



**REPORT FOR THE HEARING**  
in Case E-1/03

APPLICATION to the Court pursuant to the second paragraph of Article 31 of the Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice in the case between

**EFTA Surveillance Authority**

and

**The Republic of Iceland**

seeking an order from the EFTA Court that the Republic of Iceland has failed to respect its obligations, arising from Article 36 of the Agreement on the European Economic Area and Article 3(1) of Council Regulation (EEC) No 2408/92 of 23 July 1992 on access for Community air carriers to intra-Community air routes, by maintaining in force the Icelandic Act on Air Transport Infrastructure Budget and Revenues for Aviation Affairs No 31/1987 (*Lög nr. 31 frá 27. mars 1987 um flugmálaáætlun og fjáröflun til framkvæmda í flugmálum*; the “Aviation Infrastructure Act”), according to which flights from Iceland to other EEA States are subject to a higher tax rate (ISK 1250, approximately €15) than that charged for domestic flights and flights to Greenland and the Faroe Islands, (ISK 165 approximately € 2).

## **I Introduction**

1. The case at hand concerns a provision in the Aviation Infrastructure Act whereby the tax charged on passenger flights by the Icelandic State varies substantially depending on whether the flight is domestic or intra-EEA.
2. The application from the EFTA Surveillance Authority is based on one plea in law, namely that the Icelandic legislation that subjects flights from Iceland to other EEA States to a higher tax rate than that charged on domestic flights and flights to Greenland and the Faroe Islands, is in breach of EEA law provisions on the free movement of services.

## II Legal background

### EEA law

3. Article 36 EEA requires the abolition of all restrictions on the provision of services within the EEA in respect of nationals of EC Member States and EFTA States who are established in an EC Member State or an EFTA State other than that of the person for whom the services are intended.

4. Article 38 EEA states that the freedom to provide services in the field of transport shall be governed by the provisions of Chapter 6 of Part III of the Agreement. Article 39 EEA further provides that Articles 30 and 32 to 34, including the provision in Article 33 permitting special treatment of foreign nationals on grounds of public policy, public security or public health, shall also apply to the freedom to provide services.

5. The provisions of Articles 36, 38 and 39 EEA reflect the provisions of Articles 49, 51 (1) and 55 EC (ex Articles 59, 61(1) and 65 EC).

6. Article 7 EEA provides that acts referred to or contained in the Annexes to the Agreement or in decisions of the EEA Joint Committee shall be binding upon the Contracting Parties, and be, or be made, part of their internal legal order.

7. Council Regulation (EEC) No 2408/92 of 23 July 1992 on access for Community air carriers to intra-Community air routes was incorporated into the EEA Agreement by Decision No 7/94 of the EEA Joint Committee and is listed in point 64a of Annex XIII to the EEA Agreement.

8. Regulation 2408/92 constitutes an element of what is known as the third “package” on air transport, which aims to ensure the freedom to provide air transport services and the application of the Community rules in this sector.

9. Article 3(1) of Regulation 2408/92 provides that:

*“Subject to this Regulation, Community air carriers shall be permitted by the Member State(s) concerned to exercise traffic rights on routes within the Community.”*

10. “Traffic rights” are defined in Article 2(f) of Regulation 2408/92 as the right of an air carrier to carry passengers, cargo and/or mail on an air service between two Community airports.

## **The contested national legislation**

11. Article 5(1) of the Aviation Infrastructure Act, reads as follows:<sup>1</sup>

*“A separate airport tax shall be paid in respect of each individual travelling by aircraft from Iceland to other countries.”*

12. Article 6(1) of the Aviation Infrastructure Act, reads as follows:

*“The airport tax shall amount to ISK 1250 for each passenger travelling from Iceland to other countries...”*

13. Article 7(1) of the Aviation Infrastructure Act, reads as follows:

*“Airlines engaged in the transport of passengers within Iceland or to the Faroe Islands or Greenland shall pay a tax amounting to ISK 165 for each passenger travelling on these routes ...”*<sup>2</sup>

## **III Procedure**

### **Pre-litigation procedure**

14. By letter of 28 April 1998, the Authority wrote to Iceland requesting information concerning the Icelandic air passenger tax. The Authority referred to information received from the Commission of the European Communities according to which Icelandic air transport taxes distinguished between domestic services and services to other EEA States. The Authority further stated that the Commission, basing itself on the judgment of the Court of Justice of the European Communities in the maritime transport case *Commission v France*,<sup>3</sup> had initiated infringement procedures against EU Member States that had imposed different rates of air departure tax depending on whether the flight was bound for a domestic airport or an airport of another Member State.

15. In its response of 27 May 1998, the Icelandic Government emphasised that the air departure tax is a very important source of income for the financing of the airport infrastructure in Iceland. It stated that the income is used to finance the construction and operation of domestic airports in Iceland. The Government further stated that the same tax was charged irrespective of the nationality of the carrier, and that the distinction between domestic and international airport tax

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<sup>1</sup> The translation of the Icelandic legislation into English was provided by the Icelandic Authorities to the EFTA Surveillance Authority during the pre-litigation procedure.

<sup>2</sup> Please note that the figures in the translation of the Aviation Infrastructure Act in Annex 5 to the Application are ISK 750 and ISK 100.

<sup>3</sup> Case C-381/93, *Commission of the European Communities v France* [1994] ECR I-5145, at paragraph 21.

was due to the fact that the Icelandic authorities did not want to put too much burden upon domestic air services.

16. In its letter of formal notice to Iceland of 16 December 1998, the Authority concluded that, by maintaining legislation subjecting flights from Iceland to other EEA States to a higher tax rate than domestic flights and flights from Iceland to Greenland and the Faroe Islands,<sup>4</sup> Iceland has failed to comply with its obligations under Article 36(1) EEA and Article 3(1) of Regulation 2408/92.

17. The Icelandic Government replied by letter of 21 May 1998. It argued that the matter at hand involved only taxation, which falls outside the scope of the EEA Agreement. Moreover, the Icelandic Government argued that, for geographical reasons, there is no breach of Article 36 EEA, since domestic and international air transport services in Iceland are not comparable; the longest domestic route being 379 km whereas the shortest international route is 1382 km. The Icelandic Government deduced from this fact that there is no competition between national and international routes, and thus no special advantage conferred on the domestic market. Referring to the decision of the Court of Justice of the European Communities in *Debauve*,<sup>5</sup> and in the absence of any cross-border element in the present case, the Icelandic Government argued that *Commission v France*<sup>6</sup> is not applicable to the present case as the domestic and international sea-routes in that case could easily be in direct competition with each other. The Icelandic Government also argued that Regulation 2408/92 Article 3(1) does not contain any requirements as to collection of taxes, and cannot be interpreted as placing a heavier burden on Member States than it explicitly states.

18. The EFTA Surveillance Authority issued a reasoned opinion to Iceland on 16 September 1999. The Authority maintained its view that the measures at issue were in breach of the EEA Agreement. The reasons given in the letter of formal notice were repeated. The Authority also recalled the discussion by the Court of Justice in *Colmer*<sup>7</sup> regarding the need, in areas that do not fall within the EC Treaty, for Member States to adopt measures consistent with EC law and non-discrimination. Regarding the cross-border element, the Authority contended that an international air route between two EEA States was, by its nature and definition, a cross-border activity, which was adversely affected when it was subject to stricter conditions than those of a domestic air route. It argued that the tax applicable to most cross-border flights is higher than that applied to national flights, and is therefore liable to act mainly to the detriment of foreign service

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<sup>4</sup> The EEA Agreement does not apply to the Faroe Islands and Greenland.

<sup>5</sup> Case 52/79 *Procureur du Roi v Marc J.V.C. Debauve and others* [1980] ECR 833, at paragraph 9.

<sup>6</sup> Case C-381/93 (n 3 above).

<sup>7</sup> Case C-264/96 *Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)*, [1998] ECR I-04695, at paragraph 19.

providers. In support of the existence of a cross-border element, the Authority also contended that liberalisation of air transport would not have been necessary if all relevant elements were already confined within each individual EEA State. The Authority argued that in *Commission v France*,<sup>8</sup> the Court was not concerned with the examination of a competitive relationship between different sea routes, but with the restrictions on the right to exercise the basic freedoms guaranteed by the EC Treaty. Moreover, the Authority pointed out that there is no place for a *de minimis* rule with respect to Article 36 EEA.

