The Third Man

Investor influence on business preferences for climate change policy instruments in Canada

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Abstract:

The majority of research on business government relations in political science assumes that business preferences for government policy result from a firm's need to maximize profit and, consequently, that preferences are fixed, exogenous to the political system, and pecuniary in nature. This assumption, however, cannot explain the variation in business preferences for climate change policy instruments in Canada. Recent studies suggest the significance of government policy expectations for business preferences. This paper undertakes a historical review of government climate policy and business preferences for climate change policy instruments from 1988-2009 to test this hypothesis. It demonstrates that the most significant variable in business preference change was not government action, but investor concern. This is not to say that expectations for government policy do not matter to business at all, but that they matter most through the intervening variable of investor confidence.

Introduction

That business preferences influence government policy-making is a matter of rare consensus among political scientists. A prolific literature, largely from the United States, has debated and discussed the significance and variability of that influence (Vogel: 1989; Young and Everett: 2004; Truman: 1981), as well as the many manners in which corporations and business associations go about influencing policy outcomes (Wright: 1990; Hall: 2006). The more fundamental questions of how business preferences for government policy are formed, or even what those preferences are, have garnered far less attention.

Most political science research on business-government relations assumes a conceptualization of the firm as profit maximizing (Mitchell: 1997). Despite the existence of influential work in economics strongly criticizing this classical economic assumption from the 1960s onward (Cyert: 1963 (reprint 1993); March: 1962; Galbraith: 1967), this perception has been extremely durable within our discipline. As a result, the vast majority of research in political science assumes, either explicitly or implicitly, that firm preferences are fixed, exogenous to the political system, and pecuniary in nature. In

* Kaija Belfry is a PhD Candidate in Political Science at the University of British Columbia. She would like to thank Doug Munroe, PhD Candidate at the University of Calgary, for his patient editing and Kathryn Harrison for her continued guidance. This research would not have been possible without the support of the Weyerhaeuser Foundation, Sustainable Prosperity and the University of British Columbia.

other words, for most political scientists, business preferences are equal to those of a clear and rational "economic man".

Two recent studies have questioned this view. In his study of business reaction to neoliberal policy reforms in Brazil, Kingstone (1999) found that business preferences varied with the government's credibility in implementing them. In Canada, MacDonald (2007) established that the nature of an external threat (the characteristics of the policy itself and the effect that policy will have on company operations) was the most significant factor influencing business political action on environmental policy. These studies are supported by earlier work by Mansbridge (1992) and Lindbolm (1968) arguing that policy preferences are malleable and influenced by deliberation. For these scholars, therefore, business preferences are better conceived as the interaction between an "economic man" and a "policy-making man".

This paper argues that a third man is involved in preference formulation: the investor. Based on a study of business preferences for climate change policy instruments in Canada from 1988-2009, this paper demonstrates that while business interaction with government clearly influenced both government policy choices and, to a lesser extent, business preferences, the most significant shifts in business preferences resulted, not from government pressure, but from concern over investor confidence. Indeed, it was concern over investor perceptions that led the Canadian Association of Petroleum Producers to agree (if temporarily) to a price on carbon in a deal with the government in 2002, and led the entire business community to support carbon pricing after 2006-2007. In both cases, investors – not government – were the catalyst that led industry to shift preferences, accepting and even advocating more coercive and costly policy instruments.

This paper explores this dynamic in three parts. Part one outlines the economics of climate change policy instruments and introduces the methodology of this study; part two provides a historical review of government policy and business preferences from 1988-2009; and part three makes the case that investor confidence was the most significant variable in the two major shifts in business preference in 2002 and 2006.

The Puzzle: Climate Change Policy Instruments in Canada

Climate change policy provides, in many ways, the ideal forum for a study into business preferences for government policy. Unlike many other policy areas, climate change policy aims to interfere directly in the economy and seeks to change firm behavior at a fundamental level. As a result, almost all major industrial associations and the majority of large firms in Canada currently have clear preferences for a particular policy instrument.

Interestingly, by 2009, there was considerable variation in the type of policy instrument supported by industry associations and firms, although the vast majority supported some form of carbon pricing. This is surprising because, from a purely economic perspective based on the theoretical cost of an instrument, we would expect firms to prefer subsidies and voluntary agreements.

Of available instruments, subsidies and voluntary agreements are the cheapest policy options because, in the former case, the cost is paid by the state and, in the latter case, there is considerable leeway to negotiate weak targets. Grandfathered cap-and-trade, where firms are allocated free credits up to a certain "cap" and then may trade

credits to ensure they do not exceed their cap, would be the firm's third choice, as it provides considerable flexibility in compliance. "Command and control" regulation is more costly because firms must pay the cost of abatement above a standard set by government and there is no flexibility in compliance. Finally, taxation is expected to be the last choice of firms, as it requires payment of a particular price set by government on *all* emissions, not just those above a certain cap or standard. Consequently, we would expect a firm's order of preference for climate change policy instruments to be: 1) subsidies, 2) voluntary agreements, 3) grandfathered cap-and-trade 4) traditional "command and control" regulation, and 5) carbon taxation (Field and Olewiler: 1994).

