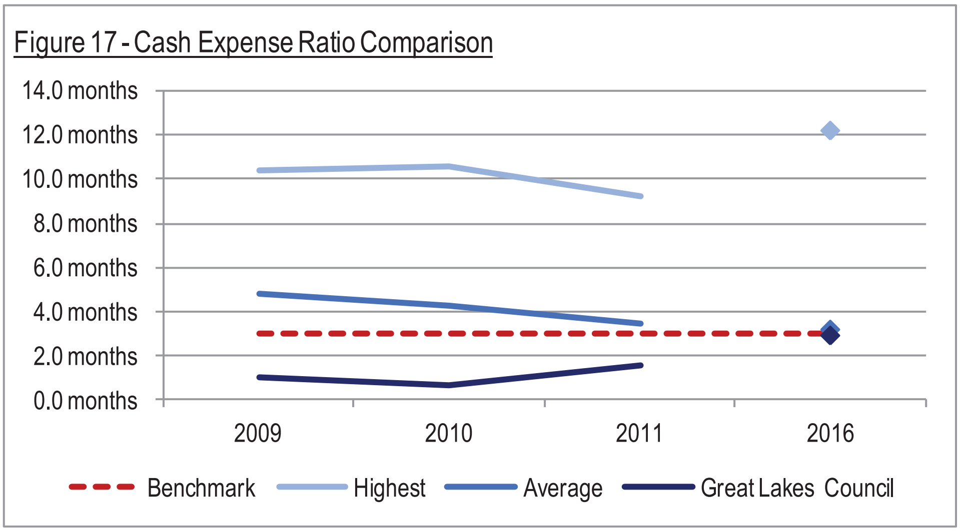


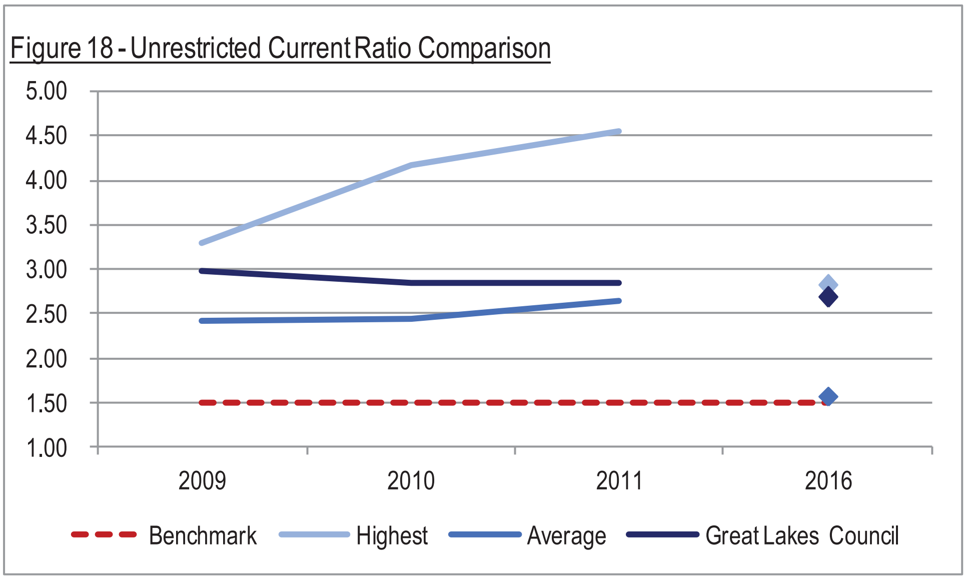

Council's own sourced revenue was below benchmark and the group's average in the past three years. This indicates that fiscal flexibility was insufficient over the review period, with Council relying more heavily on external funding than its peers.

Council is forecast to improve its Own Source Operating Revenue Ratio over the medium term, due to expected reductions in capital grants and contributions.

Overall, Council's financial flexibility is comparable to the other councils in the group.

Liquidity




Council's Cash Expense Ratio was below benchmark and the group's average in the past three years, although it is on an upward trend and expected to improve to benchmark levels over the medium term.

Council's Unrestricted Current Ratio outperformed the average council in the group over the review period and is forecast to remain strong in future years.

On average over the past three years, Council's liquidity position has been adequate and comparable to the other councils in the group.

## Debt Servicing

Figure 19 - Debt Service Cover Ratio Comparison

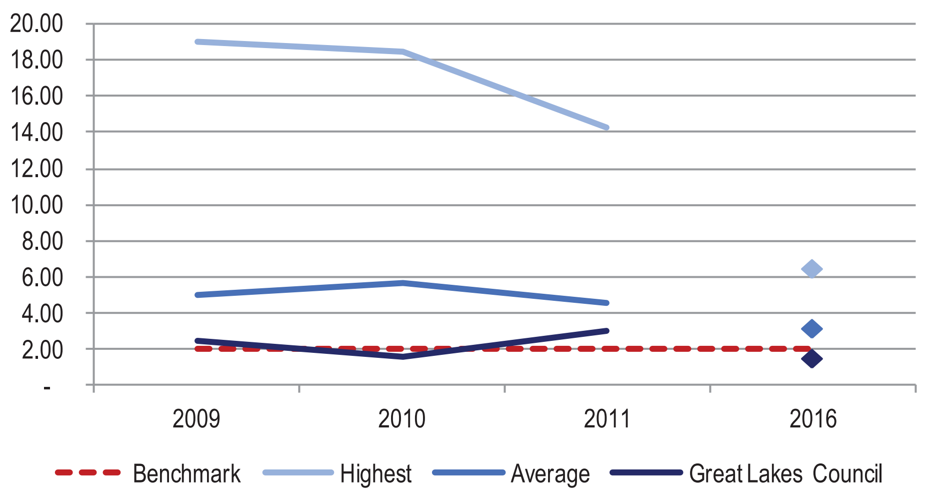
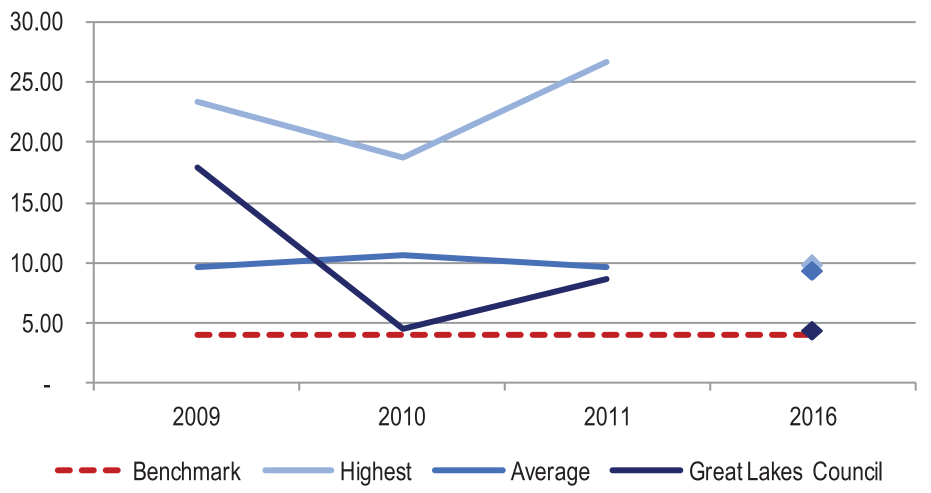



Figure 20 - Interest Cover Ratio Comparison




Council's debt servicing capacity has been sufficient in the past three years, being generally at or near benchmark, although it has generally tracked below the group's average. This indicates that whilst Council is more highly leveraged than its peers, it is still at acceptable levels.

## Asset Renewal and Capital Works

Figure 21 - Capital Expenditure Ratio Comparison

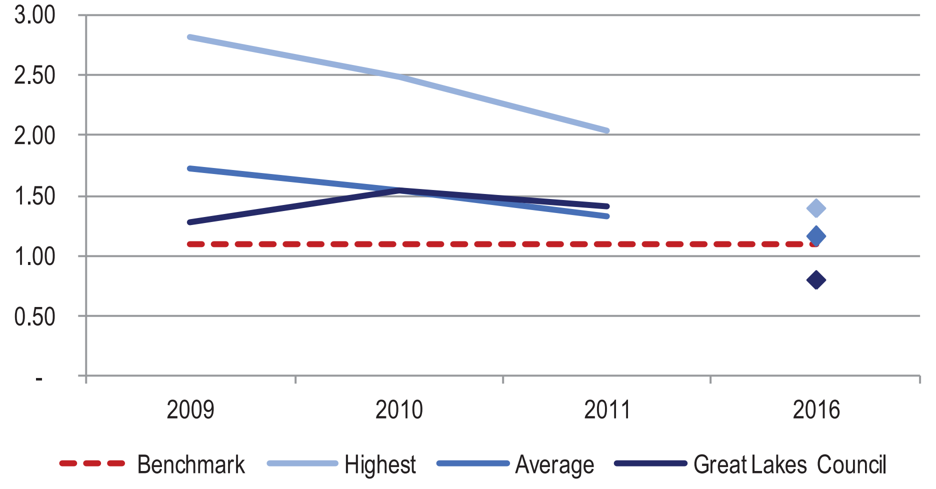



Figure 22 - Asset Maintenance Ratio Comparison

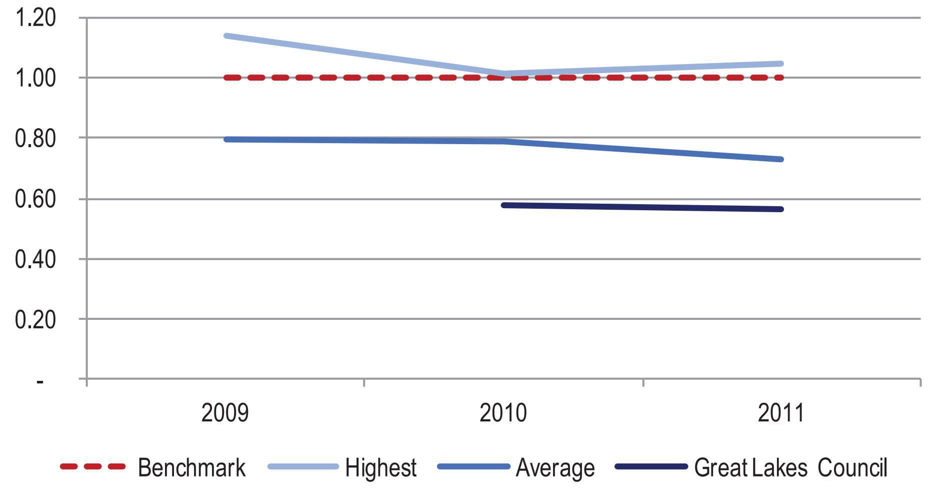


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Figure 23- Infrastructure Backlog Ratio Comparison

