Case No: 59332
Event No: 573836
Decision No: 300/11/COL

EFTA SURVEILLANCE AUTHORITY DECISION
of 5 October 2011
on the grant of state aid to Lina.Net and Reykjavik Energy by the municipality of Reykjavík

(Iceland)

THE EFTA SURVEILLANCE AUTHORITY[1],

HAVING REGARD to the Agreement on the European Economic Area[2], in particular to Article 61,

HAVING REGARD to the Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice[3], in particular to Article 24 thereof,

HAVING REGARD to Article 1(3) of Part I and Article 4(2) of Part II of Protocol 3 to the Surveillance and Court Agreement[4],

Whereas:

I. FACTS

1 Procedure

By a letter dated 24 January 2006 (Event No. 359895), LOGOS Legal Services filed a complaint to the EFTA Surveillance Authority on behalf of Síminn hf. (the complainant) alleging the grant of unlawful state aid to Reykjavik Energy (RE) by the central government and several municipalities, including the municipality of Reykjavík.

By a letter dated 20 December 2006 (Event No. 395385), the Authority acknowledged the receipt of the complaint and informed the complainant, with reference to a meeting with a representative of the complainant held in Brussels on 22 March 2006, that some of the measures subject to the complaint were already the object of a preliminary investigation by the Authority. Furthermore the Authority explained that the parts of the complaint which were not already being assessed by the Authority would need to be substantiated further in order for the Authority to take a view on the allegations. Should the Authority not receive any new information from the complainant to substantiate these allegations, it would close the case with the rejection of the complaint on the basis of Article 20(2) of

1 Hereinafter referred to as the Authority.
2 Hereinafter referred to as the EEA Agreement.
3 Hereinafter referred to as the Surveillance and Court Agreement.
4 Hereinafter referred to as Protocol 3.

Part II of Protocol 3. By a letter dated 9 March 2007 (Event No. 413060), further information and a refined substantiation of the allegations was forwarded by LOGOS Legal Services on behalf of the complainant.

By a letter dated 22 August 2007 (Event No. 435388), the Authority sent the Icelandic authorities a request for information regarding Reykjavik Energy's operations on the telecom market through the subsidiary Lina.net. The Icelandic authorities responded by a letter dated 17 October 2007 (Event No. 447464). The Authority sent a second request for information to the Icelandic authorities by a letter dated 31 January 2008 (Event No. 462001) which was responded to by a letter dated 30 April 2008 (Event No. 475802).

The case was discussed at a package meeting in Reykjavik on 24 October 2008 where the Authority requested that the Icelandic authorities provide complete information regarding the information request sent on 31 January 2008. The Icelandic authorities responded by a letter dated 14 January 2009 (Event No. 504642) providing additional information. The case was also discussed in a meeting with the complainant in Reykjavik on 10 June 2011.

2 Background

2.1 Reykjavik Energy

RE was established on 1 January 1999 as a public undertaking with the decision of the City Council of Reykjavik to merge the operations of the electricity and heat utilities owned by the city. A year later the water utility was also incorporated into the new company. The company was operated on the basis of regulation No. 793/1998 issued by the Ministry of Industry and the City Council of Reykjavik with reference to legislative Act No. 38/1940 on the Reykjavik Heating Utility and the Power Act No. 58/1967. The City Council of Reykjavik appointed five members of the board of directors in accordance with the regulation.

On 1 December 2001 RE merged with a utility company owned by several small municipalities in the western part of Iceland. After the merger the City of Reykjavik owns 94% of the company and the municipality of Akranes owns 5%. Several other municipalities own less than 1%. Five members of the board of directors are appointed by the City Council of Reykjavik and one is appointed by the Municipality Council of Akranes. After the merger the company was transferred into a cooperative which operates on the basis of a special legislative Act on RE No. 139/2001. Several successive regulations have been issued with reference to the legislative act, the latest No. 297/2006.

2.2 Liberalisation of the Icelandic telecom markets

A governmental institution, Póst og símamálastofnun, had traditionally been responsible for the provision of telecom and postal services in Iceland through a statutory monopoly. In 1997 the institution was incorporated into a limited liability company, solely owned by the state, called Póstur og sími hf. In 1998 the state owned company was split into two separate undertakings. In 1999, the Icelandic telecom sector was liberalised. The telecom services which were to become liberalised were taken over by Landsími Íslands hf. (now Síminn hf.). Íslandspóstur hf. was established for the postal services which for the time being were still subject to a statutory monopoly.

