

FUNDING RENEWAL

Lots in this issue, including:-

If you don't have a funding plan, you won't have the funds!

That is reality. See what is involved in constructing a funding plan **P. 904**

When can you safely—and advisedly—use borrowing to fund renewal?

And when is it very dangerous to do so? See debt management as an asset management tool on **P. 906**

Are debt ratios really necessary for management, particularly at a local government level, and when can they get in the way of good asset management decision making? **See p. 909.**

Should an Asset Manager Concern himself with Politics?

Dave Openshaw provides some cogent arguments why you should. **pp. 906– 907**

“THREE TO FIVE”

In a recent New Yorker magazine there was a semi-joking article about the Chambers Street subway control room fire in New York which knocked out two Manhattan lines in January. The first comment from the Transit Authority president said that full train service would not return to these lines for “three to five years”. Anyone dependent on commuter trains into a major city will understand that passengers and city politicians were less than impressed, and the estimate for time to resume service has now come down to months. What is interesting about the particular figure of three to five years, *is that all sorts of things are said to take the same amount of time*

Ruth Wallsgrove explores this issue, p 905

ACORN Live!

This Sunday evening—and every Sunday evening, 8-9 pm your local time at a computer near you.

Catch up with last week's discussion summarised on the back page, then come along and add your comments, suggest things that you would like to do, ask for help from others in pursuing better long term community decisions.

Researched and written by Dr Penny Burns, AMQ International.
Published fortnightly. Subscription, Comment, or Inquiries to

AMQ International
PO Box 75 Salisbury South Australia
Tel 618 8281 5795
Email: sam@amqi.com Website: www.amqi.com

FUNDING PLANS

Future Revenues

Is your revenue base expanding or contracting, at what rate? Why is this happening? (i.e. population movements in or out of your area) Is this something you can change or influence? Is it an even, continuous expansion or contraction or does it have its ups and downs? What is likely to cause these perturbations? Can you do anything about them? Can anyone else? (e.g. different level of government, and if so, what actions can you take?)

Future Non- Asset Demands on Revenues

What is your current non-asset demand (ie not capital and not maintenance or renewal)? Is this likely to increase or decrease over the next ten to twenty years? Why? How does the rate and direction of change compare with the rate and direction of change in future revenues?

Future Demand for New Assets and Services and Upgraded Assets and Services

How much are you currently spending on new and upgraded assets/services? Is this likely to increase/decrease? Why? What are the drivers? Is this consistent with your ten or twenty year forward Services and Assets Strategies? (do you have long term services and asset strategies?)

Future Demand for Asset Renewal

Do you have an asset renewal plan for the next 20-30 years? Do you know what you need to do, when you need to do it and how much it will cost? Do you know why you need to do it and what will happen if you don't? (e.g. do you have long term services and asset strategies?) Do you know how maintenance changes with the age of your assets? Do you know the life shortening impact of reducing maintenance on your assets?

Do your future revenues exceed or equal future expenditures?

If so, your funding plan is simple. If not, you will need to consider the following options

Reducing expenditures

- Changing funding priorities to renewal from new where appropriate; or from non-asset to asset expenditures (again, where appropriate)
- Not replacing assets when they are due (finding other ways to provide the service or changing/discontinuing the service)
- Extending the life of assets by increased maintenance where possible and appropriate (or by changing the level of service)

Caution: reducing expenditure on renewal without a plan for removing the asset from your portfolio will greatly increase risks of failure and legal liability issues as well as impact your duty of care.

Increasing revenues

Raising rate revenues and/or user charges (if your current depreciation is not being covered by revenues – i.e. you are running a deficit – then your current ratepayers are not paying their way and are transferring their costs to future generations.)

If renewal is not needed for a number of years but revenues need to increase to avoid deficits, then the extra revenues can be used to pay off debt and thus create more borrowing capacity later.

Borrow

Engage in a private-public sector partnership to provide added funds (but check the implied interest rate that you are incurring by this to ensure that straight borrowing is not a better proposition.)

Caution: Be sure that you know where you are in your *portfolio* asset renewal cycle. Borrowing is only recommended to smooth the peaks of renewal.