Two areas of complication exist. First, credits in a cap-and-trade program can be auctioned, meaning that firms would pay a price on all of their emissions. In this case, cap-and-trade acts similar to a carbon tax and we would expect business preferences to adjust accordingly. Second, revenue-neutral carbon taxation, where taxation revenue from a carbon tax is counteracted by a corresponding decrease in other taxes, may be more palatable to industry than regular carbon taxation. A firm might have all or most of its carbon tax payments returned through reductions in corporate taxes, for instance, and therefore be no worse off due to the carbon tax. It is equally likely, however, that government would decrease income taxes and not corporate taxes and that corporations would see a considerable increase in taxation as a result. It is, therefore, impossible to know where a revenue neutral carbon tax would fall on a firm's theoretical order of preferences, without more information on the details of the program.

In any event, the case of business preferences for climate change policy instruments in Canada offers a fascinating opportunity to explore business preferences for government policy, both because most firms and associations were actively articulating preferences by 2009 *and* because these preferences ran contrary to theoretical expectations. By 2008, almost all firms and associations no longer supported voluntary agreements and subsidies (their theoretical top choice) but strongly advocated carbon pricing, either through grandfathered cap-and-trade or carbon taxation. This puzzling phenomenon begs the question: why?

This study's qualitative methodology is primarily based on sixty interviews with business leaders and elite observers, including government and NGO officials. These were coupled with a comprehensive review of documentation on business preferences for climate change policy instruments from 1988-2009, including press releases, parliamentary committee testimony, letters and memos to government officials, media reports, meeting minutes and corporate annual reports.

A Historical Review of Climate Change Policy and Business Preferences in Canada

The following historical review compares government policy and business preferences from 1988-2009. As there is considerable literature on climate change policy in Canada, this historical review focuses on business preferences (an area in which the literature is sparse) and provides only a brief summary of government policy (for reviews of climate policy, see Smith: 1999; Macdonald: 2007; Bernstein: 2002; Hoberg: 1994; Harrison: Forthcoming; Harrison: 2007). Moreover, this review focuses on domestic climate policy and business preferences for domestic policy options; it does not

examine Canada's international treaty negotiations in detail or business preferences for international mechanisms.

The Beginning: 1988-1993

Canadian climate change policy was conceived at the 1988 *World Conference on the Changing Atmosphere* in Toronto, where international dignitaries and scientists, including Canada's Prime Minister, met for the first major conference on climate change (Bulkeley: 2003). Over the following five years, the Mulroney government made climate change, along with other environmental issues, a major policy priority. Many observers, however, criticized the government's 1990 Green Plan as weak and ineffectual (Hoberg: 1994). The plan focused on public education and spending and avoided any attempt to interfere in business behaviour (Hoberg: 1994).

While media, opposition and environmental groups, were unimpressed by the government's plan, industry and the provinces were far less antagonistic, largely because the plan's weak and vague measures caused little concern (Hoberg: 1994). Indeed, during the period from 1988 to 1993, business preferences for climate change policy instruments were largely articulated in the negative: business was against regulation of any sort, particularly environmental taxes. When an early draft section of the Green Plan calling for a carbon tax was leaked to the Business Council on National Issues (BCNI), the organization reacted swiftly with calls and visits to the Prime Ministers office. The final draft of the plan did not include the offending reference.

Towards Kyoto:1993-1997

The Chrétien Government came into office in 1993 promising to beat the previous government in the environmental policy arena. Initially, however, the government allowed civil society to set the pace of action through the Climate Change Task Group, made up of NGO and business leaders. Government had hoped that the group would reach a consensus on climate change, providing political cover for any subsequent actions (LeBlanc: 1995). When the group published 88 recommendations in June 1994, they called overwhelmingly for the use of voluntary programs, public education and subsidies (Macdonald: 2007; Bramley: 2000; Hornung: 2000).

From 1993-1995, Cabinet was split on the climate change issue. Environment Minister, Sheila Copps, supported regulation, while Natural Resources Minister, Anne McLellan, the government's representative from Alberta, strongly favoured voluntary agreements (Smith: 1999). McLellan's view was supported by industry. In November 1994, the Business Council on National Issues sent out a press release entitled, "Canada's Business Leaders Outline a Voluntary Strategy to Combat Global Climate Change" (Business Council for National Issues: 1994).

Three months later, it became clear that McLellan had won the battle in cabinet when she signed a Memorandum of Understanding (MOU) on behalf of her department with the Canadian Association of Petroleum Producers (CAPP). In the MOU, government and the oil industry agreed to work together on the development of a voluntary carbon registry program (Smith: 1999). In February 1995, the government announced its National Action Program on Climate Change (NAPCC), which had as its focal point the Voluntary Challenge Registry (VCR) (Macdonald: 2007). In the lead up

to Kyoto, therefore, voluntary agreements remained the governments main policy instrument in addition to subsidies.

