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SUMMARY

The introduction of the JESSICA initiative marked a change in the way the European Commission offers financial aid. In future, European funding shall no longer be handled as so-called “lost subsidies” alone but shall also include revolving financial engineering instruments (loans, guarantees and equity). The structural funding granted through the new financial engineering instruments is collected together with its co-financing in an urban development fund (UDF) and granted to individual projects by the UDF managers. The repayments generated from the project flow back into the fund, which can then use this money to grant new aid.

The development and implementation of UDFs in the EU Member States is actively supported by the European Commission and the European Investment Bank (EIB). The EIB acts as a multiplier in this process, enabling the rapid connection between the European Commission and the national administrations, bringing in its own know-how and also offering financial support. Moreover, it can be commissioned to manage a holding fund.

When compiling the Operational Programme ‘Saarland’ for the European Regional Development Fund (ERDF) 2007-2013 structural aid programme period, the Saarland had the option of using JESSICA financial engineering instruments and included them in the programme. At the end of 2008, the Ministry for the Environment requested the EIB to commission this evaluation study, which was tendered and contracted at the start of 2009 and paid for by the European Commission. After the Saarland’s state elections in 2009, the use of the JESSICA instruments was then included in the coalition agreement of the new government.

The use of a community development fund (CDF) to support the municipalities and municipal companies of the Saarland with the appropriate JESSICA financial engineering instruments shall meet the challenges raised by demographic, economic and social structural change. The development process, led by the Ministry of the Environment, involved the EIB, the commissioned expert consortium of FIRU mbH – Prof. Nadler – DLA Piper, as well as representatives of the Ministry for Economics and Science, the Ministry for Finance, the Association of Municipal Councils of the Saarland, the LEG Saar Landesentwicklungsgesellschaft mbH (LEG Saar), the Saarländische Investitionskreditbank AG (SIKB) and KomCon.

The areas of intervention for future CDFs were to be chosen based on prior studies in the area of integrated community development concepts and on circular land use management (REFINA) and – to compensate for the current focus of European funding on urban areas – concentrated on urban agglomerations and rural areas. It was not possible to rapidly implement the CDF at the end of 2009 to ensure access to the ERDF funding under the N+2 rule because the Saarland was unable to provide the necessary co-financing. Therefore, this evaluation study also had to be adjusted to reflect the new conditions for implementation at the end of 2010.

Based on these conditions, the guidelines of administration and spatial planning were examined to determine the practicability of using the JESSICA initiative and the market for such municipal and urban development projects was evaluated. After looking at the legal conditions for the implementation process, several governance models were developed and examined, projects which could be funded by CDF were identified and, based on these, financial funding models were developed in co-
ordination with the steering committee. A summary of the added value was drawn up which details the potential of a Saarland Community Development Fund and, finally, a concrete action plan for implementing the fund was added.

The market for urban and municipal development projects in the Saarland is quite difficult. Municipal budgets are extremely tight; in many cases, the municipalities must respect an enacted restriction of their room for manoeuvre. It is even difficult to make a (public) investment when other public sector bodies have approved funding to great extent because it is not possible to delineate each body’s share of the overall financing. Although there is still private investment, this is mainly targeted on the parts of the project which generate returns and is almost entirely focused on the few stably developing regions. Therefore, the demand side (project actors) has been substantially oriented toward subsidisation. However, the chances of correcting the current market failure by using the revolving funding instruments of a CDF are not small. It would thereby be possible to help financially where offered aid has to be co-financed on the one hand and, on the other, where pure subsidisation would not be of any further help to existing project types. At the same time, it might induce additional private investment in the area of urban development (leverage effect, also due to the improving image).

A slew of legal conditions have to be considered when planning the implementation of a CDF. If ERDF funding and its co-financing are deposited into a CDF, their use is subject to the provisions of European law. The principle regulations among them are the restriction to the goal of “regional competitiveness” (§ 5 of Regulation (EC) No 1080/2006), the connection to “sustainable urban development” (§ 8 of Regulation (EC) No 1080/2006), and the requirement to spend it within two years after the end of the programme period (N+2 Rule in accordance with § 93(1) of Regulation (EC) No 1083/2006). Furthermore, each Operational Programme for the use of the ERDF funding in that programme period further limits the areas of application of the CDF. The financial regulations of the state and any municipal financial restrictions are also relevant. Lending must follow the regulations of the German Banking Act (KWG) and other capital market and corporate law provisions might play a role in individual cases. Furthermore, the implementation of the CDF has to follow the regulations for granting and using public aid.

For the administrative structure of the CDF, several different governance models were evaluated from the financial and legal perspective. Given the substantial exclusion criteria, two different models were found practical: “lending with a banking licence” and “autonomy of the fund management”. The first reflects Model 2 presented in the study, in which the fund is placed within a financial institute and loans are granted, while the second is seen in Model 5, where the state establishes an independent investment fund company which grants equity. For implementation in the Saarland, a mixed model was developed, the so called “Nexthouse” model. The initial implementation step follows that of Model 5, whereby the funding is only granted as dormant partner’s interests. A second step follows, when a private partner with a banking licence joins the investment fund company per tender procedure in accordance with the KWG. The CDF is then also able to grant loans.

Based on the integrated community development concepts underlying CDF funding, the business areas “Urban Development”, “Local Business”, “Infrastructure and Environment”, and “Brownfields” were developed and potential pilot projects identified or collected for keeping in a pipeline of future projects. The five pilot projects identified – the Fibre Optic flagship project in Dillingen, the Terentiushof/Wilhelm-Heinrich-Straße project in Ottweiler, the Local Heating Supply project in Nalbach, the Spitzbunker Urban Hotel project in Neunkirchen and the Revitalisation of the Pedestrian Zone project
in Lebach – were classified in terms of urban development policy and analysed from the financial and legal perspective. They represent types of projects commonly found in the communities of the Saarland and which are typical examples of market failure:

- Investment in telecommunication infrastructure, esp. in rural areas
- Energy-conserving renovation, enhancement of energy efficiency – use of renewable energies
- Renovation of municipal centres to improve the area’s image and boost business
- Strengthening local business and ensuring the functionality of municipal centres
- Development of large brownfields important to the federal state
- Development of scattered, small brownfields

All the starting projects identified feature low returns, so they represent the classic B-list projects.

A number of assumptions were made to calculate the financial model:

- All projects will be completely or partly funded by dormant partner’s interests from the CDF. The interest will be 2.0% p.a. plus participation in profits.
- The CDF begins operation at the end of 2010 and holds EUR 30 million, composed in equal parts of ERDF funding, interest-free co-financing from the Saarland and cheap loans from the Council of Europe Development Bank (CEB). To be able to show the full spending of the funding with only five pilot projects, a repeated examination of the projects was compiled (over four to five cycles).
- During short periods of peak demand, loans at 5.0% p.a. can be drawn on, with the newly available resources being reinvested at an interest rate of 2.0% p.a.
- The CDF operates for 22–23 years.
- The management costs are 3.0% of the granted equity.

If the CDF grants the selected projects dormant partner’s interests at an interest rate of 2.0% and there is a participation in profits at the end, once the 23 years have passed and the capital granted by the CDF has been repaid, then 101.4% (EUR 20.42 million) of the deposited capital will have flowed back into the CDF. Looking at the possibilities for optimising fund performance, reducing the management costs to 1.5% (administrative expenses for dormant partner’s interests are not very high) means a return of EUR 26.56 million (capital growth of 0.9% p.a.). Considering the later use of loans and perhaps even equity, the results from these projects would change as follows: Keeping the reduced management costs, the granting of loans for the existing project portfolio would bring returns of EUR 25.91 million and the use of equity would bring EUR 25.53 million. Thus, all variations make nominal maintenance of capital possible under the given assumptions.

It follows from the results of this calculation that it makes sense to set up a CDF for the Saarland to promote an integrated community development. Even in times when budgets are tight, there are alternatives for funding the important project types in critical urban development business areas.
where the existing practice of financial contributions is out of the question. The business activities of the CDF are centred on the Saarland’s central urban and community development problem areas (revitalising urban centres with functional problems, investing in technological, future-oriented infrastructure to handle demographic and economic change, mobilisation of potential for tourism, restructuring urban problem areas and active brownfield redevelopment). Furthermore, the additional capital contributions from the CEB make it possible to promote projects in full and in part which would not be possible under ERDF conditions, thereby overcoming certain hurdles and actively generating and exploiting synergies. At the same time, Nexthouse is an implementation model which is quick, limits administrative and restructuring expenses and maintains the Saarland’s influence on the use of the resources in the Saarland Community Development Fund for another. The Saarland has already resolved to take the first implementation step: the CDF should be established by the end of 2010 as a subsidiary of the state-owned LEG Saar and dormant partner’s interests should be granted to projects eligible for funding.
1 INTRODUCTION

The Joint European Support for Sustainable Investments in City Areas – JESSICA initiative – was called to life in 2006 by the EU Commission at the start of the 2007–2013 structural programme period and creates new possibilities for funding urban development projects using ERDF resources. This initiative should make it possible for European Structural Fund resources to be allocated in urban development projects during the 2007–2013 programme period using revolving financial engineering instruments (loans, guarantees and equity capital), too. Before that time, subsidies were the primary funding mechanism. Before the new financial engineering instruments are used, the Structural Fund resources are collected (together with national co-financing) in an urban development fund (UDF), which then allocates the funding to projects in the appropriate form. As the resources return, in the form of interest, fees and capital gains, they can again be used to promote other urban development projects.

There were many reasons for creating such an initiative. On the one hand, it was clear to the EU Member States that the great expansion of the EU in 2004/2007 would shift the focus of European funding policies from the ‘old’ Member States (EU-15) to the new ones, since there was and still is greater need for structural funding there. This means that the so called net contributors among the Member States will receive less and less European funding. The idea of funding via UDFs makes it possible to ensure that European money continues to flow into sustainable urban development over the long term without being reliant on EU funding during the coming programme period. On the other, when public resources are scarce, other paths must be taken to make the necessary investment in urban development. The JESSICA initiative makes it possible to involve private investors in what have so far been typical public projects without having to hand over to private individuals the responsibility for services of general interest. Given the present financial and economic crisis, this is especially important, since municipalities are currently focussing their expenditure on co-financing measures according to the economic stimulus packages I and II.

The Implementation of the JESSICA initiative in the EU Member States is being jointly promoted by the European Investment Bank (EIB) and the European Commission (Directorate General for Regional Policy). The EIB provides financing and know-how for the implementation of UDFs and conducts evaluation studies at the request of European regions. It can also contribute co-financing for the ERDF funding deposited in the UDF and manage a holding fund responsible for several UDFs.

At the start of the programme period, many EU Member States set about implementing UDFs for the first time. In Germany, the Federal Ministry of Transport, Building and Urban Development supported this process with its ExWoSt field of research, “UDFs in Germany” in selected pilot projects in four states (Brandenburg, Hamburg, North Rhine-Westphalia and Rhineland Palatinate) and the KfW development bank. Other EU Member States initially concentrated on setting up so called holding funds to feed several UDFs (with diverse spatial and/or thematic focuses) and still do so. With the exception of Brandenburg, so far the British region of East Midlands is the only place where a UDF has been set up\(^2\).

\(^2\) As at 12 March 2010 (Jessica Networking Platform in Brussels).
The planned use of new financial engineering instruments requires a general change in thinking about funding in practice. By making funding available as loans, guarantees and equity, only certain urban development projects can be implemented, since the funded projects have to generate revenues. Although the projects to be funded need not be named at the start of a UDF, a business plan does have to be developed which clearly shows sustainable land development and a forecast capital return. The project actors on site and the participating authorities both have to prepare for that.

1.1 Conditions

Around Europe, 19 Member States are currently working on developing JESSICA financial engineering instruments and, at the start of 2010, EUR 1 billion was already contractually committed across the continent. As few steps toward the practical implementation of the JESSICA initiative have actually been taken, there are still several open questions. The fundamental differences in financially supporting projects under the JESSICA initiative instead of subsidisation have considerable implications for project procedures and organisational forms. It is not yet possible to see a complete overview of the implementation process, since no UDF has yet been fully implemented and put into practice.

1.2 Motivation

The greatest challenges for the Saarland communities currently revolve around the changes to demographic, economic and social structures and the repercussions of climate change. To react appropriately, and ensure sustainable development for future generations, the municipalities have to pursue integrated urban development policies which involve new governance and financing structures. For this reason, the Saarland Ministry of the Environment supported and still supports the conception of integrated urban and community development strategies; guidelines for this were compiled in 2008. These strategies formulate goals and measures for municipal development in the business areas of "Urban Development and Housing", "Social and Educational Infrastructure", "Local Business and Supply" and "Technical Infrastructure, Transport and the Environment".

One essential element of integrated urban development is purposeful circular land use, on which a study has already been prepared in reference to the Saarland (REFINA). One result of this study is the recommendation to set up a public property fund to best link up the available resources and contribute meaningfully to their utilisation.

Against this backdrop, the Saarland Ministry of the Environment requested the European Investment Bank (EIB) to commission the compilation of this evaluation study regarding setting up a Saarland Community Development Fund (CDF) following the principles of the JESSICA initiative. The CDF should be designed to support integrated urban development projects through loans, guarantees and/or equity capital and thereby ensure returns and the reiterate utilisation of European aid (revo-lving financial engineering instruments). The fund should support the widest possible spectrum of business areas to allow a balance between the more or less profitable areas. Furthermore, the business areas should be aligned with the strategies of the integrated community concepts and also cover the range of activities of a public property fund.

As part of the Operational Programme ‘Saarland’ for the use of ERDF resources in the 2007–2013 programme period, the Saarland allocated around EUR 35 million of European aid to the issue of sustainable urban development (priority axis 3). Depending on the decisions around and development of
the large "Stadtmitte am Fluss" project, part of these resources could be channelled into an urban and community development fund, because the option to use revolving financial engineering instruments in Operational Programmes following the principles of JESSICA has been stipulated. The fund should thus be explicitly focussed on the more rural areas, so that this region receives European funding to compensate for the urban activities in the large “Stadtmitte am Fluss” project.

After the initial phase in 2009, when the feasibility was evaluated and pilot projects were sought, the CDF was to be implemented in 2009 followed by a model phase until 2013, also in order to secure the ERDF resources normally outflowing at the end of 2009. Due to the changes in the political environment after the Saarland elections in summer of 2009 and the related administrative restructuring, this was no longer possible. The evaluation study was therefore redesigned to examine a later starting point for the CDF at the end of 2010 (also in terms of project selection). The CDF shall represent the fundamental financing base for integrated urban development in the Saarland in future; its establishment was approved in the coalition agreement of the new government of the Saarland.

1.3 Development process of the Saarland Community Development Fund

The development process of the CDF has primarily been managed by the Saarland Ministry for the Environment (herein MfE), renamed the Ministry for the Environment, Energy and Transportation (herein MEET) in October 2009. Other important participants in this process have been the Saarland Ministry of Economics, Science and Agriculture (MESA), renamed the Ministry for Economics and Science (MES) in October 2009 as the ERDF administrative authority, the Saarland Ministry for Finance, the Association of Municipal Councils of the Saarland, the SIKB, the LEG Saar as well as the KomCon consulting agency. After conducting a tender procedure, the EIB chose the consulting expert consortium FIRU mbH – Prof. Dr. Nadler – DLA Piper and commissioned it to carry out this evaluation study. Together with the MEET and the LEG Saar, the consultants organised regular meetings of the steering group as well as smaller working groups focussed on particular issues.

The submission of this evaluation study should clarify for the state administration of the Saarland the possibilities for implementing a CDF and its chances of success, as well as showing the additional steps necessary to enact one. In addition to identifying projects which might benefit from CDF funding, the planned funding has been evaluated from a financing perspective and several implementation structures are proposed and legally evaluated herein3.

In March 2009 work began ambitiously on the evaluation study. Collecting the data needed to determine the potential of projects funded by the UDF proved to be a difficult process, since many of the proposed project ideas were not developed enough to have sufficient information available. After putting together a rough portfolio of possible projects for the CDF in summer/autumn of 2009, the KomCon carried out the intensive process of further developing the ideas behind these identified pilot projects. When no secured source of capital for deposit into the CDF had been identified by the end of 2009, the financial evaluation of the CDF was examined in winter/spring 2010 and the neces-

3 At the same time this evaluation study was being developed, an expert opinion was prepared on the legal questions arising in regard to the implementation process of urban development funds in Germany. The steering group of the Saarland was actively involved in compiling this opinion by analysing which legal questions were actually relevant and forwarding these to the experts and the European Commission for consideration and response. The responses were integral to the direction taken in this evaluation study.
sary and possible governance structure for implementing the CDF were developed. The following conditions were decisive for this development process:

1. At the start of the project, the primary guidelines given (though not set) for the planned CDF volumes by the MfE were EUR 4.8 million in ERDF funding from priority axis 3 plus EUR 4.8 million in co-financing from the Saarland and/or loans from the SIKB. Since it was not possible to raise the co-financing by the end of 2009, there was also no chance to commit the corresponding ERDF funding.

2. The search for appropriate projects was in line with this fund volume and with the additional guideline from the MfE that the CDF only lend to municipal project partners.

3. The municipal elections in June 2009 complicated the communication with municipal contact partners, since they were often unavailable during the election campaign period until the start of July. The Saarland elections in September 2009 also entailed the difficult process of setting up a new government as well as restructuring the ministries and their responsibilities until the end of November 2009.

4. At the start of the development process, it was planned to assign personnel at the MfE (using national urban development policy funding) and LEG Saar (at its own cost) with the responsibility of determining the market opportunities and identifying projects. This did not happen at the MfE/MEET in 2009; the part-time individual at the LEG Saar was not actively involved in working on the project. This is why KomCon was commissioned at the end of 2009 to analyse the quality of the identified pilot projects in regard to potential CDF funding.

5. The REFINA programmes (LEG Saar) on which the implementation process was originally based on could not be used for project identification.

6. Notwithstanding points 1 to 5, the consultants put together their own projects whose content and practicality were immediately approved by the steering group. By the conclusion of this evaluation study, however, neither the Saarland nor the LEG Saar had reached any decision.

7. The steering group quickly recognised the problems of the ‘loss’ of the ERDF funding at the end of 2009 according to the N+2 Rule and prepared a discussion on these problems with the State Secretary’s office in April 2009, but this did not take place. Between October and December 2009, the short-term establishment of a CDF as a separate accounting entity in the Saarland budget was discussed to ward off the risk of losing the ERDF funding. In the end, these efforts were not successful.

8. The use of subsidies and the administration of municipal participants in the implementation of the economic stimulus packages I and II also had a significant influence on the entire process.

9. At the start of the development process, the Association of Municipal Councils of the Saarland pointed out how much in debt the Saarland municipalities are and how much of their budgets are subject to legal supervision, which was reflected in the highly limited willingness of the responsible municipal parties to look in depth at new financial engineering instruments.

10. No capital could be planned for deposit in the CDF in 2010; the MEET was unable to commit any more of its own capital. In the middle of March 2010 the CEB offered a loan of EUR 10 million. Therefore, the following observations are based on a virtual model constructed at short notice.
All of the points mentioned above had a direct influence on the process of identifying and qualifying pilot projects, the precision and bindingness of financing models and the relevant governance models to be discussed. Therefore, the results of this study show the Saarland the additional steps for implementing the CDF.

1.4 Subject of the evaluation study

Along the lines of the approach taken in other, similarly structured evaluation studies, this study looks at the conditions for implementing a community development fund or CDF in the Saarland. It also makes concrete suggestions for the following implementation process and lays out the next steps for this.

The basis for the evaluation study was the identified projects, which were reviewed and evaluated as a proxy for their project types in each business area of the CDF. Then this combination of more or less profitable projects and their impact on the business development of the CDF was analysed from the financial perspective. Finally, diverse implementation models were discussed with the parties involved and further development steps were formulated.

As part of the development process, the steering group met a total of six times, as well as carrying out several discussions in smaller working groups or on site. An overview of these meetings and discussions can be found in Figure 1 below.

<table>
<thead>
<tr>
<th>Dates</th>
<th>Meeting of the steering group or working group</th>
</tr>
</thead>
<tbody>
<tr>
<td>02.03.2009</td>
<td>Steering group: Presentation of the consultants</td>
</tr>
<tr>
<td>31.03.2009</td>
<td>Working group: Discussion of potential pilot projects</td>
</tr>
<tr>
<td>16.04.2009</td>
<td>Discussion with KomCon regarding proposed potential pilot projects</td>
</tr>
<tr>
<td>29.04.2009</td>
<td>Steering group: Update on project search, discussion about financing possibilities of the CDF</td>
</tr>
<tr>
<td>22.06.2009</td>
<td>Steering group: Discussion about involvement of SIKB</td>
</tr>
<tr>
<td>15.07.2009</td>
<td>Working group: Discussion about project proposals generated by consultants (Mettlach site</td>
</tr>
<tr>
<td>30.07.2009</td>
<td>Steering group: Decision on project portfolio, discussion about national co-financing of ERDF</td>
</tr>
<tr>
<td>15.09.2009</td>
<td>Steering group: Financial evaluation of pilot projects, discussion about national co-financing</td>
</tr>
<tr>
<td>15.09.2009</td>
<td>Working group: Discussion about fund management and implementation process</td>
</tr>
<tr>
<td>20.11.2009</td>
<td>Steering group: Recommended actions for rapid implementation of the CDF</td>
</tr>
<tr>
<td>29.01.2010</td>
<td>Working group: Coordination and scheduling of activities in 2010</td>
</tr>
<tr>
<td>22.02.2010</td>
<td>Working group: Discussion about governance models</td>
</tr>
<tr>
<td>29.04.2010</td>
<td>Steering group: Discussion about final report</td>
</tr>
</tbody>
</table>

Figure 1 – Consulting process

The original tender for this evaluation study further stipulated an overview of the initial phase of actual implementation of the CDF, including a description and future projection of the implementation
action plan, an evaluation of the first transactions and financing activities of the CDF and identification of the necessary technical assistance and advisory services. Given the conditions described in the previous chapter (particularly the fact that the CDF has not yet been set up) it was only possible to do this to a very limited degree in this evaluation study.
This chapter takes a closer look at the planning and administrative requirements regarding urban development projects and the use of JESSICA financial engineering instruments. In 2008, the Saarland encouraged communities to develop integrated community development concepts which would guide and lead the development of the communities over a period of around 15 years. In this regard, a set of guidelines was prepared which listed the methods and content to be focused on when drafting the integrated community development concepts. The Operational Programme ‘Saarland’ for the ERDF 2007–2013 programme period sets the areas of application for the structure fund resources provided by the EU and allows the use of JESSICA financing instruments.

2.1 Integrated community development concepts

The integrated development concepts are meant to react to the impact of societal megatrends and meet new challenges. The Saarland faces enormous demographic change and will presumably lose one fourth of its population by 2050, while the average age simultaneously rises steeply. Globalisation and its side effects reinforce changes to the economic structure. This is accompanied by social change, which quickly alters the demand for housing or infrastructure facilities and creates new social problems. The repercussions of climate change alter the conditions for all economic and social activities and demand that municipal facilities be adapted accordingly.

2.1.1 Objectives

An integrated community development concept represents a comprehensive approach to formulating adaptation strategies for all areas of municipal development. It is a planning instrument with a timeline of 15 years which arranges public and private plans into one regional and urban context, while at the same time taking on a steering and controlling function. It demonstrates how synergy effects can be fostered within and between communities through the optimal use of scarce resources. The integrated community development concept therefore follows the overriding principles listed below:

• Interdepartmentally integrated approach
• Adaptations tailored to meet needs of demographic change
• Inter-municipal cooperation
• Public participation
• Sustainability

One ideal example of the structure of the concept development process can be found in Figure 2. Inventory is taken to determine the starting conditions in each municipal business area. After an analysis of strengths and weaknesses, a model for future development is designed and appropriate objectives are formulated. Then action strategies are developed, from which action steps (incl. describing the general and specific implementation modalities) are derived. The complete process should be
supported by a steering committee which encompasses all fields and government agencies, though the coordination and steering should be in the hands of the highest administrative level.

The content of the integrated community development concepts should also meet certain criteria. Regarding the problems of demographic change, it should include key information such as the compilation and evaluation of population and aging forecasts, the need for municipal facilities and building vacancy figures, as well as the coordination of infrastructure planning with neighbouring communities. In accordance with the innovation strategy of the government of the Saarland, it should support the so called "accelerating factors" (education and research as motors for innovation, more entrepreneurial spirit and company formation, cooperation and transfer of innovation, ability to compete on international scale). In reference to the 2008 climate protection concept, it should also deal with tasks in pursuit of environmental education, promotion of photovoltaic energy, making buildings more energy efficient, spreading this to non-public buildings and forming local climate alliances.

2.1.2 Action strategies

The content of integrated community development concepts is aligned toward the following action strategies. It could make sense, however, to supplement these with additional development concepts for only part of the area or specific technical concepts.

2.1.2.1 Urban planning and housing

In view of the changing demand for housing, the consideration and evaluation of building structures form the basis for the identification of new construction, restructuring and dismantling potential in the community. The quality of the surroundings, recreational spaces and design are also relevant, as living spaces and high-quality building culture determine the appearance of communities and increase life quality. Here the attractiveness of centres and inner cities is the focus of sustainable and future-oriented community development.
The key to the situation of centres and inner cities is the quality and function of their planning and design. Given the current development trends and ongoing efforts to revive local centres, new proposals should be worked out and converted into projects. Moreover, this business area also covers the topic of housing. Housing projects may not have been eligible for funding in the 15 "old" EU Member States according to the former JESSICA funding guidelines. The recent decision of the Coreper on 23 December 2008 stipulated that ERDF resources may also be used for improving the energy efficiency of existing housing. Furthermore, it is possible to finance interim property acquisition for the regulated development of a housing district, which is an integral component of this business area, through urban development funds. It is (currently) not possible to use JESSICA resources to fund any other housing projects.

2.1.2.2 Customising social and education-related infrastructure

Many municipal infrastructure projects are set for the long term and can therefore not react (by restructuring or demolishing) to problems which arise in the short term, such as the increasing population loss in many communities. Given demographic trends, communities have to support family-friendly structures on the one hand and face the challenges of an aging populace on the other.

Investment projects in social infrastructure – that is, in public amenities and parks and recreational spaces – cannot simply be planned long term but must also be "demographically aligned" and support multifunctional usage by diverse target groups. For one, they should allow more than one use over the course of the day (e.g. a kindergarten which is available in the evening for cultural events and on the weekends for church services). For another, it should be simple to completely repurpose a building when needs change (e.g. rebuilding a day care centre into a retirement home).

Projects in this business area include facilities for child care and education, adult care, recreation/play/sport, health and administration/security. The special needs of specific target groups (children/youth, seniors, socially disadvantaged, immigrants) should also be dealt with. In this regard, already existing real estate in the utilisation stage could be supported long-term by the fund.

2.1.2.3 Local business and local supply

Securing and creating jobs and maintaining the buildings of companies based in the community are fundamental tasks of the community independent of the expected demographic trends. In the scope of integrated community development concepts, the most important structural features and development potential, and obstacles, are determined and the goals and starting points for each community's business development policy are defined.

Projects in this business area are primarily focused on using the commercial development potential in the communities. This means the provision and release of commercial space reserves, the revitalisation of brownfields and the use of a sector's potential and each site's unique qualifications. They also serve as starting points for promoting local business and improving the availability of qualified workers. Moreover, they should secure the long term local supply in the geographical area. This business area therefore also includes mostly non-property-related activities as well as brownfield projects, which results in some overlap with the business area of "land funds" (see below). It might be possible to unite these two business areas.
2.1.2.4 Technical infrastructure, transportation and the environment

Similar to the situation for social infrastructure, demographic trends are expected to create the same challenges and problems for the technical infrastructure. Networks and capacities can only be adjusted to current and fluctuating needs to a minor extent and the high fixed costs for operation and maintenance do not change according to demand. Projects in this category must focus on the technical and economic optimisation of utilities for supply and removal (gas, water/wastewater, electricity and telecommunication). In this regard, the efficiency of energy and resources and the use of renewable energies play an important role. More radical changes to the plants and pipe systems require long-term planning. Transportation measures also contribute strongly to life quality (business area 1), though it is primarily possible to improve the attractive of the public transportation and its local accessibility (foot and bike paths).

