



EUROPEAN COMMISSION

Brussels, 06.07.2010
C (2010)4507 final

**Subject: State aid N 158/2009 – United Kingdom
Establishment of the National Employment Savings Trust - NEST**

Sir,

1. Procedure

1. By letter of 9 April 2008, the UK authorities submitted a pre-notification for the abovementioned case and requested a meeting with DG COMP services. On 17 March 2009, the authorities of the United Kingdom (UK) notified -the "Pensions Act 2008" and the Draft of "The Pension Scheme Order 2009" making provisions for the administration and management of such Pension Scheme. Further information was submitted on 11 May 2009. The Commission requested additional information on 15 June 2009, 15 October 2009 and 10 March 2010. The UK authorities provided the requested information by letters dated 13 July 2009, 22 January and 30 March 2010 respectively. Two meetings were held in Brussels on 21 May 2008 and 17 September 2009. By letter dated 19 May 2010, the UK informed that it did not require a decision within a two month timeframe from 30 March 2010.

2. DETAILED DESCRIPTION OF THE MEASURE

2.1. Background on the UK pension system

2. The United Kingdom has a complex pension system, which mixes public and private provisions. In the following we give an indicative description of the UK's pension system which is based on three pillars. The various pillars have aims in themselves, but the system as a whole is designed to meet the aims of poverty alleviation, income smoothing over the

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life-course and to provide a foundation for those wishing to save in a private pension in order to achieve a higher income in retirement.

3. According to the UK, the first pillar of its pension system is the Pension Credit which is a means-tested benefit available to people aged 60 and over. This is a State pension providing a safety net for those on low incomes or who have not worked at all. It aims at securing access to a decent standard of living and alleviate poverty¹. The second pillar of the UK pension system consists of mandatory earnings related savings which include the Basic State pension (BSP) and the State second pension (S2P).² The Basic State pension is a flat-rate-pension based on National Insurance contribution which are mandatory deductions made from workers' wages. S2P is a second tier mandatory earnings-related pension for employees³.
4. The third pillar of the UK pension system is the private or voluntary pension saving element of the UK pension system. It allows individual top up to help maintain pre-retirement living standards. The State intervention in this pillar is limited to regulatory supervision and provision of general tax incentives to encourage retirement savings⁴. Under Pillar 3 arrangements, individuals enter a direct contract with a pension provider, such as an insurance company, to save for a pension or enter a trust based occupational pension scheme offered by their employer.

¹ The Pension Credit was introduced in 2003 as an income-related benefit ("means-tested"). There are two elements to the Pensions Credit, the guarantee credit and the savings credit. The guarantee credit part tops people's income up to a minimum income level and is thus available to those whose State or private pension entitlement is below this minimum level. If individuals have savings the amount they receive from this benefit is progressively reduced. However to reward savings the benefit has a savings credit element that limits the impact of this reduction.

² These are both Pay-as-you go (PAYG) systems where contribution revenues are used for the payments of current pensions. On the contrary, in a funded system the contributions are accumulated and paid out (together with the interest) when eligibility requirements are met.

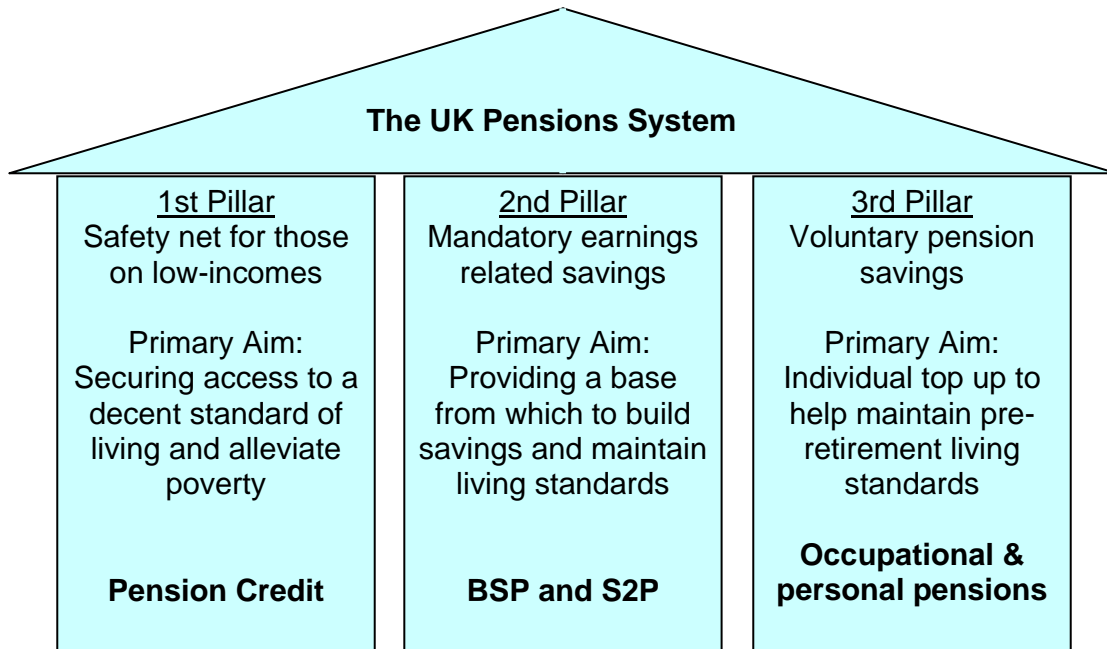
³ For BSP purposes, individuals without a full contribution record (from 2010 this is 30 years) receive a partial award of pension. The introduction of the State Second Pension in 2002 enables people on lower earning to build up their pension entitlements. S2P requires all employees (but not the self-employed) either to be members of the S2P, or to make equivalent private savings in a private pension for which the individual receives a reduction in the National Insurance contributions they would otherwise be expected to make. Persons earning between the lower earnings limit (about £4.264 for 2005/06) and £12.100 will accrue pension rights as if they had earned £12.100.

⁴ "Occupational Pension schemes" are normally established by employers on a voluntary basis for the benefit of their workers. These schemes must be set up in the form of trusts.

Workplace Personal Pensions ("WPPs") are schemes which are created by third party businesses such as insurance companies for the use of participating employers who choose to make such arrangements for the benefit of their workers. The employer usually makes contributions to the worker's pension fund, on the basis of an agreement with the worker. The key distinction between WPP and trust-based occupational schemes is that under the former the terms of membership of the scheme are governed via a contract between the worker and the provider of the scheme. Under occupational schemes, there is no such contract between the worker and the scheme.

- An estimated 47 % of employees are members of an occupational pension scheme and around 19 % have personal plans. Because some people have both plan types, overall coverage of voluntary private pension is 59 %.⁵

Figure 1: Pillars in the UK Pension System



- The mandatory State element of the UK pension system, in pillar 1 and pillar 2 above, are designed to provide a replacement rate (the ratio of post-retirement income to pre-retirement income) of around 30% for a median earner (around 20% for a high earner and 60% for a low earner) with a full contribution history⁶.
- Income replacement rates above these levels for median or higher earners have to be secured via voluntary saving in third pillar arrangements. Some individuals, in particular those working for employers who have voluntarily opted to operate a third pillar scheme, can do this now but a significant proportion of workers either cannot or do not.
- Over the past few years an intense debate has developed in the UK on the reform of the voluntary pension system to address the combined challenge of an ageing population and falling birth rates on the one hand, and of the large part of the workforce not saving enough to secure an adequate income in retirement on the other hand. In 2002, the UK government established the Pensions Commission to consider the long-term challenges faced by the UK pension system and whether the existing voluntary regime represented an adequate response. Based on the 2005 Pensions Commission report, the UK government began a reform process

⁵ OECD, Pensions at a Glance 2009: Retirement-Income Systems in OECD Countries, Chapter United Kingdom.

⁶ The different earner scenarios for individuals retiring in 2055 refer to low earner with £ 15,000, median earner with £ 28,000 and high earner with £ 46,000 per year.

to the State pension system with the Pensions Act 2007. However, the Pensions Commission concluded that changes to the State pensions systems alone would not be sufficient to provide an adequate pension income for individuals in the future. In order to avoid increases in pensioner poverty or unsustainable increases in taxation, it concluded that increases in private saving would also be needed.

9. According to the UK authorities, the pension reforms are therefore aimed at encouraging and enabling the vast majority of employees in the UK who aren't currently saving to do so. As a result, those median earners who choose to remain automatically enrolled into the scheme provided by their employer and make minimum pension contributions can expect to receive an additional 15% of income replacement, taking them up to the 45% income replacement rate identified by the Pensions Commission. This element of the UK's pension reforms is therefore aimed at extending the provision of third pillar arrangements, with NEST being one type of third pillar arrangement employers can choose to use to fulfil their legal duty.

2.2 The need for Reform: Market Failure on Demand and Supply Side

10. According to the UK authorities, reforms to the present pension system are necessary to address the combined challenge of an ageing population and an important number of employees not saving enough to secure an adequate income in retirement. This reform program tackles the supply and demand failures that exist in the current private pensions market and will be targeted at those who existing providers find uneconomic to serve.
11. With regard to the market failure on the demand side, the United Kingdom has identified that, although the current private pension market provides for significant private pensions saving, around 7 million persons are under-saving for retirement.⁷ The UK has calculated that over half of private sector employees earning over £5,000 per year are not saving in a pension. Moderate to low earners are less likely to be saving in a private pension compared to workers from higher income groups. According to the UK, such a demand side failure is due to, inter alia, a lack of understanding of the benefits of retirement saving and decision-making inertia.
12. Regarding the supply side, the market fails to supply suitable products to small firms and individuals at lower earnings levels. Selling a personal pension to someone working for a medium-sized employer involves a fixed cost of around £800.⁸ However, workers often cease making contributions and more than a third of all personal pension contracts lapse after four years.⁹ The combination of high up-front costs and non-persistency means that providers have a relatively short period in which to recoup the large set-up costs. Moreover,

⁷ Department for Work and Pensions – DWP, Personal Accounts: A new way to save, December 2006; http://www.dwp.gov.uk/pensionsreform/pdfs/PA_PersonalAccountsFull.pdf; p. 47

⁸ See Pension Commission 1st Report (2004) <http://www.webarchive.org.uk/pan/16806/20070717/www.pensionscommission.org.uk/www.pensionscommission.org.uk/publications/2004/annrep/fullreport.pdf>

⁹ This is due to the ending of contributions or transfer to another pension vehicle and this number appears to be increasing (Pension Commission 2nd Report (2005) p.256)

selling individual personal pensions to consumers' of low and moderate incomes is not profitable for providers due to the big costs of advice in relation to the low level of funds under management. This may result in disproportionately high charges. High earners, who will have more funds in the scheme generating higher revenue, or those working for large employers – where economies of scale are achieved, are more attractive for the pension providers in the market.

