



Leveraging Market-Based Capital and Concessionary Capital for Critical Infrastructure Financing

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Abstract: This white paper explores the synergistic use of Market-Based Capital and Concessionary Capital to finance First Nations' equity investments in infrastructure projects. It highlights the benefits, challenges, and strategies for integrating these two forms of capital. Additionally, it delves into the critical role First Nations have in developing infrastructure projects.

Introduction

On June 21, 2021, Canada passed the United Nations Declaration on the Rights of Indigenous Peoples Act (the "UNDRIP"). Under UNDRIP, First Nations have the right to 'free, prior and informed consent' ("FPIC") to actions that affect their lands, territories, or rights. The process of FPIC often results in collaboration, co-management and/or co-ownership with First Nations in the affected territory.

FPIC can provide First Nations with many economic benefits, especially as an owner of a project or an existing asset. Ownership, rather than an annual impact benefit payment, can have long-term benefits and is the preferred path for many First Nations. However, meaningful ownership stakes require equity capital for investment. First Nations have had difficulty securing this capital due to economic, structural and legal barriers.

Infrastructure in Canada

Canada's aging infrastructure, a large portion of which was built in the 1950s to 1970s, is due to be replaced or substantially repaired. In addition, Canada's population growth, energy transition and climate goals have exacerbated the need for capital investment. McKinsey has estimated that Canada will require an annual incremental \$200 billion of infrastructure capital between 2021 and 2030. This is in addition to the \$350-\$400 billion of capital already deployed annually in Canada.

Relative to global competitors, Canada is underspending on infrastructure. For example, Canada's transportation and utility infrastructure sector has an asset-to-GDP ratio of 67%. This is lower than the global average of 71%. To correct this, Canada's spending would need to increase by \$10 billion annually in the transportation and utility sectors. Canada must build hydroelectric generation projects, transmission lines, highways, digital transmission and other critical infrastructure to increase its national productivity. The story repeats in other sectors – energy, critical minerals, social infrastructure, etc.

Given UNDRIP, First Nations must play a key role in these developments. Under the terms of the UNDRIP, specifically article 32.2, First Nations can help facilitate new projects by being engaged early in the process and having a meaningful say in environmental assessments, project planning, and development execution. First Nations may also secure benefit-sharing through this process. This would include economic benefits like employment, supply contracts and the opportunity to invest as an owner in projects. Achieving these benefits under the UNDRIP and FPIC, which until 2021 were not available, is a key step toward social and economic self-determination for First Nations.

Concessionary Capital

Concessionary Capital is funding provided or guaranteed by a Government or a Non-Profit organization at below-market interest rates. This capital is deployed to support projects that have social, environmental, or other societal benefits. Concessionary Capital has been a primary – and in many cases, the only – component of First Nations equity funding.

Without alternative private market sources, First Nations depend solely on Government or Non-Profit equity capital to invest in infrastructure. The capital can be provided through direct funding or a loan guarantee. In the case of a loan guarantee, a third party (e.g. a Life Insurance Co.) provides a loan, and the Government guarantees the timely payment of interest and principal repayment. Concessionary Capital is the lowest cost of capital available. However, loan guarantees are not an unlimited source of capital, as they represent a potential future liability for the country or a province. If a project fails, the government must assume the liability, which might result in significant capital outlays such as the Trans Mountain pipeline expansion project ("TMX"). This type of cost overrun will draw the attention of Ratings Agencies, which assess the creditworthiness of governments, considering things such as tax revenues, debt levels, and contingent liabilities like loan guarantees. Too many loan guarantees and the Ratings Agencies may view this increase as a higher risk of default and result in a credit downgrade. The consequence of a downgrade is an increase in the government's borrowing cost on all its debt, not just the incremental loan guarantee amount. In Canada's case, an increase of 50 bps across all the Canadian debt equates to an incremental \$7 billion in annual interest cost, given Canada's current outstanding debt of \$1.4 trillion.

