

Infrastructure Funds: Creative Use of Corporate Structure and Law – But in Whose Interests?

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Abstract

Infrastructure as an asset class has commanded increasing attention from investors and the financial press over the past two years. Major asset sales in the UK – most notably of ports and water utilities such as Thames Water – and ongoing attention on road infrastructure in the United States and Europe, has been met with increased competition for assets, not from ‘trade buyers’ (such as utility companies) but from investment banks and asset managers. The asset manager model for infrastructure, where a sponsoring manager – usually but not always an investment bank – establishes a separate publicly traded entity to own infrastructure assets while contracting out management functions to the sponsor, was pioneered by Australia’s Macquarie Group Limited (known until recently as Macquarie Bank). Even as the managed infrastructure model has grown in popularity, at least among potential and actual asset managers, there are some signs of investor unease with the existing model. At the basis of these concerns is the unique governance structure that has emerged among publicly traded infrastructure vehicles. This paper initially outlines the main features of infrastructure assets. It then explains the importance of distinguishing between infrastructure *assets* and infrastructure *funds*. The predictable, and steadily growing, cash flow associated with infrastructure assets is commonly highlighted as a basis for providing an attractive, and steady, yield. However, the yield delivered by several infrastructure funds is sourced from operating cash flows of the fund’s assets *and* from capital. The paper then summarizes the key features of the infrastructure fund model, pioneered by Macquarie. It then highlights a range of investment-related concerns with the infrastructure model: a series of issues related to the sustainability of the model; a danger of overpaying for assets; fee structures that provide an incentive to increase a fund’s size without sufficient regard to returns; and accounting practices that have the capacity to provide an overly robust picture of a fund’s profitability. The paper then describes a series of governance concerns with the infrastructure model. For instance, the existence of ‘special shares’ in some funds which entitle the external manager to appoint a majority of the fund’s directors. The paper concludes with a series of reform proposals.

Keywords: infrastructure, corporate governance, corporate law, agency costs, ownership structure

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1. Introduction

Infrastructure as an asset class has commanded increasing attention from investors and the financial press over the past two years. Major asset sales in the UK – most notably of ports and water utilities such as Thames Water – and ongoing attention on road infrastructure in the United States and Europe, has been met with increased competition for assets, not from ‘trade buyers’ (such as utility companies) but from investment banks and asset managers.

The asset-manager model for infrastructure, where a sponsoring manager – usually but not always an investment bank – establishes a separate publicly traded entity to own infrastructure assets while contracting out management functions to the sponsor, was pioneered by Australia’s Macquarie Group Limited (‘Macquarie’). There are now five publicly traded infrastructure funds managed under the Macquarie model on the Australian Securities Exchange (‘ASX’) – Macquarie Airports, Macquarie Capital Alliance Group, Macquarie Communications Infrastructure Group, Macquarie Media Group and the original and largest fund: Macquarie Infrastructure Group. The growth in infrastructure funds has not been confined to Australia: Macquarie now also has an infrastructure fund listed on the New York Stock Exchange (Macquarie Infrastructure Company), the Korea Exchange (Macquarie Korea Infrastructure Fund, which is jointly listed on the London Stock Exchange),¹ the Singapore Stock Exchange (Macquarie International Infrastructure Fund Limited), and the Toronto Stock Exchange (Macquarie Power & Infrastructure Income Fund). Macquarie’s Australian peer, Babcock & Brown, now manages five infrastructure funds listed on the ASX – Babcock & Brown Infrastructure, Babcock & Brown Capital, Babcock & Brown Environmental Investments (presently subject to a takeover offer by Babcock & Brown), Babcock & Brown Wind Partners and Babcock & Brown Power. Over the past two years it has listed new funds in London (Babcock & Brown Public Partnerships) and Singapore (Babcock & Brown Structured Finance Fund).

Other investment banks and financial institutions around the world have noted the rise of the Macquarie model and joined the rush for infrastructure assets. Goldman Sachs won a bid for British Ports in 2006, outbidding (among others) Macquarie for an asset it intends not to own but to manage; while in Australia, financial and non-financial institutions have launched or are considering launching infrastructure vehicles: insurer and funds manager, Challenger Financial Services Group, launched a fund in 2005, and Singapore Power, engineering firm Transfield, the Commonwealth Bank and (now de-listed) utility Alinta have all launched or are reportedly considering launches of infrastructure funds.

Even as the managed infrastructure model has grown in popularity, at least among potential and actual asset managers, there are some signs of investor unease with the existing externally managed infrastructure model. Macquarie has declared its preference

¹ Macquarie Korea Infrastructure Fund is managed by Macquarie Shinhan Infrastructure Asset Management Company Limited, which is a joint venture between a subsidiary of Macquarie and Shinhan Bank and Shinhan Capital, which are members of the Shinhan Financial Group.

for unlisted funds in the future.² This declaration, perhaps coincidentally, came after Macquarie encountered difficulties in listing Macquarie Media Group over the fee structure of the vehicle, and after institutional investor pressure saw a collection of established toll roads spun-off from Macquarie Infrastructure Group into an *internally* managed entity, Sydney Roads Group. Alinta, an investment-banking client of Macquarie, spun-off its own collection of energy infrastructure assets into an Alinta-managed separate entity in 2005 (Alinta Infrastructure Holdings), only to announce a takeover of that entity slightly over one year after listing as investors failed to warm to the entity amid negative press coverage of its fee structure, which included an ‘asset management fee’ equal to 3 per cent of revenue.³

At the basis of these concerns is the unique governance structure that has emerged among publicly traded infrastructure vehicles. These structures, pioneered by Macquarie with Macquarie Infrastructure Group and refined by Macquarie, Babcock & Brown and others over the past five years, have married aspects of the governance structure for a publicly traded real estate investment trust (‘REIT’) with that of a traditional company. The resulting ‘stapled’ entities have multiple boards, and are run by an external management company employed under a management agreement providing for substantial fees. Many of the features of these vehicles appear to make it practically difficult, and possibly expensive, for investors to replace the external manager if dissatisfied with its performance.

This paper initially (Section 2) outlines the main features of infrastructure assets. Section 3 then explains the importance of distinguishing between infrastructure *assets* and infrastructure *funds*. The predictable, and steadily growing, cash flow associated with infrastructure assets is commonly highlighted as a basis for providing an attractive, and steady, yield. However, the yield delivered by several infrastructure funds is sourced from operating cash flows of the fund’s assets *and* from capital. Section 4 summarises the key features of the ‘infrastructure fund model’. Section 5 then highlights a range of investment-related concerns with the infrastructure model: a series of issues related to the sustainability of the model; a danger of overpaying for assets; fee structures that deliver high fees and provide an incentive to increase a fund’s size; and accounting practices that have the capacity to provide an overly robust picture of a fund’s profitability. Section 6 describes a series of additional concerns with the infrastructure model – concerns of a governance nature. For instance, the existence of ‘special shares’ in some funds which entitle the external manager to appoint a majority of the fund’s directors. Section 7 outlines a series of reform proposals, and concludes.

² See Jemima Whyte, ‘Unlisted now top of list’, *The Australian Financial Review*, 7 February 2007, page 54 and Eric Johnston, ‘MacBank rides the bull’, *The Australian Financial Review*, 10 February 2007, page 13. In the two years to 31 March 2008, 85 percent of new equity capital raised by Macquarie’s ‘specialised funds division’ (which includes infrastructure) has been for unlisted funds. See Macquarie Bank, *Annual Review 2007*, page 8; Macquarie Group, *Annual Report 2008*, page 11.

³ Alan Kohler, ‘Time to Buy an Electric Stove if Alinta Wins’, *Sydney Morning Herald*, 2 September 2006: available at <http://www.smh.com.au/news/business/time-to-buy-an-electric-stove-if-alinta-wins/2006/09/01/1156817099819.html#> (visited 22 May 2007).

The examples of publicly traded infrastructure funds used in this paper are all funds listed on the ASX.

2. What are the key characteristics of infrastructure assets?

Managers of infrastructure assets have sung the praises of infrastructure as an asset class to investors over the past decade.⁴ The classic infrastructure asset is either a monopoly or oligopoly with predictable secure long-term cash flow. Other characteristics commonly possessed by infrastructure assets are: they are providers of basic, everyday services that enjoy consistent, inelastic demand; they are generally comprised of long-life, high-value physical assets, replacement of which creates a high barrier to entry; and there is often little likelihood of the assets being rendered obsolete as a result of advances in technology.⁵

Toll roads, ports, airports, airport car parks, utilities and energy distribution networks either formerly owned by government or protected by government regulation (such as renewable energy generators) share these characteristics, resulting in stable returns linked to inflation over long periods of time.

Pension funds and retail investors seeking secure long-term returns, attracted by these characteristics of infrastructure *assets*, have invested in publicly traded infrastructure *funds* that promise exposure to steadily increasing returns coupled with liquidity.

3. Why is it important to distinguish between infrastructure *assets* and *funds*?

On the face of it, the publicly traded infrastructure model is similar to the REIT model embraced by institutional and retail investors in Australia and the United States: Exposure to stable returns through a publicly traded vehicle that either makes access possible (for retail investors) or provides (in the case of institutional investors) access with liquidity through a listing on a stock exchange.

However, on closer examination the publicly traded infrastructure model probably has more in common with private equity than with publicly traded property funds. These similarities, acknowledged by Macquarie,⁶ relate to the nature of the assets and the

⁴ Challenger Financial Services Group, 'Half-year results to 31 December 2004', ASX announcement, 28 February 2005, page 29, available at <http://www.asx.com.au/asxpdf/20050228/pdf/3pxssyg2wm3nm.pdf> (visited 22 January 2008).

⁵ Macquarie Infrastructure Company, *Annual Report 2005*, page 5.

⁶ Macquarie Bank presentation to Institutional Shareholder Services / University of Melbourne Law School 'Corporate Governance Conference', University of Melbourne Law School, 24 February 2006. See also 'Why Macquarie Manages Infrastructure Funds', Media Release, 3 March 2006, available at http://www.macquarie.com.au/au/about_macquarie/media_centre/20060303a.htm (visited 22 May 2007): 'Macquarie is an active manager of its infrastructure funds. It works with asset level management on an ongoing basis to improve the operating performance of the assets and the levels of service delivered to customers. Macquarie is also responsible for ensuring that the capital structure of the assets is appropriate and provides the best possible return to equity investors in the funds. Macquarie's infrastructure funds business has over 400 executives who conduct this active management. The base and performance fee structure is not unique to Macquarie managed funds. It is commonly used around the world in externally

management model. Private equity funds typically favour businesses with substantial recurring cash flows, strong market positions and assets that can bear substantial levels of debt. Just as in private equity, debt is raised by an external manager to acquire assets – but the debt is then borne by the assets themselves, with the external manager being paid a recurring base fee on the amount of assets managed, and an additional performance fee if a performance metric is met. A key difference between the two models however is the timeframe over which ownership is assessed: Sponsors of infrastructure funds raise ‘permanent capital for leveraged buyouts by listing funds on the stock market. While private equity funds typically have a limited lifespan and generate profits by selling businesses shortly after acquiring them, Macquarie holds its investments indefinitely.’⁷

The predictable, and steadily growing, cash flow associated with infrastructure assets is commonly highlighted by infrastructure-fund managers as a basis for providing investors with an attractive, and steady, yield:

‘Hallmarks of infrastructure vehicles include strong, stable cash flows that grow over time – cash flows that can support above-average distributions to investors.’⁸

However, as discussed below, the yield delivered to investors in several publicly traded infrastructure funds is actually sourced both from operating cash flows of the underlying infrastructure assets *and* from capital. This is commonly referred to as an example of ‘financial engineering’.⁹ Macquarie Infrastructure Company’s web site contains a (slightly oblique) acknowledgement of this:

‘The sustainable and growing long-term cash flows of infrastructure assets mean that infrastructure assets can typically support more debt than other businesses, which can increase returns to shareholders. This indicates the importance of financial structuring and capital optimization in enhancing shareholder returns to owners of infrastructure assets.’¹⁰

As an extreme example, Babcock & Brown Wind Partners (‘BBW’) had operating cash flow of \$14.2 million in the 2006 financial year, but paid distributions totaling \$48 million in relation to that year.¹¹ The distributions were equivalent to 54 per cent of the total cash receipts from customers during the year.¹² Even the most mature infrastructure fund of all, Macquarie Infrastructure Group (‘MIG’), is no exception. It had operating

managed funds involved in sourcing, acquiring and managing large and complex assets, whether those funds be infrastructure funds, private equity funds or hedge funds.’

⁷ Edward Chancellor and Lauren Silva, ‘The Wizards of Oz: Not Making Sense of Macquarie’s Business Model’, *Breakingviews*, 1 June 2007 (available by subscription at <http://www.breakingviews.com>). Note, however, that some infrastructure funds have sold assets from time to time.

⁸ Macquarie Infrastructure Company, above n 5, inside-front-cover.

⁹ See, for example, Reuters, ‘Macquarie Closes \$10.3bn Infrastructure Funds’, 2 May 2007: available at <http://www.reuters.com/article/idUSL0249467320070502> (visited 24 May 2007).

¹⁰ http://www.macquarie.com/mic/aboutus/intro_infrastructure.htm (visited 22 May 2007).

¹¹ BBW paid an interim distribution of 5.1 cents per security (A\$25.2 million in total) on 23 March 2006 and a final distribution of 5.1 cents per security (A\$22.8 million in total) on 29 September 2006: BBW, *Annual Report 2006*, page 85.

¹² Receipts from customers totaled A\$88.4 million: BBW, above n 11, page 53.

cash flow of \$306.9 million in the 2006 financial year, but paid distributions totaling \$512.9 million in relation to that year.¹³ Furthermore, the distributions were equivalent to 116 per cent of the total toll revenue received during the year.¹⁴

4. How does the ‘infrastructure fund model’ work?

While each listed infrastructure fund has its own distinctive features, the funds that are the focus of this paper tend to exhibit at least some of the following features:

- Rather than a single company, they often consist of multiple entities (companies and trusts), the securities in which are ‘stapled’ – meaning that investors can trade the securities only as a stapled bundle; they cannot trade the component securities separately.¹⁵ Figure 1 illustrates the structure of MIG.
- Management of the infrastructure fund is contracted out to an external manager¹⁶ – which is typically a wholly owned subsidiary of the investment bank or other firm that established the fund.
- The manager charges a range of fees. These typically include a base fee, which is often a percentage of the infrastructure fund’s ‘enterprise value’;¹⁷ and a performance fee,

¹³ MIG paid an interim distribution of 10 cents per security (A\$240.6 million in total) on 14 February 2006 and a final distribution of 11 cents per security (A\$272.3 million in total) on 15 August 2006: MIG, *Financial Report 2006*, pages 1, 27. MIG has a distribution reinvestment plan, so not all distributions were paid in cash.

