



New South Wales
Treasury Corporation

Kempsey Shire Council

Financial Assessment, Sustainability and Benchmarking Report

20 March 2013

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

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

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Section 1 Executive Summary

This report provides an independent assessment of Kempsey 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.

In reviewing Council's operating performance over the review period we believe they are in a weak and deteriorating operating position. This is based on the following observations:

- Council has posted consecutive operating deficits when capital grants and contributions are excluded, with the largest deficit being in 2012
- Council's underlying performance, as measured by EBITDA, has improved to \$13.3m in 2012 from \$11.7m in 2009 however this is due to the advance payment of half the 2013 FAG
- Council's DSCR has been below benchmark in each year and the Interest Cover Ratio in two of the four years indicating Council has limited capacity to utilise further borrowings
- Council has total borrowings of \$46.1m in 2012, with \$13.5m within the General Fund

The Council reported \$113.8m of Infrastructure Backlog in 2012 which represents 13.9% of its infrastructure asset value of \$821.5m. Other observations include:

- The Backlog total has increased marginally from \$109.2m in 2009
- Council have been unable to fund required maintenance costs in each year in order to keep their assets at their current standard as indicated by the Asset Maintenance Ratio being below the benchmark in each year
- The Asset Revaluations and revised AMP have significantly increased both depreciation expense and the required annual maintenance of infrastructure assets in 2012
- Council has been unable to spend enough on asset renewals and capital expenditure in 2011 and 2012 as indicated by the Buildings and Infrastructure Asset Renewal Ratio and Capital Expenditure Ratio being below the benchmark in these years, highlighting a downward trend and a reduction in Net Assets when the Asset Revaluations are excluded

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

- Council's LTFP was completed prior to the 2012 audited accounts being finalised therefore it has a historic depreciation expense included as its base which is lower than what it should be. This results in higher operating results than are likely to be achieved
- The LTFP includes an 11.37% SRV, including the rate peg, approved for 2013. In addition, Council's LTFP includes a proposed, but as yet unapproved, SRV of 10% inclusive of the rate peg in 2015 to 2017 and 4% inclusive of the rate peg in 2018. The proposed SRV is required to maintain current service levels

- In view of the comment relating to depreciation above, we believe that Council will post continuous operating deficits in each year of the review period

When analysing the financial capacity of the Council we believe that Council should not look to utilise further borrowings in addition to the \$5.6m proposed to be utilised in 2013.

While Council appears to have the capacity to increase their borrowings during the forecast period, their revenues include the proposed SRV that may or may not be approved. We expect Council to post continuous operating deficits during the forecast period, so we would not recommend further borrowings at the present time.

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 if current service levels are continued within the General Fund. Our key observations are:

- Council is not currently in a financial position to continue to operate the General Fund at the service levels that are currently in place, with an additional SRV required to retain current service levels
- The increased depreciation expense following the Asset Revaluations and updated AMP will place Council in a more adverse operating position than forecast in the current LTFP
- It also indicates Council will not have the ability to fund asset maintenance, renewals or additions

We recommend that Council update their LTFP to reflect the updated depreciation expense to determine the current operating position so that they can see if they need to revise their operational plan, delivery program and/or capital works schedule.

In respect of our Benchmarking analysis we have compared the Council's key ratios with other councils in DLG group 4. Our key observations are:

- Council's financial flexibility as indicated by the Operating Ratio and Own Source Operating Revenue Ratio is varied with a weaker than group average Operating Ratio but an above benchmark Own Source Operating Revenue Ratio
- Council has lower credit ratios than the group average as it has a weaker DSCR and Interest Cover Ratio in each year
- Council was in a sufficient liquidity position and was above the group average liquidity level with Council holding the majority of their funds within cash and cash equivalents
- Council's Capital Expenditure Ratio was below the group average in each year excluding 2010 and they have a comparatively similar level of Infrastructure Backlog when viewed against their peers in 2012. Asset maintenance funding has been inadequate, below the benchmark and group average while asset renewals have been below benchmark in three of the four years and below the group average in 2012

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 the comments stated within the conclusion

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

Kempsey Shire Council LGA	
Locality & Size	
Locality	Mid North Coast
Area	3,381 km ²
DLG Group	4
Demographics	
Population as at 2011	28,134
% under 18	26%
% between 18 and 59	46%
% over 60	28%
Expected population 2025	30,600
Operations	
Number of employees (FTE)	275
Annual revenue	\$51.8m
Infrastructure	
Roads	1,417 km
Bridges	162
Infrastructure backlog value	\$113.8m
Total infrastructure value	\$821.5m

Kempsey Shire Council Local Government Area (LGA) is located within the Mid-North Coast region, with Nambucca to the north and Port Macquarie - Hastings to the south. It is situated 428 km north of Sydney on the Pacific Highway. The Macleay River is at the heart of the LGA as it carves its way from the mountains of the New England Plateau to the sea at South West Rocks.

The LGA has a multi-skilled and stable workforce that supports a range of industries including manufacturing, retail, agribusiness and tourism. Skills in trades and professional services also support our growing area.

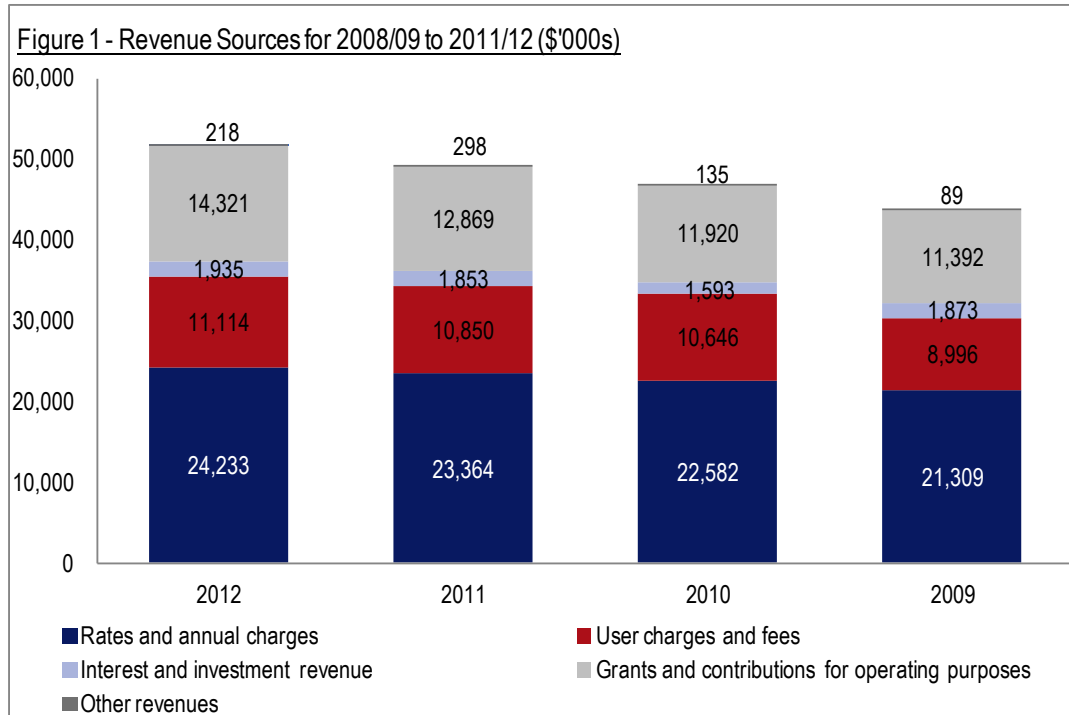
Within Council's infrastructure, property, plant and equipment (IPP&E) as at 30 June 2012 there was:

- \$406.5m of roads, bridges and footpaths
- \$177.3m of water supply network
- \$150.7m of sewerage network
- \$48.6m of drainage assets
- \$18.9m of non specialised buildings
- \$11.1m of specialised buildings
- \$8.5m of depreciable land improvements

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.

