STATE AID — UNITED KINGDOM
Aid C 7/03 (ex N 107/02) — SBS Incubation Fund

Invitation to submit comments pursuant to Article 88(2) of the EC Treaty

(2003/C 104/02)

(Text with EEA relevance)

By means of the letter dated 5 February 2003 reproduced in the authentic language on the pages following this summary, the Commission notified the United Kingdom of its decision to initiate the procedure laid down in Article 88(2) of the EC Treaty concerning the abovementioned aid.

Interested parties may submit their comments within one month of the date of publication of this summary and the following letter, to:

European Commission
Directorate-General for Competition
State Aid Greffe
J-70
B-1049 Brussels
Fax (32-2) 296 12 42.

These comments will be communicated to the United Kingdom. Confidential treatment of the identity of the interested party submitting the comments may be requested in writing, stating the reasons for the request.

SUMMARY

1. Procedure

By letter dated 31 January 2002, registered on 4 February 2002, the British authorities notified the aid measure mentioned above, pursuant to Article 88(3) of the EC Treaty. By letter dated 28 February 2002, the Commission requested additional information, which was supplied by the British authorities by letter dated 26 April 2002, registered on 30 April 2002. The British authorities provided new elements and arguments concerning the notification by letter dated 13 May 2002. On 24 May 2002, a meeting was held between the British authorities and the Commission, which was followed by a new letter of request of information, sent on 4 July 2002, and a meeting with a member of the United Kingdom representation on 29 August 2002. The British authorities replied by letter dated 13 September 2002, registered on 18 September 2002. This letter raised new issues, which led to another letter of request of information from the Commission, dated 29 October 2002, and to another meeting with a member of the United Kingdom representation on 14 November 2002. The British authorities sent their reply on 3 December 2002, and it was registered on 9 December 2002.

2. Description of the measure

The objective of this scheme, which will have a GBP 75 million budget (EUR 115.5 million) is to foster the development of incubators for small and medium enterprises in the United Kingdom. Incubators are premises specifically designed to provide a nurturing environment for SMEs in their start-up or early phase. The aim of this scheme is therefore to provide loans to firms that want to set up or develop an incubator. The incubators thus assisted will provide offices for SMEs.

The United Kingdom authorities claim that the assistance provided thanks to these loans will be limited to the minimum necessary, as assessed by independent experts. In specific cases, when the property is in public ownership, the United Kingdom authorities indicated that they may use public tenders in order to grant the aid and limit it to the minimum necessary. These loans will be granted on condition that the applicant has been turned down, in part or in full, by private capital markets. The interest rate of these loans will be set at 6 %, which happens to be very close to the Community reference rate (at present 6.01 %). They will cover between 30 and 50 % of the site purchase and construction costs. They may also cover the initial marketing of development for tenants and up to 25 % of the project’s total working capital requirement during the set-up stage.

The beneficiaries of the loans can be property developers, companies specialised in the business support sectors or non-profit making organisations. There will be no limitation on the location of the project: the British authorities asked for the possibility of granting these loans to projects in assisted as well as non-assisted areas, independently of whether the borrower operating the incubator is a large firm or a SME.
The United Kingdom authorities have not made any specific commitments with respect to the intensities of the aid provided under these loans. They have only committed themselves to limit the aid to the minimum necessary for the project to go ahead, as assessed by independent experts. Furthermore, they have asked for the possibility to top up the aid element to this loan with other sources of funding up to this minimum necessary threshold.

At the same time, the United Kingdom authorities reckon that the main target of this measure are the SMEs that will have access to these supported incubators. They claim that the incubators will normally provide these premises at market rate to these end-users. In order to ensure that this is the case, independent experts will ensure that the rents paid by the end-users are set at market rate. Any difference between the rate actually paid and market levels will be counted as de minimis aid, in conformity with Commission Regulation (EC) No 69/2001.

