Trip Insights 14

The US

January 2024

4D infrastructure

A Bennelong boutique

US listed infrastructure companies didn’t perform as well during 2023 generally, with increasing base and discount rates dampening valuations. Sectors also faced specific headwinds to earnings and cashflows through 2023, albeit stronger management teams were able to navigate these challenges and deliver steady growth in line with longer-term expectations.

Visiting management teams in early November 2023 was vital to get an understanding of their expectations for 2024, and gauge their confidence in delivering strong earnings. It feels that sector specific headwinds are moderating, and management teams were more optimistic on prospects for 2024. And from a macro perspective, stabilising or potentially declining Fed rates should also be supportive of company valuations.

This is the 14th in our series of *Trip Insights* where we share our travel experiences. It follows Peter Aquilina, Senior Investment Analyst and Head of ESG, as he travels through New York, Houston, Tulsa, and Arizona, meeting with management teams from tower communication companies, oil/gas midstream companies and regulated utilities.

In this piece, we highlight some interesting themes and observations from the trip that support our views on the region.

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Trip agenda

Investor meetings through early November 2023 included the following companies / brokers:

Company	Sector/Topic	Location
Morgan Stanley (sell side analyst)	Electric/gas utilities	New York City, NY
BMO (sell side analyst)	Electric/gas utilities	New York City, NY
Crown Castle	Towers communications	Houston, TX
Kinder Morgan	Midstream oil/gas	Houston, TX
Targa Resources	Midstream oil/gas	Houston, TX
Williams Co	Midstream oil/gas	Tulsa, OK
Oneok Inc	Midstream oil/gas	Tulsa, OK
Entergy Corp	Electric/gas utilities	Desert Ridge, AZ
Southern Co	Electric/gas utilities	Desert Ridge, AZ
Sempra	Electric/gas utilities	Desert Ridge, AZ
WEC Energy	Electric/gas utilities	Desert Ridge, AZ
Xcel Energy	Electric/gas utilities	Desert Ridge, AZ
National Grid	Electric/gas utilities	Desert Ridge, AZ
Ameren Corp	Electric/gas utilities	Desert Ridge, AZ
American Electric Power	Electric/gas utilities	Desert Ridge, AZ
American Water Works	Water utilities	Desert Ridge, AZ
Consolidated Edison	Electric/gas utilities	Desert Ridge, AZ
Edison International	Electric/gas utilities	Desert Ridge, AZ
Exelon Corp	Electric/gas utilities	Desert Ridge, AZ
OG&E Corp	Electric/gas utilities	Desert Ridge, AZ
CMS Energy	Electric/gas utilities	Desert Ridge, AZ
Alliant Energy	Electric/gas utilities	Desert Ridge, AZ
NextEra Energy	Electric/gas utilities	Desert Ridge, AZ
PPL Corp	Electric/gas utilities	Desert Ridge, AZ

Politics

Elections

Political tensions are beginning to increase with US elections to be held this year. They will likely take place in the midst of cost-of-living concerns and inflated geopolitical risks associated with conflicts in the Ukraine and Middle East.

Donald Trump is also likely to petition for the Republican primary nomination again, which is remarkable considering he is facing a litany of criminal charges, some relating to his efforts to overthrow the previous election result. This raises constitutional questions if he were to be elected president with the outstanding charges against him. Despite these concerns, it's obvious that Trump still holds strong favour with parts of the voting public. He has made selected public appearances such as at the UFC (pictured below) in November, whose viewing demographic seems to fit with his targeted voting demographic.

Donald Trump at the UFC in New York

Onshoring

Reshoring, nearshoring or onshoring, is the process of multinational companies establishing manufacturing operations within their home nation The process of onshoring operations can take time and usually requires significant investment. Since 2021, private companies have spent more than half a trillion dollars onshoring facilities back to the US, according to the White House.

US companies are increasingly looking to unwind over four decades of globalising operations. In a recent poll by Forbes and pollsters, Zogby, 55% of CEOs of US companies surveyed have plans to reshore their manufacturing operations[1].

Key motivations in companies committing significant time and money to onshoring, is to avoid the perceived elevated supply chain and geopolitical risks in manufacturing key components of their products in offshore locations. Covid and its associated shut-down of global economies raised questions regarding

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[1] https://www.globenewswire.com/news-release/2023/01/10/2586151/0/en/Accelerating-Reshoring-Strategies-Spur-CEOs-To-Modernize-America-s-Vast-Manufacturing-Industry-The-Latest-Building-American-Manufacturing-Resilience-Poll-With-Forbes-And-Zogby-Reve.html

the effectiveness of global supply chains. This combined with developing geopolitical conflicts, such as the Ukraine-Russia war, the isolation of China by western nations, and the more recent instability in the Middle East, has highlighted the importance of manufacturing in (or close to) home markets.