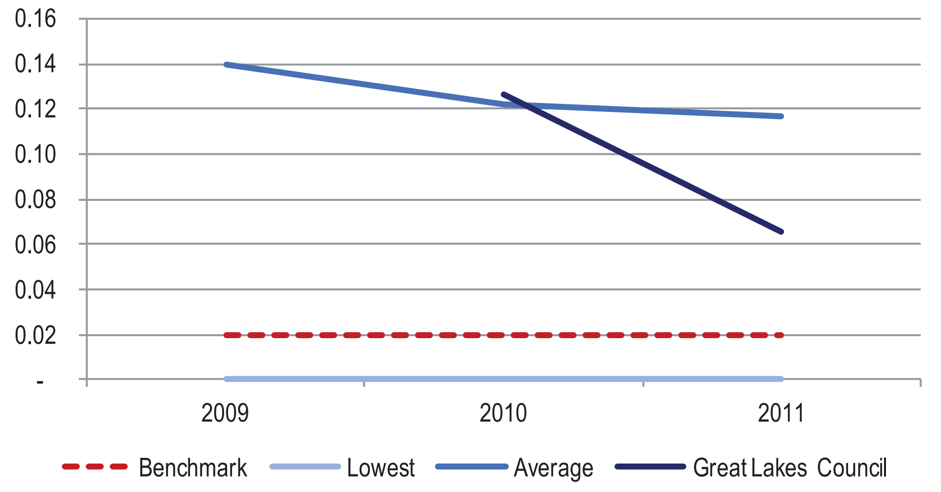
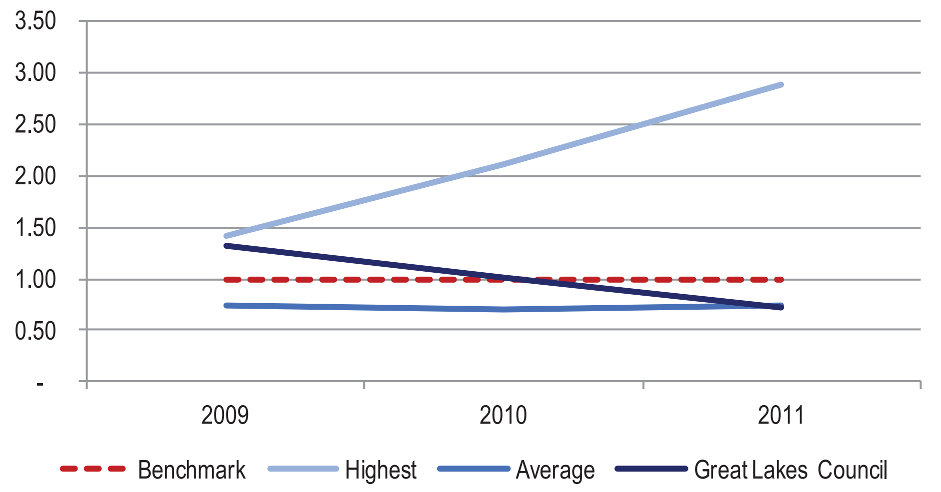



Figure 24 - Building and Infrastructure Asset Renewal Ratio




Council's Infrastructure Backlog declined in 2011 and compares favourably with the group's average, however the ratio remained above benchmark. Council did not provide data for a backlog ratio figure in 2009.

Council's Asset Maintenance was below benchmark and the group's average in the past two years (no figure was provided for 2009). Building and Infrastructure Asset Renewal trended downward over the review period to below benchmark levels.

Expenditure on capital works was above benchmark over the past three years and comparable to the other councils in the group, indicating that Council has been prioritising the purchase of new assets over maintenance and renewal work.

## 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 in a satisfactory financial position. We recommend that Council receive the LIRS facility, despite their DSCR falling below the benchmark for the majority of the forecast period.

We base our recommendation on the following key points:

- Council's underlying historical operating performance (measured using EBITDA) has improved over the three year period
- Council continues to review all service levels and expenditure with a view to continuing the efficiencies and cost savings that have been identified in the last few years. This is expected to save up to \$0.6m p.a.
- Council has maintained sound liquidity and appears to have sufficient liquidity to manage their short term liabilities during the 10 year forecast period
- While the DSCR is below benchmark for the majority of the forecast, the lowest ratio of 1.51x indicates that Council will still be in a position to repay all scheduled borrowings - the \$18.0m LIRS facility and \$20.1m additional borrowings
- The Interest Cover Ratio remains above the benchmark in all 10 years

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

- Council need to be aware that they will have reduced fiscal flexibility with a DSCR below the benchmark of 2.00x. Therefore if they are faced with any unexpected events that have not been forecast, they may face liquidity issues. If the ratio is above the benchmark it offers a higher degree of comfort to manage any out of course events. Council may wish to review their borrowing projections to improve this position.
- Council is still reliant on borrowings to assist their asset renewals, although it is noted this is reducing by approximately 10% p.a. The sooner Council is able to fund all of this funding from recurring revenues, the sooner they will be able to work towards financial sustainability in the medium to long term

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# 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 | 30,469 | 28,754 | 26,234 | 6.0% | 9.6% |
| User charges and fees | 7,442 | 5,693 | 4,470 | 30.7% | 27.4% |
| Interest and investment revenue | 2,703 | 2,184 | 2,282 | 23.8% | (4.3%) |
| Grants and contributions for operating purposes | 18,354 | 15,825 | 16,010 | 16.0% | (1.2%) |
| Other revenues | 571 | 597 | 947 | (4.4%) | (37.0%) |
| **Total revenue** | **59,539** | **53,053** | **49,943** | **12.2%** | **6.2%** |
| | | | | | |
| Employees | 20,078 | 20,285 | 18,989 | (1.0%) | 6.8% |
| Borrowing costs | 1,697 | 1,460 | 404 | 16.2% | 261.4% |
| Materials and contract expenses | 18,321 | 19,672 | 16,833 | (6.9%) | 16.9% |
| Depreciation and amortisation | 15,828 | 10,876 | 11,296 | 45.5% | (3.7%) |
| Other expenses | 6,242 | 2,603 | 2,838 | 139.8% | (8.3%) |
| **Total expenses** | **62,166** | **54,896** | **50,360** | **13.2%** | **9.0%** |
| **Operating result** | **(2,627)** | **(1,843)** | **(417)** | **42.5%** | **342.0%** |

Table 2 - Items excluded from Income Statement

| Excluded items ($'000s) | | | |
|---|---|---|---|
| | 2011 | 2010 | 2009 |
| Grants and contributions for capital purposes | 5,470 | 6,606 | 4,179 |
| Increase (Decrease) in the fair value of investments | 151 | (195) | (578) |
| Net share of interests in joint ventures and associates using equity method | 9 | 7 | 1 |
| Net gain from disposal of assets | 0 | 13 | 0 |
| Net losses from disposal of assets | 231 | 0 | 497 |
| Caravan Park user charges & fees | 0 | 5,147 | 4,808 |
| Caravan Park expenses (special schedule 1) | 0 | 3,814 | 3,537 |
| Net Loss from discontinued operations (caravan parks) | 9,973 | 0 | 0 |

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Table 3 - Balance Sheet

| Balance Sheet ($'000s) | Year Ended 30 June | | | % annual change | |
|---|---|---|---|---|---|
| | **2011** | **2010** | **2009** | **2011** | **2010** |
| **Current assets** | | | | | |
| Cash and equivalents | 5,848 | 2,658 | 3,609 | 120.0% | (26.4%) |
| Investments | 37,907 | 37,622 | 30,788 | 0.8% | 22.2% |
| Receivables | 6,223 | 5,718 | 4,093 | 8.8% | 39.7% |
| Inventories | 947 | 901 | 926 | 5.1% | (2.7%) |
| Other | 822 | 364 | 956 | 125.8% | (61.9%) |
| Total current assets | 51,747 | 47,263 | 40,372 | 9.5% | 17.1% |
| **Non-current assets** | | | | | |
| Investments | 5,014 | 6,750 | 6,000 | (25.7%) | 12.5% |
| Infrastructure, property, plant & equipment | 673,318 | 657,610 | 445,515 | 2.4% | 47.6% |
| Investments accounted for using the equity method | 40 | 0 | 0 | N/A | N/A |
| Total non-current assets | 678,372 | 664,360 | 451,515 | 2.1% | 47.1% |
| **Total assets** | **730,119** | **711,623** | **491,887** | **2.6%** | **44.7%** |
| **Current liabilities** | | | | | |
| Payables | 9,562 | 8,935 | 6,614 | 7.0% | 35.1% |
| Borrowings | 3,133 | 2,924 | 2,664 | 7.1% | 9.8% |
| Provisions | 7,938 | 7,575 | 6,919 | 4.8% | 9.5% |
| Total current liabilities | 20,633 | 19,434 | 16,197 | 6.2% | 20.0% |
| **Non-current liabilities** | | | | | |
| Borrowings | 25,940 | 19,945 | 15,847 | 30.1% | 25.9% |
| Provisions | 4,911 | 4,633 | 4,371 | 6.0% | 6.0% |
| Investments accounted for using the equity method | 0 | 53 | 60 | (100.0%) | (11.7%) |
| Total non-current liabilities | 30,851 | 24,631 | 20,278 | 25.3% | 21.5% |
| **Total liabilities** | **51,484** | **44,065** | **36,475** | **16.8%** | **20.8%** |
| **Net assets** | **678,635** | **667,558** | **455,412** | **1.7%** | **46.6%** |

Table 4-Cashflow

| Cashflow Statement ($'000s) | Year ended 30 June | | |
|---|---|---|---|
| | **2011** | **2010** | **2009** |
| Cashflows from operating activities | 17,265 | 17,450 | 15,328 |
| Cashflows from investing activities | (20,279) | (22,759) | (15,687) |
| Proceeds from borrowings and advances | 9,413 | 7,022 | 3,493 |
| Repayment of borrowings and advances | (3,209) | (2,664) | (2,561) |
| Cashflows from financing activities | 6,204 | 4,358 | 932 |
| **Net increase/(decrease) in cash and equivalents** | **3,190** | **(951)** | **573** |
| Cash and equivalents | 5,848 | 2,658 | 3,609 |

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## 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.

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[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.

New South Wales Treasury Corporation

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

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.

New South Wales
Treasury Corporation

5 April 2013

Colin Davies

Revenue Accountant

Great Lakes Council

**Updated Benchmarking Section for the LIRS Assessment Report Dated 4 October 2012**

Dear Colin,

Following our Financial and Assessment and Benchmarking Report dated 4 October 2012 which was prepared as a part of the Local Infrastructure Renewal Scheme (LIRS), TCorp has progressed to review all the 152 councils within NSW and have now collected additional data from peers within your Division of Local Government (DLG) Group.

Please find enclosed an updated version of 'Section 5: Benchmarking and Comparisons with Other Councils' including data from the financial year ended 30 June 2012 for all the NSW councils in Group 4.

We hope you find this information useful. Please contact us if you have any questions about this matter.

Yours sincerely,

Matthew Pickover

## Updated 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 4. There are 31 councils in this group and at the time of preparing this report, we have data for all of these councils.

In Figure 1 to Figure 7, 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 8 to 10 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.

