

Grange

Securities

19 January 2007

Funding Analysis and Financing Proposal

Newcastle City Council

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Table of Contents

Introduction	3
Current Financial Assets & Liabilities.....	4
a. Investment Instruments	4
b. Funding/Debt Instruments	4
Funding Options	6
a. Bank Finance	6
b. Capital Markets: Bond/Note Issuance.....	6
c. Structured (Property) Finance	9
Recommended Funding Option.....	10
a. Savings/Benefits	10
Conclusion	11

Introduction

Grange Securities Limited (Grange) has been engaged by Review Today Pty Ltd ("Review Today") to undertake an analysis of the funding requirements of Newcastle City Council ("Council"). Review Today was engaged by Council and will provide an assessment on the condition of its infrastructure and finances, in addition to identifying funding needs. GHD and Access Economics have each provided separate reports on Council's asset management and financial sustainability.

Grange provides premium investment and capital raising services to Local Government, private and institutional investors, corporate clients and other government authorities throughout Australia and the Asia Pacific region.

Grange provides an end-to-end capital management advice and solutions service, from establishment to settlement of debt programmes and has a track record in providing quality service, innovative solutions and tailored advice.

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Grange has relied upon financial data provided by Council (prepared in accordance with Financial Accounting codes as well as the Department of Local Government reporting requirements) and has not conducted an internal audit of the financial affairs of Council. Grange has also relied on the assessment of both GHD and Access Economics on the current and future infrastructure requirements, timeframe and financial sustainability of Council to reach this recommendation.

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Current Financial Assets & Liabilities

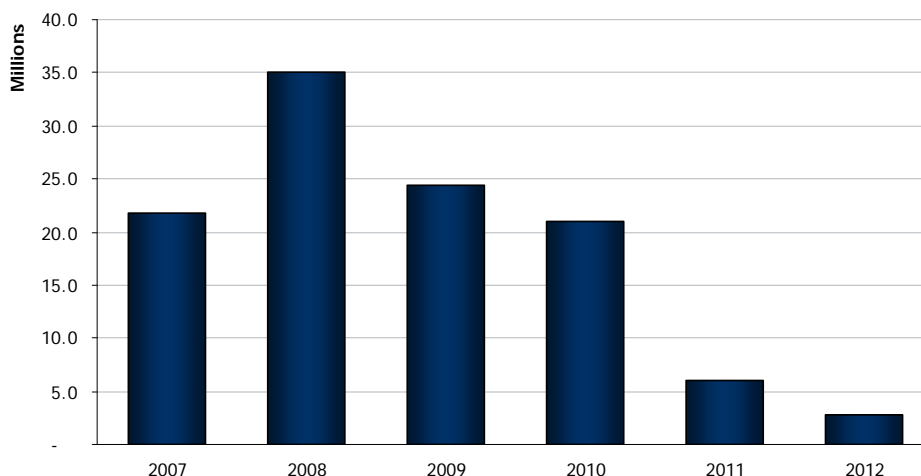
a. Investment Instruments

The Council investment portfolio currently exceeds \$125 million in value. All investments have been made in accordance with the NSW Local Government Ministers Order dated 24 November 2000, as amended, and represent a liquid basket of diversified cash and credit backed securities. Performance is well above benchmark (UBS Australia 90 day Bank Bill Index) with outperformance of 0.96%pa for the month of October. The portfolio has consistently outperformed benchmark by over 0.90% on average over the last year.

The maturity profile of Council's investment portfolio shows that 35% of the portfolio matures in less than 90 days, whilst 85% matures in less than two years. The remaining securities are readily saleable in the fixed interest market currently at a profit.

Investment Maturity Profile as at 30-Jun-06

(including LGFS managed fund as current)

