IFM Investors

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How the US Inflation Reduction Act is reshaping the investment landscape

The US Inflation Reduction Act is leading the world in showing how to accomplish a just transition, boosting domestic manufacturing, creating jobs with good pay, and reducing carbon emissions across one of the world's largest economies – all while unleashing significant investment opportunities for asset owners.

Following decades of decline in public infrastructure spending and the failure of successive US Administrations to properly address the funding shortfall, President Joe Biden's flagship Inflation Reduction Act (IRA) was heralded as a welcome investment in the future of US renewables, manufacturing and skills and training.

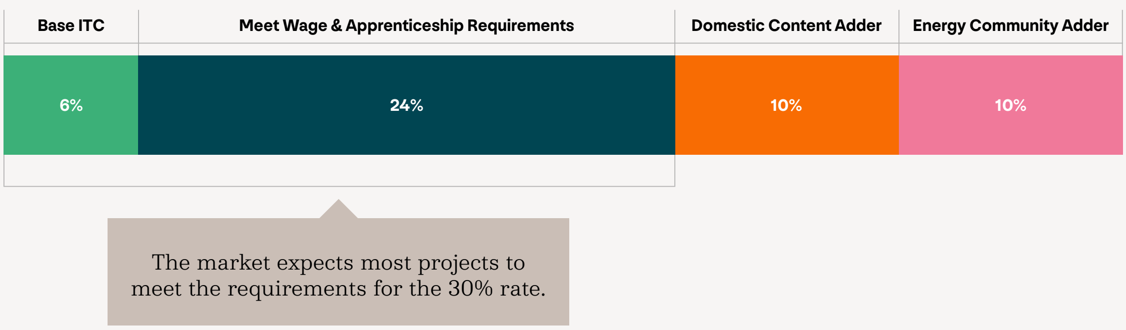
The $1.2trn[1] IRA and companion Infrastructure Investment and Jobs Act (IIJA) are the envy of many countries, helping the private sector deliver the energy transition the US requires while promoting a just transition that delivers apprenticeships and well-paid jobs. However, it initially drew the ire of some commentators outside the US over concerns it would unduly distort the flow of private capital. Re-adjusting the US investment tax credit (ITC) to a base rate of 6%, rather than 30%, projects are now instead rewarded with a 24% bonus credit where they meet wage and apprenticeship requirements – with the ITC rising as high as 50% depending on an investee's ability to draw on local steel, iron and other goods. As a result, IRA-eligible projects immediately became more attractive to build stateside than nearly anywhere else in the world, placing the emphasis on the private sector to make investment decisions capturing the value of tax credits for their investors, rather than applying for the government grants offered through the IIJA where a successful application was not guaranteed. Additionally, the qualification period's extension to 10 years meant projects had a level of certainty previously not associated with tax credits, where yearly extensions of the program by Congress were common.

At IFM Investors, we regard ourselves as well-positioned to attract the debt funding and benefit from the tax equity financing associated with ITCs and estimate that returns could improve significantly where projects are able to benefit from the domestic content and energy community ITC. However, the complexities associated with the new wage and apprenticeship requirements mean new programs need to be launched locally to comply, causing a delay in how quickly projects can benefit.

It is hard to overstate the impact of the IRA. From the $739bn total funding under the IRA, $369bn will be provided for clean energy and climate investment, including tax incentives for investments in renewable energy, decarbonisation, and energy security. Making the US a highly attractive investment destination was a stated goal of the legislation (as well as the broader economic program – 'Bidenomics', for short). The IRA has led to significant investment inflows into the US, estimated by the White House at $110bn one year after its ratification.[2] However, as it has shifted the weight of investment decisions towards the US, it has led to concerns of protectionism, which the US Administration has addressed by opening up the benefits of the Act to other friendly nations and jurisdictions, such as those within the European

FIGURE 1

BONUS CREDITS

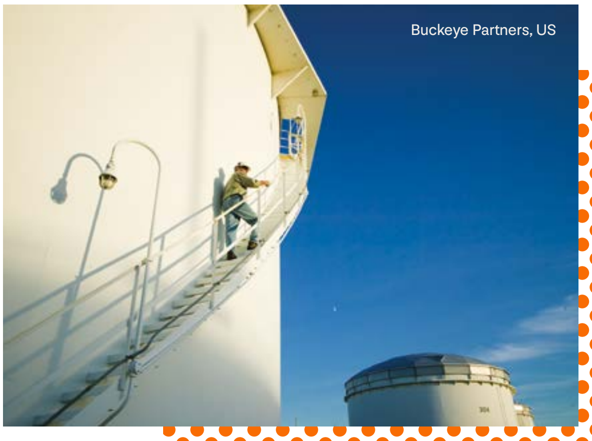


Sources: IFM Investors, US Inflation Reduction Act

[1] Currency is in US dollars unless otherwise stated.
[2] FACT SHEET: One Year In, President Biden's Inflation Reduction Act is Driving Historic Climate Action and Investing in America to Create Good Paying Jobs and Reduce Costs | The White House

single market, Australia and those with which the US enjoys free trade agreements.