See diagram on page 906

(Remember: PPPs are also a form of borrowing and so cautions should also apply)

“THREE TO FIVE”

In a recent New Yorker magazine there was a semi-joking article about the Chambers Street subway control room fire in New York which knocked out two Manhattan lines in January. The first comment from the Transit Authority president said that full train service would not return to these lines for “three to five years”. Anyone dependent on commuter trains into a major city will understand that passengers and city politicians were less than impressed, and the estimate for time to resume service has now come down to months.

What is interesting about the particular figure of three to five years, the New Yorker points out, is that all sorts of things are said to take the same amount of time, from training an air traffic controller to getting comfortable with a new industry to settling step children in a new arrangement. It's not so much a worked out estimate, more a statement that something will take a long time. Not so bad as a decade, a generation or a lifetime, but long enough.

I remember realising that colleagues at an engineering company where I worked each had time frames they could deal with. For some, it was next month; for the long term planners, they could talk about eighteen months. For many on the front line it's this week. Beyond 18 months few of us really plan. Three to five years is a unit of time meaning longer than we engineers can really work out. (IT may work to a slightly different set of frames – no IT project is ever going to be longer than 2 years, and the major ones will be in by the start of the next financial year.) Three to five years, says the New Yorker quoting experts, is frequently seen as how long it takes to transform something – longer than the one to two years most Boards want to hear, I reckon.

To recognise that real asset management change does take time, from experience, several descriptions of Asset Management excellence suggest that you have to set targets for three to five years. Organisations need to plan for quick wins – projects that deliver something in eighteen months to two years, otherwise people lose trust that change

is happening – but the underlying plan has to be much longer. Those organisations that are very good at asset management seem to have taken more like seven years to get there. In other words, more like two lots of three-to-five, at least four lots of eighteen month quick wins.

However long it takes, time frames are clearly critical to the whole basis of asset management. Many assets have very long lifetimes – a decade, generation or human lifetime or beyond - and even short life assets need much longer planning horizons of development and replacement plans. One major struggle for whole life planning is to get an organisation (or an owner, or a regulator) to think beyond accounting periods. Another is to work with operators who inevitably need to focus on the immediate, what is happening today and what can be done about it tomorrow. We know that the further into the future we plan something, the less its importance to us today (because all sorts of unforeseen things may happen to change its significance).

How do we get comfortable with three to five years, and longer? Models probably help, because they do the estimating without us having to imagine it happening in practice. Writing down what you already know was always one of my favourite tricks for planning something complex and long – if you can get people past the fact that there will almost certainly be too many critical events and deadlines in the next six months and the whiteboard will look a mess long before you get to three years out.

Recognising what is and is not likely in shorter timescales helps. That new financial system probably won't be all done and dusted by April 1, and organisations don't turn themselves into good asset managers quickly. I cannot guess what I will be doing in three to five years, but I have learnt that it's likely to be something that I started working towards by now.

NY Transit Authority quickly changed their initial estimate, but the New Yorker is not reassured. The new estimate of six to nine months to resume normal service is, apparently, also familiar to experts – as the unit of over-optimistic planning.

Ruth Wallsgrove

DEBT MANAGEMENT IS AN ASSET MANAGEMENT TOOL

Borrowing is one of the ways in which agencies can manage renewal expenditure peaks.

If you know that your renewal expenditure is low now but about to increase, this is the time to pay off existing debt to provide borrowing scope for when it is needed. (see "A" in diagram below)

There are times when borrowing can help alleviate renewal peaks. (region ticked)

And there are times when borrowing will make the peak renewal expenditures worse. (region crossed)

