Review of TCorp's Report *'Financial Sustainability of the NSW Local Government Sector'*

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1. Introduction

The New South Wales Treasury Corporation (TCorp) April 2013 report, *'Financial Sustainability of the New South Wales Local Government Sector',* (TCorp report), was informed by its detailed assessment of each council's own published financial reports.[1] Based on its analysis, TCorp gave at that time approximately 75% of councils a moderate or better financial sustainability rating and 25% a weak or worse rating.[2] It also looked at councils' forward financial projections and concluded that without a change in their financial strategies the financial sustainability outlook rating was positive for only 3% of councils, neutral for 49% and negative for the remainder.[3] It suggested that if nothing changed 48% of councils could have a weak or worse rating within 3 years.[4] TCorp also emphasised that the local government sector had been reporting that it had significant asset renewal backlog needs.

Many councils expressed concern at the rating TCorp attached to their financial sustainability. Local Government New South Wales, (LGNSW), recently engaged Mr John Comrie to undertake a review of the TCorp report and in particular to provide an evaluation of the basis by which TCorp assessed the financial sustainability ratings and outlooks of NSW councils.[5]

2. Basis of TCorp's Ratings of Councils

TCorp developed the following definition of financial sustainability in local government:

> *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.*

TCorp based its assessments on the audited financial statements and other publicly available financial information prepared by councils. It looked not only at 2011/12 financial reports but those for the previous three years too (and attached a greater weighting to

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[1] The TCorp report and those it prepared for each individual council are available at http://www.olg.nsw.gov.au/strengthening-local-government/local-government-reform/TCORP-financial-assessments

[2] See TCorp Report Table 1.

[3] See TCorp Report Table 2.

[4] TCorp's analysis focussed primarily on councils' 'General fund'. It did not explicitly consider financial matters relating to councils' 'water' or 'sewerage' funds (bit did have regard to any significant matters) and neither does this report.

[5] John Comrie operates a consultancy, JAC Comrie Pty Ltd, specialising in local government financial sustainability matters. He conducts training courses and has written much of the guidance material on this and related topics for the South Australian Local Government Association, the Institute of Public Works Engineering Australasia (IPWEA) and the Australian Centre of Excellence for Local Government (ACELG). Further details regarding his experience are available at www.jaccomrie.gov.au.

more recent financial information). It also examined councils' forward financial projections reported in their adopted long-term financial plans. It thus focussed on trend data and its assessments were therefore not materially affected by abnormal one-off events. It also spent time with each council discussing the council's data (and made adjustments in its analyses for any errors or omissions that may have been detected). It also invited each council to review its draft assessment and associated report before finalising its work.

TCorp's assessment of each council's financial sustainability outlook and rating was based on scores that were generated for 10 indicators the results for which were calculated from each council's data. Some indicators were given a higher weighting than others. A value was attached to the score a generated for each indicator based on whether it met TCorp's benchmark score and if not how close it was to the benchmark.

A rating was then attached to each council's overall weighted score in the range; Very Strong, Strong, Sound, Moderate, Weak, Very Weak and Distressed. A Moderate rating was considered to be the minimum acceptable level to be assessed as financially sustainable. To achieve a 'Moderate' rating a council effectively needed to achieve performance at levels at or near the benchmark target scores for each of TCorp's 10 indicators.[6] TCorp also generated an 'Outlook' rating (Positive, Neutral or Negative) for each council based on its forward projections and an assessment of the assumptions and availability and reliability of data that underpinned those projections. TCorp's definitions for its various financial sustainability rating categories and outlook classifications are included in Appendix I.

TCorp noted (p.36) '*that for many Councils, there is still much work to be done in upgrading their IP&R* (Integrated Planning and Reporting) *documentation and their 10 year LTFP* (long-term financial plan). *As this occurs, it may be that some of the Negative Outlooks would be removed'.* It also highlighted in various parts of its report that work was ongoing by councils to improve the reliability of accounting data such as depreciation estimates and forecasts of renewal needs. There is still considerable work to do in this regard but if the same review was undertaken today with available updated information then some and possibly many councils would be likely to receive more favourable results. Updated information for others though could generate less favourable ratings and outlooks.

[6] It should not be assumed that a rating above 'moderate' should necessarily be aspired to. Depending on the needs and circumstances of a council and its community a 'moderate' rating may be perfectly acceptable. In fact a 'very strong' rating could indicate a council is generating or is forecast to generate more revenue relative to the range and level of services provided than is absolutely necessary.

These 10 financial sustainability indicators applied by TCorp in its analyses were grouped in four categories. Details of the categories, their weighting in the overall rating and each indicator are listed below.

Financial flexibility (35%)

i). *operating ratio (17.5%)*

ii). *own source operating revenue ratio (17.5%)*

Liquidity (20%)

iii). *cash expense ratio (10%)*

iv). *unrestricted current ratio (10%)*

Debt servicing (10%)

v). *debt service cover ratio (7.5%)*

vi). *interest cover ratio (2.5%)*

Asset renewal and capital works (35%)

vii). *infrastructure backlog ratio (10%)*

viii). *asset maintenance ratio (7.5%)*

ix). *building and infrastructure renewals ratio (7.5%)*

x). *capital expenditure ratio (10%)*

Given that more weighting was assigned to some indicators than others in assessing overall performance, a council's rating depended more on how well it scored for some particular indicators compared with others. Further details regarding the basis of calculating the indicator score and the benchmark score for each indicator are provided in Section 3 and in more detail in Appendix II.

3. Assessment of TCorp Methodology

I am very comfortable with TCorp's definition of what financial sustainability should be interpreted to mean in a local government context and of its approach of focussing on recent financial data (including forward financial projections) produced by councils and giving consideration to the availability of evidence to support the reliability of that information. I am also supportive of its general conclusions regarding the financial sustainability of the NSW local government sector and especially its associated recommendations. This is so even though I am not convinced that all indicators it has applied and the basis of their calculation or the weighting they have been assigned in its analysis are optimal for this purpose.

My reservations regarding aspects of the TCorp methodology stems primarily from the fact that TCorp has scored councils using indicators that in some instances are more appropriate for financial assessment of entities operating in the business world. I accept that it is important that councils operate efficiently and in many respects in a business-like manner. However I do not see local government as an industry but as a sphere of government and believe that indicators used to assess the financial sustainability of councils should be more consistent with those applied to assess state governments' financial circumstances and capacity. I agree that particular attention also needs to be given to the asset management responsibilities and capacities of councils also but am not convinced that the methodology applied by TCorp is optimal in the circumstances.