3. Assessment of the measure

3.1. Existence of aid: The loans granted under this scheme will have an interest rate of 6%, which is very close to the current Community reference for the United Kingdom of 6.01%. However, given that one of the main conditions for granting the loans under this scheme is that the borrower could not get loans from commercial lenders, the Commission believes that there is an element of aid in these loans. The securities normally required by banks are not provided, and were private banks willing to provide loans for part or all these projects, they only would do so at a higher rate. The Commission believes that these loans may constitute an aid to the borrowers, within the meaning of Article 87(1) of the EC Treaty.

It is so even where the beneficiary of the loan is a non-profit undertaking. Contrary to the argument put forward by the United Kingdom authorities, the fact that the borrower is a non-profit making institution is not relevant for the application of State aid rules if it carries out an economic activity, open to competition.

Finally, thanks to these loans, the borrowers will establish and operate incubators for the benefit of SMEs. It cannot be excluded that the part of the aid assistance provided by the State to the establishment of these incubators may be passed to the end-users, for instance under the form of lower rents. As a result, this measure may also constitute a State aid within the meaning of Article 87(1) of the EC Treaty at the level of the end-users of the incubators.

3.2. Assessment of the aid measure: As far as aid to the end-users of the incubators is concerned, the United Kingdom authorities have undertaken to ensure that this aid at the level of the end-users is provided in accordance with Regulation (EC) No 69/2001 on de minimis aid.

As far as aid to the undertakings establishing the incubators is concerned, the Commission has found that they cannot be exempted on the basis of the Community guidelines on national regional aid or Commission regulation (EC) No 70/2001, which are the only two possible legal bases for an exemption of this scheme. First of all, these loans may cover part of the working capital requirement during the set-up stage, which may constitute operating aid. Furthermore, the United Kingdom authorities have not committed themselves to respect the thresholds for the aid intensities set by the guidelines on national regional aid and regulation (EC) No 70/2001. They have also asked for the possibility to grant aid to large firms in non-assisted areas. Finally, the rules on cumulation are not very clear.

Since this aid measure cannot be exempted under existing rules, the United Kingdom authorities have put forward a ground for exemption based on the Communication on State aid and risk capital, which states that 'where a transfer made by the State would be compatible with the State aid rules, the Commission believes that a measure which provides the minimum incentive to other economic operators to make that same transfer should also be authorised, even if technically, an aid to those operators is involved' (1). They argue that, since the aid to the end-users of the incubators is a compatible transfer (the aid at their level is de minimis), and since the incentive given to the borrowers to provide these incubators is minimal, then the aid to the borrowers should be authorised.

The Commission applied this provision of the risk capital Communication to the property development sector in one case. It concerned aid provided to property developers in order to encourage them to rehabilitate and provide social housing (2). It appears, however, that the use of this reasoning outside the scope of State aid to risk capital may have far-reaching consequences. For instance, as in the present case, this reasoning could be used to bypass existing State aid rules, as currently laid down in the existing block exemption regulations, frameworks and guidelines. It would also give Member States an incentive to start distributing aid through intermediaries, which would become recipients of aid themselves.

(2) Case N 497/01, Grants for Owner Occupation Scheme.
In these circumstances, it is necessary for the Commission to reflect on the opportunity of confirming the use of this provision of the Communication on State aid and risk capital outside its specific scope. Furthermore, should the wider use of this provision be confirmed, it is equally necessary to lay down the precise conditions of application of this principle, especially in areas that, like property development, are so different from risk capital, and to determine whether the present case fulfils these conditions. On that point, the Commission notes that the British authorities have not provided enough information showing that the aid given to the intermediary to provide the incubator is indeed the minimum necessary.

4. Conclusion

In the light of the foregoing considerations, on basis of the information available, and of the preceding preliminary assessment, the Commission decided to initiate the proceedings according to Article 88(2) of the EC Treaty. In accordance with Article 14 of Council Regulation (EC) No 659/1999, all unlawful aid can be subject to recovery from the recipient.

