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# EFTA SURVEILLANCE AUTHORITY

Doc. No: 02-3665-I  
Ref. No: SAM 090.300.005  
Dec. No: 83/02/COL

## EFTA SURVEILLANCE AUTHORITY DECISION of 24 May 2002

regarding compensation granted to Air Iceland (“*Flugfélag Íslands*”) for the temporary operation of air transport services on the route between Reykjavik and Höfn í Hornafirði (ICELAND)

THE EFTA SURVEILLANCE AUTHORITY,

HAVING REGARD TO the Agreement on the European Economic Area<sup>1</sup>, in particular to Articles 59 (2) and 61 to 63 thereof,

HAVING REGARD TO the Act referred to at point 64 a. of Annex XIII to the EEA Agreement (Council Regulation (EEC) No 2408/92 of 23 July 1992 on access for Community air carriers to intra-Community routes)<sup>2</sup>,

HAVING REGARD TO the Agreement between the EFTA States on the establishment of a Surveillance Authority and a Court of Justice<sup>3</sup>, in particular Article 24 and Article 1 of Protocol 3 thereof,

HAVING REGARD TO the Procedural and Substantive Rules in the Field of State Aid<sup>4</sup>, and in particular Chapter 30<sup>5</sup> thereof,

WHEREAS:

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<sup>1</sup> Hereinafter referred to as the ‘EEA Agreement’.

<sup>2</sup> Hereinafter referred to as ‘Regulation No 2408/92’.

<sup>3</sup> Hereinafter referred to as the ‘Surveillance and Court Agreement’.

<sup>4</sup> Guidelines on the application and interpretation of Articles 61 and 62 of the EEA Agreement and Article 1 of Protocol 3 to the Surveillance and Court Agreement, adopted and issued by the EFTA Surveillance Authority on 19 January 1994, published in OJ 1994 L 231, EEA Supplements 03.09.94 No. 32, last amended by the Authority’s Decisions No. 368/01/COL to 370/01/COL of 28 November 2001, not yet published.

<sup>5</sup> Pursuant to Chapter 30 of the Authority’s State Aid Guidelines, the EC Commission’s communication on the Application of Articles 92 and 93 of the EC Treaty and Article 61 of the EEA Agreement to State aids in the aviation sector will be applied by the Authority when assessing aid to the aviation sector; hereinafter referred to as the ‘Aviation Guidelines’.

## I. FACTS

### Procedure

Following information available on the internet regarding the continued operation of air transport services on the route between Reykjavik and Höfn í Hornafirði (hereinafter referred to as 'Höfn') v.v., the EFTA Surveillance Authority (Persons, Services and Capital Movements Directorate) invited the Icelandic authorities, by letter dated 29 October 2001 (Doc. No. 01-8558-D, Ref. No. SEA 132.300.022), to inform the Authority about the measures they intended to take in connection with the continued operations of the air route Reykjavik-Höfn. In that letter, the Authority also drew the Icelandic Government's attention to the fact that any measures involving compensation for the operation of air transport services granted by the Icelandic State to an air carrier which had not been selected under the tender procedure as laid down in Article 4 of Regulation No 2408/92, needed to be formally notified to the Authority, pursuant to Article 1 (3) of Protocol 3 to the Surveillance and Court Agreement.

By letter from the Ministry of Finance dated 3 December 2001, received on 4 December 2001 (Doc. No. 01-9776-A), the Icelandic Government submitted a notification of a draft temporary contract on scheduled flights on the route Reykjavik-Höfn. In this letter, which was registered by the Authority as a State aid case (SAM 090.300.005), the Authority was informed that the draft contract was expected to be signed within the next few days and that the Ministry would notify the final contract after the contract had been signed.

