# Clarence Valley Council

## Financial Assessment and Sustainability Report

| | |
|---|---|
| **Date:** | 12 July 2016 |

## Disclaimer

This report has been prepared by New South Wales Treasury Corporation (TCorp) in accordance with the appointment of TCorp by Clarence Valley Council (the Council) as detailed in TCorp's letter of 11 May 2016.

The report has been prepared based on information provided to TCorp. 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 Council's future Sustainability, within prudent risk parameters and the limits of its financial projections.

The report has been prepared for Clarence Valley Council. TCorp shall not be liable to Clarence Valley 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.

# Contents

# 1 Executive Summary

In October 2012 TCorp provided Clarence Valley Council (the Council) with a Financial Assessment and Benchmarking Report as part of the work undertaken for the Independent Local Government Review Panel.

In the October 2012 report TCorp made the following recommendations:

- “Operating deficits excluding capital grants and contributions are forecast for the 10-year forecast period. These operating deficit results are all substantially below the benchmark target of (4%). This is a significant issue that could impact the long term financial sustainability of the Council. We recommend Council considers its options for improving its performance in this area, either by further and ongoing cost controls, or securing new or additional revenue, such as a SRV in future years
- Council’s Infrastructure Backlog is already 0.15x of its infrastructure assets, and as the required capital expenditure amounts are not being spent each year it is likely this figure may grow. This backlog is clearly unsustainable and a problem that Council will be unable to address without significant external funding support
- Council has the difficult task of balancing sufficient liquidity, with spending as much as possible on an already daunting Infrastructure Backlog. We believe that Council should, in the short to medium term focus on developing strategies to resolve this long term forecast position”

In April 2013 TCorp also provided Council with a Financial Sustainability Rating (FSR) and Outlook. TCorp’s report stated that Council had a FSR of Weak with an Outlook of Negative.

Following receipt of the report Council has progressively sought to address the issues raised by TCorp. We understand that Council has undertaken the following key actions:

- During FY2014 Council engaged an external expert to assist in undertaking a full revaluation of its infrastructure assets and a desktop review of its land and buildings. The results of the revaluation review included an increase in the value of assets, but a significant reduction in annual depreciation expense. These changes occurred with the standardisation of unit rates, amendments to condition assessments and residual values and a review of asset useful lives
- In FY2015 Council reassessed its methodology for the ‘estimated cost to bring up to satisfactory standard’ which is a key determinant in the calculation of the Infrastructure Backlog. This reassessment occurred following consultation with other councils in the region with a view to being consistent in the application of the revised methodology
- Council has sought to address its need for additional revenue by seeking approval from IPART for a SRV commencing from July 2016. Whilst the application to IPART has been only partially approved, the need for additional revenue is clear if Council is to address its longer term sustainability position

The key observations from the review of Council’s consolidated historic performance are:

- Operating result improved markedly in FY2014 due to the revaluation of its assets and a subsequent reduction in its depreciation expense in its short to medium term depreciation. This methodology by APV would potentially expose council to increased depreciation expense in future years given the consumption-based model that it is based upon

- The Water Fund has contributed net operating losses of $8.0m over the review period as Council focuses on applying the NSW Government's 'Best Practice Management of Water Supply and Sewerage Guidelines 2007' over a 20-year period which has not at this stage provided sufficient user charges to achieve an ongoing break-even operating position in this Fund. Operating surpluses have been forecast from FY2016 and throughout the 10-year LTFP however this is primarily due to the expected 32.5% fall in depreciation expense in FY2016, which continues at similar reduced levels each year thereafter
- Council has relied on a net increase in borrowings of $23.6m to fund its capital program over the past five years, increasing the total borrowings to $135.9m, a level which TCorp believes is the maximum level of borrowings that Council can sustain. The new borrowings were utilised to assist the funding of essential Sewer Fund works in FY2012 and FY2015. TCorp would also recommend that Council consider the use of interest only borrowings rather than amortising loans as a means of improving cash flow across the Council and helping to spread the debt costs across a longer period to promote intergenerational equity
- Council's capital expenditure has predominantly been focussed on new assets. TCorp believes that asset renewals need to be prioritised over any non-essential new capital works
- Council's investment portfolio consists of predominantly term deposits with less than 12 months maturity. Council should consider diversifying its portfolio in different investment products for longer terms if it is suitable to its cash flow requirements

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

- Operating results in FY2016 and FY2017 are forecast to be adversely affected due to a reduction in expected levels of grants and contributions, which has in turn improved Council's Own Source Operating Revenue Ratio. Although the trend in later years of the forecast is positive, Council is expecting consecutive deficits larger than the $8.7m loss achieved in FY2015 for a minimum of the next nine years
- The temporary Section 508(2) SRV of 6.5% for FY2017 which has been approved by IPART will have minimal impact on Council's overall operating performance, as indicated in Scenario 2. Council has demonstrated the impact of a potential seven-year Section 508(A) SRV of 5.44% p.a. in Scenario 3, which if approved, would reduce operating losses by half by FY2025 and allow additional works to be undertaken to improve Council's asset ratios. The cumulative increase of 41.0% would be permanently built into the general rate base from 1 July 2024
- Council has implemented numerous cost containment measures to improve its operating performance – asset rationalisation strategies to reduce duplication of services, and annual service reviews to identify potential operating efficiencies and/or reduce non-essential services. These efficiency savings are projected to reduce Council's operating costs by $24.1m over FY2017 to FY2025. However, as Council's operating expenses currently exceed operating revenue by at least 10.0%, these cost savings are insufficient for Council to break-even in the short to medium term
- TCorp has concerns regarding the accuracy of depreciation expense within the LTFP where it appears that Council has used an index of 2.5% to calculate annual depreciation. Our view is as IPP&E is forecast to decline over time, so does the costs of renewing a smaller asset base. Council has advised that from FY2016, APV has adopted a straight line model for depreciation expense however without the depreciation schedule, TCorp is not able to verify if the forecast

depreciation is correct. TCorp recommends that Council conduct further work in respect of its depreciation forecasts currently contained in its LTFP to verify their accuracy

- Apart from the new depot, to be built to replace five existing assets that are being sold as part of Council's asset rationalisation strategy, Council is not forecasting new capital projects beyond FY2017 as they will be prioritising asset renewals. Contrary to Council's previous strategy that appeared to focus on new asset additions, asset renewals are budgeted to be around 90.0% of the General Fund 10-year capital expenditure program. Council has not forecast any new borrowings within the General Fund throughout the 10-year period to assist with funding its capital expenditure
- The forecast Cash Expense Cover Ratio indicates that Council's cash position is improving over time, however this is due to a smaller capital expenditure program forecast for FY2018 to FY2025. Improving the capital expenditure spending will directly reduce the Cash Expense Cover Ratio however the forecast indicates there is some limited capacity to do so

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

- Council's management is focussed on the significant challenge that they face to achieve the long term sustainability of the Council. Council's operating performance is forecast to show improvement compared to the previous LTFP forecast provided to TCorp in FY2012. However, even with the proposed SRV in Scenario 3, Council is forecasting operating deficits in each of the 10 years, highlighting the challenge that Council has to achieve financial sustainability
- While the proposed seven-year SRV in Scenario 3 will assist with improving operating results, Council will have to review all areas within the Council including its service levels if it is to break-even in the medium term to long term
- The additional income generated from the SRV will enable Council to improve its asset ratios over time however significant work is still required for the ratios to achieve the respective benchmarks. Council's Asset Maintenance Ratio is expected to achieve the TCorp benchmark of 1.0x by FY2024, however the remaining three asset ratios are still considerably below the benchmarks and if not addressed, will compound the backlog figure
- The General Fund debt is currently at acceptable levels however due to the high amount of borrowings within the Sewer Fund, TCorp does not recommend Council utilise further debt at this time. This limits Council's options to fund capital expenditure and is one of the reasons Council's asset ratios are at low levels