19. In a reply of 17 November 1999, the Icelandic Government maintained its view that the measures at issue were in compliance with EEA law. The Government repeated its view expressed in its letter of 21 May 1999 that, contrary to the *Colmer*<sup>9</sup> case, the airport departure tax does not discriminate against EEA citizens or companies on the basis of nationality. It reiterated the lack of a cross-border element by arguing that there is no basis for any kind of comparison between flights within Iceland and international flights.

20. Representatives from the Icelandic Government and the EFTA Surveillance Authority met on 8-9 May 2001 to discuss matters addressed in the reasoned opinion, and the Icelandic Government undertook to examine developments in other European countries and consider whether amendments to its legislation would be warranted. The Icelandic Government informed the Authority by a letter dated 29 June 2001 that a working group had been established to this end, and in a letter dated 19 December 2001 the Icelandic Government informed the Authority of its plan to replace the current air transport tax by a new air transport tax directly linked to the number of kilometres travelled. The Authority replied by a letter dated 22 February 2002 that such a tax did not seem to be in conformity with Article 36 EEA.

21. In a meeting on 29 May 2002, the Authority informed the Icelandic Government that it had decided, on 24 May 2002, to refer the matter to the EFTA Court, and invited the Icelandic Government to indicate, before 20 June 2002, a firm commitment to change the current airport tax system, in order to avoid the matter being brought before the EFTA Court. In a letter dated 19 June 2002, the Icelandic Government responded that the Government would put a bill before the Parliament in October 2002 according to which airport taxes would be the same for domestic and international flights. The Authority then decided to suspend proceedings, and suggested to the Icelandic Government in a letter dated 18 July 2002 that the new airport tax should apply from no later than 1 January 2003. No additional information was received by the EFTA Surveillance Authority from the Icelandic Government regarding the progress of the legislative process.

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<sup>8</sup> Case C-381/93 (n 3 above).

<sup>9</sup> Case C-264/96 (n 7 above).

## **Procedure before the Court**

22. Against the background of these circumstances, the EFTA Surveillance Authority filed the application at issue here, which was registered at the Court on 20 January 2003.

## **IV Forms of order sought by the parties**

23. The EFTA Surveillance Authority claims that the Court should:

(i) *declare that by maintaining in force the Icelandic Act on Air Transport Infrastructure Budget and Revenues for Aviation Affairs 31/1987 (Lög nr. 31 frá 27. mars 1987 um flugmálaáætlun og fjáröflun til framkvæmda í flugmálum), which subjects flights from Iceland to other EEA States to a higher tax rate than that charged for domestic flights and flights to Greenland and the Faroe Islands, the Republic of Iceland has failed to respect its obligations under Article 36 of the Agreement on the European Economic Area and Article 3(1) of Council Regulation (EEC) No 2408/92 of 23 July 1992 on Access for Community air carriers to intra-Community air routes;*

(ii) *order the Republic of Iceland to pay the cost of these proceedings.*

24. The Republic of Iceland claims that the Court should:

(i) *dismiss the application as unfounded;*

(ii) *order the EFTA Surveillance Authority to bear the costs.*

## **V Written observations**

25. Written observations have been received from the parties:

- the EFTA Surveillance Authority represented by Niels Fenger, Director, Legal and Executive Affairs, and Elisabethann Wright, Officer, Legal and Executive Affairs, acting as Agents;
- the Republic of Iceland, represented by Anna Jóhannsdóttir, Legal Officer, Ministry of Foreign Affairs of Iceland, acting as Agent, assisted by Kristín Helga Markúsdóttir, Legal Officer, Ministry of Transport, Ragnheiður Snorradóttir and Ingvi Már Pálsson, Legal Officers, Ministry of Finance.

26. Pursuant to Article 20 of the Statute of the EFTA Court, written observations have been received from:

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- the Commission of the European Communities, represented by John Forman, Legal Adviser, and Mikko Huttonen, Member of its Legal Service.

### **The EFTA Surveillance Authority**

27. In its *application*, the EFTA Surveillance Authority presents the relevant case law of the Court of Justice of the European Communities concerning Article 49 EC (ex Article 59 EC). The Authority submits that those cases are also relevant when applying Article 36 EEA, by virtue of Article 6 EEA.

28. The starting point of the EFTA Surveillance Authority is that a difference in tax of the degree at issue must be disadvantageous to intra-EEA air service providers. In this regard the Authority refers to the comment by the Court of Justice of the European Communities that the amount of airport tax directly and automatically influences the price of a journey.<sup>10</sup>

29. The Authority does not dispute that taxation remains within the control of the EFTA States. However, the EEA States must, nonetheless, exercise that competence consistent with EEA law. They must, therefore, avoid any overt or covert discrimination by reason of nationality.<sup>11</sup>

30. With regard to the existence of a cross-border element, the Court of Justice of the European Communities stated in *Debauve*,<sup>12</sup> that whether or not the elements of a case are confined within a single Member State depends on the findings of fact. Contrary to the Icelandic Government, the Authority contends that the factual situation must lead to the conclusion that the case at hand includes cross-border elements. The very fact that a distinction is made between the rates, at which a single passenger tax is charged, depending on whether the charge is levied on a domestic air route or on an international air route between two EEA States, means that, by its nature and definition, a cross-border activity is at issue.

31. The Authority recalls that it is a fundamental principle of EEA law that discrimination on the grounds of nationality is to be prohibited.

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<sup>10</sup> Case C-70/99 *Commission of the European Communities v Portuguese Republic*, [2001] ECR I-04845, at paragraph 20.

<sup>11</sup> Case E-1/01 *Hörður Einarsson* [2002] EFTA Court Report p 1, at paragraph 17, Case C-279/93 *Finanzamt Köln-Altstadt v Schumacker* [1995] ECR I-225, at paragraph 21, Case C-80/94 *G. H. E. J. Wielockx v Inspecteur der Directe Belastingen* [1995] ECR I-2493, at paragraph 16, Case C-107/94 *Asscher* [1996] ECR I-3089, at paragraph 36, Case C-250/95 *Futura Participations SA and Singer v Administration des contributions* [1997] ECR I-2471, at paragraph 19, Case C-118/96 *Jessica Safir*, [1998] ECR I-1897, at paragraph 21, and Case C-17/00 *Francois De Coster* [2001] ECR I-9445, at paragraph 25.

<sup>12</sup> Case 52/79 (n 5 above), at paragraph 9.

32. The Authority acknowledges that the disputed air passenger tax does not directly discriminate between service providers on grounds of nationality. It argues that Article 36 EEA excludes the application of national provisions that, without objective justification, restrict a service provider from exercising the freedom granted by that Article.<sup>13</sup> Moreover, the Authority argues that Article 49 EC prohibits the application of a national provision that makes the provision of services between Member States more difficult than the provision of services solely within a single Member State.<sup>14 15</sup>

33. The Authority claims that by requiring providers of intra-EEA air services to pay an air passenger tax in excess of seven times higher than the air passenger tax imposed on providers of domestic flights and flights to the Faroe Islands and Greenland, Icelandic law makes the provision of services between Member States more costly and difficult than the provision of domestic flight services.<sup>16</sup>

34. The absence of discrimination directly based on nationality cannot justify national provisions that restrict the fundamental freedom of non-nationals to provide services.<sup>17</sup> The Authority asserts that the general principle governing the freedom to provide services goes beyond the mere prohibition of any direct discrimination on grounds of nationality, and that even in the absence of such discrimination, the air passenger tax is unacceptable if it is not warranted by mandatory public interest requirements, or if the same result can be obtained by less restrictive rules.<sup>18</sup> In support of this argument, the Authority refers to *Sea-Land Service*.<sup>19</sup>

35. It is the view of the Authority that imposing an air passenger tax on international flights that is so much higher than that imposed on domestic flights and those to the Faroe Islands and Greenland, makes the provision of cross-border services, in the form of international flights, more costly than the provision of comparable domestic services. Therefore, in the absence of justification, on compelling grounds of public interest, that the measures enacted

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<sup>13</sup> Case C-381/93 (n 3 above), at paragraph 16.

<sup>14</sup> Case C-447/99 *Commission of the European Communities v Italian Republic* [2001] ECR I-5203, at paragraph 12.

<sup>15</sup> Case C-381/93 (n 3 above), at paragraph 17. See also, Case C-158/96 *Raymond Kohll* 1998 [ECR] I-1931, at paragraph 33, Case C-118/96 (n 11 above), at paragraph 23, Case C-157/99 *Smits and Peerboms* [2001] ECR I-5473, at paragraph 61, Case C-368/98 *Vanbraekel* [2001] ECR I-5363, at paragraph 44, Case C-17/00 (n 11 above), at paragraph 30, Case C-451/99 *Cura Anlagen* [2002] ECR I-3193, at paragraph 30, and Case C-136/00 *Danner* [2002] ECR I-8147, at paragraph 29.