By letter dated 5 December 2001 (Doc. No. 01-9677-D), the Authority (Competition and State Aid Directorate) acknowledged receipt of that letter and reminded the Icelandic Government to submit a proper notification and requested additional information (as identified in an annex to the letter). The Authority further pointed out that, pursuant to Article 1 (3) of Protocol 3 to the Surveillance and Court Agreement, aid shall be notified in advance and shall not be put into effect before the Authority has given its approval. Given that the Icelandic authorities had announced that the contract would be signed within the next few days, the Authority also asked the Icelandic Government to confirm in writing before 7 December 2001 that no payments would be made under the contract awarded to the selected air carrier until the Authority had finalised its assessment.

By letter from the Ministry of Finance dated 7 December 2001, received by fax and registered by the Authority on that same day (Doc. No. 01-9958-A), the Icelandic Government informed the Authority that no contract had been signed yet (the draft contract, covering at that stage both scheduled passenger flights and medical emergency flights, was still under preparation) and confirmed that no payments would be made under the contract pending the outcome of the investigation. Furthermore, the Icelandic Government provided part of the information requested by the Authority's letter of 5 December 2001.

By letter from the Ministry of Finance dated 19 December 2001, received by fax and registered by the Authority on that same day (Doc. No. 01-10331-A), the Icelandic Government announced that, as regards the future contracts for combined regular

passenger and ambulance transport services, a tender as required under Regulation No 2408/92 would be carried out.

By letter from the Ministry of Finance dated 20 December 2001, received by fax and registered by the Authority on 21 December 2001 (Doc. No. 01-10394-A), the Icelandic Government provided the Authority with the draft contract (in English) and further information.

This information was completed by letter from the Ministry of Finance dated 21 January 2002, received by fax and registered by the Authority on that same day (Doc. No. 02-536-A). By letter dated 27 February 2002, received and registered by the Authority on 1 March 2002 (Doc. No. 02-1561-A), the Icelandic Government submitted the documents regarding the imposition of public service obligations and the tender, as required under Article 4 of Regulation No 2408/92 (in Icelandic). Following further discussions between the Authority and the Icelandic Government, the final documents for publication were submitted to the Authority on 16 April 2002, received by e-mail and registered by the Authority on that same day (Doc. No. 02-2799-A).

By further letter from the Ministry of Finance dated 30 April 2002, received and registered by the Authority on that same day (Doc. No. 02-3270-A), the Icelandic Government submitted the final contract with the flight operator Air Iceland, which covered only regular passenger transport services.

### **Description of the aid measure**

According to the Icelandic authorities, Air Iceland had decided in August 2001 to cancel its scheduled air services between Reykjavik and Höfn v.v. as from 1 October 2001, considering that air transport services on that route were no longer commercially viable. However, Air Iceland continued services on that route after 1 October 2001 due to long lasting commitments to its customers.

Following these events, the Icelandic Government decided in October 2001 to maintain this route because of the high importance of air services on that route for the local population and the development of the region of Southeast Iceland. According to a new national transport plan for Iceland, travelling time between any village in the country to Reykjavik should never exceed 3 ½ hours. This goal could not be achieved without regular air services between Reykjavik and Höfn.

The airport at Höfn serves an isolated peripheral region, included in the map of assisted areas, as approved by the Authority<sup>6</sup>. The distance between Reykjavik and Höfn is 460 km. The travel time by car is, according to the Icelandic authorities, at least 5 hours. During the winter season, the road to Höfn is often difficult to access due to extremely harsh weather conditions. No regular transportation is available by sea. The nearest airport located close to Höfn is Egilsstaðir, some 250 km away from Höfn; by car, the journey takes at least 3 hours. With air transport services in place, travel time is reduced to 55 minutes.

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<sup>6</sup> Decision of 8 August 2001 on the map of assisted areas and levels of aid in Iceland, Dec. No. 253/01/COL.

The Icelandic authorities pointed out that, apart from Air Iceland, no other air carrier in Iceland had the means and the necessary equipment to operate on this route (the air carriers had to use an aircraft with at least 19 seats, equipped with an air pressurised cabin with turboprops). According to the Icelandic authorities, there was no other air carrier which could have taken over the operation of the route on such short notice. Therefore, the Icelandic authorities started negotiations directly with Air Iceland. Even though the decision to award the contract to Air Iceland was taken, the Icelandic authorities confirmed that the contract would only be signed and payments made after the Authority had given approval.

