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The Europe 2020 Project Bond Initiative

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Introduction

Europe is in need of enormous infrastructure investments. The European Commission's estimated investment needs amount to €1.5 - €2 trillion by the year 2020. The energy systems alone require €400 billion for distribution networks and smart grids, €200 billion for transmission networks and storage as well as €500 billion to upgrade and build new generation capacity.[1] €500 billion is needed for the transport networks[2] while ultra-fast broadband to all European households and businesses will cost €270 billion.[3] Europe has also set targets to reduce its emissions by 20% by 2020 and, in the "Energy Roadmap 2050",[4] by 80-95 % from 1990 levels,[5] implying a need for aggressive scale up of capital investments in low-carbon technologies.

It is unlikely that governments will bridge this infrastructure gap on their own, especially while they struggle to reduce their deficit and public indebtedness. In addition, the banking system, which project sponsors in Europe have traditionally relied on for financing, is under major stress due to the effect of the financial-and sovereign debt crises. The upcoming Basel III and Solvency II regulations will require bankers to increase their capital reserves, likely leading to higher costs for project financing.[6] As a consequence, many European banks are trying to limit their exposure to long-term infrastructure debt.

Financing constraints are further aggravated by the disappearance of monoliners - insurance companies specialized in one line of business (hence the name) - namely providing financial insurance for credits in the form of a debt service guarantee. Before 2008, monoline insurance companies were a key component for infrastructure financing but they nearly disappeared due to their exposure to subprime mortgages.

In short, the pre-crisis infrastructure-funding model that relied on bank loans and monoliners' guarantees is all but over. The need for innovative mechanisms to attract huge amounts of capital to infrastructure is thus pressing, reviving policymakers' focus on bonds, capital markets and institutional investors. For example, in 2010 the Monti Report ("A new strategy for the single

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March 2013. The views are those of the authors. The contents can under no circumstances be regarded as reflecting the position of the European Union, the European Commission, the European Investment Bank or other organizations mentioned in the text.

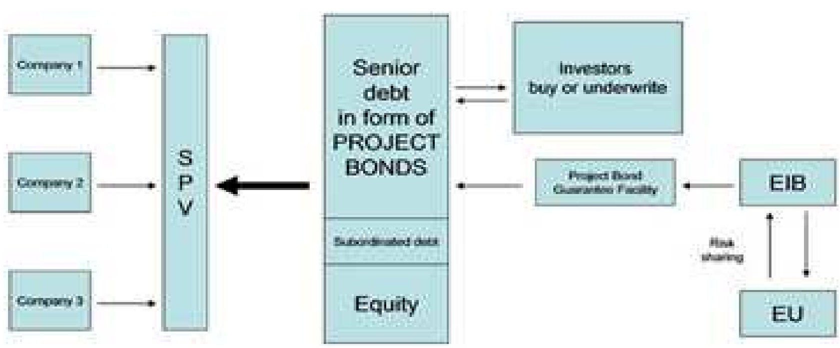
[1] European Commission, Energy Infrastructure Package Communication, COM(2010)677.
[2] European Commission-EIB, Issues Paper on facilitating additional TEN-T investment, (2009).
[3] European Commission, Broadband Communication, COM(2010)472.
[4] European Commission, Energy Roadmap 2050, Commission Communication, COM(2011)885.
[5] The target for 2050 is conditional on action taken by other developed countries.
[6] As a effect of the financial crisis new stricter Basel III regulations were issued by the Basel Committee on Banking Supervision, which set framework for the international regulation of the banking sector. Similarly, Solvency II, " the Basel for insurers," limits the risk exposure of insurance companies.

market") stated that "major public infrastructure in Europe [..] is transnational, unfit for the currently fragmented national schemes, and their funding suffers from the absence of a liquid bond market for very long maturities, while long-term investors such as pension funds cannot find a supply of bonds matching their investment needs".[7]

The Europe 2020 Project Bond Initiative

In the context of the current European sovereign debt crisis, the Europe 2020 Project Bond Initiative (PBI) has been one of the instruments designed to recreate the conditions that could attract additional private sector financing for individual infrastructure projects. The launch of a Europe 2020 Project Bond Initiative was announced on 29 June 2012 at the European Summit in Brussels as part of a growth package. The decision followed the proposal tabled by the European Commission (EC) and the agreement reached by Members of the European Parliament and the EU Council in May. The pilot phase foresees €230 million for the next two years and is to be implemented by the European Investment Bank (EIB) and the EC.[8]

