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Norfolk Island Government Financial Position: Update

August 2009

ADVISORY

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KPMG Econtech have indicated within this report the sources of the information provided. We have not sought to independently verify those sources unless otherwise noted within the report.

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The findings in this report have been formed on the above basis.

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This report is solely for the purpose set out in the Engagement Letter and for Norfolk Island Government information.

This report has been prepared at the request of the Norfolk Island Government in accordance with the terms of KPMG Econtech's Engagement letter dated 14 July 2009. Other than our responsibility to the Norfolk Island Government, neither KPMG Econtech nor any member or employee of KPMG Econtech undertakes responsibility arising in any way from reliance placed by a third party on this report.

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In the course of our work, projections have been prepared on the basis of assumptions and methodology which have been described in our report. It is possible that some of the assumptions underlying our projections may not materialise. Nevertheless, we have applied our professional judgement in making these assumptions, such that they constitute an understandable basis for estimates and projections. Beyond this, to the extent that certain assumptions do not materialise, then you will appreciate that our estimates and projections of achievable results will vary.

Contents

Executive Summary

KPMG Econtech (then Econtech) was commissioned in 2006 by the Norfolk Island Government (NIG) to examine their current and future financial position. As part of this analysis, KPMG Econtech constructed an economy-wide model of the Norfolk Island economy. The Norfolk Island (NI) Model provided the first comprehensive picture of the Island's economy.

The 2006 KPMG Econtech modelling showed that, under the existing policy, the NIG was expected to achieve a net positive operating cash flow position in each year over the five years to 2010/11. However, this net operating cash flow was not expected to be high enough to cover Norfolk Island's ongoing investment needs. It was estimated that, with no change to current policy, there would be an average annual budget hole of about $1.6 million over this period.

Since the KPMG Econtech 2006 analysis, the NIG has made a number of changes to its taxation and tourism policies. Thus, in 2008, the NIG asked KPMG Econtech to update its modelling to reflect the latest data available and to incorporate the new taxation policies and tourist initiatives. This update found that a higher number of visitors (related to the recent NIG tourist initiatives) were expected to lead to more tax being collected on the goods and services that tourists use. Higher economic activity (as a result of the higher tourism) was also expected to flow through to boost demand for goods and services provided by GBEs. These two effects were to provide an overall boost in the NIG's net operating cash flow in 2008/09.

However, since the 2008 update, tourist numbers have fallen as a result of the Global Financial Crisis (GFC). Further, the NIG has increased the GST to 12 per cent from 2009/10. In light of these changes, the NIG has again asked KPMG Econtech to update the modelling.

For this update, KPMG Econtech has produced a revised Baseline scenario that incorporates all new information to estimate the size of the Island's economy and the NIG budget. Specifically the Baseline scenario:

- incorporates all recent changes to taxation policy (including the 12 percent GST from 2009/10 financial year;
- includes a conservative tourist recovery path, with tourist numbers of 35,400 in 2007/08, 29,600 in 2008/09 and an estimated 29,000 in 2009/10, with catch up growth of around 10 per cent to reach 2007/08 levels again in 2011/12; and
- assumes real spend per tourist has grown (and will continue to grow) at 2 per cent per year since 2004/05, in line with rising living standards.

In addition to the revised Baseline scenario, KPMG Econtech has also provided estimates under a more optimistic tourism recovery path. The Higher Tourism Recovery Scenario examines the impact if tourist numbers recover more quickly to reach 32,000 in 2009/10, and then grow at 5 per cent in the following two years.

The modelling indicates that the sharp fall in tourist numbers is expected to have led to lower tax collections and economic activity in 2008/09. These two effects will combine to reduce government revenues, meaning that net operating cash flows are expected to be lower in 2008/09 than they would have been with stronger tourism.

Even if tourist numbers remain low in 2009/10, the increase in the GST is expected to prop up government revenues. With low tourism, the 12 per cent GST is expected to contribute to an estimated $3.4 million in net operating cash flow in 2009/10. This still falls short of the likely ongoing investment needs in Norfolk Island, giving a budget shortfall of around $1.3 million in 2009/10. It should be noted that, if tourism numbers recover more quickly in 2009/10, this would lead to a much stronger net operating surplus and a smaller budget shortfall.

However, under both scenarios, the drop in tourist numbers is expected to be temporary. It is estimated that when tourist numbers begin to catch back up to 2007/08 levels, they will boost GST revenues and contribute to an increasingly positive Net Operating Cash Flow position. Even under the baseline tourism recovery path, the average shortfall is expected to almost disappear, with a shortfall of only $0.1 million estimated on average over the next three years to 2011/12. Based on this, the NIG appears to be on a path to a more sustainable financial position.

1 Introduction

In February 2006, an inquiry into the governance arrangements on Norfolk Island was announced by the Minister for Local Government, Territories and Roads, the Hon Jim Lloyd.

As part of their contribution to this inquiry, the Norfolk Island Government (NIG) commissioned KPMG Econtech to examine the financial position of the NIG. KPMG Econtech's 2006 report showed that, while it was unlikely that the NIG's financial position was sustainable under their current policy framework, a few changes to its revenue and/or tourism policies should remedy this situation. In line with these findings, the NIG introduced new tax policies and tourism initiatives, including replacing more narrowly based taxes with a more broadly based GST.

In 2008, the Norfolk Island Government (NIG) commissioned KPMG Econtech to update its modelling of the Norfolk Island economy to reflect these new policies and to facilitate future projections. Since the 2008 update, the economic environment has again changed. The Global Financial Crisis (the GFC) has put pressure on tourism around the world, which is a major industry for the Norfolk Island economy. Further, the NIG has also recently increased the GST rate.

Thus, the NIG has again commissioned KPMG Econtech to update its modelling of the Norfolk Island economy to reflect the GFC induced tourism levels and the new GST rate. For this update, KPMG Econtech started by examining the NIG's current financial position under these changes. The analysis then presents updated projections of the NIG's future financial position.

