Grange Securities
A Lehman Brothers Company

31st July 2007

Funding Analysis and Financing Proposal

Wollongong City Council

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1. Introduction

Grange Securities Limited (Grange) has been engaged by Review Today Pty Ltd ("Review Today") to undertake an analysis of the funding requirements of Wollongong 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.

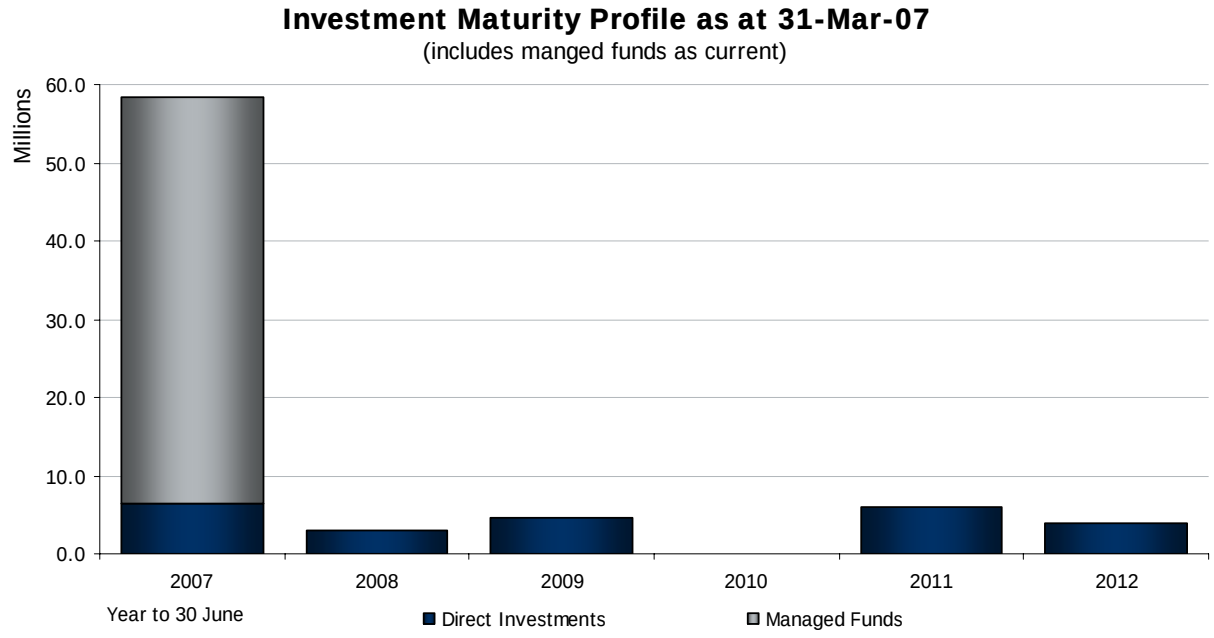
In January 2007 Lehman Brothers, a leading global investment bank, acquired Grange. As an integral part of Lehman Brothers, we can now offer our clients access to a global network of market leading products and services across investment banking, equity and fixed income sales, trading and research, private investment management, asset management and private equity.

2. Current Financial Assets & Liabilities

Investment Instruments

The Council investment portfolio currently exceeds $75 million in value. Approximately $52 million is invested in managed funds with the balance invested in a liquid basket of diversified cash and credit backed securities. All investments have been made in accordance with the NSW Local Government Ministers Order dated 24 November 2000 as amended. Recent performance has been comfortably above the benchmark target (UBS Australia 90 day Bank Bill Index).

The maturity profile of Council's investment portfolio shows that 27% of the direct investments mature in less than 90 days, whilst 54% mature in less than two years. The remaining longer term securities, $11 million, are primarily floating rate structured debt. Within the longer term category are securities for which a secondary market exists and are readily saleable. The balance, however, is less liquid and would most likely need to be held to maturity to realise full value.



The portfolio represents a significant income generation source for Council, providing assistance with creditor obligations and financial commitments.

3. Financial Strategic Plan 2006-2011

Council has incorporated within its Financial Strategic Plan, the creation and development of a Future Fund whose goal has been identified as:

> *"To create a capital pool comprising Council's income generating assets and businesses and to set performance targets that ensures maximised returns on investment(s) and to provide increasing dividend flows to Council to fund major projects and commercial business reinvestment."*

This strategy seeks to effectively link assets with performance in a more direct fashion than has traditionally been the practice in Australian local government. This represents a more commercial approach to the management of Council's strategic assets and is therefore encouraged as a working model for local government since the extraction of additional value from Council's balance sheet will potentially release funds which can then be applied to furthering the service provision objectives of Council.

