Connecting Business with Government

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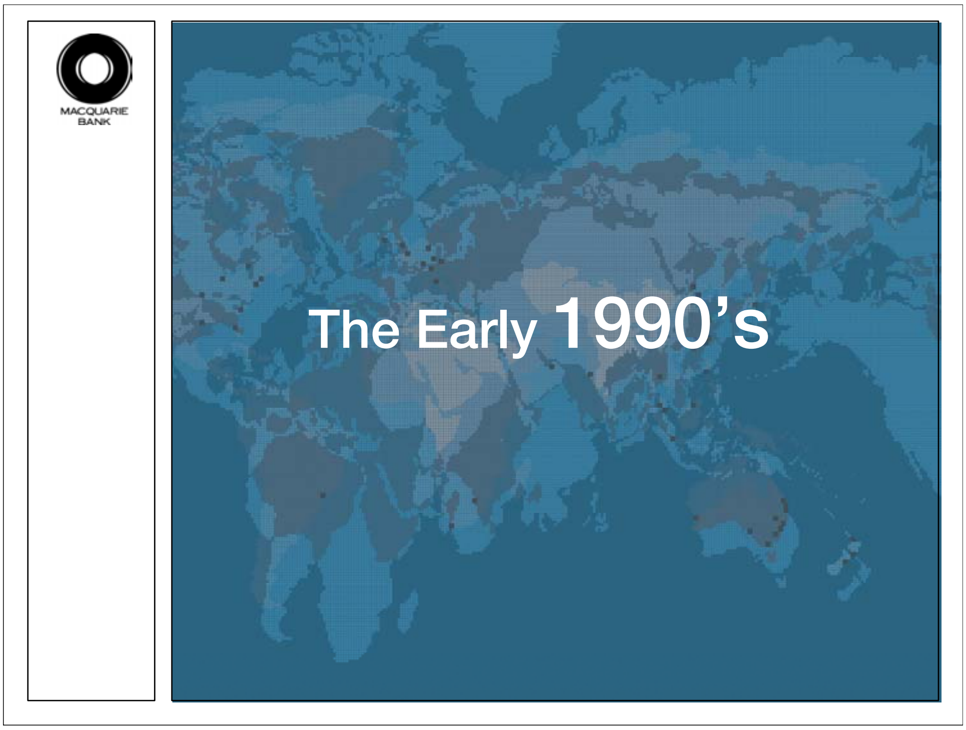
Hon Warwick Smith, Executive Director , Macquarie Bank Limited



INTRODUCTION

My thanks to our chair, Catherine Baldwin who as you know has recently joined CEDA as the Chief Executive, for the opportunity to deliver this address to the 2006 CEDA State of the Nation Conference.

This conference follows what I consider to be a very well crafted Federal Budget, one that has been well received by Business, the media and the community.

It is a Budget with an eye on the future and one that has learned lessons from the past – An approach I intend to use today to look at Business and Government working together.

I want to share with you today my views on connecting business and government from a practitioner's perspective. Somebody who has been on both sides of this Business/Government equation.

I want to start my address with a trip back in time – back 15 years or so.

Back in the early 1990's I was the Shadow Minister for Privatisation, the first to hold such a position, and the Liberal Party in Opposition was embarking on a major policy development process.

FIGHTBACK!

You may recall a document called Fightback!

A document not often referred to today by current Coalition MP's - but worth another look nevertheless.

A major part of the thinking of that time was Government and Business connecting better for the benefit of the community as a whole.

As the spokesperson on privatisation and deputy to Ian McLachlan in the economic group I helped develop and shape a large and ambitious program of privatisation. This program was outlined in Fightback!

The plan included the privatisation of many Commonwealth authorities that undertook business functions and the outsourcing of some government services, which were to be delivered by the private sector.

At the time I undertook extensive study, and had several visits to the UK and the USA. Strong interest came from "Think Tanks" and international investment banks, such as CS First Boston, Salomans, Rothchilds and JP Morgan.

Government business enterprises named in Fightback! as privatisation targets were:

- Qantas;
- The Commonwealth Bank;
- The Australian Mining Industry Development Corporation;
- The Australian National Line;
- The Pipeline Authority;
- The Commonwealth Serum Laboratories;
- The Australian and Overseas Telecommunications Corporation;
- The Federal Airports Corporation;
- The National Transmission Authority;
- Medibank Private; and
- The commencement of the sale of Telecom (Telstra)

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- the Commonwealth Bank;
- the Australian Mining Industry Development corporation,
- the Australian National Line;
- the Pipeline Authority;
- the Commonwealth Serum Laboratories;
- the Australian and Overseas Telecommunications Corporation;
- the Federal Airports Corporation;
- National Transmission Authority;
- Medibank Private and;
- The commencement of the privatisation of Telecom or Telstra as we know it today.