The liberalisation of 1999 enabled new market players to enter different markets within the telecom sector. The state owned Landsíminn however remained strong on most or all of the markets despite the abolishment of the statutory monopoly. In 2005 the government privatised Landsíminn by selling all of its shares to private investors. They subsequently renamed the company Síminn hf. During 2005–2006 Síminn and RE unsuccessfully negotiated about the sale of Síminn's basic network. The negotiations were terminated few months before Síminn alleged to the Authority that RE was receiving unlawful state aid in building its own basic network.

2.3 The Lina.Net project

The company Lina.Net was established by RE and several investors in June 1999 with the purpose of providing general telecommunication services with emphasis on data transmission and internet connections in urban areas around Iceland. The intention was moreover to enhance competition in the telecom sector which had then just recently been liberalised. Initially RE held around 77% of Lina.Net's shares and the telecom companies Íslandssími and Skýrr (which later merged and became OgVodafone) each held around 10%. In addition staff members of RE and Lina.Net held around 3% of the shares.

A business plan, a version of which was presented to potential investors in March 2000, described three different platforms from which data transmission and internet connections would be provided by Lina.Net. The first was a fibre-optic network, which was already at the time being rolled out in the Reykjavik area. The intention was to expand it to other densely populated areas around Iceland. The second platform was a microwave network which was acquired through a merger with two small companies and was mainly focused on serving businesses and institutions. The third platform was the intended use of RE's electricity cable network to transmit data by using technology that was being developed in cooperation with the German Siemens corporation.

The main business opportunity envisaged in the business plan regarded an expected exponential growth in data transmission which could be exploited after the liberalisation of the telecom sector. The main threats to the project were considered uncertainties about the viability of the electricity cable platform, strong purchase power of the service providers which could lower revenues to Lina.Net, fast and unpredictable development of technology, and uncertainties about the competitive counter measures taken by Landsiminn the dominant operator in the telecom sector.

The business plan was drawn up for ten years (2000-2009) and envisaged ISK 100 million increases in share capital in the year 2000, from ISK 214 million to ISK 314 million. It also estimated a need for an ISK 560 million investment in equipment to connect users to the fibre-optic and the microwave network during the first five years of the plan. The plan also envisaged a potential ISK 700 million investment in equipment to connect users to the electricity cable network during the years 2000-2005. According to the business plan the company would make losses during the first three years while being in a build-up phase before breaking even in 2003 and returning substantial profits from 2004 onwards. Estimated revenues in 2000 were ISK 160 million while in 2004 they were expected to have grown to ISK 600 million. The long term return on equity was predicted to be 25%.

In the years between 1999 and 2001 RE provided Lina.Net with share capital on several occasions. First with the initial capitalisation of ISK 214 million in 1999 and then with capital injections of ISK 89 million in 2000 and ISK 671 million in 2001.

2.4 The fibre optic network becomes Gagnaveitan after acquisition by RE

In October 2002 RE purchased the fibre optic network from Lina.Net for ISK 1759 million and financed the transaction by taking over loans and debts in addition to assigning a portion of its shares in Lina.Net worth ISK 408 million.

In November 2004 RE sold its remaining shares in Lina.Net to OgVodafone for ISK 271 million as a part of an agreement to cooperate further in providing homes and businesses with internet and other data transmission services. Essentially RE would provide wholesale access to its fibre optic network and OgVodafone would sell retail access. By this RE terminated its plans of using the electric cable network as a platform for transmitting data. Simultaneously, plans were initiated to extend the fibre optic network by connecting it directly to homes and businesses.[5]

The fibre optic network was operated within RE as an independent unit with separate accounts and referred to as 'Gagnaveitan' (Data Network) until January 2007 when it was transferred into a subsidiary limited liability company following recommendations made by the Icelandic Post and Telecom Administration (PTA). The fibre optic network is to date operated by this subsidiary, Gagnaveita Reykjavíkur ehf., which provides wholesale access to the network to a number of retail service providers that further provide homes and businesses with different internet and data transmission services.