The Future Fund model should be the equivalent of an internally managed Property and Investment Portfolio. To this end appropriate commercial comparisons can then be drawn for performance benchmarking purposes. Such benchmarking should consider the relative performances of both listed and unlisted property trusts (for example) which would then attract appropriate discount factors to account for community use related assets.

In order for this model to work effectively, Council needs to ensure that a number of issues are adequately addressed. These issues can best be summarised as follows:

- Appropriate and accurate asset assessments. Unrealistic asset values will detract from both future planning as well as accurate yield calculations. This in turn will impact on the assessment and payment of dividends back to Council;

- Appropriate Chart of Accounts structure. Accurate data capture underpins the success of the management of the Future Fund together with its projections. The ability to accurately assess true yields resulting from each and every property is of paramount importance as these impact on the ability to adequately evaluate and assess property performance. Such property performance assessment underscores the financial decisions that form the basis for determining sale / development decisions for each property; and finally

- Appropriate management structures. In order for the Future Fund to be successful, accurate data capture as discussed above is of paramount importance. Accurate data capture relies on an effective grid management structure that clearly delineates property management functions and allocates the correct level of resources to each property from a broad range of often disparate internal Council functions. In order for such grid structures to work efficiently there must be a central property focus attributed to each property and therefore property 'ownership' must be clearly defined. Such 'ownership' is internal only but very much real from a management and outcomes perspective.

If managed correctly and structured in accordance with the principles identified above it can be used to underpin the long term financial strategy of Council.

The above comments relate equally to the "Commercial Business" section of Council's Financial Strategic Financial Plan.

4. Funding Options

Council has a number of options available to fund the infrastructure and associated services as outlined and defined in the GHD and Access Economics reports, namely;

1. the Backlog Maintenance and Rehabilitation which has been referred to as 'Rehabilitation';
2. the future Renewals;
3. the future Enhancements, and
4. the Consequential Maintenance which is driven by the extent of the previous 3 items.

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 expenditure to be funded (such as the economic life of the asset and the cash flows generated by any resultant assets).

The funding model developed for Wollongong City Council is based on the Responsible Scenario as outlined in the Access Economics Report and detailed in the following chart:

Financial Period	07/08	08/09	09/10	10/11	11/12	12/13	12/13	12/13	12/13	12/13
	$'000s	$'000s	$'000s	$'000s	$'000s	$'000s	$'000s	$'000s	$'000s	$'000s
Change in Interest Bearing Liabilities from base year start	39,870	79,568	21,087	1,324	678	5,556	5,182	3,035	(6,391)	(8,290)

Council must also consider whether the private sector could deliver the required infrastructure assets with appropriate consideration of associated cost reduction, efficiency gains or potentially improved ratepayer focused outcomes. Such options would be delivered via a Public Private partnership ("PPP"). As Grange understands, the majority of infrastructure to be funded consists primarily of buildings, structures and roads.

The proposed funding model correlates Council's borrowings and investments and seeks to lock in the long term funding at current low rates. The model assumes that total borrowings on $135.3 million are secured in the first year and fully invested in a medium term investment portfolio that provides 30 day liquidity. Progress payments for the identified capital works are then drawn from this investment pool over the duration of the works program until the balance of the investment pool is nil and the resultant capital works are completed. The detailed analysis below provides an assessment of the impact of the investment earnings on the total cost of the borrowed funds.

Outlined here are three alternative sources of finance 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 date of this report for traditional debt funding for Council:

Loan Term	Loan Rate	Fully Amortising P&I $135.3m.	Interest Only $135.3m.
20 years	7.10% qtly	$ 12,719,255 p.a.	$9,606,300 p.a.
30 years	7.10% qtly	$ 10,929,644 p.a.	$9,606,300 p.a.

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 are the types of capital market issues Council could undertake and a description on each type is provided below:

- Inflation Index Linked Bonds
- Fixed Rate Bonds / Notes
- Floating Rate Bonds/Notes

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.

