Investing in project bonds to support infrastructure development may help to return the Eurozone to growth

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Although costly for public authorities, construction projects undertaken through the private finance initiative (PFI) tend to be well-managed on the private sector side, delivering predictably high returns to investors. Against this background, and despite the desire of policy-makers to invest in infrastructure, the sector is facing a severe credit crunch. **Mark Hellowell** *argues that, while EU-backed project-bonds may offer a solution by allowing projects to be funded by institutional investors, they may undermine the very disciplines that have led to PFI's impressive record of delivery.*

Everybody knows that major infrastructure projects tend to be managed badly. From the Channel Tunnel to Edinburgh's ill-fated tram network, estimates of costs and benefits during the planning stage prove to be absurdly optimistic once shovels are in the ground. Societies – and economies – suffer greatly but there is little accountability. Professor Bent Flyvbjerg, of Oxford University's Säid Business School, is the world's chief chronicler of this problem. He blames "strategic misrepresentation" in project business cases – "lying", in more direct terms. "Some forecasts are so grossly misrepresented that we need to consider not only firing the forecasters but suing them, too – perhaps even having a few serve time", he says.

Even if the Professor gets his wish, there is one group of managers who are likely to retain their liberty – those working for the firms in charge of private finance initiatives (PFIs). For, while expensive for public authorities, due to the high cost of capital and transaction costs relating to these projects, the PFI has an admirable record of project delivery from the perspective of investors like Carillion, Balfour Beatty and John Laing. These sponsors know how to deliver projects to time and to budget, and they usually achieve the profit margins they initially thought they would when they signed their contracts. A recent survey of 118 operational projects by the National Audit Office found that in three-quarters of cases, investors were earning an Internal Rate of Return (IRR) at or above that which they had projected at financial close.

Their creditors have also had a pretty easy ride. In a study of 805 PFI-like projects from around the world, the ratings agency Moody's found that lenders had a maximum 0.5% probability of default (defined as a scheduled debt or interest payment not paid within 90 days of the due date) in any given year. Only 18 of the 805 projects in the survey (which included deals from across the world, not just the mature project finance markets of Western Europe, North America and Oceania) had witnessed a default. And in most of these cases, creditors eventually got the vast majority of their money back anyway.

Against this background, it is a curious fact that the infrastructure sector is in the midst of a severe and prolonged credit crunch. Almost four years after the collapse of Lehman Brothers, banks in Europe still face capital and liquidity constraints that undermine their ability to provide long-term project finance. This is highly inconvenient for policy makers in both London and Brussels, whose attempts to stimulate economic growth via infrastructure spending are being frustrated. Many have come to the conclusion that, to get credit flowing into projects, the wounded banks need to be bypassed, with their role in project funding taken on by other financial institutions – such as pension funds, insurance companies and sovereign wealth funds.

In a world of perfect capital markets, this would happen naturally. Capital is supposed to flow to projects and companies offering the highest return, but instead these institutions are channelling a considerable proportion of their resources into government gilts – which offer a stable yield but one that is, at the time of writing, strongly negative in real terms. No-one who pays into a pension fund can view this investment strategy with satisfaction. I for one would rather see my savings going into projects that have, as Moody's has shown, close to zero default risk and yet typically pay a return about twice the rate of inflation – even if, as a taxpayer and public service user, I may be less thrilled.

The salience of infrastructure investment for growth plans in the UK and the Eurozone has long been clear, and it is at last receiving due attention from policy-makers. George Osborne is due to make a speech on the topic before the summer recess (though details are likely to be sparse). When Nick Clegg, the Deputy Prime Minister, talks about preparing a "massive" increase in state-backed investment in infrastructure, it is the current failure of markets to do this independently that he is talking about – though his focus is wider than those sectors associated with PFI (like healthcare, education, defence, transport, social housing), and incorporates other elements of economic infrastructure such as energy, water and digital networks.

The idea is to use the UK government's "balance sheet" – coalition code for its abundant capacity to borrow – to guarantee payments to creditors and thus enable risk-averse players to lend into projects. Yet, if the state is standing behind projects, the potential to shift the risks and rewards of projects out of the public sector is curtailed. The trick is to do this without adding to the official estimates of government indebtedness, which means that, despite bringing risks and rewards back into the public sector, debt must be continue to recorded as a private liability, not a public one.

On this difficult issue, the European Commission is playing a leading role. Under its "project bonds" initiative – a pilot for which was approved by finance ministers at the end of May – EU funds will be used to back new bond issues by the European Investment Bank, with the money raised providing the resources necessary to provide guarantees to lenders and/ or some risk capital for projects. Initially, projects with a trans-European flavour are likely to be prioritised, but eventually it is envisaged that a broad range of domestic social and economic infrastructure projects will benefit.

The aim is to enhance the credit of the project, allowing the bulk of a project's capital requirement to be financed by bonds, which will then be snapped up by institutional investors. The key to this is to improve the rating of bonds from BBB to "single A", for which the market is deeper for a variety of reasons – partly to do with the institutional investor culture, and partly to do with regulations which make anything less than A-rated paper very expensive in capital charge terms.

Mr Clegg and the eurocrats are struggling to find a way through a classic chicken and egg dilemma. The complexity of project finance transactions means institutional investors will need to make a substantial investment in qualified people. They might not be willing to make that investment until they see a market develop. But the market is unlikely to develop until they make the investment. See the challenge? Especially after the election of Francois Hollande to the French presidency, there is a huge amount of political will underpinning the project bond initiative – yet in the face of such an apparently insoluble problem, there is no guarantee that it will succeed.

EU taxpayers and citizens should monitor these efforts closely, but perhaps with a degree of ambivalence. Infrastructure investment can be an attractive source of economic stimulus because its effect on demand can be large. In the UK, the Office for Budget Responsibility estimates an impact multiplier of 1 for departmental capital expenditure on infrastructure – so that spending of £1 leads to a £1 increase in demand and thus national income.

And well-conceived and well-structured infrastructure projects can also benefit economies in the long-run, especially in an era of rapid technological progress, climate change, urbanisation and growing congestion. But herein lies the problem. Any attempt by states to stand behind projects will bring risk back into the public sector, reducing the private sector's motivation to deliver projects well – in other words, undermining those disciplines that led to the good record of project delivery highlighted by auditors and rating agencies.

The plans being drawn up in London and Brussels might, eventually, lead to new forms of infrastructure-oriented financial instruments, not unlike those seen in North American bond markets. Such instruments could play a role in helping the UK and the eurozone move out of their current economic malaise. But if these instruments are dependent on implicit state aid – and the political incentives to push ahead with such schemes are pretty clear – policy-makers might also increase the likelihood of approving deals that should never see the light of day. Professor Flyvbjerg may soon be calling for his gavel once again.

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