



FRESHFIELDS BRUCKHAUS DERINGER

Outlook for infrastructure 2011: getting Europe back on track

Will the 2020 Project Bond Initiative kick-start infrastructure investment?



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Foreword

October 2011

Welcome to our fourth annual *Outlook for infrastructure*. This year we have focused on the joint European Commission and European Investment Bank 2020 Project Bond Initiative. One only has to look back to the eerily prescient words in our foreword to *Outlook for infrastructure 2009* to understand why we have put the spotlight on the Initiative:

‘Major investments in new roads, bridges, energy plants and railway lines and the jobs these would create would unleash a positive economic stimulus...’ but ‘the fork in this road, however, is that the recession/downturn has reduced tax revenues and put greater fiscal pressure on government budgets. Therefore, governments the world over are likely to become even more reliant on the private sector as an essential component in delivering infrastructure, and project finance is arguably the key vehicle to making this happen.’

To an even greater extent than we have seen since the onset of the crisis in 2007/08, and for the same reasons as given above, governments are straining to unleash infrastructure investment and yet – in the middle of a eurozone sovereign debt crisis – governments are now more fiscally constrained than they ever have been in recent history.

Added to these constraints are other worrying factors for the objective ‘infrastructure observer’: the rise of regulation with a potentially negative effect on investment in long tenor infrastructure-backed debt so essential for project finance – Basel III for banks, the Solvency II Directive for EU insurance companies and the AIFM Directive for asset managers; the demise – to date – of the monoline model in the crisis and, therefore, the closure of the capital markets to the greenfield infrastructure project market; and, linked to the effects of Basel III together with the impact of the financial crisis itself and now the effect of the current sovereign debt crisis, the departure from the project finance market (or, as a minimum, a reduction in origination appetite) of several leading project finance banks.

So for all of these reasons, the Initiative is to be mightily welcomed. The infrastructure origination market seeks the Holy Grail represented by the re-opening of the capital markets for business. And our report shows that an overwhelming majority of market participants are supportive of the Initiative. Over 70 per cent of our respondents felt that the Initiative would attract private sector institutional investors to bonds benefiting from the Initiative. There are issues to be worked through – all market participants are aware that the devil lies in the detail – but overwhelmingly, the Initiative is to be supported.

We trust you will find *Outlook for infrastructure 2011* of interest, and we look forward to reporting great progress with the Initiative – and, generally, progress towards re-opening the capital markets to project bonds – in future Outlooks.



Nick Bliss



Nils Koffka

Introduction

In June 2011, Portugal's new government suspended plans to build a €3.3bn high-speed rail link between Lisbon and Madrid that would deliver huge long-term benefits to the Iberian Peninsula. The deficit-laden country said it did not have the financial resources to undertake the investment after requesting a €78bn international bailout in the wake of the eurozone sovereign debt crisis. The decision, which may yet be reversed in the autumn, highlights the dilemma Europe faces when it comes to upgrading the continent's infrastructure: the need to deliver long-term improvements to Europe's transport, energy, utility and telecoms infrastructure while tackling historic high deficits.

There is undoubtedly a major shortfall in infrastructure investment. Estimates for European infrastructure investment run as high as €2 trillion by 2020 of which the UK alone could require £500bn (€550bn). However, since the credit crisis, we have seen huge dislocation across the western world's public finances and capital markets. On the one hand the austerity measures needed to bring public finances back under control have reduced the public funding available for major infrastructure projects. Yet on the other the urgent need to restart growth has made investment in infrastructure even more acutely needed. At the same time financial institutions have become reluctant to lend and/or constrained from lending in the face of market volatility, the effects of the crisis on bank balance sheets and the tougher international and domestic capital adequacy requirements.

In response to these pressures, the European Commission (EC) last year unveiled the 2020 Project Bond Initiative, which aims to help in re-opening the debt capital markets for greenfield projects – effectively closed since the demise of the monolines in the crisis – and attract private capital into infrastructure with the support of the European Investment Bank (EIB). This is an exciting initiative, but it is vital that policymakers understand what infrastructure companies and financial institutions expect from it. To get a clearer picture, Freshfields commissioned a survey of infrastructure experts from leading companies involved with all aspects of the sector. The results set out in this report show:

- strong support for the concepts behind the Initiative and optimism that it will succeed in attracting private sector investment and have a meaningful long-term effect; but
- concerns over the clarity of the proposal and a lack of details on specific elements of the Initiative that threaten to undermine its success unless they are resolved to the satisfaction of potential investors before its implementation.

This report sets out the findings from the survey and seeks to highlight the areas where the European Commission and the EIB need to clarify the details of the Initiative.

Background to the research

Freshfields Bruckhaus Deringer commissioned Critical Research to survey senior investment funding staff at major companies worldwide. The companies included banks, infrastructure funds, sponsors, institutional investors and financial advisers. They have dealings in all major sectors within transport, energy and social infrastructure and their investments are spread across Europe, the Americas and the Middle East and North Africa. The results are based on telephone interviews with 100 participants who each answered more than 70 questions.

Mind the gap: the €2 trillion question

It is impossible to overestimate the critical importance of high-quality infrastructure to the modern economy. High-quality transport, energy and communication systems enable domestic businesses to thrive and attract inward investors. A recent survey by UK employers organisation the CBI and consultant KPMG found that more than 80 per cent of businesses saw the quality of energy and transport infrastructure as having a 'significant' effect on their future investment decisions¹.

Yet infrastructure investment has failed to keep up with the need. Over the rest of this decade, Europe will need a huge injection of capital into the continent's infrastructure network. Preliminary estimates by the European Commission point to an investment need of between €1.5 trillion and €2 trillion by the year 2020². The main elements of this bill are:

- transport – an estimated €500bn for the Trans-European Transport Network;
- energy – €400bn on distribution networks and smart grids; €200bn on transmission networks and storage; and €500bn to build or upgrade generation capacity; and
- communication – as much as €268bn to achieve the Commission's targets for high-speed broadband internet access.

