Financing the EU Energy Infrastructure after the Euro Crisis

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The urgent need for energy infrastructure investments in the EU

Europe is in need of massive infrastructure investments. According to the European Commission, the EU infrastructure investment requirements could reach as much as EUR 2 trillion in the sectors of energy, transport and information and communication technology by 2020. The energy sector alone is set to require EUR 1.1 trillion, of which: EUR 400 billion for distribution networks and smart grids; EUR 200 billion for transmission networks and storage; EUR 500 billion for generation capacity. This enormous investment need is mainly due to the fact that the EU energy infrastructure is ageing and, in its current state, is not suited to match future demand for energy, to ensure security of supply and to support the large-scale deployment of renewable energy sources required by the "Europe 2020" strategy and by the decarbonisation targets set in the "Energy Roadmap 2050".

A shifting energy infrastructure-funding model in the EU

This unprecedented infrastructure investment need is challenging the traditional EU energy infrastructure-funding model, also generating the risk of an energy infrastructure financing gap in the EU. Energy infrastructure projects in the EU can no longer be financed by public resources alone, at least in the high public debt countries. In fact, the impact of the Euro Crisis has reduced the scope for public investment in infrastructure within government budgets. The contribution of private capital markets has thus emerged to be crucial in ensuring the necessary resources to infrastructure investments. However, also private investors face increasing problems to finance infrastructure projects. Commercial banks are drastically reducing infrastructure investments as their ability to provide long-term financing is being negatively affected by new banking regulations (Basel III), a consequent trend toward short-term allocation, and by the increase of gathering costs caused by the downgrading of sovereign and banking ratings in peripheral EU countries. Moreover, also the utilities (the players that traditionally took on the bulk of energy infrastructure investment) are experiencing more difficulties to finance such projects, since their financial situation has weakened over the last years as prolonged stagnation or decline in demand growth, a strong increase in renewables penetration, and an overcapacity in some markets have significantly impeded their performance. In short, given the crucial role played by energy infrastructure in an economic system, this energy infrastructure financing bottleneck caused by financial, regulatory and market factors could seriously undermine the recovery of the EU economy and its future prospects for growth. For this reason a shift in the EU infrastructure-funding model is urgently needed. In particular, it should be composed by significantly higher shares of direct capital market financing and greater involvement of institutional investors.

The crucial role of institutional investors

Institutional investors such as pension funds, insurance companies, mutual funds and sovereign wealth funds could well become the pivotal element of the new EU energy infrastructure-funding model. In fact, the long duration of their liabilities allows institutional investors, at least in principle, to make buy-and-hold investments in long-dated productive assets, achieving higher yields to offset longer-term risks and lower liquidity inherent in many of these assets. Their longer time horizons enable institutional investors to behave in a patient, counter-cyclical manner, also restraining "short-termism". In OECD countries alone, institutional investors held over USD 70 trillion in assets at the end of 2011. Nevertheless, institutional investors currently place only 2% of their resources in financial products connected to infrastructures. The economic downturn has certainly had an impact on long-term asset allocation strategies of institutional investors by promoting more conservative investment strategies. However, this trend is mainly due to the fact that, exactly as banks, also institutional investors are obliged to meet a variety of prudential regulations. In particular, the new prudential rules for insurance undertakings (Solvency II) require them to hold assets to cover the nature and duration of their liabilities, affecting their ability to play a long-term financing role.

The EU: a potential catalyst for institutional investments on energy infrastructure

The EU could act as a catalyst in order to attract institutional investors into the financing of energy infrastructure projects in the EU. Such an action could target different levels, such as regulation and finance. With regard to regulation, the EC has already asked the European Insurance and Occupational Pensions Authority to examine whether the detailed calibration of capital requirements for investments in certain assets under the Solvency II regime (including infrastructure financing) should be adjusted to ensure there are no obstacles to long-term financing, albeit without creating additional prudential risks. Additionally, the EU should also facilitate the move of institutional investors towards energy infrastructure projects by facilitating the regulatory treatment of energy projects of European common interest and ensuring the implementation of these projects by providing necessary market-based and direct EU financial support. In this latter regard, the EU has progressively advanced some initiatives, of which the most important is the Connecting Europe Facility, an instrument designed to act as a catalyst to attract further funding from the private sector and other public sector actors to infrastructure through a number of financial risk-sharing instruments, including special lending, guarantees and equity investments.

The Europe 2020 Project Bond Initiative

But another instrument is envisaged to become the main EU tool to stimulate capital market financing for energy infrastructure projects: the Europe 2020 Project Bond Initiative. This initiative is intended to enable the issuance by project companies -generally public private partnerships (PPPs)- of long-term well-rated bonds instead of relying only on bank lending. The participation of the European Commission and the European Investment Bank will mitigate some of the risk associated with a project bond issued to finance a specific project. EU Member States, infrastructure managers or companies will therefore be able to access a competitive source of finance and consequently improve the cost of financing such projects.

The way forward

Infrastructure investments are essential to integrate the European economy, to increase its competitiveness, to reduce unemployment and to improve the quality of life of the European people. However, this issue has been partially overshadowed in the last five years, insofar as the European economic debate has been completely absorbed by the Euro Crisis. Nevertheless, this issue is now re-emerging in all its urgency. In fact, energy infrastructure investments are essential to put the EU back on the path of inclusive growth, creating jobs and enhancing its competitiveness in the global market place. Energy infrastructure investments could thus well become the pivotal element of a new "EU Growth Compact", the only way forward for the EU to become a truly smart, sustainable and inclusive economy.

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Note: This article gives the views of the author, and not the position of the Euro Crisis in the Press blog, nor of the London School of Economics.