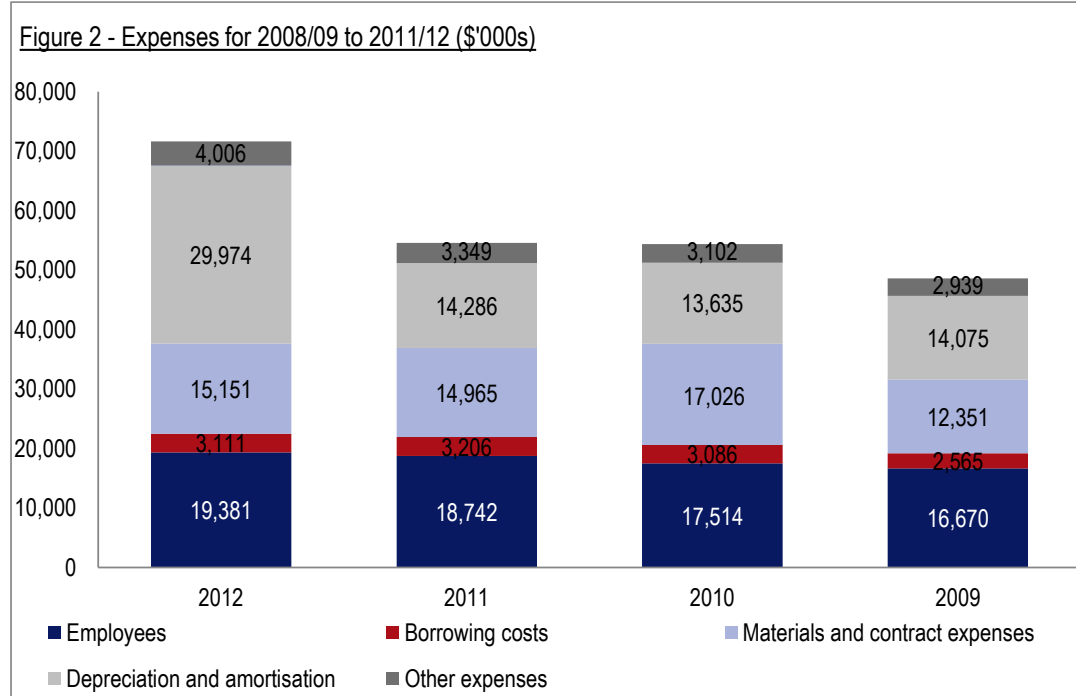
3.1: Revenue



Key Observations

- Total operating revenues have increased by \$8.2m (18.7%) over the review period to \$51.8m in 2012
- Rates and annual charges have been on an upward trend, increasing between 3.5% and 6.0% p.a. over the four years. The 6.0% increase in 2010 was above the rate peg mainly due to a \$0.6m increase in the domestic waste management services annual charge.
- User charges and fees have been on an upward trend, with the largest increase of 18.3% in 2010 due to a \$0.7m increase in water supply services and a \$0.4m increase in caravan parks and camping ground fees.
- Operating grants and contributions have been on an upward trend and increased by \$1.5m in 2012 due to the advance payment of the first half of the 2013 Financial Assistance Grant (FAG).

3.2: Expenses



Key Observations

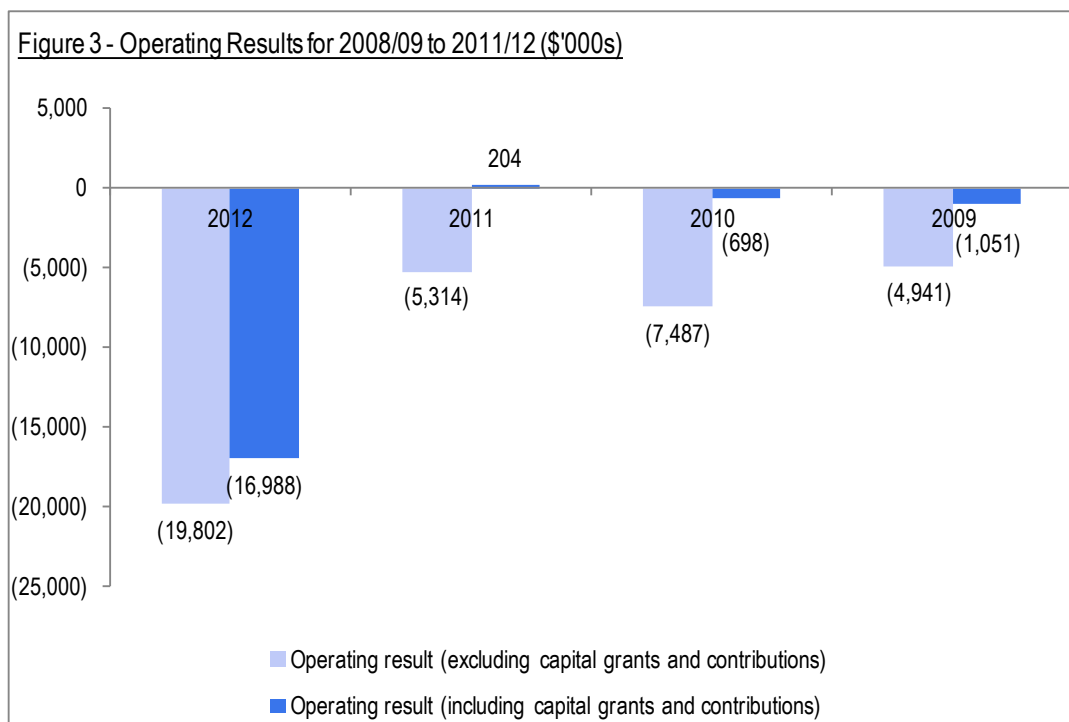
- Total operating expenses have increased by \$23.0m (47.3%) over the review period to \$71.6m in 2012.
- Employee costs have been on an upward trend, increasing between 3.4% and 7.0% p.a. The 3.4% increase in 2012 occurred due to a \$1.1m increase in salaries and wages with Council increasing the full time equivalent employees by 12 to fill vacancies from 2011 along with the annual pay award increases. This was offset by an increase in the capitalised costs of \$0.5m.
- Materials and contract expenses have fluctuated over the period but remain higher than the 2009 total. The 2010 increase by \$4.7m (37.9%) was because of \$1.6m flood damage restoration, \$1.2m for domestic waste services delivered by a contractor, \$0.9m increased road maintenance and \$0.4m increased water and sewer maintenance expenses.
- Depreciation is now the largest expense item after more than doubling in 2012. The \$15.7m increase was due to the Asset Revaluations specific to roads, bridges and footpath infrastructure assets that were completed in 2011 and the revision of Council's AMP.
- Other expenses have been on an upward trend with a 19.6% increase in 2012 due to a \$0.4m increase in electricity and heating.

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 have posted consecutive operating deficits when capital grants and contributions are excluded and the 2012 results have deteriorated due to the higher depreciation expense.
- Council expenses include a large non-cash depreciation expense, (\$30.0m in 2012), which has increased substantially in 2012 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

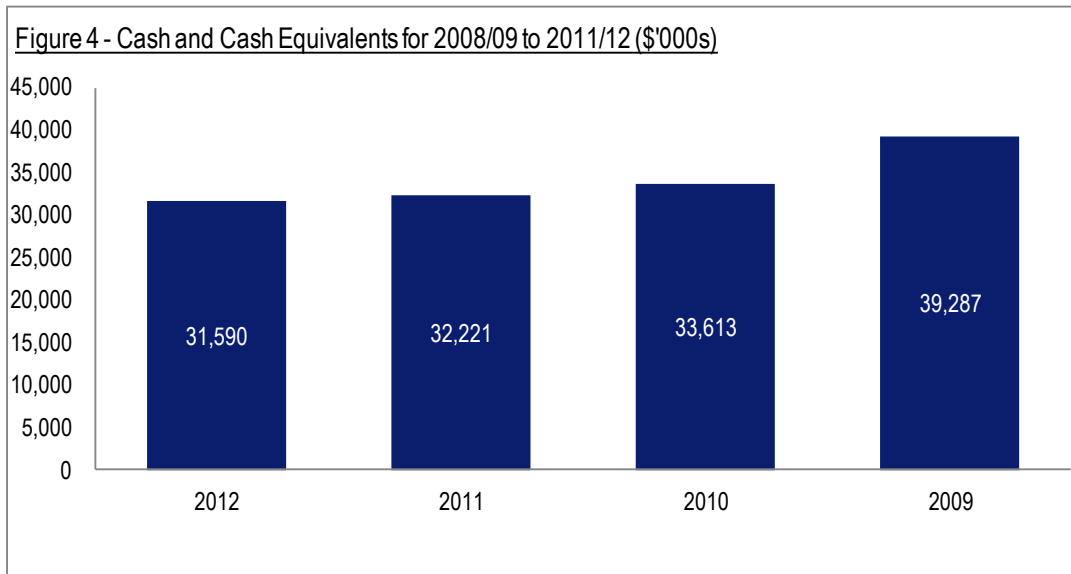
Performance Indicators	Year ended 30 June			
	2012	2011	2010	2009
EBITDA (\$'000s)	13,283	12,178	9,234	11,699
Operating Ratio	(38.2%)	(10.8%)	(16.0%)	(11.3%)
Interest Cover Ratio	4.27x	3.80x	2.99x	4.56x
Debt Service Cover Ratio	1.74x	1.57x	1.30x	1.90x
Unrestricted Current Ratio	2.49x	2.46x	2.18x	2.03x
Own Source Operating Revenue Ratio	64.7%	62.5%	61.9%	63.7%
Cash Expense Ratio	9.8 months	10.4 months	10.7 months	14.8 months
Net assets (\$'000s)	1,082,730	1,123,933	609,874	601,113

Key Observations

- Council's underlying performance, as measured by EBITDA, has improved over the four year period. It was at its highest in 2012 however the advance payment of the FAG contributed to this increase.
- The Operating Ratio has remained below the benchmark of negative 4.0% with the Operating Ratio in 2012 highlighting the significant deficit position.
- The DSCR has remained below the 2.00x benchmark in each year, while the Interest Cover Ratio has been marginally above the 4.00x benchmark in 2009 and 2012. These two ratios indicate that Council can manage their current borrowings but utilising further borrowings could cause cashflow issues.
- Council has \$46.1m in outstanding borrowings in 2012, representing 4.3% of Net Assets, a decrease from \$47.5m in 2009.
- Council's Unrestricted Current Ratio has remained above the 1.5x benchmark indicating that Council has had adequate liquidity throughout the review period.
- Council's Own Source Operating Revenue Ratio has been above the 60.0% benchmark in each year indicating Council has a degree of financial flexibility.
- The Cash Expense Ratio has trended downwards but has remained well above the 3.0 months benchmark in each year. Council has opted to invest surplus cash in term deposits however at each year end, the period to maturity has been less than three months therefore the funds have been classified as cash and cash equivalents.
- Net Assets have increased over the period due to the Asset Revaluations process. Council's infrastructure assets increased in value by \$488.1m. 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 the ongoing operations of a Council.