The PBI mechanism operates as a tool of credit enhancement by splitting the debt of the project company into slices; a senior[9] and a subordinated[10] tranche. By providing the subordinated tranche (in the form of a loan or a guarantee), the EIB reduces the risk and consequently enhances the credit quality of the senior tranche, easing its issuance in the capital market. The initiative can be explained with an example. The project sponsors create a company to raise financing for an infrastructural project and partly provide funds in the form of equity. The EIB supports the project by giving a loan or a debt service guarantee enabling the sponsors to raise senior bonds at a lower rate. The project company will reimburse the senior tranche to the market first, then the subordinated one to the EIB and the equities last. The likelihood of a timely repayment to bond holders increases the credit rating of the senior tranche, making it easier and cheaper to raise the necessary funds for the project.[11]



Source: EC website, DG ECFIN.

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[7] M. Monti, 'A new strategy for the single market, at the service of Europe's economy and society', Report to the President of the European Commission (2010).

[8] The pilot phase is based on an amendment of the Trans-European Networks (TEN) Regulation and the Competitiveness and Innovation Framework Programme (CIP) Decision.

[9] In this context: The highest level in a company's debt structure with most certainty of repayment.

[10] In this context: The debt below the senior debt, which is, however, senior to equity.

[11] Differently from Build American Bonds (BABs) initiative where bonds are issued by municipalities and public authorities and are accompanied by a strong tax rebated the EU project bonds are issued directly by the project companies.

The subordinated debt does not exceed 20% of the project debt.[12] The budget of €230 million for the pilot phase should allow the EIB to provide subordinated facility of about 3 times as much. Assuming that the EIB credit enhancement is up to its maximum, €4.6 billion can be mobilized. In short, the mechanism has very interesting cost-effective implications as one euro from the EU budget can drive about 20 additional euros of infrastructure financing.

If the pilot phase delivers good results the PBI may be continued as part of the "Connecting Europe Facility" regulation under the new Multiannual Financial Framework (MFF) 2014-2020.[13] The pilot phase will concentrate projects in the targeted sectors of transport, energy and broadband. The Commission will make an appraisal of the candidate projects on the basis of their compliance with EU policies, followed by a financial evaluation by the EIB.[14]

The PBI can be used as a tool to respond to the EU's climate change policy objectives. Transmission links and the integration of renewable energies in the production grid are already eligible for the pilot phase. In this context, it is important to add that energy generation – including renewables – is generally a responsibility of EU Member States while the EU has mainly policy competences in transmission and distribution.[15] From 2014 on, the "Connecting Europe Facility" should provide a broader policy framework to allow the PBI to better focus on building grids and transmission systems, intermodality and sustainable transport. A renewable energy project could actually be among the first ones to be supported by the PBI: the EIB is currently considering the instrument for UK offshore transmission links, tendered by Ofgem.[16] Other candidate projects may be more traditional infrastructure assets: specialized press mentioned the EC-EIB project bonds in relation to the financing of three highways, the A11 in Belgium, the A1/A6 in the Netherlands and A7 in Germany.[17]

Institutional investors are the main target of the scheme. The EC makes a significant effort to use feedback of European financial actors, project sponsors and civil society organizations to improve the initiative further. In 2011 it organized a consultation process and a conference where stakeholders provided input to the technical set-up of the facility.[18]

Key Take Aways

The initiative constitutes an important signal to the market and could encourage the private sector to promote similar schemes. 60% of the stakeholders consulted by the EC think that the mechanism is likely to attract more institutional investors, while an additional 16% pointed out that success will also depend on technical features such as the price, the structures and the attracted rating.[19] Investors

[12] According to the Commission Communication, 'A pilot for the Europe 2020 Project Bond Initiative' COM(2011)660 " this percentage is based on LGTT experience and modeling results and would provide a generous, but not excessive, liquidity cushion for most projects that fulfill the necessary financial criteria".
[13] Multiannual Financial Framework (MFF) translates into financial terms the Union's political priorities for the next 7 years.
[14] For more details see EIB 'An outline guide to Project Bonds Credit Enhancement and the Project Bond Initiative', (2012).
[15] Therefore energy generation itself is not part of the TEN-E (energy networks), consequently it is not eligible for the PBI. Supporting renewables generation with the EU budget money is possible through the structural and regional funds, whose implementation relies with EU Member States.
[16] EIB press release, EIB agrees to fund UK offshore transmission link, 26 September 2012.
[17] Freshfields Bruckhaus Deringer llp, 'From policy to proof of concept, and beyond' (2012).
[18] Written responses can be found at http://ec.europa.eu/economy_finance/consultation/written_responses_en.htm
[19] Public consultation on the Europe 2020 Project Bond Initiative: Key messages. EC.

