

December 22, 2006

## Research Update:

# Iceland's Landsvirkjun Cut To F-C 'A+/A-1', L-C 'AA/A-1+' On Sovereign News; Outlook Negative

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## Research Update:

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## Rationale

On Dec. 22, 2006, Standard & Poor's Ratings Services lowered its foreign currency long- and short-term corporate credit ratings on Iceland-based electricity generation and transmission company Landsvirkjun to 'A+/A-1' from 'AA-/A-1+'. At the same time, the long-term local currency corporate credit rating on Landsvirkjun was lowered to 'AA' from 'AA+', and the short-term local currency rating was affirmed at 'A-1+'. The outlook is negative.

In addition, Standard & Poor's lowered its foreign currency and local currency senior unsecured debt ratings on Landsvirkjun to 'A+' and 'AA', respectively, with a stable outlook on the foreign currency debt.

The rating actions follow the downgrade of the Republic of Iceland (foreign currency A+/Stable/A-1, local currency AA/Stable/A-1+). (See related article titled "Republic of Iceland Cut To FC 'A+/A-1', LC 'AA/A-1+' On Unbalanced Policy Mix; Outlook Stable," published today on RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis.)

The negative outlook on the local currency and foreign currency corporate credit ratings reflects the prospect of an incorporation and privatization of the company in the longer term that will likely result in the abolition of Landsvirkjun's government guarantee status.

The stable outlook on existing liabilities mirrors the outlook on the sovereign ratings. Standard & Poor's expects that new and existing debt will continue to benefit from the government guarantee and will be grandfathered in the event of any change in Landsvirkjun's status.

The ratings on Landsvirkjun reflect the joint and several ultimate guarantee for all Landsvirkjun's obligations provided by the utility's owners, including the Republic of Iceland; its dominant position in the Icelandic electricity market (generating 86% of supplies and to a large extent, controlling the transmission grid); and its modern asset base. Weaknesses include customer concentration (three customers account for about 45% of Landsvirkjun's revenues), and a highly leveraged financial risk profile.

As of Jan. 1, 2007, the Republic of Iceland will acquire the combined 50% stake in Landsvirkjun held by the Cities of Reykjavik and Akureyri, raising its stake to 99.99%. (The remaining 0.01% will be acquired by Eignarhlutar hf, a special purpose vehicle wholly owned by the Republic.) Following the acquisition, all existing debt will be grandfathered by the owners, while the Republic of Iceland will guarantee all new debt.

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 and

promotion of power-intensive industry, and the sovereign reputation risk if Landsvirkjun was to default.

There has been no development concerning government plans to merge Landsvirkjun with two state-owned distribution companies, and ultimately (after 2008) incorporate the combined group into a joint-stock company, a move which will allow new investors into the company. At that point, Standard & Poor's Ratings Services expects the government guarantee to be abolished for new debt.

The \$1.1 billion Kárahnjúkar generation plant to supply power for a new aluminum smelter, meanwhile, is on schedule for completion in 2007. Furthermore, Landsvirkjun has managed to increase margins somewhat and engage in long-term supply contracts after market opening starting in 2005.

Landsvirkjun's financial position is weak. FFO to debt was a low 4.4% in 2005. It could weaken toward a marginal level at the peak of the current investment phase, before the project start generate cash flow in 2007 at the earliest. Moreover, 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 50% of sales revenues being denominated in U.S. dollars. About 50% of revenues are exposed to aluminum prices.

### **Short-term credit factors**

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 end-December 2006, liquid assets were equivalent to about \$72 million, or about 30% of Landsvirkjun's annual revenues. At the same time, Landsvirkjun had a committed unused revolving credit facility of \$350 million, maturing 2012. Operating cash flow generation is expected to be about Icelandic krona (Ikr) 5 billion to Ikr6 billion (about \$80 million) annually, but exposure to foreign-currency, interest-rate, and aluminum-price risks can cause cash flow volatility. This compares with about \$800 million in remaining committed investments in the Kárahnjúkar project, and debt maturities of about \$340 million until 2007. The debt maturity profile is fairly well spread out.

## **Outlook**

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 and result in a rating reflecting Landsvirkjun's weaker stand-alone qualities. Key factors determining credit quality include the company's financial structure and debt protection measures, its business profile, and the prospects for incorporating any ownership support other than financial guarantees.

The stable 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 in the company status will continue to benefit from the government guarantee and be grandfathered in the event of any change to the company's status. 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.

## Ratings List

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

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Ratings information is available to subscribers of RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis, at [www.ratingsdirect.com](http://www.ratingsdirect.com). It can also be found on Standard & Poor's public Web site at [www.standardandpoors.com](http://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: Client Support Europe (44) 20-7176-7176; London Press Office Hotline (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; 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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