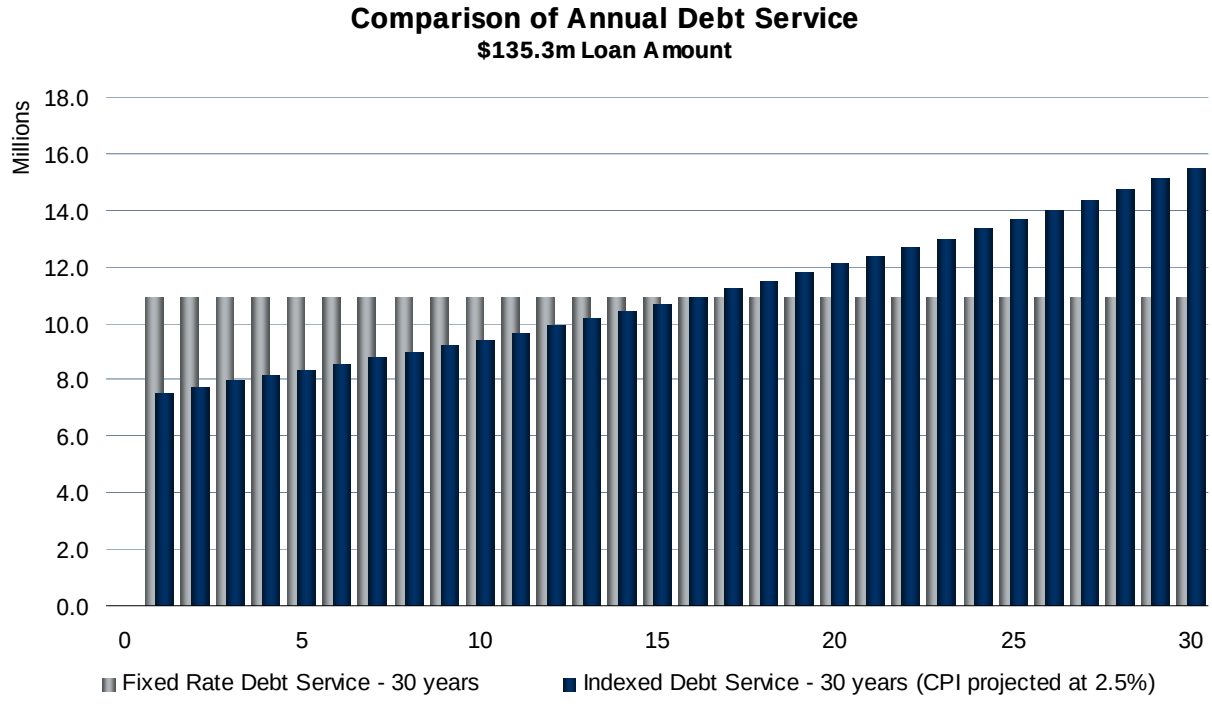
Advantages of AIBs in financing infrastructure projects are:

- The annual cash outflow (principal and interest) for an AIB is significantly lower in the early years 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 following chart illustrates various aspects of indexed and nominal funding including the debt servicing. The issue parameters are:

- Principal borrowed is $135.3 million
- Nominal loan is fixed for 30 years @ 7.1% qtly – repayment of $10,929,644 p.a. (P&I)
- Indexed loan is 30 years @ 3.65% qtly (real) – base repayment of $ 7,439,721 p.a.
- CPI is set at 2.5% 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 for a principal and interest loan.

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, having dropped below 2.2% on longer-term government indexed link bond yields from 3.6% at the beginning of 2004.
- While 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 around 3.65%, 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 relatively low debt financing cost.

If Council maintains its AA+ rating 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 advantage 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, is for an initial term of five to ten years, possibly with an option to extend at a call date. Again, this is not optimal for long term project finance.

c. Public Private Partnerships ("PPP")

In recent years, PPPs have become popular as a means of building social infrastructure around the world. PPPs are essentially partnerships between the public sector and private sector for the purposes of delivering public assets or public services. Such partnerships involve the private sector performing one or all of designing, planning, financing and constructing and/or operating projects which would be regarded traditionally as the responsibility of the public sector. Infrastructure projects such as roads, hospitals, schools, rail and bridges are prime examples of projects that have used PPP technology.

Further, external contracting differs from PPPs in that the latter usually entails a combination of services (e.g. design, construction, maintenance) whereas contracting out is usually for one or more relatively simple services.

PPPs can be extremely complex. Any government agency considering PPPs needs to understand the shift from supplying to buying services will place new demands on them towards output specification and contract management including specification of the measures by which the performance of the private sector partner is assessed.

Further, the implementation of relevant PPP legislation in NSW provides a rigid compliance structure that places substantial administrative burden on participating Councils. Accordingly any participation in a PPP solution would need to be cognisant of the management issues associated with its implementation and ongoing review.

