Macquarie Global Listed Infrastructure[1]

Regulation: Risk or opportunity? It's all a matter of perspective

Infrastructure's importance to communities in providing essential services means that regulatory risk can be one of the largest risk factors investors should consider. Essential services are typically characterised by high volumes of daily usage by a large, captive customer base – such as households, businesses, commuters, drivers, exporters/importers, and travellers – while also supporting broader economic growth.

Importantly, while regulation can be a risk factor when it comes to infrastructure assets, it also provides opportunities. Investors often focus on short-term issues and can misunderstand the impact of regulation on infrastructure assets. This can create opportunities for specialist active managers. This is also one of the key reasons we believe in the importance of using a specialised active manager within the sector.

Below we provide further information on our investment process and on current key areas of focus as it relates to regulatory risk.

The importance of an active manager

"Ask a global equity analyst how regulation impacts their companies. They will often tell you the effect is negative, as regulation potentially constrains or inhibits the company from doing business. Ask an infrastructure specialist who knows the sector, and they will tell you that regulation can be a positive, as it helps ensure companies deliver, and investors receive what they expect."

Brad Frishberg, Head of Macquarie Global Listed Infrastructure

Macquarie Global Listed Infrastructure – considering both the risks and opportunities

As part of the investment process, and after identifying infrastructure companies that are sufficiently 'pure', the investment team considers:

1. Qualitative review of the country, political, industry, regulatory and general macroeconomic factors that can impact infrastructure securities
2. Quantitative assessment of underlying fundamentals, such as capital structure sustainability, earnings multiples, earnings growth, liquidity and volatility

Appling this process also tends to exclude companies that:

- Operate in opaque regulatory regimes
- Have inappropriate or unsustainable capital structures
- Do not have sufficient earnings growth transparency
- Are infrastructure-related companies, such as construction or steel firms
- Are service companies, such as engineering or maintenance firms.

[1] Macquarie Global Listed Infrastructure is an equity team within Macquarie Asset Management's (MAM) Equities & Multi-Asset business.

What we look for…

To understand how regulatory risk may arise, we look at the broader context of the key stakeholders in infrastructure assets.

Key stakeholders in infrastructure

Consumer	Regulator	Asset Owner
• Consumers want the cheapest price and reliability • From a consumer perspective, stronger growth in rate base can deliver infrastructure upgrades and higher quality of service. • It can come at the cost of higher bills which may impact consumers	• Want a reliable service • Understanding the regulator and their approach critical to understanding the likely future path of both the rate base and their approach to "reasonable returns".	• Want to earn a reasonable return • Finding the right balance is crucial to ensure that consumers receive reliable services at reasonable rates.

It is the constant push and pull between these three stakeholders that gives rise to potential regulatory risk. Infrastructure services should be provided in a way that is both cost effective and provides a high quality of service, or value for money. In its optimal form, an infrastructure asset may provide a service that is aligned with government policy, such as one that helps elected officials meet their objectives, which may include carbon reduction, reduced fatalities, or cleaner water. If value is not being provided, or not being perceived as being provided, or the services are not aligned, then sovereign or regulatory risk may appear.

Regulatory risk, should it occur, can result in a range of impacts, including:

- Companies and assets earning lower revenues
- Licenses being adjusted
- Punitive taxes (Robin Hood tax, windfall taxes)
- Concessions being taken away
- Reputational damage.

While the risk always exists, there are mechanisms that help protect companies and investors, such as:

- **Regulator independence –** Having a regulator that is independent of the government. When a company is regulated by the government, it may lead to a conflict between objectives in some cases. For example, tariffs could be cut with the aim of freeing up headroom to raise taxes.
- **Management track record of helping governments meet their objectives –** Examples would include reducing accident rates on toll roads, decarbonisation, and reduced explosions in gas pipelines. We also want to understand that management teams respond to incidents in effective ways should they occur. We look for management teams to be open and transparent when incidents occur.

Interaction with the broader Macquarie Group

The Global Listed Infrastructure Team can draw on Macquarie's significant experience in infrastructure, which is a defining competitive advantage. This is particularly relevant when we consider regulatory and sovereign risk. For example, Macquarie's reach and experience provides us the ability to access on-the-ground expertise in relation to infrastructure assets and regulatory regimes in many countries. It is also beneficial that this expertise comes from both private and listed investment specialists, providing a diversity of thought that is not available to many other firms.

Increased insight driven by Macquarie's network

Engagement is driven both by the Macquarie Global Listed Infrastructure Team as well as our private market counterparts in a mutual exchange of information. Importantly, the network is not limited to the private side of the business, but rather the broad range of colleagues from across Macquarie divisions, such as the gas trading division in the US and the Macquarie Fixed Income Team, for additional perspectives on economic inputs and so forth. Importantly, all engagements are completed within strict compliance guidelines.