13. According to the UK's authorities, competition alone is not sufficient to deliver simple, low cost, long-term savings products for those on average incomes without access to a good company pension. A well functioning market should produce improved outcomes for individuals, such as better service, reduced charges and innovative products. In fact, studies showed that charges for near-identical products can differ widely.¹⁰
14. According to the UK, there is little evidence that choice and competition in the pensions market drove down costs. The recent reductions in charges that many people now benefit from were caused by regulatory changes - such as the introduction of stakeholder pension schemes¹¹ and changes in the charge cap – rather than competitive forces.¹²

2.3 Actions to address the demand side failure: the introduction of Auto-Enrolment and Minimum Employer Contribution

15. The UK aims at addressing the demand side failures through the introduction of a legal requirement for the auto-enrolment of individuals into a qualifying workplace pension scheme and the payment by employers of a minimum contribution of at least 3% on a band of earnings. Both provisions were incorporated under the Pensions Act 2008.¹³ The State will also provide a 1% tax relief on all contributions made into any tax registered pension scheme.

Auto-enrolment

16. The UK is therefore introducing a new legal duty on employers to automatically enrol all eligible workers into a qualifying workplace pension arrangement from 2012 onwards. Auto-enrolment applies to all jobholders who: (i) are aged at least 22 and have not reached pensionable age; (ii) are working in Great Britain and Northern Ireland under a worker's contract; (iii) have earnings over £5,035 per year.

¹⁰ The Sandler Review of Medium and Long-term Retail Investment, July 2002 http://www.hm-treasury.gov.uk/documents/financial_services/savings/fin_sav_sand.cfm

¹¹ For more information on this, see <http://www.hmrc.gov.uk/stakepension/index.htm>

¹² Department for Work and Pensions – DWP, Personal accounts: A new way to save, December 2006, <http://www.dwp.gov.uk/docs/pa-personalaccountsfull.pdf>, making in para 2.37 reference to the Sandler Review and to the first Report of the Pensions Commission.

¹³ www.opsi.gov.uk/acts/acts2008/pdf/ukpga_20080030_en.pdf.

17. The enrolment has to be made into a qualifying workplace pension scheme, which is selected by the employer, whereby an employer may choose to use either a single scheme for all its employees or a number of schemes for different types of employees (such as those with different income levels, different job types or periods of time with the employer). Auto-enrolment means that the worker also has the possibility to opt out.

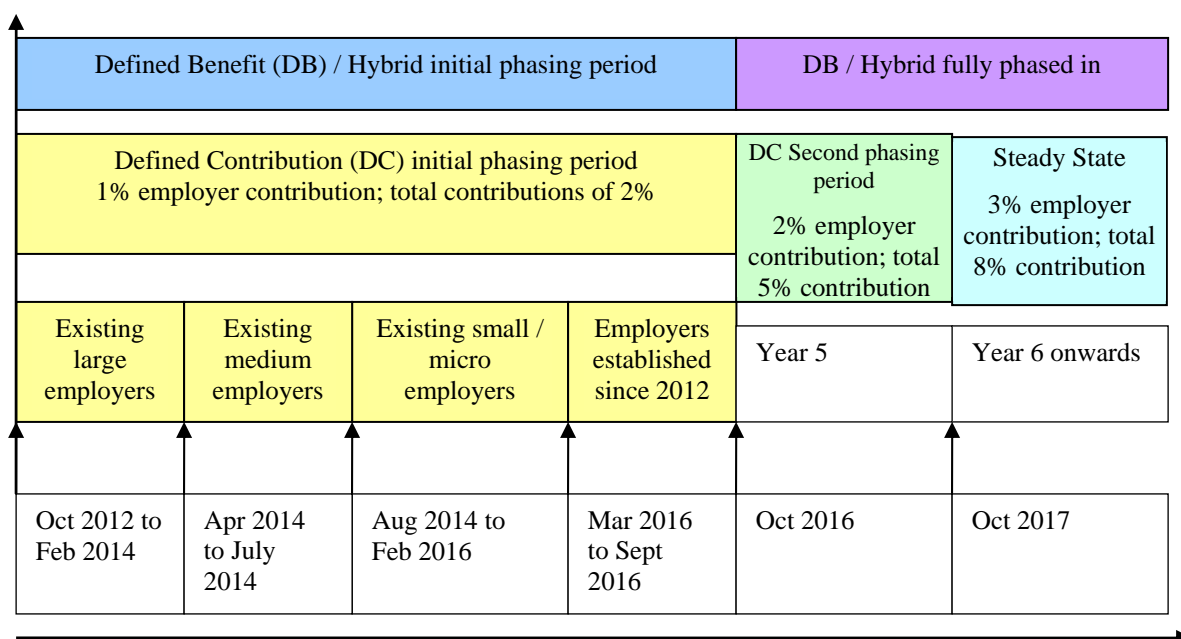
Minimum employer contribution

18. Irrespective of the workplace scheme offered, the employer will be obliged to ensure, once the phasing period is complete, that at least 8% of an employee's qualifying earnings are paid into the selected scheme. Qualifying earnings are in an earnings band of £5,035 to £33,540 per year¹⁴. This must, as a minimum, consist of a 3% employer contribution¹⁵, in which case the employee will pay a 4% pension contribution and 1% will come from the Government in the form of tax-relief. The employer may, however, choose to pay more than the 3% minimum in order to reduce the share contributed by the employee or to take the total contribution amount above 8%.
19. The requirement for employers to automatically enrol their employees will be staged from the largest to the smallest employer, starting in October 2012. To allow new businesses time to become established they will be subject to the requirements after this period. This staging process will last 48 months in order to minimise delivery risks and give employers and the pensions' industry sufficient time to adjust to the reforms. This staging will be accompanied by a phasing of the amount of contributions those employers and their employees are required to pay. This phasing of contributions is designed to help employers manage the additional costs of the reforms. Both the staging and phasing requirements are illustrated below:

¹⁴ This is based on 2006/2007 earnings terms. Both the lower and upper thresholds are reviewed annually in line with changes to the average earnings Primary Threshold and Upper Earnings Limit for National Insurance contributions. This will be up-rated annually in line with changes in average earning.

¹⁵ This compares to an average rate of employer contribution in existing schemes of 6.53%.

Figure 2: Stages in the auto-enrolment obligation



20. The overall level of an 8% contribution was set to ensure that a median earner who saves across their working life should achieve a minimum 45% replacement rate in retirement, with 30% coming from the State pension system and 15% from private pension income.¹⁶

Setting the Qualifying earnings between £5,035 and £33,540 per year

21. Employers will only be obliged to automatically enrol employees earning above £5,035 per year and to pay contributions to those employees based on a portion of their earnings between £5,035 and £33,540. These minimum requirements apply to all employers and to all schemes. They have been chosen because:
- Those earning below £5,035 can already expect a high level of income replacement rate from the State system and therefore are less likely to need to top this up through private saving. They are also more likely to find pension saving unaffordable or unsuitable given their current circumstances. This group will therefore not be auto-enrolled, but will have the option to opt-in to their employer’s scheme if they wish, although they will not attract an employer contribution.
 - It smoothes the impact of paying contributions on those whose income level is closer to the lower automatic enrolment earnings threshold. Otherwise those whose earnings increased to bring them into automatic enrolment would immediately have to pay a large amount of contributions.

¹⁶ The division of the 8% contribution between employer, individual and Government has been designed to provide employees with a good incentive to save: for every £1 contributed by the employee, they will receive another £1 into their pot from their employer and the Government.

- In order to limit the additional cost to employers of making pension contributions, these will only be made on a band of earnings rather than the employees’ full level of earnings.
- The upper limit was set to place a cap on the level of contributions an employer will have to make, while also enabling those auto-enrolled to achieve an adequate level of income replacement. This means that while employees earning above the higher qualifying earnings level (£33,540) will still be automatically enrolled into the qualifying scheme selected by their employer, the employer will only be obliged to make contributions in respect of earnings between £5,035 - £33,540. The employer and the individual may, however, choose to make contributions above that.

2.4 Actions to address the supply side failure: the establishment of the National Employment Savings Trust (NEST)

22. The UK has undertaken a detailed analysis of whether the existing pensions market would expand sufficiently following the introduction of automatic enrolment and a minimum employer contribution to cover all employers and their workers affected by the new employer duty. It concluded that although the current market would to some degree expand, many employers and workers would remain unprofitable to providers and be excluded from low cost saving. The UK concluded therefore that a different form of provision – a large scale multi-employer occupational pension scheme – was required in order to harness economies of scale and deliver widespread coverage at a low average cost.¹⁷
23. The UK considered a number of different models to achieve this, including a number proposed through consultation with the pensions industry. These were assessed against 11 criteria under the broad headings of coverage, rate of return, contribution rates, operational efficiency and risk. This analysis revealed that a single organisation responsible for running the scheme, but outsourcing its administrative and investment functions to private contractors would be the most effective way of maximising coverage and delivering low charges. In particular, it would provide members with a more simple and cost-efficient way of saving, with greater consumer protection and the best governance structure.¹⁸

2.5. Description of the NEST

Legal Basis and principles of the Scheme

24. In order to ensure effective provision for low to moderate earners and those working for smaller employers, the UK has legislated in the Pensions Act 2008 to establish a national

¹⁷ The UK has undertaken extensive consultation with the employers and the pensions industry in designing its reforms. This has been supported by a comprehensive programme of analysis and research with pension providers, intermediaries, employers and individuals to understand how the market might respond to the introduction of the workplace pension reforms. See, for instance, the study carried out by Wood, A., Leston, J. and Robertson, M., 2009, *Pension industry responses to the workplace pension reforms: Qualitative research with pension providers and intermediaries* DWP report number 592.

¹⁸ For further detail of this assessment including the models considered, the criteria applied and the evidence based used, refer to Chapter 2 of Personal accounts: a new way to save Regulatory Impact Assessment December 2006. www.dwp.gov.uk/pensionsreform/new_way_ria.asp

occupational pension scheme, branded as National Savings Employment Trust - NEST. The UK has decided that the establishment of the NEST should comply with certain public policy principles. These principles include:

- (a) Low costs for scheme members;
- (b) Members should pay for the costs of the scheme through charges;
- (c) The scheme should be established and operate at nil overall cost to taxpayers;
- (d) The scheme should be available to any employer who wishes to use the scheme to meet their legal duty;
- (e) The scheme should be designed to complement existing provision by being most attractive to employers who primarily employ low to moderate earners and who do not already have high quality provision in place.

Structure of the NEST

25. Like the majority of UK occupational schemes, NEST will be trust based. Unlike other schemes it will also be placed under a public service obligation. The duty on Government to establish NEST is contained in Chapter 5 of The Pensions Act 2008. NEST will cover the UK (England, Scotland, Wales and Northern Ireland). The territorial extent of NEST's PSO is set by Article 18 of the Scheme Order.
26. The scheme has been designed as far as possible to have the same features as other occupational pension schemes, although it has additional limitations placed upon it. It will be run by an independent corporate trustee – the NEST Corporation - which will be a Non-Departmental Public Body. The NEST Corporation will be obliged to act in the best interests of scheme members, in accordance with the Order establishing the scheme and its rules and within the same legal framework as other occupational pension schemes.
27. The setting up and commencement of the NEST will involve activities by a number of different bodies. The responsible Ministry – the Department for Work and Pensions (DWP) – establishes the legal framework under which the trustee corporation and scheme will operate (the Order and rules). In 2007 the DWP established a non-departmental public body¹⁹ – the Personal Accounts Delivery Authority (PADA) – to advise on and oversee the establishment of the scheme and undertake the commercial procurement activity with private sector suppliers. Those suppliers will build the systems and provide the operational services for the scheme. The Secretary of State for Work and Pensions establishes the NEST Corporation based on advice from PADA which will hand over the contracts to the Corporation prior to operations commencing.
28. The NEST Corporation will be responsible for the overall operation of the scheme. The day to day operation of the scheme, however, will be performed under contract by the private sector which will provide administration, IT, investment and other related services. Contracts for these services will be awarded following competitive tender and will be time

¹⁹ Non-Departmental Public Bodies are created to perform particular functions at arm's length from central Government.

limited. Once the scheme is established, PADA will pass over responsibility for the running of the scheme to the NEST Corporation in July 2010; it will then be dissolved. The scheme's trustee board will act as an informed consumer on behalf of its members, exerting effective pressure on service providers to deliver good quality services at low cost.