Thus, this report is structured as follows.

- Section 2 outlines the findings in KPMG Econtech's earlier analysis.
- Section 3 provides a brief overview of the Norfolk Island Model (NI Model) and explains the steps undertaken during this update.
- Section 4 presents the current picture for the Norfolk Island economy and discusses the developments since the 2008 update.
- Section 5 presents estimates of the NIG's future financial capacity.

2 KPMG Econtech's Previous Analysis

In response to a number of studies into the Norfolk Island Government's (NIG's) future viability (Acumen Alliance[1], Commonwealth Grants Commission[2]), KPMG Econtech was commissioned in 2006 by the NIG to examine their current and future financial position. As part of this analysis, KPMG Econtech constructed an economy-wide model of the Norfolk Island economy. The Norfolk Island (NI) Model provided the first comprehensive picture of the Island's economy.

The NI modelling had a number of advantages over the previous studies. These advantages included the following.

- In the NI Model, GTP was estimated from both the industry and expenditure sides of the economy.
- The modelling captured both the direct and indirect impacts of policies.
- The model used an economy-wide approach, with consistent methodology. For example, there was consistent application of inflation across both expenditures and revenues.

The 2006 KPMG Econtech report showed that, under existing 2006 policy, the NIG was expected to achieve a net positive operating cash flow position in each year over the five years to 2010/11. However, this net operating cash flow was not expected to be high enough to cover Norfolk Island's ongoing investment needs. It was estimated that, with no change to current 2006 policy, there would be an average annual budget hole of about $1.6 million (in 2004/05 dollars) over this period.

The analysis also found that it was likely that this budget shortfall could be filled either by:

- increasing annual tourist numbers by around 10,000 visitors (boosting the economy); or
- raising the NSL rate from 1 per cent to 3 per cent (dampening the economy).

These two alternative policies would have the same result in terms of filling the budget shortfall. However, it was expected that they would have significantly different impacts on the level of economic activity on the Island. An increase in the number of tourists would boost activity across the economy. In contrast, an increase in the NSL rate would dampen activity across the economy.

In 2008, KPMG Econtech updated the Norfolk Island Model to reflect a number of changes that had been made in terms of taxation and tourism policies. In particular the NIG introduced a GST and had been implementing new tourism strategies. With these new policies, the 2008 update showed that the NIG's financial position had improved. However, there was still expected to be an annual budget shortfall of around $0.4 million.

With the world economy now affected by the Global Financial Crisis (GFC), the Norfolk Island economy is expected to feel the effects of reduced tourism. Further, the NIG has recently increased the GST rate. Thus, this report updates the NI Model to reflect these changes and

[1] Acumen Alliance, Norfolk Island Government Financial Advisory Report, November 2005
[2] Commonwealth Grants Commission, *Review of the financial capacity of Norfolk Island*, 2006

discusses what this all means for the Norfolk Island economy going forward. The following section provides background to the NI Model and information regarding the update.

3 The NIG Model Update

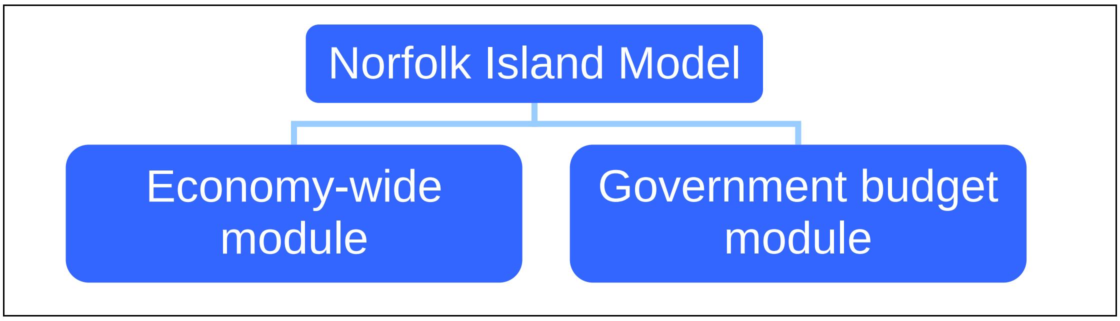
This section provides details of the methodology used in this report to estimate the current and future financial position of the NIG. It also describes the process undertaken and data used to update the 2008 modelling.

This section is structured as follows. Section 3.1 discusses the main features of the NI model, which is used to estimate the NIG's current and future financial position. Section 3.2 outlines the updating process.

3.1 The Norfolk Island Model

To estimate the current and future financial position of the NIG, KPMG Econtech constructed an economy-wide model of the Norfolk Island economy. The Norfolk Island (NI) Model is made up of two modules: the economy-wide module and the government budget module (as shown in Figure 3.1).

Figure 3.1: The structure of the Norfolk Island Model



As shown in the figure above, the NI model is an economy-wide model integrated with a budget model. This is distinct from a budget (or partial indicators) model that is driven by indicators that are not forecast in a consistent manner.

The NI modelling is based on "real" 2004/05 prices. In this way the modelling in this report avoids the problem of allowing for price inflation in some places but not others.

The two modules are each now discussed in turn.

