Europe 2020 Project Bond Initiative

Innovations in Financing European Infrastructure

ÖPP Forum NRW

EU 2020 Project Bond Initiative

- « Project Bonds » were proposed by EU President J.M. Barroso in his « State of the Union » speech in Strasbourg on 7 September 2010:

  "An EU initiative to support project bonds together with the EIB, would help address the needs for investment in large EU infrastructure projects".

- This proposed EU-EIB initiative builds on existing experience with other «joint EU-EIB financial instruments», such as Loan Guarantee Instrument for TEN Transport projects (LGTT);

- It is part of the wider « Europe 2020 » initiative;

- Under the Initiative credit enhancement instruments will be provided to allow the project companies themselves to issue bonds;

- Stakeholder consultation ended on 2nd May 2011

EIB Financing Instruments

- EIB has at its disposal a wide and flexible portfolio of financing instruments to support TEN projects

Standard Loans

“Traditional” EIB lending instrument

Guaranteed basis

Represents the bulk of EIB’s lending volumes

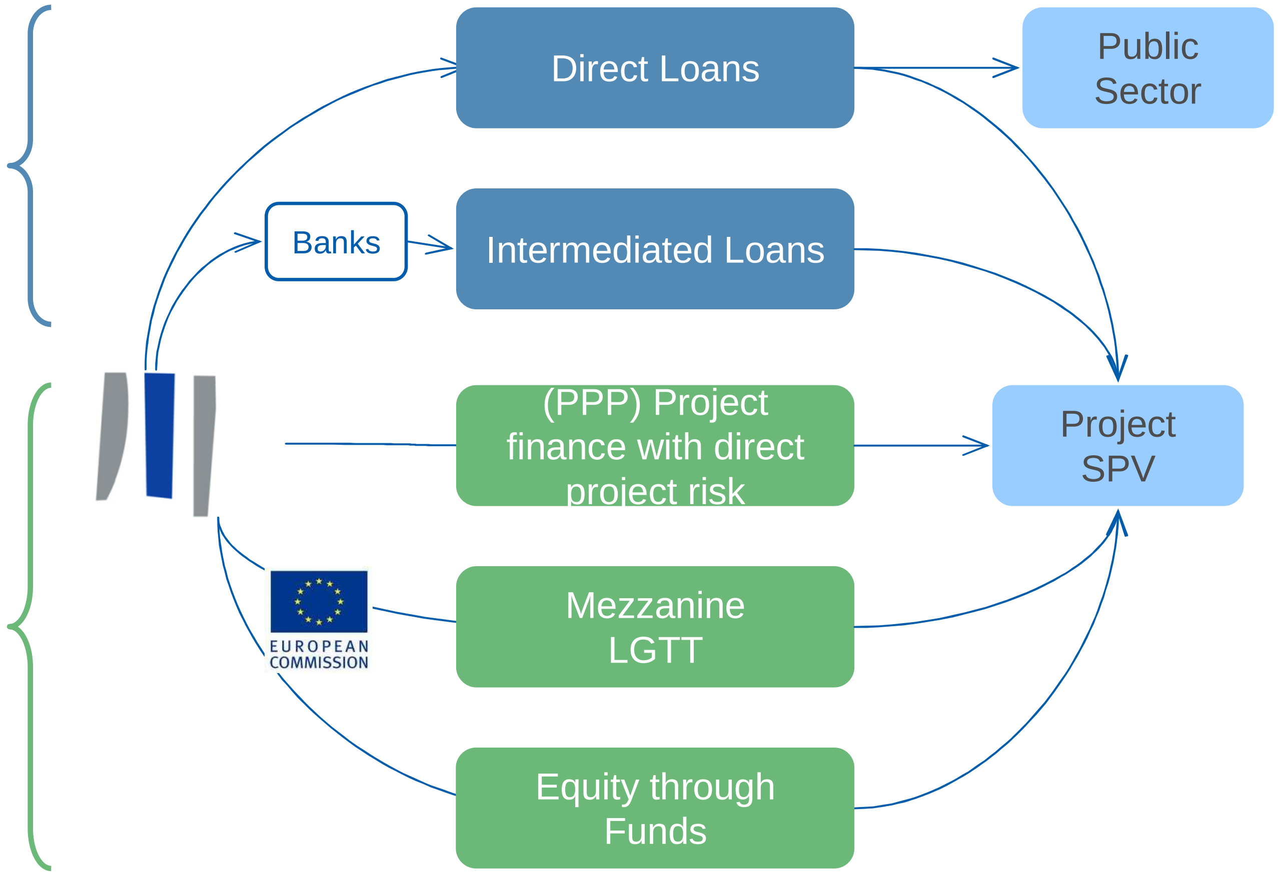
Structured Finance Facility (SFF)

