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# Coffs Harbour City Council

## Financial Assessment and Benchmarking Report

4 October 2012

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

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# Disclaimer

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

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

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

The report has been prepared for Coffs Harbour City Council, the LIRS Assessment Panel and the DLG. TCorp shall not be liable to Coffs Harbour 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 Coffs Harbour City Council's (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 application for the repaving of the Coffs Harbour Regional Airport runway for $5.0m to be repaid over 10 years.

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. For the Council, the project is being funded from the General Fund so we focused our review on the General Fund

Overall, the review has found that the Council has been satisfactorily 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 results (measured using EBITDA) have improved each year from $35.8m in 2009 to $43.0m in 2011
- Council's Unrestricted Current Ratio has been well above benchmark the past three years indicating Council has sufficient liquidity

Council reported an Infrastructure Backlog of $62.5m in 2011 which represents 5.4% of its infrastructure asset value of $1,159.8m. Other observations include:

- The required asset renewal benchmarks are not being met to keep the assets in their current condition, therefore it is likely that the backlog will grow
- Council's infrastructure, particularly the road network, has been negatively affected by natural disasters and adverse weather conditions in recent years. This has increased the cost of maintaining the road network to current standards, which has resulted in other capital projects being delayed

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

- The General Fund is likely to be unsustainable in the long term. Forecast expenses outstrip revenue, which leads to an increasing deficit each year
- The General Fund will not generate sufficient funds for capital expenditure to match depreciation of its assets. It is likely that Council will need to review current service levels, or raise additional revenues to generate funds to keep infrastructure to their current standards

Despite these areas of concern in our view, the Council has the capacity to undertake the additional borrowings of $5.0m within the General Fund for the LIRS project. This is based on the following analysis:

- The forecast DSCR remains at a level above the benchmark of 2.00x each year of the forecast period
- The Interest Cover Ratio is above the benchmark of 4.00x each year in the 10 year forecast

Before analysing Council's capacity for further debt beyond the proposed LIRS borrowings, TCorp would need to analyse full year audited accounts for at least two more years (ie 2012 and 2013) to see if anticipated increases in own sourced revenue within the Council forecast are achieved.

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 generally below the group's average
- Council currently is more heavily geared than its peers with its DSCR and Interest Cover Ratio below the group average though in the medium term Council is forecasting marginally improving ratios to be close to benchmark
- 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 and Infrastructure Backlog are stronger than its peers though they 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

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## 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

| Coffs Harbour City Council LGA | |
|---|---|
| Locality & Size | |
| Locality | Mid North Coast |
| Area | 1,174 km² |
| DLG Group | 5 |
| Demographics | |
| Population | 68,413 |
| % under 20 | 25% |
| % between 20 and 59 | 49% |
| % over 60 | 26% |
| Expected population 2025 | 85,900 |
| Operations | |
| Number of employees (FTE) | 515 |
| Annual revenue | $119.0m |
| Infrastructure | |
| Roads | 831.6 km |
| Bridges | 171 |
| Infrastructure backlog value | $62.5m |
| Total infrastructure value | $1,159.8m |

Coffs Harbour City Council Local Government Area (LGA) is located midway between Sydney and Brisbane. The LGA encompasses a total area of 1,174 square kilometres of land stretching from Red Rock, south to Bundagen and west past Brooklana and Lowanna.

The LGA is a predominantly rural area, with expanding residential, rural-residential and resort areas and some industrial and commercial use land. Much of the rural area is used for timber production and agriculture, particularly banana growing. Tourism is also an important industry, especially along the coast.

The LGA has proved a popular place for retirees and this has fuelled population growth in recent years. The median age in the LGA is 42 compared to 38 state-wide, and it is forecast that the median age in the LGA will be 49 in 2021.

## 2.4: LIRS Application

Council has made one LIRS application.

Project: Coffs Harbour Regional Airport Runway Renewal

Description: Resurfacing of the main runway at Coffs Harbour Regional Airport

Amount of loan facility: $5.0m

Term of loan facility: 10 years

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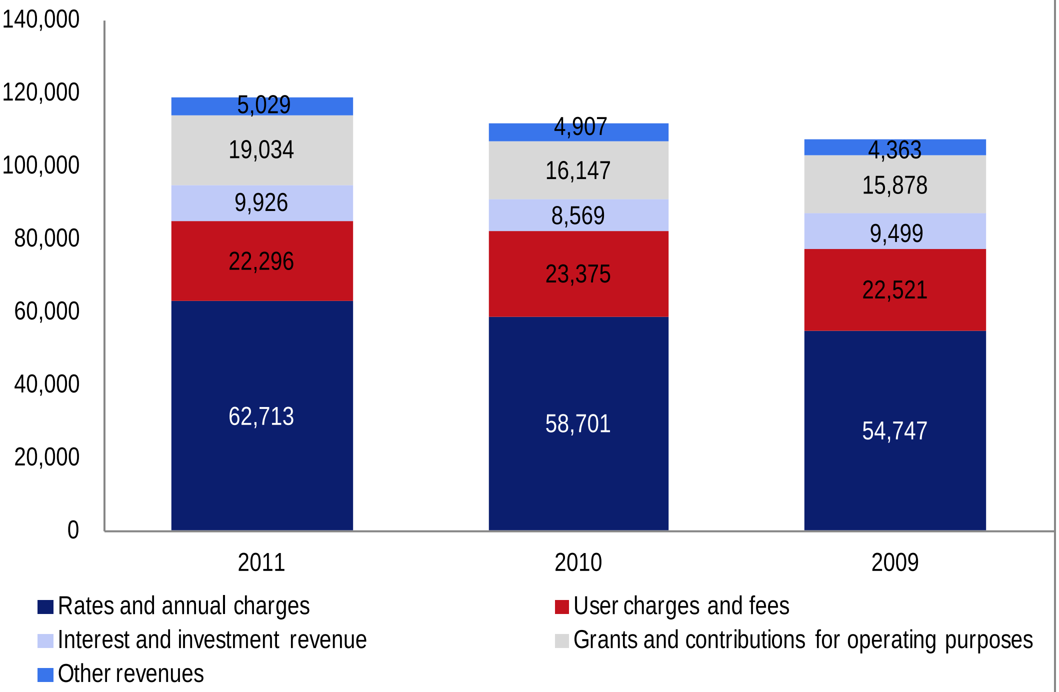
# Section 3 Review of Financial Performance and Position

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)



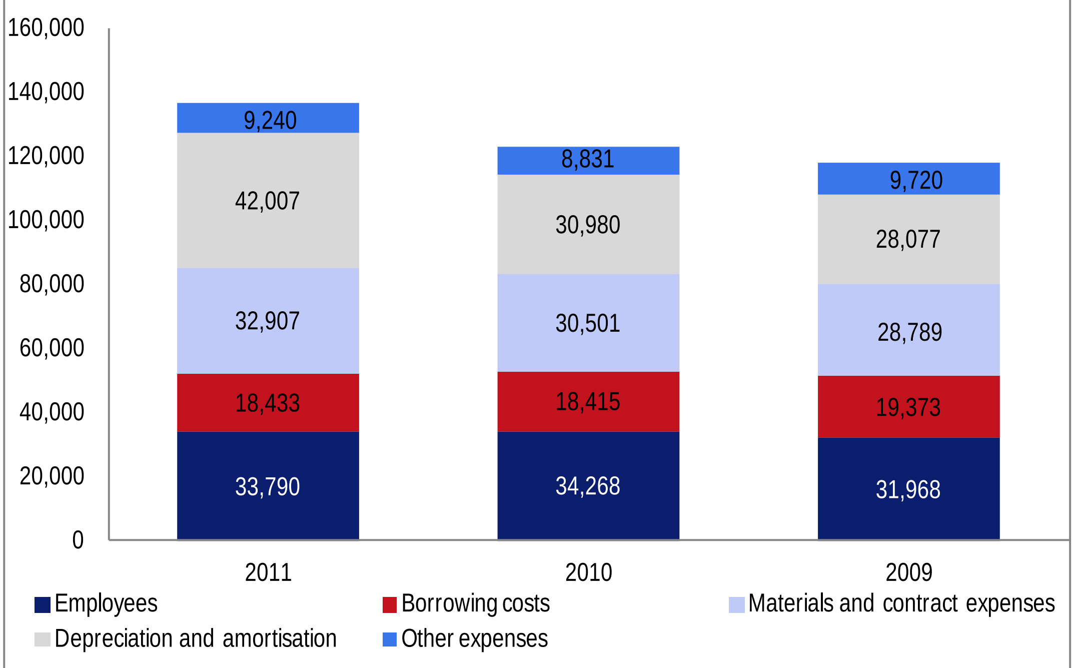

Key Observations

- Rates and annual charges have increased in line with the rate peg increments plus a 4.4% SRV in 2011 in relation to flood mitigation and drainage charges.
- Since 2000, the Council has levied the owners of business premises in the Coffs Harbour city centre with a special business rate to fund city centre improvements. This levy expired in 2012 and was recently extended by IPART for a further year. Council wanted to extend the levy for 10 years but this was denied as IPART decided that Council should reapply the following year setting out a works program for the city centre.
- Council generate user fees and charges from areas such as the airport and an environmental laboratory, as well as traditional council revenue streams such as water supply services charges and waste management services charges. Total revenue from user fees and charges decreased in 2011 due to a fall in water consumption. While the airport generated an operating surplus of $0.8m in 2011, the environmental laboratory reported a deficit of $0.3m.
- Operating grants and contributions were boosted in 2011 by a $1.7m contribution from the RMS. This contribution relates to handover conditioning works and represents 10 years worth

of maintenance funding for a road known as Pine Creek Way (part of the old Pacific highway) which is now the responsibility of Council