<sup>16</sup> Case C-381/93 (n 3 above), at paragraph 17. See also, Case C-158/96 (n 15 above), at paragraph 33, Case C-118/96 (n 11 above), at paragraph 23, Case C-157/99 (n 15 above), at paragraph 61.

<sup>17</sup> Case C-70/99 (n 10 above).

<sup>18</sup> *Ibid.*

<sup>19</sup> Case C-430/99 *Insepcteur van de Belastingdienst Douane, district Rotterdam v Sea-Land Services Inc. and Nedlloyd Lijnen BV*, [2002] ECR I-5235, at paragraph 32.

are necessary and proportionate, the tax constitutes a breach of the principle of freedom to provide services. According to the Authority, the Icelandic Government has not, to date, provided any grounds of public interest justifying this difference.

36. In *Sea-Land Service*,<sup>20</sup> the Court of Justice of the European Communities repeated its view that Article 59 EC (now Article 49 EC) requires not only the elimination of all discrimination on grounds of nationality against a person providing services, but also the abolition of any restriction, including a charge set by law for the performance of a service connected to a transport service. This requirement pertains even if the charge applies without distinction to national providers of services and to those from other Member States, when the restriction is liable to prohibit or otherwise impede the activities of a provider of services established in another Member State where he lawfully provides similar services.

37. With regard to Regulation 2408/92, the purpose of which is to define the conditions for applying the principle of freedom to provide services in the air transport sector,<sup>21</sup> the Authority refers to the first *Corsica Ferries*<sup>22</sup> case, where the Court of Justice of the European Communities emphasised that rights arising from the freedom to provide transport services became tangible only following the adoption of secondary legislation containing the measures necessary to achieve freedom to provide services in maritime transport between Member States.

38. The Authority submits that the argument of the Icelandic Government that Regulation 2408/92 addresses solely the issue of access to air routes, as opposed to the collection of taxes, must be rejected. In support of this position, the Authority refers to the conclusion of the Court of Justice of the European Communities in *Commission v Italy*<sup>23</sup> that one of the purposes of Regulation No 2408/92 is to define the conditions for applying the principle of the freedom to provide services in the air transport sector.

39. As to the application of that regulation to airport taxes, the Authority argues that the reasoning of the Court of Justice of the European Communities in *Commission v Portugal*<sup>24</sup> is applicable to the case at hand. In that case, the Court of Justice concluded that the application of different rates of transport tax according to whether the journey in question was domestic or intra-Community ran counter to the principle of freedom to provide services, being a restriction on access to routes. The Authority contends that the Icelandic legislation does not

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<sup>20</sup> Case C-430/99 (n 19 above), at paragraph 32.

<sup>21</sup> Case C-447/99 (n 14 above), at paragraph 11.

<sup>22</sup> Case 49/89 *Corsica Ferries France v Direction générale des douanes françaises* [1989] ECR 4441, at paragraph 10.

<sup>23</sup> Case C-447/99 (n 14 above), at paragraphs 11 and 12.

<sup>24</sup> Case C-70/99 (n 10 above), at paragraphs 20-22.

comply with the provisions of Regulation 2408/92 as interpreted in the light of Article 36 EEA, and states in this respect that it makes the provision of services between EEA States more difficult than the provision of services solely within one EEA State.

40. The Authority further cites *Portugal v Commission*,<sup>25</sup> where the Court of Justice of the European Communities found that, though applicable without discrimination, the national legislation at issue secured a special advantage for the domestic market by operating a distinction according to whether the vessels were engaged in internal transport or in intra-Community transport. In support of its finding of a restriction on the freedom to provide services, the Court of Justice of the European Communities further stated that the national legislation also conferred an advantage on carriers who operate more than others on domestic rather than international routes and so leads to dissimilar treatment being applied to equivalent transactions, thereby affecting free competition.

41. In support of its view that the Icelandic air passenger tax at issue is inconsistent with the freedom to provide services, the Authority refers to the recent judgment of the Court of Justice of the European Communities in a case governing the differentiated application of harbour dues for domestic and intra-Community traffic,<sup>26</sup> where the Court of Justice concluded that different harbour dues may be justified only where there are objective differences in the services provided to passengers.

42. The argument by the Icelandic Government that there is no basis for any kind of comparison between domestic and international flights, should, in the view of the EFTA Surveillance Authority, be rejected on the basis that there is no scope for a *de minimis* rule in respect of restriction on the freedom to provide services.<sup>27</sup>

43. Moreover, the Authority asserts that the fact that the longest domestic route is 379 km, while the shortest route between Iceland and any other EEA State<sup>28</sup> is 1382 km, cannot justify a difference in taxes. In support of this allegation, the Authority refers to the opinion of the Court of Justice that distance or geographical location is not, in itself, sufficient to justify a difference in taxes.<sup>29</sup> Such a difference would be permissible only where there existed objective differences in the services provided to passengers by the airports.

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<sup>25</sup> Case C-163/99 *Portuguese Republic v Commission of the European Communities* [2001] ECR I-2613, at paragraph 66.

<sup>26</sup> Case C-435/00 *Geha Naftiliaki EPE and others v NPDD Limeniko Tamio Dodekanisou and Elliniko Dimosio*, [2002] ECR I-10615, at paragraph 28.

<sup>27</sup> Case C-381/93 (n 3 above), Opinion of Advocate General Lenz, at paragraph 46.

<sup>28</sup> It is recalled that the EEA Agreement does not apply to Greenland and the Faroe Islands.

<sup>29</sup> Case C-435/00 (n 26 above), at paragraph 28.

44. In its *reply*, the Authority affirms its position, and stresses that it does not dispute the right, *per se*, of a State to impose a tax on international air passengers that is higher than that levied on domestic passengers, but that it continues to believe that the difference in the rates of air passenger tax in the present case is not justified.

45. The Authority elaborates on four points raised by the Icelandic Government in its statement of defence, namely:

- The claim that the markets are not comparable;
- The claim that there is no restriction on services;
- The arguments concerning costs; and
- Justifications on grounds of public interest.

46. With regard to the claim by the Icelandic Government that the markets are not comparable, the Authority submits that the Court of Justice of the European Communities has not been concerned with the examination of a competitive relationship between different routes, but rather with the restrictions on the right to exercise the basic freedoms guaranteed by the EEA Agreement.

47. The Authority suggests that the comment by the Court of Justice of the European Communities in *Portugal v Commission*<sup>30</sup> that flights from Lisbon to Porto and flights from Lisbon to Madrid are quite comparable, cannot be read to the effect that such comparability is a requirement. Likewise, the reference by the Court of Justice to the “*same number of landings of aircraft of the same type*”<sup>31</sup> was simply a reference to the factual situation of the case.

48. According to the Authority, the Icelandic quote from *Sea-Land*<sup>32</sup> is somewhat selective, and moreover, does not relate to Article 49 EC (ex 59 EC), but rather to the fundamental principle of non-discrimination.

49. The Authority states that the difference in air passenger tax is liable to impede or render less attractive the provision of international air services; and, no proof that a correlation exists between the amount of the international air passenger tax and the cost of the services benefiting international passengers has been forthcoming.

50. The Authority further raises a factual matter, namely the claim by the Icelandic Government that neither of the domestic airlines provides services to other EEA countries. The Authority questions this statement, since it is clear from the Annual Report of Icelandair for 2002 that one of the domestic airlines,

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<sup>30</sup> Case C-163/99 (n 25 above).

<sup>31</sup> Case C-163/99 (n 25 above)

<sup>32</sup> Case C-430/99 (n 19 above).

Air Iceland (Flugfélag Íslands), is a sister company of Icelandair that provides scheduled flights between Iceland and European destinations.

51. Turning to the second issue, namely the Icelandic contention that there is no restriction on the freedom to provide services, the Authority responds that the fact that the level of airport taxes charged by other EEA States is higher or similar to those applicable in Iceland does not, in itself, constitute an adequate justification for the Icelandic air passenger tax at issue. The Authority emphasises that it is not the level of the tax that is at issue; it is rather the difference in the amount levied on domestic and international passengers.

52. The Authority further rejects the argument by the Icelandic Government that in examining restrictions on the freedom to provide services, it is necessary to look at airport taxes more broadly, and that air passenger tax merely constitutes one element. The Authority states that whether other taxes related to air travel constitute a restriction on the freedom to provide services contrary to Article 36 EEA is not the subject of the present action. It is solely the effect of the relative levels of air passenger tax imposed by Iceland that is relevant in the present case.

