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STAKEHOLDER CONSULTATION PAPER

COMMISSION STAFF WORKING PAPER

on the Europe 2020 Project Bond Initiative

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CONSULTATION PAPER

on the Europe 2020 Project Bond Initiative

1. INTRODUCTION

The Europe 2020 Strategy for smart, sustainable and inclusive growth¹ sets out a vision of Europe's economy over the next decade. Given the huge infrastructure investment volumes required to implement the Strategy and the pressures facing government budgets, attracting private capital to the financing of infrastructure investment is crucial. There is a need for EU support to make the overall environment in all Member States more conducive to investment by the private sector.

It is against this background that the President of the European Commission, José Manuel Barroso, announced the Europe 2020 Project Bond Initiative in his State of the Union speech on 7 September 2010. The Initiative will be launched by the Commission together with the European Investment Bank (EIB) in order to build on existing experience with joint EU-EIB instruments and EIB's experience in EU infrastructure financing. Whilst the EIB will remain the Commission's principal partner, efforts will be made to ensure that the Initiative is also open to other financial institutions with the requisite expertise and the willingness to carry the associated risks in partnership with the European Commission.

The principal idea behind the Europe 2020 Project Bond Initiative is to provide EU support to project companies issuing bonds to finance large-scale infrastructure projects. The Commission's key role will be risk-sharing with the EIB (or other financing partners), enabling them to provide guarantees or loans to support such bonds. No bond issuance will be required by Member States' governments, the EU or the EIB for this purpose².

Although it is not the subject of this consultation, it is important to keep in mind that the Europe 2020 Project Bond Initiative would not stand alone, but that the proposed steps in the area of debt financing would be complemented by measures to promote the development of equity markets to obtain a better coverage of the financing needs of infrastructure projects.

The purpose of the consultation is to obtain market participants' and decision makers' feedback on the chosen mechanism and its essential terms and conditions, to gauge demand for the initiative in terms of market volumes and the depth of the investor base. A glossary of the technical terms is annexed to this paper.

¹ See Green Paper from the Commission to the European Council of 3 March 2010 COM(2010) 2020 final.

² In other words, this Initiative is not to be confused with the discussion on the so called Eurobond initiative.

In addition, the Commission, together with the EIB, intends to organise a conference in early 2011 to address a number of the questions raised in this consultation paper.

2. EUROPEAN INFRASTRUCTURE INVESTMENT NEEDS

Over the next decade, unprecedented investment volumes in Europe's transport, energy, information and communication networks will be needed in order to underpin the Europe 2020 flagship actions and develop smart, upgraded and fully interconnected infrastructures to foster the completion of the internal market. The quality and density of infrastructure varies considerably across the EU with significant investment needs for new infrastructure in some areas and for maintenance and upgrades of existing infrastructure in others.

Preliminary estimates point to investment needs of between €1.5 trillion and €2 trillion. From now until 2020, €500 billion³ is estimated to be needed for the implementation of the Trans-European Transport Network (TEN-T) programme. In the energy sector, public and private entities in the Member States will need to spend around €400 billion on distribution networks and smart grids, another €200 billion on transmission networks and storage as well as €500 billion to upgrade and build new generation capacity between now and 2020⁴. Last, but not least, between €38-58 billion and €181-268 billion capital investment are required to achieve the Commission's broadband targets⁵.

3. THE MARKET FOR INFRASTRUCTURE FINANCING

3.1. The importance of private finance for infrastructure

Governments have strong economic reasons for promoting infrastructure investments. This can be explained by the public goods nature of infrastructure. It is generally acknowledged that investing in infrastructure has significant indirect benefits, which are arguably of greater importance than the direct economic benefits⁶. As these indirect benefits are not captured exclusively by the entity financing the project, but rather by society at large, they are what economists call "externalities".