2.2 The Operational Programme of the Saarland (ERDF 2007–2013)

2.2.1 Starting point

The Saarland is facing the impact of demographic change to a strong degree. The population has been shrinking for decades and will continue to do so in future, as the birth rate is well below the population replacement level and, at 1.2, is the lowest in all of Germany. At the same time, the average age and life expectancy continue to rise.

The secondary sector, primarily the steel industry and car production, make up a large part of the Saarland’s economy, which has grown better than average in the last few years. At the same time, the number of plants has diminished, especially smaller ones. In contrast, the greatest positive balance between business registrations and deregistrations has been seen over the last few years, whereby the main reason for this record is the number of registrations among the smallest group of businesses. The unemployment rate has been above the national average for a long while now.

The intensity of research in the Saarland is still well below that of the nation. Two reasons for this are the fact that the business sectors in the Saarland have little need for it and there are few company headquarters located here, and that is where the research departments are typically based. The Saarland’s innovation strategy aims to set up competence networks (clusters) in the sectors of automotive, energy, IT, “biocom” (nano- and biotechnology) and logistics, all of which are to be interlinked through one knowledge cluster.

In regards to the urban perspective, the Saarland is in a special situation. In addition to the sole regional centre, the capital city of Saarbrucken, there is a series of medium-sized centres, though all of these have fewer than 50,000 inhabitants. Furthermore, the urban structure is polarised between the centres in the Saarbrucken conurbation tied to the coal and steel industry and the more rural centres in the northern part of the Saarland. Social problems primarily arise in the Saarbrucken metropolitan area (unemployment, crime, social distinctions). The ratio of immigrants to non-immigrants is below the national average. With the exception of a few neighbourhoods in Saarbrucken, Neunkirchen and Völklingen, there are also no extremely high concentrations of foreigners in single neighbourhoods in the Saarland.

Companies’ investment in construction is primarily dependent on the immediate availability of developed commercial and industrial land; critical factors in this regard are disturbances from more
traffic and from production-related noise. Against this backdrop, the Saarland's efforts to revitalise land and abandoned industrial sites are viewed positively.

2.2.2 Previous ERDF funding

Part of the basis for planning the 2007–2013 Operational Programme are the results of the former ERDF funding. These are based on the updated half-time evaluation of the Objective-2 programme 2000–2006, the 2005 annual report and, due to including the content of the URBAN community initiative in the goal "Regional competitiveness and employment", the 2005 annual report of URBAN 2000–2006, which should be integrated in future into the goal just named. Within the scope of funding Objective-2, the Saarland received European Structural aid during the 2000–2006 programme period totalling around EUR 178 million (ERDF and ESF).

Using the structural data, the half-time evaluation, which is an important component for checking the results of EU Structural Fund intervention, proves that the Objective-2 area, and particularly the Greater Saarbrucken Area still shows considerable structural weaknesses. Point 1 "Modern infrastructure – Capable business" funded several practical business and tourism infrastructural projects important to structural policies, the strengthening of technological transfer between science and business, and environmental projects to support sustainable development. Point 2 "Restructuring business – Alternatives to coal and steel" encompassed the funding of commercial businesses, including start-ups, of technology for SMEs, of commercial tourism and of one ESF measure. Once the European Union named "sustainable urban development" as one focus of structural policies at the end of the 90s, the funding of disadvantaged urban areas was introduced to Point 3 "liveable urban structures" for the first time. This includes innovative approaches to funding urban problem areas within the scope of integrated concepts. The "support of disadvantaged urban neighbourhoods" measure was provided with EUR 15.893 million and linked contextually and financially to the "Integrated urban development programme for urban problem areas in Saarland – City Vision Saar".

The update to the half-time evaluation made important recommendations which already set the course for future EU Structural Fund programme periods:

- The funding of the entire research and development area should continue at the same high level; so far this funding area has made an extraordinarily important contribution to achieving the primary goal of the programme, the achievement and shaping of regional structural change.

- The funding of infrastructure – commercial areas, transportation infrastructure, tourism infrastructure – also made a positive impact. The large projects still in conception should be implemented without delay.

- Given the limited demand for it, the funding of SMEs had only yielded average results. Efforts should continue to be made to use the available resources to fulfil their purpose because this has a twofold effect: For one, it supports the investment activities of SMEs; for another – and this is important from the structural policy perspective – the measure triggers innovation processes and the foundation of new companies, which together strengthen the competitiveness of medium-sized companies in the Saarland.
• The aim is noticeable improvement in the living and housing situation in the programme areas being funded. Innovative projects – investment measures flanked by social activities – have been the impetus for boosting motivation to see that the neighbourhoods thrive over the long term. The projects also benefit strongly from being incorporated into overall urban development projects.

• One important criticism of the implementation of the Objective-2 programme to date is the insufficient involvement of women. They enjoy fewer of the benefits of the programme, especially the creation of new jobs.

The results of the updated half-time evaluation of the 2000–2006 Objective-2 programme show that there is a need for structural policy intervention beyond the program period. To prevent potential disruptions and overcome the outstanding or foreseeable structural distortions, the region continues to need outside support to be able to advance its further development. In addition to the concentrated implementation of the innovation strategy developed for the Saarland, which is the key to mastering the structural change, two issues will play an important role in future: strengthening the corporate sector and the sustainable upgrading of locales.

In terms of specifying the instruments to be used, it has been determined that the previous spectrum of funding has proven successful, though it should be augmented and rounded out with additional instruments in some areas.

2.2.3 Goals/distribution of resources of the Operational Programme ‘Saarland’

The content and goals of the Operational Programme ‘Saarland’ for the ERDF 2007–2013 programme period are oriented toward the content and alignment of the National Strategic Reference Framework for the EU Structural Funds in Germany, the Lisbon Strategy and the Gothenburg Strategy. The "Regional competitiveness and employment" goal (Article 5 of the ERDF Regulation\textsuperscript{4}), which is relevant to the Saarland, was broken down into three specific goals.

2.2.3.1 Strengthening and diversifying the Saarland’s economy

The goal of "Strengthening and diversifying the Saarland's economy" is primarily focused on the creation of replacement jobs outside the coal and steel sector. This should primarily be accomplished by supporting start-ups and comprehensive funding for medium-sized businesses and accompanying company suppliers, and also includes financing assistance.

The competitiveness of existing companies should be strengthened to offer the companies positive opportunities to develop, especially in view of the loss of thousands of jobs in the coal and steel industry over the last few years. The greatest challenge to the Saarland's structural policies is currently the creation of replacement jobs outside the coal and steel industry.

In remains a goal to increase the number of companies established through the use of innovative instruments especially for this purpose. In addition to start-ups, the medium-sized companies are also among the engines of growth and jobs. The medium-sized companies represent about three quarters

of jobs in the Saarland, though at the same time they face considerable financing problems. For this reason, funding medium-sized companies around the Saarland should be granted a singular role.

It should therefore be made easier for particularly small and medium-sized companies as well as start-ups to get the capital they need through financing and investment assistance of various kinds tailored to their needs and thereby promote their business activities.

The services sector plays an ever greater role as an employment engine in the Saarland. The tourism industry holds special significance in intensifying structural change. The aim is to continue this path, which has proven so successful for employment and competitiveness, over the next few years and to help the development deficit still present in the momentum of number of overnight stays to catch up to the national average.

### 2.2.3.2 Enhancing competitiveness through innovation

The goal "Enhancing competitiveness through innovation" focuses on using knowledge, research and development, as well as innovation, as the core elements of growth and socio-economic development. The aim is to increase research competence in the Saarland and strengthen innovation at various levels. In terms of giving the Saarland as a new direction, this specific objective holds extreme importance.

Here the Saarland places special emphasis for its future-oriented alignment on a balanced mix between old and young industries and between established technologies and new innovative areas. This depends on the Saarland making additional project-related and technology-specific financing opportunities available.

### 2.2.3.3 Making the region more appealing by improving the profile of its location and business environment

The goal "Making the region more appealing by improving the profile of its location and business environment" focuses on improving the region through tourism and urban development.

The planned steps to improve the quality of the region have to meet the diverse needs of the various challenges facing the Saarland. It is particularly important to overcome the specific development bottlenecks and obstacles at the diverse levels and use existing development potential for the further improvement of the region. This focuses on four business areas:

- Improving the competitiveness of cities, also as a trigger for regional development
- Handling the consequences of demographic trends, especially the age-related changes in the populace and migration
- Battling social exclusion through better access to jobs and education
- Renovating buildings and renewing the environment to ensure the sustainability and attractiveness of the cities
2.2.4 Priority axes

The Operational Programme for the new “Regional competitiveness and employment” goal of the ERDF will be promoted by the following three priority axes once they have been coordinated with the government of the Saarland and with business and social partners:

- Promoting competitiveness through growth and entrepreneurial measures to reinforce the enterprise base,
- Stimulating structural change through knowledge-based business, innovation and development of specific strengths,
- Sustainable urban and regional development and resources protection

The interdisciplinary goals of "Environment" and "Equal opportunity/Non-discrimination" are pursued within all three priority axes.

2.2.4.1 Priority axis 1: Promoting competitiveness through growth and entrepreneurial measures to reinforce the enterprise base

Priority axis 1 encompasses enterprise-related funding with a planned volume of ERDF resources for the 2007–2013 programme period of EUR 59.965 million (30.36%).

- **Boosting entrepreneurship – the Saarland Offensive for Start-ups (SOG)**
  
  To offer entrepreneurs the best possible assistance, the government of the Saarland started the Saarland Offensive for Start-ups (SOG), a regional network including all institutions and agencies in the Saarland which offer assistance to entrepreneurs. The SOG is to be expanded and enhanced through new components. Projects to promote entrepreneurial initiatives and capabilities should be carried out, whereby the supply of coaches for entrepreneurs should be increased alongside public financing help.

- **Modern instruments for business funding**
  
  The need for financial assistance in the form of the modern financing instruments and business funding as an investment should be better met to grant companies access to the financial resources necessary to establish and expand businesses and thus for their growth. The focus here is on support during particularly risky periods, e.g. the development of innovations, modernisation, start-up and establishment or expansion. In addition to investment grants for companies in commercial sectors and tourism, financial aid in the form of loans, guarantees and equity is foreseen.

- **Business services and measures to improve the business environment**
  
  In particular, start-ups and young, growth-oriented businesses need a supportive environment for their development. Specific enhancements are planned to close the gaps in supply and in reaction to the again growing demand for space, property and business services coming from start-ups and young growth-oriented and technology-oriented businesses. The business environment should also be strengthened through regional and interregional collaboration between business and research partners and institutions. A funding programme is to be set up, e.g. for networks and clusters which promote the building of inter-
company structures and which funds the resources to handle network or cluster management.

2.2.4.2 Priority axis 2: Stimulating structural change through knowledge-based business, innovation and development of specific strengths

Priority axis 2 encompasses a planned volume of ERDF resources for the 2007–2013 programme period of EUR 64 million (32.40%).

- **Knowledge-based and business-oriented R&D capacities**
  
  One major focus of priority axis 2 is the increase of R&D and innovation transfer capacities in the research landscape of the Saarland with a concentration on the expansion of infrastructure, especially in the areas of IT, automotive and biotechnology and life sciences. Following the principle of "strengthening strengths", this axis foresees defining topical areas with the partners who are well-established in the innovative landscape of the Saarland.

- **Innovation clusters, competence centres and innovation transfer**
  
  It is intended to set up competence centres and innovation clusters for particularly topical issues. The aim is to take into account the "variable geometries" of innovation transfer and to be able to offer a suitable solution for each specific industry or technology-related problem. The promotion of technology platforms, competence centres and innovation clusters should be just as possible here as the provision of new types of financing instruments for collaborative projects between science and business. Cooperative agreements and the transfer of knowledge and technology should continue to be supported long-term.

- **Strengthening the entrepreneurial innovation base and competitiveness**
  
  The question of how to be able to generate innovation is initially closely linked with the problem how companies approach the topic of research and development. To change awareness and behaviour, it is necessary to address the management level in the appropriate way. A cornerstone of innovative companies is having leadership which values flexibility in organising one's work, co-determination and shared responsibility. Appropriate innovative measures and optimised innovation management has to be developed for this, before a company can become more innovative. To achieve this objective, the R&D funding landscape in the Saarland will be realigned. For this purpose, new instruments for technology-specific and topical promotion and financing should be developed and tested.

- **Culture of innovation, qualification and access to information and communication technology infrastructure**
  
  Since the regions also compete with each other, a targeted communication strategy is also a key component of innovation policies. Therefore, a continuous communication process should be set up which emphasises the innovation strategy of the Saarland over the medium to long term. For this purpose, the Saarland intends to further develop the "Empower Germany: Through innovation we can withstand the growth crisis" initiative successfully begun in 2004.
  
  High-quality information and communications technology infrastructure is becoming increasingly more important for the innovativeness and the structural change of the Saarland. For
this, the regional government intends to further expand and intensify the "Onlinerland Saarland" campaign. In the sense of an entrepreneur-oriented e-government, the Onlinedienste Saar initiative is to be further strengthened and expanded in the Saarland.

- "Testing Ground"

An indicative amount of EUR 2.5 million has been allotted to the experimentation of new actions (projects and concepts) under priority axis 2. The aim here is to test projects and concepts and to determine the successful projects which can be carried out on a more comprehensive basis in later years of the Operational Programme. The results of these pilot actions will be analysed and, once the results are known, the successful actions will be further developed within the scope of the priority axes of the Operational Programme.

2.2.4.3 Priority axis 3: Sustainable urban and regional development and resources protection

Overall, this priority axis deals with enhancing the appeal of the cities and the region as a place to live and do business by improving the "soft" factors.

Priority axis 3 encompasses a planned volume of ERDF resources for the 2007–2013 programme period of EUR 68.547 million (34.71%).

- Sustainable urban development

The support of sustainable urban development as an important engine for necessary structural change is given considerable importance. In this category, the successful methods seen in the 2000–2006 programme period should be further developed, taking the experience gained into account, and incorporating the integrated approach of the URBAN II community initiative. Therefore, it should tackle the strong concentration of business, environmental and social problems in the urban areas applying participative, integrated and sustainable strategies.

To further strengthen the cities, a bundle of measures will be worked out and implemented in the 2007–2013 programme period to tackle each individual urban situation. In this regard, the large "Stadtmitte am Fluss" project should be carried out in particular with ERDF funding. The Saarland intends to submit a corresponding application for approval by the EU Commission. Once this approval is granted, the ERDF resources provided for sustainable urban development will be primarily concentrated on the regional capital.

- Development of tourism infrastructure by enhancing natural and cultural heritage to foster additional potential for growth

The further development of tourism infrastructure offers the special opportunity to foster and use the endogenous potential and natural abundance of the region through and for tourism. This makes it possible to tap into existing growth potential in tourism in the Saarland and have a positive impact on employment. Moreover, the Saarland has always balanced the development and promotion of its tourism with the protection of environmental policy concerns.

The aim of funding infrastructure in the Saarland is especially to strengthen the potential for tourism inherent in each area and region. In this regard, on the one hand, it is necessary to further develop the existing tourism strengths. On the other, improving tourism offers op-
opportunities to showcase the interregional natural and cultural heritage in the long term, especially in the rural areas.

- **Development of future sources of energy and resource protection**

  For reasons of environmental and climate protection, it is necessary to find sustainable energy supplies. For this purpose, new technologies need to be developed and demonstrated, and business operations must tackle some more sophisticated technologies. This is why plans for saving energy, for the rational usage of energy, and for the market penetration of renewable energies and the development of new processes and innovations in this area should be funded.

### 2.2.5 Coherence between the Operational Programme and the JESSICA initiative

In terms of content and instrumentation, a JESSICA-based community development fund fits well into the existing Operational Programme of the Saarland. Connections to the JESSICA initiative can be made in all of the listed objectives of the Operational Programme.

For the objective of "strengthening and diversifying the Saarland's economy", the medium-sized businesses in the Saarland should be supported comprehensively and the region's competitiveness enhanced. Due to the often occurring financing problems facing medium-sized companies, financing and investment assistance tailored to their needs should simplify the companies' access to the necessary capital. Less expensive loans, guarantees and equity investments from the CDF can make it possible for medium-sized companies to obtain capital more easily and thereby support this objective.

Additional project-related and technology-specific financing opportunities should also be provided towards the objective of "enhancing competitiveness through innovation", in order to augment research competence in the Saarland and to strengthen innovation on many levels. The instruments of the CDF expand the range of existing financing possibilities and make it possible to focus on individual projects and technologies.

Funding through the CDF is only possible on the basis of integrated urban development plans, meaning that the third objective of "making the region more appealing by improving the profile of its location and business environment" is also accounted for. By reacting to the market failure in the area of urban development policy projects, existing potential for further developing the region is exploited.

Similar to the objectives of the Operational Programme, there are also links between the priority axes and the JESSICA initiative. In priority axis 1, the typical instruments of a CDF (loans, guarantees, equity investments) as means of promoting business and tourism are explicitly mentioned in the point “Modern instruments for business funding”. Furthermore, within the scope of priority axis 2, new instruments for technology-specific and topical promotion and financing are to be developed and tested to strengthen the entrepreneurial innovation base and competitiveness, which is in turn a category that would fit the instruments of a CDF. Moreover, the access to information and communications technology infrastructure should be improved, which is also a possible business area for the CDF. The contents of priority axis 3 match the objectives of the JESSICA initiative – countering the strong concentration of economic, environmental and social problems using participative, integrated and sustainable strategies. In addition, the special significance given to sustainable energy supplies (energy savings, market penetration of renewable energies) is emphasised.
All-in-all, the content and instruments of the JESSICA initiative are already built into the Operational Programme of the Saarland for the ERDF funding in the 2007–2013 programme period, even though the actual application of the JESSICA initiative had been left open. Implementing the Saarland Community Development Fund would therefore automatically also pursue all the objectives and all the priority axes of the Operational Programme, which makes it more likely to achieve the objectives.

2.3 Evaluating the market for municipal and urban development projects

Cities are the heart of any economic centre. Half of the population in Germany lives in cities, which offer the majority of jobs and thus generate the greater part of net added value. The sustainability of urban development measures can only be ensured, however, through close cooperation between the administration, businesses and citizens. Urban and economic development are tightly linked, and any economic structural change has a direct impact on city planning structures as well. To face these common challenges, there is a need for durable strategic alliances between cities (city administrations), businesses and citizens rather than hastily constructed associations during emergencies. For this purpose, suitable forms of cooperation have to be found and set up, which requires all parties to change and develop the way they work somewhat.

For a long while, urban development was the sole domain of the public authorities, who almost exclusively used the traditional regulatory instruments to offer services to citizens and businesses. Profound changes, both economic and societal, made it necessary to critically question this approach. On the one hand, the demands for public expenditure growing, becoming more complex and have to be handled more timely and tied more closely to specific projects and their implementation. On the other, serious budgetary constraints are pushing municipalities to the limits of their planning capacities and financial possibilities and putting them on the defensive – in some cases being all but unable to act. The public sector is now reliant on cooperation with investors and other actors at the planning and investment level. Cooperative forms of action which transcend legally formalised planning processes have become much more important at all levels of urban development. Because of this trend and the multitude of actors to be involved, the spectrum of potential forms of cooperation has expanded significantly; from informal instruments to contractually regulated approaches to public-private models. Since the start of the 80s, public-private partnerships have gained stature, especially for larger urban renewal and urban development projects whose success in the medium to long term depends primarily on the extent to which they can be a win-win situation for all parties. Moreover, strategic partnerships between municipalities and businesses form the basis of concerted economic actions, property and community associations are a new kind of city marketing, corporate citizenship is a new understanding of community responsibility on the side of companies and citizens, and integrated housing concepts form the foundation for dealing with shrinkage in urban areas. Nonetheless, these innovative instruments and approaches suffer from the low availability of public resources.

From this situation, it has become clear that holistic, sustainable, and future-oriented urban development cannot simply be decreed from above. The permanent nature of the problems facing urban development (overly strained public budgets, fewer employees in the public sector, less tax income, less economic growth, declining purchasing power, vacant retail outlets, and the demographic change which accompanies shrinkage and suburbanisation) require professional collaboration between all parties involved. To the same extent, changes in the role of the public sector as the central
steersman of development and any shifts in focus from issues of general welfare to individual eco-
nomic interests must be critically watched.

Because of this development, the former principles of funding policies need to be examined. The in-
clusion of business management know-how in project conception should be welcomed because of
the greater demands on how efficiently the funding is applied. To the same extent, very few non-
profit activities should be allowed to operate at the commercial “breakeven level”. By allowing pro-
ject management organisations to conduct supplementary, commercial business enterprises in fu-
ture, these might help to financially support the primarily non-profit activities (cross-financing). If this
change in the methodological perspective should become part of the basic principles behind German
funding policy, it would be even easier to incorporate the financial engineering instruments propa-
gated by the JESSICA initiative into the funding of urban development projects.

2.3.1 Current financing possibilities (public and private sector)

Investment projects in city planning are borne, financed and carried out by the public and – primarily –
by private individual investors or institutions. The condition for public investment in municipal or
state construction projects, or other projects, insofar as they are subject to the broad definition of
§ 148 of the German Federal Building Code (BauGB), is that they be financed from the public re-
sources of the manager of that construction measure plus the relevant benefits/funding from other
public agencies. Therefore, municipalities, for example, facing the pressure of budgetary bottlenecks
which were years in the making and the present financial and economic crisis, are usually only able to
invest once the corresponding (and much greater part of the) funding from other public agencies has
been approved and made available. However, the ability of municipalities to perform their financing
obligations by putting forth their own share of the financing is equally important. When the budgets
are not balanced – which is the case for most communities and cities in the Saarland – it is mainly
necessary for them to provide their share of the financing through loans, and these are subject to
more restrictive regulatory approval. This is one of the reasons why municipal investment has clearly
and considerably dwindled. In addition to the overall economic situation, the basically negative
demographic prospects in terms of shrinking populations and the composition of the population of
the Saarland have also had an impact here. For example, the population of the Saarland is projected
to decline from 1.0 million at present to 870,000 in 2030\(^5\).

Private investment is mainly interested in profitable, going concern real estate, such as housing pro-
jects, especially commercial projects, as well as shares in hotel and office projects; these occur in
those subregions or submarkets of the Saarland where the population density is stable and/or link-
age effects create enough demand. Under the planning premise of “internal development before ex-
ternal development” and the need to focus on additional services within the scope of the preference
for reusing land, as already proscribed under § 1(6) BauGB, such projects often rely on public subsi-
dies to reduce or cover the unprofitable part of the investment. According to the rules of the respec-
tive urban development funding based on the urban development administrative agreement for each
programme year and the corresponding implementation guidelines of the Saarland, public sector
bodies are usually the only ones approved for receiving funding. When needed, they pass such fund-
ing on to private partners in the form of urban development contracts and/or funding agreements.

\(^5\) Statistical Office of the Saarland (2004): The demographic trend in the Saarland, taken from
The fact that public aid and urban development funding from the state is not received until after the measure has been carried out and (partly) billed is particularly relevant here. Therefore, in pre-financing their own part of the funding, the municipalities are responsible for a considerable part of the subsidies received from the funders. In cash terms, the funding to be raised is of much less value over time than the gross amount initially provided. As in all states, the allocation and approval of funding is primarily handled by administrative category. Consequently, this means that urban development plans are initially reviewed in terms of how they fit classic urban development funding goals (modernisation, maintenance, enforcement and redevelopment measures, etc.) and thus it is important to present combined measures which also have a positive impact on environmental protection, energy efficiency, CO₂ reduction and business development. In any case, public funding is subsidiary, so that urban development funding should be used to “fill in the funding gaps”. Nonetheless, urban development funding is the most important funding source for public or private urban development projects. However, in regard to private project managers, the general stipulations tied to the use and the proof of disbursement of funding and the problems in their internal booking and their internal investment accounting created by the fact that only part of the gross amount received is tax deductible means that such funding is only partly an incentive, and it represents a considerable bureaucratic obstacle to be overcome.

In practical terms, the priority for urban development funding in the Saarland mainly directed by the municipalities, according to § 147 BauGB (enforcement and redevelopment measures, etc.) goes to projects which are not inherently profit generating on a revolving basis. The exception is urban development funding of the maintenance and modernisation measures for predetermined rural areas in accordance with § 142 BauGB (redevelopment areas) and urban development areas (pursuant to § 171 b BauGB) based on §§ 164 a ff. BauGB and following municipal guidelines for allocating funding to private parties in individual cases.

Interdepartmental cross-financing with analogous interdepartmental “cross-funding” using instruments which commit multiple departments are relatively rare because of the complexity of setting up such transactions and the problem of only being able to obtain the funding if the project has not been started yet (contradictory to funding effect).

2.3.2 Project managers’ financing needs

While public sector bodies – as shown – focus their investment mainly according to measures which fit § 147 BauGB and only partly offer financing for measures which fit § 148 BauGB (municipal constructional measures), private partners in urban development projects have completely different financing needs. In addition to minimising costs when constructing buildings and principally when purchasing or acquiring land, their main interest in terms of costs is the borrowing costs. The tax component is equally important for private partners – each organised as a private legal entity (the various forms of partnerships and companies, with varying degrees of liability). The pertinent point for the private actors here is to be able to deduct their implementation costs under the asset depreciation rules and, at the same time, that the responsible tax authorities allow them to deduct the input taxes included in these costs or expenses. Particularly when a private actor incurs the unrecoverable expenses for parts of a construction measure, such as the initial land improvement, the regulations of the Federal Fiscal Court (the Bundesfinanzhof) – and as implemented by the local tax offices – for the construction of roads, paths and public spaces (investment according to § 127 ff. BauGB) do not
allow or only partially allow the deduction of input taxes. In some cases, this minimises the gross subsidies provided by the public sector to a considerable degree. For these reasons, private investors in urban development attempt to financially and in part organisationally (through project companies and property companies) separate the initial project development stage, including the land acquisition, clearing and partial improvement, from the stage of building investment. It can often be seen that project developers do not benefit from the full extent of subsidies/grants from the public sector in terms of the subsequent cash value. Consequently, there are fewer and fewer projects where the (lost) subsidies lower the market entry and investment barriers to the wished for degree.

In order to lower project risks and improve chances of market entry, private investors not only need to conduct a careful analysis of (rental) market demand and the opportunities for exiting the project (by being bought out); better conditions for the amount of capital they put up and the borrowing costs are also crucial to their decision. Following the Basel II rating, project developers and project investors are increasingly required to raise their capital base for the project from the original average of 15–20% of total investment to the current average of 30–40%, and this is while facing the financial and economic crises. This situation is currently limiting the market activities of private actors overall and especially in weak real estate submarkets and regions. Therefore, there would be a financial advantage for private actors if it was possible to replace or augment capital through a public fund or public grant. Subsequently, guarantees and low-interest loans, coupled with the borrowing costs which would otherwise have to be refinanced over the borrower’s bank, are decisive.

Since real estate activity in the Saarland is limited in some areas, especially the housing, hotel and office construction submarkets, due to the financial and economic crisis and the aforementioned demographic trends, in terms of financing, private actors are more interested in guarantees and loan conditions to hedge rental demand than in refinancing the implementation and building construction expenses. Therefore, private actors’ financing measures are primarily aimed at hedging rental and user demand (e.g. hotel development) and/or optimising the energy and environmental conditions of a property. Urban development funding aid programmes do not generally foresee this usage. In other words: a (lost) grant to a project investor does not hedge it against the operating risks for a property in the event of user or renter default.

Due to the primary allocation of urban development funding to the role of the “owner”, this means potentially achievable effects end up in smoke, because the financing needs of tenants – borne indirectly by the investors – cannot be met.

The qualification process for building projects – currently being discussed under the topic of green building/certification and the generally accepted necessity to optimise energy efficiency and reduce CO₂ emissions– usually does not allow developers to make the additional expenses for systems and facilities to generate energy from renewable sources for the property a subject of urban development funding. The same is true for optimising telecommunication and data technology. While urban development funding is tied to entire regions, other funding instruments are mainly limited to the role of the owner. There is frequently no congruity between the market demand for sustainable, energy efficient real estate and a refinanceable tenant mix.
During the process of identifying projects suitable for CDF funding in the Saarland, it became clear that there is a tight market for urban development projects, strongly aligned toward traditional subsidisation. While conducting the project discussions on site (page Figure 3), it was only possible to identify suitable projects to a limited extent because the available information was not (yet) sufficient to evaluate the project for CDF funding. This is why KomCon was commissioned at the end of 2009 to prepare the five most promising projects for such an evaluation. The projects in the Saarland can be broken down into two groups. On the one hand, there are projects which need less investment and which have few possibilities of generating financial returns. On the other, the development of larger brownfield sights is under discussion, which require enormous upfront financing (demolition/removal, decontamination, restructuring) and whose chances of future returns can hardly be estimated.