53. The Authority disputes the relevance of the scheme applicable in the Highlands and Islands of the United Kingdom. The inaction of the Commission with regard to that scheme cannot be interpreted as an endorsement of the British course of action. The Commission's choice not to pursue enforcement does not in any way dictate over the Authority. Moreover, it is settled case law that an EC State may not rely on the fact that other States have failed to perform their obligations in order to justify its own failure to fulfil its obligations under the EC Treaty<sup>33</sup> and this principle should also apply to the EFTA States under the EEA Agreement.

54. The Authority then turns to the third issue, namely the argument by the Icelandic Government that airport facilities required for international routes are more costly than those for domestic routes. The Authority admits that a difference in the type of service provided to domestic and to intra-EEA passengers may, as a matter of principle, justify a difference in the air passenger tax. However, the Authority contests that being so in the present case, since the available facts of the case do not fulfil the requirements set out in the case law. The Authority emphasises that the Icelandic Government has not thus far argued that the difference in the rates of air passenger tax is intended to compensate for the costs of providing the services and facilities required for international flights.

55. The Authority refers to *Sea Land Services*, according to which the mere imposition of a tax is a hindrance to the freedom to provide services. While such

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<sup>33</sup> Case C-163/99 (n 25 above), at paragraph 22, Case C-146/89 *Commission of the European Communities v The United Kingdom of Great Britain and Northern Ireland*, [1991] ECR I-3533, at paragraph 47, and Case C-38/89 *Ministère Public v Guy Blanguernon* [1990] ECR I-0083, at paragraph 7.

a tax can be justified on the basis that it enables the State to cover the costs of providing the service to the persons subject to the particular tax, the principle of proportionality requires that there be a genuine connection between the costs connected to providing the service and the amount of the tax.<sup>34</sup>

56. The Authority further states that where a tax differentiates between domestic and cross-border services, that difference in itself constitutes a restriction on the freedom to provide services.<sup>35</sup> It follows from the case law of the Court of Justice of the European Communities that it is then up to the State in question to demonstrate that the difference between the services provided to passengers on intra-EEA flights and those provided to passengers travelling between two airports within that State constitutes a compelling reason of public interest.<sup>36</sup> In that respect, economic aims do not constitute public policy grounds justifying different treatment of domestic and intra-EEA services.<sup>37</sup>

57. The Authority admits that a difference in taxation between domestic and intra-EEA flights can be justified where the purpose and effect of the difference is to reflect the differing costs related to providing different services. However, the State concerned must prove that the difference in taxation is both necessary and proportionate.<sup>38</sup> The principle of proportionality requires that there be a genuine connection between the costs connected to providing the service and the amount of the tax.<sup>39</sup> If the amount levied includes cost factors chargeable to categories of persons or undertakings other than those subject to the particular tax this constitutes a breach of Article 36 EEA.<sup>40</sup> Moreover, as argued by Advocate General Alber, the State must actually show that the “*the rates of the passenger service tax ... [are] ...in fact proportionate to the expenditure necessary in each case*”.<sup>41</sup> In other words, the difference in taxation must be demonstrated to correspond to an *associated* difference in costs connected with the provision of the service for which the tax is levied.<sup>42</sup> Moreover, the level of a

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<sup>34</sup> Case C-430/99, (n 19 above), at paragraph 41-42.

<sup>35</sup> Case C-381/93 (n 3 above), at paragraph 17. See also, Case C-158/96 (n 15 above), at paragraph 33, Case C-118/96 (n 11 above), at paragraph 23, Case C-157/99 (n 15 above), at paragraph 61, Case C-368/98 (n 15 above), at paragraph 44, Case C-17/00 (n 11 above), at paragraph 30, Case C-451/99 (n 15 above), at paragraph 30, Case C-136/00 (n 15 above), at paragraph 29, Case C-447/99 (n 14 above), at paragraphs 11 and 12, and Case C-163/99 (n 25 above), at paragraph 66.

<sup>36</sup> Case C-70/99 (n 10 above), at paragraph 30.

<sup>37</sup> Advocate General Alber in Case C-92/01, *Georgios Stylianakis v Elliniko Dimosio*, judgment of 2.3.2003, not yet reported, at paragraphs 29 and 33.

<sup>38</sup> Case C-70/99, (n 10 above), at paragraphs 29 and 30, and Case C-435/00 (n 26 above) at paragraphs 22-24.

<sup>39</sup> Case C-430/99 (n 19 above), at paragraphs 41-42.

<sup>40</sup> Case C-430/99 (n 19 above) at paragraph 43, and Advocate General Alber in Case C-435/00 (n 26 above), at paragraph 53.

<sup>41</sup> Advocate General Alber in Case C-70/99 (n 10 above), at paragraph 52.

<sup>42</sup> Case C-92/01 (n 37 above) at paragraphs 27 and 29.

particular amount levied must correspond, as far as possible, to the actual costs of providing the service.

58. The Authority points out that the Icelandic Government has not substantiated that the difference in the amount levied on the two groups of passengers is related to a corresponding difference in costs for providing the services. Moreover, the legislators' intention in having a different air passenger tax for domestic and international flights was, apparently, never to reflect an associated difference in the cost of providing services to the two groups of passengers, but rather to finance the construction and operation of domestic airports.

59. The Authority has submitted to the Court a study that it commissioned from an Icelandic economist, who concluded that the higher amount of the international air passenger tax did not reflect a similarly higher cost connected to the provision of services to international air passengers. In the absence of complete and accurate information, the economist based himself on a conservative approach, which is explained in detail by the Authority.<sup>43</sup> The economist calculated that, at the very most, the air passenger tax for international passengers should be ISK 608, and ISK 811 for domestic passengers.

60. The Authority points to one issue of legal interpretation that has not yet been addressed by the Court of Justice of the European Communities, namely the extent to which it is compatible with Article 49 EC, to require an individual user to finance part of the general related costs. The matter has, however, been discussed in detail by Advocate General Alber in *Sea-Land*,<sup>44</sup> where he concludes that it could not be ruled out that an individual user might be required to finance part of the general related costs as well as the specific costs of the services from which that individual benefits.

61. With regard to the standard of proof, *i.e.* the detail in which the State must prove that the difference in taxation corresponds to a similar difference in costs, the Authority refers to the requirement for actual figures set out by Advocate General Alber.<sup>45</sup>

62. The Authority disputes the alternative argument by the Icelandic Government, that any restriction inherent in the different levels of air passenger tax is, in any event, justified on grounds of the public interest in the "compelling necessity" to provide basic airport services to remote parts of Iceland.<sup>46</sup> The laudable aim of constructing and maintaining airport facilities in the remote parts of the country cannot justify the difference in air passenger taxes at issue. The

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<sup>43</sup> At paragraphs 33 to 40 in the Reply.

<sup>44</sup> Case C-430/99 (n 19 above), at paragraph 120 *et seq.*

<sup>45</sup> Advocate General Alber in Case C-70/99 (n 10 above), at paragraph 52. See also Case C-92/01 (n 37 above), at paragraphs 31-32.

<sup>46</sup> Paragraphs 2 and 51-72 of the Icelandic Government's Defence.

Authority also contends that the Icelandic Government has neither demonstrated, nor even argued, that the revenues from international and domestic air passenger taxes are used solely to build and maintain airport facilities for the group of persons that are subject to each type of tax.

63. The Authority also disputes that a justification on grounds of public interest can be based on the argument by the Icelandic Government that most domestic scheduled routes were on the verge of, or could in fact be made, public service obligation routes<sup>47</sup> and thereby either qualify or could qualify for State aid. In the Authority's opinion, the fact that a given measure might entail State aid cannot be used as a defence in relation to the assessment of whether that measure is compatible with the rules on free movement.<sup>48</sup> The principal aims which the Icelandic Government seeks to achieve with the air passenger tax might be fulfilled by some kind of aid scheme approved by the Authority under Article 61 EEA. However, State aid can only be granted if an aid scheme is in conformity with, *inter alia*, Article 36 EEA,<sup>49</sup> and this is not the case in relation to the air passenger tax. Furthermore, operating aid to air carriers can only be provided in two exceptional cases: either to compensate for public service obligations, or when the aid has a social character. The Authority concludes that neither of these possibilities appears to be fulfilled. In any event, proof of this nature cannot be made in the context of infringement proceedings relating to Article 36 EEA.

