

# Cessnock Council Liabilities Capacity Report

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## **Cessnock Council Liabilities Capacity Report**

### **Executive Summary**

*This report commences with a review of the metric endorsed by the NSW Government, before turning to a consideration of more sensible and robust measures of liability capacity. On the basis of the evidence presented in this report there can be no reasonable doubt that Cessnock has no meaningful capacity for additional debt. When we consider that Cessnock City Council also has relatively high levels of implicit debt – constantly being exacerbated by growth pressures – then the situation that confronts us can only reasonably be described as ‘grave’. It is thus essential that the proposed Special Variation (SV) be approved and implemented without further delay.*

### **1. Introduction**

The relationship between debt and financial sustainability is a profoundly misunderstood concept for most key stakeholders (see, for instance, some of the surprising comments in Comrie, 2014). People often confuse debt as a source of revenue, when it is indeed nothing of the kind. Debt is merely a way to bring forward future revenues. Moreover, when we access future revenues through debt, the act comes at significant cost – finance institution fees, as well as interest charges. Furthermore, bringing forward revenues in this manner introduces considerable constraints on the decision-making calculus of future ratepayers.

Intergenerational equity should be a major concern when contemplating the drawing down of debt, or indeed the accrual of liabilities conceived more broadly. When we bring forward future revenues, we effectively commit a future generation of ratepayers to funding goods or services that we will, at least partly, consume in the present. Being able to commit other, voiceless, people to pay for our current spending clearly opens up a significant moral hazard.

Ironically, many commentators – such as the aforementioned Comrie, and the Independent Local Government Review Panel’s (ILGRP’s) Sansom (2013) – have tried to assert that debt is required for intergenerational equity. Commentary of this sort is convenient for (state and some local government) politicians who may wish to clear backlogs or avoid increasing taxes for short term political gain. However, arguments in favour of debt routinely neglect the fact that our generation was bequeathed most of its public infrastructure completely unencumbered – it also ignores a palpable level of debt bias.

As the Nobel laureate James Buchanan (1997) observed debt bias is a completely rational decision for older residents because in many cases it is unlikely that they will remain taxpayers long enough to pay their fair share of the debt. Moreover, as we have already touched upon, debt allows politicians to deliver popular public goods and services without the inconvenience of asking current taxpayers to pay for same.

When one considers the typical age of our politicians it is easy to understand the eye-watering national and state government debts in Australia.

Notably, in the past, politicians were extremely debt averse because they saw the imposition of burdens on a future generation as a profound moral issue. Indeed, it was generally believed that to 'spend borrowed funds on ordinary items for public consumption was, quite simply beyond the pale of acceptable political behaviour' (Buchanan, 1997, p. 119). Furthermore, politicians were alert to the risk of ballooning debts – especially in the presence of structural budget deficits – with Roosevelt famously observing that 'any family can for a year spend a little more than it earns....but you and I know that a continuation of that habit means the poorhouse' (cited in Borna and Mantriprgada, 1989, p. 38). However, worsening financial sustainability circumstances, exacerbated by constraints or fear to levy a reasonable taxation effort, means that debt sadly has to be a real consideration.

Debt *might* be morally licit under certain strict parameters, notwithstanding the fact that it is rarely a preferable state of affairs (as is sometimes naively argued by people; especially those with vested interests). Drew (2021) has employed economic and moral theory, to establish six rules that should be observed for public debt to be considered morally defensible:

1. Debt must be only taken out for capital expenditure and not operational expenditure. By definition operational expenditure refers to goods and services that will be fully consumed within twelve months. It can never be considered morally licit to force others to pay for what we have already consumed.
2. The asset financed through debt must have a long and predictable life. Unfortunately, governments tend to experience considerable difficulty in estimating the useful lives of assets, and this condition thus warrants careful attention. At a minimum, the real useful life of the asset should at least be equal to the term of the prospective loan.
3. The asset must constitute something that future generations are likely to value. Because future ratepayers will be forced to pay for a component of the said asset, we must give careful consideration to whether they will be able to extract any value from it. Particular attention should be given to infrastructure that might become redundant (due to changes in technology), as well as *prima facie* vanity projects (statues and the like).
4. Debt must be assumed for good moral reasons. As we have seen, debt bias is not a good moral reason, and nor is a misapprehension that local government ought to engage in fiscal stimulus programs.<sup>1</sup>
5. Repayments must at least be equal to the rate of consumption of the asset and be quarantined in future budgets. Otherwise stated, repayments should at

