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Research Update:

Icelandic Utility Landsvirkjun 'BB+' L-T Rtg Placed On Watch Neg After Similar Action On Iceland; 'B-1' S-T Rtg Affirmed

Primary Credit Analyst:
Andreas Kindahl, Stockholm (46) 8-440-5907;andreas_kindahl@standardandpoors.com

Secondary Contacts:
Karin Erlander, London (44) 20-7176-3584;karin_erlander@standardandpoors.com
Alf Stenqvist, Stockholm (46) 8-440-5925;alf_stenqvist@standardandpoors.com

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Overview

- We have placed our 'BBB-/A-3' foreign currency and 'BBB/A-3' local currency sovereign credit ratings on the Republic of Iceland on CreditWatch negative.
- In line with our criteria for government-related entities, we are placing our 'BB+' long-term corporate credit rating on Icelandic utility Landsvirkjun on CreditWatch negative.
- The CreditWatch placement mirrors that on the sovereign and reflects our opinion that a downgrade of the sovereign would likely lead to a downgrade of Landsvirkjun.

Rating Action

On April 14, 2011, Standard & Poor's Ratings Services placed on CreditWatch with negative implications its 'BB+' long-term corporate credit rating on Iceland-based electricity generation and transmission company Landsvirkjun. At the same time, we affirmed the 'B-1' short-term rating on Landsvirkjun.

Rationale

The CreditWatch placement follows our similar action on the Republic of Iceland (foreign currency BBB-/Watch Neg/A-3'; local currency BBB/Watch Neg/A-3') on April 13, 2011; see "Ratings On The Republic Of Iceland Placed On Watch Negative After The Electorate Rejects Icesave Agreement A Second Time."

The 'BB+' rating on Landsvirkjun is based on the company's stand-alone credit profile (SACP), which we assess as 'b+', as well as on our opinion that there is a "very high" likelihood that the government of the Republic of Iceland would provide timely and sufficient extraordinary support to Landsvirkjun in the event of financial distress.

In accordance with our criteria for government-related entities (GREs), our view of a "very high" likelihood of extraordinary government support is based on our assessment of Landsvirkjun's:

- "Very important" role for the Icelandic government, given Landsvirkjun's dominant position as the incumbent power company and 64.7% owner and monopoly system operator of the national transmission grid; Landsvirkjun's strategic importance to the Icelandic economy; and its central role in the promotion of power-intensive industries.
- "Very strong" link with the Icelandic state, given the state's 100%

ownership of Landsvirkjun and our expectation that Landsvirkjun will not be privatized in the medium term; the provision of ultimate state guarantees for all of Landsvirkjun's debt; a two-year $300 million contingent credit facility extended to Landsvirkjun by the Central Bank of Iceland in June 2009; and the risk to the sovereign's reputation if Landsvirkjun were to default.

Landsvirkjun's SACP continues to reflect our view of the company's high financial leverage and weak cash flow coverage ratios. The SACP also reflects Landsvirkjun's fair business risk profile, which is restricted by high customer concentration, the company's exposure to the aluminum sector for revenue and cash flow generation, and poor profitability. The company is, however, the dominant power producer in Iceland and has a modern and low-cost renewable generation asset base. We also note that Landsvirkjun operates in line with the strategic goals for the Republic of Iceland, providing relatively low-cost energy to power-intensive industries.

Landsvirkjun's financial performance continued to strengthen in 2010, with Standard & Poor's-adjusted funds from operations (FFO) to debt improving to 7.6% from 6.8% in 2009. Free operating cash flows also remained positive, which allowed the company to reduce debt. We anticipate that the company's ratio of adjusted FFO to debt will remain at less than 10% throughout 2011. However, we think that there are prospects for further gradual improvements in this ratio in the medium term, because we anticipate that Landsvirkjun will use positive free cash flows to further reduce debt. Nevertheless, cash flow gearing remains high, as evidenced by an adjusted debt-to-EBITDA ratio of 10x in 2010.

Liquidity

Landsvirkjun's liquidity position is adequate, in our opinion. This is due to Landsvirkjun's successful debt issuance to redeem expiring debt obligations in 2010 and recently signed new debt facilities. Therefore, available liquidity sources in terms of cash, committed credit facilities, and operating cash flows should be well in excess of forecast near-term cash outflows such as debt repayments and capital expenditures (capex). However, we continue to believe that Landsvirkjun is reliant on positive discretionary cash flow to support its debt service requirements in the medium term.

On Dec. 31, 2010, Landsvirkjun had $215 million in freely available cash and $282 million available under a committed revolving credit facility that expires in December 2012, and which is free of covenants and other restrictions. Landsvirkjun also had access to a committed Icelandic krona (ISK) 3.0 billion ($26 million) credit facility. The maturity of this facility was extended by one year in March 2011, and it now matures in March 2014. At the same time, Landsvirkjun signed an ISK2 billion ($17 million) credit facility, also due in March 2014.

In addition, Landsvirkjun recently signed a €70 million ($100 million) loan facility with the European Investment Bank (EIB; AAA/Stable/A-1+) maturing in

2031 and a $70 million loan facility with the Nordic Investment Bank (AAA/Stable/A-1+) maturing in 2027. The company plans to use these funds to finance the $225 million Búdarháls power plant project, construction of which is scheduled to commence in 2011. We note that the EIB loan facility includes a provision requiring a minimum credit rating on the Republic of Iceland. However, Landsvirkjun recently signed two new bond issues of $50 million each, maturing in 2016 and 2018, respectively, and we envisage that Landsvirkjun would secure funding for the Búdarháls project before starting construction.

Landsvirkjun generated FFO of $270 million in 2010, and we believe that its FFO should remain fairly stable in the near term. We project capex of about $100 million in 2011, and a further $120 million in 2012. We understand from the company that it does not expect to pay dividends in the near to medium term. On Dec. 31, 2010, Landsvirkjun had about $370 million of short-term debt, with an additional $241 million of debt due in 2012.

In our assessment of Landsvirkjun's adequate liquidity position, we assume that the company will address the replacement of the $358 million back-up facility expiring in December 2012 in a timely manner. A failure to extend the facility in due course, evidence of restricted access to funding, or a negative deviation in FFO from our base-case assumptions could put pressure on the company's liquidity profile, and potentially on the ratings.

CreditWatch

The CreditWatch placement mirrors that on the Republic of Iceland. We aim to review the CreditWatch within the next few weeks, when we resolve that on Iceland. A lowering of our ratings on Iceland is likely to result in a downgrade of Landsvirkjun, in accordance with our rating methodology for GREs.

Related Criteria And Research

All articles listed below are available on RatingsDirect on the Global Credit Portal, unless otherwise stated.

- Ratings On The Republic Of Iceland Placed On Watch Negative After The Electorate Rejects Icesave Agreement A Second Time, April 13, 2011
- Principles Of Credit Ratings, Feb. 16, 2011
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- Methodology And Assumptions: Standard & Poor's Standardizes Liquidity Descriptors For Global Corporate Issuers, July 2, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008
- 2008 Corporate Criteria: Ratios And Adjustments, April 15, 2008

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Landsvirkjun		
Corporate Credit Rating	BB+/Watch Neg/B-1	BB+/Negative/B-1
Senior Unsecured Debt	BB+/Watch Neg	BB+

Additional Contact:
Infrastructure Finance Ratings Europe;InfrastructureEurope@standardandpoors.com

Complete ratings information is available to subscribers of RatingsDirect on the Global Credit Portal at www.globalcreditportal.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.