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REPORT FROM THE COMMISSION

INTERIM REPORT ON THE PILOT PHASE OF THE EUROPE 2020 PROJECT BOND INITIATIVE

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1. BACKGROUND

This Interim Report (hereafter "the report") to the European Parliament and the Council is required by Regulation (EU) N° 670/2012 to evaluate the progress of the pilot phase of the Europe 2020 Project Bond Initiative (PBI).

The PBI is a risk-sharing instrument created by the European Commission (EC) and the European Investment Bank (EIB). The aim is to enable project companies to issue project bonds that are attractive to debt capital market investors in the sectors of trans-European networks in transport (TEN-T) and energy (TEN-E) as well as telecommunication and broadband networks.

Due to the significant lead time needed to launch an innovative instrument of such scale and to prepare, procure and close new infrastructure projects, the PBI pilot was set up with EU budget of EUR 230 million[1] to allow stakeholders to familiarise themselves with the new instrument on the basis of concrete transactions during an initial pilot phase. In the pilot phase[2], which started on 7 November 2012, projects may be approved by the EIB until 31 December 2014 and must reach financial close by 31 December 2016. The full roll-out is foreseen within the Connecting Europe Facility (CEF) forming part of the 2014-2020 Multi-annual Financial Framework (MFF).

This report, prepared in cooperation with the EIB, covers the first 12 month period from November 2012 to November 2013 and shows the progress made on project approval and financing. The report analyses lessons learnt during the pilot phase and highlights possible synergies and economies of scale that could be achieved within the framework of the CEF. The CEF role could be maximized by creating synergies through the combination of grants and financial instruments, such as the PBI, Loan Guarantee for TEN-Transport (LGTT) and programme support actions.

The report is supported by the draft results of an independent external assessment, which aims to evaluate the achievements of the PBI in relation to policy objectives and capital market financing in a broader context and which will be completed in Q1 2014. The pilot phase is also subject to an independent evaluation in 2015, which will provide a fuller picture on the effectiveness and efficiency of the use of EU funds.

2. POLICY CONTEXT

The importance of infrastructure investment for future growth potential and job creation remains unchallenged. Economically and financially viable infrastructure projects can have a significant countercyclical effect, improve productivity and are conducive to creating

[1] TEN-T EUR 200 million, TEN-E EUR 10 million, ICT EUR 20 million
[2] Regulation 670/2012 OJ L 204/1 of 31/07/2012

employment. At the same time, infrastructure aimed at improving market access, underpins Europe's competitiveness.

To meet the challenges of implementing the Europe 2020 strategy, Europe needs substantial infrastructure investment volume and diversity of funding models. Based on the assessed investment needs of Member States, the EC estimated that EUR 1 trillion would be required in the sectors of TEN-T, TEN-E and ICT from 2011 until 2020.

The consolidation of EU Member States' budgets has continued in recent years and public infrastructure investment and project pipeline preparation have been affected. The EU budget under the CEF will help to finance the missing links to connect energy and transport networks and the roll out of high speed broadband infrastructure across the EU[3]. However, private sector participation in the long term financing of such projects remains paramount.

The PBI is only one of the policy actions taken by EC to tackle the above challenges. A wider impact is expected by the follow up to the Green Paper on the Long-Term Financing of the European Economy planned for Q1 2014, the reforms of financial market regulation, as well as the overall macroeconomic environment and regulatory stability at sector level.

In this context, the PBI has been successful in playing a catalytic role in re-invigorating the infrastructure investment market. In 2013, a number of project bond financing solutions re-emerged on the market, without support of the EU budget. The initiative also fits well with the international debate at G20 and OECD level to make infrastructure a separate asset class and with the high-level expert group established by the Council that finalised a report on SMEs and infrastructure financing in November 2013.