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<sup>1</sup> Many economists are not convinced that fiscal stimulus is either effective or moral (see Buchanan, 1997; Drew, 2021). In addition, fiscal stimulus is best conducted by a tier of government with an appropriate scale of resources and at least a little influence over monetary policy.

least equal the projected level of depreciation. Budgets should mark this money as committed so that it is not used to fund other projects (especially discretionary projects).

6. Repayments must involve sacrifice so that a *quid pro quo* is established. This means that taxes or fees should be increased to generate additional revenue commensurate with the required repayments<sup>2</sup>, or that cuts should be made to discretionary expenditure elsewhere in the budget.

Even if these rules are observed, a number of problems persist. These problems include: (i) the fact that debt (or better still, entire liability) capacity must be precisely known; (ii) the general absence of debt products whereby the term is consistent with the expected life of the asset<sup>3</sup> (such as buildings that might be expected to survive a century or more); (iii) the problems of accurately estimating the useful life – especially for long-lived assets (see, for example, Drew and Dollery, 2015).

To fully appreciate the aforementioned debt rules, it is helpful to consider matters from the perspective of the personal budget metaphor. This thinking device is an instantiation of the rhetorical trope of *kal vahomer* which asserts that we should at least apply the same standards to weighty matters as we do to 'lighter' ones.

In our personal finances, most of us would recoil from taking on large debts for frivolous items or experiences of a transitory nature, such as holidays. We, and our bank manager, would also wish to receive assurance that our incomes were large enough to service the debt – including in a scenario whereby interest rates rose<sup>4</sup> (typically the commercial banking sector insists that incomes are at least three-times larger than projected repayments and that there is also a sufficient cushion when non-discretionary expenditures are accounted for). In addition, when we take out loans in our personal lives, we expect that repayments will commence more or less immediately, and that we personally will be responsible for meeting the repayments (not our children, grandchildren, or perfect strangers). We also usually acknowledge that the repayments will come with some sort of sacrifice – we might need to take on a second job or eschew luxuries.

It would be prudent to exercise at least the same sort of caution when it comes to public debt – and the debt rules that we set forth earlier will assist council in this regard.

Further complicating matters is the fact that formal debt is only part of the story. Local governments are also obligated on a range of liabilities that are just as binding as explicit bank loans or the like. A notable example are employee benefits which are legally protected. Moreover, different councils have different liability profiles because of either deliberate strategies or happenstance. A failure to consider the

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<sup>2</sup> This is precisely what some councils have done in the past for major capital projects.

<sup>3</sup> The absence of a suitable debt vehicle means that a local government may be exposed to rate risk at regular intervals when a new loan needs to be negotiated.

<sup>4</sup> Sovereign bond markets are starting to become extremely volatile as the amount of global debt outstrips demand. The projected ongoing and rapidly growing deficits of most developed nations suggests significant rate risk on the upside unless fiscal constraint and the courage to charge taxation commensurate with spending promises emerges shortly.

