JESSICA WALES
URBAN DEVELOPMENT FUND (UDF)

JESSICA PRELIMINARY STUDY FOR WALES

FINAL REPORT

SEPTEMBER 2008

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Note to Reader: Certain commercially sensitive data has been removed from this report.

King Sturge Consultancy

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FOREWORD AND GLOSSARY OF TERMS

FOREWORD

The following executive summary has been drafted in order to be read as easily as possible by stakeholders without specialist knowledge of 'financial engineering products'.

However this study and thus this report investigates complex, specialist areas of property and finance and therefore, although every effort has been made to make the findings as accessible as possible to a wide range of readers, the report does rely on a prior knowledge of regeneration finance in certain areas.

GLOSSARY OF TERMS

CIL – Community Infrastructure Levy

DCLG – Department for Communities and Local Government

EC – European Commission

ECF – English Cities Fund

EP – English Partnerships

ERDF – European Regional Development Fund

HACA – Homes & Communities Agency

HF – Holding Fund

IRR – Internal Rate of Return

JESSICA – Joint European Support for Sustainable Investment in City Areas

LABV – Local Asset Backed Vehicle

PPP – Public Private Partnership

PSP – Private Sector Partner

UDF – Urban Development Fund

WAG – Welsh Assembly Government

WEFO – Welsh European Funding Office

EXECUTIVE SUMMARY

JESSICA and UDFs

JESSICA stands for Joint European Support for Sustainable Investment in City Areas and is a policy initiative of the European Commission (EC) which aims to exploit financial engineering mechanisms to support investment in sustainable urban development as a component of integrated regeneration.

UDF stands for Urban Development Fund and is the key 'financial engineering' model for JESSICA. UDFs are funds set up to invest in sustainable urban development by combining primarily;

- From the public sector;
- EU funding; and
- public sector property assets with;
- From the private sector;
- institutional equity investment; and
- third party debt.

Similar mechanisms are becoming commonplace throughout the UK.

The Benefits of JESSICA and UDFs

- Efficient and effective by using 'non grant' financial instruments that mobilise additional financial resources and focus on sustainability;
- Leveraging large-scale investment and expertise with major funds to invest over the long term in challenging locations;
- A holistic approach to regeneration balancing physical, social, economic, financial and environmental goals;
- Responsiveness to change with the partners retaining the ability to add or change projects under the main partnership framework;
- Enabling the public sector to block disagreeable private sector partner proposals;
- Risk reduction through area uplift over the long term and cross subsidisation between a large number of sites;
- To utilise financial and managerial expertise from relevant international financial institutions (such as European Investment Bank).

As this round of Structural Funds could be the last that Wales will receive (given EU enlargement) it is absolutely critical that the funds are spent in the most constructive way possible. Given 'grant funding' techniques usually result in no financial return at all to the public sector, it is essential that new methods are explored that enable social and economic goals to be addressed whilst at the same time financial goals are also considered. JESSICA offers this opportunity and the potential for projects emerging in 10, 20+ years to be financed through the revolving nature of the initiative.

UDFs therefore are a very different scenario to the traditional approach of grant funding in which a 'gap' in an investment profile means that the public sector makes an upfront 'gift' after which there is not a potential return at all to the public sector purse. The essential feature of UDFs is the treatment of former grant funding as an investment on which the public sector will expect to see a return.

JESSICA Holding Funds

The regulations allow for Holding Funds, which can be very useful to Managing Authorities in ensuring early release of monies by the Commission and as a mechanism to generate finance that can then be made available to pay for the technical assistance that is likely to be necessary to establish the eventual vehicle. The Holding Fund generates income before it is investing in a UDF.

The Need in Wales

Public sector intervention in regeneration in Wales has been a necessity for many decades. Inefficiencies in the property market in Wales has regularly deterred the private sector from investing in areas outside of the major conurbations. The convergence areas in Wales in particular demonstrate the consequences of market failure and inefficiencies.

Property market conditions have worsened over the last twelve months, which in our opinion will only exacerbate the consequences of market failure. New commercial property developments have slowed across the U.K but particularly in Wales, which in turn will affect the supply and demand balance of sites and premises in due course.

As part of this study's process, meetings with local authorities throughout Wales, as well as WAG (DE & T) and WEFO representatives have resulted in a list of over 70 potential schemes and is positive proof of the extent of the need and also demonstrated an enthusiasm from consultees to participate.

The Opportunity

WEFO have indicated that under the ERDF Convergence stream, Priority 3 Theme 2 (total allocation • 116m) could potentially support JESSICA in West Wales and the Valleys. A significant allocation from this priority would enable a WAG equity contribution of c£50m (market testing indicates a £20m minimum) into a UDF which when matched by private sector equity and 3rd party debt would create a fund with access to c£250m. Market testing has indicated a fund of this size should be created given the complexities and costs of establishing the vehicle.

Options

It is essential that new approaches beyond the tradition of ‘gap funding’ are explored to ensure that a ‘legacy’ of future funds is created for investment purposes after 2013 and the current (and probably last) round of funding from Europe. Many proposals by Central Government make recommendations and statements of intent, (eg Community Infrastructure Levy, Tax Increment Financing) however they are short on practical details and/or still require further enabling legislation. The need for the public sector to look at new and independent means of catalyzing regeneration is becoming acute. A JESSICA based UDF would enable this.

Accordingly, a strong case is emerging for the promotion of JESSICA UDF policies in Wales which support the much needed move from a grant to an investment based culture and is available to implement now with the active support of the EU and its related institutions. JESSICA presents Wales with an opportunity for embarking on a more cohesive programme of regeneration, with the setting up of an Urban Development Fund (UDF) which is intended to extend beyond the timeframe for the current European Convergence funding of 2013. Traditional grant funding mechanisms have failed to achieve large scale, sustainable regeneration and are becoming increasingly unaffordable for larger scale projects. There is an obvious added value to the JESSICA approach of setting up a UDF in that it increases the overall level of finance available for regeneration projects.

Overviews of Existing Models for UDFS in the UK

UDF type mechanisms are already in operation in Wales and the UK (albeit outside of the JESSICA initiative). For example the Welsh Industrial Partnership (WIP), Dragon 24 and The Welsh Investment Strategic Partnership WISP) are all built around innovative partnership between the public and private sectors.

Other mechanisms already in operation or in the process of set-up in the UK include the English Cities Fund, ISIS (a British Waterways PPP), Blueprint (a vehicle between East Midlands RDA and Igloo – the private sector partner in Roath Basin) and numerous other English RDA and council initiatives.

A UDF for Wales

An Urban Development Fund (UDF) for Wales is likely to comprise a joint venture between Welsh Assembly Government (WAG) and a private sector institutional partner (PSP).

The essence of the UDF is to invest in Regeneration projects that the private sector would not take forward alone, either due to return profiles or risk positions. Whilst the private sector brings skills and increased funding power to deliver the projects, it must be recognised that the private sector partner is almost certainly going to require a commercial return on their investment.

The UDF will act as an enabling fund to promote, accelerate and facilitate large scale regeneration development opportunities in Wales, focusing particularly in areas where the private sector will not take forward development in its own right due to market failure or the excessive costs of remediation / infrastructure provision resulting in unacceptable risk or financial returns. WAG will commit investment comprising European funding which will be matched by the private sector with cash. The benefits of a 50/50 approach include:

- Leveraging major private sector investment;
- The potential synergies inherent in keeping individual sites in a single portfolio;
- Economies of scale; and
- Building partnerships rather than simply managing processes.

Market testing by King Sturge for this study concludes that as the UDF will not make an appropriate commercial return, a priority return to the private sector will be necessary. Eversheds have concluded that any ‘priority return’ to the private sector would be likely to constitute a State aid and would require European approval.

Overarching UDF Structure

The basic premise is that the UDF will provide equity, loans or guarantees to invest in each specific project alongside project partners. WAG will contribute ERDF funding through JESSICA, and where available and appropriate key strategic land assets.

WAG land assets may be invested at the fund level or project level, however this needs to be tested with EC. The recommended UDF structure can, therefore, be summarised as a 50/50 public / private owned and controlled joint venture vehicle.

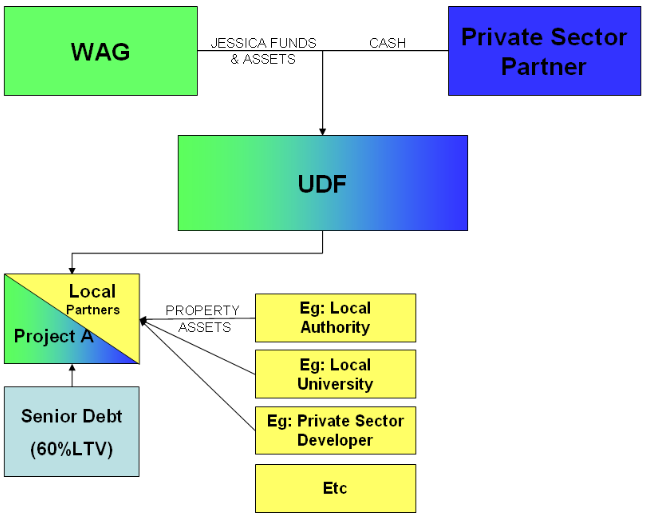
One of the key attractions of the UDF structure for WAG is the ability for policy and Ministerial priorities to be delivered by leveraging public sector ERDF funding to give influence over private sector financing. In particular Ministers will be able to define how the fund operates over its lifetime in advance of the tendering process (ie before it is even set up) through the investment principles and criteria drafted by the public sector to ensure their wider goals are enshrined in the legal documentation by which all the partners must abide. In addition the day to day management of the fund would be directed by an investment board on which the public sector would retain a 50% 'deadlock' position.

It is anticipated that a professional fund manager will be employed to manage the fund and its investments on a day to day basis. Within each project, the Project Partner will invest either existing brownfield sites, or buildings which are identified for regeneration or cash (or a combination thereof).

Project Specific Activity

Project specific activity would for example take place through a cash equity (or loan) investment by the UDF and a land contribution by a Project Partner that is sufficient to make the project viable.

The project partner will typically be a local authority, university or a private sector landowner/developer.



Project Selection

Initial consideration has been given to the nature of projects that would be most appropriate for the UDF to undertake. A set of preliminary evaluation criteria has been discussed with the JESSICA working group and is summarised in the table below:

Technical Evaluation Criteria	
1	Policy fit (ie WAG, WEFO and EIB/EU)
2	Existence of sustainable integrated regeneration plans
3	Primarily public sector ownership (WAG, Local Authorities, Universities)
4	Profitability (indicating internal rate of returns of 0-15%)
5	Commitment at the 'project level'
6	Scale/attractiveness to the private sector
7	Funds invested (defrayed) by 2015 (the ERDF 'qualifying expenditure')
8	Regulation compliant
9	Projects to be in a state of 'readiness'

Clearly further detailed work is required in regard to the evaluation (ie investment) criteria and bidding process to ensure projects emerge that both satisfy public policy and commercial investment criteria and is open and transparent.

Return Profiles

It must be recognised that the private sector partner will require an appropriate return on their investment. The nature of the activity of the UDF may therefore mean that the WAG contribution into the fund will, in many cases, need to initially act as a financing 'buffer' to the private sector partner's contribution. This would give a prioritisation of returns to the private sector which could be essential in order to assist projects where there is a financial deficit (i.e. projects where the private sector partner would not as a matter of course invest independently).

However, as projects are developed and overall fund returns exceed the minimum level of return required by the private sector partner, these further returns will either be recycled in the fund so that, if sufficient returns are generated, WAG will move up to a position of equality with the private sector partner. In this way, the WAG funding input moves away from traditional grant funding to an investment, albeit possibly with a deferred prioritised payment profile (both in terms of timing and security).

The utilisation of senior debt will again be a key ingredient in the securing of private sector financing into regeneration schemes. However, the percentage level of gearing for each project must not be considered aggressive and it is assumed that each project will have a loan to value ratio set at c.60%.

Fund Management and Operation

At the outset the objectives of WAG can be enshrined in the legal documentation and in the business plan of the UDF. In that manner, WAG will take comfort that its objectives in setting up the UDFs will be very clear opposite any private sector partner and will actually become the objectives of the UDF itself. Any deviation from those objectives or change in business direction will need to be approved by WAG.

Day to Day Activity

We have envisaged that the UDF will either staff itself up or have a investment manager appointed to it to advise in relation to projects and the manner in which the UDF may invest in those projects.

At the project level, the UDF will be a partner (alongside the Project Partner(s)), typically in a special purpose vehicle which will undertake site assembly; land remediation to enable sites to be brought forward; development works and other infrastructure provision; disposal of individual serviced plots to housing and commercial developers; and preparation of area master plans.

Investment may be placed by the UDF via equity, debt and/or guarantees (although the latter is unlikely to be used).

Investment Criteria

The investment criteria of the UDF will be agreed between WAG and the PSP, but are expected to allow flexibility to reflect changes in market conditions over the life of the fund and to align with WAG regeneration policy and the European Programmes from which the funding is sourced.

Source of Projects

The sites and schemes that will be committed to the UDF will come from a wide range of sectors including WAG; Local Authority / Project Partners; other public sector bodies (including Universities etc) and the private sector.

Financial Model

A financial model has been created, to demonstrate the principles of the structure outlined, based on three projects that might be suitable for the UDF. The UDF's overall internal rate of return (IRR) is relatively low as certain sites are likely to be loss making or only marginally profitable.

A fundamental output of this study has been to compare the UDF 'financial engineering' approach with that of traditional gap funding.

1 Grant Funding – usually this is in the form of a 'gift', though an overage mechanism is sometimes attached but practice has shown these to be unreliable. This approach therefore rarely produces any public sector returns

2 Equal Returns – this assumes a private sector partner (PSP) is willing to accept the same returns as the public sector. Unfortunately market testing has shown that this might only produce an unrealistically low level of return to the PSP ; and

3 Priority Hurdle Rate – as indicated by the market testing, an institutional fund investing in a Wales UDF may only do so if they can forecast an appropriate return.

We have concluded that the public sector typically receives a cash return of zero under traditional grant funding approaches, consequently, a UDF approach will, in financial terms provide a more attractive outcome for WAG. In the third (and most likely) scenario if private sector equity funding is to be attracted, whilst the public return would be lower than in the second scenario it is still more efficient than grant.

A UDF leverages in significant private sector equity finance and third party debt to projects that would otherwise be unable to secure finance meaning a 'virtuous circle' of investment is started, which if directed by the more enlightened criteria of the public sector enables larger scale, more balanced projects to be catalysed.

Conclusions

This study recommends the creation of a UDF for Wales. It is clear this approach will enable WAG to ensure that ERDF monies are able to make a bigger impact over the long term than a traditional grant funding approach whilst at the same time delivering on the public sector's social and economic development goals. The financial model has shown that a UDF would catalyse large scale physical regeneration projects that would not be started by the private sector in isolation and still result in a revolving fund (ie the cash return to WAG) for future projects at the end of the life of the UDF.

In addition, as already mentioned the UDF will foster a culture of investment and financial sustainability, as opposed to grant funding and 'handouts' that will be essential to Wales as it survives without European Funding after 2013.

It must be recognised that this is a very different scenario to the traditional approach of grant funding in which a 'gap' in an investment profile means that the public sector makes an upfront 'gift' after which there is no potential return at all to the public sector purse. The essential feature of UDFs is the treatment of former grant funding as an investment on which the public sector will expect to see a return. ie – a UDF investment is not the same as traditional grant funding which is in effect pure subsidy.

In short, while traditional gap funding delivers social and economic returns;

a JESSICA UDF would deliver social, economic AND financial returns.

Existing grant funding mechanisms have failed to achieve large scale, sustainable regeneration and such projects are becoming increasingly unaffordable. JESSICA affords Wales an opportunity to create a ground breaking financial vehicle to deliver a more cohesive programme of regeneration, within the setting up of an Urban Development Fund (UDF) which is intended to extend beyond the timeframe for the current European Convergence funding of 2013. Effective regeneration can only be obtained with a comprehensive programme of projects being undertaken over an extended period of time and the UDF fund is intended to span a period of 20 years, a timeframe which could accommodate a significant number of projects, many of which have already been identified.

Implementation

In order for a UDF to be created, the following headline tasks need to be completed:

Indicative Timetable	
Ministerial approval	Sept 2008
WEFO in principle approval (PMC)	Dec 2008
State aid – preliminary discussions with EC	Oct – Dec 2008
Select initial projects (with local authorities etc)	Oct – Mar 2009
Finalise fund structure	Oct – Mar 2009
Procurement of Private Sector Partner	Mar 09 – Mar 2010
Final Ministerial Approval	Mar 2010
State aid – final approvals with EC	Dec – June 2010

Accordingly, it is unlikely a Wales UDF will be in operation until mid-2010 at the earliest. Whilst in some respects this is a frustratingly slow timetable it is not unusual given the range of approvals that are required – in particular regarding State aid. Furthermore given the state of the property and wider economy, with most commentators indicating a return to a more benign economy unlikely before 2010, it is to be expected this will be a less challenging time to close the fund.

1 INTRODUCTION TO REPORT AND 'JESSICA'

1.1 THIS REPORT

This is the final report of the short-term Consultancy Study commissioned by the EIB (European Investment Bank) to analyse the potential for JESSICA financial engineering products in Wales as set out in the EIB tender of 29th February 2008.

The report may be broken down into three broad parts:

- Context;
- Options; and
- Implementation.

1.2 WHAT IS JESSICA?

JESSICA stands for Joint European Support for Sustainable Investment in City Areas and is a policy initiative of the European Commission (EC). The purpose of JESSICA is to support Member States of the EU to exploit financial engineering mechanisms to support investment in sustainable urban development in the context of cohesion policy.

JESSICA was launched with a view to providing the opportunity for Managing Authorities responsible for the current generation of cohesion policy to:

- Leverage additional resources for public and private partnerships and other projects for urban development;
- Contribute financial and managerial expertise from specialist institutions such as EIB;
- Create stronger incentives for success by combining grants with other financial tools; and
- Ensure long term sustainability through the revolving character of the funds.

The diagram below is an extract from an EIB presentation setting out the key components of JESSICA and provides a useful framework to the concept. In the context of Wales, WAG (through WEFO) is the 'Managing Authority' (in England it is DCLG and the RDAs). The next level is the optional 'holding fund' (see section 1.6 below) which is being increasingly recognised as a beneficial approach to managing the process. Finally there is the UDF level which can be a single or multiple UDF approach within a managing authority depending on scale and other factors.

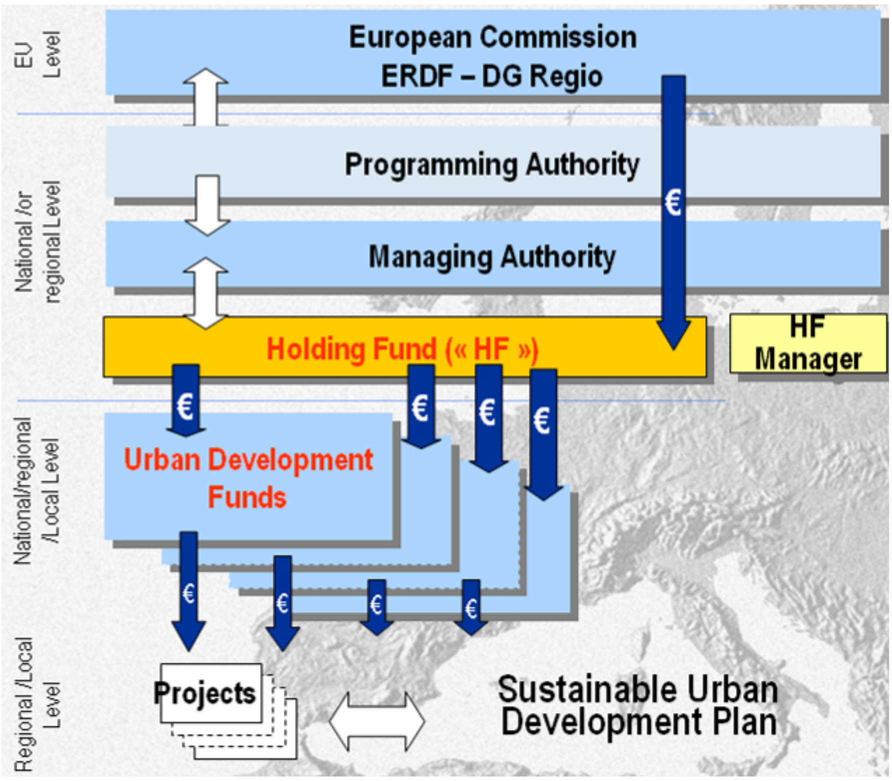


Fig 1 – EC and JESSICA Structure

1.3 THE BENEFITS OF JESSICA

The rationale and benefits of the JESSICA approach have already been well articulated by the European Commission and the European Investment Bank[1].

The stated principle aims are to make Structural Funds:

- more efficient and effective by using 'non grant' financial instruments, thus creating stronger incentives for successful project implementation;
- to mobilise additional financial resources for PPPs and other urban development projects with a focus on sustainability/recylability; and
- to utilise financial and managerial expertise from relevant international financial institutions (such as EIB).

