Who should bear carbon risk?

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A Call To Shield Companies From Carbon Risk Is A Common Trope In Policy Recommendations

- Carbon cap-and-trade versus carbon tax
  - Advocates of a tax claim that the price under a cap is volatile, while a carbon tax would be fixed. This would offer companies valuable certainty, improving the incentives to invest in low carbon
- Accepting the framework of a cap-and-trade system, many look to ways to limit price volatility.
  - There is volatility and volatility, but these proposals often make little distinction, and simply assume that any reduction in volatility, whatever the origin, is unambiguously good.

Standards and Principles for Assessing Public Policy Recommendations

- Model #1:
- Starting premise is that a large swath of economic activity can be efficiently and dynamically managed via private enterprises. The complementary role for government is to organize and police the markets, shape the rules within which business operates.
- This includes "internalizing" externalities, i.e., putting a price on carbon.
  - The whole point of putting a price on carbon is to exploit the profit making skills of business to pursue economic development along a socially optimal path.
  - Generally best to avoid favoring specific technologies and picking the paths for economic activity. Once the externality has been internalized, it is up to private enterprise to weigh the costs and benefits and select technologies and paths.
- Drilling down into a world of risk and uncertainty, how do we apply this basic framework? …

Risk and Valuation

- Risk is a normal part of economic activity.
- Companies are expected to evaluate all economic activity, plans, investments, R&D programs, and so on, with a critical eye to the risks involved.
  - Companies weigh risk and return.
  - Companies discount risky forecasted returns, and place a premium on more reliable payoffs.
  - This yields the right evaluation of tradeoffs across different alternative investments.
  - No economic activity is "worthwhile" independent of its risk. If the payoff is good, but risky; and if the payoff looks positive without discounting for the risk and negative after discounting for the risk, then the activity is "not worthwhile"
- Companies should bear risk. That is a part of what it means to "internalize" all costs in all the forms.
- Shielding companies from risk distorts their incentives, producing the "wrong" outcome… lower social welfare.

The oft forgotten MM Theorem … or its corollary in markets for risk

- Defenders of state activism vis-à-vis risk appeal to the value of risk sharing usually never bother to formalize the rationale for doing this.
- But when they do, they argue that risk borne by an individual company is expensive, while transferring the risk to the state allows it be broadly shared across all, therefore reducing the cost of the risk.
- This argument completely forgets the role of capital markets in socializing risk.
  - Indeed, the main tool for risk sharing are the global capital markets, especially the equity capital markets. Key economic risk factors are “priced” in the capital markets, where what matters is the risk borne by a well diversified shareholder.
  - This price of risk determines the valuation of all risky projects or economic activities containing these risk factors.
  - The corporate entity is a pass through for risk and value.
  - Hedging at the corporate level has NO first order benefit to the value passed along to shareholders.
  - Hedging at the corporate level is always done at a fair price. You offload risk ONLY at the cost of also offloading return. The shareholders do NOT benefit.
- Passing the risk from corporations to the states does not generally lower the cost of the risk nor the cost of the carbon policy.

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State action to shield companies from risk is a subsidy by another name.

- Where private investors would demand compensation for accepting risks that the corporation would normally bear, …
- advocates ask the state to bear the risk without accepting compensation.
- Shielding a company from risk amounts to a subsidy. It just raises the value of a given activity.
- If we need to subsidize, shielding a company from risk is seldom the right “mode” for a subsidy.

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Carbon Risk: Predictability? Its overrated.

- Companies are used to uncertainty.
- Of course, public policy shouldn't ADD to uncertainty. Of course, policy makers can exercise their role in ways that unnecessarily impose risks on companies that could be avoided.
- But neither can public policy insulate investors from the inherent risks and uncertainty at hand. And it shouldn't try to do so.
- The inherent uncertainties in the carbon problem are enormous. They encompass scientific uncertainties, technological uncertainties, economic uncertainties, not to mention political and diplomatic uncertainties. In general, many of these are risks no different from a social welfare point of view than those that face private enterprise in all economic sectors.
- The price for carbon will naturally and inevitably reflect these uncertainties, just as do prices for all sorts of other commodities, products and services. It is the job of corporate managers to assess these risks and make the appropriate investments.
- Yes, the "cost of capital" will be higher if the price of carbon is uncertain. But it is appropriately higher.
- Predictable prices are only good if the policy maker is clairvoyant and able to pick the right price to lock in.

Model #2?

- These few slides have touched on the right "perspective" on risk in the neo-classical economic world, and the neo-liberal political economy strategy.
- There are a plethora of (i) exceptions WITHIN this framework, and (ii) other models and motivations for state intervention into the economy OUTSIDE of this framework.
- Maybe the right approach to carbon risk and private enterprise is different within these contexts.
- I just don't have time in this short talk to go there.
- But I also don't think very many of the advocates for shielding companies from carbon price risk have gone there either.

The End

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