- When excluding the Asset Revaluations, Council's IPP&E asset base has decreased by \$12.0m over the review period, with asset purchases being lower than the combined value of disposed assets and depreciation.

3.5: Statement of Cashflows



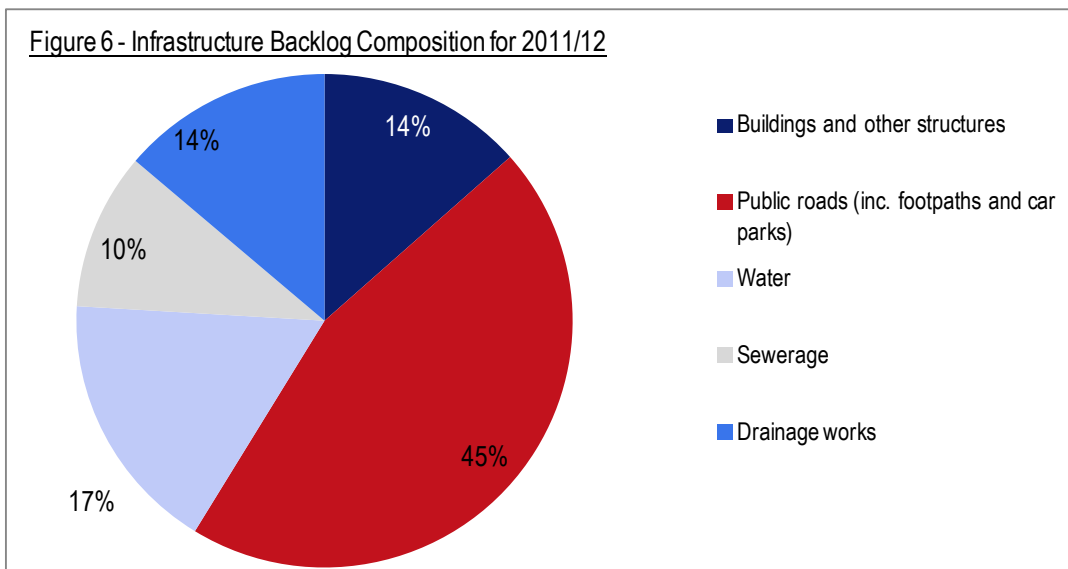
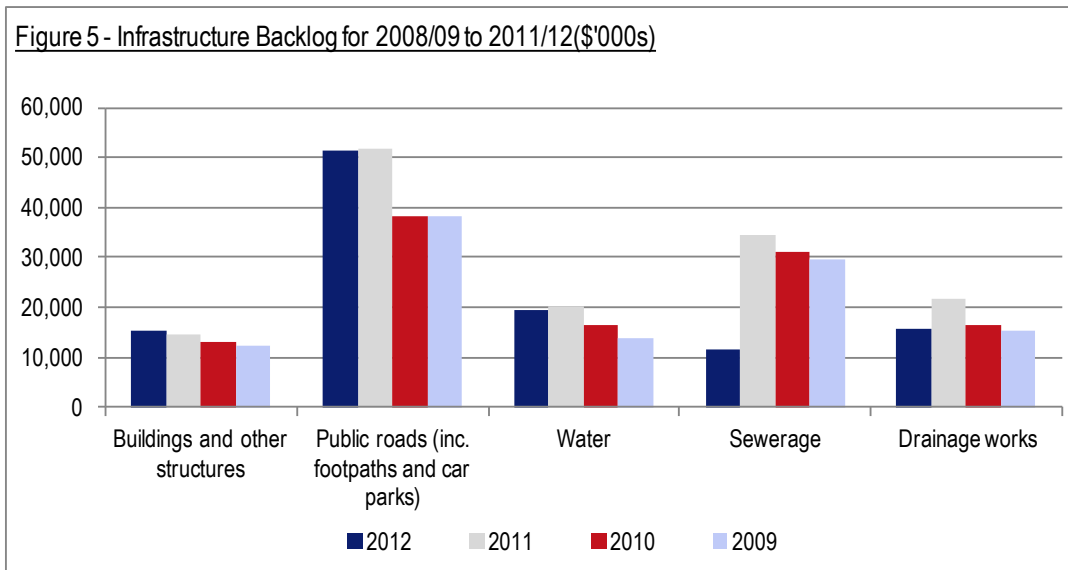
Key Observations

- Council's cash and cash equivalents have decreased over the four year period and they did not invest any funds in other forms of investments. While still at a reasonable level, a continuing decrease in the balance will lead to liquidity issues in the longer term.
- Of the \$31.6m in 2012, \$17.7m is externally restricted, \$10.6m is internally restricted and \$3.2m is unrestricted.
- The level of cash along with the Unrestricted Current Ratio above the benchmark indicates Council has sufficient liquidity.

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



Council's Infrastructure Backlog is \$113.8m in 2012, an increase from \$109.2m in 2009. In 2012 the Backlog is spread between the five infrastructure asset classes with public roads being the largest at \$51.6m.

The Backlog total decreased from \$142.2m in 2011 due to the sewerage asset backlog decreasing to \$11.7m in 2012 from \$34.4m. This occurred following the revaluation of these assets that indicated that the assets were in better condition than previously thought.

3.6(b): Infrastructure Status

Infrastructure Status	Year ended 30 June			
	2012	2011	2010	2009
Bring to satisfactory standard (\$'000s)	113,823	142,174	115,648	109,199
Required annual maintenance (\$'000s)	27,577	18,737	18,834	18,341
Actual annual maintenance (\$'000s)	17,947	10,060	11,238	8,173
Total value of infrastructure assets (\$'000s)	821,517	865,303	526,563	509,818
Total assets (\$'000s)	1,141,700	1,184,882	673,216	661,308
Building and Infrastructure Backlog Ratio	0.14x	0.16x	0.22x	0.21x
Asset Maintenance Ratio	0.65x	0.54x	0.60x	0.45x
Building and Infrastructure Renewals Ratio	0.31x	0.67x	1.16x	0.43x
Capital Expenditure Ratio	0.41x	0.81x	1.57x	1.06x

The Building and Infrastructure Backlog Ratio has reduced over the period despite the actual backlog marginally increasing. This is due to the Asset Revaluations that significantly increased the total value of infrastructure assets from 2010.

The Asset Maintenance Ratio has been below the 1.00x benchmark in each year indicating that Council has not adequately invested in maintaining the operating standard of their assets.

The Building and Infrastructure Renewals Ratio has only been above the 1.10x benchmark in one of the review years and has decreased well below the benchmark in 2012 indicating that overall Council has not invested enough to renew assets.

Council's Capital Expenditure Ratio, which takes into account assets which improve performance or capacity, has been below the benchmark in the past two years having previously been above the benchmark. The decrease in 2012 relates to the doubling of the depreciation expense and also the lowest level of asset additions in the four year period and is the reason why over the period the Net Assets have decreased over the period when the Asset Revaluations are excluded as stated in Section 3.4.