In addition, given this round of Structural Funds is likely to be the last that Wales will receive (given EU enlargement) it is absolutely critical that the funds are spent in the most constructive way possible. Given 'gap funding' techniques result in no financial return at all to the public sector, it is essential that new methods are explored that enable social and economic goals to be addressed whilst at the same time financial

[1] JESSICA is a joint policy initiative launched by the EC and the EIB. EIB's involvement is designed to assist national and local authorities in implementing JESSICA and promote the use of UDFS and best practice across Europe; act as a Holding Fund where Member States request this.

goals are not ignored. JESSICA UDFs offer the opportunity for balancing social and economic development goals with financial goals in order that projects emerging in 10, 20+ years may be financed through the revolving nature of the UDF.

1.4 WHAT ARE UDFS

According to EIB, a UDF is a fund investing in public-private partnerships and other projects included in an integrated plan for sustainable urban development. The fund needs to demonstrate sufficient competence and independence for undertaking qualifying projects as well as sound financial backing. UDFs can be established at either a national, regional or local/city level in response to integrated urban development plans, project pipelines and investor interests.

UDFs are the key implementation tool for JESSICA initiatives. Although JESSICA UDFs are yet to be established in the UK, similar mechanisms are already becoming increasingly commonplace through out the UK, increasingly referred to as Local Asset Backed Vehicles (LABVs) and defined by DCLG[2] as: 'funds, combining locally-owned public sector assets and equity from institutional investors, established to finance the delivery of major regeneration outcomes. It is envisaged that these vehicles, with their own boards and management teams, are constituted as limited partnerships. Similar funds have already been established at a regional level and have generally been owned 50/50 by the public and private sector partners. Property development and regeneration projects are delivered according to an agreed business plan established at the outset of the vehicle's life. Returns made by the vehicle are directed back into the LABV and shared on an equal basis between the partners.'

1.5 THE BENEFITS OF UDFS

Although JESSICA UDFs are yet to be established in the UK, similar mechanisms are already becoming increasingly commonplace through out the UK as a result of well recognised benefits that cover a wide spectrum of regeneration, financial and organisational issues:

- UDFs will incentivise a leading, institutional private sector investment and/or development partner to deliver over the longer term – a critical element of regeneration;
- Leveraging significant private sector investment and creating and 'packaging' an opportunity that ignites real enthusiasm with major developers and funds;

[2] DCLG Consultation Paper on City Development Companies, December 2006, s32

- Offers the opportunity for a more holistic approach to regeneration, drawing on the skills of the public and private sectors in order that the essential balance between physical, social, economic, financial and environmental goals is realised in the delivery of projects;
- The creativity and enthusiasm of the private sector is properly tapped by building a genuine partnership rather than simply managing a process;
- UDF type mechanisms are suited towards the developer-investor who is interested in the longer term returns potential from area based development;
- Achieving a higher initial land value – given the long term nature of the relationship and opportunity the private sector can offset risk against long term value uplift;
- Exploiting economies of scale (up to 30% on construction costs in some cases);
- Offers significant fluidity and responsiveness to change with the partners retaining the ability to add or change projects under the main partnership framework, allowing them to procure at will rather than through a predetermined legal agreement;
- Competitive lending against covenant strength or the ability to package projects;
- A 50/50 partnership structure (usually) that enables the public sector to block disagreeable private sector partner proposals;
- 50/50 sharing of development profits (usually) without the need for complex overage arrangements; and
- Risk reduction through area uplift over the long term and cross subsidisation between a large number of sites lowers the risk profile compared to doing individual projects or even phases of individual projects.

Clearly, this is a very different scenario to the traditional approach of grant funding in which a ‘gap’ in an investment profile means that the public sector makes an upfront ‘gift’ after which there is not a potential return at all to the public sector purse. The essential feature of UDFs is the treatment of former grant funding as an investment on which the public sector will expect to see a return. ie – a UDF investment is not the same as traditional grant funding which is in effect pure subsidy.

1.6 JESSICA HOLDING FUNDS

The regulations allow for Holding Funds, which can be very useful to Managing Authorities in 'buying time' in those constituencies where UDFs have to be established from scratch.

Although the main focus of this study is to investigate UDFs in Wales, decision makers should be aware of the opportunities that 'Holding Funds' offer. Under the terms of the new EU legislation, these funds represent 'eligible or qualifying spend' and can therefore secure investment in an area prior to an eligible UDF or project being identified that requires JESSICA investment.

A further benefit of the Holding Fund is the income it generates before it is investing in a UDF. Although the Fund is managed by a suitably qualified Fund Manager and paid for their services (c2% depending on the size of the Fund) any additional income generated by the fund can be used for eligible expenditure.

In addition to the generation of an annual return (on deposit) the Holding Fund will provide certainty over intent by the public sector for other 'investors' and reduce pressure on project development as a considered and well planned approach to project development can take place. Finally it provides for a dedicated Fund manager function who is tasked with overseeing the deployment of JESSICA funds. However, match funding would need to be in place before any ERDF could be drawn down.

1.7 THE WELSH CONTEXT – IE. THE 'NEED'

Public sector intervention in regeneration in Wales has been a necessity for many decades. Inefficiencies in the property market in Wales has regularly deterred the private sector from investing in areas outside of the major conurbations, on a scale sufficient to achieve the objectives set by Government policy.

In theory, free markets should produce the goods and services we want in the right quantities and at the lowest possible costs. However, it is possible for a free market to produce an inefficient result and hence market failure. In property terms, the consequences may relate to supply/demand imbalances across the office, industrial and retail sectors.

West Wales and the Valleys demonstrate the consequences of market failure and inefficiencies, through, for example, an undersupply of readily available modern office and industrial accommodation for sale or to lease across various size bands. This undersupply has been caused by a perceived lack or underestimation of demand from occupiers and tenants and hence a lack of private sector investment.

In addition, there is the issue that the total cost of developing the buildings (e.g. land, construction, fees, finance, profit) is generally in excess of the estimated completed value of the development, thereby not allowing developers an appropriate return on their investment. These areas are characterised by low rents and capital values and without investment in infrastructure and new build, the market does not perceive that higher rents and capital values are obtainable in order to enhance viability.

Similarly, particularly around the Heads of the Valleys, the industrial heritage and presence of contamination and underground workings lead to ground condition issues with development sites. As a consequence those sites have higher than normal site development costs. In terms of value, those areas of Wales classified as deprived areas by WAG that require major regeneration, such as the Heads of the Valleys, Anglesey etc are generally classed as secondary locations attracting both lower rental and capital values. This is as a consequence of older property stock, accessibility issues and lack of ongoing investment in the area over a period of time that has resulted in a cycle of continuing decline.

There is an existing range of grant mechanisms within Wales that address regeneration and gap funding issues and existing mechanisms include the following:

- Objective One / Convergence Funding
- Single Investment Fund
- Property Development Grant
- Land Reclamation Grant

Convergence is the successor to the Objective One programme 2000 – 2006 and West Wales and the Valleys region have been awarded the highest level of support from the European Structural Funds programming round 2007 – 2013. These areas qualify because the average Gross Domestic Product (GDP) per head was below 75% of the European average.

In addition, there are schemes in place involving more structured private public sector partnerships such as the WAG initiatives of WIP, WISP and DRAGON. They are yet another example of the need for public sector intervention to achieve private sector investment in achieving regeneration, in the industrial and office sectors.

Property market conditions in Wales and indeed the U.K have worsened over the last twelve months, which in our opinion will only exacerbate the consequences of the market failure issues detailed above. Following a number of years of strong investment property market conditions, market sentiment changed dramatically in mid 2007. Following the 'credit crunch', the market fell away, a number of funds and 'debt buyers' withdrew from the market and the volume of trading activity declined significantly. As a result, yields moved upwards and capital values moved downwards. Commercial investment values have fallen by up to 20% in the last twelve months and residential development land values by circa 30 – 40%. There is also evidence of weakening tenant demand in Wales. The RICS have published a survey dated 21 July 2008 which indicates that demand for commercial property has fallen at its sharpest rate since 2002. The demand for retail, industrial and office properties has declined by over a third in Wales with new occupier enquiries continuing to fall across all sectors. As a consequence, new commercial property developments have slowed across the U.K but particularly in Wales, which in turn will affect the supply and demand balance of sites and premises in due course. Regeneration schemes in the pipeline in Wales in the last 12 months, involving private sector investment are now looking uncertain as a result of the current property market conditions and viability issues.

Even though existing committed regeneration schemes may still proceed, they are likely to be value engineered with elements such as public realm / public open space and lower value elements being more limited than originally envisaged. In the circumstances, public funding will be required potentially to a greater extent to enable the 'right format of scheme' to proceed.

1.8 DELIVERABLES OF THE STUDY

The tender document required the final report of the study to include a review of existing potential urban development funds (as opposed to 'holding funds'); appraise the prospects for JESSICA in Wales, provide case studies of possible example projects in Wales; and recommend how JESSICA may be implemented including a timetabled programme of actions.

King Sturge has led on the consultancy study in relation to the application of JESSICA in Wales, with Eversheds LLP inputting in relation to State aid and UDF structure issues only. The scope of the study has not included a review of the ERDF regulations save where required to provide the State aid analysis.

A framework for the format of this report was presented and agreed by the working JESSICA Technical Group in the 3rd July monthly meeting.

2 STAKEHOLDER AIMS AND OBJECTIVES

Having introduced the basic concepts of and background to JESSICA, UDFs and regeneration in Wales, this section specifies the objectives of the stakeholders. The detailed aims of the key stakeholders in the study were further discussed and clarified in the study's inception meeting.

2.1 SPECIFIC STAKEHOLDER AIMS

- WAG's aim is to create a viable mechanism for the funding and delivery of large physical regeneration projects which, because of their size, are normally beyond the financial capacity of either WAG or local public sector bodies and which are currently not financially attractive to the private sector. This delivery of physical regeneration would be complimentary to other strategic Regeneration objectives in Wales. A single approach across Wales is anticipated in which WAG would act as the funding partner seeking projects (typically with local authorities, but also universities and possibly private sector land owners) who would invest principally land (development) assets through local, project based partnerships or contractual arrangements. Reference has been made to the relevance of The English Cities Fund which serves as a useful exemplar (albeit excluding the role of the development partner) which enabled a single approach across England and required State aid clearance (as is anticipated here);
- The Welsh European Funding Office (which is a part of WAG) is the Managing Authority for the Structural Fund Programmes in Wales has also indicated an interest in investing resources from the 2007-2013 Programmes. Welsh Assembly Government (WAG) has expressed an interest in the use of financial engineering techniques – and in particular JESSICA to deliver Ministerial policies on regeneration. WEFO has expressed a preference to utilising part of Priority 3 of the ERDF West Wales and the Valleys Convergence Programme (although all relevant Priorities from Convergence and Competitiveness Programmes may be considered). WEFO require the UDF to deliver the objectives of the ERDF Programme for West Wales and Valleys;
- Local Authorities in Wales, as represented by WLGA throughout the study period have presented the collectivised views of councils in Wales. In addition, as part of the study, many local authorities have been met directly to discuss projects that may become eligible for investment by a JESSICA UDF in due course and to enable further more direct representation in the process.

- EIB require a conclusion to the study that sets out clear and specific projects in which a clear judgement may be made on deliverability (projects of particular interest should be those that are currently ‘illiquid’, but with the benefit of *JESSICA* will become liquid – ie deliverable in the marketplace with the appropriate private sector partner);

2.2 EUROPEAN STRUCTURAL FUNDS IN WALES FROM 2007 – 2013

The Structural Funds are key instruments for the EU in supporting social and economic restructuring and account for over one third of the EU budget. The Structural Funds comprise the ERDF (European Regional Development Fund) and ESF (European Social Fund).

The areas assigned Convergence funding are those which formerly held Objective 1 status, (West Wales and the Valleys); whilst East Wales is eligible for the Regional Competitiveness funds which replace Objective 2 and 3 funding – as indicated in the map below:

The European Programmes seek to deliver improvements in economic, social and environmental conditions throughout the region with a focus on:

- creating high quality jobs and economic growth;
- investing in developing skills and reducing economic inactivity;
- regenerating our most deprived communities;
- contributing to tackling climate change.

WEFO have indicated that ESF may not be suitable for *JESSICA* as ESF projects do not produce a return for reinvestment. Under the ERDF Convergence stream, Priorities 3 and 5 have been identified by WEFO as funds potentially available to support regeneration in West Wales and the Valleys. In the Competitiveness areas whilst JESSICA backed projects may still go ahead these projects may not be supported by ERDF monies because of the small scale of available resource.

Priority 3 Developing strategic Infrastructure for a modern economy (• 330m)

- Theme 1 – Sustainable Transport Solutions (• 215m)
- Theme 2 – Sites and Premises (• 115m)

Theme 2 under this priority is considered by WEFO to be the most relevant source for the contribution to a *JESSICA* UDF.

Priority 5 Building Sustainable Communities (• 158m)

- Theme 1 – Supporting Physical Regeneration (• 113m). At least 80% of the funding for this theme has to be spent in specified locations for the benefit of deprived communities.
- Theme 2 – Community Economic Development (• 45m).

The projects sponsored under this Priority will be social infrastructure type projects and consequently WEFO have concluded that Priority 5 is not suitable for the UDF fund it could be utilised at a local level to support projects and programmes that are complimentary to the JESSICA funded schemes The following table summarises European Structural Funds in Wales in the context of JESSICA:

*NB - JESSICA Allocation is yet to be confirmed and is subject to market testing and final decision making by WAG/WEFO

2.3 GEOGRAPHICAL FOCUS

As part of an integrated and 'Single Regeneration Programme' for Wales, WAG is finalising twelve regeneration areas and have indicated that these locations in particular would be suitable for *JESSICA* projects. Initial assessments indicate a good match between Single Regeneration Programme priorities and Structural Fund Priorities.

3 OPTIONS ANALYSIS

Having set the context for JESSICA and ERDF in Wales this section investigates current regeneration policy in Wales and considers the options available to public sector agencies. The section concludes by making clear recommendations in light of the analysis.

3.1 CURRENT REGENERATION POLICY IN WALES AND UK

High quality infrastructure is a critical component of strong regeneration performance. However the UK has underinvested in its infrastructure for decades relative to European neighbours such as France and Germany. Central Government has started to improve matters however there is still a significant infrastructure funding gap on many projects. For example a Roger Tym & Partners study in 2005 found an infrastructure funding gap of over £7bn in the South East alone.

In order to bridge this gap, innovative and effective ways of drawing private sector finance into infrastructure investment need to be found. The Government White Paper 'Strong & Prosperous Communities (2006) sets out a statement of intent on the Government's desire to create stronger, more cohesive governance at the local and regional levels. But detailed proposals on infrastructure funding and financial freedoms depended on the subsequent Lyons Inquiry and the Comprehensive Spending Review (CSR). Whilst these two documents make recommendations and statements of intent, they are short on detail of how infrastructure is to be funded in future.

3.2 FINANCIAL ENGINGEERING MECHANISMS

Given the changing economic climate, reduction in UK government and EU funding sources, coupled with a growing trend towards devolution, the need for local and regional authorities to look at new and independent means of catalyzing regeneration and in particular infrastructure financing is becoming acute.

Managing the growing burden on the local infrastructure such as roads, schools and healthcare in coming decades will be immense. If local authorities fail to ensure that the necessary infrastructure is provided up front, transport systems will be permanently congested and schools, health care services et cetera will open years after the last house is built and occupied.

In Wales and across the UK, one of the most serious threats to development and thus future economic success is the lack of investment in the infrastructure needed to support growth. Even allowing for density of population, the UK does not lack the ability to provide land for development. What is lacking is the upfront funding for the necessary and timely infrastructure to make all the potential development viable.

While the planning system in the UK has been reformed to ensure areas are effectively planned to deliver more sustainable development, the reforms have tended to concentrate on spatial plan making and growth. There has been very little on infrastructure and funding.

Across the country, there is extensive research to support the premise that large-scale building should not be embarked upon without looking at how the infrastructure will be provided. Yet there is limited public funding available at a local level to support the cost of infrastructure.

Clearly there are numerous approaches, mechanisms, vehicles and options to facilitate delivery of physical regeneration. The following pages focus on financing mechanisms and options available now or in the near future that will compete with and/or complement JESSICA.

3.3 GRANT FUNDING

Introduction and £ potential

The principle of "gap funding", means that following a full appraisal of a developer's application for assistance, an amount is awarded that should be the minimum necessary to bridge the gap between development costs and forecast end value, and still enable the developer to go ahead. In physical development projects sometimes ‘clawback’ or overage arrangements are built in to ensure that some of the grant is repayable if a project makes greater profits than initially anticipated (however growing evidence indicates these mechanisms to be unreliable).

Gap funding therefore enables developers to go ahead with otherwise non-commercially viable projects on contaminated, derelict and disused sites, to bring them back into full economic use. Usually such sites are in areas of depressed market activity and, as a result, end values are lower than development costs.

Pros	Cons
• simple and clear • already approved by government and currently in use • relatively quick and easy to arrange	• no ‘legacy’ or revolving nature – ie once spent there is no future investment potential • promotes a culture of handouts rather than a culture of investment or ‘wealth creation’ • no contingency against the fast changing (ie depleting) nature of EU funding

3.4 PRUDENTIAL BORROWING

Introduction and £ potential

The introduction of the Prudential Borrowing framework from 2004 simplified the former Capital Finance Regulations and allows councils flexibility in deciding their own levels of borrowing based upon its own assessment of affordability. The framework requires each authority to decide on the levels of borrowing based upon three main principles as to whether borrowing at particular levels is prudent, sustainable and affordable.

Currently the majority of a council's borrowing whether Assembly supported borrowing or "Prudential Borrowing" will typically access funds via the 'Public Works Loan Board'. The Board's interest rates are determined by HM Treasury in accordance with section 5 of the National Loans Act 1968. In practice, rates are set by Debt Management Office on HM Treasury's behalf in accordance with agreed procedures and methodologies. For example, fixed interest rates are based on gilt yields and are determined each night to take effect from start of business the next working day. Councils can usually easily and quickly access borrowing at less than 5%. For more information see:

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

A number of local authorities have discussed the possibility of exploiting these very attractive borrowing rates and taking a more active role in speculative physical development. However to date, we are not aware of any council that has taken a genuinely speculative role (i.e. for profit purposes) in relation to large scale physical development in the UK. The principle barrier is the core question of what is the purpose of local government? Does it have the development expertise in-house and is it willing to arrange the on balance sheet funding necessary given the inherent risks involved? The answer to these questions appears to be a fairly resounding no.

In due course, the most likely issue for local authorities will be whether or not to utilise Prudential Borrowing which can be arranged at highly competitive rates but remains 'on balance sheet' or more expensive bond financing which is off balance sheet and does not have recourse to the local authority in the event of default.

Pros and Cons

Pros	Cons
• simple and clear • low cost of borrowing • already approved by government and currently in use • quick and easy to arrange	• on balance sheet and thus recourse to the local authority in the event of default • limited fund raising potential as based on conservative, 'prudential' borrowing principles

3.5 SUPPLEMENTARY BUSINESS RATES (SBR)

Introduction and £ potential

The SBR, proposed by local government tsar Sir Michael Lyons, would allow councils to charge a precept on existing business rates. The councils could then retain the money and spend it on major public infrastructure such as rapid transit schemes. National business groups such as the Confederation of British Industry have lobbied hard against the SBR.

For example, a two pence in the pound supplement on the business rate is set to be levied on most businesses in London to pay for Crossrail. Although SBR will require primary legislation, it is now likely it will happen as this is reported to be the only way the final piece of the financing cocktail can be found in the short term, given the official go-ahead for the project has been given by the Prime Minister.

Pros and Cons

Pros	Cons
• simple and clear • easily ring-fenced way to raise additional revenue • stable revenue stream • potential to underpin borrowing • already approved by government and currently being implemented	• limited fund raising potential • politically difficult • significant resistance from business leaders • some local authorities have already rejected (eg Manchester CC) • HMT fears impact on total tax burden • best applied at the city region level • will compromise business improvement districts (BIDs) as the SBR and BID levy falls almost exclusively on business

3.6 COMMUNITY INFRASTRUCTURE LEVY (CIL)

Introduction and £ potential

In January 2008, DCLG published a consultation paper on the Community Infrastructure Levy[1]. However, the paper is short on the specifics of how much a CIL could raise, CIL is in essence an attempt by central government to formalise some of the more innovative methods being explored and introduced by a number of local authorities (in particular the Milton Keynes 'roof tax').

[1] Although the planning system in Wales has some differences from the system in England, the Government is holding discussions with Welsh Ministers on arrangements for CIL in Wales (see s29 of the consultation paper).

Clearly, given CILs are still at the consultation stage it is too soon to establish how much impact they will have in the real world. However given the paper asserts that CIL will be paid by developers and “complement” section 106 payments it is difficult to envisage CIL providing a genuine step change in the provision of infrastructure finance.

