Port Stephens Council Financial Sustainability Report

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EXECUTIVE SUMMARY

This Financial Sustainability Report paints a rather grim picture of financial sustainability challenges facing Port Stephens Council. Indeed, matters could hardly be more serious. However, it is noteworthy that senior management – especially those involved in financial matters – have done a sterling job. There is thus good reason to believe that their efforts have been pivotal in averting a financial crisis thusfar.

In this Report we recommend a number of measures that should be taken as soon as possible to assure financial sustainability. The consequences of the COVID publicpolicy response are far from over and some of the worst effects, such as inflation, are only now starting to emerge.

Moreover, it is abundantly clear that a special rate variation (SRV) is essential moving forward. The matter is not simply about ensuring adequate revenue receipts(an immediate concern), but it is also a pre-requisite for ongoing financial sustainability and intergenerational equity, as well as a remedy for dispelling dangerous levels of fiscal illusion.

1. INTRODUCTION

Financial sustainability in local government can be defined as the ability to meet the reasonable expectations of current residents in a way that does not put at risk the capacity of future generations to meet their own needs (Drew and Dollery, 2020).

This definition requires current municipal taxpayers to at least fund their share of the consumption of long-lived assets, in addition to the full costs of operational programs. Moreover, it emphasises reasonable expectations and thus cautions against allowing fiscal illusion to develop. Fiscal illusion occurs when local ratepayers do not understand the financial circumstances of their local council and underestimate the true cost of current municipal service provision (Drew, 2021).

At present two New South Wales (NSW) local governments are in administration as a result of their failure to demonstrate financial sustainability. Moreover, a number of other local councils find themselves in a precarious financial position, most notably rural and remote councils, high growth coastal communities, and many of the entities created in the 2016 forced amalgamation program (Drew, 2021). Indeed, past financial failures have not been predicted by regulatory authorities and they also came as an unexpected shock to elected councillors (Drew and Campbell, 2016).

Every local government in NSW ought to be concerned about financial sustainability. Moreover, because budget repair for failed councils involves significant increases to intergovernmental grants derived from a relatively fixed quantum of money, each new failure places additional pressure and risk onto the remainder of the jurisdictional cohort. Furthermore, COVID-19 policy responses have imposed additional costs on local authorities, raised the spectre of a lengthy period of high inflation and interrupted both the predictability and flow of revenue. It is thus prudent to exercise extreme caution with respect to finances at this time, especially in view of the continued uncertain outlook regarding both the problem and the policy response (see Appendix 1).

This Report examines fifty metrics and reflects a combined five decades of scholarly expertise in local government economics and finance. The authors have reviewed relevant council documentation and regulatory policies to inform their judgements. In addition, discussions have been held with key stakeholders and rigorous empirical work (including econometric modelling and data envelopment analysis) has also been conducted to ensure an accurate picture of Port Stephen’s financial sustainability is established.

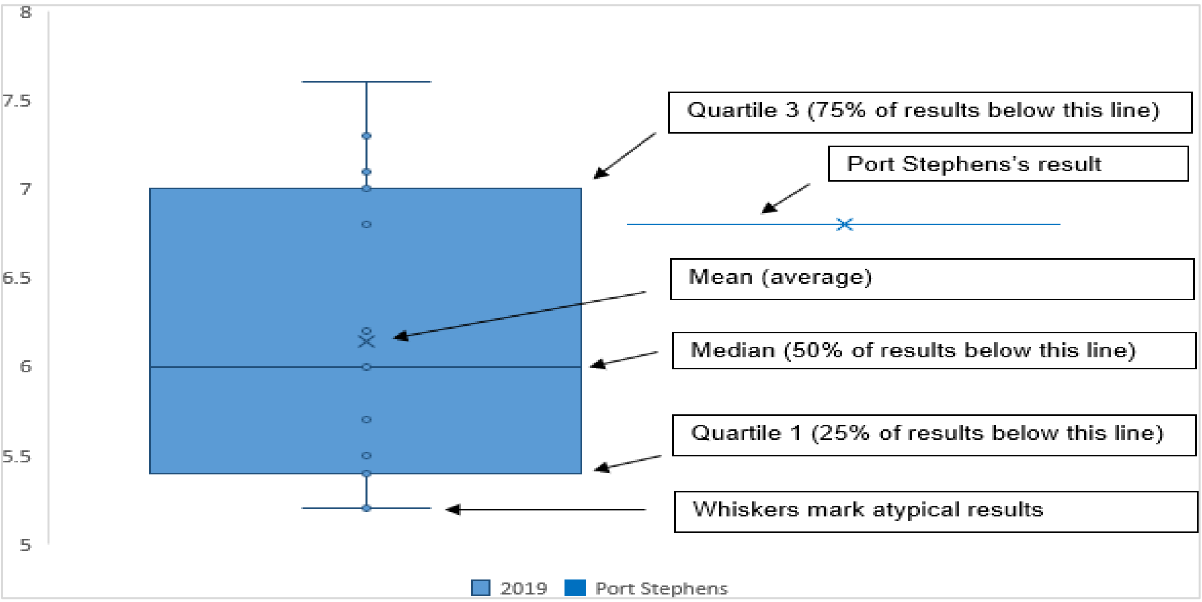
The most reliable comparison – for the purposes of evaluating local government financial sustainability – is Council itself at different time periods. This is because service levels, structures and policies tend to remain fairly constant within the single municipal entity. However, inevitably local government decision-makers wish to gain an understanding regarding how they compare to similar communities. We have thus also compared Port Stephens' performance against a group of fourteen peer councils as detailed in Table 1. Peers have been drawn from multiple NSW Office of Local Government (OLG) categories as is appropriate when one wishes to have close comparisons and also acknowledges the chronic flaws in the extant classification system (Drew and Dollery, 2016).

TABLE 1. PEERS USED IN COMPARISONS

OLG 5 Councils	OLG 5 Councils	OLG 4 Councils	OLG 11 Councils
Coffs Harbour	Tweed	Cessnock	Muswellbrook
Newcastle	Maitland	Singleton	
Shoalhaven	Shellharbour	Tamworth	
Lake Macquarie	Wollongong	Wagga Wagga	
Port Macquarie			

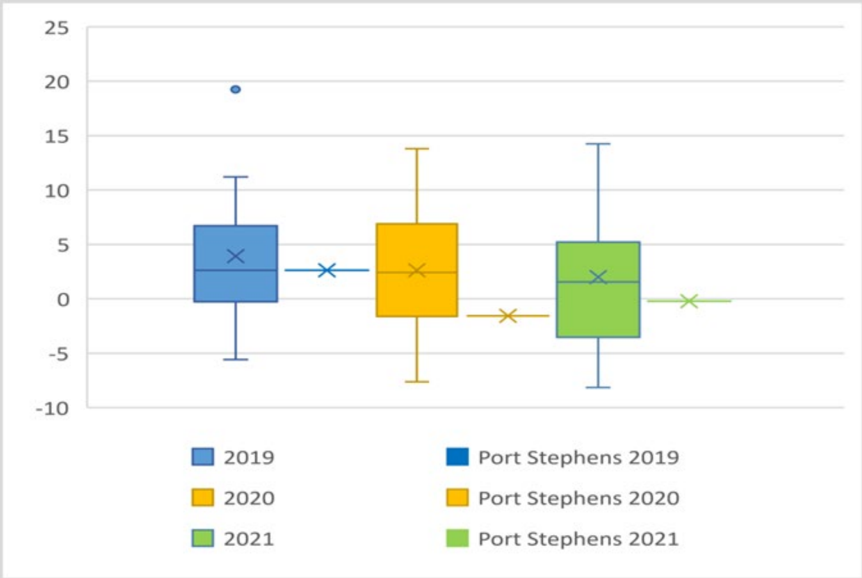
Comparative data is presented in box and whisker plots which are the best way to illustrate a particular council's performance relative to its peer group. Figure 1 explains how best to interpret such a plot.

FIGURE 1. INTERPRETING BOX AND WHISKER PLOTS



2. ANALYSIS

FIGURE 2. OPERATING PERFORMANCE RATIO



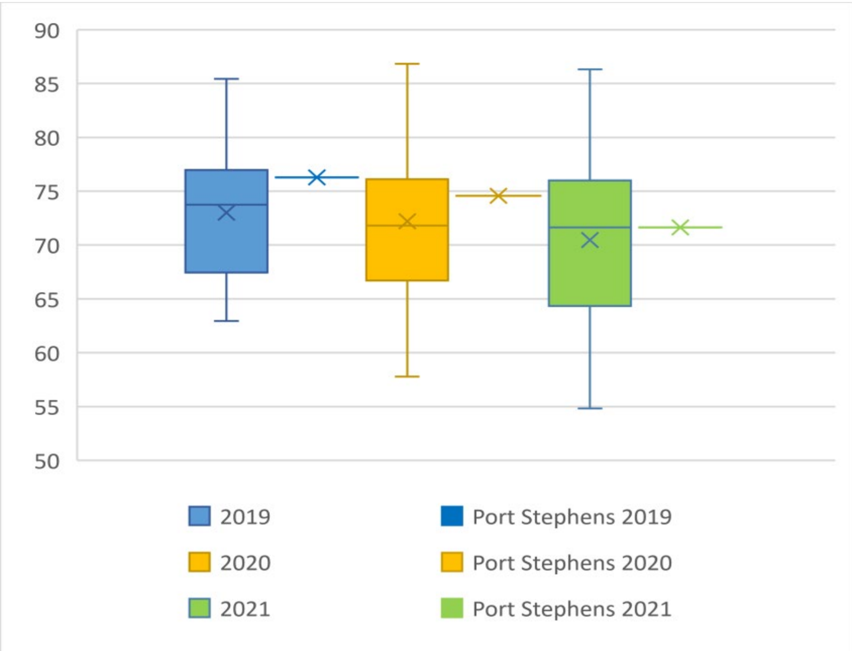
Perhaps the key ratio employed for decision making by councils and regulators alike is the operating ratio. Moreover, the Port Stephens Council's endeavours to keep this ratio above zero were prudent. However, it should be noted these prudent measures counted against it in its 2019-20 application for a Special Rate Variation (SRV)!

Unfortunately placing undue emphasis on a single ratio can tend to obscure important problems and risks associated with financial sustainability (which is why we survey some 49 other metrics in this Report). Historically, Port Stephens has tended to meet its goal of break-even on the operating ratio. However, since the advent of the COVID-19 policy responses, this has not been possible. The reason for this recent shortfall can be attributed largely to the sudden drop-off in commercial receipts, the absence of airport dividends, and drastically reduced services revenue[1].The results from the last few years highlight how exposed Port Stephens has become to commercial risk in its struggle to maintain sufficient revenues despite clearly inadequate taxation receipts.

[1] For 2021 the proportion of total fees and charges attributable to these non-core activities were: childcare (7.48%; $2,671 – all figures provided in thousands of dollars), holiday parks (40.60%; $14,506), and airport partnership (21.87%; $7,816) – in 2019 this was childcare (4.58%; $1,859), holiday parks (27.84%; $11,306), and airport partnerships (41.98%; $17,045).

As we will argue throughout this Report, inadequate taxation receipts have forced Port Stephens Council to take on significant risk which threatens financial sustainability, especially in the face of economic shocks. It is highly likely that furthershocks will occur in the future, either from COVID or some other unrelated problem. Moreover, it is by no means certain that Port Stephens will be able to withstand the impact of these potential imposts, unless significant action is undertaken to mitigate matters.

FIGURE 3. OWN SOURCE RATIO



In Figure 3 we present the own-source ratio which confirms our remarks about the operating results being associated with non-core local government revenues (and hence risk). Unfortunately, during the Fit for the Future program, a lot of uninformed commentary emerged regarding the need for local governments to grow their own-sourced revenue. Appropriate growth in own-source revenue – that is, for core local government services – is desirable because it improves the nexus between the cost of supply and the price paid and hence reduces fiscal illusion (see our observations with respect to the nexus ratio below). However, revenues obtained from non-core local government functions introduce heightened levels of risk and make communities more vulnerable in the face of economic shocks (as is clear from the 2021 financial year data in particular). Moreover, intergovernmental grants are critical for correcting vertical fiscal imbalance[2] and also promoting horizontal fiscal equity[3], but also detract from the own-source revenue. Thus, it is sometimes the case that a high achievement in this metric may indeed be reflective, at least in part,of inadequate grant flows.

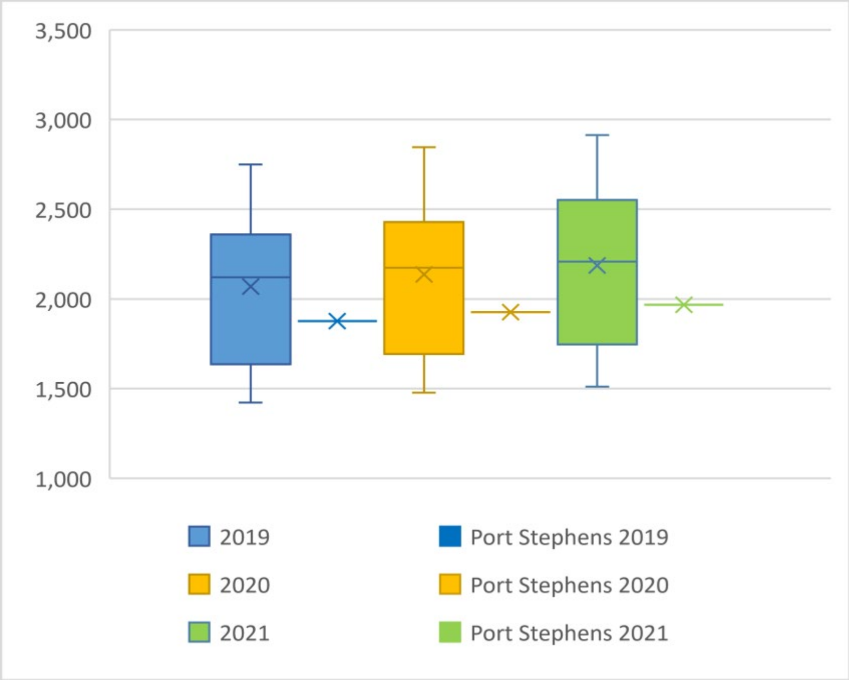
As Figure 4 demonstrates, financial assistance grants (FAGs) nominally allocated for the purposes of maintaining road infrastructure are inadequate for Port Stephens' needs. At present the council receives far less per kilometre than the typical peer group member (measured by either the median or the mean with the former being the more reliable statistic). For many years scholars have shown that the grant allocations in NSW – and indeed the whole country – are chaotic and indefensible aswell as inconsistent with the clear intent of the enabling legislation (Drew and Dollery, 2014; Drew, 2021). It is notable that the most recent community satisfaction survey at Port Stephens pinpointed high levels of discontent with the road network (45% satisfaction with road maintenance; 68% satisfaction with roadside maintenance) and clearly insufficient grant flows are part of the problem. Moreover, ifgrant flows for roads remain insufficient, then it will be necessary and appropriate to significantly increase taxation receipts[4] (that is to receive an SRV) to ensure that adequate and sustainable maintenance of roads can be assured. Notably the problem with the road component of the FAGs is compounded by real reductions foreshadowed to the Roads to Recovery grants.

[2] Vertical fiscal imbalance refers to the fact that in most federal systems of government, the national government typically collects greater revenues than it requires to discharge its remit. In contrast, because local government has a narrow tax base the opposite is true.

[3] This refers to the desirability of all local governments being able to provide a basic minimum level of localservices. Because some regions are richer than others – and also because different communities exhibit varying levels of need – horizontal equity can rarely be achieved without a specific grant scheme.

[4] Because local roads are public goods (non-excludable and non-rival) the appropriate source of funding is taxation: either direct taxation through levying of rates or increased allocation of tax receipts originating with higher tiers of government (intergovernmental grant allocations).