Concessionary Capital is critical to act as a catalytic element to ensure First Nations are included in the infrastructure investments required to rebuild Canada and increase its competitiveness on the global stage. That said, the sooner market-based capital is available, the firmer the footing of the Canadian economy and the participation of First Nations in this “emerging market”.

Below is a table detailing the nine Concessionary Capital programs outstanding in Canada. These programs total less than \$19 billion*. Further, only three of the nine can lend across Canada, which, given the size of some Provincial programs, could result in a regional shortage of capital. For example, Ontario, Canada’s largest Province by population, has a loan guarantee program of only \$1 billion but recently announced an increase to \$3 billion.

Program	Size	Focus Sectors	Governance Structure
Aboriginal Loan Guarantee Program (Ontario)	\$1.0B	Renewable energy infrastructure and transmission projects	Subsidiary of a Provincial Crown agency
Alberta Indigenous Opportunities Corp.	\$3.0B	Natural resources, agriculture, telecommunication, tourism, and transportation	Provincial Crown Corp.
Saskatchewan Indigenous Investment Finance Corp.	\$75M	Natural resources and value-added agriculture	Provincial Crown Corp.
Quebec Indigenous Initiatives Fund IV	n/a	Economic, social, and community development	n/a
Indigenous Loan Guarantee Program	\$10.0B*	Natural resources	Subsidiary of Federal Crown Corp.
First Nations Equity Financing Framework (BC)	\$1.0B	Agriculture, aquaculture, tourism, and natural resource sectors	n/a
Loan Guarantee Program (Manitoba)	n/a	Wind energy	n/a
First Nations Finance Authority	\$2.5B	Community infrastructure, economic development	Non-profit, Statutory Corp.
Canada Infrastructure Bank Indigenous Equity Initiative	\$1.0B	Clean power, green infrastructure, public transit, broadband, trade and transportation	Federal Crown Corp.

Market-Based Capital

Market-Based Capital is funding provided by ‘for-profit’ financial institutions, public markets or private capital funds. This includes Banks, Life Insurance Companies (“Life Co”), Pension Funds and Private Capital. These lenders maximize profits for their shareholders. However, unlike the finite supply of Concessionary Capital, Market-Based Capital for infrastructure investing is substantial and not subject to a change in Government policy.

Below is a table detailing the important characteristics of these four types of lenders.

Source	Equity Lending Capacity ¹	Target Term	Fixed/Floating Rate	Cost of Funds
Banks	Limited	5-yrs or less	Floating	Moderate
Life Co.	Limited	10-yrs or more	Fixed	Moderate
Pension Funds	Unconstrained	10-yrs or more	Floating or Fixed	Moderate to High
Private Capital	Unconstrained	2 to 10-yrs	Floating or Fixed	Moderate to High

Market-Based Capital lenders deploy capital at a ‘market rate’, a higher cost of funds than Concessionary Capital. In general, they lend money based on credit risk and their own relative cost of capital. Banks, Life Co, and Pension Funds are federally regulated, which creates constraints or rules that impact the amount of money they can lend against an equity investment and the interest rate they charge.

How these institutions source and manage capital directly impacts their lending terms and interest rates. Banks source and lend money on a floating rate basis. They lend money out at their ‘Prime Rate’, which is higher than the rate they pay depositors. Both the Prime Rate and deposit rates are floating, and the spread between these is profit for the Bank. The floating rate market has a short duration, typically five years or less. Five years is a bad funding match for infrastructure equity investments, which have a project life of 30+ years. In the case of a fully contracted asset (e.g. a windfarm), refinancing every five years presents several risks to a project and its equity investors, including interest rate, credit risk and market or funding risk. Banks are not an ideal source of long-term funding for infrastructure assets.

