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EFTA SURVEILLANCE AUTHORITY DECISION
OF 14 MARCH 2003
ON PROPOSED FINANCING AND TAX MEASURES CONCERNING THE
CONSTRUCTION OF AN ALUMINIUM PLANT IN THE TOWNSHIP OF
FJARÐABYGGÐ

(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 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,

WHEREAS:

I. FACTS

1. Notification

By letter of 19 December 2002 from the Icelandic Mission to the European Union forwarding a letter from the Ministry of Finance dated 16 December 2002, both received and registered by the Authority on 19 December 2002 (Doc.No.02-9218A), the Icelandic authorities notified, pursuant to Article 1(3) in Part I of Protocol 3 to the Surveillance and Court Agreement, proposed financing and tax measures concerning the construction of an aluminium plant in the township of Fjarðabyggð. By letter of 20 January 2003 from the Icelandic Mission to the European Union forwarding a letter from the Ministry of Finance dated 16 January 2003, received and registered by the

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 (State Aid Guidelines), adopted and issued by the EFTA Surveillance Authority on 19 January 1994. Published in Official Journal L 231, 03.09.1994. The Guidelines were last amended 18 December 2002 (not yet published).

Authority on 20 January 2003 (Doc.No.03-331A), the Icelandic authorities submitted additional documents supplementing the notification.

By letter of 14 February 2003 (Doc. No.03-397D), the Authority acknowledged the receipt of the notification and requested the Icelandic authorities to submit additional information and clarification. The Icelandic Government responded by letter of 18 February 2003 from the Icelandic Mission to the European Union, forwarding a letter from the Ministry of Finance dated 18 February 2003, both received and registered by the Authority on 18 February 2003 (Doc. No. 03-956A).

By letter dated 21 February 2003, the Icelandic Mission to the European Union forwarded a telefax dated 20 February 2003 from Landsvirkjun (the National Power Company), all received and registered by the Authority on 21 February 2003 (Doc.No.03-1044A).

By letter dated 27 February 2003 (Doc.No.03-1069D), the Authority acknowledged the receipt of the above-mentioned letters and requested additional information. The notification and requested additional information were discussed at meetings with representatives from the Icelandic Government on the Authority's premises on 3 and 4 March 2003. An amended notification and additional information were submitted by letter of 5 March 2003 from the Ministry of Finance, which was forwarded by a letter of 5 March 2003 from the Icelandic Mission to the European Union, both received and registered by the Authority on the same day (Doc.No.03-1365A).

By letter dated 11 March 2003 (Doc.No.03-1422D), the Authority requested further information and clarification. The Icelandic Government responded by letter of 12 March 2003 from the Icelandic Mission to the European Union, forwarding a letter from the Ministry of Finance dated 12 March 2003, both received and registered by the Authority on 12 March 2003 (Doc. No. 03-1508A).

By letter dated 13 March 2003 from the Icelandic Ambassador to the EU, received and registered by the Authority on 13 March 2003 (Doc.No.03-1533A), the Icelandic authorities submitted a declaration obliging them to keep the State aid below a ceiling of 49,9 million Euro.

2. Description of the proposed measures

2.1 Background

By Act of 16 April 2002 No.38 the Landsvirkjun was authorised to build and operate a new hydropower facility, Kárahnjúkar, in eastern Iceland. The Kárahnjúkar hydroelectric power project will be located in the Kárahnjúkar Mountains and will utilize waters of Jökulsá á Brú and Jökulsá in Fljótsdalur. The Kárahnjúkar Hydropower Station will have a rated capacity of approximately 635 MW and be able to produce about 4.700 GWh of electricity per year. The power plant is scheduled to start production in 2007.

On 19 April 2002 the "Invest in Iceland Agency" and the company Alcoa Inc., Pennsylvania, USA, signed a Joint Action Plan regarding the evaluation of an Alcoa aluminium smelting plant in Iceland. The plan was to evaluate the feasibility of

constructing and operating an aluminium plant in the township of Fjarðabyggð in the eastern part of Iceland.

On 19 July 2002 the Government of Iceland, Landsvirkjun and Alcoa signed a Memorandum of Understanding regarding the evaluation and potential implementation of the project, *i.e.* the Kárahnjúkar power plant, a primary aluminium plant located at Mjóeyri in Reyðarfjörður in the township of Fjarðabyggð in eastern Iceland, plant site facilities, harbour facilities and other related infrastructure.

The plan of Alcoa is to establish two Icelandic private limited liability companies as wholly owned subsidiaries, Alcoa á Íslandi ehf. and Reyðarál ehf. The Alcoa á Íslandi ehf. and Reyðarál ehf. will be operating and registered in Iceland for the purpose of founding, owning and financing the FJARÐAÁL SF., which is a partnership organized under the laws of Iceland. Alcoa á Íslandi ehf. will own 99% of FJARÐAÁL SF and Reyðarál ehf. will own 1%.

For the purpose of the assessment it is not necessary to distinguish between Alcoa Inc., Alcoa á Íslandi ehf., Reyðarál ehf. and FJARÐAÁL SF as the beneficiaries of the different notified measures. Hereinafter the term "Alcoa" is used as a common name for any of these companies.

Alcoa will be the owner and operator of an aluminium plant in Reyðarfjörður in the Township of Fjarðabyggð. The aluminium plant will have an annual production capacity of up to 322,000 metric tons of primary aluminium. The actual construction of the aluminium plant is expected to commence in 2004 and the plant will start production in 2007.

The electricity for the smelter will be supplied by the Kárahnjúkar hydropower project as mentioned above. The capacity and the production of the Kárahnjúkar power plant is deemed appropriate to fulfil the anticipated annual requirement of the aluminium smelter with an annual production capacity of 322,000 metric tons of primary aluminium. The Kárahnjúkar power plant will start its production and be able to supply the aluminium smelter with electricity in 2007.

- **The investment costs**

Alcoa has stipulated its total investment costs of the aluminium plant in Reyðarfjörður to be USD 1,143.2 million (in 2003 prices). The total costs and their breakdown into different cost categories are provided as follows:

Table 1

Site and infrastructure	MUSD	39.5
Raw materials handling	MUSD	48.6
Anode Rodding	MUSD	45.0
Power Supply and utilities	MUSD	35.9
Potline	MUSD	457.9
Casthouse	MUSD	24.5
Service and administration	MUSD	38.1
Total physical costs	MUSD	689.5

Engineering	MUSD	52.0
Construction supervision	MUSD	107.5
Owner management	MUSD	16.5
Start-up, testing & commissioning	MUSD	5.0
EH&S (Environment, Health & Security)	MUSD	19.3
Insurance and other costs	MUSD	20.0
Total non physical costs	MUSD	220.3
Contingency	MUSD	111.1
Main study costs	MUSD	37.3
Escalation	MUSD	85.0
Total investment costs	MUSD	1,143.2

According to the Icelandic authorities, all the investment costs will be depreciable costs according to Act No. 75/1981 on Income and Net Worth Tax, *i.e.* for tax purposes.

- **Legal base and provisions for the proposed measures**

A Legislative Bill (hereinafter referred to as “the Bill”) was submitted to the Allþingi at its 128th Session, 2002-2003, on the “Authorisation to Engage in Negotiations on an Aluminium Plant in Reyðarfjörður”. The Bill authorises the Minister for Industry to enter into agreements on behalf of the Government, within the framework of the Act, with Alcoa, on the construction and operation of an aluminium plant in Fjarðabyggð, designed for an annual production capacity of up to 322,000 tons of aluminium⁴.

The different measures and conditions concerning the construction and operation of the aluminium plant are stipulated in four contracts:

- Investment Agreement
- Site Agreement
- Harbour Agreement
- Power Contract

The Bill proposes the authorisation to enter into agreements granting special regulations and exemptions from the general provisions concerning the conditions and premises for the construction and operation of the aluminium plant. All the measures covered by the Investment Agreement are mentioned in the Bill and the Investment Agreement shall be printed in Section B of the Icelandic *Law and Ministerial Gazette*.

According to the Bill, the effective term of the agreements shall not be less than twenty years from the establishment of Fjarðaál sf. The draft agreements are all supposed to enter into force on the date of signature by the parties. The duration of the Investment Agreement, the Site Agreement and the Harbour Agreement is fixed to a period of twenty years from the agreed “Permanent Delivery Date” which, at the outset, is set to be 1 October 2007. This twenty-year contract period, after the

⁴ The Bill was adopted by Allþingi on 5 March 2003.

Permanent Delivery Date, is named the “Initial Term”. At any time prior to one year before the end of the Initial Term, Alcoa may extend the Agreement for an additional period of twenty years on identical terms and conditions under the condition that the Power Contract is in effect. Concerning this issue it is stated in the notification⁵ that “At the end of the Initial Term of the Agreement it shall automatically be extended on identical terms and conditions for a period of twenty years, unless the Parties agree on new terms and conditions, provided that Alcoa can decide not to extend the Agreement.”

The Power Contract period is fixed to forty years after the Permanent Delivery Date. However, beginning two years before the expiration of the twentieth anniversary of the Permanent Delivery Date, the parties will begin negotiations to agree upon the Contract Price to be paid during the following twenty years of the Contract period. All other terms and conditions of the Agreement will continue unchanged.

According to the notification, the Icelandic authorities are of the opinion that some provisions of the Bill and the Project Agreements, *i.e.* some of the measures of the Investment Agreement, contain financial arrangements involving the Government or local authorities, which are to be considered as State aid in the meaning of Article 61(1) of the EEA Agreement. In the notification the Icelandic authorities refer to the Authority’s decision in a case on the Aluminium Smelter at Grundartangi, Iceland, (Decision No. 174/98/COL).

2.2 The Investment Agreement

The Investment Agreement is between the Government of Iceland and Alcoa. The contract period is twenty years from the agreed “Permanent Delivery Date”, with a possibility to prolong the duration by another twenty years if the Power Contract is in effect (Article 20 of the Investment Agreement).

According to Article 1 (q) of the Investment Agreement the Plant is defined as an aluminium production plant, casthouse and all other facilities appurtenant to the plant to be constructed, owned and operated by Alcoa in Reyðarfjörður, Iceland, as the same shall be constituted and equipped at any particular time, having an annual production capacity of up to 322,000 metric tons of primary aluminium products. The Icelandic authorities assume that the Investment Agreement does not apply to any expansion of the plant above 322,000 metric tons or other activities.