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	0	5,202	6,334	21,873
Replacement/refurbishment of existing assets	12,693	8,180	17,007	0
Total	12,693	13,382	23,341	21,873

Council's capital works program in 2011 and 2012 included:

- \$8.9m spent on roads, bridges and footpaths
- \$1.5m spent on stormwater drainage
- \$1.3m spent on specialised and non-specialised buildings
- \$0.5m on depreciable land improvements

3.7: Specific Risks to Council

- Inability to reduce the Infrastructure Backlog and meet required asset maintenance levels. Council has been unable to reduce the Backlog over the review period and this trend is likely to continue. With Council's infrastructure assets now valued at fair value following the Asset Revaluations, the increase in depreciation expenses will make it harder for Council to break even financially. Assets are likely to deteriorate over time and the Backlog is likely to continue to increase.
- Managing the impacts of the Kempsey bypass. The Kempsey bypass project was approved by the NSW Minister for Planning on 10 July 2008. As part of the Building Australia Fund, the Australian Government announced that it would provide \$618m for the construction of the Kempsey bypass. The 14.5km Kempsey bypass project is part of the 40km Kempsey to Eungai project, which extends from the existing dual carriageway south of Kempsey to the existing dual carriageway at Eungai Rail.
It is Council's role to manage the potential benefits to the Kempsey CBD following the removal of heavy through traffic. This involves promoting a positive business climate within the CBD, South Kempsey and Frederickton by renewing the infrastructure and amending traffic management structure to suit the affected areas. Kempsey is to be rebranded as a desirable retail and business destination and Council would like to make sure that they make the most of this exercise to strengthen the local economy and attract businesses and consumers.
- Undiversified revenue streams. While other councils in the region have relinquished management of their caravan and camping grounds to North Coast Caravan Parks, Council remain as operators of the parks in their LGA due to the positive trading performance of these assets. Apart from these assets, in relation to their size, Council has minimal 'other revenues' and has limited options in relation to commercial activities that could boost their total revenues.

Section 4 Review of Financial Forecasts

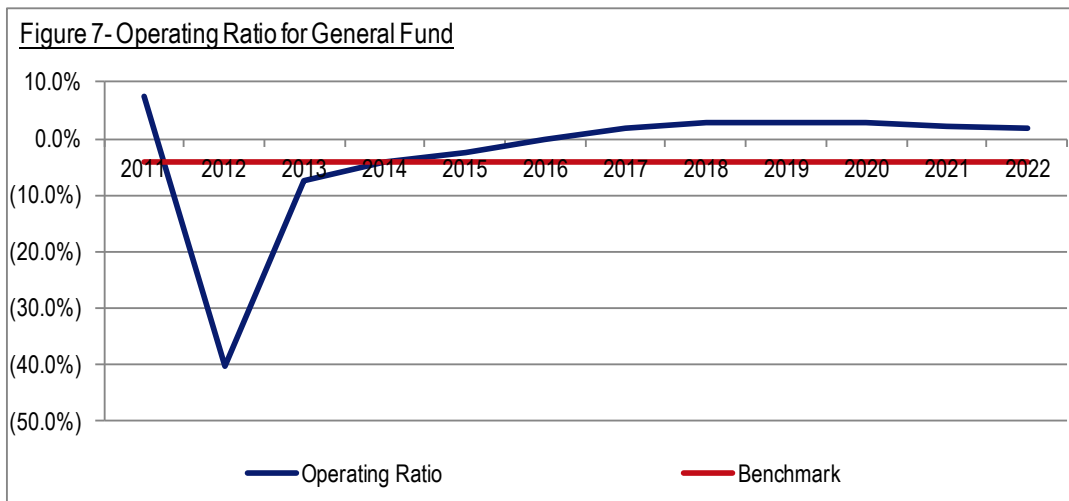
The financial forecast model shows the projected financial statements and assumptions for the next 10 years. We have focused our financial analysis upon the General Fund as although Council's consolidated position includes both a Water and Sewer Fund these are operated as independent entities, which unlike the General Fund are more able to adjust the appropriate fees and charges to meet all future operating and investing expenses.

Council originally completed their LTFP forecast with three scenarios however following the unsuccessful application for a SRV in 2012, this reverted to one scenario. This scenario includes an 11.37% SRV inclusive of the rate peg in 2013 that was a partial approval of Council's application for a multi-year SRV.

The scenario also includes another proposed but unapproved multi-year SRV of 10.0% inclusive of the rate peg from 2015 to 2017 and 4.0% inclusive of the rate peg for 2018.

The forecast was completed prior to the completion of the 2012 audited accounts and therefore does not take into account the large increase in depreciation expense that was experienced in 2012. The 2012 depreciation total for the General Fund was \$22.9m whereas the forecast depreciation varies from \$8.2m in 2013 to \$11.4m in 2022. This leads to the operating result being overstated.

4.1: Operating Results

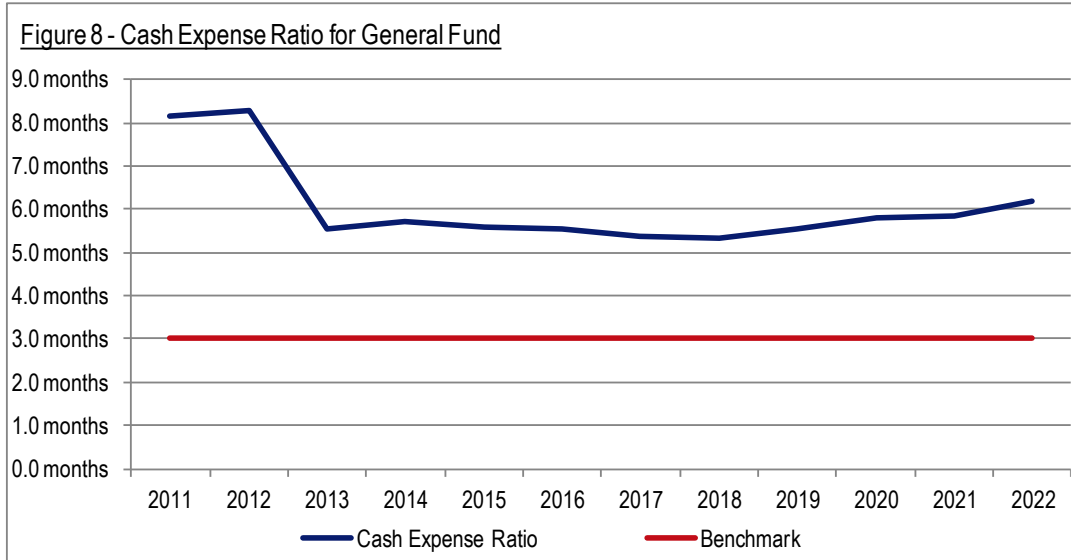


The Operating Ratio was impacted by the difference in the depreciation expense with the decrease of 47.6 percentage points to a negative 40.2% (\$15.5m) in 2012. The Operating Ratio appears to recover due to the understated depreciation expenses and the approved 11.37% SRV in 2013.

The operating result is projected to be in surplus from 2017 onwards however this will not be possible if depreciation remains similar to the 2012 figure.

4.2: Financial Management Indicators

Liquidity Ratios



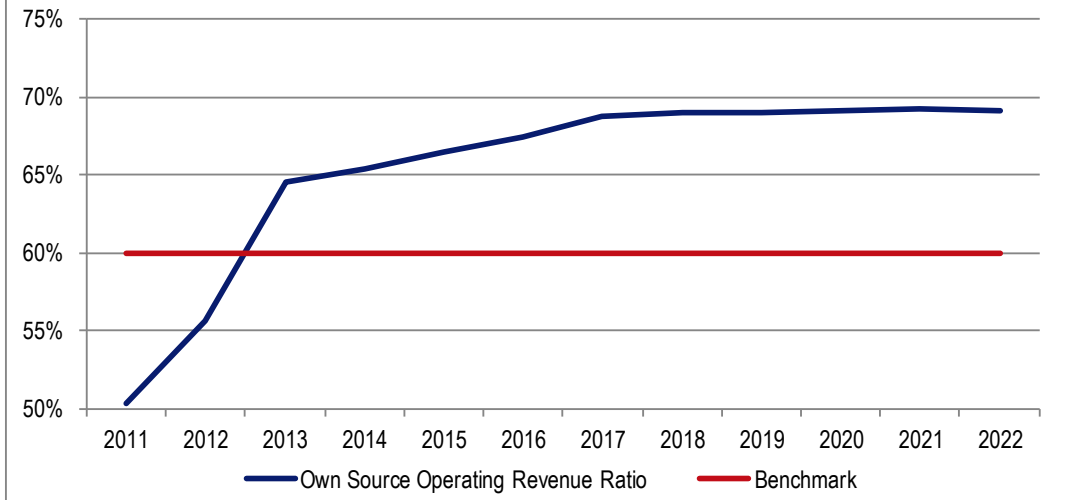
The Cash Expense Ratio is forecast to decrease from historic levels but remain above the benchmark through the 10 year period. Cash and cash equivalents balance is forecast to reduce to \$13.9m in 2013 but gradually improve to \$20.8m in 2022.

Council has not forecast the unrestricted asset and liability position in order to calculate the Unrestricted Current Ratio.

Based on the forecast Cash Expense Ratio, it is expected that Council will continue to have adequate liquidity over the forecast period.