2.5 The complaint

A complaint was filed on behalf of Siminn by a letter dated 24 January 2006 (Event No. 359895) alleging that RE received unlawful state aid in the form of exemption from the payment of taxes, an unlimited owners guarantee on all its liabilities and an exemption from the payment of stamp duties The complainant alleged that several measures from which RE benefited in its capacity as a public utility company were used to cross-subsidise its operations in the newly liberalised telecom sector. This cross-subsidisation supposedly was possible due to a failure in requiring RE to keep separate accounts and to make adequate requirements on return of capital for its telecom operations.

Moreover, the complainant also alleged that the municipalities through their ownership in RE dispensed state aid to a failing company by lending and increasing capital in Lina.Net on several occasions. Allegedly these expenditures were directly sanctioned by the municipalities.

The Complainant was informed by a letter dated 20 December 2006 (Event No. 395385) that the parts of the complaint regarding exemptions from tax payments and stamp duties, and regarding an unlimited state guarantee were already the object of a preliminary investigation.

Regarding the measures already under assessment by the Authority, in a letter to the Icelandic authorities dated 26 September 2006 (Event No. 280834) the Authority recalled that the exemptions from tax payments and stamp duties were to be considered as existing aid that, according to the information provided by the Icelandic authorities, ceased to exist on 1 January 2006. Pursuant to Article 18 of Part II of Protocol 3, on 8 July 2009, the Authority adopted Decision No. 302/09/COL recommending that appropriate measures should be taken to abolish the existing aid resulting from the unlimited state guarantees in favour of, amongst others, RE. The Icelandic authorities accepted the proposed appropriate measures and thus committed to implement the Authority's decision.

In the letter of 20 December 2006, the complainant was also informed that other parts of the complaint which concern RE's capital investments in Lina.net would need to be substantiated further in order to enable the Authority to take a view on them. Otherwise the case would be closed on the basis of Article 20(2) of Part II of Protocol 3. The

[5] See RE's Annual report for 2004, pp. 2–3.

complainant responded by sending documentation and refined arguments regarding RE's investments in Lina.net by a letter dated 9 March 2007 (Event No. 413060).

The issues which will be dealt with in this decision are thus several capital injections by RE into Lina.Net during the years 1999-2001.

2.6 The view of the Icelandic authorities

The Icelandic authorities are of the view that the motive of the municipalities' for entering into investments in telecommunication infrastructure was to create an alternative to the incumbent state owned monopoly Landsiminn and by that increase the competition on the market and thereby improve the standard of living for households by lowering prices.

The Icelandic authorities claim that all investments made by RE in Lina.Net and later in RE's optical fibre network were expected to result in a reasonable rate of return on the investment. In that regard the authorities contend that all investments made by RE in Lina.Net were based on business assumptions and founded on business plans that presupposed that within few years of the initial investments the company would yield dividends.

II. ASSESSMENT

1. The presence of state aid

State aid within the meaning of Article 61(1) EEA Agreement

Article 61(1) of the EEA Agreement reads as follows:

"Save as otherwise provided in this Agreement, any aid granted by EC Member States, EFTA States 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 Contracting Parties, be incompatible with the functioning of this Agreement."

2. The applicability of Article 61 EEA and the market economy investor principle

The first element in the assessment of whether state aid is involved normally concerns the intervention of the State and the involvement of state resources. If state resources are involved but they correspond to what a private market player would have spent or invested in a given transaction, i.e. if the transaction was carried out in accordance with the market economy investor principle, the transactions would not entail the grant of state aid[6]. In the case at hand, the Authority will firstly assess whether the investments in Lina.net were carried out under market conditions which would be acceptable for a private investor in which case even if state resources would have been involved the transaction would not entail state aid. For the reasons that will be stated below, the Authority has come to the conclusion that RE invested in Lina.Net on terms acceptable to a private investor. On the basis of this conclusion, the Authority does not deem necessary to assess whether state resources within the meaning of Article 61(1) of the EEA Agreement are involved or whether the action is imputable to the state due to the fact that the City of Reykjavik is 100% owner of RE.

[6] The market economy investor test was adopted by the European Courts in cases such as C-303/*88 Italy v Commission* [1991] ECR I-1433and C-328/99 and C-399/*00Italy and SIM 2* [2003] ECR I-4035.

