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## Landsvirkjun

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# Landsvirkjun

## Major Rating Factors

### Strengths:

- Support provided by ultimate guarantee on long-term liabilities from the company's owner, the Republic of Iceland
- Dominant position in the Icelandic electricity market as the largest generator and the monopoly transmission system operator
- Modern and efficient asset base

### Weaknesses:

- Aggressive financial profile owing to sizable debt-financed power generation expansion
- Customer concentration in the small and isolated Icelandic power market and significant exposure to aluminum prices for revenues
- Potential for longer-term restructuring and reduction of government ownership and support

Corporate Credit Rating
Foreign Currency A/Negative/A-1
Local Currency AA-/Negative/A-1+

## Rationale

The ratings on Iceland-based electricity and transmission company Landsvirkjun reflect the ultimate guarantee for all its existing and new debt obligations provided by the utility's owner, the Republic of Iceland (foreign currency A/Negative/A-1; local currency AA-/Negative/A-1+); its dominant position in the Icelandic electricity market (accounting for 72% of generated power) and control of the transmission grid; and its modern asset base. Weaknesses include customer concentration (four customers account for 65%-70% of Landsvirkjun's revenues); exposure to aluminum prices, which are inherently volatile; and an aggressive financial risk profile.

Standard & Poor's Ratings Services analyzes Landsvirkjun using its criteria for government-related entities. The ratings on the government-guaranteed debt are linked to the sovereign rating and reflect our expectations that existing and new debt will continue to benefit from government guarantee and be grandfathered if the company's status changes. Plans to merge Landsvirkjun with two state-owned distribution companies and to incorporate the combined group have been put on hold by the current government. Although incorporation is unlikely in the near to medium term, we expect that the guarantee would be abolished for new debt issued after a potential incorporation.

Formally, the debt guarantee is ultimate, but we expect the government to provide timely financial support, if needed. Our expectation is based on Landsvirkjun's strategic importance to electricity generation and supply, the company's central role in the promotion of power-intensive industry in Iceland, and the risk to the sovereign's reputation if Landsvirkjun were to default.

Landsvirkjun's financial risk profile is aggressive due to the heavy front-ended capital investments the company has made in the \$1.1 billion Kárahnjúkar hydropower plant project. However, we expect that the decline in Landsvirkjun's debt protection ratios in 2007 will be short term and that debt and interest coverage ratios will improve over the 2008-2010 period. The investment program is largely complete, and as the new power plant began to generate earnings last year, internally generated cash flows should improve substantially. Landsvirkjun's marginal level of cash flow coverage of debt, however, underlines the importance of sovereign support for the ratings on

Landsvirkjun.

### Liquidity

Landsvirkjun's liquidity position is adequate in view of its investment program. We expect capital expenditures to remain fairly high in 2008 and to be covered by existing debt. However, as the Kárahnjúkar project is near completion, we expect current liquidity and operating cash flow to be adequate to cover capital expenditures and maturing debt from 2009. At the end of June 2008, liquid assets totaled \$85 million, compared with short-term debt of \$57 million. Further support is provided by a committed multicurrency revolving credit facility of about \$400 million, maturing in 2012, of which \$350 million was undrawn at the end of June 2008.

### Outlook

The negative outlook on the local and foreign currency corporate credit ratings reflects the negative outlook on the sovereign ratings and our expectation that state support could weaken in the longer term. Given that incorporation appears unlikely in the near to medium term, however, we expect the ratings and outlook on Landsvirkjun to reflect those on the sovereign. Reduced state support would adversely affect Landsvirkjun's credit quality and result in ratings reflecting the company's significantly weaker stand-alone financial risk profile. This is particularly true if Landsvirkjun's leverage and debt protection measures fail to improve from the weak levels in 2007 or if Landsvirkjun's business risk profile deteriorates.

The negative outlook on the senior unsecured debt ratings mirrors the outlooks on the sovereign ratings and reflects our expectation that existing and new debt will continue to benefit from the government guarantee and be grandfathered if the company's status changes. Absent any signs of reduced willingness or ability to honor liabilities in a timely manner, the ratings on this debt should move in line with those on the sovereign.