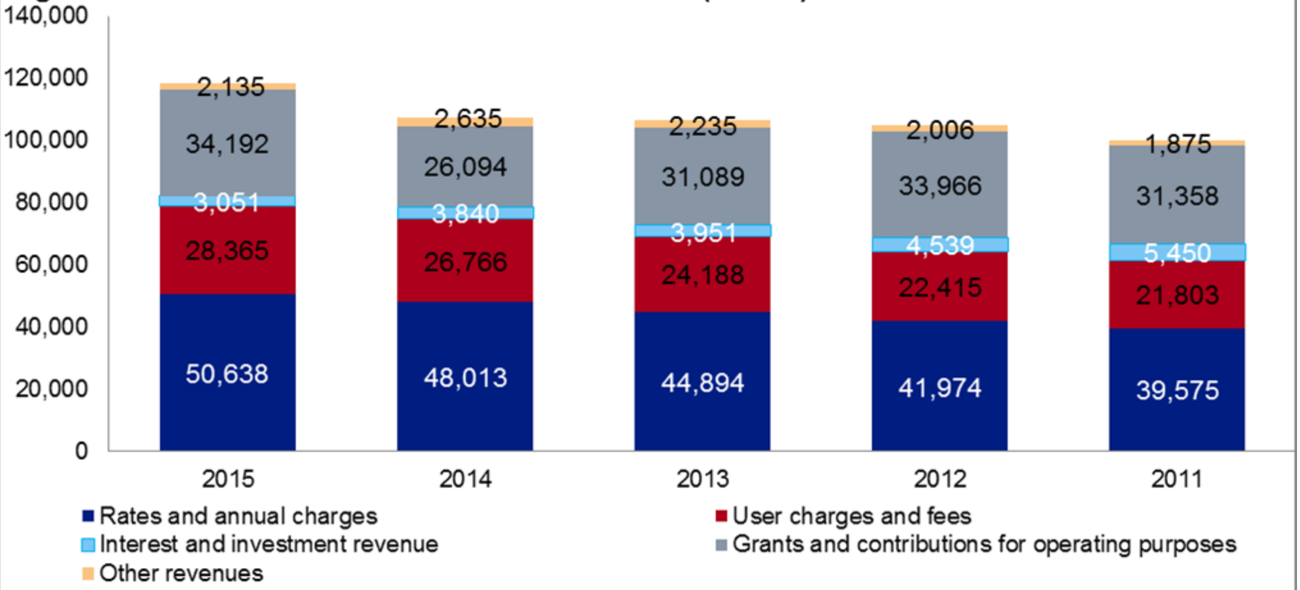
Based on our review of both the consolidated historic financial information and the 10-year financial forecast within Council's General Fund LTFP, we consider Council to have a Financial Sustainability Rating (FSR) of Weak with an updated Outlook of Neutral. This is an improvement from Council's previous Outlook of Negative, and although Council's Sustainability rating remains unchanged, there is a noticeable improvement in the FSR score band which indicates that Council is on the right path to an improved position.

# 2 Review of Financial Performance and Position

TCorp has updated its review based on the FY2015 consolidated annual audited accounts of the Council.

## 2.1 Revenue

Figure 1 - Revenue Sources for FY2011 to FY2015 ($'000s)




**Key Observations**

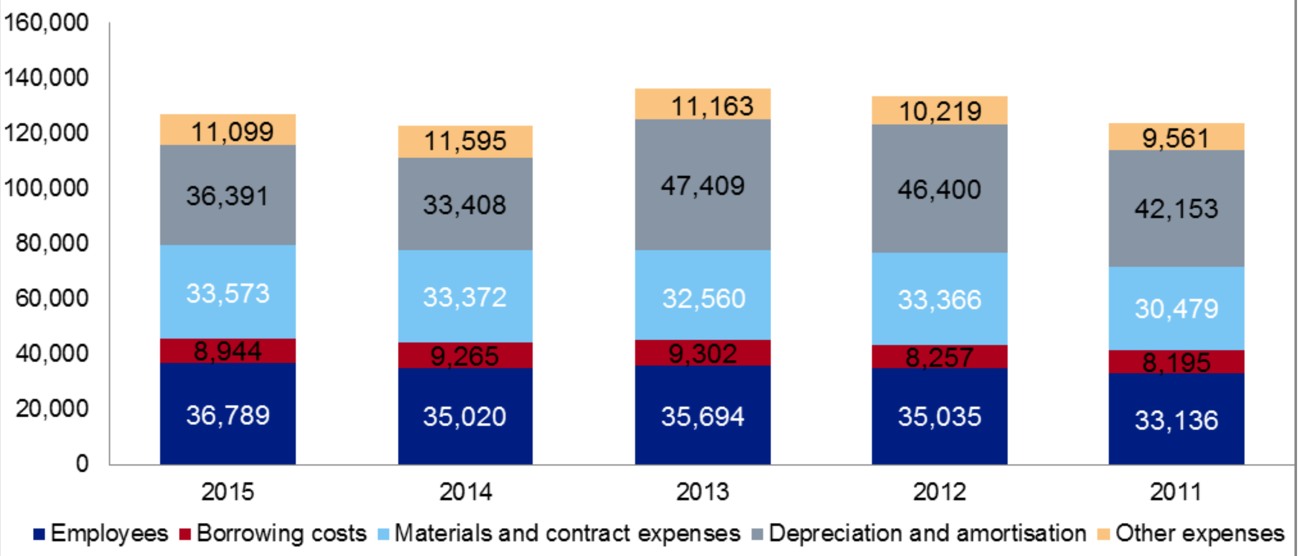
- Rates and annual charges have increased year-on-year at a rate of between 5.5% and 7.0%. This was driven by increases in charges for:
  - domestic and non-domestic waste management services, by an average of 7.5% per annum
  - water supply services, by an average of 7.5% per annum
  - sewerage services, by an average of 11.0% per annum, from $9.9m in FY2011 to $15.0m in FY2015
- User charges and fees experienced significant increases from FY2013 to FY2015 due to the collective increases of RMS charges and water charges. RMS charges increased by $1.1m in both FY2014 and FY2015, whilst water charges and fees increased by $0.8m in FY2013 and $1.0m in FY2014
- Interest and investment revenue decreased year-on-year due to a combination of a lower interest rate environment and lower average investment balances held
- The timing difference in receipt of the Financial Assistance Grants (FAG) has caused significant fluctuations in operating grants and contributions – Council received five quarters of FAG in FY2012 while only two quarters were received in FY2014. The 31.0% increase in operating grants and contributions in FY2015 was due to:
  - the Federal Government ceasing the prepayment of FAG – Council received all four quarters in FY2015

Corp

- an additional 67.4% storm/flood damage grants received in FY2015 – Council received $6.2m of this grant in FY2015 which was the highest in five years ($3.7m in FY2014 and $4.0m in FY2013)

## 2.2 Expenses

**Figure 2 - Expenses for FY2011 to FY2015 ($'000s)**




### Key Observations

- Movements in employee expenses have been influenced by the amount of capitalised costs and fluctuations in workers' compensation insurance. The number of equivalent FTE has increased year-on-year, from 495 in FY2011 to 542 in FY2015, which coincides with increases in employee expenses with the exception of FY2014. Employee expenses decreased by 1.9% in FY2014 despite 18 additional equivalent FTE due to a higher amount of capitalised costs, at $4.6m compared to the average of $2.5m for the other four years
- Borrowing costs increased by 12.7% in FY2013 following new loan borrowings of $26.1m obtained in FY2012 for the Iluka Sewerage Scheme, Materials Recovery Facility and Organic Processing Facility and general infrastructure
- Materials and contract expenses increased by 9.5% in FY2012 due to the purchase of bulk water supply from the Karangi Dam at Coffs Harbour ($0.7m) and increased natural disaster and emergency works ($0.6m). In FY2015 Council had carried out additional RMS and natural disaster works whilst materials and contract expenses remained constant as the related expenditure were capitalised and reported as an impairment reversal against equity
- In FY2014 depreciation expense decreased by 29.5% following the engagement of an external expert (APV Valuers and Asset Management) to assist with performing a full revaluation of Council's infrastructure assets and a desktop review of land and buildings. As a result of this review, Council's assets were revalued $231.7m higher. The reasons for these major changes are the standardisation/movements of unit rates, altered condition assessments, changes to residual values and useful life estimates. Council has advised that they are gradually phasing

TCorp

out the use of residual values, however this will take some time to be fully applied to all asset classes. TCorp supports the phasing out of residual values

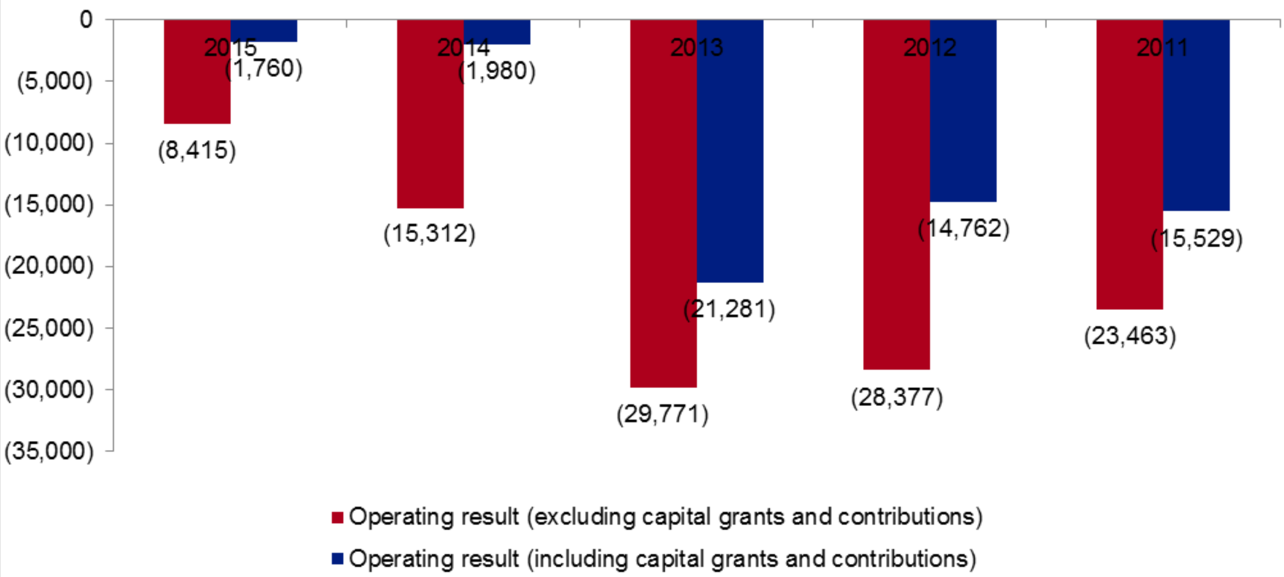
## 2.3 Operating Results

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

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

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

**Figure 3 - Operating Results for FY2011 to FY2015 ($'000s)**




### Key Observations

- Council has reported consecutive losses over the review period, which remained the case when capital grants and contributions were included. The losses have reduced significantly since FY2013
- The largest year-on-year change occurred in FY2014, mainly due to the reduced depreciation expense. The FY2015 result improved further, largely due to higher operating grants being received for the FAG and storm/flood damage grants
- The change in the depreciation methodology has had a significant positive impact on the operating results. It is TCorp's understanding that APV's methodology calculates lower depreciation in the early years of an asset's life as part of a consumption-based depreciation methodology. APV has since reverted to the straight line model, and TCorp would expect residual values to be removed for infrastructure assets that have no resale values as part of the updated asset valuation methodology

