

**Credit Opinion: Landsvirkjun**

**Landsvirkjun**

*Reykjavik, Iceland*

**Ratings**

<b>Category</b>	<b>Moody's Rating</b>
Outlook	Negative
Senior Unsecured	Baa1
Other Short Term	P-2

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**Key Indicators**

[1]

**Landsvirkjun**

	<b>2005</b>	<b>2006</b>	<b>2007</b>
FFO Interest Coverage	<b>2.4x</b>	<b>1.7x</b>	<b>1.7x</b>
FFO / Net Debt	<b>5.3%</b>	<b>3.6%</b>	<b>3.8%</b>
RCF / Net Debt	<b>4.9%</b>	<b>3.4%</b>	<b>3.5%</b>
RCF / (Capex + Acquisitions - Divestitures)	<b>18.7%</b>	<b>14.7%</b>	<b>18.9%</b>

[1] Based on "As adjusted" Financial statements. Details in "Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations - Part II, Rating Methodology, Feb-06 (#96729).

*Note: For definitions of Moody's most common ratio terms please see the accompanying [User's Guide](#).*

**Opinion**

**Corporate Profile**

Landsvirkjun is Iceland's dominant electric utility. It owns a majority of the transmission grid and draws on Iceland's large hydro resources in order to supply around 75% of the power needed by domestic users, as well as providing power for power intensive industries (PII) for aluminium smelting which forms a very important source of Iceland's foreign currency earnings.

Landsvirkjun was established on 1st July, 1965 as a jointly owned enterprise by its shareholders the Republic of Iceland (50%), the City of Reykjavik (45%) and the Township of Akureyri (5%). Following a period of negotiation, the Republic of Iceland agreed to buy the shares of the City of Reykjavik and the Town of Akureyri and therefore assumed full ownership of Landsvirkjun as of 1 January 2007. Landsvirkjun continues to be a partnership; in order to meet the requirements of the partnership agreement, 99.9% of the company is owned by the Republic of Iceland and 0.01% by Eignarhlutar hf, an SPV owned by the Republic of Iceland. The ownership changes and the amended Law on Landsvirkjun Nr 42/1983 took effect on 1 January 2007.

The debt ratings of Landsvirkjun at Baa1 with a negative outlook, are in line with the local and foreign currency bond ratings of the sovereign debt of the Republic of Iceland because of the explicit support provided by the guarantee of collection to Landsvirkjun as more fully described below.

## Recent Developments

Landsvirkjun's rating was downgraded to Baa1 negative on 5 December 2008 from A1 under review for possible downgrade in line with Moody's decision to downgrade the Icelandic government bond ratings to Baa1 with a negative outlook.

The downgrade of the sovereign rating has been prompted by Moody's view that the Icelandic government's financial strength has been irreparably damaged by the banking and currency crisis forcing the government to assume significant amounts of debt that will weigh on the public sector balance sheet. Moody's base case scenario is that there will be a gradual economic recovery, possibly in 2010-11, allowing government debt ratios to recover quickly. The negative outlook reflects, however, a degree of execution risk in stabilising the country's currency which could impede this recovery.

Given the very high support levels, the company's rating is primarily driven by the rating of the Government.

At the time of the downgrade the BCA of the company was shifted from 13 to 14 due to a significant drop in aluminium prices, as explained further under "Financial Risk Profile."

## Rating Rationale

The Baa1 ratings of Landsvirkjun reflect the application of Moody's rating methodology for government-related issuers (GRIs). Please refer to Moody's Special Comment ("The Application of Joint Default Analysis to Government-Related Issuers") published in April 2005, and its accompanying press release.

The key drivers of the rating are:

- Baa1 local currency rating of the Icelandic government with a negative outlook

- Baseline Credit Assessment of 14 (on a scale of 1 to 21, where 1 represents the lowest credit risk and maps to an "Aaa" and a 14 maps to a "B1"); A low BCA reflects a highly leveraged profile driven by significant investments in production facilities primarily to meet contracts with aluminium-smelting companies.

- High support reflects the explicit support for Landsvirkjun from its shareholders - in particular the Icelandic State - through the Guarantee of Collection. Whilst under Landsvirkjun's original Act of 1983 (as subsequently amended in 2007), and the partnership agreement, the shareholders are liable for the obligations of Landsvirkjun at the time they are incurred in proportion to their shareholding, nonetheless ultimately there is a joint and several liability of all shareholders for the obligations. As such Moody's has always believed that the State would be ultimately responsible if necessary for the obligations of Landsvirkjun.

Guarantees of collection, which are common in the Nordic Region, do not offer bondholders the same degree of protection as a standard guarantee. There is a potential risk of non-timely repayment should the company fail to meet its obligations, as exhaustive administrative and legal procedures must be followed before the shareholders are obliged to pay. However, given the vital strategic importance of Landsvirkjun to Iceland and other incentives for the shareholders (such as its liability for penalty interest), Moody's expects that the State and other shareholders would intervene in a timely fashion and provide financial or other assistance.