Legislation passed since President Biden's term began in the oval office has incentivised the establishment of US manufacturing, to support associated domestic economic and job growth. Specifically, the *Infrastructure and Jobs Act,* the *Inflation Reduction Act (IRA*), and the *CHIPS and Science Act* are all pieces of legislation that are driving the growth in onshoring of manufacturing in the US. They provide incentives for sectors such as semi-conductors, renewable generation components, EVs, etc. The development of these sectors is likely to spur the growth in other sectors which support these that are the focus of legislation. Importantly, for infrastructure investors, this economic growth will drive power demand growth as well.

Energy transition

The IRA also supports the widespread development and utilisation of a broad range of low/no fossil fuel technologies to expedite the energy transition and net zero goals. The seminal legislation was signed into law in August 2022, and is expected to deliver the US to a 40% greenhouse gas (GHG) reduction (compared to 2005) by 2030.

More detail on the legislation is included in our News & Views article, *The Inflation Reduction Act will drive US' efforts towards net-zero.* Utilities and independent power providers (IPPs) are supportive of the legislation in incentivising the adoption of renewable generation, batteries, carbon capture, clean(er) hydrogen, and driving investment. It's very pertinent that Donald Trump is rumoured to be eager to tear up the legislation if he wins the upcoming election in 2024. Trump has an ideological view that global warming is not real, or at least overstated, and therefore the IRA represents a waste of money. It's likely he will run for president on a mandate of maximising the US oil/gas industry through incentivising production.

Geopolitics

The Russian-Ukraine war began in February 2022, and continues with no signs of resolution. The ramifications for global energy markets of the embargoes on Russian commodities has been mitigated to some degree since the war began. Financial support for Ukraine from the US continues, but this is beginning to become a sensitive subject amongst US voters, who believe those funds are better utilised domestically.

The cold relationship with China, which was largely initiated under the Trump presidency, continues. There has been some relaxation with President Biden meeting President Xi at an adjacent meeting to the Asia-Pacific Economic Cooperation (APEC) meeting in November 2023. Biden did raise eyebrows when he referred to Xi as a dictator during the meetings, but analysts seem to suggest expectations were low and some progress on specific issues was made.

More recently the Israel-Palestine tensions have ignited. This has increased tensions domestically for the US, with protests by supporters of both sides. In addition, it's feared that the tensions could escalate with the participation of other countries in the Middle East, destabilising the region and having serious political and economic impacts. With the Middle East being central to global oil/gas production, it's feared that a widespread conflict could disrupt global energy supplies, which would create a tailwind for commodity and energy prices generally.

Economics

2023 defied many expectations, with a widely expected recession in the US never eventuating.

When inflation soared in 2021 and 2022 central banks globally, including the Fed, hiked rates aggressively. The easing of inflation in many developed markets was another surprise in 2023, with US CPI peaking over 9% and falling back to 3.2% as of October 2023. Six monthly annualised core CPI is now running under 3%.

While short-term rates moved up quickly as the Fed raised rates, long bond rates only started to move aggressively in the second half of 2023. From July 2023 the US ten-year rate went from 3.75% to peak at 5%, the highest since the GFC in 2007/08. Part of this was the market's acceptance of a 'higher for longer' central bank stance to manage stickier inflation.

The market is currently pricing in c125bps of rate cuts for 2024 for the Fed, on the back of moderating economic and labour force data, but it's ultimately a goldilocks scenario: not too hot and not too soft. While this has taken some heat out of the US ten-year yield (back to 4.2% in December), the long bond yield should remain elevated with the settling of inflation at higher levels than the 2010s averages, as well as higher government budget deficits and term premiums.

The US household has shown resilience among the rate hikes, supported by excess Covid savings (which depleted in Q3 2023) as well as a very tight labour market. Retail sales continued to surprise to the upside in 2023. This is particularly interesting considering cost of living concerns in large parts of the population, with significant cost increases since the Covid outbreak (in January 2020), such as electricity up 25%; natural gas up 26%; groceries up 25% and rent up 20%.

The consumer is feeling less of a pinch from higher mortgage rates, even with the cost of a 30-year mortgage around 7% (the highest since 2000), because 85% of US mortgages are fixed to the 30-year rate and haven't experienced the increases.

Consensus forecasts sees US GDP growth moderating to 1.2% in 2024 from 2.4% this year, and a very hot Q3. CPI should fall back to below 3%, but will still be higher than historical averages, which should further take the pressure off households.

Communication towers

In Houston we met with the listed communications towers company, Crown Castle. Crown Castle differentiates its strategy from the other two listed US tower companies – it's completely domestic focused and is delivering nonorganic growth through the rollout of small cell and fibre technology. This technology is intended to facilitate higher data demand levels through high frequency bandwidth, predominantly in urbanised areas. During the visit, we did a tour of downtown Houston with management to observe the small cell network installed in the area and see how it's utilised.