The think tank Policy Exchange has calculated that the UK's investment needs will amount to £500bn (€550bn) by 2020. The report, which was co-authored by a leading academic³, included a £260bn bill for replacing and renewing energy facilities and for investment in green energy; £120bn for road, rail and air transport; and £45bn for water supplies and coastal defences. But this is not just a European issue. According to the Organisation for Economic Cooperation and Development, the total global infrastructure investment requirement by 2030

for transport, electricity generation, transmission and distribution, water and telecommunications comes to \$70 trillion (€50 trillion)⁴.

Why invest in infrastructure?

At a time of record budget deficits and a commitment across Europe to cut public spending to return countries' public finances to long-term sustainability, a multi-trillion euro investment programme might seem reckless. However, there are two powerful reasons for focusing on infrastructure investment.

First, as the Policy Exchange report states, in the short term encouraging investment is preferable to stimulating consumption. Investment creates assets as well as liabilities, contributing to total demand in the economy by boosting the supply chain, creating jobs and by opening up subcontracting opportunities to small- and medium-sized enterprises.

Second, investment in core infrastructure such as transport, energy and communications creates the conditions that are ideal for business investment, which in turn drives long-term economic growth. By the same token poor-quality infrastructure will mean higher costs for current users and will deter future investors. The CBI/KPMG report referred to earlier found that four out of five firms surveyed identified the quality and reliability of energy and transport infrastructure as a significant or very significant consideration in determining location for investment. Nearly nine out of 10 firms in the engineering and high-technology sectors said digital infrastructure was a significant factor in their investment decisions.

But while the need may be urgent, the resources are in short supply. Governments are unlikely to be able to fund major infrastructure investment projects in the near-term. This puts the

onus of financing these schemes on the private sector, both infrastructure providers and financial institutions. However, these sectors too are highly indebted and are under pressure to de-lever while the financial markets are in a highly febrile state with the ongoing European sovereign debt crisis adding to investor cautiousness. Meanwhile commercial banks are preparing for the implementation of higher capital requirements (see below).

Basel, Vickers and bank lending

Commercial banks are facing the need to raise the amount of capital they hold as part of international and national reforms aimed at making banks safe following the financial crisis. The international regime, known as Basel III, will raise the amount of capital banks need to hold as a share of their risk-bearing assets from 8 per cent to 10.5 per cent. Meanwhile banks deemed to be globally systemically important financial institutions (G-SIFIs) – or ‘too big to fail’ in popular language – are already set to bear higher requirements under proposals to be approved by the G20 leaders’ summit in November 2011. These 28 institutions will have to hold an extra share of tier 1 capital, ranging from 1 per cent to 2.5 per cent depending on their systemic importance. British banks look set to face higher requirements following recommendations by the Independent Commission on Banking (ICB), chaired by Sir John Vickers⁵. The ICB has recommended that banks with both domestic retail banking operations and global wholesale and investment banking operations should ring-fence the domestic arm. It said large UK retail banks should have equity capital of at least 10 per cent of risk-weighted assets while the retail and other activities of large UK banking groups should both have primary loss-absorbing capacity of at least 17-20 per cent.

The combined effect of these reforms, while needed to deliver financial stability, and the effect of the financial crisis with subsequent bank restructurings, plus the current sovereign debt crisis, has been to reduce the appetite of many commercial banks for long-term project finance (and certain leading players such as Royal Bank of Scotland (RBS) have been selling their project finance portfolios). The model for financing a very significant element of capital for infrastructure projects must undoubtedly be found within the capital markets.

Large projects require large upfront capital investment that will take years of revenues to pay back and return a profit to the provider and its financial backers. Generation of project revenues may not start until some years after the costs have been sunk. Both of these factors mean that projects require long-term financing, often as long as 25 years. Because of the high risks and long timescales involved, tighter capital adequacy rules, and the exit of banks such as RBS from the project finance market, the commercial bank market can provide only some of the cost. According to KMPG, the maximum debt capacity of the commercial bank market is estimated to be around a maximum of \$2bn (€1.4bn) per transaction⁶.

There are other hurdles to revive capital market investment. A report by Freshfields⁷ published earlier this year showed that \$814bn of debt raised to fund leveraged buyout deals will have to be refinanced by 2016. The combined effect of all these factors will be to intensify the pressure on governments and financial institutions to find innovative ways to ensure that funding is directed towards infrastructure investment.

How monoline insurers worked

Before the credit crisis, monoline insurers provided a critical role in infrastructure finance. They provided insurance for bonds issued by special purpose vehicle project companies that enhanced the credit rating of the bonds to the highest (AAA) credit rating. They also acted as a controlling creditor, ‘monitoring’ their projects and providing a single point of contact for borrowers (issuers), agreeing to amendments and granting waivers and consents without the need for bondholder meetings. They also provided credit structuring which together with their monitoring skills, meant that institutional investors did not have to invest in developing specialist in-house credit teams. They had ‘surveillance’ teams of people with specialist skills and knowledge of credit issues ready to provide 24/7 monitoring of credit events. However, in the wake of the crisis, issuance has almost dried up. Although it was their involvement with the securitisation of subprime mortgages rather than infrastructure financing that caused the near-extinction of the monoline sector, it remains to be seen if there is a future market for these products. One monoline, Assured Guaranty, still provides the classic monoline issuance product in the AA category, albeit without recent issuance in the project bond field (though with a team dedicated to re-opening that market).

The 2020 Project Bond Initiative

The decision by European Commission President José Manuel Barroso to use his September 2010 State of the Union address to announce the Commission's own solution to re-opening the project bond market, the 2020 Project Bond Initiative, is an example of exactly that innovation. But what is it? The Initiative, which is intended to be fully operational in 2014, will provide loans and/or guarantees, in partnership with the EIB, to support bonds issued by project companies to finance infrastructure projects. The aim is to attract private capital to finance infrastructure projects and – despite its name – it will not entail

the issuance of new bonds by the EIB, the European Union (EU) or its member states.