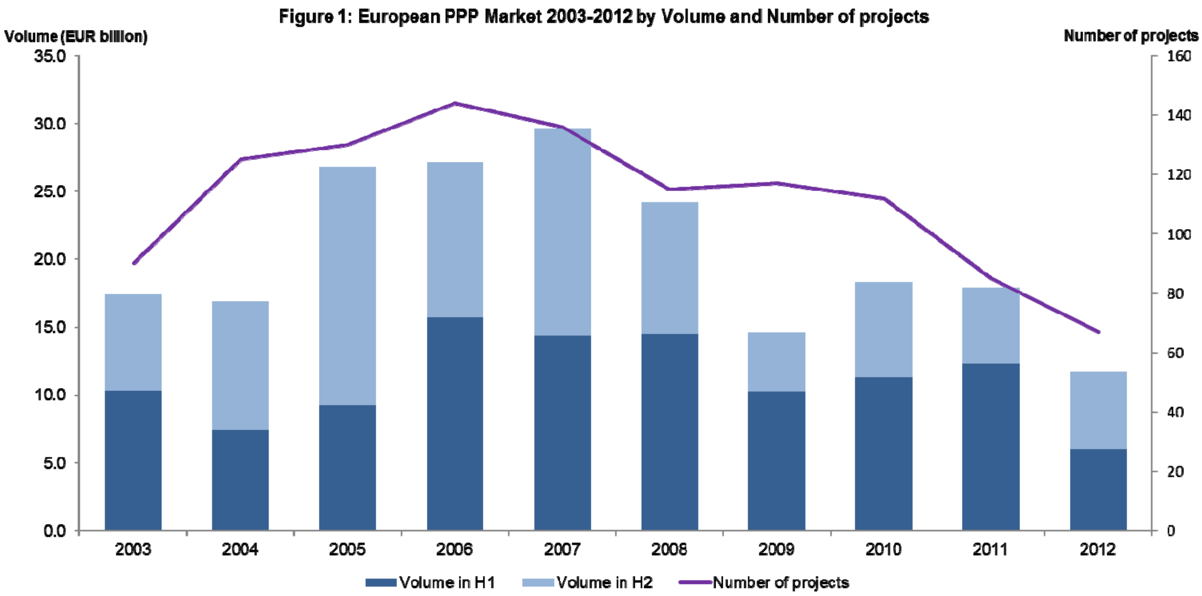
3. MARKET DEVELOPMENTS SINCE 2011

Infrastructure investment in Europe has declined since 2007 due to a decrease in public and private sector investment in this area. In the public sector this has been driven by budgetary constraints which entailed revisions of future spending priorities and infrastructure plans. Whereas the private sector was expected to complement public sector investment, economic and financial uncertainty has actually led project promoters to put projects on hold in sectors such as energy and ICT/broadband, where investment needs are large in order to upgrade networks and where private sector financing dominates.

As shown in figure 1, private sector financing of infrastructure in the EU, using project finance for PPP projects as a proxy, has not yet recovered to pre-crisis levels of EUR 25-30 billion which was still insufficient for EU infrastructure needs. This is partly due to the reduction of activity of monoline insurers. After a partial recovery in 2010 and 2011, the value of PPP transactions reaching financial close in Europe in 2012 totalled EUR 11.7 billion, a 35% drop compared to 2011 (EUR 17.9 billion) and the lowest value since 2003.

[3] In the case of projects of economic nature supported via State Aid, Member States are under the obligation to ensure that aid plans are either notified in advance or are eligible under the General Block Exemption regulation.

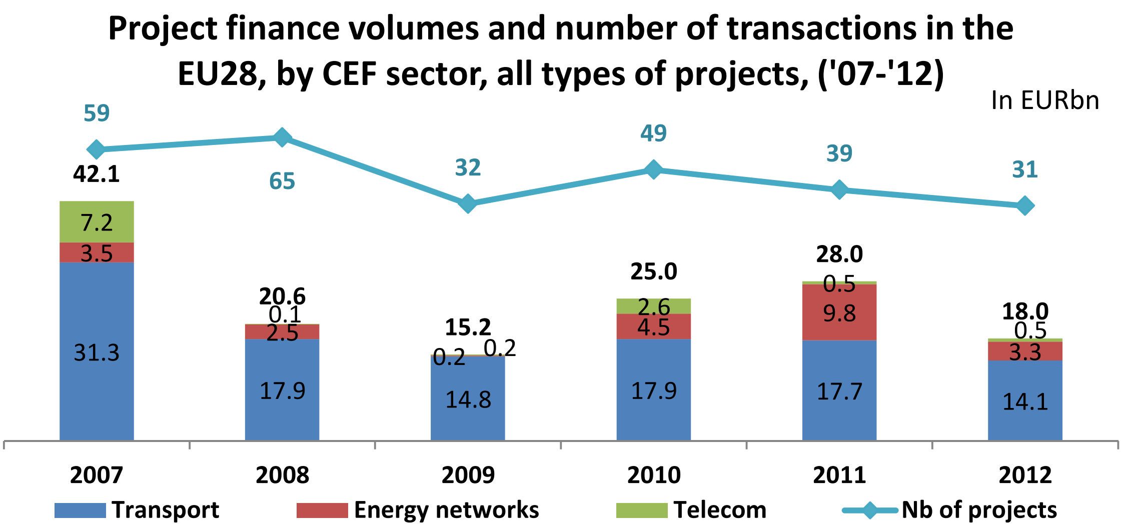
This decline in PPP projects and project financing volumes reflects firstly a limited project pipeline and project preparation, and secondly the lack of long term financing in certain sectors and countries affected by the financial crisis.



