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[The information in square brackets is covered by the obligation of professional secrecy]

EFTA SURVEILLANCE AUTHORITY DECISION

of 24 October 2016

on the sale of electricity to Norðurál

(Iceland)

The EFTA Surveillance Authority (“the Authority”),

HAVING REGARD to the Agreement on the European Economic Area (“the EEA Agreement”), in particular to Article 61(1) and Protocol 26,

HAVING REGARD to the Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice (“the Surveillance and Court Agreement”), in particular to Article 24,

HAVING REGARD to Protocol 3 to the Surveillance and Court Agreement (“Protocol 3”), in particular to Article 1(3) of Part I and Article 4(2) of Part II,

Whereas:

I. FACTS

1. Procedure

- (1) By letter dated 6 September 2016,¹ the Icelandic authorities notified for legal certainty the Third Amendment to the power contract concluded in 1997 between Landsvirkjun and Norðurál Grundartangi ehf. (“the Third Amendment”), for the operation of the existing aluminium plant of Norðurál in Grundartangi in Hvalfjarðarsveit, Iceland.

2. Description of the notified measure

2.1. The contracting parties

2.1.1 Norðurál

- (2) Norðurál Grundartangi ehf. (“Norðurál”) is a private limited liability company and fully owned by Norðurál ehf. (a holding company), both registered and operating under the laws of Iceland. Norðurál was established and organised in accordance with Act No 62/1997 from 27 May 1997,² and the Investment Agreement, dated 7 August 1997, between the

¹ Documents No 817040, 817042 and 817075, as well as 18 Annexes (Documents No 817076-817094).

² Alþingi Act No 62/1997 available in Icelandic at: <http://www.althingi.is/lagas/nuna/1997062.html>.

Government of Iceland, Columbia Ventures Corporation and Norðurál hf. (now Norðurál Grundartangi ehf.).

- (3) Norðurál has the objective of constructing, building, operating and owning an aluminium reduction metal plant in Grundartangi in Hvalfjarðarsveit, Iceland. Norðurál currently holds permits to produce up to 350 000 tons of aluminium per annum.

2.1.2 Landsvirkjun

- (4) Landsvirkjun is a public partnership company regulated by Act No 42/1983 on Landsvirkjun, as amended (“the Landsvirkjun Act”).
- (5) The introduction of competitive power markets in Iceland in 2003 led Landsvirkjun to develop a corporate strategy to maximise the potential yield and value of natural resources it has been entrusted with in a sustainable, responsible and efficient manner. Concurrently, Landsvirkjun’s emphasis moved away from the construction of new power plants to focusing on marketing and operations.
- (6) As of 1 January 2007, the State Treasury took over the full ownership in Landsvirkjun. The company remained a partnership company with joint liability of the owners. Landsvirkjun is currently jointly owned by the State Treasury (99.9%) and Eignarhlutir ehf. (0.1%). The latter is a limited liability company wholly owned by the State Treasury.
- (7) Landsvirkjun is by far the largest electricity producer in Iceland with an output of 13 710 gigawatt hours (“GWh”) in 2015, which, according to the company’s own estimates, represents approximately 73% of Iceland’s overall electricity production. The company produces electricity from hydro (96%) and geothermal (4%) sources, and operates 18 power stations.³

2.2. The characteristics of the electricity market in Iceland

- (8) The Icelandic electricity system is isolated, *i.e.* no interconnection exists to other countries. There have been discussions about a future interconnector between Iceland and the UK (“IceLink”).⁴ Landsvirkjun, along with its partners, are currently assessing the feasibility of such a project, and are working towards a commissioning date for IceLink in the time period 2025-2029.
- (9) In 2015, 73.3% of electricity production in Iceland was derived from hydropower (13 780 GWh). Geothermal production accounted for 5 003 GWh (26.6% of the total production), the rest coming from fuel and wind power (4 and 11 GWh, respectively).⁵ The total generation of electricity in Iceland in 2015 was 18 798 GWh.⁶
- (10) Landsvirkjun is active only on the wholesale market for electricity, where its main competitors are Orka náttúrunnar (Our Nature – ON) and HS Orka. The sale of electricity is completed through directly-negotiated contracts concluded with energy-intensive users.

³ Information from the website of Landsvirkjun. Annual report for 2015 available in Icelandic at: <http://arsskyrsla2015.landsvirkjun.is/>.

