



EFTA SURVEILLANCE AUTHORITY

Doc. No. 98-1960-I
Dec. No. 174/98/COL
Ref. No. SAM030.97.008

EFTA SURVEILLANCE AUTHORITY DECISION

of 8 July 1998

on public involvement in agreements
concerning the construction and operation of
an aluminium smelter at *Grundartangi* (Iceland)

THE EFTA SURVEILLANCE AUTHORITY,

Having regard to the Agreement on the European Economic Area¹, in particular to Protocol 26 and to Articles 61 to 63 of the Agreement,

Having regard to the Agreement between the EFTA States on the establishment of a Surveillance Authority and a Court of Justice², in particular to Article 24 and Article 1 of Protocol 3 thereof,

WHEREAS:

I. FACTS

1. Correspondence

By letter from the Ministry of Finance of 22 June 1997, received and registered by the Authority on 1 July 1997 (Doc. No. 97-4636-A), the Icelandic authorities notified, pursuant to Article 1(3) of Protocol 3 of the Surveillance and Court Agreement, certain financing and tax measures concerning the construction and operation of a new aluminium smelter at *Grundartangi*.

However, the Icelandic authorities clearly stated that they did not consider the arrangements concerned to contain State aid within the meaning of Article 61(1) of the EEA Agreement. In view of the financial interests involved and the importance of

¹ Hereinafter referred to as the EEA Agreement.

² Hereinafter referred to as the Surveillance and Court Agreement.

eliminating uncertainty, they nevertheless considered it prudent to notify their involvement to the EFTA Surveillance Authority.

By letter of 14 July 1997 (Doc. No. 97-4922-D), the EFTA Surveillance Authority requested certain additional information. The Icelandic authorities responded to this request with a letter by the Ministry of Finance dated 26 September 1997, received and registered at the Authority on 6 October 1997 (Doc. No. 97-6305-A).

The case was discussed in a meeting in Reykjavík on 11 December 1997, where the Authority's representatives requested certain additional information. The Icelandic authorities responded to that request by telefax of 11 February 1998 from the Ministry of Industry (Doc. No. 98-826-A). A further meeting was held in Reykjavík on 8 April 1998, following which the Authority received certain additional information by telefaxes from the Ministry of Industry of 17 April (Doc. No. 98-2490-A) and 18 April 1998 (Doc. No. 98-2506-A). Supplementary information was also received by telefax from the Ministry of Industry of 26 June 1998 (Doc. No. 98-4368-A).

2. Substance

2.1 Background

By Act No 62/1997 of 27 May 1997, the Minister of Industry was authorised to enter into agreements on behalf of the Government of Iceland with a limited liability company to be incorporated under Icelandic law, later named *Norðurál hf.* (Nordic Aluminium Ltd.), and its founder, the American company Columbia Ventures Corporation, on an aluminium smelter to be constructed and operated at *Grundartangi*. The agreements with the Icelandic authorities were signed on 7 August 1997.

The smelter will be a relatively small one, with an annual production capacity of 60.000 tonnes, with the possibility of extension at a later stage. Total investment costs and their breakdown into different cost categories are as follows:

Site preparation costs	USD 8,2 million
Buildings	- 24,0 -
Machinery	- 81,0 -
Harbour facilities	- 15,0 -
Other costs	- 51,3 -

Total investment costs	USD 179,5 million

Apart from 'cost contingency' (USD 8,9 million) and anode facility investment (USD 6,3 million), the category 'other costs' consists of construction engineering costs and other miscellaneous preparatory costs. It also includes USD 7,9 million in the form of capitalised interest on long term loans.

Construction work started in the summer of 1997, and the factory is currently commencing production.

According to the operating plan of 60.000 tonnes per year, the number of employees with *Norðurál hf.* will be approximately 130 and its annual turnover is estimated to be about USD 76 million.

The agreements in question are the following:

- (1) Smelter Site Agreement
- (2) Harbour Agreement
- (3) Investment Agreement
- (4) Power Contract

According to the Icelandic authorities, certain provisions in the three first mentioned agreements contain financial arrangements involving the Government or the local authorities that might be considered as constituting State aid in the meaning of Article 61(1) of the EEA Agreement, although this is not the view of the Icelandic authorities.

The objective of the Icelandic authorities' engagement in these agreements is *inter alia* to enhance economic activity in the '*Vesturland*' region which, according to the EFTA Surveillance Authority decision of 28 August 1996 on the map of assisted areas in Iceland, is an area eligible for regional aid.

2.2 *Provisions relevant for examination under State aid rules*

According to the notification, State aid could possibly be contained in:

- a) Lease of land and loan for site development as provided for in the Smelter Site Agreement.
- b) Loan for harbour installations as provided for in the Harbour Agreement.
- c) Tax measures as provided for in the Investment Agreement.

a) *Smelter Site Agreement*

This is an agreement between the State Treasury of Iceland and *Norðurál hf.* According to the Agreement, a State owned land of 82,2 hectares is leased to the smelter company. The rent is USD 15.000 per year. The amount is fixed for the first 23 years. The rent is subsequently connected to the price of aluminium and changes according to variations in the world market prices of aluminium relative to USD 1650 per tonne. In order to provide a sufficient site for the aluminium smelter, the State purchased land from two farms with land adjacent to the land already owned by the State at *Grundartangi*. 122 hectares of land were purchased for ISK 16,8 million, and 9,1 hectares of land were purchased for ISK 2 million. The site leased to *Norðurál hf.* is 82,2 hectares. It consists of a part of the land purchased from the two farms and of land owned by the State since 1975.

