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CAMRIDGESHIRE & PETERBOROUGH COMBINED  
AUTHORITY

Loan variations State aid advice

June 2020



## 1 INTRODUCTION

- 1.1 We have been asked to advise Cambridgeshire & Peterborough Combined Authority (**CPCA**) whether it can accept a number of proposed loan variations without breaching the State aid rules. We consider that it can do so, subject to being able to demonstrate that a comparable private lender could be prompted to do so. We set out our advice below in the following order: summary, background, an overview of the rules and an analysis of how they apply in these circumstances.

## 2 SUMMARY OF ADVICE

- 2.1 The State aid rules<sup>1</sup> apply when State resources are used in a way that subsidises market operators and distorts competition or affects trade within the European Union. The consequences of breaching the rules are potentially serious, and can result in an order to repay the aid plus interest and / or damages. It is therefore important to consider how any particular arrangement that involves State funding will be compliant.
- 2.2 The simplest and most robust method for CPCA to agree the proposed variations without breaching the State aid rules is to satisfy the private creditor test. This can be done by ensuring that a private sector lender under similar conditions and in similar circumstances could have been prompted to agree them. CPCA will need to complete a financial assessment that can be relied on to demonstrate compliance with the test. This can be done internally if there are suitable skills and experience in house (which we understand is the case). External advice is not essential under the private creditor test, but will provide additional, and independent, evidence, and should be considered if the variations are likely to be controversial, or otherwise attract public interest.
- 2.3 There is no reason in principle why extending repayment periods, introducing interest holidays and changing from compound to simple interest would not satisfy or be consistent with the private creditor test. In our view, these are the type of changes that a comparable private lender would be willing to agree to protect its overall position. However, this is subject to completing an assessment of the variations and their impact that is broad enough to show that CPCA has considered all the options for protecting its interests as a creditor. The Commercial Commentary contains much of the information that we would expect to see in an assessment, but could be strengthened by more detail in the last section (3).
- 2.4 If there is any doubt whether CPCA can satisfy the private creditor test, there are a number of other options that could be considered. For example, the UK government's umbrella scheme, which allows a wide range of State aid compliant financial support to undertakings in financial difficulty as a result of the pandemic, including grants of up to €800,000 per undertaking (not per project).

## 3 BACKGROUND

- 3.1 As part of its devolution deal with government, CPCA received £100m to support the delivery of affordable housing in its administrative area. It resolved to use this by providing up to £60m in direct grants and up to £40m as loan funding. CPCA subsequently entered into the loan facilities summarised below:<sup>2</sup>

Loan	Borrower	Project	Amount	Date of facility	Interest rate p.a.
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<sup>1</sup> Please note that our advice is based on State aid law as at the date of writing. The law may change after 31 December 2020 upon expiry of the transition period, depending on whether a free trade agreement is reached with the European Union, or whether the Government adopts a different regime.

<sup>2</sup> Please note that this is based on a high level review of the documents provided to us rather than a detailed analysis and so may not be 100% accurate. There are also various related documents such as guarantees and certificates not listed. We would be happy to update the table and include them if required.

1	East Cambs Trading Company Limited ( <b>East Cambs</b> ).	Haddenham. 54 residential units including 19 affordable.	£6,500,000.	26.11.18	2%
2	East Cambs.	Ely MOD site. 92 residential units including 15 affordable.	£24,400,000.	31.7.19	2.61%
3	Fore Hill Ely LLP <sup>3</sup> .	Alexander House, Ely. 25 units including 4 affordable.	£4,840,000.	7.1.20	3.29%
4	Linton Road (Great Abington) LLP.	Linton Road, Great Abington. 15 units including 5 affordable.	£5,780,000.	24.2.20	3.29%
5	Histon Road Development LLP.  (together the <b>Borrowers</b> )	Histon Road. 27 units including 10 affordable.	£9,647,000.	31.3.20	4.94%

3.2 The Borrowers have requested variations to the terms of their respective facilities in response to financial pressures arising from the coronavirus pandemic. For example, the need to close development sites and the consequent impact this will have on completing and selling properties. Although the exact details are different for each loan, the Borrowers have requested two main types of variations:

3.2.1 extensions to the repayment term; and

3.2.2 interest rate holidays.

