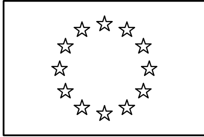

EUROPEAN COMMISSION

Brussels, 13.7.2011
C(2011) 4942 final

Subject: SA.32835 (2011/N) - United Kingdom
Northwest Urban Investment Fund (JESSICA)

Sir,

The Commission wishes to inform the UK that, having examined the information notified by your authorities on the matter referred to above, it has decided not to raise objections to the above-mentioned measure for the reasons set out below.

1. PROCEDURE

(1) By letter dated 7 April 2011, the UK authorities notified, in accordance with Article 107(3) TFEU (Treaty on the Functioning of the European Union), the above-mentioned measure to be assessed directly under Article 107(3)(c) TFEU. The UK authorities had pre-notified a UK-wide measure under PN 223/2010 in September 2010.

(2) Following a number of informal exchanges of information with the UK authorities, the Commission requested further information by letter of 7 June 2011. A meeting with the UK authorities and representatives of the European Investment Bank took place on 9 June 2011. Following a number of additional informal exchanges of information, the UK authorities replied on 20 June 2011. The Commission requested further clarifications on 22 June 2011 which the UK authorities provided on 23 June 2011.

2. DESCRIPTION OF THE MEASURE

2.1. Overview

(3) The UK authorities and the European Investment Bank (EIB) have set up a JESSICA Holding Fund under the name of the Northwest Urban Investment Fund (NWUIF). The NWUIF operates as a Holding Fund (fund of funds) and will support investments via financial intermediaries, so-called Urban Development Funds (UDFs), in urban regeneration projects in order to facilitate sustainable and integrated urban development in the Northwest region of England.

The Rt Hon William HAGUE
Secretary of State for Foreign Affairs
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United Kingdom

(4) The NWUIF has been set up based on the European Commission's JESSICA (Joint European Support for Sustainable Investment in City Areas) initiative, supported by the EIB and the Council of Europe Development Bank. The initiative is designed to help Member States use financial engineering mechanisms to support investments in sustainable urban development in the context of EU Cohesion Policy for the programming period 2007-2013, as governed by the Structural Funds Regulations (including the General Regulation, the ERDF Regulation, the ESF Regulation, and the Implementing Regulation and collectively referred to as the SF Regulations).[1]

(5) In line with the SF Regulations,[2] the terms and conditions of the public funds provided by the UK authorities to the NWUIF are contractually specified in the Funding Agreement between the UK authorities and the EIB acting as the NWUIF manager, signed on 12 November 2009, as amended by an Amendment Agreement dated 24 March 2010 and a further Amendment Agreement dated 25 February 2011.

(6) Likewise, in accordance with the SF Regulations,[3] the terms and conditions of the public funds provided by the NWUIF to the UDFs will be specified in the Operational Agreements between the EIB and the selected UDFs. According to the UK authorities, these agreements will be signed in summer 2011. The UK authorities stated in their notification that the draft Operational Agreements notified for the purpose of the present proceedings will be amended to comply with the conditions of the notified measure with a view to their approval by the Commission.

(7) These agreements are the key documents which set out the responsibilities, tasks and objectives of the financial intermediaries and their obligations, designed to be in line with the SF Regulations on financial engineering and EU rules, including the State aid rules. Under the notified measure, sub-commercial public investments will be made where the market would not deliver urban regeneration projects by itself in order to provide the necessary incentives to private investors. Moreover, public support will be limited to the minimum necessary to avoid undue distortions of competition in the internal market.

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1 Financial engineering instruments pursuant to Article 44 of Regulation (EC) No 1083/2006, hereafter referred to as the 'General Regulation' (amended by Council Regulation (EC) No 284/2009 of 7 April 2009 and further amended by Council Regulation (EC) No 539/2010 of 16 June 2010), Articles 3(2)(c), 4(1), 5(1)(d) and 6(2)(a) of Regulation (EC) No 1080/2006, hereafter referred to as the 'ERDF Regulation', Article 11(1) of Regulation (EC) No 1081/2006, hereafter referred to as the 'ESF Regulation' and Articles 43 to 46 of Regulation (EC) No 1828/2006, hereafter referred to as the 'Implementing Regulation'. Throughout this note these Regulations will also be referred to as the 'SF Regulations'. Under Article 43 of the Implementing Regulation, financial engineering instruments are 'actions which make repayable investments, or provide guarantees for repayable investments, or both'. For further information, see: http://ec.europa.eu/regional_policy/thefunds/instruments/jessica_en.cfm

http://www.eib.org/products/technical_assistance/jessica/background/index.htm.

2 Article 44 of the Implementing Regulation sets out provisions relating to investment policy and instruments, the investment process, governance rules, fund managers and fees, monitoring and reporting and compliance with applicable laws and regulations, including provisions for State aid compliance.

3 Article 43(3) of the Implementing Regulation. The agreement should include at least the investment strategy and planning, arrangements for monitoring implementation in accordance with applicable rules, an exit policy, and the winding-up provisions.

2.2. Funding approach and architecture

2.2.1. Funding approach

(8) As explained by the UK authorities, public authorities have traditionally undertaken urban regeneration activities as so-called 'direct development' by acquiring and assembling land, carrying out site clearance and remediation, and developing enabling infrastructure and public realm, which would not otherwise have been carried out by the market. They would then provide access by selling/leasing/renting developed sites and premises to the private sector for commercial development. While in some circumstances this has proved a useful mechanism, according to the UK authorities it is not always the most efficient use of public funds.

(9) In addition, public authorities have supported private sector-led regeneration activities through grants under the 'gap funding' approach to cover the difference between gross development costs, including a reasonable profit, and estimated gross development values. According to the UK authorities, public sector gap funding has proved an effective tool for addressing regeneration policy objectives and specific market failures. However, the grant approach is not always appropriate or sustainable, as the public sector does not benefit financially from the investments in new developments, although some measures could include a claw-back mechanism for grant repayment, if the actual value of development were to exceed the initial forecasts.

(10) As explained by the UK authorities in the notification, the NWUIF will pursue an investment approach to support urban regeneration activities. Public funds will be invested in the form of equity or loans on a sub-commercial basis aimed at encouraging project developers and other investors to provide funding and proceed with those projects that are not sufficiently viable if financed on a commercial basis.[4] The NWUIF will therefore enable the project developers to regenerate the property for commercial use in the target urban areas. While achieving the policy objective, the NWUIF will be capable of capturing the value created from urban projects and produce financial returns to the UK authorities.[5]

2.2.2. Funding architecture

(11) The public funds under the measure will be deployed through a cascade of investment vehicles based on the funding structure envisaged by the SF Regulations. In particular, the public funds contributed to the NWUIF will be provided as a contingent loan to two selected UDFs which are investment vehicles that will invest directly in urban projects in the form of equity and loans. The UDFs are not permitted to carry out urban projects directly. Instead, they provide funding to a range of project promoters (public or private) that will carry out the development activities.

[4] The NWUIF funds will also be deployed where possible through market-conform investments in the form of market-priced loans and/or equity invested on *pari passu* terms with private investors in commercially viable urban projects.

[5] Under a project finance model, a project company typically raises equity and debt to finance the construction of the project and pays off the financing from the revenues that the project generates. The equity is provided by the shareholders of the project company, the so-called project promoters that are developers, and third-party financial investors that are responsible for project activities and make investments in order to generate returns, while debt is raised by the promoters in the market especially when the project starts yielding returns.

(12) Following a competitive selection procedure, the EIB (as NWUIF manager) selected two UDFs: Merseyside UDF, which is focused on the Merseyside sub-region and established by Igloo Regeneration Limited that will be acting as the Merseyside UDF manager, and Evergreen UDF, which is focused on the rest of the Northwest region, is established by a number of Local Authorities of the rest of the Northwest area and is managed by CB Richard Ellis (section 2.5 provides further details on the two UDFs).

(13) The UK authorities have provided a contribution of GBP 100 million to the NWUIF, which includes GBP 50 million of ERDF funding and the equivalent match funding[6] of GBP 50 million from the Northwest Development Agency (NWDA) — GBP 12 million in cash and GBP 38 million in land asset contributions (land that could either be sold to generate cash for further investment in the UDFs, replaced by any other public/private match funding at project level or provided to the UDFs for in-kind equity contributions by the UDFs to urban projects).

(14) As set out in the Operational Agreements, each UDF will receive GBP 30 million in cash from the NWUIF in the form of a contingent loan, the key parameters of which are:

(a) Since the NWUIF should seek to be financially self-sustaining, the UDFs should seek to repay the contingent loan within the timeframe outlined in (c) and (d) below. Yet as the ultimate objective of the NWUIF is not to maximise financial return, but to ensure that the supported urban regeneration projects produce economic and social benefits, repayment could be with a minimum return expectation of not less than zero return net of management fees.

(b) All interest payments generated on the NWUIF investment will be repaid by the UDFs to the NWUIF and will be used primarily for the payment of the NWUIF management costs.

(c) If they arise prior to 10 years from the date of signing the Operational Agreement with the NWUIF (i.e. before 2021), the UDF can retain and reinvest repayments from UDF investments (but not interest payments) in other urban projects that comply with the conditions of the notified measure.

(d) If they arise after 10 years from the date of signing the Operational Agreement with the NWUIF (i.e. after 2021 and until 2031), all repayments of capital and interest on UDF investments in urban projects will be repaid to the NWUIF.

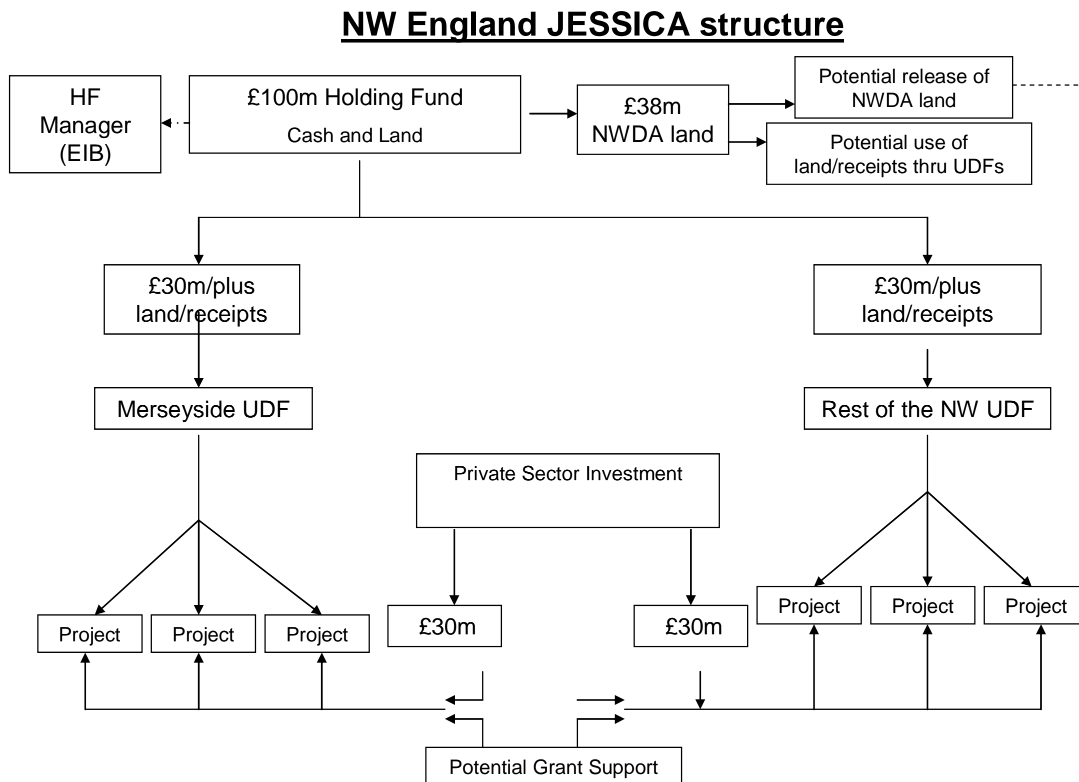
(15) In accordance with the Operational Agreements, the initial GBP 30 million contingent loans provided by the NWUIF to the UDFs must be invested by the UDFs alongside an additional GBP 30 million in public/private match funding that could be sourced at UDF and/or project level.[7] Match funding may include land contributions by the UK authorities to the UDFs. As stated in Article 7.2 of the Funding Agreement, the in-kind contributions by the UK authorities must be at a market value that has been established in accordance

[6] In accordance with the SF Regulations, the ERDF can fund up to a maximum of 50% of each operation, while the equivalent amount must be match funded through contributions from public and/or private resources, which must be invested in UDFs and/or urban projects at the same time.

[7] To avoid doubt, the match funding requirement should be treated separately from the minimum private investment requirement in point 2.8.2.1.

with Article 2 of the Commission Communication on State aid elements in sales of land and buildings by public authorities (the Communication on Land Sale).[8]

(16) The chart below shows the funding architecture and funding flows:



(17) According to the UK authorities, the notified funding structure has a number of advantages:

(a) Investment decisions will be delegated to independent and professional UDF fund managers. The UDFs are required to take prudent investment decisions and balance investment performance while at the same time achieving the policy objectives defined in their respective investment strategies.

(b) The two UDFs are specialised legal structures that allow additional funding to be leveraged, as the public resources and other public/private funding can be pulled together at fund as well as project levels to channel the funds to the final recipients.[9]

(c) It mitigates investment risks through the 'portfolio effect' and allows for more effective controls. The NWUIF invests in two UDFs (Merseyside UDF and Evergreen UDF) that will invest across a range of urban projects so as to diversify exposure. By investing on a repayable basis, the structure enables a sustainable future fund to be created.

[8] OJ C 209, 10.7.1997, p. 3.

[9] Institutional investors (pension funds, insurance companies) may not have the specialist expertise required to appraise individual projects and carry out investment follow-up.

2.3. Granting authority, legal basis, duration and budget

2.3.1. Granting authority

(18) The granting authority that has set up and provided public funding to the NWUIF is the Northwest Development Agency or its legal successor.

2.3.2. Legal basis

(19) The legal basis is the Regional Development Agencies Act 1998 (or any successor legislation), the SF Regulations applicable to financial engineering instruments, the Funding Agreement between the UK authorities and the EIB of 12 November 2009 establishing the NWUIF, as amended by Amendment Agreements dated 24 March 2010 and 25 February 2011, and the Operational Agreements between the EIB (as manager of the NWUIF) and Merseyside UDF and Evergreen UDF respectively which, according to the UK authorities, are expected to be signed in summer 2011.

(20) The draft Operational Agreements with Merseyside UDF and Evergreen UDF sent to the Commission will be amended on the basis of the conditions agreed with the Commission in the context of the notification proceedings and reflected in the final notification documents. The UK authorities have agreed to send copies of the amended Operational Agreements to the Commission, once signed.

2.3.3. Duration

(21) The duration of the measure is 10 years, i.e. from the date of the Commission's approval until 15 July 2021. The duration corresponds to the 10-year lifespan of the UDFs: the initial UDF investments of GBP 100 million in urban projects until the end of 2015, as required by the SF Regulations, and subsequent investments (up to GBP 200 million) in urban projects from the returns generated by the initial investments until 2021. The UDFs will be operational until 2031, by which time all the investments must be repaid to the NWUIF.

(22) According to the UK authorities, the 10-year duration is required to reflect the long-term nature of urban regeneration projects and their financing needs. It will help to provide the certainty necessary to attract further private-sector investment at UDF level and secure the optimum terms for this potential investment. This duration is also considered sufficient to enable a depth of information to be assembled in respect of appraisal methodologies to help address the market failures that are currently acting as barriers to development and investment. It also reflects the average duration of the EIB's own loan terms.

2.3.4. Budget

(23) The overall budget for the duration of the measure is up to GBP 500 million, comprising GBP 300 million for repayable investments and GBP 200 million for grants:

(a) GBP 100 million has been provided by the UK authorities to the NWUIF based on the funding flows described in the chart above (including match funding at both UDF and project level), to be used for initial investments until the end of 2015 including both sub-commercial investments that are part of this measure and investments that are in conformity with the market economy investor principle (MEIP).

(b) After 2015, up to GBP 200 million from resources returned to the UDFs from initial investments or from further NWUIF investment in the UDFs will be used for subsequent investments until 2021.

(c) Up to GBP 200 million is estimated for grant funding for the duration of the measure (until 2021), which will be combined with repayable investments under the measure and will be subject to the same conditions as the repayable investments.

2.4. The NWUIF

(24) As indicated above, the terms and conditions for the contribution by the UK authorities to the NWUIF are set out in the Funding Agreement with the EIB (as manager of the NWUIF), the key points of which are described below.

2.4.1. NWUIF Investment Strategy

2.4.1.1. Policy focus

(25) As required by the SF Regulations[10] and pursuant to the Funding Agreement, the NWUIF's operations are governed by an 'Investment Strategy and Planning Document' which forms an integral part of the Funding Agreement (the Investment Strategy). Pursuant to Article 8(4) of the Funding Agreement, the Investment Strategy must take into account any relevant urban development studies or evaluations and any integrated urban development plans included in the Northwest Operational Programme.

