

# **Achieving the Investment Plan for Europe's €315 billion ambition: 12 fixes**

## Acknowledgements

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# 1 Introduction and Executive Summary

The Institutional Investors Group on Climate Change (IIGCC) represents mainstream pension funds, insurance companies and asset managers as well as specialist infrastructure funds, with collectively more than €10 trillion of assets under management. We have investments across the whole of the economy. We invest into listed corporations and SMEs in all sectors, real estate, private equity funds and directly into infrastructure. Systemic risks such as climate change have a significant impact on our investments and liabilities.

IIGCC has long emphasized the need for long-term clarity on an ambitious 2030 climate-energy framework<sup>1</sup> and therefore welcomed last October's agreement by Heads of State and Government on the 2030 climate and energy framework, including a greenhouse gas reduction target of at least 40%.

Following this, we see the publication of the European Commission's Communication on the Energy Union as a key initiative to make the EU's 2030 framework a reality. We also welcome the Investment Plan for Europe, which sets out an ambitious vision for low-carbon infrastructure and energy efficiency investment.

Research suggests that investing an additional USD 100bn per annum into infrastructure for ten years would increase EU GDP by an additional 1.4%, with a potential cumulative GDP impact of USD 3 trillion<sup>2</sup>. In terms of investment needs, USD 2.2 trillion is required in Europe until 2035 to replace ageing infrastructure and meet decarbonisation goals. Renewables account for 75% of the investment in new power plants to 2035<sup>3</sup>. Energy efficiency also plays a crucial role and we welcome the recommendations contained in the recent report by the Energy Efficiency Financial Institutions Group<sup>4</sup>.

Infrastructure investment offers an attractive asset-liability match because it allows for substantial investments with steady returns over decades. On average, IIGCC members seek to allocate 8% of their assets to infrastructure. In recent years investors have fallen short of this target. It can be increased – if the conditions are right. This paper, directed at policy-makers, recommends 12 fixes to greatly increase infrastructure investment in Europe. It also offers a short introduction to the investment process for policy-makers designing the European Fund for Strategic Investments (EFSI).

<sup>1</sup> <http://www.iigcc.org/publications/publication/Investment-grade-climate-policy-the-next-phase-for-Europe>

<sup>2</sup> [http://www.linklaters.com/pdfs/mkt/london/6380\\_LIN\\_Infrastructure%20Report%20FINAL\\_WEB.PDF](http://www.linklaters.com/pdfs/mkt/london/6380_LIN_Infrastructure%20Report%20FINAL_WEB.PDF)

<sup>3</sup> [http://www.iea.org/media/140603\\_WEOinvestment\\_factsheets.pdf](http://www.iea.org/media/140603_WEOinvestment_factsheets.pdf)

<sup>4</sup> [https://ec.europa.eu/energy/sites/ener/files/documents/2014\\_fig\\_how\\_drive\\_finance\\_for\\_economy\\_1.pdf](https://ec.europa.eu/energy/sites/ener/files/documents/2014_fig_how_drive_finance_for_economy_1.pdf)

## The 12 fixes:

1	Ensure the 2030 framework guides all investment support provided under the Investment Plan for Europe and align the Energy Union plans with that framework
2	Apply transparent and robust sustainability criteria when selecting all investments
3	Focus on attracting institutional investor capital
4	Focus on project pipeline expansion, including through greater attention to project development and construction-phase projects
5	Ensure the Investment Plan crowds in, rather than crowds out, private sector investment
6	Aggregate infrastructure assets
7	Increase standardisation of contracts and other project documentation; encourage convergence of regulatory environments
8	Ensure an independent and commercially astute investment committee
9	Consider the EU's role in reducing risk to investors from retroactive policy changes
10	Consider the effect of unintended constraints from financial or competition regulations on investments in low carbon technologies and in climate resilience
11	Develop a powerful industrial strategy for the development of low-carbon infrastructure
12	Promotional banks and national governments through promotional banks should come forward with their own contributions to the EFSI

## 2 A detailed breakdown of the 12 fixes to increase infrastructure investment in Europe

Investors have a fiduciary duty to choose the best investments for our clients. This responsibility prohibits us from freely choosing investments without regard for return and risk. The regulatory environment, in particular macro-economic stability and a good credit rating of the underlying sovereign are crucial factors in making projects investable and bankable.

The following key factors influence our investment decisions and are explored in more depth in section 3: investments are evaluated against other investment opportunities both in terms of asset class and geography; the cash flows need to have the right timing to ensure a sound asset-liability match; and low correlation with other investments and a hedge against inflation increases the attractiveness of infrastructure investment.