¹⁴ Toll revenue received totaled A\$443.2 million (comprised of A\$359.4 million in actual toll revenue collected by controlled entities, plus A\$83.8 million of distributions and dividend income from non-controlled entities): MIG, above n 13, page 11. Some of MIG’s investments take the form of interest-bearing debt instruments; in the 2006 financial year MIG received an additional \$13.2 million in income from its investment in Westlink Construction Phase Loan Notes: MIG, above n 13, page 32.

¹⁵ Curiously, when Macquarie Media Group (‘MMG’) listed on ASX in November 2005, MMG consisted of one Australian company and one trust. A Bermudan company was added to the structure in March 2006 (less than four months after MMG’s listing). No security-holder approval was sought. Instead, the shares in the Bermudan company were distributed to security holders via an in-specie distribution: MMG, ‘Pre-Quotation Disclosure’, ASX announcement, 9 March 2006: available at http://www.macquarie.com.au/au/mmg/acrobat/fullfillment_of_conditions.pdf (visited 22 May 2007). Similarly, on listing in April 2005, Macquarie Capital Alliance Group (‘MCQ’) consisted of an Australian company and an Australian trust. A Bermudan company was added to the structure in June 2005 (less than three months after MCQ’s listing). No security-holder approval was sought. Instead, the shares in the Bermudan company were distributed to security holders via an in-specie distribution: ASX, ‘ASX Circular’, 22 June 2005: available at <http://www.asx.com.au/asxpdf/20050622/pdf/3r92t3m2zmvcl.pdf> (visited 24 May 2007). A Bermudan company was added to the Macquarie Communications Infrastructure Group (‘MCG’) stapled structure in January 2005, again by an in-specie distribution and without any security-holder vote: ASX, ‘ASX Circular’, 21 January 2005: available at <http://www.asx.com.au/asxpdf/20050121/pdf/3pg9xtsk8tspn.pdf> (visited 24 May 2007). MCG had listed about 2.5 years earlier.

¹⁶ Or managers. For example, MIG has two external managers (see Figure 1).

¹⁷ Enterprise value takes account not only of equity but also of debt. For example, the managers of MIG receive a base fee equal to 1.25 per cent per annum of MIG’s ‘adjusted market capitalisation’ up to \$3 billion, and 1 per cent per annum on amounts greater than \$3 billion, paid quarterly in arrears: MIG, above n 13, page 53. The ‘adjusted market capitalisation’ is the sum of: (i) the market capitalisation of MIG based on the volume weighted average price of MIG securities over the 10 trading days prior to the last day of each quarter; plus (ii) amounts firmly committed for future investment; plus (iii) borrowings by MIG; less (iv) cash or cash equivalents held by MIG at the end of the quarter: Macquarie Infrastructure Trust (I), *Constitution*, clause 19.1: available at <http://www.asx.com.au/asxpdf/20041203/pdf/3nz5h8s1gl9gq.pdf>

which is often 15 per cent or 20 per cent of the amount by which the fund outperforms a benchmark index.¹⁸

- The fund will then typically engage other parts of the manager's organisation for investment banking advisory work, arranging debt and equity financing, underwriting, and other services.¹⁹ In at least one case, the advisory fees are higher than the average fees charged by investment banks to external (unrelated) clients.²⁰
- The fund acquires assets in two ways: by purchasing them directly from third-party owners, or by purchasing them from its manager's organisation. The latter usually occurs where a new infrastructure fund is being formed, and its initial suite of assets is acquired from the sponsoring firm (e.g. Macquarie or Babcock & Brown). The sponsor will often have held those assets on its own balance sheet for a comparatively short period of time. In the case of a mature infrastructure fund, it is not always obvious why it should purchase assets from its sponsor, rather than directly from third-party owners. The explanation is sometimes that the infrastructure fund has explicitly opted not to

(visited 22 May 2007). The inclusion of items (ii) and (iii) has the potential to materially increase the size of the fee. At MIG's 2006 annual general meeting, security holders approved a proposal to allow MIG's manager to elect to take base fees in MIG securities rather than cash, subject to the approval of MIG's 'independent' directors and security holders: MIG, *2006 Annual General Meeting*: available at <http://www.asx.com.au/asxpdf/20061031/pdf/3z9l3zh0fj9b1.pdf> (visited 22 May 2007).

¹⁸ For example, the manager of MIG receives a performance fee if MIG's total security-holder returns exceed the S&P/ASX 300 Industrials Accumulation Index, after making up for any underperformance in previous years. The performance fee is 15 per cent of the dollar amount of the net outperformance and is paid in three equal annual instalments. The second and third year instalments are paid only if MIG continues to outperform the relevant index on a cumulative basis over the relevant two or three year period. The fee may be paid in stapled securities in MIG at the discretion of the 'independent' directors, subject to security-holder approval: MIG, *Annual Report 2006*, page 47. In 2004, MIG's manager forfeited an entitlement to a performance fee of \$65.7 million, which represented one-third of the performance fee earned in 2003 but not payable due to underperformance of the Index over the period 2002 to 2004. The aspect of MIG's fee model under which the performance fee is payable in three annual instalments, and subject to continued outperformance, has been abandoned for future Macquarie vehicles, and has not been adopted by Babcock & Brown in its stable of infrastructure funds after Babcock & Brown Infrastructure ('BBI'). An example of a more recent performance fee is that for MMG. The manager of MMG receives a performance fee (calculated and payable quarterly in arrears) equal to 20 per cent of the return of MMG securities in excess of 6 per cent per annum plus annual Consumer Price Index ('CPI') change, having made up for any underperformance in previous quarters. (CPI is the inflation measure in Australia.) The fee may be paid in stapled securities in MMG at the discretion of the 'independent' directors, subject to security-holder approval: MMG, *Annual Report 2006*, page 23.

¹⁹ For example, the following fees were paid or payable by MMG in relation to the 2006 financial year: (i) MMG recognised an interest expense of \$2.3 million in relation to bank facilities provided by Macquarie. (ii) MMG reimbursed Macquarie \$1.995 million for out-of-pocket expenses incurred by MMG's manager in the performance of its duties. (iii) An MMG group company paid a Macquarie subsidiary \$339,726 for the secondment of certain management staff and various other services (the agreement was terminated in November 2005). (iv) MMG paid Macquarie \$12.9 million representing arranging and selling fees associated with the initial public offer for MMG. (v) MMG paid Macquarie \$29.6 million for financial advisory, debt arranging services and reimbursement of out-of-pocket expenses associated with the Taiwan Broadband Communications acquisition. (vi) MMG paid Macquarie \$390,700 in debt advisory fees associated with securing financing used to acquire the Taiwan Broadband Communications group of companies: MMG, *Financial Report 2006*, pages 73-74.

²⁰ See Section 5.3 below.

take ‘construction risk’, and so the sponsor builds the asset and then sells it to the infrastructure fund.²¹

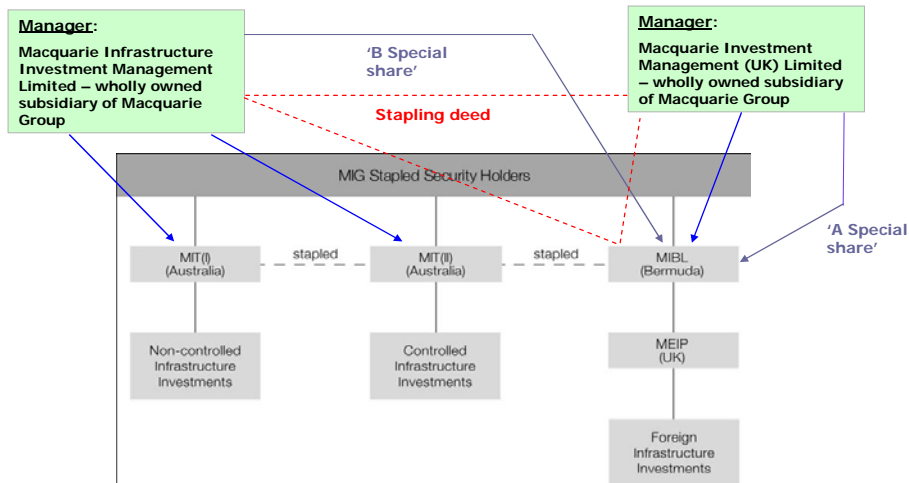
- In many instances, distributions paid to security holders are not fully covered by operating cash flow – as mentioned above.
- There tend to be obstacles to the removal of the sponsoring firm as external manager. This is not surprising, given the lucrative fees that are associated with sponsored funds – but it is nonetheless worthy of close examination from a corporate governance perspective. These obstacles fall into three broad categories: special shares, long-term contracts and contingent fees. Special shares: Several infrastructure funds (including all the Macquarie-sponsored funds) have issued special classes of shares to the external manager, giving it the right to appoint a majority of the directors of the company (or companies) in the stapled structure. Long-term contracts: Funds sponsored by Babcock & Brown have 25-year management contracts, and some other funds have management contracts with fixed terms ranging from 5 to 10 years (see Table 1). Contingent fees: Two of the most recently listed funds (Macquarie Media Group and Babcock & Brown Power) have incorporated a contingent-fee structure, under which the sponsor will continue to be paid fees even if it is removed and replaced as manager of the fund. These obstacles are explored in greater depth later in this paper.

Table 1 summarises the structural features of the most prominent infrastructure vehicles listed (or until recently listed) on the ASX.

The next section of this paper discusses a range of concerns with the infrastructure fund model. The first group of concerns are essentially financial or investment concerns, while the second group involve issues of corporate governance.

²¹ An example of a mature infrastructure fund acquiring assets directly is MIG, which has purchased several toll road interests in recent years (for example, MIG and Cintra Concesiones de Infraestructuras de Transporte, SA (Cintra) formed a consortium to bid, successfully, for the lease for the Indiana Toll Road from the Indiana Finance Authority: MIG, ‘MIG-Cintra Lodge Bid for Indiana Toll Road’, ASX announcement, 23 January 2006: available at <http://www.asx.com.au/asxpdf/20060123/pdf/3v4gby7y2l1nn.pdf> (visited 22 May 2007). An example of an infrastructure fund buying assets from its sponsor is BBW. BBW acquired the controlling interest in a portfolio of United States wind farms from its sponsor Babcock & Brown, in March 2007, around 18 months after BBW had listed on the ASX. See BBW, ‘BBW Achieves Initial Closing of US06 Portfolio Acquisition’, ASX release, 9 March 2007: available at <http://www.asx.com.au/asxpdf/20070309/pdf/311d7s4f6zf019.pdf> (visited 24 May 2007). But this is not unusual as BBW has explicitly stated that it does not intend to take ‘development risk’: BBW, above n 11, page 3.

Figure 1: Macquarie Infrastructure Group



Source: MIG, *Circular to Stapled Security Holders: Recommended proposal to replace Macquarie European Infrastructure plc with Macquarie Infrastructure Bermuda Limited in Stapled Security by means of a scheme of arrangement under section 425 of the UK Companies Act* (October 2004), page 12. The three entities which collectively make up MIG are: i) Macquarie Infrastructure Trust (I) (MIT (I)) - an Australian registered managed investment scheme (i.e. unit trust), managed by Macquarie Infrastructure Investment Management Limited (MIIML). MIIML is a wholly owned subsidiary of Macquarie. ii) Macquarie Infrastructure Trust (II) (MIT (II)). MIIML is also the manager of MIT (II). iii) Macquarie Infrastructure Group International Limited (MIGIL) – a Bermuda incorporated company managed by Macquarie Investment Management (UK) Limited (MIMUK). MIMUK is a wholly owned subsidiary of Macquarie. Investors in MIG own a unit in MIT(I) stapled to a unit in MIT(II) and a share in MIGIL. The units in MIT(I) and MIT(II) and the shares in MIGIL cannot be traded separately.

Table 1: Structure of ASX-listed infrastructure funds

Entity	IPO	Manager	Structure	Management agreement	Special voting shares
Alinta Infrastructure (AIH)	2005	A wholly owned subsidiary of Alinta Limited	One Australian company; two trusts	Open-ended	No ²²
Australian Infrastructure Fund (AIX)	1997	Hastings Funds Management Limited (a wholly owned subsidiary of Westpac)	One Australian company; one trust	Open-ended	No ²³
Babcock & Brown Capital Limited (BCM)	2005	A wholly owned subsidiary of Babcock & Brown Limited	One Australian company	25 years	No
Babcock & Brown Environmental Investments (BEI)	2005 ²⁴	A wholly owned subsidiary of Babcock & Brown Limited	One Australian company	25 years	No
Babcock & Brown Infrastructure (BBI)	2002 ²⁵	A wholly owned subsidiary of Babcock & Brown Limited	One Australian company; one trust	25 years	Yes ²⁶
Babcock & Brown	2006	A wholly owned subsidiary	One	25 years	No

²² The sponsor, Alinta Limited, had the right to appoint two directors to the board of six so long as it retained a 15 per cent holding in Alinta Infrastructure Holdings. This right was obtained as a result of the ASX granting a waiver from Listing Rule 14.4 (the listing rule that requires directors to retire by rotation at least every three years). The ASX's rationale for granting the waiver was: 'Stapled group consisting of managed investment schemes (Trusts) and company - stapled group being spun off from a listed parent company - ongoing strategic relationship between spin-off and listed parent company - listed parent company retains strategic equity stake in stapled group - listed parent company provides management and operating services in relation to infrastructure assets of stapled group under long-term contracts - listed parent company to have right to nominate 2 out of no fewer than 6 directors of board of company, and of the board of the RE of the trusts, composing the stapled group - right to nominate ceases if listed parent company ceases to have strategic relationship with stapled group - right to nominate a minority of the boards recognises strategic relationship without entrenching control in the hands of the party holding the nomination right.' See *ASX, Register of ASX Listing Rule Waivers* (November 2005), page 86: available at http://www.asx.com.au/supervision/pdf/waivers/2005_november_lr_waivers.pdf (visited 24 May 2007).

