Is JESSICA the holy grail of urban regeneration?

By Jayant Mehta[1]

I. Introduction

JESSICA is the acronym for the "Joint European Support for Sustainable Investment in City Areas." It is an initiative of the European Commission (the Commission) together with the European Investment Bank (EIB). The evolution of JESSICA can be traced back to Commission initiatives like the Community Strategic Guidelines (March 2005) and its Communication entitled "Cohesion Policy and the Cities: The urban contribution to growth and jobs in the regions[2]. The legal basis for JESSICA is in the financial engineering provisions of the structural funds regulations.

JESSICA is a mechanism for using structural funds for urban regeneration, not an additional source of finance. So what's new, one may ask. There already exists a plethora of schemes and mechanisms with the sole purpose of provide grants for urban regeneration. And that is precisely the point. All the other schemes are grant based. JESSICA's goal is to wean urban regeneration programmes away from grants, hand-outs and conditional gifts, and to steer them towards repayable investments whose proceeds can be recycled into similar projects to attain sustainability.

The manner in which JESSICA envisages this happening is the creation to something similar to what are customarily known as local asset backed vehicles. The Member State (generally acting through one of its arms, like an investment fund) enters into a joint venture with the private sector and they carry out an urban development project using each other's values, expertise, business nous and financing. The joint venture would need to be an institutionalised public private partnership (PPP). While JESSICA investments can be made in other projects, investments in PPPs form the general focus of this essay and other projects are addressed as variations to the standard further on.

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2 Cohesion Policy and cities: the urban contribution to growth and jobs in the regions COM (2006) 385 final.

The urban development project need not be restricted to land remediation and development. It could also include "softer" outcomes like incubation facilities, transport and education, skills and employment, and potentially low carbon emission technology. Indeed the projects in which a JESSICA can invest are very wide, and can be flexibly executed within the functional frameworks of the structural funds, State aid and procurement codes.

This article is descriptive in that it identifies a standard JESSICA structure within the procedural limitations of structural funds regulations and procurement law. It then analyses that structure for State aid compliance. This does not mean the structure is optimal, but is merely used to demonstrate State aid issues arising, ceteris Paribas. Variants to the standard are discussed, as is the ability to apply general principles of State aid across to them.

However there are some ideas discussed in this essay which bear mention. They are:

1. It is unlikely that JESSICA will fit within the framework for Risk Capital[3] (SARC) or the risk capital provisions of the General Block Exemption Regulations[4] (GBER). The scheme is probably more likely to fit within one or more of the following State aid justifications;

(a) Regional aid guidelines or regional aid provisions of GBER
(b) General "arm of state" or "flow through" principles (including the research organisation provisions of the Research Development and Innovation Framework).
(c) General "non aid" principles like infrastructure development or the market economy investor test
(d) Services of General Economic Interest (SGEI)

2. If the strict requirements of SARC do not apply, then there is greater flexibility in operating the JESSICA. In particular there is no need for private sector involvement in the fund, or that the fund should be profit driven with a commercial return. This would potentially mean greater ability for the JESSICA to provide incentives like below market

3 Community guidelines on state aid to promote risk capital investments in small and medium-sized enterprises OJ 2006 C 194.

4 Commission Regulation 800/2008 declaring certain categories of aid compatible with the common market in application of Article 87 and 88 of the Treaty (General block exemption Regulation) OJ 2008 L 214 Articles 28 and 29.

interest rates and guarantees in order to "wean" land regeneration projects off State grants and push them towards co-investment.

3. If SARC does not apply some important questions may need resolving which would otherwise have been dealt with by the SARC. For instance;

(a) Whether EIB contributions are "private" and
(b) Whether the fund itself is treated as an "intermediary vehicle" for passing State funds through to the intended beneficiaries and thus not an undertaking in itself for State aid purposes.

4. There will be significant procurement issues at the level of the Target (the investee). Whether the private sector developer of the site is a co investor in the Target with the fund, or whether it is simply brought in to work on State owned land, it is highly likely it will be performing a procurable contract for the State. If it is therefore hired by a contracting authority then procurement processes may be necessary in selecting it. This would have a significant impact on the State aid analysis of the Target.

II. PPPs in Urban Regeneration

O'Keeffe and Branton argue[5] that an urban regeneration project carried out entirely within the function of the Member State will raise few State aid issues. They additionally point out that the more the private sector involves itself in such projects, the more complex the State aid issues become. Of particular note are the State aid issues surrounding the creation, operations and dissolutions of PPPs. Their message is clear. The different State aid treatment of identical projects appears to be based on the nature of the entity involved. PPPs invariably involve the risk of "leakage" of State aid to the private PPP partner through residual benefit.

O'Keeffe and Branton point out that procurement of the PPP partner may minimise this risk but not necessarily resolve it. Regretfully the complexity of the State aid rules applying to PPPs in urban development projects has not yet been coherently addressed. This is despite

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5 *O'Keeffe/Branton* "State aid and urban regeneration: a UK perspective" EStAL 3/2007 p 484.

the increasing enthusiasm of the European Commission (the Commission) for these structures and their progress in codifying frameworks for PPPs in other areas of law[6]. Indeed the author has in a previous essay[7] questioned why adherence to one code (for instance procurement law) should not effectively remedy the ailments of another code (State aid law) when the two codes effectively have the same purpose when applied to PPPs, that being to ensure private investment is not "crowded out" by State support.

Nicolaides and Kleis[8] make the point that aspects of residual benefit like early access to subsidy led demand based markets should be taken into account during the procurement exercise and therefore should not be a selective advantage. It is submitted that access to markets is something which features prominently in concession contracts and so quantifying this in procurement is not novel. In addition one would surely have thought that for State aid purposes demand generation is too future and contingent to be an aid[9]. Supply led measures have the intent to create demand but their more immediate effect is to install infrastructure. And State aid is about effect rather than intent isn't it?[10]

It is submitted that the issue of residual benefit arises from a suspicion of grant conditions inserted into what is effectively a procurement contract together with the ability for the recipient to be able to derive an economic benefit from a State financed asset after the duration of a project. As discussed above, the raison d'être of a PPP is to combine commercial goals with aspects of public benefit, and this combination often manifests itself in such contracts. It is therefore reasonable to assume that in the absence of clear direction from the Commission State aid considerations will continue to arise in PPP's even after a full procurement exercise is carried out.

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6 See e.g. in procurement law the Commission's Interpretive Communication on the application of Community law on Public Procurement and Concessions to Institutionalised Public-Private Partnerships (IPPP) C(2007) 6661.

7 *Mehta* "State aid & procurement in PPPs–two faces of a single coin?" EPPPL 3/2007 p 141.

8 *Nicolaides/Kleis* "Where is the Advantage? The case of public funding of Infrastructure and Broadband networks." EStAL 4/2007 page 615.

9 E.g. joint cases C-182/03 and C-217/03 Kingdom of Belgium and Forum 187 v Commission per European Court point 117.

10 Case C-36/79 Denkavit v Finanzamt 1979 ECR 3439

III. Outline of a standard JESSICA structure

A standard JESSICA may include a Holding Fund, an Urban Development Fund and a Target. The Holding Fund acts as a "pot" for various sources of funding which are then passed down to the Urban Development Fund using a funding agreement. The Urban Development Fund in turn makes investments in the shares of an existing or newly constituted PPP which we will refer to as the Target. It is therefore envisaged that the Urban Development Fund will be a shareholder in the Target together with one or more private sector undertakings which we would expect normally to be property developers, whom we refer to as developer members. The Urban Development Fund can also lend to the Target and provide guarantees for the Target's gearing.

The Member State is expected to transfer State owned assets to which it holds title directly to the Target so as to avoid the multiple incidence of realty taxes it may incur for transfers through the Urban Development Fund to the Target. In the UK the Member State would hold title either in fee simple (outright) or a long terms of years absolute (a lease of 50 years or more following the decision in N657/1999 UK: Business Infrastructure Development). This would effectively mean that the transfer of the asset would be in consideration of an issue of shares in the Target to the Member State, or the issue of a debenture for unrequited consideration (or a combination of the two). The Member State would assign its right to the shares or debentures to the Urban Development Fund who would now manage the investment or debt on behalf of the Member State.

The developer member will perform two functions for the Target in addition to contributing to the capital of the Target. The first is to provide services connected with its shareholding, for instance the management of the Target. The second would be to facilitate the implementation of the Target's project whether that is to perform works to remediate or regenerate land transferred in to the Target, or supply goods or further services to the Target like transport, property management, incubation, education and skills or social services. Both functions may involve activities which are procurable under the general principles of equal treatment, transparency and non discrimination inherent in the Treaty for the Functioning of the European Union (TFEU). Provided both functions are scoped adequately into the specification document, and the objects of the Target do not change substantially during the project, they can be dealt with in a single procurement[11].

