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COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS

A pilot for the Europe 2020 Project Bond Initiative

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1.1. EU infrastructure policy: from grants to project bonds

Despite long-standing EU policy and grant spending on Trans-European Networks (TENs) in the area of transport, energy and telecommunications, the Commission has found that the completion of key infrastructure projects is delayed with one of the principal reasons being lack of investment.

The 2010 Monti Report "A new strategy for the single market"[1] diagnosed the problem as *"Major public infrastructure in Europe, such as the TENs, 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"*[2].

Therefore, one of the key decisions in the proposed multi-annual financial framework (MFF) for the period 2014-2020, adopted by the Commission on 29 June 2011, was to re-unite the granting of financial aid for transport, energy and ICT infrastructure under a common legislative framework, the Connecting Europe Facility (CEF)[3]:

"The Commission has decided to propose the creation of a Connecting Europe Facility to accelerate the infrastructure development that the EU needs. (…) The Connecting Europe Facility will fund pre-identified transport, energy and ICT priority infrastructures of EU interest, and both physical and information technology infrastructures, consistent with sustainable development criteria"[4].

The Commission will make a proposal for a new Regulation to establish the Connecting Europe Facility (CEF), which will use both grants and financial instruments, in recognition of their respective strengths. The instruments will comprise both equity and risk-sharing instruments. The Europe 2020 Project Bond Initiative will be one of a number of risk-sharing instruments upon which the facility may draw in order to attract private finance to projects.

In other words, from 2014 onwards, CEF will put European funding for transport, energy and telecommunications infrastructure on a solid and coherent basis for the longer term. In addition, the financial instruments under the Facility may be extended to other sectors such as social infrastructure, renewable energy or certain space projects, provided they fulfil the appropriate economic and financial criteria as laid out in Section 3. However, infrastructure projects in Europe are facing financing problems already now. Government spending is being reduced, with investment programmes frequently reduced first, and long-term bank lending continues to be scarce. Project finance volumes, after recovering somewhat in 2010, have declined dramatically in the first half of 2011[5]. Thus, at a point in time where infrastructure

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1 M. Monti: A new strategy for the single market, at the service of Europe's economy and society, 9.5.2010, p. 62.

2 Monti report p. 62.

3 COM(2011)662

4 COM(2011) 500 final.

5 Source Infrastructure Journal (IJ) database Western Europe declined from EUR 33 billion to 26 billion, half of which is transport and energy (IJ's data for Eastern Europe are distorted by Russia and Turkey, hence not included).

projects could contribute most to aid the European recovery, the financing is more challenging than it need be[6].

It will also be beneficial for the European economy as a whole due to the direct and indirect benefits of investing in infrastructure while supporting the urgent shift towards a resource efficient and low carbon economy, in line with the Europe 2020 strategy.

The Commission is therefore proposing to launch a pilot phase in the period 2012-2013, still within the current financial framework. The recent consultation[7] showed widespread support from stakeholders to open up debt capital markets for infrastructure financing as soon as possible. In addition, such a pilot phase would facilitate the market introduction of EU-supported project bonds, which will be a new type of asset and testing of the design and parameters of the initiative in order to make changes, if required, before 2014.

1.2. Large future investment needs: where will the money come from?

Europe faces higher infrastructure investment needs than in the recent past in transport, energy and ICT networks in this decade, totalling several trillion euros, to meet the policy goals of the Europe 2020 strategy and to maintain or upgrade existing infrastructure.

The Commission has recently refined its estimates as follows:

- The Digital Agenda objectives to ensure that every European has access to basic broadband by 2013 and to fast or ultrafast broadband by 2020[8] are estimated to require investments of EUR 181-273 billion.

- The Resource-efficient Europe flagship objectives are expected to require transport and energy infrastructure investments of around EUR 700 billion for the highest priority projects.

These figures do not constitute a funding gap, but represent the total investment requirements, whether publicly or privately financed or addressed by policy in these sectors.

While EU governments spend on average 1% of GDP on infrastructure investments[9], they have increasingly encouraged the private sector to finance infrastructure investment, either on a purely private sector basis through privatisation, through concessions or, more recently, using the public-private partnership (PPP) model as a basis. Such projects are financed with equity and bank loans.

However, during the financial crisis, banks in the EU reacted to liquidity and risk challenges by shortening maturities, increased pricing and collateral requirements. This led to a smaller number of lending operations and smaller volume of operations per bank as well as an increasing mismatch with the long-term financing requirements of projects. In addition, there

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6 See also the Impact Assessment on the Connecting Europe Facility and the Impact Assessment accompanying the legislative proposals for the ERDF and Cohesion Fund.