It is a very familiar list!

The arguments at the time included ensuring these Government Business run more efficiently with a better consumer focus, how they could go about getting more investment into technology and infrastructure with out the restraints of Government ownership, how could we get better outcomes for tax payers, how we could unlock the potential that existed for growth and how we could encourage more Australians into share ownership.

While the Coalition governments have implemented many of these privatisation and outsourcing options, ironically, however, many of the privatisations specifically outlined in Fightback! were actually privatised by the previous Labor government.

Australian Airlines was merged with Qantas and privatised under Labor; the Commonwealth Bank was fully privatised in a series of public floats under Labor; Aussat was sold and the Commonwealth Serum Laboratories was privatised in 1994, also under Labor and all supported by the Shadow Minister for Privatisation at the time.

Since 1996 we have had T1 and T2, The Australian National Line has been was sold; the Australian Pipeline Authority and the airports were also privatised. Currently on the agenda we have T3, Medibank Private, ASC and Snowy Hydro.

The privatisation goals we set out in Fightback! are well on the way to being achieved.

BUSINESS AND GOVERNMENT

Business and Government are now more connected than ever before.

The mutual interests that have always existed between Government, Business and the Community are now even more self-evident.

Business, Government and the Community all want to see

- Strong economic growth;
- Political stability and a flexible market;
- Effective regulation and robust institutions;
- Good social services; and a
- Well-educated workforce.

Privatisation has played an important part in our current success in these areas, not always without controversy but overall very few would argue to turn back the clock.

In fact since privatisation was pioneered in Britain in the 1980s, over 100 countries have used privatisation to sell close to a trillion dollars of state assets.

STRONG ECONOMIC GROWTH

During the past decade the Australian economy has performed very well.

In fact, the Australian economy has been a star performer among OECD nations over the past decade.

Good Economic Times

- Corporate profits as a share of GDP have risen from 20% to 24%.
- The unemployment rate has fallen from 11% in the early 1990s to 5% now.
- The level of net public debt has fallen from $95 billion in 1995 to zero now.
- The market capitalisation of listed companies has increased by 260% over the last decade.

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Here are just a few indicators of how well the Australian Economy has done:

- Corporate profits as a share of GDP have risen from 20% to 24%;
- The unemployment rate has fallen from 11% in the early 1990s to 5% now;
- The level of net public debt has fallen from $95 billion in 1995 to zero now; and
- The market capitalisation of listed companies has increased by 260%

We have also had significant investment in both public services and infrastructure, including more being spent on heath, aged care, education and increased investment in land transport, communications and energy infrastructure.

I am sure the coming ministerial speakers at this Conference could quote us the figures and they would all point to more spending than ever before.

But is it enough?

<u>THE INFRASTRUCTURE CHALLENGE</u>

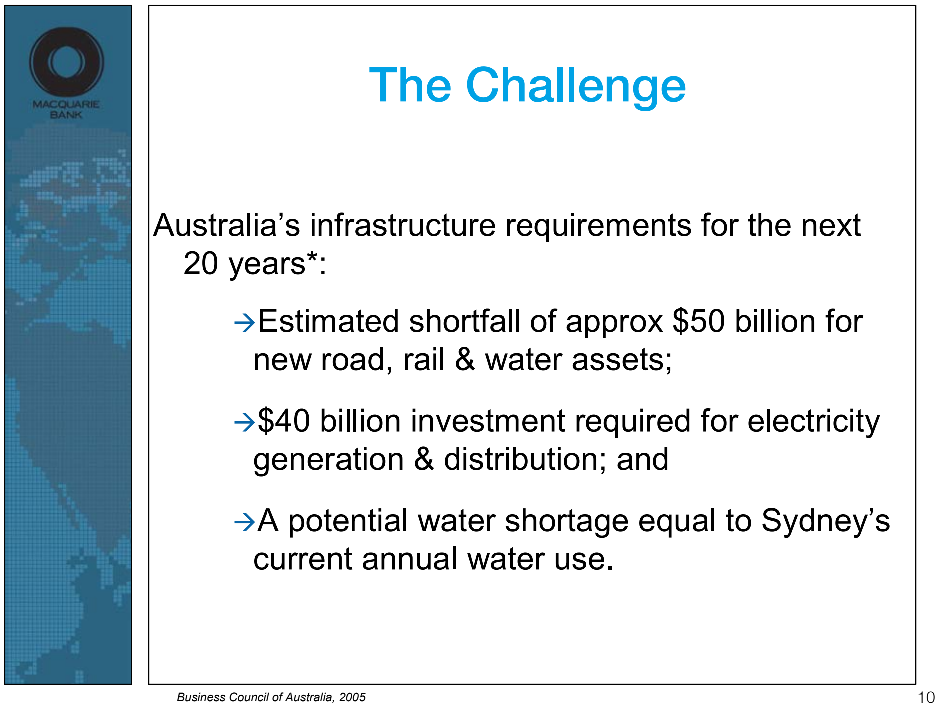
There is a growing gap between infrastructure needs and our ability to finance its construction. This is an issue that has been on the policy agenda for some time.