The Initiative is designed to fill the gap left by the demise of the monolines, whose purpose was to provide insurance for financial instruments and thus raise their credit rating. The bonds issued by structures credit enhanced by the Initiative will therefore become a new asset class that will provide investors with diversification opportunities and will carry a sufficiently high credit rating to attract investors (the Commission is aiming for a range of A to AA to attract

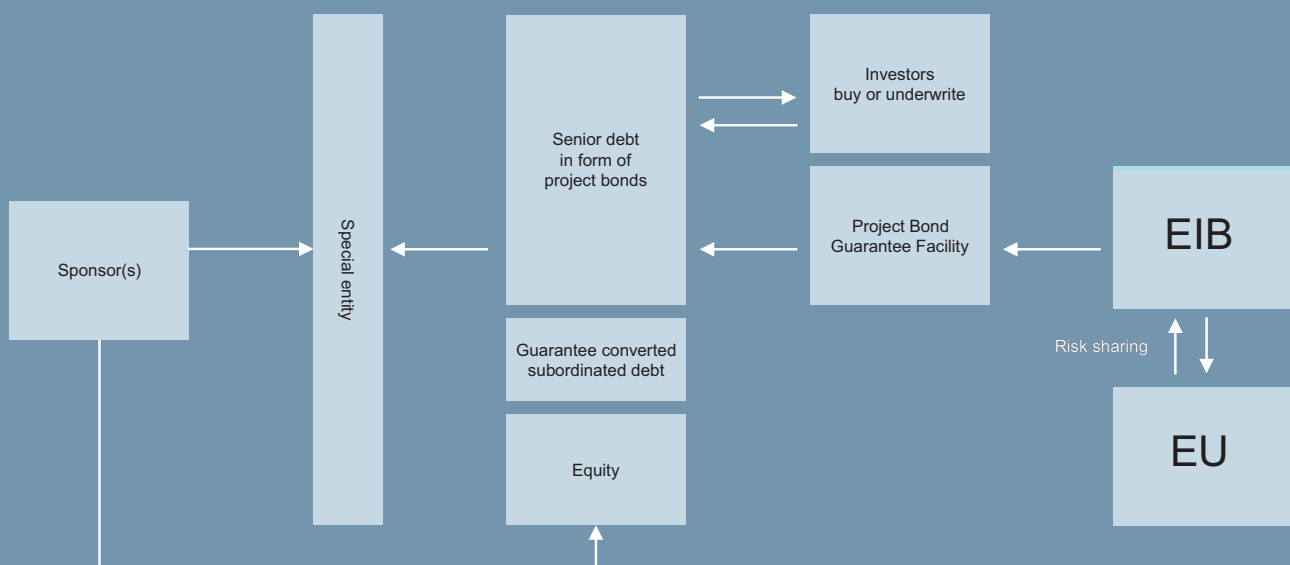
investors). This is seen as particularly attractive to long-term investors such as pension funds.

The Commission's stated ambition is to attract additional private sector financing and act as a catalyst for restoring the capital markets as a significant source of financing for infrastructure investment. It sees transport and energy projects as being particularly well suited for the Initiative although certain broadband ICT projects could also benefit and certain classes of renewable energy investments may also qualify.

How the 2020 Project Bond Initiative would operate

The Initiative will make use of a project financing technique known as 'credit enhancement'. By providing support at the subordinated debt level (ie, additional risk capital), the Initiative would raise the quality of the senior debt, allowing it to be issued to the capital markets as a new class of project bond. By improving the credit rating of the senior debt of project companies, it will reduce the financing cost for longer maturities of debt for project entities and make it easier to place the bonds with institutional investors. A similar mechanism already exists in the form of the Loan Guarantee Instrument for the Trans-European Transport Network, which is a joint EU-EIB financing instrument. Support under the Initiative could come in the form of a loan or a debt service guarantee. The guarantee could be a contingent credit line from the EIB that would be callable if the project were unable to generate sufficient funds to service its debts. Once drawn, the facility would be subordinated to the project bond, which would rank ahead of the project bonds in priority of payment.

EU Project Bond, with guarantee drawn



Source: Consultation paper on the Europe 2020 Project Bond Initiative

Businesses' views of the 2020 Project Bond Initiative

To establish a clear picture of the views of leading institutions in the infrastructure sector about the Initiative, Freshfields commissioned a detailed survey of 100 senior investment funding staff. The research was designed to gain a deeper understanding of how the leading market participants believed infrastructure financing would develop over the next one to five years, and their views about the Initiative. The results are based on analysis of the participants' answers to the survey questions and comments offered on specific issues.

Institutions' views of the market

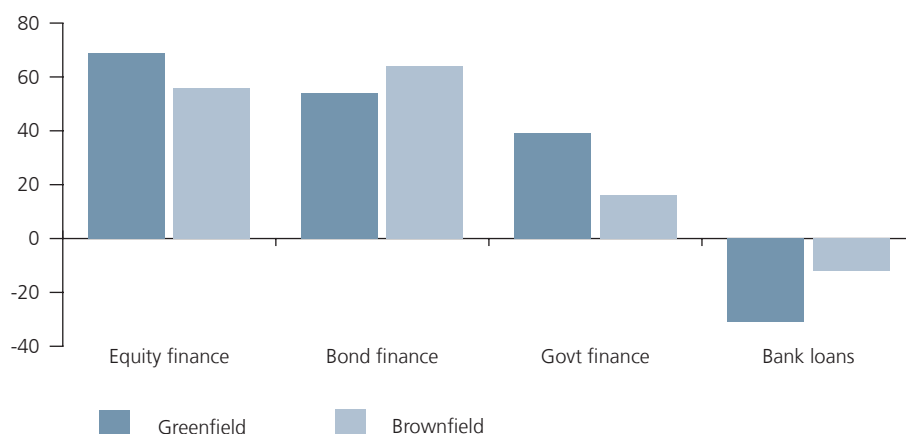
The success of the Initiative in kick-starting the capital markets' demand for infrastructure investment will partly depend on the trends already under way in the sector. Currently, the market for infrastructure finance is dominated by the commercial banks. According to Dealogic, loan financing accounted for 81 per cent of project finance volume in the first half of 2011, up from 77 per

cent in the first half of last year. Bond financing accounted for 3 per cent of volume, while equity contributed fell for the second year in a row⁸.

