CEER response to the European Commission´s consultation on the "Europe 2020 Project Bond Initiative"

29 April 2011

1. Background

On 28 March 2011 DG ECFIN launched a consultation on the "Europe 2020 Project Bond Initiative". This initiative presents one of the financing mechanisms mentioned in the European Commission´s Energy Infrastructure Communication of November 2010. During the third Energy Infrastructure Package (EIP) workshop organised by DG ENER and CEER (29 March 2011), the European Investment Bank (EIB) gave a short presentation on the EU Project Bond Initiative and its purpose. DG ECFIN also organised, together with the EIB, a public conference on the matter (11 April 2011).

CEER is pleased to submit its contribution to the online consultation, addressing questions 1 and 3 as particularly relevant for the energy sector. The CEER responses are summarised in the following pages for reference.

2. CEER identification

CEER is the Council of European Energy Regulators, formed in March 2000. In 2003 CEER was formally established as a not-for-profit association under Belgian law and a small secretariat in Brussels was set up. CEER now has 29 members – the energy regulators from the 27 EU Member States plus Iceland and Norway.

The overall aim of the Council of European Energy Regulators (CEER) is to facilitate the creation of a single, competitive, efficient and sustainable internal market for electricity and gas in Europe. CEER acts as a platform for cooperation, information exchange and assistance between national energy regulators and is their interface at European level with the European Commission, in particular the Directorate General Energy (DG ENER), DG Competition and DG for Research. It cooperates with the European Commission and competition authorities in order to ensure consistent application of competition law to the energy industry. CEER also strives to share regulatory experience worldwide through its links with similar associations in America (NARUC) and in Central/Eastern Europe (ERRA) and its membership in the International Energy Regulation Network (IERN). CEER has taken a

central role in developing an effective and competitive electricity and gas market in the Energy Community of South East Europe.

3. The Project Bond Initiative: A credit enhancement facility

The Commission consultation document starts by setting out the investment needs in energy (distribution, smart grids, transmission/storage as well as generation) but also in Trans-European Transport Networks (TEN-T) and broadband. According to DG ECFIN, investments needs total some 1.5 − 2.5 trillion euro. While recognising that the "greater part" of infrastructure investment is made by the market (”corporate finance”), the Commission notes a 10% share of “project financing”, including Public-Private Partnerships. The consultation document argues that such project financing at present suffers from the financial crisis.

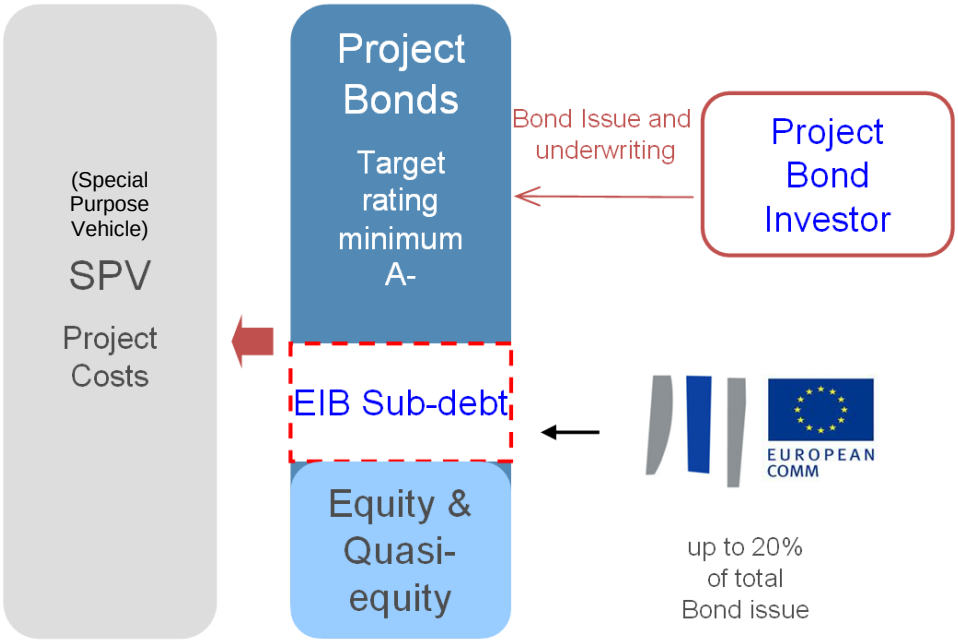
With respect to the sectors targeted for EU Project Bonds, the Commission inter alia notes that