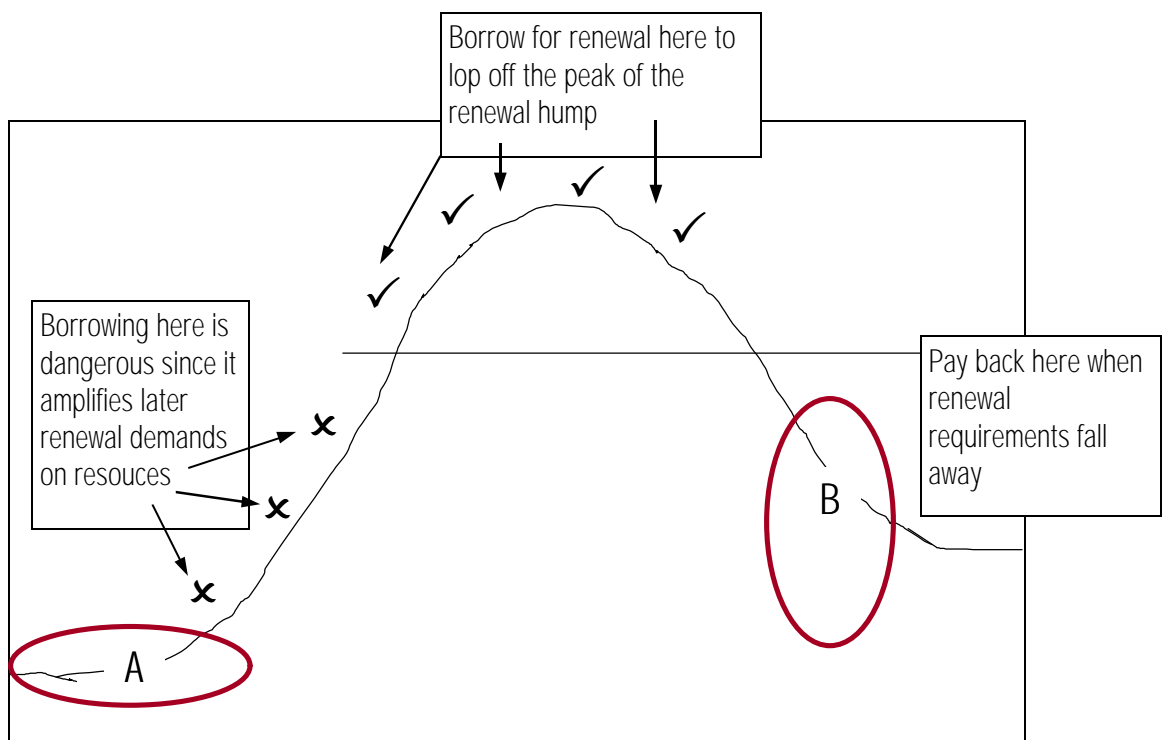
You don't want to size up your rate revenues to cope with temporary peaks. Borrowing at the peak enables you to pay off the loans when renewal demand falls off. ("B" below) Thus it evens out the demand on resources.

Borrowing at the beginning of the rise in renewal expenditures, on the other hand, requires you to make extra interest payments and/or repayments at the time when further increases in renewal expenditures are required, thus increasing the strain on your resources.

The critical thing is to know where you are on the portfolio renewal chart—and this means having a renewal plan.

Artificial debt:income or debt:capital ratios can limit your ability to use debt management in the most constructive manner. For the only two ratios you need, see page 909.

Note that after the renewal peak passes, you will be left with a higher renewal level than you had before—this is because the earlier renewal reflects a much smaller asset stock. If you have been adding to your asset portfolio over time, the new 'non peak' level will reflect these additional purchases.



Part 5: Political / Public Image

Why the Asset Manager should concern himself with politics and public image

Taking time out to consider issues surrounding 'politics' and 'public image' may not be the first item on a busy asset manager's agenda, and may even be seen as the 'cynical' side of business management; something that should be left to the 'PR guys' or 'spin doctors' (to use a currently popular term). However, these are important areas to address if we are to maximise our influence over business strategy.

The political pressures of today may become the statutory or regulatory requirements of tomorrow. So if the politics are swayed by incorrect or misinformed perceptions, then it is likely that the political pressures, and perhaps even new legislation, will not be optimally aligned with what we, as informed asset managers, know to be the real priorities. Involvement at an early stage can prevent regulatory 'difficulties' at a later stage. Public opinion (largely informed by the media) will also drive government policies, with the potential for occasional sudden changes in direction (or even 'U' turns).

Is your agency politically sensitive?

The energy industry is now at the heart of UK politics, with a new Energy White Paper having been published, reaffirming the government's commitment to renewable forms of generation as part of its strategy for energy sustainability and for reducing CO₂ emissions.

Hence, the UK government is taking a more active interest in the electricity industry, both as an enabler for increasing the portfolio of renewable forms of generation, and also in terms of supply security.

Apart from concerns over the long-term sustainability of energy policy, events arising from the recent well-publicised 'blackouts' in London and other major cities have given additional weight to the importance of infrastructure resilience. For example, predictions of worsening weather patterns (possibly due to global warming) by the UK Meteorological office, coupled with the performance of rural networks in severe storm conditions, gave rise to the UK government forming a 'select committee' to make recommendations on the need for storm resilience measures.