Freshfields' survey echoed this. Almost three-quarters of respondents said there had been no change in sources of project finance since 2010. The quiet conditions were most evident for greenfield investment where just 13 per cent saw a change in finance sourcing needs while a quarter had seen changes within the brownfield area. However, the market for infrastructure finance looks set for change and development after another year of caution and stasis in 2011. Among the minority that had witnessed change, some patterns were clearly visible. For both brownfield and greenfield projects, there was a marked net decrease in bank debt over the past year as a source of financing and an even stronger uptick in the use of equity finance, bonds and government or multilateral support.

Net change in funding, 2010-11

(%)

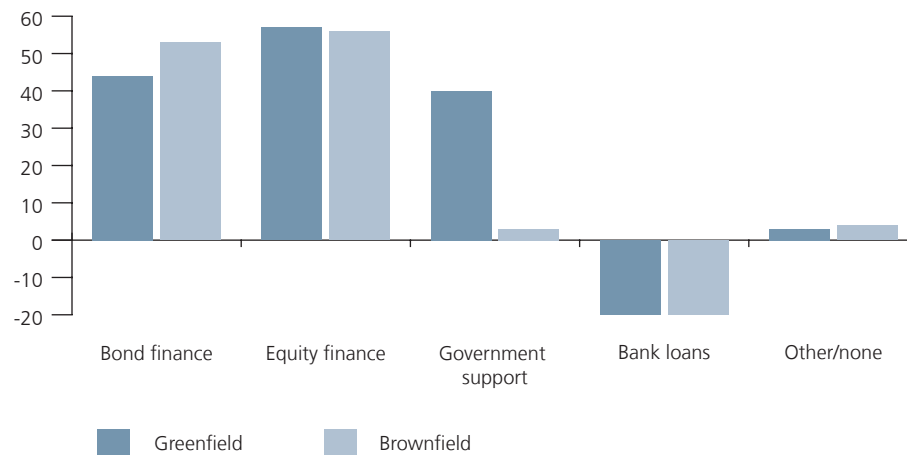


This trend towards greater use of the capital markets and less reliance on bank debt is set to continue over the next five years. According to figures cited by the UK accountancy body ICAEW, almost €25bn worth of European projects will try to access the private finance markets in the next year, headed by a €6.4bn Bulgarian Belene nuclear power plant and a €3.4bn French high-speed rail link from Bretagne to Pays de la Loire⁹.

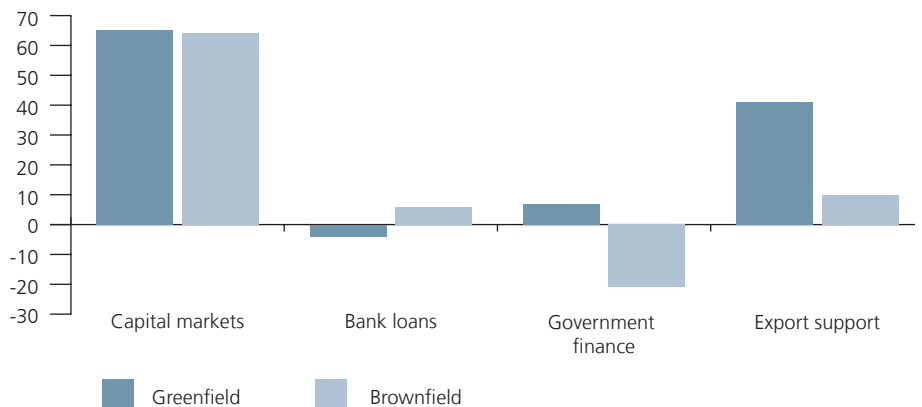
On balance, infrastructure experts expect a declining role for bank debt, with around half forecasting a decline for both brownfield and greenfield deals and just over a quarter expecting an increase over the next year and a half. There were forecasts for strong increases for equity finance, bond finance and

government support. Looking ahead five years, the market is expecting continued greater reliance on capital markets. A balance of around two-thirds of respondents expected an increase. The overall net change for government finance is expected to fall by a fifth for brownfield deals although government-backed credit support is seen to be on the rise by four out of 10 respondents. This shows clearly that respondents can see that the role of commercial banks will decline as a result of the crisis, capital adequacy rules and the other factors cited in this report. This means that unless alternative sources of capital are unlocked, there will simply be a reduction in infrastructure deal origination.

Net change in finance sources: 18 months
(%)



Net change in finance sources: 5 years
(%)



The increased appetite for infrastructure finance may be explained by expectations among respondents that they will finance more projects over the next 18 months. In terms of new-start projects, around seven out of 10 respondents saw new brownfield projects coming on stream (73 per cent) and new greenfield schemes (68 per cent). In terms of refinancing, 62 per cent said they expected to find funding for brownfield projects while slightly fewer (45 per cent) saw the need to refinance greenfield projects.