7 http://ec.europa.eu/economy_finance/consultation/index_en.htm

8 The 2020 goal has two parts: (i) all Europeans have access to much higher internet speeds of above 30 Mbps and (ii) 50% or more of European households subscribe to internet connections above 100 Mbps.

9 Between ½ and 2%, see Alegre et al, EIB Papers Volume 13/1 (2008). The main bias affecting the estimate is the classification of the investment of commercially operating companies as private even if they are owned by the public sector.

are a large number of loans to existing projects that were granted in 2006 and 2007 at high interest margins on a short term basis that are now coming up and requiring new financing arrangements. This will place an additional strain on the amount of debt available to finance the construction of new infrastructure, while banks are likely to continue to reduce risk generally[10].

The bond markets in Europe, which could offer long-term financing, are in fact not used for the financing of infrastructure projects. Although infrastructure projects generally have high costs of capital coupled with low operating costs, their usually stable and predictable cash flows should make long-term bond financing particularly attractive. Infrastructure debt generally has low default rates and higher recovery rates in case of default than comparable corporate debt. In addition, it shows a low correlation with other assets[11], which is fundamental to the reduction of risk in a diversified portfolio.

1.3. The value added of the Europe 2020 Project Bond Initiative

The Europe 2020 Strategy[12] envisaged the mobilisation of financial instruments as part of a consistent funding strategy that pulls together EU and national public and private funding to pursue the Strategy's objectives most efficiently. EU budget expenditure through financial instruments is not a new feature, as the first use of EU budget to support such instruments dates back more than ten years[13]. However, the Commission is proposing to standardise and harmonise their design, governance and other important aspects as explained in the Communication "A framework for the next generation of financial instruments"[14]. While this will allow an increased use of financial instruments in certain areas, their share of the overall EU budget will remain small compared to grants.

The main objective of financial instruments, such as the project bond instrument, is to attract and facilitate private sector finance of projects. They are particularly valuable when policies require a high speed of implementation, but uncertainties for projects are above average, as in the current environment of financial and sovereign crisis. They can reduce specific barriers that prevent the flow of debt and equity finance. Nonetheless, they let the private sector make the investment decisions.

The Europe 2020 Project Bond instrument is not intended to replace existing sources of project financing through bank loans or public sector grant programmes but rather complement these as a further means of closing the infrastructure financing gap. They serve to expand the investor base for private debt funding of projects from loan providers to bond investors. Moreover, projects with low or no revenue that are nonetheless of great public interest will continue to need grants in all stages of their life. Thus grants will continue to play an important role and could potentially even be combined with project bonds if a project can be appropriately structured.

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10 Bank for International Settlements on the assessment of long-term economic impact of stronger capital and liquidity requirements, August 2010. See also Commission staff working paper SEC(2011) 949 on prudential requirements for credit institutions and investment firms.

11 Moody's Special Comment on Default and Recovery Rates for Project Finance Loans 1983-2008, 20.10.2010

12 COM(2010) 2020.

13 Initially guarantees and venture capital for SMEs

14 COM(2011)662

The project bond initiative thus builds on the exhortation of the Monti report to *"[...] explore all combinations between public and private funding […]*", to *"[...] improve incentives for long term investors […] to direct their resources to long term infrastructure projects*" by encouraging "*[…] the development in Europe of a liquid bond market for very long maturities*".

As there is no real project bond market in Europe at present, project bonds would allow matching the requirements of institutional investors, such as pension funds and insurance companies, which need long-term assets to match their long-term liabilities, with the long-term financing needs of the projects.

However, infrastructure projects are very complex, requiring significant analysis upfront as well as continous follow-up during the life of the projects. A few institutional investors are ready to make the commitment in terms of resources to carry out the necessary analytical work, but the vast majority of investors will require some support before considering infrastructure project bonds.

Public funds from the EU, coupled with the participation of financial intermediaries, especially public development banks, can bring together the demand for long-term finance with private investors with long-term orientation but low appetite for risk. The idea is to use appropriations from the EU budget to support projects to the extent required to enhance their credit rating, and thereby attract financing from other sources, including private capital market investors. The instrument builds on proven financial techniques in the area of risk sharing, but with an extended scope. It will build on the experiences gained with Loan Guarantee Facility for TEN Transport (LGTT)[15].