In 1987 the House of Representatives Standing Committee on Transport, Communications and Infrastructure produced a report titled “Constructing and Restructuring Australia’s Public Infrastructure”

I was a member of the Committee that undertook the inquiry.

It was the first report in Australia to canvas the infrastructure funding needs, especially in water, sewerage, roads, ports and rail.

It found that the public funding models of the time were would be insufficient to maintain quality, satisfy renewal and meet growing demand.



A more recent 2005 report by the Business Council of Australia (BCA) identified Australia's infrastructure requirements for the next 20 years included:

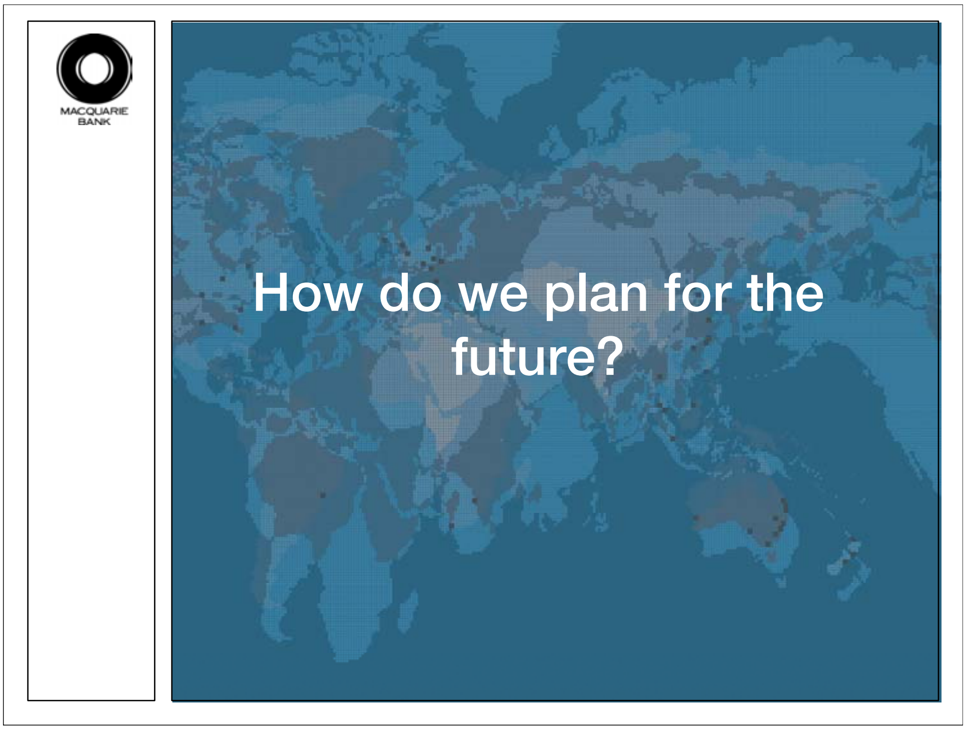
- An estimated shortfall of approx $50 billion for new road, rail & water assets;
- A $40 billion investment required for electricity generation & distribution; and
- A potential water shortage equal to Sydney's current annual water use.

On top of this public demand for all kinds of social expenditure is continuing to grow.

Voters are also increasingly reluctant to pay more tax for more public spending.

So we have a very real public policy issue to deal with.

If even in these good economic times Governments are not able to afford to satisfy all the immediate demands of the electorate, how can we meet the country's longer term needs for better infrastructure?