 Unclassified

## 2.4 Financial Management Indicators

| Performance Indicators | Year ended 30 June | | | | |
|---|---|---|---|---|---|
| | 2015 | 2014 | 2013 | 2012 | 2011 |
| EBITDA ($'000s) | 36,920 | 27,361 | 26,940 | 26,280 | 26,885 |
| Operating Ratio | (7.1%) | (14.3%) | (28.0%) | (27.1%) | (23.4%) |
| Interest Cover Ratio | 4.13x | 2.95x | 2.90x | 3.18x | 3.28x |
| Debt Service Cover Ratio | 2.58x | 1.80x | 1.80x | 1.95x | 2.12x |
| Unrestricted Current Ratio | 4.41x | 4.48x | 3.81x | 3.63x | 3.58x |
| Own Sourced Operating Revenue Ratio | 67.3% | 67.3% | 60.2% | 54.3% | 56.8% |
| Cash Expense Cover Ratio | 10.6 months | 9.0 months | 4.6 months | 4.2 months | 6.7 months |
| Net assets ($'000s) | 2,015,184 | 1,919,141 | 1,683,821 | 1,648,760 | 1,595,540 |

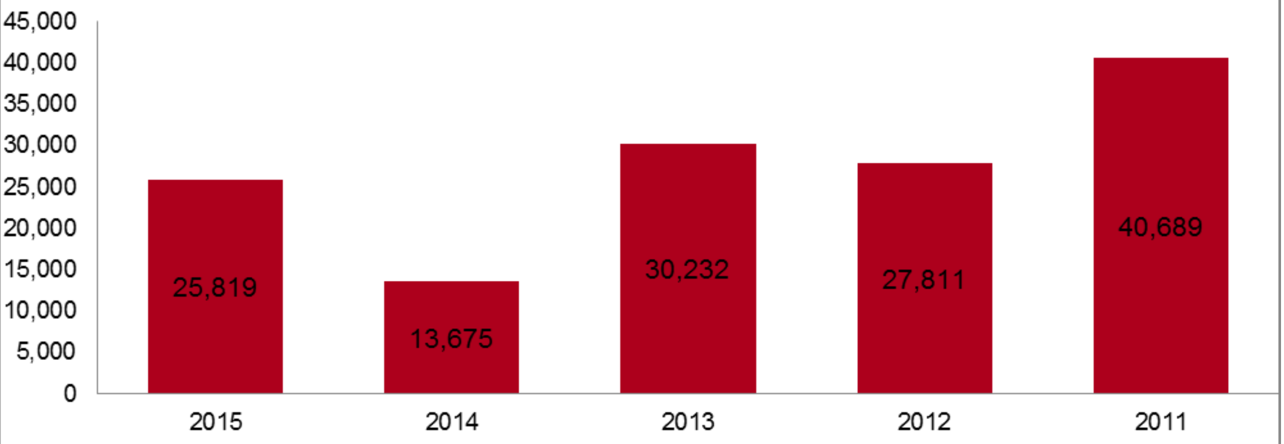
**Key Observations**

- While Council's Operating Ratio has improved in FY2015, it remains well below the updated benchmark of a breakeven position that TCorp believes councils should aim to achieve
- Council's debt metrics have been below TCorp's benchmarks for the majority of the review period. The improved FY2015 EBITDA sees both the DSCR and ICR improve above their respective benchmarks of 2.00x and 4.00x respectively, however the overall position indicates that the balance sheet is carrying too much debt based on its current operating performance
- TCorp would recommend the total borrowings be reduced to a more manageable level to provide council with improved financial flexibility. Council's total borrowings as at 30 June 2015 were $135.9m, of which 22.0% was within the General Fund, 19.0% was within the Water Fund and 58.9% was within the Sewer Fund, indicating that the Sewer Fund has a proportionally high level of debt. TCorp would recommend that Council consider the use of interest only borrowings rather than amortising loans as a means of improving cash flow across the Council and helping to spread the debt costs across a longer period to promote intergenerational equity. This structure was adopted by Council for the $15.0m Sewer Fund loan obtained in FY2015 for five years, after which Council has the option to either amortise or refinance the loan
- The Unrestricted Current Ratio has improved over the review period and remains well above the TCorp benchmark of 1.50x due to this high level of internally restricted funds
- Own Sourced Operating Revenue Ratio has achieved the 60.0% benchmark in the last three years. Council's reliance on external funding has reduced however the improvement in FY2014 is mainly attributable to changes in the methodology calculation which now includes interest, investment and other revenue. The high percentage of rates and annual charges highlights that a SRV could have a strong impact on the future performance of the Council
- Over the review period Council has utilised $50.2m of new borrowings to fund capital works which has allowed for the retention of cash. Council's Cash Expense Cover Ratio improved in FY2014 and FY2015 due to TCorp amending its methodology to include current term deposits while Council also utilised new borrowings of $15.0m in FY2015

- Net assets have increased year-on-year following consecutive occurrences of infrastructure asset revaluation. When the asset revaluations and impairment movements are excluded, the underlying trend has been a decreasing IPP&E asset value of $43.8m across the five year period as Council has not been able to invest sufficiently in capital expenditure

## 2.5 Statement of Cash Flows

**Figure 4 - Cash and Cash Equivalents for FY2011 to FY2015 ($'000s)**




**Key Observations**

- Cash and cash equivalents have fluctuated but face an overall downward trend. When investments are included, Council's total cash position decreased year-on-year from $90.0m in FY2011 to $77.7m in FY2014, then increased to $84.8m in FY2015.
- Council's capital expenditure has been larger than its operating cash flows over the review period with Council increasing its borrowings by a net $23.6m to finance the capital works The increase in FY2015 was primarily due to the $15.0m of new borrowings obtained that year within the Sewer Fund
- Of the $84.8m held in cash, cash equivalents and investments, $46.9m is externally restricted, $37.6m is internally restricted and $0.3m is unrestricted

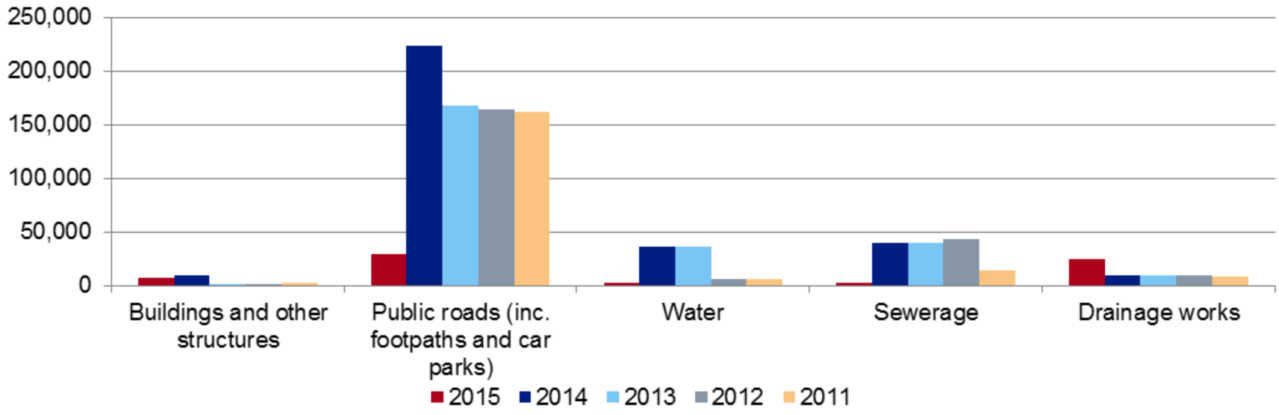
## 2.6 Capital Expenditure

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.