Pros and Cons

Pros	Cons
• favoured by central government (currently subject to consultation) • paid for by development therefore no additional burden on public sector • potentially greater certainty for developers • overcomes ‘free-rider’ problem whereby the first developer often pays an unreasonable share of costs	• limited fund raising potential (ie same source as s106; developer funding) • still in consultation stage thus lacking in clarity and unproven • mired in planning gain supplement (pgs) legacy • likely to compromise s106 negotiations and potential funds • slow and challenging organisational infrastructure to be put in place (up to 10 years according to RTPI) • lengthy delays caused by requirements to be ‘embedded in the development plan process’

3.7 TAX INCREMENT FINANCING (TIF)

Introduction and £ Potential

TIFs enable local authorities to finance infrastructure investment by borrowing against future expected increase in tax revenues that would follow an infrastructure investment.

In comparing with SBR, the £ Potential of TIFs is very attractive however the mechanism is still awaiting legislation in the UK although recent soundings from DCLG have suggested that TIFs are on the agenda for the UK as pilots are being sought.

Pros and Cons

Pros	Cons
• very significant fund raising potential • proven mechanism being used in 49 out of 50 US states • focuses on specific ‘places’ and thus underpins ‘place making’ • decentralised tool enabling local authorities to be more entrepreneurial • relatively free from the development plan and the planning process in general • paid for by future tax payers therefore no additional burden on existing tax payers or existing	• requires primary legislation • cost ‘spillovers’ to tax payers outside the TIF district • possible state aid issues • possible ‘gentrification’ as original occupiers are displaced as the district improves (may be mitigated by building in affordable housing elements etc)

funding streams • overcomes 'free-rider' problem whereby the first developer often pays an unreasonable share of costs • does not compromise existing s106 monies • simple to implement 'piggybacking' existing property tax infrastructure • off balance sheet potential • most of the TIF process parallels traditional UK development processes	

3.8 JESSICA URBAN DEVELOPMENT FUNDS (UDFS)

UDFs have already been explained above together with some of their benefits. In summary the pros and cons are:

Pros and Cons

Pros	Cons
• Incentivises the private sector partner to deliver over the longer term; • Leveraging significant private sector investment that ignites real enthusiasm with major developers and funds; • holistic approach to regeneration, drawing on the skills of the public and private sectors in order that the essential balance between physical, social, economic, financial and environmental goals is realised; • The creativity and enthusiasm of the private sector is properly tapped; • Exploiting economies of scale; • Risk reduction through area uplift over the long term; • Providing a potential legacy fund to the current round of Structural Funds after 2013	• Reduction of funding available for pure gap funding projects; • Potential for deadlock between the partners and breakdown of the JV if the aims of the parties change over time; • Changing regulations governing the public sector.

3.9 OPTIONS CONCLUSIONS

New approaches to funding infrastructure is now a very hot topic in the UK, given housing and economic development imperatives, the tightening of national government spending and the reduction in future funding from the EU.

It is clear from this short overview that there are very limited options available currently in the UK to public sector agencies seeking to bring forward large scale physical regeneration. Accordingly, a strong case is emerging for the promotion of JESSICA UDF policies in Wales which support the much needed move from a grant to an investment based culture and is available to implement now with the active support of the EU and its related institutions.

3.10 RATIONALE FOR JESSICA IN WALES

In 2005, the Auditor General for Wales produced a report – Regeneration: A Simpler Approach for Wales. The conclusion of this report stated that whilst all 22 local authorities in Wales are actively engaged in regeneration, there is a need for co-ordination, clarity and access to resources to produce more effective, efficient and sustainable regeneration. JESSICA presents Wales with an opportunity for embarking on a more cohesive programme of regeneration, with the setting up of an Urban Development Fund (UDF) which is intended to extend beyond the timeframe for the current European Convergence funding of 2013.

Traditional grant funding mechanisms have recently failed to achieve large scale, sustainable regeneration and are becoming increasingly unaffordable for larger scale projects. There is an obvious added value to the JESSICA approach of setting up a UDF in that it increases the overall level of finance available for regeneration projects. The public sector commitment of convergence funding will act as leverage for match funding by the private sector, which combined will in turn leverage additional debt financing to produce a total fund far in excess of the public sector's contribution. The public sector input will come from existing allocations, and participation in Jessica will obviously produce a more effective use of resources as a result of the private sector leverage.

JESSICA is not a traditional subsidy vehicle, as can be seen from the outline of how JESSICA works earlier in the report. It allows a move towards a commercial market in an incremental way, addressing the market imperfections, whereas to date the grant funding mechanisms have not generally resolved the consequences of market failure. JESSICA is aimed at funding projects which will ultimately produce a return to both the private and public sector partners. From the public sectors' perspective this will enable convergence funding committed to the fund as well as public sector equity to be recycled. The current round of convergence funding potentially comes to an end in 2013, whereas the UDF is intended to span a period of 20 years.

The JESSICA approach is likely to generate more effective, sustainable regeneration than is currently undertaken. The financial modelling results detailed later in the report demonstrate a range of returns for individual projects undertaken with the involvement of the UDF. Current grant mechanism projects may not be undertaken in competition with other schemes because of cost or return issues even though they are likely to produce benefits to the area. Within a UDF, there is the opportunity for internal cross subsidies which increases the scope for undertaking a wider range of projects. It will widen the scope for decision making on projects undertaken to attribute more weight to the regeneration outputs associated with the projects as opposed to decisions purely driven by costs and returns.

Effective regeneration can only be obtained with a comprehensive programme of projects being undertaken over an extensive period of time. The UDF fund is intended to span a period of 20 years, a timeframe which could accommodate a significant number of projects. The research into potential projects eligible for such a scheme involved meetings with a number of local authorities throughout Wales, as well as WAG (DE & T) and WEFO representatives. These initial discussions have resulted in a preliminary list of over 70 schemes and is positive proof of the extent of potential schemes and also demonstrated an enthusiasm from all consultees to participate in a financial mechanism which will enable returns on public sector input and therefore more effective use of public funds, structured in a way which will provide the necessary expertise and experience to actually deliver the envisaged projects within reasonable timescales.

4 OVERVIEW OF EXISTING MODELS FOR UDFS IN THE UK

Given the favourable conclusions of the above options analysis for a JESSICA styled UDF in Wales in the context of the other options currently available to WAG, this section sets out details of the key players that would be central to a UDF in Wales and gives details of UDF type mechanisms that are already in operation in the UK (albeit outside of the JESSICA initiative).

It is important to note that there are currently no JESSICA UDFs in operation in the UK and as such should WAG elect to move forward with the JESSICA initiative this will be an innovative approach. However it should also be recognised that there are now an increasing number of special purpose vehicles already in operation in the UK that have many parallels with the UDF approach.

Of particular relevance to this study will be the English Cities Fund (ECF) which has already been recognised by elements of this Study's Working Group as a possible exemplar for a UDF in Wales.

After setting out the drivers behind the key stakeholders in UDFs, this section sets out in detail the set up and operation of a growing number of UDF type mechanisms in operation or emerging in the UK.

4.1 STAKEHOLDER DRIVERS

In addition to the credit crunch and commodities inflation problems besetting the macro economy, in order to overcome the risk averse private sector developer / investor demand for piecemeal development / investment opportunities it is increasingly recognised in sophisticated property development, funding and investment circles that a critical mass of new development is a means of reducing risk. It is this critical mass that is the key to boosting investor confidence and a UDF targeted at delivering large scale site specific area based initiatives in Wales would seek to catalyse.

Often, however local public sector bodies are not in a position to make firm, timetabled, long term commitments to the development programmes required in order to create this critical mass. The private sector lacks confidence that the resources will be available from the local authorities or other public sector agencies to deliver on such commitments, and that therefore there is unlikely to be large enough pools of resources available over time in order to achieve this necessary critical mass.

In addition, developers considering investing in regeneration areas must also be confident that the necessary investments will be made in education, health and other community facilities – and that housing and economic development will go hand and hand. These are all part of the essential critical mass of development required to create sustainable communities.

WAG does have the ability to establish project specific partnerships with a private sector partner. However, the costs and time associated with establishing project specific partnerships can be high and to which the institutional type investors, to whom the scale and critical mass of a UDF appeals, are frequently not attracted. In addition, there is no opportunity to enable recycling of profits and equity (from both public and private sector partners as is currently proposed under JESSICA) from one project to another.

In response to these challenges, the establishment of a UDF is therefore increasingly recognised as a viable and natural alternative to purely publicly financed initiatives and there are now a growing number of examples in the UK.

It must be stressed, however, that in no way would a UDF seek to replace the functions performed by WAG or Local Authorities or the private sector development community. The aim of a UDF is to assist in and help accelerate the delivery of projects through additional, more structured and more consistent funding and to provide WAG with the opportunity to more efficiently recycle equity within a wide ranging number of projects rather than provide traditional grant funding on a project specific basis, with little if any equity clawback through overage, as is currently the case.

4.2 THE KEY STAKEHOLDERS

The key stakeholders in a UDF type mechanism include:

National Government

Recent initiatives suggest the UK is moving towards a more commercial approach to the use of public sector assets in joint ventures with the creation of Local Asset Based Vehicles (LABV's), and a new era of more flexible partnering as opposed to the inflexibility at the heart of PFI type arrangements.

In respect of a UDF for Wales, as WAG would be the partner at the funding level this would provide the potential for WAG to input specialist knowledge and expertise directly into many of the most important large scale regeneration projects in Wales.

It is also worth noting, that based on experience with similar mechanisms in the UK, a UDF through its structure, would be unlikely to contribute to the public sector borrowing requirement (PSBR), although policy in this regard is under constant review.

Local Authorities

Although the most valuable assets held by Local Authorities are their property holdings, Local Authorities often rely on grant support from bodies such as WAG to carry out regeneration and economic development projects. Normally, they do not use the value of their properties as *equity* in investment projects.

Recent Local Government White Papers have high-lighted the need for Local Authorities to make better use of their property assets in promoting long term regeneration. A UDF will provide a mechanism for local authorities to access a blend of public and private sector financing with the assurance that finance is delivered through a pubic private partnership between a private sector investor and Assembly Government.

A view may also be raised by the Local Authorities that by investing their assets under a UDF, they will lose control of the assets. It will therefore be necessary to demonstrate that despite partial loss of control, the Local Authorities will still achieve their goals and achieve the same end results and that the Local Authorities will retain influence in the delivery of their projects by the structure of the delivery arrangement (vehicle or contractual) with further protection afforded by the position of WAG as the public sector partner at the fund level. These controls and influence will be in addition to the usual planning and CPO powers of the local authority.

The UDF will invest in a wide range of projects throughout Wales. This will spread market risk and reduce exposure of a downturn in the sub-regional or local market. The UDF will also enable Local Authorities to promote larger scale projects and harness private sector skills into projects which the private developers would not normally consider.

Private Sector Owners

In addition to the public sector the UDF will be open to opportunities brought to it by the private sector either through site acquisitions or private sector joint ventures. The UDF will not attempt to displace private sector development activity and will not seek to unduly influence the market other than to invest on a long term basis to create a market in areas where currently there is market underperformance. The aim will be for the UDF to be classified as a private sector entity and will face competition in the market like any other developer / investor.

Clearly, opportunities to work with other private sector land owners and developers are vast. Not only will there be potential to acquire third party development sites or adjoining land interests where there may be a material marriage value to unlock, but the fund will also be able to consider funding third party development projects that meet its financial and regeneration criteria.

Private Sector Partner Involvement

A key objective of the UDF is to provide a more confident environment for private investors/developers in those locations where demand is currently weak. This can be achieved by creating a critical mass of development to generate confidence and a strong market in the convergence area as a whole, as well as in specific locations. In this way, the initiative will be self perpetuating. It is the aim of the UDF to ensure that the correct basis is created in order to start this cycle.

In broad terms, private investors and developers are seeking opportunities to re-invest within the United Kingdom and obtain national exposure. A pan-regional vehicle would be of sufficient scale to attract institutions looking to take a long term view on their investments – those such as pensions and life insurance companies where the long term nature of the vehicle would be compatible with the long term nature of their commitments.

The UDF will therefore generate the required "pipeline of product", allowing access to ongoing investment opportunities and an otherwise unobtainable land bank, complemented by the associated powers of WAG such as compulsory purchase orders and planning to achieve the required aims. It is however important, as has been confirmed by market testing, that the UDF is not established as a blind fund and that some projects are included from its inception.

4.3 UDF TYPE MECHANISMS ALREADY IN OPERATION IN WALES

Welsh Industrial Partnership

Welsh Industrial Partnership (WIP) is a formal partnership between WAG and the Royal Bank of Scotland, the purpose of which is to undertake the provision, mostly through speculative development, of modern industrial facilities in the Objective 1 areas of Wales. It was identified that this is an area of the market that the private sector was not able to meet the needs of Welsh business because of the obstacle of completed values being lower than the cost of development. Rather than provide grant to individual projects, WIP is an investment-based approach. The capital structure of WIP provides for the "A" Capital of the partnership to be held 51:49 private to public, with a secondary "B" Capital held entirely by the public sector, but this secondary layer of equity enjoys a subordinated rate of return, but this return increases with the financial performance and profitability of projects.

4.4 OTHER WELSH MODELS

WIP has been used as a basis for a further partnership for WAG and the private sector.

- Dragon 24 has a similar structure but has a developer partner instead of an investor partner and the management of the projects in Dragon is provided on a fund management basis by the commercial developer. Dragon 24 will develop small offices, predominantly for owner occupation, in the Objective 1 areas of Wales.
- Welsh Investment Strategic Partnership WISP) has a somewhat different structure, but is still built around an innovative partnership between the public and private sectors. Under WISP, the design, construction and financing risk associated with Grade A offices is borne by the private sector partner with WAG bearing the occupational risk. This partnership approach is unique to Wales but is proving very effective in creating high quality office buildings in areas where the private sector would not normally invest.

4.5 ENGLISH CITIES FUND

The following summary is an abridged version of the statement made by the UK Government to the EC in 2001 (State aid N 82/2001 ref. SG (2001) D/ 290547) in its application for State aid in respect of the ECF.

Objectives

The objectives of the fund were summarised as:

- Attracting institutional and other private sector investors into fringe of town and city locations in priority regeneration areas selected by Regional Development Agencies;
- Enabling the public sector to receive a return on its investment in regeneration;
- Hedging the risk by placing projects in a portfolio rather than by supporting them separately;
- Providing a model for regeneration projects that would encourage confidence in regeneration, by demonstrating the potential commercial viability and attractiveness of urban regeneration projects to private sector investment funds;
- Create a catalyst for the public and private sector investors in regeneration.

The objective of the ECF is to operate as a commercial developer and investor, in areas where currently the private sector is not present. According to the UK authorities, the objectives arise because there has been a failure of the market to provide long-term institutional funding for regeneration. Currently in the UK institutional investment is provided for “built and fully let” projects after a property developer or other company has taken the development risk. Institutions do not generally take on high-risk projects and invest to generate a standard return. They do not provide project finance required to create regeneration because in individual projects the risk is too high. The result is that development projects in regeneration areas suffer from a lack of finance and have to depend on short-term bank finance, which is expensive, sometimes with public support.

ECF would demonstrate how institutional investors may invest in a portfolio of projects and provide evidence of returns achievable from regeneration and the real risks. This should increase the amount of regeneration projects undertaken and reduce the cost to the public sector because of the reduced cost of private sector capital.

Duration

The Partnership would terminate on the tenth anniversary of the Agreement constituting ECF. However, the Partnership can be liquidated earlier than that, where all commitments have been drawn down in full and all investments realised or where all the Partners agree that the Fund has been (or would be) unable to implement sufficient development and that market conditions suggest no improvement in that situation. At any time before termination, the life of the Partnership may be extended with Limited Partners consent by such period and on such terms as they may agree.

Background

EP identified development and investment partners on the basis of the following criteria:

- A combination of institutional investment funds and skills and property development funds and skills;
- A willingness to take risk in priority regeneration areas;
- Investment to provide returns which genuinely reflect the blend of long term investment and short/mid term development criteria;
- A willingness to join a joint venture partnership and invest to a business plan;
- Flexibility in the investment structure (not simply equity finance but also project loan finance like mezzanine finance);
- A willingness to share risk with the public sector and take an appropriate reward.

Description of the scheme/fund

Legal structure - ECF would be an individual legal entity constituted as a Limited Partnership under English law. The Limited Partners would be the investors. They would be entities of EP, AMEC, and L&G. In Phase 2 they would be joined by Institutional Investor B procured further to tendering. The Limited Partners would agree investment terms with the General Partner, which would be established as a company to run the Fund and oversee the division of returns to the shareholders.

ECF would be an investment fund, created through a pilot partnership between the public and private sectors. It would be dedicated to land and property development in fringe areas of towns and cities in urban priority regeneration areas in England. Investments by the Fund would be limited to projects located in Assisted Areas.

ECF would make equity investments in a series of urban regeneration property development projects, on the basis of the following criteria:

- To invest in regeneration projects in Regional Development Agency priority areas;
- To bring forward development within these regeneration areas.
- Where appropriate, to enter into joint ventures with developers operating at a local level within the Fund's chosen regeneration area;
- To invest over a period of more than five years in order to participate in the value enhancement which tends to occur in the later years of regeneration programmes;
- To invest mainly in speculative developments, where pre-let must be not more than 50% of the project at commencement;
- To invest in projects which produce an estimated return at or in excess of a target return of 12%;
- ECF would not invest in Projects located outside Assisted Areas;

Internal functions

The General Partner would have overall responsibility for the Fund. It would delegate certain functions to the Investment Manager and to the Development Manager, which would receive a market fee for their services. Such fee would include a fixed amount per year plus a percentage linked to their performance.

The Development Manager would be responsible for the identification of a project, the procurement process and implementation of the development, the letting of the project until six months after the issue of the certificate of practical completion of the project, and the estate management of the project until the date of practical completion.

ECF would draw down the investment of the Partners and bank debt and invest in a number of ways:

- As a developer – working with local partners to design projects, buy land, construct properties, market space to end-users, secure first lettings by occupiers;
- As a joint venture partner with a landowner or local developer, providing long-term finance to support property development by third parties, who would fully share the risk and reward.
- ECF would not provide loans nor gap funding. It would not purchase completed projects.

ECF would invest in projects on full market terms, seeking to make a return. In developing the projects ECF would act like any market operator. Where the Fund acted as sole developer it would carry out and procure all aspects of the development process. The Fund would procure its development contracts by full open tenders run on its behalf by AMEC.

Distribution of profits

The Fund would invest in projects sufficient to get a 12% return on each project. According to the UK authorities, this is the minimum level of return to require private sector investment in ECF. However, there would be no guaranteed rate of return on projects and EP's investment would not guarantee a return to the private partners.

The distribution to the investors is based on the risk each shares in the Fund. ECF would have a life of ten years; distributions would occur when the investors have each invested all their capital.

Performance

The ECF was set up on the assumption that "early institutional involvement in regeneration projects could result in attractive returns over the longer term: attractive returns in a development context could be considered to be in the range of 15-20% annualised return on partners' equity". ECF currently expects to achieve that target over the life of the Fund[3].

More information concerning the setting up of ECF in the context of EC may be found at Appendix B.

[3] Email from ECF 10th July 2008

4.6 UDF TYPE MECHANISMS ALREADY IN OPERATION IN ENGLAND

British Waterways PPP

British Waterways (BW) is one of the first public sector bodies to establish UDF type mechanism in the UK in which they entered a joint venture (JV) with a private sector body (a JV between Amec and Morley) to develop its non-operational property portfolio. The JV vehicle, in which BW has a 50% stake, develops the properties according to a pre-agreed development plan. This ensures that the properties are developed in a way that is congruent to BW's objectives but in a shorter timescale than otherwise would be possible.

BW also benefits from the development expertise of the partner and is able to utilise financing methods not otherwise open to them. Finally, BW is guaranteed to receive at least the book value for the assets and receive a 50% share in all other development profits.

The vehicle is structured as a Limited Partnership which provides both BW and the JV partner significant operational and tax benefits and has been operating and successfully delivering on its objectives as ISIS since 2001 (see www.isis.gb.com).

One NorthEast Public Private Partnership

One NorthEast (ONE) has established a JV to hold and manage its portfolio of investment properties. A partner with property management expertise has been selected to outsource this function and who can generate additional value from the portfolio.

However, ONE retains a 50% interest in the vehicle, thus retaining some control over how the properties are managed, and receives 50% of the uplift in value created through the portfolio's improved management.

As the JV is not on ONE's balance sheet, it is able to utilise third party debt to regenerate the portfolio and develop new properties. ONE is guaranteed to receive at least the book value of the assets in addition to receiving half the rental income from the properties.

East Midlands Development Agency (ie 'Blueprint')

The East Midlands Development Agency (emda) and English Partnerships (EP) established Blueprint, a joint venture Public Private Partnership between the two agencies and Igloo Regeneration Limited. The aim of the fund is to hold and manage emda's investment portfolio and to undertake development activity targeted on the urban priority areas in the Region, to include key strategic regenerative sites in the ownership of both emda and EP.