²³ While there are no special voting shares, the external manager of AIX has very considerable power, for the following reason. There are two boards to consider: the board of the company in the stapled structure, and the board of the responsible entity of the trust in the stapled structure (which is Hastings Fund Management Limited). Security holders vote only on the election of directors to the company's board; the board of Hastings Fund Management Limited is appointed by its 100 per cent shareholder, Westpac. However, the board of the company has very limited powers – limited to refusing an investment proposal outside of the terms of the trust deed, on a reasonable fear of bankruptcy. In essence, therefore, key decisions are made by Hastings Fund Management Limited, the directors of which are not elected by AIX security holders.

²⁴ The company that became BEI listed in 1998 but only assumed its present structure in 2005.

²⁵ BBI listed in 2002 as Prime Infrastructure Group. It changed to its current, externally managed, structure in May 2005.

²⁶ The external manager of BBI holds two convertible loan notes that at the option of the 'independent' directors of the company within the stapled structure convert into special voting shares that would give the external manager the right to appoint 75 per cent of the directors of the company.

Power (BBP)		of Babcock & Brown Limited	Australian company; one trust		
Babcock & Brown Wind Partners (BBW)	2005	A wholly owned subsidiary of Babcock & Brown Limited	One Australian company; one Bermudan company; one trust	25 years	No ²⁷
Challenger Infrastructure Fund (CIF)	2005	A wholly owned subsidiary of Challenger Financial Services Group Limited	Two trusts	10 years	N/A ²⁸
ConnectEast Group (CEU)	2004	A wholly owned subsidiary of Macquarie	Two trusts	6 years	N/A
DUET (DUE)	2004	A company owned jointly (50/50) by AMP Capital Investors and Macquarie	One Australian company; two trusts	Open-ended	Yes, 100%
Hastings Diversified Utility Fund (HDF)	2004	Hastings Funds Management Limited (a wholly owned subsidiary of Westpac)	Three trusts	Open-ended	N/A
Macquarie Airports (MAP)	2002	Two wholly owned subsidiaries of Macquarie	One Bermudan company; two trusts	Open-ended	Yes, 75%
Macquarie Capital Alliance Group (MCQ)	2005	A wholly owned subsidiary of Macquarie	One Australian company; one Bermudan company; one trust	Open-ended	Yes, 75%
Macquarie Communications Infrastructure Group (MCG)	2002	A wholly owned subsidiary of Macquarie	One Australian company; one Bermudan company; one trust	Open-ended	Yes, 75%

²⁷ The constitution of the Australian company in the BBW stapled structure initially included two articles that granted Babcock & Brown wholly owned subsidiaries the right to appoint 75 per cent of the company's directors through special voting shares. The constitution stated that these two articles would only take effect if approved by the ASX: Babcock & Brown Wind Partners Limited, *Constitution*, articles 1.8, 1.9, as lodged with ASX on 28 October 2005: available at <http://www.asx.com.au/asxpdf/20051028/pdf/3t08389c28t8k.pdf> (visited 24 May 2007). However, the copy of the constitution lodged with the ASX on 14 June 2006, referred to as the 'current constitution' in a separate BBW filing the same day, does not contain articles 1.8 and 1.9. See <http://www.asx.com.au/asxpdf/20060614/pdf/3x4z6m05hjc97.pdf> (visited 24 May 2007) and <http://www.asx.com.au/asxpdf/20060614/pdf/3x4xd6xb0hxfx.pdf> (visited 24 May 2007).

²⁸ 'N/A' in Table 1 means that the entity consists only of trusts and therefore the only board is that of the responsible entity (usually a wholly-owned subsidiary of the external manager). These structures are similar to a publicly traded REIT and are governed by the managed investment provisions of the Corporations Act (see above).

Macquarie Infrastructure Group (MIG) ²⁹	1996	Two wholly owned subsidiaries of Macquarie	One Bermudan company; two trusts	Open-ended	Yes, 75%
Macquarie Media Group (MMG)	2005	A wholly owned subsidiary of Macquarie	One Australian company; one Bermudan company; one trust	Open-ended	Yes, 75%
Rivercity Motorway (RCY)	2006	A wholly owned subsidiary of ABN AMRO Australia (Leighton Motorway Investments and Bilfinger Berger BOT also have some management involvement)	Two trusts	5 years	N/A
SP AusNet Group (SPN)	2005	A wholly owned subsidiary of Singapore Power	Two Australian companies; one trust	10 years	No
Spark Infrastructure Group (SKI)	2005	A company owned jointly (50/50) by Cheung Kong Infrastructure and RREEF Infrastructure (part of Deutsche Bank)	Two Australian companies, one Bahaman company; one trust	25 years	Yes, 50%

Source: Prospectuses and annual reports.

5. Why is the infrastructure model concerning from an investment perspective?

The infrastructure model raises investment-related concerns that can be grouped as follows: a series of issues related to the sustainability of the model; a danger of overpaying for assets; fee structures that deliver high fees and provide an incentive to increase a fund's size; and accounting practices that have the capacity to provide an overly robust picture of a fund's profitability.

5.1 Sustainability

The sustainability of the infrastructure model over the longer term is called into question in particular by (i) regular payment of distributions out of capital; (ii) management contracts that require payment of significant fees to external managers without reference to cash flow; (iii) frequent equity capital raisings; and (iv) high levels of debt, and the use of interest-only loans and other forms of aggressive debt financing.³⁰

²⁹ MIG listed as Infrastructure Trust of Australia in 1996. It adopted its present triple-stapled structure in 2000 with the addition of an English company to the structure. In 2004, a Bermudan company was substituted for the English company.

³⁰ Note that not all these attributes are found in all publicly traded infrastructure funds.

5.1.1 Distributions out of capital

As Table 2 illustrates, many infrastructure funds pay distributions that exceed, or represent a substantial proportion of, operating cash flow. In MIG's case, as mentioned earlier, the 2006 financial year distributions exceeded not only operating cash flow but also the total toll revenue collected during the year. Similarly, the 2005 and 2006 financial year distributions by AIX exceeded not only operating cash flow but also operating cash receipts in each of those years.³¹

It is almost stating the obvious to say that this is not sustainable, over the longer term. Its sustainability over the short-to-medium term is a function of financial engineering. For example, the 2006 Directors' Report for MIG highlighted 13 items in the section 'Review and results of Operations'. At least three of these items help to explain how MIG is able to pay distributions that exceed operating cash flow and – at least in 2005 and 2006 – exceed toll revenue received from customers:

- Two items described securitisation of part of the expected future cash flows from particular toll roads. Under these arrangements, MIG assigned away its entitlement to those future cash flows (tolls) in exchange for immediate cash, which was provided indirectly by banks.
- Another item described the refinancing of debt in relation to a road: 'The refinancing resulted in the issue of US\$1.6 billion (A\$2.2 billion) of new debt facilities to replace the existing facilities of \$US1.0 billion (A\$1.4 billion). The financing structure provided an immediate return of US\$168.2 million (A\$221.7 million) of cash to MIG.'
- Two other items described two related equity capital raisings: an institutional placement, which raised \$667.5 million, net of underwriting and transaction costs; and a security purchase plan which raised around \$100 million. These amounts raised were used to part-fund the acquisition of Dulles Greenway for \$822.7 million in September 2005.³²

In many instances, an infrastructure fund's distributions exceed the reported net profit for the year, and also exceed the funds that would be available for distribution under Australian law if the infrastructure entity was structured as an Australian company. The payment of distributions out of capital is possible, in a legal sense, because of the stapled-

³¹ AIX, *Annual Report 2006*, pages 54, 58. For 2005, operating cash flow was \$10,465,000; operating cash receipts were \$21,454,000; and distributions totaled \$40,848,000. For 2006, operating cash flow was \$28,858,000; operating cash receipts were \$41,968,000; and distributions totaled \$53,006,000. The figures for distributions are those that relate to the financial year in question – the interim distribution paid during the year and the final distribution paid a few weeks after the end of the financial year. AIX has a distribution reinvestment plan, and therefore the amount of cash distribution is lower than the total distribution figures mentioned above. Nonetheless, AIX's cash flow statement reports that total cash distributions paid during the 12 months ended 30 June 2005 was \$22,246,000, and during the 12 months ended 30 June 2006 was \$36,344,000.

³² MIG, above n 13, pages 2-3. MIG subsequently in December 2006 sold half its interest in the Dulles Greenway toll road, along with half its interest in three other US assets, to an unlisted Macquarie-managed fund, Macquarie Infrastructure Partners. See MIG, *Financial Report 2007*, page 2.

security structure adopted by many funds, and in particular the inclusion of a trust and / or a Bermudan company within the stapled structure. Trusts and Bermudan companies are not – unlike companies incorporated in Australia – subject to section 254T of the *Australian Corporations Act*, which permits dividends to be paid only out of profits.³³

Table 2: Distributions as percentage of operating cash flow³⁴

Entity	Distributions/OCF – 2006	Distributions/OCF – 2005	Distributions/OCF – 2004
AIX	183.7%	390.3%	217.4%
AIH	Not available	108.3%	Not available
BEI	No dividend ³⁵	Not available	Not available
BBI	33.8%	92.9%	154%
BBP	Not available	Not available	Not available
BBW	178%	Not available	Not available
CEU	<i>Negative cash flow</i>	<i>Negative cash flow</i>	Not available
CIF	79.1%	Not available	Not available
DUE	18.2%	16.5%	Not available
HDF	90.6%	78%	Not available
MAP	50.2%	17.4%	94.9%

³³ MIG was the first infrastructure fund to include a Bermudan company. The information circular at the time the Bermudan company was added to the stapled structure, in place of a UK company (MEIP), acknowledged that UK law did not allow a company to pay distributions out of anything except profit (*Companies Act 1985 (UK)*, section 263), whereas Bermudan law allows companies to pay distributions without reporting a profit – provided that solvency is preserved: *Companies Act 1981 (Bermuda)*, section 54: ‘MIG is seeking to put itself in a position where it can, subject to MIG’s overall cash requirements and future commitments, return capital to Stapled Security Holders in a timely and efficient manner. Presently, MIG is prevented from paying distributions from MEIP due to English company law restrictions relating to the need for MEIP to have distributable profits. ... MEIP will shortly be receiving a proportion of the cash proceeds from the Cintra IPO. At present, MEIP would not be able to distribute these monies or any future monies to Stapled Security Holders until it has positive distributable reserves or by carrying out Court approved reductions of capital.’: MIG, *Circular to Stapled Security Holders: Recommended proposal to replace Macquarie European Infrastructure plc with Macquarie Infrastructure Bermuda Limited in Stapled Security by means of a scheme of arrangement under section 425 of the UK Companies Act* (October 2004), page 7.

³⁴ Distributions used in calculating percentages in Table 2 are those that relate to the financial year in question – typically an interim distribution paid during the year and a final distribution paid a few weeks after the end of the financial year.

³⁵ No dividends were payable by BEI as its structure is a single Australian company, and Australian companies are only able to pay dividends out of profits: *Corporations Act*, section 254T.

MCG	42.8%	26.8%	40.4%
MIG	167.1%	623% ³⁶	182.3%
MMG	156.9%	Not available	Not available
RCY	Not available	Not available	Not available
SKI	145.2%	Not available	Not available
SPN	38.2%	Not available	Not available

Source: Annual reports and authors' calculations.

5.1.2 Management fees decoupled from cash flow

Several different aspects of infrastructure-fund fees are addressed in this paper. This section focuses on the fee arrangements for the external manager.

Management contracts typically require payment of significant fees to external managers without reference to the infrastructure fund's cash flow. As mentioned earlier, external managers are typically entitled to a base fee, which is often a percentage of the infrastructure fund's 'enterprise value'; and a performance fee, which is often 15 per cent or 20 per cent of the amount by which the fund outperforms a benchmark index.³⁷

An extreme example of how this can give rise to concerns arose at BBW. In August 2006, BBW released a profit warning – stating that it would not meet its prospectus earnings forecast. Three reasons were given. First, delays in acquisitions. Second, lower-than-expected wind conditions. And third, its corporate costs were \$3 million greater than expected 'due to higher management base fees, a result of the increase in market capitalisation of BBW'.³⁸

As Table 3 shows, at nine out of 15 funds for which data was available, the manager's fees were a double-digit percentage of operating cash flow; and were above 20 per cent in six of those nine funds. In another fund, cash flow was negative.³⁹

³⁶ MIG's distributions in the 2005 financial year included a special distribution of 70 cents per security from the proceeds of the sale of MIG's interest in Cintra Concesiones de Infraestructuras de Transporte S.A. (Cintra): MIG, *Annual Report 2005*, page 3. This accounted for 90 per cent of the total distribution for the year of 77.5 cents per security. The 'regular' distribution of 7.5 cents per security represented 60.3 per cent of MIG's 2005 operating cash flow.

³⁷ See above nn 17 - 18, and accompanying text.

³⁸ BBW, 'ASX Release: Supplementary Investor Information' (14 August 2006), page 6: available at <http://www.asx.com.au/asxpdf/20060814/pdf/3xyz6jjwyxfqg.pdf> (visited 25 June 2007).

³⁹ Note that, in several funds, the manager is entitled to elect to take the performance fee in the form of securities rather than cash, and this election is commonly made – at least in regard to part of the fee.

When examining Table 3, it should be borne in mind that the fees figure does not include related-party fees – asset purchase or disposal advisory fees, underwriting fees, debt and equity arranging fees, etc – paid to other parts of the manager’s group. In some instances, these related-party fees exceeded the manager’s fees. For example, CIF paid \$19.3 million to a wholly owned subsidiary of Challenger for ‘transaction advisory services’ relating to the acquisition of a gas-transporting company in the UK. This fee dwarfed the \$2.5 million in management fees for the year.⁴⁰ And BBI paid \$55.2 million, predominantly in financial advisory fees relating to asset acquisitions and debt refinancing, to wholly owned subsidiaries of Babcock & Brown, in addition to the \$31.1 million in manager’s fees.⁴¹ As with management fees, these related-party fees are not delimited by the state of the fund’s cash flow.

⁴⁰ CIF, *Annual Report 2006*, page 33.