were more skeptical about the potential of the PBI to facilitate and accelerate the financial closure. Only 19% said it would accelerate and facilitate, while 22% believe it could either facilitate (14%) or accelerate (8%).[20]

Rating prospectives

The Commission and the EIB are aiming for project bonds issued under the Initiative to receive a single A- investment grade from credit rating agencies. However, the EIB has added that the credit enhancement facility may still be available for project bond issues that receive a lower investment grade rating, such as BBB, on the condition that there are sufficient investors who will buy the lower-rated bonds. It is important to highlight that, although the ratings should in principle be enhanced by the subordinated tranche, other qualitative aspects such as the single asset nature of many projects, the credit quality of the off-taker, the construction or the operational risk will also be taken in account. Rating agencies will surely also look at the country where the project is foreseen, despite the fact that the PBI is a European guarantee mechanism. The project rating could be higher than the sovereign rating of its country, though perhaps only to a limited extent (1-2 notches).[21] On the other hand, the market does not "merely look at ratings but at the general legal framework of the jurisdiction of the project, the exact contractual arrangements as well as the quality of the financial package".[22] The presence of the EIB and of the EC in the project is in itself an important risk-mitigation factor.

Role of the EIB

The PBI gets its comparative advantage from the pivotal role played by the EIB, the most important European infrastructure investment institution. After having appraised and selected the project, the EIB structures and prices the credit enhancement. Investors lacking the know-how in infrastructure financing can lean on the due diligence and monitoring expertise carried out for the project. It is likely though that the EIB will not be acting as a controlling creditor in order to avoid conflict of interests. Moreover, the EIB could use the PBI as a vehicle to share their know-how in project bond financing and promote flexible and standard documentation at the European level. The Bank can be supported by the European PPP Expertise Centre (EPEC)[23] to encourage best practice and expertise.

Bonds and banks

It remains to be seen if the establishment of the PBI may lead to the development of capital markets as a source of European infrastructure financing. The bond initiative is taking its first steps into a market dominated by commercial banks. In the first half of 2011, loans in Europe accounted for 81% of project finance volume while bond financing only accounted for 3%.[24] However, the market is in transition and sponsors could follow the bond route if the costs of carry and of credit enhancement permit it. Certainly the PBI is not intended to replace traditional lending but to complement it by expanding the investor base for private capital and finding the appropriate mix between bonds and

[20] Idem
[21] Fitch rating, Fitch Comments on EU Project Bonds Initiative, April 2011.
[22] Public consultation on the Europe 2020 Project Bond Initiative: Key messages. EC.
[23] The European PPP Expertise Centre (EPEC) is a collaboration between the European Investment Bank (EIB), the European Commission, and European Union members. Its primary mission is to strengthen the organizational capacity of the public sector to engage in PPP transactions. This experience is then disseminated in terms of practical and operational guidance, http://www.eib.org/epec/ .
[24] See Freshfields Bruckhaus Deringer llp, 'Outlook for infrastructure: getting Europe back on track' (2011) or 'Dealogic Project Finance Review, first half 2011', Dealogic (2011).

loans. Banks will continue to play a key role in the coming years, even if a declining one. Differently from most institutional investors, they have in-house expertise in assessing projects that should not get wasted.

Remaining challenges

The elements that contribute to the revitalization of infrastructure financing in Europe are multiple. As stated in the introduction, the financial market regulations remain a key aspect. The EC has taken a constructive approach and has announced the launch of a green paper that will examine how to conciliate long-term investments and regulations.[25] Furthermore, discussions continue among stakeholders on the possibility to approach infrastructure investments differently under the Basel III and Solvency II regulations.[26] Supporting the role of the banks and their expertise in infrastructure, encouraging standardization in the tendering process, creating solutions for investing in small-size renewable energy projects, promoting equity investment in the greenfield phase are all challenges that remain to be fully addressed. Hopefully the EU-EIB project bond initiative, endorsed at the highest political level, can generate positive momentum and improve the current scenario.

In general, credit enhancement mechanisms deserve further experimentation. They can support governments and multilateral institutions in making an efficient use of their limited public capital and crowding in resources from long-term investors into infrastructure investments.

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25 Freshfields Bruckhaus Deringer llp, 'From policy to proof of concept, and beyond' (2012).
26 idem

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