

## Landsvirkjun

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# Landsvirkjun

## Major Rating Factors

### Strengths:

- A "very high" likelihood of timely and sufficient extraordinary support from Landsvirkjun's owners, the Republic of Iceland, in case of financial distress.
- Dominant position in the Icelandic electricity market as the largest generator and monopoly transmission system operator.

### Weaknesses:

- Highly leveraged financial risk profile owing to sizable debt-financed expansion of power generation capacity in recent years.
- Customer concentration in the small and isolated Icelandic power market.
- Exposure to aluminum prices for revenues.

### Corporate Credit Rating

BB+/Negative/B-1

## Rationale

The 'BB+' rating on Iceland-based electricity generation and transmission company Landsvirkjun is based on the company's stand-alone credit profile (SACP), which we assess as 'b+', as well as on Standard & Poor's Ratings Services' opinion that there is a "very high" likelihood that the government of the Republic of Iceland (foreign currency BBB-/Negative/A-3; local currency BBB/Negative/A-2) would provide timely and sufficient extraordinary support to Landsvirkjun in the event of financial distress.

In accordance with our criteria for government-related entities (GREs), our view of a "very high" likelihood of extraordinary government support is based on our assessment of Landsvirkjun's:

- "Very important" role for the Icelandic government, given Landsvirkjun's dominant position as the incumbent power company and 64.7% owner and monopoly system operator of the national transmission grid; Landsvirkjun's strategic importance to the Icelandic economy; and its central role in the promotion of power-intensive industries.
- "Very strong" link with the Icelandic state, given the state's 100% ownership of Landsvirkjun and our expectation that Landsvirkjun will not be privatized in the medium term; the provision of ultimate state guarantees for all of Landsvirkjun's debt; a two-year \$300 million contingent credit facility extended to Landsvirkjun by the Central Bank of Iceland in June 2009; and the risk to the sovereign's reputation if Landsvirkjun were to default.

Landsvirkjun's SACP largely reflects our view of the company's high financial leverage and weak cash flow coverage ratios. We anticipate that the company's ratio of adjusted funds from operations (FFO) to debt will remain at just less than 10% through 2011, but will likely continue to improve gradually thereafter. The SACP also reflects Landsvirkjun's fair business risk profile, which is restricted by high customer concentration, the company's exposure to the aluminum sector for revenue and cash flow generation, and poor profitability. The company is, however, the dominant power producer in Iceland and has a modern and low-cost renewable generation asset base. We also note

that Landsvirkjun operates in line with the strategic goals for the Republic of Iceland, providing relatively low cost energy to power-intensive industries.

### **Key business and profitability developments**

Sales to power-intensive industries account for more than 80% of Landsvirkjun's total power sales. The price of aluminum typically drives the price of electricity in Landsvirkjun's power sale agreements with the aluminum plants. We understand that following the renegotiation of a contract with one of the smelters that buys power from Landsvirkjun, the price of power under this contract is now linked to the U.S. consumer price index instead of to the price of aluminum. This contract accounts for about 25% of the power that Landsvirkjun sells to power-intensive industries. We believe that the renegotiation will reduce Landsvirkjun's exposure to inherently volatile aluminum prices and should therefore improve the stability and predictability of the company's earnings.

### **Key cash flow and capital-structure developments**

Landsvirkjun's financial risk profile is highly leveraged, in our view, due to debt-funded capital investments in the \$1.1 billion Kárahnjúkar hydropower plant over recent years. The project is now complete and we understand that the company's capital expenditures (capex) will fall sharply in 2010 and mainly cover maintenance costs over the near to medium term.

Landsvirkjun reported a 35% drop in revenues and EBITDA in the financial year ended Dec. 31, 2009, compared with 2008. However, these drops were offset by positive income from the group's hedging program. Consequently, Landsvirkjun's free operating cash flow was positive in 2009. As a result, and as no dividends were paid, Landsvirkjun's adjusted debt was largely unchanged at \$3.1 billion on Dec. 31, 2009. Landsvirkjun's ratio of adjusted FFO to debt was also largely unchanged at 6.8% on the same date (6.9% at year-end 2008), while its FFO interest coverage ratio rose to 3.3x (from 1.8x). The latter largely reflects much lower interest costs in 2009 compared with 2008. This trend continued in the first half of 2010, with the adjusted FFO-to-debt ratio, on a rolling 12-month basis, increasing to 8.3% by June 30, 2010, when debt had dropped to \$2.8 billion. Given management's focus on debt reduction and liquidity management, we assume that Landsvirkjun will abstain from making large investments in the near term and expect its cash flow coverage to continue to strengthen, albeit gradually and from weak levels.

