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AMQ International

Strategic Asset Management

SAM CENTENARY ISSUE:

Ten years from now will you look back on your asset investment decision and rue the day?
Ask the right questions now and ensure you are not left with latter day regrets!

*This issue is especially designed for **Elected Members and CEOs in Local Government** who have to face the hard investment questions without a neatly quantifiable 'bottom line' analysis to support them. But the principles can be applied to all who need to sign off on new investment proposals and live with the consequences! What do you need to watch out for, and why.*

INVESTMENT PROPOSALS - TEN KEY QUESTIONS TO ASK (& ANSWER)

1. **What is the purpose of this project and where does it fit within the corporate and asset management strategies?**
2. **Who benefits (which demographic, geographical, etc. groups) and what are the benefits that each group receives?**
3. **What are the annual costs of the proposal?**
4. **What are the costs per use/user/beneficiary?**
5. **Look ahead, what are the likely additional demands that this project will create?**
6. **Who will be disadvantaged by this proposal, how and how much?**
7. **What alternatives would achieve all/most of the benefits?**
8. **How is the project to be financed?**
9. **What are the risks?**
10. **What is the most appropriate service delivery option for this project?**

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BEFORE WE START: THREE IMPORTANT PRECEPTS

[1] Asset Investment Proposals may be highly technologically complex

But don't even try to assess the technical merits! It's not your job as an elected member or decision maker. This is staff work. Even as CEO, it is not your job! Sure, you need to run all the checks to ensure that the correct testing procedures have been adopted and that technical sign off has been gained at the appropriate level—and this level may be that of an external specialist or specialists. But getting bogged down in technological matters at board level is not productive, and it is not strategic. If you have doubts over the technical merits, send it back for clarification.

[2] Don't Ask Questions Where You Cannot Understand the Answers

The "Yes Minister" Version is that you should never ask a question where you don't KNOW the answer. That is somewhat limiting, but you do need to understand when the answer given needs further questions! **The key checklist questions are given on the front page. The next 4-5 pages looks at what you need to know to understand the answers.**

[3] Don't Accept Answers You Don't Understand

Ask that questions be answered without technical jargon. If 'facts' are given, ask for the source. (Be particularly careful to check demand forecasts). If 'opinion' is given, ask for the assumptions that underlie that opinion. This is not to discredit the person providing the answers, but to ensure that you understand what is being said—and the limitations of that response.

EXPLORING THE TEN QUESTIONS

Q.1: What is the purpose of this project and where does it fit within the corporate and asset management strategies?

All project proposals have some benefits – else they would not be proposed. But is it the best you can do with your limited funds? So ask how this project fits within the corporate and asset management strategies. Is it meeting a high value need?

> ***Example: The sheltered workshop was on brink of bankruptcy***. A fleet of minibuses that moved their clients from home to the workshop was one of their major expenses – and yet, this service ran absolutely counter to their stated objective of helping their clients to function independently in the world! When they realised this, dispensed with the fleet and focussed on helping their clients negotiate public transport, they were able to get back into the black – and achieve their outcomes.

What are your high value needs? Some councils can clearly state them, most cannot. (Determining what these high value needs are is part of the Step-by-Step program that is winning great acceptance with councils in South Australia.) However, even where they are clearly stated, the asset management plans and investment actions of council do not always follow their strategic requirements. This is often because projects are assessed 'on their merits' – rather by their contribution to organisation as a whole.

> ***Exercise: The Eternal Flame***. The council undertook to build an 'eternal flame' in an open space just off the main road of town, near the local library. The flame was to be a monument to town citizens who had fallen in war. Councillors should have been asking questions such as "Does this monument fit in with the character of the town and what the community wants?" (and how do we know?) and "What is the justification for this monument – social or economic?" (If economic, then how precisely is it foreseen that this will add to revenues? – what evidence is there to support the figures?) Other information that you may like to take into consideration as you ponder this one: The council is a rural shire and has roughly 200,000 residents. It is inland, on a main route to a coastal holiday resort from a regional city. It gets high traffic numbers passing through its town centre.

Be extra wary of all co-funded projects. Is the major reason for this project being proposed the fact that it can attract contributing funds from other sources (private or government)? We are often attracted by the 'something for nothing' option. This is why the Federal and State Government 'seeding' schemes work so well. Money is offered for special projects if it is matched dollar for dollar. If accepted, this has three consequences:

- Money is attracted away from council's objectives towards meeting the objectives (and responsibilities!) of another level of government.
- Councils are nearly always left with all of the ongoing costs, and
- When renewal comes around, the full cost is with council!