⁴ See draft Ten-Year Network Development Plan 2014, prepared by ENTSO-E, European Network of Transmission System Operators for Electricity, pages 161-2, available at <https://www.entsoe.eu/major-projects/ten-year-network-development-plan/tyndp-2014/Pages/default.aspx>.

⁵ See energy statistics in Iceland for 2015. Available in Icelandic at the website of Orkustofnun: http://os.is/gogn/os-onnur-rit/orkutolur_2015-islenska.pdf.

⁶ See data available at the website of Orkustofnun. Available in Icelandic at: http://os.is/gogn/os-onnur-rit/orkutolur_2015-islenska.pdf.

These are in turn connected to the transmission system directly, by transmission contracts negotiated with Landsnet (the Icelandic transmission company).⁷

- (11) According to publicly available information provided by Orkustofnun (the National Energy Authority), 76.4% of the electricity is consumed by energy-intensive users (aluminium, ferrosilicon and aluminium foil industry) and 23.6% is attributed to general usage and transmission losses, see table 1 below:⁸

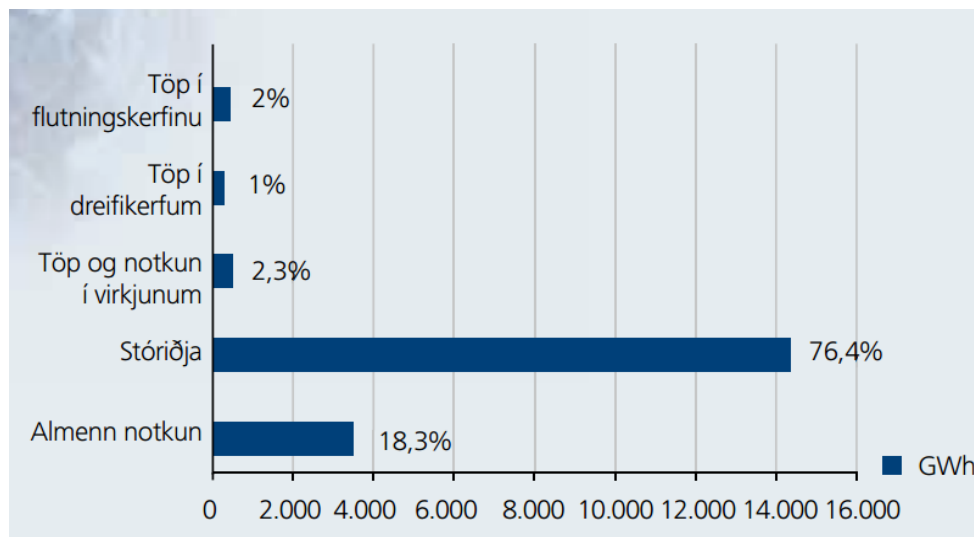


Table 1. Electricity consumption in 2015. Source: Orkustofnun⁹

- (12) Due to existing contractual engagements, growing wholesale demand and ongoing negotiations with power intensive companies planning to establish themselves in Iceland, Landsvirkjun is investing in extending existing facilities and exploring new facilities. In the time period from 2017 to 2019, Landsvirkjun will bring two new power plants online to meet increased demand in the period 2018 to 2021.

2.3. Previous power contracts between Landsvirkjun and Norðurál

- (13) There are currently three power contracts in effect between Landsvirkjun and Norðurál; a power contract from 1997 (“PC1997”),¹⁰ a power contract from 2009 (“PC2009”),¹¹ and a supplementary power contract from 2012 (“PC2012”).¹²
- (14) The PC1997, enabled Norðurál to produce about 60 thousand tons of aluminium (107 MW, 930 GWh). Two amendments have been made to the original PC1997, which resulted in increased power delivery from Landsvirkjun to Norðurál. In 1999, the parties agreed to enter into the first amendment to the PC1997, enabling Norðurál to expand to 90 thousand tons (161 MW, 1 400 GWh). The parties agreed on further amendments in 2004. However, these changes had no effect on the amount of power or the price from Landsvirkjun, but merely reflected the change of ownership of the Norðurál plant and the entry into force of the Icelandic Electricity Act in 2003.

⁷ For further information see Landsnet’s webpage: <http://landsnet.is/>.

⁸ See data available at the website of Orkustofnun. Available in Icelandic at: http://os.is/gogn/os-onnur-rit/orkutolur_2015-islenska.pdf.