### **Liquidity**

Landsvirkjun's liquidity position has strengthened in the past few months and is adequate, in our opinion. This is due to Landsvirkjun's improved access to funding, as evidenced by successful debt issuance to redeem expiring debt obligations. Most recently, a \$100 million five-year bond was increased to \$150 million due to good demand from the investor base. We continue to believe, however, that Landsvirkjun is reliant on positive discretionary cash flow to support its debt service requirements in the medium term.

On June 30, 2010, Landsvirkjun had \$130 million in freely available cash and \$282 million available under a committed revolving credit facility that expires in December 2012, and which is free of covenants and other restrictions. Landsvirkjun also had access to a committed Icelandic krona (ISK) 3.0 billion (\$24 million) bank line until April 2013. This compares with about \$290 million of short-term debt, of which we understand \$105 million had already been repaid by the end of September 2010, with an additional \$202 million of debt due in the following 12 months. We believe that the \$300 million contingent credit facility with the Central Bank of Iceland supports Landsvirkjun's liquidity position in the near term. However, the facility expires on July 1, 2011, so use of this contingency funding would only provide short-term relief.

In our assessment of Landsvirkjun's adequate liquidity position, we assume that the company will address the replacement of the \$358 million back-up facility expiring in December 2012 in a timely manner. A failure to extend the facility in due course or a negative deviation in FFO from our base-case assumptions could put pressure on the company's liquidity profile.

## Outlook

The negative outlook reflects our opinion that a downgrade of the local currency rating on the sovereign--which currently has a negative outlook--would likely result in us lowering the CCR on Landsvirkjun. This is in line with our criteria on GREs and assumes an unchanged SACP.

In addition to what we view as a stronger business risk profile, our base-case assessment assumes that Landsvirkjun's credit metrics should gradually improve, albeit from a weak position.

We could consider taking a positive rating action if Landsvirkjun's cash flow coverage of debt and financial risk profile improve further, that is, by the company maintaining an adjusted FFO-to-debt ratio of 10% on a sustainable basis.

However, we are likely to take a negative rating action on Landsvirkjun if we downgrade the Republic of Iceland, and, at the same time, maintain Landsvirkjun's SACP at 'b+'.

## Business Description

Landsvirkjun produces about 75% of the electricity in Iceland, using low marginal cost and environmentally friendly hydropower (96%) and geothermal power (4%), and is one of the largest corporations in the country.

Landsvirkjun's subsidiary Landsnet, in which it holds a 64.73% stake, owns and operates the Icelandic transmission system.

Landsvirkjun operates 11 hydroelectric power plants and two geothermal plants, backed up by one fossil-fuel reserve plant. In addition to its own production of about 12,154 gigawatt hours (GWh) in 2009, Landsvirkjun purchased 392 GWh from Reykjavik Energy (not rated) and Hitaveita Sudurnesja (not rated). Landsvirkjun sold 83% of the produced and purchased energy to power-intensive industries, predominantly aluminum smelters, under long-term take-or-pay contracts. The remainder was sold to public utilities and distribution companies.

Landsvirkjun is a fully state-owned public partnership controlled by the Ministry of Finance. The State Treasury of Iceland directly owns 99.9% of the shares and indirectly owns the remaining 0.1% through a special-purpose vehicle, Eignarhlutir ehf.

## Government Support And GRE Methodology Impact

The 'BB+' ratings on Landsvirkjun reflect our opinion that there is a "very high" likelihood that the Republic of Iceland would provide timely and sufficient extraordinary support to Landsvirkjun in the event of financial distress. We assess Landsvirkjun's SACP at 'b+'.

In accordance with our criteria for GREs, our view of a "very high" likelihood of extraordinary timely and sufficient

government support is based on our assessment of Landsvirkjun's "very important" role and "very strong" link with the Icelandic state.

We view Landsvirkjun's role as very important to the Republic of Iceland. Not only is Landsvirkjun the dominant power company in the country, generating 75% of the power produced, and the majority owner of the national transmission grid, it is also the country's largest corporation. Landsvirkjun plays a very important role in the promotion of power-intensive industries in Iceland, which has enabled Iceland to diversify away from its dependence on maritime industries and tourism.

We assess Landsvirkjun's link to the sovereign as very strong. The state owns 100% of Landsvirkjun and we do not expect privatization in the medium term. The state provides a guarantee for the ultimate collection of Landsvirkjun's debt, together with two previous owners (the city of Reykjavik and the town of Akureyri for the debt issued before Jan. 1, 2007). However, we consider that the collection does not guarantee timely payment of Landsvirkjun's debt service obligations, and that Landsvirkjun would need to exhaust its own resources before the guarantee would apply.

