

Case No: 61198
Event No: 383545
Dec. No: 368/06/COL

EFTA SURVEILLANCE AUTHORITY DECISION
of 29 November 2006
on the sale of the Icelandic State's shares in Sementsverksmiðjan hf.
(Iceland)

THE EFTA SURVEILLANCE AUTHORITY¹,

Having regard to the Agreement on the European Economic Area², in particular to Articles 61 to 63 and Protocol 26 thereof,

Having regard to the Agreement between the EFTA States on the establishment of a Surveillance Authority and a Court of Justice³, in particular to Article 24 thereof,

Having regard to Article 1(3) and (2) of Part I and Articles 4(2), 4(4), 6, 7(2) and of Part II of Protocol 3 to the Surveillance and Court Agreement,

Having regard to the Authority's Guidelines⁴ on the application and interpretation of Articles 61 and 62 of the EEA Agreement,

Having regard to the Authority's Decision of 14 July 2004 on the implementing provisions referred to under Article 27 of Part II of Protocol 3 to the Surveillance and Court Agreement,

Having called on interested parties to submit their comments pursuant to those provisions on Decision 421/04/COL and Decision No 367/06/COL⁵,

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 Guidelines on the application and interpretation of Articles 61 and 62 of the EEA Agreement and Article 1 of Protocol 3 to the Surveillance and Court Agreement, adopted and issued by the EFTA Surveillance Authority on 19 January 1994, published in OJ 1994 L 231, EEA Supplements 03.09.94 No 32. The Guidelines were last amended on 25 October 2006. Hereinafter referred to as the State Aid Guidelines.

⁵ EFTA Surveillance Authority Decision No 421/04/COL of 20 December 2004 on the sale of the Icelandic State's Shares in Sementsverksmiðjan, published in the OJ C 117 of 19.05.2005, page 17 and following as well as in the EEA Supplement to the Official Journal of the EU No 24 of 19.05.2005;

Whereas:

I FACTS

1. Procedure

By letter of 19 August 2003 from the Icelandic Mission to the European Union forwarding a letter from the Ministry of Finance dated 19 August 2003, both received and registered by the Authority on the same date (Doc No 03-5685 A), the Icelandic authorities notified the sale of the State's shares in Sementsverksmiðjan hf., pursuant to Article 1(3) of Part I of Protocol 3 to the Surveillance and Court Agreement.

On 17 December 2003, the company Aalborg Portland Íslandi ehf. lodged a complaint with the Authority against the terms and conditions of the sale by the Icelandic State of its shares in Sementsverksmiðjan hf. The Authority received and registered this letter on 23 December 2003 (Doc No 03-9059 A). The complainant requested this complaint to be processed simultaneously to the notification of the sale made by the Government.

After various exchanges of correspondence⁶, by letter dated 21 December 2004 the Authority informed the Icelandic authorities that it had decided to initiate the procedure laid down in Article 1(2) of Part I of Protocol 3 to the Surveillance and Court Agreement in respect of the sale by the Icelandic State of its shares in Sementsverksmiðjan hf. (Event No 296878).

The Authority's Decision No 421/04/COL to initiate the procedure was published in the Official Journal of the European Union and the EEA Supplement thereto⁷. The Authority called on interested parties to submit their comments thereon. The Icelandic authorities submitted comments on this Decision by letter dated 24 February 2005 (Event No 311243). On 20 June 2005, the Authority received comments from Íslenskt sement ehf., the purchaser of Sementsverksmiðjan hf. (Event No 323552). On 2 September 2005, Aalborg Portland Íslandi ehf. submitted further comments (Event No 333018).

The Authority requested the assistance of an independent expert, Mr. Erlend Kvaal, Associate Professor at the Norwegian School of Management BI in Oslo, to determine whether the sale of the State's shares in Sementsverksmiðjan hf. was done in accordance with the market investor principle. Based on the independent expert's first assessment of the information on the sale available to the Authority, an information request was sent to the Icelandic authorities on 12 July 2005 (Event No 326295). The Icelandic authorities replied by letter from the Icelandic Mission to the EU forwarding a letter of the Ministry of Finance dated 30 and 31 August 2005 respectively. This letter was received and registered by the Authority on 1 September 2005 (Event No 332274).

EFTA Surveillance Authority Decision No 367/06/COL of 29 November 2006 on the taking over by the Icelandic State of pension-related liabilities of Sementsverksmiðjan, not published yet.

⁶ For more detailed information on the various correspondence between the Authority and the Icelandic authorities, reference is made to the Authority's Decision to open the formal investigation procedure, Decision No 421/04/COL, published in the OJ C 117 of 19.05.2005, page 17 and following.

