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Take A Plumb Line!

Watch a bricklayer!

An amateur will happily charge along placing brick after brick only to discover at the end of the day that the wall has a distinct kink in it.

A professional will check regularly with his plumb line to make sure that the verticals are completely vertical and that the wall is going in the direction intended.

I think it is time for us to be professional and to take a plumb line to a number of issues that might be veering a bit off the vertical. Here are some that I think we need to stop and rethink.

- 1. What we talk to our communities about, and how we go about it*
- 2. Overstating or understating Full Costs*
- 3. Depreciation and the use of a complementary Renewal Fund - what you have to watch out for to avoid overstatement of costs*
- 4. Opportunity Costs - Overstatement occurs when you apply the cost rate to the wrong value amount.*

These issues were raised by readers - if you are worried about other issues that may be diverging from the vertical, please write - penny@amqi.com and let us start a dialogue that may help to straighten them up.

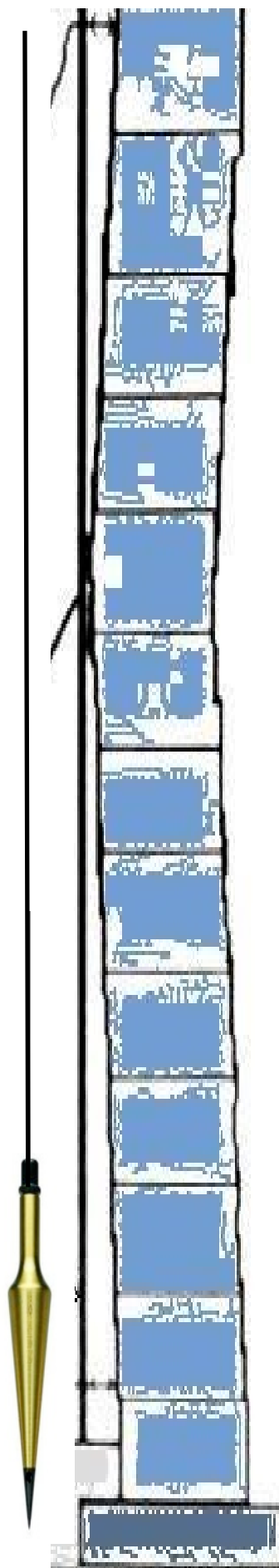
And see special message on the back about our Benchmarking for Beginners e-book in which YOU can feature.

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In the last issue, we looked at Demand Gap Analysis which requires you to understand what your community needs. If you don't understand this, you could be foisting on them assets that they do not want, do not need, and will resent you for providing. But how will you know if they don't talk to you?

Understanding your Community - when they don't speak to you!

How can you really understand your community if they ignore your press advertisements and letter drops and don't turn up to your town hall meetings? Most often the community reaction is 'why should I bother, the council will do what it wants to, anyway'.

This is a self-fulfilling prophecy. Community members do not respond, so council is forced to 'go it alone'. Next time, Council asks itself, why bother to ask the community, they won't respond. If not a vicious circle, this is at least a very unproductive one.

Are issues now too technical for the community?



I am sure that all councils have been in this position. And making things worse, as Sriya Fernando, Asset Management Engineer, Wide Bay Water in Queensland points out, our AMPs are now too technical for an ordinary person to understand. I agree, but by the time something is included in the AMP there is little likelihood that it will be changed. Council knows this and the community knows this, so - short of a major organised community backlash - we all know that we are all simply 'going through the motions'. A great waste of time.

Does consultation really matter? Don't we know enough about community needs to go it alone, anyway?



The short answer is YES it does matter and NO we don't know enough (despite councillors who frequently feel that they do.) I recall the case of a council that established a series of roundabouts to ease traffic movements - and they so greatly incensed the community that the whole council was thrown out at the next election! Sriya tells of a New Zealand council that replaced all its park benches and tables - without consultation - only to find that they were too small to meet the needs of the larger Maori physique. Maoris were a major element in the community and one would have thought that this issue, at least, would be obvious, but apparently not. *It doesn't pay to assume.*

We could be asking the wrong questions!

Technical issues are not fit subjects for consultation with lay people.

The community pays council to employ technical professionals and it has a right to expect that they do their job, and do it well. It is not the role of the community to check or validate the work of technical people. If you need this job done - why not pay another professional?

So what should we be asking the community?

We should be consulting the community on what they *want*, what they *can afford* and what they *are willing to pay for*. We should also be finding out what they *are willing to trade off to get something else*. These are not technical issues.



It is true that different technical solutions will have different outcomes. Thus, in addressing the need for a reliable supply of water, council may consider a desalination plant, stormwater recycling, or increased storages or storage capacity, amongst its options. Each option will have different outcomes in terms of safety, reliability, etc. The community needs to be informed - and to make choices about - these outcomes. But the information should be presented in clear, non-technical terms - *before you choose the technical solution and put it in your AMP!*

Should a technical AMP be publicly circulated?