According to the Agreement, *Norðurál hf.* shall undertake all necessary site preparations. However, the site infrastructure will be owned, financed and provided by the Treasury. The Treasury will pay to *Norðurál hf.*, in four equal instalments, an

amount not exceeding USD 7 million to cover its site preparation cost. It is foreseen that the financing will be in the form of loans taken by the Treasury. The smelter company in other words has the role of a contractor with respect to the site preparation. The smelter company shall reimburse to the State the site preparation costs, with interest, over a period of 23 years. The repayment shall be made in equal quarterly payments over a period of 20 years beginning 1 July 2000. The interest rate to be used for this purpose shall be the same as the interest on the loans to be taken by the Treasury to finance the project, with an additional fee of 0,35% to cover administrative and state guarantee fee costs.

The Icelandic authorities consider that no “soft loan” is given to the smelter company in this connection, as the company will repay the State the full cost of the site preparation. They therefore consider that the financing arrangement for the site preparation costs does not involve State aid.

b) *Harbour Agreement*

This agreement is between the *Grundartangi* Harbour Fund and *Norðurál hf.* According to the Agreement the smelter company is entitled to use the *Grundartangi* Harbour. The Harbour is owned and operated by *Grundartangi* Harbour Fund. The Harbour Agreement stipulates that the smelter company will use the harbour for import and export and pay harbour dues based on the general Harbour Tariff for Icelandic harbours, with the normal discount for this size of harbour user. The Harbour is operated on a profit basis without any official subsidies.

The Harbour Agreement furthermore enables the smelter company to install special equipment on the harbour premises. This equipment will be owned and operated by the smelter company.

In order to facilitate the installation of the special equipment, the Harbour Fund will lend the smelter company an amount of max. USD 3 million for the financing of the installation cost. The Harbour Fund will take state guaranteed loans of the same amount.

The smelter company will repay the loan to the Harbour Fund in twelve years from 1 July 2000. The repayment shall cover the principal of the loan and interests equal to the interests of the loan taken by the Harbour Fund with an additional fee of 0,35%.

c) *Investment Agreement*

The Investment Agreement is between the Government of Iceland on the one hand and Columbia Ventures Corporation and its subsidiary, *Norðurál hf.*, on the other. It provides for a special tax treatment with derogations from the general rules. According to the Icelandic authorities, the derogations are partly to the advantage of the smelter company and partly to its disadvantage, but on the whole the tax measures were meant to be neutral in the sense that they should not affect the total tax liability of the smelter company.

The tax measures in question are:

1. According to the current tax legislation in Iceland, limited companies are entitled to deduct from taxable income dividends up to 7% of the nominal value of the shares. However, according to the Investment Agreement, this option will not be available to the smelter company.
2. Dividends paid by the smelter company to shareholders resident in an OECD country are exempted from withholding tax.
3. The smelter company is entitled to allocate tax free profits, up to 4% of the nominal value of the shares, in a special investment account.
4. The smelter company is exempted from net worth tax.
5. The smelter company is exempted from paying certain turnover charges, namely the Industrial Loan Fund charge, the industrial charge, and the market charge.
6. Stamp duties on loans and purchase contracts registered in Iceland are reduced from 1,5% to 0,15%. Shares and loans for refinancing are exempted from stamp duties.
7. Instead of the standard formula for municipal property tax, the smelter company will pay a property tax to the municipalities calculated as 0,75% of ISK 2.393 million, which is the estimated value of buildings and other production facilities. The amount of the tax will be linked to the building cost index.
8. The smelter company is exempted from paying the so-called street connection fee.
9. The smelter company shall pay a building licence fee in the amount of USD 100.000 and zoning fee in the amount of USD 30.000. These amounts are determined so as to cover the costs of the competent surveillance bodies.

The above tax measures are valid for the initial period covered by the Investment Agreement, which is 20 years. However, as from the year 2000, the company has the option to be taxed in accordance with the existing Icelandic tax law.

Further details of the tax measures will be given below, where they will be assessed in relation to the relevant State aid rules.

d) *Power Contract*

The Power Contract is between The National Power Company ('*Landsvirkjun*') and *Norðurál hf.* Although the Power Contract is not referred to in the notification as possibly involving elements of State aid, the Authority has found it appropriate to examine certain basic aspects in this respect, cf. section II.1.d) below, where the relevant facts are set out.

II. APPRECIATION

1. The presence of State aid

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.”

This implies that for a measure to constitute State aid within the meaning of Article 61(1) EEA it must:

1. be granted through State resources;
2. distort or threaten to distort competition by favouring certain undertakings or the production of certain goods;
3. affect trade between Contracting Parties.

The measures presently to be examined all involve the use of State or municipal resources. It is established case law³ that the use of municipal resources is also considered to fall within the notion of aid granted “through State resources” in the meaning of Article 61(1) EEA. The first condition is therefore fulfilled for all the measures considered in the present decision, if they are found to contain aid elements.

Norðurál hf. will produce primary aluminium for export from Iceland, including to other EEA countries. Primary aluminium is a product extensively traded within the EEA and in world markets. Any financial benefits provided by public authorities to producers of primary aluminium, such as *Norðurál hf.*, are therefore liable to affect trade between the Contracting Parties to the EEA Agreement. The third condition would therefore evidently be fulfilled in the present case.