Established in 2001

Expands the ability of EIB to provide financing

Allows lending to projects with higher risk (PPP’s)

Allows for more flexible financing solutions



Financing needs

The EU economy is heavily dependent on infrastructure in areas like the transport and energy trans-European networks, and Information and Communication Technologies (ICT)

Over EUR 1000 billion of investments are estimated to be needed to fulfill the priority targets of the Europe 2020 objectives in these sectors

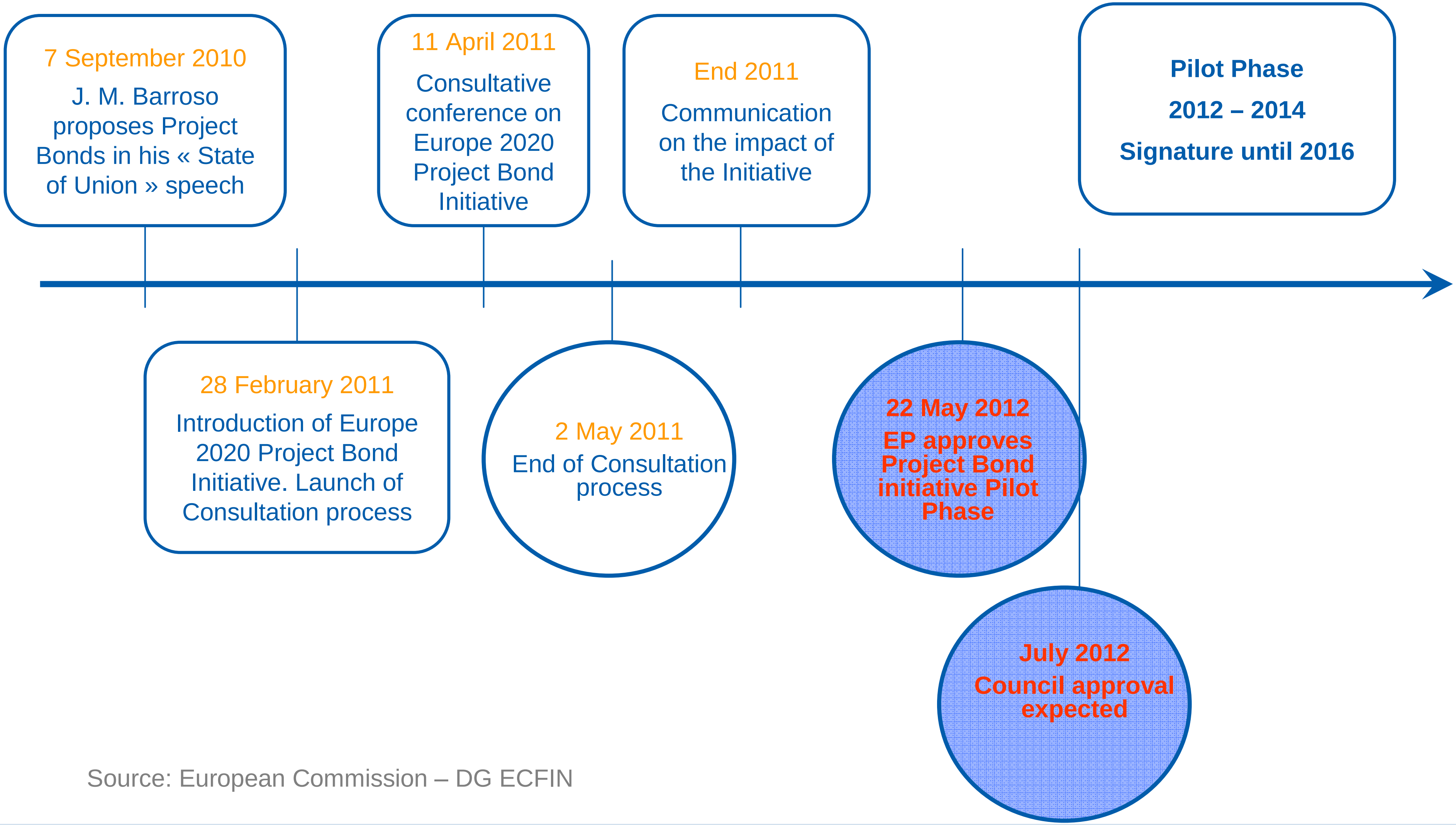
How to finance these investments?? –
Reduced availability of LT financing due to:

- Disappearance of monoline insurance companies that provided guarantees for capital market issues.
- Regulatory requirements under Basel 2 & 3 acting as disincentive to LT bank financing.
- Constrained public budgets

This challenging environment demands **diversified, cost efficient and long term** financing sources to fill the financing gap

→ Need to find ways to leverage EC Funds, bring the private sector back to the financing of individual infrastructure projects, without increasing direct public funding and therefore public indebtedness

EC Process



Source: European Commission – DG ECFIN

Why Project Bonds?