## 3.2: Expenses

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




Key Observations

- Employee costs increased by 7.2% in 2010, and then decreased by 1.4% in 2011 to $33.8m. Employee costs rose in 2010 due to salary increments, an additional 12 full time employees, and increased superannuation costs. Employee costs fell in 2011 mainly due to decreased employee long service leave expenses due to the departure of long term staff members, and decreased workers compensation policy premiums.
- Materials and contract costs have been increasing each year due to rising contractor and consultancy costs. Council received increased operational grants in 2011 which required the engagement of additional contractors.
- In 2010 the Asset Revaluations increased the value of Council's infrastructure assets by $344.6m. This resulted in the annual depreciation charge increasing by 35.6% in 2011 to $42.0m.

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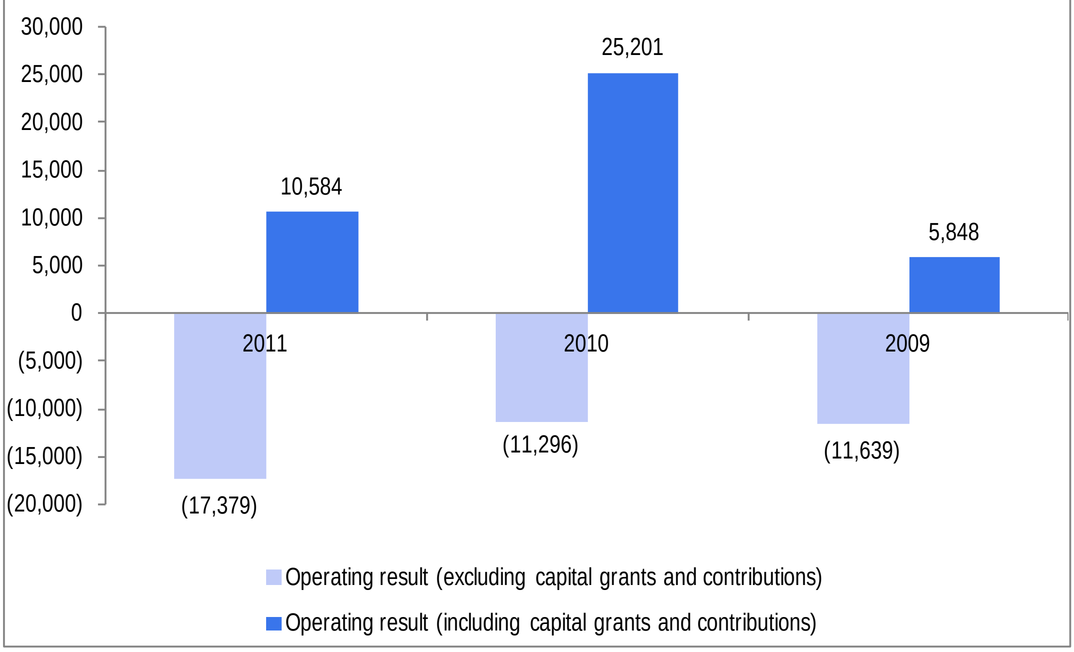
## 3.3: Operating Results

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 2010/11 ($'000s)




Key Observations

- Council has consistently posted net operating deficits excluding capital grants and contributions. The deficit increased in 2011 due to increased depreciation charges of $11.0m. Excluding the impact of this increased depreciation of $11.0m for the 2011 year, shows an improved operating result of a deficit of $6.352m.
- Council expenses include a large non-cash depreciation expense ($42.0m in 2011), that has increased substantially over the past three years 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.

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## 3.4: Financial Management Indicators

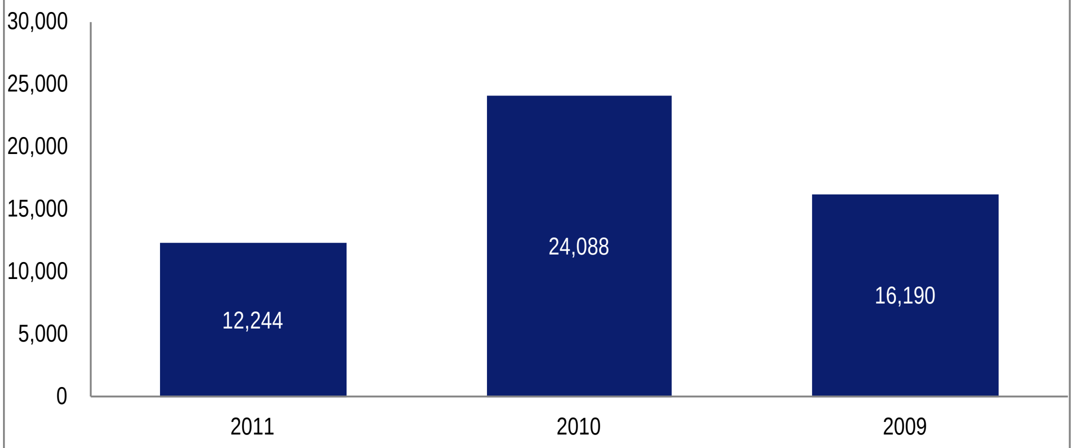
| Performance Indicators | Year ended 30 June | | |
|---|---|---|---|
| | 2011 | 2010 | 2009 |
| EBITDA ($'000s) | 43,061 | 38,099 | 35,811 |
| Operating Ratio | (14.6%) | (10.1%) | (11.0%) |
| Interest Cover Ratio | 2.34x | 2.07x | 1.85x |
| Debt Service Cover Ratio | 1.26x | 1.12x | 1.07x |
| Unrestricted Current Ratio | 3.22x | 2.35x | 2.09x |
| Own Sourced Revenue | 57.8% | 55.4% | 62.4% |
| Cash Expense Ratio | 1.9 months | 3.9 months | 2.8 months |
| Net assets ($'000s) | 1,519,381 | 1,526,881 | 1,049,839 |

Key Observations

- Council's underlying operating performance (measured using EBITDA) increased over the three year period.
- Council's Interest Cover Ratio and DSCR are both well below benchmarks indicating that they have limited flexibility in regard to carrying additional debt. Performance against the benchmarks has improved over the past three years. Council had $256.5m (16.9% of Net Assets) in borrowings outstanding in 2011 of which $221.0m is related to an extensive capital works program in the Water and Sewerage Funds undertaken over recent years.
- The Unrestricted Current Ratio has been above the benchmark of 1.50x over the past three years, indicating that Council had acceptable liquidity although performance against the cash expense ratio benchmark has been declining.
- Net Assets have increased by over $469.5m between 2009 and 2011 due to the consecutive Asset Revaluations in 2010, and 2011, which increased the value of Council's infrastructure assets.
- The Asset Revaluations over the last three years have resulted in a high level of volatility in Net Assets over this period. 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 the Asset Revaluations are excluded, the underlying trend in all three years has been an expanding infrastructure, property, plant, and equipment (IPP&E) asset base with asset purchases being larger than the combined value of disposed assets and annual depreciation. Over the three years this amounted to an $81.9m increase in IPP&E assets.

## 3.5: Statement of Cashflows

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




Key Observations

- Cash and cash equivalents decreased in 2011, however total cash and investments increased from $151.9m in 2010 to $171.8m in 2011.
- Within Council's total cash and investments of $171.8m in 2011, $130.0m is externally restricted, $38.8m is internally restricted and $3.0m is unrestricted.
- Within Council's investments were $85.8m in long term deposits, $9.0m in managed funds, $3.0m in CDOs, and $17.4m in constant protection portfolio notes (CCPI). During the 2012 financial year, Council has been able to sell most of its CPPI. By June 2012, Council's exposure to CPPI had reduced to $6.3m. Council expect to receive 100% of their carrying value back when they mature between November 2012 and August 2013.
- The cash reserves, along with the Unrestricted Current Ratio, indicate Council has sufficient liquidity to meet its day to day obligations.

