STANDARD & POOR'S

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Landsvirkjun

Primary Credit Analyst:
Peter Kernan, London (44) 20-7176-3618; peter_kernan@standardandpoors.com

Secondary Credit Analysts:
Karin Erlander, London (44) 20-7176-3584; karin_erlander@standardandpoors.com
Mark Schindele, Stockholm (46) 8-440-5918; mark_schindele@standardandpoors.com

Table Of Contents

Landsvirkjun

Major Rating Factors

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

Strengths:

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

Weaknesses:

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

Rationale

The ratings on Iceland-based 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+Stable/A-1+; local currency AA/Stable/A-1+), its dominant position in the Icelandic electricity market (generating 85% of supplies and controlling the transmission grid), and its modern asset base. Weaknesses include customer concentration (three customers account for close to half of Landsvirkjun's revenues), and a highly leveraged financial risk profile. The rating on government-guaranteed debt is linked to the sovereign rating, which has a stable outlook.

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

No developments have been made regarding government plans to merge Landsvirkjun with two state-owned distribution companies and to incorporate the combined group into a joint-stock company, which would allow new investors into the company. At that point, which cannot be before 2008, we expect the government guarantee to be abolished for new debt.

The $1.1 billion Kárahnjúkar hydro plant to supply power for a new aluminum smelter, meanwhile, is on schedule for completion in the fourth quarter of 2007. Furthermore, Landsvirkjun has managed to increase margins somewhat and engage in long-term supply contacts after market opening in 2005.

Landsvirkjun's financial position is weak. FFO to debt weakened to a low 3.9% in 2006, a reflection of the heavy front-ended investment the company made in the Kárahnjúkar project ahead of cash flow generation. This marginal level of cash flow coverage of debt underlines the importance of sovereign support for Landsvirkjun's ratings.

Furthermore, a substantial part of Landsvirkjun's funding is in unhedged foreign-currency loans (of which 43% are dollar-denominated and 24% euro-denominated), although this is partially mitigated by about half of the company's sales revenues, which are denominated in U.S dollars. The dollar revenues come predominantly from supply contracts with aluminum producers and give Landsvirkjun significant exposure to aluminum prices, through the linkage of revenues to aluminum prices, a further ratings weakness.

Liquidity

The foreign and local currency short-term ratings are 'A-1' and 'A-1+', respectively. On a stand-alone basis, Landsvirkjun's liquidity position is adequate in view of its investment program. Current liquidity and operating cash flow should be adequate to cover capital expenditures and maturing debt. At the end of December 2006, liquid assets were Icelandic krona (Ikr) 4.6 billion, or about 22% of Landsvirkjun's annual revenues. At the same time, Landsvirkjun has a committed unused multicurrency revolving credit facility of about $400 million (Ikr24.5 billion), maturing 2012. Operating cash flow generation is expected to be about Ikr5 billion-Ikr6 billion annually, but exposure to foreign currency, interest rate, and aluminum price risk can cause cash flow volatility. This compares with debt maturities of about Ikr52 billion until 2011. The debt maturity profile is spread out fairly well.

Outlook

The outlook on the corporate credit rating is negative, and the outlook on the senior unsecured government-guaranteed debt is stable.

The negative outlook on the local- and foreign-currency corporate credit ratings reflects the expectation that government support is set to decrease in the longer term, which would adversely affect Landsvirkjun's credit quality and result in ratings reflecting Landsvirkjun's weaker stand-alone qualities. Key factors determining the credit quality include the company's financial structure, debt protection measures, business profile, and the prospects for incorporating ownership support other than financial guarantees.

The stable outlook on the senior unsecured debt ratings mirrors the outlooks 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 will be grandfathered if the company's status does change. 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 provides about 85% of Iceland's power generation using low marginal cost and environmentally friendly hydropower and geothermal power (94% of 2005's total production of 7,143 GWh was generated from hydropower, with the balance from geothermal). In 2005, Landsvirkjun's sales of 7,647 GWh were split between sales to general market (32%) and sales to power intensive industries (68%) and were sourced from its own production (93%) and market purchases (7%).

Its 69.4% owned subsidiary Landsnet (an independent limited company that started operation on Jan. 1, 2005, in accordance with the new Electricity Act), owns and operates the national transmission grid. Two state-owned distribution companies, Iceland State Electricity and Westfjord Power Company own the remaining Landsnet shares.

Government ownership

In January 2007, Landsvirkjun became a fully state-owned public partnership, following the Icelandic State's take over of the 50% shares owned by the municipalities of Reykjavik and Akureyri. The State Treasury directly owns 99.9% of the shares, whilst the remaining 0.1% of shares are owned by Eignarhlutir ehf, a special-purpose vehicle wholly owned by the State Treasury.