It is important that tools and measures that are used to assess the financial circumstances and capacity of an entity have regard to its operating environment and in particular the reliability of its future income streams and the nature of service level responsibilities. Governments for example typically have more reliable income streams than individuals and private sector businesses. They have taxing and charging powers and such revenue can be increased subject to political and longer-term economic considerations. They also have at least some discretion over the range and level of services provided and are generally able to borrow more (and more cost-effectively) than corporates because there is less risk for lenders of not being repaid.

Local governments in NSW have some (but not full) control over their revenues and service level outlays. It is also noteworthy that they have more control over their net financial inflows and outlays than the state and federal governments.[7] Local governments' costs are heavily influenced by the provision and ongoing maintenance and renewal of long-lived assets (typically infrastructure and to a lesser extent buildings). Their outlay needs associated with provision of service from such assets can vary significantly between periods. This may be so even if service provision and population and properties served remain relatively constant over time, e.g. because there will be peaks and troughs in asset renewal needs between periods.

My views regarding TCorp's indicators are outlined below. The reasons why I am nevertheless comfortable with its general findings and recommended ways forward are documented in Section 4 of this report.

[7] Councils on average generate far more own source revenue than state governments. The income and outlays of both the state and federal governments are also far more sensitive to changes in economic conditions than is the case for local governments.

i). Operating Ratio

This ratio measured the annual cost of as council's current ongoing service provision (i.e. its operating expenses) relative to operating revenue (excluding capital grants and contributions). A council's score for this ratio measured relative to TCorp's benchmark of 'Better than negative 4%' was given a weighting of 17.5% in its overall assessment.

I am a strong advocate for this indicator and argue that generally speaking a council should base its capital expenditure, service level and revenue raising decisions on achieving a modest (say typically up to 10%) underlying (i.e. net of material abnormal revenues and expenses) operating surplus ratio (net of capital revenue, i.e. revenue required to be spent on acquisition of assets) on an ongoing basis (including in its long-term financial plan forward projections). If this can be achieved then a council's service levels would always be sustainable and it would have the capacity to renew and replace assets as required (even if that necessitated raising additional debt at times and repaying it in subsequent periods). I emphasise several times in this report the importance of a council ensuring its service levels are affordable over time. By affordable I mean that a council can maintain achievement of an appropriate operating surplus target.

Given the above I would argue for the operating ratio to be given a much higher weighting in an assessment of councils' financial sustainability that the 17.5% allocated in TCorp's assessments (say at least 50%). I would also argue for a higher benchmark than 'Better than negative 4%' (say usually to at least a breakeven result). During discussions with TCorp representatives they pointed out that if it had used a higher weighting for this ratio more councils would have received more adverse overall assessments. TCorp for example notes that in 2012 only one third of councils (50) reported an operating surplus but that 52% had an operating result of better than negative 4%.[8]

An arguable weakness of this indicator is that depreciation represents a very large proportion of the total operating expenses of councils on average. The reported level of a council's depreciation expenses can therefore have a big bearing on its operating result and can be difficult to reliably estimate. This estimate is nevertheless far too important to disregard. Councils' services are asset intensive. Recognition of the cost of asset consumption is a critical component of assessment of councils' financial and service level sustainability. The key therefore is to ensure that auditors and management teams pay careful consideration to the basis of their councils' annual estimates of depreciation expenses and that councils generally aim for modest (but not excessive) underlying annual operating surpluses over the medium term. Such a strategy (rather than a breakeven result) would help offset the risk that past estimates of annual asset depreciation may have been understated.

[8] See TCorp p.7 and p.40.

ii). Own Source Operating Revenue Ratio

This ratio measures the extent of a council's reliance on external funding sources. It is calculated by expressing a council's rates, utilities and charges revenue for a period as a ratio of its total operating revenue (inclusive of capital grants and contributions) for the same period.

I see merit in this type of indicator but would argue for refinements. First of all I suggest that consideration should be given to including financial assistance grants revenue in the numerator (or at least having an additional indicator that included such that was given equal weighting with this one). Such revenue is in the main a reliable source of revenue for local governments (despite the Commonwealth's decision to hold the quantum constant in nominal values over the three years following 2013/14). For many rural councils with small populations financial assistance grants are a major source of revenue that they should comfortably rely on in planning affordability of future proposed works and services. (I would not make the same arguments in relation to Roads to Recovery or other grants which unlike FAGs would not require legislative change for their availability to be discontinued or annual quantum reduced). The basis of distribution of the available FAGs pool is such that councils with greatest needs for FAGs receive a higher share.

Secondly I question the inclusion rather than exclusion of capital revenues in the denominator. Such revenues can be both significant relative to other operating revenue and lumpy over time. I'd claim the circumstances of two councils that had the same score for this indicator but where one had significant capital revenues and the other didn't were not identical. This is notwithstanding the fact that receipt of capital revenues will generally consequentially lead to higher operating costs for a council in future. (A large share of capital revenues is from developer contributions and development will lead to future higher operating revenues too.)

TCorp suggests that this measure is an indicator of a council's 'fiscal flexibility'. I accept it is an indicator of to what extent it has influence over its annual revenue quantum and that such information has some value in this regard. Given the nature of councils' operating environment and service delivery responsibilities I'm not convinced though that significant 'financial flexibility' is a critical consideration.

A council's score for this indicator measured against TCorp's benchmark of 60% was given a weighting of 17.5% in determining its overall assessment. I believe this indicator (modified as discussed above or not) should not be attached as great a weighting in assessing financial sustainability as the Operating Ratio.

iii). Cash Expense Cover Ratio

This ratio, the score for which was given a weighting of 10%, measured a council's cash and cash equivalents at year end relative to its average monthly outlays for the year. It thus was an indicator of the number of months a council could continue paying for its immediate expenses without additional cash inflow.

The score for such an indicator can be an important consideration for a private sector entity (or others interested in its performance and capacity). Uncertainty may exist for such entities regarding future revenue streams and capacity to borrow at short-notice to meet cashflow needs. By comparison most local governments' future revenue inflows are relatively reliable and future expenditure outflows reasonably predictable. Most would also be able to borrow at short notice if unforeseen circumstances arose (and could establish such facilities as a safeguard in advance of any such financing needs).