Contributions from Members and Investments by the NEST

29. The scheme will operate on a defined contribution (DC) basis – that is it will accept contributions from employees and employers and, with investment returns on those contributions, build up a sum of money from which the individual will purchase a pension, in the form of an annuity. The scheme will not be subject to any additional investment requirements over and above those placed on other trust based occupational pension schemes within the UK.
30. A contribution made to the scheme by or on behalf of a member will be held by the trustee for the benefit of that member. A contributing employer will have no further legal or other interest in the fund. All investment decisions will be made by the trustee or, where the law permits, authorised persons where day to day investment decisions are delegated by the trustees to such persons (such as investment managers). Individual members may choose different investment funds constructed by the trustee, however they will not be able to make direct investment decisions (such as buying or selling stocks). There will be no Government involvement in the investment decisions taken by the trustee.
31. The NEST will offer a small range of investment funds for members to choose. There will be a default fund for members and this is where individuals who make no choice will have their contributions invested. It is currently expected that the default fund will contain the vast majority of members. The default fund will be composed of a number of different assets creating asset classes (for example equities, bonds property etc) in order to assure appropriate diversification in line with a prudent approach to investing.
32. In setting an investment strategy, which will be set after seeking independent advice from regulated experts, the trustee will seek to invest prudently in line with Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision (the IORP Directive), in particular Article 18²⁰ (and the corresponding UK legislation). The trustee will then choose, following advice from suitably qualified third parties and using a value for money selection process in accordance with the EU legislation relating to the purchase of securities, pooled investment funds. A unit price will be calculated on the basis of the aggregate investments value. This will form the fund value that the member would see. This form of investment is not available to individuals.

²⁰ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:235:0010:0021:EN:PDF>. The purpose of Article 18 of the IORP Directive is to set minimum standards to ensure that IORPs adopt a prudent approach to investment. The overarching concern is protection of members' future pension benefits. In particular, the Article requires IORPs to invest assets in such a manner as to ensure the security, quality, liquidity and profitability of their portfolio as a whole. In that investment context, Article 18(2) prohibits an IORP from borrowing or acting as a guarantor on behalf of third parties, except for liquidity purposes and on a temporary basis.

Transformation of savings into additional replacement income

33. A member would receive their portion of the value of the default fund when they come to turn their pension saving into a pension income. The value of their final pension pot will vary depending on contributions received and also the performance of the fund they are invested in.
34. The choice of fund, i.e. either the member selected fund or the default fund, will not influence the type of pension eventually received by the member. It will only influence the value of the fund which will be used to secure the pension income.²¹ Such pension income is conventionally secured through the purchase of an insurance product termed an annuity, which provides a regular income for as long as the purchaser (and, in some cases depending on annuity choice, their spouse) lives.²² The NEST will not be providing annuities itself, members will instead be expected to choose an annuity from the commercial annuities market and processes will be put in place to enable this to occur.

Commencement of Operations

35. It is the UK's intention to require employers to automatically enrol all eligible employees into the NEST (or any other qualifying scheme) from October 2012, to coincide with the introduction of the minimum employer contribution described in section 2.3.
36. There will be some limited activity prior to October 2012 to set up the scheme and to ensure the reforms are delivered as effectively as possible: in April 2011 a limited number of employers will voluntarily participate in the scheme. At this point NEST will not be required to operate under its Public Service Obligation (PSO), which will only begin in October 2012 when it is fully launched.

2.6. The Public Service Obligation and Public Policy Constraints

37. In order to fulfil its reform objective of increasing the number of those saving for retirement and the overall level of saving, the UK has decided that the NEST will, unlike other schemes offering services linked to the minimum employer contribution, be subject to an ongoing PSO which, as it is expressed in legislation, can only be amended by Parliament. In particular:

²¹ Legislation in the UK requires that a retirement fund, built up by employee and employer contributions attracting tax relief and the investment return enjoyed by those contributions, must be used to secure a pension income by age 75.

²² The scheme member can either use the full value of their investment to provide an income or choose to take up to 25% of the value as a tax-free lump sum. The remaining amount is used to secure the pension income. The only common exception to this requirement, which applies to all schemes including the NEST, is in the case of very small retirement funds which may be taken as cash, with the first 25% being tax free and the remainder taxed as income.

- The scheme trustees will be placed under an obligation to accept as members all eligible workers auto-enrolled by any employer who chooses the scheme to fulfil their legal duty²³ (see also above section 2.5)
 - The trustee must also accept those who are not eligible for auto-enrolment but nonetheless wish to save, such as self-employed individuals and those whose earnings are below the minimum eligibility level.²⁴
 - The scheme will also have to offer a core level of service for a standard price with no price differentiation between members choosing the core service. This is to prevent lower income workers being discriminated against in terms of price, discouraging participation in the scheme.²⁵
38. The UK is placing a number of constraints on the scheme in its design features as follows:
- An annual contribution limit of max. £3,600²⁶, which would restrict the amount of contributions that an individual can make to the scheme;
 - A general prohibition of pension transfers to and from the scheme, with limited exceptions.²⁷
39. The scheme will be designed to offer a basic pensions product with limited features and to operate a low cost service for members. The restrictions on the scheme's operation, including a contribution cap, a ban on transferring existing pension pots into and out of the scheme and a requirement that the scheme only provide a single product will help ensure the scheme remains focussed on its target group since the UK intends it to complement, not replace, the good quality pension provision that currently exists in the market. The constraints will also require the scheme to meet additional costs associated with enforcing the contribution limit.

²³ Article 18 of the Scheme Order requires NEST to accept all employers who wish to use it to fulfil their legal automatic enrolment duty. Article 19 requires NEST to admit as members all the jobholders²³ of that employer. A jobholder is defined in section 1 Pensions Act 2008.

²⁴ Jobholders, who are not eligible to be automatically enrolled but are aged between 16 and 21 and State pension age and 75 may opt in to qualifying pension saving and receive an employer contribution. Jobholders aged between 16 and 75, who are ordinarily working in Great Britain but who earn below the lower threshold of the qualifying earnings band may also opt in to pension saving but will not be entitled to an employer contribution. The self employed may also opt in to NEST. Individuals who are not working but previously saved in NEST whilst they were in employment may continue to make pension contributions in their account. Workers without qualifying earning, individuals no longer working but with an existing account and the self-employed may save at a rate of their choosing subject to the limits that apply to all NEST members.

²⁵ Article 27 of the Scheme Order requires NEST to make deductions (charges) that are the same irrespective of the number of jobholders in the selecting employer, the length of time contributions will be paid or the income level of those jobholders.

²⁶ This limit, set out in Article 22 of the Scheme Order, will be initially set at an amount that reflects the up-rated value of £3,600 (2005 level) based on the average earnings index.

²⁷ The transfer ban is set out in the Transfer Values (Disapplication) Regulations 2010.

40. The consequences for the scheme of the PSO and policy constraints placed upon it include:
- (a) A requirement to take on members whose revenue will not be sufficient to recoup the costs of running their account - including members other providers would not supply to;
 - (b) The scheme will not be able to generate additional charge revenue either through differential pricing for the core service or from competing in the broader market for higher earning individuals or existing pension scheme members; and
 - (c) The scheme will need to be built on a scale which will enable it to serve its anticipated maximum membership from the outset; it will not be able to control supply cost or risk by controlling its uptake of members through restricting access.

2.7 Financing the Funding Gap of NEST

Funding NEST

41. The UK expects that once the NEST Corporation has paid off the scheme set-up and finance costs and the scheme has reached adequate scale, it will be able to fulfil its PSO and deliver low charges to members comparable to other products available in the market without continued Government support. This is because its revenues will be sufficient to cover its operational costs and enable the scheme to reasonably cross-subsidize the smaller number of members whose revenues do not cover their costs²⁸ from revenue generated by other members.
42. However, before it can achieve this scale, the scheme will face a mismatch between its costs and revenues. This is due to the need to finance its set up costs and meet its operating costs in advance of scheme revenues building. The size of this funding gap is dependent upon the costs and numbers of members joining the scheme and the revenues those members generate. It is therefore subject to inevitable uncertainty going forward.
43. The costs of establishing and operating NEST are compiled in six main categories: (i) scheme administration set-up costs; (ii) scheme administration operating costs (running the pension schemes); (iii) investment management fees (the cost of investing members' funds); (iv) customer awareness (the costs of attracting and retaining members); (v) NEST Corporation (the cost of procuring and managing the scheme); (vi) VAT (the recoverability or otherwise of VAT paid). All services will be procured from the private sector, as opposed to being built from scratch. In terms of the scheme administration, one lead supplier will establish and operate the pension scheme. The other categories cover multiple suppliers. It is also assumed that the initial contract for the scheme administration will be for a period of 10 years and that the market conditions in 2020, when the initial contacts will expire, will negate the need for further set-up costs should the renewal be awarded to a different supplier.

²⁸ The UK estimates that some 10% of members joining the scheme will still be 'loss-making' after the end of payback period.

44. The UK has estimated the cost of building and operating the NEST to be £ [856-938]*m over the next 10 years as set out in the table below:²⁹

£m	Up to 2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	Total
Set Up Costs	[...]	[...]	[...]	[...]	[...]	[...]	[...]	[...]	[105-117]
Operating Costs	[...]	[...]	[...]	[...]	[...]	[...]	[...]	[...]	[395-466]
Fund Mgt Costs	[...]	[...]	[...]	[...]	[...]	[...]	[...]	[...]	[20-60]
Customer Acquisition	[...]	[...]	[...]	[...]	[...]	[...]	[...]	[...]	[20-80]
PADA/NEST Corporation Costs	[...]	[...]	[...]	[...]	[...]	[...]	[...]	[...]	[170-325]
VAT Recovered									
Total	[132-138]	[59-62]	[74-79]	[84-93]	[87-96]	[116-129]	[146-164]	[158-177]	[856-938]

Note: totals may not sum due to rounding

Volumes

45. The anticipated number of members joining the NEST is estimated to be [3-6] million active members when the staging period finishes at the end of September 2016. In terms of total membership the UK estimates that contributing members may increase from around [3-6] million in 2016 to reach around [6.5-8.0] million by 2056 in line with projected population growth. NEST will also have to manage a significant and growing number of dormant accounts where members are no longer contributing. This is due to the high level of job mobility of expected members.

Funds under Management

46. It is expected that the scheme's funds under management will grow over time. The UK anticipates that there will be £ [1.5-3] billion of funds under management in 2016. This increases to £ [150-460] billion 20 years later in 2036. It is this growth in funds that will enable NEST to achieve the scale which will allow it to perform its PSO in the long term.