Many councils are now taking the option of circulating a simplified version that concentrates on the issues and the outcomes, but making the full AMP available if required. Since the AMP should only be prepared *after consultation has taken place*, the role of this simplified AMP is *information only*. It is too late at this stage to ask for comment - you are not in a position to make proper use of it and the community know this, so it is hypocritical and an affront to their intelligence. And it is not surprising that little comment is forthcoming.



We shouldn't expect community members to put in their time for nothing!

“If a thing's worth doing, it's worth doing well - and it's worth paying for!” If you don't pay for community time then all you will attract are those people who are fanatics or have nothing better to do with their time. And you don't want either. So recognise that community input is not just a cost for you to organise but is also costly for the community in terms of lost time - and be prepared to compensate.

THE BOROONDARA EXPERIMENT. In the last SAM I referred to SAM 90, the Boroondara Experiment in how to get *valuable and informed* community information. This is **WHY** I think you should take the time to read (or re-read) this issue which is now available to you in the Archives. Informed and unbiased feedback from the community doesn't fall off trees - it has to be worked for. It takes effort but pays dividends many times over.

Boroondara first identified its service levels and its service costs. This was a major exercise taking about 5 months, involving much data collection and staff discussion. They then applied a 'value management' methodology for which a panel was recruited as an 'informed customer reference group'. 30 members of the public were randomly selected from a pool of citizens representing key community factors - employment status, gender disability, housing, location, etc. They were paid to take part in 6 half day sessions, first learning about the assets and then providing their input. See full details in Issue 90. A great example to follow!

FULL COST & DEPRECIATION

If you are asked to calculate the FULL COST for a new project, you will be expected to calculate

1. DEPRECIATION,
2. OPPORTUNITY COST and
3. RECURRENT, OR, OPERATING COSTS.

Difficulties can arise in all the calculation of all three! However, in this issue, I wish to look at only Depreciation and Opportunity Cost. (Further difficulties arise when looking to external costs but that discussion is for another time.)

It is important to get the full cost right, regardless of whatever charging mechanism - or even none at all - should be applied later. This is the amount that it is really costing your community to get the services that you are costing.



We **understate** full costs whenever we do not include all of the costs incurred. For example, if we exclude a grant from another level of government or from the community.

We **overstate** full costs when we *double count* elements in depreciation and opportunity cost.

Let us look to the sources of this double counting.

DEPRECIATION

It has been common practice to use a figure of 50 years as a notional life for buildings for the purpose of calculating depreciation. This is a *weighted average* of the short, medium and long living components of buildings in general.

For example, the South Australian Public Accounts Committee in 1985 calculated the average annual renewal cost of each of 26 elements of public housing and the weighted average renewal cost was 2.26% per annum (or just under 50 years) Coincidentally, the Commonwealth came up with the same renewal percentage using different methods but with the same philosophy of weighted costs.

Thus the use of 50 years as a notional life for buildings has good precedent.

But this does not mean that the building has a 50 year life.

In 50 years time, the long living elements (foundations, strength bearing walls, roof support and roof) may well be 50 years old - but almost everything else, all the shorter and medium term elements would have been replaced, maybe several times, and be much

younger. Any element with a 40 year life will have been replaced and be now only ten years old. All 20 year life elements will have been replaced several times and be now only ten or so years old.



So it is a short step - but a mis-step - to move from a 'weighted average life of elements' of 50 years to the statement that the asset is at the end of its life at age 50! You may wish to consider your own house for proof of the opposite.

The asset records need to be written down for depreciation (say 1/50th per year) but then *written up* each time renewal of components takes place. It is this second step that does not always get done. So we end up overstating accumulated depreciation and understating the value of our assets.

Or, conversely, we may add on the value of the new and replaced components but not remove whatever costs remain for the element just replaced and so overstate our values.

Take Care when using a Restoration Fund

Recently, some more advanced asset managers, have taken to ensuring the functionality of their buildings, particularly new buildings, by separately costing those short to medium term components that will need to be replaced within the next, say 15-20 years and creating a fund for their renewal - a Restorative Maintenance Fund. (This is in addition to routine maintenance, the normal yearly or bi-ennial maintenance activities which would be separately calculated.) This is excellent practice.

But it is important not to confuse such a Restorative Fund with Depreciation. They are not the same thing - for three reasons:



One: since we are continuously replacing the shorter lived elements through the Restorative Fund, they are not depreciating, but

Two: this does not mean that the asset as a whole is not depreciating; for the longer lived elements which are not being renewed *are* wearing out and becoming obsolescent. These elements need to be depreciated in the books, but only these elements.

Three: if the weighted average of all building elements is about 50 years; then if some are shorter than 50, others must be longer. Indeed, the longer lived elements of a building may have a life of 75 to 100 years.