The purpose of Alcoa is to implement the project only for the production of primary aluminium products and to carry out such production and related business or activities.

All the issues of the Investment Agreement that will be addressed beneath are measures/special regulations concerning a diversity of taxes, charges and duties. All these measures will take effect on the day of signature of the agreement, and for some of the issues with retroactive effect from the date of formation of FJARÐAÁL SF and its Owners (Alcoa á Íslandi ehf. and Reyðarálf ehf. will hereinafter be referred to as “the Owners”).

⁵ In the letter dated 19 December 2002.

FJARÐAÁL SF will, as an Icelandic partnership, be a non-taxable entity, according to the general provisions of Act No. 75/1981 on Income and Net Worth Tax. However, the owners of FJARÐAÁL SF, (or their successors of interests) will be liable to tax pursuant to Act No. 75/1981.

The Icelandic authorities stressed that the main rule, according to the Investment Agreement, is that Alcoa shall be subject to taxes and other public charges generally levied in Iceland, with certain limited exceptions as provided for in the agreement. Alcoa will have to pay all new taxes and charges which are generally levied in Iceland.

(a) Government Income tax

- Corporate income tax rates

The general Icelandic corporate income tax rate has been reduced from 30% to 18% as of 1 January 2002.

The current and maximum income tax rate applicable according to the Investment Agreement is 18%. According to Section 8.1 a) of the Investment Agreement, the Income Tax cannot exceed 18% during the Contract Period. However, if the income tax rate applicable is lower than 18% on the Permanent Delivery Date (1 October 2007) then such lower income tax rate shall apply. Subsequent increases (before or after 1 October 2007) in the tax rate would apply to Alcoa until the tax rate reaches the 18% ceiling. The reason for this is that the parties are entering into an agreement in 2003 but the operation of Alcoa does not commence until 1 October 2007.

The Icelandic authorities have submitted a sensitivity analysis on the impact of possible increases in the general income tax rate on the Net Present Value (hereinafter “NPV”) of State aid granted (and the potential aid element on the general income taxation of Alcoa). The analysis shows that for every 2% increase in the general income tax the aid element will increase by approximately USD 5 million with a time horizon of 20 years.

- Classification of fixed assets in different depreciation categories

According to Articles 32 and 38 of Act No. 75/1981 on Income Tax and Net Worth Tax, fixed assets are categorised into three main groups: buildings, machinery and equipment. Each of the three main groups of assets is divided into at least seven more specific sub-categories with different depreciation rates.

According to the Icelandic authorities, all of the eligible costs as mentioned above will be subject to depreciation classified as buildings, machinery or equipment, according to the Icelandic tax legislation. The breakdown of the eligible costs into the different depreciation categories will be finalised when the construction of the plant is completed, all in compliance with the general provisions of Act No. 75/1981.

- Depreciation of fixed assets

According to Articles 34 and 45 of Act No. 75/1981 on Income Tax and Net Worth Tax, the general rule is that fixed assets can only be depreciated down to 10% of the residual value.

According to Section 8.4 of the Investment Agreement, Alcoa shall be exempt from this limitation, as the fixed assets of Alcoa will be allowed to depreciate down to zero residual value. This regulation will apply for any fixed assets acquired and taken into operation by Alcoa during the contract period. According to the Icelandic authorities, the vast majority of the capital expenditures on the plant will be included in the initial investment of USD 1,143 million. Over the lifetime of the plant, expenditure will incur to keep the facility in proper maintenance, *i.e.* repair and maintenance expenses. Future “sustaining” capital expenses will be of minimal value.

The permission to depreciate assets down to no residual value is estimated to decrease the NPV of the paid income tax by USD 3.5 million based on a twenty-year horizon and to USD 1.9 million based on a forty- year horizon. The calculations are based on the effects of the allowed depreciations of the last 10 % residual value of the assets by decreasing the income tax basis over the years 2015 to 2018.

However, when estimating the advantage of the measures concerning income tax, it is taken into account that the exemptions for Alcoa to pay the Industrial Charge and Market Charge,⁶ which would normally be deductible in the tax base, increase the factual income tax burden of Alcoa with an NPV of USD 0.9 million. This increase in tax burden has been taken into account when calculating the aid element concerning income tax to an NPV of USD 2.7 million.

(b) Municipal Property tax

According to Act No. 4/1995, a municipal property tax shall be levied every year on all buildings (including industrial real estate), evaluated for property tax purposes on 31 December the previous year. The tax base is the value of the property as annually assessed by the Valuation Office of Iceland. The basis for this evaluation is expected market value with certain exceptions in cases where it is difficult to establish such market value. The first valuation takes place when the building is completed (with the primary levying of property tax the following year).

Tax rates are fixed each year by the individual municipalities, up to a maximum of 1.65% for industrial property. The legislation stipulates no minimum rate. The factual rates differ widely between the municipalities. The current property tax rate in Fjarðabyggð is 1.65%.

According to Section 9.1 of the Investment Agreement, Alcoa shall be levied with municipal property tax at a rate of 1% to the Township of Fjarðabyggð. The rate shall apply to all buildings, premises and facilities as listed in Annex B to the Agreement.

Furthermore, Section 9.2 of the Investment Agreement implies that the valuation of the real estate of Alcoa shall be fixed to an amount of USD 255,000.000. As there is

⁶ Concerning the exemptions of the Industrial Charge and Market Charge, see further below.

no purchase price for the aluminium smelter, the evaluation is based on a recognised engineering firm's cost estimate of non-production facilities usually eligible for real estate evaluation. The evaluation is based on the facilities, listed in Annex B to the Agreement. This evaluation will serve as a basis for levying property tax during the whole Contract Period. The fixed value will be converted into IKR in the year 2007. From that point on the amount will be indexed using the Icelandic Building Cost Index. This will give the Municipality of Fjarðabyggð a constant income.

The regulations of the agreement shall be in lieu of property tax according to the current legislation, as well as any identical or substantially similar tax, which might be imposed in place of property tax.

The advantage and aid element for Alcoa for the use of a deviating tax rate is calculated to a NPV of USD 11.8 million based on a twenty-year horizon (over the years 2007 to 2026). Based on a forty-year horizon the NPV of the element is calculated to be USD 14.8 million.

The estimates are based on a normal property tax rate of 1.65% throughout the contract period. The possibility of future reductions of the property tax rate of Fjarðabyggð is not taken into account.

(c) Net Worth Tax

According to Article 84 of Act No. 75/1981 on Income Tax and Net Worth Tax, limited liability companies are liable to pay 0.6% tax on their net worth. The tax base is the total capital, *i.e.* the total assets less total liabilities, of Alcoa less equity and taxes payable.

According to Section 8.2 of the Investment Agreement, Alcoa shall be exempt from Net Worth Tax.

The aid element deriving from this exemption is calculated at 0,6% Net Worth Tax based on the estimated tax base, *i.e.* the annual total capital less equity and payable income and net worth taxes as estimated for the year previous to the levying of the tax. The NVP of the aid element is calculated to be USD 3.2 million based on a twenty-year horizon, *i.e.* over the years 2018 to 2026. Based on a forty-year horizon the NPV is calculated to be USD 14.1 million.

(d) Industrial Charge

Industrial charge is levied on manufacturing and construction industries, as well as certain service industries, according to Act No. 134/1993, as amended by Act No. 81/1998. The only general exemption to this rule applies to enterprises wholly or largely publicly owned. The basis for levying the charge of 0.08% is the annual turnover as defined by Act No. 50/1988 on Value-Added Tax. The revenue from the charge is allocated to the Federation of Icelandic Industries and can be deemed as membership fee. The fee is used for the promotion of industrial development in Iceland. The revenue from the charge is used for purposes that are not considered to be a benefit for the aluminium companies.

According to Section 8.3 of the Investment Agreement, Alcoa shall be exempt from this Industrial Charge, as well as any identical or substantially similar tax or charge, which might be imposed in addition to, or in place of the Industrial Charge. The same exemption applies to other aluminium companies in Iceland.

The advantage for Alcoa is calculated on the basis of the estimated annual revenue of the plant of USD 499 million from 2008. Based on a twenty-year horizon over the years 2007 to 2026, the aid element is estimated to a NPV of approximately USD 2.7 million. Based on a forty-year horizon the NPV is calculated to be approximately USD 3.4 million.

(e) Market charge

Market charge is levied on the basis of Act No. 114/1990 on the Trade Council of Iceland. The charge is levied on all economic enterprises in Iceland. The charge is 0.05% and the tax base is the same as for the Social Security Charge as defined by Act No. 113/1990 on Social Security Charge, *i.e.* total wages.

Act No. 114/1990 was replaced by a new Act, which passed the Parliament on 13 December 2002. The new act entered into force on 1 January 2003. The charge and the tax base and the manner of levying the charge, will be the same as under Act No. 114/1990. According to the new Act, the Market Charge will be cancelled as from 1 January 2008.

According to Section 8.3 of the Investment Agreement, Alcoa shall be exempt from the Market Charge, as well as any identical or substantially similar tax or charge which might be imposed. The same exemption applies to other aluminium companies in Iceland. The revenue from the charge is used for purposes that are not considered to be a benefit for the aluminium companies. These companies use their own marketing and distribution network.

The advantage for Alcoa is calculated based on the estimated annual labour costs of the plant. The calculations are based on the assumption that the Market Charge will be levied throughout the contract period. The aid element is calculated to be a NPV of USD 0.074 million based both on a twenty-year and to USD 0.091 million over a forty-year horizon. Both figures are rounded up to USD 0.1 million in the summary below.

(f) Withholding Tax on Dividend

According to Icelandic tax legislation, a withholding tax is applicable to dividends paid by companies resident in Iceland to non-resident shareholders. The tax rate is 15% both for individual and corporate shareholders, unless reduced by tax treaties. According to the convention between the United States of America and the Republic of Iceland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital, the rate of tax imposed on dividend shall not exceed 5% of the gross amount actually distributed when the recipient is a corporation.

According to Section 8.6 of the Investment Agreement, a tax of 5% shall be levied and withheld from dividends, which are distributed to any shareholder of Alcoa, who resides in an OECD member state.

Based on the current regulations and the assumption that the Owners will be wholly owned subsidiaries of Alcoa Inc. throughout the contract period, the aid element of this measure is considered to be zero.