⁷ Published in the OJ C 117 of 19.05.2005, page 17 and following as well as in the EEA Supplement to the Official Journal of the EU No 24 of 19.05.2005.

A second information request was sent to the Icelandic authorities in the framework of the formal investigation procedure on 28 October 2005 (Event No 347691). This request was followed by a meeting in Brussels on 23 November 2005 between representatives of the Authority, the Icelandic authorities, Sementsverksmiðjan hf. and one of the investors participating in the consortium which acquired the State's shares. The independent expert engaged by the Authority attended this meeting as well.

By letter dated 6 December 2005, received and registered by the Authority on 7 December 2005 (Event No 353483), the Icelandic Mission to the EU forwarded a letter from the Ministry of Finance dated 2 December 2005, replying to the above-mentioned information request as well as to some pending issues raised during the meeting.

On 31 January 2006, the independent expert presented to the Authority his final report on whether the sale by the Icelandic State of its shares in Sementsverksmiðjan hf. had been accomplished on market terms (Event No 360438).

On 16 February, 9 March and 4 August 2006, the Authority sent letters to the Icelandic authorities requesting further information and clarifications on still unclear points (Event No 363213, 365145 and 383227). The Icelandic authorities replied with letters dated 20 February, 19 April and 25 September respectively (Event No 363608, 370425 and 390092).

On 12 October 2006 in the annual State Aid Package Meeting in Reykjavik, this case was discussed. As a follow-up to this discussion, the Icelandic authorities send a letter to the Authority on 2 November 2006 (Event No 396476).

On 29 November 2006, the Authority adopted Decision No 367/06/COL to extend the formal investigation procedure opened with the Authority's Decision No 421/04/COL. The extension relates to the taking over by the State of pension related liabilities of Sementsverksmiðjan hf. in the process of preparing the company for sale. With the current Decision, the Authority closes the formal investigation opened on the sale of the Icelandic State's shares in Sementsverksmiðjan hf. to the investors group Íslenskt sement ehf. for the price of ISK 68 million. The other elements of the formal investigation procedure remain under investigation.

2. Description of the measures assessed in the current decision

The state-owned undertaking Sementsverksmiðjan hf. had enjoyed a *de facto* monopoly in the market for cement in Iceland until the entry in 2000 of an importer of cement from Denmark. It seems that as a result of the new competitive situation, Sementsverksmiðjan hf. experienced economic difficulties and started cumulating losses. Under these circumstances, in 2003, the State decided to sell its shares in the company⁸. According to the State's announcement on the selling of the shares: *"The Executive Committee on Privatisation and the Minister of Industry intend to sell all shares currently owned by the State in Sementsverksmiðjan hf. of the nominal amount of 450.000.000 kr. to an individual or group of investors. This regards 100 % of issued stock in the company. It is expected that the purchase price will be paid with cash. An investor is seeked which is interested in*

⁸ Letter from the Icelandic authorities dated 19 August 2003, page 3.

continuing the operations of the company, strengthening it and contribute to healthy competition in the Icelandic construction market.”

On 2 October 2003, the Ministry of Industry, on behalf of the Government of Iceland, signed a Share Purchase Agreement with the investors group Íslenskt Sement ehf. On the basis of this Agreement, the State, owner of 100 % of the shares in Sementsverksmiðjan hf., sold them to Íslenskt sement ehf. for a price of ISK 68 million.

Simultaneously, a separate agreement was made between Sementsverksmiðjan hf. and the National Treasury. According to this agreement, the Icelandic State bought certain fixed and financial assets from Sementsverksmiðjan hf., which were redundant for cement production, for the price of ISK 450 million. Proceeds were used to pay outstanding debts of the company.

In addition, following Article 4 of the Share Purchase Agreement between the Government of Iceland and Íslenskt sement ehf., the Icelandic State took over pension liabilities encumbered on Sementsverksmiðjan hf. by means of an agreement between the Ministry of Finance and the Pension Fund of State Employees.

In other words, the company, the shares of which Íslenskt sement ehf. bought, was accordingly stripped for these assets and liabilities.

It is this transaction, the sale of Sementsverksmiðjan hf. to Íslenskt sement ehf., which is addressed in the current decision. The formal investigation procedure regarding the other alleged state aid measures in favour of Sementsverksmiðjan hf. initiated with Decision No 421/04/COL has been extended to cover the taking over by the State of pension-related liabilities of the company with Decision No 367/06/COL, and will be addressed in another decision.

