European Investment Bank

Luxembourg, 11 July 2003

Memorandum to Ecofin

Subject: **The EIB's role in promoting long-term growth through investment in TENs and major R&D projects**

1. Introduction

The Thessaloniki European Summit noted *"the Commission's intention to launch, in cooperation with the EIB, an initiative to support growth and integration by increasing overall investment and private sector involvement in TENs and major R&D projects*" and invited the Italian Presidency to pursue this further. The original idea had been highlighted by President Prodi during the 2003 Spring European Council in Brussels. It is all the more important as the Union prepares for a major enlargement, which is thus bound to increase further the differences between Member States in terms of infrastructure endowment and research activities.

Boosting European long-term growth in general and investment in the TENs and the R&D activities in particular obviously requires a sustained, appropriately resourced and comprehensive approach. If it is to be successful, it needs to be consistent with the Lisbon strategy and take into account the Broad Economic Policy Guidelines. The specific role of the European Investment Bank is most effective in this wider context when it comes to advising on and ultimately financing viable investment projects in these fields – often through co-financing with EU budgetary funds, public sector and/or private finance . In the area of TENs, the EIB has a long-standing role as the major financier (EUR 73 billion of loans signed since 1993). In the related field of PPPs (Public-Private-Partnerships) that support private sector finance for infrastructure, EIB has approved loans of EUR 18 billion of which EUR 14 billion have been signed. In the area of research and innovation the Bank has just launched its "Innovation 2010 Initiative", based upon a successful 'first phase' which has mobilised over EUR 15 billion of loan commitments in the last three years for innovative projects.

This paper highlights in more detail the main areas where the EIB could make a significant contribution.

2. The EIB's contribution to TENs

2.1. Preliminary considerations

The EIB's support for TENs, and notably to private involvement for the development of TENs, is based on the following basic considerations:

- TENs represent an important sector of economic development and investment, in improving economic productivity and constructing the single market both for EU-15 and the Accession Countries. While there is continued progress in implementing TENs overall, there have nevertheless been notable difficulties in certain sectors (such as public transport), in particular in strategic cross-border projects and in the acceleration of investment both in the EU and in the Accession countries (ACC).

- Underperformance in the implementation of TENs is due to a range of reasons, most notably the absence of sufficient commitment and prioritisation by public authorities. **Financing issues can only explain part of the existing backlog of investment in TENs**; delays are more often related to the absence of a common priority and timetable (notably for cross-border projects), technical (standardisation, interoperability) or administrative complexities (intermodal planning, lengthy environmental and procurement procedures).

- Clear priorities must be established based on economic merit. The gross capital investment requirements identified by the Van Miert High Level Group for TENs (EUR 600 billion) need to be disaggregated by country, promoter, role of Government authority, by project and by potential sources of funds over time to 2020 in order to carry on a pragmatic discussion on how to accelerate progress on the ground, particularly to identify those projects which might be accelerated by virtue of additional commitment of political, physical and financial resources. This can only be achieved if there is highly selective prioritisation and if there is more effective collaboration of all the public authorities involved with the private sector as well as EU institutions.

- Private investment is a welcome additional resource for implementing TENs and can be mobilised if the projects provide for sufficient profitability. **PPP schemes require appropriate management, within a coherent regulatory framework, and the introduction of efficient revenue-generating mechanisms** if they are to improve Value For Money (VFM) and Affordability of infrastructure investment for the public sector.

- Private resources alone cannot resolve all the financial needs as many priority TENs projects, even of economic merit, are not financially viable on a stand-alone basis. **Direct government investment in TENs is an**

unavoidable component of the overall financing solutions, whether provided by classic budgetary transfers or more sophisticated instruments such as PPPs, cross-financing, securitisation of non-related assets, establishment of specialised financing institutions, etc. While such new instruments are promising in certain cases and should be utilised to the extent appropriate, they cannot replace budgetary transfers/guarantees in toto.

