

CONSULTATION DOCUMENT ON STATE AID FOR INNOVATION

– October 2005

Representations submitted on behalf of CABERNET

CABERNET Network and Contributing Authors:

This paper has been developed from the activities of CABERNET Network. It draws on the findings of a Network Position Paper initially developed by the CABERNET Working Group (WG6) on Economic Issues¹.

CABERNET is an expert multidisciplinary European Network that facilitates new practical regeneration solutions for urban brownfields (www.cabernet.org.uk). The Network's vision is to continue to 'enhance rehabilitation of brownfield sites, within the context of sustainable development of European cities, by the provision of an intellectual framework for coordinated research and development of tools.' CABERNET has defined brownfields as sites which:

- have been affected by former uses of the site or surrounding land;
- are derelict or underused;
- are mainly in fully or partly developed urban areas;
- require intervention to bring them back to beneficial use; and
- may have real or perceived contamination problems.

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¹ See <http://www.cabernet.org.uk/network/workinggroups> for further information on Working Group 6 activities

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³ European Commission 5th Research Framework Programme Key Action City of Tomorrow and Cultural Heritage

SUMMARY

1. CABERNET welcomes the position implicit in the Commission's 'Consultation Document on State Aid for Innovation'⁴, namely that State aid can be conducive to fostering innovation by the private sector. This is in line with the view, developed by CABERNET in the course of its deliberations and as set out more fully in a CABERNET Position Paper⁵, with regard to addressing market failure in the re-use of brownfield land.

2. As more fully described in the CABERNET Position Paper, the current application of State aid rules results in the unequal treatment of direct action undertaken by the public sector acting alone, when compared to risk-sharing activity jointly undertaken via a public-private partnership, in facilitating the return to beneficial use of vacant or under-used brownfield land.

Vacant or under-used brownfield land, especially when concentrated in a particular locality, has a negative impact on communities and can increase the difficulty of achieving sustainable urban regeneration.

Various public policy interventions can be adopted to address this problem – which typically is an indicator of failure in the local property market. These interventions can comprise either 'market substitution' or 'market enhancement' initiatives. Market enhancements, in the form of public-private partnerships, face greater scrutiny and constraints from EU Competition Policy than market displacement by the activity of the public sector.

Well-designed and well-managed public-private partnerships offer access to a wider range of resources than can be provided solely by the public sector. They run fewer risks of crowding-out the private sector thereby, ultimately, promoting competition and innovation. Without access to private sector skills and resources the pace of re-use of brownfield land will be slower than it might otherwise be – to the disadvantage of local communities in terms of the 'quality of life' and competitiveness of the area. It is undesirable, therefore, for market enhancement schemes (e.g. partnership schemes that combine the resources of the public and private sectors) that increase the pace of regeneration to face greater scrutiny and restriction from EU Competition Policy than market displacement schemes (e.g. direct development undertaken at a loss by the public sector acting alone).

The (probably unintended) consequence of this unequal treatment is that innovation by the private sector in bringing brownfield land back to beneficial use is discouraged and the pace at which brownfield land is re-used is less than it could be. As a result, Europe's cities are less competitive and sustainable than they might otherwise be.

The different treatment by EU Competition Policy appears, paradoxically, in part to reflect the greater financial transparency of partnerships schemes, rather than the overall value of the assistance afforded to the private sector.

3. CABERNET would wish to draw the attention of the Commission to the following perspectives:

⁴ See: COM(2005) XXX, at http://europa.eu.int/comm/competition/state_aid/others/action_plan/cdsai_en.pdf

⁵ See: <http://www.cabernet.org.uk/index.asp?c=1155>

- not all valid and valuable innovation is technologically-driven – as is the case with brownfield land, innovation can comprise the novel application of established expertise and skills to better manage the risks inherent in tackling ‘new’ problems;
- ‘market failure’ in local property markets (to the extent that public externalities are, at best, imperfectly reflected in private decision making) can be a major cause of vacant or under-used brownfield land;
- under-used brownfield land can both:
 - ‘blight’ the competitiveness of a locality seeking new investment and thereby undermine the quality of life of local people, and
 - represent a ‘lost opportunity’ in the pursuit of sustainable urban development and thereby undermine the long term competitiveness of Europe’s cities.
- in the case of the regeneration of brownfield land, the clear beneficiary of any apparent State aid made available to help to address ‘market failure’ in local property markets is not the enterprise formally in receipt of the financial assistance, rather it is the land itself and thereby the local community and area;
- the focus of the proposed adjustments to State aid policy cannot be restricted to SMEs and / or the assisted regions of Europe because:
 - few if any SME property companies have at their disposal the resources required to address the problems of under-used brownfield land in any meaningful way; and
 - ‘market failure’ in terms of under-used brownfield land is evident in most regions of the EU, not just the assisted regions.