### 2.3.3 Addressable market failure and potential role of JESSICA instruments

It was already explained in the previous chapter that, given the economically motivated position of private actors, they seldom invest in urban development projects except for a few regional or use-specific real estate submarkets. These (still) typical submarkets in the Saarland generally refer to the commercial segment and mainly to certain regions in the state. Private actors are also engaged in the areas of setting up and improving telecommunication and data technology structures and optimising the energy efficiency of buildings; however, this cannot be expected for specific neighbourhoods. Thus, the primary investment in setting up site-development facilities, clearing land, and strengthen-
ing and increasing the attraction of public spaces, as undoubtedly realised by urban development funding, decreasingly leads to investment in upgrading adjacent private property and land.

This ‘market failure’ seen here is really more of a ‘market decrease’ of private investment. Considering the demographic change and the changing consumer habits, demand parameters and financing opportunities resulting from the financial and economic crisis, there is therefore a need to stimulate market demand in future, not only using the lost subsidy components, whose net effect has been shown to be considerably less than the gross amount made available, but also by providing financial engineering instruments in the form of (low-interest) loans, guarantees and equity with the prospect of success. Because of the financial weakness of the municipalities and their agencies, this concerns the private urban development partners more. On the path to the desired market deregulation, this is an inherently desirable social investment phenomenon. The JESSICA instruments, i.e. loans, guarantees and equity, thus materially supplement local market events in those places where the lost subsidies – the second public source of intervention – might have been offered. Although the commercial and some residential real estate submarkets in the Saarland can be called A-list projects, completely supported by the private market, alignment toward the ‘office, hotel and social infrastructure’ real estate submarkets, together with investment in energy and data technology optimisation for specific properties, is a decentralised focus for the use of urban development funds (B-list projects).

Based on integrated community development concepts, there is a structural framework (‘integrated urban development plan’) within each municipality. The targets for receiving aid in the form of JESSICA instruments in the Saarland should thus be the municipalities and their agencies as well as public/private companies and partners from the private market.

As earlier studies have already made clear, the JESSICA instruments (loans, guarantees and equity) all feature the use of revolving resources. In contrast to loans and their related guarantees, for which repayment is periodic, the repayment of equity capital investment is usually done once from the sales proceeds upon exiting the project. This makes it possible to cover the much higher costs of capital. Equity capital investments are the only instrument where the investor maintains far-reaching influence in the project, the capital invested in the project has a maximum leverage effect, and the investor participates in equal parts in both the project risks and the chances of profit. Additionally, it is only through the use of equity capital investment that the risk of so called “crowding out effects” can be limited, which makes it easier to review a project’s eligibility for aid. Moreover, there is normally not enough equity capital available for development projects, which regularly results in market failure, i.e. those projects are not carried out.

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8 When equity capital is granted as a dormant partner’s interest, this only applies to a limited extent.
3 LEGAL CONDITIONS FOR IMPLEMENTING THE SAARLAND COMMUNITY DEVELOPMENT FUND

The general legal framework regulating the investment and financing activities of a CDF are described herein. Any specifics tied to particular pilot projects – based on information available today – are laid out again in Chapter 5.3. Due to the current status, this does not represent a conclusive legal analysis. Therefore, the following legal framework must be considered in the conception and further implementation of the CDF.

A look at the legal framework first considers the rules specific to Structural Funds. Then there is the general legal framework set up by European and national provisions, which established the borders within which a UDF can be set up and operate.

3.1 Structural Fund Ordinances and COCOF Notes

The general regulations regarding UDFs, which, like the planned CDF, are based on the JESSICA initiative, can be found in the EU Structural Fund Ordinances (Regulation (EC) No 1080/2006, 1083/2006 and revisions to such). Their programme period currently runs from 2007 to 2013. The relevant legal provisions therein form the European legal framework for JESSICA, though only the core provisions will be repeated here. The publications of the Coordination Committee of the Funds (COCOF) and any subsequent revisions to the relevant regulations must also be taken into account.

3.1.1 Reg. (EC) No 1083/2006 (General provisions on the Structural Fund and the Cohesion Fund)

Regulation (EC) No 1083/2006 contains rules, regulations and general principles for the ERDF, the European Social Fund (ESF) and the Cohesion Fund. The goal of the ordinance is to strengthen economic and social cohesion to promote harmonious, well balanced, and sustainable community development during the 2007–2013 programme period.

The ordinance sets up a framework within which cohesion policies can be carried out, and sets individual goals for the diverse funds to achieve. Moreover, the ordinance lays down criteria for which Member States and regions are eligible for funding, sets out how much financing is available and describes the criteria for its allocation.

Articles 36, 44 and 78 of the ordinance are especially relevant here. In terms of how to structure the fund, we look to Article 44, which lists the approved financial engineering instruments, opens the fund to holding models and stipulates how to set these up, particularly how to apply public procurement law. Article 78 regulates the declaration of expenditure and state aid legal classification of fund trading.

Another crucial regulation for contributing resources is the N+2 Rule pursuant to Article 93(1) of Regulation (EC) No 1083/2006. Here it is set down that the EU funding committed to an Operational Programme must be automatically decommitted on 31 December of the second year after the commitment was made as long as the resources have not been called upon by advance or interim payment or an approved request for payment has been submitted. The financing tranche stipulated in the Operational Programme for that year commits the capital in the EU budget and has to be called upon by 31 December of year n+2. In terms of how the cost reimbursement principle applies, this means that the expenses in fact have to be paid before they are reimbursed. Since placing the re-
sources into a JESSICA fund counts as spending it for the specified purpose, the N+2 Rule no longer applies after the point at which the money is paid into the fund. In regard to the CDF to be set up in the Saarland, the decisive point is that the fund must be implemented by 31 December 2010. This would prevent the loss of the resources. Nonetheless, the money must then after be used for the specified purposes and the fund has to spend it by 2015; otherwise, it will be in breach of Article 1(7) of Regulation (EC) No 1083/2006. Any EU monies not spent by the end of the programme period have to be repaid to the EU. This must be borne in mind as the project selection is further structured and the during the actual investment activities of the fund.

3.1.2 Regulation (EC) No 1080/2006 (ERDF Regulation)

Articles 4 and 5 of Regulation (EC) No 1080/2006 initially lay out the diverse areas approved for investment depending on whether the goal of the Operational Programme is “convergence” or “regional competitiveness and employment”. The resulting guidelines for the existing Operational Programmes thus mainly cover the use of ERDF money within the scope of JESSICA funds. The relevant goal for the Saarland is “regional competitiveness and employment”, according to Article 5 of this same regulation.

Article 7 of this regulation specifies the types of expenses and excepts certain types of ERDF funding, thereby limiting the possibilities laid out in Articles 4 and 5.

Article 8 of this regulation basically expands the areas of application listed in Articles 4 and 5 as they apply to the “sustainable urban development” goal once — as has happened in the Saarland — the Operational Programme has been opened accordingly.

3.1.3 Regulation (EC) No 1828/2006 (Implementation Regulation)

This ordinance contains the main regulations for the financial implementation of the CDF models. Of particular relevance are the regulations in Section 8 – Financial measures (Articles 43, 44, 45 and 46), which show how to apply Regulation (EC) No 1083/2006 to a fund. It includes detailed guidelines on setting up and using financing elements (administrative costs, business plans, appropriate of earnings). Moreover, it lays out special requirements for holding funds and UDFs.

In basically expounds on the so called Rule 8 guidelines from the abolished Regulation (EC) No 448/2004 for the programme period coming to an end. In principle, these are the already known guidelines for setting up funds. Regulations were added for holding funds and UDFs, including, but not limited to, the following conditions of use:

- Revolving usage of funding which also extends beyond the end of the programme period to the advantage of urban development projects or to fund SMEs (Article 78(7) of Regulation (EC) No 1083/2006). It recommends that the funding be used in pursuit of the Operational Programme’s goal (cf. COCOF 08/0002/03-EN, pg. 4).
- Setting up the fund as an independent legal entity ... or a separate block of finance within a financial institution (Article 43(3) of Regulation 1828/2006, modified by Article 43(2) of Regulation 846/2009).
- The UDF, not the company, is the beneficiary. This means that the resources can be granted to the fund without proof of already having been spent. Payment to the UDF counts as an
expense and does not have to be accounted for until the end of the programme period (no application of the expense reimbursement principle at the fund level). It is possible to invest the ERDF resources profitably in the interim. This has the advantage that interest can even be generated in the fund, increasing the capital.

3.1.4 COCOF Notes

According to Article 103 of Regulation (EC) No 1083/2006, the Commission is supported by the COCOF as the coordinating committee for the fund in terms of applying the regulation guidelines. The committee develops tips for practical application, for public administrators, beneficiaries, potential beneficiaries and other agencies involved with the supervision, control and implementation of cohesion policies. It supports these groups in the correct interpretation and application of community legislation in the area of cohesion policy. The COCOF Notes do not have any legally binding effect on these guidelines, neither for the Commission nor the other users and affected parties. Thus, neither the CDF nor the Saarland, as the recipient of ERDF resources, is directly obligated. The COCOF Notes explicitly do not pre-empt interpretation by the ECJ and the Court of First Instance nor the ongoing decision-making practices of the Commission. Even though the Commission is not bound to the interpretations laid out in the COCOF Notes, it shall not deviate from the published perspective without substantive reason.

The interpretations especially relevant to the application of JESSICA are contained in the two Guidance Notes on Financial Engineering from 2007 and 2008 and the Guidance Note on the Eligibility of Energy Efficiency Measures and Renewable Energies for Funding by the ERDF and the Cohesion Fund in the Construction Sector (including housing).

3.2 Operational Programme

The Operational Programme ‘Saarland’ (ERDF 2007-2013) pursues the goal of “regional competitiveness and employment” according to Article 5 of Regulation (EC) No 1083/2006. Pursuant to Article 37 of the same regulation, it contains the strategic framework for the use of funding. In particular, it lays out an analysis of the current economic situation in the relevant regions, a list of funding needs and the funding strategy, a breakdown by priority axis, the individual funding measures, and a financing plan. The Operational Programme already includes reference to the JESSICA initiative and reaffirms the intention to use this to support sustainable urban development (see Chapter 0).

3.3 Budget Law of the Saarland

The budget law of the Saarland is only relevant insofar as it does not contradict European law (European law holds precedence). The restrictions included in the budget law on the acquisition of shares in companies organised under private law are especially important. For example, § 65 of the Budget Provisions of the Saarland (hereinafter referred to as LHO) lays out the conditions under which the state may invest in a company organised under private law. Since the planned CDF will be set up as a venture capital fund with its own legal entity, these guidelines play a central role in both the establishment and the activities of the fund. The acquisition of land is also subject to restrictions found in § 64 LHO. For example, like the acquisition or sale of interests in private companies, the consent of the Minister for Finance is needed for the acquisition or sale of land and property.
The issuance of lending commitments and the assumption of guarantees of all kinds by the Saarland also requires the consent of the Minister for Finance according to § 39(2) LHO. If, for example, a CDF needs to borrow additional capital, the Saarland may only give the lender guarantees in line with § 39(2) LHO.

Moreover, any restrictions in the municipal budget laws must also be considered. For example, a municipality subject to budgetary supervision may not participate in setting up a UDF, since any revenues first have to be used to pay off debt. Revenues would have to be used to pay off debt instead of being reinvested in urban development projects or SMEs, as investment in JESSICA funds stipulates.

3.4 Capital Market and Corporate Law

Aside from issues of European and general public law, there are numerous implementation issues which fall under the purview of general civil law and especially capital market, corporate and tax law.

For direction on questions about implementing a CDF as a venture capital fund under capital market law – particularly the German Banking Act (KWG) – and corporate law, we refer to the diverse governance models in Chapter 4.

Note also that the issues covered in this category are primarily in reaction to individual decisions of commercial implementation. This is why these issues are particularly relevant in terms of involving institutional investors. As present, this is not the case from the perspective of the CDF. Nonetheless, attention should already be drawn to the relevant legal factors now, so that the fund can be set up with sufficient flexibility where possible. Some of the factors are named below:

- Compliance of mandatory investment principles with the regulatory conditions for certain investors (insurers, pension plans, utilities).
- Implementation of individual profit participation clauses and preferential rights for individual investors (investors operating under market economy investment principles in accordance with Article 43(7) of Regulation (EC) 1828/2006).
- Determining the regulations on liability for the fund’s activities externally and internally and any agreements on indemnification from liability.
- Structuring “loss protection clauses” for investment in non-profit projects.
- Creating exit clauses for fund investors, should they wish to exit before the programme period is over.
- Compliance with tax guidelines, especially income, value added and land transfer taxes.
- Compliance of co-investments in the target project by private investors.
- Determining the exit structures of the various possible wrap-up scenarios (expiration of that programme period, wrap-up of funded projects, etc.).
3.5 Public Procurement Law

There are public procurement legal issues at both the fund and project level. At the fund level, private investment in the planned fund is subject to mandatory tendering. This investment at the fund level might have implications for any participation of the investor at the project level. Fundamentally, however, private investors’ interests in a JESSICA fund do not conflict with their investment as lender to a bidder or bidding consortium. If, however, the participating investor acts as a bidder itself or member of a bidding consortium, e.g. by investing as an institutional equity investor, then it must be ensured that this double participation does not give it a competitive advantage over bidders with no ties to the fund. In general, this should not be a problem since the investment in the fund is structurally set up differently than participation in a concrete, individual project and because the fund itself does not award the contract. The latter is also the reason why the regulation for project participants laid out in § 4(5) VgV (the German Ordinance on the Award of Public Contracts) is not applicable to the constellation presented. Should private investors with interests in a JESSICA fund later participate in the tender procedure for a project being funded, they have not “advised or otherwise supported the awarding body before the start of the award procedure”.

If the public investors in the fund intend to commission a private person to manage the fund, this is subject to the conditions for awarding public contracts. However, this is only so if the fund can be qualified as a public awarding authority. The concrete setup is the crucial point here. If there is no legal autonomy and if the fund is located at the SIKB, for instance (Model 2, Chapter 4.2), its ability to award contracts relies on whether it is classified as a public awarding authority. If it is legally autonomous and partly held by private partners, there might not be enough governmental control to qualify as a public institution according to § 98 No 2 GWB (Restriction of Competition Act). When the fund’s investors and management are both public bodies, however, this condition is fulfilled.

At the project level, project managers might be obligated to conduct a tender procedure to award concrete contracts for the implementation of their project. This is not so for the selection of projects to be funded. The actual choice of projects is not influenced by public procurement law. The acceptance of projects into the funding programme has to be transparent and non-discriminatory, but is not tied to public contracts. Rather, public procurement law first takes effect in the relationship between the project managers and the companies bidding on the concrete project undertakings.

3.6 European Law

European law is particularly relevant when looking at the question of state aid. The state aid guidelines listed under Article 107ff. TFEU (Treaty on the Functioning of the European Union) have to be followed whenever state financing measures are applied to companies. European state aid legislation is part of the European rules on competition and, as such, is aimed to counter any attempts by Member States to restrict competition. In principle, European Community aid – which includes ERDF resources – is not subject to Article 107ff. TFEU. Though monies deposited into and granted by the CDF are also partly ERDF funding, the beneficiaries are not entirely excluded from the jurisdiction of European state aid law. Regardless of the legal form of the fund and the origin of the deposits, Article 9(5) of Regulation (EC) No 1083/2006 stipulates that operations financed by the Structural Fund shall comply with the provisions of the EU treaty. The term operations denotes both the contribution to the CDF and the subsequent provision of equity investments, loans and guarantees for companies.
or urban development projects, meaning that European state aid law is applicable at both the fund and the project level. The Operational Programme 'Saarland' (ERDF 2007-2013) – like all Operational Programmes – includes an indication on page 164 that the company-related funding must comply with EU state aid legislation.

For a measure to be considered ‘aid’, the state has to grant preferential treatment in the broadest sense (“no matter what kind”). It can be said that the state is involved in the operations of the fund because the fund is co-financed using public resources in all of the proposed models. Because the state aid should not restrict competition, the legal form of the beneficiary company and the shares of ownership it holds are not relevant; merely whether it participates in a competition. This is to be assumed in case of doubt – unless it is for general infrastructure measures (streets, bridges etc.). Another condition of state aid is that there can be no appropriate payment for the preferential treatment granted. Given the lack of experience and relevant ECJ decisions in evaluating appropriateness, one should turn to the general criteria and instruments of state aid, especially the private investor test (PIT). The PIT examines whether private investors of comparable size and the public sector administrative body in a comparable location would have acted as the public entity did. If in this case the state behaves as an investor in a market economy, this condition rules out the existence of aid. This also raises the question, when examining the eligibility of fund activities for state aid, whether a comparable private investor would have invested under the same conditions. Based on the fundamental idea behind the JESSICA initiative that those projects should be funded which purely private investors would avoid due to their questionable profitability, the PIT would normally return a negative result.

Looking at the proposed guarantee fund, a fund which operates with guarantees, criteria for evaluating the eligibility for state aid can be found in the Commission Notice on ... State aid in the form of guarantees (Official Journal of the European Union No C 155 dated 20 June 2008, pg. 10). The core elements here include whether the price paid for a guarantee is “market-oriented” and the basic restriction that the guarantee does not cover more than 80% of the outstanding loan or other financial obligation. Applied to the planned guarantee fund, this means that this fund model is not very attractiveness, because the JESSICA-funded projects normally face increased risk of default, which entails a high fee for the guarantee.

Preferential treatment which may qualify as aid because of its type, but which falls below the so called De-Minimum Regulation (Regulation (EC) No 1998/2006) due to its minor extent and thus little relevance to competition is not covered by Article 107(1) TFEU. The relevant size is a total volume of EUR 200,000 for aid in the form of grants or indirect subsidies. In terms of the CDF, note that it is not meant to issue grants, but rather operate using loans or equity and venture capital investments. For forms of grant other than subsidies, a “gross subsidy equivalent” shall be calculated to clarify whether they qualify for the De-Minimis Regulation. This is only allowed, however, if it can be calculated “transparently” in advance. According to Article 1(4) of Regulation (EC) No 1998/2006, the calculation for loans shall use customary market interest rates. Equity and venture capital shall only be considered transparent according to the guidelines if the total amount remains below the de-minimis threshold of EUR 200,000. Against this backdrop, in concrete terms the De-Minimis Regulation can be ruled out for everything but loans.
Even outside the De-Minimis limits and the special rule for SMEs, there is still the possibility of granting funding which complies with state aid law. Pursuant to the exemption guidelines in Article 107(2) TFEU, aid can be compatible with the domestic market or, according to Article 107(3) TFEU, the Commission can declare it to be compatible with the domestic market. The crucial point here is always that the measure does not distort competition in any way.

If, for purposes of security, the conformity of preferential treatment with state aid law needs to be established in advance, it is possible to follow a notification procedure, whereby the Commission is notified in a timely manner, i.e. before the measure is carried out. Once the Commission has all the information needed to examine the measure, it generally decides on the legality of the preferential treatment within two months\(^9\). This presents a problem insofar as all economic parameters have to be determined before the investment is carried out, so that the these can be evaluated by the Commission.

4 POTENTIAL GOVERNANCE MODELS FOR THE SAARLAND COMMUNITY DEVELOPMENT FUND

In this chapter the diverse potential governance structures for the Saarland Community Development Fund – as they were developed in the consulting process – are presented and evaluated from the financial perspective. The models are both described and illustrated, with each fund and its allocation among the individual actors highlighted in grey.

4.1 Model 1: In-house Loan Fund in the MEET and MES of the Saarland

4.1.1 Financial Analysis

The independent legal experts behind this study and members of the Saarland working groups conceived the following “in-house model” during a number of meetings as a solution to the governance problems of the Saarland Community Development Fund (see Figure 4).

This CDF is set up in the federal state ministry as an administrative department without its own legal entity. The fund should extend loans to municipalities and/or companies. The necessary banking license of the SIKB should be “used” for this purpose.

The financial institute sees itself as merely a disbursing bank undertaking no credit risk, which the CDF alone should bear. The refinancing should occur in three equal parts from ERDF resources, state resources and a CEB loan to the fund.

Use of the banking license in this model must comply with all regulations of the German Banking Act. In concrete terms, this means the credit and financial aspects of the project must be evaluated (bringing in outside experts if necessary), the lending decisions must be made by the holder of the banking license, and the financial institute is responsible for both monitoring the loan and bearing...
the risk of credit default. Furthermore, depending on the project borrower, the bank must also back the risk with capital. Therefore, how well this model works financially depends in the end on how well the holder of the banking license makes lending decisions. If the individual project types are found to not be creditworthy and there is a considerable risk of default, they would not pass the bank’s requirements and would not be financed.

Against this backdrop, it does not seem possible that the ministerial fund management makes lending decisions (as has been foreseen in the discussion so far). If the CDF is refinancing with credit, the implicit acceptance of a lower probability of repayment also seems debatable. The case of a ministerial decision maker without banking license and banking know-how (KWG) overriding a lending decision (for a project actor eligible for funding but not creditworthy) also seems problematic (“the fund manager makes the funding decision”). Moreover, the capital requirement of a bank and thus its financial collateral appears to be at risk. The alternative of lending exclusively to municipalities seems quite ineffective given the communities’ debt situation, not just in the Saarland. Extending purely subordinated loans does not fit the foreseen project financing of real estate and land development.

Furthermore, the JESSICA regulations stipulate that the UDF should be established either as a new company with its own legal personality or as a fixed part of a financial institute, where it would be recognised as its own accounting entity. The fund property held and managed by the ministry (in-house model) is currently not foreseen and might also contradict the principle of “independent fund management”.

4.1.2 Legal Analysis

In this model, requests for JESSICA funding and loans are directed to the “fund management”, which is merely an administrative department at the state ministry (in-house model). The fund management also makes the lending decisions. The SIKB simply functions as a paying agent and signs the loan contract with the borrower in the name of and on behalf of the state (in reference to the fund set up there as a separate asset). The lender is the state.

Extending cash loans is a lending transaction according to § 1(1.2.2) KWG, if the lending is commercial (i.e. long-term and with the aim of generating profit) or to an extent required by a commercial enterprise; the latter is regularly the case when there are 100 loans or more, or when there are 21 loans or more with a total volume of more than EUR 500,000. Once this threshold has been reached, regulations prohibit the state in said paying agent model without a banking license from extending loans (directly) unless they are purely subordinated loans (loss participation clause/qualified subordination agreement), since they are then not viewed as loans according to the regulation.

Implementing the in-house model is problematic from the perspective of the Structural Fund regulations. According to Article 43(2) of Regulation (EC) No 1828/2006, a UDF shall either be its own legal entity (similar to the venture capital model in Chapter 4.5) or a fixed block of finance within a financial institution – such as the SIKB.10

10 Urban development funds are financial engineering instruments (Article 3(2c) of Regulation (EC) No 1080/2006, Article 44.1 of Regulation (EC) No 1083/2006) which must be independent legal entities ... or a separate block of financing within a financial institution (Article 43(3) of Regulation (EC) No 1828/2006, amended by Regulation (EC) No 846/2009). References in this study to Article 43(3) of Regulation (EC) No 1828/2006 are understood to be references to this norm in the revised version.
This is where an in-house model, which includes a separate asset of the state as a separate accounting entity in the form of a settlement account through which the SIKB merely directs money in the name of and on behalf of the state (paying agent model), fails. In this case, the separate asset of the state would not be an independent legal entity but a block of financing in the state. However, the latter is only possible “within a financial institution” according to the Structural Funds regulations. In addition, there would be the problems of financial regulation.

### 4.2 Model 2: Loan fund in the SIKB

#### 4.2.1 Financial Analysis

The fund is established without its own legal personality as part of the SIKB as a separate accounting entity there. In this case the bank is the fund owner and manager and obtains the appropriate allocation of ERDF and state funding. The SIKB would set this up as a separate asset within the bank. The fund would extend loans to municipalities and/or companies directly through the SIKB using its own banking license. The bank bears all credit risks for the fund assets. The refinancing should occur in three equal parts from ERDF resources, state resources and a CEB loan (see Figure 5). For this purpose, the SIKB would be a borrower from the CEB and a funding recipient of the state and the ERDF (within the scope of the planned refinancing capital).

Although this model effectively solves the JESSICA regulatory problem, the financial problem is still clearly there. How well this model works still depends in turn on how well the SIKB makes lending decisions.

![Figure 5 – CDF as separate SIKB asset](image)

Given the bank’s basic risk-averse attitude, it seems possible that only a few or no projects would be deemed creditworthy from the perspective of the SIKB. Due to the necessary acceptance of credit
risks, the capital requirement for the credit business and the administrative and refinancing costs (of the CEB loan), the financial problems get even worse. These can only be lessened to a limited degree if the public allocations form a liability buffer for the SIKB as “first loss” capital, which would have to be clearly set down in the relevant financing agreements.

An analysis of the governance structure from the view of European law would be required to determine whether it would be necessary to conduct a tender procedure to commission the SIKB.

4.2.2 Legal Analysis

In contrast to the paying agent model above, here lending requests are directed to the SIKB. The bank signs lending agreements in its own name and on its own behalf and thus sets up its own credit relationship, refinanced with ERDF funding.

As long as the outsourcing agreement complies with the outsourcing regulations of the KWG, the (outsourced) fund management may prepare a noncommittal project evaluation and lending decision (credit processing/approval) for the SIKB; this is also true for the funding approval (notice of granting), whose submission would also be a requirement for credit approval.

Such a modified in-house solution, where the SIKB handles and is responsible for the lending, is also justified under the Structural Funds regulations. In this case, the UDF would be set up as a separate block of financing (Model: lending through the SIKB), fulfilling the requirements of Article 43(3) of Regulation (EC) No 1828/2006. If the SIKB handles the lending, the financial regulatory problems do not arise. The in-house element would still be reflected in the fact that – according to the outsourcing regulations – the lending, including the decisions regarding funding requests, would still be prepared by a fund management agency set up in the state.

4.3 Model 3: Saarland Holding Fund in the EIB

4.3.1 Financial Analysis

As an alternative to the in-house model, the EIB proposed that a Saarland EIB holding fund be established, into which the planned refinancing would flow. Consequently, the holding fund would give resources to the UDFs in the Saarland, which could then be used to extend loans to urban development projects. In this model, it is also imaginable that the EIB holding fund provides equity to the individual UDFs in the Saarland (see Figure 6).

This governance alternative does not solve the final problem of giving cash and loans to urban development projects. In the end, a UDF financed by the holding fund would still have to solve the same problems presented in structural alternatives 1 and 2.

Moreover, another “administrative level” would be introduced with its own costs. Covering the administrative costs is already the greatest challenge for the fund manager (aside from the default risks). The likelihood that there will be the need for several UDFs in the Saarland seems low as well, since the search for projects, conducted by the working group and experts for a UDF, already proved to be very difficult. Therefore, there is not enough business for a holding fund in the Saarland. Looking at the administrative costs of the EIB, the complete fund volume might be too small for a holding fund anyway.
4.3.2 Legal Analysis

This structure adds an additional level above the UDF, where the holding fund is to be found. The holding fund gives the funding to one or several UDFs.

From the regulatory perspective, the same statements are true as which apply to setting up a UDF as its own legal entity. The only difference, which is irrelevant in terms of regulations, is that a holding fund stands above the UDF. This does not change the fact that the UDF, which will do the individual lending in the end, does not have a banking license. A banking license at the holding level would not help the UDF, since the holding fund gives the resources to the UDF, so that the lending regulations would still apply to the UDF.

4.4 Model 4: Guarantee Fund for Lending by the SIKB

4.4.1 Financial Analysis

Against this backdrop, another alternative can be imagined: To solve the lending problems in Model 2, it might be feasible that the SIKB – as foreseen in the KWG – examines, grants, secures (with its own resources) and monitors all loans itself. The CDF would be established as a pure guarantee fund to compensate for the high default risks. In order to avoid the problems in regard to the JESSICA
regulations, this would not be set up within the ministries, but as its own legal entity. In this case, the fund would solely carry out the role of a guarantor for the SIKB (as social property of the state), thereby reducing its risks practically to zero (see Figure 7).

