ACUMEN ALLIANCE

Department of Transport and Regional Services

Norfolk Island Government

Financial Advisory Report

NOVEMBER 2005

CONTENTS

1. EXECUTIVE SUMMARY

1.1 INTRODUCTION

The Department of Transport and Regional Services commissioned a review of the financial position of the Norfolk Island Government (NIG) on behalf of the Australian Government. This review analysed both the current financial position and the future financial position of the NIG in the short to medium terms and addressed the following terms of reference:

- A detailed examination of the NIG's revenues, recurrent and other expenditures, liabilities and cash reserves;
- Whether the NIG is currently solvent and is likely to become insolvent in the next 6-12 months based on current policies;
    - o If so, the options available to prevent this and an assessment/ranking of the options for implementation;
    - o Analysis of the risks associated with implementing each of the options;
- A forecast of the NIG's future financial position for the next five years based on current policies;
- An analysis of the relationship between tourist numbers and NIG revenues, based on the past five years;
- Asset and infrastructure investment patterns by the NIG and the future funding implications of the Asset Management Plan, either based on the draft or final document. Consideration should also include an analysis of the risks and the implications of any proposed asset replacement plan not being met;
- The ability/capacity of the NIG to fund increased levels of debt for capital assets replacement based on current revenue collection methods and cash reserves, without compromising recurrent expenditure on administration and services; and
- Assessment of the quality of relevant Norfolk Island financial and budgetary information.

1.2 FINDINGS

In addressing the terms of reference, we make the following findings:

1. As at 30th September 2005 cash reserves totalled $11.3m which means that the NIG is not currently insolvent. However, the current financial position of the NIG is forecast to deteriorate considerably within two years. If the NIG undertook the minimal required capital expenditure to maintain the island's living standards, the financial model forecasts that cash reserves

will be reduced to $2,762,100 by 30th June 2006 and that the NIG will deplete all operating cash reserves by the end of June 2007;

2. In terms of implementing remedial strategies it is critical to recognise un-sustainability. It is far easier to develop rescue plans 12- 18 months out from a point of insolvency rather than at the point of insolvency;
3. The detailed examination of the NIG's revenues, recurrent and other expenditures, liabilities and cash reserves indicates that the NIG is currently at/or approaching the point of un-sustainability. Furthermore, based on its current fiscal management policies, the modelling indicates that the NIG is unable to provide both the level of services to the island that currently exist (or should exist) and maintain the level of assets required to provide for those services.

4. Technically, from a pure accounting definition perspective, the NIG is not insolvent. This, however, is only because it has the capability to "pull the economic levers" and raise additional income when needed, or, as it has done in the past, asset strip the public utilities and publicly owned enterprises to meet cash shortfalls. Both of these temporary remedies to avoid insolvency have short life spans. The modelling predicts that the NIG will be insolvent within 2-3 years;

5. The analysis of the relationship between tourist numbers and NIG revenues over the last ten years shows a positive correlation of 0.96. A correlation of such a high statistical magnitude indicates significant dependency and total elasticity. Any minor change in tourist numbers incurs a proportional and almost immediate impact on government revenues;

6. The model shows that tourists directly contribute a minimum of 50% of the NIG's revenue. We are unable to determine the revenue that is generated directly from residents who are dependent on tourism for their livelihood; however a reasonable estimate of a further 20% would not be unrealistic;

7. The financial modelling estimates that tourist numbers would have to increase to over 100,000 each year (current tourist numbers approximate 32,000) to generate sufficient revenues for the NIG to adequately finance the capital requirements of NI, replace existing run down assets and achieve self sustainability.

8. The management and maintenance of public assets over the last 20 years has been less than optimal. This has emanated from the NIGs inability to design and implement long term fiscal strategies to secure the bng term financial security of Norfolk Island. If suitable policies are not implemented immediately the model predicts a major deterioration in the

living standards for a majority of the permanent residents of Norfolk Island within two to three years;

9. The modelling shows that the NIG is incapable of financing any further debt unless debt is invested in profit making activities in excess of the interest cost;

10. The optimum capital expenditure requirement used in models 1 and 2 of $46m immediately, $1.3 in 2006-07, $4.6m in 2007-08, $4.5 in 2008-09 and $7.1m in 2009-10 to maintain public infrastructure to a reasonable standard has been based on the Asset Management Plan commissioned by the NIG. This report was not complete at the time of the review, and on completion, may suggest higher levels of capital expenditure.

11. The modelling has confirmed a direct relationship between tourist numbers and NIG revenues. However, the current financial position of the NIG has resulted from a series of complex interrelated factors over and above a short term fall in tourist numbers. It is essential that the severity and complexity of the situation be fully appreciated and solutions not be concentrated on tourism only;

12. Acumen did not undertake an audit of the NIG. However, the quality of relevant financial and budgetary information used for the modelling appeared to be accurate, complete and adequate. This does not mean that the financial data is suitable for management and budgetary purposes. Adoption of relevant accounting standards, true accrual accounting, more relevant management accounting and financial management techniques and improvements in management reporting and performance management systems would facilitate more informed decision making.

13. The budget developed by the NIG is an accounting budget based around levels of revenue and expenditure required to get from one year to the next. It does not forecast forward estimates and is therefore short term in nature. It is not a strategic economic statement in which holistic consideration is given to the achievement of long term macro and micro economic outcomes aimed at stimulating the economy, addressing pending social and environmental needs, providing for future generations and assuring long term sustainability and growth.

14. The current financial strategy of delaying capital expenditure to fund operational expenditure will provide sufficient cash for operations in the short term. However, this strategy is unsustainable in the medium to longer terms and will ultimately result in deterioration in living standards.

1.2.1 Overall conclusion

The financial analysis and modelling has demonstrated that the current financial position of the NIG is characterised by:

- A relatively stable revenue base;
- Significant increases in the costs of the welfare system and the operation of the public service;
- Increasing salary costs in the GBE sector; and
- The deferral of major capital expenditure.

These characteristics have been in place for a number of years (and under previous administrations) and have now resulted in a clear picture of un-sustainability under current policies and financial strategies. In effect, the current situation has been predicted in previous reports on the financial situation of Norfolk Island.

It is reasonable to conclude that if action is not taken immediately and major fiscal reforms implemented the current standard of living for all Norfolk Islanders will significantly deteriorate within the immediate short term period of two years.

The findings need to be interpreted in the context of the size of the island and the difficulty in implementing unpopular, but necessary, financial reforms eg broadening the tax base. In this regard, there are also substantial issues surrounding the ability of the NIG to design, implement and manage a taxation system that incorporates residents - specifically compliance, enforcement and collections management.

An alternative is to place taxation in the hands of the Australian Government rather than it being administered by the NIG in order to protect privacy issues, ensure enforcement and provide a cost-effective collection system that will not be a burden to the NIG.

1.3 MODELLING SCENARIOS

The financial position of the NIG was modelled against three scenarios:

1) Tourist numbers restricted by the existing Air Nauru contract (27,400);
2) Tourist numbers increasing to 31,000 by brokering alternative airline arrangements to increase seat capacity; and
3) The number of tourists required to achieve self sustainability under the current financial strategies and policies.

The snapshot of the results of the modelling are as follows:

Scenario 1

Cash reserves will reduce to $2,762,100 by 30 June 2006 and the NIG will consume all cash reserves by the end of 2007 based on minimum capital requirements

Scenario 2

Cash reserves will reduce to $3,766,900 by 30 June 2006 and the NIG will consume all cash reserves by April 2007 based on minimum capital requirements

Scenario 3

The model predicts that tourist numbers would need to increase to approximately 100,000 to provide sufficient net revenues to support current financial strategies and policies, generate sufficient cash for an adequate maintenance programme, provide for an optimal capital investment programme and sufficient capital reserves to fund the ongoing replacement of assets as and when required (eg the replacement of the hospital building within 15 years).

The findings need to be interpreted in the context of the size of the Island and the associated difficulty in implementing unpopular but necessary financial reform eg broadening the tax base.

1.4 REVIEW METHODOLOGY

The development of this financial assessment is based upon a clear understanding of the interrelationship of the fundamental financial elements within the NIG. Consequently our approach involved identifying, reviewing, and then deriving a value for each one of the following financial elements of the NIG over a five year period. The review included detail analysis of;

- assets;
- revenue and expenditure;
- cash flow; and
- the financing of assets and working capital, (with a particular focus on the funding for the replacement of infrastructure)

both within the main administration of government and the Government Business Enterprises (GBE). Upon completion of this exercise, a dynamic financial model was developed to estimate the financial position of the NIG over the next five years.

In undertaking this review Acumen held discussions with the following people;

1. NIG Chief Minister – Geoffrey Gardner;
2. NIG Minister for Finance – Ron Nobbs;
3. Administrator – Grant Tambling;
4. Official Secretary – Michael Stephens;
5. NIA CEO – Steve Mathews;
6. NIA CFO – Barry Wilson;
7. Queensland Deputy Auditor General – Eric Muir;
8. Members of the Queensland Audit Office external audit team;
9. Norfolk Island Telecom – Kim Davies;
10. Norfolk Island Hospital – Rees Waldon;
11. Norfolk Island Tourism – Steve McInnes;
12. Norfolk Island Electricity – John Christian;
13. Norfolk Island Airport – Glenn Robinson;
14. Norfolk Island Water Assurance – Neil Tavener;
15. Norfolk Island Customs & Immigration – Alan Buffett;
16. Roads – Peter Davidson;
17. Norfolk Island Liquor Bond – Doug Jackson;
18. Senior Member of the Norfolk Island Administration – Allen Bataille;
19. A number of business owners including tourist operators;
20. A representative of the Chamber of Commerce.

and reviewed the following documentation, reports and financial information:

1. Norfolk Island Annual Reports (2000/01 to 2004/05);
2. NIG Financial Statements (2000/01 to 2004/05);
3. NIG Tourist Bureau Financial Statements (2001/02 to 2004/05);
4. Norfolk Island Hospital Enterprise Financial Statements (2001/02 to 2004/05);

5. NIG 2005/06 Budget;
6. NIG Tourist Bureau 2005/06 Budget;
7. Norfolk Island Hospital Enterprise 2005/06 Budget;
8. Norfolk Island Government Asset Register;
9. Norfolk Island Government Tourist Bureau Asset Register;
10. Norfolk Island Hospital Enterprise Asset Register;
11. Norfolk Telecom – Ten Year Strategic Telecommunications Plan 2005/06 to 2014/15 (Overview, Context and Recommendations);
12. NIG Asset Maintenance Plan;
13. Loan Agreement – Resurfacing of the Norfolk Island Airport Runways;
14. Nauru Air Corporation and the Government of Norfolk Island Charter Agreement.

2. FORECAST FINANCIAL POSITION OF THE NORFOLK ISLAND GOVERNMENT

2.1 DEVELOPMENT OF AN ECONOMIC MODEL

2.1.1 Model Overview

To assist in developing a financial position of the NIG an extensive economic model was developed to forecast the cash position of the Norfolk Island Government on a monthly basis from October 2005 through to 30 June 2010. Determination of the cash position is critical as it establishes both the liquidity and hence the viability of an organisation. This model was based on a detailed review of historical financial and non financial details, external economic data as well as discussions with the key personnel in the Norfolk Island Administration, Legislative Assembly and material GBEs.

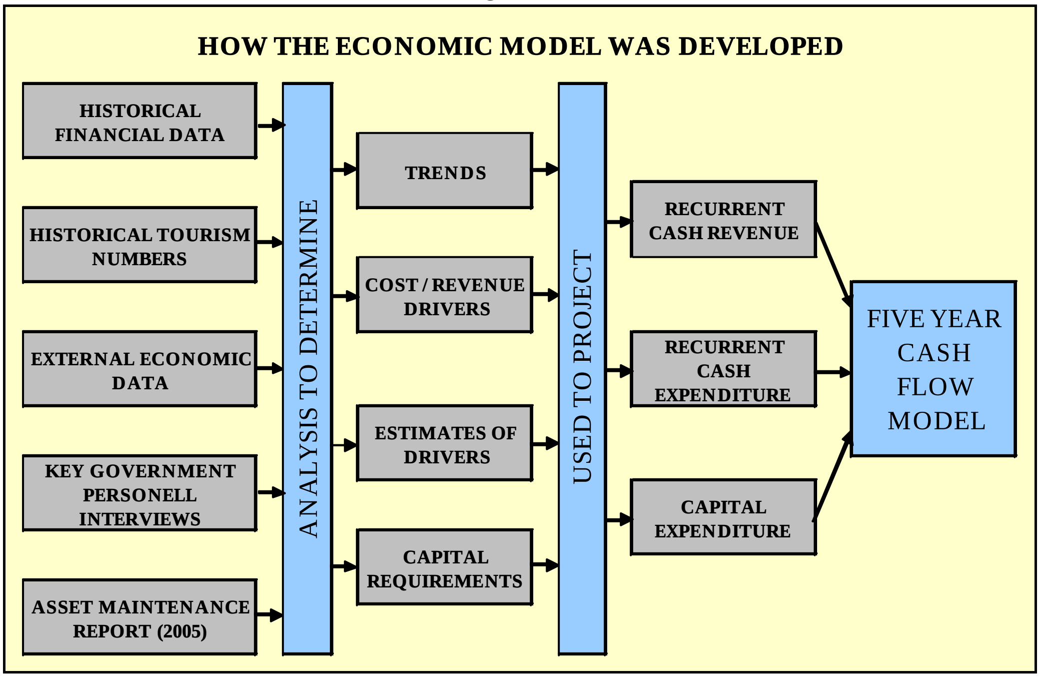
In order to assist in determining the financial sustainability of the NIG we have developed flexibility in the model to deal with the following three scenarios:

1. Continuation of the current Air Nauru contract;

2. Alternative airline arrangement provided independently of Air Nauru;

3. Sufficient tourist numbers to deliver a balanced budget as well as for adequate reserves for all future capital replacement to maintain living standards.

Diagram 1



2.1.2 Underlying Assumptions

In order to develop the model a significant number of assumptions were made. In all instances a conservative approach has been applied in developing these assumptions. These assumptions differ slightly based on each separate scenario. Below are the underlying assumptions consistent to each scenario:

2.1.2.1 Tourism

1. The model is based on 31,000 tourists visiting Norfolk Island;

2. Average stay per tourist is 7.35 days;

3. 77.5% of all tourists to Norfolk Island are from Australia;

4. The percentage of tourists for each month (given no airline restrictions) is consistent with historical trends;

5. Analysis of income and expenditure trends attributable to tourists is based on financial results and tourist numbers over the previous 5 years. Revenue attributable to each tourist is accordingly calculated to be:

    - Customs duty based on 45% of revenue - $49.35 per head;
    - Fuel levy based on 40% of revenue - $5.00 per head;
    - Financial Institution Duty based on 35% of revenue - $10.37 per head;
    - Norfolk Postage based on 20% of revenue - $2.31 per head;

- IDD Telephone charges based on 50% of revenue - $34.08 per head;
- Electricity revenue based on 40% of revenue - $97.50 per head;
- Workers Compensation based on 40% of revenue - $21.34 per head;
- Liquor Sales based on 90% of club and restaurant sales and historical average of tourist sales - $70 per head.

Revenue from the resident population is assumed to remain constant.

2.1.2.2 Economic Data

6. General Inflation is constant at 2.8% per annum. Wages are anticipated to increase at 3.3% per annum whilst fuel is expected to increase at 10% per annum;

7. All government charges per unit are assumed to be constant with the exception of customs duties and liquor prices which are expected to increase with inflation;

8. No interest has been applied to cash reserves and or debt;

9. Resident population (inclusive of Temporary Entry permit and General Entry permit holders) is assumed to remain constant;

2.1.2.3 Opening Position

10. The cash and term deposits held by the NIG at 30 September 2005 amount to $13,650,900. Of this $138,200 is held for KAVHA fund, $2,133,800 in trust accounts and $16,200 quarantined to be paid to the Commonwealth government in relation to the Cascade Cliff loan;

    Accordingly the opening cash balance for the model is $11,362,700;

2.1.2.4 Airport Loan

11. The balance of the Commonwealth Airport loan not drawn down as at 30 September 2005 will be drawn down prior to 30 June 2006;

12. Loan repayments to the Commonwealth government will be consistent with the requirements of the Airport loan agreement;

13. The Norfolk Island Government will meet its obligation under the Airport Loan Agreement to set aside specific amounts towards the subsequent resurfacing of the airport runways;

14. The financial obligations on the NIG under the Airport Loan Agreement have been deferred for three years. Accordingly the first loan repayment and trust contribution are not required until June 2009.