Post Kyoto: 1997-2001

After the federal government agreed to an onerous cut of 6% of 1990 levels under the Kyoto Protocol, Mr. Chrétien tried to mend fences by promising greater consultations with both the provinces and civil society (Harrison: Forthcoming). In 1998, the provincial and federal environment and energy ministers jointly initiated a National Climate Change Process. Central to the process was the creation of 16 issue tables in which 450 experts from all levels of government, industry, environmental groups and the scientific community were brought together to discuss a number of facets of climate change policy (Bramley: 2000).

The issues tables provided industry representatives with an opportunity to both learn about climate change policy and articulate their preferences. In the report of the Upstream Oil and Gas working group under the Industry Issues Table, for instance, the oil and gas industry continued to argue in favour of voluntary programs. Over the longer term, it conceded that flexible international mechanisms were reasonable; however, it went to great lengths to highlight the problems with domestic emissions trading (Upstream Oil and Gas Working Group: 1999). Thus, throughout the late 1990s, industry remained squarely in favour of voluntary agreements in the near term. In 2000, the government issued *Action Plan 2000* which demonstrated its continued accord with industry, focusing on spending programs and public education (Bramley: 2000). These programs supplemented the Voluntary Challenge Registry, which remained operational from 1997-2004 (Macdonald: Forthcoming).

The Ratification debate: 2002

While government climate policy shifted little throughout the 1990s, that changed in 2002 as the government prepared to ratify the Kyoto Protocol. In May, 2002, the Government of Canada published a *Discussion Paper on Canada's Contribution to Climate (Government of Canada: "Discussion Paper on Canada's Contribution to Climate": 2002)*. The paper laid out three options for Canada's climate change policy, including domestic emissions trading. With this document, the government signaled for the first time its willingness to consider "regulation or, possibly, fiscal measures" in the fight against climate change (Government of Canada: "Discussion Paper on Canada's Contribution to Climate": 2002: 19). This shift was confirmed in November when the government released another plan, which for the first time linked subsidies with "covenants, with a regulatory or financial backstop, and emissions trading with access to domestic offsets and international permits" for large industry (Government of Canada: "Government of Canada Releases Climate Change Plan for Canada": 2002).

During this period, industry fought the government with vigour. Throughout 2002, Canadian corporations and associations mounted their "largest effort to date to influence the environmental policy of the government of Canada" (Macdonald: 2003: 2). Letters from major associations were sent to the Prime Minister and relevant ministers starting in September 2001 and other lobbying techniques continued throughout 2002 (Macdonald: 2003). The Canadian Council of Chief Executives (CCCE), formerly the Business Council on National Issues, published a policy statement*, The Kyoto Protocol*

Revisited in June. The statement called for greater public investment in research and development (subsidies), continued use of voluntary agreements, and argued forcefully against domestic emissions trading (CCCE: 2002).

In September, business groups formed the Canadian Coalition for Responsible Environmental Solutions (CCRES) to fight ratification. In its inaugural press release, the group again called for a "made-in-Canada" (Macdonald: 2003). Over the following two months, CCRES representatives, led by CAPP and CCCE officials, wrote letters to high level officials, appeared before parliament, created websites in both official languages and began a major television campaign (Macdonald: 2003). Despite the large expense in effort and money, the group was ultimately unsuccessful: the government ratified the Kyoto protocol in December 2002.

The Deal: Fall 2002

Publicly, it appeared that business and government could agree on little in the fall of 2002; privately, however, they managed to come to an accord. In a letter to CAPP, dated December 18th, five days after ratification, the Minister of Natural Resources made a surprising commitment to industry. The government would not ask petroleum companies to pay a price on carbon greater than $15/tonne and industry's target would be only 15% below business-as usual in 2010, far less than the Kyoto commitment (Dhaliwal: 2002). While no formal agreement was ever signed between government and industry, the letter represented a negotiated settlement between the government and the petroleum sector, which, at the time, both parties accepted (Alvarez: 2010). It was the culmination of three months of negotiations between the Prime Minister's own deputy (the Clerk of the Privy Council), the Minister of Natural Resources, and the President of CAPP, Pierre Alvarez (Alvarez: 2010).

The NRCan years: 2003-2004

In the wake of this agreement, Chrétien designated National Resources Canada (NRCan) as the lead department on climate change. While NRCan moved developed policy options, no policy ever made it past the proposal stage during this time. Nonetheless, during this period, NRCan's Large Final Emitters Group was in consultation with industry on a system that would include binding covenants (negotiated agreements) with an emissions trading component.

