New South Wales
Treasury Corporation

Shoalhaven City Council

Financial Assessment and Benchmarking Report

5 October 2012

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

Disclaimer

This report has been prepared by New South Wales Treasury Corporation (TCorp) in accordance with the appointment of TCorp by the Division of Local Government (DLG) as detailed in TCorp's letters of 22 December 2011 and 28 May 2012. The report has been prepared as part of the Local Infrastructure Renewal Scheme (LIRS) announced by the NSW Government.

The report has been prepared based on information provided to TCorp as set out in Section 2.2 of this report. TCorp has relied on this information and has not verified or audited the accuracy, reliability or currency of the information provided to it for the purpose of preparation of the report. TCorp and its directors, officers and employees make no representation as to the accuracy, reliability or completeness of the information contained in the report.

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The report has been prepared for Shoalhaven City Council, the LIRS Assessment Panel and the DLG. TCorp shall not be liable to Shoalhaven City Council or have any liability to any third party under the law of contract, tort and the principles of restitution or unjust enrichment or otherwise for any loss, expense or damage which may arise from or be incurred or suffered as a result of reliance on anything contained in this report.

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Section 1 Executive Summary

This report provides an independent assessment of Shoalhaven City Council's (the Council) financial capacity, and its ability to undertake additional borrowings. The analysis is based on a review of the historical performance, current financial position, and long term financial forecasts. It also benchmarks the Council against its peers using key ratios.

The report is primarily focused on the financial capacity of the Council to undertake additional borrowings as part of the Local Infrastructure Renewal Scheme (LIRS). Council has made one LIRS application for $2m for its Accelerated Road Renewal Program.

TCorp's approach has been to:

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

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

- While Council has incurred operating deficits (excluding grants and contributions for capital purposes), Council's underlying operating result (measured using EBITDA) has improved from $40.3m in 2009 to $45.1m in 2011.
- Approximately 76% of the Council's revenue base is derived from own sourced revenue (annual charges, and user charges and fees). They can rely upon these revenue streams on an ongoing basis for financial flexibility.
- The Council is facing pressure from rising employee costs, and material and contracts costs above inflation but it has acknowledged the issue and is seeking to address this through expenditure review measures.

Council reported $43.1m of Infrastructure Backlog in 2011 which represents 2.3% of its infrastructure asset value of $1,873m. Other observations include:

- The Backlog is on an upward trend particularly in the roads asset category
- A significant portion of the Backlog (77.9%) is related to roads assets. This is being addressed by a detailed list of capital programs including the LIRS application project

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

- The forecast shows deficit positions excluding capital grants and contributions in all forecast years
- The Council's forecast liquidity position is particularly weak, particularly from 2015 when the Unrestricted Current Ratio falls to negative levels which indicate that Council will have difficulty meeting its day to day expenses
- Council's level of fiscal flexibility, as indicated by its above benchmark Own Source Operating Revenue Ratio, is sound when excluding the impact of internal transactions

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

- The DSCR remains above the benchmark of 2.00x in the 10 year forecast
- The Interest Cover Ratio is well above the benchmark of 4.00x in the 10 year forecast
- However, the Unrestricted Current Ratio, and cash and investment levels drop to very low levels in the medium term which will become a solvency issue. Reductions in spending or increases in revenue sources need to be sought immediately.

In respect of the Benchmarking analysis TCorp has compared the Council's key ratios with other councils in DLG Group 5. The key observations are:

- Council's financial flexibility as indicated by the Operating Ratio and Own Source Operating Revenue Ratio are the best in its group
- Council's DSCR and Interest Cover Ratio are below the group average though in the medium term Council is forecasting stable ratios close to the group average
- Council was in a sufficient liquidity position though this is expected to marginally deteriorate in the medium term
- Council's performance in terms of its Asset Maintenance Ratio is weak although the Infrastructure Backlog is lower than its peers. Both ratios are weaker than the benchmarks

Section 2 Introduction

2.1: Purpose of Report

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

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

The key areas focused on are:

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

2.2: Scope and Methodology

TCorp's approach was to:

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

In undertaking its work, TCorp relied on:

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

Benchmark Ratios

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

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

Therefore these benchmarks are intended as a guide to performance.

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

Ratio	**Benchmark**
Operating Ratio	> (4.0%)
Cash Expense Ratio	> 3.0 months
Unrestricted Current Ratio	> 1.50x
Own Source Operating Revenue Ratio	> 60.0%
Debt Service Cover Ratio (DSCR)	> 2.00x
Interest Cover Ratio	> 4.00x
Infrastructure Backlog Ratio	< 0.02x
Asset Maintenance Ratio	> 1.00x
Building and infrastructure asset renewal ratio	> 1.00x
Capital Expenditure Ratio	> 1.10x

2.3: Overview of the Local Government Area

Shoalhaven City Council LGA	
Locality & Size	
Locality	Illawarra
Area	4,660 km²
DLG Group	5
Demographics	
Population	96,967
% under 20	23.9%
% between 20 and 59	46.8%
% over 60	29.4%
Expected population in 2026	119,100
Operations	
Number of employees (FTE)	890
Annual revenue	$173m
Infrastructure	
Infrastructure backlog value	$43.1m
Total infrastructure value	$1,873m

The LGA is located on the south coast of New South Wales, approximately 160km from the centre of Sydney. It covers 4,660 km2 and is approximately 120km long and 80km wide, stretching from Berry and Kangaroo Valley in the north to Durras in the south. The LGA coastline is approximately 170km, excluding all bays and inlets. Nearly 70% of the LGA is national park, state forest or vacant land.

The Council looks after $2.3b of community assets with 32.7% ($738.4m) of this being roads, bridges and footpaths. The Council also manages a combined value of $821.2m of sewerage networks, water supply network and stormwater drainage.

The LGA population was estimated at 96,967 in 2010 representing a 1.3% increase from the previous year. The Council has forecast an average population growth of 0.5% each year. Typical of a coastal area, the LGA has a higher than average population age. The main employment sectors are defence, tourism, manufacturing, government services, agriculture, education and health.

2.4: LIRS Application

Council has made the following LIRS application.

Description: The Accelerated Road Renewal Program is the road resealing (surfacing renewal) component of Shoalhaven's Local Road Repair Program. The other two components are the sealed road rehabilitation program (for pavement and surfacing renewal) and the gravel road resheeting program (for pavement renewal).

Amount of the loan facility: $2.0m

Term of the loan facility: 10 years

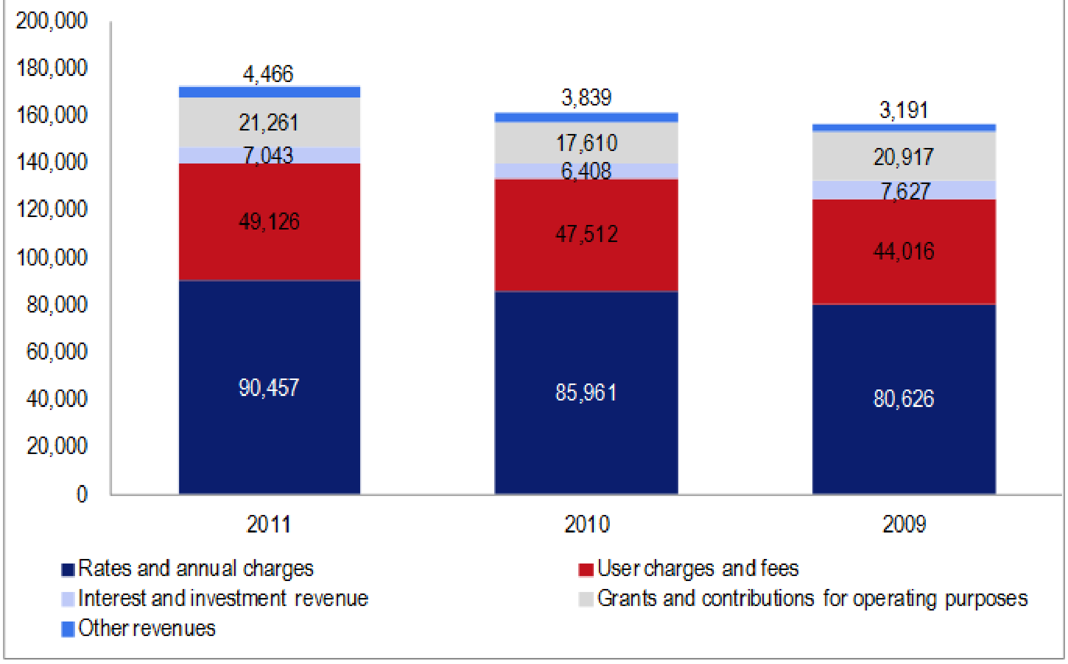
The Council has applied for a 10 year loan term for its Accelerated Road Renewal Program. The cost of the project and the intended borrowing amount is $2.0m.

