EUROPEAN COMMISSION

Brussels, 19.10.2011
C(2011) 7296 final

In the published version of this decision, some information has been omitted, pursuant to articles 24 and 25 of Council Regulation (EC) No 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 93 of the EC Treaty, concerning non-disclosure of information covered by professional secrecy. The omissions are shown thus […].

PUBLIC VERSION

WORKING LANGUAGE

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Subject: State aid SA.32147(2011/N) – Spain.

Jessica Holding Fund Andalucía

Dear Sir,

The Commission wishes to inform you that it has decided not to raise objections to the above-mentioned case for the reasons set out below.

1. PROCEDURE

(1) Following a pre-notification procedure under PN SA.32147 - 2010/PN, by letter of 27 May 2011, the Spanish authorities notified the above-mentioned measure pursuant to Article 107(3) of the Treaty on the Functioning of the European Union (TFEU).

(2) Following a number of informal exchanges of information with the Spanish authorities, a meeting between the Spanish authorities, representatives of the European Investment Bank and Commission services took place on 20 June 2011. As a result of that meeting, the Commission requested further information by letter of 22 June 2011 to which the Spanish authorities replied on the same day. Following a number of additional informal exchanges of information, the Commission requested further clarifications on 22 August 2011 which the Spanish authorities provided on 23 August 2011 and on 29. September.

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2. DESCRIPTION OF THE MEASURE

2.1. Structure and Objective

2.1.1. Facilitating sustainable urban development by provision of sub-commercial conditions via Urban Development Funds to private investors

(3) The notified measure consists in an aid scheme making use of financial engineering instruments such as provision of equity and loans at sub-commercial terms to private investors that carry out sustainable urban development projects. Aid is granted by means of two Urban Development Funds (the "UDFs" or "funds") set up by Banco Bilbao Vizcaya Argentaria (BBVA) and S.A. Ahorro Corporacíon Financiera, S.V., S.A. (ACF) respectively. The UDFs act under the umbrella of the JESSICA Holding Fund Andalucía (JHFA). The funds' legal obligations result from the Funding Agreement between the JHFA and the Spanish authorities[1] and from the two Operational Agreements between the JHFA and the UDFs,[2] which are part of the notification.

(4) The notified scheme seeks to facilitate sustainable urban development in the Spanish region of Andalucía by fostering private investment in projects that contribute to sustainable urban development. It will ultimately result in greater market efficiency and social cohesion.

(5) The notified scheme is part of the Joint European Support for Sustainable Investment in City Areas initiative (JESSICA), a policy initiative of the European Commission supported by the European Investment Bank (EIB) in cooperation with the Council of Europe Development Bank. JESSICA is designed to help Member States in using financial engineering mechanisms to support investment in sustainable urban development in the context of EU cohesion policy in the programming period 2007-2013.[3]

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1 Funding Agreement between the European Investment Bank (acting as the Holding Fund) and the Junta de Andalucía signed on 8 May 2009.

2 Operational, Management and Loan Agreement under Jessica Holding Fund Andalucía between European Investment Bank (acting as the Holding Fund) and Banco Bilbao Vizcaya Argentaria, S.A. signed on 4 March 2011 and Operational, Management and Financing Agreement under Jessica Holding Fund Andalucía between European Investment Bank and AC JESSICA Andalucía and Ahorro Corporacíon Financiera, S.V., S.A. For details on funding architecture please see recital (62) ff.

3 See Article 44 of Council Regulation (EC) No 1083/2006 of 11 July 2006, laying down general provisions on the European Regional Development Fund, the European Social Fund and the Cohesion Fund and repealing Regulation (EC) No 1260/1999, OJ L 210 of 31.7.2006, p. 25, hereafter referred to as the "General Regulation";

Articles 3(2)(c), 4(1), 5(1)(d) and 6(2)(a) of Regulation (EC) No 1080/2006 of the European Parliament and of the Council of 5 July 2006 on the European Regional Development Fund repealing Regulation (EC) No 1783/1999, OJ L 210 of 31.7. 2006, p. 1, hereafter referred to as the "ERDF Regulation",

Article 11(1) of Regulation (EC) No 1081/2006 of the European Parliament and of the Council of 5 July 2006 on the European Social Fund and repealing Regulation (EC) No 1784/1999, OJ 210 of 31.7.2006, p. 12, hereafter referred to as the "ESF Regulation"; and

Articles 43 to 46 of Commission Regulation (EC) No 1828/2006 of 8 December 2006 setting out rules for the implementation of Council Regulation (EC) No 1083/2006 laying down general provisions on the

(6) JESSICA has been set up as a response to perceived market failures in the urban development funding environment, the lack of an integrated urban development approach, a funding deficit necessitating greater leverage of scarce public resources and, overall, the need for a more commercial approach to the regeneration of urban areas.

(7) The essence of JESSICA is to use the Structural Funds' resources and national match-funding to support Urban Development Projects (UDPs) that have a potential to contribute to sustainable urban development, but have an internal Rate of Return (IRR) that is not sufficient to attract financing on a purely commercial basis. That support takes the form of repayable investments at sub-commercial terms.

(8) The JESSICA mechanism aims at enabling public resources to be invested in a repayable way and thus to be "recycled" and become available for further reinvestment in UDPs. JESSICA is therefore an alternative mechanism to the traditional use of Structural Funds as non-repayable, one-off grants. It aims at the same time to be less distortive to competition than such grants.

(9) JESSICA was launched with a view to providing new opportunities and instruments to Member State for the European Regional Development Fund (ERDF) programming period 2007-2013 by the following means:

   (a) Ensuring long-term sustainability through the revolving character of the Structural Funds' contribution to specialised funds investing in UDPs;

   (b) Creating stronger incentives for successful implementation of UDPs by beneficiaries, by combining grants with loans and other financial instruments;

   (c) Leveraging additional resources for UDPs with a focus on their sustainability/recyclability in the regions of the EU; and

   (d) Contributing financial and managerial market expertise from specialists to UDPs.

2.1.2. Addressing well-defined objectives of common European interest

(10) In its notification, Spain points out that the measure addresses a well-defined objective of common European interest in accordance with the following provisions:

(11) Under the SF Regulations in the programming period 2007-2013[4], managing authorities in Member States are allowed to use financial engineering mechanisms in order to invest part of their Structural Funds' allocations to catalyze investment in UDPs.

(12) Under the Convergence Objective (Article 4 of the ERDF Regulation), the ERDF focuses its assistance on supporting sustainable integrated regional and local economic development and employment, where urban areas are equally eligible for benefiting from that type of investment.

European Regional Development Fund, the European Social Fund and the Cohesion Fund and of Regulation (EC) No 1080/2006 of the European Parliament and of the Council on the European Regional Development Fund OJ L 371 of 27.12.2006 p. 1., hereafter referred to as the "Implementing Regulation".

Throughout this decision those regulations will be referred to collectively as the "SF Regulations".

[4] See footnote 3.

(13) Under the Regional Competitiveness and Employment Objective (Article 5 of the ERDF Regulation), the ERDF focuses its assistance on the following three priorities:

a) Innovation and the knowledge economy, including promoting innovation and entrepreneurship by supporting business networks and clusters in all sectors of the regional and local economy;

b) Environment, and in particular promoting investment for the rehabilitation of the environment, including contaminated, abandoned and other brownfield sites and land, promoting energy efficiency and renewable energy production;

c) Access to transport and telecommunication services of general economic interest, including the establishment of public internet access points.

(14) Article 8 of the ERDF Regulation focuses specifically on sustainable urban development, and states that "in the case of action involving sustainable urban development as referred to in Article 37(4)(a) of Regulation (EC) No 1083/2006, the ERDF may, where appropriate, support the development of participative, integrated and sustainable strategies to tackle the high concentration of economic, environmental and social problems affecting urban areas."

(15) That provision also states: "These strategies shall promote sustainable urban development through activities such as: strengthening economic growth, the rehabilitation of the physical environment, brownfield redevelopment, the preservation and development of natural and cultural heritage, the promotion of entrepreneurship, local employment and community development, and the provision of services to the population taking account of changing demographic structures."

2.1.3. Providing an integrated approach by the use of Integrated Plans for Sustainable Urban Development (IPSUDs)

(16) In order to achieve sustainable urban development, the notified measure foresees a holistic approach composed of social, economic and environmental elements that are reflected in the Funding Agreement for the JHFA as well as the Operational Agreements between the JHFA and the two UDF managing institutions mentioned in recital (3). In addition, the measure will be in line with the integrated planning included in the Operational Programme 2007-2013 for Andalucía.[5] Those four documents will thus provide the basis for ensuring the overarching integrated approach for sustainable urban development.

(17) In accordance with the SF Regulations, the JHFA has to operate on the basis of the overarching planning mentioned above that is complemented by specific local IPSUDs. According to the Spanish authorities, urban regeneration is an explicit aspect of the overarching IPSUD.

(18) The Spanish authorities, taking account of Article 8 of the ERDF Regulation, as well as of Section 2.1 of the Community Strategic Guidelines on Cohesion 2007-2013[6] informed the Commission that in the context of the notified measure local IPSUDs,

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5 http://www.juntadeandalucia.es/economiainnovacionyciencia/fondoseuropeosenandalucia/prog4.php

6 Council Decision of 6 October 2006 on Community strategic guidelines on cohesion (2006/702/EC), OJ L 291, 21.10.2006, p. 11.

which correspond to urban planning measures under applicable Spanish urban development laws, will furthermore have to meet the following main requirements:

(a) Any IPSUD must be officially proposed and certified by the relevant local authority or public sector agency on the basis of existing legislation on land use planning.

(b) IPSUDs must indicate a geographical area of intervention precisely defined.

(c) IPSUDs have to be based on a clear strategy, justifying the need for public intervention.

(d) IPSUDs shall contain the elements of a land-use plan, i.e. sufficient physical definition of any public works to be undertaken, specification of standard land-use parameters, and the minimum level of public services required and the associated infrastructure endowment have to be established.

(e) Integration into a wider area must be insured for any IPSUD

(f) IPSUDs must entail corrective measures from applicable environmental impact assessment procedures under EU law.

(g) A study of the needs and a socio-economic appraisal has to be carried out for each IPSUD.

(h) In each IPSUD, a governance scheme setting up a clear timetable and responsibilities has to be present.

(i) Financial analysis and a well-defined funding structure ensuring its implementation and long-term financial sustainability is necessary for every IPSUD.

(19) The Spanish authorities confirmed that the integrated planning documents mentioned above are in line with the criteria set out in the Community Strategic Guidelines on Cohesion 2007-2013.[7]

2.1.4. *Alternative approaches to address the objective*

(20) The Spanish authorities informed the Commission that prior to their notification they introduced other measures in order to address urban development needs, notably the Urban Initiative (Iniciativa urbana) and the Initiative for Local and Urban development (Iniciativa para desarrollo local y urbano). The initiatives aim to support, through subsidies, the actions taken by municipalities in accordance with an Integrated Plan. Those alternative measures are not part of the notification and are therefore not affected by the present decision.