According to the terms and conditions of the final contract between the Public Roads Administration and Air Iceland, the latter is obliged to provide regular passenger flights on the route between Reykjavik and Höfn with at least 7 to 9 round trips per week. The contract further specifies the timetable and tariffs (in particular social discounts). Compensation for each round trip was finally fixed at ISK 70 000 (approximately 840 €), compared to ISK 84 000 in the draft contract (approximately 1000 €). The maximum amount of compensation was fixed at ISK 31.5 million (approximately 380 000 €) for the entire contract period (12 months). This amount would be adjusted should the contract be terminated before 30 September 2002 (such a termination could occur in the event that a new carrier is chosen according to formal tender procedure or in the event that another operator shows interest in serving this route commercially).

According to the Icelandic authorities, the contract price as determined in the draft contract is based on cost accounting figures for this route from the current flight operator. These figures were based on the operating cost incurred on the route in question, and reviewed by the Icelandic authorities. According to the Icelandic authorities, the service level required under the current contract was similar to the service level previously offered by the operator. Furthermore, the Icelandic authorities have stressed that the amount granted to the air carrier would not include any return on capital employed. This is in line with the Icelandic authorities' aim to compensate only for operating losses and not to provide the air carrier with any financial gain. Even though the Icelandic authorities finally decided to prolong the duration of the contract from 10 months to 12 months, the amount of compensation granted remained the same.

Payments are made once every month in arrears. Apart from this compensation, there will be no additional State payment in case the deficit incurred by the air carrier is bigger than expected. On the other hand, the air carrier is not obliged to repay compensation received in case the revenues are higher than expected. The financial compensation to be granted under the 'interim contract' has been approved in the extra budget bill for 2001 as well as the budget proposal for 2002 (State Budget, para. 10-211, point 1.13.).

The contract period is limited to 12 months (from 1 October 2001 – as opposed to 1 December 2001 in the draft contract - until 30 September 2002). The contract may be terminated by the Icelandic authorities if a new carrier has been selected according to the formal tender procedure under Regulation No 2408/92 or if another operator shows an interest in serving the route commercially.

According to the Icelandic authorities, the company will not enjoy exclusive rights on the route concerned.

Initially, the Icelandic authorities had taken the view that regular passenger transport services could be tendered out according to the public procurement rules if offered in combination with ambulance services, without necessarily complying with the tender procedure as required under Regulation No 2408/92. However, after further consultations between the Icelandic authorities and the Authority, the Icelandic Government agreed to carry out a formal tender procedure as required under Regulation No 2408/92. This tender will cover only regular passenger transport services, contrary to the Icelandic authorities' initial intention to cover both regular transport services and ambulance services.

After consultation with the Authority, the Icelandic Government finalised the tender documents. According to the tender documents, the new air carrier is supposed to start operation on this route on 1 November 2002 until 31 December 2003.

## **II. APPRECIATION**

### **Introductory remarks**

It should be recalled that, with the adoption of Regulation No 2408/92, a new legal framework was established providing that air carriers holding a licence would generally enjoy free access to all intra-Community routes. However, the Regulation allows free market access to be restricted for public policy reasons, such as the maintenance of air services on certain routes which would not, otherwise, be served by operators on purely commercial grounds.

As regards the maintenance of transport services in the public interest, Regulation No 2408/92 lays down more detailed rules governing the imposition of public service obligations, the selection of air carriers on such routes, as well as reimbursement of costs stemming from the public service obligations imposed on air carriers (cf. Article 4 of Regulation No 2408/92).

It follows from the above that EC Member States and EFTA States are allowed to adopt measures with a view to ensuring air transport services on routes in the public interest, including compensation for the provision of such air services, provided these measures are in compliance with the pertinent provisions in Regulation No 2408/92.

