EFTA SURVEILLANCE AUTHORITY

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EFTA SURVEILLANCE AUTHORITY DECISION
of 27 July 2001
on alleged aid to Iceland Post and Telecom Ltd.
(ICELAND)

THE EFTA SURVEILLANCE AUTHORITY,

HAVING REGARD TO the Agreement on the European Economic Area[1], in particular to Articles 61 to 63 thereof,

HAVING REGARD TO the Agreement between the EFTA States on the establishment of a Surveillance Authority and a Court of Justice[2], in particular Article 24 and Article 1 of Protocol 3 thereof,

HAVING REGARD TO the Procedural and Substantive Rules in the Field of State Aid[3], in particular Chapters 19 and 20 thereof,

WHEREAS:

I. FACTS

A. Procedure

In June 1999, alleged aid to Iceland Post and Telecom Ltd. had been brought to the Authority's attention through articles in the press. Press reports indicated that according to the Icelandic Competition Council ("*Samkeppnisráð*"), aid in the form of an under-valuation of the company's assets and a reduction of pension obligations amounting to at least ISK 10 billion had allegedly been granted to Iceland Post and Telecom Ltd. when the former Post and Telecommunication Authority (PTA) was transformed into a public limited-liability company. According to information in the Authority's possession at that time, the Icelandic Competition Council had adopted an opinion concluding that the assets of the newly established Iceland Post and Telecom

[1] Hereafter referred to as the EEA Agreement.
[2] Hereafter referred to as the Surveillance and Court Agreement.
[3] 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, last amended by the Authority's Decision No. 152/01/COL of 23 May 2001, not yet published; hereafter referred to as the Authority's State Aid Guidelines.

Ltd. were undervalued and that it was partially relieved of its debt toward the Pension Fund.

Against this background, the Authority requested the Icelandic authorities by letter dated 5 July 1999 (Doc. No. 99-5002-D), to submit all relevant information enabling it to assess the compatibility with Article 61 of the EEA Agreement. On 24 September 1999, the matter was discussed at a bilateral meeting in Brussels between representatives from a working party, set up by the Icelandic authorities and asked to analyse the findings of the Icelandic Competition Council, and representatives from the Competition and State Aid Directorate. By letter of 8 October 1999, registered by the Authority on 13 October 1999 (Doc. No. 99-7639-A), the Icelandic authorities submitted part of the requested information. Further information and comments were submitted by letters dated 19 November 1999 and 14 December 1999, registered by the Authority on 25 November 2000 and 10 January 2000 respectively (Doc. Nos. 99-8980-A and 00-143-A). The information submitted included in particular the report of the working group dated 6 October 1999. The report concluded that the method used, when the value of the assets was estimated, was not in conformity with the EEA Agreement. However, it was also concluded that – without carrying out a new assessment based on the net cash flow method – it was not possible to establish whether aid had been granted in the form of an undervaluation of the former Post and Telecom Administration’s assets. The Icelandic Government informed the Authority that in light of these conclusions, the Ministry had decided to set up a new working group to carry out a new valuation. The pending issues were discussed at a package meeting between the Icelandic authorities and the Authority in Reykjavik on 26 November 1999.

By letter dated 23 December 1999, registered by the Authority on 4 January 2000 (Doc. No. 00-49-A), the Authority received a complaint alleging that assets were transferred from the Post and Telecom Administration to Iceland Post and Telecom Ltd. at an acquisition value of at least ISK 10 billion below commercial value. The complaint further alleged that Iceland Post and Telecom Ltd. was partially relieved of debts towards the Government Employee’s Pension Fund and that Iceland Post and Telecom Ltd. was exempted from the payment of stamp duty on the shares issued by the company. By letter dated 8 February 2000 (Doc. No. 00-1071-D), the Icelandic authorities were informed that the Authority had received the complaint and invited them to submit their comments in this respect. Furthermore, the Authority requested the Icelandic authorities to furnish additional information, in particular with respect to the follow-up work regarding the re-valuation of the assets to be carried out by a new group of experts. A further meeting took place between the representatives of this new working group and representatives from the Competition and State Aid Directorate on 3 March 2000. By letter dated 7 March 2000, registered by the Authority on 21 March 2000 (Doc. No. 00-2409-A), the Icelandic authorities submitted supplementary information.

By letter dated 27 July 2000 (Doc. No. 00-5317-D), the Authority reminded the Icelandic authorities to submit the new working group’s report on the re-valuation of Iceland Post and Telecom Ltd.’s assets which was – to the Authority’s knowledge – already presented on 8 April 2000 and to inform the Authority of the implementing measures adopted by the Government in accordance with the findings of the report. Furthermore, the Authority asked the Icelandic Government to further elaborate on the allegations regarding the reduction of pension fund obligations as well as the exemption from stamp duty. By letter dated 15 September 2000, registered by the Authority on 4 October 2000 (Doc. No. 00-6964-A), the Icelandic authorities submitted the requested explanations. The Icelandic authorities explained which measures were taken in order to take full account of the findings of the report, which had concluded that the former Post and Telecom Administration's assets had been undervalued by ISK 3.8 billion. The requested report (without the relevant annexes) had been sent previously in electronic version. By letter dated 24 November 2000 (Doc. No. 00-8525-D), the Authority asked the Icelandic authorities to submit the missing annexes and to clarify certain issues. The Icelandic Government responded by letter from the Ministry of Finance dated 5 February 2001, received and registered by the Authority on 14 February 2001 (Doc. No. 01-1156-A).