3. Grounds for initiating the formal investigation procedure

Regarding the sale by the State of 100 % of its shares in Sementsverksmiðjan hf., in the decision to open the formal investigation procedure No 421/04/COL, the Authority questioned the applicability to the case at hand of Chapter 18B of the State Aid Guidelines on the sale by public authorities of land and buildings. The Authority considered that the State was not merely selling land and buildings which it owned but its shares in a 100 % owned undertaking.

Furthermore, the Authority had doubts whether the sale had taken place in accordance with the market investor principle. It was uncertain to what extent the State took into account other considerations beyond the mere economic return of the transaction during the negotiation process and whether, accordingly, the price obtained in the sale corresponded to the market value of the company.

With the notification of the transaction, the Icelandic authorities had presented a valuation of Sementsverksmiðjan hf. carried out by an independent expert on the basis of the liquidation value. In the decision to open the formal investigation procedure, the Authority questioned whether the value of a company in operation could be assumed to be equivalent to its liquidation value, which is based on the supposition that operations would cease. The Authority reasoned that had the market value of 100% of the State's shares in

Sementsverksmiðjan hf. been higher than the price of ISK 68 million paid by Íslenskt sement ehf., the State would have sold the company below its market price. State resources within the meaning of Article 61(1) of the EEA Agreement would have been involved, in form of foregone revenue, because the State would have obtained a lower price than a private operator, acting on market terms, would have got for the same assets.

4. Comments from the Icelandic authorities

In a letter dated 23 February 2005, the Icelandic authorities submitted their comments on the Authority's decision to open the formal investigation procedure regarding the sale of the State's shares in Sementsverksmiðjan hf.

The Icelandic authorities stressed that one of the most important reasons for the existence of the condition that cement production should continue was to raise the value of Sementsverksmiðjan hf. when selling the Company to a third party. The Icelandic authorities stated that: *“If no such condition would be applicable the costs for clearing the site would be immediate for the buyer. By imposing a condition that cement production would continue this cost remained latent. Furthermore, it should be noted that the condition was negotiated with the buyers and incorporated in the Share Purchase Agreement as solely an intention from the buyers to continue the operation of Sementsverksmiðjan hf. as long as it is economically viable. The State can not impose the buyers to run the Company if not economically viable. This can not be seen as evidence that the State took considerations beyond the economic return into account.”*

In the opinion of the Icelandic authorities, as also stated in the Authority's Guidelines, it is only where there are no objective grounds to reasonably expect that an investment gives an adequate rate of return that would be acceptable to a private investor in a comparable private enterprise operating under normal market conditions, that state aid can be involved.

The Icelandic authorities submitted that: *“In consideration of the above it can not be held that there were no objective grounds for the State to believe that the sale of Sementsverksmiðjan would not give the State an adequate rate of return. On the contrary, the State could, after negotiations with the buyers, expect a purchase price for the Company well above the market value. Hence, it must be concluded that the State did not obtain lower revenue than a private operator, acting on market terms, would have got for the same assets. The State therefore acted in accordance with the market economy investor principle. It is for the Authority to show that the State could not expect an adequate rate of return. Since this has not been shown, and in the State's opinion can not be shown, it must be concluded that the State has acted according to the market economy principle”*

In the notification of the transaction, the Icelandic authorities argued that the value of the company corresponded to its liquidation value. The liquidation value of Sementsverksmiðjan hf. had been estimated to correspond to ISK - 46.5 million without taking into account the costs of clearing the plant in Akranes. In the Decision to open the formal investigation procedure, the Authority expressed doubts as to whether the market value of a company which was sold as going concern should be determined by using the liquidation value. In their comments to the Authority's decision to open the formal investigation procedure, the Icelandic authorities furthermore referred to the cash-flow

valuations submitted to the Authority. In particular, according to the cash flow valuation provided in the annex to their letter of 23 February 2005, the market value of Sementsverksmiðjan hf. amounted to an amount of ISK – 1,5 billion. On this basis, the Icelandic authorities considered that the market value of Sementsverksmiðjan hf. as a going concern was considerably lower than its liquidation value.

The Icelandic authorities further contended that since the market value of Sementsverksmiðjan hf., whether applying a cash flow valuation or a liquidation valuation was lower than the sales price of ISK 68 million, neither Sementsverksmiðjan hf. nor Íslenskt sement ehf., had obtained any economic advantage within the meaning of Article 61(1) of the EEA Agreement.

