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STRATEGIC ASSET MANAGEMENT

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By and For Asset Management Leaders

REGULATING ASSET MANAGEMENT

- NEW ZEALAND EXPERIENCE

New Zealand has never been one for excessive regulation. Even after a collapse of their energy utilities that blacked out the CBD for many days and where some sections were not restored for almost three months, they did not follow the normal governmental knee-jerk approach and impose major regulation. They simply required that all utilities should prepare and publish an asset management plan - and then left it to the customers of the utility to monitor and apply appropriate pressure.

But in 2002, councils were required to prepare Long Term Council Community Plans (LTCCPs) to ensure that councils understood, and met, the service needs of their communities. The LTCCP requirements were quite detailed and complex and to support them, councils were required to prepare activity plans (or asset management plans where activities were asset intensive).

How has this level of regulation been received? Has it been a help or a hindrance to asset management and winning the hearts and minds of decision makers? In SAM 237 “The Right Debate”, I outlined some of the pros and cons of regulation. What has been the NZ experience so far? I was pleasantly surprised. See Page 2.

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What was the New Zealand experience to regulation in the LTCCPs?

Overall, I would say it has been positive. Better information has been obtained and people have had their eyes opened to the potential of asset management and better infrastructure decision making. For example:

From a Regional Councillor

> "When the LTCCPs were introduced, I hated them! Wouldn't have a bar of them!" said the Regional Councillor with quite some heat. But then his voice softened and, in an almost puzzled tone, he admitted " But now that we have worked our way through the 2006-16 LTCCP, I can see that they really are quite useful."

From an Asset Manager

> "I really appreciated our experienced Auditor who took the time to read through everything I had written and then discuss it with me. It was great to be able to discuss what I was doing with someone who was genuinely interested."

From both councillors and asset management staff

> "It is easier for staff to lock in elements in a ten year plan"

Pressure on Audit reduced potential value

With over 80 councils, each with an average of 5-8 plans supporting their LTCCPs, to attend to in a limited time frame the Audit Office needed to call on more than just its experienced auditors. It brought in auditors from overseas and used a number of new graduates, some of whom may have wished simply to have a couple of years of audit experience on their CVs rather than being fully committed to audit work. Whatever the reason it was these new auditors who were responsible for most of the angst.

> "Right at the last moment, the Auditor, a recent graduate, turned up with the requirement to make amendments. No discussion, just do it! None of the changes made sense. I argued, but my boss said just to give in and change them and let them have what they wanted."

Overall Council Reaction?

It seems that most of the leading councils took the exercise seriously, but there were those who took the perceived easy route (not necessarily to the satisfaction of the asset manager involved!)

> "We used a template prepared by one of the consultants. It was one of those check box things, and that's what we did, checked the boxes!"

Lessons from the New Zealand Experience?

- The quality and experience of the Auditors is key. The Audit Office has already begun to stage the development of the next series of LTCCPs to avoid the 2006-2016 problems.
- Light handed regulation (ie outcome guidance rather than specific practice requirements) brings out the most innovative and positive responses from councils and elected members.
- Time for dialogue is positively received by asset managers - last minute instructions are not.
- Good results take time! It will probably take about three iterations before all the lessons are fully incorporated in council's plans. Audit is continually 'raising the bar'.

For those of you thinking to apply "New Zealand" practice,

A little history may help.

From about 1984 to 1993, things in New Zealand were not good. Unemployment was running at around 12%, mortgage rates soared to 21.5% at one stage. It was in the middle of this period that accrual accounting was introduced, around 1987-89, but New Zealand was effectively broke and asset management at this time was lightly resourced and did nothing; there were no renewals and very low levels of maintenance.

But in 1987 a new attitude was taken by the Government; it decided its state owned enterprises were going to take on responsible commercial attitudes. It created a Minister for State Owned Enterprises, Richard Prebble. His book "I've been thinking" (or the second edition "Now it's time to act" 1996) is just about the funniest, yet at the same time, most enlightening, book you will ever read on the management - or mis-management - of infrastructure.