TCorp

### 2.6.1 Infrastructure Backlog

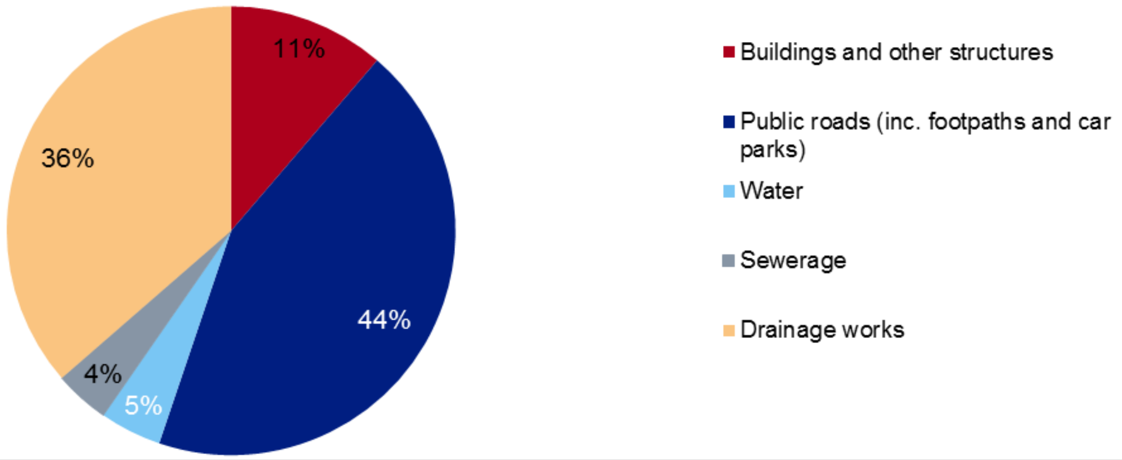
Figure 5 - Infrastructure Backlog for FY2011 to FY2015 ($'000s)




**Key Observations**

- Council's Infrastructure Backlog increased to $318.9m in FY2014 at the same time as the $231.7m asset revaluation increment before reducing to $66.0m in FY2015
- In FY2015 Council reassessed its methodology for the 'estimated cost to bring up to satisfactory standard' which is a key determinant in the calculation of infrastructure backlog. This reassessment occurred following consultation with other councils in the region with a view to being consistent in the application of its revised methodology
- Following discussions with Council, it was advised that residual values on water and sewer assets have been removed or reduced, and Council will continue to address this for other asset classes

Figure 6 - Infrastructure Backlog Composition for FY2015




**Key Observations**

- Council's reported infrastructure backlog of $66.0m represents 3.8% of its infrastructure assets value of $1.8b

- The $1.8b total asset value comprises 19.4% buildings and other structures, 35.0% public roads, 22.8% water, 14.4% sewer and 8.3% drainage works

### 2.6.2 Infrastructure Status

| Infrastructure status | Year ended 30 June | | | | |
|---|---|---|---|---|---|
| | 2015 | 2014 | 2013 | 2012 | 2011 |
| Bring to satisfactory standard ($'000s) | 65,978 | 318,948 | 253,859 | 224,053 | 191,991 |
| Required annual maintenance ($'000s) | 20,934 | 19,261 | 24,324 | 26,079 | 28,730 |
| Actual annual maintenance ($'000s) | 15,862 | 17,359 | 13,326 | 13,420 | 15,474 |
| Total value infrastructure assets ($'000s) | 1,750,237 | 1,679,962 | 1,374,416 | 1,337,922 | 1,290,722 |
| Total assets ($'000s) | 2,182,925 | 2,072,729 | 1,842,179 | 1,809,826 | 1,732,704 |
| Infrastructure Backlog Ratio | 0.04x | 0.19x | 0.18x | 0.17x | 0.15x |
| Asset Maintenance Ratio | 0.76x | 0.90x | 0.55x | 0.51x | 0.54x |
| Building and Infrastructure Asset Renewal Ratio | 0.31x | 0.39x | 0.13x | 0.09x | 0.11x |
| Capital Expenditure Ratio | 0.88x | 0.83x | 0.58x | 1.19x | 0.49x |

**Key Observations**

- Ongoing asset revaluations have played a part in Council's fluctuating asset ratios. The trend of fluctuations indicates that the historic infrastructure figures cannot be confidently relied upon
- Prior to the engagement of APV in FY2014, Council acknowledged that insufficient focus had been placed on accurately estimating these figures. The significant improvement to the Infrastructure Backlog Ratio in FY2015 was a correction of previous figures and not due to increased renewal works carried out during the year
- The Capital Expenditure Ratio is in a stronger position compared to the Building and Infrastructure Asset Renewal Ratio as Council's capital expenditure program consists of predominantly new assets, at 55.2% new capital works and 44.8% renewal of existing assets across the five years. Council should prioritise asset renewal works over non-essential capital expenditure for new assets in future years
- Actual asset maintenance has remained relatively stable over the review period, with the improvement in the Asset Maintenance Ratio (in FY2014 and FY2015) caused by Council reducing the required annual maintenance on its assets
- Overall Council's asset ratios have improved from FY2011, however significant work is still required to ensure the backlog is addressed and does not increase

TCorp

### 2.6.3 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 | | | | |
|---|---|---|---|---|---|
| | 2015 | 2014 | 2013 | 2012 | 2011 |
| New capital works | 27,684 | 15,845 | 13,831 | 40,579 | 12,620 |
| Replacement/refurbishment of existing assets | 9,978 | 18,177 | 21,074 | 20,328 | 20,060 |
| **Total** | **37,662** | **34,022** | **34,905** | **60,907** | **32,680** |

TCorp believes that wherever possible, Council's focus should be on renewing existing assets rather than constructing new assets. It is recognised that on some occasions, new water and sewer assets will have to take priority.

# 3 Review of Financial Forecasts

TCorp has been provided with a revised financial forecast model that 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.

TCorp's appointment included the review of the current approved version of the LTFP. As one year has elapsed since the adoption of the last approved FY2016-2025 LTFP, TCorp's analysis has been focused on updated drafts of the FY2017-2026 LTFP (with FY2016 as the base year) which includes three scenarios:

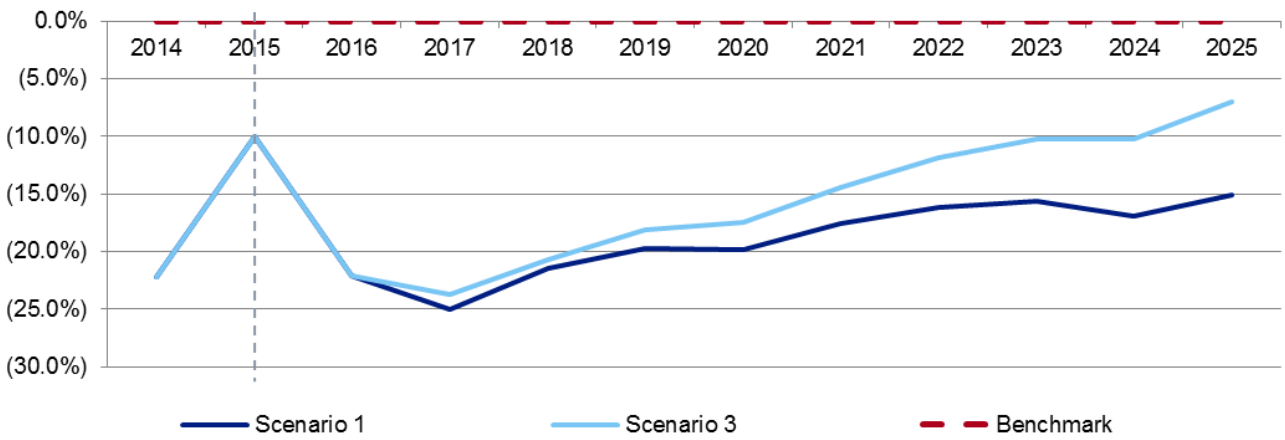
- **Scenario 1** – Base case scenario with no SRV for the 10-year forecast
- **Scenario 2** – Section 508(2) SRV of 6.5% (including the 1.8% rate peg) approved for FY2017, retained in Council's general income base for one year
- **Scenario 3** – Scenario 2 plus a proposed Section 508(A) seven-year SRV of 5.44% p.a. from FY2018, to be permanently retained in Council's rate base. This scenario is an option for Council to consider and would require the approval of IPART. This scenario demonstrates a smaller SRV that will be implemented across a longer period to reduce the burden on ratepayers. The proposed SRV will improve Council's financial sustainability and fund gaps in operating and capital expenditure

TCorp was provided with a number of iterations of the three scenarios. Our analysis was based on the latest versions received on 22 June 2016 (Scenario 1 and 3) and 23 June 2016 (Scenario 2).

The LTFP has been based on maintaining the existing standard of services to the community. Scenario 2 has not been represented on the graphs because the result is very similar to Scenario 1, with the exception of FY2017. The benefits of the single-year SRV is minimal as the 6.5% increase is removed from Council's rate base after FY2017.