Section 3 Review of Financial Performance and Position

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

3.1: Revenue

Figure 1 - Revenue Sources for 2008/09 to 2010/11 ($'000s)



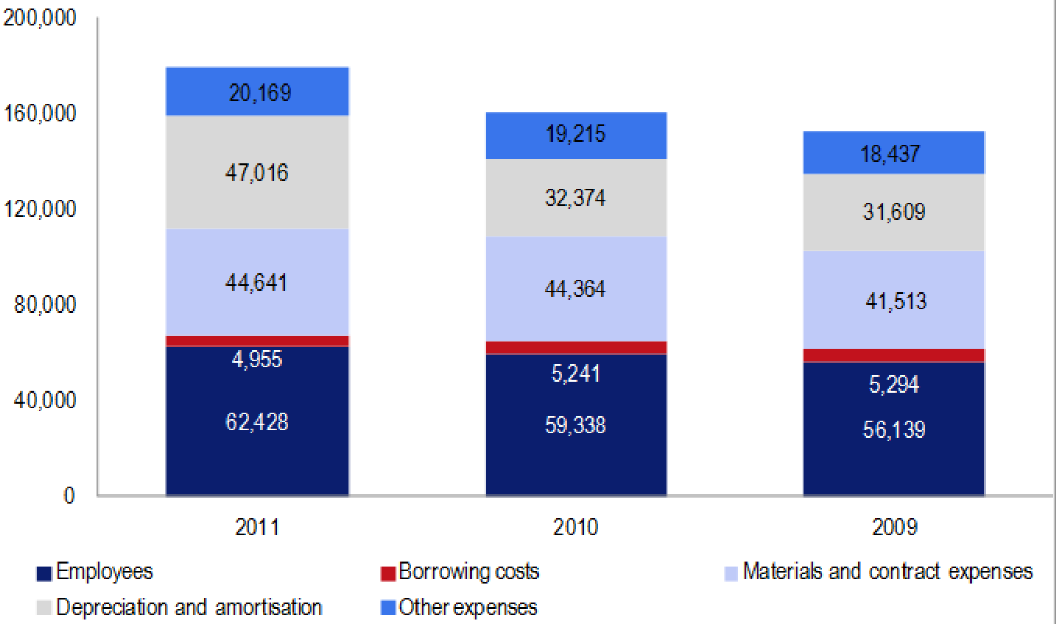
Key Observations

- The Council's revenue sources have been historically stable and gradually increasing overall. The Council's Own Sourced Income Operating Revenue Ratio was 75.6% in 2011 which is very strong compared to the benchmark of 60%.
- The Council's rates revenue is its main source of income with more than half its revenue derived from this source. It has been increasing by approximately $5m (5% to 6%) each year. This growth is partly attributed to a steady increase of $1.7m (6.4% to 6.8%) p.a. in sewerage service charges and steady increases in the rate pegged residential rates.
- The increase in rates is supported by steady population growth of around 1% each year. This growth is mainly through migration into the area and influenced by factors such as available zoned land and economic trends. Land zoning is an important lever that the Council can use to control its population growth.
- Income from tourist parks is the highest category of general user charges generating a stable net surplus of around $3m per annum from its 12 parks. In the past three years, tourist park income has not been affected by volatility in the tourism industry.

- The Council also generates over $5m each year from managing swimming / leisure centres, cemeteries and various other services. These operations have been incurring operating deficits and this trend is expected to continue.
- Interest income for the last two years has been maintained at a steady level around $7.5m per annum. A $5.9m fair value downward movement in investment income was recorded in 2009 as a result of the Global Financial Crisis negatively impacting the Council's managed funds and CDO investments. Significant writedowns did not continue in the subsequent years within the review period. The Council valued its CDO holdings at $2.3m in 2011.
- Overall, the Council's receipt of operating grants and contributions has increased over the last three years and there has been a noted increase in financial assistance grants and community care related operating grants.
- Developer contributions have increased greatly from $3.3m in 2008 to $7.1m in 2011. This reflects the significant increase in the amount of residential development and commercial development which complement the new residential areas.

3.2: Expenses

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



Key Observations

- The Council had set a target of achieving a 10% to 20% productivity gain/cost saving over a five year period starting from 2006. This was a Council initiative to enable it to allocate more funding to maintenance, renewal, upgrade and new infrastructure for the community. Initiatives include savings in employee costs, purchasing better equipment to reduce operating costs, improved prices from tendered contracts and improved negotiations for lease revenue.

- Employee costs have been increasing at around 5% year on year with the number of Full Time Equivalent employees fluctuating around the 760 mark in the last three years. The increased cost is largely attributed to the $3m per annum increase in salary and wages cost, excluding superannuation. This increase in employee costs appears higher than many other NSW councils and increases of such levels are not sustainable over the medium to long term. Increases in a range of 3% to 4% would be more sustainable.
- The increase in materials and contract expenses in 2010 is mainly attributed to a community centre constructed by Council but it is not owned by Council. The Council received grants to fund the centre construction.
- The increase in consultancy and contractor cost is partly due to a freeze on employee numbers which led to an increase in contractors.
- Depreciation has increased significantly over the period because it has been impacted mainly by the Asset Revaluation process and partly due to the increase in new assets of around $50m each year.
- The Council expensed around $5m of borrowing costs each year and this has been slightly decreasing as loan repayments are made on amortising loans. The Council has just under $60m in non-current secured loans at 30 June 2011. The Council has publicly expressed their policy to not borrow for operating purposes which is considered a prudent policy.

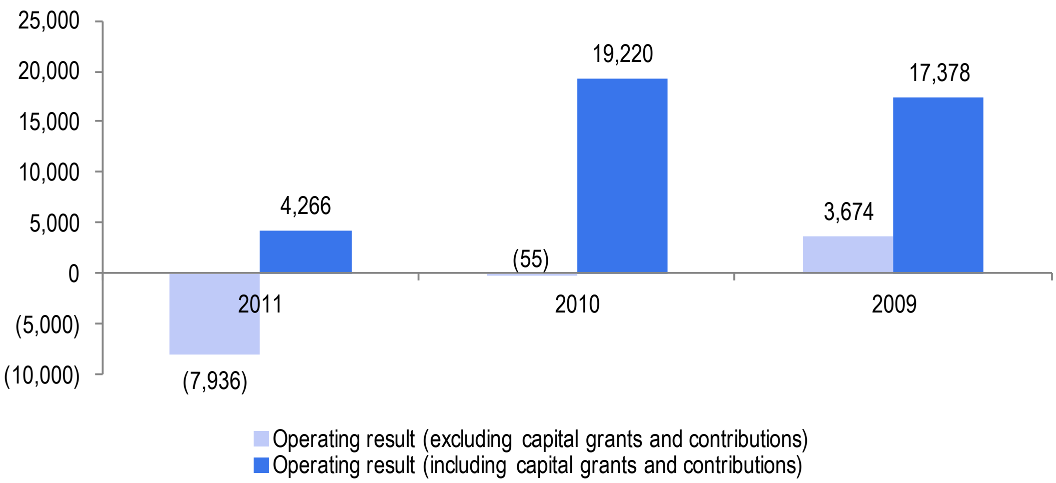
3.3: Operating Results

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

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

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

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



Key Observations

- The Council has posted declining operating results when grants and contributions for capital purposes are excluded. This is largely due to the high depreciation expense which has been negatively impacted by the Asset Revaluations in the last two years. 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.
- Expenses have also increased at a faster rate than revenue which contributes to deteriorating deficit results.
- This trend of declining operating results is not financially sustainable in the long term.

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3.4: Financial Management Indicators

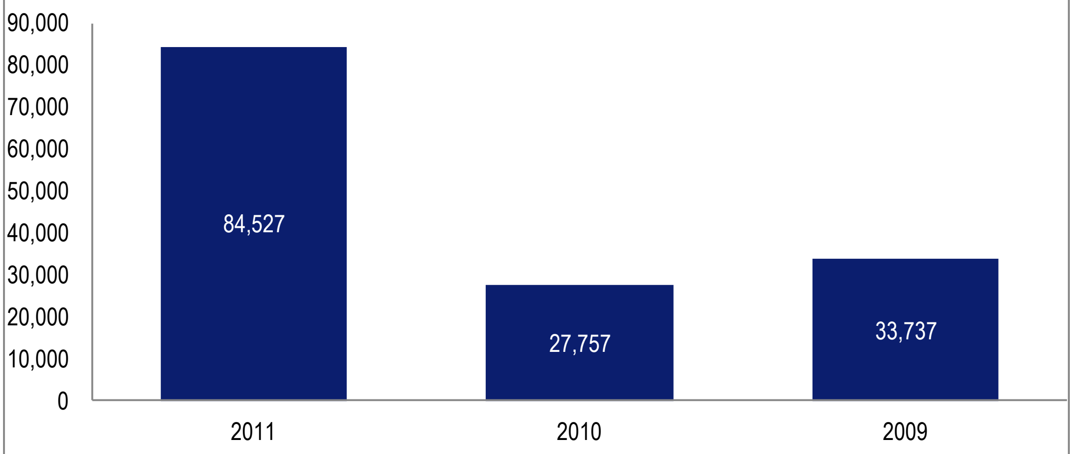
Performance Indicators	Year ended 30 June		
	2011	**2010**	**2009**
EBITDA ($'000's)	45,115	38,413	40,288
Operating Ratio	(4.0%)	0.5%	2.2%
Interest Cover Ratio	9.10x	7.33x	7.61x
Debt Service Cover Ratio	3.44x	2.90x	2.91x
Unrestricted Current Ratio	2.35x	2.02x	2.50x
Own Source Operating Revenue Ratio	75.6%	73.9%	73.3%
Cash Expense Ratio	8.0 months	2.7 months	3.5 months
Net assets ($'000's)	2,271,097	2,101,273	1,724,605