4. To conclude:

- CABERNET recommends that the Commission formally recognises the unique and invaluable contribution that a less strict interpretation of State aid rules would make to the regeneration of Europe’s cities;
- the current interpretation and application of policy materially restricts the ability of the private sector to be innovative with regard to the redevelopment of brownfield land, to the detriment of the competitiveness of Europe’s cities and economy;
- by facilitating public-private partnerships to share the risks of redeveloping brownfield land, an acceleration in the pace of re-use of brownfield would be achieved resulting in more competitive, sustainable cities able to offer a higher quality of life to the citizens of Europe;
- State aid rules therefore need to reflect that the beneficiaries of the financial assistance in properly structured public-private regeneration partnerships are not the enterprises involved, but the land and the local communities; and
- these perspectives are universal and not restricted to either SMEs or to the assisted regions.

1 INTRODUCTION

In the course of its deliberations over the past three years, CABERNET has become very aware that public-private partnerships offer a powerful means to overcome '**market failure**' in local property markets in the remediation and re-use of brownfield land. By sharing the risks and responsibilities of bringing back into beneficial use brownfield land that is not commercially viable to re-develop, such partnerships can, CABERNET believes:

- contribute to the **sustainable regeneration** of Europe's cities;
- improve the **competitiveness** of Europe's cities;
- enhance the **quality of life** of local communities; and
- stimulate **innovation** and **competition** by the private sector.

However, CABERNET has also developed an appreciation of the limitations that current State aid policy, probably inadvertently, places on the ability of Member States (at national and subsidiary levels of government) to enter into effective partnerships with the private sector. Furthermore, CABERNET has learned that other forms of intervention by the public sector, when acting in isolation of the private sector, do not attract the same degree of attention from EU Competition policy because they do not involve State aids. However, CABERNET believes that such public sector interventions run the risk of 'crowding out' the private sector and also reduce the aggregate pace of re-use of brownfield land.

CABERNET therefore welcomes the current review of State aid policy by the Commission, including consideration of the role that State aid can make to fostering innovation. It offers an to address the current shortcomings, as identified by CABERNET, with regard to the formation of effective public-private partnerships that have the aim of returning non-commercially viable brownfield land to beneficial use.

This submission comprises:

- as background, a summary of CABERNET's understanding of how current State aid rules inadvertently place limitations on public-private partnerships being used to address market failure and to accelerate the beneficial re-use of brownfield land in cases of market failure;
- comments from CABERNET on certain specific proposals in the Consultation Document that are of relevance to brownfield land; and
- CABERNET's specific recommendations to the Commission for future State aid rules that will better support attempts to use effective public-private partnerships to accelerate the re-use of brownfield land.

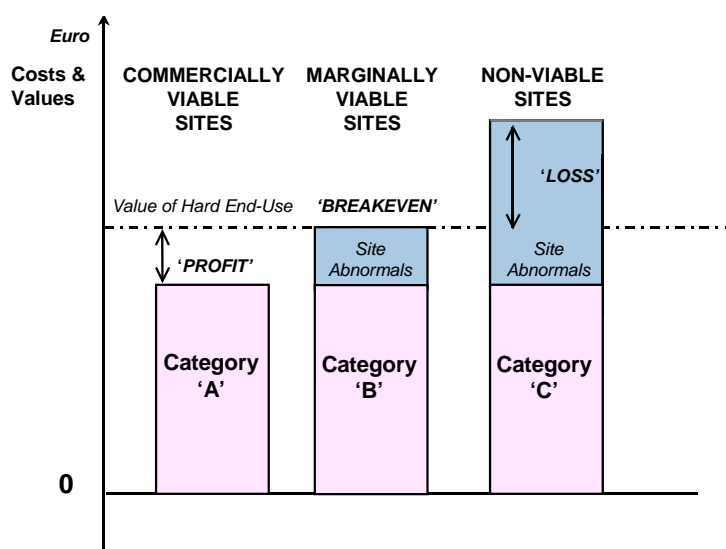
2 THE RE-USE OF BROWNFIELD LAND – AN OVERVIEW

CABERNET has defined brownfield land as sites which:

- have been affected by former uses of the site or surrounding land;
- are derelict or underused;
- are mainly in fully or partly developed urban areas;
- require intervention to bring them back to beneficial use; and
- may have real or perceived contamination problems.

It is these factors that determine the commercial viability of development of a given parcel of land, and so determine whether a particular brownfield site will readily find a new use, or will remain persistently under- or unused. The effects are summarised schematically in Figure 1:

FIGURE 1 CABERNET 'ABC Model' of Brownfield Land Commercial Viability



However, brownfield land that, for whatever reason, remains vacant or derelict is both:

- a **lost opportunity**, in that if re-used the land can save the release additional greenfield land for urban development, thereby helping to achieve sustainable development; and
- a **problem** that can have a negative impact on the surrounding area and community, increasing the difficulty of achieving effective regeneration.

2.1 The Case for Public Intervention

Whilst certain brownfield land may well be brought back into beneficial use by the market (i.e. Category A sites in Figure 1), in many other cases, vacant and derelict brownfield land persists (i.e. Category B and C sites in Figure 1). These persistent sites can often be concentrated in areas of social need, and so policies to deal with the backlog of vacant and derelict brownfield land are clearly a justifiable and crucial component of urban regeneration in these cases of market failure.

If the perceived **redevelopment value is less than anticipated costs**, a brownfield site will under market circumstances remain vacant or under-used for the foreseeable future - Category B and C sites in Figure 1. This can only change if there is some means of creating a surplus between costs and value. Policy initiatives can variously seek:

- to raise predicted values;
- to reduce anticipated costs; or
- a combination of the two.

Only modest adjustments to predicted costs and values are required for the market to redevelop Category B. In contrast, the market is far less likely to be able to respond with Category C sites, implying a more leading role for the public agencies (whether at national, regional or municipality level).

To summarise, a proportion of brownfield sites (those in Category B) can be taken forward by the private sector if the public sector is able to assist with the costs (or values) at the margin.

2.2 Alternative Styles of Intervention

There are essentially two forms of public intervention:

- 'market enhancements'; and
- 'market displacements'.

Market enhancements involve public agencies **improving the working of the market** by sharing, or modifying, the costs and/or risks faced by the private sector or by taking steps to enhance the market values likely to be achieved.

There are a variety of market enhancements available. These include:

- tax incentives;
- 'soft' loans (i.e. loans made on less than commercial terms);
- area-based initiatives (e.g. improving infrastructure or changing the planning status of sites);
- land assembly activities (e.g. compulsory purchase of land from the existing owner); and
- discretionary grant aid (e.g. 'gap funding' to address the private sector cost-value gap).

Discretionary grant aid regimes can be among the most cost-efficient means of dealing with market failure in the remediation and re-use of brownfield land. Such regimes focus on bridging a well-defined 'gap' between the costs and values anticipated values to arise from the redevelopment. The advantages of such forms of funding include:

- only those projects that can demonstrate a need for assistance to become commercially viable actually receive assistance, those that are viable do not;
- there is the opportunity to impose clawback provisions if actual costs are lower than expected, or if values are higher; and
- case-by-case economic appraisals of the direct and indirect effects of the proposed project seeking grant aid can be used to determine the maximum level of grant commensurate with public benefit, or to minimise any displacement effects.

Such forms of 'partnership' funding can however attract the attention of EU Competition Policy and yet, without some form of intervention, the sites will remain under- or unused for

the foreseeable future. Non-discretionary systems, such as tax incentives do not attract the same attention from EU Competition Policy, so long as they are available to all projects, whether or not they require assistance. However, tax incentives can be less efficient as they cannot readily be restricted solely to aid commercially non-viable schemes; and also require the developer to have sufficient tax liability if eligible schemes are to be able to realise the full tax incentive.