2.1.5. *Efficiency objective: Addressing Market failure(s)*

(21) Addressing the above-mentioned urban development needs requires substantial capital investments. However, according to Spain, those investments would not be delivered by

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7 Article 8 of the ERDF Regulation and Section 2.1 of the Annex to Council Decision 2006/702/EC. 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).

the market even though it could be efficient from a wider economic perspective, thus constituting a market failure both on the demand and supply side.

(22) The Spanish authorities provided information, including an evaluation study on implementation of Jessica in Andalucía[8], stating the existence of market failures. Those failures mostly falls into the categories of (i) externalities not included in the market price, (ii) information asymmetries combined with resulting risk aversion and (iii) transaction and agency costs increasing single projects' costs. In addition, Spain committed to verify the existence of a case-specific market failure whenever claimed in a UDP application for funding, see section 2.10.2 below.

(23) In their notification the Spanish authorities made reference to a number of market failures both on the demand and on the supply side, and which are specifically linked to the urban development objectives supported by the JHFA's investment strategy (see below section 2.5.2)

2.1.5.1. Demand side market failures

(a) Brownfield redevelopment (reconversions of industrial and degraded sites)

(24) <u>Externalities:</u> Reconversions of industrial and degraded areas are projects where the benefits of improvements to the physical environment or contamination removal are higher for society as a whole than for developers. Private markets may fail to capture collective benefits such as environmental benefits, improved neighbourhoods and health impacts.

(25) <u>Information asymmetries</u> concern the high and uncertain risks attributed to brownfield redevelopment by developers and investors. Brownfield sites are often associated with high-risk development, including contaminated land and ground water, structural problems with land and buildings, high costs of remediation and development and high risk perception. Cleaning contaminated site results in additional costs, where it is not possible to identify the polluter and make it pay for repairing the environmental damage it has caused. In addition, those costs are often very difficult to calculate ex-ante.

(26) <u>Risk aversion</u>**:** Investors may become more reluctant to provide equity to regeneration projects, the more the provision of equity is subject to imperfect or asymmetric information. In other words, imperfect or asymmetric information tends to exacerbate risk aversion. The main elements of risk in the appraisal of urban regeneration land comprise planning, yield and rent, development costs, contamination and stigma, project duration and finance and volatility. Furthermore, regeneration plans can involve significant upfront preparatory costs which increase significantly the term between first investment and first returns. It results in overly conservative projections of the value of new developments in such locations and also affects both the amount and pricing of financial resources offered by debt providers and the level of return equity investors are willing to accept.

(27) <u>Transaction and agency costs:</u> Problems may arise where it may be time-consuming/expensive to gain full and robust information on UDPs. Potential investors face more difficulties in gathering reliable information on the business prospects of an urban regeneration project, particularly for highly risky projects. Furthermore, small

8 http://www.eib.org/attachments/documents/implementation-of-jessica-in-andalucia_en.pdf

deals are less attractive to investment funds due to relatively high costs for investment appraisal and other transaction costs.

(b) Urban infrastructure

(28) Externalities: A major concern regarding urban infrastructure is the internalisation of the positive externalities generated by those project components that are public goods and produce no or insufficient revenues. Such components may not be particularly profitable in their own right (e.g. public spaces, socio-cultural activities, residential parking etc.), but nevertheless necessary for the overall success of the project.

(29) Information asymmetries**:** Difficulties in assessing future cash flows are exacerbated for projects with a long-term payback period to amortise the high upfront investment such as urban infrastructure. They involve lengthy pre-construction and construction periods where no project revenues are available. In consequence, projects which provide higher short-term returns are preferred to longer-term urban infrastructure projects. As a result, profitable (over the lifetime of the project) long-term investments might be sacrificed, leading to under-investment.

(c) Renewable energy and low carbon

(30) Information asymmetries: As for renewable energy or low carbon projects, a challenge arises when the projects use to a significant extent untested technologies where estimated costs and revenues are uncertain.

(d) Improvement in energy management, energy efficiency and waste management

(31) Externalities: Undertakings acting in their own interest have no incentive to take into account the negative externalities arising from production either when they decide on a particular production technology, or when they decide on the production level. In other words, the costs of production that are perceived by the undertaking are lower than the costs borne by society. Therefore undertakings have no incentive to reduce their level of pollution or to take individual measures to protect the environment. Without public support, it results in an under-investment in energy efficiency refurbishment projects.

(e) Development of technology clusters and added value infrastructures harmonized in overall city planning **-** *the creation of facilities for SMEs and innovative firms*

(32) Coordination problems and network failures: The failure of individuals and single institutions to coordinate the development of technology clusters and added value infrastructures may prevent the emergence of profitable clusters and thus jeopardize overall economic development. Consequently, projects in the common interest are unlikely to be pursued unless the public sector intervenes to create appropriate facilities.

2.1.5.2. Supply side market failures

(33) In addition to demand side market failures due to the UDP characteristics identified above, there is, according to the Spanish authorities, a market failure in the provision of long-term development finance. Long-term investors, including financial investors, such as pension funds and insurance companies, are particularly risk averse and in general not interested in lending to risky projects. Furthermore, commercial banks face capital and liquidity constraints and it has become more difficult to obtain bank loans with the long maturities required by urban development projects.

(34) As for investor risk aversion in Spain, financial activity at local levels is, according to the Spanish authorities, currently experiencing a significant decrease, which is expected

to be longstanding. In fact, according to the last information provided in April 2010, the net balance of business activities financed is 3,3% lower than that from the previous year; and most likely that tendency will last.

(35) Within that context, the credit crunch suffered by the Spanish economy may jeopardize the renovation and rehabilitation of the urban environment. The market is stagnant as economic actors operating in those projects do not have access to funding at fair conditions and are risk averse. The support of public institutions is hence required to solve problems derived from the incorrect functioning of the financial markets and the existence of market failures in the financial market.

2.1.6. Equity objective: Addressing socio–economic problems in deprived urban areas

(36) In addition to addressing the above economic inefficiencies in the form of market failures, investments into UDPs may, as pointed out by the Spanish authorities, seek to compensate for economic or social problems that characterise deprived urban areas. Those problems also affect the viability of investments, in particular in regions qualifying as assisted areas within the meaning of the regional aid guidelines, such as Andalucía.

(37) The Spanish authorities pointed out that the JESSICA initiative responds to the request by several Member States and the European Parliament to give special attention to the need for renewal and/or regeneration of certain urban areas in order to improve convergence across EU regions. Economic and social cohesion is a Union objective, pursuant to Articles 4, 14 and 174 TFEU. Strengthening economic and social cohesion implies, in particular, the reduction of disparities between levels of development of different areas.

(38) According to Spain it is recognised that cohesion policy can help to create sustainable communities, by ensuring that economic, social and environmental issues are tackled through integrated strategies for renewal, regeneration and development in both urban and rural areas[9].

(39) In the case of Spain it is explained[10] that urban neighbourhoods are characterised by low income population, high unemployment and social exclusion. To address those difficulties, the measure aims at reducing social or regional disparities within Andalucía, supporting activities such as the following categories of projects:

(a) Establishment of cultural infrastructures;

(b) Establishment of social and educational infrastructures;

(c) Rehabilitation and upgrading of cultural heritage;

(d) Social housing, within the limits imposed by the SF Regulations.

(40) Spain further pointed out to the Commission that those categories of projects constitute an integral part of the Andalucía regional development strategy (Axes 5.3, 6.1 and 6.3 of the Operational Programme 2007-2013 for Andalucía). Hence, by providing financial support for the establishment of cultural, social and educational infrastructure and social

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9 Cf. Council Decision of 6 October 2006.

10 Rubio del Vara, "Rehabilitación Urbana en España (1989-2010) – Barreras actuales y sugerencias para su eliminación"

housing in Andalucía, the authorities pursue genuine cohesion and social development objectives.

2.2. Budget, granting authority duration and legal basis

2.2.1. Budget

(41) According to the Spanish authorities, the initial public budget for the measure will be EUR 85 714 286 for the investments made until 31 December 2015. The budget will be used for investments containing State aid within the meaning of Article 107(1) TFEU aid, as well as investments on *pari-passu* conditions together with private co-investors that are free of aid.

(42) The aid is funded under the ERDF Operational Programme 2007-2013 Andalucía from the resources of the ERDF and match-funding from the resources of the "Junta de Andalucía".

(43) In line with Article 4(2) of Regulation (EC) No 794/2004[11] budget increases of more than 20% will be subject to notification to the Commission.

(44) The value of public in kind contributions such as provision of public land granted will be established under market conditions. The Spanish authorities committed to respect applicable Union rules such as the Commission Communication on State aid elements in sale of land and buildings.[12]

2.2.2. Granting Authority

(45) The Junta de Andalucía will serve as the granting authority.

2.2.3. Duration

(46) With prejudice to specific provisions under the Structural Funds rules, as far as compliance with State aid rules is concerned, aided investments under the measure can be made until 31 December 2015.

2.2.4. Legal basis

(47) The implementation of the JESSICA initiative in Andalucía is regulated by the Funding Agreement signed on 8 May 2009 between the Junta de Andalucía acting as the Managing Authority of the ERDF Operational Programme Andalucía 2007-2013) and the European Investment Bank. The Funding Agreement's provisions are complemented by those of the two Operational Agreements concluded between the Holding Fund and the UDFs, see recital (3). Those three documents, which form part of the notification, tasks and requirements for the Holding Fund as well as for the UDFs, stipulate, amongst other matters, investment strategy and planning, selection of UDPs, monitoring and reporting, remuneration and compliance with State aid rules.

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11 OJ L 140, 30.4.2004, p. 1

12 OJ C 209, 10.07.1997, p. 3

(48) The Spanish authorities committed to alter and/or amend the Operational Agreements as well as any other relevant document in order to bring the notification in line with this decision and send copies of the up-dated documents to the Commission.

(49) Additional legal sources relevant for the notified measure are the Structural Funds provisions mentioned above in footnote 3.

2.3. Form of aid: Granting of revolving investment at sub-commercial conditions to UDPs

(50) As foreseen in Article 43(1) of the Implementing Regulation and the relevant funding agreements, investments in UDPs will be made in a revolving way, namely, in the form of loans, equity and guarantees. Such repayable investments will be "recycled" and become available for further reinvestment in UDPs.

(51) To remedy the above-identified market failures and to facilitate socio-economic development in deprived urban areas in the region of Andalucía, the measure will act as a catalyst to leverage private funding to finance UDPs. According to the Spanish authorities, the measure will provide aid in the form of sub-commercial public (subordinated or at a preferential interest rate) loans as well as equity investments together with private co-investors benefitting from preferential *non-pari-passu* terms as compared to public investors. Deviation from market rules will be limited to the necessary minimum (As to its limitations, including the concept and establishment of a Fair Rate of Return (FRR) please see section 2.10.2.4 below).

(52) Detailed investment terms and conditions, including the choice of investment tools – (subordinated) loan and/or equity - will be determined prior to making an investment on the basis of business plans prepared for each UDP and will depend on the exact nature and financing characteristics of the project and the lack of commercial viability, which will be evaluated on a project-by-project basis (For details, please see section 2.10.2 below).