FIGURE 4. ROAD GRANT PER KILOMETRE

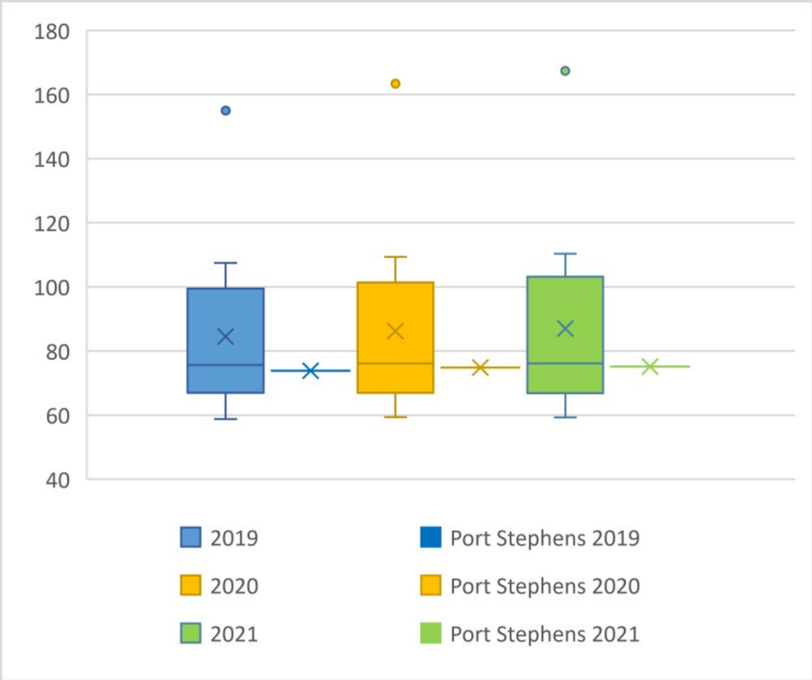


Matters are better for the general component of FAGs, at least in a relative sense. Here the median is the most appropriate comparative statistic because of the skewing associated with the extreme outlier (represented by the dot to the north of the graphs). However, it should be noted that in all likelihood the grants are still insufficient and not at the level that they ought to be set at due to both chaotic methodology and lack of commitment by the higher tier governments to the financialsustainability of rural and high-growth local governments (Drew, 2021).

Moreover, there is considerable uncertainty regarding the level of grant receipts moving forward, because of at least two factors. First, the federal budget is in deep deficit which will inevitably encourage politicians to look for cuts that generate minimum political costs (such as the FAG freeze implemented previously). Second, financial failures of other councils in NSW inevitably result in significant upwards ‘adjustments’ to FAGs for these councils. Because the total quantum is fixed, this means that the rest of the local authorities in the state jurisdiction receive less than what they would have otherwise received (Drew and Campbell, 2016). Given the riskof further local councils failing over the next few years, it would be optimistic to believe that FAG allocations to Port Stephens will continue to grow in future.

Once again, inadequate grants means that local councils need to respond bysecuring increased taxation receipts (through SRVs).

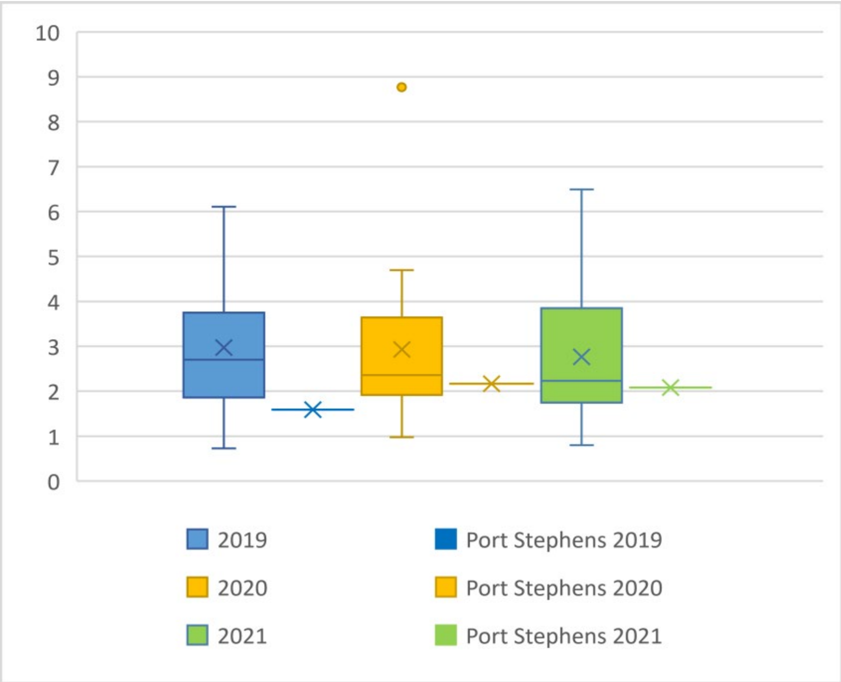
FIGURE 5. GENERAL COMPONENT OF FINANCIAL ASSISTANCE GRANT PER PERSON



The unrestricted current ratio is a liquidity ratio commonly employed to measure the sustainability of commercial businesses. Unfortunately, regulators have adopted this metric without considering its appropriateness to the much more lumpy nature of municipal revenue. Unlike commercial businesses that are constantly accruing income from selling products, local government tends to receive most of its money according to quarterly invoices. Thus, meeting the benchmark of 1.50 should not be considered as reason for comfort. Indeed, most of the metrics used in NSW have arbitrary benchmarks and they are also insufficient to fully reflect the state of financial sustainability for a given council. In this regard, it is notable that the metrics did not predict the last municipal financial failure, which is an obvious cause for concern regarding their fitness for purpose. Put differently, no local government should feel that achieving the benchmark for the liquidity ratio or the other regulatory ratios means that they are necessarily financially sustainable.

Port Stephens has chronically low (and recently declining) liquidity in a relative sense. When combined with its higher risk profile and concomitant susceptibility to economic shock, it is by no means certain that it will be able to pay its bills when they fall due in the future. While we do not mean to induce unnecessary alarm, there should be no doubt that the situation is serious and warrants urgent attention.

FIGURE 6. UNRESTRICTED CURRENT RATIO

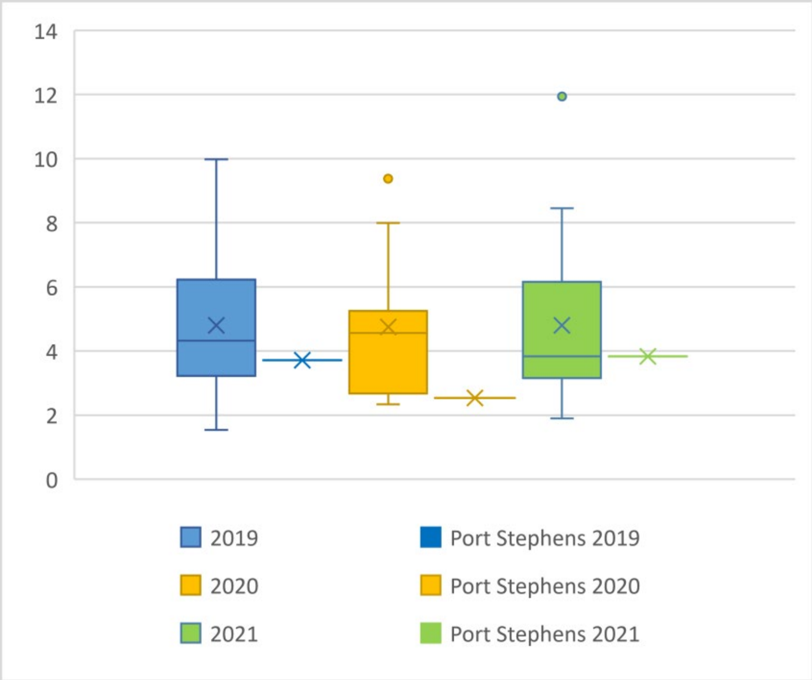


The debt service ratio suggests that Port Stephens has a relatively low capacity to take on additional debt. However, to fully understand this problem, debt capacity modelling will need to be undertaken (see Drew, 2021). We understand that Port Stephens plans to take on more debt to upgrade depots, council buildings and conduct public domain upgrades. We urge caution before doing so and do not consider this ratio (or its arbitrary benchmark) adequate for decision-making purposes. Nor should reliance be made on bank assessments because these institutions have demonstrated in the past that they are largely unconcerned aboutrepayment capacity due to their belief in extant soft budget constraints[5].

We also note that Port Stephens considers debt financing to be an important tool toassure intergenerational equity. However, as demonstrated by Drew (2020; 2021), intergenerational equity can only be achieved when certain strict criteria are observed, including a *quid pro quo* via increases to revenue (such as an SRV) or decreases in expenditure elsewhere in line with the expected consumption of the asset.

[5] That is, commercial banks understand that there will be a bailout should the council fail (as in the case of Central Darling Shire) (Drew and Campbell, 2016).

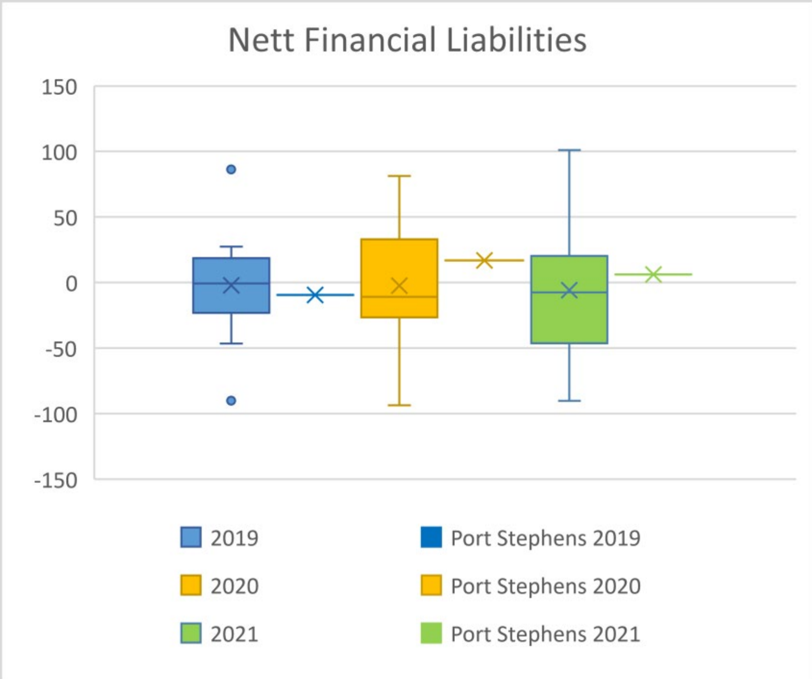
FIGURE 7. DEBT SERVICE RATIO



The nett financial liabilities ratio is much better (although still inadequate) at indicating debt capacity because it includes important liabilities (such as non-loanobligations related to staff) neglected by the former metric. This is probably the reason why versions of this metric are preferred by Queensland, South Australian and Western Australian regulatory authorities.

For this ratio a negative result is preferred (and generally expected) because this would mean that relevant assets exceed liabilities. The typical council in the peer group does have a near-zero or negative result as desired. However, the result forPort Stephens has been positive for the last two years. When considered in light ofthe ongoing risk posed by COVID-19 policy, as well as Port Stephens' proposed borrowings, this metric provides solid grounds for concern.

FIGURE 8. NETT FINANCIAL LIABILITIES



Depreciation accruals have been a source of ongoing difficulties for all local governments in Australia. As noted in the scholarly literature, full accrual accountingis problematic for governments because an active market does not exist for most infrastructure assets (and hence there is no reasonable fair market benchmark to judge asset value (Drew, 2020)). Moreover, accurate depreciation accruals are critical to a number of other metrics (especially the asset ratios) and also play an important role in financial sustainability planning.

The aggregate rate of depreciation at Port Stephens is on the low side in a relative sense as indicated by Figure 9. However, we should not jump to the conclusion that depreciation is being under-expensed (because usage rates and climatic conditionsare strong determinants for the accrual). Nonetheless, it does indicate the need for another look at the relevant schedules. If it transpires that depreciation has been under-expensed, then this would mean that the financial sustainability situation at Port Stephens is even more serious than it currently appears. Moreover, inaccuracies in depreciation tend to resolve as losses and gains on disposal which tend to result in unstable and unpredictable operating results.

To assist the process of potential problem identification, we have also disaggregateddata even further according to the four major common classes of depreciable items. This more disaggregated data is presented in Figures 10 through to 13.

FIGURE 9. TOTAL DEPRECIATION OF INFRASTRUCTURE, PROPERTY, PLANT AND EQUIPMENT DEFLATED BY CARRYING AMOUNT

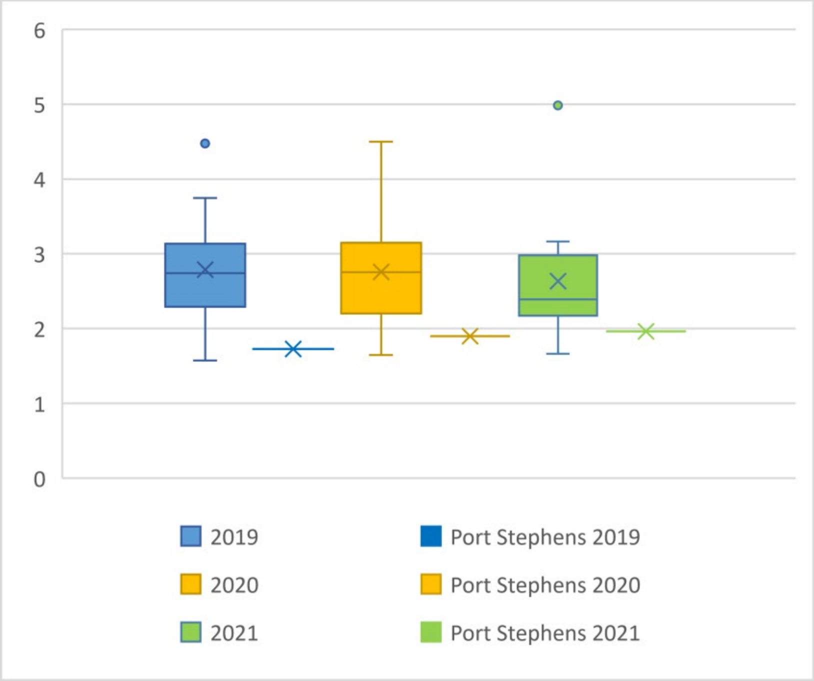
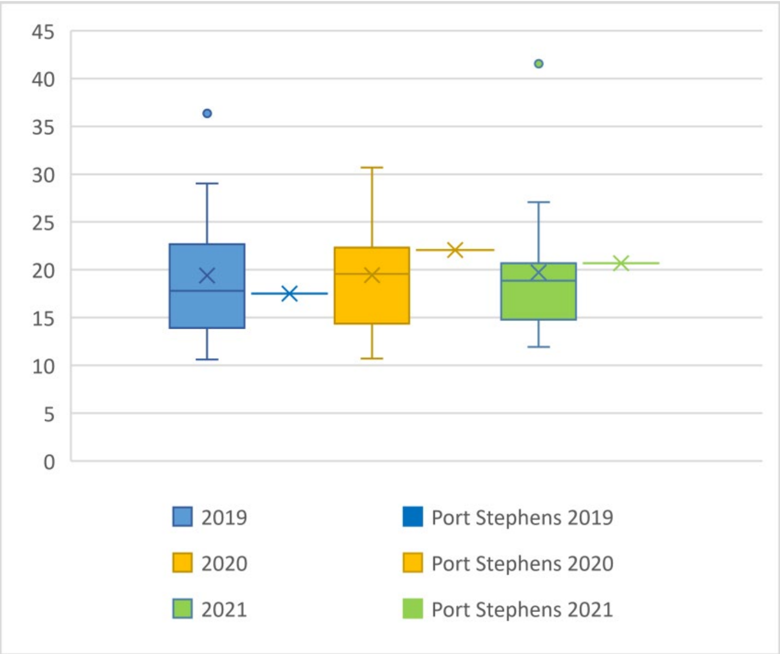


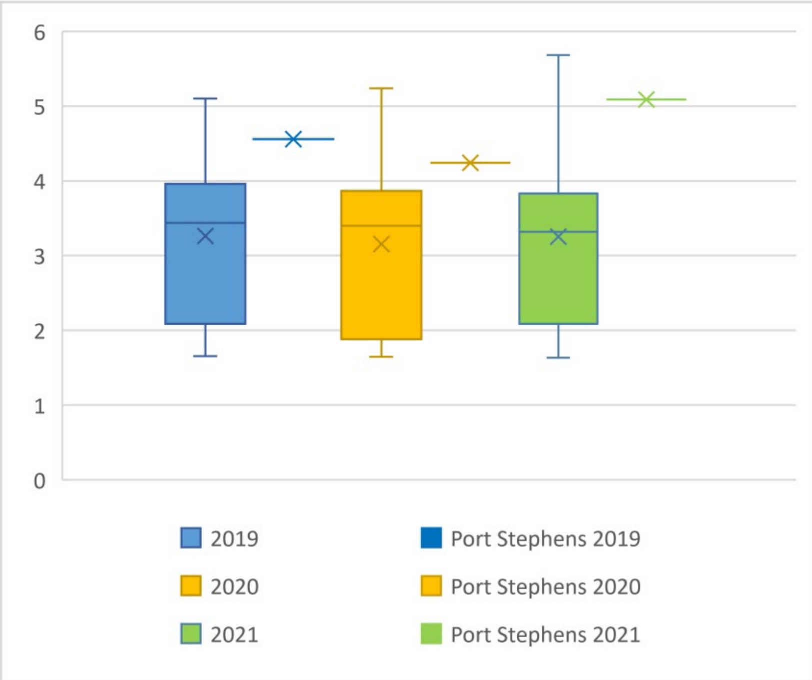
Figure 10 provides a comparison of the rate of depreciation for plant and equipment. It appears that Port Stephens is slightly more aggressive in its observation of this accrual than the peer group. This may mean that plant and equipment is being used more, not lasting as long as might be reasonably expected, or being depreciated too quickly.