## 3.1 Operating Results

Figure 7- Operating Ratio for General Fund



**Key Observations**

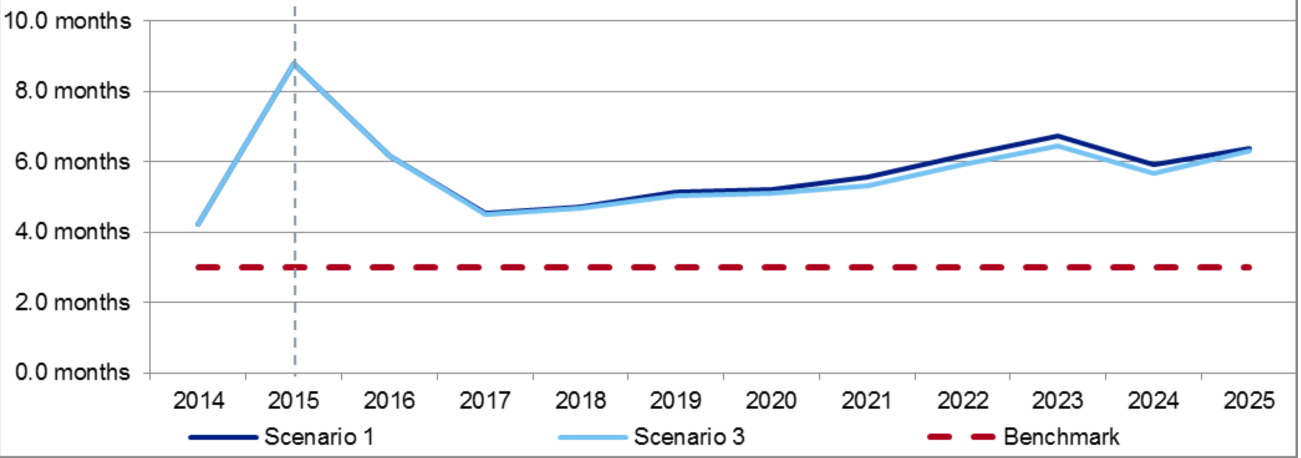
- Operating results are forecast to decrease in FY2016 and FY2017, after which an upward trend is expected for the remaining years. The adverse result in FY2016 and FY2017 is caused by the forecast decrease in operating grants and contributions, of 21.3% and 12.4% in the respective years. Due to the uncertainty of forecast grants and contributions, Council tends to be conservative with its estimates
- The improvement in later years is attributable to Council's cost containment measures such as:
  - asset rationalisation to reduce duplication of services and the related operating costs
  - ongoing service reviews to identify potential operational efficiencies which includes reducing under-utilised services provided by Council
- Council has forecast depreciation expense to increase by 5.9% in FY2016 due to the removal of residual values on its infrastructure assets, after which it is expected to reduce in FY2017 as a result of Council's asset rationalisation strategies. Council has used a 2.5% index to forecast depreciation expense from FY2019, which does not correlate with Council's declining IPP&E balance. Without analysing the depreciation schedule TCorp is unable to verify if the 2.5% annual increase is accurate. As depreciation is a material expense for Council (28.0% of operating expense in FY2015), we recommend that the estimates for these figures are verified to ensure that the adopted methodology is accurate
- **Scenario 1**
  - As operating expenses are currently 10.0% higher than operating revenue and will continue to increase with CPI, it is difficult for Council to become sustainable without raising additional revenue (on top of the annual rate peg increases) or significantly reducing expenses and/or services. Despite the improvement in operating performance in later years of the LTFP, operating deficits are forecast to be a cumulative $164.5m over the 10 years
- **Scenario 2**
  - The single-year SRV in FY2017 will generate additional income of $1.3m over and above the rate peg increase and will cushion the losses forecast for FY2017. This will happen in conjunction with increased road infrastructure renewals of $0.7m and maintenance of $0.6m
- **Scenario 3**
  - With the additional revenue generated from a potential seven-year SRV, Council has forecast a significantly smaller operating deficit by the end of FY2025, $7.5m compared to the $14.9m and $14.8m forecast in Scenario 1 and Scenario 2 respectively
  - This significant improvement in performance is forecast to occur whilst Council increases its spending on capital expenditure (by approximately $23.5m) and materials and contract expenses (by approximately $12.4m) to reduce the backlog and asset maintenance gap over the next 10 years

TCorp

## 3.2 Financial Management Indicators

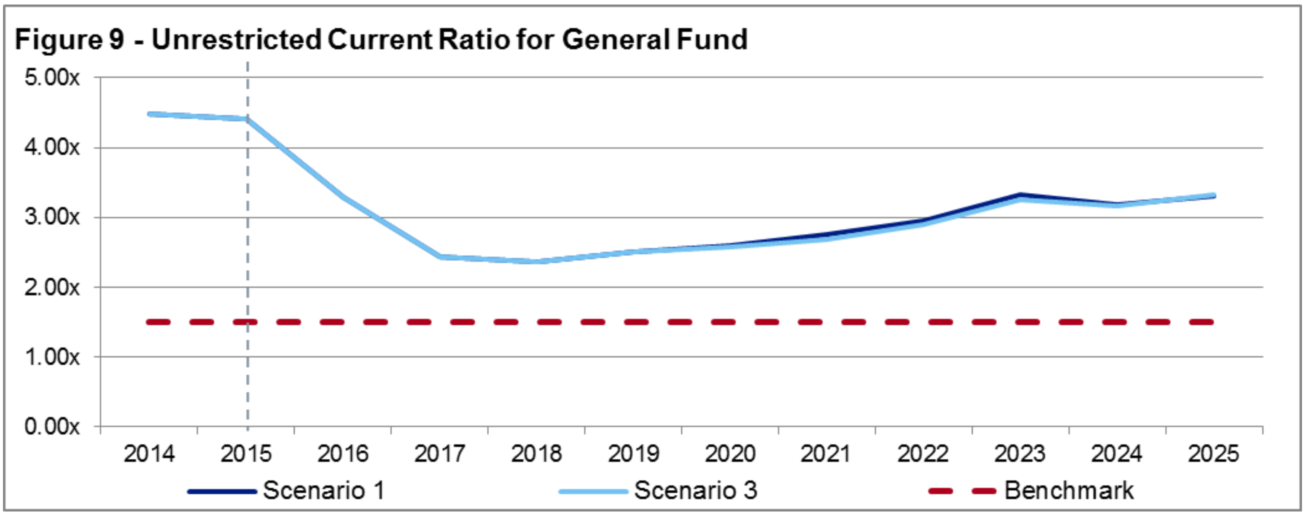
### 3.2.1 Liquidity Ratios

Figure 8 - Cash Expense Cover Ratio for General Fund




**Key Observations**

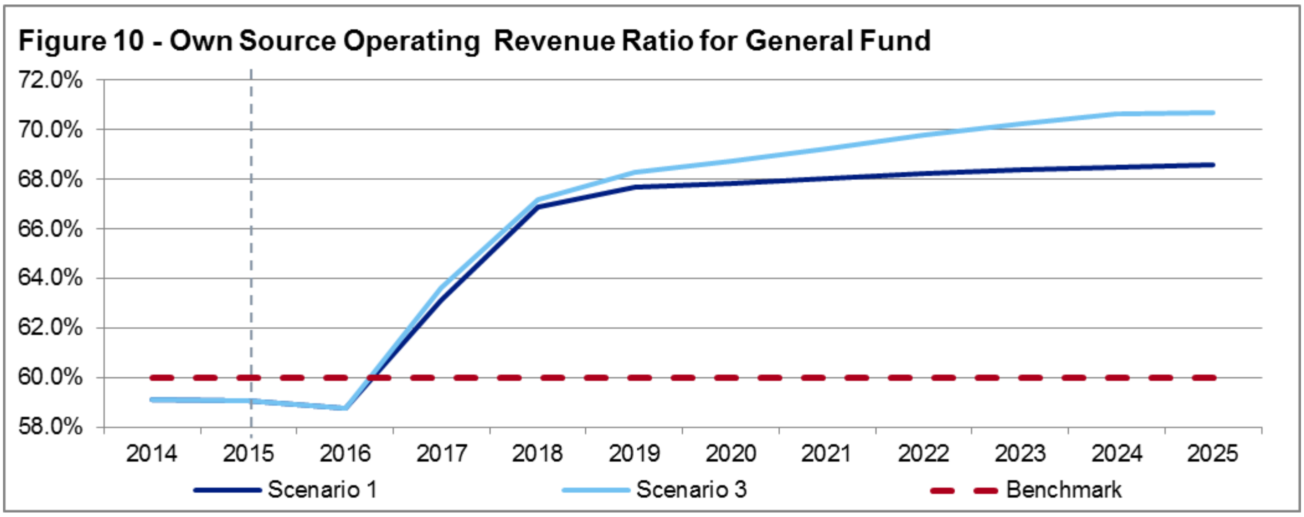
- As Council has not forecast any new borrowings within the General Fund, the Cash Expense Cover Ratio is forecast to correlate with movements in operating results – decrease in FY2016 and FY2017 then face an upward trend towards to end of the forecast period
- The increase from FY2017 also coincides with Council's declining capital expenditure program, which reduces to lower levels from FY2018 as Council has not forecast any new projects apart from asset renewals
- Council is not expected to have any liquidity issues throughout the 10-year forecast, but if a higher amount is spent on asset renewals, Council would see a decreasing cash balance
- **Scenario 1**
    - TCorp has adjusted cash and cash equivalents on the Balance Sheet to correspond with the end of year cash balance on the Cash Flow Statement
- **Scenario 2**
    - The additional revenue received from the SRV will be mostly spent towards renewal and maintenance works in FY2017 therefore the cash balance does not increase from Scenario 1
- **Scenario 3**
    - The ratio is forecast to be marginally lower in later years due to additional renewal works planned in conjunction with the proposed SRV, which will be self-funded using internally generated revenue and reserves




