



A large part of the Strategic Asset Management task is Communication. And in this issue we deal with communicating with the media.

A recent news story (above) about Toronto City Council selling off its street lights and leasing them back has put the City Councillors on the back foot, fending off public criticism of the “rip-off”. On the face of it, you can see why the public are angry when the figures are stated baldly as selling off for \$60M and paying close to \$420M over the next 30 years to lease them back.

But **they** don't have your strategic asset management expertise! So in “Is it really a Rip-Off?” I ask: What could you do, working with your public relations people and councillors, to help defuse this explosive situation? (A surprising number of media issues for public infrastructure agencies are related to assets in some way. This is just a more obvious example.)

And then we look at the difficult - but important - issue of sorting out the relevant from the irrelevant - on the grounds that there is no point to buying into arguments when you don't have to!

Also: In ‘*View from the Coffee Shop*’ I look at the dangers of overconfidence in “Leave Room for Doubt”.

And, good news, our new website is now uploaded!

We hope you like it. We are working on a number of new features and hope to add them at the rate of about one 6-8 weeks, so - something to look forward to, keep your eyes open!

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View from the Coffee Shop

Leave room for doubt.



Read something the other day that has not let go of me since!

Here is the story. In 1993 a very successful American bond trader gathered together a few of his disciples and a handful of super-economists and set up a new hedge fund company that promised to be different from anything that had gone before. The new company *apparently genuinely believed that their ingenious computer models would allow them to bet on the future with near mathematical certainty* - and because their team had some high powered players - including two future Nobel Prize winners - *investors believed them*. Their company portfolio had grown to \$100 billion when a default in Russia set in train a sequence of events that the models had not anticipated. This placed the whole financial system at risk and the Federal Reserve quickly called in Wall Street's leading bankers to underwrite a bailout. Roger Lowenstein in "When Genius Failed" tells the whole fascinating story.

I was staggered to think that **anybody** - let alone the super intellects in that hedge fund company - could possibly believe that a computer model, *no matter how finely tuned*, could predict the future 'with near mathematical certainty'. And I was equally amazed that investors clever enough to have amassed the funds to invest, would *believe* them!

Then I thought of the asset managers I have met who so passionately believe in their models, that they brook no doubt, no exploration of better ways, no questioning. This may well start with *assuming* the confidence in order to convince financial backers in the organisation. But when it moves from confidence *in the potential*, to *absolute belief in the infallibility* of the model, a line has definitely been crossed. I have seen this unwarranted level of confidence also in treasury officials calculating industry risk profiles, or officers supporting algorithms so complex that few really understand them - but no one is prepared to admit that he/she is one of those who doesn't.

A phalanx of PhDs - in economics, engineering, or any other field - can *never* yield certainty. The whole rationality of any scientific endeavour is to be open to challenge. Nothing can ever be proven to be correct - the most we can ever say is that it hasn't been proven to be false - *yet!*

A few weeks ago I quoted Chris Lloyd's 'key message to the asset management community' - Asset Management should challenge mindsets. Indeed it should, but it can't, unless we are always prepared to **leave room for doubt**.

Do consider, and enjoy!
Penny

When your organisation is in the spotlight, what can you do?



In every serious media criticism you will need to do three things:

1. Deal with invalid comparisons
2. Establish the real ballpark for debate
3. Sort out the relevant from the irrelevant issues

--- and it is my contention that you are possibly better able to do this for infrastructure related issues than maybe anyone else in your organisation. Do it with grace - and allow others (your PR section, CEO, board, etc.) to take the credit and you will win yourself and your section much kudos.

Is it really a Rip-Off?

This particular example just happens to be from Canada; it could equally come from Australia, New Zealand, the UK or America.

Here are the facts as we know them.

In 2005, the City of Toronto, facing a sudden \$60M hole in its budget when the Province reduced its funding at short notice, made a deal with Toronto Hydro, a wholly owned trading enterprise of the City, to buy its street lights for \$60 M and lease them back to the City. The contract details have just been released showing that the City has agreed to pay \$13.6 M a year to lease back the lights. The Press is having a field day and the Council is on the defensive.

Additional fact: The City tried to block the release of the contract and it took 5 years for a Freedom of Information request to produce the information requested.

What questions do we need to answer?

There are a number, including: Is this a good deal for the City? for the Hydro? for the Community at large? For Hydro customers?

(there are also questions that are not strictly germane to this decision but that were brought up in the letters to the editor and in the related blog sites, and we will look at some of these in Section 3 -sorting out the relevant from the irrelevant issues.)

1. The Invalid Comparison

This is an example of what we may call “the invalid comparison”. Two figures, or situations, are posited and it is implied that they are comparable. **But are they?**

Consider

An example (easy): If you were told that before taking a certain diet pill, someone weighed 200 lbs and now weighted just over 90Kg your first reaction might be to notice the large difference in the numbers and say “Wow!” but this would only last for a split second before you noticed that different measures were being used. **You know it is important to make a like-for-like comparison**, so you would convert both to the same measure and then realise that the diet pill has caused no discernible difference at all.