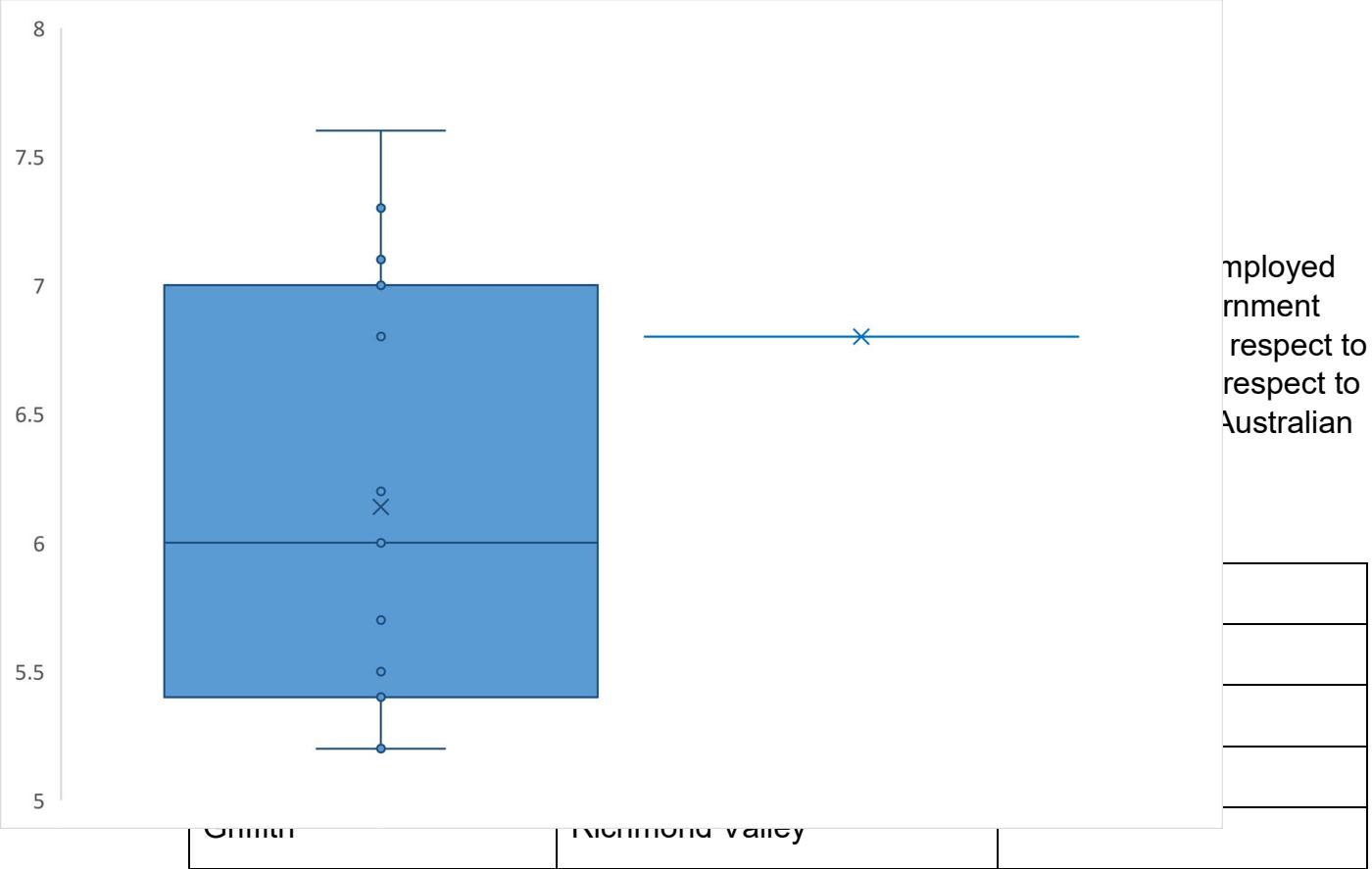
broader suite of liabilities – which often dwarf the scale of explicit bank loans – could easily result in poor decisions, and potentially imperil a community’s sustainability. Indeed, the extant ratios used in New South Wales fail to acknowledge this crucial point and therefore fail to contribute meaningfully to an evaluation of financial sustainability. The key output of this report redresses this serious oversight in the regulatory metrics and thus provides critically important information to decision-makers contemplating the sustainability of Cessnock City Council.

