RockCreek

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INVESTOR BRIEF: INFLATION REDUCTION ACT

On August 7th, the US Senate passed the Inflation Reduction Act, a package of tax, healthcare, climate, and energy measures that Democrats passed with no Republican support through the budget reconciliation process. The House of Representatives is expected to vote to pass the measure today, then it will head to President Joe Biden's desk for his signature.

Flashback

At the RockCreek Climate Summit last summer, White House Climate Czar Gina McCarthy told us that with the right investments, tax credits, and signals, "we can actually change markets. We can show you where the money is going to be."

What's in the bill?

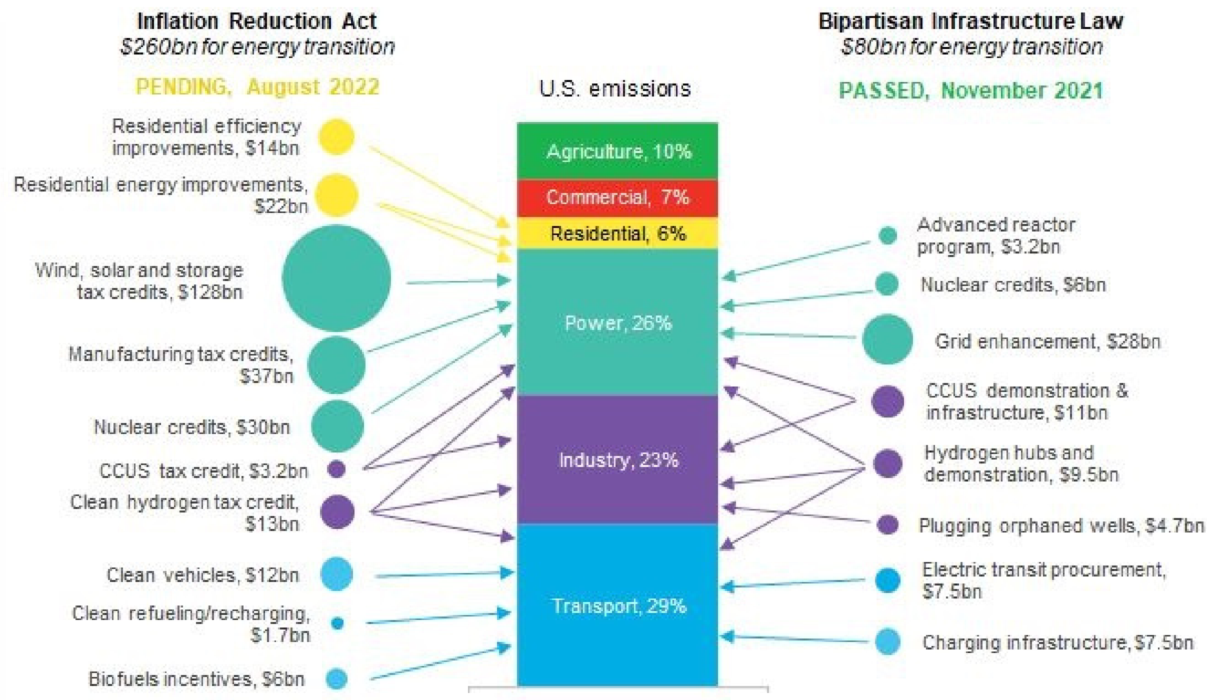
The Inflation Reduction Act includes $369 billion in funding for energy security and fighting climate change, sets a 15% corporate minimum tax, allows Medicare to directly negotiate the price of prescription drugs, and strengthens IRS tax enforcement.

What is the overall effect on climate change?

Much has been chronicled about the political compromises to secure the vote of Senator Joe Manchin of West Virginia, a state whose economy depends heavily on fossil fuels. The bill does include what one petroleum industry lobbyist called "Easter eggs" for oil and gas companies, such as provisions to expand oil and gas exploration and overhaul a tax credit to develop carbon capture technology, which is a focus for big oil companies.

Overall, the climate benefits far outweigh the setbacks. The bill puts the US on the path to cut emissions by 40% by the end of the decade. Coupled with last year's bipartisan infrastructure law, the bill will cut annual emissions by an additional 1 billion metric tons and reduce cumulative greenhouse gas emissions by roughly 6.3 billion metric tons over the next decade.

Funding for Energy Transition



Source: BloombergNEF

The Natural Resources Defense Council (NRDC) urged Congress to pass the bill, and NRDC modeling showed that the bill's emissions cuts would be 10 times greater than effects from its support for fossil fuels. The World Resources Institute likewise cheered the bill's passage, saying it would strengthen US influence in international climate talks and "shows the world that the United States is still an ally in the global fight against climate change."

