Sundays at 9.10am, repeated Tuesdays at 7.10pm

The Millionaire Factory

Sunday 29 May 2005

Print

Program Transcript

Stan Correy: Macquarie Bank…another year, another record profit. The headlines say it all:

New Masters of the Universe

The Millionaire Factory

The Money Machine

It's a banking phenomenon and a global success story, and they're part of your everyday life. That, in itself, is what makes some people nervous. they now own many services that are essential to how we live.

Hello, I'm Stan Correy, and Background Briefing is coming to you via transmitters owned by Macquarie Bank. You may be driving on a road owned by Macquarie or going to visit an elderly relative in a Macquarie retirement home. Your glass of water may have got to you with the help of Macquarie. Perhaps you buy underwear in a shopping centre owned by a Macquarie company. Or you go on holidays to Dream World on the Gold Coast. It's part of the Macquarie Leisure Trust.

There's been a boom in the global economy for the past ten years, and Macquarie is a child of these bullish times.

> **MC:** It does give me great pleasure this evening to introduce Alan Moss, the managing director and CEO of Macquarie Bank. You probably do know that Macquarie Bank is the leading provider of financial and investment banking services, with nearly six thousand staff operating in 23 countries. Alan joined Hill Samuel, Macquarie's predecessor, in 1977, and was appointed managing director and CEO in 1993. Since that time—and it probably isn't coincidental—the bank has reported successive years of consistent growth and record profit.

I think you'll all have read about Macquarie's diversified investments. Some of the most recent were Wales and West Gaslink, I think more recently, and the ING Equities in Asia. Alan, at a recent event, was quoted as saying, 'When I get off a plane I land at a Macquarie airport, I travel to the office on a Macquarie road, and then I travel to the office trust building by Macquarie, also.' And he explicitly added, 'And there are still many countries to conquer.' You kind of wonder what's next, so Alan, maybe you'll give us some insights to that. So please welcome Alan Moss.

Stan Correy: Speaking last September at a banking and finance forum, CEO of Macquarie, Alan Moss.

Alan Moss: Globalisation has been a great opportunity for Macquarie Bank, and one that we're very focused on continuing to respond to. And we're managing some important assets now. This is a list of some of the assets that we're managing in our specialist funds in our specialist infrastructure funds and our specialist real estate funds around the world. You'll see here, in the Americas, SR125 is an potentially important tollway that's being built in California near San Diego. We've got real estate assets, shopping centres, factories, warehouses, office buildings… We've got some airport support infrastructure—and that's all going well. In Canada, some big tollways, some electricity distribution… And in the UK the M6 tollway, which is a big road around the outskirts of Birmingham; half of Bristol airport, a quarter of Birmingham airport, Southeast Water and, as Ray mentioned, the gas distribution network now in Wales and the west of England. These are in funds or consortia which we're managing.

> **"Globalisation has been a great opportunity for Macquarie Bank, and one that we're very focused on continuing to respond to."**

> Retirement Care Australia… Sydney Airport… Eastlink, Melbourne… Westlink… M7, Sydney…M4 plus M5, Sydney… Macquarie Regional Radio works…
> ***From Macquarie's assets list***

Stan Correy: Macquarie Bank's speciality is all tied up in that rather dreary buzzword, infrastructure. It's the sexy and valuable essential backdrop to every thing that keeps a society going. And it's nowadays in wedded bliss with the three Ps—public, private, partnership. What's behind it all is the big political idea that there is no need for government to own—or even run—anything very much at all. Everything, from communications to social services, can be done better by private investors. Graeme Hodge, director of the Centre for Privatisation and Public Accountability at Monash University:

Graeme Hodge: Governments have been doing deals with business consortia for hundreds of years. But that's not new. Governments have also been making long-term commitments and, in terms of building dams and roads and so on, they've been making decisions that influence our children and our children's children, again, for centuries. So the long term nature is not new, and the kind of public-private relationship is not new.

So what is new? What's new, I think, is three aspects. First aspect is this preference for private finance as distinct from taking out government bonds, or going into public debt. So the preference for private finance is new. Secondly, there's a new set of hugely complex arrangements when you bundle services and bundle arrangements together in one huge set of contracts. So that complexity is new. But thirdly, and importantly, what's new, is new governance and accountability assumptions that we're making.

Stan Correy: In fact, it's a lack of accountability that Graeme Hodge means is the concern. Over the decades, the complexity of financial services has become bewildering. Back in the 60s, before Hill Samuel became Macquarie, Bill Gurry was there.