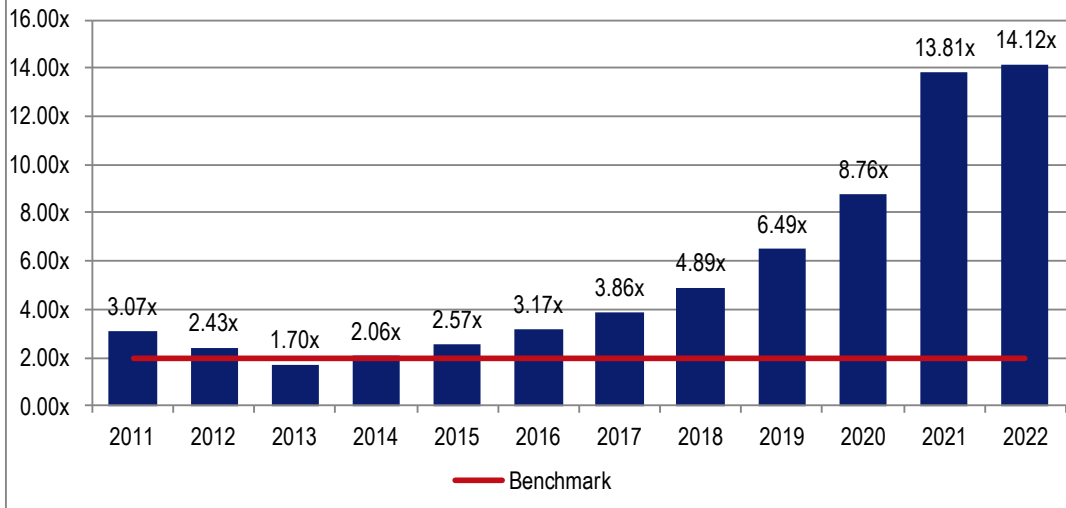
Fiscal Flexibility Ratios

Figure 9 - Own Source Operating Revenue Ratio for General Fund



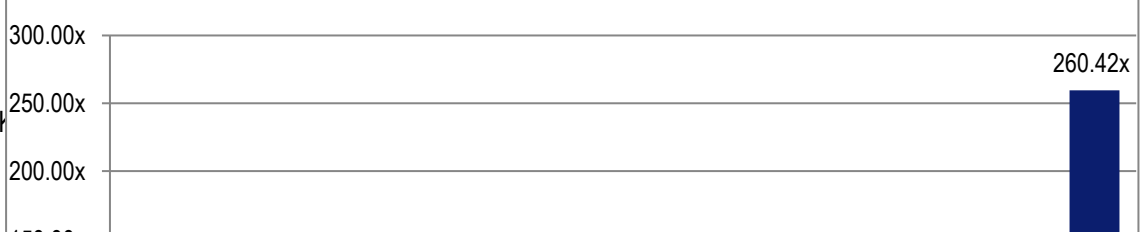
Council's Own Source Operating Revenue Ratio is projected to increase from the historic levels to above the benchmark in 2013 and to gradually increase over the review period. This is due to a combination of increasing rates revenues from the SRV in 2013 and the proposed SRV from 2015 to 2018 along with a reduction in the forecasted capital grants and contributions that skews the ratio upwards.

Figure 10 - DSCR for General Fund



The General Fund has projected new borrowings of \$5.6m in 2013 and no further borrowings for the rest of the forecast period. The DSCR reduces below the benchmark in 2013 but strengthens each year thereafter as Council projects a stronger EBITDA each year with the assistance of the approved and proposed SRV along with the reduction in Council's debt repayments as their borrowings reduce.

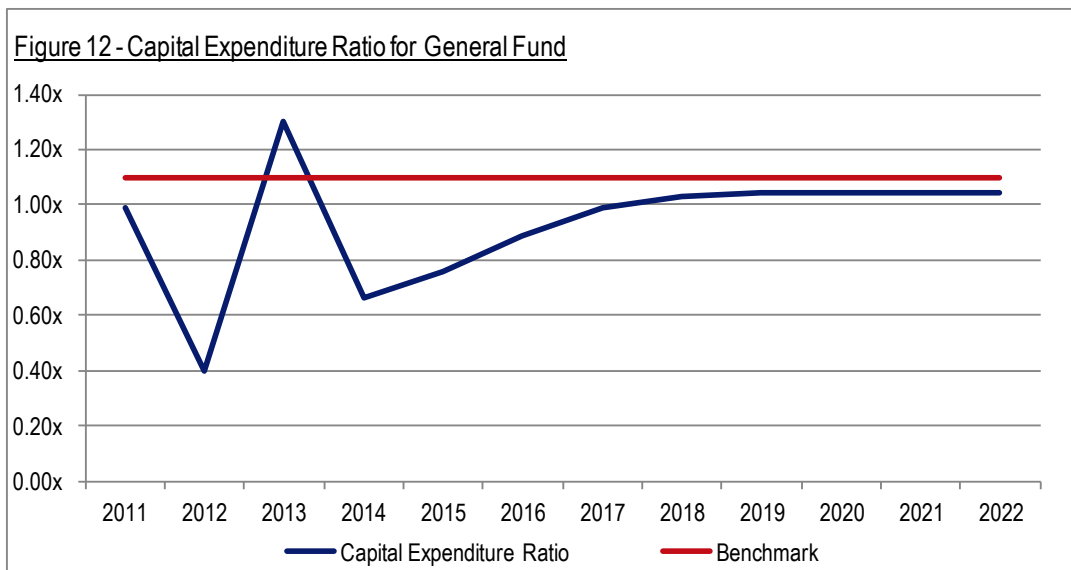
Figure 11 - Interest Cover Ratio for General Fund



The Interest Cover Ratio follows a similar pattern to the DSCR although it remains above the benchmark in all the years. The interest cost reduces from \$1.1m in 2013 to \$0.05m in 2022.

It appears that the General Fund is close to the limit for borrowings in 2013 however once the total borrowings reduce as debt is repaid, Council may be in a position to utilise further borrowings if they do not have liquidity constraints.

4.3: Capital Expenditure



The Capital Expenditure Ratio is skewed upwards against what TCorp expects to occur due to the potentially understated depreciation expense. It is therefore likely that the ratio will be below the benchmark for the full forecast period, leading to a decline in Council's Net Asset position. This indicates that Council is not able to maintain and renew its assets to satisfactory condition.

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

- The LTFP includes the proposed SRV from 2015 to 2018 so that current service levels can be maintained. If the SRV is not approved then it is likely that service levels will have to be reduced. Council has engaged in extensive community consultation since 2008 in the form of surveys, meetings and workshops among both the general public and business communities.
- The now inaccurate depreciation expenses within the LTFP result in overstated operating performance throughout the forecast period than is likely to occur.
- The proposed SRV leads to projected rates and annual rate and charges income to increase by 8.8% in 2015, 8.9% in 2016 and 2017 and 4.2% in 2018. The ordinary rates annual rate peg has been forecast to increase by 3.6% p.a.
- Materials and contract expenses are forecast to reduce to \$10.5m in 2013 from \$13.4m in 2012. Council has stated that this decrease is due to a different classification of some costs that are included within other expenses, inflating this category.
- Operating grants and contributions are forecast to reduce to \$10.2m in 2013 from \$13.9m in 2012 as the timing of the FAG realigns itself during the forecast period.
- Other expenses are forecast to increase from \$0.6m in 2012 to \$3.8m in 2013. As stated above, Council has stated that this increase is due to a different classification of some costs that are included within other expenses instead of materials and contracts, inflating this category.
- Employee costs have been forecast to decrease by 3.4% in 2013 and then increase between 1.5% and 6.6% p.a. for the rest of the forecast.
- Noting the above points, Council's underlying assumptions are deemed to be reasonable.

4.5: Borrowing Capacity

When analysing the financial capacity of the Council we believe that Council should not utilise further borrowings in addition to the \$5.6m proposed to be utilised in 2013. This is because the current LTFP is not entirely accurate or up to date.

Based on the current LTFP, Council appears to have the capacity to increase their borrowings during the forecast period. However, the forecast revenues include the unapproved proposed SRV and understated depreciation expense which inflates its forecast income. When these factors are taken into account, we expect Council to post continuous operating deficits during the forecast period. We would not recommend further borrowings at the present time until analysis on an updated LTFP can be done.

4.6: Sustainability

Based on its historical performance and the current LTFP for the General Fund, Council is unsustainable in the medium and long term if they are to continue providing the current service levels. Operating deficits are expected to continue over the 10 year LTFP forecast period once the depreciation expense has been updated, leading to a probable reducing Net Asset position over time.

As stated within Council's delivery program and operational plan for 2012-13, if changes do not occur from the existing resourcing and management of the sealed road network, at the end of the ten year period covered by the resourcing plan:

- 88% or more of the road surface will be rough in some way or another,
- The ride will feel 26% rougher than now,
- 40% more cracking will be in the road pavement,
- Leading to 44% more potholes, and
- 32% more broken off road edges on the side of the road.

This highlights the problem that Council faces as they try to maintain the service level of their infrastructure assets. With Council unable to maintain the current standard of the infrastructure assets, they are also unable to tackle the issue of reducing the Infrastructure Backlog within the General Fund and with the asset quality decreasing this is likely to lead to an increase in the Backlog total. Council may have to reduce service levels by lowering the quality standards on certain assets as Council cannot fully fund the maintenance and renewals for their road infrastructure assets to current standards.