Across the EU, from 2006 to 2009 the government sector financed directly around one third of all infrastructure investment; the private sector is therefore the predominant source of funding⁷. There are, however, important sectoral differences, for example, the utilities (energy, water, sewage and waste) are overwhelmingly privately financed, education investment is principally publicly funded.

The greater part of the private sector's infrastructure investment is made directly by utility and transport companies, so called corporate finance. However, since the 1990s national

³ Commission-EIB Issues Paper on facilitating additional TEN-T investment (October 2009).

⁴ Figures from the Energy Infrastructure Package Communication COM/2010/677.

⁵ See the Commission's recent Broadband Communication (COM(2010)472 final). Targets: By 2020, all Europeans should have access to internet of above 30 Megabits per second (Mbps) and 50% or more of European households have subscriptions above 100Mbps set out in the "Digital Agenda for Europe" flagship.

⁶ Empirical evidence shows a generally positive impact of infrastructure investment on long-term growth, although this effect varies across countries and sectors. See for instance OECD Economics Department Working Papers No. 685: Infrastructure and Growth – Empirical Evidence.

⁷ R. Wagenvoort, C. de Nicola and A. Kappeler "Infrastructure finance in Europe: Composition, evolution and crisis impact", in "Public and private financing of infrastructure", EIB Papers, Volume 15 N° 1 2010, p. 23, p. 25 and p.33.

policies of many Member States have sought to increase private sector participation in the financing and implementation of infrastructure projects by other complementary means, notably through project finance. Overall, around 10% of private sector infrastructure investment uses project finance, including public private partnerships (PPP)⁸.

3.2. Project finance for infrastructure

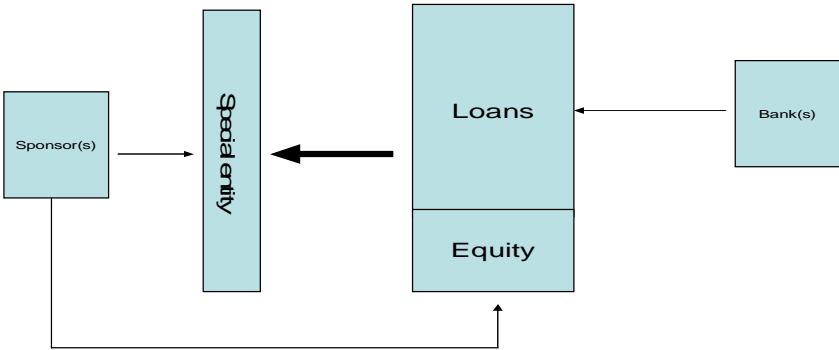
Large infrastructure projects often require decades of revenues to amortise the high upfront investment. In addition, they:

- have lengthy pre-construction and construction periods where no project revenues are available,
- are often built and managed under concessions with transfer of considerable risk to the project company and its private shareholders,
- require long-term financing, in many cases over 25 years, with financing costs that can typically represent 20% or more of the total project costs.

Projects are typically financed and implemented through an entity set up for these purposes only (the project company).

The project company raises equity and debt to finance the construction of the project and pay off the financing from the revenues that the project generates (for example in the form of availability payments made by the public sector grantor or market based revenue from the end user of the project). The equity is provided by the shareholders of the project company: developers, construction companies and increasingly, financial investors such as infrastructure funds. As discussed in Section 5, debt can have different levels of seniority. Typically the project entity would obtain a bank loan as shown below, but it may also issue a bond, i.e. a project bond.

Project financing model



⁸ PPP structures are particularly prevalent in transport, as well as increasingly in waste, health, education and other social sectors. Non PPP project financing is well established in the energy and other utility sectors.