The State Treasury of Iceland and Eignarhlutir provide a guarantee of collection on all new debt issued by Landsvirkjun since the change of ownership. It also grandfathers all existing debt, which is guaranteed on a joint and several ultimate basis by the previous shareholders. Although a guarantee of collection formally only ensures payment in the event of liquidation, Standard & Poor's expects financial support to be timely, because of:

- The company's strategic importance to Iceland's electricity production and transmission;
- Its role in providing for industrial expansion in Iceland; and
- The potential negative consequences for the sovereign's position in the financial markets if Landsvirkjun were to default.

In the medium-term, the government plans to merge Landsvirkjun with Iceland State Electricity and Westfjord Power Company (the two other Landsnet owners), which would improve its vertical integration and could strengthen Landsvirkjun's business profile by increasing the share of earnings from non-competitively exposed networks and proportionately reducing the companies commodity exposure. The government potentially could incorporate the combined group into a joint-stock company, which would allow new investors into the company. At that point, we expect the government guarantee to be abolished for new debt. Any privatization of Landsvirkjun and removal of the state guarantee for new debt issues would have an adverse effect on Landsvirkjun's corporate credit rating and on the ratings for any non-guaranteed debt. The ultimate impact on the ratings would depend on whether the State would retain a significant stake in the company, and our view of actual or implied support that could be imputed to the then (i.e. at the time any change in the States ownership would be implemented) stand-alone ratings.

Business Risk Profile

Strategy

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 whole of Iceland.

Regulation

Market liberalization and restructuring are expected to have limited impact. Landsvirkjun sells electricity in a fully deregulated market. However, a large amount of its power contracts are long-term contracts, which provide some revenue security over the contract period. Iceland's electricity prices are low by international standards, and there is no generation overcapacity that could put pressure on prices. In addition, given Iceland's small market, its geographical isolation, and no cross-border interconnection capacity, the threat of competition from nondomestic new entrants is deemed very limited. Landsvirkjun has increased market share somewhat following the introduction of competition for 100 kilowatt customers in 2005, and has entered into several long-term supply contracts. The introduction of full competition in 2007 has not posed a threat to Landsvirkjun, and its industrial sales under long-term contracts will be unaffected by competition.

Landsvirkjun's transmission and system operations have been transferred to a separate subsidiary, Landsnet, with separate management. An independent regulator supervises these activities under a revenue cap regime to encourage efficiency improvements, which are expected mainly at the distribution company level.

Markets

Landsvirkjun's market is weaker than the European utility industry average, because it is small, and the economy's industry structure is concentrated on only a few sectors, including marine products, aluminum, and tourism. This concentration leads to strong, but volatile, economic growth, as demonstrated by the current period of stagnation that follows a 2003-2005 boom. Investments in energy-intensive industrial projects are expected to improve the diversification and productivity of the Icelandic economy, however. According to Standard & Poor's (see Summary: Iceland (Republic of), published on RatingsDirect May 24, 2007) the Icelandic economy is likely to stagnate in 2007, but recover gradually to an annual growth rate of about 3% by 2010. Iceland is expected to enter this weakening with a low general government debt burden of 23% of GDP in 2007, one-half the level of five years earlier. The possibility of a significant economic contraction remains real, however.

Iceland is a relatively wealthy country, with a strong GDP per capita (forecast to reach $50,000 in 2006). Electricity demand growth (excluding the power-intensive industry segment) is expected to continue at 1.0%-1.5% per year.

Landsvirkjun is exposed to customer concentration, with sales to three aluminum smelters providing about 50% of 2006 revenues. This figure is expected to increase to more than 65% after the new Alcoa Inc. (BBB+/Watch Neg/A-2) smelter is operational later this year. Furthermore, industrial power agreements are long-term (20-40 years) take-or-pay contracts, and tariffs (which are denominated in U.S. dollars) may fluctuate with the price of aluminum or other commodities.

Operations

Landsvirkjun has a strong operational profile, underpinned by its modern hydroelectric power plant and transmission asset portfolio. The company is by far the dominant electricity producer in Iceland and operates 12 hydroelectric power plants and two geothermal plants, backed up by two fossil-fuel reserve plants. Total installed capacity stands at 1,212 MW, which will increase by 690 MW on the completion of the Kárahnjúkar hydro project, which is expected by fourth-quarter 2007. Landsvirkjun is exposed to precipitation risk, but it can handle capacity shortages by reducing 20% of nonguaranteed and interruptible electricity sales.

