EU Consultation

EU SUPPORT FOR PROJECT BONDS

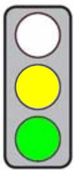
Status: 18 April 2011

cep Centrum für Europäische Politik

MAIN ISSUES

Objective of the Consultation: The Commission presents a model for infrastructure financing: payment guarantees or credits from the European Investment Bank (EIB) are to encourage private investors to bear the major part of infrastructure investments.

Parties affected: Investors and operators of infrastructure projects.



Pros: (1) The direct participation of private investors promotes the development of infrastructure in accordance with economic rather than political considerations.

(2) Public payment guarantees or credits encourage the participation of private investors in infrastructure development through improved ratings.

Cons: EIB payment guarantees or credits for infrastructure projects beyond trans-European networks would impede the development of the trans-European network itself.

CONTENT

Title

Stakeholder Consultation Paper [without number] of 28 February 2011: **The Europe 2020 Project Bond Initiative**

Brief Summary

- **Background and objective**
  - According to the Commission, by 2020 there will be considerable investment needs in European energy, transport and information and communication technology (ICT) infrastructures.
  - Due to the indebtedness of public budgets, the Commission intends to intensify its efforts to encourage private investors to participate in financing infrastructure directly.
  - The aim of the Consultation is to gather feedback on the following financing model for infrastructure projects:
    - Private or public-private project companies issue bonds on capital markets to finance infrastructure ("project bonds").
    - Limited payment guarantees or credits provided by the European Investment Bank (EIB) are to encourage private investors to buy project bonds.
  - Project bonds must not be confused with Eurobonds. Eurobonds are (not yet existing) bonds issued by the EU or a pool of Member States. This idea is controversial as Eurobonds would infringe the EU ban on state debt (see CEP Analysis).
- **Investment needs for infrastructure projects**
  The Commission estimates that by 2020 the investment needs for energy, transport and ICT infrastructures will amount to 1.5 to 2 billion Euros. Of this:
  - 1.1 billion Euros are allocated to the trans-European energy network (TEN-E) [cp. COM(2010) 677; see CEP Policy Brief]:
    - 500 billion Euros are needed for the maintenance of existing energy generation capacities and for building new ones,
    - 400 billion Euros are needed for distribution networks and "smart grids" and
    - 200 billion Euros are needed for transmission networks and electricity and gas storage;
  - 500 billion Euros are allocated to the trans-European transport network (TEN-T) [cp. COM(2010) 212; see CEP Policy Brief];
  - up to 268 billion Euros are allocated to ICT infrastructures, in particular to the further development of broadband networks [cp. COM(2010) 472].
- **Public and private finance of infrastructure**
  - According to the Commission, a (partial) public infrastructure financing is justified due to "significant indirect benefits" for society at large (p. 3). In particular, a well-developed infrastructure has a positive impact on long-term economic growth.
  - Since the early 1990s, in the case of individual projects (project-related financing) Member States have been striving more and more for (partial) private infrastructure financing.
- **Project-related financing of project companies**
  - A project company is to finance, implement and operate the project concerned.
  - A project company is:
    - a purely private company in which private investors (e.g. real estate developers or financial investors) bear the entire investment risk or

Authors: Benedikt Langner and Marcus Schwenke | langner@cep.eu
CEP | Kaiser-Joseph-Straße 266 | 79098 Freiburg | Germany | Telephone +49 (0)761 38693-105 | www.cep.eu

  - a public-private company in which public and private partners share the investment risk [so-called public-private partnerships (PPP); see CEP Policy Brief].
- The project company raises investment costs through:
  - equity (contributions by shareholders) and
  - debt capital (bank loan or "project bonds").
- After the completion of the project construction, the company receives revenues generated by the project:
  - through payments from the public purse for providing the infrastructure and/or
  - through payments by users of the infrastructure, e.g. toll fees ("user-pays-principle").
- The project company uses the revenue dividends to repay the debt and equity capital.

► **Promoting project bonds by the European Investment Bank (EIB)**
- The certain high investment costs are faced with uncertain current revenues, possibly distributed over decades. The acquisition of project bonds therefore bears a high risk for private investors.
- The risk is reduced, however, if a part of the current revenues is insured by payment guarantees. This leads to an improved rating of project bonds.
- In the past, bond insurers known as "monolines" have issued payment guarantees for project bonds against risk premiums. However, in the wake of the financial crisis in 2008, the monoline business model "came to a halt".
- As a substitute, the Commission promotes payment guarantees (or credits) to be issued by the EIB ("Europe 2020 Project Bond Initiative").