Scheme revenues and charge structure

²⁹ The costs of the first three years are aggregated to reflect the point prior to the undertaking commencing in April 2011.

* Confidential information also indicated below by a series of dots between square brackets or by a range providing for a non confidential approximation of the figure.

47. Scheme revenues will depend on the level of participation, persistency of membership and contribution levels as well as the charge structure and charge level the scheme operates under. The NEST scheme will operate on a not for profit basis.
48. The UK is taking forward the reforms on the basis that NEST will operate under a Combination Charge structure. This structure consists of a charge on contributions made into the scheme and an annual charge on the members' funds under management. The exact level of each of the components of a combination charge has yet to be decided as this will depend on the final overall costs and affordability given the fiscal position at the time. At present, however, the UK expects charges to be around a 2% contribution charge (CC) and 0.3% Annual Management Charge (AMC) although the final levels might be slightly different depending on the results of outstanding procurements.

Financing the Funding Gap

49. All schemes face a funding gap to a certain extent. In some occupational schemes, the sponsoring employer can meet this shortfall by paying for set-up costs and may also meet some of the ongoing administrative costs. In other schemes, such as workplace personal pensions, costs are controlled by limiting the volume of members (building the customer base over time) and varying the charge level offered to different employers and members. The combination of the PSO and the policy constraints placed on the scheme will prevent the NEST from addressing the funding gap in these ways and place costs on the NEST, such as needing infrastructure to deal with the maximum initial volumes, which other commercial providers do not have to meet. The scheme, therefore, is operating under a commercial disadvantage.
50. The UK has concluded that private sector finance which could be used to bridge this gap will not be forthcoming. This is due to the scale of the funding required, and the risks involved in establishing a scheme of this scale with a public service obligation and within the policy constraints required to serve a currently uneconomic segment of the market. The UK therefore concluded that finance to meet the funding gap will need to be provided by the Government.

Assessing the Disadvantage faced by the Scheme

51. The UK has assessed the disadvantage faced by the scheme by comparing the effect of the PSO and limitations with the approach that would be adopted in the rest of the market. In considering whether to supply a product, commercial providers would typically consider the income and likely saving profile of potential members in order to determine, firstly, the likelihood of securing a return on investment (costs of provision) from member charges, and, secondly, the period over which the new business is expected to cover its costs – the payback period.
52. The resulting funding gap exists over a considerably longer period than a commercial provider would accept. According to the UK, commercial providers wish to minimise the payback period before which their costs are covered. Analysis provided by consultants Deloitte estimated the maximum payback period that would be acceptable to commercial pension providers is between 8-12 years for this type of product.

53. The UK estimates that in order to achieve such a payback period in NEST, considerable charges would have to be paid by participants, varying from a minimum of at least 2% Annual Management Charge (AMC) to potentially much higher. This would provide a significant disincentive for people to save and undermine the public policy aim of helping moderate to low earners achieve an adequate pension income. For instance, a charge rate of 2% AMC would result in a median earner with a full savings history losing some 50% of their final pension pot in charges.
54. The UK calculates that the overall payback period of the scheme, under the principle estimate of costs and volumes is [20-27] years. This extended payback period, in comparison to a commercial provider, allows losses due to charges from the final pension pot of a median earner with a full savings history to be restricted to 12% despite the public service obligation the NEST operates under.
55. The UK considers the length of the payback period, and the consequential burden of additional finance costs that fall on members, as the key reason to provide compensation to the Trustee Corporation for its operation of NEST. The imposition of the PSO and the limitation of the contribution cap and transfer ban, along with an inability to cross-sell additional products, mean that the scheme is not a commercial proposition. Importantly, the financing profile of the scheme is such that it cannot payback its funding and offer a low cost pension to all members within what would be considered a commercial period in this market.
56. The public policy requirements that will be placed on NEST mean that if it had to structure its financial arrangements on a commercial basis it would face costs of £359-£463m (Net Present Value) greater than what a commercial provider would judge acceptable. The UK therefore plans to provide compensation to NEST by providing it with interest relief in the form of a grant so that its finance costs are equal to the Government's own cost of borrowing. The value of this compensation is calculated to be between £200-£379m (NPV) depending on the number of members joining the scheme. The calculation of the range of aid is based on the upper and lower range of anticipated scheme members, the cost profile following the completion of the procurement for the main contract, the expected charge level³⁰ and the current interest rate profile.

2.8. Government Loan for Financing the Funding Gap – Compensation for Performing the Public Service Obligation

57. One of the UK's central policy principles is that, as the scheme is a vehicle supporting individuals in making private retirement provision over and above the mandatory State retirement pension scheme, its costs should be met in full by its members and the scheme should be established at no overall cost to other taxpayers. As such, the UK will primarily be providing finance in the form of a loan.³¹ The UK authorities will provide State aid in the

³⁰ The Personal Accounts Delivery Authority has now completed the procurement for the main administration services that will underpin NEST. As a consequence it is proceeding on the assumption that NEST will have charges equal to [1.5-2.5] % of contributions and 0.3% of members' funds under management. The relevant aid amounts mentioned above are based on this charge level assumption.

³¹ The terms of any loan will be in line with the UK's policy for lending to bodies operating in competitive markets and subject to a statutory requirement that interest must, as a minimum, cover the cost of Government borrowing.

form of a grant to NEST: the grant will cover the difference between the interest on the loan and the cost of Government borrowing³².

The Loan Arrangement

58. According to the UK, the loan agreement will aim to:
- give the NEST Corporation adequate reassurance that the funding it needs to operate the scheme in the interests of its members and to fulfil its PSO will be available; whilst
 - ensuring the Government as lender can effectively manage its own finances, comply with domestic and EU law (including the State aid rules) and adhere to national government lending policies.
59. The overall agreement will not contain a fixed draw down or repayment schedule at the outset in recognition of the uncertainties around the numbers of employers and thus members who will join it. Instead the loan agreement will be underpinned by an agreed financial model. This financial model will generate the annual draw down amounts available to the NEST Corporation throughout the draw down period and will be used to set an annual repayment schedule. The financial model will produce these draw down and repayment schedules based on forecasts of the scheme's costs and revenues. These in turn will be based on the scheme's expected size and membership profile.
60. In order to ensure the NEST Corporation operates efficiently, remains affordable and receives funding proportionate to the fulfilment of its PSO, the draw down and repayment schedules will be subject to certain limits. If the NEST Corporation breaches one of these limits then a series of escalating intervention rights³³ will be activated that will allow the

The mechanism for any subsidy related to the terms of the loan will be in line with the appropriate UK budgetary guidance. www.hm-treasury.gov.uk/psr_bc_consolidated_budgeting.htm

³² The rate of Government borrowing varies depending on prevailing interest rates and is set by the UK's Debt Management Office www.dmo.gov.uk/index.aspx?page=PWLB/PWLB_Interest_Rates. The precise Government interest rate will depend on the rates operating at the time the loan is given. For the calculations in the notification a Government rate of 4.41% has been used.

³³ The loan agreement will give the Ministry escalating intervention rights in certain circumstances. These circumstances include:

- Failure to supply monthly management information in the specified format and to specified standards;
- Breach of the annual limit dictated by the agreed financial model;
- Forecast or actual breach of the annual affordability limit;
- Forecast or actual breach of loan facility amount;
- Forecast or actual breach of the minimum repayment schedule.

These events act as triggers and will allow the Ministry to require the NEST Corporation to undertake particular activities, the extent of which depends on the seriousness of the event. The key, incremental, interventions are rights to:

- ask for an explanation and require the NEST Corporation to make plans to ensure the trigger is not repeated;
- ask the borrower to supply an explanation and initiate a full review of the financial model. If the Ministry is not content with the explanation, then the Ministry has the right to require the NEST Corporation to put in place an action plan to get back in line with the agreed model;
- dictate additional measures to be taken by the borrower (e.g. specific cost reductions) if the annual limit dictated by the financial model continues to be breached; and

Ministry to understand the cause of this breach, adjust the funding model or take steps to remedy the cause.

61. The limits the loan will impose are:

- A set of annual affordability limits based on the amount of funding the Ministry can afford to advance to the NEST Corporation. If these affordability limits are, or are forecast to be exceeded, the Ministry as lender will gain rights to assess whether to continue with the lending arrangement;
- A set of annual draw down and repayment limits generated by the funding model based on forecast costs and revenues. These limits will be less than the affordability limits and set at a level designed to provide the Ministry with assurance that the scheme is being operated efficiently. Exceeding these limits at any point will trigger escalating rights for the lender to understand why the limit has been exceeded and to require actions to remedy the problem if appropriate.
- A facility limit setting the total amount available to the NEST Corporation across the lifetime of the loan agreement – this will be the sum of the annual affordability limits;
- A date after which NEST Corporation must be in net repayment – this will be set once final contract costs are known and is expected to be set at the date when the final draw down is expected to be made if the scheme is on a lower than expected volume trajectory;
- A maturity date by which the loan has to be fully repaid – this will be set once final contract costs are known and will represent the latest date the Ministry is prepared to accept as a maturity date. If the date of last draw down and the maturity date are, or are forecast to be exceeded, the Ministry as lender will gain rights to assess whether to continue with the lending arrangement.

The Loan Agreement Framework

Interest Rate

62. The credit rating of NEST, which informs the interest rate of the loan, will be reviewed annually and will reflect its actual performance. Therefore, changes in volumes may lead to a change in that rating depending on how that impacts the overall financial risks associated with the scheme. The rating can be adjusted both upwards and downwards.

63. On the basis of the current expectation of costs, revenues and investment risks, the UK's Government Actuary's Department has recommended that the NEST loan interest rate should be assessed on the basis of a BB rated bond at the outset. This initial credit rating of BB is based on the revenue uncertainty that in turn stems from uncertain membership numbers in the initial years of operation. Membership volumes will stabilize after the

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- re-assess whether to continue with the arrangement. To facilitate this, the Ministry gains rights to:
 - (a) request information to assist in this assessment;
 - (b) approve the borrowers' spending plans and financial commitments;
 - (c) dictate pricing policy of the borrower.

staging period, reducing the levels of revenue uncertainty and allowing a better assessment of the risks associated with the loan. This is because it will be based on actual data collected over the preceding period. The assessment of expected volumes and the uncertainties surrounding them does and will take account of the current expected economic outlook for the UK.

64. The Government Actuary Department has further advised that the expected reduction in volume uncertainty that will accompany the end of the staging period is likely to lead to a revision of the initial BB credit rating to an A-rating after some [5-10] years. The UK remains confident that this remains a reasonable basis for calculating both loan amounts and the level of compensation. The UK has explicitly recognised this volume uncertainty in its calculation of aid amounts and based its maximum aid amounts on a low volume assumption.
65. Loan amounts will therefore be advanced over the course of the loan period at the appropriate interest rate applicable at the time. For the purposes of its notification the UK has based its assumptions on current rates in the market as at 11th January 2010. These are 11.42% for a BB and 5.78% for an A rated bond. The actual rate used will be set when loan amounts are advanced and be in line with the credit rating and the relevant corporate bond rate in the market at that time. The calculation of the value of the compensation will equally be based on the corresponding cost of Government borrowing to ensure this too reflects prevailing market conditions.
66. Given the level of uncertainty around the NEST Corporation's exact borrowing requirements at the outset of the agreement, it is difficult to predict with certainty the exact maturity date at the outset of the loan. The UK therefore intends to set the initial interest rate on the basis of the loan's maturity date given expectations in the underpinning model. NEST Corporation will be required to make payments in accordance with the repayment schedule based on the anticipated maturity date. Uncertainty can be dealt with through allowing additional borrowing at the interest rate that applies at the time.

