GMO
FOCUSED EQUITY INSIGHTS

# THE FUTURE OF THE INFLATION REDUCTION ACT

## *Rhetoric vs. Reality*

***Lucas White*** | December 2024

> *"The market appears to be pricing in a high probability of significant disruption to the IRA, but…there are a variety of reasons to believe that Republicans may not be so keen to dismantle it.*

## *Introduction*

Republicans have lashed out at the Inflation Reduction Act (IRA), a landmark package of incentives for clean energy, since it was passed two years ago. With the Republican party gaining control of the White House, the Senate, and the House of Representatives, the future of the IRA is in question. The market has reacted by savaging an already beaten-down clean energy sector. While not surprised by the direction of the move, we have been surprised by the magnitude. The market appears to be pricing in a high probability of significant disruption to the IRA, but the situation is rife with uncertainty. We believe clean energy provides investors with a positively skewed distribution of prospective returns, as many companies are trading below what we see as fair value even in a full repeal scenario.

## *Election Market Reaction*

The knee jerk reaction of the market to the Republican sweep has been to punish clean energy. While the broad market rallied in the first five market days after the election (S&P 500 +3.5%, MSCI ACWI +1.7%), the Invesco Solar ETF plummeted almost 20% while the First Trust Global Wind Energy ETF dropped around 10%. Biofuel and electric vehicle (EV) battery companies fell by a similar magnitude, and just about everything touching clean energy tumbled.[1] The market clearly took Donald Trump's campaign trail promises to "terminate" the IRA to heart.

Tesla, the biggest clean energy company of them all, was notably immune to the pain and suffering, rising over 30% in the first few days after the election. The market seems confident that CEO Elon Musk's budding relationship with Donald Trump will ensure favorable treatment for the company, but at the end of the day, Tesla is an EV, solar, and energy storage company. Catastrophic changes for these industries would not be good for Tesla.

Regardless, the market's reaction was quite clear that the election results are terrible for clean energy more generally. Yet, there is great uncertainty about what will actually happen to the IRA, and there are a variety of reasons to believe that Republicans may not be so keen to dismantle it.

## *Historical Context*

Before looking at the prospects for the IRA, let's look at some historical context for perspective. Federal incentives for renewables have existed since 1978, spanning many administrations. Republican President George H.W. Bush upped the ante when he signed the Energy Policy Act of 1992 into law, establishing the Production Tax Credit (PTC) for renewables. With Republicans controlling both the Senate and the House a little over a decade later, Bush's son, President George W. Bush, upped the ante again when he signed the Energy Policy Act of 2005, introducing a 30% Investment Tax Credit (ITC) for qualified renewables projects. These tax credits have been extended repeatedly in both Democratic and Republican

1 Interestingly, many of the higher quality, larger clean energy companies dropped particularly far. They're more liquid and perhaps easier targets for short sellers.

regimes, including during Trump's first term in office, and the IRA extended the ITC and the PTC once again. Hence, alternative energy incentives have been around for decades and certainly didn't start with the IRA. Furthermore, these incentives have largely experienced bipartisan support.

We can look to the first Trump administration for some context as well. During Trump's first term in office, U.S. renewables capacity additions dwarfed the levels seen in Barack Obama's two terms, major renewables tax credits were extended, and the WilderHill Clean Energy Index rose 500%.[2] Not all was rosy for clean energy. In an effort to support the fossil fuel industry, the Trump administration did disadvantage the biofuels industry at one point. However, the farming lobby stepped in and underscored the importance of corn and soybean oil as feedstocks for biofuels, at which point the Trump administration promptly increased support for biofuels.

It's also important to note that the IRA is not a radical piece of legislation. With substantial influence from the fossil fuel industry, many rounds of negotiations watered down the original proposals in the Build Back Better Act. Given their role in crafting the IRA, it's perhaps not surprising that oil companies have been supportive of it as they benefit from incentives for carbon capture and storage, hydrogen, biofuels, etc. Exxon's CEO Darren Woods, for example, has repeatedly expressed his support for the IRA and for the U.S. remaining in the Paris Agreement. He has also noted the damage caused by policy bouncing back and forth as political winds change.

## *What are Trump's intentions?*

Given the historical support for renewables and the growth during Trump's first term, it's not clear what the president elect's intentions are with regards to the IRA. While he's railed against it here or there, referring to it as a "con job" and the "greatest scam in history," he spent more time dancing on the campaign trail than he did discussing clean energy. At times, he even claimed to be a "big fan of solar," that he's "all for electric cars," and that he will prioritize the U.S. production of rare earth minerals – a critical input for many clean energy solutions.