3.3 East Cambs has also requested a variation so that it is charged simple rather compound interest on the Ely MOD development (loan 2 above).

3.4 We understand that there are no other lenders on the developments, although East Cambridgeshire District Council has invested equity in East Cambs.

3.5 CPCA would like to support the Borrowers, who are planning how best to re-start developments and updating delivery programmes and financial plans. CPCA is currently reviewing its options for doing so, but wishes to ensure that any support will comply with the State aid rules. We note that each loan facility contains a general obligation to comply with the aid rules, including a clawback provision in favour of CPCA.

3.6 To help it consider the options, CPCA has prepared a commercial commentary (**Commercial Commentary**) on the proposed variations, including how market lenders are responding to the pandemic, and the financial impact on CPCA if it agrees to them, for example, in foregone interest and later repayments. The Commercial Commentary also states that it would be reasonable to include a clawback mechanism that would operate if interest holidays are agreed and a project subsequently

<sup>3</sup> We understand that Laragh House Developments Limited (registered number 6080115) is the parent company of Fore Hill Ely LLP, Linton Road (Great Abington) LLP and Histon Road Development LLP.

returns the amount of profit originally expected. We have included the Commercial Commentary and its appendices in Schedule 2 as they are an important part of CPCA's decision making process.

#### 4 STATE AID OVERVIEW

4.1 The State aid rules will be engaged when a public sector body such as CPCA renegotiates the terms of loans to private sector entities. However, loans can usually be varied compliantly by relying on what is known as the market economy operator principle, which in effect means that there will be no aid because the variations are on market terms. This is explained in more detail below.

4.2 As context for our advice, we have included an overview of the rules in Schedule 1. In summary, aid is unlawful unless permitted under the Treaty on the Functioning of the European Union (**Treaty**), or by the European Commission (**Commission**). Article 107 states:

*"Save as otherwise provided in this 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, in so far as it affects trade between Member States, be incompatible with the common market."*

4.3 This definition can be reduced to four limbs (**State Aid Conditions**), each of which must be satisfied for there to be aid:

4.3.1 the assistance must be granted by the State or through State resources (**Limb One**);

4.3.2 the assistance must favour a certain "*undertaking*" / group of "*undertakings*" (i.e. an entity / entities engaged in economic activity) or the production of certain goods (**Limb Two**);

4.3.3 the assistance must distort or threaten to distort competition (**Limb Three**); and

4.3.4 the assistance must affect trade between Member States, or be capable of having an effect on cross-border trade (**Limb Four**).

4.4 The definition of "*undertaking*" (used in Limb Two) is broad, and is determined by whether an organisation's activities are economic or not, rather than its legal status, for example, as a local authority or a local authority owned company.<sup>4</sup> It includes any entity that offers goods or services on a market.<sup>5</sup>

#### 5 ADVICE

5.1 The starting point in deciding whether the variations could result in unlawful State aid is to work through the State Aid Conditions to decide whether or not they will each be satisfied. As the loans and therefore the variations involve State resources, Limb One will be met. In this respect, although the variations involve CPCA foregoing interest and allowing later repayment rather than positive support such as grant payments, the State aid rules will still apply.<sup>6</sup> The rationale is that aid can be provided in any form, and this includes foregoing revenue due to the State (for example, tax or by undervalue property disposals).

5.2 The Commission and courts recognise residential (and commercial) property development as economic activity, and the Borrowers will therefore qualify as "*undertakings*" under the rules. Limb Two of the State Aid Conditions will as a result also be met. However, another critical component of Limb Two is that State resources must provide an advantage for there to be aid. Decisions by the Commission and the courts confirm that there will be no advantage if a transaction is in line with normal market conditions.<sup>7</sup> This broad principle has become known as the market economy operator principle

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<sup>4</sup> *Van Landewyck* (Joined Cases C-180/98 to C-184/98).

<sup>5</sup> Case 118 / 85 *Commission v Italy* [1987] ECR 2599.