2.3.1. Sub-commercial equity instruments

(53) Under the measure, private investors could receive preferential *non pari-passu* (and therefore sub-commercial) investment conditions as compared to public investors. In accordance to Article 43(5) of the Implementing Regulation, returns from investments, less a pro rata share of the management costs and performance incentives, may be allocated preferentially to private investors as described below.

(54) Various forms of preferential equity instruments can be granted by the UDF, depending on project nature and its financing needs, which can comprise for example, subject to the profit-loss sharing arrangements specified below:

(a) <u>*Preferential return*</u> - public equity contribution requiring a lower rate of return than private equity. This instrument will result in different expected IRR rates for the private equity investor compared to the IRR on the equity investment provided under the measure;

(b) <u>*Priority return*</u> – public equity contribution allowing for a rate of return being paid to the private equity investor first. It means that after the equity initially invested is repaid to both public and private investors, the private equity investors takes the remaining capital return to enable a profitability that is equal to the FRR previously agreed. The public equity investor then takes any remaining capital return to enable the same level of profitability as the private investor. Above the rate, any surplus returns are then split proportionately and at the same time between the private investor and the investment provided under the measure;

(c) _First losses_ – public equity contribution ranking behind private equity for repayment, therefore effectively being exposed to first loss in the event that the expected return of invested capital does not materialise in actual performance. Therefore when exiting the project, equity is returned to the private investor until it has covered its equity investment, then the public investor will take remaining capital return until its equity investment is repaid. Thus, in instances where an actual loss is made on the capital invested, the loss is limited to the level of the public investment in the project's first-loss clauses, constituting a quasi-guarantee element will be taken into account when establishing the FRR.

2.3.2. Sub-commercial loans

(55) In addition to preferential equity instruments, aid can also be granted in the form of sub-commercial loans, i.e. loans with an interest rate or other conditions below market rate. Provision of sub-commercial loan will result in a higher IRR for the private project investor and follow the same limitations as sub-commercial equity investments under the measure, i.e. private project investors will be ensured an IRR corresponding but not exceeding the relevant FRR on their loans.

2.4. Funding architecture I: Overview

(56) As foreseen under Article 43 of the Implementing Regulation, investments into eligible UDPs will be made via investment vehicles, i.e. UDFs. UDFs will be managed by professional independent fund managers, selected through an open and transparent procedure that will make investment decisions within the agreed investment strategy. The managers will carry out the due diligence and financial appraisal in the project structuring phase, price the loan and negotiate equity profit-sharing arrangements with other equity holders, and monitor project performance until the exit.

(57) Investment becomes more reliable because UDF managers provide professional project appraisal. They thereby ensure that UDPs are feasible from the economic, social and technical points of view and comply with the eligibility criteria in the relevant regulations. They also analyse the risks involved, the information on financial structure and the expected revenues for the different stakeholders.

(58) As foreseen in the Funding Agreement as well as in the Operational Agreements, public funding to the UDFs will be channelled through the JHFA that is an investment vehicle set up to invest the public funding under the measure in several UDFs.

(59) The participation of both JHFA and additional UDFs allows the public authorities to rely on the financial expertise present in these institutions. It also allows them to leverage additional funding, as the fund structure public resources and other public/private funding to be pulled together at the fund level. Moreover, the intention is to build a portfolio of transactions diversified in terms of size and sector so as to mitigate investment risks through the "portfolio effect".

(60) The funding objectives, terms and conditions provided to HFs and subsequently UDFs are contractually specified in the Funding Agreement, in particular in its number 7 and Appendix A on "*Investment Strategy and Planning*" as well as the Operational

Agreements, in particular in their clause 2 "*Portfolio of Eligible Urban Projects*". They will include the investment policy, the rights and obligations of fund managers, investment process, governance rules, monitoring and reporting provisions as well as rules on management fees.

(61) While a large portion of the decision-making process on investments is thus outsourced to the HF as well as to UDFs, ultimate responsibility for State aid compliance remains with the Spanish authorities.

2.5. Funding Architecture II: The Holding Fund

(62) As an option foreseen in the SF Regulations, the JHFA was set up by agreement signed on 8 May 2009, between the Junta de Andalucía acting on behalf of Spain, and the European Investment Bank. It was established to invest the public resources under the measure in several UDFs. In accordance with the SF Regulations, the JHFA has been established as a separate block of finance within the fund manager European Investment Bank (EIB). Separate accounts will be kept.

(63) The HF structure provides a mechanism for the diversification of investments in several types of UDFs and more effective controls. It is intended to achieve significant economies of scale and act as centralised manager for payments and a catalyst in the investment process.

2.5.1. Holding Fund's funding agreement

(64) The Funding Agreement sets out the funding terms and conditions, in line with paragraphs 1 and 2 of Article 44 of the Implementation Regulation, such as the investment strategy and policy (including an indication of the target UDPs and products), appraisal and selection of UDFs, monitoring, reporting and auditing systems, and winding-up provisions (including the reutilisation of resources).

2.5.2. The Holding Fund's investment strategy

(65) In line with paragraph 1 of Article 44 of the Implementation Regulation, the Funding Agreement makes, in particular under its number 7, "*Investment Strategy and Planning"* reference to urban development studies and IPSUDs included in the relevant ERDF Operational programme 2007-2013 Andalucía (OP). According to the Spanish authorities, the investment strategy of the JHFA reflects furthermore policy goals agreed with the Spanish authorities that are in line with the SF Regulations and based on the investment priorities defined in the IPSUD and the objectives set out in the OP for Andalucía. In addition, it reflects the key findings of the analysis on efficiency as well as on equity objectives described above.

(66) As for urban development studies, the analysis of specific urban development needs and actions in Andalucía was carried out through a so-called JESSICA evaluation study[13]. It represents a key step which permitted the institutions involved to define urban development needs and an investment strategy in accordance with the sustainable urban development objectives. The evaluation study comprises a market analysis and provides recommendations and proposals for appropriate actions regarding possible JESSICA implementation.

[13] http://www.eib.org/attachments/documents/implementation-of-jessica-in-andalucia_en.pdf

(67) According to the Spanish authorities, a wide range of UDPs mirroring the efficiency and equity objectives referred to above in section 2.1.5 and 2.1.6 could receive UDF investments. Examples are UDPs aiming at:

- Improvement of social integration
- Improvement of mobility
- Improvements in energy management, energy efficiency and waste management
- Increase of the use of renewable energy
- Reconversion of industrial and degraded areas
- Development of clusters of technology and added value infrastructures harmonised in the overall city planning
- Social housing within the limits laid down by SF Regulations
- Rehabilitation of the physical environment and brownfield redevelopment provided that those projects form part of a larger urban plan.

2.5.3. Management of the Holding Fund

2.5.3.1. Responsibilities of the HF manager

(68) The Spanish authorities have set up the JHFA and entrusted the EIB with management of the JHFA comprising the following activities:

(a) Selection of and investment in UDFs: launching a tender process, evaluation of the business plans submitted by UDF and the quality of the management, negotiation and signing of Operational Agreements with UDFs;

(b) Operation phase: evaluation of the updated business plans submitted by UDFs in the selection and operational phase, monitoring and control of UDF investment activities in accordance with of the Operational Agreements, reporting.

(c) Treasury management of the outstanding funds

2.5.3.2. Selection process

(69) Based on Article 44 of the General Regulation, the Spanish authorities decided to entrust the EIB with the management of the JHFA through a direct award of a contract.[14] The General regulation allows the EIB to be appointed without procurement procedures.

Management fee

(70) Total management fees for the EIB may not exceed, on a yearly average, a cap of [1.5 - 2%][*] [15] of the total amounts contributed into the measure.

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[14] Funding Agreement signed on 8 May 2009 between the Junta de Andalucía acting as the Managing Authority of the ERDF Operational Programme Andalucía 2007-2013) and the European Investment Bank.

[*] A range due to a business secret.

2.5.4. *Holding Fund investment into UDFs*

2.5.4.1. Selection of UDFs

(71) In line with Article 44(2b) of the Implementation Regulation, the EIB launched on 15 April 2010 on its website[16] as well as on the website of the Junta de Andalucía a call for expression of interest to identify potential UDFs. That call for expression of interest was also published in the Official Journal of the European Union[17]. Six financial entities participated in that process, and were examined under the exclusion criteria. Among the candidates who met the selection criteria, two entities submitted offers, including the corresponding business plans.

(72) In line with Article 43(3) of the Implementation Regulation, UDFs are to be selected on the basis of the business plan established by the UDFs specifying the following elements: the target market and projects, investment conditions, budget, ownership and financing, provisions on professionalism and independence of the management, winding-up provisions.

(73) To assess the business plan and the suitability of potential UDFs, the JHFA applied assessment criteria such as the quality of the applicant's investment strategy and governance structure including experience in the market, the level of annual management fee charged and the ability to provide own investment resources or attract third party private co-financing.

(74) Since the JHFA delegates decisions to invest in individual UDPs to the UDF, the JHFA relies on appraisal, risk-control and monitoring standards of the UDFs. Therefore, in order to ensure that the JHFA is financially sustainable and that the public investments are repaid and recycled, the JHFA has carried out a credit/investment risk assessment of the selected UDFs as well and determined ex-ante the exit policy from those UDFs.

2.5.4.2. JHFA Investment Board

(75) The JHFA is governed by an Investment Board, the body that supervises and is broadly responsible for governing the implementation of the JHFA. Implementation of the JHFA includes approving or rejecting recommendations made to the Investment Board by the EIB as the JHFA manager. The Investment Board of the JHFA will carry out the following tasks:

(a) After being notified of the selected UDF(s) by the JHFA, the Investment Board is responsible for ratifying (or rejecting) the proposal.

(b) The Investment Board will perform periodic reviews of the JHFA's overall performance in implementing the investment strategy and the underlying projects,

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15 Article 43(4a) of the Implementation Regulation foresees that the management costs for the holding fund may not exceed 2 per cent of the capital contribution to the HF.

16 http://www.eib.org/attachments/ir-899-udf-andalucia.pdf

17 Tenders Electronic Daily, online version of the Supplement to the Official Journal of the European Union, http://www.ted.europa,eu, 2010/S 77-113766, BEI - JESSICA Holding Fund Andalucia - Spain: Selección de fondos de desarrollo urbano (Luxemburgo).

(c) In consultation with the Spanish authorities, the Investment Board will review the progress and the strategy of the JHFA.

(d) The Investment Board will supervise the activities carried out within the scope of the Funding Agreement, including UDF selection, UDF contract management, budget, costs and reporting.

(76) The Investment Board consists of five Members appointed by the Spanish authorities after consultation with the EIB. The Spanish authorities proposed Investment Board members who are experts in the field of urban or public infrastructure financing, urban planning or other areas of expertise relevant to the JHFA's investment strategy. The members of the Investment Board are contractually obliged to act independently and in the sole interest of the JHFA.

2.5.5. Monitoring implementation at UDF level

(77) In accordance with Article 43(2) of the Implementation Regulation, the JHFA will monitor the implementation of the business plan of each selected UDF. After signing the Operational Agreements with the UDFs, the UDF managers must propose the definitive project portfolio which is subject to the approval of the JHFA. If certain projects from the portfolio cannot proceed due to circumstances unforeseen at the moment of the submission of the portfolio, the Operational Agreements define the detailed arrangements of substituting projects included in the portfolio by others.