Key Observations

- EBITDA has increased in the last three years, reflecting the steady growth of the Council's operating activities.
- The Council's Operating Ratio is declining and together with the increasing EBITDA, highlights the negative impact of the increased depreciation expense on operating results.
- The Council has a sustainable level of debt as demonstrated by its strong debt servicing ability. The Council's EBITDA is increasing and is gradually repaying debt which leads to a gradually improving Interest Cover Ratio and DSCR. It has maintained a DSCR at 2.8x or above in the last three years which is well above the benchmark ratio of 2.0x. The Interest Cover Ratio is also well above the benchmark of 4.0x.
- A large portion of the debt, $50.4m in 2011, is used for sewerage services, recoverable by sewerage charges if sustainably managed in isolation.
- The Council's Unrestricted Current Ratio has been decreasing over time partly due to the decrease in the value of its current investments. Overall, the Unrestricted Current Ratio remains above the benchmark level of 1.5x and is considered to be at a sustainable level.
- The Cash Expense Ratio is above benchmark of 3.0 months in two of the three years. This demonstrates that the Council had the ability to meet its day to day expenses. The 2011 ratio is partly skewed because the Council moved a portion of its investments into short term deposits which are now classified as cash.
- The Council's Net Assets have increased over the period particularly in 2010 when Asset Revaluation added $168m to the value of infrastructure assets.
- Removing the impact of Asset Revaluations, the Council's infrastructure, property, plant and equipment assets have increased in the last three years by a net $30.4m (asset purchases less the combined value of disposed assets and depreciation expense).

3.5: Statement of Cashflows

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



Key Observations

- The Council's significant increase in its cash balance in 2011 is because it moved a large portion of its non-current deposits to shorter term deposits (which are now classified as cash and cash equivalents).
- The Council's cash and investments in 2011 include $35.5m in internally restricted and unrestricted funds.
- The Council's $22.9m investment portfolio balance, as at 2011, includes $5.5m in managed funds, $8.1m in long term deposits, $7.0m in floating rate notes and negotiable certificate of deposits, $2.3m in CDOs and a very small amount in unlisted equity securities.
- The Council's cashflow position has been improving in the past two years since the low in 2009. Council has been generating an increasing level of operating cashflow from the steady sources of rates and annual charges, and user charges and fees.
- In 2011, the Council's cashflow from investing activities has been supplemented with the sale of assets and improving cashflow from the sale of investment securities. Significant cashflow from the sale of investment securities is not expected to continue as the Council moves away from securities investment, following the Ministerial Investment Order issued in 2008 and later revised in 2011.
- Overall, the level of cash and investment assets, and the Unrestricted Current Ratio suggest that the Council was comfortable in meeting their day to day obligations.

3.6: Capital Expenditure

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

3.6(a): Infrastructure Backlog

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

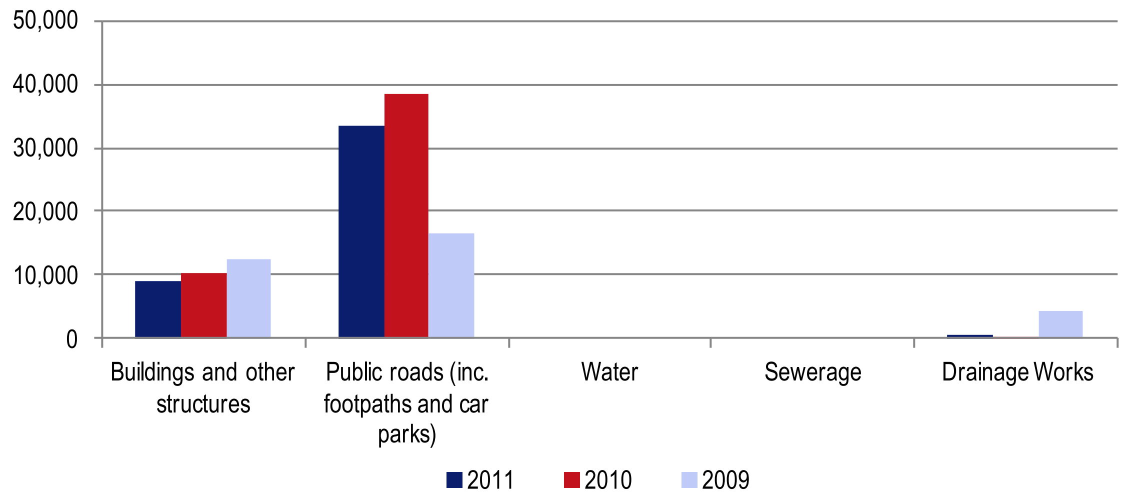
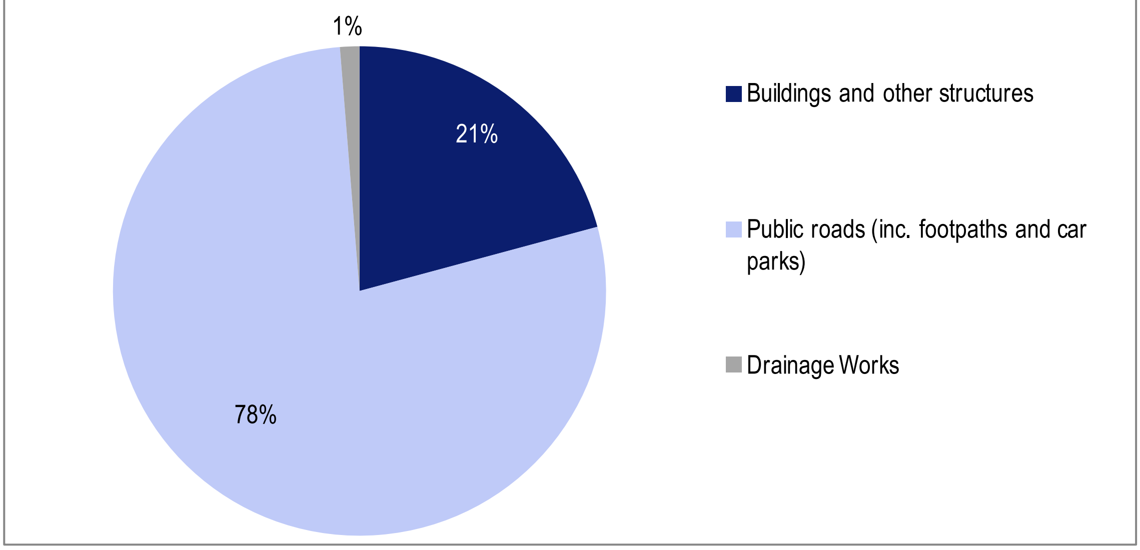


Figure 6 - Infrastructure Backlog Composition for 2010/11



In 2011, the Council reported a total backlog of $43.1m which is an increase from 2009.

- The largest category of backlog is in public roads representing 77.9% ($33.6m) of backlog in 2011. The large increase in public roads backlog in 2010 was mainly due to higher than average rainfall following a period of drought which adversely impacted the condition of the roads.

- The Council has attempted to reduce some of this public roads asset backlog and it reduced by $4.8m from 2010 to 2011.
- The Council is prioritising its public roads backlog in particular with detailed bridge programs, resheeting and resealing work schedules and road strategy programs (such as widening and extension projects). A small portion of this will be funded by Roads to Recovery funding which is to provide $1.4m in 2013. It has also applied for LIRS to assist in addressing its public roads related backlog.
- The Council appears to have its water and sewerage assets well maintained since these assets have been continually upgraded to meet higher demand and environmental standards.
- Community buildings and amenities buildings have also improved over the years through a number of upgrade projects. A large portion of its drainage works backlog, valued at $3.8m, was also addressed in 2010.
- Overall, the Council has been proactively addressing its infrastructure backlog.

3.6(b): Infrastructure Status

Infrastructure Status	Year ended 30 June		
	2011	2010	2009
Bring to satisfactory standard ($'000's)	43,102	49,076	33,223
Required annual maintenance ($'000's)	24,007	24,210	23,463
Actual annual maintenance ($'000's)	16,756	16,520	17,431
Total value of infrastructure assets ($'000's)	1,872,723	1,616,833	1,437,792
Total assets ($'000's)	2,400,298	2,229,746	1,856,829
Building and Infrastructure Backlog Ratio	0.02x	0.03x	0.02x
Asset Maintenance Ratio	0.70x	0.68x	0.74x
Building and Infrastructure Renewals Ratio	0.23x	0.42x	0.61x
Capital Expenditure Ratio	0.97x	1.47x	1.52x

The Council has a maintenance shortfall of around $7m each year which can impact on the condition of the infrastructures. This is reflected in an Asset Maintenance Ratio of below 1.0x in all three years.

The challenge for the Council is to resolve the backlog at a faster rate than their deterioration and to maintain the existing assets at an adequate standard.

Asset renewal spending decreased by nearly 40% ($5.5m) over the last three years reflecting the fact that the backlog has been addressed mainly through major upgrade projects as oppose to asset renewal spending which only capture spending on existing assets to bring it to an equivalent capacity or performance. The Council's newer assets may also require a lower cost of maintenance in earlier years but continues to be depreciated on a straight line basis.

