



New South Wales  
Treasury Corporation

Cessnock City Council

## Financial Assessment and Benchmarking Report

25 September 2012

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



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## Disclaimer

This report has been prepared by New South Wales Treasury Corporation (TCorp) in accordance with the appointment of TCorp by the Division of Local Government (DLG) as detailed in TCorp's letters of 22 December 2011 and 28 May 2012. The report has been prepared 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 Cessnock City Council, the LIRS Assessment Panel and the DLG. TCorp shall not be liable to Cessnock 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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## Section 1 Executive Summary

This report provides an independent assessment of Cessnock City 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 two applications, the first for Wollombi Road and Mitchell Avenue upgrades at \$3.5m, and the second for the replacement of Millgang Bridge, Ellalong at \$1.5m.

TCorp's approach has been to:

- Review the most recent three years of Council's consolidated financial results
- Conduct a detailed review of the Council's 10 year financial forecasts. The review of the financial forecasts focused on the particular Council fund that was undertaking the proposed debt commitment. Council operates two funds being a General Fund and a Domestic Waste Management Fund. As the Domestic Waste Management Fund represents only 7% of total Council revenue we have included both Funds in our analysis

Historically, the Council appears to have been well managed over the review period based on the following observations:

- Council has posted an operating surplus in the last two years when capital grants and contributions are excluded
- Operating results are trending higher over the three year period
- Council's expenses have decreased over the period, with materials and contracts costs, and depreciation both decreasing. The overall decrease in expenses indicates that Council has a strong focus on managing its costs

However, from discussions with Council management we understand that Council faces a number of significant financial obligations commencing from the 2013/14 financial year for which no provision has been made in the financial accounts or in the LTFP. The most significant of these obligations relate to the costs associated with the remediation of Council's existing tip site and development of a new tip site. Estimated costs of this work are in excess of \$40m.

Council's reported Infrastructure Backlog of \$112.3m in 2011 represents 19.4% of its infrastructure asset value of \$579.4m. Other observations include:

- The backlog has increased in each year and is 78.3% higher than the 2009 figure of \$63.0m due to updating and refining of Council's Asset Management Plan
- The Building and Infrastructure Backlog Ratio has decreased as the Asset Revaluations have increased the asset values at a quicker rate than the backlog increase
- Of the backlog, 93% relates to public roads, with buildings making up the majority of the remaining 7%

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

- Council will become illiquid in 2016 as indicated by an Unrestricted Current Ratio of less than 1.00x. The main factor affecting liquidity is the large forecast capital expenditure program between 2012 and 2017, funded by reductions in cash and investments, and increases in borrowings
- Council are forecasting operating surpluses in all 10 years of the forecast
- Council's level of fiscal flexibility appears sound as own source operating revenue is above 70% for each year of the forecast
- Council has forecast to utilise an additional \$7.6m over the 10 years on top of the \$5.0m LIRS funding. This would result in total borrowings peaking at \$17.5m in 2013

In our view, the Council does not have the capacity to undertake the combined additional borrowings of \$5.0m for the two LIRS projects. This is based on the following analysis:

- Council has an Unrestricted Current Ratio below 1.00x from 2016 to 2021 at levels between 0.68x to 0.92x therefore Council would need to reduce services in order to cover the scheduled loan repayments or would otherwise become illiquid in this period and be unable to meet all of their short term liabilities
- Council's forecast capital expenditure is too large for their current revenue base

Council have indicated that the Millgang Bridge Project is the highest priority because the bridge is nearing the end of its useful life and will have to be replaced, with or without the LIRS approval.

TCorp have conducted some scenario analysis testing of the Council's forecasts and amended Council's forecasts to exclude the \$3.5m LIRS application for the Wollombi Road and Mitchell Avenue road upgrades and the additional \$7.6m borrowings scheduled for other capital works within the forecast. When the \$11.1m in borrowings is excluded the Unrestricted Current Ratio improves and remains above 1.00x for the duration of the forecast. This indicates that Council will be able to remain liquid if they amend their LTFP and capital expenditure program through their Asset Management Plan.

Under this scenario, the Council could meet their financial obligations and undertake the smaller of their proposed LIRS projects being the Millgang Bridge Project at a cost (and borrowing) of \$1.5m.

TCorp therefore recommends that approval be given to the Millgang Bridge project but that the Wollombi Road and Mitchell Avenue road upgrade project be declined at this time. We also recommend that Council urgently revisits its LTFP including its capital works forecasts and possibly delay the scheduling of some projects, whilst taking into account the need to consider the financial implications of the required expenditure on Council's tip sites and any other necessary capital works or other financial obligations. Council also needs to consider other initiatives to improve Council's forecast liquidity position.

## Section 2 Introduction

### 2.1: Purpose of Report

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

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

The key areas focused on are:

- The financial capacity of the Council to undertake additional borrowings
- The financial performance of the Council in comparison to a range of similar councils and measured against prudent benchmarks

### 2.2: Scope and Methodology

TCorp's approach was to:

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

In undertaking its work, TCorp relied on:

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

### Benchmark Ratios

In conducting our review of the Councils' financial performance and forecasts we have measured performance against a set of benchmarks. These benchmarks are listed below. Benchmarks do not necessarily represent a pass or fail in respect of any particular area. One-off projects or events can impact a council's performance against a benchmark for a short period. Other factors such as the trends in results against the benchmarks are critical as well as the overall performance against all the benchmarks. As councils can have significant differences in their size and population densities, it is important to note that one benchmark does not fit all.

For example, the Cash Expense Ratio should be greater for smaller councils than larger councils as a protection against variation in performance and financial shocks.

Therefore these benchmarks are intended as a guide to performance.

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

Ratio	Benchmark
Operating Ratio	> (4.0%)
Cash Expense Ratio	> 3.0 months
Unrestricted Current Ratio	> 1.5x
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

Cessnock City Council LGA	
Locality and Size	
Locality	Hunter
Area	1,966 km <sup>2</sup>
DLG Group No.	4
Demographics	
Population (as at 30 June 2011)	52,610
% under 18	26%
% between 18 and 64	60%
% over 64	14%
Expected population 2021	60,500
Operations	
Number of employees (FTE)	267
Annual revenue	\$59.0m
Infrastructure	
Roads	1,000 km
Infrastructure Backlog value	\$112.3m
Total infrastructure value	\$579.4m

Cessnock City Council Local Government Area (LGA) is located within the Hunter Valley, approximately 120 km north of Sydney and 40 km west of Newcastle.

Historically, the principal industry was mining, however while this has been in decline since the second half of the 20<sup>th</sup> century, the growth in the wine industry has meant that this is now the prime industry within the LGA. It is the oldest wine region in Australia and has around 4,500 acres under vine. With the reputation and popularity of the wine industry, tourism is an important secondary industry for the LGA.

It had an average growth rate of 1.7% between 2006 and 2011 with the 2010/11 annual increase at 1.9%. Council have projected the population to grow by 40,000 to 2031 within the Lower Hunter Regional Strategy.

Council has 267 full-time staff at the end of the 2011 financial year, a small increase from 265 in 2009.





## 2.4: LIRS Application

Council has made two LIRS applications.