> *"in the renewable energy or low carbon sectors, a challenge arises when the underlying infrastructure projects use untested technologies or are located in a new market, have uncertain operating costs or when the financing cannot be obtained at reasonable cost. However, certain classes of renewable energy projects may have the required characteristics."*

The proposal for EU Project Bonds consists of a so-called "credit enhancement" facility whereby the attractiveness of the projects to other (private) funding parties is improved to "investment grade" by giving the public debt share a "subordinate" status, i.e. a lower seniority when it comes to repayment compared to the private debt holders and the equity partners.

The chart below shows the EU Project Bond financing mechanism as described by the EIB:
By complementing the commercial bond and equity/quasi-equity elements with subordinated debt provided by the EIB (max. 20% of total bond funding), the equity basis is enlarged from a debt investor point of view. The commercial Project Bonds issued on top of subordinated debt will therefore benefit from a better rating than without EIB support. This is expected to

enable a project company that might not have found investors otherwise, to undertake the investment, or the costs of debt decrease.



4. Reply to question 1 of the consultation

In reply to the question *"Is the chosen mechanism likely to attract private sector institutional investors to the sectors of transport, energy and ICT in particular?"*, European Energy Regulators would like to note that in the energy sector, as mentioned in the consultation document, project financing is relatively not well established and that only a limited number of energy infrastructure projects are likely to fall in the category that will benefit from support of this nature.

The EU Project Bond mechanism could make a useful contribution to project finance schemes that are struggling to find debt capital at reasonable cost (as for example in some Eastern European countries). However, the application of EU Project Bonds needs to be considered on case-by-case basis and eventually implemented in those cases where this instrument qualifies as easy to implement and as a cost efficient tool.

Of the estimated 200 bn Euro investment needed in energy infrastructure up to 2020, the projects that are harder to fund will be those that have no guaranteed revenue stream (for example smart grid activities) or involve innovative technologies (such as the North Seas Offshore Grid).

These project types make up a significant portion of the required build in the energy sector, and, as elaborated in the consultation document, the EU Project Bond concept is not designed to accommodate either of these cases.

European Energy Regulators therefore caveat their response with this early conclusion that whilst the initiative may provide some assistance (e.g. in eastern European countries), in the energy sector this positive benefit will, unfortunately, be limited to a small tranche of the overall projects needed.

The energy network business works within a regulated framework. The aim of the regulatory framework, *inter alia*, is to ensure efficient and reliable operation of energy supply systems. To reach this goal in the long run, efficient investment is essential. Regulation must therefore aim to incentivise investment.

In the course of the follow up to DG ENER's Energy Infrastructure Communication (COM2010(677)), European Energy Regulators undertook an internal survey in March 2011 to deepen their understanding of network investment financing. The most important result was that the majority of Transmission System Operators (TSOs) in electricity and gas will be able to finance the investments needed until 2020 on their own.

In the regulators' internal survey, only a few countries (Cyprus, Estonia, Lithuania and Greece) noted that they do observe difficulties to finance the investments required on their territory. One argument put forward was that tariffs would need to rise significantly to shoulder the investments. For these countries, EU Project Bonds could be a useful instrument to decrease the cost of debt.

In the view of investors and energy regulators, in general there is a need for European TSOs to attract new equity capital. Raising debt capital does not pose a particular problem at present. The energy transmission business is relatively unaffected by general economic trends or fluctuations. Thus, it produces stable returns which have led to a growing popularity of investments in network infrastructure for investors. The bonds issued by network operators in 2010 (e.g. by Tennet) have been a huge success.

In the case of EU Project Bonds, there are limitations to implementation of these tools in the energy network sector. Projects Bonds are not *per se* suitable financing mechanisms for electricity and gas networks at transmission or distribution levels; given this, their use should be applied on case-by-case basis.