Taking these factors into account, we believe the following 12 fixes could greatly increase private sector investment into infrastructure at an EU and member state level.

### **Fix 1 Ensure the 2030 framework guides all investment support provided under the Investment Plan for Europe and align the Energy Union plans with that framework**

It is essential that all policies are coherent with the 2030 climate and energy framework. No new investment into high-carbon infrastructure should be supported by the European Fund for Strategic Investments (EFSI). As measures to address climate change are tightened further and technologies evolve rapidly, there are significant risks that high-carbon assets will be stranded. Energy sector investment should be focussed on renewables, energy storage, grid expansion and energy efficiency. Renewables, grid, storage and energy efficiency are investments for the future and as a result are more likely to attract capital.

*High-carbon infrastructure projects should be excluded from the European Fund for Strategic Investment's mandate: all projects should be assessed according to their fit with the infrastructure requirements of a low-carbon economy. When facilitating investment into energy, the fund should focus on renewables, energy efficiency and grid expansion. Transport investments also need to be fully aligned with the 2030 targets, in particular by taking electric mobility into account.*

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### **Fix 2 Apply transparent and robust sustainability criteria when selecting all investments**

We are increasingly assessing the sustainability performance of potential investments. In order to ensure full alignment between the Investment Plan for Europe and the 2030 framework, it is essential that transparent and robust sustainability criteria are put in place for evaluating all investments. EFSI may wish to consult organisations such as the Green Investment Bank in order to come up with suitable sustainability criteria, considering both the likely environmental (carbon and pollution) impact of an individual project, and its contribution to the cumulative impact of all of EFSI's funded projects.

If the EFSI's ambition of making projects that are marginally below investment grade investable is realised, the fund will have a crucial role in determining which additional European infrastructure projects are implemented. Infrastructure projects are long-term, and so are their environmental and social impacts. In selecting a particular infrastructure project, the EFSI is in effect selecting a particular carbon emissions path. This path, in our view, should always be a low carbon path that aligns with Europe's 2030 climate and energy framework. As such, it is essential that the EFSI apply transparent and robust sustainability criteria when selecting all investments. If all EFSI projects must pass a rigorous sustainability evaluation, the EFSI marque can evolve into a signal for high quality assets.

*The EFSI should create and publish a set of robust sustainability criteria that will be integral when evaluating prospective projects for funding. Each EFSI project should be selected using robust sustainability criteria as an integral part of the overall assessment of the project. This will increase investor confidence in the quality of the assets.*

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### Fix 3 Focus on attracting institutional investor capital

While banks and traditional infrastructure companies face stretched balance sheets, investors have increased their capital allocation to infrastructure in recent years. We therefore play a crucial role in financing projects that might otherwise not be able to secure capital. While infrastructure debt will continue to play an important role in many projects, there has been a growing trend towards unlevered (all-equity) investments from institutional investors.

More capital will be available if projects are both commercially viable for investors and economically sound, i.e. they result from a rigorous macroeconomic cost-benefit analysis.

*The EFSI should be designed so it can accommodate the rising trend towards unlevered equity investments and the needs of institutional investors, rather than only banks.*

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### Fix 4 Focus on project pipeline expansion, with greater attention given to project development and construction-phase projects

Most of the projects put forward by national governments for consideration under the European Investment Plan are pre-construction projects. As explained in more detail in the next chapter, our involvement in pre-construction projects will always be smaller due to demand and construction risk. The main obstacle to increased infrastructure investment is the **shortage of operational bankable projects** that offer an attractive investment proposition. The EFSI should have a focus on project development and construction phase projects. This should complement the European Investment Advisory Hub that will target project development. It should be noted that most projects fail well before the project development phase, due to a lack of political will or the ability or willingness of governments to run tendering procedures and ensure the associated funding streams.