FIGURE 10. DEPRECIATION OF PLANT AND EQUIPMENT DEFLATED BY CARRYING AMOUNT



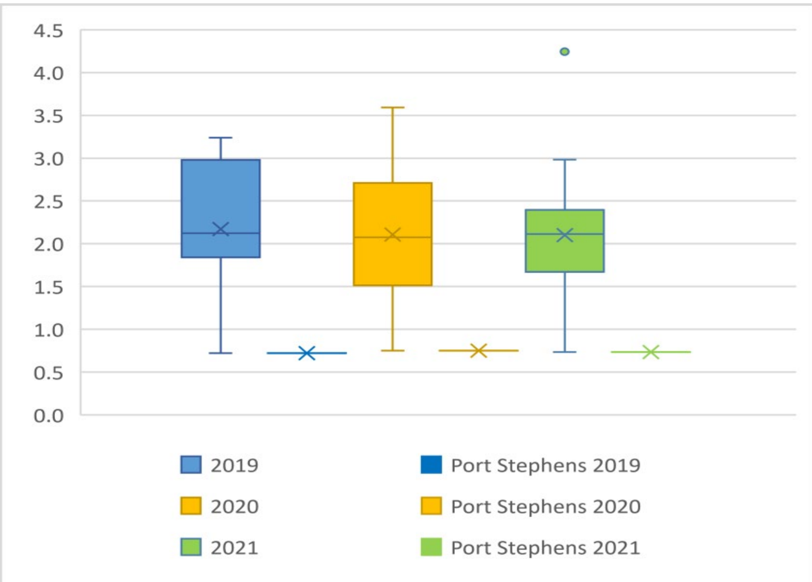
Similarly, Port Stephens is depreciating buildings much more aggressively than the rest of the peer group. As we have already noted, there could be good reasons for doing so, but the comparative data suggests the need for a review of the relevant schedules.

FIGURE 11. DEPRECIATION OF BUILDINGS DEFLATED BY CARRYING AMOUNT



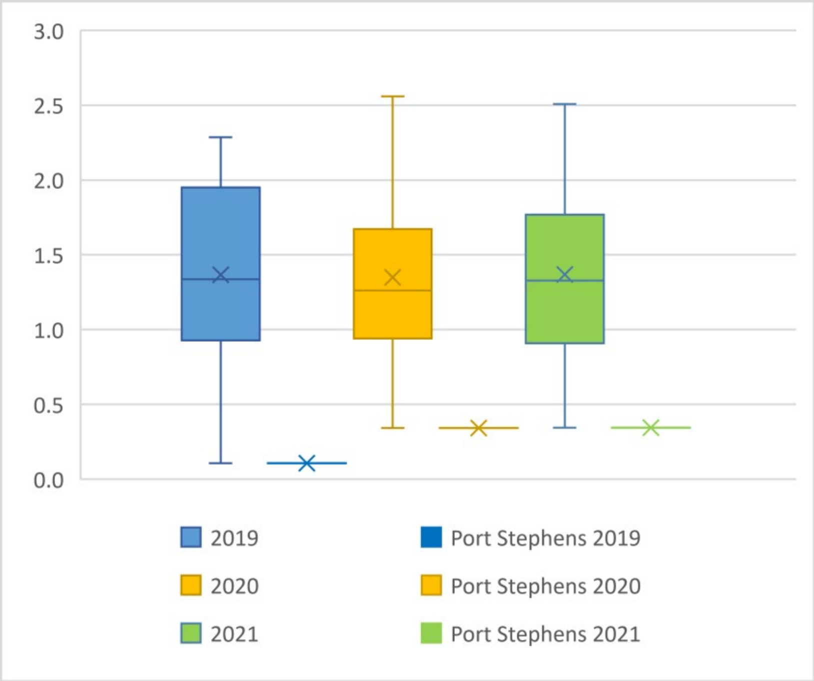
Depreciation of transport infrastructure seems concerning in a relative sense. Moreover, when we also consider the citizen dissatisfaction with this class of assets,there could be good reason to review these accruals upwards.

FIGURE 12. DEPRECIATION OF ROADS, BRIDGES AND FOOTPATHS DEFLATED BY CARRYINGAMOUNT



In a similar vein, accruals for stormwater seem lower than expected, although we offer some caution in interpreting this particular graph because some local governments do not adequately separate out non-depreciable earthworks.
Nevertheless, drainage asset schedules might warrant some review.

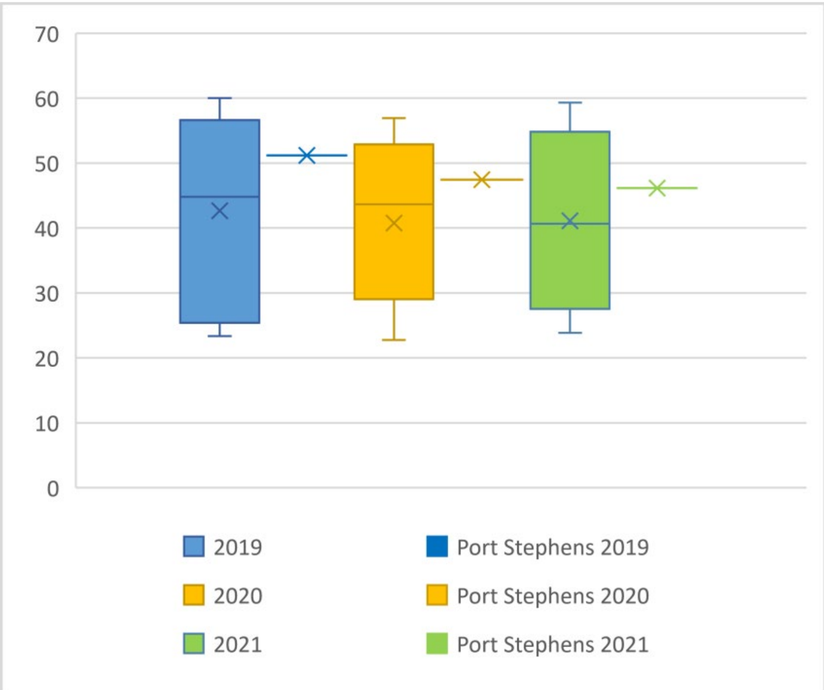
FIGURE 13. DEPRECIATION OF STORMWATER DRAINAGE DEFLATED BY CARRYING AMOUNT



The nexus ratio is designed to measure how much of operational expenditure is covered by fees and charges. The nexus result for Port Stephens Council is quite high in both an absolute and comparative sense. Ordinarily this would be considered a good thing because it would indicate that the bulk of goods and services were funded by fees and charges as is appropriate for all non-public goods. However, because of the large revenue flows generally produced from Port Stephens' non-core businesses, the ratio seems to suggest cross-subsidisation of local residents by commercial operations of council. Whilst understandable in terms of the incredibly low taxation receipts received at Port Stephens (and the recent denial of an SRV), subsidisation of this kind exposes both local residents and council to significant risk, as demonstrated by the drop in the result for the last two years. Given the continued uncertainty surrounding the pandemic, policy responses to the pandemic and potential inflation, risk of this kind is problematic (see Appendix 1). Moreover, when councils aggressively pursue own-source revenue by operating non-core services this presents a number of other problems. First, it diverts organisational attention away from core functions. Second, it distorts local economies and eliminates much of the existential space for people and businesses. Third, it tends to create a better image of financial sustainability during good business conditions than might be warranted upon closer inspection (hence the previous rejection of the SRV application). Fourth, and most importantly, it fuels fiscal illusion.

Fiscal illusion occurs when citizens do not understand the true cost of goods and services consumed nor the financial predicament of council. It is clear from the IPART (2020) ruling that fiscal illusion is particularly rife at Port Stephens. This not only contributed to the rejection of the SRV application, but is also a major driver of expenditure moving forward. When people receive a discount price for municipal services – and also think that their local government is in a good financial position – then economic theory predicts that they will demand an excessive quantity and quality of local municipal services. Hence fiscal illusion places financial sustainability in jeopardy.

FIGURE 14. NEXUS



Our observation regarding cross-subsidisation is further illuminated by the rates and annual charges data presented in Figure 15. As can be seen, revenue per assessment is far lower than the typical council in the peer group and generally sits at the very bottom of the second quartile. Moreover, the rather flat progression in this metric over the last three years suggests that fees (as well as local taxes) are being increased according to an index number. This is not a financially sustainable practice.

Fees and charges should generally be set according to supply-side methodology. This means that the fee should be equivalent to the long-run cost of producing one more unit (making provision for capital investment and the like). Clearly it is not possible to carefully review each and every fee each year. However, a schedule should be made so that each fee is reviewed at least once each political term with the emphasis being placed on ensuring full cost recovery, except for cases where arobust rationale can be articulated for providing a specified subsidy from the common tax pool. Drew (2021) provides detailed instructions for setting fees and annual charges in a sustainable manner.

In view of the concerning threat to financial sustainability, as well as the delay to anSRV exacerbated by the COVID-postponed elections, we strongly recommend that Port Stephens reviews as many non-regulated fees and charges as possible for theupcoming operational plan. Other NSW councils we have worked with have been surprised by the discrepancy between extant fees and charges with respect to the actual costs of delivery. Failing to price local services at cost fuels fiscal illusion andalso visits inequity on the broader cohort of local government taxpayers (who are effectively forced to subsidise the consumption of local services by some localresidents (Drew, 2021)).

FIGURE 15. RATES, FEES AND ANNUAL CHARGES PER ASSESSMENT ($)

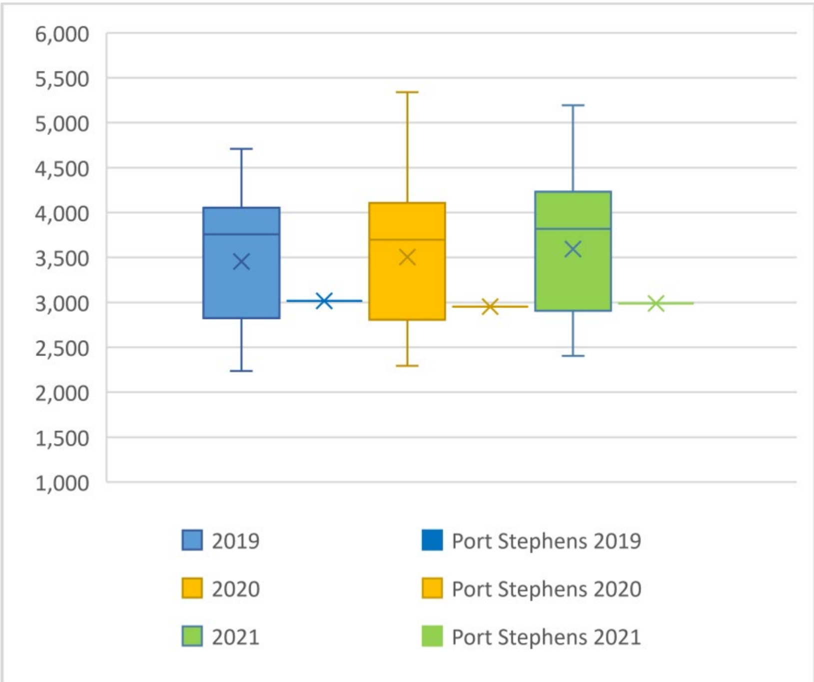
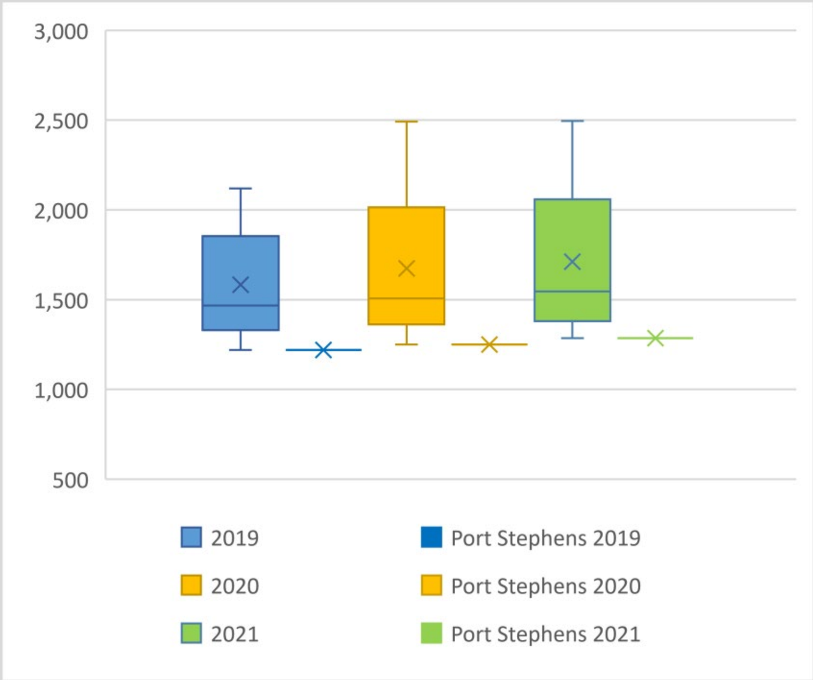


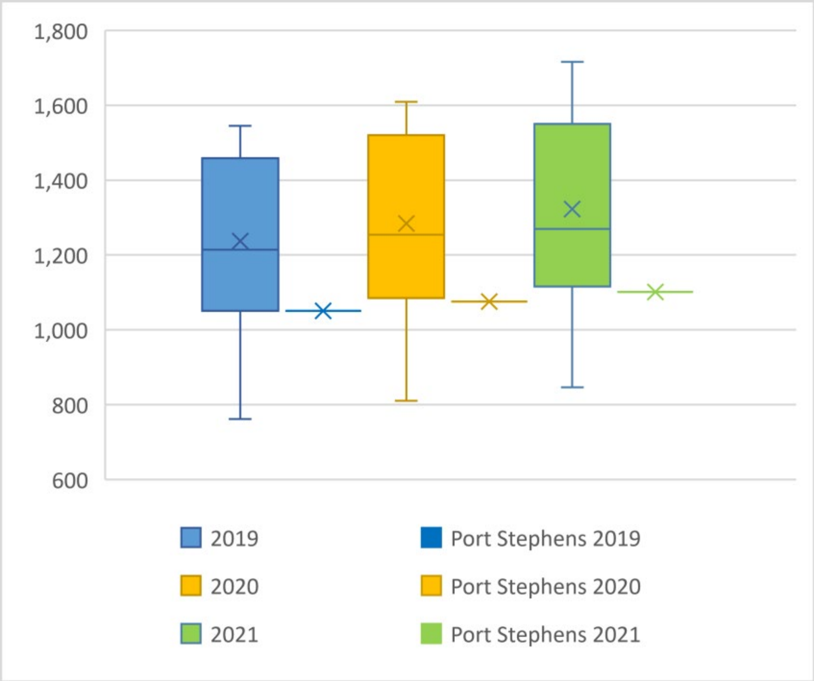
FIGURE 16. TOTAL RATES PER PROPERTY ASSESSMENT ($)



Residential rates in Port Stephens are extremely low on a comparative basis and generally sit in the bottom quartile of the peer group. This suggests that residents have not been paying the full price for the local public services that they consume. Itthus fuels fiscal illusion which explains both the unwillingness to pay (noted by IPART, 2020), as well as the demands for higher levels of services noted in council documentation. It also means that residents are visiting inequity on future taxpayers (because the *quid pro quo* for recent debt has clearly not occurred), which by definition means that matters are not financially sustainable. Put differently, past andplanned borrowings must be serviced through higher taxes or reductions to service levels for there to be any possibility of making the case that the current taxpayers have paid their fair share of long-lived assets consumed.