The long-term aim is to promote the integration of European capital markets and their further development as well as creating a new asset class of European project bonds by seeking to standardise their terms. This will also allow private sector initiatives to enter the market more easily.

2. MAKING PROJECT BONDS OPERATIONAL

Project Bonds are issued neither by the European Union nor by Member State governments. They are private debt, issued by the project company. The Europe 2020 Project Bond instrument would enhance the credit standing of private entities that need to raise private funds for the infrastructure projects they promote. By addressing capital market investors, the Project Bond Initiative opens up a further avenue for project sponsors to attract funds. The EU Budget contribution will be capped ex ante.

The principal mechanism to provide such enhancement of the credit standing of projects is to separate the debt of the project company into slices, a senior[16] and a subordinated[17] tranche. The insertion of the subordinated tranche increases the credit quality of the senior tranche to a level where most institutional investors are comfortable holding the bonds for a long period[18].

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15 Established in Regulation (EC) No 680/2007.

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

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

18 The consultation on the Project Bond Initiative broadly endorsed the principle of using a subordinated tranche as well as its magnitude.

The subordinated tranche can take the form of a loan, which is given to the project company from the outset, or a contingent credit line[19], which can be drawn upon to service the senior debt in case of need, or a combination of the two. The support would be available during the lifetime of the project, including during the construction phase, which is usually the riskiest part of a project, but would not exceed 20% of the senior debt of the project. This percentage is based on LGTT experience and modelling results and would provide a generous, but not excessive, liquidity cushion for most projects that fulfill the necessary financial criteria.

The consultation on the Project Bond Initiative broadly endorsed the principle of using a subordinated tranche as well as its magnitude. In terms of credit quality[20], a lower credit quality (rating of BBB+ or equivalent) appears to be acceptable for smaller, less complex projects than initially envisaged by the consultation paper. However, for larger projects the target credit quality (single A range or equivalent) was broadly endorsed. On these terms, market participants regard it likely that the initiative could reduce financing costs, while lengthening maturities.

While from 2014 onwards the Project Bond instrument would be firmly rooted in the Connecting Europe Facility, the Commission has seen from the experience with other financial instruments, most pertinently the LGTT, that they often require a significant lead time even when extensive prior consultation of stakeholders has taken place, simply because there is a difference between considering a hypothetical proposal and working through a concrete transaction. This is valid in particular for complex infrastructure projects which consist of a large number of financial and legal interacting aspects. Stakeholders need to familiarise themselves with all issues of the structuring of a transaction in order to satisfy themselves that it is sound, the parameters of the financial instrument or the tendering process may need to be changed slightly and, most notably, the economic and financial market environment may change. A pilot phase will help to clarify a number of these issues.

Therefore the Commission is proposing to advance such pilot phase to 2012-2013 instead of it taking place during the first two years of the Connecting Europe Facility.

3. HOW WILL THE PILOT PHASE WORK?

The Commission proposes to base the pilot phase on an amendment of the Trans-European Networks (TEN) Regulation and the Competitiveness and Innovation (CIP) Decision[21], so as to draw on the budget lines of these programmes up to a total of EUR 230 million. EUR 200 million can be drawn from the TEN-T budget line, specifically from LGTT and EUR 10 million from the TEN-E budget line, initially intended to be used exclusively for grants. From the CIP ICT line, up to EUR 20 million can be drawn to support project bonds.

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19 The use of the credit line is dependent or conditional on defined events.

20 The classification of a borrower's credit quality 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.

21 Regulation (EC) No 680/2007 of the European Parliament and of the Council of 20 June 2007 laying down general rules for the granting of Community financial aid in the field of the trans-European transport and energy networks and Decision No 1639/2006/EC of the European Parliament and of the Council of 24 October 2006 establishing a Competitiveness and Innovation Framework Programme (2007 to 2013), respectively.

3.1. Implementation through EIB

As the initiative has been developed on the basis of the risk sharing concepts employed and the experience gained from the LGTT model, the Commission intends to continue working with the European Investment Bank (EIB) during the short pilot phase in order to refine the parameters for the post-2013 phase as rapidly as possible. Thereafter, the Commission will look into the possibility of involving other public financial institutions at that stage.

The EIB, as an EU organisation with the mission to support EU policies, has a unique long-standing experience in the financing of infrastructure projects in the EU. Its share capital is held by the 27 Member States, its role is long-term financing in support of EU policy objectives and it reports to all relevant European Institutions. It is politically accountable to the European Parliament and subject to the control of the Court of Auditors when it is responsible for spending EU budgetary resources. However, the Commission also intends to draw on the pools of knowledge of other financial institutions and also examine their interest and possibilities in becoming risk-sharing partners.