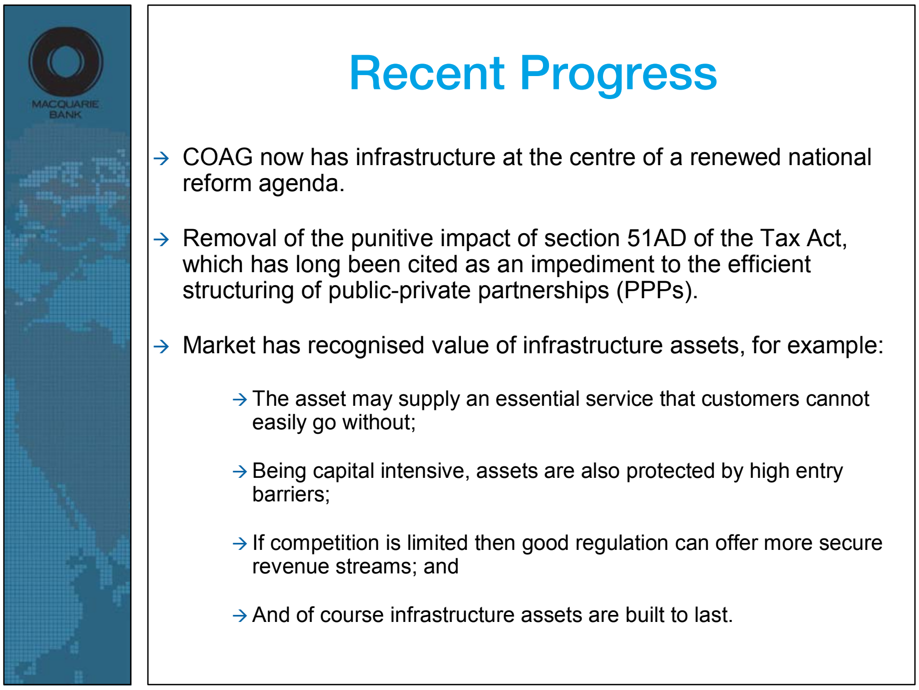


This is not just an issue for Australia.

In 2004 the OECD Futures Programme launched a major project to assess 'Global Infrastructure Needs' over the next 25 years. The Project Steering Group includes OECD Governments and some large private companies.

Macquarie Bank is one company represented on the Project Steering Group though our London Office.

The work will not be completed until next year but the broad conclusion is already clear – the global need for infrastructure investment will run well beyond the ability of governments alone to fund.



Australia's Governments have certainly made progress and at the February 2006 Council of Australian Governments (COAG) agreed to place Infrastructure at the centre of renewed national reform agenda.

The Governments decision to remove the punitive impact of section 51AD of the Tax Act, which has long been cited as an impediment to the efficient structuring of public-private partnerships (PPPs) is also a very positive move.

But the BCA also tell us that there is no time to waste and it estimates that if these agreements are not translated into action in the next two years the cost to Australia's economy through lost growth from ongoing infrastructure bottlenecks will be in the order of $10 billion a year.

We do face a serious problem with the need for more and better infrastructure. - The big question is what to do about it.

As you have heard the funding needs just in water, energy road and rail the cost is estimated at 90 billion dollars without looking at communications or other important needs. No doubt some of the funding for public infrastructure will continue to come from public investment. - But that will still leave a huge gap.

So the challenge that fronts Government and Business is to create incentives that will attract enough investment to bridge the gap.

Over the last few decades, there has been a slow trend towards private financing of infrastructure projects

Certainly one very positive factor is that the market has now recognised that infrastructure assets do have special attractions for some big investors. For instance:

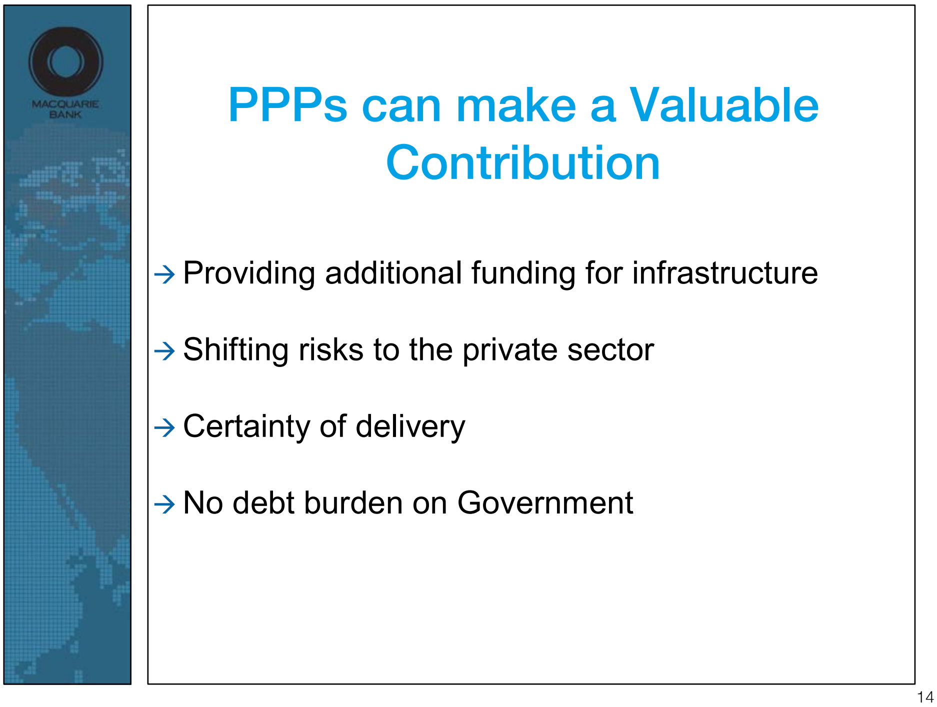
- The asset may supply an essential service that customers cannot easily go without
- Being capital intensive, assets are also protected by high entry barriers
- If competition is limited then good regulation can offer more secure revenue streams
- And of course infrastructure assets are built to last:

That suits big investors with long-term liabilities like insurers and superannuation funds. The challenge of many demands from key areas of government spending competing for limited government funds is universal. Governments seek to meet all of these demands while remaining fiscally responsible.

PUBLIC PRIVATE PARTNERSHIPS

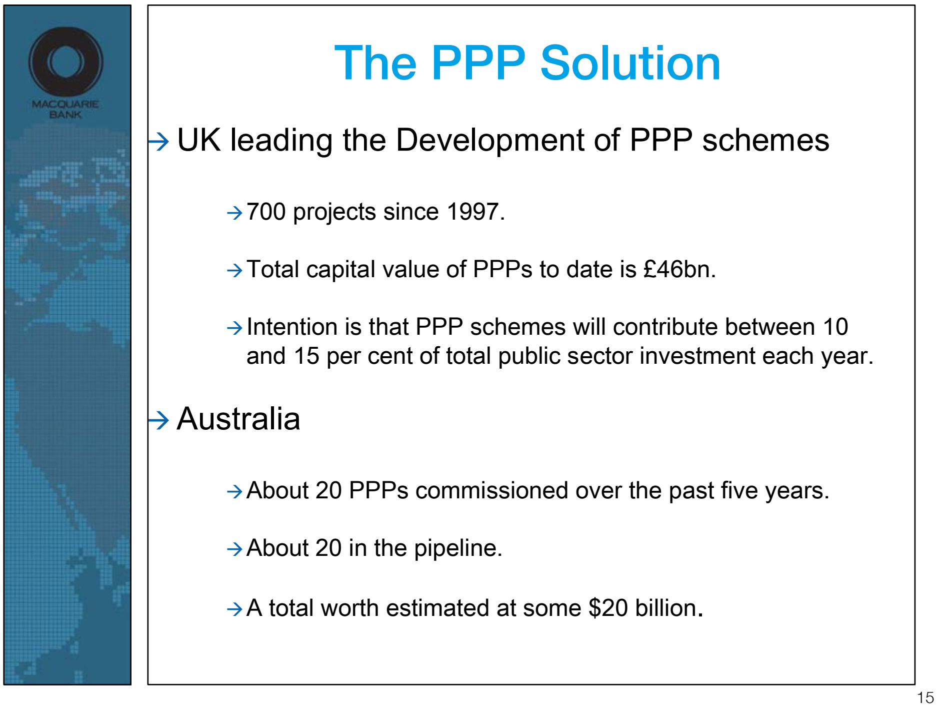
One way of meeting this challenge is the use of Public Private Partnerships or PPPs to fund Infrastructure investment.

Following on from the privatisation of government owned infrastructure businesses PPPs are another way of bridging the gap particularly in new "Greenfield" infrastructure projects.



PPPs can make a valuable contribution to Australia's infrastructure needs by:

- Providing additional funding for infrastructure;
- Shifting risks to the private sector;
  - The government does not guarantee private sector returns; and
  - It should be remembered that when the public sector develops a project, the taxpayer bears the risks.
- Certainty of delivery;
  - The private sector better at managing projects and concession contract provides for financial penalties for late opening ; and
- No debt burden on Government;
  - For example if Sydney's toll roads were developed by traditional public sector finance, then NSW government would have $7 billion more government debt.