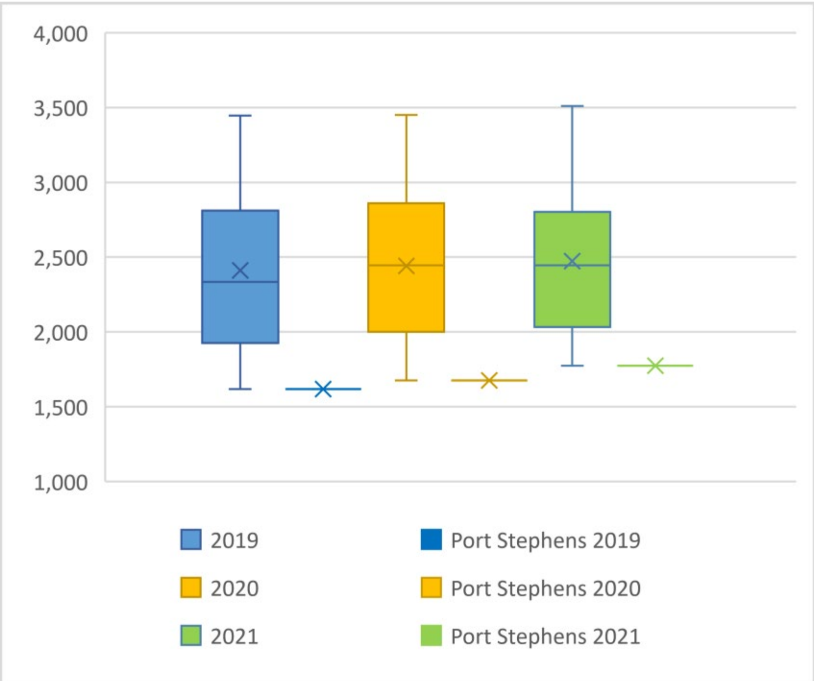
Only by canny financial management has Port Stephens managed to survive this long with such low residential property tax receipts. However, the risks taken to do so are now made plain.

FIGURE 17. RESIDENTIAL RATES PER ASSESSMENT ($)



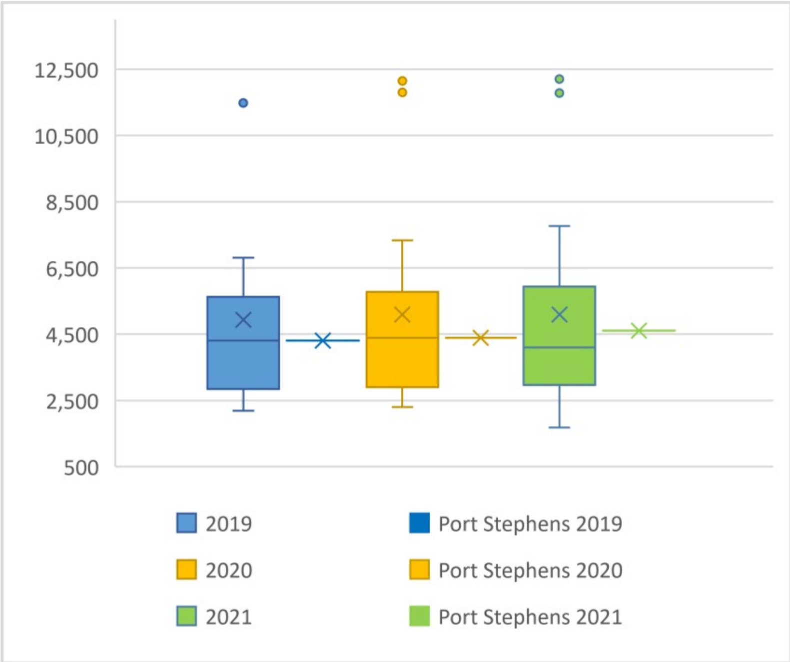
Farm rates are also at incredibly low levels but are mitigated in part by the relatively low numbers of this kind of assessment.

FIGURE 18. FARM RATES PER ASSESSMENT ($)



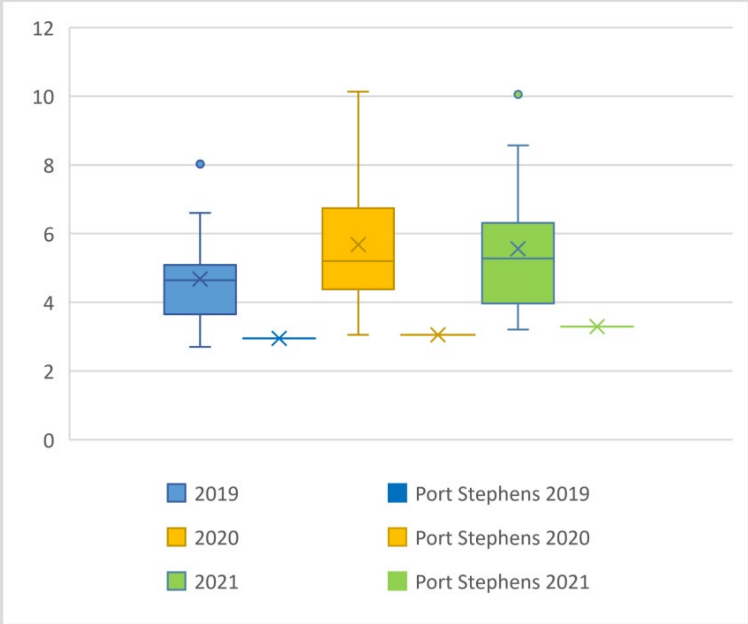
Interestingly, business rates on a per assessment basis at Port Stephens are typical of the cohort (as measured by the median). Given that the challenges of the COVID public policy response fall disproportionately on business, there is thus a *prima facie* strong case to be made for allocating most of any future SRV to the residential and farm taxpayers. This would exert less stress on the local economy and also serve tobest address the fiscal illusion problem. Further commentary on this question will beprovided in the Capacity to Pay report.

FIGURE 19. BUSINESS RATES PER ASSESSMENT ($)



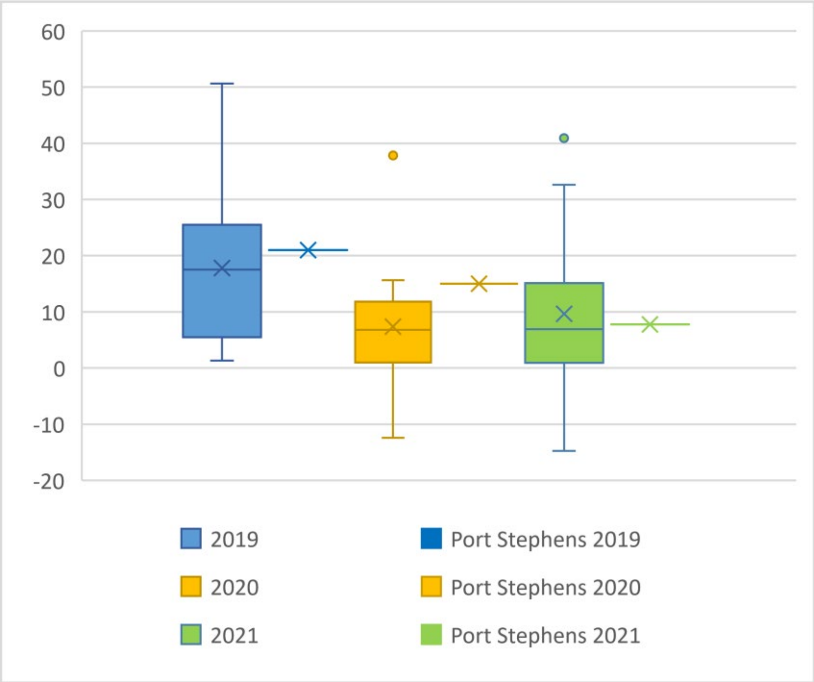
In Figure 20 we present the rates and charges outstanding data. Port Stephens hasthe best data in the peer group which is far from surprising given the extremely low rates of taxation levied in its local government area. This metric suggests strong capacity to pay a more adequate rate of taxation that is needed to assure financial sustainability, establish intergenerational equity, reduce risk and combat high levels of fiscal illusion. Further information will be provided in the Capacity to Pay report.

FIGURE 20. RATES AND CHARGES OUTSTANDING



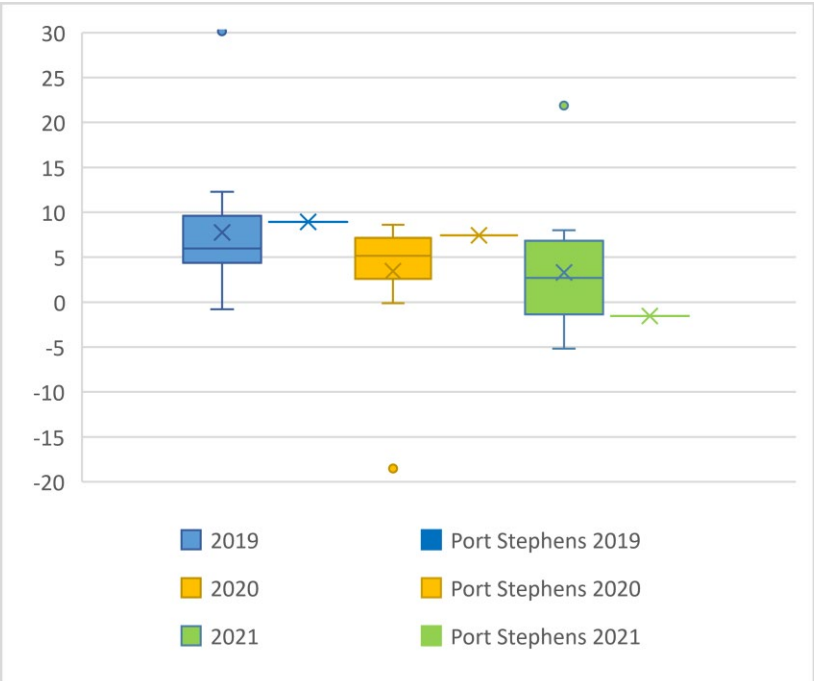
Empirical research into local government has demonstrated an important and oft-overlooked link between budget accuracy and technical efficiency (defined by economists as the conversion of inputs (staff and money) into outputs (local government goods and services)) (McQuestin, Noguchi and Drew, 2020). Essentially, higher budget accuracy translates into higher efficiency. In addition, budget accuracy has a clear association with financial sustainability and thus warrants some attention. Generally, council staff at Port Stephens have done a goodjob of predicting revenue, with the understandable exception of 2020 (COVID assistance). This is a further indication of the skill exercised by financial and senior management at the council that have clearly been crucial in surviving, despite significant obstacles (grant and taxation revenues, in particular). It might be noted that a positive result suggests council received more revenue than it had budgeted.

FIGURE 21. DEVIATION FROM BUDGETED REVENUE



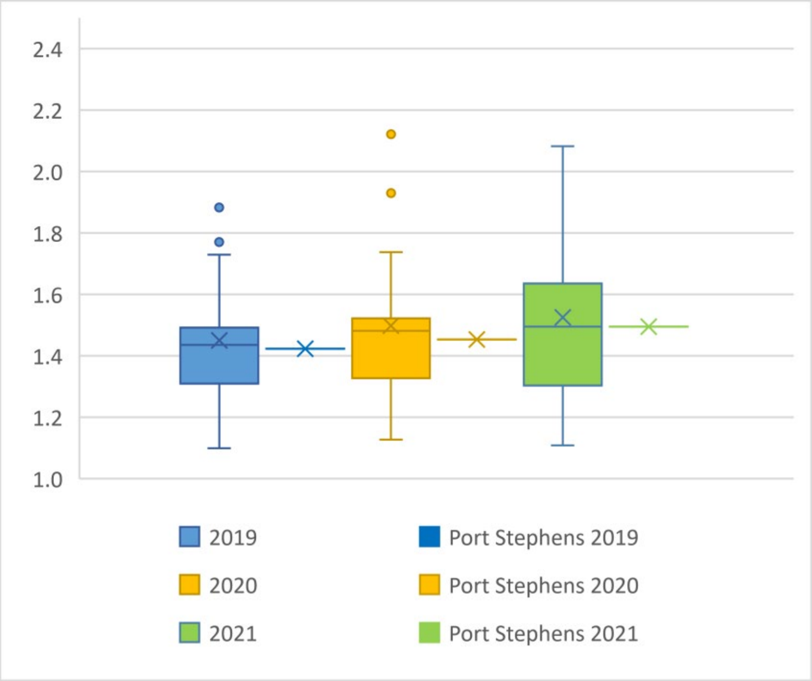
Matters were not quite as good on the expenditure side in 2019 and 2020, notwithstanding the understandable and unpredictable blowout in 2020. However, in2021, senior staff have exercised extraordinary cost control. This will have to also bea feature in 2022 and 2023 (until such time as adequate additional revenue can be realised).

FIGURE 22. DEVIATION FROM BUDGETED EXPENDITURE



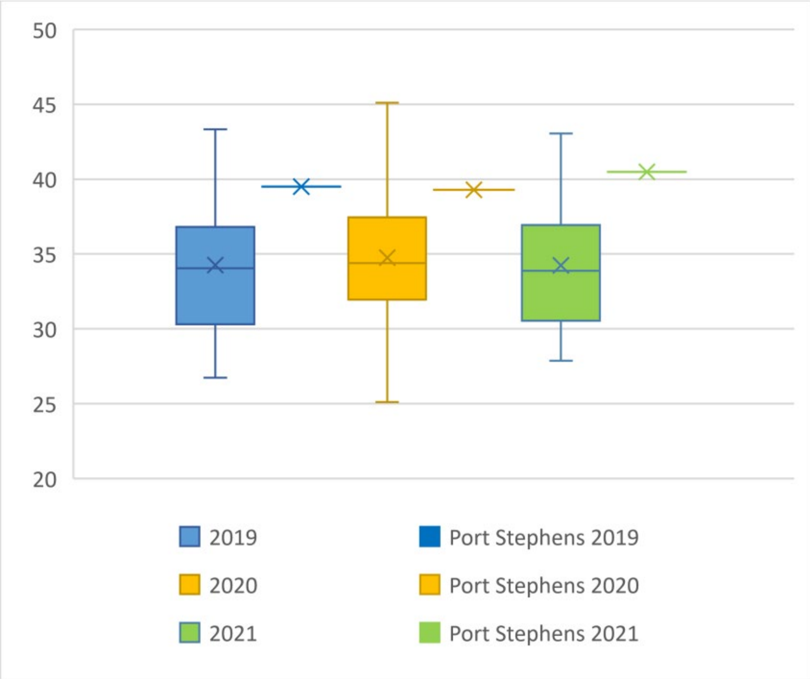
Good cost control is also evident with regard to staff expenditure. In a comparative sense, Port Stephens spends slightly less on staff per assessment than its typical peer. We note from council documents that leave entitlements are carefully monitored and staff encouraged to regularly take leave. This practice exerts marginaldownward pressure on staff costs and it should also be extended to long-service leave. It is noteworthy that the gap between typical staff expenditure in the peer group and Port Stephens has closed in the most recent year which suggests that attention should remain on controlling this cost item.