Despite its apparent acceptance of carbon pricing in the fall of 2002, the oil industry quickly returned to a state of pessimism and hostility where climate change policy was concerned. In the February/March 2003 edition of HAZMAT magazine, CAPP president Pierre Alvarez lamented the treaty's effect on competitiveness:

> Canada is the only country with a growing energy sector that is forcing the industry to absorb an additional financial burden associated with reducing emissions. The result will be to add more costs on hydrocarbon basins that are already some of the highest cost places to produce oil and gas in the global market. (Crittenden: 2003).

Alvarez argued that, "energy innovation, research and development programs hold far more promise" than other options – in other words, for CAPP in early 2003, subsidies

remained the preferred instrument (Crittenden: 2003). For other major associations, like CCCE, "covenants" may have been acceptable but a "regulatory backstop" was not (Proceedings "Senate": April 3, 2003).

Over time, however, the preferences of some firms and one association began to shift, however slightly, in response to government policy changes. In fall 2003, the Government signed memorandums of understanding with the Forest Products Association, Dupont Chemicals and the International Emissions Trading Association (IETA), the latter supported by a number of firms. All three MOUs laid out the principles involved in a potential emissions trading system (GreenBiz: 2003; Government of Canada: 2003). While these principles were generally broad, they do demonstrate growing acceptance by some firms that emissions trading was likely (CIPEC: 2003). Nonetheless, the majority of firms and associations at this time remained hostile to regulation (Bradley: 2009).

The Dion Years: 2004-2006

Immediately following Paul Martin's ascent to the office of the Prime Minister in December 2003, little changed in the realm of climate change. After the subsequent election in June 2004, however, Martin appointed former intergovernmental affairs minister, Stéphane Dion, as Environment Minister. Dion lobbied hard to have the climate change file moved from NRCan to his department and ultimately succeeded in 2005 (Former Advisor to Minister of the Environment: 2009). His department subsequently developed regulations, which included intensity targets for large emitting industries, emissions trading, and a technology fund for partial compliance. In July 2005, the government published a *Notice of Intent to Regulate* in the Canada Gazette (Government of Canada: 2005). In November, the government added carbon dioxide to the Canadian Environmental Protection Act (CEPA) list of toxic substances, providing the legislative authority for regulation. Dion planned for the actual regulations to be published in January 2006 (Former Advisor to Minister of the Environment: 2009).

During this period, the majority of business actors remained hostile to regulation (Former Advisor to Minister of the Environment: 2009). In January 2005, the Canadian Chemical Products Association (CCPA) wrote to Minister Dion arguing in favour of a Memorandum of Understanding between the chemical industry and the government. CCPA was not, however, looking to support a regulatory cap-and-trade program. Instead, they called for an MOU in the place of "permitting or other climate change legislative or regulatory measures"(Paton: 2005).

The day after the government unveiled its new climate change plan in April 2005, CCCE put out a press release decrying the governments continued focus on meeting its Kyoto targets. The release again called for a "more innovative, made-in-Canada approach" to "develop new technologies" (CCCE: 2005). According to senior staff in the Minister Dion's office at that time, CCPA and CCCE were not alone in this: "No one was saying regulate [in 2004-2005]. Everybody was saying, 'let's keep it voluntary. We're taking voluntary action. Trust us. Trust us'"(Former Advisor to Minister of the Environment: 2009). According to senior ministerial aids, industry continued to extol the virtues of voluntary programs up until the Liberals left office in early 2006 (Former Advisor to Minister of the Environment: 2009).

The Harper Government: 2006

In January 2006, after a surprise election, Conservative leader, Stephen Harper, became Canada's new Prime Minister. Mr. Harper had previously made clear his skepticism about climate change (Harper: 2002) and during his first six months in office abandoned all of the previous government's climate policies (Harrison: Forthcoming). When his government put out its "Made-in-Canada" plan in October 2006, in the guise of the Clean Air Act, it focused primarily on conventional air pollutants and delayed any possible climate regulations until after yet another round of consultations.

Given that a "made-in-Canada plan" was first proposed by the CCCE in 2002, it is understandable that most in the business community thought the threat of regulation had subsided in early 2006. Industry's first strategy in this new political environment was to attempt to influence the new government's future plan. In Summer 2006, CCCE drafted a memorandum for Environment Minister, Rona Ambrose, which emphasized investment in new technologies and feasible targets, suggesting that the organization continued to support public spending and voluntary agreements at that time (CCCE: 2006).

By the time that the Conservatives announced their plan in October 2008, however, the political landscape had changed. The public, which had been largely inattentive to climate issues, suddenly became interested and concerned. In January 2006, only four percent of respondents viewed the environment as the most import issue facing the nation. By July, climate change had moved into second place after health care and by January 2007 it was considered the most important issue with the support of 26% of respondents (The Strategic Council: 2009). As a result, both the business community and the Harper government found themselves offside with the public.