(26) As indicated in the Investment Strategy, the business case for the NWUIF has been established based on the *ex ante* evaluation of market gaps, which also assessed the fit with the policy objectives and value for money. In addition to the JESSICA Wide Scoping Study for the UK,[11] the EIB commissioned a 'JESSICA Evaluation Study' in early 2009[12] which outlined the case for using JESSICA in the Northwest region of England. In September 2009, the UK authorities commissioned a further study to establish the business case for the NWUIF.[13]

(27) As stated in the Investment Strategy, the NWUIF will operate in line with the Northwest Regional Economic Strategy (the RES), which sets out an integrated social, economic and environmental framework for the future development of the Northwest region over a 25-year period and sets out a framework for regional, sub-regional and local action. The RES covers five sub-regions (Greater Manchester, Merseyside, Cheshire & Warrington, Lancashire and Cumbria). Each sub-region has developed a Sub-regional Action Plan.

(28) In accordance with the SF Regulations, the NWUIF has to operate on the basis of integrated plans for sustainable urban development (IPSUDs), including local IPSUDs approved by responsible local authorities. According to the UK authorities, urban regeneration is an explicit aspect of the Northwest Regional Economic Strategy that is the

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[10] Article 44(6) of the Implementing Regulation.

[11] JESSICA Preliminary Evaluation Study for the UK, January 2007.

[12] Northwest Evaluation Study carried out by King Sturge, June 2009.

[13] Northwest JESSICA Fund Business Case by EKOS Consulting, September 2009.

overarching IPSUD. The UK authorities confirmed that the overarching IPSUD is in line with the criteria set out in the Community Strategic Guidelines on Cohesion 2007-2013.[14]

(29) In addition to the IPSUDs, the NWUIF's operations will be aligned with the Northwest Operational Programme (the NWOP) and the associated Investment Frameworks, which are based on the region's current RES and are the underlying documents for investing the ERDF allocation for the period 2007-2013. The NWUIF will focus on the following Priority Axes of the NWOP:

(a) Action Area 3.2, which seeks to develop high-quality sites and premises by targeting investments in the 36 Strategic Regional Sites defined in the RES and agreed by the NWOP Monitoring Committee;

(b) Action Area 4.3, which focuses on the areas of regeneration need, i.e. so-called areas of socio-economic deprivation, in the priority spatial areas set out in the Investment Strategy. The objective of this action area is to encourage employment creation by supporting the development of sites and buildings for economic use.

(30) According to the Investment Strategy, the NWUIF will focus on property regeneration in the above-mentioned urban areas, aiming to bring back into commercial use land or buildings which are derelict, contaminated, under-used or vacant. According to the UK authorities, regeneration is defined as a set of activities that seek to reverse economic, social and physical decline in areas where market forces alone will not do this.[15]

(31) The NWUIF will therefore support a range of property regeneration projects involving a number of activities, such as land assembly and remediation, the development of site-related infrastructure, the development or refurbishment of premises and associated public realm works (urban projects). Modern business space for mixed use will be developed, such as offices, light industrial space or warehousing, in line with the planning use classifications.

(32) As pointed out in the Investment Strategy and studies undertaken prior to the establishment of the NWUIF, the rationale for the NWUIF is twofold. It will seek to enhance the economic performance in the target urban areas by addressing market failures inherent in urban regeneration projects, focusing on market failures on both the demand side (project developers that carry out regeneration projects) and the supply side (investors and lenders who provide finance). In addition, it will seek to strengthen socio-economic cohesion among the urban areas of the Northwest region, thus pursuing a cohesion objective. A summary of the findings of the above-mentioned studies is given below.

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[14] Article 8 of the ERDF Regulation and Section 2.1 of the Annex to Council Decision 2006/702/EC of 6 October 2006 on Community strategic guidelines on cohesion, OJ L 291, 21.10.2006. According to the Strategic Guidelines, the following aspects should be included in an integrated urban development plan: a definition of the target urban areas and the geographic focus of projects, an analysis of urban socio-economic and environmental needs, the demand for assets/services and a coherent development plan (a multi-purpose, multi-sector approach, including the elements of a land-use plan).

[15] Review of sub-national economic development and regeneration, HM Treasury, Department for Business, Enterprise & Regulatory Reform (BERR) and Communities and Local Government, July 2007.

2.4.1.2. Rationale: tackling market failures (an efficiency objective)

(33) The economic studies provided by the UK authorities in the context of their notification have identified a number of market failures related to integrated urban regeneration projects that pursue sustainable urban development objectives. These make it difficult to attract investors and developers to certain projects that would generate new economic activity. The analysis points out that market failure reflects a number of issues, such as undersupply of property due to a perceived lack of demand, low returns generated by regeneration projects (below the level which the market will accept), and both negative (contamination issues) and positive externalities.

(a) Demand-side market failures: nature of projects

- *Imperfect information/information asymmetries*

(34) Imperfect information exists where it is difficult or expensive to gain detailed information on demand either because markets are weak or because information is expensive (or in some cases impossible) to collect. This creates uncertainty which the market seeks to price into projects. Alternatively, there may be assumed site problems or contaminated ground conditions in respect of which it may be expensive and/or impossible to gain full and robust information. These unknowns also create perceptions of high investment risk from both developer and funder perspectives and tend to lead to a decision not to invest/develop.

(35) Information is not only imperfect but can also be asymmetric, with funders and developers possessing different levels and depth of information about local markets in general and specific developments in particular. This tends to result in both sides using limited information to justify their own position, and to their own advantage, without the benefit of the information held by the other. Information asymmetries reflect the high and uncertain risks attributed to urban regeneration by developers and investors. This increases risk aversion among investors and results in overly conservative projections of the value of new developments, which often means that investors perceive development to be economically unviable.

(36) Regeneration projects often involve significant upfront preparatory costs and lengthy pre-construction and construction periods. This leads to potentially significant time lags before value can be realised for investors. Urban regeneration is associated with high-risk development, involving the need to address contamination, dereliction and site assembly or remediation issues. These costs are often uncertain in nature and may also involve environmental liability risks where development is undertaken on what was contaminated land.

(37) Developers/investors tend to ascribe inappropriate levels of investment risk to particular developments not only due to the nature of projects, but also based on the spatial characteristics of sites, demand uncertainty and low end values. Project viability may be affected by the fact that it is located in a deprived urban area characterised by a low-income population, high unemployment and social exclusion, which may lead to higher development costs and uncertain revenues due to an underdeveloped market. In addition, the characteristics of urban regeneration sites often result in information failures related to their valuation.

(38) Imperfect and asymmetric information gives rise to scenarios where funding markets do not provide funds for developers, who in turn are unable to fund regeneration projects. In some circumstances, even when funding is available, developers may choose not to pursue particular regeneration projects due to information failures leading to the perception of high investment risk which they are unable to include in the pricing mechanism. Thus, the market often perceives regeneration, especially until completion and the confirmation of first results, to be commercially unviable and does not take the projects forward, even though this would be efficient from a wider economic perspective.

- *Externalities*

(39) In the case of regeneration projects there are a number of positive externalities that cannot be included in the pricing mechanism. The regeneration activities will take place on previously developed urban sites (i.e. brownfield sites), which will have wider positive regeneration benefits beyond the normal property returns that the private sector is seeking to achieve. Private markets may fail to capture collective benefits such as environmental benefits, improved neighbourhoods and health impacts.

(40) A major concern regarding regeneration projects is internalisation of the positive externalities generated by those project components that are public goods and produce no or insufficient revenues. Such components may be integral to an urban development project and not particularly profitable in their own right (e.g. public spaces, residential parking etc.), but nevertheless necessary for the overall success of the project.

(41) Negative externalities could also affect the commercial viability of regeneration projects. This is the case where sites have previously been developed and/or are contaminated and where the cost of redevelopment is abnormally high — this will lead to a position where costs are greater than values. In this instance the market would choose not to intervene but the public sector might if it could achieve the wider regeneration benefits.

(42) Another constraint which constitutes a barrier to development may also lie in the location of the land and possibly restrictions placed on its use under the land use planning system (e.g. a town centre site cannot be used for warehousing or parking because of transport issues). In such cases, the current landowners will frequently decide to leave the site vacant rather than paying for its development or accepting an inevitably very low price for someone to take it off their hands.

(b) Supply-side market failures: the financial markets

(43) On the supply side, the studies point to the lack of funding (loan/equity) to deliver regeneration projects. Due to capital and liquidity constraints faced by commercial banks it has become more difficult to obtain bank loans with the long maturities required by urban projects. The perception of higher risks also affects the level and pricing offered by debt providers. As a result, the regeneration projects are less able to attract bank loans and when loans can be contracted, they are more expensive, thereby increasing financing costs and further impacting on the financial viability of projects.

(44) The perception of risks also affects the level of return that equity investors require and the levels of risk that they are willing to accept. Insufficient debt funding often leads to investors requiring higher levels of equity before they will provide finance. Higher returns required by equity providers again increase financing costs and impact on the overall financial viability.

2.4.1.3. Rationale: tackling socio-economic deprivation (an equity objective)

(45) The other rationale for the NWUIF is based on the wider equity or distribution objectives of delivering economic growth in underperforming urban areas of the Northwest region. Therefore, in addition to investments on brownfield land located in the Strategic Regional Sites, the NWUIF's activities will also be specifically targeted at the so-called urban regeneration areas specified in both the Action Areas of the Investment Frameworks identified above. It will address distribution objectives by creating new business premises in areas that would normally have limited, if any, property development activity.

(46) Based on the information provided by the UK authorities, the above-mentioned urban regeneration areas suffer from physical, economic and social deprivation and are characterised by a weakened economic base, low levels of employment and a poor physical environment. The deprived urban areas can be small and localised, and in some instances found within relatively prosperous regions and often outside assisted areas eligible for regional aid. These characteristics of the above-mentioned urban regeneration areas are based on a formal definition adopted by the Department for Communities and Local Government (CLG).[16]

(47) Urban projects carried out in the above-mentioned urban regeneration areas often involve higher costs due to public good components, which may affect their financial viability. Moreover, the very characteristics of distressed urban areas make the projects commercially less attractive due to the perception of risks concerning market strength, which may affect end values and mean that the market being less willing to proceed. As a result, it is unlikely that the private sector would invest in the underperforming urban regeneration areas.

2.4.2. NWUIF set-up

(48) In line with the SF Regulations[17] and pursuant to Article 3(1) of the Funding Agreement, the NWUIF has been set up as a separate block of finance within the EIB, as NWUIF manager. As stated in Article 3(2) of the Funding Agreement, the funds are to be held by the EIB (as NWUIF manager) exclusively for the purpose of funding operations under the measure.

[16] 'Transforming Places, Changing Lives', 2008.

[17] Article 43(2) of the Implementing Regulation.

2.4.3. NWUIF manager

(49) In line with the SF Regulations[18] and following the recommendation of the NWDA Business Case,[19] the UK authorities have appointed the EIB to act as the manager for the NWUIF based on its specialist skills and expertise, through the direct award of a contract. In its day-to-day management of the NWUIF, the EIB will apply its own internal rules and procedures.

(50) Pursuant to Article 8(1) of the Funding Agreement, the EIB must manage the NWUIF in accordance with the Investment Strategy. In line with the SF Regulations[20] and Article 4 of the Funding Agreement, the NWUIF manager is responsible for selecting and setting up the UDFs and monitoring their operations:

(a) Selection phase: procuring UDFs (evaluation of the business plans submitted by the UDFs and the quality and remuneration of the manager), negotiation and signing of Operational Agreements with the UDFs;

(b) Operation phase: evaluation of the updated business plans submitted by the UDFs in the operation phase, monitoring and overseeing UDF investment activities in accordance with the Operational Agreements and reporting;

(c) Treasury management of the funds not invested in the UDFs in accordance with Appendix 4 (Idle Funds Policy) to the Funding Agreement.

(51) Under Article 4(7) of the Funding Agreement, if the EIB is involved in financing a UDF or an urban project that will be receiving a financial contribution from the NWUIF to the UDFs, the EIB must ensure that conflicts of interest, where identified, are appropriately managed.

(52) The SF Regulations[21] cap the holding fund management fee at 2 % on a yearly average of the capital contributions, which reflects market levels for such fees. The UK authorities negotiated management fees for the EIB that are lower than the regulatory cap, at a yearly average of [0,5-2%][*] of the total contributions made. Under Article 11(1) of the Funding Agreement, the fee is calculated on the aggregate of all assets contributed to the NWUIF, including in-kind contributions.

2.4.4. NWUIF Investment Board

(53) As provided for in Article 5 of the Funding Agreement, an independent Investment Board has been established to oversee the NWUIF and will be responsible for governing the NWUIF operations, which includes approving or rejecting recommendations made by the EIB as NWUIF manager. In order to ensure professionalism and independence of the investment decisions, the Investment Board has the power only to approve or reject the

18 Article 44(1) of the General Regulation.

19 Northwest JESSICA Fund Business Case by EKOS Consulting, September 2009.

20 Article 44(1) of the General Regulation.

21 Article 43(4a) of the Implementing Regulation.

* A range due to a business secret.

proposals and recommendations proposed by the EIB in their entirety. However, it does not have the power to change the recommendations of the EIB as NWUIF manager.

(54) In line with Article 5(2) of the Funding Agreement, as amended, the Investment Board is currently composed of nine members and includes appointees of the UK public authorities and three external independent experts that have been appointed after a rigorous selection exercise undertaken by the UK authorities and an independent recruitment consultant. The experts have expertise in the field of urban and public infrastructure financing or urban planning or other competences appropriate to the Investment Strategy of the NWUIF. The EIB has been consulted on all proposed Investment Board members.

(55) All members of the Investment Board must act independently in the sole interest of the NWUIF. The Investment Board is governed by strict rules of procedure which address issues such as independence and conflicts of interest, pursuant to a code of conduct. The Investment Board must comply with the requirements for the Investment Board set out in the Funding Agreement (Appendix 5 to the Funding Agreement). Decisions or recommendations by the Investment Board are to be adopted by simple majority.

2.4.5. NWUIF investment process (selection of UDFs)

(56) As required by the SF Regulations[22] and in line with Articles 4(1) and 9 of the Funding Agreement, the EIB has selected the UDFs through its internal UDF selection process. The selection was based on a call for expressions of interest that was published in the *Official Journal of the European Union* and on the EIB's website,[23] to ensure transparent and equal treatment. In line with the SF Regulations[24] and pursuant to Article 9(3) of the Funding Agreement, the appraisal and selection was based on *ex ante* defined outline investment strategies and business plans established by the UDFs that were assessed by the EIB in the light of the Investment Strategy to ensure that they can achieve the policy objectives and deliver the desired economic impact.

(57) To ensure the financial sustainability of the NWUIF, the EIB carried out the credit/investment risk assessment of potential UDFs. The assessment of the business plan also included an assessment of the indicative project portfolio identified by the UDFs since the repayment of the NWUIF investment will ultimately depend on the performance of the underlying UDF urban project portfolio (the initial project portfolio included in the business plan submissions was only indicative and could therefore not be interpreted as exhaustive; it is based on instances where the UDF manager has made initial contacts with project developers[25]).

(58) In addition, since the NWUIF delegates investment decisions to the UDFs, it relies on their appraisal, risk management and monitoring standards. Therefore, the EIB also assessed the

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[22] Article 44(2b) of the Implementing Regulation.

[23] http://www.eib.org/products/technical_assistance/jessica/eoi/northwest-urban-investment-fund%20.htm.

[24] Article 43(2) of the Implementation Regulation sets out requirements for the business plans: they must specify investment strategies, target projects, investment conditions, the governance structure, management requirements, including remuneration, compliance and winding-up provisions.

[25] According to the information provided by the UK authorities, there was a list of over 230 possible projects, of which a shortlist of 14 potential projects was selected for subsequent financial and economic appraisal by the UDFs.

quality of the UDFs' governance structure, investment process, exit policy, management capacity and structure and level of management remuneration (see the section on the UDFs below for further controls, such as contractual obligations in respect of management, monitoring and reporting, performance incentives and private co-investment).

(59) The following two UDFs have been selected following the above-mentioned selection process:

(a) ***Merseyside UDF*,** focused on the Merseyside sub-region and established by Igloo Regeneration Limited, which will be acting as the Merseyside UDF manager. Igloo is a property developer and fund manager that currently runs Blueprint, a public sector fund structure (operating under MEIP principles) similar to JESSICA in the East Midlands.

(b) ***Evergreen UDF*,** focused on the rest of the Northwest region and established by a number of Local Authorities of the rest of the Northwest area. It is managed by CB Richard Ellis, a property advisory consultancy that provides a wide range of agency, asset management and property finance services.

2.4.6. NWUIF treasury management

(60) In accordance with the Idle Funds Investment Policy specified in the Funding Agreement, the funds contributed to the NWUIF and not yet disbursed to a UDF are placed either in interest-bearing accounts at the EIB or on deposit with a commercial bank selected by the UK authorities. According to the UK authorities, the funds could be deposited in any bank established in the EEA. The idle funds could otherwise be invested in line with the principle of sound financial management. According to the UK authorities, the idle funds management will be carried out at market conditions and must yield market rates which will be used to cover in part the NWUIF management costs.

2.4.7. NWUIF exit policy

(61) In accordance with Appendix 3 to the Funding Agreement, the exit policy of the NWUIF from the underlying UDFs will be set out in the Operational Agreements. The Funding Agreement sets out a potential exit scenario where the NWUIF funds could be reattributed to the EIB for further management of the funds, transferred to another entity performing the NWUIF manager function or transferred back to the UK authorities.

2.5. The UDFs

(62) As indicated above, the terms and conditions for investments by the EIB (on behalf of the NWUIF) in the UDFs, including the conditions for the UDF investments in urban projects, are set out in each Operational Agreement, the key points of which are described below. As also indicated above, the UK authorities confirmed that each Operational Agreement will be amended to fully comply with the commitments provided to the Commission in the context of the notification.

