29 April, 2011

Attention:

Commissioner Olli Rehn
European Commission
Directorate General for Economic and Financial Affairs
Brussels, Belgium

Re: Response of Citigroup Global Markets Limited to European Commission’s Europe 2020 Project Bond Initiative

Citigroup Global Markets Limited (CGML)\(^1\) is pleased to provide a response to the questions posed in the European Commission (EC’s) Stakeholder Consultation Paper – Commission Staff Working Paper on the Europe 2020 Project Bond Initiative (‘Initiative or Working Paper’). We are providing comments based on our experience as an arranger of infrastructure, energy and so-called ‘social infrastructure’ (ie, UK Private Finance Initiative (PFI) or European Public-Private Partnerships (PPP)) in the past and what we believe constitutes the thrust of the proposed Project Bond Initiative.

We welcome the EC’s initiative in looking at the topic of Project Bonds as a means to help finance the trillions of euros of infrastructure projects that are being discussed for future work in areas such as energy, broadband, and transport. In the current marketplace, there is already an active fixed-income investor base for mezzanine or subordinated debt capital in support of properly structured and creditworthy infrastructure and utility borrowers – whether in corporatized or project format. Nonetheless, new entrants into this layer of the capital structure have been potentially hampered by elevated risk/return objectives since September 2008 as investors across the capital structure re-assess credit spreads, tenors as well as key terms and conditions. As a result, certain investors may find that the risk associated with many infrastructure projects is too high when compared with the potential return, and thinking about how to improve this balance is a key objective in terms of attracting new investors to investing in debt backed by cash flows derived from essential service infrastructure.

The preparedness of the EU to consider providing subordinated or mezzanine finance to said projects, in concert with the private sector, should be welcomed by the investor community and builds on precedents adopted by the European Investment Bank (EIB) and Member Countries in the past. It is CGML’s view that the proposed Project Bond Initiative is potentially an important and useful financing tool to attract additional private sector financing to large-scale infrastructure projects. Nonetheless, the key to unlocking investor appetite, on such a scale, will require a stepped-up level of

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\(^1\) Citi, the leading global financial services company, has approximately 200 million customer accounts and does business in more than 160 countries and jurisdictions. Through Citicorp and Citi Holdings, Citi provides consumers, corporations, governments and institutions with a broad range of financial products and services, including consumer banking and credit, corporate and investment banking, securities brokerage, transaction services, and wealth management. Additional information may be found at [www.citigroup.com](http://www.citigroup.com).
investor understanding of the risks and associated mitigants with investing in long-dated project bonds.

We would welcome further dialogue with the EC in terms of creating a plan that will meet key infrastructure needs of the EU as well as meeting the needs and requirements of third-party investors.

**General Questions:**

Is the chosen mechanism likely to attract private sector institutional investors to the sectors of transport, energy and ICT in particular? If you are an investor, would you be prepared to buy such project bonds?

Are there other sectors with large-scale infrastructure financing needs that should be included?

**Response:**

In our opinion, the preparedness of the EC to consider providing mezzanine or subordinated capital in support of bonds backed by cash flows associated with infrastructure and/or energy projects will attract fixed-income investor interest. This view is based upon our experience, over the last decade, in structuring and arranging capital market transactions in which the EIB has provided co-financing support (at the senior layer of the capital structure) and the resultant investor support demonstrated by monoline, lender and capital markets participation.

Nonetheless, there are a number of details that are missing, that will be essential for the overall programme to be readily acceptable to investors and third-parties involved in the capital placement process:

First, the underlying projects must meet strict creditworthy conditions with full political backing in the Member Country that the project is being considered;

Second, the degree of control rights and/or influence that the EU may wish to exert vis-à-vis the senior debt investors (ie, the inter-creditor regulating non-fundamental and fundamental waivers / event of defaults) will be a key area of focus for the investor community;

Third, to the extent that private sector investors are able to provide sub-debt on a competitive basis to these projects, then the EC’s initiative should encourage such co-investment schemes;

Finally, the mechanics of implementing a financial guarantee (rather than direct funding) require clarification in terms of how and under what terms a third-party will provide funding.

We do not believe that there is any inherent reason as to why ICT projects should not attract funding so long as the underlying project exhibits strong fundamental credit and structural enhancements features.
**Specific Question:**

Would the credit enhancement facilitate/accelerate the conclusion of financing packages?

**Response:**

Long lead times between start of the advising and due diligence phase of an underlying project and its eventual funding in the loan and/or capital markets is commonplace. In our opinion, these lead times will not differ significantly as a result of this Initiative. Nonetheless, the presence of a permanent source of financing support will allow deal resources to focus more intently on key risk-mitigation issues required by transaction third-parties, including the investor base and rating agencies.