Through the utilisation of private sector expertise and funding, Blueprint enables emda and EP to undertake more regenerative property development activity and to refurbish and redevelop the investment portfolio to maximise returns, sharing in these returns through the structure of the partnership but minimising its position with regard to the risks of undertaking such developments.

A bespoke financial model was developed in order to assess the viability of a number of investment and development option scenarios and to determine the most appropriate strategy to be undertaken. The model enabled comparison of both the internal rates of return and net present values of the differing approaches, as well as providing indicative annual receipt forecasts.

emda and EP developed the strategy for the establishment of the joint venture vehicle. The process included a detailed business case, securing all internal approvals and subsequently providing assistance in presenting the concept to Government and gaining all necessary statutory approvals.

A new fund has now been created, using a Limited Partnership structure, and is operating successfully with emda, EP and Igloo Regeneration having 25%, 25% and 50% stakes respectively (see www.blueprint.gb.net)

North West Development Agency

North West Development Agency (NWDA) established a Public Private Partnership (PPP) to hold and manage its £130m portfolio of investment properties.

The Agency's core objectives of social and economic resurgence for the region were integrated into the PPP's operation in a way that also enabled the private sector to operate and meet its primary objectives of producing a financial return.

In implementing the strategy developed, the NWDA went through the procurement exercise following the European procurement guidelines. The PPP was established in December 2006 with Ashtenne Industrial Fund.

Advantage West Midlands (AWM)

AWM wished to progress development opportunities at a faster rate, benefiting from the private sector's knowledge and expertise, producing sites for local businesses' needs and creating and safeguarding jobs for the West Midlands Region. Retention of the investment portfolio of properties was no longer regarded as a core objective of the RDA and was used to provide an income stream to assist with the development costs. The aim was to develop a strategy that would meet its financial requirements but without the Agency having to dispose of the property assets outright.

AWM's structured a vehicle, which holds the assets together with a Private Sector Partner. In forming this partnership, it was imperative that AWM's core objectives of social and economic resurgence for the region were integrated into its operation.

The process required a detailed assessment of AWM's property portfolio and developing a detailed financial model to demonstrate to AWM and central Government the financial viability of the strategy proposed. This culminated in writing an Outline Business Case for the fund that was presented to the Board and Treasury/ODPM to obtain formal approval to progress with the project.

This culminated in a procurement exercise following the European procurement guidelines and the new Competitive Dialogue process. The vehicle was established in April 2007 with Langtree Group and Bank of Scotland Corporate forming the PSP.

Croydon Council

Croydon Council has completed an options appraisal, outline business case and procurement exercise including selection of John Laing Developments Ltd as a preferred partner for the regeneration of Croydon town centre. The vehicle is based around relocating 20,000 sqm of the Council's core office space into a new, purpose built town hall from a building that is at the end of its economic life. The Council's new premises will be subsidised by the creation of market and affordable housing in the Council's current premises and further commercial space from three other identified sites. The partners expect to conclude the agreement imminently which will catalyse an anticipated £500m worth of development.

Other Local Authority Type UDFs

We are aware of numerous other local authorities either in procurement or going through a strategic options study in which UDF type mechanisms (usually referred to as local asset backed vehicles) is being actively considered. These include Aylesbury, Bournemouth, Devon, Manchester, Newcastle, Newham and Torbay amongst others.

4.7 SUMMARY

The above examples show the many parallels that exist in the UK in regeneration vehicles that are already in operation. This trend for 'corporate' type legal vehicles between the public and private sector as opposed to more contractual relationships (ie PFI, development agreements) is a strong growing trend in the UK as witnessed by the recent Property Week article (29th August, 2009):

www.propertyweek.com

Residential + regeneration – Local authoriti
29.08.

UNSTOPPABLE VEHICLE

■ Councils are warming to the idea of forming public-private asset-backed vehicles to kick-start regeneration. **Mark Shepherd** reports

CROYDON (PICTURED) DID IT FIRST. MANCHESTER followed. Now the London Borough of Newham is getting in on the act. All have set up local asset-backed vehicles (LABVs) – a phrase that will soon be common parlance in regeneration.

The vehicles were floated in the 2007 Housing Green Paper as a way for local authorities to take the lead in regeneration projects and take a greater share of the final development value.

The idea has been taken up with enthusiasm. In June, Newham Council became the latest local authority to announce the setting up of a LABV, in an £800m initiative to regenerate for redevelopment in partnership with private developers. We think they will be very successful, although many are still in the very early stages.'

Under a typical LABV structure, public sector bodies, such as local authorities and the new Homes and Communities Agency, contribute land accounting for 50% of the vehicle's total value. The other 50% is provided by private sector developers in the form of equity (see graph). Between them they create a special-purpose vehicle, which then develops the chosen sites.

finance vehicles alongside developers.

'There is this feeling among councils that b entering into these kinds of vehicles they are selling the family silver,' says Kuljeet Hothi, partner in the company commercial division. 'They don't like the idea of putting up to 20 development sites together and signing up with just one partner.'

There are some risks for local authorities, which would account for their caution. A rep to be published by CBRE says that, while thes vehicles have proved popular among bigger cities and London boroughs, they may not sui

Caution should be exercised in the differences that exist in this genre. In particular the difference between investment and development funds. Although a decision is yet to be announced by the Commission, it is becoming increasingly likely that any JESSICA UDFs will be required to focus on investment and not carry out development directly.

However even allowing for these differences, clearly given the outputs of the options exercise set out in the previous section and the wealth of support in regeneration practice in the UK for initiatives of this nature, there is a growing body of evidence supporting the creation of a JESSICA / UDF in Wales to underpin large scale physical regeneration.

The subsequent sections of this report investigate how this could be implemented in terms of the structure, legal issues, risks and likely market response (ie market testing).

5 THE UDF STRUCTURE

5.1 INTRODUCTION

An Urban Development Fund (UDF) for Wales is likely to comprise a joint venture between Welsh Assembly Government (WAG) and a private sector institutional partner (PSP).

The essence of the UDF is to invest in regeneration projects that the private sector would not take forward alone, either due to return profiles or risk positions. As such, whilst the private sector is bringing skills and much increased funding power to deliver the projects, it must be recognised that the private sector partner is almost certainly going to require a commercial return on their investment. This will be a minimum return on cash / property invested. The UDF will act as an enabling fund to promote, accelerate and facilitate large scale regeneration development opportunities in Wales, focussing particularly in areas where the private sector will not take forward development in its own right due to market failure or the excessive costs of remediation / infrastructure provision resulting in unacceptable risk or financial returns. WAG will commit investment comprising European funding and public equity, possibly in the form of property assets, the value of which will be matched by the private sector also with cash and / or land (albeit it is likely that the private sector equity contribution will comprise largely cash and treatment of the land contributions element requires confirmation from EC).

The concept of establishing the UDF on a 50/50 basis, with equal equity contributions, but allowing the PSP to receive financial returns in advance of the public sector partner, has been explored in detail by King Sturge. The benefits of a 50/50 approach include:

- Leveraging major private sector investment;
- The potential synergies inherent in keeping individual sites in a single portfolio;
- Economies of scale;
- Building partnerships rather than simply managing processes; and
- Retention of strategic control at public sector level

King Sturge and Eversheds have discussed that any ‘priority return’ to the private sector would be likely to constitute a State aid and would require European approval with the resultant impact on timescales and potential conditions associated with securing such approval. If, however, the fund could be established on a pari passu basis between the public and private sector, State aid would not be triggered at the fund level and, in principle, the fund could operate on a pan Wales basis.

It is considered likely that a condition limiting the level of State aid otherwise available to entities at the project investment level will be imposed under cumulation rules, where the UDF investment in the project is via equity instruments (as opposed to where the investment is by way of loans at or above the applicable reference rate in accordance with the latest Communication from the EC or guarantees in compliance with the Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees). This is due to the Commission generally taking the view that such entities will indirectly benefit from the non pari passu nature (if there is a priority return) of the public/private sector investment in the UDF, which is the position adopted by the Commission within the Community guidelines on State aid to promote risk capital investments in small and medium-sized enterprises (*OJ C 194, 18.8.2006, p. 2–21*) ("SARC"). The Regional Aid Guidelines require cumulation of aid to keep within the Regional aid limits. It is also noted that the cumulation provisions within SARC and the final version of the General Block Exemption Regulation (in the context of risk capital measures) (OJ L214, 09.08.2008) limit aid at the project investment level to 50% of otherwise permitted aid for a period of years.

Appendix A sets out further questions and issues to be addressed in relation to DG Comp and Regio.

5.2 ASSUMPTIONS

The most relevant sources for Convergence funding under the ERDF Programme are Priorities 3 and 5. Final contributions to a JESSICA initiative are yet to be decided and as such for the sake of this exercise we have not specified the quantum of public sector cash investment (no WAG cash match funding is anticipated at this point).

Consideration is being given to WAG investing land alongside their JESSICA funding contributions which will be especially relevant where WAG land assets are of strategic importance and have a direct impact on projects being considered.

To illustrate the potential of how a fund could be leveraged, if we did assume a total JESSICA funding contribution together with land value injection by WAG of £50m (note the market testing at section 10 proposes a fund in which WAG would make an equity investment of no less than £30-50m), when matched by the private sector partner this firepower doubles to some £100 million of equity. Senior debt will then be introduced alongside the equity, geared on a conservative loan to cost ratio of say

60% (i.e. an equity / debt ratio of 2:3). Assuming that £100 million of equity is available, debt totalling some £150 million will therefore be raised. The combined equity and debt will enable a fund with capital (equity and debt) totalling £250m to be established.

These figures are not unrealistic in the context of Wales. The market testing conducted indicated a need by the private sector funding institutions that may be interested in a fund of this nature to be able to invest c£50m to justify the risk of a public sector competitive bidding process and achieve economies of scale. However some market testing interviews stated the opportunity could be of interest if their investment was only £10m.

5.3 WHAT WILL THE WALES UDF DO?

The purpose of the UDF is to act principally as a funder and enabler, and not necessarily as developer, ie to finance land acquisition, land remediation, and infrastructure provision[4] for mixed use commercial and housing developments across Wales.

The UDF should be an over-arching fund, not a project or location specific vehicle, and will focus on larger, longer term projects of commercial mixed use land development that build investment value but which are also part of wider Urban Regeneration strategies.

It is envisaged that the UDF will be created by WAG and a private sector investment partner. This public private 'Fund' will invest in projects through project specific arrangements in conjunction with a Project Partner(s) (where appropriate and where Project Partners have land or another interest in a project) to invest in regenerative development.

The Project Partner is likely to be a Local Authority, another public sector organisation (eg Universities etc), a private sector land owner or a combination thereof dependent upon the extent and mix of tenure of land ownership within each project. The UDF will also have the ability, where there are no other appropriate land owners (whether public or private sector bodies) to directly acquire land (possibly with the support of WAG CPO powers) and to act in its own right and take forward infrastructure provision and some vertical development.

[4] This is referred to as horizontal development, as opposed to the construction of buildings which is referred to as vertical development.

5.4 GEOGRAPHY

In short, there are two options to be considered in regard to the geographic spread of projects however they have conflicting benefits and disadvantages:

- A Pan-Wales UDF would be more attractive to the private sector as it will have the opportunity to invest in stronger investment locations (such as Cardiff) thereby creating potential 'subsidy' for projects in the most deprived locations (the essence of the portfolio approach). The disadvantage is this is a complex and challenging option in terms of satisfying State aid (which is considered further at section 7.2) and other EC regulations.
- The alternative is a UDF for the Convergence Areas only which brings greater focus to the areas inherently deprived of investment and would be a significantly easier passage through the State aid minefield (which is considered further at section 7.2). Given the Convergence Areas include the relatively attractive urban locations of Swansea and Bridgend, there should be the potential for these locations to 'cross subsidise' within the Convergence Areas to support more challenging investment locations (ie generally further west).

5.5 OVERARCHING UDF STRUCTURE

One of the key benefits of the UDF structure for WAG is the ability for policy and Ministerial priorities to be delivered by leveraging public sector ERDF funding to give influence over private sector financing. In particular Ministers will be able to define how the fund operates over its lifetime in advance of the tendering process (ie before it is even set up) through the investment principles and criteria drafted by the public sector to entail their wider goals and enshrined in the legal documentation by which all the partners must abide.

Whilst other models are possible, it is envisaged the UDF will be structured as a 50/50 joint vehicle between WAG and a private sector investment partner (see section 5.1 for the benefits of the 50/50 approach). WAG has a particularly strong track record of innovation and success in the delivery of Regeneration and Property Development through partnership with the private sector:

- partnership with RBS since 2002 in an LP undertaking speculative industrial developments and have an LLP with a developer that will build a £45m programme of small office units over the next 5 years.
- a £200m strategic partnership with the infrastructure investor Babcock & Brown to build grade A offices over the next 8/10 years.

This approach has also been successful in England, having been adopted by a number of RDAs (including One NorthEast and North West Development Agency) in respect of property specific joint ventures and is a concept well known to, and accepted by, the private sector institutional market.

The UDF will not be established for specific projects, though the potential initial projects and investment pipeline will be identified at the commencement of the UDF. The Fund will, within the governance framework of a well defined and prior agreed investment criteria, take decisions on the projects that are identified and taken forward during the fund's life.

It is anticipated that a professional fund manager will be employed to manage the fund and its investments on a day to day basis. This role could be linked to the PSP.

Within each project, the Project Partner will invest either existing brownfield sites, or buildings which are identified for regeneration or cash (or a combination thereof). These projects will be at a level beneath the primary fund as illustrated below:

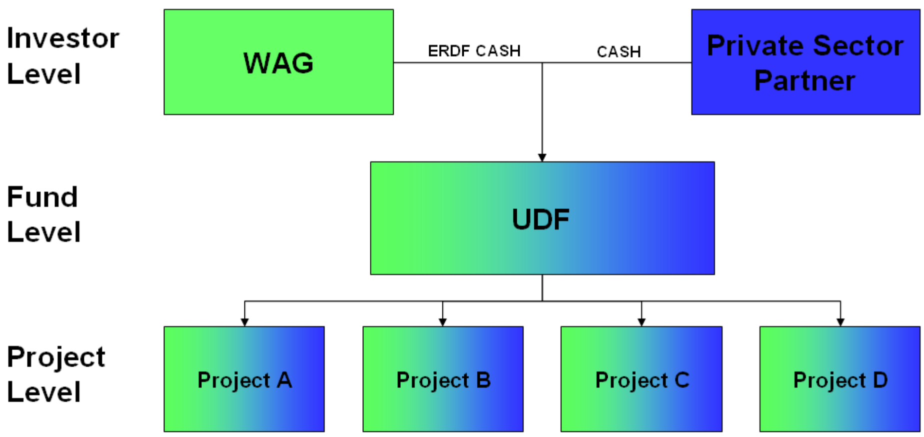


Figure 2 : Basic UDF Structure

The basic premise is that the UDF will provide equity and / or land assets to invest in each specific project alongside the Project Partner. WAG will contribute ERDF funding through JESSICA, and where available and appropriate key strategic land assets. WAG land assets may be invested at the Fund level or project level, however this needs to be tested with EC (one solution to investing WAG assets at the fund level is to make them conditional on being sold or transferred to the project level). This will enable the public sector asset base to be combined at project specific level to ensure comprehensive development can be taken forward.

The recommended UDF structure can, therefore, be summarised as a 50/50 public / private owned and controlled joint venture vehicle. WAG will contribute a mixture of land assets and cash to the Fund, whilst the private sector partner will match this with cash (although it could also contribute assets if they were deemed appropriate by the partnership).

5.6 PROJECT SPECIFIC ACTIVITY

Figure 3 below illustrates how project specific activity would take place in practice. Here, it is assumed that an equity investment is made by the UDF and a land contribution by the Project Partner (in the example shown a Local Authority), and this equity coupled with a conservative level of senior debt financing is sufficient to undertake the defined project.

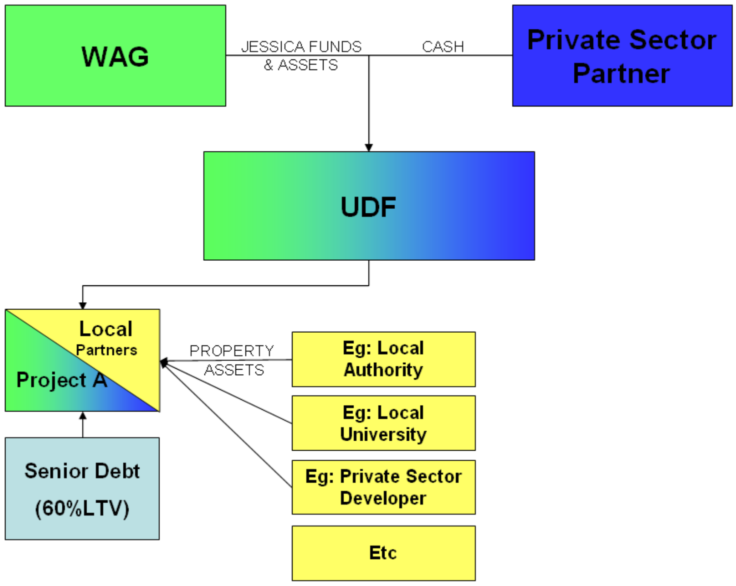


Figure 3 : UDF Joint Venture with various local partners as the Project Partner

Should the project qualify for additional funding from other public sector initiatives (be it from WAG or elsewhere), then this would further enhance the funding mix available to the specific project.

The UDF can use its initial investment criteria and ongoing business planning processes as the means through which to identify which projects to invest in and how. The investment manager or equivalent would provide advice to the board as to how it may invest in projects, expected return rates etc.

Project Investment Method

The manner in which the UDF may invest in projects is not pre-determined. It may invest by way of loan finance or equity finance (perhaps, even, contributing land assets).

A formalised joint venture special purpose vehicle may not be desirable in all projects. However, certain projects may lend themselves to a special purpose vehicle arrangement in which the UDF is an equity participant and, therefore, captures value at that level as well as through returns flowing back up to the UDF.

Potential joint venture partners may be the project partners, the relevant developer for the project(s) and potentially a funder or funders who are providing finance in relation to that specific project. Each will have an identified role - for example: a funder may wish to take a "back seat" and only reserve key strategic matters to it whereas the developer will run the day to day activities of the vehicle.

Where a special purpose vehicle is the preferred route we note below some key issues that WAG and the UDF will need to consider:

- equity participation in a project joint venture vehicle opposite the Project Partners - ie what is the economic commitment of each of the parties and, therefore, the equity split?
- what level of involvement the UDF will want to have in the decision making arrangements of the joint venture vehicle - for example: board representation, veto on strategic matters

The level of control which WAG retains within the UDF and that the UDF ultimately then exercises in any project special purpose vehicle will be key in determining whether the transaction is on or off the WAG balance sheet and each case will need to be looked at on its own facts. Broadly, however, if WAG is not exercising a dominant influence a strong argument can be run that such arrangements will not need to be accounted for on its balance sheet - both in terms of assets transferred out of WAG and in terms of the borrowing. However it should be noted that this issue is currently the subject of an active examination by ONS (Office National Statistics) in England regarding a number of similar funds being created there. It will be pertinent for WAGs Finance Department to ensure that any final structure chosen does not create any balance sheet issues.

Project Selection

Initial consideration has been given to the nature of projects that would be most appropriate for the UDF to undertake. A set of 'evaluation' criteria has been discussed by the JESSICA working group and is summarised in the table below:

Evaluation Criteria	
1	Policy fit (ie WAG, WEFO and EIB/EU)
2	Existence of sustainable integrated regeneration plans
3	Primarily public sector ownership (WAG, Local Authorities, Universities)
4	Profitability (indicating internal rate of returns of 0-15%)
5	Partner commitment at the 'project level'
6	Scale/attractiveness to the private sector
7	Funds invested (defrayed) by 2015 (the ERDF 'qualifying expenditure')
8	Regulation compliant
9	Projects to be in a state of 'readiness'

Clearly further detailed work is required in regard to the evaluation (ie investment) criteria and through the process of this study over 70 projects around Wales have been identified that to a greater or lesser degree have the potential in the short, medium or long term to become a project for the UDF.

It will be important for a clear and transparent project selection process to be designed and communicated with project level partners – in particular local authorities – in order a flow of the best physical regeneration projects is maintained for consideration by the fund.