2.5.1. UDF investment strategies

(63) In accordance with Article 10(2) of the Funding Agreement and the Operational Agreements, the UDFs must make repayable investments in line with the Investment Strategy and in compliance with the EU rules and any other applicable rules, including those relating to State aid. It will act in accordance with its investment strategy and business plan that have been reviewed and approved by the EIB as part of its due diligence and can only be amended with the explicit approval of the EIB and the UK authorities. Furthermore, the UDFs must achieve the physical output targets set out in the Investment Strategy, such as new or refurbished floor space (225 000 m2), hectares of brownfield land reclaimed (18 ha) and gross jobs created (7 300).

(64) In addition to the policy objectives, in line with the respective UDF investment strategies and as set out in the Operational Agreements, the UDFs should seek to be financially self-sustaining so that investments can be recycled and generate returns above the initial capital invested, thus enabling the contingent loan to be repaid to the NWUIF.

2.5.2. UDF set-up

(65) The UDFs are investment vehicles that have been set up for the purpose of providing financing for the urban projects. In line with the SF Regulations,[26] they will be established as separate legal entities governed by agreements between the co-financing partners or shareholders; specifically:

(a) ***Merseyside UDF's*** legal structure is still being finalised. According to the UK authorities, it is most likely going to be in the form of a company limited by guarantee or shares (wholly owned by Igloo Regeneration Limited), which reflects the fact that Igloo Regeneration Limited is the sole entity that has set up the UDF.

(b) ***Evergreen UDF*** will be based on a Limited Partnership structure and will comprise Limited Partners that are local authorities within each of the four sub-regions covered by Evergreen UDF that have subscribed equity to the UDF.[27] The General Partner (a separate legal entity) will be established to undertake the operational management of the partnership and it will be accountable to the Limited Partners.

2.5.3. Private investors in the UDF

(66) Private investments[28] in the UDFs could be made on non-*pari passu* terms (not equal risks and rewards) with the public funds invested in the UDFs, which will only be granted in relation to new portfolio investments undertaken by the UDFs, i.e. not the existing project portfolio. Preferential treatment of private investors will only be offered in relation to sub-commercial UDF investments under the measure. This preferential treatment will take the

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[26] Article 43(2) of the Implementing Regulation.

[27] Equity holdings of GBP […]* each.

[28] Under the measure, the term 'private investor' means any investor no matter whether private or public that invests its money in a profit-oriented way, following market economy logic in a way defined by the Court for meeting the requirements of the Market Economy Investor Principle. See for example case T163/05, Bundesverband deutscher Banken/Commission, OJ C 100 17.4.2010, page. 37.

* Business secret

form of the upside risk protection specified under point 2.8.1 below and may not exceed fair market rates for the same type of investment, in line with the criteria set out under point 2.7.2.2 below.

(67) Should the UDF managers become involved in the financing of urban projects that will be receiving UDF investments under the measure, they will be required to invest on *pari passu* terms with the UDF investment. If the UDF managers are involved in financing an urban project that will be receiving a financial contribution from the UDFs, they must ensure that any conflicts of interest are appropriately managed. The UDF manager will respect arm's length principles and keep transparent records for reporting, monitoring and auditing purposes.

2.5.4. UDF managers

(68) The day-to-day management of the UDFs will be delegated to the selected UDF managers, specifically:

(a) ***Merseyside UDF:*** Igloo Regeneration Limited (Igloo) will be acting as the Merseyside UDF manager, advised by Royal Bank of Canada and the property consultancy GVA.

(b) ***Evergreen UDF:*** CB Richard Ellis (CBRE) will be acting as the Evergreen UDF manager (under the term GPREA in the Operational Agreement).

(69) The role of each UDF manager is defined in the Operational Agreement, pursuant to which the UDF managers are responsible for investing in urban projects in line with the *ex ante* approved business plans and the investment strategy set out in the Operational Agreement, including managing the urban projects throughout the investment period. The key tasks for the UDF manager are:

(a) Selection phase: identifying, appraising and structuring investments in viable urban projects which fit within the agreed business plan of the UDF and the NWUIF investment strategy;

(b) Seeking to secure public/private match funding as well as the required level of private funding to ensure that the UDF funds are sufficiently and appropriately leveraged;

(c) Operation phase: monitoring operational and financial performance of urban projects and managing investment exits.

(70) The UDF manager or its advisors must be a financial services company authorised and regulated by the Financial Services Authority (FSA) in the UK under the Financial Services and Markets Act 2000. It must follow professional fund management best practice. Any suitable company set-up anywhere in the EEA and established in the UK is eligible.

(71) In addition, the UDF manager must possess the required capabilities and skills to fulfil the role of UDF manager and apply industry and regulatory standards. The UDF manager must have appropriate management capacity and a suitable track record in financing operations in the commercial real estate development sector. The Operational Agreement contains provisions on professionalism, competence and independence as well as management of conflicts of interest.

(72) The UDF manager must have an Investment Committee to ensure that the proposed investments that the UDF manager submits for the UDF Board's approval/rejection are in line with the UDF's investment strategy. The Investment Committee will be independent from the UDF Board and consist of appropriately qualified and experienced individuals. In Merseyside UDF, it will comprise representatives of the UDF manager (Igloo) and its advisors (RBC and GVA), together with three representatives of the Local Authorities. In Northwest Evergreen UDF, it will comprise four representatives of the UDF manager (CBRE).

(73) Pursuant to the SF Regulations[29] and Article 10(2) of the Funding Agreement, the UDF manager will receive remuneration in relation to its duties under the Operational Agreement. The level of the management fees, which under the SF Regulations are capped at 3 % unless a competitive tendering procedure has revealed that higher rates are necessary, has been determined through the competitive UDF selection process undertaken by the EIB as NWUIF manager, and is established in the Operational Agreement. In the event of non-performance by the UDF, the UDF will receive reduced management fees. The EIB also has the right in the event of non-performance to terminate the Operational Agreement.

(74) An element of the fee structure is paid as a percentage of the value of the invested loans and equity before the end of 2015. According to the UK authorities, this element of the fee structure will reward the UDF manager for selecting/appraising and recommending projects which are compliant with the relevant policies. It also incentivises the UDF manager to invest in projects in a timely manner before the end of 2015.

(75) After 2015, in line with the SF Regulations and the Operational Agreements, the UDF manager may only receive fees from amounts returned from investments in urban projects. According to the UK authorities, since the UDF manager's ability to generate fee income beyond 2015 depends entirely on its ability to invest in sound investment propositions, the fee will incentivise the UDF manager to invest in financially sound projects that have the potential to repay, while at the same time delivering policy objectives and limiting preferential treatment of private investors to the minimum necessary to trigger their investments.

2.5.5. UDF Board

(76) The Board of each UDF will approve/reject recommendations made by the UDF fund manager and ensure that decisions concerning investments, divestments and risk diversification are implemented in accordance with the Operational Agreement. Each UDF Board will include persons appointed by local authorities involved. All members of the UDF Board must act independently in the sole interest of the UDF and are only responsible towards the UDF. Each Operational Agreement includes conflict of interest procedures. Each UDF will be required to provide the EIB with details of the composition and qualifications as applicable of its Board and its Investment Committee as a pre-condition for the effectiveness of the contract.

[29] Article 43(4) of the Implementing Regulation.

(77) While the EIB (as NWUIF manager) is not represented on the UDF Boards, it is involved in the overall supervision of the UDFs through the UDF selection process, the negotiation of the Operational Agreements and the subsequent monitoring of the performance of UDF operations based on quarterly and annual progress reporting. In addition, the UDF manager is required to provide the EIB with a project factsheet for each proposed project (the key items of the project factsheet are defined in the Operational Agreements), prior to investment to enable the EIB to review compliance with the Investment Strategy and the investment strategy of each UDF.

2.5.6. UDF investment process (selection of urban projects)

(78) The measure is a demand-driven instrument where investments are made in principle on a 'first come, first served basis', i.e. project developers will be proposing projects for funding and requesting investments from the UDFs. Investment opportunities will be screened by the UDF managers. The UDFs will be publicly launched and potential stakeholders and project promoters will be invited, which is the same as the approach followed when the NWUIF was launched in December 2009.

(79) A call for project proposals will be publicised at each UDF launch, followed by further regular calls and publicity events. The UDF managers are also expected to utilise their knowledge of the local property markets and developer networks and their UK authority relationships to develop awareness of their respective UDFs with a view to identifying potential investment proposals. Each UDF already has an indicative project portfolio which is identified in its initial business plan/project pipeline.

(80) Following the identification of a potential investment, each UDF will carry out a detailed assessment in line with its investment strategy. The assessment will be on the basis of what, in the UDF's judgment, is the most economically viable proposal, including the level of returns sought by the private investors:

(a) Compliance appraisal to ensure each project fits within the scope and eligibility requirements set out in section 2.6 below;

(b) Investment appraisal - investment due diligence and financial appraisal based on a business plan to ensure that the project is feasible from an economic, social and technical point of view, taking also into account the proposed investment exit strategy, and that the costs and values promoted by the developer are in line with market benchmarks, in accordance with the criteria set out in sections 2.7 and 2.8 below.

(81) According to the UK authorities, the UDF appraisal process ensures competition for UDF sub-commercial investments between project developers and between investors, as it is expected that there will be a higher number of projects seeking resources than the budget available. The UDF appraisal process will ensure that investment proposals are selected based on policy fit (including the ability to meet output targets) and the minimum profit margin sought by the project developers and investors, thus minimising any potential advantage granted to them.

2.5.7. UDF investment exit policy

(82) A return on equity investments will be realised through an investment ‘exit’, in line with the exit policy set out in each Operational Agreement. According to the UK authorities, an exit policy will be devised and agreed in advance before each investment is structured and may include simple repayment of loan investments or selling equity or loan investments to other investors or developers.

(83) As stated in the notification document, before the exit, there will be an independent valuation of any UDF equity investments based on the ‘International Private Equity and Venture Capital Valuation Guidelines’ or other more appropriate and market-recognised standards. Actual value may also be determined through an open-market disposal of assets.

(84) Where an open competition to determine market prices on exit is not possible (e.g. the project developers buy the UDF equity stake), the UDF will be required to review the proposed price achieved to determine whether or not it is line with market expectations. The UDF review will then be further certified by an Independent Expert.

2.5.8. UDF treasury management

(85) In accordance with the Operational Agreements, the public funds committed but not disbursed to urban projects must be placed in an interest-bearing account acceptable to the EIB yielding an interest rate commensurate with market rates that will be used to cover in part the UDF management costs. According to the UK authorities, the funds could be deposited in any bank established in the EEA. The idle funds could otherwise be invested according to the principle of sound financial management.

2.6. Project eligibility requirements

(86) The UDF managers are contractually required by the Operational Agreements to ensure that each urban project complies with the following eligibility criteria, requirements and restrictions. The eligibility requirements reflect the provisions of the SF Regulations as well as the specific requirements imposed by the UK authorities, which altogether form the basis of the notified measure and will be included in the Operational Agreements.

2.6.1. Eligible recipients

(87) In line with the SF Regulations, eligible recipients are public-private partnerships and other projects included in an IPSUD. According to the UK authorities, any undertaking in any ownership or legal form with an economic establishment in the UK is eligible for UDF investments. Urban projects in any industry sector are eligible, with the exception of the following: fisheries and agriculture, shipbuilding, coal industry, steel industry, synthetic fibres and primary production of agricultural products.[30]

[30] The multisectoral framework of the RAG, OJ C 54, 4.3.2006, p. 13.

(88) In line with the SF Regulations, a project is defined as an investment undertaken within a period of three years by one or more companies and consisting of fixed assets combined in an economically indivisible way. To assess whether an investment is economically indivisible, account will be taken of technical, functional and strategic links and immediate geographic proximity. Economic indivisibility will be assessed independently from ownership.

(89) Investments may not be made in urban projects that favour domestic over imported products or focus on the establishment and financing of distribution networks in other countries. Investments may not be made where the company undertaking an urban project is:

(a) subject to an outstanding order for the recovery of aid that has been declared by the Commission to be illegal and incompatible with the common market;

(b) 'a firm in difficulty' within the meaning of Chapter 2 of the Guidelines on State aid for rescuing and restructuring firms in difficulty.[31]

2.6.2. Compliance with policy objectives

(90) The UDFs are required to invest only in urban projects that have a clear public-interest objective to contribute to sustainable urban development. Each urban project must be consistent with the investment strategy and business plan of the UDF. It must contribute to the achievement of objectives, including the output targets, stipulated in the two Action Areas of the NWOP and the objectives of the RES, thus forming part of the overarching IPSUD. In addition, each urban project must demonstrate compliance with the local IPSUDs.

2.6.3. Geographic requirements

(91) The NWUIF and the UDFs will operate in the Northwest of England, covering the five regions of Cumbria, Lancashire, Greater Manchester, Merseyside and Cheshire. The spatial priorities of Merseyside UDF are the Merseyside Local Authority areas and Evergreen UDF will focus on the remaining areas, namely Cumbria, Lancashire, Greater Manchester and Cheshire. Urban projects must be carried out in the spatial areas covered by Action Areas 3.2 and 4.3 defined above.

2.6.4. Eligible activities

(92) As indicated in the NWUIF Investment Strategy, urban projects will seek to bring back into commercial use land or buildings which are derelict, contaminated, under-used or vacant and are suitable for use or conversion for business purposes. Therefore, according to the UK authorities, eligible activities will be focused on primary rather than secondary market projects, i.e. projects in the development or construction phase to create new or extend/refurbish existing establishments, rather than projects in the operating phase.

(93) As defined in the Investment Strategy, the following activities related to urban regeneration projects are eligible:

[31] OJ C 244, 1.10.2004, p. 2.

(a) ***site clearance and remediation;***

(b) ***development of site-specific infrastructure and site servicing***, including site-specific IT/broadband, utilities, energy infrastructure, site-specific transport facilities (e.g. a connecting road to the site);

(c) ***construction of new buildings and/or renovation of existing ones***, including landscaping and public realm works.

(94) In line with the SF Regulations,[32] re-financing acquisitions or existing participations in projects, i.e. replacement investment, is excluded. The creation and development of financial instruments, such as financing venture capital, loan and guarantee funds, is also excluded.

2.6.5. Eligible expenditure

(95) The initial investment, i.e. investments in material assets (assets relating to land, buildings and plant/machinery)[33] which are to be made available for the purpose of setting up new establishments or extending existing establishments, in relation to the eligible project activities must fall under the following cost categories:

(a) ***Land acquisition:*** the cost of purchasing land which is not built on may not exceed the limit of 10 % of the total eligible project costs. A higher percentage may be permitted by the managing authority for operations concerning environmental conservation;[34]

(b) ***Building acquisition:*** the cost of acquiring a building if there is a direct link between the purchase and the objectives of the project;

(c) ***Site investigation and preparation:*** the cost of preparing the land for development, including the cost of site investigation, remediation, reclamation, decontamination and demolition and preparation. The cost of pollution must be assessed in accordance with the polluter pays principle;[35]

(d) ***Building & construction:*** external/internal refurbishment and conversion of existing buildings, new build premises, provision of services (i.e. infrastructure and related services specific to the property), and landscaping;

(e) ***Plant & machinery:*** tangible fixed assets used for the purpose of providing a service for the project. If plant and machinery is subject to hire/lease purchase agreements, the capitalised value of leasing and hire purchase can be included. The purchase costs of second-hand equipment are eligible provided they meet the needs of the projects and

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[32] Article 46 of Regulation 1828/2006.

[33] As defined in Article 2(1)(e) of Regulation 1628/2006.

[34] Article 7 of Commission Regulation 1080/2006 covers the purchase of land and stipulates that 'where land has been purchased, the value of land should not be in excess of 10 % of the total eligible expenditure of the operation'.

[35] The Community Guidelines on State aid for environmental protection, OJ C 82, 1.4.2008, p. 1. Where the person responsible for causing the pollution is clearly identified, that person must finance the rehabilitation in accordance with the polluter pays principle. According to the polluter pays principle in the UK, those responsible for causing the pollution are obliged to make the land safe for its current use. Public support will not be available under the scheme in such cases unless the polluter cannot be identified or made to bear the cost.

have not been purchased with the aid of national or EU grants. If there are any mobile or portable items then an apportionment of costs should be provided separately;

(f) ***Fees***: fees and salaries for design and supervision should not normally exceed 12.5 % of the total eligible costs. Fees include legal consultancy fees, notary fees, and the cost of technical and financial experts if they are directly linked to the project and are necessary for its preparation or implementation, including marketing and disposal fees.

(96) In line with the SF Regulations, the following expenditure is not eligible:[36] interest on debt, decommissioning of nuclear power plants and recoverable value added tax.

2.6.6. Project delivery requirements

(97) An urban project could be implemented through a special purpose vehicle (SPV), a legal entity set up for project activities, or undertaken in an existing corporate structure alongside other commercial activities carried out by that entity. In the case of a corporate structure, there must be separate accounts and cost/revenue allocation in line with the IFRS. Project accounts will be monitored by an Independent Expert (see point 2.10) and audited.

(98) An urban project may not have started before a proposal for UDF funding is submitted and before the UDF takes an investment decision. As pointed out in the Guidelines on National Regional Aid for 2007-2013,[37] the notion of 'start of work' will mean either the start of construction work or the first legal commitment, excluding preliminary feasibility studies. An urban project must be in a state of readiness, i.e. must have planning permission.