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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

Figure 5 - Infrastructure Backlog for 2008/09 to 2010/11 ($'000s)

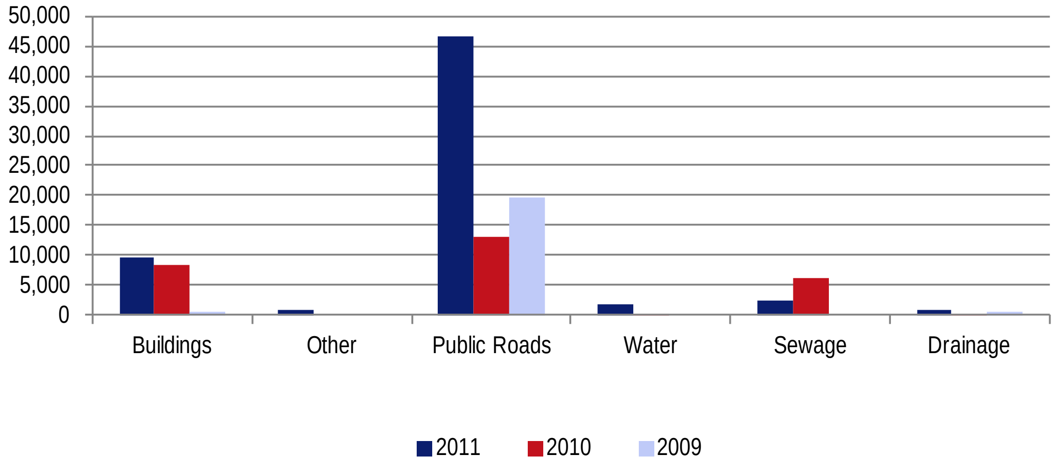
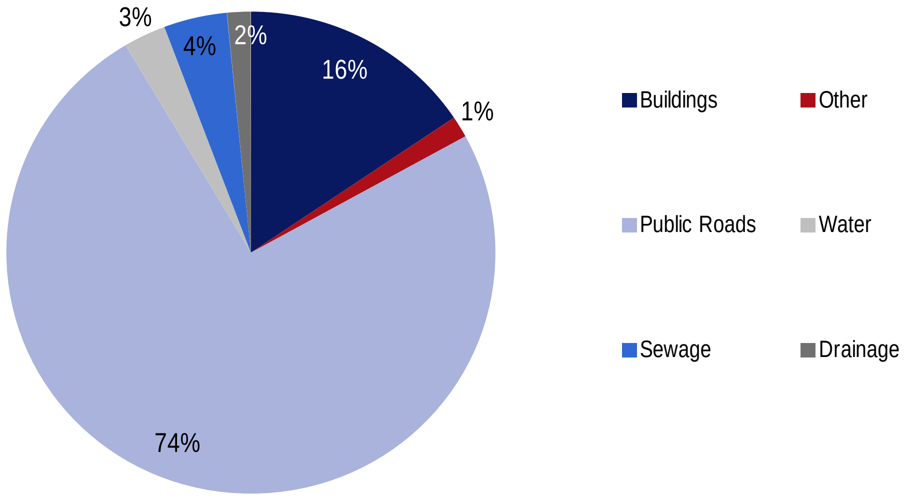



Figure 6 - Infrastructure Backlog Composition for 2010/11




The Council reported a $62.5m backlog in 2011 up from a reported backlog of $21.0m in 2009. The Infrastructure Backlog is 74.4% road related. Council is aware of the extent of the backlog and the risks it represents to the sustainability of the LGA, but has found that community concern is generally driven by specific interests.

In the past three years the road network has deteriorated markedly. Since February 2009 the LGA has experienced flooding after several significant storm events, with the LGA being declared a natural disaster area on four occasions. As a consequence of receiving much higher than average rainfall over a number of years, the road network has required significantly more maintenance resources than in previous years.

By April 2012 there was around 19km of local and regional roads that are rated unserviceable and 51km that were in poor condition in need of significant renewal or upgrade. Road maintenance budgets have not been able to cope with demand on continual road patching works required by these failing pavements. The city works department has noticed that there has been an increase in community comment and customer complaint regarding the condition of the road network and the time it now takes before potholes are patched.

### 3.6(b): Infrastructure Status

| Infrastructure Status | Year ended 30 June | | |
|---|---|---|---|
| | 2011 | 2010 | 2009 |
| Bring to satisfactory standard ($'000s) | 62,504 | 28,158 | 21,030 |
| Required annual maintenance ($'000s) | 15,625 | 15,145 | 20,139 |
| Actual annual maintenance ($'000s) | 15,385 | 14,323 | 11,088 |
| Total value infrastructure assets ($'000s) | 1,159,783 | 1,217,959 | 859,397 |
| Total assets ($'000s) | 1,804,977 | 1,811,287 | 1,346,848 |
| Infrastructure Backlog Ratio | 0.05x | 0.02x | 0.02x |
| Asset Maintenance Ratio | 0.98x | 0.95x | 0.55x |
| Building and Infrastructure Asset Renewal Ratio | 0.12x | 0.24x | 0.24x |
| Capital Expenditure Ratio | 0.94x | 1.80x | 3.20x |

The Building and Infrastructure Asset Renewal Ratio is not meeting the benchmark and indicates that Council did not spend enough on asset renewal in all three years. The Capital Expenditure Ratio has generally been exceeding the benchmark due to Council's participation in the Country Towns Water Supply and Sewerage Program. Please see section 3.6 (c) for more details.

Council is currently reviewing its infrastructure requirements and will present these in a second Asset Management Plan. Following the availability of this plan and in conjunction with a review of current service levels, Council will be endeavouring to address its maintenance and renewals 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 | | |
|---|---|---|---|
| | 2011 | 2010 | 2009 |
| New capital works | 36,929 | 50,799 | 88,733 |
| Replacement/refurbishment of existing assets | 4,027 | 6,484 | 5,049 |
| Total | 40,956 | 57,283 | 93,782 |

Both the Water and Sewerage Funds have undertaken extensive programs of capital works in recent years. Capital expenditure in the last three years has been dominated by Council's participation in the Country Towns Water Supply and Sewerage Program. This project has seen the construction of a water treatment plant and a water reclamation plant. Work is progressing on the final project: the decommissioning of the Sawtell Sewerage Treatment Plant and the construction of a sewerage trunk main from Sawtell to Coffs Harbour.

The level of capital works undertaken each year is dependent on additional projects that arise each year such as flood works, or new grant projects, and there are usually some projects that are required to be pushed back to future financial years.

### 3.7: Specific Risks to Council

- Climate change. Council has a large sea frontage and rising sea levels will impact as well as potential increased storm and rainfall events. Council levied a 4.4%SRV in 2011, with the proceeds to be expended on flood mitigation and drainage.
- Ageing population. The LGA has an increasing population fuelled by an influx of retirees. Council over the past decade have undertaken major water and sewerage infrastructure works costing more than $250.0m. These works will enable the LGA to sustain population growth over the next 50 years. Also Coffs Harbour is a Group 1 Council, having implemented the State Government's Integrated Planning and Reporting Framework in July 2010. This framework supports Council's long term Community Strategic Plan.
- Asset failure. Over 19km of roads were rated unserviceable in 2012. Council manages this issue by deferring capital projects to future financial years to concentrate on the most urgent work required. This is not a sustainable solution.
- Natural disasters. The LGA has been declared a natural disaster area four times in the last three years. As a result Council have had to prioritise repair work at the expense of other projects which are deferred in Council's delivery program.
- Council held $6.3m in Constant Protection Portfolio Notes as at June 2012. These grandfathered investments are no longer prescribed by State government. These notes theoretically allow an investor to maintain an exposure to the upside potential of a risky asset while providing a capital guarantee against downside risk. Council currently hold two Lehman products which were purchased for $0.8m and now have a carrying value of $0.1m. Council have shown their willingness to mitigate against this risk by disposing of $11.4m of these assets

in 2012. The remaining assets (with the exception of the Lehman products) have a credit rating of between BBB and AA+.

- As at June 2011, $3.0m of Council's investments were held in CDOs. CDOs are not capital protected and the return to Council on their maturity is largely dependent on the number of defaults occurring in the underlying "basket" of securities comprising the investment. Councils CDO investments as at June 2012 have reduced in value to $1.0m. This is mainly due to a CDO product maturing in 2012. Council's remaining CDOs are products previously distributed by Lehmann Brothers and remain part of current legal proceedings.