2.6. Funding architecture III: The UDF(s)

(78) Following the competitive procedure described above, UDFs have been set up with Banco Bilbao Vizcaya Argentaria (BBVA), focussing on providing loans, and Ahorro Corporación Financiera (Ahorro Corporación), focussing on providing equity for the purpose of investing the HF's public funds in several UDPs.

(79) As is the case with the HF structure, the UDF structure provides a mechanism for the diversification of investments in several types of UDPs and more effective controls. It allows significant economies of scale to be achieved and acts as centralised manager for payments and a catalyst in the investment process.

2.6.1. Operational agreements

(80) In line with Article 43(5) of the Implementation Regulation, the Operational Agreement between the JHFA (the EIB) and BBVA was signed on 4 March 2011 and the Operational Agreement between the JHFA (the EIB) and AC JESSICA Andalucía S.A / Ahorro Corporacion Financiera, S.V., S.A. (ACF) was signed on 17 May 2011

(81) The Operational Agreements set out the funding terms and conditions, such as the investment strategy and policy of the UDF, monitoring, reporting and auditing systems as well as winding-up provisions, including the reutilisation of resources.

2.6.2. Legal form and structure of the UDFs

(82) The UDF managed by BBVA has been set up not as a separate legal entity. That UDF is a separate block of finance within the financial institution, with only the JHFA contributing public funds to the UDF. Separate accounts must be kept which distinguish the new resources invested in the UDFs from those initially available in the institution.

(83) On the other hand, the UDF managed by ACF consists of a vertical structure integrated by (i) ACF, acting as the manager of the JHFA funds invested in the UDF, and (ii) AC JESSICA Andalucía, S.A., a separate legal entity wholly owned by ACF, acting as the UDF that borrows the JHFA funds and follows instructions from the manager.

2.6.3. UDF management

2.6.3.1. Responsibilities

(84) The JHFA delegates to the UDFs individual investment decisions that will be made using commercial appraisal principles within the limits of the investments strategy agreed and the policy objectives sought. The key tasks envisaged for the UDFs, i.e. its management, are to:

(a) Identify, appraise and structure investments in viable UDPs which fit within the agreed business plan of the UDF and the investment strategy of JHFA;

(b) Monitor UDPs' operational and financial performance and manage appropriate exit strategies from UDPs to ensure most profitable investment exits;

(c) Seek to secure maximum co-financing at UDF level and/or project level to ensure that JHFA’s investment is sufficiently and appropriately leveraged;

(d) Monitoring and reporting to the HF on the UDP portfolio performance, providing the necessary information to ensure compliance with the relevant EU rules;

(e) Promote its UDPs and partnerships with the private sector.

2.6.3.2. Remuneration

(85) The JHFA will compensate the UDFs for investment management services in the form of a management fee agreed in advance and contractually defined in the Operational Agreements with BBVA and ACF.

(86) The precise management fee structure and its level have been determined through the competitive process of selecting UDFs and was an important part of the selection criteria.

(a) <u>Remuneration provisions concerning the UDF managed by BBVA</u>

(87) The remuneration provisions foresee an overall limit of 3% p.a. of the capital to be contributed by the JHFA to the UDF.

(88) The fee is paid only in relation to investments in UDPs. The management fee shall not be calculated on the interest earned by a UDF on any deposits of funds contributed to the UDF by the JHFA and not yet invested in Urban Projects or returned to the UDF from investments in Urban Projects and not yet re-invested.

(89) Within the restrictions mentioned above, the fee shall be calculated in the following way:

(90) Until 31 December 2015, the fee will be composed of the Project Assessment Fee plus the Structural Funds Supervision Fee, each being an annual fee equivalent to EUR

563,836.14 or, in case of termination of the UDF contract due to exceptional circumstances, an annual fee equivalent to 1.5% of the amount indicated in recital (88).

(91) From 31 December 2015 and until Maturity Date, the management fee will be the Loan Management Fee. Contractual clauses in the operational agreement stipulate that BBVA managers are entitled to 3% of the principal repaid and/or interest paid to the UDF by the borrower i.e. a fee linked to the amounts repaid and interest earned on the loans.

(92) The Spanish authorities point out that the fee structure described will encourage BBVA managers to take optimal investment decisions in line with the investment strategy, since from the end of the investment period under the current programming period of the ERDF (i.e. after 31 December 2015) management remuneration will be payable only in respect of proceeds received from successful UDPs.

(93) As an additional incentive to take economically sound decisions, the UDF manager BBVA is obliged to offer co-investments by means of its own financial resources or resources from eligible third-parties into every UDP under exactly the same conditions as the UDF itself does. Any derogation from that principle will be subject to prior approval obtained from the Investment Board.

(b) Remuneration provisions concerning the UDF managed by ACF

(94) As stipulated for the UDF managed by BBVA, the remuneration provisions for the UDF managed by ACF also foresee an overall limit of 3% p.a. of the capital to be contributed by the JHFA to the UDF.

(95) Within that ceiling mentioned in recital (94), the management fee shall consist of a fixed part and a variable part which will be calculated as follows:

(96) During the investment period the fixed part of the management fee shall consist of (i) a project evaluation fee, which is a fee equal to 0.75% of any investments effectively disbursed, and (ii) a monitoring Structural Funds fee which shall be a fee equal to an annual percentage of 0.75% of the investments effectively disbursed. In addition, during the investment period an annual fund administration fee will be paid of 2% of the funding provided from the JHFA to the ACF to the extent not yet repaid by, or recovered from UDPs.

(97) After the investment period or in case of an extraordinary termination of contract until the date of exit from the UDP, a fund administration fee will be paid that equals to the sum of the annual percentage of 1.5% on the aggregate funds invested into UDPs and 3% of any Paid Interest and Repaid Principal received by ACF from UDPs.

(98) The variable part of the management fee is an incentive for accelerated investment, in the form of a one-time payable fee of 1% of the funds invested into UDPs. That fee will be payable if ACF has invested all the funds received from JHFA by 30 September 2014.

(99) The variable part will also comprise a performance incentive, a one-time payable fee equal to between 2% and 7% of the excess, if any, of all repaid investments discounted for inflation reduced by any recovery costs and any management fees over the funds effectively disbursed to UDPs.

2.7. Funding architecture IV: Eligibility criteria for UDF investments

2.7.1. Eligible beneficiaries

2.7.1.1. General conditions

(100) Under the notified measure, the Spanish authorities intend to grant State aid to private investors[18] in UDPs. Such investors can benefit from preferential investment conditions as compared to public investors.

(101) Beneficiaries of aid under the measure must be located or exercise economic activities in Andalucía. UDPs supported under the measure must be carried out in the urban areas of Andalucía defined in the IPSUD as pointed out above.

(102) The physical delivery of a UDP, e.g. construction of buildings, shall be carried out under market conditions and therefore not benefit from any State aid granted under this scheme.

(103) If the preferential investment conditions granted under the measure translate into sub-commercial conditions for operators or end-users of UDPs (e.g. a shop tenant paying a sub-commercial rent in a building that has been built or renovated as part of UDPs), State aid potentially included in those conditions is not part of the current notification.

(104) Each UDF receiving funding from the JHFA under the measure will operate in accordance with a business plan which will include the UDF investment strategy as well as an indicative list of eligible projects. The quality of the UDF's investment strategy is one of the selection criteria established by the JHFA.

(105) Each UDF's business plan will be in line with the investment strategy of the JHFA. The definitive list of eligible projects will be agreed with the JHFA. The definitive project portfolio of each UDF will be subject to the approval from the JHFA's Investment Board. In case certain projects from the portfolio cannot proceed due to circumstances unforeseen at the moment of the submission of the portfolio, the Operational Agreements defines the detailed arrangements of substituting projects for them.

(106) The Call for Expression of Interest expressly states that the maximum financial amount to be invested in an individual UDP will be set ex ante by JHFA and in such a manner as to allow the portfolio of UDPs to be sufficiently diversified, taking into account the business plan of the UDF. For UDPs presented by large towns (more than 50.000 inhabitants), the maximum financial amount to be invested by the UDF in a single UDP will be EUR 15 million. For medium and small cities (less than 50.000 inhabitants), the maximum financial amount would not exceed EUR 5 million.

(107) UDPs can either be organised as a separate block of finance following international accounting standards and normally within the legal structures of the beneficiary or a UDP can have a legal entity of their own e.g. a Special Purpose Vehicle established in order to run a development project.

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18 Under the measure, the term "private investor" means any investor whether private or public that invests its money in a profit-oriented way in line with a market economy logic, in conformity with the Union Courts' rulings on the Market Economy Investor Principle. See for example Case T-163/05 *Bundesverband deutscher Banken* v *Commission* [2010] ECR II-0000, judgment of 3 March 2010.

2.7.1.2. Contribution to policy objectives

(108) UDPs will comply with the SF Regulations. Each UDP will in addition contribute to the objectives defined in the Andalucía OP and comply with relevant IPSUDs, including quantitative outputs stipulated in the Andalucía OP.

2.7.1.3. Repayment of initial investments plus inflation rate

(109) Selected UDPs will be economically and technically sound and have a minimum prospect of financial viability. The existence of positive project cash flows is a key financial requirement. It is necessary to at least repay investments plus inflation rate. All projects will be assessed in detail by the UDF to determine the robustness of their financing structure.

2.7.1.4. Incentive effect

(110) Investments may in general only be made in non-started UDPs, i.e. if the beneficiary has submitted his proposal for UDF funding before the start of the project work. As pointed out in the Guidelines on National Regional Aid for 2007-2013[19,] the notion of 'start of work' will mean either the start of construction work or the first legal commitment in a specific project, excluding preliminary feasibility studies.

(111) When investments are made in UDPs not meeting the requirements mentioned above, the conditions listed in recital (137), resulting in the substantial increase of an existing project must be complied with.

2.7.2. Eligible costs

(112) Investment into urban projects will be made into eligible expenditure determined by the SF Regulations. It will be subject in particular to the following limits:

(113) The Spanish authorities will apply the limitation of "investments in material and immaterial assets" relating to "initial investments", i.e. projects involving the setting-up of a new establishment, the extension of an existing establishment, diversification of the output of an establishment into new additional products or a fundamental change in the overall production process of an existing establishment, and the limitation of operating aid as defined by the Guidelines on National Regional Aid for 2007-2013.

2.7.3. Excluded investments

(114) In line with the SF Regulations, the Spanish authorities have committed that the creation and development of additional financial instruments, such as venture capital funds, loan funds or guarantee funds is excluded in line with Article 46(1) of the Implementing Regulation.

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[19] OJ C 54/13 of 04 March 2006, paragraph 38, footnote 40.

(115) No investment will be granted to projects which are active in any of the sectors or is linked to any of the activities specified in Article 1(2) of Regulation (EC) 800/2008,[20] i.e. aid to export-related activities towards third countries or Member States, namely aid directly linked to the quantities exported, to the establishment and operation of a distribution network or to the other current expenditure linked to export activity as well as aid contingent upon the use of domestic in preference to imported goods.

(116) Enterprises in the shipbuilding, coal, synthetic fibres and steel industry are excluded from the measure, as are enterprises in fisheries and agriculture[21].