As to the second condition, it is obvious that in so far as the measures may establish a preferential treatment, the beneficiary would be a certain undertaking, namely *Norðurál hf.* However, a further examination is called for of the individual measures covered by the above agreements, in order to determine whether and to what extent they imply that the smelter company is ‘favoured’, and thus to identify and quantify possible elements of State aid.

a) and b) *Lease for the smelter site, loan for site development and for harbour installations*

³ See e.g. Case 248/84 *Federal Republic of Germany v Commission of the European Communities*.

In order to provide a sufficient site for the aluminium smelter, the State purchased land from two farms with land adjacent to the land already owned by the State at *Grundartangi*. Together, 131,1 hectares of land were purchased for ISK 18,8 million. Of this land and the land already owned by the State, 82,2 hectares are leased to the smelter company. The rent is USD 15.000 per year. The amount is fixed for the first 23 years (July 1997 - July 2020). Subsequently the rent is connected to the price of aluminium and changes according to variations in the world market prices of aluminium relative to USD 1650 per tonne.

According to the Authority's calculations (cf. Table 1 annexed to this decision), the present value of rent payments by the smelter company during the 23 year term of the Smelter Site Agreement is approx. USD 166 thousand. The State's acquisition costs are estimated, on a pro-rata basis, to be approx. USD 161,5 thousand. The rent is therefore considered to adequately reflect the State's acquisition costs for the land and not to involve any element of State aid.

As has been explained above, site preparation costs of up to USD 7 million will be financed by the State Treasury, which will be the owner of the site infrastructure. The smelter company will effectively repay the State Treasury the principal of the loans which it intended to take for this purpose with interest over a period of 23 years, according to a certain repayment schedule (equal quarterly payments over a period of 20 years beginning 1 July 2000). The interest rate to be used for this purpose shall correspond to the rate on the loan to be taken by the Treasury plus an additional fee of 0,35%. The precise figure for the interest rate has not yet been determined.

It shall be noted that as for financing of the site preparation cost, the State is not directly granting loans to the company, but leasing to it the smelter site in a prepared state. However, in view of the circumstances in the present case, *inter alia* the specialised nature of the site infrastructure (no immediate alternative user) and the fact that the rental fee to be paid for it by the smelter company is linked to the State's borrowing costs, the arrangement is considered comparable to the State providing a loan of USD 7 million to *Norðurál hf.*⁴

The arrangement agreed upon with regard to financing the investments in harbour installations - which will be owned by *Norðurál hf.* - is that the *Grundartangi* Harbour Fund will take two sequential loans in the amount of USD 3 million, with a total repayment period of 15 years. The principal and interest shall be paid by *Norðurál hf.* in equal quarterly payments over a period of ten years beginning 1 July 2000. The interest payable on the loans shall be the same as the interest on the loans taken by the Harbour Fund with an additional fee of 0,35%. According to latest available information from the Icelandic authorities, this loan had not yet been taken in June 1998. However, given that the State will guarantee the loan, it is assumed here that the borrowing terms will correspond to those enjoyed by the State for similar loans.

⁴ It shall furthermore be noted that according to information from the Icelandic authorities, the Treasury disbursed to *Norðurál hf.* in 1997 half of the above amount of USD 7 million and the remainder is expected to be disbursed in 1998, without any corresponding loans being taken to cover this expenditure. However, what is material to the present assessment is not the means chosen by the Treasury to finance its involvement in the project, but the terms on which it has agreed to make funding available to *Norðurál hf.*

Due to its financial strength, the State normally enjoys more favourable borrowing terms than private enterprises, as credit markets typically perceive the risk of lending to private enterprises as being higher than when the State is the borrower⁵. The expectations of the Icelandic authorities may of course turn out to be right, with the loans being fully paid back to the State, including the stipulated interest, in which case there would be no net cost to the State. However, the Authority cannot overlook the fact that any lending activity involves an element of risk. The Authority considers that credit markets normally provide the best available measurements of such risks. Accordingly, the answer to the question whether lending by the Icelandic authorities to *Norðurál hf.* favours that undertaking within the meaning of Article 61(1) of the EEA Agreement, depends on whether the credit terms offered are more favourable than those which the company could obtain on the market.

The loans in question are effectively granted in favour of *Norðurál hf.*, and are without any formal backing by the mother company, Columbia Ventures Corporation. *Norðurál hf.* is a new company established in the context of the investment project at *Grundartangi*. Thus, *Norðurál hf.* does not itself have a track record on the credit market. However, having examined the relevant provisions of the Site Preparation Agreement and the Harbour Agreement, the Authority considers that the Icelandic authorities' right to receive reimbursement of the loans is relatively well secured.

Under these circumstances, and in the absence of any better information on the risks involved, the Authority considers that the borrowing terms of the investor in the main financing package for the aluminium smelter at *Grundartangi* can be taken as a proxy to indicate how the market would perceive the risk of providing the financing in question.

Following a request by the Authority, the Icelandic authorities have informed that the interest rates on the main loan taken by the investor for financing the project at *Grundartangi* are variable and depend on a number of factors, but on average the interest rate is estimated to be 1,2 - 1,8 percentage points over LIBOR.

According to information available to the Authority, interest rates on long-term loans in US Dollars which the Icelandic Treasury has taken recently have typically been close to or even 5-10 basis points (0,05 - 0,10%) below LIBOR when account has been taken of the procurement costs.

The precise conclusion to be drawn from the above parameters is subject to a certain degree of uncertainty, due to limitations of the available information and to difficulties in comparing interest rates applicable in different kinds of credit arrangements. However, taking into account the fact that the smelter company will pay interest on the loans equivalent to the State's borrowing costs with an additional fee of 0,35%, and also considering that the repayment periods of the financing provided by the

⁵ In circumstances where the relevant State has a low credit rating and the company concerned, by virtue of its size, solid financial position and active presence in capital markets, is able to raise credit on the finest terms available, this presumption may not be justified. However, such circumstances are not relevant in the present case.