⁹ The Authority’s informal translation: Töp í flutningskerfinu (transmission losses), Töp í dreifikerfum (distribution system losses), Töp og notkun í virkjunum (power plant own use), Stóriðja (energy intensive users), Almenn notkun (public use).

¹⁰ The power contract between the parties from 1997. Document No 804768.

¹¹ The power contract between the parties from 2009. Document No 804769.

¹² The supplemental power contract between the parties from 2012. Document No 804772.

- (15) In accordance with the PC1997, the electricity price was tied to prices on the aluminium markets. The PC1997 also stipulated that Landsvirkjun should bear the all the cost of transmitting the energy, *i.e.* the transmission charges.
- (16) According to the PC2009, Landsvirkjun supplies Norðurál with an additional 25 MW. However, it was agreed that Norðurál would make an independent agreement with the transmission system operator (“TSO”),¹³ Landsnet hf., and pay for the transmission of the 25 MW (212 GWh).
- (17) The current notification is neither related to the PC2009 nor the PC2012. It only concerns the extension and amendment of the PC1997.

2.4. The Third Amendment to the PC1997 (the notified measure)

- (18) The negotiations between Landsvirkjun and Norðurál went on for several months before both parties agreed on a draft. The draft Third Amendment to the PC1997 was later discussed and agreed to at a meeting of the Board of Directors of Landsvirkjun, and subsequently signed by the parties on 31 August 2016.
- (19) With the Third Amendment to the PC1997, Landsvirkjun will be supplying practically the same contract power (161 MW capacity remains unchanged while energy changes slightly from 1 400 to 1 410 GWh) to Norðurál as under the existing power contract. The Third Amendment also includes the same “Take or Pay” obligation¹⁴ as the previous contract.
- (20) In accordance with the Third Amendment, Norðurál’s payments to Landsvirkjun for the electricity each month will be tied to the delivered volume of energy, the market price for power in the Nordpool Elspot power market (Elspot System Price reference used; hereafter “Nordpool power prices”) and the foreign exchange rate between [...].
- (21) The Third Amendment stipulates that Norðurál will enter into an agreement with the TSO, Landsnet hf., on transmission of power to the Plant. Landsvirkjun shall thus be released from its obligations in that respect. During the extended contract period, [...].
- (22) The contract price can be expressed as follows:

$$\text{Contract price in month } t = [\dots]^{15}$$

- (23) Pursuant to an amended fairness clause found in Article 22(4) of the PC1997 as amended by the Third Amendment, should the referenced power market price fail to reflect the market value of power, the parties shall meet in good faith, discuss and agree on a new pricing mechanism which reflects market value.
- (24) The extended contract period is from 1 November 2019 until 31 December 2023. Prior to the end of the contract period, and upon written request of either party, the parties shall enter into discussions in good faith with regard to the possibility of extending or renewing the power contract for an additional period on mutually agreeable terms

¹³ A transmission system operator (“TSO”) is an entity entrusted with transporting energy in the form of natural gas or electrical power on a national or regional level, using fixed infrastructure.

¹⁴ A “Take or Pay” obligation requires the buyer to either purchase and receive a minimum amount of a product (“Take”) or pay for this minimum without taking immediate delivery (“Pay”).

¹⁵ [...].