Life Co and Pension Funds can lend capital at fixed or floating rates and have long-duration needs. Both are looking for investments that are 10 years+, matching the expected term of a life insurance policy or the expected term of retirement. However, Life Co. and Pension Funds are constrained from making equity loans through regulation. The Office of the Superintendent of Financial Institutions (“OSFI”) closely monitors and ensures financial institutions have enough

¹ Equity lending capacity without a government loan guarantee

capital to cover their obligations. OSFI's 'risk-weighted capital' rules on capital affect the amount and interest rate charged on equity loans. Equity loans have a high risk-weighting and require institutions to set aside a larger amount of capital to absorb potential losses. Reserving more capital restricts the supply of available capital and results in substantially higher interest rates charged for equity loans. Although Life Co and Pension Funds can provide fixed-rate long-term loans for infrastructure, they have limited lending capacity at an expensive interest rate without a credit enhancement, such as a government loan guarantee.

Private Capital firms have investment funds that typically invest outside of the public markets. OSFI does not regulate Private Capital firms, but does regulate Banks, Pension Funds and Life Co's. They can also source funding from institutional investors, endowments, foundations, family offices and high net worth investors. In general, Private Capital investors expect their capital to be deployed broadly and at an appropriate risk-adjusted return.

Private Capital firms can lend money secured against equity investments in the form of a secured loan, mezzanine or structured equity tranche without a government loan guarantee. In the context of infrastructure, Private Capital firms are highly specialized in underwriting all aspects of project risk, including counterparty risk, regulatory risk, life cycle costs, and environmental risk. Further, Private Capital funds are not constrained by risk-weighted capital rules (i.e. OSFI) or limited to originating short-term floating rate loans (i.e. Banks). Rather, they have the advantage of structuring their loans to fit the Borrower's specific needs. This structuring flexibility would be ideal for equity loans for First Nations.

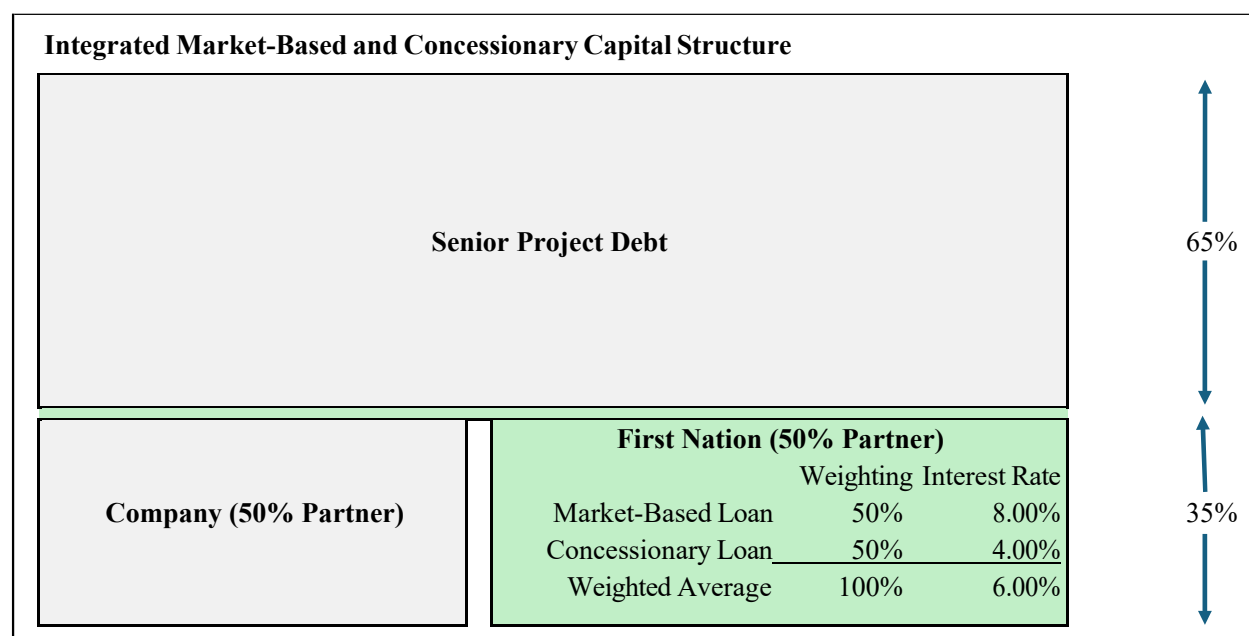
Unfortunately, no Private Capital funds in Canada are currently targeting First Nation equity lending. As stated earlier, all completed equity funding for First Nation investments have been executed using Concessionary Capital. Without private market alternatives, First Nations depend solely on the Government or Non-Profit equity capital or guarantees to invest in infrastructure. With only \$19 billion* of Concessionary Capital available to meet a \$100 billion+ need identified by RBC, Private Capital will be needed to fill this void.