The aim of the Authority is not to replace investors' judgement when assessing the applicability of the market economy investor principle (MEIP). Any request for extra finance naturally calls for public undertakings and public authorities, just as it does for private undertakings and private providers of finance, to analyse the risk and the likely outcome of the project. In turn the Authority realises that this analysis of risk requires public undertakings, like private undertakings, to exercise entrepreneurial skills, which by the very nature of the problem implies a wide margin of judgement on the part of the investor. Within that wide margin the exercise of judgement by the investor cannot be regarded as involving state aid.[7]

When applying the market economy investor principle to the allegations of aid being granted through RE in favour of Lina.Net, which the competitor Simin brought forward, each of the three capital injections must be assessed separately as a potential aid measure since each of them constitutes a separate decision governed by its own logic.

The first measure was the initial investment of ISK 214 million during Lina.Net's establishment in the year 1999. As stated above, together with other investors (in particular Íslandssími and Skýrr, which later became Og Vodafone) RE decided to establish a new company called Lina.Net in 1999. According to the available information, their intention was to provide telecommunications services and enhance competition in the recently liberalised sector in Iceland. A detailed business plan was prepared, which forecasted that after a period of initial investment in infrastructure the company would start to return considerable profits by the year 2004 and that the estimated returns on the investment in the long term would be around 25%. The reservation was however made that the business plan was based on the development of a new technology in a technological and competitive environment where trends and changes occurred very fast so that in worst case the technology solution used would not manage to establish itself on the market.

The investment was thus based on a business plan that predicted considerable returns on the investment, although a risk of loss was present as well. Private investors participated in the investment on the basis of this business plan which indicates that the intention was not to provide aid, but to invest in a profitable enterprise. Private investors frequently invest in businesses despite a risk of losses and the state aid rules of the EEA Agreement are not intended to prevent public undertakings from making investments, even if these investments later turn out not to be profitable.

Based on the business plan and anticipated return on the investment, and based on the participation of private investors in the initial capitalisation, it must be concluded that RE acted within its margin as a market economy investor when establishing and making its initial investment in Lina.Net.

The second measure was an ISK 89 million capital injectionvestment in the year 2000. According to minutes from RE's board meeting on 5 December 2000, installation of the

[7] See Part VI of the Authority's State Aid Guidelines: Rules on public service compensation, state ownership of enterprises and aid to public enterprises: Application of State aid provisions to public enterprises in the manufacturing sector; Section 5(1). This corresponds to the Commissions Communication to the Member States on the application of Articles 92 and 93 of the EEC Treaty and of Article 5 of Commission Directive 80/723/EEC to public undertakings in the manufacturing sector.

basic infrastructure to operate the fibre optic cables was near completion and additional financing was needed to connect particular customers to the network. In addition there was a need for more capital for the electricity cable platform. To raise the capital a decision was taken to issue new shares in Lina.Net and to offer them to the current shareholders. Additionally some new shares were also offered to new shareholders. RE decided on this occasion to exercise its purchase rights by investing ISK 89 million in new shares. Other shareholders did however not sign up for new shares.

At the time a considerable investment had been made in the company with the participation of private investors following a business plan that predicted return on the capital invested within a reasonable time. RE was however the main shareholder holding approx. 77% of the shares. Considering that the business plan was only a few months old at the time of the capital injection the forecast for expected return on the investment was still valid. The capital injection was aimed at maturing the investment already made by adding essential infrastructure to the network to enable customers to connect to it and thus make it possible for the company to raise revenues. The business plan was also based on the assumption that the share capital would be increased by ISK 100 million during the first year. It was in RE's interest to maintain its level of influence in the company by exercising its purchase rights during this share capital increase. The Authority therefore concludes that RE made this investment on the basis of and in accordance with the initial business plan as a market economy investor aiming to protect its initial investment and control over Lina.Net.

The third measure was an ISK 671 million capital investment in the year 2001. According to minutes from RE's board meeting on 13 November 2001, Lina.Net needed additional capital to continue its operations. This need for capital was roughly forecasted in the business plan as operational losses during the first years of the build-up phase. Due to a downturn in the general economy in Iceland at the time, plans for offering shares in Lina.Net to the public were not deemed advisable. The downturn in the economy also made it difficult to arrange for loans from credit institutions. In these circumstances RE decided to provide the needed capital by increasing its share capital in Lina.Net with an ISK 671 million investment.

