28 April 2011

Our ref: ICAEW Rep 47/11

European Commission
Directorate General for Economic and Financial Affairs
Unit R 4
B-1049 Brussels
Belgium

By email: ecfin-l3@ec.europa.eu

Dear sirs

CONSULTATION PAPER ON THE EUROPE 2020 PROJECT BOND INITIATIVE

ICAEW is pleased to respond to your request for comments on the Europe 2020 Project Bond Initiative. ICAEW is listed in the Commission's Interest Representative Register (ID number: 7719382720-34).

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours faithfully

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ICAEW REPRESENTATION

EUROPE 2020 PROJECT BOND INITIATIVE

Memorandum of comment submitted in April 2011 by ICAEW, in response to the EC consultation on the *Europe 2020 Project Bond Initiative* issued in February 2011.

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the EC consultation paper on the *Europe 2020 Project Bond Initiative* (the Initiative). ICAEW is listed in the Commission's Interest Representative Register (ID number: 7719382720-34).

WHO WE ARE

2. ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 136,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

3. Our membership includes numerous audit committee chairs, finance directors and members involved in investment management activities as well as auditors. Members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. We ensure these skills are constantly developed, recognised and valued.

4. The ICAEW Corporate Finance Faculty is a network of some 5,000 corporate finance professionals. They include advisers on infrastructure projects as well as sponsors, nominated advisers, reporting accountants, lawyers, bankers and brokers. The faculty regularly responds to consultations from government, listing authorities and regulators in the UK and overseas.

GENERAL COMMENTS

5. We are generally supportive of the EC's *Europe 2020 Project Bond Initiative* (the Initiative). We believe that it will serve to attract institutional financing for certain infrastructure projects post construction which, as a result, will also help stimulate bank lending at the pre- and construction phases. Providing post construction financing will be a 'quick win'.

6. Financing construction, on the other hand, could be considered once the project bonds are established. This is because bond finance for construction has been difficult to achieve for a number of reasons, such as:

- bond investors tend not to be organised to effectively manage construction risk; and

- bond investors tend to prefer a liquid investment which is not generally the case if there is construction risk.

7. We agree that transport and energy projects are well suited for the Initiative. This is especially so where revenue is due to availability payments that make for stable cash flows that are attractive to capital markets. We are less convinced that ICT projects are suitable projects due to their nature and complexity.

8. To boost greater liquidity the Initiative should support and enhance finance provided by other financing partners such as other international financial institutions and Member States banks with a public sector mandate, eg UK's Green Investment Bank.

GENERAL QUESTIONS

Q1. Is the chosen mechanism likely to attract private sector institutional investors to the sectors of transport, energy and ICT in particular? If you are an investor, would you be prepared to buy such project bonds?

9. Drawing from our members' interaction with institutional investors we consider that the chosen mechanism will help attract private sector funding to the transport and energy sectors. The relative credit strength of the contractors and the appropriateness of risk allocation and performance incentives within the payment mechanism will also determine investors' interest.

10. In our view, ICT assets are generally more complex and not perceived as long-term infrastructure assets. Due to inherent obsolescence risks and frequency of modification, it is doubtful whether new institutional investors will be attracted to this sector.

Q2. Are there other sectors with large-scale infrastructure financing needs that should be included?

11. In the experience of our members, regulated sectors best suit large-scale project finance such as the Initiative.

12. In addition to key sub-sectors of energy and transport such as renewable energy (eg offshore wind transmission) and high speed rail, sectors that should also be considered in the remit of the proposals include:

- coastal defence
- waste
- water

SPECIFIC QUESTIONS

Q3. Would the credit enhancement facilitate/accelerate the conclusion of financing packages?

13. The proposed credit enhancement will facilitate conclusion of financing packages with capital constraints and make viable projects that would not otherwise have been financed.

14. Initially we would not expect introducing an additional layer of capital to accelerate the conclusion of financing packages but, as more projects are financed in this way, efficiency levels should increase although such efficiencies would not necessarily address a project's operational constraints (eg supply chain capacity). Clarity at an early stage of a project as to the availability of credit enhancement would be helpful.

Q4. What minimum rating of the bonds would be sufficient to attract investors?

15. We consider that a rating of A- would attract a wider range of institutional investors.

16. As we expect bond investors to be more cautious in assessing project assets, a BBB+ rating may not produce, in all cases, the required appetite for large infrastructure projects. A rating of BBB+ on projects with a strong contractor could however attract investors already in this space (eg certain North American institutions). The robustness of the ratings will be very important.

Q5. What degree of credit enhancement would be necessary to achieve this rating?

17. A range of factors - sector, regulation, reliability of the revenue stream, asset volatility and strength of contractor - will determine the necessary degree of project credit enhancement.

18. As a rule of thumb, taking account of the impact of availability payments on the payment stream, a rating of A- could require a credit enhancement of 10-20%, depending on the riskiness of the project. This is subject to the rating agency's assessment.

Q6. Which impact would the Initiative have on financing costs and on maturities?

19. The impact on financing costs will depend on the level of risk premium and on how much mezzanine debt replaces senior debt on a project. It is reasonable to expect lower financing costs due to (a) new investors creating competitive tension and (b) the positive impact on liquidity generated from senior bank debt being redeployed to fund other capital projects and projects becoming attractive to bond investors which otherwise would not be.

20. Maturities might also be expected to lengthen with the entry of new investors but this will depend on the impact on investors of Solvency II requirements. Many banks may be interested in reducing their maturity by becoming construction period lenders that are refinanced by bond investors and mezzanine debt in the Initiative, if there is sufficient certainty that the bond debt and mezzanine will be available in a defined period after the end of construction.

Q7. Is it essential that a single entity acts as controlling creditor?

21. The controlling creditor position is key and it would be more efficient for a single entity to act as controlling creditor. The controlling creditor will need to manage the project day to day (possible for a mezzanine debt holder) and oversee alignment of the interests of all bondholders. The controlling creditor must be capable of taking a lead position, especially if the projects runs into difficulties and this may sit with more naturally with a senior debt holder. Developing manageable and efficient inter-creditor arrangements will be critical to the success of the Initiative. Unless different classes of investors can work together effectively, the Initiative will not have a significant impact.

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