However, except in the case of low risk projects, such bonds are rarely attractive to a broad investor base. Hence, the issuance of such bonds by the private sector have been an established, but relatively small, feature in project financing in the various EU bonds markets. One way to raise the attractiveness of project bonds has been to obtain insurance from specialist insurers known as monolines. In the UK, more than 50% of UK Private Finance Initiative projects with a funding requirement exceeding £200 million used such "wrapped bonds" funded in the GBP capital markets⁹. However, with the demise of the monoline business model in the wake of the crisis, such issuance practically came to a halt and the volumes of project bond issues generally have declined.

Thus, the majority of infrastructure in the EU with a trans-European dimension and interest is still financed from the public purse (EU, national and regional level) and only a small part draws on private funding¹⁰. Two thirds of the privately funded projects are concession-based, in an attempt to optimise the "user pays" model of infrastructure financing.

4. THE INFRASTRUCTURE FINANCING GAP

Looking ahead, given the distressed state of many Member States' budgets, it will be essential to mobilise additional sources of private finance, if the EU's infrastructure needs are to be met.

However, as described above, project bond issuance has come to a halt as a result of the financial crisis. Due to their risk characteristics, project companies are generally not able to issue bonds of investment-grade rating until after the completion of the project construction period and the confirmation of operating results even with unrealistically high levels of risk-absorbing equity¹¹. Long-term investors, notably pension funds and insurers, lack the appetite for the diversity of project risks and currently do not have the specialist expertise required to appraise projects and carry out the resulting analytical and administrative follow-up, tasks which used to be performed by the monolines.

At the same time, it has become more difficult to obtain bank loans with the long maturities required by infrastructure projects as commercial banks face capital and liquidity constraints. Multi-lateral lending institutions, in particular the EIB, have stepped in to bridge the financing gap temporarily, but cannot continue to do so single-handedly.

While there are some signs of latent recovery, Europe needs to find an effective way to re-establish a stable mechanism for financing infrastructure through the various European capital markets, as well as from the EU banking market.

5. THE EUROPE 2020 PROJECT BOND INITIATIVE

5.1. Support for bonds issued by private sector entities

The Europe 2020 Project Bond Initiative will use EU funds to attract additional private sector financing of individual infrastructure projects through the capital markets with the help of project finance techniques. The intention is to act as a catalyst for to the re-establishment of capital markets as a significant source of financing in this area, while increasing overall funding to infrastructure projects. While the Initiative will primarily address project bonds, it

⁹ EPEC: Capital markets in PPP financing

¹⁰ Abadie R. and S. Pagdadis "The global reality of public-private partnerships" in PwC Gridlines: Building Intelligent Infrastructures, June 2010.

¹¹ More equity makes the financing less risky for investors, other things being equal.

could also be used to support project loan financing and corporate financing in certain sectors and projects.

Transport and energy projects would seem to be particularly well-suited for the Europe 2020 Project Bond Initiative, while certain ICT projects in the area of broadband could also benefit. The project finance model is well-tested in the transport area, requiring little adaptation. In the renewable energy or low carbon sectors, a challenge arises when the underlying infrastructure projects use untested technologies or are located in a new market, have uncertain operating costs or when the financing cannot be obtained at reasonable cost. However, certain classes of renewable energy projects may have the required characteristics.

The Initiative does not intend to increase direct public funding and therefore governments' indebtedness. Thus, it is not to be confused with what is commonly termed "Eurobonds", namely the pooling of sovereign debt issuance to finance the general public budgets of the EU Member States. The Initiative will also not replace the existing sources of project financing through bank loans or public sector grant programmes. Both sources of funds will continue to remain necessary for infrastructure projects and the Europe 2020 Project Bond Initiative will act as a complement to them.

5.2. Using established EU/EIB risk sharing mechanisms

The Europe 2020 Project Bond Initiative would make use of project financing techniques that rank the future claims on a project's cash flows in order of seniority, whereby senior claims are served before subordinated claims, which in turn are repaid before equity holders.

