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**Summary:**  
**Landsvirkjun**

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## Summary:

# Landsvirkjun

	Local Currency	Foreign Currency
<b>Credit Rating:</b>	BBB+/Negative/A-2	BBB/Negative/A-3

## Rationale

The ratings on Iceland-based electricity generation 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 BBB/Negative/A-3; local currency BBB+/Negative/A-2); its dominant position in the Icelandic electricity market (accounting for about 75% of generated power); control of the transmission grid; and its modern asset base. Weaknesses include customer concentration (four customers account for 75%-80% of Landsvirkjun's revenues); exposure to aluminum prices, which are inherently volatile; and an aggressive financial risk profile.

The long-term, take-or-pay contracts with aluminum smelters are linked to the aluminum price. Although the long-term nature of the contracts provides security, currently falling aluminum prices is a risk factor, which Landsvirkjun actively hedges against.

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 ratings 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. Although privatization 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, the investment program is largely complete and the new power plant began to generate earnings last year. Also, due to the market turmoil and the global banking crisis, Landsvirkjun has not committed to any new projects and has postponed plans to invest in renewable power projects internationally. The company aims to complete the Budarhals hydropower plant but only if secured funding is in place beforehand.

In combination, these factors should ensure a gradual increase of revenues and EBITDA as well as substantially lower capital expenditures in the near to medium term. 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. Adjusted funds from operations (FFO) interest coverage and FFO to debt deteriorated to 0.9x and 2.7% in 2007, respectively, from 1.1x and 3.8% in 2006. Landsvirkjun's marginal level of cash flow coverage of debt underlines the importance of sovereign support for the ratings on Landsvirkjun.

## Liquidity

Landsvirkjun's liquidity position is adequate. At Sept. 30, 2008, Landsvirkjun had \$105 million in cash and \$350 million available under a \$400 million credit facility, expiring in July 2012, compared with short-term debt of \$194 million.

The credit facility is provided by 16 banks and financial institutions, including three Icelandic banks. Given the problems currently facing the Icelandic banking sector, the Icelandic banks' participation is uncertain. However, Landsvirkjun has access to about \$290 million under the facility if the Icelandic banks fail to honor their commitments.

We expect Landsvirkjun's free operating cash flow after dividends to be negative in 2008, due to some final costs for the hydropower plant, but only marginally negative in 2009. From 2010, we expect the company's cash flow from operations to comfortably cover capital expenditures and dividends. This reflects that Landsvirkjun has largely completed the hydropower project, has not committed to any new projects, and has postponed plans for international projects.

## Outlook

The negative outlook on the local and foreign currency corporate credit ratings on Landsvirkjun reflects the negative outlook on the sovereign ratings. Given that incorporation appears unlikely in the near to medium term, we expect the ratings and outlook on Landsvirkjun to reflect those on the sovereign.

The negative outlook on the senior unsecured debt ratings mirrors the negative outlook 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.

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