- The Eurostat rules on Deficit Financing (ESA 95) have evolved in response to new market instruments and new risk sharing procedures. This may constrain the use of new financial instruments until final rules settle down.

2.2. EIB collaboration with the Member States and the Commission

A successful initiative on TENs will require a wide multiplicity of parties to address the key issues in which the Bank's influence is much less or immediate than in the case of its own financing decisions. Some of these issues are:

Identification/Acceleration of TENs projects:

- The population of eligible TENs projects is, as EIB financing to date has proven, substantially wider than those projects listed as Priority TENs, whether in the initial Essen list or in any new proposals by the Commission on the basis of the Van Miert report.

Two practical conclusions should therefore be drawn.

- The Bank will continue to finance the general run of TENs projects for transport, energy and communications as before within the normal range of its financial products;
- The Bank will give particular attention to how it can help member states/public authorities in "pulling through" the development of the new priority TENs projects that could arise from the Van Miert report as many of these have both upstream difficulties of development as well perhaps as financing.

Collaboration with the Member States whose public authorities are frequently the key promoters of TENs projects as well as the Commission must remain an on-going priority if an enhanced TENs programme is to be delivered. While the prospect of increased and better collaboration is to be welcomed, the difficulty in demonstrating an adequate economic rate of return on many projects will continue to make progress difficult in certain cases. **The underlying problems that limit the economic rate of return need also to be addressed.**

2.3. The EIB's TENs Investment Facility (TIF)

In response to the request from the European Council in Thessaloniki, EIB is prepared to launch a pluriannual TENs Investment Facility (TIF), to be inserted into its overall lending priorities and planning process. It would build on its accumulated expertise in financing TENs through increased collaboration with the public authorities in the Member States and the Commission and in promoting private sector involvement through PPPs and Structured Finance. EIB could also strive at further developing its instruments so as to increase its leverage on overall financing arrangements and thereby better meet the current challenges, while remaining within its statutory remit as well as sound banking practice. The Bank's initiative could be developed using the following **five "Building Blocks"** described below on which it has already established a strong track-record so as to develop more detailed proposals in cooperation with the Commission and the Italian Presidency for submission in due time to the Ecofin Council in view of the European Council meeting in December.

2.3.1. EIB loans for Investment Grade Projects

EIB is willing to provide a TIF loan facility of up to EUR 50 billion senior debt for investment grade projects for public and private sector borrowers up to 2010. While representing a clear increase on recent EIB loans for TENs, such amount is in principle compatible with the Bank's pluriannual programming of its lending priorities, as well as its capital requirements; it signals pre-eminent policy and institutional support as well as financial value added for the development of the TENs network. EIB's willingness also to provide long maturities of up to 35 years and, in exceptional cases to finance up to 75% of project costs, further marks the Bank's substantial commitment to the TENs sector.

EIB finance is not however the sole nor indeed the main source of finance nor of senior debt finance for TENs. Cash flows from the operations of public bodies remain key as do various sources of private capital. Senior debt should continue to be available from Capital Markets, Banking or Insurance Markets without notable difficulties provided that the debt is investment grade. **EIB's catalytic role** will remain essential through the EIB's value added for the public sector bodies that require support, and for the private sector / PPP arrangements in which this Bank's role is particularly critical to the financing of private sector participation in the provision of public infrastructure. This has been the case for the development of PPPs as a new instrument over the last decade. This may grow in the future as PPPs and other forms of ABS become, as currently expected, an even more important major feature of financing infrastructure through securitisations. EIB's substantial financing of PPPs over the last decade and its expertise in securitisation of infrastructure can therefore provide both financial and institutional support for the expansion of private sector investment in public infrastructure

The development of a more coordinated use of EIB and EU budgetary resources, particularly in ACC countries, is highly desirable and needs to be pursued in the context of the ongoing preparation for the Community Support Frameworks for the 2004-2006 period. Means to achieve this co-ordination are under discussion with the Commission.

