ethos ESG

Special Issue Brief

Carrots Over Sticks

The climate provisions of the Inflation Reduction Act will have profound effects on the energy industry. Who will benefit? And is ESG data a useful guide?

Government policy can have enormous impacts on financial markets. Legislation or regulation may slow a company's growth and reduce profitability, presenting obvious risks to investment portfolios. Other times, elected officials may favor economic incentives for businesses contributing to the public good. Instead of risk, investment opportunity abounds as policymakers opt for proverbial carrots over sticks.

In recent decades, federal responses to the climate crisis have repeatedly failed in the United States. Cap and trade schemes, carbon taxes, and emission reduction targets have proved too politically unpalatable. For that reason, policymakers largely abandoned those sticks and embraced almost exclusively carrots to pass landmark climate legislation in August of 2022. Dubbed the Inflation Reduction Act for obvious political reasons, the new legislation will shower the US economy over the next ten years with a variety of tax credits, grants, and loans designed to accelerate the transition to a net zero economy. The Inflation Reduction Act also allocates spending to healthcare and raises corporate taxes, but climate provisions dominate the new law and represent a meaningful deviation from the United States' policy inertia. Therefore, this analysis will focus on the climate elements of the legislation which are expected to slash US emissions 40% by 2030 and create enormous opportunities for investors.[1]

Environmental, social, and governance (ESG) data is a valuable tool for discerning investors. Ethos ESG provides wealth managers, asset managers, and asset owners with powerful software that aggregates thousands of data points related to climate action. This Special Issue Brief will explore the Inflation Reduction Act, the theoretical implications for capital markets, and the potential to identify beneficiaries within Ethos' database.

Climate-Focused Elements of the Inflation Reduction Act...

Scaling Production of Solutions

- $30 billion in tax credits for solar panel, wind turbine, battery manufacturing and critical minerals processing
- $20 billion for programs focused on cutting emissions in the agricultural sector
- $20 billion in loans to build new manufacturing facilities of clean vehicles
- $2 billion for retooling existing auto manufacturing facilities to make clean vehicles
- $27 billion for a cleantech accelerator to advance emission reduction technologies
- $10 billion in tax credits to build new cleantech manufacturing facilities

values-based investing tools for a sustainable future

Changing Consumer Behavior

- $30 billion in grants and loans for states and electric utilities to adopt renewable energy
- $9 billion for rebate programs to improve home energy efficiency and electrify home appliances
- $9 billion for federal procurement of American-made cleantech
- $1 billion in grants to make affordable housing more energy efficient
- $7,500 point of sale tax credits for the purchase of new electric vehicles and $4,000 for used EVs
- Ten years of tax credits for decarbonizing homes with solar, heat pumps, electric HVAC and water heaters

Effects on Capital Markets...

Companies that produce climate-friendly products and deliver green services may see a significant surge in demand. Coinciding reductions in production costs due to government subsidies may simultaneously increase market share, revenues, and margins for beneficiaries of the Inflation Reduction Act. Most importantly, it provides confidence for market actors to make long-term investments. Whereas previous climate-focused incentives offered clarity over month or years, this legislation will dole out carrots over the coming decade. Consequently, the research firm Wood Mackenzie expects the legislation will inspire $1.2 trillion in private investments into the renewable energy industry by 2035.[2] The following industries are likely to benefit.

Renewable Energy

Solar, wind, and battery manufacturers are eligible to receive incentives to build new manufacturing facilities.

The cleantech accelerator will help innovative companies scale new low-carbon technologies.

Utilities

Utilities can receive grants and loans to facilitate renewable electricity generation.

The electrification of heating and transportation will likely increase demand for electricity after decades of stagnating or declining demand driven by energy efficiency.

Electric Vehicle Manufacturers & Suppliers

The growing group of electric vehicle start-ups, as well as legacy automakers transitioning away from the internal combustion engine, may receive significant incentives to build new manufacturing plants and retool existing plants.

Millions of drivers in the US will be incentivized to buy their first new or used electric vehicle.

Cleantech

Home energy rebates, focused on low-income households, will generate demand for companies producing products such as heat pumps.

The federal government will shift procurement to climate solutions.

Hydrogen and energy storage technologies will be eligible for new subsidies.

The new law also presents a few carrots to the traditional energy industry by expanding fossil fuel extraction on public lands. However, it is less clear that these carrots will significantly impact earnings in the traditional energy sector. Less than 10% of fossil fuels extracted onshore in the United States come from public lands.[3] Offshore leases may present a larger opportunity for energy companies, but regardless, they must grapple with secular changes to their industry, now accelerated by the new law. Consider that in the first half of 2022, wind and solar accounted for 67% of all new electricity generating capacity in the United States according to the Federal Energy Regulatory Commission.[4] Market dynamics already favor renewable energy, and the Inflation Reduction Act will only exacerbate the advantage.

