advancing with ESIF financial instruments

Stocktaking study on financial instruments by sector

Progress to date, market needs and implications for financial instruments

The use of financial instruments in the 'Environment' sector

Synthesis

DISCLAIMER

This document has been produced with the financial assistance of the European Union. The views expressed herein can in no way be taken to reflect the official opinion of the European Union or the European Investment Bank. Sole responsibility for the views, interpretations or conclusions contained in this document lies with the authors. No representation or warranty express or implied is given and no liability or responsibility is or will be accepted by the European Investment Bank or the European Commission or the managing authorities of Structural Funds Operational Programmes in relation to the accuracy or completeness of the information contained in this document and any such liability or responsibility is expressly excluded. This document is provided for information only. Financial data given in this document has not been audited, the business plans examined for the selected case studies have not been checked and the financial model used for simulations has not been audited. The case studies and financial simulations are purely for theoretical and explanatory illustration purposes. The case projects can in no way be taken to reflect projects that will actually be financed using financial instruments. Neither the European Investment Bank nor the European Commission gives any undertaking to provide any additional information on this document or correct any inaccuracies contained therein.

The study has analysed all sectors of environmental investment. Most potential for financial instruments was identified in the waste and water sub-sectors, with only minor scope in air quality, environment risk management and rehabilitation of industrial sites. Therefore the study concentrates, if not specifically mentioned, on waste and water. **The estimated EU-wide investment needs for 'water and waste' infrastructures amount to about EUR 98 billion annually**[1]. Given the current investment levels, the resulting **EU-wide investment gap** may amount up to **EUR 63 billion per year**. Following this, the **investment gap points to a need for the Member States** (MSs) **to step up their environmental action**, and indicates the need for ERDF/CF financial instruments in the sector.

1. ESIF investments and the use of financial instruments

A total of almost **EUR 20.2 billion of ERDF/CF investments has been planned to support investments in environment** during the 2014-2020 programming period across the EU. The largest allocations of ERDF/CF are planned for water, waste water, drinking water and water management (EUR 14.7 billion) and for waste management (EUR 5.5 billion). The largest allocation for this sector can be found among the Cohesion countries[2].

Four MSs are using ERDF/CF funding for **financial instruments in the Environment sector** (*as of 31 December 2017*); namely: Bulgaria, Greece, Portugal, and Slovenia. The four MSs together have committed EUR 168.2 million to financial instruments in the Environment sector, representing 0.7% of the total eligible costs for the sector across all MSs. Furthermore, in the meantime, Czechia has set up a financial instrument in the environmental sector that was not reported in the 2017 report, and Slovakia is currently establishing an instrument in the sector.

Bulgaria and Greece together have committed EUR 150 million to environmental investments. The instruments are providing equity or quasi-equity for large environmental infrastructure projects (the same applies to Slovakia). The remaining EUR 18.2 million in Portugal and in Slovenia are allocated through debt financial instruments to Small and Medium-sized Enterprises (SMEs) (the same is also true for Czechia).

2. Market opportunities

The EU is lagging behind in reaching the targets set in its environmental legislation. The **annual investment gap** between actual investments and required investments amounts to **EUR 45 billion in the water infrastructure, EUR 13 billion in water management, and EUR 5 billion in waste management**[3]. There is a clear economic case for undertaking these investments, as insufficient investments in these areas is leading to increasing public health cost, environmental degradation and/or missing the opportunity for circular economy activities, creating new business opportunities and additional jobs.

1 European Investment Bank, *Restoring EU competitiveness,* 2016.
Available here: https://www.eib.org/attachments/efs/restoring_eu_competitiveness_en.pdf.

2 For the 2014-2020 period, the following countries are eligible for the Cohesion Fund: Bulgaria, Croatia, Cyprus, Czechia, Estonia, Greece, Hungary, Latvia, Lithuania, Malta, Poland, Portugal, Romania, Slovakia, and Slovenia.