Bill Gurry: The first thing was, we were called merchant bankers, and most people found that confusing because most people had never heard of what a merchant bank was. I became interested in it when I was at university and followed a friend who went into merchant banking and decided that being a barrister and solicitor of the Supreme Court of Victoria sounded impressive but was pretty boring…so I went off into a merchant bank. And I found myself at Hill Samuel, the forerunner of Macquarie Bank, in the days—I think there were probably about 30 people there when I first joined, so it was very small.

Stan Correy: Are there any similarities between what you did then and what investment banking is today, or is it completely changed?

Bill Gurry: Look, there are some similarities. Overall an investment bank, and in those days, a merchant bank, was a skill-based organisation. So that basically hasn't changed. Where those skills have been directed has probably changed over the period. But if we go back 25 to 30 years, the merchant banks of that time had small corporate finance departments, small money market operations—everything was small, really—and small banking operations. And then probably the first innovations occurred with the commodities markets; the merchant banks became involved in them. And Hill Samuel in particular became involved in the investment management markets via the cash management trust operation, which they originated in Australia. And when you think about it, when we started the cash management trust at Hill Samuel, we had a goal of getting to $50 million in funds under management and thinking that would be enormously successful, and if we ever got to $100 million it would be just a huge success—and I think the last time I looked at a Macquarie annual report, they have $10 billion in the cash management trust alone.

Stan Correy: These days, Bill Gurry is semi-retired. He's still a director on some of Australia's largest companies, but he's one of the most experienced investment bankers in Australia. His last job was as chairman of UBS Warburg. It was 1985, one year after Keating started financial deregulation that Hill Samuel leapfrogged into the big league. As Sally Begbie reported at the time:

> **Sally Begbie:** Situated in the heart of Sydney's central business sector, the Macquarie Bank is upmarket banking for the professional. From the start it was apparent; this is boutique banking. Macquarie aims to be a bank of service. It has 'relationships' with clients. It's an extension of the merchant bankers Hill Samuel and, at a time when foreign banks are sharpening local competition, Macquarie hopes to attract people who can afford a higher level of charges.
>
> **Macquarie Managing Director:** Of course, Hill Samuel, whose business we acquired on 1 February, already deals with a lot of the corporate customers, so I think they're used to dealing with us. They understand what levels of service we give, and I think they'll see the new trading bank branch as just being an extension of that.
>
> **Sally Begbie:** You've been open for half a day now, and you still haven't finalised yourself with at least one client. Why are you going to survive?
>
> **Macquarie Managing Director:** Well, I don't agree we ever expected to have a lot of clients in the first half hour. But in fact I haven't even got my cheque book yet—I can't get that till

next Wednesday.

Sally Begbie: the bank aims to process normal loans within minutes, and interest will be paid on all of the balance on cheque accounts. Branches of the new bank will be opened in all capital cities within two years.

Stan Correy: that was 20 years ago, and these days its main interest is corporate finance and investment fund management. It moved with the political climate of the day and clicked into high gear when it was listed on the Australian Stock Exchange in 1996. That was the year John Howard came to power, and the government pumped up the rate of privatisation and sale of government assets. Macquarie was ready and willing to buy.

Working in Parliament House in Canberra at the time, with finance minister John Fahey, was Greg Barns.

Greg Barns: Macquarie bankers tend to be of a certain type. They are called the Millionaires' factory. Even by the standards of investment banks, extraordinarily rapacious in the sense that, you know, they really want to extract every dollar out of the deal. It's a very, very aggressive bank, and a very aggressive working environment for people. And the key leaders of Macquarie Bank, like Nicholas Moore and Alan Moss and others, have been extremely good at working government circles. We had one incident where we had to have words with Alan, when I was working for Fahey, about an issue; and he came into the office—I think with Nicholas Moore—and they were suitably contrite, they fixed the problem and we never heard about it again. So these people are not cowboys. These people know how to play the game and play it very, very effectively.

Stan Correy: Macquarie Bank was never shackled by ideology or political affiliations.

Greg Barns: Well, David Clarke, who was, or is, chairman of the bank, has strong connections with the Liberal Party—I think for a time was federal treasurer of the Liberal Party, certainly a party official—and it has to be said that most investment banks are close philosophically to the Liberal Party, as are its operatives. On the other hand, Macquarie Bank has been very clever at cultivating Labor governments when it needs to. It uses, from time to time, Labor-aligned lobby groups and lobbying firms. It will take on ex-Labor staffers. So it's always ready for that change of government. But I think it's fair to say that Macquarie Bank, its alignment with the Liberal Party is fairly strong. Mind you, having said that, that's not unusual, as I say; most investment banks have much greater philosophical alignment to the Liberal Party than they do to the Labor Party.