FIGURE 23. STAFF EXPENDITURE PER ASSESSMENT



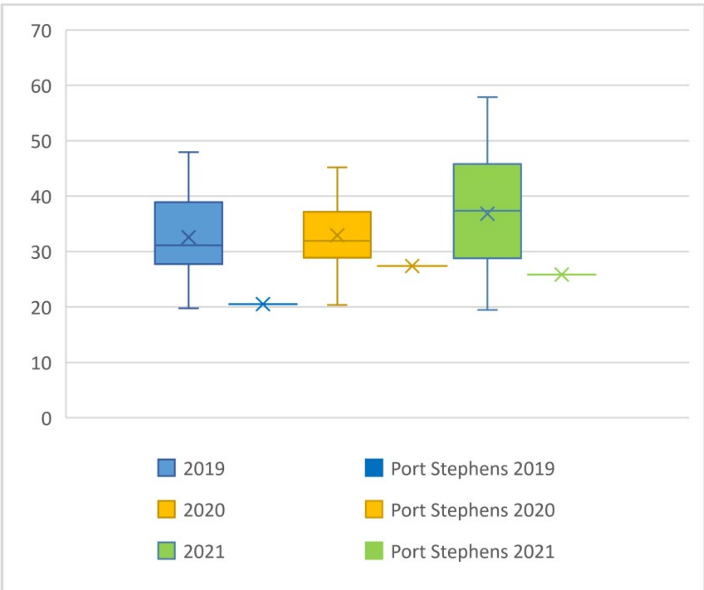
In terms of the proportion of the budget spent on staff, Port Stephens has a much better outcome than its peer group. When we interpret this metric in terms of the average staff expenses per property, it clearly indicates lower than usual material, contract and other expenses. This is yet a further indication of excellent cost control,but it may have implications for service levels in future (especially with respect to maintenance of infrastructure assets as suggested by recent citizen survey results).

FIGURE 24. PROPORTION OF EXPENDITURE ON STAFF



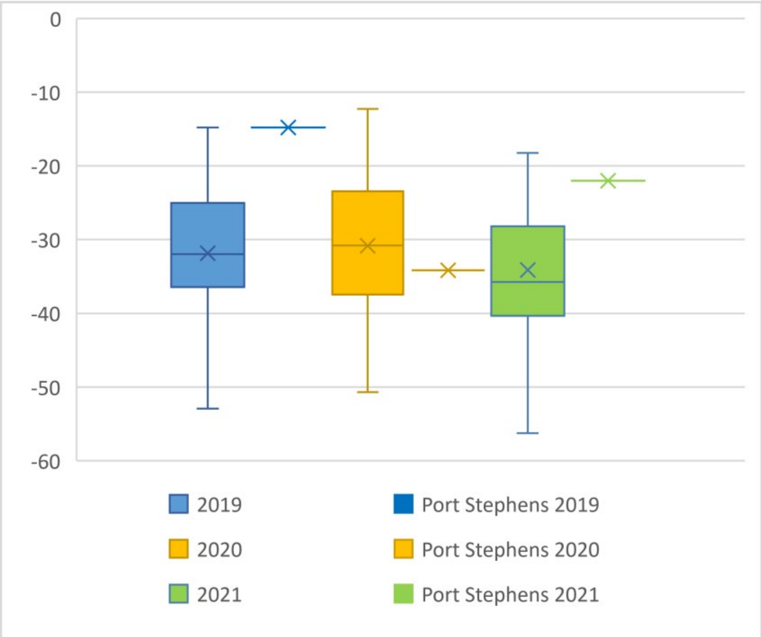
Cash flow is essential to the liquidity of a local government. Generally local governments in Australia have highly positive operating cash flow, very negative investing cash flows and near-to-zero cash flows for financing activities. Port Stephens has consistently recorded much lower operating cash flows than the typical member of its peer group. This should be considered to be a very concerningmatter. Further investigation suggests that insufficient taxation receipts are the majorcause of the problem. This is not a sustainable position going forward, especially when considered in relation to the relatively parlous state of cash holdings (see Figure 31 onwards).

FIGURE 25. OPERATING CASH FLOWS (DEFLATED BY REVENUE)



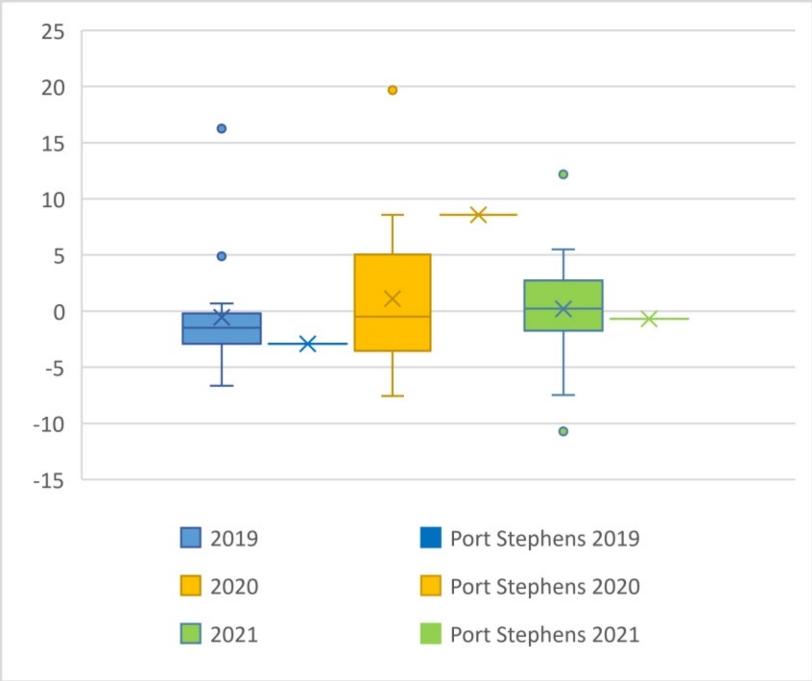
The investing cash flows are not as negative as the typical peer, which suggests that Port Stephens is likely to be under-investing in important community infrastructure. Moreover, we note that forthcoming investments in infrastructure appear to be planned to be funded through debt. As we noted earlier, it is by no means certain that Port Stephens has sufficient debt capacity and we recommend postponing the planned investments. Indeed, Council will need to exercise very careful expenditure controls until additional revenue can be obtained. Port Stephens is thus advised to defer discretionary spending until matters improve. In addition, unless there is eitheran increase in revenue or decrease in other expenditure, then it is quite unlikely thatdebt funding will be defensible in terms of intergenerational equity.

FIGURE 26. INVESTING CASH FLOWS (DEFLATED BY REVENUE)



Financing cash flows tend to be lumpy in nature. As we have discussed previously, debt levels are a concern as reflected by the strong inflows from borrowing in 2020.

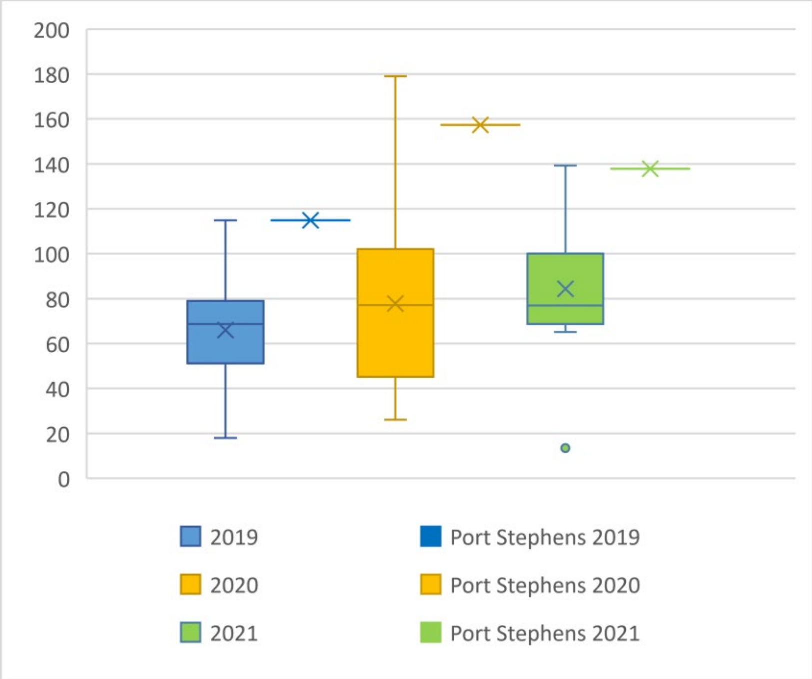
FIGURE 27. FINANCING CASH FLOWS (DEFLATED BY REVENUE)



A good deal of caution needs to be exercised with respect to the three asset ratios employed in NSW which (taken together) attempt to measure the hard aspects of financial sustainability. Indeed, there is significant scholarly evidence to suggest that the renewals and backlog ratios are extremely unreliable (Drew, 2017; Drew and Grant, 2017; Drew, 2020). Some of the problems stem from ongoing confusion with respect to depreciation. Other problems are caused by the difficulty experienced in defining variables such as ‘satisfactory standard’, or ‘required maintenance’. In addition, definitional drift between years renders intertemporal comparisons also unreliable. Moreover, during *Fit for the Future* a number of the peer councils deliberately distorted data to meet state government benchmarks and this also makes comparisons to the peer group unreliable.

The buildings and infrastructure renewal ratio data presented in Figure 28 should be considered a case in point. The denominator uses unreliable depreciation data whichis associated with a number of problems that we have previously alerted readers of this report to. Indeed, the depreciation rate at Port Stephens seems lower than expected in a relative sense and this will largely explain the results which *prima facie* suggest that Council is consistently spending more on renewals than is required. In view of the fact that IPART (2020) cited infrastructure renewal and backlogs in its decision to reject the previous SRV request it would be prudent to carefully review depreciation schedules as indicated earlier.

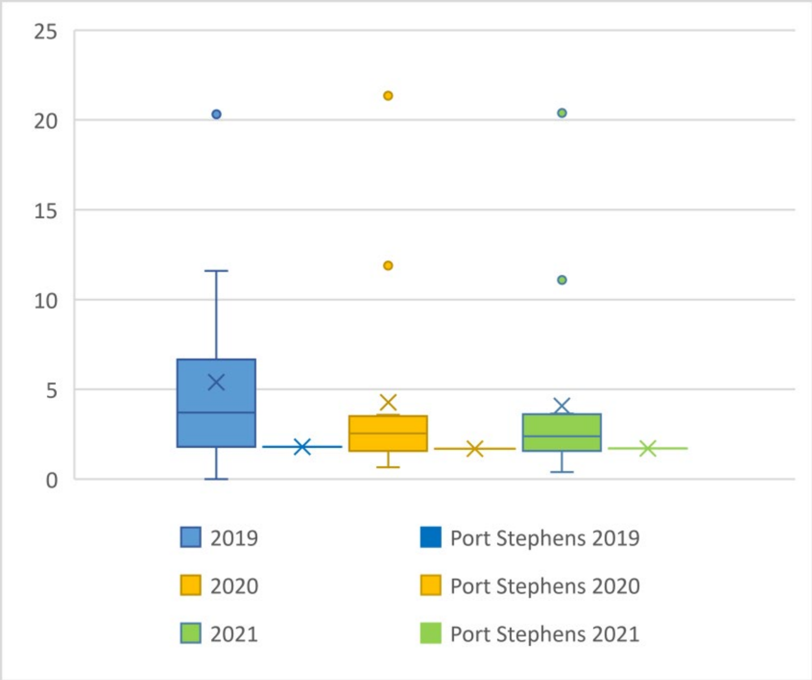
FIGURE 28. BUILDINGS AND INFRASTRUCTURE RENEWAL RATIO



The backlog ratio also looks good for Port Stephens Council in a relative sense andon the surface. Here the variable of concern is input as the numerator – estimated cost to bring assets to a satisfactory condition. Accurately recording this data is a problem for most local governments. We strongly suggest that Council construct a comprehensive definition of 'satisfactory', with photographic examples of the kinds of conditions that are deemed to be satisfactory or not, to mitigate the definitional vacuum that exists at a jurisdictional level and also combat definitional drift.

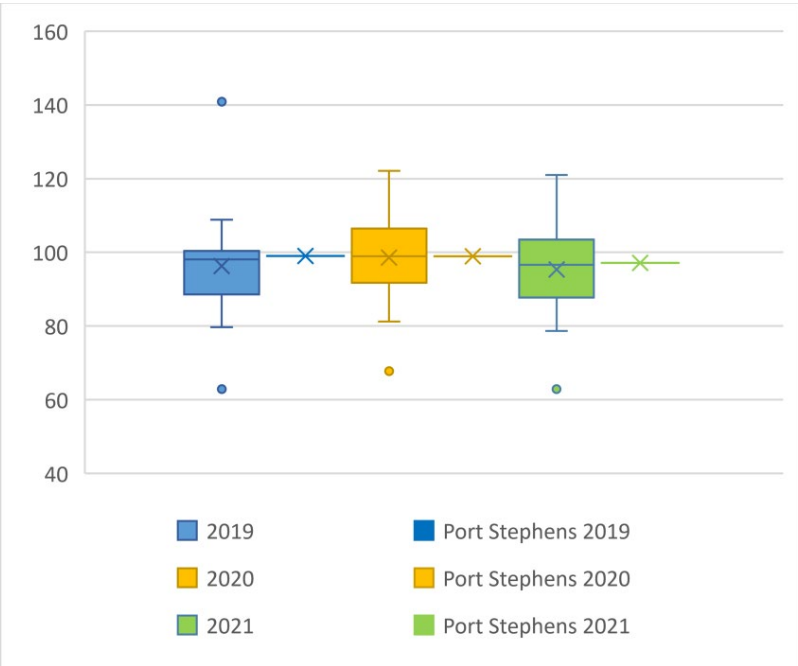
Moreover, in view of the recent citizen satisfaction survey results there might be acase for believing that the Council definition of satisfactory is at odds with the preferences of its citizens. We thus recommend that Port Stephens consider conducting some focus groups to review photographic evidence of infrastructure conditions in order to arrive at a shared understanding on this matter. We suspect that when this activity is completed, Council will be obliged to review this ratio upwards for the next set of financial statements.

FIGURE 29. INFRASTRUCTURE BACKLOG RATIO



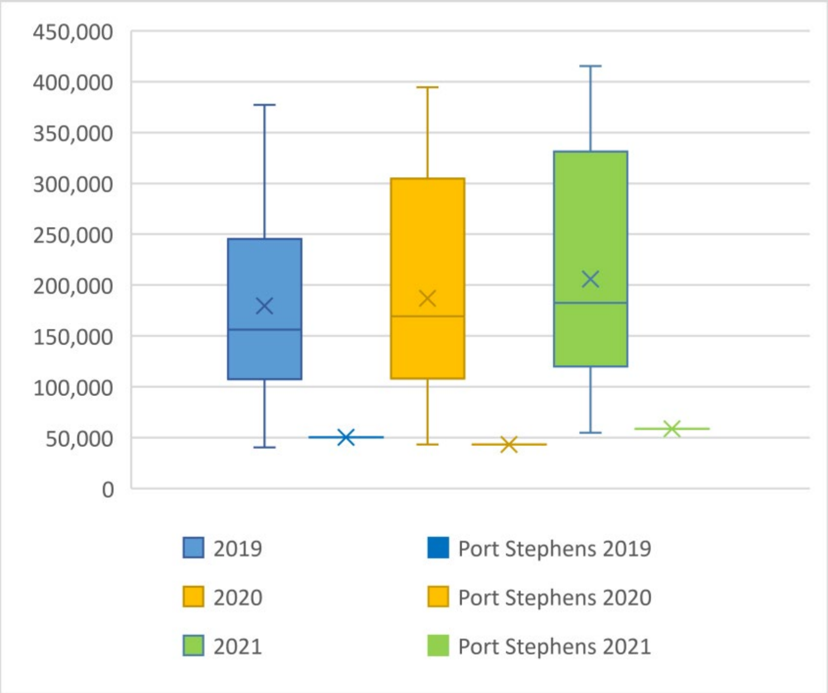
For the asset maintenance ratio the problem resides with the denominator – required asset maintenance – although matters tend to be on a firmer foundation for this input owing to a better evidential base. For this metric Port Stephens is pretty typical of the peer group and there is thus less likely to be a need for significant adjustments to this particular data moving forward.

FIGURE 30. ASSET MAINTENANCE RATIO



We now turn our attention from assets to cash holdings. Figure 31 presents total cash and equivalents data for Port Stephens and its peer group. It is painfully clearthat cash holdings at Port Stephens are at very low levels in a relative sense. It is noteworthy that these figures include both restricted and unrestricted holdings.