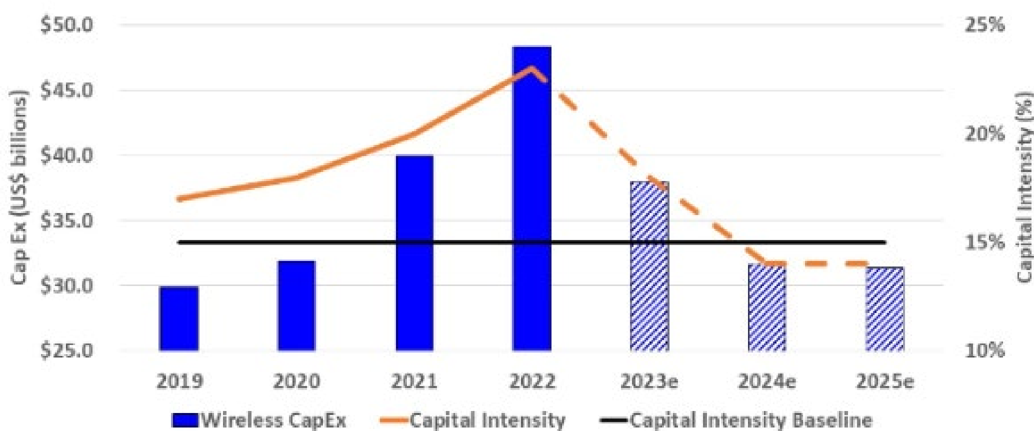
Up until the beginning of November 2023, the three listed communications tower companies had experienced a long period of poor share price performance, which began between 18-24 months ago. The poor performance over this period was driven by a number of factors, including the initial high valuations of the companies; rising interest rates affecting their cost of debt and discount rates; reducing customer investment activity (that is activity by the mobile network operator (MNO)) post the initial roll-out of 5G; and contractual churn as a result of the merger between MNOs, Sprint and T-mobile.

Mobile network operators roll-out of 5G

There are three major MNO customers to the tower companies, with a fourth operator building out a mobile communications network. These MNOs have spent over $100 billion on C-band (or 5G) spectrum in the auction processes, which were held from early 2021 through 2022. Following these auctions, the MNOs were rapidly investing in the roll-out of updated antenna technology on tower assets to facilitate delivering 5G to customers. This technology update improves the leasing fees and services charges paid to the tower companies from the MNO customers.

Communications tower near Crown Castle HW in Houston.

Cown Castle management outlined their view that following the initial rapid roll-out of 5G antenna technology, the MNOs had established a basis national 5G network for customers, and therefore have begun to wind down their technology upgrade activity. The MNOs are still contracted to upgrade a certain number of towers with 5G technology, which will drive organic leasing growth for the tower companies out to at least 2027. Management confirmed that approximately 85% of organic leasing growth to 2027 from augmentation of 5G technology was contractually locked in with MNOs.



Annual MNO capital investment in wireless mainly for 5G as at 1Q23
Source: Company accounts and Inside Towers Intelligence

To varying degrees, the MNOs have been inhibited from investing in updating 5G antenna technology because of constrained balance sheets. The rapid rise in interest rates has impeded free cashflow growth of the MNOs, placing pressure on balance sheets and the ability to raise reasonably priced debt to finance investment. There have been other issues raising market concerns for MNOs financial viability, such as potential legal liabilities associated with legacy lead covered cables. This issue has dissipated in recent months compared to when it was first raised in the media and by analysts.

The small cells opportunity

Crown Castle have differentiated their investment proposition compared to peer US listed tower companies by investing extensively in the roll-out of fibre and small cells. Crown Castle has invested approximately $19.1 billion in fibre and small cells since 2015. Management acknowledges that cash yield on that investment to date (between 6-7%) has been lower than that achieved in the tower business (c.13%). This was because small cells are averaging less than one tenant (one-two small cell nodes per mile of fibre), with capital investment to date focused on laying fibre for anchor tenants in new markets. Laying fibre is the capital-intensive component of the small cells business, but does provide a barrier to new entrants to the market where fibre already exists.

Management outlined that the remaining contracted small cell pipeline of 50,000 nodes, which will be delivered in the coming three to four years, will require less fibre to be laid. They outlined the expectation that approximately 30,000 small cell nodes will be co-located (no additional fibre) and 20,000 will be anchor tenanted (which will require some fibre). The reduced capital intensity of this pipeline will improve the tenancy and cash yields to high single or low double digits (9-12% cash yield) over time. The widespread requirement for small cells will be driven by density requirements as higher data demand from customers requires higher frequency spectrum. This growing data demand is actually unfolding now with the increase in artificial intelligence (AI), cloud computing, the Internet of Things (IoT), virtual reality and increasing usage of mobile video.

Flexibility of small cells – attached to a streetlight and a utility building. The millimetre, 5G antenna is located at the top just under the light (on left).
Source: 4D Infrastructure

Factors affecting short/medium- term cashflow expectations

Crown Castle management have outlined there are other factors which are expected to be a detriment to cashflows in the short term, but these are expected to dissipate over time. They have identified that higher interest rates on debt raised to finance investment and on legacy floating rate debt, combined with expected contractual customer churn, is expected to have a detrimental impact on cashflows in 2024 and 2025.