<sup>6</sup> *Commission v Buczek Automotive*, C-405/11 P.

<sup>7</sup> For example, *SFEI and Others*, C-39/94, ECLI:EU:C:1996:285, *Commission v EDF*, C-124/10 P, ECLI:EU:C:2012:318.

(MEOP), although there are different variations of it depending on the particular circumstances, for example, the market economy investor principle, the private creditor test, the private vendor test and the market economy guarantor principle.

- 5.3 To rely on the MEOP, CPCA must demonstrate that it is acting like a market operator in similar circumstances would act, which is broadly interpreted to mean that it is motivated primarily by profit. The Commission and the courts have concluded that this requires an assessment of the financial case for any particular transaction before it is entered into, for example, by way of a credible and robust business plan that would be sufficient for a private operator to rely on when deciding whether to proceed. The assessment:

*"Should be carried out with the support of experts with appropriate skills and experience. Such evaluations should always be carried out on objective criteria and should not be affected by policy considerations. Evaluations conducted by independent experts may provide an additional corroboration for the credibility of the assessment."*<sup>8</sup>

- 5.4 When assessing a proposed transaction, a public authority such as CPCA may only take into account the benefits linked to its role as a market operator; it may not take into account any that are linked to its role as a public authority. For example, a policy objective of increasing affordable housing.<sup>9</sup>

- 5.5 The following broad conclusions can be drawn from the State aid rules and the MEOP:

5.5.1 CPCA may rely on the MEOP if it can demonstrate that a private entity, taking into account all the relevant circumstances and in similar circumstances, would act this way;

5.5.2 to do so, it must

- (a) identify the comparator i.e. the market economy operator that it will be compared against; and
- (b) assess the financial case using objective and verifiable criteria;

5.5.3 it may obtain expert evidence to support the case if there is any doubt. This is often done where evidence is needed in a specialist field or profession, or where there may be other statutory duties involved that justify it, for example, being able to demonstrate compliance with section 123, Local Government Act 1972;

5.5.4 CPCA should also consider assessing the transaction using a variety of methods, including not only obtaining expert evidence but also benchmarking to corroborate advice obtained and conclusions reached;

5.5.5 a counterfactual analysis should be undertaken where CPCA is already invested in an arrangement (as is the case here).<sup>10</sup>

- 5.6 A State aid challenge against Coventry City Council provides a useful explanation of the MEOP (**Sky Blue**).<sup>11</sup> It involved a challenge concerning a loan of approximately £14 million by the authority to the operator of the Ricoh Arena, which was 50% owned by the authority and was in financial difficulty. The loan was to be repaid over 41 years, which broadly equated to the remaining term of a head lease from the authority. The challenge failed.

- 5.7 *Sky Blue* removed any doubt about the level of discretion given to a local authority in concluding whether it was acting on commercial terms, and so could rely on the MEOP. We have copied three relevant parts of the judgment below, and emphasised certain parts using bold text:

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<sup>8</sup> Footnote 133, Commission Notice on the notion of State aid (2016/C 262/01).

<sup>9</sup> *Commission v EDF C-124/10 P*, paragraphs 79 – 81.

<sup>10</sup> *ING Groep NV, C-224/12 P*, ECLI:EU:C:2014:213.

<sup>11</sup> *Sky Blue Sports & Leisure Limited and others v Arena Coventry Limited and others* [2016] EWCA Civ 453

- 5.7.1 "...the law recognises that there is a wide spectrum of reasonable reaction to commercial circumstances in the private market. Consequently, **a public authority has a wide margin of judgment**...";<sup>12</sup>
- 5.7.2 "...the transaction **will not** fall within the scope of the State aid rules unless the recipient "would **manifestly** have been unable to obtain **comparable facilities from a private creditor** in the same position...";<sup>13</sup>
- 5.7.3 "...it cannot be the touchstone that a **prudent investor would not ordinarily** be expected to have entered into the transaction. The test is rather whether he **could have been prompted to do it**, because it is **only when such conduct can be entirely ruled out as inconceivable** that...it must be regarded as State aid."<sup>14</sup>

5.8 The application of the MEOP in the context of pre-existing aid is given by the European Court of Justice in *The Commission V Netherlands and ING Groep*<sup>15</sup>. In this case, the Commission had sought to argue that the Dutch Government could not rely on MEOP in deciding to extend the period over which a capital injection (itself approved aid) was to be repaid. The Court held that the basis on which the injection was given did not mean that MEOP was not applicable; indeed the Commission had a duty to consider whether there was a rational economic case for allowing the extension of time for repayment.