5.7 INDICATIVE PROCESS FOR THE UDF AND PROJECT PARTNERS

Set out below is an illustration of how the development activity on a specific project might progress. This should not be read as a prescriptive account of how the UDF investments will unfold but as illustrative only to provide further context:

Year 1	Project specific joint venture agreed between the UDF and a Local Authority (the Project Partner). An assessment is made of the equity required to allow the project specific joint venture to fund the required service / infrastructure costs and the value of the asset owned by the Project Partner is agreed. This determines the apportionment of returns (between the UDF and the Project Partner) as they become available to the project specific joint venture. The UDF and Project Partner commit to the project through the establishment of an appropriate legal structure.
Yrs 1 to 3	Objectives and masterplanning for the scheme confirmed. Outline planning consent secured.
Yrs 2 to 4	UDF provides equity to the project specific joint venture to enable horizontal development - infrastructure provision (including roads, services such as gas, electricity, drainage etc) - to commence.
Year 3	Project specific joint venture commences first phase of vertical development and constructs an office – for example – on a speculative basis to 'kick start' the development and test / prove the local market.
Year 3	In parallel a fully serviced residential plot with planning consent is sold, subject to development agreement, to a local housing developer specialist. The value of the plot is greater than the initial value (as contributed to the project specific joint venture by the Project Partner) as the plot has the benefit of a planning consent , is fully serviced and is part of a wider more comprehensive regeneration project that anticipates 'area uplift'.
Yrs 4 to 10	Both horizontal and vertical development activity continues across the scheme – the project specific joint venture has already developed out 10% of the vertical development by value and undertakes no more vertical development. It continues to provide infrastructure and servicing to remaining plots of land and sells these plots for development by private sector developers. The project specific joint venture (including the UDF and its partner) will have benefited from land value uplift as more development activity takes place and the local property market becomes more established. The

	project specific joint venture retains the investment of the original office for a period of time to enable sharing in long term holistic value uplift for the area.
Year 10	The local market / area has been proved and further development across the wider project area is taken forward naturally by the private sector. The land servicing / infrastructure provision is complete and there is no longer a justification for the project specific joint venture involvement. The project specific joint venture partnership is ended. If there are additional investment assets held within the area, these can be sold or held for the longer term, dependent upon the wishes of the partners within the specific project joint venture (ie UDF and its Project Partner), and returns available are shared between the partners and in turn shared within the UDF.

During the life of each project, any developments completed by the project specific joint venture (the 10% of vertical development activity by value), together with serviced land plots, are sold. On realisation of profits available to the project specific partners, and subsequent to the repayment of any senior loan facilities outstanding, profits will be split between UDF and the Project Partner according to their relative interest in the projects. It is likely that for the majority of the specific projects, the UDF will be the majority shareholder due to the level of equity that is likely to be required compared to the value attributed to the land committed by the Project Partner.

UDF's share of profits from the project will then be distributed to the fund's partners (WAG and private sector partner), or retained and recycled within the vehicle (the UDF) for reinvestment elsewhere.

5.8 ASSET CONTRIBUTION

WAG

It is intended that WAG will contribute ERDF funding in cash and possibly land assets into UDF to make up their equity contribution to the fund. If land assets are contributed it is likely that they will be transferred at market value and may relate to proposed projects or may be other assets which this UDF could utilise as debt security or dispose of to raise additional cash.

Project Partners (usually local authorities)

At the project level, the 'Project Partners' assets will be transferred into an arrangement with the UDF via specific joint venture projects, development agreements or other investment/development mechanisms as appropriate in each case. It is anticipated that the UDF will enter into a series of distinct and wholly separate projects with the Project Partners. These scheme specific projects will be established with the specific regenerative / development intentions and objectives of WAG and the local public sector partners, and as agreed with UDF.

The aims and objectives of WAG will be clearly agreed and enshrined in the appropriate legal documentation at the outset. The level and proportion of the shareholding between the UDF and the Project Partner will be dependent upon the value the respective parties' equity contribution to the project. The project specific arrangements could range from a formal 50/50 joint venture to a straight sale of the asset to the UDF.

It is for the UDF to negotiate the best possible deal with each Project Partner and this is an area where, when dealing with a private sector Project Partner, the private sector partner within the UDF will draw on its commercial skills and expertise in order to negotiate the most attractive terms possible for the UDF.

Even where there is not a 50/50 or greater partnership between the UDF and the Project Partner, the public sector's interest and objectives for the site will be ensured not only through the aforementioned legal documentation, but also by having public sector involvement and interest on both sides of the partnership.

Project Partners would not be obliged to enter into a joint venture with the UDF. It may be more appropriate for the Project Partner to sell its asset(s) to the UDF at value and receive a financial payment, knowing that the public sector objectives and outputs for the site will be protected and safeguarded by WAG's 50% interest in the vehicle. There is no obligation on the Project Partner to maintain an involvement in the project allowing each Project Partner to maintain flexibility dependent upon its specific needs and requirements at the appropriate time.

Private Sector Partner

The private sector partner within UDF will contribute cash (and potentially assets if their location and strategy are aligned to the proposed projects) to match the equity committed by WAG. If the private sector partner commits assets, these will also be transferred to the UDF at market value.

5.9 RETURN PROFILES

The attributes of UDFs differentiate it from the other asset based initiatives established by RDAs in England and other public sector organisations. These initiatives include those which have featured the transfer of business space assets into a joint venture vehicle to maximise the value of the assets and share the uplift between the partners. They also include the transfer of public sector owned urban regeneration sites to joint venture vehicles to progress them with private sector funding and expertise.

The concept of utilising private sector funding to initiate public sector led projects targeted at regeneration in its wider sense is therefore not new. What a UDF does however is to provide a more flexible tool with which to take forward projects on a rolling basis where the possibility of differentiated returns is recognised and addressed at the outset and the public sector has the ability not only to make a return on equity committed over time, but to recycle the equity in new projects on a rolling basis.

5.9.1 PROJECT LEVEL

The returns available to each partner at the project level (i.e. the UDF and the Project Partner) will be shared in proportion to each partners' equity commitment. The quantum of return will be dependent upon the proportion of the value of the equity / asset committed to the project specific joint venture vehicle (or other mechanism) by the partners.

It is important to note that it is currently assumed that the UDF and the Project Partner will receive returns (in their proportionate share) at the same rate when the profits within each project are available for distribution (albeit in all likelihood both the UDF and the Project Partner will recycle returns within the project to share in further value enhancement / uplift). This will minimise the level of any Aid at the Project Level. There may be a disparity in numerical returns due to the timing of the equity commitment (eg UDF will invest equity as and when required whereas the Project Partner will inject its assets at the outset).

There is potential for further Aid issues to arise here which would need to be addressed at the project level. For example, where the Project Land Partner is a public sector body, the EC in assessing whether an investment is made on a pari passu basis looks at both the amount and timing of the investment and the return on the same.

5.9.2 PROJECT RETURN PROFILE

In all projects, the UDF and the Project Partner will agree the commercial basis of the make up of the returns achieved by the project and the risk position to be adopted by either side. In the first instance, this will be a commercial negotiation, between the Project Partner (whether it is a Local Authority, other public sector partner or private sector partner) and the UDF, as it would be with any other private sector investor.

It has been assumed that the Project Partner and the UDF will receive the same level of returns (in order to minimise State aid issues). It is important to note that, even though the project is likely to require equity over a period of time, the UDF will be absolutely committed to providing the total level of equity required for each project. The level of equity to be committed by the UDF will be assessed and agreed between the UDF and Project Partner at the outset of each project.

However, for each specific project, the UDF and the Project Partner will agree the most cost effective means of introducing land / assets (through means of option agreements or other legally contractual methods) and equity as appropriate.

5.9.3 PRIVATE SECTOR INVESTMENT PARTNER AND WAG RETURNS AT UDF LEVEL

Returns from the projects to the fund (after Project Partners have received their returns) will be split between WAG and the private sector partner at the fund level.

The essence of the UDF is to invest in projects that the private sector would not take forward alone, either due to return profiles or risk positions. As such, whilst the private sector is bringing skills and much increased funding power to deliver the projects, it must be recognised that the private sector partner will require to receive a return on their investment. This will be a minimum return on cash / property invested.

The nature of the activity of the UDF will therefore mean that the WAG contribution into the fund will, in many cases, need to initially act as a financing buffer to the private sector partner's contribution. This gives a prioritisation of returns to the private sector which is essential in order to assist projects where there is a financial deficit or insufficient funds to give a return on cash / assets invested by the private sector partner in the early years of a specific project's life (i.e. projects where the private sector partner would not as a matter of course invest independently). The actual return profile to be adopted by the UDF will only be confirmed as part of the competitive procurement process of the private sector partner and investment manager.

However, as projects are developed and overall fund returns exceed the minimum level of return required by the private sector partner, these further returns will be distributed back to WAG first so that, if sufficient returns are generated, WAG will move up to a position of equality with the private sector partner. In this way, the WAG funding input moves away from traditional grant funding to an investment, albeit with a deferred prioritised payment profile (both in terms of timing and security).

It is anticipated that returns on a project specific basis will be re-invested into further projects. In certain circumstances the private sector partner's return for a project, given the prioritisation arrangement outlined above, will be greater than that of WAG. Therefore a mechanism will be put in place to ensure that the amount of equity recycled is equal between the partners to ensure parity of investment in all projects. This is likely to take the form of a protected account within the UDF to hold any difference in returns from a project. This will ensure that the equity committed by WAG and the private sector partner remains equal at all times. Any funds within the account can be used by the UDF in the future as appropriate. The levels of returns that are recycled within UDF will be reviewed periodically between the partners, potentially on a 5 or 7 yearly basis.

This recycling of returns will ensure the pan-regional cross subsidisation will occur to promote the overall objectives being met. It will also be possible to introduce other project specific funding where possible.

5.10 SENIOR DEBT CAPABILITY

The utilisation of senior debt will again be a key ingredient in the securing of private sector financing into regeneration schemes. Due to the value of the equity investment within each scheme being increased through public and private sector equity contributions, the level of senior debt that will be available to each project will also be improved.

However, the percentage level of gearing for each project must not be considered aggressive and it is assumed that each project will have a loan to cost ratio set at 60%, with the potential to exceed this figure only for specific short phases of development and only with the specific agreement of the partners within the project. Clearly we are currently in extraordinary challenging times for raising debt finance, however given the lead-in time to set up the UDF and allowing for the life of the fund it is anticipated that more normal credit conditions will return and appropriate lending will be possible along the lines indicated here.

In addition it is worth noting that access to the lending facilities of the European Investment Bank may be available, if the UDF considered that commercially advantageous.

5.11 RETURNS FROM COMPONENTS NOT ELIGIBLE FOR STRUCTURAL FUNDS

It is highly likely that the projects identified will include residential elements, which are not eligible for Structural Funds. In order to navigate this, a clear audit trail distinguishing eligible and ineligible expenditure is maintained via a separate accounting system (or separate accounting code for co-financed expenditure down to the final level of the project). There should be clear identification of the capital contributed from each operational programme to the UDF and the expenditure which is eligible under the Structural Funds (see Article 60 (c, d and f) and Article 90 of Regulation (EC) No 1083/2006 and Art.15 Reg (EC) No 1828/2006) – as summarised in the draft guidance note on financial engineering by COCOF on 17 June, 2008[5].

5.12 RECYCLING OF FUNDS

Throughout the life of the fund it will need to be decided whether profits are to be recycled within the fund only or whether – in effect – dividends may be drawn if available and agreed by the partners and paid out. In this scenario WAG would then be able to reinvest the funds in any project or initiative it selected rather than be limited to those that satisfy the investment criteria of the UDF upon its establishment.

JESSICA/ERDF capital has to be deployed within N+2 (the programme period plus two years), and then re-cycled at least once (but not necessarily within the programme period), before it becomes the property of the Managing Authority authority. During the life of the fund, which is likely to extend way beyond the programme period, the

[5] Residential development is not eligible for Structural Funds, but can sometimes be re-defined as Urban Renewal, which is eligible. Although precise workings are still unclear it is generally understood that: new residential development on green-field sites is invariably ineligible however classified, except in very exceptional circumstances;
the redevelopment of brownfield sites for residential purposes can occasionally qualify as urban renewal in appropriate circumstances and may sometimes be eligible, but the lines of demarcation are blurred; and
refurbishment of the existing stock in appropriate central locations can often qualify as urban renewal, and would therefore be eligible. In any event, a transparent audit trail is clearly essential.

monies will presumably remain in the fund as the Managing Authority's equity/share and, depending on the business plan, there appears to be no reason why dividends should not then be paid. Once the fund closes, the JESSICA or MA's equity entitlement, including its share of any profits that have not yet been distributed, is then returned to the MA to do with as it sees fit, eg – to invest in another fund or to redistribute as grants, providing the expenditure/investment is for urban projects and/or urban in nature. Again, the regulations are quite vague on this last requirement, i.e. that the sequential expenditure should be urban, but it's a logical interpretation.

6 LEGAL STRUCTURE

6.1 FUND MANAGEMENT AND OPERATION

The main legal structures for the UDF will be a company limited by shares, a limited partnership or a limited liability partnership. The exact structure will be driven by a number of key factors - namely, tax efficiency and robust governance and control mechanisms. Limited partnership and limited liability partnerships can offer certain tax efficiencies as they are generally invisible for corporation tax purposes. As such profits are treated as being received directly by the partners in such partnerships and this can be particularly attractive to institutional investors who themselves will participate through fund structures.

In all structures, robust control and governance provisions are achieved at a number of levels - the key ones being:

- shareholder/partner control level
- board level
- day to day level
- transfer of shares/exit provisions

We take each of those in turn below. At the outset, however, it should be noted that - as with other models similar to the proposed UDF model - the objectives of WAG can be enshrined in the legal documentation at the outset as well as being enshrined in the business plan of the UDF. In that manner, WAG will take comfort that its objectives in setting up the UDFs will be very clear opposite any private sector partner and will actually become the objectives of the UDF itself. Any deviation from those objectives or change in business direction will need to be approved by WAG. This is where Ministers will be able to exercise strategic control over the purposes and objectives of the UDF (as noted also in section 6.2).

It is most likely that the management of the JESSICA fund will be undertaken by a commercial organisation that would be procured competitively, the key advantage being that not only are funds are added via the JESSICA mechanism but also essential commercial and entrepreneurial skills of the private sector

6.2 SHAREHOLDER/PARTNER CONTROL LEVEL

Whereas we expect that WAG will not want to take day to day control in the UDF, it will want to ensure that it retains strategic control. We set out below how this can be achieved.

Shareholder/partner control will be key to this and can encompass the issues we note above (in relation to deviation from the pre-defined objectives/change in business direction) and a number of others which we explore below. Essentially, these are matters which can be set out in the UDF's constitutional documentation as requiring the prior written approval of both WAG and the private sector partner before the UDF (through the board/investment manager/project teams/staff) can undertake such activity. It is in this top partnership level of the governance structure that Minsters will be able to exert strategic and policy influence.

On establishment of the UDF it is expected that the business plan of the UDF will be adopted - as such business plan has been agreed by WAG and its private sector partner. That business plan will be a key operational document for the UDF as it will act as the strategic document shaping the UDF's activities. It is envisaged that the business plan will be subject to annual review. WAG may wish to exercise its control through that document such that, provided the activity of the UDF is consistent with and within the parameters contemplated by the UDF's business plan, then the board/investment manager/staff can undertake such activity. Any business outside of those parameters would need to come back to WAG and its private sector partner for approval.

Other areas where the unanimous consent of WAG (as an organisation) and the private sector partner may be required may be decisions:

- to make a material variation to the business plan of the UDF
- to wind up the UDF
- to admit a new shareholder/partner to the UDF
- expenditure over a certain threshold
- forming subsidiary vehicles (which may include project specific joint venture vehicles, where appropriate)

6.3 BOARD CONTROL

We would expect WAG and its private sector partner to have equal representation on the board of the UDF. The shareholders/partners would delegate the running of the UDF's business to the board (subject to those reserved matters noted above). Therefore, WAG may determine, for example, that the board should consist of 4 representatives (2 appointed by WAG and 2 appointed by the private sector partner).

Individuals appointed to a company board have duties and responsibilities as directors of the company and will need to take advice in relation to this to ensure that they are familiar with such responsibilities.

Further detail will be required in relation to the following areas:

- voting at board level - namely, is it by majority or unanimous vote? We would suggest that WAG would want unanimity to preserve its strategic control. However, this needs to be balanced against not exercising a dominant influence and the balance sheet issues related to that (see section 5.5 above)
- frequency of board meetings
- quorum of board meetings
- ability to appoint directors
- identity of the chair
- deadlock resolution

6.4 DAY TO DAY ACTIVITY

We have envisaged that the UDF will either staff itself up or have a investment manager appointed to it to advise in relation to projects and the manner in which the UDF may invest in those projects. It is envisaged that the procured investment manager will undertake the day to day role in managing the UDF and the authority delegated to it by the board will be set out in a service level agreement/terms of reference.

A service level agreement with a investment manager will set out the following key things:

- the services the investment manager is providing
- any relevant key personnel
- key performance indicators
- default and termination provisions
- remuneration provisions

It will be the board's responsibility to ensure that the investment manager is accountable to it for its activities and the identification of robust key performance indicators will be key to this as will regular reporting back to the board.

The degree of specificity in the service level agreement is key to ensuring that the management of the fund is cognisant of the needs and objectives of the Managing Authority, but that the fund manager enjoys sufficient flexibility/freedom to undertake investment decisions unencumbered by undue interference occasioned by the minutiae of any local political issues and/or concerns that might crop up from time to time.

An external fund manager (or at least someone at arms' length) is probably the most sensible way forward, with the parameters for her/his modus operandi very carefully defined in an appropriate service contract. This is clearly a sensitive issue, but one that needs to be addressed in a transparent and robust way in the preparation of the business plan.

6.5 EXIT AND DISPUTE RESOLUTION

WAG will want to ensure that the legal documentation contains pre-defined exit and dispute resolution provisions.

For example, in relation to exit WAG will need to consider the duration of the UDF and whether there will be a lock in period for its partner and what pre-emption provisions it will require on a share transfer.

In relation to dispute resolution consideration is needed in relation to the consequences of a lack of unanimity between WAG and its private sector partner on those matters which require unanimous approval - for example: approval and review of the business plan. For example: WAG may consider that such matters are referred to mediation and/or expert determination (where capable of expert determination).

In addition, WAG will want to ensure that it has robust default provisions to incentivise its partner to adhere to the contractual and constitutional arrangements. Therefore, default provisions can be cast such that where a default occurs (for example: non payment of funding) the defaulting partner's share in the UDF can be bought out at a discount to market value.

7 TYPE OF PROJECTS

It is envisaged that at the project level, the UDF will be a partner (alongside the Project Partner(s)), typically in a special purpose vehicle which will undertake the following development functions:

- site assembly, including transferred parcels and the purchase of additional parcels necessary to assemble attractive development sites;
- land remediation to enable sites to be brought forward;
- site development works and other infrastructure provision;
- disposal of individual serviced plots to housing and commercial developers; public sector projects (e.g. University faculties etc) and
- Preparation of area master plans and securing planning consents on transferred sites where not already in place.

The types of development projects in which the UDF will participate, will be predominantly mixed use regeneration schemes, some of which are likely to be commercial property led as opposed to others being predominantly housing led. An example of a current WAG led project is SA1 Swansea, see project website - www.sa1swanseawaterfront.com.

The investment criteria of the UDF will be agreed between WAG and the PSP, but are expected to allow flexibility to reflect changes in market conditions over the life of the fund. WAG will initially seek alignment with its strategic regeneration priorities and the initial projects will be required to align with the European Programmes from which the funding is sourced. Investment return potential will, clearly, be an important component of the investment criteria alongside the public policy objectives.

7.1 INVESTMENT CRITERIA

The investment criteria of the UDF will be agreed between WAG and the PSP, but are expected to allow flexibility to reflect changes in market conditions over the life of the fund. WAG will initially seek alignment with its strategic regeneration priorities and the initial projects will be required to align with the European Programmes from which the funding is sourced. Investment return potential will, clearly, be an important component of the investment criteria alongside the public policy objectives.

In particular the Convergence Area has a strategic focus on the following key areas:

- creating high quality jobs and economic growth;
- investing in developing skills and reducing economic inactivity;
- regenerating our most deprived communities;

• contributing to tackling climate change.

Under the ERDF stream, Priority 3 has been identified by WEFO as appropriate funds to support *JESSICA.*

7.2 STATE AID IMPACTS ON INVESTMENT LOCALITIES

If, investments made into the UDF do not operate on a pari passu basis (and with investments down stream not being limited to SMEs and thus not covered by SARC and the equivalent provisions in the General Block Exemption), the most likely basis for justifying State aid as compatible aid by the EC would be under the requirements of the Guidelines on National Regional Aid for 2007-2013 (*OJ C 54, 4.3.2006, p. 13–44*). An approach based on regional aid would require that the UDF only operates within locations covered by the UK Regional Aid Map (2007/C 55/02) ("assisted areas"). An example of this approach is the English City Fund approval granted by the EC.

It is considered that inter alia due to the lack of transparency of the measure at the UDF level it would not be possible to rely upon regional aid measures under the new General Block Exemption Regulation. Other issues including the ad hoc nature of the aid at the UDF level, the potential level of the aid and the fund size (details however to be determined) may also preclude use of this Block Exemption.

If the UDC operated PAN Wales the position would be complex if there was to be any non pari passu investment. An early discussion with DG Competition would be recommended to see if, for example, they would allow one UDF operating with ring fenced accounts so that (i) in assisted areas operation is on a non pari passu basis and (ii) in the rest of Wales operation it is on a pari passu basis.