*The EFSI should focus on project pipeline expansion by building government support and targeting projects in the development and construction stage, in line with the 2030 targets. Government could focus its role on project development and construction phase projects, selling suitable operational assets on to institutional investors, as appropriate. Returns from selling on operational assets can be recycled to build new projects or upgrade existing infrastructure. The optimal distribution of public versus private ownership depends on country circumstances and the type of infrastructure.*

#### Box 1 Risk development during the life of an infrastructure asset

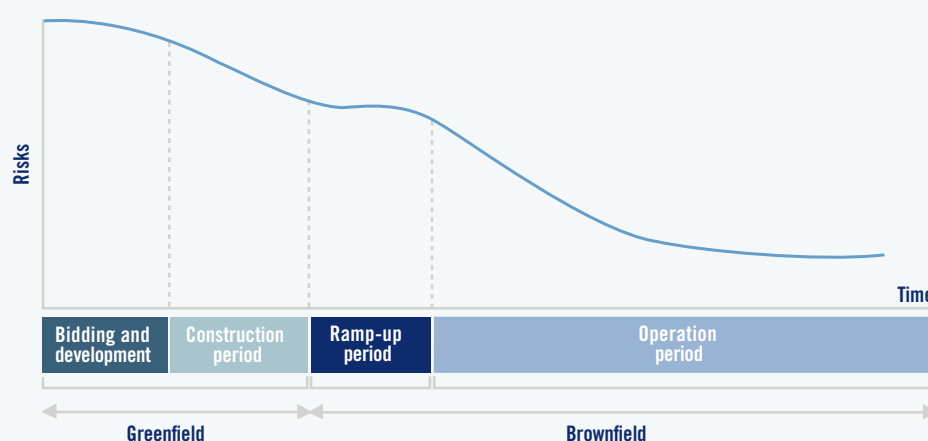
The project development process can be broken down into the development, construction, ramp-up and operational phase of the project. Operational assets have the advantage of having demonstrated the associated revenue stream.

Figure 1 below shows how the risk profile of an infrastructure asset evolves over the life of the asset.

Most institutional investors, in particular most defined benefit pension schemes, can only take on operational projects. However, in order to address the shortage of operational projects despite significant demand for projects from institutional investors, we have increasingly taken on construction risk.

These approaches are commonly known as the BOO (Build Own Operate) approach or the BOT (Build Own Transfer) approach. In the majority of cases, investors tend to be the off-takers of BOT projects that get transferred, although some have also invested in projects in the construction phase.

**Figure 1 Risk Profile Development of an Infrastructure Asset**



Source: World Economic Forum, for illustrative purposes only

## Fix 5 Ensure the Investment Plan crowds in, rather than crowds out, private sector investment

It is crucial that the favourable terms that the EFSI might offer do not crowd out potential private investment.

The EFSI should have the capacity, including the risk appetite and expertise, to operate effectively as an infrastructure development fund and leverage the EU's relationships with national and regional governments. Leveraging high amounts of private sector capital will be easier if the EFSI is designed so it addresses market failure, i.e. gaps in the availability of capital, and does not compete with private capital in areas where markets are functioning. This particularly relates to project development and construction-phase projects, where there is generally more of a capital shortage.

*In its relationships with potential investment counterparties, EFSI should be wary of creating self-imposed rules e.g. requiring matched private sector investment, minimum hurdle rates or insisting on “equivalent” commercial terms, that may limit its ability to foster sound projects which will be capable of attracting private investment once the development risk has been navigated.*

## Fix 6 Aggregate infrastructure assets

Even if the scale of European infrastructure markets was increased, it would still not change the fact that the underlying investment volume per project is often too small to meet our requirements. **Aggregation of infrastructure assets** through infrastructure funds and large-scale infrastructure companies would help to attract more potential investors and diversify risk across projects with different risk profiles.

*The EFSI and the development banks should encourage market participants to aggregate assets and they should continue aggregating those assets themselves. Aggregation will accelerate investment particularly into low-carbon energy generation.*

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## **Fix 7 Increase standardisation of contracts and other project documentation; encourage convergence of regulatory environments**

The standardisation and adoption of sectoral or industry best practices and the development of standard models for legal contracts, underwriting processes, procurement procedures, adjudication, measurement, verification, reporting, energy audits and energy savings insurance products would add volume to the infrastructure market and lower finance and transaction costs. For example, standardising concession contracts between government and project owners would reduce transaction costs and improve deal flow. Furthermore, national level tendering procedures and other ways of awarding infrastructure contracts need to ensure sustainable risk-adjusted returns for investors.

*Improving the regulatory environment, expediting permitting procedures and ensuring gradual convergence of funding and regulation arrangements across Europe will make it easier for us to invest. Convergence should be centred on the needs of the emerging low-carbon economy.*

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## **Fix 8 Ensure an independent and commercially astute investment committee**

Regarding the governance of the EFSI, we cannot stress enough how important it is that the fund invests according to commercial criteria, with an independent non-political professional investment committee composed of finance practitioners. Policy-maker intervention in investment decision should be limited to determining the investment committee's mandate and to the steering board. Box 2 sets out the expectations that asset owners would have for any asset manager. Fulfilling these expectations will increase the ability of the EFSI to attract private sector capital.