However, based on a forty-year horizon a negative aid element of USD-0.1million is estimated due to the withholding tax being calculated from dividends that depend on the profit after taxes, which again depend on many items such as income tax, net worth tax, industrial and marketing charges and property tax.

(g) Stamp Duties

Stamp duties are levied on various kinds of legal documents, including purchase contracts, issuance of loan contracts for resident creditors, lease agreements and deeds of sale, on the basis of Act No. 36/1978 on Stamp Duties. Issuance of shares in private limited liability companies and loan agreements with non-resident creditors are not levied with stamp duties. The same applies for the transfer of shares and transfer of obligations/claims.

According to Section 12.1 of the Investment Agreement, stamp duties, to the extent payable according to Act No. 36/1978, shall be levied with a rate of 0.15% on all documents issued or entered into in connection with the construction and operation of the plant. In addition all documents related to the financing of Alcoa shall be exempted from stamp duties.

The general provisions concerning stamp duty compared with the Invest Agreement are summarised as follows:

Table 2

Document type	General rates for stamp duties according to Act No. 36/1978	Rates for stamp duties according to the Investment Agreement
Bonds with collateral	1.5%	0.15%
Bonds without collateral	0.5%	0.15%
Loan agreements for non-resident creditors (without collateral in Icelandic valuables)	0%	0%
Loan agreements for resident creditors with collateral	1.5%	0.15%
Loan agreements for resident creditors with collateral connected to refinancing of already issued loan agreements	0.75%	0.15%

Loan agreements for residents without collateral	0.5%	0.15%
Loan agreements for resident creditors with collateral connected to refinancing of already issued loan agreements	0.25%	0.15%
Security agreements	0.5%	0.15%
Deeds of title	0.4%	0.15%
Site lease agreements	2.0%	0.15%
Issuance of shares in private limited companies	0%	0%

The Icelandic authorities have calculated the aid element of this measure to a NPV of USD 300,000 based on a twenty-year horizon, as well as under a forty-year horizon. The calculations cover the advantage of reduced stamp duty on loan agreements with resident creditors and are based on an assumption that only 4% of the loans obtained by Alcoa will be from resident creditors.

(h) Street Connection Fee

Street Connection Fee is levied pursuant to Act No. 17/1996 by the township. According to the Icelandic authorities the fee is to be regarded as a service charge payable to the municipalities in return for street construction.

According to Section 9.7 of the Investment Agreement, Alcoa shall not be liable to pay such a Street Connection Fee or any other tax, fee or charge, which would be imposed in lieu thereof.

The Township of Fjarðabyggð has no obligation whatsoever to construct streets on the site of the aluminium plant or to Alcoa, or to render other services covered by the fee. According to the Icelandic authorities this item should therefore not count as State aid.

(i) Building Licence Fee

According to Article 53 of the Zoning and Building Act No. 93/1997, the townships are authorised to demand fees for the issuing of a building licence. The Township fixes tariffs for the fees. According to Article 53 of the Act the fees may not amount to more than the cost of issuing permits, site measurements, monitoring inspection and certification provided. The tariff for Building Licence Fee settled for the Township of Fjarðabyggð is normally USD 0.39 on each cubic meter of building. For Alcoa the actual size of the building is based on an estimated size of 1.180.000m³, which would amount to a fee of USD 460.200.

According to Section 10.3 of the Investment Agreement, Alcoa shall pay a Building Licence Fee of USD 400.000 in connection with Alcoa's application for a building licence. According to the Icelandic authorities this fixed amount is based on the estimated cost of issuing a building licence and surveillance of the construction of the plant. This item should therefore not count as State aid.

(j) Zoning Fee

According to Article 35 of Act No. 73/1997, a Zoning Fee is levied *i.a.* on new buildings with 0.3% of assessed value for fire damage or if the buildings are not assessed, on initial investment. This provision also comprises buildings related to an aluminium plant project. The Zoning Fee is intended to finance the making of zoning plans.

The estimated initial investment costs of all buildings related to the aluminium plant are assessed to be USD 255 million, see point (b) on Municipal Property Tax above. If the general provisions of the Act No. 73/1997 were directly applied to the plant the Zoning Fee would amount to USD 765,000.

According to the Icelandic authorities, a fee of USD 765,000 would not reflect the planning/zoning costs in relation to the plant. It is considered that the Act No. 73/1997 does not take into consideration the size and investment of projects like the project at issue; it is necessary to negotiate the Zoning Fee. The principle for determining the amount shall be to cover the costs of the competent surveillance body.

According to Section 12.2 of the Investment Agreement, a one-time Zoning fee of USD 150,000 is determined for Alcoa. This amount is determined so as to cover the costs of the competent surveillance body and should not amount to State aid.

(k) Import and Export Duties

According to Article 11 of the Investment Agreement, Alcoa will be subject to exemptions from Icelandic customs and excise duties pursuant to Act No. 97/1987, as well as any identical or substantially similar taxes or duties which might be imposed. By agreements entered into within the framework of the enabling Act, customs duties and excise duties on goods and services purchased within the country in respect of the construction of the smelter, may be waived or refunded.

According to the Icelandic authorities these derogations are all pursuant to the general Icelandic legislation. The general regulations applicable are explained as follows:

“Article 6 of the Customs Act No. 55/1987 (cf. Article 12(2) of Act No. 97/1987 mentioned in the investment agreement) lays down conditions for waivers, reductions of refund of duties. Article 6 reads as following:

“Duties shall be reduced, waived or refunded in the following instances, subject to the conditions specified:

...

8. On raw materials, components and parts for the production of domestic goods, as well as on packing for such goods. If the processing taking place in this country is insignificant, such as packing, repacking, bottling or mixing, the product shall not be considered to be domestic within the meaning of this point. The waiver of duty on raw materials or components provided for in this point does not cover goods subject to quantitative duty (A1-duty) in accordance with Annex I to this Law.

9. *On machinery, machinery parts and spare parts used in the production of domestic goods.* “

Article 6(8) states that duties shall be reduced, waived or refunded on raw materials, components and parts for the production of domestic goods. Article 6(9) states that duties shall be reduced, waived or refunded on machinery, machinery parts and spare parts used in the production of domestic goods. Paragraph 2 of Article 6 states that the Minister of Finance can stipulate further on conditions for waivers, reductions or refund of duties provided for in Article 6. These conditions are laid down in Regulation No. 719/2000 (Reglugerð um undanþágu aðflutningsgjalda af aðföngum til ýmissrar atvinnustarfsemi.)

In Article 4 of the regulation it is stated that the scope of the regulation is following:

- 1. Raw materials, components and parts for the production of domestic industrial goods.*
- 2. Material for package of industrial goods.*
- 3. Machinery, machinery parts and spare parts used in the production of domestic industrial goods.*

Exemptions are made from the scope of the regulation in Article 5:

- 1. The operation in question is not production of industrial goods.*
- 2. Materials for shipbuilding.*
- 3. Insufficient working or processing.*
- 4. Agricultural products.*
- 5. Raw material, components and parts for the production is used to manufacture domestic industrial goods which are meant to derive exemptions from duties in other EEA countries, on the condition that the material comes under Article 14 of Protocol 4 of the EEA Agreement on prohibition of drawback of, or exemption from, customs duties.* “

As regards the prohibition of drawback of, or exemption from customs duties according to Article 15 of Protocol 4 to the EEA Agreement, subsequent verifications of invoice declarations made by verified exporters are carried out randomly by the Icelandic Customs authorities at regular intervals and when they have doubts about the correctness of information given.

According to the Icelandic authorities the raw materials procured for future production of the aluminium plant, are all classified under the following headings of the Icelandic Tariff:

“2606.0 *Aluminium ores and concentrates*
 7601 *Unwrought aluminium*
 8545.1100 *Carbon electrodes*
 8545.1900 *Other electrodes.* “

According to the general Icelandic regulations there are no customs or excise duties applicable to materials under the above-mentioned headings, independent of origin.

According to Article 4 of Regulation No. 719/2000, imported machinery or parts of machinery used in production of industrial goods are generally exempted from tariffs and excise duties. These exemptions are also applicable to the operations of the plant.

However, an excise duty of 15% is levied on a few categories of construction materials, such as switches, electrical circuits, fuses etc which the Icelandic authorities presume to be of insignificant importance to the Alcoa project. Subsequently, the total amount of revenue foregone on the basis of the provisions of Article 11 of the Investment Agreement is minimal.

(l) Assurances

According to Article 17 of the Investment Agreement the Government issues assurances in relation to the implementation of the project.

It is the opinion of the Icelandic authorities that the assurances do not imply that the Government will be liable to indemnify for any loss for the project caused by defects in the performances covered by the guarantees. This article is only intended to highlight the contractual obligations of the Government and it shall not use its powers to affect the implementation of the project and operations of Alcoa. The assurances will not be mirrored in any other agreements concerning the project.

It is the opinion of the Icelandic authorities that the assurances have no special value and that there is no market premium for such assurances.

(m) Other regulations

According to Section 6.2 of the Investment Agreement, the Government shall not impose any environmental charges or taxes related to the emission of CO₂ and SO₂ gases, or any other emission or pollutant, on Alcoa unless such charges or taxes are generally levied on other companies in Iceland, including but not limited to all other primary aluminium companies.

According to Section 8.7 of the Investment Agreement, the deductibility of interest expenses shall remain unchanged during the Initial Term as it is under Act No. 75/1981 on Income and Net Worth Tax, as amended, on the date of the signing of the Agreement.

According to Section 12.3 of the Investment Agreement, the Government shall not impose any charges or taxes related to electricity purchase and/or consumption by Alcoa unless such charges or taxes are generally levied on other companies in Iceland, including but not limited to all other primary aluminium companies.

(n) Calculations by the Icelandic authorities on the aid elements of the Investment Agreement - Summary

To the extent that the Icelandic authorities consider the measures of the Investment Agreement to be State aid in the meaning of Article 61 of the EEA Agreement, estimates of the NPV of the advantages were submitted. The calculations are based on “The IIA Model for Profitability Analyses” developed and revised in November 2002 by Mr. Páll Jensson for the “Invest in Iceland Agency” .

When applying the model on the investment and measures at issue, the calculations of the aid elements are based on estimated payments of taxes and duties according to the

general legislation on the one hand and according to the special regulations of the Investment Agreement on the other. In the notification, the Icelandic authorities primarily refer to the submitted calculations of the aid elements based on estimated payments of taxes and duties over a contract period of twenty years after the Permanent Delivery Date, i.e. the Initial Term. However, the Icelandic authorities have also submitted calculations of the aid elements based on an extended contract period of an additional 20 years, i.e. for a total contract period of 40 years after the Permanent Delivery Date.