3 European Investment Bank, *Restoring EU competitiveness,* 2016.

Market opportunities for financial instruments arise from the, even if limited, **revenue generation potential of environmental infrastructure**. The Common Provisions Regulation (CPR) recognises this potential through flat rates of net-revenue generation for different type of investments. The rate for waste management projects is 20% and 25% for water projects[4]. This means that at least 20%, and respectively 25%, may be financed from financial instruments, whereas the remaining 80%, or respectively 75%, are eligible for grant support from Operational Programme resources.

The majority of investments in the waste or water sub-sectors need to be undertaken for **publicly-owned infrastructure**. Municipalities may benefit from soft loans with long maturities, aligned with the economic life of the infrastructure. There is also the possibility to realise projects with **private or public companies managing or even owning environmental infrastructure**, in structures like Private-Public-Partnerships (PPP) or concessions, which undertake these investments without increasing public sector debt. For such companies, equity or long-term debt may be needed.

A further market opportunity comes from the **enterprise** sector, which needs to comply with increased environmental standards, or use the opportunities of investing in waste reduction, water savings measures, or are active in the circular economy. For these companies, SME-type financing adapted to the needs of environmental investments are suitable, such as long-term loans with longer grace periods, and with the possible combination with investment grants or interest rate subsidies.

Financial instruments can help bridge the investment gap between current deployment and the EU target. Thanks to their **leverage effect**, they can attract private financers and participate to the annual additional EUR 63 billion environmental infrastructure spending needed to reach compliance with EU legislation. During the 2021-2027 programming period, more ERDF/CF-supported financial instruments would facilitate investment in environmental infrastructure.

3. Barriers

Main challenges for the development of ERDF/CF-supported financial instruments financing environmental infrastructure are:

- **Limited awareness of the potential of financial instruments among the key stakeholders**. Public sector support for investments in environmental infrastructures usually takes the form of national or EU grants, which are considered the primary policy intervention tool, particularly for projects with high up-front investments and long-investment horizons. However, where projects are revenue-generating and potentially bankable, there is the potential for the deployment of revolving financial instruments. Consultation with stakeholders revealed that unfamiliarity with ERDF/CF financial instruments compared with grants hinders their deployment.
- **Competition with traditional public financing.** In many MSs, water and waste management projects get financed either via municipal financing or directly by the national treasury. ERDF/CF-supported financial instruments, despite their potentially lower interest rates, with their limitations in eligibility and the perception of compliance and reporting burden, may not be sufficiently attractive for all potential final recipients.

4 Annex V of Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013.

- **Problems in developing investment-ready projects**. There is a challenge in preparing a sufficient number of projects in which financial instruments can invest, especially due to the low return on investment of projects. Environmental projects should be integrated in other non-environmental projects, such as investments in expanding production capacity in enterprises, refurbishments of residential buildings or other urban development projects, in order to increase scale and bring together projects of lower and higher returns on investment to increase the bankability of the portfolio of projects.

4. Potential for the use of financial instruments for the environment

The role of financial instruments depends very much on the type of investments and the type of final recipients addressed. In order to **catalyse additional private sector investment**, the provision of long-term debt, possibly combined with grants, equity or SME-type financing should be considered. More precisely:

- **Long-term debt** with a payback period of 20-25 years and preferential interest rates, could offer a solution to finance environmental infrastructure. Where the expected revenues proceeding from the tariffs on the service(s) provided are expected not sufficient to repay the investments, such as in sparsely populated areas or in countries with low disposable income, debt can be **combined with investment grants**. This grant may be provided in the form of capital rebate, which would consist in a write-off of part of the loan, when specific objectives are reached.
- **Financing to Public-Private Partnerships and public enterprises**. Environmental infrastructures may also be implemented under a PPP model, which are repaid either by user fees or through availability payments. Alternatively, waste and water projects are often realised through public enterprises. Such projects need **equity and long-term debt**. Depending on the local market situation, part of the financing needs may be provided by financial instruments.
- **Financial instruments integrating environmental and non-environmental investments.** Households and SMEs, can be encouraged to undertake environmental projects, especially if they are combined with other activities. For example, Energy Efficiency measures in a building can be combined with investments in boilers with less polluting fuel, or with water savings measures, e.g. the use of rain water in toilets. Similarly, SMEs can be encouraged to integrate waste reduction or environmental risk measures when investing in new production capacities. This is best realised through **guarantee or loan instruments**, where the environmental part is combined with **lower interest rates or Technical Assistance** (TA), *e.g.* for an environmental audit.