We also need to be mindful of the backdrop of implicit debt when considering liabilities and liability capacity. This matter is serious for Cessnock and represents the main reason for the proposed SV. We simply must get deferred works on roads and bridges done before the infrastructure fails entirely and results in an eight-fold or more increase to costs (not to mention the potential public safety risk). We will not go into more detail in this report because the matter was already dealt with substantially in both the University of Newcastle *Financial Sustainability Review* and the *Capacity to Pay Report*. However, cognisance of the pressing issue of implicit liabilities at Cessnock City Council is essential to a proper understanding of why council should be very careful around even approaching its liabilities capacity level<sup>5</sup>.

The remainder of this report is dedicated to carefully exploring the explicit debt and liability capacity of Cessnock City Council. In the section that follows we will review two of the principal debt ratios used in the sector, with respect to the peer group of similar councils employed throughout all of these reports. Thereafter, we will conduct sophisticated empirical analysis that redresses most of the insufficiencies of crude ratio analysis. We also compare the typical liabilities capacity predicted by our econometric work, with respect to the current loads of council. We conclude with our recommendations regarding debt, financial sustainability, and the necessary special rate variation.

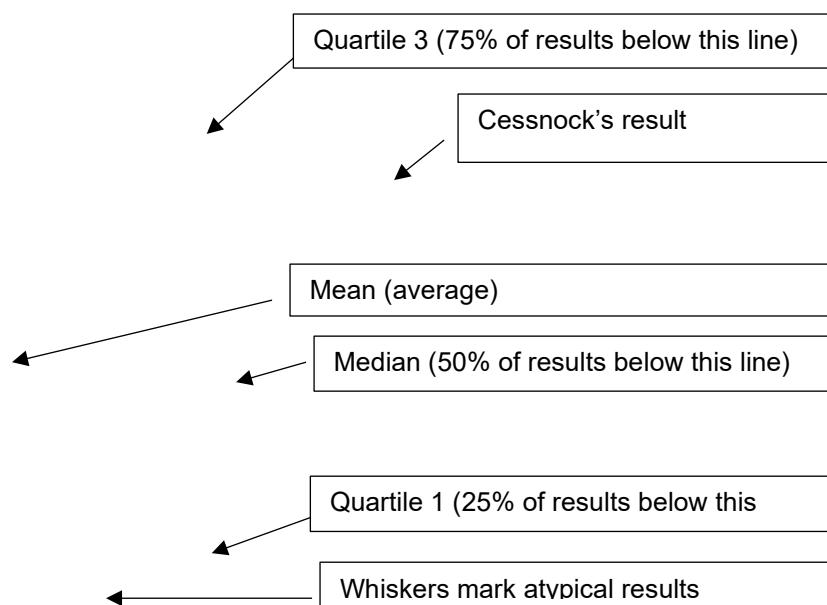
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<sup>5</sup> That is, Cessnock has a significant level of implicit liabilities already which has the potential to dwarf its explicit obligations. Given this problem, which seems to be of a scale larger than most councils, it would clearly be wise to exercise utmost caution in approaching the explicit liability capacity.



The ratios that follow are presented as box and whisker plots which are the best way of making judgements around relative performance with respect to typical outcomes and spread of same. Figure 1 provides a reminder of how to read these.

**Figure 1. Interpreting Box and Whisker Plots**



All of the regulators in Australia employ debt ratios, of one species or another, to try to measure the capacity of local governments to service their borrowings. However, in most cases the ratios have been directly imported from the corporate world with little thought given to the vastly different operating environment faced by local governments in this nation. The most important difference is that debt, and leverage, in the corporate world is a way to amplify profits because most debt is used to purchase income generating assets. By contrast debt in local government tends to be for assets that not only fail to generate profits, but also typically come with substantial ongoing maintenance costs (for example, roads). For this reason, it is inappropriate to directly import ratios from the commercial world and the benchmarks used there have little relevance (clearly benchmarks for the government sector ought to be far lower than those for commercial operations).

Indeed, the revenue collection patterns in the corporate and local government sector also differ considerably. Typically, revenue in corporate enterprises flows in on a daily basis. By contrast revenue in local government is lumpy – quarterly taxation receipts, as well as infrequent or annual grant flows. This is yet another reason why most ratios abjectly fail to measure the true debt capacity of councils (especially when the quarters do not map neatly onto financial years).