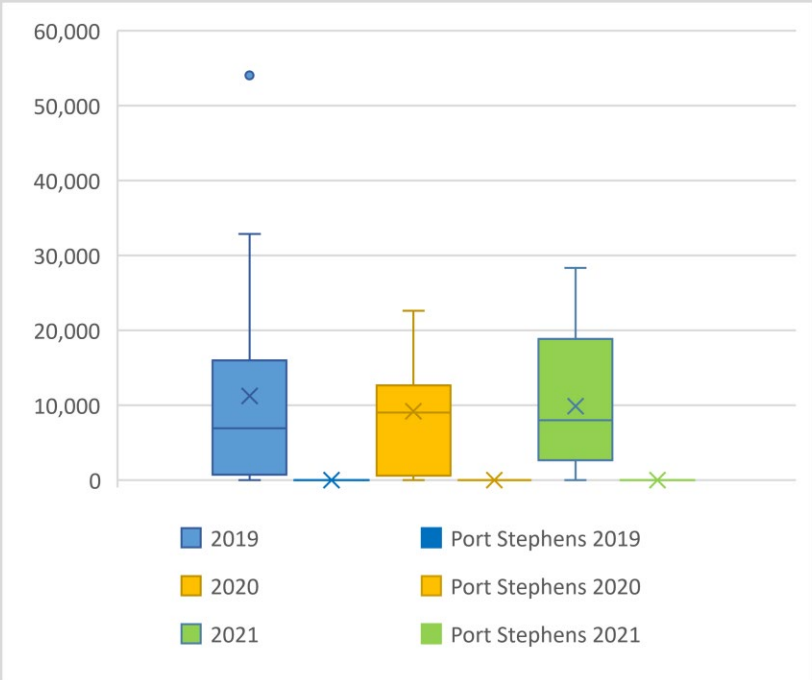
FIGURE 31. TOTAL CASH, CASH EQUIVALENTS AND INVESTMENTS ($000)



In Figure 32, we plot the crucial unrestricted cash position for Ports Stephens Council relative to the peer group. Matters could hardly be more serious in a financial sustainability sense and support our previous prescriptions: (i) the suspension of discretionary spending where practical, (ii) a thorough review of pricing for non-regulated fees and charges to be reflected in the 2022-23 Operational Plan, (iii) deferment of new debt drawdowns until capacity has been measured and (iv) a SRV. Hopefully the Council's non-core operations – such as holiday parks, after school care and the like – will pick up in the new calendar year. However, given the continued uncertainty surrounding the pandemic and attendant public policy responses, it would be prudent to take strong measures as soon as possible.

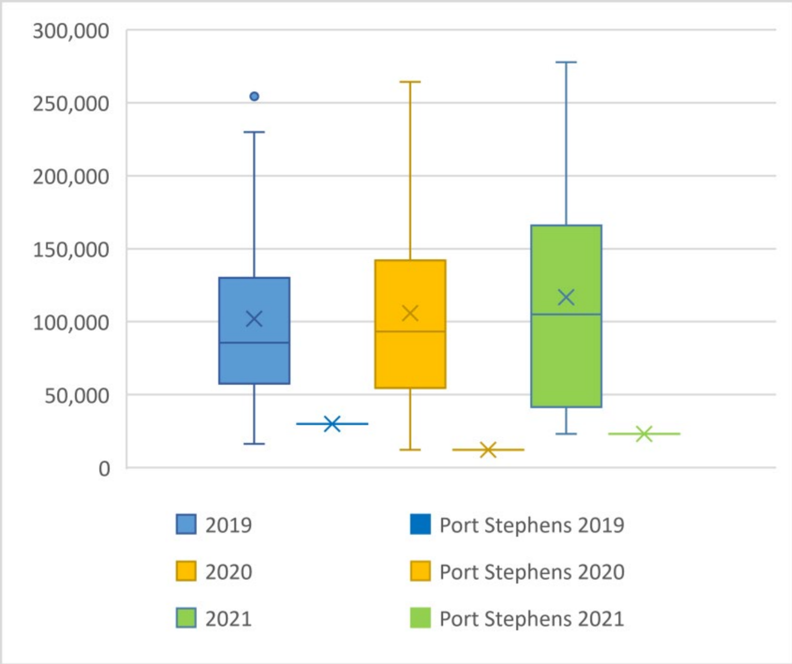
Moreover, the inflation outlook is not good and is compounded further by the disastrous new IPART rate cap methodology (IPART, 2021) which decrees a mere 1.3% increase to rates for next year when the best-case scenario for inflation is likelyto be 3%. This means that the parlous state of unrestricted cash reserves at Port Stephens is even more serious than it might at first appear.

FIGURE 32. TOTAL UNRESTRICTED CASH, CASH EQUIVALENTS AND INVESTMENTS ($000)



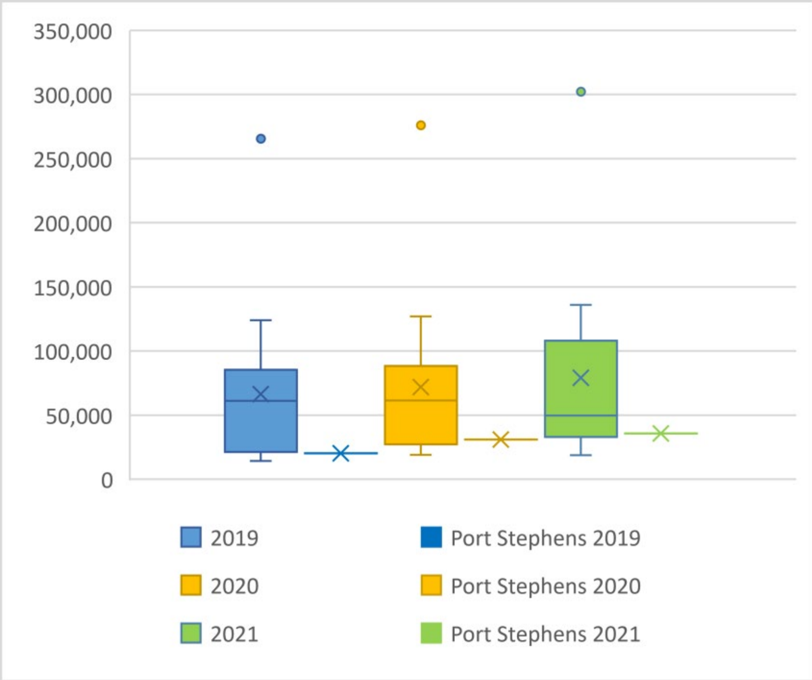
Externally restricted reserves are also at low levels in a relative sense. This does not play a direct part in meeting present liquidity needs, but is important to long-run financial sustainability. The most likely causes for low reserves could be: (i) comparatively low developer contributions, (ii) recent completions of developer fee related projects or (iii) relatively low rates of development. We recommend that developer contribution schedules be reviewed along with the review of fees and charges that Port Stephens needs to conduct early next calendar year.

FIGURE 33. TOTAL EXTERNALLY RESTRICTED CASH, CASH EQUIVALENTS AND INVESTMENTS($000)



Internally restricted reserves provide a little comfort and could be used if the COVID pandemic and public policy conditions do not improve. It is noteworthy that internal reserves are lower than most of the peer group and are a reflection of low revenues, expanding infrastructure and a preference for debt as a means of funding infrastructure. We reiterate our comments regarding the need for current generations to contribute revenue or savings at least in proportion to the consumption of long- lived assets for intergenerational equity to be met. Moreover, the combined message that needs to be understood by councillors arising from our analysis of reserves is that there is simply no money available for any new discretionary programs and projects for some time (probably until at least September 2023 assuming IPART makes the prudent decision on an SRV application that is necessary to assure financial sustainability).

FIGURE 34. TOTAL INTERNALLY RESTRICTED CASH, CASH EQUIVALENTS AND INVESTMENTS($000)

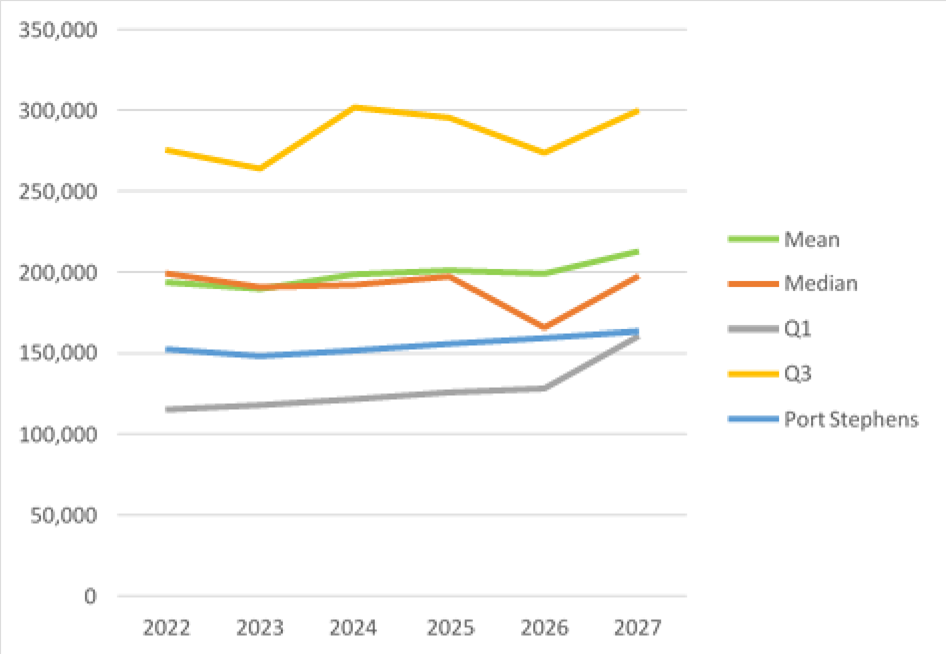


We now turn to a comparative analysis of Long-Term Financial Plans (LTFP). In order to facilitate the maximum number of comparisons we have had to restrict our analysis to the years up to and including 2027. Data cited is for standard scenarios. Moreover, we also note that the Cessnock data is missing from much of the followingwork.

LTFP are inherently unstable and inaccurate. They involve the making of a number of assumptions that might seem reasonable at the time when projections are first made, but can quickly appear rather incongruous with respect to facts on the ground.For example, Port Stephens reasonably assumed a 2% rate cap increase, but IPART (2021) recently advised that the increase for 2022-23 would be just 1.3 percent. In addition, Council predicted that grant revenue would continue to increaseat 2.2% per annum, when the current budgetary plight of higher tier governments suggests the possibility of reductions to the quantum in real terms. Furthermore, the standard model assumes commercial receipts will not be adversely affected by new COVID policy responses, nor impacted by a likely slowing economy in the forward years. The income projections also assume that the airport dividend is reinstated in 2023, which we feel is an optimistic assumption.

Despite these assumptions – which now appear questionable – Port Stephens is expecting revenue to grow quite slowly and remain firmly in the lower half of the second quartile until 2027. This is a concern given what we have already had to sayabout reserves and proposed works.

FIGURE 35. TOTAL INCOME ($000)

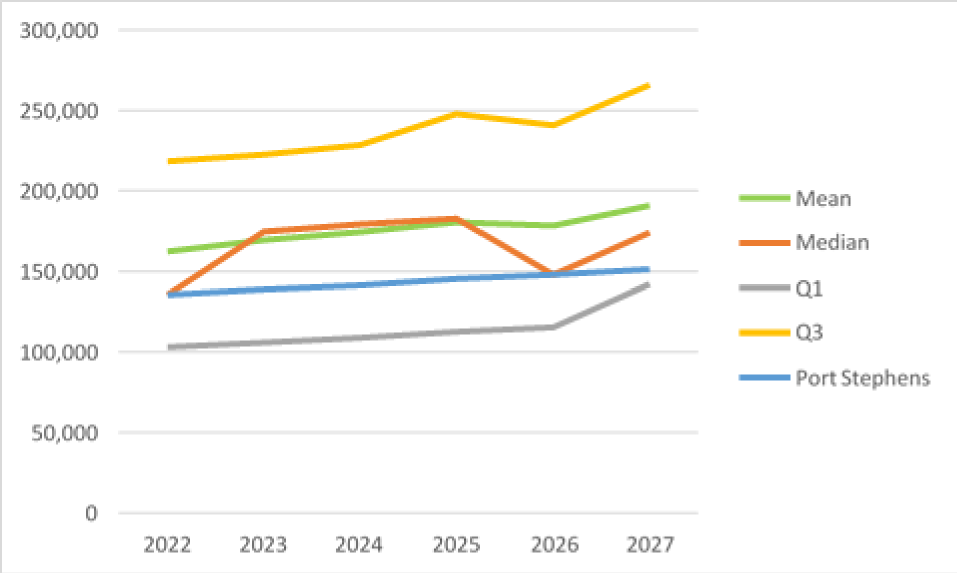


Expenditure assumptions probably also warrant revisiting in the wake of the COVID public policy responses. In particular, it is now clear to almost everyone – except perhaps the members of the Reserve Bank of Australia (RBA) Board – that we are entering a lengthy cycle of elevated inflation. Thus, most of the assumptions regarding increases to wages, contracts and materials look overly optimistic. At the very least these assumed rates of growth should be increased to the top of the RBA target band (3%[6]). However, this would likely prove insufficient given continuing high Producer Price Indices numbers in China and America that are approaching ten percent. In addition, the LTFP assumes no major new capital works in the next ten years which we believe will be difficult to comply with given high rates of development, an incoming new council with many new faces and extant levels of citizen satisfaction (arising from entrenched fiscal illusion). Indeed, the assumption of 150 new rateable properties per year is almost certainly an under-estimate and it must be remembered that on the whole growth in assessments is associated with nett additional expenditure (Drew, 2021).

We thus expect expenditure to actually rise much more steeply than predicted, which is a problem given that it is already forecast to close in on the typical result for the peer group over the next six years or so.

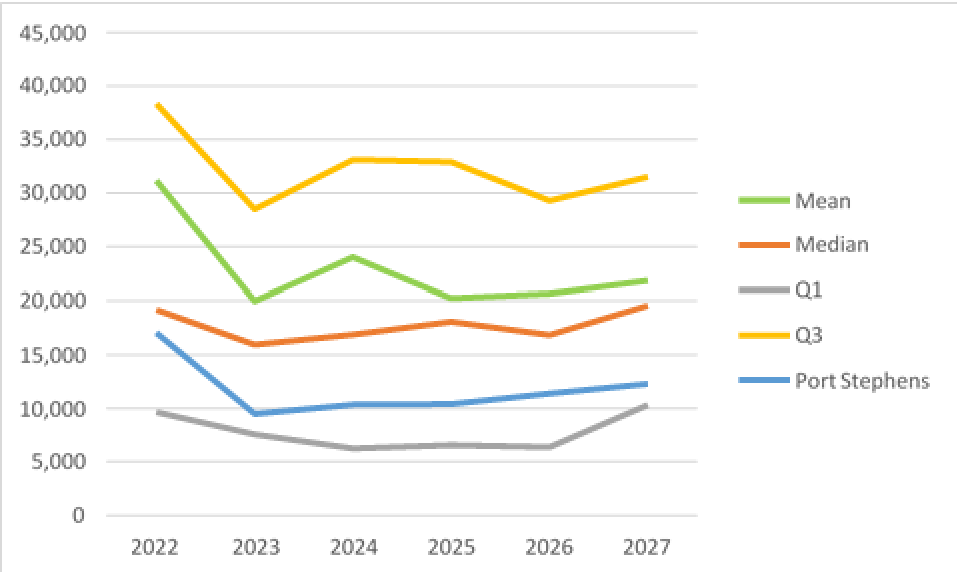
[6] Of course, the timing of the next EBA and expiry of existing contracts will need to be taken into account.