When compared to depreciation, the Council's Building and Infrastructure Renewal Ratio and Capital Expenditure Ratio are deteriorating year on year. This is partly due to the significant increase in depreciation expense. Particularly in 2010, the Asset Revaluation process resulted in a 55% ($13.2m) increase in building and infrastructure depreciation from 2009.

3.6(c): Capital Program

The following figures are sourced from the Council's Annual Financial Statements at Special Schedule No. 8 and are not audited. New capital works are major non-recurrent projects.

Capital Program ($'000's)	Year ended 30 June		
	2011	**2010**	**2009**
New capital works	49,508	37,000	30,000
Replacement/refurbishment of existing assets	8,542	10,000	14,000
Total	**58,050**	**47,000**	**44,000**

The Council has been spending an increasing amount in major capital programs but determining the amount spent on renewal of assets as opposed to new assets can be difficult as some projects have both a renewal and upgrade/new assets component. Part of the new capital works program includes large scale sewerage projects, and new sporting and aquatic centres. The sewerage projects have been partly funded by external grants and debt.

Other recently completed projects include:

- Extensions to Shoalhaven Entertainment Centre
- Works on Main Road 92 from Nowra to Nerriga
- Currarong Sewerage Scheme for $14.6m
- Work on the Bernie Regan Sporting Complex Hockey Field for $2.2m
- Upgrade of eight tourist parks for $2.0m

3.7: Specific Risks to Council

- Growing population. Population growth places pressure on existing infrastructure and services and also increases demand for new infrastructure and services. The challenge for the Council is to maintain service levels across new and existing facilities and maintain financial sustainability. The Council is aware of the issue as stated in its Resourcing Plan. It plans to address this by ensuring additional rates revenue generated from the new residents is used to fund the operating cost of expanded services and infrastructure. New capital works to address growth is forecast to be funded from Developer Contributions and if applicable, matching capital funds from other sources.
- Ageing population. The LGA generally has an older community compared to other NSW regions and a lower than average workforce participation rate. Retirees generally cannot afford significant increases in charges and will require different types of services and facilities. The Council has highlighted this issue in its Resourcing Plan and will continue to adjust its workforce skills to meet the changing population.

- Ageing workforce. A shrinking workforce and an ageing population create challenges in managing the Council's employees. 26% of Council's staff is in the 51 to 60 years age bracket with 6.4% over 61 years. The Council is aware of this issue and is actively addressing it with its Workforce Plan.
- Capital projects cost overrun and delays. Large scale capital projects are planned on water, sewerage and drainage assets to meet population demands and environmental guidelines. These projects are susceptible to general project risks and the Council will need to have the financial and planning flexibility to accommodate any variations in the projects. The Council has demonstrated its ability for project management and financial risk management in the recent capital works program and appears to have managed risks adequately.
- Environmental factors and natural disasters. The LGA is at risk of storm and flood events with five Natural Disaster Declarations since 2009. Costly coastal area management is also a key management and planning concern because of rising sea levels and coastal erosions. The Council's management of this risk is substantially reliant on being able to receive both State and Federal funding under various "natural disaster" funds.

Section 4 Review of Financial Forecasts

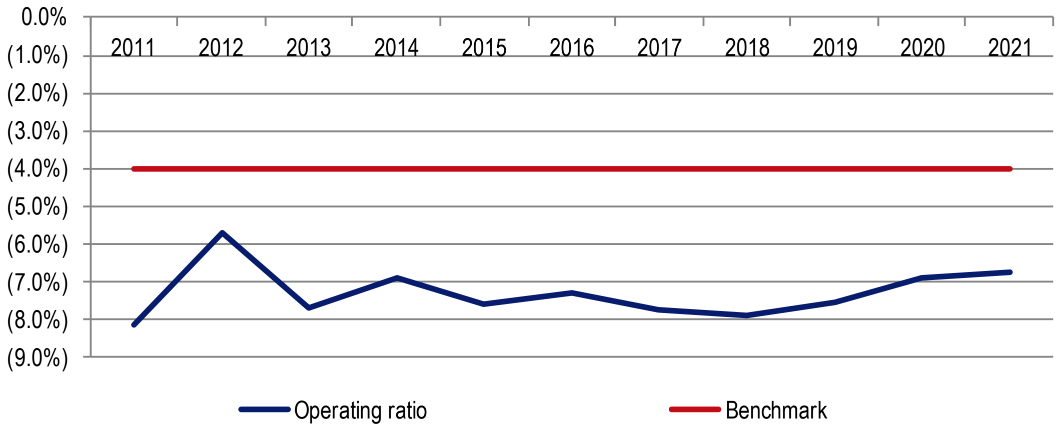
The financial model shows the projected financial statements and assumptions for the next 10 years. The model includes the $2m loan without any LIRS subsidy and the cost of the project.

The LIRS loan relates to the General Fund, therefore we have focused our financial analysis solely upon this General Fund. Council's consolidated position includes both Water and Sewer Fund and these are operated as independent entities, which unlike the General Fund, are able to adjust their fees and charges to meet all future operating and investing expenses.

The Council has assumed it will maintain its existing level of service in its forecasts and any new services and infrastructure are to be funded by s94 Developer's Contribution and rates from the new property.

4.1: Operating Results

Figure 7 - Operating Ratio for General Fund



The Council's Operating Ratio is forecast to be below benchmark in all the forecast years and is not expected to improve until 2019.

The Council has stated that it aims to achieve a target of a "break even operating position or better (before capital grants and contributions)" in each year. It also aims to reduce debt and improve reserve funding. To achieve this, it has set itself a target of reducing expenditure by $1m p.a. by 2015 starting from 2012.

4.2: Financial Management Indicators

Liquidity Ratios

Figure 8 - Cash Expense Ratio for General Fund

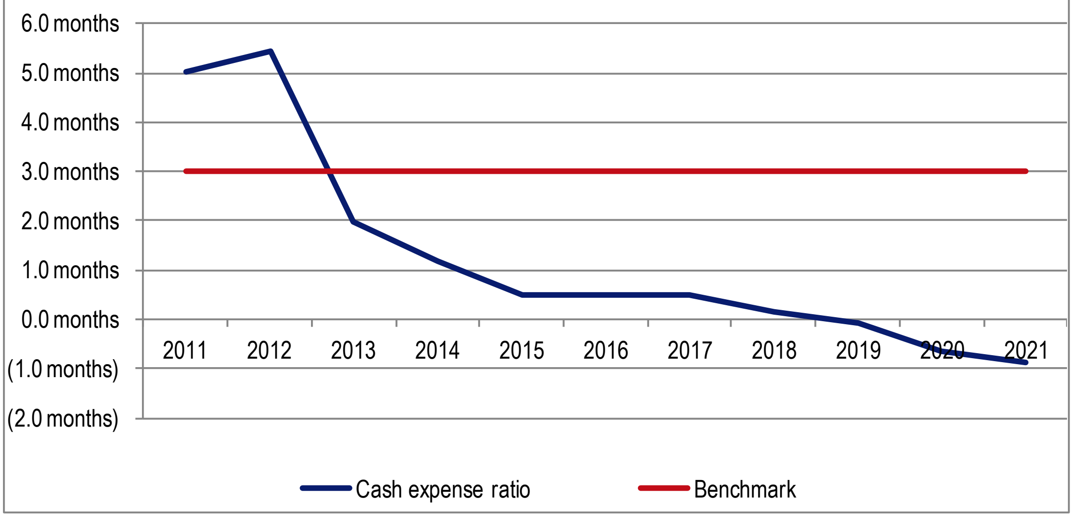
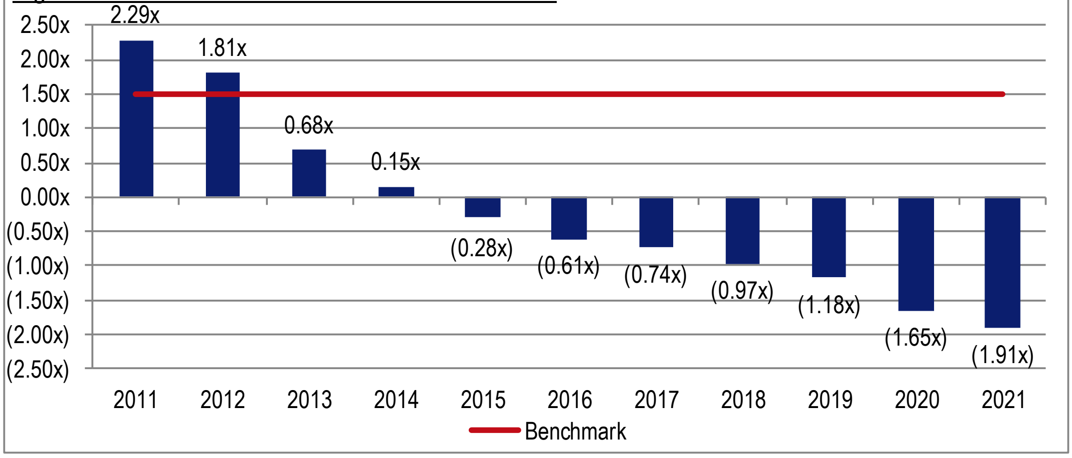