3. Comments by the Icelandic authorities

- (25) The Icelandic authorities and Landsvirkjun are of the view that the notified Third Amendment does not entail state aid. The Icelandic authorities have notified the Third Amendment for legal certainty.
- (26) The Icelandic authorities note that with the Third Amendment the parties decided to extend the PC1997 with a short-term contract, and wait for challenging market uncertainties to be resolved without making longer-term commitments. The aluminium industry is currently going through a period of low commodity prices, which is affecting global aluminium prices. At the same time, power prices in many European wholesale markets have dropped substantially in an environment of oversupply due to subsidy schemes which aim to bring on more renewable power supply.
- (27) According to the Icelandic authorities, Landsvirkjun has managed to improve power pricing expectations through the Third Amendment and provide for a direct linkage to Nordpool power prices. For several years, it has been Landsvirkjun's strategy to link its contract prices with European power prices, and by leveraging current market circumstances the company has been able to advance its strategy. The agreed extension terms allow Landsvirkjun to expect significantly higher prices compared to what would apply if the current PC1997 contract price mechanism would be continued and, in any event, prices which are higher than Landsvirkjun's average generation cost.
- (28) The Icelandic authorities note that Landsvirkjun's price of electricity in new and renegotiated contracts is generally set with reference to the price for power in competing markets. This holds true for both long-term and short-term contracts. The alignment in the Third Amendment with the Nordpool power prices, allows Landsvirkjun to sell power at the same prices as competing companies in the Nordic countries. In support of this assertion, the Icelandic authorities highlight that the power intensive industry in Norway pays electricity prices that are closely aligned with Nordpool power prices.
- (29) The Icelandic authorities also note that the agreed extension terms expose both parties to fair market risks since short-term direct exposure to power markets replaces the long-term direct exposure to aluminium markets, which currently results from the PC1997. As neither party expects new investments to be able to honour the Third Amendment, parties are able and willing to expose themselves to different risks than would otherwise be the case, thus the appetite for a direct link to spot market pricing for power and short contract duration. Furthermore, exposure to neighbouring power markets is a normal risk for a power company such as Landsvirkjun to carry.
- (30) According to the Icelandic authorities, Landsvirkjun would incur a significant risk by not renegotiating the supply of 161 MW in question to Norðurál, both in terms of price and volume. Landsvirkjun expects it would take some years to sell the full amount of power in light of the company's experience with long lead times for new industrial project development. As a point of reference, the Icelandic authorities note that keeping 100 MW unsold for one year involves revenue loss of around [...] million USD per annum for Landsvirkjun.
- (31) Finally, according to the Icelandic authorities, the short contract period gives Landsvirkjun the opportunity to renegotiate the price when the electricity markets and the aluminium markets may be more balanced.
- (32) In light of the above considerations, the Icelandic authorities argue that no economic advantage has been granted to Norðurál through the proposed Third Amendment as the

transaction complies with the requirements of MEO (market economy operator) test, and Landsvirkjun has acted as a prudent private operator.¹⁶

¹⁶ Document No 817076, pages 28-29.

II. ASSESSMENT

1. The presence of state aid

1.1. Article 61(1) of the EEA Agreement

- (33) According to Article 61(1) of the EEA Agreement, a measure constitutes state aid if it is granted by the State or through state resources, confers a selective economic advantage on undertakings, and is liable to distort competition and to affect trade between the Contracting Parties to the EEA Agreement.
- (34) The Authority notes that the main arguments put forward by the Icelandic authorities relate to the absence of an economic advantage conferred on Norðurál by the Third Amendment to the PC1997. The assessment below will therefore focus on the question of whether the measure confers an economic advantage.

1.2. No economic advantage conferred by the Third Amendment

- (35) The Icelandic authorities argue that the Third Amendment was concluded on market terms and that Landsvirkjun expects significantly higher prices for its electricity under the Third Amendment compared to what it would receive if the current PC1997 contract price mechanism were to be continued. Thus, according to the Icelandic authorities, no economic advantage has been granted to Norðurál.
- (36) The Court of Justice of the European Union has stated that in order to confirm whether a State measure constitutes aid, it is necessary to establish whether the recipient undertaking, in this case Norðurál, receives an economic advantage that it would not have obtained under normal conditions.¹⁷ In doing so, the Authority has to apply the market economy operator (MEO) test, which in essence provides that state aid is granted whenever a State makes funds available to an undertaking which, in the normal course of business, would not be provided by a private investor applying ordinary commercial criteria and disregarding other considerations of a social, political or philanthropic nature.¹⁸
- (37) Accordingly, the Authority will apply the MEO test to the Third Amendment. It will examine whether a private operator in the same situation as Landsvirkjun would have chosen to enter into a short-term bilateral contract for the same price and on the same terms as in the Third Amendment under assessment.¹⁹
- (38) The measure at hand – a power contract entered into with a state-owned company – could thus entail an element of state aid if its terms are such that they would not have been acceptable to a private market operator, and in particular if the sale of electricity could not have been expected to be sufficiently profitable for a private operator.
- (39) Whilst the Authority fully recognises the right for public companies such as Landsvirkjun to operate on the market on commercial terms, it nevertheless must consider carefully whether similar agreements would have been concluded by a private market operator.²⁰

¹⁷ Judgment in *SFEI v La Poste*, C-39/94, EU:C:1996:285, at paragraph 60.

¹⁸ See for example Opinion of Advocate General Jacobs in *Spain v the Commission*, C-278/92, C-279/92 and C-280/92, EU:C:1994:112, at paragraph 28.