Please note that this section of the report has been prepared separately to the LIRS financial assessment and includes the latest information at the time of preparation which includes data from the 2012 financial year.

Financial Flexibility

Figure 1 - Operating Ratio Comparison

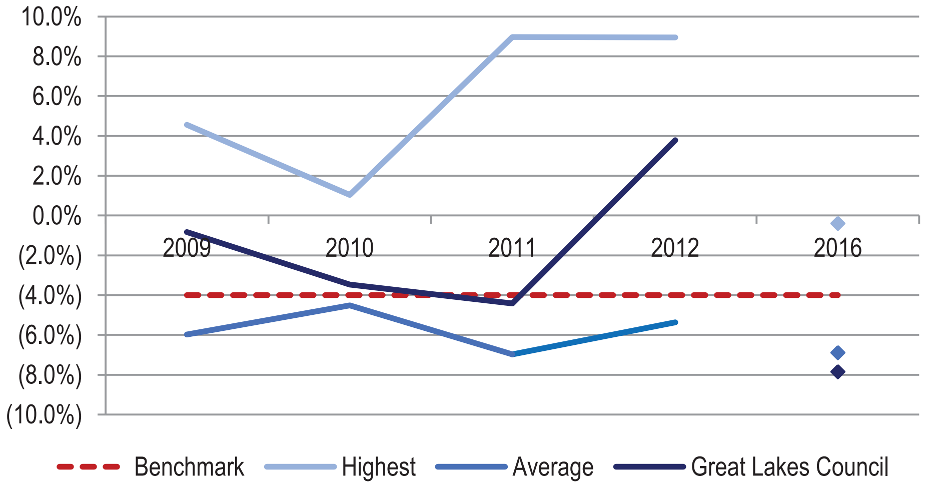
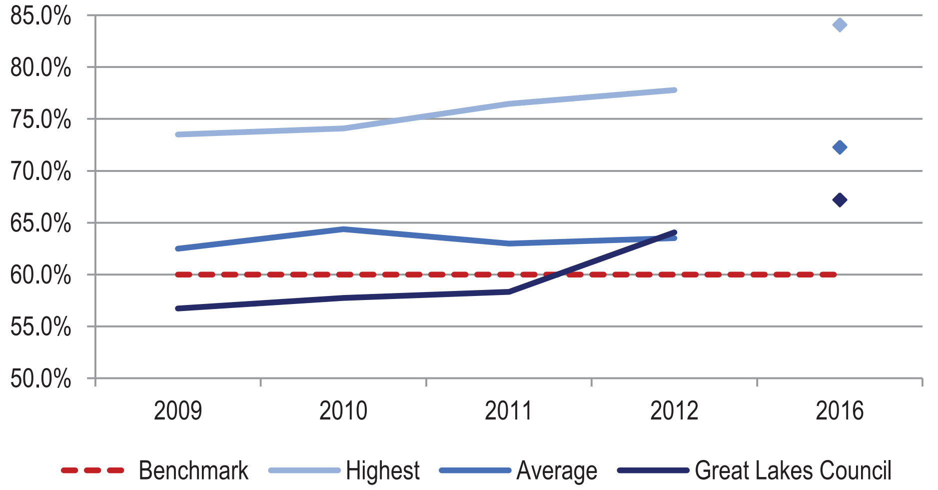


Figure 2 - Own Source Operating Revenue Ratio Comparison




Council has moderate financial flexibility with the Operating Ratio and the Own Source Operating Revenue Ratio improving since 2009 to be above benchmark and the group's average in 2012 as a result of higher user fees and charges. This upward trend is forecast to 2016, driven by higher operating grants and user fees and charges.

Liquidity

Figure 3 - Cash Expense Ratio Comparison

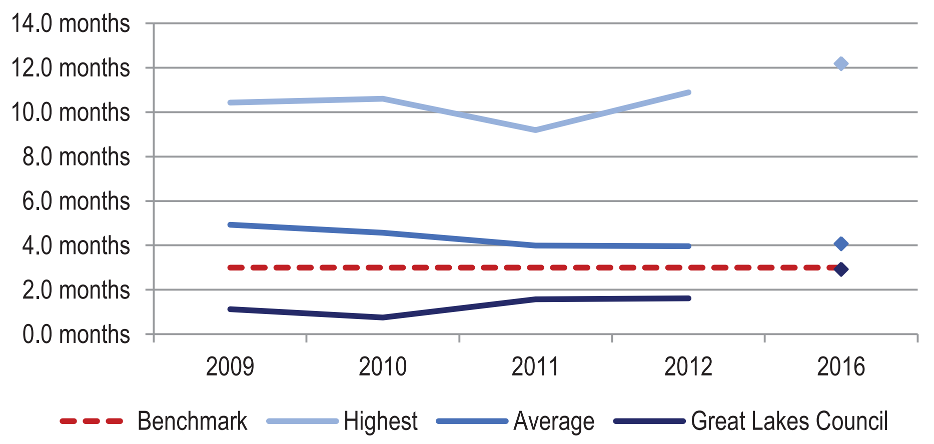
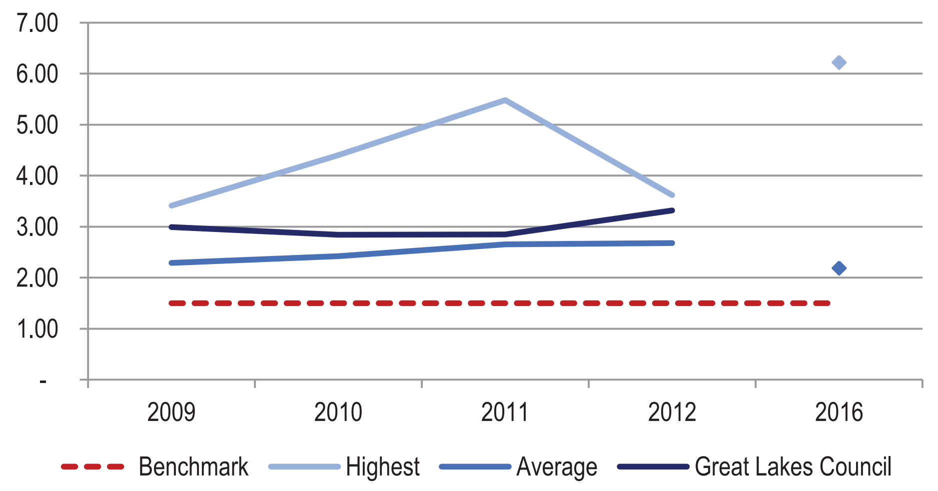



Figure 4 - Unrestricted Current Ratio Comparison




Council has sufficient liquidity with the Unrestricted Current Ratio above the benchmark and the group's average since 2009. While the Cash Expense Ratio is below benchmark and the group's average, this calculation does not include short term deposits which are classified as investments and if included, Council would be above benchmark.

Debt Servicing

Figure 5 - Debt Service Cover Ratio Comparison

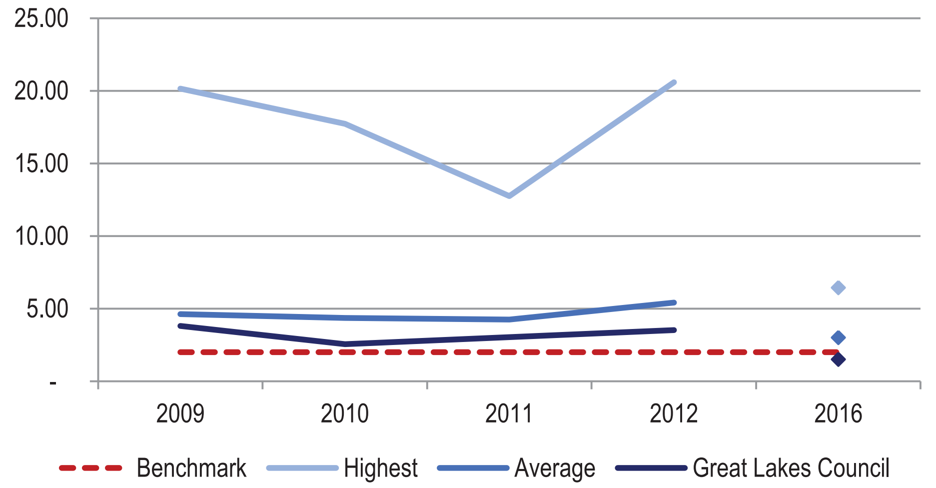
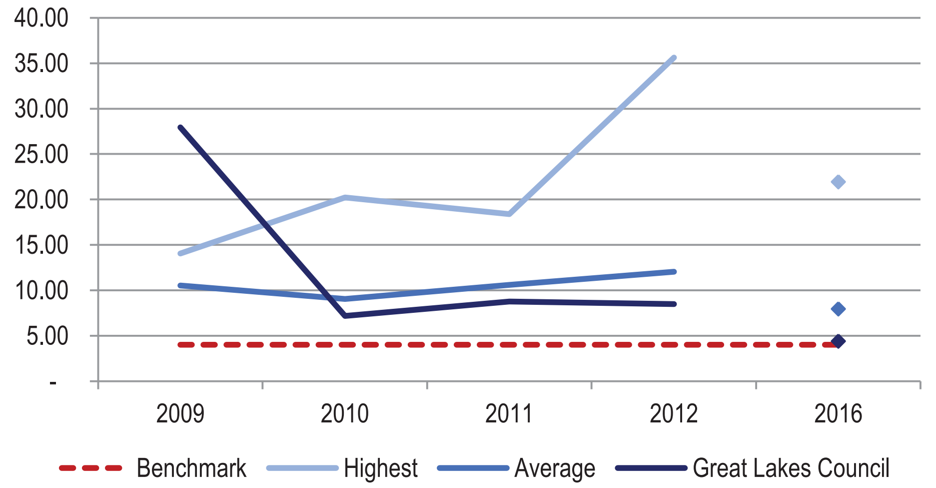



Figure 6 - Interest Cover Ratio Comparison




Council has acceptable debt servicing capacity with the Interest Cover Ratio and the Debt Service Cover Ratio above benchmark but below the group average for the past few years. Both ratios are forecast to marginally decline with Council undertaking further borrowings which are forecast to peak in 2015 at $48.7 million.