5. Key enabling factors for the use of financial instruments

Market stakeholders reported during interviews, focus groups and a survey that key enabling factors that may facilitate the deployment of ERDF/CF supported financial instruments in the sector include:

5.1 Integrating environmental objectives into other financial instruments

Following the need for a more comprehensive approach for urban development and infrastructure, integrating environmental objectives into broader financial instruments can increase their scope. This would allow municipalities to access financing for their investment needs more easily, independently of the sector. Similarly, financing environmental measures in SMEs, have potential to be **integrated into existing 'standard SME financial instruments'**. This would facilitate SMEs' access to finance and create larger project pipelines and allow for economies of scale for financial intermediaries.

5.2 Designing financial instrument-friendly Operational Programmes

Financial instruments require a sufficient pipeline of investable projects and attract financial intermediaries to implement them. To avoid multiple Funding Agreements and contributions from multiple Priority Axes, it is advisable to concentrate contributions to financial instruments within the Operational Programmes (OPs). This will also simplify the governance and the monitoring of the financial instruments. It is also advisable to differentiate eligibility criteria for grants, which should be stricter, and those for financial instruments, with broader eligibility criteria. This approach would facilitate the use of financial instruments and of grants in a complementary way. Furthermore, OPs should be designed in a way that they allow a support to projects independent of their form of implementation. Often OPs are formulated in a way having traditional implementation via local governments in mind, making it difficult to provide support in the form of financial instruments and/or grants to PPPs, or other form of private involvement.

5.3 Combining grants with financial instruments

Grants are the preferred financing option for environmental projects even for revenue-generating or cost-saving projects. Integrating grants into financial instruments is an option that allows projects to become economically viable and bankable at the same time. Investment grant elements in loan or guarantee instruments should act as enabler for the uptake of financial instruments in the Environment sector.

5.4 Technical Assistance

The provision of TA can facilitate the smooth implementation of financial instruments in the sector, and can be implemented at the level of public authorities, project promoters, as well as final recipients. Smaller municipalities could benefit from an access to technical assistance when preparing their project(s), business plan(s) or funding applications. Early support to municipal investment plans can also lead to better prepared projects.

The EU needs to undertake significant additional investment to implement the existing environmental legislation. Depending on the type of investments and the type of final recipients, financial instruments addressing the environmental infrastructure investment gap can either provide long-term debt or equity to large waste or water infrastructure projects, or provide financing to enterprises and/or households. Barriers to investment in this sector relate to high upfront investment cost, uncertain demand and limits to public debt. Financial instruments may be part of the solution, providing long-term financing at preferential conditions. Barriers to the development of such ERDF / CF supported financial instruments however also exist. In this context, key enabling factors for a better uptake of ERDF / CF-supported financial instruments in the environmental sector are: combining financial instruments with grants, integrating environmental aspects into other 'larger' financial instruments, and designing financial instruments-friendly Operational Programmes.

www.fi-compass.eu
contact@fi-compass.eu

European Commission
Directorate-General
Regional and Urban Policy
Unit B.3 "Financial Instruments and IFIs' Relations"
B-1049 Brussels

European Investment Bank
Advisory Services
fi-compass
98-100, boulevard Konrad Adenauer
L-2950 Luxembourg