2. DESCRIPTION OF THE MEASURE

2.1. Title and legal basis

The title of this aid scheme is SBS Business Incubation Fund. It will be operated across all the English regions by the Small Business Service of the Department of Trade and Industry, on the basis of Section 8 of the Industrial Development Act of 1982.

2.2. Objective of the measure

The objective of this scheme is to foster the development of incubators for small and medium enterprises in the United Kingdom. Incubators are premises specifically designed to provide a nurturing environment for SMEs in their start-up or early phase. The firm that operates the incubator not only provides offices with specific equipment (e.g. broadband), but will also provide ‘incubation services’, such as mentoring, access to finance, peer group support, etc.

The United Kingdom authorities argue that there is a ‘market failure’ in the provision of these incubation services for SMEs. The number of new incubators is constrained by the lack of experienced managers of such facilities. There is a number of existing business incubators, but they tend to focus on the perceived lowest risk classes of entrepreneurs or on potentially high-growth companies, where an equity stake is often taken to secure high returns in cases of success. This leaves the medium-risk, medium start-ups with few facilities. In this context, it is claimed that the commercial financiers are less likely to lend all the borrowing requirement, or to lend at all into riskier incubation projects.

The aim of this scheme is therefore to provide loans to firms that want to set up or develop an incubator. These loans will act as an investment incentiviser for projects that were turned down, in part or in full by the private sector. The incubators thus assisted will provide offices for SMEs.

2.3. Mechanisms for granting the loans

The United Kingdom authorities claim that the assistance provided thanks to these loans will be limited to the minimum necessary. This minimum necessary will be assessed by independent experts, including chartered surveyors. A claw-back mechanism (repayment of part of the aid) will be applied when a situation of overcompensation is identified after the project is completed.
In specific cases, when the property is in public ownership, the United Kingdom authorities indicated that they may use public tenders, conducted in accordance with the EC rules on public procurement where such rules are deemed to apply.

2.4. Characteristics of the loans

These loans will have the following characteristics:

— As already explained, the main conditions for granting a loan is that the applicant must have been turned down, in part or in full, by private capital markets.

— The interest rate of these loans will be set at 6 %, subject to annual review, with the right to change if the base rate varies upwards by more than 1 %. According to the British authorities, this is the interest rate applied in the few projects that succeeded in obtaining private financing. It should be noted that this interest rate happens to be very close to the Community reference rate (at present 6.01 %).

— Securities will be required whenever possible. The United Kingdom authorities reckon that securities will not always be available.

— A capital repayment holiday will be offered until the completion of the project. Applicants will have an option to roll-up interest during the capital repayment holiday.

— The repayment of the loan will typically be over 10 years, but may be up to 20 years.

2.5. Eligible costs

The loans will cover between 30 and 50 % of the following costs:

— Site purchase and construction costs, or building purchase and refurbishment costs. All land and property costs will be assessed by independent Chartered Surveyors.

— Fixtures and fittings equipement.

— Associated professional fees.

— Initial marketing of development for tenants.

— In some cases, up to 25 % of the project’s total working capital requirement during the set-up stage, limited to the time scale for completion of the project development and receipts of rental income.

2.6. Beneficiaries

The beneficiaries of the loans can be property developers, or companies specialised in the business support sector, without any limitations concerning their size. The beneficiaries may also be non-profit making beneficiaries, such as higher educational institutions, social enterprises, regeneration partnerships and bodies established by regional development agencies. Large firms as well as SME will be eligible for these loans.

At the same time, the United Kingdom authorities admit that the main target of this measure are the SMEs that will have access to these supported incubators. They claim that the incubators will normally provide these premises at market rate to the end-users. In order to ensure that this is the case, independent experts and chartered surveyors will ensure that the rents paid by the end-users are set at market rate. The loan conditions will include a requirement for the borrower to inform each end user that if the actual rent paid by the end-user is below market level, this will be counted as de minimis aid, and subject to the requirements of Commission regulation (EC) No 69/2001. Any amount in excess of an amount provided for in the latter regulation will have to be paid back by the beneficiaries.