The calculations of the aid elements are based on a discount factor of 7.49%, which is based on the reference rate for Iceland calculated by the Central Bank of Iceland and notified to the Authority.

The calculations are based on the operational assumption of a production of 322,000 metric tons of aluminium as from 2008 and an aluminium price of USD 1.550 a tonne throughout the period. The annual consumption of electricity purchase by the aluminium plant is assumed to be 4,476 GWh. The price of electricity is assumed to be constant at USD 19 pr tonne aluminium. The annual costs of electricity purchase are assumed constant at USD 85 million as from 2008, i.e. the first year when the smelter is in full production.

The Icelandic authorities have *i.a.* submitted a sensitivity analysis of the effects on prices on aluminium differing from USD 1.350 to 1.750 a tonne.

Furthermore, the calculations concerning investment and financing are based on 35% equity of the total capital of USD 1,203.0 million, i.e. the investment costs of USD 1,143.2 million and additional capital costs during the construction period and need for working capital, which the cash flows generated in the first years of operation do not cover. The estimates are based on a repayment period of the loan of twenty years and an interest rate of 6% p.a.

The Icelandic authorities' calculations of the aid element based on a twenty-year contract period after the Permanent Delivery Date can be summarised as follows:

Table 3

	Icelandic Tax System	Investment Agreement	NPV Tax & Duties 20 years horizon Difference in MUSD
Industrial Fee	0.08%	0%	MUSD 2.7
Market Charge	0.05%	0%	MUSD 0.1
Property Tax	1.65%	1.00%	MUSD 11.8
Income Tax	18.00%	18.00%	MUSD 2.7
Net Worth Tax	0.60%	0%	MUSD 3.3
Withholding Tax	5.00%	5.00%	MUSD 0
Stamp Duties on Loans	1.50%	0.15%	MUSD 0.3
Total			MUSD 20.9

The Icelandic authorities' calculations of the aid element based on a forty-year contract period after the Permanent Delivery Date can be summarised as follows:

Table 4

	Icelandic Tax System	Investment Agreement	NPV Tax & Duties 40 years horizon Difference in MUSD
Industrial Fee	0.08%	0%	MUSD 3.4
Market Charge	0.05%	0%	MUSD 0.1
Property Tax	1.65%	1.00%	MUSD 14.6
Income Tax	18.00%	18.00%	MUSD 1.9
Net Worth Tax	0.60%	0%	MUSD 14.1
Withholding Tax	5.00%	5.00%	MUSD – 0.1
Stamp Duties on Loans	1.50%	0.15 %	MUSD 0.3
Total			MUSD 34.3

Independent of the calculations above, the Icelandic authorities have committed themselves to limit any aid relating to the project to 49.9 Million Euros, see point I.5 below.

2.3 The Site Agreement

The Site Agreement is between the State Treasury of Iceland and Alcoa.

According to the Site Agreement, the Treasury leases to Alcoa a tract of state owned land of 90.04 hectares in Reyðarfjörður on which the aluminium plant will be constructed. The Treasury also leases Alcoa an additional tract of land of 10.09 hectares. The land at issue was bought by the Treasury in the year 1982 and has been in very limited use for agricultural purposes.

The annual rent for the tract of land comprised by the Site Agreement is fixed at USD 25,000. According to the Icelandic authorities there is no existing market value for land for industrial purposes in the area where the plant is going to be built. The rent for the lease of the site is the result of negotiations between the Treasury and Alcoa. The rent is calculated in accordance with other lease agreements for comparable operations. In comparison, Norðurál aluminium company pays an annual rent of USD 15,000 for 82.2 hectares of State owned land as approved of in the Grundartangi case (Decision No. 174/98/COL).

The possession of the site will be delivered to Alcoa free from any liens, privileges, servitudes or encumbrances. Except for the removal of existing transmission lines on the site, which shall be carried out at the Treasury’s cost, Alcoa shall carry out and finance all necessary site preparations.

The Site Agreement shall become effective on the date of its signature and shall continue in force for twenty years from the Permanent Delivery Date with possible extension for another twenty year period as mentioned in point 2.1 above. The rent applicable to any extension of the term of the Site Agreement shall be calculated according to the following formula fixed in Section 6.5 of the Site Agreement, but never lower than the annual rent for the Initial Term:

$$“ Ri = \frac{(25,000) (avLME i-10)}{1,550}$$

where: R_i = the Rent in USD in year “i”
 $avLME_{i-10}$ = the average price for primary Aluminium in USD per metric ton, minimum purity 99.7 per cent, three months delivery, as published by the Metal Bulletin during a 10 years period prior to year “i”

2.4 The Harbour Agreement

The Harbour Agreement is between the Fjarðabyggð Harbour Fund and Fjarðaál sf. The contract period is twenty years from the agreed “Permanent Delivery Date” with a possibility to prolong the duration by another twenty years.

Harbours in Iceland are operated by Harbour Funds owned by the municipalities. According to the Harbour Agreement Alcoa shall be entitled to use the harbour at Mjóeyri in Reyðarfjörður. The harbour area will be owned by the Fjarðabyggð Harbour Fund, which undertakes to construct, administer, operate and maintain the harbour. According to an annexed Harbour Site Agreement between the same parties, Alcoa is also entitled to lease a part of the Harbour Site for an annual rent of USD 5,000, which is to be amended every year in conformity with the Building Cost Index.

The harbour dues are listed in Article 6 of the Harbour Act No. 23/1994. According to Article 8 of the Act No. 23/1994, the harbour board settles all harbour dues other than certain ship and cargo dues. The dues that are not settled by the Harbour board are settled in the Harbour Tariff No. 132/2001. According Article 8(2) of the Harbour Act and Article 19 of the Harbour Tariff, the Minister is authorised to allow harbour boards to grant discounts or raise the harbour tariff under special circumstances.

For the use of the harbour for import and export, Alcoa shall pay harbour dues. Pursuant to the Harbour Agreement the harbour dues are based on the general Harbour Tariff for Icelandic harbours No. 132/2001, with a derogation of a 55% discount from category 1 of harbour dues, *i.e.* on all inbound shipments of raw materials for the plant that are greater than or equal to 100 metric tons per vessel.

The dues with discount go to the Harbour Fund and shall cover the Harbour Fund’s cost of land, construction, maintenance and operating costs of the harbour and a reasonable profit. The Harbour Agreement involves an unusually high quantity of goods shipped on a constant level. Hence, it is possible with a high degree of accuracy to calculate the amount of harbour dues needed to cover the costs and a fair rate of return on equity. It is assumed that the total harbour dues will amount to ISK 108 million per annum.

The obligations for Alcoa as well as for the Harbour Fund to undertake and finance the construction of the harbour facilities are specified in the Harbour Agreement and the Harbour Site Agreement. According to Annex C and the Harbour Agreement, the Harbour Fund shall supply and finance the following harbour installations:

“List of installations, to be constructed and supplied by the Harbour Fund at its own cost and expense under the Harbour Agreement, Article 2, Section 2.4.

- *Installations of navigational lights and markings for safe navigation in and out from the berth, in and out the fjord, from and to the open sea, night and day, for vessels up to 80,000 DWt, 230 m length, 33 m width.*
- *Provide for pilot and tugboat service 24 hours a day, 7 days a week. For ships exceeding 60,000 DWt, Fjarðaál sf. will use its best efforts to provide at least seven days' advance notice in order to allow the Harbour Fund to arrange for additional tugboat(s). Likewise, where Fjarðaál sf. is not able to provide seven days' advance notice, the Harbour Fund will use its best efforts to accommodate such larger ships on shorter notice. If, after the Permanent Delivery Date, either of the parties experiences significant additional costs as a result of [Alcoa Iceland sf.'s] frequent requirements for larger tugboat service, the parties will negotiate in good faith a permanent resolution of such issue.*
- *Construction of berth, and approaches 35 m fore and aft of the berth, with a minimum draft of 14.3 m (at minimum low water spring) for safe mooring and approach of vessels up to 80,000 DWt, 230 m length, 33 m width.*
- *Piping and connections for fresh water supply to the wharf and for delivery to vessels.*
- *Tele- and data communication cables.*
- *Equipment for receiving garbage and sewage (including waste oil) from vessels.*
- *Installations for receiving spill oil from vessels (could be tanks on trucks or boats).*
- *Backfilled and compacted to finished grade area of 17,000 m² close to the wharf, to be leased to Fjarðaál sf. for construction of a warehouse.*
- *10,000 m² of outside space on the wharf for container storage.*
- *Adequate parking area for trailers and private cars close to the wharf.*
- *Outdoor lights for the berth, storage and parking area.*
- *Harbour administration building of approx. 100 m² to accommodate harbour master, customs officer, medical service and vessel's agent as well as public convenience.*
- *Fence around part of the Harbour Area with controlled gate entrance for security reasons."*

The total investment costs of the harbour and development of the Harbour Site (excluding the investments by Alcoa) are estimated to be ISK 1,350 million. According to the Icelandic legislation, the State funds 60% of the eligible investment costs for State contributions, which in this case is ISK 1.081 million. Therefore, the State will invest about ISK 600 million. The investment costs concerning the harbour and development of the Harbour Site, to be financed by the Harbour Fund, are estimated to be ISK 750 million.

The Icelandic authorities have estimated the internal rate of return (hereinafter "IRR") of the investments of the Harbour Fund at ISK 750 million, to be 15.4% based on a twenty-year period and 15.6% based on a forty-year horizon. The calculations are based on the forecasted cash flow over the twenty and forty year periods as the estimated harbour dues with 55% discount according to the Agreement, 8% interest rate and 20% equity. If it is assumed that there is no discount on the harbour dues, the calculated IRR on equity becomes 33.3% over a twenty-year period and 32.7% over a forty-year period.

If the State funding of ISK 600 million is added to the investment to be covered by the calculations, the IRR will become 0% if the discount is granted, but 11,3% if there is no discount on the harbour dues based on a twenty-year horizon. Over a forty-year period the IRR on equity becomes 12.7% without a discount and 0% with a discount.