15. No interest will be applied to the airport loan as per the Airport Loan Agreement;

2.1.2.5 Welfare System / Health Care

16. As at 30 September there are currently 118 welfare recipients with an average fortnightly payment of $363.15 each. The number of recipients is assumed to grow by 5% per year, whilst the average payment is expected to increase by 3%;

17. The number of Medivacs required to be funded by the NIG is expected to be seven in 2005/06 increasing by one each year. The average cost for each medivac is $26,000 in 2005/06 increasing with inflation;

18. The number of medical procedures at the hospital is assumed to increase at 10% per annum with the ageing of the population. Costs associated with each procedure are expected to increase with inflation;

19. The hospital subsidy is assumed to be paid on a just-in-time basis, i.e. the hospital carries no cash reserve;

2.1.2.6 Asset Maintenance / Capital Requirements

20. Where the Asset Maintenance report has been completed for the assets in question the capital replacement requirements and timing has been applied as stipulated;

21. Where no Asset Maintenance report is available the capital requirement has been estimated in conjunction with the relevant manager / official of the Norfolk Island government. In circumstances where the timing of the requirement is unclear the expense has been applied uniformly over the period of the model;

2.1.2.7 Other

22. The electricity output is based on 3.5 kilowatt hours per litre of diesel consumed;

23. Electricity wastage through the reticulation network is five percent of production;

24. Rock at the Cascade quarry will run out in 2 years time. Annual contribution to the revenue fund is $74,000.

25. Timing of liquor sales to residents is consistent with historical trends;

26. Liquor purchases (cost of goods sold) are assumed to remain at 61% of liquor sales.

27. Collection of Electricity and Telecom revenue is based on the following collection patterns:

    - 60% in the month in which the bill is issued;
    - 30% one month after issuing the bill;
    - 8% the following month;
    - 2% of invoices issued are never realised.

    All other income streams (with the exception of airline ticket sales – covered separately) are assumed to be collected in the month in which the service is provided;

28. All expenditure is assumed to be paid in the month in which incurred.

2.2 MODEL LAYOUT

The opening cash balance for the model ($11,362,700) is based on the bank reconciliation provided by the NIG accounts department as at 30 September 2005. The balance was then reduced for amounts held for specific purposes (including KAVHA and trust monies).

In order to arrive at the net operating cash flow for each month the amount of recurrent cash outflows is subtracted from the recurrent operating cash inflows.

Recurrent cash inflows are those cash receipts that the NIG can expect to collect based on current government policy including all taxes, custom duties, fees and charges, liquor sales and GBE revenues. Recurrent operating cash outflows include all cash payments incurred by the NIG in delivering government services. No depreciation expense is included as it is not a cash payment but rather an accounting entry to reflect the consumption of fixed assets.

The next step is to add the net cash flows from financing activities to the net operating cash flow. Financing cash flows are those received from finance arrangements reduced by any cash payments made as a result of contractual obligations with respect of those arrangements. Currently, the only loans that the NIG has are with the Commonwealth government. One of the loans is for the resurfacing of the airport runways and the other is for Cascade Cliff.

At this point in order to arrive at the closing cash balance the model is split into two scenarios:

- one based on the minimum capital expenditure and;
- the other on optimal capital expenditure.

The minimum capital expenditure is that amount that is required to maintain the current standard of living. Optimal capital expenditure is the amount required to deliver a similar level of government services and standard of living to that of comparable regional communities on the mainland. In either case the capital requirement has been determined based on the "NIG Asset Maintenance Plan" and interviews of key NIG personnel.

In order to arrive at the closing cash balance based on the minimum capital expenditure the following calculation is performed:

Opening Cash Balance Minimum capital expenditure
Add: Net Operating Cash Flow
Add: Net Financing Cash Flow
Less: Minimum Capital Expenditure

Similarly to arrive at the closing cash balance based on optimal expenditure the following is applied:

Opening Cash Balance Optimal capital expenditure
Add: Net Operating Cash Flow
Add: Net Financing Cash Flow
Less: Optimal Capital Expenditure

The closing cash balance in both instances is then carried forward as the opening cash balance for the following year.

The financial position of the NIG was modelled against three scenarios:

4) Tourist numbers restricted by the existing Air Nauru contract (27,400);
5) Tourist numbers increasing to 31,000 by brokering alternative airline arrangements to increase seat capacity; and
6) The number of tourists required to achieve self sustainability under the current financial strategies and policies.

The snapshot of the results of the modelling are as follows:

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Scenario 2

Cash reserves will reduce to $3,766,900 by 30 June 2006 and the NIG will consume all cash reserves by April 2007 based on minimum capital requirements

Scenario 3

The model predicts that tourist numbers would need to increase to approximately 100,000 to provide sufficient net revenues to support current financial strategies and policies, generate sufficient cash for an adequate maintenance programme, provide for an optimal capital investment programme and sufficient capital reserves to fund the ongoing replacement of assets as and when required (eg the replacement of the hospital building within 15 years).

The findings need to be interpreted in the context of the size of the Island and the associated difficulty in implementing unpopular but necessary financial reform eg broadening the tax base.

2.3 SCENARIO # 1 – TOURIST NUMBERS RESTRICTED BY THE EXISTING AIR NAURU CONTRACT

2.3.1 Model Results

Norfolk Island Government Summary
SCENARIO # 1: CONTINUATION OF CURRBET AIR NAURU CONTRACT
Cashflow forecast

		2005/06 (Nine months only)	2006/07	2007/08	2008/09	2009/10
Opening Cash Balance - Minimum Capital Expenditure	a	11,362,700	2,762,183	(331,731)	(4,222,328)	(10,111,554)
Operating Cash Inflows						
Cash Received						
Charter Flight Revenue		8,771,839	14,618,447	14,619,469	14,620,053	14,620,053
Custom duties		3,059,013	4,095,019	4,210,781	4,329,508	4,451,583
Departure Fees		756,960	970,440	970,560	970,560	970,560
Electricity Revenue		2,442,711	3,169,081	3,169,240	3,169,240	3,169,240
Financial Institutions Levy		710,537	934,537	934,579	934,579	934,579
Fuel Levy		262,223	343,438	343,458	343,458	343,458
Landing Fees		1,188,021	1,671,957	1,672,169	1,672,169	1,672,169
Liquor Sales		2,967,288	3,953,970	4,065,756	4,180,394	4,298,264
Postal Service Revenue		523,705	695,411	695,420	695,420	695,420
Telephone Revenue		2,484,973	3,295,430	3,322,867	3,350,933	3,379,789
Other Revenue		4,124,654	5,502,114	5,456,070	5,459,816	5,476,404
Total Cash received	b	27,291,924	39,249,843	39,460,368	39,726,130	40,011,519
Cash Used						
Air Nauru Contract		7,761,417	9,997,798	9,997,798	9,997,798	9,997,798
Hospital Subsidy		632,836	931,854	958,129	985,144	1,012,921
Maintenance		825,130	1,128,579	1,160,400	1,193,119	1,678,635
Other Expenses		7,977,088	11,043,615	11,203,983	11,435,841	12,288,878
Power House Fuel		1,750,786	2,508,957	2,771,821	3,062,067	3,382,706
Telecommunication subcontract (Reach)		762,989	1,010,172	1,021,147	1,032,373	1,043,916
Salaries & Wages (incl on costs and staff costs)		6,641,527	9,117,336	9,412,189	9,716,853	10,031,653
Welfare		1,800,667	2,605,447	2,825,500	3,076,268	3,338,930
Total Cash used		28,152,440	38,343,758	39,350,966	40,499,462	42,775,436
Net Cash to/from Operating	b-c	(860,517)	906,086	109,402	(773,332)	(2,763,916)
Financing Activities						
Cash Received						
Loan Drawdown - Commonwealth Government		8,260,000	-	-	-	-
Total Cash Received	f	8,260,000	-	-	-	-
Cash Used						
Commonwealth Loan - Repayments		-	-	-	600,000	1,200,000
Runways Trust Fund		-	-	-	515,893	493,026
Total Cash used	g	-	-	-	1,115,893	1,693,026
Net Cash to/from Financing Activities	h=f-g	8,260,000	-	-	(1,115,893)	(1,693,026)
Investing Activities						
Cash Used						
Runway resurfacing		12,000,000	-	-	-	-
Minimum capital requirement		4,000,000	4,000,000	4,000,000	4,000,000	4,000,000
Net Cash to/from Investing Activities	j	16,000,000	4,000,000	4,000,000	4,000,000	4,000,000
CLOSING CASH POSITION	j	2,762,183	(331,731)	(4,222,328)	(10,111,554)	(18,568,496)
Optimal Capital Requirements [1]						
Roads		32,407,200	1,100,000	4,020,000	2,440,000	4,670,000
Airport		12,039,700	-	250,000	1,720,000	125,000
Norfolk Island Liquor Supply		50,000	50,000	25,000	-	10,000
Norfolk Island Electricity		40,000	-	-	-	2,000,000
Norfolk Island School		265,000	-	-	-	-
Waste Management Centre		147,000	147,000	147,000	147,000	147,000
Norfolk Telecom		809,300	-	1,000	-	-
Other		176,200	99,600	194,900	169,000	180,500
	l	45,934,400	1,396,600	4,637,900	4,476,000	7,132,500

[1] Optimal capital expenditure is the amount required to deliver a similar level of government services and standard of living to that of comparable regional communities on the mainland

Table 1

2.3.2 Outcomes of the Model

1. By 30 June 2006 the model projects cash reserves will be reduced to $2,762,100 and that the NIG will run out of cash by the end of June 2007; (blue line in diagram 2)

2. The optimal capital requirement based on the Asset Management Plans received to date actually requires a total of $46m to be spent in this financial year, and a further $17m over the remaining 4 years;

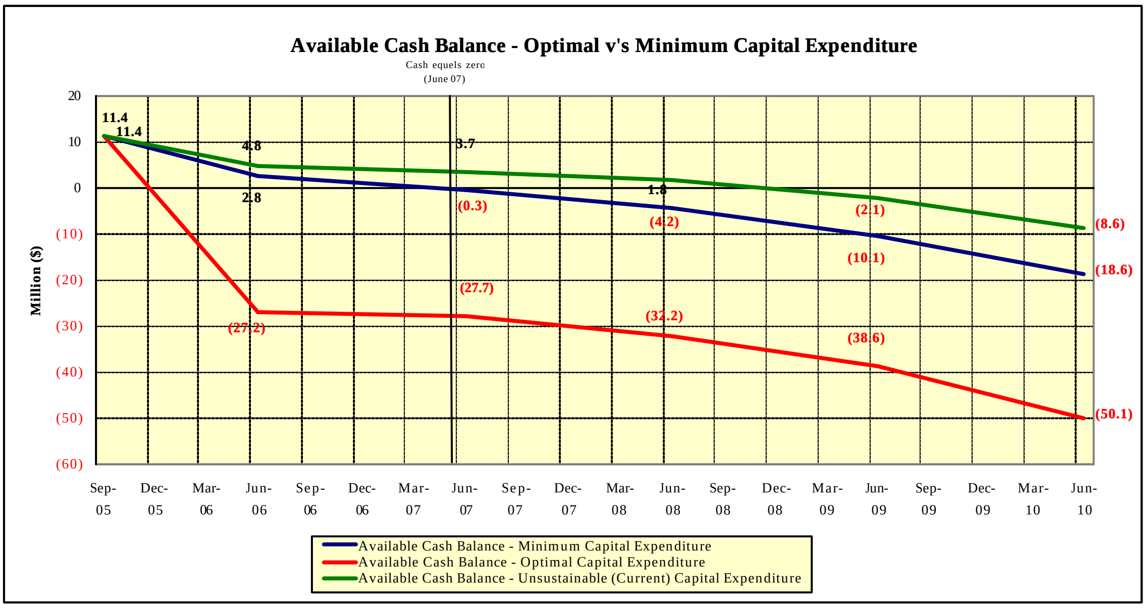

Diagram 2

3. By the 2007/08 financial year the combined operating surpluses of the GBE's will be insufficient to cover the operating deficit of the Revenue Fund. This is primarily the result of increasing welfare costs associated with an ageing population as well as forecast increases in world fuel prices;

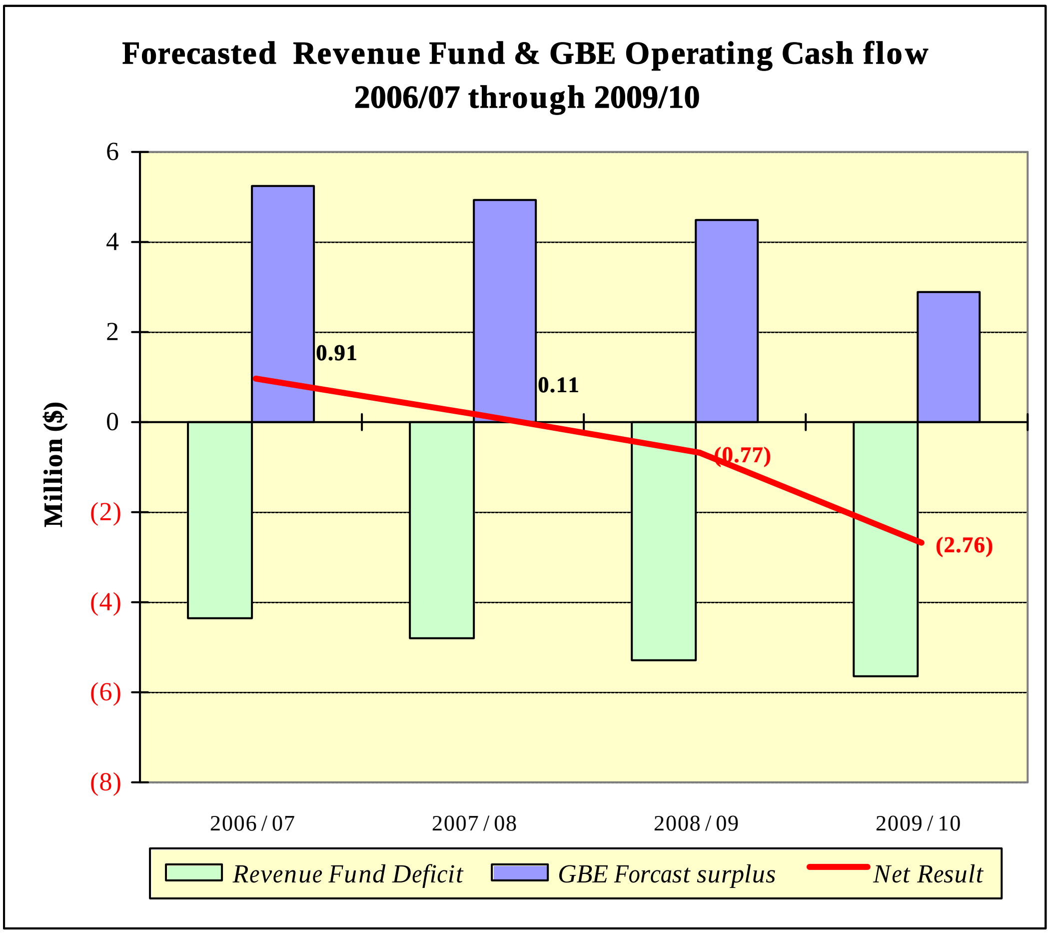

Diagram 3

4. Without consideration for depreciation and appropriations the model predicts continuous deficit budgets from 2007/08 unless significant reductions in expenditure are implemented;

5. The current revenue and expenditure patterns are not sustainable without significant subsidies from the Commonwealth;

6. The current charter agreement with Air Nauru is profitable and makes a positive contribution to the operating revenues of the NIG;

7. The Norfolk Island Government will not be able to service its obligations under the current airport loan without cutting government services leading to a further reduction in residents' standard of living;

2.3.3 Observations from the model

1. As at 30th September 2005 cash reserves totalled $11,362,700;

2. Even if the NIG restricted its capital expenditure to current inappropriate levels of $2m per annum the model estimates that the NIG will run out of cash in December 2008; (green line in diagram 2)

3. The number of tourists from Australia will be restricted due to the capacity of the flights from Sydney and Brisbane to 20,400. Accordingly total tourist numbers for each year are expected to be approximately 27,400.