3.1.1 Economy-wide Module

The NI model's economy-wide module uses an input-output model framework. It distinguishes the following 11 industries, which are largely based on the industry classifications used by the ABS in their Norfolk Island business survey.[3]

- Agriculture, forestry & fishing
- Mining, manufacturing & construction
- Retail trade
- Accommodation
- Cafés, restaurants & takeaway food services
- Clubs (hospitality), pubs, taverns & bars
- Travel agency & tourist arrangement services
- Government
- Government Business
- Ownership of Dwellings
- All other industries

In addition to industry detail, the NI model's economy-wide module also separately identifies 9 taxes, including the temporary NSL and the new GST:

- Customs Duty
- Accommodation Levy
- Norfolk Sustainability Levy (NSL)
- Norfolk Goods and Services Tax (GST)
- Vehicle Registrations and Licenses
- Departure Fees
- Financial Institutions Levy
- Fuel Levy
- Land Title Fees

The NI model's economy-wide module is demand driven. This means that activity across the economy depends on residents, tourists and government demand. This is reasonable for this model for two reasons, being:

- The Island can expand labour supply through temporary residents. It is understood that Norfolk Island currently has the ability to meet labour demand through its Temporary Entry Permits (TEPs) scheme.
- The tourism accommodation industry has spare capacity. Norfolk Island currently has 582 accommodation units[4] operating across varying standards of accommodation. While tourist numbers have recently ranged between 25,000 and 35,000, in the past (2000/01) the Island has successfully accommodated over 40,000 tourists.

[3] ABS, *Norfolk Island Business Statistics*, Catalogue no. 8139.0
[4] There is also another 12 accommodation units not operating/not yet developed, but with secured quota positions. This means there is currently capacity for a total of 594 units.

The economy-wide model provides a picture of the Norfolk Island economy under a Baseline (or current policy) scenario from 2004/05 to 2011/12. This picture is in terms of GTP by both industry (separated into the 11 industries outlined above), and by four expenditure categories (private final demand, NIG final demand, Australian Government final demand and net exports). It also provides data to the NI model's budget module.

3.1.2 Budget Module

The NI model's budget module is used to estimate the current and future financial position of the NIG. To do this, the budget module draws on data from the economy-wide module. This data is then allocated across revenue and expenditure items either directly or based on existing relativities.

The budget module provides estimates of the current and future financial position of the NIG under the Baseline (or current policy) scenario from 2004/05 to 2011/12.

For a complete picture of the implications of the current policy on the NIG, the budget module includes estimates relating to both General Government (Revenue Fund) and Government Business Enterprises (GBEs).

3.2 Model Specifications

To examine the current and future financial position of the NIG under the Island's current taxation policies and tourism initiatives, KPMG Econtech produced an updated Baseline scenario. This Baseline scenario includes the following assumptions.

- It incorporates all the recent changes to taxation policy (discussed further in Section 4). For example, while the original 2006 modelling incorporated a 1 per cent (compounding) NSL into its baseline, this updated Baseline scenario instead includes the 9 percent GST in 2007/08 and the 12 percent GST from 2009/10.
- It includes tourist numbers of 34,300 in 2006/07, 35,400 in 2007/08, 29,600 in 2008/09 as well as an estimated 29,000 in 2009/10. The modelling then incorporates a recovery in annual tourist numbers to reach 2007/08 levels by 2011/12. This is lower than the 2008 update projection (39,700 in 2008/09) due to a sharp decline in tourist numbers in 2008/09 brought about the onset of the Global Financial Crisis.
- It assumes real spend per tourist has grown (and will continue to grow) at 2 per cent per year since 2004/05, in line with rising living standards. This is the same assumption used in the original 2006 modelling, and the 2008 update.

In addition to the Baseline scenario, this analysis includes one alternative scenario.

The alternative scenario is designed to simulate a quicker recovery in tourism, with annual tourist numbers reaching 2007/08 levels by 2010/11. This scenario is outlined below and discussed in the main body of the report.

- The ***High Tourism Recovery*** scenario estimates the size of the Island's economy and the NIG budget if tourist numbers recover more quickly, to reach 32,000 in 2009/10, and then grow at 5 percent in the following two years. This differs from the Baseline scenario which assumes annual tourist numbers remain low in 2009/10.

The difference in the economic and budget outcomes between the High Tourism Recovery scenario and the Baseline scenario was provided to show the possible benefits of a faster recovery in tourist numbers.

The following section looks first at the current NIG financial position. The discussion in that section looks at what has changed since the last update, in terms of taxation policy and tourism, and what this is likely to mean for the Norfolk Island economy.

A more complete and detailed discussion of the Baseline results is then provided in Section 5.

4 The Norfolk Island Government's Current Financial Position

Following the release of the KPMG Econtech 2006 report, the Norfolk Island Government (NIG) has been working towards a more sustainable future. There have been two main areas of change in terms of tourism and taxation.

The NIG recognises the importance of tourism to the Norfolk Island economy, and has been putting in place strategies to attract more visitors. Since the collapse of Norfolk Jet Express in June 2005, the Norfolk Island Government has worked to maintain air services to Australia by establishing Norfolk Air. Norfolk Air is a government business enterprise (GBE) operated by the Norfolk Island Government. Norfolk Air initially provided direct flights from Brisbane and Sydney. More recently, Norfolk Air has expanded its schedules to include direct flights from Melbourne and Newcastle[5]. In addition, Norfolk Island has been working to strengthen relationships with travel industry partners and to focus more on the group and events market[6].

The NIG has also recognised the need to raise sufficient taxes to remain viable. In assessing the right mix of taxation in Norfolk Island, the NIG has removed a number of more narrow based taxes (such as the Accommodation Levy) and replaced these taxes with a more broad based Goods and Services Tax (GST).

Since the previous update, the onset of the Global Financial Crisis has sharply reduced tourist numbers visiting Norfolk Island. This makes it all the more important that the NIG continue to implement tourist initiatives and encourage visitors to return to Norfolk Island.

4.1 The NIG's Financial Position

The table below compares the NIG's current financial position (as reflected in 2007/08) with results from 2005/06 and 2006/07. The results in each year have been adjusted to remove variations due to price inflation. By presenting the results in constant 2007/08 dollars, this allows a direct comparison to be made across the years.