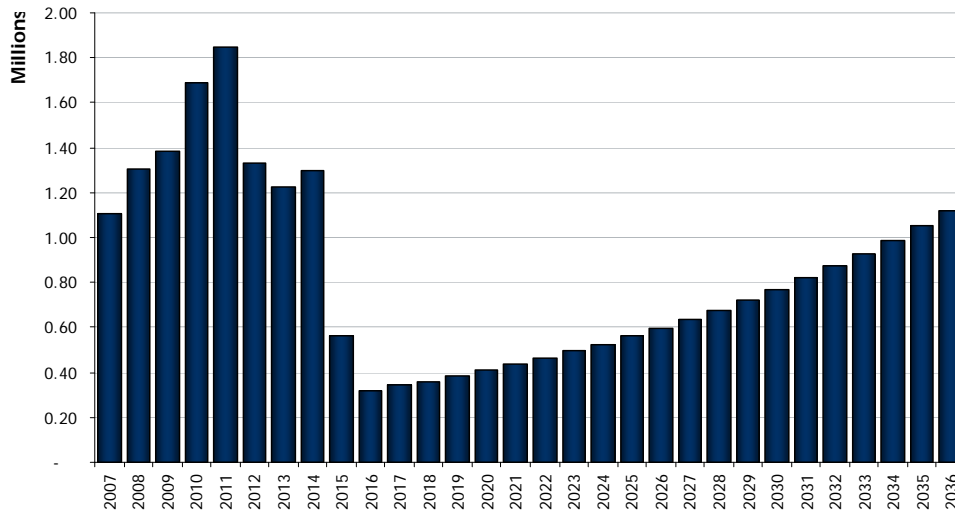


This represents a significant income boost to the internally and externally restricted reserve components of the portfolio given that only a relatively small portion of the total portfolio is available as working capital surplus.

b. Funding/Debt Instruments

Council currently has traditional principal and interest, and interest only type loans of approximately \$25.3 million (based on a payout calculation as at 15 December 2006), on a principal balance of \$24.7 million. All loans appear to have been obtained at competitive rates of interest. Recently, Council borrowed \$15 million for 30 years at a rate of 6.41% pa. The weighted average cost of funds is approximately 6.35%pa. The loan maturity profile is represented below:

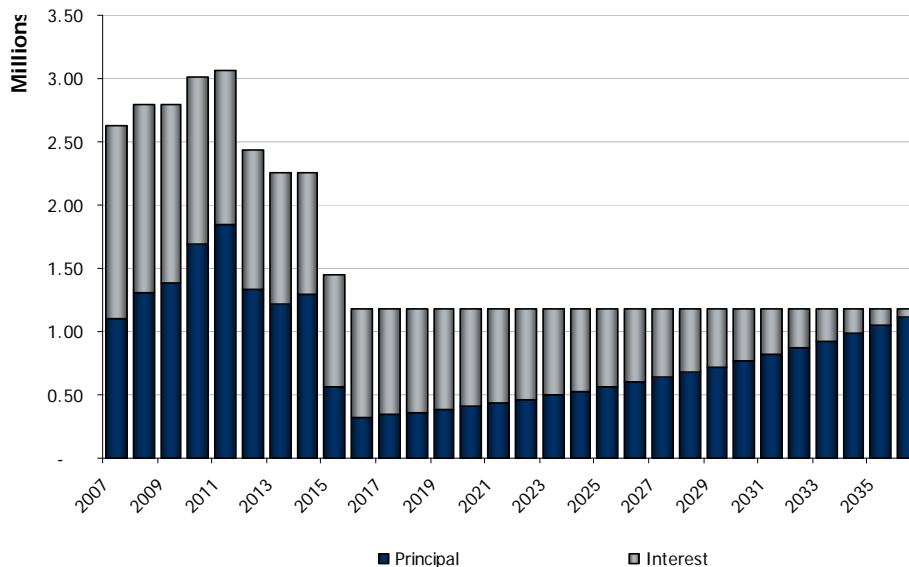
Loan Maturity Profile



The weighted average term to maturity is a guide to the expected expiry of the debt. The weighted average term to maturity of these loans is 13.44 years, where the majority of the loans raised have been used to fund infrastructure. At the time when each loan was originally drawn down, the liability would have matched the assets estimated life, however from a liability management perspective Council should also consider more technical measures.

The weighted average modified duration of a loan portfolio is a more accurate guide to the cash flow maturity profile. The modified duration of Council's loan portfolio is 7.75 years, which Grange considers to be too "short-dated" given the underlying funding purpose; and could prove to be inappropriate were Council to increase its debt to fund the backlog of infrastructure in the future. Thus, there is scope to lengthen the duration of outstanding loan maturities.

Debt Service Profile



As the debt service profile chart above illustrates, a large proportion of cash flow is required to service debt until 2015.

Funding Options

Council has a number of options available to fund the backlog of its required infrastructure investment and its ongoing renewal and maintenance expenditure.

Any financing solution for Council will be driven by, inter alia, Council's cost of capital, the term of the funding and the nature of the capital expenditure to be funded (such as the economic life of the asset and the cash flow generated by the asset). As Grange understands, the majority of infrastructure to be funded consists primarily of buildings, structures and roads.