Previous engagements related to regulation include:

- Political regimes change in Latin America – impacts GDP-sensitive exposures within the region
- Regulatory risk regarding pass-through of inflation in Europe, particularly France – impacts GDP-sensitive exposures within the region
- UK water utilities – regulatory change and impact on discount rates
- Probability and impact of windfall taxes – impacts electric utilities and energy generation

Case studies

Below we have also provided a range of examples where regulatory and sovereign risk is currently impacting the infrastructure sector.

1. Airports

Regulation remains a key consideration for airports. Below, we outline four examples of the potential implications.

Airport	
Auckland Airport (New Zealand)	Recently had its draft aeronautical pricing decision and the company may need to cut tariffs depending on the final decision in early 2025.
ENAV S.p.A. (Italy)	ENAV is currently in discussions with the European Air Traffic Control regulator (EuroControl) for the next regulatory period (2025 to 2029). EuroControl recently announced a pan-EU target for unit cost reduction of 1.2% for the period (this drives the tariff development), which compared favourably with the ~3% unit cost reduction target in the current regulatory period.
Aeroports de Paris (AdP) (France)	AdP currently does not have a regulatory framework, which means that the company needs to resort to annual negotiations with the regulator to determine tariffs. While this has advantages and disadvantages, one of the key challenges of the past few years has been trying to pass through higher-than-expected inflation without a clear mechanism to do so.
Aena (Spain)	Aena is about to embark on regulatory discussions for the next regulatory period, which will start in 2027. One of the key considerations is the tariff projection path. During the first two regulatory periods, Aena could not raise its tariffs, but that moratorium expires with the next regulatory reset.

2. United States – energy priorities, level of investment and ability to recover costs remain key

While there has been concern about changes to energy policy with the election of President Trump, most US utility spending is regulated by state-level regulatory commissions, who are focused on regional needs and interests. Federal tax policy and renewable energy support may change with the new administration, but reliability, affordability and safety will remain the key tenets that underlie long-term capital investment decisions. A strong investor understands each state's energy priorities, the level of investment needed to achieve those priorities, and the ability to recover costs with an attractive return on investment. Macquarie analysts gain an edge by following politics and regulation, reading local media and corporate filings, speaking with corporate management and state regulators, collaborating with Macquarie's investment network, understanding energy affordability and customers' ability to pay bills, and incorporating these insights into a valuation driven by cash flow projections and discount rates.

3. France – political uncertainty, opportunities, but the devil is in the details

The political uncertainty in France has weighed on both bond and equity markets over the past few months as the country has struggled to appoint a prime minister and implement a budget. The main challenge is that Parliament is split roughly equally between the left, centre and right parties. However, with President Macron responsible for appointing the candidates for prime minister, the risks to the infrastructure sector are limited, in our view. We believe that the bigger risk to the infrastructure names is the broader risk around corporate tax increases. The main challenge remains the budget, with the country likely experiencing a 5-6% budget deficit in 2024 and 2025, which is well ahead of the EU rules. To close the gap, both former prime minister Michael Barnier, who lost a vote of no confidence at the start of December, and current prime minister Francois Bayrou have proposed a mix of tax increases and spending cuts. However, both the left and the right have so far been hesitant to support the spending cuts. The increase in corporate income taxes is supposed to be temporary, and if such a measure should pass, the increase in the corporate income tax would impact near-term earnings for all infrastructure names under our coverage. However, there are a few nuances between the sectors, especially if the tax increases end up being permanent.

- **Toll roads (Eiffage, Vinci) |** The concession contract for the toll roads does not provide any provision for changes to the corporate income tax, meaning that the concessionaire bears 100% of this risk. As a result, a tax increase would be a small negative for the names, especially if they become permanent. Indeed, the regulator (the ART) has found that one of the main drivers of value creation for the concessionaires over the past 15 years has been the cut in the corporate income tax.
- **Construction (Eiffage, Vinci) |** As with toll roads, in construction the increase in corporate income tax would be borne completely by the contractors, although it could impact the price of future contracts. Additionally, tighter budgets could impact both the federal and local governments' ability to invest in large construction projects.
- **Airports (AdP) |** Technically, AdP can recover higher income taxes via the regulation, which is based on an after-tax return on invested capital (RoIC). However, given that AdP currently has no regulatory framework in place, any recovery would depend on the annual negotiations with the regulator. This means that any potential recovery would be capped by the regulator's requirement that tariff increases are 'reasonable'. When considering a multiyear regulatory agreement, should the tax cuts be viewed by the regulator as temporary, it may be more difficult for AdP to recover the taxes. However, should the increase become permanent, it would likely be reflected in the allowed RoIC.
- **Railroads (Getlink) |** Although Getlink theoretically would face a similar impact as the toll roads (i.e. the company would have to bear the risk of higher income taxes), the company has significant tax-loss carry forwards, which means that the company pays close to zero income tax. A higher income tax would increase the pace of the drawdown of the losses; however, they are large enough (€3 billion as of year-end 2023) that the valuation impact of a permanent tax increase is limited, in our view.