In Trump's 2016 campaign, he was much more vocal about his promise to repeal Obamacare as a central policy point. Yet, Obamacare emerged unscathed despite Republican control of both chambers of Congress, including a large edge in the House, for his first two years in office. Campaign rhetoric often fails to translate into policy. There's little doubt that the incoming Trump administration will support fossil fuels. However, it's far less clear that clean energy will be targeted for punishment. Trump has typically been more pro-business than anything else, and his rhetoric about the IRA may be less about striking against clean energy and more about supporting fossil fuels.

*"Trump has typically been more pro-business than anything else, and his rhetoric about the IRA may be less about striking against clean energy and more about supporting fossil fuels.*

## *The Musk Factor*

Musk's recent emergence at the heart of Trump's inner circle is another wild card. Musk clearly has Trump's ear and is a huge proponent of EVs, solar, and energy storage. Musk recently posted on X that it is "utterly obvious that essentially all energy generation will be solar," and he runs the biggest EV manufacturer in the world. However, it's a bit more complicated than you might think, as Musk is against subsidies for EVs (and everything else, including oil and gas) and relishes the impact that getting rid of the $7,500 EV tax credit would have on his competitors, despite the fact that it would likely hurt Tesla's business as well.

It's impossible to know exactly what impact Musk will have on Trump's views on the transition, but it's reasonable to think that Musk's influence will make Trump more sympathetic toward some of the things he has vilified historically.

2
See the Appendix of Misguided Mayhem: Exploring Sentiment in Clean Energy (October 2024) for more detail.

## *Does the will exist to repeal the IRA?*

Even if Trump wants to do away with the IRA, he can't do so unilaterally. To repeal or adjust the IRA, he would need a majority of both the House and Senate, and that will be difficult with a razor thin Republican majority and strong economic and political reasons against repeal. Republicans and Democrats alike note the economic growth and jobs driven by the IRA and that most of the investments have been made in historically Republican states and districts.[3] They worry about national security and energy independence. They recognize the country's growing energy needs driven by AI, data centers, electrification, etc., and that the Microsofts, Googles, and Amazons of the world want clean energy to fulfill their decarbonization goals. They worry that rising energy demand may lead to inflation, one of the big issues that sunk Kamala Harris's campaign. They're concerned about ceding leadership of high growth, critical industries to China and others. They understand that drastic policy changes create distrust and disrupt investment in the private sector, typically more of an issue in emerging markets.

Citing a number of these considerations, 18 Republican representatives signed a letter to House Speaker Mike Johnson (R-LA) in August describing repeal as a "worst-case scenario." Signing the letter purposefully put a stake in the ground for these legislators, and since the election, Representative Anthony Garbarino (R-NY), the lead author of the letter, has been very clear that the signatories will not bow to pressure from Trump to gut the IRA.[4] There are reports that many other Republican members of the House and Senate express similar pro-IRA sentiments privately, but if Democrats are joined by just the Republicans who signed the letter, efforts to repeal the IRA are dead in the water.

Dysfunction within the Republican party complicates matters further when considering policy outlook. Traditional conservatives and MAGA Republicans have very different worldviews and priorities. In an administration bent on dramatically overhauling government as we know it, there are questions about whether a fractured Republican party will make the IRA a focal point of its efforts. With such a slim margin in Congress, the different factions within the Republican party will have to become much more harmonious to enact legislative changes, and the last few years suggest that may be challenging.

In the wake of the recent elections, the top two candidates for the next Senate majority leader were traditionalists with Senator John Thune coming out on top. Thune represents South Dakota, where more than three quarters of their electricity generation comes from renewables (wind, hydro, etc.).[5] On Thune's website, he trumpets his clean credentials repeatedly, touting his work to "increase the availability and use of alternative energy sources." He notes that he has "long been a supporter of renewable energy," that he's "proud that South Dakota is a leader in clean energy sources like hydroelectric, wind, and biofuels," and that "biofuels are central to American agriculture and our energy security."

For his part, Speaker Johnson seems to understand the challenges in going after the IRA, recently noting that "you've got to use a scalpel and not a sledgehammer." Now that campaigning has wound down, there have even been reports that Trump's transition team has acknowledged that it will be difficult to roll back some IRA programs given their popularity in Republican states.

> *"...there have even been reports that Trump's transition team has acknowledged that it will be difficult to roll back some IRA programs given their popularity in Republican states.*

## *So, what will happen to the IRA?*

By this point, it should be clear that nobody really knows what's going to happen to the IRA. Yet, there's no shortage of reporters, analysts, political insiders, legal experts, and environmentalists who have strong views. We likely won't know the future of the IRA until next year when tax cut deliberations take place. After all, there's no point in killing policies that benefit the economy unless you have something positive to offer in return.