This shift in public opinion clearly influenced business preferences. CCCE may still have been prevaricating about regulation in July, but by November it was being forceful and clear. While testifying in front of a Commons Committee, CCCE Representative John Dillon declared, "Industry is not opposed to regulation, as many of our critics have tended to suggest" ("Evidence": 2006). Despite the implication that support of regulation was a long time industry policy, this was the first indication CCCE had ever given publicly that it, or its members, would accept a regulatory instrument. It also represented the beginning of a significant shift in business preferences for climate policy.

A Climate of Change: 2007-2008

Having fully digested the public's mood, governments – both provincial and federal – began to put in place concrete regulatory frameworks in 2007. At the federal level, the government replaced its rookie environment minister in January 2007 and announced a regulatory policy, *Turning the Corner*, in April. In March 2008, more details were provided. The policy would similar to the previous government's regulatory framework: intensity targets for large industry, domestic emissions trading to reach targets, and a limited compliance technology fund at $15/tonne. The technology fund component was to be phased out by 2018 (Environment Canada: 2008).

At the provincial level, Alberta and British Columbia put in place significant prices on carbon. In 2007, Alberta implemented the former Dion ministry's ready-made

climate policy[1], with two exceptions: credits could only be purchased in Alberta and there was no limit on the use of a technology fund. In BC, the government announced its revenue neutral carbon tax in 2008. During this same period, the federal Liberals also proposed a carbon tax, which they called *The Green Shift*. The idea that was soundly rejected by the public in the 2008 general election, however. Finally, Ontario, Quebec, Manitoba and BC joined the Western Climate Initiative, promising to implement a cap-and-trade program by 2012.

In 2007, business preferences also shifted decidedly in favour of carbon pricing. Interviews for this study were carried out with 13 associations and 17 firms in 2008 and 2009. At that time, all but one association and one firm articulated clear support for carbon pricing. Moreover, most traced this preference back to 2006/2007, a claim that is supported by documentation from the period. The majority of associations and firms supported grandfathered cap-and-trade, but five firms and one association articulated preferences for taxation. Additionally, in one firm and four associations where no official preference existed, representatives articulated personal support for carbon taxes, indicating that at least among some within industry there was strong support for the instrument.

Waiting for Obama: 2008-present

After the eruption of the economic crisis during the 2008 Canadian election and the subsequent election of President Obama in the United States, the Canadian government abandoned its planned regulatory policy. As of May 2010, it continued to delay policy implementation, claiming that the government was waiting for the American administration to act in order to create a continental policy (McCarthy: 2010). Surprisingly, despite the government's retreat, the business community remained strongly in favour of carbon pricing in 2009, suggesting that once a preference is adopted, industry is far less likely to abandon it than government. The reason for this is discussed in greater detail below.

The Third Man: Investors and Business Preferences

Summary of business preferences and government policy

The preceding historical review summarizes government policy on climate change and business preferences for climate change policy instruments in Canada over a twenty-one year period from 1988 to 2009. During that time, both government policy and business preferences changed, at times in tandem, suggesting a relationship between the two (although this covariance weakened after 2006). Part three of this paper will demonstrate that while industry clearly prefers less costly policies when left to its own devices, this tendency is not absolute; industry preferences are affected by other actors, namely governments and investors. Moreover, while there is some support for findings that focus on government's influence on business perceptions of a policy option, this influence pales in comparison to that of investors. In the two time periods when business preferences shifted drastically, it was concern over investor confidence that led to this shift, not any action on the part of government.

[1] Intensity targets and emissions trading with a technology fund for partial compliance.

The pattern of business preference and government policy variation is plotted chronologically in Chart 1. The policy instruments are arranged on an ordinal scale on the Y access by theoretical cost as detailed in part one above. Two adaptations to this theoretical preference ordering were required, however. First, while it is impossible to know where revenue-neutral carbon taxation will fall on the cost scale without the details of the policy, it is placed here with grandfathered cap-and-trade because business officials interviewed for this study considered these two policies to be alternative forms of carbon pricing. Additionally, neither auctioned cap-and-trade, nor non-revenue neutral carbon taxation have been included, as neither politicians nor business officials in Canada have seriously considered these options.

The data points plotted for the government represent clear policy declarations. for business, an estimated placement for aggregate business preference at a given time was created based on the most common preference of industry associations and firms at that time. This is possible because, despite industry's heterogeneity of products and processes, a majority preference was discernable at all time periods. The declared preferences of CCCE provided the key indicator of this placement, because they played a leadership role on climate change within the business community.