Landsvirkjun's traditional role to support the expansion of power-intensive industry continues with the $1.1 billion Kárahnjúkar hydro project. The reservoir-based and glacial-fed hydropower plant in eastern Iceland will supply a new 322,000-ton aluminum plant, owned by an Alcoa subsidiary. Completion risk, which lies with Landsvirkjun, was significant, given this is the largest project ever known in Icelandic power development. The majority of the major engineering work was completed, however, at the end of 2006 and first power was produced in April 2007. Completion is scheduled for end-2007. Smelter-completion and project-abandonment risk with Alcoa.

Further expansion projects could be carried out by the company, but this will depend on growth of power-intensive industry in Iceland, and on what role Landsvirkjun has in that process. Standard & Poor's understands that while there are unexploited hydro and geothermal resources, any additional expansion would be smaller than the Kárahnjúkar project, although it could involve more plant sites.

Competitive position/Profitability

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, however, by the resulting relief on the company's financial position.

Despite its dominant position, Landsvirkjun's profitability has historically been weak, mainly owing to the company's commodity price exposure, the negative impact of the Icelandic krona's depreciation and increasing debt. Results also are burdened by high asset depreciation charges and interest costs. High exchange rate losses and hedging expenses totaling Ikr23.1 billion further contributed to a weakening of Landsvirkjun's results in 2006.

Financial Risk Profile

Accounting

Landsvirkjun prepares its accounts in Icelandic krona, in compliance with the provisions of the Financial Reporting Act. The financial statements are prepared based on the historical cost convention of accounting. The company has capitalized part of the interest expenses during the current construction period, and this is added back by Standard & Poor's in its analysis. In addition, Standard & Poor's adds Landsvirkjun's post-tax postretirement benefit obligations of Ikr1.8 billion to its calculation of adjusted debt.

Financial policies

Landsvirkjun's leverage is high because of its debt-financed investments. A substantial part of the company's funding is unhedged foreign currency loans, owing to the small domestic capital market and the lack of an Icelandic krona swap market. The financial objectives set by the owners include a 4%-5% real return on equity and a dividend payment range related to the ratio of pre-interest cash flow to liabilities. The electricity sector's tax-exempt status was abolished on Jan. 1, 2006, but Landsvirkjun is not expected to pay any taxes in the medium term, given its significant tax-deductible depreciation base.

Cash flow adequacy

Cash flows, which are unaffected by unrealized foreign exchange losses and historic inflation adjustments, are better indicators of Landsvirkjun's financial position than profitability. Underlying cash flow debt protection is historically weak, a reflection of the company's significant debt-financed investments. FFO interest coverage weakened further in 2006 – to 1.9x from 2.5x in 2005 – reflecting the debt funding of the Kárahnjúkar hydro project, which has not yet made any earning contribution. FFO to adjusted debt fell to a marginal 4.1%.

Cash flow protection measures should strengthen following the completion of Landsvirkjun's current expansion project (expected at the end of 2007), as ongoing capital expenditure requirements thereafter are expected to be low. Net cash flow to capital expenditures was a low 16% in 2006, while a recovery to more than 100% is expected in 2008.

Capital structure/Asset protection

Landsvirkjun's capital structure is weak, given the high debt levels, significant interest, and foreign currency exposure. In fact, 2006 was Landsvirkjun's largest funding year ever, owing to both peak activities in the Kárahnjúkar hydro project and some refinancing. Total (pre-adjusted) debt rose by Ikr55.7 billion year on year. With Ikr163.7 billion long-term liabilities outstanding at the end of December 2006, the debt leverage ratio was a high 73%, although Standard & Poor's does not a significant increase above this level.

The debt duration is adequate, at more than five years on average and maturity concentration is low, with a peak at 10% in 2008. Only about 18% of debt is denominated in Icelandic krona, while about 45% is in U.S. dollars and 25% in euro, with the remainder in Swiss francs, British pounds and Japanese yen. This foreign currency exposure is mitigated by the denomination of about 50% of revenues in dollars via sales to the metallurgy industry and by the use of currency swaps. At the same time, sales to the metallurgy industry provide less revenue stability, as tariffs are linked to volatile world market aluminum prices. Landsvirkjun is actively hedging up to 40% of the downside risk in aluminum price-linked revenues and is targeting a 50% hedge over the longer term. Interest rate exposure is also high, with about 50% of debt having floating interest, but the company has agreements on interest-rate swaps, mainly to fix interest over the long-term.