Naturally the need to comply with procurement law will only arise if the Urban Development Fund is itself regarded as a contracting authority as defined by Procurement Directive 2004/18/EC. Certainly this would be so if the Urban Development Fund was itself a public authority like a local or regional authority, or a body established for the public good which did not distribute surpluses but instead re-invested them in its on-going projects. In the current economic climate this is likely to be the case in the initial stages of the JESSICA life cycle as the private sector would find its investments too risky to generate a proper return. However there is always the possibility of a private sector fund manager itself joining a joint venture with the Urban Development Fund later on in its life cycle, which itself is a separate legal entity, like a Limited Liability Partnership or joint stock company. In this case it is no longer certain whether that new entity would be a contracting authority.

However for State aid purposes procurement of the developer partner may be beneficial, regardless of whether the procuring entity is a contracting authority bound by procurement law or not. The reasons are discussed in the State aid analysis below.

IV. State aid General Observations

State aid rules will apply to the manner in which the co-financed fund is implemented. This is because State aid compliance needs to be certified to the Commission when drawing down the structural fund allocation, either as an interim or a final payment[12].

Before we analyse in detail the State aid position at each level of our standard JESSICA structure, it is necessary to step back and look at the structure as a whole to see whether it falls within a recognisable framework (notifiable) or exemption (not notifiable). Articles 4 and 5 of SARC provide a framework for the assessment of state aid if a JESSICA structure

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11 Judgment of 15 October 2009 Case C-196/08 - Acoset SpA v Conferenza Sindaci e Presidenza Prov. Reg. ATO Idrico Ragusa and others n.y.r

12 Commission Regulation 1828/2006 setting out rules for the implementation of Council Regulation (EC) No 1083/2006 laying down general provisions on the European Regional Development Fund, the European Social Fund and the Cohesion Fund and of Regulation (EC) No 1080/2006 of the European Parliament and of the Council on the European Regional Development Fund: OJ 2006 L 371/1 Annex X

qualifies as a "risk capital scheme". It would qualify as a risk capital scheme if certain fundamental conditions are met, namely:

(i) Target can only be a Small or Medium Sized Enterprise (as defined by Annex 1 of GBER).

(ii) The investing fund is managed and operated on a profit driven and commercial basis (it is paid a market-tested fee and makes investments with a market rate of return[13]).

(iii) Target cannot be a "firm in difficulty"[14].

A fund may still be commercially managed and operated even though it is a public sector not for profit body and does not have a private sector fund manager[15]. This is particularly so where the commercial involvement is at the level of the Target[16]. Additionally for certain investments made within a limited period of time, the standard of what is a "market rate of return" has been loosened somewhat[17]. Firms in difficulty as a result of the "credit crunch" can be Targets and the investor fund only needs 30% private sector financing, regardless of whether the Targets are in assisted areas or not. Investments of EUR 2.5 millions per Target per annum can be made under the safe harbour provisions of SARC[18].

There are several advantages in applying this framework, for example:

(i) The legal certainty accorded a Member State in setting up a compliant structure. A compliant structure may be approved by the Commission under SARC. If the approval is sought under Article 4 the approval would have been quick under the

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13 N 696/2007 Germany (Land Brandenburg) ERDF Risk Capital Fund Brandenburg OJ 2008 C 180.

14 As defined in Community guidelines on State aid for rescuing and restructuring firms in difficulty OJ 2004 C 244, Article 2.1 as prolonged by OJ 2009 C 156.

15 N 696/2007 sections 1.7.3 and 1.7.4.

16 N 696/2007 Para 68.

17 Communication from the Commission on Temporary framework for State aid measures to support access to finance in the current financial and economic crisis (consolidated version) OJ 2009 C83. Discounts are allowed on guarantee fees (Article 4.3) and loan interest (Article 4.4) in certain circumstances. Borrowers of poor credit rating can now benefit from guarantees and Firms which were in difficulty from 1.7.2008 may benefit from investments.

18 Article 4.6.2 Temporary Framework.

"fast tracked" or "simplified procedures[19]". If the approval is sought under Article 5 then it may take more time involving a more detailed investigation by the Commission, and very often resulting in an approval with limitations and conditions imposed by the Commission. In some cases the scheme may fall within Articles 28 and 29 of GBER and not require any notification to the Commission.

(ii) The application of the Temporary Framework. This considerably widens the scope not only of the type of investment that a fund can make, but also of the nature of the Target it can invest in. For example discounts on loan interest and guarantee fees are permitted for a limited period, and the tranches of investment which can be made under Article 4 is increased to Euro 2.5m per Target per annum. Guarantees can be provided to Targets with poor credit ratings and firms who have fallen into difficulty since 01.07.2008 are eligible investments. It should be noted that the Temporary Framework only applies to schemes approved by the Commission, and not to those falling within GBER[20].

There are several disadvantages in applying SARC, for example:

(i) Lack of flexibility in the structure. Targets must be Small or Medium Sized Enterprises. Investments in them cannot exceed certain limits without a detailed assessment. Only a certain proportion of the fund can be allocated to loans and loan guarantees[21]. The requirement that the fund be managed and operated commercially is unsuitable for not for profit altruistic or public sector regeneration bodies. While the private sector need only contribute 30% of the capital of a fund[22], commercial reality and the requirements of the Structural Funds

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19 Commission Notice on a Simplified procedure for the treatment of certain types of State aid OJ 2009 C136 Article 5(a)(i).

20 Article 4.6.2 of the Temporary Framework.

21 This does make it difficult to set up a fund purely for loans and loan guarantees unless the market economy investor test or the de minimis rules are satisfied.

22 Article 4 SARC where the fund focuses on Targets in assisted areas (and unassisted areas until 31.12.10 using Article 4.6 of the Temporary Framework).

Regulations may require a higher contribution[23]. Any flexibility provided by the Temporary Framework is limited in time and scope.

(ii) Furthermore, It is uncertain whether the definitions of expansion capital and follow on investments therein will allow for investments in Management Buy Outs (MBO), Buy Ins (MBI) or a combination of the two (BIMBO)[24]. It has been commented that that the Commission refused to countenance this in the Welsh JEREMIE notification which, as a result, was dropped from the notification[25]. However in an earlier case such investments were allowed as part of a risk capital scheme provided it involved a fresh issue of equity rather than a transfer of existing securities[26]. It is submitted that it very much depends on how the transaction is carried out, and that such investments should be a necessary part of any investment scheme to enable Targets to emerge from global recession in a lean and streamlined manner.

Applying these requirements to our standard JESSICA structure, it is doubtful whether it is likely to qualify as a risk capital scheme. The reasons stem from the fact that the Urban Development Fund and the Fund Manager are likely, at least initially, to be public sector bodies. It should be noted that an issue of securities by the Target to the Urban Development Fund such that the latter is deemed to exercise a certain amount of control over the Target, may not on its own disqualify the Target as a Small or Medium Sized Enterprise[27]. However in practical terms, the co-investor in the Target will invariably be a developer, and developers tend to be members of a group qualifying as a large enterprise. It is additionally likely that a public sector Urban Development Fund will wish to offer considerably more discounts and benefits to the Target than is envisaged by SARC, or even the preferential returns envisaged

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23 It should be noted though that all EIB contributions are regarded as private sector financing for these purposes (see Article 4 of SARC).

24 An MBO is broadly where the existing management team wants to take over the company or a division within it. An MBI is where an external management does this. A BIMBO is where there is a combination of the existing and an outside management team. These transactions can occur in a variety of ways, some which may well be compatible with the risk capital framework.

25 JEREMIE Networking Platform second meeting 30 June 2009 presentation by Egle Striungyte and Almoro Rubin de Cervin at page 14.

26 N722/2000 UK Coalfields Enterprise Fund OJ 2002 C 133.

27 Definition of Small and Medium Enterprise in GBER Article 3(2)(c) Annex 1.

by the structural funds regulations[28]. Otherwise it may be difficult to attract private sector involvement at all, and the private sector developer may well instead prefer to rely on the plethora of State aid approved urban regeneration grant schemes already in existence.

Indeed there are precedents for asset backed vehicle investment schemes similar to those envisaged by JESSICA to have been approved for State aid purposes under the Regional Aid provisions as opposed to SARC. An example is the UK English Cities Fund which is basically a fund set up as a PPP which invests in the equity and quasi equity of development companies carrying out regeneration projects in assisted areas. Provided the regional aid provisions are met, it is possible for a JESSICA structure to qualify as a regional aid scheme[29].

Subject to the above, it may be necessary then to apply the basic principles of Articles 107 and 108 of TFEU to each stage of the standard structure. It is worth noting, however, that just because SARC do not apply to a standard structure, does not mean that it's governing and underlying principles will be ignored in assessing the State aid position of the structure under Article 107. In N 497/01 – United Kingdom (Scotland) Grants for Owner Occupation para 3 the principles in SARC were extended to a non risk capital scheme. This decision was disapproved and restricted to its facts in C 7/03 (ex N 107/02) SBS Incubation Fund[30]. However, the SBS notification was subsequently withdrawn, and the Commission's views therein were probably obiter dicta, and perhaps no longer so strongly held particularly following N782/2005 Germany: Managed Workspace (OJ C(1315) 2005 fin).