**Key Observations**

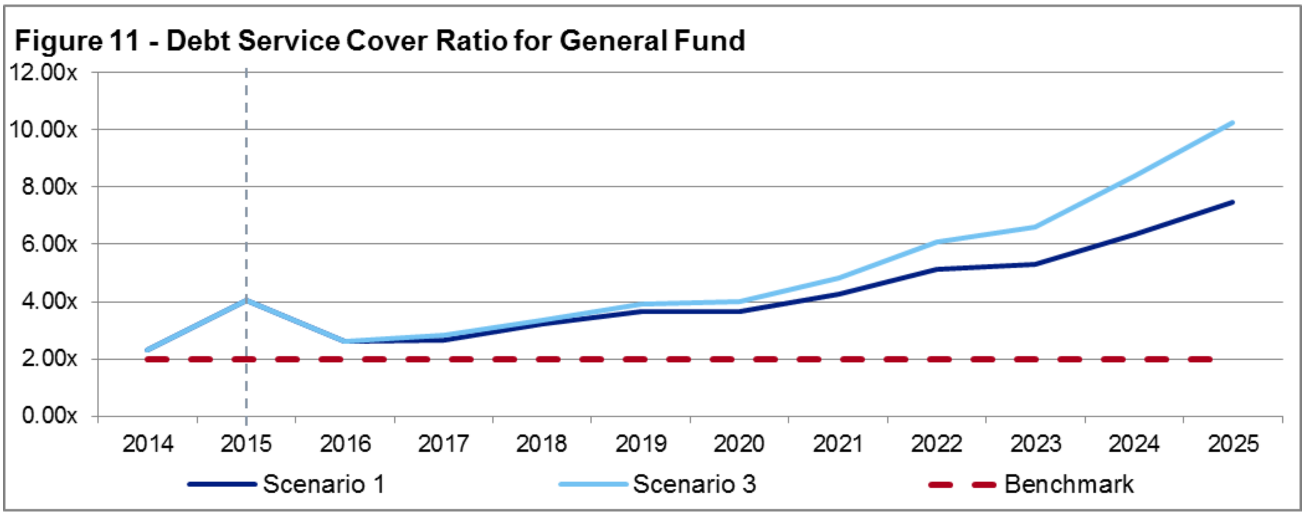
- The Unrestricted Current Ratio for all three scenarios is forecast to remain above the TCorp benchmark of 1.50x and follow movements in cash and cash equivalents

### 3.2.2 Fiscal Flexibility Ratios




**Key Observations**

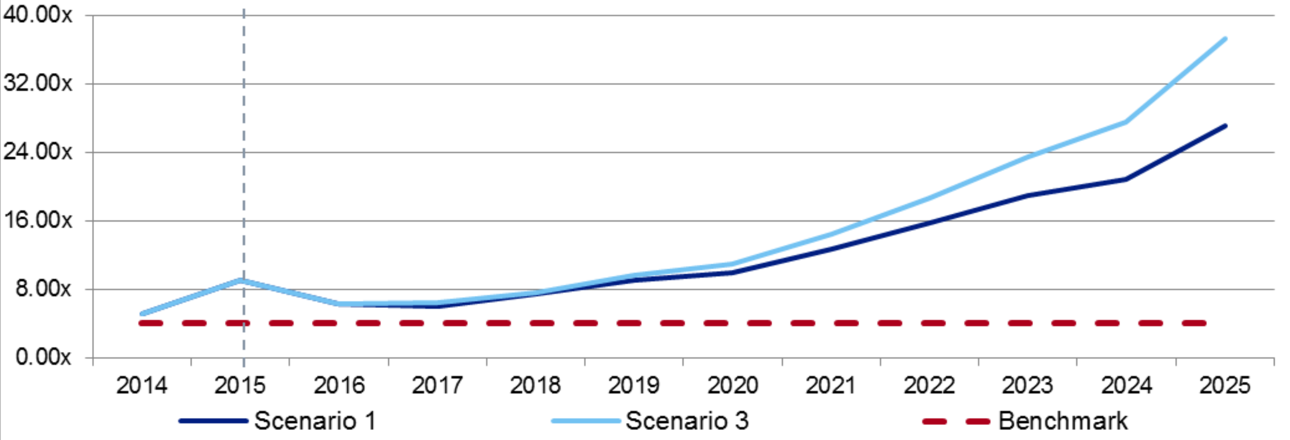
- The Own Source Operating Revenue Ratio is forecast to achieve the 60.0% benchmark from FY2017, after being below the benchmark between FY2011 and FY2016. The increase in FY2017 and beyond is a combination of increased own source revenue and a forecast reduction in grants and contributions (less than $32.7m forecast from FY2017 compared to $37.0m received in FY2015 and $37.9m budgeted in FY2016). Councils are usually conservative when forecasting grants and contributions therefore this ratio may be overstated in the forecast years
- **Scenario 3**
  - With the proposed permanent increase in rates revenue from FY2018 to FY2024 from the SRV, the ratio is expected to further improve in later years of the LTFP




**Key Observations**

- As the majority of Council's borrowings are within the Sewer Fund (58.9%), Council's General Fund debt levels (22.0%) are considered acceptable on an individual fund basis, achieving the 2.00x benchmark throughout the 10-year forecast. Similarly to EBITDA, DSCR will increase over time due to improved operating performance, while the improvement in later years is also attributable to Council paying down its debt
- This improvement also relates to an exercise performed by Council in FY2015, where independent consultants were engaged to evaluate Council's debt portfolio. The consultants found that $42.0m of consolidated borrowings could be refinanced without significant break costs. Council has acted on this and is forecast to save $0.6m over 13 years
- Based on our calculations, in addition to the existing loans in the LTFP, Council's General Fund would be able to service additional borrowings of up to $10.0m, calculated with a repayment term of 10 years and an interest rate of 4.0%, while remaining above the respective credit metric benchmarks. However, Council should consider the use of interest only loans as part of a core debt portfolio which would smooth cash flows and reduce the need to borrow on a regular basis – consistent with other levels of government and business. However, in light of the current and forecast operating performance, TCorp does not recommend further borrowings in the General Fund until operating improvements are achieved
- **Scenario 3**
    - The improvement in later years corresponds with the increase in EBITDA due to the proposed SRV

Figure 12 - Interest Cover Ratio for General Fund

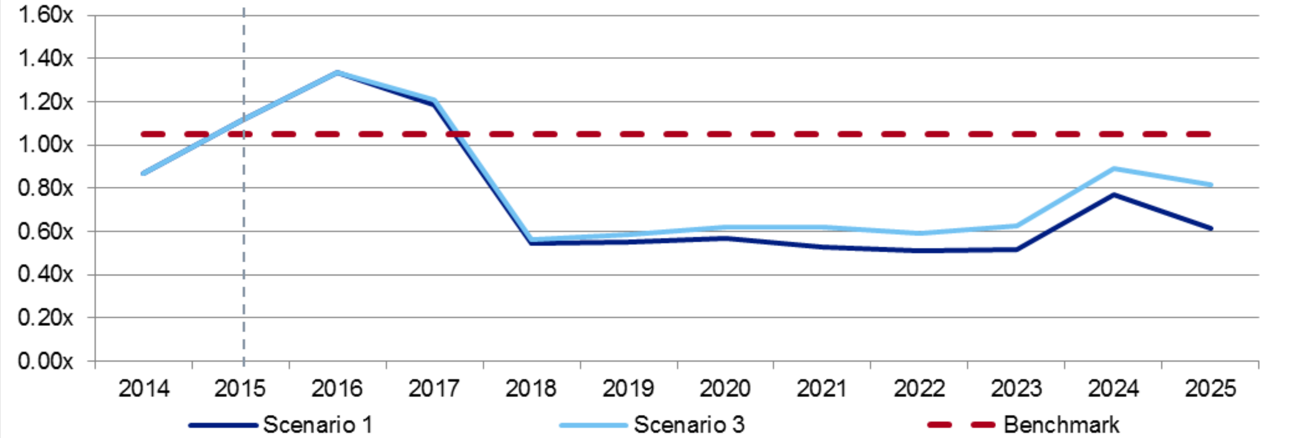



**Key Observations**

- The ICR follows a similar trend as the DSCR and remains above the benchmark in each year given no increase in borrowings

## 3.3 Capital Expenditure

Figure 13 - Capital Expenditure Ratio for General Fund




**Key Observations**

- Based on Council's 10-year capital expenditure program, it appears that Council's primary focus will be on the renewal of existing assets, with its main upcoming project being a new depot and related offices to replace five separate office admin buildings that are being rationalised. This is budgeted to cost $12.7m in FY2017
- Post completion of the new depot in FY2017, capital expenditure is forecast to reduce by half and will remain at reduced levels up to FY2023
- The Capital Expenditure Ratio is impacted by the forecast 2.5% increase in depreciation expense from FY2019, and if the index increase is not properly estimated, will reduce the accuracy of this ratio

- **Scenario 1**
  - The General Fund Capital Expenditure Ratio over the review period averaged 0.92x, and this is forecast to decline to 0.71x averaged over the forecast period. Although Council appears to be prioritising asset renewals over new projects, a significant annual renewal gap continues to exist, ranging from $7.5m to $15.6m
- **Scenario 2**
  - Council is forecasting to spend an additional $0.7m on road asset renewals in FY2017 but the effect of this is minimal on the ratio
- **Scenario 3**
  - With increased funds from the SRV, Council is able to reduce the renewal gap however this Capital Expenditure Ratio still remains below the benchmark