According to state aid law, however, it appears necessary for a pure guarantee fund to calculate its guarantee fees to cover the costs of the high default risks (in accordance with the likelihood of default and the refinancing costs).

From the financial perspective, it can be assumed that it would no longer be possible for lending to urban development projects to be profitable. In addition to the interest on credits, the project actors would also have to bear the cost-effective guarantee fees. It seems unrealistic that the SIKB will bankroll the costs. This significantly increases the burden on the individual urban development projects, which again makes it doubtful that the projects are financially viable.

**Figure 7 – CDF as guarantee fund**

4.4.2 Legal Analysis

Under the guarantee fund model, the SIKB handles the lending in its own name and on its own behalf. The fund issues a guarantee to hedge the debt service.

Granting guarantees of all kinds to others is banking business according to § 1(1.2.8) KWG, if it is commercial or to an extent required by a commercial enterprise. (The threshold is as shown in 4.2.1: more than 100 individual guarantee credits or more than 21 individual guarantee credits with a total volume of more than EUR 500,000). No banking license is necessary if provisions have already been taken to fulfil the guarantees, such as backing the guarantee with cash. The fund could deposit the cash collateral in an escrow account, for example.
If the guarantee fund was established as a separate asset of the Saarland, like the in-house model, it would not comply with Article 43(3) of Regulation (EC) No 1828/2006. This could be avoided by setting it up as an independent legal entity, as conceived.

4.5 Model 5: Venture Capital Fund with its own Legal Personality (start-up)

4.5.1 Financial Analysis

This leaves the final alternative of establishing the fund like a venture capital fund as a legal entity. As long as this public company (e.g. a limited liability company) has state funding and a loan from the CEB, it can receive allocations. Consequently, it can invest equity into individual projects (see Figure 8).

This would comply with the JESSICA regulations. Moreover, the KWG would not apply. The risk would be borne completely by the newly created project company or partnership of convenience. No paying agent with a banking license would be needed; the majority (if not all) of the company shares would be held by the Saarland. A tender procedure could be used to engage an independent agency to manage the fund.

Instead of an expensive loan, the projects would obtain interest-free venture capital. This might enable them to take on a commercial loan for financing, thereby spreading the default risks. The returns come from the project cash flows, which would be paid according to the share of equity finance in the fund.

The future CDF would be a classic private equity fund in this case. This is not currently subject to any comprehensive capital market regulations. The AIFM (Alternative Investment Fund Manager) guidelines planned at the European level will not impact the fund, since its asset portfolio has not already...
surpassed the EUR 100 million threshold. If the fund chose not to refinance using loans, it could even grow to a volume of EUR 500 million without having to comply with additional regulations. This would offer the opportunity to set up the business activities of the fund in this model strongly in line with the individual situation of the Saarland.

4.5.2 Legal Analysis

In contrast to the in-house model, the UDF is set up as an independent legal entity for equity investment. Two legal forms seem relevant, a company organised in a corporate form – especially the GmbH or Limited Liability Company because there are few formal requirements – and a partnership – particularly the limited partnership due to its limited liability and flexible setup under company law. Before reaching a final choice, the taxation aspect must be considered if private investors join in. The SME investment fund set up under the JEREMIE initiative offers some orientation in this regard.

There are currently no regulatory problems in investing ERDF resources via an equity (investment) fund in the setup described above, since it either does not, or can be designed so that it does not fall under the definitions of the KWG, or is exempt from them. Nonetheless, an eye should be kept on the current development of the AIFM guidelines if there are plans to gather or invest private investor capital via an equity fund. The draft guidelines particularly cover private equity funds and include stipulations for the supervisory duties of the fund manager. However, this only refers to the administrators of those funds which can be considered undertakings for collective investment, meaning that a fund with the Saarland as the sole partner would not be included. As long as Germany makes use of the optional threshold exemption rule, funds with volumes up to EUR 100 million (and those without leverage or right of return before 5 years up to EUR 500 million) are also not included. The draft guidelines were and are being strongly criticised and are still in the legislative procedure. Insofar as the (implementation of the) AIFM guidelines would have a negative impact on the fund, this might (at the current stage) be avoided though a direct investment or co-investment by the private investors at the project level.

4.6 Model 6: Venture Capital Fund with its own Legal Personality as a Separate Asset of the State

4.6.1 Financial Analysis

As in Model 5, the CDF is established as a venture capital fund. Assuming the other premises regarding business activities remain the same, the Saarland acts here as regional authority. It would be considered its own legal entity under public law (like a “credit institution” in the first models).

The fund in the strictest sense is also set up as a separate block of finance (separate asset), which as an administrative department within the state government is subject to special implementation provisions and, in particular, separate accounting (separate accounting entity at the LHK (state exchequer)). This administrative department in the ministry manages all investments, with the support of external experts if necessary (see Figure 9).
It is unclear whether this would actually fulfil the requirements of Article 43(2) of Regulation (EC) 1828/2006. If European law was to say yes, this would be a more efficient variant than Model 5 (venture capital start-up) from the financial perspective. It might be faster, simpler and cheaper to establish the fund. In doubt, this would be reflected in the form of lower management costs.

4.6.2 Legal Analysis

In evaluating the merits of this model, reference is first made to the remarks on Model 5 regarding the financial framework. The extent to which the setup fulfils the requirements of Article 43(2) of Regulation (EC) No 1828/2006 depends on the legal nature of the separate asset. It is not enough at this juncture that the Saarland itself, as a “legal person under public law”, represents an “independent legal entity”. This is already the result of the Structural Funds regulations being based on the idea that the independent legal entity as a special purpose vehicle only has the resources for funding one specific project. Other legal entities with access to funding for other purposes have to put this money into a separate block of finance with separate accounting to avoid mixing them up with other resources. As mentioned, the Structural Funds regulations only foresee this possibility for financial institutions. Moreover, they stipulate that the administrative authorities select the financial engineering instruments and sign a financing agreement between them. The administrative authority is a national, regional or local agency or public or private body appointed by the Member State to manage the Operational Programme. In the present case, the Saarland is the administrative authority and must perform be separate from the financial engineering instrument. Accordingly, it depends on the legal form of the separate asset. Note that separate assets at the federal level do not normally have the legal capacity of the federal government (e.g. the German Rail Authority, Sonderfonds Finanzmarkstabilisierung, ERP-Sonderfonds). The peculiar aspect of this asset form is that, while it is a part of federal property, it is not subject to the general budgetary rules. Insofar as the separate asset of the Saarland also holds this status, the requirements of Article 43(2) of Regulation (EC) No 1828/2006 are not fulfilled, since the legal entity is not independent. If this separate asset can be

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11 Article 43(2) and (3) of Regulation (EC) No 1828/2006 in the form revised by Regulation (EC) No 846/2009.
12 Article 59(1a) of Regulation (EC) No 1083/2006.
given its own legal capacity within the scope of the Budget Law of the Saarland, however, this model would comply with the regulations.

4.7 Interim Summary of the Governance Models under Discussion

Models 5 and 6 would be extremely innovative at present, even from the federal level, because there is no alternative equity fund in the area of integrated urban development in Germany outside the implementation of a KfW Bundesfonds. Because of its innovative character, this might in future open up a special “start-up funding” by the federal government, if there are no comparable offerings created in other states. However, this should not be assumed at present.

Furthermore, due to its clear legal structure and the existing commercial experience with equity funds, Model 5 would be preferred from the legal perspective, because it is clearly outside the application area of the KWG for one, and it meets the legal independence criterion set by the Structural Funds regulation for another. In contrast, to comply with Article 43(2) of Regulation (EC) No 1828/2006, Model 6 can only be implemented if a separate asset also has legal capacity.

While the traditional orientation of UDFs towards lending (Models 1 and 2) is understandable, the consequence is that they have to conform largely to the regulatory conditions of the KWG. Nonetheless, this fundamental, financial variation should not be dismissed. In the remainder of this study the design of loan funds will be included in the analysis of the financial evaluation of project financing and fund capital preservation.

Regardless of the regulatory conditions in KWG, Model 1 does not meet the requirements of Article 43(3) of Regulation (EC) No 1828/2006. An in-house model, which sets up a separate asset of the state as a separate accounting entity in the form of a settlement account (paying agent model) is not in compliance because such a separate asset of the state is not an independent legal entity but a block of finance in the state. A legally dependent block of finance is only possible “within a financial institution” according to the Structural Funds regulation.

<table>
<thead>
<tr>
<th>Model</th>
<th>Compliance with Art. 43(2) of Regulation (EC) No 1828/2006</th>
<th>KWG approval required?</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. 1 – In-house loan fund</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>No. 2 – Loan fund at SIKB (modified in-house solution)</td>
<td>Yes</td>
<td>Not if outsourced</td>
</tr>
<tr>
<td>No. 3 – Holding fund</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>No. 4 – Guarantee fund</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>No. 5 – Venture capital fund with own legal personality</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>No. 6 – Venture capital fund as separate state asset</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

*Figure 10 – Evaluation matrix for governance models presented*

Models 3 and 4 (guarantee fund and the additional establishment of a holding fund) are the only two models which do not offer any additional financial value at the current time, which is why they are
not considered in the further evaluation of the alternatives. At this point, it should also be noted that these models would further require a banking license.

See Figure 10 for an evaluative overview of the diverse models.

4.8 Implementation-orientated enhancement of the Governance Models (“Nexthouse model”)

4.8.1 Starting point: Proposal of MEET Saarland – In-house loan fund

The MEET and MES proposed an in-house loan fund design for the implementation of the Saarland Community Development Fund. The central element of this concept was fund management by an administrative department within one of the ministries, which finances the selected projects by giving out loans. The SIKB would act as a “paying agent” for the loan sums. The lending decisions would be made by the administrative department as the fund manager.

The motivation for the choice of this approach was that it could be rapidly implemented and that the Saarland maintained influence over the management and the fund resources. Compliance with the KWG should be ensured by involving the SIKB.

In concrete terms, the concept limited the activity of the fund to lending. Granting guarantees and (venture) capital was excluded.

4.8.2 Demand – Which financial engineering instruments are wanted on the ‘market’?

Demand is an important issue in arranging the CDF and the financial engineering instruments it will use. The main point is which financing possibilities are in demand for the individual projects the fund should invest in. At first all the functions of a loan can also be handled using guarantees, dormant partner’s interests and equity. Furthermore, most of the relevant target groups are even interested in other financial engineering instruments. A look at the potential targets at the project level shows the following points about demand:

- Private and municipal companies are asking specifically for equity, hybrid and mezzanine capital. This is also helpful for the company to garner additional capital, since better capitalisation makes it possible to borrow on the financial markets.

- From the ministry’s perspective, municipalities without their own project or project management companies are interested in having revenues for their budget. Since it is not possible to invest equity in a municipality, only loans and guarantees can be used here.

- No specific interest in guarantees could be identified in the market when loans and equity were available as an alternative.

In terms of demand, the in-house model needs to be critically examined. Although equity is the main request on the demand side, this financing engineering instrument is not initially being offered; a later expansion of the offer is under discussion, but given how far along the programme period is, it is doubtful that this is realistic. Against this backdrop, the design of a pure loan fund does not come close to the interests of the target groups on the demand side.
4.8.3 Legal implementation issues of in-house solution

In addition to evaluating how it matches the demand for financial engineering instruments, the legal implementation of the in-house model must also be a selection criterion.

4.8.3.1 Compliance with the EU Structural Funds regulations

Model 1 is not in compliance with the relevant EU regulations. The general belief of the consultants is that the solution presented as Model 1 in this evaluation study is not compliant with Art 43(2) of Regulation (EC) No 1828/2006.

The financial engineering guidelines included in the Implementation Regulation require that the fund either be an independent legal entity or be managed by a financial institution as a separate block of finance.

Neither alternative is the case here. Involving the SIKB as a mere paying agent does not count as a separate block of finance. Nor is the fund an independent legal entity as presented. In particular, it is not possible to fall back on the legal personality of the Saarland as a “public corporation”. This was already assumed by the regulation. The regulation requires an independent legal entity above and beyond this. The individual arguments for this are shown in detail in Chapter 4 of this evaluation study.

4.8.3.2 Requirement of approval according to the German Banking Act (KWG)

Even if one was to ignore the lack of compliance with Article 43(2) of Regulation (EC) No 1828/2006, the in-house solution could not be implemented without getting independent approval according to the KWG. Looking at the paying agent solution, the KWG license held by the SIKB cannot be used because the real lending decision is taken by the administrative department, so that it would have to hold the KWG license. The only alternative would be to apply for an exception under § 2(4) KWG.

During the discussions, the point was raised that, in the current public attribution law based on § 23 LHO Saarland, ‘loans’ were extended without the state needing permission from the KWG. In the federal state of Rhineland Palatinate, ‘loans’ were also extended to fund urban development as an administrative act without a KWG license.

Looking at the LHO Saarland, it is clear that, according to LHO administrative regulations, handling the allocation according to §§ 23, 44 LHO is a matter of public law. This applies primarily to the approval, which is basically handled per notice of appropriation of funding (A. regulatory provisions under § 44 to paragraph 1.4.1 VV-LHO; B. regulatory provisions under § 44 LHO on project funding allocations to local authorities and associations of local authorities VV-P-GK), by way of exception by funding agreement, for which the regulations for notification of appropriations apply accordingly (No 4.3 VV-LHO, No 4.3 VV-P-GK). The invalidity, revocation or cancellation of notices of appropriation, as well as the reimbursement of the funding and the interest on the refund, are determined according to the VwVfG (Administrative Procedure Act). Even if the lending was handled under civil law, it could conflict with the requirements of the Structural Funds regulation. As long as the fund is not an independent legal entity or run as a separate block of finance within a financial institution, its actions are not compliant with Article 43(2) of Regulation (EC) No 1828/2006. If it was independent, the fund manager would not have the authority under the state’s budget law to initiate the administrative act in accordance with § 35 sentence 1 VwVfG at the first stage.
4.8.4 Solution proposed by consultants – Equity fund (Model 5)

Based on the evaluations shown, the consultants proposed Model 5 in this evaluation study – a venture capital fund with its own legal personality. This would comply with the guidelines in Article 43(2) of Regulation (EC) No 1828/2006. At the same time, it would not need a permit to invest equity capital according to the KWG. However, it would be unable to lend. One point of criticism is that it requires the fund managers to have certain management know-how, because investment venture capital normally involves the exertion of economic interest on the object of investment. The CDF is not currently in a position to avail itself of these investor rights. In terms of the possible involvement of private investor capital in the fund as foreseen, a bill was put forth on 3 May 2010 by the BMF for a law to strengthen investors and improve functionality. The bill declares fund shares to be financial engineering instruments. If the attraction of investment capital was set up in accordance with this, there would be no legal KWG problems.

4.8.5 General solution agreed upon on 29 April 2010 – "Nexthouse" solution

After laying out the legal considerations on the evaluation of the in-house solution and showing the implementation issues for the venture capital model, a modification to the venture capital approach (Model 5) was developed, called the "Nexthouse" model. This should be understood as its own model, based on Model 5. The main features are as follows (see Figure 11).

An independent company in the form of a state organisation to be newly established represents the urban development or community development fund. It would initially be wholly owned by the state.
If establishing it this way is undesirable for budgetary or administrative reasons, an existing shell company can be used. From the advisory standpoint, establishing a new company is recommended in order to avoid taking over existing risks and, especially, to not have to separate the fund assets from existing assets, since this would be little more than the block of finance reserved for the exclusive use of financial institutions. It would also underline the role of the fund as an instrument of innovation.

- Fund volumes: EUR 30 million. The decision for the large solution is based on the advertising impact of such budgets among the municipalities and project developers. This should bring in a much greater selection of projects to the fund.

- The management of the company would conceptually belong to a ministry (the MES is especially well suited as an ERDF administrative authority), but would legally be in the hands of (one or more) natural persons associated with a ministry, which would delegate them to the company through a management contract.

- The advisory committee of the company is composed of representatives of the Ministries for Finance, Economics and the Environment.

- Initially, “dormant partner’s interests” would be handed out to private project managers and municipal companies\(^\text{13}\). This does not legally require the approval of the KWG if participation in profits and losses is foreseen. Since in this case – as long as it is not set up as an atypical dormant partner’s interest – there is no, or only limited exertion of influence on the management of the target company, it is not necessary for the fund to acquire additional know-how.

- Capital can be provided to municipalities without their own company in the form of investments in land or real estate transactions: conceivable models are the financing of leasehold rights or land charges. In addition, it is always possible to continue funding following the allocation practices already in use.

The following is a potential way of expanding the concept (see Figure 12): The fund conducts a tender procedure to attract a private investor with a KWG license. This would create two synergies;

- With the KWG license, the fund could extend loans. This would work if the CDF is run in the legal form of a commercial partnership and the KWG-licensed partner takes on the role of sole personally liable partner. In this case, the fund gains the character of an institution, with the partner remaining the KWG licensee. It is possible for the administrative department to continue managing the fund in this model through an outsourcing contract compliant with the KWG.

- With the additional project and management know-how of the private actor in the fund, a further step is possible which does not seem unlikely from today’s perspective: changing the “dormant partner’s interest” into a real venture capital investment with the corresponding perception of the project on the side of management as an investment vehicle.

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\(^\text{13}\) One characteristic feature of dormant partner’s interests is that they are viewed as equity investments at the project level, but in contrast to normal equity investments, they include a flexible, predetermined repayment plan at a fixed interest rate (like a loan) and a limited participation in profits at the end of the financing period. Insofar, the cash flows for the fund hardly deviate from those of pure lending.
In addition to subsidising urban development projects, the additional funding possibilities enabled by setting up such a CDF include the investment of equity in the first step. By involving banking partners in the investment company, these projects could then be funded with loans in the second step. Fig-
Figure 13 illustrates the instruments to be used in addition to the current subsidies. This means that the current funding practices should not be replaced by the new financial engineering instruments (substitution), but that there are no additional resources for these new instruments (addition).

During the meeting at the State Secretary’s office on 12 May 2010, the Saarland decided to further pursue implementation of the “Nexthouse” model (Step 1) and set up the CDF in this structure by the end of 2010. It is not to be set up as an independent company, but rather a subsidiary of the Strukturholding Saar (SHS), next to the already existing state-owned companies for business development (gw Saar), project management (LEG Saar), commercial land management (SBB) and housing (WOGE Saar). This new implementation structure can be seen in Figure 14. The only problem relevant to implementation regarding the planned use of dormant partner’s interests by the Saarland Community Development Fund is still the limited accessibility of the municipalities, since they are not able to profit directly from equity capital investment (or they would have to go through the complicated process of establishing new municipal project companies to obtain CDF funding). The proposal subsequently made that the so established CDF also extends interest-free loans to the municipalities does not work out, because the KWG still requires a license in principle if the CDF extends loans to project companies or managers. This is true regardless of how the loan is financially set up, because even interest-free loans fall under the application of the KWG (credit business). The situation is somewhat different for purely subordinated loans, but such a restriction would not fit the model. The consultants have already proposed Step 2 as a solution to this problem.

„Nexthouse“ Model (Implementation)

State of Saarland

LEG Saar

gw Saar

Strukturholding Saar

SBB

WOGE Saar

Saarland Community Development Fund

Equity

Private

Public companies

Municipalities

Municipal land acquisition

Figure 14 – Implementation of the "Nexthouse“ model
5 CONCRETE INTERVENTION POSSIBILITIES WITH JESSICA INSTRUMENTS

5.1 Identifying Business Areas of CDFs and their Significance for Urban Development Policy

The basis of the discussion on implementing a Saarland Community Development Fund was the result of conceptual work in regard to the sustainable development of the cities and communities of the Saarland. The new instrument of an integrated community development concept should actively face the challenges of demographic, economic and social structural change. At the same time, the tight budget situation in the municipalities is understood. During the development of a guideline for creating integrated community development concepts, the action strategies described in Chapter 2.1.2 were identified, becoming the topical focus.

Looking at real estate, a study on circular land use management (REFINA) in the Saarland was also compiled to deal with the vacancy problems which are becoming increasingly more important for the municipalities of the Saarland. The currently explosive situation of vacant and underutilised buildings and land as a central problem of urban development policy was made even clearer during the project identification process for this evaluation study.

Based on these findings, future business areas for the Saarland Community Development Fund were determined (see Figure 15). The business areas of “urban development and housing” and “business and local supply” (“local business”) were taken directly from the action strategies for the develop-
ment of integrated community development concepts, since it was thought to be quite easy to find projects in these areas with a certain profitability (in part) which should thus have been able to repay their funding from the CDF within a certain time period.

Projects for the social and educational infrastructure and technical infrastructure, transportation and the environment frequently represent investments for which financial returns are hardly possible and thus for most of which subsidies are the most effective. For this reason, the two action strategies were combined into a single central business area, infrastructure and the environment. As some projects subsequently reviewed show, in the greater area of infrastructure, there are indeed project types with revolving aspects which are important to central urban and municipal development policy and for which funding through the Saarland Community Development Fund can make a lot of sense. Central areas of intervention in this segment are primarily supplying rural areas with high performance telecommunication infrastructures and more efficient energy generation and utilisation.

Finally, the central REFINA topic of brownfields was also included in the future activities of the CDF, since this is extremely relevant to urban and municipal development policy in a region strongly impacted by structural change, like the Saarland. At the same time, redeveloping brownfields will involve the other three business areas of the Saarland Community Development Fund as well. Many approaches to projects have failed because all the unpresentable costs were to be taken over by the public sector while the project developer and property developer anticipated standard returns for the industry and could therefore seldom find an alternative to subsidisation.

FIRU and KomCon selected “pilot projects” which match the various business areas as closely as possible. At the end of these efforts, a “project pipeline” for the business areas of the Saarland Community Development Fund had also been identified.

5.2 Evaluation Criteria in the Selection of Appropriate Starting Projects

5.2.1 Urban development policy evaluation criteria

In this chapter, all of those projects identified as part of the evaluation study will be presented which can be considered for funding by the Saarland Community Development Fund. Depending on the availability of data and their relevance to development policy and to the business areas of the CDF, five pilot projects were identified which will be reviewed in detail and which form the foundation of this evaluation study (see Figure 16 on the selection process and Figure 17 on the business areas).

![Diagram of project selection process](Figure 16 – Project selection process)
The projects (in the project pipeline) might be considered in future (once the ideas have matured and more detailed data is available) for funding by the CDF (see Figure 18).

### Table: Project Pipeline and Business Areas of the CDF

<table>
<thead>
<tr>
<th>Project</th>
<th>Business Areas of the CDF</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Fibre Optic flagship project in Dillingen</td>
<td>Infrastructure and the Environment</td>
</tr>
<tr>
<td>2. Terentiushof/Wilhelm-Heinrich-Straße Ottweiler</td>
<td>Urban Development</td>
</tr>
<tr>
<td>3. Local heating supply for the community of Nalbach</td>
<td>Infrastructure and the Environment</td>
</tr>
<tr>
<td>4. Spitzbunker City Hotel in Neunkirchen</td>
<td>Local Business</td>
</tr>
<tr>
<td>5. Revitalisation of pedestrian precinct in Lebach</td>
<td>Local Business</td>
</tr>
</tbody>
</table>

Figure 17 – Classification of projects in the business areas of the Saarland Community Development Fund

The projects and their goals are briefly presented in terms of how they fit into urban development policy. Their eligibility for funding is also reviewed: in terms of the guidelines of European law and the Operational Programme ‘Saarland’ for the current programme period for one and the presence of integrated community development plans for another. An integrated community development plan – from which the project was developed or into which the project fits – has to be haptic; ideally, it is an integrated community development concept as already described in Chapter 2.1. However, this requirement for funding is also met if such a concept is being set up (or this will be begun in the near future) or if the already existing, individual plans are technically or spatially interlinked between business areas in such a manner that it can be assumed there is a holistic, integrated approach to the planning.

#### 5.2.2 Financial evaluation criteria

In order to be able to consider the selected pilot projects in terms of urban development policy independent of their financing – especially financing by the CDF – they should all be financially evaluated in a comparable form on the basis of their cash flow structures. Initially, this analysis was done sepa-
rately. In the second step, the project cash flows were merged into a portfolio cash flow, which was then also evaluated.

As the projects run over several years, the only method of comparing them was to use dynamic investment calculations, particularly the criteria of relative profitability, since the volumes and durations among the projects varied significantly.

To conduct an evaluation of the projects and the portfolio independent of the concrete project financing, the criterion of internal rate of return (IRR) was used. This also has the advantage of comparing the success of the project directly to the necessary capital expenditure (‘capex’) and therefore also acts as an indicator of the efficient use of (scarce) capital. By implication, this is not synonymous with a positive financial return from the project, as it measures whether the project is advantageous. Rather, the calculated project returns have to be higher than their financing costs to result in a positive project difference.

By the effective annual yield percentage or internal yield (internal rate of return) of a project, one refers to the standardised rate of return \( i_0 \), where the sum of the final revenues \( E \) equals the sum of the final expenses \( A \). Clearly, the (sought for) internal rate of return is found by setting the final values in the formula to zero:

\[
C_n = \sum_{t=0}^{n} \left( E_t - A_t \right) \cdot (1 + i_0)^{n-t}
\]

The IRR thus denotes the profitability of the capital tied up in the project or the average of such.

Note, however, that for any investment project, this definition of the IRR as a indication of profitability is only valid insofar as the calculated IRR is identical to the actual financing cost rate (interest on debit balances) and, at the same time, the actual profitability of interim reinvestments (interest on credit balances). More will be written on this later.

As part of the financial review, the specific project cash flows for the five pilot projects of the Saarland Community Development Fund will first be calculated and used as a basis for determining the returns on each project.

Finally, the legal framework which is important for the development of each pilot project will be assessed.

5.2.3 Legal evaluation criteria

Within the scope of the legal review of the project – and independent of particular questions specific to one project – the following aspects of European and national legal guidelines are relevant.

In regard to the general conditions for using European funding (Regulation (EC) No 1083/2006), it must be reviewed whether a project should be considered a large project in accordance with Article 39 (total investment of more than EUR 25 million for environmental projects, EUR 50 million for all others), since they are financed from the ERDF differently than the “normal” smaller projects. Furthermore, it must be noted whether the ERDF funding and its co-financing will be used to finance land acquisition. In this case, the possibilities for funding are limited to 10% of the land acquisition
costs by Article 7(1b) of Regulation (EC) No 1080/2006 (exception: environmental protection measures).

State aid legislation on project funding first looks at whether the intended public municipal project actors (municipalities or municipal companies) should be considered as market participants whose funding would give them an advantage over other (also private) market participants. It is equally important to review in which private actors are way tied into the project level (e.g. through shares in a municipal development company) and to what extent they would also gain an advantage over other market participations through the planned project funding. When a public-private partnership is set up to carry out the funded project, a tender procedure might also be mandatory.

Finally, when necessary for the project it must be clarified whether and under which conditions the use of the CDF’s financial engineering instruments can be combined with other funding instruments (e.g. KfW funding programme, urban development funding etc.).

5.3 Project level (model portfolio)

5.3.1 Fibre Optic flagship project in Dillingen

5.3.1.1 Presentation and classification under urban development policy

The Fibre Optic flagship project in Dillingen, under the Infrastructure and the Environment business area, foresees the installation of a fibre optic infrastructure for the Rundwies and Dillingen-Nord industrial zones (see Figure 19) to strengthen the competitiveness of these sites.

Figure 19 – "Rundwies" (west of main road) and "Dillingen-Nord" (east) industrial zones (Source: KomCon)
The funding from the CDF should serve as interim financing for the project, which will have to be granted until the industrial zones have enough subscribers to be profitable. The city of Dillingen is currently developing a community development concept (contract awarded at the end of 2009) into which the project will be integrated. The project falls under Article 5(3b) of Regulation (EC) No 1080/2006 of the European Parliament and of the Council dated 5 July 2006 on the ERDF “promoting access to, take up, and efficient use of ICTs by SMEs by supporting access to networks, the establishment of public internet access points, […]”, since the project entails enabling local businesses to access information and communication technologies. According to the current Operational Programme ‘Saarland’, the project is classified under priority axis 2, business area 4 (“Stimulating structural change through knowledge-based business, innovation and development of specific strengths – Culture of innovation, qualification and access to ICT infrastructure”). This reaffirms the eligibility of the project for funding by the CDF.