Paying State Aid: Calculating the Offsetting Grant

67. The objective of the offsetting grant is to put the Corporation in the same position as they would have been if the terms of the loan agreement had been set in line with the Government's own borrowing terms. The grant will be calculated as the difference between the financing costs incurred by the NEST Corporation under the terms of the loan agreement and the financing costs that it would have otherwise incurred if a Government rate of borrowing had been applied. The Government rate of borrowing used for this calculation will be defined by the Public Works Loan Board (a statutory body operating within the United Kingdom Debt Management Office³⁴) and will be based on a maturity date consistent with that under the commercial interest rate defined in the loan agreement.

³⁴ http://www.dmo.gov.uk/index.aspx?page=PWLB/PWLB_Interest_Rates

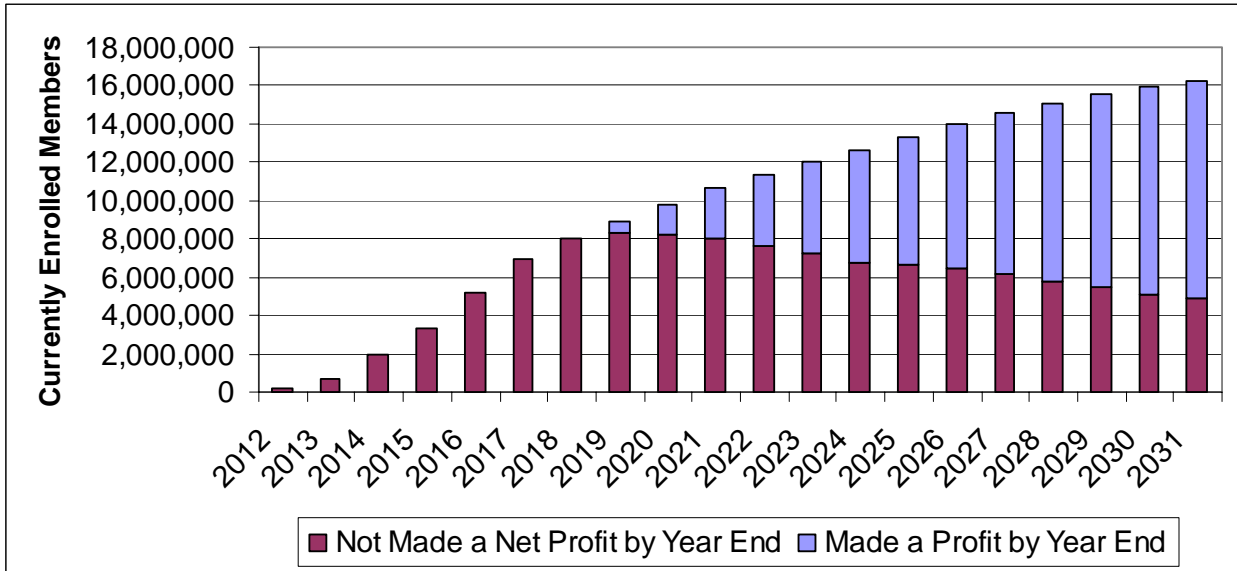
68. The grant will be paid by the Ministry in arrears and at the same bi-annual point when the NEST Corporation is required to pay interest on the loan. The grant amount will be generated by calculating what the financing costs on the previous six months draw downs would have been had a Government rate of interest applied. This figure will be deducted from the actual financing costs accrued under the loan agreement to give the amount of the grant. The difference will be provided to the Corporation to offset a proportion of the financing costs to be paid at that time.
69. The provision of a grant to make the NEST Corporations' finance costs equal to the Government's cost of borrowing would result in aid [...] in the range of £200-£379m (NPV). This is the finance cost difference between the commercial and effective rate of the loan. Under PSO, the maximum amount of compensation for SGEI providers has to take into account all the relevant receipts which, are represented by the remuneration from all members of the fund (i.e. also members that do not belong to a loss-making group). If the Ministry believes that Trustee actions have led to a breach and they are not complying with the terms of the loan agreement, the Ministry can exercise a legislative power to take action outside the loan agreement and remove the trustee board. The delivery of aid, however, will be via an off-setting grant which provides the Ministry with a separate control process. This grant process allows the Ministry, if necessary, to alter the amounts of aid outside of the loan agreement. The amounts of off-setting grant, however, will not exceed an amount necessary to reduce the finance costs of NEST to a level equating to the Government cost of borrowing. The NEST Corporation will be required to provide detailed monthly reports to the Ministry during the period of the loan agreement. These will include all the necessary information to enable the Ministry to understand and monitor the corporation's actual costs and revenues against the draw down and repayment schedules set-out by the financial model.
70. The UK has also calculated the amount of aid that would be provided and the amount of allowable compensation under different volume and cost scenarios. In all cases the aid given is less than the amount of compensation necessary to overcome all of the commercial disadvantages the scheme will be required to operate under. The table below sets out the scheme financial outcomes for these scenarios in terms of:
- Maximum loan amount in nominal (cash) terms, which records the largest magnitude of the total loan outstanding between the Ministry and NEST Corporation at the end of a financial year;
 - Maximum loan amount in NPV terms, which records the largest magnitude of the discounted total loan outstanding between the Ministry and NEST Corporation at the end of a financial year. If the rate of increase in the loan in nominal terms between the year when it is at its maximum level, and the year before, is less than the annual discount rate used, then the financial year in which the discounted total loan peaks will be earlier than the year in which the loan peaks in nominal terms;
 - Total amount of aid, which records the State aid, in NPV terms, which NEST is forecast to receive in each given scenario;

- Number of years State aid is provided, which records the period over which NEST is forecast to be in receipt of State aid under each given scenario. This period is equal to the period between the establishment of PADA (whose loan is transferred to NEST) and the time when a commercial rate loan to NEST, without the off-setting grant payment, would repay;
- Total allowable compensation, which records the costs which NEST incurs above those a commercial provider would judge acceptable. This is the finance costs remaining outstanding at the end of the 12 year commercial payback period – the maximum period a private provider would adjudge to be acceptable.

Table 1: Finance and State Aid Amount

	Maximum loan amount (NPV)	Maximum loan amount (cash in peak year)	Total aid amount	Number of years aid provided	Total Allowable compensation
Central estimate	£330m	£904m	£235m	26	£405m
Low volumes	£360m	£1275m	£379m	38	£463m
High volumes	£331m	£814m	£200m	22	£359m
High cost	£371m	£1067m	£281m	28	£466m
Low cost	£321m	£841m	£222m	25	£384m
15% lower contributions	£363m	£1119m	£308m	31	£467m
15% higher contributions	£315m	£771m	£196m	23	£343m

71. The UK has calculated the number of loss making accounts NEST will be required to support. In the initial years of operation of NEST the vast majority of members who join will never generate sufficient revenue to cover their costs. After this initial period an increasing number of members who join *will* eventually cover their costs over their entire period of membership. However, this does not immediately translate into a build up of members who are covering their costs in a given year, which is much more gradual (this is illustrated in the chart below). This is because costs will be higher during the scheme’s early years as it pays off its set-up costs and because those joining in later years, while eventually profitably, will initially be loss-making until they have had time to build up their pension pots.



Monitoring and reviewing the payment of aid

72. The Ministry will review whether it is necessary to continue to provide aid on an annual basis based on NEST’s fulfilment of its PSO, the cost of doing so and to ensure no adverse impact on the wider market. This review process will be supported by information gained from Stewardship arrangements and from information the NEST Corporation is required to provide under the terms of the loan agreement. This review process is also inherent in the UK’s financial planning processes³⁵ and is supported by the key aspects of the loan agreement (an automatic adjustment mechanism, regular management information and annual reviews of the financial model).

(a) Automatic Adjustment of Aid

73. The amount of aid paid will be derived by comparing the financing costs associated with a commercial rate loan to the financing costs associated with a Government rate of borrowing. Therefore the level of aid is directly related to the level of funding provided to the NEST Corporation, which in turn will be driven by the effect of performing its PSO on its costs and revenues. If NEST’s PSO leads to a higher proportion of lower income individuals joining the scheme than currently assumed this will lead to lower scheme revenues and a greater amount of initial funding. Similarly, if there is a higher proportion of high income individuals this will lead to lower amount of initial funding. Consequently there will be an automatic adjustment of the amount of aid provided.

(b) Regular Management Information

³⁵ The Ministry will be required to review its aid decision as part of future spending reviews. Spending reviews are the process in which the UK finance ministry set the spending limits for each spending Ministry and the activities to be undertaken for that funding.

74. The Ministry will monitor the working of this automatic adjustment process closely. Throughout the period of the loan, the Ministry as lender will receive regular management information from the NEST Corporation. This will include information on:
- actual costs incurred (broken down by key area of spend e.g. costs of running the corporation, fund management costs and operating costs relating to the scheme administration contract, financing costs etc);
 - forecast costs for the remainder of the financial year and the following financial year (broken down on the same key areas of spend); and
 - information on actual volumes and nature of members flowing into the scheme.
75. The NEST Corporation will provide information about amounts actually drawn down (the Corporation is able to draw down against the facility monthly) alongside the monthly management information setting out costs incurred by the scheme and volumes of members. This information will enable the Ministry to form an ongoing view about whether the level of funding and aid is as expected given the scheme’s public service duties and the nature and size of its membership.

(c) Review of the Financial Model

76. The financial model which underpins the loan agreement will be based on a set of assumptions agreed between the Ministry and the Corporation and will be reviewed at regular intervals throughout the period of the loan. These will occur at least annually or more frequently when required.
77. The review of the financial model will produce updated estimates of scheme costs and revenues for the full period of the loan and will give an updated schedule of draw down and repayments. This will also enable the UK Ministry to monitor updated metrics on:
- total amount of funding required during the period of the loan (which will be assessed against the total loan facility);
 - the date that repayment will start (which will be assessed against the draw down availability period set out in the loan agreement);
 - the date that the UK expects the loan to be repaid (which will be assessed against the term of the loan set out in the loan agreement); and
 - the total amount of aid provided to the scheme during the period of the loan (which will be used to inform reviews of the extent of aid required).

Recovering aid amounts

78. In addition to annual reviews of the amount of aid, the loan agreement will contain a provision to recover aid previously given in the event that repayment is or forecast to be within 12 years of the date the loan agreement becomes effective. This period has been selected to reflect the maximum acceptable commercial payback period and hence, if NEST was self-funding in this period the UK would see no need for compensation. In the event that this happens, rights will be triggered to allow the Ministry to levy a financial charge on

the NEST Corporation to recover amounts of aid previously given. The UK has, however, modelled a number of scenarios considering membership numbers, costs and investment returns which show such a payback period is highly unlikely to occur.

79. Prior to October 2010, the activities of the PADA and the NEST Corporation in respect of setting up the scheme will be covered by an interim loan arrangement. This will be given at a commercial rate of interest. It is intended that the liability built up under this loan will at the point the main contract is signed in October 2010 be incorporated into and then superseded by the terms and conditions of the main loan agreement.
80. The aid the UK plans to provide will not begin until after approval has been gained and will off-set the interest accrued on both the interim and long-term loans.