(99) In line with the SF Regulations, the urban projects that will receive the first round of UDF investments must be completed (money disbursed) by the end of 2015 and all outputs from the first investment round must be delivered by 2017. According to the UK authorities, urban projects must remain in operation for a minimum period of five years starting on the date of their completion. This should not prevent developed assets being disposed of earlier, although the new owners would be required to maintain the premises for the approved use and the above duration.

(100) In line with the Operational Agreement, each urban project must address the cross-cutting themes and must pursue appropriate environment, health and safety, sustainability and equal opportunities policies. Urban projects must comply with the design principles set out in the Operational Agreements, such as best practices in information and communication technology design, and environmental sustainability (use of renewable energy generation, and where feasible compliance with the NWDA's Sustainable Building Policy).

(101) The assets (land or buildings) on which development will take place should be owned or held via a suitable interest by the prospective project developer (a private or public body) before the UDF investments are made. Project promoters must have a freehold, long leasehold or other suitable interest (which may include a building permit) in the asset on which the investment is to be made.

[36] Commission Regulation 1080/2006.

[37] OJ C 54, 4.3.2006, p. 13, paragraph 38, footnote 40.

(102) According to the notified measure, at any stage of project delivery, the project developer will ensure that all development expenditure is in line with market prices so as to not overcompensate suppliers but rather maximise its own potential return. Market prices for ***physical delivery works contracted to third parties*** will be determined in one of the following ways:

(a) If the developer is a public body, all works will be competitively tendered, in accordance with the EU public procurement regulations, and contracted on normal market terms. This would involve the project developer seeking quotes and obtaining the best prices available so as to avoid overcompensating suppliers.

(b) Where an open competitive tender is not possible (e.g. only one offer is received, the developer has its own in-house construction arm), the UDF managers will verify that the costs do not exceed market prices, the UDF managers may be supported in this process by the Independent Expert.

(103) Similarly, ***acquisitions or leases of land or buildings for project implementation*** will be conducted at market prices determined in one of the following ways:

(a) Contributions of land and buildings by the public sector to an urban project must be at market value, in line with the Communication on Land Sales.

(b) Where the land is owned by the private sector or it has not proved possible to determine the market price through an open procurement process (i.e. only one offer has been received) the UDF managers will verify that the values reflect market prices. The UDF managers may be supported in this process by the Independent Expert.

(104) Finally, ***developed assets will be rented/sold*** on market terms in one of the following ways:

(a) If the developer is a public body, an open and non-discriminatory disposal process should where possible be followed to secure the optimum price for the sold/rented asset.

(b) Where the developer is a private body or it has not proved possible to determine the market price through an open procurement process (i.e. only one offer is received) the UDF managers will verify the rental/sales values achieved. The UDF managers may be supported in this process by the Independent Expert.

2.7. Project financial performance requirements

(105) In addition to the eligibility requirements set out above, the measure imposes a number of specific financial requirements on urban projects that must be verified by the UDF managers before they make an investment for each urban project on the basis of financial forecasts, which will be set out in each Operational Agreement. Each urban project will be appraised by the UDF manager on the basis of a realistic business plan to ensure soundness in terms of business model and financial sustainability and establish a financial viability gap to justify the need for sub-commercial UDF investments.

2.7.1. Efficient projects

(106) Since the NWUIF and the UDFs should aim to be financially self-sustaining, the UDF investments will be made using commercial appraisal principles based on a long-term business plan and *ex ante* defined exit strategy for equity investments. Returns through interest payments (for loan investments) and rent/capital value receipts (for equity investments) must be sufficient to repay the UDF sub-commercial investments (at least the initial capital with no profits to the UDF) as well as to repay private investments at market rates.

(107) The UDF managers are contractually obliged to carry out investment appraisal using criteria and processes that are in line with international investment management practices and in line with the UDF's investment strategy. They are contractually required to act with independence and due care and skill in undertaking such investments, as is expected of an organisation managed or advised by a qualified and competent FSA-regulated investment institution. Failure to comply with the above management duties would constitute a breach of the Operational Agreements.

(108) The business plan will be subject to rigorous appraisal by the UDF managers based on commercial investment appraisal standards to establish the project's economic and technical feasibility and the prospects for long-term viability over its development period. The UDF managers will assess forecasted financial performance using a discounted cash flow method and applying a risk-adjusted discount rate that reflects project-specific risks. Financial criteria will include internal rate of return, net present value, pay-back period, cash flow profile and other financial indicators.

2.7.2. Viability gap (the necessity test)

2.7.2.1. Establishing a viability gap

(109) While each urban project must have a viable business plan and should have the capacity to generate some returns to justify the use of the UDF sub-commercial investments, projects that are affected by the market failures and socio-economic deprivation explained above, which result in a financial viability gap, must be analysed with a view to determining the amount and conditions of the required sub-commercial UDF investment and possibly grant funding.

(110) For a financial viability gap to exist, it must be proven that the NPV calculation is negative over the development period of the project, i.e. the gross development cost[38] exceeds the gross development value,[39] which indicates that the project does not break even and would not have been carried out at all or with the proposed size, scope, and timing without the UDF sub-commercial investments. As explained by the UK authorities, any State aid received for the projects targeted by the UDFs will be taken into account and reflected through a reduced viability gap.

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[38] Total of all costs incurred from initiation to implementation of a project, including the required profits.

[39] The value of the completed project prior to the deduction of purchase tax.

(111) The viability gap essentially means that the estimated rate of return for private debt/equity investors is below market benchmarks, i.e. below an appropriate fair rate of return (the FRR) that reflects the required return that a project promoter and/or any other investors require while also reflecting the level of risk proposed by the project and the level of capital they plan to invest (point 2.7.2.2 describes how the FRR will be determined).

(112) The project developer will present the estimates of project viability with and without UDF investment, demonstrating that the profitability of the project is insufficient to obtain funds at market conditions and that UDF sub-commercial investment is needed. As part of the above-mentioned investment due diligence process, the UDF manager will carry out the necessity test and verify the extent of the viability gap before making its investments by comparing the estimated costs of a project, including the expected market return sought by the private investors, and its market value on completion.

2.7.2.2. Establishing the FRR

(113) The section below describes the process and requirements for establishing the FRR for each private transaction at UDF and/or project level, which will be used as a benchmark both to establish a viability gap and to limit the investment incentives.

(a) Establishing the FRR through a public procurement process

(114) Where public authorities own the assets on which development will take place (where the land is owned by a public body or the project promoter is a public body, including instances where the NWDA may contribute its land to the UDFs) and in any case when the development in question will constitute a public works contract or public works concession within the meaning of Directive 2004/18/EC, the selection of a project developer and its investment conditions will be subject to a public procurement process in accordance with applicable EU law as this has been interpreted by the Court of Justice of the EU[40]. The procurement process will include the possibility of sub-commercial UDF investments under this measure, possibly combined with grant funding. This process would determine the value of the publicly owned land and any further arrangements proposed for profit sharing with the public sector. The process would also identify the rate of return sought by the project developers, which in these instances would be considered the FRR.

(b) Establishing the FRR through a competitive benchmarking process

(115) For those cases where the above process is not followed (e.g. there is no legal obligation to launch a formal public procurement process), the FRR for the private investors in the UDF or a project may be determined through competitive market testing addressed to several investors interested in being offered the possibility to provide funding to the project. This will be followed by appropriate negotiations with potential investors through a process similar to competitive dialogue (although this would not be a formal public procurement process).

[40] See, for example, Case C-220/05 *Jean Auroux and Others* v *Commune of Roanne* [2007] ECR I-385, and Case C-451/08 *Helmut Müller*, judgment of 25 March 2010, not yet reported.

(116) Either the project promoter or the UDF could initiate the competitive process. However, the ultimate responsibility to ensure that the competitive process is appropriate rests with the UDF manager. An appropriate competitive process will involve negotiations with several potential investors whose terms may vary depending on the circumstances of each project (at least two offers must be received). Where the competitive process is followed, the most economically advantageous offer, which may not always equate to the lowest rate, will be accepted.

(117) The UDF manager will oversee this process to ensure that each potential finance provider was offered the same opportunity and that the offer the project promoter intended to accept was the most economically advantageous. Evidence that that has been the case will be documented and retained by the UDF manager. The offer that is accepted will be deemed to represent the FRR.

(c) Establishing the FRR using the Independent Expert

(118) While a properly conducted competitive process would be the preferred way of establishing the FRR, this may not always be an option where competition is not feasible (e.g. where the project promoter is the owner of the asset to be developed and is the sole equity provider in the project) or limited (e.g. only one offer is received as a result of the above-mentioned competitive process).

(119) Where the UDF is not able to establish the FRR through a public procurement or competitive benchmarking process, it will verify the cost and revenue figures proposed by the project promoter based on its market knowledge and available benchmarks. The Independent Expert will be required to provide an opinion on the FRR to developers or other investors as an independent check in this particular circumstance.

(120) In providing its opinion, the Independent Expert will be required to review the outcome of the UDF's viability assessment, including the proposed costs, values and viability gap and level of returns to advise whether such returns are reasonable and market comparable (see the section below for the tasks of and requirements of an for the Independent Expert). The Independent Expert's opinion will be based on its professional analysis and experience of commercial market conditions and comparable transactions.

2.8. Investment instruments and conditions

2.8.1. Investment instruments

(121) Having established the viability gap and the respective FRRs, the UDF managers will determine the form, amount and conditions of the required UDF funding, exploring the use of the following investment instruments. The nature and mix of investment instruments and conditions will be project-specific and depend on the nature of the project and its investment needs, which will be determined by the UDF managers in the investment structuring phase.

(122) Under the notified measure, in line with the SF Regulations, investments in urban projects will be made in a revolving way, i.e. in the form of equity and loans in order for the public funds to be 'recycled' and become available for further reinvestment, thus ensuring the

sustainability of the NWUIF and the UDF. The UDFs will make sub-commercial investments in urban projects in line with the SF Regulations[41], which may, in certain cases, be combined with grant funding (see section 2.9).

(123) The investment approach is based on project financing techniques that estimate and rank the future claims on a project's cash flows in order of seniority, whereby senior debt claims are served before subordinated claims and equity claims come at the end, allowing for profit/loss-sharing arrangements among equity holders. Sub-commercial investments reduce gross development costs to project developers, thus in some instances allowing the investment to break even.

(124) While arrangements for the allocation of returns from loan and equity investments will be agreed in advance when investment decisions are made based on realistic business plans, the actual allocation of returns will take place when the project is completed and generates returns or losses that may differ from the initial forecasts.

2.8.1.1. Senior loans

(125) The UDFs may provide senior debt below market rates. According to the UK authorities, this measure will only be applied in limited circumstances where projects are unable to secure senior debt at all or at a level which enables the project to generate market returns. Senior loans will be repaid through interest and principal payments by the project. While there is a contractual obligation to repay capital, the interest repayment will depend on the credit risk rating of the project and the company.

2.8.1.2. Subordinated loans

(126) The UDFs may provide subordinated loan investments below market rates. Subordinated loans must be contractually repaid and are entitled to interest. Because the risk is consequently higher than senior debt, the interest charged on subordinated loans is higher than that on senior loans. By their nature, subordinated loans are structurally subordinated to senior loans, thus non-*pari passu* compared to senior debt, as repayments and any other claims are subordinated to senior debt, but rank ahead of equity.

2.8.1.3. Equity[42]

(127) The UDF will make equity investments (in cash or in kind) in urban projects. Typical investment projects require equity in their initial phase, which is characterised by high risks. There is not always a fixed interest rate for equity, nor periodic interest payments, but often a single repayment after 5–10 years upon exit, i.e. when the equity holding is sold at a hopefully higher value than its cost.

[41] Article 43 paragraph 7 of the Implementation Regulation. "Returns from equity, loans and other repayable investments, and from guarantees for repayable investments, less a pro rata share of the management costs and performance incentives, may be allocated preferentially to investors operating under the market economy investor principle".

[42] Does not exclude quasi-equity instruments, e.g. subordinated loans that have more equity-like features, for instance requiring an equity 'upside', unsecured, in line with the definition of quasi-equity given in the Risk Capital Guidelines, OJ C 194, 18.8.2006, p. 2.

(128) To share the upside and downside investment risks, the UDF non-*pari passu* equity/equity investments could be made through a shared return structure (preferential returns, priority returns and/or different investment timing) and/or public investments being in a capped 'first loss' position. A combination of investment incentives could be offered at the outset of the urban project.

(a) Upside risk sharing: preferential returns

(129) The UDF could provide equity/quasi-equity investments with a rate of return that is below that of private investors, thus allowing the project to break even. The project developer's rate of return would be capped at what had been deemed to be the FRR. The expected rate of return on the UDF's investment can be reduced until the project breaks even, but this is subject to a floor of zero return. When returns arise, these are shared at the same time between the UDF and the private investor based on the different expected rates of return.

(130) Once the absolute amount of return equivalent to the private investor's FRR estimated in the initial appraisal has been paid to it, any returns in excess of this would then be paid exclusively to the UDF until it receives an absolute amount equivalent to the FRR established by it before discounting its expected return in order to attract private investors, after which any additional returns would be shared pro rata to the initial investment. The UDF could use this tool in isolation or in combination with the mechanism mentioned below.

(131) In principle, the pro-rata approach to additional returns is similar to the claw-back mechanism under the grant funding approach in that it incentivises the project developer to exceed the return projections of the project, while enabling both the private and public sector to financially benefit. Under the grant approach once the initial capital and operational costs, plus an agreed percentage, have been recovered, any subsequent margin accrued by the private investors as a result of increased uptake will be subject to the claw-back mechanism at an agreed percentage rate.

(b) Upside risk sharing: priority return sharing

(132) The UDF could invest public funds in the form of equity/quasi-equity by allowing the private investor to take a priority return which could be achieved by enabling the return to be first paid to the private equity investor, up to the level of the FRR, before the UDF. Once the private equity investor has received its FRR, the UDF public investment will then be entitled to receive its FRR, after which any additional returns will be shared pro rata to the initial investment and at the same time. In contrast to (a), the UDF has to wait in this case until the private investor has received its full FRR before it receives any return.

(c) Upside risk sharing: timing of investment

(133) This mechanism would enable the UDF to invest first, before the project developer or other third-party investors in the project, which may increase investment profitability for the private investors. The private investors will not pay any equalisation fees. While the timing of public and private investments may differ, at the time when public investments are made, there will be contractual arrangements in place to ensure that the requirement for the minimum private investment set out in point 2.8.2.1 is complied with.

(d) Downside risk sharing: first loss position

(134) UDF equity investments could rank behind private equity for repayment, therefore effectively being exposed to first loss in the event of poor investment performance, i.e. a (partial) loss being made on the capital invested. The UDFs will invest in a project which at the time of the investment, following the application of the measure, is not estimated to make a loss on the capital invested, but in instances where an actual loss is made on the capital invested, the UDFs would adopt a capped 'first loss' position of 25 % of the overall outstanding loss, in any case limited to the level of the UDF's investment in the project. By applying the first loss tool, the UDF would reduce the risk profile on the development and subsequently the viability gap.

(135) To protect the public investments, a preferential return structure is preferred to a first loss position and the first loss position will only be used where it is absolutely necessary. The tool can therefore only be utilised where it reduces the viability gap of a project such that it breaks even and it should only be used where the above options have been exhausted and have proved insufficient to address the viability issues of the project.

(136) According to the UK authorities, the UDF managers will have limited economic incentives to use this mechanism, as they will incur a financial loss if they use it; fundamentally it will also reduce the capital they have available for reinvestment, which will erode their fee-earning capacity.

2.8.2. Investment conditions

(137) When structuring their investments, the UDF managers must ensure that the minimum level of private investments is achieved and that the UDF's sub-commercial investments are limited to the minimum necessary to bridge any viability gap and enable the urban projects to go ahead.

2.8.2.1. Minimum private investments

(138) There must be private investment in each urban project to demonstrate financial commitment and share investment risks and to avoid crowding out private investors. The private investors must have already invested, or be prepared to invest based on contractual arrangements in place. Investments could be made by institutional and other investors in the UDFs or directly in the urban projects.

(139) The private investors must cover in any form at least 50 % of the total eligible project costs, which must be free of any public support. Consequently, the total amount of sub-commercial public investments (in any form) in each project will always be limited to 50 % of the eligible costs. In any case, the maximum UDF investment exposure (in any form) in each project is limited to GBP 6 million (20 % of the NWUIF funds allocated to the UDF).

(140) Additionally, as part of the 50 % of private investment in any form, there must be an equity contribution by the project promoter. Consequently, the UDF will never be a sole equity holder in a project and will share investment risks with project developers and other

investors. This equity contribution must be deemed to be significant[43] by the UDF (and the Independent Expert where there has been no public procurement process or form of competitive benchmarking process) in the context of the overall project costs, taking into account the form of the UDF contribution, the nature of the project and the reliability of the project cash flows.

2.8.2.2. Minimum profit for private investments

(141) The UDF sub-commercial investments must be the minimum necessary to meet investment needs based on realistic business plans and to close the viability gap so that the projects break even, thus rendering them commercially viable. This means that the initially expected FRR for the UDF investment must be adjusted (reduced) to ensure that expected returns for the project developer or other investors reach their respective FRRs.