Close collaboration by EIB with specialised bodies at national level such as the various national PPP Task Forces or entities such as Infrastructure Spa (I), GIF (Spain), NDFA (Ireland) as well as long term credit institutions such as KFW (D), CDC (F), ICO (Spain), SPIMI (I) will also be of potential importance in increasing the leverage of EIB resources committed to TENs.

In addition to external sources of funds, necessary measures must in any case continue to be taken by national authorities to strengthen the capability of the existing transport bodies to generate increased operating cash flow in order to meet new capital investment to the extent possible; these measures include improved commercial performance as well as more structural reforms.

2.3.2. EIB guarantees for investment grade projects

The EIB Group already has an established track record in providing and monitoring guarantees for TENs projects. The availability of an EIB AAA guarantee for investment grade projects should enable EIB to maintain its existing risk profile while transferring the funding role to third parties while nevertheless giving a clear signal of continuing EIB support for TENs.

The use of capital and banking market financing for TENs financing will be facilitated once existing guarantee instruments are more widely available as they will either reduce the cost of finance or increase the coverage of risks which the capital or banking markets have insufficient capacity or capability to provide.

Some examples are:

- Capacity payment mechanisms by Member States where payment is related to the availability for use and performance of the infrastructure or service required. Examples in the rail sector are the High Speed Train (HST) in the Netherlands and AVE in Spain. Examples following similar lines in the road sector are the SCUT Shadow Toll Road project in Portugal or the DBFO Capacity Payment Road projects in the UK.
- Minimum traffic/revenue guarantees where Member States/Public authorities underwrite the minimum volume of traffic/revenues that will be paid for by the public authorities: examples include the Rail Minimum Usage contract by SNCF/NTR for Eurotunnel and the minimum passenger usage by the UK authorities for CTRL.

In respect of financial guarantees additional resources could be made available through **the further expansion of the guarantee provision in the existing TENs Budget Guidelines**. This theme is also mentioned in the Van

Miert report but the suggested development of a mutual risk guarantee fund, its objectives and mechanisms, would require further study.

The accelerated implementation of the BIS decision (already proposed) to reduce the risk weighting attached to the EIB (and other IFIs) guarantees to 0% merits attention and priority as it would also reduce costs of financing, and facilitate the development of capital and banking markets.

Additional resources may be drawn from the private sector through the increased use and co-financing with monoline (and multiline) insurance companies whose role to date has been valuable in facilitating PPP's and in improving Value For Money (VFM) for the public sector. The provisions of guarantees and collaboration with Monolines is however a highly specialised area which will need further development.

2.3.3. SFF - Structured Finance Facility (Senior/Subordinated/Mezzanine Debt/Quasi-Equity)

It is recalled that, in line with previous decisions following the Amsterdam Summit in 1997, the EIB Governors authorised in 2001 the main elements of the necessary framework for EIB to implement the Structured Finance Facility. Under this Facility the Bank has been entitled to provide different financial products (senior debt, subordinated debt, mezzanine and quasi equity) the credit profile of which is lower than the standard senior debt normally provided by EIB. It was foreseen that SFF products could be applied both to i2i and TENs operations. It is thus a very relevant framework for the perspectives discussed in this note.

In the context of TENs, the demand for SFF is potentially significant in private sector/PPP financings. From a policy point of view, SFF is particularly valuable as it has a high value added, is generally used in limited amounts and therefore has a high leverage factor.

Particular synergies should be possible, as demonstrated in the recent case of the First Irish Infrastructure Mezzanine Fund (a co-financing with Allied Irish Banks) in which EIB guarantees senior loans for up to EUR 25m as a component of the mezzanine fund's overall investments. The first allocation under this fund was for the A28 TENs autoroute project in France. Similar funds such as this are potentially attractive, as mezzanine debt seems to be in short supply.

The availability of (Quasi-) Equity for TENs

EIB currently can provide (1) equity for TENs from the EU TENs budget under the cooperation agreement signed last year between EIB and the Commission as well as (2) quasi-equity for TENs under the Governors decision on SFF taken in 2001.