V. Detailed analysis of the State Aid rules

1. The Holding Fund

In our standard JESSICA above, the Holding Fund will receive a grant which includes the public contribution and the structural funds. If the grant is interpreted as a conditional gift to the Holding Fund, then there is a risk that a gratuitous advantage is conferred to it amounting to State aid. However, as will be seen below, this interpretation is unlikely for the following reasons:

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28 See Article 43.7 Regulation 1828/2006.
29 See N 82/2001 UK English Cities Fund OJ 2001 C 263.
30 OJ 2002 C 104.

1. While the State resource is transferred to the Holding Fund in the first instance, it is not intended to benefit the Holding Fund, but to be passed down to the Urban Development Funds. Indeed the effect of Article 80 Regulation 1083/2006 is to tie as little structural funds as possible in administration and would make the ability of the Holding Fund to retain any of the grant at all for its own costs very restricted. Under UK law, it would be possible for the Urban Development Funds to sue the Holding Fund for non-transfer of the state resources even though they are not a party to that grant contract[31]. The net effect therefore of the grant on the overall balance sheet of the Holding Fund should not be significant.

2. To the extent there is a net balance sheet effect in the Holding Fund, it can be argued that the grant is more in the nature of a contract than a conditional gift in that the deliverables in the grant are more clearly defined than an ordinary grant. This may be demonstrated by the investment strategies and policies it sets out as a condition precedent to the grant approval. These will almost certainly go beyond the “wishes” and “desires” so common in a conditional gift and appear to be more concrete contractual deliverables. It is therefore arguable that if the grant retained in the Holding Fund (for instance applied in the payment of administrative or banking fees) can be bench marked against some independent expert valuation (similar banking charges and fees in a comparable market) then there is no gratuitous advantage to the Holding Fund as the Member State is simply paying the market rate for this service under the market economy investor principle (MEIP)[32].

3. In 2 above the bench marking may not be necessary if the Holding Fund is not treated as an undertaking for State aid purposes. This conclusion may be reached in different ways depending on whether the EIB is the Holding Fund or not.

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31 Contracts (Rights of Third Parties Act) 1999 s 1. Also e.g. law of trusts or agency.

32 It should be noted that such an interpretation could imply procurement rather than a grant. The structural funds regulations also refer to this possibility. However even if the contract is regarded as one for a procurable service, there are several possible exceptions to the procurement rules applying.

2. The Holding Fund as a block of finance within the EIB

If the Holding Fund is a block of finance within the EIB, then it is unlikely that there will be any State aid implications associated with it. This conclusion could be for a variety of reasons, for example:

(i) TFEU specifically deals with the powers and duties of the EIB[33], and therefore excludes the application of Article 107[34].

(ii) An undertaking has to engage in economic activity.[35]. Project coordination is not an economic activity, though project management is. On balance it could be argued that the EIB leaves the project management with the Urban Development Fund and simply coordinates (administrates) the implementation of the financial engineering instrument. The Commission has consistently held that administrative activities are to be regarded as a non-economic activity because a part of State activity is outsourced and there is no intention to offer goods or services on a particular market[36].

(iii) EIB does not receive an advantage, and is simply acting as an intermediary body, which passes state resources through to benefit Targets. This argues by implication that the EIB is an "arm of state" or "conduit" for state resources to the Target and its actions are imputable to the Member State instructing it[37].

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33 See e.g. Articles 175, 209 and 309 TFEU.

34 Article 107 TFEU starts with the phrase "Save as otherwise provided in the Treaties…"

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

36 N 225/2009 UK Agriculture and Horticulture Development Board Advertising and Promotion Scheme OJ 2009 C 212 point (118). See also N 175/2003 UK MLC Generic Advertising Scheme OJ 2004 C 155; N 230/2003 UK (Scotland) Meat Quality Advertising Scheme OJ 2004 C 041.

37 Indeed the EIB's members pursuant to Articles 266 and 267 of TFEU are the EU Member States who then contribute to its capital. This suggests that EIB is an arm of State – see e.g. treatment of "Caisse" in Case T 358/94 Air France ECR 1996 Page II-02109 at paras 58-62.

(iv) EIB acts on a not for profit basis[38]. It has social and community objectives, rather than commercial ones[39]. This is reinforced by the constitution of the EIB in that its membership comprises of the member states and so does its financing[40]. It arguably cannot be operating in the market if it is carrying out the essential functions of the Member State in its capacity as a public authority[41].

Indeed, taking the last point, it is submitted that the EIB's mandate bears more than a passing resemblance to the status of "banking foundations" in Italy. These bodies have to manage their assets and use the proceeds to donate grants to not for profit entities. There are legislative and regulatory requirements limiting their ability to deal with commercial banks and other financial institutions. There are limits to the sort of undertakings and institutions they can hold interests in and control. As a result they are not regarded as undertakings for state aid purposes[42]. Indeed it has been stated in the European Court that the fact that one of the tasks of the banking foundations is "the economic development of the system" does not by itself turn them into undertakings[43].

3. JESSICA as an SGEI

It would be possible to argue that EIB was "entrusted" by regulation[44] or funding agreement[45] to deliver an SGEI. The consequences of classification as an SGEI would be that the Member State can aid the Holding Fund using the Altmark[46] criteria and this would make the approval of the aid by the Commission easier to seek. However what is an SGEI depends on such a classification being made by a Member State and verified by the Commission. Factors to take into account in classifying an activity as an SGEI are:

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38 Article 267 TFEU

39 Article 267 (a)-(d) TFEU

40 Part V Title 1 Chapter 5 TFEU.

41 Case T 196/04 Ryanair v Commission OJ 2004 C 228/42.

42 Case C-54/2000 of 23.08.02 reported IP/02/1231 as approved in Case C-222/04 Ministero dell'Economia e delle Finanze v Cassa di Risparmio di Firenze SpA.

43 Case C-224/04 paras 124-125.

44 NN 8/2007 Spain : Financing of workforce reduction measures of RTVE, OJ 2007 C 109; N 395/05 Ireland : Loan Guarantee for social infrastructure schemes funded by the Housing Finance Agency, OJ 2007 C 77.

45 C 24/2005 France Laboratoire National d'Essai, OJ 2007 L 95/25.

46 Case C-280/00, Altmark Trans (2003) ECR I-7747.

1. The definition of the SGEI must not be in conflict with Community legislation in the given field[47]

2. The service in question must carry a general interest that goes beyond the generic interest associated to each economic activity [48]

3. The public intervention must be justified by the nature and needs of the public service[49]

JESSICA projects do not fit easily within the existing SGEIs already approved by the Commission. While the object of a JESSICA is to regenerate the economy, the effect of particular projects like land regeneration sites may not be sufficiently general[50]. There are also eligibility restrictions in the use of structural funds for SGEIs like the provision of affordable housing[51]. Due to its urban regeneration focus, a JESSICA is unlikely to operate in a rural or remote area. Thus its public transport or broadband wholesale projects may not qualify as an SGEI[52]. It is therefore considered that while a Target could involve itself in a project which was an SGEI, it would be unusual for an Urban Development Fund to be able to use the SGEI exemption, unless it was much specialised in the delivery of its projects.

4. The Holding Fund is a separate Legal Entity to the EIB

If the Holding Fund is a separate legal entity, it may benefit from an EIB loan. The loan agreement may include preferential repayment terms. Typically income distributed by a Target on a deal by deal basis may be first allocated to repayment of the EIB loan[53]. This is

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47 T-106/95 FFSA ECR 27.02.1997 p II-0229.

48 Case C-179/90 Merci convencionale porto di Genova SpA ECR 1991 p I 5889 point 27.

49 Case C-18/88 GB INNO BM ECR p I-5941 point 22.

50 For example the Broadband wholesale provision in Pyrenees Atlantiques (IP/04/1371 of 16.11.04) n.y.r.

51 Regulation 1080/2006 of the European Parliament and of the Council of 5 July 2006 on the European Regional Development Fund and repealing Regulation (EC) No 1783/1999 OJ 2006 L 210 Article 7(2) as amended by Regulation 397/2009 making expenditure on eligibility of energy efficiency and renewable energy investments in housing OJ 2009 L 126/3.

52 Both the Altmark Trans (transport) and Pyrenees Atlantiques (wholesale broadband) cases had the SGEI being delivered in remote and rural areas.

53 The balance may then be "recycled" within the fund to make more investments, lever in more private sector funding or be distributed to investors in the Target in accordance with an exit strategy.

arguably an advantage to the EIB. If, for these activities, the EIB is regarded as an "undertaking" despite the arguments against this conclusion in the preceding paragraph, then there may be a potential state aid to the EIB.