Project: Priority road renewal - Wollombi Road and Mitchell Avenue upgrades

Description: Survey, design and reconstruction of Wollombi Road and rehabilitation of Mitchell Avenue, severely deteriorated sections of two priority Regional Roads.

Amount of loan facility: \$3.5m

Term of loan facility: 10 years

Project: Millgang Bridge, Ellalong replacement

Description: Survey, design and replacement of a single lane timber bridge with a two lane concrete bridge on Sandy Creek Road, Ellalong. Sandy Creek Road is a Rural Collector Road with in excess of 1,000 vehicle movements per day, including 10% heavy vehicles. It is a critical road link with no short alternate route or detour available.

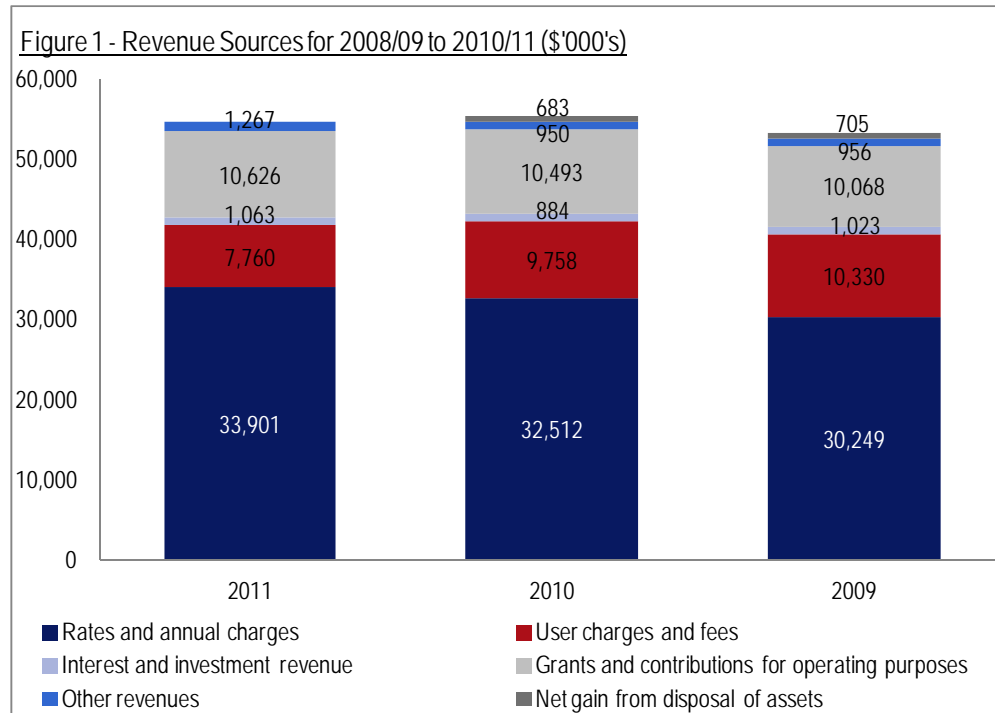
Amount of loan facility: \$1.5m

Term of loan facility: 10 years

## Section 3 Review of Financial Performance and Position

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

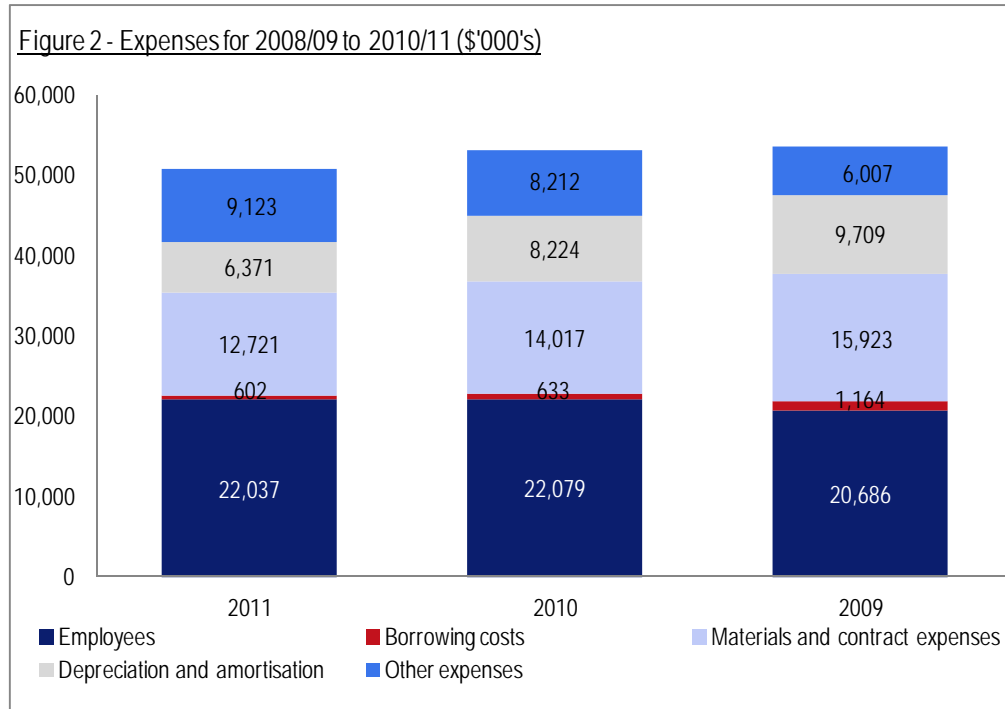
### 3.1: Revenue



#### Key Observations

- Operating revenues have increased by \$1.3m over the period, representing a 2.4% increase.
- Rates and annual charges are the largest revenue source and have increased by \$3.7m over the last two years, an average 6.0% p.a. The increase has been to a combination of general rates increases, an increase in assessment numbers, and an increase in annual charges that were driven by a \$1.5m increase in the domestic waste management services charge. Over the period Council has benefitted from an ongoing SRV that is in place to provide additional funds for the resealing and rehabilitation of the Council's priority roads. The SRV was originally agreed in 2007 and was a single year increase of 9.65% that was incorporated within the general rates revenue for a fixed term of five years. Council was granted a continuation of this SRV for a two year fixed period to 2013 that will maintain the general rate revenue increases over this period and then cease.
- User fees and charges have decreased by an average 12.4% p.a. over the period due to reduced road works conducted for the RTA (now known as RMS). This specific revenue source reduced by \$2.8m between 2009 and 2011 to \$2.9m.
- The relatively small net gain from disposal of assets in 2009 and 2010 relates to the sale of real estate assets held for sale.