The State participation is regarded as a contribution to the infrastructure. Although the construction of this particular harbour is linked to the construction of the aluminium plant there is an obligation for the harbour to service other customers. The same applies for all other harbours in Iceland funded by the State. The Fjarðabyggð municipality is planning industrial sites for other industries in the area. Such industries would use the harbour for import and export. One of the two main export harbours in Iceland is located in the municipality of Fjarðabyggð.

2.5 The Power Contract

The Power Contract is between Landsvirkjun and Alcoa. Landsvirkjun is a public partnership company regulated by public law, Act No 42/1983 on Landsvirkjun. Its present ownership is divided among the Icelandic State (50%), the city of Reykjavík (44.525%) and the town of Akureyri (5.475 %). Landsvirkjun produces, transmits and sells electricity at wholesale level to local public utilities and, under special agreements, to power intensive industries.

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

The Power Contract has been negotiated independently between Landsvirkjun and Alcoa without participation by representatives of the State. The contract period is as mentioned in point 2.1 above. The power price shall be re-negotiated for the second twenty-year period of the contract.

According to Article 15 of the Power Contract, the power price is fully linked to the price for Aluminium on the London Metal Exchange. The power price applicable for each month shall be calculated at the beginning of the next calendar month according to a formula set down in the Contract.

The power price according to the Power Contract does not have any fixed elements to it, nor are there floors or ceilings on the power price. The absence of a floor and ceiling in the formula is preferred by Landsvirkjun, partly because it contributes to placing the basic reference of the formula at a higher level, and partly because the aluminium market price tends to have a natural floor, while a ceiling may preclude full benefit from an upward swing of the price.

According to Article 3 of the Power Contract, Landsvirkjun undertakes to make available for Alcoa an annual energy total of GWh 4,704 (hereinafter the "Contract

Power”), whereof GWh 4,231 is to be made available on a firm basis (“Firm Energy”).

Article 7 of the Power Contract contains a “Take or Pay Obligation” for Alcoa. The Article states that the Alcoa smelter must pay for a minimum of 3,998 GWh per calendar year regardless of whether the actual consumption is less. This constitutes 85% of the Contract Power and 94% of the portion constituting Firm Energy. The obligation is substantially similar to that applicable to the other two Icelandic smelters.

The Kárahnjúkar hydroelectric project is primarily a fixed cost project. The project is highly capital intensive with total estimated capital costs of approximately USD 1,088 million (assuming a long term exch. rate of ISK/USD 87.5) incurred over the period up to 2009. The investment costs include the estimated construction cost for connecting the countrywide national grid to the Kárahnjúkar Power Station, which is scheduled for completion in 2006. There is a small component of ongoing operating costs of approximately USD 8.6 million per annum. In addition, reinvestment costs are taken into account, based on historic experience, to ensure even further the long life earning power of the project. However, no salvage value is assumed at the end of the calculation period.

The Icelandic authorities have submitted a “Report to the owners of Landsvirkjun: Profitability and financial risk for Landsvirkjun in connection with the Kárahnjúkar project” dated 7th January 2003 (hereinafter “the report”). The report presents the findings of a committee appointed by the owners of Landsvirkjun and assisted by the staff of Landsvirkjun’s Finance Division.

Landsvirkjun uses the “Discounted Cash Flow” method for calculating the rate of return on new projects. This method is based on future cash flows of the relevant project, *i.e.* determining the cash outlet at the beginning and estimating the future revenues less future operating cost. The difference of the cost 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 cost, *i.e.* interest cost and returns that owners request on their equity funding. Taking into account the portion of loans and equity, one can measure the weighted average cost of capital, (hereinafter the “WACC”) for the project. The project must have an internal rate of return (IRR) at least equal or higher than the weighted average cost of capital. In evaluating the project, Landsvirkjun is using a synthetic WACC as a hurdle rate for this project.

The estimates of the report are based on an aluminium price (at 2002 price levels and exchange rates) of USD 1,564 at the beginning of the energy sales period, falling by 0.45% per year in real terms, based on the producers price index (PPI) in the USA, during the lifetime of the power plant.

The future revenues are based on the estimated life of the relevant assets rather than using the depreciation time for accounting purposes. This is especially the case for power plants that, if well maintained, can have a lifetime of eighty to a hundred years.

Furthermore, the estimates are fully based on the remunerations of the Kárahnjúkar power project generated from the long term Power Contract between Landsvirkjun and Alcoa. Landsvirkjun is estimated to sell 99% of the Contract Power on average over time, or 4,657 GWh.

The calculations of the report are based on the period 2007 to 2080. It is also assumed that the power price will be reset after twenty years and again after forty years at the same level.

Calculated *i.a.* on the assumptions mentioned above, the present value of cash flows is estimated to ISK 6.6 billion.

The calculation of the WACC has been based on a required rate of return on equity investment (hereinafter “ROE”) of 11% per annum (nominal), a ratio of 25% equity and 75% loan capital and a debt cost of 5.5% per annum (nominal). A weighting of the 75/25 debt/equity has been assumed giving a WACC of 6.9% per annum (nominal) or a WACC of 5.0% per annum (real) based on a 1.8% US PPI inflation assumption).

Based on the above-mentioned assumptions, the assessment in the report shows that the Kárahnjúkar power project yields a real rate of return (IRR) of 5.5% per annum over the assumed project period. This is 0.5 % in excess of Landsvirkjun’s WACC of 5.0% per annum (real). The nominal equity return (ROE) is 12.8%, which is 1.8 percentage points above the required ROE.

The submitted report also contains sensitivity analysis on the impact of the following changes on the premises of the total profitability (IRR), return of equity (ROE) and the net present value of cash flows:

- construction costs rise by 10%,
- aluminium price falls by 10% as energy sales commence,
- annual lowering of aluminium prices increases by 0.1%,
- initial aluminium price is lower than basic premises,
- energy sales are reduced by 2%,
- energy sales are delayed by 1 year,
- lending rate rises by 0.5% ,
- exchange rate ISK goes up by 10% and
- other income than the Power Contract.

In addition, the Icelandic authorities have provided their considerations concerning the impact of possible amendments in the guarantee arrangements from the public owners of Landsvirkjun and the possibility of future amendments concerning Landsvirkjun’s present advantage of being exempted *i.a.* from income tax and net worth tax.

According to the Icelandic authorities, the required rate of equity return (ROE) of 11% per annum (nominal) used in the report is currently in excess of the returns typically required by international investors using capital pricing models reflecting *i.a.* current risk free rates and equity risk premium for companies in the electricity and aluminium sectors, especially when taking into consideration the strong investment grade characteristics of the off-taker under the Power Contract. As an example

Statkraft in Norway is using 11% ROE as a target for equity returns after having experienced an average ROE of 7.5% in the years from 1998-2001. The return of equity for Vattenfall in Sweden was 11.2% in 2001 and Alcoa's average ROE was 9.5% in the years from 1998-2001. The return of equity of EDF in France was 6.2% in 2001. The average ROE for EDF in the years from 1998-2001 was 8.6%.

The Icelandic authorities have also stressed that the smelter is assumed to be in operation for the life of the power plant and that Landsvirkjun believes that the above-mentioned assumptions of the report are very conservative given Iceland's position in the global merit order for the production of aluminium and on the basis of the outlook for green power demand globally. It is envisaged that after forty years, technological advances will offer Landsvirkjun additional potential purchasers for the power generated by the Kárahnjúkar power plant both in Iceland and internationally. Landsvirkjun estimates the life of the power plant to exceed eighty years.

3. The objective of the aid measures

The object of the Project and the Project Agreements is *i.a.* to strengthen economic activities in the Central East Region, which is an area eligible for regional aid, according to the decision of the Authority of 8 August 2001 (253/01/COL). According to this decision, the Township of Fjarðabyggð is part of the regional aid with a maximum general aid ceiling of 17% NGE. The area is qualified for the Article 61(3)(c) EEA derogation on the basis of Chapter 25.3 (17) of the State Aid Guidelines.

Nearly 12,000 people live in the East Region, including barely 8,100 in the Central East Region. The East Region has a low population density and experiences relatively high net out-migration. While the economic picture is reasonably good for the region as a whole, there is a limited diversity in the economic base and some communities and areas are doing much better than others. The region has a high proportion of primary and secondary activities but low share of the main growth sectors of the national economy.

No other projects comparable in terms of size and economic effects to the plant appear likely in the East Region. All indications are that, if the project does not proceed, the region will experience continuing out-migration and economic stagnation as it has seen over the last decade. Farming will continue to decline and fishing and fish processing will see continued fluctuations in activity and employment levels.

The Icelandic authorities have submitted quantifications of the Socio-Economic Impact of the construction and the operation of the aluminium plant. The estimated total labour requirement for the construction of the aluminium plant (including the harbour) is around 25,000 person-months. The construction of the plant and the harbour will involve a total number of workers amounting to about 2,300 person-years in 2003-2007, peaking in 2006 with about 1,300 person-years. Executives from construction companies estimate that the construction labour force will be drawn from the following sources:

- Local residents – 10%

- Workers from away who move temporarily into the region with their families – 15%
- Foreign construction workers – 30%
- Domestic construction workers staying in the work camp but going home during work breaks - 45%.

An aluminium plant with a production capacity of 322,000 tons a year is expected to provide 420 permanent jobs. An additional 8 % will be required for vacation and other release work, totalling to about 455 jobs.

The plant will create various business opportunities for companies in the East Region and elsewhere in Iceland. It is estimated that this employment multiplier effect will result in an additional 300 jobs being created in the Central East Region by the plant activity.

The expected sources of labour for the expected recruitment by 2009 are presented in the table below.

Table 5

Labour source	Plant	Plant-related	Total
Local residents	120	80	200
School leavers	120	80	200
Return migrants	60	40	100
In-migrants	155	95	250
Total Labour requirement	455	295	750

4. The primary aluminium market

According to the Icelandic authorities, the worldwide production capacity for aluminium is approximately 25 million metric tonnes. The production capacity for aluminium in Europe is approximately 4.5 million metric tonnes, excluding production from the former Soviet Union. As stated above, the production capacity for the smelter in Fjarðabyggð in Iceland is 322,000 metric tonnes.

The primary aluminium market is a global market. In 2001 and 2002, the aluminium market, like most world markets, contracted and demand decreased. Market recovery is expected to begin in 2003 and to continue as the world economy recovers. According to various external sources, the Icelandic authorities are of the opinion that aluminium demand is projected to increase at rates ranging from 1½ to 3% per annum. Therefore, by the time the smelter in Fjarðabyggð becomes fully operational in 2007, it is anticipated that there will be sufficient demand to absorb the production from the plant.