"...it's always ready for that change of government. But I think it's fair to say that Macquarie Bank, its alignment with the Liberal Party is fairly strong."

Stan Correy: Greg Barns, a former adviser to former federal finance minister, John Fahey.

In the days of Hill Samuel, success was measured in millions. Now the Macquarie investment funds are awash with money. They have assets under management worth $88.9 billion. That's up 42% from last year. Their profit after tax is $823 million. That's up 67% from last year. Their investors love it, as shares go up and dividends flow in. But there's a rub. Out of their profits the company took $700 million for management and performance fees. There's much feeling around that this is a little steep. Sure, the investors are still making money, and times are good, but should Macquarie be taking quite such a large slice of the profit pie?

These criticisms are still muted. Times are good; everyone's winning. If Macquarie Bank can do it, well, that's capitalism.

Bill Gurry: They've been managing all of this during very buoyant times. the last decade has been a very healthy decade for a good investment bank. And the shareholders have been amply rewarded through that period. If there's ever a downturn—and maybe we're seeing the first signs of that at the moment—but if that downturn occurred and the stock market came back a bit and the same performance levels were not being achieved, I think that's when people start to become a bit disgruntled. But while the markets are buoyant nobody gets disgruntled; they're all getting their fair share.

Stan Correy: All this is at a very soft spot in international business. How much care needs to be taken during good times to keep a company secure in case of a bust? Who should be watching that? Everything's happening fast and furiously and the complexity is mind-boggling.

Bill Gurry: I think it is harder for the regulators to keep up, and I think that's what they generally do. They're generally coming from behind to try and catch up, and it generally takes a disaster for them to catch up—and then they think they've caught up and then another disaster will occur and they have to catch up again. Unfortunately that usually leads to overregulation and probably doesn't help it, because it's after the event. In relation to the investment banks themselves—look, there just seems to be an endless stream of very smart people going into investment banks. I certainly know amongst all the young people that I talk to that most of those—if I just take the discipline that I came from, law, people want to go to an investment bank rather than going to a top law firm these days. And I have an endless stream of people asking me about it and asking me which ones to go to.

Stan Correy: And the deals for the young investment bankers are endless and global.

> Chicago Skyway…Rome Airport…Brussels Airport…Highway 407, Toronto…SR125 Road, San Diego…South West Water …Seek Skyroad, Vancouver…
> ***From Macquarie's assets list***

Many of these companies across the world—and the most profitable —involve government at every level. Business often doesn't like to get involved in political affairs because governments can change and policies can change. But Macquarie executives put their faith in the law and the fine print of some very powerful contracts.

Greg Barns: Well, my first impression of Macquarie Bank was that it was determined to play the banking game in a very different way to that which had traditionally been played in Australia. It saw government as being a major cash opportunity and it aggressively targeted government schemes —for example, infrastructure bonds, R&D tax concessions—and was very active in buying up government assets, so Macquarie Bank I think to a much greater extent than other investment banks, has made the transformation from being a very conventional bank to one which really pioneered the use of taxpayer-funded vehicles and also asset sales.

Stan Correy: And the Macquarie executives who roam the halls of parliament throughout Australia knew how to bargain.

Greg Barns: I always found Macquarie Bank a bit difficult. On the one hand they could be charming and they could be adversarial at the next moment. We sold—the Australian government sold—Dasfleet, which was the government car service, essentially. And that very quickly, as a result of the sale, ended up in a long arbitration, which I think eventually was resolved in Macquarie Bank's favour. But they played it hard in any of their deals. I can recall a Macquarie banker giving me a call just prior to the announcement of sales of some rail assets, indicating which assets Macquarie wanted to buy and which they didn't want to buy. That, I should point out, had absolutely no bearing on the results. But it was typical of the very aggressive style of Macquarie Bank. On the other hand, investment banks—and particularly during the Telstra sale that I was involved in, the first Telstra float—investment banks were extraordinarily aggressive, generally, in their lobbying efforts to try and win business from government. So Macquarie, again, wasn't alone. But they were a bank that was regularly walking around the corridors of Parliament House, probably more so than any other bank.

> **"They were a bank that was regularly walking around the corridors of Parliament House, probably more so than any other bank."**

Stan Correy: When Macquarie Bank wants to buy a government asset —say, an airport or a road system—the next step is to set it up as an investment fund. Macquarie later can re-finance the purchase by selling the airport or road system into a related managed fund. Capital for this new fund is raised from investors, but owned and managed by Macquarie. Macquarie charges fees for advice and management of the businesses and of the fund. It collects fees at every step of the process. Editor of the banking newsletter The Sheet, **Ian Rogers:**

Ian Rogers: Macquarie have gone out and in essence invented new asset classes, or figured out how to corral capital—some of it their own, some of it that comes out of their own generic fund management business, but most of it from other specialised investors—and then to go and chase assets that have come on the market that it used not to be very easy for investors of any kind to take a stake in. And that is, of course, related to the whole privatisation and asset sales boom. So there are many airports and toll roads and water utilities and broadcast communications infrastructure in Australia, and some closely related asset classes. And it's out of those businesses that Macquarie have made most of their money in the last few years. And they've figured out a formula under which they can effectively gouge extreme fees.