Following further contacts between the Icelandic authorities and the Authority, the former submitted additional information via the Icelandic Mission to the EU, by letter dated 11 June 2001, received and registered by the Authority on the same day (Doc. No. 01-4331-A), regarding the interest rates applied for the calculation of the debt of ISK 3.8 billion towards the Treasury, which will have to be repaid by Iceland Telecom Ltd. By letter dated 27 June 2001 (Doc. No: 00-4827-D), the Authority required additional clarifications. The Icelandic authorities replied by letter of 9 July 2001, received and registered by the Authority on that same day (Doc. No. 01-5446-A).

B. Transformation from Post and Telecom Administration into Iceland Post and Telecom Ltd.

In 1996, the Icelandic Parliament adopted Act No. 103/1996 on the establishment of Post and Telecom Ltd. ("*Lög um stofnun hlutafélags um rekstur Póst- og símamálastofnunar*")[4].

Pursuant to Article 1 of the Act, the Government is authorised to establish a corporation for the operation of the Post and Telecom Administration's activities. The Government is further authorised to furnish the newly established company with all assets and liabilities of the Post and Telecom Administration, its rights, commitments, and goodwill as further specified in the Act.

Article 2 (2) of the Act states that the company is permitted to establish one or more new companies, which will entirely belong to the company, to take over the tasks of certain aspects of its operations.

Article 4 of the Act provides that the nominal value of the initial capital stock of the Iceland Post and Telecom Ltd. shall amount to 75% of the book value of the Post and Telecom Administration's equity according to the audited balance sheet of 31 December 1995, which shall also be regarded as the company's initial balance sheet (with the remaining 25% as statutory reserve). Share capital shall be increased or decreased according to the decision of an Evaluation Committee, established according to Article 5 of the Act.

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[4] Hereafter referred to as "the Act".

Article 5 of the Act provides that the Minister for Transport and Communications shall appoint a committee of three persons to re-evaluate the Post and Telecom Administration's assets, commitments and goodwill, and to evaluate other assets and liabilities on the Post and Telecom Administration's balance sheet. The former Post and Telecom Administration's pension fund obligations shall be entered as debt in the institution's balance sheet at year-end 1995, in accordance with an explanatory note regarding Article 5.

Article 7 (2) of the Act provides that the Minister for Transport and Communications shall appoint a committee of three persons for the preparation and procedures necessary for the transformation of the public body to a corporation. The committee was authorised to make any kind of legal contracts necessary for the preparation of the company's establishment and its future operations. Upon its establishment the company was to be bound by the contracts in question.

According to Article 15 of the Act, Iceland Post and Telecom Ltd. was to take over all obligations of the Post and Telecom Administration.

According to Article 7 of the Act, Iceland Post and Telecom Ltd. was established as from 1 January 1997. As from 1 January 1998, the telecommunication and postal activities were organised separately with the creation of Iceland Telecom Ltd. and Iceland Post Ltd., respectively.

C. Determination of the value of PTA's assets and set up of initial balance sheet for Iceland Post and Telecom Ltd.

On 30 June 1996, the Ministry of Transport and Communications appointed a special Evaluation Committee in accordance with Article 5 of the Act, to re-evaluate the fixed assets of the PTA, its commitments and goodwill, and to evaluate other assets and liabilities. The results were reported on 1st October 1996, accompanied by a proposal for the initial balance sheet. The Committee based its assessment on the asset evaluation method, meaning that the appraisal of assets was mainly based on book values for year-end 1995. According to the report, "*it was not provided that the committee shall base its appraisal on calculations of the net present value of cash flow, which is a method commonly applied in the appraisal of companies*". Based on the chosen method, the Evaluation Committee increased the book value, *inter alia*, because of discrepancies between official real estate appraisals of assets and their book value. With respect to the partial relief of debts towards the pension fund, the Committee stated that "*…the debt is a heavy burden to the company, and that the owner is bound to consider lowering it and raising the company's equity capital by the same amount*". The Government took account of these concerns and decided to lower the debt in an agreement concluded on 27 December 1996 (see below for further details).

Based on the Evaluation Committee's report, the initial balance sheet as of 1 January 1997 was as follows (expressed in *Íslenskar Krónur* (ISK)):

Table 1:

	Assets		Equity and Liabilities
Current assets	4,591,288,990	Current liabilities	2,308,673,483
Fixed assets	15,613,290,101	Long term liabilities	6,553,480,140
		Equity	11,342,425,468
Total assets	20,204,579,091	Total liabilities and equity	20,204,579,091

On 22 September 1998, the main competitor in GSM services, Tal hf. lodged a complaint with the Icelandic Competition Council and made demands regarding the organisation of Iceland Telecom Ltd.'s GSM unit. On 9 June 1999, the Icelandic Competition Council adopted a decision regarding the issues relating to the conduct of Iceland Telecom Ltd. in the mobile phone market, in order to eliminate any restrictions on competition. The Icelandic Competition Council also issued Opinion No. 6/1999 in which it concluded that Iceland Post and Telecom Ltd., and thus Iceland Telecom Ltd., had received aid in the form of undervalued assets that had been transferred to it when the former PTA was transformed into a public limited liability company as of 1 January 1997. In this connection, the Icelandic Competition Council criticised amongst others that when establishing the value of Iceland Post and Telecom Ltd., the goodwill had not been assessed. The Competition Council stated that the initial capital of Iceland Post and Telecom Ltd. was underestimated by at least ISK 10 billion. In this context, the Council referred to various estimates and calculations that had been articulated. It was, however, amongst others pointed out that estimates were rough and that calculations were based on simple operating projections. Finally, the Icelandic Competition Council considered the reduction of long-term debt of the Post and Telecommunications Administration to the Government Employees' Pension Fund as aid incompatible with the State aid rules under the EEA Agreement. In its conclusions, the Icelandic Competition Council recommended to the Minister of Transport and Communications that measures be taken to retract aid which Iceland Post and Telecom Ltd. enjoyed. It further suggested that a re-valuation of the fixed assets and obligations of Iceland Post and Telecom Ltd. be carried out as soon as possible and that the company's goodwill be evaluated with a view to equalising the competitive position on the telecommunication market.