3
See Turbulence on the Path to Transformation: Clean Energy Challenges Create Opportunities (September 2023).

4
Let's not forget that Trump will be in his final term in office and may not have as much influence on his fellow Republicans as he's had in recent years. Of the 18 Republican representatives who penned the letter to Johnson, 14 won their reelection bids and one (John Curtis, R-UT) is now a senator.

5
U.S. Energy Information Administration

We can quibble about the probabilities, but let's say there's a 5-10% chance of full repeal and a 5-10% chance that the IRA stays in place as is. That leaves an 80-90% chance that modifications are made to the IRA.[6] Some IRA provisions are likely safer than others. The ITC and the PTC may not be major targets, as they've been around for decades and benefit Republican districts. The methane tax is likely at risk. Offshore wind has been a particular target of Trump's ire and may find itself in his crosshairs, but to put things in perspective, there were zero offshore wind capacity additions in the U.S. in each of the last three years. Some unspent funds from climate-related grant programs may be recaptured as well, but that's small change in the grand scheme of things.

Trump's transition team will reportedly specifically target the EV tax credit, potentially harming an industry already in the midst of a cyclical slowdown. One can imagine that Trump sees this as a way of raising funds for his promised tax cuts while simultaneously supporting the oil industry. However, as of April, around 80% of the $200+ billion in clean tech manufacturing projects announced during Biden's term had gone into EVs and batteries.[7] Around 85% of this investment is targeted for Republican districts, where the newly created jobs typically pay much more than the median income. We're talking about many billions of dollars of investment and tens of thousands of highly paid jobs with multiplier effects on local businesses and tax income. You can't support manufacturing and then kill demand for the manufactured goods! Eliminating the EV tax credit would put many of these projects at risk, and a few have already been postponed due to the policy uncertainty and soft EV demand.

Sabotaging the EV industry right now could also have major ramifications for the U.S. automotive industry's ability to compete in the future. The Alliance for Automotive Innovation, a major industry trade group representing all the major auto manufacturers except for Tesla, sent a letter to Congress in October stressing the importance of the EV tax credits if the U.S. is to continue to be competitive with China and others in the global automotive market, where EVs are clearly the wave of the future. Will Republican senators and representatives from Michigan and other big automobile manufacturing states vote to handicap the major U.S. manufacturers in their competition with China, Europe, and Tesla?

There are no easy paths when making major policy changes, and the IRA provisions cannot be unwound without far-reaching implications for economic growth, jobs, and competitiveness in critical industries for the future. Many seem to take stated policy intentions as a done deal, but all these things will be discussed at great length before decisions are ultimately made.

> *"A full repeal would clearly be a setback, but the U.S. federal government isn't alone in supporting the energy transition. In fact, prior to the IRA, U.S. federal government policy had lagged relative to China and Europe...*

## *What if there is a full repeal?*

A full repeal would clearly be a setback, but the U.S. federal government isn't alone in supporting the energy transition. In fact, prior to the IRA, U.S. federal government policy had lagged relative to China and Europe, and last year, Japan enacted the Green Transformation Policy with the goal of attracting $1 trillion of investment in decarbonization.[8] If the U.S. federal government falters on clean energy, the rest of the world won't stand still. Nothing happens in a vacuum, particularly when the stakes are this high.

We saw this when Trump pulled the U.S. out of the Paris Agreement during his first term; states, cities, businesses, and universities banded together to ensure that the U.S. would abide by or exceed its commitments to the Paris Agreement. States like California, which would be the 5$^{th}$ largest economy in the world were it a separate country, are already gearing up to fill the gap if the Trump administration hacks away at the IRA.[9] The scale of big business is unprecedented, dwarfing all but the largest countries, and the companies dominating the business landscape are deeply committed to the transition. U.S. federal policy is undoubtedly important, but there are clearly many other major stakeholders.

6
For simplicity, let's consider repeal and replace to be an adjustment to the IRA.

7
Bloomberg

8
See Turbulence on the Path to Transformation: Clean Energy Challenges Create Opportunities (September 2023).

9
California has pledged to institute EV rebates if the Trump administration does away with the federal EV tax credit.

## *Other risks from the upcoming administration*

Given Trump's pro-tariff platform, tariffs are another concern for clean energy, but large tariffs already exist on Chinese solar panels, EVs, lithium-ion EV batteries, etc., and once again, there's much uncertainty about how tariffs will be implemented, how long they might last, and which companies would be advantaged or disadvantaged. Perhaps a larger concern than the impact on clean energy specifically may be the general impact of tariffs and the deportation of cheap labor on inflation. If government policies produce inflation, higher interest rates could be a headwind. Given that Harris just lost her campaign in no small part due to inflation, one might think Republicans would be wary to implement inflationary policies, but time will tell.