(117) No investment will be granted to undertakings which are subject to an outstanding recovery order following a previous Commission Decision declaring an aid illegal and incompatible with the internal market.

(118) No investment will be granted to "a firm in difficulty" within the meaning of Chapter 2 of the Community guidelines on State aid for rescuing and restructuring firms in difficulty.[22]

(119) Furthermore, in line with the SF Regulations, the Spanish authorities have declared that the following expenditure is not eligible: interest on debt, decommissioning of nuclear power plants and recoverable value-added tax.

2.7.4. Conditions for private co-investment

2.7.4.1. Minimum size co- investment at risk

(120) As the existence of private co-investors is a significant indicator of the degree of economic soundness of the investment, in case of UDF sub-commercial loans or *non-pari-passu* equity, the private investment at risk in any UDP will be significant.

(121) In order to qualify as investment at risk, private investment will either be in the form of equity or any other contribution whose repayment is subject to the UDP's economic success. Standard senior loans do not qualify as investment at risk.

2.7.4.2. Minimum participation in overall eligible project costs

(122) In addition to the provision of significant investment at risk, private co-investors will provide for at least 30% of the overall eligible project costs.[23]

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[20] Commission Regulation (EC) No 800/2008 of 6 August 2008 declaring certain categories of aid compatible with the common market in application of Articles 87 and 88 of the Treaty (General block exemption Regulation), OJ L 214, 9.8.2008, p, 3,

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

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

[23] According to the applicable National Regional Aid map 1.1.2007-31.12.2013, Commission Decision of 20.12.2006, OJ C 35, 17.02.2007, p. 4, Andalucía is currently eligible for Regional Aid with an aid ceiling of 30%.

2.7.4.3. Special conditions for co-investments by the UDF manager

(123) The ability of the UDF managers to provide investment resources from sources other than the JHFA or attract third party private co-financing is one of the selection criteria. In order to meet that criterion, the UDF manager may also invest its own resources.

(124) UDF managers will be contractually prevented from imposing on private co-investors the acceptance of the UDF managers' own resources as a requisite to obtain preferential UDF financing. In other words, private investors may choose to provide co-financing from sources other than the co-financiers selected by the UDF.

(125) Whenever investing own resources, the UDF manager will respect arm's length principles and keep transparent records for reporting, monitoring and auditing purposes.

(126) In case a UDF manager intends to invest its own resources on terms different from those applicable to the resources provided by JHFA, the conditions will be assessed by an Independent Expert. The same is true in cases when a UDF manager provides in-kind contribution as a co-investor to a project, where the value of the contribution also has to be assessed by an Independent Expert. For further details on Independent Experts see below section 2.7.6.2.

2.7.4.4. Special conditions for co-investment at the level of the UDP

(127) Article 78(6) of the General Regulation allow private or public co-financing to be effectively paid in cash or in kind at the level of UDPs without having to be paid at the level of the UDFs. According to the SF Regulations, private or public co-financing paid at the project level would only be eligible if complies with the following conditions:

(a) The UDF retains overall responsibility for the investment operation including subsequent monitoring of the contributions from the operational programme according to the funding agreement;

(b) The expenditure paid by such private or public entities is reported formally to the UDF which is responsible for verifying the reality and eligibility of the expenditure claimed; and

(c) The audit trail is maintained down to the level of the payment of private/public co-financing to the final recipient UDP.

2.7.5. Investment process

(128) The UDF manager is responsible for making commercial decisions within the agreed investment strategy regarding the UDF funds invested into individual UDPs.

2.7.5.1. Identification of potential UDPs

(129) The measure is a demand-driven instrument where investments are made in principle on a “first come, first served" basis.

(130) The UDF will identify potential UDPs through a competitive call for offers. To that end, a website for the JHFA has been created by the Junta de Andalucía where information and indications for potential UDP promoters is included and the UDFs are also

contractually obliged to establish websites for JESSICA[24]. After signing operational agreements with UDF managers, a marketing campaign will be undertaken in order to attract UDPs.

2.7.5.2. Investment appraisal and commercial investment decisions

(131) The UDF manager is contractually obliged to assess the creditworthiness of each UDP using criteria and processes that are in line with international investment management practices and in line with the UDF's investment strategy as well as use all reasonable efforts to ensure optimal investment exits from UDPs. Failure to comply with those management duties would constitute a breach of the managing contract.

(132) The UDF takes commercial risk on the success of the UDPs, as its investments will be repaid through debt service or equity remunerated through investment exit. Therefore, the UDFs will invest only in projects that are technically and – together with the UDF investment - economically viable (see the requirement above).

(133) For any form of investment, the UDFs will carry out investment appraisal of estimated investment performance based on the Discounted Cash Flow (DCF) method. They will assess investment costs, operating costs and revenues throughout the project cycle in order to determine the financial return on investment through the following indicators that measure the capacity of the net revenues to remunerate the investment cost of equity: the financial net present value of the project (NPV)[25] and financial internal rate of return (IRR).[26]

(134) Following standard investment appraisal practice, cash flow forecasts will be estimated for a certain time frame, typically between five and ten years. Revenues further in the future will be accounted assuming they will grow at a constant rate. The growth rate will be chosen conservatively. In case the expected return depends critically on the choice of the growth rate, cash flow forecasts based on a detailed business plan should be established for a longer horizon.

2.7.5.3. Necessity test

(135) The UDFs may provide sub-commercial debt or equity at sub-commercial terms to UDPs only when a project is unable to secure the necessary equity or debt finance to start the project due to market failures or socio-economic deprivation mentioned in sections 2.1.5 and 2.1.6. As part of the application to the UDF, the UDP promoter must demonstrate to the satisfaction of the UDF manager that, prior to applying for sub-commercial conditions under the measure, reasonable efforts were taken to secure the maximum level of private finance under market conditions. It must present estimates of the 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.

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24 Clause 8.1.3 of the Operational Agreement with BBVA and Clause 10.1.3 of the Operational Agreement with Ahorro Corporación.

25 The NPV is defined as the difference between the expected revenues and operating costs discounted with a suitable discount rate, i. e. a risk adjusted cost of capital

26 The IRR is defined as the discount rate that produces a zero NPV.

(136) The UDF managers are responsible for the precise identification and record-keeping of alleged market failures or socio-economic factors that affect project's viability. Where the UDF manager also acts as a co-investor, that assessment will be carried out by an Independent Expert in order to avoid possible conflicts of interest. For further details on Independent experts section see 2.7.6.

(137) The UDF managers will verify that its investment will have one or more of the following effects on a specific project:

- A substantial increase of the project/activity size arising from the aid;
- A substantial increase of project/activity geographical scope arising from the aid;
- A substantial increase of the project/activity amount invested by the beneficiary arising from the aid;
- A substantial increase of the project/activity execution speed arising from the aid.

2.7.5.4. Investment structuring: limiting preferential conditions for private UDP partners to a Fair Rate or Return

(138) Detailed terms and conditions for financing to be provided by an UDF must be determined prior to making an investment for each UDP on the basis of financial forecasts prepared for that UDP and verified by an UDF. Financial criteria will differ according to the projects and financial products selected by the UDF (loans, equity) and will be established by a UDF manager on a case-by-case basis. Those criteria may include: internal rate of return, net present value, pay-back period, cash flow profile, availability and form of collateral (if required) and other financial indicators typically used in credit analysis.

(139) According to the Spanish authorities, UDF investments will be limited to the minimum necessary to make UDPs commercially viable for project promoters to undertake investment activities and market investors to provide additional funding. It is to be understood that as an overall principle, in order to limit the aid to the minimum amount necessary for the particular UDP, UDF equity and loans at sub-commercial conditions may only improve expected returns for market investors at the UDF or project level up to a Fair Rate of Return (FRR), equivalent to a risk-adjusted discount rate which reflects the level of risk of the project and the nature and level of capital the private investors plan to invest.

(140) The FRR is to be understood as the hurdle rate set *ex-ante* up to which the private project promoter will benefit from preferential *non-pari-passu* conditions in case of successful exit from UDP. The FRR is therefore never guaranteed to the private UDP partner. Given the risk of UDP failure, the FRR mechanism will result in an average profitability for UDPs after exit which is likely to be significantly below the FRR.

2.7.6. Establishing the Fair Rate of Return (FRR)

2.7.6.1. Preferable option: a competitive process to establish FRR

(141) The preferred approach to establish the FRR for investors in a specific UDP is to run a competitive process among potential investors. Where such a competitive process has been followed, the resulting rates agreed for investors would then constitute the FRR.

(142) For cases where there is no EU or national legal obligation to launch a formal public procurement, competition is ensured by the UDF manager through a transparent, open and non-discriminatory selection process, addressed to any interested parties, followed by appropriate negotiations with potential investors, through a process similar to a competitive dialogue.

(143) An appropriate competitive process will involve negotiations with at least two potential investors. Evidence of that process will be recorded by the UDF manager.

2.7.6.2. Second option: use of Independent Experts in non-competitive scenarios

(144) While a properly conducted competitive process would always be the preferred way of establishing the FRR, it can not be applied in all cases due to the characteristics of project financing. Competition may not always be an option e.g. in case where the potential private investor is the owner of the site/building to be developed and therefore the requirement concerning the tender cannot be met. Where the scope of the competitive process is limited or non-existent, the FRR will be determined by an Independent Expert on the basis of a professional analysis of industrial benchmarks and market risk using the discounted cash flow valuation method.

Methodology for establishing the FRR by the Independent Expert

(145) Depending on the case, an Independent Expert may be engaged by the UDF to assess the FRR for private investors either at project level or at UDF level. In both cases the Independent Expert's report will be based on a standardized methodology.

(146) Review of Industry Benchmarks: The starting point of the process of ascertaining the FRR will be a review of comparative data as to the returns currently expected on similar projects or regeneration investments in the market place. The Independent Expert will pool various sources of information and collate the most relevant data for each particular project or fund.

(147) In certain cases such data might not be publicly or readily available. Therefore, the Independent Expert will be allowed to draw upon its own past and recent experience of involvement in other projects or financings. The FRR report should specify which benchmarks have been referred to, and how those benchmarks have been taken into account.

(148) Review of Project/UDF Risk: That part of the assessment will have similarities with the credit committee / credit risk assessment processes in place in banks as part of loan approval.

(149) The project risk review will include, among other elements:

- Construction cost risk, including also inflation and exceptional factors;
- Planning risk;
- Demand risk (including impact of the geographic location);
- Economic environment and funding climate;
- Complexity of project;
- Competence of project sponsor and ability to deliver the project to time and budget;

- Financial analysis - it should include sensitivity analysis on the project financial model;
- Project sponsor's 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).

(150) As far as UDF risks are assessed in total, the relevant FRR will be set by assessing the portfolio risks, if any, stemming from the fact that the UDF may at any time hold a series of investments in assets. Additional risks might occur in the context of:

- Cross-collateralisation of financial exposure;
- Potential to generate profitable income through services offered by the UDF across a series of projects;
- Negotiation of operational costs efficiencies due to buying power across the UDF;,
- Treasury management of cash flows;
- Risk of losses in projects that would reduce the UDF's net worth as a result of the portfolio approach to project investment that will be present at UDF level. Transitional investment as private investors entry and exit may take place at different phases of an investment cycle and represent a reduced risk for incoming investors;
- The potential for UDF-level gearing over time could enhance returns above the level of the direct investment into projects;
- other opportunities for investment available in the market at the time, and the rates of return they offer to the private investor, as above.