FIGURE 36. TOTAL EXPENDITURE ($000)



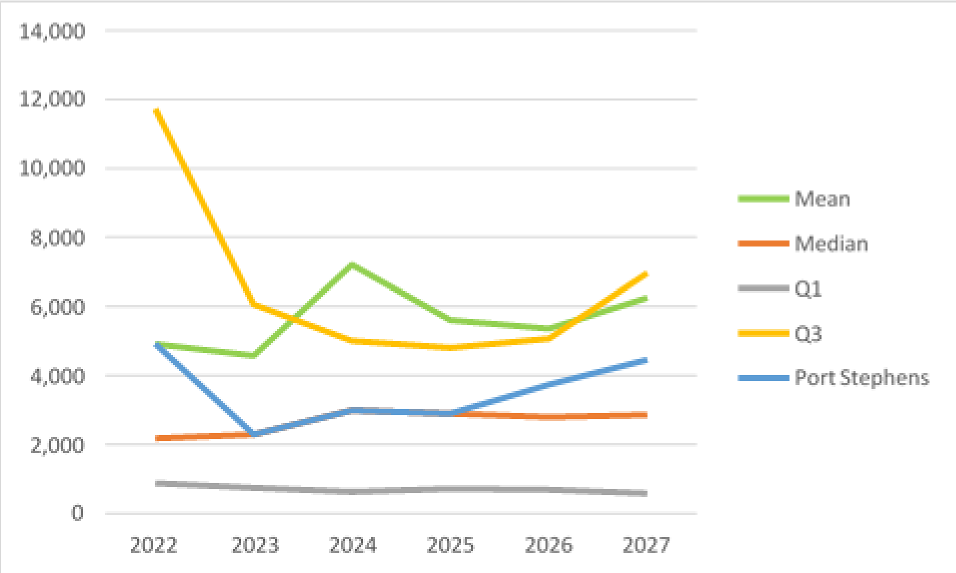
The nett operating result is predicted to improve over time. However, given our reservations regarding forecast predictions, we do not anticipate that this will actually occur unless significant changes to both revenue and expenditure are made. Given the current state of cash holdings – as well as the ongoing uncertainty regarding COVID and associated policy responses – changes that ought to be made to the LTFP are likely to paint a very concerning picture.

FIGURE 37. NETT OPERATING RESULT ($000)



The picture is a little better in a relative sense when capital grants are excluded. However, our reservations regarding the veracity of assumptions means that little comfort should be taken from Figure 38.

FIGURE 38. NETT OPERATING RESULT WITHOUT CAPITAL GRANTS ($000)



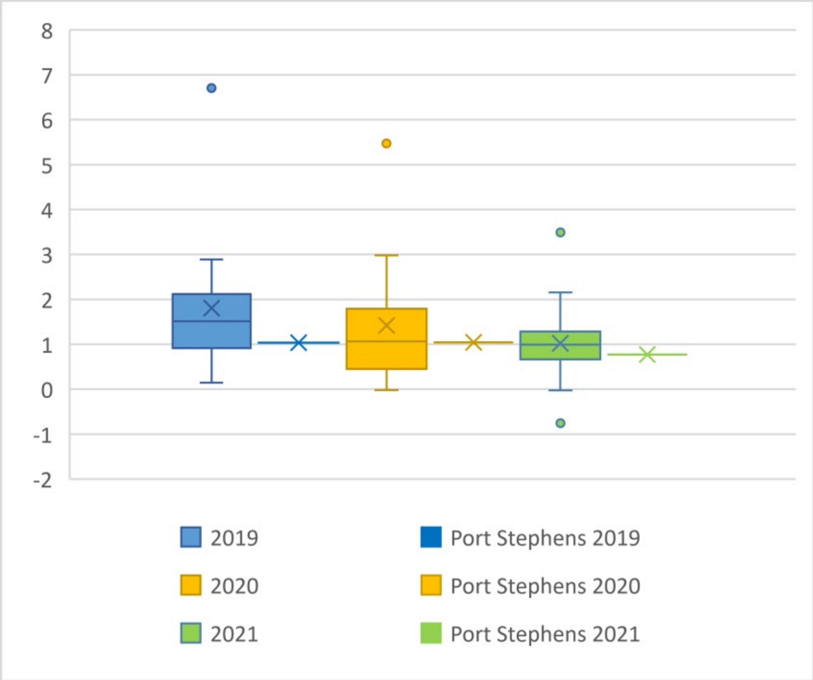
Growth in the number of rates assessments is an important determinant of financial sustainability. Because NSW councils operate under a rate cap regime, growth in assessment numbers contributes comparatively little to revenue (with the main contribution through fees and charges, some of which are regulated or must only be set at cost recovery[7]). Yet new residents bring new demands for services and exert additional pressure on current infrastructure. Growth in assessments thus generally represents a nett negative to financial sustainability in NSW local government (Drew,2021).

Growth at Port Stephens is relatively typical of its peer group, but it should be remembered that the peer group encompasses a number of high growth areas.Moreover, since the advent of COVID more people have chosen to move out ofcapital cities in favour of regional communities. Furthermore, the population in Australia is ageing and people often desire to live in picturesque seaside communities in their retirement years (Drew, 2021).

All of this means that Port Stephens ought to expect even more development in the future, which will undoubtedly place more strain on its already stressed financial condition.

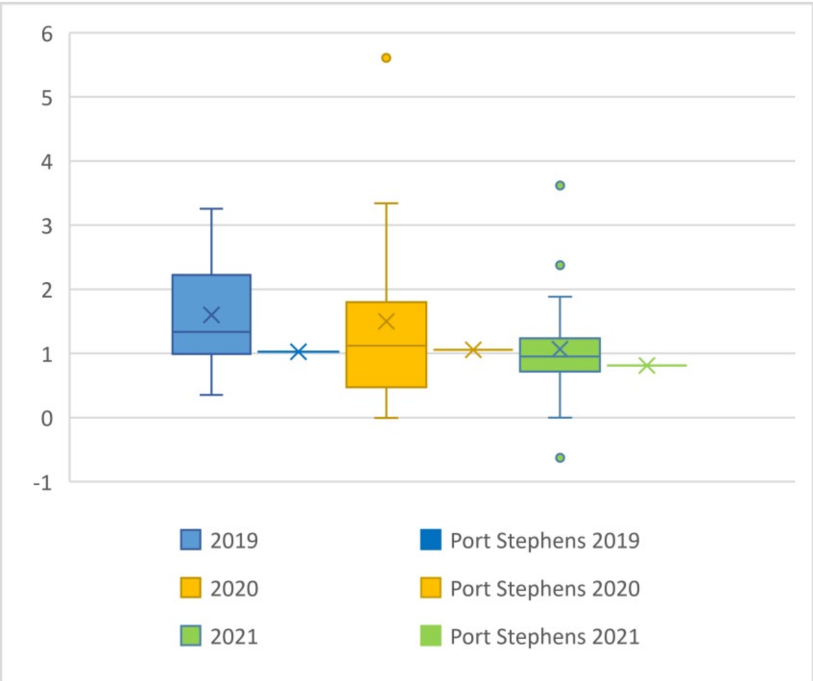
[7] In view of the new IPART methodology population growth may act to increase the cap. However, given theproportion of aged persons moving to Port Stephens it is unlikely that population growth factors will keep pace with growth in expenditure terms (which is driven by both numbers of properties and socio-demographic need).

FIGURE 39. GROWTH IN NUMBER OF ASSESSMENTS



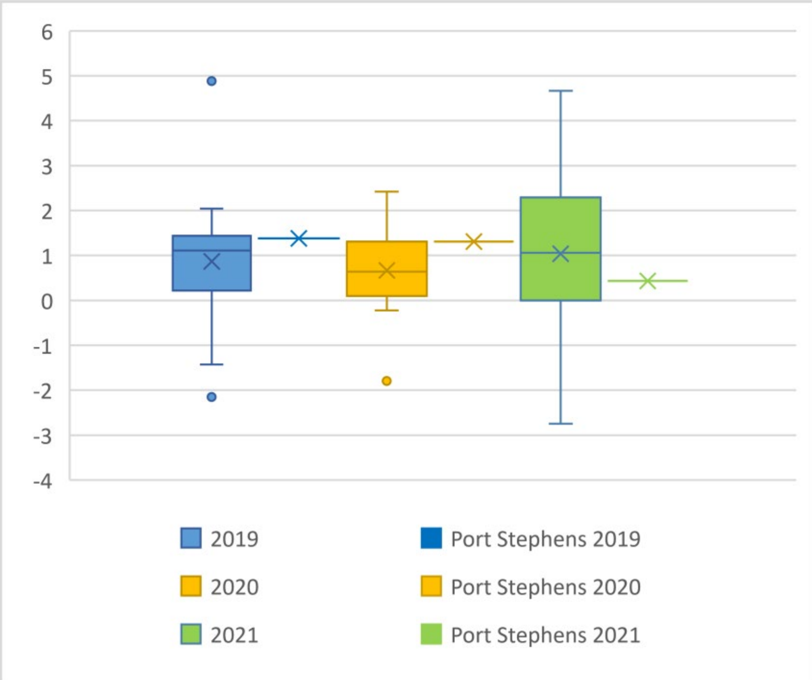
Growth in residential assessments has been relatively strong and is likely to accelerate from 2021 levels.

FIGURE 40. GROWTH IN NUMBER OF RESIDENTIAL ASSESSMENTS



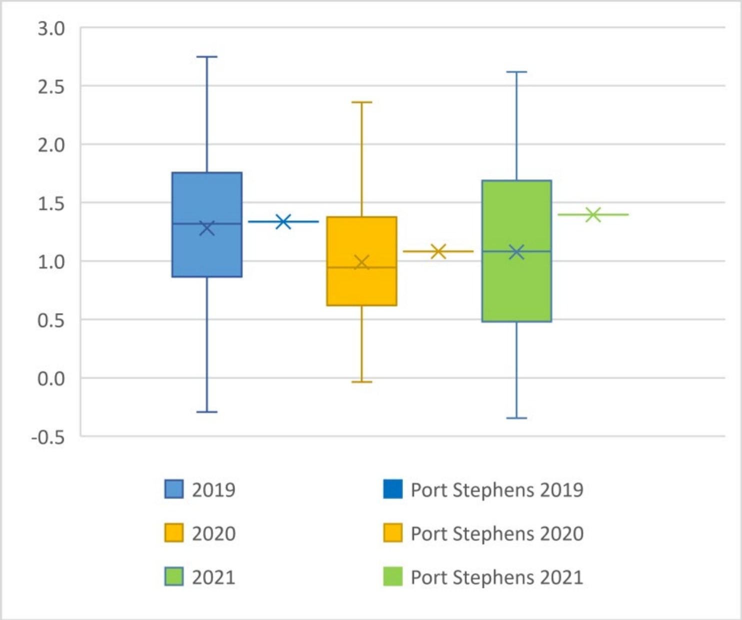
However, growth in business assessments has been much slower of late. Many of the businesses in the Port Stephens local government area revolve around the service industry which has been hit particularly hard. Because of continued policy uncertainty related to COVID, business investment is unlikely to grow as fast as residential investment for the next few years. Indeed, as the immediate post-COVIDboom fades, many economists expect growth to revert back to lower-than-trendlevels. This is not good for the local community, but it may relieve a little of the pressure for spending on Port Stephens Council.

FIGURE 41. GROWTH IN NUMBER OF BUSINESS ASSESSMENTS



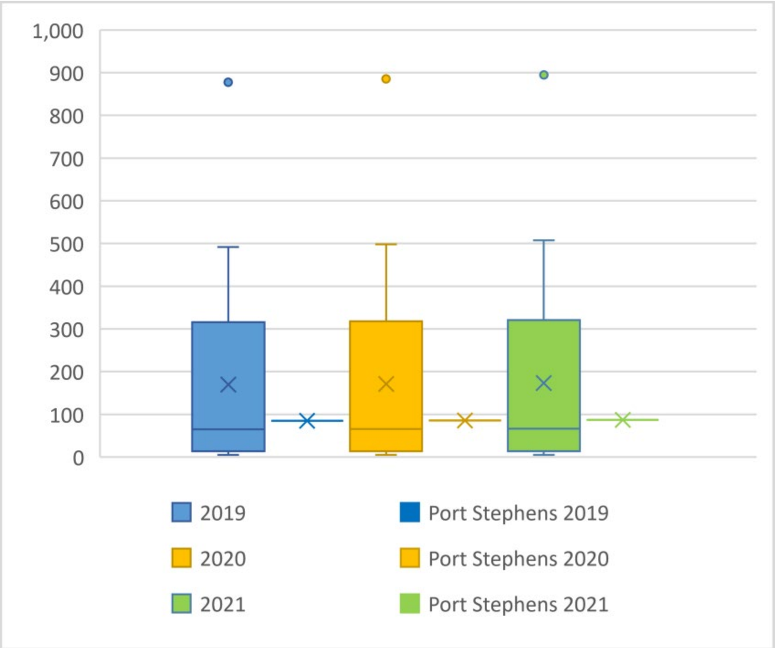
Population growth is slightly above the typical result for the peer group. As a host of econometric studies show, expenditure need is most closely related to growth in assessments as well as socio-demographic factors (which we consider from Figure 44 onwards) (Drew, 2021). However, population growth has become more importantas a result of recent ill-advised changes to the rate cap methodology (IPART, 2021) (see also the video on this topic on the YouTube site 'Professor Joseph Drew's World of Local Government'). Thus, the slightly higher level of growth means that Port Stephens received a slightly higher rate cap (1.3% compared to the 0.7% most councils received), notwithstanding the fact that it is clearly insufficient for the new higher inflation cycle.

FIGURE 42. POPULATION GROWTH



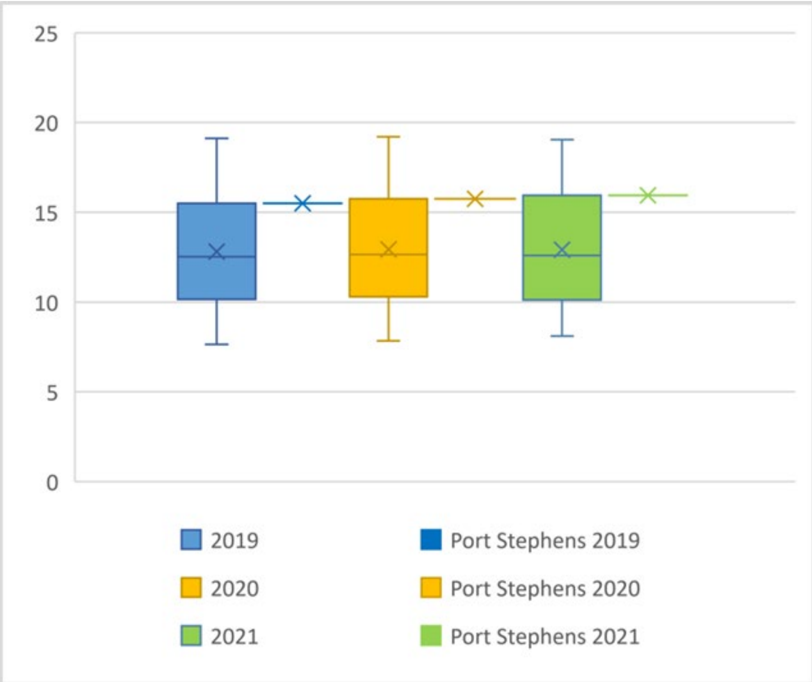
Population density is important because of the potential for economies of density (whereby costs are initially expected to decrease as population density increases).Port Stephens is more-or-less typical of the peer group (according to the median) which means that it is not disadvantaged in relative terms. However, to promote sustainability emphasis should be placed on encouraging in-fill and brownfield development over the much more expensive greenfield options.

FIGURE 43. POPULATION DENSITY



In Figure 44 we plot comparative data for aged pensioners over time. Port Stephens has relatively high levels of aged pensioners even when compared to its peer group which includes a lot of desirable retirement destinations. This is extremely problematic because the mandated pensioner discount is only partially funded by the NSW Government. Moreover, a host of scholarly work shows that pensioners are positively correlated with increased expenditure demand (Drew, 2021). Indeed, the proportion of pensioners should be considered to be a significant threat to financial sustainability (notwithstanding that COVID has left most pensioners in a far better economic position relative to many workers).

FIGURE 44. AGED PENSION



Moreover, matters are only likely to get worse over coming years. Figure 45 shows the proportion of people likely to retire in the next five years. The numbers are very high for Port Stephens and suggest that even without the large numbers of expectedinternal migrant retirees financial sustainability will get rather more difficult in the near future.