## Asset Renewal and Capital Works

Figure 7 - Capital Expenditure Ratio Comparison

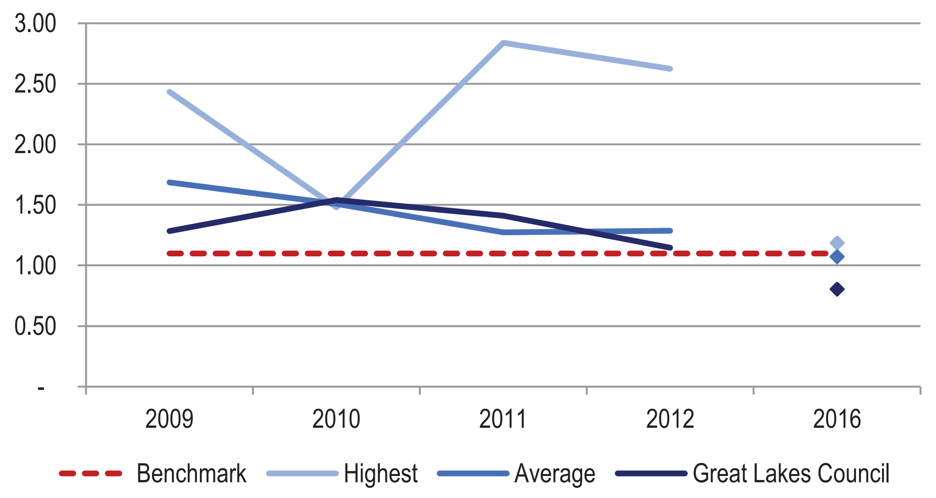



Figure 8 - Asset Maintenance Ratio Comparison

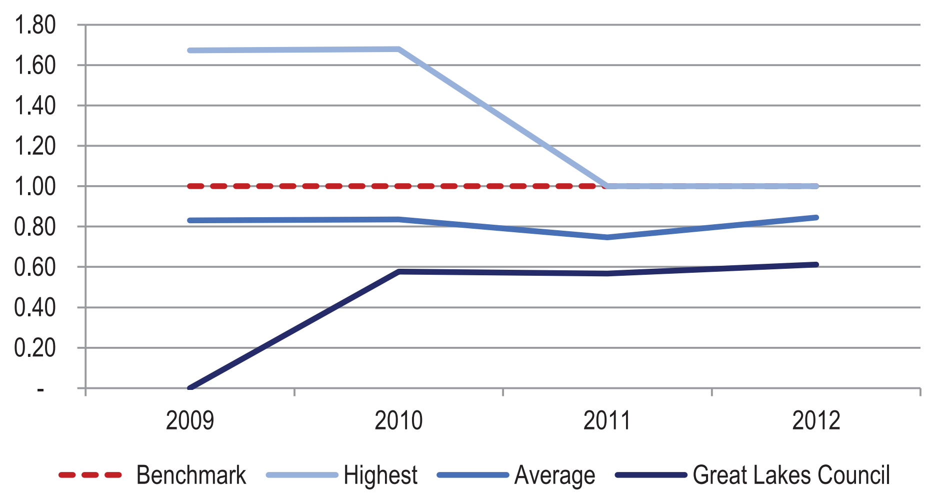


Figure 9 - Infrastructure Backlog Ratio Comparison

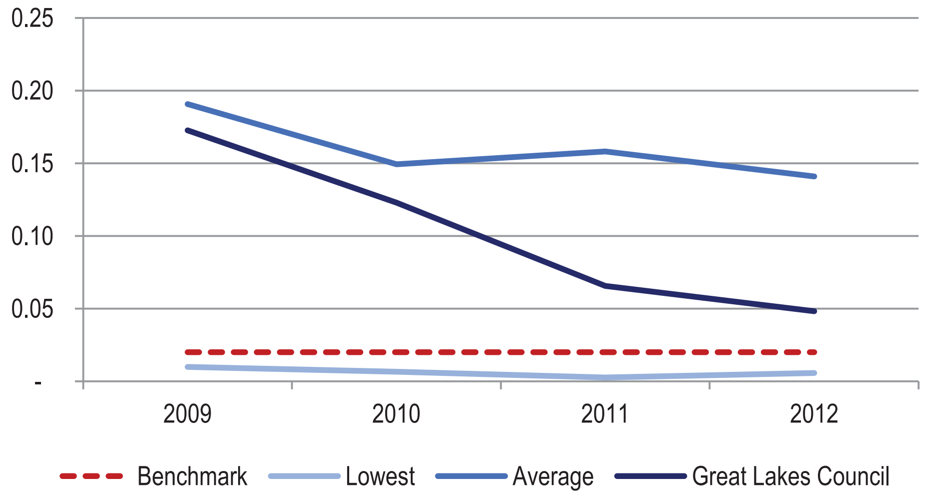
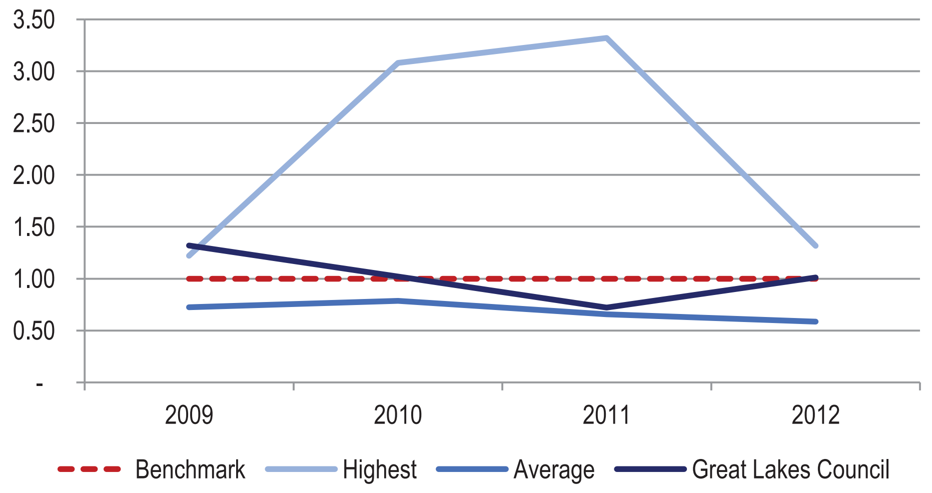



Figure 10 - Building and Infrastructure Asset Renewal Ratio




Council's Capital Expenditure Ratio has trended above benchmark but has declined since 2010 and is forecast to be below benchmark by 2016. While both asset renewal and asset maintenance are trending upwards, these expenditures are either only at or below benchmark. Should this level of expenditure continue the Infrastructure Backlog Ratio is likely to increase in the future, despite it decreasing over the review period.

New South Wales
Treasury Corporation

10 April 2013

The General Manager
Great Lakes Council
Breese Parade,
Forster NSW 2428

Dear Sir/Madam,

**Financial Assessment of NSW Councils – LIRS Applicants**

As part of TCorp's work for the Independent Review Panel chaired by Professor Graham Sansom, New South Wales Treasury Corporation (TCorp) has undertaken an assessment of the financial capacity and sustainability of all 152 Councils in New South Wales. Each Council has received, or is about to receive, a report prepared by TCorp that provides an assessment of the following key areas:

- 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

In addition, TCorp has also prepared a Financial Sustainability Rating (FSR) and Outlook for each Council. These FSRs and Outlooks have been developed by TCorp to provide an overall position of the sustainability of Councils when compared with each other Council within NSW.

The Appendix attached to this letter provides details of the seven FSR categories and the three Outlook categories that have been used in arriving at the assessed FSR and Outlook of each Council.

The Council has been assessed as:

| | |
|---|---|
| FSR | Moderate |
| Outlook | Neutral |

The FSR of each Council has been determined based on TCorp's review and consideration of the historical and forecast financial results and against a set of benchmark indicators. TCorp has categorised the benchmark ratios into four broad categories and then considered the relative importance of each category in terms of a Council's financial capacity and sustainability. The category of financial flexibility has been assigned a greater weighting because it measures two key measures for sustainability, the Council's revenue raising capacity, and its ability to sustain financial shocks, which are important factors for sustainability. As a Council's core servicing function and main asset is its infrastructure, its asset renewal and capital works program is an important factor in its long term sustainability. Debt servicing has been given the least weighting because most Councils are lowly geared.

The Outlook is TCorp's assessment of the potential movement of a Council's FSR within the next three years. A Positive Outlook indicates that a Council's FSR is likely to improve in the short term, whilst a Neutral Outlook indicates that the FSR is likely to remain unchanged. A Negative Outlook indicates that a Council's FSR is more likely to deteriorate and is a sign of a general weakening in performance and sustainability.

For example, a Council with a FSR of Moderate and an Outlook of Negative, is assessed as being in a deteriorating position or at risk of being downgraded from Moderate to Weak. As TCorp considers a FSR of lower than Moderate to be at much greater risk of being unsustainable, Councils in this position need to be considering options for addressing the areas of poor performance that are contributing to Council's assessed FSR and Outlook.

The Outlook is TCorp's current assessment of the potential movement of a Council's FSR and will change as a Council undertakes actions to reduce perceived risks, such as completing Asset Management Plans, or obtaining approval for a special rate variation to increase investment in renewal capital expenditure.

TCorp's Report to the Independent Review Panel is expected to be released in mid-April and the FSR and Outlook for each Council will be included in TCorp's Report.

TCorp would be happy to discuss with you any questions that you may have in regard to the assessed FSR or Outlook for the Council.

Yours Sincerely
New South Wales Treasury Corporation

[redacted]

Kevin Pugh
Senior Manager Corporate Finance

# Appendix 1 Ratings and Definitions

Table A1 - Financial Sustainability Ratings

| Rating | Definition |
|---|---|
| Very Strong | • A local government with a very strong capacity to meet its financial commitments in the short, medium and long term.<br>• It has a record of reporting operating surpluses.<br>• It is highly likely to be able to manage unforseen financial shocks and any adverse changes in its business without revenue and/or expense adjustments.<br>• Its capacity to manage core business risks is very strong. |
| Strong | • A local government with a strong capacity to meet its financial commitments in the short, medium and long term.<br>• It generally has a record of operating surpluses and may occasionally report minor operating deficits. It is able to address its operating deficits, manage major unforseen financial shocks and any adverse changes in its business with minor revenue and/or expense adjustments.<br>• The expense adjustments are likely to result in only minor changes to the range of and/or quality of services offered.<br>• Its capacity to manage core business risks is strong. |
| Sound | • A local government with an adequate capacity to meet its financial commitments in the short, medium and long term.<br>• While it is likely that it may have a record of minor to moderate operating deficits, the local government is expected to regularly report operating surpluses. It is likely able to address its operating deficits, manage major unforseen financial shocks and any adverse changes in its business with minor or moderate revenue and/or expense adjustments.<br>• The expense adjustments are likely to result in some changes to the range of and/or quality of services offered.<br>• Its capacity to manage core business risks is sound. |

| | |
|---|---|
| Moderate | • A local government with an adequate capacity to meet its financial commitments in the short to medium term and an acceptable capacity in the long term.<br>• While it has some record of reporting minor to moderate operating deficits the local government may also have recently reported a significant operating deficit.<br>• It is likely able to address its operating deficits, manage unforseen financial shocks and any adverse changes in its business, with moderate revenue and/or expense adjustments. The expense adjustments are likely to result in a number of changes to the range of and/or quality of services offered.<br>• Its capacity to manage core business risks is moderate. |
| Weak | • A local government with an acceptable capacity to meet its financial commitments in the short to medium term and a limited capacity in the long term.<br>• It has a record of reporting moderate to significant operating deficits with a recent operating deficit being significant. It is unlikely to be able to address its operating deficits, manage unforseen financial shocks and any adverse changes in its business, without the need for significant revenue and/or expense adjustments.<br>• The expense adjustments would result in significant changes to the range of and/or quality of services offered.<br>• It may experience difficulty in managing core business risks. |
| Very Weak | • A local government with a limited capacity to meet its financial commitments in the short to medium term and a very limited capacity long term.<br>• It has a record of reporting significant operating deficits. It is highly unlikely to be able to address its operating deficits, manage unforseen financial shocks and any adverse changes in its business without the need for structural reform and major revenue and/or expense adjustments.<br>• The expense adjustments are likely to result in significant changes to the range of and/or quality of services offered and it may need the assistance from higher levels of government.<br>• It has difficulty in managing its core business risks. |
| Distressed | • A local government with a very limited capacity to meet its short term financial commitments and no capacity to meet its medium to long term financial commitments.<br>• It has a record of reporting significant operating deficits.<br>• To be able to address its operating deficits, meet its medium and long term obligations, manage unforseen financial shocks and any adverse changes in its business, major revenue and expense adjustments and structural reform will be required.<br>• The local government is unlikely to have the capacity to manage core business risks and may need assistance from higher levels of government. |