### 3.2: Expenses



#### Key Observations

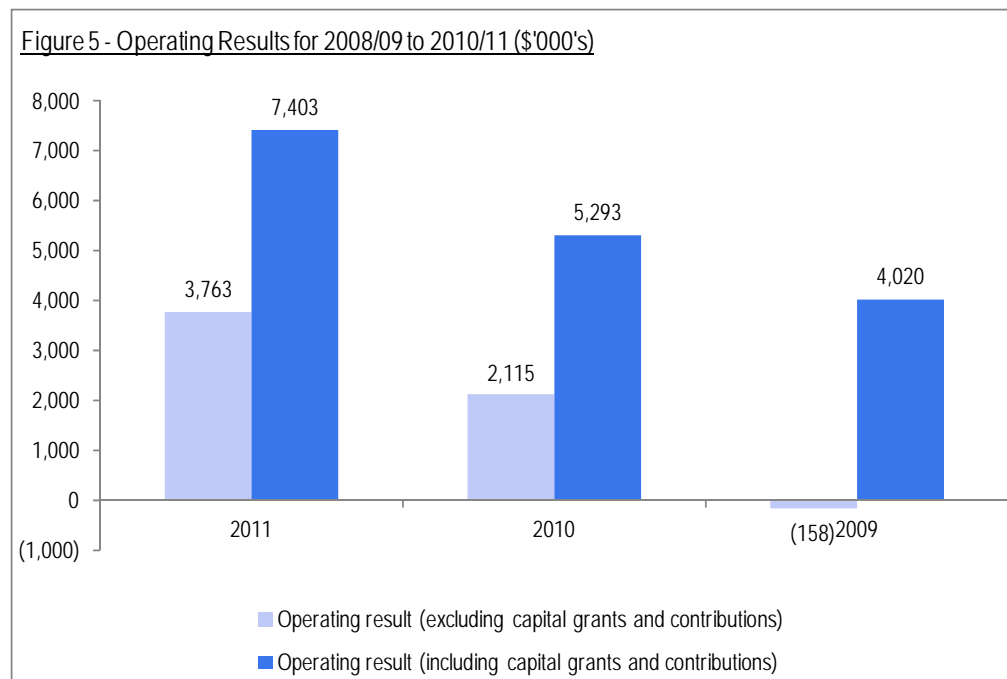
- Expenses have decreased by \$2.6m over the period representing an average reduction of 2.5% p.a.
- Employee costs are the largest expense and have increased by 6.5% over the period but remained static in 2011. The 2010 increase was predominantly due to larger superannuation payments, in line with the actuarial assessments for defined benefit liabilities that are impacting many councils.
- Materials and contracts costs have decreased due to reduced maintenance activities, directly correlating with the reduction in RTA road work revenues.
- Depreciation has decreased by an average of 17.2% p.a. which equated to a decrease of \$3.3m over the three year period. The reduction in 2010 is linked to a provision for tip remediation being fully depreciated in 2009 at \$1.7m, while the decrease in 2011 is because of the new Asset Management Plan strategy being operational for the full 2011 year which provided a lower but more accurate depreciation charge for Council's infrastructure assets.
- 'Other expenses' have seen the largest percentage increases of 51.9% over the period. This increase was primarily due to State Government waste levies that increased by \$2.5m between 2009 and 2011.

### 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.



#### Key Observations

- Council has achieved an improving operating result with surpluses achieved in both 2010 and 2011, excluding capital grants and contributions.
- The small increase in revenues alongside the decrease in expenses has resulted in the improved performance.
- Excluded from the 2011 result was a loss of \$3.1m on the disposal of assets, as this was a one-off loss attributable to the replacement of road, bridge and footpath infrastructure assets.
- The continuation of the SRV for the 2011/12 and 2012/13 financial years will contribute to a further improvement of the revenue base to assist the priority road maintenance and operating result overall.

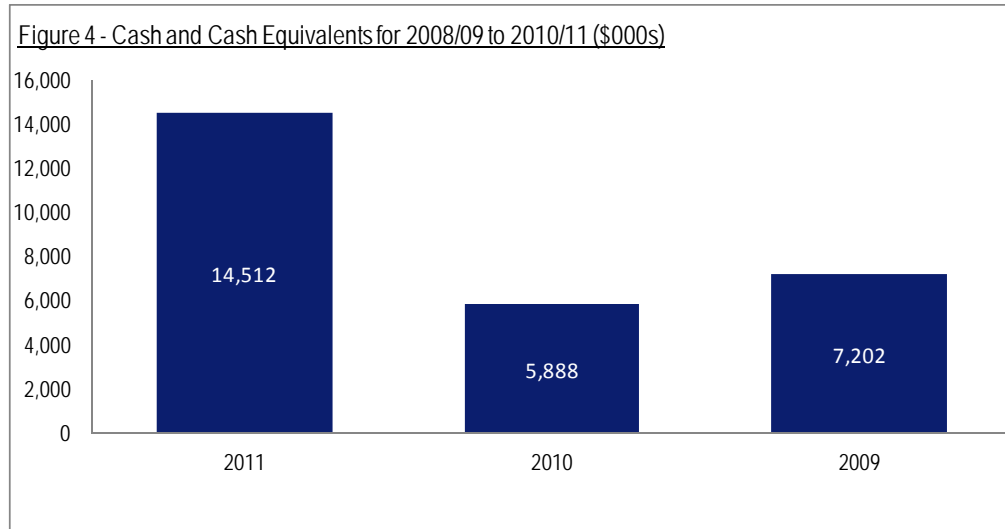
3.4: Financial Management Indicators

Performance Indicators	Year ended 30 June		
	2011	2010	2009
EBITDA (\$'000's)	10,736	10,972	10,715
Operating Ratio	6.9%	3.8%	(0.3%)
Interest Cover Ratio	17.83x	17.33x	9.21x
Debt Service Cover Ratio (DSCR)	5.74x	5.77x	4.17x
Unrestricted Current Ratio	1.91x	1.91x	2.06x
Net assets (\$'000's)	651,811	630,865	479,781

Key Observations

- Council's EBITDA has remained static over the three year period.
- The Operating Ratio shows a positive trend with Council above the benchmark in all three years.
- The DSCR and Interest Cover Ratio have improved over the period and both are strongly above the benchmarks, indicating that Council can adequately service their current debt commitments while also indicating that capacity is held to incorporate further debt funding to assist capital expenditure.
- The Unrestricted Current Ratio has reduced from the 2009 result. This ratio remained above the benchmark and was static in the two subsequent years, indicating that Council can adequately meet their day to day creditor payments.
- The Net Asset position has increased over the period as the Asset Revaluations increased the value of road, bridge and footpath infrastructure assets by \$146.3m in 2010 and community land assets by \$14.2m in 2011.
- When excluding the Asset Revaluations, the Council has increased the infrastructure asset base by \$16.7m, with asset purchases being higher than the combined value of disposed assets and depreciation of IPP&E.
- Council's total borrowings stand at \$9.1m, reduced from \$9.7m in 2009. This equates to 1.4% of Net Assets.