There is an opportunity cost from holding cash and cash equivalents (including term-deposits) in excess of immediate cashflow needs. My ACELG Working Paper on the role and use of debt argues that councils should adopt treasury management practices that generally reasonably minimise their cash holdings to reduce net interest costs and interest rate risk exposure (e.g. by repaying debt (and ensuring a significant share of their debt is structured in a way so that this can occur) and by deferring an otherwise need to raise debt).

NSW councils current treasury management practices are far from optimal but are generally consistent with guidance instructions that have traditionally been in place. In the circumstances I can understand why TCorp made use of the Cash Expense Cover Ratio indicator in its analyses. I would not though recommend its use in future and would instead encourage assessment of performance relative to treasury management approaches applicable to the circumstances of the local government environment.

iv). Unrestricted Current Ratio

Councils' score for this ratio relative to TCorp's benchmark of 'greater than 1.5' attracted a weighting of 10% in a council's overall assessment. It was calculated by comparing a council's current assets (net of monies with external restrictions on their use) with its current liabilities (net of specific purpose liabilities).

The current ratio is a commonly used liquidity ratio applied in the private sector to assess an entity's ability to meet short term obligations as they fall due. TCorp made refinements to the usual basis of calculating that indicator to take account of the fact that councils often hold significant monies that can only be applied for specific purposes and cannot be used to meet other outlay needs. Regardless of these adjustments, and as highlighted in iii) above, I question the merit of applying liquidity and debt servicing indicators to financial assessments in the local government sector given the differences in operating circumstances.

TCorp's benchmark for this indicator favours councils holding a large (i.e. a conservative level) of unrestricted current assets. I would argue many councils would be better served in future by targeting a considerably lower unrestricted current ratio score than the TCorp benchmark. This could in many instances reduce both a council's net interest costs and interest rate risk exposure. Before implementing such a strategy a council should establish sound treasury management policy frameworks relative to their circumstances and ensure that they have complementary levels of knowledge and understanding by responsible staff.

v). Debt Service Cover Ratio (DSCR)

This ratio was given a weighting of 7.5% in each council's overall assessment. It measured a council's operating result before interest and depreciation (effectively approximately net operating cash inflow) relative to repayments of debt (principal amounts) and interest costs on debt.

This ratio is commonly used in the private sector to assess the capacity of a borrower to take on and repay borrowings. The fact that local governments' service responsibilities are very asset intensive and that their ongoing revenue streams are typically more reliable and expenditure needs reasonably predictable means it will often be appropriate for councils to carry large stocks of borrowings (In order to finance asset acquisition and then equitably fund associated costs over time from taxes and charges on service recipients). As such a council could possibly appropriately have a higher level of debt (and a lower debt service cover ratio score) than what may be warranted for entities in various private sector industries.

TCorp applied a benchmark of 'greater than 2 times' in assessing councils' performance for this indicator. All other things being equal this meant that a council that repaid debt more quickly (as I would advocate it should if it had cashflow capacity available) would receive a lower score than one that repaid it less quickly. This is because the former council would incur higher principal repayments (albeit over a lesser number of periods) and the denominator in its scoring for the indicator would therefore be larger.

My preference would be for councils to base service level decisions on long-run affordability and generally borrow only when cashflow needs warrant and for borrowings to be structured in ways that allow repayment arrangements to minimise net interest costs and interest rate risk exposure. Structuring loan repayment arrangements to achieve a higher DSCR score could in fact add to a council's net interest costs and interest rate exposure risks.

vi). Interest Cover Ratio

This ratio, the score for which was given a weighting of only 2.5%, is intended to provide an indication of the extent to which a council can service its interest bearing debt and take on additional borrowings. Its calculation was based on a council's operating result before

interest and depreciation for a period relative to interest costs from borrowings for the same period.

TCorp indicated in discussions that its benchmark of 'Greater than 4.0x' for assessing councils' performance is commonly applied in the private sector. For reasons highlighted elsewhere (see e.g. item v) above in this section) I question the merit of applying liquidity and debt servicing indicators to financial assessments in the local government sector given the differences in operating circumstances.

The circumstances of some councils are that they could and should appropriately carry more net debt (e.g. often those that need to meet infrastructure upgrade costs associated with growth) compared with others. Such councils may therefore be warranted in having a lower interest cover ratio result than others.

vii). Infrastructure Backlog Ratio

This ratio identified a council's reported asset renewal backlog relative to the total reported value of its depreciable buildings and infrastructure. A council's score for this indicator was given a weighting of 10% in calculating its overall assessment.

In calculating a council's score, TCorp based the council's asset renewal backlog on its reported Special Schedule 7 forecast of the estimated cost to bring assets it was responsible for up to a satisfactory condition. The basis of information reported in that document is quite variable between councils. Special Schedule 7 is unaudited and interpretations as to what is needed and what constitutes satisfactory condition are necessarily subjective. Answers to this question will depend on the willingness of service recipients to pay (and also whether there is a perception of the possibility of grants from others to fund such expenditure) and consideration by a council of its community's other needs and priorities.

My report for the Independent Panel last year highlighted concerns with the basis of the reporting requirements of Special Schedule 7 and reliability of reported data. TCorp in its report also highlighted concerns with the reliability of data and consistency between councils as to the basis of reported backlogs. I also suggested in my report for the Independent Panel that many councils have considerable capacity to address reported asset management backlog needs by taking on additional debt but appear unwilling to do so suggesting either a lack of confidence in reported 'needs' (and/or an unwarranted fear of debt).[9]

I appreciate that there is considerable ongoing work being undertaken by councils to refine the reliability and basis of their asset renewal backlogs. Some councils have reported very significant revisions of their estimates post the finalisation of the TCorp report. Even with these refinements it will always remain problematic to compare one council's reported backlog quantum with that of another or to add all councils' figures and arrive at an

[9] See in particular Sections 3.3 and 3.4 of 'Roadmap to Financial Sustainability for Local Governments in NSW'.

estimated renewal backlog for the sector. The point at which an asset should be renewed is not definitive. It will depend to a large degree on the circumstances and subjective preferences of individual councils.

