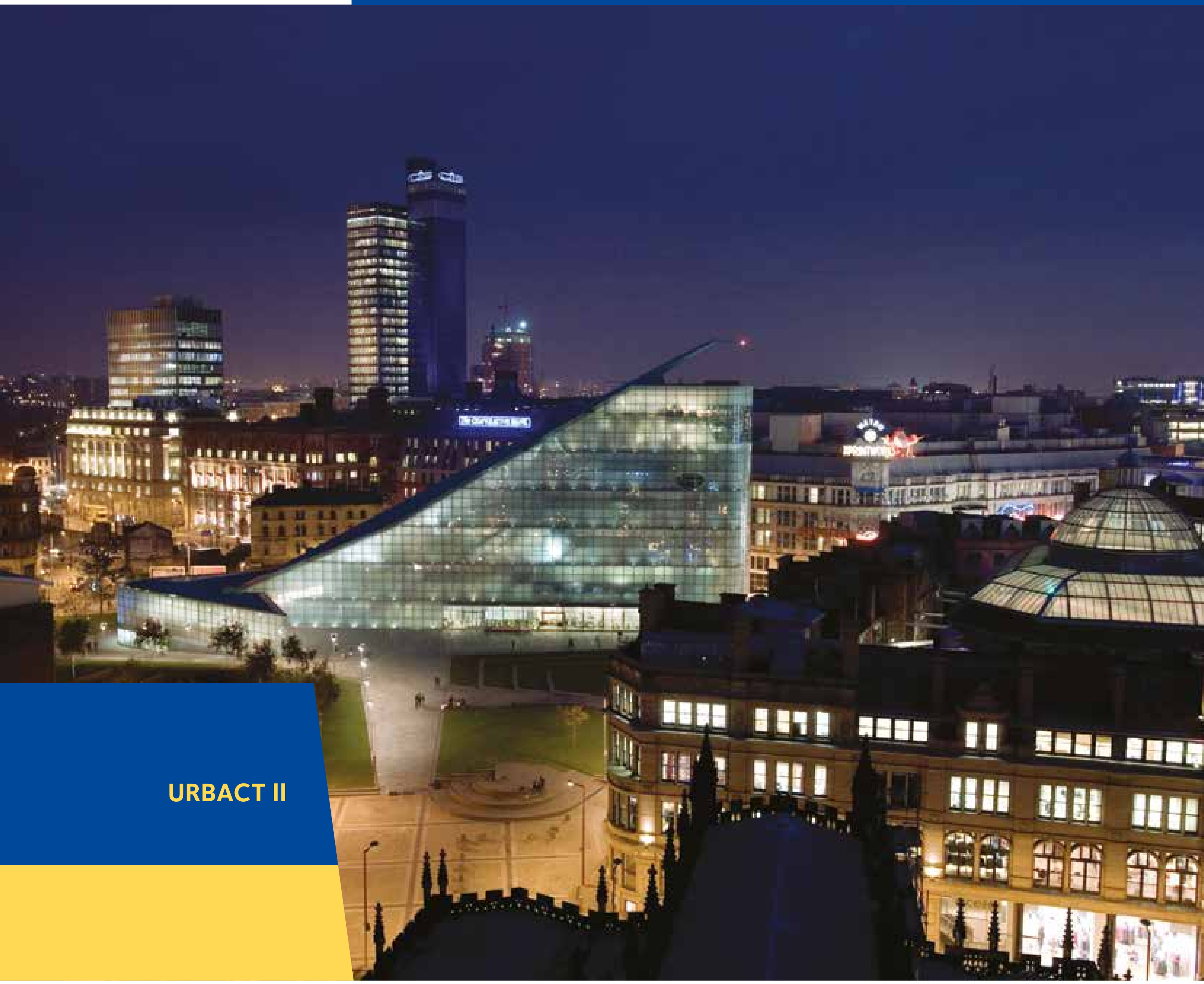
Making financial instruments work for cities