Nevertheless, **all** forms of market enhancements have the effect of:

- encouraging private sector involvement in sites that they would otherwise decline to invest in;
- stimulating adjustments to market perceptions of costs, risks and values; and
- over time, permitting the public sector to withdraw from the market.

In other words, the pursuit of market enhancements assists with the achievement, over time, of self-sustaining market activity, thereby avoiding the need for continued public sector interventions.

Market displacement, by contrast, involves public agencies **taking over responsibility** for dealing with problematic brownfield land. Under this scenario, the public sector acquires the problem site and takes full responsibility for its reuse, meeting the costs of remediation, developing the desired accommodation, letting to tenants and disposing of the development to the private sector. So long as all transactions are conducted at market value and statutory obligations (such as 'the polluter pays' principle) are respected, no State aid is deemed to apply – even when providing accommodation for an individual enterprise.

The role of the private sector in the development process is limited – perhaps it sells the site to the public sector, it rents or buys the completed accommodation and, an investor might buy the occupied development. Inherently, the role of the private sector is reduced to that of a contractor to the public sector, rather than that of a risk-sharing partner. Such a relationship may well be justified by the particular circumstances, such as sites that have deep-seated problems (eg Category C sites).

In conclusion, if market displacement activity becomes the norm for **all** non-viable brownfield sites there are adverse implications:

- private sector innovation and risk-taking cannot be rewarded and,
- over time, market innovation and competition in the field of urban regeneration may well be discouraged rather than encouraged.

In other words, market displacement activity can over time discourage the private sector from urban regeneration activity except in the most buoyant areas.

To summarise, market enhancement activities (including well-designed State aid schemes) offer the opportunity to **foster market activity** and to **stimulate innovation and competition** in urban regeneration. Market displacement activities, by contrast, will require the public sector to wholly fund the urban regeneration process other than in the most buoyant market areas.

2.3 The Consequences of Dependence upon Market Displacement Initiatives

On further analysis, dependence on market displacement initiatives by the public sector in the field of urban regeneration has certain undesirable consequences.

Public agencies typically operate in a cash limited budgetary environment (and therefore have limits placed upon the scale and pace of their operations). The direct provision of land remediation requires **all** costs, not just the **excess** costs, to be addressed by the public sector (again, with consequences for the overall scale or pace of land remediation).

The public sector does not operate in a market environment and may therefore be less innovative, cost-conscious or adaptable to changes in circumstances than the private sector (and so the private sector can offer complementary skills and ideas to those of the public sector).

Continued activity by the private sector can, especially in a given locality, discourage market interest in even commercially viable brownfield sites (thereby exacerbating the underlying cause of market failure, obliging the public sector to take full responsibility for treating brownfield land for the foreseeable future).

To summarise, the above factors mean that over-dependence on direct public sector activity is:

- an inefficient use of limited public funds;
- probably less cost-effective than partnerships with the private sector;
- anti-competitive, in that it discourages the private sector from re-using brownfield land; and
- results in a pace of re-use of brownfield land that is lower than if public-private partnerships are also employed.

This is not to say that there is not a place for direct intervention by the public sector (particularly for Category C sites, as shown in Figure 1), but over-dependence on such means of achieving the re-use brownfield land has its cost – namely, innovation and risk taking in the re-use of brownfield land may be discouraged to the disadvantage of economic growth, social welfare and sustainable development.

In conclusion, it must be noted that public resources for regeneration are limited - whether for national or regional governments, for municipalities or for special-purpose agencies. The public sector, acting alone, lacks the resources to do everything that is needed and yet urban renewal policies that combine the resources of the public and private sectors in partnership can be declared as unfair State aids under EU Competition Policy⁶. A case in point was the UK's former 'Partnership Investment Programme'⁷.

3 IMPLICATIONS FOR THE REVIEW OF STATE AID AND INNOVATION

Partnership activity between the public and private sectors, when addressing local property market failures, can **promote competition and innovation** in urban regeneration. It is therefore unfortunate, and probably unintended, that EU Competition Policy has challenged the legality of such schemes, certainly any such schemes available outside the agreed regional policy areas or unless solely for the benefit of SMEs. Various 'market displacement' initiatives are not constrained to a similar degree.

