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Project bonds as a new initiative of European Union in financing infrastructure projects

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PROJECT BONDS AS A NEW INITIATIVE OF EUROPEAN UNION IN FINANCING INFRASTRUCTURE PROJECTS

Introduction

Investment in infrastructure projects is an important means to maintain economic activity during the crisis and support a sustained economic growth. One of the ways of financing infrastructure projects, in situation of scarcer and scarcer country budgets, is an involvement of private sector capitals in form of Public Private Partnerships (PPPs). PPPs can provide effective ways to deliver infrastructure projects, to supply public services and to innovate more widely than public sector.[1]

Infrastructure investment needs in Europe are really huge. According to OECD projections a demand for new investment in economic infrastructure is assessed on EUR 1.5–4 trillion until 2030.[2]

These two factors – scarce budget means and huge infrastructure needs are the most important drivers of PPP projects implementations. Infrastructure projects are long-lived, capital absorbing, intense and with high profile of risks. Alongside to PPPs' development more often private sector sponsors occur prob-

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[1] Communication from the Commission to The European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions. *Mobilising private and public investment for recovery and long term structural change: developing Public Private Partnerships*, Commission of The European Communities, Brussels, 19.11.2009, COM (2009) 615 final, p. 1.

[2] *Strategic Transport Infrastructure Needs to 2030. Main findings*, OECD Future Project on Transcontinental Infrastructure Needs to 2030/50, OECD 2011, s. 10; *Commission sets 2050 transport targets*, 28 March 2011.

lems to provide sufficient funds to finance capital-intense infrastructure projects or ensure money providers that investment risks of infrastructure projects is not extremely high. Economic and financial crisis 2007–2008 have caused also negatively on supply of funds and weakening a confidentiality to partners and contracts.

The newest solutions suggested by EU is an implementation an innovative capital market instrument called project bonds or in common Barroso bonds. This initiative has two objectives: to revive project bond markets and to help the promoters of individual infrastructure projects to attract long-term private sector debt financing. It will thus act as a catalyst to re-open the debt capital market as a significant source of financing in the infrastructure sector.[3]

The aim of a paper is to indicate the main features of EU projects bonds. The Initiative will not replace the 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. The objective is to expand the investor base for private debt funding of projects from loan providers to bond investors.

1. PPP's determinants

PPPs are arrangements typified by joint working between the public and private sectors. Whilst the principal focus of PPPs should be on promoting efficiency in public services through risk sharing and harnessing private sector expertise, they can also relieve the immediate pressure on public finances by providing an additional source of capital. In turn, public sector participation in a project may offer important safeguards for private investors, in particular the stability of long term cash-flows from public finances, and can incorporate important social or environmental benefits into a project.[4] The main characteristics of PPP projects are shown in table 1.

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[3] *A pilot for Europe 2020 Project Bond Initiative – legislative proposal adopted by the Commission*, Brussels, 19 October 2011, http://europa.eu (7.06.2012).

[4] Communication from the Commission to The European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions. *Mobilising private and public investment for recovery and long term structural change: developing Public Private Partnerships*, Commission of The European Communities, Brussels, 19.11.2009, COM (2009) 615 final, p.1.

Table 1

Why PPPs

Positives	Risks
Harness private sector expertise and investment – can lead to a better service and encourage innovation, **Effective risk transfer** – increases the likelihood of on-time on-budget delivery, better service quality and asset maintenance, **Whole life approach** – solutions which minimize costs over the life of the asset, **Spread payments over the long term** – pay for the service, not for the asset, **Third party finance** – may ease public finance constraints	**Expertise** – PPPs require a strong public sector throughout project selection, preparation, procurement and through the life of the contract, **Flexibility** – public sector must have a good idea of its long-term needsat the outset, **Cost of private finance** – there needs to be a clear case that the additional cost of private finance incentivizes better outcomes than the public sector alternative, **Supportive environment** – legal and institutional set-up needs to allow/incentivize private participation, **Sustainability** – understand the budgetary implications of PPPs, **Doing PPPs for the wrong reasons** – off-balance sheet treatment, unreasonable expectations of what the private sector can do

Source: A. Carty, *PPPs: An introduction*, The 10th Annual European Infrastructure & PPP Summit, Berlin, 8–10 November 2011, p. 8–9.