64. Referring to *Commission v Portugal*,<sup>50</sup> the Authority contends that a difference in the amounts of tax levied on domestic and international flights cannot be attributed to public service obligations designed to benefit certain regions where no public service obligation is in fact imposed upon the airlines serving those regions. Such obligations must be defined beforehand and any financial *quid pro quo* must be capable of being identified as specific compensation for those obligations. In this respect it is immaterial that the Icelandic Government explicitly states that its policy is not to impose public service obligations on the relevant flights. That policy decision obviously cannot serve as a justification for not following the obligations of the EEA Agreement.

## **The Republic of Iceland**

65. In its *statement of defence*, the Icelandic Government states that its principal submission is that the lower rate of air passenger tax levied on flights within the domestic market, the Faeroe Islands and Greenland, in no way restricts or impedes the free provision of air services within the EEA. In support of this

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<sup>47</sup> Paragraph 64 of the Icelandic Government's Defence.

<sup>48</sup> Case 249/81 *Commission v Ireland*, [1982] ECR-4005.

<sup>49</sup> Case C-225/91, *Matra SA v Commission*, [1993] ECR I-3203, at paragraph 41.

<sup>50</sup> Case C-70/99 (n 10 above).

submission, the Icelandic Government argues, firstly, that the taxes compensate airport services and facilities necessary for the processing of passengers, where the cost of these services is proportionately higher for international flights than domestic flights. Secondly, it argues that the markets are quite incomparable – eliminating the aspect of competition; and thirdly, the tax rate on international flights is in line with comparable intra-EEA passenger charges.

66. In the alternative, if the two-tiered tax is considered a hindrance to the provision of services, the Icelandic Government argues that it is in any event justified for compelling reasons of public interest. In support of this contention, it is argued that it is a necessary source of revenue for maintaining and building airports and airport facilities both for international and domestic flight services. These facilities are essential for the peripheral regions to secure a reliable means of transport to a population centre, which can provide administrative assistance, medical services and commercial facilities. The reduced tax rate on domestic services is therefore both necessary and proportional.

67. The Icelandic Government further contends that the lower tax rate for domestic services is aimed at maintaining and stimulating competition in providing services in the small and isolated Icelandic market. This is described as a transparent and simple way of providing indirect market support, to the benefit of all service providers willing to offer their services in this market.

#### *Factual background and geographical situation*

68. The Icelandic Government provides a detailed factual outline in support of its legal arguments. It states that the objective leading to the adoption of the Aviation Infrastructure Act was to secure a source of special revenue to construct and maintain airports and airport facilities necessary to provide air services in Iceland. At that time, there were many small airports in Iceland, most of them without any terminals and some with only gravel surface. There was one international airport situated in Keflavik, and no alternate airport was available if weather conditions were unfavourable. Facilities were quite unsatisfactory for security checks and customs clearance.

69. According to the Icelandic Government, there are currently scheduled flights to 13 airports in Iceland. Of those, nine airports can only accommodate landings by small and medium sized propeller driven aircraft. Three other domestic airports, Reykjavik, Akureyri and Egilsstadir, can accommodate larger aircraft such as jet transport aircraft, and are the alternative airports for international flights. The international airport in Keflavik has no scheduled domestic flights and approximately 98% of the international air traffic is handled there.

70. The 13 domestic airports serve a population of around 288,000 that live in a country with an area of approximately 103,000 km<sup>2</sup>. More than two thirds of the population live within 50 km of the capital, Reykjavík, and the number of

passengers within the catchment area of each airport is very limited. The Icelandic Government states that it is difficult for the providers of air services to maintain a sustainable business. Scheduled domestic flight services have for the last few years been reduced severely. The airport infrastructure in Iceland has been aimed at serving regional population centres, so as to provide a minimum service to the outermost regions. Weather conditions can hamper flight services considerably within Iceland.

71. The Icelandic Government refers to the need for peripheral and regional areas to have minimum transport accessibility to a population centre for public services, commerce, education and culture. The criterion used in European discussion is that the travel time, using the fastest possible means of transport, should not exceed three hours. The Icelandic Government has stated that travelling time between any village in the country and Reykjavik, should never exceed three and a half hours. All scheduled flights within Iceland provide air transport between regional areas, which have a driving distance between major regional populations of between four and nine hours.

72. According to the Icelandic Government, there are two providers of scheduled passenger flight service within the domestic market and to the Faeroe Islands and Greenland,<sup>51</sup> and neither of them provides services to other EEA countries. Currently there are also two companies operating scheduled flights between Iceland and European destinations.<sup>52</sup> The Government states that neither of them offers domestic flights.

73. The Icelandic Government has twice held tenders for Public Service Obligation (“PSO”) flights, under the provisions of Article 4(1), Regulation 2408/92. No foreign air carrier showed any interest or made any bid as regards these tenders. In the Government’s view, it has therefore been very clear that the domestic market for air services in Iceland is very distinct and separate from the rest of the internal market of the EEA. In both instances, when deciding to allow PSO routes in Iceland, the Authority acknowledged that the air services at issue could be considered as services in the general economic interest.

74. According to the Icelandic Government, the geographical situation of Iceland makes the domestic market very distinct, in a manner which in no way places it in competition with international flights. The longest air-route within the domestic market is 379 km<sup>53</sup> while the shortest route in service between Iceland and the rest of the EEA is approximately 1350 km. As Iceland is an island, there are no other means of rapid and convenient transport between Iceland and the rest of Europe.

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<sup>51</sup> Flugfélag Íslands Ltd. and Íslandsflug Ltd.

<sup>52</sup> Icelandair Ltd. and Iceland Express Ltd.

<sup>53</sup> It seems from the Statement of the Defence that the Government of Iceland here refers to routes within the island of Iceland and not to the Faroe Islands and Greenland, which are not covered by the EEA Agreement.

75. By its decision of 8 August 2001, the Authority has defined the regions of Iceland as regards assistance and levels of State aid in Iceland. The Icelandic Government emphasises that all airports in Iceland that only serve domestic flights are situated in areas which are defined as eligible for regional State aid by the Authority.

*The Icelandic Government's principal submission*

76. In support of its principal submission, that there is no restriction on the freedom to provide services, the Icelandic Government argues that the services at issue are not comparable and therefore the tax rates on those different services can not have the effect of impeding or restricting the provision of services in the markets. Only if the services were comparable, could the restrictive effect of dissimilar taxation or charges be assessed as a hindrance regarding the freedom to provide services.

77. The Icelandic Government refers to the ruling of the Court of Justice of the European Communities in *Commission v Portugal*,<sup>54</sup> where the Court of Justice stated that it has: “...had the occasion to rule that a measure that makes the provision of cross-border services more onerous than that of comparable domestic services amounts to a restriction of the freedom to provide services...”<sup>55</sup> In the same paragraph, a comparison is made between flights from Lisbon to Oporto and flights from Lisbon to Madrid, which are quite comparable. The Government states that no such comparison can be made regarding domestic flights and intra-EEA flights as regards Iceland.

78. The Icelandic Government further refers to the recent judgement *Stylinakis v Dimosio*,<sup>56</sup> where the Court of Justice of the European Communities also found that different taxation is justifiable where the services rendered for flights with higher taxation are more costly. The Court of Justice of the European Communities held that Article 3 (1) of Regulation 2408/92 should be interpreted as precluding different taxation, “...unless it is shown that those taxes compensate airport services necessary for the processing of passengers and that the cost of these services provided to passengers flying to other Member States is proportionally higher than the cost of those services necessary for the processing of passengers on domestic flights.”<sup>57</sup>

79. The Government recalls that comparability is also a key issue in other rulings of the Court of Justice of the European Communities, which refer to

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<sup>54</sup> Case 70/99 (n 10 above).

<sup>55</sup> At paragraph 28.

<sup>56</sup> Case C-92/01 (n 37 above).

<sup>57</sup> At paragraph 29.

“*analogous provision of services at domestic level*”<sup>58</sup> and “*comparable domestic services*.”<sup>59</sup>

80. The Icelandic Government submits that there are significant differences in services between intra-EEA flights and domestic flights in Iceland. The services needed to accommodate international flights in Iceland are much more extensive and costly than those required for domestic flights. The differences in services result from the different facilities, personnel and technological equipment necessary, the different customs rules applicable, and the different requirements for small aircraft compared to jets.

81. The type of aircraft that can be used in domestic flights is limited to propeller driven planes less than 25 tons, and in fact only aircraft below 10 tons operate on routes to the nine airports that only serve domestic traffic. Purely domestic airports can only accommodate small, propeller driven aircraft that require shorter runways with less sophisticated surface and fewer facilities than jet planes. Only jet transport aircraft are used in international flights. The facilities and services available for aircraft operating in the domestic market are very small and simple, based on the requirements of the air carriers and the limited number of passengers using them. The domestic terminals are not built for customs inspections or passport control.