3. ASSESSMENT OF THE MEASURE UNDER ARTICLE 107(1) TFEU

3.1. Existence of aid

81. According to Article 107 (1) of the TFEU “save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, insofar as it affects trade between Member States, be incompatible with the internal market.”
82. Thus for a measure to constitute State aid it has to:
 - be adopted by the State or be imputable to the State
 - involve a transfer of State resources
 - be selective in nature
 - provide the beneficiary with an advantage
 - distort or threaten to distort competition
 - affect intra-Union trade

NEST as an undertaking

83. It is established case law that competition rules only apply to "undertakings". This concept covers any entity engaged in an economic activity, regardless of the legal status of the entity or the way in which it is financed³⁶. According to standard case law, any activity consisting in offering goods and/or services on a given market is an economic activity³⁷. At the same time, the mere fact that an entity is non-profit making does not mean that the activities

³⁶ Joined cases C-180/98 to C-184/98, Pavlov and others, [2000] ECR I-6451.

³⁷ Cases 118/85 *Commission v Italy* [1987] ECR 2599, paragraph 7, C-35/96 *Commission v Italy* [1998] ECR I-3851, paragraph 36, Jointed cases C-180/98 to C-184/98, *Rec.2000, p.I-6451*.

which it carries on are not of an economic nature³⁸. The Commission will firstly assess whether NEST carries out an economic activity.

84. The NEST Corporation is an 'undertaking' carrying out an economic activity i.e. an activity that consists of offering services on the UK pensions' market. It will be funded by pension contributions and will be managed commercially on a 'not for profit' basis. It will manage one of the UK occupational pension schemes intended to supplement a basic compulsory scheme. The NEST Corporation is introduced with the Pensions Act 2008, as an optional scheme for employers with employees earning between £5,035 and £33,540. NEST is, according to the UK, one type of the third pillar arrangement employers can choose to use to fulfil their legal duty. Other undertakings are free to offer the same or similar services to the same categories of employers and employees. The UK intends to complement and not replace the good quality pension provision that currently exists in the market while keeping with the rules laid down by the authorities in particular with regard to conditions for membership, contributions and benefits. Therefore, participation in NEST is not compulsory but on a voluntary basis only i.e. employers can choose to enroll their eligible employees in other schemes.
85. The NEST Corporation is operating according to the principle of capitalization. This means that the benefits to which it confers entitlement depend solely on the amount of contributions paid by the members and the financial results of the investments made. NEST Corporation is financed on a contribution basis from employees and employers and, with investment returns on those contributions, will build up a sum of money from which the individual will purchase a pension, in the form of an annuity. The contributions may not fall below a certain level, so as to establish adequate reserves, and may not, in order to preserve its non-profit-making status, exceed an upper limit. A member would receive their portion of the value of the default fund when they come to turn their pension saving into a pension income. The value of their final pension pot will vary depending on contributions received and also the performance of the fund they are invested in.
86. Auto-enrolment in the scheme will be obligatory only for those employers with employees earning over £5,035 per year who have not yet chosen another private pension scheme. However, employees can opt out from the scheme if they so wish. Furthermore, enrolment for employees earning below £5,035 per year is optional. The reason for the establishment of NEST was to provide members with a more simple and cost-efficient way of saving, with greater consumer protection and the best governance structure. NEST will not grant pension rights where no contributions have been made and will only grant pension rights that are proportional to the contribution. The benefits of the scheme are not identical for all members, although contributions are proportionate to income.
87. The goal of NEST is to break even, i.e. not to depend on government resources, in the long term, including providing adequate remuneration on the funds it borrows to start its activities. However, NEST will not be able to remunerate the borrowed funds at a market rate for a number of years [20-27]. The State aid provided is necessary to compensate for

³⁸ Joined cases 209/78 to 215/78 and 218/79 Van Landewyck [1980], ECR p. 3125 and case C-244/94, FFSA and Others [1995] ECR I-4013, paragraph 21.

this gap. The State intervention is therefore aimed at getting NEST 'up and running' to carry its economic activity, not at financing a solidarity element in pension provision.

88. Therefore, NEST Corporation is to be regarded as an undertaking for the purposes of Article 107(1) TFEU.

3.1.1. Imputability to the State and existence of State resources

89. In order to be qualified as State aid, advantages must be imputable to the State and granted directly or indirectly by means of State resources.
90. The measure at issue is an act of the State. The UK authorities have set up the NEST Corporation, a large scale occupational pension fund, and will provide it with a grant financed from the State budget. Specific agreements between the UK Government and the NEST Corporation and laws are the bases for the award of this grant. Moreover, PADA is accountable to Parliament and reporting, through a Board, to the Secretary of State for the Department for Work and Pensions. The possibility to control implies *per se* imputability of the measure to the State.
91. Therefore, the two above-mentioned cumulative conditions i.e. that the compensation given is imputable to the State and that it is given through State resources are met in the present case.

3.1.2 Selectivity

92. Article 107(1) EC prohibits 'aid which favours certain undertakings or the production of certain goods', that is to say, selective aid. The measure at issue is clearly selective in nature since it targets exclusively the NEST Corporation and there is no other beneficiary of the measure in the market.

3.1.3. The notion of Advantage

93. To constitute a State aid, a measure must confer on recipients an advantage. It is apparent from the case-law of the Court of Justice that public service compensation does not confer an advantage and thus does not constitute State aid within the meaning of Article 107(1) TFEU if it fulfils certain conditions. However, if public service compensation does not meet these conditions and if the general criteria for the applicability of Article 107(1) TFEU are satisfied, such compensation constitutes State aid.
94. In its judgment in *Altmark*³⁹, the Court laid down the conditions under which public service compensation does not constitute State aid as follows:

(...) First, the recipient undertaking must *actually have public service obligations to discharge and those obligations must be clearly defined* (...).

³⁹ See Judgments in Case C-280/00 *Altmark Trans GmbH and Regierungspräsidium Magdeburg v Nahverkehrsgesellschaft Altmark GmbH* ("Altmark") [2003] ECR I-7747 and Joined Cases C-34/01 to C-38/01 *Enirisorse SpA v Ministero delle Finanze* [2003] ECR I-14243.

(...) Second, the parameters on the basis of which the compensation is calculated must be established in advance in an objective and transparent manner (...).

(...) Third, the compensation cannot exceed what is necessary to cover all or part of the costs incurred in the discharge of the public services obligation, taking into account the relevant receipts and a reasonable profit (...).

(...) Fourth, where the undertaking which is to discharge public service obligations, in a specific case, is not chosen pursuant to a public procurement procedure, which would allow for the selection of the tenderer capable of providing those services at the least cost to the community, the level of compensation needed must be determined on the basis of an analysis of the costs, which a typical undertaking, well run and adequately provided within the same sector would incur, taking into account the receipts and a reasonable profit from discharging the obligations.'

95. Where these four criteria are met, public service compensation does not constitute State aid because it does not grant an economic advantage and Articles 107(1) and 108 TFEU do not apply. If the Member States do not respect these criteria and if the general criteria for the applicability of Article 107 TFEU are met, public service compensation constitutes State aid, which must be notified pursuant to Article 108(3) TFEU.
96. To assess the measure under *Altmark*, the service provided by NEST has to constitute a service of general economic interest pursuant to the first *Altmark* condition.
97. Member States have a wide margin of discretion regarding the nature of services that could be classified as being services of general economic interest. The Commission's task is to ensure that the margin of discretion is applied without manifest error as regards the definition of service of general economic interest.
98. The UK is reforming its private pension system in order to help million of citizens who currently making insufficient provision for their old age. As a part of the pension reforms, the UK has concluded that is necessary to provide limited compensation to establish and operate the scheme to extend low cost pension savings to those on low to moderate earnings.
99. The State plays an important role in the UK pension system and is involved directly in old age provision in all but the third pillar (private pension saving)⁴⁰. However, the UK pension reforms is aimed at extending the provision of third pillar arrangements, with NEST being one type of third pillar arrangement employers can choose to use to fulfil their legal duty. UK Government is setting up NEST to ensure all employers have access to a low-cost pension vehicle with which to fulfil their auto-enrolment duty, because many employers will not be sufficiently profitable for existing pension providers to be willing to serve them at a reasonable level of cost.

⁴⁰ In the third pillar, state involvement is also high but not direct. The state provides tax incentives for retirement savings, regulates private pensions and also provides guarantees for insolvent defined-benefit schemes.

100. The Pensions Commission, in its second report⁴¹, recommended that NEST should be designed as a targeted addition to the wider pensions market. To ensure that NEST is targeted on those on low to moderate earners that the existing market does not serve, the UK has put in place a number of restrictions on NEST, as explained in section 2.6.
101. The UK therefore intends to establish NEST so that it can ensure all employers have access to a scheme with which they can fulfil their auto-enrolment duties.
102. The UK believes that the increase in pension saving resulting from its pension reforms will result in a substantial welfare gain to society. In particular NEST as one type of third pillar tool, is specifically targeted at this and will especially benefit many low to middle income earners who have not previously had access to low cost retirement savings provision. NEST will address a market failure since it mainly aims at ensuring effective provision for low to moderate earners and those working for smaller employers who will not be sufficiently profitable for existing pension providers to be willing to serve them at a reasonable level of cost.
103. In view of these considerations, the service provided by NEST can be considered a SGEI pursuant to the 1st Altmark condition.
104. In the case at hand, the UK authorities have not claimed that the measure does not constitute aid because it does not grant an economic advantage. The Commission concurs with this analysis, in particular as it finds that the fourth criterion in the *Altmark* judgment is not met, because the NEST Trustee Corporation has not been awarded the public service as a result of an open public procurement procedure but has, on the contrary, been entrusted directly with the public service obligation. Moreover, given that NEST is only in the process of being set up it cannot be established whether it is a "typical undertaking, well run and adequately equipped, within the same sector", and thus cannot conclude that this criterion is met.
105. In addition, the measure at hand clearly provides an advantage to the beneficiary since it is intended to reduce the finance costs of NEST over its set up and initial operational phase. In the absence of this Government intervention, there would be no other provider in the market to provide NEST with such a grant. Therefore, NEST could not be set up and become operational without the Government support.
106. Consequently, the Commission concurs with the position of the UK authorities that the measure confers an advantage to NEST.

3.1.4 Effect on trade and distortion of competition

107. Article 107(1) TFEU also prohibits aid which affects trade between Member States and which distorts or threatens to distort competition.

⁴¹ Pensions Commission, 2005, 'A new pension settlement for the twenty first century'.