2.3.4 Additional Assumptions

1. For the month of October 2005 the cost of the Air Nauru charter is $1,096,219 (based on $252,585 per week). Beyond this the cost is assumed to be fixed at $833,150 (based on 4.32 weeks at $191,970). The differential in October 2005 is due to an additional flight being scheduled from Sydney over and above the contract with Air Nauru;

2. It is assumed that Air Nauru will not apply a fuel levy as allowed under the current contract. As at 30 September 2005 none had been applied;

3. The Air Nauru contract will remain in place for the duration of the model;

4. Commission paid to Qantas will remain at 19% of ticket price (excluding taxes). The balance will be paid as follows:

    - 80% in the month in which the flight is taken;
    - 20% one month after the flight is taken.

5. The Air Nauru aircraft is restricted to 140 passengers per leg;

6. There will be two return flights per week from Sydney and two from Brisbane;

7. All tourists from Queensland will embark the Air Nauru aircraft in Brisbane and all other passengers from Australia will originate their journey from Sydney. Based on historical tourist numbers it is assumed that 68% of Australian tourists embark the flight in Sydney and 32% in Brisbane;

8. The number of resident trips to Australia each year would be 4,917 with 52% to Sydney and 48% to Brisbane. It is assumed that the timing of resident trips will be consistent with previous years;

9. When there is a shortage of seats on an Air Nauru flight it is assumed that a resident will obtain a seat at the expense of a tourist;

10. Ticket prices per return ticket will be $540 per tourist and $500 per resident. Taxes per return ticket of $147 will be charged on each ticket;

11. The percentage of tickets presented until June 2006 that no revenue will be collected by the NIG (due to the demise of Norfolk Jet Express) is:

Oct-05	20%
Nov-05	20%
Dec-05	15%
Jan-06	15%
Feb-06	10%
Mar-06	10%
Apr-06	10%
May-06	0%
Jun-06	0%

Beyond June 2006 it is assumed that no Norfolk Jet Express vouchers will be presented.

2.4 SCENARIO # 2 – ALTERNATIVE AIRLINE ARRANGEMENT TO NORFOLK ISLAND

2.4.1 Model Results

Norfolk Island Government Summary
SCENARIO # 2: INDEPENDENT AIRLINE PROVIDER
Cashflow forecast

		2005/06 (Nine months only)	*2006/07*	*2007/08*	*2008/09*	*2009/10*
Opening Cash Balance - Minimum Capital Expenditure	**a**	**11,362,700**	**3,766,900**	**(1,140,958)**	**(6,840,371)**	**(14,533,517)**
Operating Cash Inflows						
Cash Received						
Charter Flight Revenue		-	-	-	-	-
Custom duties		3,130,625	4,217,878	4,337,105	4,459,394	4,585,131
Departure Fees		787,350	1,021,320	1,021,440	1,021,440	1,021,440
Electricity Revenue		2,475,125	3,232,613	3,232,772	3,232,772	3,232,772
Financial Institutions Levy		721,044	952,129	952,171	952,171	952,171
Fuel Levy		267,289	351,920	351,940	351,940	351,940
Landing Fees		1,208,295	1,563,731	1,563,943	1,563,943	1,563,943
Liquor Sales		3,038,901	4,076,830	4,192,079	4,310,279	4,431,812
Postal Service Revenue		526,047	699,332	699,341	699,341	699,341
Telephone Revenue		2,519,840	3,355,249	3,384,373	3,414,172	3,444,812
Other Revenue		4,133,581	5,517,250	5,471,429	5,475,404	5,492,227
Total Cash received	**b**	18,808,098	24,988,251	25,206,592	25,480,856	25,775,588
Cash Used						
Air Nauru Contract		-	-	-	-	-
Hospital Subsidy		632,836	931,854	958,129	985,144	1,012,921
Maintenance		825,130	1,128,579	1,160,400	1,193,119	1,690,570
Other Expenses		6,228,733	8,546,478	8,704,180	8,933,709	9,803,206
Power House Fuel		1,780,816	2,563,570	2,832,153	3,128,716	3,456,333
Telecommunication subcontract (Reach)		776,936	1,034,099	1,045,749	1,057,669	1,069,925
Salaries & Wages (incl on costs and staff costs)		6,618,779	9,086,082	9,379,895	9,683,484	9,997,174
Welfare		1,800,667	2,605,447	2,825,500	3,076,268	3,338,930
Total Cash used		18,663,897	25,896,109	26,906,006	28,058,108	30,369,060
Net Cash to/from Operating	**b-c**	**144,200**	**(907,858)**	**(1,699,414)**	**(2,577,253)**	**(4,593,472)**
Financing Activities						
Cash Received						
Loan Drawdown - Commonwealth Government		8,260,000	-	-	-	-
Total Cash Received	**f**	8,260,000	-	-	-	-
Cash Used						
Commonwealth Loan - Repayments		-	-	-	600,000	1,200,000
Runways Trust Fund		-	-	-	515,893	493,026
Total Cash used	**g**	-	-	-	1,115,893	1,693,026
Net Cash to/from Financing Activities	**h=f-g**	8,260,000	-	-	(1,115,893)	(1,693,026)
Investing Activities						
Cash Used						
Runway resurfacing		12,000,000	-	-	-	-
Minimum capital requirement		4,000,000	4,000,000	4,000,000	4,000,000	4,000,000
Net Cash to/from Investing Activities	**j**	16,000,000	4,000,000	4,000,000	4,000,000	4,000,000
CLOSING CASH POSITION		**3,766,900**	**(1,140,958)**	**(6,840,371)**	**(14,533,517)**	**(24,820,015)**
Optimal Capital Requirements [1]						
Roads		32,407,200	1,100,000	4,020,000	2,440,000	4,670,000
Airport		12,039,700	-	250,000	1,720,000	125,000
Norfolk Island Liquor Supply		50,000	50,000	25,000	-	10,000
Norfolk Island Electricity		40,000	-	-	-	2,000,000
Norfolk Island School		265,000	-	-	-	-
Waste Management Centre		147,000	147,000	147,000	147,000	147,000
Norfolk Telecom		809,300	-	1,000	-	-
Other		176,200	99,600	194,900	169,000	180,500
		45,934,400	1,396,600	4,637,900	4,476,000	7,132,500

[1] Optimal capital expenditure is the amount required to deliver a similar level of government services and standard of living to that of comparable regional communities on the mainland

Table 2

2.4.2 Outcomes of the Model

1. By 30 June 2006 the model projects cash reserves will be reduced to $3,766,900 and that the NIG will run out of cash by the end of April 2007;

2. The optimal capital requirement based on the Asset Management Plans actually requires a total of $46m to be spent in this financial year, and a further $17m over the remaining 4 years;

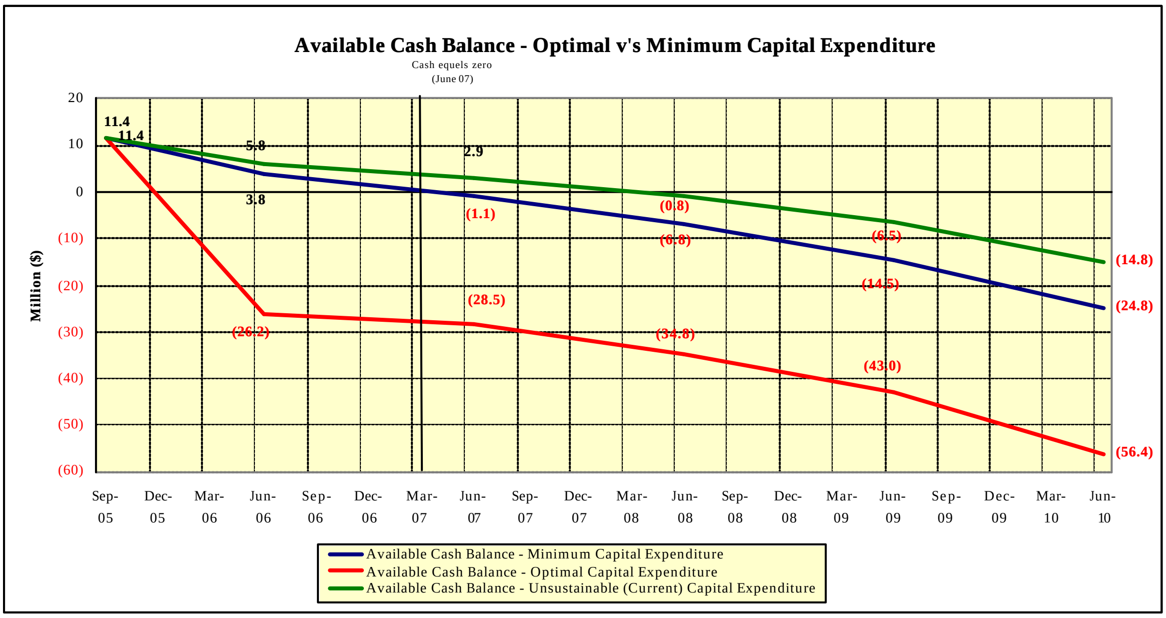

Diagram 2

3. In the 2006/07 financial year the combined operating surpluses of the GBE's will be insufficient to cover the operating deficit of the Revenue Fund. This is primarily the result of increasing welfare costs associated with an ageing population as well as increases in world fuel prices;

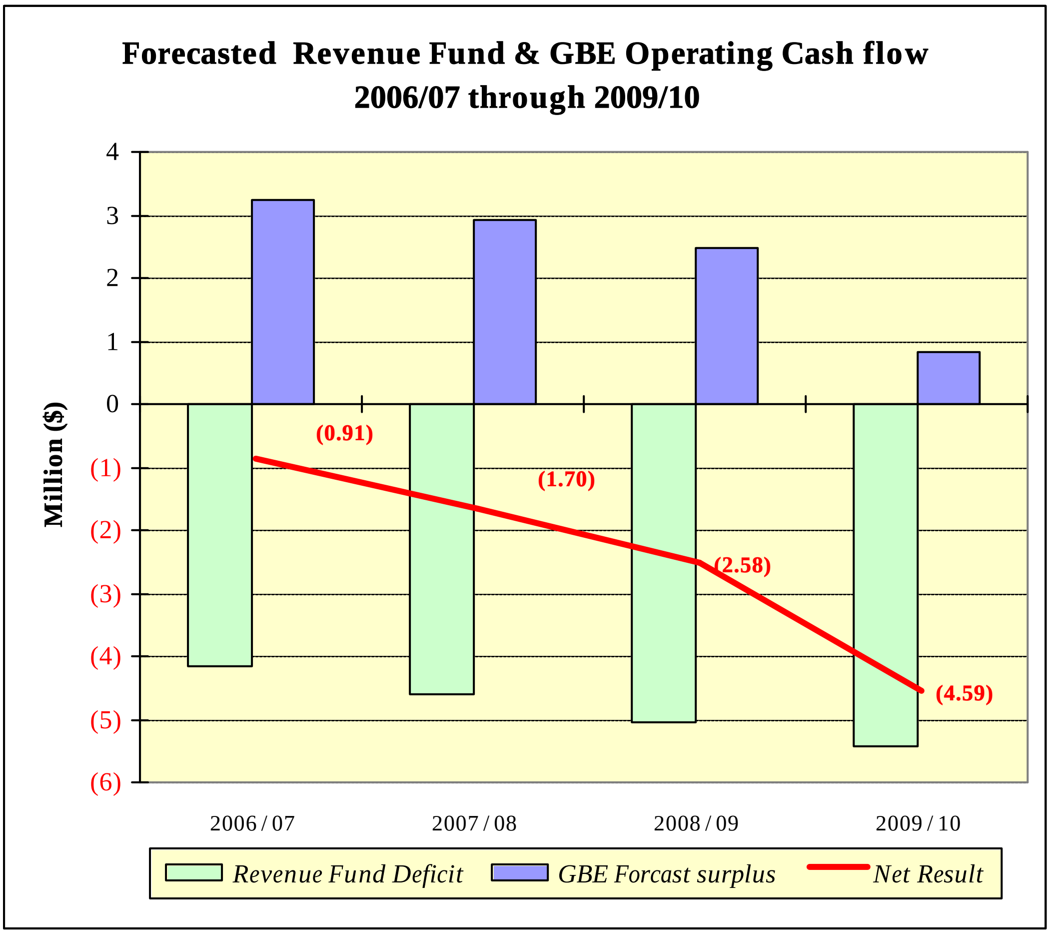

Diagram 3

4. The Norfolk Island Government will not be able to service its obligations under the current airport loan without cutting government services leading to a further reduction in residents' standard of living;

2.4.3 Observations from the model

1. As at 30th September 2005 cash reserves totalled $11,362,700;

2. Even if the NIG restricted its capital expenditure to current inappropriate levels of $2m per annum we estimate that the NIG will run out of cash in May 2008;

3. Though there are an additional 3,600 tourists to Norfolk Island the additional revenue, in 2006, collected through increased departure fees, customs duties and GBE revenue of $356,800 doesn't compensate NIG for the loss in the charter flight operating surplus of $2,016,800.

2.4.4 Additional Assumptions

1. Flights to and from Australia will be provided by an independent airline provider.

2. The NIG will not be required to provide any financial assistance or incentives to the provider.

3. The provider will be able to provide sufficient services to meet market demand.

4. There is no need for capital expenditure by Norfolk Island Airport over and above the $12 million resurfacing of the runways.

2.5 SCENARIO # 3 – SUFFICIENT TOURISTS TO PROVIDE A SUSTAINABLE FUTURE.

2.5.1 Model Results

Scenario three attempts to determine the number of tourists that would be required for the NIG to be financially sustainable.