However the Commission has been reluctant to analyse the State aid position of the EIB in great detail. The Welsh JEREMIE case involved a loan by the EIB to a Holding Fund established as a separate legal entity. The terms of the loan were that the EIB secure preferential payment for its loan and accrued interest from distributions by the Target. The Commission had this to say;

"The EIB funding is different from equity as it has limited upside reward, since all returns realised from the investments after the repayment of the funding and its interest rate are allocated to the other investors. At the same time this funding is without collateral, and thus entails full risk of complete default in case of no revenues. In addition the funding has a relatively high interest rate reflecting the risks involved, and only the returns from the investments, collected on a separate realisation account, may be used to repay the EIB funding[54]."

The Commission then went on to justify the scheme without further analysing the EIB's position.

"At least 50 % of the funding will be private for each investment, regardless of the EIB's contribution. [The Holding Fund] and private investors / business angels will share the same upside and downside risks and rewards by agreeing up-front the valuation of the business. All the parties are bound by the terms of the agreement and all rights are distributed equally, including the same level of subordination. Unless agreement is reached on the valuation of a business, an investment would not proceed[55]."

"The Co-Investment Scheme fulfils the criteria of pari passu investments, and hence the investment decisions are based on the market economic investor principle[56]."

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54 N 700/2007 – United Kingdom, Wales Finance Wales JEREMIE Fund OJ 2008 C 331 para 15.

55 Para 2.8.1 N 700/2007

56 Para 3.1.2.1 and 3.4.1 N 700/2007

It appears the Commission considers the EIB to be an undertaking which does not receive an advantage. The Commission appears to have traded off the advantage of the preferential return with the disadvantage of the lack of collateral without necessarily quantifying both sides of the transaction. It is submitted that while the conclusion of no aid to the EIB would be logical, reaching it with the "no advantage" argument is not. The subordination of a state return in favour of other creditors may constitute an aid to those creditors[57]. . It is better to reach the conclusion on the basis that for these purposes EIB is not an undertaking.

If the JESSICA qualifies as a risk capital scheme, then SARC provide for the EIB contribution to be treated as private sector funding[58]. For state aid purposes, it simply means that the contribution is not to be treated as state resources. That does not automatically mean that EIB is an undertaking. The tests in Article 107 it is submitted are to be applied independently of one another. The EIB's input is a matter of State aid to the fund. The preferential rate of return is a matter of State aid to the EIB. They are separate matters. Even if the JESSICA does not qualify as a risk capital scheme, then the EIB contribution may still be interpreted as private sector financing by extending the principles of SARC to the current facts. This would be important where the JESSICA as a whole was being justified for State aid purposes under the market economy investor test on a "drip down" basis[59]. However as will be seen below, this is unlikely to be the case due to the nature of the projects JESSICA is set up for. The JESSICA structure will probably need justification using some form of "arm of State", "conduit" or "flow through" mechanism. If this is used then the issue of whether EIB's contribution is public or private source is irrelevant and the discussion above rendered academic.

5. Aid to the Urban Development Fund

The Urban Development Fund could receive a gratuitous benefit in several ways. One could be the grant from the Holding Fund. Another could be the transfer of the right to receive securities to it from the Member State. This would include the right to the income from those securities, and the right to participate in a capital distribution of the Target. The latter could

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57 C-342/96. Tubacex ECR 1999, page I-02459; C-480/98 Magfesa ECR 2000 Page I-08717.

58 Article 3.2 SARC.

59 As in NN 42/a/2007 UK Enterprise Investment and Corporate Venturing Scheme OJ 2009 C 145 and NN 42/b/2007 UK Venture Capital Trust scheme OJ 2009 C 145 para 3.2.4.

be, for instance, when the Target disposes of its assets and makes a distribution on winding up. If the Urban Development Fund is treated as an undertaking then there is a risk that these advantages may be State aid to it.

The Commission tends to the view that an investment fund is a vehicle for the transfer of State aid to investors and/or enterprises in which the investment is made, rather than being an aid beneficiary itself (for State aid, as opposed to structural funds purposes). In a case involving a fund owned and administered by the German Government the following observations were made[60].

"The Fund will operate as separate limited private company under German law with the sole purpose to work as a legal frame for the fund's financial resources in the context of the notified measure and carry out no other economic activities. No additional advantages for the fund are included in the scheme. The Commission therefore does not consider the Fund to be a separate aid beneficiary. The Commission concludes that there is no State aid within the meaning of Article 87(1) EC Treaty at the level of the Fund."

This "arm of state" or "conduit" position was not affected by whether the investments were made pari passu or not[61]. This case involved the application of SARC. As noted above, it is unlikely that the standard JESSICA will qualify for protection under these guidelines. As noted above, however, the Commission may well extend the principles of the guidelines by analogy. This view is strengthened by the application of the "arm of state" principles to intermediary bodies outside SARC[62]. This has occurred in cases where the beneficiaries were undertakings and advantages to them were covered by block exemptions or the de minimis rules. The intermediary body was an "arm of state" as it operated on a non-profit making or distributing basis. Assets acquired as a result of state resources were maintained for the project for a period of time (fifteen years in one case). Income or surpluses received were re-invested into the project.

This is often achieved by ensuring a transparent system of cost and profit centre recording for the project so that there is no risk of cross subsidy to other, potentially commercial, activities.

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60 N 511/2008 Germany Risikokapitalfonds BFB II para 50 OJ 2009 C 109

61 Para 74 N 511/2008.

62 See e.g. State aid No N 503/2005 UK Great Yarmouth Outer Harbour OJ 2006 C 083

It may also be achieved by placing restrictions on the title of assets preventing any change in ownership or use for a particular period. If these conditions are met, the argument is that the intermediary body is a “conduit” for state resources to the beneficiaries and does not itself perform an economic activity. Indeed the basis of accounting for the project implies that it does not receive an advantage either. The argument here is that it only withholds the amount of state resources required to meet its costs, and passes the balance to the beneficiaries by way of gratuitous benefit covered by block exemptions[63].

Beneficiaries in these schemes tend to be Small or Medium Sized Enterprises. However the principle here is that were the Member State to transfer state resources directly to the beneficiary, the advantage would be covered by an exemption. Therefore the insertion of an intermediary body, which simply acts as a “conduit” for state resources to the beneficiary, should have no effect. In other words it should be “State aid neutral”. On this basis it should be possible to extend this principle to the standard JESSICA structure, where the beneficiary (the Target) may be a large enterprise which can receive an advantage for which there is a wide selection of state aid cover[64].

This principle has obtained legislative backing recently[65]. This further endorses the view that there is an underlying principle which can be applied even if the frameworks in question do not strictly cover the scheme in question. There is a strong argument therefore that the Urban Development Fund is not an undertaking as it is simply an “arm of state” and acts as a “conduit” for state resources to the Target. The latter receives those resources in a state aid compliant manner. This would particularly be the case where the investments in the Target satisfy either the de minimis rules[66] or the market economy investor test[67].

There is authority for the proposition that if the fund is not a separate legal entity, it is more likely to be regarded as a “flow through” body and thus not an undertaking. For example in the UK a partnership set up under the Limited Partnership Act 1907 (where the Member State

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63 Case N782/2005 notified under C(1315)2005fin.

64 See the arguments in C 7/03 (ex N 107/02) SBS Incubation Fund OJ 2003 C 104/02.

65 See Article 3.1.2 Community Framework for State aid for Research and Development and Innovation OJ 2006 C 323 where these principles are applied to Research Organisations

66 Article 3.3 SARC. This limit may be enhanced by the Temporary Framework as Article 3 is more a statement of the law (ie a non aid) rather than an approval mechanism.

67 Article 3.2 SARC.

is a sleeping partner and the Fund Manager is a General Partner who takes title to assets and gives good receipt) is not regarded as a separate legal entity from its partners and this is a common manner for setting up funds[68].

6. Aid to the Fund Manager

If a Fund Manager independent of the Urban Development Fund is required, then its State aid position must also be analysed. A separate Fund Manager will be required if the investments in the Target are to be carried out on a commercial or semi-commercial basis. If the Fund Manager is procured, then much of the State aid analysis will focus on the contents and scope of the specification. The considerations are similar to those encountered by the Target when procuring a developer member. These are discussed in more detail below.

Care should be taken to ensure that no amount of residual benefit could potentially be accorded to the Fund Manager. Its remuneration must either be set, or capable of being quantified, as at the time of the procurement. Additionally, if it is placed in a position where it can generate a market through supply led techniques then it may also receive a residual benefit. Setting the Fund Manager's consideration at the time of the procurement is notoriously difficult to do, even with established and sophisticated investment appraisal and discounted cash flow techniques. Particularly in land regeneration projects that have a lengthy duration, it is difficult to predict with any certainty what the yield from the asset or its disposal value will be. Since these factors underlie the market valuations of the asset, and thereby the level of investment into the Target, they will affect the budgeted consideration the Fund Manager is to receive under the specification.