Chart 1: Aggregate Business Preference and Government Policy Changes from 1988-2009

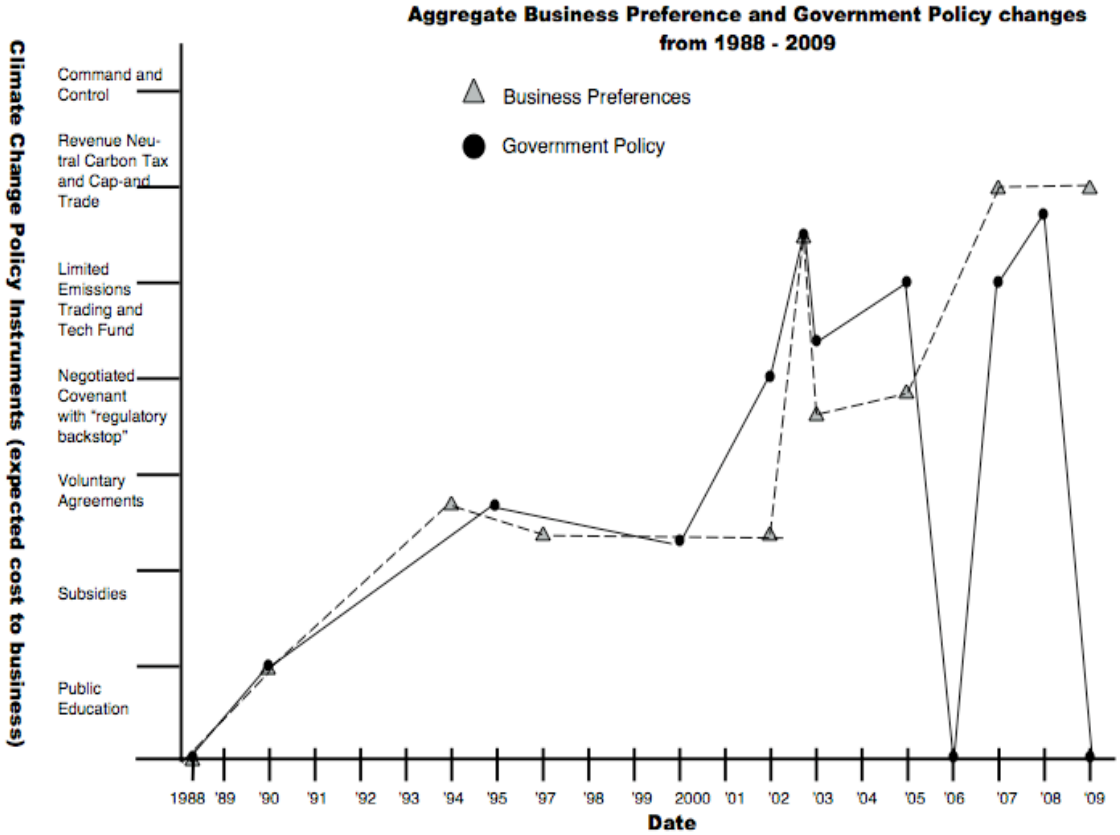

Chart 1 demonstrates that, between 1988 and 2006, business preferences and government policy followed a similar pattern. From 1988-2002, this was because

government allowed industry to set the tone of climate policy, deferring to its views first in the early 1990s and again in 2000. Interestingly, as the profit maximization assumption would expect, in the absence of external pressure, industry preferred the theoretically least costly policy instruments. Consequently, the characterization of business preferences as equal to those of an "economic man" does hold during this period.

It is possible, however, that, as Kingston found in Brazil, business preferences would be influenced by expectations of government action. Even if industry associations and firms actually preferred voluntary agreements and subsidies, they might shift their preferences in response to government policy declarations in order to ensure that the least costly of the range of *probable* policies was adopted. This was the case after 2002 when government became far less deferential to industry and began developing regulation.

Despite the fact that government by 2005 was moving as aggressively as ever on climate change, this had only a minor impact on aggregate business preference. While a handful of firms and one association signed memorandums of understandings on the principles of an emissions trading system, the majority of associations in Ottawa remained hostile to the concept of regulation and continued to argue in favour of voluntary initiatives (Bradley: 2009; Former Advisor to Minister of the Environment: 2009). This fact undermines the hypothesis that industry preferences are largely determined by expectations of government action or that, facing an expected loss in the policy arena, industry would concede to government in order to cut its losses. In other words, while "Policy-Making Man" may have been in discussions with "Economic Man," the former had only a minor effect on the latter.

As Chart 1 illustrates, there were two periods in which business preferences appeared to shift significantly. The first is in 2002, when government and the oil industry negotiated an agreement on a $15 price on carbon. This agreement was subsequently extended to all industrial sectors and, thus, is treated for the purposes of this analysis as aggregate business preference at the time. The second is in 2006, when industry moved to support carbon pricing. In both cases, these shifts resulted from concern over investor confidence.

An unexpected agreement: 2002

It is not surprising that government was willing to negotiate with industry in the fall of 2002, given the political challenge that the business campaign against the Kyoto Accord was creating for the Chrétien government (Macdonald: 2003). Nor is it surprising that industry was willing to negotiate with government; after all, the business community was beginning to recognize that Mr. Chrétien was intent on ratifying and, consequently, they may have wanted to gain as many concessions as possible (ISC3: 2002). That the negotiations were led by the Canadian Association of Petroleum Producers and that these negotiations led to an agreement, given the level of animosity between industry and government at the time, is surprising, however. More surprising was the fact that that agreement included a price on carbon at $15/tonne.