CSI EUROPE CASE STUDY

NORTHWEST URBAN INVESTMENT FUND

A CSI EUROPE CASE STUDY ON STATE AID



URBACT II

European Union
European Regional Development Fund

Connecting cities
Building successes

NORTHWEST URBAN INVESTMENT FUND

THE FIRST JESSICA STATE AID DECISION
A CSI EUROPE CASE STUDY

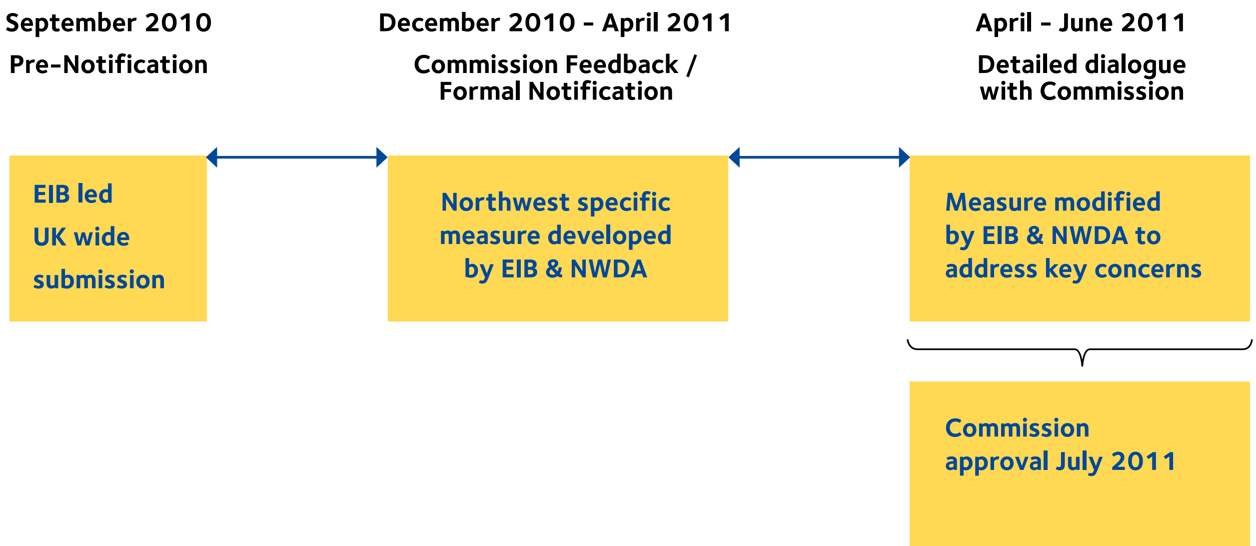
INTRODUCTION

The Northwest Urban Investment Fund is a JESSICA holding fund, established by the Northwest Development Agency and managed by the European Investment Bank. The holding fund operates in the Northwest of England and was capitalised with £100m of ERDF and regional match funding in 2009 to invest in urban regeneration projects. The holding fund procured two urban development funds (UDF) in 2010 – Evergreen and Chrysalis and the first investments commenced in 2011.

The initial feasibility work undertaken to support the development of the holding fund had highlighted the presence of complex market failures in the urban regeneration sector in the region. A number of the projects identified as policy priorities were unviable as commercial propositions and discussions were therefore advanced in respect of a possible state aid notification, so as to enable the fund to target the widest range of projects and those projects that best met its investment strategy. The State Aid decision was approved by the European Commission in July 2011 (SA.32835). It has subsequently been followed by State Aid decisions in Spain, Greece, Bulgaria and the Netherlands.

DEVELOPMENT OF THE STATE AID NOTIFICATION

The notification was developed over a two year period, alongside the development and establishment of the holding fund and the procurement of the two UDFs. Initially, a UK wide proposal was envisaged, however a Northwest only approach was ultimately taken forward in the interests of time.



OBJECTIVE AND KEY FEATURES OF THE NOTIFICATION

The notification sought to encourage private sector investment by providing loan and/or equity funding to projects that would not be viable if financed on a commercial basis – enabling projects to proceed where they would otherwise be stalled and broadening the potential UDF pipeline and ultimate benefit of the UDF investment. To ensure this objective was achieved the following key features were incorporated:

- A ten year duration
- The ability for the UDFs to provide a greater range of incentives to private investors to deliver projects in line with the UDF Investment Strategy:
- Where:
  - Projects have viability gaps as a result of high initial costs and/or low values caused by market failures
  - Projects are not commercially attractive for market investors
  - The project developer and investors are unable to generate a fair rate of return and critically -
  - The project would not proceed without the use of the state aid decision

To ensure proportionality, provisions had to be developed to ensure that UDF sub-commercial investments (in any form) were adjusted to the minimum necessary to limit State aid to investors both at project or UDF level. There are also co-investment requirements.

THE FUNDING ARCHITECTURE

The notification and subsequent decision describes in detail the funding architecture and legal documentation which govern the use of the funds. In particular, it sets out the following key roles:

Holding Fund: Selection, investment and performance monitoring of the UDFs. EC reporting obligations and the procurement of the Independent Expert

The UDF: Responsibility for the application of the state aid decision, establishing the need for the application of the decision through due diligence, determining the fair rate of return, identifying the most appropriate tool of the state aid decision to apply, reporting and monitoring obligations

The Independent Expert: Responsibility for providing an opinion on the fair rate of return (FRR) and the significance of the private equity contribution in certain circumstances and in all proposed grant proposals.

TOOLS

WHERE CERTAIN CONDITIONS ARE SATISFIED, THE STATE AID DECISION ENABLES THE UDF TO PROVIDE:

- **Loans at lower than market rates**, so as to allow projects to break even;
- Equity/quasi-equity with non pari-passu risk sharing of the upside and/or downside between public and private investors. This includes:
  - **Preferential rates of return**

    – The UDF rate of return could be below that of private investors, subject to a floor of zero return to enable the project to break even.