Rather than focus on the content of Special Schedule 7 in evaluating asset management needs a better approach would be to consider the content of councils' asset management plans (I acknowledge that the reliability of data therein is often still being refined). Such plans should be of course consistent with a council's long-term financial plan and therefore the achievement of their financial targets (thus forcing councils to wrestle with and make judgement calls in preparation of these documents regarding trade-off choices between service level preferences and service recipients' willingness and capacity to pay).

viii). Asset Maintenance Ratio

This ratio, the score for which was given a weighting of 7.5% in each council's overall assessment, measured actual asset maintenance expenditure relative to the asset maintenance expenditure for the period that the council deemed was warranted in its Special Schedule 7 report.

In theory I have no argument with the indicator or its assigned weighting. Councils need to make service level (and therefore asset maintenance level) decisions that are consistent with likely long-run revenue availability (which will to varying degrees depend on a council's capacity and willingness to generate own source revenue). A ratio of less than one may mean:

a) Available revenue is less than is needed to accommodate justified maintenance levels for a given preferred level of service. If so (and assuming this is the projected ongoing scenario) then a council needs to act to either generate more revenue or accept a lower level of service (and lower associated maintenance costs); and/or,

b) Available revenue is adequate to accommodate justified maintenance levels for a given preferred level of service but the council has chosen (implicitly or explicitly) to spend a lower amount on maintenance. That is, whether it realises it or not it has effectively decided that it prefers to utilise available funds in other ways – if so reported warranted maintenance expenditure is not in fact consistent with a council's preferences.

A council always needs to ensure that actual and future planned maintenance levels are consistent with warranted maintenance levels. It can do this by ensuring its asset management plans are based on preferred and affordable service levels and annual expenditure budgets are generally consistent with asset management plans.

Some people sometimes claim that it would be cost-effective but unaffordable to spend more on maintenance. This makes no sense. A council may be financially challenged but if it would really save money over time by spending more on maintenance now it should do so –

even if it needed to borrow additional money. In reality what they often mean is that a council's existing budget decision-making process has not delivered asset maintenance funding levels consistent with what such individuals prefer.

It is clear that there is a high degree of variability in the Special Schedule 7 reported needs of councils. This is likely to be so even for councils in similar circumstances. This often reflects differences in viewpoints of 'needs' between councils. Reported 'needs' should be based on long-run affordable service levels and if they are not then it is hard to make any conclusions regarding relative asset maintenance performance of councils. Differences in scores generated between councils for the asset maintenance ratio indicator will reflect this variability in the basis of reported Special Schedule 7 maintenance 'needs'.

ix). Building and Infrastructure Renewals Ratio

This ratio measured asset renewal expenditure relative to the recorded annual depreciation expense for the same classes of assets (i.e. buildings and infrastructure). Each council's score was given a weighting of 7.5% in its overall assessment.

Intuitively it seems reasonable to assume that this ratio score should be about 100% as that would mean that infrastructure asset renewal expenditure over any particular period of one or more years was approximately offsetting the decline associated with age and use in the service potential of existing assets. In practice though there may be good grounds why a ratio of substantially more or less than 100% is more appropriate.

The weighted average life of local governments' stock of depreciable assets is typically very long (often 40 years or more). Annual average asset renewal needs for classes of assets like stormwater drainage, road pavements and buildings are unlikely to be constant over time. They are likely to be periods of peaks and troughs. Rather than spend an amount on asset renewal each period consistent with annual depreciation, a council would be better advised to undertake asset renewal in accordance with levels and timing outlined in a soundly based asset management plan.

An indicator comparing asset renewal with depreciation can prove a useful guide of performance for individual classes of assets that have a significant stock of items and that have relatively short lives (e.g. plant and sheeted roads) or for councils that do not have material levels of long-lived assets (e.g. rural councils with large sheeted road networks).

South Australian councils were required to report asset renewal relative to depreciation for several years but results proved generally an inconclusive indicator of warranted performance. Now that SA councils have had several years' experience with asset management planning they are instead required to report (in their budgets, financial statements and long-term financial plans) asset renewal expenditure levels relative to asset management plan identified renewal needs for the same period.

x). Capital Expenditure Ratio

This ratio measured a council's annual capital expenditure relative to its annual depreciation for the same period. Each council's score was given a weighting of 10% in its overall assessment.

TCorp suggested that the indicator measures the extent to which a council is expanding its asset base (and used as a benchmark a score of 'greater than 1.1'). I accept that low ongoing scores for this indicator may indicate an under-investment in service providing capital works but such a conclusion will not always be valid. A higher score is likely to be far more warranted and appropriate for some councils (e.g. possibly those that are rapidly growing) than others (e.g. possibly those with a relatively stable or declining population and an asset stock in generally good condition and with a long weighted average useful life).

The fact that the numerator doesn't distinguish between expenditure on new additional assets and renewal of existing assets is also problematic. As highlighted previously expenditure on new assets has a much greater impact on long-run costs than renewal outlays. Furthermore warranted asset renewal can vary significantly between years, particularly for councils with a larger share of long-lived assets relative to classes with shorter useful lives.

Acquiring new additional depreciable assets adds to long-run operating costs. A council that has financial sustainability challenges will quite possibly be adding to those challenges rather than helping to address them by spending on new capital works. It seems potentially anomalous therefore to assume a higher score for such an indicator suggests greater financial sustainability.

In the private sector a firm will of course only invest in additional capital works if it helps it improve its long-term financial performance. The indicator therefore is likely to have more applicability in that context. Local governments have multiple objectives. Acquiring new assets may help meet some strategic social objectives but also adversely impact on financial ones. Their financial objectives are not about maximising long-run profits but instead more about efficiently providing affordable services and equitably generating revenue to pay for them.

4. General Discussion regarding financial sustainability indicators

I have expressed in Section 3 concerns and reservations regarding either the suitability, basis of measurement, weighting and/or benchmark targets (to varying degrees) for each of the indicators applied by TCorp in its assessment of the financial sustainability of NSW councils. Despite this I am comfortable with its overall findings regarding the sector. Its assessment of the reported circumstances is broadly consistent with the one I have formed

from various work I have undertaken in recent years.[10] Simplistically this congruence of our assessments can be reconciled as follows:

a) I would give much greater weighting to the underlying operating result of councils which would drag down the overall assessment ratings,

b) I would assign less weight to reported asset management needs and performance and anticipate that this would improve the collective assessed ratings of councils, and

c) I would also assign less weight to liquidity and debt servicing considerations. The impact on overall assessments of this is less clear and would vary between councils.