1. The EU TENs Financial Guidelines provide for a TENs Equity Facility, for a maximum amount of up to EUR 90m. EIB is Manager of this facility on behalf of

the Commission for the allocation of this facility to private sector equity funds; the first such investment of EUR 7m in the Galaxy Fund has just been signed. Further allocations of such equity funds are envisaged over the coming years but it will remain a small field of activity until the limited resources the TENs Budget have committed to it are increased. An increase of the TENs budget for this purpose is one of the Van Miert recommendations.

2. EIB can provide quasi-equity for TENs as of now following the Governors decision in 2001 on SFF, which authorises quasi-equity for TENs. This is an area of potential development that needs to be considered further as there are a number of TENs infrastructure equity funds in the EU and ACC which are soliciting EIB investment in TENs infrastructure. EIB is also being solicited to invest quasi-equity directly in major projects of EU interest.

The explicit provision of operational equity for TENs infrastructure by EIB, whether for direct operations or for fund-of-fund operations, is not authorised under the EIB's current statutes. Any change would seem to be dependent on a future IGC approval.

As far as volumes under SFF are concerned, they are linked with the constitution of a dedicated reserve through annual allocations of the Bank's surplus (as decided by its Boards) and, for a given reserve, depend on the risk profile of the products. Under present rules and within existing decisions, available global financing capacity under SFF could be up to 2.3 billions. Further scope would necessitate lessening of capital allocation requirements and/or additional annual allocations from the Bank's surplus. An allocation to the SFF reserve in the order of 200 millions allows for up to EUR 1.3 billions in new SFF operations under the present capital allocation requirements.

It is recalled that SFF products can support both TENs and i2i operations.

2.3.4. Securitisation

Securitisation is becoming an important tool for financing infrastructure at all levels, both for the public as well as private sectors. Securitisation of infrastructure is undoubtedly very different from that of consumer receivables, SMEs, etc, each of which have been developed using their own specific techniques and risk assessment/management systems.

EIB has already some experience in securitisation in the project finance sector as PPPs are in many cases a form of project securitisation; the Metronet PPP of EUR 1.5 billion, already in place, and the proposed EUR 15 billion Network Rail securitisation are examples. **Moreover, the Bank has already financed a series of corporate securitisations** such as Porterbrook Rolling Stock and the AAE Freight Rolling Stock securitisation (both TENs) in which EIB has participated both as senior and mezzanine financier; these are significant examples of the type of private sector TENs securitisations that could be encouraged.

However, as securitisations will in most cases involve a “true sale” of government assets, the wide application of this technique in Member States may raise questions about the availability and acceptability of privatising assets in this way. Such securitisations will also require increased “political commitment”, at a level which has yet to be seen in practice for the proceeds of such securitisations to be dedicated entirely to new infrastructure investments as discussed under the Italian Presidency proposals. PPP infrastructure securitisations are therefore likely to be the main elements of these programmes for the time being until the broader policy and political issues on wider securitisation are resolved.

Given the rapid growth of securitisation in recent years the development of financial leverage from securitisation would seem to be a worthy and achievable ambition that could improve the availability of capital market resources for Member States if developed on a more extensive and systematic basis.

2.3.5. EIB Expertise / Technical Support

The Bank is already making a useful technical contribution to the Commission for FEDER and Cohesion Fund/ISPA projects by providing the necessary advice on project submissions as well as with public authorities in the Member States on a case-by-case basis. Similar developments could be envisaged in respect of TENs

- with the Commission, and
- with public authorities, particularly for strategic advice in respect of financing, including financial structuring, PPPs, securitisations, etc.

The Bank has already demonstrated its capabilities in these areas and could develop these capacities further, preferably applying them on a case-by-case basis for priority TENs projects when requested by the relevant Member States or the Commission.