The Icelandic authorities considered that when determining whether state aid was granted, the Authority should assess the total sales price of the company after the sale of the assets that were redundant to cement production back to the Icelandic State: *“It is further the State’s opinion that if the Authority comes to the conclusion that a [cash flow valuation] of the Company is the correct valuation for determining the sales price [...] [t]he Cash Flow method should then be used, assessing the worth of the Company after the sale of the assets.”*

The Icelandic authorities explained that the State was not prepared to negotiate a sales price corresponding to a calculated cash flow value of Sementsverksmiðjan hf. *“[B]ecause of the accumulated losses of the company since the time of tender it became clear that for the sale of the Company to the buyer it would be necessary to restructure the Company. The State would buy from the Company all assets that were not elemental to the production and operation, to lessen the operational costs and make the operation of the Company viable.”*

For the above-mentioned reasons, the Icelandic authorities considered that no state aid was involved in the transaction. However, should the Authority come to the conclusion that state aid was involved, in their opinion such state aid should be regarded as justified in accordance with the derogation provided in Article 61(3)(c) of the EEA Agreement, in particular the provisions of Chapter 16 of the State Aid Guidelines as aid for restructuring a firm in difficulty.

In a letter dated 2 November 2006, the Icelandic authorities requested the Authority to consider not closing some aspects of the existing formal investigation since *“one has to regard all the aspects of the transaction in whole in order to have a clear understanding of the matter.”*

5. Comments from third parties

5.1 Comments from Íslenskt sement ehf.

By letter dated 20 June 2005, Íslenskt sement ehf. submitted its comments to the Authority’s Decision No 421/04/COL to open the formal investigation procedure on the sale of the Icelandic State’s shares in Sementsverksmiðjan. In the opinion of Íslenskt sement ehf., no state aid was involved in the above-mentioned sale. The company stated that: *“Íslenskt Sement is convinced that the market investor principle was met, especially*

as the overall purchase price of Sementsverksmiðjan was at least equivalent, if not considerably higher, than the company's real market value in the addressed transaction."

Íslenskt sement ehf. considered that a cash flow valuation, as generally used in the valuation of cement companies, was the only fair method of valuing the company. The company alleged, however, that the Icelandic State was not willing to negotiate on this basis as it would have resulted in a negative purchase price. According to Íslenskt sement ehf., had the cash flow method been applied in the case of Sementsverksmiðjan, the estimated market value would have been zero or even negative. For this reason, Íslenskt sement ehf. considered that the value obtained by the application of the liquidation method corresponded to the maximum market value of the company at the time of purchase. Íslenskt sement ehf. further argued that the liquidation value of ISK 69.6 million did not take into account any expenses due in connection with the liquidation and closing down of operations, including the clearing of the ground. Íslenskt sement ehf. claimed that the purchase price for the shares in Sementsverksmiðjan hf. by far exceeded the company's liquidation value.

Íslenskt Sement contended that the particular assets purchased by the National Treasury were not sold individually but in connection with the sale of the shares, as an integral part of the overall purchase agreement. Therefore, *"when assessing whether state aid was involved in the sale of Sementsverksmiðjan the Authority cannot place an individual evaluation on each asset sold but has to take into account the effect of the sale of the individual assets to the overall assessment of the valuation of the company at the time of sale."*

5.2 Comments from Aalborg Portland Íslandi ehf.

By letter of 2 September 2005, Aalborg Portland Íslandi ehf. submitted comments on the Authority's Decision 421/04/COL to open the formal investigation procedure regarding the sale of the State's shares in Sementsverksmiðjan hf. The company shared the concerns and views expressed by the Authority in the said decision but also referred to the Icelandic State's taking over of Sementsverksmiðjan hf.'s pension obligations which had not been addressed in the Authority's Decision.

II APPRECIATION

1. The existence of state aid in the sale of the State's shares in Sementsverksmiðjan hf.

According to the information provided by the Icelandic authorities, the State sold its shares in Sementsverksmiðjan hf. for a price of ISK 68 million, in a transaction linked to the acquisition by the National Treasury of Iceland of some assets of the company which were not necessary for the operation of the company. Although these two elements of the transaction are closely connected, so that what Íslenskt sement ehf. bought was the operative part of Sementsverksmiðjan hf. released from assets and shares redundant to cement production, in this decision, the Authority will assess the sale of shares on its own merits. This is because the potential beneficiary of state aid in the case of the sale of the State's shares in Sementsverksmiðjan hf. would be Íslenskt sement ehf. In contrast, the potential beneficiary of any possible state aid granted in the context of the assets-liabilities restructuring of the company made by the State in connection to the sale of shares would

be the cement producer itself, i.e. Sementsverksmiðjan hf. It is from the latter that the State purchased various assets and took over pension liabilities.

Article 61(1) of the EEA Agreement provides that:

“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.”

Before assessing whether the present sale contains state aid within the meaning of Article 61 of the EEA Agreement, the Authority will address the Icelandic Government’s arguments that the presence of state aid can be excluded due to the application of Chapter 18B of the State Aid Guidelines on *“State aid elements in sales of land and buildings by public authorities”*.