82. The Icelandic Government recalls that as Iceland is a party to the EEA Agreement, it is not part of the customs union of the EU. In *Commission v Portugal*,<sup>60</sup> Advocate General Alber refers to the fact that no passport control or customs checks are necessary within the Community. His reasoning is that this should support lower tax within the Community, compared to international flights.<sup>61</sup> As Iceland has for the last two years been a party to the Schengen Agreement, passengers on flights originating within the Schengen area do not need to go through passport control. This is, however, not the case regarding intra-EEA flights from the United Kingdom and Ireland, since those EEA Members are not Schengen Members. Full passport control is needed for passengers on those flights, making the required provision of services for part of the EEA exactly the same as for flights for non-EEA destinations.

83. The Government states that in addition, there is always a need for customs checks irrespective of the country in which the flight originates. The EEA Agreement does not establish a customs union but only provides, in Article 21, for co-operation in the field of customs and facilitation of border controls. Therefore the requirements for facilities for customs clearance, technical equipment in that regard, and increased personnel to handle customs clearance

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<sup>58</sup> Case C-381/93 (n 3 above), at paragraph 5.

<sup>59</sup> Case C-70/99 (n 10 above), at paragraph 28.

<sup>60</sup> *Ibid.*

<sup>61</sup> Case C-70/99 (n 10 above), at paragraph 50.

are only needed for international flights. This constitutes a fundamental difference between domestic flights and international flights in Iceland, including EEA flights, which does not exist in EU countries.

84. The extensive services, facilities, and personnel required for accommodating international flights require space. In addition, technological equipment is much more sophisticated for international flights, due to various obligations arising from international police cooperation. The air terminals for international flights are required to have facilities to accommodate all these additional services and personnel. The three alternative airports also need facilities to keep cross-border passengers separate from domestic passengers, due to customs rules and security control.

85. In addition to the differences in services between domestic and international flights outlined above, the Icelandic Government contends that the intra-EEA air services are a distinct and separate market from the domestic Icelandic market.

86. The Icelandic Government submits that the tax rate on international flights, including flights from other EEA countries to Iceland, neither constitutes a barrier to the freedom to provide services nor renders it more difficult to provide intra-EEA air services. The distinctive markets of domestic and international air services in Iceland, with different types of aircraft, very different lengths of air routes and different geographical and meteorological conditions, create a situation that excludes any competition between the two markets. No service provider in the domestic market can effectively compete with the service providers in the international market, because of the distinctive and different requirements and demands of the consumers.

87. In support of its contention that the markets are separate, the Icelandic Government reiterates and develops the factual description of the domestic and international markets.

88. The market for air services within Iceland constitutes approximately 335 thousand passengers per year. On each domestic flight, there are 13-14 passengers on average. Domestic flight services are in direct competition with bus services and the use of private cars, since there are no train services in Iceland, and ferry services to only two scheduled flight destinations, the Westmann Islands and Grimsey Island. The potential consumer market is mostly domestic traffic, which is limited on grounds of the number of inhabitants, 288,000 people, although there is in addition some tourist traffic.

89. The market for international air services to and from Iceland constitutes approximately 1,400,000 passengers per year, with an average of approximately 80 passengers on each flight.

90. In support of its argument, the Icelandic Government refers to the statement of the Court of Justice of the European Communities in *Sea Land Services*,<sup>62</sup> where the relevant markets were domestic transport services on the one hand, and intra-EEA services on the other: “...it is also true that a difference of treatment cannot constitute discrimination unless the circumstances in question are comparable...” and further, “...there are in this case objective differences between sea-going vessels longer than 41 meters and inland waterway vessels, in particular as concerns their respective markets - differences which reveal, moreover, that those two categories of means of transport are not comparable.”<sup>63</sup>

91. The Icelandic Government emphasises that intra-EEA air services are a distinct and separate market from the Icelandic market. Because of this very clear distinction between the two markets, there is no possibility of a special advantage being secured for domestic service providers. Thus, the risk that different levels of taxation will allow domestic service providers to be indirectly compensated and supported through their international services is non-existent.

92. The Icelandic Government contrasts this situation with that in *Portugal v Commission*,<sup>64</sup> where the Court of Justice pointed out that the different landing charges in Portugal conferred an advantage on carriers who operated more on domestic routes rather than international routes. The Court of Justice of the European Communities stated that this led to dissimilar treatment being applied to equivalent transactions and therefore affected free competition.<sup>65</sup> In the same paragraph, the Court refers to the “...same number of landings of aircraft of the same type.” Contrarily, in Iceland, there are obvious differences in type, size, facilities, and quality.

93. In the view of the Government, therefore, the different types of aircraft, different length of air routes and different geographical and meteorological conditions, create a situation which excludes any competition between the two markets. No service provider in the domestic market can effectively compete with the service providers in the international market, because of the distinctive and different requirements and demands of the consumers

94. The Icelandic Government states that the only realistic option for travelling to neighbouring countries from Iceland is by air. There is no question of choosing whether to go by train or ferry from Iceland to a destination in the EEA. The providers of intra-EEA flights to and from Iceland are in direct competition with each other in offering services to destinations within the EEA, and they have a choice of four airports that can accommodate international flights

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<sup>62</sup> Case C-430/99 (n 19 above), at paragraph 36.

<sup>63</sup> Case C-430/99 (n 19 above), at paragraph 37.

<sup>64</sup> Case C-70/99, (n 10 above).

<sup>65</sup> Case C-163/99 (n 25 above), at paragraph 66.

in Iceland. There is, however, no overt or covert discrimination resulting from the reduced tax on the domestic flights, as the domestic and international markets are quite distinct and separate.

95. The Icelandic Government submits that the rate of airport taxes and charges in most EEA-States are higher than or similar to the rates on international flights to Iceland, and refers in this respect to a comparison of data accumulated by the Civil Aviation Administration in Iceland. With regard to passenger charges in particular, the Icelandic Government submits that passenger charges on international flights to Iceland are similar to or lower than in most neighbouring countries in Europe.

96. The total charges on each flight to European airports comprise many factors, including passenger service taxes, security taxes, landing charges and various other elements. When examining whether any one such tax constitutes a restriction on the freedom to provide air services, it is necessary to look at the whole picture, not just a fragment of it. When considering the overall effect of the various taxes and charges, it is not possible to see how the air passenger tax in Iceland can in any way be a hindrance to any air service provider looking to expand his market and offer his services in Iceland, when taxes and charges in other EEA countries are not considered to be such a restriction.

97. Airport taxes have not been harmonised within the EU and certainly not within the EEA, as direct taxation falls outside the application of the EEA Agreement. The Government therefore has full competence to decide the rate of its taxes, including air passenger taxes, within the limits of its obligations under the EEA Agreement.

98. The Icelandic Government submits that population dispersion and the characteristics of the outlying regions of Iceland should be taken into consideration when estimating the effect on free provision of services. In this regard, the Icelandic Government refers to the new air passenger tax system within the United Kingdom established in 2001, according to which £10 is the standard intra-EEA tax, while double the amount is charged for 1st class or luxury fares. However, certain passengers, and all flights on small aircraft (less than 10 tons), as well as all flights to peripheral areas in Scotland, usually referred to as “Highlands and Islands” are exempted from the air passenger tax.

99. In determining the areas where these exemptions apply, the UK has used a criterion based on population density, which shall not exceed 12.5 inhabitants per kilometre. In comparison, population density in Iceland is approximately 2.8 inhabitants per square kilometre or 4.7 if interior highlands are excluded. With regard to the special scheme of tax exemption in the Scottish Highlands and Islands, the Icelandic Government submits that the exemption from air passenger duties is considered vital in recognition of the reliance on air transport of the remote regions, even if there are both road transport and rail transport facilities available within most of the Scottish Highlands.

100. The Icelandic Government remarks that the Commission of the European Union has not seen reason to challenge the system in the United Kingdom, which has been in effect despite the recent judgments of the Court of Justice of the European Communities regarding air passenger taxes. The Authority seems to have adopted a different and much more stringent approach in the interpretation of the provisions regarding freedom to provide air services.