Table 4.1: NIG current financial position

NIG Financial Position (constant 2007/08 prices, $'000)			
	2005/06	**2006/07**	**2007/08**
Government Revenue	7,724	9,633	11,111
Government Expenditure	12,661	12,760	13,985
General Government Balance	-4,938	-3,128	-2,874
GBE balance	5,161	5,714	6,031
Net Operating Cash Flow	**223**	**2,586**	**3,157**

Source: Norfolk Island Government's Financial Statements

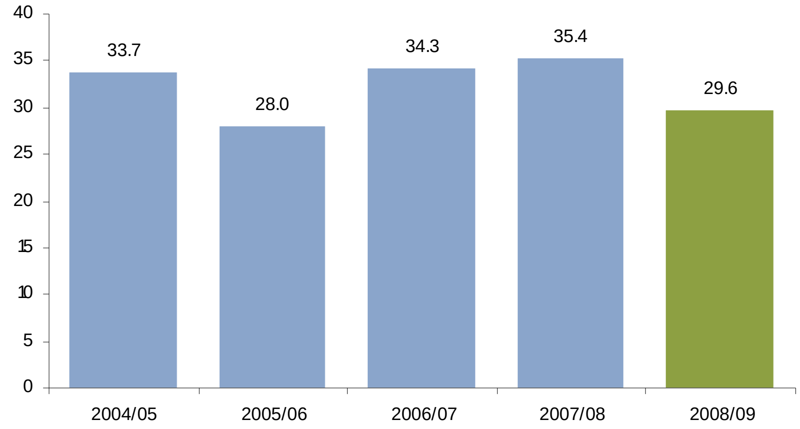
5 http://www.norfolkair.com/schedules.aspx
6 http://www.norfolkisland.com.au/special_features/21.cfm

As noted in the 2008 update, there has been a marked improvement in the budgetary position since 2005/06, and this has continued in 2007/08. Net Operating Cash flow increased by a further $571,000in that year, and shows that the NIG tax reform and tourist initiatives continue to work in helping the NIG ensure sustained viability. However, current indicators show that tourist numbers have fallen in 2008/09 as a result of the GFC. The following section discusses these tourist numbers.

4.2 The Impact of the Decline in Tourist Numbers

The Norfolk Island continues to rely heavily on tourism as a main driver of economic growth. The sharp drop in tourist numbers in 2008/09 have impacted heavily on the Norfolk Island economy. Figure 4.2a below shows the annual tourist pattern for Norfolk Island over the last few years.

Figure 4.2a: Annual visitor numbers ('000 people)



Source: Norfolk Island Model

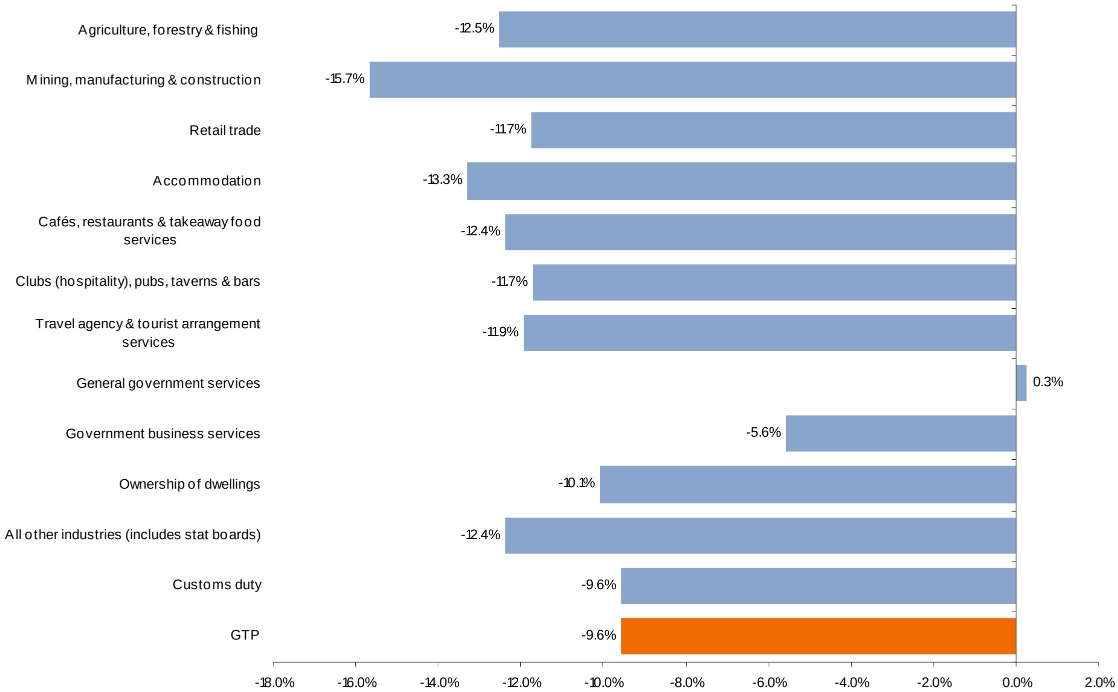
As mentioned in the 2008 update, there was a significant dip in tourist numbers in 2005/06 due to the collapse of Norfolk Jet Express. However, the establishment of Norfolk Air, combined with increased marketing activity, resulted in a strong recovery in tourist numbers in 2006/07.

During 2008/09, additional funding of $900,000 ($500,000 from external grant partnership funding and $400,000 from Norfolk Air) has been invested into tourism marketing. In addition, the NI Tourism Bureau has implemented a comprehensive marketing plan which should see more strategically focused marketing expenditure. This contribution to marketing is expected to continue into the future.

However, the recent economic crisis has dampened tourist activity across the board causing a sharp drop in tourist numbers in 2008/09. Despite this, the continuation of strong marketing campaigns in Norfolk Island is deemed essential to help stimulate a recovery in tourist numbers back towards the 40,000 levels it has seen in the past.

Figure 4.2b shows the expected impact of the decline in tourist activity on industry activity on the Norfolk Island economy. The decline in tourism, (with tourist numbers falling by around 16 per cent to approximately 29,639 visitors in 2008/09), is estimated to reduce GTP by around 10 per cent in 2008/09, compared to 2007/08. This effect includes both the direct and indirect impact of the decline in tourist numbers.

