

Event No: 346204
Case. No: 55362
Dec. No.: 187/05/COL

EFTA SURVEILLANCE
AUTHORITY

EFTA SURVEILLANCE AUTHORITY DECISION

OF 20 JULY 2005

ON TAX AND FEE CONCESSIONS IN FAVOUR OF THE ALUMINUM SMELTER, NORÐURÁL HF. AT GRUNDARTANGI, ICELAND

THE EFTA SURVEILLANCE AUTHORITY,

HAVING REGARD TO the Agreement on the European Economic Area¹, 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 Justice², in particular to Article 24 and Article 1 in Part I and Article 2 and 10 in Part II of Protocol 3 thereof,

HAVING REGARD TO the Authority's Guidelines³ on the application and interpretation of Articles 61 and 62 of the EEA Agreement, and in particular Chapters 17B, 25 and 26A thereof,

WHEREAS:

I. FACTS

1. Notification

By letter of 6 November 2003 from the Icelandic Mission to the European Union forwarding a letter from the Ministry of Finance dated 31 October, both received and registered by the Authority on 6 November 2003 (Doc. No: 03-7671 A), the Icelandic authorities notified, pursuant to Article 1(3) in Part I of Protocol 3 to the Surveillance and Court Agreement, amendments to legislation enabling the grant of state aid by means of tax and fee concessions for the financing of an expansion of the aluminium smelter, Norðurál hf., at Grundartangi, Iceland which increase its capacity from 90,000 to 260,000 tonnes per annum (with the possibility of increasing the capacity

¹ Hereinafter referred to as the EEA Agreement.

² Hereinafter referred to as the Surveillance and Court Agreement.

³ Procedural and Substantive Rules in the Field of State Aid - 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 17.06.2005.

even further up to 300,000 tonnes per annum by increasing potline output).⁴ By the same letter the Authority has become aware of a previous expansion of the aluminium smelter, Norðurál hf. which took place in 2000-2001 and which increased the capacity of the smelter from 60,000 to 90,000 tonnes per annum.

In the letter dated 31 October 2003 the Icelandic authorities stated that further information would still be forthcoming in relation to the power contracts (for the supply of power to Norðurál hf. after the notified expansion) as well as in respect of other issues, which would be submitted as soon as it would be available in order to complete the notification.

By letter of 18 May 2004 (Event no: 281687), forwarding a letter from the Ministry of Finance dated 14 May 2004, both received and registered by the Authority on 19 May 2004, the Icelandic authorities submitted part of such supplementing information. By letter dated 8 July 2004 (Event no: 287358), forwarding a letter from the Ministry of Finance dated 1 July 2004, both received and registered by the Authority on 8 July 2004, the Icelandic authorities forwarded yet further information in order to complete the notification.

By letter dated 8 September 2004 (Event: 289638), the Authority acknowledged the receipt of the notification and supplementing information and requested the Icelandic authorities to submit additional information and to clarify certain issues. The Icelandic authorities sent a response in a letter, enclosed in an e-mail from the Icelandic Mission to the European Union, dated 22 September 2004, forwarding a letter from the Ministry of Finance, dated 21 September 2004, received and registered by the Authority on 22 September 2004 (Event no: 293453).

The Authority requested further information from the Icelandic authorities by letters dated 3 and 26 November 2004 (Events Nos: 295505 and 299411) in response to which the Icelandic Mission to the European Union sent a letter dated 8 December 2004, forwarding two letters from the Ministry of Finance dated 8 December 2004, both received and registered by the Authority on 10 December 2004 (Event No: 302659).

The Authority requested yet further information from the Icelandic authorities by letter dated 16 December 2004 (Event No: 302307). The response was enclosed in a letter from the Icelandic Mission to the European Union, dated 17 January 2005, forwarding a letter from the Ministry of Finance dated 17 January 2005 (Event No: 305609), both received and registered by the Authority on 18 January 2005.

Following a meeting between the Icelandic authorities and the Competition and State Aid Directorate of the Authority (“CSA”), the Icelandic authorities submitted further information in a letter, dated 22 March 2005 from the Ministry of Finance, forwarded by the Icelandic Mission to the European Union on 22 March 2005 (Event No: 316081).

Subsequently, the Authority introduced the procedure for reviewing existing aid under Article 17 in Part II of Protocol 3 to the Surveillance and Court Agreement. On 1 June 2005 the Authority issued a decision, proposing appropriate measures to the Icelandic authorities in order to ensure compatibility with the functioning of the EEA

⁴ In actual fact the letter dated 31 October 2003 notified an expansion with a capacity up to 240,000 tonnes per annum, but the Icelandic authorities have subsequently informed the Authority that the expansion would increase the capacity up to 260,000 tonnes per annum.

Agreement. By letter dated 15 July 2005 (Event No: 326984) the Icelandic authorities accepted the appropriate measures proposed by the Authority.

2. Background

2.1 The aid scheme approved in the context of the original construction of Norðurál hf.

The background for the state aid measures considered in the present decision is the Authority's decision, taken on 8 July 1998, concerning the grant of state aid for the construction and operation of an aluminium smelter, Norðurál hf. at Grundartangi, Iceland with a capacity of 60,000 tonnes per annum (Decision No. 174/98/COL). In this decision (hereinafter referred to as the "Grundartangi Decision" or the "Decision") the Authority approved aid measures for the grant of state aid, by means of derogations from various statutory tax and fee provisions to the establishment of Norðurál hf. The approval was granted with reference to the rules in the State Aid Guidelines on regional state aid. The aid measures approved in the Grundartangi decision were subsequently considered by the Authority to constitute an aid scheme (hereinafter the "Grundartangi Aid Scheme") in the decision proposing appropriate measures adopted by the Authority on 1 June 2005.

It appears from the Grundartangi Decision that the provisions allowing for the relevant derogations from statutory Icelandic tax and fee legislation (which were approved by the Authority) are laid down both in (i) Act No. 62/27 May 1997 on Enablement to Enter into agreements on an Aluminium Smelter at Grundartangi (hereinafter the "Grundartangi Act"); and (ii) the Investment Agreement of 7 August 1997 between the sole shareholder of Norðurál hf., Columbia Ventures Corporation, and the Government of Iceland (hereinafter referred to as the "Investment Agreement").⁵

In the Grundartangi Decision the Authority also assessed potential state aid elements in other agreements entered into in relation to the construction of Norðurál hf. One of those was the "Smelter Site Agreement" between the State Treasury of Iceland and Norðurál hf. for the lease of land to Norðurál hf., dated 20 March 1997.

2.2 The application of the Grundartangi aid scheme applied to the first expansion of Norðurál hf.

In the context of reviewing the notification, dated 31 October 2003, for a subsequent expansion of Norðurál hf., the Authority learned that Norðurál hf. had already been expanded once during 2000-2001 (hereinafter referred to as "Expansion I") which increased the capacity of the smelter from 60,000 to 90,000 tonnes per annum. The Icelandic authorities have informed the Authority that in respect of Expansion I Norðurál hf. benefits from state aid granted by means of the tax and fee concessions that form part of the Grundartangi Aid Scheme. Moreover, in respect of Expansion I Norðurál hf. did not pay street connection fee and paid specific amounts to cover building license fee and zoning fee. All three fees constitute one-off fees that do not form part of the Grundartangi Aid Scheme by virtue of their ad-hoc character.

2.3 Notification of amendments to the Grundartangi Aid Scheme in the context of the second expansion of Norðurál hf.

⁵ The Investment Agreement has already been amended once on 14 June 2000.

By the notification dated 31 October 2003 the Icelandic authorities informed the Authority that it planned to grant state aid to a further expansion to be constructed during 2004-2008 (hereinafter referred to as “Expansion II”) in order to increase the capacity from 90,000 to 260,000 tonnes per annum (with a possibility to increase further up to 300,000 tonnes per annum by increasing potline output). In this respect the Icelandic authorities have informed the Authority that with respect to Expansion II, Norðurál hf. will benefit from state aid by means of the tax and fee concessions that form part of the Grundartangi Aid Scheme.

However, the Icelandic authorities also informed the Authority that certain amendments have been made to the Grundartangi Aid Scheme. Negotiations for such amendments were initiated in September 2002 between Norðurál hf. and the Icelandic authorities and were finalised on 9 February 2005 with the signature of the “Second Amendment to the Investment Agreement” by the Icelandic Government and Century Aluminum (hereinafter referred to as the “Amendment to the Investment Agreement”).⁶ With the exception of certain provisions which shall only take effect on 1 January 2009, the Amendment to the Investment Agreement entered into effect upon signature.

The Icelandic authorities have also forwarded a copy of Act No. 85/2003 which was passed on 13 March 2003 by the Althingi and which amends the Grundartangi Act in a manner similar to the Investment Agreement (hereinafter referred to as the “Amendment to the Grundartangi Act”). With the exception of certain provisions which enter into effect on 1 January 2009, the Amendment to the Grundartangi Act entered into effect upon its adoption.

The notification dated 31 October 2003 also informed the Authority that in the context of Expansion II Norðurál hf. did not pay street connection fee and paid specific amounts to cover the building license fee and zoning fee – all three of which constitute one-off fees.

Moreover, in connection with the notification for Expansion II the Icelandic authorities also informed the Authority of the signature on 9 February 2005, of a second amendment made to the Smelter Site Agreement of 20 March 1997 according to which the site leased by the State Treasury of Iceland to Norðurál hf. had been increased. In this context it appeared that the Smelter Site Agreement had already been amended once on 7 August 1997.

Finally, in the context of the notification of amendments to the Grundartangi Aid Scheme the Icelandic authorities informed the Authority of the fact that Norðurál hf., which up until recently was a wholly owned subsidiary of the American company Columbia Ventures corporation, had changed ownership. On 28 March 2004, Columbia Ventures Corporation and Century Aluminum company executed a stock purchase agreement for the transfer of 100% of the shares in Norðurál hf. from Columbia Ventures Corporation to Norðurál Holdings ehf. and Norðurál Holdings II ehf., both wholly owned subsidiaries of Century Aluminum company.

2.4 The appropriate measures fixed a ceiling

As referred to above under section 1, on 1 June 2005 the Authority issued a decision under Article 18 of Part II of Protocol 3 to the Surveillance and Court Agreement proposing appropriate measures to the Icelandic authorities for purposes of ensuring

⁶ Century Aluminum company is the new owner of Norðurál hf. as explained below.

compatibility of the Grundartangi Aid Scheme with the functioning of the EEA Agreement (hereinafter referred to as the “Appropriate Measures”). On 15 July 2005 the Icelandic authorities accepted the Appropriate Measures.

According to the Appropriate Measures agreed to by the Icelandic authorities, the tax and fee concessions, approved by the Grundartangi Decision, constitute an aid scheme for the grant of state aid which does not qualify as investment aid. Since the tax and fee concessions are not themselves related to a specific investment, and since there was no general ceiling limiting the amount of state aid to be granted in terms of a percentage of the investment costs, the aid granted under the scheme constitutes operating aid. In order to ensure that state aid granted on the basis of the Grundartangi Aid Scheme is compatible on the grounds that it qualifies as investment aid, a ceiling expressed as a percentage of the investment costs was fixed for the three investment projects. These ceilings were calculated under the rules in the State Aid Guidelines regarding the grant of regional aid and the multisectoral framework in Chapters 25 and 26.A. The ceiling for the total aid to be granted to Norðurál hf. for all three investments was fixed at 88,3 million Euro giving an aid intensity of 10.7% – which forms an integral part of the absolute ceiling for the grant of state aid to Norðurál hf.⁷

According to the Appropriate Measures agreed to by the Icelandic authorities, the Grundartangi Aid Scheme can be applied for a maximum of 20 years from the date of the adoption of the Grundartangi Decision. Accordingly, that the Grundartangi Aid Scheme will expire on 31 October 2018,⁸ irrespective of whether the total amount of aid under the above stated ceiling has been granted.