Table A2 – Outlook

| Outlook | Definition |
|---|---|
| Positive | As a result of a foreseeable event or circumstance occurring, there is the potential for enhancement in the local government's capacity to meet its financial commitments (short and/or long term) and resulting change in its rating. However, it does not necessarily indicate that a rating change may be forthcoming. |
| Neutral | There are no known foreseeable events that would have a direct impact on the financial sustainability of the local government. It may be possible for a rating upgrade or downgrade to occur from a neutral outlook, if warranted by an event or circumstance. |
| Negative | As a result of a foreseeable event or circumstance occurring, there is the potential for deterioration in the local government's capacity to meet its financial commitments (short and/or long term) and resulting change in its rating. However, it does not necessarily indicate that a rating change may be forthcoming. |

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.**

New South Wales
Treasury Corporation

## 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.

New South Wales
Treasury Corporation

# Index

## 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:

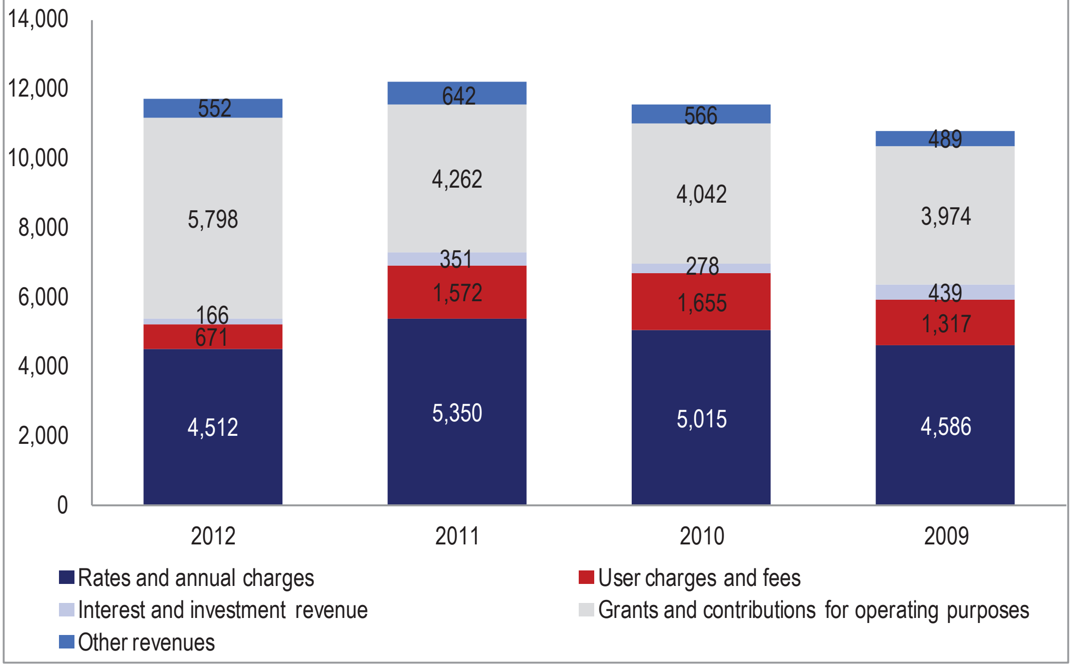
- $92.0m of roads, bridges and footpaths
- $5.9m of non specialised buildings
- $3.8m of specialised buildings
- $3.7m of other structures
- $2.7m of stormwater drainage

## 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

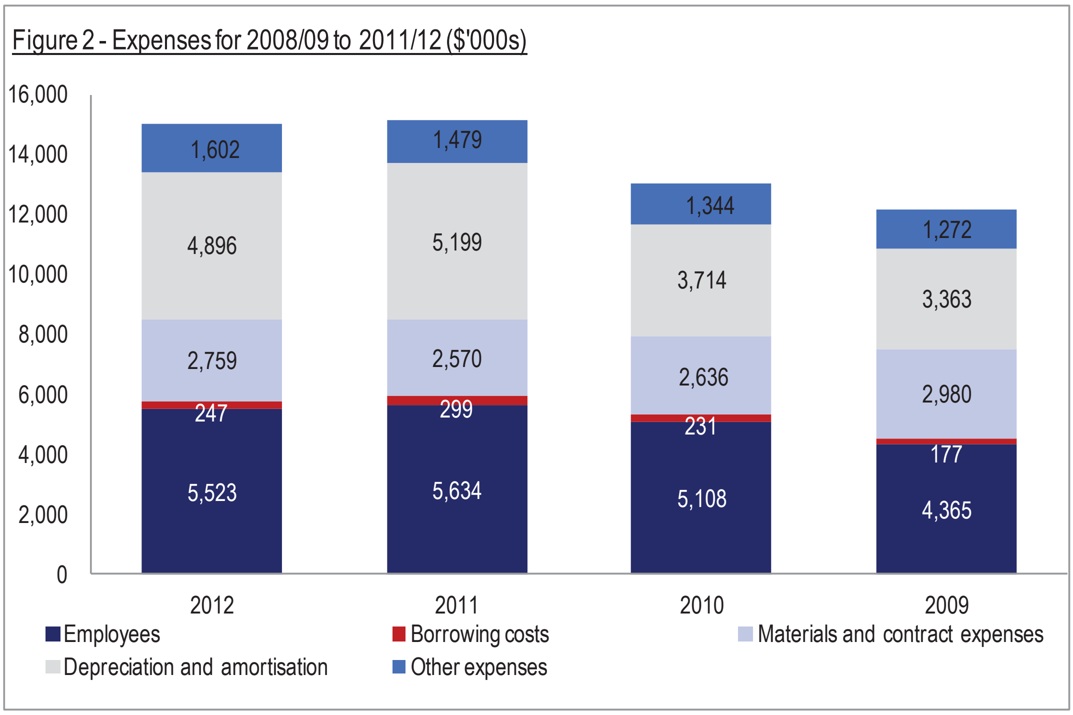
Figure 1 - Revenue Sources for 2008/09 to 2011/12 ($'000s)




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.

## 3.2: Expenses




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.

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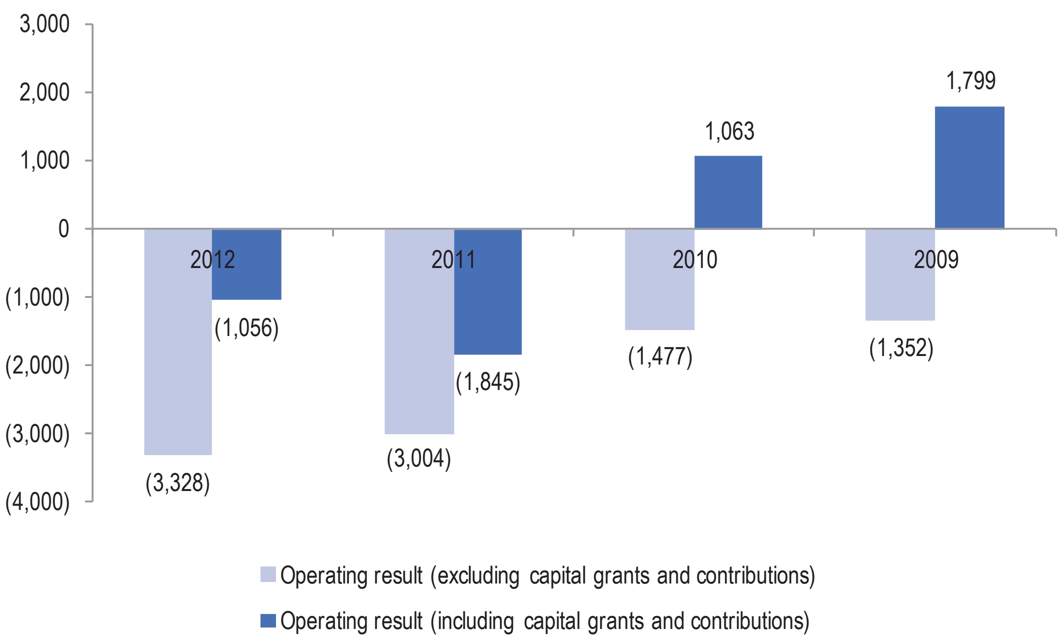
### 3.3: Operating Results

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.

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### 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 |

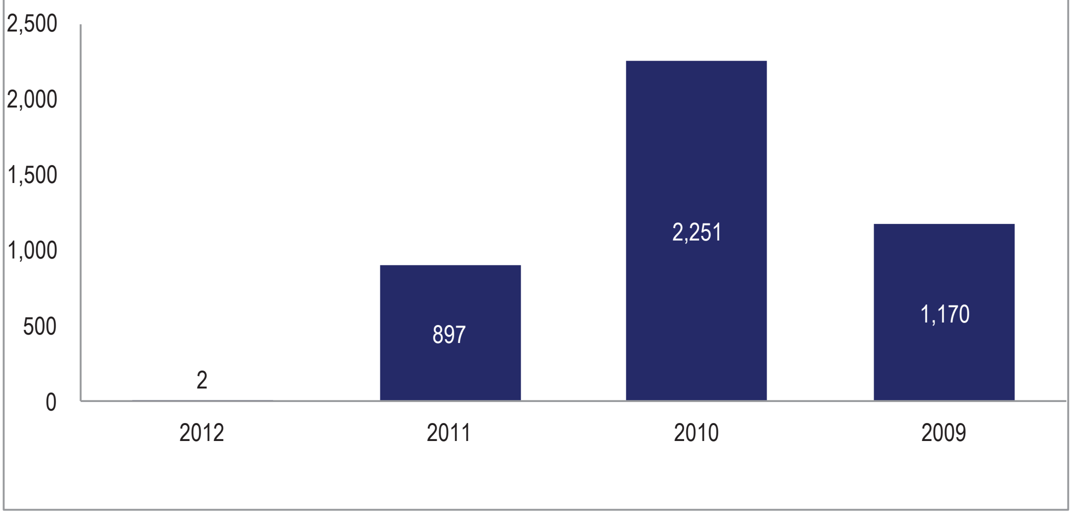
Key Observations

- 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.