The use of crude ratios is further ill-advised because this method of analysis only accommodates a very limited suite of variables.

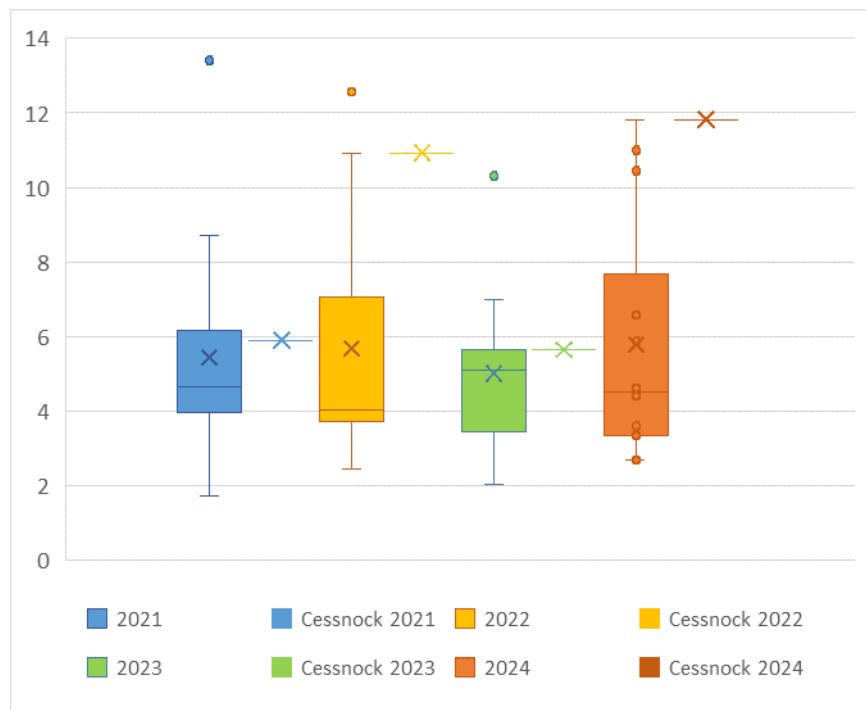
The overall outcome of the many serious deficiencies associated with debt ratio analysis is that end-users stand a high chance of being fundamentally misled (Drew and Dollery, 2015).

The Debt Service ratio, used in New South Wales, is a perfect exemplar of our criticisms. This metric divides earnings before interest, taxation, depreciation, and amortisation (EBITDA) by the sum of principal repayments and borrowing costs. A ratio of this kind *might* make sense in the corporate world where there is a clear nexus between debt and revenue generation (and hence profits) but makes absolutely no sense for the local government sector. In addition, there are a number of other reasons to doubt the wisdom of using a metric of this kind. For instance, the ratio perversely penalises Councils for making additional repayments, even though doing so is often a feature of good capital management. Indeed, the ratio has been used in the past to try to argue that Councils with zero debt were somehow financially 'unfit' for the future. Second, the numerator is likely to be distorted in a rate cap environment because it is rarely representative of actual capacity to pay (see our Capacity to Pay Report). Third, the ratio only takes account of a small portion of total explicit liabilities.

It should be very clear that the ratio is not fit for purpose given that it routinely fails to identify Councils suffering fiscal distress – in fact, there were just twenty-four instances of urban councils (16 unique councils) which failed to meet the benchmark (2.0) over the last five years, and this figure notably excluded Councils subsequently placed into administration. It would thus be unreasonable to place any assurance around meeting this arbitrary benchmark for an entirely unsuitable ratio.

In Figure 2 we present the NSW debt service ratio metric which putatively measures debt capacity. The results over the last four financial years seem to suggest that Cessnock has plenty of untapped debt capacity – indeed, almost the entire cohort seems to have additional debt capacity by this flawed metric. This suggestion could hardly be further from the truth, given that at least three of the peer group are experiencing significant and chronic financial distress. Figure 2 also seems to imply that Cessnock has even greater capacity than most in the peer group – finishing as the highest council in 2024 and at the limit of the top whisker in 2022. As we will see later in this report, this suggestion is completely wrong – Councillors and other decision-makers would do well to ignore this metric entirely given its obvious potential to profoundly mislead.