Figure 4.2b: Industry output (relative change since in 2008/09 compared to 2007/08)



Source: Norfolk Island Model

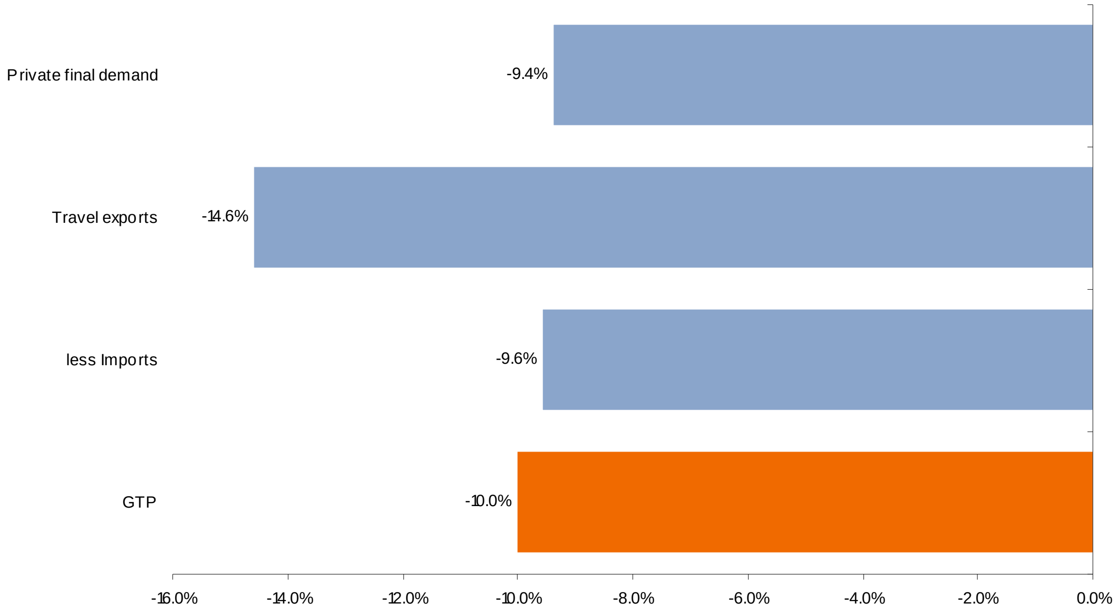
The <u>direct impact</u> occurs as lower tourist numbers will reduce demand for goods and services, such as accommodation services and restaurant meals. The figure above shows activity in the tourist related service industries (such as the Accommodation industry, the Café's, restaurants and takeaway services industry; the Clubs, pubs, taverns and bars industry, and the Travel agency and tourist services industry) is all expected to be around 12-13 per cent lower with the decline in tourism, compared to 2007/08.

This in turn will flow through the economy, resulting in lower demand by the tourist related industries for the goods and services that they use in producing their output. For example, in servicing a smaller numbers of tourists, the restaurants industry is likely to reduce its demand for ingredients. This means that there is less demand for, and consequently less activity in the food manufacturing industry. This, in turn, will flow through to result in lower demand by the food manufacturer for the goods and services that are used in the production of those restaurant ingredients. All of these flow-on (or <u>indirect</u>) impacts are captured in an economy-wide model such as the NI model.

Figure 4.2b above, shows that the industry losses (relative to the 2007/08) range from around 6 per cent for Government Business Services to 16 per cent for in the Mining, Manufacturing and Construction industry. The only industry to advance on 2007/08 was the General Government Services industry, which rose slightly by 0.3 per cent.

As discussed above, the decline in industry activity is driven by a decline in demand for industry output. Figure 4.2c below, shows the expected impact of a fall in tourist activity on demand in the Norfolk Island economy.

Figure 4.2c: Expenditure (relative change in 2008/09 compared to 2007/08)



Source: Norfolk Island Model

Figure 4.2c shows that lower tourist numbers mean lower travel exports by around 15 per cent. With less tourist spending across the economy, the decline in economic activity leads to decreased private disposable income. With less money to spend, consumption by Norfolk Islanders (private final demand) is expected to decline by around 9 per cent compared with 2007/08. Lower demand will lead to less local production and imports. Figure 4.2c shows imports are expected to be around 10 per cent lower, relative to 2007/08.

The following figure 4.2d presents the NIG overall position in 2007/08 and 2008/09 in order to discern the impacts of the decline in visitor numbers.

Figure 4.2d: The NIG overall position for 2007/08 and 2008/09 ($ million, 2007/08 prices)

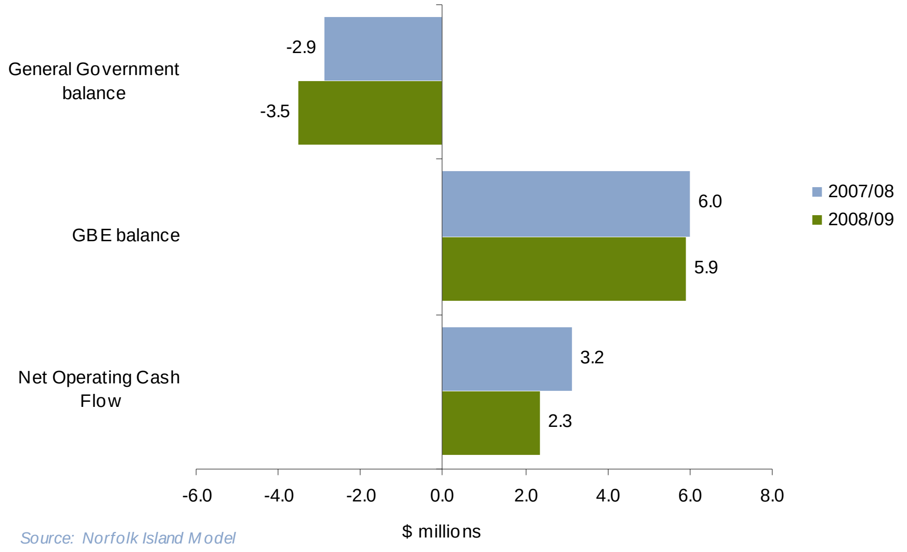


Figure 4.2d above, shows the expected impact of additional tourist activity on the NIG. The lower tourist spending in 2008/09 is expected to lead to less tax being collected on the goods and services that tourists use. In particular, GST collections are expected to be lower. This decline in taxation revenue will flow through to raise the General Government's deficit.