Figure 9 - Unrestricted Current Ratio for General Fund

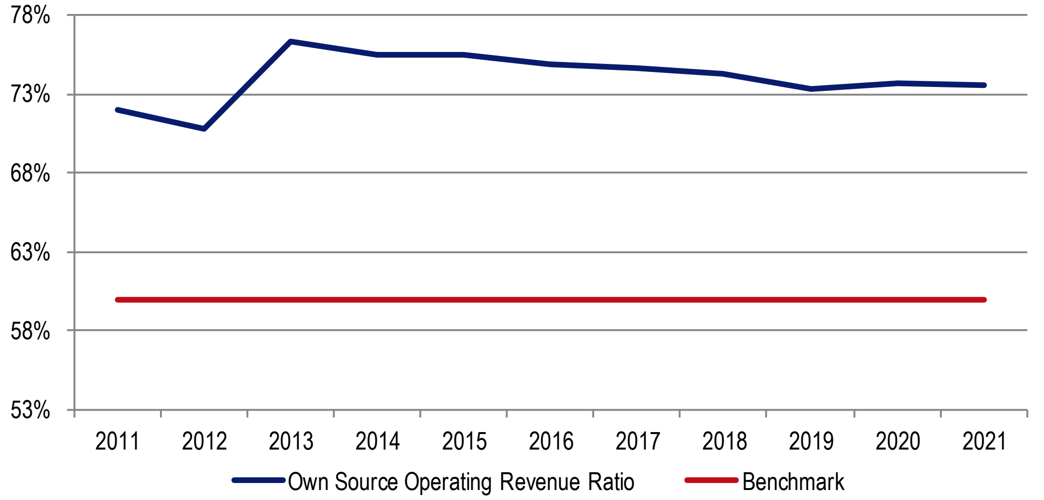


Based on the Council's cash and cash equivalent forecasts, the Cash Expense Ratio is below benchmark in most of the forecast years. This Ratio continues to deteriorate and cash dips into negative territory in 2019.

Unrestricted Current Ratio is below benchmark for most of the forecast years and falls into negative territory in 2015. This is not a sustainable position and Council will need to review its revenue, operating expenses and capital expenditure levels in the short term.

Fiscal Flexibility Ratios

Figure 10 - Own Source Operating Revenue Ratio for General Fund



In forecasting the General Fund's income statement, the Council included internal transactions in its revenue number. This skewes the calculation of Own Source Operating Revenue Ratio by inflating Operating Revenue in the denominator. TCorp has adjusted the calculation of this ratio by deducting an assumed internal transaction amount of the revenue.

Based on this calculation, the Council's Own Source Operating Revenue Ratio is well above the benchmark of 60% throughout the forecast period. This indicates that the Council is not heavily reliant on external grants and contributions in their forecasts and have the financial flexibility to manage its own finances.

Capital grants and contributions assumptions are lower than historical results from 2013 onwards. This skews the Own Source Operating Revenue Ratio upwards from 2013.

Figure 11 - DSCR for General Fund

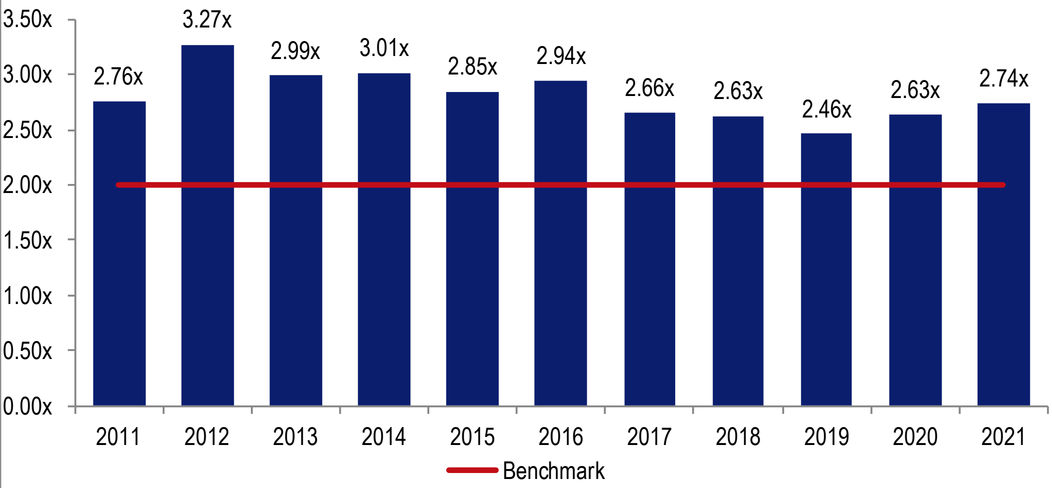
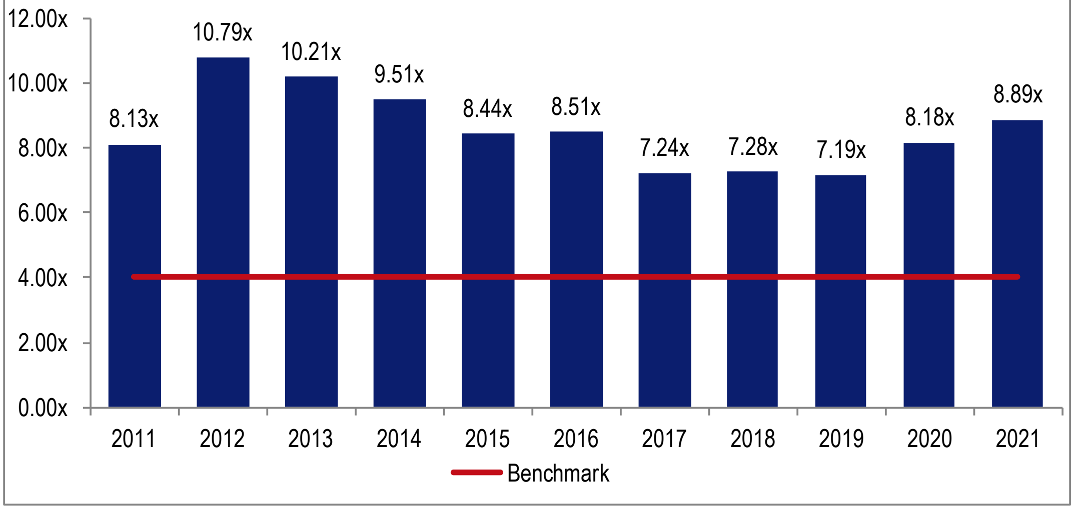


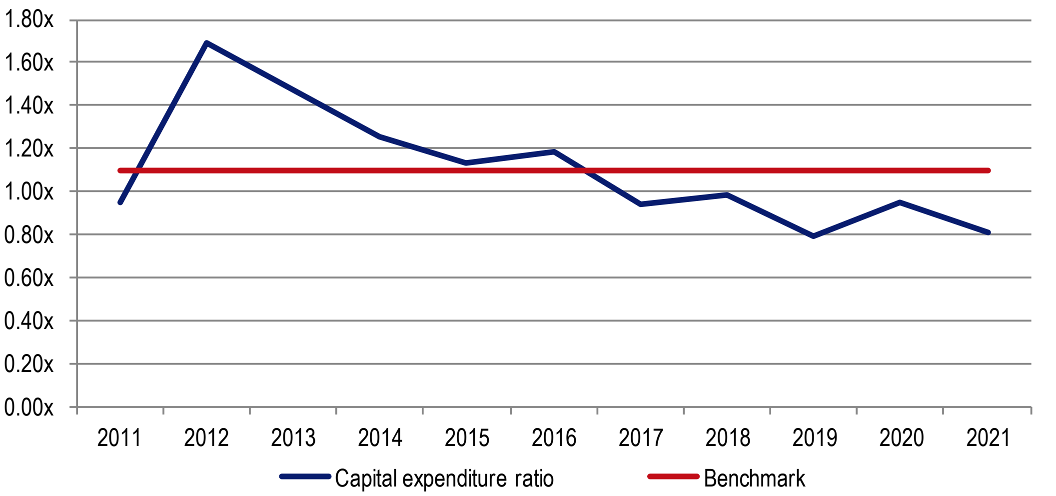
Figure 12 - Interest Cover Ratio for General Fund



Overall, the Council's DSCR is well above the benchmark level of 2.0x and its Interest Cover Ratio is well above 4.0x in the forecast period. Both these ratios demonstrate its ability to service not only the $2.0m LIRS loan subject to its cash and liquidity levels being maintained. It reflects that Council has a low level of borrowings at 2.6% of the General Fund's net assets in 2011.

4.3: Capital Expenditure

Figure 13 - Capital Expenditure Ratio for General Fund



After the peak in 2012, the Council's Capital Expenditure Ratio is forecast to decline and it falls to below benchmark levels in 2017. The shortfall in capital expenditure below depreciation expense for the forecast years accumulates to $38.0m in nominal terms.

The Council has stated that its first priority for capital project expenditure is renewal and replacement works, the second priority is projects that address the growth of the Council, and the last priority is the construction of new assets to deliver new facilities or increased levels of service.