Stan Correy: Gouging extreme fees…Macquarie is so used to this accusation that their fees are too high, it seems almost like a badge of pride. After the recent record profit results, this is the sort of remark you could read in the financial media: 'Nobody has said Macquarie is not avaricious,' writes a rival banker, but he admits, 'The results speak for themselves.'

The Macquarie model is a phenomenon here and overseas. The view is; they almost can't fail because even in a recession Macquarie would be able to make money out of fees. In early May deputy managing director, Richard Sheppard, was spruiking the Macquarie message to his investment banking peers in New York:

Richard Sheppard: Now, just in terms of an introduction and the way you should look at Macquarie Bank, we see ourselves as somewhat unique; not directly comparable with many of the listed commercial banks, and certainly not directly comparable with the Wall Street banks, but quite a diversified financial institution. We listed in 1996. Today, as I've mentioned, almost 17,000 employees across 23 countries; compound growth rates around 20% in earnings and earnings per share and so on over the past ten years or so, and quite highly rated for an institution of our size.

There are lots and lots of opportunities. We do not regard Macquarie Bank as a mature company which has gone ex-growth. We see lots of opportunities to expand the business. I think that the growth will be faster outside Australia than inside Australia, so we're probably well on the way to being 50 % Australian, 50% international—and no-one knows quite where from there. Across every group of the bank, people are working on opportunities with a view to getting growth five years out. The bank's growth has been very rapid over recent years, so nobody's pretending that we can sustain that sort of incremental and compound growth forever, because if we did we'd, you know, in a sense own the world.

Stan Correy: Owning the world. Well, someone has to do it. Richard Sheppard, deputy managing director of Macquarie Bank. But there's also the dangers of flying too close to the sun. At this level, big business is an art as much as a science. Interest rates may go up; the stock market can go down. Macquarie Bank says—and few doubt them—that they have the best risk managers in the world. Every dollar of every deal is scrutinised, they say. Here's managing director, Alan Moss, speaking at a banking forum last September.

Alan Moss: We have a relatively small number of things that we seek to control centrally, but we take those things very seriously. Credit risks, market risks, reputation risks, operational standards—we seek to control. Within that we generally give a lot of operational freedom. And we have a hierarchy of controls and we have rigorous reporting. We report on performance, but also on exceptions. We have operational risk review teams which are in effect very like internal audit teams. All the accounting people, globally, report to our chief financial officer. So they may also report in a dotted line to the local business head, but they are black-line working to the chief financial officer. There's a whole series of controls there. And risk management is the number one job of all the managers in Macquarie Bank.

Stan Correy: Managing risk is one of the most difficult jobs in financial services. And it's not always possible to be completely immune to the ebb and flow of world affairs. Frank Partnoy is professor of law at the University of San Diego. A former investment banker and a world expert on risk in complex financial transaction.

Frank Partnoy: I do think that there's a difference between the ability of an investment bank to keep tabs on its risks if the bank has been around for a while and is relatively stable and is not growing dramatically, and the tasks facing an investment bank that is growing dramatically—or really any financial services system that's growing dramatically. And if you look back across history at the financial services firms that have run into difficulties, it has been those that are growing very quickly. Bankers Trust is probably the leading example. Long Term Capital Management, the hedge fund, was another one where they'd experienced record profits, record growth, claimed that they were quite sophisticated about monitoring the risks… Really, Enron falls into the same category, even though most people think of it as an energy firm, it was essentially an investment bank and a trading firm, and it also was growing very rapidly, reporting record profits—and claiming that it had a handle on risks. It was quite sophisticated in terms of the risk disclosure of the CEO, in terms of the level of disclosure it was giving the public, frankly. The amount of information that was coming out in terms of monitoring of risk was unprecedented, really. But whenever you see that fast growth, you know that within the firm it's difficult, as the horse starts to gallop faster and faster, you can think that you'll be able to control the horse, but inevitably there are rocks in the path, there are dangers, there are fences, there are obstacles that any financial services firm will confront. And you can imagine, if you're the charioteer, adding horse after horse and picking up speed; it's increasingly difficult and not surprisingly, the problems that we've had in the past have been with financial services institutions that were growing very rapidly, adding horse power and growing profits and at the same time claiming to the public—and maybe believing themselves —that they had a deep and accurate understanding of their own risk.

