Wellington energy storage investment

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Two of our climate- and energy-focused investment professionals discuss what the low-carbon transition may look like and how investors can think about the challenges and opportunities it represents.

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The recent energy crisis in Europe, inflated oil and gas prices in the US, and ongoing climate disasters around the world have underscored the need to stay focused on decarbonization. By increasing the amount of energy produced from renewable sources, incentivizing demand-side efficiency, and investing in climate mitigation and adaptation solutions, we believe society can reduce long-term costs, bolster energy independence and national security, and mitigate the worst effects of climate change.

At the peak of Europe"s crisis, in August 2022, European natural gas prices spiked to more than 300 euros per megawatt hour, nearly a 20-fold increase over historical averages.1 Now, owing to a mild winter, demand reductions, and ample gas storage, those prices have somewhat normalized. Market watchers remain concerned about long-term energy affordability, however. The structural themes of lowering costs, boosting our energy security, and improving climate resilience present a host of challenges for policymakers along with important opportunities for investors.

While the fiscal and social challenges associated with decarbonization are many, the private sector is one key to overcoming them, in our view. Innovative companies are already finding ways to support the energy transition and help society increase climate resilience. Many of these companies are taking advantage of falling input costs and rising demand. They also have long runways for growth and enormous addressable markets, given that the energy transition and climate change are global issues.

Notably, expanding clean power requires more than panels and turbines. Since renewables are not yet viable sources for base-load power, investment in technologies like batteries and fuel cells that enable storage should increase, and as should spending on more efficient methods of facilitating power distribution. Companies that modernize and reconfigure electricity infrastructure for the renewable landscape could experience decades of stable, recurring earnings, which may be largely insulated from economic cycles.

As with any megatrend, economy-wide decarbonization involves many challenges, from the mundane to the systemic. One underappreciated barrier is permitting. In Europe today, getting an onshore wind farm up and running can take nearly eight years, largely due to the slow, cumbersome permitting processes that are still in place.

Another challenge is market stability, which helps spur investment. Policymakers must structure incentives to provide developers with a long-term view onto their potential return on investment and profitability. This is a key benefit of the US Inflation Reduction Act. Passed in 2022, the legislation provides companies with a 10-year window for market stability and a framework to estimate earnings over time. The European Commission is currently looking to add similar structures to the REPowerEU framework and the nascent Net Zero Industry Act.

A third challenge involves electricity grid infrastructure and power storage. Renewables provide intermittent power, which cannot be base loaded. Until the development of storage solutions, most utilities and electricity grids will need to be reconfigured to deliver power as efficiently as possible.

Finally, arguably the biggest challenge hindering decarbonization is changing behavior at the world"s largest emitters, most notably traditional energy companies. While the world needs carbon-based fuels to enable the transition, the changing energy cost structure, shifting policy environment, governmental focus on energy security as national security, and growing consumer awareness of climate change will require fossil-fuel companies to change course.

Many traditional companies are now focusing their incremental investments and allocation of capital toward clean technology, applying cash flows from existing fossil-fuel infrastructure to future clean energy projects. Several of the largest energy names are investing the most -- billions of dollars -- into renewables and other sustainable projects. They still have legacy fossil-fuel exposure, but they understand the market"s direction of travel and are preparing to compete in a lower-carbon world.

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