How does the bill change the climate investment landscape?

Significantly. The bill provides the most resources the US has ever marshaled to fight climate change. And the structure of the bill is significant for future climate investment – it is nearly all carrots and very few sticks. The $369 billion comes mostly in the form of tax credits and grants, which delivers on Gina McCarthy's promise to send a clear signal to investors about what the market will look like in the next decade and beyond.

The bill includes:

- $7,500 tax credit for new clean vehicles;
- $4,000 tax credit for used clean vehicles;
- $10 billion investment tax credit to build clean tech manufacturing facilities;
- 10 years of consumer tax credits to make homes more energy efficient and function on clean energy

The bill also contains tax credits for areas such as clean electricity and energy storage, clean fuels and clean commercial vehicles, and the domestic production of biofuels.

Taken together, the bill's tax credits and grants paint a clear picture of the market's direction. We see five provisions that stand out.

First, the bill provides critical clarity on tax credits such as the solar and wind Investment Tax Credit (ITC). The ITC has been extended recently for a year or two at a time, leaving uncertainty for consumers, companies, utilities, and other potential investors about when and whether to take the credit, with a risk of losing the incentive altogether or taking it at a level that is subsequently raised. This uncertainty undermined the effectiveness of the credit as an incentive for typically long-term projects.

The bill extends the ITC at 30% for 10 years. Having an advantageous rate in place for a set period of time will remove the guessing game, improve transparency around benefits for customers, and directly increase the adoption of solar, wind, energy storage, and other related technologies. Places where solar and wind already make economic sense will be no-brainers for further expansion; marginal areas will be more attractive. The entire solar and wind ecosystem will benefit, attracting further investment and capital to the sector and fueling the growth envisioned in the bill.

Second, the bill includes sizable funding for critical emissions reduction infrastructure that is well-proven and commercial, but which we don't usually read about in headlines.

Energy efficiency projects and home retrofits are some of the most cost-effective and highest return-on investment projects to reduce emissions. They also happen to be strong opportunities for investment. Up front capital investments are typically large barriers to retrofitting homes and other buildings. While there has been progress on innovative financing models to help overcome this hurdle in some parts of the market, consumers (low-income consumers in particular) and companies will get more financial help to install solutions like energy efficient electrical appliances, modern heat pumps, and insulation. This will not only help attract investments to companies providing the actual solutions, but also to the companies that help install and implement these projects.

Third, the bill will ignite a cascading effect that creates investment themes even in areas that did not receive direct funding or tax incentives.

The tax credits for clean cars will obviously create new investment opportunities to develop, manufacture, and sell clean cars and their component parts. But this will also create opportunities to recycle and salvage old cars coming off the road. Dealing optimally with old cars is essential to this program having its intended benefits: there is no environmental benefit of an older, high-polluting car being passed along to a new owner simply to continue its polluting life. More clean cars coming onto the road will require a greater focus on identifying high-polluting cars and removing them from the road, which is an investment theme that will only grow over the next decade.

Fourth, the bill will help drive investments in solutions that reduce the emissions footprints of traditional industries to help them become more sustainable.

The bill includes funding to reduce industrial plant emissions, minimize methane leaks from natural gas production and distribution, install zero-emissions equipment at ports, and produce more sustainable aviation fuels. These investments will not completely eliminate emissions from these resource-intensive industries, but they will help the critical mission of reducing emissions in the near and intermediate term while new technologies are developing.

Finally, the bill funds areas of global public goods that will also greatly impact private markets. This includes $20 billion to support climate-smart agricultural practices, $5 billion in grants for forest conservation and management, and $2.6 billion in grants to conserve and restore coastal habitats.

On Earth Day, RockCreek CEO Afsaneh Beschloss moderated a discussion hosted by the White House unveiling the first US national system of natural capital accounts. This effort – along with funding from the bill – could help investors emphasize natural capital investments the way they do investments in other economic goods and drive more private sector investment in natural capital.

The Bottom Line

The Inflation Reduction Act will reduce emissions significantly and bring critical leadership and momentum to the global fight against climate change. Like any legislation, its effectiveness will depend on implementation.

We will watch closely to see how the implementation of the tax credits affects consumer choices and investor focus. And we will closely monitor the bill's impact on emissions, technology development, and consumer spending to understand how the changed market will affect policymakers, consumers, investors, and – most critically – future generations.

With more to come,

Team RockCreek