Norfolk Island Government Summary
SCENARIO # 3 – SUFFICIENT TOURISTS TO PROVIDE A SUSTAINABLE FUTURE
Cashflow forecast

		2005/06 (Nine months only)	2006/07	2007/08	2008/09	2009/10
Opening Cash Balance - Minimum Capital Expenditure	a	11,362,700	7,686,131	11,081,917	13,701,471	14,323,650
Operating Cash Inflows						
Cash Received						
Charter Flight Revenue		-	-	-	-	-
Custom duties		7,008,414	9,448,155	9,715,078	9,989,004	10,270,654
Departure Fees		2,434,566	3,186,705	3,186,915	3,186,915	3,186,915
Electricity Revenue		4,708,363	6,123,659	6,124,001	6,124,001	6,124,001
Financial Institutions Levy		1,290,587	1,700,835	1,700,908	1,700,908	1,700,908
Fuel Levy		541,890	712,903	712,938	712,938	712,938
Landing Fees		4,118,377	5,389,245	5,389,616	5,389,616	5,389,616
Liquor Sales		6,916,689	9,307,107	9,570,052	9,839,889	10,117,335
Postal Service Revenue		652,974	866,186	866,202	866,202	866,202
Telephone Revenue		4,407,888	5,901,807	6,002,843	6,106,473	6,213,025
Other Revenue		5,422,408	7,235,140	7,198,827	7,212,550	7,239,396
Total Cash received	b	37,502,156	49,871,741	50,467,378	51,128,495	51,820,989
Cash Used						
Air Nauru Contract		-	-	-	-	-
Hospital Subsidy		632,836	931,854	958,129	985,144	1,012,921
Maintenance		825,130	1,128,579	1,160,400	1,193,119	2,059,501
Other Expenses		8,632,262	11,787,004	12,034,802	12,356,830	13,904,281
Power House Fuel		3,396,896	4,884,267	5,395,962	5,960,989	6,585,183
Telecommunication subcontract (Reach)		1,532,155	2,052,723	2,093,137	2,134,589	2,177,210
Salaries & Wages (incl on costs and staff costs)		6,618,779	9,086,082	9,379,895	9,683,484	9,997,174
Welfare		1,800,667	2,605,447	2,825,500	3,076,268	3,338,930
Total Cash used	c	23,438,725	32,475,955	33,847,824	35,390,423	39,075,200
Net Cash to/from Operating	b-c	**14,063,431**	**17,395,786**	**16,619,554**	**15,738,073**	**12,745,789**
Financing Activities						
Cash Received						
Loan Drawdown - Commonwealth Government		8,260,000	-	-	-	-
Total Cash Received	f	8,260,000	-	-	-	-
Cash Used						
Commonwealth Loan - Repayments		-	-	-	600,000	1,200,000
Runways Trust Fund		-	-	-	515,893	493,026
Total Cash used	g	-	-	-	1,115,893	1,693,026
Net Cash to/from Financing Activities	h=f-g	8,260,000	-	-	(1,115,893)	(1,693,026)
Investing Activities						
Cash Used						
Runway resurfacing		12,000,000	-	-	-	-
Cash reserve - Capital Replacement		5,000,000	5,000,000	5,000,000	5,000,000	5,000,000
Minimum capital requirement		4,000,000	4,000,000	4,000,000	4,000,000	4,000,000
Additional Capital Requirement		5,000,000	5,000,000	5,000,000	5,000,000	5,000,000
Net Cash to/from Investing Activities	j	26,000,000	14,000,000	14,000,000	14,000,000	14,000,000
CLOSING CASH POSITION		**7,686,131**	**11,081,917**	**13,701,471**	**14,323,650**	**11,376,413**
CAPITAL REPLACEMENT RESERVES (CASH)		**5,000,000**	**10,000,000**	**15,000,000**	**20,000,000**	**25,000,000**

Table 3

2.5.2 Outcomes of the Model

1. The NIG requires in excess of 100,000 tourists each year in order to cover all capital requirements including replacement of assets now run down, maintenance of these assets and long term replacement.

2. Cash reserves to replace assets as at 30 June 2010 will equal $25 million. Cash balances (after capital reserves) will remain at $11.3 million.

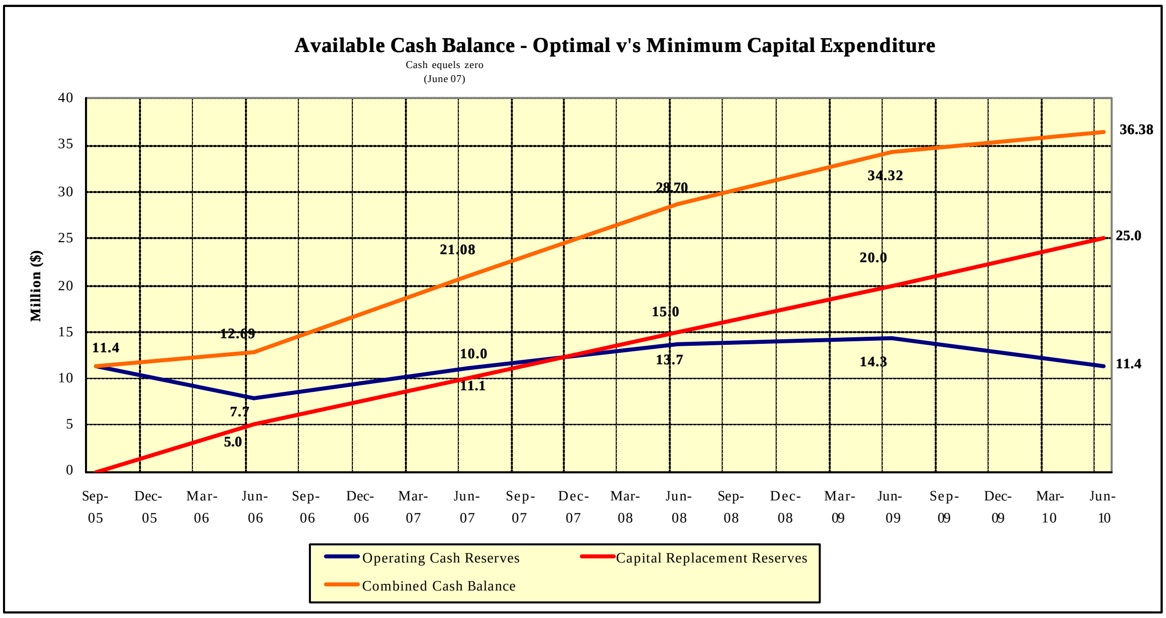

Diagram 2

3. In the 2006/07 financial year the combined operating surpluses of the GBE's will be $12.0 million whilst the revenue fund will contribute $5.4 million. Note, however, the net surpluses will fall over the five years to $11.4 million in 2009/10

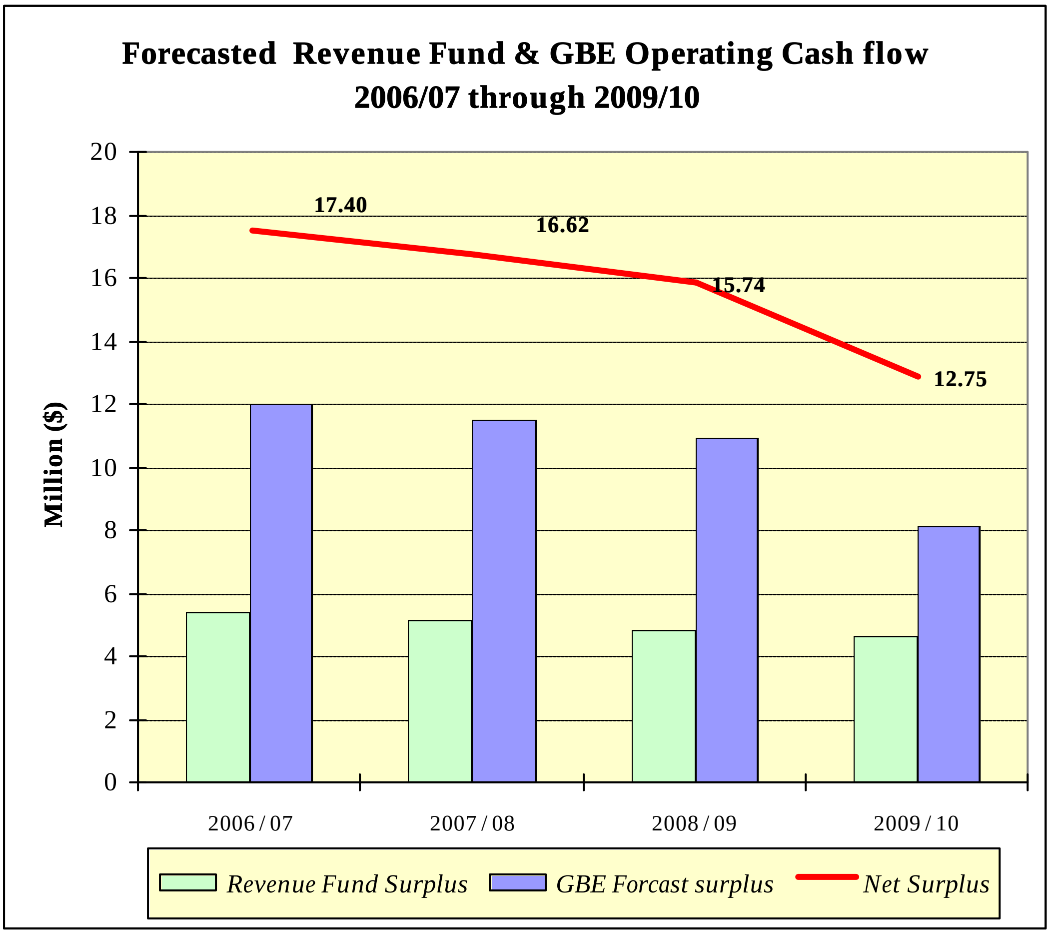

Diagram 3

2.5.3 Additional Assumptions

1. The number of tourists to Norfolk Island is sufficient to generate an operating surplus over the next five years to:

   a. Cover "minimum capital requirements" (namely those to maintain the current state of capital assets held by the NIG)
   b. Cover "capital improvement in capital assets" (over a five year timeframe) to such a level as would be comparable with a regional community in Australia.
   c. Build up sufficient cash reserves to allow the replacement of capital assets as and when they require replacement.

Based on these assumptions as at the end of five years (June 2010) Norfolk Island will have sufficient cash reserves to allow for future capital replacement as well as carrying a suitable asset base to allow delivery of government services. From this point it will only be necessary for the NIG to run sufficient operating surpluses to cover capital replacement.

2. Minimum capital requirements are assumed to be $4 million a year.

3. The amount required for capital improvement in assets is assumed to be $6 million a year. This is arrived at by deducting the "minimum capital requirement" over the next five years from the "optimal capital requirement" as defined previously, divided over the five year period.

4. The amount of cash reserves required to allow for capital replacement is assumed to be $5 million per annum. This is based on the cost of asset replacement being $100 million whilst assuming a useful life on average of those assets of 20 years (that is progressively over a 20 year period the NIG will have to spend $100 million on asset replacements).

5. Flights to and from Australia will be provided by an independent airline provider. The aircraft operator will be able to provide sufficient aeroplane services to meet market demand and the NIG will not be required to provide any financial assistance or incentives to the provider.

6. There is no need for capital expenditure by Norfolk Island Airport over and above the $12 million resurfacing of the runways.

2.5.4 Interpretation of Outcomes

In order to achieve a balanced and sustainable financial position it is necessary to generate additional operating surpluses over and above those in Scenario # 1 of $79.9 million over five years. This clearly can not be achieved solely through tourism as tourist numbers in excess of one hundred thousand are neither achievable nor sustainable for the following reasons:

1. The resident population would on average be out numbered by tourists. If, as historically has been the case tourists stay on average 7.35 days there would be in excess of 2,000 tourists on the island at any point in time.
2. Assuming that tourist numbers remain constant from month to month, which is not the case, there would have to be a minimum of fifteen flights on and off the island each week (assuming no upgrade to airport runways).
3. The dramatic increase in tourist numbers from current levels would require substantial capital investment by both the public and private sectors such as:
    a. Additional tourist accommodation;
    b. Road improvements;
    c. Electricity grid and telecommunication infrastructure upgrades;

2.6 ALTERNATIVE REVENUE SOURCES

The issue of alternative revenue sources has adequately been debated in the following documents;

- The 1997 Access Economics report
- The 1997 Grants Commission Report
- The Focus 2002 Review
- The 2004 Taxation Options for Norfolk Island Discussion Paper (Department of Treasury Paper).

Each of these reports advocated diversity and a change in the revenue source of the Norfolk Island Government and recommended a taxation system that moves away from taxing tourists and making residents more accountable.

We are concerned over the naive belief by certain sections of the Norfolk Island community (including that of the Government and business community) that the long term sustainability issues of Norfolk Island are tourist related and will be resolved purely by increased tourist numbers or alternatively that there exists some "white knight" industry that will save the island.

The scope of additional revenue raising from existing sources appears limited:

1. Tourists are already taxed to the point that makes Norfolk Island an un-competitive tourist environment.
2. High charges to residents for utilities already exist. For example price rises in electricity have only just increased.

Alternative sources providing for diversity in revenue raising appears to be the optimal solution.

Extraordinary wealth exists on Norfolk Island with this wealth being held by individuals who are willing to have their assets protected , legal rights upheld, health, education and living standards maintained, commercial practices regulated, sovereignty of the island protected , human rights maintained and a host of other benefits that sound government provides (most of which are provided by the Australian Government).

It is our belief (as it was with the previous reports) that Norfolk residents can afford to contribute to the provision of general services they consume through a more broadly based taxation system.

There is however an issue of compliance, enforcement and collections management. Consequently an alternative taxation system may best be put in the hands of the Australian Government rather than administered by the NIG in order to protect privacy issues , ensure enforcement and provide a cost effective collection system that will not be a burden to the NIG.

3. EXAMINATION OF NORFOLK ISLAND FINANCIALS

3.1 INTRODUCTION

The two main components of the NIG financial framework are the central Revenue Fund and the Government Business Enterprises (GBEs). The Revenue Fund is responsible for the day to day running of the NIG and the provision of services to the Norfolk Island community such as health, education, welfare and roads. In support of this, GBEs are government owned monopolies that provide essential services and infrastructure such as telecommunications, electricity, and sewerage. The GBEs operate as separate entities and, due to their monopolistic status, derive revenues to pay dividends to the Revenue Fund. Some GBEs such as the Museum and K.A.V.H.A. receive grants from the NIG. GBEs also pay management fees to the Revenue Fund for administrative services.

The diagram and table below show the NIG structure and a summary of the inter-entity transactions for the year ended 30th June 2005 respectively.

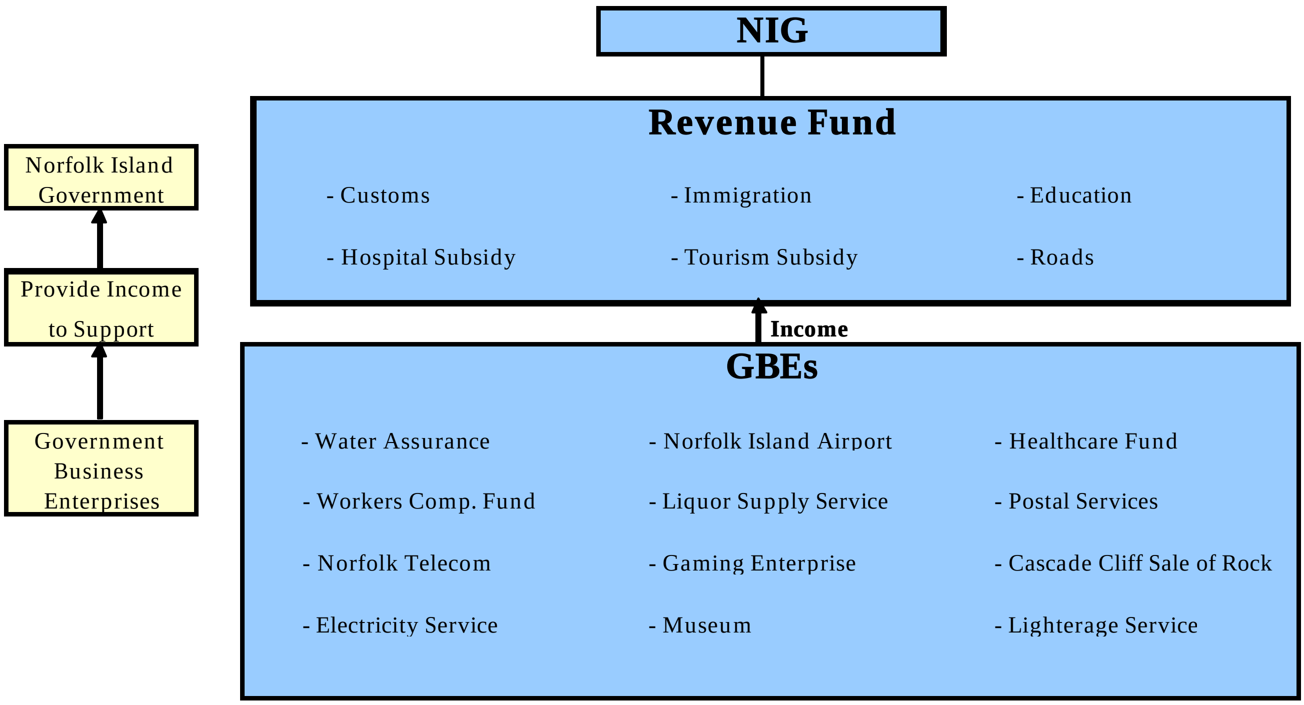

Diagram 4

Summary of the inter-entity transactions for the year ended 30th June 2005 respectively

GBE	Dividend	Grant	Management Fee
Water Assurance Fund	-	-	25,000
Norfolk Island Airport	185,000	-	100,000
Healthcare Fund	-	-	10,000
Workers Compensation Fund	-	-	20,000
Liquor Supply Service	1,231,952	-	20,000
Postal Services	100,000	-	20,000
Norfolk Telecom	-	-	92,000
Gaming Enterprise	250,000	-	2,000
Cascade Cliff Sale of Rock	-	-	23,000
Electricity Service	200,000	-	85,000
Museum	-	(100,000)	2,000
Lighterage Service	-	-	25,000
K.A.V.H.A.	-	(308,000)	-
Total	1,966,952	(408,000)	424,000

Table 2

In examining the financial position of the NIG this report has focused on the consolidated position of the government which includes both the Revenue Fund and the GBEs. In generating this review Acumen did not undertake an audit of the NIG and as such the financial data supplied by the NIG has been assumed to be accurate.