Outlined here are three alternative sources of debt available to Council to finance the funding gap, and the ongoing maintenance programme:

a. Bank Finance

The “**banking market**” in Australia remains a competitive source of loan funding or “senior debt”. Typically however, banks (including building societies and credit unions) are less willing to provide longer dated finance to suit the asset funding requirements, or to tailor repayment schedules around asset revenues. The nature of the loan documentation can also be more restrictive than other forms of debt finance.

A traditional loan to Council from a lending institution can be at a fixed or floating rate of interest for any of the following loan structures:

- Principal & Interest – fully amortising
- Interest Only – balloon Principal repayment
- Interest Only then Principal and Interest

The average loan term is ten years with generally a maximum term of 25 years. Grange has secured bank finance for terms up to 40 year terms for longer dated projects.

The following table highlights conservative repayment options as at the 13th of December 2006 for traditional debt funding for Council:

Loan Term	Loan Rate	Fully Amortising P&I \$134m.	Interest Only \$134m.
10 years	6.40% qtly	18,204,814	8,556,800
20 years	6.45% qtly	11,946,066	8,623,650

Whilst longer term funding has been secured it is not guaranteed and shorter term funding increases debt servicing costs in the early years of an assets economic life.

b. Capital Markets: Bond/Note Issuance

The “**capital markets**” have also proven to provide competitive funding, particularly for longer dated requirements, or where repayment flexibility is paramount.

While Grange has not specifically considered the financial position of Council relative to its peers, the following table provides a summary of the credit ratings of those local governments that have received ratings from Standard & Poors. It supports the general proposition that local government is a well respected risk alternative to corporate, structured and other government related debt in Australia.

Entity	S&P Rating
Newcastle City Council	AA+
Brisbane City Council	AA+
Gold Coast City Council	AA
City of Melbourne	AAA
Penrith City Council	AA
Wollongong City Council	AA+

An important factor supporting potential demand for a Council capital raising is the lack of local government related transferable investment product in the Australian market. Investors typically respond favourably to opportunities to diversify their portfolios, and experience has shown that local government related issues benefit from this effect. In Council's favour is also the relationship Council has with the NSW State Government, and its general powers to "rate" residents.

The following is a summary of the types of capital market issues Council could undertake:

- **Inflation Index Linked Bonds**

The inflation ("CPI") index linked market in Australia is well developed and the prevailing investor demand for CPI Indexed Linked Bonds provides an opportunity for borrowers to access long term debt finance efficiently.

Many investors are seeking to acquire inflation indexed securities to match their superannuation and other long term liabilities. This presents Council with the opportunity to fund its infrastructure gap and ongoing programme with inflation indexed borrowings. In the prevailing market, the cost of inflation indexed financing is historically low, and for this reason, many large infrastructure projects have recently been financed with Annuity Indexed Bonds (AIB's).

An AIB borrowing is fully amortising where the principal and interest payments are adjusted in line with inflation.

Advantages of AIBs in financing infrastructure projects are:

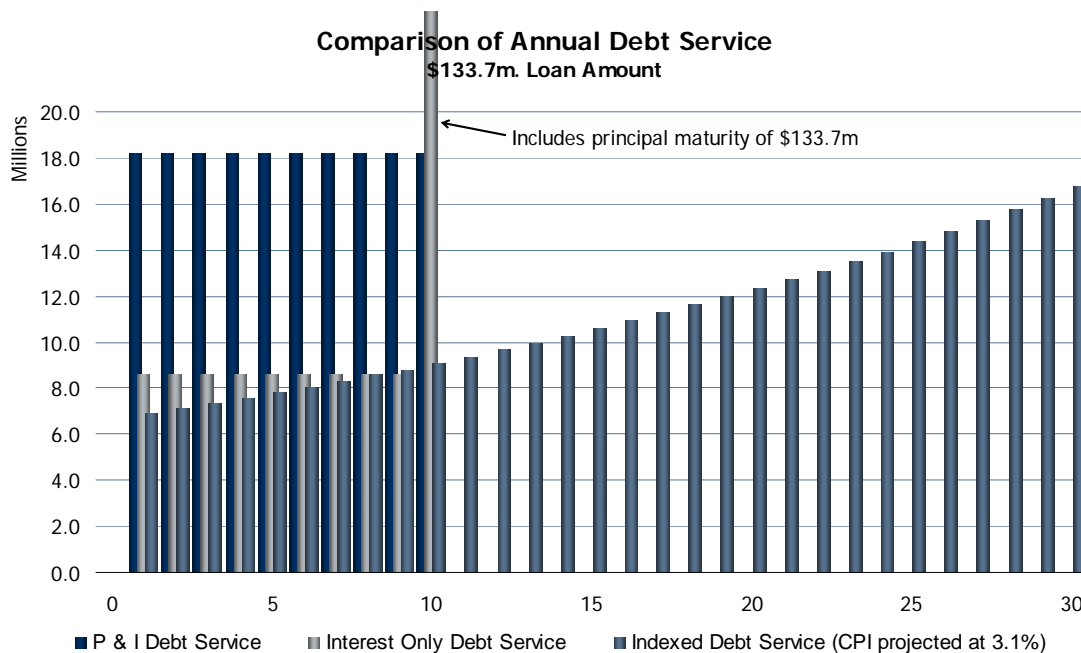
- The annual cash outflow (principal and interest) for an AIB is significantly lower than that for a nominal borrowing of the same amount.
- The cost of funds of an AIB moves in line with inflation fluctuations, as do the revenues of many infrastructure projects. The revenue and debt servicing cost generally move together and therefore debt servicing costs, as a percentage of income, remain very stable though-out the life of the project.
- Council income such as rates, investment income and Government funding move broadly in line with inflation and so funding with AIB's generates a natural revenue: cost matching for Council.
- AIB's can be issued for terms of up to 50 years. These funding terms can therefore be tailored to closely match the life of the infrastructure assets they are financing. Nominal debt is traditionally issued for substantially shorter terms as mentioned previously.
- The longer terms of AIBs mean that funding costs can be spread more equitably across the generations of users who benefit from the infrastructure projects.

The chart following illustrates various aspects of indexed and nominal funding including the debt servicing.

The issue parameters are:

- Principal borrowed is \$133.7million
- Nominal loan is fixed for 10 years @ 6.40% qly – repayment of \$18,204,814 pa (P&I)
- Indexed loan is 30 years @ 3.00% qly (real) (6.10% nominal) – base repayment of \$6,774,620 pa
- CPI is set at 3.1% p.a. for illustration of future indexed debt service

The following chart highlights the difference in debt service cash flows for traditional debt versus inflation linked debt.



As the chart clearly shows, the debt servicing in early years is considerably lower for an AIB than either the principal and interest or interest only type loans.

Traditional loan funding which does not match the economic life of the asset provides for a mismatch in debt service costs to revenue, and can make it difficult in the early years to fund.

Economic Reasoning for CPI Linked Funding:

- Labour costs have been contained by strong local and international competition, limiting returns on labour while increasing returns on capital investment spending.
- In this cycle real interest rates have stayed very low, down below 2.2% on longer-term government indexed link bond yields from 3.6% at the beginning of 2004.
- Current very low real interest rates are one of several examples where markets are temporarily failing to price risk adequately.
- While unusually low real interest rates persist in combination with another unusual phenomenon, long-term interest rates below short-term interest rates, real borrowings can be invested short-term with a yield pick-up boosting other revenue.
- Borrowing long term at real yields below 3%, and allowing for inflation to average 2.5% over the next 10 years (the middle of the Reserve Bank's 2% to 3% target) results in a sub 6% debt financing cost.

If Council is rated AA+ by Standard and Poors, we believe the domestic financial markets will receive an AIB issued by Council favourably. Further, Grange considers this to be the most cost effective and efficient form of funding available to Council.

▪ Fixed Rate Bonds / Notes

Council can issue fixed rate bonds into the capital markets. The fixed interest market is the largest securities market in Australia and globally it is three times larger than the equities market.

A fixed rate bond is similar to an interest only fixed rate loan from a banking institution, but in the case of the bond the lender is one or more wholesale investors. The bonds would also then be transferable and "traded" in the market place. The advantages of issuing via a fixed rate bond is the market presence the Council name will achieve. Unfortunately, though the market appetite for fixed rate bonds tends not to go beyond ten years and as such is an inflexible form of financing for long term projects.

