ODC Observatori del Deute en la Globalització | Counter Balance – Challenging Public Investment Banks

August 2014

Policy briefing – Project Bond Initiative

1. Summary:

As the pilot phase of the Project Bond Initiative descends into acrimony amid the closure of its flagship pilot project, the recent downgrading of the Castor bonds to junk status and the Spanish government's announcement that it expects to compensate investors for the project, it is hard to imagine that this is what the EIB had in mind when it launched its much-vaunted Project Bond Initiative.

After the fallout from the Castor project, more systemic weaknesses begin to emerge in the initiative. As more projects are earmarked, a worrying bias towards fossil fuel infrastructure can be noticed, which is at odds with the EU's long terms goals towards a decarbonised economy. It is time the EIB put aside its usual intransigence and recognised that the Project Bond Initiative is not fit for purpose.

2. An initiative born in a specific financial climate

After a two year development period, the Project Bond Initiative, which was announced to great fanfare in 2012 by European Commission (EC) President José Manuel Barroso, is reaching the end of its pilot phase. Central to the initiative was its promise to unlock new private investment for EU infrastructure projects in a bid to "boost our economy and invest in our future."[1] In Europe's sputtering post-financial crisis economy, existing avenues to raise finance for projects had dried up; the market in monoline insurance (companies that guaranteed payments associated to a security over the lifetime of a project) as a source of project financing had almost disappeared after the stress of the financial crisis. In addition, banks had to keep increased amounts of capital on their books as part of the Basel III Accord. It was in this financial context that the EC and the European Investment Bank (EIB) sought to devise a low-cost strategy to attract new investment from a jittery private sector which balked at large-scale, long-term financial investments.

3. A new wave of infrastructure projects for the next EU budget: PCIs and CEF

In October 2013, the EC published a list of 248 energy infrastructure projects, known as Projects of Common Interest (PCIs), which were chosen under new guidelines for trans-European energy infrastructure (TEN-E). These projects could potentially tap into the €5.12bn budget made available to the Connecting Europe Facility (CEF) – designed to improve trans-European energy infrastructure in the period 2014-2020. In addition to the €5.12bn allocated for energy, the CEF financial envelope comprises €13.17bn for transport (TEN-T) and €1bn for ICT: €19.3bn in total at 2011 prices.[2]

1 EU press release: "President Barroso and Vice-President Rehn welcome the European Parliament's final vote on Project Bonds." http://ec.europa.eu/economy_finance/articles/financial_operations/2012-07-05-project-bonds_en.htm

2 Council of the European Union 12602/13 http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%2012602%202013%20INIT

PCI projects are to be afforded preferential treatment in a favourable regulatory environment which, put simply, is the speeding-up of the permit-granting procedure.[3] Counter Balance has previously argued that the list was drawn up without an adequate consultation period for civil society groups and local citizens.[4] Out of the 248 projects, more than 100 are designated for the transmission and storage of natural gas and 15 will facilitate an increase in EU gas imports, which is at odds with the EC's own demand forecast.

4. The creation of the Project Bonds Initiative

It is within this context that the EC and the EIB designed the Project Bond Initiative to act in tandem with the CEF as a means to finance these projects, albeit with a more limited initial scope for the pilot phase. Whilst the EC's principle role has been to define the eligibility criteria for projects, the EIB is tasked with appraising potential projects, carrying out the relevant due diligence and financial analysis and then pricing the subordinated loan appropriately. In October 2011, the EC announced the creation of the 'Europe 2020 Project Bond Initiative' (PBI) which was then duly followed in June 2012 by the launch of the Project Bond pilot phase and a €220m commitment from EU coffers towards the initiative. At the time, European Commission Vice-President, Olli Rehn, claimed that this €220m would lead to €4.5bn of investment in infrastructure from the private sector.[5] In other words, the injection of public funds into the projects would be the spark to attract private sector investment.