### Business Description

Landsvirkjun produces, distributes, and sells wholesale electricity to local distributors and provides electricity-intensive industry (predominantly aluminum producers) with power under long-term take-or-pay contracts. The company generated 8,481 gigawatt-hours (GWh) in 2007, corresponding to about 72% of Iceland's power generation, using low marginal cost and environmentally friendly hydropower (94%) and geothermal power (6%). Landsvirkjun's sales of 8,903 GWh were split between sales to the general market (30%) and sales to power-intensive industries (70%) and were sourced from its own production (95%) and market purchases (5%).

Its 64.73% owned subsidiary Landsnet owns and operates the national transmission grid. The other owners of Landsnet are RARIK (Iceland State Electricity; 22.51%), Orkureita Reykjavíkur (Reykjavík Energy; 6.78%), and Orkubú Vestfjarda (Westfjord Power Co.; 5.98%).

### Government ownership

Landsvirkjun is a fully state-owned public partnership controlled by the Ministry of Finance. The State Treasury of Iceland directly owns 99.9% of the shares and indirectly owns the remaining 0.1% through special-purpose vehicle Eignarhlutir ehf.

The City of Reykjavik, the Municipality of Akureyri, and the State Treasury are liable as guarantors of collection of

debt issued by Landsvirkjun before year-end 2006. The two municipalities' liability will remain until fully discharged, or until Jan. 1, 2012, after which the Republic of Iceland shall guarantee the full indemnity of the two municipalities, with regard to any undertakings of Landsvirkjun, which may remain collectible from them. The State Treasury has sole liability as guarantor of collection of debt issued after Jan. 1, 2007, when it acquired the two municipalities' 50% share in Landsvirkjun and became the sole owner.

Although a guarantee of collection formally ensures payment only in the event of liquidation, we expect financial support to be timely because of Landsvirkjun's strategic importance to Iceland's electricity production and transmission; its role in providing for industrial expansion; and the potential negative consequences for the sovereign's reputation in the financial markets if Landsvirkjun were to default.

Incorporation or privatization of Landsvirkjun is not a priority for the current government, and no discussions in this respect are ongoing. Hence, it appears unlikely that the company will be incorporated or privatized in the near to medium term.

However, in the longer term, plans to merge Landsvirkjun with Iceland State Electricity and Westfjord Power Co. could improve Landsvirkjun's vertical integration and strengthen its business profile by increasing the share of earnings from noncompetitively exposed networks and proportionately reducing the commodity exposure. An incorporation of the combined group into a joint-stock company would allow new investors into the company. At the point of privatization, however, we would expect the government guarantee to be abolished for new debt, which would have an adverse effect on the corporate credit ratings on Landsvirkjun and on the ratings on any nonguaranteed debt. The ultimate effect on the ratings would depend on whether the state would retain a significant stake in the new group and our view of actual or implied support that could be applied to the then stand-alone ratings.

## **Business Risk Profile: Dominant Position In Small And Isolated Power Market**

Landsvirkjun's business risk profile reflects its dominant position in the Icelandic electricity market as well as its modern and efficient asset base. Landsvirkjun is the country's largest power generator and acts as the monopoly transmission system operator through its subsidiary Landsnet. These strengths are to a degree offset by the company's customer concentration in the small and isolated power market and its exposure to inherently volatile aluminum prices for revenues.

### **Strategy: To support the expansion of power-intensive industry in Iceland**

Landsvirkjun's strategy is to support the expansion of power-intensive industry in Iceland and to meet the growing demand from the ordinary markets across the country. The company also emphasizes the importance of risk management, customer diversification, and obtaining the highest possible price for electricity. The company aims to broaden its client base and spread the risk by providing electricity to data centers and manufactures of silicon for solar cells, which are industries currently being established in Iceland. In order to take advantage of opportunities outside Iceland, Landsvirkjun has formed subsidiary Landsvirkjun Power and established a joint venture with Landsbanki Island, HydroKraft Invest hf. The new entities will advise on and operate new hydro or geothermal projects abroad and focus on restructuring existing or entering new construction projects in renewable energy.

**Regulation: Fully deregulated market**

Landsvirkjun sells electricity in a fully deregulated market. Although Iceland's electricity prices are low by international standards, many of Landsvirkjun's power contracts are long term, which provides some revenue security over the contract period. In addition, given Iceland's small market, geographic isolation, and lack of cross-border interconnection capacity, the threat of competition from nondomestic new entrants is very limited.