The sharp drop in tourist numbers has reduced government revenue, resulting in a higher General Government deficit estimated at around $3.5 million (an increase of $667,000). Lower economic activity will also flow through to result in lower demand for goods and services provided by GBEs. These two impacts combine to give an estimated Net Operating Cash Flow of around $2.3 million, which is $812,000 lower than in 2007/08.

5 The Norfolk Island Government's Future Financial Capacity under Current Policy Arrangements

The previous section examined the impact of the recent decline in tourist numbers. In particular, it compared the NIG's position in 2007/08 – when tourist numbers were around 36,000 – to the NIG's expected position in 2008/09 – when tourist numbers had fallen to around 29,000 as a result of the Global Financial Crisis.

This section looks at the NIG's future financial capacity under two alternative scenarios. These alternative scenarios vary in terms of how quickly tourist numbers recover. Figure 5.1 shows the two alternative recovery paths. Importantly, both scenarios incorporate the increase in the GST rate from 2009/10. The results under each scenario are then discussed in turn.

Figure 5.1: Baseline and Higher Tourist Recovery Scenarios ('000 visitors)

Source: Norfolk Island Model

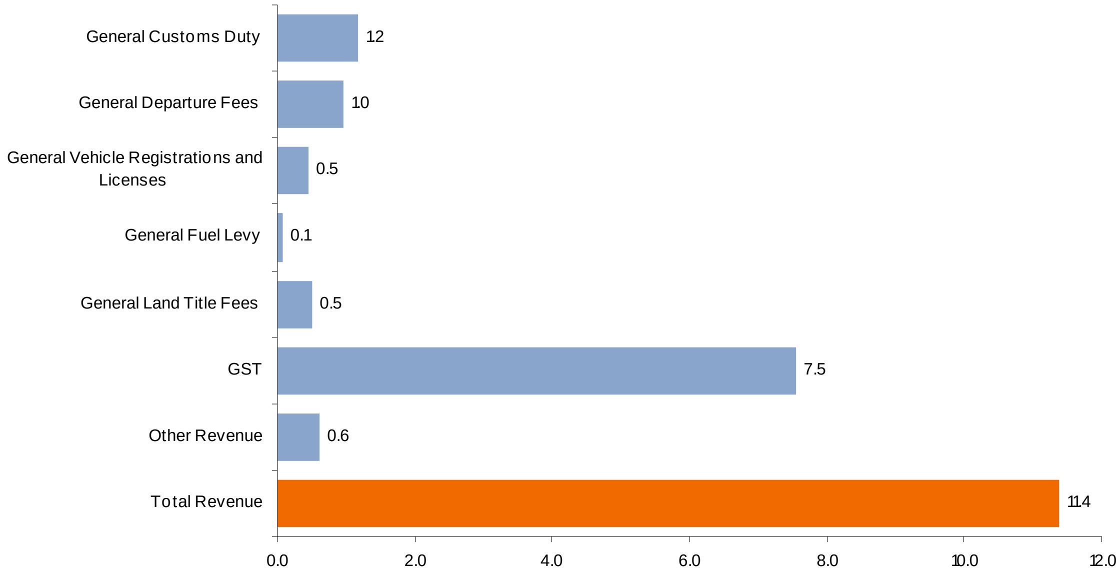
5.1 The Baseline Scenario

As discussed above, the Baseline Scenario looks at the NIG's future financial capacity under a modest tourism recovery path. The main difference between the 2008/09 results (discussed in the previous section) and the 2009/10 results under the baseline scenario will be the increase in the GST. The GST rate was increased to 12 percent in 2009/10.

5.1.1 General Government Revenue

The Island's estimated General Government revenue was examined under the Baseline tourism path and is presented in Figure 5.1.1.

Figure 5.1.1: NIG Revenue ($ million, 2007/08 prices)



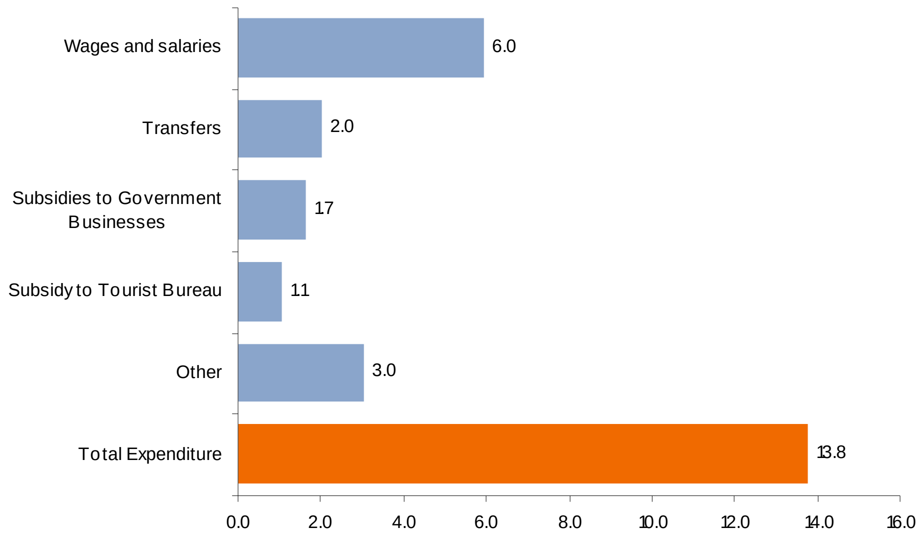
Source: Norfolk Island Model

Figure 5.1.1 shows that under the Baseline tourism assumptions, the Island's General Government revenue in 2009/10 is estimated at around $11.4 million. This is dominated by GST revenue, which is estimated to be $1.5 million higher than in 2008/09 at $ 7.5 million. This expected increase in GST collections is due a change in NIG taxation policy, which involved an increase in the GST rate to 12 percent in 2009/10. This is shown to account for all the increase in total revenue, indicating the importance of GST revenue to the NIG.