1.1. Chapter 18B of the State Aid Guidelines regarding *“State aid elements in sales of land and buildings by public authorities”*.

Chapter 18B of the State Aid Guidelines *“State aid elements in sales of land and buildings by public authorities”* gives information on how the Authority interprets and applies the provisions of the EEA Agreement governing state aid when it comes to assessing sales of land and buildings by public authorities. If the procedures laid down in Chapter 18B of the Authority’s State Aid Guidelines related to public authorities’ sales of land and buildings are followed, there is a presumption that no state aid is involved in the sale.

Although the Icelandic authorities notified the terms of the transaction regarding the sale of the State’s shares in Sementsverksmiðjan hf., they held the view that the sale had taken place in accordance with Chapter 18B of the State Aid Guidelines on the sales of land and buildings. Therefore, in their opinion, no state aid had been involved in the transaction.

As already stated in the decision to open the formal investigation procedure, the Authority considers that Chapter 18B cannot be applied to the transaction at stake. The State did not merely sell land and buildings which it owned, but its shares in a 100 % owned undertaking which continues operations. Even if Chapter 18B was applicable, the procedures described to exclude the presence of state aid were not followed.

The bidding procedure followed in the case at hand did not comply with the definition foreseen under Chapter 18B.2.1(1)(b). First of all, it was not sufficiently publicised. Moreover, it only served to select a future buyer with whom the price was negotiated afterwards. Regarding the alternative procedure, i.e. the sale on the basis of an independent expert evaluation, in the case at hand, an expert, MP-verðbréf hf. established the liquidation value of Sementsverksmiðjan hf. Nevertheless, the company was sold as an on-going concern, implying that cement production would continue. In these circumstances, it cannot be presumed that the liquidation value corresponded to the market value excluding the existence of state aid without further assessment.

It seems necessary to determine which is the more appropriate method to determine the market value of a company in these circumstances and to carry out an assessment

accordingly. A further analysis of what the market price of the company could be and whether any state aid was involved in the sale of Sementsverksmiðjan hf.'s shares to Íslenskt sement ehf. is given in the following.

1.2 State aid assessment of the sale of shares

In order for a measure to be considered state aid within the meaning of Article 61(1) of the EEA Agreement, it must fulfil the following cumulative conditions:

- the aid constitutes a selective advantage,
- the aid is granted through state resources,
- the aid distorts or threatens to distort competition,
- and affects trade between the Contracting Parties to the EEA Agreement.

A selective advantage – market price

A measure which grants an advantage to certain specific beneficiaries, and which is not a general measure, fulfils the first of the conditions mentioned above. It is therefore necessary to establish whether the undertaking concerned receives an economic advantage which it would not have obtained under normal market conditions⁹. Article 61(1) of the EEA Agreement does not distinguish between state interventions by reference to their causes or their objectives but defines them by reference to their effects¹⁰. It follows that the concept of aid is an objective one, the test being whether a state measure confers an advantage on one or more particular undertakings¹¹.

The acquisition of assets for a price under their market value constitutes, in principle, an advantage. Therefore, had Íslenskt sement ehf. paid for Sementsverksmiðjan hf. a price which corresponded to the market value of the company, it would have obtained no advantage from this transaction.

In order to determine whether Íslenskt sement ehf. paid a price of the State's shares below their market value, the Authority entrusted an independent expert with the assessment of the market value of Sementsverksmiðjan hf. at the time the sale took place. The independent expert assessed the market value of the company once the whole transaction was completed, taking into account the undertaking which continues operations. This means that the independent expert assessed the market value of Sementsverksmiðjan hf. after the National Treasury of Iceland had re-purchased some assets of the company which were not necessary for cement production,¹² and the Ministry of Finance had taken over pension-related liabilities of the company. In other words, the independent expert assessed

⁹ Case C-39/94 *Syndicat français de l'Express international (SFEI) and others v La Poste and others* [1996] ECR I- 3547, paragraph 60, Case C-256/97 *DM Transport* [1999] ECR I-3913, paragraph 22, Case CT-116/01 and T-118/01 *P&O Ferries v Commission* [2003] ECR, paragraph 112.

¹⁰ Case C-56/93 *Belgium v Commission* [1996] ECR I-723, paragraph 79, and Case C-241/94 *France v Commission* [1996] ECR I-4551, paragraphs 19 and 20.

¹¹ Case T-67/94 *Ladbroke Racing v Commission* [1998] ECR II-1, paragraph 52, and Case T-46/97 *SIC v Commission* [2000] ECR II-2125, paragraph 83.