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## 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)

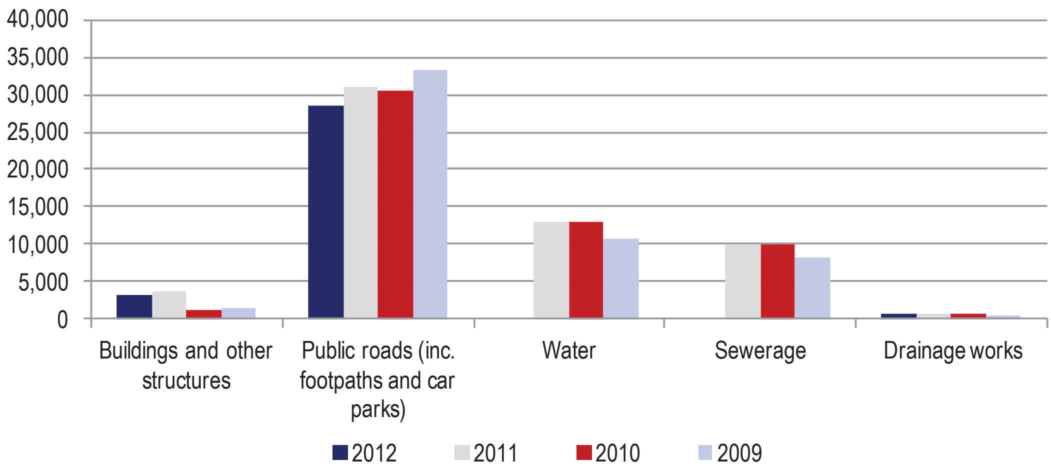
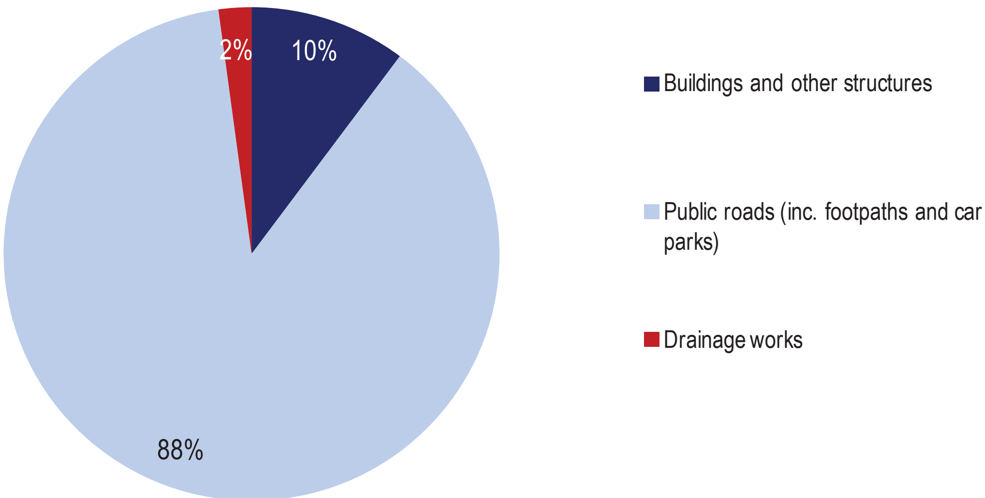



Figure 6 - Infrastructure Backlog Composition for 2011/12




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.

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## Section 4 Review of Financial Forecasts

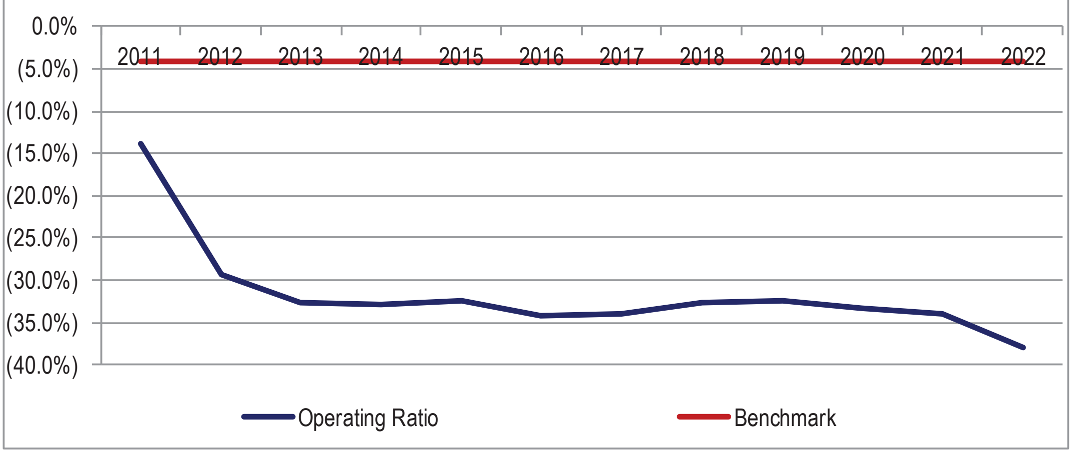
The financial forecast model shows the projected financial statements and assumptions for the next 10 years for Council's General Fund.

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

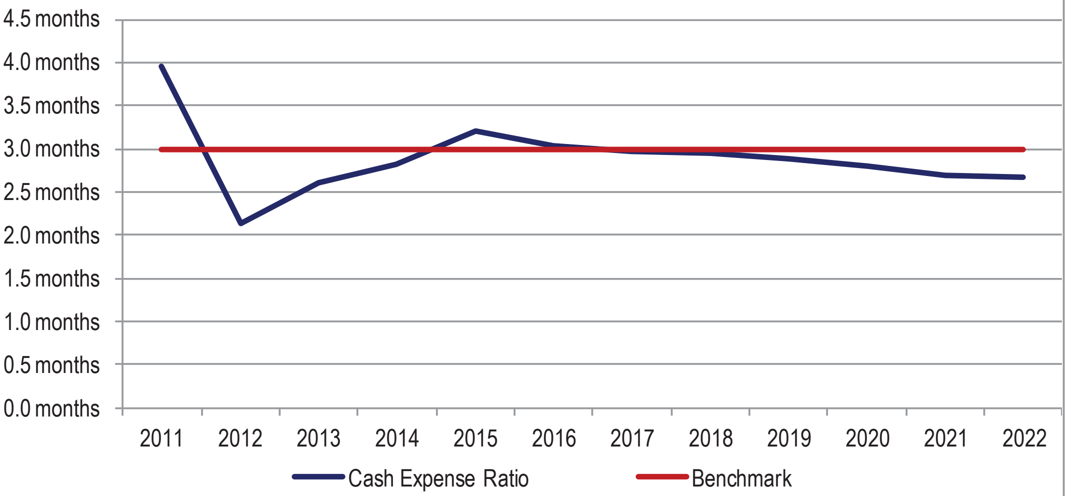



The Operating Ratio is projected to continue to deteriorate with Council's revenue base not able to meet all existing and forecast expenses. The deficits will continue to grow and forecast to be at $5.0m in 2022, equating to an Operating Ratio deficit of negative 38.0%.

## 4.2: Financial Management Indicators

Liquidity Ratios

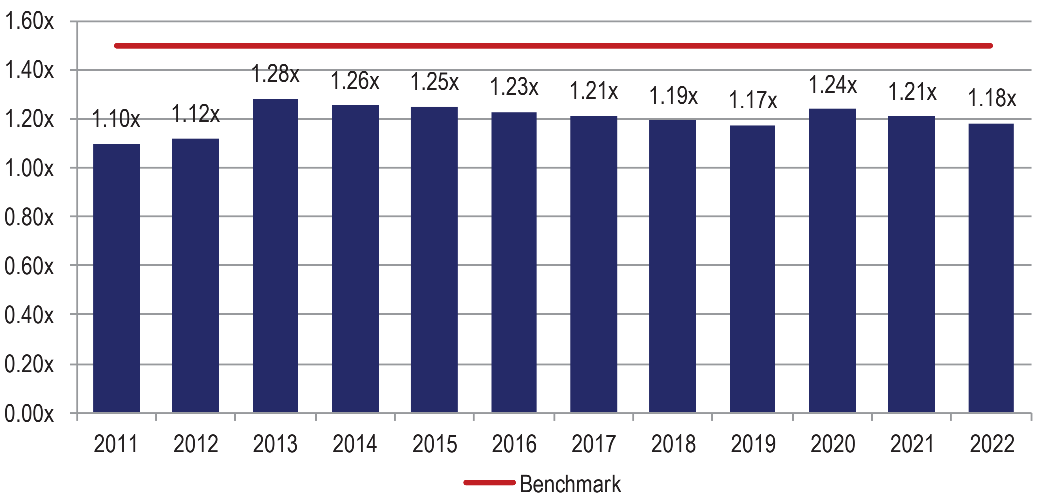
Figure 8 - Cash Expense Ratio for General Fund inc. current investments




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.

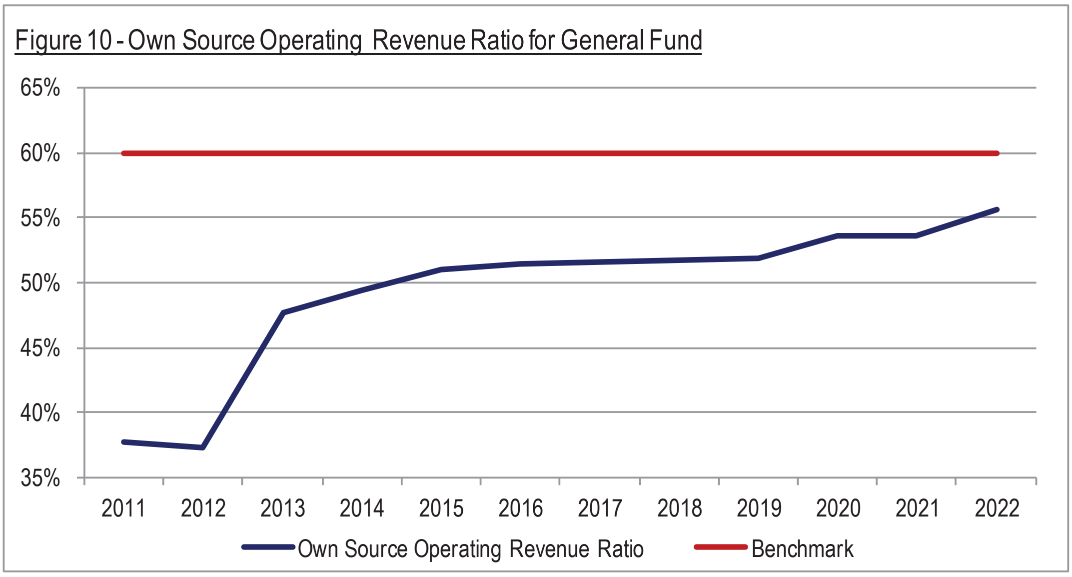
The ratio with current investments remains close to the benchmark in each year although is on a marginal downward trend from 2015 as Council's Operating Ratio declines each year.