Icelandic authorities is relatively long (23 years for site preparation costs and 15 years for harbour installations) it is estimated that the loans will involve an interest subsidy of 1,15% percentage points. According to the Authority's calculations, the cash grant equivalent of that interest subsidy is USD 802 thousand for the financing of the site preparation costs (cf. table 2), and USD 263 thousand for the loan to finance harbour installations (cf. table 3), or combined approximately USD 1,1 million⁶.

c) Tax measures (Investment Agreement)

The Investment Agreement provides for a number of derogations from the general rules of Icelandic tax legislation. The Icelandic authorities have argued that these derogations are partly to the advantage of the smelter company and partly to its disadvantage, and that on the whole, the tax measures are meant to be neutral and not to affect the smelter company's overall tax liability.

The Authority can in this case accept the approach that individual deviations from the standard tax rules, which increase the company's tax burden, should be counted against those which reduce it. In other words, what matters here is the overall effect of the Investment Agreement on the net tax liability of the smelter company over time. However, this effect must be evaluated in present value terms.

Following a request by the Authority, the Icelandic authorities have provided calculations, covering the contract period of 20 years, showing estimated present value of tax revenues based on the standard tax rules on the one hand and on the other hand the specific rules established by the Investment Agreement. These calculations are in turn based on a simulation over the 20 year period of *Norðurál's* operating statement and balance sheet, given a certain set of assumptions on main operating parameters. The main result of these calculations by the Icelandic authorities is that when calculated according to the specific rules in the Investment Agreement, using the price of aluminium of USD 1650 per tonne and the current reference rate of interest for Iceland of 7,6%, the present value of tax revenues is USD 30,4 million, while a calculation based on the standard tax rules gives a little lower present value of USD 29,9 million. The operating results and hence the tax payments of *Norðurál hf.* will obviously be highly dependent on the price of aluminium. Calculations have therefore been made assuming prices of aluminium may range from USD 1450 to USD 1850 per tonne. However, these variations do not lead to significant deviations in the present value of tax payments under the two alternative tax regimes. Only aluminium prices below USD 1600 will, according to the Icelandic authorities' calculations, result in tax payments pursuant to the Investment Agreement becoming slightly lower than under the standard tax rules.

While the Authority can, in principle, accept for the most part the premises of the calculations referred to above, adjustments need to be made concerning certain

⁶ Given the volatility of market interest rates, the actual level of the relevant interest rates for these calculations is *inter alia* dependent on when the loans would actually be taken. However, the precise level of the rates is not significant here, but rather the fact that according to the Smelter Site Agreement and the Harbour Agreement, *Norðurál hf.* is entitled to loans at interest rates only 0,35% above the State's borrowing costs.

elements. Furthermore, as the income and expenditure streams of *Norðurál hf.* are presented in USD and not in Icelandic *krónur*, the Authority will for discounting purposes use an interest rate of 7,2%⁷ rather than the current reference rate of interest for Iceland.

The Authority's assessment of the individual tax provisions of the Investment Agreement is set out point-by-point below, in the same order as they have been listed above. The relevant calculations are summarized in Table 4 annexed to this decision. The headings of the columns in the table refer to the following paragraph numbers.

1. Absence of right to deduct dividend payments from taxable income.

According to the tax legislation in Iceland, limited companies have been entitled to deduct from taxable income dividend payments up to 7% of the nominal value of shares⁸. However, according to the Investment Agreement, this deduction shall not be available to *Norðurál hf.*

The Icelandic authorities consider that this derogation will increase the yearly tax liabilities of the smelter company by approximately 2,3% of the nominal value of the shares.

In the circumstances of the present case, the Authority can accept the claim by the Icelandic authorities, that this more restrictive rule should be counted against those deviations from the standard tax rules, which are more favourable to the smelter company. This acceptance is reflected in the estimates of tax payments in Table 4, column (1)&(3).

2. Exemption from withholding tax on dividend income.

According to the Icelandic tax legislation, a withholding tax is applicable to dividends paid by companies resident in Iceland to non-resident shareholders. The tax rate is 28,78% in the case of individual shareholders and 20% in case of

⁷ In determining the specific USD reference rate in this case, the Authority has taken account of the method currently used by the EC Commission for setting the reference and discount rate of interest (cf. Commission notice published in OJ No C 273, on 9 September 1997). According to this method the Commission currently sets the reference rates for the EU Member States as equal to five-year interbank swap rates (average recorded in September, October and November of the previous year), plus a premium, which is 75 basis points for all Member States except Italy, Portugal and Greece. Instead of an interbank swap rate, which is not quoted for the US dollar in comparable form, the Authority has taken as a basic point of reference the average yield on 5 year government bonds. In countries with well developed financial markets, these two rates are closely interrelated, the interbank swap rate usually exceeding the 5-year government bond yield by 10-40 basis points. In view of this the Authority has taken as a basis the yield on 5-year US Treasury notes. In the period September - November 1996, the average yield on 5-year US Treasury notes was 6,2%; this coincides with the average yield in August 1997 (when the agreements between *Norðurál hf.* and the Icelandic authorities were finalised). A premium of 100 basis points (1 percentage point) was added, resulting in a notional USD reference rate of 7,2%.