FIGURE 45. PERCENTAGE OF POPULATION AGED 60-64

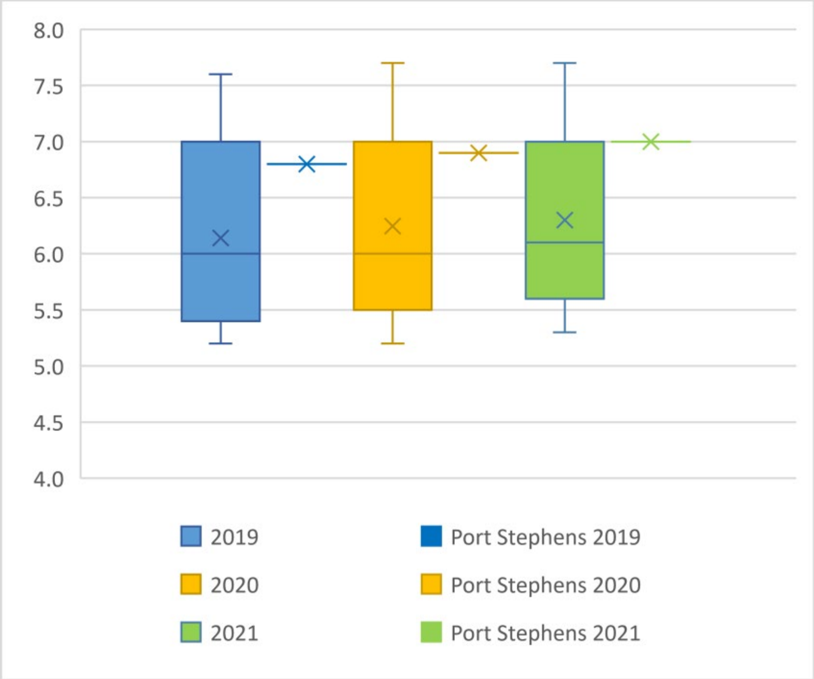
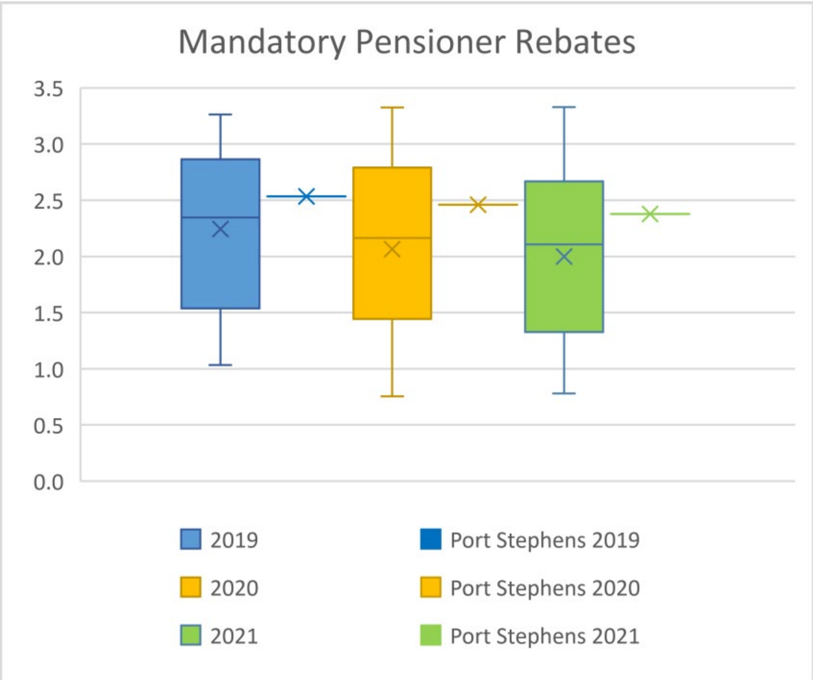


Figure 46 provides a comparative analysis of the effect of pensioner rebates expressed as a proportion of total collectible rate revenue. As can be seen, this is a weighty problem for Council and yet another reason why a SRV is imperative.

FIGURE 46. PENSIONER REBATE (AS A PROPORTION OF RATE REVENUE)



Figures 47 to 49 inclusive present some other data regarding the relative rate of receipt of various welfare payments. Generally Port Stephens is pretty typical of the peer group and it is thus not under a particular relative disadvantage. However, it is interesting to note the large increase in Newstart and Jobseeker allowance in 2021 (a one year lag applies to this ABS data) which confirms the susceptibility of Port Stephens to shocks to its service industries. This has important implications for revenue receipts, as we have already discussed.

FIGURE 47. DISABILITY SUPPORT PENSION

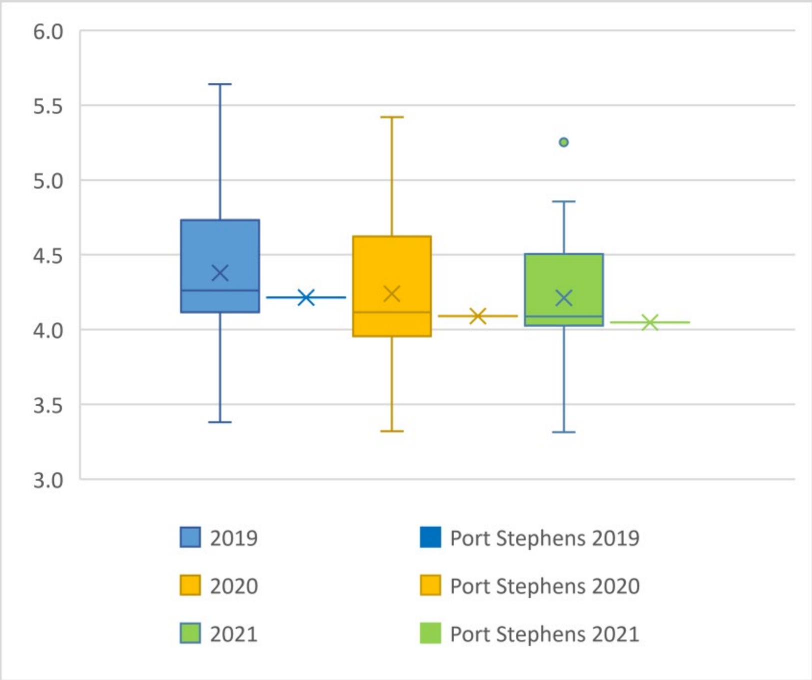


FIGURE 48. NEWSTART ALLOWANCE/ JOBSEEKER

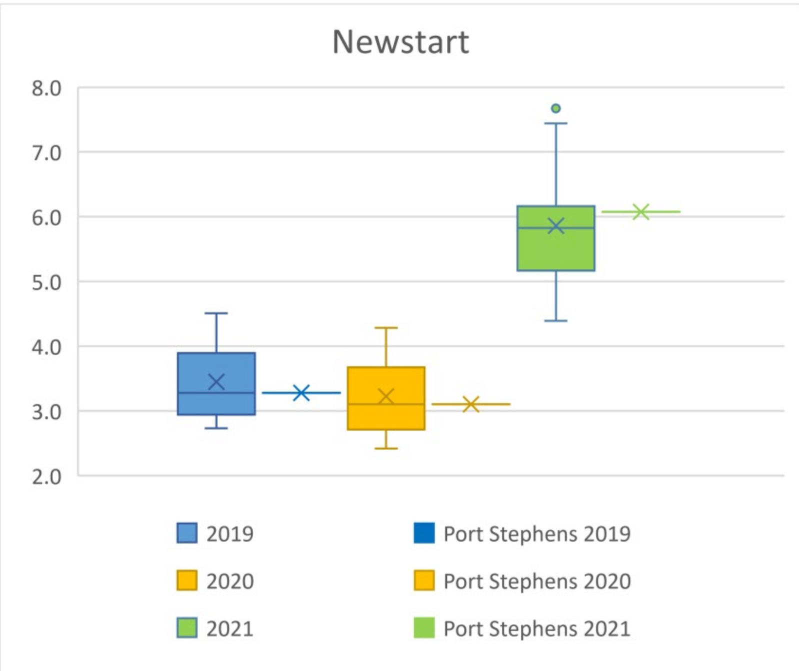
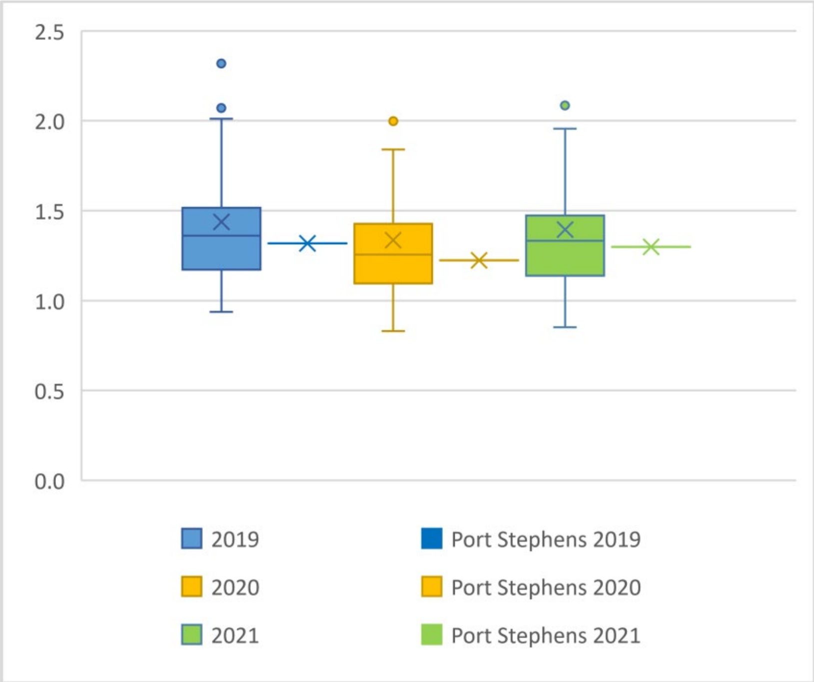
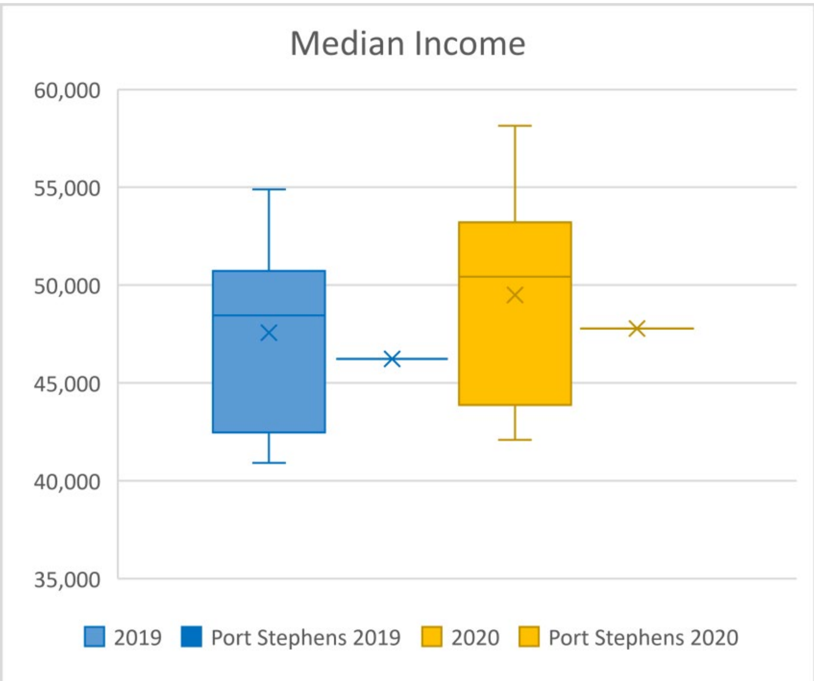


FIGURE 49. SINGLE PARENT PENSION



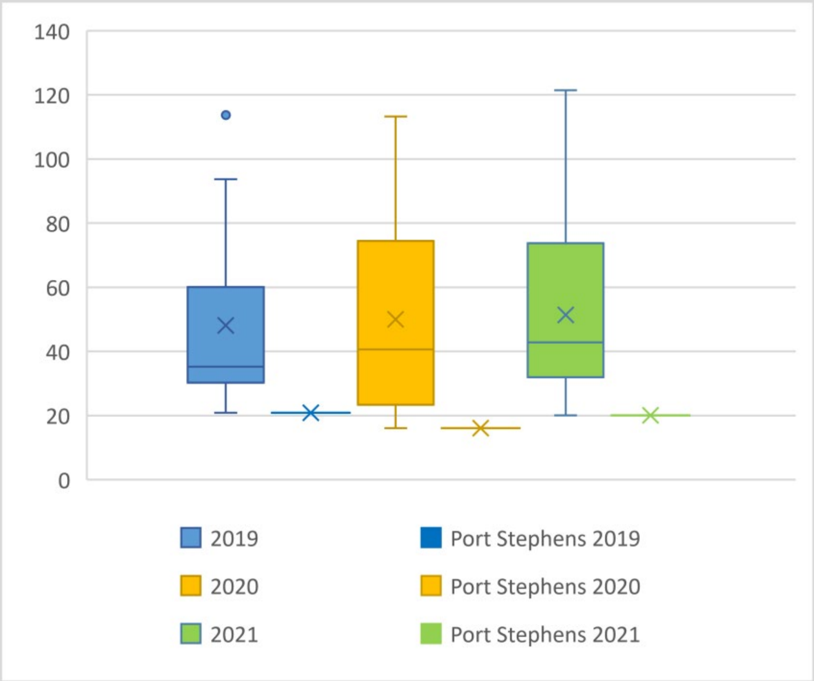
The median employee income is also important because along with other socio-demographic factors (such as the proportion of persons on an aged pension) it is known to drive expenditure higher. Fortunately, in this particular area Port Stephens has not scored highly in a relative sense. This means that the Council will have relatively less pressure (from income earners) for higher expenditure than some of its peers.

FIGURE 50. MEDIAN EMPLOYEE INCOME



The final data that we look at is the cash expense cover ratio (expressed in weeks). Both in a relative and absolute sense matters are very serious. It is thus imperative that an SRV is approved.

FIGURE 51. CASH EXPENSE COVER RATIO (WEEKS)



3. CONCLUSION

As we have stressed throughout this Report, considerable work must be done to ensure ongoing financial sustainability, especially given the significant risks on the horizon. In particular, a SRV is absolutely essential to (i) ensure financial sustainability, (ii) meet intergenerational equity, (iii) dispel fiscal illusion and (iv) collect adequate revenue in a legitimate manner. In our Capacity to Pay Report, we will deal with this matter in detail. Moreover, our Efficiency Report will look at relative technical efficiency and cast further light on where efforts should be concentrated moving forward. Accordingly, the Financial Sustainability Report must be read in concert with the Port Stephens Capacity to Pay Report, the Port Stephens Efficiency Report and the Port Stephens Debt Report.

APPENDIX 1: INFLATION AND ECONOMIC GROWTH

Over the past two years, market economists across the developed world have carefully considered the economic impact of COVID fiscal stimulus packages and associate monetary easing by central banks. During this period, billions of dollars have been injected into the economies of advanced economies by way of fiscal intervention accompanied by substantial quantitative monetary expansion. To date,the net result has been historically low interest rates, promising increases in economic activity and rising Consumer Price Indexes (CPI) and Producer Price Indexes (PPI) across the developed world.

In general, central banks in most advanced countries, including the Reserve Bank ofAustralia (RBA), had ascribed the observed increases in their CPIs and PPIs to various supply shortages arising from COVID lockdowns, constraints on internationaltrade and changes in consumer demand. However, over the past month continued price inflation has seen some major central banks express concern over rising inflation, such as 6.8% in the US, 6% in Germany and 5.1% in the UK in November 2021. This has led several central banks to reduce their stimulatory policies.

For instance, in the UK continued strong aggregate demand, engendered by massive government expenditure financed through borrowing from the Bank of England, has seen an ongoing increase in British inflation. While inflation was 0.7%in early 2021, by November it stood at 5.1%. As a consequence, the Bank of England finally felt obliged to lift interest rates from a record low of 0.1% to 0.25% inearly December. However, this still meant real rates are negative by almost 5%.

Other central banks are also beginning to unwind their COVID stimulus programs and raise interest rates. For example, both the US Federal Reserve and the European Central Bank have moved to tighten monetary policy in response to concerns over inflation. Consumer prices in the US increased by 6.8% in November 2021 over November 2020, the largest increase in almost four decades. In Australia,RBA governor Philip Lowe announced in December that its $4billion per week bond buying program would probably end in February 2022, with inflation edging towards 3%. The RBA now anticipates inflation in 2022 will approximate 3%.

Alongside rising inflation, we have seen most developed economies bounce back interms of economic growth after the initial depressing effects of lockdowns and other COVID measures. In Australia, the RBA forecasts economic growth of about 3% in 2021, 5.5% in 2022 and 2.5% in 2023.

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