New South Wales
Treasury Corporation

Kyogle Council

Financial Assessment, Sustainability and Benchmarking Report

20 March 2013

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

Disclaimer

This report has been prepared by New South Wales Treasury Corporation (TCorp) in accordance with the appointment of TCorp by the Division of Local Government (DLG) as detailed in TCorp's letters of 22 December 2011 and 28 May 2012. The report has been prepared to assist the DLG and the Independent Local Government Review Panel in its consideration of the Sustainability of each local government area in NSW.

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

In addition, TCorp does not warrant or guarantee the outcomes or projections contained in this report. The projections and outcomes contained in the report do not necessarily take into consideration the commercial risks, various external factors or the possibility of poor performance by the Council all of which may negatively impact the financial capability and sustainability of the Council. The TCorp report focuses on whether the Council has reasonable capacity, based on the information provided to TCorp, to take on additional borrowings, and Council's future Sustainability, within prudent risk parameters and the limits of its financial projections.

The report has been prepared for Kyogle Council, the DLG and the Independent Local Government Review Panel. TCorp shall not be liable to Kyogle 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 Kyogle Council's (the Council) financial capacity, and its future Sustainability. The analysis is based on a review of the historical performance, current financial position, and long term financial forecasts. It also benchmarks the Council against its peers using key ratios.

TCorp's approach has been to:

- Review the most recent four years of Council's consolidated financial results
- Conduct a detailed review of the Council's 10 year financial forecasts, with a particular focus on a council's General Fund. Where a council operates a Water or other Fund the financial capacity of these other Funds may be reviewed where considered necessary.

We have analysed the Council's operating performance over the review period and make the following observations:

- Council's underlying operating performance, measured by EBITDA, declined over the review period from \$6.4m in 2009 to \$2.9m in 2012
- The net book losses from the disposal of infrastructure assets at the time of replacement negatively impact the operating performance in each year, increasing the operating deficits
- Council has had adequate liquidity as identified by an Unrestricted Current Ratio and Cash Expense Ratio above benchmark in each year

The Council reported \$42.9m of Infrastructure Backlog in 2012 which represents 20.0% of its infrastructure asset value of \$213.6m. Other observations include:

- Council's reported backlog has increased from \$36.3m in 2009
- When compared to benchmark, Council has been unable to maintain, renew, or upgrade their asset base to a sufficient level in 2011 and 2012 following the increase in depreciation that has occurred since the Asset Revaluations

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

- Council's LTFP does not include a statement of cashflows or any performance ratio indicators therefore the analysis has been completed utilising the forecast income statement and balance sheet
- Operating deficits are expected in each year and are forecast to increase from \$3.2m in 2015 to a high of \$6.3m in 2019
- The LTFP was completed prior to the requirement for increased depreciation resulting from the Asset Revaluations. This will adversely impact the forecast operating deficits
- Council's liquidity is forecast to decrease over the forecast period but remain above benchmark as indicated by the Cash Expense Ratio. The consecutive decreases will lead to Council having reduced resources to deal with unexpected events in future years

In our view, the Council does not have the capacity to undertake additional borrowings in addition to the approximate \$0.5m included within the forecast when analysing the LTFP. This is based on the following analysis:

- The forecast EBITDA is negative in six of the 10 years indicating there is limited capacity to manage additional borrowings

Based on our review of the information provided, TCorp believes Council is in a weak and deteriorating financial position. If the current trends continue and forecasts contained within the LTFP are realised, Council will become unsustainable when based on the current service levels within the General Fund. Our key observations are:

- Council has projected operating deficits that are projected to increase over the forecast period with a negative EBITDA forecast in six of the 10 years of the LTFP
- Since 2010 and following the Asset Revaluations, Council has been unable to spend sufficient funds on asset maintenance, renewal or upgrades when compared to benchmarks, and the AMP forecasts that this is to continue which will increase the Infrastructure Backlog
- Council's IPP&E value is therefore forecast to decrease over the forecast period due to the decline in quality of the asset base

In respect of our benchmarking analysis we have compared the Council's key ratios with other councils in DLG group 10. Our key observations are:

- Council's financial flexibility as indicated by the Operating Ratio and Own Source Operating Revenue Ratio is generally below the group average
- Council's DSCR is generally below the group average
- Council has been in an adequate liquidity position and has been above the group average in its liquidity ratios compared to its peers Council's Asset Maintenance Ratio and Capital Expenditure Ratio have decreased below the group average in 2012 and they also has a comparatively high level of Infrastructure Backlog

Section 2 Introduction

2.1: Purpose of Report

This report provides the Council with an independent assessment of their financial capacity, Sustainability and performance measured against a peer group of councils. It will complement Council's internal due diligence, the IP&R system of the Council and the DLG, together with the work being undertaken by the Independent Local Government Review Panel.

The report is to be provided to the DLG and the Independent Local Government Review Panel.

The key areas focused on are:

- The financial capacity of the Council
- The long term Sustainability of the Council
- The financial performance of the Council in comparison to a range of similar councils and measured against prudent benchmarks

2.2: Scope and Methodology

TCorp's approach was to:

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

In undertaking its work, TCorp relied on:

- Council's audited financial statements (2008/09 to 2011/12)
- Council's financial forecast model (which excludes a statement of cash flows)
- Council's IP&R documents
- Discussions with Council officers
- Other publicly available information such as information published on the IPART website

In completing the report, TCorp worked closely with Council management to analyse and understand the information gathered. The Council was given a draft copy of the report for their review and comment. Based on our discussions with Council:

- Council agrees with the findings of the report and has acknowledged TCorp's comments

Definition of Sustainability

In conducting our reviews, TCorp has relied upon the following definition of sustainability to provide guidance:

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

Benchmark Ratios

In conducting our review of the Councils' financial performance, forecasts and Sustainability we have measured performance against a set of benchmarks. These benchmarks are listed below.

Benchmarks do not necessarily represent a pass or fail in respect of any particular area. One-off projects or events can impact a council's performance against a benchmark for a short period. Other factors such as the trends in results against the benchmarks are critical as well as the overall performance against all the benchmarks.

As councils can have significant differences in their size and population densities, it is important to note that one benchmark does not fit all. For example, the Cash Expense Ratio should be greater for smaller councils than larger councils as a protection against variation in performance and financial shocks. Therefore these benchmarks are intended as a guide to performance.

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

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

2.3: Overview of the Local Government Area

Kyogle Council LGA	
Locality & Size	
Locality	Richmond Tweed
Area	3,589 km²
DLG Group	10
Demographics	
Population as at 2011	9,228
% under 18	26%
% between 18 and 59	48%
% over 60	26%
Expected population 2025	9,200
Operations	
Number of employees (FTE)	90
Annual revenue	$22.5m
Infrastructure	
Roads	1,319 km
Bridges	388
Infrastructure backlog value	$42.9m
Total infrastructure value	$213.6m

Kyogle Council Local Government Area (LGA) is located on the NSW and Queensland border and adjoins the Scenic Rim Regional Council in Queensland and the Northern Rivers Shires of Tweed, Lismore, Richmond Valley, Clarence Valley and Tenterfield in NSW.

The LGA is within two hours drive from Brisbane and one hour from Queensland's Gold Coast and the NSW coastal communities of Byron Bay, Ballina and Tweed Heads.

The LGA boasts a wide range of natural assets, including the World Heritage listed Border Ranges, Toonumbar National Park and no fewer than 12 state forests, all within easy reach of the towns and villages.

Council has experienced a number of natural disasters over the last few years mainly from flooding and also from a bushfire.

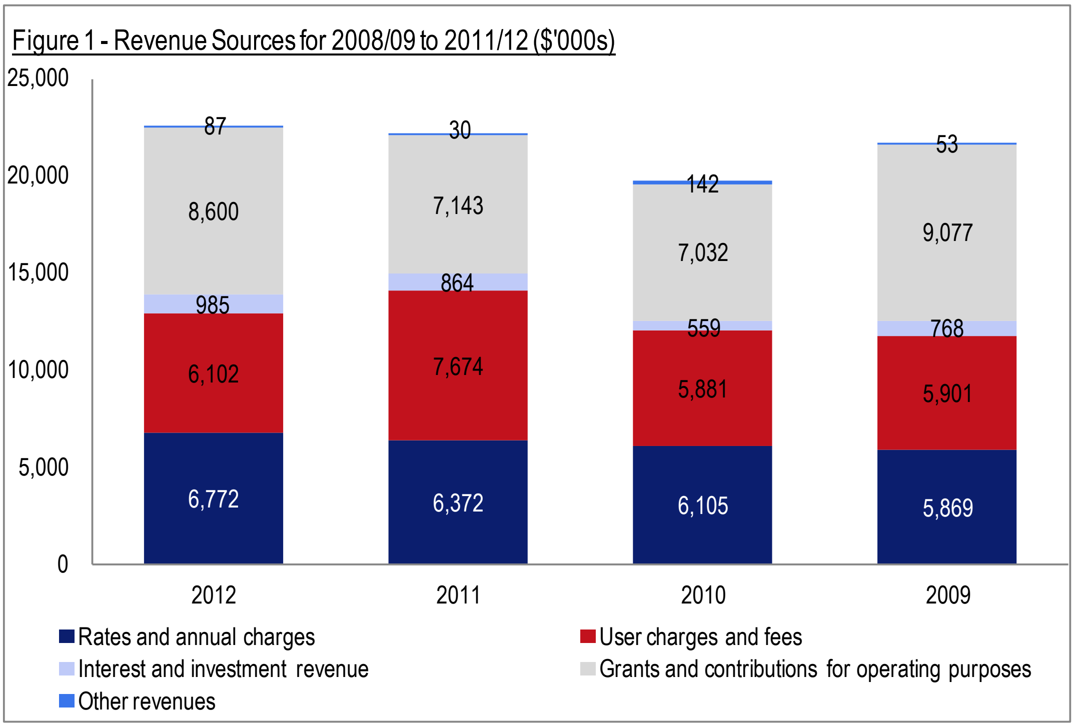
Within Council's Infrastructure, Property, Plant and Equipment (IPP&E) as at 30 June 2012 there was:

- $150.4m of roads, bridges and footpaths
- $21.5m of sewerage infrastructure
- $17.4m of stormwater drainage
- $11.2m of water supply infrastructure
- $7.8m of specialised buildings, $1.6m of non specialised buildings, $2.7m of other structures

Section 3 Review of Financial Performance and Position

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

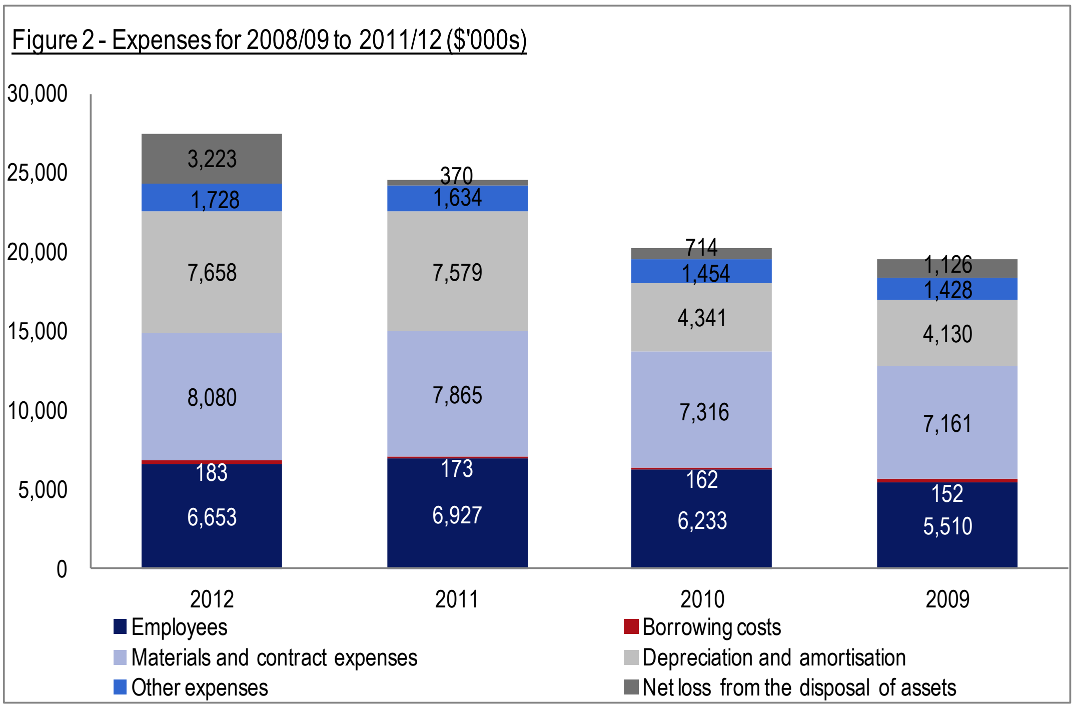
3.1: Revenue



Key Observations

- Total operating revenues have increased by $0.9m (4.1%) over the review period to $22.5m in 2012.
- Rates and annual charges have increased each year at an annual rate of between 4.0% and 6.3%. The 6.3% increase in 2012 occurred due to a 35.7% increase in domestic waste management services annual charges.
- User charges and fees have fluctuated over the review period and are marginally higher in 2012 than in 2009. The large increase in 2011 was due to increased RMS fees for works Council completed on State roads of $5.2m. There was also an increase in quarries revenue to $0.8m. These two revenue sources reduced to $4.0m and $0.5m respectively in 2012.
- Operating grants and contributions fluctuated over the review period. The increase in 2012 was partly due to the advance payment of half of the 2013 Financial Assistance Grant (FAG) while Council also received an additional $0.5m in roads and bridge grants. In 2009 Council received an additional $1.7m in natural disaster grants in relation to flooding in January 2008 and May 2009 as well as $0.8m also from the advance payment of a quarter of the 2010 FAG.

3.2: Expenses



Key Observations

- Total operating expenses increased by $8.0m (41.0%) over the review period to $27.5m in 2012.
- Employee expenses have increased over the review period but reduced by 4.0% in 2012. The decrease occurred due to a reduction in full time equivalent employees from 92 to 90 and also a reduction in the number of casual staff used. Despite this decrease in 2012, employee expenses increased 20.7% over the period. The large increase in 2010 and 2011 were partly related to the completion of the flood damage works that required additional casual staff while increases in employer contributions to the defined benefit pension scheme and workers' compensation premiums also contributed. The additional employee and other expenses incurred by Council due to the floods were offset by increased grants.
- Materials and contract expenses have been on an upward trend with the largest annual increase of 7.5% in 2011 relating to the additional road maintenance works completed in this year.
- Depreciation expenses have been significantly higher in 2011 and 2012 when compared to 2009 and 2010. The $3.2m (74.6%) increase in 2011 followed the Asset Revaluations for roads, bridges and footpath infrastructure assets.
- Other expenses have been on an upward trend. Insurance of $0.4m, the regional library, and electricity and heating both of $0.3m were the largest items in this category.
- Net losses from the disposal of assets have been included as Council has forecast that they will make gains from the disposals in each year of the forecast period. The losses in each year relates to infrastructure assets that were written off when they were replaced.

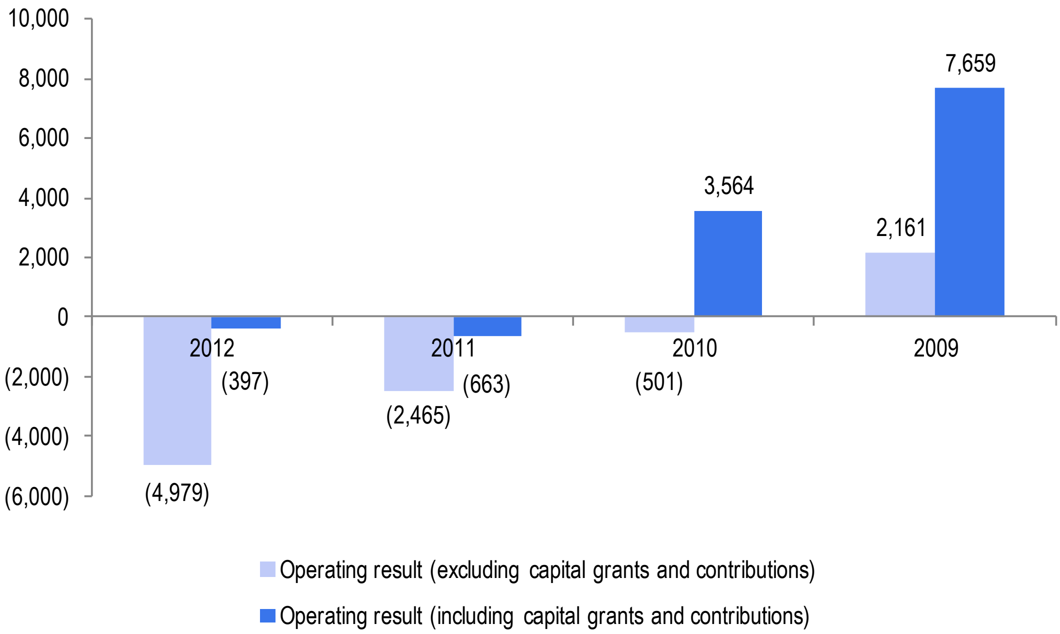
3.3: Operating Results

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

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

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

Figure 3 - Operating Results for 2008/09 to 2011/12 ($'000s)



Key Observations

- Council's operating result when capital grants and contributions are excluded has been on a downward trend with deficits experienced in the past three years.
- Council expenses include a large non-cash depreciation expense, ($7.7m in 2012), which increased substantially in 2011 following the Asset Revaluations process. Whilst the non cash nature of depreciation can favourably impact on ratios such as EBITDA that focus on cash, depreciation is an important expense as it represents the allocation of the value of an asset over its useful life.
- The net losses from the disposal of assets are compounding the deficit position, especially in 2012. In TCorp's view, once Council fully incorporates it's AMP into its LTFP these profits and losses on disposals should decrease as depreciation rates, asset lives and residual values will be co-ordinated.