Council's Water and Sewer Funds are also projected to post operating deficits when capital grants and contributions are excluded for all 10 years of the forecast period as they undergo significant capital expenditure and renewals works to improve their assets to a satisfactory standard. These two Funds are forecast to begin posting operating surpluses during a 20 year forecast period with the already agreed annual increases of 5% p.a. for Water Fund and 6% p.a. for Sewer Funds once the borrowings for the major capital works begin to decrease.

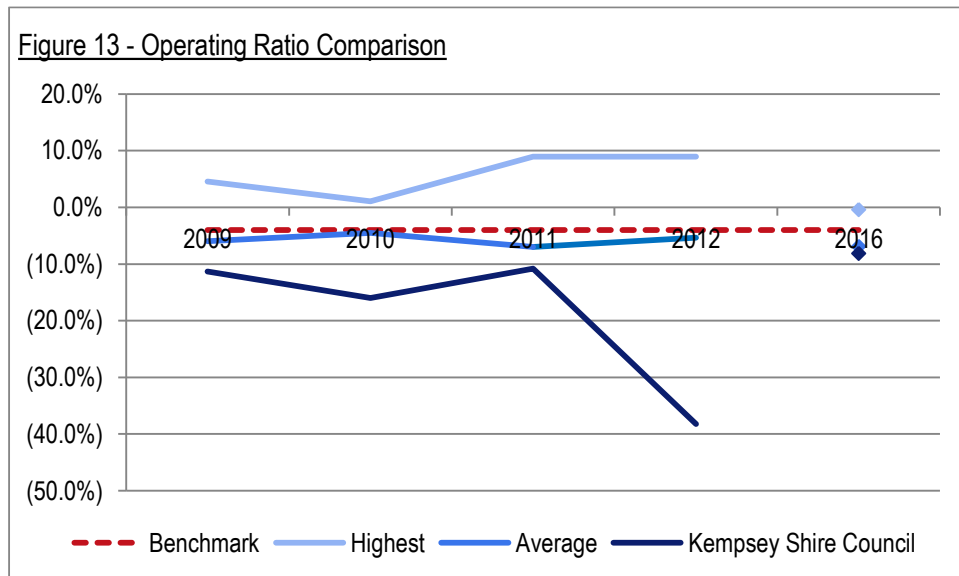
Section 5 Benchmarking and Comparisons with Other Councils

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.

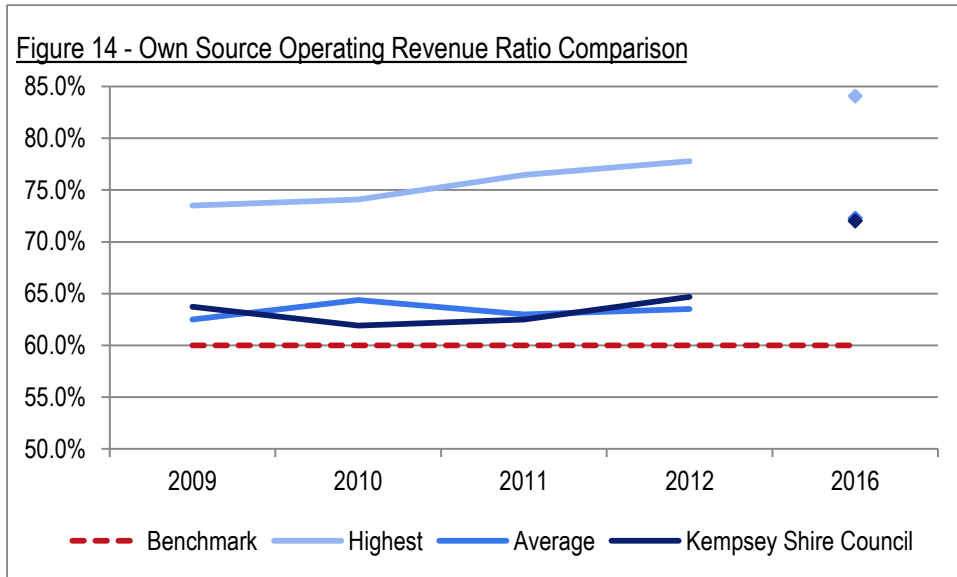
In Figure 13 to Figure 22, the graphs compare the historical performance of Council with the benchmark for that ratio, with the average for the Group, with the highest performance (or lowest performance in the case of the Infrastructure Backlog Ratio where a low ratio is an indicator of strong performance), and with the forecast position of the Council as at 2016 (as per Council's LTFP). Figures 20 to 22 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

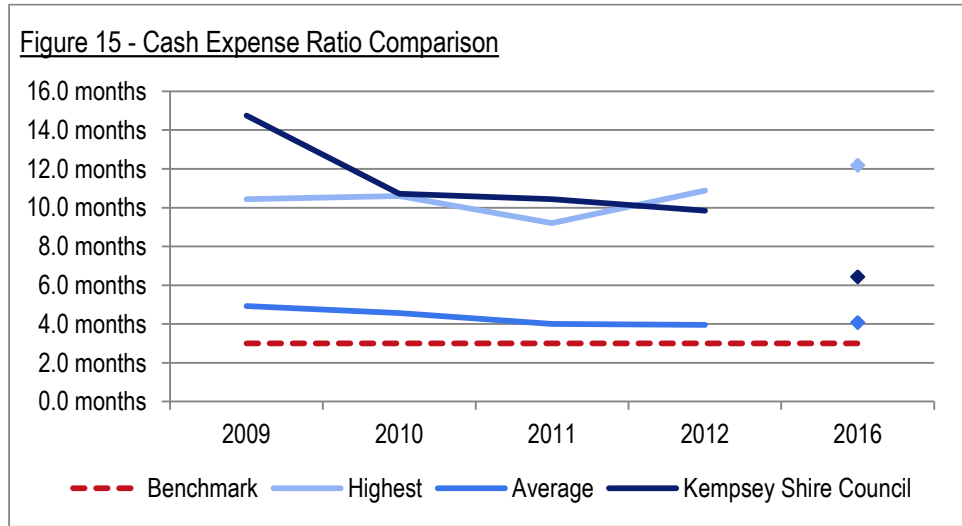


Council's Operating Ratio has been below the benchmark and group average indicators in each year and this is forecast to continue but at a less significant deficit level than experienced historically.



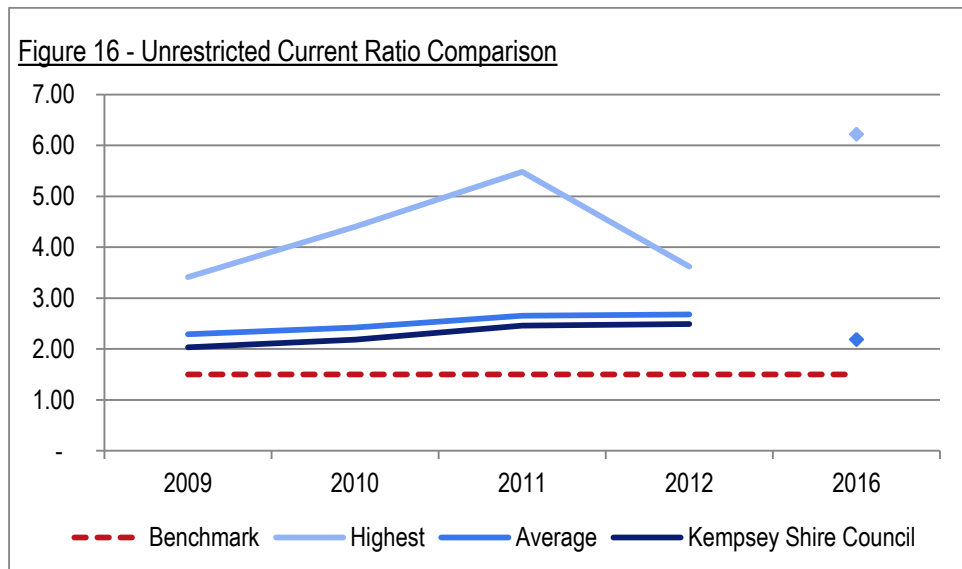
Council's Own Source Operating Revenue Ratio has been in line with the group average and above the benchmark. It is forecast to increase alongside the group average due to councils in the group generally forecasting a lower level of grants and contributions in future years as some grants and contributions are not certain to be received.

Liquidity



Council has been above the group average and benchmark in each review year. Council holds all of their funds within cash and cash equivalents, as opposed to investments that are not included within this ratio.

Council is not investing in longer dated, higher return investment products.



Council's Unrestricted Current Ratio has been above the benchmark and marginally below the group average in each year indicating adequate liquidity levels.

Council has not forecast this ratio within their LTFP.