► "**Europe 2020 Project Bond Initiative"**
- **Concept**
  - The project company issues project bonds on the capital market to finance an infrastructure project.
  - Against the payment of a risk premium, the EIB grants a payment guarantee covering the entire term of the project bond; the sum guaranteed must not exceed 20% of the investment sum ("Project Bond Guarantee Facility").
  - The guarantee is just high enough to ensure a project bond rating of "around A" ("investment-grade level").
  - Private investors (e.g. insurance companies and pension funds) buy the project bonds.
  - The project company repays the bond from its current revenues.
- **Guarantee case**
  - The guarantee case enters into force if and when the bond cannot be serviced from the current revenues "for any reason" (p. 6). In this case, the holders of the bond concerned are serviced by EIB guarantee payments to the maximum of the previously determined guarantee sum.
  - The partners of the project company do not receive any profit distributions until the guarantee payments by EIB have been fully compensated.
- **EIB credit as an alternative to payment guarantees**
  Rather than issuing a permanent guarantee, the EIB can also issue a credit to the project company to the maximum amount of 20% of the investment sum.
- **EU participation**
  - The EIB shares the default risk together with the EIB, in that the EU also issues a payment guarantee to the EIB to the amount of its share in the default risk.
  - The maximum amount of the default risk borne by the EU is limited to the reserves of the EU financial framework, retained especially for such cases. Beyond this, the EU has no further obligations.

► **Selection of infrastructure projects**
- The Commission deems all infrastructure projects "that have a real prospect of financial viability" eligible for promotion. This includes, in particular, all infrastructure projects with "stable and strong cash flows" from public monies for the provision, or from user fee tolls.
- The EIB could:
  - carry out the due diligence of the projects as it has the appropriate expertise and
  - monitor the implementation of the projects ("controlling creditor").
- At first, the initiative will apply to projects related to TEN-E, TEN-T and ICT infrastructures. However, the Commission intends to make further infrastructure projects "bankable".
- In order to spread the default risk, the promoted projects are to be chosen from various sectors. As it is unlikely that the guarantee payment is needed by all projects at the same time, more projects can be supported by the same means ("portfolio approach").

► **Extension to the financing of infrastructure through credits**
- Although the primary aim of the "Europe 2020 Project Bond Initiative" is that project bonds are subscribed to by investors, it also allows for the EIB insuring commercial bank credits.
- For the financing of large-scale infrastructure projects through credits has also become more difficult because since the financial crisis, the capital and liquidity requirements for commercial banks have become much stricter.

Statement on Subsidiarity by the Commission

The Commission does not address the issue of subsidiarity.

Policy Context

The trans-European networks (TEN) are financed by Member States and private investors on the one hand, and by the EU through structural funds, cohesion funds and TEN budgets on the other hand; the EIB grants loans. The conditions and the procedure for EU financial aid under the framework of trans-European networks in respect of transport and energy are regulated by the Regulation 2007/680/EC and in respect of ICT by the Regulation 2010/67/EU.
In 2008, the Commission entered into a cooperation agreement with the EIB on credit guarantee instruments for projects of TEN-T (Loan Guarantee Instrument for Trans-European Transport Network Projects, LGTT). With 500 million Euros each, the Commission and the EIB wish to raise a total of 20 billion Euros in private capital for transport infrastructure finances, in order to hedge the high profit risk through credit guarantees during the early implementation stages of projects.

Options for Influencing the Political Process

Leading Directorate General:	DG Economic and Financial Affairs
Consultation procedure:	Each citizen may submit a statement by 2 May 2011: http://ec.europa.eu/economy_finance/consultation/index_en.htm