2.7. Scope

There will be no limitations concerning the location of the projects: the British authorities ask for the possibility of granting these loans to projects in assisted as well as non-assisted areas, independently of whether the borrower that will operate the incubator will be a large firm or a SME.

No projects involving the agricultural, fisheries and transport sectors will be eligible for loans. Any project involving the synthetic fibres, steel, shipbuilding and motor vehicle sectors will be notified individually.

2.8. Intensities

The United Kingdom authorities have not made any specific commitments with respect to the intensities of the aid provided under these loans. They have only committed themselves to limit the aid to the minimum necessary for the project to go ahead, as assessed by independent experts.

2.9. Cumulation

In situations where the loans provided under this scheme are not sufficient to provide the estimated minimum necessary for the project to go ahead, the United Kingdom authorities have asked for the possibility to top up the aid element to this loan with other sources of funding (for instance the Single Regeneration Budget or the ERDF), up to this minimum necessary threshold. The United Kingdom authorities have not provided any further indication on this additional aid, nor committed themselves to notify it when they want to grant it in addition to the loans described above.
In order to calculate the aid element of these loans with the view of cumulating it with additional aid, the British authorities have agreed to calculate the net grant equivalent of these loans in accordance with Annex I of the Community guidelines on regional aid. They agreed to use as reference rate the Community rate plus 400 basis points, in application of Commission notice on the method for setting the reference and discount \(^{(3)}\), which recommends the use of such a reference rate where the security normally required by banks for a loan is not provided.

2.10. **Budget and duration**

An initial GBP 75 million will be available across four financial years. Clearance is requested from the Commission to cover the period until the end of March 2006.

3. **PRELIMINARY ASSESSMENT OF THE MEASURE**

According to Article 6 of the Procedural Regulation \(^{(4)}\), the decision to initiate the formal investigation procedure shall summarise the relevant issues of fact and law, shall include a preliminary assessment of the Commission as to the aid character of the proposed measure, and shall set out the doubts as to its compatibility with the common market.

3.1. **Existence of aid under Article 87(1) of the EC Treaty**

Under Article 87(1) of the EC Treaty, ‘any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, insofar as it affects trade between Member States, be incompatible with the common market’.

3.1.1. **Aid to the undertakings establishing and operating the incubators**

It is not contested that the present aid measure will be funded out of State resources. Furthermore, the Commission believes that they may constitute an advantage to the undertakings that are granted these loans. This point is contested by the United Kingdom authorities, at least in certain circumstances. First, the British authorities have argued that these loans' interest rates will be set at 6 %, while the current Community reference for the United Kingdom is 6,01 %. In that case, they argue that when the borrower can provide full security for the loan, the rate is almost identical to the Community reference rate, and therefore the aid element in the loan is negligible. The Commission has doubts concerning such an argument: one of the main conditions for granting the loans under this scheme is that the borrower could not get loans from commercial lenders, for the totality or at least for part of the funding of the project. In this context, the Commission believes that the securities normally required by banks are not provided, and that, were the banks willing to provide loans for part or all the project, they would do so at a higher rate. Consequently, and again because the beneficiaries of these public loans, by definition, could not get private financing, the Commission believes that these loans constitute an advantage, which is selective since only a limited number of firms will benefit from them. Furthermore, beneficiaries of these loans are undertakings involved in property development and/or business service. These activities are likely to be internationally traded. This aid measure may therefore have an effect on competition and trade between Member States.

The British authorities also claimed that the loan cannot constitute a State aid when the beneficiary is a non-profit undertaking, since such organisations lack the profit motive and will recycle any profit back into their public good activities (such as education in the case of universities). Their motivation is not to develop new business or to undermine commercial operators in any way. As a result, they argue that this assistance provided under this scheme to non-profit organisations is unlikely to distort competition, and does not constitute a State aid within the meaning of Article 87(1) of the EC Treaty. It is not possible for the Commission to retain such an argument. These non-profit organisations would undertake economic activities, i.e. the establishment and operation of an incubator providing accommodation and services to SMEs. This economic activity is also carried out by private firms. These non-profit-making institutions must therefore be considered, in the context of this specific activity, undertakings within the meaning of Article 87(1) of the EC Treaty. The fact that the motivation of these institutions is not to make a profit or to undermine competitors is not relevant: what matters is the effect of their activity, which is, in the present case, of a clear economic nature. In addition, services will be provided in a competitive environment.