At present, it is anticipated that the smelter production of primary aluminium from Iceland will be shipped to Europe, where Alcoa has numerous aluminium fabricating facilities. However, depending on demand, the plant is also positioned to service the North American market.

Demand in the EU is estimated to be approximately 6 million metric tonnes. The production of the smelter in Fjarðabyggð in Iceland should help balance supply and demand in Europe.

5. Commitment from the Icelandic authorities.

By letter dated 13 March 2003, the Icelandic Ambassador to the EU submitted the following commitment to the Authority:

"The Icelandic Government is fully aware of its obligation to respect that the aid element relating to the construction of the aluminium plant in the Township of Fjarðabyggð should not exceed a total value of 49.9 million Euros expressed in 2003 prices, covering the entire contract period of twenty + twenty years, discounted to Net Present Value as of 2003 with a discount factor of 7.49%."

II. APPRECIATION

1. Procedural requirements

Article 1(3) in Part I of Protocol 3 to the Surveillance and Court Agreement states: *"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."* Aid provided without notification or aid that is notified late, *i.e.* notified after being "put into effect" is considered unlawful aid, see Article 1 f) in Part II of Protocol 3 to the Surveillance and Court Agreement.

By letters from the Icelandic Mission to the European Union dated 19 December 2002 (Doc. No. 02-9218A), 20 January 2003 (Doc. No. 03-331A), 8 February 2003 (Doc. No. 03-956A), 21 February 2003 (Doc. No. 03-1044A), 5 March 2003 (Doc. No. 03-1365A), 12 March 2003 (Doc. No. 03-1508A) and 13 March 2003 (Doc.No.03-1533A), the Icelandic authorities have fulfilled their obligation according to Article 1(3) in Part I of Protocol 3 to the Surveillance and Court Agreement.

2. The presence of State aid

2.1 Article 61(1) EEA

Article 61(1) of the EEA Agreement reads as follows:

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

The Authority would point out that, for the purpose of applying the EEA rules on State aid, the tax nature of several of the measures in question does not matter since Article 61(1) of the EEA Agreement applies to aid measures *"in any form*

*whatsoever*⁷. Nevertheless, the Authority emphasises that, to be regarded as aid, the measures must satisfy all four of the criteria set out in Article 61(1) EEA.

Firstly, the measures must confer on Alcoa advantages that relieve it of charges that are normally borne from its budget. Advantages may for example be provided through different types of reduction in Alcoa's tax burden. In points II 2.2-2.5 below, the Authority will examine in detail whether and to what extent the different measures contained in the agreements between the Icelandic authorities and Alcoa confer advantages on Alcoa.

Secondly, the advantage must be granted by the State or through State resources. A reduction in the tax base or a total or partial reduction in the amount of tax (including fees and charges) involve a loss of revenue and is therefore equivalent to the consumption of State resources in the form of fiscal expenditure. This criterion is also applied to aid granted by regional and local bodies⁸. The intervention of the State can be affected both through tax provisions of a statutory, regulatory or administrative kind and through the practices of the tax authorities. In this specific case, State intervention is present in a set of agreements negotiated between, on the one hand, the Government of Iceland (Investment Agreement), the State Treasury of Iceland (Site Agreement), the Fjarðabyggð Harbour Fund (Harbour Agreement) and Landsvirkjun (Power Contract) and, on the other hand, Alcoa.

Thirdly, the measures must affect competition and trade between the Contracting Parties. In the case at hand, Alcoa will produce primary aluminium for export from Iceland, including to other EEA countries. Primary aluminium is a product extensively traded within the EEA and in world markets. Any aid will strengthen Alcoa's position vis-à-vis its competitors within the EEA area. Any financial benefits provided by public authorities to producers of primary aluminium, such as Alcoa, are therefore liable to affect trade between the Contracting Parties to the EEA Agreement. Furthermore, the increase in Alcoa's profit after tax improves its profitability. This enables it to compete with firms that are not eligible for the aid.

Lastly, the measure must be specific or selective in that it favours "*certain undertakings or the production of certain goods*". In the case at hand, it is obvious that any aid will benefit Alcoa and/or its subsidiaries.

2.2 The Investment Agreement

A description of all the different measures under the Investment Agreement is given in point I.2.2 above.

(a) Government Income tax

- Corporate income tax rate

The current Icelandic corporate income tax rate, as well as the maximum corporate income tax rate applicable according to the Investment Agreement, is 18 %. *I.e.* if the general corporate income tax rate in Iceland does not increase, this part of the

⁷ See State Aid Guidelines Chapter 17B, Application of State aid rules to measures relating to direct business taxation, paragraph 17B.3.(1).

⁸ Case C-248/84 *Germany v Commission* [1987] ECR 4013.

investment agreement would not contain any actual aid element. However, as described in point I.2 above, should one day the corporate income tax rate exceed 18%, for every 2 % increase in the general income tax the aid element would increase by approximately USD 5 million. However, as referred in point I.5 above, the Icelandic authorities are obliged to keep the aid amount below 49,9 Million Euro (see point II.2.2(n) below).

- Classification of fixed assets in different depreciation categories

All of the eligible costs as described in point I.2.1 above, will be subject to the normal depreciation rules in accordance with the general Icelandic tax legislation. This element of the Investment Agreement does thus not contain any element of State aid.

- Depreciation of fixed assets

Alcoa is exempt from the limitation that fixed assets can only be depreciated down to 10 % of the residual value and will be allowed to depreciate its assets down to no residual value. The net effect is an aid element of approximately USD 2,7 million, in Net Present Value terms, with a 20-year horizon and USD 1,9 million with a 40-year horizon.

(b) Municipal Property tax

The current property tax rate in Fjarðabyggð is 1,65 % while Alcoa shall be levied with municipal property tax at a rate of 1 %. The reduced property tax rate will relieve Alcoa of charges that are normally borne from its budget. This confers, in the Authority's view, an advantage to Alcoa. The aid is calculated at 11,8 million USD with a 20-year horizon, and 14,6 million USD with a 40-year horizon.

According to the Investment Agreement, the property tax shall be levied only from the Permanent Delivery Date. At present, it is difficult to say whether this arrangement confers an advantage or a disadvantage compared to the general legislation. For example, if the buildings are completed before 31 December 2006, Alcoa is exempted for the period from 1 January 2007 until 30 September 2007. On the other hand, if the buildings are completed in the period between 1 January 2007 and 31 December 2007, Alcoa will have commenced tax payments three months earlier than it would have under the generally applicable legislation. The Authority considers that this does not constitute any aid.

(c) Net Worth Tax

According to the Investment Agreement, Alcoa shall be exempt from 0,6% Net Worth Tax. This confers in the Authority's view an advantage for Alcoa. The aid is calculated at 3,3 million USD with a 20-year horizon, and 14,1 million USD with a 40- year horizon.

(d) Industrial Charge

Alcoa is exempted from the Industrial Charge of 0,08% on its turnover. This confers, in the Authority's view, an advantage for Alcoa. The aid is calculated at 2,7 million USD with a 20-year horizon, and 3,4 million USD with a 40-year horizon.

(e) Market Charge

Alcoa is exempted from the Market Charge of 0,05% on total wages. This confers, in the Authority's view, an advantage for Alcoa. The aid is calculated at 0,1 million USD with a 20-year horizon, and 0,1 million USD with a 40-year horizon.

(f) Withholding Tax on Dividend

According to the Investment Agreement, a tax of 5% shall be levied and withheld from dividends, which are distributed to any shareholder of Alcoa, who resides in an OECD member state. This is in accordance with the convention between the United States of America and the Republic of Iceland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital. The Authority agrees that there is no aid element in this part of the Investment Agreement.

(g) Stamp Duties

According to the Investment Agreement stamp duties, to the extent payable according to Icelandic legislation, shall be levied with a rate of 0,15 % on all documents issued or entered in connection with the construction and operation of the plant to the extent that stamp duties are payable according to the legislation. In addition, all documents related to the financing of Alcoa shall be exempted from stamp duties. This confers in the Authority's view an advantage for Alcoa. The aid is calculated at 0,3 million USD with a 20-year horizon, and 0,3 million USD with a 40- year horizon.

(h) Street Connection Fee

According to the Investment Agreement, Alcoa shall *i.a.* not be liable to pay Street Connection Fee. As the Township of Fjarðabyggð enjoys wide discretion in fixing street fees, and is under no obligation to construct streets on the site of the aluminium plant or to Alcoa, or to render other services covered by the fee, the Authority agrees that this item should not count as State aid.

(i) Building Licence Fee

According to the Investment Agreement, Alcoa shall pay a Building Licence Fee of USD 400.000 in connection with Alcoa's application for building licence. This fixed amount is based on the estimated cost of issuing a building licence and surveillance of the construction of the plant. The Authority agrees that there is no aid element in this part of the Investment Agreement.

(j) Zoning Fee

According to the Investment Agreement, a one-time Zoning fee of USD 150,000 is determined for Alcoa. This amount is determined as to cover the costs of the competent surveillance body. If the general provisions of the Icelandic legislation were directly applied to the plant, the Zoning Fee would amount to USD 765,000. However, the Authority accepts the arguments put forward by the Icelandic authorities arguing that a fee of USD 765,000 would not reflect the planning/zoning costs in relation to the plant and that the general legislation does not take into

consideration the size and investment of projects like the project at issue. This part of the Investment Agreement is therefore considered not to contain State aid.

(k) Import and Export Duties

According to the Investment Agreement, Alcoa will be subject to exemptions from Icelandic customs and excise duties. Customs duties and excise duties on goods and services purchased within the country in respect of the construction of the smelter, may be waived or refunded. The Icelandic authorities have documented that these derogations are all pursuant to the general Icelandic legislation and that this part of the Investment Agreement thus does not contain any aid element. However, should the general Icelandic legislation one day change on this point and customs and/or excise duties would be introduced, the Icelandic authorities would be obliged to include this possible aid element within the above-mentioned expressed State aid ceiling. The same counts for the benefit of Alcoa to purchase some categories of construction materials, as specified above under point I.2.2(k), free of excise duty.