5.1.2 General Government Expenditure

Figure 5.1.2 looks at the Island's estimated general government expenditure in 2009/10 under the Baseline tourism assumptions.

Figure 5.1.2: General Government Expenditure ($ million, 2007/08 prices)



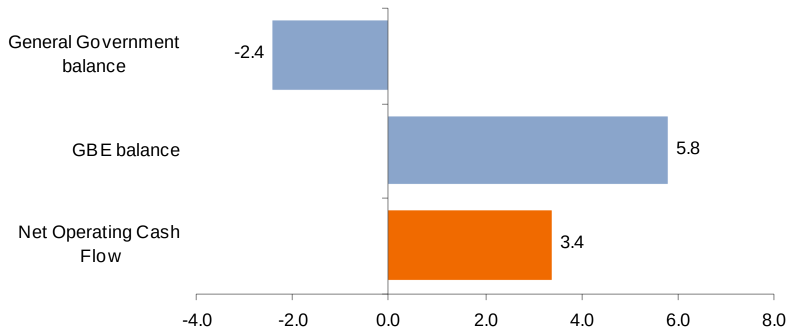
Source: Norfolk Island Model

The above figure presents the Island's expected general government expenditure in 2009/10. The $6 million spent on wages and salaries is expected to account for almost half the total $13.8 million in general government expenditure. The majority of the remaining expenditure is largely on transfers and subsidies to GBEs and statutory bodies. Overall expenditure patterns remain largely similar to the previous year.

5.1.3 NIG Net Operation Cash Flow

The resulting Net Operating Cash Flow for the Norfolk Island Government is presented in figure 5.1.3.

Figure 5.1.3: NIG Net Operating Cash Flow (2007/08 prices)



Source: Norfolk Island Model

Under the Baseline tourism assumptions, the NIG is expected to have a Net Operating Cash Flow in 2009/10 of around $3.4 million. This result is higher than the 2008/09 estimate by around $1.1 million. This improvement on the 2008/09 position is largely attributable to the increased GST revenue, as described above.

5.1.4 Meeting Ongoing Investment Needs

As shown above, the General Government activity is expected to contribute a net deficit of $2.4 million (with the Government's $13.8 million expenditure not fully offset by its $11.4 million in revenue). However, the GBE balance of $5.8 million in revenue offsets the deficit in the General Government balance, bringing an estimated positive Net Operating Cash Flow of $3.4 million.

As discussed in KPMG Econtech's 2006 and 2008 reports, the net cash flow will be used to cover the costs of likely ongoing investment. As such, it is not enough for the NIG to simply be in a neutral or positive net cash flow position. The net cash flow must also be significant enough to cover these likely investment needs. KPMG Econtech's 2006 report estimated that, at that time, a realistic annual public investment figure for Norfolk Island would be around $4 million (in 2004/05 prices). This would cover depreciation of current capital, and make allowance for new capital – to cater for both economic growth and the renewal of old infrastructure.

Using the 2006 estimates as a starting point, KPMG Econtech has updated its estimate of Norfolk Island's ongoing investment needs.

- In 2007/08 Norfolk Island's annual depreciation charge was around $3.1 million.[7] This is up slightly on the $2.9 million in 2006/07. Around $0.8 million of this **depreciation** charge can be attributed to higher Airport depreciation – arising from additional investment in the Airport. At the minimum, the cash flow surplus would need to at least cover the total depreciation charge.
- In addition, the cash flow surplus would also need to allow for additional infrastructure to cater for **economic growth**. The report estimated annual infrastructure investment requirements of around $878,000[8]. Assuming that the recent additional investment in the Airport will cover the Airport component of this annual additional investment requirement for a number of years, this leaves a requirement of around $588,000 to cover further additional annual infrastructure investment.[9]
- As discussed in the 2006 report, there is also a need to allocate funds for **renewal of infrastructure**. An annual allowance of around $1.5 million dollars[10] was estimated in the 2006 report (equivalent to 5 per cent of the current capital stock). Again, assuming that the recent additional investment in the Airport covers the Airport component of this annual renewal allowance for a number of years, this leaves an annual allowance of around $978,000 to cover further renewal of infrastructure.

[7] _The Administration Of Norfolk Island Financial Statements_, Year Ended 30 June 2008.
[8] The original report estimated annual infrastructure investment requirements of around $750 thousand in 2004/05 prices. This is equivalent to $878 thousand in 2007/08 prices.
[9] The new investment in the Airport is estimated to contribute to around one third of total capital stock on the Island. Thus, the additional investment is estimated to cover about one-third of ongoing investment needs.
[10] The original report estimated annual infrastructure renewal allowance of around $1.25 million in 2004/05 prices. This is equivalent to $1.5 million in 2007/08 prices.

Thus, KPMG Econtech's updated estimate for a realistic annual investment figure for Norfolk Island is around $4.7 million ($3.1 million + $0.6 million + $1 million). This would cover the depreciation of current capital, and make allowance for new capital – to cater for both economic growth and the renewal of old infrastructure.

Therefore, the NIG's estimated net operating cash flow of $3.4 million in 2009/10, falls short of the likely ongoing investment needs in Norfolk Island. With no improvement in tourist numbers, there is likely to be a budget shortfall of up to $1.3 million in 2009/10. Once tourist numbers pick up, the shortfall is expected to moderate, with an average annual shortfall of around $0.1 million estimated over the next three years to 2011/12 (under the Baseline scenario). This is an improvement on the 2008 results, indicating the NIG is progressing well towards the goal of a financially sustainable position.

