Redirected energy

Government investment in infrastructure is littered with tales of inefficiency and rapid obsolescence. With a little tweaking, mechanisms such as bonds could do a better job *By Michael Mainelli*

The numbers are enormous: $300bn for sewers in the US over 20 years; €1trn for energy in Europe over the next 10; £200bn for UK infrastructure between 2011 and 2015. These plans all assume significant government funding yet, given governments' frankly woeful track record of success in infrastructure investment, why is so much public sector finance involved in infrastructure?

Let's focus on the estimated £550bn for green investment in the UK over the 10 years to 2020. Calls for government support through pilot projects, tax incentives, special investment zones, capital allowances, accelerated depreciation or even a green investment bank assume investors are making the wrong decisions and government distortion of markets can help them make the correct ones. Few dare to name the real risk: government.

Clean-energy projects face virtually the same risks as traditional ones, except that their competitiveness depends on government policy to create a favourable environment being enacted. With governments selling bonds furiously to fund expenditure on schools, roads and hospitals, clean-energy investment or subsidy could dry up at any time.

THE DEVIL YOU KNOW

Why are new mechanisms needed when tweaking old ones might do? One simple proposal on clean-energy finance is index-linked carbon bonds (see box). By issuing carbon bonds linked to independent, auditable indices, these 'bond cuffs' would directly address private sector investors' primary concern – lack of confidence in governments' commitment to preventing climate change. Given that failure to perform would incur costs, governments would have real incentives to meet their own emission targets.

Bonds could be created against other government risks too, such as education or healthcare. Companies would locate corporate facilities in deprived areas that governments claim they will improve, and hedge the risks of non-performance with government debt. Investors want to 'cuff' governments to their targets, not invest alongside them.

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ILCBs: nuclear option?

Index-linked carbon bonds (ILCBs) are government-issued bonds where interest payments are linked to levels of feed-in tariffs for renewable energy, emission certificate prices or greenhouse gas emissions. Investors receive an excess return if targets are not met. Investors can hedge projects or technologies that pay off in a low-carbon future because, if the low-carbon future fails to arrive, the government pays them higher interest rates. ILCBs eliminate the uncertainty of whether government policy is actually directed at a low-carbon future.

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