RBS
The Royal Bank of Scotland

28 April 2011

Eva Romer
Deputy Head of Unit
European Commission
Directorate-General Economic and Financial Affairs
Drosbach Building B2 / 060
L-2920 Luxembourg

Re: RBS Response to Europe 2020 Project Bond Initiative

Dear Ms Romer

The RBS Secured Debt Markets team is responsible within RBS for the origination, structuring and distribution of secured capital markets transactions for key Infrastructure and Utility assets across the EMEA region. RBS led 87% of the c. £10 billion Secured Corporate bonds in 2009/10 and has led all four Sterling issuances so far in 2011 highlighting an unrivalled knowledge of the market and investors in this sphere.

In addition to applying this experience in considering the specific questions posed in the Europe 2020 Project Bond Initiative Stakeholder Consultation Paper, RBS has spoken to the bond investor base across the UK, Italy, Spain, Germany and the Nordics to gain first hand feedback on the proposal. Whilst we appreciate that a number of these investors will respond directly, hopefully this spectrum of feedback will also prove useful to the consultation.

In general the project has been met positively by the investor base. Long maturities are viewed as a positive for insurers & pension funds which are likely to be the key buyers for infrastructure debt, although it should be noted that the appetite would be significantly less for hedge funds. Investors prefer single asset financings rather than pooled projects. As with all capital markets transactions, many investors require secondary market liquidity, with issue size of a benchmark quantum.

A clear preference for at least single A rated debt is an almost unanimous consensus across the board, and whilst some investors have said they would consider high BBB rated debt, the likely impact of Solvency II on these holdings will be a key consideration, particularly for Insurance companies.

A view shared by both the origination teams and the investor base is that the initiative should try to keep the projects under consideration as simple as possible to attract a sizeable investor base, particularly with respect to the early projects, in order to “open the market” with successful transactions which can act as the benchmark going forward.

Aligned to making the projects “simple” from an investor perspective, in order to open the market in size, there is a belief that there will need to be affirmative action from the public sector to open markets, with a particular emphasis on the procurement process and the current requirement for financing costs to be “locked in”. A standardised financing approach, consistent across bidders, which allowed for parallel tracking of a bond and bank solution, eventually potentially leading to both existing on a pari-passu basis (if required) would further enhance the likelihood of success of the initiative.

We have set out below our responses to the specific questions raised in the Europe 2020 Project Bond Initiative Stakeholder Consultation Paper, and would welcome the opportunity to discuss the points raised here in further detail to the extent that it would be beneficial for the process. In conclusion, the initiative has been welcomed by the investor base across Europe, and the potential opening of a significant new asset class in the capital markets represents an exciting opportunity for all connected with the market. As always, the debate will increase as the proposals are firmed up, although the level of engagement we have had to date on the initiative highlights significant interest from the market.

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1. 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?

    - Yes, based on feedback received to date, although it should be noted that investors will undertake analysis of underlying transactions. Investors will be wary of projects based on unproven volume forecasts. In the energy sector volume and energy price risk may not be acceptable to investors. There also needs to be very clear and transparent regulation. Investors will also focus on technology risk around ICT projects.
    - To echo our introductory remarks, we believe there would be value in opening the market with simpler availability based structures first, before moving on to more challenging “merchant” or volume dependant structures.
    - It should also be noted that investors will want to avoid excessive exposure to a single sector, again emphasising that the broader and deeper the market can be made, the more successful the initiative will be.

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

    - Whilst appetite for projects will remain a function of the credit quality of the underlying projects, feedback suggests that the sectors targeted (particularly Energy and Transport) remain the areas of focus for investors. Investors have also expressed a particular appetite for renewable electricity generation projects, to the extent these are not already covered by Energy as currently contemplated.