Putting this all together, while current rhetoric claims that the corporate income tax should be temporary, we believe that given the size of the budget deficit and the resistance to spending cuts, there may be pressure for the taxes to become permanent. In the event of a temporary income tax increase, Getlink would be in the best position, given that it currently does not pay any income tax. AdP could also potentially recover part of the increase, though it depends on discussion with the regulator. However, in the case of a more permanent increase, we believe that AdP has the least exposure to any increase, while Vinci and Eiffage have the most. With the adoption of a multiyear regulatory period (potentially in 2027), AdP should be able to pass on most of the tax increases via the regulated cost base, limiting the valuation impact. Getlink will also likely face limited valuation impact given the large tax-loss carry forward.

Conclusion

With uncertainty, such as that caused by regulation and sovereign risks, can come opportunity. The sometimes-conflicting dynamic between regulators, politicians, consumers and investors is nothing new, and it will persist. With an unwavering focus on identifying 'pure' infrastructure and identifying those areas where we believe clients will be rewarded in the future, we take the view that some of today's challenges could be creating tomorrow's opportunities.

Contact us

Visit Macquarie Asset Management to find out more about our range of investments and how our solutions can help you to meet your goals.

Have a question? Please contact us and we will respond as soon as possible.

Key risks

The potential for adverse events in the global infrastructure sector to impact the performance of the investments of the Strategy. Investments in securities issued by companies which are principally engaged in the infrastructure business will subject the Strategy to risks associated with direct investment in infrastructure assets. Factors such as the availability of finance, the cost of such finance in general as well as in comparison to prior periods, the level of supply of suitable infrastructure projects and government regulations relating to infrastructure may influence the value of these investments and hence the Strategy.

The risks of investing in the infrastructure sector include those listed here.

New project risk: Where an infrastructure issuer invests in new infrastructure projects, it is likely to retain some residual risk that the project will not be completed within budget, within the agreed time frame and to the agreed specification.

Strategic asset risk: Infrastructure assets may include strategic assets, that is, assets that have a national or regional profile, and may have monopolistic characteristics. The nature of these assets may generate additional risk given the national/regional profile and/or their irreplaceable nature and may constitute a higher risk target for terrorist acts or political actions.

Documentation risk: Infrastructure assets are often governed by a complex series of legal documents and contracts. As a result, the risk of a dispute over interpretation or enforceability of the documentation may be higher than for other issuers.

Operation risk: Should an infrastructure issuer fail to maintain and operate the assets efficiently, the ability to maintain payments of dividends or interest to shareholders may be impaired. Failure by the infrastructure issuer to carry adequate insurance or to operate the asset appropriately could lead to significant losses and damages.

International investments entail risks including fluctuation in currency values, differences in accounting principles, or economic or political instability. Investing in emerging markets can be riskier than investing in established foreign markets due to increased volatility, lower trading volume, and higher risk of market closures. In many emerging markets, there is substantially less publicly available information, and the available information may be incomplete or misleading. Legal claims are generally more difficult to pursue. The Strategy may invest in preferred stock and hybrid securities, which may have special risks. Preferred and hybrid securities may include provisions that permit the issuer, at its discretion, to defer distributions for a stated period without any adverse consequences to the issuer. Some preferred and hybrid securities are non-cumulative, meaning that the dividends do not accumulate and need not ever be paid. A portion of the Strategy's assets may include investments in non-cumulative preferred or hybrid securities, under which the issuer does not have an obligation to make up any arrears to its investors. Preferred and hybrid securities may be substantially less liquid than many other securities, such as common stocks or US government securities. Generally, preferred and hybrid security holders (such as the Strategy) have no voting rights with respect to the issuing company unless preferred dividends have been in arrears for a specified number of periods, at which time the security holders generally may select a number of directors to the issuer's board. Generally, once all the arrears have been paid, the security holders no longer have voting rights. In certain varying circumstances, an issuer of preferred or hybrid securities may redeem the securities prior to a specified date. For instance, for certain types of preferred or hybrid securities, a redemption may be triggered by a change in federal income tax or securities laws. A redemption by the issuer may negatively impact the return of the security held by the Strategy.

Important information

Source for all performance data unless noted: Macquarie.

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