5. How the Project Bond Initiative works

At the outset of a project, a project promoter is set up by one or more companies (quite often as a public-private partnership, PPP), whose purpose is the planning, construction, operation, and most importantly, the financing of the project. To raise the necessary finance, the project company can use all the traditional project finance instruments; debt through loans from private or public financial institutions and equity. For companies that are large enough to access financial markets, project bonds or corporate bonds can be emitted, as part of the debt finance. In the case of Europe 2020 Project Bonds, the framework of the initiative allows the division of the debt into two tranches; senior and subordinate. The EIB takes the burden of the subordinated tranche through a contingent credit line throughout the life of the project or a direct loan at the outset, known as the Project Bond Credit Enhancement (PBCE). As the EIB assumes the risk of the subordinated debt tranche, it thus increases the rating of the senior debt tranche to the much desired single-A rating. This is seen as the ideal threshold to attract institutional investors in the capital markets. The credit line is designed to ease the pressure on the promoter if it suffers from liquidity problems during the project. In fact, EU taxpayer derived funds act as a buffer to better insulate the promoter from financial risks. The size of the subordinated debt facility is to be limited to 20% of the total senior debt that the company issues. If the

---

3 European Commission. Projects of Common Interest. http://ec.europa.eu/energy/infrastructure/pci/pci_en.htm

4 Counter Balance and CEE Bankwatch joint submission for public consultation on the list of projects submitted to be considered as potential Projects of Common Interest in energy infrastructure http://www.counter-balance.org/counterbalance-eib.org/wp-content/uploads/2013/02/comments-EC-EnergyCommonInterest-04Oct2012.pdf

5 European Policy Centre: A push for growth and jobs http://www.epc.eu/events_rep_details.php?cat_id=6&pub_id=3090

pilot phase is deemed to be a success, the scheme will be fully integrated into the EC's next multi-annual spending plan for 2014-2020.[6]

Structural concerns relating to the Project Bond Initiative

6. Financial risks to the public: the dangers of infrastructure as an asset class
Despite being labelled by Werner Hoyer, President of the EIB, as "a great leap forward"[7] in project financing, and the repeated use of the word "innovative" throughout the EIB's literature, it is hard not to feel that, far from being an innovative solution to project financing in tough budgetary conditions, the initiative covers familiar territory – namely the use of EU funds as a risk-sharing mechanism to attract funds from the private sector. If we imagine a piece of public-private (PPP) infrastructure that does not perform well in the future (either due to incorrect calculations of the project's capacity to repay itself or incorrect calculations relating to its future usefulness), then a debt is incurred which has the potential to fall back on the public in the future. Herein lies the problem: by treating infrastructure as an asset class (as an anonymous product traded on the financial markets with shares changing hands between investors who are not bound to the construction itself) and using public funds to attract the private sector, the population becomes vulnerable to the changing winds of the market and future energy needs. Infrastructure supposedly designed for the needs of the population thus has the potential to become an albatross around its neck, as debt liabilities in the future. Whereas in the past infrastructure was conceived as an essential service for the population, the investors' necessity for returns on infrastructure investments requires a constant stream of profit, which trumps the real needs of the population.

In the rush towards the privatisation of key infrastructure across the EU, the wisdom of the market is often cited. Nevertheless, this claim must be questioned when it requires a public risk-sharing mechanism, such as the Project Bond Initiative, to achieve its aims. The increased financialisation of infrastructure is characteristic of the shift from public decision making regarding the control of key infrastructure to decisions made at private board meetings and relayed at annual AGMs. With infrastructure so critical to the everyday life of the population, it is hard to see how side-lining the public's role in the management of infrastructure could be beneficial at all for European citizens.

7. Relevance of Project Bonds questioned by the market
One of the stated objectives of the Project Bond Initiative is to "establish tradable infrastructure project bonds that will enable investors to invest in Infrastructure as an asset class."[8] In this context the EC and EIB are attempting to create a Pan-European market for EU project bonds, yet there is growing sentiment from the private sector that the moment has passed for credit support mechanisms and that their post-

---

6 European Investment Bank: An outline guide to Project Bonds Credit Enhancement and the Project Bond Initiative http://www.eib.org/attachments/documents/project_bonds_guide_en.pdf

7 European Policy Centre: A push for growth and jobs http://www.epc.eu/events_rep_details.php?cat_id=6&pub_id=3090

8 European Investment Bank: An outline guide to Project Bonds Credit Enhancement and the Project Bond Initiative http://www.eib.org/attachments/documents/project_bonds_guide_en.pdf

financial crisis proliferation now threatens to crowd out private capital from the market.[9] If proved true, this would substantially hollow out the EIB's case for increasing the size of the PBI as the EIB is prevented from extending support which undermines existing markets.