The UK is also in the forefront of Public Private Partnerships with over 700 projects closed since the New Labour Government came to power in 1997.

Total capital value of PPPs to date in the UK is £46bn.

The UK Treasury intention is that PPP schemes will contribute between 10 and 15 per cent of total public sector investment each year.

In Australia, according to the national PPP forum, which has been recently launched by the Australian Government, there are 17 projects currently in the market and 17 potential projects.

With about 20 PPPs commissioned over the past five years, and as many in the pipeline, the impact of this method of financing infrastructure projects is growing with a total worth estimated at some $20 billion.

We are also broadening out the type of projects that PPPs are being applied to, including toll roads, prisons, schools and ports.

Privately financed infrastructure has delivered measurable benefits in Australia.

A recent independent review of Victoria's PPP projects by Peter Fitzgerald found real benefits coming out of innovation, price certainty, timely delivery and the whole-of-life approach to refurbishment and maintenance.

Private risk finance is central to these projects. It is the glue that holds together the transaction and the risk allocation between the various parties.

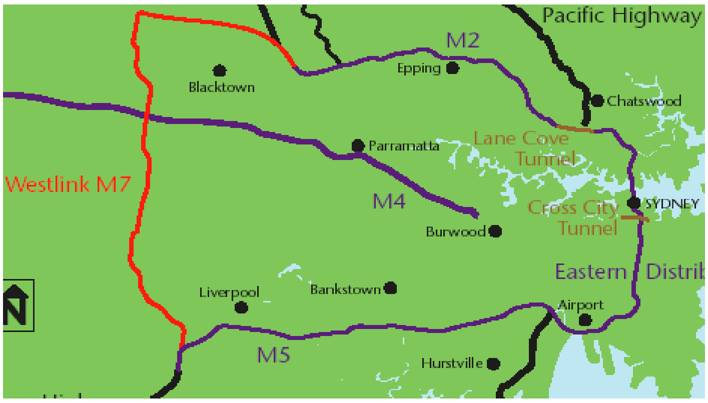
At present the market response is positive.

There is a growing understanding and acceptance of PPPs and yet some public sensitivity to government/private transactions remains.

CASE STUDY

I want to look further at a recent Australian case study - The M7 – Westlink road project.

Westlink M7



- 40km motorway;
- Connects M5 in south to M2 in north and is bisected by M4;
- Construction cost: A$1.5 billion.

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The M7 is a 40km motorway that opened in December 2005 at a construction cost of A$1.5 billion.

Westlink M7

- 17 interchanges;
- 175 bridges/overpasses;
- Bypasses 56 sets of traffic lights;
- Fully electronic tolling;
- Open to traffic in December 2005 – 8 months ahead of schedule;
- Economic boost to the region:
  - 1,500 jobs created during construction;
  - Additional 24,000 jobs created. Generating more than $260 million for the Australian economy.

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It has 17 interchanges, 175 bridges or overpasses, bypasses 56 sets of traffic lights and has fully electronic tolling.

It was completed 8 months ahead of schedule and can save users up to 65 minutes in travel time.

Results

Project Delivery	✓ Completed 8 months early
Risk Transfer	✓ Project risk transferred to private sector
Business Case	✓ 100,000 vehicles use the road per day
Community Acceptance	✓ Strong support from local government
Tolling	✓ Toll price perceived to offer good value for money

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The project transferred the risk to the private sector and had strong support from local Government and the general public.