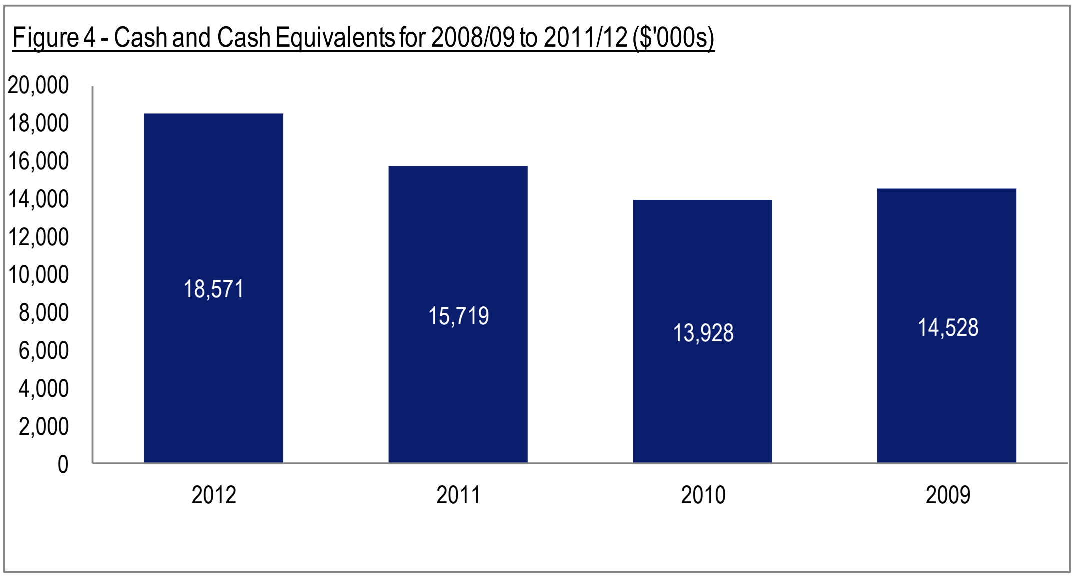
3.4: Financial Management Indicators

Performance Indicators	Year ended 30 June			
	2012	2011	2010	2009
EBITDA ($'000s)	2,862	5,287	4,002	6,443
Operating Ratio	(22.1%)	(11.2%)	(2.5%)	10.0%
Interest Cover Ratio	15.64x	30.56x	24.70x	42.39x
Debt Service Cover Ratio	13.50x	26.44x	21.75x	38.35x
Unrestricted Current Ratio	8.39x	7.52x	7.80x	4.59x
Own Source Operating Revenue Ratio	47.5%	58.8%	50.4%	43.3%
Cash Expense Ratio	11.3 months	11.2 months	10.6 months	11.5 months
Net assets ($'000s)	293,912	272,594	258,817	257,975

Key Observations

- Council's underlying performance, as measured by EBITDA, has decreased over the four year period. The lowest result in 2012 is predominantly due to the increased loss from the disposal of assets.
- The Operating Ratio has been below the benchmark of negative 4.0% in 2011 and 2012. If this trend continues it is likely to impact Council's Sustainability over the long term.
- The DSCR and Interest Cover Ratio have remained above the respective 2.00x and 4.00x benchmarks in each year, indicating that Council can manage their current borrowings.
- Council has $1.2m in outstanding borrowings in 2012, a marginal increase from $1.0m in 2009, representing 0.4% of Net Assets.
- Council's Unrestricted Current Ratio has remained above the 1.5x benchmark and has been on an upward trend indicating that Council has had adequate liquidity throughout the review period.
- Council's Own Source Operating Revenue Ratio has been below the 60.0% benchmark in each year indicating Council has a limited degree of financial flexibility.
- The Cash Expense Ratio has remained stable and has been above the 3.0 months benchmark in each year.
- Net Assets have increased over the period due to the Asset Revaluations process with Council's infrastructure assets increasing in value by $92.0m. Consequently, in the short term the value of Net Assets is not necessarily an informative indicator of performance. In the medium to long term however, this is a key indicator of a Council's capacity to add value to its operations. Over time, Net Assets should increase at least in line with inflation plus an allowance for increased population and/or improved or increased services. Declining Net Assets is a key indicator of the Council's assets not being able to sustain the ongoing operations of a Council.
- When excluding the Asset Revaluations, Council's IPP&E asset base has increased by $5.3m over the review period, with asset purchases being higher than the combined value of disposed assets and depreciation.

3.5: Statement of Cashflows



Key Observations

- Council's cash and cash equivalents have increased over the review period while Council has no funds classified as investments.
- Of the $18.6m in 2012, $2.7m is externally restricted, $15.7m is internally restricted and $0.2m is unrestricted.
- The level of cash and cash equivalents, along with the Unrestricted Current Ratio being above the benchmark indicates Council has sufficient liquidity.

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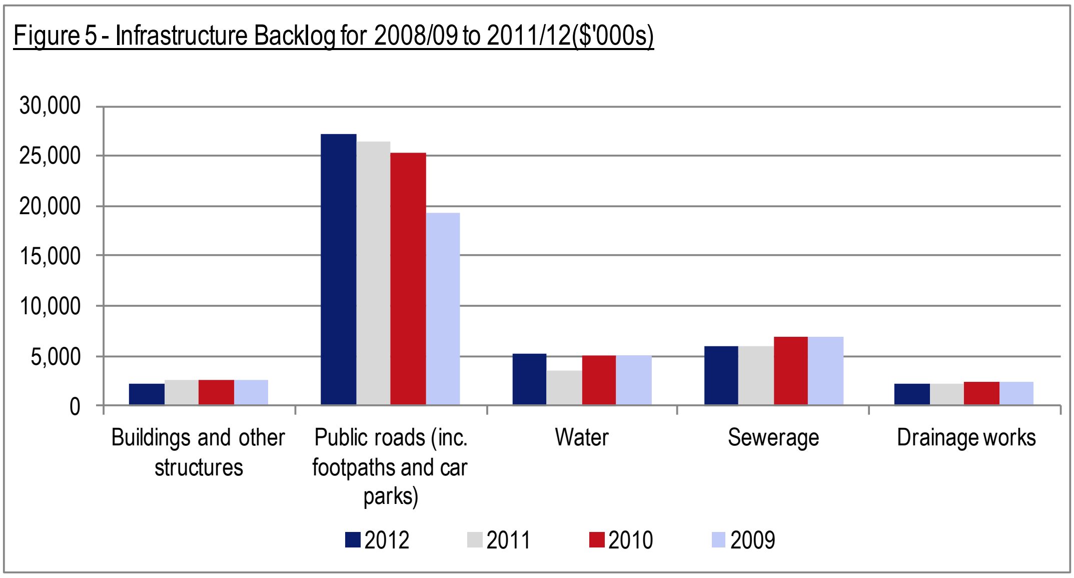
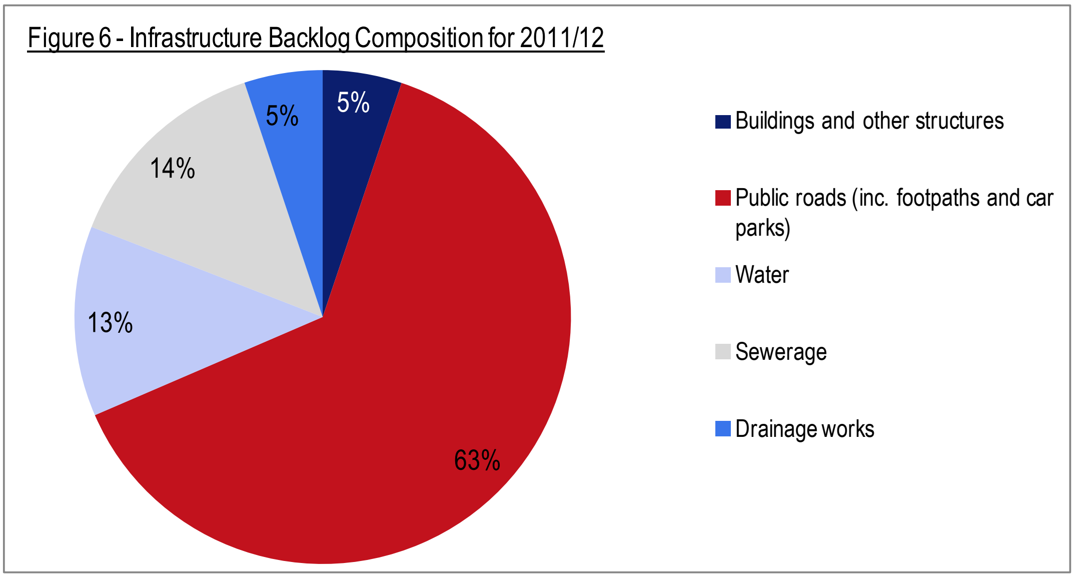
3.6: Capital Expenditure

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

3.6(a): Infrastructure Backlog





Council's Infrastructure Backlog of $42.9m in 2012, was an increase from $36.3m in 2009. In 2012, the Backlog is spread between the five infrastructure asset classes with public roads being the largest at $27.2m (63.4%).

The public roads Backlog value has increased each year since 2009.