**Figure 2. Debt Service Ratio**

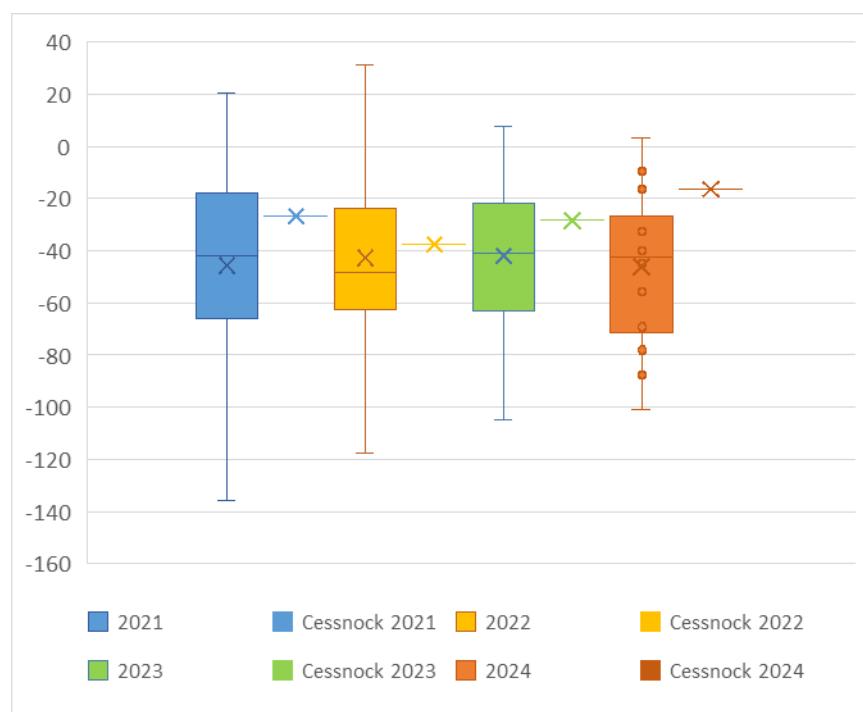


A much better, but still flawed, ratio is the nett financial liabilities metric which is used in most of the other states according to various alternate specifications. The denominator for this ratio – revenue less capital grants – better reflects how debt is actually serviced (from free revenue flows). The numerator – total liabilities less current assets – better reflects prudent capital management practices.

However, the ratio is still marred by at least two problems. First, analysis is restricted to a single year, and it is clear from recent events (such as the coronavirus pandemic) that atypical data might easily mislead end-users. Second, the nett financial liabilities ratio ignores actual revenue capacity which is a crucial flaw when applied in a long-standing rate cap regime.

Figure 3 details the nett financial liabilities (NFL) ratio result for Cessnock relative to the fourteen peer councils for the last four financial years. It should be noted that in this particular specification of the NFL ratio a more negative result is the most desirable outcome. Thus, according to this much more sensible metric Cessnock is currently in the worst quartile of performance after having previously been well below average in the three preceding years. Indeed, recent approved borrowings at Cessnock will have deteriorated this absolute position even further. There is thus good reason to be concerned – especially if we also pause to consider the large implicit debts at council.

**Figure 3. Nett Financial Liabilities**



There is little point in trying to reconcile these two diametrically opposed readings from these two crude ratios. This is because the NSW debt service cover ratio is completely flawed. The nett financial liabilities ratio is certainly relatively better and hence more likely to provide a sensible guide – however, as we stated earlier, it is still less than competent.