- Since 2000, more than EUR 100 bn of infrastructure assets in Europe are estimated to have been financed in the capital markets;

- Monoline-wrapped capital market issues became important providers of liquidity for infrastructure;

- However, as a result of the financial crisis no new projects have been wrapped by monolines. Basel 2 & 3 have put pressures on banks' balance sheets, while public budgets remain constrained. This has significantly reduced the available long term funding for infrastructure assets;

- There is thus the need to find ways to bring back private sector financing of infrastructure projects, without increasing direct public funding and therefore public indebtedness.

Europe 2020 Project Bond Initiative

Objective

To increase the debt financing availability for large scale infrastructure projects

Target areas

Transport

Energy

Broadband

→

How?

EU/EIB joint support to project companies issuing bonds to finance infrastructure projects

Form of support

Funded/unfunded subordinated credit enhancement by EIB to ensure sufficient rating of the bonds

→

Result

More private sector financing attracted from the capital markets to finance key infrastructure

Potential investors

Long-term institutional investors

Project Bonds – An Evolution of LGTT

- “Project Bond” instruments 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 (“ramp up”) period of TEN transport infrastructures are jointly taken by EIB and EU;

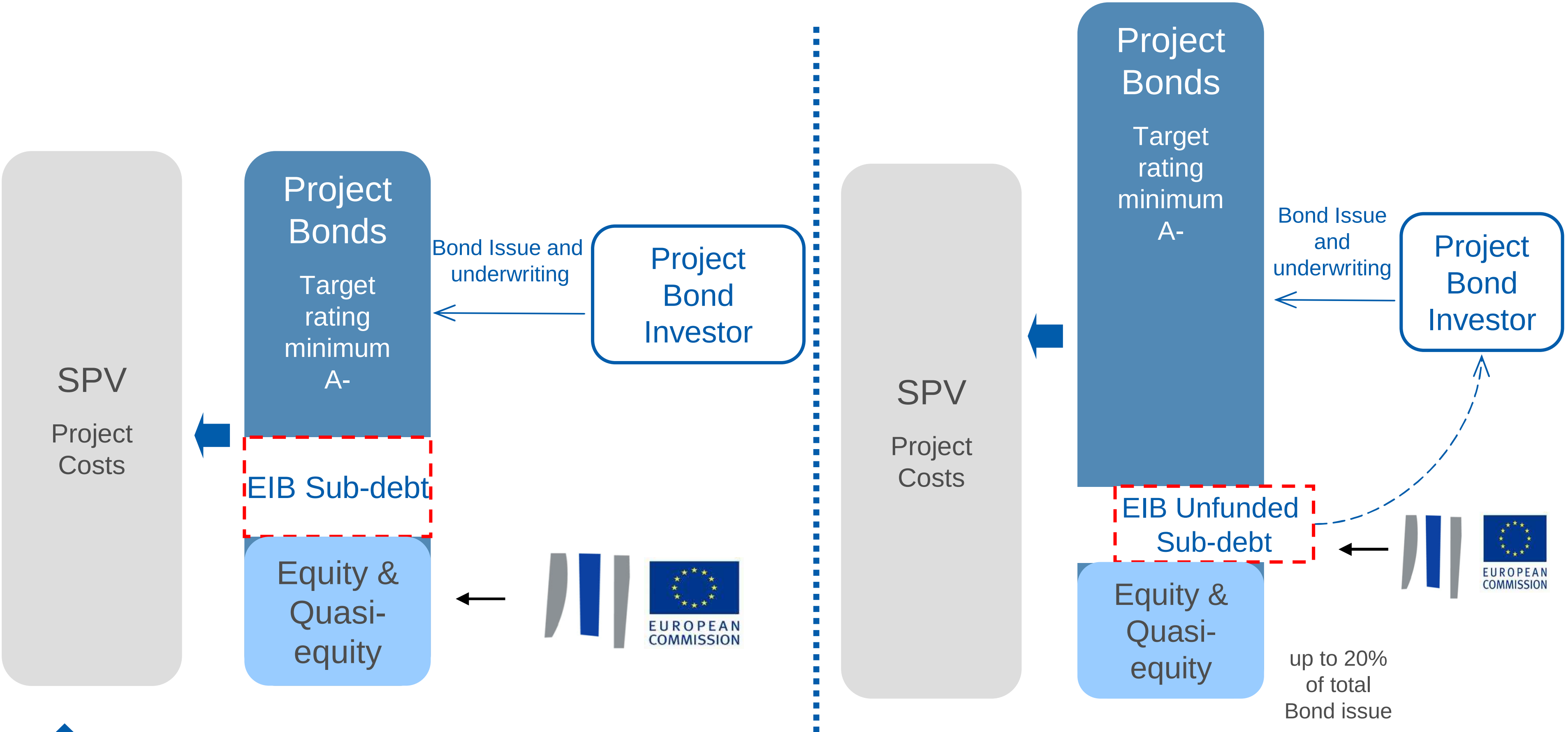
- LGTT, like “Project Bonds”, is a subordinated product designed to provide cover to senior (bank) lenders supplying stand-by facilities in the early phases of such infrastructure projects.