In practice PPPs deal with the provision of assets and associated services in structures which are:

- long-term contractual arrangements, often 25–30 years,
- financed either in part or in whole through private finance,
- drawn-up in a way which allocates risks between the parties on the basis of which party is best placed to manage and bear them,
- designed to ensure the private sector is incentivised to deliver the required services or obligations under the arrangement.

There is now considerable evidence that PPPs can:

- improve delivery of projects – PPPs have a track record of on-time, on-budget delivery,
- better value for money from infrastructure – by exploiting the efficiency and innovative potential of a competitive private sector to either costs, or achieve a better quality ratio,
- spread the cost of financing the infrastructure over the lifetime of the asset – thus reducing immediate pressures on public sector

budgets and allowing the completion of infrastructure projects — and the benefits they deliver — to be brought forward by a number of years,

– improve risk sharing between public and private parties – provided it is properly apportioned, more efficient risk management reduces the overall costs of projects,
– boost sustainability, innovation and research and development efforts for delivering the breakthroughs needed for new solutions for society's socio-economic challenges.
– give the private sector a central role in developing and implementing long-term strategies for major industrial, commercial and infrastructure programmes,
– enlarge EU companies' market shares in the field of government procurement in third country markets – European public works and utilities companies can gain important contracts in certain markets of major trading partners as regard e.g. airport construction and management, motorways and water supply and treatment.

The combination of public and private capacities and money can therefore help the process of recovery and the development of markets that will form the basis of Europe's future economic prosperity. However, just at the time when the more systematic use of PPPs would bring considerable benefits, the crisis has made the conditions for these instruments more difficult.

2. EC process on the Project Bonds Initiative

The works on project bonds initiative last almost 2 years starting from President Barroso proposal presented on 7th September 2010. The further works are presented on table 2.

Table 2

Project bonds initiative processing

Date	Action
7 September 2010	J. M. Barroso proposes Project Bonds in his *State of Union* speech
28 February 2011	Introduction of Europe 2020 Project Bond Initiative. Launch of Consultation process
11 April 2011	Consultative conference on Europe 2020 Project Bond Initiative
2 May 2011	End of Consultation process
December 2011	Communication on the impact of the initiative
2012	Work closely with EIB on details of the Initiative
2014	Fully operational Project Bond Initiative in next multi-annual financial framework

Source: by own based on data of European Commission – DG ECFIN.

Time schedule of works connected to Project Bond Initiative clearly presents how intensive and speed was the time spent on this idea.

On the end of May 2012 political agreement between Parliament and Council of a European Commission proposal to launch the pilot phase of the EU-EIB Project Bond Initiative was achieved.[5]

3. Project bond concept

Project bonds will be introduced in 2012 and 2013 to pave the way for possible wider use under the "Connecting Europe Facility" at the start of the EU's new Multiannual Financial Framework (MFF) for 2014–2020. The project bonds will be issued by infrastructure project companies, but EU and EIB funds will be used to cover part of the project risk. It is hoped this will appeal to investors such as insurance companies and pension funds. Initial allocation of €230m for project bonds during a pilot phase in 2012 and 2013, as part of the €50bn infrastructure plan from 2014.