Stan Correy: Frank Partnoy is not speaking in particular about Macquarie Bank, but about the whole field of investment banking.

Frank Partnoy: I think that the way investment banks manage risk is much more sophisticated than it was, even a decade ago. But it still is based on certain fundamentally flawed principles. It is in its essence historic. It looks back in time and calculates very complicated numerical measures of risk based on history. And everyone knows that the past is not a perfect predictor of future results; that various kinds of financial instruments, financial market participants, can behave in ways they've never behaved in before. And my basic concern is the same concern that financial market historians have had over the last hundreds and hundreds of years, and that is that people will assume that markets will behave the way they've always behaved. And that is not true. Periodically, and with increasing frequency, markets will behave in new, unforeseen ways. And we're not prepared for that, and we've assumed that the level of risk is simply that dictated by the performance of prices in the past.

"The hard science of assessing risk has got much better, the soft art of assessing risk has in some sense been lost."

So I think that while the hard science of assessing risk has got much better, the soft art of assessing risk has in some sense been lost. And I hope that the managers of large financial institutions remember that managing risk is in many ways an art, not a science.

Stan Correy: Frank Partnoy, professor of law at the University of San Diego, and a world expert in the regulation of complex financial investment.

> Airport Infrastructure No. 2 Ltd, Caiman Island… Macquarie Communication Infrastructure Bermuda Ltd… Macquarie Capital Alliance Management Ltd, Australia… Macquarie Cotton International Incorporated, US… Infrastructure Investment No. 2 Ltd, Cayman Islands…
> ***From Macquarie's assets list***

One of the most juicy and profitable infrastructures to invest in anywhere in the world is transport. In good times transport of every kind increases and there's money to be made. And governments around the world have been busy divesting themselves of airports, roads and railways. Speaking from his home in Aalborg, Danish risk analyst, Bent Flyvbjerg:

Bent Flyvbjerg: Well, there's always an initial enthusiasm for new ideas. I think it was Machiavelli who said, 'Things are always at their best at the beginning/' this is also the case for public-private partnerships. But there actually is also some basis some for a certain enthusiasm—a limited amount of enthusiasm—which comes out of the UK, where the National Audit Office has studied a number of public-private partnerships or private finance initiatives as they also call them in the UK, and found that cost overruns are lower and value for money is higher on these projects. So there is some basis. But it's not panacea, it's not something that will be a miracle cure, and it's very important that public-private partnerships are put together in the right manner and then the contracts—and this is the key thing in public-private partnerships, is writing the right contracts—and if you do that you may gain some benefits. If you don't do that, you may get into a situation that is much worse and much more complicated than before, because you have both the public sector and the private sector and the interface between the two to take care of. And that's complicated.

Stan Correy: Bent Flyvbjerg knows all about complexity in risk. His most recent book, Megaprojects and Risk, deals with how governments and companies interact on large infrastructure projects—especially how the contracts are written.

Bent Flyvbjerg: It's extremely important to take all these motives into account in writing the contracts, and especially to be sure that we don't have what is called 'rent-seeking behaviour', where you have certain parties going in for having an extra profit for themselves and trying again to get money out of the taxpayer and making a profit in that way. Because this would again mean that we wouldn't have a cost-effective solution.

Stan Correy: And what about the specific area where Macquarie Bank dominates—transport infrastructure, toll roads, airports—these projects are especially prone to risk because of what Professor Flyvbjerg calls 'optimism bias'. And they are incredibly sensitive to changes in the economy.

Bent Flyvbjerg: So if in Australia the toll roads have been built and had success during a recession, that's really impressive, if that's the case. If the case is that their success has been during an upturn in the economy where everything is going well and people are making money and therefore are driving more both in business and privately, then the success is not so surprising, then it's what we have seen, as well. Also there's what we call a multiplier in the relationship between economic growth and transport in the sense that if you have an economic growth you have even larger growth in transports. For instance, in my part of the world, if you have a 2% increase in growth, you typically had a 4% increase in transportation. So in that sense, transport is doing even better than other parts of the economy during an upturn, and vice-versa, during a downturn. so these projects are very sensitive. Sensitive to the second degree, so to speak, to general economic development. And I would say that the past ten to fifteen years a lot of projects, including a lot of toll roads and toll bridges and toll tunnels have been saved on the balance sheets exactly by a very low interest rate combined with high growth. And the low interest rate, of course, means that the costs, the financial costs, of running these projects are much lower than we could have expected, and the high economic growth leading to higher traffic, means that the revenues are higher than you could expect. And as long as this goes on, these projects will be okay. But if the interest rate goes up and traffic starts to stagnate or even fall, there will be huge problems.

