CA ANSWERS

August 30, 2022

Does the Inflation Reduction Act Increase the Attractiveness of Clean Energy Investments?

Yes. The Inflation Reduction Act (IRA) will generate significant benefits for companies involved in clean energy. The bill is anticipated to provide almost $370 billion over the next decade to a variety of industries, including utilities, transportation, and manufacturers of products such as batteries and solar components. The ten-year life of these tax credits provides certainty around making the investments necessary to help decarbonize the US economy.

The IRA provides funding for energy security and climate change via tax credits and loans. Production tax credits will lower the after-tax cost of generating clean energy (solar, wind, nuclear, etc.) and spur more investment in energy storage. Meanwhile, investment tax credits will lower the manufacturing cost of renewable generation components such as solar panels and wind turbines, and loans will provide incentives to expand electric vehicle (EV) manufacturing plants. These tax credits will materially lower the current costs of various types of renewable energy relative to fossil fuel equivalents. For example, up to $1.75/gallon of credits for sustainable aviation fuel production could make it cost competitive with regular jet fuel in just a few years.

The IRA's impact is magnified by preexisting trends in the clean energy space. Given increasingly competitive relative production costs, low-carbon renewables and nuclear were already generating an increasing share of US electricity. According to several sources, between 70% and 80% of US electricity could come from these sources by 2030, up from around 40% today. Similarly, while annual US EV sales have routinely exceeded forecasts despite the phasing out of earlier subsidies, some analysts believe they will now roughly triple to two million vehicles by 2024.

Expanded markets and higher margins will create opportunities for a variety of companies, as well as investors. Aside from the utility, transport, and biofuel plays mentioned above, a variety of firms will benefit in other categories, such as home solar, EV charging, grid modernization, and fuel cells. Many of the beneficiaries are intended to be American firms, and incentives are designed to tip the economies of scale to favor domestic production in areas such as battery and solar panel manufacturing. However, some foreign companies will also benefit, specifically those that are moving manufacturing capabilities to US shores.

Not everyone wins or benefits to the same degree from this legislation. Some companies and sectors are likely to see reduced domestic demand, including those involved in mining fuel sources e.g., coal, as well as auto manufacturing and part companies that are not well positioned for the accelerated transition to EVs. There will also be utility companies that are ill prepared for the improved economics of renewables, as well as foreign companies in areas such as batteries and solar panels that will see relative cost advantages eroded by the new subsidies.

Investors motivated by the IRA to allocate more capital to the clean energy space should consider several things. Nuances in the bill and its disparate effects across public companies mean active managers and long/short strategies run by experienced teams might work better than a passive approach, especially considering that valuations for many publicly traded clean energy stocks continue to be volatile. Increased demand for electricity (and subsidies embedded in the bill) should boost demand and potentially domestic production of certain metals (e.g., lithium). With this in mind, we would recommend investing via specialist managers, given global markets for these metals and nuances of supply chains. Private investments should continue to be attractive in this field, both via real asset funds with exposure to renewables and clean fuels, as well as venture capital funds with exposure to climate tech.

Investors eyeing the run-up in clean energy plays in recent weeks may be wondering if it is “too late” to allocate to the energy transition space. To the contrary, we believe we are only in the early innings of what will be a multi-decade investment opportunity, though in the United States, the IRA has accelerated the process by providing more clarity around timeframes and economics.

Wade O’Brien
Managing Director, Capital Markets Research