ASSESSMENT

Economic Impact Assessment

Ordoliberal Assessment

The Commission's (at least preliminary) decision to finance infrastructure without Eurobonds constitutes a change of direction. In its first considerations regarding the revision of the TEN-T policy [COM(2009) 44; see CEP Policy Brief] it still propagated Eurobonds.
The "Europe 2020 Project Bond Initiative" now being proposed, however, is a priori out of the question for the majority of infrastructure projects, as most of them do not have sufficient attributable current revenues, e.g. user toll fees, and are therefore not attractive to private investors. As far as the eligible projects are concerned, the following is true:
The direct participation of private investors means that there is a chance that infrastructure development occurs in accordance with economic rather than political considerations. For investors will only participate if the projects are based on a sustainable financing model. This applies particularly to projects which generate their current revenues from user toll fees ("user-pays-principle"). In this case, the revenues reflect approximately the economic benefit. However, if projects generate their current revenues from public payments which are fixed by policy, these projects may be profitable from a business point of view but unsuitable for the economy as a whole.
Basically, the question is whether or not public guarantees (or credits) are needed at all to gain private investors. On the one hand, as a consequence of the current debt crisis of many Member States, project companies have become more attractive to investors since payment defaults can no longer be excluded for government bonds. On the other hand, in general investors are already in their own interest distributing their risks amongst various infrastructure projects so as to insure themselves against possible payment defaults.
Either their own or statutorily prescribed minimum requirements related to the rating of individual investment projects, however, can help prevent insurance companies and pension funds from buying project bonds with a worse rating than "A". In such cases, by upgrading a rating to "investment-grade", **public guarantees** (or credits) can lead to a situation in which investors subscribe project bonds and thus **promote a participation of private investors**.
Guarantees (or credits) from the EIB and the EU should, however, be used only for infrastructure projects within the scope of trans-European networks. **The** considered **extension of the "Europe 2020 Project Bond Initiative" to potentially "bankable" infrastructure projects beyond trans-European networks, however, threatens to make the construction and further development of trans-European networks more difficult, as scarce EU financial means will no longer be available then.**
In the transport sector in particular, further restrictions on the scope of the "Europe 2020 Project Bond Initiative" are desirable. For the definition of the trans-European networks is already very broad, including even exclusively national sections that have no European relevance (see CEP Policy Brief on the revision of TEN-T). EU funds should therefore be used to develop infrastructures that are clearly of benefit to Europe. This condition might well exist, especially in the case of projects falling within the scope of the TEN-T "core network" as planned by the Commission: after its completion, it will facilitate the smooth flow of transport on all of the sections most important for the EU economy [see also the White Paper on Transport COM(2011) 144; see CEP Policy Brief].
With the "Europe 2020 Project Bond Initiative", the EU by definition adopts the monolines business model. Unfortunately, the Commission fails to state whether this business model has "come to a halt" permanently or

only temporarily. If the latter, the initiative makes it difficult for bond insurers to re-enter the market, as they would be in competition with EU funds.

However, the extent of this possible distortion of competition can be reduced by means of the amount of the risk premium to be paid by the project company to the EIB: the more the risk premium amount is adjusted to the reduction in debt capital costs resulting from improved ratings from the EIB guarantees, the more this corresponds to the "market price" of a guarantee and the less possibility there is of a distortion of competition. Naturally, the Commission does not address this issue.

Impact on Efficiency and Individual Freedom of Choice

High-performance transport, energy and ICT networks increase overall economic efficiency.

Impact on Growth and Employment

A well-developed infrastructure facilitates the division of labour among Member States and therefore increases growth and employment. At the same time, this is only true for infrastructure projects established in accordance with economic criteria rather than political wishful thinking.

Impact on Europe as a Business Location

Measures to maintain and upgrade key infrastructure make the business location "Europe" more attractive.

Legal Assessment

Legislative Competence

The EU is empowered to grant financial aid for the development of trans-European networks in the field of transport, energy and ICT (Art. 171 (1) TFEU in conjunction with Art. 170 TFEU). For a financial support of infrastructure projects beyond the definition of trans-European networks, i.e. without any cross-border function and EU-wide relevance, no legal basis is given.

Subsidiarity

Without prejudice to the issues of competence, the financial support of projects beneath the level of trans-European networks would infringe the principle of subsidiarity. Increasing the attractiveness of projects of purely national relevance can also be achieved through national guarantees or credits granted by the Member State concerned.

Proportionality

Currently not assessable.

Compatibility with EU Law

Unproblematic.

Compatibility with German Law

Unproblematic.

Alternative Action

Rather than using EU guarantees, infrastructure development can on the one hand be promoted in line with market rules by improving the regulatory environment for infrastructure operators. Only investors expecting high returns are willing to take the high risks characteristic of infrastructure development. Hence the high investment risk should be sufficiently taken into account when regulating infrastructure, for instance through greater freedom in fixing user toll fees. On the other hand, the Member States could increase public payment themselves or issue them with credible payment promises to ensure the profitability of an infrastructure project.

Possible Follow-up Actions by the EU

Upon the expiry of the consultation, the Commission will probably propose under the future EU financial framework after 2013 to defer funds for the "Project Bond Guarantee Facility". The credit guarantee instrument for projects of the TEN-T (LGTT) could serve as a model here.

Conclusion

The proposed direct participation of private investors encourages infrastructure development in accordance with economic rather than political considerations. By upgrading a rating to "investment-grade", public guarantees (or credits) can lead to a situation in which investors subscribe project bonds and thus encourage the participation of private investors. The considered extension of the "Europe 2020 Project Bond Initiative" to include bankable infrastructure projects beyond trans-European networks, on the other hand, impedes the development and expansion of trans-European networks, as scarce EU funds would then no longer be available for that. The "Europe 2020 Project Bond Initiative" should therefore be strictly limited to projects within the scope of trans-European networks.