3.2. Project eligibility and monitoring

During the pilot phase, general project eligibility would be determined according to the relevant TEN (TEN-T and TEN-E) and CIP policy guidelines as proposed by the Commission and approved by the co-legislators.

The EIB and the Commission would work on developing a pipeline of projects thus eligible. Once a project moves from the drawing board and closer to implementation, the EIB would use its specialist expertise to appraise the project, carry out the due diligence and financial analysis in the structuring phase and price the guarantee or loan. Projects would need to provide stable and strong cash flows in addition to being economically and technically feasible. Project sponsors would also need to demonstrate ability to run a funding competition and carry out a project successfully. If the project sponsor decides to use the facility, the project would have to be approved by the EIB in line with standard procedures. The detailed selection and structuring tasks could only take place once the project reached an appropriate stage of maturity and projects would be evaluated in the order that they achieve this stage. The application and implementation would have to be compatible with EU policies and comply with all applicable EU law, including in the area of state aid.

To conclude, the EIB would subsequently accept and monitor the project in accordance with the EIB‘s standard policies and procedures including its Credit Risk Policy Guidelines in a manner already agreed in the context of joint EU/EIB instruments such as LGTT or the Risk Sharing Financial Facility (RSFF).

Finally, the Commission would report on the implementation of the initiative annually following the request laid down in Article 49 of the Interinstitutional Agreement of 17 May 2006[22].

It is clear that only a limited number of projects can be supported in the pilot phase, as the budgetary resources available are limited and the remaining time horizon for implementation is very short. Therefore, the project selection would be made with the aim of enhancing up to 10 projects, concentrating on those that are at a relatively developed stage of the bidding and

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[22] OJ C 139, 14.6.2006.

financing process or that require refinancing after the construction phase, in one or more of the three targeted sectors. In this manner, the experience gained would be maximised, while specific projects facing difficulties renewing their short maturity bank loans may be helped.

From 2014 onwards, the Europe 2020 Project Bond instrument, like other financial instruments targeting infrastructure projects, may be used in all infrastructure policy sectors with the appropriate financial characteristics of projects, provided the EU is in a position to allocate budgetary funds for this purpose.

3.3. Pricing

As part of the due diligence, the EIB carries out analysis and provides advice on how to incorporate the project bond support into the proposed financial structure. This enables the project company to issue a bond rather than rely on bank lending. The advantage or disadvantage of one or the other type of financing would depend on interest rates and fees for either solution at the time. Normally, a bond would only be used if the financing were cheaper than a loan. However, it is conceivable that having financing with the appropriate maturity or other aspects of a bond also have an implied value. These real or implied benefits have to be priced in order to avoid market distortions through a quasi-subsidy.

In practice, the EIB would base pricing on its standard pricing methodology and would therefore reflect the risk of the project, the proposed financing package and the quality of the sponsor(s). In other words, this may mean that the support may not be offered to all players at the same price. However, it would be made available to all projects on the same consistent methodological basis. Appropriate pricing will ensure that the interests of all actors are appropriately aligned and is fundamental to the success of the scheme.

Revenue from pricing may be earned upfront, i.e. upon conclusion of a financing, or on an annual basis or a combination of the two. It would be used to benefit new projects.

3.4. Risk sharing

As lending or contingent lending at the subordinated level is riskier than a standard senior loan, the EIB and the EU would share the risks involved. For the EU, this would take the form of an upfront budgetary contribution to cover its agreed share of the potential losses on the projects supported. The residual loss would be borne by the EIB.

Current joint EU-EIB instruments use pro-rata risk-sharing where all losses are shared by EU and EIB on a project-by-project basis according to fixed percentages. This is also called vertical risk-sharing. A first loss portfolio approach would involve the EU absorbing the first losses up to a certain pre-agreed percentage and maximum amount on a portfolio with EIB absorbing losses thereafter. This is also called horisontal risk-sharing. The project bond pilot may use either risk-sharing without affecting the agreed budgetary impact. The appropriate scheme will depend on how soon a suitable portfolio of projects can be set up. This depends in part on the project pipeline and on the conditions of use of three separate budget lines from a Commission perspective. For example, under vertical risk-sharing the percentage of risk assumed by either partner may have to vary to reflect the separate nature of the budget lines on which the initiative may draw and the different project sizes. The detailed terms and conditions will therefore be agreed with EIB and laid down in a cooperation agreement between the two institutions. The Commission and the EIB may review the appropriateness of the agreed risk-sharing scheme and percentage and propose changes if necessary. Once again, the budget impact will not change as explained in Section 3.6. However, the multiplier effect of the EU contribution will depend on the risk-sharing scheme and percentage chosen.