(m) Assurances

The Authority understands Article 17 of the Investment Agreement to merely reflect the parties' commitments towards a satisfactory execution and performance of the Agreement. Thus, Article 17 only seems to stress the contractual liabilities of both parties and thus only reflects the basic contractual law, without containing an additional aid element.

(m) Other regulations

According to the Investment Agreement, the Government shall *i.a* not impose any environmental charges or taxes related to the emission of CO₂ and SO₂ gases (or any other emission or pollutant) and any charges or taxes related to electricity purchase and/or consumption by Alcoa unless such charges or taxes are generally levied on other companies in Iceland. The deductibility of interest expenses shall remain unchanged during the Initial Term as it is under the Act on Income and Net Worth Tax. The Authority considers that Alcoa is not relieved from any current charges and is subject to the same rules as any other Icelandic company if such taxes or charges were introduced. The Authority therefore considers that this does not confer any advantages on Alcoa.

(n) Summary of aid elements contained in the Investment Agreement

Table 3 and 4 in part I above gives a summary of the aid elements of the Investment Agreement based on a twenty-year and forty-year contract period, respectively. The calculated total aid under the Investment Agreement based on a twenty-year period is 20,9 million USD, while the total calculated aid based on a forty-year period is 34,3 million USD.

As has been demonstrated above in part II.2.2, points (a) – (m), the Authority agrees with the Icelandic authorities concerning which part of the Investment Agreement contains aid elements. The Authority also agrees with the calculations undertaken by the Icelandic authorities to quantify the aid.

However, on an interpretation of Article 20 (in particular of its paragraph four) of the Investment Agreement, the Authority considers for its assessment the relevant contract period to be forty years. According to Article 20(4) of the Investment Agreement, Fjarðaál sf. and the partners will be entitled, before the end of the Initial Term of twenty years, to an "automatic" extension of the Investment Agreement for an additional period of twenty years on identical terms and conditions, if the Power Contract is in effect. First, it has to be noted that the power contract period is fixed to forty years after the Permanent Delivery Date. Secondly, the Authority finds it unlikely that the Power Contract will not be in effect before the end of the Initial Term, since it is an indispensable condition for the production of aluminium and since no alternative power supply seems, at least under the current circumstances, to be a realistic option for the future. Furthermore, it transpired from the notification and the meetings with the Icelandic authorities that the total contract period will most likely be forty years.

Consequently, the Authority considers that the total aid under the Investment Agreement, based on a comparison between the conditions laid down in the Agreement and the current applicable Icelandic general rules, is USD 34,3 million.

In addition, the Authority refers to the commitment from the Icelandic authorities referred in point I.5 above (see also point II.4).

2.3 The Site Agreement

Under the Site Agreement Alcoa leases approximately 100 hectares of land from the State Treasury of Iceland. The annual rent is fixed at USD 25,000 for twenty years from the Permanent Delivery Date. If the Site Agreement is prolonged, the new rent is linked to the price of Aluminium. The Authority considers that the Icelandic authorities have demonstrated that the rent for the lease of the site is calculated in accordance with other lease agreements for comparable operations, *i.e.* at market conditions, and that the Site Agreement therefore does not contain any element of State aid.

2.4 The Harbour Agreement

The Harbour Agreement is between the Fjarðabyggð Harbour Fund and Fjarðaál sf. According to the Harbour Agreement, Alcoa shall be entitled to use the harbour at Mjóeyri in Reyðarfjörður. The harbour area will be owned by the Fjarðabyggð Harbour Fund, which undertakes to construct, administer, operate and maintain the harbour. According to an annexed Harbour Site Agreement between the same parties, Alcoa is also entitled to lease a part of the Harbour Site for an annual rent of USD 5,000, which is to be amended every year in conformity with the Building Cost Index.

For the use of the harbour for import and export, Alcoa shall pay harbour dues. Pursuant to the Harbour Agreement the harbour dues are based on the general Harbour Tariff for Icelandic harbours, with a derogation of a 55% discount. The dues with discount go to the Harbour Fund and shall cover the Harbour Fund's cost of land, construction, maintenance and operating costs of the harbour and a reasonable profit.

The total investment costs of the harbour and development of the Harbour Site (excluding the investments by Alcoa) are estimated to be ISK 1,350 million.

According to the Icelandic legislation, the State funds 60% of the eligible investment costs, i.e. in this case ISK 1,081 million. Therefore, the State will invest about ISK 600 million. The investment costs concerning the harbour and development of the Harbour Site, to be financed by the Harbour Fund, are estimated to be ISK 750 million.

The State participation is regarded as a contribution to infrastructure. Although the construction of this particular harbour is linked to the construction of the aluminium plant, there is an obligation for the harbour to service other customers. The same applies for all other harbours in Iceland funded by the State. The Fjarðabyggð municipality is planning industrial sites for other industries in the area. Such industries would use the harbour for import and export.

The forecasted cash flow (over the Initial term of the Agreement) based on harbour dues with discount according to the Agreement, 8% interest rate and 20% equity, is estimated by the Icelandic authorities to give an internal rate of return (hereinafter “IRR”) of 15,4% for the Harbour Fund. If there is no discount the IRR on equity becomes 33,3%. If, however, the State funding is added to the investment to be covered, the IRR will become 0% if the discount is granted, but 11,3% if there is no discount.

The Authority considers that it is correct to regard the State participation in the development of the harbour as a contribution to infrastructure. The harbour is obliged to also service other customers than Alcoa, and the State participation of 60% is in accordance with the general Icelandic legislation applicable for all other harbours funded by the State. Furthermore, the Authority finds that the Icelandic authorities have demonstrated, with reference to other Aluminium producers located in Iceland, that the 55% discount in the harbour dues are normal in Iceland for this size of harbour user. Given that the internal rate of return for the Harbour Fund is 15,4% (with the discount), the Authority concludes that the Harbour Agreement does not contain any aid element.

2.5 The Power Contract

The Power Contract is between Landsvirkjun and Alcoa. The contract has been negotiated independently between the parties. The power price is linked to the price for Aluminium on the London Metal Exchange and shall be re-negotiated for the second twenty-year period of the contract.

The Kárahnjúkar hydroelectric project is highly capital intensive with total estimated capital costs of approximately USD 1,088 million (assuming a long term exchange rate of ISK/USD 87,5) incurred over the period up to 2009. The investment costs include the estimated construction cost for connecting the countrywide national grid to the Kárahnjúkar Power Station, which is scheduled for completion in 2006.

The “*Report to the owners of Landsvirkjun: Profitability and financial risk for Landsvirkjun in connection with the Kárahnjúkar project*” presents the findings of a committee appointed by the owners of Landsvirkjun.

The “Discounted Cash Flow” method is used for calculating the rate of return on the project. The future revenues are based on the estimated life of the relevant assets

rather than using the depreciation time for accounting purposes. The discount factor is based on total funding costs, *i.e.* the interest costs and return that the owners request on their equity funding. Taking into account the portion of loans and equity, the weighted average cost of capital (WACC) is calculated for the project. The project must have an internal rate of return (IRR) at least equal or higher than the weighted average cost of capital.

The estimates of the report are based on an aluminium price (at 2002 price levels and exchange rates) of USD 1,564 at the beginning of the energy sales period, falling by 0,45% per year in real terms, based on the producers price index (PPI) in the USA, during the lifetime of the power plant. The calculations of the report are based on the period 2007 to 2080. It is also assumed that the power tariff will be reset after twenty years and again after forty years at the same level.

The calculation of the WACC has been based on a required rate of return on equity investment of 11% per annum (nominal), a ratio of 25% equity and 75% loan capital and a debt cost of 5,5% per annum (nominal). A weighting of the 75/25 debt/equity has been assumed giving a WACC of 6,9% per annum (nominal).

Based on the above-mentioned assumptions the assessment in the report shows that the Kárahnjúkar power project yields a real rate of return (IRR) of 5,5% per annum over the assumed 63 year project period, a 12,8% nominal equity return (ROE) and a 11 % real equity return. This is 0,5 % in excess of Landsvirkjun's WACC of 5,0% per annum (real) and the ROE is 1,8 percentage point above the required ROE.

The submitted report also contains sensitivity analysis on the impact of changes in the major assumptions on the total profitability (IRR), return of equity (ROE) and the net present value of cash flows.

According to the Icelandic authorities, the required rate of equity return (ROE) of 11% per annum (nominal) used in the report is currently in excess of the returns typically required by international investors using capital pricing models reflecting current risk free rates, equity risk premium and stock betas for companies in the electricity and aluminium sectors. As an example Statkraft in Norway is using 11% as a target for equity returns whilst having an average ROE of 7,5% in the years from 1998-2001. The return of equity for Vattenfall in Sweden was 11,2% in 2001 and the company's average ROE was 9,5% in the years from 1998-2001. The return of equity of EDF in France was 6,2% in 2001. The average ROE for EDF in the years from 1998-2001 was 8,6%.

Based on the above documentation and argumentation from the Icelandic authorities, the Authority is of the view that the Power Contract does not contain any State aid elements.

3. Compatibility of the aid.

- Investment aid or operating aid?

In Chapter 17B, Application of State aid rules to measures relating to direct business taxation, paragraph 17B.4.(3) and (4) of the State Aid Guidelines, it is stated:

(3) Where a fiscal aid is granted in order to provide an incentive for firms to embark on certain specific projects (investment in particular) and where its intensity is limited with respect to the costs of carrying out the project, it is no different from a subsidy and may be accorded the same treatment. Nevertheless, such arrangements must lay down sufficiently transparent rules to enable the benefit conferred to be quantified.

(4) In most cases, however, tax relief provisions are general in nature: they are not linked to the carrying-out of specific projects and reduce a firm's current expenditure without it being possible to assess the precise volume involved when the Authority carries out its ex ante examination. Such measures constitute 'operating aid'. Operating aid is in principle prohibited. The Authority authorises it at present only in exceptional cases and subject to certain conditions, for example in shipbuilding, certain types of environmental protection aid¹ and in regions covered by the Article 61(3)(a) aid derogation provided that they are duly justified and their level is proportional to the handicaps they are intended to offset². It must in principle (with the exception of the two categories of aid mentioned below) be degressive and limited in time. At present, operating aid can also be authorised in the form of transport aid in certain Nordic regions that are sparsely populated and are seriously handicapped in terms of accessibility. Operating aid may not be authorised where it represents aid for exports between Contracting Parties. As for State aid in favour of the maritime transport sector the specific rules for that sector apply.”