By providing support at the subordinated level, the Initiative would absorb much of the risk of insufficient cash being available to service the senior debt, thereby raising its credit quality. This is known as "credit enhancement". The EU-supported credit enhancement would allow the senior project debt to be issued in the capital markets in the form of a new class of project bonds, resulting in reduced funding costs for longer maturities for project entities, while meeting the demand of institutional investors (such as pension funds and life insurance companies) for stable, long term assets.

For loans, a similar mechanism is already used in existing EU-EIB financing instruments such as the Loan Guarantee Instrument for TEN-T projects (LGTT)¹². In principle, the Europe 2020 Project Bond Initiative would apply this technique to bonds issued to finance infrastructure projects in a range of policy areas and would cover all project-related risks arising over the full term of the project debt.

The EU backed EIB support could take the form of a debt service guarantee or an additional layer of debt at the subordinated level. The choice of a guarantee or a loan would depend on the exact financial characteristics of the project, but neither would substitute for shareholder contributions in the form of equity or shareholder loans.

The debt service guarantee could be in the form of a contingent credit line provided to the project entity by the EIB (or another financing partner), which would inject funds into the entity if the project were unable to generate sufficient cash in the short to medium term to service its debt for any reason. During the construction period, the credit line could be called upon to meet funding shortfalls and thus ensure that projects will reach the operating period.

¹² Commission Communications COM/2005/0075 and COM/2005/0076.

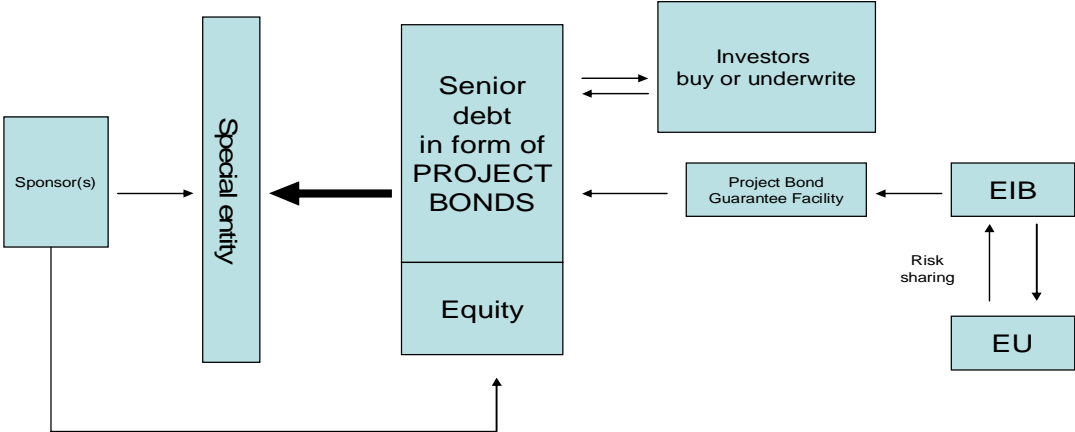
The Initiative could also support, under certain conditions, refinancing efforts of infrastructure projects currently under construction.

To ensure that the senior debt is and remains investment-grade at a level attractive to the investors in most scenarios, a guarantee amounting to maximum 20% of the total bond funding of an individual project would be required. If fully drawn, the guarantee would be able to cover several years' debt service, which experience shows to be sufficient when the guarantor can benefit from the diversification of a portfolio of projects¹³.

The precise amount would be calculated with the objective of achieving a protection effect significant enough to ensure an investment grade rating of the project bonds. Ideally, the rating should be around A or higher to allow the debt to be financed via project bonds.

A significantly higher coverage ratio could potentially prompt private project sponsors and other equity providers to lower their risk by providing less equity, while simply making the Initiative more expensive for the EU and EIB.