*The Icelandic Government's alternative submission*

101. The Icelandic Government then turns to its *alternative submission*, namely that even if the two different tax rates for the separate categories of air services in Iceland constitute a restriction on the freedom to provide services, such restriction is justified on grounds of public interest, in accordance with the case law of the Court of Justice of the European Communities.<sup>66</sup>

102. The Government refers to the four main conditions established by the Court of Justice of the European Communities for such restrictions to be justified:

- The restriction has to be applied in a non-discriminatory manner;
- It must be justified by compelling reason of public interest;
- It has to be suitable for securing the attainment of the objective; and
- It must not go beyond what is necessary to attain that objective.

103. As to the first condition, the Government expresses the view that there is no discrimination entailed in the application of the measure at hand, and that the Authority seems to acknowledge this in its application, at paragraph 47.

104. With regard to the second condition, the Government asserts the existence of compelling reasons of public interest. In essence, the Government invokes both public policy and public security reasons, based on the necessity to provide basic airport services to the many remote parts of Iceland, and the importance of a special source of revenue for the construction and maintenance of such airport facilities.

105. Firstly, it is public policy in Iceland that the regional areas shall be provided with all the services possible to maintain the regional population and to prevent the depopulation of the regions towards the urban area in the south-western part of Iceland. It is essential for economic, environmental and social reasons to maintain habitation, although sparse, in all parts of Iceland. This is a policy widely accepted in the EEA and supported by the policy makers in the EU with structural assistance and legislation, taking social cohesion into account.

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<sup>66</sup> Case C-55/94 *Reinhard Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-4165, at paragraph 37, Case C-70/99 (n 10 above) Advocate General's opinion, at paragraph 48, Case C-430/99 (n 19 above), at paragraph 39.

106. The taxation on air passengers aims at securing the financing for building and maintaining an infrastructure of airports in Iceland, which has been an essential aspect of the regional policy, as well as part of Iceland's contribution to facilitate the provision of services and movement of people and goods, under the EEA Agreement.

107. A great emphasis has also been put on building alternate international airports in Akureyri in the North of Iceland, and in Egilsstaðir in the East of Iceland, so as to provide secure and dependable air services internationally. This has been very costly. The airport in Keflavik is still the main international airport in Iceland and the building of facilities there was a priority, especially in relation to Iceland's participation in the EEA, and later Schengen.

108. The alternatives available for transport to Iceland are few. Being an island, Iceland has no intra-EEA land transport by road or rail. Domestically, public or private transport by car is the only realistic option if there are no flight services, however, most roads are dirt roads and illumination of roads is very limited, Roads are often closed for periods of time in the winter.

109. Secondly, with regard to public security, the Icelandic Government emphasises the necessity of a good and secure airport network. Iceland does not have many optimally equipped hospitals and treatment centres. Many hospital services can only be provided in the capital. The need for a good airport infrastructure to transport patients by ambulance flights, to the sophisticated high-technology hospital services in the capital or other major cities, is therefore vital.

110. The revenues from the passenger tax have enabled the development of four airports in Iceland that can accommodate international flights. Service providers have taken advantage of these possibilities and sometimes offered services directly from the northern and eastern regions, mainly in the summer when the passenger traffic is sufficient to sustain such services.

111. In relation to public policy considerations and security concerns, the Government further states that the basic objective of the difference in taxation is to allocate the costs fairly, so that the passengers and airlines requiring the most costly services and facilities (international flights) also provide revenue that takes those issues into account.

112. The annual financing of the airport system in Iceland far exceeds the revenue from the air passenger service tax. The Government submits that a decision on tax rate and redistribution of financial support to the airport infrastructure and maintenance is within its exclusive competence.

113. In further support of compelling reasons of public interest, the Icelandic Government further invokes a public service aspect. In this respect the Government submits that profit margins on most scheduled domestic flights are

very narrow, due to the limited number of passengers. Most domestic services are on the verge of, or could in fact be made Public Service Obligation flights, according to Article 4(1) of Regulation 2408/92. Two scheduled air services, the Akureyri-Gjögur route, and Reykjavik-Höfn route, were made into PSO routes in 1999 and 2001 respectively, when it was foreseen that no airline would continue services there, unless compensation and market support were offered.

114. According to the Government, its policy has been to limit State aid in this sector as much as possible, changing air-routes into PSO flights only in very extreme situations. By levying a reduced air passenger tax on domestic flights, the Government endeavours to enable all service providers to maintain services in spite of the limited number of passengers, and also facilitates access to the Icelandic market for new service providers. Through this approach, the Government tries to ensure the necessary minimum public services, in relation to passengers, services, cargo and supplies. The reduced air passenger tax is therefore, in essence, indirect market support for air service providers who are willing to offer their services in this difficult and small market.

115. The Icelandic Government refers in this context to the Commission's guidelines on State aid in the aviation sector,<sup>67</sup> according to which direct operational subsidisation of air routes can be accepted, either in accordance with Article 4 (1) of Regulation 2408/92, or, on social grounds: "*The aid must have a social character, i.e. it must, in principle, only cover specific categories of passengers travelling on a route (e.g. children, handicapped people, low income people). However, in case the route concerned links an underprivileged region, mainly islands, the aid could cover the entire population of this region.*"<sup>68</sup> The Government asserts that this is directly relevant in the case of Icelandic domestic air services.

116. With regard to the third condition, that the restriction has to be suitable for securing the attainment of the objective, the Icelandic Government submits that differentiated air passenger taxes are quite suitable for the twofold purpose to be achieved: firstly, to enable more service providers to offer their services within the internal market, including the Icelandic market, and secondly, to maintain a minimum standard of service to the public in the regional and secluded areas of Iceland to enable transport of passengers and goods within the country.

117. In this regard the Icelandic Government contends that the provisions of Article 36 EEA, and the provisions of Regulation 2408/92, should not be interpreted to the effect that competition and freedom to provide services shall be reduced, by forcing more flights into Public Service Obligation requirements. This would not be in the spirit of the EEA Agreement. Nevertheless, this will be the outcome in the Icelandic market if the Authority's demands are

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<sup>67</sup> Commission of the European Communities: *Application of Articles 92 and 93 of the EC Treaty and Article 61 of the EEA Agreement to State aids in the aviation sector* (94/C 350/07).

<sup>68</sup> *Ibid.*, at paragraph 24.

acknowledged. The small domestic market for air services would thereby to a large extent be supported directly by the State, giving one or two air carriers an effective monopoly and making it very difficult and unattractive for new service providers to enter the market.

118. The differentiated air passenger tax is the least interventionist means whereby the Government may facilitate the provision of air services in the Icelandic market by all service providers, irrespective of nationality or place of establishment. Putting most of the flights out to tender, under the provisions of Article 4(1) of Regulation 2408/92, would be a much more rigorous and restrictive method.

119. As to the fourth condition, the principle of proportionality, (that the restriction must not go beyond what is necessary to attain that objective) the Government submits that the air passenger tax is proportional in regard to both the services rendered and the cost of the flights. The alternative way of achieving the policy goals at issue, namely state aid to certain flight operators and monopoly on certain air routes as Article 4(1) of Regulation 2408/92 foresees, cannot be considered a more suitable approach. There is no provision in the Regulation, nor is there determined case law stating that no other provisions can be accepted than the ones found in that Article, as concerns special requirements of small and peripheral markets.

120. In its *Rejoinder*, the Government maintains its position and provides further arguments with regard to three of its main positions;

- the legal reasoning concerning comparable markets in relation to restriction of services;
- the relation between the air passenger tax and cost of services; and
- the regional and peripheral aspects regarding authorised support and state aid in air transport.

121. As to the first issue, the Government states that comparability is a prerequisite for differences in fees or treatment to be viewed as restrictive or discriminative.<sup>69</sup> The Government reiterates the citation from *Sea Land Services*, at paragraph 36, and extends it to include the references by the Court of Justice of the European Communities to *Francovich*<sup>70</sup> and *Germany v Commission*.<sup>71</sup> The Government further analyses the factual background in *Sea Land Services*, stating that irrespective of its conclusion, the Court of Justice found real and valid differences between domestic and international transport, which led to the clear statement that the markets were not comparable.<sup>72</sup>

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<sup>69</sup> Case C-70/99 (n 10 above), at paragraph 28.

<sup>70</sup> Case C-479/93 *Francovich*, [1995] ECR I-3843, at paragraph 23.

<sup>71</sup> Case C-156/98 *Germany v Commission*, [2000] ECR I-6857, at paragraph 84.

<sup>72</sup> Case C-430/99 (n 19 above), at paragraph 37.