Tables 3 and 4 demonstrate that the NIG relies heavily on the income from the GBEs to fund the running of government. Historically the Liquor Supply Service and Norfolk Telecom have provided the two largest sources of this income. The tables below outline the net assets, operating surplus (deficit) and dividends for the Revenue Fund and the GBEs.

Revenue Fund	**2004/05**	**2003/04**
Assets	13,118,950	15,480,149
Liabilities	2,057,262	2,020,626
Net Assets	**11,061,688**	**13,459,523**
Operating Surplus (Deficit)	(4,014,787)	(1,959,546)
Dividend from GBEs	1,616,952	3,211,071
Net Surplus (Deficit)	**(2,397,835)**	**1,251,525**

Table 3

Total of GBEs	2004/05	2003/04
Assets	22,689,128	22,438,605
Liabilities	1,751,415	2,624,231
Net Assets	**20,937,713**	**19,814,374**
Operating Surplus (Deficit)	2,740,291	3,319,212
Dividend Paid to Revenue Fund	(1,616,952)	(3,211,071)
Net Surplus (Deficit)	**1,123,339**	**108,141**

Table 4

The dividend revenue paid to the NIG has decreased significantly during 2004/05 due to the absence of a dividend from Norfolk Telecom. Under normal circumstances Norfolk Telecom would have paid a dividend in excess of $1.2 million.

From just two years analysis it is possible to highlight a number of concerning issues:

1. The increase in the operating deficit from $1.959m to $4.014m;

2. More importantly, the failure by the GBEs to fund this deficit. Whereas in 2003/04 the operating surplus from the GBEs of $3.3m funded the $1.9m deficit of the NIG, in 2004/05 surpluses from the GBE were unable to fund the operating losses, resulting in an overall net deficit of $2.4m.

The other concerning issue is the reduction in operating surplus of the GBEs, thereby indicating a fall in the return on assets. Whilst this normally would not be an issue for a government, it is a concern for a government that is funded by monopolies. Falling returns on assets in government owned monopolies are usually very good indicators of asset stripping or operational inefficiencies.

Given that the net cost of social services such as hospitals, roads, welfare, and education are funded through the distribution from these monopolies, it is imperative that assets are maintained to a level that assures sufficient revenue is derived from them. This imperative assumes that the GBE's are managed efficiently.

Diagram 5 analyses the operating surplus as a proportion of the assets maintained by the NIG. It is in effect, the NIG's return on assets.

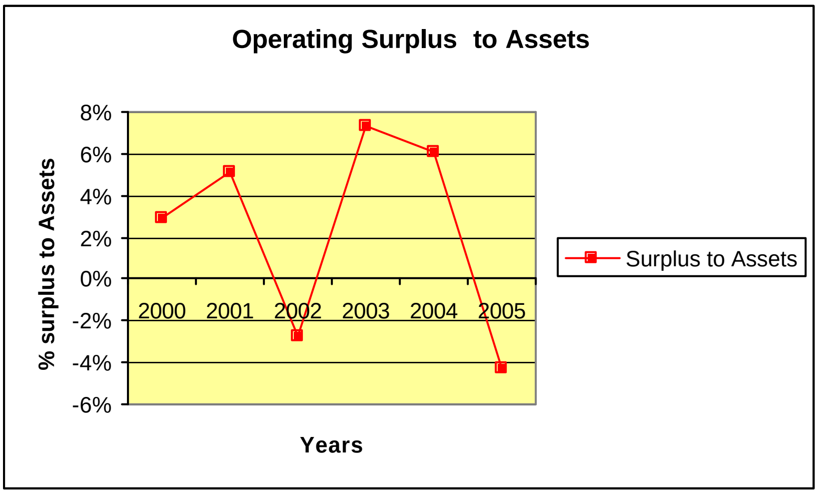

Diagram 5

This is an extremely useful summary and overview of the financial dilemma of the NIG because it indicates three pertinent issues. Firstly, the declining revenues from assets resulting from either operating inefficiencies or asset run down, resulting in an inability to fund future recurrent expenditure. Secondly, by referring to Diagram 6 the strong relationship between operating surpluses and hence performance of the NIG to tourist numbers is identified. This implies thirdly, that the capacity to increase revenues and hence surpluses to upgrade and replenish assets to acceptable levels is intrinsically linked to a variable (tourists) that the NIG has effectively no control over.

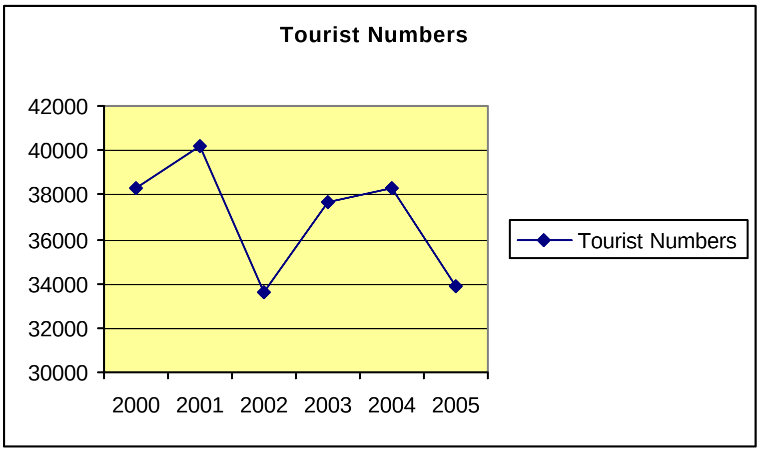

Diagram 6

Basically, because of its current revenue raising structure the NIG has almost no control over its destiny.

3.2 SOLVENCY OF THE NIG

The method of measuring an organisation's short term liquidity position or solvency is by comparing the values of "current assets" with "current liabilities". In essence this is measuring the cash or access to cash the NIG has immediately available to enable it to pay the debts that will fall due within the current financial period.

Three ways of analysing this relationship and hence the solvency of the NIG are to undertake the following ratio analysis;

1. Current ratio
2. Quick ratio
3. Working Capital Ratio

3.2.1 Current Ratio

The first test of an organisation's financial position is whether it will have sufficient cash over the immediate future to meet its short term liabilities as they fall due. Unless the answer here is positive, the organisation is in a financial crisis irrespective of its operating surplus performance. The current ratio aims at identifying how much cash is available to meet the immediate short term debt. Whilst it is usually a good indicator for the corporate sector, it has its limitations within the public sector. The reasons being that, usually, at any time a government has the capacity to generate cash by increasing revenues from duties or taxes and secondly, unlike commercial organisations, governments (as with the NIG) rarely have onerous ongoing interest commitments to external financial institutions.

Acumen has calculated the current ratio position of the NIG as at the 30 June 2005.

Ratio	Current Ratio Calculation
$\frac{\text{Current Assets}}{\text{Current Liabilities}}$	**2.08**

This can be interpreted that for every $1 of immediate debts the NIG has $2.08 in current assets to repay this debt. Whilst a ratio of one is standard, most types of organisation can effectively operate with a current ratio much less than this value. This is particularly relevant to an organisation that derives revenues from long term infrastructure assets like a government that can easily raise revenues.

3.2.2 Quick Ratio

The disadvantage of the Current Ratio is that it does not distinguish between different types of current assets, some of which are far more liquid than others. Hence, a more realistic approach is to remove the current assets that can not be used to eliminate debt or meet financial commitments. The quick ratio is the same as the current ratio but removes inventories or stock on hand from the equation. The reason for this is that often inventories cannot be quickly converted into cash and in instances of a "fire sale" often do not realise their full value.

Ratio	Quick Ratio Calculation
Current Assets (less inventories) / Current Liabilities	**1.55**

Again this can be interpreted that for every $1.00 of immediate debt the NIG has $1.55 in cash to pay for this debt.

In interpreting these two ratios, technically from a pure accounting definition perspective the NIG is not insolvent. However, there are a number of issues that need to be taken into consideration. Firstly, ratios assume a point in time and do not take into consideration demands on cash through the normal day to day operations of the organisation and secondly they do not recognise dramatic change in circumstances.

3.2.3 Working Capital Ratio

The issue of cash availability or working capital availability is particularly critical to the NIG where a significant proportion of its cash is generated both directly and indirectly from tourists. Working capital is effectively a measure of liquidity and financial management. It is a most important value as it represents the amount of day to day operating cash available to the NIG to carry out the function of government, especially the payment of salaries.

Working capital needs can only be met from three sources, operating surpluses, loans or from the disposal of assets. Hence, as a government grows and provides additional services to the public or the cost of existing services increase, it needs to constantly contribute to the working capital balance to sustain itself. Therefore as an indicator of prudent fiscal management one would expect to see the proportion of the NIG's working capital being maintained within the levels of both revenue and expenditure and that ideally this proportional growth is funded from operating surpluses.

Any increases in the proportion of working capital over time would indicate two key issues:

1. That the day to day funding of operations of the Public Service has grown and that more cash is being channelled into operational activities and;

2. That this cash is being diverted away from asset /capital replacement expenditure in preference to fund operational expenditure.

These outcomes are usually a result of inefficient treasury management, cash-flow management or debt management procedures.

The working capital analysis illustrated in Diagram 7 indicates exactly this scenario.

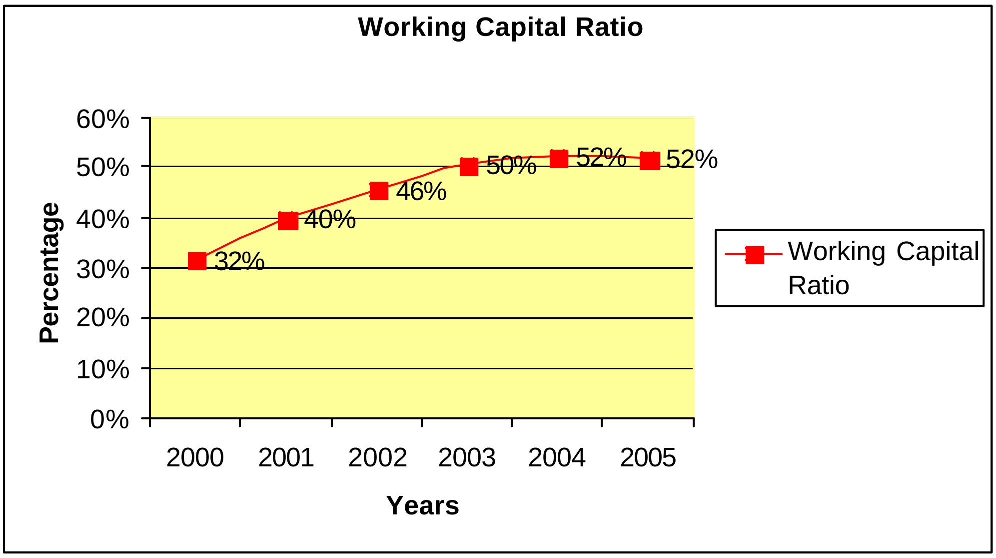

Diagram 7

We can interpret this data by saying that in 2000 where as 32 cents of every dollar raised from revenue was used to fund the cash flow of the NIG's day to day operations, this has now increased to 52 cents by the end of 2005. An increase of 65%.

This scenario is supported by an increase in cash reserves of over 100% (excluding airport loan) from $5.4m in 2000 to $10.8m (30 June 2005), a significant increase in debtors of 100% to $4m and a marginal increase in the quantities of stock held. Conversely, liabilities over the same period have only increased $800K.

In an environment of efficient fiscal management, one would expect that as the revenue base grows then the working capital requirements as a ratio would remain relatively constant, if not decrease. If, however, a government is paying more for salaries due to an increase in the size of the public sector, more welfare payments, not collecting its debts and generally not managing its overall cash in a timely fashion then the amount of working capital it requires would increase. We believe this to be the case of the NIG. As the NIG has required more and more cash to fund the operations of government it has financed this cash by channelling necessary expenditure away from capital asset replacements and into the payment of salaries, welfare, healthcare, education and other operational expenditures.

3.2.4 Asset Base Ratios

Any significant increase in the working capital ratio would immediately suggest that this has been at the expense of fixed assets. Meaning that, as a proportion of the size of government, if liquid assets (cash) have increased, then fixed capital assets must have decreased.

Acumen reviewed the assets base of the NIG over the last five years and can confirm that there has been a significant reduction in the fixed asset base of the NIG. Diagram 8 shows that as a proportion of total Government net worth or wealth, fixed assets have decreased from 83% of equity to 67% of equity.

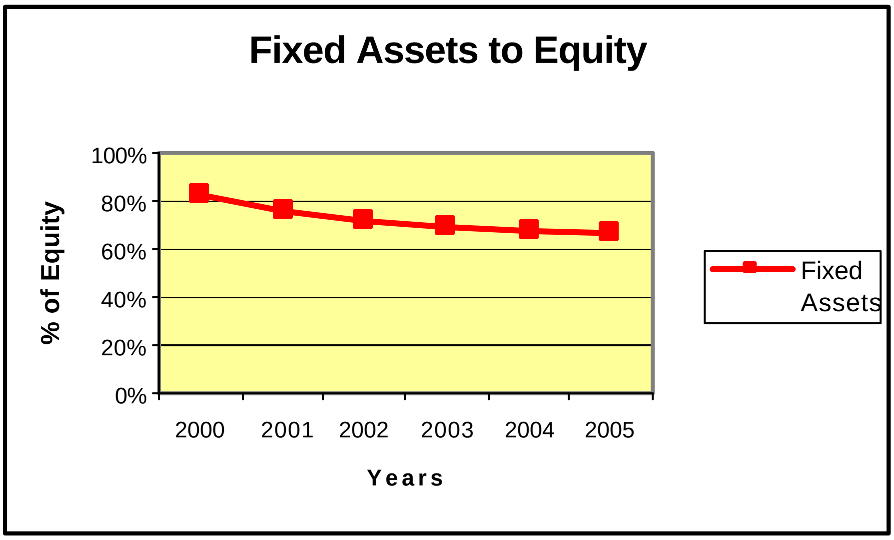

Diagram 8

Diagram 9 highlights the movement between the NIG's asset make up showing the decrease in fixed assets and the increase in current assets over the last five years.

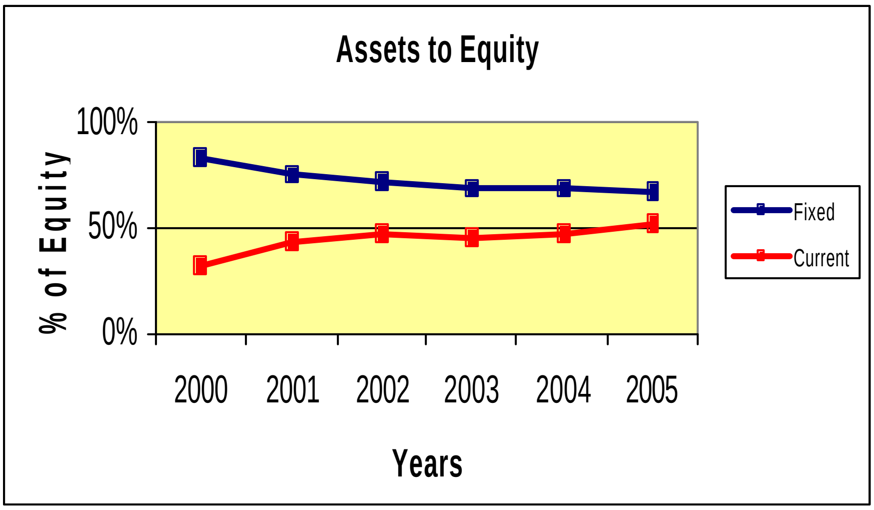

Diagram 9

This decrease and the rate of decrease in fixed assets is disturbing given that most revenues, if not all revenues are derived from the fixed assets of the NIG and confirms that the increase in operational day to day functions of the NIG have been funded at the expense of maintaining the revenue producing assets of the NIG. This policy, consistently adopted by the NIG, has been extremely short sighted and has now placed the NIG at a point of un- sustainability.