108. In its assessment of those two conditions, the Commission is not required to establish that the aid has a real effect on trade between Member States and that competition is actually being distorted, but only to examine whether that aid is liable to affect such trade and distort competition⁴². When aid granted by a Member State strengthens the position of an undertaking compared with other undertakings competing in intra-Union trade, the latter must be regarded as affected by that aid. Moreover, State aid falls within the scope of application of Article 107(1) TFEU, even if there is no Union trade at the time when the aid was granted and the Commission has to examine the effect that aid is likely to have on the future inter-State trade.⁴³ Therefore, it is not necessary that NEST itself be involved in intra-Union trade. Aid granted by a Member State to an undertaking may help to maintain or increase domestic activity, with the result that undertakings established in other Member States have less chance of penetrating the market of the Member State concerned. Furthermore, the strengthening of an undertaking which, until then, was not involved in intra-Union trade may place that undertaking in a position which enables it to penetrate the market of another Member State.⁴⁴ Establishing NEST could have potentially an **effect on competition** since it cannot be excluded that it will affect the existing pensions market and the competitive positions of the respective players on the market.
109. The newly established scheme run by the NEST Corporation shares the same relevant market with other pension providers, such as insurance companies, banks, investment companies and building societies,. Therefore, NEST will be competing with other providers on the UK pension market.
110. The aid provided by the UK authorities will relieve NEST of the expenses which it would normally have had to bear in its day-to-day management or its usual activities which in principle distorts competition.⁴⁵
111. As for the **effect on intra-Union trade**, the Commission notes that the pensions market is part of the internal market for services and that cross-border trade and investment activity in the sector across Europe is substantial. The pension sector providing pension products is one of the sectors covered by Union legislation and is open to competition. The adoption of the Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision⁴⁶ represented a first step on the way to an internal market for occupational retirement provision organised on a European scale. By setting the "prudent person" rule as the underlying principle for capital investment and making it possible for institutions to operate

⁴² See for instance judgment of the Court in case C-372/97 *Italy v Commission* [2004] ECR I-3679, paragraph 44.

⁴³ Cases T-447-449/93, *AITEC v Commission* (1995) ECR II-1971, paras 139-140.

⁴⁴ Case 102/87, *France v Commission* (1988) ECR4067, para 19; Cases C-278/92-280/92. *Spain v Commission* (1994) ECR I-4103, para 40; Case C-75/97, *Belgium v Commission* (1999) ECR I-3761, par 47.

⁴⁵ Case T- 459/93 *Siemens v Commission* (1995) ECR II-1675, paras 48 and 77.

⁴⁶ Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision.

across borders, the redirection of savings into the sector of occupational retirement provision is encouraged, thus contributing to economic and social progress. Thus, the pensions market is part of the internal market for financial services and cross-border trade and investment activity in the sector across Europe is substantial.

112. Financial institutions from different Member States operate in the UK, either directly through branches or representative offices, or indirectly by controlling UK-based banks and financial institutions.

113. The Commission is also of the view that the measure might make it more difficult for undertakings established in other Member States to penetrate the UK market.

114. To conclude, the measure is liable to affect trade and distort competition.

Conclusion

115. The compensation to be granted to NEST is State aid within the meaning of Article 107(1) TFEU. As the UK consider that the provision of pension services by NEST constitute a Service of General Economic Interest (SGEI) compatible under Article 106(2) TFEU, its compatibility with the internal market needs to be assessed.

3.2. Assessment of compatibility of the aid under Article 106(2) TFEU

116. Article 106(2) provides that “Undertakings entrusted with the operation of services of general economic interest or having the character of a revenue-producing monopoly shall be subject to the rules contained in this Treaty, in particular to the rules on competition, in so far as the application of such rules does not obstruct the performance, in law or in fact, of the particular tasks assigned to them. The development of trade must not be affected to such an extent as would be contrary to the interests of the Union.”

117. This article provides a derogation from the prohibition of State aid contained in Article 107 TFEU provided that the aid is necessary in that the lack of aid would hinder the performance of the SGEI (...obstruct the performance, in law or in fact of the particular tasks assigned to them) and proportionate in its effects on trade (...trade must not be affected to such an extent as would be contract to the interests of the Union.) Under Article 106(3) it is for the Commission to ensure the application of this article, including inter alia to specify under which conditions it considers the criteria of necessity and proportionality to be fulfilled. Following the *Altmark* ruling, the Commission specified those conditions in the Community framework for State aid in the form of public service compensation (SGEI Framework) of 2005, which therefore represents the Commission’s policy of applying the derogation of Article 106(2) TFEU. In particular paragraph 8 of the SGEI Framework makes it clear that the Commission considers the aid measure to be proportional and necessary if the Framework’s conditions are complied with.

118. On the basis of the SGEI Framework⁴⁷, the Commission considers that, “*at the current stage of development of the common market, public service compensation which is State aid within the meaning of article 87§1 of the Treaty may be declared compatible with the Treaty under article 86§2 if it is necessary to the operation of the service of general economic interest and does not affect the development of trade to such an extent as would be contrary to the interests of the Community*”.

119. Under the framework the three basic criteria of compatibility are that: (i) the service in question is a genuine public service (i.e. qualifying it as a service of economic general interest is not a manifest error); that (ii) the service is entrusted to the undertaking by an official act that contains all the elements of the service and that (iii) the undertaking is not overcompensated from the provision of public service (taking into account a reasonable profit).

(i) Genuine service of general economic interest within the meaning of Article 106 TFEU

120. As explained in section 3.1.3, NEST can be qualified as service of general economic interest under Article 106 TFEU.

(ii) Entrustment

121. According to paragraph 12 of the SGEI Framework, the service of general economic interest must be duly entrusted. The entrustment must specify in particular the precise nature and the duration of the public service obligation, the undertaking and the territory concerned, the nature of the right conferred to the undertaking, the parameters for calculating, controlling, and reviewing the compensation and the arrangements for avoiding and repaying any over-compensation.

122. The proposed scheme, introduced by the Pension Act 2008 and the Pension Scheme Order, contains an overall description of services. The UK authorities have defined the public service obligation in the legally binding order, rules and subsidiary documentation under which the NEST will operate.

123. The relevant legislation gives more precision and indicates the territory covered: the NEST order will oblige the scheme trustees to accept the eligible employees of all UK employers who select the scheme to fulfil their employer duty.

124. The UK does not intend to provide the scheme with any special or exclusive rights. The NEST scheme will operate on a not for profit basis. The loan agreement will however allow the period of the loan to vary depending on NEST’s actual operation. Therefore, if there is an increase in scheme revenues or a decrease in its costs, it will be able to repay the loan more quickly than would otherwise be the case. This will lead to the scheme accruing a lower level of interest costs and so to a consequent reduction in the amount of aid given to the scheme. If NEST is able to repay the loan amount within the 12 years that would be expected of a commercial body, the UK will recover all of the aid given to the scheme. Over

⁴⁷ O.J C297 of 29.11.2005

the same period a commercial provider would expect to recover all its annual losses and begin to generate a positive return. That period is shorter than the estimated [20-27] year time for the overall payback period of the scheme. The NEST Corporation will be required to provide detailed monthly reports to the Ministry during the period of the loan agreement. These will include all the necessary information to enable the Ministry to understand and monitor the corporation's actual costs and revenues against the draw down and repayment schedules set-out by the financial model.

125. The legislation further describes the type of measure granted and refers to the services at stake. The aid to NEST will be in the form of a grant which will be calculated as the difference between the financing costs incurred by the NEST Corporation under the terms of the loan agreement and the financing costs that it would have otherwise incurred if a Government rate of borrowing had been applied. The Government rate of borrowing used for this calculation will be defined by the Public Works Loan Board (a statutory body operating within the United Kingdom Debt Management Office⁴⁸) and will be based on a maturity date consistent with that under the commercial interest rate defined in the loan agreement. The terms of this grant will be set out in a Memorandum of Understanding between the NEST Corporation and the Ministry. The services of general economic interest are entrusted to NEST Corporation pursuant to Draft Pension Scheme Order 2009, laid before the Parliament under section 143(4) of the Pension Act 2008, for approval by resolution of each House of Parliament. The Memorandum of Understanding clearly defines the financial parameters and makes provisions for the payment, review and control of the aid amounts. The amount of compensation granted to NEST will be in the range of £ 200 million - £379 million, depending on the numbers and types of scheme members.

126. Therefore, the entrustment is sufficiently clear and transparent and contains all the elements required by the SGEI Framework. Consequently, the second criterion can be deemed to be fulfilled.

(iii) General need for a compensation mechanism and parameters of compensation established beforehand in an objective and transparent manner

127. The Commission examines first whether there is a general need for some kind of compensation mechanism to fund the NEST and whether the parameters of compensation are established beforehand in an objective and transparent manner. The costs are clearly laid down and the methodology and parameters of the compensation are set in advance, as explained in the following paragraphs.

128. Pursuant to paragraph 14 of the SGEI Framework, the amount of compensation may not exceed what is necessary to cover the costs incurred in discharging the public service obligations. Therefore the Commission also examines the assumptions underlying the establishment of NEST in order to ensure that no overcompensation will be provided.

Funding of the NEST

⁴⁸ http://www.dmo.gov.uk/index.aspx?page=PWLB/PWLB_Interest_Rates

129. The Commission positively takes note that the assumptions underlying the funding of the NEST are clearly defined and are related to: volume of members; proportion of loss makers the scheme will serve; scheme's costs; comparator commercial interest rate; the size and duration of the scheme's funding requirement; comparator payback period a commercial provider would consider acceptable; compensation amounts.

Volumes and revenues of the NEST

130. The Commission notes that the UK authorities clearly estimate the members joining the scheme, as explained in section 2.7. The Commission notes that the estimate is based on objective and reliable sources, i.e. Employer Pension Provision (2007), Annual Survey of Hours and Earnings (2007), Occupational Pension Scheme Survey (2007), HM Revenue & Customs RC data (2007/2008). In estimating the members entering the scheme, the UK authorities modelled also the number of loss-makers, who are those individuals where the charges received over the total duration of the membership are insufficient to cover the administration and the investment costs associated with their accounts.

131. The Commission acknowledges the assessment of the number of loss making accounts NEST will be required to support, provide by the UK. The modelling shows that in the initial years of operation NEST the vast majority of members who join will never generate sufficient revenue to cover their costs. After this initial period an increasing number of members who join *will* eventually cover their costs over their entire period of membership. However, this does not immediately translate into a build up of members who are covering their costs in a given year, which is much more gradual, as explained in section 2.7. In the Commission's view, the underlying assumption are sound, since the costs will be higher during the scheme's early years as it pays off its set-up costs and because those joining in later years, while eventually profitably, will initially be loss-making until they have had time to build up their pension pots.

132. As regards the member volumes, the methodology assumes that the entry of a small number of members to the scheme commences in 2011/12. These are voluntarily enrolled members, and this new membership cohort will enable the NEST Corporation to ensure its systems are functioning as expected and iron out any unforeseen difficulties prior to very large volumes being enrolled once auto-enrolment and the scheme's public service obligation comes into effect from October 2012. The staging of auto-enrolment obligations, and therefore initial volumes, is set up to 48 months, which seems a reasonable length of time. The length of the staging is directly linked to the total revenues (an increase of the staging reduces the revenues) made by the scheme in early years. The full assumed rate of contributions of 9% (made up of 4% individuals' contributions, 3% employer contributions, 1% tax relief, and 1% voluntary contributions) will not be reached until October 2017, which seems a reasonable assumption.

133. With regard members' incomes, the Commission notes that, according to the model provided by the UK, they vary with age, rather than remaining at the level set a member joins the scheme until they retire. This is a realistic model since the assumption of the change in members' earnings by age is based on survey data relating to the type of employees currently without a pension. The Commission notes that the variation in the profile of

members' lifetime earnings has been introduced through quantitative variables, such as the use within each age group of 5 different earnings paths corresponding to the five quintile earnings groups within the assumed earnings distribution of NEST members. Thus, in effect, there are five income classes in the current profitability modelling; these are dynamic income classes, where modelled individuals earning vary with age. In the modelling provided by the UK authorities, members are broken down into individual year age bands resulting in an increase in the number of age classes.