⁸ In the parliamentary session 1997-98, the Government presented a bill to the Parliament amending *inter alia* provisions of the corporate income tax relating to tax treatment of dividends and reducing the tax rate for corporations from 33% to 30%. According to the bill, the right to deduct from taxable income dividend payments up to 7% of the nominal value of shares is to be abolished. However, these amendments to the tax legislation are not relevant for the present purposes, as the special tax rules for the smelter company are to be assessed in relation to the general rules of the Icelandic tax system prevailing when the Investment Agreement was concluded in August 1997.

corporate shareholders, unless reduced by tax treaties. As for Iceland's tax treaty with the United States (where the mother company is established), the withholding tax rates which apply to Icelandic source dividends are 5% for corporate shareholders with a minimum ownership of 10%, but 15% for other shareholders. In the present case, the relevant tax rate, from which the Investment Agreement grants an exemption, is 5%.

The Icelandic authorities submit that this exemption should not be counted, as it does not affect the tax liabilities of the smelter company, nor the after tax rate of return of shareholders in countries with double taxation treaties with Iceland, as the withholding tax would be deductible from tax liabilities in the relevant country (i.e. the United States).

The Authority's position on these matters is, firstly, that when evaluating whether and to what extent the special tax arrangement involves elements of State aid, it is appropriate to take into account not only the effect it has on the tax liability of the smelter company but also on the shareholders' tax liabilities in Iceland, i.e. the investor's total tax liability in Iceland⁹. Secondly, although it may very well be that shareholders in *Norðurál hf.* would be eligible in their home country(-ies) for a tax deduction in respect of withholding taxes paid in Iceland, this is not relevant for the present purposes. In the present assessment, the Authority simply seeks to quantify the extent to which the special tax arrangement for *Norðurál hf.* deviates from the standard rules of the Icelandic tax legislation. It cannot, in that context, take into account possible tax deductions under the tax legislation of other countries. The exemption from withholding tax on dividends will therefore be counted among items reducing overall tax liability, cf. estimates of withholding tax (under standard tax rules) set out in column (2) of Table 4 annexed to this decision. For this purpose the Authority has based its calculations on *Norðurál's* projected Operating Statement and Balance Sheet, which the Icelandic authorities have made available to it. The Operating Statement reflects the assumption that profits will mostly be paid out as dividends and not retained in the company. Should this not happen, the aid element for this item, as calculated in Table 4, is overestimated. At the same time, however, this would to a certain extent be offset by an underestimate of the aid element derived from exemption from net worth tax, cf. item 4 below.

3. The right to allocate profits to a special investment account.

The Investment Agreement grants *Norðurál hf.* a special right to allocate tax free profits, up to 4% of the nominal value of share capital, into a special internal investment account. The amounts allocated in the investment account and used for investments in depreciable assets within 6 years from the allocation, shall be added to taxable income in the investment year. Accelerated depreciation is allowed up to the same amount. Amounts in the account that

⁹ In general, a preferential tax treatment of the capital income of shareholders in a particular company can obviously favour that company by making investments in it more attractive than they would otherwise be.

have not been invested or have been offset against losses within six years from the allocation are to be added to taxable income in the relevant year.

In the opinion of the Authority, the above rule represents a possibility for tax deferral which must be taken account of and evaluated in present value terms. This is reflected in columns (1)&(3) of Table 4.

4. Exemption from net worth tax.

According to the Icelandic tax legislation, limited companies are liable for a tax of 1,2% on their net worth. According to the Investment Agreement, *Norðurál hf.* is exempted from this tax.

The tax base for the net worth tax is the total assets of the company less total liabilities and less nominal value of the shares. Hence, for a limited company, a tax base accrues only to the extent profits are retained in the company.

The above exemption should be counted amongst items reducing overall tax liabilities, as is done in column (4) of Table 4. However, given the assumptions which according to the information submitted by the Icelandic authorities have been made about the development over time of *Norðurál's* finances (projected Operating Statement and Balance Sheet), in particular the fact that it is assumed that profits will be retained in the company only to a limited extent, there would be very limited tax liability under the standard rules. Under the given assumptions, the exemption is therefore of minor significance to the investor.

5. Exemption from certain turnover-based fees.

The Investment Agreement exempts *Norðurál hf.* from the following turnover-based fees (the rates of the fees are indicated in brackets): the Industrial Loan Fund charge (0,14%), the industrial charge (0,08%) and the market charge (0,015%). However, by Act No 61/1987, on the New Business Venture Fund ('*Lög um Nýsköpunarsjóð atvinnulífsins*'), adopted on 26 May 1997, i.e. before the conclusion of the agreements with *Norðurál hf.*, the Industrial Loan Fund charge has been abolished, with effect as from 1 January 1998. That charge therefore need not be considered here. Together, the two remaining charges are 0,095% of turnover. The implication of the exemption from these charges is therefore relatively minor. It is nevertheless necessary to determine whether or not the exemption from these charges involves State aid.

According to the Icelandic authorities, the revenues from these charges are used for special purposes which were not considered to be of benefit for the smelter company, the industrial charge being a membership fee to an industrial organisation, and the market charge being used to finance export promotions of the Trade Council of Iceland.

The industrial charge is levied on the basis of state legislation, Act No 134/1993 ('*Lög um iðnaðarmálagjald*'), as amended by Act No 81/1996, on manufacturing and construction industries as well as certain service industries, as defined in the law (by reference to the Icelandic industrial classification). The only exemption to this rule are enterprises wholly or largely publicly

owned. Revenue from the charge is allocated to the Federation of Icelandic Industries, for the promotion of industrial development in Iceland. The basis for levying the charge is turnover as defined by the Act on Value-Added Tax, including turnover exempted from VAT according to §12 of the law (zero-rate activity).