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

    - Credit enhancement from the EIB would assist in generating support and ensuring participation of bond investors.
    - The gestation period of large infrastructure projects is generally quite long in any case, and whilst the initiative should not significantly extend timetables, it is difficult to see it accelerating the process. Consideration will also have to be given to the timetable for a rating from 2 agencies, although this workstream can run in parallel with the overall process.
    - Whilst current indications are that there will be demand from the institutional investor base, using the capital markets could add execution risk due to difficulty in getting advance commitments from the market.
    - We recommend execution risk is managed by running the bank market and the bond market in parallel, particularly for the pathfinder transactions. The transaction could then potentially be closed by executing a tranche in bank and a tranche in bond. We have significant recent experience in managing the intercreditor issues arising from pari passu bank and bond debt.
    - We also believe that affirmative action may be required to launch the project bond market. There is still significant bank appetite which will price the more straightforward projects (‘the low hanging fruit’) more cheaply than perhaps the bond market. However we would recommend that the EC takes positive action to facilitate bond tranches on these transactions, even if this results in slightly higher weighted cost of debt. It will be far harder to open up a project bond market on more challenging projects and credits where bank appetite is scarce or more expensive.

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

    - Investors in Investment Grade bonds are generally looking for a rating of BBB or better.
    - A rating of BBB- will attract little or no appetite from long term investors because of the risk that a one notch downgrade will push the bonds into sub-investment grade. If bonds are placed in an investment grade portfolio, a downgrade to sub-investment grade may require the investor to sell the bonds.
    - In current markets there remains significant appetite at BBB and BBB+, as has been demonstrated over the last 12 months through the significant issuance from both UK Rolling Stock Leasing Companies and subordinated utility issuance.
    - However, at an A category rating, liquidity and demand increases significantly.
    - Indeed, many investors, particularly outside of the Sterling market, have indicated that a minimum A category rating would be required in order to attract interest.
    - That being said, the size of the transaction and the quantum of debt to be issued may impact the rating to be targeted. For a transaction of €300m to €500m, there should currently be sufficient liquidity and demand from investors to comfortably absorb the transaction at a rating of BBB (subject to Solvency II considerations). For larger transactions with senior debt of up to €1bn, a rating in the A category should be targeted to attract sufficient liquidity.

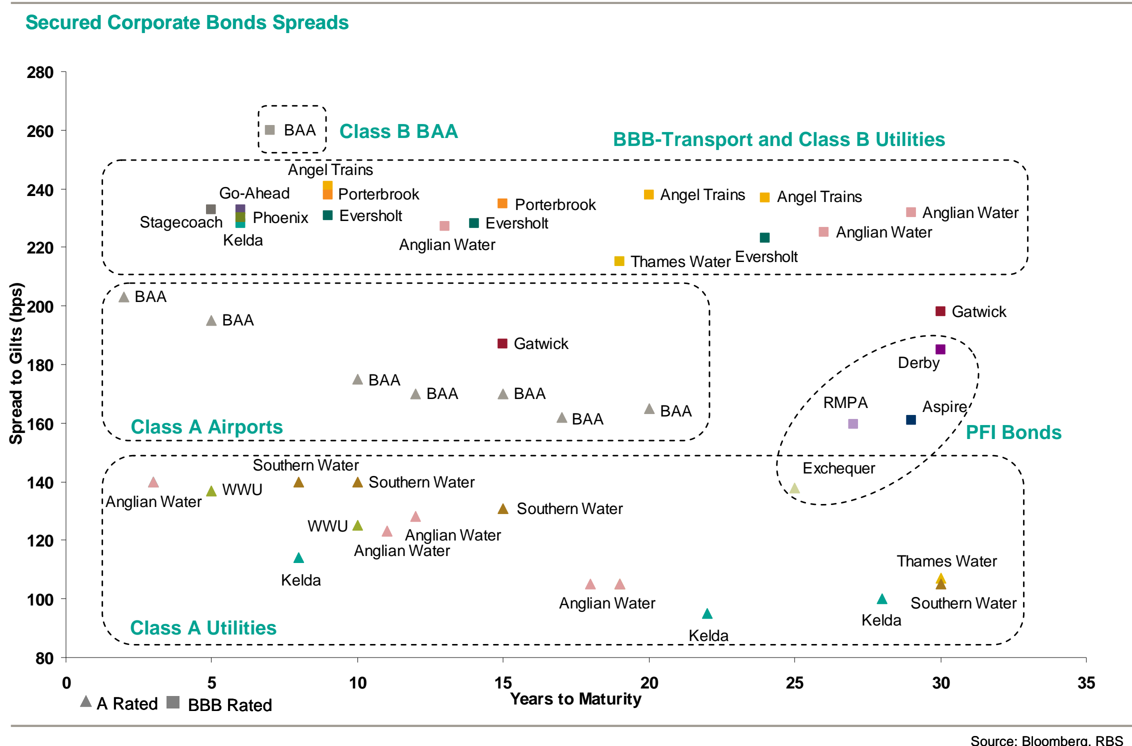
- Whilst, given the opportunity, investors would clearly prefer to reach a rating in the AA category, we would be sceptical around the level of support required to reach this rating level and whether that would represent best value to the EIB / EC.