In its reasoning, the Icelandic Competition Council pointed out that the Evaluation Committee should have applied the net present value method for assessing the company's true worth. This had been necessary in order to ensure that the limited liability company did not, without paying compensation, receive valuable assets, consisting of goodwill, which had been built up on the basis of decades of monopoly. In the Icelandic Competition Council's view, figures available in 1995 and 1996 regarding the financial performance of PTA indicated that the enterprise enjoyed considerable goodwill, which contrary to the provisions of Articles 1 and 5 of Act No. 103/1996 had not been assessed nor entered as an asset in Iceland Post and Telecom Ltd.'s accounts.

Furthermore, with respect to the reduction of pension fund obligations, the Icelandic Competition Council pointed out that considerations such as to provide the newly established company with a stronger financial position should not have influenced the appraisal. Further, the Icelandic Competition Council was of the opinion that the company's competitors could not strengthen their financial position unless the owners supplied capital, which would be subject to full profitability requirements.

By letter of 23 July 1999, the Ministry of Transport and Communications appointed a special working group to investigate the Icelandic Competition Council's findings and to submit proposals for further steps in this regard. In their report of 6 October 1999, the working group expressed agreement with the view of the Icelandic Competition Council that the methods used in evaluating the Post and Telecommunications Authority had not been satisfactory, since the assessment did not include calculations of the net present value of future cash flow. The working group thus proposed that a new assessment of the assets, obligations and goodwill be carried out by independent parties. All assumptions should be made according to information available at year-end 1996. Should such a re-valuation conclude that the previous evaluation was too low, the balance sheet of Iceland Telecom Ltd. and, as appropriate, of Iceland Post Ltd. should be corrected by the same amount. The working group was of the opinion that until the results under the NPV-method were available it was not possible to state definitively that Iceland Post and Telecom Ltd. had benefited from State aid. On the other hand, regarding the reduction of pension fund obligations, the Committee was of the opinion that no aid had been granted.

Accordingly, in a letter dated 1 November 1999, the Ministry of Transport and Communications set up a new working group of independent experts to undertake the re-valuation. The mandate of the group was to determine the value of the company based on the NPV of future cash flow taking into account information available at year end 1996, to compare the results with the initial balance sheet and to evaluate whether deviations were substantial or within acceptable limits and to assess whether the balance sheet of Iceland Telecom Ltd. and, as appropriate, of Iceland Post Ltd. needed to be corrected. The group of independent experts presented their report on 8 April 2000. Keeping current assets and liabilities unchanged and expressing the opening balance in net current assets (ISK 4.6 billion – ISK 2.3 billion = ISK 2.3 billion[5]), the group concluded that "*the total value of the company's assets would have been ISK 20.4 billion at year end 1996, the market value of long-term debt ISK 6.6 billion and the value of equity ISK 13.8 billion, based on the cash flow of operations. To this should be added the value of additional assets which do not belong to general operations amounting to ISK 1.3 billion, making the total value of equity ISK 15.1 billion.*"

Hence, the equity was estimated to be ISK 3.8 billion higher than originally recorded (ISK 15.1 billion – ISK 11.3 billion). Adding short-term liabilities, a revised balance sheet total would amount to ISK 24.0 billion (ISK 20.4 billion + ISK 1.3 billion + ISK 2.3 billion). The working group's findings implied likewise that the amount by which the assets transferred from the former Post and Telecom Administration to the newly established Post and Telecom Ltd. had been undervalued by ISK 3.8 billion.

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[5] See table 1 above.

The re-assessment of the value of assets of Iceland Post and Telecom Ltd. was based on the net present value of future cash flow method. According to this method, the value of a company's asset is determined by estimating the net cash flow, which the company's assets will provide in the future, including its anticipated resale value at the end of the estimation period or the "residual value". This free cash flow is then discounted using a required rate of return. Finally, long-term debt is deducted to arrive at the estimated value of the company's equity capital.

Cash flow was determined by estimating operating revenues and expenses for the next 5-10 years, adding capital income/expenses on net working capital, deducting income tax, adding depreciation and implicit items and deducting investment and the change in net working capital.

The estimates for operating revenues/expenses, capital expenses and investments were based on assumptions concerning the general operating environment and forecasts regarding the development of income and costs in the telecom and postal sector.

As regards the general operating environment, the report stresses that "[w]*hen the Icelandic Post and Telecommunication Authority was transformed into a limited-liability company there was a great deal of uncertainty concerning the company's operating environment in the years to come. Following the deregulation of the telecommunications market, foreign enterprises were expected to enter the Icelandic telecom market and compete with Iceland Post and Telecom. Competition was expected in particular in international telephony and GSM services. Since these were the areas where the contribution margin was highest the company's management feared that this change could have a detrimental effect on the company's operating performance. There is very little to be found in the information and estimates from this time concerning a vision of future. It was very difficult to predict what developments would occur on the telecommunications market and in postal operations. At the time of the transformation of the Post and Telecommunication Authority into a limited-liability company substantial changes to the company's environment were in the offing, competition was just around the corner as were revolutionary technological advances.*"

As regards assumptions for operating income and costs, the report based itself on figures available in the company's annual accounts for 1995 and 1996, in order to determine the proportion of the various costs and income items of the company's total turnover, taking into consideration future developments as they could be reasonably expected to be at year-end 1996.

As regards the discount factor, the experts determined in a first step the required rate of return on equity. This assessment is based on the so-called capital asset pricing model, using the following formula:

$$\text{Required rate of return} = RF + RP\ (\beta)$$

RF is the risk-free return on 10-year, inflation indexed national government bonds, which at year-end 1996 was around 5.8%.