In the context of the acceptance of the Appropriate Measures the Icelandic authorities also informed the Authority of the abolishment of a previously non-notified provision in Article 10 of the Investment Agreement (that is based on Article 9 of the Grundartangi Act regarding imports and exports) which provides for an exemption from excise/customs duties on the export of the products of Norðurál hf. As no such duties existed in the general legislation when the provision was in force, the provision will not be assessed in this decision.

2.5 Sum of state aid granted under the Grundartangi Aid Scheme up to 2003

The Icelandic authorities have informed the Authority that for the period between 1998 and 2003 the aid incurred under the Grundartangi Aid Scheme amounts to approximately 4,8 million USD based on 2003 price levels.⁹

⁷ The ceiling of 88,3 million is the result of the following individual ceilings: (i) 41,29 million Euro based on investments costs of 242,9 million Euro for the original construction of the smelter in 1997-1998; (ii) 10,83 million Euro for Expansion I in 2000-2001 based on investment costs of 77,4 million Euro; and (iii) 36,15 million Euro for Expansion II in 2004-2008 based on investment costs of 504,9 million Euro.

⁸ The original decision of the Authority, approving the aid scheme in respect of Norðurál hf., was adopted on 8 July 1998. However, it should be noted that in the notification of October 2003 the Icelandic Authorities implies that the “Initial term” of the Agreement expires only on 31 October 2018.

⁹ Chapter 33 of the Authority’s Guidelines states that: *“Any amounts expressed in these guidelines in ECUs will be converted into the currencies of EFTA States throughout any calendar year at the exchange rates prevailing on the first day of the year on which exchange values for ECUs into all currencies of the EEA are available. The exchange rates may be revised during the year by agreement between the EFTA Surveillance Authority and an EFTA State if necessitated by a significant change.”*

2.6 Primary aluminium market

Norðurál hf. produces primary aluminium for purposes of export, including to other EEA countries where primary aluminium is extensively traded.

The Icelandic authorities have provided preliminary information on the market for primary aluminium and its expected future developments based on the expert opinion of the CRU Group.¹⁰ In this regard, the Icelandic authorities have informed the Authority that according to said the opinion of the CRU Group, the world demand for primary aluminium was expected to increase by 7.4% in 2004 (which is a slightly lower increase than in 2003 when consumption grew by 8%), and that prices had been increasing. In terms of London Metal Exchange (“LME”) prices (based on 3 months USD/Tonne) the prices were averaging USD 1364 in 2002, and USD 1428 in 2003, and were estimated to be USD 1642 in 2004.

The Icelandic authorities have also submitted more recent information on the market circumstances prevailing in early 2005 and the expected future developments based on the opinion of the CRU Group. In this respect, the Icelandic authorities have stated that while volatility has been the feature of the market in 2004 it appears that by the end of the year prices moved up further, with the three-month LME price reaching a nine-year high of USD 1960. It has also been stated, however, that although the market fundamentals are decidedly positive, the price spike appears to have been driven more by fund and speculative interest. According to the CRU Group the market price continued to be driven by technical factors over this period, and in particular, the value of the US dollar, as emphasised by the 8% fall in the LME prices in early January, triggered by a rebound in the value of the US dollar.

The CRU Group has nonetheless found that the world consumption of primary aluminium grew by 9.3% in 2004, driven mainly by the economical growth in the USA and continued activity in Asia and China in particular, which expanded its aluminium consumption by 17%. Western world average demand also grew strongly, rising by 7.5%. According to the expert opinion (CRU Group) demand growth is expected to ease back from the levels seen in 2004, but the prices will remain firm in 2005 and 2006 before easing in the medium term as surplus capacity re-emerges. World consumption is projected to be 37,5 million tonnes by 2009, compared with 30,1 million tonnes in 2004, with an annual average rise of 4.5% over the next five year period. The forecast for the average nominal LME aluminium price over the period is down to USD 1450 in 2009 from USD 1721 average price in 2004.

The table below provides an overview of the world consumption forecasts and the European share of it and specifically shows that the primary aluminium consumption is expected to grow by an annual average of 4.5% over the forecast period.

¹⁰ The source is CRU International, which is a world leading business consultant in metals and mining. Established in 1969, the company is wholly independent and has a staff of over 170 in London, the USA and Singapore. Further information can be found at <http://www.crugroup.com>.

Table 1

Year	World aluminium consumption forecasts in 1000 tonnes per year			LME 3-months avg. price USD¹¹	
	Western Europe	Total	Western World	Total World	
1999	5,768	19,709		23,565	
2000	5,933	20,483		24,972	
2001	5,829	18,933		23,734	
2002	6,022	19738		25,341	
2003	6,422	20,920		27,539	1,428
2004	6,580	22,492		30,102	1,721
2005	6,696	23,100		31,558	1,778
2006	6,817	23,641		32,837	1,666
2007	6,967	24,128		34,087	1,590
2008	7,108	24,868		35,668	1,546
2009	7,289	25,759		37,549	1,479

Source: CRU Group

Finally, according to statements by the European Commission, primary aluminium is traded and transported throughout the world, and the pricing of aluminium ingots is substantially uniform because of the link to the LME. The EEA is a net importer of primary aluminium and there are substantial trade flows and imports of aluminium remelt ingots into the EEA. These are then remelted and converted into each and every form which allows further processing for customers (*inter alia*, into billets).¹²

2.7 Objective of the Grundartangi Aid Scheme

The Icelandic authorities have informed the Authority that the Norðurál hf. smelter is located at Grundartangi on the northern side of Hvalfjörður, in the municipalities of Hvalfjarðarstrandarhreppur and Skilamannahreppur. The Authority has, by Decision No. 103/96/COL of 28 August 1996 on the map of assisted areas in Iceland, and, by Decision No. 253/01 of 8 August 2001, found the aforementioned municipalities to qualify for regional aid up to a limit of 17% NGE of eligible investment costs.

In the Grundartangi Decision the Authority considered that in terms of employment and income, the aid scheme would make a significant contribution to economic development in the southern part of the Vesturland region which had been characterised by unemployment above the national average and slow depopulation. At that point in time, it was expected that the Norðurál hf. would employ 130 persons upon reaching its full capacity, and that further jobs would be created in the area in dependent businesses. Moreover, the project was considered to have a positive impact in terms of diversifying the Icelandic economy with respect to its export industries. Also, it was expected that the construction of the smelter and investments in the

¹¹ The LME 3-months average price forecast in US\$/tonne (Nominal prices).

¹² See the Commission's decision in the merger case No COMP/M.2702 Norsk Hydro/VAW of 4 March 2002 para, 9, available at:

http://www.europa.eu.int/comm/competition/mergers/cases/decisions/m2702_en.pdf

energy sector would lead to a rise in overall investment in Iceland and that GDP should be growing by 1% more in 1997 than it would otherwise have done.

The Icelandic authorities have informed the Authority that the expectations of the investment project of 1998 have largely been met. In this regard the Icelandic authorities have stated that since 1998, the Vesturland region has experienced a considerable population increase and the construction of Norðurál hf. has been a significant factor in reversing the previous trend of the 1990s of fluctuating and declining population in the area. This statement is supported by information from the Institute of Regional Development in Iceland ("Byggðastofnun") from which it appears that the unemployment rate for the area decreased from 2.7% of workforce in 1997 to 0.9% in 1999/2000, with a slight increase in 2004 up to 1.9%. Moreover, the number of inhabitants in the area increased during 2000 to 2004 at an annual rate of 1.1%. Norðurál hf.'s contribution to this development appears from the fact that it started up with a workforce of 150 persons in 1998 and hired another 40 persons in the context of Expansion I, leading up to its current workforce of 200 employees. 85% of these employees are from the Vesturland region.

Moreover, the Icelandic authorities estimate that the most recent expansion to benefit from the aid scheme (i.e., Expansion II) will also have a major socio-economic impact which will be felt within a radius of 50 km from the plant site. The Icelandic authorities expect that the smelter expansion will create a considerable number of new jobs, which will contribute significantly to the continuation of the population increase in this area of Western Iceland. Furthermore, it is expected that Expansion II will contribute to the growth in other sectors in the area. Demand for various types of services will increase, as will demand for various forms of industrial activities, such as construction. Moreover, increased employment opportunities at the smelter will enable farmers in the neighbouring areas to supplement their declining income from farming, thus further countering the depopulation trend seen in most rural areas of Iceland in recent years. It is considered that Expansion II will create around 300-450 new jobs, thereby increasing the total number of jobs at Norðurál hf. to 500-650. It is foreseen that the vast majority of new employees (approximately 90%) will come from the Vesturland region since, as stated above, at present, approximately 85% of Norðurál hf.'s employees are residents in this area. Finally, the Icelandic authorities state that the project will make a considerable positive contribution to the Icelandic economy and will contribute to the diversification of exports, reducing the current strong reliance on the one commodity of fish.

The Icelandic authorities consider that Expansion II will contribute an additional 1.5% per annum to GNP during construction of the first expansion phase and of the associated power plant. For the latter phase, the level could be 1% higher. Expansion II's permanent contribution to GNP is estimated to be about 0.5%.

3. Description of the individual aid measures

The following describes the individual measures which will be assessed in the present decision.

In the letter, dated 22 June 1997¹³, notifying the plans to grant state aid to Norðurál hf., the Icelandic authorities notified nine measures in the Investment Agreement to the Authority. The Decision of the Authority of 8 July 1998 involved an assessment

¹³ The letter was received and registered by the Authority on 1 July 1997 (Doc. No. 97-4636-A).

and an approval of those nine measures. However, the Investment Agreement contains certain other derogations from statutory provisions that were not notified in 1997-98, and hence not approved in the context of the adoption of the Grundartangi Decision in 1998. Nonetheless they constitute part of the Grundartangi Scheme. The first section describes these measures.

The second section describes the content of the amendments subsequently made to the Grundartangi Aid Scheme by means of the Amendment to the Investment Agreement. The third section describes how certain one-off fees, which do not form part of the Grundartangi Aid Scheme, have been applied to Norðurál hf. The fourth section describes the power contracts for the supply of power to Norðurál hf.

3.1 Non-notified aid measures in the Grundartangi Aid Scheme

(a) Corporate income tax

Prior to any amendments, Article 7.1 of the Investment Agreement and Article 6.1 of the Grundartangi Act provided that notwithstanding any changes in the Act No. 75/1981 on Income Tax and Net Worth Tax, Norðurál hf. shall pay an income tax at the rate of 33%.

The abovementioned provision was amended in 2003 by means of Article 3.1 of the Amendment to the Grundartangi Act which provides that the income tax rate of Norðurál hf. shall be 18%, but if the corporate income tax rate should be reduced according to Act No. 75/1981 on Income Tax and Net Worth Tax, then such lower rate shall also apply to Norðurál hf. However, Article 3.1 also states that if the rate in Act No. 75/1981 is increased again, the increase shall apply to Norðurál hf. but only up to the maximum of 18%. The Investment Agreement has been amended in a corresponding manner by means of Article 5.1 in the Amendment to the Investment Agreement.

The statutory corporate income tax rate in the Icelandic Act No. 75/1981 was amended first in 1999 from 33% to become 30% and then again in 2002 in order to be fixed at 18%. In fact Norðurál hf. was taxed at 30% when Act No. 75/1981 was changed to set this rate, and taxed at 18% when the Act was changed to provide for this rate.

(b) Depreciation rules

It appears from Article 7.5 of the Investment Agreement and Article 6.5 of the Grundartangi Act that in the year when new assets are taken into operation, Norðurál hf. can choose to depreciate such assets with a proportional factor of the annual depreciation instead of full year's depreciation as otherwise provided for in Article 33 of the Act No. 75/1981. Moreover, irrespective of Articles 34 and 45 of Act No. 75/1981 Norðurál hf. may depreciate its assets down to no residual value.