5.3.1.2 Financial analysis

The gradual connection of 50 current and about 15 new coming businesses creates potential income which can be used for revolving financing by a UDF. At present, their telecommunication mainly occurs via copper wiring. All carriers should be able to compete for the use of the new infrastructure. The recipients of the financing are the Stadtwerke Dillingen public utilities, a municipal holding company held by the city of Dillingen (51% of shares) and Energis GmbH (49%).

KomCon estimates that a one-time investment of EUR 540,000 is needed to make the telecommunication infrastructure available. Implementation of the measure is judged to be timely, and the infrastructure should be complete in a period of nine months. Therefore, the following assumes that the investment will be made in 2010 and that revenues can already be expected by the end of 2011. In regard to revenues, KomCon projects that five new buildings can be connected and supplied by a carrier each year. At the estimated number of 65 commercial businesses to be connected, this means the maximum amount of revenue can be generated after 13 years, or from 2023 on. With a basic fee
of EUR 30 per month per subscription plus a premium of 10% of the carriers’ total sales, the average annual revenues are estimated at EUR 960 per subscription. This results in steadily growing revenues, reaching a maximum of EUR 62,400 from 2023 on. The projected duration of use for the telecommunication infrastructure is 30 years; after this duration, the investment is considered completely depreciated, so no fictional residual value has been calculated (see Figure 20).

This project is shown to be viable under the given assumptions, since it results in a project rate of return (as measured using the project IRR) of around 6.38%. Although this return would be (barely) commercially viable, it must be noted that the full amount of the revenues is not reached until 13 years have passed, meaning that if e.g. a commercial bank loan, which has a much shorter grace period (i.e. interest-free years at the start), were taken out, it would be necessary to find interim financing.

Furthermore, there are two other factors which put the profitability into perspective. For one, the effects of inflation have been abstracted from the calculation of revenues. If this is integrated into the calculation because of the very long duration of the project, it becomes clear that the price index for telecommunication has even been negative over the last 10 years. As the Federal Statistical Office’s price index for communications for 1999 to 2009 shows, by the end of this period it had fallen to 75% of its original price (cf. www.destatis.de, Consumer Price Index No 8, Communication). The reverse conclusion is that the revenues would not even remain at their nominal amount, assuming a similar price trend in future. For another, it must be considered that the total duration of the CDF was assumed to be 20 years, whereas this project was projected to last 30 years. With duration of only 20 years, the return on the project falls to 4.69%.

In principle, the periodic repayments from the project from the revenues for the basic fee and the additional, sales-related charges allow it to receive long-term equity capital from the UDF. The repayment schedule to the fund should be adjusted to match the project cash flows, however, so that, except for the interest portion, no or only a minor amount of repayment is scheduled during the start-up years. The cash flows would appear as calculated in the following (see Figure 21).

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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash flow</td>
<td>-540,000</td>
<td>4,800</td>
<td>9,600</td>
<td>14,400</td>
<td>19,200</td>
<td>24,000</td>
<td>28,800</td>
<td>33,600</td>
<td>38,400</td>
<td>43,200</td>
<td>48,000</td>
<td>52,800</td>
<td>57,600</td>
<td>62,400</td>
<td>62,400</td>
<td>62,400</td>
</tr>
</tbody>
</table>

Figure 21 – Cash flows from Fibre Optic Lighthouse project in Dillingen (in euro)

### 5.3.1.3 Legal analysis

In terms of volume, the investment is not considered a large project according to Article 39 of Regulation (EC) No 1083/2006. Moreover, no land acquisition is foreseen in this project, so that Article 7(1b) of Regulation (EC) No 1080/2006 does not apply.

In addition to the municipal investment company of the city of Dillingen, the private company Energis GmbH should own 49% of the project, so it is important in any case to ensure that the financing through the CDF is in compliance with state aid laws. It must also be noted that, depending on the division of shares in the business and the sphere of action, a municipal investment company can also be viewed as a market participant and thus as a recipient of aid.
5.3.2 Terentiushof/Wilhelm-Heinrich-Straße project in Ottweiler

5.3.2.1 Presentation and classification under urban development policy

The community of Ottweiler is developing the Terentiushof redevelopment area and the connecting street Wilhelm-Heinrich-Straße on its own initiative in preparation for the planned relocation of the adjacent Federal Highway 41 underground. The area lies on the edge of the historic old city centre. Wilhelm-Heinrich-Straße is one of the primary shopping streets in the inner city. The largest building in the area is the former Ottweiler Department Store, which stretches between Wilhelm-Heinrich-Straße and Federal Highway 41 (see Figure 22).

In 2009 an urban development framework was developed for the Terentiushof and the Wilhelm-Heinrich-Straße. The primary urban development goals were to clear the interior of the Terentiushof, redevelop and redesign it. It also included redesign measures for the Wilhelm-Heinrich-Straße and the land to be restored after the relocation of Federal Highway 41.

Figure 22 – Terentiushof and Wilhelm-Heinrich-Straße project in Ottweiler (Source: city of Ottweiler)

The CDF funding serves to raise the necessary investment costs. At the same time, the city makes its contribution by resorting to urban development subsidies. Cash flows are expected to come from the sales proceeds for the redeveloped land and from running the newly developed car park. The city of Ottweiler is currently developing community development concepts for some parts of the city and, once the decision to set up a CDF in the Saarland is taken, it is ready to prepare such a concept for the city centre right away. There is already an urban development framework for the redevelopment area which the new conceptual plans can directly refer to. The project falls under Article 8 of Regulation (EC) No 1080/2006 of the European Parliament and of the Council dated 5 July 2006 on the
ERDF, “These strategies shall promote sustainable urban development through activities such as: strengthening economic growth, the rehabilitation of the physical environment, brownfield redevelopment, the preservation and development of natural and cultural heritage, the promotion of entrepreneurship, local employment and community development, and the provision of services to the population taking account of changing demographic structures”, since it involves revitalising and thereby repurposing a traditional but underutilised building structure in the inner city area. According to the current Operational Programme ‘Saarland’, the project is classified under priority axis 3, business area 1 (“Sustainable urban and regional development and resources protection – Sustainable urban development”). This reaffirms the eligibility of the project for funding by the CDF.

5.3.2.2 Financial analysis

The project of the city of Ottweiler in the Terentiushof area, which includes transforming the Wilhelm-Heinrich-Straße, involves reshaping an entire neighbourhood, which is why it is classified under the business area of “Urban Development”. The measures for accounting and thus financing by the fund are only those which primarily resemble land development. The financing recipient is the municipality through the city of Ottweiler.

In detail, the capital expenditure based on the estimates of KomCon first includes the acquisition of the land on which the department store currently stands for EUR 630,000 and for the land readjustment and removal of the department store for EUR 200,000. One alternative might be an agreement with the private owners, so that the land would not have to be acquired by the city; however, this is assumed in the following due to the lack of information otherwise. In addition, there is capex for setting up the public infrastructure, including creating parking spaces and green spaces for approx. EUR 170,000 and for rearranging and developing the Wilhelm-Heinrich-Straße for approx. EUR 600,000. Further intended capex for the existing property at Wilhelm-Heinrich-Straße 35 to expand the library and for housing in the upper stories has not been reflected, as the project actors will attempt to find private investors for these purposes. The total investment amount comes to EUR 1.6 million.

This capital expenditure is offset by potential revenues from the sale of the buildings along Federal Highway 41. With 2,000 m² of space at an estimated sales price of EUR 100 per square metre, the total sales proceeds could be EUR 200,000. Moreover, rental income for the parking spaces created on the Wilhelm-Heinrich-Straße is calculated at EUR 15,000 per annum. Furthermore, the sale of the buildings at Wilhelm-Heinrich-Straße 31 to 35 might bring in another EUR 225,000, which could also be used to repay the fund. Thus, in the year of the sale, the three cash flow components combined total revenues of EUR 440,000, which could be used to repay the fund.

As urban development funding can be counted on to subsidise EUR 645,000 of the total capital expenditure of EUR 1.6 million, and the city will contribute its share of EUR 330,000, EUR 625,000 is left to be financed by the UDF. Splitting this evenly over the proposed construction period of three years means capex of EUR 208,333 per year. The financed amount should be repaid within 20 years. The time of the potential sale of the building projects on Federal Highway 41 cannot be determined exactly ex-ante, but the city assumes that the properties will be sold in a timely manner because the public investment functions as a beacon. If it is assumed in the most optimistic of all cases that the property is sold right after completion of construction, the revenue-expenditure progression would look as follows (see Figure 23).
Figure 23 – Business plan for the Terentiushof/Wilhelm-Heinrich-Straße project in Ottweiler (in euro)

Calculating the investment’s IRR in regard to the total sum of EUR 1.6 million, it is somewhere below –100% and thus not defined. Looking only at the amount invested by the CDF totalling EUR 625,000 in capital expenditure over the years 2010 to 2012, however, yields a minimum positive project IRR of 0.39% for the following concrete cash flows (see Figure 24).

<table>
<thead>
<tr>
<th>Year</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>...</th>
<th>2029</th>
<th>2030</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash flow</td>
<td>-208.333</td>
<td>-208.333</td>
<td>-208.333</td>
<td>440.000</td>
<td>15.000</td>
<td>15.000</td>
<td>15.000</td>
<td>15.000</td>
<td></td>
</tr>
</tbody>
</table>

Figure 24 – Cash flows for the Terentiushof/Wilhelm-Heinrich-Straße project in Ottweiler (in euro)

This makes it a classic “B-list project”, since there are revenues and returns, but these are far from being high enough for commercial land and project development. It should be noted at this early stage that the project return for a revenue-generating project has to be higher than the financing rates, which is why it is clear here that commercial project financing at market rates would mean high losses in the project. If, contrary to the assumptions made, it was assumed that it would not be possible to sell the buildings along Federal Highway B 41 until the end of the project duration, the project’s IRR would drop to –2.95%.

5.3.2.3 Legal analysis

This is also not a “large project” according to Article 39 of Regulation (EC) No 1083/2006.

It does, however, foresee the acquisition of land. The capital to be provided by the CDF amounts to EUR 630,000. According to Article 7(1b) of Regulation (EC) No 1080/2006, the important point is that the CDF does not use more than 10% of ERDF monies deposited there to finance land acquisition. This restriction does not apply to the projects. Moreover, note that this restriction only applies to the ERDF funding. Since, in addition to the EUR 20 million in ERDF funding (including national co-financing), the CDF holds another EUR 10 million from the CEB, it has plenty of flexibility. Nonetheless, this threshold has to be considered when selecting additional projects.
As, according to the current plans, the city of Ottweiler itself as a municipality should be the funding recipient, the circumstances are not a problem from the perspective of state aid legislation. Note, however, that this is only true if no private partners are involved at the project level.

### 5.3.3 Local Heating Supply project for the Community of Nalbach

#### 5.3.3.1 Presentation and classification under urban development policy

The first phase of the Local Heating Supply project for the Community of Nalbach foresees investment in a central heating supply facility which, when complete, will heat the following public services: city hall, secondary school, kindergarten and an event hall. In contrast to the current oil and gas heating supply, the new facility will burn renewable energy sources in the form of wood chips. Like the Fibre Optic flagship project in Dillingen, this is an investment in the business area of “Infrastructure and Environment”. There could be a second construction phase in the medium term, whereby approx. 125 homes would also be connected to the new heating supply grid. However, this is not reflected in the following, more detailed look at and calculations for the project.

The CDF funding serves to help cover the total adjusted implementation costs. Cash flows are expected from the savings enabled by the cheaper energy supply. Implementation could begin in 2010, with a proposed implementation period of 12–15 months. The project is part of the development concept drafted in 2005; the community could rapidly make any necessary amendments to the concept based on the existing information basis. The project falls under Article 5.2c of Regulation (EC) No 1080/2006 of the European Parliament and of the Council dated 5 July 2006 on the ERDF “stimulating energy efficiency and renewable energy production and the development of efficient energy management systems”. In accordance with the current Operational Programme ‘Saarland’, the project is classified under priority axis 3, business area 3 (“Sustainable urban and regional development and resource protection – Promotion of future-oriented energies and the efficient use of resources”). This reaffirms the eligibility of the project for funding by the CDF.

#### 5.3.3.2 Financial analysis

The new local heating supply for the community of Nalbach represents a transformation in energy supply. By lowering the heating costs through the use of renewable energy sources, the resultant savings could be used to refinance the capital expenditure. Who will receive the funding has not fully been determined yet. It would be conceivable to establish a company under private law for the construction and subsequent operation of the plant, in the sense of a public-private partnership (PPP) into which various investors could be brought together.

The capital expenditure for the heating supply plant is broken down in Figure 25). It has been calculated that setting up the heating supply plant would require capex of EUR 748,500. Since investment in renewable energies is one focus of the funding activities of the KfW bank, the wood chip plant and local heating supply lines are eligible for KfW subsidies, which lowers the amount to be financed by the CDF to EUR 668,000.
| Plant equipment with automatic control | 233,000 |
| Additional wood-fired boiler system | 32,700 |
| Gas connection costs | 22,200 |
| Underground lines and earth works | 191,000 |
| Arrangement of technical building | 200,000 |
| Electrical installations | 19,400 |
| Central building control system | 46,000 |
| Additional overhead expenses | 4,200 |
| **Total setup expenses** | **748,500** |
| Funding for wood chip heating system | 12,500 |
| Funding for local heating supply lines | 68,000 |
| **Capital expenditure for fund** | **668,000** |

**Figure 25 – Breakdown of capital expenditure for the heating supply plant (in euro)**

To calculate the potential cash flows to the CDF, the fuel savings from the partial switch to renewable energies have to be quantified in kWh (see Figure 26).

<table>
<thead>
<tr>
<th>Usage in kWh p.a.</th>
<th>Status Quo</th>
<th>After investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kindergarten</td>
<td>85,000</td>
<td>72,500</td>
</tr>
<tr>
<td>Secondary school</td>
<td>386,000</td>
<td>330,000</td>
</tr>
<tr>
<td>Event hall</td>
<td>476,000</td>
<td>405,000</td>
</tr>
<tr>
<td>City hall</td>
<td>650,000</td>
<td>260,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,597,000</strong></td>
<td><strong>1,067,500</strong></td>
</tr>
</tbody>
</table>

**Figure 26 – Reduction in energy needs due to heating supply plant**

The annual savings through the new heating supply plant can be quantified at 529,500 kWh. Note, too, that the fuel volumes are not the only thing to sink; the fuel costs fall as well. While the prices for oil in 2008 averaged 6.53 cent per kWh and gas even cost 7.44 cent per kWh, the average price for wood chips was only 3.91 cent per kWh. It is not possible to completely switch over to wood chips; rather the previous mixture of oil and gas is replaced by a mixture of wood chips and gas. Combining this with the reduced volumes and fuel costs, the energy costs could be lowered from EUR 105,400 to EUR 64,300 p.a., leaving annual savings of EUR 41,100 available as cash flows to the UDF. In view of Figure 26, these savings are the result of changes in both consumption and fuel. Formerly, 1,597 million kWh p.a. were used at a ratio of 95% oil to 5% gas at the prices given above; now only 1,067.5 million kWh are used at a ratio of 41% wood chips to 59% gas. The intended duration of the CDF financing over 20 years generates the following revenue-expenditure progression (see Figure 27).
According to the information of KomCon, construction should begin as soon as possible and thus already in 2010. With a construction period of 12 to 15 months, the savings could already begin in 2012. Figure 27 assumes the capital expenditure totalling EUR 668,000 is split in equal parts of EUR 334,000 each in 2010 and 2011. Assuming constant revenues over the 20-year duration of the investment in the Local Heating Supply project for the community of Nalbach, this results in a project IRR of 2.34%. Since the project yield based on this IRR again reflects zero financing costs, it is clear that this is another classic B-list project with moderate cash flows which would generate a loss if a commercial bank loan were needed. The project yield could be raised, however, if an increase in energy prices were also included in the calculation. Based on the average annual energy price increases over the last 10 years, the price would rise by 2.07% p.a. (cf. www.destatis.de, Consumer Price Index No 4 for Rent, Water, Fuel and Power, average of 2000 to 2009 period). In this scenario, the project IRR would be lifted to 4.16%. Since there is a great level of uncertainty about future energy price trends, however, the following does not reflect energy price increases and figures are based on cash flows at a project yield of 2.34% (see Figure 28).

<table>
<thead>
<tr>
<th>Year</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>...</th>
<th>2030</th>
<th>2031</th>
<th>2032</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash flow</td>
<td>-334.000</td>
<td>-334.000</td>
<td>41.100</td>
<td>41.100</td>
<td>41.100</td>
<td>41.100</td>
<td>41.100</td>
</tr>
</tbody>
</table>

Figure 28 – Cash flows for the Local Heating Supply project for the community of Nalbach (in euro)

5.3.3.3 Legal analysis

In terms of volume, this investment is not a “large project” according to Article 39 of Regulation (EC) No 1083/2006. No land acquisition is foreseen for this project, so Article 7(1b) of Regulation (EC) No 1080/2006 does not apply.

At the time of appraisal, the funding recipient had not been determined. In particular, implementing it within the scope of a PPP together with partners from the private sector was under discussion. In regard to this decision, it should be mentioned at this early stage that, depending on how the partnership is to be set up, a tender procedure might be required. It has to again be emphasised that the partnership must be reviewed from the perspective of state aid legislation as soon as a private actor benefits from the financing.
In terms of the planned combination with KfW financing, it has been determined that combining ERDF funding with other funding instruments is not a problem according to the Structural Funds regulations. However, it will have to be reviewed to see if the KfW financing includes any conditions which might conflict with the guidelines of the Structural Funds regulations.

5.3.4 Spitzbunker city hotel project in Neunkirchen

5.3.4.1 Presentation and classification under urban development policy

The redevelopment of the Spitzbunker site in Neunkirchen includes setting up retail space and attracting a hotel, for which a developer but no operator has been found (see Figure 29). Within the scope of potential CDF funding, the operating rents on the site should be reasonable to assist development of the hotel. Its development and operation should be imparted via public tender procedure, and the willingness to use funding from the CDF for financing should be part of the invitation to tender.

![Figure 29 – Planned hotel and retail usage of the Spitzbunker site (source: KomCon)](image)

The CDF funding serves to cover part of the investment costs and thereby reduce the ongoing costs of capital. Cash flows are expected from the operation of the hotel (revenues from accommodations and board). The project is part of the Urban Development Concept 2020. It falls under Article 8 of Regulation (EC) No 1080/2006 of the European Parliament and of the Council dated 5 July 2006 on the ERDF “these strategies shall promote sustainable urban development through activities such as: strengthening economic growth, the rehabilitation of the physical environment, brownfield redevelopement, the preservation and development of natural and cultural heritage, the promotion of entre-
entrepreneurship, local employment and community development, and the provision of services to the population taking account of changing demographic structures”, as the attraction of a hotel will strengthen local business and tourism. In accordance with the current Operational Programme ‘Saarland’, the project is classified under priority axis 3, business area 2 (“Sustainable urban and regional development and resource protection – Expansion of tourism infrastructure through the development of natural and cultural heritage and the creation of additional growth potential”). This reaffirms the eligibility of the project for funding by the CDF.

5.3.4.2 Financial analysis

In addition to retail space, a hotel should be developed upon the Spitzbunker site in Neunkirchen, its construction should be financed by the CDF. This is a classic building project for a speciality property classified under the business area of “Local Business”. The revolving element required for financing by the CDF comes from the revenues for providing board and accommodation to hotel guests. The funding recipients are the investors of the hotel, who would first have to put up an investment amount of EUR 1 million from private sources to finance the purchase price of the land and ancillary construction costs. The final investor and the subsequent operator of the urban hotel should be found via a European-wide tender procedure.

In detail, this is the construction of a five-storey hotel with 40 double rooms. The one-time capital expenditure for the construction of the hotel amounts to EUR 4.3 million according to the estimates of a project developer based in the Saarland. This partial financing should come from the CDF and the additional, aforementioned investment sum of EUR 1 million will presumably be financed from the equity capital of the investors, so the CDF should (only) provide the direct construction costs. To calculate the ongoing revenues from the hotel operation, it is assumed to be running at 65% of capacity. Assuming an average price of EUR 68 for an overnight stay, reflecting the charge for double rooms, their rental as single rooms and special conditions for travel groups, the assumed capacity utilisation of 65% results in calculated sales revenues from overnight stays and breakfast of

![Figure 30 – Business plan for the Spitzbunker urban hotel project in Neunkirchen (in euro)](image)

In detail, this is the construction of a five-storey hotel with 40 double rooms. The one-time capital expenditure for the construction of the hotel amounts to EUR 4.3 million according to the estimates of a project developer based in the Saarland. This partial financing should come from the CDF and the additional, aforementioned investment sum of EUR 1 million will presumably be financed from the equity capital of the investors, so the CDF should (only) provide the direct construction costs. To calculate the ongoing revenues from the hotel operation, it is assumed to be running at 65% of capacity. Assuming an average price of EUR 68 for an overnight stay, reflecting the charge for double rooms, their rental as single rooms and special conditions for travel groups, the assumed capacity utilisation of 65% results in calculated sales revenues from overnight stays and breakfast of
EUR 650,000 p.a. In addition, the sale of food and beverage is assumed to count for EUR 250,000 p.a., bringing total calculated revenues from hotel operation to EUR 900,000 p.a. In turn, yearly running costs for personnel, materials and energy are calculated to be EUR 525,600, though KomCon did not break this figure down further. Further assuming the construction costs totalling EUR 4.3 million are split evenly between the years 2010 and 2011, this results in the following revenue-expenditure progression (see Figure 30).

Based on these premises, with the twelve-month construction period beginning in 2010, and looking at a period of 15 years, the project IRR for the urban hotel is 3.93%, given the concrete cash flows shown in Figure 31.

<table>
<thead>
<tr>
<th>Year</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>...</th>
<th>2027</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash flow</td>
<td>-2.150.000</td>
<td>-2.150.000</td>
<td>374.400</td>
<td>374.400</td>
<td>374.400</td>
<td>374.400</td>
</tr>
</tbody>
</table>

Figure 31 – Cash flows for Spitzbunker urban hotel project in Neunkirchen (in euro)

In considering this moderate yield, which is still well below that of commercial project financing, several points need to be kept in mind. First, it is clear that the revenue potential is determined by the capacity utilisation assumptions for the hotel. It is therefore quite unclear whether the planned utilisation rate of 65% can be reached. Furthermore, the calculation does not consider price increases (personnel, materials, energy expenses, as well as room prices). Finally, it must be considered that the resulting net revenues are not only for the CDF; the other investors require returns on their capital employed. In this project, they are still investing EUR 1 million. Therefore, only approx. 81% of the total investment (EUR 5.3 million) need to be financed through the CDF, which will thus get only that share of the cash flows.

5.3.4.3 Legal analysis

In terms of volume, this investment is not a “large project” according to Article 39 of Regulation (EC) No 1083/2006. No land acquisition is foreseen for this project, so Article 7(1b) of Regulation (EC) No 1080/2006 does not apply.

As is clear in the project description, the EUR 1 million needed for land acquisition should come from the hotel operator as equity capital. The funding from the CDF totalling EUR 4.3 million should exclusively be used to finance the construction measures themselves. It something changes in this setup, this has to be considered at the fund level. Since there is only one other project which contains land acquisition funding at present, there is still plenty of flexibility.

State aid laws also have to be complied with in this project, because involving private investors is a central component of its implementation.

5.3.5 Revitalising the pedestrian precinct in Lebach

5.3.5.1 Presentation and classification under urban development policy

The vacancy rates in the inner city of Lebach are high and steadily rising. Without a fundamental redesign, especially of the public areas, this downward spiral cannot be turned around. The return of specialist retailers and service providers is unrealistic until comprehensive revitalisation measures have been carried out. Investment is planned in the reconstruction of traffic roads, the creation of
more parking spaces and in public amenities and greenery. In the following, the project is classified under the business area “Local Business”.

The CDF funding serves to pre-finance the investment costs, which should be refinanced through the cost savings for maintaining the existing structures. The construction is expected to take 15 months. The city of Lebach began to create a community development concept in 2008. It should be complete in the middle of 2010. The revival of the inner city plays a central role in the concept. The project falls under Article 8 of Regulation (EC) No 1080/2006 of the European Parliament and of the Council dated 5 July 2006 on the ERDF “these strategies shall promote sustainable urban development through activities such as: strengthening economic growth, the rehabilitation of the physical environment, brownfield redevelopment, the preservation and development of natural and cultural heritage, the promotion of entrepreneurship, local employment and community development, and the provision of services to the population taking account of changing demographic structures”, as it entails the revitalisation and thus repurposing of an historical and underutilised building in the inner city. In accordance with the current Operational Programme ‘Saarland’, the project is classified under priority axis 3, business area 1 (“Sustainable urban and regional development and resource protection – Sustainable urban development”). This reaffirms the eligibility of the project for funding by the CDF.

5.3.5.2 Financial analysis

The recipient of the financing is the municipality, either the city of Lebach directly or, alternatively, the real estate company Lebacher Grundstücksgesellschaft mbH & Co. KG, a wholly owned subsidiary of the city. In detail, the following measures have to be carried out to revitalise the area, most of which is brownfield (see Figure 32).

<table>
<thead>
<tr>
<th>Revitalisation measures</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reconstruction of “Am Markt” street</td>
<td>200.000</td>
</tr>
<tr>
<td>Reconstruction of car park between “Am Markt and Theel flood wall</td>
<td>160.000</td>
</tr>
<tr>
<td>Construction of new car park at the entrance of the pedestrian precinct</td>
<td>120.000</td>
</tr>
<tr>
<td>Addition of traffic street at the entrance of the pedestrian precinct</td>
<td>280.000</td>
</tr>
<tr>
<td>Construction of rear car park</td>
<td>200.000</td>
</tr>
<tr>
<td>Street furniture</td>
<td>100.000</td>
</tr>
<tr>
<td>Plantation</td>
<td>140.000</td>
</tr>
<tr>
<td><strong>Total amount</strong></td>
<td><strong>1.200.000</strong></td>
</tr>
<tr>
<td><strong>+ 20% ancillary costs</strong></td>
<td><strong>1.440.000</strong></td>
</tr>
</tbody>
</table>

*Figure 32 – Capital expenditures for revitalising the pedestrian zone in Lebach (in euro)*

The table shows that the needed investment totalling EUR 1.44 million refers exclusively to the beautification of the public space, including the greenery. Assuming that the parking spaces to be created will be free of charge, it is clear that this investment in public infrastructure will not generate any revenues. Therefore, this is the development of a purely public space in the form of a non-revenue-generating C-list project. In this regard, it might be possible to link funding from the CDF to
EUR 460,000 in urban development subsidies, thereby reducing the investment volume to be financed by the CDF to EUR 980,000.

In order to make it possible for the CDF to finance the project despite the lack of revenues, the following assumes the investment will save the city EUR 80,000 p.a. by its own estimate. This amount has been spent on average over the last three years to handle incidental repairs in the desolate inner city of Lebach, e.g. due to vandalism. Assuming construction begins in the middle of 2011 and takes 15 months, the result is the following revenue-expenditure progression (see Figure 33).

![Figure 33 – Business plan for revitalising the pedestrian zone in Lebach (in euro)](image)

Under the assumptions in Figure 33 that the CDF only finances EUR 980,000 in capital expenditure – divided equally over 2011 and 2012 – a project IRR of 3.33% is calculated with the following concrete cash flows (see Figure 34).

<table>
<thead>
<tr>
<th>Year</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>...</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash flow</td>
<td>-490.000</td>
<td>-490.000</td>
<td>80.000</td>
<td>80.000</td>
<td>80.000</td>
<td>80.000</td>
</tr>
</tbody>
</table>

![Figure 34 – Cash flows for revitalising the pedestrian zone in Lebach](image)

If it is instead assumed that the full EUR 1.44 million is financed by the CDF, the project IRR would drop into the red at −1.35%. Like the other projects, a yield of 3.33% defines this as a classic B-list project, which would be a disadvantage for finding market-rate financing.

### 5.3.5.3 Legal analysis

This investment is also not a “large project” according to Article 39 of Regulation (EC) No 1083/2006. No land acquisition is foreseen for this project, so Article 7(1b) of Regulation (EC) No 1080/2006 does not apply.