### **Box 2 Asset owner expectations for asset managers**

- Adequate level of staff with necessary qualifications and experience
- Independent governance; good agency in the interest of the principal
- Strong risk management
- Systems & procedures
- Compliance
- Applying high ESG standards in developing and managing assets
- Alignment of interests

*The EU should consider appointing representatives of the institutional investment community to the board of the EFSI and tap into the investment advisory community for the European Investment Advisory Hub.*

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## Fix 9 Consider the EU's role in reducing risk to investors from retroactive policy changes

Most infrastructure investment depends on government guarantees, regulated revenue streams and/or subsidies. As such, **political and regulatory risk** is critically important and we look with the greatest care at the track record individual governments have in adhering to their promises. Because infrastructure investments are long-term by nature they need to be resilient to changes in government. Political and regulatory risk can over-shadow the opportunities offered even by projects with a high return on investments. Retroactive policy changes for renewable energy have brought foreign direct investment to a standstill in some countries, and have caused investors to suffer billions in losses, hugely damaging investor confidence. Investment in R&D has also been affected, as companies are less likely to commit funds to products which are reliant on policies that might change. Infrastructure investment – in particular by international investors – will only rebound in those countries if risks from retroactive policy changes are mitigated.

Risk sharing for specific projects by pooling capital in the EFSI will make it easier for us to invest, but ultimately does not remove risks from retroactive policy changes risk. Financing infrastructure from private sources of capital can remove these liabilities from the government balance sheet, but does not reduce the liability these impose on the macro economy of the country concerned. As such, EU-level guarantees should be coupled with **some protection against risks from retroactive policy changes** since this risk according to our experience increases with worsening macroeconomic conditions. This should also cover renationalisation risk.

*This involves setting investment incentives at the right level so that revenue support mechanisms are sustainable, and considering a mechanism at EU level to mitigate the risk stemming from retroactive policy changes in member states.*

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## Fix 10 Consider the effect of unintended constraints from financial or competition regulations on investments in low carbon technologies and in climate resilience

Competition regulation (e.g. the unbundling regulations in the Third Energy Directive) and Solvency related requirements can act as barriers to infrastructure investment by financial investors. Coherence between the EU's infrastructure investment objectives and wider European regulation could make investment in infrastructure more accessible.

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## Member state level

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### **Fix 11 Develop a powerful industrial strategy for the development of low-carbon infrastructure**

National governments can increase the visibility of their infrastructure objectives by bundling them together in an infrastructure development vision that is climate-smart. Also at the national level, full coherence between the 2030 targets and the infrastructure development vision must be ensured. These infrastructure plans should therefore be future-proof, taking into account emerging technological developments such as electric mobility, smart grids, renewables and energy efficiency.

Such a vision can signal significant market size and incentivise institutional investors to enter a particular national infrastructure market. It should be an industrial strategy for the development of a low-carbon economy, guided by the EU energy union and the 2030 targets.

In addition, national governments should improve regulatory stability and improve the investment environment.

*National governments should develop an industrial strategy for the development of low-carbon infrastructure. The European Semester process could be utilised to improve further the investment environment in member states.*

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### **Fix 12 Promotional banks and national governments through promotional banks should come forward with their own contributions to the fund**

Infrastructure investment needs are much greater than the €315bn figure aimed at by the European Investment Plan.

*Promotional banks and national government through promotional banks should come forward with their own contributions to the EFSI, in addition to co-investing alongside the EFSI and the EIB on a project level.*

### 3 How we invest into infrastructure

The following section outlines how institutional investors view the investment process. It is intended to serve as background for policy-makers designing the Investment Plan for Europe.

As asset owners and managers we supply the capital that helps drive economies. IIGCC members invest into infrastructure through a wide range of structures, traditionally listed equities, direct equity investments in unlisted infrastructure, infrastructure debt such as project bonds (including green bonds), project finance and private equity.

#### Box 3 The investment chain & asset classes

The majority of capital from institutional investors is allocated to capital markets (i.e. listed equity and bonds) and accordingly, the majority of our infrastructure investment is indirect investment through listed companies such as power or water utilities and owners/developers of transportation assets. We are the most significant providers of capital to those companies. This means that our contribution to infrastructure investment is greater than the numbers on direct investment suggest.