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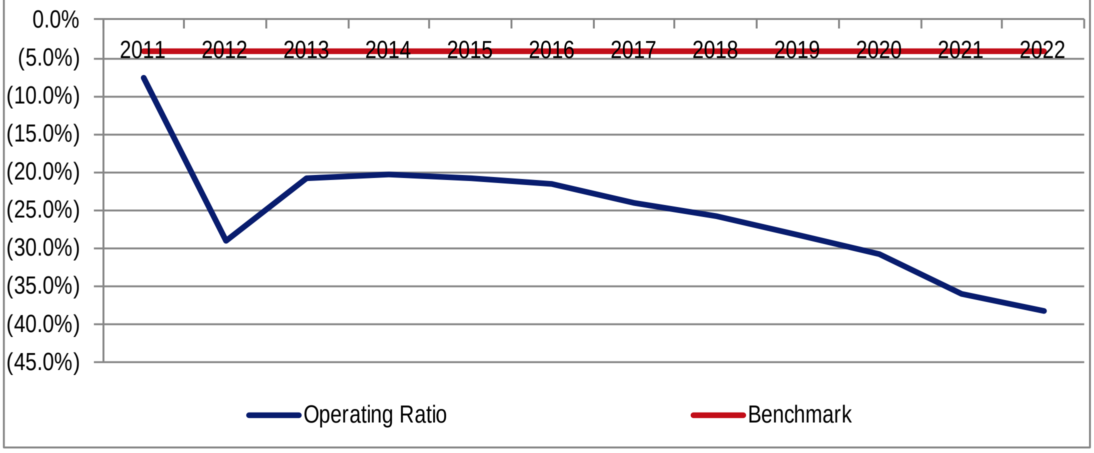
## Section 4 Review of Financial Forecasts

The financial forecast model shows the projected financial statements and assumptions for the next 10 years. The model includes the $5.0m loan without any LIRS subsidy. Also included in the model are other borrowings of $2.8m for land acquisitions, and community group funding in 2013.

The LIRS loan relates to the General Fund, therefore we have focused our financial analysis solely upon this Fund. Council's consolidated position includes both a Water and Sewer Fund however 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.

### 4.1: Operating Results

Figure 7- Operating Ratio for General Fund




The Operating Ratio is below the benchmark and forecast to decrease over time. Council has continuing issues in regard to a balanced General Fund against a background of cost increases which outstrip revenue increases, and increased community expectations. The deficit increases significantly in 2012 due to operating grants and contributions forecasting to drop due to natural disaster grants from State and Federal Government decreasing.

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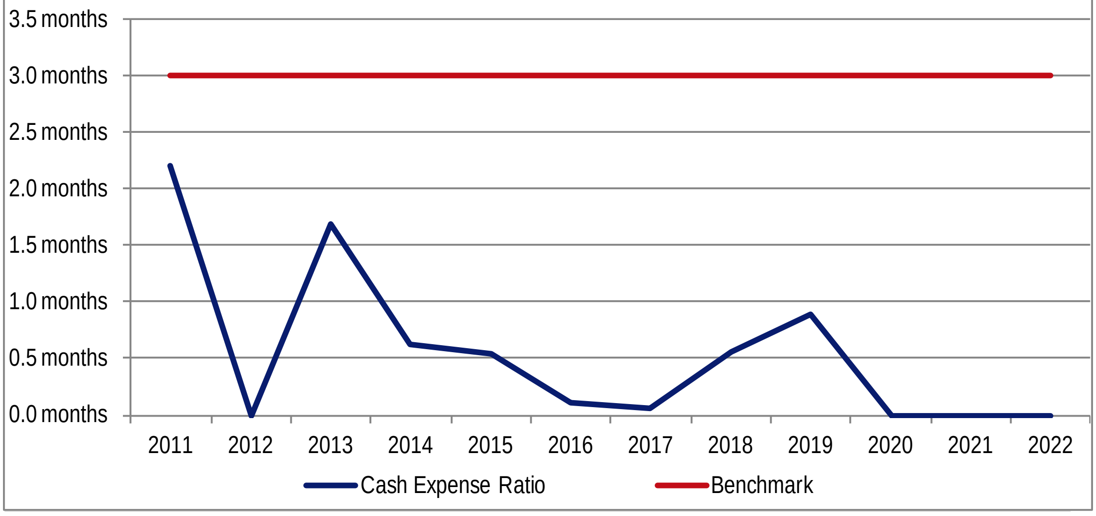
## 4.2: Financial Management Indicators

The financial management indicators are linked to the utilisation of debt in early years and improve over time as the amortising debt reduces.

Liquidity Ratios

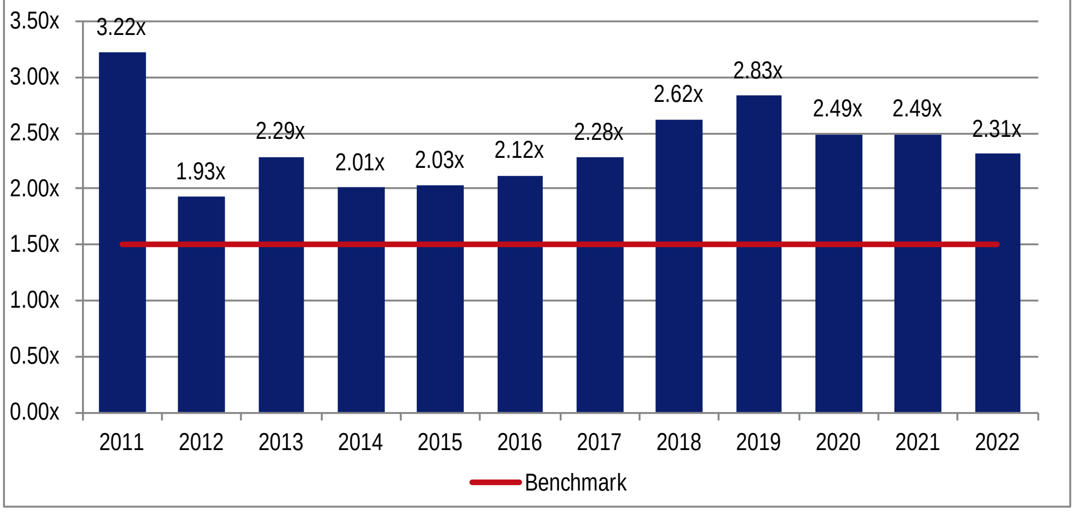
Figure 8 - Cash Expense Ratio for General Fund




Council's Cash Expense Ratio is not meeting the benchmark in any year. Council is also hampered by zero cash reserves in 2012 and from 2020 onwards. This ratio does not take into account Council's level of investments. When current investments are considered, Council has a satisfactory liquidity position, and would be above the benchmark for the majority of the forecast. See section 3.5 for more detail on the composition of Council's investments.

The reduction of Cash & Cash Equivalents to zero is a product of how Council's LTFP operates. In reality, longer term investments would be reduced sufficiently to maintain a reasonable cash and cash equivalents position.

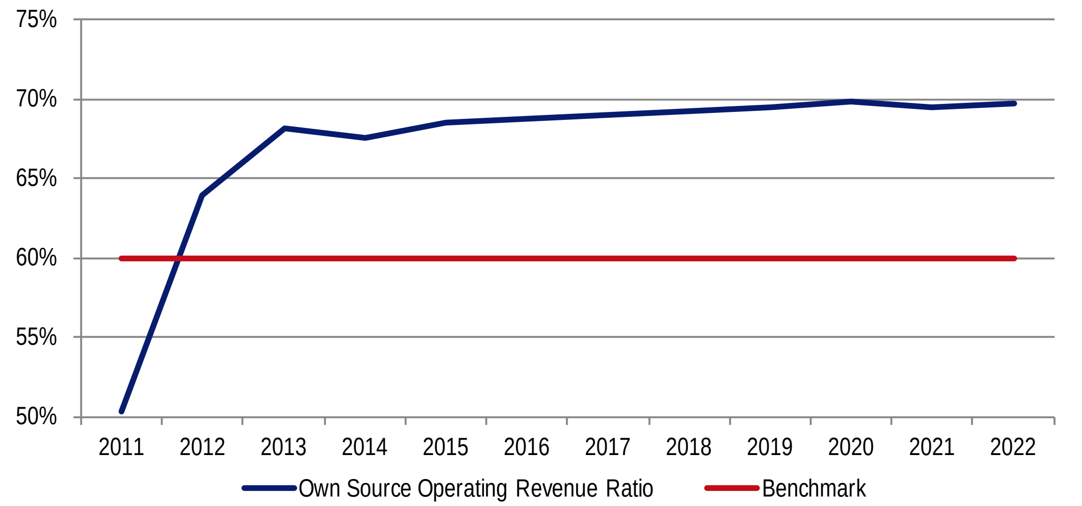
Figure 9 - Unrestricted Current Ratio for General Fund




The Unrestricted Current Ratio indicates that Council will have sound liquidity. Council should be able to service all short and long term liabilities and currently scheduled capital expenditure.