This was the time that New Zealand started to take itself in hand. The NZ Treasury model became literally world famous. By 1996, the Treasury was entertaining at least one foreign deputation a week! And there were a couple of smaller European countries applying the "New Zealand Model". Infrastructure decision making took off. It was no longer acceptable for government departments to 'muddle through', they were commercialised and then privatised.

At the local government level, asset managers in New Zealand learnt from earlier work carried out in Australia where the "National Asset Management Manual" had been developed for local government. A New Zealand version appeared, and then the local government engineering associations in both countries combined to produce the "International Asset Management Manual" which is now marketed across the world.

Because of the low level of renewals and maintenance up to the mid 1990s, it is not surprising that the early emphasis was strongly renewals focussed. This also influenced local government's approach to depreciation. They argued that since infrastructure assets were being constantly renewed, to depreciate as well as renew would be to 'double count'. The Auditor General could see the logic to this, but in effect said "prove it!". He told councils that they could count renewals towards depreciation provided that they could substantiate their claims to keeping up the asset by reference to a well developed asset management plan. This was the origin of New Zealand's adoption of 'condition based depreciation', the 10 year cash flow statements and asset management plans. Some years later, the accounting profession rejected this AMP based renewals figure and councils (albeit in many cases quite reluctantly) reverted to standard, mostly straight-line, depreciation.

Asset management really started to kick in in 1998. It had, as we said, a renewals focus. With the introduction of the Local Government Act, 2002, the emphasis had moved to a Capex focus. The trend is now to an Opex focus. The key issue is to embed asset management into normal council management practice. Some 'early adopters' are already here.

(my thanks to Ross Waugh who, over dinner, kindly pointed out the importance of history to a full understanding of current NZ practice. For a fuller story, see Ross' article in *SAM 176)*

Depreciation continues to fuel debate

The Myth of 'Double Dipping'

Councils continue to be concerned that raising depreciation on assets acquired via developer contributions constitutes an unfair impost on new ratepayers.

It is strange, as I do not hear similar concerns for assets purchased from reserves paid by *existing ratepayers* or even for assets purchased from borrowed funds. Yet these assets are 'paid for' by existing ratepayers, and existing ratepayers then pay for the depreciation.

When we are talking about *existing ratepayers*, charging depreciation is never regarded as 'double dipping'. Somehow we seem to understand that we are paying for the asset in the first instance, and for its continued renewal in the second (the making good of the wear and tear that happens through time so that the functionality of the asset is preserved).

There is no difference when we consider assets acquired by way of developer contributions. The *new ratepayers* who are the beneficiaries of the services of these assets pay for the assets in the first instance in the price of their house and land package. They then pay rates, which include depreciation, to ensure that these assets are maintained.

> If we wished to be purists, we could argue that the new ratepayers, far from being disadvantaged, are in fact being subsidised by existing ratepayers! With straight line depreciation, the depreciation paid each year is the same, whether the asset is new or old. New ratepayers pay the same as existing ratepayers for depreciation (if it is averaged out over all assets as it usually is, rather than being individually set per sub-division). So old and new ratepayers pay the same in depreciation - but the new ratepayers have the advantage of getting better service from their brand new assets! In terms of value for money, then, there is a subsidy from existing to new ratepayers. Now when you add on the diversion of general rate revenues to the growth assets required by the new subdivisions away from renewal of older assets, this implicit subsidy becomes even stronger! Makes you think, doesn't it? Is growth good for existing ratepayers?

Free Riding

> "We don't depreciate gift assets. We assume that when they come to the end of their lives, they will be replaced with another gift asset."

The conference participant making this comment did not make it clear whether 'gift asset' was synonymous with 'developer contribution'. In any case, this amounts to a 'free ride' for the current generation. Is that what we want?