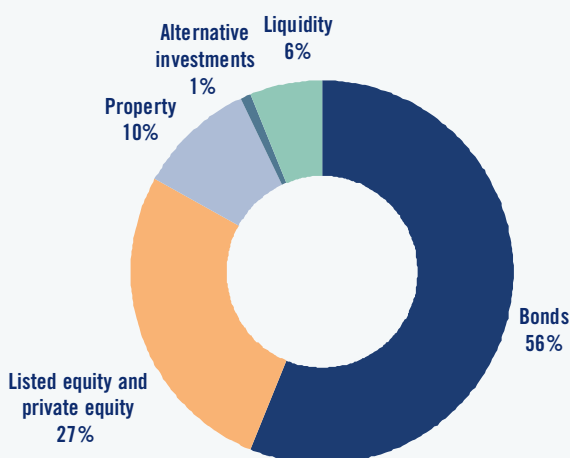
We have increasingly invested through private equity funds. These have the advantage of offering a specialisation that can be too costly to maintain in-house. They also allow for “co-investment” structures where we might increase our exposure to a particular asset through a parallel direct investment.

More recently, we have also engaged in direct ownership. This is particularly suitable for larger institutional investors and/or institutional investors with a high capital allocation dedicated to infrastructure.

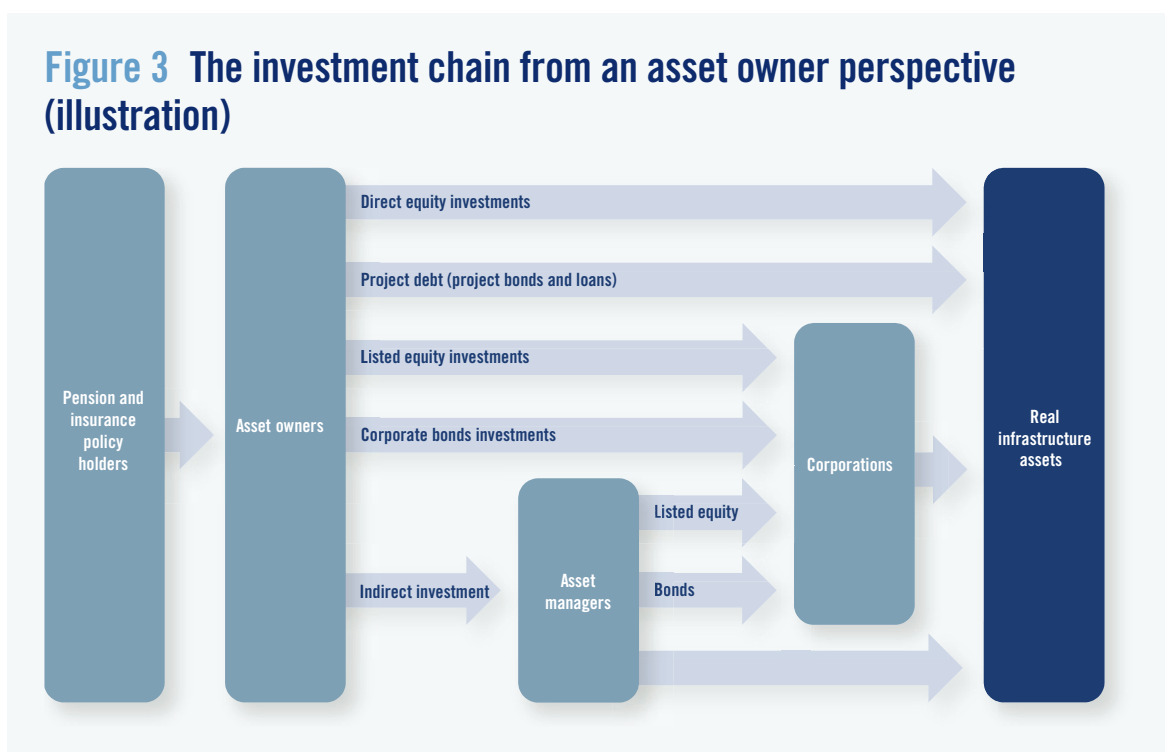
As there has been difficulty in securing affordable long-term debt against attractive projects, we have increasingly also provided infrastructure debt, most commonly through project bonds and project finance.

Figure 2 shows the allocation of a generic institutional investor to these asset classes. Figure 3 shows the investment chain from an asset owner perspective.