## *Investment outlook*

All this policy uncertainty has helped create an intriguing investment landscape. After dropping around 35% this year through November 15, the WilderHill Clean Energy Index has fallen 85% since its peak in February 2021.[10] Despite strong growth prospects, clean energy stocks were trading at steep discounts even before the election results sent them on another down leg,[11] and worst-case scenarios with regards to the IRA have largely been priced in.

*"...we believe market prices reflect what could reasonably be viewed as a somewhat extreme bear case, leaving strong upside in reasonable base case scenarios and mouth-watering returns in bull cases.*

We've stress tested the financial models for many global clean energy companies under a full repeal scenario. Our models indicate that almost all the companies that we've stress tested have upside even in a full repeal world, and in many cases, the upsides are substantial. The only exceptions are a couple solar companies with particularly large U.S. exposure. This leaves us with a skewed distribution of prospective returns in the sector. In many situations, we believe market prices reflect what could reasonably be viewed as a somewhat extreme bear case, leaving strong upside in reasonable base case scenarios and mouth-watering returns in bull cases. Opportunities like this are rare, and we have substantial exposure to clean energy in our Climate Change and Resources strategies as a result.

The recent cyclical slowdown and policy wobbles are distracting investors from the multi-decade secular growth opportunities. Though policy is, of course, important, the transition will ultimately be driven by economics and the urgency to decarbonize. At this point, incentives aren't required for solar, wind, EVs, etc., to be viable, growing industries. Solar and wind costs have fallen to the point where they're the cheapest form of electricity generation in many areas, and costs will continue to fall.[12] EVs are a bit more expensive than internal combustion engine vehicles, but they're cheaper to operate and maintain, leading to cheaper lifecycle ownership.[13] At this point, incentives are more about speeding up the transition as the world has fallen woefully behind on decarbonization targets.

## *Conclusions*

Recent campaign rhetoric has obfuscated the fact that clean energy incentives enjoy substantial bipartisan support. While it's impossible to handicap political outcomes, history, logic, and financial motives suggest that large portions of the IRA will remain. The future of the IRA won't be settled until next year at the earliest, and uncertainty will reign until then. Even the impact of the uncertainty on clean energy projects is unclear. Some investors and developers will rush to lock in credits before changes are made. Others will pause while the dust settles.

When looking back at the IRA uncertainty in the future, the current concerns are likely to appear overblown. Administrations come and go, the transition is global, and actions lead to reactions. If the incoming administration slows the transition now, other entities will have to move faster now and in the future. Regardless, incentives only serve to speed up the transition at this point. The economics of clean energy are compelling even in the absence of policy support.

10
Our quality and value orientations have helped us fare much better in our clean energy investments.

11
See Misguided Mayhem: Exploring Sentiment in Clean Energy (October 2024).

12
See Turbulence on the Path to Transformation: Clean Energy Challenges Create Opportunities (September 2023).

13
The electric version of the Ford F-150, for example, is more expensive than the gas-powered version but about $2,000 cheaper to fuel and maintain each year. With the EV tax credit, consumers break even in about two and a half years. Without the EV tax credit, break-even occurs in about six years. EV costs are expected to continue to fall, which will lower the break-even timeframes.

***Lucas White***
Mr. White is the lead portfolio manager for the Resources and Climate Change strategies. He is a member of GMO's Focused Equity team and a partner of the firm. Previously at GMO, he was engaged in portfolio management for the Global Equity team, including responsibilities for the Quality, Tactical Opportunities, and U.S. Growth strategies. Prior to joining GMO in 2006, he worked at Standish Mellon Asset Management and MFS. Mr. White earned his bachelor's degree in Economics and Psychology from Duke University. He is a CFA charterholder.

There may be a profound silver lining for clean energy in this situation. A cloud has been hovering over the sector since the passage of the IRA, with many questioning the bill's future should political winds change. Now we're going to find out. If large portions of the IRA remain in place in a government under Republican control, the certainty may provide a bigger boost to clean energy than the initial announcement of the IRA did. Whatever survives will represent a bipartisan solution that would likely set a floor for U.S. federal support going forward and provide developers and investors with stable ground on which to build.

We've been seeing signs of improvement in business conditions for clean energy companies throughout the year, and expectations for growth are strong over the next few years. Yet, dire scenarios have been priced by the market, with many companies showing upside even in an unlikely full repeal scenario. We believe policy uncertainty and cyclical conditions have helped create a unique opportunity to invest in high growth companies at steep discounts to the market. Don't let the rhetoric distract you!