### 3.5: Statement of Cashflows



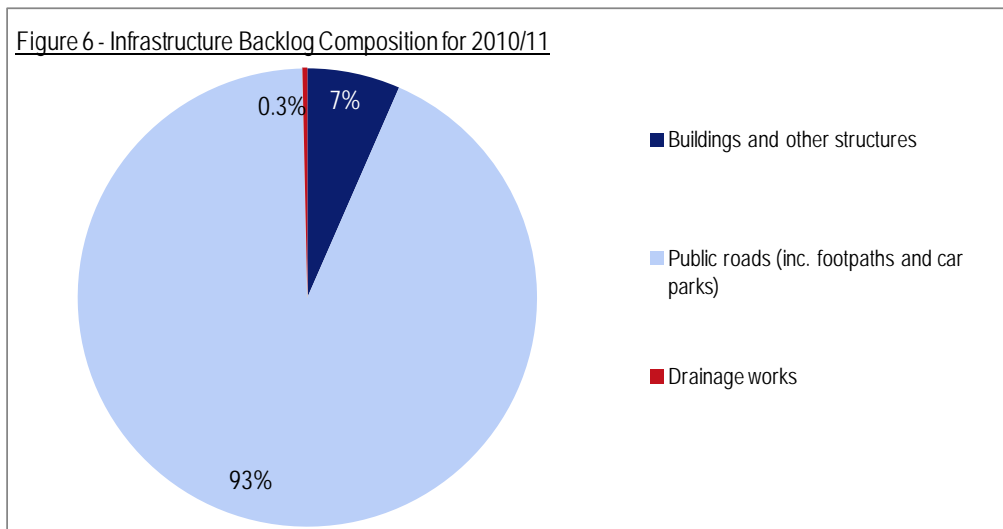
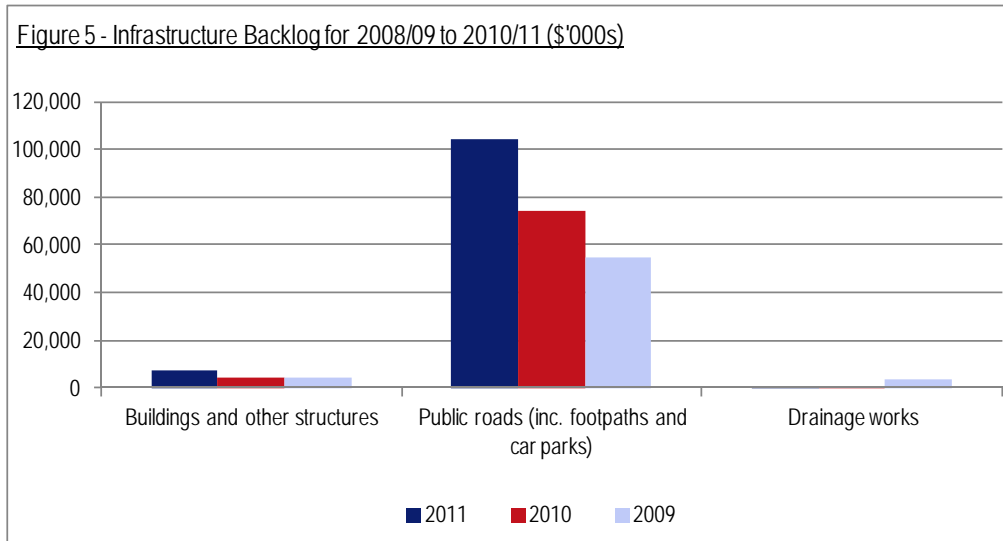
#### Key Observations

- Council's cash and cash equivalents increased by \$8.6m in 2011; following the reclassification of deposits from long term to short term.
- Overall, the cash and cash equivalents, and investments have reduced slightly from \$19.9m in 2009 to \$18.6m in 2011. Of the \$18.6m, \$4.9m is externally restricted, \$12.2m is internally restricted and \$1.5m is unrestricted.
- Over the three year period there has been no abnormal events impacting the Council's cash position. The small variance when cash and cash equivalents, and current investments are combined alongside the Unrestricted Current Ratio above the benchmark highlights an adequate liquidity position.
- Within the investments portfolio of \$4.0m, \$1.0m is held in long term deposits and \$3.0m relates to outstanding CDOs. Of this \$3.0m, \$1.9m was redeemed at the carrying amount in October 2011, therefore \$1.1m remains outstanding that is scheduled to mature in 2014. In recent discussions, Council has stated that the remaining CDO's are rated as high risk in terms of receiving the carrying value of these investments when they mature.

### 3.6: Capital Expenditure

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

#### 3.6(a): Infrastructure Backlog



The Infrastructure Backlog has increased from \$63.0m in 2009 to \$112.3m in 2011. This increase is primarily due to the increase in public roads backlog that is linked to the Asset Revaluations although the increase does not directly correlate each year. Council's progressive improvement of their measuring of the estimated cost of replacement of infrastructure assets is the reason for the increase.

The backlog is dominated by public roads with the 93% representing \$104.6m of the \$112.3m total.

### 3.6(b): Infrastructure Status

Infrastructure Status	Year ended 30 June		
	2011	2010	2009
Bring to satisfactory standard (\$'000's)	112,315	78,810	62,988
Required annual maintenance (\$'000's)	14,121	14,620	8,384
Actual annual maintenance (\$'000's)	6,295	6,620	6,638
Total value of infrastructure assets (\$'000's)	579,435	575,455	208,827
Total assets (\$'000's)	686,364	666,220	513,882
Building and Infrastructure Backlog Ratio	0.19x	0.14x	0.30x
Asset Maintenance Ratio	0.45x	0.45x	0.79x
Building and Infrastructure Renewals Ratio	2.88x	2.12x	1.42x
Capital Expenditure Ratio	2.03x	1.63x	1.52x

While the Infrastructure Backlog has increased, the ratio has actually reduced in 2010 as the increase in backlog is smaller than the increase in the overall value of infrastructure assets following the Asset Revaluations.

Council's investment in maintenance in each of the three years is below the benchmark. This may impact negatively on the backlog figure in future years. The shortfall in maintenance expenditure in 2011 was \$7.8m.

Conversely, Council has shown a strong result against the benchmark for both the Building and Infrastructure Renewals Ratio and Capital Expenditure Ratio indicating Council has adequately invested both in new and renewal capital expenditure in all three years. The excess in 2011 was \$6.5m and \$6.6m respectively.



### 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 (\$'000's)	Year ended 30 June		
	2011	2010	2009
New capital works	4,851	2,719	4,996
Replacement/refurbishment of existing assets	12,398	11,729	10,759
<b>Total</b>	<b>17,249</b>	<b>14,448</b>	<b>15,755</b>

The largest focus over the three year period of the capital programs were roads, bridges and footpaths with \$25.1m expended out of the \$47.5m total. This is in line with the communities wishes as this was the number one priority highlighted during a survey completed by 500 residents when asked to rank 33 services/facilities.

The four-lane Hunter Expressway is the major road infrastructure project that is currently ongoing in the LGA however this is being managed and funded by Federal and State levels of Government. This \$1.7b project stretches over 40 km between the F3 freeway, Kurri Kurri and Branxton and is scheduled to be completed in late 2013.