## 3.4 Financial Model Assumption Review

Council has used its 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 Local Government Cost Index (LGCI) increased by 3.4% in the year to September 2011, 3.7% in 2012, 2.8% in 2013, 2.5% in 2014 and 1.8% in 2015. In December 2015 IPART announced that the rate peg to apply in the FY2017 will be 1.8%. Beyond FY2016 TCorp has assessed a general benchmark for rates and annual charges to increase by mid-range LGCI annual increases of 1.5% to 2.5%
- IPART developed the LGCI to use for setting the maximum allowable increase in general income for local government in NSW (rate peg). The LGCI is the measure of movement in the unit costs incurred by NSW council activities funded from the general rate base
- Interest and investment revenue: annual return of 2.5% to 3.5%
- All other revenue items: the estimated annual CPI increase of 1.5% to 2.5%
- Employee costs: 2.5% to 3.5% (estimated CPI+1.0%)
- All other expenses: the estimated annual CPI increase of 1.5% to 2.5%

| Key Assumptions | Year ended 30 June | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Estimated Historical Average | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 |
| **Rate peg** | 3.0% | 2.4% | 1.8% | 2.5% | 2.5% | 2.5% | 2.5% | 2.5% | 2.5% | 2.5% | 2.5% |
| **Domestic waste increase** | 6.4% | 0.0% | 2.3% | 3.5% | 3.5% | 3.5% | 3.5% | 3.5% | 3.5% | 3.5% | 2.5% |
| **Water charges increase** | 7.2% | 6.5% | 1.5% | 1.5% | 1.5% | 1.5% | 1.5% | 2.5% | 2.5% | 2.5% | 2.5% |
| **Sewer charges increase** | 10.7% | 8.9% | 1.5% | 1.5% | 1.5% | 1.5% | 1.5% | 2.5% | 2.5% | 2.5% | 2.5% |
| **Interest on investments** | 4.9% | 2.9% | 2.8% | 2.8% | 2.8% | 2.8% | 2.8% | 2.8% | 2.8% | 2.8% | 2.8% |
| **Employee award increase** | 2.0% | 2.7% | 2.8% | 2.5% | 2.5% | 2.5% | 2.5% | 2.5% | 2.5% | 2.5% | 2.5% |
| **Recurrent operating expense increase** | 0.9% | 2.4% | 1.8% | 2.5% | 2.5% | 2.5% | 2.5% | 2.5% | 2.5% | 2.5% | 2.5% |
| **Efficiency savings** | N/A | N/A | $0.6m | $1.6m | $2.4m | $3.1m | $3.2m | $3.3m | $3.3m | $3.3m | $3.3m |

## Key Observations and Risks

- Council has completed its base case LTFP (Scenario 1) on the basis that current service levels will be maintained. Scenario 2 and Scenario 3 incorporates the SRVs which will increase renewal and maintenance works for Council's road assets in those years
- Based on interest and investment revenue on the LTFP, it appears that interest rate used is higher than the 2.8% assumption, between 4.0% and 6.0%. Council's interest and investment revenue may therefore be overstated
- Council's previous LTFP provided to IPART for the SRV application did not incorporate efficiency cost savings in its base case scenario. These savings have now been included in the draft LTFP provided to TCorp for this assessment
- Depreciation expense is forecast to be indexed at 2.5% from FY2019 which does not correlate with Council's declining IPP&E balance
- The remaining underlying assumptions are deemed to be within the ranges that TCorp would consider reasonable

## 3.5 Sustainability

Based on the information received and the revised LTFP, TCorp believes the Council's Financial Sustainability Rating remains as Weak, however significant improvement is evident in the score band.

In considering the longer term financial Sustainability of the Council we make the following additional comments in respect of their General Fund:

- Based on Council's previous LTFP provided to TCorp during the initial financial sustainability review in FY2012, Council was forecasting continuing deficits for the 10-year forecast period, achieving Operating Ratios of between (40.0%) and (50.0%). Although Council is still a distance from achieving a break-even position, the upward trend is a significant improvement from the results previously forecast
- Council has been conducting service reviews and asset rationalisations to reduce its operating expenses which has improved the operating performance. However, as Council's forecast operating expense exceeds operating revenue by $10.0m to $20.0m per annum, these cost savings are insufficient for Council to achieve financial sustainability in the short to medium term. While implementing a multi-year SRV in Scenario 3 shows it will further assist with the improvement, it appears Council will also have to reduce its non-essential services if it is to achieve a break-even operating position in the medium to long term
- Council's cash position is gradually increasing as seen through its Cash Expense Cover Ratio. The level of capital expenditure forecast between FY2018 and FY2025 is significantly lower than prior years, which indicates that further planning for the later years in the forecast is required. Improving the capital expenditure spending will directly reduce the Cash Expense Cover Ratio however the forecast indicates there is capacity
- Council has completed a full review of its infrastructure assets and reassessment of its backlog position. This has resulted in a decrease in depreciation expense and a reduction in Council's Infrastructure Backlog from $318.9m in FY2014 to $66.0m in FY2015. Council is also gradually phasing out the use of residual values and will be reverting to straight line depreciation, a view supported by TCorp
- Three out of four of Council's asset ratios are forecast to remain below the respective TCorp benchmarks by FY2025, supporting TCorp's concern in this area. These ratios will compound the backlog if Council does not have sufficient funding to allocate to asset maintenance and renewals
- The level of debt within the General Fund is manageable however when the Council's total debt is reviewed on a consolidated basis, TCorp does not recommend Council utilises further borrowing at the current time. This limits Council's options to fund capital expenditure to its operating cash surpluses and reserves, and is one of the reasons Council's asset ratios are at the low levels

# 4 Conclusion and Recommendations

Based on our review of both the consolidated historic financial information and the 10-year financial forecast within Council's General Fund LTFP, we consider Council to have a Financial Sustainability Rating (FSR) of Weak with an Outlook of Neutral. This is a modest improvement from the previous review when Council had a FSR of Weak and an Outlook of Negative.

We base our analysis on the following key points:

- Council's management is focussed on the task at hand and is well aware of the challenges that the Council is facing. The operating performance has seen an improvement in the past two years
- However, despite Council's improvement to an operating deficit of (10.0%) in FY2015, the operating result is forecast to return to deficits larger than the FY2015 result for a minimum of the next nine years, despite the adoption and approval of the proposed multi-year SRV in Scenario 3
- While Scenario 3 is forecasting improvement in asset ratios, three out of four of these ratios remain below the respective benchmarks, indicating that the infrastructure backlog will grow as sufficient funds are not available for maintenance and renewals
- Council is advised not to utilise additional borrowings to assist funding its capital expenditure given the high level of borrowings on a consolidated basis. Council therefore needs to continue its review of asset rationalisation and whether it can reduce non-essential services to save costs

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

- Council's Water and Sewer Funds are forecast to achieve consistent operating surpluses throughout the 10-year period, despite the Water Fund historically achieving deficits in four out of the past five years. TCorp has not reviewed these individual Funds however if these results are achievable it will assist with the long term sustainability of the Council on a consolidated basis. If Council's Water and Sewer Fund are sustainable then it can continue to focus all of its efforts on improving the General Fund performance
- Council has undertaken significant work to understand its underlying financial position in order to be in a position to identify the options to become financially sustainable. The continuation of this work is paramount if the Council is going to achieve its long term goal of becoming sustainable
- TCorp's review of Council's 10-year forecast results under Scenario 3 indicate that if the forecast results are achieved, Council will be able to achieve a Moderate Sustainability rating in FY2022, and this improvement is expected to continue for the remaining years

TCorp

# Appendix A Historical Financial Information Tables

**Table 1-Income Statement**

| Income statement | Year ended 30 June | | | | | % annual change | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2015 | 2014 | 2013 | 2012 | 2011 | 2015 | 2014 | 2013 | 2012 |
| **Revenue** | | | | | | | | | |
| Rates and annual charges | 50,638 | 48,013 | 44,894 | 41,974 | 39,575 | 5.5% | 6.9% | 7.0% | 6.1% |
| User charges and fees | 28,365 | 26,766 | 24,188 | 22,415 | 21,803 | 6.0% | 10.7% | 7.9% | 2.8% |
| Interest and investment revenue | 3,051 | 3,840 | 3,951 | 4,539 | 5,450 | (20.5%) | (2.8%) | (13.0%) | (16.7%) |
| Other revenues | 2,135 | 2,635 | 2,235 | 2,006 | 1,875 | (19.0%) | 17.9% | 11.4% | 7.0% |
| Grants and contributions for operating purposes | 34,192 | 26,094 | 31,089 | 33,966 | 31,358 | 31.0% | (16.1%) | (8.5%) | 8.3% |
| **Total revenue** | **118,381** | **107,348** | **106,357** | **104,900** | **100,061** | **10.3%** | **0.9%** | **1.4%** | **4.8%** |
| **Expenses** | | | | | | | | | |
| Employees | 36,789 | 35,020 | 35,694 | 35,035 | 33,136 | 5.1% | (1.9%) | 1.9% | 5.7% |
| Borrowing costs | 8,944 | 9,265 | 9,302 | 8,257 | 8,195 | (3.5%) | (0.4%) | 12.7% | 0.8% |
| Materials and contract expenses | 33,573 | 33,372 | 32,560 | 33,366 | 30,479 | 0.6% | 2.5% | (2.4%) | 9.5% |
| Depreciation and amortisation | 36,391 | 33,408 | 47,409 | 46,400 | 42,153 | 8.9% | (29.5%) | 2.2% | 10.1% |
| Other expenses | 11,099 | 11,595 | 11,163 | 10,219 | 9,561 | (4.3%) | 3.9% | 9.2% | 6.9% |
| **Total expenses** | **126,796** | **122,660** | **136,128** | **133,277** | **123,524** | **3.4%** | **(9.9%)** | **2.1%** | **7.9%** |
| **Operating result (excluding capital grants and contributions)** | **(8,415)** | **(15,312)** | **(29,771)** | **(28,377)** | **(23,463)** | 45.0% | 48.6% | (4.9%) | (20.9%) |
| **Operating result (including capital grants and contributions)** | **(1,760)** | **(1,980)** | **(21,281)** | **(14,762)** | **(15,529)** | 11.1% | 90.7% | (44.2%) | 4.9% |