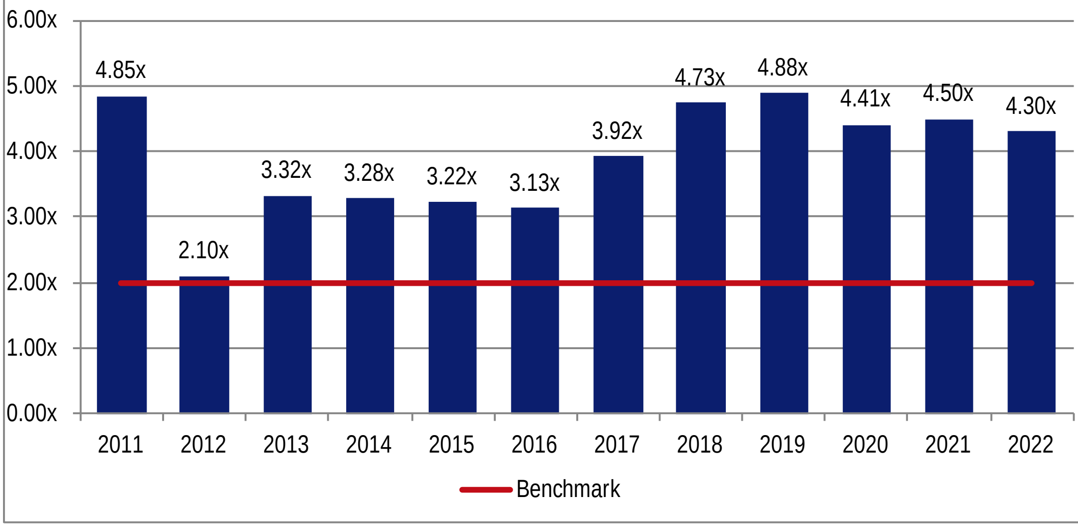
Fiscal Flexibility Ratios

Figure 10 - Own Source Operating Revenue Ratio for General Fund



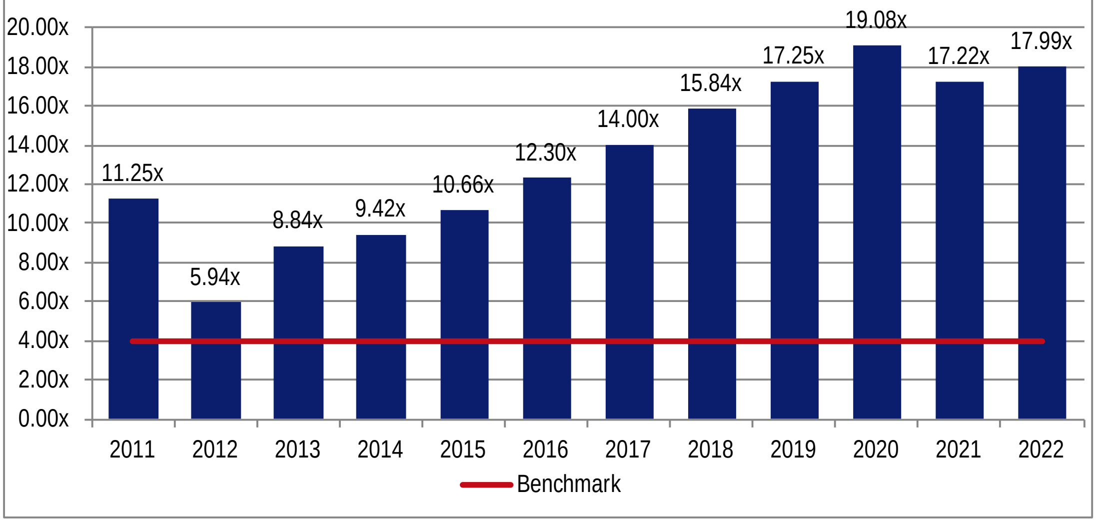

The Own Source Operating Revenue Ratio remains above the benchmark for each year of the forecast from 2012 onwards. The ratio is rising over the lifetime of the forecast due to capital grants and contributions forecast being lower than historically received. This skews the proportion of Own Source Revenue Ratio upwards. Also affecting the ratio is a 12.0%increase in user fees and charges in 2012 due to increases in waste fees. Council are currently reviewing commercial opportunities such as the commercialisation of the City Works function related to private works, expansion of consultancy services for information and technology services, and expansion of Council run conferences.

Figure 11 - DSCR for General Fund




The DSCR shows that Council has the capacity to service the $5.0m loan relating to the runway project, and the other planned borrowings of $2.8m in 2013. Outstanding borrowings in the General Fund will peak in 2013 at $30.2m reducing to a low of $5.6m in 2022.

Figure 12 - Interest Cover Ratio for General Fund




The Interest Cover Ratio, similar to the DSCR, shows the Council has sufficient capacity to service scheduled debt commitments, including the LIRS loan. There is capacity to service further debt interest costs before the Council's ratio decreases to the 4.00x benchmark.

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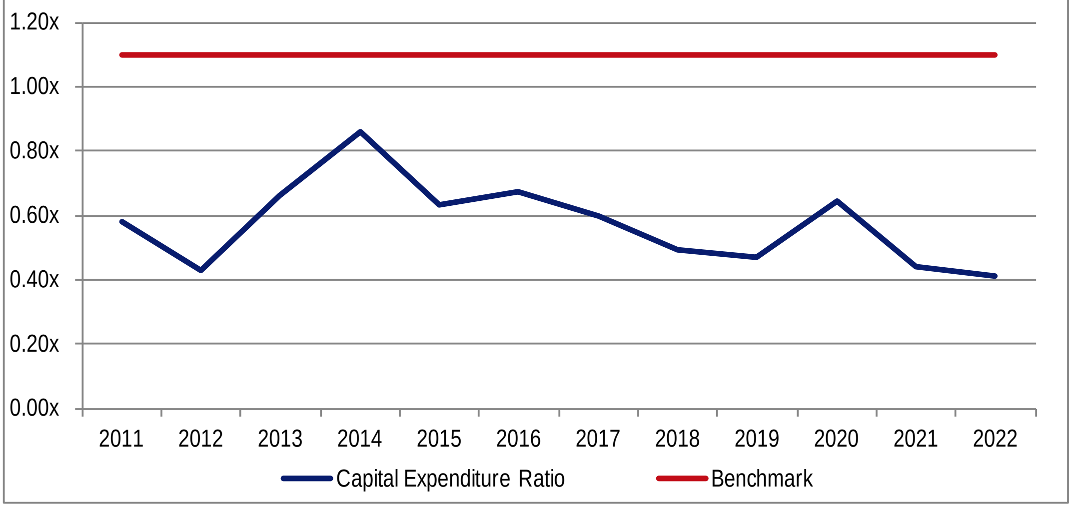
## 4.3: Capital Expenditure

Figure 13 - Capital Expenditure Ratio for General Fund




Due to Council's ongoing issues in relation to achieving a balanced general Fund, Council do not meet the Capital Expenditure Ratio benchmark in any year. The General Fund faces the challenge of limited funds to address the backlog and current requirements for infrastructure renewal and maintenance.

The capital budget for the General Fund for the lifetime of the forecast is $237.6m of which 50.0% is road related expenditure. 56.6% of council expenditure is on asset renewal with the remainder on new assets. Council will to need to continually review this strategy to ensure that capital expenditure is being spent on the most vital projects.

## 4.4: Financial Model Assumption Review

Councils have used their own assumptions in developing their forecasts.

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

TCorp's benchmarks:

- Rates and annual charges: TCorp notes that the LGCI increased by 3.4% in the year to September 2011, and in December 2011, IPART announced that the rate peg to apply in the 2012/13 financial year will be 3.6%. Beyond 2013 TCorp has assessed a general benchmark for rates and annual charges to increase by mid-range LGCI annual increases of 3.0%
- 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%

<u>Key Observations and Risks</u>

- The LTFP assumes current service levels will be maintained.
- TCorp find the majority of the assumptions behind the forecast reasonable with one notable exception.
- Council has forecast that employee costs will increase by over 6.0% p.a. due to salary increments and staff moving to higher pay grades. Increases of this level are significantly above our benchmarks and as revenue is constrained by the rate peg while employee costs continue to increase at rates higher than 6%, it is likely the General Fund will become unsustainable over time unless savings can be achieved in respect of these employee costs.
- The airport runway project will provide great community benefit by maintaining the main runway at Coffs Harbour Regional Airport to Boeing 767 standard, which is vital to meet the future growth of the region and to accommodate current and future jet operations.