Even though my assessment for the collective grouping of councils would I anticipate be similar to TCorp's our assessment of individual councils may well be different. Given that I would place more emphasis on some factors and less on others it is likely that I would rate some councils more highly and others less so.

I also believe that many councils (but certainly not all) could potentially be in a better position than the data TCorp necessarily used in its assessments suggests (or certainly can become so over time). It is still relatively early days in terms of councils developing and working with asset management and long-term financial plans and in refining estimates of asset renewal needs and warranted and affordable service levels. My experience (from leading various related training courses throughout NSW) suggests that there is still considerable inconsistency within and across councils regarding the recording and interpretation of asset management and financial data. Progress is being made though in improving data and its interpretation and appropriate responses. Intuitively for example I think it is more likely that councils on average have in the past been overstating rather than understating estimates of annual depreciation and asset renewal backlogs. (It is not uncommon for councils to have in service assets that they have already fully depreciated).

I agree with TCorp that most councils will need to improve their financial performance over time. I am also though of the view that most NSW councils with appropriate guidance and encouragement will be able, with incremental changes in policy settings, to make significant improvement in their financial sustainability over the medium term relative to the assessments and outlooks determined by TCorp in 2013.

In all Australian jurisdictions councils are now required, or at least strongly encouraged, to disclose results for specified financial sustainability indicators in their annual financial statements and long-term financial plans. There is reasonable (but not uniform) consistency in promotion of some particular indicators (and even for these there are some slight

[10] In particular work for the Independent Panel and ACELG listed in the references.

differences in their basis of calculation) but most states also encourage publication of others not widely applied elsewhere.

ACELG and IPWEA's Practice Note 6, Long-term Financial Planning (which I authored) encourages attention on just three indicators in order to maintain a clear and simple focus in strategic financial decision-making.[11] The three indicators are the :

i). Operating Surplus Ratio (same as the (Operating ratio described at item viii) of Section 3),

ii). Asset Renewal Funding Ratio (actual renewal expenditure relative to asset management plan identified needed renewal outlays for the same period),

iii). Net Financial Liabilities Ratio (debt and other financial liabilities less financial assets all expressed as a ratio of operating revenue (exclusive of capital revenue)).

Practice Note 6 suggests that the key to financial sustainability is ensuring a council sets own source operating revenues and service levels such that it will maintain a small operating surplus (including in its future projections) whilst also addressing asset renewal needs as required. In order to achieve these targets it may be necessary for many councils to carry more debt than they have traditionally been comfortable with so doing. My ACELG Debt Paper argues that if councils have reliable financial data and commit to strategies that help them achieve satisfactory targets for their operating surplus ratio and asset renewal funding ratio then they should not fear making greater use of debt.

There has been in-principle interest between jurisdictions in agreeing on a standard set of core financial sustainability related indicators for all local governments across Australia to report against. No significant objections have been raised to the proposal but local priorities in individual jurisdictions have meant that it has not yet been actively pursued to finalisation. The three ACELG and IPWEA recommended indicators are suitable prime financial sustainability indicators for application by NSW councils (or at least can become so over time). Having regard to the current level of reliability of some financial and asset management information and traditional guidance, understandings and practices I acknowledge that there is still some way to go before these indicators would be sufficient by themselves for sound financial sustainable strategy setting by all councils.

From discussions I had with TCorp I believe it may have refined its thinking regarding appropriate financial sustainability indicators and targets as a result of the work it did in preparing its 2013 report and in considering applications by councils for subsidised borrowings through the NSW Government's Local Infrastructure Renewal Scheme.

The NSW Government has recently announced a 'Fit For the Future' reform program. The assessment of councils as being 'fit for the future' will include their performance against six

[11] See Section 7.3 of 'Long-term Financial Planning, Practice Note 6'.

financial sustainability indicators.[12] Those indicators and their benchmarks are set out below:

a) Operating Performance Ratio with a performance benchmark of breakeven or greater over 3 years,

b) Own Source Revenue Ratio (benchmark performance of greater than 60% over 3 years),

c) Building and Infrastructure Asset Renewal Ratio (benchmark performance of greater than 100% over 3 years),

d) Infrastructure Backlog Ratio (benchmark performance of less than 2%),

e) Asset Maintenance Ratio (benchmark performance of greater than 1.0),

f) Debt Service Ratio (benchmark performance greater than 0 and less than 20% of operating revenue excluding capital grants and contributions).

It is not clear at this time how those indicators will be measured. The September 2014 IPART Report indicates that the basis of calculation of the first five may be as per items i), ii), ix), vii) and viii) respectively of Section 3 of this report. The proposed 'debt service ratio' indicator is not the same as item v) (debt service cover ratio) in Section 3. It is based on loan repayments (principal and interest for a period as a percentage of operating revenue).[13] Whether these 6 indicators will be weighted to generate an overall financial sustainability score and if so how is also not known at this time.

It would also appear that indicators iii), (cash expense ratio), iv) (unrestricted current ratio), vi) (interest cover ratio and x) (capital expenditure ratio) (as described in Section 3) will not be applied in 'fit for the future' assessments.

5. TCorp's overall findings and recommendations

As highlighted previously, despite some misgivings regarding TCorp's financial sustainability indicators I am supportive of its report's key findings and recommendations. I have listed below (generally in paraphrased form) some that I think are particularly noteworthy and or wished to comment on. (My comments below are generally restricted to adding to rather than repeating comments made earlier in this report.)