Due to the complex nature of the economics intrinsic in PPPs, our discussion below is more a high level overview of PPPs and the circumstances under which Council might consider using them.

Forms of PPPs

The choice of form depends on factors such as government's objectives, the nature of the project, the availability of finance, and the expertise that the private sector can bring.

Traditional Design and Construction (TDC)

The Government, as principal, prepares a brief setting out project requirements before inviting tenders for the design and construction of the project. Private sector contractors undertake to design the project in accordance with the brief, and construct it for an agreed sum, which may be fixed or subject to escalation.

Sale / Leaseback

Structured sale and leaseback solutions can also be employed for some infrastructure assets, but are particularly applicable to specific use real estate assets. Essentially this is an equity based solution which can be applied to existing assets as well as new-build assets. In the case of existing assets (typically real estate) the basic structure is for Council to sell the asset to a private owner and lease back the property over a given period of time. The transaction has to be structured such that it is treated as a true sale (of equity). The private owner has all the rights and responsibilities of ownership (revenue, management, depreciation, asset maintenance, etc). The underlying lease would usually be long term, and would typically be applicable for government buildings such as council offices. For new-build assets, Council would specify the asset and the private owner would build to specifications, with a confirmed contract to lease, by Council.

Build - Own - Operate - Transfer (BOOT)

Projects of the Build-Own-Operate-Transfer (BOOT) type involve a private developer financing, building, owning and operating a facility for a specified period. At the expiration of the specified period, the facility is returned to the Government.

BOOT structures are applicable for large new-build infrastructure projects, with limited but relatively long concessions, with final asset transfer to the government agency after the end of the concession period. Applicable for assets such as water utilities and sewage treatment plants – assets that are true monopolies and that are usually tariff regulated (by government or a regulatory body). The government agency typically provides a throughput/volume guarantee and a tariff guarantee to the private asset builder/concession holder.

Build - Own - Operate (BOO)

The Build-Own-Operate (BOO) project operates similarly to a BOOT project, except that the private sector owns the facility in perpetuity. The developer may be subject to regulatory constraints on operations and, in some cases, pricing. The long term right to operate the facility provides the developer with significant financial incentive for the capital investment in the facility.

BOO structures are typically used for private ownership of public usage infrastructure and social infrastructure assets. They can be limited-time or permanent concessions, with guaranteed contracts or, in the case of non-guaranteed concessions, the private owner takes patronage risk. BOO can be applied to toll roads, bridges, airports and other classical infrastructure, but is more commonly employed in the education sector (eg school buildings), the healthcare sector (eg hospital buildings), and other community facilities (e.g. police stations). Effectively the assets are not held on the government agency's balance sheet. However the government agency can exert a degree of control over the way the assets are run (in safeguarding public interest) through to the way the contracts are structured.

Under what circumstances should Government agencies use PPPs

The underlying rationale for PPPs is that they offer better value for money than the alternative. Most State Governments in Australia require that PPP finance options demonstrate superior value-for-money to the Government and community compared to conventional, publicly funded approaches to infrastructure provision.

There are a number of reasons State Governments are attracted to PPPs, and why Local Governments should consider PPPs.. They include the potential for value for money, early project delivery, gains from innovation, off balance sheet finance advantages and access to improved services.

Risk Transfer

The transfer of risk is a key driver when considering whether value for money exists. Risk can take many forms including those relating to construction, the size of the market (demand risk), and the cost of operations and maintenance. The key decision to be made when considering a PPP is which of the Public or Private sector can manage the overall (or a particular) risk at the least cost.

Incentives

PPPs may contain incentives for the private sector partner to perform well in order to make the transaction a profitable one. E.g. under a contract to construct a road, the developer has an incentive to do the minimum necessary to meet the contract terms. However, under a design, construct and maintain arrangement, the developer has an incentive to minimise whole-of-life costs and so construct the road to the standard that will minimise those costs. This incentive is reinforced by the fact that payment under PPPs depends on the developer meeting agreed maintenance standards.

Other examples where PPPs show value for money

PPPs generally involve the bundling of services. The total bundle of services should cost less than the sum of contracting the services separately

Funding projects through PPPs replaces the need to borrow on-balance sheet, which for indebted public sector agencies could mean the bringing forward of otherwise postponed projects.

In summary, for Council to decide whether a PPP offers value for money they will need to build a model that estimates what the total project would cost if the Public Sector were to undertake the project, (using best practice assumptions) and compare this to the proposed cost provided by the Public Sector participant.