Landsvirkjun's transmission and system operations are managed by subsidiary Landsnet. The National Energy Authority (Orkustofnun), the independent regulator, supervises these activities under a revenue cap regime to encourage efficiency improvements.

**Markets: Small and concentrated industry structure**

Iceland is a relatively wealthy country, with a strong GDP per capita, which is forecast to exceed \$60,000 in 2008. Electricity demand growth (excluding the power-intensive industry segment) is expected to continue at 1.0%-1.5% per year.

Nevertheless, Landsvirkjun's market is weaker than the European utility industry average because it is small and the economy's industry structure is concentrated in only a few sectors, including marine products, aluminum, and tourism. This concentration has resulted in strong, but volatile, economic growth. Over the last cycle between 2003 and 2007, the peak and trough of GDP growth rates differed by nearly nine percentage points. According to Standard & Poor's, growth in Iceland will remain more volatile than in other rich European economies (please refer to the full analysis titled "Iceland (Republic of)," published May 8, 2008, on RatingsDirect).

Landsvirkjun is exposed to customer concentration. Sales to four aluminum smelters provide 65%-70% of revenues, following the commission of the new Alcoa Inc. (BBB+/Stable/A-2) smelter in June 2007.

**Operations: Strong profile underpinned by modern asset base**

Landsvirkjun has a strong operational profile, underpinned by its modern power plant and transmission assets. The company is the dominant electricity producer in Iceland and operates 11 hydroelectric power plants and two geothermal plants, backed up by two fossil-fuel reserve plants. Total installed capacity increased by 690 megawatts (MW) in 2007 to 1,902 MW, following completion of the Kárahnjúkar hydropower plant.

Work on the Kárahnjúkar project, which began in 2003, is largely complete and expected to conclude in 2009. The electricity generation takes place in the Fljótsdalur station, which supplies power to the Alcoa aluminum smelter. Further expansion could be carried out, but we expect future projects to be smaller than Kárahnjúkar. They would also depend on the growth of power-intensive industries in Iceland and Landsvirkjun's role in that process. Landsvirkjun has, for instance, signed declarations of intent or energy supply contracts with companies planning high-tech data centers in Iceland and manufacturers of aluminum foil or pure silicon for solar cells. Landsvirkjun may also extend its power sales to existing customers if they decide to expand their aluminum production operations.

**Competitive position/Profitability: Strong competitive position but profitability historically weak**

Landsvirkjun has a dominant position in the isolated Icelandic market, and only a total restructuring of the company could change this. The possibility that other suppliers will have a greater role in providing electricity to further power-intensive industry projects could reduce Landsvirkjun's market share over time. This could, however, be balanced by the resulting relief on the company's financial position.

Despite Landsvirkjun's dominant position, profitability has historically been weak, mainly owing to the company's commodity price exposure and the negative effect of the Icelandic krona's depreciation. Results have also been burdened by high asset depreciation charges and high interest costs due to high interest rates and increasing debt levels.

However, according to Landsvirkjun, the outlook for 2008 is positive. Landsvirkjun expects the Kárahnjúkar power plant to generate an annual pretax profit of Icelandic krona (ISK) 4.22 billion (about \$59 million), on average, at 2008 price levels (which compares with a total reported pretax profit of ISK38.9 billion in 2007). Nevertheless, the company also expects exchange rate developments and adjustments to the fair-value price of embedded derivatives to determine 2008 performance. Landsvirkjun defines the part of the power sales contracts that is linked to aluminum prices as embedded derivatives. For this reason, the fair value of embedded derivatives in power sales contracts alters concurrently with changes in aluminum prices, with changes to the fair value of the agreements entering into the company's profit and loss account.

Landsvirkjun reported substantial foreign exchange gains on the company's debt portfolio in 2007 as the krona strengthened during the year. Positive fair-value changes to embedded derivatives in electricity supply contracts also boosted reported net income. However, these gains are for the most part unrealized and excluded from our profitability measures.

The volatility in reported foreign exchange gains and losses should decrease because Landsvirkjun has reported in U.S. dollars since Jan. 1, 2008. However, U.S. dollar denominated revenues come predominantly from supply contracts with large aluminum producers, and part of the company's operating income is therefore based on the development of aluminum prices in the world market, exposing the company to a substantial commodity price risk.