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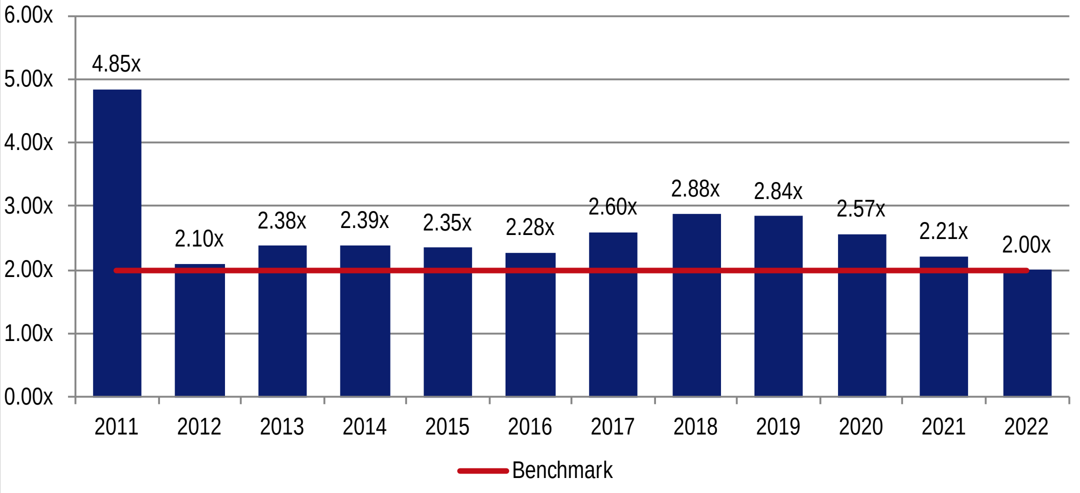
## 4.5: Borrowing Capacity

When analysing the financial capacity of the Council we believe Council may be able to incorporate additional loan funding in addition to the LIRS loan facilities. Some comments and observations are:

Figure 14 - DSCR for General Fund with additional borrowings of $15.1m




- TCorp cannot recommend any further borrowing beyond the existing planned borrowings of $7.8m until the audited 2012 and 2013 results are available for examination due to the forecast 12.0% increase in user fees and charges included in the LTFP and to see if employee costs rise at the projected 6.0% rate
- Based on a benchmark of DSCR>2x, $15.1m could be borrowed in addition to the $5.0m borrowings proposed under LIRS, and the other proposed borrowings of $2.8m in 2013.
- This scenario has been calculated by basing additional borrowing capacity on a 10 year amortising loan with an interest rate of 6.8%
- Council are currently not considering any additional borrowing, as they think that any additional loan repayments are likely to have a further negative impact on council's General Fund Operating result.

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# Section 5 Benchmarking and Comparisons with Other Councils

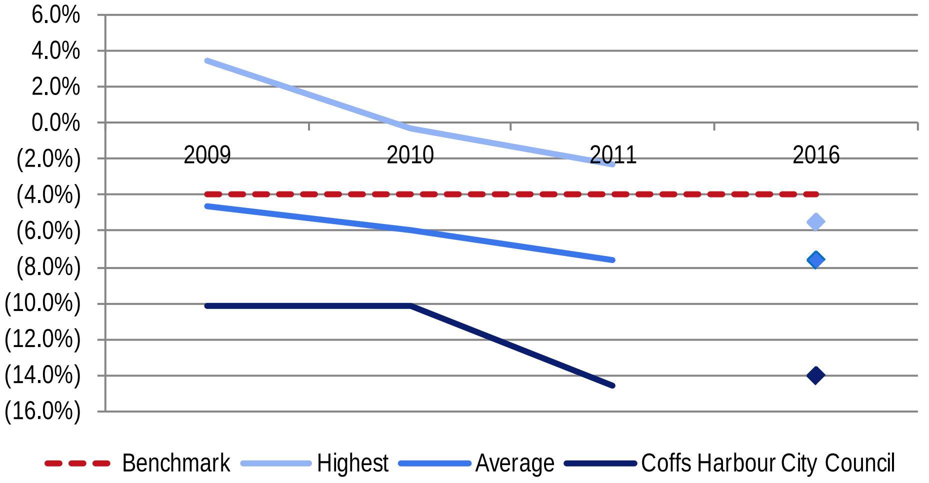
As discussed in section 2 of this report, each council's performance has been assessed against ten key benchmark ratios. This section of the report compares the Council's performance with its peers in the same DLG Group. The Council is in DLG Group 5 and there are six councils in this group.

In Figure 15 to Figure 21, 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 22 to 24 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 15 - Operating Ratio Comparison




Council's Operating Ratio was below average over the past three years. Consistent with other councils in the group, it experienced a decline in operating results in 2011 due to increased depreciation expense. The results are forecast to remain relatively stable in the medium term and remain below the group's average and benchmark.

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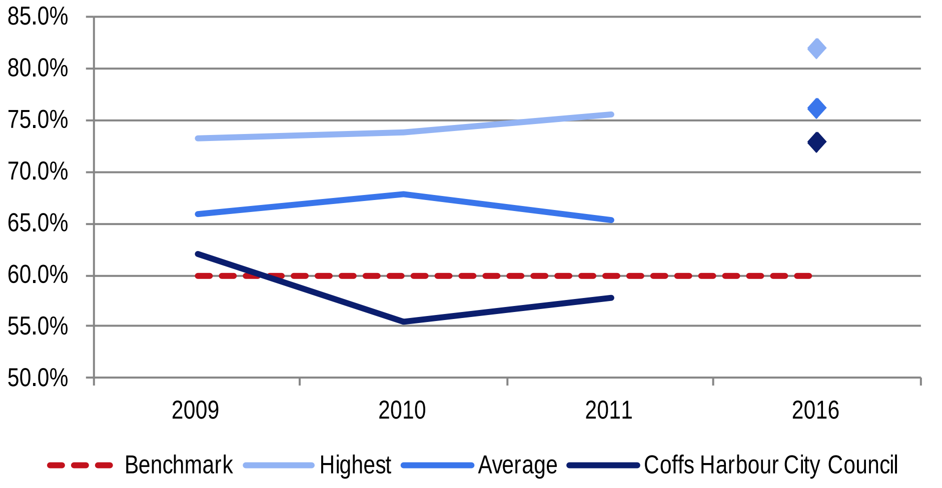
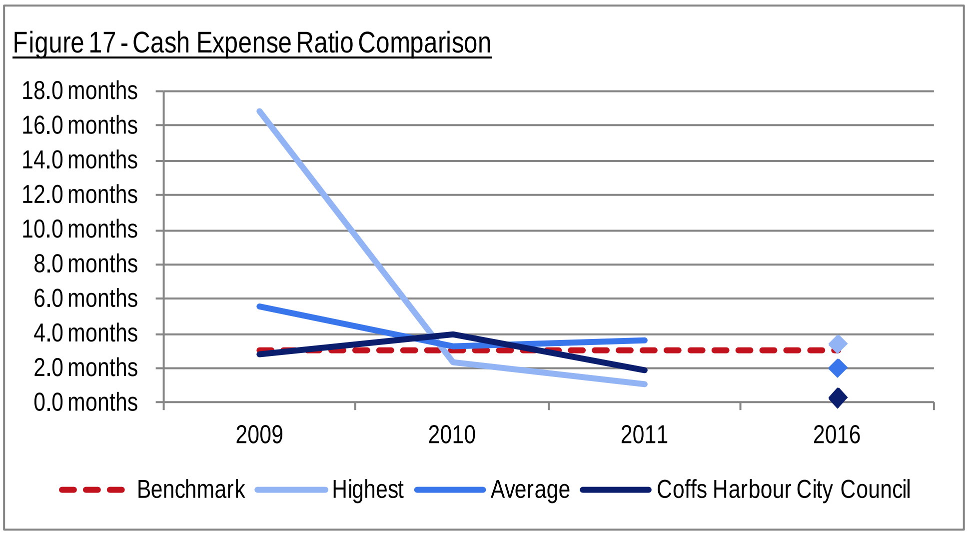
Figure 16 - Own Source Operating Revenue Ratio Comparison

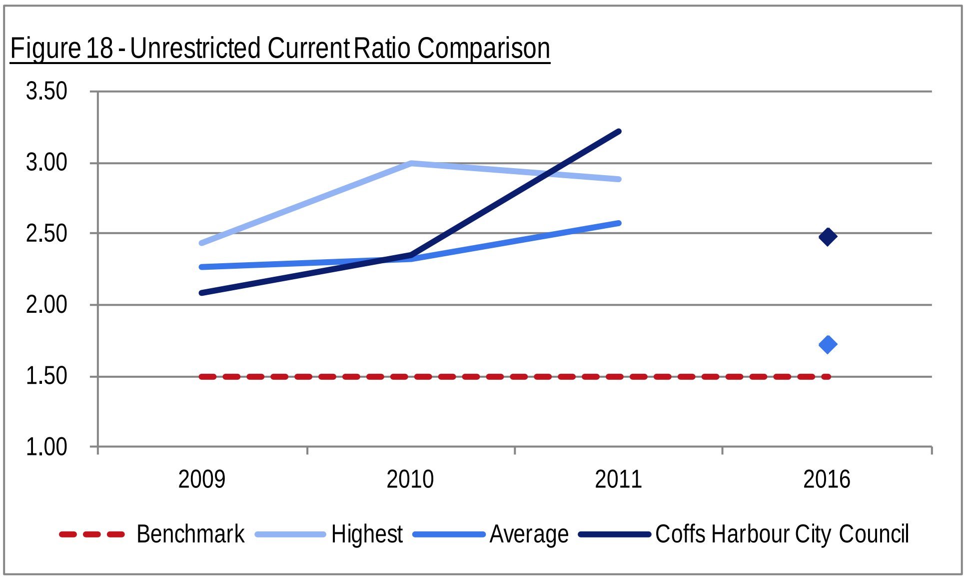



Council's Own Source Operating Revenue Ratio was below the group average and the benchmark. The Council's ratio is forecast to improve in the medium term to be above the benchmark and close to the group average.

Overall, Council's current financial flexibility is below the group's average and benchmarks.