(151) <u>Calculation of FRR by an Independent Expert:</u> Having assessed relevant Industry Benchmarks and specific risks, the FRR should then be assessed, starting with the minimum level of FRR and adding on the appropriate margin to reflect project/ fund risk.

Selection of Independent Experts

(152) The Spanish authorities pointed out that the mission of the Independent Expert is of great importance for the success of the measure. It requires industry and market knowledge as well as financial expertise, both related to the investment policy and strategy in the particular type of project. Therefore, the Independent Experts should fulfil mutatis mutandis the requirements established by the Spanish Law on Civil Procedure,[27] mainly that experts shall bear the official title corresponding to the matter of expertise.

(153) The category of professionals eligible to perform the functions of Independent Experts is subject to registration with and license by regulated professional associations under the

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[27] Ley de Enjuiciamiento Civil, article 340.

Spanish Law 2/1974 on Professional Associations[28]. Independent Experts will need to comply with deontological and professional rules issued by the professional associations in order to ensure independence and professional behaviour of its members. Professional associations have to enjoy supervisory powers and may impose sanctions on its members. In exceptional cases where matters are not covered by official qualifications and professional rules, experts must be appointed among persons with a proven expertise in the subject.

(154) The choice of eligible Independent Experts would depend on the type of eligible Urban Project to be financed and the sector and geographical area in which the concerned project will take place. Generally speaking, Independent Experts may fall in the following categories:

- Professional Service Firms, such as accounting firms;
- Property Firms, such as chartered surveyors or real estate development consultants;
- Investment banks carrying out advisory work;
- Specialist consultancies involved in public private investment funds and project finance.

(155) In order to facilitate the identification of appropriate Independent Experts and as a safeguard to prevent risks of collusion, the JFHA 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 and national Management Authorities would appoint individual Independent Experts for specific projects.

(156) The JFHA will also provide UDFs with a contract template to be used when appointing an Independent Expert. In that 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 JHFA.

Ensuring independence of Experts

(157) Independence of Experts from the UDF will be crucial and any potential candidate will be required to ensure the absence of any potential conflict of interest for each UDP. Accordingly:

- The Independent Expert shall disclose all current relationships with the UDF or the candidate investor at the time at which its mandate is entered into.
- If the Independent Expert is a legal person, no capital links shall exist between the Independent Expert and the UDF or the candidate investor offered to co-finance a UDP.
- During the term of the mandate, the Independent Expert shall undertake not to create a conflict of interest by having or accepting employment or appointment as a member of the board of the UDF or the candidate co-investor, or by having or

[28] Ley Estatal de Colegios Profesionales, Law 2/1974, of 13 February 1974, as amended by the Law 74/1978, of 26 December 1978, the Law 7/1997, of 14 April 1997, the Royal Decree 6/1999, of 16 April 1999, the Royal Decree 6/2000, of 23 June 2000, and Law 25/2009 of 22 December 2009. The AC Laws also governing professional bodies and associations Might also be applicable, such as the Law 10/2003 of 27 November 2003 of Andalucía: Ley Reguladora de los Colegios Profesionales de Andalucía.

accepting any assignments or other financial interests in the UDF or the candidate investor.

- 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 MA and resolve the problem immediately and. If the conflict of interest cannot subsequently be resolved, the UDF and/or the MA will be entitled to require the termination of the Independent Expert mandate.

(158) The rules concerning conflicts of interests will apply to the Independent Expert itself, members of its team, their spouses and the Independent Expert's Partner Firms, meaning members of the same group of companies or organisation.

(159) An UDF shall not use the same Independent Expert more than twice within a period of six moths.

2.7.6.3. Monitoring and accounting of UDFs

(160) For compliance with the monitoring and reporting requirements on the implementation of investments, UDFs will contribute to the monitoring system of the Holding Fund. To that extent, UDFs will establish a computerized registration system to collect any relevant data to be transmitted to the JHFA.

(161) Annual reporting will provide a detailed analysis on the execution of the operations carried out during the year, and will contain an analysis of the implementation of the investment and planning strategy as well as detailed information on the progress of the UDP

(162) The Holding Fund will be entitled to realize a monitoring and active follow-up of the projects, mainly towards the UDFs, but also and if necessary to the UDP themselves, with the purpose to verify the accuracy and veracity of the referred information, the transparency of the Selection process, and to ensure that funds are invested in compliance with the Andalucía OP.

(163) In case of irregularities, the UDF and the Holding Fund will actively collaborate with a view to solving them. It may include all measures aiming at obtaining a payback of the financing, the exclusion the UDP from financing or its replacement by another UDP. The JHFA will report the irregularities to be processed to the Spanish authorities.

(164) Representatives of the European Commission, the European Union Court of Auditors, the Holding Funds, the Spanish authorities or any other institutions properly empowered by law to realize audit and control will have constant access to the documents of the UDF, with a view to obtain guarantees on the legality and regularity of the financial contribution.

(165) The UDF will establish fiscal controls and accounting procedures conforming to international accounting principles.

2.7.6.4. Treasury management of the UDF

(166) The use of interests and other gains generated by payments from the JHFA as well as the use of returns, resources returned to funds and returns from investments at the level of final recipients, will comply with Article 78(7) of the General Regulation and Article 43(5) of the Implementing Regulation. The interest rate applicable on available funds (funds transferred to the UDF and not yet invested in UDPs) will be in line with market rates.

2.7.6.5. Winding up provisions of the UDF

(167) Resources returned to the UDF – even after the liquidation of the UDF – must be used for sustainable urban development in line with Article 78(7) of the General Regulation. Returned resources will be reemployed in the area targeted by the OP Andalucía through repayable instruments, with a view to ensuring further multiplication of and recycling of public money. It does not apply to the resources of private investors, which can be returned to them after the completion of the project.

2.8. Cumulation and applicability of other EU legislation

(168) Notwithstanding limitations in existing EU State aid legislation, aid provided under the measure can be granted together with other State aid as long as the latter is taken into account when structuring investment conditions and notably when calculating the appropriate FRR.

(169) Once investment conditions including the relevant FRR under the current measure are fixed, no additional State aid can be granted.

(170) In cases of investments aimed at repairing environmental damage (e.g. land decontamination), the "polluter pays" principle will be respected. Therefore no aid should be provided if there is a private entity responsible for the pollution of a contaminated brownfield or greenfield[29] and it is still legally possible for that entity to repair and compensate the consequences of the pollution.

(171) In case of investments in the field of transport, the notification is without prejudice to legally binding EU legislation.

2.9. Monitoring, Record Keeping, Individual Notification and Standardized Information Sheets (SIS)

(172) Notwithstanding additional obligations under Structural Funds rules, an annual report on the expenditure under this scheme, allowing assessment of compliance with State aid rules, will be provided to the Commission.

(173) For compliance with State aid requirements, records will be kept for ten years from the date the last award of aid under the scheme. Records will be sufficiently detailed to establish that the conditions of the scheme are met, to include confirmation of the beneficiaries' status and eligibility of supported costs.

(174) If the Commission requests information necessary for it to assess whether the State aid conditions have been complied with, the Management Authorities will provide it within the agreed time period.

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[29] By entity or person responsible for the pollution is meant the person liable under the law applicable in each Member State, without prejudice to the application of European Union rules in the matter, such as Directive 2004/35/EC of the European parliament and the Council of 21 April 2004 on environmental liability with regard to the prevention and remedying of environmental damage (OJ L 143, 30.4. 2004, p. 56).

(175) The Spanish authorities have agreed to notify individually, for approval by the Commission, aided major projects exceeding an overall volume of EUR 50 million, irrespective of the proportion of those costs financed by the UDF. This obligation is without prejudice to the provisions of the *de-minimis* Regulation,[30] setting conditions for the absence of State aid under certain circumstances.

(176) The Spanish 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 Spanish authorities and Commission services. The Commission will not approve each SIS as a condition for making investments.

3. ASSESSMENT

3.1. Presence of State aid pursuant to Article 107(1) TFEU

(177) 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 Member State or through State resources. Secondly, the measure confers a selective advantage to certain undertakings or the production of certain goods. Thirdly, the measure is liable to affect trade between Member States. Fourthly, the measure distorts or threatens to distort competition in the internal market.

3.1.1. Types of State resources

(178) The measure's initial budget is composed of resources from the ERDF as well as national match funding and therefore entirely qualifying as State resources.

(179) Additional public in-kind contributions (e.g. land or buildings at the UDF and/or project level) will also constitute State resources.

3.1.2. Advantage: Levels of assessment

(180) Under the measure, State resources will typically be transferred to the JHFA and further on to UDFs Funds that will invest those resources together with private co-investors in UDPs, where they will be used to provide for goods and services such as construction of buildings required for physical project delivery.

(181) Similar to Commission's considerations on potential State aid at various levels under point 3.2 of the Community Guidelines on State Aid to promote Risk Capital Investments in Small and Medium-Sized Enterprises (RCG),[31] the Commission has assessed the existence of a selective advantage at several levels.

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[30] Commission Regulation (EC) No 1998/2006 of 15 December 2006 on the application of Articles 87 and 88 of the Treaty to *de minimis* aid

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

3.1.2.1. Advantage at the level of the Holding Fund and/or its management

(182) As pointed out under the fifth paragraph of point 3.2 of the RCG, the Commission in general considers that an investment fund is an intermediary vehicle for the transfer of resources rather than a beneficiary of aid itself. Applying that consideration to the present notification, the Commission finds that no State aid within the meaning of Article 107 (1) TFEU is granted to the Holding Fund.

(183) With regard to the Holding Fund's management, the Commission has taken note that, as pointed out above, the EIB has been entrusted with the management in line with applicable EU provisions, including the foreseen remuneration cap of [1.5 - 2%][*] of the funds administered. The HF management is therefore not receiving State aid within the meaning of Article 107(1) TFEU.

3.1.2.2. Advantage at the level of an UDF and/or its management.

(184) As regards potential State aid at the level of the UDF, the Commission finds that, based on the same arguments as stated in recital (182) with regard to the Holding Fund, no State aid within the meaning of Article 107(1) TFEU is present.

(185) As far as the UDF management is concerned, the Commission has assessed whether under the measure a remuneration arrangement for management of UDF resources might be established that entails a management fee higher than under normal market rules thus comprising State aid. As pointed out above in recital (71), the management for UDFs under the notified measure is carried out by means of open tender. The remuneration, while capped at 3% p.a. of administered resources, is therefore subject to negotiations between the Holding Fund and candidates for UDF management. Given the significant number of potential applicants for UDF management, the Commission finds that the tendering procedure will result in remuneration terms for the UDF management that are in line with market rules and no State aid within the meaning of Article 107(1) TFEU will be provided to the UDF managers.