It may therefore be necessary, even after a procurement process, to afford additional comfort that the Fund Manager is not receiving a residual benefit. Benchmarking the consideration it receives at various stages in the project through independent valuations may assist here. However, benchmarking is often regarded as a poor substitute to a proper competition on price. If benchmarking of this nature is carried out, care should be taken that it is not simply an analysis of comparative yields. In order to satisfy state aid rules, a discounted cash flow

68 NN 42/a/2007 and NN 42/b/2007 para 3.2.2 and N 722/2000 para 3.1.2.

analysis of projected future cash flows should be carried out. The projected cash flows should then at least reflect the net income the Target is able to generate from the asset[69].

If the Fund Manager is not procured[70], then the management fee it is to be paid must also be benchmarked[71]. This will be of particular importance where the management fee is linked to the profitability of its investments. In a case approved under SARC, the fund management was carried out "in-house" by a regional authority in the German Member State. The remuneration package included the following aspects:

- during the investment phase: the annual management fee together with all administrative costs up to a certain limit of the average annual fund capital invested;
- during the disinvestment phase: an annual management fee of a set percentage of the invested capital as managed in the fund's portfolio
- a profit dependent element, being a set proportion of the profits after deduction of all investors' stakes[72].

It was held by the Commission that there was no overcompensation through residual benefit in this case. It based its conclusion on an independent expert's opinion commissioned by the German Member State. The opinion confirmed that the proposed remuneration corresponded fully with the rates payable in the market for managing early stage funds of a comparable size. The expert had calculated the actual average fixed management fee as a percentage of the capital committed, rather than being within a range of historical fees paid out to fund managers in the relevant market[73].

The structural funds rules limit the management fee, which can be charged to the "yearly average over the duration of the assistance" of:

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69 Case C 35/2006 (ex NN 37/2006) implemented by Sweden for Konsum Jämtland Ekonomisk Förening OJ 2008 L 126 para 47 – this case is analysed further below in relation to the Target.

70 This could be, for instance, where the Teckal exemptions apply or where it is exempt from procurement for services connected with investments in securities.

71 Paras 17-19, 74 and 75 of N696/2007. This case involved an in-house delivery of commercially driven investments, whose principles are extrapolated outside SARC.

72 Para 18 N696/2007

73 Para 19 N696/2007.

“(a) 2% of the capital contributed from the operational programme to holding funds, or of the capital contributed from the operational programme or holding fund to the guarantee funds;
(b) 3% of the capital contributed from the operational programme or the holding fund to the financial engineering instrument in all other cases, with the exception of micro-credit instruments directed at micro-enterprises;
(c) 4% of the capital contributed from the operational programme or the holding fund to micro-credit instruments directed at micro-enterprises[74].”

In order to avoid overcompensating the Fund Manager care must therefore be taken to ensure that the remuneration outside of procurement should be set at the lower of the benchmark and the upper limits allowed by the structural funds regulations. While these limits were not discussed in the Brandenburg scheme above[75], it is assumed that the benchmark did not contradict the structural funds limit in any way. While the actual remuneration rates were not disclosed on grounds of confidentiality in that case, it is interesting to note that the basis for calculating them in Brandenburg differed substantially from the structural funds rules[76].

7. Aid to the Target

The involvement of the private sector in a PPP arrangement will also mean that the structural funds are used in a “co-investment” scheme.

Investment in the Target may involve a transfer of state resources and thus be State aid if the activities of intermediary bodies like the Holding Fund and the Urban Development Fund are “imputable to state.” Various factors are considered in ascertaining imputability. Some indicators provided by the European Court are:

- The integration of the intermediary body into the structures of the public administration,
- The nature of its activities

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74 Article 43.4 Regulation 1828/2006 which applies in the absence of procurement.

75 N696/2007 paras 49-52.

76 In particular the disinvestments phase and the profit based element.

- The exercise of the intermediary body on the market in normal conditions of competition with private operators.

- The legal status of the intermediary body (in the sense of its being subject to public law or ordinary company law),

- The intensity of the supervision exercised by the public authorities over the management of the intermediary body,

- Any other indicator showing, in the particular case, an involvement by the public authorities in the adoption of a measure or the likelihood of their being involved, having regard also to the compass of the measure, its content or the conditions which it contains[77].

The test of imputability appears to be one of independence from the state. It appears that if the intermediary body satisfies the market economy investor principle then it would be sufficiently independent of the state and its investments will not constitute a transfer of state resources[78].

The question for the market economy investor test is whether in similar circumstances a private shareholder, having regard to the foreseeability of obtaining a return and leaving aside all social, regional policy and sectoral considerations would have provided the capital for use in question. The Court has stated that an appropriate way of establishing whether a capital injection is State aid is to apply the criterion of determining to what extent the undertaking would be able to obtain the sums in question on the private capital markets[79].

On the facts, the projects where investment in a Target is needed, typically involves sites with nil or negative value. The sites may be derelict, abandoned or even contaminated. The sites may have significant restrictions on their use and disposal, and may only be available for use

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77 Case C-482/99, Stardust marine [2002] ECR I-04397, paragraphs 55 to 56.

78 Case C 38/03 2005/652/EC Spain (further restructuring aid to the public Spanish shipyards) (notified under document number C(2004) 3918) OJ 2005 L 240/0045 – 0053 Para 37.

79 Case C-342/96 Spain v Commission [1999] ECR I-2459, paragraphs 41 and 42, and Case C-256/97 DMT [1999] ECR I-3913, paragraphs 22 to 24 and the opinion of AG Jacobs in that case, paragraphs 34 to 36.

for specific purposes. A developer would only engage itself in projects with such sites if there was an assumption of a risk by the state which is disproportionate to the nature of its investment. In particular the risk assumption would be towards the "gap" between the cost of developing the site and the market value of the remediated or developed site. It is therefore unlikely that the investments in the Target would be of the nature the market would adopt and therefore it is likely that these investments transfer state resources to the Target and are potentially state aid to it.

Whether the Target is a newly formed PPP or an existing one, the State aid considerations are similar. Broadly, we must look at the State aid position at three stages of the project. They are (i) investment into the Target, (ii) its operation and management and (iii) its Exit Strategy. These are examined in turn below.

A Investment in Target

The state assets could be transferred to the Target at market value at the date of the transfer. This value could be set either by benchmarking using an independent valuer, or set in the specification of procurement process from which the Target's developer member is selected[80]. The latter is more likely in the case of newly formed PPPs and is generally preferable as an indication of market value[81].

The base value of the equity and debt (securities) issued by the Target should therefore equal this value. Otherwise there is a risk of a gratuitous advantage to the Target by the Member State transferring the asset. A similar reasoning applies to any cash contribution by the Urban Development Fund/Fund Manager. If the securities do not match the value of the cash contribution and the activities of the Urban Development Fund are imputable to the Member State, then again there is a risk of gratuitous advantage to the Target which may need to be justified in State aid terms. This is rarely likely to occur in practice as restricting the market value of the securities issued is a complex exercise and may additionally adversely affect future capital taxes assessments in relation to them.

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80 It is likely that procurement will be required under procurement law, if conditions requiring works to be carried out to detailed specifications are inserted into the transfer (see e.g. Case C 220/2005 Jean Auroux v Commune de Roanne).

81 Case C 35/2006 (ex NN 37/2006) para 58

Where the Member State transfers assets to the Target, it may assign the right to receive these securities to the Urban Development Fund or the Fund Manager. This may be a gratuitous advantage conferred to them. If both are themselves public authorities then it is arguable that there is no transfer of state resources[82]. A safer course of action would be to ensure that the transfer is included within the State aid justifications for those bodies[83].

There may be a selective advantage to the developer member. This could be for instance where the developer has not been procured. If its contribution to the capital of the Target is less than the contribution by the Member State or on more favourable terms then it may receive an advantage[84]. An example of this could be where securities are issued to the Target whose value is in excess of the value of its contribution, or where the Member State has a controlling interest in it[85]. The fundamental principle here is there should at least be an equal sharing of risk and reward between the Member State and the developer member[86]. Absence of this would be evidence of the fact that the Member State is not acting as a private investor would in making this investment.[87]

A selective advantage to the developer member may even occur where it has been procured. The nature of the specification needed in JESSICA projects raises the risk of a residual benefit accruing to the developer member. A good example of the latter is in predicting the possible income from a works concession contract, or the potential proceeds of sale of the developed site. While procurement law may well allow for some flexibility in setting the

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82 This is a risky argument as a state department can very often be held to be an undertaking in its own right even if acting within the vires of a governing public law (see eg NN 21/2006: UK City of Derry Airport OJ 2006 C 272 and T-196/2004 where the Walloon Region, managing airport infrastructures within its powers under the Walloon Parliament Act 1994 was held to be an undertaking which could satisfy the market economy investor test).

83 For instance if they are regarded as “flow through entities”.

84 N 511/2008 Germany Risikokapitalfonds BFB II paras 71 and 75.

85 This could be where the Urban Development Fund and/or the Fund Manager are part of the Member State, for instance a local or regional authority.