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 rates 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%
- Interest and investment revenue: annual return of 5%
- All other revenue items: the estimated annual CPI increase of 2.5%
- Employee costs: 3.5% (estimated CPI+1%)
- All other expenses: the estimated annual CPI increase of 2.5%

Key Observations and Risks

- In preparing the LTFP, Council has assumed that the same service level and funding policy as current will continue to apply.
- Council has forecast an average rate and annual charges increase of 3.5% p.a. This incorporates a rate peg increase plus an increase in rateable properties and overall seems reasonable.
- User charges and fees are forecast to increase at a rate of 3.8% to 6.7% year on year. Council has stated that user charges and fees have been calculated according to the recovery cost of providing the services. This seems higher than a general increase of 2.5% CPI plus an allowance for population growth. However, given that the Council has the flexibility to adjust its user charges and fees, this assumption seems reasonable if the community is willing to accommodate these increases.
- Employee expenses are forecast to increase by an average of 3.3% p.a. This is a reasonable assumption based on historical award wages increases. The LTFP does not take into account workforce growth to meet increasing service demands and to meet population growth.
- Depreciation is forecast to increase by an average of 3.0% each year which seems reasonable given that the value of the assets should increase by around CPI plus a small addition of new assets every year to cater for service growth.

4.5: Borrowing Capacity

When analysing the financial capacity of the Council we believe Council will be able to incorporate the $2.0m LIRS loan facility but note its forecast liquidity issues in the medium and long term need to be addressed and resolved. Our recommendation for approval is on the basis that its DSCR and Interest Cover Ratio are comfortably above benchmark.

Besides the liquidity issue, the recommendation is also subject to the achievement of the target expenditure savings. We would not recommend additional borrowings above the proposed LIRS borrowings until these issues are resolved.

Section 5 Benchmarking and Comparisons with Other Councils

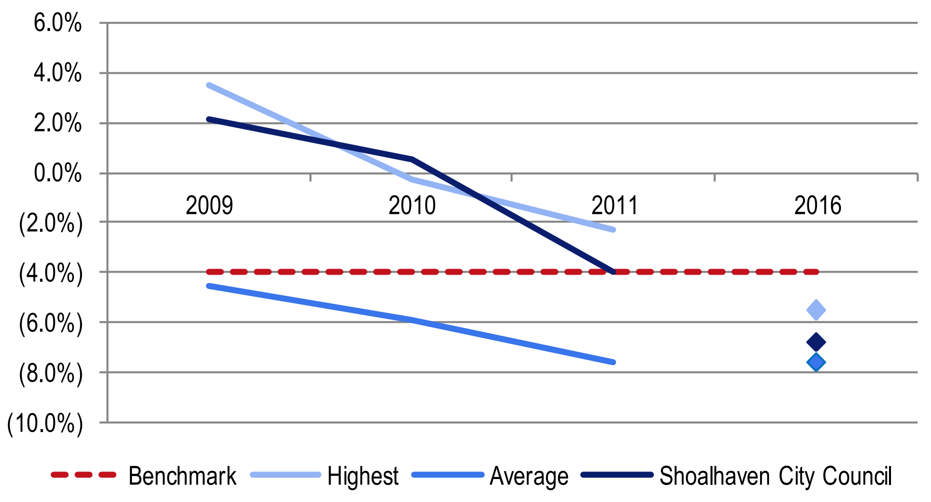
As discussed in section 2 of this report, each council's performance has been assessed against ten key benchmark ratios. This section of the report compares the Council's performance with its peers in the same DLG Group. The Council is in DLG Group 5 and there are six councils in this group.

In Figure 14 to Figure 20, the graphs compare the historical performance of Council with the benchmark for that ratio, with the average for the Group, with the highest performance (or lowest performance in the case of the Infrastructure Backlog Ratio where a low ratio is an indicator of strong performance), and with the forecast position of the Council as at 2016 (as per Council's LTFP). Figures 21 to 23 do not include the 2016 forecast position as those numbers are not available.

Where no highest line is shown on the graph, this means that Council is the best performer in its group for that Ratio.

Financial Flexibility

Figure 14 - Operating Ratio Comparison



Council's Operating Ratio was above average and the benchmark in the past three years and close to the highest council. The results are forecast to deteriorate in the medium term to be below the benchmark.

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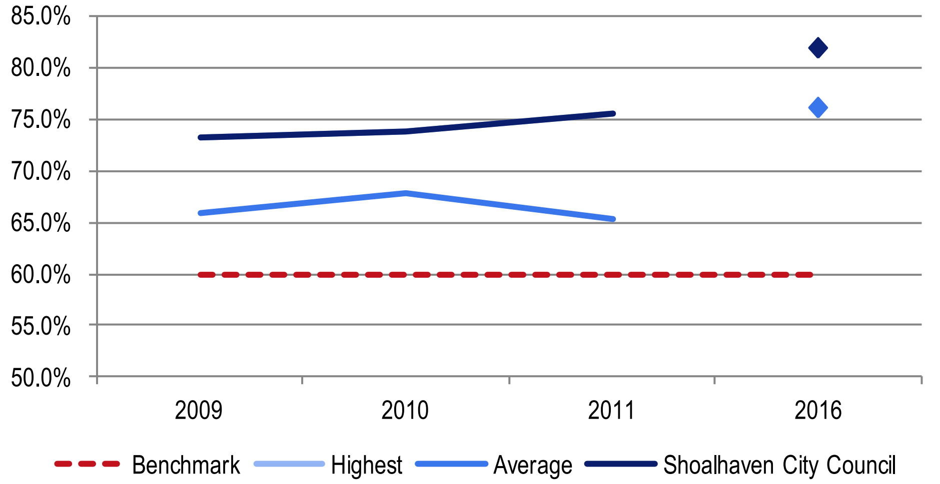
Figure 15 - Own Source Operating Revenue Ratio Comparison



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

Overall, Council's financial flexibility is sound and is the best in the group.

Liquidity

Figure 16 - Cash Expense Ratio Comparison

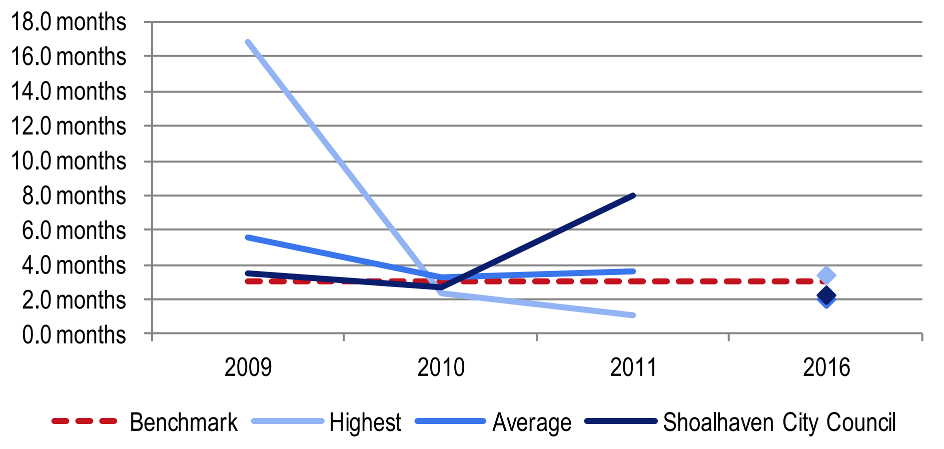
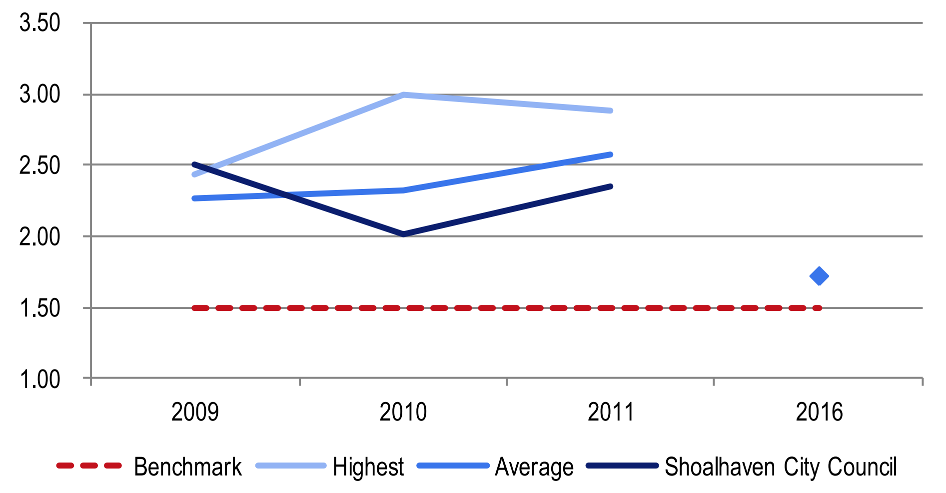


Figure 17 - Unrestricted Current Ratio Comparison



On average over the past three years, the Council's liquidity position has been adequate. Council did not provide a forecast Unrestricted Current Ratio, but their Cash Expense Ratio is forecast to deteriorate in the medium term.