¹² As foreseen in the Share Purchase Agreement between the Government of Iceland and Íslenskt sement ehf. and accomplished on the basis of the provisions of the Purchase Contract between Sementsverksmiðjan hf. and the Treasury.

the market value of what Íslenskt sement ehf. really purchased, *i.e.* the shares in a stripped-off company.

In the opinion of the independent expert, the only method that can give an idea of what might be the fair value of the company in a transaction like the sale of the State's shares in Sementsverksmiðjan hf. is the method of discounting estimated future cash flows (value in use)¹³. The net present value of the expected cash flows from future use of a fixed asset represents the calculation of an investor for the outcome of a potential project. Cash flow projections may therefore vary with the strategies of each individual investor. Therefore, in the opinion of the independent expert, the best approach to follow was to identify a range of possible outcomes for the value in use, establishing an upper and a lower limit to the outcomes. The Icelandic authorities were asked to provide information and calculations necessary to establish these limits¹⁴ to obtain an idea of the fair value of the core activity, which is cement production. Once the operational value had been established, any asset added that did not belong to the core activity (such as any financial asset) represented an addition to the value, and any liability (such as any debt or other financial obligation) represented a reduction.

Cash flow scenarios presented by the Icelandic authorities

On this basis, upon the request made by the independent expert, the Icelandic authorities were asked to produce two scenarios, Scenario I that assumed cement imports to Iceland at 30 % of the total market, and Scenario II that assumed no import. Scenario I (so-called pessimistic scenario) produced a negative net present value (hereinafter: NPV) of future free cash flows of approximately ISK 1000 million, and Scenario II (so-called optimistic scenario) a positive NPV of future free cash flows of approximately ISK 200 million. Adjusting the NPV measures by subtracting long-term debt and adding excess net current assets, the Icelandic government arrived at estimated equity values of ISK - 897 million for Scenario I, and ISK 307 million for Scenario II. Capacity utilisation was decisive for the variation in outcome. Variable production cost per ton were estimated to amount to ISK 5.749 in years with full capacity utilisation (130.000 tons) to ISK 7.479 in years with very low capacity utilisation (70.000 tons). There was therefore a double economy of scale effect in the calculation, since both variable and by definition fixed costs per ton decrease with the higher volume produced¹⁵.

In the accompanying letter, the Icelandic authorities argued that the optimistic scenario was not realistic, because it assumed no competition in the Icelandic cement market. In view of the investments in facilities by the Danish competitor Aalborg Portland, it was considered unlikely that competition would cease in the Icelandic cement market. The Icelandic authorities did not comment upon the realism of the most pessimistic scenario.

The expert criticised that a high discount rate (which included a risk premium) had been used in the models presented by the Icelandic authorities. A high discount rate may underestimate the liability that followed from negative cash flows and thus embellish the prospects unduly. Notwithstanding this criticism, for consistency reasons, the real discount

¹³ Expert's report, page 2.

¹⁴ The Authority's letter of 12 July 2005.

¹⁵ Expert's report, page 8.

rate of 12.4% suggested by the Icelandic authorities has been used throughout the analysis in the different scenarios proposed.

Reformulating the pessimistic scenario

Scenario I showed an undertaking making continuous losses over a period of thirty years, which seems wholly irrational. Considering that the intention pursued by the independent expert with the establishment of a pessimistic scenario was to determine a lower limit for possible outcomes, Scenario I presented by the Icelandic authorities was clearly inadequate¹⁶. Any rational investment decision is based on an expectation of a positive return. The question arises of how a rational investor would react if the expected positive return does not materialise. A common behaviour in such cases would be to minimise losses in the light of revised expectations.

Accordingly, the independent expert reformulated the pessimistic scenario on the assumption of five years time frame with low capacity utilisation (82.000 tons per year, equal to the average of Scenario I), low sales prices maintained at the level of 2003 (ISK 7.071 per ton), and assuming that the company would be liquidated after five years of operations. It was further assumed that all negative cash flows are carried on to the owners. According to the expert, this seemed a reasonable strategy for the worst case scenario since any rational investment decision would be based on an expectation of a positive return and on the possibility to react if this positive return did not materialise.

A worst case scenario that would lead to the discontinuance of cement production after five years would trigger a clean up activity to be carried out immediately thereafter. According to the lease agreement signed between Sementsverksmiðjan hf. and the Town of Akranes in July 2003, “*if cement production ceases for a continuous period of 24 months, Iceland Cement Ltd. must demolish the materials storage at its own expense*”¹⁷. On the basis of the information provided by the Icelandic authorities, the clean up costs had been estimated to ISK 460 million, presumably at current prices¹⁸.