Stan Correy: This is one of the reasons that a rise in household debt is seen as a big risk for Macquarie Bank. Households that don't have a steady cash flow begin to resist and resent high tolls, and Macquarie depends on that 'good times' feeling to keep the money coming in. This has been at the core of a big legal case in Canada. In Ontario a few years ago the new provincial government discovered that the Macquarie consortium could raise toll charges without referring to the government. the government challenged that right in the courts, and the dispute still drags on. Greg Barns is a frequent visitor to Canada.

Greg Barns: Now, Highway 407, for any of your listeners who's been over to Toronto know, is a very busy road. It's one of the major thoroughfares of Ontario. Macquarie Bank is putting up the tolls—says it will put up the tolls—basically when it feels like it under the agreement, and it doesn't have to consult the Ontario government. But I think that's a really interesting example of the way in which—you know, who drives on this road? The people of Ontario. At the end of the day it's their road. It's public infrastructure, but Macquarie Bank is really using such a key piece of infrastructure almost as though it's just a private investment. And I think for governments that's quite disturbing that a bank would behave in that way.

> **"Macquarie Bank says it will put up the tolls basically when it feels like it under the agreement, and it doesn't have to consult the Ontario government."**

Stan Correy: But Macquarie does own the road, and in every step of the legal challenge, the Macquarie consortium has won. It's in the contract. In California there's another toll road project that so far has been relatively uncontroversial for the Macquarie Infrastructure Group or MIG. The SR125 South in San Diego was MIG's first big investment in the US. As MIG's website points out, this toll road will open up 'a potentially very large market.'

A few weeks ago, this headline appeared in the Voice of San Diego, a web newspaper catering for the people of Southern California.

'State Senate Bails Out Private Otay Mesa Toll Road Project'.

On reading the story, it was clear that the toll road being talked about was Macquarie's SR125. Don Wood, a community activist who campaigned against the toll road, wrote the story. It's about a current Bill before the California Legislature, called the FB463. Documents published with the Bill say Macquarie's company CTV has said that it 'will not be able to earn the return on investment necessary to cover the increased costs. Extending the term of the agreement by ten years will provide enough time to earn a reasonable return on total investment.'

Don Wood discovered the issue when reading the minutes of meetings of the San Diego Association of Governments, Sandag. Sandag represents the city councils in the San Diego area on planning and transportation. The minutes stated that Macquarie needed to extend the lease because of cost overruns.

Don Wood: Yes, apparently the costs had escalated by about 50% or more than 50% over their original projections, and they were looking for a way to recoup those costs. This brings up a problem for anybody proposing a new toll road, especially in a place like California, where most roads and freeways are built at taxpayer expense, where politics drives transportation funding, and where people are used to driving for free. It's inherently—any project for a toll road in a state like California is inherently risky. Not only because of the inability to foresee the potential costs of project development and environmental challenges and law suits, but also because of uncertainties about what the state might do later in the process.

Stan Correy: What 'later in the process' means is the possibility of non-toll roads being built or improved by Caltrans, the California Department of Transport, next to the SR125. In the original 35-year lease, there were so-called non-compete clauses built in. If the state built or improved a competing road, CTV—that's Macquarie—would have to be reimbursed for lost revenues. Don Wood.

Don Wood: Apparently CTV, according to the Sandag meeting minutes, negotiated non-compete clauses in its lease agreement with Caltrans and apparently with Sandag, which limits those agencies' ability to make improvements to local state freeways that parallel the new toll road. According to the meeting minutes, CTV is trying to convince the transportation agencies to extend those non-compete clauses in the lease agreement, but the meeting minutes said that CTV has asked Sandag to support the legislative Bill extending the lease, but the Sandag has refused to support the lease extension unless the non-compete clauses are dropped from the lease agreement.

Stan Correy: So Macquarie and Sandag are discussing what to do. The state politicians won't proceed with the Bill to extend Macquarie's lease to 45 years unless the local council politicians support it. The locals won't support it unless they're allowed to increase the lanes of the free public highway.

Don Wood: What that could mean is that once the toll road opens, there could be increasing political pressure on the politicians to do something about the tolls charged and about the fact that people are still stuck in traffic unless they pay what may be some very high tolls. Under our political system, this may very well translate into additional state-funded improvements to state highways 5 and 805, which run west of, and parallel with, the new toll road. If those freeways are expanded and improved to take more traffic without charging tolls, the project toll revenues upon which 125 project was based may fall short. If that happens, both CTV and MIG may find themselves with a white elephant of a project, having sunk hundreds of millions of dollars into a toll road nobody uses.