5.2 The High Tourism Recovery Scenario

The High Tourism Recovery Scenario is identical to the Baseline Scenario in all respects, except it expects visitor numbers to pick up much faster. It expects visitor numbers to pick back up to 32,000 in 2009/10 and then grow by 5 percent through to 2011/12. This section will discuss the main divergences from the baseline.

5.2.1 NIG Future Position

For ease of reference, the following figure again compares the tourist recovery assumptions under the more conservative Baseline and the High Tourism Recovery scenarios.

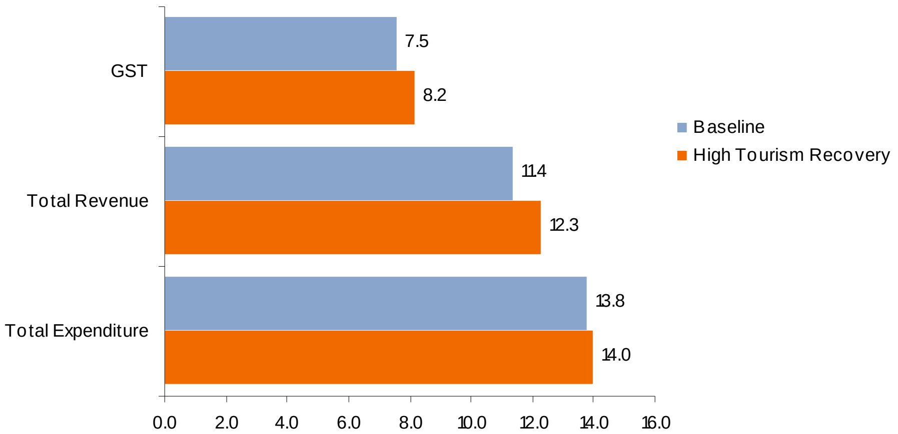
Figure 5.2.1a: Annual visitor numbers ('000 visitors)

Source: Norfolk Island Model

As can be seen, the main difference under the higher Tourist Recovery scenario is that in 2009/10, visitor numbers are expected to pick back up to around 32,000. In comparison, under the Baseline scenario visitor numbers are expected to stay low in 2009/10, at around 29,000.

The modelling shows that an increase in visitor numbers, combined with the GST increase, will dramatically increase NIG revenues. The main finding are presented in figure 5.2.1b below.

Figure 5.2.1b: NIG expected financial position in 2009/10 under High Tourism Recovery Scenario ($ million, 2007/08 prices)

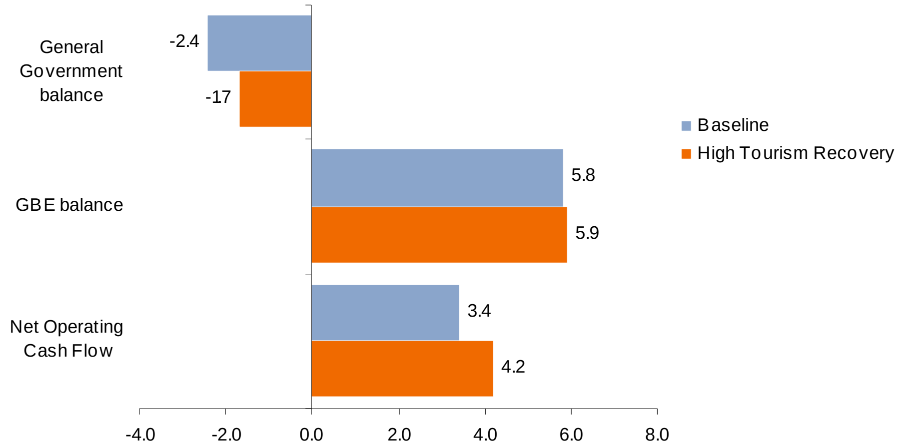


Source: Norfolk Island Model

Figure 5.2.1b shows that the $0.2 million extra expenditure under the Higher Tourist Recovery scenario is more than offset by an expected $0.9 million extra revenue. This increase in revenue under the Higher Tourist Recovery scenario is primarily through higher GST revenue of $0.7 million, driven by higher visitor numbers expected in 2009/10.

This higher revenue, compared to under the Baseline scenario, would reflect positively on the NIG's overall position. Figure 5.2.1c illustrates this likely impact.

Figure 5.2.1c: NIG expected overall position in 2009/10 under the High Tourism Recovery Scenario



Source: Norfolk Island Model

The above figure 5.2.1c shows that if tourism recovers faster than expected under the Baseline, the extra GST revenue would improve the Island's General Government balance to only record a deficit of $1.7 million (an improvement of $0.7 million). Combined with a slightly higher GBE balance of $5.9 million, the modelling estimates an more positive Net Operating Cash Flow Position (of $4.2 million in 2009/10) if tourist numbers recover faster than expected. This is a marked improvement on the Baseline by $0.8 million.

5.2.2 Meeting Ongoing Investment Needs

As discussed above, if tourism recovers quicker than expected (as shown in the High Tourism Recovery Scenario) this would lead to a marked improvement in the NIG's Net Operating Cash Flow Position. This, in turn, would improve the NIG's ability to meet ongoing investment needs.

The higher revenue, associated with higher tourist numbers, could improve the NIG's overall position (after depreciation and investment needs are considered) by around $0.8 million. This means that, with higher tourist numbers, the budget shortfall could be reduced to around $0.5 million in 2009/10.

Further, if tourist numbers recover more quickly, the modelling shows that it is likely that the Norfolk Island Government would be able to meet its future investment needs. More specifically, with higher visitor numbers, it is estimated that the NIG could achieve a modest average annual surplus (of around $0.3 million) over the next three years to 2011/12.