Generally, contractual churn of MNOs within the towers business is low, somewhere between 1-2%. The merger between MNOs, T-mobile and Sprint, which closed in April 2020, increased that churn expectation. The combined company announced that it would be rationalising its antenna footprint on towers where there is overlapping coverage by both a legacy Sprint and T-mobile antenna. This is expected to play out

over time with maturing of contractual agreements for antennas on towers. The biggest churn levels for Crown Castle are expected to occur in 2024 and 2025, reducing organic leasing cashflows in those years by $155 million and $200 million at the midpoints of guidance respectively. After 2025, the impact of T-mobile/Sprint churn is expected to be de-minimis.

Crown Castle has a solid balance sheet relative to peers, but is still expected to incur a higher cost on new debt raised, as well as floating rate debt. Management has focused on minimising the company's floating rate exposure, but is expected to incur a reduction in cashflows of between $140 - $170 million in 2024. A view on the potential trajectory of US interest rates is discussed in *Economic* section above, but a relaxation in rates through 2024 would support cashflows in 2025.

Following the US trip, activist investor, Elliot Management, have issued an open letter to Crown Castle making a number of recommendations. These centre arounds its belief that the investment in small cells was a mistake, and the company should undertake a review of the strategy. They also recommended replacing the CEO, Jay Brown, and changing a number of Board members.

Midstream oil/gas

We spent several days in Houston, Texas and Tulsa, Oklahoma meeting key oil/gas midstream companies. It's clear that the economies of these cities are very much driven by the oil/gas sector (see picture from Tulsa Airport below). Shareholder returns of midstream companies in the year-to-date have largely been strong, with few outliers. After a strong 2023 we wanted to explore if valuations were getting stretched going into 2024; what the likely drivers of cashflow growth would be; and what companies intended to prioritise for cashflow allocation.

Mural depicting Oklahoma's oil/gas drilling past at Tulsa International Airport.
Source: 4D Infrastructure

Strong US supply dynamics

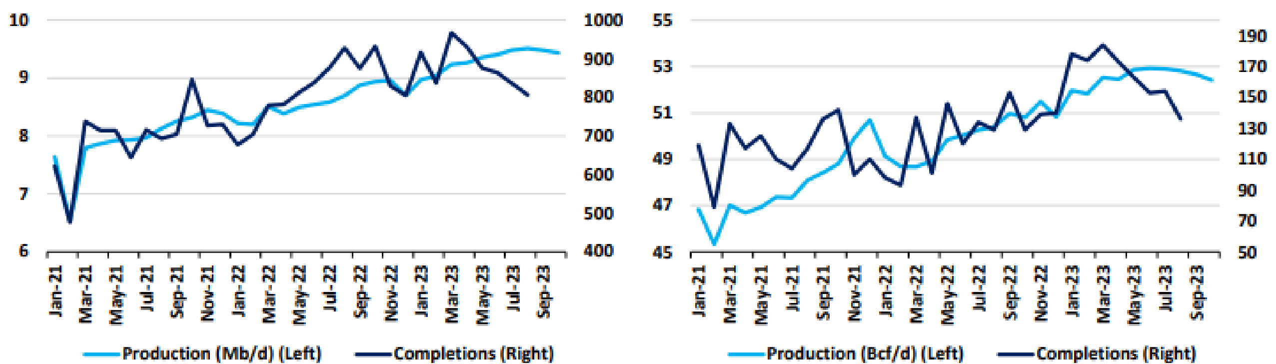
Commodity prices were extremely high in 2022 during the European energy crisis, as a result of the Russian commodity embargo associated with the Russian-Ukraine war. This drove investment in growing US supply through drilling operations by oil/gas producers. This supported capacity utilisation and investment on behalf of the midstream companies – growing earnings. With global commodity supply chains having made adjustments, 2023 saw commodity prices fall significantly, back to pre-Covid levels. Most midstream companies showed their defensive qualities by continuing to grow earnings, albeit at lower rates compared to 2022.

With commodity prices in November at levels which support production growth in the more economic US basins, midstream companies are optimistic about the trajectory of demand going into 2024. This was supported by the announcement of record US oil production in September 2023 of 13.2 million barrels per day. Tailwinds driven by increasing domestic energy demand (as discussed in the *Politics* section above), and continued demand from Europe and parts of Asia, most management teams are optimistic about the trajectory of production growth and opportunities for investment in the pipeline networks.

Management identified particular oil and gas directed basins which they believe will support their earnings growth.

- The Permian was identified as one of the most economic oil directed basins globally, with a breakeven wellhead oil price in the low-mid $30/Bbl. Oil volumes are expected to grow from this basin through 2024, which will also increase the production of associated gas and NGLs.
- The Bakken basin is expected to largely maintain oil volumes at current levels, the volume of associated gas from the basin is expected to increase based on rising gas to oil ratios (GOR) – that is volume of gas associated per barrel of crude is increasing.
- The Haynesville basin is predominantly a natural gas basin which has been heavily utilised due to its proximity to new LNG facilities being developed on the Texas and Louisiana coastline. It will continue to be utilised to supply LNG developments as they are commissioned, although no major LNG projects are expected to be commissioned in 2024.
- The Marcellus/Utica basin had experienced a slight decline in natural gas volumes through 2023, although NGL volumes were strong based on attractive NGL pricing. Continued volume growth is expected from this basin through 2024 to support domestic demand and supply growing LNG capacity.