The EIB’s decision to finance particular projects and the terms on which it is done can also be potentially influential in catalysing market support for complex difficult projects. EIB’s involvement may also be important in ensuring support from markets, and in certain limited cases, from the long-term credit institutions, monolines, etc. EIB should continue to develop and use this influence where appropriate.

Private sector investment in public infrastructure continues to grow both in volume and in diversity, frequently taking an increasingly complex form and involving maturities and risks that require experienced capital/banking markets and sophisticated institutions capable of rigorous project appraisal and risk management. **Therefore, the enhanced contribution of institutions such as EIB and others that have these particular capabilities is becoming increasingly important and necessary to the implementation of an enhanced TENs policy within the enlarged EU.**

EIB would also welcome the greater involvement of the private sector industry in developing a **Private Sector Forum for Infrastructure** (such as done by the European Roundtable of Industrialists in the past) where industries' priorities for the development of TENs in infrastructure can be more clearly discussed and established. Such a Forum would also serve as a channel of communication to increase public and political understanding and support for more effective investment in infrastructure both by the public and private sectors.

3. The EIB's contribution to Research and Innovation

3.1. Preliminary considerations

The EIB has been closely involved in the implementation of the Lisbon strategy since its launch in 2000. The Bank's lending program "Innovation 2000 Initiative" (i2i) has generated up to EUR 15.8 bn of loan commitments to innovative projects between 2000 and early 2003. Following the invitation by the Spring EU Summit in March of this year, EIB has launched the successor operation under the "Innovation 2010 Initiative" label, as approved by its Council of Governors on June 3rd, 2003. The objective is to mobilise until 2006 a further 20 bn for projects, notably in the fields of education & training, R&D and innovative downstream investment, as well as in the creation and dissemination of information and communication technology. **Preliminary estimates are that total lending under i2i over the decade may well exceed EUR 50 bn in total, throughout the EU, and with special attention given to its less developed regions.**

By strengthening financial means and the use of various instruments within the EIB Group (loans, equity and guarantees), i2i should contribute to leverage more public and private investment in R&D and innovation, thereby supporting the objective set by the European Council in Barcelona (3% of GDP by 2010).

The implementation of i2i proceeds in close cooperation with the corresponding actions of the EU Commission, notably in the context of the 6th Framework Programme for Research and Technological Development, as well as of efforts to insert research and innovation into the priorities supported by EU structural funds assistance in the assisted areas. Cooperation with Member States is equally sought, e.g. through the co-financing of national programmes promoting innovation. Notably when defining support measures to innovative SMEs, the expertise and the resources of the European Investment Fund (EIF) are being drawn upon, e.g. to provide venture capital, guarantee coverage to SME portfolios, or advice on setting up such initiatives in the assisted areas.

3.2. New developments under the Innovation 2010 Initiative

The Innovation 2010 Initiative provides a solid and yet flexible base on which the EIB Group can further develop its support to research and innovation. The EIB expects to further expand R&D finance and to equally support innovative downstream investment under i2i, putting special emphasis on such areas as:

- coordination and, where possible, co-financing of key initiatives of European interest supported by the 6th EU Framework Programme for Research and Technological Development (FP6);

- support for cutting edge R&D activities by European companies, notably if they are of a pan-European nature and include the Cohesion Countries or the new Member States. **Particular attention will be given to projects arising from the frame of FP6, Eureka or the "*European technology platforms*"** set up by the Commission in different technological areas (e.g. aeronautics, hydrogen, photovoltaics, plant genomics, steel, etc.);

- support to private initiatives for the development and initial use of new processes or production of new products, thus implementing and combining research results;

- reinforcement of national or regional programmes aimed at boosting innovation, notably by SMEs;

- development of appropriate financial products to support medium sized companies engaged in R&D activities;

- finance for incubator-type structures catering for the needs of young and technologically oriented companies and the transfer of knowledge from public sector research to the business sector;

- support to public research facilities, including if they are involved in basic research (like CERN).