Source: EPEC

Looking at the broader market by CEF sector, infrastructure financing saw a decline to EUR 18 billion in 2012 from EUR 28 billion in 2011 and fewer transactions. EUR 14.1 billion worth of projects were from the transport sector versus EUR 3.3bn for energy networks and EUR 0.5 billion from the telecom sector.

Graph 2



Source: Infrastructure Journal database, converted to EUR using average FX rate

In the first half of 2013, the activity in the EU28 in the CEF sectors increased by +33% in terms of volume, from EUR 9.2 billion in H1 2012 to EUR 12.2 billion in H1 2013. The number of transactions slightly decreased (12 versus 15) and the average transaction size in 2013, EUR 1.0bn, was 66% higher than the EUR 0.6bn registered in 2012. This is mainly due to several large refinancing transactions occurring in 2013 (Open Grid Europe, Brebemi Toll Road).

Banks continue to review their business models. Some are willing to lend to projects again, albeit at shorter maturities than before the crisis, others are developing capacities to originate and place project finance deals, in response to the increased role anticipated to be played by institutional investors. These developments are interpreted by some as a sign of the recovery of bank financing. However our estimates are that banks will not deliver the volume of debt to meet EU infrastructure needs.

There is a real risk that post financial crisis infrastructure spending as a means of delivering future growth and jobs will be constrained, unless alternative sources of funding can be developed. In this regard a number of insurance companies and infrastructure debt funds have emerged that are able to invest in senior or subordinated debt in primary and secondary transactions. Some insurance companies have set up in-house teams dedicated to infrastructure financing to strengthen their presence in the market while others act through managed accounts. Several have closed first transactions, although the majority have been modestly sized in relatively straight-forward UK social infrastructure projects (e.g. university accommodation) and have been mainly private placements rather than public bonds. While several smaller transactions at local level are greenfield investments, larger operations at national level are often re-financings and brownfield investments.

In conclusion, while traditional bank financing will continue to be important, there is potential for these and other new market actors to promote private sector financing of infrastructure projects via debt capital markets. This is a key objective of the PBI.

4. OBJECTIVES OF THE PROJECT BOND INITIATIVE

The PBI aims to provide a concrete tool to contribute to the post-crisis economic recovery. Its main objectives are two-fold:

- to stimulate investment in projects of European interest in the trans-European transport, energy and broadband sectors with a clear EU added value, thereby helping investment to grow to pre-crisis levels, and

- to facilitate greater involvement of institutional investors in the long-term debt capital market financing of economically viable projects in these sectors.

The PBI intends to complement existing sources of project financing and to provide a credible alternative through other sources of debt funding (bank and emerging debt funds). This would not only broaden available financing sources, but also address sub-optimal investment situations and improve the conditions of financing. The ultimate aim of the PBI is to broaden the appeal of infrastructure to private sector investors.

The Project Bond Credit Enhancement (PBCE) provided by the EIB through the PBI aims to bridge the gap between the typically low investment grade ratings of privately financed infrastructure projects and the higher target ratings of investors . This would broaden financing sources and should help support the tenor and reduce costs of financing. The PBCE can be provided in the form of:

- a funded facility, which is a subordinated debt tranche (i.e. a direct loan to the project that would be repaid only after the senior bonds have been serviced), or

- an unfunded facility, which is a contingent credit line that, once claimed, converts into a subordinated loan.

