

Credit Opinion: Landsvirkjun

Landsvirkjun

Reykjavik, Iceland

Ratings

Category	Moody's Rating
Outlook	Stable
Senior Unsecured	Aaa
Other Short Term	P-1

Contacts

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Key Indicators

[1]

Landsvirkjun

	31/12/2004	31/12/2005
Adjusted FFO Interest Coverage [2]	2.3x	2.5x
Adjusted FFO / Net Adjusted Debt [3]	5.5%	5.3
Adjusted RCF / Net Adjusted Debt [4]	5.1%	4.9%
Adjusted RCF / Capex [5]	25.1%	18.7%

[1] Based on "As Adjusted" financial statements. Details in "Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations - Part II, Rating Methodology, Feb-06 (#96729). [2] (Cash flow from operations (CFO) pre-Working Capital + Interest Expense) / Interest Expense [3] CFO pre-Working Capital / Net Debt Adjusted [4] (CFO pre-Working Capital - Dividends Paid) / Net Debt Adjusted [5] (CFO pre-Working Capital - Dividends Paid) / Capex

Note: For definitions of Moody's most common ratio terms please see the accompanying [User's Guide](#).

Opinion

Company Profile

Landsvirkjun is Iceland's dominant electric utility. It owns a majority of the transmission grid and draws on Iceland's large hydro resources in order to supply around 85% of the power needed by domestic users, as well as providing power for power intensive industries (particularly aluminium smelting) which forms a very important source of Iceland's foreign currency earnings. It operates under a Guarantee of Collection as described below.

Credit Strengths

- Guarantee of Collection provided by its shareholders including the Republic of Iceland
- Vital strategic importance of Landsvirkjun
- Limited competition and high barriers to entry into Icelandic electricity market

Credit Challenges

- Weak financial profile of the company; high leverage and modest profitability
- Exposure to currency and commodity price risks, although mitigated by hedging techniques
- Possible negative impact on margins and market share of proposed market liberalisation

Rating Rationale

The Aaa ratings of Landsvirkjun reflect the application of Moody's rating methodology for government-related issuers (GRIs). Please refer to Moody's Special Comment ("The Application of Joint Default Analysis to Government-Related Issuers") published in April 2005, and its accompanying press release.

-Aaa local currency rating of the Icelandic government

-High support

The rating of Landsvirkjun at Aaa, is in line with the foreign currency ceiling of the sovereign debt of the Republic of Iceland, which owns 50% of the company. It was established on 1st July, 1965 as a jointly owned enterprise by its shareholders the Republic of Iceland (50%), the City of Reykjavik (45%) and the Township of Akureyri (5%).

High support reflects the explicit support for Landsvirkjun from its shareholders - in particular the Icelandic State - through the Guarantee of Collection and Moody's belief that there are powerful incentives for timely payment.

Guarantees of collection, which are common in the Nordic Region, do not offer bondholders the same degree of protection as a standard guarantee. There is a potential risk of non-timely repayment should the company fail to meet its obligations, as exhaustive administrative and legal procedures must be followed before the shareholders are obliged to pay. However, given the vital strategic importance of Landsvirkjun to Iceland and other incentives for the shareholders (such as its liability for penalty interest), Moody's expects that the State and the other shareholders would intervene in a timely fashion and provide financial or other assistance.

Landsvirkjun is strategically important because of its position as the country's dominant electric utility and the significant and growing role in the economy of the aluminum smelting industry which relies on hydro power.

Landsvirkjun operates the national transmission grid and generates around 85% of the country's electricity, mainly from hydro plants. Landsvirkjun today derives over half its revenues from sales to local utilities, but a good 40% of its revenues come from its power sales to power intensive industries - PII -(primarily for use in aluminium smelting) and this proportion is expected to grow significantly over time. Overall transmission accounts for around 25% of revenues (spread between local utilities and power intensive industries.) Given the capital intensive nature of its investments, particularly for PII, the financial flexibility of Landsvirkjun is constrained by high leverage, very weak profitability and exposure to currency fluctuations and aluminum prices, although Landsvirkjun does enter into hedging contracts to mitigate these risks.

On the regulatory front, in response to the EU directive on separation of transmission, generation, distribution and sales of electricity, the Icelandic Parliament ratified a law that entered into force on 1 July 2003 - The Electricity Act. This Act aims at deregulation of electricity market in stages, which over time could lead to pressure on the company's margins, although this market might be too small and isolated for meaningful competition. In 2005, transmission activities were spun off into a separate subsidiary, Landsnet, in which Landsvirkjun owns a 69.44% share and as a result of this Act, Landsvirkjun no longer operates the transmission grid. In due course, should full ownership be transferred to the State, as discussed below, Landsvirkjun is likely to be merged with two state-owned distribution and supply companies, which should provide a degree of downstream hedging. Landsvirkjun has also entered into a number of long term sales contracts with distribution companies to mitigate the impact of competition.

The high support factor is the key driver of the rating. However we also consider Landsvirkjun in the context of other European utilities. Given its mix of business, of which the contribution from regulated transmission activities is relatively low, we would consider that Landsvirkjun falls outside the scope of the Global Methodology for Regulated Utilities. The sales to local utilities would be considered relatively low risk given the number of long term sales contracts in place. However the exposure to PII, through contracts linked to aluminium and dollar, are considered more volatile, despite conservative hedging techniques.

Landsvirkjun is currently constructing a new hydro power plant to supply a new aluminum plant. The construction costs are estimated at US\$1.1 billion and the smelter will be supplied by the 690MW Karahnjukar power plant, wholly owned and operated by Landsvirkjun. Significant progress has been made on this project and it is currently on track in terms of budget and time, with production scheduled to begin in 2007. Given the very capital intensive nature of this project, Moody's expects Landsvirkjun's debt to peak in 2007 and for its credit metrics to improve very gradually from a very weak financial position as cash flows come onstream. Further investments for new PII projects are under consideration. Such further investments, without equity injections from its owners, could put the company under some financial stress. The company has put in place a USD400million revolving credit facility to address backstop liquidity needs. A difficult liquidity situation may put pressure on the rating although our

assessment of timely government support would remain the key rating driver.

Recent Events

In February 2005 there was a declaration of intent by the representatives of the sovereign state and Reykjavik and Akureyri that the Icelandic State should take over the shares of the city of Reykjavik and the Municipality of Akureyri. It was stated that the changes should take place by January 2006. However this decision has been postponed, due to a failure to agree on pricing and there are new elections shortly in the City of Reykjavik. It is nonetheless considered fairly likely that discussions will be resumed at some point in the future, although there is no clarity as to timing.

A further statement was made in February 2005 that the State would plan to convert Landsvirkjun into a joint stock company at some point from 2008 onwards. There is also no clear timetable for this event. Nonetheless should any changes in the ownership structure or in its status occur, existing liabilities would still be enforceable against the current owners.

Rating Outlook

Rating outlook is stable and is likely to track the sovereign debt rating.

What Could Change the Rating - Down

Changes in the shareholders' Guarantee of Collection -which could happen if the company were incorporated (although all existing debt would be grand fathered) - or a change in the sovereign rating could have a negative impact on the rating.

In addition to the factors listed above the ratings may also be impacted by changes in the rating of the supporting government, or by changes in Moody's assessment of support described in the rating rationale.

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