### **Reimbursement of air carriers pursuant to Regulation No 2408/92**

According to Article 4 (1) (a) of the Regulation, EFTA States “...*may impose a public service obligation in respect of scheduled air services to an airport serving a peripheral or development region in its territory or on a thin route to any regional airport in its territory, any such route being considered vital for the economic development of the region in which the airport is located, to the extent necessary to ensure on that route the adequate provision of scheduled air services satisfying fixed standards of continuity, regularity, capacity and pricing, which standards air carriers would not assume if they were solely considering their commercial interest. The EFTA Surveillance Authority*

*shall publish the existence of this public service obligation in the Official Journal of the European Communities.”*

Article 4 (1) (d) of the Regulation allows EFTA States to limit access to routes, if no carrier has commenced or is about to commence scheduled air services on that route in accordance with the public service obligation which has been imposed on that route. This provision further stipulates that “[t]he right to operate such services shall be offered by public tender either singly or for a group of such routes to any...air carrier entitled to operate such air services. The invitation to tender shall be published in the Official Journal of the European Communities and the deadline for submission of tenders shall not be earlier than one month after the day of publication. The submissions made by air carriers shall forthwith be communicated to the other EEA States concerned and to the EFTA Surveillance Authority.” It further follows from Article 4 (1) (g) of the Regulation that “...a period of two months shall elapse after the deadline for submission of tenders before any selection is made, in order to permit other Member States to submit comments.”

The selection among the submissions shall be made in accordance with the criteria enumerated in Article 4 (1) (f) of the Regulation.

Finally, Article 4 (1) (h) allows EFTA States to “...reimburse an air carrier, which has been selected under subparagraph (f), for satisfying standards required by a public service obligation imposed under this paragraph. Such reimbursement shall take into account the costs and revenue generated by the service.”

The Icelandic Government proposed to award the contract for the provision of air services on the route between Reykjavik and Höfn to Air Iceland. The selection of this company took place without having invited other potentially interested air carriers. It is apparent from the information submitted to the Authority that the Icelandic authorities have not followed the procedural requirements laid down in Regulation No 2408/92, in particular in Article 4 (1) (d) and (g), as regards publication of the call for tender and deadlines.

However, the Authority acknowledges that the provision of air services in the general interest may be obstructed by full compliance with the requirements under Regulation 2408/92 where, due to circumstances beyond the State’s control, a route considered as being in the general interest would not be served or would have to be interrupted until an air carrier was selected under the procedure laid down in Regulation 2408/92.

Information submitted by the Icelandic authorities shows that, when the incumbent operator publicly announced its decision to terminate air transport services on the route between Reykjavik and Höfn as from 1 October 2001, the remaining time was too short for the Icelandic authorities to follow the procedures as laid down in Regulation No 2408/92 and at the same time ensure the re-establishment of air services on that route as quickly as possible. The incumbent operator’s announcement of its intention to stop services had immediate effects, in particular since the incumbent operator could not be obliged to continue services until a new carrier had been selected. Given the lack of interest from air carriers in running this service on a commercial basis, it is obvious that, without immediate action from the part of the authorities, air transport services on this route would have been interrupted and passengers deprived of an air service until a new

carrier had been selected under the normal tender procedure. This would have implied that the route would have been without air services for at least 8/9 months. Recourse to the award of a contract without carrying out a formal tender procedure was, therefore, and for reasons beyond the Icelandic Government's control, unavoidable in order to limit the interruption of air services on that route to a minimum.

Under these circumstances, the Authority was satisfied that the Icelandic authorities found themselves in an emergency situation, in which full compliance with the tender procedure as laid down in Regulation No 2408/92 might have obstructed the provision of air services on the route and in which Article 4 of the Regulation had not been applied. As a consequence, the compensation to be granted to Air Iceland is not covered by Article 4 (1)(h) of Regulation No 2408/92.

In such a situation, the Authority will examine whether compensation to an air carrier for the provision of air services on a public service route may be regarded as compatible with the basic provisions of the EEA Agreement, in particular Article 61 (1) and 59 (2) thereof.