(142) If, using an initial expected FRR for the UDF's investment, the cash flow appraisal showed a negative residual value, the expected FRR on the UDF investments would be reduced until the project breaks even. If all the upside risk sharing measures are exhausted and the project still produces a negative residual value, only then can the first loss measure be introduced in order to reduce the private investor's required FRR. If, after applying the first loss measure, the project still produces a negative residual value, it must be considered unviable without grant support (see section 2.9 for grant funding).

(143) Where there has been no public procurement or form of competitive benchmarking, the Independent Expert would need to review the proposed UDF investment and provide an opinion that it represents the minimum necessary to allow the project to break even and does not result in the project promoter (or other investors) receiving more than their FRR.

2.9. Combining repayable investments with grant funding

(144) According to the notification, grant funding will be provided only as the funding of last resort to close the viability gap where the competitive process has not resulted in any offering that could ensure the full use of the UDF sub-commercial investments, i.e. in instances where the UDF investments have been offered at a no-profit return and the upside and downside measures have been exhausted but there is still a viability gap and the project is unviable without grant support, while the project scores high on account of its sustainable urban development objectives.

(145) The UDF managers will estimate the need for grant funding as part of the appraisal to establish the FRR. The Independent Expert must review the justification for grant funding and ensure that it is being used in limited cases and as a last resort. Grant funding will be subject to the same conditions as the UDF sub-commercial investments under the measure, including *inter alia* ensuring that the UDF sub-commercial investments combined with

[43] The UK authorities will use by analogy the principles contained in previous Commission decisions, such as C 53/2006, 11/12/07 — Investment by the city of Amsterdam in a fibre-to-the home (FttH) network (CityNet Amsterdam):

'… it has to be identified whether these investors are market investors and whether the investments by the private investors have real economic significance. Such significance should be assessed in absolute terms (a significant portion of the total investment) and in relation to the financial strength of the private investor concerned.'

grants may not result in the FRR for any private investor being exceeded and that the required level of private investment is achieved.

(146) Grant funding will be provided by the UK authorities or administered by the UDF managers on behalf of the UK authorities. Once the need for grant funding is established by the UDFs and verified by the Independent Expert, there will be no need for final recipients to apply for grant funding separately, subject to the procedures applicable to the grant source. Once the funding package is completed, no additional grants may be provided for the same project after the UDF investments have been made.

2.10. Independent Expert

2.10.1. Verification scope and methodology

(147) The Independent Expert will be required in relation to projects where there has been no form of public procurement or other competitive benchmarking, without prejudice to its role in the context of the latter as specified above under section 2.7.2.2 (b).

(148) The Independent Expert will provide an opinion on the basis of sufficient market evidence on the viability of the project based on its costs and values, the FRR of the project and the significance of the private-sector equity contribution. In all cases where grant funding is proposed, the Independent Expert will be required to provide an opinion on the costs, values, viability gap and level of FRR to private-sector investors/developers.

(149) The Independent Expert will draw on comparative data, market benchmarks and previous relevant experience of similar projects as part of this process. This will include an assessment of the risk and reward profile of the project that will take into account a number of factors.[44]

2.10.2. Independence requirements

(150) Independence of Independent Experts from the UDF and projects will be crucial and any potential candidate will be required to ensure that there is no potential conflict of interest for each individual urban project. This will mean that:

(a) A UDF may not use the same Independent Expert more than twice within a period of six months.

(b) The Independent Expert must disclose all current relationships with the UDF or the candidate investor at the time at which its mandate is entered into.

(c) If the Independent Expert is a legal person, no capital links may exist between the Independent Expert and the UDF or the candidate investor offering to co-finance a project.

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[44] Construction cost risk, including also inflation and exceptional factors, planning risk, demand risk (including impact of geographic location), valuation — potential void and rent-free periods, economic environment & funding climate, complexity of project, competence of project sponsor and ability to deliver the project to time and budget, financial analysis — this should include sensitivity analysis on the project financial model, project sponsors' cost of finance, security of other funding streams, appropriateness of contingencies, extent to which assets are pledged as debt security (equity as a percentage of project value).

(d) During the term of the mandate, the Independent Expert must undertake not to create a conflict of interest by having or accepting employment or appointment as a member of the UDF Board or the candidate co-investor, or by having or accepting any assignments with or other financial interests in the UDF or the candidate investor.

(e) If the Independent Expert becomes aware of a potential conflict of interest during the mandate, the Independent Expert will be obliged to notify the UDF and/or the UK authorities and resolve the problem immediately and, if the conflict of interest cannot subsequently be resolved, the UDF and/or the UK authorities will be entitled to require the termination of the Independent Expert's mandate.

(151) The above rules concerning conflicts of interest should apply to the Independent Expert itself, members of its team, their spouses and the Independent Expert partner companies as members of the same group of companies or organisation.

2.10.3. Competence requirements

(152) The choice of eligible Independent Experts would depend on the type of eligible urban project to be financed and the sector and geographic area in which the project concerned will take place. The chosen Expert will need to be a recognised market specialist or be able to provide clear evidence of its expertise by reference to recent market involvement.

(153) The Expert will require industry-specific knowledge, market awareness/knowledge and financial expertise in the particular type of project, or in the establishment of regeneration investment funds in the case of an investment in a UDF. The roles to be fulfilled will require knowledge of: construction and development costs, commercial office space rental and value levels, investment market equity and debt costs/return levels and appropriate rates of return on a variety of project types.

(154) The professionals eligible to perform the functions of an Independent Expert should be registered with and licensed by regulated professional associations. Independent Experts will need to comply with the professional rules issued by those professional associations in order to ensure the independence and professional behaviour of their members.

2.10.4. Selection

(155) In order to facilitate the task of finding appropriate Independent Experts and as a safeguard to prevent risks of collusion, the NWUIF will carry out an open pre-qualification and pre-selection procedure at national level resulting in a list of eligible Independent Experts from which UDFs would appoint individual Independent Experts for specific projects exclusively.

(156) The NWUIF will also provide the UDFs with a contract template to be used when appointing an Independent Expert. In this template it will be stated that the Independent Expert is liable for the accuracy of its expertise not only to the UDF but also to the NWUIF.

2.11. Monitoring and reporting system

2.11.1. Monitoring

(157) In line with the SF Regulations[45] and the respective funding agreements, monitoring applies to each actor at the following three levels:

2.11.1.1. NWUIF level

(158) Under the SF Regulations,[46] the UK authorities are responsible for the overall management and control of the NWUIF operations in accordance with the control and audit requirements set out in the SF Regulations. The UK authorities must ensure that the NWUIF operations comply with the agreed investment policy and the relevant EU and national rules, including those on State aid, and comply with the conditions of the measure. While the UK authorities have delegated the management of the NWUIF to the EIB, they retain overall responsibility for management and control of the NWUIF operations.

(159) The UK authorities will monitor performance of the NWUIF through the provisions of the Funding Agreement and the Investment Board, where they have representation. Pursuant to Article 5(8) of the Funding Agreement, the Investment Board, on the basis of the information provided by the EIB, will monitor the EIB's performance in managing the NWUIF in accordance with the Investment Strategy.

(160) Article 14 of and Appendix 2 to the Funding Agreement set out monitoring and auditing obligations. The NWUIF will also be audited by an independent external auditor. Auditing will take place in accordance with the Treaties and the EIB Statute, which includes audit by the European Court of Auditors.

2.11.1.2. UDF level

(161) The NWUIF will monitor the UDF operations in relation to the investment strategy set out in each Operational Agreement. The performance of the UDFs will be monitored through the UDF Boards. In addition, in line with Article 4(1) of the Funding Agreement, the EIB will monitor the implementation of the business plan of each selected UDF in accordance with the terms and conditions of the applicable Operational Agreement and will monitor the performance of each UDF through the receipt of quarterly progress monitoring reports.

2.11.1.3. Project level

(162) Once investments are made, the UDF manager will monitor the performance of each urban project for the investment period in accordance with professional investment management practice, seeking where appropriate to improve operational performance and increase the value of the investment. In the project implementation stage, according to the UK authorities, project developers (not the UDF) will bear the responsibility for any cost overruns. According to the UK authorities, the UDF managers will set performance targets in the project implementation and operating phase and will monitor performance.

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[45] Articles 43(3) and 44(2) of the Implementing Regulation.

[46] Article 59 of Council Regulation 1083/2006.

(163) Article 10(2)(21) of the Funding Agreement lays down a number of requirements that must be incorporated in every investment agreement between the UDF and an urban project, including the provision that the urban project may not engage in actions or decisions contrary to EU rules. As indicated in Article 10(2)(21) of the Funding Agreement, the UK authorities, the Commission, the European Court of Auditors, the EIB and any other national or European entity empowered to carry out audit and/or control activities may access the premises and documents of the urban project.

2.11.2. Reporting

(164) Reporting is an essential part of the monitoring system and is designed to ensure appropriate management as well as enable fulfilment of the reporting obligations placed on the UK authorities by the Commission, including reporting for State aid compliance based on the conditions of the measure. In line with the SF Regulations[47] and the Funding Agreements, reporting will be at four different levels:

2.11.2.1. From final recipients to the UDFs

(165) At final recipient level, reporting includes among other things details on status and progress compared with the investment objectives, use of funds, repayments made, dividends, interest returns and potential defaults (if applicable). Reporting will be on a quarterly and annual basis.

2.11.2.2. From the UDFs to the NWUIF

(166) Pursuant to Article 10(2) of the Funding Agreement and the Operational Agreements, the UDFs must report to the EIB (as NWUIF manager) on a quarterly basis using a standardised form which sets out an analysis of activities carried out in the period in question. The quarterly report will include among other things details on investments made, including values and balances remaining, status and progress of urban projects, potential and actual defaults, management costs and fees or other performance incentives charged. The UDF will also deliver for each financial year its annual report, balance sheet, profit and loss account and auditors' report prepared in accordance with the IFRS and audited by an independent auditor.

2.11.2.3. From the NWUIF to the UK authorities and the Investment Board

(167) The EIB (as NWUIF manager) is required to report to the UK authorities in a transparent manner, in accordance with Article 14 of the Funding Agreement. Pursuant to the Funding Agreement (Appendix 2), the EIB will prepare for each calendar year an annual progress report, setting out a detailed analysis of the NWUIF operations, including an analysis of progress with the implementation of the Investment Strategy and detailed information on the operations of the UDFs. The report will also include the information relating to the NWUIF in order to allow the UK authorities to comply with their reporting obligations towards the Commission.

[47] Article 44(2) of the Implementing Regulation.

2.11.2.4. From the UK authorities to the Commission

(168) Notwithstanding any additional obligations under the SF Regulations, an annual report on the expenditure under this scheme, allowing assessment of compliance with State aid rules, will be provided to the Commission. By analogy with point 7.1 of the Risk Capital Guidelines, the annual reports will provide information on compliance with the provisions of the measure, in particular on UDF investments in urban projects, including eligible costs, risk sharing arrangements, recipients and nature of investors, and investment performance.

(169) The UK authorities will provide a Standardised Information Sheet (SIS) for each sub-commercial UDF public investment exceeding EUR 5 million in a single project. The format of the SIS will be agreed between the UK authorities and Commission staff. The Commission will not approve each SIS as a condition for making investments. The SIS should allow the Commission to monitor, *ex post*, compliance with the conditions of the notified measure.

(170) For compliance with State aid requirements, records will be kept for ten years from the date of the last award of aid under the scheme. Records will be sufficiently detailed to establish that the conditions of the scheme are met. If the Commission requests information necessary for it to assess whether the State aid conditions have been complied with, the UK authorities will provide it within the agreed time period.

2.12. Cumulation

(171) After the receipt of the UDF investments and in some cases grant funding, aid granted under the notified measure cannot be cumulated with aid received from other local, regional, national or EU sources to cover the same eligible costs.

2.13. Individual notification

(172) The UK authorities have agreed to notify individually, for approval by the Commission, major projects as defined in the SF Regulations[48] (currently projects exceeding EUR 50 million) irrespective of what proportion of these costs is financed by the UDF.

3. PRESENCE OF STATE AID

(173) By virtue of Article 107(1) TFEU *'any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.'*

(174) In order for a measure to constitute State aid within the meaning of Article 107(1) TFEU it has to fulfil four conditions. Firstly, the aid is granted by a Member State or through State resources. Secondly, the measure confers an economic advantage by relieving the recipients of costs they would normally have to bear. Thirdly, the measure is selective as it targets certain undertakings or the production of certain goods. Fourthly, the measure is liable to

[48] Article 39 of the General Regulation.

affect trade between Member States and distort or threaten to distort competition in the internal market.

3.1. State resources

(175) The concept of State aid applies to any advantage granted directly or indirectly, financed out of State resources, granted by the State itself or by any intermediary body acting by virtue of powers conferred on it. As has been stated by the Court,[49] for the measures to be classed as State aid within the meaning of Article 107(1) TFEU, they have to be derived from the State's resources, either indirectly or directly, and their use has to be imputable to the State.

(176) In the case at hand, at all material times the State exercises (indirect) control over the resources under consideration. The funding provided by the UK authorities (cash or in-kind) to the NWUIF and then provided by the NWUIF (cash or in-kind) to the UDFs is financed out of the State budget, i.e. the ERDF and the national contributions. The decision to provide these State resources is imputable to the State, as the NWDA has decided to set up the NWUIF to deploy the public funding via the UDFs for the purposes of financing eligible urban projects.

(177) State resources are generally considered to be involved where funds come from contributions made by the State and are managed and apportioned in accordance with that State's legislation, even if they are administered by institutions separate from the State. While the NWUIF and UDFs will operate independently of direct State interference, investment decisions made by the Investment Boards will comply with the conditions set out in the Funding Agreement and then further specified in the Operating Agreements.

(178) On the basis of the above, the Commission can conclude that the funding provided to the UDFs under the conditions of the notified measure constitutes State resources.

3.2. Economic advantage

(179) To constitute State aid, a measure must provide recipients with an economic advantage.[50] To verify whether an undertaking has benefited from an economic advantage, the Commission applies the criterion of the 'market economy investor principle'. The assessment makes no distinction between the different types of beneficiaries in terms of their legal structure or ownership (public or private). The principles of non-discrimination and equality do not exempt public authorities or public companies from complying with EU competition rules.

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[49] See Case C-482/99 *France v Commission (Stardust Marine)* [2002] ECR I-4397.

[50] The European Court of Justice has held that any activity consisting in offering goods and services on a given market is an economic activity. See Case C-35/96 *Commission v Italy* [1998] ECR I-3851 and Cases C-180/98 to 184/98 *Pavlov* [2000] ECR I-6451.

(180) The investment of capital or provision of loans by the State is considered State aid within the meaning of Article 107(1) TFEU if the funds would not have been provided by a private undertaking under the same market conditions. This is considered to be the case if the (monetary) compensation that the State receives in exchange for the loan or equity investments is lower than what a private investor would have required in the circumstances.

(181) The presence of an economic advantage will be assessed at several levels of the measure's funding architecture by analogy with point 3.2 of the Risk Capital Guidelines (RCG).[51] It will also be assessed at the level of the undertakings involved in urban project delivery (contractors) in the project implementation phase as well as at the level of operators, end-users and buyers of development results.

3.2.1. The NWUIF level

(182) The Commission has to assess whether the conditions/parameters of the contribution provided by the UK authorities to the NWUIF confer an economic advantage on the NWUIF and whether the payment to the EIB as NWUIF manager for its management services confers an economic advantage on the EIB.

(183) As for the NWUIF, the Commission in general considers that an investment fund is an intermediary vehicle for the transfer of resources rather than being a beneficiary of aid itself (point 3.2 of the RCG). The NWUIF is established as a separate account with the EIB and will be transferred to the UDFs for investments in urban projects. The NWUIF is not the EIB itself, but rather a ring-fenced fund in a separate account held with the EIB. Based on the above, the NWUIF can be considered as a vehicle for the transfer of funds to the UDFs, rather than being a beneficiary itself.

(184) The Commission notes that the funds committed to the NWUIF but not disbursed to the UDFs will be placed in interest-bearing accounts and may be used to cover the administrative costs of the EIB for managing the NWUIF, thus not benefiting any EIB activities outside the notified measure. Therefore, the Commission finds that no State aid within the meaning of Article 107(1) TFEU is granted to the NWUIF.

(185) As regards the EIB as NWUIF manager, the Commission has noted that it has been entrusted with the management of the NWUIF in line with applicable EU provisions, reflecting the special status of the EIB as an EU body[52] and is entitled to a management fee that is below the 2 % cap on a yearly average of the capital contribution laid down in the SF Regulations. The Commission can therefore conclude that no State aid within the meaning of Article 107(1) TFEU is granted to the EIB as NWUIF manager.

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[51] OJ C 194, 18.8.2006, p. 2.

[52] The EIB may be mandated by the EU to carry out special financial tasks in support of economic and social cohesion. Article 175 of the TFEU empowers the EU to support the achievement of the objectives set out in Article 174 through actions which it takes, *inter alia*, through the EIB. The EIB is the only international financial institution over which the Commission exercises a *de facto* veto right in respect of proposed financing from own resources through the *ex ante* consultation procedure set out in Article 19 of the EIB Statute.

3.2.2. The UDF level

(186) The Commission must also assess whether the contingent loans provided by the NWUIF to the UDFs confer an economic advantage on the UDFs and the private investors in the UDFs which the recipient undertakings would not have obtained under normal market conditions. The Commission must assess whether the remuneration paid by the NWUIF to the UDF managers is market conform.