⁴¹ BBI, *Annual Report 2006*, page 140 (Expense reimbursement: \$2,286,000; Financial advisory fee with asset acquisition: \$4,045,000 + \$18,699,000 + \$5,973,000 (contingent) + \$3,530,000 (contingent) + \$11,155,000; Financial advisory fee for refinancing: \$2,310,000 + \$6,800,000; Investment management / management fees: \$42,000 + \$377,000).

Table 3: Management fees relative to operating cash flow and net profit/loss

Entity	Base + performance fees: 2006	Fees as % of cash flow	Fees as % of net profit	Operating cash flow: 2006	Net profit / (loss): 2006
AIX	\$8,364,627	29%	7.6%	\$28,858,000	\$109,516,000
AIH	\$10,699,000 ⁴²	24.7%	138.6%	\$43,398,000	\$7,720,000
BEI	\$24,035,513	20,060%	<i>Negative profit</i>	\$119,821	(\$28,827,623)
BBI	\$31,141,000 ⁴³	10.1%	37.7%	\$307,195,000	\$82,681,000
BBP	Not available	Not available	Not available	Not available	Not available
BBW	\$44,379,000	313.5%	<i>Negative profit</i>	\$14,158,000	(\$16,235,000)
CEU	\$1,019,000	<i>Negative cash flow</i>	1.7%	(\$6,259,000)	\$61,579,000
CIF	\$2,483,833	5.8%	<i>Negative profit</i>	\$43,080,000	(\$20,685,000)
DUE	\$19,333,995	3.5%	150%	\$550,739,000	\$12,892,000 ⁴⁴
HDF	\$5,675,000 ⁴⁵	12.8%	13.7%	\$44,198,000	\$41,306,000
MAP	\$57,681,250	6.9%	9.6%	\$830,263,000	\$600,460,000
MCG	\$25,681,617	7.1%	24.9%	\$359,972,000	\$103,087,000
MIG	\$97,962,000	31.9%	30.9%	\$306,919,000	\$317,371,000
MMG	\$18,010,000	97.2%	412.6%	\$18,524,000	\$4,365,000
RCY	Not available	Not available	Not available	Not available	Not available
SKI	\$11,225,000	10.6%	43.4%	\$105,673,000	\$25,882,000
SPN	\$5,003,000	2.8%	1.5%	\$177,875,000	\$335,232,000

Source: Annual reports and authors' calculations.

⁴² AIH figures are for the period from listing (5 October 2005) to 31 December 2005: Management fee: \$1,534,000; Operating, construction, maintenance: \$5,586,000; Corporate costs: \$3,579,000: AIH, *Annual Report 2005*, pages 57-58.

⁴³ For BBI, performance fees are those payable as at balance date (\$7,534,000), not those earned in the preceding 12 month period: BBI, above n 41, page 139.

⁴⁴ DUET's net profit for the year ended 30 June 2006 was artificially low due to the treatment of DUET securities under new AIFRS accounting standards. Net profit attributable to DUET security holders would have been in the order of \$56 million if the units in the trusts in the stapled structure had been classified as equity rather than debt for that year: DUET Group, *Annual Report 2006*, page 55.

⁴⁵ Includes \$1,156,000 as responsible entity of the TAPS Trust: Hastings Diversified Utilities Fund, *Annual Report 2006*, page 28.

5.1.3 Aggressive structuring of asset purchases

Some infrastructure funds use aggressive structuring techniques when they acquire assets. For example, BBW has acquired an interest in several wind farms in the United States. The structure used to obtain an economic interest in these wind farms involves Delaware limited liability companies (LLC):

- One LLC (known as the Project LLC) owns the wind farm.
- One or more other LLCs (known as Investment LLCs) have an ownership interest in the Project LLC. The Investment LLCs are also called Class B Members. BBW is, indirectly, a Class B Member. For some wind farms, BBW is the only Class B Member; for others, it co-invests with one or more other Class B Members.
- If there is only one Class B Member, it is the managing member of the Project LLC. If there is more than one Class B Member, they are collectively co-managing members of the Project LLC. The duties of the managing member/s consist principally of selecting and supervising contractors and service providers to the Project LLC, and communicating with investors (Class A Members).
- There is another class of member in the Project LLC – the Class A Members. They are also known as ‘tax equity investors’, and are commonly investment banks and other institutional investors.⁴⁶
- Cash flow from operating the wind farms is distributed first to the Class B Members until they receive a return of their capital contributions. This typically covers the first five years. After that, all cash distributions go to the Class A Members until the ‘reallocation date’ has been reached. This typically covers the next 10 years. After that (i.e. after year 15), a designated percentage goes to the Class B Members (approximately 80 per cent) and to the Class A Members (approximately 20 per cent).
- In effect, the Class B Members (which is what BBW is, indirectly) receive all the wind farm’s cash distributions for the first five years, but none for the following 10 years (during which time the Class A Members receive all cash distributions).⁴⁷

The upshot of this structure is that, as BBW was established only recently, it will need to keep acquiring new wind farms over the next few years because, after the first five years, the cash flows from its existing wind farms in the United States dry up.⁴⁸

⁴⁶ BBW’s annual report summarises the tax-driver as follows: ‘The Class A Members receive a significant portion of their return on investment from the allocation of Production Tax Credits (PTCs) to them (available during the first 10 years of operation calculated on the electricity sales of a wind farm) and depreciation deductions on plant and equipment. Because the Class A Members are allocated all of the tax benefits prior to the Reallocation Date, the Class A Members may receive more of their economic return through tax benefits than as a direct cash return: BBW, above n 11, page 74.

⁴⁷ BBW, above n 11, pages 74-75, 110.

⁴⁸ This is not to suggest that new farms will need to be acquired into perpetuity because, once it has a larger portfolio of wind farms, acquired over a period of years, the cash flows from newer plants will cover the 10-year ‘no cash period’ for older farms; and, after 15 years, cash flows revert predominantly to Class B Members. Since listing in late 2005, BBW has continued to acquire Class B interests in US wind farm portfolios, raising capital for this purpose in June 2006 and seeking security holder approval to acquire Class B interests from BNB in February and November 2007.

5.1.4 Frequent equity capital raisings

Table 4 provides an illustration of the extent to which some infrastructure funds utilise equity capital raisings to fund their operations (using that term in a broad sense to include acquisition of new assets). Five funds (out of the 15 funds for which an annual report was available) had more than doubled their issued equity capital over the past four-to-five-year period ending in 2006. Some of the newly issued equity was a result of security holders participating in distribution reinvestment plans (DRP) for some or all of their holdings. And at some funds the manager had the option of taking new securities rather than cash for part or all of its performance fee. Nonetheless, issuing substantive quantities of new equity – even if partly due to a DRP and a cash-sacrificed performance fee – results in a larger equity capital base to service with distributions in the future. There is, therefore, an issue of sustainability to consider.

Table 4: Growth in securities on issue

Entity	Securities on issue 5 years before end of FY06 (or at listing, if IPO post-2001)	Securities on issue end of FY06	Percentage increase in securities on issue
AIX	147,158,632	367,122,968	149.5%
AIH	289,333,333 (Listed 2005)	289,333,333	0%
BEI	83,403,105 (Listed 2005)	126,839,712	52.1%
BBI	284,500,000 (Listed 2002)	1,471,906,576	477.4%
BBP	Not applicable ⁴⁹	Not applicable	Not applicable
BBW	494,164,654 (Listed 2005)	575,301,766	16.4%
CEU	1,079,000,000 (Listed 2004)	1,217,060,822	12.8%
CIF	179,982,860 (Listed 2005)	239,977,146	33.3%
DUE	246,870,297 (Listed 2004)	426,568,448	72.8%
HDF	148,000,000 (Listed 2004)	175,046,661	18.3%
MAP	500,000,000 (Listed 2002)	1,690,302,448	238.1%
MCG	155,000,000 (Listed 2002)	394,891,280	154.8%
MIG	963,923,930	2,475,499,390	156.8%
MMG	200,000,000 (Listed 2005)	200,506,612	0.3%

⁴⁹ 'Not applicable' means these vehicles had not filed a full year financial report since listing, at the time this paper was completed.

RCY	Not applicable	Not applicable	Not applicable
SKI	827,212,067 (Listed 2005)	1,008,651,000	21.9%
SPN	2,092,680,010 (Listed 2005)	2,092,680,010	0%

Source: Annual reports and authors' calculations.

5.1.5 High debt levels, and aggressive debt financing practices

Publicly traded infrastructure funds often have high levels of debt. For example, BBI's 2005 annual report disclosed non-current interest-bearing liabilities of \$2.58 billion, together with current interest-bearing liabilities of \$31 million. In the same year, receipts from customers were \$371 million, and operating cash flow was \$60 million.⁵⁰ Interest-bearing liabilities were, therefore, seven times the total cash received from customers, and 43 times operating cash flow.

MIG's 2006 financial statements disclosed non-current interest-bearing liabilities of \$4.67 billion, in addition to current interest-bearing liabilities of \$299 million. Receipts from customers were \$443 million, and operating cash flow was \$307 million.⁵¹ Interest-bearing liabilities were, therefore, 11 times the total cash received from customers, and 16 times operating cash flow.⁵²

At some infrastructure funds, additional debt is incurred at the 'asset' level. In essence, the debt is incurred by a company (X) that holds (directly or indirectly) an infrastructure asset, and the publicly traded infrastructure fund has only a minority holding in X. The holding may be significant (say 40 per cent), but if it does not confer 'control' on the publicly traded infrastructure fund, X is not treated as a subsidiary and therefore its financial position and performance – including its debt – does not need to be consolidated in the fund's financial statements. Instead, the non-controlling shareholding in X is

⁵⁰ BBI, *Annual Report 2005*, pages 69, 70.

⁵¹ MIG, above n 13, pages 9, 11. Receipts from customers comprises toll revenue of \$359.4 million (from toll roads in which MIG has a controlling interest) plus distributions and dividend income of \$83.8 million (relating to toll roads in which MIG does not have a controlling interest). MIG receives interest in addition to toll revenue and dividends, as a result of having debt investments in some roads: see above n 14.

⁵² MIG highlights that much of its debt is 'non-recourse to the Group'; presumably meaning the publicly traded entity and all its subsidiaries other than the one that is party to the particular financing agreement are not required to guarantee repayment, and there is no fixed and floating charge over all group assets. As at 30 June 2006, \$4.17 billion (or 89 per cent) of MIG's non-current interest-bearing liabilities was non-recourse: MIG, above n 13, page 43. Typically, however, the subsidiary which holds the leasehold interest, and which is the party to the financing agreements, gives security of some form. For example, in the case of Midland Expressway Limited ('MEL': a wholly owned subsidiary of MIG, which holds MIG's interest in the M6 toll road in the United Kingdom), a \$1.86 billion loan facility, drawn down to \$1.54 billion as at 30 June 2006, is 'secured by way of debenture over MEL's assets': MIG, above n 13, page 44. So, even though the debt is non-recourse to 'the Group', there is still a risk of assets being lost to the Group if there is a default on the loan.

treated as an investment in an ‘associate’.⁵³ The investment is revalued either six-monthly or annually, and any resulting increase (decrease) in X’s value – even though it is unrealised – is booked as revenue (expense) in the Income Statement, and thereby serves to increase (decrease) reported profit for the year.⁵⁴ Therefore, where debt is also incurred at the asset level, an examination of the fund’s balance sheet and cash flow statement provides only a partial view of the demands on the fund’s cash flows.

Also, some infrastructure assets, such as toll roads, are not owned outright by the fund. Instead, the fund has a ‘concession’ from the regional government; typically, a long-term lease. For example, the Indiana Toll Road in the United States, which MIG leases jointly with Cintra, has a 75-year lease; and the Warnow Tunnel in Germany, in which MIG has a 70 per cent interest, has a 30-year concession. Where an asset is leased for a fixed period, rather than owned, debt refinancing cannot go on forever – and therefore, at first glance, it appears that the cash flows from that asset over the concession life will need to be sufficient to repay the debt or there will be an insolvency (assuming the concession is not extended). However, this is overly simplistic. Other options include:

- As it matures, the infrastructure fund may build up a sizeable portfolio of assets, some of which can be traded (sold) to raise cash as debt related to other assets falls due for repayment. Some of the more mature funds do have a significant number of assets, and do trade those assets. MIG’s 2005 annual report disclosed that, since it listed nine years earlier, it had acquired interests in 28 toll roads in eight countries, but at year-end it had interests in 14 roads in six countries.⁵⁵ A year later, it had interests in 11 roads in seven countries.⁵⁶
- The asset – and the accompanying debt – could be disposed of prior to the concession expiring. A good example is MIG’s spin-off of three roads in 2006. MIG’s interest in the M4, M5 and Eastern Distributor toll roads in Sydney was spun-out into a new entity, Sydney Roads Group (‘SRG’), which was listed separately on the ASX. Existing MIG security holders received securities in SRG via an in specie distribution, and MIG received \$125 million cash consideration. At the time of the spin-off, the Eastern Distributor’s concession had 42 years to run, the M5’s had 17 years to go, and the M4’s lease had only four years left.⁵⁷ Importantly, the debt associated with MIG’s interest in the roads was transferred to SRG along with the lease interests. SRG was subsequently taken over by Transurban Group only a year after its inception.

⁵³ In some cases, even a holding of more than 50 per cent is not treated as conferring control. For example, MIG owns 70 per cent of an entity that has contracted to build, own and operate a tolled tunnel in Germany. However, MIG ‘does not have the capacity to control the casting of a majority of votes at a board of directors meeting of the [entity]. Accordingly, [the entity] is treated as an associate for the purposes of [MIG’s] financial report.’ MIG, above n 13, page 37. See Australian Accounting Standard AASB 128, *Investments in Associates*.

⁵⁴ See below, nn 65 - 71, and accompanying text. This assumes that X is unlisted. If it is publicly traded, its value is the closing bid price on the balance date.

⁵⁵ MIG, above n 36, pages 1, 3.

⁵⁶ MIG, above n 18, page 1.

⁵⁷ MIG, *Information Memorandum on the Demerger and In-Specie Distribution of Sydney Roads Group* (2006), page 19.

Infrastructure funds are often aggressive in their debt financing. For example, they borrow using interest-only facilities – which serves to postpone the need to repay the principal. Delaying the repayment of principal cannot be postponed forever, of course (though the obligation to repay principal can be shifted to a new owner, if the asset to which debt is tied is sold, as outlined above). Often, when debt is refinanced, the new facilities are larger than those they replaced.⁵⁸

5.2 Asset prices

Concerns have been expressed that infrastructure funds run the risk of overpaying for assets. There are at least three reasons lying behind these concerns.