Not a fund for renewal (despite the belief of many engineers to the contrary)

Gary Pritchard, speaking at Conferenz' LG Asset Management Conference in Auckland, made the point in his presentation that depreciation was many things but what it was not was a fund for renewal. Depreciation allocates cost over generations of users, it's rate of allocation should reflect the benefits received. It is a factor in the setting of prices (rates) and a means of guiding financial policy making. It approximates economic service potential decline. But it is NOT a fund for renewal. Neither is it optional. Accountants have been making this point for at least 20 years, yet still engineers find it difficult to believe. Why? Confusion could arise when councils are required to fund depreciation.

Funding of Depreciation.

In New Zealand councils have been required to fund their depreciation. The ostensible reason for this is to make it clear to council that depreciation is real, not merely a 'book entry'. But how are these funds to be deployed? This is often not at all clear. Many assume that the money will be put aside to replace assets as renewal comes due. But there is no obligation on councils to do this. There is, in fact, nothing to stop them from spending the money to acquire yet more assets, and charge more depreciation, from which they can buy more assets - and so on, ad infinitum. Or at least until their ratepayers rebel. Whichever comes first.

I have argued before that the safest, most transparent and accountable procedure is not to fund depreciation at all, but instead to fund (needed and justified) renewal. (*see SAM 202 and 203).*

Depreciation increasing as a proportion of Operating Costs

An interesting point from Gary's address was that depreciation is increasing as a proportion of operating costs. He quotes an increase from 13.5% in 1993 to 21% in 2006 because of a move from historic to replacement costs and price increases. He also argues that this proportion could double over the next ten years because of improving levels of service, increasing prices and increasing compliance and legislation.

However, will this actually happen? The move from historic to replacement costing is a 'once off' and it has already occurred and price increases (inflation) affect both depreciation and other elements of operating cost. So these two elements will not be influential in continuing to increase the proportion of depreciation in operating costs.

Increasing compliance and legislation is an important element and will surely impact the cost of replacement. But it is probably also affecting the way we operate and maintain. If so, these operating costs will increase and that is an issue that has to be coped with. But it does not necessarily lead to an increased proportion of depreciation.

We are also increasing our levels of service. But just because we intend to replace a tiny tin bicycle shed with a larger brick combination cycle storage and inclement weather play area, does not mean that we should now value the tin shed at the value of the new asset. This is surely to misrepresent the nature of replacement. By the new asset we are replacing a storage function and at the same time extending the asset.

Whether the increase in service levels is a compliance issue or a service issue, the replacement cost should be the cost of replacing the current service, not the augmentation. This is really a consequence of the fact that depreciation is the allocation of the cost, not a fund for renewal!

It is also true that as we start to account separately for short lived components of assets rather than assuming that they all have the life of the longest living component (eg houses equal 60 years), depreciation will increase. But the counter to this is that as we understand more about service levels, renewing to 'as new' is often not necessary. Much of our current 'renewal gap' may in fact be mythical. For a fuller discussion of this, *see SAM 215 and 216.*

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Capital Decision Making -

Should Councils think of themselves as Investors?

Ross Bauld, speaking at the Conferenz' LG AM Conference in Auckland, asked whether councils should think of themselves as investors. In other words, is it appropriate to consider the ratepayer as the equivalent of a shareholder in the council 'corporation'?

What difference does it make if councils consider themselves as investors or as service providers? Actually, a lot!

He points out that the tools that we commonly use such as "Payback Period", "IRR", "NPV" with aspects of the Capital Asset Pricing Model (CAPM) have been developed by financial analysts to identify the best investment decision. If we use these models, then the rationale must be that the best investment decision for the organisation must be the best for the shareholder/ratepayer.

This viewpoint is often not challenged. **But he suggests we consider the Investors View:**

- A dollar today is worth more than a dollar tomorrow
- The worth of an investment is measured by the value of the net cash flows generated
- The cost to the customer is of no relevance in the evaluation of an investment

[This means that benefits today trump benefits tomorrow so that the development of a stronger future community is not a concept that is well served by investment techniques. In a business, net cash flows are meaningful - but in a local government setting they may not be, depending on the flexibility of councils to manage cash flows. But it is the last point that is the killer for it suggests that if choosing between one large community facility that people have to drive to rather than several smaller facilities that they can walk to, the transport and convenience costs of the ratepayer have no bearing on the decision. Is this what we want?]