(c) Right to deduct remaining net operating losses for a certain minimum of preceding calendar years

Prior to any amendments, Article 7 of the Investment Agreement and Article 6.1 of the Grundartangi Act provided that Norðurál hf. was entitled to deduct from taxable income in any given year, the remaining net operating losses from the preceding eight calendar years as further stipulated in Act No. 75/1981.

Article 7 of the Investment Agreement has been amended by means of Article 5 of the Amendment to the Investment Agreement and Article 3.1 of the Amendment to the Grundartangi Act, which both provide that the time span for deducting operating losses is, in the case of Norðurál hf., fixed at a minimum of nine years, as is further stipulated in Act No. 75/1981. However, if the Act should be changed to provide for a time span (for deducting operating losses) of more than nine years, then this longer time span shall also apply to Norðurál hf., but if the time span is subsequently reduced Norðurál hf. will still be entitled to deduct operating losses in respect of a time span of a minimum of nine years.

Currently Act No. 75/1981 provides that remaining net operating losses may be deducted for a time span of ten years. At the present time this is also the time span which is being applied to Norðurál hf.

(d) Exemption from customs and excise duties on imports or domestic purchase of materials used for the construction of Norðurál hf.

Article 10 of the Investment Agreement and Article 9 of the Grundartangi Act provides for an exemption from Icelandic customs/excise duties under Act No. 97/1987 (and any identical or substantially similar taxes or duties, which might be imposed in addition to or in place of such duties) on the import or domestic purchase of construction materials, machinery and equipment and other capital goods and spare parts for Norðurál hf. and related facilities, and the operation thereof. Moreover, customs duties and excise duties on goods/services purchased within the country for the construction of Norðurál hf. may be waived or refunded.

It appears from Article 6(8) and 6(9) of the Icelandic Customs Act No. 55/1987 that customs and excise duties shall be reduced, waived or refunded on (i) raw materials, components and parts for production of domestic goods; and on (ii) machinery, machinery parts and spare parts used for the production of domestic goods. Moreover, Article 4 of Regulation No. 719/2000 (issued on the basis of Article 6(2) of Act No. 55/1987) emphasises these rules by providing that customs and excise duties shall be waived or refunded for raw materials, components and parts for the production of domestic industrial goods, material for packaging of industrial goods and machinery, and machinery parts and spare parts used in the production of domestic industrial goods. These statutory provisions have been applicable as of 1998.

(e) Deferral from the payment of Value Added Tax (“VAT”)

Article 10 of the Investment Agreement provides for a deferral (custom credit) for VAT under Act No. 50/1988 on VAT on import until payment of the refund for the respective clearing period is due. Article 10 provides also that VAT on the purchase of electricity shall be deferred to the same effect.¹⁴

- VAT deferral in respect of imports

¹⁴ The next to last paragraph of Article 6 in the Grundartangi Act provides, however, that general provisions of Icelandic income tax, value-added tax and municipal tax legislation relating to tax returns and their due dates, assessment, reviews, re-assessment, collection, due dates and payment and other settlement procedures of income tax, value-added tax and municipal tax and protests and disputes arising in this connection, shall apply to Norðurál hf.

As regards VAT on imports, the Icelandic authorities have informed the Authority that according to the main rule in Regulation No. 667/1995, the payment of VAT may be deferred for a period of one month and five days following the VAT period during which payment falls due. In addition hereto the payment of VAT in respect of imports may be deferred for another 15 days according to Regulation No. 640/1989 (issued pursuant to Article 34(3) of the VAT Act No. 50/1988). Hence the payment of VAT on all imports may be deferred for a total period of one month and 20 days.

The Icelandic authorities have informed the Authority that Article 10 of the Investment Agreement has been implemented by the Ministry of Finance by permitting Norðurál hf. to defer payment of VAT on imports for a period of one month and 20 days. Thus the time period during which the payment of VAT is deferred in the case of Norðurál hf. is the same as for all other companies operating on Iceland.

- VAT deferral in respect of electricity

As regards deferral of the payment of VAT in respect of electricity, the Icelandic authorities have informed the Authority that Norðurál hf. must pay VAT on the purchase of electricity directly to the company supplying it with power, namely Landvirkjun. Norðurál hf. therefore pays the VAT at the same time that it pays its electricity bill to Landvirkjun. Landvirkjun, on the other hand, does not benefit from any right to defer VAT – beyond what follows from statutory legislation – and therefore forwards the VAT paid by Norðurál hf. to the State in accordance with Regulation No. 667/1995 (which allows for a deferral of one month and five days following the VAT period during which payment falls due). Thus the time period during which the payment of VAT on electricity is deferred in the case of Norðurál hf. is the same for Norðurál hf. as for all other electricity customers of Landvirkjun.

It appears from Article 16 of the Investment Agreement that the Icelandic authorities must take all the necessary steps in order to ensure that Norðurál hf. can enjoy all the rights and benefits conferred under the Investment Agreement.

(f) *Exemption from excise and customs duties on material for the operation of Norðurál hf.*

Article 10 of the Investment Agreement (which is based on Article 9 of the Grundartangi Act regarding imports) provides for an exemption from excise and customs duties on the import or domestic purchase of raw materials and production supplies required for the operation of Norðurál hf. (and its harbour installations). The statutory rules regarding excise and customs duties are set out above in sub-section (d).

3.2 Amendments made to the Grundartangi Aid Scheme in 2003 and to the Smelter Site Agreement

The following addresses amendments which have been introduced in 2003 to the provisions that constitute part of the Grundartangi Aid Scheme.

(a) Withholding tax on dividend income

According to the previous version of Article 6.1 of the Grundartangi Act and Article 7.1 of the Investment Agreement, Norðurál hf. was exempt from paying dividends tax on the distribution of dividends to shareholders who are resident in an OECD country and fulfil specific conditions in the double taxation treaty between Iceland and the US. In the context of accepting the proposal for Appropriate Measures the Icelandic authorities undertook to abolish this provision.

However, prior to the procedure leading to the issuance of the Appropriate Measures, the Icelandic authorities had already notified (via its notification dated 31 October 2003) an amendment to the abovementioned provision. While the amended provision would enter into force on 1 January 2009, the Icelandic authorities have in the meanwhile informed the Authority in a letter dated 15 July 2005 that the amended provision has been withdrawn from the notification.

(b) Right to allocate tax free profits of up to 4% of the nominal value of share capital into a special internal investment account.

According to Article 3.1 of the Amendment to the Grundartangi Act and Article 5.1 of the Amendment to the Investment Agreement, the provision, stating that Norðurál hf. shall be entitled to deduct from taxable income in any given year and allocate into a special internal investment account an amount equivalent to up to 4% of the nominal value of shares, has been amended. Under the new provision there is no longer any right to deduct funds up to 4% of the nominal value of shares from taxable income nor to allocate such funds into a special account. However, the provision still provides that amounts allocated in the investment account which are used for investment in depreciable assets within six years, succeeding the allocation, shall be added to the taxable income of Norðurál hf. in the year of investment. It also still provides that in the same year Norðurál hf. shall have the right to accelerate the depreciation of the assets by the same amount used from the investment account. Moreover amounts in the special investment account that have not been invested, or have been offset against operating losses within the mentioned period of time (six years) shall still be added to taxable income and taxed at the tax rate applicable in the year of allocation. The same shall apply if Norðurál hf. is dissolved.

According to Icelandic statutory legislation there is no such right to deduct funds up to 4% of the nominal value of shares from taxable income and to allocate such funds into a special account.

(c) Exemption from payment of fees for safety controls of electricity production

A new provision was inserted in the Investment Agreement via Article 9.3 of the Amendment to the Investment Agreement and Article 4 of the Amendment to the Grundartangi Act which provides that Norðurál hf. shall be exempt from the provisions of subsections 1 and 4 of paragraph 1 of Article 14 of Act. No. 146/1996 on the safety of electrical installations, consumer utilities and electrical equipment.

Act No. 146/1996 on the safety of electrical installations, consumer utilities and electrical equipment (the “Electricity Act”) provides for the payment of fees in order to cover the costs of Löggildingarstofa which is the body responsible for surveillance and inspections in the field of electrical safety. In this regard it appears from subsections 1 and 4 of Article 14 of the Electricity Act that electrical utilities (enterprises which produce, transport, distribute and/or sell electricity) are obliged to

pay a service fee to Löggildingarstofa for the overall supervision of such utilities.¹⁵ The fee rate is 0.2% of the total income of sale of electricity and rental of measuring equipment (net of value of electrical power purchased and VAT).

However, the Electricity Act provides for an exemption from the abovementioned obligation for utilities to pay a fee to Löggildingarstofa. Based on the explanations that have been offered to the Authority in this regard, the last sentence of Article 14 subsection 1 and the last sentence of Article 14 subsection 4 provide that the utilities are exempt from paying the fee in respect of revenue derived from electricity sold to Icelandic Aluminium Co. Ltd. and Icelandic Alloys Ltd. and industrial plants exempted by law.¹⁶

(d) Amendment to the Smelter Site Agreement

The Icelandic authorities have informed the Authority of the signature on 5 February 2005 of the “Second Amendment to the Smelter Site Agreement” according to which the Smelter Site Agreement (of 20 March 1997) has been amended in order to increase the size of the site leased by the State Treasury of Iceland to Norðurál hf. from 82.7 hectares to 129.1 hectares. The rent has increased from USD 15,000 to 23,500 on an annual basis. The Icelandic authorities have informed the Authority that the amount of rent per hectare for the increased site is comparable to the amount of rent currently paid per hectare (of approximately 182 USD per hectare). However, Article 4 of the Second Amendment to the Smelter Site Agreement provides that the increase in the size of the rented land shall take effect on 5 February 2005 whereas the corresponding increase in the rent shall only take effect 1 January 2006. In other words, as of 5 February 2005 Norðurál hf. may occupy an increased size of the land (i.e., the increase from 82.7 hectares to 129.1 hectares) but need only to start paying rent for the increased size of the land as of 1 January 2006. This means that Norðruál hf. does not pay any rent for the increased size during the period between 5 February 2005 and 1 January 2006.

In terms of background, it appears from the Grundartangi Decision that in 1997 the State purchased 131.1 hectares of land for a price of ISK 18,8 million or USD 257,534 from two farms with land adjacent to the land already owned by the State at Grundartangi. 82.2 hectares have, so far been leased to Norðurál hf. for an annual rent of USD 15,000 (reflecting the approximate price of USD 182 per hectare).¹⁷ On this basis it was considered that no state aid was involved.

The notification states that the State will rent out the remaining part of the land purchased in 1997 to Norðurál hf. , i.e., the increase from 82.7 hectares to 129.1

¹⁵ Utilities also pay a service fee to Löggildingarstofa for the overall supervision of new consumer apparatus and consumer apparatus in operation of 0.6% of the total income of sale of electricity.

¹⁶ Subsection 1 of Article 14 provides that “Electrical power sales to Icelandic Aluminium Co. Ltd. And Icelandic Alloys Ltd. shall be exempt from the provisions of this Point, as shall be the case with other industrial plants which may be exempted by law.”

¹⁷ In the Grundartangi Decision the Authority considered that the rent reflects the purchase costs borne by the state for the land because the acquisition costs of the state for 82.2 hectares (price x 82.2/131.1 = USD 161,475) would be adequately recovered via the total amount of rent received by the state over the rent period of 23 years (using a discount factor of 7.20%) of USD 166,234. In the Grundartangi Decision it appears that the total acquisition costs of the state were estimated on a pro-rata basis due to the fact that 122 hectares of the purchased land was priced differently per hectare than the remaining 9.1 hectares.

hectares at a price based on a calculation formula similar to that used in the Grundartangi Decision.¹⁸

The Icelandic authorities have informed the Authority that the land purchased by the State and rented by Norðurál hf. consists of bare rocks, sand and small amounts of grass and moss. It is unfit for any other use other than for industrial purposes and due to its location and condition there is no general demand for the land (or the neighboring land). For these reasons, the estimated value of the land has not been subject to change with reference to indexation etc.