3.6(b): Infrastructure Status

Infrastructure Status	Year ended 30 June			
	2012	2011	2010	2009
Bring to satisfactory standard ($'000s)	42,875	40,899	42,147	36,257
Required annual maintenance ($'000s)	6,773	5,307	5,794	4,919
Actual annual maintenance ($'000s)	4,748	4,828	6,040	5,984
Total value of infrastructure assets ($'000s)	213,632	194,258	189,250	102,458
Total assets ($'000s)	301,445	279,771	264,956	265,015
Building and Infrastructure Backlog Ratio	0.20x	0.21x	0.22x	0.35x
Asset Maintenance Ratio	0.70x	0.91x	1.04x	1.22x
Building and Infrastructure Renewals Ratio	0.87x	0.53x	1.38x	2.73x
Capital Expenditure Ratio	0.79x	0.65x	1.54x	2.73x

The Building and Infrastructure Backlog Ratio has reduced over the period despite the actual Backlog increasing by 18.3% over the period. This is due to the Asset Revaluations that significantly increased the total value of infrastructure assets by 108.5% since 2009.

The Asset Maintenance Ratio has been on a downward trend and has been below the 1.00x benchmark in 2011 and 2012. The combination of the required maintenance increasing and the actual maintenance undertaken decreasing, highlights that Council has not adequately invested in maintaining the operating standard of their assets in the past two years.

The Building and Infrastructure Renewals Ratio and Capital Expenditure Ratio have also decreased below the benchmark in 2011 and 2012 indicating that Council has not invested enough in those years to renew assets to their original standard or improve assets performance or capacity. It is noted that over the four year review period, sufficient renewals and capital expenditure was undertaken, but it has reduced significantly in 2011 and 2012. The 2009 results for both ratios are higher than subsequent years due to flood related works being completed against the lower depreciation expense prior to the Asset Revaluations.

The negative trend experienced with the Asset Maintenance Ratio, Building and Infrastructure Renewals Ratio and Capital Expenditure Ratio is likely to result in the decline of the quality of the asset base and an increase in the Infrastructure Backlog.

3.6(c): Capital Program

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

Capital Program ($'000s)	Year ended 30 June			
	2012	**2011**	**2010**	**2009**
New capital works	2,839	989	784	2,646
Replacement/refurbishment of existing assets	7,192	4,843	7,093	10,383
Total	**10,031**	**5,832**	**7,877**	**13,029**

Within Council's capital works program in 2011 and 2012 there has been:

- $3.5m spent on road flood damage restoration
- $1.5m spent on the replacement of 11 timber bridges
- $1.4m spent on the Kyogle Main Street redevelopment
- The completion of the Bonalbo water treatment plant
- The completion of the Urbenville treatment plant for Urbenville, Muli Muli and Woodenbong
- The upgrade of the Kyogle water treatment plant

3.7: Specific Risks to Council

- Inability to reduce the Infrastructure Backlog. Council's Backlog has increased over the review period following the Asset Revaluations and their inability to meet any of the asset benchmarks in the last two years suggest that Council is unable to allocate sufficient funding in order to maintain their infrastructure assets. If this continues then the Backlog is more likely to increase rather than decrease. Council has completed their AMPs in 2012 and it is anticipated that the improved accuracy of data may highlight where maintenance efficiencies can be made.
- Ageing population. While the LGA's population has remaining relatively static across the past five years, the community continues to age. The median age within the LGA is 45 years old which is three years older than the median age recorded at the 2006 census. The younger community members appear to be leaving the LGA for work opportunities while the new community members are nearer retiree age. The service delivery requirements of the community may change as the demographics change and this may place additional pressure on Council to provide the necessary services.
- Environmental disasters / climate change. The LGA has been affected by four flood events in recent years and one bushfire. As a result Council has had to prioritise repair work at the expense of other projects which are then deferred in Council's delivery program.

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Section 4 Review of Financial Forecasts

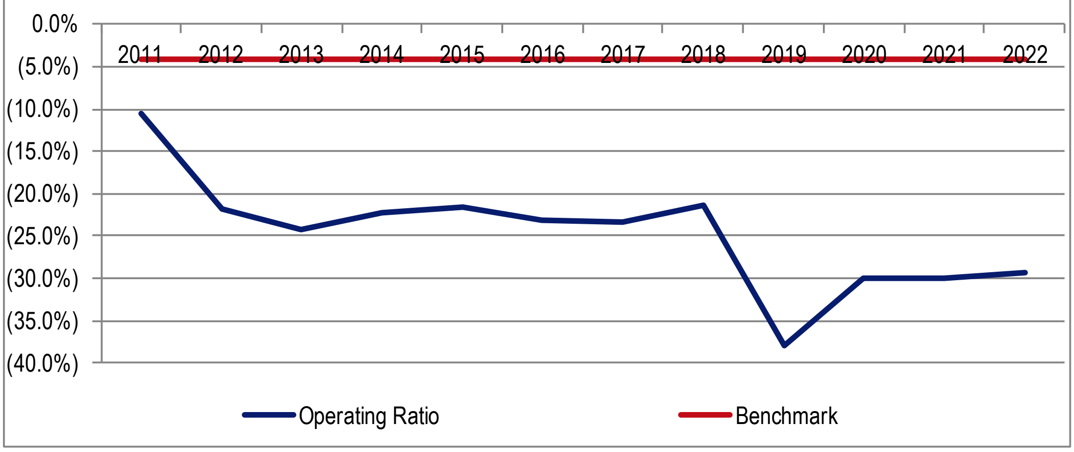
The financial forecast model shows the projected financial statements and assumptions for the next 10 years. We have focused our financial analysis upon the General Fund as although Council's consolidated position includes both a Water and Sewer Fund these are operated as independent entities, which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

The LTFP provided to TCorp does not include a statement of cashflows or any projected performance ratio indicators therefore we are unable to complete our ratio analysis in full.

There is currently no scenario analysis although Council has confirmed that this and the other items will be included within the next version of the LTFP that is due to be completed and adopted for the 2014 financial year.

4.1: Operating Results

Figure 7 - Operating Ratio for General Fund



Council's Operating Ratio is forecast to remain below negative 20% with annual operating deficits of between \$3.2m and \$3.7m between 2013 and 2018. The deficit reaches \$6.3m in 2019 due to a \$2.9m increase in material and contract expenses to \$10.0m. The increase in materials and contract expenses is related to a larger allocation made to local roads and bridge maintenance. The improvement from 2019 to 2020 is due to a forecast increase in operating grants and contributions received however the 2022 to 2022 forecast deficits are close to \$5.5m.

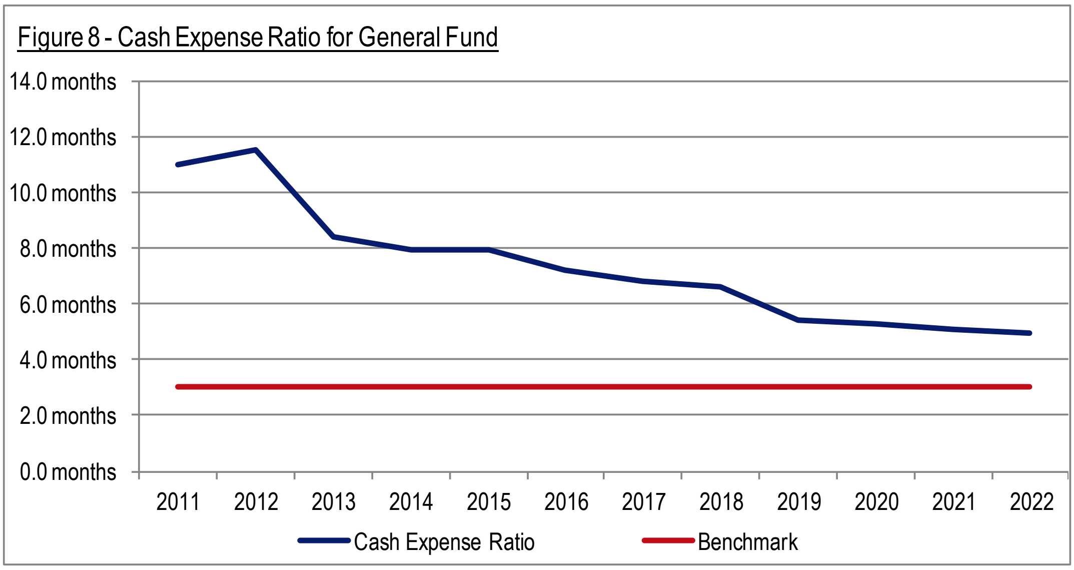
The actual operating performance and Operating Ratio are likely to be in worse deficit positions because the forecast includes understated depreciation costs. Annual depreciation between \$3.3m and \$4.0m is in the LTFP however the actual depreciation in 2012 was \$7.1m. The LTFP was completed prior to the large increase in depreciation in 2011 and 2012 following the Asset Revaluations and refinement of the AMP.

Council has forecast small gains of between \$0.1m and \$0.2m in each year from the disposal of assets that relates to the sale of plant and equipment as opposed to infrastructure assets. Council has stated that the write-down of infrastructure assets is likely to continue in the future however these have not been included within the forecast.

The continuation of the significant operating deficits will negatively impact Council's ability to be sustainable in the long term.