Normally a capital injection that leads to a significant increase in the level of public holding in company's capital, indicates the absence of normal market economy conditions. However the Authority's State Aid Guidelines provide for an exception in certain circumstances. If the enterprise concerned is small or medium-sized and is unable due to its size to provide adequate security on the private financial market, but whose prospects are otherwise positive, an increase in the level of public holding of its capital through a capital injection would normally not constitute state aid.[8] Lina.Net did at the time fall within the definition of a small or medium-sized enterprise as defined by the Authority's State Aid Guidelines. [9] It employed fewer than 250 employees and its annual turnover did not exceed € 50 million, or the alternative € 43 million ceiling for the total balance sheet.[10]

[8] See Part VI of the Authority's State Aid Guidelines: Rules on public service compensation, state ownership of enterprises and aid to public enterprises: Public authorities' holdings; paragraphs (6) (b) and (c).

[9] See Part III of the Authority's State Aid Guidelines: Aid to micro, small and medium-sized enterprises (sme's); paragraph 18.

[10] The business plan expected seven fulltime employees and a total balance sheet of approximately ISK 700-1000 million (€7.4 – 10.6 million at the exchange rate of the Icelandic Central Bank on 1 November 2001) between 2000 and 2004.

According to the business plan provided by the Icelandic authorities a considerable investment had to be made before Lina.Net could start to make profits. The plan predicted that it would at least take three-four years before the company would make enough revenues to cover its fixed operational costs and start to make profits. During the build up phase the company had two options with regards to financing the needed investment in infrastructure. The first was seeking loans on the credit markets, and the second was offering shares in the company.

For the sake of comparison regarding the market's approach towards investment in the telecom sector at the beginning of the 2000s, in September 2001, two months before RE's board decided to increase its share capital in Lina.Net, the government initiated the first phase in its plan for privatising Landsíminn (the old state telecom monopoly) by offering 24% of its shares to the public. The public offer failed as less than 10% of the shares were signed up for. This forced the government temporarily to cancel its privatisation plan. Given that investors were reluctant at the time to invest in the state owned telecom company which had a strong position on most markets within the telecom sector it is not surprising that the directors of Lina.Net advised against offering new shares to the public as a way of financing additional investment in its data transmission platforms.

Moreover the circumstances in the Icelandic economy during the autumn of 2001 where tainted by the recent burst of the Dot-Com Bubble which made the credit markets prohibitively expensive. During the second half of 2001 general interests on non-indexed loans as published by the Icelandic Central Bank in accordance with Article 10 of Act No. 38/2001 were at a prohibitive rate of 14 to 14,5%. The interest rates decided by the Central Bank reflect the terms at which credit institutions were offering loans at the time. The high interest rates support the view that it was difficult to arrange for loans at the time of the capital injection at a reasonable cost.

In this situation RE had two realistic business options. The first one was to pull out of the investment and allow creditors to liquidate Lina.Net. The second was to defend the initial investment by injecting more share capital into the company to help it realise its plans of building up a profitable data transmission infrastructure. Even though the other shareholders were not in a position to participate in the capital increase due to the difficulties on credit markets that telecom companies were experiencing at that time, the situation for RE, active in the stable and profitable sector of energy, was different. RE's board of directors decided for the capital injection in view of the positive expectations of receiving a satisfactory return in the long term.

Given the two options of either abandoning the project and writing off the share capital already invested, or supporting it through the credit crisis, it must be concluded that RE acted on the basis of commercial considerations when deciding to provide Lina.Net with the additional capital which the business plan forecasted it would need during the early years of the build-up phase. The Authority therefore concludes that by investing ISK 671 million RE acted as a market economy investor with regard to the state aid provisions of the EEA Agreement.

3 Conclusion

On the basis of the foregoing assessment, the Authority concludes that RE acted as a market economy investor in the three capital injctions made in Lina.Net.

HAS ADOPTED THIS DECISION:

Article 1

Reykjavik Energy's three capital investments in Lina.Net of ISK 214 millions in 1999, ISK 89 millions in 2000 and of ISK 671 millions in 2001 do not involve state aid within the meaning of Article 61 of the EEA Agreement.

Article 2

This Decision is addressed to Iceland.

Article 3

Only the English language version is authentic.

Done at Brussels, 5 October 2011.

For the EFTA Surveillance Authority

Oda Helen Sletnes *President*	Sverrir Haukur Gunnlaugsson *College Member*