To understand what ought to be done to accurately ascertain liability capacity one would be well-advised to reflect on the personal budget metaphor again. {The lead author of this report used to be an executive in a commercial bank and is therefore well acquainted with lending protocol}. There are three main things that a bank will ask if a person applies for a loan (i) the number of parties to the loan, (ii) the incomes of the parties, and (iii) the length of time that they have held their job. (The third criterion is about trying to understand the likelihood that incomes might change in the future – due to unemployment or a career change – and is thus not applicable to

government (where revenue is largely guaranteed by punitive provisions in the Act (1993, NSW)). Therefore, for the case of local government the main factors in question are the number of parties (assessable properties) and the incomes of the ratepayers. Indeed, the scholarly literature has, in fact, illustrated an econometric approach to the question of ascertaining debt capacity, using precisely these data inputs (see, for instance, Ramsay et al., 1988; Levine et al., 2013).

Accordingly, in the section that follows we outline our empirical approach to a more precise determination of liability capacity with respect to the scholarly precedent.

### 3. Liabilities Capacity Modelling

In this section we conduct a multiple regression analysis on a seven-year panel principally derived from the audited financial statements of all urban councils in NSW, augmented by Office of Local Government (OLG) data.

In econometrics we use sophisticated mathematics along with robust statistical reasoning to first establish a formula that best describes the mean response of the dependent variable (in this case, total liabilities), to a number of relevant independent variables. We can then insert the precise values, for the Cessnock local government area, into the equation that we derive and use this to predict the liability capacity that would be expected *if council were exerting a typical revenue effort*.

Regression has a number of advantages over other potential methods. First, it allows us to take account of all of the important variables known to affect liability capacity simultaneously. In particular, it allows us to properly account for the number of assessments, as well as the incomes of the ratepayers. A second advantage of regression is that panel methods can allow us to ascertain matters over multiple years and thus mitigate any distortions that may have arisen if a given year were atypical. In addition, regression allows economists to make *ceteris paribus* claims – that is, precisely understand statistical associations between the regressand and regressors, holding all other things constant.

Readers should be aware that the professors who have authored this report are extremely experienced scholars, with a combined output topping over a hundred works, which have been cited thousands of times by their scholarly peers. Indeed, the lead author is an editor for one of the best empirical journals overseas. They are thus some of the best in the world, and routinely conduct far more sophisticated empirical analysis than even econometrics.

Econometrics is based on a strong body of theory developed over centuries, and is something that students study at both the undergraduate and graduate levels. Typically, to become an econometrician one studies at least a bachelor's degree (three years), followed by a two-year master's. All of the professors involved in this present work hold doctorates in the field (the highest qualification available from universities), and all have successfully taught postgraduates at the highest level. For readers interested in further information on econometrics, we refer them to the introductory works of Wooldridge (2006) or Kennedy (2003).

As noted, the econometric work is considerably broader than the earlier ratio analysis, because it employs the entire cohort of urban councils (rather than merely the same OLG group) for the entire liability burden and goes back seven years with respect to the data.

The final model specification that we employ in our analysis can be expressed as follows:

$$\mathbf{B}_{it} = \alpha_i + \beta_1 \mathbf{A}_{it} + \beta_2 \mathbf{X}_{it} + \mu_{it} \quad t = 1..7$$

Where **B** is the total liabilities, **A** is the disaggregated assessment data, **X** is a vector of relevant economic and demographic data for particular local government areas at specific times and **μ** is an idiosyncratic error term. The subscript *it* refers to the *i*<sup>th</sup> council entity and the *t*<sup>th</sup> year. Log transformations were employed to counter skewness when econometric diagnostic tests revealed the need to do so. We also conducted and satisfied all other relevant diagnostic tests. Table 2 provides the definition for each variable. It should be noted that for this particular econometric exercise we used standard OLS regression with year dummy variables. We elected to do so because fixed-effects is not an appropriate technique when the key data is almost time-invariant (it is known to provide biased estimates in these cases) – in addition, a random-effects model failed the well-known Hausman test and was therefore also not appropriate.