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

- The amount of credit enhancement required to get to a high BBB or an A category rating is dependent on the credit profile of the underlying project and the sponsors involved, making this question very difficult to answer.
- That being said Fitch have already indicated in their paper "Fitch Comments on EU Project Bonds Initiative" dated 27 April 2011 that *"The potential size of the support (up to 20% of the senior debt amount) is significant and may, in pure metric terms, justify a multi - notch improvement in rating".*
- This implies, and concurs with our view as structurers, that in the context of an availability based revenue transaction (without volume risk), with a relatively straightforward construction programme and structured on generally accepted market terms, it may well be possible to achieve an uplift from BBB category to A category with a contingent facility amounting to 20% of debt.
- Transactions with significant technology risk, or volume risk around build out of revenues (i.e. more qualitative risks) may have more difficulty achieving a high BBB or A category rating despite credit enhancement.
- In order to build out a true view of the potential for the initiative, it will be necessary to take a transaction through the rating process to start building up a series of benchmarks that can help to provide more visibility on how the agencies will look at different projects.

6. Which impact would the Initiative have on financing costs and on maturities?

- The chart below shows secondary pricing across different ratings and maturities in the Sterling market, highlighting how some of the infrastructure project bonds compare favourably with similar rated utility transactions, demonstrating demand from the investor base for assets of this nature.



Source: Bloomberg, RBS

- The rating achieved will have an impact on pricing of the bonds. Over and above the rating impact, the involvement of the EIB in undertaking due diligence, structuring and ongoing surveillance may give investors

confidence in the structure and long-term importance of the project that may have a positive impact on pricing.

- Sterling investors have demonstrated appetite for long-dated bonds, and long dated amortising bonds, for utilities, transport and PFI sectors, and we expect that the Euro market will have interest in Euro denominated long-term amortising project bonds (although potentially more limited appetite than they would have in the UK), either for their Euro portfolios, or potentially in Sterling if the project is able to enter into cross currency derivatives to swap back to Euros.
- Changes to regulatory capital arrangements for the Insurance industry arising from Solvency II may have an impact on pricing such that long-dated maturities and low investment grade (BBB) ratings will be penalised, although we have not yet seen significant impact from these changes on transactions executed in the Sterling market to date in 2011 (e.g. Angel (BBB with 20yr maturity) or Gatwick (BBB+ with 15 and 30 year maturities)). However to the extent that these changes do have an impact, credit enhancement to an A category rating may assist both pricing and ability to structure a long tenor.
- In the Euro market, there has not in the past been a demonstrable track record of investment in long-dated amortising bonds. However, there remains an increasing interest in the infrastructure market, and moreover an increasing appreciation that financial costs for projects of this nature could grow substantially, due to the lack of financing from the project finance market. The capital markets also have a role to play.

7. Is it essential that a single entity acts as controlling creditor?

- Whilst not essential, it would be very helpful, this mechanism in particular has been seen as helpful to investors, particularly having a managing creditor to deal with administration, waivers, surveillance and reporting.
- That being said, lessons have been learned from the Monoline precedent, and information disclosure is now viewed by investors as being as important as deal structure/intercreditor.
- We believe investors will require resolution on questions/issues beyond day to day management by bondholder vote. We can envisage situations where bondholders will see conflict of interest with their position and a controlling creditor, particularly if that party has a junior position or political motivation.

We trust you will find this response useful and remain available to follow up on any of these points if helpful.

Yours sincerely

Bruce Riley
RBS Secured Debt Markets
Global Banking and Markets

Direct tel: +44 207 085 1816
Email: bruce.riley@rbs.com