Stan Correy: The CEO in Macquarie's company in San Diego, CTV, sent a letter to the Voice of San Diego, saying that the SR125 project is not in financial trouble, and there are other reasons for extending the lease. Sandag told Background Briefing that they're still in negotiations with Macquarie. According to Sandag, Macquarie are checking their financial models to assess the impact of a non-toll highway next to their toll road. This story about Macquarie's first big investment in the United States has got no coverage in the Australian media. and there's no mention of it on MIG's website. Background Briefing asked Macquarie about what was happening with the SR125. Mr Stephen Allen, CEO of Macquarie Infrastructure Group, said, 'We are in discussion with the various parties in California about amendments to the SR125 South concession agreement. As part of our ongoing business, MIG does this from time to time to see if there aren't mutually beneficial amendments that can be made. The project remains on track for a late 2006 opening. the budget is tracking as forecast, and beyond that we have no comment to make.'

There are conferences about infrastructure and investment banking and financial services going on every week. The world of public-private partnerships is one of the hottest gains in any town that has more than a dirt road and bicycle.

Chris Brown: So much to be done. There is such a demand in the community for faster roads, better water, better schools, better hospitals—you name it. And as Sharman said, we've got to help government get over some of the community obsession that these things are like pristine wilderness and that the private sector should never get anywhere near them. That's fine, but you won't get them, it's as simple as that. The community is going to have to make a decision if it wants these projects, if it wants current ones upgraded, renewed; if it wants new projects, if it wants them quicker, if it wants them done with more private sector discipline in construction, if it wants them managed better with private operational skills, with marketing, consumerism built in—then there's only one option. There's ten million taxpayers in Australia. An entire continent unto ourselves, and the rest of the world hankering not only for our money, but for our expertise; professional skills, expertise in building, in finance, in design. And if Australia doesn't get the finger out and doesn't take more projects to market, and governments overcome this obsession of—we daren't promise anything we don't deliver, therefore we won't promise anything—let us in to the game, let the private sector in and talk to you and work our projects and how they can be delivered.

Stan Correy: Chris Brown, from the Tourism and Transport Forum. He was speaking at an infrastructure finance conference in Sydney the day before Macquarie Bank announced its record profit. The crème de la crème of Australia's infrastructure were in attendance. This lone Background Briefing person seemed to be the only journalist there, but there were plenty of high fliers. Plenty of bankers, fund managers, lawyers, accountants, federal and state bureaucrats with nametags mentioning departments like Finance, Infrastructure, Development, and Roads and Transport. The minister for planning in NSW gave a speech; so did the Victorian treasurer. A federal minister was in attendance, as was the former Liberal minister Ross Cameron, who now works for Macquarie Bank.

The speech we wanted to hear, and to use in this program, was by the head of investment banking for Macquarie, Nicholas Moore, entitled 'Infrastructure Development: Recognising Communities' Needs and Concerns'. All other speeches at the conference could be recorded, and there was equipment provided for that. But not the Macquarie Bank one. In fact when Mr Moore's speech started, our recording plug was pulled out of the system. And that was a shame, because Mr Moore gave a very good speech. He took on the critics of public-private partnerships and their sensitivities about private ownership of essential services. And he exposed their weaknesses. This fear is irrational, he said, because today you have a sophisticated private sector who can manage investment in infrastructure better than government. Smart investors know this. Nicholas Moore pointed out that the world has plenty of unspent capital and investors love the idea of putting money into infrastructure funds, many of them managed by Macquarie. The constraint today, in financing infrastructure, isn't the government or the private sector, but community attitudes.

After his speech, Mr Moore, who is, by the way, the $18 million man, agreed to an interview as long as the questions only related to what he said in his speech.

Nicholas Moore: This infrastructure touches thousands, millions of people. There are a hundred million people who are actually receiving services provided by Macquarie today, globally. Now these are essential services to people. They have a right and a natural concern as to how those services are being delivered to them and they need to know those services will continue to be delivered to them at the quality and the price that they expect.

Stan Correy: Does Macquarie take into account that concern, because you mentioned things…the debate about privatising monopolies—this is not only I suppose from the community, it's from the media and some in the investment community as well. For example, I suppose Chris Corrigan, he's already called you a privatising monopoly…

Nicholas Moore: Well the concessions and the assets we work in have all —if they're providing services to the public—usually come, as I mentioned in the presentation, with a regulatory framework, or a concession framework that's around them that's actually reflecting the concerns of the community. So the big picture; the government sets up the structure that we fill in. As far as we're concerned, if we are going to deliver for our investors, we have to make sure that our customers actually feel that they're getting a good service.