The PBCE targets bonds of single A- investment grade quality so that most institutional investors could purchase them. Whereas a few institutional investors are now ready to absorb more risk through the acquisition of mezzanine bond tranches, the objectives of PBI to bring a critical mass of investors in the market, to increase standardisation and to contribute to the development of a more mature market are still valid.

The PBCE addresses the specific risks of projects during the construction and operating phases, providing additional liquidity to improve the financial profile in response to unforeseen events. As the PBCE claim is senior to equity investors, but junior to debt investors, it improves the bonds' credit rating.

The EU contribution to the PB Instrument serves to partly absorb the EIB's additional risk from engaging in riskier-than-normal transactions by covering the first losses on the portfolio of projects up to a maximum. This enables EIB to support more operations than otherwise possible. Projects must comply with the Union guidelines establishing eligibility criteria in each of the three sectors, must generate stable and sufficiently high cash-flows, and be economically sound and technologically feasible.

5. ACHIEVEMENTS

The PBI pilot phase commenced 12 months ago and allows project approval by the EIB Board until the end of 2014 and financial close until the end of 2016.

To date, eight energy and transport projects eligible for PBCE within several EU Member States have been approved by the EIB Board. Furthermore, the EIB has demonstrated the feasibility of Project Bonds by providing credit enhancement to bonds in respect of two of the approved projects (only one of which was supported by the EU due to budget constraints), with an additional one expected to be signed soon.

5.1. Approved projects by the EIB

The projects range from motorways in several Member States, to grid connections to offshore wind farms in Germany and the UK and gas storage facilities in Italy and Spain. In broadband, the EIB is proactively working on an executable project pipeline.

Table 1:

Policy	**Project**	**Country**	**Expected size of credit enhancement facility (EUR million)**
TEN-T	Motorway	Belgium	150
TEN-T	Motorway	Germany	120
TEN-T	Motorway	UK	200
TEN-E	Grid connections to several offshore wind farms	UK	150
TEN-E	Gas Storage	Spain	200
TEN-E	Gas Storage (1)	Italy	200
TEN-T	Motorway	Slovakia	200
TEN-E	Grid connections to several offshore wind farms	Germany	170
Total Approved			**1,390**

(1) subject to EU funding being available

Further projects approved by the EIB Board by the end of 2014 may also be added to the list.

The pilot phase can provide credit enhancement facilities of approximately three times the EU budget contribution of EUR 230 million, i.e. around EUR 700 million, ultimately supporting senior debt volumes of 15-20 times the EU budget contribution.

The subordinated facilities for the eight approved projects exceed EUR 700 million, but a lower use will likely result as a project bond with PBCE is typically one of several financing options, which the project company and/or granting authority can choose. For example, the motorways in the UK and in Slovakia will be financed without PBCE as, for project specific reasons, the rating of the projects was sufficient to raise funds in the bond market without the higher ratings provided by PBCE. Nonetheless, the existence of PBCE as another funding option is seen to have helped maintain pricing tension on these two projects, ensuring that the final outcome represents value for money for the respective procuring authority.

5.2. Project Bonds supported by the EIB

The EIB has supported the issue of a EUR 1.4 billion bond for the Castor gas storage facility[4] without the use of EU budget, as the amount required for the EC contribution exceeded the available budget.

[4] The project was subject to an Environmental Impact Assessment approved by the Spanish competent authority in 2009. Following seismic activity in the region in September 2013, the Spanish Authorities decided to perform additional technical studies on the impact of the project.

The first project bond

The first EUR 1.4 billion project bond due December 2034 was launched in July 2013 with a coupon of 5.756 at a spread of 100 basis points over Spanish government bonds. The bonds financed the construction and operation of an underground gas storage and associated facilities off the northern Spanish Mediterranean coast. Standard & Poor's issued a 'BBB' rating to the bonds.

There were 30 investors in the bond with insurers and pension funds taking over 60% of the issue, the remainder being agencies, fund managers and banks (only 4%). The investors were geographically diversified with approximately equal shares going to Germany, France, Spain, Italy, UK and Luxembourg.