The reason being that the NIG now has to spend on average $12m every year over the next five years just to restore and maintain the standard of wealth and hence the standard of living of the residents. The critical issue is that the NIG can not generate sufficient revenues to sustain that level of capital expenditure whilst maintaining current expenditure levels and revenue raising sources.

The issue of asset management is addressed further in this report. However, succinctly, we do not believe that the NIG under its current policies and fiscal management practices has the capacity to replace these assets to a level of acceptable standards in both the short and long term and, as a result, there is serious risk that the standard of living for the majority of residents will decrease within two years.

3.2.5 Summary

In addressing the issue of solvency we make the following statements:

1. Given the limitations of generating revenue and current expenditure patterns it is inevitable that deficit budgets will be required over the next 2 years;

2. These budget deficits can be funded by existing cash reserves of approximately $11m;

3. Technically the NIG is not insolvent i.e. it can meet its current obligations;

4. However its solvent position is derived only because it is not undertaking the necessary capital expenditure;

5. If basic capital expenditure was undertaken, we expect that the cash reserves will be depleted by June 2007 and hence the NIG will move into insolvency by this period;

6. If the NIG neglects capital expenditure it runs the risk of depleting the revenue producing assets and hence the capacity to maintain current levels of revenue;

7. Therefore, based on the fact that the NIG must undertake some degree of capital expenditure we believe that its position whilst solvent is one of un-sustainability.

3.3 REVENUE ANALYSIS

The adverse financial position of the NIG can be directly attributed to the refusal by the NIG to address the issue of revenue diversity. Although this issue has been raised in every financial and economic report into NI since the mid nineteen nineties, it still remains the single most contributing factor to the well being of the island.

For many years the people of Norfolk Island have elected to pay minimal tax, financing their standard of living through revenue raised substantially from tourism whilst making insufficient provisions out of this income for the funding of essential infrastructure.

In terms of revenue we make the following comments:

1. Since 2001 whilst revenues have increase on average 1.7% in nominal terms, in real terms they have consistently decreased;

2. The impact of a changing tourist market, the reluctance to diversify the revenue base and the reluctance to significantly increase the population level means that under current policies the NIG's revenue raising capacity has more than likely reached its limit;

3. We estimate that 50-70% of revenue is directly and indirectly related to tourists;

4. Because of the high percentage of reliance on tourists, revenue management is effectively uncontrollable by the NIG.

3.4 EXPENDITURE ANALYSIS

3.4.1 Overview

In reviewing expenditure, we have tried to identify where operating expenditure has been growing at the fastest rate, thereby indicating where fiscal expansion has occurred. The first step in this process is to group expenditure items as outlined in table 5.

Expenditure 2005	
Employee Costs	9,240,700
Maintenance & Repairs	1,564,900
Grants, Subsidies & Contributions	1,928,400
Welfare	2,210,000
Other Operational Costs	8,350,800
Total	$23,294,800

Table 5

Diagram 10 demonstrates the relativity of the expenditure groups for the 2005 year.

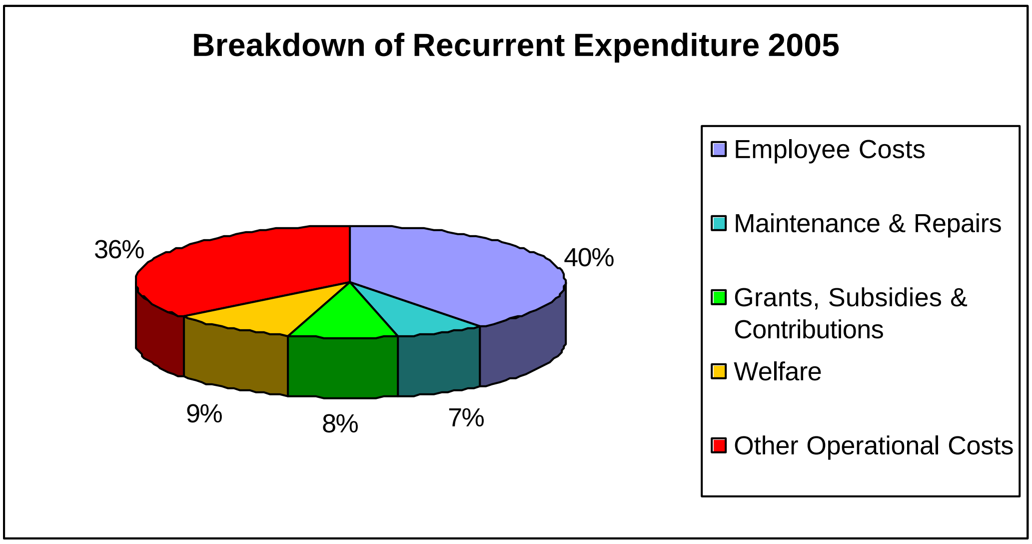

Diagram 10

3.4.2 Recurrent Expenditure

Review of the recurrent expenditure identifies that over the last five years there has been a significant increase in two main areas. Firstly, the size of the public service and the associated salary expenditure and secondly, welfare. Since 2002 public sector salary costs has increased approximately 20% whilst welfare payments have increased over 40%. Other discretionary payments such as grants and submissions have also increased 20%. Simultaneously over the same period maintenance of assets has been maintained to 2002 actual levels but decreased both in real terms and as a proportion of total expenditure, as has general operating expenditure.

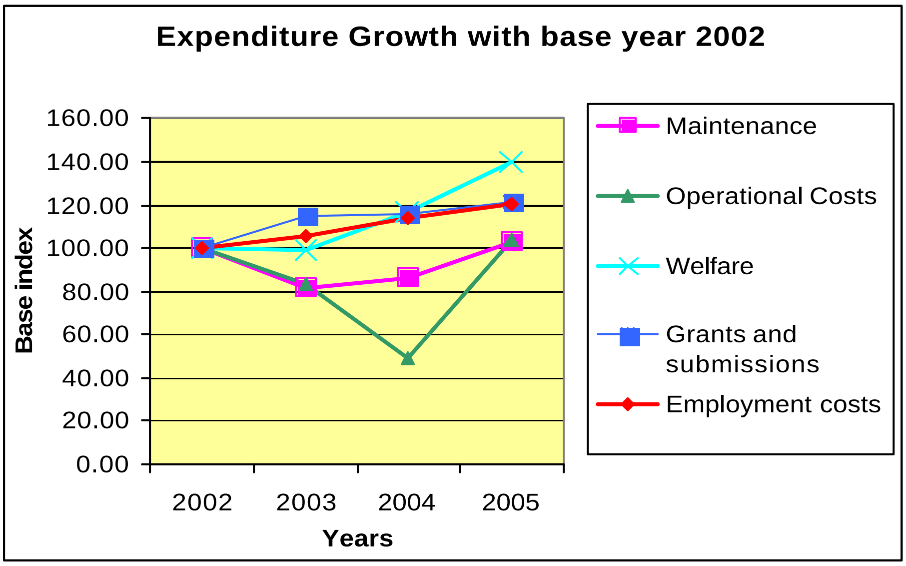

Diagram 11

3.4.2.1 Salaries and Wages

Since 2000, the public sector wages bill has increased approximately 7% a year and now represents over 40% of the NIG's operational expenditure budget. This is an alarming expansion of a public sector with such a small revenue base and population, particularly at a time when there has been a decline in tourist numbers.

3.4.2.2 Education

The impact of salaries increases is highly prevalent in overall education cost. The NIA has a contract with the NSW Department of Education for the supply of education to the Island. As a consequence wage increases are tied to the NSW certified agreement. This recurrent cost is committed and unavoidable and will be subject to further increases thereby adding additional long term pressures to the NIA's overall operation cost.

3.4.2.3 Welfare Benefits

Given the demographics of the island and current economic and social welfare policies we are concerned over the NIG's capability to continually manage and finance its current and immediate future welfare system and question if, as a recurrent expense, it has been fully costed.

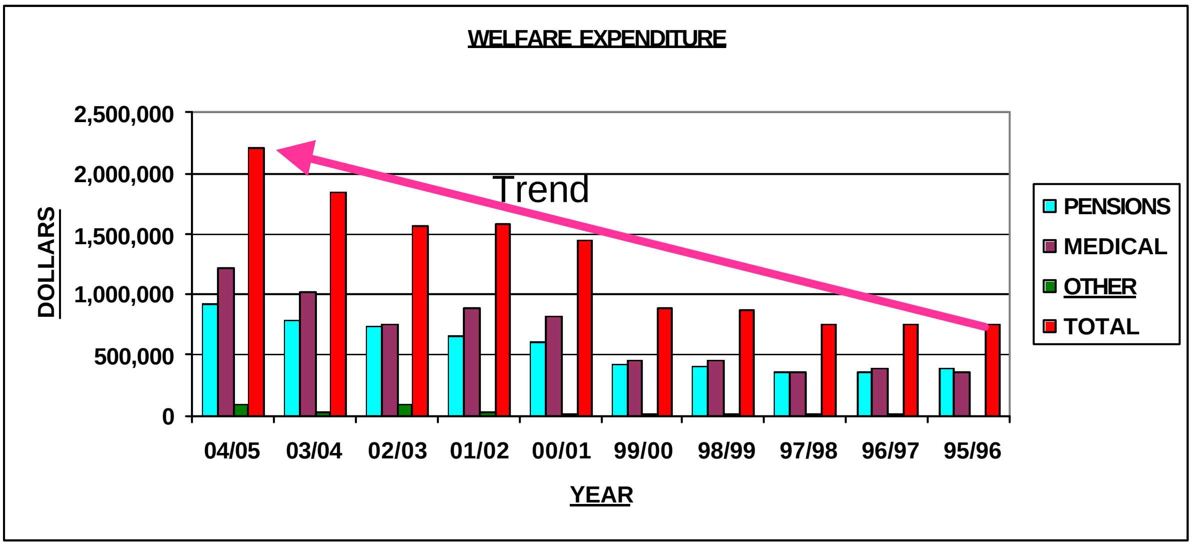

Diagram 12

There are also some anomalies with the welfare system.

- The welfare system is open to wide ranging exploitation. Wealthy older owners of property can be eligible for welfare by transferring their Island assets to their children. Income verification on the island is almost impossible. Confirmation of overseas asset holdings and income is also impossible.

- It is estimated that approximately 25-30 % of the island residents have an Australian Medicare card (making no contribution to the Australian tax system);

- The "superannuation fund" for the public sector is a saving fund. Over the working life the government contributes on average 5% of salaries to the fund. Employees also contribute to the fund. Upon retirement the employee receives an unconditional lump sum, is entitled to spend it in its entirety and is then eligible to welfare payments.

3.4.2.4 Maintenance

There is a concern that in real terms maintenance expenditure has decreased. This would support the concept that not only are assets not being replaced, but operation expenditure savings are being achieved by reducing the maintenance on assets, further contributing to their devaluation, reduction in useful life and income generating capacity.

3.4.2.5 Power House Fuel

All electricity on the island is produced by diesel generation. Significant increases in the price of fuel have impacted dramatically on the cost of production over the last year. This increase in cost of production has had an impact on the dividends available and diminishes the levels of revenue to the NIG for redistribution.

The recovery of future fuel price increases is a risk to the NIG as electricity prices have only recently increased. Politically there is very little scope for the NIG to increase electricity prices further to mitigate future price rises.

Procrastination on the part of previous Legislative Assemblies and the NIG to address alternative power opportunities is well known and well documented. In the current financial situation the NIG does not have the necessary capital funds to invest in alternative power sources.

3.4.2.6 Hospital Subsidy

The ageing population will, in the very near future, place increasing demands on the hospital and welfare system, in particular in the areas of aged care. As a result, it is estimated that over the next 5 years there will be a need for the NIG to increase its subsidy to the hospital at a rate significantly greater than inflation.

3.5 LIABILITIES ANALYSIS

Overall the NIG has very limited amounts of gearing or liabilities. As fiscal management has deteriorated over the last five years there has been a slight decrease in current liabilities emanating from the day to day management of operational expenditure. However, overall these are general trading liabilities within the GBEs.

In summary there are no concerns over the existing levels of current liabilities.

3.5.1 Long Term Liabilities

The only significant long term liability is the loan to finance the airport runway improvements. Repayment of this loan impacts on the cash reserves and we expect that the NIG will not be in a position to make any repayments on this loan. Furthermore, the requirement under the loan agreement to deposit money in trust for future airport maintenance is unlikely to be achieved.

3.5.2 Provisions and other commitments.

Overall provisions and other commitments are immaterial. Irrespective of their immateriality, given that cash reserves are forecast to be consumed at an accelerating rate, it is likely that within two years the NIG will not have the cash to pay these commitments when they arise. Of particular concern will be employee entitlements.

3.6 ASSET MANAGEMENT

The 1997 Access Economics' report, the 1997 Grants Commission report and the Focus 2002 Review all warned of, and highlighted asset stripping and asset run down had been occurring. Due to the current and past policies adopted by the NIG, the NIG has passed the point where it is able to replace and maintain the optimum level of infrastructure. That is, the NIG does not, and is unlikely to have in the future the capacity to replace the assets and hence the wealth of the island to acceptable levels.

We have reviewed the asset management plan completed to date. Unfortunately not all the evaluations of the assets were completed at the time of our review. However the table on the following page shows a summary of the reports completed to date and highlights the significant and imminent hurdle faced by the NIG.

1. SUMMARY

Following is a summary of the life cycle costings prepared for all built assets and infrastructure audited to date:

Facilities	Non-Statutory Backlog Total		Statutory Backlog Total		Preventative Maintenance Total	Reactive Maintenance Total	Capital Replacement Total	Capital Investment Total	Total Expenditure
	Maint.	Refurb.	Maint.	Refurb.					
Hospital	$29,300	$20,000	$800	$31,900	$306,900	$413,300	$1,390,050	$151,000	$2,343,250
Public Library	$1,150			$3,000	$3,000	$52,350	$11,100	$5,000	$75,600
Radio	$1,250		$50	$2,000	$13,700	$75,800	$41,500	$55,000	$189,100
Telecom	$1,900		$400	$7,000	$678,400	$429,550	$587,600	$4,500	$1,709,350
Roads	$37,200	$31,270,000				$13,593,040	$37,880,000	$3,300,000	$86,080,240
Police Station	$1,950		$100	$5,100	$30,000	$105,700	$15,500		$158,350
Radio Shack	$200		$7,500	$78,500			$4,000		$90,200
Rawson Hall	$12,600		$1,450	$11,500	$63,700	$151,600	$133,300		$374,150
Satellite Building	$2,200		$7,500	$64,000			$29,400		$103,100
Airport	$33,400		$1,400	$4,900	$725,000	$466,600	$592,000	$12,960,000	$14,783,300
Bicentennial centre	$27,300		$1,100	$14,300	$151,700	$498,900	$365,200	$80,000	$1,138,500
TOTALS	**$148,450**	**$31,290,000**	**$20,300**	**$222,200**	**$1,972,400**	**$15,786,840**	**$41,049,650**	**$16,555,500**	**$107,045,140**

At this point of time, cash flow is adequate to meet day to day operational activities should no capital expenditure occur. We estimate that if the NIG undertook their normal level of capital replacement they would run out of cash in September 2008.

The unfortunate issue is that the NIG's normal level of capital expenditure has been inadequate to maintain the level of services and living standards of the residents. There is simply not enough cash (nor future revenue generating opportunities) for the NIG to undertake the required asset and maintenance expenditure and hence we conclude that their position is one of un-sustainability.