Before this agreement, industry had given little indication it would accept a carbon price (with the exception of periodic and vague references to long-term use international mechanisms). Industry's *Made-in-Canada* approach showed no support of carbon pricing and industry groups had spent millions promoting this policy stance. That

the organization that led the charge in this campaign, the Canadian Association of Petroleum Producers, was simultaneously negotiating with government and accepting a price on carbon at any level was peculiar. It is made even more peculiar by the fact that as soon as the deal was done, oil industry representatives returned to their previous stance of supporting voluntary agreements and disparaging the costs of Kyoto.

As it turns out, the simplest explanation for these peculiarities is in part correct. The deal resulted from a need to limit the possible costs of future climate programs, which the ratification of Kyoto was deemed to make more likely. However, it was not that industry representatives themselves were concerned by the possible future costs of climate policy and, consequently, decided to concede on carbon pricing. Instead, the concern was voiced by a third party, which insisted that industry negotiate to create certainty around future carbon liabilities. That third party was the institutional investors whose funding was required to develop the Alberta oil sands (Alvarez: 2010) (Confidential Interview with a government official: 2009).

It is no coincidence that the deal resulted from negotiations between CAPP and government, and not any other association, despite CAPP's reputation for hostility towards climate policy (Fairbank: 2009). The organization was forced to act to ensure the continued growth of its industry. At the time, there were a number of upgrader projects under development in the oil sands[2]. These multibillion-dollar facilities required considerable external funding from institutional investors who at the time were refusing provide capital without greater certainty over the future price of carbon.

The lack of clarity on a future carbon price increased the risk of oil sands projects for investors. Risk in portfolio management is defined as "the uncertainty that an investment will earn its expected rate of return" (Reilly: 2006). The greater the probability that expected returns will not be provided, the greater the risk. Riskier investments are only acceptable if they offer a higher return to offset the possibility that this return will not be realized (Reilly: 2006). In this case, uncertainty over the price of carbon made the risk-return tradeoff unpalatable for oil sand investors (in other words, the expected returns of the project were not high enough to counteract the increased risk). Petroleum companies, therefore, were forced to acknowledge that without greater certainty on this issue these major projects would have to be moved to areas without climate policy, where funding would be easily acquired (Alvarez: 2010; Confidential Interview with a government official: 2009).

Indeed, the True North project at Fort Hills, Alberta, was abandoned in 2002 due to a number of factors including uncertainty over a price on carbon (CBC: 2003). While this fact was not made official until January 2003, CAPP official, Rick Hyndman, referred to the project's cancellation in a presentation to the House of Commons Standing Committee on Industry, Science and Technology on December 11, 2002, suggesting the actual decision was made much earlier ("Evidence": 2002). Other projects threatened to follow suit. The Government of Alberta was understandably livid at the loss of investment and jobs and called on the federal government to act (Confidential Interview

[2] Upgrading is the process through which bitumen from the oil sands is transformed into synthetic crude oil, which is subsequently refined into gasoline and other petroleum products.

with a government official: 2009). Negotiations began and, by December, a deal was struck.

The Real Green Shift: 2006

Its investors now satisfied by carbon price certainty, oil industry representatives returned to articulating their actual preference for voluntary agreements and subsidies. This practice remained consistent across all industrial sectors (save forestry) in 2003, 2004 and 2005, with only a minor change due to the government's aggressive stance. In the fall of 2006, however, industry preferences began shifting substantially. Senior CCCE official, John Dillon, testified to a parliamentary committee that industry was not against regulation; the first indication ever given that the major industrial groups were no longer married to their voluntary-focused "Made-in-Canada" approach. This testimony took place several months after polls had shown that climate change was now a top issue for Canadians, and while the government was still trying to defend its weak and insubstantial Clean Air Act. It was not until two months after Dillon's testimony that government finally conceded to public opinion. Consequently, it is clear that the shift in industry preference began prior to and independent of government policy, most likely as a result of the shift in public opinion.

Why did industry preferences shift in response to public opinion? It could be that industry cares about public opinion because members of the public are consumers and business leaders were worried that continued hostility to regulation would lead to decreased demand from angry customers. If this were the case, however, why did business not return to supporting voluntary agreements and subsidies once public interest in environmental policy fell drastically during the economic crisis in 2008 (The Strategic Council: 2009)? Instead, the entire business community shifted in favour of carbon pricing in 2006/2007 and remained committed to that preference throughout 2008 and 2009, despite retreating public interest (The Strategic Council: 2009).