8. Suitability of selected projects is highly questionable

Questions abounded when the Castor project was announced as the first pilot project under the initiative. Indeed, downward revisions to the growth in gas consumption across Europe[10] placed the necessity for new gas storage infrastructure in doubt. When the list was expanded to include more projects, it became apparent that the PBI mechanism was anything but climate friendly; projects to finance 5 motorways and 2 gas storage facilities were included.[11] The 9 projects in the pipeline so far (5 motorways, 2 gas storage plants and 2 grid connections to wind farms) show a marked bias towards supporting projects, either through direct financing or the refinancing of an existing debt, which would increase the life-time of existing fossil fuel infrastructure. This would, de facto, lock Europe into further decades of fossil fuel dependence, in contradiction to the EC's long term objective to reduce dependence on these fuels as part of its 2050 roadmap. The trend towards this kind of project was confirmed by the longer PCI list which contained more than 100 projects aimed at natural gas transmission, storage and LNG.

9. Project Bonds favour a centralised and old-fashioned energy model

Even when the EIB announced support for projects covering transmission links for wind farms in the UK and Germany, concerns were raised about the further centralisation of energy production and the cementing of the role of big energy companies, to the exclusion of the population. Maintaining a centralised system of energy production produces an indefensible level of waste, which is incurred by sending energy over long distances from centralised generation stations. This form of energy production is an outmoded concept which, even when powered by renewable energy, does not offer the best solution for our energy needs. The company which will operate the Greater Gabbard wind farm off the UK coast received the biggest ever fine meted out by the UK's energy regulator, Ofgem, for numerous breaches of its obligations relating to telephone, in-store and doorstep sales activities. In its ruling the regulator emphasised that, "the likely substantial harm"[12] the company caused and the record fine reflected the seriousness of the company's failings to its customers. The behaviour of such companies is a far cry from increased community control over energy production which a decentralised system would offer.

Moreover, concerns have been raised in the UK regarding its investment in large centralised renewable energy projects. Eight such projects have benefited from £16.6bn in public support, yet will only generate 5% of the government's target for

---

[9] "Money, money, money: No Lack of Choice", Infrastructure Investor, March 2014, pp.20-26

[10] International Energy Agency. Gas Medium Term Market Report 2013. http://www.iea.org/Textbase/npsum/MTGMR2013SUM.pdf

[11] European Commission: The pilot phase of the Europe 2020 Project Bond Initiative http://ec.europa.eu/economy_finance/financial_operations/investment/europe_2020/index_en.htm

[12] Ofgem press release: https://www.ofgem.gov.uk/ofgem-publications/76232/sse-press-release.pdf

renewable energy. The Rt Hon Margaret Hodge MP, Chair of the Committee of Public Accounts, has warned against the lack of value for the taxpayer that these project pose; “despite the huge consumer subsidy that has gone into supporting these projects, the Department has failed to put in place any arrangements to recoup consumers’ money if providers make bigger-than-expected profits from these projects. Private providers must not be allowed to make excessive profits at the expense of consumers and taxpayers.”[13] Whilst the push towards renewable sources is welcomed, doing so through the old centralised system is not the answer to our energy needs.

Cases already financed: the failure of project bonds

10. Castor Project

The underground gas storage plant, Castor, was shut down by Spanish authorities soon after a series of 1,000 earthquakes[14] affected the mainland, following the injection of natural gas to prepare the plant for use. Throughout the lifetime of the Castor project, a litany of errors has been produced which points to the poor management of the project by both successive Spanish governments and the EIB. The original risk-assessment did not take into account the risk of increased seismic activity associated with the injection of gas, despite existing studies clearly warning of the potential dangers. The company in charge of the risk assessment proclaimed that no risk should be categorised as severe or critical.[15] Additionally, the consultation process afforded to the local population proved to be insufficient to allay their concerns and merely consisted of the presentation of documents translated into Spanish for a limited period of 30 days.

In June 2014, Fitch Ratings downgraded the Castor bonds from BBB+ to BB+ and maintained them on its Ratings Watch Negative (RWN) list. The BB+ rating marks a significant deterioration in the bonds’ value as BB+ denotes ‘non-investment grade’ bonds (colloquially referred to as ‘junk bonds’). The downgrading by Fitch of the Castor bonds put the Spanish government in a corner and, in a move to limit the further downgrading of the bonds and to shore up confidence among investors, the Spanish Minister for Industry, Energy and Tourism, José Manuel Soria, announced that the government expected to pay compensation to ACS for the residual value of the project (€1.7bn).[16] Alluding to the compensation clauses the Spanish government signed as part of the Royal Decree 855/2008, Soria accepted that there was “no other option.”[17]

---

[13] United Kingdom Treasury Select Comittee. Early contracts for renewable electricity - Chair's statement. http://www.parliament.uk/business/committees/committees-a-z/commons-select/public- accounts-committee/news/renewable-electricity-contracts---chairs-statement/