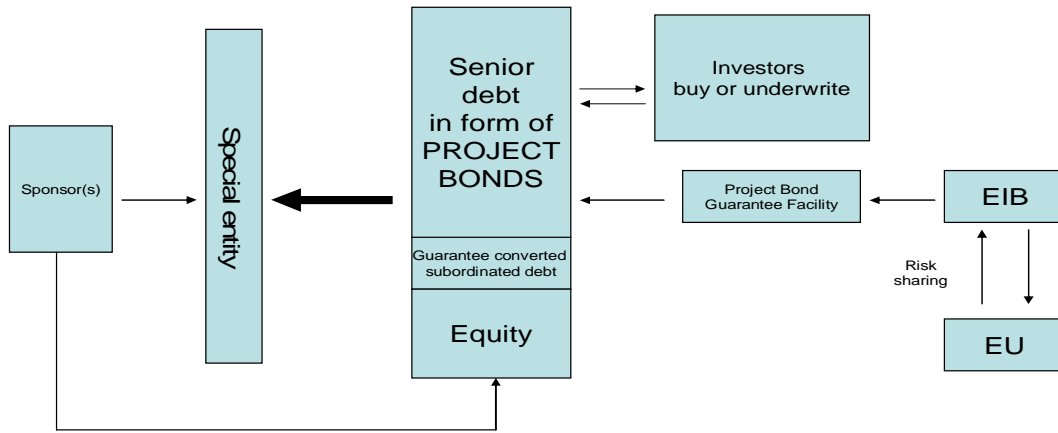
EU Project Bond – Guarantee not drawn



Once drawn, the facility would be subordinated to the project bonds, i.e. the project bonds would be repaid first and any funds left over would be used to repay the facility through a subordinated cash sweep mechanism, i.e. all remaining cash is used for repayment, with none going to equity until the facility has been repaid.

¹³ If the targeted portfolio of projects is sufficiently large and diverse, a portfolio approach could be used to model the behaviour of the portfolio of projects. This lowers the overall risk as it is unlikely that all projects in a diversified portfolio default at the same time, ensuring an efficient and effective use of EU funds and EIB capital.

EU Project Bond – Guarantee drawn



Alternatively, an EIB subordinated loan of sufficient size could be provided to the project entity with the same effect as the drawn guarantee of increasing the cash flow available to cover the senior project bonds in order to achieve the necessary investment-grade rating required by institutional investors.

5.3. The role of the EU and of the EIB

The EU will define the project eligibility framework and seek greater synergies between EU grants and the use of specialised financial instruments.

The EIB has, within the EU, a unique long-standing experience in the financing of infrastructure projects and is already working on LGTT. The Europe 2020 Project Bond Initiative should build on this existing experience. Therefore, in partnership with the Commission, the EIB will help develop and continuously expand a pipeline of PPP projects on the basis of a clearly defined eligibility framework. The EIB would subsequently carry out the due diligence and financial appraisal in the structuring phase, price the guarantee or loan and monitor the project thereafter. EIB may also be prepared to act as controlling creditor according to principles to be established in agreement with market participants.

The EU and the EIB would share the risk of the losses of the project portfolio. The EU risk would be ring-fenced and its participation therefore capped at an agreed annual budgetary amount. The EIB would be covering the residual risk up to its maximum exposure on any individual transaction. The risk-taking of the EU and the EIB would be compensated via a risk premium charged up-front to the project entity at the time of agreement of the guarantee¹⁴. This premium will be priced to reflect the subordinated status of the credit line and the associated risks for the EIB and the EU as well as covering expected management and other costs. The appropriate pricing system, while similar to that used in the LGTT, will

¹⁴ The alternative would be an annual payment over the life of the facility or over a certain initial period, which could be related to the duration and type of the project.

require further fine-tuning in order to ensure that it is at a level where it does not deter the bond financing it tries to support, while covering the above-mentioned factors.

The intention is to build a portfolio of transactions sufficiently diversified in particular in terms of size and sector so as to benefit from the risk reduction through the "portfolio effect". This would increase the impact of EU budgetary funds and EIB interventions in terms of credit enhancement volumes available for projects.