Taking refinancing and new money deals together, those who saw a need for finance expected that bank loans would provide 60 per cent of the total finance needed for both greenfield and brownfield projects. Capital markets would provide 15 per cent of the greenfield finance needs and 22 per cent of brownfield funding while government funding, multilateral support, balance sheet finance and other sources would provide an average of just 5 per cent of funding for both brownfield and greenfield sites. While bank debt looks set to be a key source for project finance over the short term, the fact that many respondents expect that source to decrease in importance over the longer

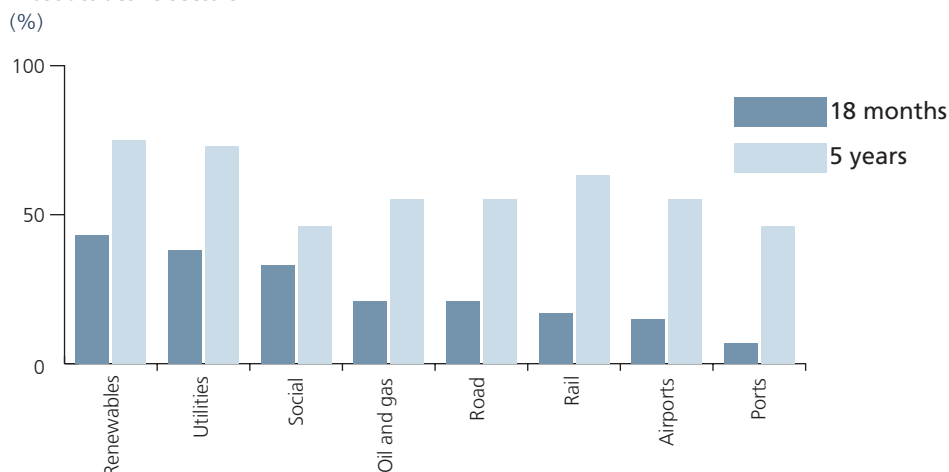
term highlights the need to ensure that other sources of finance increase to meet any future shortfall in bank funding.

The Commission is keen that the Initiative primarily supports investments in transport and energy. However, asked which sectors they expected to be most active in over the coming 18 months, more than four out of 10 respondents highlighted renewables and utilities (water, gas and electricity distribution) while fewer than one-fifth picked non-renewable energy, airports, rail or road in their top three priorities. Looking over a five-year time horizon, three-quarters said that renewables and utilities would remain among the most attractive sector for infrastructure investment while two-thirds said that rail would be most attractive to investors.

The 2020 Project Bond Initiative: seeking clarity

While the Initiative is well known and generally well thought of by institutions, our survey has revealed some concerns among the senior executives who were likely to be involved with taking investment decisions. Three-quarters of respondents said they were familiar with the Initiative, an answer broadly shared

Most attractive sectors



across different types of institution and infrastructure sector. The vast majority – almost nine out of 10 – agreed that it was a good idea with all of the infrastructure funds and sponsor institutions who responded to the survey taking that view.

‘It’s giving people a bit more comfort to invest in bonds as opposed to what’s happened recently.’

On the critical question of whether the Initiative will re-open the debt capital markets to greenfield infrastructure there was a mixed view. A large majority agreed that the Initiative would attract investors, but many were doubtful whether that would by itself lead to the re-establishment of the capital markets as a source of infrastructure finance.

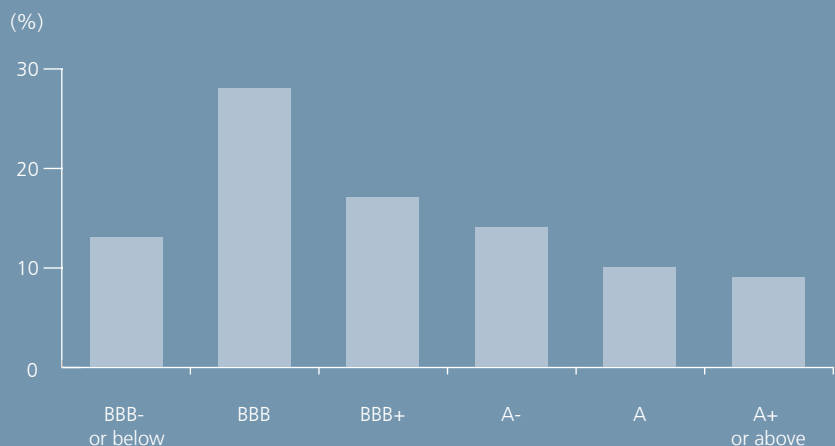
More than seven out of 10 believed that it would attract private sector institutional investors – the stated aim of the Commission and the EIB.

This was similar to the 80 per cent recorded by the Commission’s survey of investors¹⁰. Many of the people who took part in the Freshfields survey pointed to the role it would play in reducing risk to investors. ‘The product the EIB is providing... will improve the ratings of the senior debt, so will make it more attractive to institutional investors,’ one said. Another pointed out that it should open up a market that institutions wanted to invest in. ‘This will enable the product to be available because they already want to invest in this stuff.’ Others pointed to growing demand among investors, such as pensions funds, for long-dated assets to match their liabilities.

Two-thirds agreed the Initiative would have a ‘meaningful impact’ with a fifth undecided and only 15 per cent unconvinced.

Focus on credit ratings

At the heart of the Initiative is the idea of credit enhancement – raising the credit rating of the senior debt so that is seen as more attractive in the capital markets. The Commission has outlined a target of A on the ratings used by Standard & Poor’s and Fitch. However, fewer than a fifth of investors saw an A rating as being necessary to attract investors. In fact, almost half the companies we spoke to, albeit not all of whom were themselves investors, believed that BBB or BBB+, the two lowest investment grade ratings, would be sufficient to attract investors.