3.2.2.1. The UDFs

(187) The funding provided by the NWUIF to the UDFs is intended to be invested in urban projects. The UDFs (the Limited Partnerships) are investment vehicles and are prohibited from undertaking any development activities themselves. Therefore, they can be considered as vehicles for transferring the funds to urban projects, rather than being aid beneficiaries themselves. Accordingly, the Commission can conclude that no State aid within the meaning of Article 107(1) TFEU is granted to the UDFs.

3.2.2.2. The UDF managers

(188) The UDF managers are undertakings as they provide the service of investing and managing the UDF resources. In line with point 3.2 of the RCG, there is a presumption that no aid is involved if the managers or management company are chosen through an open and transparent tender procedure. The Commission notes that the remuneration for the UDF managers was part of the open and non-discriminatory tender procedure to select the UDFs and was subject to negotiations between the EIB acting as the NWUIF manager and the UDF managers, as stated above (paragraph 73). Given the significant number of potential applicants, the Commission finds that the tendering procedure resulted in market-conform remuneration for the UDF management, and no State aid within the meaning of Article 107(1) TFEU will be provided to the UDF managers.

3.2.2.3. Private investors in the UDFs

(189) As stated in point 3.2 of the RCG, where a measure allows private investors to effect equity or quasi-equity investments on terms more favourable than public investors, or than if they had undertaken such investments in the absence of the measure, then those private investors will be considered to receive an advantage. In contrast, the Commission will consider the investment not to constitute State aid where the investments are effected *pari passu* between public and private investors and public and private investors share exactly the same upside and downside risks and rewards and hold the same level of subordination, and normally where at least 50 percent of the funding is provided by private investors that are independent from the companies in which they invest.

(190) Private investors can provide funding (cash or in kind) at the level of the UDFs in exchange for a share of potential ownership of the UDF. The investors could be exercising an economic activity across the EU. The Commission notes that private investments can be made on non-*pari passu* terms with the public funds in the UDF, which provides an advantage to the private investors compared to normal market conditions in the absence of State intervention, where both public and private investment would normally be made at identical *pari passu* conditions.

(191) While investments are open to any investors, given that the advantage to the private investors is only granted for the specific purpose of providing funds for investments under the measure, the private funding is subject to the eligibility and further requirements imposed by the measure and to the UDF managers' discretion to appraise and negotiate final investment terms with the private investors.

(192) The Commission therefore concludes that private investors investing in the UDFs on non-*pari passu* terms with the public funds receive a selective economic advantage within the meaning of Article 107(1) TFEU.

3.2.3. The urban project level

(193) The Commission must assess whether the conditions of the loan and equity investments provided by the UDFs to urban projects confer an economic advantage on the project developers and other investors involved in the urban projects, which the recipient undertakings would not have obtained under normal market conditions.

(194) Urban projects will be initiated, funded and undertaken by project developers, which could comprise property developers, investment companies and any other undertakings that are responsible for the project and provide investments for the purpose of achieving investment returns. Project developers could be national, regional or local players or international players active in any market across the EU.

(195) The Commission notes that in many cases the project developers will set up a special purpose vehicle (an SPV) for the purpose of carrying out project activities and providing funding. The SPV will be owned by them and will be dissolved once the project is completed and the investments returned to the owners. While the SPV will be the direct recipient of the UDF funding and will be carrying out the project activities, the Commission considers that the SPV is just a project vehicle, and that the real recipients are the project developers that initiate the project and provide the investments.

(a) Economic activity

(196) The Commission notes that the regeneration activities, including the development of enabling infrastructures, which are the subject of the measure will be carried out for commercial use. Project developers will charge operators/users for the use of developed property or sell it in the market rather than making it available free of charge in the common interest. Therefore, the companies carrying out the activities are undertakings within the meaning of EU competition law.

(b) Advantage

(197) The Commission will assess whether the UDF loan and equity investments in urban projects confer an economic advantage.

- *Loans*

(198) According to its decision practice, in order to determine whether loans will be granted on favourable conditions, the Commission must verify if the interest rate on the loans in question complies with the Commission's reference rate set out in the Reference Rate

Communication,[53] which should be compared on the date of the legally binding act when the loan is granted to the recipient by the UDF.

(199) In the case at hand, the UDFs may provide senior loans and subordinated loans below the FRR, which might in any event be below the rates established under the Reference Rate Communication. The subsidised loans reduce the investment costs that the undertakings carrying out urban projects would normally have to bear and therefore confer an economic advantage on them.

- *Equity/quasi-equity*

(200) Equity/quasi-equity provided to urban projects will not constitute State aid within the meaning of Article 107(1) TFEU if the market economy investor test can be met. In this regard the European Court stated in its judgment in the *Stardust Marine* case that *'capital placed directly or indirectly at the disposal of an undertaking by the State in circumstances which correspond to normal market conditions cannot be regarded as State aid'*.[54]

(201) The Commission must therefore analyse whether the UDFs will act as private investors in financing the urban projects by assessing whether in similar circumstances a private investor operating under normal conditions in a market economy would have entered into the same or similar commercial arrangements as the UDFs as equity providers for this type of urban regeneration projects.

(202) The Court held in *Stardust Marine* that, *'… in order to examine whether or not the State has adopted the conduct of a prudent investor operating in a market economy, it is necessary to place oneself in the context of the period during which the financial support measures were taken in order to assess the economic rationality of the State's conduct, and thus to refrain from any assessment based on a later situation'*.[55]

(203) The conduct of an investor in the market economy is guided by prospects of profitability.[56] The market investor test will normally be satisfied where the structure of and future prospects for the company are such that a normal return, by way of dividend payments or capital appreciation by reference to a comparable private undertaking, can be expected within a reasonable period.

(204) While the UDF decisions to invest equity/quasi equity in urban projects would have to be made on the basis of underlying business plans for project activities and long-term prospects for profitability, this cannot rule out the possibility of an economic advantage being conferred on the company receiving the investment. Under the measure in question, the UDF equity/quasi-equity investments in urban projects are made on non-*pari passu* terms when compared with those of project developers and other investors in the project. This could be due to the UDFs accepting a lower or delayed share of returns compared to

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53 OJ C 14, 19.1.2008, p. 6.

54 *Stardust Marine*, paragraph 69.

55 *Stardust Marine*, paragraph 71.

56 Case T-296/97 *Alitalia v Commission* [2000] ECR II-3871, paragraph 84; Case C-305/89 *Italy v Commission* [1991] ECR I-1603, paragraph 20.

project developers and other investors or the UDFs accepting higher risks of losses compared to private investors.

(205) In any of the scenarios described above, project promoters and other investors will be in a position that is economically advantageous compared with normal market conditions in the absence of State intervention, where co-investment would normally be carried out at identical, *pari-passu* conditions for all investors. While in some specific cases the advantages granted might correspond to specific additional economical burdens that the private investor has accepted, such as the provision of publicly available infrastructure, there will also be a significant number of cases where the UDF will provide advantageous investments simply to cover a viability gap and make projects commercially viable.

(206) The Commission has also assessed whether the establishment of the FRR by a competitive process or by using an Independent Expert will rule out the possibility of a selective advantage within the meaning of Article 107(1) TFEU. However, given the measure's numerous eligibility criteria together with the UDF manager’s discretion when choosing and structuring projects, the Commission has concluded that, particularly when foreseen as part of a notified scheme, the provision of preferential investment conditions will normally confer a selective advantage on project developers and other private investors in the projects covered by the measure.

(207) Moreover, under point 3.2 of the RCG, where aid is present at the level of the investors, the Commission will normally consider that it is at least partly passed on to the target enterprises and thus that it is also present at their level. This is the case even where investment decisions are being taken by the managers of the fund according to a purely commercial logic.

(c) Conclusion

(208) On the basis of the above, the Commission concludes that the UDF investments referred to above will confer an economic advantage within the meaning of Article 107(1) TFEU on the project developers and other investors that undertake and invest in the urban development projects within the scope of the notified measure.

3.3. Selectivity

(209) Article 107(1) TFEU requires that a measure, in order to be defined as State aid, has to favour *‘certain undertakings or the production of certain goods’*. In the case at hand, the EIB and the UDF managers enjoy a degree of discretionary power, as investment decisions will be made based on pre-defined project eligibility criteria. The selectivity criterion is further satisfied if the scheme applies to only part of the territory of the Member State, which in the case at hand is the Northwest of England. The Commission therefore concludes that the economic advantage granted to private investors in the UDF as well as the project developers and other investors that undertake and invest in the urban development projects under the measure is selective within the meaning of Article 107(1) TFEU.

3.4. Distortion of competition and effect on trade

(210) When aid granted by a Member State strengthens the position of an undertaking compared with other undertakings competing in intra-EU trade, the latter must be regarded as affected by that aid. In accordance with settled case-law,[57] for a measure to distort competition it is sufficient that the recipient of the aid competes with other undertakings on markets open to competition. Distortions of competition and effects on trade are assumed to be present when the measure is selective, that is, when the aid improves the market position of the aid beneficiary *vis-à-vis* its competitors.

(211) Under the measure in question, in addition to the competition that exists generally to attract investment, and in particular in a situation where each Member States may be devising schemes to achieve the same objectives, competition also takes place between property developers and investors in the property development market. The economic advantage which recipients might receive from the UDFs to undertake the regeneration of sites and premises might strengthen their position *vis-à-vis* their competitors on the European market of commercial property developers and investors. Therefore, the Commission considers that the measure could distort or threaten to distort competition and could affect trade between the Member States.

3.5. Conclusion

(212) For the reasons set out above, the Commission takes the view that the public funding provided by the NWUIF to the UDFs on non-*pari passu* terms with the private funds in the UDFs and, subsequently, the sub-commercial investments made by the UDFs involves State aid to the private investors in the UDFs and project developers and other investors in the projects within the meaning of Article 107(1) TFEU.

3.6. Legality of aid

(213) The Commission notes that the UK authorities have complied with Article 108(3) TFEU by notifying the measure to the Commission and by not putting it into effect until the Commission has authorised it.

4. COMPATIBILITY ASSESSMENT

4.1. Applicability of existing State aid provisions

(214) The UK authorities have invoked the applicability of Article 107(3)(c) TFEU directly as the basis for assessing the compatibility of State aid granted under the measure. The present case displays the specific feature of addressing under one single scheme projects which, by their very nature, are made up of very different components. As demonstrated below, individual projects, if taken in isolation, may fall under one of the existing legal frameworks. However, the very essence of the NWUIF is that the projects supported under the measure form part of an integrated plan and are therefore interdependent. For this main reason, and in view of the more detailed explanations below, the assessment of the notified measure will be carried out directly under the Treaty.

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[57] Case T-214/95 *Het Vlaamse Gewest v Commission* [1998] ECR II-717.

4.1.1. Services of General Economic Interest (SGEIs)

(215) The Commission has assessed the applicability of EU rules on the provision of SGEIs such as the Community framework for State aid in the form of public services compensation (the SGEI Framework)[58] and the Commission Decision of 28 November 2005 on the application of Article 86(2) of the EC Treaty to State aid in the form of public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest (the SGEI Decision).[59]

(216) These provisions have not been cited by the UK authorities and accordingly their specific requirements have not been addressed in the notification. While developed property could be used for the provision of SGEIs, the measure will support physical development rather than the provision of SGEIs. Therefore, the projects will most likely fail to meet the wide definition of SGEIs provided for under point 2.2. of the SGEI Framework. Furthermore, it is not sufficiently certain that the selection of urban projects by the UDFs would, despite the large discretion involved in the process, fulfil conditions for entrustment by a Member State as stipulated in Article 4 of the SGEI decision.

(217) Based on the above, the Commission concludes that EU rules on the provision of SGEIs are not directly applicable to the notified measure.

4.1.2. Guidelines on national Regional Aid (RAG)[60]

(218) When assessing the applicability of the RAG, the Commission has taken note that certain areas of the Northwest region targeted by the measure are eligible for national regional aid under the current UK Regional Aid Map.[61] The RAG are not directly applicable because the measure focuses on sustainable urban development, which covers both assisted and non-assisted areas. As explained above, pockets of urban deprivation could indeed occur in both assisted and non-assisted regional aid areas. The Commission therefore does not consider that the measure as a whole is a regional aid measure within the meaning of the RAG.

4.1.3. Risk Capital Guidelines for SMEs (RCG)[62]

(219) As regards the applicability of the RCG, the Commission has taken note that the funding structure involving investment vehicles as well as public-private investments on non-*pari passu* terms present analogies with the funding set-up envisaged in point 3 of the RCG. At the same time, the RCG stipulate a series of requirements e.g. a maximum annual investment tranche of EUR 2.5 million for standard assessment and restriction of the investments to SMEs as target enterprises, which are not fulfilled in the present case.

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[58] OJ C 297, 29.11.2005, p. 4.

[59] OJ L 312, 29.11.2005, p. 67.

[60] OJ C 54, 4.3.2006, p. 13.

[61] State aid N 673/2006 — United Kingdom — Regional aid map 2007-2013, OJ C 55, 10.3.2007, p. 2.

[62] OJ C 194, 18.8.2006, p. 2.

(220) By contrast, the notified measure incorporates the significant additional feature of addressing integrated sustainable urban development objectives. Furthermore, unlike the RCG, the current measure provides fine-tuned instruments aimed at limiting advantages to private investors, whereas the RCG provides hardly any such limitation[63] and rather relies on the safe-haven clauses concerning investment amounts.

(221) It follows from the foregoing that only smaller projects under the notified scheme could be covered by the RCG, which at the same time do not fully reflect the integrated character of investments in urban projects under the notified measure. The Commission therefore finds that the RCG do not prevent an assessment of the notified measure directly under Article 107(3)(c) TFEU.

4.1.4. Applicability of the Environmental Aid Guidelines (EAG)[64]

(222) The EAG may cover the part of urban regeneration activities related to land remediation. Therefore, they do not provide a suitable instrument to assess the whole range of activities related to urban regeneration projects. Nevertheless, the principles of the EAG concerning the polluter pays principle will be applied to the measure in question. The Commission therefore does not consider that the measure as a whole is an environmental aid measure within the meaning of the EAG.

4.1.5. Conclusion

(223) Given the above, the measure does not *per se* fall within the applicability of the existing compatibility rules.[65] No existing secondary legislation on State aid would provide the NWUIF and the UDFs with a uniform set of compatibility conditions for State aid compliance. At the same time, no current legislation fully reflects the integrated approach to sustainable urban development that is pursued by the notified measure. The Commission therefore finds that no existing EU legislation prevents the notified scheme from being assessed directly under Article 107(3)(c) TFEU and the UK authorities correctly rely on the applicability of Article 107(3)(c) TFEU.

4.2. Assessment under Article 107(3)(c) TFEU

(224) Taking into account that no specific secondary EU legislation appears directly applicable, the Commission has examined whether the measure could be approved on the basis of Article 107(3)(c) TFEU, which stipulates that *'aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest'* may be considered to be compatible with the internal market.

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63 The upper limit for loss limitation to 50 % of the private contribution as stipulated under point 4.2. (b) RCG being the only explicit exception.

64 OJ C 82, 1.4.2008, p. 1.

65 This, however, does not rule out the possibility of devising measures that are in compliance with existing rules:

Competition Handbook of 1 March 2011: http://ec.europa.eu/competition/state_aid/legislation/compilation/state_aid_11_03_11_en.pdf;

Vademecum on urban regeneration: http://ec.europa.eu/competition/state_aid/studies_reports/vademecum.pdf.

(225) In examining the compatibility directly under Article 107(3)(c) TFEU, the Commission has carried out a detailed economic assessment to evaluate its positive and negative effects. The Commission takes into account whether the aid measure is aimed at a well-defined common interest objective, is an appropriate instrument, is well targeted and proportionate to the targeted objective and does not adversely affect trading conditions to an extent contrary to the common interest. Positive and negative aspects are balanced against each other.

4.3. Objective of common interest

4.3.1. Targeting an objective of common interest

(226) The Commission will assess whether the urban regeneration activities supported by the NWUIF through the UDFs are aimed at achieving a well-defined common interest objective.

(227) EU Cohesion Policy supports cities as drivers of regional development. Following the Bristol Accord that established the principles of a common EU urban policy, JESSICA was announced to facilitate sustainable urban development in order to improve convergence across EU regions and economic and social cohesion, which is a common interest objective, pursuant to Articles 4, 14 and 174 TFEU.

(228) In line with Article 8 of the ERDF Regulation, which highlights action to 'support the development of participative, integrated and sustainable strategies to tackle the high concentration of economic, environmental and social problems affecting urban areas', the measure supports urban regeneration in the Northwest region in order to reverse economic, social and physical decline in areas where market forces alone will not do this.

(229) To facilitate urban regeneration, the measure will seek to bring into commercial use land or buildings which are derelict, contaminated, under-used or vacant. The nature of urban regeneration activities supported under the measure is in line with the activities set out in Article 8 of the ERDF Regulation, such as the rehabilitation of the physical environment and 'brownfield' redevelopment. The Commission also notes that the definition of the eligible recipients, activities and costs ensures that the design of the measure is aligned with the policy objectives.

(230) Moreover, the measure follows an integrated approach to urban development. The NWUIF and the UDFs will operate on the basis of the IPSUDs. This will ensure that the individual projects supported under the measure are integrated in nature and have a place within a coherent urban and regional development policy. The Commission notes that the UK authorities have ensured that the key components of integrated urban development plans comply with the SF Regulations[66] and the requirements of the Strategic Guidelines on Cohesion 2007 - 2013.

[66] Article 44 of the General Regulation.