RP is the risk premium of the market, which based on historical data, was determined as being 7%.

The β-value is the risk co-efficient intended to measure price fluctuations in the price of a company's stocks as compared with the price fluctuations of all stocks on the market. The experts used a β-factor of 1.2, which was comparable to the β-factor of other telecom enterprises in both Europe and the USA.

Based on these variables, the experts determined the required rate of return on equity as being 14.2%

As regards the rate of return on long-term debt, the experts based themselves on the interest on 10-year national government bonds, which was 5.8% at that time, plus a normal risk premium, estimated to be 70 basis points. The rate of return on long-term debt was thus assessed as being 6.5%. Adjusting the rate of return on long-term liabilities for tax savings, the weighted average cost of capital, and thus the overall required rate of return, was calculated as being 11%.

The experts stressed that the results were highly sensitive to any changes in the assumptions used. Sensitivity tests had shown that changes in the required rate of return or the estimated cash flow would have a major impact on the outcome of the assessment. However, according to the expert's report, "*a cautious estimate* [of the equity] *would place the confidence interval between ISK 13 and 17 billion, based on a deviation of +/- 1% in the required rate of return and +/- 5% in cash flow estimates*."

The working group expressed its view that the difference of ISK 3,8 billion compared to the net value recorded in the initial balance would require changes to the company's accounts. In the opinion of the working group, all necessary changes should be entered in the accounts of Iceland Telecom Ltd. This was based on the fact that as to postal operations the findings of the new working group differed only slightly from the assessment of Iceland Post Ltd. when it was established. In the working group's view all changes to the assessment are thus to be regarded as pertaining to telecom operations. According to the experts, it would make no substantial difference, whether the increase would be regarded as a re-valuation of the fixed assets or as recognition of the goodwill the company enjoyed.

In accordance with the findings of this report, the Ministry of Transport and Communications, in a letter dated 11 April 2000, instructed the board of Iceland Telecom Ltd., in consultation with the State Auditor, to take full account of the findings of the report and to register corrections proposed in the report as goodwill in the annual account for 1999. The Treasury would receive a bond issued by Iceland Telecom Ltd. as a repayment for the goodwill.

In addition, an agreement was concluded between the Ministry of Finance and Iceland Telecom Ltd. on 4 July 2000 regarding the corrections to be made. According to the terms of the agreement, it was decided to raise the assessed value of the company's assets by ISK 3.8 billion, as of the beginning of 1997, and enter this figure as a debt to the national Treasury.

According to this agreement, this debt was to bear an annual interest rate of 6% and to be indexed with the rate of inflation according to the consumer price index; thus the nominal interest rate was calculated as 8.15% in 1997, 7.34% in 1998 and 11.94% in 1999. By the end of 1999, the debt had thus increased to ISK 4.938 billion. It was further agreed that to this debt, Iceland Telecom Ltd. would, no later than 30 November 2000, transfer to the national Treasury a minimum of ISK 1 000 million as down payment. The remainder shall be paid with a five-year debenture with 16 equal instalments, the first to be made 30 January 2001 and subsequently at three-month intervals until the debenture is fully paid up. The debenture shall bear a 6.4% rate of fixed interest as from 1 January 2000, adjusted for inflation according to the consumer price index as calculated and published by the Statistics of Iceland. Thus the nominal interest rate on the debt was 10.84% in 2000.

The terms of the agreement were decided in April/May 2000. At that time, the Ministry of Finance had obtained information on market interest rates for this kind of debt. According to the Icelandic authorities, various banks and financial institutions were consulted. It followed from these consultations that the interest rate for indexed State bonds with five years maturity plus 50-80 basis points was what the market would find appropriate. The rate of 6.4% was determined on this basis.

At the end of November 2000, Iceland Telecom Ltd. made a cash payment of ISK 1 099 million (agreed first payment of ISK 1 000 million, plus ISK 99 million in accrued interests on this part of the loan). At the end of 2000, the outstanding debt to the Treasury with accrued interests included amounted to ISK 4.365 billion. This amount was entered as the principal of the bond, which was finally issued 1 March 2001. This amount is indexed and bears a real interest rate of 6.4% from 1 January 2001.

In Iceland Telecom Ltd.'s annual report for 1999, full account was taken of the effects of the special retrospective review of the company's worth as per 31 December 1996. According to note 2 of the Annual Report for 1999, the restated opening Balance Sheet as of 1 January 1997 for Iceland Post and Telecom Ltd. would have been as follows:

Table 2:

	Assets		**Equity and Liabilities**
Current assets	4,591,289	Current liabilities	2,308,674
Fixed assets	19,413,290	Long term liabilities	10,353,480
		Equity	11,342,425
Total assets	24,044,579	Total liabilities and equity	24,044,579

The value adjustment was entered into the company's books as a letter of credit against payment to the owner and was valued on 31 December 1999 at ISK 4,938 million. The Board of Directors decided to write off this special revaluation of goodwill over a period of five years. This special depreciation will appear in the company's income statement until the year 2001 and will have no direct effect on the profit and loss calculations after that time.

As the financial statements of the years 1997 and 1998 are not reopened, the impact of the changes on the financial status and equity of the company in these years is shown under “changes in shareholders’ equity”.[6] In the 1999 Annual Report, the financial figures for 1998 have been restated for comparability. According to the 1999 Annual Report, these accounting changes would have reduced the company’s net profit by ISK 911 million in 1997, ISK 636 million in 1998, and the impact in 1999 is reported to be ISK 734 million.

The payment to be made by Iceland Telecom Ltd., under the debt settlement agreement of July 2000, is recorded as maturities of long-term liabilities. The implications of the agreement concluded between the Treasury and the company are reflected in the company’s “revised plan”[7].