Debt Servicing

Figure 18 - Debt Service Cover Ratio Comparison

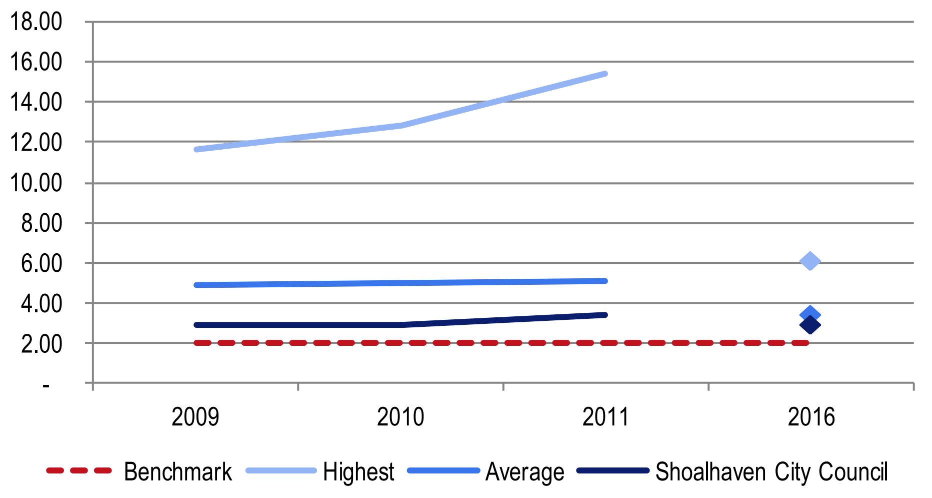
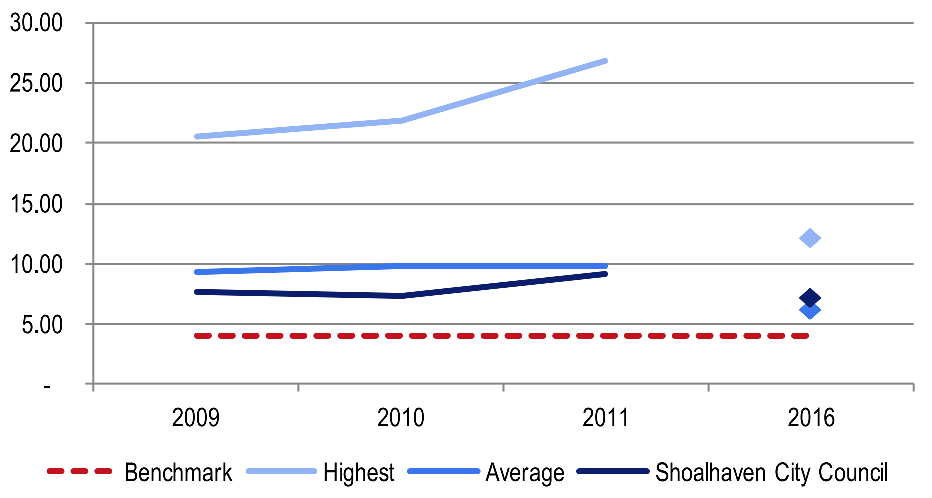


Figure 19 - Interest Cover Ratio Comparison



Council had above benchmark DSCR and Interest Cover Ratio in the past that is below the group average and the ratios marginally deteriorate in the forecast.

Asset Renewal and Capital Works

Figure 20 - Capital Expenditure Ratio Comparison

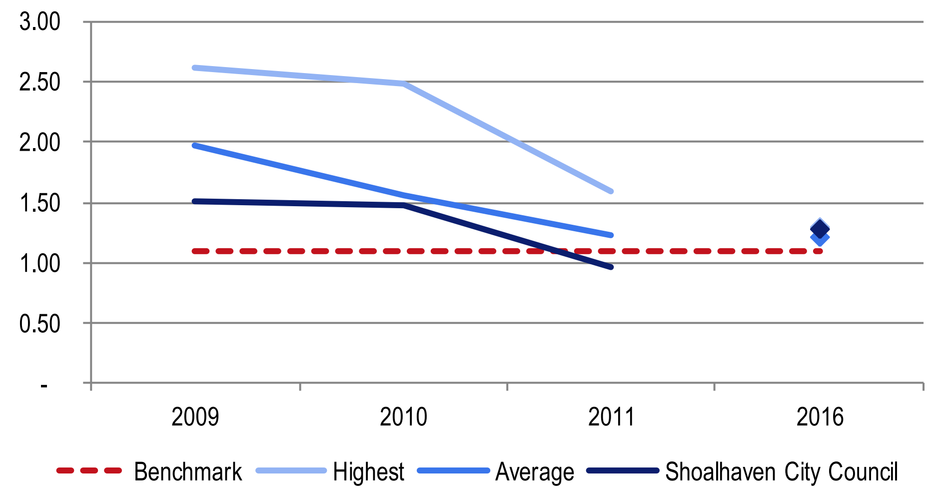


Figure 21 - Asset Maintenance Ratio Comparison

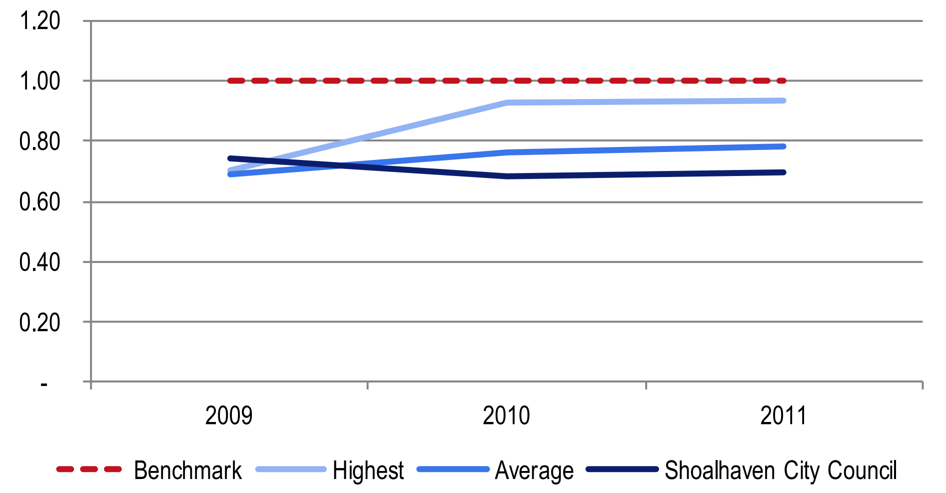


Figure 22- Infrastructure Backlog Ratio Comparison

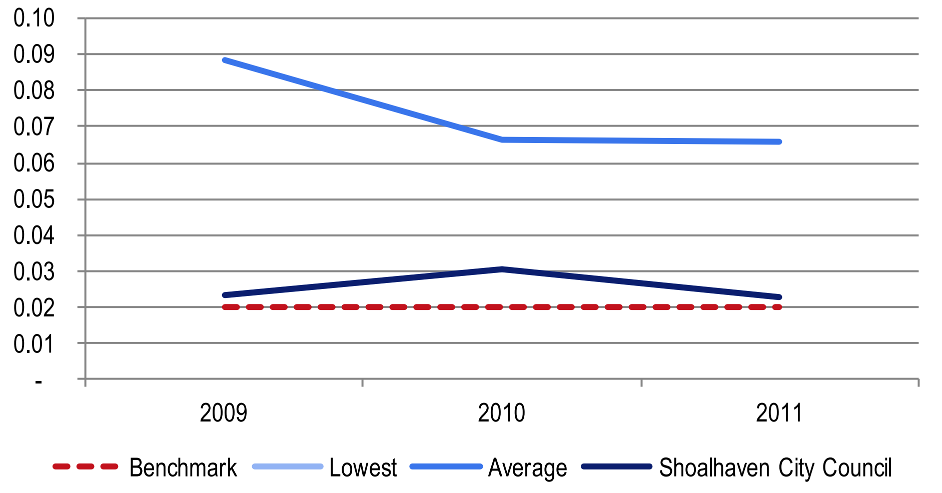
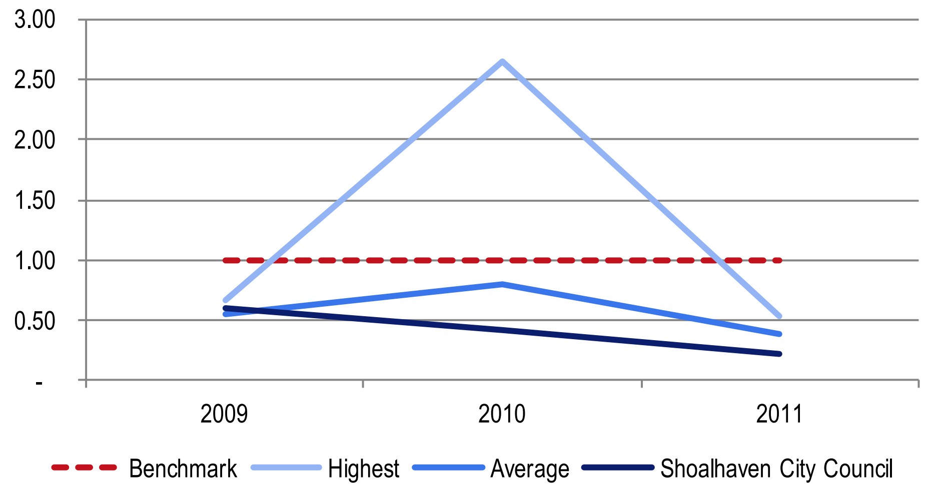


Figure 23 - Building and Infrastructure Asset Renewal Ratio



Overall, the Council has the lowest Infrastructure Backlog in the group.