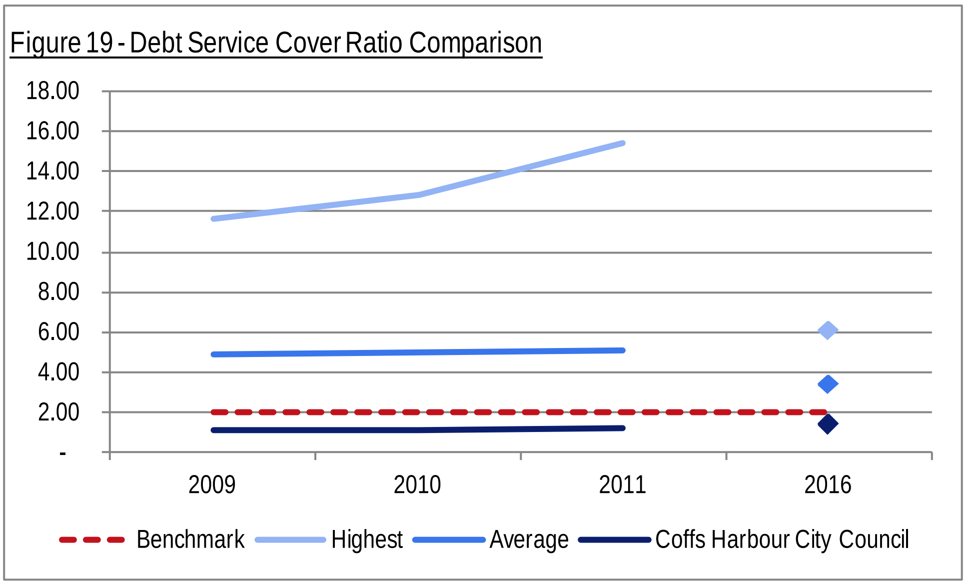
## Liquidity

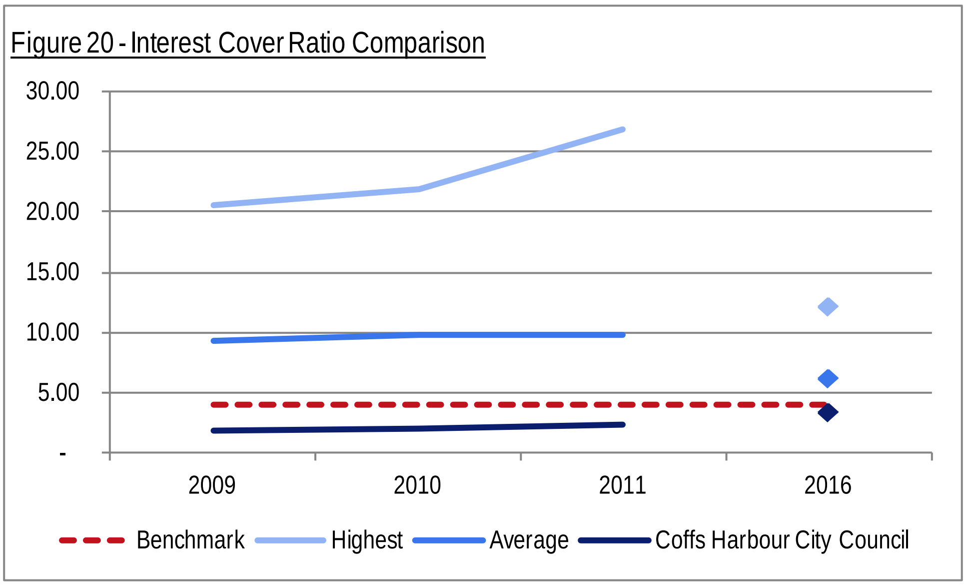



On average over the past three years, the Council's liquidity position has been sufficient and is comparable to both the group average and group highest, though this is forecast to marginally deteriorate in the medium term.

Debt Servicing




Council has had below benchmark DSCR and Interest Cover Ratio in recent years that is also below the group average. These ratios are forecast to marginally improve in the medium term though they remain below the benchmark and group average.

## Asset Renewal and Capital Works

Figure 21 - Capital Expenditure Ratio Comparison

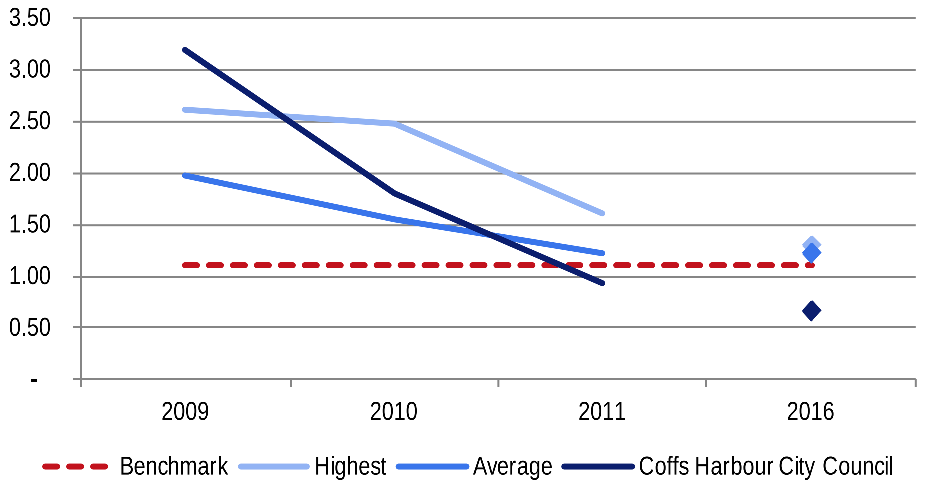



Figure 22 - Asset Maintenance Ratio Comparison

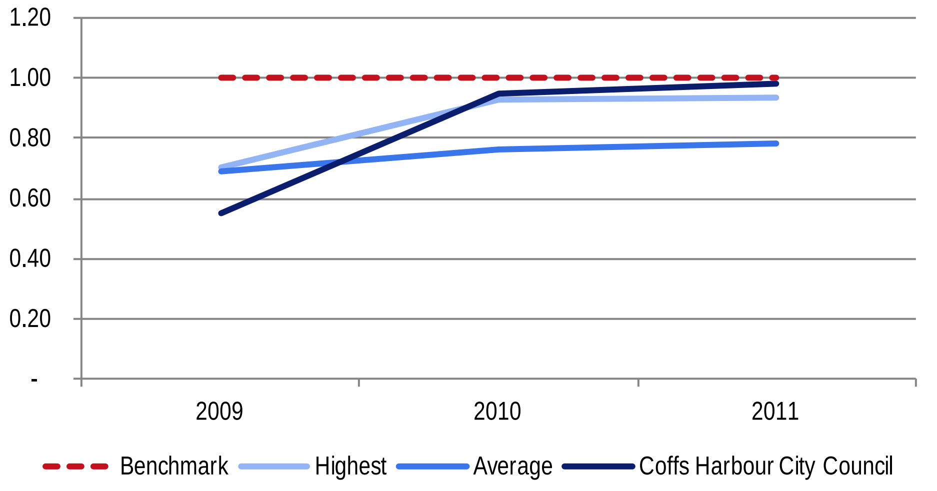


Figure 23- Infrastructure Backlog Ratio Comparison

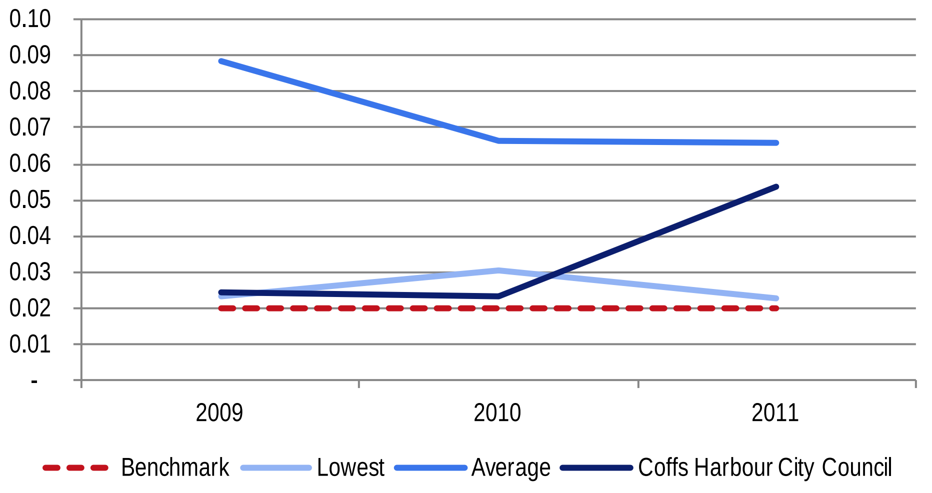
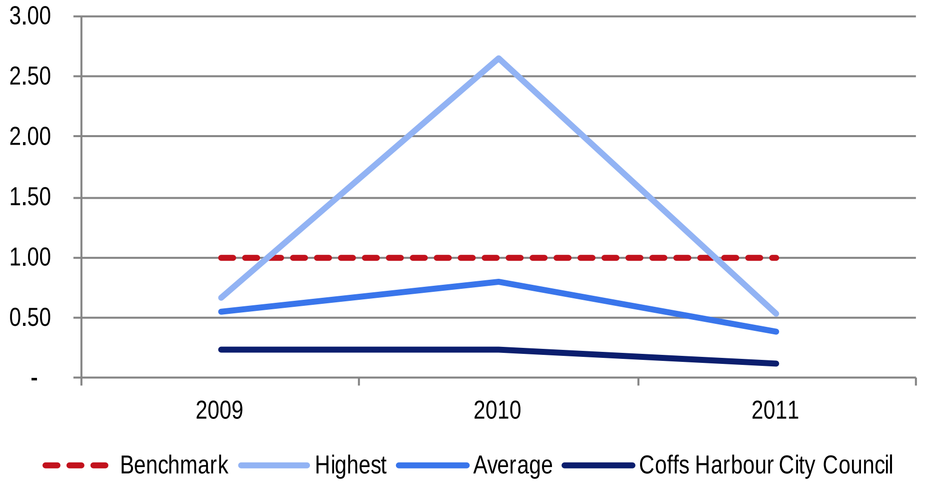