It is important that the Regulator 'stays in tune' with government and reflects these changes by creating the right regulatory incentives.

Politics is also about Perception

Politics is also about perception. And perceptions can change remarkably quickly – for example perceptions as to what constitutes good or poor service.

A very good illustration of this in the UK can be formed by comparing the consequences of two very severe storm events that occurred in 1987 and 2002. Both resulted in very serious damage to electricity networks with significant numbers of customers experiencing long interruptions to their supply. However, although the networks generally performed better in 2002 than in 1987, the customer (and media) perception was radically different. In 1987, companies were praised for their exceptional

effort in restoring supplies whereas in 2002 companies were strongly criticised for not reconnecting customers quickly enough.

The industry had failed to fully recognise that, in just 15 years, customers' tolerance for being without supply for extended periods had greatly reduced. Even the Regulator's many customer surveys had failed to identify the effects surrounding scenarios involving long periods of time without electricity. Had they done so, companies may well have reached agreement with the Regulator to increase investment to address some of the risks associated with rare weather events.

Poorly performing infrastructure is more than a customer issue

But the impact of poorly performing infrastructure is far more than a customer service issue. Our national infrastructures (transport and utilities) are our lifeblood or, perhaps a better analogy, the cardiovascular systems that enable that lifeblood to flow. Quality of life is influenced far more by the quality of our essential infrastructures than by personal wealth (you may find that hard to believe at first – but think it through and you will probably agree). As such, asset managers are in a unique position to help shape our future. Inadequate infrastructure (inadequate, that is, in terms of capacity, functionality, safety, reliability, etc. etc.) will constrain the performance of a country in exactly the same way that an inadequate cardiovascular system will constrain the performance on athlete.

And be in no doubt that our countries will need good 'athletes' if they are to remain competitive in this globally expanding business world. As such, our countries would benefit greatly from giving asset managers the respect they deserve. But deserving it is one thing, getting it is another. Being expert at our job is vital, but equally important is having the 'PR' skills to engage with and influence the decision makers and opinion formers, and this is the bit that asset managers need to work harder at.

Current Practice

Managing relationships with politicians is often left to a company's 'corporate' centre. It has become clear however that a much better understanding of how to react at times of change or crisis is needed across the business. More can be done at the local level if these links are established and nurtured. (df SAM 152 on Managing Reputation Risk).

Learning Points

- **Influencing Politics**

Political perspective can influence all parts of the business and therefore needs to be incorporated into our overall business risk assessment. Asset managers need to reflect the 'political' dimension in their asset risk management policies. But more than this, *they need to work hard at influencing the politics*. The greatest contribution that an asset manager can make is to bring a high level of objectivity to complement (or mitigate) the high level of subjective opinion that all too often influences politics.

- **Asset managers have a big responsibility to get their message across.**

But to do so, they must demonstrate a clear causal linkage between the performance of the infrastructure assets that they manage and the impact of that performance on customers, the general public, and ultimately the country's international competitiveness (and hence the prosperity of its subjects).

- **Understand that the viewpoints of others have merit**

This means not only understanding the business environment, *but also being able to empathise with the politician's point of view* and with those, such as the media, who may see things from a different perspective.

All you need are
TWO RATIOS
Manage these and thrive!

RATIO 1:

Annual Revenue > or = Annual Expenditure

This looks at the short term, it is your **cash flow ratio**. Manage this to **survive**—it doesn't matter how much money you are going to make in ten years time if you don't last out till it comes in!

Budgets are designed to manage cash flow and we generally do a pretty good job with them.

RATIO 2:

Annualised Revenues > or = Annualised Expenditures

This looks at the long term picture. Will you—over the long haul—receive more (or, at a minimum, as much as) you pay out? Manage this ratio **to thrive**

This is the ratio that tells you whether you are long term sustainable.

These are the only two ratios you really need. Debt ratios don't matter if you are able to clearly demonstrate that you are on the right side of the ledger with Ratio 2.

For that matter, capital and recurrent budget separation doesn't matter if this ratio is managed. It doesn't matter, for example, that you increase recurrent expenditure (maintenance) and, by doing so, save more in capital—because the annualised expenditures count both of them.