A second example (more difficult): You will have met people who tell you proudly of the foresight of their fathers or grandfathers who ‘bought a house many years ago and it is now worth ten times what he paid for it!’ **You know it is important to make a like-for-like comparison**. so you would want to determine what has happened to the general price level over the period concerned before making a judgement on whether the real value of the house has increased or not. This is not such an easy conversion as pounds to kilos but it can be done.

A third example (very difficult): The comparison task gets more difficult when we are asked to compare a lump sum *now* with a series of annual payments *out into the future*, and impossibly more difficult for the non-specialist when the annual payments have to be adjusted for unknown amounts before an honest comparison can be made. But, again, **you know it is important to make a like-for-like comparison** so that is what needs to be done.

Here there are **TWO** clean up jobs to be done to make a fair comparison in order to answer the question: does the sale of Toronto’s street lights for \$60 M and their leaseback at \$13.6 M a year for 30 years constitute a good deal or a rip off? We have to remove any elements in the annual payments that are not also represented in the sale price, and then we need to find a way to express a time series and a fixed amount in a way that makes a clean comparison.

The annual payments of \$13.6 M will include the maintenance of the street lights that would previously have been paid for by the city but now has to be paid for by the Hydro out of the annual payment. **How much was this maintenance?**

The annual payment of \$13.6 M would also have to allow for the fact that over 30 years the assets will be ageing and ‘wearing out’. The wearing out is measured by depreciation. **How much is the depreciation?**

2. Establishing the Ballpark

For Toronto we do not know these figures (*however, if this were your organisation, if your AM is any good at all, you would!*)

But we can make some 'guesstimates' to put us in the ballpark.

Toronto has some 16,000 street lights. How much does it cost to maintain them each year? At this stage we don't know. So let us make an estimate, an assumption or place marker that can be checked.

What is the annual depreciation on these lights? Again, we don't know. So again we make an assumption - and this assumption can also be checked, corrected or confirmed against the records.

Note: If you were doing this exercise for your organisation, you would *still* start with 'ballpark' assumptions, finish the analysis - and *then* look for the evidence details.

If we assume that street lights typically last, say, 50 years, then depreciation would be 1/50th of the replacement cost, or 2% per annum.

But how much is the replacement cost? Another thing that we do not know. What we do know is that, in ordinary circumstances, it would be more than the sale value of the assets because the replacement cost is calculated by multiplying the number of street lights by the average *cost of replacing each light with a brand new street light*. And the street lights sold were not brand new but rather partially worn out. We could make the assumption (again to be checked against the facts) that the street light portfolio was on average 50% consumed and that the sale value was fair value. (Of course, it may not have been but this is where we start.) On this basis the replacement cost of the lights would be \$120M and Depreciation (at our assumed 2%) would be \$2.4 M a year.

On the basis of these figures \$5 M per annum for Maintenance and \$2.4 M per annum for depreciation, we can now recalculate the 'cost' of the annual payment of \$13.6. After allowing for these costs that the City now saves (since the Hydro is paying for them out of the annual \$13.6 payment), the actual net cost of raising the \$60 M is therefore \$ 6.2 M. per year. ($\$13.6 - \$5 - \$2.4 = \6.2)

If the City had raised the \$60 M it needed by borrowing, instead of selling the lights to the Hydro, how much would the borrowing rate have been if they had to pay interest of \$6.2 M? Clearly it would have been just over 10%.

OK, so we now have a ballpark figure. If the maintenance costs and depreciation were lower, then the equivalent borrowing rate would have been higher, but if the maintenance costs and depreciation were higher, then the equivalent borrowing rate could be less than 10%.

What we can see from this is that the analysis of a Rip-Off is NOT a foregone conclusion.

One more economic consideration:

Now 10% may seem to be a pretty high borrowing rate, but it is not exorbitant. However, before jumping to the conclusion that this figure is too high, we have to consider *what effect an extra \$60 M of city debt would have done to the City's credit rating*. If it would have had the effect of lowering its credit rating (entirely possible considering that most City expenditure is not revenue increasing) then the flow on costs to other debt outstanding by the City needs to be taken into account. The greater borrowing ability of the Hydro, a revenue raising entity, also needs to be taken into account here.

And a political consideration

"Contract talks with the city's two big union locals were in full swing at the time, and would have been upset by sudden moves to slash services or staff" Comment by a councillor.

In order to make a proper assessment of the situation, we need to know

annual maintenance costs
annual depreciation costs
actual replacement cost of the street lights
borrowing rate - assuming that the city could have borrowed \$60M at short notice.
estimated impact on the city's credit rating and the flow costs to its outstanding debt.

We would need all of this to determine the answer to the question: is this a good deal for the city (and for the Hydro) or is it a rip-off. (Note carrying out the analysis in real terms avoids having to guess at inflation rates.)