C. Reduction of Pension Fund Obligations

In the past, the PTA contributed to the Governmental Employees’ Pension Fund. These contributions were equivalent to 6% of total wages without overtime. The employees contributed another 4% to the Fund. It was the Government’s decision to hold the PTA responsible for the part of the pension liabilities which the Fund could not meet financially. According to calculations for 1995 and 1996, the Fund could only meet 20% of its obligations, meaning that PTA would be responsible to cover the remaining 80% of accrued pension liabilities.

The explanatory notes for Article 5 of the Act on the establishment of the limited-liability company for the operation of the PTA stated that the Government had decided that obligations of the PTA towards the Government Employees’ Pension Fund should be entered as a debt on the institution’s balance sheet at year-end 1995. According to the annual financial statement for 1995, the pension fund debt amounted to ISK 9.4 billion.

The year-end 1995 pension debt, which amounted to ISK 9.4 billion, based on a 3.5% discount factor, was adjusted by the original Evaluation Committee based on a 25-year debenture, with an interest rate of 6% p.a.. This made the amount of the debenture just under ISK 7.5 billion to be reported in the initial balance sheet. Consequently, in the Evaluation Committee’s draft of the initial balance sheet for Iceland Post and Telecom Ltd. the enterprise’s pension obligations were entered as a debt of ISK 7,484 million.

On 27 December 1996, an agreement was concluded between the Ministry of Finance and the preparatory committee according to Article 7 of Act No. 103/1996, in which the Treasury assumed responsibility for a part of accrued pension fund obligations in accordance with Article 25 of Act No. 29/1963 on the Government Employees’ Pension Fund. The newly created company agreed to pay the additional contributions to the fund. On the other hand, the national Treasury confirmed that it would make no further claims on PTA or Iceland Post and Telecom Ltd. due to accrued pension obligations. The contribution of the new company would be 6% of the difference between total wages and the reference wages of the employees concerned in

[6] See Note 16 to the Annual accounts for 1999.

[7] See Note 21 to the Annual Accounts for 1999 and Notes 18-20 in the Annual Accounts for 2000.

accordance with the second paragraph of Article 17 of the above-mentioned act. The settlement of the accrued pension obligations for employees of the former Post and Telecommunications Authority would be concluded with the issue of debenture. The debenture has a 25-year term, is inflation-indexed according to the consumer price index, bears a fixed real interest rate of 6% and is mortgaged against the assets of the newly created company. The amount of the debenture was calculated at ISK 6 billion. Since the debt was originally calculated as amounting to ISK 7.5 billion, the difference of ISK 1.5 billion was entered in the annual budget as an expense of the Ministry of Transport and Communications.

D. Stamp Duty

Act No. 36/1978 on Stamp Duty requires share certificates in limited liability companies to carry a stamp duty of 0.5% of the nominal value of the shares. Article 4 (2) of Act No. 103/96 provided that the only share certificate in Iceland Post and Telecom Ltd. to be issued at the incorporation of the company was to be exempted from stamp duty. On 11 April 2000, the Icelandic Parliament, by adopting Act No. 19/2000, amended the relevant provision in Act No. 103/96 so as to abolish the exemption and introduced a temporary provision obliging Iceland Post and Telecom Ltd. to pay a stamp duty of 0.5% on all shares already issued. In all other respects, the fee would be as provided for in Act No. 36/1978. The payment of the stamp duty plus accrued interests based upon average deposit money banks lending rates (non-indexed) from the date the shares were issued by Iceland Telecom Ltd. took place on 29 December 2000, and from Iceland Post Ltd. on 17 January 2001.

II. APPRECIATION

A. Notification requirement and Stand-still obligation

Pursuant to Article 1 (3) of Protocol 3 to the Surveillance and Court Agreement, "[*t*]*he EFTA Surveillance Authority shall be informed, in sufficient time to enable it to submit its comments, of any plans to grant or alter aid…The State concerned shall not put its proposed measures into effect until the procedure has resulted in a final decision*".

Pursuant to Articles 1 and 5 of the Transparency Directive[8], EFTA States are under an obligation to make the flow of all public funds to public undertakings transparent and to supply the Authority on request with any information concerning the financial relations between public authorities and the public undertaking. Furthermore, and pursuant to Article 1 (3) of Protocol 3 to the Surveillance and Court Agreement, there is an obligation to notify to the Authority any aid before it is put into effect. As concluded by the Icelandic Competition Council and subsequently confirmed by the working group, which carried out the re-evaluation of Iceland Post and Telecom

[8] At the material time, the applicable Directive was Commission Directive 80/723/EEC of 25 June 1980 on the transparency of financial relations between Member States and public undertakings, as amended by Commission Directive 85/413/EEC of 24 July 1985, incorporated into Annex XV to the EEA Agreement.

Ltd.'s assets, the assets transferred from the former Post and Telecom Administration to Iceland Post and Telecom Ltd. were undervalued. As to the exemption from stamp duty, the Authority notes that it was not informed about this measure by the Icelandic authorities.

Therefore, the Authority observes that the Icelandic authorities have failed to fully comply with their obligations under Article 1 (3) of Protocol 3 of the Surveillance and Court Agreement.

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

The EEA Agreement recognises the principle of neutrality with regard to the system of property ownership in the EFTA States and the principle of equality between publicly owned and private undertakings (Articles 125 and 59 of the EEA Agreement). In accordance with those principles, the Authority must not prejudice or favour publicly owned undertakings, in particular when examining economic transactions in the light of Article 61 (1) of the EEA Agreement.