- **Floating Rate Bonds/Notes**

Floating rate notes are similar in underlying documentation to fixed rate notes with the primary difference being that the interest rate is floating and benchmarked against an index, such as the Bank Bill Index. The generally accepted form of floating rate notes, which are similar to an interest only loan, are for five to ten years, with an option to extend at a call date. Again, this is not optimal for long term project finance.

c. Structured (Property) Finance

A bespoke **structured finance** solution may be available to Council. A structured solution can provide cost effective longer dated funding, particularly for property financings. A relevant example in this context is the issuance of \$131m nominal annuity bonds by the Brisbane Square project (in April 2004); a securitization of lease receivables from the Brisbane City Council. The bonds are rated AA+, mature in November 2028, and were issued at 65 basis points over the equivalent modified duration Commonwealth Government bond.

Given the generality of the capital expenditure financing requirement to fill the “backlog”, a structured financing solution is not being envisaged at this point. However, it is necessary to explore bespoke asset financing solutions on an ongoing basis.

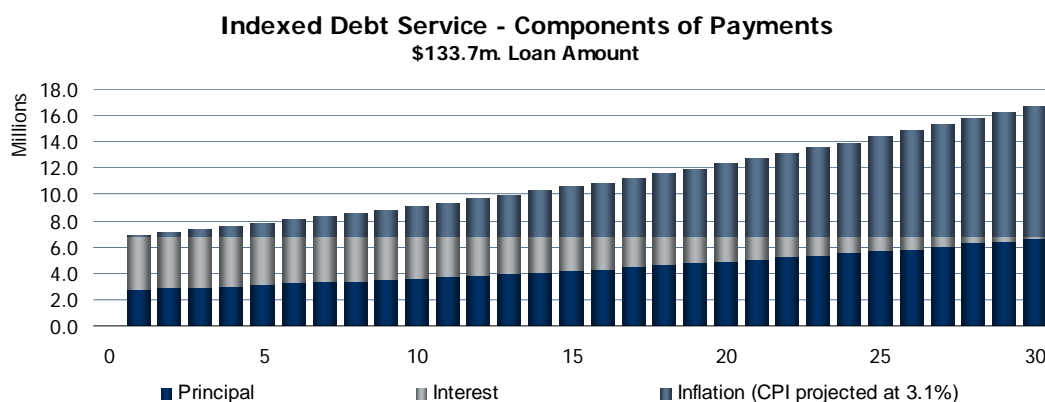
Recommended Funding Option

Our recommendation is for Council to fund its infrastructure backlog and ongoing infrastructure programme via an Annuity Index Linked Bond issue into the capital markets.

Indicative Bond Details:

Term	:	30 years
Amount	:	\$133.7million
Real Yield	:	3.00% qty
Base Payment	:	\$6,774,624 pa
Payment/Loan	:	5.07%
CPI Estimate	:	3.10%

Graphically the debt servicing is made up of the following components:



a. Savings/Benefits

Typically, the savings and benefits from an AIB financing include the following:

- Intergenerational Equity**
 For long lived infrastructure projects the AIB funding will ensure that current ratepayers do not bear the full costs of services and facilities which benefit further rate payers into the future. Thus, the costs are shared between present and future generations and provides an equitable solution to funding infrastructure.
- Lower Up Front Costs**
 Lower up front debt servicing costs of an AIB structure will provide Council with financial flexibility in the early years to absorb the total funding plan
- Matching Loan Term to Asset Life**
 Matching loan term to the life of the asset is a common form of balance sheet management in corporate Australia and an AIB structure will provide Council the ability to match more closely assets and liabilities. This will further enhance the efficiency of Council in managing its balance sheet.

Conclusion

- ❏ Grange recommends a CPI Index linked bond issue in the form of an AIB as a borrowing “solution” given a recommendation to borrow long term debt funding of approximately of \$133.7million to fulfill an infrastructure degradation backlog, and ongoing long term requirement to fund maintenance and renewal of infrastructure.
- ❏ Provided Council maintains a credit rating of AA+ at issue, an AIB is the recommended form of financing as it has a number of advantages over traditional debt funding:
 - ❏ Reduces all up cost of funds on long term assets;
 - ❏ Reduces the amount of “up front” debt servicing;
 - ❏ Allows for future generations of rate payers to service debt; and
 - ❏ Simplifies liability management.

Grange has a comprehensive liability advisory capability which encompasses existing loan portfolio research and analysis, full portfolio optimisation and the outsourcing of initial administration which is supported by skilled and experienced client servicing personnel. Proof of the effectiveness of our service is evident in past performance of equivalent loan borrowings and we look forward to assisting Council achieve a successful funding arrangement.