Finally, the British authorities put forward the argument that these incubation services could be seen as infrastructure, on the ground that these incubators would be of a general benefit to a range of undertakings and would be available to SMEs on a non-discriminatory basis. Furthermore, the firms providing these ‘infrastructures’, i.e. the incubators, would receive no overcompensation, since they will only receive the minimum necessary to provide and start operating this facility. The Commission has strong doubts about such an argument which would greatly extend the definition of ‘infrastructure’ to situations which are clearly commercial and benefit a very specific and very limited category of users (i.e., in the present case, SMEs in their start-up phase and in need of incubation services). Furthermore, for reasons that will be explained in greater detail further below, the Commission is not convinced at this stage of the procedure that the aid is limited to the minimum and that there is no overcompensation.


Given that this measure, granted through State resources, seems to give a selective advantage to the beneficiaries of these loans, and given that this advantage may distort competition and affect inter-Member State trade, the Commission can conclude that it may constitute a State aid to these undertakings within the meaning of Article 87(1) of the EC Treaty.

3.1.2. Aid to the end-users of the incubators

Furthermore, thanks to these loans, the borrowers will establish and operate incubators for the benefit of SMEs. Despite the claim that these end-users will be charged market prices, it cannot be excluded that the assistance provided by the State for the establishment of these incubators may result in lower rents charged to the end-users. This would constitute a selective advantage, which could affect inter-Member State trade since these end-users may engage in activities affecting international trade. As a result, this measure may also constitute a State aid within the meaning of Article 87(1) of the EC Treaty, at the level of the end-users of the incubators.

3.2. Assessment of the aid measure

Having established that the SBS Incubation Fund may involve State aid within the meaning of Article 87(1) of the EC Treaty, it is necessary to consider whether this scheme can be found to be compatible with the common market.

As far as aid to the end-users of the incubators is concerned, the United Kingdom authorities have undertaken to ensure that the aid at the level of the end-users is provided in accordance with Regulation (EC) No 69/2001 on de minimis aid. At this stage, it is not entirely clear by which means this could be ensured.

As far as aid to the undertakings that will establish and operate the incubators, the Commission notes that the loans that they will get are provided in order to support the creation of incubators and essentially constitute an investment aid. Therefore this aid measure should be analysed under the Community guidelines on national regional aid (5) or Commission Regulation (EC) No 70/2001 (6). No other Commission's legal text seems to be relevant for the analysis and possible exemption of this aid measure. It does not seem however that the guidelines on national regional aid and Commission regulation (EC) No 70/2001 can be used to exempt this aid measure:

— these loans will essentially cover investment costs (site and building purchase, construction and refurbishment, costs, specific equipment, etc.) but also the initial marketing development for tenants and up to 25 % of the project's total working capital requirement during the set-up stage, until receipts of rental income. These loans may therefore constitute, at least in part, operating aid,

— the rules on cumulation remain unclear,

— the United Kingdom authorities have not committed themselves to respect the thresholds for the aid intensities set by the guidelines on national regional aid and regulation (EC) No 70/2001. They only committed themselves not to give more than the 'minimum necessary' for the project to go ahead, as assessed by independent experts. This minimum necessary may be more than would be allowed under Regulation (EC) No 70/2001 or the guidelines on national regional aid,

— the United Kingdom authorities have asked for the possibility of granting loans for projects located anywhere in England, irrespective of the size of the borrower. This may result in providing loans to large firms in non-assisted areas, within the meaning of the Community regional map.