"What is **decisive** in the context of that comparison is whether the amendment to the repayment terms of the capital injection has satisfied an **economic rationality test**, so that a private investor might also be in a position to accept such an amendment, in particular by **increasing the prospects of obtaining the repayment** of that injection."<sup>16]</sup>

## 6 PROPOSED VARIATIONS AND NEXT STEPS

- 6.1 As mentioned earlier, there are different variations of the MEOP, although all are based on the principles outlined above. In the current circumstances, the private creditor test is applicable, which is applied to examine whether debt renegotiations by public creditors involve State aid by comparing them to a hypothetical private creditor in a similar situation.<sup>17</sup> CPCA must therefore identify clearly the comparable private sector creditor in similar conditions, and then demonstrate that the comparator, taking into account all the relevant circumstances, could be prompted to agree to the variations. This requires CPCA to complete an assessment of the proposed variations, including the full range of options available in relation to the loans. In a recent State aid decision (the *Frucona* case in footnote 17), it was held that a tax authority which waived recovery of tax should have considered the full range of bankruptcy options available. It is also critical that the assessment is completed before the variations are agreed as the Commission and courts will not accept evidence prepared after financial support has been given.
- 6.2 To be able to meet the requirements of the private creditor test, CPCA must therefore put itself in the place of the hypothetical private comparator and undertake a financial assessment of the variations using objective and verifiable criteria, excluding any policy objectives. In effect, it must be able to demonstrate that there is a business case that would be acceptable to the comparator i.e. one that protects its interests as a creditor, and seeks to maximise repayment of the loans.
- 6.3 The case law quoted in paragraph 5.7 recognises that a public authority has a wide range of discretion in reaching commercial decisions such as this, which reflects the fact that investors and lenders generally may have different financial objectives / expectations about the level of return they wish to realise and how quickly they wish to generate it. For example, there is no requirement that the lender

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<sup>12</sup> Paragraph 16 x), *Sky Blue*.

<sup>13</sup> Paragraph 16 x), *Sky Blue*.

<sup>14</sup> Paragraph 27, *Sky Blue*.

<sup>15</sup> Case no Case C-224/12P

<sup>16</sup> Ibid para 35

<sup>17</sup> *Frucona Kosic v Commission* (Case C-73/11P, Case T-103/14 and Case 300/16P – these spanned 12 years hence the different references).

or investor must be motivated by short term profit. As highlighted in paragraph 5.7.3, “*the test is rather whether he **could have been prompted to do it**, because it is **only when such conduct can be entirely ruled out as inconceivable that...it must be regarded as State aid**”.* This flexibility is particularly useful to CPCA as it means the threshold for satisfying the private creditor test is not being able to demonstrate that the comparator would definitely agree to the variations, but that it could have been prompted to.