Figure 9 - Unrestricted Current Ratio for General Fund



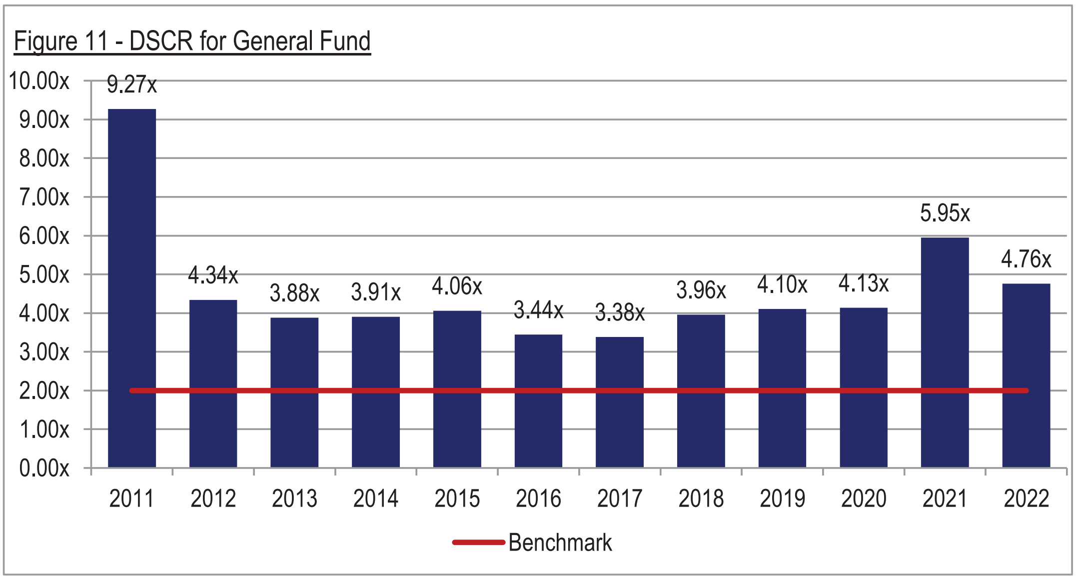

The projected Unrestricted Current Ratio is forecast to remain below the benchmark through the forecast period indicating Council will have to continue to prudently manage their cash and that any substantive adverse financial events may lead to Council experiencing liquidity issues.

Fiscal Flexibility Ratios



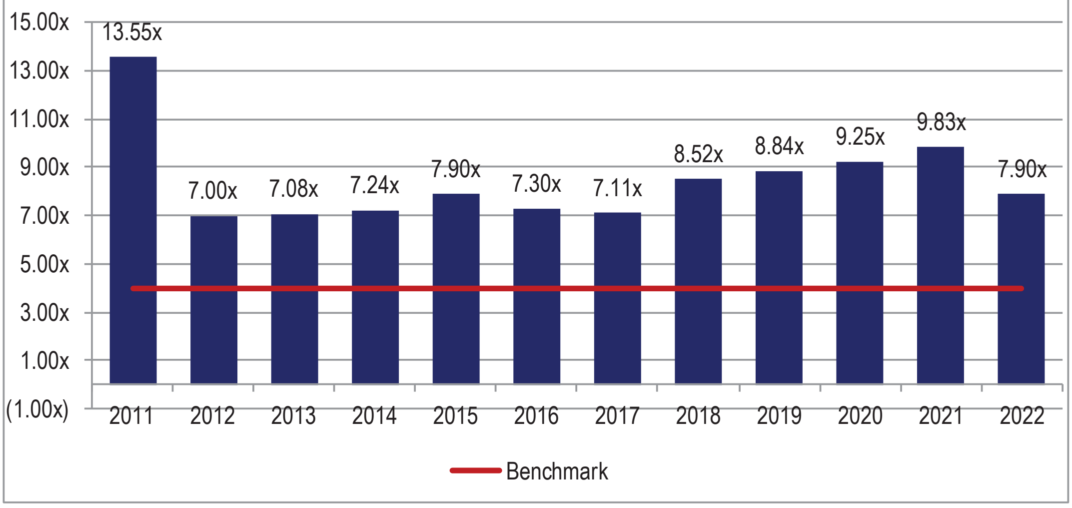

Council's Own Source Operating Revenue Ratio is projected to increase from the historical results but not sufficiently to reach the benchmark, highlighting Council's ongoing reliance on grants and contributions from State and Federal Government.

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.




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

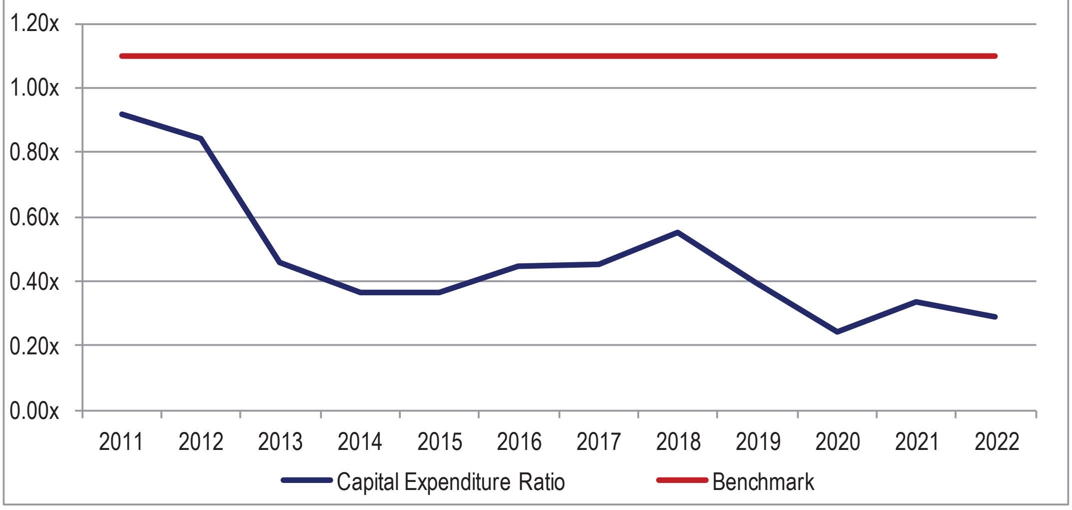



The Interest Cover Ratio is also forecast to remain above the benchmark for the full forecast period.

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

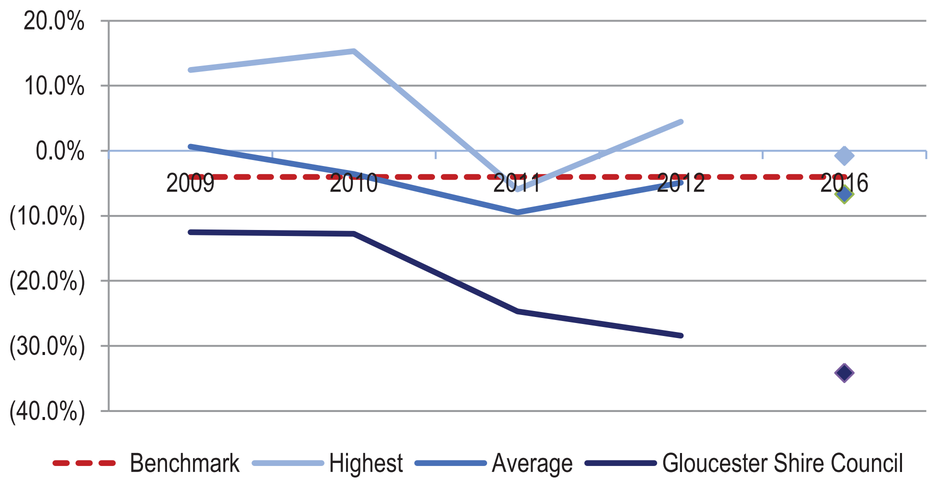
Each council's performance has been assessed against ten key benchmark ratios. The benchmarking assessment has been conducted on a consolidated basis for councils operating more than one fund. This section of the report compares the Council's performance with its peers in the same DLG Group. The Council 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.

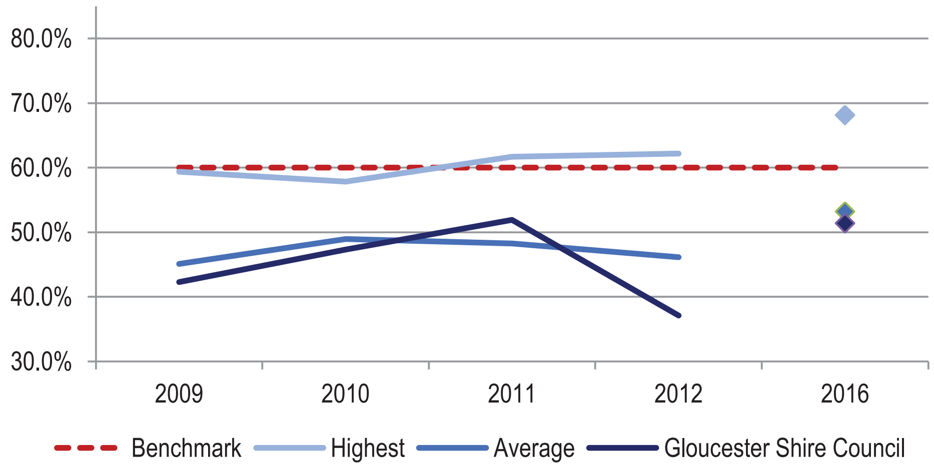
Financial Flexibility

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

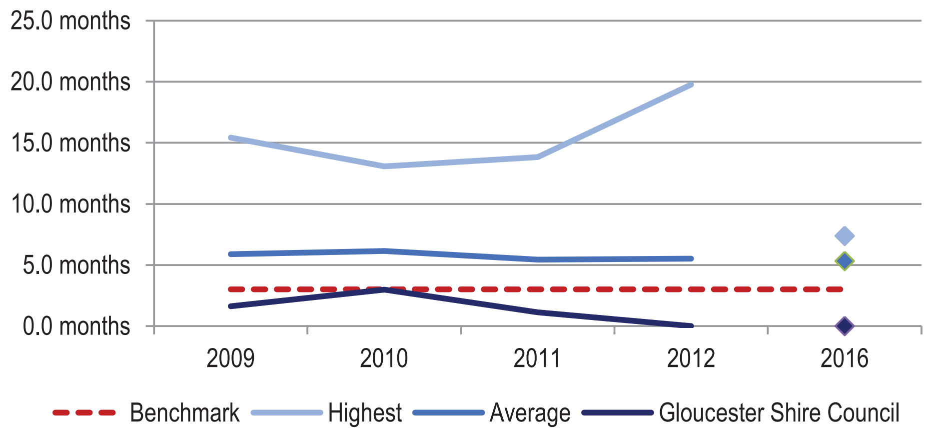
Figure 15- Own Source Operating Revenue Ratio Comparison




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

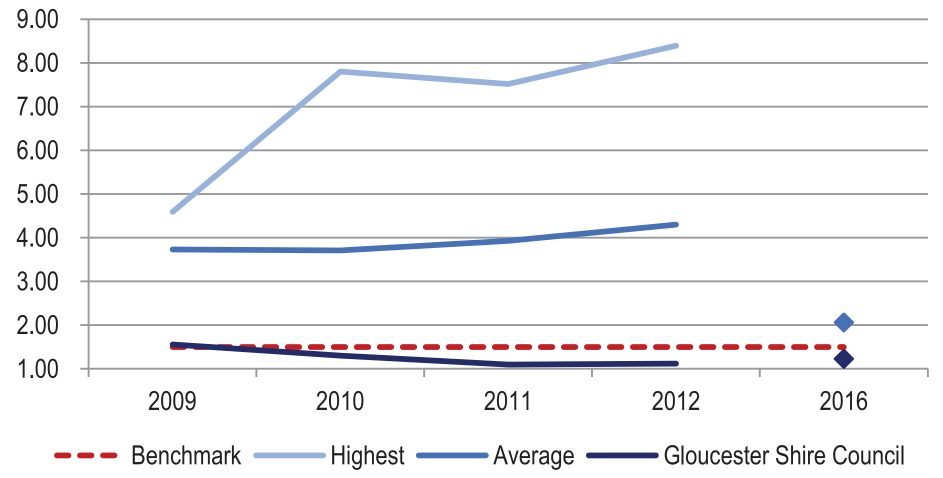
Figure 16 - Cash Expense Ratio Comparison




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.