[14] El Mundo. Un estudio internacional cifra en un millar los terremotos del Castor http://www.elmundo.es/comunidad-valenciana/2014/07/01/53b27759e2704e6f3d8b4571.html

[15] URS review of Castor Project. http://www.eib.org/attachments/pipeline/20060184_nts_es.pdf

[16] El Economista. Soria: "No hay otra opción que indemnizar a ACS por el almacén Castor" http://www.eleconomista.es/interstitial/volver/aciertoj/empresas-finanzas/noticias/5897227/06/14/Soria-No-hay-otra-opcion-que-indemnizar-a-ACS-por-el-almacen-Castor-.html#Kku8eJi0Su5qsLJd finanzas/noticias/5897227/06/14/Soria-No-hay-otra-opcion-que-indemnizar-a-ACS-por-el-almacen-Castor-.html#.Kku8lCNMBmHRRP8

[17] El País. Soria admite que habrá que indemnizar por el almacén

In response to an open letter penned by 14 Spanish civil society organisations, it was emphasised that, "as part of its due diligence, the EIB has reviewed the key agreements that govern the project. However, the EIB is not a party to the Concession Agreement which governs Project Castor." Thus the responsibility for the formation and implementation of thorough due diligence procedures is shifted onto nation states. Therefore, the pilot-project of the PBI looks likely to end in a massive government bail-out by an EU Member State, which in the case of Spain's beleaguered tax-payers, could not come at a worse time. In the context of Castor, the increasing financialisation of infrastructure pushed by the EIB and EC demonstrates that when markets are involved, the public purse risks forking out for initiatives such as the PBI.

11. A11 Belgian Motorway

The first transport project to benefit from the EC-EIB Project Bond Initiative is the A11 motorway connection between Bruges and Westkapelle in Belgium. In order to get the project off the ground, the EIB will provide a subordinate credit facility of €115m and the EIB has also acted as an anchor investor by purchasing €145m of the bond issue.[18] By the EIB's own reckoning, the project is expected to cost a maximum of €554m[19] and, at €65m per kilometre, is set to be the most expensive motorway ever built.[20]

With so much backing from the EIB, it is little surprise that the project received favourable ratings from the agency Moody's. With the building of any new motorway on a green-field site, concerns arise relating to the possible environmental impact. In the case of the A11 motorway, the EIB has accepted as part of its environmental statements that the project will cross directly through the 'Poldercomplex' Natura 2000 site[21] (an ecological network of protected areas in the European Union) and is in close proximity to 'Polders' - a special area of conservation (SAC).[22]

The consortium set up to construct the motorway - Via Brugge NV - is fronted by a Belgian dredging and construction company, Jan De Nul Group, which is mired in controversy all over the world.[23] But it is within its native Belgium that criminal charges were brought against the managing director, Jan Pieter de Nul, and his brother Dirk. In 2002 both were found guilty of attempting to bribe a Belgian federal tax official and were sentenced to a three year suspended prison sentence.[24] In 2003 the Court of Appeal in Ghent revoked the guilty verdict, arguing that as it would bar the

---

Castorhttp://sociedad.elpais.com/sociedad/2014/06/27/actualidad/1403865273_383549.html

18 EIB press release. EIB backs A11 Belgian motorway link http://europa.eu/rapid/press-release_BEI-14-66_en.htm

19 EIB. A11 Brugge PPP http://www.eib.org/projects/pipeline/2010/20100717.htm

20 AutoFans. "A11 TUSSEN BRUGGE EN WESTKAPELLE WORDT DUURSTE WEG VAN BELGIË. http://www.autofans.be/nieuws/overheid/25461-a11-tussen-brugge-en-westkapelle-wordt-duurste-weg-van-belgie

21 European Environment Agency. Poldercomplex. http://eunis2013.eaudeweb.ro/sites/BE2500932

22 EIB. A11 Brugge PPP. http://www.eib.org/projects/pipeline/2010/20100717.htm

23 As part of a consortium which won the contract for the expansion of the Panama canal which saw the Panamanian president extradited to Italy to face corruption charges. Newsmax. http://www.newsmax.com/Newsfront/Panama-Canal-Ricardo-Martinelli-Italy/2014/04/15/id/565764/

24 De Standaard. "Zware straffen in dossier De Nul."
http://www.standaard.be/cnt/nfld21012002_002

company from winning future public contracts around the world, the company itself (and its 1,650 employees) would be put in jeopardy by the ruling.[25] In a legal dance, the court maintained the series of events but backed away from enforcing the punishment. Article 45 of the EU directive 2004/18 on the awarding of public contracts would have prevented the involvement of Jan de Nul in the bidding process had the Belgian court upheld the verdict.