Article 61(1) of the EEA Agreement stipulates: " *Save as otherwise provided in this Agreement, any aid granted by EC Member States, EFTA States or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, insofar as it affects trade between the Contracting Parties, be incompatible with the functioning of the Agreement.*"

In the case at hand there are three issues that need to be addressed in this context:

- the under-valuation of assets;
- the reduction of pension fund obligations; and
- the exemption from Stamp Duty.

1. Under-valuation of assets

The complainant maintained that Iceland Post and Telecom Ltd. received illegal State aid contrary to Article 61 of the EEA Agreement. To support this view, reference was made to the Opinion of the Icelandic Competition Council. In addition, the complainant maintained that the value as recorded in the initial balance sheet would not represent what a knowledgeable willing buyer would consider to be the real value. The under-valuation was in particular due to the failure to apply the discounted cash-flow method. In order to remedy the situation, the complainant requested that a new valuation be carried out by an independent party. Should the conclusions show that the assets were under-valued, a correction would have to be made to the opening balance of Iceland Post and Telecom Ltd. as of 1 January 1997. The aid should be recovered in the form that the State received increased share capital equal to the amount of the under-valuation.

Following the Icelandic Competition Council's opinion, the Icelandic Government initiated a fresh assessment of Iceland Post and Telecom Ltd.'s assets which would determine whether Iceland Post and Telecom Ltd.'s assets had been under-valued, and thus whether Iceland Post and Telecom Ltd. had received illegal aid.

State resources

In accordance with Act No. 103/1996, the State transferred all assets from the former Post and Telecom Administration to a newly created company. It is established case law that Article 61 is not limited to capital grants or subsidies, but also includes all other measures, while not having the nature of a subsidy, which are capable of producing the same effects.[9] . The State aid rules of the EEA Agreement do not only apply to purely financial transactions, but also to the provision of services or the supply of assets on preferential terms between the State and the beneficiary undertaking.[10] In accordance with established case law and practice[11], the transfer of assets between State authorities and (public) undertakings without full remuneration constitutes a transfer of State resources within the meaning of Article 61 (1) EEA Agreement (see below).

Benefit to certain undertakings

Pursuant to Article 61 (1) of the EEA Agreement, for a measure to be considered as State aid, the measure must give the recipient company an economic advantage. Insofar as the transfer of assets/provision of initial capital confers an economic advantage on Iceland Post and Telecom Ltd. that it would not have obtained in the normal course of business, the measure at issue falls under Article 61 (1) of the EEA Agreement.

To the extent that assets were transferred at a price below their real value, the newly created company would have received an advantage within the meaning of Article 61 (1) of the EEA Agreement. In this respect, the question is whether the State as the sole shareholder of the newly created Iceland Post and Telecom Ltd. has received adequate compensation for the transfer of assets from the former Post and Telecom Administration. It is clear that should the transferred assets have been undervalued, the value of the shares the State had received as compensation was equally undervalued. This would constitute a financial advantage to Iceland Post and Telecom Ltd. as well as foregone revenue for the State as the owner of the former Post and Telecom Administration.

In order to verify whether the transfer of State resources to a public undertaking favours this undertaking and thus is liable to constitute aid within the meaning of Article 61 (1) of the EEA Agreement, the Authority applies the so-called "market economy investor principle" as laid down in Chapter 20 of the Authority's State Aid Guidelines. According to this principle, no State aid is involved if financial measures are taken at "*terms which a private investor would find acceptable in providing funds*

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[9] Court of Justice of the European Communities (ECJ), Case C-387/92, Judgment of 15 March 1994, "*Banco Exterior*", [1994] ECR I-877, para. 13.

[10] Commission decision regarding State aid C 63/2000 (ex NN 102/2000)- Germany; reference is made in this context to the "La Poste" Judgment, Case C-34/94, *SFEI et al. La Poste et al.*, [1996] ECR I-3547.

[11] Judgments by the ECJ in Case C-305/89, *Italy v. Commission* ("Alfa Romeo"), [1991] ECR I-1603 and in Case 303/88, *Italy v. Commission* ("ENI-Lanerossi"), [1991] ECR I-1433; see also the Authority's decision of 3 December 1998, "Arcus", Dec. No. 98-8120-I and the Commission's decision of 8 July 1999, on a measure implemented by the Federal Republic of Germany in favour of Westdeutsche Landesbank Girozentrale, published in the OJ L 150/1 of 23.6.2000.

to a comparable private undertaking when the private investor is operating under normal market economy conditions".

Against this background, the Authority had to ascertain the correct value of assets transferred from the former Post and Telecom Administration to the newly created Iceland Post and Telecom Ltd.

According to the independent expert group's report issued on 8 April 2000, the value of the former Post and Telecom Administration's balance sheet total should have amounted to ISK 21.7 billion plus short-term liabilities, resulting in a balance sheet total of ISK 24.0 billion. This re-valuation shows that the value as initially recorded in the opening balance sheet of 1 January 1997 constituted an under-valuation of ISK 3.8 billion of the assets transferred to Iceland Post and Telecom Ltd.

As described in more detail above, this appraisal was based on the method of net present value (NPV) of future cash flows. In its assumptions, the experts based themselves on data available at year-end 1996.

This is in accordance with Chapter 20 of the Authority's State Aid Guidelines. Under point 20.5.(2) of the Guidelines it is stated that "[t]*here is no question of the EFTA Surveillance Authority using the benefit of hindsight to state that the provision of public funds constituted State aid on the sole basis that the out-turn rate of return was not adequate*".