Investment in projects which have no returns per se cannot be understood by state aid law as the equivalent of an action taken by a commercial investor, so this can clearly be a subject of state aid in principle. In regard to this concrete project, the lack of revenue generation is not a problem under
state aid law as long as the municipality remains the direct recipient of the financing, since there could be no disadvantage to participants in commercial competition in this case. This should also apply if the city’s real estate company takes the position of financing recipient. This assumes that the real estate company, as a subsidiary of the municipality, only undertakes public spending and does not operate in other business areas as a commercial competitor in the market.

5.3.6 “Pipeline Projects”

Gesellschaft für Stadtumbau und Strukturentwicklung (GfSS)

The GfSS, an urban redevelopment and structural development company, should bring together smaller, individually parcellated vacant plots of land in small and medium-sized communities and develop them through portfolio policies which activate the money brought in by profitable properties added to the portfolio. This tackles a core problem of urban and municipal development in the Saarland. The company could be a subsidiary of the LEG Saar and other public and private partners might be enticed to join, such as the Association of Towns and Municipalities, the Entsorgungsverband Saar (association of disposal), municipal housing authorities, the SIKB and private actors.

The company’s business model shown in Figure 35 includes the identification and assessment of land and sites, a future-oriented on-spot acquisition policy, project development and marketing, building law and approval management, facility management and external management services for other land portfolios.

To date, this is nothing more than a basic idea. During the process of implementing the CDF, the Saarland can consider how it might make sense to set up such a company in combination with the activities of the fund, what it would look like in concrete terms, and which actors might get involved.

\[\text{Figure 35 – Business model of the Gesellschaft für Stadtumbau und Strukturentwicklung (Source: FIRQ mbh 2009)}\]
Mettlach Site Development Company

The community of Mettlach has been interested in developing the site of the former (Villeroy & Boch) mosaic factory for years. To date it has not been possible to align the divergent interests of the community and the owner in terms of how to develop the property. During the process of preparing this evaluation study, the consultants proposed a cooperative development model to the actors on site which could also be supported by the CDF.

![Figure 36 – (Villeroy & Boch) Mosaic tile factory in Mettlach](image-url)

![Figure 37 – Cooperative development model for the mosaic tile factory in Mettlach (Source: FIRU mbH 2009)](image-url)
Together, the municipality and the owners establish a site development company and split the costs for preparing, clearing and zoning the land according to their share of ownership in the company. In addition to potential support from the CDF, other funding (grants) might be obtained from the state. This construction has significant advantages for both parties: the community is directly involved in the development without the problems inherent in owning it and the owners get easier access to funding and are thereby supported in developing the property. The yields for the development could be shared between the two partners (see Figure 37).

Both the community and the owner were in agreement with the model. The project development will first have to be examined as part of an evaluation study before the project is mature enough to be eligible for CDF funding. The first preparatory measures for thus are currently underway.

Revitalisation of the Bliespromenade in Neunkirchen

Since the end of 2009, two large retail properties on the Bliespromenade (around 6,000 m² of floor space) have stood vacant in the city centre of Neunkirchen. To revitalise the site and meaningfully restructure (or successfully repurpose) the property, there are plans to redesign the adjacent Blies embankment (create public areas and bring it to life). The costs for this are currently estimated at EUR 1.5 million, which are also eligible for subsidisation through an urban development funding programme. The entire project should be implemented in a period of five years, which requires close cooperation with the owners (and potentially the new users). The community will have to be active in this regard. In this context, CDF funding would most likely apply to the restructuring/revitalisation of the retail properties, since this is the only part to generate cash flows for the fund. In return for the potential funding, the property developers can participate in the design measures.

Energy supply for community of Losheim am See

More renewable energies for, and a more efficient, local energy supply are to be used in the community of Losheim am See. A combined heat and power plant shall be developed in the town centre to supply several homes and a day care centre via local heating supply lines. There are plans to develop a cooperative wood chip burning power plant for the district of Britten to provide energy and heat to both a large nursing home and a large part of the district. Innovative elements will be chosen for the energy generation and the controlling technology, accompanied by the University of Applied Sciences in Saarbrucken. Once the project concept has become more concrete, it can be examined to determine eligibility for funding by the Saarland Community Development Fund.

Energy efficiency enhancement and energy supply for community of Illingen

The town hall in the community of Illingen is to be renovated at an estimated cost of approx. EUR 480,000. In return, the future energy savings will be approx. EUR 6,000 p.a., which makes it clear that, due to the minor possible cash flows, only a small part of the investment costs can be borne by the CDF. However, it is a commonly known project type.
Furthermore, the development of a biomass power plant to supply power to an industrial area is under review. The investment costs were estimated at EUR 4 million; so far it is still unclear whether the project itself is marketable or whether it requires funding.

**Energy efficiency enhancement of sports and recreation hall in Saarwellingen**

The sports and recreational hall built in 1972 had to be partially renovated in 2008 due a mining-related tremor on 23 February 2008. As part of the further renovation of the ceiling, ventilation system and lighting system, a PV system shall be installed on the roof of the hall. The solar energy fed into the grid might provide the necessary cash flows for the CDF funding. As the investment cost estimates are still quite imprecise and the expected maintenance costs have not been submitted, the project could not be brought in directly as a pilot project.

**Saarfürst-Centre in Merzig**

![Figure 38 – Aerial view of construction areas in the Saarfürst Centre in Merzig (source: OBG Projekt GmbH & Co. KG)](image_url)

In the period during which this evaluation study was being prepared, the OBG Projekt GmbH attempted to develop a higher standard, inner city residential neighbourhood on the Saarfürst site in Merzig. The one-sided utilisation structure of the project, which made it ineligible for ERDF funding, also disqualified it for funding by the Saarland Community Development Fund. At the start of 2010,
however, this concept fell through due to the lack of demand\textsuperscript{14}. A utilisation concept for the land must now be developed which upgrades the inner city and includes other usages such as office, commercial and retail space. Since the market chances for these uses were assessed to be negative preliminary to the first concept, it should be assumed that funding will be necessary to develop the site. Once the new concept has become more concrete, it should be reviewed to determine the extent to which it makes sense to involve the CDF in this project.

Renovation of property in Wallerfangen

Directly in the centre of the community of Wallerfangen, the former Goldener Schwan inn stands vacant (see Figure 39). The historically listed building included a restaurant which closed more than one year ago and a large ballroom (incl. additional dining rooms) which has not been usable for structural reasons since the 60s.

Funding the rehabilitation of this hallmark building would not only be meaningful from the perspective of the protection of monuments, but would also be important to the local gastronomy. According to the community administrators, there is also demand for the ballroom, since most local events do not come close to filling the capacity of the large event hall on the edge of the community. The instruments of the CDF could be used as start-up funding to revitalise the property. There have already been interested investors, though the community has not been informed of any concrete offers to buy (since it is a listed building, the city has pre-emption rights).

\textsuperscript{14} “Vermarktungskonzept blamabel für die Stadt”, (marketing concept embarrassing to the city), article in the \textit{Saarbrücker Zeitung} dated 19 March 2010, No 66, Regional section for Merzig-Wadern district, page C1.
Other large brownfields given preliminary consideration for development:

- DSD property in Homburg
- Höll property in Illingen
- Former tar factory SARG in Saarbrücken-Malstatt
- Becolin property and Milchhof property in Saarbrücken

5.4 Summary overview of model portfolio

5.4.1 Initial urban development policy conclusions in regard to identified model projects

A summary overview of the projects identified in the Saarland which might be eligible for funding by the CDF, and in particular of the identified pilot projects, clearly shows that a number of projects can be classified under the business areas laid down for the fund. These projects represent project types which are frequently found in the communities of the Saarland and which are characteristic examples of market failure.

There is considerable pent-up demand in the Saarland in the area of telecommunication, especially as access to telecommunication infrastructure comes an increasingly more important factor for industrial, commercial and service companies. In particular, the rural areas of the Saarland are insufficiently serviced by high speed internet. Combined with the fact that they are hit harder by the impact of demographic and economic structural change than the conurbation areas, this is a crucial stumbling block for initiating positive development processes in these areas. Typically, it is possible to find a profitable enough subscriber density within the communities but the costs for connecting this large area are so much higher that private businesses do not take action. The activities of the Saarland Community Development Fund now make it possible for the rural communities to take their own action in this development and thereby benefit twofold. For one, their own location factors are developed to a significant extent, making the communities more attractive to new businesses; for another, the communities (or community-owned companies) can take the setup of the necessary telecommunication infrastructure into their own hands with the support of the CDF and profit financially from its use.

One of the most important markets of the future in Germany and in Europe is the energy sector. Due to rising raw material costs, more and more energy should be generated from renewable raw materials and less from fossil fuels. To the same extent, innovative solutions for the more efficient use of renewable raw materials should be generated from renewable raw materials and less from fossil fuels. To the same extent, innovative solutions for the more efficient use of

15 Although the often discussed option to connect rural areas to high-speed internet via Wi-Fi is an attractive alternative for the present time, it is assumed that the rapid increase in data volumes in the past will continue and quickly reach the capacity of wireless LAN.

Since 12 April 2010 an auction has been running for mobile licenses for newly available frequencies; the only bidders are the large mobile operators T-Mobile, Vodafone, E-Plus and Telefonica O2. The future use of these frequencies is tied to the condition that “fast internet” initially be gradually extended to smaller communities on these radio frequencies. Once 90 % of them have been connected, the next larger category of communities may be approached. Environmental protection associations have already begun protesting against the planned, enormous expansion of mobile networks and the related, strong increase in electric smog effects on humans, animals and plants. In addition, there are currently a number of complaints by companies and organisations about the auction practices of the Federal Network Agency (cf. Spiegel Online: "Netzagentur startet Milliardenpoker um Mobilfunklizenzen", retrieved on 14 April 2010 at http://www.spiegel.de/wirtschaft/soziales/0,1518,688384,00.html).
energy should be implemented. Communities with such efficient and sustainable energy supply systems already have a great advantage over other locations in attracting businesses and private households. Given the increasingly more limited financial flexibility of communities in the Saarland, it becomes increasingly more difficult for the public sector to pre-finance such investments. Because they dominate the market and/or the market is too small, private power supply companies feel there is no acute need for action. Funding by the CDF could support more involvement by municipalities and municipal power suppliers and the public sector would then regain part of its capacity to act in this area. Through inter-municipal collaboration and mutual participation, the sizes of projects could increase and become more efficient.

A back log of necessary renovation has been building in the inner city area of many communities of the Saarland for many years and it is rare that the municipalities can handle it alone. Although the classic instruments for subsidising urban development offer important funding effects in this regard, some communities are seldom able to put up the necessary municipal contribution because of their tightened budgets. The returns in this area are hardly enough for private investors. The image and the business life of the location suffer from the lack of revitalisation and enforcement measures. The assistance of the new funding possibilities through the CDF makes it easier for the municipalities to carry out the necessary urban development measures and, at the same time, requires that sustainable, cash flow-generating solutions be found. This is the way to reach a multitude of communities and prompt them to tackle their urban development problems more intensively.

Strengthening local business is another interest for the involvement of the CDF. As the identified projects demonstrate, the communities of the Saarland are hardly able to carry out the measures needed to improve the conditions for local business on their own. With its revolving financial engineering instruments, the CDF can help make the measures needed for municipalities to make themselves more attractive locations for business financeable in spite of tight budgets and also stimulate activities in the private sector to ensure the communities function as centres.

Though none of the pilot projects selected fall under the classic brownfield development category (because none of the concepts listed in the product pipeline were developed enough to be assessed during the period in which the evaluation study was prepared), the number of projects currently under discussion and the fact that they are not only local but also significant across the state shows the relevance of this business area for the activities of the CDF. The most frequent project types of this category to occur in the Saarland are the many small buildings and plots of land gone fallow in individual (usually rural) communities for one, and the sustainable development of larger industrial brownfields for another. The concept of an urban redevelopment and structural development company was developed to solve the first problem; with the incentive of getting funding, it should pool together and develop brownfields and other, value-generating real estate in a single portfolio. The use of subsidies is definitely necessary to develop large brownfields into order to reduce the investment costs and even make economical development possible in the first place. With the aid of CDF instruments, the public sector can also then directly participate in these developments, i.e. stipulate development goals and promote their achievement, and at the same time benefit from their financial success. This justifies the subsidies granted in advance to a large degree.

It becomes clear that the activities of the CDF can support the central business areas of urban and community development. Even though the projects themselves do not shine in the financial analysis,
compared to the situation to date, the urban development policy benefits from the implementation of these projects are that much greater.

5.4.2 Initial financial conclusions in regard to the five pilot projects

For the five pilot projects of the community development fund, the relevant capital expenditure and revolving cash flows over each project’s individual duration were laid out in the previous chapters. Based on these cash flows, the yield for each project was calculated in the form of the internal rate of return or IRR. The resulting project yields came out between 4.69% in the best case (Fibre Optic flagship project in Dillingen) and 2.13% in the worse case (Terentiushof/Wilhelm-Heinrich-Straße project in Ottweiler). It is clear that, given the inherent risks, private project developers would not be willing to implement the projects in this portfolio at these low yields. Not one of these projects would be considered a commercial, freely financeable A-list project.

As explained at the start, the project yields also demonstrate the average annual return on capital employed in the project – and this is independent of how the project is financed. Thus, these yields do not include any financing costs, which also have to be covered from the calculated returns. Assuming normal project financing from commercial credit institutes, the financing cost calculation for each project would be composed of four components:

1. the refinancing costs of the bank,
2. the administrative costs for the credit check and for issuing and controlling the loan,
3. the standard risk costs, based on the average default rates in the project development business in the past, and finally
4. the cost of equity (COE) of the loan based on the capital adequacy regulations for the project business laid out in Basel II.

Project development is one of the riskiest business areas for a bank. This is directly reflected in the financing costs for project initiators, which are nearly in the double digits. This, in turn, is a result of the fact that the administrative costs tend to be very high because reviewing the business plan of the project ex-ante is extremely time consuming. There are also high standard risk costs because the project business has higher default rates than other business areas. Finally, Basel II stipulates higher capital adequacy rates for project development loans than for all other business areas of a bank. Thus, it is clear that none of the five pilot projects would hold up to a project financing review by commercial banks, because it would be loss-making for the banks. This statement may not hold true, however, if the project financier and borrower are not private investors, but rather public institutions, e.g. a municipality. Since loan default is, by definition, not possible for a municipality, only the refinancing costs and administrative costs for the loan have to be covered by the bank margins; there is no fee for standard risk costs or COE. Therefore, municipalities can borrow at much cheaper conditions than private investors. This difference will also be considered in the further conception of the CDF. At the same time, however, municipalities themselves are prohibited from getting funding via equity investment; this instrument can only be used in conjunction with municipal companies or land acquisition.

One initial conclusion regarding the five pilot projects is that they fit squarely within the designation of a so called B-list project for a UDF (or, in this case, a CDF). After financing costs, profit-generating
A-list projects require no financing help while, due to the complete lack of cash flows, it is only sensible to implement C-list projects through subsidies. It is the remaining B-list projects, with slightly positive project yields which would still be loss-making under the conditions for commercial financing, which are suitable for the fund model. Now that all five pilot projects appear to feature the typical characters of that type, the fund model can be developed as soon as the legal framework for the projects has been clarified.

5.4.3 Legal analysis of the pilot projects

A legal analysis of the proposed projects had to take into account that they are still in the planning stages and it is not yet clear in which form the CDF will invest. Therefore it is not possible to do a legally binding analysis at this point in time. Hence, individual legal points will now be examined. It should also be noted that the relevant legal conditions in general and in detail are shown in Chapter 3. Special attention has been paid to the guidelines of the Structural Funds regulations, public procurement law and state aid law.

From the perspective of the CDF, it is critical that the decision to invest in individual projects be transparent and proper. Understanding the reasons behind these decisions can be relevant for various legal issues. It is especially relevant to first interpret the state aid legislative concepts of “fair market conditions” and “investors in a free market”. Under budget law, it is also necessary to properly assess the suitability of a project in terms of its investment needs.

In terms of the guidelines of the Structural Funds regulations regarding the eligibility for funding as such, the primary source is Article 5 of Regulation (EC) No 1080/2006, since the Saarland falls under the funding focus on “Regional Competitiveness and Employment”. Furthermore, the Operational Programme ‘Saarland’ opens up the possibility of investment in “Sustainable Urban Development” according to Article 8 of Regulation (EC) No 1080/2006. The passages in the Operational Programme ‘Saarland’ which establish the priority axes “Promoting competitiveness through growth and entrepreneurial measures to reinforce the enterprise base” (1); “Stimulating structural change through knowledge-based business, innovation and development of specific strengths” (2) and “Sustainable urban and regional development and resources protection” (3) are critical to determining the eligibility of individual projects.

Finally, it must be considered that the individual budget situation of each of the municipalities and communities affected can have an influence on the analysis of the legal situation (indebtedness, budget constraints etc.). In this regard, a legal analysis must be done individually and look specifically at the point of time the investment is to be made.
6 CONSTRUCTING A FINANCIAL MODEL FOR THE SAARLAND COMMUNITY DEVELOPMENT FUND

The starting point for further analysis is the project portfolio, with its cash flows and yields, as calculated in the previous chapter. The necessary maximum capital requirements of the CDF can be derived from these figures. After that, the forecast project financing to come from the CDF for individual plans is included and finally the refinancing of the fund, together with the costs of the entire fund, are incorporated into the fund architecture.

6.1 Capital requirement analysis at the fund level

To calculate the capital requirements of the CDF, it first has to be determined whether the five presented pilot projects will require full financing by the fund or whether complementary sources of financing mean that one or more projects only require partial financing.

Although it would be possible to fully finance all five pilot projects in principle, since the required financing volume would be EUR 8.55 million and thus less than the planned fund volume, the following assumes that two projects, Ottweiler and Lebach, will only need partial financing. This partial financing was either expressed implicitly as a wish of the project actors for potential fund financing (in the case of Ottweiler) or explicitly named as one of two alternatives (for Lebach). Since it is possible in both projects to cover the remaining financing with urban development subsidies and, in the case of Ottweiler, also with a contribution from the city, subsidisation can be combined with revolving financing from the CDF in each case. The partial financing has an advantage for the CDF because the minor project cash flows can be gained with less capital employed, as no cash flows are estimated for the remaining subsidisation.

In concrete terms, this means that, for the Ottweiler project, assuming total financing needs of EUR 1.6 million, 61% is covered by urban development subsidies (EUR 645,000) and by contributions from the city (EUR 330,000), while the remaining 39% (EUR 625,000) is financed by the CDF. In the Lebach project, the CDF finances 68% (EUR 980,000) of the total investment amount of EUR 1.44 million, with the rest coming from urban development subsidies.

Under the assumption that these two projects are partially financed, the cumulative capital requirement to cover the capital expenditure for the five pilot projects amounts to nearly EUR 7.113 million (see Figure 40).
These capital requirements are focussed on the years 2010 and 2011; only the Ottweiler project, which has an estimated construction period of three years, shows a minor capital requirement in 2012 of EUR 208,333 (see Figure 41).

As was seen in the look at the concrete project cash flows, the project in Dillingen already delivers minor returns in 2011, while the cash flows in 2012 are already higher than the capital requirements. From 2013 on, the total cash flows of the CDF are consistently positive until the end of the planned duration of the fund in 2032. The high cash flows in 2013 are the result of the high, one-time sales proceeds for the project in Ottweiler.

Furthermore, it is clear that the cumulative gross capital requirements of the CDF, i.e. not including cash flows which have returned to the fund in the interim, are EUR 7.113 million and that more than half of this amount (EUR 4.3 million) is estimated for a single project, the construction of a hotel on the Spitzbunker property in Neunkirchen, so that this project represents a financing heavyweight. The other four projects all show much lower capital requirements between EUR 0.98 million (Lebach) as the second largest project and EUR 0.54 million (Dillingen) as the smallest. The calculated total cash flows result in a portfolio yield of 3.59% in the form of an IRR for the cash flows; though note that this is before the financing and administrative costs of the fund.
Now analysing the net capital requirements of the CDF by cumulating each of the reported cash flows per period, it becomes clear that the financing amount paid out by the fund to the five pilot projects would be repaid from project cash flows alone by 2023 (see Figure 42). This would not be possible, however, if one includes the financing costs and administrative or management costs for the fund in the equation. These cost components will raise the capital requirement considerably, since interest-bearing capital should also be invested in the CDF. Thus, it is not just the management costs, but the refinancing costs for business activities which have to be integrated into the fund calculation. Therefore, as was the case for project financing, the final capital requirement can only be determined when all three design parameters are considered, as in the approach shown in Figure 43.
In evaluating the projects, one advantageous criterion for handling investment accounting, including financing, can be exploited. In contrast to the traditional project financing approach, the following calculation does not apply the net present value but rather the final asset values based on the complete finance plans. This recursive configuration of the final asset value realistically integrates the imperfect capital market with its separate interest rates for debits and credits, which means that the financing of shortfalls and the reinvestment of profits do not have to be calculated using the regular consistent rates of return which are typical for net present value.

\[
V_0 = E_0 - A_0 \\
V_t = V_{t-1} + E_t + ZE_t - A_t - ZA_t \quad \text{für} \quad t = 1, \ldots, n \\
mit \quad ZA_t = s \cdot S_{t-1} \\
ZE_t = h \cdot H_{t-1} \\
S_t = S_{t-1} + K_t - T_t
\]

To calculate the asset value \( V_t \) (\( t = 0, 1, \ldots, n \)) the fund revenues \( E_t \) are extrapolated yearly in a finance plan and added to the current expenses \( A_t \) for management, tax, and project funding costs, as well as the interest income \( ZE_t \) and the interest expenses \( ZA_t \). It is necessary to examine for each year whether the fund turned a profit and was thus able to reinvest newly available (CDF) money \( H_t \) at investment or credit interest rates \( h \) which would result in interest income in the following years. If it is unable to cover expenses, however, it would be necessary to raise capital \( K_t \), which would result in additional interest expenses and repayments \( T_t \) in the following years to refinance the business activities.

### 6.2 Fund accounting premises

The main assumptions for fund accounting, which have already been agreed upon with the future fund managers, will be clarified in the following (see Figure 44).

The fund is assumed to begin operations at the end of 2010. The duration of the fund will be tied to the duration of the projects. These vary from 16 years for the Lebach project (ending in 2026), 17 years for the Neunkirchen project (ending in 2027), 20 years for Ottweiler (ending in 2030) and 22 years for Dillingen and Nalbach (ending in 2032). It should be noted here that the Dillingen project is actually planned to last until 2040, but this would be a very long planning period for the CDF. It was thus proposed that the Dillingen project also runs until 2032 at which point the debt should be transferred to another lender.

Because of the overall, very long project durations, it is assumed in the following that the CDF will have a duration of 22 years (until the end of 2032). Should the point in time at which the fund goes into operation be delayed by one year due to organisational preparatory work or political decision (to the end of 2011), this would not have any initial impact on the value of the fund under the premise that the projects do not change. Rather, the fund would (only) continue activity until the end of 2033 instead.

In terms of fund management a number of different interpretations of the laws which stipulate the remuneration for management services came up during the compilation of this study. According to Article 43 of Regulation (EC) No 1826/2006, if there is no tender procedure, then a cap of 3% of the
capital contribution of the Operational Programme to the financial engineering instrument (here, the CDF) is set for management costs. Since the fund manager was planned to be a public sector body, no mention has been made of tax payments in the following fund accounting. Since the governance model would proscribe conducting a tender procedure for the review of the eligibility of project proposals to the CDF for financing and loans, the 3% threshold may be exceeded. Additional costs incurred would then be covered by the state budget. However, the following assumes that the SIKB will be responsible for the financing and loan eligibility review. Insofar, the following fund account reflects 3% of the capital contribution from the Operational Programme in the CDF as administrative and management costs.

<table>
<thead>
<tr>
<th>Duration of fund activity:</th>
<th>22/23 years (2010-2032; note: longest project 22 years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Administrative and management costs:</td>
<td>maximum 3% of capital contribution of Operational Programme to the financial engineering instrument possible</td>
</tr>
<tr>
<td>Fund volume:</td>
<td>EUR 30 million,</td>
</tr>
<tr>
<td>Thereof ERDF funds:</td>
<td>EUR 10 m (33.33% grant)</td>
</tr>
<tr>
<td>Co-financing from state budget:</td>
<td>EUR 10 m (33.33% grant)</td>
</tr>
<tr>
<td>CEB loan:</td>
<td>EUR 10 m (33.33% interest-bearing loan)</td>
</tr>
</tbody>
</table>

**Conditions of CEB loan:**
- Interest at the 3-month EURIBOR (currently 0.65 %) + 35 basis points
- Term 10 years, thereof the first five years interest-free, then paid off by annuity

**Interim financing costs:** 5% p.a. (if required) for any short-term peak needs

**Reinvestment interest income** (unused funds remaining): 2.0% p.a.

**Scope of project financing:**
- Granting dormant partner’s interests (perhaps also loans and equity at a later time);
- Repayment by annuity with durations similar to projects of up to 22 years;
- Extension for repayment possible at the beginning (development and construction phases);
- Interest rate: 2.0% p.a. plus participation in profit or loss at end of project;
- Typical dormant partner’s interest without active project management by the fund;
- All five identified project types;
- Full and partial financing of projects;
- Number of cycles (until funds are returned): each project type 4-5 times

Within the working group, it was decided to set the fund volume at EUR 30 million during the initial phase. In contrast to other UDFs already in planning (see the concepts on UDFs e.g. in Hamburg, North Rhine-Westphalia, Berlin and Brandenburg), which all foresee the maximum amount of co-finance for ERDF funds from the Operational Programmes provided to the UDF, another refinancing method was chosen for the CDF in the Saarland. In addition to the starting deposit of EUR 10 million the ERDF puts into the CDF at no interest, another EUR 10 million will be deposited by the Saarland as state co-financing. Moreover, the CEB will lend the CDF a further EUR 10 million, bringing the total fund capital to EUR 30 million split evenly among the three sources of financing.

In terms of interest, it is assumed in the following that two thirds of the fund capital, the parts contributed by the ERDF and the state co-financing, are non-interest-bearing and provided as grants and that this capital does not have to be paid back. In regard to interest on the state co-financing, there is a difference between the Saarland Community Development Fund and other UDF concepts being developed in Germany at present. In most models, the state co-financing is provided by a development bank (e.g. the NRW.BANK in North Rhine-Westphalia or the IBB in Brandenburg). Although some of these waive interest on the capital during the start-up phase, the co-financing should not generally be understood to be non-interest-bearing as is the case in the Saarland. Thus, the CDF has a cost advantage as there is no need to pay refinancing costs on this EUR 10 million of the fund.
capital. The last third of the fund capital, provided by the CDF, does bear refinancing costs. These are very low, however, and based on the 3-month EURIBOR rate plus a premium of 35 basis points. Since the 3-month EURIBOR stood at 0.65% as at 17 March 2010, for example, at this point in time the refinancing costs for the fund would be (0.65% + 0.35% =) 1% p.a. Nonetheless, these refinancing conditions could fluctuate to a limited extent with changes in the EURIBOR. Since this depends on the future development of interest rates, the rate is assumed in the following to be 1% p.a. for the EUR 10 million CEB loan to the fund. The repayment schedule for the CEB loan is set up as a ten-year term with a five-year grace period. The principle is then repaid over the remaining five years of the term, with the first repayment due at the end of the sixth year.

If, within the scope of the CDF’s activities, there is a short-term need for more capital than the EUR 30 million starting deposit, these are assumed to be interim financed at a current market interest rate of approx. 5.0% p.a. Given the high CDF volume compared to the capital requirements of the pilot projects in the start-up phase, this is quite unlikely; nonetheless, this also serves as the assumption for the individual projects if, due to limitation to partial financing, the remaining financing has to be found on the market. If the CDF has unused capital, it will be reinvested at 2.0%. These assumptions represent a conservative starting situation which could still vary due to the further potential for optimising the fund. This might come, for example, when the fund management reinvests the unused capital in new projects (which are not yet determined). In this case, even when the fund charges a low interest rate for the loan, it will generate higher interest income from the reinvestment. More details are found on additional optimisation potential at the end of the chapter.