### 3.7: Specific Risks to Council

- Population growth. Council is forecasting an additional 40,000 residents by 2031. This is an increase of 83% over 25 years from 2006. An increase of this magnitude would place considerable pressure on existing infrastructure and services while increasing demand for new infrastructure and services. The increase has been identified within the Lower Hunter Regional Strategy that incorporates five LGA's and is the sixth largest urban area in Australia. This strategy is coordinated by the State Government Planning and Infrastructure department therefore there is a sufficient focus on the issue.
- Ageing population. The current demographic is dominated by families, however as these families age the trend is for the parents to remain in the region while the age group 18 to 24 tend to leave the LGA to find work or to study. As the parents retire they generally cannot afford significant increases in charges and will require different types of services and facilities. Council is aware of this issue and how it will impact healthcare and infrastructure. They have incorporated the forecast ageing population within their IP&R documents to ensure the Council is able to manage community demands.
- Ageing workforce. An ageing workforce creates challenges in managing the Council's employees. 49% of Council's staff are 45 or over and could be actively considering their retirement options within the next 10 years. The Council is aware of this issue and is actively addressing it with its Workforce Plan, specifically looking at developing ways to attract potential younger employees.
- Unfunded financial obligations. Discussions with Council management reveal that Council faces a number of significant financial obligations commencing from the 2013/14 financial



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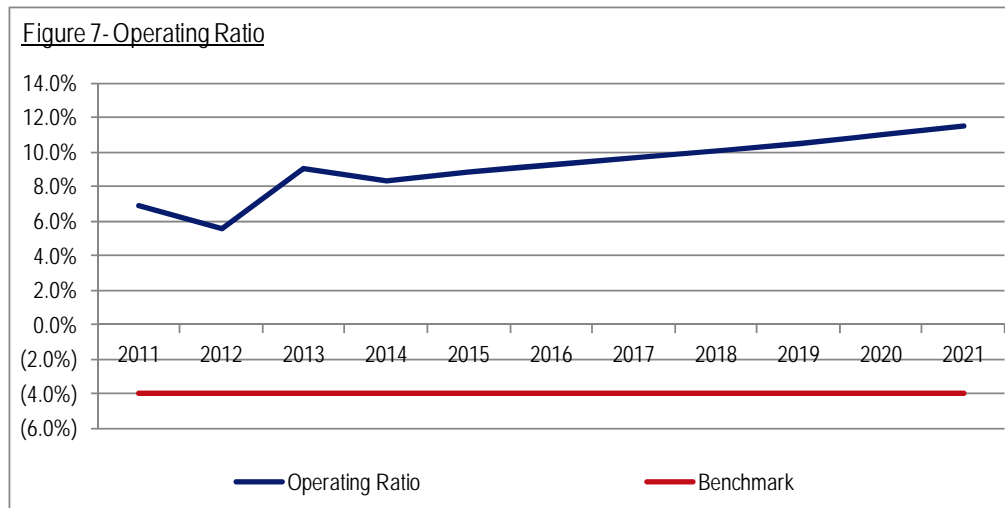
year for which no provision has been made in the financial accounts or in the LTFP. The most significant of these obligations relate to the costs associated with the remediation of Council's existing tip site and development of a new tip site. Estimated costs of this work are in excess of \$40m. Council urgently needs to revisit its LTFP including its capital works forecasts and possibly delay the scheduling of some projects, whilst taking into account the need to consider the financial implications of the required expenditure on Council's tip sites and any other necessary capital works or other financial obligations. Council also needs to consider other initiatives to improve Council's forecast liquidity position.

## 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 two loans amounting to \$5m, without any LIRS subsidies.

Council does not operate a Water or Sewer Fund therefore our analysis is upon Council's General Fund. They do operate a small Domestic Waste Management Fund however for the purposes of our analysis this is incorporated within the results below as it represents only 7% of Council's revenue.

### 4.1: Operating Results

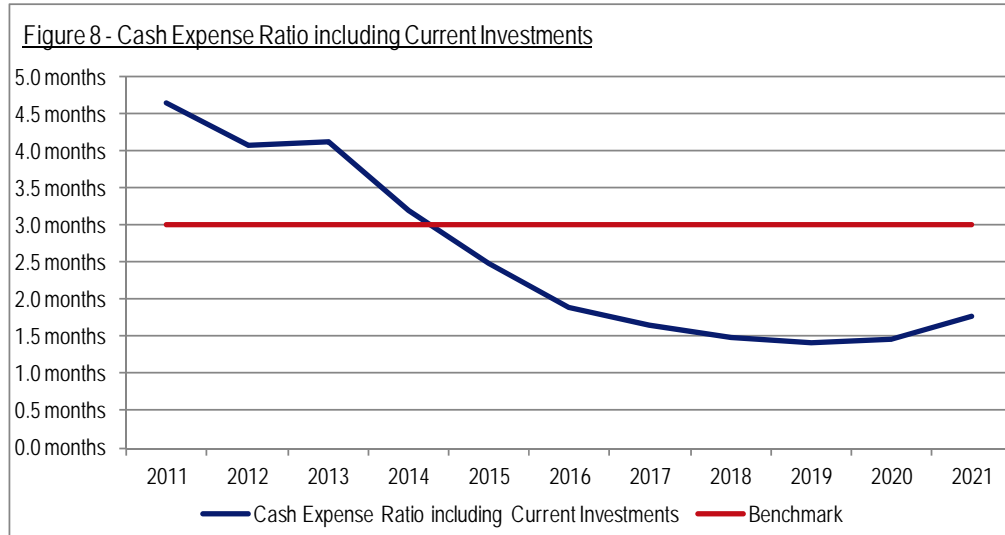


Council has forecast a decrease in the Operating Ratio in 2012 when compared to the 2011 historical result. For the following nine years the forecast is above the 2011 result and forecast to steadily grow to 2021.

The forecast is strongly above the benchmark throughout the model with Council forecasting operating surpluses in all 10 years.

## 4.2: Financial Management Indicators

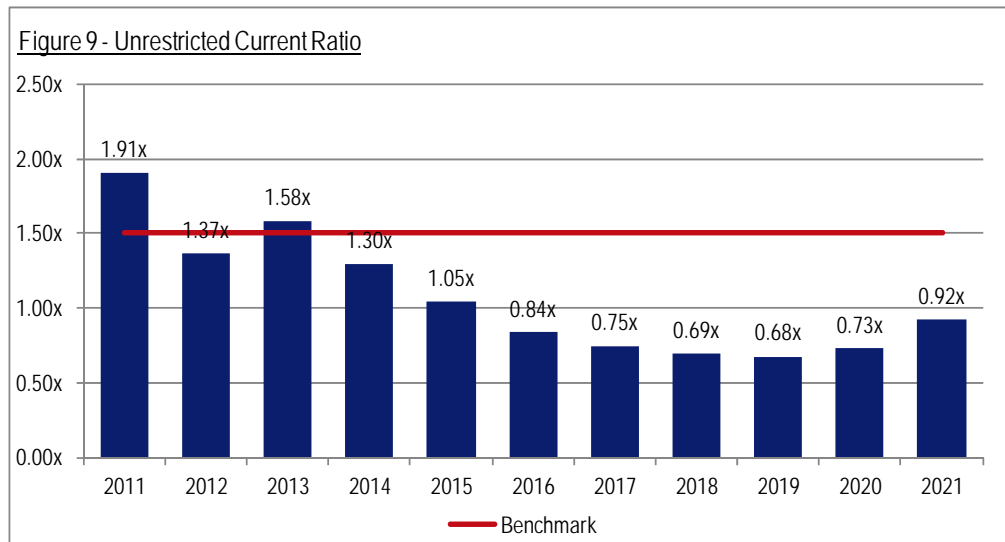
### Liquidity Ratios



The forecast that Council has provided combines cash and cash equivalents, and current investments therefore this ratio has the current investments included.

Despite the addition of current investments, the ratio is forecast to deteriorate from the 2011 result and reduce below the benchmark from 2015 onwards.