In a similar way, **the EIF will continue to reinforce and adapt its means to mobilise venture capital resources as well as extend loan and equity guarantees to pursue the objectives of i2i when involving SMEs**; EIF will thus contribute to the Action Plan conceived to implement the Barcelona 3% objective on its own resources, under a Community mandate or under EIB resources. Concerning the latter, the Management Committee has recently decided to propose to the Bank's decision bodies the allocation of EUR 500 million from a specific reserve (previously agreed by the Board of Governors) in

favour of **an extension of the Risk Capital Mandate (RCM) managed by the EIF**.

Two new strategic and operational developments are foreseen:

- EIF considers taking a flexible approach to better address market failures and current equity gaps; consequently, EIF envisages to use part of the extended RCM for mid and later stage financing, as advocated by the 2002 November EU Competitiveness Council (which stressed the key role of the EIB Group in innovation financing, in particular for late stage investments).

- EIF has launched new advisory services in the financial engineering field to help potential EU-funding recipients, including national and regional entities, academic and research institutions, to raise funding.

Moreover, it is worth mentioning that the Commission and the EIF are considering a special action to support the setting up of common seed and development capital funds by groups of leading technology universities.

The Bank and the Fund will continue to develop strategies that take full advantage of potential synergies between the two institutions to maximise their impact and leverage.

The EIB will mobilise the full spectrum of its lending products to pursue the objectives of i2i. The Bank's lending formulae are generally flexible enough to suit the needs also of innovation-oriented projects. Moreover, certain adaptations have been introduced and will be further developed. The Bank's Structured Finance Facility, under which it can engage in risk-sharing financing, would be deployed in appropriate cases.

Moreover, the product developments which are envisaged for TENs will also be considered for financing promoters of research and innovation, notably when it comes to support major projects and the realisation of Intellectual Property (IP) Rights where the financial structuring needs can be particularly complex.

Actions to increase awareness of potential customers and EIB intermediaries at the national and regional levels about the possibilities offered by i2i to finance R&D and innovation activities will be stepped up. Also, in cooperation with the Commission, specific consideration will be paid to the case of large European technology projects.

4. Additional Observations

The Bank has the capacity and stands ready to increase support for investment in TENs and in Research and Innovation. A more competitive and cohesive Europe will need both.

One important feature in this context is that whereas the financing of TENs requires specific efforts to attract more private capital into the sector, most activities in the research and innovation fields are already undertaken by the private sector, both by large corporates as well as SMEs. The EIB's financing will therefore have to be targeted to meet the needs of both industrial groups if, as underlined in the Barcelona EU Summit (March 2002), the investment notably by the private sector is to increase substantially (by about 1% point of GDP, on average) so that the EU can bridge the gap which separates it from more performing economies, like the US.

The financing of small and medium sized initiatives, be they SMEs or in the infrastructure sector, will need to attract special attention from EIB, as well as from EIF, as it is this type of initiatives which may most require specific support, and which may also be more capable of responding more rapidly to well targeted support measures. But private sector involvement in research and innovation, as well as in TENs, will not be limited to small and medium sized initiatives; nor can EIB support - if the Bank is to provide a significant contribution to the underlying objectives. Therefore, as a necessary corollary, lending to larger corporates must be considered with an open attitude, if and when loans to them are well in line with the declared priorities of the Union.

A further issue that requires to be studied is how the orders of magnitude of lending mentioned above can be best accommodated within the EIB's pluri-annual planning, also as far as capital requirements are concerned, though this could involve constraints on developing the use of SFF. Should the timing of the requested support to either TENs or research and innovation be faster than expected or go well beyond the indicated envelopes of some EUR 50 bn each over the decade, then the Bank would either have to reduce the lending to other lending priorities - or it would have to examine with its shareholders the need for a capital increase earlier than currently planned, i.e. before the end of 2007. The same constraint may arise in respect of the commitment of resources for the development of products (SFF), which require the constitution of special reserves from the Bank's annual surplus.