[12] See 'Fit for the Future, A Roadmap for Stronger, Smarter Councils' available at http://www.fitforthefuture.nsw.gov.au/sites/fftf/files/Fit-for-the-Future-A-roadmap-for-Stronger-Smarter-Councils.pdf

[13] I am not a fan of this indicator. Principal repayments are not an accrual accounting expense. I discuss my concerns regarding this indicator more fully in my ACELG Debt Paper (Comrie 2014) where this indicator is described as 'debt servicing ratio' (see e.g. p.22).

i). TCorp provided some recommendations to assist councils in improving their financial sustainability (see p.6 and p.38) These included:

   a) Sourcing additional revenue, e.g. through a Special Rating Variation,

   b) Using debt funding to assist in reducing the Infrastructure Backlog (TCorp noted (p.55 & p.59) that some councils have no debt and significant capacity to repay additional debt, yet report that they have Infrastructure Backlogs),

   c) Devising programs and strategies to contain rising costs and improve efficiencies,

   d) Refining the content of asset management and long-term financial plans and better ensure their consistency (and I would add reviewing service levels upon which they are based, including the timing of provision of new additional capital works, or the upgrade of existing assets to a higher level of service),

   e) Increasing spending on maintenance and infrastructure renewal.

ii). It emphasised the importance of councils aiming to achieve at least breakeven operating positions and developing pricing paths that help them achieve this over the medium term,

iii). TCorp highlighted that debt is underutilised and there are opportunities for it to be structured in a more cost effective manner (p.63 & p65),

iv). It also emphasised that liquidity levels are in some cases overly conservative (p.61) and that treasury management policies need to be reviewed to improve council management of liquidity (p.66). I would add that such policies would also help improve councils' use of debt. TCorp also suggested that there should be a review to consider improved use of restricted funds. In my view greater 'internal borrowing' between funds by councils if carefully managed could generate very significant overall savings and reductions in councils' interest rate risk exposure,

v). TCorp noted that reported infrastructure backlogs are not audited and require further refinement,

vi). It stressed that the provision of capital grants to build new additional assets or upgrade existing assets to higher levels of service can adversely impact on financial sustainability (p.63). I would argue that councils need to consider the impact on their overall financial sustainability and capacity to maintain existing service levels before seeking capital grants to add to their stock of assets and increase service levels,

vii). TCorp identified (see p.48) that the recognition and treatment of depreciation remains a contentious issue amongst some councils and that depreciation rates, expenses and methodologies vary widely. It suggested that further work may be warranted to provide guidance to refine such estimates. I support these findings. Asset consumption

(depreciation) is a very significant component of the cost of service delivery in local government. It is as a legitimate a cost as any other a council may incur. The fact that it doesn't automatically result in a cash outlay is irrelevant. Councils should be basing their revenue raising and service level decisions on accrual accounting rather than cash accounting information. In order to be financially sustainable depreciation expenses generally need to be fully offset with revenue,[14]

viii). TCorp suggested that a review should be conducted to ensure a consistent approach to the future auditing of all councils' annual accounts. There is currently in my view some very inconsistent advice and direction being given by auditors and other external advisors to councils regarding appropriate accounting treatments for valuing and depreciating infrastructure assets. Increased guidance or sector-wide oversight is certainly worth consideration,

ix). TCorp suggested a need to enhance the capacity of councillors and their management staff as regards financial management. In my view good progress has generally been made in transitioning from a traditional short-run cash accounting mindset in decision-making but I don't disagree with TCorp's suggestion. It also recommended that increased community consultation will be needed to help improve understanding of and inform decisions regarding service level and revenue raising trade-offs. I agree with this. It will be essential for residents and ratepayers to feel that they've been listened to in order for financial sustainability improving reforms to be accepted and effectively implemented.

6. Case Studies

LGNSW asked that liaison take place with a small group of 3 councils in the preparation of this report and suggested Bourke, Greater Taree and Penrith. All 3 willingly agreed to assist and provided valuable input to help form and refine the content of this report. Brief comments regarding each council follow.

i). Bourke

Bourke was assigned a 'Weak' financial sustainability rating by TCorp in its 2013 assessment and a 'Negative' outlook.

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[14] An exception for example may be where a council is satisfied that it would not be justifiable to replace significant depreciable assets in future. In such cases an adjusted lower operating result target may possibly be appropriate.

It scored adversely against TCorp's benchmarks for the following:

a) Operating ratio
b) Own source operating revenue ratio
c) Capital expenditure ratio
d) Infrastructure backlog ratio
e) Building and infrastructure renewal ratio

At the time of TCorp's review Bourke reported a significant asset renewal backlog relative to its total value of infrastructure assets and annual operating income and a forecast gradual reduction in its operating deficit over time. TCorp concluded based on available reported data that Bourke was unsustainable in the medium to long term.

What TCorp effectively meant was that Bourke's service levels appeared to be unsustainable beyond the medium term based on reported information. This scenario was predicted because Bourke's service generating assets (predominantly roads) were being reported as being consumed at a rate in excess of which they were being renewed. TCorp recognised that rural councils serving large land areas with small population bases and large road networks face greater challenges than other councils in achieving and maintaining financial sustainability.[15] TCorp suggested that Bourke needed to review its service levels to ensure that they were set based on what was optimally sustainable on an ongoing basis.

I have no disagreement with TCorp's assessment based on then available information.

TCorp's findings have proved to be a driver for Bourke to look closely at the factors that gave rise to its rating score and what it may be able to do to better meet ongoing challenges. It appreciates that the rating is not an assessment of 'how well it is doing in the circumstances' and recognises it faces more operating environment challenges than many other councils. It also now has an increased appreciation of the value of asset management and long-term financial planning and the importance of ensuring accounting data reliably reflects the value and rate of consumption of infrastructure assets.

Bourke is currently reviewing depreciation rates, expenditure capitalisation policies and asset management needs. Based on evidence to date Bourke recognises that it's previously forecast asset renewal needs and road asset useful lives were more 'aspirational' than reflective of current actual service levels. Work is ongoing but it is reasonably confident that it can maintain current service levels on an ongoing basis and that they are acceptable to its community.

[15] I have argued in my ACELG 'In our Hands' and Independent Panel 'Roadmap to Financial Sustainability' reports that whilst such councils often can and must do more to help themselves they also need additional external financial support. I have suggested that consideration should be given to providing a larger share of the existing pool of Commonwealth Financial Assistance Grants to such councils if an increase in the overall pool of available grants is not able to be secured.

ii). Greater Taree

TCorp awarded Greater Taree City Council a 'Very Weak' financial sustainability rating and a 'Negative' outlook.

