

**Credit Opinion: Landsvirkjun**

**Landsvirkjun**

Reykjavik, Iceland

**Ratings**

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

**Contacts**

Analyst	Phone
Helen Francis/London	44.20.7772.5454
Stuart Lawton/London	

**Key Indicators**

[1] Landsvirkjun	2004	2005	2006
Adjusted FFO Interest Coverage [2]	2.3x	2.4x	2.2x
Adjusted FFO / Net Adjusted Debt [3]	5.5%	5.3%	4.9%
Adjusted RCF / Net Adjusted Debt [4]	5.1%	4.9%	4.6%
Adjusted RCF / (Capex + Acquisitions - Divestitures) [5]	25.1%	18.7%	19.9%

[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). [2] (Cash flow from operations (CFO) pre-Working Capital+ Interest Expense) / Interest Expense [3] (Cash flow from operations (CFO) pre-Working Capital) / Net Debt Adjusted [4] (Cash flow from operations (CFO) pre-Working Capital - Dividends Paid) / Net Debt Adjusted [5] (Cash flow from operations (CFO) pre-Working Capital - Dividends Paid) / (Capex + Acquisitions - Divestitures)

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.

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 Aaa, 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 March 2008 Moody's revised to negative from stable the outlook for the Aaa senior unsecured rating of Landsvirkjun following the revision of Iceland's sovereign rating outlook to negative. Landsvirkjun's baseline credit assessment, government support and default dependence have remained unchanged.

## 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.

The key drivers of the rating are:

-Aaa local currency rating with a negative outlook of the Icelandic government

-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.

## ASSESSMENT OF BUSINESS AND FINANCIAL RISKS

Landsvirkjun owns 64.73% the national transmission grid, Landsnet, and currently generates over 80% 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 has been 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 64.73% share although Landsvirkjun no longer operates the transmission grid.

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 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 has nearly completed the construction of the new 690 MW Karahnjukar hydro power plant. This is already operational and supplies a new 322,000 tonne aluminium plant owned by a subsidiary of Alcoa. The

construction costs are estimated to amount to US\$1.7 billion. The power plant is wholly owned and operated by Landsvirkjun.

Given the very capital intensive nature of this project, Moody's expects Landsvirkjun's debt to peak in 2009 and for its credit metrics to improve very gradually from a very weak financial position as cash flows come onstream.

However further investments for new PII projects are under consideration. Such further investments, without equity injections, would add to the very high debt load of this company at a time when cash flows are still relatively weak. A difficult liquidity situation may put pressure on the rating although our assessment of timely government support would remain the key rating driver.

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.

## **Liquidity**

Landsvirkjun's current liquidity profile is sound. As at 31 December 2007 the company had approximately US\$230million 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\$210 million and capital expenditure of US\$325 million.

## **Rating Outlook**

Rating outlook is negative following the revision in March 2008 of Iceland's sovereign rating outlook to negative.

## **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 (ii) or a move downwards in the sovereign rating.

---

© Copyright 2008, Moody's Investors Service, Inc. and/or its licensors including Moody's Assurance Company, Inc. (together, "MOODY'S"). All rights reserved.

ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY COPYRIGHT LAW AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT. All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, such information is provided "as is" without warranty of any kind and MOODY'S, in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such information. Under no circumstances shall MOODY'S have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of MOODY'S or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if MOODY'S is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The credit ratings and financial reporting analysis observations, if any, constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER. Each rating or other opinion must be weighed solely as one factor in any investment decision made by or on behalf of any user of the information contained herein, and each such user must accordingly make its own study and evaluation of each security and of each issuer and guarantor of, and each provider of credit support for, each security that it may consider purchasing, holding or selling.

MOODY'S hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MOODY'S have, prior to assignment of any rating, agreed to pay to MOODY'S for appraisal and rating services rendered by it fees ranging from \$1,500 to approximately \$2,400,000. Moody's Corporation (MCO) and its wholly-owned credit rating agency subsidiary, Moody's Investors Service (MIS), also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually on Moody's website at [www.moody's.com](http://www.moody's.com) under the heading "Shareholder Relations - Corporate Governance - Director and Shareholder Affiliation Policy."