If, however, the UDF could operate on a pari passu basis in totality, perhaps by the portfolio approach that a PAN Wales UDF would bring, then State aid would not arise at the UDF level.

7.3 SOURCE OF PROJECTS

The sites and schemes that will be committed to the UDF will come from a wide range of sectors including:

- WAG
- Local Authority / Project Partners;
- Other public sector Project Partners (including Universities etc)
- Private sector Project Partners;
- A combination of both public and private sector land partners; or

- Acquisitions made by the UDF itself.

In practice, the initial sites identified to be committed to the fund are likely to be provided wholly by the public sector and will include sites that WAG and public sector Project Partners currently own or where purchases are currently in progress. Once established the UDF will have the ability to purchase land and assets surrounding existing projects either in the open market or by better utilising the CPO powers available to both the WAG and the Project Partner (if that specific Project Partner comprises / includes a Local Authority). In addition, the UDF will have the ability to purchase sites where there is currently no public sector land interest, where the objectives and rationale for committing to such a project fits with the agreed investment criteria of the UDF (set by WAG at the outset).

7.4 COMPULSORY PURCHASE ORDER POWERS

An important aspect of what the UDF will do is linked to its ability to potentially utilise CPO powers. It is important that, at each project specific level, the CPO powers of both WAG and the Project Partner (where that Project Partner comprises or includes a Local Authority) may be utilised in order to ensure that the proposed development activity is not frustrated by private sector owners wishing to retain ownership of their specific asset and share in the value uplift that will naturally occur over time, without contributing to the infrastructure provision and other key costs associated at the early stage of any development.

It should be remembered that the potential use of CPO powers will be justified by WAG and the local public sector partners, should frustration of development activity occur, as the proposed development will be aligned to both WAG and Local Authority's (where appropriate) objectives. It is assumed that at the project level, through the use of the equity committed by the UDF the cost of the CPO activity is likely to be underwritten.

8 FINANCIAL RETURN MECHANICS AND MODEL

8.1 OVERVIEW

As the riskier elements of each of the development opportunities will largely be assumed at the project level (ie typically by the UDF and the Project Partner for each specific project), the vertical development element of the delivery process (the remaining 90% of the vertical development) will on the basis that it is less risky to the private sector development market.

As this remaining vertical development has been de-risked by the UDF, the returns that the private sector development market (taking forward the remaining 90% of the vertical development) will expect will be reduced and this will result in an improved residual land value being paid to the project specific joint venture as serviced plots are sold. The UDF and the Project Partner will share in these returns.[3]

This is only one way in which the PSP will potentially generate a return. There are – subject to State Aid and EC confirmation – up to three ways in which the PSP may potentially generate a satisfactory return as summarised in Table 1:

Basis of Return		State Aid/ EC Cohesion Funding Issues
1	Priority Returns from the UDF	Requires State Aid notification (see s9.4 below)
2	Carrying out 10% development activity to stimulate higher values in subsequent 90% of land holdings	Requires EC Decision as to consistency with the requirements of the cohesion fund rules applicable to JESSICA
3	Project Level Partners Transferring land at less than market value into a project	Could potentially be addressed as part of overall notification to the EC regarding the UDF or on a project by project basis

It is difficult to accurately assess the extent of returns that the private sector development market will demand when bidding for the serviced sites that are sold by the project specific joint venture, but it is expected that a private sector partner will look for an internal rate of return of at least 15%.

Soft market testing has now been undertaken with four prospective partners and in each case it was confirmed that unless an IRR of between 15-25%[6] could be forecast either directly or more indirectly through a prioritised return mechanism the opportunity of a Wales UDF would not be of interest to them.

[3] In addition a structure could be considered in which land is invested at the project level at a discounted rate in order to support returns. However this would carry further State Aid implications which would need to be addressed at the project level.

[6] Based on our experience of similar regeneration projects over the past five years these IRRs are unusually high and a direct result of the current economic climate. In more benign times circa 15% is more typical.

In order to further ensure that development activity takes place and to further encourage private sector involvement in undertaking the vertical development[4] activity, it is likely that the receipts for land disposals should not be demanded by the project specific joint venture until after that specific element of development activity has been undertaken and completed.

Traditionally a private sector developer will pay for the land before any vertical development is undertaken. Due to the long term nature and intent of the UDF, it will have the ability to demand a receipt for a land / site disposal later in the development programme (i.e. on a deferred basis). This will have a number of positive influences including:

- Increase the amount of interest from both the local and national private sector development markets;
- Reduce the private sector developer risk significantly by reducing up front project costs;
- Further enhance the likelihood of project deliverability; and
- Potential to improve land values available to the UDF and Project Partner as developer risk is mitigated and land values uplift over time.

The impact of any benefit from the flow down of aid at the UDF may need to be considered. Alternatively the UDF and Project Partner might agree to receive a percentage of the value of the completed development (when it is ultimately disposed by the private sector developer), thereby further sharing in the long term value / equity uplift as each developed area benefits from holistic regeneration.

The over-arching intention of the fund is to act as a strategic enabler, not a developer and in the majority of circumstances the UDF will move on projects once the aspirations and targets for each scheme have been met. However, in order to ensure that the UDF can share in value uplift and associated returns through growth, which in turn can be recycle into other projects, the UDF may also hold the assets that it has developed (the 10% of vertical development activity by value) for the short to medium term in order to share in the wider area value uplift that will be achieved through the initiation and acceleration of development in the area.

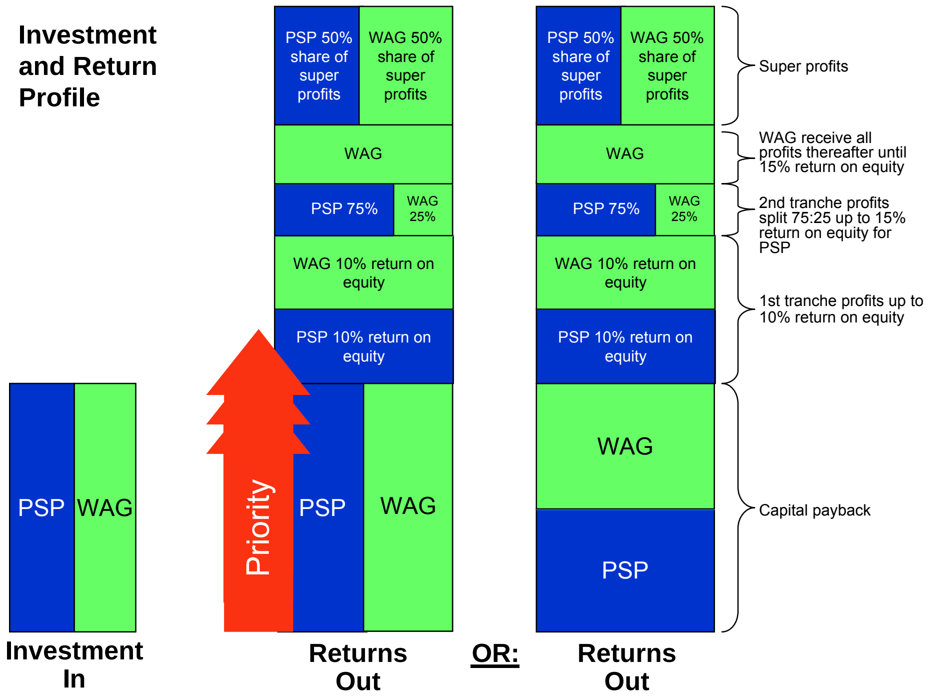
The private sector partner within the UDF may wish to look to purchase some of the completed developments to hold themselves, and this will be one of the exit routes for projects from the UDF (assuming best value requirements etc. are met). It is possible that the UDF could engage, or even implement itself, an asset management structure to

[4] The construction of buildings is referred to as vertical development as opposed to infrastructure which is referred to as horizontal development.

ensure the long term success of the developments. In this regard, the participation of RSLs and the Local Authorities will play a key role.

8.2 RETURNS AT UDF LEVEL

As the returns are fed up from the project specific vehicle into UDF, due to the nature of the projects, the private sector partner within UDF will require a priority return. The exact nature of this will be part of the bidding criteria during the procurement process but for current purposes we have assumed the following, illustrated diagrammatically:



In sequential terms, this return profile can be explained as:

PSP and WAG have their capital paid back on an equal basis

OR

Private sector partner receives back its capital before WAG[5]

Thereafter, if there are additional funds available for distribution:

- Private sector partner receives a further amount to provide an internal rate of return equivalent to 10% based on its share of the equity committed to the project by the UDF; then if there are additional funds available for distribution
- WAG receives a further amount to provide an internal rate of return equivalent to 10% based on their share of the equity committed to the project by the UDF; then if there are additional funds available for distribution

[5] The preferred structure may need to be tested by the commission

- Private sector partner receives 75% of further available returns until the internal rate of return on its share of equity committed reaches 15%; in parallel
- WAG receive 25% of further available returns until the internal rate of return of the private sector partner's share of equity committed has reached 15%; then if there are additional funds available for distribution
- WAG receive all further available returns until the internal rate of return on their share of equity committed reaches 15%;
- Any further additional profit available, once both the private sector partner and WAG have received an internal rate of return of at least 15% on equity commitment for each specific project, will be distributed equally.

By continually incentivising the private sector partner, the profits for each specific scheme are maximised as far as possible and therefore so is the return ultimately available to the public sector (both for WAG and where local authority Project Partners maintain an involvement).

It should be noted that the more attractive scenario from WAG's perspective is the first 'Returns Out' scenario (in the diagram) in which WAG would receive its original investment returns on an equal basis to the PSP and therefore will be able to afford to invest in more and/or higher risk regeneration projects.

8.3 FINANCIAL MODEL

A financial model has been created, to demonstrate the principles of the structure outlined, based on three pilot projects that might be suitable for the UDF. The three projects have been modelled to demonstrate the mechanics of the financial model and the return profiles that might be expected to be received by the partners within UDF and at the project specific level, based on informed assumptions[7]. The three projects therefore are:

§ Project A

§ Project B

§ Project C

These sub-sections have been structured to:

1. first set out the principles of the individual projects,
2. then consider and provide commentary on what the UDF will do on each of the sites and how the Project Partners returns relate to those of the UDF on each project,

[7] Prior to establishing UDF, as part of the OBC work, a more detailed analysis of actual projects across the region would need to be undertaken.

3 then consider how UDFs returns are split between the partners (i.e. WAG and the private sector partner PSP),

4 and finally look at the overarching UDF returns illustrating the benefits of the cross subsidisation approach of the fund.

8.4 ASSUMPTIONS

Overarching UDF assumptions

1 An overall development exposure (by area) of approximately 5% is assumed (Site C is to be entirely sold off and only 10% of Site B is to be developed).

2 It is envisaged that the UDF will set up project level partnerships with a Project Partner. The Project Partner will transfer in the land whilst the UDF will provide funding to be injected prior to any senior debt. The amount of funding will be calculated to cap the amount of senior debt to 60% LTC.

3 The ratio of land versus cash equity investment will determine the percentage of profits each party receives from the project. Whenever there is surplus cash in the project (after debt repayments) it is split between the Project Partner and UDF. Therefore no surplus cash is held at the project level

4 The UDF splits its share of profits between the WAG and PSP, therefore no surplus cash has been assumed to be held at the UDF level. The profit share at this level can either be on a 50/50 basis or as priority returns, as described previously in this report

5 It is assumed that the Project Partner and the UDF will receive their returns equally – ie side by side.

6 2% stamp duty will be incurred at the project level.

7 2.5% p.a. inflation has been assumed on all costs and values, including the land value transferred into each project.

8 7.50% p.a. senior debt interest with 0.5% arrangement fee.

9 The UDF will incur £200k p .a. in management fees, which are shared equally between the WAG and PSP.

10 UDF setup fees have been excluded in the return analysis.

11 The land sales within each project will incur a 2.5% disposal fee.

12 The cash equity investment for each project will be split equally between the WAG and PSP.

Project specific assumptions

Project A

The project entails site service costs (e.g. Infrastructure type costs) with plot sales after these works have been carried out. In addition there is existing income which will be received for two years.

Project B

Approximately 10% of the site area is developed, this relates to developing part of the 1st phase only. The remaining area is sold off as a land sale, which excludes the site service costs as they will be funded before this. It is assumed that the serviced land is sold when the construction of the units can begin.

Project C

This site cannot be split up and therefore the entire area is sold to a purchaser after the site has been serviced. The value of this land sale has been calculated to give the purchaser a 15% profit on cost (assuming the purchaser will incur a finance cost of 7.5% p.a.). Furthermore this is quite a large site and therefore it has been assumed it will take 12 months to find a purchaser after the site service works have been carried out.

8.5 RETURNS FROM THE EXAMPLE PROJECTS TO THE UDF

For the example projects, using the differential return profile set out above, the total returns to WAG and PSP can be illustrated as set out below. As outlined earlier, although the quantum of returns shared between the UDF and the Project Partner will be in direct proportion to each parties' total investment commitment, each parties' own Internal Rate of Return will depend on when its equity is actually committed to the project.

Project A

The site level geared IRR is 8.63%

Project A	UDF	Project Partner
Total Equity/Land Contribution	£301,134	£685,423
Cash Distributions	£362,656	£825,455
Project Profit(loss)	£61,522	£140,032
Profit on Cost	20.4%	20.4%
IRR	8.70%	8.60%

The Project Partner has a larger share of the profit as the land investment is greater than the cash equity investment by the UDF. The UDF's IRR is greater as its cash equity is invested as and when required, as opposed to the Project Partner investing the land upfront.

Project B

The site level geared IRR is 20.14%

Project B	UDF	Project Partner
Total Equity/Land Contribution	£4,545,105	£750,463
Cash Distributions	£12,281,868	£2,027,916
Project Profit(loss)	£7,736,763	£1,277,452
Profit on Cost	170%	170%
IRR	20.59%	17.93%

The UDF has a larger share of the profit as the cash equity investment is greater than the land investment by the Project Partner. The UDF's IRR is greater as its cash equity is invested as and when required, as opposed to the Project Partner investing the land upfront.

Project C

The site level geared IRR is 0.00% (loss making site)

Project C	UDF	Project Partner
Total Equity/Land Contribution	£7,606,299	£9,505,866
Cash Distributions	£3,959,605	£4,948,460
Project Profit(loss)	(£3,646,695)	(£4,557,406)
Profit on Cost	-47.9%	-47.9%
IRR	0.00%	0.00%

The Project Partner has a larger share of the profit as the land investment is greater than the cash equity investment by the UDF. This site is loss making due to the high level of site servicing costs, and because a large enough land sale still cannot be realised. Furthermore there is a long void period between the site servicing and sale date.

8.6 OVERALL RETURNS

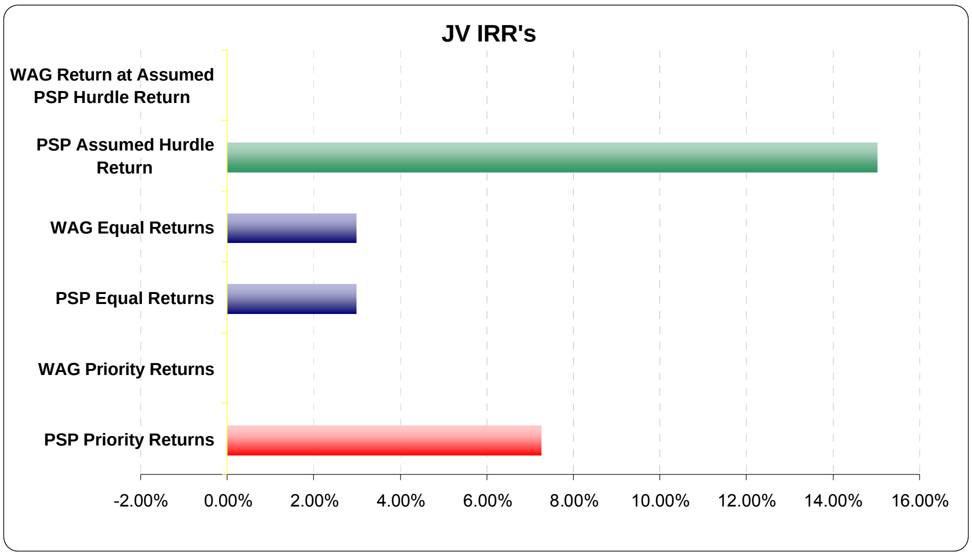
The table below highlights the returns for WAG and the PSP as partners in the UDF.

Project C	UDF	WAG	PSP
Total Equity Contribution	£12,452,539	£6,226,269	£6,226,269
JV fees (shared equally)	£2,199,322	£1,099,661	£1,099,661
Total Cash Investment	£14,651,860	£7,325,930	£7,325,930
Total Cash Investment Returned	£14,651,860	£7,325,930	£7,325,930
Profit/(loss)	£1,952,269	£0	£1,952,269
IRR	2.94%	0.00%	7.22%

The UDF's overall IRR is relatively low as Site C is loss making and the majority of profits only come from Site B, coupled with Site A only delivering a low proportion of the profits. Furthermore the UDF's IRR takes into account the JV fees.

8.7 PRIORITISED RETURNS – IRRS

The UDF profits are then split between the WAG and PSP, the following graph displays the difference in returns when using the priority returns mechanism over equal share of profits.



It can be seen that if there is an equal share in profits the WAG and PSP will have the same level of returns as the UDF. As we are considering the priority return mechanism, the graph highlights that the WAG simply has its cash investment returned – ie 0% return (after the PSP is reimbursed). After this the remaining profits are given to the PSP in order to boost its IRR.

Based on the projects we have explored this still does not provide enough returns to give the PSP an acceptable IRR. Accordingly in order to attract funding from the private sector it will be necessary to consider WAG receiving a negative return on its investment.

8.8 CASH RETURNS

A fundamental output of this study has been to compare the UDF 'financial engineering' approach with that of traditional gap funding. The following table enables us to do this:

			WAG	PSP
	Grant:		£7,326,000	£7,326,000
1	**Equal Returns**	Cash Return	£8,302,000	£8,302,000
2	**15% Hurdle Rate for PSP**	Cash Return	£4,271,000	£12,332,000

- Grant Funding – usually this is in the form of a 'gift', though an overage mechanism is sometimes attached but practice has shown these to be unreliable. This approach therefore rarely produces any public sector returns
- Equal Returns – this assumes a private sector partner (PSP) is willing to accept the same returns as the public sector. Unfortunately market testing has shown that this might only produce an unrealistically low level of return to the PSP ; and
- Priority Hurdle Rate –as indicated by the market testing, an institutional fund investing in a Wales UDF may only do so if they can forecast an appropriate return.

The public sector partner only receive c£4.2m cash returned relative to the PSP's 15% IRR which as the table indicates equates to £12m+. However given the public sector typically receives a cash return of zero under traditional gap funding approaches and the priority return allows for increasing returns to the public sector in the event that projects perform more successfully than initially forecast the UDF approach has a growing number of attractions.

This coupled with the fact that the UDF leverages in significant private sector equity finance and third party debt to projects that would otherwise be unable to secure finance means that a 'virtuous circle' of investment is started which if directed by the more enlightened criteria of the public sector enables larger scale more balanced projects to be catalysed.

8.9 CONCLUSIONS

Despite the example projects identified above generating returns that are not attractive to the private sector on a pari passu basis it is clear that a UDF approach will still enable WAG to ensure that ERDF monies are able to make a significantly bigger impact over the long term than a traditional grant funding approach.

The financial model has shown that a UDF would catalyse large scale physical regeneration projects that would not be started by the private sector in isolation and still result in a revolving fund (ie the cash return to WAG) for future projects at the end of the life of the UDF of:

- c.£4m - if c.£7m is invested by WAG in the UDF;
- and based on current project modelled and extrapolated:
- c.£14m - if c.£25m is invested; and
- c.£28m - if c.£50m is invested

In addition, as already mentioned the UDF will have foster a culture of investment and financial sustainability as opposed to grant funding and ‘handouts’ that will be essential to Wales as it survives without European Funding after 2013.

9 KEY ISSUES AND RISKS

9.1 FINANCIAL (ECONOMIC) RISKS

Clearly the current economic and financial climate is a particularly challenging one for the property development and regeneration sector. Particular concerns will include the macro economic climate in general (ie the ‘credit crunch’); changes in interest rates; inability to raise third party finance secured on property; and changes in balance sheet and taxation treatments.

9.2 PROPERTY MARKET RISKS

The possibilities that there is a protracted down turn in the property market (with associated effects on development activity) or occupancy rates fall, rental growth is slow and/or capital growth is slow, must be considered.

9.3 OPERATIONAL RISKS

As mentioned, there are not actually any JESSICA UDFs in operation currently in the UK. Accordingly there is inherent risk attached to the largely innovative nature of this approach. However given there are a fast growing number of similar mechanisms now in operation at nationally (UK) and at the RDA level in England (ONE, EMDA, NWDA and AWM) in England plus many in the process of being established at the local authority sector there are precedents that inform the likely risk profile of UDFs.