Landsvirkjun's stand-alone financial flexibility is weak, as it is a small company and is largely obliged to resort to the international capital markets. The company has a US$2.0 billion EMTN program in place to help with this issuance. In the past dividends have been tied to the ratio of pre-interest cash flow to liabilities rather than to net income, but this is expected to become more restrictive over the forecast period. Investment projects are generally non-deferrable. This is mitigated by the guarantee of collection provided by the State Treasury.

Table 1

Landsvirkjun--Financial Summary*

Industry Sector: Utilities

	--Fiscal year ended Dec. 31--		
	2006	**2005**	**2004**
Rating history	AA/Negative/A-1+	AA+/Negative/A-1+	AA+/Stable/A-1+
(Mil. Irk)			
Revenues	20,303.5	15,374.3	13,542.6
Net income from cont. oper.	3,503.5	6,293.9	7,195.3
Funds from oper. (FFO)	6,986.9	5,055.3	3,646.8
Capital expenditures	39,811.4	29,517.0	19,761.0
Debt	172,321.4	116,801.9	99,806.4
Common equity	61,106.7	58,002.6	51,376.9
Adjusted ratios			
Oper. income/sales (bef. D&A) (%)	73.5	62.7	66.5
EBIT interest coverage (x)	1.6	1.3	1.0
EBITDA interest coverage (x)	2.3	2.5	2.3
Return on capital (%)	5.0	3.1	2.5
FFO/debt (%)	4.1	4.3	3.7
Debt/EBITDA (x)	11.5	12.1	11.1

*Fully adjusted (including postretirement obligations). N.M.--Not Meaningful.

Table 2

Landsvirkjun's Operating Statistics	2006	2005	2004	2003	2002	2001	2000
Total capacity (MW)	1212	1212	1,212	1,212	1,212	1,202	1,122
Generation (GWh)	7,428	7,143	7,260	7,245	7,193	6,838	6,579
Hydro (%)	93	93	96	96	96	93	94
Other (%)	7	7	4	4	4	7	6
Employees	249	277	375	362	379	372	362
Output per regular employee (GWh)	34.5	31.2	25.3	24.4	24.7	18.6	18.2

Table 3

Reconciliation Of Landsvirkjun Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. Irk)*

	--Fiscal year ended Dec. 31, 2006--						
Landsvirkjun reported amounts							
	Debt	**Shareholders' equity**	**Operating income (after D&A)**	**Interest expense**	**Cash flow from operations**	**Cash flow from operations**	**Capital expenditures**
Reported	170,533.4	61,106.7	9,789.1	3,585.0	9,642.9	9,642.9	42,752.4
Standard & Poor's adjustments							
Postretirement benefit obligations	1,788.0	--	--	--	--	--	--
Capitalized interest	--	--	--	2,941.0	(2,941.0)	(2,941.0)	(2,941.0)
Reclassification of nonoperating income (expenses)	--	--	453.1	--	--	--	--
Reclassification of working-capital cash flow changes	--	--	--	--	--	285.0	--
Minority Interest	--	1,668.4	--	--	--	--	--
Total adjustments	1,788.0	1,668.4	453.1	2,941.0	(2,941.0)	(2,656.0)	(2,941.0)
Standard & Poor's adjusted amounts							
	Debt	**Equity**	**EBIT**	**Interest expense**	**Cash flow from operations**	**Funds from operations**	**Capital expenditures**
Adjusted	172,321.4	62,775.1	10,242.2	6,526.0	6,701.9	6,986.9	39,811.4

*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.

Ratings Detail (As Of July 10, 2007)*	
Landsvirkjun	
Corporate Credit Rating	
Foreign Currency	A+/Negative/A-1
Local Currency	AA/Negative/A-1+
Senior Unsecured	
Foreign Currency	A+
Local Currency	AA

Ratings Detail (As Of July 10, 2007)***(cont.)**		
Corporate Credit Ratings History		
22-Dec-2006	*Foreign Currency*	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+
20-Nov-2002		A+/Stable/A-1+
22-Dec-2006	*Local Currency*	AA/Negative/A-1+
22-Feb-2005		AA+/Negative/A-1+
20-Nov-2002		AA+/Stable/A-1+
Business Risk Profile		1 2 3 4 5 $\boxed{6}$ 7 8 9 10
Financial Risk Profile		Aggressive
Debt Maturities		
2007 Ikr6.8 bil. 2008 Ikr17.6 bil. 2009 Ikr1.7 bil. 2010 Ikr10.7 bil. 2011 Ikr15.2 bil. 2012+ Ikr118.4 bil.		

*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.

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