Project Bonds – An Evolution of LGTT

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, 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. As in the LGTT, in the unfunded version, once EIB guarantee is called it would crystallise into a subordinated loan.

The « Project Bonds » Concept



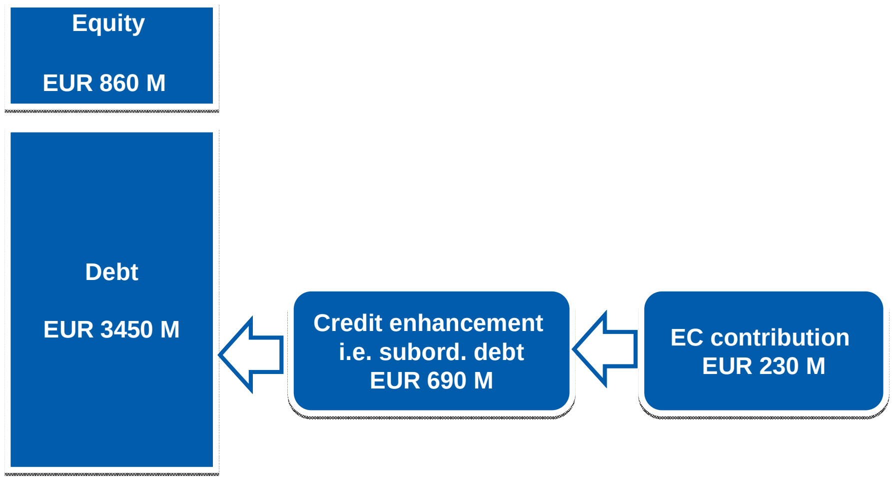
EIB Sub-debt participation can be combined with different types funding sources (bonds and other senior loans)

EIB Unfunded Sub-debt participation can be flexibly used and structured in order to ensure target rating.

- Covers funding shortfalls during construction
- Comes on top of a fully funded structure
- Revolving capacity, available until the end of the project

Efficient use of EC funds – « mulitiplier effect »

- EU funds together with EIB's contribution will enable the credit enhancement of the senior debt of the project
- The EU contribution will be limited to the budgeted amounts
- The exact multiplier factor will be determined on a case by case basis for each project.



<u>Indicative multiplier effect of EU budget</u>

Credit enhancement budget vs. instrument x3
vs. total project cost x19

Project Bonds: Delivery Mechanism

- 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 the 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.

Project Bonds: Delivery Mechanism

- 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;

Summing Up:The Potential Role of the EIB

EIB's participation could provide substantial benefits to the Project Bond investor

Project Bond investors need	EIB would provide
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 DD during appraisal / structuring
External financial analysis of the project	Thorough financial analysis during appraisal / structuring
Monitoring and surveillance post financial close	EIB participates in monitoring the project
Appropriate well functioning inter-creditor regime	EIB could decide certain matters, more fundamental issues subject to bondholder vote