86 State Aid No N 791/2006 – Sweden, Business Case Norrköping. OJ 2007 C 227 p. 4.

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

mechanism for ascertaining these values at a future date[88], it is not certain this would comply with State aid rules. This is for two reasons:

(i) The contract price needs to be market tested before the contract for the transfer of state resources becomes unconditional[89]. This means in practice that there should be no possibility of adjusting the price after the selection process is complete[90].

(ii) The inherent nature of works or services concessions, in that they allow for market access through the generation of demand, and this is often regarded as a gratuitous advantage in its own right[91].

Therefore there is a chance that regardless of whether procurement is carried out, there will be a gratuitous advantage to a developer member at the investment stage. This may be intentional, as the nature of JESSICA development contracts would involve a risk of cost-value gap for the developer. The Member State may want to accept some of that risk to incentivise developer members to come forward. If such advantage is provided, then it will need to be justified under the State aid rules. There are many options by which to do so. Sometimes these options can be used in combination without breaching the cumulation rules. The use of these options depends on the facts of each project[92]. Some of the more standard ones are set out below.

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88 Case C-454/06 Pressetext Nachrichtenagentur GmbH v Republik Österreich (Bund), APA-OTS Originaltext-Service. ECR 2008 Page I-04401.

89 N 525/01 Ireland Cluster Incubator Scheme OJ 2005 C 136 para 3.1 and Commission communication concerning aid elements in land sales by public authorities OJ 1997 C 209 Article 1.

90 C 35/2006 (ex NN 37/2006) para 61.

91 N 508/2008 UK Provision of Remote Broadband Services in Northern Ireland OJ 2009 C 18 para 22. However see para 117 Joint Cases C 182 and 217 2003 Forum 187 v Commission where it is said that benefits which are "future and contingent" will not constitute an advantage.

92 Indeed the "integrated plan for sustainable urban development" which is the basis for the setting up of an Urban Development Fund requires a multi disciplinary or integrated approach by the Member State in constructing such a plan (see e.g Community Strategic Guidelines on Cohesion 2007-13 (2006/702/EC), OJ 2006 L291 Section 2.1). This would by definition mean that JESSICA investments would benefit from a whole range of state aid approved measures and exemptions.

(a) Whether there is State aid or not is determined at the date of transfer of State resources[93], and this normally involves the date of an unconditional contract between the Member State and the undertaking. It follows that the date of transfer of State resources in a secured or unsecured loan relationship is often the date of execution of the debenture. Therefore it can be argued that if the interest rate at that date reflects that required by the official journal reference rates published from time to time, as adjusted for the availability of security and the credit worthiness of the borrower, then there is no State aid even if interest rates subsequently rise. In the current climate where interest rates are low, entering into loan relationships is a useful mechanism to transfer State resources on the expectation that rates will rise. On this analysis there is no requirement to "peg" the interest rate set out in the loan relationship with the actual rise in interest rates as a result of increased liquidity in the money markets.

(b) There are several land regeneration schemes approved within the regional aid provisions of GBER[94]. These provisions are geared more towards grants than investments, but do not exclude a transfer of state resources through investments[95]. Where the intervention rates for large enterprises within GBER do not provide sufficient cover, the environmental aid provisions could be useful[96]. The cumulation rules in GBER[97] do not forbid two or more of its provisions from applying to a single project provided the eligible costs are kept separate and the maximum intervention rates of each are not breached.

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93 See Article 14.2 and 15.2 Regulation 659/1999 of 22 03 99 laying down detailed rules for the application of (Article 108) of TFEU OJ 1999 L 83/1, and how these provisions are given effect for instance in Articles 2.3 and 2.4(a) of Regulation 1998/2006 of 15 12 06 on the application of Articles 87 and 88 of the Treaty to de minimis aid OJ 2006 L 379.

94 GBER Articles 12 and 13.

95 Indeed in N747/A/1999 and N747/B/1999 UK Partnership Investment Programme: Support for Speculative and Bespoke Developments the provision of advantage to a developer by means of a joint venture was expressly provided for.

96 For instance through the remediation of polluted land, or the demolition and clearance of derelict sites in order to facilitate fresh development.

97 GBER Article 7.

(c) There are approvals of structures similar to those envisaged in JESSICA involving PPPs for asset backed vehicles which invest in the equity of developers in assisted areas. These schemes are approved under the regional aid provisions[98]. The JESSICA could be allied to these pre-approved schemes either at fund level or (more usually) Target level in order to benefit from these approvals.

(d) If the project involves the environmental aspects in the provision of affordable housing[99], any aid to the Target may benefit from its classification as an SGEI[100]. The contractual relationship between the Urban Development Fund and the Target could qualify as an act of entrustment. A concession contract or a tender document may also so qualify[101]. So would an annual or pluriannual performance contract[102]. There is no limit to the aid that can be provided to the Target within this framework[103]. It can include a reasonable amount of profit for the recipient[104]. The remaining strict criteria specified in Altmark[105] need not be met like the need for a public procurement procedure, or by benchmarking with the costs of a typical well run company[106].

If the Target specialised entirely in the provision of housing, then this would enable it to carry forward compensation over and above that needed to deliver the project to the

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98 See e.g. N 82/2001 UK English Cities Fund.

99 Provision of social housing per se is an ineligible cost so care must be taken not to let the “state aid tail wag the structural funds dog.” (Article 7 Regulation 1080/2006 as amended).

100 Commission Decision of 28 November 2005 on the application of Article 86(2) of the EC Treaty to State aid in the form of public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest OJ 2005 L 312, Article 2.1.

101 N 562/2005 Italy - Allongement de la durée des concessions de sociétés d'autoroutes du Tunnel du Mont-Blanc (ATMB) et du Tunnel Maurice Lemaire, OJ 2007 C 90

102 C 24/2005 France: Laboratoire National d'Essai, OJ 2007 L 95/25.

103 OJ 2005 L 312 Preamble para 16.

104 OJ 2005 L 312 Article 5.1, though this will need to benchmarked against the sector – see Article 5.4.

105 Altmark Trans case.

106 Commission Staff Working Document SEC(2007) 1516 final Article 3.4.

following year[107]. If the Target performs other activities, the SGEI should be within a suitably "ring fenced" accounting system[108].

Special mention is made in respect of guarantees provided by the Urban Development Fund or Fund Manager to secure debts of the Target. Under ordinary circumstances, if state resources are deemed transferred to an undertaking, then there should be either a net cost to the state or some revenue foregone[109]. However there may be a partial exception to this rule in the issue of guarantees[110]. Aid can arise on the issue of the guarantee, rather than on the eventual crystallisation of the contingent liability. The argument here is that there is a transfer of risk to the Member State, for which it needs to be adequately compensated through the charging of a market rate premium. Foregoing all or part of this premium has a net cost to the Member State[111]. The partial exception arises with the additional and separate argument that the assured undertaking may be able, as a result of the guarantee, to raise credit on the market on more favourable terms[112]. This does appear to suggest on its own that there may be a transfer of state resources without there being a net cost to the state. However this would have the effect of contradicting decisions like Preussen Elektra[113] and it is therefore suggested that 2.1 and 2.2 of the framework on state guarantees be interpreted together. The conclusion is that should a market premium be charged for the guarantee, there should be no transfer of state resources to the assured, regardless of its consequently enhanced position in the credit or money markets.

Loan guarantees of less than EUR 1.5m which assure no more than 80% of the outstanding capital of the loan at the date of grant may be issued at less than or without a market premium

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107 Article 6 OJ 2005 L 312 (it can carry forward upto 20%).

108 Article 5.5 OJ 2005 L 312.

109 C2/2003 TV2 Denmark 2006 OJ L85/1 p.8 at para 68; NN70/88 Kinderkanal and Phoenix 1999 OJ C238/3. These cases should be contrasted with C-200/97 Ecotrade 1998 ECR I-79-7 at para 35 and C-295/97 Piaggo 1999 ECR I-3735 at para 35.which suggest that transfer of state resources may be occasioned by a "charge" or "claim" on the Member State.

110 Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees OJ 2008 C 155 page 10.

111 OJ 2008 C 155 para 2.1.

112 OJ 2008 C 155 para 2.2.

113 Case C-379/98 PreussenElektra AG v Schleswag AG ECR I-2099.

under the De Minimis rules[114]. The ceiling is based on a collection of Europe wide data on the premia charged for loan guarantees, and a computational methodology that assumes a maximum loan default rate of 13% across the Community[115]. It should be noted that the Urban Development Fund should qualify as a guarantee "scheme" within Article 1.3 (a) of the Guarantees Framework[116]. It is unclear whether Article 4.2.2 of the Temporary Framework would allow for a corresponding increase in the ceiling for guarantees granted before 31.12.10. It is clear that the calculation methodology justifying any increase in the ceiling needs to be approved prior to implementation in order to benefit from the de minimis rules. Unless such a methodology is incorporated in the general approval sought under Article 4.2.2 it is unlikely that it would cover guarantee schemes. This interpretation is logical since the basis for setting the De Minimis ceiling in the first place is the assumption of a default rate of 13%. This is likely to increase substantially in the current climate raising guarantee premia for corresponding debts substantially. The De Minimis rules estimate that market rate for a guarantee premium for a guarantee covering 80% of an outstanding loan of EUR 1.5m should equal the de minimis limit of EUR 200,000. In the current economic climate the market rate may be considerably higher. It is therefore unsafe to assume that simply because the de minimis limit has been temporarily raised to EUR 500,000 under Article 4.2.2, that there should be a corresponding increase in the guarantee ceiling.

