INSIGHTS INTO THE FINANCIAL OPERATION OF BOOT SCHEME TOLL ROADS IN AUSTRALIA

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Part 1: OVERVIEW

The BOOT (Build-Own-Operate-Transfer) method of providing road infrastructure in Australia lacks transparency in two ways: the financial arrangements and the role of government in facilitating the schemes. Numerical evidence, much of it derived from balance sheets, profit and loss accounts and cash flows, shows that these BOOT schemes exhibit fundamental weaknesses which were not apparent before the projects became operational.

One of the first BOOT projects in NSW was the M2 Motorway, the construction of which was funded by debt and equity. Its financial model was prepared in 1994 by the Macquarie Bank for the Hills Motorway Group but did not become available for scrutiny until it was released by order of the NSW Parliament in October 1999. Present value analysis[1] of this model has revealed the economic worth today of the stream of future profits, and it is much less than the model shows because of the existence of positive interest rates. Because of its large negative net present value (NPV), this project is not commercially viable over the concession period even if the forecast traffic is achieved.

In any case the traffic forecasts lack credibility, because the model shows that increased congestion and loss of travel time savings, particularly during peak periods, attracts more road users willing to pay toll increases. Such an economic anomaly is more consistent with a desired financial outcome than with one derivable from proper considerations of land use and transport planning.

The Australian Securities Commission (now the ASIC) that permitted the prospectus to be listed on the Australian Stock Exchange (ASX) in 1994 may not have appreciated the non-viability of the project. The same conclusion of non-viability can be shown to also apply to Melbourne City Link. The financial model for this project was derived from the prospectus. It is also not financially viable on present value criteria, yet the ASC permitted it to be registered on the ASX in 1996. Both prospectuses lead equity investors to believe that based on toll revenue alone, large equity dividends can be paid over the concession period. Possible future failure of the project is deceptively attributed to “traffic risk”. But

[1] Recommended by the Economic Planning Advisory Commission (EPAC). Private Infrastructure Task Force. Interim Report May 1995. s 9.1 Project Appraisal (page 162) AGPS

as already noted, the failure would occur in any case even if the traffic volumes given in the prospectuses were to be achieved.

The deficiency of revenue from tolls is clearly shown in the annual financial statements for both projects. Additional revenue has had to obtained from
the so-called *Infrastructure Borrowings Tax Offset Scheme* (IBTOS). This scheme has enabled the project revenue to be increased by at least one-third. In any year. Without this support, the M2 Motorway, after seven years operation and City Link after five years of operation would be unable neither to pay a dividend nor fully meet debt service obligations, much less repay any of the large long term debts.

The additional revenue is obtained as follows. Capital amounts are raised from lenders and then invested by the borrowers (the project owners). The lenders are supposed to receive the major part of the interest earned and the borrowers a smaller part. The amount borrowed is limited by the size of the corresponding tax offset, which is applied at the current company tax rate and is limited to $75m per annum for each project.

The Department of Transport and Regional Services (DOTARS) and the Australian Taxation Office (ATO) give a superficial description of this scheme on their websites. It is therefore instructive to consider an actual numerical example taken from the Transurban Group financial statements[2] for fiscal 2004.

The total capital sum borrowed was $1249m, and the interest received was $180.48m. The corresponding interest rate applying to the borrowing is calculated as 14.45% per annum. The lenders are entitled to an interest rate of 10% per annum. The interest amounts to $124.9m on which the lenders pay a tax offset at the company rate of 30% amounting to $37.47m. This is well below the allowable limit of $75m. The borrowers would therefore be entitled to receive only $55.6m, which corresponds to the interest rate of 4.45% per annum.

Moreover it needs to be explained why the entire amount of interest $180.48m appears as “revenue from outside operating activities” and is added to the toll revenue. Where is the amount paid to lenders recorded? As the inclusion of all the interest directly affects the reported losses, one could be led to the conclusion that the true financial position has not been correctly reported. This conclusion, if correct, would have implications for superannuation funds with long-term investments in these infrastructure projects.

This lack of transparency is present in all the financial statements of both the Hills Motorway Group (M2) and the Transurban Group (City Link) from the beginning of their operating phase. The Hills Motorway Group, have never issued

[2] The Transurban Group Preliminary Final Report (2004). Notes to the financial statements: 3. Revenue (page 30). Financing arrangements and credit facilities, notes (a) and (b). (page 39)

any information about the magnitude of its infrastructure borrowings. However, from data in the financial statements, it can be estimated that infrastructure borrowings in fiscal 1998 were $190.9m reaching $328.7m in fiscal 2004.
The average share prices are significantly related in a statistical sense to the project revenues including IBTOS interest and not to the net profit or loss

Revaluation of property, plant and equipment (PPE) can also be shown to be closely related to the market capitalization based on share prices. The increases in non-current asset values enable debt to be increased if required. In 1999, the M2 Motorway was revalued to over twice its original capital cost and in 2002, City Link was revalued to over three times original capital cost.

