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Ninety One

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# Turning one: celebrating the Inflation Reduction Act's first birthday

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**The Inflation Reduction Act (IRA) turns one this August. As with any infant, we do not know precisely what it will accomplish. But we can already say that it has potential to spur massive investment in decarbonisation.**

Much of the last year has been spent working out the details, with the Internal Revenue Service (IRS) combing through the fine-print to determine which projects and products will receive the full benefit of the act's generous tax credits. That process is coming to an end and we think it has been broadly positive for climate-solutions companies.

## Underappreciated opportunities

For example, the focus on 'domestic content' has been interpreted carefully so that the global supply chains required to build many green projects can still function. While certain renewable-energy projects will need to procure all of their steel from the US to qualify for the maximum tax break, other components can be sourced from elsewhere, such as solar glass and inverters from China. Consequently, we think there are underappreciated investment opportunities in non-US listed companies that should benefit from the act.

To date, we have not seen a meaningful impact on electric-car sales. That should follow once new models reach showrooms. But we have seen major announcements of investment in clean-tech manufacturing facilities, with US$50 billion destined for the electric vehicle and battery manufacturing sector alone. This offers exciting opportunities for businesses that are helping factories become more energy efficient, such as a US factory-automation company we hold in the Global Environment portfolio.

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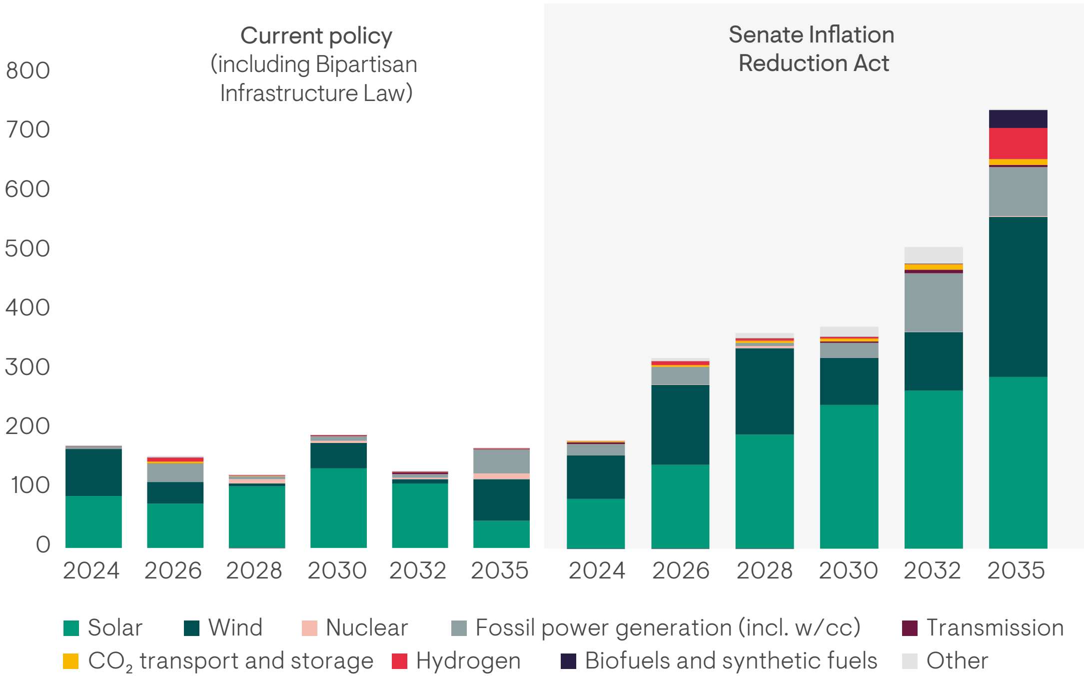
Since the IRA is almost entirely comprised of tax credits, it is not possible to say how much government spending it will ultimately unleash – it depends how many projects get built. Estimates vary wildly. The Congressional Budget Office (CBO) initially forecast US$391 billion between 2023-2032. Analysis by Goldman Sachs suggests total government outlay of three times that amount, about US$1.2 trillion, as lower-carbon products and technologies take market share and attract capital spending. Princeton University's Zero Lab's REPEAT analysis suggests the incremental boost to capital investment in green-energy supply-related infrastructure could be c.US$1.7 trillion, or four times the CBO's forecast (see Figure 1). Our guess is the CBO figure is a significant underestimate, given the attractive economics of many lower-carbon solutions, particularly against a backdrop of relatively high energy costs. But whatever the final total, the IRA puts a lot more cash on the table for climate-solutions companies.

**Figure 1: Projected annual capital investment in US energy-supply rated infrastructure**

Princeton University Zero Lab; billion 2018 USD per year




Source: Princeton University Zero Lab; Rapid Energy Policy Evaluation and Analysis Toolkit; Preliminary Report: The Climate and Energy Impacts of the Inflation Reduction Act of 2022; August 2022. Please note that this chart has been redrawn by Ninety One.

Recent IRS guidance on transferability will also help the IRA deliver on its potential, since it should make it easier to monetise the tax credits up front. In the past, it has often been highly complex and expensive for those with limited tax liabilities to fully benefit from tax credits. The IRA allows entities to transfer credits in a much simpler way, which should increase the number of projects the act generates and lower the cost of capital.

Funding costs and the economic environment will also shape what the IRA grows into. There are plenty of question marks around both at present. What we do know is that clean-tech sectors will be more resilient than they would have been without the act. A company receiving a large portion of its capital expenditure from the government via tax credits is less likely to cancel a project in tougher economic conditions. From the investors' perspective, we believe this gives businesses that are positively exposed to the IRA an advantage over other companies in uncertain times.

## Crowding out?

Cyclical vagaries notwithstanding, there is every chance the IRA will grow into a significant force. Of course, introducing such a strong chick to the nest could harm the growth of its siblings, and there is a risk that clean-tech projects outside the US may be crowded out. Projects worldwide have already been relocated to the US, lured by the generous tax breaks. The optimistic view is that the IRA will accelerate climate sectors broadly, particularly more nascent solutions like hydrogen and carbon capture, bringing costs down and driving global adoption – just as overly generous German subsidies once did for solar technologies.

The act may also spur other governments to further incentivise their own clean-tech sectors. Arguably the most important climate bill the EU has passed this year is the Temporary Crisis and Transition Framework, which makes it easier for companies contributing to the EU's net-zero drive to receive state aid. Among other things, it has allowed the German government to provide the funding to keep a lithium-ion battery plant within its borders. Among the companies likely to benefit is a Chinese equipment supplier to the plant, one of our larger portfolio holdings – a reminder to investors to look along global supply chains for the potential beneficiaries of regional legislation, rather than focusing only on the region itself.

Finally, it should be acknowledged that the young are often vulnerable. Republicans briefly suggested that rolling back the IRA would be a condition of agreeing to raise the debt ceiling, and it is likely the GOP will make reforming the act a pillar of its 2024 election campaign. However, analysis suggests that two-thirds of IRA-driven investment is likely to go to Republican-leaning states. As more projects are announced and the fact that decarbonisation means reindustrialisation and jobs becomes better understood, the chances of the IRA being scrapped get ever smaller.

> Overall, we think companies in decarbonisation-linked sectors have plenty of reasons to celebrate the IRA's first birthday. The act may still be in its infancy, but it is rapidly growing into a powerful regulatory tailwind for a diverse group of companies in the US and beyond.

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