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**Research Update:**

# Iceland-Based Landsvirkjun Ratings Affirmed On Steady Fundamentals; Outlook Negative

**Primary Credit Analyst:**

Karin Erlander, London (44) 20-7176-3584; karin\_erlander@standardandpoors.com

**Secondary Credit Analyst:**

Peter Kernan, London (44) 20-7176-3618; peter\_kernan@standardandpoors.com

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## Rationale

On Dec. 4, 2007, Standard & Poor's Ratings Services affirmed the 'A+/A-1' foreign currency and 'AA/A-1+' local currency corporate credit ratings on Iceland-based electricity generation and transmission company Landsvirkjun. The outlook is negative.

The ratings on 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 (generating 75% of supplies and controlling the transmission grid); and its modern asset base. Weaknesses include customer concentration, with three customers accounting for about 65% of Landsvirkjun's revenues; exposure to foreign exchange, aluminium price and interest rate risk. The ratings are also constrained by Landsvirkjun's highly leveraged financial position, although an improvement is expected near term.

The rating on government-guaranteed debt (A+/Negative) is linked to the sovereign rating and reflects our expectations that existing and new debt will continue to benefit from government guarantee and be grandfathered if the company's status were to change. Formally, the guarantee is ultimate. That said, Standard & Poor's expects the government to provide timely financial support if needed. Our expectation is based on Landsvirkjun's strategic importance to electricity supply, its central role in the promotion of power-intensive industry, and the sovereign reputation risk if Landsvirkjun were to default.

While development of government plans to merge Landsvirkjun with two other state-owned distribution companies and to incorporate the combined group is limited, we expect the government guarantee to be abolished for new debt on incorporation.

Landsvirkjun's heavy capital expenditure program is largely complete, with investments relating to the \$1.1 billion Kárahnjúkar plant gradually decreasing over the next three years. At the same time, internally generated cash flow should improve as the hydro plant starts generating earnings.

While we expect Landsvirkjun's financial risk profile to improve, the strengthening will be marginal, with funds-from-operations-(FFO)-to-debt and FFO interest coverage expected at about 5% and 2x near-to-medium term, compared with 4.0% and 1.9x in 2006.

## Liquidity

Landsvirkjun's liquidity position is adequate. At Sept. 31, 2007, liquid assets totaled Icelandic krona (ISK) 3.9 billion, but is projected to increase to about ISK10 billion before year-end. At the same time, Landsvirkjun has

access to an undrawn committed credit facility of about \$350 million (ISK21.7 billion), maturing in 2012. This compares with short-term debt maturities of about ISK14.6 billion.

## Outlook

The negative outlook on the local and foreign currency corporate credit ratings reflects the negative outlook on the sovereign ratings as well as the expectation that government support could decrease in the longer term, which would adversely affect Landsvirkjun's credit quality and result in ratings reflecting Landsvirkjun's significantly weaker stand-alone qualities. However, this risk has diminished following the inauguration of a new government earlier this year. The ratings could also be revised downward if the company's financial structure, debt protection measures, or business profile weakens.

The negative outlook on the senior unsecured debt ratings mirrors the outlook on the sovereign ratings. This reflects our expectation that existing and new debt issued until any change occurs in the company status will continue to benefit from the government guarantee and be grandfathered if the company's status change. In the absence of 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.

## Ratings List

### Landsvirkjun

Foreign currency corporate credit rating	A+/Negative/A-1
Local currency corporate credit rating	AA/Negative/A-1+
Foreign currency senior unsecured debt*	A+/Negative

\*Guaranteed by the Republic of Iceland.

NB: This list does not include all ratings affected.

### Additional Contact:

Infrastructure Finance Ratings Europe; [InfrastructureEurope@standardandpoors.com](mailto:InfrastructureEurope@standardandpoors.com)

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Stockholm (46) 8-440-5914; or Moscow (7) 495-783-4017. Members of the media may also contact the European Press Office via e-mail on: [media\\_europe@standardandpoors.com](mailto:media_europe@standardandpoors.com).

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