But there are more questions than this that need to be answered, in order to determine whether this was a good deal for the City. E.G.

What other options did the City have?

Could the City have borrowed the \$60M at short notice at a reasonable rate?

If, on the other hand, the budget was cut and the \$60 M in the budget was not spent, what would have been the consequences for city services? And for union discussion

Given that the City is the sole beneficiary of Hydro surplus, **would the City have really benefited had it sold the lights for more money upfront but had less coming back from Hydro surpluses.**

In the discussion that followed, in the newspapers and on the blogs, it is clear that nobody had a good idea, nor good figures, on what constitutes maintenance and what depreciation and in the following comment they seem to have been rolled in together.

“The most misleading part of the article is that the Star attempts to compare the ongoing \$14 million cost over a period of 30 years with the funds received from the sale of the asset without ever acknowledging that there is a cost to Toronto Hydro to maintain the system. Either way the cost of operating the system must be paid for The Star story fails to account for the fact there are costs that go along with owning street lights (such as repairs to poles, new poles, changing bulbs and fixtures) that would have had to be paid on an ongoing basis if the City had kept ownership of the street lights.”

Another contributor ‘estimated the ballpark’ by reference to another city, which is a useful way to proceed when direct information is not available, as follows:

For the life of me, I can't find how much Toronto spends/spent on streetlight maintenance each year prior to their sale. I'm not surprised, but, that is going to be a problem. So, I'll try to work around that a bit. Below is a very rough numbers calculation based on old facts and unreliable figures.

Hamilton, who debated roughly the same topic in 2003, actually posted their discussions online without any attempted lawyer cover-up (how about that!), had about 35,000 streetlights in 2003 and by Toronto Hydro numbers, Toronto has about 150,000 [Ed: another report said 160,000 but this is close enough for ballpark estimation]. So, roughly 5 times the population, and roughly 5 times the number of streetlights (by the numbers I saw..). Makes sense, downtown density aside.

Hamilton, in 2003 spent just under \$500,000 for streetlight maintenance. So, let's say there's an increased of about 20% from those numbers to 2010, and I'll concede an additional \$100,000, just guesstimating. (For comparison, Toronto Hydro is just adjusting their 30 year fee with inflation.) That means that if I had to guess, Hamilton is spending about \$600,000 a year on streetlight sustenance. Converting these numbers to Toronto (x5), streetlight upkeep should currently cost us about 3 million dollars a year. ... Now, maintenance doesn't include administration (turning lights on/off/handling complaints, etc...). I have no idea what the costs are, and I assume it's fairly automated, but seeing as it's Toronto, let's say another \$2 million a year?”

But the most telling comment was by one of the Councillors themselves.

No Long Term Strategy

“There's no question that we sold the asset for the wrong reason, for the wrong price,” Councillor Karen Stintz (Eglinton-Lawrence) said yesterday. “We knew it at the time that we did it, and we did it **because we didn't have a long term strategy around how we deal with assets**. If we're going to monetize them, what are we trying to achieve through that monetization, why are we doing it and what is the public benefit?” [Ed: my emphasis]

3. Sorting the Relevant from the Irrelevant Issues

And now, just for the exercise, (very good for strengthening your strategic muscles!) try your hand at assessing the validity of the following comments from the blogs. Some of them make valid points, others don't. Some of the valid points are mixed in with rubbish. How do you sort the wheat from the chaff? Which issues would you choose to debate - and which would you be better off ignoring altogether?

The electrical contractors say the city might have got a more favorable deal for the streetlights if it had sought competitive bids.

Former Toronto councillor David Soknacki, who engineered the transaction as budget chief, said in an interview that the city might well have made a better deal if it had had more time. But the shortfall came to light just a day or two before the budget was to be unveiled, and during sensitive contract talks with the city's biggest union locals.

The city also argues that it made money on the streetlights, because it bought the lights for \$1 in 1989 from the former municipal hydro systems. "By any measure, the return on investment to the city was more than adequate," it said.

O'Donnell was also critical of the penalty clauses in the 2005 street light contract. Problems are ranked as high, medium or low priority. A high priority problem – an entire area without lights, say, or a pole knocked down – requires a response within an hour and a half. For less serious problems, five or 10 days may be allowed. If those standards are not met, Toronto Hydro may be fined, there's a \$250,000 annual penalty limit. When the city is paying a \$14 million-a-year fee, that provides little incentive to perform, said O'Donnell.

BE PREPARED

Analysing the media reporting of others is a very useful way of preparing yourself against the time when you may need to do it for your organisation - and in a hurry!

And it is a fun way to involve others, e.g. your public relations officer. A good relationship with others in your organisation will stand you in good stead when it is your time to be in the firing line!

And if you would like to share your analyses with others, I welcome any contributions of past or future media coverage for the new website and for SAM. Hope to hear from you!