Stan Correy: With the investors, the Macquarie model is also discussed, in the sense of the infrastructure funds and what they provide and they value they provide for investors—and investors have obviously got a very good deal from them—but there is also talk in the market about fees and performance and management fees. How important is that to the Macquarie model? Can that model last if interest rates or the market turns—what's your feeling about that kind of criticism?

Nicholas Moore: I think that investors are voting with their feet or with their chequebooks and that they actually do believe that Macquarie is providing a good role in terms of the management of these assets. So I think that's the fact today. In terms of can it last? Well, gosh, I hope so. If we continue to provide the services and if we continue to provide the assets to the investors that they require, and manage them in a way that's sensitive to the needs of the customers and therefore to the investors, I can't see why it can't continue.

Stan Correy: Nicholas Moore had emphasised that the interests of the investors should be aligned with community needs.

Nicholas Moore: It can be good for investors and it can also be good for the community as a whole. And the limited view of the world to say if it's good for one it's bad for the other, I think, just doesn't carry weight. This infrastructure area would represent probably about 10% of the workforce of Macquarie.

Stan Correy: But you don't think this infrastructure area is dominating Macquarie at the moment?

Nicholas Moore: No.

Stan Correy: Nicholas Moore, head of investment banking for Macquarie Bank. Infrastructure may only employ 10% of Macquarie's staff, but it is by far the biggest money-spinner for the company.

Ian Rogers: I would say that infrastructure is the dominant feature of Macquarie Bank business model. One of the numbers that Alan Moss, the managing director, and David Clarke, the executive chair, were keen to talk about at their profit briefing in the middle of May was the amount of money —new capital—that Macquarie have raised for all sorts of funds managed by Macquarie Bank. And it's an extremely large number. In the last 12 months Macquarie raised $13.8 billion in new capital for its array of infrastructure funds. That's nearly as much money as Macquarie Bank have under management in their conventional funds management business, which isn't very profitable for them and isn't going very well for them. But they've raised $14 billion in one year for their infrastructure funds. They've now got I think it's around $89 billion in funds under management altogether, and given the trajectory that they're on, it's plausible to imagine that because of their infrastructure fund management business, Macquarie Bank will become the largest fund manager in Australia over the course of the rest of the decade.

"It's plausible to imagine that Macquarie Bank will become the largest fund manager in Australia over the course of the rest of the decade."

Stan Correy: Macquarie's infrastructure funds have been able to capture the biggest investors in the world. Those with the biggest bags of money to put into your company, the super funds. Australia has a council of super investors, which keeps an eye on things in general and they're very happy with the big profits Macquarie Bank is earning. But, says the council president, Michael O'Sullivan, they are paying a bit of attention to the big fees Macquarie is skimming off the profits.

Michael O'Sullivan: For us, all fees are money out of our members' pockets into the pockets of the managers, and therefore we scrutinise fees very closely. And we've, I think, driven down fees in the equity market. But in areas like the alternative investment class like infrastructure and many of these other specialist funds, like the ones that Macquarie pioneers and runs extremely effectively, I'd have to say, extremely effectively—there is an issue about fees. And even in the return figures just announced, which are stellar, almost beyond criticism—the amount attributed to income from fees has gone up to $388 million as the base fees from the specialist fees, which is about 11% of all of their income. And there's another $302 million coming in from performance fees. Now we don't mind performance fees, as long as they're properly hurdled. But $700 million of their $3.7 billion has come in from fees. So fees are a very critical part of their income and a very critical part of our outgoings. So, yes, we're keen to keep fees low.

Stan Correy: Charging fees for service in managing funds is perfectly okay. But are Macquarie's fees reasonable?

Michael O'Sullivan: Some assets require very intensive corrective management. When they buy them they're in a hole and they build them back into successful ventures and they deserve some credit for that. On the other hand, they've taken out of profits something like $73 million for the top four or five of their executives so share. So profits would have been almost ten per cent higher if they hadn't taken that out. Now clearly they would have taken something decent out for people who've worked very well, but it's a very large amount in remuneration. And part of it is generated by this fee income. When you're a market leader like they are, I think a certain kind of responsibility devolves on to you—maybe unfairly—to set a tone and to set if you like ethical standards about the way you go about these things. I'm not suggesting that any of this is unethical in the sense of morality, but to set business ethical tone about the way you do your business, because if you're going to be imitated you should set a high standard rather than whatever standard you can get away with.

Stan Correy: Background Briefing's co-ordinating producer is Linda McGinnis. Executive producer, Kirsten Garratt. Research by Paul Bolger. And technical production today by John Jacobs.