Furthermore, the risk of the public sector not meeting their policy objectives will, to a large extent, be mitigated by the control mechanisms embodied in the partnership documentation and also by the deadlock provision that will exist.

9.4 STATE AID RISKS

The risks will primarily revolve around the likely need for approval from the EC if the returns from the UDF operate in favour of the private sector (i.e. on a non pari passu basis) and the likely flow down of aid to the project level through equity investments. These risks include the timescales to secure approval and the conditions that the EC may impose within any approval. These could include limitations on the geographic areas of Wales (e.g. areas covered by the regional aid map) within which investments could be made (or added complexity of how to introduce non assisted areas for a PAN Wales UDF - potentially on a ring fenced pari passu basis), requirements on the balance of public and private sector investment into the UDF and limitations on cumulation with other State aid at the project specific level where applicable.

Alternatively if the UDF could operate on a pari passu basis then there will be no State aid at the fund level.

10 MARKET TESTING THE PROSPECTS FOR THE WALES UDF

10.1 INTRODUCTION

A number of private sector organisations have been consulted through a soft market testing exercise undertaken by King Sturge including:

- ING
- Igloo Regeneration Ltd
- Barclays
- Prudential Portfolio Managers

They were selected on the basis that the private sector partner that will be required to participate in the UDF will have to be of significant covenant and financial strength in order to match the contributions of structural funds and must understand the ideals and objectives of the public sector in respect of regenerative development and have a thorough understanding of property and development as a core part of its business.

It is therefore assumed that the successful partner will be an institutional investor (life fund etc), a large property company or potentially one of the new large property REITS.

10.2 CURRENT MARKET CONTEXT

Clearly the UK and world economies and property markets are going through a very challenging period. This report does not intend to investigate in detail the wider trends other than to summarise the current situation by reference to the most authoritative index (the IPD Regeneration) which shows returns in All UK property and in specifically in regeneration areas dramatically declining from double digit returns over the past decade, now languishing in negative territory:

Fig 4 All Property Annual Returns (Regeneration areas v. UK Average)

In the context of a potential UDF for Wales what is most important to note is the fact that many more physical regeneration projects will now become illiquid and thus require some sort of public sector intervention to catalyse development. Accordingly the need for a properly funded UDF will be even greater than ever in the short to medium term.

10.3 THE FEEDBACK

Full details of these discussions are included at Appendix C, however set out below is a summary of the feedback:

What will the Wales UDF Do?

The interviewees expressed concerns that the Wales regeneration story needs to be told to an institutional investment market that is largely London based. All interviewees agreed it was important the fund did not start out ‘blind’ in order to have something tangible to present and ensure that it was active as soon as possible after inception. Ideally the fund should be clearly and simply articulated – eg ‘X key urban areas; university focussed; CPO backed powers etc” – ie it needs a clear story.

Type of Projects

Some interviewees expressed concern in the geography – ie the least competitive locations of a relatively uncompetitive UK region – namely the convergence areas in Wales. Some even went as far to say Wales investments come with a ‘big health warning’. Most of the funds have a general preference for the larger urban areas. Eg Igloo state they will only invest in the top 20 UK cities by size. That said, given the right opportunity they are ‘flexible’ on this criterion (eg their PPP with the East Midlands RDA is through out that region in many smaller urban locations).

Fund Structure

Being a ‘funder’ only and not a ‘developer’ drew mixed reactions. Most anticipated the need for development expertise at the fund level in terms of a strategic and supervisory role. Igloo is an exception here – it is set up to invest and develop, however it usually only starts the development process in order to establish superior masterplans and qualities of build before selling on opportunities to other developers who are required to match the quality standard they have set.

The interviewees agree that the fund requires scale given the cost of setting up the vehicle. References were made to exemplars such as Blueprint etc that have a total equity commitment approaching £50m by the private sector.

Financial Return Mechanics

Until 12-18 months ago this concept is one that most of the funds would have quite readily considered. As such although conceptually it is something they could do it is more challenging in the current economic climate and in broad terms in the past returns of 12-13% IRR had been sought, now it is projects with IRRs closer to 20% are required. Some of them (eg ING) said they could not even consider a regeneration fund in Wales at the present time, however that could change given changes in the economic climate and the fact they are always launching new funds that could more readily align with the focus of a Wales UDF.

In contrast, Igloo did not state such aggressive IRR position, their current expectations being 15% ungeared on projects or a lower return if projects are underwritten by the public sector or they are given a priority return.

They would require the total investment opportunity to be of a reasonable size to make the effort of engaging with EC (concerns regarding State aid) worthwhile – ie c£25-30m as a minimum but preferably closer to £50m (their commitment to the Igloo partnership with East Midlands RDA for example was £45m).

10.4 SUSTAINABLE AND ETHICAL INVESTMENT FUNDS

Given the ethical and social dimension of a UDF consideration was given to investors with an active interest in regeneration. According to the UN (UN EP Finance Initiative, Innovative financing for sustainability, CEO Briefing – the UNEP FI Property Working Group (PWG) • October 2007) urban regeneration is now attracting greater interest from large scale investors. However, unfortunately examples are still rare – Igloo/Morley being the most obvious high profile one in the UK.

Indeed Igloo has been heralded by the UN as ‘the world’s first sustainable property fund’ however even Igloo expect a commercial return from their activities; ‘The Fund will aim to achieve an ungeared Internal Rate of Return (IRR) of at least 12% per annum over the life of the Partnership.[8]

Beyond Igloo, all other examples cited are US or Japan based. The UN summarise their activities as follows:

Igloo / Morely

Morley Fund Management (UK) has created the UK’s first urban regeneration fund, called the Morley Igloo Fund. It invests in mixed-use urban regeneration projects in major towns and cities in the UK. The fund was designed to take advantage of under-priced opportunities created by the regeneration market being erroneously perceived as high risk and low return. It is expected to outperform its benchmarks.

[8] http://www2.igloo.uk.net/media/dContent/mediaCentre/investment_criteria.pdf

CAIPERS – US

California Public Employees' Retirement System created the California Urban Real Estate (CURE) program as part of its overall property portfolio. It invests in low-to-moderate-income housing, urban infill, community redevelopment and similar projects where the risk is no greater than in other property investments made by CalPERS. Since CURE's inception, CalPERS' average annual return has been 16.5% after fees, through December 31, 2006. This compares to the benchmark industry returns of 8.1 percent.

Shamrock Capital

Shamrock Capital Advisors and DECOMA Developers (USA) are investing in the development of South Pas Town Square – six mixed-use buildings on three blocks in South Pasadena's historic downtown core in the Los Angeles metro area. The certified green project is expected to produce an internal rate of return of more than 25% over four years.

Cherokee

Cherokee Investment Partners (USA) specializes in the sustainable redevelopment of brownfields, or properties complicated by environmental contamination. Since 1993, they have acquired more than 520 properties.

Mitsumishi Estates

Mitsubishi Estate Company (Japan) is redeveloping the 120 hectare Marunouchi Area in Tokyo where it owns 30% of the buildings. The project is focusing on sustainable urban infrastructure to maintain property values and increase competitiveness.

11 IMPLEMENTATION TIMETABLE

11.1 INDICATIVE TIMETABLE FOR IMPLEMENTATION

Assuming agreement to proceed, in order for Wales to establish a UDF the following headline tasks need to be completed:

Indicative Timetable	
Ministerial approval	Sept 2008
WEFO in principle approval (PMC)	Dec
State aid – preliminary discussions with EC	Oct – Dec
Select initial projects (with local authorities etc)	Oct – Mar 2009
Finalise fund structure	Oct – Mar 2009
Procurement of Private Sector Partner	Mar 09 – Mar 2010
Final Ministerial Approval	Mar 2010
State aid – final approvals with EC	Dec – June 2010

Accordingly, it is unlikely a Wales UDF will be in operation until the second half of 2010. Whilst in some respects this is a frustratingly slow timetable it is not unusual given the range of approvals that are required – in particular regarding State aid. Furthermore given the state of the property and wider economy, with most commentators indicating a return to a more benign economy in 2010 it is to be expected this will be a less challenging time to close the fund.

11.2 PROCUREMENT OF UDF PARTNER

In order for WAG to select the most appropriate partner and therefore realise their objectives from the UDF, the selection procedure must be both comprehensive and robust.

The approach to procure the UDF partner will depend on whether the partner will provide services as well as investment and the nature of the services. The selection of candidates could include inter alia the following criteria:

- Financial proposals (including the robustness of the candidates financial bid, an assessment of the candidates ability to raise required funds and covenant strength and suitability of the candidates organisation becoming a Limited Partner);
- Willingness and capacity to fund (and possibly part deliver – ie 10%) physical regeneration projects;
- Ability to participate in the partnership (including acceptability of management structure, the candidates experience and capability of key personnel proposed);

- Acceptability of the key legal structure (including the candidates commitment and acceptance of legal and funding structures); and
- Commitment to WAG objectives e.g. environmental, sustainability and diversity.

11.3 RESOURCING

In order to compile the information and engage with the bidding parties and other RDAs through the procurement process, it is considered necessary for WAG to have a high level “champion” who will provide project leadership (as for subsequent stages WAG will be the procuring body).

The complexity of the process will require a fulltime project manager who can immediately fulfil this role – it may be necessary to engage external support that can call upon the property team within WAG (and other public sector bodies if identified projects are included in the launch fund) to meet the requirements of the project.

The UDF will be a major property investment organisation and will require a number of full time staff. It is therefore suggested, that the project managers who will have built up a wealth of knowledge of the projects and the fund itself be available to the new fund following establishment. Over time, the UDF can recruit additional or replacement staff.

11.4 BUDGETING

In order to establish this fund, significant external resource is required:

- Lead consultants to run the procurement process and co-ordinate input from other advisers and across WAG and stakeholders, ie Local Authorities etc.
- Property advisers for valuation, market and due diligence work
- Legal advisers for the fund structuring, State aid and property legal due diligence
- Environmental consultants to undertake warranted investigations on the sites
- Cost consultants to help prepare appraisals for the development sites
- Accounting advice
- Policy advice

These consultants will take the project through OBC stage to signing up with a partner and in certain circumstances help resource the UDF in the early years.

APPENDIX A – QUESTIONS FOR DG COMP / REGIO

DG Regio

1 Can a UDF invest in initial stages (ie 10%) of 'vertical' development given how important this is to 'kick start' an area?

2 Clarity over how WAG can invests land as part of its equity stake if it is:

a. transferred with direct development in mind;

b. if it is transferred without direct development in mind (ie just to be traded it out or sell it down into a project SPV below the main fund etc).

3 Will assets to be transferred by WAG be treated differently if they are:

a. held directly. or

b. through some existing SPV etc.

4 Is there a clear difference between 'market failure' and 'market imperfections' (and can public money be only used in areas of market failure). Isn't an area classified as 'convergence' therefore suffering from market failure?

DG Comp

1 Market Testing is indicating no appetite for pari passu and thus there is a need for priority returns (reference COCOF "Draft Guidance Note on Financial Engineering" and Article 43 (7) of Regulation 1828/2006 reference is made to "returns from equity investments and loans…may be allocated preferentially to investors operating under the Market Economy Investor Principle"). Clarification of the meaning of this word would be welcome.

2 Confirmation that if you have aid at the 'top level' of the fund, and there is no additional State aid (including selling land at below market value from the public sector partner at the project level) then you would only need to notify at that top level unless the UDF made an equity investment where is it presumed aid will flow to the project level which could be approved as part of the UDF top level notification. It is assumed in this context that if the UDF makes loans at or above the applicable reference rate in accordance with the latest Communication from the EC or guarantees in compliance with the Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees that no State aid will flow to the project level and therefore the fund could operate quite efficiently on projects once the aid issue at the top level is sorted?

3 EC's view on cumulation at the project investment level would be helpful as the flexibility for further State aid at this level will be helpful to the operations of the UDF.

4 Is the concept of layering of returns (i.e. fund invests 50/50, capital returns 50/50 and then first say 10% of returns goes PSP, next 10% goes to WAG and then split 50/50 thereafter) acceptable at the 'top level'.

APPENDIX B – ENGLISH CITIES FUND – STATEMENT BY UK GOVERNMENT TO EC IN 2001

EUROPEAN COMMISSION
Brussels, 25.07.2001
SG (2001) D/ 290547

Subject State aid N 82/2001 – United Kingdom
English Cities Fund

Sir,

1. PROCEDURE
By letter dated 23rd January 2001, registered by the Secretary General of the Commission on 26th January 2001, the UK authorities notified the scheme "English Cities Fund". The Commission asked for additional information by letters dated 7th March 2001 and 21st May 2001. The UK authorities replied by letters dated 23rd April 2001, 11th June 2001 and 5th July 2001, which were registered by the Secretary General on 25th April 2001, on 13th June 2001, and on 5th July 2001, respectively.

2. DETAILED DESCRIPTION OF THE SCHEME
2.1. Title and legal basis
The scheme is designated as "English Cities Fund" (hereinafter referred to as : "ECF"). Its legal basis is to be found in the UK Statutory Powers contained in the "Leasehold Reform, Housing and Urban Regeneration Act 1993", which gives powers of activity in relation to property and land regeneration to the Urban Regeneration Agency, called English Partnerships (hereinafter referred to as : "EP").

The Right Hon Jack Straw MP
Secretary of State for Foreign and
Commonwealth Affairs
Downing Street
LONDON SW1A 2AL

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-
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2.2. Objective
The objective of public sector investment, which would occur through EP, in ECF is to create a pilot public-private investment vehicle, which is aimed at :

· Attracting institutional and other private sector investors into fringe of town and city locations in priority regeneration areas selected by Regional Development Agencies;
· Enabling the public sector to receive a return on its investment in regeneration;
· Hedging the risk by placing projects in a portfolio rather than by supporting them separately;
· Providing a model for regeneration projects that would encourage confidence in regeneration, by demonstrating the potential commercial viability and attractiveness of urban regeneration projects to private

sector investment funds;
· Create a catalyst for the public and private sector investors in regeneration.
The objective of the Fund is to operate as a commercial developer and investor, in areas where currently the private sector is not present. According to the UK authorities, the objectives arise because there has been a failure of the market to provide long-term institutional funding for regeneration. Currently in the UK institutional investment is provided for "built and fully let" projects after a property developer or other company has taken the development risk. Institutions do not generally take on high-risk projects and invest to generate a standard return. They do not provide project finance required to create regeneration because in individual projects the risk is too high. The result is that development projects in regeneration areas suffer from a lack of finance and have to depend on short-term bank finance, which is expensive, sometimes with public support. If successful, EFC would demonstrate how institutional investors may invest in a portfolio of projects and provide evidence of returns achievable from regeneration and the real risks. This should increase the amount of regeneration projects undertaken and reduce the cost to the public sector because of the reduced cost of private sector capital.

2.3. Duration
The Partnership would terminate on the tenth anniversary of the Agreement constituting ECF. However, the Partnership can be liquidated earlier than that, where all commitments have been drawn down in full and all investments realised or where all the Partners agree that the Fund has been (or would be) unable to implement sufficient development and that market conditions suggest no improvement in that situation. At any time before termination, the life of the Partnership may be extended with Limited Partners consent by such period and on such terms as they may agree.

The Fund would be built in two phases :
Phase 1, during which the total investment would amount to £ 100 m (nearly € 165 m);
Phase 2, during which a further investment of £ 150 m (about € 247 m) would be sought on the capital market.
Although no fixed date is foreseen for the take-off of Phase 2, it is anticipated that three years as of the launch of Phase 1 would be required to work up and undertake projects demonstrating a successful track record.

2.4. Budget
English Partnerships would invest in over three years :
· 2001 – 2002 : £ 5 m (about € 8 m);
· 2002 – 2003 : £ 10 m (about € 16 m);
· 2003 – 2004 : £ 10 m (about € 16 m).
2.5. Background
In developing the Fund EP has been assisted by independent market advice from the international property advisors Jones Lang LaSalle (hereinafter referred to as : "JLL"). EP asked JLL to identify development and investment partners on the basis of the following criteria :

· A combination of institutional investment funds and skills and property development funds and skills;
· A willingness to take risk in priority regeneration areas;
· Investment to provide returns which genuinely reflect the blend of long term investment and short/mid term development criteria;
· A willingness to join a joint venture partnership and invest to a business plan;
· Flexibility in the investment structure (not simply equity finance but also

project loan finance like mezzanine1)
· A willingness to share risk with the public sector and take an appropriate reward.
Mezzanine finance, also known as subordinated debt or quasi-equity, is a risk-absorber senior to
equity but subordinated to bank debt.

For the Development Manager role twenty-two companies judged to have the capability were approached, five companies made outline bids and four made full bids. AMEC Developments (hereinafter referred to as : "AMEC") and Grosvenor Property Holdings were chosen. Grosvenor eventually withdrew. AMEC is a property development company.

Discussions were held with ten potential investment partners, of whom four accepted an invitation to discuss in detail but only two of which, Legal and General and Norwich Union, wished to enter into detailed negotiations. Following a formal bid and selection process Legal and General (hereinafter referred to as : L&G) were chosen as Investment Manager. L&G are a private sector financial institution.

A full open tender published in the Official Journal would be run by EP in order to procure the further private sector investment required :

· £ 125 m (about € 207 m) bank debt facility (£ 50 m or nearly € 83 m in Phase 1, £ 75 m in Phase 2);
· £ 75 m (about € 124 m) additional institutional investor.
2.6. Description of the scheme/fund
2.6.1. Legal structure
ECF would be an individual legal entity constituted as a Limited Partnership under English law. The Limited Partners would be the investors. They would be entities of EP, AMEC, and L&G. In Phase 2 they would be joined by Institutional Investor B procured further to tendering. The Limited Partners would agree investment terms with the General Partner, which would be established as a company to run the Fund and oversee the division of returns to the shareholders. The General Partner would be formed by EP, AMEC and L&G in such a way that the involvement of these Partners in ECF Company would be separate from the Limited Partner investing entities as required under English law. The General Partner would be formed to agree the objectives of ECF, its business plan and investment criteria and to approve or reject individual investments and sales nominated by the Investment Manager.

The General Partner Board would consist of two directors from each of the Partners plus an independent person agreed by all the Partners who would chair the company but who would not have a vote or shares. The General Partner would issue ordinary shares to each of the Partners in proportion to the voting rights on the Board such as 33.3%, 33.3%, 33.3%.

As commercial Fund, ECF would be subject to financial services regulation – the Financial Services Act 1986.

2.6.2. Scope and investment criteria
The Fund structure would enable the public and private sector to invest in a small number of projects - expectedly eight-ten projects. The total size of the Fund would be £ 250 m (about € 418 m). As mentioned above in § 1.3., ECF would be built in two Phases :

Phase 1

· EP's investment totalling £ 25 m (nearly € 42 m);
· AMEC Developments Ltd's investment totalling £ 6.25 m (about € 10 m);
· L&G's investment totalling £ 6.25 m (about € 10 m);
· L&G's mezzanine finance totalling £ 12.5 (nearly € 21 m);
· External bank loan finance totalling £ 50 m (nearly 84 € m) – no equity – to be procured by market competition Europe - wide on commercial terms, with no underpinning, subsidy or guarantee by EP.

Phase 2

· £ 150 m (about € 247 m), consisting of £ 75 m (nearly € 126 m) mezzanine finance from an institutional investor and of £ 75 m (nearly € 126 m) loan finance from a bank, to be secured by full open tender advertised in the Official Journal.

ECF would be an investment fund, created through a pilot partnership between the public and private sectors. It would be dedicated to land and property development in fringe areas of towns and cities in urban priority regeneration areas in England. Investments by the Fund would be limited to projects located in Assisted Areas.

ECF would make equity investments in a series of urban regeneration property development projects, on the basis of the following criteria :

–
To invest in regeneration projects in Regional Development Agency priority areas;
–
To bring forward development within these regeneration areas. Where appropriate, to enter into joint ventures with developers operating at a local level within the Fund's chosen regeneration area;
–
To invest over a period of more than five years in order to participate in the value enhancement which tends to occur in the later years of regeneration programmes;

To invest mainly in speculative developments2, where pre-let must be not more than 50% of the project at commencement;
–
To invest in projects which produce an estimated return at or in excess of a target return of 12%.

ECF would not invest in :

–
Projects located outside Assisted Areas;
–
Operational cost of running businesses, business start-up, plant and equipment related to manufacture or any projects involving businesses in the so-called sensitive sectors, namely transport, steel, shipbuilding, synthetic fibres and motor vehicles;
–
Projects concerning production, processing, and marketing of agricultural products and fisheries as listed in Annex I to the EC

Treaty;
–
Projects covered by the multisectoral framework.
EP can only transfer its share of ECF to a statutory successor.

2.6.3. Internal functions
The General Partner would have overall responsibility for the Fund. It would delegate certain functions to the Investment Manager and to the Development Manager, which would receive a market fee for their services. Such fee would include a fixed amount per year plus a percentage linked to their performance.