Below is graphed US crude (left) and natural gas (right) production levels over the past three years.



Source: Wolfe Midstream Research; EIA. Natural gas basins include Haynesville and Appalachia only.

Strong cashflow and solid balance sheets

Unlike pre-Covid times, North American midstream companies generally now have strong balance sheets and are producing free cashflows, often after consideration of discretionary capital investment. This provides flexibility for companies to withstand operational challenges, and finance capital investment opportunities. A summary of gearing levels, dividend yields, and dividend coverage ratios are summarised in the table below. Dividend coverage ratios exclude discretionary capital investments, but with dividend coverage close to and above 2x, companies are able to significantly finance their capital programs without accessing capital markets.

As at 3Q23	ND / EBITDA	Div (2024)	Div yield %	Div (2023) coverage
Williams Co	3.8x	$1.86	5.5%	2.3x
Kinder Morgan	4.0x	$1.16	7.0%	1.9x
Targa	3.6x	$3.00	3.5%	6.2x
Oneok	4.2x	$3.93	6.2%	2.3x
Enbridge	4.0x	C$3.66	8.1%	1.5x
TC Energy	5.2x	C$3.88	8.3%	1.4x

Source: 4D Infrastructure

A key question for various management teams is - what do companies do with the excess free cashflow? The unanimous preferred option was to invest in growth projects associated with their existing business strategy to maximise future earnings growth. Making organic investments in existing networks which enhance capacity for low capital cost, provides companies attractive returns on invested capital (ROIC). This is also low risk investment, as companies are investing in enhancements where they have strong visibility on demand dynamics, and lower permitting requirements than greenfield projects.

Beyond these discretionary investments, companies varied on their preferred allocation of excess cashflow. Companies like Williams Co and Kinder Morgan opted to grow dividends at levels consistent with the recent past – within 2-5% annually. They were happy to retain some cash to reduce debt gearing levels in light of the high interest rate environment. Gearing levels (as measured by net debt/adj EBITDA) of Williams Co and Kinder Morgan as at Q3 2023 were 3.5x and 4.0x respectively, which were below their communicated target levels of 4.0x - 4.5x.

Targa Resources communicated a big increase in their dividend. This follows Targa management's prudent decision to cut the dividend 90% during the Covid pandemic, in order to rapidly reduce debt in light of concerns around lack of NGL volumes being utilised by the company's assets when oil prices went negative in April 2020. With the balance sheet in a much healthier position, and volumes and earnings having grown significantly, management felt it was the right time to re-establish the dividend to a reasonable level, increasing it 50%, to a payout ratio of 40-50%. Targa management outlined the significant investment needs through 2023 and 2024, but that 2025 would represent a step-down in capital requirements.

Plenty of M&A

A number of M&A transactions have been announced by midstream companies in the past 12 months. Most of these transactions were to complement the companies' existing asset footprints, with the potential for significant cost and revenue synergies to be extracted. It feels that management is selectively executing these transactions as a means to utilise excess cashflow, while acquiring complementary asset portfolios at attractive/reasonable valuations.

Oneok and Magellan Midstream:

The most prominent midstream transaction in the past 12 months was Oneok's acquisition of Magellan Midstream for stock and cash, valuing the business at US$18.8 billion. The implied EV/EBITDA valuation of

the merger is 12.3x, which should improve over time with execution of identified synergies. The strategy behind the merger/acquisition from Oneok's perspective included:

- Diversifying into refined product and crude oil transportation and handling;
- The potential to extract synergies ranging from $400 - $600 million in EBITDA – this is primarily through blending, batching, and bundling NGLs and refined products, and extracting cost savings;
- The transaction is cashflow and earnings accretive from 2024; and
- Supportive of improving the balance sheet.

Oneok management outlined they had to initially educate analysts as to the justification for the deal, but it seems well understood now. Their focus post-closing the deal has been to amalgamate teams and systems, which has resulted in execution of cost synergies earlier than anticipated. They are very optimistic on the potential of the combined business.

Williams Co acquisition of Cureton Front Range LLC and 50% of Rocky Mountain Midstream holdings:

On its Q3 earnings call, Williams Co announced the company had agreed to acquire Cureton Front Range and the remaining 50% of Rocky Mountain Midstream for a combined EV of $1.3 billion, and an implied EV/EBITDA of approximately 7x, with the potential to reduce the multiple over time through deal synergies. The transaction was partially financed with proceeds from the sale of legacy ethane pipelines for $300 million, and $533 million in net legal litigation proceeds from a failed past merger attempt by Energy Transfer.