(231) The Commission also notes that the SF Regulations provide a set of controls to ensure that NWUIF and UDF investment strategies are delivered in line with the policy objectives. The SF Regulations define key parameters for the investment strategy and business plans of investment intermediaries and require that contractual agreements are in place. As stated above, each urban project must contribute to the achievement of policy objectives indicated in the UDF investment strategies and must form part of an integrated urban development plan.

(232) On the basis of the above, the Commission considers that urban regeneration is clearly an EU objective, pursuant to Articles 4, 14 and 174 TFEU. Accordingly, the scheme's objective to support urban regeneration in the Northwest region of England can thus be considered to be in the common interest. As noted above, each individual application of that scheme (that is, each urban project in receipt of a sub-commercial UDF investment) must, under the SF Regulations, contribute to that objective. The Commission considers that any investment made in a project that does not in fact contribute to the identified common interest objective is not covered by the present decision.

4.3.2. Well designed to deliver the common interest objective

(233) The Commission needs to examine whether the measure is suitable to attain the common interest objective of sustainable urban development. In line with economic theory, a measure contributing to such an objective of common interest can be based on two fundamental welfare aspects — efficiency and equity, which are in practice not necessarily mutually exclusive, i.e. the measure can pursue both efficiency and equity objectives at the same time:

(a) contributing to overall welfare and increasing the efficiency of an economy[67] (State aid must remedy market failures,[68] thus 'making the cake bigger');

(b) contributing to welfare equity (State aid could contribute to welfare distribution leading to an equitable outcome, thus 'dividing the cake better').

(234) As stated above, the NWUIF has been set up to enhance economic efficiency by addressing market failures inherent in urban regeneration and strengthen socio-economic cohesion among the urban areas of the Northwest region.

4.3.2.1. Improving market efficiency by tackling market failures

(235) In order to assess whether the measure is well designed to address efficiency objectives, the Commission needs to assess the justification for and objectives of the NWUIF and UDF investment strategies as well as the investment criteria in order to verify that the investments will seek to remedy the identified market failures, i.e. situations where urban

[67] In economic theory, an efficient outcome corresponds to a situation where the allocation of resources is optimal in the sense that no-one can be made better off without making someone else worse off. State aid, as it has an impact on the incentives of market participants, can change business behaviour, thereby altering the market outcome in a way that makes everyone (potentially) better off.

[68] Market failure refers to a situation where the market, if left to its own devices, is unlikely to produce efficient outcomes in terms of prices, output and use of resources, i.e. it does not provide a good or service even though the economic benefits outweigh the economic costs.

projects would not otherwise be delivered by the market and investors would not have provided the necessary funding.

(236) The Commission notes that the JESSICA initiative has been set up as a response to perceived market failures in urban regeneration and the need to support regeneration projects that contribute to sustainable urban development but are not sufficiently viable to be financed on a commercial basis. While regeneration projects could generate wider positive economic benefits, private investors perceive that the risks of undertaking investments outweigh potential benefits.

(237) As stated above, the NWUIF and the associated UDFs have been set up to improve the efficiency of the property regeneration market. The Commission notes that the evidence provided by the UK authorities suggests that there are a number of issues due to market failures affecting urban regeneration projects, such as undersupply of property due to a perceived lack of demand, low returns generated by regeneration projects, and both positive and negative externalities, as indicated above.

(238) The Commission must assess whether the identified market failures will be properly addressed by the design of the measure. The Commission considers that by ensuring that regeneration projects are integrated in their approach and are part of a broader plan for the area, the measure will create long-term value and help address investors' negative perceptions of regeneration areas. Moreover, a portfolio approach to the financing of urban projects makes it possible to obtain greater long-term investment opportunities and a diversification of risks.

(239) As indicated above, the UDF managers must verify a number of financial requirements prior to making an investment. The Commission considers that professional project appraisal on the basis of financial forecasts ensures that urban projects are feasible from the economic, social and technical points of view and has the potential to improve market efficiency. The Commission also notes that aid will only be provided to those urban projects that are affected by the above-mentioned market failures, which will be reflected in a financial viability gap.

(240) The Commission takes into consideration that the project eligibility requirements are well aligned with the nature of market failures tackled by the measure. Investments will focus on derelict, contaminated, under-used or vacant land and buildings that are affected by the above-mentioned market failures. As stated above, the measure excludes projects in the operating phase in order to ensure that the measure addresses the specific risks related to the development and construction phase. Furthermore, only the initial investment expenditure related to the eligible activities will be supported. The measure excludes financing acquisition of the enterprise from its previous owners.

(241) On the basis of the above, the Commission concludes that the measure targets market failures related to the property regeneration market that are specific to the Northwest region for which there is sufficient evidence and that the measure has potential to improve market efficiency in the Northwest region.

4.3.2.2. *Pursuing an equity objective by tackling socio-economic deprivation*

(242) In order to assess whether the measure is suitable to address equity objectives, the Commission will verify how the NWUIF and the UDFs will be tackling socio-economic deprivation in the target urban areas. From an economic theory point of view, while functioning markets establish an efficient allocation of goods, the outcome might be perceived as inequitable. Therefore, public authorities may intervene with a view to creating a more equitable outcome than that produced by market forces alone.

(243) As indicated above, the measure will focus on urban projects that are carried out in deprived urban locations, i.e. so-called urban regeneration areas that suffer from physical, economic and social deprivation and are characterised by a weakened economic base, low levels of employment and a poor physical environment. The Commission considers that the UK authorities have provided sufficient economic evidence to justify disparities within urban areas and characteristics of the urban regeneration areas.

(244) The Commission finds that the need to facilitate investments in deprived urban areas is sufficiently justified. The deprived urban areas are small and localised, and in some instances found within relatively prosperous regions and often outside assisted areas for regional State aid.[69] The inherent profitability of investment in these areas is low due to high investment costs, often entailing non-commercial components, and low demand. The regeneration areas struggle to attract new private inward investment while experiencing low levels of indigenous investment.

(245) The Commission considers that resolving market failures in disadvantaged urban areas has the effect of both increasing the efficiency of the urban development market and fostering socio-economic cohesion within the urban areas. Urban regeneration projects will be integrated in their approach and form part of a broader plan for the urban area, which will tackle socio-economic deprivation issues alongside market deficiencies.

(246) On the basis of the above, the Commission concludes that the measure targets underperforming urban regeneration areas for which there is sufficient evidence and has potential to improve socio-economic cohesion among the urban areas of the Northwest region.

4.4. Appropriateness

(247) The Commission must examine whether the measure is an appropriate policy instrument to support sustainable urban development in the Northwest region. In this context, the Commission takes into account whether there are measures that are better suited to overcome market failures and foster socio-economic cohesion.

(248) Member States can make different choices with regard to policy instruments and State aid control does not impose a single way to intervene in the economy. However, State aid under Article 107(1) TFEU can only be justified by the appropriateness of a particular

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69 The UK Regional Aid Map approved by the Commission: State aid N 673/2006 — United Kingdom — Regional aid map 2007-2013, OJ C 55, 10.3.2007, p. 2.

instrument to meet the public policy objective and contribute to one or more of the common interest objectives.[70]

(249) The Commission normally considers that a measure is an appropriate instrument where the Member State has considered whether alternative policy options exist which are equally suitable to achieve the common interest objective but at the same time less distortive to competition than the selective State aid and where it can demonstrate the appropriateness of the measure in targeting efficiency and/or equity objectives.

(250) The Commission notes that the UK authorities have provided a number of economic studies[71] demonstrating that other instruments, while being complementary to the measure, would be not well suited to achieving the objectives of the JESSICA initiative. For example, MEIP-compliant investments via a number of special purpose vehicles active in the Northwest may not be suitable for mitigating investment risks of projects that have a financial viability gap and are not able to generate market-level returns on investment.

(251) The existing State aid schemes for land remediation and bespoke development cover only a limited part of urban regeneration activities and, therefore, are not sufficiently suitable in relation to the scope of the proposed measure. Moreover, grant-based gap funding is not appropriate for projects that have some return generation capacity, which is the focus of the notified measure. Grant measures will continue to be used for non-commercially viable projects and, therefore, will be complementary to the measure.

(252) The Commission takes into consideration that the appropriateness of the notified measure essentially relates to the JESSICA investment approach to supporting regeneration projects, which seeks to:

(a) ensure long-term sustainability of public resources through the revolving character of the public funding — projects are financed through repayable investments rather than grants; public funds could be ‘recycled’ and become available for further reinvestment in urban projects;

(b) create stronger incentives for successful implementation of urban projects by combining grants with repayable investments — grant funding will be subject to the same criteria and limitations as the repayable investments, thus increasing transparency and minimising potential distortions;

(c) leverage additional resources for urban projects with a multiplying effect which achieves a much larger impact for the final recipients;

(d) contribute financial and managerial expertise from specialist institutions, including investment management by professional and independent intermediaries, pursuant to professional investment and banking criteria.

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[70] See for a discussion of appropriateness Cases C 25/2004 — DVB-T Berlin-Brandenburg (OJ L 200, 22.7.2006) or N 854/2006 — Soutien de l’agence de l’innovation industrielle en faveur du programme mobilisateur pour l’innovation industrielle TVMSL, OJ C 182, 4.8.2007.

[71] E.g. the Lyons Inquiry commissioned by the UK authorities.

(253) In line with the JESSICA funding mechanism, the Commission considers that the notified measure is an appropriate instrument for the following reasons:

(a) public funds are contributed as repayable investments to the UDFs and then invested in the form of equity or loans to urban projects;

(b) grant funding combined with the repayable investments will be subject to the same conditions and limitations;

(c) each UDF must attract at least 50 % of private funding to each project, of which private equity must account for a significant share;

(d) the NWUIF will be managed by the EIB and the UDFs by professional and independent fund managers.

(254) A contractual relationship between the UK authorities and investment management service providers is an appropriate tool for the proposed funding model involving a cascade of investment intermediaries. The UK authorities have defined what the service providers are expected to deliver and the key criteria for the approval of their service obligations, while enabling the investment intermediaries to operate flexibly in response to changing market needs.

(255) On the basis of the above, the Commission concludes that the measure is an appropriate policy instrument to support sustainable urban development in the Northwest region of England.

4.5. Incentive effect

(256) The Commission considers that the existence of market failures or socio-economic deprivation issues is a *necessary* but not sufficient condition for granting State aid. State aid must be effective, i.e. have an incentive effect, in relation to the legitimate objective in order to be compatible with the internal market. In the absence of an incentive effect, State aid constitutes a windfall profit (economic advantage) for the company, which may give rise to various types of distortion in the market.

(257) With regard to efficiency objectives, the incentive effect is demonstrated by the fact that the beneficiaries are likely to change their level of activity, and consequently improve the market outcome. With regard to equity objectives, the incentive effect is demonstrated by the expected positive effects corresponding to the provision of the equity-enhancing output or to a change in the way output is delivered: e.g. if projects are carried out in a disadvantaged urban area.

(258) The Commission must therefore establish whether State aid granted to private investors at any level would change their behaviour in such a way that they would carry out the target urban regeneration projects and provide the necessary funding. For this, the Commission needs to assess whether sub-commercial funding provided by the NWUIF to the UDFs and then invested by the UDFs on preferential terms in urban projects is necessary in order to bring about the desired change in behaviour.

4.5.1. Aid application

(259) The Commission usually considers that aid does not present an incentive effect for the beneficiary where the project was started prior to the aid application being made by the beneficiary. As indicated above, UDF investments in urban projects will be made before their commencement. Likewise, preferential treatment of private investors at the UDF level will be granted only in relation to new portfolio investments undertaken by the UDFs.

4.5.2. Efficient projects

(260) The Commission notes that NWUIF/UDF investments will be based on a business plan and *ex ante* defined exit strategies ensuring that they will be repaid. To protect the public funds, they may not be invested with less than zero return expectations, net of management fee, i.e. they cannot be used to support inefficient enterprises that could not repay even the initial invested capital. This will ensure financial sustainability of the NWUIF and the UDFs and enable them to cover the operating costs of their investments.

(261) The Commission notes that investments will only be made in projects that make a return on investment on the basis of a realistic business plan that will be assessed by the UDF manager, that is, by a financial institution regulated by the Financial Services Authority (FSA) that must exercise due care. The Commission looks positively on the fact that the UDF manager's remuneration is based on the overall investment value, thus incentivising the UDFs to invest in efficient projects.

4.5.3. Necessity

(262) The Commission notes that the UDF sub-commercial investments will be provided only to those urban projects that are not able to generate returns on investments at the level that private investors would usually seek and, consequently, would not be carried out to the same extent and in the same timeframe (a counter-factual scenario in the absence of the measure) without the State intervention. At the UDF level this means that much of the UDF portfolio will comprise assets whose returns are uncertain and insufficient. This is due both to the market failures inherent in the nature of regeneration activities and to the additional costs linked to projects carried out in deprived urban locations.

(263) As stated above, the UDF managers will carry out an investment appraisal of each project not only to examine technical quality and economic and financial viability, but also to establish a financial viability gap in order to justify the need for sub-commercial investments. The investment gap is established to verify that due to the specific nature of the project and the risks and/or location characteristics private investors would not provide the investments necessary to carry out that regeneration project.

(264) The Commission notes that from a financial point of view, State aid is necessary[72] when the IRR is lower than the risk-adjusted opportunity cost of capital. This essentially means that the project is not viable and would not be undertaken by private investors, as the net revenues do not remunerate the investment costs above the opportunity cost of capital. The Commission notes that the viability gap will be calculated by comparing expected IRR with

[72] Provided a common interest objective is justified and an enterprise is efficient.

a benchmark IRR, which is the fair rate of return (FRR). Based on economic logic, private developers and investors would not go ahead with projects with an IRR below the FRR, i.e. the investments would not take place to the same extent and in the same timeframe.

4.5.4. Nature of incentives

(265) The Commission must also assess the nature of the incentives generated by the measure. The change of behaviour can be identified by comparing a situation with and without the aid, which must be likely to lead to the achievement of the targeted policy objectives. The Commission notes that the rationale for the sub-commercial public investments at the UDF or project level is to encourage project developers to engage in the regeneration activities and private investors to provide the necessary funding.

(266) The UDFs will help to bring new investment products helping to finance urban regeneration and achieving the wider regeneration benefits. The UDFs will encourage investment in regeneration projects where positive spillover effects will be generated. Given a choice between a greenfield and a brownfield site, the market is likely to choose the former, as there are lower costs and less uncertainties. The UDFs will address this market failure by focusing investment on brownfield sites, thus directing the private sector to these sites.

(267) The Commission notes that public investments under the measure could be provided with a minimum return expectation, or even zero return net of management fees, which creates economic incentives to project developers and private investors. The Commission considers this 'floor of zero' requirement is a suitable tool to ensure the minimum economic viability of urban projects and at the same time a transparent means to exclude excessive deviation from market rules.

(268) The sub-commercial public investments will bridge the gap between the estimated costs of an urban project (or project portfolio at the UDF level) and its market value on completion. This would create a strong financial incentive for the project developers and other private investors because their investments would become commercially viable and enable to achieve market-level returns, thus helping to catalyse development activity:

(a) Subsidised loans will reduce the cost of funding, thus improving expected financial performance, as risky regeneration projects have limited ability to borrow or obtain finance at affordable rates;

(b) Subordinated loans provide structural subordination of debt repayment, thus reducing the risk for senior lenders;

(c) Non-*pari passu* allocation of equity returns ahead of public equity reduces investment risks for private investors.

(269) In addition, the Commission notes that preference is given to upside rather than downside investment protection. The shared return structures (albeit with preferential treatment of private investors) provide efficiency gains shared between public and private investors, which provides the necessary incentives for the UDF managers and project developers to improve investment performance and allows the public investments to benefit from the upside.

(270) Public investments made through the UDFs will improve the efficiency of the urban regeneration investment market so that capital can be allocated effectively to address urban regeneration needs. The measure will make capital, expertise and management skills available to urban projects capable of delivering regeneration objectives as well as a financial return. By leveraging additional sources of funding, it will address the under-provision of capital by increasing the supply of finance available to the urban regeneration investment market.

(271) The NWUIF will act as a lead or cornerstone investor, providing key investment and carrying out due diligence on UDFs. By providing sub-commercial investments to the UDFs, the NWUIF will facilitate the development of the UDFs, which will provide effective mechanisms for matching demand and supply for urban regeneration investments. The NWUIF will support the UDFs by helping them to expand their investor base and raise capital for investments to support urban regeneration.

(272) With regard to the socio-economic cohesion objectives, the positive effects correspond to the achievement of the equity-enhancing output of the UDF investments provided to urban projects to be carried out in the target deprived urban areas, which will create new jobs and promote local economic activities, thus enhancing socio-economic cohesion.

4.5.5. Conclusion

(273) In the light of the above, the Commission considers that the measure is designed in such a way as to ensure that the aid is necessary and will trigger the urban regeneration projects that would not be carried out by the market. The UDFs will target efficient urban projects that have potential to generate some returns to repay investments but that would not have been carried out by the market as the repayment is not sufficient to generate market-level returns for market investors. Therefore, the Commission concludes that the measure has an incentive effect.

4.6. Proportionality

(274) State aid must be proportionate in relation to the legitimate objective in order to be compatible with the internal market. The Commission must therefore examine whether State aid granted to project developers and other private investors at the UDF or project level is proportionate to securing their participation. The aid is considered to be proportionate only if the same result could not be reached with less aid and less distortion.