### **State aid within the meaning of Article 61(1) of the EEA Agreement and procedural requirements pursuant to Article 1 (3) of Protocol 3 to the Surveillance and Court Agreement**

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

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

In addition, it follows from the Aviation Guidelines that, where an EFTA State selects an air carrier and awards compensation without following the rules laid down in Regulation No 2408/92, there is a presumption of aid within the meaning of Article 61 (1) of the EEA Agreement. This aid must be notified to the Authority pursuant to Article 1 (3) of Protocol 3 of the Surveillance and Court Agreement.

The compensation provided for under the contracts to be awarded is covered by the Ministry of Transport and Communications' budget to air carriers (cf. State Budget for 2001 and 2002, para. 10-211, point 1.13). Payments are thus granted by the Icelandic State. As stated above, the Icelandic authorities have not followed the procedural requirements laid down in Article 4 (1) of Regulation No 2408/92 with respect to the contract to be awarded to Air Iceland. Under these circumstances, it cannot be excluded that the compensation payment gives the air carrier a financial benefit that it would not have enjoyed in the normal course of business. The

compensation may thus strengthen the position of the selected air carrier compared with other undertakings competing on the market for air transport services, which was opened to EEA-wide competition pursuant to Regulation No 2408/92, as of 1 July 1994. Consequently, the aid may distort competition and affect trade between the Contracting Parties.<sup>7</sup>

Therefore, the compensation payment to Air Iceland to the amount of max. ISK 31.5 million for the whole contract period as regards the provision of regular passenger transport services constitutes aid within the meaning of Article 61 (1) of the EEA Agreement.

As regards compliance with the obligations laid down in Article 1 (3) of Protocol 3 to the Surveillance and Court Agreement, the Authority observes that the plans to award aid to Air Iceland were notified to the Authority by letter dated 7 December 2001. The Icelandic Government confirmed that the final contract would not be signed before the Authority had given its approval. The Icelandic Government has further promised not to make any payments under the contract pending the outcome of the present investigation. The Authority can therefore conclude that the Icelandic Government has complied with its obligations under Article 1 (3) of Protocol 3 to the Surveillance and Court Agreement.

### **Compatibility of Aid Measures**

According to point 14 of the Aviation Guidelines, “[d]irect aids aimed at covering operating losses are, in general, not compatible with the common market and may not benefit from an exemption. However, the Commission must also take into account the concern of Member States to promote regional links with disadvantaged areas”. In this respect, the Guidelines further specify that “direct operational subsidization of air routes can, in principle, only be accepted in the following two cases: public service obligations... and aid of a social character...”.

Point 18 of the Aviation Guidelines states that “...it is important that the airline which has access to a route on which a public service obligation has been imposed, may be compensated only after being selected by public tender (underlined here)”.

As a rule, compensation for public service obligations on a specific air route must comply with the conditions for public tender laid down in Regulation No 2408/92. However, under certain exceptional circumstances, such as, in the present case, the emergency nature of the situation due to the immediate termination of services by the incumbent operator, the procedural rules regarding the public tender as laid down in Regulation No 2408/92 may not be applied (see above). In such a case, compensation granted to an air carrier, selected without having followed the tender procedure as required under Article 4 of Regulation No 2408/92, may be regarded as compatible with the functioning of the EEA Agreement, pursuant to Article 59 (2) thereof.

Article 59 (2) of the EEA Agreement reads: “Undertakings entrusted with the operation of services of general economic interest...shall be subject to the rules

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<sup>7</sup> See Judgment of the Court of Justice of the European Communities of 17 September 1980, Case 730/39 *Philip Morris Holland BV v Commission*, ECR 1980 p. 2671, para. 11.



*contained in this Agreement, in particular to the rules on competition, in so far as the application of such rules does not obstruct the performance, in law or in fact, of the particular tasks assigned to them. The development of trade must not be affected to such an extent as would be contrary to the interests of the Contracting Parties.”*

Consequently, the Authority has assessed whether:

- The air services on the route in question could be regarded as services in the general economic interest (*public service remit*);
- The air carriers had been entrusted with the provision of air transport services in the general economic interest (*entrustment*);
- Compensation granted under the contracts in question was limited to the amount necessary for the fulfilment of the public service obligation (*necessity of compensation*); and
- The contracts awarded to the selected air carriers would not affect the development of trade to an extent contrary to the interests of the Contracting Parties to the EEA Agreement (*proportionality*).