In the UK there has been much talk of a 'singlepot' of money, not artificially set up to distinguish capital and recurrent.

For this to work—it is annualised figures that need to be measured and monitored.

Annualised expenditures are simply the net present value of all expenditures over the planning period divided by the number of years.

How long should the planning period be? For councils, where demand and technology changes moderately fast, ten to twenty years is probably optimal. For water agencies, where change is very slow, a thirty year planning period makes more sense.

We have come a long way in calculating Annualised Expenditures.

Where we don't do so well is in estimating **Annualised Revenues**.

This requires consideration of the unknown. What will be the rate of growth of revenues—and what will be driving it? How will demand change over the next 10-20-30 years?

Annual budgets can be prepared by finance,. Annualised Expenditures can be prepared by engineers.

But Annualised Revenues requires understanding all of your client services, under a range of possible scenarios, including ones that you create yourselves by changing your asset portfolio mix and the standards at which assets and their services are maintained.

Estimating Annualised Revenues means estimating where the business as a whole is going—and this is a task that involves everyone in the organization.

These estimates are an important ingredient in the construction of funding plans that enable organisations to survive peak renewal periods. (see page 904)

ACORN Live! Every Sunday, 8-9 pm your local time

On Sunday, 10th April, ACORN Live! held its debut online meeting. We had contributors from all States in Australia and from the UK. Each week we summarise the previous contributions so that you need only read one paragraph on each topic to catch up and take your part, contribute your ideas. Here is last week's summary.

The mood of the evening was aptly summed up by Jeff Roorda in the following:

"This is a historic moment - the first early steps of sharing information online via Acorn.

I come from an Engineering Background but have a particular interest in helping our community leaders plan for our children. We have done many things with a short term focus eg environment, social, economic and many of our decisions on infrastructure assets have had a short term focus. I see Acorn being in a unique position to assemble the ideas and technologies of many to better understand the consequences of the past 100 years of decisions in order to plan for the future.

For example:

1. What if growth does not continue?
2. What if the demographics of the baby boom changes our land use and infrastructure needs
3. What impacts will global warming have on infrastructure?
4. Are our current structures of government, and especially taxation suitable to fund the renewal of the infrastructure boom that accompanied the post ww2 baby and growth boom?

Looking forward to the quest for answers

How can we develop these ideas? David offered to organise conversation cafes in Adelaide; Ernst had suggested a TV hypothetical. Ruth observed that TV programs on 'terrible things that can go wrong' e.g. ice caps melting, forests being decimated, etc are popular but usually conclude with 'someone must do something'. What about a TV panel that looked at the positive things that could be done? Say around topics like demographics (fewer people of working age around) or oil going short/ too expensive, I can think of some obvious people who'd be interested in being part of a panel. Anyone interested in training & education and for that matter trying to counter old fashioned views on immigration would be interested in the former; any Green organisation in the latter.

As for the how, writing a proposal/ pitch for a TV programme would be a great exercise. But running such a discussion with other interested organisations in the local community centre could be very interesting. Wish Ernst had suggested this before the UK election campaign had started, because it could make a wonderful fresh perspective on some key issues."

New Ideas

A skills development program that presents AM as an integrated solution to **balancing competing service objectives**, including environmental sustainability, economic health, social and cultural wellbeing, is what is needed to enable Asset Managers to develop their skills, broaden their horizons and take a larger part in addressing tomorrow's challenges, says Chris. *Any ideas on how we could progress this?*

Good governance is closely related to good Asset Management. Good governance is about making good decisions based on transparent processes with clear objectives and understanding of all stakeholder views, then implementing these decisions with clear goals, management autonomy and sufficient resources to deliver – and, in the end, accountability. Chris asks how we can develop the dialogue on governance and asset management to further the common goals. He points out that Ingenium in NZ have developed a DVD and training program for councillors in local government. Could this idea be taken further? *Any ideas?*

The Sim City Game Competition. Neville suggested we would need to determine what we wanted to gain from the competition and David offered to study the latest version to see what could be done with it

Discussions since the last ACORN Live!

suggest that our online discussion this Sunday night on the Sim City topic could be very lively! So please join us. Contribute to the ideas already on the board or suggest new ones, or just sign in to let us know that you are thinking! **Look forward to seeing you online this Sunday evening, 8-9 pm your local time.**