Debt Servicing

Figure 18- Debt Service Cover Ratio Comparison

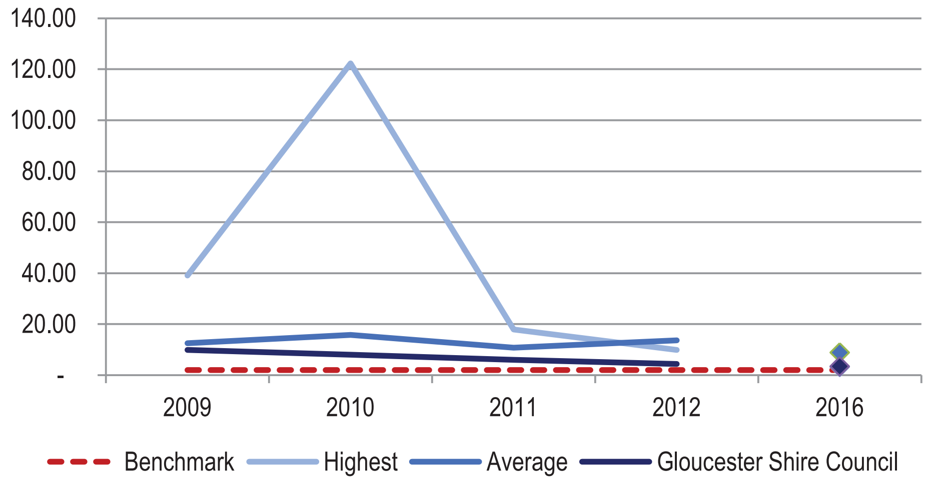
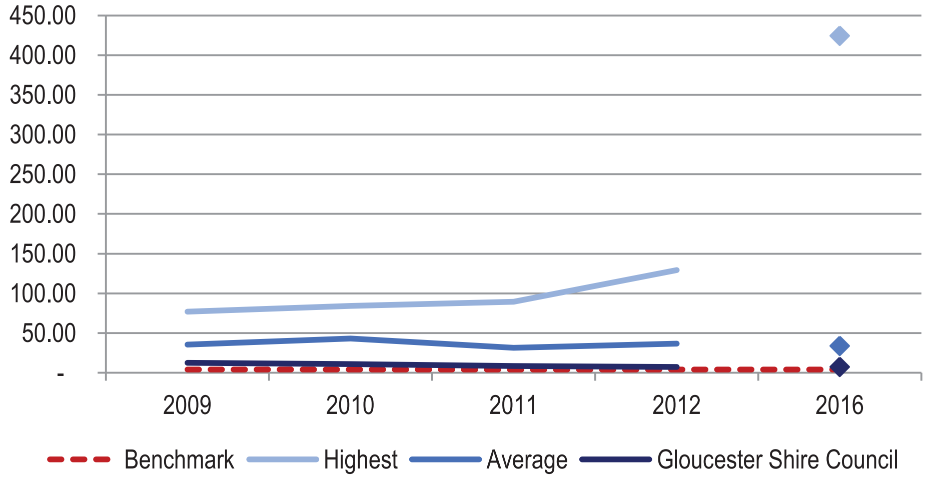



Figure 19 - Interest Cover Ratio Comparison




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 20 - Capital Expenditure Ratio Comparison

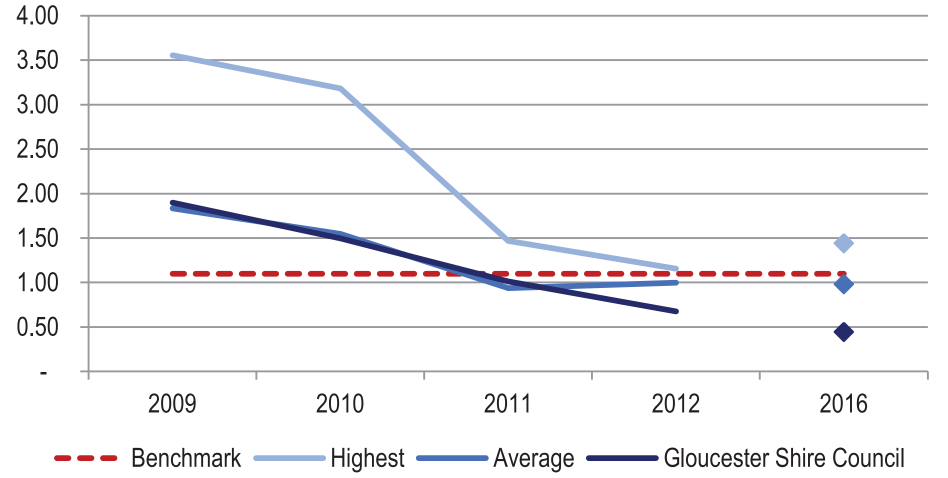



Figure 21 - Asset Maintenance Ratio Comparison

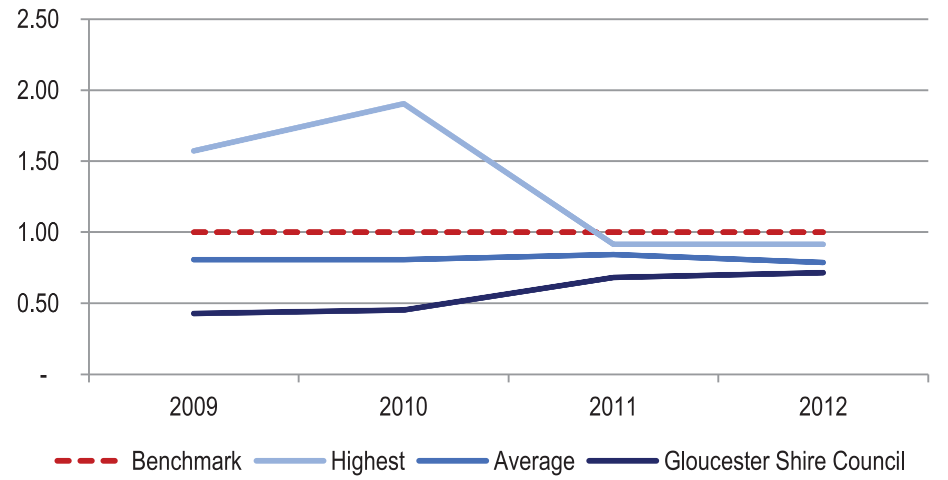


Figure 22 - Infrastructure Backlog Ratio Comparison

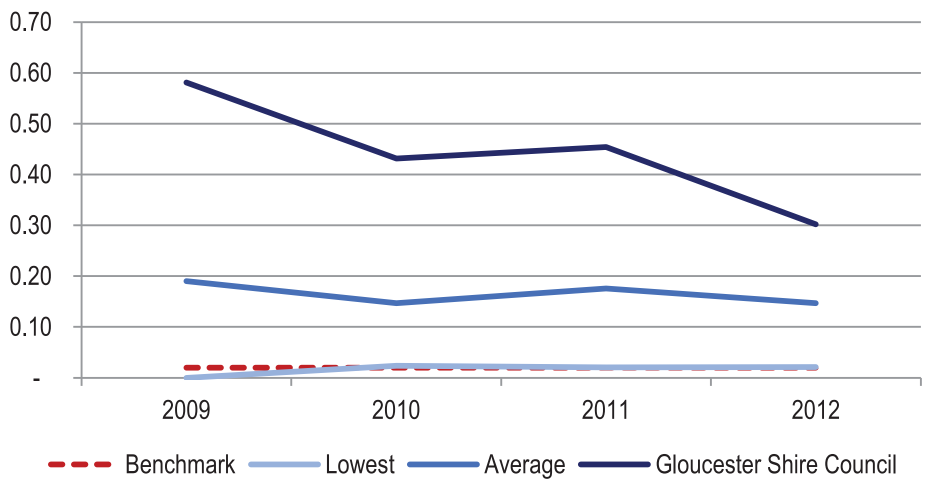
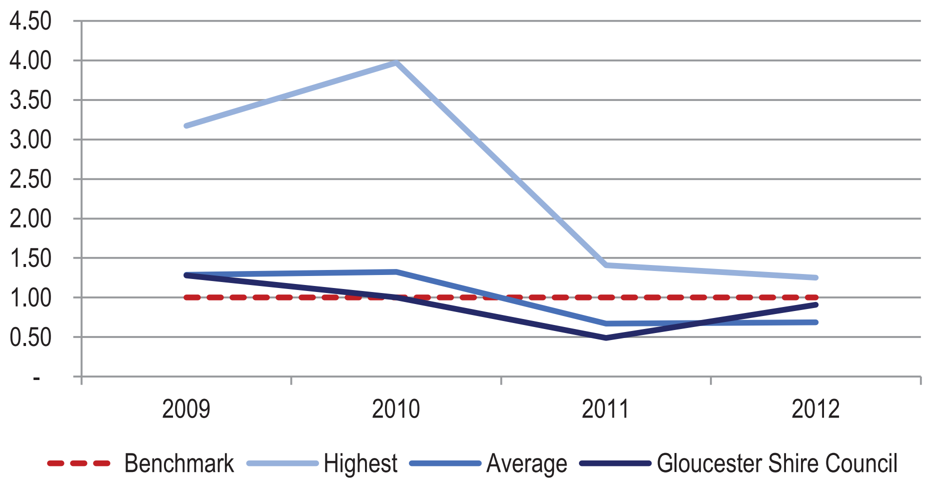



Figure 23 - Building and Infrastructure Asset Renewal Ratio




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.

<u>Unrestricted Current Ratio</u>

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.