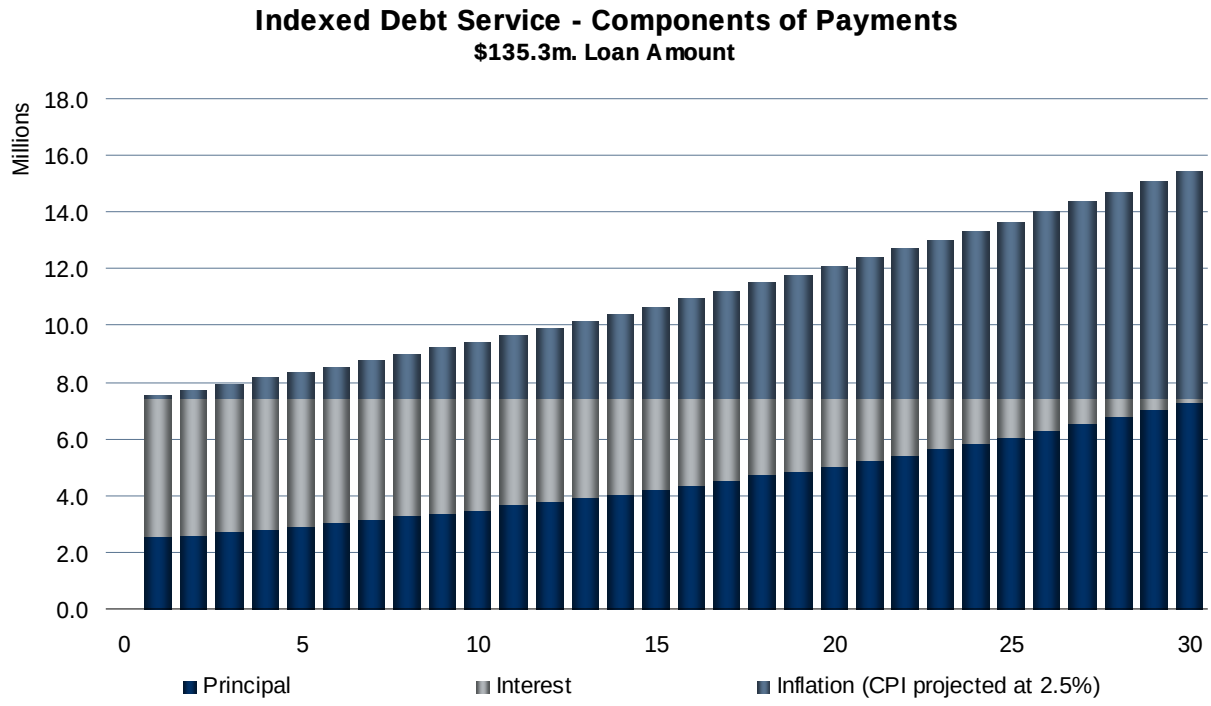
4. Recommended Funding Option

Our recommendation is for Council to execute its funding requirements for the amounts identified in the Access Economic's report via the use of an Annuity Indexed Bond as detailed in this report. The balance of any additional funding requirements should be structured via a PPP using the BOOT format as further detailed in this report.

Indicative Bond Details:

Term	:	30 years
Amount	:	$135.3 million
Real Yield	:	3.65% qty
Base Payment	:	$7,439,721 p.a.
CPI Estimate	:	2.50%

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



An analysis of the Net Present Value (NPV) calculations associated with this recommended option appears as follows:

The NPV calculation undertaken here compares the cash flows associated with a nominal 30 year funding arrangement with a 30 year Annuity Indexed Linked Bond funding arrangement. The analysis assumes that future inflation will average 2.50% p.a. and uses the fixed rate loan borrowing cost to discount the debt service cash flows of both loans. The NPV of each debt service is then compared to determine their relative present value cost.

The Net Present Value saving of the transaction as detailed above is $ 14,501,809

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.

5. 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 totaling $135.3 million to fulfill the infrastructure and associated service funding as outlined in the GHD and Access Economics Reports.

- An Annuity Indexed Bond is the recommended form of financing as it has a number of advantages over traditional debt funding:
  - Manages 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 an equitable portion of debt; and
  - Simplifies liability management.

- The balance of any additional funding requirements should be structured via a PPP using the BOOT format as further detailed in this report.

- The proceeds of the accelerated funding to be invested in a liquid investment portfolio from which progressive draw down of funds would be used to meet the progress payments associated with the capital works program.

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.