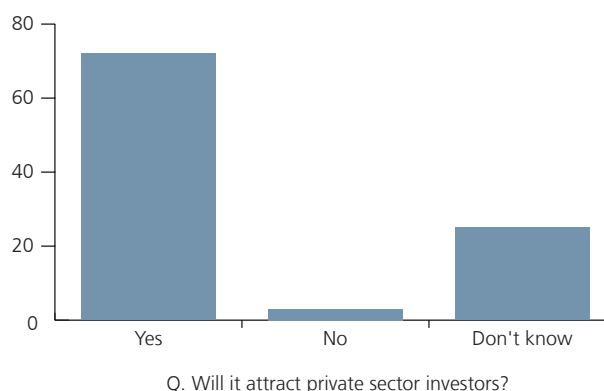
However, when asked whether the Initiative would facilitate and/or accelerate the conclusion of project financing, the majority in favour slipped to 56 per cent. Those who believed it would do said that it would attract new investors and provide new sources of capital and liquidity. 'It will make capital financing possible in situations where this would not have previously happened,' one said. However, the doubters were sceptical that the EIB and its product would speed up a bond financing process that was driven by the complexity of the transactions involved. Some said that adding an extra layer of finance in the form of the Initiative 'might even slow the process.'

Asked whether the Initiative would by itself re-establish capital market infrastructure financing, only a quarter thought it would. For many respondents, the issue came down to the timing of the Initiative within the business cycle. Many pointed out that there needed to be a stronger general appetite from the markets, reduced levels of volatility in the capital markets and a return of confidence in the global economic outlook. 'The Initiative in itself contributes but is not sufficient to create the right conditions for a bond market to flourish,' one said. While almost six out of 10 saw the Initiative as being sustainable despite the eurozone crisis, several raised impact of the ongoing market problems as a potential hurdle to the success of the Initiative.

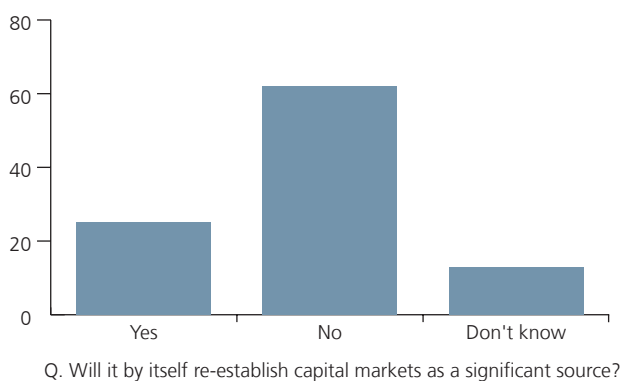
Investors' concerns

The main criticism that investors have with the Initiative is a lack of clarity on the details. Fewer than a fifth (19 per cent) of the infrastructure experts in our survey were happy that the proposals were set out clearly enough at this stage while two-thirds said there was insufficient clarity. Asked what troubled them about the draft proposals, many respondents felt that insufficient detail about the terms of

Initiative will attract investors...
(%)

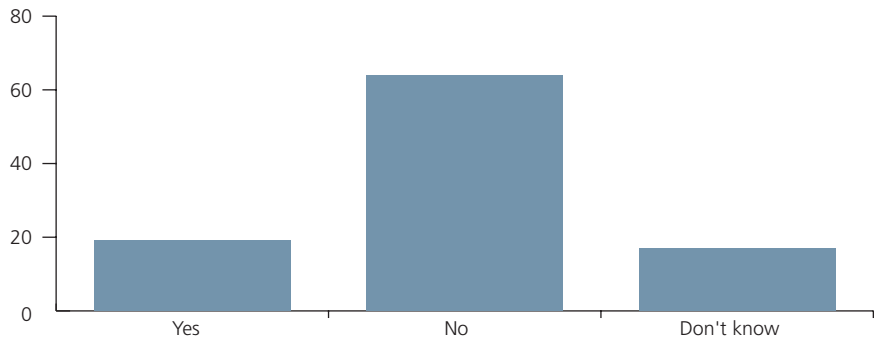


...but unlikely to re-establish market
(%)



Plans not clear enough

(%)



the credit to be provided had been given in the consultation document. 'Proper discussions are needed to ensure that it works,' said one, adding: 'More detail will be required.' Many said they were unclear about the mechanics of the structure and how it would work in practice. 'The actual mechanism and what it is going to look like is unclear,' another said. Another added: 'It is fine as a framework, but they have got a long way to go before it turns into a real product.'

Many respondents had specific concerns about how the Initiative would operate. These related to the identity of the controlling creditor and within that issues of conflict of interest, political influence and adequate staffing for what will turn out to be, in effect, an agency

function in bank terms; the location of responsibility for the surveillance function; and the lack of detail on issues such as pricing.

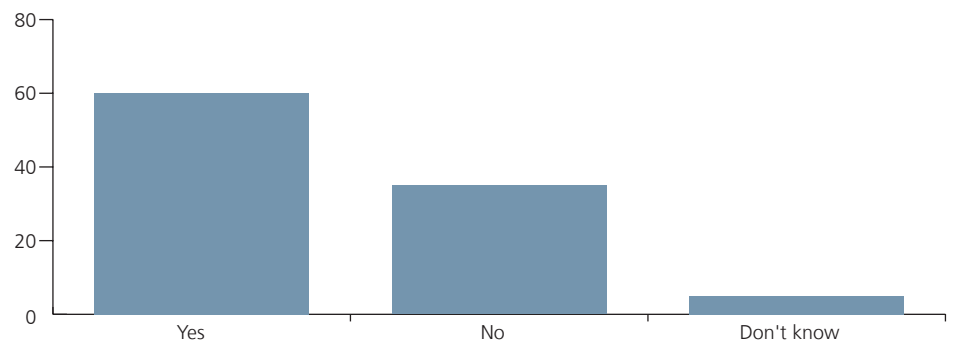
It will not be until the rules of the game are clearly set out and the potential stakeholders are able to get around the table and deliver deals using the product that it will become clear whether the Initiative will re-open the capital markets to project bonds and whether long-term investors are likely to buy the bonds issued.

EIB or not EIB?

In its consultation document the European Commission stated that the EIB might be prepared to act as controlling creditor in any structure that includes the Initiative in line

Should EIB be controlling creditor?

(%)



with ‘principles to be established in agreement with market participants.’ Six out of 10 respondents to our survey said that the EIB was best placed to act as controlling creditor. This was even more supportive than the Commission’s own survey, which found that 50 per cent believed there should be a single controlling creditor of whom a fifth said it should be the EIB or EU.