4.2: Financial Management Indicators

Liquidity Ratios

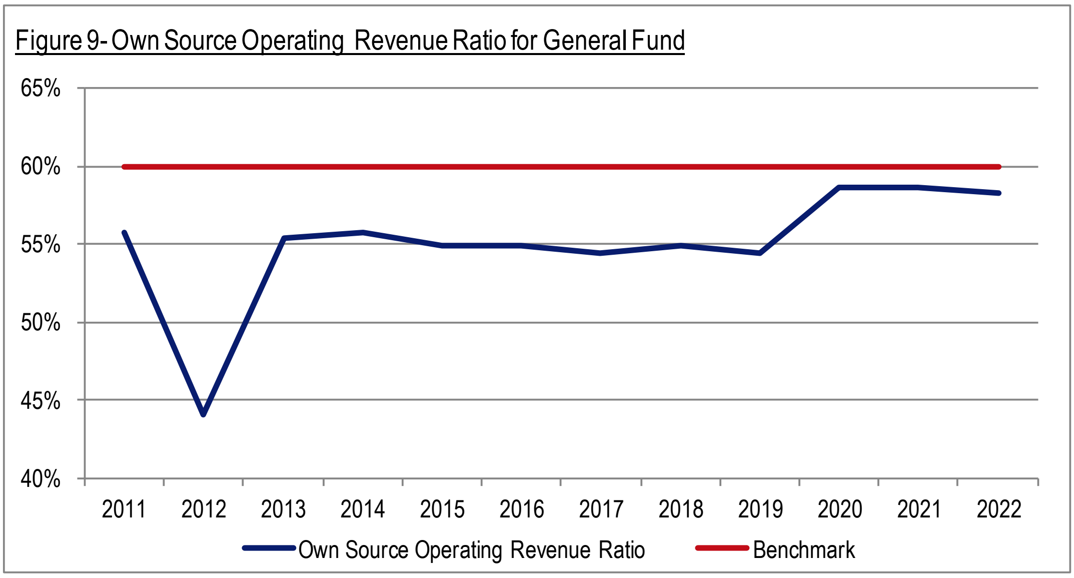


The Cash Expense Ratio is projected to decrease from the 2012 position of 11.6 months to 5.0 months in 2022. The balance of cash and cash equivalents is forecast to reduce from $17.0m in 2012 to $9.8m in 2013 and then marginally decrease each year to $8.5m in 2022 while the current liabilities are forecast to remain relatively static around $3.0m each year.

With the ratio forecast to remain above 5.0 months it appears that Council will have adequate liquidity during the forecast period albeit with a lower margin to cover any unexpected events than achieved historically.

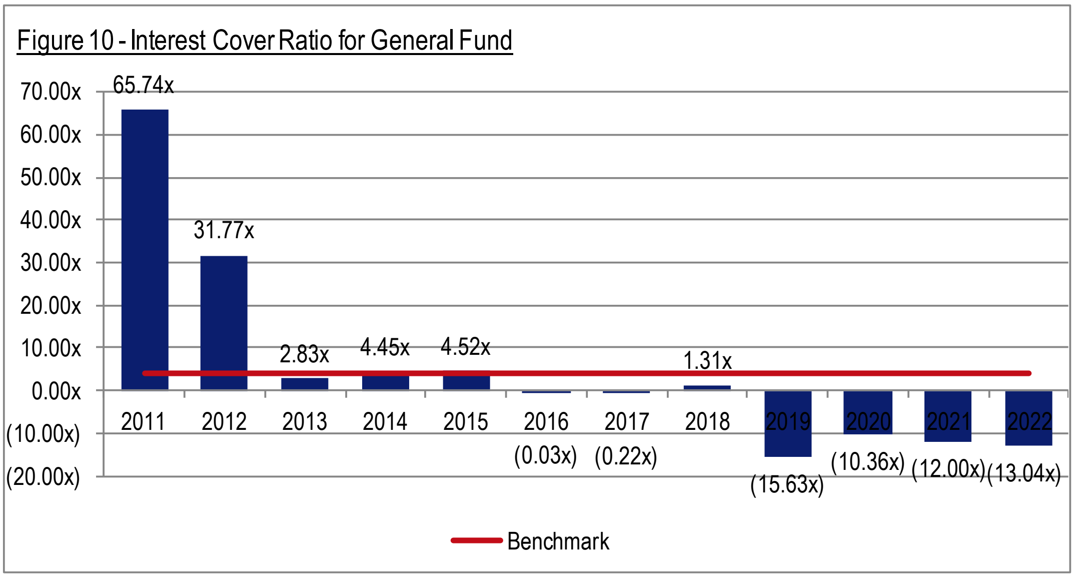
As stated above Council has not projected any performance indicators therefore the Unrestricted Current Ratio has not been forecast.

Fiscal Flexibility Ratios



The Own Source Operating Revenue Ratio is projected to improve from the low in 2012 with both operating and capital grants and contributions forecast at lower levels than received in 2012.

The increase in 2020 to 2022 has been confirmed as an error with user charges and fees increasing in these years however Council have confirmed that this is incorrect and operating grants and contributions are where the additional funds should be allocated.



The Interest Cover Ratio indicates that Council will be unable to meet the projected interest costs after 2015 without utilising reserves.

Without a statement of cashflows, we are unable to calculate the DSCR to analyse Council's ability to incorporate further borrowings, however as Council is unable to meet their interest costs we would not recommend any further borrowings for Council in addition to the approximate $0.5m drawdown scheduled within the forecast.

4.3: Capital Expenditure

Without a statement of cashflows we are unable to analyse Council's forecast capital expenditure however the balance sheet indicates that Council's IPP&E is forecast to decrease by $15.8m from 2013 to 2022 within the General Fund.

4.4: Financial Model Assumption Review

Councils have used their own assumptions in developing their forecasts.

In order to evaluate the validity of the Council's forecast model, TCorp has compared the model assumptions versus TCorp's benchmarks for annual increases in the various revenue and expenditure items. Any material differences from these benchmarks should be explained through the LTFP.

TCorp's benchmarks:

- Rates and annual charges: TCorp notes that the LGCI increased by 3.4% in the year to September 2011, and in December 2011, IPART announced that the rate peg to apply in the 2012/13 financial year will be 3.6%. Beyond 2013 TCorp has assessed a general benchmark for rates and annual charges to increase by mid-range LGCI annual increases of 3.0%
- Interest and investment revenue: annual return of 5.0%
- All other revenue items: the estimated annual CPI increase of 2.5%
- Employee costs: 3.5% (estimated CPI+1.0%)
- All other expenses: the estimated annual CPI increase of 2.5%

<u>Key Observations and Risks</u>

- Council's current service levels are forecast to remain during the LTFP period.
- Council has not yet developed any scenario analysis however this is planned for the next version of the LTFP.
- Rates and annual charges are forecast to increase between 2.9% and 3.2% p.a.
- Council has forecast a 27.8% ($1.0m) increase in user charges and fees in 2020 however TCorp has been informed that this is an error and this increase should be allocated within grants and contributions
- Council's interest and investment revenue is forecast to reduce from $0.9m in 2012 to $0.4m in 2013 and remains at $0.3m p.a. from 2014 to 2022.
- Operating grants and contributions are forecast to reduce by 44.3% ($3.8m) in 2013 from $8.5m in 2012 due to the reduced FAG and flood restoration grants not being received.
- Employee costs are forecast to increase by 4.6% in 2013 and at a rate of 3.0% p.a. thereafter.
- Council has forecast a 10.4% ($0.7m) decrease in 2013, a 15.3% ($0.9m) increase in 2016 and a 40.2% ($2.9m) increase in 2019 within materials and contracts due to changes in the allocation made to local roads and bridge maintenance.
- With the forecast being modelled prior to the Asset Revaluations, depreciation expense is lower than the 2012 historic figure and is understated throughout the LTFP.
- Council has stated that a loss from the disposal of infrastructure assets is likely to continue although this has not been included within the LTFP.
- Council's underlying assumptions appear reasonably realistic with the exception of the depreciation expenses as noted above.

4.5: Borrowing Capacity

When analysing the financial capacity of the Council we believe Council will not be able to incorporate additional loan funding in addition to its existing debt facilities and the approximate $0.5m scheduled within the LTFP. Council's forecast EBITDA is negative in six of the 10 years and operating deficits are projected in each year of the forecast indicating there is limited capacity to manage additional borrowings.

4.6: Sustainability

Financial

Based on the information reviewed, TCorp believes Council is in a weak and deteriorating financial position. Council forecasts operating deficits in all 10 years of the LTFP when capital grants are excluded, with a negative EBITDA forecast in six of the 10 years.

The limited size of the rate base makes it difficult for Council to address the future operating deficits, manage unforseen financial shocks or any adverse changes in its business and to fund the Infrastructure Backlog. In addition, Council has a very high reliance on the receipt of operating grants and contributions. Any material change in these grants could undermine Council's financial situation.