## Financial Risk Profile: Aggressive, Owing To Sizable Debt-Financed Expansion Of Power Generation Capacity

Landsvirkjun's aggressive financial risk profile reflects its high leverage, weak debt protection ratios, and negative free operating cash flows. This is a result of the company's sizable debt-financed expansion of its power generation capacity, including the \$1.1 billion Kárahnjúkar hydropower plant project.

### Accounting

Landsvirkjun has changed accounting standards and prepared its 2007 annual accounts (and comparative 2006 accounts) in accordance with International Financial Reporting Standards (IFRS). Electricity companies in Iceland became taxable as of Jan. 1, 2006, and Landsvirkjun reported a tax expense for the first time in 2007. The decision to adopt the U.S. dollar as the functional and reporting currency from Jan. 1, 2008, is in line with Landsvirkjun's activities and strategy as about 65%-70% of revenues are U.S. dollar denominated in 2008 and the company aims to increase the proportion of U.S. dollar denominated debt to about 70% of its portfolio.

Standard & Poor's makes adjustments to Landsvirkjun's reported income, balance sheet, and cash flow statement (see table 1). The company capitalizes part of the interest expenses incurred (ISK4.31 billion) during the recent construction period, which we add back to Landsvirkjun's interest expense. We include ISK2.77 billion in accrued interest and ISK3.47 billion in bills of exchange to adjusted debt, to which we also add Landsvirkjun's posttax postretirement benefit obligations of ISK1.75 billion.

Table 1

Reconciliation Of Landsvirkjun Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. ISK)*						
--Fiscal year ended Dec. 31, 2007--						
Landsvirkjun reported amounts						
	Debt	Shareholders' equity	Operating income (after D&A)	Interest expense	Cash flow from operations	Capital expenditures
Reported	191,151.1	97,444.5	11,226.0	5,716.2	8,588.4	39,852.5
Standard & Poor's adjustments						
Postretirement benefit obligations	1,750.5	--	--	--	--	--
Capitalized interest	--	--	--	4,305.0	(4,305.0)	(4,305.0)
Reclassification of nonoperating income (expenses)	--	--	385.1	--	--	--
Minority interests	--	1,764.5	--	--	--	--
Other	6,231.0	--	--	--	--	--
Total adjustments	7,981.5	1,764.5	385.1	4,305.0	(4,305.0)	(4,305.0)
Standard & Poor's adjusted amounts						
	Debt	Equity	EBIT	Interest expense	Cash flow from operations	Capital expenditures
Adjusted	199,132.6	99,209.0	11,611.0	10,021.2	4,283.4	35,547.5

\*Please note that two reported amounts (operating income before D&A and cash flow from operations) are used to derive more than one Standard & Poor's-adjusted amount (operating income before D&A and EBITDA, and cash flow from operations and funds from operations, respectively). Consequently, the first section in some tables may feature duplicate descriptions and amounts. ISK--Icelandic krona.

### Corporate governance/Risk tolerance/Financial policies

A substantial part of the company's funding is unhedged foreign currency loans. At the end of June 2008, 39% and 41% of Landsvirkjun's debt portfolio were denominated in euros and U.S. dollars, respectively. However, as mentioned above, the company is systematically increasing the proportion of U.S. dollar denominated debt. Landsvirkjun aims to have access to liquid funds at short notice covering requirements for six months. At the end of 2007, the company had ISK11 billion in cash and access to ISK22 billion in bank loans (\$350 million in undrawn credit facilities)--enough to cover 12 months of funding needs.

### Cash flow adequacy

Cash flows, which are unaffected by unrealized foreign exchange gains and losses, and unrealized changes to the fair value of derivatives are better indicators than earnings or profitability of Landsvirkjun's ability to fund its operations and service its debt obligations. Underlying debt protection ratios are historically weak, however, reflecting the company's significant debt-financed investments in recent years. Debt to EBITDA increased to 12.2x in 2007, from 11.8x in 2006.

That said, the investment program is largely complete, and internally generated cash flows should improve because the new power plant began to generate earnings in 2007. Hence, we expect Landsvirkjun's cash flow coverage of debt to strengthen over the 2008-2010 period. This assumes that new construction or power plant projects are of moderate size. Nevertheless, Landsvirkjun's marginal level of cash flow coverage of debt underlines the importance of sovereign support for the ratings on Landsvirkjun.