Greater Taree scored adversely against TCorp's benchmarks for the following:

a) Operating ratio
b) Capital expenditure ratio
c) Asset maintenance ratio
d) Infrastructure backlog ratio
e) Building and infrastructure renewal ratio

TCorp highlighted that in particular Greater Taree had reported a very high infrastructure renewal backlog (about 25% of the replacement cost of its stock of infrastructure assets) and had forecast large ongoing operating deficits. It also indicated that Greater Taree believed that its reported asset renewal backlog was conservative and could not realistically be reduced without additional funding.

TCorp concluded that Greater Taree was currently in a satisfactory financial position but that '*clearly Council has insufficient financial resources to meet its future capital expenditure requirements or to address its infrastructure backlog*'.[16] I would agree with that assessment if a reasonable degree of confidence could have been attached to the council's then estimates of its annual depreciation expense and outstanding asset renewal needs.

In my September 2013 'Roadmap' report for the Independent Panel I highlighted that depreciation represented about double the share of Greater Taree's total operating expenses relative to the average for all NSW councils even though the council's asset stocks were not above the average proportion (compared with income) of other councils. I indicated then that the council had initiated work to review the basis of its assumptions regarding asset useful lives, depreciation rates and asset maintenance and renewal needs. In fact considerable work had already been commenced by the council well before the TCorp review to resolve the issues of asset renewal needs and service level affordability. TCorp's assessments were not a surprise to the council.

Greater Taree's work to refine its projections and determine appropriate responses is continuing and has been assisted by the introduction in NSW of the local government Integrated Planning and Reporting framework. It is noteworthy that for the year ending 30 June 2013 Council's depreciation expense was $26 million compared with $32 million for the previous two years. Council is anticipating a further reduction of about $4 million in its recorded depreciation expense for 2013/14. Council is currently preparing for a

[16] P.33 of TCorp's Greater Taree City Council Financial Assessment and Benchmarking Report of Oct 2012.

conversation with its community regarding affordable service levels and asset renewal expenditure.

TCorp also was critical of Greater Taree for preparing its long-term financial plan in real rather than nominal values. This surprised the council because it had relied on the ACELG/IPWEA Practice Note advice recommending use of real values (the document suggests such an approach in order to aid inter-period comparisons). Providing a council adjusts individual classes of financial inputs (e.g. employee costs or rate revenue) for real movements in prices (i.e. relative to the expected general inflation rate) then a long-term financial plan will generate the same outcomes and indicator scores regardless of whether real or nominal input values are used.

iii). Penrith

Penrith scored a 'Weak' financial sustainability rating from TCorp in its 2013 assessment and a 'Neutral' outlook.

It scored adversely against TCorp's benchmarks (generally for most years) for the following:

a) Operating ratio
b) Cash expense ratio
c) Interest cover ratio
d) Infrastructure backlog ratio
e) Building and infrastructure renewal ratio

It is noteworthy that Penrith has well above benchmark levels of own source revenue. This suggests to me that it has considerable control over its own financial destiny. Even if depreciation expenses remained at the levels reported when TCorp undertook its assessment I would claim that Penrith has good capacity to improve its financial performance in future, e.g. by holding service levels reasonably constant and increasing its own rates and charges at an incrementally higher rate than costs over time. I would also argue that it has capacity to borrow considerably more if this was necessary to address justified asset renewal needs.

In the course of my work associated with the preparation of this report Penrith advised that it undertook a comprehensive review of its depreciation methodology post its TCorp assessment. This resulted in its depreciation expense falling from $39M to $19M in 2012/13. I am not in a position to comment on whether this estimate will prove to be a reliable long-run base but simply note that such a change would have had a very material impact on Penrith's score for several of the indicators TCorp applied in its assessment.

Penrith also advised that it felt that the basis of calculation of TCorp's cash expense ratio indicator was excessively restrictive. It is its understanding that TCorp used 'cash at bank' as

the numerator for this liquidity ratio and did not allow inclusion of short-dated term deposits that Council had and was able to access with 24 hours' notice. Penrith changed its treasury management practices in order for such monies to be counted in the numerator in 2013. It also understands that from 2014 onwards term deposits will be allowed to be included in the numerator under the coding classifications applied for reporting purposes by the Office of Local Government.

As regards the unrestricted current ratio indicator, Penrith advised that it considers TCorp's benchmark is excessive and although it could easily meet the benchmark it instead conducts its treasury management affairs to achieve a lower target score that saves it money. I concur with its approach.

Penrith believes its reported asset renewal backlog is relatively small and is comfortable with its current and future planned levels of asset renewal expenditure. (This illustrates the point I've made elsewhere regarding the care needed in interpreting reported backlog levels. In some cases they reflect 'what in a perfect world would be nice to do but not now if we had to pay for it'.)

The experiences and responses of the three case study councils highlight the points that I've made earlier throughout this report that councils are still coming to grips with ensuring that their accrual accounting asset related information and their asset management data is consistent and reflective of current service levels and that this information is then used for critical decision-making. This is not surprising and consistent with experiences in other states. Councils Australia-wide traditionally focussed on short-run cash accounting information and it is only in recent years with the emphasis on accrual accounting and the requirement to regularly revalue assets and prepare asset management and long-term financial plans that the shortcomings of the traditional approach are becoming more widely recognised.

7. Conclusions and Summary

TCorp was entitled to rely on the data it used in its analysis but this data prepared by councils is not as robust as it could be. In particular councils are still refining their estimates as regards future asset renewal needs and ensuring that asset useful life and depreciation accounting estimates are closely correlated with actual practice and preferred, affordable service levels.

TCorp's ratings of councils has caused many of them to reflect on their accounting practices and implicit and explicit service levels, including estimates of warranted asset renewal needs. This in itself has made TCorp's work worthwhile. Elected councils, their management teams and communities and others that councils are accountable to should, indeed need to, be able to depend on the reliability of financial information produced by councils to make

strategic decisions and judge performance. It is quite likely that if the TCorp review was repeated today with the same methodology but with updated financial data, that some, and possibly many, councils would be likely to receive more favourable ratings and outlooks. Others though could receive less favourable results. There would though at least be a better appreciation by such councils of the reasons for the assessments and what the implications may be and what further actions may be warranted.

I am supportive of TCorp's general findings regarding the sector's financial sustainability and particularly its recommendations to help strengthen councils' financial performance and capacity. This is despite the fact that that I would advocate some differences in the range of financial sustainability indicators applied and in their computational basis and weighting. Such changes would result in some councils getting better and others a less favourable rating.