Infrastructure

In respect to transport infrastructure, Council does not have enough funding to provide all services at the current service levels or provide new services in the long term. There is an estimated $70m of assets in poor to very poor condition and Council has estimated that they are only able to provide funding for 55% of the operations, maintenance, renewal and upgrade costs of existing assets that have been identified within the transport AMP. Council has stated that despite some of these assets being classified as poor condition they are deemed to be satisfactory in relation to Special Schedule 7 and the Infrastructure Backlog total that is stated as $42.9m.

It appears that current service levels cannot be maintained in the long term and Council is planning to meet service levels that are set by Council in the annual budgets. They recognise that long term planning is required to manage any reduction in service levels over the next 10 years.

The Infrastructure Backlog is already at $42.9m in 2012 and Council is unable to reduce this figure. With a shortfall in maintenance, renewal and upgrade funding the Backlog figure is expected to increase.

In considering the longer term Sustainability of the Council we make the following comments:

- Council's forecast operating deficits that are projected to increase over the next 10 years are not sustainable
- Following the Asset Revaluations, Council has been unable to spend sufficient funds on asset maintenance, renewal or upgrades and the AMP forecasts that this is forecast to continue
- The LGA's population is expected to continue ageing over the next 10 years with Council continuing its reliance on operating grants and contributions to boost revenues

- Council has maintained a moderate level of borrowings over time. In the long term, we believe that the increasing operating deficits will prevent Council from undertaking further borrowings
- Council do not appear to have reached a developed stage of the LTFP and it is important that this is integrated with the AMP, and the LTFP produces an income statement, balance sheet and statement of cashflows
- As Council's funds are limited, service levels need to be reviewed and agreed with the community. This then needs to be incorporated into Council's LTFP

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Section 5 Benchmarking and Comparisons with Other Councils

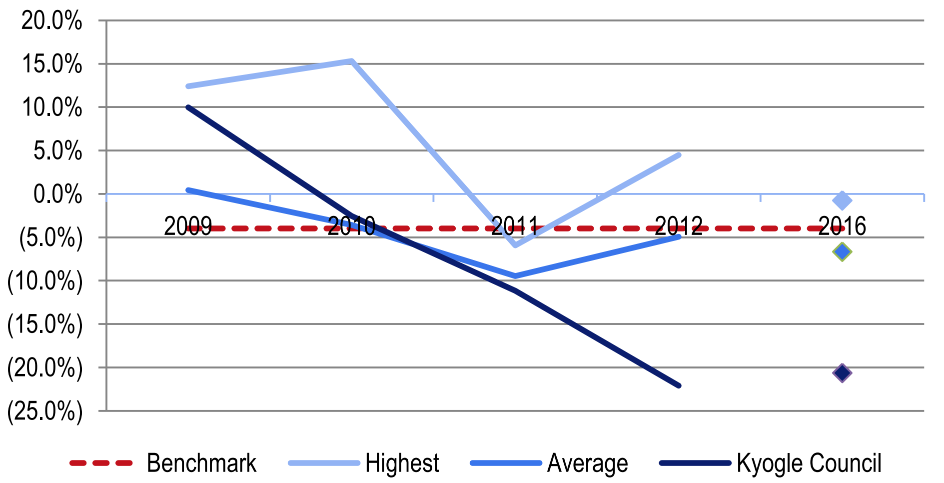
Each council's performance has been assessed against ten key benchmark ratios. The benchmarking assessment has been conducted on a consolidated basis for councils operating more than one fund. This section of the report compares the Council's performance with its peers in the same DLG Group. The Council is in DLG Group 10. There are 25 councils in this group and at the time of preparing this report, we have data for all of these councils.

In Figure 11 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 18 to 20 do not include the 2016 forecast position as those numbers are not available.

Where no highest line is shown on the graph, this means that Council is the best performer in its group for that ratio. For the Interest Cover Ratio and Debt Service Cover Ratio, we have excluded from the calculations, councils with very high ratios which are a result of low debt levels that skew the ratios.

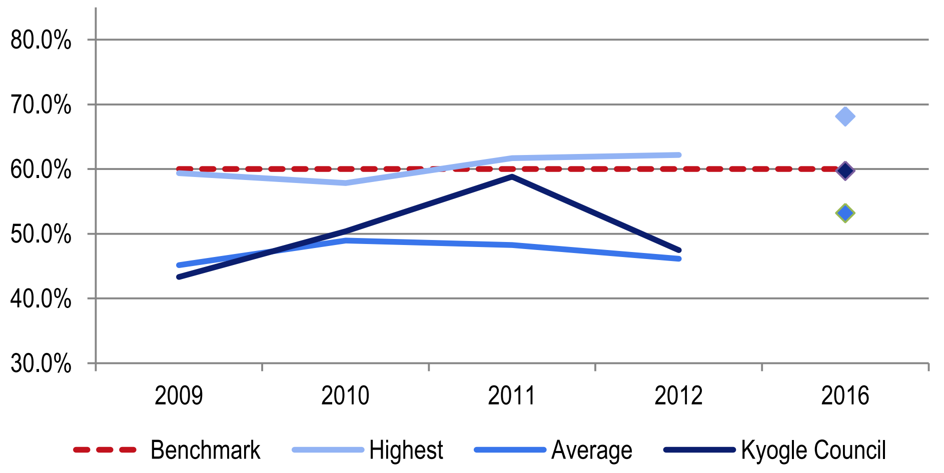
Financial Flexibility

Figure 11 - Operating Ratio Comparison



Council's Operating Ratio has been below the group average and benchmark since 2011 and is forecast to remain below both indicators

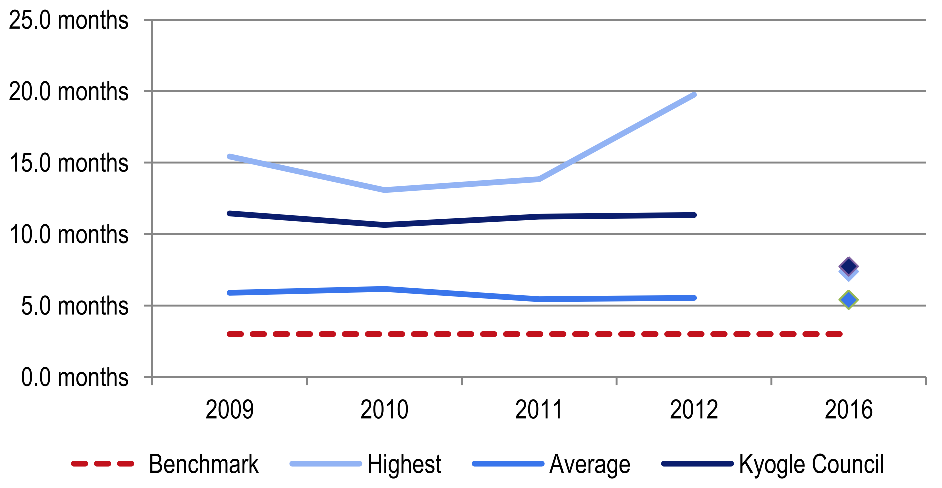
Figure 12- Own Source Operating Revenue Ratio Comparison



Council's Own Source Operating Revenue Ratio has been above the group average in three of the four years while remaining below the benchmark in each year. Council's ratio is forecast to remain above the group average and increase to a level in line with the benchmark in 2016.

Liquidity

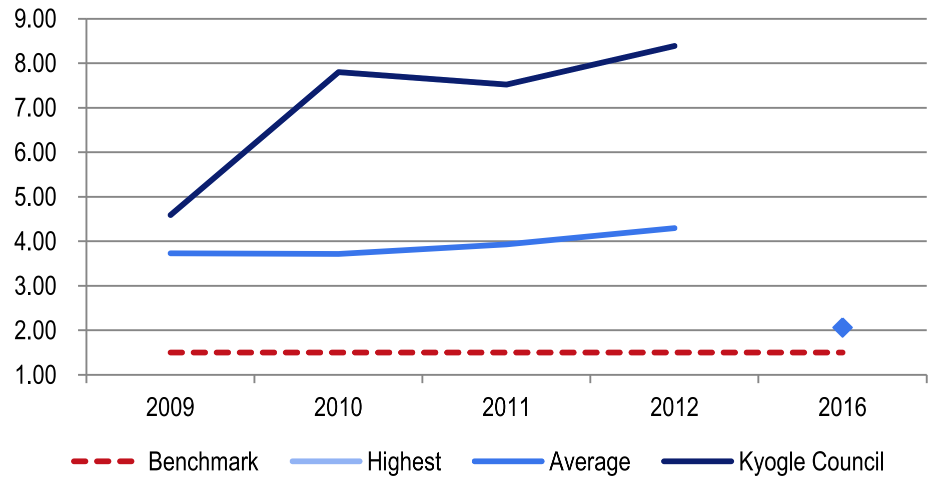
Figure 13 - Cash Expense Ratio Comparison



Council's Cash Expense Ratio has been above both the group average and benchmark in each year and this is forecast to continue although at a lower level than historically achieved.

Council has relatively high cash and cash equivalents as all their funds are held within this category, rather than in long term deposit accounts that are classified as investments and not captured within this ratio. Investing in longer term deposit accounts could increase Council's return on investments.

Figure 14 - Unrestricted Current Ratio Comparison



Council's Unrestricted Current Ratio is above the group average and benchmark. Council has not projected a forecast ratio within the LTFP.