Prudent investors must also consider parts of the law that produce investment risk. The Inflation Reduction Act imposes a new 15% minimum corporate tax on companies averaging at least $1 billion of pretax profit over the previous three years. Some of the same companies poised to benefit from subsidies may see the benefits to their bottom lines nullified by new the tax floor. Investors must also contemplate a potential reduction in share buybacks resulting from a one percent tax on the age old strategy of amplifying earnings per share.

How Ethos Helps...

ESG data is widely accepted as an essential tool to identify and understand investments well positioned for the energy transition. Ethos ESG is focused on making such data accessible and navigable by providing powerful software allowing investors and advisors to sort companies and funds by a wide variety of causes. Two causes that are specifically relevant to the Inflation Reduction Act are:

Renewable Energy Growth

A materiality-weighted analysis of 35 unique or modeled proprietary and third-party metrics.

Climate Action

A comprehensive analysis of 74 metrics sourced from NGOs, government agencies, company filings, and proprietary research.

Ethos ESG is also highly committed to transparency. All data points underlying Renewable Energy Growth and Climate Action scores are accessible to users. Consequently, investors may benefit from more granular research targeting specific investment characteristics that align with the new legislation. The metrics germane to an accelerated energy transition include, but are not limited to:

Renewable Energy Leaders

Whether a company has a major renewable energy division as researched by Ethos ESG.

Leaders in Transitioning to Clean Energy

A ranking of the top 200 companies in cleantech as provided by the non-profit and corporate watchdog, As You Sow.

Inclusion in Reputable Impact Funds and Indexes

Ethos ESG conducts proprietary research to identify the companies most commonly held in impact-focused funds and indexes.

Top Green Utilities

Those utilities most focused on renewable electricity generation and carbon emission reduction as identified by Energy Intelligence.

In the weeks since the new legislation was presented to the public, many investors have flocked to mutual funds and ETFs with high exposure to the themes presented in this analysis. In fact, funds focused on clean energy reversed a trend of outflows and attracted over $430 million in net new assets from July 28th to August 10th.[5] Fortunately, Ethos ESG allows investors to sort mutual funds and ETFs as well as companies by the causes and metrics listed above. This need not be limited to thematic cleantech funds as Ethos allows investors to sort funds in any asset class by their impact on and exposure to Renewable Energy Growth and Climate Action. For example, the following Large Cap Blend Funds receive top scores for Renewable Energy Growth.

Boston Common ESG Impact US Equity Fund	BCAMX
Calvert US Large Cap Core Responsible Index Fund	CSISX
Domini Impact Equity Fund	DSEPX
PAX Large Cap Fund	PXLIX
Boston Trust Equity Fund	BTEFX

The Bottom Line...

There are many provisions in the Inflation Reduction Act that are not discussed in this analysis. The overall implications for portfolios will be extensive and nuanced, and shrewd investors should research the entirety of the law. Ultimately, the Inflation Reduction Act represents a seminal policy change affecting how the United States produces and consumes energy. Its promise conjures memories of historical legislative packages that have birthed and dispatched entire industries. Navigating such change is always challenging for investors, which is why the most prudent of them will look to all available sources of information to discern winners from losers. While ESG data is not a panacea for making those distinctions, it can serve as a useful tool for researching the companies, funds, and ETFs likely to benefit from the cornucopia of carrots.

[1] Stokstad, Erik. 2022. “Surprise Climate Bill Will Meet Ambitious Goal of 40% Cut in U.S. Emissions, Energy Models Predict.” *Science*, Aug 1. https://www.science.org/content/article/surprise-climate-bill-will-meet-ambitious-goal-40-cut-us-emissions-energy-models

[2] Salzman, Avi. 2022. “The Senate Passes Climate Bill. The Rush to Renewable Energy is On.” *Barron’s*, August 7. https://www.barrons.com/articles/senate-passes-climate-tax-inflation-bill-renewable-energy-51659900714

[3] Magill, Bobby. 2022. “U.S. Oil Thirst Defies Easy Fix of Drilling on Federal Lands.” *Bloomberg Law*, March 15. https://news.bloomberglaw.com/environment-and-energy/u-s-oil-thirst-defies-easy-fix-of-drilling-on-federal-lands

[4] Federal Energy Regulatory Commission. 2022. *Energy Infrastructure Update for June 2022.* Office of Energy Projects. https://cms.ferc.gov/media/energy-infrastructure-update-june-2022

[5] Hale, Jon. 2022. “The Inflaction Reduction Act is Spurring Interest in Clean Energy and Climate-Conscious Investing.” *Morningstar,* August 12. https://www.morningstar.com/articles/1109048/the-inflation-reduction-act-is-spurring-interest-in-clean-energy-and-climate-conscious-investing

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