In regard to the financial engineering instruments which the CDF gives to the projects, it is initially only foreseen to grant dormant partner’s interests. Once cash flows return to the fund at the end of the pilot projects, however, it is possible that the CDF could expand its range of financial engineering instruments to include equity and loans. This depends on the governance model chosen. Due to the generally higher risk-reward potential of equity capital investments, for example, it would be advantageous for the CDF to be its own legal entity in this case. The advantage of equity capital investments over lending are seen when projects offer the possibility of strong profits, which are (far) higher than the agreed upon credit interest rate. In the case of loan financing, these profits go to equity investors outside the fund, whereas the fund would participate in the cash flows if it has financed through equity capital. Insofar, the preferred option is for the CDF to invest through dormant partner’s interests. Lending, as well as equity, is not ruled out for the CDF, at least for the “second round” of financing integrated urban and community development projects.

The durations of the pilot projects in the starting portfolio show, however, that a second round of financing would come at a quite late stage. All of the five pilot projects are longer running projects with durations of at least 16 years and the longest project – as explained above – is actually even 40 years. The long financing periods are absolutely necessary for each project, since shortening them would mean that the annual payments, composed of interest and the repayment of principle, would be too high to pay from the project cash flows. In the area of dormant partner’s interests, durations of more than five years in connection with predetermined principle repayment plans are customary.

In order to grant the individual projects the most favourable possible repayment conditions for their credits, but also cover all costs for the CDF’s business activities, a low, steady repayment (annuity) of the capital over up to 22 years was seen as practical. Funding with an unclearly defined amortisation
schedule, e.g. in which the repayment is determined variably according to the cash flows in each period, is not allowed. Such funding conditions would have a large disadvantage for the CDF, as the returns to the fund could not be planned, but would directly depend on the project cash flows. The financing of new projects might then be at risk or not occur according to plan.

This does not exclude the agreement on a grace period, since most of the projects generate very small cash flows in the early years. It is “indirectly” necessary to defer payment in projects which are unable to repay in the first years of the construction stage and instead increase outstanding debt by raising additional capital.

In terms of financing rates, the aim is to set the lowest possible rate in order to further reduce the encumbrance on the project and achieve the stated public goals. This depends on the selected refinancing structure of the fund and is also determined based on the impact on the pilot projects. If the current interest rates for municipal loans are used for orientation, such as they are granted by the KfW bank (some below 2.0%), a rate of 2.0% currently seems realistic. Given the project returns calculated in the previous chapter, it is also essential to grant favourable financing conditions with long durations. Since all five pilot projects are long-running and show low project returns well below 5% across the board, higher financing costs and/or higher repayments would be a disadvantage for these projects and put the cash flows to the fund at risk. Therefore, an interest rate of 2% p.a. is used throughout the rest of the evaluation of the feasibility of the fund. During the implementation stage, the fund management shall decide whether higher or, if necessary, even lower credit interest rates can be granted depending on the current project risks and refinancing costs.

It should also be noted that, in addition to the fixed, minimum interest rates, dormant partner’s interests also require that the CDF participate in the profits or losses of the projects. This participation occurs at the end of the project’s duration and can mean additional income for the fund (if the project is profitable) or the acceptance of default costs for the fund (if it is not). The amount of the default costs cannot be limited in advance. They are the total of the still outstanding participation amounts at the end of the project. Looking at the amount of the profit participation, guidelines regarding appropriate yields for dormant partner’s interests have been developed in the German legal system over the last few years. They fall between 15% and 35%. Although this rate shall be negotiated by the future fund managers on an individual basis, it will be assumed from this point on to be the minimum participation of 15% in the profits of the projects as each comes to the end of its duration. In terms of fund capital preservation, this is a conservative premise which still positively supports the ability of projects to be financed.

At the same time, it has to be noted at this point that the project types and their financing volumes only mean total capital requirements of approx. EUR 7.113 million for the CDF. This was already clearly shown in the capital requirements analysis at the fund level in the previous chapter. Therefore, far more projects of the same type could be supported by the Saarland Community Development Fund. Assumming that capital is distributed evenly to all five project types at the corresponding financing rates according to Figure 45, then all model projects could be carried out 4-5 times, which means more than 20 individual projects could be financed within the foreseen duration of the CDF.

The members of the working group estimated that, if a call for projects was done across the Saarland, this would realistically represent the demand for projects and financing. Refer to the comprehensive analysis in Chapter 2.3 for more information.
<table>
<thead>
<tr>
<th>Project</th>
<th>Type of financing</th>
<th>Financing rate</th>
<th>Financing conditions</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dillingen</td>
<td>Dormant partner’s interest</td>
<td>100% (= € 540,000)</td>
<td>22 years; even repayment of principal after 6-year grace period</td>
<td>Transfer debt to other creditor at end of fund duration (= repayment to fund)</td>
</tr>
<tr>
<td>Ottweiler</td>
<td>Dormant partner’s interest</td>
<td>39% (= € 625,000)</td>
<td>20 years; even repayment of principal after 2-year grace period</td>
<td>Partial financing, combined with urban development subsidies and city’s own contribution</td>
</tr>
<tr>
<td>Nalbach</td>
<td>Dormant partner’s interest</td>
<td>100% (= € 668,000)</td>
<td>22 years; even repayment of principal after 1-year grace period</td>
<td>Potential setup of a PPP model</td>
</tr>
<tr>
<td>Neunkirchen</td>
<td>Dormant partner’s interest</td>
<td>100% (= € 4.3 m)</td>
<td>15 years; even repayment of principal after 1-year grace period</td>
<td>Partial financing: private investors finance the rest (€ 1 m) for land and ancillary building costs</td>
</tr>
<tr>
<td>Lebach</td>
<td>Dormant partner’s interest</td>
<td>68% (= € 980,000)</td>
<td>16 years; even repayment of principal after 1-year grace period</td>
<td>Partial financing, combined with urban development subsidies</td>
</tr>
</tbody>
</table>

Figure 45 – Potential fund financing for pilot projects

6.3 Results of fund calculations

Based now on the 4-5 cycles for the five project types, using these to derive the cash flows of the portfolio, and handling the fund calculations in accordance with the premises set in the previous chapter, the result is the following finance plan for the CDF (see Figure 46).

<table>
<thead>
<tr>
<th>2010 Dec</th>
<th>2011</th>
<th>2012</th>
<th>2030</th>
<th>2031</th>
<th>2032</th>
</tr>
</thead>
<tbody>
<tr>
<td>+ fund revenues</td>
<td>-16,127,665</td>
<td>-13,403,665</td>
<td>902,121</td>
<td>755,834</td>
<td>158,644</td>
</tr>
<tr>
<td>+ interest income</td>
<td>-277,447</td>
<td>3,246</td>
<td>364,355</td>
<td>386,227</td>
<td>396,939</td>
</tr>
<tr>
<td>- fund expenses</td>
<td>-483,830</td>
<td>-895,616</td>
<td>-26,628</td>
<td>-9,240</td>
<td>-4,666</td>
</tr>
<tr>
<td>- interest expenses</td>
<td>-100,000</td>
<td>-100,000</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>fund cash flow</td>
<td>-16,127,665</td>
<td>-13,719,048</td>
<td>-90,250</td>
<td>1,093,561</td>
<td>535,630</td>
</tr>
</tbody>
</table>

Figure 46 – Finance plan for the Saarland Community Development Fund, Part 1 (in euro)

One notes that the fund cash flow looks like a typical investment. Expenses dominate income in the first two years. From the third year until the possible end of the fund (and all projects), there are only cash flows to the fund in the form of profits. The greatest gap between income (none) and expenses (high) happens in the first year. At the end of the fund’s duration, the cash flows shrink drastically in those years when individual projects have completely repaid, e.g. after 2026 and 2031. Since the fund calculations do not include any reinvestment of the newly available capital into projects, in the sense of a second round of financing, the income drops at the end of the fund duration. Adding in the refinancing, default and management costs, the cash flows to the CDF over its entire duration look as follows (see Figure 47).
Following the path of the related fund capital, i.e. the sum of the capital paid out, it becomes clear that the CDF will have actually used nearly exactly its entire starting capital of EUR 30 million to finance the pilot projects. The capital will have already been completely employed by 2015. Furthermore, the complete amount of capital employed is repaid by the end of 2031 and thus shortly before the end of the fund duration (see Figure 48).

The following examines the impact of the granted fund financing on both the project level and the fund level in terms of the goal of capital preservation. It should be noted that the proposed fund model does not aim to be a single, specified nominal value, but rather an iterative solution. This gradually brings the fund architecture closer to the needs of the Saarland, as an analysis of the impact of the fund financing on the pilot projects clearly shows.
6.4 Evaluation of fund financing in regard to pursuing public sector goals at the project level

6.4.1 Fibre Optic flagship project in Dillingen

The Saarland Community Development Fund will provide the full capital expenditure of EUR 540,000 needed to finance the Fibre Optic flagship project in Dillingen. The financial engineering instrument granted to the project will be a dormant partner’s interest with a 20-year repayment schedule at a 2.0% fixed interest rate. KomCon proposed an eight-year grace period, wherein no repayment needs be made. Analysing the cash flows of the project in detail, it becomes clear that the returns from the project through 2012 are not enough to afford the interest payment to the CDF, to say nothing of the repayments. The amount of the participation rises to a minor extent until 2013 due to the deferment of payment; starting in the seventh year, an annual capital service of EUR 45,210 will be paid to the fund until the end of the duration. Therefore, a grace period of six years is granted for the participation. Figure 49 shows that the financing can then be completely repaid to the CDF within 20 years.

![Figure 49 – Participation in the Dillingen project (in euro)](image)

At the same time, a comparison of the project cash flows and the necessary capital service to the CDF shows that the capital service cannot be financed by annual cash flows alone until 2020. In the prior years, i.e. between 2016 and 2020, at a debt service coverage (the ratio between cash flows and capital service) under 100%, this is only possible if the project cash flows from the years 2013 to 2016, when the grace period was still in force, can be temporarily reinvested and then used to pay down the principle. Not until 2023, when the project has the revenues from connecting all 65 units to the fibre optic network, does the debt service coverage rise to 138% and stay at this level until the participation of the CDF is over (see Figure 50).
One risk factor is a change in the price for telecommunication services. As already discussed in the project chapter, it is not feasible to expect a price increase to raise sales. Rather, the price for these services has fallen on average by 2.84% p.a. over the last few years. Although the future need not follow the trends of the past, a price increase would significantly reduce the telecommunication coverage. Another factor of uncertainty in the project in Dillingen which might cause a change in cash flows is the actual number of potential businesses to be connected to the fibre optic network. This figure was forecast at 15 but it might come out lower (or in the best case, higher). Since the debt service coverage for the years 2016 to 2019 is below 100%, a lower number of subscribers might initially mean that the capital service cannot be fully repaid to the CDF. If the full number of 65 subscribers is reached in the long term and there is no further price erosion on the market for telecommunication services, however, the CDF financing for the Dillingen project would financially feasible under the given premises in any case.

At the end of the duration, under the premises given, the project generates a minor profit, in which the CDF’s participation entitles it to 15%. This means additional income of approx. EUR 30,000.

### 6.4.2 Terentiushof/Wilhelm-Heinrich-Straße project in Ottweiler

The Saarland Community Development Fund will provide EUR 625,000 of the full EUR 1.6 million needed to finance the Terentiushof/Wilhelm-Heinrich-Straße project in Ottweiler. Like for the Dillingen project, the financial engineering instrument granted to this project will be a dormant partner’s interest with a 20-year repayment schedule, though here the grace period is only two years. Since the remaining financing need will come from urban development subsidies, supplemented by a contribution from the city, all the project cash flows can be used to repay the CDF, which means the funding will be completely repaid in 2030 (see Figure 51).
In terms of its cash flow structure, the Ottweiler project shows the peculiar feature that these cash flows will come from two sources, EUR 15,000 from regular rental income from the parking spaces created on Wilhelm-Heinrich-Straße for one, and the one-time sales revenues of EUR 440,000 for selling the land along the Federal Highway 41 plus the sale of the real estate in Wilhelm-Heinrich-Straße 31 to 35. Assuming now that the sales revenues are generated in the year directly after completion and can thus be brought in in 2013, these one-time cash flows would ensure that a debt service of EUR 42,528 p.a. could be afforded from 2013 to 2030. Without these one-time cash flows, however, the annual rental income of EUR 15,000 would not be nearly enough to cover the debt service. Thus, the following debt service coverage calculations incorporate these sales revenues, which are reinvested in the interim and then continuously used to pay back the debt service each year (see Figure 52). Leaving out these sales revenues would have meant an insufficient debt service coverage of (€ 15,000/€ 42,528 =) 35%.

Insofar, it again becomes clear at this point that the ability of the project to repay the CDF is directly determined by the point in time when the land along Federal Highway 41 and the buildings at Wilhelm-Heinrich-Straße 31 to 35 are sold. If they cannot be sold in 2013, the annual cash flows of EUR 15,000 from renting the parking spaces is just enough to pay the interest of EUR 12,752 (2% on the accrued debt) to the CDF and, in theory, to make a minimal amount of repayment. Thus, the project yield worsens when the sales revenues are delayed.

At the end of the duration, under the premises given, the project generates a minor profit, in which the CDF’s participation entitles it to 15%. This means additional income of approx. EUR 750.
Figure 52 – Debt service coverage in Ottweiler project including reinvested amounts from one-time sales proceeds

6.4.3 Local Heating Supply project for the community of Nalbach

The Saarland Community Development Fund will provide the full EUR 668,000 needed to finance the construction of a local heating supply plant in Nalbach. Once again, the financial engineering instrument granted to the project will be a dormant partner’s interest at a 2.0% fixed interest rate, but in contrast to the previous projects, this one will have a 22-year duration. Due to the very even cash flows from the project with exactly the same revenues from the year it goes into operation (2012), it will only be necessary to defer repayment during the construction stage, i.e. there is a one-year grace period. As shown in Figure 53, the project is able to repay the full amount of the financing to the CDF by the end of the fund duration in 2032.

Figure 53 – Participation in Nalbach project (in euro)
In calculating the debt service coverage, however, it becomes clear that, at a steady 103.63%, it is only barely possible to repay the debt service to the fund from the project cash flows. If the cash flows come out even a little lower, however, the debt cannot be completely serviced (see Figure 54).

![Figure 54 – Debt service coverage in Nalbach project](image)

In terms of the risk-reward potential of the Nalbach project, however, it should be pointed out that the underlying cash flows are based on very conservative assumptions, both in regard to the value of the revenues and the volumes. The energy price is assumed to remain constant over the entire duration of the credit. In contrast, assuming a moderate to high increase in energy prices would mean that the income from the energy savings comes out considerably higher. Assuming the price of energy increases at the average rate over the last ten years, or 2.07% p.a., the income would increase by 50% from the start of the fund duration to the end. As far as the volumes go, there is also potential for increase here if the additional connection to 100 households in the second construction stage is included. In comparison to the previous projects, the Nalbach project offers more opportunities than risks, and these could increase the cash flows and thus the project yield. In other words, in spite of the tight debt service coverage, it can be assumed that this project can be financed by the CDF.

At the end of the duration, under the premises given, the project generates a minor profit, in which the CDF’s participation entitles it to 15%. This means additional income of approx. EUR 5,000.

### 6.4.4 Spitzbunker City Hotel in Neunkirchen

The goal is for the Saarland Community Development Fund to provide the EUR 4.3 million needed to finance the construction of the hotel in Neunkirchen, while private investors contribute another million to finance the land acquisition and ancillary construction costs. Once again, the financial engineering instrument granted to the project will be a dormant partner’s interest at a 2.0% fixed interest rate, but this time with duration of 15 years (see Figure 55).
Figure 55 – Participation in Neunkirchen project (in euro)

Totalling the forecast revenues from the operation of the hotel and the gastronomy less the planned expenses, and assuming 65% capacity utilisation of the hotel over half of the year, results in net revenues of EUR 374,400 p.a. This is enough to cover the steady debt service of EUR 337,996 p.a. to the CDF (see Figure 56).

Figure 56 – Debt service coverage in Neunkirchen project

In this project, it must be noted that private investors have put up EUR 1 million, which also has to generate returns. As recipients of residual income, however, the investors (only) get the amount
available after the creditors have been paid their due from the project. In this case, it amounts to \((€ 374,400 – € 337,996 =) € 36,404\) p.a. This equals a return on equity (ROE) of 3.64%. Though this yield is very low relative to the high risk of the investment, it does not reflect that the investors also acquire ownership of the building and thus any revenues from its sale go to them as well. In the event of disposal at 10 times net income (EUR 3.74 million), this already means a yield of 11.4% p.a. for the investors. This should already been seen as sufficient for this segment of the German real estate market. This changes little for the participation of the CDF, since the yield only falls from 11.4% to 11.2%. This means additional income of approx. EUR 95,000 for the fund.

Given the presumed partial financing of the Ottweiler and Lebach projects, the significance of financing the Neunkirchen project is even more than if it was fully financed. Of the total € 7.113 million paid out by the CDF, 60.45% of the financing volumes goes to this hotel project. This creates a cluster risk for the CDF, that is, insufficient risk diversification. This is expressed in the fact that the cash flows to the CDF depend on the capacity utilisation of the hotel in Neunkirchen to a disproportionately high degree.

6.4.5 Revitalisation of the pedestrian precinct in Lebach

For reasons of risk, the Saarland Community Development Fund will provide only 68% of the full capital expenditure needed in the last project in the starting portfolio to finance the revitalisation of the pedestrian zone in Lebach. Once again, the financial engineering instrument granted to the project will be a dormant partner’s interest at a 2.0% fixed interest rate, but this time with duration of 16 years and a one-year grace period. As visible in Figure 57, the full sum of the financing will be paid back by 2026.

The fact that the remaining capital is to come from urban development subsidies is advantageous for the CDF, because the EUR 80,000 saved annually from the repair work is available for cash flows to
the CDF alone and so the credit volume is lower. This means steady debt service coverage of 103.85% (see Figure 58).

![Debt service coverage in Lebach project](image)

In terms of the cash flows, it is questionable whether revitalising the pedestrian precinct in fact only means savings compared to the status quo, or whether additional costs will have to be deducted each year to care for the green spaces and maintain the parking spaces.

At the end of the duration, under the premises given, the project generates a minor profit, in which the CDF’s participation entitles it to 15%. This means additional income of approx. EUR 7,500.

### 6.5 Evaluation of the business activity at the fund level

Based on the five pilot projects, the business plan (see Figure 59) of the Saarland Community Development fund reveals the risks as well as the additional chances for optimising this innovative financial engineering instrument for urban planning.

![Finance plan for the Saarland Community Development Fund, Part 2 (in euro)](image)

Continuing the financial planning from Chapter 6.1 shows that, after completion of the projected 22 years in total, the fund will have additional assets of a good EUR 0.42 million (see Figure 60). This amount at the end of the duration should be understood as fund profits. In regard to the three sources of financing to the CDF, this means:
1. the loan from the CEB for EUR 10 million at an interest rate of 1% and a duration of 10 years, with a five-year grace period will have been paid back completely in 2020 according to plan,

2. the state co-financing of EUR 10 million will have been preserved, and

3. the EUR 10 million from the ERDF will again be available for investment in sustainable urban development once the fund is done.

After servicing all three financing sources, there will still be a said surplus of a good EUR 0.42 million or 1.4%. This means that the lowest goal of preserving the nominal capital has been achieved.

Thus, even when considering all interest, default and management costs, over the duration of the CDF the fund capital grows by a nominal 0.06%. Including an annual inflation rate of 1.5–2.0% would show that the fund capital is not preserved in real terms. Because of the difficult project portfolio, increasing the capital was not expected in the first place.

Under the given assumptions, there is a lot of value added to the ERDF or other resources relative to granting “lost” subsidies. At the end of the fund duration, there is still EUR 20.42 million available, i.e. more than the originally provided EUR 20.0 million (see Figure 60). It can be used for new integrated urban or community development projects in the Saarland (even outside the fund). Moreover, according to the business plans submitted, the fund would not merely have provided financing to the pilot projects but, according to the analyses conducted, also carried out all public interests at the project level.

![Figure 60 – Cumulative fund cash flows over the entire duration of business activity (in euro)](image)

### 6.6 Additional opportunities to optimise future fund management

It should already be noted here that there are more opportunities to further optimise the implementation of the CDF in the Saarland. The future fund management of the CDF will play a crucial role in this.
In this regard, it is worth mentioning that increasing the participation profits and/or shortening the repayment schedules would also improve the preservation of fund capital. However, this would come at the cost of implementing the public interests at the level of the individual projects, as it would only raise the cost of the project financing from the fund. It is this shift toward commercial project financing, like that offered on the capital market, which should be prevented through the offering of the CDF. For this reason, nothing further is said about this option.

The same applies when the CDF financing is reduced to individual parts of the total investment needs, especially for those projects which are currently planned to receive full financing from the fund. In this case, the remaining financing would have to come from commercial sources. This would raise the financing costs and limit or even jeopardise the achievement of public project goals. Even extending guarantees from the fund combined with parallel lending from commercial banking partners would increase the financing costs at the project level, since the guarantee fees and the market rate loan interest rates will not be lower than the currently assumed fixed rate of 2.0%. Moreover, guarantees only offer a limited coverage of default risks for the financiers (up to 80%).

It actually seems better for the fund management to reinvest cash flows to the fund into new projects to thereby generate higher interest income and achieve additional public project goals. Furthermore, the funding of more short-running projects and smaller projects (instead of individual large projects) seems to make sense due to the faster returns and lower cluster risks at the fund level. The starting portfolio of the CDF only features long-running projects – the shortest project duration is 16 years – as well as considerable cluster risk from the Neunkirchen project, which accounts for more than 60% of the total funding volume for the entire CDF. Herein lies the challenge to the future fund management in identifying suitable projects for financing by the CDF.

![Figure 61 – Cumulative fund cash flows over the entire duration of business activity (alternative scenario 1: Reduction of management fees to 1.50%; in euro)](image)

It would greatly improve the preservation of fund capital if the fund management fees could be reduced. Because dormant partner’s interests are being granted, which typically feature no independent, active management activities in the project companies, it would presumably be possible to lower
administrative fees considerably, for example, by setting up a ministerial administrative department (cf. details on governance models). Applying a rate of approx. 1.5% for the Saarland Community Development Fund results in a surplus of EUR 6.56 million (see Figure 61). In this case, the total net income is 21.88%, or nominal capital growth of 0.90% p.a. Again, this is not equivalent to real fund capital preservation.

If the management fees were actually reduced, it would also make sense for the Saarland Community Development Fund to use other financial engineering instruments for the project types presented. The discussion regarding the various governance models raised the possibility that the CDF – or a financial institution, if involved – finance the pilot projects through loans or equity in the form of venture capital.

In the case of loan financing, the performance of the ExWoSt model projects for UDFs clearly show that management fees of 1.50% are realistic when a financial institution is involved. Assuming this rate and leaving the other premises for financing, durations and fixed interest rates unchanged, means a slightly worse result for the fund from the pure lending scenario. The reason for this is the fact that the fund no longer participates in profits and losses. Figure 62 on the alternative scenario reveals that the fund surplus would be EUR 5.91 million or 19.69%.

![Figure 62 – Cumulative fund cash flows over the entire duration of business activity (alternative scenario 2: extending loans to projects, management fees 1.50%; in euro)](image)

As far as equity is concerned, i.e. investing venture capital, in all projects is assumed that the (proportionate) project cash flows replace the repayments from the project to the CDF. (In the case of the Neunkirchen project, the cash flows are split with the private partners, each according to his share). Leaving all other premises unchanged from the prior scenarios (incl. the lower management costs) results in scenario 3 below (see Figure 63).

Although the ability of all of the projects to pay back the investment would improve in accordance with the already detailed project cash flows, the surplus for the CDF would shrink minimally to EUR 5.23 million. This is a surplus of 17.50% or annual nominal fund capital growth of 0.74%. Even though this also “only” means nominal capital preservation at the fund level, the advantages at the
project and governance level could justify the implementation of this form of project financing by the Saarland Community Development Fund.

In contrast, this scenario considers charging higher fund management fees due to the doubtlessly greater administrative needs. In scenario 3, up to 2.30% in management fees could be charged without putting the financial feasibility of the Saarland Community Development Fund at risk. Even with these management costs, the full amount of capital is preserved, though there would no longer be any nominal capital growth. Paying higher management costs appears to be necessary if venture capital is invested, since active management support by the CDF via its representative(s) at the project level (e.g. in the executive or supervisory board of the project company) can be relevant.

In summary, the Saarland Community Development Fund would enjoy the surpluses listed below based on the four fund calculation scenarios (including the starting situation). All four scenarios exhibit nominal capital preservation, which means the financial feasibility criterion is fulfilled under the given premises for the projects and the fund (see Figure 64). From the purely financial perspective, in principle the Saarland Community Development Fund could use all of the financial engineering instruments mentioned in the discussion (loans, equity and dormant partner’s interests).

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Form</th>
<th>Fund Surplus</th>
<th>Nom. Capital Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Starting values</td>
<td>Dormant partner’s interest, 3% management costs</td>
<td>EUR 0.42 million</td>
<td>0.06% p.a.</td>
</tr>
<tr>
<td>Alternative scenario 1</td>
<td>Dormant partner’s interest, 1.5% management costs</td>
<td>EUR 6.56 million</td>
<td>0.90% p.a.</td>
</tr>
<tr>
<td>Alternative scenario 2</td>
<td>Loans, 1.5% management costs</td>
<td>EUR 5.91 million</td>
<td>0.82% p.a.</td>
</tr>
<tr>
<td>Alternative scenario 3</td>
<td>Equity, 1.5% management costs</td>
<td>EUR 5.53 million</td>
<td>0.74% p.a.</td>
</tr>
</tbody>
</table>

Figure 63 - Cumulative fund cash flows over the entire duration of business activity
(alternative scenario 3: investing venture capital (equity) in the projects, management fees 1.50%; in euro)

Figure 64 – Comparison of nominal capital preservation in four scenarios for the CDF
7 SUMMARY DETERMINATION OF NECESSARY IMPLEMENTATION STEPS

7.1 SWOT analysis: Added value of JESSICA instruments in the Saarland

The calculated model of the Saarland Community Development Fund shows that the revolving use of ERDF funding as equity capital investments and, as the fund progresses, as loans is possible. Although the cash flows needed for this from the identified pilot projects are tied to (in some cases) greater risk, there are also possibilities to optimise the design and calculation of the fund model. Given the shift in the focus of European funding to the new EU Member States and the related, very likely decrease in ERDF funding available for use in Germany, and thus for the Saarland as well, any lower capital consumption by the fund would make it possible for the Saarland to finance urban development projects in future as well, since all capital returning to the CDF would be available for reutilisation.

This repeated use of returning capital is no longer subject to the guidelines of the ERDF regulations; they only need to further the goal of sustainable urban development in accordance with Article 78(7) of Regulation (EC) No 1083/2006.

Once the ERDF funding and its co-financing are deposited into the CDF, they count as disbursed. Thus, there is no longer any risk that they must go back to the European Commission due to non-use during the period stipulated by the N+2 Rule. The proof of disposition for the ERDF funding and its co-financing is not due until the end of 2015, i.e. it is critical to invest them into projects and construction measures before that time. A look at the fund calculations presented in this study shows that far more projects have to be identified at the start of the implementation stage than the five pilot projects in order to actually get all the targeted capital paid out (EUR 10 million ERDF + EUR 10 million state co-financing).

The additional EUR 10 million in capital from the CEB loan to the CDF worsens the economic results of the fund due to the payments of interest and principle and may seem unfeasible due to the allocation conditions described, but it has the undisputed advantage that this EUR 10 million is not subject to the provisions of the EU and can thus be used in areas outside those presented above. For example, investment in housing could be funded with this capital, which would be excluded under the ERDF regulations. This puts the CDF in the position to also fully fund mixed usage projects which are important for central urban development policy.

In spite of periods of empty coffers, the funding activities of the CDF should stimulate public and private investment in urban development policy activities. This creates a leverage effect which far exceeds the amount of funding employed.

In contrast to issuing subsidies, which limits the public sector’s regulatory influence in a project to its very start in practice, the use of JESSICA instruments means its influence on behalf of the common good extends throughout the project. In the event of an equity capital investment, it can even participate directly in the profits.