According to Opinion No. 6/1999 of the Icelandic Competition Council, the original opening balance represented an under-valuation of at least ISK 10 billion. The Authority has not found reasons to base its assessments on this estimate but rather to accept the conclusion of the group of independent experts that the under-valuation amounted to ISK 3.8 billion. In the view of the Authority, the estimate of the Competition Council may be seen as a first attempt to address the question of under-valuation using rather simplified methods. To the Authority's knowledge the value assessment undertaken by the group of independent experts is the only thorough analysis that was undertaken to establish the value of Iceland Post and Telecom Ltd. This analysis was based on the net present value method and with specified assumptions on future market shares, volume of operations, price forecasts, and itemized forecasts of various revenue and cost components. The Authority also notes that, to its knowledge, the complainant has not contested the valuation carried out by the working group.

Against the background of the comments above, the Authority concludes that a reasonable estimate of Iceland Post and Telecom Ltd.'s assets as of 1 January 1997 is ISK 24.0 billion. Consequently, by entering the value of assets in the original balance sheet as being ISK 20.2 billion, Iceland Post and Telecom Ltd. enjoyed a financial advantage of ISK 3.8 billion. Since the resulting financial benefit awarded to Iceland Post and Telecom Ltd. strengthens its position compared with other undertakings competing within the EEA, the aid must be considered as distorting competition and affecting trade between the Contracting Parties.[12]

[12] See Judgment of the ECJ of 17 September 1980, Case 730/79, *Philip Morris Holland BV v Commission*, [1980] ECR 2671, para. 11.

The Authority observes that, in the meantime and following the re-valuation of the assets, the Icelandic authorities have undertaken steps, described above, to recover the amount of aid retroactively since 1 January 1997. The Authority is satisfied with the changes made in the company's accounts in order to reflect the increased value of the assets (the initial balance sheet as of 1 January 1997 has been restated and the consequences of this correction on the financial performance of the company has been identified in Iceland Telecom Ltd.'s annual accounts for 1999). Furthermore, the Authority takes note of the agreement concluded between Iceland Telecom Ltd. and the State Treasury regarding the repayment of the debt, corresponding to the increased value of the company's assets. The Authority also takes note of the payment already made by Iceland Telecom Ltd. as well as the issuance of a bond to the State Treasury covering the remaining debt.

As regards the interest rate applied when calculating the amount of debt at year end 1999 (to be recorded as the principal of the bond), the Authority observes that the interest rates used by the Icelandic authorities in the years 1997 to 1999, were set to 6% p.a. inflation indexed. This rate was determined according to data for yields on five-year Government bonds in this period, increased by a risk premium which was assessed to be 50-80 basis points.

The use of the yield on five year government bonds leads to interest rates differing from the reference rate of interest as fixed by the Authority for Iceland in the respective years, which was based on prime rates for commercial loans increased by 150 basis points (reference is made to the Authority's letters to the Mission of Iceland dated 30 July 1997 (Doc. No. 97-5256-D), 16 February 1998 (Doc. No. 98-963-D) and 25 February 1999 (Doc. No. 99-1564-D)).

In this respect, it should be recalled that the Commission revised its method regarding the determination of commercial interest rates as from 1 August 1997 and introduced the possibility to use either the five-year interbank swap rates, increased by a risk premium of 75 points or the yield on five year government bonds increased by 25 points. The calculation of the reference rates of interest based on this method was considered to reflect more truly commercial lending conditions.

Even though the Authority adopted a similar approach only as from 1 April 2000, this belated adoption of the Commission's method and inclusion in the new Chapter 33 of the Authority's State Aid Guidelines, does not prevent the Authority from using this method when determining the interest rates applicable in the present case. This is even more so, where it has been shown that the commercial lending rates as fixed by the Authority under the old Chapter 33 (based on average prime rates on bank loans plus 1.56 percentage points) do not reflect the individual lending conditions enjoyed by the beneficiary of the aid on the market.

As regards the interest rate used with effect as from 1 January 2000 for the bond issue to the Treasury, the Authority observes that the interest rate of 6.4% inflation indexed is above the reference rates of interest applicable in 2000. Furthermore, this interest rate was calculated based on the yields on five year Government bonds, as recorded at the time the terms of the agreement were decided (March/April 2000), plus a premium of 50-80 basis points.

In light of the foregoing considerations, the Authority is satisfied that the Icelandic Government has undertaken the necessary steps to retroactively abolish the effects of the aid Iceland Telecom Ltd. enjoyed in the form of an undervaluation of assets.

The Authority would, however, draw the Icelandic Government's attention to the fact that this conclusion is based on terms and conditions of the debt settlement agreement and of the issued bond, and that any deviations from the provisions laid down in these documents will not be covered by the present decision. Any such deviations, and in particular delays in payment, must be notified to the Authority in order to enable it to examine whether these deviations contain elements of aid.

2. Reduction of pension fund obligations

The Icelandic authorities are of the opinion that the reduction of pension fund obligations is comparable to an injection of fresh capital. It was considered necessary for Iceland Post and Telecom Ltd. to have a strong equity base. Given the fact that in particular the postal part did not have a sufficiently strong revenue base, it was decided to partially reduce the pension fund obligations instead of a direct capital injection. The Icelandic Government maintained that the reduction of pension fund obligations had increased the net worth of Iceland Post and Telecom Ltd., and thereby increased the potential price of the company in case of privatisation. In this respect, mention is made of the PTA's estimated net worth of ISK 8,400 million compared to the net worth of ISK 11,300 million as recorded in the opening balance. By making a demand of 15% rate of return[13] (regardless of the stronger net worth status), the State would receive a comparable rate of return as a market investor would have demanded under comparable conditions.

In light of these circumstances, the Icelandic Government is of the opinion that the reduction of pension fund obligations was in fact in line with the market economy investor principle, as laid down in Chapters 19 and 20 of the Authority's State Aid Guidelines.