The bond was issued by Watercraft Capital, an SPV based in Luxembourg, which on-lends the proceeds to the project company to re-finance its outstanding shorter-dated loans which financed the construction of the gas storage facility. The project company will thus have financing more suited to its 30-year concession.

The PBI also supported the issue of a GBP305 million bond for the Greater Gabbard OFTO project in the UK, which involves the electricity transmission assets linking 500MW of offshore wind farms to the UK onshore grid. The project is the first OFTO project to be funded through the capital markets. The bond benefitted from an unfunded PBCE of around GBP46 million and as a result received a rating of A3 from the Moodys, pricing at a very competitive 125 bps over gilts. The PBCE was provided with the benefit of EU budget and fully utilised the EUR 10 million EU budget available for energy projects during the Pilot Phase.

Greater Gabbard OFTO reaches financial close

The 504MW Greater Gabbard offshore transmission project (OFTO) reached financial close on 27 November 2013. The OFTO Licence, granted by Ofgem, the UK regulator of electricity and gas markets, entitles the project company to own and operate the assets for a period of 20 years and in return receive availability-based revenues. The value of the fully operational asset is roughly GBP 350 million to be financed by the project company in part through the issue of a project bond.

A GBP 305m public bond, which pays a fixed coupon of 4.137% and matures on 29 November 2032, has been issued to support the financing of the deal.

Moody’s assigned a provisional A3 rating to the issuance, with a stable outlook. The agency said that the rating reflected the credit enhancement provided by the PBI. A total of GBP 46m of equity has been provided by the project’s sponsors.

This is the first round 1 OFTO of sufficient size to have attracted the interest of the capital markets. Such funding has long-been viewed as a good fit for the OFTO sector as the tariff paid to the operator is RPI-linked and 90% of the revenue is guaranteed.

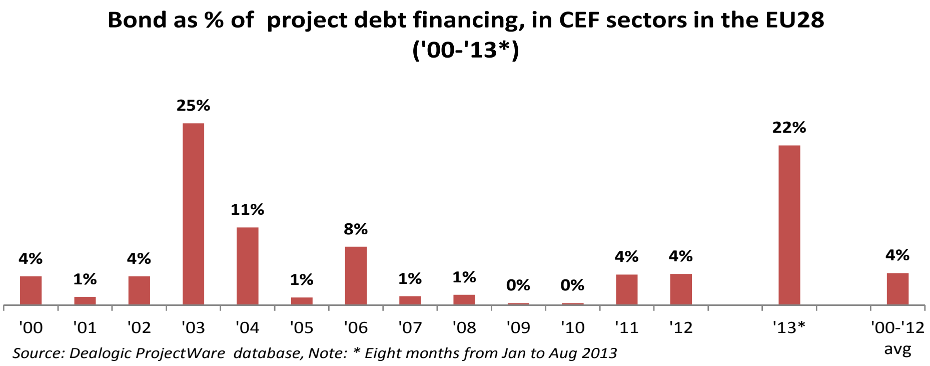
These two transactions are expected to be followed by the A11 motorway project in Belgium by year-end 2013 or early 2014. This transaction will also be supported by the EU budget and will provide a further benchmark in terms of investor potential and pricing levels.

The **A11 Brugge PPP** is a new motorway linking the harbour of Zeebrugge with the E40 to Ghent and the E34 to Antwerp, which will improve the connection of the port to the city of Brugge and tourist connections to the Belgian coast, in particular Knokke and Blankenberge. Currently, the A11 financing structure is being finalised with a targeted closing end of 2013 or early 2014 with signature contingent on finalisation of negotiations and approval by the contracting authorities. The A11 project would be the first transport TEN-T project under the PBI and the first ‘greenfield’ transaction. It is expected, that the EUR 575 million bonds would be supported by around EUR 114 m of unfunded PBCE in the form of a subordinated letter of credit issued by the EIB.

5.3. Other issuance of infrastructure bonds

The increased focus on and support for capital market financing of infrastructure projects has also led to a significant increase in other infrastructure bond issues compared to 2007 - 2012. However between 2007 and 2013, in terms of volumes, more than 90% of bonds issued in sectors covered by the CEF were re-financings, 6% greenfield investments and 3% acquisitions.