    – The project developer's rate of return would be capped at what had been deemed to be the fair rate of return (FRR)
  - **Priority return**

    – The return would be first paid to the private equity investor, up to the level of the FRR before the UDF. Once the private equity investor has received its FRR, the UDF public investment will then be entitled to receive its FRR.

    – The UDF has to wait in this case until the private investor has received its full FRR before it receives any return
  - **Timing**

    – Enables the UDF to invest first, before the project developer or other third party investors in the project.
  - **First Loss**

    – Enables UDF equity investments to rank behind private equity for repayment, therefore effectively being exposed to first loss in the case of poor investment performance.

    – For use only where project is not estimated to make a loss on the capital invested, but in instances where an actual loss is made on the capital invested

    – The UDF would adopt a capped "first loss" position of 25% of the overall outstanding loss, in any case limited to the level of the UDFs investment in the project.

Where following the application of the debt and equity tools, viability gaps still persist and the project scores highly as a regeneration priority:

- Grant support can be given alongside a loan by the finanicial instrument, capped at the level required to enable the project to break even and generate a fair rate of return. However, the grant requirement to be reviewed by the Independent Expert

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PRACTICAL APPLICATION OF THE STATE AID DECISION

To date the NW decision has been used by both the Evergreen and Chrysalis UDFs to support one project each in the respective pipelines, this may increase over the next year as the Chrysalis pipeline is finalised and strategies for the use of recycled funds are developed. It is nevertheless envisaged that the majority of the loans made by the UDFs will be on a commercial basis, so as to ensure that the state aid decision is used only where it is necessary and to also enable the UDFs to generate returns on their investments.

In the two instances, it has been used, the NW decision has enabled the UDFs to provide 0% interest loans which have been combined with grant resources from other funding sources to address the viability gaps presented and enable the projects to proceed.

The Evergreen Chester project involves the development of a new supply of Grade A office accommodation in the centre of Chester. The Chrysalis Duke Street project involves the redevelopment of a derelict historical building

CONCLUSION

The NW decision was the first of its kind and has proved to be robust and capable of providing a clear process for making sub-commercial investments. In particular the methodology that uses an independent expert to validate assessments of Fair Rate of Return, allows the financial instrument to demonstrate market failure and that the aid is the minimum support required to make the scheme viable.

The strength of the approach is reflected in the fact that similar provisions have been included in several other notified schemes for financial instruments including the Andalucian and the Hague Funds within the CSI Europe network. The "off the shelf" scheme for Assisted Areas in Article 16 of the General Block Exemption Regulation (No.651/2014) (GBER) also borrows heavily from the methodology in the NW decision.

It is interesting to note, however, that the GBER model does not include the provision in the NW decision that allows grant to be used alongside a 0% loan. This measure, which has been used on both occasions loans have been made under the NW decision, would facilitate greatly the use of financial instruments alongside grant. Therefore, whilst it may not be suitable for inclusion in GBER, such a measure may be considered by promoters of financial instruments considering preparing a notified scheme in the future.

The aim of CSI Europe is to build on the different experiences of the partners in relation to financial instruments and urban investment. By working together we will seek to: identify common issues that affect financial instruments and work together to identify solutions; work at a local level to translate our experience to the delivery of projects and act as a voice for cities in the development of future investment models at both a local and EU level.

The key themes that the network will seek to explore are: Governance, State Aid, Technical Assistance and Regulation and through this work we will seek to identify new models for investment through financial instruments.

The URBACT II Operational programme will support the partners' work over the next three years, providing a framework for joint working and supporting the partners' local activities. The partners will work together through thematic partnerships where two or more partners will work together to explore, in depth, a key theme; transnational conferences where all the partners will come together to consider the key themes, share experiences, celebrate success and exchange ideas; and URBACT Local Support Groups established in each city, bringing together key public and private sector stakeholders to deliver a Local Action Plan reflecting the city's priorities for the network.

The network will also seek to develop links with the European Commission, Managing Authorities and other organisations who will help shape the role of financial instruments in the next Structural Fund programme. This may allow CSI Europe to play a constructive role in the development of financial instruments for the future support of urban development across the EU area.

URBACT II

URBACT is a European exchange and learning programme promoting sustainable urban development. It enables cities to work together to develop solutions to major urban challenges, reaffirming the key role they play in facing increasingly complex societal challenges. It helps them to develop pragmatic solutions that are new and sustainable, and that integrate economic, social and environmental dimensions. It enables cities to share good practices and lessons learned with all professionals involved in urban policy throughout Europe. URBACT is 181 cities, 29 countries, and 5,000 active participants.

www.urbact.eu/csieurope

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