First, by its nature, the infrastructure model encourages asset acquirers to calculate purchase prices based not only on sustainable returns on capital, but also on the level of fees able to be garnered over the (long) life of a management agreement. This is because acquisitions are either made by the external sponsor with the knowledge that the assets will be on-sold to a fund (usually attracting an advisory fee for the sponsor in the process) or are made by the fund itself using security holders' funds. The financial risk borne by the external sponsor is often not substantial, and every asset acquisition increases the ongoing fees that will be paid over the life of the vehicle, and in addition provides separate advisory, debt arranging and/or underwriting fees. This can give rise to perverse incentives for external sponsors, similar to those identified for external managers of publicly traded REITs.⁵⁹

Second, there is reportedly some concern that 'Macquarie can offer more in bidding wars because its investors have more modest return expectations than typical private equity investors'.⁶⁰ This in turn relates to the buy-and-hold approach of most infrastructure funds, compared to the typical private-equity fund, which plans to sell assets within a few years of buying them.

⁵⁸ See, for example, MIG, *Financial Report 2005*, page 3: 'On 3 June 2005 MIG announced the refinancing of the debt in relation to the M5 Motorway in Sydney, Australia. ... The refinancing has resulted in new debt facilities of \$540 million (which will be drawn to \$500 million) and a reset of the interest rate swaps. The new debt facility is a five-year, interest only facility, with repayment due in 2010 and replaces the previous \$485 million facility.'

⁵⁹ As expressed by a fund manager: 'the concern ... is that these managers will be looking at their own P&L rather than the P&L of their investors when they're looking at assets': Richard Hemming, "'Fee Factory" Fund Model Starting to Misfire', *Australian Financial Review*, 14-15 October 2006, page 42. In relation to externally managed REITs, see Dennis Capozza and Paul Seguin, 'Debt, Agency and Management Contracts in REITs: The External Advisor Puzzle', *Journal of Real Estate Finance and Economics*, 2000, Vol 20, No 2, pages 91-116 (The study investigated why externally advised REITs in the U.S. underperformed their internally managed counterparts. Consistent with previous studies, Capozza and Seguin found that externally managed REITs underperformed internally managed ones by over 7 per cent per annum. Property-level cash-flow yields were similar between the two managerial forms, but corporate-level expenses (especially interest expenses) were responsible for lower levels of cash available to shareholders in externally managed REITs. The higher interest expenses were due to higher levels of debt and higher debt yields for externally advised REITs. The authors posit that compensating managers based on either assets under management or on property-level cash flows creates incentives for managers to increase the asset base by issuing debt even if the interest costs are unfavourable.)

⁶⁰ Chancellor and Silva, above n 7.

Third, now that the infrastructure model has been around for more than 10 years, Macquarie is facing ever-more competition from rival investment banks (and other groups) that wish to replicate the highly attractive fee-generating model. So, there is a concern that now, when regional governments put infrastructure assets up for sale, there is an increasing chance of a competitive auction, driving up the price.⁶¹

Particularly in light of the first point, an infrastructure-fund sponsor may come up with a different price calculation than that for traditional asset acquirers. A trade buyer for a wind-farm portfolio, for example, would be likely to calculate the purchase price based on the future earnings to be derived by the business. An external asset manager, however, is likely to calculate what is an acceptable price for the same wind-farm portfolio with reference not only to the earnings potential of the assets acquired but also to the earnings potential of the acquisition for itself as external manager. For example, Babcock & Brown reaped just over \$100 million in fees relating to the IPO, management and asset-acquisition activities of BBW in the 2006 financial year; BBW listed with four operational wind farms and net assets of \$524 million, and ended its first year as a publicly traded entity with 16 operational wind farms and net assets of \$666 million.⁶²

Constraints do exist, however, for an external manager in acquiring assets. In cases where an external sponsor is acquiring an asset using its own funds, the price must be recoverable and therefore must be ‘reasonable’ in the eyes of the institutional investors likely to provide the bulk of the initial public offering subscriptions for the new infrastructure fund. Even when an existing infrastructure vehicle makes an acquisition, the price cannot be seen as too high by investors in the vehicle lest they sell their holdings, reducing investor appetite for the securities of the publicly traded entity and thereby reducing the market capitalisation, which is one of the key drivers of the base management fees paid by most vehicles (see Table 1). These constraints depend, however, not on fundamental financial metrics but on the acceptability to professional investors of the price paid for a particular asset.

5.3 Fees

It is clear that at the heart of the infrastructure model is an attractive source of fees for the sponsor of the fund in question – fees that are derived from a wide range of management, advisory and financial services, and which are not, in many instances, contestable.

Table 5 shows the total fees (management, advisory, etc) for a range of infrastructure funds, expressed as a management expense ratio (‘MER’) – a concept well-known in the fund-management industry. The high MER for two comparatively new funds, BBW and

⁶¹ For example, there was media attention about the auction for Associated British Ports in 2006, in which Macquarie was outbid by Goldman Sachs: David Teather, ‘Goldman Raises Takeover Offer for AB Ports’, *The Guardian*, 24 June 2006.

⁶² BBW, *Prospectus and Product Disclosure Statement* (September 2005), page 102 (net assets figure is from pro-forma Balance Sheet based on AIFRS, as at 30 June 2005); BBW, above n 11, pages 6, 51, 93, 94.

MMG, illustrates the front-end loading effect that happens when assets are first tipped into a newly created fund, with a spectrum of accompanying fees.

Table 5: Total fees paid as MER: 2004-06 (dollar amount in brackets)⁶³

Entity	MER: 2006	MER: 2005	MER: 2004
AIX	1.2% (\$9,501,627)	0.6% (\$5,939,843)	1.4% (\$4,227,625)
AIH	Not available	1.9% (\$10,699,000)	Not available
BEI	7.6% (\$24,035,513)	Not available	Not available
BBI	3.7% (\$86,358,000)	4.2% (\$67,161,000)	1.5% (\$7,395,000)
BBP	Not available	Not available	Not available
BBW	11.8% (\$102,217,000)	Not available	Not available
CEU	0.2% (\$2,206,000)	11.1% (\$94,962,000)	Not available
CIF	7.4% (\$21,736,833)	Not available	Not available
DUE	1.8% (\$21,251,531)	3.0% (\$30,826,301)	Not available
HDF	1.3% (\$6,952,000)	2.1% (\$7,535,000)	Not available
MAP	1.7% (\$102,934,373)	2.8% (\$144,713,006)	1.2% (\$278,242,188)
MCG	1.3% (\$29,524,432)	5.6% (\$137,355,774)	8.6% (\$19,734,084)
MIG	1.9% (\$157,459,100)	2.2% (\$201,177,506)	3.3% (\$81,355,169)
MMG	10.5% (\$62,895,700)	Not available	Not available
RCY	Not available	Not available	Not available
SKI	0.9% (\$11,225,000)	Not available	Not available
SPN	1.3% (\$7,358,000)	Not available	Not available

Source: Annual reports and authors' calculations.

⁶³ MER is calculated as total fees divided by market capitalisation as at financial year end for each infrastructure vehicle. Market capitalisation is arrived at by multiplying securities on issue by the closing security price on the last trading day of the financial year. 'Total fees' includes base management fee, manager's performance fee, and all related party fees. Related party fees include all fees paid for advisory work, under separate management agreements via subsidiaries and for custody, as well as fees such as loan facility and other bank fees. Distributions paid and interest rate swaps are excluded. Where fees were paid by a partly owned subsidiary or associate of the parent entity, the share of the fees that equates to the disclosed economic interest in the partly owned subsidiary or associate is included in the total fee number.

Unpacking the fees in Table 5 is also revealing. A comparison of the various types of fees paid by the more established vehicles – BBI, MAP, MCG and MIG – over the 2004-06 period highlights the rising importance of the fees that are within the control of the external manager. Base fees, which in all cases are based primarily on the market capitalisation of the publicly traded entity, and related party fees – fees for advisory, underwriting and debt arranging – are all open to influence by the external manager, as it is the external manager that initiates acquisitions, restructurings and disposals, all of which have an influence on assets under management and hence market capitalisation. Performance fees, which for all four of these vehicles are linked to outperformance of a broad market index, are significantly harder to influence for the external manager. In 2004, performance fees accounted for 61.9 per cent of all fees paid by these four entities; this fell to 39.5 per cent in 2005 and just 2 per cent in 2006, when only one entity, BBI, paid a performance fee. Across these four entities, non-performance fees totaled \$110 million in 2003, rising each year for the next three years to \$147 million, \$333 million and \$369 million respectively.

These findings are consistent with principal-agent theory: A rational agent will seek to maximise its return, which may not necessarily maximise the returns of the principal. As publicly traded infrastructure vehicles become larger and more established, their ability to outperform the relevant benchmark index lessens as they become a larger part of the index (of the five ASX-listed infrastructure funds that paid a performance fee in 2006, all bar BBI were in their first year of listing). This increased size is to the benefit of the agent/external manager as it maximises the recurring base fee, and also ensures that any acquisitions or disposals are likely to be substantial, resulting in larger investment banking fees given these fees are generally charged as a percentage of transaction size.

Three other aspects of fees are worthy of mention. First, the fees charged by the sponsor of at least one stable of infrastructure funds are known to be materially higher than the investment-banking industry average. The authors have sighted the fee schedule for a prominent publicly traded infrastructure fund. The total fees are a combination of ‘base’, ‘arranging’ and ‘incentive’ fees, and get smaller in percentage terms as the size of the acquisition or disposal increases (but in a non-linear fashion). For example:

- For a deal with an enterprise value of \$100 million, the total fees charged would be \$3.04 million (3.04 per cent).
- For a deal valued at \$500 million, the total fees charged would be \$12.84 million (2.57 per cent).
- For a deal valued at \$1 billion, the total fees charged would be \$19.75 million (1.98 per cent).
- For a deal valued at \$3 billion, the total fees charged would be \$47.4 million (1.58 per cent).
- For a deal valued at \$5 billion, the total fees charged would be \$71.6 million (1.43 per cent).

In contrast, an M&A fee template for a Wall Street investment bank, sighted by the authors, involves the following fees for comparable-sized transactions:

- For a deal valued at US\$100 million, the total fees charged would be US\$1.2 million (1.2 per cent).
- For a deal valued at US\$500 million, the total fees charged would be US\$3.6 million (0.72 per cent).
- For a deal valued at US\$1 billion, the total fees charged would be US\$4.5 million (0.45 per cent).
- For a deal valued at US\$3 billion, the total fees charged would be US\$11.4 million (0.38 per cent).
- For a deal valued at US\$5 billion, the total fees charged would be US\$16.25 million (0.325 per cent).

Second, as new infrastructure funds have listed over time, there appears to have been an incremental increase in the ‘reach’ of fees. For example, MMG saw the introduction of a contingent-fee structure, under which fees remain payable to Macquarie group entities even if Macquarie is removed as manager of MMG.⁶⁴

Third, over time there appears to have been an incremental change in the way that certain fees are earned, with the change normally making the fee easier to earn. For example, the performance fee that MIG’s managers earn in any particular year is payable over a three-year period (one-third each year), with the second and third instalments payable only if MIG continues to outperform the relevant index during the second and third years. No infrastructure fund listed on the ASX after BBI has retained this feature – so that other funds’ performance fees are payable entirely at the end of the year in which they were earned (subject to a high-water mark feature in several cases).

5.4 Booking profits from revaluing assets

Infrastructure assets are often held via an unlisted company, which may be either a subsidiary or an ‘associate’ of the publicly traded infrastructure fund. Provided the company is unlisted and is not a subsidiary, it is possible for the infrastructure fund to report an increase in profit through revaluing its holding in the unlisted company. This occurs under Australian Accounting Standard AASB 139, *Financial Instruments: Recognition and Measurement* (equivalent to IAS 39), and has been described in the following way by AIX:

‘Investments in unlisted securities are initially brought to account at cost. At the end of each distribution period being 30 June and 31 December of each year, investments in unlisted securities are brought to account at market value based on a valuation by an appropriately qualified independent valuer ignoring any future selling costs ...

⁶⁴ See below, notes 101 - 102, and accompanying text.

Any gain or loss on adoption of market value of investments is included in total revenues from ordinary activities.’⁶⁵

Sensitive to this issue, MIG goes so far as to include the following footnote to its Income Statement:

‘Earnings used in the calculation of basic earnings per stapled security includes unrealised revenue from revaluation of MIG’s investments. Consequently, basic earnings per stapled security reflects the impact of unrealised revaluation income.’⁶⁶

MIG relies primarily on the discounted cash flow (‘DCF’) technique to value its interests in toll roads (both where it has a controlling interest and where it has a non-controlling interest). In turn, this relies on MIG’s estimates of future cash flows (drawing on traffic projections, etc) with a discount rate being applied to these cash-flow estimates. The discount rate is the risk-free interest rate for the country in which the asset is located, plus a risk premium (which reflects the fact that there is some uncertainty as to the accuracy of the estimates of future cash flows). The risk premium can therefore be a significant factor in the valuation, and adjusting the risk premium can result in profit or loss.

In its financials, MIG discloses the risk premiums applied to MIG’s interests in toll roads. The 2006 financial report provides risk premiums for 13 toll roads, and for 10 of these there is comparative risk-premium information for 2005 and 2006 (the other three road interests were not acquired until 2006). In respect of four of these 10 road interests, MIG applied the same risk premium for 2005 and 2006; in respect of six, MIG lowered the risk premium between 2005 and 2006; the risk premium was not increased for any road interest. The smallest adjustment was for the 407 ETR road in Canada: the risk premium used in 2005 was 4.2 per cent; in 2006 this was reduced to 4 per cent. The largest adjustment was for Westlink M7 in Sydney: the risk premium used in 2005 was 7 per cent; in 2006 this was reduced to 5.5 per cent.⁶⁷ In the 2007 financial report, MIG discloses that the risk premium was lowered for eight out of nine road interests; the risk premium was held constant for only one road.⁶⁸

The gains from revaluation can be material. In 2005, MIG’s revenue from revaluing unlisted securities in companies and trusts was \$786 million, representing 57 per cent of total revenue for the year. In 2006, revaluation revenue for unlisted holdings was \$425 million, representing 40 per cent of total revenue.⁶⁹ In 2005, AIX’s revenue from revaluing unlisted securities in companies and trusts was \$96 million, representing 80 per cent of total revenue for the year. In 2006, revaluation revenue for unlisted holdings was \$85 million, representing 65 per cent of total revenue.⁷⁰

⁶⁵ AIX, *Annual Report 2004*, page 47. This statement appears in a pre-AIFRS annual report, but it conveys the point succinctly. AIFRS led to one material change in this area – investments in controlled entities (subsidiaries) are no longer able to be revalued under AASB 139.