We also factor into our assessment of Landsvirkjun's link to the sovereign the fact that the Central Bank of Iceland extended a two-year \$300 million contingent credit facility to Landsvirkjun in June 2009, which the company could draw on if all other funding sources were exhausted. The contingent credit facility was established to ensure that Landsvirkjun meets all of its debt obligations in a full and timely manner. At the same time, the government enhanced its surveillance of state-owned entities, including Landsvirkjun. We also consider that there is considerable reputational risk for the sovereign if Landsvirkjun were to default, as the company is inherently linked to the sovereign.

## **Business Risk Profile: Fair, Due To Lack Of Diversification In Small And Isolated Power Market**

The major constraints for Landsvirkjun's fair business risk profile are:

- A lack of diversification, given that over 80% of the power produced is sold to power-intensive industries, predominantly aluminum smelters.
- Exposure to inherently volatile commodity prices, given that about 60% of the power supply contracts with the aluminum smelters contain embedded derivatives linking the price of the power sold to the price of aluminum.

These constraints are mitigated by:

- Landsvirkjun's dominant position as the incumbent power producer in Iceland and majority owner of the transmission grid.
- The generation of about 20% of Landsvirkjun's FFO from the monopoly transmission grid in 2009.
- A modern and efficient asset base comprising low-cost renewable generation assets. Landsvirkjun operates 11 hydroelectric power plants and two geothermal plants, backed up by a small fossil-fuel reserve plant.
- Long-term pay-or-take contracts with the power-intensive industries. We consider that this should provide some predictability of earnings. We also consider that earnings will stabilize following the renegotiation of one of the contracts, which diversifies risk exposure between aluminum prices, the U.S. consumer price index, and the Norwegian consumer price index.

## Financial Risk Profile: Highly Leveraged, Due To Sizable Debt-Financed Investments

The main weaknesses of Landsvirkjun's highly leveraged financial risk profile are:

- A highly leveraged balance sheet due to heavy front-ended and debt-financed investments in power generation. Landsvirkjun's debt-to-capital ratio was 64% on June 30, 2010 (66% on Dec. 31, 2009).
- Very weak cash flow protection of debt. Landsvirkjun's FFO to debt (on a rolling 12-month basis) was 8.3% on June 30, 2010 (6.8% on Dec. 31, 2009), and we anticipate a gradual improvement in the medium term, albeit from weak levels. FFO interest coverage (on a rolling 12-month basis) was 3.5x on June 30, 2010 (3.3x).

These weaknesses are partially mitigated by:

- An improved liquidity position in recent months. In our opinion, Landsvirkjun's liquidity position is now adequate, and is no longer weighing on the rating.
- An extended maturity profile. Landsvirkjun's debt maturity profile is well spread, with debt duration of more than six years on average, and a relatively low maturity concentration.

## Financial Statistics/Adjustments

Landsvirkjun has been reporting under International Financial Reporting Standards (IFRS) since 2007, and has been using the U.S. dollar as its reporting currency since Jan. 1, 2008.

We make adjustments to Landsvirkjun's reported income, balance sheet, and cash flow statement (see table 1). We adjust reported debt to include \$21.0 million in accrued interest and post-tax postretirement benefit obligations of \$16.3 million. We also adjust Landsvirkjun's reported revenues for realized aluminum hedges related to electric power sale agreements. This adjustment added \$42.5 million to revenues in 2009 (having reduced revenues by \$54.8 million in 2008).

## Related Criteria And Research

- Methodology And Assumptions: Standard & Poor's Standardizes Liquidity Descriptors For Global Corporate Issuers, July 2, 2010
- General Criteria: Enhanced Methodology And Assumptions For Rating Government-Related Entities, June 29, 2009
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009

**Table 1**

Reconciliation Of Landsvirkjun Reported Amounts With Standard & Poor's Adjusted Amounts*							
--Fiscal year ended Dec. 31, 2009--							
Landsvirkjun reported amounts							
(Mil. \$)	Debt	Shareholders' equity	Revenues	Operating income (before D&A)	Operating income (before D&A)	Operating income (after D&A)	Cash flow from operations
Reported	3,018.1	1,541.0	295.8	229.1	229.1	114.8	197.0