The acquired assets interconnect with Williams' existing pipeline assets located in DJ Basin. Management outlined that the DJ was an under-appreciated oil directed basin, with wellhead break-evens around $30-$35/Bbl (in line with the Permian), but regulation in Colorado is more difficult than Texas, increasing the production costs post wellhead. The transaction will look to utilise Williams' excess capacity in the region, and downstream interconnection to demand centres. This strategy maximises tariffs earned from the wellhead connection down the vertical supply chain of Williams' existing assets. We are supportive of this deal.

Kinder Morgan's acquisition of South Texas assets:

In early November, Kinder Morgan announced the acquisition of NextEra Energy Partner's (NEP) South Texas assets, STX Midstream, for $1.82 billion. The STX Midstream system consists of seven pipelines that can transport 4.9 Bcf/d. NextEra's Texas pipeline portfolio provides natural gas to Mexico as well as to power producers and municipalities in South Texas. The STX Midstream system includes 90% ownership of the NET Mexico pipeline and a 50% share in Dos Caminos LLC. The portfolio of assets is highly contracted, with an average contract length over eight years. Approximately 75% of the business is supported by take-or-pay contracts.

Kinder Morgan management are of the view that there is a high nitrogen content in Permian basin sourced gas, which causes some issues with its utilisation by LNG facilities on the Texas Gulf Coast. They believe that Eagle Ford gas provided by STX Midstream may provide a good blending mix with Permian gas for utilisation by the expected growing LNG demand.

The communicated EV/EBITDA multiple is 8.6x by Kinder Morgan, where NEP has communicated a multiple of 10.0x. NEP's multiple is based on 2023 EBITDA, where Kinder Morgan has used 2024 EBITDA with a few very obvious synergies included, and the full year run rate effect of an expansion project undertaken this year. We are suspicious of the longer-term earnings potential of STX Midstream's assets, post-maturity of existing contractual protections, due to their interconnection with a historically less favourable basin in the Eagle Ford.

Electric and gas utilities

Most engagement with electric and gas utility companies occurred during the Edison Electric Institute (EEI) Conference, which was held over three days just outside Phoenix, Arizona. We had 16 meetings over the three-day period with companies based across the US.

Rewinding approximately 12 months to our attendance at the 2022 EEI Financial Conference, the messaging from companies was that they were expecting significant headwinds to financial performance in 2023, including high inflation, rising interest rates, and more scrutiny from regulatory commissions due to customer affordability concerns. At the time, some companies communicated confidence in being able to 'pull levers' to navigate these challenges and deliver upon long-term earnings guidance. Others had less flexibility, or greater challenges, and so were more bearish on the 2023 earnings outlook. A few companies announced strategic reviews, with the intention to divest non-core assets and repair balance sheets.

The messaging from companies at this year's EEI conference was a lot more optimistic. Energy demand in the US is expected to be strong over the medium term, driven by growing commercial and industrial (C&I) demand associated with onshoring of certain industries, and the buildout of data centres. This should support investment growth and provide a tailwind to earnings for some companies in 2024. It also diminishes the concerns of regulatory bodies around customer affordability – by sharing the network's fixed cost base with new, high load demand customers.

Strong load demand growth

The overwhelming message from companies at the EEI conference was their expectation for a step-change in load demand across multiple parts of the country. This strong net load demand growth was expected with C&I customer load growth surpassing a slight fall in demand from residential customers across most jurisdictions. Residential load demand is expected to be impacted by continued implementation of 'return to work' policies following covid-19, combined with energy efficiency efforts.

Companies outlined that the C&I load demand was partially driven by government legislation incentivising the establishment of manufacturing facilities in the US, especially for specific industries such as technology (outlined above).

The strongest load demand growth was expected from utilities operating in the Midwest and southern states. The southern states were experiencing the aforementioned manufacturing demand growth, and also benefitted from net migration inflow of the domestic population. Specific examples of C&I and retail load growth includes:

- American Electric Power - increased 2023 normalised retail sales growth from 0.8% to 2.3%, largely driven by increased commercial growth from 0.8% to 7.3%. The company also doubled 2024 and 2025 retail sales growth to 1.7% and 3.3% respectively.
- Sempra - Texas power market, ERCOT, set 10 peak demand records in summer 2023, with a new all-time peak of 85 GW, representing 16% growth since 2018. Significant C&I growth in Oncor service territory evidenced by ~34% year-over-year increase in active transmission point of interconnection requests.
- WEC Energy - communicated strong manufacturing developments within its jurisdiction including Microsoft, Foxconn, and Amazon. Long-term retail power sales growth of 4.5% - 5.0% pa expected.
- Pinnacle West Capital – have communicated long-term demand growth expectations of 4.5% - 6.5%, driven by customer premises growth and manufacturing developments by companies such as a Taiwan Semiconductor company, Proctor & Gamble, Air Products & Chemicals, and KORE Power.

Updated investment plans

As is normal practice, many companies updated their multi-year capital investment guidance at the EEI conference. Others will update their guidance on Q4 calls, which occur early in 2024, but did give indications as to the size of forecasted capital programs.