The legislation establishes no direct relationship between charges paid by companies and the services which they receive. Companies are liable for the industrial charge irrespective of whether they are members of the Federation of Icelandic Industries. Membership entails a separate membership fee collected by the Federation itself.

With reference to the above facts, the Authority considers the industrial charge to represent state resources within the meaning of Article 61(1) of the EEA Agreement. Furthermore, it considers it to be in the nature of the scheme that *Norðurál hf.*, as a manufacturing company, should be liable for the industrial charge, as its position appears comparable to other manufacturing companies, whether or not members of the Federation of Icelandic Industries. The exemption must therefore be regarded as a selective derogation constituting State aid within the meaning of Article 61(1) EEA (ref. column (5) of Table 4):

The market charge is also levied on the basis of state legislation, Act No 114/1990 on the Trade Council of Iceland (*Lög um Útflutningsráð Íslands*). The charge is levied on all economic enterprises in Iceland, on the basis of turnover as defined by the VAT-legislation. All companies paying the charge are automatically affiliated with the Trade Council. The legislation does not provide for any relationship between the market charge paid by companies and the service which they receive from the Trade Council. The charge is apparently intended to finance general activities, and the Trade Council is explicitly instructed to ensure that the cost of services rendered to individual companies is largely covered by separate service charges. In view of these facts, the Authority considers that the market charge is in the nature of a general tax or parafiscal charge, and in view of its general applicability, any exemptions, such as the one granted to *Norðurál hf.*, must be considered to constitute State aid within the meaning of Article 61(1) EEA (ref. column (5) of table 4).

6. Reduction of and exemption from stamp duties.

Stamp duties are levied on various kinds of legal documents, including purchase and loan contracts, shares, leases, and deeds of sale, on the basis of Act No 36/1978.

According to the Investment Agreement, stamp duties on loan and purchase contracts are reduced from 1,5% to 0,15%. Shares and loans for refinancing are exempted from stamp duties. This exemption is clearly selective in nature, and has the effect of favouring the investor. It shall therefore be counted as an element of State aid. On the basis of available information on documents liable for stamp duties, and on the prevailing rates of stamp duties, the reduction in stamp duties has been estimated at USD 1,79 million, related to the year 1997 (cf. Table 4).

7. Special provisions on municipal property tax.

According to Act No 4/1995 on municipal taxes (*Lög um tekjustofna sveitarfélaga*), a municipal property tax shall be levied annually on all real estate property whose value is assessed by the Valuation Office of Iceland (*Fasteignamat ríkisins*). This includes all industrial real estate property. The tax base is the depreciated replacement value. Tax rates are fixed by the individual municipalities, up to a general maximum rate of 1,32% for industrial property. Municipalities are however authorised to raise the tax rate by up to 25% beyond 1,32%. According to a provisional clause, the above general maximum rate is 1,27% for 1998. In the present context, the relevant maximum rate is therefore in the order of 1,27 - 1,5875% for 1998 and 1,32 - 1,65% for the remaining years. The legislation stipulates no minimum tax rate. In practice there is variation between the rates actually applied by different municipalities. In the bigger municipalities, the rate for industrial property is typically between 1% and the maximum permissible rates (Reykjavík currently applies the maximum of 1,5875%).

Instead of the above standard formula, the smelter company will pay an annual property tax to the municipalities levied on a fixed estimated value of buildings and other taxable production facilities of ISK 2.393 million, at the rate of 0,75%. The amount of the tax will be linked to the building cost index. The tax base will not be subject to any depreciation, as is the case according to the standard rules.

The special formula provided for by the Investment Agreement represents a clear derogation from a generally applicable tax legislation. Although in practice it does not entail a substantial reduction in tax burden, in present value terms, it is nevertheless appropriate to take account of this deviation from the standard tax legislation. This item is therefore included in the calculations in column 7 of Table 4.

Given the municipalities' autonomy in fixing their rates of the municipal property tax, it is not considered appropriate for the present purposes to compare the estimated revenue for that tax according to the Investment Agreement with that derived from a benchmark rate for the country as a whole. Instead, the benchmark used is 0,935%, which corresponds to the weighted average of the rates currently applied by the two municipalities where the smelter is located, *Hvalfjarðarstrandarhreppur* (1,3%) and *Skilamannahreppur* (0,85%).

8. Exemption from street connection fee.

Street connection fees (*gatnagerðargjöld*), although levied on the basis of a general legislation (Act No 17/1996), are not in the nature of general taxes but of service charges payable to municipalities in return for street construction. Within certain upper limits defined in the legislation, municipalities enjoy wide discretion in determining the level of their street connection fees. The Icelandic authorities have informed that the municipalities concerned have no obligation to build streets on the smelter site or for the smelter company, or render other services normally covered by this fee. The Authority therefore concurs with the

Icelandic authorities that the exemption from this fee is not to be counted in the present comparison.

9. Provisions on Building Licence Fee and Zoning Fee.

These fees are both in the nature of service charges and not of generally applicable taxes or parafiscal duties. The Authority has no reason to doubt that the amounts of the fees fixed in the Investment Agreement cover the costs of the relevant surveillance bodies. This item is therefore not counted amongst potential elements of State aid.