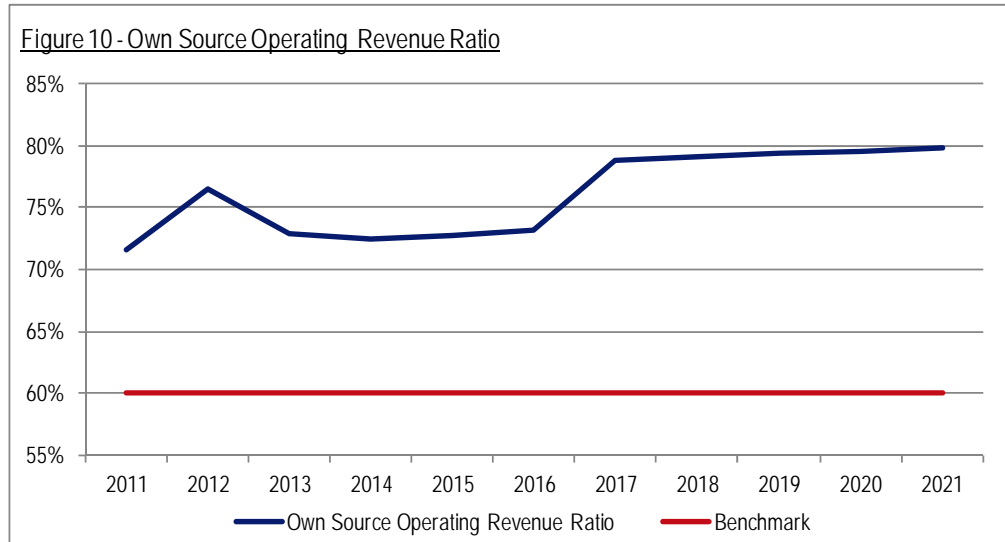
This indicates that Council may not have sufficient liquidity to manage any adverse financial events.



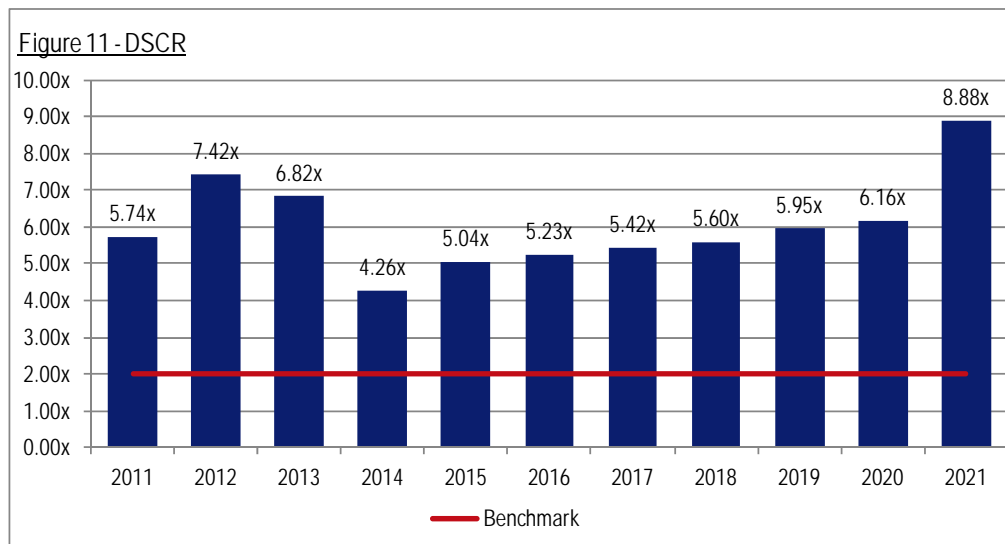
Council is forecasting that the Unrestricted Current Ratio will be significantly weaker than historical results, with the ratio falling below the benchmark from 2014. Council's capital expenditure is focussed

on the renewal of existing assets and this is depleting the Council's cash balances, indicated by the illiquid position from 2016 onwards.

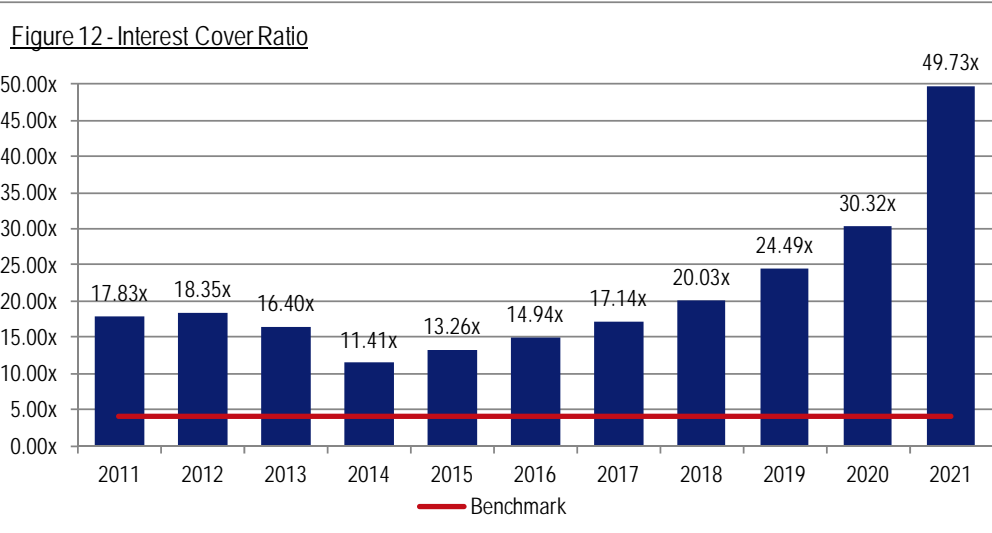
Fiscal Flexibility Ratios



Council is forecasting a strong performance in the Own Source Operating Revenue Ratio, well above the benchmark. The first five years are not too dissimilar from the historic performance with the increase in the final five years due to the fact that Council have forecast minimal capital grants and contributions which skew the proportion of own source revenue.

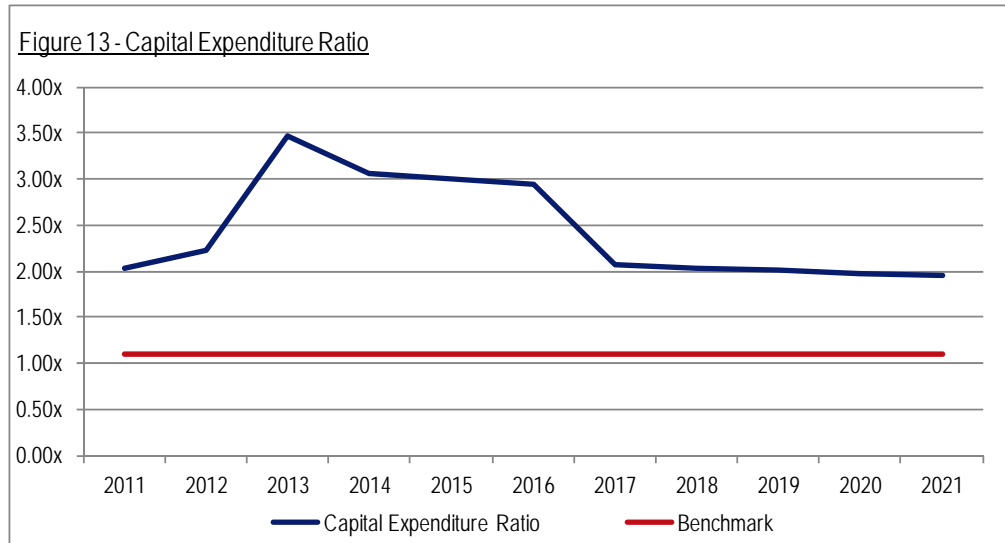


Council is forecasting a strong DSCR result throughout the 10 year period against the benchmark and the majority of these are in line or below the 2011 historical position. The reduction in 2014 coincides with the proposed LIRS loans being utilising during 2013 with the position improving as the total debt reduces over time.