Those who backed the idea described the EIB as ‘very experienced’, ‘competent and well-informed’ and said it had a strong track record of carrying out similar transactions. This echoes the Commission’s view that the EIB has ‘long-standing experience in the financing of infrastructure projects.’ The EIB does, indeed, have great experience with the financing of infrastructure projects, as 60 per cent of the respondents asserted. However, the concern seems to be over whether the EIB will be prepared to be an active participant in the nature of the pre-crisis monolines once the Initiative is put into operation.

‘I think the EIB’s interests are not aligned with the private sector investors.’

Among those who were negative or unsure about the EIB taking on the controlling creditor role, there were three broad concerns, set out below.

- Conflict of interest: 15 respondents cited this as an unprompted concern. Many said they were worried that there would be a conflict between the EIB’s public policy role and its standing as an investor. Others said this would create a conflict of interest between the EIB, the senior creditors and the junior creditors. ‘There is a conflict of interest as the EIB are mezzanine providers,’ one said. Many said that they would prefer an independent entity to carry out the controlling creditor role.

- Political concerns: some were concerned by the potential danger of political influence by the EIB, which is ultimately owned by all 27 EU member states. ‘They are too great a political influence on [the project],’ one said. Others said that the bureaucratic nature of the EIB would act as a brake on the process. ‘The EIB is notoriously a decelerator of projects,’ one said.
- Staffing and resources: some respondents were concerned that the EIB did not have enough staff to oversee the large number of projects that may come on stream under the Initiative and the need, as controlling creditor, to perform an agency/communication role for the other lenders with the borrower (and, therefore, the project).

Under surveillance

Effective surveillance of the obligations of the different debt and equity holders in the finance structure is an important function. There was a wide range of views on whom should carry out that role. A third thought the EIB was the most appropriate entity while a similar proportion said they would prefer a banking agency team, with others suggesting the monolines¹¹ or other

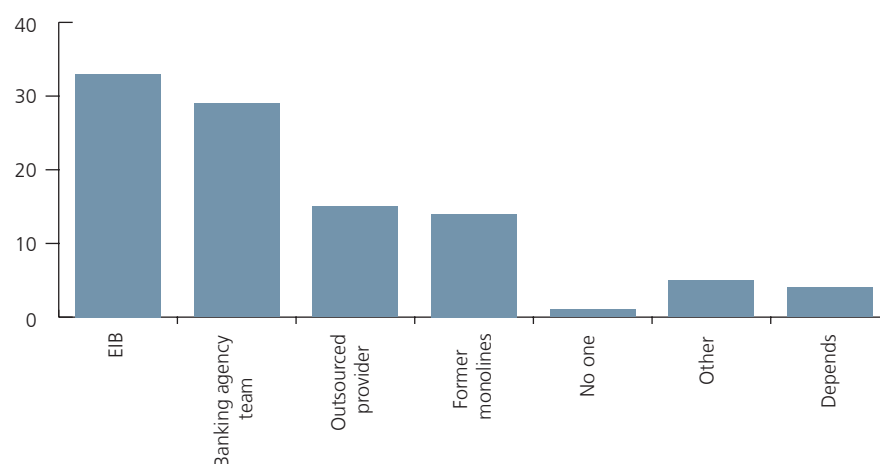
outsourced providers. Respondents who suggested an outsourced provider suggested banks, law firms, accountancy firms and the credit rating agencies. ‘From a sponsor point of view it would be a combination of a monoline who understands the market, a bank team and someone from a sponsor organisation,’ one said.

The devilish detail must be right

While the proposal is still at the consultation stage, some respondents have started to raise concerns over the lack of technical details. Some investors were worried by the lack of information about how the EIB product would be priced. One expressed concern about ‘the whole structure, pricing and the detail because [investors] are waiting to develop the detail of the first deal.’ ‘It’s a chicken and egg situation,’ they added. Others cited the lack of information on contribution levels and incentives to help in the purchase by long-term investors of bonds issued with the backing of the Initiative. Another issue was a lack of clarity over which types of projects in terms of sizes and countries the Initiative was aimed at. One said: ‘The only benefit of these [bonds] will be for less attractive projects. I don’t believe it will have an impact on significant projects.’

Who should carry out surveillance?

(%)



Forging a secure bond

As this report has stressed, revitalising the capital markets is a crucial precondition for mobilising the capital needed to finance the large range of infrastructure investments that will be required over the rest of this decade (and beyond). Finding a form of instrument or product to fill the gap left by the monolines who until their decline in the wake of the credit crunch had provided support for project finance will be an essential element of that.

As a concept, the Initiative has the potential to help fill that gap alongside other private sector organisations. It also has the capability to provide credit enhancement to the project bonds and thus attract greater private sector investment. This message comes out strongly from our survey.

However, that support is conditional on the EU/EIB and the market resolving important issues before the Initiative is put into practice. As this report has shown, respondents have highlighted concerns over how the Initiative will operate. In many cases the doubts are caused by a lack of clarity and a shortage of details in the proposals that have been set out so far. There are issues where the Commission and EIB must determine how the scheme will operate and to address some of the specific concerns that have emerged in this report. These are focused primarily on:

- the identity of the controlling creditor; and
- the wider political context within which this initiative will operate but also cover areas such as pricing.

Controlling creditor

The EIB consultation paper envisages that the EIB will be the controlling creditor, in effect fulfilling in that regard a similar function to that performed by the monoline insurers. Our survey showed some support for this idea but a sizeable minority – 35 per cent of those expressed an opinion – had strong

reservations about the EIB's ability to take on that role due to staffing, resource levels and potential conflicts of interest.