In Table 4, calculations have been made of estimated tax payments under the two alternative tax regimes during the 20 year period of the Investment Agreement. The result is that the present value of total tax payments under the Investment Agreement is USD 41,2 million, compared to USD 46,1 million under the standard tax rules. This implies an aid element of USD 4,9 million.

d) Power Contract with the National Power Company

The Power Contract is not referred to in the notification as possibly involving elements of State aid. However, electricity is an important input in the production of aluminium, often amounting to around 30% of variable operating costs. The Authority has therefore found it appropriate to request relevant information on the Contract. On the basis of the information provided by the Icelandic authorities, the Authority has examined the basic modalities of the sale of electricity to the plant and drawn the conclusions set out below.

The Power Contract is between *Norðurál hf.* and the National Power Company (*'Landsvirkjun'*). *Landsvirkjun* is a public partnership company regulated by public law (Act No 42/1983). Its present ownership is divided among the Icelandic State (50%), the city of Reykjavík (45%) and the town of Akureyri (5%). *Landsvirkjun* produces, distributes and sells electricity at wholesale level to local public utilities and, under special agreements, to power intensive industries.

According to the law on *Landsvirkjun*, the company shall be financially independent, and it is foreseen that it shall pay dividends to its owners taking into account its financial results. The company is instructed to set its tariff so as to secure normal return on owners' capital. *Landsvirkjun* requires the approval of the Minister of Industry and Energy for concluding long-term power contracts with industrial companies using more than 100 million KWh per year. Such contracts must not result in increased prices of electricity delivered to public utilities.

The EFTA Surveillance Authority notes that the Power Contract with *Norðurál hf.* is a negotiated agreement, where the board of *Landsvirkjun* has been under the mandatory instructions reviewed above.

The EEA Agreement is neutral in the choice of national authorities between public and private ownership (cf. Article 125). At the same time, Article 59 EEA stipulates that the general rules on competition, including those on State aid, shall apply to

public undertakings, unless the exemptions provided for in the second paragraph of that Article (concerning undertakings entrusted with the operation of services of general economic interest or having the character of a revenue-producing monopoly) are applicable.

In order to determine whether and to what extent the terms of the Power Contract involve an element of State aid, the Authority considers it appropriate to apply the test of the market economy investor principle (cf. Chapter 20 of the State Aid Guidelines). This implies that a possible aid element must be assessed as the difference between the terms actually agreed upon and the terms which a private investor would find acceptable in order to undertake the investments necessary for supplying electricity to the plant, assuming that the private investor is operating under normal market economy conditions. In particular, a market economy investor normally provides finance for a project only if the present value of expected future cash flows exceeds the initial investment costs. Or, in other words, there is no State aid involved in circumstances where the State, in common with any other market economy investor, undertakes projects where the expected rate of return on the investments concerned is commensurate with a normal rate of return obtained by comparable private enterprises.

The present assessment is confined to examining public involvement in supplying *Norðurál hf.* with electricity. The Authority considers, given that the energy price in the Power Contract has been fixed in US Dollars, that the notional reference rate of interest for USD of 7,2% determined above provides an appropriate yardstick for a 'normal' rate of return.

Landsvirkjun estimated the rate of return on the investments relevant for the Power Contract to be 6,5%, and on that basis the Contract was confirmed by the Minister of Industry. Following a request by the EFTA Surveillance Authority, the Icelandic authorities have provided clarifications of the calculation methods used by *Landsvirkjun* in this context. The calculations are based on comparing on the one hand the investments necessary to meet the general increase in demand for electricity (without any new contracts with power intensive industries) and on the other hand the investments required to meet also the extra demand from the Power Contract. On the basis of detailed plans of investments in power plants and distribution network for both options, the difference in investment and operating costs over a period of 20 years has been estimated. The profitability of the Power Contract is calculated by deducting from annual sales revenue this additional investment and operating costs and taking account of estimated scrap value of the investments at the end of the 20 year period. The rate of return on the relevant investments is the discount rate which makes the sum of the present value of the difference in costs and revenue equal to zero.

It is important to note that according to the Icelandic authorities, the above estimated rate of return on investments of 6,5% has been calculated in real terms, where *Landsvirkjun*'s has assumed an annual rate of inflation of 3%. This corresponds to a nominal rate of return of 9,7%, which is well above the relevant notional reference rate of interest of 7,2%.

The increased demand for electricity resulting from the Power Contract with *Norðurál hf.* will be met by *Landsvirkjun* partly through supply from a new power plant presently under construction at *Nesjavellir*¹⁰. That plant, where electricity will be co-generated from geothermal resources, is owned and operated by the Reykjavík District Heating (*Hitaveita Reykjavíkur*), a public utility fully owned by the city of Reykjavík. The Authority has obtained information from the Icelandic authorities on the specific investment project by the Reykjavík District Heating for electricity generation at *Nesjavellir*. According to this information, the project is estimated to be profitable, yielding an expected rate of return on the relevant investments of 8% per year.

With reference to the above facts and considerations, it is concluded that the terms of the Power Contract do not involve elements of State aid.

Conclusion concerning assessment of aid elements.

With reference to the above considerations, it is concluded that the agreements considered in point a) - c) above involve certain elements of State aid corresponding in total to a grant equivalent of USD 6 million.

2. Procedural requirements

According to Article 1(3) of Protocol 3 to the Surveillance and Court Agreement, “[t]he EFTA Surveillance Authority shall be informed, in sufficient time to enable it to submit its comments, of any plans to grant or alter aid.” The last sentence of the same paragraph provides that “[t]he State concerned shall not put its proposed measures into effect until this procedure has resulted in a final decision”. In Part II of its Procedural and Substantive Rules in the Field of State Aid (State Aid Guidelines), the Authority has set out further clarifications of the procedures to be followed regarding plans to grant aid.