Council is below the group average and benchmark in terms of spending on building and infrastructure asset renewal and asset maintenance. The Council's capital expenditure declined to be below the benchmark in 2011 and was below the group average, though it is forecast to improve to be around the group average and above the benchmark in the medium term.

Section 6 Conclusion and Recommendations

Based on our review of both the historic financial information and the 10 year financial forecast within Council's long term financial plan we consider Council to be in a reasonably sound financial position if the proposed expenditure reductions are realised and its liquidity issues in the forecast medium term are resolved. Both past performance and the financial forecasts support our findings that Council has sufficient financial capacity to service the additional borrowings proposed under its LIRS applications.

As noted in our report, the forecast analysis has been focussed on the General Fund where the LIRS application relates to, whereas the historical analysis has focused on the consolidated audited accounts.

We based our recommendation on the following key points:

- Council has sufficient capacity to manage the additional $2.0m debt highlighted by a DSCR and Interest Cover Ratio above the benchmarks in all 10 years of its financial forecast.
- Council has a high level of own sourced income and is not heavily reliant on grants and contributions compared to most Councils.
- Council has a low level of borrowings of 2.6% of the General Fund's net assets
- Most of the borrowings in the Consolidated Funds relate to the Sewerage Fund which is self sufficient

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

- Council's forecast that it may face liquidity issues in the medium to long term. This is indicated by very low Unrestricted Current Ratio and Cash Expense Ratio which falls to negative levels in later years.
- Operating deficits are forecast in the current 10 year model and Council is reliant on meeting its expenditure savings and productivity improvements to reach the forecast results. The declining result is not a sustainable trend.

Appendix A Historical Financial Information Tables

Table 1- Income Statement

Income Statement ($'000)	Year ended 30 June			% annual change	
	2011	2010	2009	2011	2010
Revenue					
Rates and annual charges	90,457	85,961	80,626	5.2%	6.6%
User charges and fees	49,126	47,512	44,016	3.4%	7.9%
Interest and investment revenue	7,043	6,408	7,627	9.9%	(16.0%)
Grants and contributions for operating purposes	21,261	17,610	20,917	20.7%	(15.8%)
Other revenues	4,466	3,839	3,191	16.3%	20.3%
Total revenue	**172,353**	**161,330**	**156,377**	**6.8%**	**3.2%**
Employees	62,428	59,338	56,139	5.2%	5.7%
Borrowing costs	4,955	5,241	5,294	(5.5%)	(1.0%)
Materials and contract expenses	44,641	44,364	41,513	0.6%	6.9%
Depreciation and amortisation	47,016	32,374	31,609	45.2%	2.4%
Other expenses	20,169	19,215	18,437	5.0%	4.2%
Total expenses	**179,209**	**160,532**	**152,992**	**11.6%**	**4.9%**
Operating result	**(6,856)**	**798**	**3,385**	**(959.1%)**	**(76.4%)**

Table 2 - Items excluded from Income Statement

Excluded items ($'000)			
	2011	2010	2009
Grants and contributions for capital purposes	12,202	19,275	13,704
Increase (Decrease) in the fair value of investments	440	1,122	(5,898)
Net gain/(losses) from the disposal of assets	(1,080)	(853)	289

Table 3 - Balance Sheet

Balance Sheet ($'000)	Year Ended 30 June			% annual change	
	2011	**2010**	**2009**	**2011**	**2010**
Current assets					
Cash and equivalents	84,527	27,757	33,737	204.5%	(17.7%)
Investments	15,623	58,265	50,978	(73.2%)	14.3%
Receivables	11,927	13,456	14,594	(11.4%)	(7.8%)
Inventories	3,202	3,373	9,839	(5.1%)	(65.7%)
Other	1,449	1,280	1,136	13.2%	12.7%
Total current assets	**116,728**	**104,131**	**110,284**	**12.1%**	**(5.6%)**
Non-current assets					
Investments	7,326	14,383	13,762	(49.1%)	4.5%
Receivables	11,039	9,680	9,664	14.0%	0.2%
Inventories	6,618	6,804	0	(2.7%)	N/A
Infrastructure, property, plant & equipment	2,257,079	2,093,271	1,721,672	7.8%	21.6%
Investment property	1,508	1,477	1,447	2.1%	2.1%
Total non-current assets	**2,283,570**	**2,125,615**	**1,746,545**	**7.4%**	**21.7%**
Total assets	**2,400,298**	**2,229,746**	**1,856,829**	**7.6%**	**20.1%**
Current liabilities					
Payables	16,929	16,149	19,003	4.8%	(15.0%)
Borrowings	8,680	8,153	7,969	6.5%	2.3%
Provisions	30,482	30,630	28,988	(0.5%)	5.7%
Total current liabilities	**56,091**	**54,932**	**55,960**	**2.1%**	**(1.8%)**
Non-current liabilities					
Borrowings	63,271	64,233	66,639	(1.5%)	(3.6%)
Provisions	9,842	9,308	9,625	5.7%	(3.3%)
Total non-current liabilities	73,113	73,541	76,264	(0.6%)	(3.6%)
Total liabilities	**129,204**	**128,473**	**132,224**	**0.6%**	**(2.8%)**
Net assets	**2,271,094**	**2,101,273**	**1,724,605**	**8.1%**	**21.8%**

Table 4-Cashflow

Cashflow Statement ($'000)	Year ended 30 June		
	2011	**2010**	**2009**
Cashflows from operating activities	53,189	51,489	49,612
Cashflows from investing activities	4,129	(55,520)	(67,163)
Proceeds from borrowings and advances	7,606	6,034	82
Repayment of borrowings and advances	(8,154)	(7,983)	(8,554)
Cashflows from financing activities	(548)	(1,949)	(8,472)
Net increase/(decrease) in cash and equivalents	**56,770**	**(5,980)**	**(26,023)**
Cash and equivalents	84,527	27,757	33,737

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Appendix B Glossary

Asset Revaluations

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

Collateralised Debt Obligation (CDO)

CDOs are structured financial securities that banks use to repackage individual loans into a product that can be sold to investors on the secondary market.

In 2007 concerns were heightened in relation to the decline in the “sub-prime” mortgage market in the USA and possible exposure of some NSW councils, holding CDOs and other structured investment products, to losses.

In order to clarify the exposure of NSW councils to any losses, a review was conducted by the DLG with representatives from the Department of Premier and Cabinet and NSW Treasury.

A revised Ministerial investment Order was released by the DLG on 18 August 2008 in response to the review, suspending investments in CDOs, with transitional provisions to provide for existing investments.

Division of Local Government (DLG)

DLG is a division of the NSW Department of Premier and Cabinet and is responsible for local government across NSW. DLG’s organisational purpose is “to strengthen the local government sector” and its organisational outcome is “successful councils engaging and supporting their communities”. Operating within several strategic objectives DLG has a policy, legislative, investigative and program focus in matters ranging from local government finance, infrastructure, governance, performance, collaboration and community engagement. DLG strives to work collaboratively with the local government sector and is the key adviser to the NSW Government on local government matters.

Depreciation of Infrastructure Assets

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

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

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

EBITDA

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

Grants and Contributions for Capital Purposes

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

Grants and Contributions for Operating Purposes

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

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

Independent Commission Against Corruption (ICAC)

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

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

Independent Pricing and Regulatory Tribunal (IPART)

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

Infrastructure Backlog

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

Integrated Planning and Reporting (IP&R) Framework

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

Local Government Cost Index (LGCI)

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

Net Assets

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

Roads and Maritime Services (RMS)

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

Section 64 Contribution

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

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

Section 94 Contribution

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

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

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

Special Rate Variation (SRV)

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

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

The applications are reviewed and approved by IPART.

Ratio Explanations

Asset Maintenance Ratio

Benchmark = Greater than 1.0x

Ratio = actual asset maintenance / required asset maintenance

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

Building and Infrastructure Renewals Ratio

Benchmark = Greater than 1.0x

Ratio = Asset renewals / depreciation of building and infrastructure assets

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

Cash Expense Cover Ratio

Benchmark = Greater than 3.0 months

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

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

Capital Expenditure Ratio

Benchmark = Greater than 1.1x

Ratio = annual capital expenditure / annual depreciation

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

Debt Service Cover Ratio (DSCR)

Benchmark = Greater than 2.0x

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

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

Infrastructure Backlog Ratio

Benchmark = Less than 0.02x

Ratio = estimated cost to bring assets to a satisfactory condition (from Special Schedule 7) / total infrastructure, building, other structures and depreciable land improvement assets (from note 9a)

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

Interest Cover Ratio

Benchmark = Greater than 4.0x

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

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

Operating Ratio

Benchmark = Better than negative 4%

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

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

Own Source Operating Revenue Ratio

Benchmark = Greater than 60%

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

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

Unrestricted Current Ratio

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

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

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