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Fitch: Inflation Reduction Act May Spur Public Power Renewable Spending.

Fitch Ratings-Austin/New York-16 August 2022: The introduction of direct pay tax credits through the Inflation Reduction Act (IRA) is expected to spur greater direct investment in clean energy projects across the public power sector, Fitch Ratings says. Public power systems steadily added production from renewable energy projects, including wind and solar projects, to their energy mix over the last decade but energy is typically purchased from private developers. The ability to monetize production tax credits pursuant to the IRA will improve the economics of direct ownership and could help reverse a trend of declining investment in the sector.

In recent years, the rate of capital investment lagged historical levels at most of the wholesale public power systems rated by Fitch. Our 2022 US Public Power Peer Review reported that the median ratio of capital investment to depreciation was only 77% in 2021. This marked the sixth time in the last eight years that the ratio was below 100%, indicating that systems are depreciating their assets faster than they are reinvesting.

Fitch believes that this trend is due, in part, to the inability of tax-exempt enterprises to take direct advantage of production tax credits and other subsidies related to renewable energy projects. Public and cooperatively owned power systems instead added renewable energy to their power supply through purchase power agreements with private developers able to capitalize on tax subsidies. Wind and solar projects accounted for 13.8% of total US generating capacity in 2020 but only 0.9% and 0.5% of the total capacity owned by public power systems and electric cooperatives, respectively, according to the American Public Power Association.

Systems may continue to add new renewable purchase power agreements when economic but direct pay tax credits will lower the cost of alternative ownership, particularly for systems that prefer project design and operating control. When factoring power purchase agreements, wind and solar capacity available to public power systems increased to more than 9,300MWs in 2020 from roughly 1,050MWs.

Higher capital spending will drive increased borrowing but is unlikely to materially weaken credit quality, as Fitch's rating methodology factors purchase power obligations in its financial metrics and analysis, limiting the effect on leverage. This approach improves the comparability between systems that purchase and own resources and buffers the effect of debt-funded capital spending on projects that displace purchase power costs.

The expanded options for project ownership and financing made possible by the IRA are likely to provide the greatest benefit to systems operating in one of the 24 states or US territories that have adopted renewable energy portfolio standards for clean energy goals that apply to publicly- and cooperatively-owned systems. Although new project development is likely to be obstructed in the near term by inflationary pressures and supply chain constraints, delaying the delivery of solar panels and wind turbines, market conditions should improve in time for utilities to meet more stringent goals and targets set to take effect in 2025 through 2030.

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The above article originally appeared as a post on the Fitch Wire credit market commentary page. The original article can be accessed at www.fitchratings.com. All opinions expressed are those of Fitch Ratings.