3.3 One-off fees in the context of investments for Expansions I and II

The following addresses the specific amounts paid by Norðurál hf. to cover certain one-off fees, and the non-payment of one of those fees, in the context of the expansions of the aluminium smelter. In this regard Article 6.8 of the Grundartangi Act states that the Investment Agreement can contain provisions which provide that Norðurál hf. shall pay certain agreed amounts to the relevant municipalities in lieu of the (a) street connection fee under Act No. 17/1996; (b) building license fee under Act No. 54/1978 and (c) zoning fee under Act No. 19/1964, respectively.

(a) Street connection fee

As regards the street connection fee Article 8 of the Investment Agreement provides that Norðurál hf. shall not pay the street connection fee, referred to under Act No. 17/1996, for the production capacity of 60,000 tonnes, nor any other tax, fee or charge which would be imposed in lieu thereof. In the Grundartangi Decision the street connection fee was considered by the Authority to constitute a service charge, payable to the municipalities in return for street construction. As a result it was considered that no state aid was involved.

The Icelandic authorities have informed the Authority that for the same reasons Norðurál hf. has not paid street connection fee in the context of constructing Expansion I and Expansion II. In this regard the Icelandic authorities have explained that the street connection fee is payable in return for street construction. In each specific case the imposition of the street connection fee is linked to the construction of a particular street. There is therefore a direct link between the service performed and the charge imposed. For this reason the municipalities enjoy a wide discretion in fixing the level of the street connection fee. The Icelandic authorities have also informed the Authority that the municipalities are not obliged to build any street for Norðurál hf. or on its site, or otherwise render services covered by the street connection fee.

It appears from Article 7 of the Amendment to the Investment Agreement (which amends Article 8.5 of the Investment Agreement) that Norðurál hf. shall not pay street connection fee according to Act 17/1996 to the municipalities for the expansion of the smelter of additional 210,000 tonnes and up to 300,000 tonnes. The Icelandic authorities have explained that this statement expresses the consequence of having applied the law: Since there was no street built for Norðurál hf., or on its site in

¹⁸ The Icelandic authorities have informed the Authority that in 1997 it was discovered that the size of the land rented by Norðurál hf. had been incorrectly measured to cover 82.2 hectares but that this mistake was corrected following a re-measurement undertaken in August 1997 which showed that the land rented by Norðurál hf. covered 82.7 hectares.

connection with the expansions of the smelter the municipalities have not levied the street connection fee.

(b) Building license fee

With respect to building license fee Article 9 of the Investment Agreement provides that Norðurál hf. shall pay a building license fee which is calculated so as to cover the costs of the competent surveillance body.

In the Grundartangi Decision the Authority considered that such a provision did not involve the grant of state aid on the grounds that the building license fee was considered to be a service charge and therefore not a generally applicable tax or parafiscal duty. Moreover, the Authority assumed that the fee paid by Norðurál hf. covered the cost of the relevant surveillance body.

In the context of the notification of Expansion II the Icelandic authorities have informed the Authority that Article 53 of Act No. 73/1997 provides that the building license fee may not exceed the actual costs of issuing a building license and other related services such as surveillance.

The Icelandic authorities have also informed the Authority that the amount payable by Norðurál hf. as building license fees was ISK 3,500,000 in the context of Expansion I and ISK 11,000,000 in relation to Expansion II. The latter amount also appears from Article 8 of the Amendment to the Investment Agreement which amends Article 9 of the Investment Agreement. The Icelandic authorities have also informed the Authority that both amounts are based on the estimated costs of license issuance and construction surveillance in respect of the respective expansions.

(c) Zoning fee

Article 35 of the Zoning Act No. 19/1964 provides that the zoning fee for covering the costs of the Planning Agency shall be fixed at 0.3% of the insurance value of either fire damage or initial investments costs of the building. According to Article 11 of the Investment Agreement Norðurál hf. shall, irrespective of the calculation formula provided for in Article 35 of the Zoning Act, pay a fixed zoning fee of USD 30,000.

In the Grundartangi Decision the Authority considered that the zoning fee did not involve state aid as the fee was in the nature of a service charge and therefore not a generally applicable tax or parafiscal duty. It was considered that there was no reason to doubt that the amount of the fee covered the costs of the relevant surveillance body.

It appears from a letter of the Ministry of Finance dated 22 September 2004, that the zoning fee paid by Norðurál hf. was 15,000 USD in the context of Expansion I and 85,000 in relation to Expansion II. The Icelandic authorities have informed the Authority that both zoning fees have been fixed so as to cover the costs incurred by the relevant surveillance authority.

3.4 The power contracts

The Icelandic authorities have forwarded a power contract for the supply of power to Norðurál hf. by Orkuveita Reykjavíkur and Hitaveita Suðurnesja hf. (the “Power Contract”). It appears from the preamble of the Power Contract that the power supply by Orkuveita Reykjavíkur and Hitaveita Suðurnesja hf. to Norðurál hf. is based on the

construction of new facilities at Hellisheiði and Reykjanes, on the one hand, and the development of facilities at Nesjavellir/Svartsengi, on the other hand.

Both Orkuveita Reykjavíkur and Hitaveita Suðurnesja hf. produce, transmit, distribute and sell (hot) water and electricity in various municipalities.

The Icelandic authorities have provided the Authority with information on the profitability of the plans of Orkuveita Reykjavíkur and Hitaveita Suðurnesja hf. to construct new facilities. Both Orkuveita Reykjavíkur (which is a partnership company regulated by Act No. 139/2001) and Hitaveita Suðurnesja hf. (which is a limited company regulated by public law) are owned by cities, towns, municipalities and the State Treasury.

It also appears from the information submitted on the profitability of new construction plans of Orkuveita Reykjavíkur and Hitaveita and Suðurnesja hf. that the Power Contract has been negotiated independently between Orkuveita Reykjavíkur and Hitaveita Suðurnesja hf., as sellers and Norðurál hf. as buyer, without any representatives of the State. The duration of the Power Contract is 20 years. However, it shall be renegotiated within 17 years after the Date of Full Delivery (which is either 1 May 2006 or 1 September 2006) for purposes of agreeing on an extension of no less than 10 years.

Under the Power Contract Orkuveita Reykjavíkur and Hitaveita Suðurnesja hf., undertake to make available for Norðurál hf. on an annual basis energy of GWh [...] * of which GWh [...] is to be made available on a firm and on interruptible basis. Orkuveita Reykjavíkur and Hitaveita Suðurnesja hf. shall supply Norðurál hf. with [...] GWh each. A clause entitled “Take or Pay Obligation” provides that Norðurál hf. must pay for a minimum of [...] GWh per calendar year (constituting [...]% of the power to be delivered under the Power Contract) regardless of whether the actual consumption is less.

Profitability of new facilities

The profitability analyses regarding the new facilities contain calculations on the estimated rate of return of the power contract based on the “Discounted Cash Flow” method. The profitability analyses contain the following further information:

Orkuveita Reykjavíkur is responsible for constructing the Hellisheiði geothermal power plant whereas Hitaveita Suðurnesja hf. is responsible for constructing the Reykjanes geothermal power plant. Both Orkuveita Reykjavíkur and Hitaveita Suðurnesja hf. are financially independent and dividends shall be paid out on the basis of the financial results. Both companies are instructed to set their tariffs so as to secure a normal return on the owner’s equity.

The power price of the Power Contract is fully linked to the price for aluminium on the London Metal Exchange and calculated on a monthly basis according to a formula laid down in the Power Contract (commonly referred to as “metal-linked power tariffs”). The power price does not have any fixed elements in it nor are there floors or ceilings. The approval of the Minister on tariffs for electricity and hot water is nonetheless required.

* In the following the square brackets indicate that the information is covered by the obligation of professional secrecy.

The metal-linked tariffs offer is based on a risk sharing arrangement whereby a low aluminium price may mean that the power companies sell power at a lower tariff than normally applicable, but when the aluminium prices increase, the power companies receive a share of the profit resulting from power tariffs that may be higher than normal.

Both the Hellisheiði geothermal power plant and Reykjanes geothermal power plant are fixed cost projects. The projects are very capital intensive with total estimated capital costs of each project of approximately USD [...] and USD [...], respectively (assuming a long term exchange rate of ISK/USD 87,5) incurred over the period up to 2006. There is a small component of ongoing operating costs on the average 1.5 to 2% of the capital costs per annum.

The Icelandic authorities state that the Hellisheiði geothermal power plant is a 80 MW powerplant which shall supply all its power to Norðurál hf. whereas the Reykjanes geothermal power plant will be a 100 MW powerplant of which 80 MW will be delivered to Norðurál hf. during the entire contract period whereas 20 MW will be delivered to Norðurál hf. for a period of five years.¹⁹

The “Discounted Cash Flow” method applied in both projects is based on future cash flows of the relevant project, i.e., determining the cash outlet at the begining and estimating the future revenues less future operating costs. The difference between the costs and revenues is then discounted to today’s value with a discount factor. If the discounted net value is positive the project is considered feasible.

The discount factor is based on total funding costs, i.e., interest cost and returns that owners request on their equity funding. By taking into account the portion of loans and equity the weighted average cost of capital (“WACC”) can be measured for the project and used as a discount factor.

The project must have an internal rate of return (“IRR”) at least equal to or higher than the weighted average cost of capital.

The calculation of the cash flow is based on a 60 year period from 2006 to 2065 and it is assumed that the power price will be renegotiated after twenty years, and again after forty years at the same level.

The cash flow analysis is based on an aluminum price (at 2002 price levels and exchange rates) of USD 1,564 at the begining of the energy sales period (2006), falling by 0.45% annually in real terms during the lifetime of the power plant. The price assumptions are derived from a report entitled *“Profitability and risks for Landvirkjun with regard to the construction of the Kárahnjúkar plant”* of 7 January 2003, which was prepared by an ad-hoc committee, established by Landvirkjun in the context of the construction by Landvirkjun of new facilities for purposes of delivering power to the Alcoa aluminium plant on Iceland.²⁰ The report states that in calculating future aluminium prices, it is appropriate to rely on the long term tendency in aluminium prices, and reveals that the price of USD 1,564 is based on the estimates of two expert opinons in the field of aluminium (the CRU Group and James King).²¹

¹⁹ The agreement concerning the delivery of 20 MW for a five year period results from an amendment to the Power Contract of 28 October 2004.

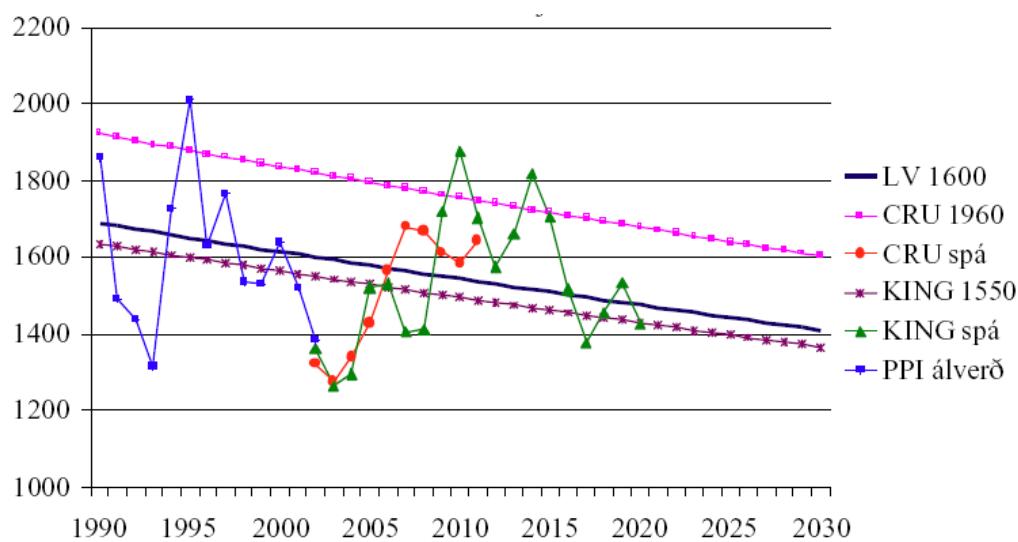
²⁰ See decision 40/03/COL of the Authority of 14 March 2003.