Graph 3



In addition to the EUR 1.4 billion Castor bond, enhanced by EIB, 2013 saw the completion of a number of significant refinancing deals in the bond market including:

- The refinancing of High Speed 1, the UK high speed rail project with a GBP 760 million 25-year bond, as part of a GBP 1.55 billion senior debt package. It attained an A- rating with the UK Government effectively underwriting availability payments to High Speed 1 through a domestic underpinning agreement;

- Open Grid successfully refinanced EUR 2.7 billion of debt with EUR 1.2 billion of loan facilities and EUR 1.5 billion of A- rated bonds with tenors of seven, 10 and 12 years.

- In Slovakia, the refinancing of approximately EUR 1.2 bn of debt with long dated bonds rated BBB+ and a maturity in 2039.

These transactions do demonstrate the depth and appetite of European capital markets for straightforward refinancing of infrastructure projects.

In addition, 2013 has seen a number of innovative debt capital market solutions, which have sought to provide funding for greenfield projects from institutional investors in various ways. The majority are in the social infrastructure sectors, e.g. student accommodation, where projects are smaller and less risky.

Project	Rating	Tenor	Nominal (million)	Features
L2/A507 ring road	Baa3	28 years and 30 years for tranche I and tranche II, respectively	EUR 79 (tranche I) EUR 86 (tranche II)	Over 65% of financing provided by the French Government, the remaining EUR 165 million purchased by an insurance group with tranche II benefitting from the Dailly (i.e. a guarantee from the French State)
Holyrood student accommodation, UK	AA-/A2	35 years fixed & index-linked	GBP 63	Underlying bond rated BBB/Baa3 and enhanced by Assured Guaranty
Pendleton Together Housing	n/a	29 years	GBP 71.7 (A tranche) GBP 10.9 (B tranche)	Partial wrap bond financing (senior class A bond benefits from credit enhancement from the subordinated class B tranche)
Zaanstad prison	n/a	28 years	EUR72	The senior notes are credit enhanced by the subordinated B loan tranche
ULiving Hertfordshire, UK	A-	41 years index-linked	GBP 144	
UPP, multiple-site student accommodation, UK	A-	27 yrs fixed, 34 yrs index-linked	GBP 382	Rental income from multiple universities with risk-reducing cash pooling
Sustainable Communities for Leeds	AA-/A2	19 years	GBP 102	Underlying bond enhanced by Assured Guaranty

Sources: Infrastructure Journal, Standard & Poors

It is noteworthy that the L2, Holyrood, Pendleton, Zaanstad, and Leeds projects all employ some form of credit enhancement. Two transactions mark the return to the market of a bond insurer for these medium-size transactions. The largest transaction overall, the UPP student accommodation, is for GBP 382 million and is based on a portfolio of projects. In several cases a single institutional investor bought a large share of the transaction.

All but two of these transactions were in the UK where capital markets financing of PPP using monoline guarantees was common. Across continental Europe, appetite for bond-financed solutions is just emerging and procuring authorities are adapting slowly to new financing possibilities. Procurement practices for committed finance at bid stage are still common, which limits bond solutions to private placements and largely precludes publicly issued bonds where increased volume and improved pricing could otherwise be available.

5.4. Summary of achievements

In the first year of operation, eight projects have been approved by the EIB Board as potential beneficiaries of PBCE and further projects are being advanced. Two projects have been credit enhanced by EIB and an additional project is expected to be signed by early 2014. One of these three projects was closed without support from the EU budget.

The active promotion by the EC and the EIB of Project Bonds for infrastructure financing has been recognised and appreciated by the market and has supported the development of other market solutions through the catalytic effect envisaged. It confirms that Europe is making real progress towards creating a project bond market. In particular, the PBI has provided a wider range of investors with access to infrastructure assets as evidenced by the transactions completed already. Even where PBI has not ultimately been selected as the preferred funding option, it has provided competitive pressure reducing overall financing costs for a number of projects.

However, the market has so far focused on smaller sized local infrastructure projects in the UK with limited activity in support of larger projects at national level. In particular, the conditions for TEN greenfield projects remain difficult. Member States should speed up the identification and preparation of infrastructure projects in order to bring them to the market.