Ross looks at each of the common 'investment' decision models in the light of the three elements of the Investors' View and discovers that none are well adapted for a council whose purpose is to serve their community.

A dollar today is worth more than a dollar tomorrow

Discounted Payback - the original cost of the investment is divided by the annual discounted net cash flows to give the time to repay the original investment. The investment with the shortest payback is the favoured investment. Disadvantage: The calculation takes no account of returns after the original investment has been paid back so has the potential to discard investment which produce their best returns in later years.

The worth of an investment is measured by the value of the net cash flows generated

The Internal Rate of Return calculates the return on the cash flows allowing for both positive and negative flows and assuming that the annual flows can be lent or borrowed at the same rate as the overall average. Technically this can give a number of different answers unless all flows are net positive.

[The IRR can be misleading in another way as well. Suppose the IRR is 4%. That may seem small, but OK, (after all it is still positive!). What is not often understood with this model is that to appreciate the worth of the project you have to compare the IRR (what you get back) with the current market rate (the rate at which you need to borrow/or could invest). So if the market interest rate is 7%, the net return on the project is not 4% but actually -3%. Any IRR less than the market rate will make a loss.]

The Cost to the Customer is of No Relevance

The Net Present Value method is generally accepted as being the most robust investment analysis model. It calculates the value in today's dollars of the returns expected over the period of the investment.

But what should the discount rate be? The **Capital Asset Pricing Model** allows for the differential risk applicable to the project which is normally added to the risk free bond rate.

But what discount rate should be used for Local Government?

Is it:

- Rate of inflation?
- Council rate for debt?
- Ratepayers mortgage rate?
- The investment rate that the ratepayer could get if they invested in another project?
- Something else?

Local Government projects have benefits flows rather than cash flows

What worries Ross most is that none of the investment models take into account **the Customers Viewpoint**. And this should really be the distinguishing feature of local government projects which would hardly ever be judged on the basis of cash flows alone. While local government could undertake commercial projects, the current philosophy is that these are better undertaken by the private sector.

The customers viewpoint is more than the direct cost they incur for the service. It includes all the associated costs of travel, inconvenience, and costs to supplement the service where the quality is inadequate. Not relevant for an investor, maybe, (unless the field is highly competitive) but definitely relevant for an organisation set up to improve community welfare.

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How Do You Know?

or the Tao of Asset Management

In a certain country, the road planners said that their extensive country roads were under-utilised. "This is bad", said the Treasury.

"How do you know?" said the Asset Manager.

The planners sought to increase the utilisation by encouraging greater traffic flows and they were successful. "This is good", said the Treasury.

"How do you know?" said the Asset Manager.

The greater traffic flows led to increased pollution, accidents, and congestion. "This is bad" said the EPA, the Road Users Associations, and the Road Accidents Board.

"How do you know?" said the Asset Manager.

The road planners put in bypasses to move traffic away from the country towns. This increased traffic flow and reduced accidents and congestion in the townships. "This is good" said the road planners.

"How do you know?" said the Asset Manager.

The reduced traffic flow from the country towns reduced trade in the townships, businesses became non-viable and closed down and the local people had to travel farther afield for employment and purchases .....

For every action there is a reaction! It occurred to me some time ago that we cause a lot of the problems we face by signing off too quickly to a solution as "right" or "wrong" and we take too narrow a focus, looking only at our own, immediate, objectives.

We all need to follow the path of our proposal and try to anticipate how it may play out over time. And we need to stand ready to make adjustments to our policies or our proposals as new information comes to light. This means, essentially, that we need to take a program or process management approach rather than a project management approach where we sign off and hand over. In asset management, there is no 'hand-over'.

(This was originally published as an editorial in March 1995, inspired by Treasuries across Australia focussing on asset utilisation to the exclusion of other issues.)