By letter from the Ministry of Finance of 22 June 1997, received and registered by the Authority on 1 July 1997, the Icelandic authorities notified the Authority of the above measures. However, by letter of 14 July 1997 (Doc. No. 97-4922-D) the Authority announced that it considered the notification to be incomplete and requested certain additional information. A response was received to this request on 6 October 1997.

The law authorising the Minister of Industry to enter into the agreements considered above was enacted on 27 May 1997. The agreements with Columbia Ventures Corporation and *Norðurál hf.* were concluded on 7 August 1997.

With reference to the above facts, it is clear that the measures were put into effect before the notification procedure had resulted in a decision by the Authority, and thus

¹⁰ The Power Contract foresees delivery of 837 - 930 GWh per year. The electricity power plant at *Nesjavellir* will have a capacity of 480 GWh per year. Initially, 400 GWh of that capacity will be allocated to *Landsvirkjun* for delivery to power intensive industries, but this will be gradually reduced to 200 GWh in the year 2004, as supply to the Reykjavík Electricity (*Rafmagnsveita Reykjavíkur*) utility will be increased.

that the Icelandic authorities have failed to fully respect the above procedural obligations. Hence, the aid was allocated on procedurally unlawful grounds, cf. Chapter 6 of the Authority's State Aid Guidelines.

3. Application of the relevant State aid rules

The Icelandic authorities have stated that the objective of the measures which they have taken to facilitate the project at issue is *inter alia* to enhance economic activity in the 'Vesturland' region.

The measures are limited in time to 20-23 years. Although their effect is partly to mitigate operating expenses, they are directly linked to the investment project. They are therefore considered not to be operating aid, but to represent incentives for undertaking the investment project concerned, i.e. the aid is clearly conditional on initial investment. The measures therefore fall to be assessed under the rules on regional aid, cf. Part VI of the Authority's State Aid Guidelines.

The smelter is located at *Grundartangi* on the northern side of 'Hvalfjörður', in the municipalities of 'Hvalfjarðarstrandarhreppur' and 'Skilamannahreppur'. These municipalities belong to the 'Vesturland' region (mid-western part of Iceland), which the EFTA Surveillance Authority has, by Decision No 103/96/COL of 28 August 1996 on the map of assisted areas in Iceland, found to qualify for regional aid, up to a limit of 17% NGE of eligible investment costs.

It is beyond doubt that in terms of employment and income generation, the project will make a very significant contribution to economic development in the southern part of the *Vesturland* region, which in recent years has been characterised by unemployment above the national average and slow depopulation. When the factory reaches full output, approximately 130 persons will be directly employed with *Norðurál hf.*, the majority of which are expected to come from the neighbouring municipalities within travel-to-work distance, the distance to the town of *Akranes* (approx. 5.400 inhabitants) being 16 km and 29 km to the village of *Borgarnes* (approx. 1.700 inhabitants). Further jobs are expected to be created in the area in dependent businesses.

It is also clear that the project will make a measurable positive impact on the small Icelandic national economy and help diversify its export industries. Besides the investments by *Norðurál hf.*, the project entails substantial investments in the hydro- and geothermal energy sectors. As a result of the project and related investments in the energy sector, the overall level of investment in Iceland was forecast to rise by 12% in 1997 and 21% in 1998, and GDP is expected to have grown by 1% more in 1997 than it otherwise would have done. The impact of the sharp increase in investments will fade out in 1999-2000, but at the same time the factory will commence production. The permanent increase in GDP has been estimated at 0,8%. Because of interest and dividend payments, the long-term impact on GNP is smaller, probably in the order of 0,5%.

The estimated direct investment costs for the project are USD 179,5 million. With reference to the breakdown of these costs set out above, and with the exception of capitalised interest on long term loans (USD 7,9 million), they are all considered to fall within the notion of 'initial investments', cf. para. 25(11) of the State Aid Guidelines. Total costs eligible for regional investment aid are therefore USD 171,6 million. Their present value in July 1997 is estimated at USD 168 million. Together, the aid elements identified above are estimated to correspond to a grant equivalent of USD 6 million. The estimated aid intensity is therefore 3,6%. This is well below the admissible ceiling of 17% NGE, according to the existing map of assisted areas for Iceland.

With reference to the above considerations, it is concluded that the aid elements contained in the agreements with the Icelandic authorities examined above, corresponding to 3,6% of eligible investment costs, qualify for exemption under Article 61(3)(c) of the EEA Agreement, as aid facilitating the development of certain economic areas in Iceland without adversely affecting EEA trading conditions to an extent contrary to the common interest.

HAS ADOPTED THIS DECISION:

1. The EFTA Surveillance Authority has decided not to raise objections to the financing and tax arrangement provided for by the Icelandic authorities in favour of the investment project by Columbia Ventures Corporation and its subsidiary, *Norðurl hf.*, for the construction and operation of an aluminium smelter at *Grundartangi*, Iceland, as notified by the Icelandic authorities by letters of 22 June 1997 (Doc. No. 97-4636-A) and 26 September 1997 (Doc. No. 97-6305-A), as well as by telefaxes of 11 February 1998 (Doc. No. 98-826-A), 17 April 1998 (Doc. No. 98-2490-A), 18 April 1998 (Doc. No. 98-2506-A) and 26 June 1998 (Doc. No. 98-4368-A).

Done at Brussels, 8 July 1998.

For the EFTA Surveillance Authority

Knut Almestad
President

Hannes Hafstein
College Member