**Table 2: Definitions and Means of Variables, 2018-2024**

Variable	Definition
<b>Debt</b>	
Liabilities	Total explicit liabilities (\$'000)
<b>Assessments</b>	
Residential (ln)	Number of residential assessments, logged
Farm	Number of farm assessments, divided by 100
Business (ln)	Number of business assessments, logged
<b>Controls</b>	
Median employee income	Median employee income (lagged), divided by 1,000
Aged (ln)	Proportion of people on an aged pension, logged
DSP	Proportion of people on a disability support pension
Newstart (ln)	Proportion of people on a Newstart allowance, logged
Carer	Proportion of people on a carers' pension
Single (ln)	Proportion of people on a single parent pension, logged

Total Operating Grants The total value of non-capital grants, logged (In)

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We have not tabled the coefficients, standard errors and statistical significance of each regressor because recent experience has demonstrated to us that most end users find this very confusing. Instead, we will only discuss the excess liability capacity for Cessnock based on the formula derived from all urban NSW local governments, with predictions according to the particular characteristics of Cessnock City Council.

**Table 3. Additional Liability Capacity, Cessnock, 2021-2024 (\$'000)**

Year	Additional Liability Capacity	Additional Capacity (%)
2022	42,702.9	77.4%
2023	42,639.6	66.3%
2024	32,867.3	38.8%

It seems, on the face of things, that Cessnock City Council might have had significant capacity to borrow more money over the last three years. However, we remind readers that these figures must be interpreted in cognisance of the massive implicit debt burden at Cessnock – this burden actually dwarfs the additional capacity predicted by the model (for instance, the draft financial statements for 30<sup>th</sup> June 2025 state an estimated cost to bring extant assets to a satisfactory standard of over \$47 million).

In addition, during the most recent financial year Council has had to take out debt for important projects as well as to redress some of the imposing infrastructure backlogs. Other liabilities have also grown substantially – including contract liabilities and payables. The result is that for the 30<sup>th</sup> June 2025, total liabilities had grown from the previous year by over thirty-one percent, which is a sobering statistic. Indeed, the total liabilities for the 2025 financial year were just a few percentage points below the capacity predicted by our sophisticated empirical model.

What we are seeing at Cessnock City Council is the typical pattern of events for a council that has endured a lengthy period of financial *unsustainability*. Implicit liabilities are now being converted into explicit liabilities and other liabilities are accumulating at concerning rates of change. Council is now very close to its liability capacity calculated under the assumption of a typical revenue effort – but we know from the *Capacity to Pay Report* that Cessnock is not indeed exerting anywhere near this effort. This means that without urgent corrective action the sustainability of council is likely to deteriorate to a condition from which only drastic actions will be feasible. For this reason, we urge Council, the community and IPART to support an SV along the levels previously recommended in our *Capacity to Pay Report*. However, we caution that this alone will not be sufficient – fees and charges will

need to be revised prudently so that they cover actual costs of providing the goods and services, new discretionary works will need to be re-thought, postponed or abandoned, and the efficiency measures articulated in our Efficiency Report should be adopted as quickly as possible. Furthermore, a second SV in the last half of the LTFP will almost certainly be required (see our Draft Financial Statements and LTFP Analysis report).

#### 4. Conclusion and Recommendations

It is clear that Council and management have been profoundly misled by the flawed debt ratio mandated by the NSW state government. Other ratio analysis, as well as our sophisticated empirical modelling, make clear that Council does not have capacity for additional borrowings unless taxation revenues increase significantly. Moreover, the imposing burden of implicit liabilities have clearly reached a point where they are now apparently being converted into explicit liabilities.

We note that TCorp as recently as April 2025 came to a similar conclusion writing that:

*Consequently, to provide a loan, TCorp would require Council to address the financial sustainability of the Council and substantially increase recurrent revenue. TCorp is happy to reconsider the loan request once council has progressed its strategy towards financial sustainability.*

Thus, it is abundantly clear that an SV is urgently required. It is unfortunate that Councillors and Management were misled by flawed metrics in the past and that rates had not been increased to at least typical levels many years (or decades) ago. We commend this report to all stakeholders and emphasise the urgency of prudent action.

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