122. The Government disagrees with the EFTA Surveillance Authority that what is at issue is the *difference* in the amount of tax levied on domestic and international passengers, *per se*, and asserts that it is rather the *effects* of that difference. It is necessary to look at the case in real terms and reasonably examine whether a restriction may exist, based on the effect of the tax, not only consider the situation in elevated hypothetical terms that have little to do with the real situation. The Government submits that the Authority has not established that the *effects* of this difference in taxation are such that the freedom to provide services, protected by Article 36 EEA, is in any way restricted.

123. The Government explains that its comparison in its defence between Iceland and the Scottish Highlands, where no tax is charged on domestic flights, was based on the special situation concerning peripheral and regional areas in Iceland, difficult transportation and dangerous roads, weather conditions and other aspects that necessitate secure, affordable and dependable domestic air services. The EEA Agreement has as its goal to reach a dynamic and homogeneous European Economic Area, with common rules and equal conditions of competition. In light of the need for a harmonized approach in interpretation, enforcement and obligations in the internal market, the Government saw reason to draw attention to the practice of the Commission.

124. Turning to the second issue, the relation between taxation and cost of services, the Government identifies two elements that in its view constitute the essence of the dispute between the parties; firstly, whether there are objective justifications for the higher tax on international flights, such as the cost of the services rendered; and secondly, whether the tax on international passengers is in fact mainly used to subsidise and finance infrastructure and maintenance of domestic airports, and does therefore not benefit the passengers who pay the tax.

125. With regard to both of these issues, the Government reiterates that the cost of services rendered to international passengers far exceeds the revenue from the air passenger tax. According to the Government, the economic report commissioned by the EFTA Surveillance Authority and submitted to the Court in the *reply* suffers from misconceptions and miscalculations, which the Government seeks to correct by providing statistical data, and by explaining them in detail. Based on the calculations at hand, the tax has been very cautiously and fairly set, and is far from covering the cost that the State has of providing international air services.

126. The costs of upgrading the Akureyri and Egilsstaðir merely for domestic flights would have been approximately ISK 561 and 681 million respectively, as opposed to the actual costs of upgrading those airports to also accommodate international flights, which were ISK 925 and 1.836 million respectively.

127. The Government further states that the various tasks undertaken by the Icelandic Defence Force at the Keflavik Airport by virtue of an extensive bilateral Defence Agreement between the Government and the United States

entail costs that do not appear as statistics in the State Accounts and are therefore difficult to calculate at this juncture.

128. The operating cost for the Keflavik Civil Aviation Administration and the District Commissioner of Keflavik, whose activities solely relate to the international airport in Keflavik was close to ISK 1.122 million in 2001. The contribution from landing fees was ISK 590 million. The operating cost of the Keflavik air terminal can cautiously be estimated at ISK 878 million per year.

129. According to calculations by the Icelandic Aviation Authority submitted to the Court by the Icelandic Government, 38.4% of the total cost of operations regarding airports and air services within their field of operation, is attributable to international aviation services. The methodology underlying this finding is supported by the economic report submitted by the EFTA Surveillance Authority, which calculated a slightly higher percentage of costs attributable to international flights (42,1%). However, contrary to that report, the analysis by the Icelandic Aviation Authority takes into account all necessary factors.

130. While the total costs attributable to international operations, during the fifteen years that the airport tax has been in effect (1987-2002), is ISK 7.308 million, the total revenue from the air passenger tax on international passengers during the same period of time amounts to ISK 7.758 million. This specific cost, has therefore constituted approximately 94.2% of the total revenue, leaving 5.8% for other purposes. Consequently, there has hardly been any revenue to compensate the contributions from the State Budget to Keflavik Air Terminal, Keflavik Civil Aviation Authority or the District Commissioner at Keflavik Airport.

131. The Government submits that only a fraction of the cost of services concerning international aviation and international airports in Iceland is charged to passengers by means of the air passenger tax. The total annual revenue from the tax, including the domestic air passenger tax, only contributes a maximum 28-29% of a cautiously estimated and calculated, un-updated total cost.

132. The Government contends that it has acted in accordance with the statements of Advocate General Alber's Opinion in *Sea Land Services* on how thoroughly the charge or tax must be calculated.<sup>73</sup>

133. The Government further notes that in *Sea Land Services*, the vessels on inland waterways (domestic traffic) did not have to pay part of the general cost of the system. Advocate General Alber came to the conclusion in *Sea Land Services* that the fact that other traffic did not have to bear these costs did not in itself constitute a breach of the principle of proportionality. That would only have been

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<sup>73</sup> Case 430/99 (n 19 above), Advocate General Alber's Opinion at paragraph 123.

the case if the paying vessels would have to contribute to the cost of all of the vessels.<sup>74</sup>

134. The Government submits that there is no obligation to charge a similar percentage of the cost of providing domestic services, to passengers on domestic routes, in which case the tax would have to be very high on the shortest routes, although the services are not expensive.

135. With regard to the third main issue addressed by the Government, the considerations of regional and peripheral policy, the Government emphasises that the comparison with the State aid rules, is primarily intended to establish two things. First, that by defining certain domestic routes as Public Service Obligation routes and compensating one air carrier for operating that route, in accordance with Regulation 2408/92, access for other air carriers to this route is hindered. Establishing PSO routes is therefore far more restrictive, in the sense of Article 36 EEA, than the contested Icelandic Act. Secondly, the two PSO tenders that were published in the Official Journal in 1999 and 2001 did not, as expected, attract any offers from non-domestic flight operators, which further demonstrate that the two markets in question are distinctly separate and not comparable.

136. The Government holds that in its view, and contrary to the EFTA Surveillance Authority, the air passenger tax does have a social aspect. The tax does not impose the total cost of providing a domestic network of air services necessary to maintain basic living conditions on the few domestic passengers. It rather recovers one-fourth to one-third of the cost of the extensive services enjoyed by international passengers.

137. The cost of building a domestic airport network is paid by the State. The cost is therefore borne by all the taxpayers in Iceland irrespective of whether they need air services regularly, only on occasion or only in case of a need for an ambulance flight. The Government does not believe that this policy can be contrary to its obligations under the EEA Agreement.

### **The Commission of the European Communities**

138. The Commission points out that the first two recitals of Regulation 2408/92 make it clear that the very purpose of the Regulation is to define the conditions for applying in the air transport sector the principle of the freedom to provide services. Article 3(1) of that Regulation does not make any distinction between routes within a Member State and those between Member States: all routes are “routes within the Community” or, for the purposes of the EEA Agreement, “routes within the EEA.”

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<sup>74</sup> Case 430/99 (n 19 above), at paragraph 127.

139. The Commission states that the principle of the freedom to provide services precludes the application of any national legislation which has the effect of making the provision of services between Member States more difficult than the provision of services purely within one Member State, irrespective of whether there is discrimination on the grounds of nationality or residence.

140. The Commission refers in particular to *Commission v Portugal*,<sup>75</sup> Case C-447/99 *Commission v Italy*<sup>76</sup> and *Stylianakis v Dimosio*,<sup>77</sup> and states that the situation in those cases was essentially identical to the present case. Differences in the taxes to be paid by passengers will automatically be reflected in the transport cost so that, if the tax is lower for domestic flights, access to such flights will be favoured over access to intra-EEA flights.

141. Furthermore, even if the criterion used to differentiate the amount of tax imposed were ostensibly neutral, the principles referred to above would, nevertheless, apply where the most onerous tax would specifically concern non-domestic flights.

142. With regard to the argument by the Icelandic Government that the matter at hand only concerns taxation, the Commission states that national authorities must exercise their competence in respect of direct taxation consistently with EEA law, and refers in this respect to *Hörður Einarsson v The Icelandic State*<sup>78</sup> and to judgments by the Court of Justice of the European Communities.<sup>79</sup>

143. On this basis, the Commission comes to the conclusion, which coincides with that of the Authority, that the Republic of Iceland has failed to respect its obligations under Article 36 EEA and Article 3(1) of Council Regulation (EEC) No 2408/92.

Per Tresselt  
Judge-Rapporteur

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<sup>75</sup> Case C-70/99 (n 10 above).

<sup>76</sup> Case C-447/99 (n 14 above).

<sup>77</sup> Case C-92/01 (n 37 above).

<sup>78</sup> Case E-1/01 *Hörður Einarsson v The Icelandic State*, at paragraph 17.

<sup>79</sup> Case C-136/00 *Danner*, (n 15 above), at paragraph 28, Case C-80/94 *Wielockx* (n 11 above) at paragraph 16, Case C-264/96 (n 7 above), at paragraph 19, Case C-311/97 *Royal Bank of Scotland* [1999] ECR I-2651, at paragraph 19, and Case C-35/98 *Verkooijen* [2000] ECR I-4071, at paragraph 32.