For these reasons, the Commission can provisionally conclude that this aid measure cannot be approved under existing rules. As a result, the United Kingdom authorities have put forward a ground for exemption based on the Communication on State aid and risk capital (7). This communication states that where a transfer made by the State would be compatible with the State aid rules, the Commission believes that a measure which provides the minimum incentive to other economic operators to make that same transfer should also be authorised, even if technically, an aid to those operators is involved (8). It is therefore argued that, since the aid to the end-users of the incubators is a compatible transfer (the aid at their level is de minimis), and since the incentive given to the borrowers to provide these incubators is minimal, then the aid to the borrowers should be authorised.

The application of this principle to the property development sector was accepted once by the Commission in the case N 497/01 Grants for Owner Occupation Scheme. That case concerned aid to property developers in order to encourage the rehabilitation and provision of private housing. Since there was no aid at the end level (housing for private individuals) and since the aid to the developer was the minimum necessary, the Commission concluded that the scheme could be exempted under Article 87(3) of the EC Treaty, in application of this provision of the risk capital Communication. That case was in many ways a specific one, since the end user and real target of the measure was not an enterprise but private individuals seeking access to social housing while in the present case, the targeted recipients are start-up companies.

(8) Idem, point V.6.
Furthermore, this reasoning has far-reaching consequences. Such a reasoning could give Member States an incentive to start distributing aid through intermediaries, which would become recipient of aid themselves. This reasoning could also be used to bypass the State aid rules, as currently laid down in existing block exemption regulations, frameworks and guidelines. This is clearly the case under this scheme, since accepting this reasoning would enable the British authorities to provide these soft loans to any firms, whether SMEs or large ones, in assisted as well as non-assisted areas. It would also empower them to provide the ‘minimum necessary’ for each project to go ahead, which may imply that, in certain circumstances, the intensities allowed under the regional map or Regulation (EC) No 70/2001 will be exceeded. In these circumstances, it is necessary for the Commission to reflect on the opportunity of using this reasoning outside the specific scope of the Communication on State aid and risk capital. Furthermore, should the wider use of this reasoning be confirmed, it is equally important to lay down its precise conditions of application, especially in areas that, like property development, are so different from risk capital.

On the specific question of the criteria of application of this provision of the risk capital Communication, the Commission notes that one of them is that the incentive for the intermediary to transfer that aid should be minimal. On that point, the United Kingdom authorities have not provided any satisfactory evidence on how they intend to calculate this ‘minimum level of support’. In the Communication on State aid and risk capital, from which this principle is taken, the Commission normally takes the view that there must be a call for tender for the establishment of preferential terms, and therefore the level of aid given to the investors. The best way of guaranteeing that the level of support necessary for a project to go ahead would seem to be a call for tender. However, the United Kingdom authorities have acknowledged that this procedure will be limited to situations where the land on which the incubator is to be developed is in public ownership and is consequently unlikely to be used to any great extent. In the other, more frequent, situations, the United Kingdom authorities only indicate that independent experts including chartered surveyors will analyse project in line with local market conditions in order to determine the minimum level of support necessary. Despite the requests of the Commission, they have not provided any detailed explanation of the criteria that will be taken into account by these experts or the method that will be used (e.g. gap funding).

To summarise, at this stage, the Commission has doubts concerning the applicability of this provision of the Communication on State aid and risk capital to situations falling outside its scope. Furthermore, if this reasoning is found to be applicable in the present case, the Commission has doubts as to whether the present aid scheme fulfils its conditions of application.

4. CONCLUSION

In the light of the foregoing considerations, the Commission, acting under the procedure laid down in Article 88(2) of the EC Treaty, requests the United Kingdom to submit its comments and to provide all such information as may help to assess the aid, within one month of the date of receipt of this letter.

The Commission wishes to remind the United Kingdom that Article 88(3) of the EC Treaty has suspensory effect, and would draw your attention to Article 14 of Council Regulation (EC) No 659/1999, which provides that all unlawful aid may be recovered from the recipient.'