The regulators' internal survey shows that in the electricity sector project finance companies are not prevalent. This is primarily because the properties of today's electricity transmission networks as meshed alternating-current (AC) grids do not lend themselves to project finance, as individual expansion projects ("lines") need to be considered with a view to the larger grid. Connections of offshore wind farms to the mainland ("offshore connection"), merchant interconnectors or future high voltage direct-current "overlay" networks in contrast would qualify more easily for project finance.

In the gas sector, likewise, project finance is not widespread, but it can in principle be used.

In the regulators' internal survey, 3 countries noted that they had previously used project financing (Denmark, Germany and Poland in gas interconnectors and LNG terminal projects). Similar projects could therefore qualify for and benefit from EU Project Bond support.

In the electricity sector where the bulk of investment volumes (142 bn Euro) up to 2020 will be delivered through corporate finance, EU Project Bonds will rather not provide a significant addition to existing EIB support schemes. However, as an alternative, the EIB could consider taking support for corporate finance forward, for example via EIB subordinated loans, as mentioned in the consultation document. This would create incentives for projects that would otherwise not be built, but would not require the formation of a project finance structure. Furthermore, it would not restrict the use of debt capital to the issuance of Project Bonds alone.

Certain joint characteristics of the electricity and gas network business render project finance relatively difficult and therefore often more expensive than corporate finance:

- In most EU Member States a revenue cap allows the TSO to earn a certain amount of income. Revenue is not granted for specific infrastructures as a single line. In contrast to that, a project company does not have a meshed network (or "portfolio") of different lines to rely on.
- A project company may build a grid and lease it to the corresponding TSO. That results in a dependency of the project company on the TSO, which means that the risk of the TSO going into bankruptcy needs to be priced into the rating conditions of the project company. The cost of debt and equity therefore increase.
- A project company may build a grid and operate the grid on its own. As a consequence the project company is then considered as a TSO under the 3rd Energy Package (Directives 2009/72/EC and 2009/73/EC) and will need to fulfil several additional obligations and be subject to the overall regulatory regime. Not every TSO, depending on the type of unbundling model transposed into national legislation (full ownership unbundling, Independent System Operator or Independent Transmission Operator) appears to be allowed to accept third party funding as it needs to be the owner of the network.

The consultation document is not explicit on the selection of specific projects and to which type of European projects the EU Project Bonds will be made available. In the transport sector, the Commission seeks to develop the current TEN-T policy further with a view to applying a new planning methodology with a dual layer network structure, comprising a comprehensive network and a core network.

In the energy sector, the Commission's Energy Infrastructure Communication suggests to identify relatively few "Projects of European Interest" (PEI). The 3rd Energy Package provides important tools for assessing the value of interconnection development in Europe with the various ten year network development plans (TYNDP) at national, regional and Community levels.

There is a need to ensure that each identified Project of European Interest (PEI) is genuinely essential and offers the most cost-effective solution. If EU Project Bonds are to be applied to these PEIs, such projects should be identified in the TYNDP; be part of a "priority corridor"; confirmed by the Regional Initiatives; not viable with current available financing mechanisms; highly ranked in the list of Projects of European Interest; and confirmed by a specific EU act as eligible (with financing rules). Otherwise the risk exists that the EU Project Bonds might replace commercial financial products.

5. Reply to question 3 of the consultation

The question *"Would the credit enhancement facilitate/accelerate the conclusion of financing packages?"* should not only be considered from an investor's perspective.

As mentioned in the reply by European Energy Regulators to question 1 above, project finance companies are not well established in the electricity transmission business, while in the gas sector project financing has been applied in some cases. It appears that for most companies outsourcing of the investment to a new project company is not the first choice. For these companies, the question arises whether it is feasible to incentivise them in a structure they would not otherwise choose.

Even if the EU Project Bond concept proves beneficial for specific project-financed initiatives in the energy sector, these benefits are likely to be limited because of the small proportion of

the overall investment that they apply to. Project Bonds should also be designed in order to avoid that perverse incentives maximise return on equity could lead to restructuring of already arranged projects, causing some investments to slow down.