3.1.2.3. Advantage at the level of private co-investors and project promoters

(186) Private investors can invest their resources either at the level of fund or at an individual project together with resources managed by the UDF. They can invest money or contribute in kind, e.g. land owners contributing their land into a UDP in exchange for a share of potential profits or losses incurred in that project. As pointed out above, private investors can, following the procedure for establishing a FRR, benefit from investment conditions that are more favourable than those entered into by the UDF. That outcome can be due to UDF leaving higher profit options to private investors as well as UDF accepting higher risks of losses. Another reason can be the possible grant of sub-commercial loans by UDFs to increase projects' profitability.

(187) In any of the scenarios described above, private 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-*

[*] A range due to a business secret.

passu conditions for all investors and no sub-commercial loans would be available. While in some specific cases the advantages granted might correspond to specific additional economical burdens that the private investor accepted, such as provision of publicly available infrastructure, there will also be a significant number of cases where the UDF will provide advantageous investment conditions simply in order to increase economic viability in a project facilitating sustainable urban development.

(188) The Commission has also assessed, whether the establishment of the FRR by a competitive process or by using an Independent Expert respectively will exclude the existence of a selective advantage within the meaning of Article 107(1) TFEU. However, given the numerous eligibility criteria and the UDF manager's discretion when choosing and structuring projects, the Commission has concluded that the provision of preferential investment conditions will normally confer a selective advantage to private investors under the measure.

(189) As a result, the Commission concludes that private investors under the measure can receive an advantage within the meaning of Article 107(1) TFEU.

3.1.2.4. Advantage at the level of UDPs

(190) While UDPs can have the form of a block of finance that is sufficiently transparent for monitoring and auditing purposes, UDPs might also constitute a legal entity of their own. In that case, UDPs can be recipients of State aid provided all conditions in Article 107(1) TFEU are met. The Commission thus finds that under the notified measures, UDPs can receive an advantage within the meaning of Article 107(1) TFEU.

3.1.2.5. Effect on Trade and Potential Threat to Competition

(191) Under the measure, as pointed out above, private co-investors as well as UDPs themselves can benefit from a selective advantage. The undertakings in question, among them project developers and possibly financial institutions, will be active in markets open to competition and in many cases subject to intra-Union trade. The measure therefore has an effect on trade and poses a potential threat to competition.

(192) In the light of the foregoing, the Commission finds that the notified measure contains State aid within the meaning of Article 107(1) TFEU.

3.2. Notification of aid

(193) In notifying the current measure prior to implementation, the Spanish authorities complied with the obligation in Article 108(3) TFEU.

4. COMPATIBILITY ASSESSMENT

4.1. Applicability of existing State aid provisions

(194) Prior to considering a JESSICA specific assessment directly under Article 107(3)(c) TFEU, the Commission had to verify whether the notified scheme falls within the scope of existing secondary State aid provisions. Given the large variety of UDPs to be funded under the notified measure, the Commission has limited that verification to a number of horizontal rules which in principle apply across all industries.

4.1.1. *Applicability of EU rules on the provision of Services of General Economic Interest (SGEI)*

(195) The Commission has assessed applicability of EU rules on the provision of SGEIs pursuant to the Community framework for State aid in the form of public services compensation (hereinafter the "SGEI Framework")[32] 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 (hereinafter the "SGEI Decision").[33] While these provisions have not been invoked by the Spanish authorities and their specific requirements therefore have not been addressed in the notification, some of the possible UDPs (e.g. creation of social housing) might fall within the applicability of SGEI rules. It is in particular worth noting that one of the key principles inherent to SGEI rules (avoiding overcompensation) shows similarities with the mechanisms under the current measure in order to limit the granting of advantages to private investors.

(196) However, a significant number of UDPs, such as the creation or refurbishment of shopping centres or hotels as well as the creation of office space will most likely fail to meet the wide definition of SGEI under point 2.2. of the SGEI Framework. Furthermore, it is not sufficiently sure that the selection of UDPs by UDFs in cooperation with the JHFA would, despite the large discretion involved in the process, fulfil conditions for entrustment by a Member State laid down in Article 4 of the SGEI decision.

(197) It follows that EU rules on the provision of SGEI are not applicable on the notified scheme.

4.1.2. *Applicability of the Guidelines on national Regional Aid for 2007-2013 (RAG)*[34]

(198) When assessing the applicability of the RAG, Commission has taken note that, while Andalucía is in principle eligible for national Regional Aid under the current Spanish Regional Aid Map,[35] the notified measure does not comply with a number of provisions on aid ceilings and eligible expenditures laid down under point 4.1.2. of the RAG. On the contrary, the notified measures does not provide for fixed maximum amounts of aid, but lays down rather general limitation criteria reflecting the asymmetric sharing of investment risks and options.

(199) As a result, the Commission finds that the notified scheme does not fall within the scope of the RAG.

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

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

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

[35] State aid N 626/2006 – Spain Regional aid map 2007-2013

4.1.3. *Applicability of the Community Guidelines on State aid to promote Risk Capital Investments in Small and Medium-Seized Enterprises (RCG)*[36]

(200) As regards the applicability of the RCG, Commission has taken note that the funding structure involving investment funds as well as joint public-private investments at preferential terms for private investors present some analogies with the set-up foreseen in point 3 of the RCG.

(201) At the same time, the RCG stipulate a series of requirements (e.g. maximum joint public private investments of EUR 2.5 million for standard assessment and general investments restriction to SME as target enterprises) that will not be met by all possible UDPs under the measure. Moreover, the notified measure includes the significant additional element of addressing integrated sustainable urban development. Furthermore, the current measure provides for fine-tuned mechanisms aimed at limiting the advantages granted to private investors, whereas the RCG provides hardly any such limitations[37] and rather relies on safe haven clauses concerning investment amounts.

(202) In the light of the above, the Commission concludes that only smaller projects under the notified scheme could be covered by the RCG. The Commission therefore finds that the RCG do not prevent an assessment of the notified measure directly under Article 107(3) c) TFEU.

4.2. Conclusion

(203) As pointed out above, none of the existing State aid provisions is applicable to all UDPs which can be possibly designed under the notified measure. It follows that no existing secondary State aid legislation would provide 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 fostering sustainable urban development projects of the scheme notified by the Spanish authorities.

(204) The Commission therefore finds that no existing EU legislation prevents the notified scheme from being assessed directly under Article 107(3)(c) TFEU.

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

(205) 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.

(206) 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

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

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

to an extent contrary to the common interest. Positive and negative aspects are balanced against each other.

4.3.1. *Targeting an objective of common European interest*

(207) State aid may be authorised by the Commission if it contributes to the achievement of one or more of the objectives of common interest identified in Article 107(3) TFEU. Whether a measure contributes to an objective of common interest can be understood in terms of its contribution to efficiency or equity.

(208) As pointed out above in section 2.1, the measure aims at facilitating sustainable urban development by providing sub-commercial conditions to private investors with a view to achieving greater market efficiency or equity objectives.

(209) The Commission notes that the Spanish authorities correctly refer, as pointed out in section 2.1.2, to Structural Funds rules, underlining the importance of sustainable urban development in order to increase market efficiency and social cohesion.

(210) Also in previous decisions, the Commission has considered that the physical, economic and social regeneration of urban areas is clearly a European objective.[38]

(211) The Commission therefore finds that the notified measure targets an objective of common European interest.

4.3.2. *Appropriateness*

(212) The Commission must examine whether the measure is an appropriate policy instrument to support sustainable urban development in the Andalucía. 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.

(213) 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 falling under Article 107(1) TFEU must be justified by the appropriateness of that particular instrument of State intervention to meet a well-defined public policy objective and contribute to one or more objectives of common European interest.[39]

(214) The Commission will consider a measure to constitute an appropriate instrument where the Member State has considered policy options equally suitable to achieve a given objective of common European interest, including measures less distortive to competition than the selective grant of State aid, and where the Member State can demonstrate to the Commission that the measure is suitable in view of achieving the relevant efficiency or equity objectives.

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[38] European Commission (2009), decision N555/2008, Centrumplan gemeente Mill en St. Hubert, OJ C 294, 3.12.2009 p. 1 rec. 48; European Commission 2011, SA.32835 (2011/N) - United Kingdom Northwest Urban Investment Fund (JESSICA) (not yet published)

[39] See for a discussion of appropriateness cases C 25 / 2004 - DVB-T Berlin-Brandenburg (OJ L 200, 22.07.2006) or N 854 / 2006 - Soutien de l'agence de l'innovation industrielle en faveur du programmemobilisateur pour l'innovation industrielle TVMSL, OJ C 182, 04.08.2007.

4.3.2.1. Consideration of other policy options less distortive to competition

(215) Traditionally, urban development and regeneration projects, including infrastructure development projects, have been structured around types of activity involving public and private sectors with clearly delineated roles. While the public sector traditionally undertook the role of acquiring and assembling land, addressing the need for site clearance, remediation and the provision or improvement of large-scale infrastructure and the public realm, the private sector has traditionally focused on commercial development.

(216) Due to the pressures facing government budget, public authorities are no longer in a position to provide the necessary funding required for addressing urban development needs. Therefore, private capital is needed to provide financing of urban investment projects, which means that projects must be commercially viable to remunerate market investors and service the debt. In that respect, public funds can act as a catalyst to leverage additional funding to finance urban investments.

(217) As pointed out above in recital (20), in the past the Spanish authorities have used different measures in order to address urban development, namely grant funding to public authorities such as municipalities with no undertakings involved.

(218) Those policy options differed significantly from the current approach under the Jessica Andalucía scheme which is designed to provide new opportunities for urban development by the following means:

a) Ensuring long-term sustainability through the revolving character of the funds invested in UDPs;

b) Creating stronger incentives for successful implementation of UDPs by beneficiaries, by combining grants with loans and other financial instruments;

c) Leveraging additional resources for UDPs with a focus on their sustainability and recyclability in the target area; and

d) Contributing financial and managerial expertise from specialist institutions to UDPs.

(219) When assessing whether the Spanish authorities have considered alternative and less distortive options equally suitable to achieve the common European interest objective, the Commission has taken into account that the notified measure includes numerous components aimed at maximising the participation of private investment and professional expertise, while at the same time limiting State aid to a minimum through of the application of the FRR criterion in combination with commercial management of UDFs.

(220) As a result, the Commission concludes that the Member State did not fail to consider alternative options as suitable to achieve the common interest goal but less distortive to competition.

4.3.2.2. Measure's suitability to address efficiency objectives

Existence of market failures

(221) As pointed out above in recitals (21) to (35), the Spanish authorities provided the Commission with evidence of possible market failures in the context of UDPs in Andalucía. In addition, as pointed out above in recital (136), the claimed existence of a

market failure will be duly verified and recorded prior to any UDF investment into specific UDPs.

Addressing market failures with JESSICA Andalucía

(222) In order to assess the measure's appropriateness, the Commission has also assessed whether the identified market failures will be properly addressed by the instruments foreseen under the notified measure.

Addressing market failures due to externalities

(223) As regards positive externalities such as the improvement of public spaces or other public goods components, the measure's integrated approach can result in the inclusion of those benefits if, for example, the creation of a park and the construction of apartments are part of the same UDP and the park will lead to an increase in value of the apartments.