Figure 2 Capital allocation of a generic institutional investor



**Figure 3 The investment chain from an asset owner perspective (illustration)**



## Optimising our portfolios

In allocating capital to infrastructure, we aim to optimise our portfolios. We balance geographical considerations and the associated regulatory and macroeconomic environment, striking a balance between different asset classes, and protecting ourselves against macroeconomic risks such as inflation. We evaluate investments in infrastructure against other opportunities, such as government bonds and equity markets as well as against other industries. Within our infrastructure investments, we also tend to spread risk across sectors.

Infrastructure investment has a number of unique attractive features. It generally provides a hedge against inflation since the associated cash flows often rise with inflation, and it is resilient to macroeconomic developments since it provides basic services that are always in demand.

However, as cautious investors we often do require some additional form of government guarantee and risk enhancement, such as through monoline insurance.

## Asset-liability match

The overarching priority is to match assets and liabilities, i.e. ensure that we can at all times meet our responsibilities towards pension and insurance policy holders. Infrastructure investment has the advantage of requiring high up-front capital expenditure and steady “annuity-type” returns over decades that are in general reasonably predictable.

However, the cost and ease of exit has been an issue as they are often illiquid and hard to sell on once they are on the balance sheet. This is less an issue for long term investors like us but higher liquidity would further enhance their attractiveness and open the projects to a wider pool of investment capital.

## Investment case

Of course, in order to fulfil our responsibilities towards pension and insurance holders, we do require a certain minimum rate of return (hurdle rate) that is highly project dependent. We aim to optimise the risk-return relationship and select the most attractive projects. This doesn't mean a single-minded focus on chasing the highest returns, but choosing projects which optimise risk across our portfolio and offer attractive returns. Returns are usually measured on the basis of their internal rate of return, which is the maximum cost of capital that would lead the project to break even. The investment case is an important part of our considerations, and governments can go a long way in providing the right stable macroeconomic and regulatory environment for projects to become more attractive. Nevertheless, infrastructure projects need to be commercially viable and competitive in relation to other countries and other investment opportunities. Currently, there is a large amount of competition for good projects.

## Financing model and leverage

The investment case crucially depends on the financing model and leverage ratio (the proportion of debt raised against the equity provided). Although development banks such as the EIB are required to implement lengthy and onerous procedures before investing or financing an infrastructure project, they are welcome partners that can improve the risk-return relationship by providing guarantees, take first loss tranches and the assurances investments by state-owned entities provide. Other co-investors, such as project developers, construction companies or government agencies are also common and they can take part in the distribution of risks in a project. Since the global financial crisis, we have faced difficulty in securing sufficient debt from banks, although they are likely to remain the main providers of project debt. In consequence, we have increasingly provided debt financing ourselves, either through bonds or through direct debt in individual projects.

Green bonds are a useful way for public or private sector actors to raise capital against infrastructure projects. We have been supporters of the rapid increase in green bond issuances and see this as one way in which infrastructure financing can be substantially improved to better match our requirements.

# 4 Conclusion

There is currently a lack of a **robust deal flow and difficulty in identifying repeatable investment opportunities** for project development and construction-phase projects. If the EFSI focuses on those projects, it will have the most transformative impact.

To attract institutional investment, it is important that the design of the Investment Plan for Europe is compatible with the needs and legal requirements of investment institutions. The recommendations proposed herein originate from our experience of the barriers that have halted investments in the past.

We believe the EFSI can drive significant investment into the EU economy. It has an opportunity to reinvigorate the EU industrial and energy sectors while making strides towards achieving greater energy sector coherence and the EU's 2030 climate obligations.

We are very keen to see a co-operative dialogue between the Commission and the investment community continue. This can ensure that past mistakes are avoided and the investment environment is further improved. Designed correctly, this co-operative funding structure has the potential to become a permanent aspect of the EU economic landscape, accelerating investment in R&D and infrastructure.

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WHEB Group  
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Baptist Union of Great Britain  
BMS World Mission  
Charles Plater Trust  
Christian Aid  
Church of Scotland  
CIG South Africa  
Friends Provident Foundation  
Jesuits in Britain  
Joseph Rowntree Charitable Trust  
The Lutheran Council of Great Britain  
Panapur  
Polden-Puckham Charitable Foundation  
Religious Society of Friends  
Representative Body of the Church in Wales  
Roman Catholic Diocese of Plymouth  
Roman Catholic Diocese of Portsmouth  
Servite Friars  
United Reformed Church Ministers Pension Fund  
United Reformed Church South Western Synod  
United Reformed Church Trust  
William Leech Foundation