Both liquidity ratios highlight that Council have sufficient funds to manage any short term unforeseen financial events.

Debt Servicing

Figure 15- Debt Service Cover Ratio Comparison

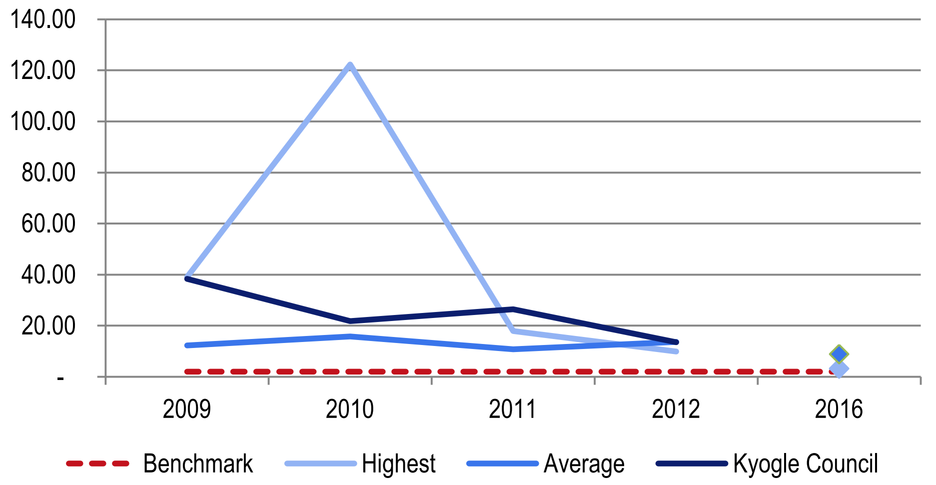
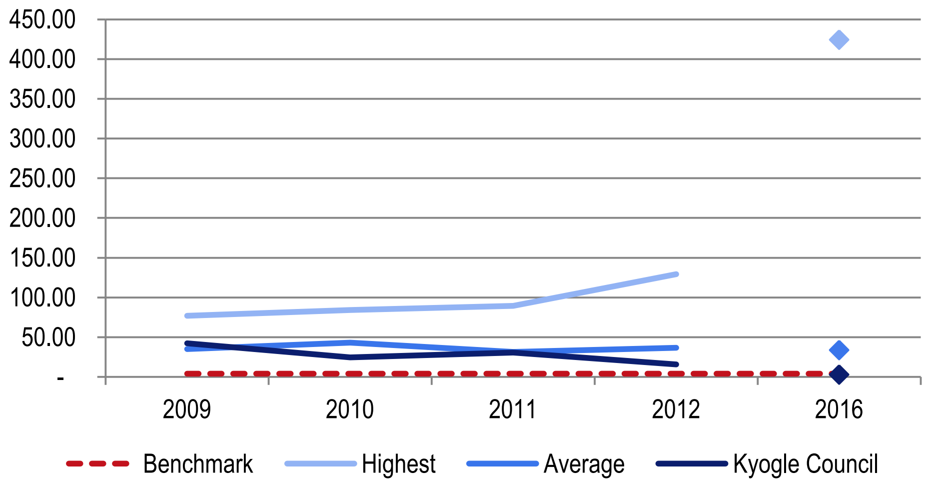


Figure 16 - Interest Cover Ratio Comparison



Council's DSCR has been above the group average until 2012 when it decreased marginally below this indicator. It has historically remained above the benchmark in each year although it has been on a downward trend. Council has not provided a statement of cashflows within their LTFP therefore there is no 2016 debt repayment figure to analyse.

The Interest Cover Ratio has also been on a downward trend while remaining above the benchmark in each year but has been below the group average since 2010. It is forecast to remain marginally above the benchmark in 2016 and below the group average indicating Council has less capacity than its peers to utilise further borrowings.

Asset Renewal and Capital Works

Figure 17 - Capital Expenditure Ratio Comparison

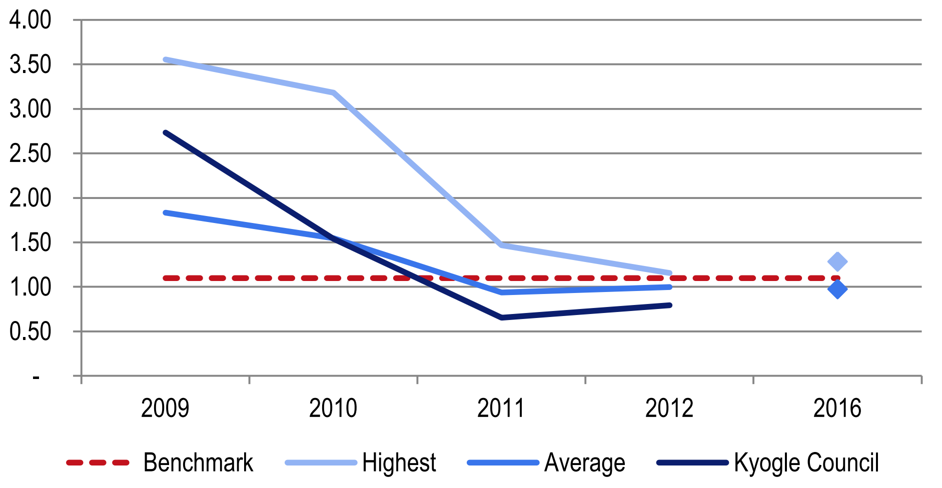


Figure 18 - Asset Maintenance Ratio Comparison

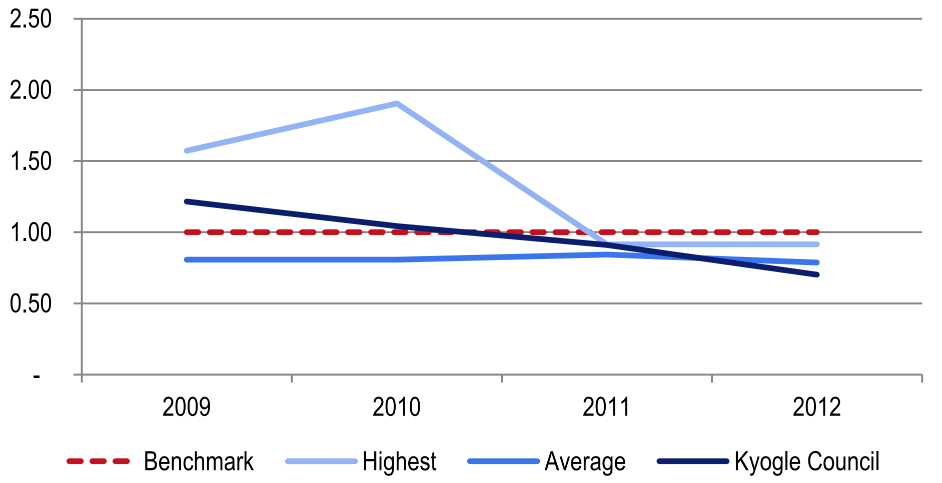


Figure 19 - Infrastructure Backlog Ratio Comparison

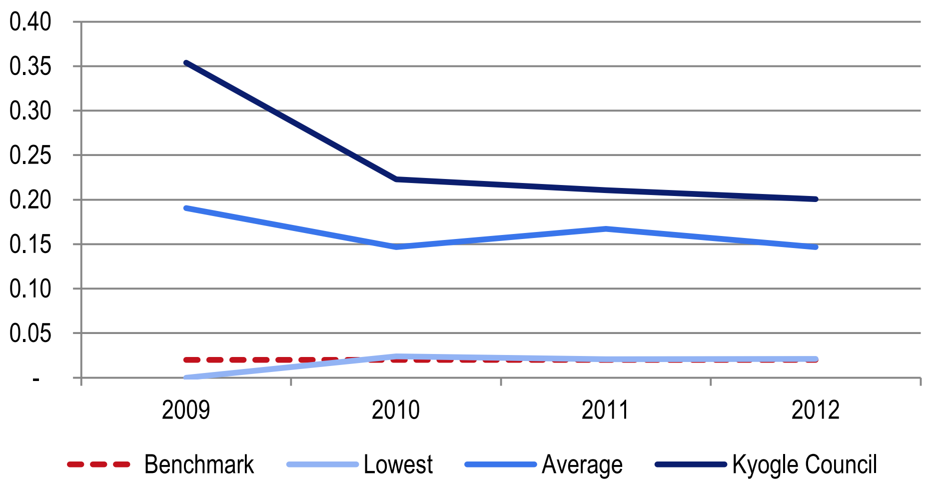
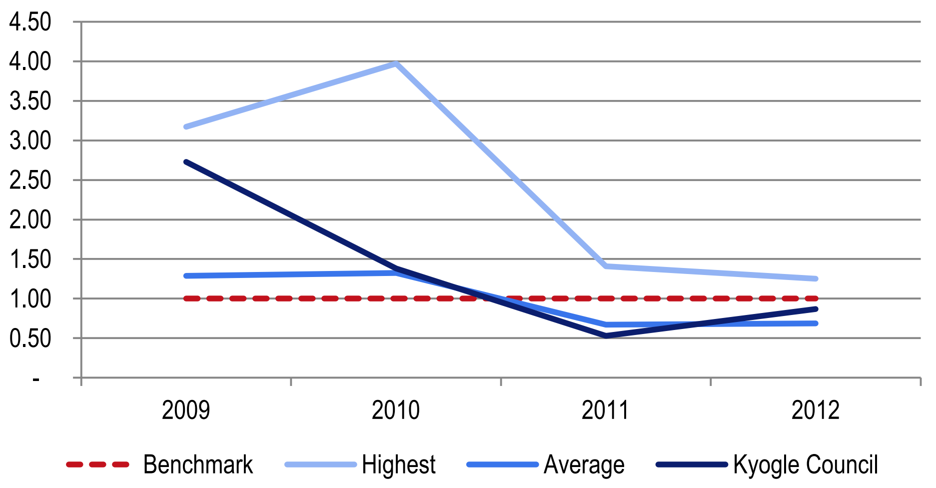


Figure 20 - Building and Infrastructure Asset Renewal Ratio



Council's Capital Expenditure Ratio has been on a downward trend, similar to the group average. Council's Capital Expenditure Ratio has been below the benchmark and group average since 2011. Council's forecast Capital Expenditure Ratio continues on the same trend and decreases further below the benchmark and group average in the medium term.