134. The Commission positively notes that the UK authorities modelled also exit from the scheme. For any member of any age-cohort, there is a small probability⁴⁹ of exit from the scheme in any given year, due to the 'death' of that member. Additionally, until 2020/21 when the UK male and female state retirement ages are due to be aligned, a substantial proportion of members at the female State retirement age exit NEST.
135. The Commission acknowledges the approach to modelling member incomes over time is a dynamic one and it is adequately prudent and realistic, since, it will result in, all other things being equal, younger members being more profitable in general than in the less dynamic approach whilst older members will appear less profitable in general. Modelling the probability of a member exiting the scheme prior to the male retirement age will lead to a small decrease in the profitability of older members, all other things being equal.

Costs of building and operating the NEST

136. In the terms of the scheme administration, one lead supplier will establish and operate the scheme; the other categories cover multiple suppliers. The services will be procured from the private sector, in an open and transparent manner, in particular through "value for money process". As explained in section 2.7. the costs of establishing and operating the NEST are compiled in the following categories: (i) scheme administration set-up costs; (ii) scheme administration operating costs (running the pension schemes); (iii) investment management fees (the cost of investing members' funds); (iv) customer awareness (the cost of attracting and retaining members); (v) Trustee Corporation (the cost of procuring and managing the scheme). It is also assumed that the initial contract for the scheme administration will be for a period of 10 years and that the market conditions in 2020, when the initial contracts will expire, will not include the need for further set-up costs should the renewal be awarded to a different supplier.
137. More in detail, the *costs of set-up* the scheme are estimated to be £ [105-117] m (covering the period 2010/11-2017/18) and include the expenses for the scheme administration unit, the services teams that support the developers and the introduction of the system and the hardware costs. The assumptions underlying these figures were based on information gleaned from potential suppliers and on in-house experience. The costs, as described above, are appropriate since correspond with or are within a range of the prices in the market.
138. The figures of scheme initial *operating costs*, estimated to be £ [395-466] million (covering the period 2010/11-2017/18) were influenced by the information gathered from potential

⁴⁹ Based on expected mortality rates, by age, for the UK populace.

suppliers. The key drivers of the scheme's initial operation costs are clearly detailed: (a) the number of people participating in the scheme and whether they are active members or dormant (dormant accounts require less activity); (b) the number of processes the scheme must perform and the degree to which these may be handled electronically. These factors determine the number of staff required by the contact centre, the cost of which accounts for 60% of the scheme initial operating costs. The estimates are based on the volume forecast. The number of staff required is calculated by PADA's Capacity Model, a computer model⁵⁰ that applies standard pension market timings and the channels (internet, telephone, paper) used for each of the 107 processes the scheme must handle and calculates the required operating staffing level. The numbers of management and ancillary staff are then calculated by applying ratios to the operating staff total. Average fully loaded pay rates (basic salaries were sourced from current vacancy advertisements) are then applied to the staff numbers to calculate the staff costs. The central forecast assumes the contact centre will require an average of 1,231 full time equivalent staff per year over the 5.52 years of operation to 2017/18.

139. The *investment and management charges* are estimated to be £ [20-60] million (covering the period 2010/11-2017/18). The UK authorities explained that this estimate was informed by research into current market costs and detailed the main drivers of this charge, therefore in the Commission's view they are defined in an objective and transparent manner.
140. The *cost of customer acquisition* is estimated to be £ [20-80] million (covering the period 2010/11-2017/18). The rationale of this estimate is explained, the all the cost items are detailed and they are based on market assumptions: the estimate is based on the cost of similar large scale public information and awareness campaigns. The major element of the costs relate to a series of extended campaigns: (a) intermediaries & influencers – to raise awareness; (b) employers – as the key decision maker in selecting a scheme; (c) employees – to prevent opting out and dormancy.
141. The *trustee corporation costs* are estimated to be £ [170-325] million (covering the period 2010/11-2017/18). The underlying assumptions are reasonable and objective, since they compiled adopting a zero based budgeting approach including the relevant costs of PADA activity. Each strand was asked to forecast their requirements for 08/09 in detail and then to prepare annual forecasts covering the rest of the period to 2017/18. These annual forecasts included the resources PADA would require until its demise, and the strand's view of what the trustee corporation will require in the years from its establishment to the end of the period. The costs have been categorised into three classes: 1) staff costs, 2) consultancy fees, 3) other including accommodation, IT, professional fees and operating expenses.
142. As regards the assumptions as described underlying the initial costs of establishing and operating the NEST, the Commission positively notes the choice to outsource, through public tenders, the services to different suppliers on the market which could ensure the best balance between price and quality. It also positively takes note that UK envisages a number of safeguards in order for the scheme to receive the most efficient services from the suppliers. Moreover, in the Commission's view the initial period for the scheme

⁵⁰ Designed and built with the support of consultancy 'Accenture'.

administration of 10 years is reasonable in order to set up the administrative infrastructures which are necessary for the scheme to be operational.

143. The Commission positively notes that the UK authorities provided the explanation on how initial financing costs have been attributed across members. Set up and initial financing costs were split equally between all forecast members of the scheme over the period before the entire loan has been repaid. The UK has included initial financing costs (the cost of interest accrued on the loan to the trustee corporation) with other set up costs as the need for long term financing largely arises from NEST having a long tail of expenses prior to it actually enrolling any members, and hence deriving any revenue. Only initial financing costs accruing in the period when the NEST scheme has no members are added to other (operational) set up costs, and split equally between all members of the first 20 cohorts of the NEST scheme.
144. The *commercial interest payable* on the loan is assumed by the UK to be that of a BB bond rate for the period up to [...] rising to A after [5-10] years (in January 2010, the respective rates were 11.42% and 5.78%). The commercial interest rate for the first [5-10] years of the loan will be set in line with those of BB corporate bonds at the time the loan is made to the trustee corporation (June 2010). After [5-10] years, assuming volumes follow the expected trajectory, the credit rating will be reviewed and it is anticipated the interest will be revised to reflect an A-rated corporate bond rate of that time. The Commission considers the above underlying assumption detailed and robust assumptions sound and realistic. These rates also serve as the discount rates used for the profitability modelling.
145. The methodology used is a credit rating-based methodology which was recommended by the UK Government's Shareholder Executive⁵¹ and undertaken by the independent Government Actuary's Department⁵² (GAD). The methodology is based on an assessment of the likely credit rating of the scheme given its forecast revenues and costs, the risks around those, as well as the terms of the loan, and the rate this would attract given current market yields on traded corporate bonds. While this is a stricter approach to using the standard EU's reference rate⁵³, the UK believes it provides a more accurate rate based on a fuller consideration of the risk profile of the scheme and more closely matches the approach that would be taken by a commercial lender.
146. The Commission positively acknowledges that GAD undertook further comparison with bond markets by considering the historic default rates on bonds of different ratings. The

⁵¹ Shareholder Executive is the body charged with overseeing the UK Government's interests in commercial or quasi-commercial bodies. They provide advice to Departments on the treatment of such bodies including the setting of lending rates.

⁵² GAD provides independent actuarial advice and consultancy services to Government Departments including to public sector occupational pension schemes.

⁵³ The 'Commission Communication on the revision of the method for setting the reference and discount rates' OJ C14 of 19.1.2008 p.6 provides that the methodology for setting the reference rates is normally based on: 1-year IBOR plus a margin, depending on the undertaking's rating category and the quality of the collateral offered. In January 2010, the overall rate for NEST (assuming a BB rated undertaking with low collateralisation) would have been 5.6%, i.e. the UK's reference rate uplifted by 400 basis points.

credit rating agency Moody's annual default study⁵⁴ was consulted to establish the average cumulative default rates over different terms over the period 1920-2008. This illustrated that lower rated bonds exhibit high default rates in the early years but lower rates subsequently. The Commission accepts that default rate of 10% in the early years would support their BB rating for this type of loan. The Commission finds the methodology used by the UK adequate and has no ground to object to it.

147. The *payback period* of the scheme is estimated to be [20-27] years. This period is longer than the payback period a commercial provider would consider acceptable which is between 8-12 years according to recent analysis by consultant Deloitte carried out for the UK authorities. The methodology of calculation is based on the costs, volumes and commercial rate. However, the envisaged payback period intends to fulfil the aims of the scheme as it strikes the balance between a sustainable level of annual management charge (AMC) and a higher level of pension saving in order to achieve an adequate level of income in retirement. A reduced payback period would lead to a higher charge level and would also reduce the likely replacement rate savers would secure. Moreover, the particular requirements the UK is placing on NEST to ensure it performs its social policy function increases its short term costs as it cannot balance its costs and revenues in the manner other providers can. This increases the length of its payback period.

The amount of compensation is the minimum necessary and there is no overcompensation

148. The UK has undertaken sensitivity analysis, based on the factors referred to above such as number of members, scheme costs and the income levels of members in order to identify the possible range of compensation. The scenarios do not result in over-compensation as the amount of aid provided moves in line with that required to support the scheme in fulfilling its public service obligation. The monitoring and management provided to the Ministry would also allow for steps to be taken if it were considered that over-compensation had, in fact, occurred.
149. The NEST Corporation will provide information about amounts actually drawn down alongside the monthly management information setting out costs incurred by the scheme and volumes of members. This information will enable the Ministry to form an ongoing view about whether the level of funding and aid is as expected given the scheme's public service duties and the nature and size of its membership. The Commission considers that the above constitutes an adequate safeguard in order to address the issue of possible over-compensation.
150. The Commission positively notes the UK's intention that after the loan is repaid NEST will have achieved a scale and level of revenue that means it can become self-financing with no further need for State intervention or support.
151. The Commission acknowledges the methodology of the scheme which is set up in a way that the actual amounts will be based on forecast expenditure and provided in accordance with the finance agreement. The Scheme envisages monitoring and reviewing of the payment of aid through automatic adjustment of aid, regular management information, review of the financial model and recovering of the aid amount as explained in section 2.8.

⁵⁴ Corporate Default and Recovery Rates 1920-2008.

More specifically, the Scheme envisages annual reviews of the amount of aid and loan agreement provisions to recover aid previously given in the event that repayment is or forecast to be within 12 years of the date the loan agreement becomes effective. Any expenditure variances above or below forecast will be absorbed in subsequent periods such that in the long run, finance payments match actual net costs. If it were found that the scheme had been overcompensated for the burden placed upon it then this could be corrected by reviewing the details of the finance arrangements. For instance, no overcompensation could arise, were a different estimation of the commercial interest rate to be used as a benchmark for the schemes costs, since calculations based on a higher commercial interest rate would result in a higher gap between the benchmark financing costs and the government cost of borrowing effectively paid by NEST on the soft loan. However, the resulting higher aid amount would still be the minimum necessary to perform the SGEI and would therefore be compatible. In the Commission's view this is an adequate mechanism in order to prevent over-compensation.

4. CONCLUSION

The Commission has accordingly decided to consider the notified measure to be compatible with Article 106(2) TFEU.

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

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

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

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Yours faithfully
For the Commission

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