Almost unanimously, companies communicated significantly increased capital investment programs. The drivers of the increased investment programs include the aforementioned increased load growth; strong decarbonisation efforts supported by legislation; resiliency investment in light of storms and wildfires; and the impact of high inflation on regular replacement investment.

This increased capital investment is expected to support rate base growth at high single digits over the next five years or so. The improved rate base growth didn't really result in improved EPS growth expectations. Over recent years, companies have generally converged EPS growth guidance over the forward five year to between 5-8%. Based on the improved rate base growth expectations, management teams pointed expectations to the upper half of this range. EPS growth was moderated by increased expectations for equity issuances to finance the increased capital plans, while maintaining balance sheet credit ratings.

Affordability concerns subsiding

Cost of living concerns have been front of mind for legislators and regulators in the US throughout 2023. Utility companies have had to manage these concerns through managing their operating costs, but were supported through reducing energy and commodity costs post the easing of the European energy crisis, providing a tail wind to prices. This aside, the inflationary environment did result in more scrutiny on business plans from regulatory bodies throughout the year.

Coming into EEI, companies were a lot more optimistic of their ability to manage affordability in 2024, and were hopeful this would support improved regulatory outcomes. Their confidence in being able to manage customer affordability was primarily based on spreading fixed costs across greater C&I load, given increased load demand expectations. Other factors supporting affordability include moderating cost inflation, tax credits on renewables being passed to customers, moderating power prices compared to 2022 levels, and the potential for interest rates to begin coming down over the back half of 2024.

Mixed regulatory support of rate increases

With regulatory concerns regarding affordability subsiding going into 2024, management teams detailed some of the major regulatory decisions made through 2023 and highlighted their focus for 2024. Some specific rate cases referenced included:

Company	Process / date	Revenue increase requested	Revenue increase proposed	Context
WEC Energy	Settlement achieved; October 2022	$504 million	$510 million	WEC achieved a settlement on its rate filing in Wisconsin on constructive terms. The commission initially wanted to review the settlement, which was procedurally unusual, but there were only minor changes in the end.
Exelon	ALJ recommendation; October 2023	$1,545 million over five years	$1,174 million over five years	First electric utility multiyear rate plan (MYP) in Illinois following the passing of the *Climate and Equitable Jobs Act*. Companies in the state engaged with regulators and staff on ensuring a constructive regulatory outcome.
Ameren	ALJ recommendation; October 2023	$448 million over five years	$338 million over five years	Similar to Exelon, this represented the first MYP in the state following the passing of legislation.

American Electric Power	Settlement achieved; November 2023	$94 million	$75 million	Following the failed divestment of its Kentucky subsidiary, AEP management was focused on improving the regulatory relationship and achieving a constructive outcome to earn a reasonable level of return on investment.
CMS Corp	Filed new rate case; September 2023	$169 million	No feedback yet	With some negative sentiment regarding Michigan's regulatory decision for DTE Energy, the market is observing whether CMS can continue getting constructive outcomes.
Edison International	Filed new rate case covering 2025-2028; May 2023	$3,883 million over four years	No feedback yet	The filing looks to confirm investment requirements and costs for the four-year period, with cost of capital decided in a separate filing. The revenue increase is substantial (23% in first year) but this increases the avg monthly bill by only 10% in that same year.

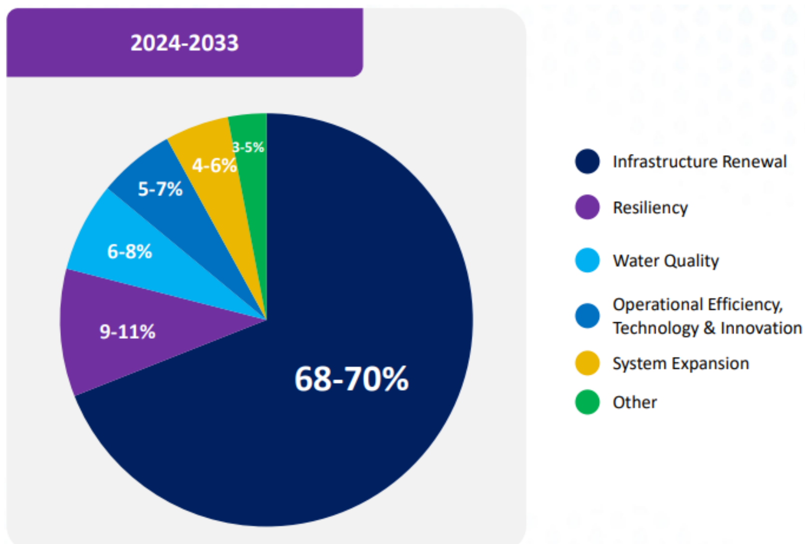
Water utilities

American Water Works (AWK) attended the EEI Conference, which seemed a wise decision considering it was one of only two water companies to attend, so received significant investor attention. The messaging from management was – 1) increasing water/wastewater regulation was increasing pressure on small municipal water networks to amalgamate with larger players; 2) continued asset replacement investment was required; and 3) there was a legislative focus on reducing the intensity of 'forever chemicals' in water which would require upfront investment and ongoing management costs.