The Initiative is also open to other financing partners, such as international financial institutions (IFIs) and/or other Member States banks with a public sector mandate, with experience in the financing of EU infrastructure projects and the willingness to carry the associated risks in partnership with the European Commission.

6. ELIGIBILITY

The Initiative would be available to those projects that are economically and technically sound and cost-effective and that have a real prospect of financial viability. It will need to be determined whether eligibility extends beyond EU-27 to candidate and other pre-accession countries.

An important financial characteristic of a suitable project is stable and strong cash flows, whether the revenue is from users/customers or due to availability payments, where the public sector pays the operator for making infrastructure available according to certain performance criteria. A combination of the user and availability payments, even from multiple sources, is also possible. The aim would be to make the maximum number of projects "bankable". The intention is to focus on TEN-T, TEN-E and certain ICT-related projects. However, in the initial phases of the Initiative a compromise might need to be found between supporting large EU priority projects and currently available projects that would help build a large, well-granulated and diversified portfolio.

In principle, the Initiative should be available to brown-field and green-field projects, in particular in the early stages of its implementation. All projects would, of course, be assessed in detail by the EIB to determine the robustness of their financing structure.

In addition, the need to foster and maintain a solid project pipeline is also an important consideration. The EIB, in cooperation with the Commission, will be responsible for developing the project portfolio. Furthermore, projects may also require technical and financial advisory services. Where appropriate, technical assistance from JASPERS and other EU schemes could be made available.

7. CONCLUSION AND NEXT STEPS

The aim of the Europe 2020 Project Bond Initiative is to enhance the development of well functioning project finance and capital markets in a manner transparent to the investors, the project promoters and the public. It is expected that more infrastructure projects financed by the private sector will be implemented, at lower overall cost and faster.

The contributions from stakeholders to this consultation paper received by 2 May 2011 will directly feed into the reflection on the design of the Initiative. It is also intended to have a consultative conference on 11 April 2011. The aim is to have a fully-fledged proposal ready in June 2011 in the context of the next Multiannual Financial Framework with the intention of having the Europe 2020 Project Bond Initiative fully operational in 2014.

8. QUESTIONS

General questions

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?

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

Specific questions

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

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

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

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

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

9. ANNEX: GLOSSARY

Cash sweep mechanism	A mechanism which dedicates all revenue at a certain level of seniority in the financing structure to the repayment of an outstanding loan or credit line before the next more junior layer receives any cash.
Contingent	Dependent or conditional on defined events
Controlling creditor	An institution which takes responsibility for monitoring the project implementation and negotiates with the project company or sponsor on behalf of all bondholders in case of need. .
Credit line	An amount of credit extended by a lender, which the borrower may use on a revolving basis.
Credit ratings	The classification of a borrower's creditworthiness made by specialised agencies such as Standard and Poors, Moody's or Fitch. Of particular interest is the investment-grade segment above BBB-/Baa3/BBB- respectively. A “good” investment grade rating is A/A2/A.
Debt Service Coverage	Amount of cash available to meet annual interest and principal repayments.
Monoline	An insurance company which specialises in one line of business (hence the name), namely providing financial insurance of credit products in the form of a debt service guarantee. This is also known as wrapping.
Probability of default	The likelihood that a scheduled payment under a loan will not be made. Used in the calculation of regulatory capital.
Provisioning	Earmarking funds for probable future losses on loans due to defaults.
Ratings	See Credit Ratings.
Risk-sharing	The risk of a loan is shared with other parties, which have an interest in promoting lending to the sector or beneficiary in question. The other party may or may not be better able to evaluate the risk.
Senior debt	In this context: The highest level in a company's debt structure with most certainty of repayment.
Subordinated debt	In this context: The debt below the senior debt, which is, however, senior to equity.
Tranche	A piece or slice of a company's debt with specific characteristics in terms of seniority etc.

Wrapped

Another term for guaranteed