Example: Islander Wisdom: I heard a story about 15 years ago of a Pacific Island tribe that was offered an airfield by the USA as part of its defence policy. The Chieftain and his tribe considered the offer and asked "And will you maintain this airfield". "Well, no", said the Americans, surprised to have their generous gift queried, "You would do that". "In that case, said the tribe, "Thankyou but no". I would like to think that we all have the wisdom of these islanders.

2. Who Benefits, How, and What are the Benefits?

Benefits should be attributed and quantified. This does not mean dollars; it does mean estimating who gets what. Consider a road-sealing program, who are the beneficiaries and what is the nature of the benefits (e.g. reduced mud and dust been tramped into neighbouring properties – how many properties? Better quality of crops to market – how many crops, how much is the better quality worth to the farmers? Greater access to facilities – for how many people, how much greater?

Example: Proposal for floodlighting for night football matches. How many matches? Two matches a night on Tuesday and Thursday nights between April and September. Beneficiaries – Players? Teams? Spectators?

Exercise: The Eternal flame. Who would be the beneficiaries? When would they benefit, how, how much?

Don't buy the car when you only want the stereo system! Often proposals are presented in the form of 'package deals' with separable parts. Where one part has high benefits relative to cost, another part may actually be loss making. As long as the whole package has benefits greater than costs it is often accepted – but the wise investment decision is to pull these apart, select only the profitable parts and leave the rest.

3. What are the annual costs?

In other words what will this asset cost, on average, <u>for each year of its expected life</u> – this includes interest on the capital invested, depreciation, operations costs, maintenance and eventual demolition.

Example: The Public Barbeque. (The following actual costed example was provided by John Howard, while he was with Cairns City Council and was published in "Strategic Asset Management", No 72.) It shows how easy it is for ongoing costs to mount up so much that they exceed the initial capital cost. In this example, because of the very high costs of operations (power and regular cleaning) of the public barbeque, the actual annual costs exceed the initial capital cost.

CALCULATING ANNUAL COSTS—PUBLIC BARBEQUE EXAMPLE

	Capital	Annual Service Cost	Remarks
Capital	$8,000		
Annual			
- Interest		$640	8% p.a
- Depreciation		$800	10yrs
- Operations		$7,600	Power, regular cleaning
- Maintenance		$500	
- Demolition		$100	$1K @ 10 years
TOTAL	**$8,000**	**$9,640**	

This is not an isolated case. Take the "Eternal Flame". It capital cost was reported as $5,000 but after only six months of operation, the gas costs of operating the flame had run up a bill of almost $4,000! The "Eternal Flame" was thereafter only operated on special occasions – like ANZAC day itself and during special ceremonies.

Figures you can understand. When dealing with very large numbers – projects that cost many millions of dollars – often the only way to get your head around them properly is to convert to annual costs, and then to costs per use.

4. What are the costs per use/user/beneficiary?

If the project provides a range of services, eg a learning centre with library, conference facilities, local tourist information centre, etc., it is a useful exercise to apportion the costs between the various services. Even within one element, such as the library itself, this should be done – so that an appreciation of the costs per service can be obtained. The bigger and more complex the proposal, the more important this exercise is. In doing the apportioning, assumptions will need to be made and these should be documented. Do not accept the argument that this exercise cannot be done. Even less should you accept the argument that it would take time and delay the project! This exercise is crucial to the questions that follow.

> ***Example: The public barbeque***. In the costing above the annual service cost of one public barbeque was $9,640 per annum. This figure shocked the council because it was higher than the capital cost ($8,000) itself, but more shocks were to come. If the barbeque was used twice a day on average throughout the year, the cost of providing the service would be $13.20 per use. The judgement can now be made as to whether the users and/or the community (through subsidy) are willing to pay this cost per use.

The same cost per use calculations can be done for road sealing programs and for complex investments such as learning or entertainment centres or museums, art galleries and eternal flames.

5. Now look Ahead: What are the likely additional demands that this investment could create?

Try to visualise the asset in operation. If it is high tech, specialised expertise may be needed to operate and maintain it – ask yourselves whether this will be easily attainable and affordable. One organisation invested millions of dollars in a complex computer system. After 7 years they still did not have it functioning properly because every time their staff member became proficient at its use, they were attracted away by higher salaries paid in the private sector. In hindsight, the system was too complex for their needs and they were better off buying in the services of a bureau service. If you are a country council, some skills may be in short supply, consider this.

What are the risks? Some years ago while I was advising the Minister of Water Resources here in Tasmania, some councils were attracted to water and sewerage treatment facilities that required a high level of expertise in biochemistry to run safely. However, that expertise was hard to come by on the island. Without it, the community and council were at risk of unsafe practices.

What extra demands might this asset generate? Will this decision set a precedent? Will this decision set in motion a train of demands for related assets?