Continued strong investment drivers

AWK outlined confidence in the continued investment needs of its various networks, and the capacity to grow rate base and earnings. It updated its five and 10-year capital plans, which increased $2 billion and $4 billion respectively since the last guidance provided by the company. The 10-year capital plan of $34 - $38 billion (excluding regulated acquisitions of municipal networks) to 2033 is expected to be the key driver of rate base growth 8-9%. This rate base growth incorporates an allocation to municipal network acquisitions, but still represents one of the stronger growth rates of any utility.

The drivers of investment focus on asset renewal, with many areas of the US water network in bad condition. AWK's efforts in improving the asset quality makes up approximately 70% of its 10-year capital plan. The requirement for this investment is well understood by regulatory bodies, and the likelihood of rejection is low. Most scrutiny will be in ensuring the investment is cost-efficient, and affordability for customers is maintained. Some of the other drivers of investment are graphed below.



Source: American Water Works investor presentation

Reducing levels of 'forever chemicals' in drinking water

Per- and Polyfluoroalkyl substances (PFAS) are a large, complex group of synthetic chemicals that have been used in consumer products around the world since the 1950s. They are used in various everyday products. These chemicals do not degrade easily because of their chemical makeup, and studies have linked PFAS in humans to adverse health effects including altered metabolism and fertility, reduced foetal growth, increased risk of being overweight or obese, increased risk of some cancers, and reduced ability of the immune system to fight infections. The focus of reducing human contact with PFAS is limiting its levels in water supplies and food.

At the 2022 EEI Conference, AWK management outlined the Environmental Protection Agency (EPA) was expected to set the upper threshold volume of PFAS for US water supplies over the course of 2023. Their concerns were twofold:

1. Management wanted to ensure that the PFAS upper threshold was set at a level to avoid negative long-term health ramifications for the public; and
2. The threshold wasn't set at such a low level that would create difficulties in delivering without excessive investment and ongoing management costs.

In March 2023, the EPA set the thresholds for most PFAS contaminants in US water supplies at a maximum of four parts per trillion. This threshold needs to be achieved three years after the EPA's rule is finalised, which is expected in Q1 2024 – the threshold should be met by early 2027. AWK management outlined that they had done significant research into different technologies to remove PFAS from supplies and were likely to generally adopt granular activated carbon (GAC) because of its effectiveness and low cost. This could be supplemented by ion exchange resins in certain circumstances. The implementation of these technologies into AWK's network is expected to cost $1 billion over the period 2024-2027, and ongoing annual management costs of $50 million.

Reducing PFAS levels in water supplies is obviously costly for water utilities. Many municipal water networks don't have the financial capacity to implement the technology to achieve the EPA's new threshold. This could provide a further incentive to sell the network to larger operators such as AWK who have more balance sheet capacity and scale to implement the required technology. This further supports the company's consolidation efforts in the industry.

Increasing optimism for US infrastructure

Share price performance of all US infrastructure sub sectors, excluding midstream oil/gas, was disappointing over the course of 2023. The share price reaction was potentially associated with weaker earnings expectations through the year for some companies, but for many names, the negative share price reaction was despite delivering consistent earnings growth.

No doubt increasing US treasury bond yields increased valuation discount rate expectations through the course of the year. Higher discount rates deflated valuations of many listed infrastructure companies, more so than the rest of the market, with capital intensive sectors such as regulated utilities and tower communication companies most penalised by investors.

Looking into 2024, management teams seem less concerned about negative impacts of cost inflation and rising interest rates on earnings expectations. They were buoyed by the prospect for rates to decline in 2024, and the potential for strong load growth from manufacturing, data centres and the tech sector generally.

- **Towers communication**: concerns regarding the capacity of MNO customers to invest in the continued roll-out of 5G raised questions regarding the domestic leasing growth potential for tower companies in 2023. Some MNOs are now looking more financially healthy, which reduces this risk in 2024. Although, the impact of contractual churn from the T-mobile/Sprint merger will continue to dampen earnings. The potential for long-term growth from small cells needs to be proven out over time.
- **Midstream oil/gas**: companies are optimistic going into 2024 based on the continued demand for oil, gas and NGLs in light of strong domestic demand for energy, and overseas supply concerns associated with geopolitical tensions. The sector is well positioned, with companies largely within their debt gearing targets, and with expectation of strong cashflow generation to be maintained.
- **Utilities**: plateauing and potentially falling interest rates in 2024 should be supportive of valuations, which are currently at the lowest point since the start of Covid. This, combined with moderating regulatory concerns and strong earnings drivers, should provide a strong year for shareholder returns.

At current valuations, a number of US infrastructure companies offer attractive implied shareholder returns. We prefer companies that offer quality asset exposures, predictable and steady earnings growth, and are valued below their estimated intrinsic value.

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