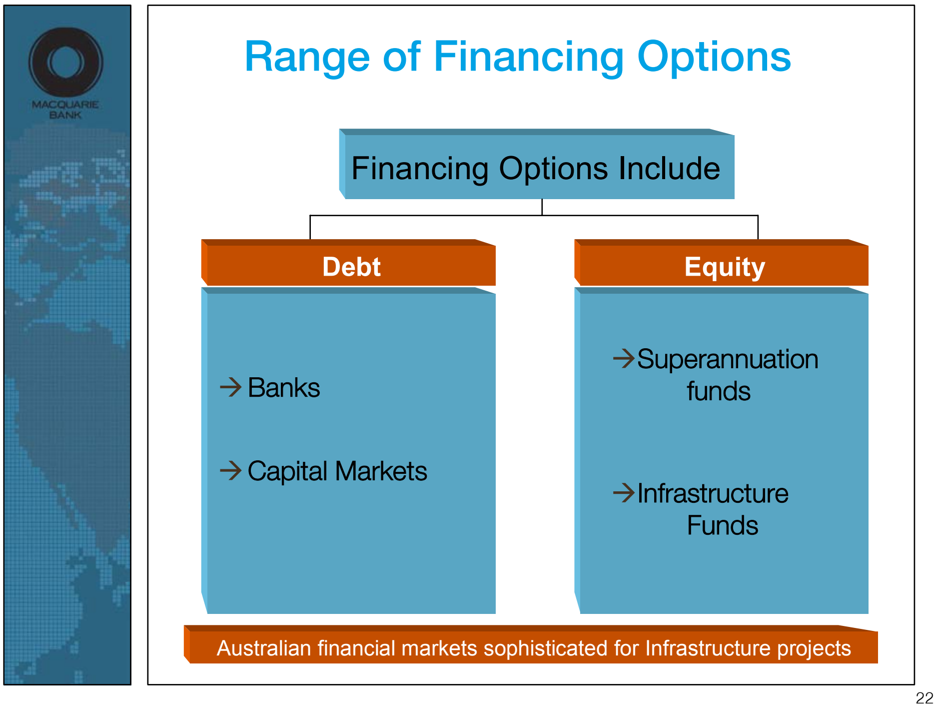
With 100,000 vehicles using the road each day the public has accepted the toll as good value for money.

There is a very strong case for more PPPs, provided the mix of interests between business and Government are right.

PPPs can allow Governments to provide a faster response to demographic needs.

PPP-type arrangement can offer better value for money over traditional financing and ownership options.

PPPs can help governments to harness the innovation, financing and marketing skills of the private sector.



FINANCING OPTIONS

There are a range of financing options for PPPs, very broadly these are:

Debt Financing – like bank debt or capital markets; and

Equity Financing – like superannuation funds and infrastructure funds.

Equity Investors

- Superannuation funds have grown very rapidly in Australia in recent years, from $95 billion in June 1988 to $730 billion in December 2005;
- Superannuation funds will continue to be strong cash flow positive until beyond 2020;
- New investment opportunities outside of existing capital markets are highly attractive; and
- Australia now has the fourth largest managed investment pool in the world.

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We all know about the growth of super funds in Australia and around the world.

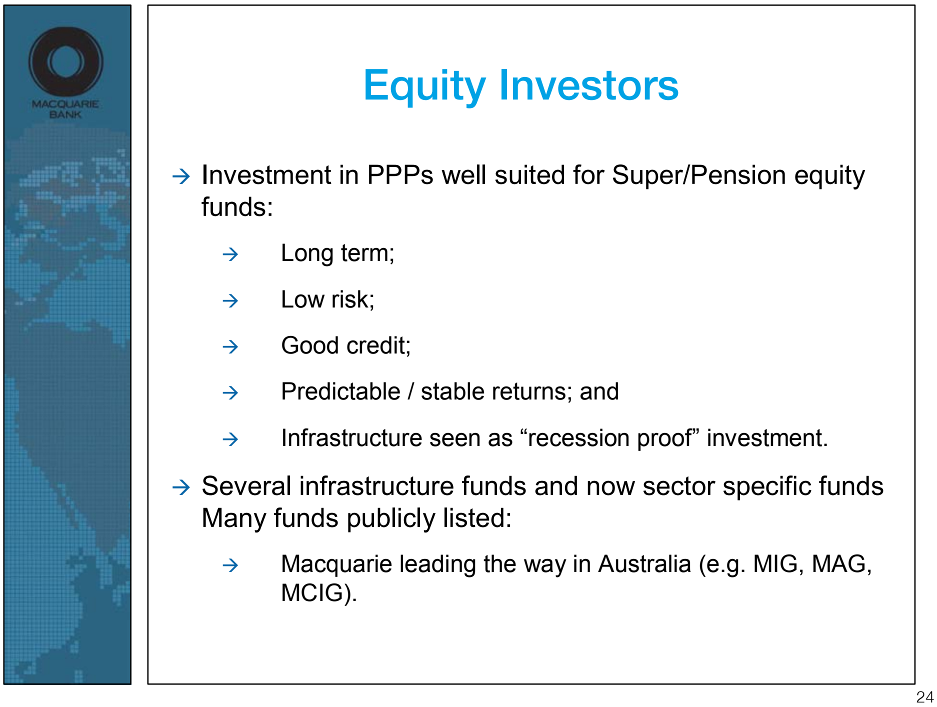
Superannuation funds have grown very rapidly in Australia in recent years.

Total assets held in funds has gone from $95 billion, or 21% of GDP in June 1988, to $730 billion, or about 80 per cent of GDP in December 2005.