It should be noted that EU risk-sharing does not change the Eurostat assessment of whether the project belongs on the balance sheet of the national general government sector or the private sector. In order words, if the EU takes up to 20% of the risk, the assessment would simply apply to the remaining 80% of the project. Since the intention is to attract private funding for these 80%, the project should normally be classified as private. However, if the government provides a guarantee higher than 50% the part financed by the private sector partner, this will trigger a classification into the general government sector in the cases where a contract foresees a transfer of the infrastructure to the government in the future. These guarantees should include guarantees for a loan from an International Financial Institution (IFI). In addition, if a national government unit provides minimum revenue guarantees and minimum demand guarantees, such that government would bear a majority of the risks in the project, the debt would be classed as general government debt.

3.5. Known maximum budgetary impact

The EU budget contributions would be strictly capped and not create contingent liabilities. All the co-fincanced instruments which are based on risk-sharing involve allocations to programmes which are capped in size and so none of these instruments pose a risk to the budget beyond the amounts initially committed under those budget lines. In addition, and unlike for grants, there will eventually be a reflow of funds to the EU budget from fees charged to the beneficiary that are not re-used for new projects or other purposes within the programming period.

As the amount available to launch the pilot phase is limited, only a limited number of at most 10 EU-based projects can be supported. In addition, the pilot phase is limited in scope to TEN-T, TEN-E and telecommunication projects, while the post-2013 instrument could be open to infrastructure financing in other areas such as for example social infrastructure, renewables and certain space projects.

4. HOW WILL THE PILOT PHASE RELATE TO THE CONNECTING EUROPE FACILITY?

The lessons drawn from the pilot phase will serve to optimise the design of the initiative for the post-2013 period, when the Project Bond instrument will become an integral part of the Connecting Europe Facility.

For example, there are multiple views on which entities can best monitor the performance of the project in terms of technical and financial progress and contractual compliance throughout its lifetime and take the small or large decisions required to keep the project on track, while ensuring appropriate voting rights for investors when it comes to the most important decisions. The pilot phase will also have as a goal to see how this aspect of a project can be structured in practice to the satisfaction of all investors and project sponsors.

In addition, it may be necessary to adjust legal and financial structures depending on the jurisdiction of a project company or bond, which can only be discovered in practice, since it is not practical to go through the theoretical obstacles of 27 Member States. Other EU regulations are also likely to come into force in the area of capital markets, which may have unintended consequences in the area of infrastructure financing.

At the same time, the transactions concluded during the pilot phase may form part of the future portfolio of the operational phase from 2014.

Furthermore, the Commission will conduct an independent evaluation of the LGTT in 2012 to complement the current internal review and will also carry out an in-depth study of the financing models used for different sectors and sub-sectors if applicable. The review of the pilot for the project bond instrument is also foreseen in the second half of 2013.

Finally, it is already foreseen that for the post-2013 financial instruments supporting the implementation of the Connecting Europe Facility, a range of financial institutions will be invited to participate in the instruments as permitted by the Financial Regulation.

5. CONCLUSIONS

Major efforts are needed to facilitate infrastructure projects' access to private finance and to develop alternative ways of debt financing for them. Privately financed infrastructure projects in Europe rely heavily on bank lending, which is not readily available at maturities which would reflect the long-term life-cycle of an infrastructure project.

In order to improve projects' access to financing and develop a vibrant infrastructure bond market, where private initiatives have made little progress so far, the EU intends to cooperate with the EIB in order to create a facility to support the private issuance of project bonds, the Europe 2020 Project Bond Initiative.

Past experience has shown that a pilot phase is needed for stakeholders to familiarise themselves with the novel financing structures and for final changes to optimise the design. Even though the scale and scope of the pilot phase would be limited, it is expected to stimulate market behaviour towards an increased acceptance of capital market debt financing and thus lay the ground to improve the initiative and implement it as a fully-flegdged proposal in the next multiannual financial framework. Therefore the Commission is proposing to advance this pilot phase to 2012-2013 instead of it taking place during the first two years of the Connecting Europe Facility.

Given the short time available, the Commission invites the Parliament and the Council to adopt the proposal for a pilot phase as speedily as possible.