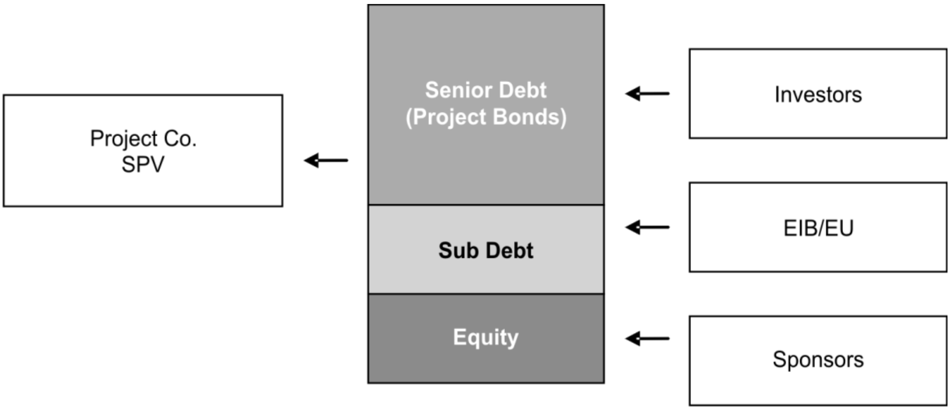
The plan will support up to 2020 projects in three sectors:

- transport – €200 million,
- energy – €10 million,
- broadband – €20 million.

[5] The pilot phase of the Europe 2020 Project Bond Initiative, http://ec.europa/economy (7.06.2012).

The idea of issuance of project bonds belongs to European Commission together with European Investment Bank. Such bonds are to be aimed at providing funding support to big investments of private sector energy and transport infrastructure projects (TEN-T and TEN-E), which are greater than EUR 200 million in size.[6]

The scheme will be managed by the European Investment Bank (EIB). EIB can play a double role – as a supplier of subordinated debt (scheme 1) or as a issuer of project guarantee (scheme 2).

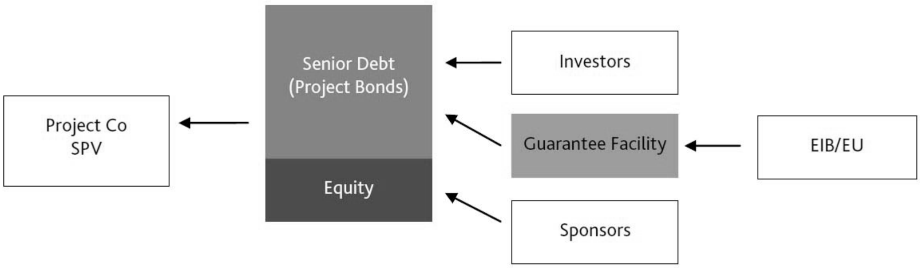


Scheme 1. EU Project Bonds – subordinated debt structure

Source: Moody's Investor Service – Special Comment Europe 2010 Project Bond Initiative.

Guarantees backing project bond issuing companies should make the bonds that they issue safer and more attractive to capital market investors such as pension and investment funds. With an expected multiplier ratio of between 15 and 20, these guarantees could mobilise up to €4.6 billion in private investment. Investment needs for transport, energy and Information and Communication Technologies (ICT) infrastructure projects in Europe are estimated at €1.5 trillion for 2010–2020.

[6] UE Project bonds: More smoke and mirrors at taxpayer's expense, EurActiv 3rd May 2012, www.euractiv.com.



Scheme 2. EU Project Bonds – Guarantee Facility

Source: Moody's Investor Service…

Credit enhancement of EIB as subordinated debt, or an unfunded partial guarantee of senior debt service is aimed to mitigate credit risk over the full term of the senior debt.[7] Participation of EIB in form of sub-debt and can be combined with different types funding sources, like as bonds and other senior loans. Unfunded (guaranteed) sub-debt participation of EIB, to 20% of total investment can cost) be flexibly used and structured in order to ensure target rating at least on A- level. EIB guarantee can cover funding shortfalls during construction, or come on top of a fully funded structure, or revolve capacity available until the end of project.[8]

Similar to Risk Sharing Finance Facility and Loan Guarantee instrument for TEN-Transport projects, the EU budget would be used to provide capital contributions to the EIB in order to cover a portion of the risk the EIB is taking when it finances the eligible projects. While the EU budget will provide some risk cushion for the EIB to finance the underlying projects, the EIB would have to cover the remaining risk.