Figure 24 - Building and Infrastructure Asset Renewal Ratio




Overall, the Council has a lower Infrastructure Backlog than other councils in the group though it increased significantly in 2011. Council has improved its spending on asset maintenance to be above the group average and close to benchmark. The Council's Capital Expenditure Ratio and Building and Infrastructure Asset Renewal Ratio have declined against benchmark and the group average over the review period.

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## Section 6 Conclusion and Recommendations

Based on our review of both the historic financial information and the 10 year financial forecast within Council's long term financial plan we consider Council to be in a satisfactory short to medium term financial position.

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 application.

We base our recommendation on the following key points:

- Council has sufficient financial capacity to repay the additional $5.0m debt highlighted by a DSCR and Interest Cover Ratio above the benchmarks for each year of its financial forecast
- Council's underlying operating performance (measured using EBITDA) improved year on year

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

- Operating deficit results excluding capital grants and contributions are forecast to remain for the 10 year forecast period.  These operating deficit results are all substantially below the benchmark target of negative 4%.  This is a significant issue that could impact the long term financial sustainability of the Council.  We recommend Council considers its options for improving its performance in this area, either by further and on-going cost controls, or securing new or additional revenue, such as an additional SRV in future years
- Council has the difficult task of balancing sufficient liquidity, with spending as much as possible on reducing the Infrastructure Backlog.  We believe that Council should, in the short to medium term focus on developing strategies to resolve this long term forecast position
- Projected levels of borrowings for Council's General Fund over the next 10 years are sustainable.  Council, however, cannot afford, given its General Fund operating result, to meet additional loan repayments related to activities that are not funded.
- Council to revise their LTFP with updated audited 2012 and 2013 figures before TCorp can recommend if Council has further borrowing capacity
- As at 30 June 2012 Council held grandfathered investments in constant protection portfolio notes of $6.3m and $1.0m of CDOs.  As these types of investments are no longer prescribed under state investment guidelines, TCorp would like to see them be repaid before advising on further borrowing capacity.

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# Appendix A Historical Financial Information Tables

Table 1- Income Statement

| Income Statement ($'000s) | Year ended 30 June | | | % annual change | |
|---|---|---|---|---|---|
| | 2011 | 2010 | 2009 | 2011 | 2010 |
| Revenue | | | | | |
| Rates and annual charges | 62,713 | 58,701 | 54,747 | 6.8% | 7.2% |
| User charges and fees | 22,296 | 23,375 | 22,521 | (4.6%) | 3.8% |
| Interest and investment revenue | 9,926 | 8,569 | 9,499 | 15.8% | (9.8%) |
| Grants and contributions for operating purposes | 19,034 | 16,147 | 15,878 | 17.9% | 1.7% |
| Other revenues | 5,029 | 4,907 | 4,363 | 2.5% | 12.5% |
| Total revenue | 118,998 | 111,699 | 107,008 | 6.5% | 4.4% |
| Expenses | | | | | |
| Employees | 33,790 | 34,268 | 31,968 | (1.4%) | 7.2% |
| Borrowing costs | 18,433 | 18,415 | 19,373 | 0.1% | (4.9%) |
| Materials and contract expenses | 32,907 | 30,501 | 28,789 | 7.9% | 5.9% |
| Depreciation and amortisation | 42,007 | 30,980 | 28,077 | 35.6% | 10.3% |
| Other expenses | 9,240 | 8,831 | 9,720 | 4.6% | (9.1%) |
| Total expenses | 136,377 | 122,995 | 117,927 | 10.9% | 4.3% |
| Operating result (excluding capital grants and contributions) | (17,379) | (11,296) | (10,919) | (53.9%) | (3.5%) |
| Operating result (including capital grants and contributions) | 10,584 | 25,201 | 6,568 | (58.0%) | 283.7% |

Table 2 - Items excluded from Income Statement

| Excluded items ($'000s) | | | |
|---|---|---|---|
| | 2011 | 2010 | 2009 |
| Grants and contributions for capital purposes | 27,963 | 36,497 | 17,487 |
| Impairments | 0 | 63 | 128 |
| Fair valuation movement in investments | 1,904 | 3,553 | (5,806) |
| Revaluation Reserves realised on investment sale | (837) | (812) | (1,003) |
| Interest free loans received | 0 | 1,087 | (458) |
| Net gain/(loss) from the disposal of assets | 328 | (286) | 1,105 |

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Table 3 - Balance Sheet

| Balance Sheet ($'000s) | Year Ended 30 June | | | % annual change | |
|---|---|---|---|---|---|
| | 2011 | 2010 | 2009 | 2011 | 2010 |
| Current assets | | | | | |
| Cash and equivalents | 12,244 | 24,088 | 16,190 | (49.2%) | 48.8% |
| Investments | 64,089 | 72,496 | 74,076 | (11.6%) | (2.1%) |
| Receivables | 15,679 | 19,226 | 15,016 | (18.4%) | 28.0% |
| Inventories | 1,436 | 1,415 | 1,199 | 1.5% | 18.0% |
| Other | 2,234 | 1,719 | 1,722 | 30.0% | (0.2%) |
| Assets held for sale | 431 | 431 | 203 | 0.0% | 112.3% |
| Total current assets | 96,113 | 119,375 | 108,406 | (19.5%) | 10.1% |
| Non-current assets | | | | | |
| Investments | 95,483 | 55,304 | 71,053 | 72.7% | (22.2%) |
| Receivables | 1,095 | 880 | 1,130 | 24.4% | (22.1%) |
| Infrastructure, property, plant & equipment | 1,542,588 | 1,565,160 | 1,095,132 | (1.4%) | 42.9% |
| Investment property | 1,433 | 1,432 | 1,427 | 0.1% | 0.4% |
| Intangible assets | 68,265 | 69,136 | 69,700 | (1.3%) | (0.8%) |
| Total non-current assets | 1,708,864 | 1,691,912 | 1,238,442 | 1.0% | 36.6% |
| Total assets | 1,804,977 | 1,811,287 | 1,346,848 | (0.3%) | 34.5% |
| Current liabilities | | | | | |
| Payables | 9,419 | 12,370 | 13,038 | (23.9%) | (5.1%) |
| Borrowings | 17,056 | 15,180 | 15,564 | 12.4% | (2.5%) |
| Provisions | 11,864 | 12,096 | 10,474 | (1.9%) | 15.5% |
| Total current liabilities | 38,339 | 39,646 | 39,076 | (3.3%) | 1.5% |
| Non-current liabilities | | | | | |
| Payables | 750 | 10 | 0 | 7400.0% | N/A |
| Borrowings | 239,482 | 238,788 | 252,255 | 0.3% | (5.3%) |
| Provisions | 7,025 | 5,962 | 5,678 | 17.8% | 5.0% |
| Total non-current liabilities | 247,257 | 244,760 | 257,933 | 1.0% | (5.1%) |
| Total liabilities | 285,596 | 284,406 | 297,009 | 0.4% | (4.2%) |
| Net assets | 1,519,381 | 1,526,881 | 1,049,839 | (0.5%) | 45.4% |

Table 4-Cashflow

| Cash Flow Statement ($'000s) | Year ended 30 June | | |
|---|---|---|---|
| | 2011 | 2010 | 2009 |
| Cash flows from operating activities | 49,231 | 47,402 | 32,452 |
| Cash flows from investing activities | (63,645) | (26,740) | (96,678) |
| Proceeds from borrowings and advances | 18,430 | 2,800 | 82,300 |
| Repayment of borrowings and advances | (15,860) | (15,564) | (14,185) |
| Cash flows from financing activities | 2,570 | (12,764) | 68,115 |
| Net increase/(decrease) in cash and equivalents | (11,844) | 7,898 | 3,889 |
| Cash and equivalents | 12,244 | 24,088 | 16,190 |

# 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.

## 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.