The Interest Cover Ratio also has a very strong performance, both historically and within the forecast against the benchmark. This is in line with the low level of borrowings that Council currently utilise. The results increase towards the end of the model period as Councils forecast debt position reduces.

#### 4.3: Capital Expenditure



Council has forecast a very high level of capital expenditure against the benchmark, varying between 3.46x and 1.95x. While the historical performance is in line with 2.0x the levels of projected capital expenditure adversely impacts on the liquidity position of Council and in practice it will not be possible for Council to complete the scheduled capital expenditure within their current revenue base and cash reserves.

The scheduled capital expenditure program is at its highest in 2013 at \$22.3m and remains above \$20m p.a. until 2017 when it reduces to approximately \$15m p.a. to 2021. A figure of \$15m p.a. is more in line with the historic figures where the average across the three years was \$15.8m p.a.



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The scheduled capital expenditure program in 2013 includes:

- \$9.5m on road upgrades
- \$7.7m on road renewals (including the Wollonbi Road and Mitchell Avenue renewals)
- \$1.8m on bridge replacement (including Millgang Bridge)
- \$0.8m on drainage upgrades
- \$2.5m on various other projects

#### 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 be increased 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 model has specific adjustments included for the 2012 and 2013 years to reflect known items that differ from the annual forecast changes for some items in those years.
- Rates and annual charges are forecast to increase by 5.7% in 2012 and 10.9% in 2013 and then by 3.2% p.a. for the remaining eight years. The larger increases relate to the SRV in both these years along with a \$2.6m increase in Other Rates for 2013. The larger than CPI increases relate to increases in the domestic waste management services, and in 2013 a forecast charge of \$2.1m is input to recuperate the \$2.1m expense for the carbon tax relating to the Council's landfill site.
- User fees and charges are forecast to increase by 52.9% in 2012 due to a \$3.1m increase in RMS state road fees from additional maintenance completed on state roads and then reduce by 23.1% in 2013 due to the RMS fees reducing by \$3.9m. After this, user fees and charges are forecast to grow by 1.4% p.a. for the remaining eight years. An increase in garbage tipping fees is a major component of the overall increase.
- Employee costs are forecast to increase by 10.7% in 2012, 5.2% in 2013, and then below the TCorp benchmark for the remaining eight years. The 2012 increase relates to an organisation realignment that created new positions within the Council while the 2013 increase relates to increased Workers Compensation following legislation changes.
- Materials and contracts costs are forecast to increase by 4.6% in 2012, reduce by 24.1% in 2013, and then increase by 1.5% p.a. for the remaining eight years. The 2012 increase of \$3.8m in materials cost is partly offset by \$3.3m reduction in general contractor fees. In 2013, materials costs are forecast to decrease by \$3.2m and general contractors by a further \$0.7m. The decrease is because of a \$2.0m decrease in RMS contract works completed in 2013 and also \$0.6m for one off works completed in Millfield. A Development Engineering contractor was also employed in 2012 for \$0.3m and has been budgeted into salaried employees for 2013.



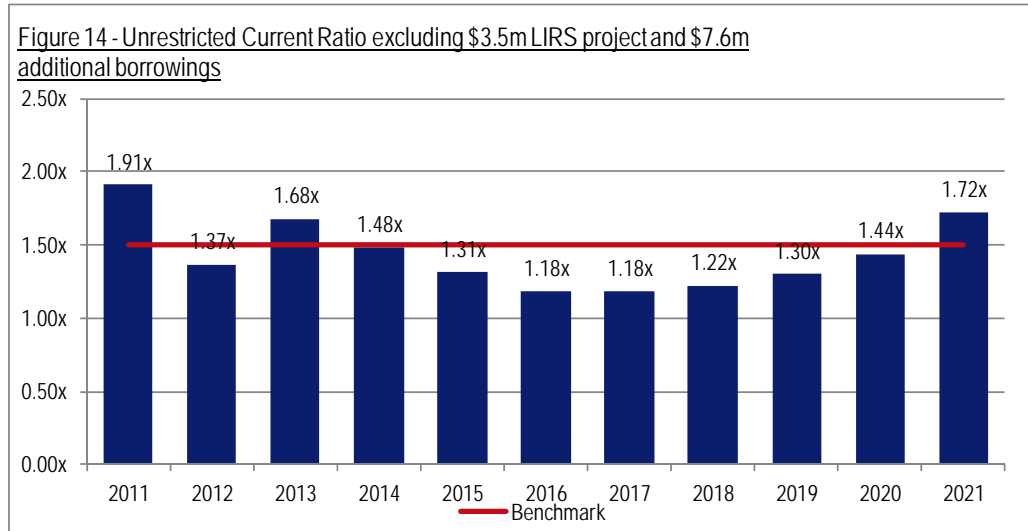
- Depreciation increases by 30.2% in 2012, then reduces by 22.4% in 2013. The 2012 increase is an oversight on Council's behalf and will be amended in future forecasts so that this large increase is reduced to be in line with the 2011 figure and the subsequent years within the forecast.

#### 4.5: Scenario Analysis

Based on our analysis of the Council's model assumptions, we have created an alternative scenario with the following amendments to the Council's model:

- The \$3.5m LIRS facility and \$7.6m additional borrowings for roads and drainage infrastructure from 2013 to 2021 have been removed from the 10 year forecast

By amending the above assumptions, the impact on the liquidity of Council, as indicated by the Unrestricted Current Ratio is seen below:



The ratio remains below the benchmark in each year from 2014 to 2020 but the removal of these borrowings and related capital expenditure from the forecast improves the liquidity position so that the Unrestricted Current Ratio remains above 1.00x throughout the period indicating Council should be able to meet all short term liabilities and remain liquid.



#### 4.6: Borrowing

When analysing the financial capacity of the Council we do not believe Council will be able to incorporate additional loan funding in addition to the LIRS loan facilities when analysing the current LTFP and capital expenditure program. Some comments and observations are:

- It is Council's liquidity position that has influenced our opinion of Council's inability to manage additional borrowings at this time, rather than their debt servicing capabilities
- If Council were to revise their LTFP and capital expenditure program, we could review our borrowing capacity analysis because it is evident that Council would have capacity to utilise further borrowings if their cashflow position was improved. This is evident by the DSCR and Interest Cover Ratio remaining above their benchmarks in all 10 years of the forecast

## Section 5 Benchmarking and Comparisons with Other Councils

[This section still being finalised]

## 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 historically, although we are concerned that Council has not made any provisions in its accounts for some significant future expenditure requirements.