¹⁹ See the Authority's Decision No 67/15/COL on the sale and transmission of electricity to United Silicon in Helguvík.

²⁰ See the Authority's guidelines, Part IV: Rules on public service compensation, state ownership of enterprises and aid to public enterprises, Application of state aid provisions to public enterprises in the manufacturing sector, paragraph 5(1), (OJ L 274, 26.10.2000, page 29 and EEA Supplement No 48, 26.10.2000).

Moreover, the Authority must base its assessment of the price and terms of the Third Amendment on the information available at the time it was concluded.

- (40) Ordinarily, when a sale by a public company or a public authority is assessed, the market price for the good or service under assessment can be used as a relevant benchmark. In the case at hand, however, a market price is not readily available, given the peculiarities of the Icelandic electricity market. A large majority of all electricity is sold to a few customers, which have all concluded long-term agreements with the domestic power providers at different points in time. Furthermore, the Icelandic market is isolated from the rest of the world, as currently no power can be transmitted across the border.²¹ The abundant potential to produce electricity in Iceland and its isolation are assumed to be the main reasons for the differences in the price of electricity in Iceland and elsewhere in the EEA States.
- (41) Since market data is not available and market conditions cannot be empirically established by reference to “*pari passu*” transactions or an open, transparent, non-discriminatory and unconditional tender procedure, and since benchmarking (comparable transactions carried out by comparable private operators in comparable situations)²² is not an available method for establishing whether the transaction was in line with market conditions, determination of the return on the investment by calculating the net present value (“NPV”) and/or internal rate of return (IRR) on the project are generally-accepted standard methodologies that can be used for establishing whether the transaction was in line with market conditions.²³ For making the assessment, the Authority must base its methodology on available objective, verifiable and reliable data.²⁴ This data must be sufficiently detailed, reflecting the economic situation at the time at which the terms of the Third Amendment to the PC1997 were decided, taking into account the level of risk and future expectations.
- (42) Based on these premises, the Authority has assessed the economic effects for Landsvirkjun of the Third Amendment.
- (43) To assess its potential total benefit of the Third Amendment to the PC1997, Landsvirkjun has calculated the NPV of the transaction, which takes into account the gross revenues of the Norðurál contract and the required minimal revenues of Landsvirkjun. The following assumptions were made:

²¹ See paragraph (8) above.

²² According to the CJEU “*in the absence of any possibility of comparing the situation of [La Poste] with that of a private group of undertakings [...], normal market conditions, which are necessarily hypothetical, must be assessed by reference to the objective and verifiable elements which are available*”. Judgment in *Chronopost*, C-83/01 P, C-93/01 P and C-94/01 P, EU:C:2003:388, paragraph 38.

²³ The Authority has already stated in its State aid Guidelines – Application of State aid provisions to public enterprises in the manufacturing sector (OJ L 274, 26.10.2000, page 29 and EEA Supplement No 48, 26.10.2000), that “*only where there are no objective grounds to reasonably expect that an investment will give an adequate rate of return that would be acceptable to a private investor in a comparable private undertaking operating under normal market conditions, is State aid involved*” (see paragraph (1), under the subtitle “*Practicality of the market economic investor principle*”). Consequently, the compliance with the market economy operator test (MEO) of a given project can be assessed by reference to the economic conditions under which a private company in similar circumstances would accept to undertake it. This is normally done by calculating the NPV or IRR of the project. The NPV is the sum of the discounted value of all cash flows that it generates including the original capital investment and the end-of-period or residual value. A company will carry out projects with a positive NPV. See also the Commission Notice on the notion of state aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union, OJ C 262, 19.7.2016, p. 1–50, paragraphs 105 et seq. See also judgment in *Ciudad de la Luz*, Joined Cases T-319/12 and T-321/12, EU:T:2014:604, paragraphs 40 and 73.

²⁴ See judgment in *Scott v Commission*, T-366/00, EU:T:2007:99, paragraph 134. See also judgment in *Chronopost*, C-83/01 P, C-93/01 P and C-94/01 P, EU:C:2003:388, paragraph 38.