**Specific Question:**

What minimum rating of the bonds would be sufficient to attract investors?

**Response:**

There is no obvious answer to whether investor depth and liquidity will be more or less attracted to issuance with ratings in the single-A category versus that of the (mid) triple-B category. Investors in sterling-denominated paper have demonstrated a greater propensity to purchase long-dated, amortising bonds primarily at (low) single-A ratings or better although, increasingly, certain issuers have been able to access funding (up to £500-600 million at the time of issuance) with a (mid) triple-B or better rating. Conversely, euro-denominated investors almost exclusively invest on a ‘bullet’ basis but whose underlying risk appetite allows for triple-B paper or lower.

Issues around Basel II/III and Solvency 2 will have a substantial impact on the ability of lenders and institutional investors, respectively, to invest funds on a long-dated basis regardless of the merits of the underlying structure and associated rating. Leaving these regulatory issues aside for the purposes of this discussion, it is worth noting that very few of the non-UK monoline-wrapped transactions from the period of 1995-2007 revolved around long-dated, amortising capital markets issuance but were rather financed on a bullet (or a series, thereof) basis.

**Specific Question:**

What degree of credit enhancement would be necessary to achieve this rating?

**Response:**

There is no empirical data that would suggest a ‘blanket’ amount of credit enhancement is required to gain investment grade ratings: rather this needs to be reviewed and analysed on a case-by-case basis.

However, we would like to point out that during the initial phase of any user-pay transaction based upon varying levels of volumetric or demand risk, there is a
negative rating agency bias against ‘investment grade’ ratings without some meaningful form of third-party credit enhancement or shareholder support. After 5 years of operating history, projects are more readily able to ratings of at least triple-B. A similar bias exists against UK PFI and European PPP’s during the construction and pre-operational phase whereby underlying borrowers tended to be rated non-investment grade or low investment grade at best.

Unless supported by highly-rated counterparties (corporate, governmental or multi-lateral), project bond ratings are constrained by the narrowness of their business operations. Although this does not preclude certain projects from gaining ratings into the single-A category over time, it is our experience that these rating levels are more consistent with regulated utility or transport companies.

Specific Question:
Which impact would the Initiative have on financing costs and on maturities?

Response:

The Initiative will have a positive impact on the underlying credit quality of any project that the EC decides to support even if only for the so-called ‘halo’ effect that might be perceived by investors. The associated impact on future credit spreads will be difficult to assess, although we would expect that investors will demand a slight premium to then-applicable spreads in order to take into account principal amortisation.

As noted previously, investor demand for long-dated, amortising paper is primarily the province of sterling investors. Over the medium- to long-term, we are of the opinion that the EC’s proposed programme will have a pronounced effect in terms of increased (greater) demand for long-dated, amortising paper. In the near-term, there will likely be the need for significant investor education in terms of the tools required to analyse projects and their associated structure before these goals can be achieved.

Specific Question:
Is it essential that a single entity acts as controlling creditor?

Response:

In our view, it is not essential for a single party to be able to act as controlling creditor unless said party has absorbed substantially all of the risk-bearing characteristics of the transaction. However, we do note that a controlling creditor (or a number of key creditors, as the case may be) that can monitor, influence and act alongside the underlying borrower is an absolute necessity. Project finance is characterised by high recovery values in the event of default, ie 80%+ vs corporate unsecured recovery rates of 30-40%). Therefore, the role of the controlling creditor (s) is an attempt to achieve high recovery levels which is key to end-investor interest in the product.

The key question is not whether a single party should act as controlling creditor but whether all investors require a single party to be able to monitor, disseminate and
afford the opportunity to any and all investors to be able to act in their best interests and in accordance with a pre-agreed inter-creditor framework which dictates actions to be voted and within a suitable timeframe. This so-called ‘snooze you lose’ framework is common to bank loan syndications and purposely seeks to disenfranchise non-active investors.

The origins of a single controlling creditor (at least within the context of recent capital markets issuance) is the result of a monoline insurer typically providing a financial guarantee for substantially all of the rated senior debt of an underlying project company. This made sense in that the monoline provided an unconditional promise to pay under their financial guarantee and hence, they effectively took on the role of an indemnified bank agent/security trustee in order to minimize the probability of default or enhance recoveries upon work-out or default.

Over the last decade, there are a number of corporate borrowers within the infrastructure and energy sectors who accessed the capital markets with a combination of bank and bond issuance in which the latter may have been split amongst a number of monolines and/or uninsured bond investors. In a number of these deals, there are provisions that permit any creditor prepared to post indemnities to be able to vote pro-rata to their share of the par exposure on substantive waivers and/or consents. As previously noted, the unwillingness on the part of an investor to act should not defer decisions that the overall investor group may need to implement save for any entrenched rights available to each and every investor at the time of issuance.