"Project Bond" instruments will provide credit enhancement for senior debt – similar to the "Loan Guarantee Instrument for TEN-T Projects" (LGTT) Financial Instrument. LGTT, like "Project Bonds", is a common initiative of the EU and EIB, where traffic and revenue risks relating to the initial operating

[7] M. Schweer, *Debt and Bond finance – where are we now?* Sumitomo Mitsui Banking Corporation Europe Ltd., The 10th Annual European Infrastructure & PPP Summit, Berlin, 8–10 November 2011, p. 17.

[8] *The European Investment Bank and Europe 2020 Project Bond Initiative. Innovations in Financing European Infrastructure*, The 10th Annual European Infrastructure & PPP Summit, Berlin, 8–10 November 2011, p. 15.

(“ramp up”) period of TEN transport infrastructures are jointly taken by EIB and EU. LGTT, like “Project Bonds”, is a subordinated product designed to provide cover to senior (bank) lenders supplying stand-by facilities in the early phases of such infrastructure projects.

The Project Bonds Initiative, as currently conceived, has points in common with LGTT, but it would extend the LGTT experience to:

- other categories of project-related risks, possibly including construction, operations, performance, traffic etc.;
- a wider sector eligibility range, to be defined by the EU, but potentially extending to: transport, energy, and ICT;
- in principle, both unfunded and funded structures, depending on the project’s characteristics and requirements.

It is anticipated that the credit enhancement provided by EIB could go up to 20% of the senior securitised project debt. Traditional equity requirements to be met, i.e. subordinated debt supplied by EIB is not meant to replace shareholders’ loan or equity contributions.

Underlying projects must satisfy EIB’s ordinary assessment criteria, that is projects must be technically robust and financially sound.

4. Position of European Investment Bank (EIB) in project bond initiative

The EIB, the EU’s long term lending institution, has actively sought to support efficient PPP schemes across Europe, and in particular in transport infrastructure. The Bank has made nearly € 30bn available in loans for PPPs since the late 1980s. The EIB is also the leading financier of the TEN-T networks. It is expected to contribute 14% of total TEN-T investment between 2007 and 2013.[9]

EIB’s participation in project bond processing and issuance could provide substantial benefits, like as presented in comparison of potential investors needs and EIB share in it (scheme 3).

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[9] *The Europe 2020 Project Bond Initiative*, 27.04.2012, www.eib.org (7.06.2012).

Investors approach	**EIB approach**
Good investment – grade credit rating	Target of at least strong investment grade
Shield against project risks	By injecting sub-debt, provides protection against a wide range of risks at project level
Diversification	Separate asset class
External project due diligence they can rely on	Extensive due diligence du ring appraisal/ structuring
External financial analysis of the project	Thorough financial analysis during appraisal/structuring
Monitoring and surveillance post financial close	Participation in monitoring the project
Appropriate well functioning inter-creditor regime	Acting as controlling creditor with inter-creditor framework

Scheme 3. The role of EIB in Project Bond Initiative

Source: The European Investment Bank and Europe 2020 Project Bond Initiative. Innovations in Financing European Infrastructure, The 10th Annual European Infrastructure & PPP Summit, Berlin, 8–10 November 2011, p. 22.

Under the Project Bond proposal, the EIB would not undertake the traditional guarantee function of Monolines, that is it will not provide a full AAA wrap like he Monolines did. The appraisal and pricing of the individual subordinated loans underlying the Project Bond Initiative will be based on EIB's traditional standards. Therefore, in addition to its attractive pricing, EIB would be perceived "to add value" also given its reputation and track record in screening, assessing, mitigating and monitoring project risk.