Council's Asset Maintenance Ratio has declined over the period and reduced below the benchmark in 2011 and group average in 2012.

Council's Infrastructure Backlog Ratio has decreased over review period but remains higher than the group average and benchmark. This indicates Council has comparatively a larger Backlog value than their peers.

Council's Building and Infrastructure Asset Renewal Ratio has decreased below the benchmark in 2011 however it increased above the group average in 2012. The group average is below the benchmark since 2011 which indicates the limited capacity of councils within this group to adequately spend on asset renewals.

Section 6 Conclusion and Recommendations

Based on our review of both the historic financial information and the 10 year financial forecast within Council's current version of its LTFP, we consider Council to be in a weak and deteriorating financial position. Based on the current financial position and LTFP, Council is unsustainable.

We base our recommendation on the following key points:

- Council's historic results have been on a downward trend with operating deficits experienced in the past three years
- The operating deficits are forecast to continue in each of the 10 years of the LTFP
- Council's cash position will decline and they will not have the resources to deal with unexpected events in future years
- Council's AMP projects that they do not have the funds to spend on adequate asset maintenance, renewal or upgrades for their transport assets. This results in Council's IPP&E being forecast to decrease by $15.8m from 2013 to 2022 within the General Fund while also increasing the Infrastructure Backlog during the same period

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

- Further improvements to the LTFP have been highlighted with Council completing the revised forecast for the 2014 financial year. The community's view on desired service levels need to be defined and agreed, then incorporated into future editions of its AMP and LTFP
- Council is aware that if funding levels cannot be increased then reduced service levels will need to be agreed in consultation with the community and that Council will have to manage the associated risks involved

Appendix A Historical Financial Information Tables

Table 1- Income Statement

Income Statement ($'000s)	Year ended 30 June				% annual change		
	2012	2011	2010	2009	2012	2011	2010
Revenue							
Rates and annual charges	6,772	6,372	6,105	5,869	6.3%	4.4%	4.0%
User charges and fees	6,102	7,674	5,881	5,901	(20.5%)	30.5%	(0.3%)
Interest and investment revenue	985	864	559	768	14.0%	54.6%	(27.2%)
Grants and contributions for operating purposes	8,600	7,143	7,032	9,077	20.4%	1.6%	(22.5%)
Other revenues	87	30	142	53	190.0%	(78.9%)	167.9%
Total revenue	**22,546**	**22,083**	**19,719**	**21,668**	**2.1%**	**12.0%**	**(9.0%)**
Expenses							
Employees	6,653	6,927	6,233	5,510	(4.0%)	11.1%	13.1%
Borrowing costs	183	173	162	152	5.8%	6.8%	6.6%
Materials and contract expenses	8,080	7,865	7,316	7,161	2.7%	7.5%	2.2%
Depreciation and amortisation	7,658	7,579	4,341	4,130	1.0%	74.6%	5.1%
Other expenses	1,728	1,634	1,454	1,428	5.8%	12.4%	1.8%
Loss on disposal of assets	3,223	370	714	1,126	771.1%	(48.2%)	(36.6%)
Total expenses	**27,525**	**24,548**	**20,220**	**19,507**	**12.1%**	**21.4%**	**3.7%**
Operating result	**(4,979)**	**(2,465)**	**(501)**	**2,161**	**(102.0%)**	**(392.0%)**	**(123.2%)**

Table 2 - Items excluded from Income Statement

Excluded items ($'000s)				
	2012	2011	2010	2009
Grants and contributions for capital purposes	4,582	1,802	4,065	5,498

Table 3 - Balance Sheet

Balance Sheet ($'000s)	Year Ended 30 June				% annual change		
	2012	2011	2010	2009	2012	2011	2010
Current assets							
Cash and equivalents	18,571	15,719	13,928	14,528	18.1%	12.9%	(4.1%)
Receivables	4,488	5,160	3,939	3,279	(13.0%)	31.0%	20.1%
Inventories	736	954	962	846	(22.9%)	(0.8%)	13.7%
Other	256	248	254	0	3.2%	(2.4%)	N/A
Total current assets	24,051	22,081	19,083	18,653	8.9%	15.7%	2.3%
Non-current assets							
Infrastructure, property, plant & equipment	277,394	257,690	245,873	246,362	7.6%	4.8%	(0.2%)
Total non-current assets	277,394	257,690	245,873	246,362	7.6%	4.8%	(0.2%)
Total assets	**301,445**	**279,771**	**264,956**	**265,015**	**7.7%**	**5.6%**	**(0.0%)**
Current liabilities							
Payables	2,553	1,681	1,199	2,642	51.9%	40.2%	(54.6%)
Borrowings	31	29	27	17	6.9%	7.4%	58.8%
Provisions	1,786	1,747	1,829	1,572	2.2%	(4.5%)	16.3%
Total current liabilities	4,370	3,457	3,055	4,231	26.4%	13.2%	(27.8%)
Non-current liabilities							
Payables	123	131	124	128	(6.1%)	5.6%	(3.1%)
Borrowings	1,210	1,241	1,270	1,002	(2.5%)	(2.3%)	26.7%
Provisions	1,830	2,348	1,690	1,679	(22.1%)	38.9%	0.7%
Total non-current liabilities	3,163	3,720	3,084	2,809	(15.0%)	20.6%	9.8%
Total liabilities	**7,533**	**7,177**	**6,139**	**7,040**	**5.0%**	**16.9%**	**(12.8%)**
Net assets	**293,912**	**272,594**	**258,817**	**257,975**	**7.8%**	**5.3%**	**0.3%**

Table 4-Cashflow

Cashflow Statement ($'000s)	Year ended 30 June			
	2012	**2011**	**2010**	**2009**
Cashflows from operating activities	9,700	6,550	6,520	12,914
Cashflows from investing activities	(6,819)	(4,732)	(7,398)	(12,199)
Proceeds from borrowings and advances	0	0	300	0
Repayment of borrowings and advances	(29)	(27)	(22)	(16)
Cashflows from financing activities	(29)	(27)	278	(16)
Net increase/(decrease) in cash and equivalents	**2,852**	**1,791**	**(600)**	**699**
Cash and equivalents	18,571	15,719	13,928	14,528

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Appendix B Glossary

Asset Revaluations

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

Collateralised Debt Obligation (CDO)

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

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

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

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

Division of Local Government (DLG)

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

Depreciation of Infrastructure Assets

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

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

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

EBITDA

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

Grants and Contributions for Capital Purposes

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

Grants and Contributions for Operating Purposes

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

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

Independent Commission Against Corruption (ICAC)

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

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

Independent Pricing and Regulatory Tribunal (IPART)

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

Infrastructure Backlog

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

Integrated Planning and Reporting (IP&R) Framework

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

Local Government Cost Index (LGCI)

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

Net Assets

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

Roads and Maritime Services (RMS)

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

Section 64 Contribution

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

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

Section 94 Contribution

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

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

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

Special Rate Variation (SRV)

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

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

The applications are reviewed and approved by IPART.

Sustainability

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

Ratio Explanations

Asset Maintenance Ratio

Benchmark = Greater than 1.0x

Ratio = actual asset maintenance / required asset maintenance

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

Building and Infrastructure Renewals Ratio

Benchmark = Greater than 1.0x

Ratio = Asset renewals / depreciation of building and infrastructure assets

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

Cash Expense Cover Ratio

Benchmark = Greater than 3.0 months

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

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

Capital Expenditure Ratio

Benchmark = Greater than 1.1x

Ratio = annual capital expenditure / annual depreciation

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

Debt Service Cover Ratio (DSCR)

Benchmark = Greater than 2.0x

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

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

Building and Infrastructure Backlog Ratio

Benchmark = Less than 0.02x

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

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

Interest Cover Ratio

Benchmark = Greater than 4.0x

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

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

Operating Ratio

Benchmark = Better than negative 4%

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

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

Own Source Operating Revenue Ratio

Benchmark = Greater than 60%

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

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

<u>Unrestricted Current Ratio</u>

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

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

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