Alternatively the guarantee scheme could be approved under Article 4.3 of the Temporary Framework. This allows for substantial discounts on the guarantee premia[117], a larger proportion of the underlying loan to be assured and a loosening of the risk assessment methodology. This latter is done through adjusting the credit rating and collateralisation requirements the scheme needs to assess in ascertaining the premium to be charged for each assured undertaking.

B Operation and Management of Target

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114 Regulation 1998/2006 Article 2.4(d).

115 Regulation 1998/2006 Preamble para 19.

116 OJ 2008 C 155 page 10.

117 For a maximum period of 2 years from the date of the guarantee (OJ 2008 C 155 para 4.3.2(h)). The reduction is 15% where the assured enterprise is a large company for guarantees of up to 90% of an underlying loan. The underlying loan itself must broadly be linked to employment emoluments and so the purpose of the Framework is clearly to ensure that Member States can assist in preserving jobs.

Article 44.7 of regulation 1828/2006 provides:

"[Member States] shall take precautions to minimize distortion of competition in the venture capital or lending markets. Returns from equity investments and loans, less a pro rata share of the management costs and performance incentives, may be allocated preferentially to investors operating under the market economy investor principle up to the level of remuneration laid down in the by-laws of the financial engineering instruments, and they shall then be allocated proportionally among all co-financing partners or shareholders"

If the investment in the Target was justified under MEIP, then it will be necessary for the Urban Development Fund or the Fund Manager to see a return on their investment. This will involve a distribution of the income to the members of the Target within a few years of the investment. In deciding how long the Target members can wait before receiving a distribution, the commercial needs of the developer member will doubtless be important. Additionally the peculiar traits of the Member State as a hypothetical private investor are also taken into account. Some of these traits are its theoretically almost unlimited resources, higher credit rating, the long-term nature of the investment and the difference between majority and minority holdings[118]. However the specific objectives of the Member State in making an investment, for instance in order to preserve or increase employment, regenerate land or achieve social purposes, cannot be take into account in assessing whether it meets the criteria of a private investor[119].

The income should be commensurate with the investment by the Urban Development Fund or Fund Manager. If the developer member receives a greater share of the income than its investment merits, this may be an advantage to it. Another possible advantage to it may be the preferential distribution of income to it. However, we have seen in the case of the Holding Fund and the EIB above, that if the EIB were regarded as an undertaking, then the Commission seem not to be overly concerned with the possibility that its outstanding liabilities get paid off first. This treatment would seem to support the application of Article 44.7 above. However this does not detract from the view that strictly Article 44.7 is a fallacy

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118 Case T-296/97 Alitalia.

119 Case C278/92 to C280/92 Spain v Commission [1994] ECR I-4103.

as the preferential distribution to the private sector itself is prima facie a breach of MEIP and provides a selective advantage to the developer member.

Any such advantage to the developer member could be justified in many ways for State aid purposes.

As stated in the previous section, it is unlikely that the investment in the Target will satisfy MEIP, for the simple reason that the nature of the projects envisaged in JESSICA are such that it is expected that the Member State will assume a disproportionate segment of the risk in comparison to its investment. The advantage to the developer member should therefore be capable of justification within the State aid rules. Possible ways of doing so could be:

1. Include a set yield in a procurement specification for the developer member. This is common when advertising works concession contracts. This would ensure the advantage was not selective. A maximum yield calculated as a percentage of the capital invested may suffice.

2. Apply the de minimis exemption to the developer member[120]. This is particularly useful where the State support constitutes operating aid for which other exemptions are not available

3. The Member State could subsidise the rental, service charges, franchise or consultancy fees payable by tenants of the Target to the developer member under a concession arrangement. If these subsidies could be covered by GBER or the de minimis provisions then it is arguable that there is no State aid to the developer member. However this would be a matter of interpretation as we have seen from the cases on residual benefit above that where an undertaking has access to a market which it would not have but for the discounts allowed through state resources, this may be a State aid to that undertaking. On our facts this could mean that the developer member receives a residual benefit even though it receives no state resources, as without the state subsidy paid to the tenants, it would not have access to this market. This is not an imputability argument although there is a prima facie resemblance to the facts of cases like Case C-126/01 (GEMO). Instead it is an argument used

120 Regulation 1998/2006 OJ L 379 Article 2.1.

specifically in the Broadband cases outlined in previous sections, but may be expanded to others[121].

C Exit Strategy

The Urban Development Fund or the Fund Manager can transfer its equity in the Target to the developer member. Alternatively the asset can be disposed of, the surpluses distributed to the members of the Target and the Target is then wound up by voluntary liquidation. The state aid analysis of the exit strategy will be performed at the time of investment. This is because the Urban Development Fund or the Fund Manager will require as a very minimum a business plan and an exit strategy from the Target under the structural funds rules[122]. The grant funding agreements entered into by the Urban Development Fund with the Holding Fund and the Member State also require an exit strategy to be clearly defined[123]. In both cases the exit strategy will need to address

“the winding-up provisions of the financial engineering instrument, including the reutilization of resources returned to the financial engineering instrument from investments made or left over after all guarantees have been honoured which are attributable to the contribution from the operational programme”

It is necessary to ensure that the developer member is not overcompensated. As pointed out earlier, it is difficult to anticipate, in a properly carried out procurement, what the level of surplus will be in respect of an asset in these circumstances. It would therefore be prudent to insert the requirement of benchmarking and associated claw backs within any arrangement between the developer member and the Target.

The exit could involve an MBO or MBI of the Target. Again as long as these are performed in a manner where no advantage is conferred on the parties, no state aid issues should arise.

There is a possibility that further investment or funding may be required by the Target or the developer member in order to affect the exit. To the extent these enter the hands of the

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121 However see point 117 of C-182/03 and C-217/03 where the European court stated quite clearly that a contingent or future advantage couldn’t be a State aid.

122 Regulation 1828/2006 Article 43.2(i).

123 Regulation 1828/2006 Articles 43.6(d) and 44.2(i).

developer member; they would need to be cumulated with any other advantage it receives directly or indirectly from state resources to see if it results in an overall overcompensation.

Aid provided to the Target to effect an MBO or MBI could be submitted for approval under the Rescue and Restructuring Guidelines. In particular the development and implementation of a restructuring plan can be financed through state resources. In addition it should be noted that any new entity de-merged or taking over the Target cannot benefit from aid under this framework[124]. However aid directly to the new entity may benefit from other frameworks, particularly the Research and Development Framework for "spin off" companies[125] and the Regional Aid Framework for newly established undertakings[126].

VI. Variant to the Standard JESSICA

There is no requirement in the structural funds legislation for the Member State to transfer title in its asset to any party[127]. It is conceivable therefore, that the Target could be simply provided with a development licence or a usufruct arrangement in order to carry out the project. If the Member State retains ownership of the asset, this reduces the risk of residual benefit to the Target[128]. The developer member could either be procured or its remuneration benchmarked to reduce the risk of overcompensation. The users would either need to pay independently assessed market rates to the Member State for any facilities, rent or services provided[129], or benefit from an exemption or decision for any discounts they receive. Indeed Article 43.1(b) of Regulation 1828/2006 appears to imply that JESSICA investments are not restricted to PPP's and that "other urban projects" can also be supported by it. This does raise the question whether a JESSICA could feasibly invest in a project which would qualify under

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124 OJ 2004 C 244, pages 2-17 point 2.1 para 12.

125 GBER Articles 35 and 37.

126 GBER Article 14.

127 In the London Development Agency JESSICA a restriction on title of the site to its use to the JESSICA was sufficient to lever in the co-financing of structural funds. See http://www.lda.gov.uk/upload/pdf/Public_Item_02_3_Committing_land_premises_to_the_JESSICA_Fund.pdf para 4.7.

128 See discussion of residual benefit which follows.

129 See e.g. Case C68/2003 Netherlands Investment aid for a propylene pipeline OJ 2005 L056 and Case C11/2005 Germany: Aid for an ethylene pipeline in Bavaria OJ 2007 L 143.

normal circumstances as a "direct development" compliant with N 657/1999 UK Business Infrastructure Development, where the Member State still holds title to the asset after the project is completed. It is submitted that legally this is a possibility.

