

WebMemo



Published by The Heritage Foundation

No. 2277
February 6, 2009

The Problem with Increasing Energy Loan Guarantees

Jack Spencer

There has been a push to expand the clean energy loan guarantee program established by the Energy Policy Act of 2005. Despite there already being tens of billions authorized for guarantee, some are pushing to add up to \$100 billion more in the stimulus bill.

Although most alternative and renewable energy sources are eligible, only nuclear energy has the near-term promise to actually achieve America's economic and environmental goals. Therefore, it is critical to the future of the nation to understand how loan guarantees will help or hinder nuclear power.

Market Distortion. The program, under which the government guarantees bank loans for power projects, was originally sold as a way to help move new, clean energy sources toward market viability. Regarding nuclear power, given the past role of organized political opposition and overzealous regulators in making the industry uncompetitive, some limited, near-term help to reduce government-imposed risk seemed appropriate. In support of including nuclear energy as part of the program, former Secretary of Energy Spencer Abraham argued, "I am not calling for massive ongoing subsidies to the nuclear industry, [but] I do believe some federal financial participation is in order to help defray a percentage of the high, first-time costs associated with new generation construction."¹ The same was argued for other energy sources as well.

But as America edges toward a \$150 billion loan guarantee program, not all of which will go to

nuclear, this starts looking very much like an ongoing subsidy.

And it is a subsidy that does not need to be extended. Consider an exchange between Senator Richard Burr (R-NC) and Secretary of Energy Steven Chu during his recent confirmation hearing. Senator Burr suggested that the existing loan guarantee program was so poorly run that utilities were being forced to build reactors without the loan guarantees.

Emblematic of the subsidy-first mentality of modern U.S. energy policy, Burr and Chu deduced not that this demonstrates the market viability of nuclear power but that the subsidy program should be more workable. They are inviting government dependence.

And that is the problem with loan guarantees: They distort normal market forces and encourage government dependence.

One problem with the larger national economic debate is the notion that money—or, more accurately, savings or capital—does not grow on trees. It comes from real people who have saved and invested and exists in finite amounts. By subsidizing a portion of the actual cost of a project through a loan guarantee, the government is actually distort-

This paper, in its entirety, can be found at:
www.heritage.org/Research/EnergyandEnvironment/wm2277.cfm

Produced by the Thomas A. Roe Institute
for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002-4999
(202) 546-4400 • heritage.org

Nothing written here is to be construed as necessarily reflecting
the views of The Heritage Foundation or as an attempt to
aid or hinder the passage of any bill before Congress.

ing the allocation of resources by directing capital away from a more competitive project.

This signals to industry (be it nuclear, wind, clean coal, natural gas, or anything else) that it does not have to be competitive. It reduces incentives to manage risk and be independent, innovative, and efficient. The end result will be a new nuclear industry that is built for the short run and not sustainable.

While a loan guarantee may be good for the near-term interests of the individual guarantee recipient, it is not good for consumers, taxpayers, or long-term competitiveness.

How Loan Guarantees Distort the Market

- ***They remove incentives to decrease costs.*** The loan guarantee discounts the cost to build a project, and this artificial price reduction allows the recipient's project to be market viable at a point where it otherwise would not be. The consumer will eventually have to pay for this artificial reduction either through higher prices once the subsidy is removed or by being denied access to the less expensive technology that the guarantee recipient displaced. Eventually, these inefficiencies will result in higher electricity prices for consumers.
- ***They stifle competition and innovation both between sectors and within sectors.*** The loan guarantee artificially reduces the cost of capital, which allows a recipient to offer its product at below actual cost. This removes the incentive to look for less expensive or more competitive options. If a product is not competitive in a free market, then it should be allowed to adjust or fail.

Part of the success of nuclear energy will depend on competition within the industry. While a utility might not be able to afford a single large reactor without subsidies, it might be able to afford multiple smaller reactors or a reactor based on some other technology. This would create competition, and the subsidized technologies would have to either reduce costs or lose market share. This competitive environment, with other energy sources and within the nuclear sector, would

force the entire industry to become more efficient, innovative, and cost effective.

- ***They perpetuate the regulatory status quo.*** Nuclear energy could transform how the nation produces energy. But one of the big problems with the success of nuclear power in the United States is not that it lacks subsidies but that the regulatory environment for nuclear power does not promote growth, innovation, or competition.

Assuming the permitting process works perfectly, it takes the Nuclear Regulatory Commission four years to permit a new reactor. That is too long. Furthermore, the commission is prepared to permit only one type of reactor, essentially limiting competition to a handful of companies and one technology.

Another regulatory obstacle is the nation's dysfunctional nuclear waste management strategy. The federal government has taken responsibility of nuclear waste (or used fuel) management, allowing nuclear power users to ignore waste production—a critical element of the nuclear fuel cycle—when developing their business models. Because each nuclear technology produces a unique waste stream that has its own characteristics, some reactor types would be more attractive than others depending on how the waste was being managed. But so long as nuclear operators do not have to consider waste management, reactors with attractive waste characteristics can be ignored.

Furthermore, developing a sound approach to waste management would substantially reduce investor risk, which would be reflected in lower financing costs. Guaranteeing the loans reduces near-term pressure to fix this ongoing problem.

- ***They suppress private-sector financing solutions.*** Companies invest in major projects with substantial risk all the time and do so without government loan guarantees. If they believe that the potential reward justifies the risk, they figure out a way to secure financing. This might include

1. Ben Geman, "Power: Ex-Energy Secretary Urges Doubling of Nuclear Capacity," Greenwire, Energy Policy and Markets, Vol. 10, No. 9, February 25, 2005.

forming a consortium with other firms to share risk or developing an industry insurance scheme of some sort. Numerous companies exist in the private sector to insure large projects. Finding a way to develop an investment is at the heart of capitalism. But loan guarantees distort this process and remove the incentive to come up with better long-term solutions.

Encouraging Government Dependence. While the significant costs of the program are paid by the applicants and limited subsidies can have a role in overcoming some initial regulatory uncertainty, expanding the loan guarantee program as part of the stimulus bill is not appropriate. It is detrimental to taxpayers, consumers, and long-term competitiveness.

It seems that business models are being based more on subsidies, preferences, and protections rather than on sound market principles. The result is that the prospect of a rebirth of the American nuclear industry is coming dangerously close to being completely dependent on government largesse before even one plant is built.

And that is why adding a massive, long-term energy loan guarantee program is just one more example of how the stimulus package has gone awry. Instead of a series of short-term incentives that promote real and sustainable economic growth, it is a massive spending bill with provisions that should go through the normal legislative process.

—Jack Spencer is Research Fellow in Nuclear Energy in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.