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MACQUARIE INFRASTRUCTURE GROUP

RESPONSE TO DR JOHN L. GOLDBERG'S PAPER
"TOLL ROAD OPERATIONS IN AUSTRALIA: A
CRITICAL EXAMINATION OF THE FINANCIAL AND
ECONOMIC REALITIES"

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Macquarie Infrastructure Group has reviewed the paper “Toll Road Operations in Australia: A critical examination of the financial and economic realities” prepared by Dr John L. Goldberg (the “Paper”). However the source data described in the paper has not been examined. The following responses address the theory or logic presented in the Paper.

Summary

In summary, there are a number of fundamental flaws in the Paper. However, the most significant error in the Paper is reflected in a lack of understanding of both Generally Accepted Accounting Practices (“GAAP”) and the economics of infrastructure projects.

Dr Goldberg has drawn a number of conclusions based on what is referred to as Discounted Cash Flow (“DCF”) analysis. In the Paper, the concept of Operating Profit is used as a proxy for cash flow in the DCF analysis. Internationally, GAAP have recognised that Operating Profit does not represent Operating Cash Flow. For this reason, accountants also prepare a Statement of Cash Flows. The major difference between these two approaches is that Operating Profit can include a number of non-cash expenses, the most significant of which is typically depreciation.

By basing the DCF analysis on Operating Profit instead of Operating Cash Flow, the Paper materially understates the cash flow generated by the projects analysed, resulting in erroneous conclusions.

Based on these erroneous conclusions, Dr Goldberg suggests that a number of other artificial features or “stratagems” have been created to support toll road projects. The analysis presented does not accurately reflect the economics of toll road and other infrastructure projects.

Accounting Principles and DCF

The Paper defines the cash flow available to repay debt and equity returns as Operating Profit. While not completely transparent as to what has been included or excluded in this measure, the Paper describes Operating Profit as “derived by subtracting the debt servicing costs, depreciation and other charges from the toll revenue”.

The most obvious error in this measure is the inclusion of depreciation. Depreciation is an accounting measure used to represent the economic reduction in value of an asset as it is used by an enterprise – it does not represent a current cash flow. To the contrary, it is the accountant’s way of recognising a capital cash flow which has occurred in the past. To correctly analyse the cash flows and timing which should be used for DCF analysis, it is the capital expenditure which should be recognised and not the depreciation charge. In the case of infrastructure projects, this usually refers to the cost of constructing the asset at the commencement of the project. In the case of the projects analysed in the Paper, these amounts have been spent already and including the depreciation charge effectively “double counts” these expenditures. The conclusions drawn therefore significantly understate both the cash flows and the present value of the projects.



Repayment of External Debt

Based on this erroneous DCF analysis, the Paper concludes that toll road assets will have difficulty repaying external borrowings.

The financial analysis of one of the projects analysed, M2 motorway, shows that the current interest coverage ratio for Hills Motorway is approximately 2.0 times (excluding the Infrastructure Bond interest). This means that the project is generating current excess cash flow after paying interest, equal to 1.0 times the interest. This excess cash may be used to make principal repayments on debt, make distributions to equity, or a combination of both.

By way of a simple example, if debt is \$100 and interest rate is 6%, an interest coverage ratio of 2.0 times means that the project would be generating \$12 of cash available to service debt (i.e. twice the interest) leaving \$6 per annum of excess cash after meeting interest costs. Accordingly even if the project cash flows did not grow from current levels, all debt could be repaid in approximately 14 years. It is therefore difficult to follow Dr Goldberg's analysis that such projects would have difficulty repaying debt when the concession term is in excess of 30 years.

Integrity of Traffic Forecasts

Another assertion in the Paper is that toll revenue forecasts used to value toll road assets are unrealistic and have been engineered to achieve the required outcome. The M2 motorway is used as an example with the conclusion being that its forecast toll revenue grows "exponentially" through time.

It is important to note that toll revenue is a function of both traffic and the toll escalation mechanism. For the M2 motorway, the Concession Deed allows tolls to escalate at the greater of CPI or 1% per quarter. Therefore, toll revenue reflects both increases in forecast traffic coupled with increases in the toll price due to inflation (or 1% per quarter). The implied cumulative average growth in toll revenue indicated by Figure 3 of the Paper from 1998 to 2030 is 4.65% pa. which is not considered excessive, given the economic environment at the time.