- Norðurál purchases contract capacity of 161 MW (approx. 1 410 GWh/annum).
 - The contract period is 1 November 2019 to 31 December 2023.
 - The minimum price required of Landsvirkjun equals [...] USD/MWh indexed at year 2016.
 - WACC equals [...].
- (44) Therefore, based on the cost value of Landsvirkjun's current fixed assets on its balance sheet, the company has calculated a required minimum price as a reference for prospective contract prices. In order to receive the required [...] rate of return ([...] return on equity based on a 40% equity ratio), the minimum price for Landsvirkjun at 2016 price level is [...] USD/MWh.
- (45) Using the software @Risk and Monte Carlo simulations, Landsvirkjun estimated the possible development of the Nordpool Elspot System Price and the [...] exchange rate until year-end 2023. The Monte Carlo simulations were based on historical data over the 15-year period 2001 to 2015. Landsvirkjun also estimated the average price during the contract period 2019 to 2023. The contract price is the output of the price equation described in paragraph (22) above. The calculation submitted by Landsvirkjun shows that the Third Amendment to the PC1997 leads to positive NPV results, thus achieving at least the required [...] return on equity, with 90% probability.
- (46) At the request of the Authority, Landsvirkjun also performed three different simulations of probability distribution of NPV using historical data from 2006 onwards, *i.e.* from the time the Nordpool Elspot power market adopted the Euro as its currency.²⁵ The results of those simulations suggest a close to 100% probability that the [...] required rate of return will be achieved and that the average contract price will be higher than Landsvirkjun's minimum price of [...] USD/MWh.
- (47) These calculations thus show that, depending on the data set used for the simulation, there is a risk of up to 10% that Landsvirkjun's required rate of return on equity will be not be achieved. At the same time, there is probability of at least 90% that the Third Amendment will either achieve or surpass the required minimum rate of return for Landsvirkjun. The Authority notes that the pricing mechanism and the risk associated with using the Nordpool Elspot power prices is, as argued by Landsvirkjun, in line with standard commercial practices of competing power companies in the Nordic countries. In light of these elements, the Authority considers that the pricing of the Third Amendment, and the level of risk associated with it, is in line with what a private power producer would consider acceptable in the same situation.
- (48) Other characteristics of the Third Amendment further support the conclusion that it has been concluded on market terms.
- (49) As noted in paragraph (23) above, the pricing risk is mitigated by the amended fairness clause which ensures that, should the referenced power market price fail to reflect the market value of power, the parties shall meet in good faith, discuss and agree on a new pricing mechanism which reflects market value.

²⁵ Document No 817087.

- (50) Moreover, as noted in paragraph (21) above, the Third Amendment to the PC1997 is considerably more favourable to Landsvirkjun than the previous agreements with Norðurál when it comes to transmission costs, since the Third Amendment [...].
- (51) Finally, as noted by the Icelandic authorities, the extension terms expose both parties to fair market risks since short-term direct exposure to power markets replaces long-term direct exposure to aluminium markets, and the short contract period gives Landsvirkjun the opportunity to renegotiate when the electricity markets and the aluminium markets may be more balanced.
- (52) For the above reasons, the Authority considers, on the basis of the information provided by the Icelandic authorities and in line with the MEO test, that Landsvirkjun has acted as a private operator would have done when signing the Third Amendment to the PC1997, and that the company acted within the margin of discretion that public companies enjoy in running their business. Consequently, the Authority concludes that the conditions of the Third Amendment to the PC1997 do not entail an economic advantage for Norðurál.
- (53) Since the criteria in Article 61(1) of the EEA Agreement are cumulative,²⁶ there is no need to establish whether the other criteria of the notion of state aid are met in the case at hand. The Authority therefore concludes that the Third Amendment does not result in the granting of state aid in favour of Norðurál.

²⁶ See judgment in *Belgium v Commission* (“*Tubemeuse*”), C-142/871 EU:C:1990:125, paragraph 25.

2. Conclusion

- (54) On the basis of the foregoing assessment, the Authority finds that the Third Amendment, dated 31 August 2016, to the power contract concluded in 1997 between Landsvirkjun and Norðurál Grundartangi ehf. does not constitute state aid within the meaning of Article 61(1) of the EEA Agreement.

HAS ADOPTED THIS DECISION:

Article 1

The Third Amendment to the power contract between Landsvirkjun and Norðurál Grundartangi ehf. dated 31 August 2016, notified for legal certainty, does not constitute state aid within the meaning of Article 61(1) of the EEA Agreement.

Article 2

This Decision is addressed to Iceland.

Article 3

Only the English language version of this decision is authentic.

Done in Brussels, on 24 October 2016.

For the EFTA Surveillance Authority

Sven Erik Svedman
President

Helga Jónsdóttir
College Member

Frank J. Büchel
College Member

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