(224) As regards problems due to negative externalities such as pollution, by favouring, for example, the installation of solar panels, the notified measure enables UDF managers to grant favourable investment conditions in order to attract private investment that otherwise could not benefit from reduced emissions.

Addressing market failures due to information asymmetries and risk aversion

(225) By ensuring that regeneration projects are sustainable and 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.

(226) Furthermore, by providing for professional project appraisal, the notified measure ensures that selected UDPs are feasible from an economic, social and technical point of view and comply with the eligibility criteria in the relevant regulations. In that context, the analysis of the financial structure, risk profile and the expected revenues for the different stakeholders makes investment decisions more transparent and therefore more reliable.

(227) In addition, the portfolio approach developed in the financing of UDPs ensures greater long-term investment opportunities and a diversification of the financial risk.

Addressing market failures due to transaction and agency costs

(228) By centralising and internalising project appraisal, transaction and agency costs, project participants can benefit from economies of scale.

Conclusion as to the measure's suitability to address efficiency objectives

(229) In the light of the above, the Commission concludes that the measure is suitable to tackle the identified market failures, thus addressing efficiency objectives.

4.3.2.3. Measure's suitability to address equity objectives

(230) When considering the measure's suitability to address equity objectives, the Commission notes that the Spanish authorities, as stated in recitals (36) to (40), can underpin the identified need to tackle socio-economic problems in deprived urban areas both by reference to general EU documents as well as to scientific publications for Spain. In addition, Spain correctly refers to the Operational Programme 2007-2013 that covers measures to tackle socio-economic issues. The Commission therefore finds that

the need for tackling socio-economic problems in deprived urban areas of Andalucía is sufficiently explained.

(231) Moreover, the Commission has taken note that, as pointed out in recital (108), every UDP must comply with the SF Regulations and in addition contributes to the objectives defined in the relevant IPSUD and Andalucía OP, including the quantitative outputs stipulated in the latter.

(232) The Commission concludes therefore that the measure is suitable to address equity objectives.

4.4. Incentive effect

(233) The existence of a market failure or a cohesion objective is a *necessary* but not sufficient condition for granting State aid. State aid must be effective, i.e. have an incentive effect. The measure at issue contains sufficient safeguards aimed at ensuring this condition is fulfilled in all UDPs concerned.

4.4.1. Application for UDF investment prior to the start of a project

(234) State aid will only be considered to have an incentive effect if, before starting a project or activities, the beneficiary submitted an application for the aid, i.e. submitted an application for UDF funding. That condition is fulfilled in the present case.

4.4.2. Necessity test for every UDP

(235) Due to the nature of the investment or characteristics of deprived urban areas, the investment would not have been implemented by the market on its own because of the fairly low expected financial return and the relatively high risk of investing in the area. The necessity test essentially shows that projects of the same nature, i.e. with an IRR below the FRR, would not be carried out by the market (a counter-factual scenario) or, at least, the investments would not take place to the same extent and in the same timeframe.

(236) Moreover, UDF managers will carry out an investment appraisal for each project and will examine technical quality and economic and financial viability. In the context of that exercise, they will duly establish a viability gap to justify any finding that the market would not proceed on its own.

(237) The Commission finds therefore that the measure's incentive effect is sufficiently demonstrated.

4.5. Proportionality

(238) 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.

4.5.1. Commercial management and success-based remuneration

(239) When it comes to assessing the measure's proportionality, i.e. whether mechanisms are in place to minimize State aid granted under the measure to a minimum, the Commission has paid particular attention to those parts of the measure that enhance decision-making in line with commercial logic.

(240) In that context, the Commission has noted that under the measure, investments entered into by UDFs, while potentially granting sub-commercial conditions to private investors, are selected and structured by professional and independent fund managers that have been chosen in an transparent process. The Commission finds that the selection of professional fund managers adds to the likelihood of economically sound investment decisions with limited deviations from market rules.

(241) The Commission also notes that in addition to the selection of professional management, the remuneration system as explained above in section 2.6.3.2 foresees a variable part which is subject to overall fund performance. It will normally encourage UDF managers to limit granting of sub-commercial conditions to co-investors because any such grants will at the same time reduce the management's remuneration.

(242) In addition, management requirements such as the existence of a business plan including an exit strategy and the governance structures including reporting obligations to the JHFA will further improve the commercial soundness of the UDF management.

4.5.2. Required repayment of initial investments plus inflation rate

(243) As pointed out above in recital (109), UDFs can only invest in UDPs whose business plan foresees the full repayment of UDF investment plus inflation rate. The Commission considers that "zero floor" requirement a suitable tool to ensure a minimum economic viability of selected projects and, at the same time, a transparent means to exclude excessive deviation from market rules.

4.5.3. Private participation

(244) The notified measure foresees, as explained in section 2.7.4, a minimum participation of private investors, i.e. investors following purely profit-oriented goals in line with market logic in the form of investment at risk for every UDP. Private co-investment is a requirement that limits the use of public resources and, at the same time, ensures the benefit of market experience and professionalism in joint investment projects. In addition, the requirement for any UDF investment to find a private investor willing to put his own investment at risk increases the economic soundness of funded projects significantly.

4.5.4. Limiting preferential investment conditions for private investors

(245) When weighing the effect that private participation has on public investments' compliance with State aid rules, the Commission has paid special attention to advantages granted to private co-investors at the expense of public investment. While the Commission normally considers public investments carried out at identical – *pari-passu* - investment conditions with private investors to be in line with the Market Economy Investor Principle and therefore free from State aid, public-private investments with preferential conditions for the private partner can under certain

circumstances constitute compatible State aid as pointed out for example in the Risk Capital Guidelines.

(246) The Commission has verified the mechanism implemented under the notified measure (see recitals (138) to (159)) in order to limit to the minimum preferential investment conditions granted to private investors in the form of sub-commercial loan and equity up to a properly established FRR. As a result, the Commission considers that the application of the FRR criterion a suitable tool in order to avoid any over-compensation of private investors.

(247) The Commission has also noted that any profits beyond the FRR agreed beforehand between the UDF and private investors will be shared proportionally. Thus both private investors and the UDF will benefit from unforeseen project over-performance in proportion to their investment.

4.5.5. Limited project size and diversification of investment portfolio

(248) The Spanish authorities explained, as stated in recital (106), that the maximum financial amount to be invested by the UDF in an individual UDP will not exceed EUR 15 million for UDPs carried out in large towns (more than 50.000 inhabitants), while for UDPs carried out in medium and small cities (less than 50.000 inhabitants) the maximum financial amount will not exceed EUR 5 million.

(249) Taking into account the overall limitation of projects, the Commission finds that it adds another element averting the risk of non-proportionate State aid.

4.5.6. Conclusion as to proportionality of the measure

(250) In the light of the above, the Commission finds that the measure is proportionate.

4.6. Distortion of competition and trade

4.6.1. Relevant markets

(251) The Commission has identified several relevant markets, potentially affected by a distortion of competition due to the notified scheme: the market for financial investments, for investment intermediation (asset management companies and financial institutions), as well as the market for property and infrastructure development.

4.6.2. Effects on the market

(252) The Commission has analysed the effects of the notified measure taking into account (i) the aid granting process, (ii) the characteristics of the relevant markets and (iii) the type and amount of aid when assessing the significance of the distortive effects the measure and its effect on trade.

4.6.2.1. Long-term dynamic effects

(253) State aid may have long-term dynamic effects on the incentive to invest and compete in affected markets. In the longer run, such a change in dynamic incentives leads to less choice, and potentially to lower quality or higher prices for consumers.

(254) The Commission notes that the aid increases the supply of new commercial property on the Andalucían market. That property will however be open to any interested end user or buyer. Besides, the current notification only covers the supply of commercial property at prices corresponding to those customarily observed for similar property in that area.

(255) The Commission considers that the aid, to the extent that it covers the UDPs' viability gap does not provide the companies undertaking the project with resources that they can use for cross-subsidizing future projects in order to distort competition and affect trade. On the contrary, regeneration efforts targeted at remedying market failures can actually unlock opportunities for commercial developments, which had previously been inhibited.

(256) Investments will be made 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 have to be repaid through efficient operations.

(257) While the absolute amount in any given UDP is not calculated, the amount of aid is in all cases limited to what is strictly necessary in order to cover a viability gap. Thus, it would not result in project promoters or financial investors obtaining significant market power as a result of the measure.

4.6.2.2. Crowding out

(258) At a more specific level, State aids may affect competition in the product market when competitors react by reducing their own sales and investment plans (crowding out).

(259) The Commission notes that State aid will be exclusively provided to unlock those projects where the market would not undertake the activities on its own. Besides, there will be an overall increase in the level of investment activity in the markets due to the minimum private participation requirement. Thus, crowding-out effects remain unlikely.

4.6.2.3. Input markets and location

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

(261) The measure will support development activities that are predominantly of 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.

4.6.3. Conclusion as to distortion of competition and trade

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

4.7. Cumulation

(263) As pointed out in recital (168), the notified aid scheme contains rules in order to prevent a cumulation with State aid granted under different provisions that would result in State aid beyond the limitations foreseen in the current notification.

(264) The Commission finds that the notified scheme contains appropriate provisions on cumulation with other aid.

4.8. Monitoring and reporting

(265) As pointed out above in recitals (77) and (160), substantial monitoring requirements will enable the EIB, acting as the JHFA, to verify compliance with UDF investment rules that also result in compliance with State aid provisions including this decision. In addition, as explained in section 2.9, exhaustive monitoring requirements and reporting obligations will provide Commission with sufficient information to verify compliance with State aid rules.

(266) Simplified information sheets for UDPs above EUR 5 million of sub-commercial UDF investment and individual notification for UDPs above EUR 50 million irrespective of the proportion of that amount financed by the UDF will further enhance transparency for the Commission services.

4.9. Balancing test

(267) In order to decide about the measure's compatibility with the internal market, the Commission had to weigh its contribution to common European objectives against a possible distortion of competition.

(268) In addressing lack of efficiency in the form of market failures as well as socio-economic problems in the context of Sustainable Urban Development, the scheme thrives to reach a common European objective of great importance.

(269) The common European objective of great importance mentioned above will be achieved by a minimum public intervention. It will be ensured by means of professionally managed financial engineering instruments, providing sub-commercial investment conditions resulting from either a competitive selection process or impartially established industry benchmarks to private investors who will in exchange leverage public investment. Compared to grant funding, the aid amount will be particularly low. As far as market distortion is concerned, the requirement of in-depth knowledge of local specificities will limit distortive effects of aid granted under the scheme to non-aided EU competitors, the aid therefore not being likely have significant impact on EU trade.

(270) In the light of the above, the measure's positive effects clearly outweigh any potential distortion of competition.

5. DECISION

(271) In the light of the foregoing, the Commission has decided not to raise objections to the notified measure, because the aid can be found compatible with the internal market in accordance with Article 107(3)(c) TFEU. This decision does not prejudice the position the Commission might take on the compatibility of the relevant measures with the EU rules on free movement of services.

(272) The Commission reminds the Spanish authorities that, in accordance with Article 108(3) TFEU, plans to refinance, alter or change that aid have to 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[40].

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_es.htm

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

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

Yours faithfully,

For the Commission

Joaquín ALMUNIA,

Vice-President

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