⁶⁶ MIG, above n 13, page 8.

⁶⁷ MIG, above n 13, page 14.

⁶⁸ MIG, *Financial Report 2007*, page 10.

⁶⁹ MIG, above n 13, page 22.

⁷⁰ AIX, *Annual Report 2006*, page 54.

Revaluing unlisted securities in non-controlled entities, and booking any increase as revenue in the Income Statement, is what AASB 139 and IAS 39 require, and in this sense is not of concern. However, to the extent that investors focus on profit-related measures of performance, such as earnings per security ('EPS' – a very widely cited metric for assessing financial performance), there is a risk of placing insufficient weight on the composition of those earnings. In fairness, MIG's annual report draws this matter to investors' attention:

'care is needed when interpreting MIG's financial statements. Certainly, most commentators believe that investors should place less weight on the magnitude of MIG's net profit than they would for a typical industrial company. Instead, more emphasis is given to change in Net Asset Backing per security and to MIG's operating cash flows.'⁷¹

6. Why is the infrastructure model concerning from a governance perspective?

6.1 Background – A case study of MIG

Some of the most significant governance concerns with publicly traded infrastructure funds stem from the complex stapled structure, and in particular the presence of a company in the structure. MIG was the first publicly traded infrastructure fund, and it did not initially have a company in its stapled structure. The history of the 'company part' of the MIG stapled structure is, therefore, worthy of consideration.

MIG was floated on the ASX in December 1996. At that time it was called Infrastructure Trust of Australia Group, and it consisted of just the two Australian trusts which are now referred to as MIT(I) and MIT(II).

MIG's early investments were all in Australia. However, in 1999 it diversified geographically when it bought toll road assets, predominantly located in the UK, from Kvaerner plc. The acquisition was announced in July 1999 and completed in November 1999.

In a MIG presentation used at investor meetings in November 1999, the last slide was headed 'The future of MIG'. It included this statement: 'It has been suggested that MIG should be a closed Fund or that a commitment be made not to acquire new assets for a number of years'.⁷² MIG's response, on the same slide, was: 'The Manager believes that: Assets should only be acquired if they improve the return of the fund; Such opportunities are becoming increasingly rare; Investing is often opportunistic, eg Kvaerner; MIG has outperformed the market even while undertaking a significant capital raising.'⁷³ This

⁷¹ MIG, above n 18, page 50. A broadly similar statement appears in the 2005 annual report: MIG, above n 36, page 49.

⁷² The presentation is available at <http://www.macquarie.com.au/au/mig/news/19991109.htm> (visited 24 May 2007).

⁷³ Ibid.

slide appears to indicate that MIG's management was under some investor pressure in the second half of 1999.

The Kvaerner prospectus released in August 1999 (contemporaneous with the investor pressure referred to above) included this description of the MIG structure:

'A Stapled Security is currently comprised of one unit in MIT(I) and one unit in MIT(II) which are stapled and cannot be traded separately. In order to provide the maximum flexibility to MIG to invest in potential opportunities in Europe, the Manager is reviewing the current structure to ensure that it provides MIG with the most efficient structure to invest in assets in the future. Stapled Security Holders will be advised of the outcome of this review, and if appropriate their approval will be sought for any changes which may be proposed.'⁷⁴

In April 2000, security holders voted to approve the addition of a company to the stapled structure.⁷⁵ The company that was inserted initially was a UK-incorporated company called Macquarie European Infrastructure plc (MEIP). This company was already part of the MIG group; it was 'elevated' in the group structure to the same level as MIT(I) and MIT(II) so that security holders held a share in MEIP stapled to a unit in MIT(I) and a unit in MIT(II).⁷⁶ From a governance and control perspective, this was a very significant development because it meant:

- MIG was no longer simply two Australian trusts, whose responsible entity (manager) could be removed by a bare majority vote of security holders under the managed investments provisions of the Corporations Act.⁷⁷
- Instead, it had become a triple stapled entity: the two Australian trusts were joined by a UK company, MEIP.
- MEIP's articles of association contained an innovative share-capital structure – which has been replicated in the Bye-Laws of the Bermudan company that replaced MEIP in the MIG structure in 2004. This is the 'A Special Share' and 'B Special Share' structure detailed later in this paper, which gives wholly owned subsidiaries of Macquarie the power to appoint 75 per cent of the directors of the Bermudan company.

Accompanying the insertion of MEIP into the stapled structure was a management agreement between MEIP and a wholly owned subsidiary of Macquarie, called Macquarie Infrastructure Investment Management (UK) Limited (MIMUK). This agreement provided for a mandatory termination payment if MIMUK were ever to be removed as manager of MEIP following a vote of security holders. The agreement said the quantum of the fee was to be determined 'at the time that Share Stapling ceases to apply and is to be negotiated by the Board [of MEIP] and the board of directors of the

⁷⁴ MIG, *Prospectus 1999*, page 7.

⁷⁵ Macquarie Infrastructure Trust (I), *Notice of Meeting of Unitholders to be held on 14 April 2000* (10 March 2000), Resolution 4.

⁷⁶ The company was a wholly owned subsidiary of MIT(II), and security holders received shares in it by way of an *in specie* distribution. See Macquarie European Infrastructure Limited, *Information Memorandum*, 16 August 2000.

⁷⁷ Corporations Act, section 601FM.

Manager [MIMUK] acting in good faith and having regard to all the circumstances.’⁷⁸ The management agreement provided that if security holders voted for the removal of MIMUK, removal could only occur if the board of MEIP subsequently decided to terminate MIMUK’s appointment. That is, the board of MEIP would need to exercise a discretion to terminate; the vote of the security holders of itself was not sufficient.⁷⁹

It is not clear whether exactly the same arrangement exists in the management agreement between the current (Bermudan) company in the MIG structure and MIMUK, because that management agreement has never been made public by MIG or by the ASX.⁸⁰ (The earlier management agreement between MEIP and MIMUK was posted on the ASX announcements page at the time the company was added to the stapled structure.⁸¹)

The notice of meeting for the security-holder meeting which approved the replacement of MEIP with the Bermudan company stated that ‘MIMUK, a wholly owned subsidiary of Macquarie, will act as adviser to [the Bermudan company] on the terms of an advisory agreement in a similar form to the existing Management Agreement with MEIP.’⁸² The use of the word ‘similar’ leaves open the possibility that the provisions dealing with removal of MIMUK and payment of a termination fee may have been changed in the current agreement.

MIG’s 2005 and 2006 annual report have included this statement: ‘Under the Corporations Act (in respect of MIIML) and the Advisory Deed (in respect of MIMUK) if security holders are not satisfied with the performance of the MBL Group managers, MIIML and MIMUK, they can be removed by ordinary security holder resolution.’⁸³ The same disclosure was made in the 2004 MIG annual report,⁸⁴ which related to the former structure – with the UK company MEIP rather than the Bermudan company. As such, this

⁷⁸ *Management Deed: Macquarie European Infrastructure Public Company Limited and Macquarie Infrastructure Investment Management (UK) Limited*, clause 9.3. This agreement was posted as an ASX announcement on 21 September 2000. No subsequent management agreements for any ASX-listed infrastructure funds sponsored by Macquarie or Babcock & Brown have ever been posted as ASX announcements. See below, n 80.

⁷⁹ The information memorandum to security holders at the time of the triple-stapling stated that MEIP was not entitled to remove MIMUK as manager while stapling applied and MIIML or any of its related bodies corporate was the responsible entity of either or both of MIT(I) and MIT(II): Macquarie European Infrastructure Limited, above n 76, page 44. In essence, it appears that three steps would need to have occurred before MEIP’s board could have removed MIMUK: (i) security holders, in their capacity as unit-holders in MIT(I) and MIT(II), would have had to exercise their power under Corporations Act, section 601FM, to remove MIIML as the responsible entity of MIT(I) and MIT(II); (ii) security holders, in their capacity as shareholders in MEIP, would have had to vote for MIMUK’s removal as manager; and (iii) the structure would have to have been ‘unstapled’.

⁸⁰ MIG stated in the Bermuda company’s ASX listing application that the agreement would be provided to the ASX ‘when finalised’: MIG, ‘Appendix 1A: ASX Listing Application and Agreement’, 13 January 2005, page 4: available at <http://www.asx.com.au/asxpdf/20050113/pdf/3pcpn9p6gfv2b.pdf> (visited 24 May 2007). The authors have been informed by the ASX that it is ASX’s policy not to make such agreements publicly available.

⁸¹ See above n 78.

⁸² MIG, above n 33, page 13.

⁸³ MIG, *Annual Report 2005*, page 41; MIG, *Annual Report 2006*, page 41.

⁸⁴ MIG, *Annual Report 2004*, page 42.

statement appears to oversimplify the position that applied under the management agreement between MIMUK and MEIP – which, as outlined above, required the board of the company in the stapled structure to exercise a discretion to terminate the manager; the vote of the security holders of itself was not sufficient.

The reason MIG provided for transforming from a dual-stapled to a triple-stapled structure was ‘to make MIG more attractive to offshore investors [and therefore provide] greater liquidity and the potential for better returns for existing and future investors in MIG. ... Under the restructure MEIP dividends paid to foreign investors would not be subject to either withholding tax consequences in foreign jurisdictions or Australian tax events...’⁸⁵ However, the addition of a company to the structure has, as the analysis above indicates, also added considerable complexity – and possibly expense – to the removal of Macquarie as manager.

6.2 Special shares

As reported in Table 1, all five Macquarie infrastructure funds listed on the ASX, together with three other funds, have special shares that allow the external manager to appoint a majority (or, in one case, all) of the directors of the company / companies in the stapled structure. Typically, the manager holds one ‘A Special Share’, which entitles it to appoint 50 per cent of the directors; and one ‘B Special Share’, entitling it to appoint another 25 per cent of the directors. These directors would otherwise be appointed by holders of the ordinary equity securities.

In a traditional company, one of the directors’ key functions is to hire and, if necessary, fire the chief executive officer (who is the most senior manager). The special shares that exist in several infrastructure funds give the manager the power to hire and fire three-quarters of the directors! These special shares therefore appear to turn a fundamental corporate governance precept on its head. In the light of that, it is curious that the funds’ annual reports contain the standard statement that monitoring the performance of the manager is a function of the board.⁸⁶

The special shares are inconsistent with the one-share one-vote principle. This principle is reflected in ASX Listing Rule 6.9, which says that, on a poll, each holder of an ‘ordinary security’ is entitled to one vote for each fully paid ordinary share held.

On one interpretation, the special shares appear to have been designed so as to fall outside the definition of an ‘ordinary security’ and therefore outside Listing Rule 6.9. This is done by giving these shares no right to participate in profits (i.e. no dividend entitlement), only a nominal right to participate in return of capital on a winding up, and minimal voting rights (they lack the right to vote on any matter at a general meeting besides (i) election / removal of a ‘Special Share’ director; (ii) a proposed variation of the

⁸⁵ Macquarie European Infrastructure Limited, above n 76, page 8. A Bermudan company was inserted into the stapled structure, in place of the UK-domiciled MEIP, in 2004, ostensibly to facilitate the paying of distributions by MIG: see above nn 80 - 82, and accompanying text.

⁸⁶ See, for example, MMG, above n 18, page 14.

class rights attached to the special shares; and (iii) any other matter in respect of which corporate law in the country of incorporation prevents the right to vote being excluded or restricted).

However, at least two of the Macquarie funds, and one Babcock & Brown fund, have sought and obtained a waiver from Listing Rule 6.9 in relation to the special shares.⁸⁷ The ASX's waiver register does not make it clear why the ASX regarded it as appropriate to grant a waiver from the fundamental principle of one share / one vote.

In each case, the level of board control these special shares give the manager is well above the manager's economic interest in the fund. For example, at the end of the 2006 financial year, Macquarie held less than 5 per cent of MIG, 12 per cent of MCQ, 18 per cent of MAP, and 20 per cent of MMG.⁸⁸

6.3 Independence from sponsor

Despite being sponsored into existence, managed and advised by, and sharing the brand of, an external entity, corporate law and managed investments law requires the directors and other fiduciary office-holders of an infrastructure fund to make decisions in the best interests of the fund's security holders. It is therefore incumbent on them to prioritise the interests of security holders over the interests of the external sponsoring entity. Circumstances sometimes arise, however, where there is no public disclosure of how a fund's directors went about prioritising the interests of security holders.

For example, in 2007 a consortium described as 'Singapore Power / Babcock & Brown'⁸⁹ made a takeover bid for the utility company Alinta Limited.⁹⁰ While Babcock & Brown was responsible for the accompanying media releases and promotion of the offer, the providers of the equity consideration were actually three Babcock-sponsored infrastructure funds: BBI, BBP and BBW. Putting the deal together must have presented some significant challenges, given that the boards of all three funds would have needed separately to conclude that (a) the participation of their fund in the bid was appropriate, and (b) the terms and conditions for their fund were appropriate (in particular, the amount of equity to be provided by the fund and the assets to be received as consideration).

⁸⁷ For the waiver granted to MCQ, see ASX, *Register of ASX Listing Rule Waivers* (April 2005), page 31: available at http://www.asx.com.au/supervision/pdf/waivers/20050517_LR_WAIVE.pdf (visited 28 September 2007). For the waiver granted to MMG, see ASX, *Register of ASX Listing Rule Waivers* (March 2006), page 22: available at http://www.asx.com.au/supervision/pdf/waivers/200603_asx_listing_rule_waivers.pdf (visited 28 September 2007). It is not known if waivers were obtained by other Macquarie funds, as the ASX only began disclosing waivers in 2005. For the waiver granted to BBI (formerly known as Prime Infrastructure) see ASX *Register of ASX Listing Rule Waivers* (April 2005), page 32: available at http://www.asx.com.au/supervision/pdf/waivers/20050517_LR_WAIVE.pdf (visited 22 January 2008).