We would strongly emphasise that the timing of the recognition of un-sustainability is critical. It is far easier to develop rescue plans 12- 18 months out from a point of insolvency rather than at the point of insolvency.

In summary we make the following comments with regards to assets and infrastructure investments.

1. In two years the NIG will not have the capacity to maintain existing assets;

2. The NIG is incapable of sustaining any further debt for any non-revenue producing capital investments, in particular infrastructure expenditure such as roads, schools, hospitals, harbour areas or internal government capital expenditure (ie. system upgrades) ;

3. In terms of both a financial and an economic fiscal management perspective, the management of public assets over the last 20 years can only be described as less than optimal. If not addressed immediately we predict a major deterioration in the living standards for a majority of the permanent residents of Norfolk Island within two to three years.

4. REVIEW OF MAJOR GOVERNMENT BUSINESS ENTERPRISES

All significant GBEs were included in the financial review. The remainder of this section is an analysis of each GBE reviewed and includes:

- A snapshot of their actual and forecast financials;
- A commentary on their financial position; and
- A discussion of risks and issues confronting each GBE.

4.1.1 Overall observations

The review showed that the majority of GBEs have maintained a stable revenue base but employee costs have increased markedly. In order to maintain the historical levels of dividends, capital maintenance and investment programmes have been delayed resulting in a run down of infrastructure assets.

Electricity generation has traditionally been profitable, however, rising fuel prices and the inability to raise prices further has resulted in an inability to maintain dividend levels.

In an optimum environment, governments develop policies which take into account the future capital investment needs of GBEs before determining dividend levels. The NIG has not developed such a policy which has resulted in asset stripping, a lack of consistency in dividends from year to year and deterioration in infrastructure.

4.2 NORFOLK ISLAND HOSPITAL

	Actual		Forecast		
	2003/04	2004/05	2005/06	2006/07	2007/08
Revenue	2,492,948	2,813,962	2,895,000	3,165,000	3,468,000
Expenditure *	3,568,108	3,673,966	3,667,000	4,215,368	4,675,220
Net Position	**(1,075,160)**	**(860,004)**	**(772,000)**	**(1,050,368)**	**(1,207,220)**
Capital Requirements	n/a	n/a	372,600	269,600	249,600
Dividend to NIG	(843,500)	(843,500)	n/a	n/a	n/a
Dividend as % of Revenue	(34%)	(30%)	n/a	n/a	n/a

* Excludes Depreciation, Management Fees and Dividends paid to the NIG

Table 6

The Norfolk Island Hospital is operated by the Norfolk Island Hospital Enterprise (NIHE) and under the *Hospital Act 1985* is responsible for the efficient and effective management of the hospital.

4.2.1 Financial Position

The hospital is partly funded by a subsidy from the NIG ($843,000 in 2004-05) which over the last four years has equated to approximately 23.2% of revenue. The hospital charges Norfolk Island residents for most services based on the scheduled fees prescribed by the Australian Medicare system even though Medicare does not operate on Norfolk Island. Tourists are charged an additional surcharge of ninety percent for services. The Hospital Pharmacy, the only one on the island, also makes a contribution to the overall funding of the hospital. Over the past four years this contribution to overall operating costs has on average exceeded $175,000.

Under the current funding policies revenues from each of the core medical services fails to recover costs. Over the past four years salaries have exceeded 58% of total expenses. Unlike the remainder of the public sector there has been only a minimal increase in salaries of approximately 0.5%. Consistent with the mainland the hospital has also incurred increases in insurance premiums of approximately 370% over the last four years. In an environment of near static funding this has required funds to be redirected from maintenance and capital expenditure activities to cover increased operating costs.

Historically the hospital has been able to maintain the book value of its plant and equipment, however the estimated capital requirements for medical equipment over the next five years to be $1.09 million. This ignores the need for significant maintenance requirements of the hospital estimated to be $0.3 million over the same period.

4.2.2 Risks and Issues

The main issues facing the hospital are an ageing of the population and the increasing age of the hospital buildings.

The ageing of the population is already impacting on the hospital with twelve of the hospitals twenty six beds allocated to aged care. The hospital provides the only aged care facility on the island. Whilst this is currently not an issue there has been a significant increase in occupancy in recent years. Recent changes to the pricing of aged care beds has resulted in an improved recovery of costs whilst changes in collection from the welfare system has resulted in 75 percent of aged pensions of those permanently in hospital being paid directly. While hospital management believes the hospital is currently able to deal with the ageing of the population an assessment has to be made of the hospital's ability to cope beyond three years.

The ageing hospital buildings will put significant financial pressure on the hospital's financial operations. In recent years the normal maintenance of the building has not occurred due to the overall fiscal position of the NIG. There is also a need for the ultimate replacement of the hospital within ten to fifteen years.

4.3 AIR NAURU CHARTER FLIGHTS

	Actual		Forecast		
	2003/04	2004/05	2005/06	2006/07	2007/08
Revenue	-	486,089	11,696,000	14,618,000	14,619,000
Expenditure *	-	1,116,947	12,769,000	12,602,000	12,608,000
Net Position	**-**	**(630,858)**	**(1,073,000)**	**2,016,000**	**2,011,000**
Capital Requirements	n/a	n/a	-	-	-
Dividend to NIG	-	(630,858)	n/a	n/a	n/a
Dividend as % of Revenue	n/a	(130%)	n/a	n/a	n/a

* Excludes Depreciation, Management Fees and Dividends paid to the NIG

Table 7

As a result of Norfolk Jet Express (NJE) going into liquidation in early June 2005 the NIG was required to provide an air link between Australia and Norfolk Island. In June 2005 the government entered into a contract with Air Nauru under which the NIG provides air services using an Air Nauru aircraft. Under this agreement the NIG charters the aircraft from Air Nauru but is responsible for all ticket sales. The NIG has a secondary agreement with Qantas to provide ticket services and baggage handling for which Qantas is paid a 19% commission on all ticket sales.

4.3.1 Financial Position

In order to maintain tourism numbers and confidence the NIG agreed to recognise tickets sold by the then defunct NJE. As a result in the initial period the NIG made significant losses on the airline as it was required to pay Air Nauru almost $200,000 a week with minimal income. Consequently, during the first four months expenditure exceeded receipts by more than $1 million dollars.

Based on the capacity of the Air Nauru plane and historical Australian travelling patterns the maximum number of tourists that can be transported from the mainland is approximately 20,400. In this instance, based on current ticket pricing it is estimated the profit in 2006-07 would be $2.0 million from the charter flight agreement. In addition to this the NIG would receive an additional $1.2m by way of landing fees to the Norfolk Island Airport. From our calculations, the operation of the Air Nauru charter is profitable and will continue to be profitable should tourist numbers remain at current levels.

OPERATING STATEMENT (FORECAST 2005-06)	
REVENUE	
Tourist Sales (at $540 per return flight)	11,046,000
Resident Sales (at $500 per return flight)	1,870,000
	12,916,000
Add: Ticket taxes	
- Fuel Levy	1,142,000
- Insurance	290,000
- Landing Fees (Norfolk)	1,084,000
- Landing Fees (Brisbane / Sydney)	711,000
	3,227,000
Less: Qantas booking fees	(2,453,000)
Add: Air Freight & Mail	600,000
NET CHARTER REVENUE	**14,290,000**
LESS: EXPENDITURE	
Air Nauru Contract ($833,150 per month)	9,998,000
Ticket Taxes	
- Insurance	290,000
- Landing Fees (paid to Norfolk Island airport)	1,282,000
- Landing Fees (Brisbane / Sydney)	841,000
Salaries and Wages	31,000
Sundry costs	160,000
	12,602,000
NET CONTRIBUTION TO GOVERNMENT REVENUE	**1,688,000**
Add back: Landing Fees paid to Norfolk Island Airport	1,282,000
REAL CONTRIBUTION DIRECTLY THE NIG	**2,970,000**

Table 8

4.3.2 Risks and Issues

The main risks facing the NIG associated with the current contract is that Air Nauru only has one aircraft and is only required to give eight weeks notice to remove the aircraft from the route.

Secondly, the use of Air Nauru restricts the capacity to increase tourist numbers to the Island. Accordingly the NIG is negotiating with other airlines that operate larger planes.

4.4 NORFOLK ISLAND ELECTRICITY

	Actual		Forecast		
	2003/04	2004/05	2005/06	2006/07	2007/08
Revenue	3,095,735	3,105,984	3,257,000	3,169,000	3,169,000
Expenditure *	2,123,390	2,379,632	3,190,000	3,358,000	3,645,000
Net Position	**972,345**	**726,352**	**67,000**	**(189,000)**	**(476,000)**
Capital Requirements	n/a	n/a	40,000	-	-
Dividend to NIG	80,000	285,000	n/a	n/a	n/a
Dividend as % of Revenue	3%	9%	n/a	n/a	n/a

* Excludes Depreciation, Management Fees and Dividends paid to the NIG

Table 9

Norfolk Island Electricity maintains the electricity generation equipment and the reticulation network for all of Norfolk Island. Currently all electricity is generated from diesel fuel generators.

4.4.1 Financial Position

Revenue from the sale of electricity in the 2004-05 financial year was $3.06 million which has steadily increased from $2.66 million in the 2000-01 financial year. This has been principally achieved through increased charges. Due to the lack of other taxation options the NIG uses this monopoly to fund other government functions. The price of electricity is currently set at $0.44 per kilowatt hour which has increased significantly in recent years due to upward trends in world fuel prices.

The primary cost of electricity generation on Norfolk Island is diesel fuel which at 1 October 2005 cost 0.9635 per litre; this translates to a production cost of $0.29 cents per kilowatt hour (based on 3.32 kilowatts per litre).

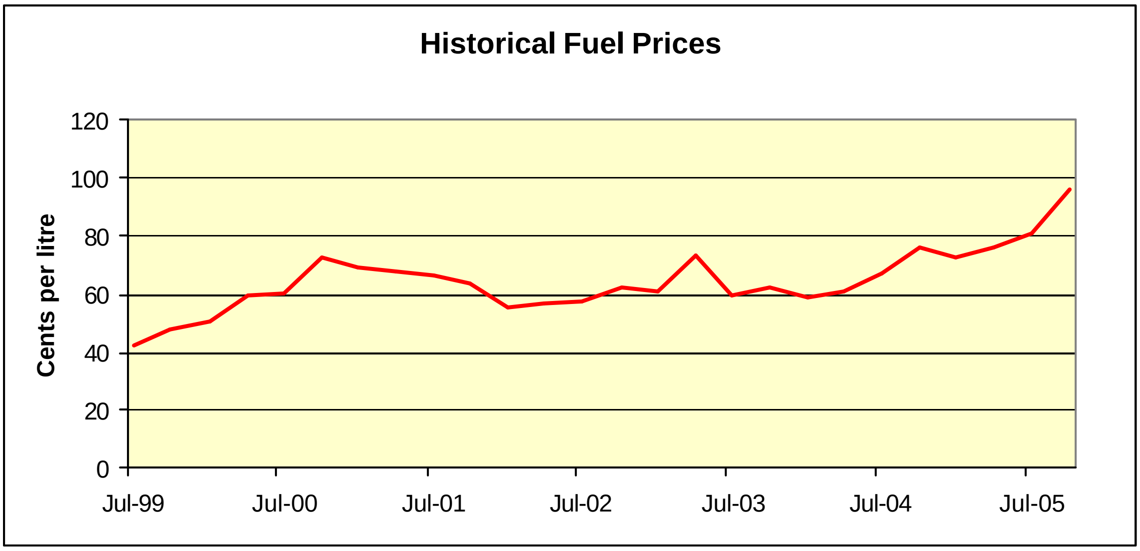

Diagram 13

Based on the financial statements as at 30 June 2005 the electricity generators are nearing the end of their useful life and are written down to 21% of their original cost (31% as at 30 June 2002). The island currently has six operational generators which to replace would cost an estimated $1 million each. The electricity manager stated that the written down value of the assets does not reflect the useful life of a generator if it is well maintained. He feels though maintenance costs are steadily increasing (currently around $150 thousand per annum) that only two generators require replacement in the next five years with the rest in approximately ten years. Based on current demand the reticulation network is adequate for the foreseeable future

4.4.2 Risks and Issues

The island's dependency on diesel fuel for electricity is causing significant pressure on the NIG due to spiralling cost of fuel which has increased by more than 26% in the last six months. It is feared if prices continue to increase that the cost of production may become higher than the price that can be collected from consumers. If it is assumed that fuel prices increase at ten percent per annum over the next five years the fuel cost by 2010 would be $0.47 per kilowatt hour (currently $0.29). Based on current consumption and cost structure, if the NIG is unable to increase the price paid by consumers the cash deficit in 2009-10 will be $1.9 million as against the $0.6 million surplus before depreciation in 2004-05.

There has been a realisation by the NIG that the use of diesel fuel is not sustainable and an alternative power source is required in the medium term. Feasibility studies undertaken by the NIG indicate that the best options for Norfolk Island are either tidal or wind power. However, as stated earlier, the NIG does not have the necessary capital funds to invest in alternative power sources.

4.5 NORFOLK ISLAND LIQUOR SUPPLY

	Actual		Forecast		
	2003/04	2004/05	2005/06	2006/07	2007/08
Revenue	4,487,277	4,101,072	3,961,000	3,959,000	4,071,000
Expenditure *	3,146,206	2,889,120	2,833,000	2,830,000	2,884,000
Net Position	**1,341,071**	**1,211,952**	**1,128,000**	**1,129,000**	**1,187,000**
Capital Requirements	n/a	n/a	50,000	50,000	25,000
Dividend to NIG	1,341,071	1,211,952	n/a	n/a	n/a
Dividend as % of Revenue	30%	30%	n/a	n/a	n/a

* Excludes Depreciation, Management Fees and Dividends paid to the NIG

Table 10

The Norfolk Island Government Liquor bond has the sole authority for the importation and sale of liquor products to Norfolk Island.

4.5.1 Financial Position

The pricing of liquor is based on a fixed mark-up percentage added to the landed cost. The mark-up percentage is dictated by the NIG and is applied to products based on class (i.e spirits, wines, light beer, mid strength beer or full strength beer). The current mark-ups applied range between 40% and 180%. The liquor bond is responsible for the collection of the liquor licensing fee which is charged on all sales to licensed premises at a flat ten percent on the retail price.

Besides the direct costs associated with the purchase of stock the main expense of the liquor bond is salaries and wages. As with the rest of the public service there has been a substantial increase in staffing costs without any offset in productivity gain.

The main asset of the liquor bond is stock which at anytime is between $0.4 and $1.0 million. Average stock levels through out the year are $0.5 million with a substantial spike in the lead up to Christmas. The only capital requirements in the next five years are a new shop fit-out and carpet ($50 thousand), delivery truck ($25 thousand) and a website ($10 thousand). Negotiations are currently underway to establish a duty free outlet at the airport; this should not have significant costs over and above a shop fit-out ($50 thousand).

4.6 NORFOLK TELECOM

	Actual		Forecast		
	2003/04	2004/05	2005/06	2006/07	2007/08
Revenue	3,786,179	4,124,957	3,413,000	3,396,000	3,423,000
Expenditure *	2,049,382	2,140,313	3,268,000	2,230,000	2,279,000
Net Position	**1,736,797**	**1,984,644**	**145,000**	**1,166,000**	**1,144,000**
Capital Requirements	n/a	n/a	809,300	-	1,000
Dividend to NIG	1,940,000	92,000	n/a	n/a	n/a
Dividend as % of Revenue	51%	2%	n/a	n/a	n/a

* Excludes Depreciation, Management Fees and Dividends paid to the NIG

Table 11

Norfolk Telecom provides the public with both local and international telecommunications services. These services include the provision of local public switched communications, international direct dialling (IDD) and the operation of the Norfolk Telecom ISP (internet service provider). The provision of off island telecommunications is made possible via an operating agreement between Reach Global Services Limited and the NIG.