The complainant has considered the relief of debts towards the Pension Fund amounting to ISK 1,5 billion to constitute State aid. He has not agreed that this measure, to financially strengthen Iceland Post and Telecom Ltd., can be justified by making reference to the market economy investor's hypothetical behaviour in this respect. Measures taken to strengthen the financial position of Iceland Post and Telecom Ltd. to make the company more competitive are, according to the complainant, incompatible with the EEA Agreement. Since, in his view, the aid cannot benefit from any of the exemptions in Article 61 (2) and (3) of the EEA Agreement, he has suggested that the relieved debt should be repaid with interests.

The Authority has based its view on the relief of the pension fund obligations on the following considerations: The partial debt relief implied a redistribution of items on the liabilities side of the balance sheet of Post and Telecom Ltd. Long-term liabilities were reduced with ISK 1.5 billion and equity increased correspondingly. Requirements to ensure a required rate of return on an increased equity were thus

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[13] A rate of 15% was determined by the original Evaluation Committee to constitute a normal rate of return demanded by the owner of a company in this particular form of business activity.

substituted for obligations to serve the debt. Demands on serving equity would be similar to a situation with injection of new equity of the same amount.

The Authority has then assessed whether these financial operations could be in conflict with the market economy investor principle. Such a conflict might arise in particular where it could be shown that the company would not be able to ensure an adequate rate of return on its increased equity, based on expected business prospects.

Pursuant to point 20.7.4 of Chapter 20 of the Authority's State Aid Guidelines, "[*t*]*he State, in common with any other market economy investor, should expect a normal return obtained by comparable private enterprises on its capital investments by way of dividends or capital appreciation. The rate of return is measured by the profit…expressed as a percentage of assets employed. It is therefore a measure that is neutral with respect to the form of finance used in each enterprise (i.e. debt or equity) which for public enterprises may be decided for reasons extraneous to purely commercial considerations…*"

The Authority observes firstly that, as the Icelandic Government has stressed, the decision to reduce the pension fund obligations was based on an expected rate of return of 15% (as established by the initial valuation carried out in 1996). Furthermore, the Authority notes that based on estimates regarding future business operations, made by the independent experts in the course of the re-valuation of the company's assets (report submitted in 2000, based on figures at year end 1996), return on equity was expected to be around 14%. The Authority has no reason to question the soundness of these estimates and the determination of the required rate of return.

In light of the above comments, the Authority is of the opinion that the Icelandic State could, at the time of the establishment of the new company, reasonably expect an adequate return on the amount by which equity was increased and the debt towards the pension fund reduced. Consequently, the act to reduce the pension fund obligations by ISK 1.5 billion cannot be said to be contrary to the market economy investor principle. Therefore, the reduction of debt towards the Pension Fund does not constitute aid within the meaning of Article 61 (1) of the EEA Agreement.

3. Exemption from Stamp Duty

The complainant considered this measure to constitute aid. Furthermore and since the aid could not, in his view, benefit from any of the exemptions in Article 61 (2) and (3) of the EEA Agreement, he suggested that the relieved debt should be repaid with interests.

With the adoption of Act No. 19/2000, the stamp duty exemption for Iceland Post and Telecom Ltd. was abolished. This implies not only that Iceland Post and Telecom Ltd. had to pay the duty on shares that had been issued, but also that such a duty would accrue on all shares that would be issued by the company(ies) in the future. In order to ensure retroactive effects to the abolishment, Article 2 of the Act requires both Iceland Post Ltd. and Iceland Telecom Ltd. to pay 0.5% for all shares already issued. Shares in Iceland Telecom Ltd. had a value of ISK 7,049 million and in Iceland Post Ltd. of ISK 1,447 million. The stamp duties of shares in the companies would thus amount to a total of ISK 42.5 million (ISK 35.3 million for Iceland Telecom Ltd. and ISK 7.2 million for Iceland Post Ltd.) According to the Icelandic authorities, interests were calculated based on the average deposit banks lending rates (non-indexed), from the date the shares were issued, amounting to approx. ISK 14.6 and 3.0 million. The Icelandic authorities have further confirmed that both companies have retroactively paid the stamp duties as if the exemption from the stamp duty had never been granted.

The Authority observes that the amount of interest repaid by both companies is below interest payments based on the reference rates of interest fixed by the Authority for the years 1997-2000. However, the deviation is well below the *de minimis* threshold, as set in Chapter 12 of the Authority's State Aid Guidelines. Hence, since this difference is deemed not to meet all the criteria of Article 61 (1) of the EEA Agreement, the Authority concludes that the amount of aid enjoyed by Iceland Post and Telecom Ltd. due to the exemption from the stamp duty has been retrieved from the beneficiaries namely, Iceland Post Ltd. and Iceland Telecom Ltd. (successors to the former Iceland Post and Telecom Ltd.).

C. Conclusions

The Icelandic authorities have adopted the necessary measures to retroactively abolish the effects of aid granted to Iceland Telecom Ltd. in the form of an undervaluation of the assets transferred from the former Post and Telecom Administration to Iceland Post and Telecom Ltd., as well as aid granted in the form of an exemption from the stamp duty. The investigation can therefore be closed without further action being necessary. The Icelandic Government is reminded to notify the Authority of any deviations from the terms and conditions of the debt settlement agreement as submitted to the Authority.

Finally, the Icelandic Government is asked to inform the Authority when the debt has been fully repaid by Iceland Telecom Ltd. to the State Treasury.

HAS ADOPTED THIS DECISION:

1. The Authority has decided to close the own initiative investigation (SAM 090.300.002) without further action.
2. The Icelandic Government is asked to inform the Authority when the debt has been fully repaid by Iceland Telecom Ltd to the State Treasury.

Done at Brussels, 27 July 2001

For the EFTA Surveillance Authority

Hannes Hafstein
College Member

Peter Dyrberg
Director