(275) The Commission notes that no gross grant equivalent of aid will be calculated and compared to the eligible costs. Instead, criteria and processes are in place to ensure that the advantage provided to private investors at any level is the minimum necessary to enable the private developers to undertake urban regeneration projects and provide the necessary funding.

4.6.1. Maximum investment amount

(276) As stated above, the maximum amount of funds committed by the UDF to any one project is limited to GBP 6 million (20% of the NWUIF funds allocated to the UDF). The

Commission considers that this mitigates the underlying project risks through increased leverage and project portfolio diversification.

4.6.2. Minimum level of private participation

(277) The Commission considers that private investments at the UDF or project level are necessary in order to reduce public investment exposure and share investment risks. Private investors have to assume the commercial risk linked to the investment, albeit on better terms and conditions than the public investments. By analogy with the RCG, private investors ensure the economic soundness of investments and contribute experience and professionalism.

(278) Firstly, the Commission notes that the notified measure limits overall public funds to a maximum of 50 % of each project's eligible costs. Consequently, at least 50 % of overall project costs will be covered by private investors in some form, i.e. investors that are MEIP-conform, pursue profit-oriented goals in line with market logic and are free of any public support.

(279) Secondly, private developers must contribute a significant amount of equity in each project to share investment risks. 'Significant' is not defined in percentage terms, but will be determined on a case-by-case basis. The Commission notes that the degree of private equity will largely depend on the viability of each urban project and its capacity to generate returns as well as the incentives offered to the private investors.

(280) The Commission considers that the size of the private equity investment in each project will determined by a number of factors:

(a) the size of market failures, which determines the financial viability of a target project the more a project is affected by market failures, the less returns it can generate, thus reducing the scope for private investments at market rates;

(b) the higher the financial return that could be received through preferential conditions offered by the UDFs, the higher the leverage will be.

4.6.3. Minimum profitability for private investors

(281) The Commission has paid special attention to the advantages granted to all types of private investors, whether at the UDF or the project level.

(282) As explained above, the sub-commercial public investments under the measure are intended to cover the viability gap, including a reasonable profit for private investors, which is up to the FRR. The Commission considers the FRR to be an appropriate benchmark as it reflects the required return that a project promoter and/or any other investors require while also reflecting the level of risk proposed by the project and the level of capital they plan to invest.

(283) The Commission notes that the UDF sub-commercial investments will be 'tendered out' to any suitable investors. The UDFs are required to publish a call for tender for potential project proposals so that any suitable investor could bid for the UDF sub-commercial

financing. The UDFs will select projects based on their compliance with policy objectives and overall profitability, involving the least amount of aid.

(284) The Commission considers that the process of determining the FRR provides sufficient assurance that the FRR for each transaction will be determined objectively. When the development in question constitutes a public works contract or public works concession within the meaning of Directive 2004/18/EC, then the selection of a project developer and its investment conditions will be subject to a public procurement process in accordance with applicable EU law. Where however the procurement rules do not apply, an open and transparent competitive benchmarking process will determine the FRR.

(285) If none of the above processes is suitable, the FRR will be determined through benchmarking carried out by the Independent Expert. The Commission finds that the requirements for professionalism and independence applicable to the Independent Expert are adequate. Moreover, the Independent Experts will be selected by the EIB through an open and transparent selection process.

(286) As regards taking underwriting risks through public funds being in a first loss position, the Commission notes that the first loss position will only be used where it is absolutely necessary and where the options outlined in section 2.8.1.3 above have been exhausted and have proved insufficient to address the viability issues of the project. In addition, exposure to the downside risk is limited to a capped 'first loss' position of 25 % of the overall outstanding loss and is in any case limited to the level of the UDF's investment in the project, which may not exceed 50 % of total project costs.

(287) In any of these cases, the UDF managers will negotiate final investment conditions with private investors. The Commission notes that performance-based management remuneration will ensure that the UDF managers will seek to maximise investment performance and will not overestimate the FRR.

(288) As pointed out by the UK authorities, while upside and downside protections may need to be offered at the outset of a project, they could not apply at the same time when actual investment performance is known. This is because a project which makes a positive return would not need to use a first loss mechanism and, conversely, a project making losses would have no return to share.

(289) The Commission notes that any profits beyond the FRR will be shared proportionally between public and private investors. This means that both private investors and the UDF will benefit from the upside. The actual investment performance, thus the degree of profits or losses, may differ from the initial estimates and will be calculated at the investment exit.

(290) The Commission therefore concludes that the FRR methodology is a suitable tool in order to ensure that the advantages granted through the sub-commercial public investments under the measure at any level will be kept to the minimum necessary to encourage private investments, while avoiding any overcompensation.

4.6.4. Sound investment management

4.6.4.1. Selection procedure

(291) In relation to the selection procedures and the appraisal of business plans on which selection was based, the Commission notes that the UDF managers have been procured according to the principles of equal treatment, proportionality, non-discrimination and transparency, in line with the EIB selection procedure. The selection has been carried out according to adequate criteria on the basis of *ex ante* defined business plans to establish the economic viability and sustainability of UDF operations. The Commission considers as good practice that the EIB has carried out its own risk analysis/due diligence process during its evaluation of the UDFs' business plans. The Commission finds that the selection of the fund managers contributes to economically sound investment decisions in line with market rules.

4.6.4.2. Professionalism and independence

(292) When assessing whether the processes for ensuring that the State aid provided is limited to the minimum necessary, the Commission has paid particular attention to investment decision-making to ensure that it is aligned with commercial logic and follows best investment management principles.

(293) The Commission notes that investments will be carried out by professional and independent fund managers that are FSA-regulated financial institutions which will operate in line with market investment principles seeking to maximise investment performance, while achieving the policy objectives. The managers are contractually required to use care and diligence when investing on behalf of the investors. As explained above, investments will be made on the basis of a realistic business plan for each project, which the Commission considers as a positive feature by analogy with the RCG.

(294) The Commission also notes that the NWUIF and the UDFs have appropriate governance structures and investment processes and procedures, which were subject to the EIB's approval and will ensure that decisions concerning investments, divestments and risk diversification are implemented in accordance with the applicable requirements of the Funding Agreements and market standards. Provisions are in place to ensure the impartiality and independence of the UDF manager and to prevent conflicts of interest. The above processes and procedures are in compliance with FSA-regulated requirements, and are thus in accordance with best practice in the financial service industry.

(295) The Commission notes that the NWUIF and the UDFs will be independent of the UK authorities due to the legal and governance structure. Instead, they will be accountable to their boards, which include representatives of the UK authorities. The Commission also notes that, in line with the Funding Agreement, the EIB […][*] in managing the NWUIF and is liable to the UK authorities for any direct loss or damage caused by any failure to exercise its duties.

[*] An exact degree of the EIB's legal obligation is a business secret.

4.6.4.3. Performance-based management remuneration

(296) By analogy with point 4.3.6 of the RCG, the Commission takes a positive view where fund manager remuneration is linked to investment performance for the effective repayable investments paid to final recipients and the quality of investment effectively made, namely measured through their contribution to the achievement of the policy objectives in line with the specific objectives and investment strategy as well as the value of resources returned.

(297) As indicated above, the management fee has been subject to a competitive tendering process and an element of the fee structure is paid as a percentage of the value of the loans and equity invested before the end of 2015, which will reward the UDF manager for selecting projects that are compliant with the relevant policies and incentivise the UDF manager to invest in projects in a timely manner before the end of 2015.

(298) After 2015, management remuneration is payable in respect of investment proceeds received, namely the fee is linked to the amounts repaid and interest earned on loans as well as any earnings on equity investment (e.g. dividends) and the value of the equity investments on investment exit. Therefore, the UDF manager's ability to generate fee income beyond 2015 depends entirely on the financial performance of the urban projects and sums recovered from previous investments.

(299) The Commission considers that the performance-based fee structure will incentivise the UDF manager to take an appropriate level of risk when making investment decisions in order to limit financial incentives to the private investors to the minimum necessary. Moreover, the performance-based fee structure will ensure that the UDF managers monitor closely the project portfolio to ensure the investments are repaid with a maximum return on investment.

(300) The Commission takes note of the fact that in the event of non-performance by the UDF, the UDF will receive reduced management fees. The EIB also has the right in the event of non-performance to terminate the Operational Agreement. Combined with the performance-based management remuneration system, these provisions ensure that the UDF manager is sufficiently incentivised to make sound investment decisions and limit incentives to private investors.

4.6.4.4. Monitoring and control

(301) As described above, monitoring and controls will be carried out through the governance structures of the NWUIF and the UDFs. The UDF managers will also carry out hands-on monitoring of project performance. The Funding Agreements include provisions for monitoring of implementation which will enable the actors involved to monitor compliance with the conditions of the Funding Agreements as well as returns from equity, loans and other repayable investments.

(302) The Commission finds that the monitoring system covers key investment decisions by the NWUIF and the UDFs, which will enable implementation performance to be measured against the objectives and criteria set out in the investment strategy and the agreed terms and conditions, including monitoring the repayment of interest and other returns from equity and loan investments, as well as the recycling of funds (resources returned and returns).

4.6.4.5. Treasury management

(303) The Commission considers that the Funding Agreements contain adequate requirements and procedures regarding treasury management of funds, such as the type of acceptable treasury/investments, and demonstrate a prudent approach to the matter at the level of both the NWUIF and the UDFs.

4.6.5. Cumulation

(304) As stated above, the UDF sub-commercial investments could in limited cases be combined with grant funding, which will only be used as a last resort when the repayable investments have been applied and have proved insufficient to enable the project to proceed. The Independent Expert must review the justification for grant funding and ensure that it is being used in limited cases and as a last resort.

(305) The Commission notes that grant funding will be awarded under the same conditions as are applicable to the UDF repayable investments and may not result in higher than FRR levels for private investors. The Commission considers that the proposed grant funding mechanism ensures efficiency, integration and transparency.

(306) As stated above, after the receipt of the UDF investments and in some cases grant funding, cumulation with aid received from other local, regional, national or EU sources to cover the same eligible costs is not allowed. The Commission therefore finds that the notified scheme contains appropriate provisions on cumulation.

4.6.6. Conclusion

(307) On the basis of the above-mentioned features, especially considering that there will be a minimum degree of private participation, the profit margin for private investors will be limited to what is necessary to trigger regeneration activities, and the process of determining the FRR is credible and transparent, the Commission considers that State aid provided under the measure is proportionate.

4.7. Further positive features

4.7.1. Individual notification

(308) The Commission notes in addition that the UK authorities have agreed to notify individually, for approval by the Commission, major projects as defined in the SF Regulations[73] (currently projects exceeding EUR 50 million) irrespective of what proportion of these costs is financed by the UDF, which will further enhance the transparency of State aid granted under the measure.

4.7.2. Reporting on State aid compliance

(309) As for the reporting requirements set out in the Funding Agreements at NWUIF, UDF and final recipient levels, the Commission considers that the content is adequate for reporting progress in implementation and performance to the upper levels and ultimately to the Investment Board and the UK authorities. The reporting to be provided from one level to

[73] Article 39 of the General Regulation.

the other for the purposes of monitoring and control of operations will be regular and detailed.

(310) The Funding Agreement between the UK authorities and the NWUIF includes provisions for reporting to the UK authorities. Such reporting ensures on the one hand that sufficient detail is provided to the UK authorities to allow them to comply with their reporting obligations to the Commission, and on the other hand that sufficient, timely and relevant information is provided for monitoring implementation.

(311) The Commission notes that the UK authorities will provide an annual report on State aid compliance. The UK authorities will also provide a Standardised Information Sheet (SIS) for each sub-commercial UDF investment exceeding EUR 5 million in a single project. For the avoidance of doubt it needs to be stated that the Commission will not be approving each SIS as a condition for making investments. The SIS should allow the Commission to monitor compliance with the conditions of the notified measure.

(312) The Commission therefore considers that exhaustive monitoring and reporting obligations will provide it with sufficient information to verify compliance with State aid rules.

4.8. Effects on trade and competition

4.8.1. Relevant markets

(313) Considering the nature of the target activities and the funding model, the potentially relevant markets are as follows:

(a) the property development market (project developers), including the market for sale (buyers) and rental of commercial premises (operators and end-users);

(b) the property investment market (providing investments to urban projects);

(c) the investment management market (asset management companies, real estate funds and other financial institutions).

4.8.2. Effects on the relevant markets

(314) When assessing the significance of the distortive effects the measure and its effect on trade, the Commission needs to identify and analyse the extent of the distortion of competition and the effect on trade in the relevant markets taking into account (i) the aid granting process, (ii) the characteristics of the relevant markets and (iii) the type and amount of aid. These aspects will be considered together with the common interest objective pursued and the market failures addressed.

4.8.2.1. Long-term dynamic effects

(315) State aid, by interfering with the market allocation of rents, may have long-term dynamic effects on the incentive to invest and compete. In the long run, such a change in dynamic incentives could lead to less choice, and potentially to lower quality or higher prices for consumers.

(316) While the absolute amount of aid is not calculated, the Commission considers that the aid, to the extent that it covers the viability gap, does not provide the developers carrying out the project with resources that they can use for future projects in order to distort competition and affect trade. The measure will therefore not distort competition as the investments merely offset the viability gap.

(317) On the contrary, regeneration efforts targeted at remedying market failures can actually be pro-competitive. They facilitate activities and unlock opportunities for commercial developments that had previously been inhibited.

(318) Investments will be made in efficient companies on the basis of business plans and realistic prospects of profitability. Therefore, State aid will not be granted in markets featuring overcapacity and in declining industries, as investments will be repaid through efficient operations.

(319) The aid is provided through repayable instruments, thus benefits will be re-invested. There will be efficiency gains shared with private investors, so the measure is less distortive. The measure provides investment aid, so it does not have a direct impact on the level of variable cost, and thus on the price level to end-users/operators or buyers.

4.8.2.2. Crowding-out

(320) At a more specific level, State aid may affect competition in the product market and affect competitors. In particular, competitors might react by reducing their own sales and investment plans (in particular, crowding-out).

(321) The Commission notes that State aid will be provided exclusively to unlock those projects where the market would not undertake the activities on its own. Furthermore, there will be an overall increase in the level of investment activity in the markets due to the minimum private participation requirement.

(322) The UK authorities do not intervene directly or set up a public fund that would effectively be in competition with other existing intermediaries and could potentially crowd out the market. Instead, public funds are invested through existing investment intermediaries and any qualified intermediary had the opportunity to participate.

(323) The aid granting process, i.e. the process of UDFs providing sub-commercial investments, is transparent and follows an open and non-discriminatory procedure — project proposals competing among themselves to get investments. The minimum aid necessary will be determined in an open tender procedure. Where this is not possible, it will be verified by an Independent Expert.

(324) The Commission notes that the aid increases the supply of new commercial property on the market. The developed property will be made available to any potential end-users, operators and buyers at market price. Thus, there are no crowding-out effects.

4.8.2.3. Input markets and location

(325) State aid may affect competition in the input markets and in particular the location of investment, if it favours the use of particular inputs. The overall effect on input markets may be negative if it discourages competitors' investment.

(326) The measure will support development activities that are predominantly of a local character and for which the effects on trade are purely indirect (e.g. through input markets) and the distortion of competition and trade is most likely to be limited.

(327) As regards the choice of particular inputs, contractors for physical project delivery will be chosen through a genuine competitive process in a competitive market.

4.8.3. Conclusion

(328) On the basis of the above, the Commission can therefore conclude that the measure does not distort the proper functioning of the internal market and does not produce significant disparities between undertakings established in different Member States and/or in the location of the production factors within the EU.

4.9. Balancing test

(329) The Commission considers that the UK has sufficiently demonstrated that the aid will change the behaviour of the beneficiaries in favour of achieving the identified common interest objective. Accordingly, the Commission considers that the assisted urban projects have value for the EU in supporting sustainable urban development.

(330) Given that the beneficiaries would not have carried out the projects without the aid and taking into consideration the common interest, these positive effects for the EU appear to outweigh the potentially negative effects of the aid, which appears to be necessary for carrying out integrated urban development projects.

(331) As to potential distortion of competition in the relevant markets, the measure does not distort the proper functioning of the internal market and does not produce significant disparities between undertakings established in different Member States and/or in the location of the production factors within the EU and it may therefore be concluded that it does not affect trade or distort competition to an extent contrary to the common interest.

5. DECISION

(332) The Commission considers that the aid is compatible with the TFEU on the basis of Article 107(3)(c) thereof and has accordingly decided not to raise objections to the notified measure.

(333) The Commission reminds the UK authorities of their obligation to submit an annual report on the implementation of the measure as well as an SIS for each UDF sub-commercial investment exceeding EUR 5 million in a single project.

(334) The Commission further reminds the UK authorities that, in accordance with Article 108(3) TFEU, all plans to alter the measure must be notified to the Commission pursuant to Commission Regulation (EC) No 794/2004 implementing Council Regulation (EC) No 659/1999 laying down detailed rules for the application of Article 93 of the EC Treaty[74] (now Article 108 TFEU).

If this letter contains confidential information which should not be disclosed to third parties, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to the disclosure to third parties and to the publication of the full text of the letter in the authentic language on the Internet site:

http://ec.europa.eu/eu_law/state_aids/state_aids_texts_en.htm

Your request should be sent by registered letter or fax to:

European Commission
Directorate-General for Competition
Directorate for State Aid
State Aid Registry
B-1049 Brussels
Fax No: (0032) 2-296.12.42

Yours faithfully,
For the Commission

Joaquín ALMUNIA
Vice-President

[74] OJ L 140, 30.4.2004, p. 1.