²¹ CRU International is referred to and described above in section 2.7. James King has been an independent consultant since 1980, specializing in the economic and commercial aspects of the aluminium and steel industries.

The following graph is extracted from the report prepared for Landvirkjun. It shows various estimates of aluminium price developments given by the CRU Group and by James King. It appears from the report that Landvirkjun took account of the estimates of both parties in assuming that the price of aluminium, at 2002 price levels and currency rates, would be USD 1,564 in 2006 and would then fall by 0.45% annually (in real terms) during the lifetime of the power plant.

The report explains furthermore that the price of aluminium has a tendency to fluctuate and that the current prices (until 2002) are historically low, meaning that current prices are therefore lower than what they would be according to “normal” long term tendencies. The report also makes reference to the fact that the table shows the estimates of the experts with respect to short term fluctuations in aluminium prices, which are based on an assumption that aluminium prices would rise in accordance with increased economic welfare and stability in the aluminium market. Finally, the report states that due to the fluctuation in aluminium prices Landvirkjun chose to base itself on the longterm outlook in aluminium prices. It further states that the price line of Landvirkjun in the graph, reproduced below, is to be considered as an average where the factual prices are foreseen to be either above or below that line.

Aluminium price forecasts



Spá = Estimate

Álverð = Aluminium price

LV 1600 = Estimate of Landvirkjun = King's high estimate = assumptions in the case at hand

CRU 1960 = Price tendency line from 1960 – 2002

CRU spá = Estimate of CRU on fluctuating aluminium prices between 2002 – 2011 (from the CRU report “The ten year outlook for aluminium 2002”).

King 1550 = Lower trend estimate of James King of the price tendency line (his upper estimate corresponds exactly to the line marked LV 1600).

King spá = Estimates of James King on fluctuating aluminium prices until 2020.

PPI álverð = Real aluminium price (2002-prices)

The results specified below are based on the assumptions set out above and certain additional factors that are specific to each project, set out below:

- Hellisheiði geothermal power plant:

Debt/equity ratio:	[...];
Required rate of return on equity:	[...]% (real) and [...]% (nominal);
Inflation:	1.8 % PPI ²² (USA)
Debt costs:	[...]% (real) and [...]% (nominal).

This gives a WACC of [...]% (real) and [...]% (nominal).

The nominal debt cost is calculated as a sum of the following elements:

- [...];
- [...];
- [...];
- [...].

The 0.25 percentage points premium payment for the state guarantee is based on the fact that Orkuveita Reykjavíkur (which is in charge of the Hellisheiði geothermal plant) is a partnership company owned by the State (via municipalities). The Icelandic authorities have explained that the State by virtue of its partnership is liable for the company's debts without limitation. This means that the company benefits from a *de facto* state guarantee which is unlimited both as regards amount and time. The benefit of the state guarantee and the fact that the Local Government Act No. 45/1998 provides that the Icelandic municipalities cannot be subject to insolvency proceedings has meant that Orkuveita Reykjavíkur could raise capital for financing the Hellisheiði project on more favourable terms than the company would have been able to otherwise. As a result Orkuveita Reykjavíkur has obtained loans for the Hellisheiði project at a margin of approximately [...] basis points above LIBOR/swap rates.²³ In 2003, the average rate paid by Orkuveita Reykjavíkur was approximately [...]% on a mix of floating and fixed rate loans.²⁴

In a letter dated 23 June 2005 from the lender, the Nordic Investment Bank, it appears that the interest rates offered to Orkuveita Reykjavíkur are based on a good credit worthiness resulting partly from the strong operations and balance sheet of the company, and partly from the unlimited liability of the state referred to as a "first-class municipality". It appears furthermore that the interest rate extended to Orkuveita Reykjavíkur would have increased with a maximum of 25 basis points if the company had been a limited liability company. The additional 25 basis points are considered by the bank to eliminate the advantage of the unlimited partner liability of future obligations.

Using the WACC as a discount factor, the present value of cash flow is estimated to be ISK [...]. The internal rate of return is calculated to [...]% in real terms and the return on equity is [...]% in real terms.

- Reykjanes geothermal power plant:

Debt/equity ratio:	[...];
Required rate of return on equity:	[...]% (real) and [...]% (nominal);
Inflation:	3% (based on 2.5% (Iceland) plus a safety margin);

²² Producer Price Index.

²³ LIBOR= London Inter Bank Offered Rate

²⁴ In 2004 the average rate was about 2.4 % (including profit margin) and for the first half of 2005 the average was about 2.65 % (including profit margin).

Debt costs: [...]% (real) and [...]% (nominal).

This gives a WACC of [...]% (real) and [...]% (nominal).

The nominal debt cost of [...]% is based on using fixed rates based on swap rates for five years. In May 2004 the rates were [...]. [...] percentage points was added as a risk premium.

The net cash flow gives a present value of the project equal to ISK [...], using the WACC as discount factor. The internal rate of return is calculated to [...]% (in real terms) and the return on equity is estimated to be [...]% in real terms.

Development of existing facilities

The power supply by Orkuveita Reykjavíkur and Hitaveita Suðurnesja hf. to Norðurál hf. is also based on the development of facilities at Nesjavellir/Svartsengi. With respect to the development of existing facilities at Nesjavellir/Svartsengi, the Icelandic authorities have explained that a new generator will be installed at the existing power plant in Nesjavellir of 30 MW in order enable the existing Nesjavellir Power Plant to supply Norðurál hf. with power (at the same sales price as will be applicable to the sale of power by the Hellisheiði plant). This will last for a short period of time during the start up phase of Norðurál hf. (estimated to be 12-15 months) until the Hellisheiði geothermal plant is able to start producing electricity. In a longer-term perspective the installation of the generator is aimed at meeting the forecasted growth in the general market for electricity as a result of the forthcoming liberalisation of the electricity market.

Aside from this, Hitaveita Suðurnesja hf. has been responsible for building new operating facilities (*inter alia* computer room with facilities etc.) at the existing power plant in Svartsengi from which the Reykjanes power plant will be operated. The relevant costs of approximately 300,000-400,000 Euro for building these facilities have been included in the profitability calculations set out above for the Reykjanes geothermal plant.

II. APPRECIATION

1. Procedural requirements

Pursuant to Article 1(3) in Part I of Protocol 3 to the Surveillance and Court Agreement, “*the 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 State concerned shall not put its proposed measures into effect until the procedure has resulted in a final decision*”.

By submitting a notification for the amendments to the Grundartangi Aid Scheme authorising tax and fee concessions to Norðurál hf., letter dated 31 October 2003, the Icelandic authorities have partly complied with the notification requirement.

While the Icelandic authorities have stated that the Amendment to the Grundartangi Act entered into force in March 2003, the Amendment to the Investment Agreement

entered into force upon being signed on 8 February 2005. Article 11 of the Amendment to the Investment Agreement provides, however, that the amendments regarding the maximum rate of corporate income tax of 18%, the minimum time span of nine years for deducting operating losses, the tax deferral and accelerated depreciation in respect of funds from a special account shall only enter into force on 1 January 2009.²⁵ Since the remaining part of the Amendment to the Investment Agreement entered into force on 8 January 2005, it means that the exemption from payment of fees for safety controls in respect of electricity production and the provisions on the one-off fees for street connection, building license and zoning fee have already entered into effect.

Secondly, Article 4 of the Second Amendment to the Smelter Site Agreement provides that the increase in the size of the rented land (i.e., from 82.7 hectares to 129.1 hectares) shall take effect on 5 February 2005 whereas the corresponding increase in the rent shall take effect as of 1 January 2006.

Thirdly, the aid measures in the Investment Agreement which have neither been notified in 1997 nor in the context of the amendments made to the Investment Agreement (i.e., the maximum corporate income tax rate of 33%; the accelerated depreciation of assets; the minimum time span of eight years for deducting operating losses; the exemption from customs and excise duties on imports or domestic purchase of materials used for the construction of Norðurál hf; deferral from the payment of VAT on imports; and the exemption from excise/customs duties on material for the operation of Norðruál hf.) have been in force since 1997. Finally, the one-off fees for street connection, building license and zoning fee in relation to Expansion I were neither notified in 2000 when the expansion took place nor at a later point in time.

The Icelandic authorities have not therefore awaited the approval of the Authority before letting certain measures in the Investment Agreement (including an amendment thereto) and an amendment to the Smelter Site Agreement enter into effect. On this basis the Authority regrets that the Icelandic authorities have only partially respected their obligations pursuant to Article 1(3) in Part I of Protocol 3 to the Surveillance and Court Agreement.

2. The presence of state aid

2.1 The requirements for establishing the presence of state aid

In order to establish that a measure involves the grant of state aid under Article 61(1) of the EEA Agreement the Authority must establish that the measure confers an economic advantage which the undertaking would not have received in the normal course of business. The advantage must be granted by the State or through State resources. It must favour certain undertakings or the production of certain goods, and it must distort competition or threaten to distort competition and affect trade between Contracting Parties. The Authority wants to make the following preliminary observations as to whether these conditions are met in the measures examined in the present case.

²⁵ The reference in Article 11 to measures that only enter into effect on 1 January 2009 also includes a reference to the rules on depreciation. However, the rules in the amendment on depreciation are the same as those applicable previously.

As regards the requirement that the measure must confer an economic advantage, such an advantage may be provided through a reduction in the undertaking's tax burden in various ways, including a reduction in the tax base or total or partial reduction in the amount of tax or a deferment, cancellation or even special rescheduling of tax debt.²⁶

With respect to the requirement that the advantage must be granted by the State or through State resources, a loss of tax revenue is equivalent to consumption of State resources in the form of fiscal expenditure, and that state support may be provided just as much through tax provisions of a legislative, regulatory or administrative nature as through the practices of the tax authorities.²⁷ In this specific case the Grundartangi Act and the Amendment to the Grundartangi Act, as well as the Investment Agreement and the Amendment to the Investment Agreement between the State and Norðurál hf., is the basis on which the State has intervened for purposes of deviating from the statutory rules generally applicable on Iceland. Moreover, the State has intervened by amending the Smelter Site Agreement between the State Treasury and Norðurál hf.

As to the requirement that the measures must distort, or threaten to distort, competition and affect trade, it appears from the information on the primary aluminium market, set out in point 2.7 of Part I above, that Norðurál hf. produces primary aluminium for purposes of export, including to other EEA countries where primary aluminium is extensively traded. The grant of aid to Norðurál hf. will therefore strengthen the position of Norðurál hf. compared to other undertakings in Iceland and in other countries competing in EEA-trade, and thus reinforce its competitive position.²⁸ On this basis, the Authority considers that any grant of aid to Norðurál hf. will distort competition and affect trade thereby fulfilling the conditions for state aid to arise within the meaning of Article 61(1) of the EEA Agreement.

The Authority will therefore, in the following, only examine whether the different provisions confer economic advantages on Norðurál hf. In this respect, the Authority notes that some of the measures have not yet led to any payment since the statutory rules for the time being correspond to the deviations. This is, however, irrelevant for the assessment of the measure as state aid and will therefore be disregarded in the following.