This does give rise to certain difficulties in practice. For instance if the Target does not have an interest in the asset, it is difficult to see what the investments in it from the Urban Development Fund would be levered against. It would additionally be difficult to meet the objectives of sustainability inherent in the structural funds legislation, particularly if income and surpluses need to be repatriated back to the Member State. Indeed one may argue what the need is for a JESSICA joint venture anyway in such cases, as the development could quite easily be achieved using existing schemes and decisions[130]. In response to the last point it should be noted that the very act of allocating an asset to JESSICA project may be sufficient leverage to "draw down" co-financing from structural funds. This is particularly beneficial for Member States with high asset holdings but low liquidity.

Another variant may involve the nature of funding the Target as opposed to its constitution. As seen above, the structural funds rules prohibit the Urban Development Fund from providing grants to the Target. However, rather surprisingly, there does not appear to be a similar provision prohibiting the Member State from doing so. In practical terms the Member State could transfer title to an asset either into the Urban Development Fund or the Target. It could then proceed to provide the Target with grants in addition to the investments made in it by the Urban Development Fund or the Fund Manager.

It is possible for grant funding terms to be introduced into the framework of a procurement contract. For instance this is common in contracts for the provision of broadband network services[131]. If the developer member is selected on the basis of the lowest grant required alone, then there is a strong argument that it does not receive an advantage[132]. In practical

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130 See eg N657/1999 UK : Business Infrastructure Development.

131 See eg N 266/2008 – Germany : Broadband in rural areas of Bayern OJ 2009 C 12.

132 Para 3.2 of N 525/2001 Ireland : Cluster Incubation Scheme where it was said that "The developers have to compete for the contracts to construct and operate the building by means of sufficiently well-publicised and open bidding procedure, available to all developers within the EU. The Irish authorities will normally select the project involving with the lowest amount of aid. This competition procedure will normally force the bidder to reveal the real expected difference between his (higher) cost and the future revenue from renting the

terms this is unlikely to happen, as most contracts for the delivery of works and related services are selected on the basis of a variety of factors other than price. In such cases the grant element brings with it a risk of "residual benefit" to the developer member. An example of residual benefit is the ability to utilise state funded assets for the commercial benefit of the recipient after the project has been completed. Another is the ability for the recipient to generate demand through subsidised prices[133].

If suitable precautions are taken, it is possible to avoid residual benefit. There could be a requirement for a state funded asset to be transferred back to the Member State once the project is complete. Alternatively the contract between the Target and the developer member could include a clause that prohibited a disposal of the asset for a period of time. This could prevent the alienation of a state funded asset through outright disposal of a right or interest in it. It could additionally prevent a material change in use of the asset or a change in its ownership. A suitable grant repayment condition would be required in the contract should these eventualities materialise[134]. The repayment should be linked with interest at the Official Reference rate published in the Official Journal at the date of the contract[135].

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premises to the ITS firms which he would like to have bridged by the aid. If the developer overestimates the difference and requests a higher level of aid, he risks not to get the contract and if he underestimates it, he runs the risk of not recovering his costs when renting the constructed premises. Thus, the tendering procedure should guarantee that the grant to the developer is the minimum necessary to ensure that the premises are built and can then be rented at lower levels than normal market ones, to the benefit of the end-users. At the same time, it cannot be excluded that the tendering process will not always be conducted according to the principles described above. The Irish authorities admitted that they will also carry out a qualitative assessment of each proposal. As a result, it is possible that the lowest tender will not always be selected. In that case at least, part of the aid would remain with the developers. Therefore, the developers must also be considered as possible beneficiaries of the aid."

This should be contrasted with N 266/2008 where the specification clearly stated that the bidder requiring the lowest grant to fill the "profitability gap" would be selected. Yet this was still held to leave a residual benefit to the winning bidder.

133 N 266/2008 para 23.

134 In 2005/782 (notified under C(1315)2005fin) concerning German aid for the development of local authority infrastructure, construction of and space management of hubs a 15 year restriction with suitable claw back provisions was held to be sufficient to eliminate or minimise the inference of advantage to the Centre.

135 An example of this is the kind of rebate mechanism introduced into the contract in N 282/2003 UK Cumbria Broadband Project Access Advancing Communication for Cumbria and Enabling Sustainable Services OJ 2004 C 016 para 2.13. Additionally

Arguably the grant then takes on the features of a loan. Since the repayment is at market rates, there is arguably no State aid to the developer member. This would be a simplistic view for several reasons. The first is where the developer member would not be able to obtain a loan on the open market at all. This could be for instance, where its credit rating is poor, or where it has no assets to offer as security. If this is so, then arguably the entire capital of the "loan" is an aid, regardless of whether the interest is at market rates. The second is that in reality this is not a loan at market rates but a conditional gift. That is certainly the intention of the aid. It is accepted that the effect of the aid is really what is relevant to see if there is a distortive advantage to the recipient. However the importance of the intention of the aid should not be ignored. This is often an underlying factor in adjudications on the compatibility of the aid with the common market. It is possible that it is an important underlying factor in whether an aid exists or not as well.

Residual benefit in terms of subsidised early access to a potential market is more problematic to overcome. There needs to be a market the price can be compared to. Thus in some of the Broadband cases, the residual advantage was indirect. Users were able to access the service at a lower price to what they would have to pay in a neighbouring region where the market provided the broadband supply. As the lower prices were the result of state subsidy, the aid gave the service providers the opportunity to create a supply led market. It was the opportunity that was the aid. There was no guarantee that a market would in fact be created. To this end the advantage was indubitably "future and contingent". Nevertheless it was held to be aid to the service providers. Indeed the Broadband cases are the clearest case line of authority on the importance of intention over effect.

Such a benefit may be avoided if there is no market to compare access prices with. Broadband cases involve the extension of Broadband coverage to areas where a critical mass of demand cannot be generated without state support. Therefore, by implication, there is always a comparator for the access prices charged to users. This is not necessarily the case with JESSICA assets. The type of assets earmarked for JESSICA projects would be contaminated, brown field or other sites with nil or negative market value. Where such sites are involved, it is arguable that no matter where they are located, there will be no market

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the repayment could materialise into a profit share, and more in the nature of a claw back – see e.g. N 172/2009 Slovenia Broadband development in Slovenia OJ 2009 C 264 para 18 where a combination of repayment and claw back was used.

surrounding them or which they are a part of. It is arguable therefore that if demand for access to these sites is enhanced by state subsidy, this in itself does not provide an aid by opportunity. The main reason for this is because at the time the aid is granted, there is no market comparator for a possible return from a derelict or polluted site.

Thus in the Partnership Investment Programme schemes it can be seen that the aid to the developers was not in the form of their opportunity to develop a supply led market through state subsidy. They were held to be state aided because they were "itinerant" in nature and could transfer the aid to a commercial activity of theirs anywhere in Europe. Nowhere in these decisions was it mentioned that the ability for the developer to generate demand for what could possibly be a successful science park or incubator built on currently derelict and polluted land would in itself be an aid to the developer.

Bearing these arguments in mind, it is arguable that residual benefit can be avoided in contracts with the Target or its developer member where there is an element of grant aid involved. However the law in this area is developing, and may soon be applied to non-Broadband cases. It is prudent therefore to ensure that the overall consideration to the developer member from the contract (including the grant and any concessionary income) is suitably benchmarked on a discounted cash flow basis with the rest of the market. To the extent the overall consideration to the developer member exceeds the benchmark, the excess may need to be justified on state aid grounds either within the de minimis rules or through an existing scheme or decision.

Finally we have seen that the entire JESSICA is unlikely to qualify as a risk capital scheme for the purposes of SARC. However it is possible that discrete parts of the structure could be brought within the framework, for instance separate ring fenced funds which satisfy the requirements therein.

VII. Conclusion

JESSICA schemes are unlikely to qualify as risk capital schemes to benefit from the full strength of that framework for their State aid justification. However there is no reason why the principles inherent in that framework cannot be applied across to a standard JESSICA structure. This would be done through analogy and has already been attempted in past cases.

Based on the principles inherent within the framework, it is likely that the creation, operation and dissolution of the Holding Fund and the Urban Development Funds will not, in our standard structure, have any State aid implications. The main argument for this conclusion is that they are intermediate bodies, flow through or conduit entities, acting as the arms of state, and whose activities are imputable to the state.

It therefore follows that the state aid concerns in a standard JESSICA arise at the level of the Fund Manager and the Target. In both these cases, a suitable procurement exercise may minimise the risk of overcompensation. However in order to be certain, some form of benchmarking exercise should be carried out at appropriate milestones in the project. To the extent there is a risk of overcompensation, there are several frameworks and exemptions that could be used to provide State aid cover on a project by project basis.

But for JESSICA to truly become the holy grail of urban regeneration it is important that the State aid rules allow for structures like this. In particular a defined framework, akin to SARC, should be enacted to support what is otherwise a very forward looking programme of the Commission.

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