#### *Public Service Remit*

In principle, EFTA States enjoy wide discretion in determining the level of services in the general interest and may, where necessary, impose public service obligations (PSOs) in order to ensure that service level. However, this freedom may, to a certain extent, be limited by the existence of secondary EEA legislation. In the field of air transport, Regulation No 2408/92 contains more detailed provisions regarding the imposition of PSOs, which will be used as interpretative means for the application of Article 59 (2) of the EEA Agreement.

Pursuant to Article 4 (1) (a) of the Regulation, “*a Member State...may impose a public service obligation in respect of scheduled air services to an airport serving a peripheral or development region in its territory or on a thin route to any regional airport in its territory, any such route being considered vital for the economic development of the region in which the airport is located, to the extent necessary to ensure on that route the adequate provision of scheduled air services satisfying standards air carriers would not assume if they were solely considering their commercial interest*”.

According to Article 4 (1)(b) of the Regulation, “[*t*]he adequacy of scheduled air services shall be assessed by the Member States having regard to:

- (i) *the public interest;*
- (ii) *the possibility, in particular for island regions, of having recourse to other forms of transport and the ability of such forms to meet the transport needs under consideration...”.*

It is worth recalling that it is primarily for the EFTA State who invokes the exemption from the general prohibition of operating aid to demonstrate that the air services in question are services in the general economic interest within the meaning of Article 59 (2) of the EEA Agreement. It must also assess the public service character of the route in question taking into account the criteria laid down in Article 4 of the Regulation No 2408/92.

According to the information submitted by the Icelandic authorities, this route is not served by other air carriers. The air carrier which previously provided air transport services on that route decided to terminate services because it was no longer commercially viable. Furthermore, the Authority is not aware of any other air carrier having shown an interest in serving this route on a commercial basis. It can, therefore, be concluded that air carriers, solely considering their commercial interest, would not provide air services on this route.

Alternative means of public transport consist mainly of transport by road. However, according to the Icelandic authorities, this means of transport is not always available and entails long travel times which are regarded as not being acceptable under the Icelandic regional and transport policy.

The Authority takes note of the information and explanations provided by the Icelandic Government as regards the inadequacy of alternative means of transport. Based on these explanations, the Authority has concluded that the air transport services provided on the route between Reykjavik and Höfn could be considered as services in the general economic interest within the meaning of Article 59 (2) of the EEA Agreement for the purpose of the present State aid proceedings.

#### *Entrustment*

By the contract to be awarded to Air Iceland, which contains obligations in the public interest for which compensation is granted, the air carriers were entrusted by public act with the provision of air transport services on this route<sup>8</sup>.

#### *Necessity and proportionality of the compensation payment*

According to settled case law and practice of the European Commission, the grant of State aid may, under Article 59 (2) of the EEA Agreement be justified ” *provided that the sole purpose of that aid is to offset the additional costs incurred in performing the particular task assigned to the undertaking entrusted with the operation of a service of general economic interest and that the grant of aid is necessary in order for that undertaking to be able to perform its public service obligations under conditions of economic equilibrium* (underlined here)”<sup>9</sup>.

In this respect, it must be observed that without State support no air carrier would be willing to operate this route. Therefore, State compensation is, in principle, to be regarded as necessary.

As regards the proportionality of the amount of the compensation payment, the Authority had to ascertain that the compensation granted to Air Iceland did not exceed the amount required to compensate for public service obligations imposed on the air carrier.

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<sup>8</sup> According to the Judgment of the Court of Justice of 23 October 1997, Case C-159/94 *Commission v. France*, ECR 1997 p. I-5815, para. 65/66, and the recent Commission communication on services of general interest in Europe (COM (2000) 580 final, 20 September 2000, point 22), contracts are also regarded as a public act of entrustment.