Debt Servicing

Figure 17 - Debt Service Cover Ratio Comparison

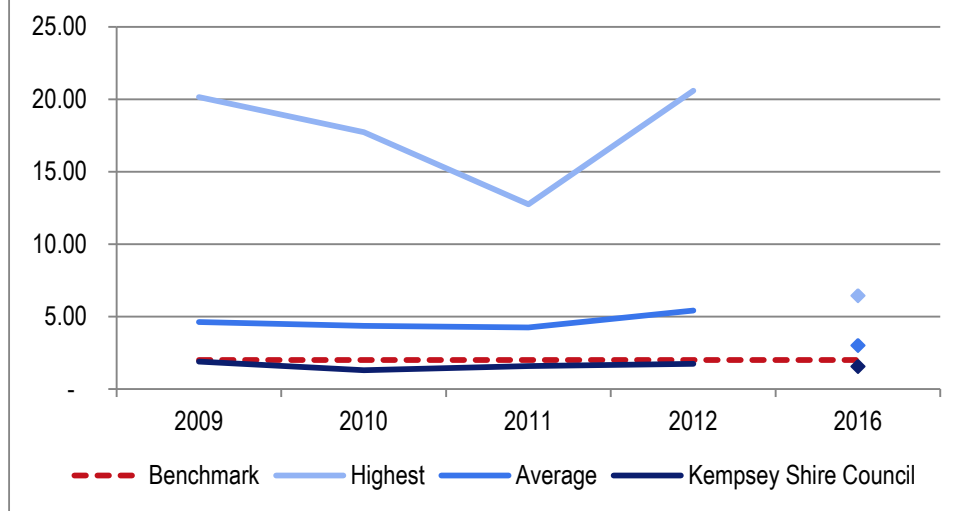
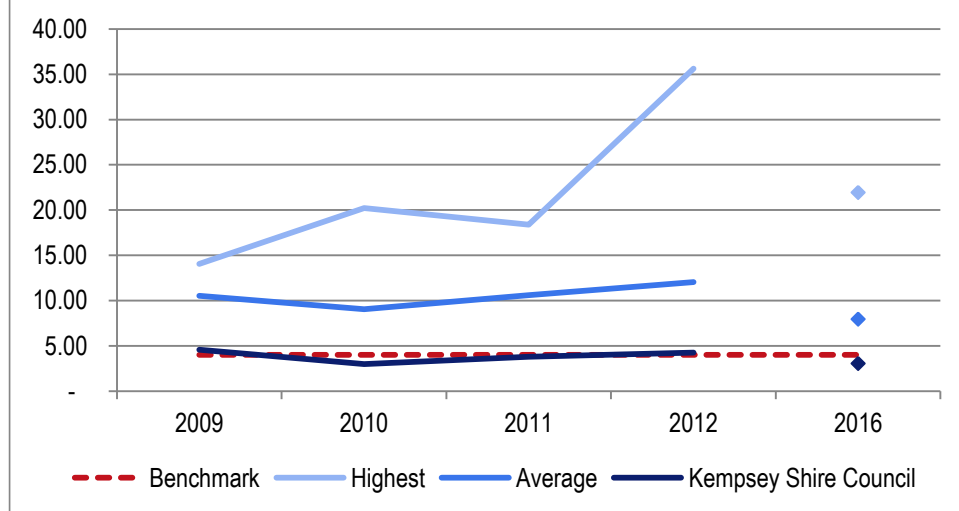


Figure 18 - Interest Cover Ratio Comparison



Council's DSCR and Interest Cover Ratio have been below the group average in each year. The DSCR is below the benchmark in each year and the Interest Cover Ratio rose marginally above the benchmark in 2009 and 2012.

Both ratios are forecast to remain below the benchmark in 2016

Asset Renewal and Capital Works

Figure 19 - Capital Expenditure Ratio Comparison

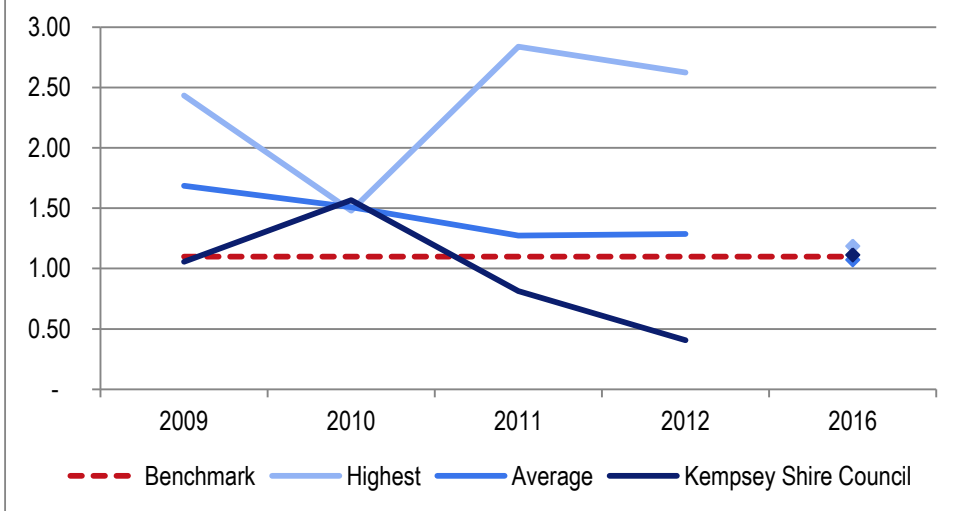
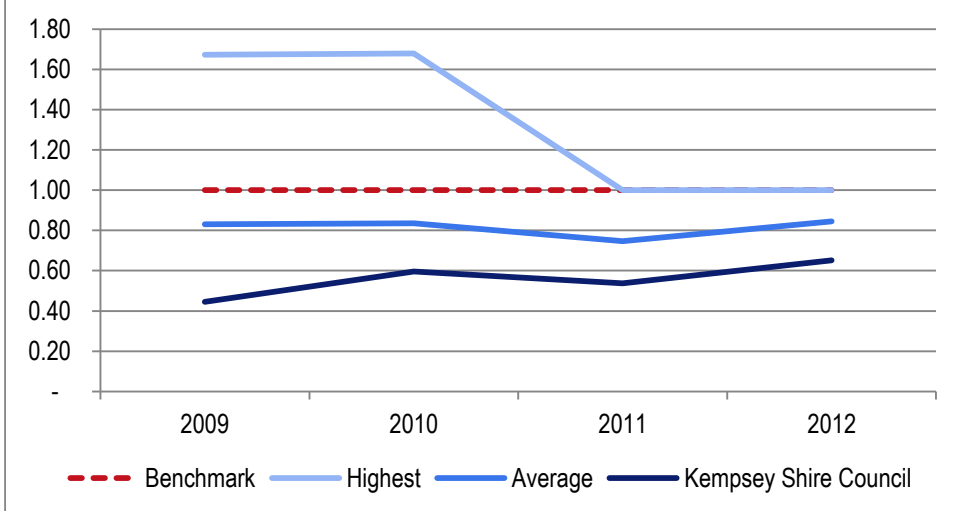


Figure 20 - Asset Maintenance Ratio Comparison



Council's Capital Expenditure Ratio was below the benchmark and group average in each year apart from 2010 when it improved above both indicators following Council's increased capital works program during that year.

Council's Asset Maintenance Ratio has consistently been below both the group average and benchmark but has been on a slight upward trend.