It follows that if you are using a Restorative Fund you must also

- reduce the total value of the asset to which depreciation is applied (i.e. only the long lived elements)
- and increase the economic life to take account of the omission of short lived elements

Both of these things act to reduce the value of depreciation as a whole. If you don't do this whilst simultaneously using a renewal fund, you will *double count* and *over-cost*. (And if you are charging, this also means over-charging.)

DIFFERENCE BETWEEN 'COSTING' AND 'CHARGING'

By the way, Accountants will regularly say that Depreciation is NOT a fund for renewal. This often comes as a surprise to Engineers, who think that it is, or at the very least, that it *should* be!




In this case (sorry, Engineers!) the Accountants are right.

Depreciation is simply a cost. It is a cost that reflects the wearing out of assets - and this occurs whether we pay for it in our charges or not.

If depreciation costs are included in charges and revenues are raised to cover these costs, the revenues raised CAN be set aside for a renewal fund, *but they don't have to be*, and this is a financing decision.

OPPORTUNITY COST




Like depreciation, opportunity cost is another of those non-cash costs that are often not well understood. Omitted, they lead to understatement of costs. But *unless included in the right way* they can lead to overstatement.

The opportunity cost is the loss of the opportunity to use the resources tied up in the given asset for any other purpose. It is common to calculate this by reference to the risk free long term interest rate. **But to what asset value should this rate be applied?**

The short answer is:

$$\text{Opportunity Cost} = \text{\% Rate (usually dictated by your Treasury)} \times (\text{Land Value plus the } \textit{written down} \text{ value of the facilities})$$

Think of Opportunity Cost this way:



Imagine that instead of purchasing your asset you put your money in a bank and earned interest (the opportunity cost) on the amount. If you didn't use up any of that money in your account then you would earn interest on the TOTAL amount you deposited each year. BUT, if you were to withdraw a small amount of your initial deposit each year for your personal use, then only the remaining amount would generate interest. A depreciating asset is like withdrawing a small amount each year for use (= asset consumption).

It follows that to apply opportunity cost to the full asset amount, rather than the depreciated amount, would lend itself to significant overstatement.

It may seem counterintuitive to place a “read me first” file at the end of the issue - but how often do we do this in practice?

READ ME FIRST

A new series of e-books

Before the days of ‘plug ‘n play’ there was the ‘read me first’ file, and it kept me out of a lot of trouble when tackling new software. It is in this spirit that I have created a series of “Read me First” e-books.

They are not designed to tell you HOW to do something - there are lots of manuals and textbooks for that kind of thing - rather they are there to HELP YOU THINK THROUGH WHETHER, AND WHY, YOU WANT TO DO IT: to help you avoid the “*I wish I had known that before I started*” reaction.

Now book authors and service companies are enthusiasts. They are there to convince you of the benefits of their product or service and to encourage you to be an enthusiast too. And that is a good thing. But in their enthusiasm they may overstate their case.

Those that point out the difficulties or disadvantages might, and often are, doing so in support of another approach that they are promoting, so they may also overstate their case.

The end result is that even when we take care and do our due diligence, we can well be presented with biased information on both sides.

Now I am not promoting any cause - other than good asset management. I might be wrong in what I say, but I have no commercial stake in whether you take one side of the story or the other.

That’s why I have created a small series of “Read Me First” e-books. All being well, the first in the series “Benchmarking for Beginners” will be out at the end of November.

(for more information on this, see next page)

Other possible subjects include: *Performance Indicators for Beginners* and *Maturity Models for Beginners*

The e-books will be available for purchase from amqi.com but you can get them for free. If you believe that “Strategic Asset Management” is worth reading and subscribing to, please encourage your friends and colleagues to do so. When they subscribe, all they have to do is tell me who recommended them and both of you will get the first e-book in the series for free.

BENCHMARKING FOR BEGINNERS

now in production

Avoiding bias hopefully does not mean being deadly dull and boring. Having looked at many benchmarking models over the last 15 years, I do have views on what is useful and what is not. But to make sure that I do not fall into the trap myself of being either too negative or too positive, I am inviting others to be part of the story and to keep me honest.

And there is a role for you if you would like

- all who participate will receive a personally signed hard copy of the e-book!*

- If you have taken part in a benchmarking study and would like to tell me the **benefits** that you have reaped from your efforts, you could find yourself featured in this new issue. (but you can equally be anonymous if you prefer - your choice.)
- If you are planning to take part in a benchmarking study, and would like to tell me **what you hope to gain from it, ...**
- If you have a **good case study** on benchmarking that you would like to contribute, or a recounting of the lessons learnt from going down the wrong track ...
- If you feel strongly about **an issue** that should be raised at the beginning of thinking about benchmarking ...

..... You can write to me at penny@amqi.com , or if writing is not 'your thing' - then feel free to ring me on 08 8281 5795 and we can talk about it.

Finally, if you would be willing to read and comment on the draft

I would love to hear from you!

* Creating tomorrow's heritage today - pass it on to your grandchildren!