

Intelligence MEMOS



From: Dale Beugin and Blake Shaffer

To: Infrastructure Minister Catherine McKenna

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Re: **THE CLIMATE POLICY CERTAINTY GAP AND HOW TO FILL IT**

Canada now has a pan-Canadian carbon price that is due to rise to \$170 per tonne by 2030. Yet some firms appear to be holding off on investing capital in expensive, long-lived, low-carbon projects that make sense at \$170. Why?

The source of that gap, in a word, is uncertainty.

It's one thing for the federal government to commit to \$170 per tonne in 10 years. It's another thing for firms and investors to have the confidence to make big investments now that rely on that future carbon price, given future governments might set a different course.

Expectations around future carbon prices matter as much as the price today. As a result, future carbon prices play a key role in determining rates of return for emissions-intensive projects. Expectations of future carbon prices also create an incentive for [low-carbon innovation](#), helping to unlock the [wild cards](#) critical for Canada's path to net zero.

This certainty gap is a problem for policymakers because it dilutes the incentives from carbon pricing policy. It's also a problem for businesses looking for clarity around future policy conditions as they look to attract capital to new projects.

It's a problem that might have a straightforward policy solution: using the Canada Infrastructure Bank (CIB) to de-risk big, low-carbon investments by directly targeting policy certainty.

Here's how:

- The CIB would create a sort of insurance for future carbon incentives. To borrow language from investment finance, this is roughly akin to a forward contract on government policy.
- Think of it this way: the CIB acts as a partner for a firm looking to invest in a capital-intensive, low-carbon project. The bank shares risk by signing up for the value of a project that comes from the rising carbon price. Should policy get more stringent over time, those benefits accrue to the CIB; should government relax or remove carbon pricing, the CIB bears the loss.
- In practice, the CIB could operationalize this approach in one of two ways. First, the CIB and a firm could agree to exchange payments at a future date based on the difference between expected and actual policy costs. Alternatively, the CIB could provide upfront capital to a project, along the lines of current loan relationships, but the firm's payback obligations are conditional on future policy stringency (and perhaps the future existence of the CIB as well).
- Essentially, the firm gets to make the investment as if carbon pricing policy is fixed. This places the investment decision in the firm's hands – where it ought to be – while the CIB takes on the risk of government policy. The policy certainty gap is closed.
- Finally, this role would be consistent with the CIB's stated mandate to “crowd-in” private investment, tipping the scales in favour of needed investments. In this case, it would be doing so in the place it is best suited: resolving government risk.

This solution is not unique. Future contracts in cap-and-trade markets on the price of future permits have resulted in robust trading that allows participants to lock in the value of future emissions reductions by purchasing or selling contracts. Our proposal goes a step further in efficiently allocating risk because when it comes to policy uncertainty, no entity is better suited to bear the risk of future government policy change than the government itself. The CIB provides a means of doing so.

This approach better targets the problem of policy uncertainty than the alternatives. Grants, subsidies and tax credits are blunt tools to solve this particular market failure: while they do indeed boost the returns of specific low-carbon investments, the heavy discounting on future costs or benefits from uncertain future carbon prices remains. As a result, these alternatives will cost more. And they require governments to pick winners, rather than relying on market forces to do so.

Finally, this proposal has policy durability. By signing up for the policy risk, the CIB will impose a cost on future governments if they choose to weaken carbon pricing. Should the carbon price fall from \$170 to \$50, the CIB – and thus ultimately the government of the day – would bear that loss. This creates a credible commitment to the current path of policy. As a result, all firms – not just those with CIB projects – face less uncertainty.

The certainty gap is a real problem as Canada navigates the path to net zero. We hope this proposal stimulates some creative policy thinking on possible solutions.

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