Superannuation funds will continue to be strong cash flow positive until beyond 2020 and new investment opportunities outside of existing capital markets are highly attractive to fund mangers.

Australia now has the fourth largest managed investment pool in the world – behind the United States, Luxembourg and France and ahead of Italy, the UK, Ireland and Japan.

About 25% of these funds are invested offshore.



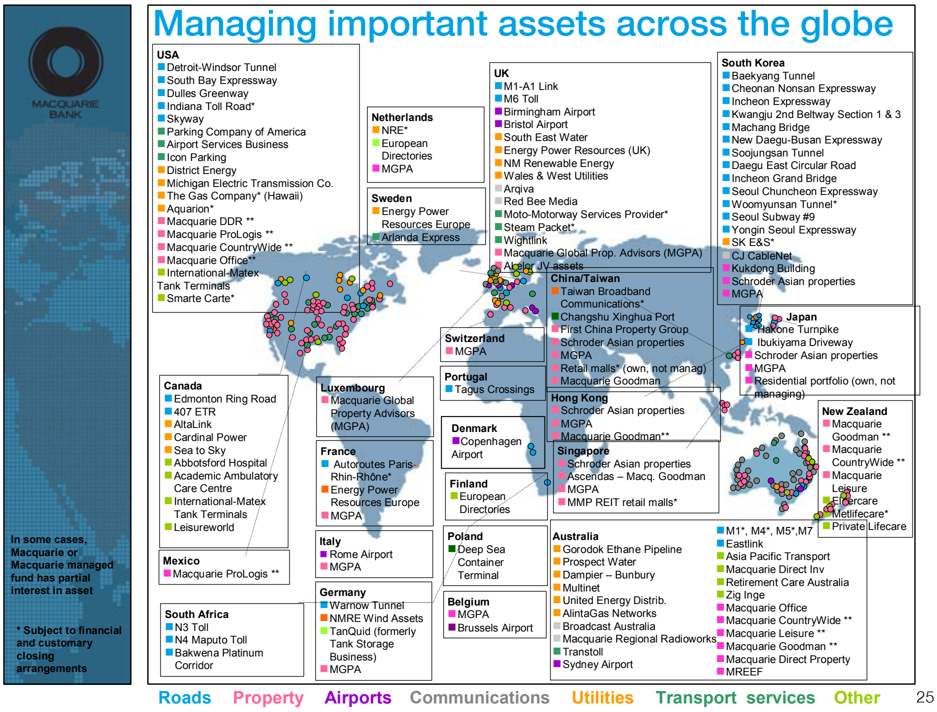
Investment in PPPs is well suited for Superannuation equity funds

It has the following characteristics:

- Long term;
- Low risk;
- Good credit;
- Predictable / stable returns;
- Infrastructure seen as “recession proof” investment; and
- Good, positive, steady yields.

There are now several Infrastructure funds, including many sector specific funds.

Many funds publicly listed and Macquarie are leading the way in Australia, but other investment banks are now following.



As you can see from this slide Macquarie is now managing many important assets across the globe.

In Australia they include the M1, M4, M5, M7, Eastlink, Sydney Airport, Broadcast Australia, AlintaGas Networks, United Energy Distribution, and the Dampier – Bunbury gas pipeline.

Internationally they cover UK, USA, France, Italy, Belgium, Poland, Canada, South Africa, South Korea, and China to name a few.

Summary

- Privatisation and PPPs are an important part of the mix for meeting our infrastructure needs into the future;
- There is demand from fund mangers wanting to invest in infrastructure assets;
- Community acceptance is a key success factor and needs to be paid more attention; and
- For either privatisation or PPPs a stable political, legal and regulatory environment is needed.

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IN SUMMARY

As we have seen, there will be no shortage of infrastructure needs – the challenge is to transform those needs into projects.

This is where specialist infrastructure investors can offer important reassurance to communities understandably concerned about the future of essential services. Whereas Private Equity owners might sell out too soon at too high a profit for political comfort, and strategic investors might dispense with local HQs and management – the specialist infrastructure investor will lock in long term for steady yield and therefore want to build strong stakeholder relations.

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There is demand from fund managers wanting to invest in infrastructure assets.

Community acceptance is a key success factor and needs to be paid more attention.

For either privatisation or PPP, perhaps the biggest consideration is whether investors can operate public infrastructure on a commercial basis in a stable political, legal and regulatory environment.

These are key investment criteria – as these are long term investments, partnering industry with Governments and communities.