On this basis, the worst case scenario was found by simulating five years of production at low levels and cement prices maintained at 2003 levels. The net present value of related cash flows was adjusted with the assets and liabilities outside the production cycle at the purchase date. The net effect of alternative usage of the fixed assets (such as for cement importation) and the clean-up costs were added.

According to the reformulation made by the independent expert, a cash flow simulation on these premises gave a negative cash flow from operations of ISK 144 million each year during five years, and a net present value of a negative outlay of ISK 360 million in the sixth year. The discounted value of these cash flows was calculated at ISK - 691 million, and after the adjustment for balance sheet items outside the operating cycle the value of the investment was determined at ISK - 332 million.

¹⁶ Expert’s report, page 8.

¹⁷ Lease contract between the Town of Akranes and Sementsverksmiðjan hf. of 2 October 2003.

¹⁸ Expert’s report, page 9.

Reformulating the optimistic scenario

The purpose of the optimistic scenario was to establish an upper limit to the possible outcomes. The essential feature of an optimistic scenario was that operations should balance after five years. The starting point was the first operating year after privatisation, with an assumed production of 100.000 tons, a cement price of ISK 7.489, variable costs as stated in the cost formula (ISK 6.381 per ton), and overheads as assumed in scenario I (ISK 127 million). The annual cash effects of reinvestments were assumed at ISK 40, which could well exceed depreciations. On the basis of these assumptions, the net cash flow for the first year was calculated at ISK - 38 million. Subsequently, the net cash flow would gradually converge over five years towards zero in the sixth year.

The net present value of the cash flows of the first five years of operations was estimated at ISK - 59 million. Assuming that the operating profit would be close to zero thereafter, the present value of the operations in succeeding years was set to zero. In this scenario the expert assumed it was reasonable that the tax loss carry-forwards¹⁹ would not be exploited during the first years. The result of the operations was adjusted with balance sheet items outside the operating cycle (as it was done in the pessimistic scenario) and resulted in a net present value of ISK 300 million. The expert used again a discount rate of 12.4 %, as in the pessimistic scenario. He pointed out that this rate reflects the cost of equity (pre-tax) only, whereas the investment project under this scenario would normally be financed for a large part with debt, thus lowering the overall required rate of return. A lower discount rate would produce a less positive result, since the cash flows included are all negative. However, he pointed out that it was important to consistently use the same rate throughout all scenarios.

Summary

On the basis of the above-mentioned assessments, in the opinion of the independent expert, it was appropriate to determine an upper and a lower limit for fair value measurements through discounting future cash flows. The lower limit would relate to the pessimistic scenario, in which cement production was to be interrupted after some years of operation, during which the owners would become persuaded that operations would not become profitable. In addition to the drain on resources from those loss-making years, the company would have to assume clean up-costs when ending the production²⁰. On the positive side in this scenario were initial stocks and financial resources, which would give positive proceeds when liquidated, as well as alternative use of some fixed assets. On the basis of cash flow valuations, the lowest market value of Sementsverksmiðjan hf. was estimated at ISK - 322 million.

The upper limit would be established by the optimistic scenario, in which the profitability of cement production was considered to gradually improve and a break-even would be struck after some years. As in the pessimistic scenario the initial years would bring losses that drained resources from the company, albeit at a more modest level. The net present

¹⁹ An income tax loss in one year may be used to refund previously paid taxes in any of the most recent years past or may be used to reduce taxes due in any of the next years.

²⁰ As mentioned above, the mere moral obligation of the State to clean the production site in Akranes has been transformed into a legal obligation imposed on Sementsverksmiðjan hf. with the signature of the lease contracts for the land in Akranes between the company and the Township of Akranes.

value of operations after striking break-even was most likely negligible and was therefore ignored in the calculation. In this scenario too, there were positive contributions from initial stocks and financial items. On the basis of cash flow valuations, the highest market value of Sementsverksmiðjan hf. was estimated at ISK 300 million.

The cash flow calculations therefore suggested a fair value interval rather symmetric around zero with reasonably likely outcomes within a range of approximately \pm ISK 300 million.

Private interests

In some cases, an agreed transaction may deviate from an observable or hypothetical market value because one party to the transaction has identifiable private interests in that particular transaction. In the opinion of the expert, in the acquisition of the State's shares in Sementsverksmiðjan hf. by Íslenskt sement ehf. there were clearly private interests involved, which may have influenced the transaction price.

Íslenskt sement ehf. was a consortium of three companies created for the acquisition of the State's shares in Sementsverksmiðjan hf.: BM Valla, Björgun and Norcem. BM Valla is a major construction firm in Iceland and a large buyer of cement. According to the information provided in the meeting between representatives of the Authority, the independent expert and representatives of the Icelandic authorities and Íslenskt sement ehf., BM Valla has two strategic interests in the Icelandic cement plant. One is to ensure that cement supply in the Icelandic market will not be dominated by one single supplier. The second interest is to maintain local product development and competence, to the long-term benefit of the construction industry, in particular, taking into account the technical specificities of the Icelandic cement market.

