

Credit Opinion: Landsvirkjun

Landsvirkjun

Reykjavik, Iceland

Ratings

Category	Moody's Rating
Outlook	Stable
Senior Unsecured	Aa1
Other Short Term	P-1

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Key Indicators

[1]

Landsvirkjun

	2005	2006	2007
FFO Interest Coverage	2.4x	1.7x	1.7x
FFO / Net Debt	5.3%	3.6%	3.8%
RCF / Net Debt	4.9%	3.4%	3.5%
RCF / (Capex + Acquisitions - Divestitures)	18.7%	14.7%	18.9%

[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).

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

Opinion

Corporate 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 72% 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.

Landsvirkjun 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%). Following a period of negotiation, the Republic of Iceland agreed to buy the shares of the City of Reykjavik and the Town of Akureyri and therefore assumed full ownership of Landsvirkjun as of 1 January 2007. Landsvirkjun continues to be a partnership; in order to meet the requirements of the partnership agreement; 99.9% of the company is owned by the Republic of Iceland and 0.01% by Eignarhlutar hf, an SPV owned by the Republic of Iceland. The ownership changes and the amended Law on Landsvirkjun Nr 42/1983 took effect on 1 January 2007.

The debt ratings of Landsvirkjun at Aa1, are in line with the local and foreign currency bond ratings of the sovereign debt of the Republic of Iceland because of the guarantee of collection in support of Landsvirkjun as more fully described below.

Recent Developments

In May 2008 Moody's downgraded to Aa1 from Aaa the senior unsecured rating of Landsvirkjun following the revision of Iceland's sovereign rating. Landsvirkjun's baseline credit assessment, government support and default dependence are as follows.

Rating Rationale

The Aa1 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.

The key drivers of the rating are:

-Aa1 local currency rating of the Icelandic government

- Baseline Credit Assessment of 13 (on a scale of 1 to 21, where 1 represents the lowest credit risk and maps to an "Aaa" and a 13 maps to a "Ba3"); A low BCA reflects a highly leveraged profile driven by significant investments in production facilities primarily to meet contracts with aluminium-smelting companies.

-High support reflects the explicit support for Landsvirkjun from its shareholder - in particular the Icelandic State - through the Guarantee of Collection. Whilst under Landsvirkjun's original Act of 1983 (as subsequently amended in 2007), and the partnership agreement, the shareholders are liable for the obligations of Landsvirkjun at the time they are incurred in proportion to their shareholding, nonetheless ultimately there is a joint and several liability of all shareholders for all the obligations. As such Moody's has always believed that the State would be ultimately responsible if necessary for the obligations of Landsvirkjun.

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 other shareholders would intervene in a timely fashion and provide financial or other assistance.

In addition 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 aluminium smelting industry which relies on baseload electricity provided by hydro and geothermal power.

The high support factor is the key driver of the rating, hence the final rating is not currently sensitive to movements in the underlying BCA.

- High dependence. In the unlikely event of a government default, the circumstances surrounding this would also lead to conditions that would adversely affect this GRI. Moreover a government default would reduce its ability and willingness to support the GRI, and hence lead to a high co-dependency of default.

Key drivers of the BCA are described below.

Baseline Credit Assessment

BUSINESS RISK PROFILE

Landsvirkjun owns 65% the national transmission grid, Landsnet, and currently generates over 70% of the country's electricity, mainly from hydro plants. Around 90% of revenues come from power sales. Landsvirkjun derives the bulk of these revenues from sales to power intensive industries - PII - (primarily for use in aluminium smelting) with the balance coming from sales to local utilities. Overall transmission accounts for around 5% 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 aluminium 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. The market has been progressively liberalised, and there has been some pressure on domestic electricity prices, however the market is rather small and isolated for meaningful competition.

The possibility of Landsvirkjun merging with two state-owned distribution and supply companies was under discussion which would provide a degree of downstream hedging if it went ahead. However as this did not take place on the transfer of full ownership to the State, the likelihood of this happening in the near term seems remote.

Landsvirkjun has also entered into a number of long term sales contracts with distribution companies to mitigate the impact of competition.

In 2005, as a result of the Electricity Act, transmission activities were spun off into a separate subsidiary, Landsnet, in which Landsvirkjun now owns a 65% share although Landsvirkjun no longer operates the transmission grid.

Given its mix of business, of which the contribution from regulated transmission activities is 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 certain hedging techniques.

Landsvirkjun recently completed the construction of a major project in the East of Iceland involving a new hydro power plant to supply a new aluminium plant. The construction costs amounted to US\$1.1 billion and the smelter is supplied by the 690MW Karahnjukar power plant, wholly owned and operated by Landsvirkjun. There remains some capex related costs for this project, which did have some cost and time overruns, nonetheless the major execution risks related to the project have been removed.

FINANCIAL RISK PROFILE

Given the very capital intensive nature of this project, its slight delay in completion and some cost overruns, Moody's expects Landsvirkjun's debt to peak in 2009 and for its credit metrics to improve gradually from a very stretched financial position as cash flows come onstream (Debt levels of around US\$3billion and adjusted CFO/net debt of 2.3% in 2007).

However further investments for new projects are under consideration - possibly related to further hydro power or data warehousing. Further large investments, without equity injections or other support from its owners, could add to the very high debt load of this company at a time when cash flows are still very weak. Were such investments to take place without a suitable capital structure, thus maintaining the very low ratios currently demonstrated, then this could put negative pressure on the current, weakly positioned, BCA of 13.

Liquidity

Given the weak financial profile of the company, appropriate liquidity and treasury management is a prime focus. Landsvirkjun's current liquidity profile is sound. As at 30 June 2008 the company had approximately US\$85million of cash and cash equivalents as well as access to US\$350 million undrawn under a MAC- and covenant- free revolving credit facility sufficient to cover short term debt repayments of approximately US\$130 million and capital expenditure of US\$138 million.

In addition the company has a well-spread maturity profile which partially mitigates refinancing issues. The company now also receives 70% of its revenues in US\$ which partially offsets its currency risk exposures: Landsvirkjun funds itself mainly through a basket of currencies; today its major currency exposure is EUR/US\$ and the company is therefore looking to increase its dollar funding. The company should benefit from expected higher aluminium prices, although these introduce volatility into the cash flows of the company which uses hedging techniques to lock in a percentage of forward prices.

Other Considerations

Incorporation, which would permit a privatisation of Landsvirkjun, has been periodically raised as a topic in Iceland. The recent change in ownership however maintains a partnership structure and hence this suggests that no such change is contemplated in the medium term.

Rating Outlook

The rating outlook is stable in line with that of the sovereign.

What Could Change the Rating - Down

(i) A change in legal form and hence withdrawal of the guarantee of collection from future debt - which could happen if the company were incorporated. All existing debt would however be grandfathered and retain the current rating (ii) or a move downwards in the sovereign rating.

What Could Change the Rating - Up

A move upward in the in the sovereign rating.

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