The Paper further concludes that "extraordinary" levels of distributions are forecast from financial models. Dr Goldberg makes reference to Figure 5 in the Paper which shows the forecast yield of Hills Motorway and states that the yield post-2023 is expected to be greater than 100%, as further evidence that traffic forecasts have been artificially inflated. This appears to be again a fundamental misunderstanding of simple financial concepts. The yield presented in Figure 5 is the forecast distributions as a percentage of the initial public offer ("IPO") price. Hills Motorway in fact paid \$0.365 per share in financial year 2004 representing a yield of 36.5% in relation to the IPO price of \$1.00. The example illustrates that caution should be exercised in drawing conclusions on yield where forecast distributions in nominal terms are compared to original equity value.



Value of Toll Road Investments

As noted above, the DCF analysis presented in the Paper includes depreciation and therefore invalidates the conclusion that toll road investments have a negative present value.

Toll road assets require large amounts of initial capital expenditure in the construction phase and as with other assets, this cost can be depreciated over the life of the concession. The high construction cost of infrastructure assets provides significant depreciation deductions over the early years of operation. These deductions reduce accounting profit and taxable income, but do not have a corresponding impact on project cash flow. On this basis, toll road assets may be producing free cash flow despite recording substantial tax and accounting losses. Dr Goldberg has made the fundamental error of using accounting profit as a proxy for free cash flow in his DCF analysis.

Company/Trust Structure

The Paper notes that the “trust/company structure is used to achieve anomalous results” and concludes that “accounting anomalies based on this dual structure may also play a role in concealing the extent of the losses”. The primary reason for the dual stapled structure is the efficiency of the project financing rather than the accounting treatment. As noted above, in the early years of operation toll road assets may be generating free cash flows while recording substantial tax and accounting losses. The dual entity structure facilitates the release of this excess cash to investors via trust distributions without the need to have accounting profits in the company. It is no secret that toll road assets record accounting losses in the early years of operation. The trust/company structure is not used to conceal these losses.

Trusts in the structure are Managed Investment Schemes registered with the Australian Securities and Investments Commission and governed by the Corporations Act. A trust is a reporting entity and as such is subject to the same disclosure requirements as a company would have in accordance with Accounting Standards. There are also rules specifically developed for consolidated disclosure by stapled entities which have the same effect as the Accounting Standards.

Dr Goldberg criticises concepts of accounting consolidation without providing any alternative. The accounting “anomalies” referred to in the Paper between the individual accounts of the company, trust and consolidated group are due to the elimination of inter-entity transactions on consolidation.

Infrastructure Bond Borrowing Scheme

The discussion in the Paper on Infrastructure Bond borrowings suggest a fundamental misunderstanding of the mechanics and the economic result. Infrastructure Bonds were instituted in the early 1990's to provide a mechanism to assist in the development of key infrastructure projects. The scheme permits infrastructure projects to exchange tax losses for a lower cost of debt funding. The cash backed Infrastructure Bond structures achieve this by the project company deriving a margin for the use of tax losses. In these structures the Infrastructure Bonds are not used as a source of funding. Instead, their role is to supplement project cash flows allowing a greater amount of external debt and equity to be raised. As the loan from the



bond lender is wholly backed by a deposit, the deposit funds will be used to repay the bond principal at the end of the financing term. Such arrangements were subject to favourable rulings from the Australian Tax Office before being implemented.

The statement in the Paper in relation to tax position of borrowers of Infrastructure Bonds is incorrect. In reality, the interest payments on the bonds are not assessable to the lender but are also non-deductible to the borrower. The borrower therefore pays a lower rate of interest on its debt, but uses up its tax losses more quickly. In the early years of operation, the tax losses generated are of limited value to toll road projects. The ability to exchange these losses for a lower cost of debt increases the efficiency of project financing.

The assertion that toll road projects are reliant on Infrastructure Bond borrowings is also incorrect. It is important to note that there are examples of financially viable toll road projects without Infrastructure Bond borrowings such as the M4 motorway. Furthermore, and as stated above, Infrastructure Bond borrowings are not a source of additional risk as they are fully cash backed (i.e. an equivalent amount in cash is held on deposit which in the event of default could be used to repay the loan).