In my opinion some of TCorp's indicators are more appropriate for assessment of the financial worthiness of private sector entities (and in particular their worthiness to take on more debt) than for a sphere of government. Local governments generally have more reliable revenue streams, discretion regarding expenditure and stable and predictable operating environment than is typically the case for entities in the commercial business world.

I would encourage in particular a prime focus on the current and projected operating result (net of capital revenues) of councils in assessing their financial sustainability. Secondly I would also caution against assessment of asset management performance that involved comparison of asset renewal levels with depreciation. Asset renewal needs can vary significantly over time and may justifiably in any period be at levels higher or lower than depreciation. Thirdly councils generally need to make greater use of debt if they are to cost-effectively manage their service level responsibilities and equitably charge beneficiaries of these services over time. Not only should councils make greater use of debt (subject to having sound financial plans, strategies and policies in place) but they could also benefit substantially from changes in their treasury management practices. As such I would give less regard to liquidity considerations than TCorp has in its assessments.

Acknowledgement

I acknowledge and thank TCorp and the three case study councils, Bourke, Greater Taree and Penrith for the very valuable assistance provided by their representatives in the preparation of this report. All were not only willing to assist but genuinely interested in hearing and understanding other perspectives on the issues discussed.

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The TCorp ratings and their definitions are listed below. (This information has been sourced from Appendix 1 of the TCorp report.)

FINANCIAL SUSTAINABILITY RATING

Very Strong

- A local government with a very strong capacity to meet its financial commitments in the short, medium and long term.
- It has a record of reporting operating surpluses.
- It is highly likely to be able to manage unforseen financial shocks and any adverse changes in its business without revenue and/or expense adjustments.
- Its capacity to manage core business risks is very strong.

Strong

- A local government with a strong capacity to meet its financial commitments in the short, medium and long term.
- It generally has a record of operating surpluses and may occasionally report minor operating deficits. It is able to address its operating deficits, manage major unforseen financial shocks and any adverse changes in its business with minor revenue and/or expense adjustments.
- The expense adjustments are likely to result in only minor changes to the range of and/or quality of services offered.
- Its capacity to manage core business risks is strong.

Sound

- A local government with an adequate capacity to meet its financial commitments in the short, medium and long term.
- While it is likely that it may have a record of minor to moderate operating deficits, the local government is expected to regularly report operating surpluses. It is likely able to address its operating deficits, manage major unforseen financial shocks and any adverse changes in its business with minor or moderate revenue and/or expense adjustments.
- The expense adjustments are likely to result in some changes to the range of and/or quality of services offered.
- Its capacity to manage core business risks is sound.

Moderate

- A local government with an adequate capacity to meet its financial commitments in the short to medium term and an acceptable capacity in the long term.
- While it has some record of reporting minor to moderate operating deficits the local government may also have recently reported a significant operating deficit.
- It is likely able to address its operating deficits, manage unforseen financial shocks and any adverse changes in its business, with moderate revenue and/or expense adjustments. The expense adjustments are likely to result in a number of changes to the range of and/or quality of services offered.
- Its capacity to manage core business risks is moderate.

Weak

- A local government with an acceptable capacity to meet its financial commitments in the short to medium term and a limited capacity in the long term.
- It has a record of reporting moderate to significant operating deficits with a recent operating deficit being significant. It is unlikely to be able to address its operating deficits, manage unforseen financial shocks and any adverse changes in its business, without the need for significant revenue and/or expense adjustments.
- The expense adjustments would result in significant changes to the range of and/or quality of services offered.
- It may experience difficulty in managing core business risks.

Very Weak

- A local government with a limited capacity to meet its financial commitments in the short to medium term and a very limited capacity long term.
- It has a record of reporting significant operating deficits. It is highly unlikely to be able to address its operating deficits, manage unforseen financial shocks and any adverse changes in its business without the need for structural reform and major revenue and/or expense adjustments.
- The expense adjustments are likely to result in significant changes to the range of and/or quality of services offered and it may need the assistance from higher levels of government.
- It has difficulty in managing its core business risks.

Distressed

- A local government with a very limited capacity to meet its short term financial commitments and no capacity to meet its medium to long term financial commitments.
- It has a record of reporting significant operating deficits.
- To be able to address its operating deficits, meet its medium and long term obligations, manage unforseen financial shocks and any adverse changes in its business, major revenue and expense adjustments and structural reform will be required.
- The local government is unlikely to have the capacity to manage core business risks and may need assistance from higher levels of government.

FINANCIAL SUSTAINABILITY RATING OUTLOOK

Positive

As a result of a foreseeable event or circumstance occurring, there is the potential for enhancement in the local government's capacity to meet its financial commitments (short and/or long term) and resulting change in its rating. However, it does not necessarily indicate that a rating change may be forthcoming.

Neutral

There are no known foreseeable events that would have a direct impact on the financial sustainability of the local government. It may be possible for a rating upgrade or downgrade to occur from a neutral outlook, if warranted by an event or circumstance.

Negative

As a result of a foreseeable event or circumstance occurring, there is the potential for deterioration in the local government's capacity to meet its financial commitments (short and/or long term) and resulting change in its rating. However, it does not necessarily indicate that a rating change may be forthcoming.

The TCorp indicators, their basis of calculation and the weightings attached to each in arriving at a council's overall financial sustainability rating is set out below. (This information has been sourced from Appendix 2 of the TCorp report.)

i). 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 achievement of containing operating expenditure within operating revenue. It is important to distinguish that this ratio is focussing on operating performance and hence capital grants and contributions are excluded.

Weighting: 17.5%

ii). 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 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.

Weighting: 17.5%

iii). 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.

Weighting: 10%

iv). Unrestricted Current Ratio

Benchmark = 1.5x

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 used to assess liquidity of businesses as cash allocated to specific projects is 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 short term obligations as they fall due.

Weighting: 10%

v). 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 operating cash to service debt including interest, principal and lease payments

Weighting: 7.5%

vi). Interest Cover Ratio

Benchmark = Greater than 4.0x

Ratio = Operating results before interest and depreciation (EBITDA) / Borrowing interest costs (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.

Weighting: 2.5%

vii). 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.

Weighting: 10%

viii). 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.

Weighting: 7.5%

ix). 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.

Weighting: 7.5%

x). 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.

Weighting: 10%