This paper argues that firms care about public opinion because it is a convenient proxy for shareholder concerns. Unlike institutional investors, who can clearly articulate their risk perceptions to firms seeking funds, shareholders are a diffuse and disparate group, whose voices are only heard at a company's annual general meeting. Even then, shareholders often vote by proxy or they do not bother to vote at all (Coyle: 2004: 264). They are, however, no less important to a firm's ability to grow and survive and, if unhappy, will simply move their money elsewhere with problematic consequences for industry. As one petroleum company executive explained:

> When I talk about shareholders, it's just a recognition that it's not our money, it's their money. They expect and deserve a competitive rate of return. If they don't get it, you run the risk of having them withdraw their funds and having them go invest in someone else . . . [if a policy leads to a decrease in returns] you end up with Canadian companies being disadvantaged. Their credit rating goes down, their share price goes down, they still have reserves, someone comes along and takes them out. (Robson: 2009)

Given the lack of communication between company executives and shareholders, executives are forced to look for indicators of shareholder concern. Public opinion is one of those indicators.

Strong shifts in public opinion, like the one that took place in 2006/2007, demonstrate areas of potential shareholder concern. Shareholders, like other investors, analyze investments for their risks and returns. When public opinion shifts so decidedly, it is taken to indicate *both* a change in the direction of society *and* a clear awareness by shareholders of this shift. If a company is fighting against this direction, they are perceived to be less likely to be prepared for changing circumstances and are consequently perceived as a more risky investment. While this would have been no less the case had the Dion Ministry implemented regulation in 2005/2006 as expected, firms and associations at that time had no indication that shareholders were paying attention. In other words, while expectations of government action had little effect on business preferences independently, expectations for government action did matter to corporations once it was clear that shareholders had noticed and were concerned.

Ensuring that investors perceive them as able to adapt to a low carbon society has lead all of the oil companies in this study to declare their readiness to face the "risks" of climate policy in their annual reports to shareholders over the past five years[3]. Indeed, there was a clear increase in references to climate change within the annual reports of these companies since 2006, suggesting a correlation between public opinion and corporate perceptions of shareholder concern. The, only exception was Suncor[4], which is considered the leader in climate change action within the industry. It referred to climate change in annual reports at a relatively constant rate from 2005-2009 (approximately 5 times per report). Other companies, however, clearly adapted their reports to shareholders in response to public opinion. Nexen, for instance, referred to climate change once time in 2005, never in 2006, three times in 2007, seven times in 2008 and thirteen times in 2009. In 2008, the company told potential shareholders, "We believe we are well positioned to meet the challenges of climate change and environmental regulations" (Nexen: 2008). Moreover, many of these companies listed climate change issues under the heading of "risks" or "risk management", further supporting the conclusion that climate change had become an area of investor concern, which companies wished to assuage.

Why did industry not shift its preferences back to less costly options once Canadian public interest collapsed and government policy threats subsided in the fall of 2008? These events, it turns out, did not decrease the likelihood of policy and movement towards a low carbon economy at the North American level. Ironically, while President Obama's election gave the Canadian government an excuse to abandon climate policy instruments, it increased the likelihood of carbon pricing in North America. International investors, therefore, continue to be concerned that firms will continue to provide expected returns in a low carbon future and, consequently, for Canadian industry, retreat was not

[3] The companies were: Suncor, Nexen, ConocoPhillips, Shell Canada and Petro-Canada.
[4] Petro-Canada, however, did not begin to increase references to climate change around 2006/2007 like other firms. Instead, that company never mentioned climate change until 2008 far later than the others. Nonetheless, there is an increase in references to the issue in the company's final annual report. Petro-Canada was taken over by Suncor in 2009.

an option. Instead, industry argues in favour of a price on carbon *now* to provide certainty to both institutional investors and shareholders.

Conclusion

Most research into business-government relations assumes business preferences can be reduced to pure profit maximization, akin to a rational and calculating "economic man". Recently, other studies have demonstrated that industry preferences are influenced by government policy expectations, suggesting the impact of a hypothetical "policy-making man". This paper argues that a third man, the investor, significantly influences business interaction with government on public policy. While the argument here does not deny that government policy does influence business preferences and vice versa, the most significant influence on business preferences for climate change policy instruments in Canada is investor confidence. In other words, expectations for government policy matter, but they matter most through the intervening variable of investor confidence. It was when investors began to articulate their concern over the implications of possible government action, either directly or through the proxy of public opinion, that industry changed its preferences in favour of more costly, regulatory policies. Otherwise, despite shifts in government policy, industry had remained overwhelmingly in favour voluntary agreements and subsidies.

This research demonstrates that, while the profit maximization assumption still has a place in the study of business-government relations, business preferences are more complicated and variable than the assumption implies. As a result, political scientists should expect business preferences for government policy to vary away from the theoretically cheapest options and that, where public opinion and/or investor attitudes are clear, a correlation will be found between those views and business preferences. Greater research is required, however, into the implications of investor influence for the policy making process. Areas of future study include: the significance of policy certainty for economic actors; the possibility of firm objectives other than profit maximization; as well as the role of subjectivity in managerial interpretations of investor risk. With respect to Canadian climate policy, however, the puzzle endures: contrary to all expectations, we have an indifferent public, an evasive government and a business community calling for action.

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