It is, therefore, important that the architects of the Initiative ensure that the controlling creditor has the resources, both in terms of numbers and specialist skills, to carry out those functions. While most projects will simply require regular monitoring, intensive periods of action may be required in the instance of a credit event (an event of default, a major project variation, or similar). It is essential that the controlling creditor has the resources to deal with such an event and is used to responding rapidly to a fast-moving situation.

Resource requirements

The controlling creditor function is vitally important for ensuring communication between the equity, senior debt and junior debt. Allied to this is the monitoring and surveillance function to oversee the infrastructure project on a frequent and regular basis. This is a resource-heavy and time-consuming function, and that burden will increase if the Initiative is a success and leads to the funding of many infrastructure projects.

Bearing in mind the nature and extent of the resources that it takes an organisation to act as controlling creditor, particularly during the construction period, the controlling creditor has to be an active player.

One solution would be to separate the monitoring function from that of controlling creditor. Outsourcing the resource-heavy monitoring and surveillance functions to a bank, an insurer or a group of such bodies would reduce the workload on the EIB as controlling creditor. An alternative model would be for the EIB to act as an interim controlling creditor during the early stages of the project and then hand over those rights to an identified creditor or group of creditors at a later stage.

Conflicts of interest

As an investor in infrastructure projects with a potential exposure of around 20 per cent of the capital required, the EIB, as the financial traders say, will have 'skin in the game'. As several respondents pointed out, there could be a conflict of interest inherent if the EIB is the controlling creditor given its mezzanine debt position, as its interests will not be entirely aligned with the bonds at the senior debt level. While this is not an insuperable problem, it is vital that the Commission and EIB clearly describe their views on conflict of interests resolution in the case of a credit event. In particular, it is important to understand how the interests of the junior creditors will not dominate those of the senior debt holders.

Looking over Hadrian's Wall

The Initiative product will complement initiatives by other private and public sector organisations that can offer lessons for the Commission and EIB. One model for the Initiative is Hadrian's Wall Capital (HWC), a start-up debt advisory that is raising funds to provide subordinated debt positions for capital markets investors to enhance the underlying credit ratings of infrastructure projects. The EIB itself took a £50m (€57m) stake in the fund in March 2011 that is aiming to raise around €1bn. The HWC product has been developed to offer debt through a single instrument. This is then divided into B notes that are put into a fund and that will provide 'first loss' on a project. It could be considered that the B notes are, in effect, mezzanine debt. The A notes will be issued as senior debt and will benefit from a credit enhancement. This should enhance a BBB- rating of total project debt to BBB+ or above. Once executed, HWC would provide a monitoring service for the investors to ensure they receive timely information. By providing this range of functions, Hadrian's Wall would become one of the first private sector solutions to help investors access the infrastructure market.¹²

The political context

If the Initiative is to succeed in its aim of attracting private investors back into infrastructure finance, it will have to overcome those concerns highlighted in the survey. There are several issues that the market will need to understand ahead of the implementation stage, such as:

- what is the total budget allocated to the Initiative?
- what is the resource allocation strategy in terms of the countries and sectors?
- will the Initiative's operations be spread among a large number of small projects or focused on a small number of large or pan-European investments?
- how will it balance its risk portfolio between projects with the greatest financial risk but greatest long-term returns and conservative projects with low risk and returns?
- what are the criteria for determining which projects to support?
- how will tensions between the economic criteria for resource allocation and political priorities be resolved?

Conclusion: more questions than answers

In these times of fiscal austerity and economic slowdown in Europe, the need for long-term investment in infrastructure on the continent has never been so important. These same financial and economic problems mean that innovative solutions must be found to encourage and enable private sector investors to fill the gaps in infrastructure financing needs that governments can no longer satisfy.

The Initiative, supported by the EIB, could play a crucial role in attracting capital market investment back to greenfield, 'shovel-ready' infrastructure projects. This would enable the long-term debt provision to move from banks to investors such as life insurers and pension funds.

Our survey has shown financial institutions see that the Initiative will be highly beneficial to the market. But they have also made clear they want to see clarity over issues that they will need

to see resolved before they are prepared to commit to new infrastructure investment projects; the market feels it has more questions than answers.

As this report has shown, the core issues that need to be investigated in greater depth are the identity of the controlling creditor, the responsibility for monitoring and surveillance, the detailed terms of its operations, the size of the funding, the criteria for selecting projects; and the mechanism it will use in balancing the economic demands and the political constraints.

If clarity on these issues is provided by the EU/EIB, a great step forward will have been taken and – we hope – the Initiative will be up and running. If this results in the capital markets re-opening for institutional investors in long-term greenfield infrastructure debt, the EIB and the Commission will have performed a hugely beneficial role for the citizens of Europe.

Notes

- ¹ *Making the right connections – CBI/KPMG infrastructure survey 2011*, September 2011.
- ² *Consultation paper on the Europe 2020 Project Bond Initiative*, February 2011.
- ³ *Delivering a 21st Century Infrastructure for Britain*, Dieter Helm, James Wardlaw and Ben Caldecott, Policy Exchange, 2009.
- ⁴ *Infrastructure to 2030: main findings and policy recommendations*, OECD, June 2007.
- ⁵ *Final Report and Recommendations*, Independent Commission on Banking, September 2011.
- ⁶ *Project finance and the capital markets: bridging the divide*, KPMG, 2010.
- ⁷ *The new normal: the outlook for the global private equity industry*, Freshfields Bruckhaus Deringer, 2011.
- ⁸ *Dealogic Project Finance Review – First half 2011*, Dealogic, August 2011.
- ⁹ *Who will pay?* McKenna, J. *Corporate Financier*, magazine of the ICAEW Corporate Finance Faculty, September 2011.
- ¹⁰ *Public Consultation on the Europe 2020 Project Bond Initiative: Key Messages*, European Commission, June 2011.
- ¹¹ MBIA UK Insurance Ltd and its sister company Trifinium Advisers Ltd are an example of a UK monoline.
- ¹² *Project finance and the capital markets: bridging the divide*, KPMG, 2010.

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