The activities of the CDF also make it possible for the communities of the Saarland to raise the co-financing needed for national and state funding projects in spite of their tight budgets.
The following SWOT analysis gives another overview of the general advantages, disadvantages, chances and risks:

**Strengths:**

- Use of new funding instruments (equity, later loans as well) in urban development, which makes other project types possible that were not able to use the existing grants.
- The EUR 20 million in ERDF funding and its co-financing deposited in the CDF can be used continuously and reused (revolving, sustainable and efficient usage).
- After the first round, the revolving capital is not subject to ERDF provisions; twice-revolved funds are not subject to any usage provisions after exit.
- The use of funding with repayment conditions should also activate private investment in the sense of the eligibility requirements of the CDF (leverage effect).
- The repayment-based funding approach promotes project discipline and sustainability in their preparation and implementation. Turning to banks for their competence in making the funding decisions helps reduce the economic risks to the CDF (no “disguised” grants via the CDF are possible).
- Decreasing the N+2 problems as funding is considered disbursed once paid to the CDF.

**Weaknesses:**

- The co-financing of the ERDF funding has to be financed from the state’s budget or through an (interest-bearing) loan. The possible combination with federal or state funding when subsiding is not possible for deposit into the CDF.
- The late start of the JESSICA initiative in the programme period means that all ERDF funding is actually tied up in grant projects. ERDF funding can only be put into the CDF if the capital is not retrieved in time by the targeted grant projects.
- High administrative costs due to new funding principle; increased administrative costs from involving banks and fund managers.
- Mandatory proof of disposition for the ERDF funding and its co-financing at the end of the programme period is still required and necessitates the complicated agreement between funding recipients, fund managers and the responsible ERDF administrative agency. More costs through separate accounting of the CEB loan.
- Greater project discipline means more costs when applying for funding; project conception must be more developed than earlier and already be in the financing planning stage, which normally only has a small time frame.

**Opportunities:**

- Against the backdrop of the geographic shift in European funding policy, additional funding is secured for the coming programme period (repeated usage of funding in this programme period), thereby compensating for the expected drop in funding allocation.
- Due to its revolving character, the CDF funding can also serve to co-finance future ERDF funding allocated to the Saarland.
• Since the business areas of the CDF represent the main requirements for action by the public sector in terms of urban and community development, other goals for the common good can be achieved as well.

• In times of economic crisis, granted JESSICA funding can have a positive image effect (better credit rating, project seen as more important...).

• The activities of the CDF can increase the success in implementing the goals and content of integrated community development concepts. By instituting a first loss provision for the public capital into the financing agreements on the CDF between the state and the fund management, higher than normal financing risks can be justified to initiate the funding of especially important urban development projects with great benefits for the common good.

• ERDF funding and their co-financing can also be used to finance the fund management until the end of 2015, which helps offset the upfront costs (project review and selection process). This is not possible thereafter, since all funding must be financed by that date due to the proof of disposition requirement. Because of the CEB loan, however, the CDF is not entirely dependent on the project cash flows in 2016 to pay the fund management costs.

• The capital from the CEB loan can also be used for projects which are ineligible under ERDF provisions. This broadens the CDF’s range of action considerably. It can also fund important projects by financing the eligible parts with ERDF funding and its co-financing and the ineligible parts with the CEB loan capital. This makes it possible to fund the entirety of mixed usage projects which include, e.g. housing.

**Risks:**

• The ERDF funding tied up in the CDF cannot longer be used for grants.

• Together with the related co-financing, the ERDF funding deposited in the CDF must have been invested in projects once by the end of 2015.

• Utilisation of the CEB loan reduces the total economic performance of the CDF, since the interest and repayment have to be serviced.

• The acceptance of greater project risks due to the first-loss rule for the public capital employed to enable greater common good effects might mean much worse financial results for the CDF.

• Due to the economic crisis and the generally tight budgets for the communities of the Saarland, the use of the JESSICA instruments improves the possibility of borrowing by private parties and municipalities beyond the range originally (2005) foreseen. However, this is a temporary problem.

• The administrative infrastructure is not yet set up for the use of a CDF. The capacities needed to administrate a fund can only be roughly estimated. Locating the CDF and its management outside the direct influence of the state as financier is (still) viewed critically.

• This evaluation study only reviewed relatively small projects as funding recipients. Though the funding of larger projects (e.g. development the large brownfields mentioned) was not analysed, it appears extremely practical.
7.2 Review of advantages for various actors

From the perspective of the various parties involved in the implementation of the CDF or receiving its funding, there are quite specific benefits beyond the general advantages listed previously.

Due to the integrated approach and focus on urban development, a multitude of projects can be considered in principle for funding by the CDF. The range of potential project development broadens significantly: in addition to subsidisation, public and private (in the sense of municipal companies) managers now have the instruments of the CDF (equity and later loans as well). In practice, land and real estate can now also be brought in.

Private companies do not directly enjoy funding by the CDF. By limiting the use of the JESSICA instrument to fund municipalities and municipal companies, private companies only benefit indirectly, by being commissioned to construct or carry out the planned measures.

By overcoming the existing market failure, projects which have been successfully implemented using CDF funding help improve the reputation and thus the image of those urban neighbourhoods or development areas. As community development key investments, the projects radiate their positive effect through the region and might thereby promote additional processes for sustainable economic and social development. This could attract additional public and also private investment to urban development.

For the private finance sector, the consulting services, especially in regard to setting up the CDF, are relevant. Classic areas of activities which might become more important because of this development are the preparation of project business plans for funding applications on the one hand and the financial evaluation of these business plans on the other. The close collaboration between the banking institution managing the fund and the responsible ministries in the Saarland can directly benefit the public sector because of the increase in financial know-how. Furthermore, there is the possibility that these thoughts of profitability might influence the actions of other departments, which might mean the corresponding changes to existing funding programmes in the long term.

7.3 Future potential for JESSICA financial engineering instruments in the Saarland

The study illustrates that the use of a CDF for the realisation of sustainable urban and community development in the Saarland is immediately practical. The current urban development policy problem areas restrict the ability of the municipalities of the Saarland to act more and more, and private and especially public investment capital is becoming increasingly scarcer. Against this backdrop, the evaluation study demonstrates that more efficiently using the few public resources available for urban development not only achieves the goals of the public sector but even loosens the restrictions on their ability to act. There is no great demand for the instruments of the CDF at present because, for one, they are viewed sceptically or with reservation due to their novelty, and for another, the tight financial budgets in the public and private sector mean that subsidisation is (still) the preferred option, since the funding, once allocated, need not be paid back.

Nonetheless, it can be assumed that the demand for the funding instruments of the CDF will increase considerably in future. If the downward trend in the financial flexibility of public and private actors continues, grants as a “competing project” will no longer be used as much as now because of the...
general scarcity of capital. In addition, this will increase the importance of the JESSICA instruments as a possibility for co-financing the grants.

Moreover, because of the setup of its business areas, the CDF promotes measures in the central problem areas of urban and community development in the Saarland. Functionally problematic urban centres such as in Lebach, which discourage private companies from the retail and gastronomy sectors from settling in the area, can also be found in many other communities in the Saarland. Successful revitalisation through the intervention of the CDF might serve as an effective role model for other communities.

The two infrastructure-related projects in Dillingen and Nalbach represent investment in the future of technology which will improve the general location factors and, at the same time, decrease the costs for maintaining the infrastructure. This will actively help overcome exactly the problems which are becoming very important to the communities of the Saarland due to demographic and global economic developments.

Through the support of the CDF, the project in Neunkirchen also helps to solve one of the common problems in medium-sized cities: Attracting a hotel is urgently needed for the city and environs for economic and structural reasons; however, this usually fails due to the lack of an operator. This problem cannot be solved through a grant but requires the revolving instruments of the CDF. In addition to meeting this structural need, implementing such a project opens up the possibility for the community to tap into tourism potential as is frequently recommended medium-sized communities in rural areas do through land-use plans, as well as overall and developmental concepts.

The need to restructure inner city problem areas, as in Ottweiler, is also shared by many communities in the Saarland. Necessary investments are frequently waiting which generate financial cash flows at the end of their development but which the municipality is unable to handle due to their large volume. The expected project returns are not high enough for private investors, and the development risk is too high for banks as potential lenders. In such constellations, the CDF is the only effective instrument.

7.4 Summary and recommended plan of action

Based on the findings of this evaluation study as presented, it is recommended that the Saarland sets up an urban development fund. An implementation model has been developed for this and the legal framework has been laid out.

The approach described as the “Nexthouse” model and agreed upon by the responsible state secretary foresees the establishment of the CDF as a subsidiary of the state-owned Strukturholding Saar, which grants dormant partner’s interests (and thus equity capital) to projects. The fund manager will be delegated by a state ministry (presumably the MES, to benefit from sharing know-how with the ERDF administrative agency) via management contract to the fund company; the decisions whether to fund a project will be prepared by external consultants and taken by the fund management in agreement with an interministerial advisory board (with representatives from the MEET, MES and Ministry for Finance). This decision-making system is important; especially should the approach be expanded. In a second step, the fund company conducts a tender procedure to find a private partner with a KWG-compliant banking license to join it. This would make it possible for the CDF to also ex-
tend loans, while still maintaining the influence of the state on the funding decision via the advisory board.

Notwithstanding the final decision regarding the structure of the Saarland Community Development Fund and its use of instruments, all JESSICA instruments show positive funding effects on the projects.

The following are the further steps recommended to the Saarland for implementing the CDF\textsuperscript{16} (see Figure 65); more detailed information on the particulars of the expanded equity capital model (granting venture capital), which is not deemed unlikely from today’s perspective, can be found in the annexes on page 118ff.

<table>
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<th><strong>Equity Capital Model</strong></th>
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<td>a. the ERDF funding, from the diverse priority axes,</td>
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<td>b. the co-financing from the state from the budgets of the responsible ministries, and</td>
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<td>c. accepting the loan offered by the CEB.</td>
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<td>4. Establishing a fund company by the state (articles of association, participation agreement). Arrangement depends heavily on participation of private parties at the fund or project level, including investment principles, risk-return distribution, first loss, tax optimisation, exit)</td>
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<tr>
<td>5. Public announcement that CDF will be set up (e.g. via funding programme—see pg. 112—or bulletin)</td>
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<td>6. Financing agreement between state and fund management or CDF</td>
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<td>7. Central informational event for the municipalities and municipal companies</td>
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<td>8. Review of first project applications by the responsible ministries and then the fund management</td>
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<td>9. Structure the legal foundation for individual project funding (funding agreements, loan agreements)</td>
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<td>11. Authorise equity capital investments of CDF for accepted project applications</td>
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<td>13. Transfer the money for the equity capital investment to the project</td>
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*Figure 65 – Additional steps to implement discussed model for the Saarland Community Development Fund*

\textsuperscript{16} As agreed in the contractor’s agreement dated 2 March 2009 and the 1st addendum dated 30 November and 7 December 2009, Service Area 6, an implementation time table will be compiled based on the chosen fund model, governance structure and the de facto target group of the CDF.
ANNEX 1: POSSIBLE COMPONENTS OF A BUSINESS PLAN FOR THE CDF

The following is an example business plan for the Saarland Community Development Fund (CDF) in accordance with Article 43(2) of Regulation (EC) No 1828/2006, as it would have to look to implement the Nexthouse model.

**Purpose: Use of ERDF funding to finance projects**

The provisions of the funding agreement determine the use of loans, guarantees and equity capital investments. During the initial stage of the CDF, only dormant partner’s interests will be made; investing venture capital and extending loans, and perhaps guarantees as well, is not possible until the cash flows from the first lending to the project return to the fund.

Projects should be funded which meet the criteria to be eligible for ERDF funding and which have incorporated an integrated community development concept. They will then be classified under one of the four business areas of the CDF (Urban Development – Local Business – Infrastructure and Environment – Brownfields).

The projects applying for funding will then be reviewed by the responsible ministry. Which ministry is responsible is determined by the classification of the project goals under the relevant priority axes of the Operational Programme ‘Saarland’ for the current programme period. The main criteria in terms of eligibility for funding are:

- Integration in urban development and urban planning;
- Fulfilment of Operational Programme requirements.

The second phase of project review is then done by the fund management, which bases their review on the following criteria:

- Examination of project cost effectiveness and project risks (incl. amount of expected project revenues and expenses over the entire project duration; ability to cover debt service; securities in the project; complementary financing elements (including possible investment grants outside the fund); quantification of project risks for the CDF).
- Projected target groups for funding by the CDF are initially municipalities and municipally dominated mixed-sector project managers. At a later point in time, the funding of privately dominated and pure private sector companies is possible.
- The concrete arrangement of project financing will be determined by the business conditions and/or funding guidelines of the fund.

The fund management as equity capital investor makes the funding decisions based on the project-related credit rating of the funding recipient. It is possible to take on more risk than this creditworthiness justifies (to fund projects which are especially important for urban development policy), if the financing agreement between the state and the fund management stipulates a “first loss clause” for the public allocations to the fund.
Budget and outflow of capital

The CDF will start with a volume of EUR 30 million.

Source of capital:

- EUR 10 million in ERDF funding
- EUR 10 million in national grants from the state budget
- EUR 10 million from a CEB loan at the conditions shown in Chapter 6.2.

Additional capital should be deposited in the following years. With the availability of additional national capital, it should also be possible to turn to additional, inexpensive loans from development banks (e.g. SIKB).

Depending on the status of the selection and preparation of projects, the aim is to authorise and pay out the entire fund volume by the end of 2015.

Moreover, the goal is a revolving use of capital, i.e. the fund management would like to preserve 100% of the capital employed, at least in nominal terms.

Co-financing partners, ownership structures and legal foundation

The CDF will be established as a new company owned by the Saarland. The fund management will be taken over by an administrative department at the MES created for this purpose.

The ownership structure is set down in the administrative agreement, in terms of capital paid in and the revenues generated. The ministries participating in the setup (depending on the priority axis in play) deposit the corresponding ERDF funding and the state co-financing into the fund. The CEB extends the aforementioned loan to the CDF.

Fund management

The administrative department at the MES takes over the administration of the fund. It updates the proof of disposition, administrates the dormant partner’s interests and decides how to invest the CDF capital. It is responsible for:

- The final application review and project evaluation (defining the catalogue of criteria, compiling a scoring model to prioritise the projects should the demand exceed the supply of capital)
- The final decision on whether to grant dormant partner’s interests (and other financial engineering instruments at a later time) from the CDF
- Development of funding guidelines wherein the conditions are set (duration, repayment schedule, interest rates) under which the dormant partner’s interests will be granted.
- Examination of disbursement requirements
- Control of the CDF (monitoring projects, mandatory reporting, analysis of long-term impact).

The state ministries have no costs for reviewing the content of the project applications. The fees for external financial and other necessary consultants will be set in the financing agreement between the state and the fund company.
Verification of the disposition of the Operational Programme funding (ERDF funding + state co-financing) remains the responsibility of the ERDF administrate agency until the end of 2015. The fund management shall supply the agency with the proof of disposition.

**Justification for the use of ERDF funding**

In the Saarland the EU Commission’s JESSICA initiative is being actively pursued and implemented according to the local conditions. The following goals have been set:

- Set up a revolving fund for integrated, sustainable urban and community development projects beyond the end of the current ERDF Structural Fund programme period
- Increased consideration of cost effectiveness of funded projects
- Mobilisation of additional public and private capital for integrated, sustainable urban and community development

For the 2007-2013 programme period, a total of EUR 68.547 million is available to the Saarland under priority axis 3 for sustainable urban development. Of this amount, EUR 10 million will be fed into the CDF in the initial stage. Over time the fund volume should be increased.

To date funding with ERDF funding has been concentrated exclusively on granting subsidies. The CDF is a new funding instrument to supplement the current offering.

The returns from the projects should be reinvested into new projects, whereby the CDF will gradually broaden its spectrum of funding instruments to include venture capital investment and loans. The returns from the project will be used in accordance with the guidelines in Article 78(7) of Regulation (EC) No 1083/2006 for urban development projects or SMEs. It is planned to use the capital for urban development projects in the area of the Operational Programme ‘Saarland’.

**Conditions for the CDF to exit projects**

In the notifications of allocation from the fund management, the funding recipients shall be obligated to note and comply with all relevant ERDF regulations regarding the restrictions and additional provisions. The banking institution reviews compliance with these guidelines in its role as fund manager.

Should individual projects be found in violation of the relevant national and ERDF regulations to an extent which requires the ERDF funding not be granted or be reclaimed in full or in part, this will be enforced by the fund management in the manner foreseen by administrative law.

Reclaimed capital returns to the CDF and is thus available for funding other projects within the scope of integrated, sustainable urban and community development.

**Provisions for winding up the CDF**

The existence and effectiveness of the CDF should be ensured over the long term; any adjustments necessary for this can and should be undertaken. Regulations regarding any liquidation of the CDF are part of the financing agreement.
### Annex 2: Key Points of a Funding Programme

- **Occasion for funding**  
  ERDF Regulation/Operational Programme

- **Object of funding**  
  Projects which
  - Cannot be implemented due to market failure but could generate revenues,
  - Are part of integrated community development plans,
  - Are eligible for funding according to the ERDF regulations and Operational Programme.

- **Legal foundation**

- **Funding goals and principles**  
  Priority axes of the Operational Programme

- **Funding recipients**  
  Municipalities
  Municipal companies
  Later private sector companies as well

- **Project selection criteria**  
  Eligibility for funding
  (cf. page 117)
  Contents in concordance with funding goals and principles

- **Application and selection procedure**  
  Implementation
  Decision of fund management on dormant partner’s interests
  Change applications
  Interim and final proof of disposition – retention periods
  Disbursement/repayment

- **Type, scope, amount of funding**  
  Funding instruments used
  Expenses eligible/ineffective for funding
  Possibilities of combining with subsidisation
  Beneficiaries’ own capital

- **Repayment to CDF**  
  Conditions
  Revenues/collateral

- **Other provisions**  
  EU guidelines (disclosure)
  Catalogue of beneficiaries (transparency)
  Controlling/reporting

- **Participants in the implementation**
ANNEX 3: POSSIBLE STRUCTURING GUIDELINES FOR PROJECT APPLICATIONS

1. Name of project

2. Short description of project
   ▪ Current utilisation structure
   ▪ Ownership structure
   ▪ Building law situation
   ▪ Structural policy goals for and importance of area
   ▪ Future land usage
   ▪ Parties involved in project development
   ▪ Plans for funding

3. Project stage
   ▪ In the planning stage
   ▪ In the implementation stage
   ▪ Already complete

4. Project type
   ▪ Development of new land or brownfields
   ▪ Financing interim acquisition of land/buildings (no own development)
   ▪ Structural engineering measure – renovation/new construction
   ▪ Structural engineering measure – external stimulus
   ▪ Financing utilisation stage of land/buildings
   ▪ Non-real estate-related activities

5. Project data
   ▪ Duration of project
   ▪ Investors, project managers, relevant actors
   ▪ Existing plans and expert opinions (e.g. feasibility study, integrated action concept)
   ▪ Draft of business plan based on cash flows (with project managers)

6. Classification of risks
   ▪ Database of cost estimates in business plan
   ▪ Project stages when JESSICA funding will be needed
   ▪ Revenue estimates: timing of returning cash flow, break-even point, certainty of income forecasts etc.
   ▪ Assessment of demand (utilisation)
   ▪ Planning risks
   ▪ Risks of contamination and other incalculable risks

7. Eligibility for funding according to ERDF regulations
   ▪ Yes
   ▪ No
   ▪ Classification under priority axes of the Operational Programme

8. Planned types of financing (JESSICA funding)
   ▪ Loans
   ▪ Guarantees
   ▪ Mezzanine or hybrid financing (debt/equity mezzanine)
   ▪ Venture capital

9. Regular and aerial photos and plans
ANNEX 4: VENTURE CAPITAL FUND

Purpose: Use of ERDF funding to finance projects

The provisions of the funding agreement determine the use of loans, guarantees and equity capital investments. During the initial stage of the CDF, in principle only dormant partner’s interests will be made; extending loans is not possible until a private partner with a banking license has been found. With the private sector know-how gained thereby, investing venture capital would then be a further development step.

The ERDF funding would be invested as venture capital by the CDF in the form of a venture capital fund. The arrangement of the fund would fundamentally reflect the classic elements of private equity/venture capital funds. In the following, a differentiation is made between the fund level and the actual participation or investment level.

Fund level

The design elements differ depending on whether private investors should participate at the fund level and on the legal form of the actual legal entity. To be determined in any case are:

- Investment principles to follow when investing

  In case already identified projects are cancelled, but also for future participation on additional projects, it is necessary to lay down certain investment principles, as is typical of blind pool investing. These investment principles should include the investment criteria to be fulfilled by each project to be invested in. In addition to the funding-relevant provisions [EU/Operational Programme], the projects must meet certain financial and legal evaluation criteria, such as those used for the selection of the pilot projects as presented in Chapter 5.2. From the risk participation perspective particularly that of the private investors, it comes down in the end to the risk-reward profile based on the portfolio compiled according to the investment principles. The investment principles also include the non-negotiable participation conditions – see the following section on the Investment Level for more details – to be complied with at the investment level and which justify rejecting a project.

- Distribution of risks and returns

  The regulations in this segment reflect the revolving character of the funding. In regard to the returns on the ERDF funding, Article 78(7) of Regulation (EC) No 1083/2006 stipulates their retention and reuse for UDFs or SMEs. In contrast, private investors link funding on the expectation of generating risk-appropriate returns in order to receive these as profits, which they may do in accordance with the second COCOF Note 08/0002/03-EN, Point A.317.

- First Loss

  Particularly to establish an incentive for attracting private investors, one should consider making the ERDF funding the first loss piece. That is, this capital would have the lowest pay-

17 “Any private contribution to an operation or a financial engineering instrument should be returned to the private entity ...”.
ment priority, being the last paid when profits are generated or the first loss – in part or full – if there is a loss.

- Exit

Capital in the private equity/venture capital segment is typically invested for 5 to 7 years, at the end of which there is a profitable exit. This is principally done using an initial public offering (IPO), whereas a so called trade sale will be used to disinvest from the projects here.

These regulations are normally set down in the partnership agreement. Ancillary agreements are also possible. The aspects here can be similar to those at the investment level, since the private investors will also be concerned about these issues at this level.

**Investment level**

The conditions for participation are usually laid down in the partnership agreement and normally in the participation agreement and shareholders’ agreement. The important points of regulation here (differing according to the legal form of the project company) are:

- Partnership agreement

  - Advisory board (perhaps with participation of private investors)

    The CDF can delegate its own or other people to the advisory board. This representation on the advisory board is a way for the CDF to control the arrangement of the advisory board’s powers, e.g. by withholding consent. Regulations on the right to more information from management are also typical. In this manner, errors at the project level can be avoided beyond the rights of the CDF as investing partner. In particular, large private investors can thereby gain a greater measure of security for their investment. The detailed regulations on the rights and duties of the members of the advisory board are also set down in the bylaws for the advisory board.

  - Management

    Principally, the CDF as an investor will not participate in management. To nevertheless be able to exert control, it is possible and usual to stipulate in the partnership agreement that the management must get the agreement of the CDF and the investors – perhaps via the advisory board – before acting in certain areas. Areas where the management must act quickly are excluded from this for reasons of practicability.

  - Partner resolutions

    Regardless of the legal form, the partners’ general meeting is the supreme body of the project company, responsible for making fundamental decisions. The more investors there are – aside from the CDF – the more relevant it is to work out the fundamental regulations, because these can be the basis for all decisions.

  - Inclusion

    In regard to taking on additional investors, especially if the CDF itself is only a minority shareholder, attention must be paid that the inclusion rules, coupled with the cor-
responding settlement rules upon exit, cannot be used against the CDF but rather serve as the last resort.

- Shareholders’ agreement

This is where the CDF as partner and the project partners can set down their future legal relationships beyond the partnership agreement. Such issues are regulated here which – depending on the legal form – need not necessarily be regulated in the partnership contract or which the partners do not wish to make public. The concrete arrangement depends on the legal form of the project company and the negotiation situation.

  - Drag along rules

 Such regulations enable the CDF as investor to exit the investment with a profit if – as part of a trade sale – investors can be found who are interested in taking over the shares as well as those of the other partners. Due to the relevant (drag along) regulations, the other partners would then be obligated to sell their shares. This rule is frequently set down in the partnership contract, like the tag along rights and preferential rights listed below.

  - Tag along rights

 This is the flip side of the drag along rules. If a partner sells its shares, the other partners have the right to obligate that partner to sell theirs in the same transaction.

  - Pre-emption rights

 Pre-emption rights (also known as rights of first refusal) enable the CDF to control whether other partners are accepted into the project company. Undesirable partners can be prevented from forcing their way in by exercising pre-emption rights. If the CDF does not wish to purchase the shares itself, it can exit the investment completely by exercising its tag along right.

  - Exit strategy

 It is a good idea to set down the means of conducting an exit which go beyond the partnership agreement – rights of disposal of shares, resolution to dissolve etc. – in an exit strategy, e.g. when this is foreseen etc.

  - Liquidation preferences

 The CDF can hereby ensure better proprietary conditions upon liquidation of the project company. A typical rule is double dipping, whereby the investor, after removing its share of the revenues, also gets a part of the remaining profit. The revenue benefit is composed of the contributions, additional payments and a spread. The liquidation preference also applies to processes similar to liquidation, such as the disposal of majority shareholdings, restructuring etc...

  - Voting rights/Rights to information

 The right to information and voting rights beyond what is legally stipulated can be set down in the partnership agreement, especially in regard to financial figures. This
can take the form of an agreement to reveal the figures which would be compiled in any case as well as explicit additional reporting.

- **Binding present management**

  The provision of funding may not be useable by project partners’ management to gain wealth through the quick and profitable exit from the company. In order to prevent this, binding instruments are necessary such as holding periods and compulsory redemption.

- **Participation agreement**

  In order to keep the additional regulations relevant to cooperation–partnership agreement/shareholders agreement – separate from the agreements relevant to the entry of the CDF into the investment, the CDF can set the latter down in a participation agreement with the project partners, as is not atypical. The following points are usually regulated.

  - **Capital increases/Initial valuation**

    The entry of the CDF into the project company can occur by taking over the share of a project partner or through a capital increase. In both cases, an initial valuation of the project company is required to calculate the share of ownership held by the CDF. If the project company is unable to deliver any meaningful valuation indicators, this is to be based on the discounted future value. It can already be foreseen at this point that the CDF will increase its participation gradually over several capital contribution rounds depending on certain milestones being reached.

  - **Milestones**

    The CDF can use milestones to mark the achievement of certain goals on which additional financial or funding commitments rely. These can be certain figures (sales etc.) or factual goals (construction phases and the like). This shall be formulated with particular care to avoid disputes.

  - **Anti-dilution/Ratchet**

    Should additional investors be interested in buying themselves into the project company, it might happen at that time that the enterprise value of the company has fallen, so that the investors are able to buy in more cheaply, thereby diluting the shares held by the CDF. In order to prevent this, it is recommended to work out an anti-dilution clause, whereby the selling project partner surrenders some shares free of charge or the protected partner(s) exercise subscription rights at the nominal value. In this manner, the CDF can set up the situation as though it had also first entered under the less expensive conditions (“full ratchet”).

  - **Guarantees to project partners**

    Particularly when the project company is unable to deliver any meaningful valuation indicators due to its lack of current account and the valuation must be conducted based on the discounted future value, it is essential to the CDF that the project partners take on guarantees for the relevant indicators. These might also refer to points
which were or are relevant within the scope of the due diligence. The guarantees could affect the financial situation of the company, for example.

Participation is typically preceded by:

- **Letter of Intent**
  
  That is, the nonbinding agreement of intent in which the CDF lays down the main points for continuing and the arrangement of later contractual commitments.

- **Nondisclosure Agreement**
  
  This is especially relevant for the project partners, since and insofar as their project contains particularly confidential information. It is also critical that such shared information remain confidential even if the partners do not come together.

- **Due Diligence**
  
  This is particularly relevant to property and environment due diligence, i.e. the careful examination of the property and environmentally relevant points in the project company, especially those with inherent risks and which must be considered as the contracts and valuations are undertaken.

In addition to the direct participation in the existing project companies, it is also possible to participate via a holding structure, for example, when there are or when it makes sense to have several project companies. In this case, the project partners put their shares in the project companies into a holding company in which the CDF participates.

Overall, the arrangement depends strongly on the concrete projects, so that the preceding information only offers a rough guide. In particular, the tax aspect of fund design, of which nothing further is said herein, depends very strongly on which type of private investor is to be attracted. Working out the various contracts and the balance of interests to occur therein offers an excellent opportunity to take an intensive look at the planned course of the investment, which is especially necessary to keep the inherent risks as low as possible.