But these large revaluations do not make economic sense. The owners do not pay economic rent for the traffic volumes on public roads, which are the critical factor in the production of toll revenue.

With the financial structure of these BOOT schemes so dependent on infrastructure borrowings, what will happen when the 15-year currency of the scheme ends in 2011 for City Link and 2009 for the M2? Will there be more non-transparent renegotiations of the infrastructure borrowings scheme, or will there be a need for a bailout by Governments? Are the very large revaluations of the projects mentioned above, based as they are on market capitalization, a sign that such a move may be contemplated?

It is obvious that capital resources could be better allocated if State Governments simply paid for the roads out of appropriation. Governments are less likely to default and consequently can obtain access to capital at lower interest rates than the private sector.

Complex corporate arrangements are needed so that these BOOT projects may avoid the consequences of corporate collapse. By structuring each project as a Trust and a Company the project owners may believe that they have secured a limit to the liability they may face if the project collapses. Securities in these projects are issued as stapled units. For example, for the M2 Motorway $1 stapled securities are issued to equity investors in the form of a one cent share in the Company stapled to a 99 cent share in the Trust. As the Trust does not operate the business it does not assume ongoing liability if the Company fails. At the same time the liability of the Company is limited to 1% only.

This is an example of the "corporate veil of protection",[3] used here in an attempt to limit the liability of the Group. However, if the venture fails, the Court may find that the financial structure is a sham, designed to create limited liability for the

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[3] Justice Andrew Rogers (1993) Reforming the Law Relating to Limited Liability. Australian Journal of Corporate Law, Vol. 3, No.1. pages 136-140

project. In this case one can see the possibility of the directors being held responsible and the unit holders of the Trust as well.

The hybrid corporate structure has also enabled consolidated amounts to be entered which do not aggregate to the amounts in the company and trust accounts. This finding could lead to the view that the magnitude of the losses has been understated. This possibility of using consolidated data has been noted by Clarke et al[4] who state that "consolidated data are accounting's fabrications *par excellence*".

Additional questions need to be raised about the conduct of government departments in allowing the situation described in this paper to develop.
The financial sophistry described in this paper would not have been possible if the government departments involved had properly exercised their discretion in favor of the public interest, examining the financial statements on an annual basis The role of the Australian Securities Commission (ASC) has already been noted. The complex financial arrangements necessary to overcome the intrinsic non-viability of the projects are well protected from inconvenient revelation as described below.

The Development Allowance Authority, which certified the projects to receive the advantage of infrastructure borrowings, can appeal to Part 4, s.112 of the Act, to ensure that information supplied by the applicant for certification would be treated as commercial-in-confidence. It could only be published if the public interest could be shown to outweigh prejudice to commercial interests.

The Freedom of Information Act offers an additional layer of protection. An application made by the author in 2004 to the Department of Transport and Regional Services (DOTARS), to determine what information on commercial viability of the M2 Motorway and City Link had been supplied to that agency was rejected. The agency appealed to .the confidentiality provisions of the Income Tax Act 1936, notably section 16(2), which explicitly prevents an officer from making any disclosure of information in an Infrastructure Borrowings Tax Offset form[5]

Any claim that these toll road projects are de-facto public-private partnerships should be rejected, because concession fees payable to the State Governments of NSW and Victoria will never be collected by these governments because of a clever but misleading deferral scheme against the public interest.

[4] Clarke, F.L, Dean, G.W, Oliver, K.G. (1997) Corporate Collapse- Regulatory, Accounting and Ethical Failure. (Cambridge University Press).

[5] Letter to the author, 24 May 2004. Internal Review of decision in accordance with the Freedom of Information Act. Department of Transport and Regional Services (DOTARS).

Concluding Remarks

The financial operation of BOOT scheme toll roads in Australia, has been shown to be critically dependent on government support through the Infrastructure Borrowings Tax Offset Scheme. (IBTOS). Without the IBTOS, no dividends could be paid to equity investors, nor debt-servicing obligations properly discharged, nor would the share prices be at the current levels. The share prices in turn have allowed non-current assets to be revalued to levels, which are not only economically meaningless, but also permit more debt to be engaged through the lowering of the debt to asset ratio. If the IBTOS were to be terminated now, the projects would not be sustainable.

These conclusions emphasize the essential weakness of BOOT schemes in Australia as revealed after seven years of operation of the M2 Motorway and five years of City Link.

Part 2 of this paper will examine in detail the matters raised in Part 1.

2 September 2004