- 6.4 The Commercial Commentary contains much of the information that we would expect to see in an assessment under the private creditor test. In order to build on the work already done and strengthen the case further, we recommend that CPCA:
- 6.4.1 satisfies itself that it has sufficient skill and experience in house to conduct the assessment (we understand that this is the case) and keep a record of the conclusion;
  - 6.4.2 satisfies itself that the market lenders referred to in the Commercial Commentary are suitable comparators in similar circumstances such that they can be relied on here;
  - 6.4.3 considers in particular whether a private sector comparator would require the Borrowers to agree a form of clawback that would be engaged should projects return profit beyond a defined amount (perhaps linked to what it was envisaged they would have returned but for the pandemic);
  - 6.4.4 considers the full range of options available to protect its debt, including the “do nothing” option that could result in it needing to rely on the default provisions in the loan agreements and / or formal insolvency proceedings. When considering the various options, the case law recognises that the costs of and length of time taken in using any particular procedure can be taken into account, as well as the prospects for recovery;
  - 6.4.5 seeks from the Borrowers details of variations to any similar loan facilities they have in place on comparable projects as this could provide evidence of what other lenders are willing to agree, and so could potentially be used to justify reliance on the private creditor test;
  - 6.4.6 considers obtaining external financial advice in order to provide additional expertise and bring greater independence to the decision making process – this will be particularly important if the decision is likely to be controversial or otherwise subject to public scrutiny.
- 6.5 Once CPCA has completed these tasks, we recommend that the Commercial Commentary is amended to include the additional level of detail, perhaps by way of expanding section 3 to set out explicitly who the comparator is, what the options are and why the comparator could be prompted to agree the variations.
- 6.6 Against this context, there is no reason in principle why extending repayment terms, introducing interest holidays and changing the type of interest would be inconsistent with the private creditor test. In our view, they are exactly the type of changes that a comparable private sector lender would be likely to agree to maximise the prospect, and amount, of debt being repaid. The position might be different if CPCA had already varied the loans, but this is not the case. Our view is subject to CPCA completing the assessment to an appropriate level of detail that is proportionate to the value of the loans and the proposed variations, taking into account the points flagged above.

## 7 POSSIBLE ALTERNATIVE OPTIONS

- 7.1 From what we have seen, it appears likely that CPCA will be able to rely on the private creditor variation of the MEOP to comply with the State aid rules in relation to the proposed variations. There are a number of alternative options, including those listed below, and we suggest that we consider these in more in detail if it becomes apparent that the MEOP cannot be relied on.

- 7.2 First, the *De Minimis* Regulation<sup>18</sup> allows support to an undertaking up to the approved level to be given outside of the aid rules i.e. it is not seen as aid because of its low value and the low prospect of it affecting cross-border trade. To rely on this Regulation, it is necessary to:
- 7.2.1 ensure that support is not for an excluded sector, for example, the fishery and aquaculture sector; and
- 7.2.2 calculate the gross grant equivalent for the support to make sure it is beneath the ceiling (€200,000) for any given three-year period.<sup>19</sup>
- 7.3 When calculating the level of aid already provided, the *De Minimis* Regulation defines "single undertaking" in a way that means a borrower and its parent company must be viewed together. Assuming this is below the ceiling, CPCA would then need to obtain a certificate from the borrower confirming that the additional aid will not cause it to exceed the ceiling. Subject to that, we note that the interest which would be foregone on the three loans to the subsidiaries of Laragh House Developments Limited should fall within the threshold.
- 7.4 Second, the UK government has established an umbrella scheme<sup>20</sup> under which aid can be provided to undertakings experiencing financial difficulties as a result of the coronavirus pandemic - the Covid-19 Temporary Framework for UK authorities. This permits various types of aid to SMEs and large enterprises / companies<sup>21</sup> up to a total of £50 billion, for example, grants of up to €800,000 per undertaking (not per project). It would be necessary to work through the detail of the scheme and how it applies to the variations, but it does provide an additional potential option for compliance.
- 7.5 Third, it may be possible to rely on the rules allowing aid for services of general economic interest (**SGEI**) contained in the SGEI Decision<sup>22</sup> if the underlying purpose and intention of the variations is to provide affordable housing. Affordable housing (i.e. housing provided on below-market terms for those selected by means testing) has been recognised as meeting the requirements of SGEI by the Commission and the courts.<sup>23</sup> However, this would require further thought as to how the variations could be restricted so that they only support the affordable housing element of the schemes. There will also be a risk created where a scheme develops shared ownership rather than affordable rental accommodation.

## 8 CONCLUSION

- 8.1 The State aid rules will be engaged if CPCA agrees to the proposed variations, but the simplest way of complying with them will be to rely on the MEOP. Although there are some potential alternative options available, we would need to consider them in more detail to decide exactly how they could apply here.