Depending on the robustness of the financial structure, the EIB's intervention targets to "credit enhance" the Senior Bonds issued by the "Project Company" into a A – AA rating level, thus making these "Project Bonds" eligible for the portfolios of institutional investors;

The EU will support the products under the Project Bond Initiative via appropriate risk sharing mechanisms with the EIB.

The European Commission will work closely with the EIB and the private sector in order to increase the overall leverage effect of EIB funding, for instance through the blending of grants from theEU budget and EIB loans.

5. The pilot actions of Project Bonds Initiative

The aim of the pilot phase is to test the project bond concept during the remaining period of financial period 2007–2013. The pilot phase is to be implemented by EIB and will start in Summer 2012, after formal approve by EU Parliament and Council the legislative amendments in current regulations connected to TEN and Competitiveness and Innovation Programs.

Before the pilot phase has been put two-fold objectives:[10]

– to stimulate investment in key strategic EU infrastructure in transport, energy and information technology,
– to establish debt capital markets as an additional source of financing for infrastructure projects.

The intention is, by EU support, to attract institutional investors to the purchase capital market instruments with stable and predicted cash flow generation potential by greater credit quality of project bonds issued by private companies. Throughout the pilot phase 2012–2013 stakeholders can familiarize themselves with the novel financing structures. Feedback received during the pilot phase can then be used to fine-tune parameters of this financial instrument.

It is clear that only a limited number of projects could be funded in the pilot phase, as the budgetary resources available are limited and the remaining time horizon for implementation would be very short. Therefore, the project selection would be made with the aim of enhancing approximately 5–10 projects, concentrating on those that are at a relatively developed stage of the bidding and financing process or require refinancing after the construction phase, in one or more of the three targeted sectors of transport, energy and broadband.

Conclusion

The Project Bond proposal must be a competitive alternative based on high quality asset cash flows and parties. In order to be meaningful and successful Project Bonds must gather a varied set of conditions, like as to attract quality sponsors from private sector, to target institutional investors and to provide high quality projects of enough big size.

[10] The pilot phase of the Europe 2020...

There are crucial conditions to fulfill to achieve project bonds success, because high quality of private sponsors means cost effective financing alternative and good liquidity, strong rating (range from A – to AA) and long-term assets matching the long term liabilities of institutional investors like pension funds and insurance companies provides liquidity at competitive cost, and well structured projects with all usual features in terms of lenders protection (reserve accounts, performance bonds, liability caps etc.) can give high quality cash flows.

It should be underlined that project bonds are directed to finance really big investment in transport, energy and information technology projects. It will be helpful tool, but it does not solve the problems in EU countries with a gap between infrastructure investment needs and financial possibilities of their covering.

OBLIGACJE PROJEKTOWE JAKO NOWA INICJATYWA UE W FINANSOWANIU PROJEKTÓW INFRASTRUKTURALNYCH

Streszczenie

Europa stanęła przed problemem niedoboru kapitału na finansowanie ciągle rosnących potrzeb inwestycyjnych w zakresie infrastruktury gospodarczej. Od kilku dziesięcioleci propagowane jest włączanie kapitału prywatnego w ramach partnerstwa publiczno-prywatnego. Kryzys ekonomiczny i finansowy spowodował znaczące zmniejszenie kapitału, a także spadek zaufania na rynkach finansowych.

Idąc naprzeciw oczekiwaniom społecznym, a jednocześnie chcąc ożywić rynek kapitałowy w Europie, Komisja Europejska we współpracy z Europejskim Bankiem Inwestycyjnym opracowała założenia emisji obligacji projektowych przeznaczonych na finansowanie strategicznych (dużych) inwestycji w sektorze transportu, energii i technologii informacyjnych. W artykule przedstawiono główne założenia koncepcji obligacji projektowych, rolę EBI oraz podejście pilotażowe do pierwszych emisji tych instrumentów.

Tłumaczenie Krystyna Brzozowska