Table 1

Reconciliation Of Landsvirkjun Reported Amounts With Standard & Poor's Adjusted Amounts* (cont.)							
Standard & Poor's adjustments							
Postretirement benefit obligations	16.3	--	--	--	--	--	--
Accrued interest not included in reported debt	21.0	--	--	--	--	--	--
Reclassification of nonoperating income (expenses)	--	--	--	--	--	(5.3)	--
Reclassification of working-capital cash flow changes	--	--	--	--	--	--	10.7
Minority interests	--	23.5	--	--	--	--	--
Realised aluminum hedges	--	--	42.5	42.5	42.5	42.5	--
Total adjustments	37.3	23.5	42.5	42.5	42.5	37.2	10.7
Standard & Poor's adjusted amounts							
	Debt	Equity	Revenues	Operating income (before D&A)	EBITDA	EBIT	Funds from operations
Adjusted	3,055.4	1,564.5	338.3	271.7	271.7	152.1	207.7

\*Please note that 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.

Table 2

Landsvirkjun Financial Summary*						
--Fiscal year ended Dec. 31--						
(Mil. \$)	2009	2008	2007	2006	2005	
Rating history	BB/Stable/B-1	BBB-/Negative/A-3	AA/Negative/A-1+	AA/Negative/A-1+	AA+/Negative/A-1+	
Revenues	338.3	386.9	302.6	20,303.5	15,374.3	
Net income from continuing operations	188.8	(293.4)	463.8	11,060.5	6,293.9	
Funds from operations (FFO)	207.7	209.0	86.6	6,738.7	5,055.3	
Capital expenditures	79.9	264.6	573.3	39,811.4	29,517.0	
Cash and short-term investments	194.2	125.0	179.6	4,647.7	3,063.6	
Debt	3,055.4	3,027.5	3,211.8	175,404.6	116,801.9	
Preferred stock	0.0	0.0	0.0	0.0	0.0	
Equity	1,564.5	1,376.8	1,600.1	70,882.9	59,722.7	
Debt and equity	4,619.9	4,404.3	4,812.0	246,287.4	176,524.6	
Adjusted ratios						
EBIT interest coverage (x)	1.6	1.1	0.8	1.2	1.3	
FFO interest coverage (x)	3.3	1.8	1.4	1.4	2.5	
FFO/debt (%)	6.8	6.9	2.7	3.8	4.3	
Discretionary cash flow/debt (%)	3.8	(3.2)	(16.0)	(19.4)	(21.9)	
Net cash flow/capex (%)	260.0	76.0	13.7	15.9	15.8	
Debt/debt and equity (%)	66.1	68.7	66.7	71.2	66.2	
Return on common equity (%)	13.0	(20.5)	1.1	12.8	8.5	

Table 2

Landsvirkjun Financial Summary* (cont.)					
Common dividend payout ratio (unadjusted) (%)	0.0	0.0	1.7	4.5	6.8

\*Fully adjusted (including postretirement obligations).

Ratings Detail (As Of October 29, 2010)*		
<b>Landsvirkjun</b>		
Corporate Credit Rating		BB+/Negative/B-1
Senior Unsecured (1 Issue)		BB+
Short-Term Debt (1 Issue)		B-1
<b>Corporate Credit Ratings History</b>		
20-Oct-2010	<i>Foreign Currency</i>	BB+/Negative/B-1
30-Jun-2009		BB/Stable/B-1
08-May-2009		BBB-/Watch Neg/A-3
24-Nov-2008		BBB-/Negative/A-3
07-Oct-2008		BBB/Negative/A-3
30-Sep-2008		A-/Watch Neg/A-2
18-Apr-2008		A/Negative/A-1
01-Apr-2008		A+/Watch Neg/A-1
22-Dec-2006		A+/Negative/A-1
20-Oct-2010	<i>Local Currency</i>	BB+/Negative/B-1
30-Jun-2009		BB/Stable/B-1
08-May-2009		BBB-/Watch Neg/A-3
18-Dec-2008		BBB-/Negative/A-3
07-Oct-2008		BBB+/Negative/A-2
30-Sep-2008		A+/Watch Neg/A-1
18-Apr-2008		AA-/Negative/A-1+
01-Apr-2008		AA/Watch Neg/A-1+
22-Dec-2006		AA/Negative/A-1+
<b>Business Risk Profile</b>		Fair
<b>Financial Risk Profile</b>		Highly leveraged
<b>Debt Maturities</b>		
As of Dec. 31, 2009:		
2010: \$303 mil.		
2011: \$306 mil.		
2012: \$201 mil.		
2013: \$146 mil.		
2014: \$120 mil.		
Thereafter: \$1,827 mil.		

\*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.

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