<sup>9</sup> Judgment of the Court of First Instance of 27 February 1997, Case T-106/95, *FFSA and others v. Commission*, ECR 1997, II-229, para. 178.

Where an air carrier is not selected according to the procedures laid down in Article 4 of Regulation No 2408/92, there is a risk that the amount required by air carriers will not reflect the minimum price necessary for the provision of the service in question.

However, in the case at issue, the Authority was satisfied that the amount of compensation was based on the operating losses incurred by the carrier previously serving the same route under similar conditions. Furthermore, the Authority took note of the fact that the compensation as calculated by the Icelandic authorities would only cover the operating losses without compensation for capital costs.

In light of these circumstances, the amount of compensation for regular passenger transport services amounting to ISK 70 000 per round trip (or ISK 31.5 million for the entire contract period) can be regarded as necessary and proportionate for the provision of the air services in question.

#### *Proportionality and effect on trade between the Contracting Parties*

As regards the effects of the compensation granted to Air Iceland on the development of trade between the Contracting Parties, the Authority observes that, where the tender formalities as laid down in Article 4 of Regulation No 2408/92 are not followed, there is, in principle, a risk of impeding domestic and, in particular, foreign air carriers from fully benefiting from market access, which these rules intend to achieve.

The resulting negative effect on trade may, under circumstances requiring immediate action from the competent authorities not allowing them to fully comply with the tender requirements laid down in Article 4 of Regulation No 2408/92, be considered as not being “*contrary to the interests of the Contracting Parties*”. This would be to the extent that the conditions under which the contract was awarded, or the terms and conditions of the contract itself did not limit competition and trade on the air transport market more than was necessary and proportionate to guarantee air services on the route in question.

In this respect, the Authority examined in particular whether:

- (1) the contract would be strictly limited to the time necessary to fully comply with the requirements under Regulation No 2408/02 (*temporary nature of the ‘interim contracts’*);
- (2) the contract would not grant exclusive rights; and that
- (3) the conditions under which the contract was awarded respected the general principles of an open, transparent and non-discriminatory procedure (*minimum procedural requirements*).

#### *(1) Temporary nature of the ‘interim contracts’*

The Authority emphasises that any deviations from the tender procedure laid down in Regulation No 2408/92 must be strictly limited in time. This implies that the Icelandic authorities have to undertake, within the shortest possible delay, the necessary steps to ensure operation of this route under the conditions laid down in Article 4 of Regulation No 2408/92.

As has been emphasised by the Authority on previous occasions, where compensation for the operation of air routes is granted under an interim contract, such compensation

may only be approved by the Authority once the documents regarding the new tender have been submitted. It is only then that the Authority knows with certainty if and when a new carrier will operate the route in question according to the requirements laid down in Regulation No 2408/92. It is only then that the Authority has the necessary assurance that the contract will be of a temporary nature strictly limited to the time necessary for the Icelandic authorities to fully comply with Regulation No 2408/92.

The Authority would like to stress that in situations of alleged urgency, requiring the award of an interim contract without following the formal tender procedure as laid down in Regulation 2408/92, the Icelandic Government is expected to initiate the tender procedure as soon as possible and without unnecessary delays (i.e. immediately after having been informed of withdrawal of transport services on a certain route considered to be in the public interest).

Against this background, the Authority regrets that the necessary documents were submitted to the Authority more than half a year after Air Iceland had announced that it would terminate the operation of air transport services on the route in question. The Authority takes note that the Icelandic authorities claimed that a tender procedure according to the public procurement rules would be sufficient regarding the award of contracts for regular passenger transport provided in combination with ambulance services. Furthermore, the Icelandic authorities might not have had the necessary experience to establish tender documents fulfilling the requirements of Regulation 2408/92 in an expeditious way. These circumstances may explain the considerable delay in initiating the tender procedure.