**Bevan Brittan LLP**  
**[v1] June 2020**

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<sup>18</sup> Commission Regulation 1407 / 2013 of 18 December 2013.

<sup>19</sup> There is a lower ceiling of €100,000 for road freight transport.

<sup>20</sup> Under the Commission's Temporary Framework dated 19.3.20 (and since updated).

<sup>21</sup> Large company and large enterprise are used as if they have the same meaning, although neither is defined. However, large enterprise is defined in Article 2, GBER as one that doesn't fall within the definition of an SME in Annex 1 of GBER.

<sup>22</sup> Commission Decision (2012/21/EU).

<sup>23</sup> State aid N 89/2004 – *Ireland – Social housing schemes funded by the HFA*. Case C-132/12 P *Stichting Woonpunt v European Commission*.

## SCHEDULE 1 – STATE AID OVERVIEW

- 1 State aid is a concept deriving from European law, in particular articles 107 and 108 of the Treaty on the Functioning of the European Union (**Treaty**). It has been interpreted broadly to include many different forms of financial assistance, both direct and indirect, for example, grant funding, loans at below the market rate, the provision of premises, equipment or staff at a discount, foregoing tax revenue and equity investment on below-market terms.
- 2 State aid is unlawful unless permitted under the Treaty, or by the European Commission (**Commission**) pursuant to the regulatory framework under the Treaty. Article 107 states:  
  
*"Save as otherwise provided in this 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, in so far as it affects trade between Member States, be incompatible with the common market."*
- 3 The definition can be reduced into four limbs:
  - 3.1 the assistance must be granted by the State or through State resources;
  - 3.2 the assistance must favour a certain undertaking / group of undertakings (i.e. an entity / entities engaged in economic activity) or the production of certain goods (with the concept of assistance being widely construed);
  - 3.3 the assistance must distort or threaten to distort competition; and
  - 3.4 the assistance must affect trade between Member States, or be capable of having an effect on cross-border trade.
- 4 Assistance will only constitute State aid if each of the four conditions is satisfied. If one or more are not met, a proposed scheme will fall outside of the definition in Article 107. For example, if the recipient is not in fact an "undertaking" or aid will have only a local effect. In addition, aid can be made compliant by:
  - 4.1 notifying and obtaining approval from the Commission under Article 107(2) or (3) through the formal clearance process;
  - 4.2 relying on an existing exemption, for example:
    - 4.2.1 the market economy operator principle – essentially, that there would be no aid because the "benefit" flows from the transaction on market-facing terms;
    - 4.2.2 the General Block Exemption Regulation;<sup>24</sup>
    - 4.2.3 the *De Minimis* Regulation;<sup>25</sup>
    - 4.2.4 the rules governing provision of services of general economic interest, and in particular the services of general economic interest decision.<sup>26</sup>
- 5 The consequences of breaching the rules are serious, and can result in the Commission bringing infringement proceedings against the Member State. If a complaint is successfully made to the Commission, the recipient can be ordered to repay the aid plus compound interest at the statutory rate. Following the UK's departure from the European Union, the limitation period for lodging a

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<sup>24</sup> Commission Regulation (651 / 2014 / EU) of 17 June 2014.

<sup>25</sup> Commission Regulation 1407 / 2013 of 18 December 2013.

<sup>26</sup> Commission Decision (2012/21/EU).

complaint with the Commission has been reduced to four years from the end of the transition period.<sup>27</sup> As there is no charge for bringing such a complaint, it is relatively easy to bring a challenge this way. A challenge can also be brought in the UK courts by way of judicial review, for example, by a competitor who believes that it has suffered loss as result of not being given the same level of support.<sup>28</sup> Such a challenge must be brought promptly and in any event not later than three months after the grounds for challenge first arose.

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<sup>27</sup> Article 93, Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community.

<sup>28</sup> For example, *Betws Anthracite v DSK Anthrazit Ibbenburen* [2004] 1 CMLR 12.

**SCHEDULE 2 – COMMERCIAL COMMENTARY**



Commercial paper  
restructuring 40m re



Commercial paper  
appendix 1.xlsx



Commercial paper  
Appendix 2 40m Rev