The contract for the Development Manager would be awarded to AMEC and the Investment Manager role would be assigned to L&G. The Development Manager would be responsible for the identification of a project, the procurement process and implementation of the development, the letting of the project until six months after the issue of the certificate of practical completion of the project, and the estate management of the project until the date of practical completion. The Investment Manager would be regulated by Investment Management Regulatory Organisation (IMRO) under the UK Financial Services Act, therefore would have a responsibility to draw down and receive the investors' funds and thereby run the account on behalf of the General Partner, carry out investment appraisals and make decisions on individual investments. The Investment Manager would make recommendations to the General Partner on individual investments meeting the criteria of the Fund and which the Investment Manager thinks would make a return for the Fund. Although the ultimate project approval powers lies with the General Partner and require unanimous approval, this power is one of endorsement rather than initiation.

All fundamental decisions – such as raising finance, selecting projects, and distribution – are to be taken unanimously by the General Partner.

2.6.4. Means of action
ECF would draw down the investment of the Partners and bank debt and invest in a number of ways :

–
As a developer – working with local partners to design projects, buy land, construct properties, market space to end-users, secure first lettings by occupiers;
–
As a joint venture partner with a landowner or local developer, providing long-term finance to support property development by third parties, who would fully share the risk and reward.
ECF would not provide loans nor gap funding. It would not purchase completed projects.

ECF would invest in projects on full market terms, seeking to make a return. In developing the projects ECF would act like any market operator. Open calls for tender would be applied

· As the only way to secure additional funding in Phase 2;
· As the only way to select building contractors;
· As the only way to select third parties to enter into contracts

with.
Where the Fund acted as sole developer it would carry out and procure all aspects of the development process. The Fund would procure its development contracts by full open tenders run on its behalf by AMEC. The market for such development and construction works includes other AMEC group companies (such as AMEC Construction), which may bid for work from ECF against other development and construction companies. The awards of contracts by ECF would be on full market terms and AMEC companies would be limited to 30% in value of the ECF construction contracts. In clause 7 of the Development Management Agreement, it is stipulated that AMEC as

Development Manager "may not on its own account, and shall not procure that no other member of its group will, undertake or advance or otherwise enter into negotiations in relation to prospective projects [… .] without first offering the Partnership the opportunity of undertaking the project".

Where the Fund carried out development in joint venture with others it would do so in strict accordance with equal measure of risk/reward. Where the Fund operates in joint venture with other developers or a funding partner it is likely that the development partner will have identified the site and carried out some feasibility and planning work; in which case the Fund would carry out due diligence. Procurement and management of the physical development could be carried out by either partner as appropriate and by agreement.

The Fund would invest in mixed use projects, generally comprising commercial office and office/workspace, residential (mainly for rent) and associated retail/leisure development. In all case lettings invested in by ECF would be made on the open market on fully commercial terms and would be available for a normal range of occupiers. The end users in ECF projects would pay market prices as exclusively evaluated by Independent Chartered Surveyors3.

2.6.5. Distribution of profits
The Fund would invest in projects sufficient to get a 12% return on each project. According to the UK authorities, this is the minimum level of return to require private sector investment in ECF. However, there would be no guaranteed rate of return on projects and EP's investment would not guarantee a return to the private Partners.

The distribution to the investors is based on the risk each shares in the Fund. ECF would have a life of ten year; distributions would occur when the investors have each invested all their capital.

Distributions for the Phase 1 investors would be :

Capital

(1) Banks – first priority repayment of principle and interest;
In the private property market, commercial contracts do not necessarily take the form of a constant rent over time, but may for example consist of rent that is low for an initial period, to allow companies to better manage their cash flow while they move premises, and then higher than it might otherwise have been. Therefore an Independent Chartered Surveyors would take all

market conditions into account.

(2) Mezzanine – the institutional Limited Partner secures second priority repayment of principle and interest;

(3)
The Partners in the General Partner each secure repayment of their equity.
Profit

(4)
General Partner profit distributions – four priority repayment as follows :
· EP equity – 36%
· AMEC equity – 27%
· L&G equity – 27%
· L&G mezzanine – additional 10%
If a project makes a loss, the risk of the three Partners is limited to the value of their investment at the appropriate moment. It is estimated, that if the project does slightly worse than forecast, EP would still secure repayment of its investment. If the Fund does very badly and losses occur across the portfolio at a lower rate of market growth than forecast, EP's equity is at risk before the two private Partners lose their initial investment. The consequence of EP bearing first level risk is that the private sector Partners are protected against any loss on any one project carried out by the Fund to the extent of EP investment (through ECF) in that project. However, under such circumstances, also the private Partners would get low returns, below market levels. Therefore they would share some risk.

The distribution policy of the Fund means that if the Fund did better than expected the Partners would share proceeds in relation to the risk they are exposed to. Therefore in that case EP would enjoy proportionately greater returns.

The value of the properties would be exclusively evaluated by Independent Chartered Surveyors. In cases of disputes between the Investment Manager and the Development Manager on matters of technical substance, the issue is to be determined by an independent expert, which could be either an Independent Chartered Surveyor or another Chartered Expert, in cases where other professional disciplines would be required, for instance an Independent Chartered Engineer. The valuation of the Fund investments for profit calculations would be exclusively carried out by Independent Chartered Surveyors. More generally, where valuations were involved/required, Independent Chartered Surveyors would carry them out.

2.7. Intensity
The aid intensity within ECF would be calculated by reference to the disproportionate share of profit provided to the private sector Partners. It would not exceed the maximum aid intensity ceilings as foreseen in the UK Regional Aid Map for the period 2000 – 20064.

2.8. Eligible costs
The EP investment would take the form of an equity stake in the Fund.

Eligible expenditure would comprise land (at lower than market price or at market price), the costs of preparing sites, servicing and infrastructure related to the investment, contribution or refurbishment costs for buildings suitable for a range of uses, finance costs at market levels, professional fees and an appropriate development fee. The Fund would only invest in property based regeneration so that investment in plant and machinery and/or replacement investment is excluded.

2.9. Cumulation rules
Some projects in which ECF would invest would be eligible for public funding support of other kinds. These other public funding bodies would ensure that their support is within maximum aid intensity ceilings as foreseen in the UK regional aid map for the period 2000 – 2006 and, should Phase 2 occur, possibly in the UK regional aid map which is in force for the following year/s.

EP would not provide gap funding to ECF projects. The only other sources of gap funding are the Regional Development Agencies. The Regional Development Agencies would be required to carry out the cumulative aid intensity calculation and ensure ceilings are respected when offering assistance to projects in which the Fund is or would be a party, as they are required to do for all other projects. They would be also required to include in any offer of assistance to a project in which the Fund is a party a requirement of notification should additional assistance be provided with the right to clawback should that occur. The UK authorities would also place a requirement on EP to notify details of any other form of assistance for projects in which the Fund is active to the Department of Environment, Transport and the Regions, which would carry out the calculation and ensure that ceilings are respected. Wherever a project financed by the Fund receives at the same time for any phase of development gap funding as foreseen in both schemes N 747/A/99 and N 747/B/995, all works would be competitively tendered, in line with the requirements of both schemes.

4
The Decision adopting the UK Regional aid map was notified on 17.8.2000 to the UK authorities and published in OJ C 272, 23.9.2000, p. 43.

5
Approved by Commission’s decision of 28 February 2001, OJ C 160 of 2 June 2001, p. 42

2.10. Commitments
The UK authorities have committed

· To respect the maximum aid intensity ceilings as foreseen in the UK Regional Aid map for the period 2000 – 2006;
· To send an annual detailed report;
· Not to extend the scheme geographically nor in scope without prior notification and Commission’s approval;
· To notify any amendment of the Operating Documents establishing the Fund where that would be of such a nature as to have an impact on the functioning of the scheme and on the Commission’s assessment of it;
· To re-notify the scheme, should the Phase 1 investments not have been committed by 31st December 2005;
· To ensure no undertaking operating in the so-called sensitive sectors such as transport, steel, shipbuilding, synthetic fibres or motor vehicle would be a shareholder in ECF;
· To ensure no bespoke developments destined to any undertaking operating in the so-called sensitive sectors such as transport, steel, shipbuilding, synthetic fibres or motor vehicle would be supported by ECF;

· To ensure the Fund would not be used to support firms in financial difficulty.
· To ensure no projects concerning replacement investment would be financed by ECF;
· Should the Fund proceed to Phase 2, to ensure no greater risk would be borne by EP or any other public sector body, no further equity would be invested by EP or any other public sector body, and there would be no further deterioration in the relative distribution of profit against equity to EP;
· To ensure any possible change in both the present and future UK Regional Aid maps would be automatically taken into account in the implementation of the present scheme.
3. ASSESSMENT OF THE SCHEME
3.1. Procedure
By notifying the scheme, before putting it into force, the UK authorities complied with their obligations as set out in Article 88 (3) of the EC Treaty.

3.2. Existence of aid under Article 87 (1) of the EC Treaty
Article 87 (1) of the EC Treaty states that “any aid by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings […] in so far as it affects trade between Member States” is incompatible with the common market.

In the present scheme the aid is represented by the initial investment to be made by EP as a commercial investor. Without EP’s involvement, the Fund would not come into existence and and the regeneration projects might not proceed.

In the Commission Decision of 22 December 1999 concerning English Partnerships6, the concepts of “bespoke development” and “speculative development” were already identified. By “bespoke development” reference is made to “cases where the development was designed to suit the needs of an end user known at the moment the development works were undertaken”7. By “speculative development” reference is made to “cases where the site was to be developed in order to be open to different uses not established at the time when the decision to develop was taken”8. In accordance with recital (62) of the same decision, as regards regional aid, the Commission notes that it is unnecessary for it to determine the precise identity of the beneficiary in all cases since, in any event, the regional aid rules and particularly the applicable aid intensities in relation to eligible costs will have to be respected. In these circumstances and for the purposes of applying the present scheme, the Commission agrees that the beneficiary in the case of speculative development may be considered to be the landowner/developer and in the case of bespoke development the end-user.

In the present scheme, the Fund will mainly finance speculative development projects. The scheme favours the private investors selected as Partners of ECF by providing equity in order to make them carry out investments they would not have undertaken without the assistance. Furthermore, the undertakings selected are favoured by the fact that risks are not equally shared between the public and the private Partners within the Fund. The selected enterprises receive benefits in the form of an unequal share of the risks associated with investment. The fact that EP might eventually receive returns from its investment cannot cancel the first level risk, which it accepts to bear. In the unlikely scenario of bespoke development projects, the end user would be considered as aid beneficiary.

6 OJ L 145 of 20 June 2000, p. 27.

7 Recital (24) (a) of that Decision.

8 Recital (24) (b) of that Decision.

The scheme can well distort or threaten to distort competition and affect trade between the Member States. The recipients are financial and property development companies, all of who may participate in trade between the Member States. In particular, companies that conceive and carry out business property development may trade across Member State frontiers.

The Commission concludes that the scheme “English Cities Fund” would operate in such a way as to distort or threaten to distort competition by favouring certain undertakings and affect trade between the Member States. Therefore, the Commission concludes that the scheme meets the criteria of Article 87 (1). Such assessment is not altered by the fact that these advantages may be the minimum necessary for the project to go forward, and may in fact be a more efficient method of public investment than if any public agency had undertaken the investment directly.

3.3. Compatibility under Article 87 (3) (a) and (c) of the EC Treaty
Article 87 (3) (a) and (c) provide exceptions for State aid in areas, which are economically underdeveloped by comparison with the Community as a whole or with the rest of the Member State. Portions of England, as designated by the UK Regional aid map 2000–2006, fall within the Article 87 (3) (a) and (c) derogation.

The scheme is limited in scope to Assisted Areas.

The UK authorities, having notified the scheme as State aid, have structured it so as to respect the Guidelines on national regional aid and to avoid aid to beneficiaries in sensitive sectors.

The Commission believes that the scheme is designed to stimulate investment in the under performing business premises market proportionate to the need and in the interest of the Community.

Aid vetted through the notified instrument is in keeping with the types mentioned in the said Guidelines.

The Partners’ contribution to the Fund is at least 25%, as foreseen in paragraph 4.2. of the Guidelines on national regional aid.

Therefore, the Commission concludes that the notified scheme falls within the definition of investment aid under the Guidelines on national regional aid.

The notified development programmes incorporate the aid intensities ceilings set forth in paragraph 4.8 and 4.9 of the Guidelines on national regional aid and, more specifically for UK, in the approved Regional Aid map for the period 2000 - 2006.

The UK authorities have agreed to respect the State aid cumulation requirements. Application of more than one aid scheme to a given

investment project must respect the rules on cumulation of aid set forth, inter alia, in points 4.18 – 4.21 of the Guidelines on national regional aid.

Also from an environmental perspective, the Commission considers that the scheme should promote environmental concerns, notably a more rational use of natural resources such as land.

The UK authorities will provide the Commission with detailed annual reports. The Commission requests that these reports should include an assessment of the environmental impact of the scheme.

The Commission retains the capacity to propose appropriate measures under Article 88 (1) of the EC Treaty.

The Commission finds that the notified scheme confers State aid, which is compatible with the EC Treaty.

4. DECISION

The Commission has accordingly decided to consider the notified aid scheme "English Cities Fund" to be compatible with the EC Treaty in application of Article 87 (3) (a) and (c).

If this letter contains confidential information, which should not be disclosed to third parties, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to the disclosure to third parties and to the publication of the full text of the letter in the authentic language on the Internet site : http://europa.eu.int/comm/secretariat_general/sgb/state_aids/. Your request should be sent by registered letter or fax to:

European Commission
Directorate-General for Competition
State aid Greffe
Rue de la Loi/Wetstraat, 200
B- 1049 Brussels
Fax No: + 32. 2. 2961242

Yours faithfully,
For the Commission

Mario MONTI
Member of the Commission

APPENDIX C – MARKET TESTING

Igloo Regeneration Ltd – John Tatham **1. Introduction**	Igloo are a regeneration fund owned by Morley (part of Aviva). They already invest in UDF type mechanisms (eg Blueprint) and are very familiar with the JESSICA concept as they are in active discussions with the EC in re projects in other parts of UK.
2. What will the Wales UDF Do? • blind or not? • regen/sectors?	Igloo insist some projects should be put into the fund on Day 1 - otherwise there is a danger it will be 'a lame duck' in its early years (eg Blueprint had six such projects and now has over a dozen projects). Regeneration sectors do appeal to Igloo, however they see residential as an essential part of the mix and understand the ring-fencing of the housing element as an accounting function Igloo stressed the need to show there is a regeneration plan for Wales that clearly sets out what the objectives are (for Blueprint in the E Midlands their Urban Action Plan served this purpose).
3. Type of Projects • urban nature • geography; region or sub region? • city size (Swansea and smaller)?	The Igloo fund was set up to invest in urban regeneration and as such many of the criteria are ideal. However its preference is for the UK's Top 20 cities. Although in Wales this would mean only Cardiff, provided enough of the other investment criteria were sufficiently attractive they would not rule out a Wales Convergence Area Fund (in a similar fashion their Blueprint investments are largely outside UK top 20 cities).
4. Fund Structure • 'funder' only and not a 'developer' • development expertise • the 'project partner' level • how to improve the structure	Igloo is part of Morley. Igloo believe Morley would be interested in being investor only but Igloo would not – they structure Igloo was set up to invest and develop the initial elements of a larger scheme, including masterplanning and setting the standard of development before selling off or contracting out subsequent elements. On this basis the '10%' developer element could be of interest or if they have sufficient control over the Project Level SPVs/mechanisms. Igloo are currently in discussions with EC re the investor/developer issue (the solution could be for the public sector to set up a structure agreed between EC and WAG (they will require something with advanced clearance fm EC) that an altv bid would be ok (this would take the nature of Igloo believe 10yrs too short for a fund of this nature. They suggest a minimum of 15yrs – ideally more and an opportunity to invest a sizeable sum given the set up costs – eg the Blueprint investment was c£45m.
5. Financial Return Mechanics • their reqd return? • priority or not? • conceptually acceptable? • more benign market view? • if not now when?	A Wales UDF would be of interest - they may even set up a specific fund to channel JESSICA funds (ie a JESSICA Holding Fund to invest in Wales and other areas). However they require a 15% IRR ungeared on a projects (unless substantially underwritten by the public sector or via a prioritised return as indicated by this structure). ie they will consider lower returns for lower risk. They are still investing in current market.
6. Summary Pros and Cons	
PROS	CONS
• Regeneration focus • Prioritised return structure • Public / private nature	• Prefer larger cities • Accounting and tracking requirements (eg housing) • Procurement costs risks (State aid issues etc)

Barclays Property Finance – Peter Scott **1. Introduction**	Barclays is heavily involved in Wales and estimate they have a 30-40% market share. In addition they are increasingly investigating EU / JESSICA opportunities generally in other parts of Europe.
2. What will the Wales UDF Do? • blind or not? • regen/sectors?	Thus Barclays have no problem with Wales as an investment location including the Convergence Areas. Barclays urge that the fund does not start blind – it definitely requires some specific projects to benchmark against although subsequent projects can be added through the life of the fund. The concept of investing in mixed use regeneration projects is accepted by Barclays.
3. Type of Projects • urban nature • geography; region or sub region? • city size (Swansea and smaller)?	As set out above, the nature of the projects being regeneration in Wales is acceptable to Barclays. Although the opportunity to cross subsidise with projects in stronger investment locations outside the Convergence locations is attractive it is not essential.
4. Fund Structure • 'funder' only and not a 'developer' • development expertise • the 'project partner' level • how to improve the structure	The main concern of Barclays was to emphasise the need to keep things as simple as possible given the inherent complexities of setting up funds and satisfying EU requirements. Thus they advised the fund should not necessarily do guarantees etc - keep it simple as possible at the fund level and purely 50/50. The likely EC requirement disallowing a development role is not a problem for Barclays, though clearly there has to be understanding of development investment with absolute rigour to assess projects.
5. Financial Return Mechanics • their reqd return? • priority or not? • conceptually acceptable? • more benign market view? • if not now when?	Barclays current IRR requirements are 'going North quickly' and currently stand at c25% (in the past closer to 15%). They point out that using senior debt would be cheaper. The only way that this could be reduced is if the Bank recognised the 'CSR' focus of the large which may enable a reduced IRR requirement of c15% (though on a smaller amount of c£5m only). This would be easier to do if sharing the risk with other banks / investors. Barclays understand and are attracted to the concept of priority returns and recommend an investment opportunity of no less than £10m should be brought to market.
6. Summary Pros and Cons	
PROS	CONS
• Wales as an investment location • The general principle of a long term physical regeneration fund • The EC promotion	• Complexity • Timing (ie macro issues)

ING Real Estate (Andrew Barlow) **1. Introduction**	ING – a typical investment fund manager, owned by the bank's HQ in The Hague. This includes their entirely owned and financed ING RED (Real Estate & Development) – largely retail focussed. Although at the present time they do 'have money to invest', the nature of these investments are either focussed on 'opportunity investments' (ie distress opportunities) or more defensive investments (ie prime). Generally most investment has come to a standstill – this is not a time to invest. They are waiting for markets to be more favourable.
2. What will the Wales UDF Do? • blind or not? • regen/sectors?	The Wales regeneration story needs to be told. There would definitely be a need to show the nature of the fund via the initial projects (ie it should not be blind); ideally some other concrete principles for the fund – eg 'the six key urban areas outside Cardiff; university focussed; CPO backed powers etc".

3. Type of Projects • urban nature • geography; region or sub region? • city size (Swansea and smaller)?	Their principle concern lay in the geography – ie the least competitive locations of a relatively uncompetitive UK region – ie the cohesion areas in Wales. Wales investments come with a 'big health warning'. It is a big mental jump for fund managers in London to invest in the Welsh locations outside of Cardiff. Ie it is easier for them
4. Fund Structure • 'funder' only and not a 'developer' • development expertise • the 'project partner' level • how to improve the structure	Being a 'funder' only and not a 'developer' would not be a problem for ING – although they would anticipate the need for development expertise at the fund level in terms of a strategic and supervisory role of the implementers. ING could potentially supply this level of development expertise in-house. They are happy with the principle of the implementation expertise being at the 'project partner' level. One suggestion was to attach an 'expert advisor' to the fund – ie a 'world class' developer who is known to the London property financing markets and who would be a trusted source of knowledge and reliability and would give credibility to the fund.
5. Financial Return Mechanics • their reqd return? • priority or not? • conceptually acceptable? • more benign market view? • if not now when?	Until 12-18 months ago this concept would have largely been one they could have considered (eg they were market tested in respect of the ONE fund which in many respects is similar and they were quite positive about). Conceptually it is something they could do – it is more an issue of the current economic climate. Right now they would not even enter serious discussions (his colleagues would laugh at the proposal to invest in a regeneration fund in Wales at the present time). Although they are always doing fund launches that could be relevant to the Wales UDF, this is a non-starter at the present time, though could become relevant over the next 18 months (in readiness for the upturn).
6. Summary Pros and Cons	
PROS	CONS
WAG driven (CPO powers etc) Minimal up-front investment Focus on urban areas Minimal funding required now	Macro economic climate Wales region Regeneration is not currently a priority Outside Cardiff ING are seeking returns of c20% currently