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Back-up slides

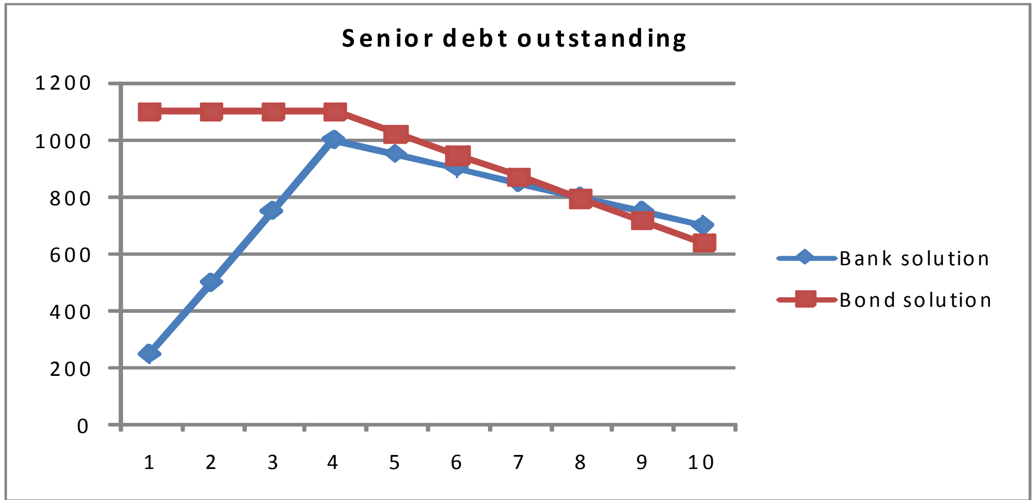
Technical features

Project Bonds: Delivery Mechanism

- The Project Bond Initiative should mainly concern projects exceeding EUR 100m in capital costs given the additional development costs (rating cost, legal fees…) and the complexity of a bond issue;

- The bond issue could either be
  - Public i.e. the bonds are listed on a stock exchange and available to a wide range of investors; or
  - Private i.e. the bonds are taken out by a limited number of identified investors (requiring in general less disclosure than a public offering)

- The lower all-in financing costs for the bond solution should compensate for the negative carry:



« Project Bonds » - Other Features

- It is anticipated that the credit enhancement provided by EIB could go up to 20% of the senior securitised project debt;
- This is expected to provide de facto debt service protection in the vast majority of scenarios during project's life;
- Traditional equity requirements to be met, i.e. subordinated debt supplied by EIB is not meant to replace shareholders' loan or equity contributions;
- EIB is open to other institutions joining in the offering of sub-debt credit enhancing products;
- Underlying projects must satisfy EIB's ordinary assessment criteria, that is projects must be technically robust and financially sound;
- Changes to the Project Documentation required to accommodate a bond issue are expected to be limited and should not lead to any changes in the accounting treatment of debt in the national accounts (on/off balance sheet).

« Project Bonds » - Key procurement issues
Possible impacts on timetable and rating involvement

- Impact of a bond solution on the procurement timetable:
  - Key Milestones:
    - 'Pre-rating' at BaFO stage to demonstrate deliverability (provided the Project Agreement is almost "frozen")
    - Bank versus Bond drop-dead date no less than 3 months prior to planned financial close to limit costs and impact on the timetable
    - Start of the final rating process once project documentation is virtually finalised
  - Involvement of the rating agencies:
    - Indicative / 'pre-rating' process takes approximately 4-6 weeks; however preparation of supporting material will track progress of the BaFO bid.
    - Final rating takes approximately 4 weeks
  - Final rating and marketing activities may add around 4 weeks compared to a bank financed deal.

« Project Bonds » - Key procurement issues

- Volatility of the all-in financing costs (bank/bond solutions)
  - Under the bank solution, the margins are usually fixed during 3-4 months while the granting authority retains the risk on movements in the underlying reference rate (LIBOR or EURIBOR);
  - Under the bond solution, both the underlying reference rate and the spreads will not be locked down until financial close, the risk of fluctuation being borne by the granting authority;
  - Reference rates and bond spreads tend to move inversely, therefore over the last 5 years, it appears that the all-in financing cost of the bank solution was more volatile than the all-in financing cost of the bond solution.

- Required amendments to the project documentation
  - No major changes to the project documentation are anticipated to accommodate for a bond issue;
  - Potentially adjustment of some clauses to facilitate the bond issue and reduce pricing (for example, SPENS protection in the event of authority default).

« Project Bonds » - Key procurement issues

- Required amendments to the tender documents
  - No requirement to provide committed funding at bid stage;
  - Requirement for the final bid to provide evidence of the expected rating (a minimum rating of A- is anticipated to match the expectations of bond investors);
  - Requirement to provide an indicative bond pricing together with supporting pricing methodology;
  - Requirement for bidders to accept the risk of any price increases associated with failing to secure the targeted rating (other than as a result of material changes to the Project Agreement required by the granting authority);
  - Requirement for bidders to consider what share of pricing increase they are willing to bear in the event that the bond spreads move outside the range anticipated giving due regard to the bidders pricing methodology.