TCorp

### Table 2 - Items excluded from Income Statement

| Excluded items | 2015 | 2014 | 2013 | 2012 | 2011 |
|---|---|---|---|---|---|
| Grants and contributions for capital purposes | 6,655 | 13,332 | 8,490 | 13,615 | 7,934 |
| Net gain/(loss) from the disposal of assets | (7,490) | (568) | (2,965) | (2,700) | (8,943) |
| Net share of interests in joint ventures | (54) | (59) | (52) | (44) | (37) |
| Impairment gain/(loss) | 0 | 0 | 0 | 0 | (8,784) |
| Amortisation of premiums & discounts on interest free/reduced loans | 5 | 6 | 5 | 3 | 0 |
| Reversal of revaluation decrements for IPP&E | 0 | 0 | 2,966 | 5,818 | 0 |
| Sewer STP design compensation | 0 | 0 | 0 | 375 | 0 |
| Fair value adjustments on recognition of advances & deferred debtors | 0 | (1) | (13) | 0 | (19) |
| Discount adjustments on remediation provisions | (169) | (182) | (148) | (134) | (152) |
| Interest applicable on interest free loans | (31) | (36) | (40) | (45) | (48) |

### Table 3 – Employee Numbers

| | 2015 | 2014 | 2013 | 2012 | 2011 |
|---|---|---|---|---|---|
| Full Time Equivalent Employees at year end | 542 | 538 | 520 | 512 | 495 |

**Table 4 – Balance Sheet**

| Balance sheet ($'000s) | Year ended 30 June | | | | | % annual change | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2015 | 2014 | 2013 | 2012 | 2011 | 2015 | 2014 | 2013 | 2012 |
| Current assets | | | | | | | | | |
| Cash and cash equivalents | 25,819 | 13,675 | 30,232 | 27,811 | 40,689 | 88.8% | (54.8%) | 8.7% | (31.6%) |
| Investments – current term deposits | 46,005 | 46,005 | 39,000 | 53,000 | 40,500 | 0.0% | 18.0% | (26.4%) | 30.9% |
| Receivables | 19,811 | 17,760 | 14,778 | 17,319 | 15,521 | 11.5% | 20.2% | (14.7%) | 11.6% |
| Inventories | 1,444 | 1,637 | 1,702 | 1,933 | 1,909 | (11.8%) | (3.8%) | (12.0%) | 1.3% |
| Other | 489 | 478 | 356 | 1,143 | 975 | 2.3% | 34.3% | (68.9%) | 17.2% |
| *Total current assets* | 93,568 | 79,555 | 86,068 | 101,206 | 99,594 | 17.6% | (7.6%) | (15.0%) | 1.6% |
| Non-current assets | | | | | | | | | |
| Investments | 13,000 | 18,000 | 13,128 | 4,991 | 8,785 | (27.8%) | 37.1% | 163.0% | (43.2%) |
| Receivables | 625 | 594 | 587 | 487 | 481 | 5.2% | 1.2% | 20.5% | 1.2% |
| Inventories | 209 | 209 | 209 | 209 | 209 | 0.0% | 0.0% | 0.0% | 0.0% |
| Infrastructure, property, plant & equipment | 2,074,405 | 1,973,221 | 1,742,133 | 1,702,873 | 1,623,572 | 5.1% | 13.3% | 2.3% | 4.9% |
| Investments accounted for using equity method | 48 | 47 | 54 | 60 | 63 | 2.1% | (13.0%) | (10.0%) | (4.8%) |
| Intangibles | 1,070 | 1,103 | 0 | 0 | 0 | (3.0%) | N/A | N/A | N/A |
| *Total non-current assets* | 2,089,357 | 1,993,174 | 1,756,111 | 1,708,620 | 1,633,110 | 4.8% | 13.5% | 2.8% | 4.6% |
| **Total assets** | **2,182,925** | **2,072,729** | **1,842,179** | **1,809,826** | **1,732,704** | **5.3%** | **12.5%** | **1.8%** | **4.5%** |

| Balance sheet ($'000s) | Year ended 30 June | | | | | % annual change | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2015 | 2014 | 2013 | 2012 | 2011 | 2015 | 2014 | 2013 | 2012 |
| Current liabilities | | | | | | | | | |
| Payables | 14,042 | 10,848 | 12,018 | 15,032 | 11,436 | 29.4% | (9.7%) | (20.1%) | 31.4% |
| Borrowings | 6,181 | 6,034 | 5,946 | 5,639 | 6,769 | 2.4% | 1.5% | 5.4% | (16.7%) |
| Provisions | 12,163 | 11,539 | 11,435 | 11,439 | 11,227 | 5.4% | 0.9% | (0.0%) | 1.9% |
| *Total current liabilities* | 32,386 | 28,421 | 29,399 | 32,110 | 29,432 | 14.0% | (3.3%) | (8.4%) | 9.1% |
| Non-current liabilities | | | | | | | | | |
| Borrowings | 129,704 | 120,197 | 125,135 | 125,049 | 104,531 | 7.9% | (3.9%) | 0.1% | 19.6% |
| Provisions | 5,651 | 4,970 | 3,824 | 3,907 | 3,201 | 13.7% | 30.0% | (2.1%) | 22.1% |
| *Total non-current liabilities* | 135,355 | 125,167 | 128,959 | 128,956 | 107,732 | 8.1% | (2.9%) | 0.0% | 19.7% |
| **Total liabilities** | **167,741** | **153,588** | **158,358** | **161,066** | **137,164** | **9.2%** | **(3.0%)** | **(1.7%)** | **17.4%** |
| **Net assets** | **2,015,184** | **1,919,141** | **1,683,821** | **1,648,760** | **1,595,540** | **5.0%** | **14.0%** | **2.1%** | **3.3%** |

**Table 5 - Cashflow**

| Cash Flow Statement ($'000s) | Year ended 30 June | | | | |
|---|---|---|---|---|---|
| | 2015 | 2014 | 2013 | 2012 | 2011 |
| Cash flows from operating activities | 33,714 | 29,738 | 27,054 | 32,859 | 23,691 |
| Cash flows from investing activities | (31,193) | (41,409) | (24,986) | (65,080) | (18,629) |
| Proceeds from borrowings and advances | 15,000 | 1,060 | 5,992 | 26,112 | 1,999 |
| Repayment of borrowings and advances | (5,377) | (5,946) | (5,639) | (5,186) | (4,463) |
| Cash flows from financing activities | 9,623 | (4,886) | 353 | 20,926 | (2,464) |
| **Net increase/(decrease) in cash and equivalents** | **12,144** | **(16,557)** | **2,421** | **(11,295)** | **2,598** |

# Appendix B Glossary

**Asset Revaluations**

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

**Office of Local Government (OLG)**

OLG (previously DLG) is an Office in the Planning and Environment cluster and is responsible for local government across NSW. OLG'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 OLG has a policy, legislative, investigative and program focus in matters ranging from local government finance, infrastructure, governance, performance, collaboration and community engagement. OLG strives to work collaboratively with the local government sector and is the key adviser to the NSW Government on local government matters.

**Depreciation of Infrastructure Assets**

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

**EBITDA**

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

**Financial Sustainability Rating (FSR)**

The FSR is an assessment of a council's capacity to meet its financial commitments in the short, medium and long term. The FSR for each Council has been determined based on the review and consideration of a Council's historical performance against a set of benchmark indicators. The rating methodology consists of seven FSR categories. The FSR is calculated using weighted benchmarks according to the relative importance of each benchmark in terms of a Council's financial capacity and sustainability.

**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.

[1] IPART "Revenue Framework for Local Government" December 2009 p.83
[2] DLG "Recognition of certain assets at fair value" March 2009

## 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).

**Outlook**

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

**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

TCorp

- 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 + current term deposits) / (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 – WDV of asset disposals) / 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

TCorp

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 = 0%

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 + user charges + interest and investment income + other revenues) / 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.

# Ratings and Definitions

## Financial Sustainability Ratings

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

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

## Outlook

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

Level 22, Governor Phillip Tower, 1 Farrer Place
SYDNEY NSW 2000, AUSTRALIA

**T:** +61 2 9325 9325 **F:** +61 2 9325 9333
**W:** tcorp.nsw.gov.au **ABN:** 99 095 235 825