⁸⁸ MIG, above n 18, page 94; MCQ, *Annual Report 2006*, page 79; MAP, *Annual Report 2006*, page 62; MMG, above n 18, page 50.

⁸⁹ See 'Singapore Power/Babcock & Brown Alinta Offer – Market Briefing': available at <http://www.babcockbrown.com/bnb-news/general-news.aspx> (visited 25 June 2007).

⁹⁰ The proposal was structured as a scheme of arrangement, rather than a Chapter 6 takeover offer.

Similarly, there has been no specific disclosure as to how the board of BBW determined that the exclusive 10-year financial advisory agreement between BBW and a Babcock & Brown subsidiary, that essentially gives Babcock & Brown the right to all financial advisory work from BBW, was in the best interests of BBW security holders. The agreement provides that once a minimum fee for a service provided under the agreement is set it cannot subsequently be decreased. It also provides that the fee for any financial advisory work connected with an acquisition by BBW must be at least 1.5 per cent of the investment value of the relevant target.⁹¹ In relation to assets purchased in the United States, this is a materially higher advisory fee level than what Wall Street banks would typically charge, at least for assets worth more than US\$50 million.⁹² These fees are subject to approval by the independent directors of BBW. The advisory agreement appears only able to be terminated by BBW after the initial 10-year period has expired, and then only in very limited circumstances.⁹³ While it is possible to conceive of some advantages to an exclusive agreement, it would be useful for security holders – and potential investors – to have the benefit of these being detailed, together with a summary of how the board determined that the advantages outweighed the disadvantages.

As another example, the management agreement for BCM requires the company to offer co-investment rights on any investment opportunity to Babcock & Brown and its associates. On the other hand, BCM does not have any co-investment rights in relation to investments made via other Babcock & Brown entities, and the manager has ‘no obligation to present investment ideas to’ BCM – although it has incentives to do so.⁹⁴ There are also pre-emptive rights between BCM and Babcock & Brown and its associates in relation to the sale of co-investments.⁹⁵

6.4 Lack of detailed information about material contracts

From a governance perspective, infrastructure funds listed on the ASX tend to have two particularly important contracts: the management agreement with the sponsor, and the ‘stapling deed’ (for those funds that have a stapled structure). However, with the exception of the agreements that applied to MIG between 2000 and 2004, these key contracts have not been put on the public domain.⁹⁶

These documents have been received by the ASX as part of normal pre-listing disclosures. However, the ASX refused requests to be given a copy of these documents for the purposes of preparing proxy voting research. ASX’s justification was that:

⁹¹ BBW, above n 62, pages 86, 143.

⁹² See Section 5.3 above.

⁹³ BBW, above n 62, page 143.

⁹⁴ BCM, *Prospectus* (December 2004), page 59.

⁹⁵ *Ibid.*

⁹⁶ For some funds, the prospectus stated that a copy of material contracts would be provided free of charge to any person on request, during the period of the offer: see, for example, MCQ, *Prospectus and Product Disclosure Statement* (February 2005), page 86. Where there is a Bermudan company in the stapled structure, it is not uncommon for its management agreement to be accessible only by inspecting it at the registered office of the Bermudan company – in Bermuda: see, for example, MCQ, *Circular to Stapled Security Holders* (June 2005), page 30.

‘ASX does not as a practice release stapling deeds and management agreements to the general public. Instead, ASX relies on the prospectus requirements under the Corporations Act to include all the information that investors and their professional advisers would reasonably require to make an informed assessment of the offer. In this regard, I note that the prospectus includes summaries of both these documents.’⁹⁷

The summary of the stapling deed in an infrastructure fund’s prospectus is commonly only one-third of a page in length, and the summary of the management agreement is often only 1.5 pages in length. However, each actual management agreement and the actual stapling deed is expected to be at least 30 pages long. Sophisticated investors could reasonably expect the ASX, as the market regulator, at a minimum to provide these documents to those investors or their advisers, on request. By way of comparison, the management agreement for the NYSE-listed Macquarie Infrastructure Company is available for anyone to view on the internet via the Securities and Exchange Commission (SEC) EDGAR database.⁹⁸

6.5 Lack of information about cost of removing manager

The importance of the material contracts discussed above is that they may contain highly material information about, for example, termination fees payable to the manager in the event that it is removed.

The management-agreement summary in a fund’s prospectus typically outlines the very limited circumstances in which the manager may be removed, but is silent on the issue of termination fees. As Table 1 illustrates, funds sponsored by Babcock & Brown have long-term management contracts – usually a fixed term of 25 years. From discussions with Babcock & Brown over such contracts, the authors understand that the contracts do not usually include a specific termination fee, or liquidated damages clause (other than the payment of accrued but unpaid fees). However, if the contract is terminated early for reasons not contemplated in the agreement, any payment would be based on negotiations between the manager and the fund’s directors, and with reference to the unexpired period of the contract. This could potentially result in a substantial fee being payable.

Due to the lack of availability of material contracts, as discussed above, it is not possible to say whether the manager of a Macquarie-sponsored fund would be entitled to a fee on termination. The annual report for each of the five Macquarie-sponsored funds listed on the ASX states that Macquarie may be removed as manager by an ordinary resolution of security holders.⁹⁹ In such circumstances, Macquarie would be entitled to be paid the

⁹⁷ Copy of email on file with authors.

⁹⁸ *Form of Management Services Agreement Among Macquarie Infrastructure Company LLC, et al:* available at <http://www.sec.gov/Archives/edgar/data/1289788/000095012304012123/y97636a2exv10w1.txt> (visited 25 June 2007).

⁹⁹ See for example MMG, *Annual Report 2007*, page 22; MAP, *Annual Report 2006*, page 45; MIG, *Annual Report 2006*, page 36; MCG, *Annual Report 2007*, page 34; MCQ, *Annual Report 2007*, page 27.

performance fee (if any) accrued for the most recent period. It is not clear if any other fee would be payable.

The above discussion may be largely moot, because changing the manager would apparently be a difficult undertaking in many cases. It is not unusual for a change of manager to trigger other consequences – for example, pre-emption rights over co-owned assets; requirement for the consent of asset co-owners, etc.¹⁰⁰

6.6 Contingent fees

Macquarie introduced an innovation when it listed its youngest fund: MMG. In addition to the wholly owned Macquarie subsidiary appointed as manager, another wholly owned subsidiary (MDAA) was appointed under an ‘Asset Advisory Agreement’ to provide advisory services to an MMG operating subsidiary – Macquarie Regional Radio Networks Pty Limited. If Macquarie is removed as manager, base and performance fees will become payable to MDAA under that Asset Advisory Agreement. This means if investors wished to and did successfully remove one Macquarie subsidiary as manager of the stapled entities, similar fees will then become payable to a different Macquarie subsidiary (MDAA). And, MDAA is significantly more difficult for investors to remove – this may occur only after ‘a sustained period of underperformance’ and a resolution of more than 50 per cent of all security holders (rather than 50 per cent of votes cast).¹⁰¹ Given that fees would presumably be payable to the replacement manager, the upshot of investors voting out Macquarie as manager would likely be an overall increase in fees.¹⁰²

When Babcock & Brown floated BBP in late 2006, a broadly similar contingent-fee provision was incorporated.

While the contingent-fee arrangements are clearly in the interests of Macquarie and Babcock & Brown, respectively, the prospectuses for MMG and BBP did not make clear what benefit the funds’ security holders derive from these arrangements.

6.7 Lack of detailed disclosure about handling of conflicts

There are two circumstances where a fund’s security holders would benefit from additional disclosure. First, where an infrastructure fund acquires an asset from, or pays a

¹⁰⁰ See, for example, BBW, above n 11, page 110.

¹⁰¹ MMG, *Prospectus and Product Disclosure Statement* (October 2005), page 5.

¹⁰² MMG explicitly acknowledged this in the prospectus: ‘There may be disincentives to remove MMML as the responsible entity of MMT and manager of MMHL. The termination provisions which apply to the Asset Advisory Agreement are more restrictive than those at the MMT and MMHL level. In particular, the Stapled Security Holders’ ability to remove asset advisers is limited to a sustained period of underperformance and a resolution of more than 50% of Stapled Security Holders. While MMML is the MMT responsible entity and MMML the Manager, management fees ... will be payable only at the MMT and MMHL level. If the Macquarie Bank Group companies cease to manage MMT and MMHL, similar fees will then become payable under the Asset Advisory Agreements at the asset level, with the result that there may be an increase in the total management fees payable by the MMG entities and investor returns may be adversely affected.’: MMG, above n 101.

material sum for services provided by, its sponsor. Second, where a fund does *not* bid for an asset but another fund with the same sponsor *does* bid.

In relation to the first situation, an issue arises where a sponsor acquires an infrastructure asset and then, later, on-sells the asset to an infrastructure fund in its stable. While security holders are normally appraised of the price paid by the infrastructure fund, it is not common for the price paid by the sponsor – and hence any profit on disposal – to be disclosed.

The other aspect of the first situation is the provision of advisory and other services. The annual reports for Macquarie funds state that the terms and conditions of mandates with Macquarie are subject to ‘third party expert review’ unless the independent directors decide otherwise.¹⁰³ However, the instances where a third-party expert was used and those where the independent directors decided not to use an external adviser are not disclosed.

In relation to the second situation – failure of a fund to bid for an asset where its sponsor is part of a bidding consortium – the terms of the agreements between the funds and their external managers create the opportunity for potential conflicts of interest. Specifically, the management agreement often provides that the external manager is free to pursue other opportunities in conflict with the interests of the fund. The summary of the terms and conditions for Babcock & Brown-managed funds makes it clear that although the relationship between Babcock & Brown and each fund is exclusive from the perspective of the funds – in that Babcock & Brown must be appointed as the manager of each asset – Babcock & Brown is under no obligation to present all investment opportunities in a particular asset class to the relevant fund. In the case of BBW, for example, ‘Babcock & Brown is under no obligation to present each or any wind energy opportunity’ to BBW, even though Babcock & Brown must be appointed as the manager of any asset owned by BBW.¹⁰⁴

These one-way exclusivity arrangements – where the fund is bound by the exclusivity agreement but the external manager is not – were illustrated in Singapore Power’s acquisition of energy assets from Alinta in 2007. After acquiring these assets, Singapore Power announced its intention to sell the assets it had acquired from Alinta to SP AusNet, the publicly traded infrastructure vehicle it controls and manages. In the explanatory memorandum accompanying the notice of meeting seeking approval for this transaction, the directors of SP AusNet noted that Singapore Power may, if security holders refused to approve the purchase of the Alinta assets, list the Alinta assets in a new vehicle but have them managed by the same entity that manages SP AusNet.¹⁰⁵ As the Alinta assets are

¹⁰³ See, for example, MIG, *Annual Report 2005*, page 38.

¹⁰⁴ BBW, above n 62, pages 25, 142. There are two exceptions to the requirement for Babcock & Brown to act as manager under the management agreements: (i) where an asset was acquired on the condition existing management arrangements continue; and (ii) in cases where the asset was not sourced by Babcock & Brown *and* where it is a condition of the acquisition of the asset that be managed by the party that introduced the asset to BBW or where security holders by resolution require that the asset be managed by another party.

¹⁰⁵ SP AusNet, *Explanatory Memorandum and Notice of Meeting*, 9 November 2007, page 17.

approximately three times larger than those held by SP AusNet, this placed the security holders of SP AusNet in a difficult situation: Accept the purchase of assets from a related party or face the external manager dividing its expertise between two publicly traded funds, one of which is three times larger than the other. (The proposed sale was withdrawn shortly before SPN security holders were due to vote on the proposal, with conditions in debt markets cited.)

These differential exclusivity arrangements also make clear a lack of alignment between the external manager and security holders. The external manager is under no obligation not to compete with the publicly traded fund, or even to offer it investment opportunities on an exclusive basis, while the fund is barred from seeking expertise outside of the external manager even if the external manager is competing with the fund, or lacks the expertise necessary to manage particular assets.

It also appears that while Macquarie is under a contractual obligation with many of its listed funds to invite these funds to invest in opportunities it may identify, this right is often waived. For example, under a five-year agreement between MIG, Macquarie and Transurban (a publicly traded toll-road competitor of Macquarie) signed in December 2003,¹⁰⁶ Macquarie and MIG agreed to bid jointly on Australian toll-road projects. MIG has however waived its right under the agreement to participate in bids by a Macquarie consortium for Brisbane's North-South Bypass Tunnel project and did not make a counter-bid or participate in the Macquarie-organised bid to build the Mitcham-Frankston freeway in Melbourne, despite this bid being specifically outside the cooperation agreement.¹⁰⁷ MIG's decision not to participate in either of the Macquarie consortia bidding for these projects may of course be taken as evidence of MIG's independence from Macquarie. On the other hand, the fact that MIG did not make a counter-bid against Macquarie for the Mitcham project (assuming it was not precluded from doing so under the management agreement) could equally be viewed as bringing into question the independence of MIG from Macquarie. As indicated, an infrastructure fund's security holders would benefit from additional disclosure in circumstances such as these.

6.8 Alignment of manager's and investors' interests

The base and performance fee structure of the infrastructure vehicles provides at least some – albeit imperfect – alignment between returns to security holders and fees paid to the manager (although fees paid for other services such as investment banking have little if any link to returns to security holders). In contrast, the pay structure of the executives actually responsible for managing these vehicles has until recently been driven almost entirely by the bonus structure of the external manager and not by returns to the funds'

¹⁰⁶ See Transurban Group, 'ASX Release: Transurban, Macquarie Infrastructure Group and Macquarie Bank Joint Agreement', 16 December 2003, available at <http://www.asx.com.au/asxpdf/20031216/pdf/3k4dgsmdqtyqj.pdf>. Macquarie is the preferred financial advisor on all bids under the cooperation agreement.