12. Passante Di Mestre

The EIB's admission that, as part of the PBI, it leaves the ultimate responsibility for undertaking proper due diligence on projects to the nation state backfired spectacularly in the case of the Castor project. The same failings seem to be repeated in the Passante di Mestre project (a motorway bypass around the city of Mestre in northern Italy). Yet, even more worryingly, despite the ongoing Police investigation into possible fiscal fraud and Mafia infiltration via the main subcontracting companies, the EIB has at no stage considered pulling out of the project. The inexorability of the EIB in continuing to a support a project mired in such controversy undermines the credibility of the institution and its supposed zero-tolerance approach to fraud and corruption. It is especially disconcerting to see that in the pilot-phase of the PBI, the EIB's anti-fraud benchmark standards seem to be slipping, in contrast to the tightening-up of anti-fraud policies across other EU institutions.

Counter Balance has already urged the EC's Anti-Fraud Office (OLAF) to open an investigation into the EIB's handling of the project.[26] The €350m loan approved in 2011 and disbursed in 2013 might have been used to refinance a debt related to the principal sub-contracting companies which were under police investigation by the Italian courts at the time. Despite the fact that the CEOs connected to the project entered guilty pleas, the EIB has not seen this as sufficient grounds to reassess its support for the project. The obvious failure of the EIB's due diligence procedures and its continued support in face of strong evidence of the involvement of organised crime is a deeply worrying development. This is compounded when we take into consideration the fact that the EIB uses funds derived from European taxpayers.

The Passante di Mestre project is the first project in Italy to be selected for the emission of Project Bonds; this was due to occur in June 2014 but was subsequently delayed until September of the same year. Considering the recent judicial developments surrounding the project, which have been well reported in Italian and international media, it is inconceivable that the EIB would push ahead with the emission of the bonds as planned without undertaking a substantial and conclusive review of the project thus far. The risk of public funds becoming entangled with the proceeds of corruption should propel the EIB to undertake such a review. The fact that the EIB has not done so raises profound questions about what due diligence the EIB carries out when selecting projects under the Project Bond Initiative.

Conclusions and Recommendations

25 De Standaard. "ANALYSE. Staan bedrijfsleiders boven de wet? http://www.standaard.be/cnt/dst18042003_075

26 Counter Balance letter to EIB. http://www.counter-balance.org/wp-content/uploads/2014/07/CSO-Letter-to-EIB_Passante-di-Mestre_8-July-2014.pdf

The Project Bond Initiative was presented as a cheap way to finance infrastructure across the EU in a bid to kick-start the flagging economy and create jobs. Nevertheless, what has happened instead, so far, is the use of public money to support a round of financially unviable and unsustainable infrastructure projects which are neither climate-friendly nor address the needs and interests of the population they are intended to serve. A worrying feature of this initiative is the use of limited public resources to help finance projects which impede the transition to a more sustainable economy and put an additional debt burden on the public. Moreover, the connections to organised crime via subcontracting companies in the case of the Passante di Mestre project fundamentally undermine the EIB's supposed zero tolerance policy on corruption and raises crucial questions as to how it selects projects for inclusion in the Project Bond Initiative and the Project Bond Credit Enhancement.

Therefore, in our view, the PBI should be put on hold in order to re-assess the financial, social and environmental impact on EU citizens. The end of pilot phase in December 2014, and the evaluation to be carried out by the EC at this time, is an opportunity to do so. The increased engagement of the European Parliament would be a key factor in drawing lessons from the failure of the Project Bond Initiative. Thus, Counter Balance calls on MEPs to urge the European Commission to set up an inclusive and open consultation process on the future of project bonds before the initiative is fully rolled-out at EU level for the period 2015-2020.

Finally, MEPs should ensure genuine accountability on the part of the EIB for the damage already caused under the PBI and ensure that new innovative financial instruments created at EU level result in taxpayers footing the bill for badly handled projects and instruments.

Author: Daniel Beizsley

Editor: Sarah O'Farrell

Text closed July 2014

This publication has been produced with the financial assistance of the European Union. The contents of this publication are the sole responsibility of Counter Balance and can under no circumstances be regarded as reflecting the position of the European Union