The pivot to Private Capital will take time and will result in a significant change in the cost of capital for First Nations. As discussed, Market-Based Capital lenders deploy capital at a 'market rate', which is a higher cost of funds relative to Concessionary Capital. However, unlike Concessionary Capital, the availability of Private Capital is not subject to changes in Government policy. Developing a market for reliable, market-based capital alongside Concessionary Capital should advance the First Nations' goal of economic self-determination.

Integrating Market-Based and Concessionary Capital

Integrating Market-Based and Concessionary Capital to fund First Nation equity investments in infrastructure creates a powerful synergy that leverages the strengths of both funding sources. Especially given the limited amount of available concessionary capital, blending these two sources will increase the total amount of capital available. More projects will be funded by spreading these two sources of capital further. This is particularly important for Provinces that may have limited or no government-sponsored Indigenous lending programs. In addition, the underwriting discipline of Private Capital firms will attract additional market-based investors as successful projects are announced. Importantly, increased Private Capital competition will ensure interest rates reflect market prices.

Blending Market-Based and Concessionary Capital will lower the borrowing rate relative to a Market-Based only loan because Concessionary Capital is provided at a below-market rate. Blending the Concessionary Capital funding with a Market-Based loan lowers the weighted average interest rate to fund the loan in question. A lower interest rate should improve the debt service coverage on the loan, allowing for amortization, and a greater current distribution for First Nations.



Having the Government partner with private market underwriters could improve the overall underwriting process. By working together, each could benefit from the other's perspective. Market-Based Capital offers expertise in underwriting loans, while the Government can ensure that social and environmental objectives are met.

Conclusion

With the passing of UNDRIP, First Nations secured the right to FPIC on any new infrastructure projects affecting their lands, territories, or rights. This significant paradigm shift in the development process presents First Nations with a meaningful opportunity. FPIC can provide First Nations with long-term economic benefits, especially in the case of an ownership stake in critical infrastructure. But ownership requires equity capital, and for First Nations, this requires third-party funding.

At present, First Nations are exclusively dependent on Concessionary Capital to invest in infrastructure. At less than \$19 billion*, the supply of Concessionary Capital is insufficient relative to Canada's current need for infrastructure spending of more than \$1.5 trillion. Although not in place today, Private Capital is expected to fill this capital need in an emerging market opportunity within Canada's borders.

In addition, the significant capital needs for First Nations to participate as equity investors in existing critical infrastructure, such as the Trans Canada Gas Transmission system, will only increase the demands on Concessionary Capital to be supplemented and blended with Private Capital solutions.

Although not constrained by Government policy or regulation by OSFI, Private Capital is more expensive relative to Concessionary Capital. Blending Market-Based and Concessionary Capital to fund First Nation equity investments in infrastructure will decrease the average cost of funds. This blending of capital sources leverages the strengths of both funding sources and will increase the total amount of capital available. Further, the development and availability of Private Capital will provide greater agency for First Nations away from Government. These are important steps for First Nations in their journey to rightful economic self-determination.

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