When analysing the 10 year financial forecast concerns arise in relation to Council's liquidity if they were to follow the forecast capital expenditure program with Council forecast to become illiquid in 2016.

As a result TCorp has run a scenario, with the \$3.5m LIRS loan and additional \$7.6m borrowings from 2014 to 2021 excluded, to analyse the impact on Council's liquidity. The result of this is an improved liquidity position over the 10 year forecast that should allow Council to meet all scheduled liabilities when they are due.

After analysing this scenario, we recommend the approval of the LIRS loan of \$1.5m relating to the replacement of Millgang Bridge, Ellalong. After discussions with Council, we recognise that this project is a priority that cannot be delayed and Council will have to access loan funding with or without the LIRS subsidy. At this time we do not recommend approval of the LIRS loan of \$3.5m for the Wollombi Road and Mitchell Avenue road upgrade projects.

We base our recommendation on the following key points:

- Council's operating performance appears strong with operating surpluses in 2010 and 2011 when capital grants and contributions are excluded, and the current LTFP forecasts that these are to continue in all 10 years of the forecast
- Council expenses have reduced over the past three years indicating sound management of costs
- Council has a relatively low level of borrowings at \$9.1m, only 1.4% of net assets and would be able to utilise further borrowings if the liquidity issue is addressed

This recommendation is made with the following points to be reviewed by the newly elected Council in conjunction with the management team:

- The current LTFP and capital expenditure program is likely to lead to Council becoming illiquid by 2016



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- A review of the LTFP assumptions should be undertaken to identify a sustainable way forward, whether that be by identifying new revenue sources, revising service levels, or rescheduling capital expenditure to ensure that all liabilities are able to be met as required

Council needs to ensure that of its financial obligations are included in its LTFP so that an accurate picture of its forecast financial position can be reviewed

## Appendix A Historical Financial Information Tables

Table 1- Income Statement

Income Statement (\$'000)	Year ended 30 June			% annual change	
	2011	2010	2009	2011	2010
<b>Revenue</b>					
Rates and annual charges	33,901	32,512	30,249	4.3%	7.5%
User charges and fees	7,760	9,758	10,330	(20.5%)	(5.5%)
Interest and investment revenue	1,063	884	1,023	20.2%	(13.6%)
Grants and contributions for operating purposes	10,626	10,493	10,068	1.3%	4.2%
Other revenues	1,267	950	956	33.4%	(0.6%)
Net gain from the disposal of assets	0	683	705	(100.0%)	(3.1%)
<b>Total revenue</b>	<b>54,617</b>	<b>55,280</b>	<b>53,331</b>	<b>(1.2%)</b>	<b>3.7%</b>
<b>Expenses</b>					
Employees	22,037	22,079	20,686	(0.2%)	6.7%
Borrowing costs	602	633	1,164	(4.9%)	(45.6%)
Materials and contract expenses	12,721	14,017	15,923	(9.2%)	(12.0%)
Depreciation and amortisation	6,371	8,224	9,709	(22.5%)	(15.3%)
Other expenses	9,123	8,212	6,007	11.1%	36.7%
<b>Total expenses</b>	<b>50,854</b>	<b>53,165</b>	<b>53,489</b>	<b>(4.3%)</b>	<b>(0.6%)</b>
<b>Operating result</b>	<b>3,763</b>	<b>2,115</b>	<b>(158)</b>	<b>77.9%</b>	<b>1438.6%</b>

Table 2 - Items excluded from Income Statement

Excluded items (\$'000)			
	2011	2010	2009
Grants and contributions for capital purposes	3,640	3,178	4,178
Increase (Decrease) in the fair value of investments	770	1,177	(516)
Loss on disposal of assets	3,054	0	0

Table 3 - Balance Sheet

Balance Sheet (\$'000)	Year Ended 30 June			% annual change	
	2011	2010	2009	2011	2010
<b>Current assets</b>					
Cash and equivalents	14,512	5,888	7,202	146.5%	(18.2%)
Investments	2,500	10,100	7,700	(75.2%)	31.2%
Receivables	5,059	6,451	3,243	(21.6%)	98.9%
Inventories	306	793	1,286	(61.4%)	(38.3%)
Other	534	598	485	(10.7%)	23.3%
<b>Total current assets</b>	<b>22,911</b>	<b>23,830</b>	<b>19,916</b>	<b>(3.9%)</b>	<b>19.7%</b>
<b>Non-current assets</b>					
Investments	1,540	2,870	4,993	(46.3%)	(42.5%)
Receivables	59	81	78	(27.2%)	3.8%
Inventories	3,280	3,250	2,492	0.9%	30.4%
Infrastructure, property, plant & equipment	658,574	636,189	486,403	3.5%	30.8%
<b>Total non-current assets</b>	<b>663,453</b>	<b>642,390</b>	<b>493,966</b>	<b>3.3%</b>	<b>30.0%</b>
<b>Total assets</b>	<b>686,364</b>	<b>666,220</b>	<b>513,882</b>	<b>3.0%</b>	<b>29.6%</b>
<b>Current liabilities</b>					
Payables	7,213	8,203	6,375	(12.1%)	28.7%
Borrowings	935	1,261	1,148	(25.9%)	9.8%
Provisions	6,459	6,458	6,333	0.0%	2.0%
<b>Total current liabilities</b>	<b>14,607</b>	<b>15,922</b>	<b>13,856</b>	<b>(8.3%)</b>	<b>14.9%</b>
<b>Non-current liabilities</b>					
Payables	472	466	431	1.3%	8.1%
Borrowings	8,119	7,631	8,511	6.4%	(10.3%)
Provisions	11,355	11,336	11,303	0.2%	0.3%
<b>Total non-current liabilities</b>	<b>19,946</b>	<b>19,433</b>	<b>20,245</b>	<b>2.6%</b>	<b>(4.0%)</b>
<b>Total liabilities</b>	<b>34,553</b>	<b>35,355</b>	<b>34,101</b>	<b>(2.3%)</b>	<b>3.7%</b>
<b>Net assets</b>	<b>651,811</b>	<b>630,865</b>	<b>479,781</b>	<b>3.3%</b>	<b>31.5%</b>



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Table 4-Cashflow

Cashflow Statement (\$'000)	Year ended 30 June		
	2011	2010	2009
Cashflows from operating activities	14,044	11,404	17,772
Cashflows from investing activities	(5,582)	(11,951)	(12,493)
Proceeds from borrowings and advances	1,431	500	500
Repayment of borrowings and advances	(1,269)	(1,267)	(1,403)
Cashflows from financing activities	162	(767)	(903)
<b>Net increase/(decrease) in cash and equivalents</b>	<b>8,624</b>	<b>(1,314)</b>	<b>4,376</b>
Cash and equivalents	14,512	5,888	7,202

## Appendix B Glossary

### Asset Revaluations

In assessing the financial sustainability of NSW councils, IPART found that not all councils reported assets at fair value.<sup>1</sup> In a circular to all councils in March 2009<sup>2</sup>, 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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<sup>1</sup>IPART “Revenue Framework for Local Government” December 2009 p.83

<sup>2</sup>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.