6. REQUIRED IMPROVEMENTS FOR THE PBI

6.1. Need for stronger and more mature project pipeline

The demand for infrastructure investment in Europe is evident. However, there is a growing concern that the current projects in terms of number and maturity are not sufficient to meet such demand[5].

For projects and sectors which crucially rely on public sector involvement, governments across Europe have an important role to play in committing to unlock new infrastructure investment and in addressing uncertainty over the future supply or pipeline of infrastructure projects. Without a proper pipeline of (suitable) deals, long term investment cannot be increased. Building investor confidence in transaction flow, so that investors remain willing to both commit their funds and invest in building the new capabilities required to analyse finance for infrastructure projects necessitates a greater degree of transparency in the pipeline of projects at the national and supranational levels, as well as long-term planning and commitment on the part of tendering authorities.

In this context, sudden changes in the regulatory approach for specific sectors still represent a major challenge for the effective implementation of project pipelines. Across sectors in general, factors such as lack of standardisation, lack of certainty in pricing of capital market issues as well as the perceived novelty of such deals in the market at the moment, are seen as challenges being faced by bond solutions. Here the PBI can also demonstrate its beneficial role.

6.2. Use of the EU budget

In light of the risk-sharing mechanism set up between the Commission and EIB, as described in Section 4, the use of the EU budget would become more effective if the first loss provisioning provided by the EU budget were shared among all projects in the three sectors covered by the PBI. There are clear limits to risk diversification and hence leverage with three separate first loss provisions underpinning three sectoral portfolios, as it is currently the case. Moreover, the limited leverage on smaller portfolios necessitates finding projects of the right size for the given amount of budget available. For example EIB funded the Castor project on its own balance sheet as the contribution from the TEN-E budget was insufficient to cover the EU contribution required.

[5] Source: *Infrastructure Journal, 17/11/2013*

Essentially, the EU budget and risk-sharing instruments can achieve more leverage through diversification. Diversification increases with the number of projects in the portfolio while sectoral diversity of projects decreases their correlation. Consequently, a larger portfolio which also spans across different sectors yields greater diversification benefits. On the other hand, the management of risks within a portfolio of projects presenting different risk profiles may increase complexity whilst still being manageable by the EIB. In order to maximise the benefits from diversification, the CEF could only have a single portfolio of projects in full compliance with the CEF Regulation and the Financial Regulation on EU spending. This will facilitate the financing of projects regardless of size or timing.

This same mechanism can be extended to the existing LGTT and PBI portfolios, thereby reaping the full benefit of economies of scale. By merging these portfolios with the CEF portfolio, a seed portfolio would be created which could reduce the relative contributions of the EU budget to new projects sooner than would otherwise be the case. The external study commissioned by the EC referred to in the introduction is expected to point towards this conclusion.

7. CONCLUSIONS

As evidenced by the issuance of 2 project bonds with credit enhancement after only 12 months, the initiative is fulfilling expectations and is a success in terms of providing financing to projects.

Market interest in and feedback on the initiative have been positive and this has been instrumental in terms of focusing investors on bond solutions. In terms of developing project bonds, more work is needed to develop an active bond market, including the issuance of further bonds so that a sufficient stock is outstanding and benchmarks for future issuance can more easily be defined. This will make it easier for investors and procuring authorities to assess likely funding levels and make the pricing of bond solutions more predictable, perhaps enabling procuring authorities to move away from requiring fully committed funding. Furthermore, a liquid project bond market requires better prepared and more mature projects. Governments should thus commit to long term planning so as to ensure a more stable and transparent pipeline of infrastructure projects. In this respect, CEF foresees technical assistance at institutional and project level to help prepare future pipelines of project of common interest in order to support Member States and the private sector. There is also scope to expand the PBI to other policy areas where the financing of smaller local infrastructure projects could be pooled at national or regional level.

The CEF role could potentially be maximized if a merger of the three sector portfolios (i.e. transport, energy and broadband), as referred to in Article 14(3) of the upcoming Regulation establishing the CEF, were carried out. With a view to increasing the efficiency and leverage effect of EU budget spending, this opportunity could be used to create a shared first loss provisioning system to benefit from the inherent diversification of the three sectors wherein the pre-existing instruments could be used as a seed portfolio.