2.2 Non-notified aid measures in the Grundartangi Aid Scheme

The following refers to derogations from tax and fee provisions which were not notified and hence not approved in the context of the Grundartangi Decision.

(a) Corporate income tax

The provision entails that Norðurál hf. pays a maximum income tax rate of 33% (prior to amendment) or 18% (after amendment), irrespective of any changes in statutory rules on income tax entailing any increases in the rate beyond a certain maximum of 33% (prior to amendment) or 18% (after amendment). Both before and after its amendment, the provision entails a protection against any future increases of the

²⁶ See point 2 of Chapter 17.B.3 of the State Aid Guidelines regarding state aid measures on direct business taxation.

²⁷ See point 3 of Chapter 17.B.3 of the State Aid Guidelines.

²⁸ See in this respect Case 730/79, ECR 1989 2671, at paragraph 11 where it is stated that “When State financial aid strengthens the position of an undertaking compared with other undertakings competing in intra-Community trade the latter must be regarded as affected by that aid.”

statutory rate of income tax, first beyond 33% in the period between 1998 and 2009, and then beyond 18% as of 2009. In other words, the fixing of a maximum rate of corporate income tax for Norðurál hf. constitutes a deviation from the statutory rules to the benefit of Norðurál hf. that guarantees Norðurál hf. of a maximum rate of corporate income tax. If the statutory tax rate becomes higher than the guaranteed maximum rate of 33% or 18% (as of 2009), the difference between the statutory rate and the maximum rate will confer an economic benefit to Norðurál hf. This guarantee against future legislative changes in itself constitutes state aid within the meaning of Article 61 (1) of the Agreement.²⁹

(b) Depreciation rules

In line with the position taken in the decision regarding Alcoa (40/03/COL) of 14 March 2003, the Authority considers that the permission for Norðurál hf. to deviate from statutory rules by being able to depreciate assets with a proportional factor of the annual depreciation (instead of full year's depreciation), and to depreciate assets down to no residual value (compared to depreciating assets down to 10% residual value), confers an economic advantage on Norðurál hf. and thus constitutes state aid within the meaning of Article 61(1) EEA.

As regards the possibility of depreciating assets with a proportional factor of the annual depreciation the Icelandic authorities have informed the Authority that this allows for a slower depreciation than otherwise prescribed by statutory rules. The Authority considers that this provision may be used by Norðurál hf. in order to postpone deducting the cost of depreciation at a point in time where Norðurál hf. is loss-making. Norðurál hf. can then take this cost into account at a later point in time when Norðurál hf. is generating profits in order to bring down such profits and thereby reduce its tax liability. The fact that the tax liability is reduced means that the company has more funds at its disposal than it would have had otherwise. The Authority considers therefore that the economic advantage consists of the amount by which the tax liability is reduced.

As regards the possibility to depreciate down to no residual value compared to depreciating down to 10% residual value (as prescribed in statutory legislation), Norðurál hf. may deduct a cost that it would not otherwise have had and thereby reduce its profits and hence also its tax liability. The fact that the tax liability is reduced means that the company has more funds at its disposal.

The advantage consists of depreciating down to no residual value, instead of to 10% residual value. In this case, a lower tax liability (resulting from deducting an additional cost) provides additional funding on a permanent basis since in the absence of the right to depreciate the additional amount (between 10% residual value and no residual value), Norðurál hf. would not be able to deduct this cost at all. The Authority therefore considers that the economic advantage consists of the amount by which the tax liability is reduced.

(c) Right to deduct remaining net operating losses for a certain minimum of preceding calendar years

²⁹ This is line with the Authority's finding in the Alcoa decision (40/03/COL of 14 March 2003) where a maximum corporate tax rate was considered as involving aid where the tax rate by statutory law would be higher than that applicable to Alcoa, see Section 2.2(a).

The provision essentially provides that Norðurál hf. is entitled to deduct from taxable income in any given year, the remaining net operating losses for a certain minimum amount of preceding calendar years. The minimum was eight years prior to the amendment and nine years after the amendment.

The Authority considers that a provision according to which Norðurál hf. is guaranteed to be able to deduct operating losses for a minimum number of years, irrespective of a reduction in the permissible time span in statutory legislation, confers an economic benefit on Norðurál hf. In a case where the time span in statutory legislation for deducting operating losses is reduced to be lower than nine years the advantage is constituted by the difference between using the time span following from statutory provisions and the minimum level of nine years. This guarantee provision in itself constitutes an advantage within the meaning of Article 61(1) of the EEA Agreement.

(d) Exemption from customs and excise duties on imports or domestic purchase of materials used for the construction of Norðurál hf.

The Authority considers that an exemption from statutory customs/excise duties on imported or domestically purchased construction materials, machinery, spare parts and other equipment/capital goods enjoyed by Norðurál hf. and its related facilities could confer an economic advantage to Norðurál hf.

The present Icelandic statutory rules provides for far-reaching general exemptions from the application of customs and excise duties. Therefore, Norðurál hf. would not have paid the relevant customs and excise duties even in the absence of the specific exemption provided for in the Investment Agreement and the Grundartangi Act. However, should the statutory legislation in this regard change and provide for the imposition of customs/excise duties, the fact that Norðurál hf. enjoys an exemption from these duties, confers an economic advantage on the company. In the opinion of the Authority, this guarantee provision in itself constitutes an advantage within the meaning of Article 61(1) of the EEA Agreement.

(e) Deferral from the payment of VAT

- VAT deferral on imports

So far, Norðurál hf. has only benefited from a deferral for the payment of VAT which is in line with the statutory rules in this regard. However, the presence of the entitlement to benefit from a deferral from the payment of VAT, irrespective of what the result of applying the applicable statutory rules would be, means that the provision in the Investment Agreement on the right to defer the payment of VAT may materialise if the statutory rules change. In the opinion of the Authority, this guarantee against future changes in the statutory legislation constitutes in itself an advantage within the meaning of Article 61 (1) of the EEA Agreement.

- VAT deferral on electricity

The right of Norðurál hf. to defer the payment of VAT on the purchase of electricity constitutes a right to deviate from the statutory rules and results in an economic advantage for Norðurál hf. Even though Norðurál hf. in its relation towards Landvirkjun is currently obliged to pay VAT in accordance with the statutory rules the fact that Norðurál hf. can require that the State meets its obligation under the

Investment Agreement of implementing the necessary legislation (enabling Norðurál hf. to defer VAT towards Landvirkjun), means that Norðurál hf. has a legal claim to benefit from the advantage. On this basis the Authority considers that the provision entitling Norðurál hf. to defer the payment of VAT on electricity in the Investment Agreement and Grundartangi Act involves state aid within the meaning of Article 61(1) of the EEA Agreement.

- (f) *Exemption from excise/customs duties on imported or domestic purchase of material for the operation of Norðurál hf.*

The Authority considers that this general exemption granted to Norðurál hf. from statutory import duties constitutes an economic advantage. It therefore involves state aid within the meaning of Article 61(1) of the EEA Agreement. This is so although Norðurál hf. has not so far benefited from any exemption from the payment of excise/customs duties on imports or domestic purchases other than what it would have enjoyed on the basis of the statutory rules.

2.3 Amendments made to the Grundartangi Aid Scheme and to the Smelter Site Agreement

- (a) *Right to allocate tax free profits of up to 4% of the nominal value of share capital into a special internal investment account.*

In the Appropriate Measures the Authority considered the provision on the right to allocate tax free profits into a special account in its un-amended form. The Authority found that the provision involves state aid by virtue of a tax deferral (as funds allocated into the special account would only be taxed at the time of a later investment) and accelerated depreciation (as assets purchased for funds allocated may be depreciated at a higher speed).

The Authority considers that even though the right to deduct funds of up to 4% of the nominal value of shares from taxable income, and to allocate such funds into a special account has been abolished, the fact that the provision still provides that funds already allocated but not used for investments would only be taxed at the time of investment and that Norðurál hf. still shall have the right to accelerate the depreciation of the assets down to 0% residual value, means that the two aspects of the measure which involve state aid are still in effect.

- (b) *Exemption from the payment of safety control fee for electricity production*

Article 14 of the Electricity Act provides that the utilities shall pay a fee of 0.2% of their sale of electricity. Article 14 provides furthermore that power sales to Icelandic Aluminium Co. Ltd. and Icelandic Alloys Ltd. shall be exempt from paying a fee of 0.2% of their purchases, as shall be the case with other industrial plants which may be exempted by law. Such a law has been adopted by the amended Grundartangi Act which provides that Norðurál hf. shall also be exempted.

Based on the above, the utilities are as, a starting point, obliged to pay the safety control fee of 0.2% in respect of the revenue derived from electricity sold. However, the utilities are exempt from paying the safety control fee in respect of 0.2% of the revenue derived from Aluminium Co. Ltd. and Icelandic Alloys Ltd. and Norðurál hf.

The Icelandic authorities have explained the general system under the Electricity Act. In this regard the authorities have explained that under the Electricity Act the fee for

safety controls is fixed in relation to the revenue obtained from the sale of electricity (or rental equipment). This means that the level of the fee is dependent on how much electricity the customer purchases (or consumes). Moreover, under the Electricity Act the principle for determining how the costs of the fee should be attributed to (or recovered from) customers is the extent to which the individual customer purchases electricity. In other words, the fee must be recovered from the customers on a pro rata basis in relation to the extent to which the individual customer has purchased electricity. It is therefore the customer who *de facto* pays for the safety control fee.

In the absence of an exemption granted in relation to the revenue of Norðurál hf. (and the other companies) Norðurál hf. would therefore have been paying the fee via the prices charged to it by the utility. The Icelandic authorities have explained that the exemption granted in relation to the revenue of Norðurál hf. (and the other companies) means that the utilities are legally obliged to reflect the fact that they have not paid the safety control fee (of 0.2% of the revenue of Norðurál hf.) in the prices charged to Norðurál hf. In other words, the utilities are legally obliged to confer the benefit of not having paid the safety control fee, in respect of the revenue of Norðurál hf., to the latter.

In view of the above, the Authority concludes that the fact that Norðurál hf. benefits from not having paid safety control fee confers an economic advantage on the company. It therefore constitutes state aid within the meaning of Article 61(1) of the EEA Agreement.

In the following the Authority considers the comments submitted by the Icelandic authorities, arguing that the fact that Norðurál hf. benefits from not having paid safety control fee, is not a selective advantage.

- **Selectivity**

The Icelandic authorities have argued that the following criterion is the one used for purposes of exempting the utilities from paying the fee in respect of sales to Norðurál hf. (as well as the two alloy and aluminium companies): “*The criteria here is whether companies are directly connected to the Grid or not.*”

Aside from the fact that the criterion submitted by the Icelandic authorities is not stipulated in statutory legislation, such a provision is still selective because not all companies are, nor could be, connected to the grid.

- **Justification**

Even a selective measure may be justified by the nature and internal logic of the system from which the measure deviates. In this regard, the Icelandic authorities have explained that when companies are directly connected to the grid, they undertake part of the work in relation to distributing the electricity. On this basis, the Authority considers that it could potentially be justified that the fee payable by the utilities for safety checks of the utility as such (that is, of the infrastructure and equipment for producing, transmitting and distributing electricity) would be somewhat lower in respect of the consumption of customers that are directly connected to the grid.³⁰ In this regard, the Icelandic authorities have also submitted that the Electricity Act

³⁰ This seems also to be in line with the Electricity Act which provides that a fixed fee is payable by these specific customers in return for inspections undertaken directly on their premises that are necessary as a result of their direct connection to the grid.

provides that a fixed fee is payable directly to the surveillance body of Löggildingarstofa by the specific customers (which are connected to the grid), in return for inspections undertaken on their own premises.