The IRA's introduction nevertheless resulted in calls from parliaments across the world for similar targeted tax breaks and subsidies to ensure each country's domestic manufacturing base and private capital otherwise attracted to it did not focus entirely on projects in America and could be similarly turbo-charged.[3]



Buckeye Partners, US

Rush to subsidise

The European Commission, itself overseeing a raft of legislation meant to bring about the European Green New Deal, has come under pressure since passage of the IRA to relax its strict state aid rules, which advocates believe would allow member states to better counter its impact. The suspension of the rules against state aid would allow a potentially impacted member state to match subsidies with those the project would otherwise receive in the US. Additionally, the Commission's proposed Green Deal Industrial Plan would streamline planning rules and allow EU member states to take on greater debt to fund the required green transition.

However, relaxation of state aid rules does not provide the same certainty as dedicated funds. Critics argue such relaxation would disproportionately benefit Germany and France, the bloc's largest member states.

To balance Germany and France's dominance, the European executive has been weighing up the launch of a Sovereignty Fund that would "crowd in" private investments. It would be unlikely to match the impact of the significant tax credits granted by the IRA unless any state-owned stake was only used to absorb any downside risk, rather than benefitting from the upside.

Similarly, Japan passed the Green Transformation Act in May 2023 which leverages the government's borrowing to support private sector projects the government deems would struggle to otherwise attract funding. The ¥150trn (US$1trn) estimated spending over the coming decade compares favourably to the planned overall cost of the IRA, especially once accounting for the economies' respective sizes. However, unlike the IRA, the funds will be spent in Public-Private Partnerships rather than by allowing investors to reduce the risk of projects through tax credits.

The transferability of tax credits

Benefits of investing under the IRA principally stem from the allocation of the tax credits – but also the ability to trade those credits if they are not fully utilised by the company that qualify for them. As the IRA is set to support the growth of renewable energy and other, newer climate change mitigation technologies, many projects taking advantage of the tax credits will be start-ups with little-to-no tax to pay. These entities may now trade their tax credits on the open market and bring forward their benefit by several years, thus further improving potential returns.

While a typical tax equity scheme allowed project tax credits to be acquired by another entity, a specific allowance in the Act for transferability of credits greatly widens the field of buyers for those projects. As a result, the broader market means credits can be sold faster and on more favourable terms. Credit Suisse estimated that the tax equity market will grow to $49bn in 2024, a near doubling compared to 2022, and overall trade in tax credits will reach $500bn in the decade since the Act's introduction.[4]

[3] Cooperation with the US could drive Australia's clean energy shift – but we must act fast | Climate Council
[4] Credit Suisse Treeprint Inflation Reduction Act

Prospects for pension capital

Ultimately, the large-scale rollout of renewable energy generation and transition to net zero will not be successful unless private, long-term capital can be deployed to support and accelerate the transition. This sustained investment can come from a number of places, but notably, pension funds will be a key source of this patient capital.

As in many other countries shifting from a centralised energy system to one where renewable projects are less geographically clustered, new transmission lines will be needed to ensure the green energy is delivered to consumers. This will lead to investment opportunities both in local grid upgrades and expansions, as well as new transmission interconnections.

Additionally, in line with the rise in popularity of the electric vehicle, investors are being encouraged to step up to fund the construction of charging infrastructure. Where in some jurisdictions governments have stepped in to commit the first capital for such charging infrastructure – in part in an effort to alleviate the range anxiety associated with EVs – a rollout that properly covers a country as large as the US will need significant private capital.

CASE STUDY

Double Black Diamond solar project

The 800 MWdc (593 MWac) Double Black Diamond solar project is set to be the second largest single-phase solar project built in the US once it is complete in 2024.

Commissioned by Swift Current Energy, which is majority owned by IFM portfolio company Buckeye Partners, it will produce enough energy each year to power the equivalent of more than 100,000 homes and reduce carbon dioxide emissions by approximately one million tonnes per year.

The project financing, which closed in August 2023, included $695m in construction and tax equity bridge loans and an $84m letter of credit facility, making it one of the largest project financings ever for a US solar project. The tax equity component sees the project directly benefit from the investment tax credit bolstered by the IRA, with the tax equity market where these are traded forecast to nearly double to $40bn a year by 2030 due to the reforms.

Credit: Wood Mackenzie

Conclusion

As shown in the Double Black Diamond case study, the IRA not only allows investors to benefit from the transferability of tax credits, but it should also ease the investment risk associated with a range of renewable energy projects.

Overall, the IRA increases the potential returns for many climate-aligned and transition-friendly projects and is already driving immediate investment in both production and energy generation – creating a decade of policy certainty by expanding tax credits to a broad range of green and renewable projects in need of funding. From that perspective, the legislation is, arguably, unprecedented.

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IFM-19February2024-3387845