From the State aid point of view, the delay in initiating the formal tender procedure as required under Article 4 of Regulation No 2408/92 could be acceptable provided that it will not result in an unnecessary extension of the duration of the 'interim contract', and with it an unnecessary prolongation of financial compensation. In this respect, the Authority observed that the compensation granted to the air carrier for each round trip was reduced (from initially ISK 84 000 to ISK 70 000), while the contract period was extended (from initially 10 to 12 months). Even though the contract period was extended, the overall amount of compensation granted throughout the contract period remained the same as initially calculated (i.e. ISK 31.5 million). In light of these circumstances, the Authority was satisfied that the delay in initiating the tender procedure (and as a consequence the prolongation of the 'interim contract' from 10 to 12 months) did not result in an increase in the compensation payments.

The provisions of the contract further stipulate that the contract can be terminated prior to 30 September 2002, should another air carrier wish to serve the route on a commercial basis or should another air carrier have been selected under the normal tender procedure. The Icelandic authorities have initiated the tender procedure in order to ensure that the new carrier will start operation of air services on that route on 1 November 2002 and continue until 31 December 2003. The Authority has verified that the date on which the new carrier would start operation on that route was the earliest date possible.

Against this background, the Authority is satisfied that the Icelandic authorities have finally undertaken the necessary steps to comply with the requirements under Regulation No 2408/92 regarding the initiation of a tender procedure concerning the

future operation of air services on that route as from 1 November 2002, and that the interim contract to be awarded to Air Iceland, starting from 1 October 2001 until 30 September 2002, is limited to the time allowing the initiation and conclusion of the formal tender procedure. The Authority accepted this long contract period of the 'interim contract' only due to the difficulties the Icelandic authorities encountered in finalising the relevant documents. Given that according to the final tender documents the new carrier is supposed to start operations only as from 1 November 2002, the Authority emphasises that any prolongation of the 'interim contract' as submitted to the Authority implying compensation payments to the air carrier concerned after 30 September 2002 (i.e. date of expiry of the 'interim contract'), which would exceed ISK 31.5 million, could not be regarded as complying with the criteria established by the Authority in the present and in similar cases, in particular the criterion regarding the limitation in time to what is strictly necessary to comply with the requirements under Regulation 2408/92.

*(2) Non-exclusive rights*

In this respect, the Authority observes that, under the terms of the contract Air Iceland does not enjoy exclusive rights on the route between Reykjavik and Höfn.

*(3) Minimum procedural requirements*

The Authority observes that the Icelandic authorities have not carried out an open, transparent and non-discriminatory procedure before awarding the contract to Air Iceland. The Authority acknowledges however that, based on the information submitted by the Icelandic authorities, no other carrier in Iceland fulfilled the technical requirements for flight operations on that route.

In light of these circumstances, the Authority accepted that the contract was directly negotiated and concluded between the Icelandic authorities and Air Iceland.

In light of all the above considerations, the Authority concluded that the compensation granted to Air Iceland for the temporary operation of air transport services on the route between Reykjavik and Höfn does not affect the development of trade to such an extent as would be contrary to the interests of the Contracting Parties.

***Conclusions***

The Icelandic Government having demonstrated that full compliance with the tender formalities as laid down in Article 4 of Regulation No 2408/92 would have obstructed the provision of air transport services in the public interest, and further having shown that the measures taken in this respect do not go beyond what is necessary for the purpose of ensuring air services until an air carrier is selected under the formal tender procedure, the Authority considers that the compensation granted to Air Iceland for the operation of air services on the route between Reykjavik and Höfn can be regarded as compatible with the functioning of the EEA Agreement, pursuant to Article 59 (2) of the EEA Agreement.

**HAS ADOPTED THIS DECISION:**

The Authority has decided not to raise objections to the compensation of ISK 70 000 per round trip (or max. ISK 31 500 000 for the whole contract period of 12 months) granted to Air Iceland for the operation of regular air transport services on the route between Reykjavik and Höfn from 1 October 2001 until, at the latest, 30 September 2002.

Done at Brussels, 24 May 2002

For the EFTA Surveillance Authority

Einar M. Bull  
President

Bernd Hammermann  
College Member