⁶ Article 87 of EC Treaty

⁷ An established grant regime, used to further urban and regional regeneration by means of the provision of gap funding for otherwise non-viable commercially-led projects, but which was declared in breach of EU Competition Policy

These Competition Policy perspectives of the European Commission severely limit the ability for the public sector to develop effective partnerships, certainly at a site-specific level, with the private sector to bring about the re-use of brownfield land, and especially in those areas outside the assisted regions that are suffering local property market failure. Great care is required when developing grant aid schemes and to achieve 'prior approval' of schemes to avoid them being declared illegal by the Commission.

CABERNET's position is that State aid rules should facilitate 'public-private partnerships' that seek the return to beneficial use of non-viable brownfield sites, whatever the location of the site and irrespective of the size of enterprise that is partnering the public sector.

4 SPECIFIC COMMENTS ON CONSULTATION PAPER

On the basis of a review of the Consultation Paper, CABERNET offers the following comments (with the relevant paragraph to which they relate shown in parentheses).

CABERNET is of the view that market failure in local property markets is crucial to the creation of the brownfield land 'problem' – as pointed up in the Consultation Paper at para 14 – and agrees that well-designed State aid can address these problems and encourage innovation by the private sector:

“A **market failure** occurs when the market on its own does not lead to an economically efficient outcome. The Innovation Vademecum indicated that private companies may be reluctant to innovate:

- they may feel they cannot appropriate fully the benefits of innovation as a public good and
- they may not be aware of the positive spill-over effects of innovation (externalities).

In such cases, State aid providing direct support to undertakings can be an appropriate instrument to compensate for unfavourable risk/return factors linked to innovation. Other market failures identified in the Vademecum were

- inefficient dissemination of information;
- shortcomings in the capital markets; and
- mismatches on the labour market.

In addition, coordination problems may lead to market failure, thus hampering innovation.”

CABERNET also believes that experience with public-private partnerships in the regeneration field can positively address the key characteristics of acceptable State aid, as described in the following abstracts from the Consultation Paper:

“State funding for innovation activities should not aim at picking winners; it should rather make innovation more likely by optimising the business environment [para 18]

State aid for innovation must have an incentive effect and result in the beneficiaries changing their behaviour in the desired way. Aid should be granted only if it can be shown that, without it, the proposed innovation activities would not have been undertaken. [para 19]

State aid can be granted by different means. In general, only the grant equivalent and intensity is taken into account. However, the incentive effects of an aid measure may be influenced by its form (e.g. direct subsidy, repayable loan, tax reduction or guarantee). [para 20]

The aid measure also has to be proportionate to the market failure tackled. There should be no other less distortive measure (such as general measures, or measures involving less aid, or aid for a more limited duration) which could deal with the market failure as effectively. The aid should be limited in time and scope and should be subject to some evaluation, so that it can be stopped if it does not produce the expected result over time. [para 21]”

5 RECOMMENDATIONS

CABERNET believes the well-designed State aids can stimulate innovation in the regeneration of Europe's cities and in particular in the better and faster re-use of under or unused brownfield land.

In particular, CABERNET believes that the following specific recommendations are in the interest of accelerating the pace of re-use of brownfield land - land that might otherwise remain unused:

- that in the case of State aids designed to address the 'cost-value' gap in the re-use of commercially non-viable brownfield land, recognition is given to the beneficiary being the local community and environment and **not** the enterprise formally in receipt of the assistance; and
- that a 'block exemption' (or 'derogation') from the provisions of State aids be introduced for grant aid used specifically to encourage the re-use brownfield land in areas of demonstrable local property market failure, irrespective of the region in which the land is situated or the size of the enterprise that is the formal recipient of the grant.

Such aid instruments would readily be wholly transparent and the grant awarded would be no more than the 'gap' between costs and the value to the private sector of the project outputs, and eligible instruments would readily be able to respect the principle of 'the polluter pays'.

With such a 'block exemption', Member States will be able to develop effective, transparent partnerships that offer the prospects of fostering innovation by the private sector in sharing and addressing the risks of bringing brownfield land back into beneficial use – land that might otherwise remain unused – furthering the sustainable regeneration of Europe's cities

Without such an 'block exemption' Member States will in time be obliged to depend on almost wholly on public sector initiatives for urban regeneration activities – with adverse consequences for the pace and scale of re-use of brownfield land.

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