¹⁰⁷ See MIG, 'ASX Release: MIG – Brisbane North South Bypass Tunnel Project Update', 26 October 2005, available at <http://www.asx.com.au/asxpdf/20051026/pdf/3sy72v6rgqg2w.pdf> and MIG, 'ASX Release: MIG – Mitcham-Frankston Freeway Update', 15 March 2004, available at <http://www.asx.com.au/asxpdf/20040315/pdf/3kzb2y7yf6hd0.pdf>.

security holders. For example, the Macquarie Group executives responsible for managing MIG, MCG, MMG and MAP are remunerated largely out of the Macquarie Group bonus pool, which is determined by Macquarie's growth in profit relative to its cost of capital. One contributor to this profit is fees derived from Macquarie's management of the infrastructure funds, meaning these executives – who investors could reasonably expect to be motivated to increase returns to security holders – are paid out of a bonus pool that will increase with every fee received by Macquarie from the externally managed entities.

This is not to say that the Macquarie executives managing infrastructure vehicles prioritise the interests of Macquarie over those of fund investors; merely that their pay structure appears to align their interests with those of Macquarie more than the fund to which they are assigned. Macquarie's 2006 remuneration report states that each division of the company is allocated a share of the bonus pool based on contribution to overall profit (adjusted for capital usage), with individual bonuses linked to 'outcomes actually achieved in the current year that contribute directly to net profit after tax and excess return on ordinary equity'. That is, the bonus pool for Macquarie's specialised funds division that oversees MIG and similar vehicles is determined on those vehicles' contributions to profit. And, until the change made in 2007 outlined below, allocations within the division were determined by individual executives' contributions to Macquarie and not to the vehicles they managed.¹⁰⁸

Macquarie has however made several reforms to the way in which the executives involved in managing its publicly traded funds are remunerated over the past two years. As part of its remuneration structure for senior executives, Macquarie requires 20 per cent of any annual bonus paid to be deferred for up to 10 years. In 2006, 'in order to better align the interests of management with security holders', Macquarie began requiring the deferred profit share of senior executives responsible for infrastructure vehicles to be notionally invested into the securities of the vehicle they manage.¹⁰⁹ Prior to this time, however, these executives seemingly had no requirement to hold any securities in the vehicles they managed.

In addition, in the 2007 remuneration reports for its externally managed vehicles, Macquarie began disclosing that the annual bonus paid to executives responsible for externally managed funds is 'driven predominantly by their individual contribution to the performance of [the infrastructure fund], taking into account' factors such as operational performance, capital management, and maintenance of Macquarie's reputation in respect of its branded funds.¹¹⁰ The authors have also been told by a Macquarie representative that the bonuses of Macquarie investment banking staff who specialise in providing advice to the externally managed Macquarie funds are linked partly to the performance of the publicly traded funds and not just to the revenue generated for Macquarie by advising these funds.

¹⁰⁸ Macquarie Bank, *Annual Review 2006*, page 58.

¹⁰⁹ See, for example, MIG, *Annual Report 2006*, page 93; MCG, *Annual Report 2006*, page 42; MAP *Annual Report 2006*, page 61. The investment into securities is in fact notional, but the eventual deferred profit share amount will reflect the returns to security holders over the same period.

¹¹⁰ See, for example, MMG, *Annual Report 2007*, pages 53-54; MCG, *Annual Report 2007*, pages 80-81.

The remuneration model for Babcock & Brown staff responsible for managing external funds is similar to the pre-2006 Macquarie model. Executives responsible for BBI and other publicly traded vehicles were in 2007 and earlier years remunerated through Babcock & Brown's incentive schemes. In 2006 disclosures however, Babcock & Brown appeared to acknowledge the potential conflict these arrangements posed and disclosed that in future years:

'Babcock & Brown Infrastructure's Boards going forward will develop specific Key Performance Indicators for the senior management providing services to Babcock & Brown Infrastructure. The framework provides that the Babcock & Brown Infrastructure Independent Directors will be given the opportunity to provide formal input to Babcock & Brown on the performance of the Manager as a whole and the key Babcock & Brown employees who perform services for them. The framework also provides that this input will be taken into account in determining the proposed remuneration of those key employees, as it relates to the services to Babcock & Brown Infrastructure, and the Independent Directors are consulted on that remuneration.'¹¹¹

The review of the remuneration arrangements for Babcock & Brown managed funds staff appears to have taken longer than expected; almost identical disclosures – describing *proposed* changes – were made 12 months later in the 2007 reports for Babcock-managed vehicles listed on the ASX.¹¹² The implication behind the proposed changes outlined above is that the performance-based pay of Babcock & Brown executives managing vehicles such as BBI has not to date been linked directly to returns to BBI security holders.

Not all externally managed funds link the remuneration of fund staff to the profit generated for the manager. For example, SP AusNet's executive remuneration structure is linked to (among other measures) returns to SPN security holders, and SP AusNet's net profit, cost control and earnings per security.¹¹³ At the other extreme, Spark Infrastructure disclosed that, as Spark Infrastructure 'is not liable for expenses referable to the executives ... executive remuneration details are not provided'.¹¹⁴

6.9 Use of same audit firm as sponsor

In several cases, the external auditor of the publicly traded infrastructure fund is also the auditor of the manager.

The most notable examples of this dual audit role are the Macquarie entities. All vehicles externally managed by Macquarie and listed on the ASX are audited by PricewaterhouseCoopers, the auditor of Macquarie Group. Indeed, the 'Auditor

¹¹¹ BBI, *Annual Report 2006*, page 61.

¹¹² See for example BBI, *Annual Report 2007*, page 65.

¹¹³ SPN, *Annual Report 2007*, pages 43-47.

¹¹⁴ SKI, *Annual Report 2006*, page 40.

Independence Policy' for each of the Macquarie-managed infrastructure funds says the fund's entities are to appoint PricewaterhouseCoopers as auditor 'wherever practicable'.¹¹⁵

In the most recent financial year, the aggregate fees paid to PricewaterhouseCoopers by Macquarie and the nine largest publicly traded entities managed by Macquarie was \$36.9 million, of which 48.6 per cent related to fees paid by Macquarie itself to PricewaterhouseCoopers.¹¹⁶

This dual audit role for PricewaterhouseCoopers means that it is the external auditor of both the manager of the publicly traded funds and the funds themselves. This creates a potential conflict of interest as PricewaterhouseCoopers has substantial revenue at risk from being removed as auditor of Macquarie. The fact that Macquarie employs the same auditor across the Group and all of its publicly traded entities does not necessarily mean the auditor will be subject to a conflict of interest but it does create the potential of such a conflict arising simply because of the potential impact of losing Macquarie as a client. The decision to appoint PricewaterhouseCoopers as auditor of the Macquarie-managed entities gives rise to obvious cost savings, especially given that so many of the management systems of the externally managed entities reside within Macquarie. However, the counter-argument is that each externally managed fund is a separate entity from Macquarie, with interests that may differ from those of Macquarie and with different security holders to Macquarie. It is not clear what governance benefits security holders in Macquarie-managed entities derive from sharing an auditor with Macquarie.

It is not impossible for an external manager to have a different auditor to the vehicle it manages. Only one publicly traded entity managed by Babcock & Brown employs Ernst & Young, the auditor of Babcock & Brown; and this entity, BEI, was 30.7 per cent owned by Babcock & Brown.¹¹⁷ Of the other entities, BBP, BBW and BCM are audited by PricewaterhouseCoopers and BBI is audited by Deloitte. This reflects Babcock & Brown's governance arrangements for its external funds which it says are intended to 'ensure the independence of each of the specialised funds' and include a provision that 'The external auditor of a Fund will not be the auditor of Babcock & Brown or any of its subsidiaries.'¹¹⁸

¹¹⁵ See, for example, MMG, *Macquarie Media Group Auditor Independence Policy* (undated), page 1: available at http://www.macquarie.com.au/au/mmg/acrobat/auditor_ind_policy.pdf (visited 18 July 2007). DUET Group, which is co-managed by AMP Capital and Macquarie, uses Ernst & Young, the auditor of AMP, as its external auditor.

¹¹⁶ Figures derived from annual reports. The figure includes \$2.87 million in fees paid by four Macquarie-managed REITs to PricewaterhouseCoopers. The total audit and non-audit fees paid to PwC by the 10 Macquarie entities increased by 59.4 per cent over the prior financial year.

¹¹⁷ On 14 November 2007, Babcock & Brown announced a proposal to acquire all the shares in BEI it does not already own after prolonged underperformance by BEI. See BEI, 'ASX Release: Proposal Received from Babcock & Brown', 14 November 2007, available at <http://www.asx.com.au/asxpdf/20071114/pdf/315t34np0nx6q1.pdf>.

¹¹⁸ BBP, *Prospectus and Product Disclosure Statement* (November 2006) page 72. This disclosure does not appear in the 'Governance in Funds' section on Babcock & Brown's website - <http://www.babcockbrown.com/bnb-about-us/corporate-governance/governance-in-funds.aspx> (visited 18 July 2007).

7. Conclusion and suggested reforms

This paper has highlighted a range of concerns about the infrastructure fund model. Several of the issues discussed in the paper relate to the sustainability of the model. For example, the predictable and steadily growing cash flow associated with infrastructure assets is commonly highlighted as a basis for providing an attractive, and steady, yield. However, the yield delivered by several infrastructure funds is sourced from operating cash flows of the fund's assets *and* from capital. Other investment-related issues identified in the paper are a danger of overpaying for assets; fee structures that deliver high fees and provide an incentive to increase a fund's size; and accounting practices that have the capacity to provide an overly robust picture of a fund's profitability. The paper also describes a series of additional concerns with the infrastructure model – concerns of a governance nature. For instance, the existence of 'special shares' in some funds which entitle the external manager to appoint a majority of the fund's directors; and concerns about insufficient alignment between the interests of the external manager and fund investors.

A range of potential reforms (primarily to disclosure rules) are outlined in Section 7.2 below. Before that, a competing infrastructure model is outlined, which appears not to give rise to the same range of concerns as the more widely adopted model discussed in this paper.

7.1 Competing model

A second infrastructure model has arisen over the past decade, embodied in toll road operator Transurban, and replicated in two externally managed toll road developers, ConnectEast Group and RiverCity Motorway. Under this model, the publicly traded entity is externally managed in its development phase, with the administration function performed by an investment bank (Macquarie in the case of Transurban and ConnectEast and ABN Amro for RiverCity). The powers and fees of this external manager are however limited through contracts between the toll road consortium partners, with the developers – usually engineering and construction companies – having a substantial voice in management. The external managers' fees are limited to a flat dollar annual base fee, and an option is built into the structure and management contracts enabling the external manager to be internalised at the completion of the project, with the price for buying out the external manager tied to the profitability of the project.

Transurban is the only mature example of this internally managed model listed in Australia. Like ConnectEast and RiverCity, it began life as a funding vehicle for a particular toll road project, but has since expanded to own and operate toll roads around the world. The Transurban model is similar to the stapled security model in ASX-listed REITs, where the formerly external management company is stapled to the property trust

it once managed, giving investors access not only to property rents and capital gains but also to management fees.¹¹⁹

The two competing infrastructure models have, as indicated by Macquarie's role in both kinds of model, co-existed peacefully in Australia to date. Macquarie and Transurban, despite being competitors for toll road assets outside of Australia, appear to retain fairly close ties – an executive director of Macquarie was until recently chairman of Transurban, and Macquarie frequently provides investment banking services to Transurban, while Macquarie and Transurban have agreed to cooperate on toll road tenders within Australia.¹²⁰

Despite these apparent ties, signs of competitive tension have recently emerged between Macquarie and Transurban: For example, the former Managing Director of Transurban was quoted saying that the Transurban owner/operator model was superior to Macquarie's externally managed model as Transurban's ownership of the assets it managed led to 'a better transport outcome' and Transurban's internal-management model 'is the long-term sustainable model'.¹²¹ It is also significant that when Macquarie, in response to investor pressure, spun-out the mature Australian toll road assets of MIG into Sydney Roads group, it adopted an internally managed model similar to that of Transurban. (Sydney Roads Group was subsequently taken over by Transurban.)

7.2 Reform proposals

This section concludes the paper by outlining some modest reform proposals, which are aimed primarily at reducing the information asymmetry between those managing, and those investing in, publicly traded infrastructure funds.

First, the ASX should make publicly available the management agreement when it is filed by the fund. As noted above, the summary of the management agreement in the fund prospectus is often only 1.5 pages in length. However, each actual management agreement is expected to be at least 30 pages long. Sophisticated investors could reasonably expect the ASX, as the market regulator, to adopt the SEC's practice of posting management agreements in full on the online database. These agreements are received by the ASX, so there is minimal additional cost involved in posting them on the online database.¹²²

¹¹⁹ Investor pressure has driven a wave of management internalisations in Australia's publicly traded REITs over the past five years, with Westfield and GPT the most notable entities to move to an internally managed structure.

¹²⁰ See Transurban Group, above n 106.

¹²¹ Henry Byrne, 'He's On the Road', *Australian Financial Review*, 24 February 2007, page 23.

¹²² The ASX in June 2007 released a proposed new regime for disclosing the terms of management agreements, including requirements for explicit disclosure of fees payable on termination and change of control provisions. See *ASX Exposure Draft: Proposed ASX Listing Rule Amendments* 20 June 2007, page 69, available at http://www.asx.com.au/about/pdf/exposure_draft_20jun2007.pdf. This represents a substantial improvement on the existing requirements although there would still be no requirement to publish the agreement to the market.

Second, managers should be required to disclose more than just their policy and procedure for handling related-party transactions. They should also be required to disclose, after the event, how a particular potential conflict of interest was resolved. For example, as discussed in the paper, the annual reports for Macquarie funds state that the terms and conditions of mandates with Macquarie are subject to ‘third party expert review’ unless the independent directors decide otherwise. However, the instances where a third-party expert was used and those where the independent directors decided not to use an external adviser are not disclosed. It would benefit security holders if this type of additional disclosure were made. As another example, where a sponsor on-sells an asset to a fund in its stable, there should be a requirement to disclose the carrying value of the asset held by the sponsor – and hence any profit it made in the on-sale to the fund.

Third, the Australian Securities and Investments Commission (‘ASIC’) should scrutinise particularly carefully the prospectus of each newly listed infrastructure fund. In particular, and regardless of whether the first proposal is adopted, the summary of the management agreement should be examined to ascertain whether it is sufficiently detailed in relation to the financial consequences of the manager being terminated.

Fourth, the ASX should reconsider its approach to granting waivers from Listing Rule 6.9. As discussed earlier, this is the one-share / one-vote listing rule, which has been waived on several occasions to enable infrastructure funds to issue special shares to their managers, giving the manager the power to appoint a majority of the fund’s directors.