However, having said this, the Authority considers that the fact that the relevant customers are subject to direct inspections (as a result of their direct connection to the grid and participation in electricity distribution) still does not justify them being entirely exempt from paying the fee. In other words, the present total exemption from paying the fee cannot be justified by the mere fact that the customers, in respect of whose consumption the fee is payable, are connected to the grid.

The Icelandic authorities have argued that the electricity distribution to the 200,000 regular users of electricity (accounting for 35% of the electricity consumption on Iceland) is integrated into the society to such an extent that it calls for much more supervision and complex safety measures and thus much more inspection than the three power intensive users (accounting for 65% of the Icelandic electricity consumption) which receive the electricity at a single contact point at the location of each industrial plant.

However, the Authority considers that even assuming that it is correct that certain safety inspections need not to be carried out in relation to the network/equipment for distributing electricity where companies are directly connected to the grid, this does still not change the fact that the fee paid for safety inspections by the utilities cover the utilities as such, that is, also the part where production and transmission are carried out. The present total exemption from paying the fee is therefore not justified.

The conclusion of the above is that the exemption from paying the electricity fee by utilities when selling to Norðurál hf. involves state aid to that undertaking.

(c) Amendment to Smelter Site Agreement

The Amendment to the Smelter Site Agreement consists of the State renting out to Norðurál hf. the remaining part of the land i.e., up to 129.1 hectares out of the 131.1 hectares that it purchased in 1997. The Authority considers that the increase in the annual rent from USD 15,000 (corresponding to USD 181.37 per hectare) to USD 23,500 (corresponding to USD 182.01 per hectare) as a result of the fact that the site rented by Norðurál hf. has been increased from 82.7 to 129.1 hectares does not involve the grant of state aid. This is because the increase results in a rent per hectare which corresponds to the same amount of rent per hectare (of approximately USD 182) considered in the Grundartangi Decision to adequately reflect the acquisition costs of the state. The additional land rented by Norðurál is unfit for other than industrial use and there is no demand for the land. The value of the land has therefore remained unchanged.

However, the Authority considers that the fact that as of 5 February 2005, Norðurál hf. could occupy an increased portion of the land (i.e., the increase from 82.7 hectares to 129.1 hectares) but only would need to start paying the increased rent for the increased size of the rented land as of 1 January 2006, is equivalent to letting Norðurál hf. occupy the increased size of the land for free during the period between 5 February 2005 until 1 January 2006. The state thereby foregoes revenue whereas Norðurál hf. is granted an economic advantage which it would not have received in the normal course of business. The fact that no rent is paid for the increased part of the land between 5 February 2005 and 1 January 2006 therefore involves the grant of state aid within the meaning of Article 61(1) of the EEA Agreement.

2.4 One-off fees in the context of investments for Expansions I and II

The following addresses whether the specific amounts paid by Norðurál hf. to cover certain one-off fees, and the non-payment of one of those, in the context of its respective expansions, constitute the grant of state aid within the meaning of Article 61(1) of the EEA Agreement.

(a) Street connection fee

As mentioned above, the provision on street connection fees was not considered to involve state aid in the Grundartangi Decision as the street connection fee was considered to be a service charge payable to municipalities in return for street construction.

In line with this approach, the Authority considers that the provision on street connection fee referring to Expansion I and II for increasing the production capacity of Norðurál hf. does not involve state aid on the grounds that the street connection fee is a service charge paid in return for the construction of a particular street. In the present case, the municipalities have not levied the fee, since no streets have been built for Norðurál hf. in the context of its expansions. Moreover, it is the understanding of the Authority that construction of new streets would not be covered by the provision. As such, the provision in the Amendment to the Investment Agreement which provides that street connection fee shall not be paid in relation to the expansions of Norðurál hf. is a mere consequence of the municipalities' application of the statutory rules and it does therefore not result in an economic advantage for Norðurál hf.

(b) Building license fee

As mentioned above, in the Grundartangi Decision the Authority considered that the manner in which the building license fee had been fixed did not involve the grant of state aid. Rather, the fee was considered to be a service charge. Moreover, that the fee paid by Norðurál hf. covered the cost of the relevant surveillance body.

The Authority considers that the building license fees paid by Norðurál hf. in the context of Expansions I and II do not involve state aid. This conclusion is based on the fact that the relevant Act No. 73/1997, on the basis of which the fee is levied, refers to the principle that the building license fee shall not exceed the actual costs of issuing a building license and other related services and that the fees paid in relation to Expansion I and II have been fixed by the authorities in accordance with the principle laid down in the statutory rules i.e., so as to cover the costs of the surveillance body. The amount of building license fee paid in relation to the expansions of Norðurál hf. is therefore the result of applying the statutory rules and it does therefore not result in an economic advantage for Norðurál hf.

(c) Zoning fee

The Authority considers that the fact that the zoning fee paid by Norðurál hf. in relation to Expansion I and II has not been calculated according to the formula laid down in Act No. 73/1997 confers an economic advantage to Norðurál hf. It therefore constitutes state aid within the meaning of Article 61(1) of the EEA Agreement. The amount of the state aid is the difference between the amounts paid by Norðurál hf. in

relation to the expansions and what the latter should have paid had the fees been calculated in accordance with the statutory rules.

2.5 Power contracts

Profitability of new facilities

Norðurál hf. will be buying power from two newly constructed facilities of Hellisheiði geothermal power plant and Reykjanes geothermal power plant, both owned by the two state controlled utilities of Orkuveita Reykjavíkur and Hitaveita Suðurnesja hf., respectively. The latter utilities qualify therefore as public undertakings within the meaning of the Transparency Directive.³¹ According to both the Transparency Directive and the case law of the ECJ, aid may be granted through the intermediary of public undertakings or financial institutions.

However, the question of whether there is imputability to the state in the present case will only be relevant to assess if the Power Contract is not concluded on market conditions in line with the market economy investor principle.³² In other words, if public undertakings invest in new facilities which sell power exclusively to Norðurál hf. at prices that would be acceptable to a private market investor and that the investments would therefore be profitable it can already for that reason be concluded that no state aid will be involved.

In the present case the Authority considers that it is necessary to examine whether a private investor would consider offering metal-linked power tariffs. In this regard, it is relevant to take into account the forecasts for the aluminium price, as well as the other factors applied in the profitability analysis in the two power projects.

The Authority considers that a private market investor could consider offering metal-linked tariffs if the assumptions of the future metal prices appear reasonable and if the investments are calculated to yield an adequate return. In this respect it should be noted that there is no alternative outlet in the general Icelandic market for supply of electricity of the magnitude as in the case at hand. The isolated and limited size of the Icelandic market for general consumption of electricity would not be able to absorb the production generated by the two new power plants. The only outlet would be, as in the current case, large industrial consumers.

Concerning the projected aluminium prices, it should first be noted that they are based on a set of forecasts elaborated by two independent experts. The foreseen price at the start of power delivery, USD 1564 (2002 prices), is in the lower range of the various forecasts. Furthermore, an annual decline of 0.45% in the real price is in line with forecast price trends as developed by both experts. It may be noted that the experts, in addition to forecast price trends, have also projected annual price shifts for the first years to come. These forecasts, as well as historical developments, show rather large

³¹ Commission Directive 80/723 on the transparency of financial relations between Member States and public undertakings (the “Transparency Directive”); OJ 1980 L 195/35, as amended by OJ 1985 L 229/20; OJ 1993 L 254/16; and OJ 2000 L 193/75. The Directive is incorporated into the EEA Agreement by means of Article 1 of Annex XV.

³² This principle is explained in the Commission’s communication to the Member States, OJ 1993 C 307/ 3. Section 11 thereof provides that “*To ensure respect for the principle of neutrality the aid must be assessed as the difference between the terms on which the funds were made available by the State to the public enterprise, and the terms which a private investor would find acceptable in providing funds to a comparable private undertaking when the private investor is operating under normal market economy conditions (hereinafter ‘market economy investor principle’).*”

annual variations in the price of aluminium. Such forecasts predicting annual shifts are intrinsically uncertain. The Authority finds it more reasonable for a long-term analysis, like in the case at hand, to be based on projections on average price trends. It may also be noted that the chosen price trend presumes lower prices than these fluctuating forecasts for most of the periods that such forecasts are made. Based on this background, the Authority finds no reason to doubt the reliability of the price assumptions.

The next step is to verify whether the debt costs for financing the new geothermal plants may be considered to reflect market rates. If this is not the case and the costs of the debts are below the market rate, the overall costs for constructing the new plants would be correspondingly lower. This means that the utilities could accept to charge lower power prices to Norðurál hf. and thereby pass on an economic advantage to the company.

a) Hellisheiði geothermal power plant

As regards the debts costs for financing the Hellisheiði geothermal power plant it appears that Orkuveita Reykjavíkur has been able to obtain favourable rates on the costs of debts for financing the Hellisheiði project due to the fact that it enjoys an unlimited state guarantee. While the state guarantee enjoyed by Orkuveita Reykjavíkur will not be examined in the present context it is, however, necessary to assess whether state aid is being conferred on Norðurál hf. as a result of the fact that the loans for financing the establishment of the Helliesheiði plant have been obtained on favourable terms.

The interest rate used in the profitability analysis is set on the basis of what would have been the available market rate had Orkuveita Reykjavíkur been a limited liability company. In the Authority's opinion, this is sufficient to eliminate the advantages obtained via the state guarantee.

The debt costs for the Hellisheiði plant are estimated at a rate of 3% per year in real terms and 4.8% per year in nominal terms. The latter figure is based on a ten-year swap rate of a basket of main international currencies plus certain mark-ups to cater for lender margin (0.25 percentage points), uncertainties related to future financing (0.3 percentage points) and the effect of a state guarantee (0.25 percentage points). As regards the influence of the state guarantee on the level of the interest rate, the Authority notes that the estimate by the relevant lender of the difference between the actual debt costs and the costs of debts, which would have been charged in case Orkuveita Reykjavíkur had been a limited liability company (i.e., without the state guarantee) is fixed to correspond to 25 basis points. It should also be noted that so far the Hellisheiði plant has raised capital at an average of 2.13% in 2003, 2.4% in 2004 and 2.65% so far in 2005. In view of those considerations the Authority considers that there is no reason to doubt that the overall debt costs of 4.8% reflect a market rate.

b) Reykjanes power plant

For the Reykjanes power plant, the Authority has taken into account that the real terms debt costs are assumed to be 3.2% per year and that the calculated debt cost is fixed at 5% in nominal terms per year, based on a five-year swap rate which was 4.46% in 2004, plus a margin for uncertainty of 0.54 percentage points. On the basis of those factors, the Authority considers that there is no reason to doubt that the foreseen debt costs for the Reykjanes project are based on reasonable market assumptions.

Turning now to the verification of the profitability of the investments made in the two projects the Authority considers that the following two key assessments show that the projects are profitable:

First, the result of the cash flow analysis gives an internal rate of return (IRR) for both projects of [...]% (real) for the Hellisheiði geothermal power plant and [...]% (real) for the Reykjanes geothermal power plant. This is higher than the WACC which is [...]% (real) for the Hellisheiði geothermal power plant and [...]% (real) for the Reykjanes geothermal power plant.

Secondly, the analysis gives a return on equity of [...]% (real) for the Hellisheiði geothermal power plant and about [...]% (real) for the Reykjanes geothermal power plant.

According to the Icelandic authorities, the return on equity for the two projects is higher than the returns typically required by international investors using capital pricing models, reflecting, *inter alia*, current risk free rates and equity risk premium for companies in the electricity and aluminium sectors. As an example, Statkraft in Norway is using 11% as a target for nominal equity returns after having experienced an average of 7.5% in the years from 1998-2001. The nominal return of equity for Vattenfall in Sweden was 11.2% in 2001. The equity return of EDF in France was 6.2% in 2001. The average equity return for EDF in the years from 1998-2001 was 8.6%.