4.6.1 Financial Position

Norfolk Telecom does not charge for local telephone calls but instead charges an over inflated per minute price for IDD calls. It is perceived that having such a pricing structure will enable the revenue from IDD calls to compensate for and provide the ability to have free local phone calls, thus targeting tourists as the main source of income. This strategy has enabled Norfolk Telecom to consistently pay a dividend in excess of $1 million to the NIG.

The operation of the Norfolk Telecom ISP has proved to be another major source of revenue for Norfolk Telecom. During the 2004/05 financial year Norfolk Telecom has implemented ADSL broadband to supersede the old dial up service and provide a faster, more reliable internet connection.

At present Norfolk Telecom has a contract with Reach Global Services who provide the satellite telecommunications link for both inbound and outbound IDD traffic. The operating charges from the Reach Global Services contract make up the largest source of expenditure for Norfolk Telecom. Since its inception more than four and a half years ago the charges under the 'Reach contract' have become somewhat burdensome for Norfolk Telecom. The pricing under the current contract is higher than the current market price for such services. However, the 'Reach contract' is due to expire in April 2006, at which point Norfolk Telecom has the ability to negotiate a new contract with another carrier.

Staff salary and wages costs are the second largest item of expenditure for Norfolk Telecom and constituted some 27% of all expenditure over 2004/05. Staff costs have been consistently high, growing at an average rate of 5.3% during the past four years.

The NIG commissioned a report to develop a ten year strategic telecommunications plan for Norfolk Telecom. The plan recommended the implementation of Broadband technology as well as a GSM cellular mobile network. As a result, Norfolk Telecom has recently introduced ADSL Broadband technology to the island at a speed of 128 Kbits/s. Broadband is now available to the majority of the island with only a handful of private residences not being included in the coverage as the investment in infrastructure to include these properties far outweighs any future returns.

In the very near future Norfolk Telecom will be requesting tenders for the implementation of a GSM cellular mobile network on the basis of the recommendations outlined in the strategic telecommunications plan. It is envisaged that initial installation costs of the GSM network will be in the vicinity of $800,000.

Although Norfolk Telecom consistently produces profits in excess of $1 million, these profits are generally transferred to the NIG to fund other government operations. As Norfolk Telecom has not been able to set aside its profits for future capital requirements it is unclear how the installation of the GSM network will be funded.

4.6.2 Risks and Issues

As Norfolk Telecom is highly dependant on IDD call charges for revenue, it is imperative that the illegal use of voice over internet protocol (VoIP) software such as Skype is kept to a minimum. VoIP software enables users to make free international phone calls via a computer and internet connection, thus bypassing the toll on IDD calls. There is a real possibility that the use of VoIP software will seriously erode the profits of Norfolk Telecom on which the NIG relies heavily to provide funds for the Norfolk Island community.

The recent 'Norfolk Telecom – Ten Year Strategic Telecommunications Plan' report shows the projected profit and loss for Norfolk Telecom to 2015. However, we have a number of reservations over the financial viability of this plan. These reservations centre on the optimistic projected revenues for both the proposed GSM network and ADSL Broadband network. We would recommend further evaluation to ensure the validity of the numbers and the assumptions made within the report to arrive at these projections.

4.7 Norfolk Island Airport

	Actual		Forecast		
	2003/04	2004/05	2005/06	2006/07	2007/08
Revenue	1,970,428	2,264,822	1,684,000	1,772,000	1,772,000
Expenditure *	1,009,872	1,541,672	1,809,000	2,907,000	2,920,000
Net Position	**960,556**	**723,150**	**(125,000)**	**(1,135,000)**	**(1,148,000)**
Capital Requirements	n/a	n/a	12,039,700	-	250,000
Dividend to NIG	90,000	285,000	n/a	n/a	n/a
Dividend as % of Revenue	5%	13%	n/a	n/a	n/a

* Excludes Depreciation, Management Fees and Dividends paid to the NIG

Table 12

The Norfolk Island Airport consists of two asphalt sealed runways, an asphalt sealed apron from the primary runway leading to the airport terminal and the terminal itself. The operation and management of the airport was handed over to the Norfolk Island Legislative Assembly in 1991.

Current airport traffic includes regular public transport (RPT) airlines servicing the island and various other non RPT airlines and light aircraft. The two major RPT airlines are Air New Zealand which utilises a Boeing 737-300 from Auckland and Air Nauru that operates a Boeing 737- 400 from Sydney and Brisbane. The Air Nauru flights have been chartered by the NIG following the collapse of Norfolk Jet Express in early June 2005. The details of these charter flights are outlined in the section entitled 'Air Nauru Charter Flights'.

The airport receives the vast majority of its income (95.8%) from RPT landing fees based on a per passenger charge. These landing fees are included in the taxes, levies and charges paid by each passenger upon purchase of an airline ticket to Norfolk Island. The remaining income received by the airport is made up of smaller inflows such as income from investments and security screening charges.

As a result of Norfolk Jet Express collapsing on the 3rd June 2005 the Norfolk Island Airport has reported $473,000 of bad or doubtful debts. The debt is in the form of landing fees owed to the airport by Norfolk Jet and a minimal amount, if any, is likely to be received from the Norfolk Jet liquidators.

During the past five years the Norfolk Island Airport has made a cumulative deficit of more than $1.3 million which has been funded by accumulated surpluses. As a consequence, the airport has been unable to 'put aside' any cash for future capital requirements. As a result, now that resurfacing of both runways is required the NIG has found it necessary to finance this project through a $12 million loan from the Commonwealth. The loan is essentially an interest free loan (subject to several conditions) that originally required repayments on the first day of June and the first day of December in each year commencing on 1 June 2006 to 1 December 2015. The original agreement also stipulated that the NIG should make yearly deposits in to the 'Runways Trust Fund' from 30 June 2006 to 30 June 2020 and that the total minimum amount deposited, including the projected interest should be no less than $17.5 million. Whilst the Australian Government has deferred both the repayments of the loan and contributions to the trust fund for 3 years, it would have been highly unlikely that the NIG would have been able to meet the repayments and deposit the required amounts in to the trust fund in the next two to three years. Furthermore, if the cost of the airport resurfacing project significantly exceeds the $12 million loan and additional funds are required, it is unclear as to where these funds will be sourced.

The airport apron leading from the main runway to the airport terminal is also due to be resurfaced but has not been included in the resurfacing work scheduled under the $12 million agreement. If the apron was to be included in the scheduled resurfacing work it would cost an estimated additional $800,000 as the work could utilise the same machinery as that used for the runway resurfacing. However, if the resurfacing of the apron was delayed it would cost an estimated $1.6 million as the large machinery would have to be re-sent to Norfolk Island in order to complete the work separately.

In addition to the resurfacing work the airport manager, as well as the customs and immigration manager has expressed a need to extend the airport terminal at an estimated cost of $125,000. It is currently believed that the customs and immigration area within the terminal is far too small to effectively process both inbound and outbound passengers. The extension of the terminal would allow customs and immigration officers to carry out their tasks more effectively.

4.8 IMMIGRATION AND CUSTOMS

The Norfolk Island Customs section provides an assessment and collection of customs duty payable on goods imported into the Island, border protection and arrival and clearance formalities for passengers, aircraft and ocean vessels.

The customs duty received from imports is a major source of revenue for the NIG and is closely linked to tourist numbers. It has typically generated revenue of $3.5 to $3.9 million per annum during the past five years, while expenses for Customs and Immigration are generally around $0.5 million. This trend is expected to continue in the foreseeable future despite revenues from customs duties declining by 11% over the past five years.

There are a number of capital requirements that have been highlighted by the Customs and Immigration manager. Firstly, both the immigration and the customs IT systems need to be upgraded at an estimated cost of $200,000. Secondly, a mezzanine floor is required at the Customs office at Burnt Pine at a cost of $45,000. Finally, as outlined earlier under the airport section, an extension to the arrivals hall of the airport terminal at a cost of $125,000 is required.

At present, goods imported are not held by customs until the relevant duty is paid. Instead, the goods are collected by the owners immediately after they have been landed and the duty is then paid at a later date. As customs officers are not able to reconcile physical items against invoices (on which the duty to be paid is based) there is potential for the importer to evade duties payable to the NIG. Consequently there is a need for a holding warehouse to be built so that imported goods can be held until such time as the duty is paid. This will ensure customs duty is paid on a timelier basis and customs officers will be able to reconcile physical goods with the invoices on which the duty is based. We are unable to determine the cost of building such a facility and have not included this in our capital projections.

4.9 WATER ASSURANCE FUND

	Actual		Forecast		
	2003/04	2004/05	2005/06	2006/07	2007/08
Revenue	527,166	612,945	563,000	573,000	583,000
Expenditure *	400,755	394,593	600,000	575,000	588,000
Net Position	**126,411**	**218,352**	**(37,000)**	**(2,000)**	**(5,000)**
Capital Requirements	n/a	n/a	147,000	147,000	147,000
Dividend to NIG	25,000	20,000	n/a	n/a	n/a
Dividend as % of Revenue	5%	3%	n/a	n/a	n/a

* Excludes Depreciation, Management Fees and Dividends paid to the NIG

Table 13

The Water Assurance Fund can be broken down into two sections, namely water assurance and waste management. The objective of the water assurance section is to develop, maintain and operate the Water Assurance Scheme as well as approve and inspect sewer connections and septic tanks. The Waste Management Centre provides a facility for sorting household and business waste for recycling and processing.

The water assurance fund obtains the vast majority of its revenue from two sources. The first is effluent disposal charges that are based on a per household fee for private residences and a per customer fee for commercial properties. These charges are generally increased in line with inflation. The second major source of revenue is the waste management levy. This levy was introduced during 2003/04 based on a flat fee of $15 per cubic meter of imported goods and has not been increased since its inception.

Salaries and wages constitute the Water Assurance Fund's largest expense with the majority coming from the labour intensive waste management section. The salaries and wages from this section represented 81% of the revenue received from the waste management levy during 2004/05.

In general, the Water Assurance Fund collects enough revenue to cover its day-to-day operating expenses. As a result, deficits have not exceeded $40,000 and surpluses have not exceeded $70,000 (excluding revenue from internal asset transfers) during the past five years. However, this has led to insufficient funds for capital investments, which in the past have been sourced from the NIG or through Commonwealth grants.

At present, the NIG has postponed $310,000 worth of the Water Assurance Fund's capital requirements. These requirements include plant and equipment for waste management and sewerage treatment as well as buildings and other infrastructure. In addition to this, the Water Assurance Fund requires $200,000 to establish a facility to turn sludge into garden fertiliser and a further $220,000 for various other small capital investments.

4.10 NORFOLK ISLAND GOVERNMENT TOURIST BUREAU

The Norfolk Island Government Tourist Bureau (Bureau) is a body corporate whose primary functions are to encourage travel to and around Norfolk Island, seek feedback on Norfolk Island tourism and offer advice to the NIG on any matters concerning Norfolk Island tourism.

The major costs for the Bureau are supplier and services expenses with 74% of costs borne from advertising, promotions and trade shows. There is prevailing thought within the NIG that greater expenditure in this area will lead to an increase in tourists. However, spending in these three areas has increased by 32% over the past four years while tourist numbers have increased by only 0.6% over the same period.

By far the largest source of revenue for the Bureau is the annual government grant from the NIG. The grant given to the Bureau for 2004/05 was $950,000 compared to the next largest revenue source, fees and commissions, which constituted $78,000 for the same year.

As a result of increased spending on advertising, promotions and trade shows without increased revenues (excluding the government grant) the Bureau has experienced losses for the past three financial years. These losses have been funded through increases in the grant from $826,000 in 2002 to $950,000 in 2005. In addition to these losses, liabilities of the Bureau have consistently increased, while total assets have decreased. This suggests that the NIG will have to fund the Bureau's ever increasing deficits if the current belief that tourist numbers hold the single key to the islands future economic success continues.

The Bureau does not have a large amount of capital infrastructure and does not plan to expand its current operations. As a result, both current and future capital expenditure is expected to be minimal.

5. THE RELATIONSHIP BETWEEN TOURIST NUMBERS AND NIG REVENUE

Both the NIG and the private sector on Norfolk Island are heavily geared towards tourism. Furthermore, the NIG is reliant on the private sector for additional revenue through the provision of services and various duties. As a result, sustained decreases in tourist numbers will lead to decreased direct revenue for the NIG and a shrinking private sector will compound the problem further.

Many of the GBEs consciously target tourists as their main source of revenue. This scenario is no more prevalent than in Norfolk Telecom where international calling charges are severely inflated while local calls remain free. Therefore, it comes as no surprise that an analysis of the relationship between tourist numbers and NIG revenues over the last ten years has revealed a positive correlation of 0.96. A correlation of such a high statistical magnitude indicates significant dependency and total elasticity. As a consequence, any minor changes in tourist numbers incur a proportional and almost immediate impact on government revenues.

With this in mind we estimate that tourists directly contribute a minimum of 50% of the NIG's revenue. We are unable to determine the revenue that is generated directly from residents who are dependent on tourism for their livelihood, however a reasonable estimate of a further 20% would not, in our view, be unrealistic.

The recent decrease in tourist numbers paints a bleak picture for the NIG given the strong correlation outlined above and the high percentage of NIG revenue derived from tourism.

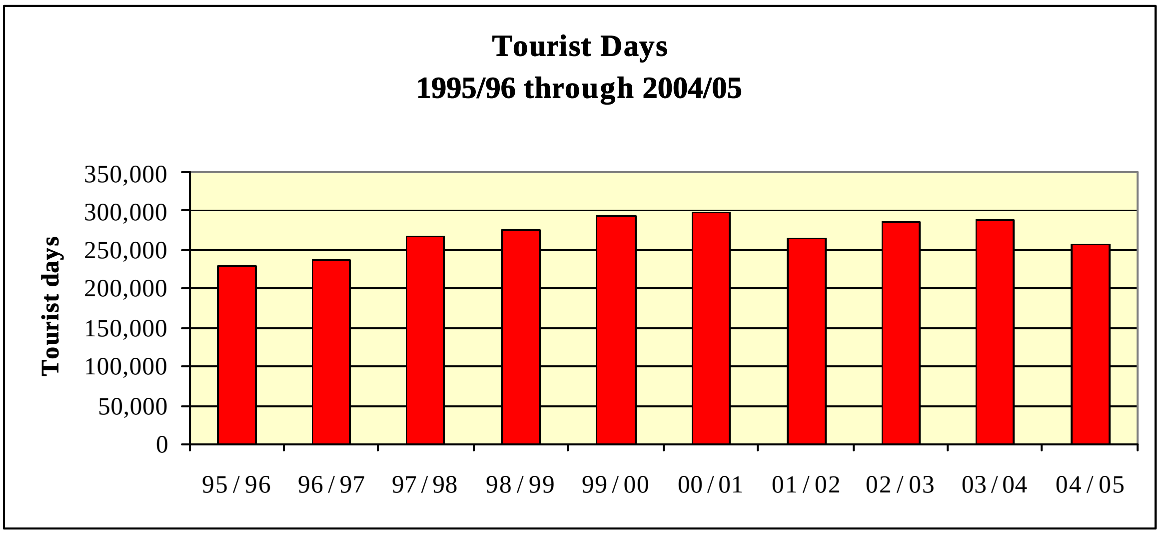

Diagram 14

6. QUALITY OF THE NORFOLK ISLAND GOVERNMENT FINANCIAL AND BUDGETARY INFORMATION

The relevant financial and budgetary information produced by the NIG is accurate, complete and adequate. However, the adoption of relevant accounting standards, true accrual accounting, more relevant management accounting and financial management techniques would enhance the financial decision making of the NIG.

There is a real need for stakeholders to be provided with relevant information on which to base their decisions. At present, only very limited, basic and high level information is produced. This information provides a general overview of the NIG but does not present financial information on which decisions can be made with a high level of certainty.

The budget developed by the NIG is an accounting budget based around levels of revenue and expenditure required to get from one year to the next. It is not a strategic economic statement in which holistic consideration is given to the achievement of long term macro and micro outcomes aimed at stimulating the economy, addressing pending social and environmental needs, providing for future generations and assuring long term sustainability and growth.