## Capital structure/Asset protection

Landsvirkjun's gross adjusted debt increased by about ISK25 billion in 2007 to nearly ISK200 billion by the end of the year. Adopting IFRS accounting resulted in an additional ISK8.1 billion in equity and a debt leverage ratio of 67% in 2007, down from 71% in 2006. The increase in equity was mainly due to the recognition of derivatives and embedded derivatives at fair value, which resulted in an increase of equity of ISK10.8 billion, and total effect on income tax, resulting in a decrease in equity of ISK2.9 billion. Other items affecting equity included the accounting of shares in associated companies and subsidiaries and depreciation methods for operating assets.

Landsvirkjun has a \$2.5 billion euro medium-term note program in place, under which it issued four bonds in 2007. In May, the company issued bonds equivalent to €160 million (\$240 million) and \$75 million with 10-year maturities, and in December, bonds amounting to \$75 million for a seven-year term. Landsvirkjun's debt duration is adequate, at more than five years on average, and maturity concentration is low. Landsvirkjun's debt maturing over the next five years is evenly spread and amounts to \$846 million (at June 30, 2008), of which \$57 million is due in 2008. The rest of the company's debt portfolio, \$2.33 billion, is fairly evenly spread between 2013 and 2028, with a peak in 2020. At the end of 2007, the proportion of loans with variable interest was 76%, up from 73% in 2006, but the company has agreements on interest-rate swaps, mainly to fix interest rates over the long term. The average nominal interest on long-term loans was approximately 4.7% in 2007, slightly up from 4.6% in the previous year.

**Table 2**

Landsvirkjun Financial Summary*					
--Fiscal year ended Dec. 31--					
(Mil. ISK)†	2007		2006		2005
	AA/Negative/A-1+	AA/Negative/A-1+	AA+/Negative/A-1+		
Rating history§	AA/Negative/A-1+	AA/Negative/A-1+	AA+/Negative/A-1+		
Revenues	22,446.9	20,303.5	15,374.3		
Operating income (after D&A)	11,226.0	10,154.0	4,734.7		
Net income from continuing operations	28,752.9	11,060.5	6,293.9		
Capital expenditures	35,547.5	39,811.4	29,517.0		
Free operating cash flow	(31,264.1)	(33,651.5)	(25,210.7)		
Cash and short-term investments	11,133.8	4,647.7	3,063.6		
Debt	199,132.6	175,404.6	116,801.9		
Equity	99,209.0	70,882.9	59,722.7		
Debt and equity	298,341.6	246,287.4	176,524.6		
EBIT interest coverage (x)	1.2	1.2	1.3		
EBITDA interest coverage (x)	1.6	1.7	2.5		
Free operating cash flow/debt (%)	(15.7)	(19.2)	(21.6)		
Debt/debt and equity (%)	66.7	71.2	66.2		
Return on common equity (%)	29.3	12.8	8.5		
Common dividend payout ratio (unadjusted) (%)	2.1	4.5	6.8		

\*Fully adjusted (including postretirement obligations). 2007 and 2006 accounts reported under International Financial Reporting Standards; 2005 accounts reported under Icelandic generally accepted accounting principles. †ISK--Icelandic krona. §Corporate credit rating at end of 12-month period.

### Ratings Detail (As Of August 15, 2008)\*

#### Landsvirkjun

Corporate Credit Rating

Foreign Currency

A/Negative/A-1



<b>Ratings Detail</b> (As Of August 15, 2008)* <b>(cont.)</b>		
<i>Local Currency</i>		AA-/Negative/A-1+
Senior Unsecured (1 Issue)		A
Senior Unsecured (1 Issue)		AA-
<b>Corporate Credit Ratings History</b>		
18-Apr-2008	<i>Foreign Currency</i>	A/Negative/A-1
01-Apr-2008		A+/Watch Neg/A-1
22-Dec-2006		A+/Negative/A-1
22-Feb-2005		AA-/Negative/A-1+
10-Feb-2005		AA-/Stable/A-1+
17-Dec-2003		A+/Positive/A-1+
18-Apr-2008	<i>Local Currency</i>	AA-/Negative/A-1+
01-Apr-2008		AA/Watch Neg/A-1+
22-Dec-2006		AA/Negative/A-1+
22-Feb-2005		AA+/Negative/A-1+
<b>Business Risk Profile</b>		<b>1 2 3 4 5 6 7 8 9 10</b>
<b>Financial Risk Profile</b>		Aggressive

\*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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