On the basis of the above observations, the Authority considers that in view of the fact that both the Hellisheiði geothermal power plant and the Reykjanes geothermal power plant are profitable and yield an acceptable return that a private market investor could, under similar circumstances, also have made similar investments. The Authority, therefore, concludes that no state aid is involved.

Development of existing facilities

The Authority considers that the installation of a new generator at the existing power plant in Nejsavellir does not involve the grant of state aid as such an investment appears to have been made on market conditions in line with what a private market investor would find acceptable. Even if one were to equate the actions of the publicly owned power companies with a state action within the meaning of Article 61(1) of the EEA Agreement, the forthcoming liberalisation of the Icelandic electricity market will imply that the new generator, in the longer run, will enable the Nesjavellir power plant to meet the growth foreseen in the general market for electricity. The new generator will initially on a short-term and transitional basis enable the existing Nesjavellir power plant to supply Norðurál hf. with power until the start up of the Hellisheiði geothermal plant (which will take over subsequent power production jointly with the Reykjanes power plant). However, the fact that a transitional arrangement is needed in order to enable the functioning of an otherwise profitable project, such as the power production in the Hellisheiði geothermal plant, cannot, in itself, be considered as granting an economic advantage to Norðurál hf., where the intermediate solution (i.e., the installation of a new generator) also serves long-term commercial goals.

As regards the installation of new facilities at the existing power plant in Svartsengi the Authority considers that since the costs of the building of new operating facilities

at Svartsengi already have been taken into account in the profitability calculations for the Reykjanes geothermal plant no further assessment of this item is necessary.

3. Compatibility

In the following, the Authority reviews the possibility of considering the aid measures identified above compatible on the basis of Article 61(3)(c) of the EEA Agreement, the rules on regional aid and the multisectoral framework in Chapters 25 and 26.A of the State Aid Guidelines.

3.1 Investment aid - the ceiling fixed in the agreed Appropriate Measures

The Appropriate Measures agreed to by the Icelandic authorities, fixed a ceiling of a total aid for all three investments of 88,3 million Euro with an aid intensity of 10.7%.³³ An absolute time limit for the application of the scheme until 31 October 2018, in order to qualify the aid as investment aid was also fixed. This ensured the compatibility with the functioning of the EEA Agreement of the Grundartangi Aid Scheme, in particular the rules on regional aid and the multisectoral framework in Chapters 25 and 26.A of the State Aid Guidelines.

The Authority considers that all non-notified aid measures under the Grundartangi Aid scheme and the amendments thereto may be counted towards the general ceiling fixed in the Appropriate Measures and thereby qualify as investment aid which is compatible with the functioning of the EEA Agreement. For clarity and transparency, in the following, the Authority sets out the circumstances of each of the aid elements in this regard.

3.2 Non-notified aid measures in the Grundartangi Aid Scheme

(a) Corporate income tax

Since Norðurál hf. has been taxed in accordance with the income tax rate following from statutory legislation the provision has, so far, not resulted in any direct transfers. However, should this provision result in any future transfers by virtue of an increase of the statutory tax rate, such transfers should be counted towards the ceiling fixed in the Appropriate Measures agreed to by the Icelandic authorities.

(b) Depreciation rules

The Authority considers that the transfers resulting from this provision as from its application in 1998 should be counted towards the ceiling fixed in the Appropriate Measures agreed to by the Icelandic authorities. In this regard, the Icelandic authorities have informed the Authority that the relevant transfers received by Norðurál hf. as a result of this provision have been taken into account in the amount of 4,8 million USD submitted as representing the aid already incurred between 1998 and 2003, see point 2.5 above.

(c) Right to deduct remaining net operating losses for a certain minimum of preceding calendar years

³³ See point 2.3 of Part I.

Since Norðurál hf. has, so far, deducted operating losses over a time span which has been in compliance with statutory legislation, the provision has not resulted in any direct transfers. Should this provision, however, result in any future transfers by virtue of a reduction in the statutory time span for deducting operating losses, the Authority considers that such transfers should be counted towards the ceiling fixed in the Appropriate Measures agreed to by the Icelandic authorities.

(d) Exemption from customs and excise duties on imports or domestic purchase of materials used for the construction of Norðurál hf.

Due to the fact that Norðurál hf. has not benefited from any exemption from the payment of customs/excise duties other than what it would have enjoyed on the basis of the statutory rules, the exemption has, so far, not resulted in any direct transfer to Norðurál hf. Should this provision, however, result in any future transfers by virtue of the fact that the statutory rules change in order to impose customs and/or excise duties, such transfers should be counted towards the ceiling fixed in the Appropriate Measures agreed to by the Icelandic authorities.

(e) Deferral from the payment of VAT

- Deferral from the payment of VAT on imports

Since Norðurál hf. has, so far, benefited from a deferral for the payment of VAT which is in line with the statutory rules the right to defer VAT payments has not resulted in any direct transfer to Norðurál hf. Should the statutory rule change any future transfers shall be counted towards the ceiling fixed in the Appropriate Measures agreed to by the Icelandic authorities.

- Deferral from the payment of VAT on electricity

Since Norðurál hf. has, so far, benefited from a deferral for the payment of VAT which is in line with the statutory rules the right to defer VAT payments has not resulted in any direct transfer to Norðurál hf. Should the statutory rule change any future transfers shall be counted towards the ceiling fixed in the Appropriate Measures agreed to by the Icelandic authorities.

(f) Exemption from excise/customs duties on material for the operation of Norðurál hf.

Since Norðurál hf. has not benefited from any exemption from the payment of customs/excise duties other than what it would have enjoyed on the basis of the statutory rules, the exemption has, so far, not resulted in any direct transfer to Norðurál hf. Should this provision, however, result in any future transfers by virtue of the fact that the statutory rules change in order to impose import/excise duties, such transfers should be counted towards the ceiling fixed in the Appropriate Measures agreed to by the Icelandic authorities.

3.3 Amendments made to the Grundartangi Aid Scheme and to the Smelter Site Agreement

(a) Right to allocate tax free profits of up to 4% of the nominal value of share capital into a special internal investment account.

Taking into account that two aspects involving the grant of state aid (i.e., the tax deferral and the accelerated depreciation) have remained in the otherwise abolished provision on the right to allocate tax free profits into a special investment account, the Authority considers that the transfers resulting from the right to benefit from a tax deferral and accelerated depreciation should be counted towards the ceiling fixed in the Appropriate Measures agreed to by the Icelandic authorities.

(b) Exemption from the payment of safety control fee for electricity production

The aid resulting from the fact that Norðurál hf. is not paying the electricity fee should be counted towards the ceiling fixed in the Appropriate Measures agreed to by the Icelandic authorities.

(c) Amendment to the Smelter Site Agreement

The state aid granted as a result of the fact that Norðruál hf. does not pay any rent for the increased size of the rented land (i.e., the increase from 82.7 hectares to 129.1 hectares) during the period between 5 February 2005 until 1 January 2006 should be counted towards the ceiling fixed in the Appropriate Measures agreed to by the Icelandic authorities.

3.4 One-off fees in the context of investments for Expansions I and II

Norðurál hf. did not pay the normal zoning fees in relation to Expansion I and II, and was hence granted state aid. The difference between the amounts paid by Norðurál hf. in relation to the expansions and what it should have paid had the fees been calculated in accordance with the statutory rules should be counted towards the ceiling fixed in the Appropriate Measures agreed to by the Icelandic authorities..

3.5 The assessment of advantages versus distortions of competition

Chapter 25.2 of the State Aid Guidelines provide that a derogation from the general prohibition against State aid established by Article 61(1) of the EEA Agreement may be granted in respect of regional aid only if the equilibrium between the resulting distortions of competition and the advantages of the aid in terms of the development of a less-favoured region can be guaranteed. The weight given to the advantages of the aid is likely to vary according to the derogation applied, having a more adverse effect on competition in the situations described in Article 61(3)(a) than in those described in Article 61(3)(c) of the EEA Agreement.

However, Chapter 25.2 of the State Aid Guidelines also provides an individual ad hoc aid payment made to a single firm or aid confined to one area of activity may have a major impact on competition in the relevant market and its effects on regional development are likely to be too limited. Such aid is therefore considered often not to be in keeping with the spirit of regional aid policy as such. The aid granted in such a context must be neutral towards the allocation of productive resources between the various economic sectors and activities. The Authority considers that unless it can be shown otherwise, such aid does not fulfill the requirements set out above.

The Icelandic authorities have submitted comprehensive information on the socio-economic impact of the investments made in respect of the aluminium smelter of Norðurál hf.; see point 2.8 of Part I above. This information shows, amongst others, that previous expectations to the effect that the investments in Norðurál hf. would reverse the fluctuating and declining depopulation trend in the Vesturland region have

been met. In line with this trend, it also appears from the relevant information that the Icelandic authorities consider that the more recent investments in the form of Expansion II are expected to further improve the socio-economic situation of the region both in terms of growth and job creation. For example, it appears that Expansion II is expected to create around 300-450 jobs (which will bring the total number of jobs at Norðurál hf. up to 500-600 jobs) and that the majority of future employees will come from the Vesturland region.

On this basis, the Authority considers that the aid scheme benefiting investments made for the construction and the two subsequent expansions of the aluminium smelter of Norðurál hf. has already made, and will continue to make, a significant contribution to the economic development in the Vesturland region.

Moreover, as is apparent from the information provided in point 1.6 of Part I above on the primary aluminium market, the relevant market grew by 8% in 2003 and 9.3% in 2004 which shows that the expectations of a future market increase have been met. Moreover, it appears that world consumption is projected to increase even further although not at the same high rate as in recent years. Based on this information as well as that set forth in Table 1, set out in point 2.6 of Part I above, showing that primary aluminium is traded world-wide, including in the EEA, and the degree to which world consumption and prices for primary aluminium are increasing, the Authority considers the primary aluminium market to be a well-functioning world market.

On this basis the Authority considers that the Icelandic authorities have demonstrated that, as a consequence of the aid granted on the basis of the non-notified aid measures of the Grundartangi Aid Scheme as well as the amendments made thereto, potential distortions of competition on the level of the world and the EEA are limited, while positive regional effects of the aid scheme are significant.

HAS ADOPTED THIS DECISION:

Article 1

1. On the basis of Article 61(3)(c) of the EEA Agreement and Chapters 17B, 25 and 26A of the State Aid Guidelines, the Authority has decided not to raise objections to the grant of aid in favour of Norðurál hf. by means of the following aid measures:
 - (a) the maximum corporate income tax of 18%;
 - (b) the accelerated depreciation of assets;
 - (c) the minimum time span of nine years for deducting operating losses;
 - (d) the exemption from customs and excise duties on imports or domestic purchase of materials used for the construction of Norðurál hf.;
 - (e) deferral from the payment of VAT on imports;
 - (f) the exemption from excise customs duties on material for the operation of Norðurál hf.;
 - (g) the tax deferral in respect of funds allocated into a special account and accelerated depreciation of assets purchased for such funds;
 - (h) the exemption from payment of fees for safety controls of electricity production;
 - (i) the difference between the statutory zoning fee and the amount actually paid; and

- (j) the non-payment of rent for the increased size of land between 5 February 2005 and 1 January 2006.
- 2. The state aid measures listed in point 1 above must be counted towards the ceiling, fixed in the Appropriate Measures agreed to by the Icelandic authorities, and respect all the conditions set forth herein.
- 3. Iceland is requested to submit annual reports regarding the implementation of the aid in accordance with Article 21 in Part II of Protocol 3 to the Surveillance and Court Agreement in conjunction with Articles 5 and 6 of the Authority's Decision 195/04/COL.

Article 2

This Decision is addressed to the Republic of Iceland.

Article 3

The Decision is authentic in the English language.

Done at Brussels, 20 July 2005

For the EFTA Surveillance Authority

Einar M. Bull
Acting President

Kurt Jäger
College Member