Figure 21 - Infrastructure Backlog Ratio Comparison

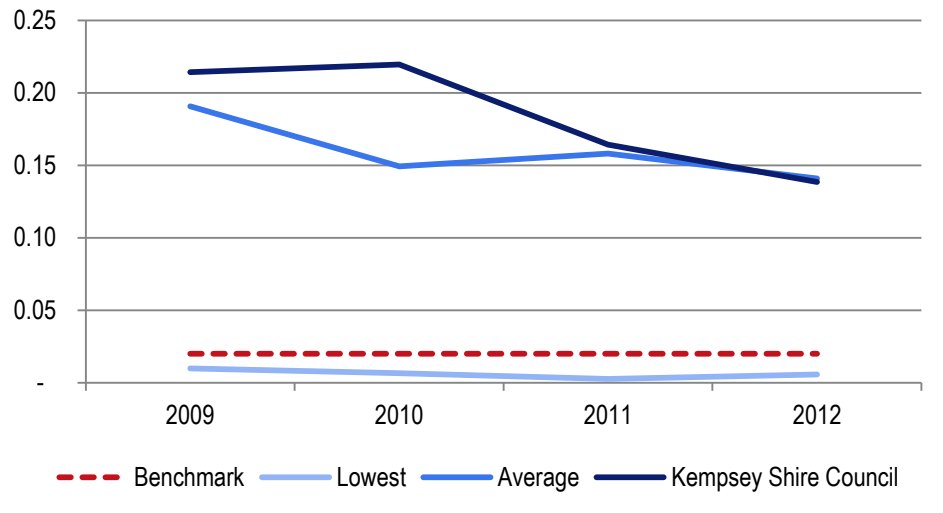
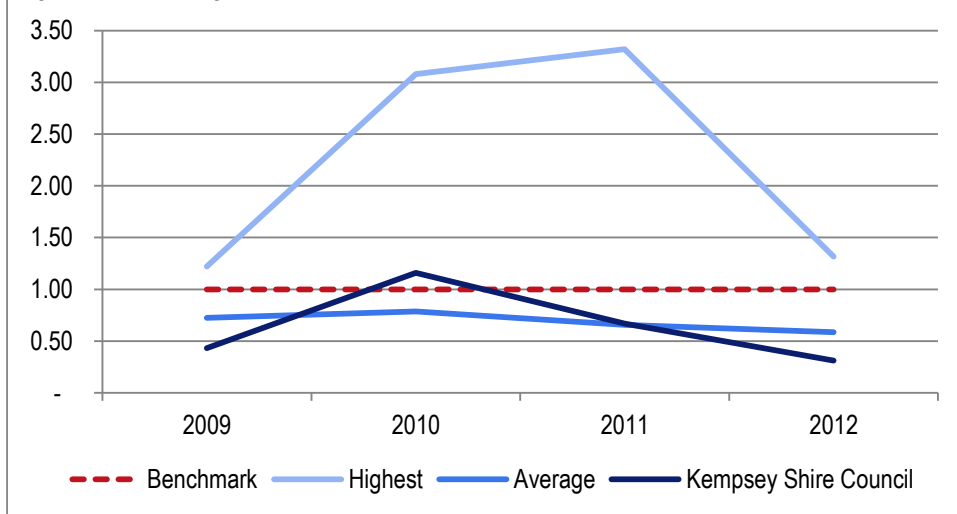


Figure 22 - Building and Infrastructure Asset Renewal Ratio



Council's Infrastructure Backlog Ratio was above the group average until 2012 when it reduced to marginally below the group average. It remains above the benchmark over the review period.

Council's asset renewals have been below the benchmark in each year with the exception of 2010 but the downward trend since then has seen Council decrease below the group average in 2012.

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 if current service levels are continued within the General Fund.

We base our recommendation on the following key points:

- Once Council's LTFP is updated with the accurate depreciation figures, significant operating deficits are expected to continue throughout the forecast period, with Council unable to raise sufficient revenues to meet their ongoing expenses
- This will lead to Council being unable to fund asset maintenance, renewals and additional assets, with the Net Asset base deteriorating and the Infrastructure Backlog increasing

We would also recommend that the following points be considered:

- Council is fully aware of the financial position that they face and are being pro-active by investigating and applying for a SRV to boost their revenues as they look to maintain the current service levels provided
- Council will benefit from the LTFP being updated for depreciation expense to a more accurate forecast operating position so that they can review their operational plan, delivery program and capital works schedule
- Council's refinement of their AMP and review of how the depreciation expense is calculated is ongoing, with the accuracy likely to improve. Potentially, with the ongoing review and refinement of the AMP, depreciation numbers may vary from current forecast or actual 2012 levels which could impact forecast operating results.

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	24,233	23,364	22,582	21,309	3.7%	3.5%	6.0%
User charges and fees	11,114	10,850	10,646	8,996	2.4%	1.9%	18.3%
Interest and investment revenue	1,935	1,853	1,593	1,873	4.4%	16.3%	(14.9%)
Grants and contributions for operating purposes	14,321	12,869	11,920	11,392	11.3%	8.0%	4.6%
Other revenues	218	298	135	89	(26.8%)	120.7%	51.7%
Total revenue	51,821	49,234	46,876	43,659	5.3%	5.0%	7.4%
Expenses							
Employees	19,381	18,114	17,514	16,670	7.0%	3.4%	5.1%
Borrowing costs	3,111	3,206	3,086	2,565	(3.0%)	3.9%	20.3%
Materials and contract expenses	15,151	15,593	17,026	12,351	(2.8%)	(8.4%)	37.9%
Depreciation and amortisation	29,974	14,286	13,635	14,075	109.8%	4.8%	(3.1%)
Other expenses	4,006	3,349	3,102	2,939	19.6%	8.0%	5.5%
Total expenses	71,623	54,548	54,363	48,600	31.3%	0.3%	11.9%
Operating result	(19,802)	(5,314)	(7,487)	(4,941)	(272.6%)	29.0%	(51.5%)

Table 2 - Items excluded from Income Statement

Excluded items (\$'000s)				
	2012	2011	2010	2009
Grants and contributions for capital purposes	2,814	5,518	6,789	3,890
Gain / (loss) on disposal of assets	189	(871)	(141)	(564)

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	31,590	32,221	33,613	39,287	(2.0%)	(4.1%)	(14.4%)
Receivables	6,046	6,203	5,249	5,073	(2.5%)	18.2%	3.5%
Inventories	345	506	482	461	(31.8%)	5.0%	4.6%
Other	33	31	0	0	6.5%	N/A	N/A
Total current assets	38,014	38,961	39,344	44,821	(2.4%)	(1.0%)	(12.2%)
Non-current assets							
Receivables	215	227	235	121	(5.3%)	(3.4%)	94.2%
Infrastructure, property, plant & equipment	1,103,471	1,145,694	633,637	616,366	(3.7%)	80.8%	2.8%
Total non-current assets	1,103,686	1,145,921	633,872	616,487	(3.7%)	80.8%	2.8%
Total assets	1,141,700	1,184,882	673,216	661,308	(3.6%)	76.0%	1.8%
Current liabilities							
Payables	3,706	3,925	4,891	5,590	(5.6%)	(19.8%)	(12.5%)
Borrowings	4,650	4,407	4,546	4,129	5.5%	(3.1%)	10.1%
Provisions	8,223	7,399	6,829	6,359	11.1%	8.3%	7.4%
Total current liabilities	16,579	15,731	16,266	16,078	5.4%	(3.3%)	1.2%
Non-current liabilities							
Payables	526	532	553	495	(1.1%)	(3.8%)	11.7%
Borrowings	41,512	44,412	46,318	43,375	(6.5%)	(4.1%)	6.8%
Provisions	353	274	205	247	28.8%	33.7%	(17.0%)
Total non-current liabilities	42,391	45,218	47,076	44,117	(6.3%)	(3.9%)	6.7%
Total liabilities	58,970	60,949	63,342	60,195	(3.2%)	(3.8%)	5.2%
Net assets	1,082,730	1,123,933	609,874	601,113	(3.7%)	84.3%	1.5%

Table 4-Cashflow

Cashflow Statement (\$'000s)	Year ended 30 June			
	2012	2011	2010	2009
Cashflows from operating activities	13,981	10,655	12,612	14,141
Cashflows from investing activities	(11,955)	(10,002)	(21,646)	(15,528)
Proceeds from borrowings and advances	1,850	2,500	7,364	12,750
Repayment of borrowings and advances	(4,507)	(4,545)	(4,004)	(3,590)
Cashflows from financing activities	(2,657)	(2,045)	3,360	9,160
Net increase/(decrease) in cash and equivalents	(631)	(1,392)	(5,674)	7,773
Cash and equivalents	31,590	32,221	33,613	39,287

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 2009², 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.

¹IPART “Revenue Framework for Local Government” December 2009 p.83

² DLG “Recognition of certain assets at fair value” March 2009

EBITDA

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

Grants and Contributions for Capital Purposes

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

Grants and Contributions for Operating Purposes

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

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

Independent Commission Against Corruption (ICAC)

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

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

Independent Pricing and Regulatory Tribunal (IPART)

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

Infrastructure Backlog

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

Integrated Planning and Reporting (IP&R) Framework

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

Local Government Cost Index (LGCI)

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

Net Assets

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

Roads and Maritime Services (RMS)

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

Section 64 Contribution

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

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

Section 94 Contribution

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

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

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

Special Rate Variation (SRV)

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

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

The applications are reviewed and approved by IPART.

Sustainability

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

Ratio Explanations

Asset Maintenance Ratio

Benchmark = Greater than 1.0x

Ratio = actual asset maintenance / required asset maintenance

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

Building and Infrastructure Renewals Ratio

Benchmark = Greater than 1.0x

Ratio = Asset renewals / depreciation of building and infrastructure assets

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

Cash Expense Cover Ratio

Benchmark = Greater than 3.0 months

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

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

Capital Expenditure Ratio

Benchmark = Greater than 1.1x

Ratio = annual capital expenditure / annual depreciation

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

Debt Service Cover Ratio (DSCR)

Benchmark = Greater than 2.0x

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

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

Building and Infrastructure Backlog Ratio

Benchmark = Less than 0.02x

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

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

Interest Cover Ratio

Benchmark = Greater than 4.0x

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

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

Operating Ratio

Benchmark = Better than negative 4%

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

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

Own Source Operating Revenue Ratio

Benchmark = Greater than 60%

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

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

Unrestricted Current Ratio

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

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

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