Björgun is the supplier of shell sand to Sementsverksmiðjan hf. If local cement production ceases, Björgun would have no alternative outlet for its products.

Norcem is a Norwegian cement producer, owned by the German group Heidelberger Zement. Norcem may have strategic and competitive interests in strengthening its presence in the Icelandic market.

In light of the specific circumstances of the consortium of buyers, in this case, the independent expert considers that the agreed exchange price has been influenced by the existence of private interests.

For these reasons, the independent expert concluded that²¹ *“although I find the agreed price of 68 m ISK rather on the high side, there may be elements of the situation of the owners that increase the probability of recovery of the investment cost”*.

The Authority has assessed the facts and figures presented by the Icelandic authorities and carefully scrutinised the assessment and the report presented by the independent expert. The Authority has found the analysis of the expert to represent a fair way to establish the value of Sementsverksmiðjan hf. As already indicated in the Decision to open the formal investigation procedure Decision No 421/04/COL, one cannot assume that the liquidation

²¹ Expert's report, page 13.

value of a company that is foreseen to continue operations represents the market value of the company. In line with the view of the independent expert, the Authority considers that a discounted cash flow analysis is an appropriate way to calculate the value of an undertaking as the one in the case at hand. The Authority reckons, however, that an assessment of the value of the company at the time of the transaction is obviously liable to considerable uncertainty. Therefore, in the view of the Authority, for the purpose of estimating the value of a company it appears reasonable to study different scenarios, as the expert did, to establish a range within which it would be justified to assume the value to be found. The sales price of the State's shares in Sementsverksmiðjan hf. was within the established range and even above the middle value of approximately zero.

Moreover, the Icelandic authorities had determined that the liquidation value of the company corresponded to ISK 69.6 million. An agreement between the Township of Akranes and Sementsverksmiðjan hf. dated 31 July 2003 states that: "*if clinker production ceases for a continuous period of 24 months, Iceland Cement Ltd must demolish the materials storage at its own expense*". Thus, the liquidation value of Sementsverksmiðjan hf. was lower than ISK 69.6 million because the costs of demolishing the materials storage, as laid down in the above-mentioned legal agreement, would have to be added²². Thus, the price that Íslenskt sement ehf. paid for the State's shares in Sementsverksmiðjan hf. was higher than the liquidation value of the company.

2. Conclusion

On the basis of these considerations, the Authority cannot conclude that the company was sold under market value. Therefore, the Authority cannot conclude that Íslenskt sement ehf., as the company founded by the investors group to purchase the State's shares in Sementsverksmiðjan hf., obtained an economic advantage within the meaning of Article 61(1) of the EEA Agreement.

According to Article 61(1) of the EEA Agreement, four cumulative conditions must be fulfilled in order for a measure to constitute state aid. On the basis of the foregoing assessment, the Authority has not found reasons to investigate any of the other three conditions listed above for a measure to constitute state aid. As Íslenskt sement ehf. has not received any advantage, the Authority considers that the sale of the State's shares in Sementsverksmiðjan hf. to the group of investors Íslenskt sement ehf. does not constitute state aid within the meaning of Article 61(1) of the EEA Agreement.

The adoption of this Decision to close the investigation on the sale of the State's shares to Íslenskt sement ehf. for the price of ISK 68 million, part of the formal investigation opened with Authority's Decision No 421/04/COL and extended with Decision No 367/06/COL, does not prejudice the outcome of the remainder of the investigation.

²² In the assessment of the liquidation value carried out by MP Verdbref in March 2003, the costs associated with tearing down and cleaning the factory plant (buildings and machinery) were estimated at ISK 460 million. Even if this figure should not be absolutely correct, it gives an idea that there is an encumbrances on Sementsverksmiðjan which can diminish the estimated liquidation value considerably.

HAS ADOPTED THIS DECISION:

Article 1

The EFTA Surveillance Authority considers that the sale by the Icelandic State of its shares in Sementsverksmiðjan hf. to Íslenskt sement ehf. for a price of ISK 68 million does not constitute state aid within the meaning of Article 61 of the EEA Agreement.

Article 2

This Decision is addressed to the Republic of Iceland.

Article 3

Only the English version is authentic.

Done at Brussels, 29 November 2006

For the EFTA Surveillance Authority,

Bjørn T. Grydeland
President

Kristján A. Stefánsson
College Member