Foreseeable With thought, 'unexpected' problems can be foreseen. Consider the following scenario.

> ***The Public Barbeque Scenario*** The barbeque is built, but there is no shelter from the summer sun so a shelter needs to be constructed and bench seats provided. Extra rubbish bins need to be provided – with more regular servicing. Where eating areas are, there is a need for public toilets, so a toilet is provided.
> Already the simple cost of $8,000 for a barbeque has been multiplied manyfold.
>
> But it can easily get worse – the sheltered barbeque attracts a hooligan element late at night that keeps the residents awake with the noise and leaves broken bottles in the grass. The residents complain and the council puts up signs saying that use of the barbeque after 10pm is forbidden – but now has to police this rule, more cost. Inevitably, the day comes when a child is severely injured falling on a broken bottle while playing on the reserve and the council is sued. Etc. etc.

We don't have to prophesy doomsday, but many problems that occur are actually foreseeable.

6. Who will be disadvantaged by this proposal? By how much?

It is important to discover those who will be disadvantaged before the investment occurs, because fixing up problems after they occur is expensive and loses community goodwill.

Possible sources of disadvantage are: noise, environmental damage, traffic congestion, loss of amenity (view), loss of business, safety hazards.

7. Consider the alternatives. There are ALWAYS alternatives.

What alternatives are there that would achieve

- all/most of the benefits?
- the most important benefits?

at lower cost and risk?

Considering alternatives is easier once you have a clear idea of the high priority needs of council (Question 1); who benefits from the existing proposal and the nature of those benefits (Question 2); how much the investment will really cost in continuous, ongoing, annual cost terms (Question 3); what the cost per use is (Question 4); and have anticipated the future in terms of additional demands (Question 5) and the concerns of those disadvantaged by the proposal (Question 6).

Now council is in a position to select the elements of the proposal that are key to its objectives and to search for options that will increase the benefits and reduce cost and risk.

Example: Window Screens The facility manager was asked to put security screens on the windows of a particular building because of concerns for children's safety. But was this the best option? He argued that the screens were very costly, would not necessarily achieve the safety objective, and the windows did not need to be opened at all because the building was air conditioned, and if they were opened, it played havoc with the conditioning system. His solution? Nail the windows shut! Everyone gratefully agreed.

Beware the 3-Card Trick! When I was in the public service, the standard ploy to promote the favoured proposal was to present two unacceptable alternatives in the normal 'three alternative' format. A good indication that things are not what they seem is the tendency, under questioning, for the justification to continuously change.

Example: Police Housing The police department had many houses on its books and were looking to invest in more. Why? The rationale given was that police were frequently moved within the region and needed accommodation. When it was argued that rental accommodation was readily available in all areas, the justification changed to the need to have a permanent location that could double as a 'second' or 'defacto' police station. When this was challenged on the grounds that second police stations were not part of departmental policy, the real rationale eventually surfaced. Moving police officers at short notice was a disciplinary tool! Maybe holding a portfolio of houses is worth the disciplinary advantages, maybe not, but that is the question that needs to be resolved – and finding the question sometimes takes some searching!

8. How is the project to be financed?

Notice that this is Question 8 and not Question 1. Many projects may be eliminated long before this stage is reached.

Revenue/Expenditure Projections. The choices for financing are basically: Borrowing; Using Reserves: Displacement of other projects on the Investment Plan, or Outsourcing/Private Provision. How do you choose? It will largely depend on the shape of your forward expenditure and revenue projections. 'No man is an island' and 'No project stands alone'.

Over the next ten years, what are your revenues likely to be and what are the current, known demands on these revenues? No investment decision should be made without considering this expenditure/revenue profile. Require this projection to be updated and provided with each investment proposal. Look for evidence that re-investment /renewal requirements for existing assets have been accounted for. Check what assumptions lie behind the revenue projections. (e. g. do they assume continuation of the R2R funding?)

Remember, borrowing will add to future outgoings and constrain future recurrent expenditures in other directions; using reserves will increase risks and reduce financial flexibility; displacement of other projects will lose the benefits of those projects (are the benefits of this one higher?); private sector involvement .

9. What are the risks?

If this project does not go ahead, what will happen to community services and costs? If this project is delayed for one or two years, what will happen to community services and costs? Look for answers to this question in terms of service outcomes. (and see previous SAM)

10. What is the most appropriate service delivery option for this project?

It may be better to buy the service rather than the asset (see the computer system example above) Other alternatives are: purely private provision of the service; subsidized private provision, joint private/public partnership, full in-house provision. (See SAM 98: "Outsourcing: A Refresher Course" for fuller exploration of the issues involved here.)

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