

February 10, 2005

Research Update: Iceland Electric Co. Landsvirkjun LT Foreign Currency Rating Raised to 'AA-'; Outlook Stable

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	Local Currency	Foreign Currency
Credit Rating:	AA+/Stable/A-1+	AA-/Stable/A-1+

Rationale

On Feb. 10, 2005, Standard & Poor's Ratings Services raised its foreign currency long-term corporate credit rating on Iceland-based electricity generation and transmission company Landsvirkjun to 'AA-' from 'A+'. At the same time, Standard & Poor's affirmed its 'AA+' long-term local currency corporate credit rating and its 'A-1+' short-term foreign and local currency corporate credit ratings on the company. The outlook is stable.

The rating action followed a similar rating action on the Republic of Iceland (foreign currency AA-/Stable/A-1+, local currency AA+/Stable/A-1+); see "Republic of Iceland LT FC Rating Raised To 'AA-' On Better Financial Stability; Outlook Stable", published today on RatingsDirect, Standard & Poor's Web-based credit analysis system.

The credit ratings on Landsvirkjun reflect the joint and several ultimate guarantee for all its obligations provided by the utility's owners, which include the Republic of Iceland. The ratings also reflect the utility's dominant position in the Icelandic electricity market, and its modern asset base. These factors offset the utility's weaknesses such as customer concentration, significant exposure to foreign exchange rates and aluminum prices, and a weak financial profile.

The government can be expected to provide timely financial support if needed, although it only provides a guarantee of collection, which formally only ensures payment in the event of liquidation. Such support would be expected in view of Landsvirkjun's strategic importance to Iceland's electricity supply, its role in supporting the country's industrial expansion, and the potential negative consequences for the sovereign's position in the financial markets if Landsvirkjun were to default. On a stand-alone basis, Landsvirkjun's credit quality is noninvestment grade, owing to further financial weakening and the construction risks that result from its expansion projects.

Landsvirkjun generates about 86% of all electricity produced in Iceland. The company also owns and operates the country's main power grid via a subsidiary. Landvirkjun is strategically important because it makes the large investments in new generation capacity required to support the expansion of power-intensive industries. This also leads to significant customer concentration, with three customers accounting for about 45% of Landsvirkjun's revenues. Current expansion projects include the \$1.1 billion Kárahnjúkar generation plant to supply a new aluminum smelter,

with completion expected in 2007.

Standard & Poor's does not expect any intense competition resulting from the market opening starting in 2005 because there is no overcapacity in this small, isolated, and concentrated market.

Landsvirkjun's financial position is weak. Funds from operations (FFO) interest coverage could decrease to less than 1.5x in the medium term from 2.8x in 2003, possibly temporarily dipping as low as 1.0x, because large debt-funded investments will be undertaken for power projects, while revenues from these projects will be generated in 2007 at the earliest. FFO to debt was a low 7% in 2003, and could weaken toward a marginal level at the peak of the investment phase. Furthermore, a substantial part of Landsvirkjun's funding is in unhedged foreign-currency loans, although this is mitigated by 45% of sales revenues being denominated in foreign currency. About 40% of revenues are exposed to aluminum prices.

Liquidity.

Landsvirkjun's stand-alone liquidity position is adequate considering its investment program. Current liquidity and operating cash flow should be adequate to cover capital expenditure and maturing debt until the end of 2005. At June 30, 2004, liquid assets were equivalent to \$140 million, or about 80% of Landsvirkjun's annual revenues. At the same time, Landsvirkjun had a committed unused revolving credit facility of \$400 million maturing in 2008. Operating cash flow generation is expected to be about Icelandic krona (Ikr) 4 billion annually, but exposure to foreign-currency, interest-rate, and aluminum-price risks can cause cash flow volatility. This compares with about \$870 million in remaining committed investments in the Kárahnjúkar project, and maturities of about \$250 million until 2007. The debt maturity profile is fairly well spread out.

Outlook

The stable outlook reflects the outlook on the sovereign ratings, because Standard & Poor's expects government support to continue given the strategic importance of Landsvirkjun to Iceland's economic development. This is underlined by the government's decision to invest in the Kárahnjúkar project. Sector deregulation and restructuring appears to have limited negative or neutral credit implications.

The ratings are expected to move with those on the sovereign in the absence of any privatization, abolition of guarantee status, or any signs of reduced willingness or ability to provide timely support if needed. A significant reduction in the sovereign ratings would be likely to impair the government's ability to provide support, increasing the negative pressure on Landsvirkjun's rating. Existing guaranteed debt is expected to be grandfathered in the event of any change to the company's status.

Ratings List

To	From
Landsvirkjun	

Research Update: Iceland Electric Co. Landsvirkjun LT Foreign Currency Rating Raised to 'AA-'; Outlook Stable

Foreign currency corporate credit rating

AA-/Stable/A-1+ A+/Positive/A-1+

Local currency corporate credit rating

AA+/Stable/A-1+ AA+/Stable/A-1+

NB: This list does not include all ratings affected.

Ratings information is available to subscribers of RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. It can also be found on Standard & Poor's public Web site at www.standardandpoors.com; under Credit Ratings in the left navigation bar, select Find a Rating, then Credit Ratings Search. Alternatively, call one of the following Standard & Poor's numbers: London Ratings Desk (44) 20-7176-7400; London Press Office Hotline (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5916; or Moscow (7) 095-783-4017. Members of the media may also contact the European Press Office via e-mail on: media_europe@standardandpoors.com.

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