Furthermore, in Annex X, Net Grant Equivalent of Investment Aid, footnote 2, of the State Aid Guidelines, it is stated:

“Tax aid may be considered to be aid connected with an investment where it is based on an amount invested in the region. In addition, any tax aid may be connected with an investment if one sets a ceiling expressed as a percentage of the amount invested in the region. Where the grant of tax aid is spread over several years, any balance remaining at the end of a given year may be carried over to the following year and increased in accordance with the reference rate.”

The Authority consequently considers that, for the aid in question to be characterised as investment aid, it must be linked to the carrying-out of specific project(s), it must be based on an amount invested in the region, it must be possible to quantify the aid (assess the precise volume), and there must be a ceiling expressed as a percentage of the amount invested in the region.

In the present case, the aid is clearly linked to the carrying-out of a specific project (the Aluminium smelter) and an amount (1,143 million USD) invested in the region. The Icelandic authorities have also committed themselves to limit the aid to 49,9 million Euro, calculated in Net Present Value Terms.

The aid amount and the aid intensity are based on a comparison (in Net Present Value terms) of the current applicable Icelandic tax rules on the one hand, and the conditions applicable to Alcoa under the negotiated agreements on the other hand. If the current applicable tax rules are changed during the contract period, the aid amount (volume) and the aid intensity will thus also change. Given that the tax rules can change (in both directions), it is not possible to assess with certainty the precise volume of the aid ex ante, only ex post. However, the Icelandic authorities have committed themselves to limit the aid to maximum 49,9 million Euro.

The Authority consequently considers that the aid qualifies as investment aid.

- Eligibility for regional aid

In the notification dated 19 December 2002 (Doc.No.02-9218A), the Icelandic authorities stated that the objective of the measures is *inter alia* to strengthen economic activities in the eastern part of Iceland in a sustainable context.

The plant site is located in the Township of Fjarðabyggð, in the eastern part of Iceland. On 8 August 2001 the Authority approved a proposal from the Icelandic authorities on the system of regional aid in Iceland (Dec. No. 253/01/COL). The new map of assisted areas has been authorised until the end of 2006. According to the map of assisted areas in Iceland, the Township of Fjarðabyggð qualifies for regional aid up to a limit of 17% of eligible investment costs, expressed in net terms.

- Eligible costs and aid intensity

The notified eligible initial investment costs, as described in point I 2.1 above, amounts to USD 1,143 million. Chapter 25.4.(6) of the State Aid Guidelines states that: *"Initial investment means an investment in fixed capital relating to the setting-up of a new establishment, the extension of an existing establishment, or the starting-up of an activity involving a fundamental change in the product or production process of an existing establishment (through rationalisation, diversification or modernisation)⁹."*

Chapter 25.4.(8) of the State Aid Guidelines states that: *"Aid for initial investment is calculated as a percentage of the investment's value. This value is established on the basis of a uniform set of items of expenditure (standard base) corresponding to the following elements of the investment: land, buildings and plant/machinery."*

The Authority accepts that the total investment costs of USD 1,143 million can be considered as falling within the notion of *"initial investments"* for the purpose of calculating the aid intensity. Total costs eligible for regional investment aid are therefore USD 1,143 million.

The Icelandic authorities have performed calculations of estimated tax payments during the 40-year period of the Investment Agreement under the standard tax regime on the one hand and the Investment Agreement on the other hand¹⁰. The result of these calculations is that the present value of total tax payments under the Investment

⁹ Replacement investment is thus excluded from the concept. Aid for this type of investment falls within the category of operating aid. Also excluded from this concept is aid for the financial restructuring of a firm in difficulty within the meaning of the Guidelines on State aid for rescuing and restructuring firms in difficulty. Restructuring aid within the meaning of the said Guidelines may be granted, in so far as it relates to investment measures (rationalisation, modernisation, diversification), without needing separate notification, under a scheme of regional aid. However, since such regional aid is part of proposed aid for the restructuring of a firm in difficulty, it must be taken into account in the examination carried out under the said Guidelines.

¹⁰ The calculations are based on a model of profitability analysis developed by Professor Páll Jensson for the Invest in Iceland Agency (IIA) and described in Annex 8 to the notification dated 19 December 2002. The model is in Excel and has been used for more than 15 years to evaluate power intensive industry projects in Iceland.

Agreement is USD 66.9 million compared to USD 91.3 million under the standard tax rules over 40 years with 7,49% discounting and an aluminium price 1,550 USD/ton. This implies an aid element of USD 34.3 million.

The reference rate of interest of 7,49% used in the calculation is based upon the rules laid down in chapter 33.2 of the State Aid Guidelines. The indicative rate is defined as the level of the rate of yield on five-year State bonds plus a premium of 25 basis points. The reference rate is deemed to be equal to the average of the indicative rates recorded in the preceding months of September, October and November 2002. According to information from the Central Bank of Iceland the reference rate of interest according to these rules is 7,49%.

The Icelandic authorities have also made calculations assuming prices of aluminium ranging from USD 1,350 to USD 1,750 per tonne. However, these variations do not lead to significant deviations in the present value of tax payments under the two alternative tax regimes. The calculations were based on the taxes and duties described in point I 2.2 above. Together the aid elements identified are estimated to correspond to a grant equivalent of USD 34.3 million (based on a time horizon of 40 years). The estimated aid intensity is therefore 3.00%. This is well below the admissible ceiling of 17% NGE laid down in the existing map of assisted areas for Iceland.

- Balance between the distortion of competition and the advantages for the development of the region

In chapter 25.2.(2) and (3) of the State Aid Guidelines it is stated:

“(2) 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 region¹¹ 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)¹².

(3) 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 effect on regional development are likely to be too limited. Such aid generally comes within the ambit of specific or sectoral industrial policies and is often not in keeping with the spirit of regional aid policy as such¹³. The latter must remain neutral towards the allocation of productive resources between the various economic sectors and activities. The EFTA Surveillance Authority considers that, unless it can be

¹¹ See in this respect the judgment of the European Court of Justice in Case 730/79 *Philip Morris* [1980] ECR 2671, at paragraph 17 and in Case C-169/95 *Spain v Commission* [1997] ECR I-135, at paragraph 20.

¹² See in this respect the judgment of the European Court of First Instance in T-380/94 *AIUFFASS and AKT* [1996] ECR II-2169, at paragraph 54.

¹³ As a result, under the WTO Agreement on subsidies and countervailing measures, this type of aid has been expressly excluded from the category of non-actionable regional aid (authorised without scrutiny).

shown otherwise, such aid does not fulfil the requirements set out in the preceding paragraph¹⁴."

The Icelandic authorities have submitted comprehensive information on the socio-economic impact of the construction and running of the aluminium plant, see point I.2.8 above.

The Authority considers that it is beyond doubt that in terms of employment and income generation, the project will make a very significant contribution to economic development in the East Region, which in recent years has been characterised by unemployment above the national average and by depopulation. When the factory reaches full output, Alcoa will directly employ approximately 455 persons. Further jobs are expected to be created in the area in dependent businesses.

At present, it is anticipated that the smelter production of primary aluminium from Iceland will be shipped to Europe, where Alcoa has numerous aluminium fabricating facilities. However, depending on demand, the plant is also positioned to service the North American market.

The worldwide production capacity for aluminium is approximately 25 million metric tonnes. The production capacity for the plant in Fjarðabyggð in Iceland is 322,000 metric tonnes.

In 2001 and 2002, the aluminium market, like most world markets, contracted and demand decreased. Market recovery is expected to begin in 2003 and to continue as the world economy recovers. According to various external sources, aluminium demand is projected to increase at rates ranging from 1 ½ to 3% per annum. Therefore, by the time the plant becomes fully operational in 2007, it is anticipated that there will be sufficient demand to absorb the production from the plant.

The production capacity for aluminium in Europe is approximately 4.5 million metric tonnes, excluding production from the former Soviet Union. Demand in the EU is estimated to be approximately 6 million metric tonnes. As mentioned above, the production capacity for the plant in Iceland is 322,000 metric tonnes; this production should help balance supply and demand in Europe. As also mentioned above, depending on regional demand for metal, the plant may also ship some of its production to North America.

The Authority considers that the Icelandic authorities have demonstrated that, as a consequence of the aid, potential distortions of competition are limited while the positive regional effects of the project are significant.

4. Commitment from the Icelandic authorities.

The Icelandic authorities have submitted a commitment concerning a ceiling of 49.9 million Euros for the total aid related to the project¹⁵. The Authority understands the commitment to mean that under no circumstances will the total aid for the whole project, as notified to the Authority, exceed a total value of 49.9 million Euros expressed in 2003 prices, covering the entire contract period of 40 years, discounted to Net Present Value as of 2003 with a discount factor of 7.49%.

¹⁴ Ad hoc aid for firms in difficulty is governed by specific rules and is not conceived of as regional aid as such.

¹⁵ See point I.5 above.

5. Conclusion

In view of the above facts and considerations, the Authority concludes that the aid elements contained in the agreements examined above qualify for exemption under Article 61(3)(c) of the EEA Agreement, as aid facilitating the development of certain economic areas in Iceland without adversely affecting EEA trading conditions to an extent contrary to the common interest.

HAS ADOPTED THIS DECISION:

1. The EFTA Surveillance Authority has decided not to raise objections to the financing and tax arrangements provided for by the Icelandic authorities in favour of the investment project by Alcoa and its subsidiaries for the construction and operation of an aluminium smelter at Reyðarfjörður in the Township of Fjarðabyggð, as notified by the Icelandic authorities by letters dated 19 December 2002 (Doc. No. 02-9218A), 20 January 2003 (Doc. No. 03-331A), 8 February 2003 (Doc. No. 03-956A), 21 February 2003 (Doc. No. 03-1044A), 5 March 2003 (Doc. No. 03-1365A), 12 March 2003 (Doc. No. 03-1508A) and 13 March 2003 (Doc.No.03-1533A).
2. The Icelandic authorities are requested to submit simplified annual reports regarding the implementation of the aid. Failure to comply with this obligation may oblige the EFTA Surveillance Authority to initiate proceedings under Article 1(2) in Part I of Protocol 3 to the Surveillance and Court Agreement.
3. This Decision is addressed to Iceland.

Done at Brussels, 14 March 2003,

For the EFTA Surveillance Authority

Einar M. Bull
President

Hannes Hafstein
College Member