In addition Landsvirkjun is strategically important because of its position as the country's dominant electric utility and the significant and growing role in the economy of the aluminium smelting industry which relies on baseload electricity provided by hydro and geothermal power.

- High dependence. In the unlikely event of a government default, the circumstances surrounding this would also lead to conditions that would adversely affect this GRI. Moreover a government default would reduce its ability and willingness to support the GRI, and hence lead to a high co-dependency of default. Nonetheless Moody's also recognises the high level of US\$-based revenues that the company receives from contracts with aluminium smelters with international parent companies.

Key drivers of the BCA are described below:

## Baseline Credit Assessment

### BUSINESS RISK PROFILE

Landsvirkjun owns 65% the national transmission grid, Landsnet, and currently generates over 75% of the country's electricity, mainly from hydro plants. Around 90% of revenues come from power sales. Landsvirkjun derives the bulk of these revenues from sales to power intensive industries - PII - (primarily for use in aluminium smelting) with the balance coming from sales to local utilities. Overall transmission accounts for around 5% of revenues (spread between local utilities and power intensive industries.) Given the capital intensive nature of its investments, particularly for PII, the financial flexibility of Landsvirkjun is constrained by high leverage, very weak

profitability and exposure to currency fluctuations and aluminium prices, although Landsvirkjun does enter into hedging contracts to mitigate these risks.

On the regulatory front, in response to the EU directive on separation of transmission, generation, distribution and sales of electricity, the Icelandic Parliament ratified a law that entered into force on 1 July 2003 - The Electricity Act. The market has been progressively liberalised, and there has been some pressure on domestic electricity prices, however the market is rather small and isolated for meaningful competition.

The possibility of Landsvirkjun merging with two state-owned distribution and supply companies was under discussion which would provide a degree of downstream hedging if it went ahead. However as this did not take place on the transfer of full ownership to the State, the likelihood of this happening in the near term seems remote. Landsvirkjun has also entered into a number of long term sales contracts with distribution companies to mitigate the impact of competition.

In 2005, as a result of the Electricity Act, transmission activities were spun off into a separate subsidiary, Landsnet. Landsvirkjun still maintains a majority 65% share but no longer operates the transmission grid.

Given its mix of business, of which the contribution from regulated transmission activities is low, we would consider that Landsvirkjun falls outside the scope of the Global Methodology for Regulated Utilities. The sales to local utilities would be considered relatively low risk given the number of long term sales contracts in place. However the exposure to PII, through contracts linked to aluminium and the dollar, are considered more volatile, despite employing certain hedging techniques.

Landsvirkjun's customer base comprises public utilities including Reykjavik Energy, State Electricity Works and other municipal distribution companies for contracts amounting to 2,100 GWh pa. Its PII customers, totalling 10,600 GWh pa, are as follows: Alcan Iceland (2800 GWh pa; Nordural 1400 GWh pa; Icelandic Alloys 1055 GWh pa; Alcoa Fjarðaál 4700 GWh pa; Becromal 640 GWh pa.) These "Take or Pay" contracts have maturities of between 15-20 years. 8900GWh of them are linked to the LME, whilst the Icelandic Alloys contract is linked to the NOK CPI and the Becromal contract has a fixed step-up in prices.

Landsvirkjun recently completed the construction of a major project in the East of Iceland - the 690MW Karahnjúkar hydro power plant. This plant remains wholly owned and operated by Landsvirkjun and its purpose is to supply a newly constructed aluminium plant - overall costs amounted overall to US\$1.1 billion. There remain some limited capex-related costs for this project although the major execution risks related to the project have been removed. Overall Landsvirkjun's capex is estimated to be around US\$100 million in 2009 and should drop to around US\$25 million p.a. thereafter.

## FINANCIAL RISK PROFILE

Given the very capital intensive nature of the Karahnjúkar project, its slight delay in completion and some cost overruns, Moody's expects Landsvirkjun's debt to peak in 2009. Its credit metrics are currently very stretched - with debt levels of around US\$3 billion and adjusted CFO/net debt of 2.3% at FYE 2007. Cash flows from the new project came fully on stream in March 2008. The company is however exposed to the aluminium price through a number of its major contracts with the PII and the significant drop in prices in recent months will mean lower cash flows than previously expected, despite a number of hedges that the company has put in place. Whilst lower prices pertain, this is likely to prolong the recovery of Landsvirkjun's financial metrics. This has prompted the recent change in the BCA from 13 to 14 of the company.

Further investments for new projects have been under consideration - possibly related to further hydro power (a further such plant at Budarhals is under consideration) or data warehousing. Further large investments, without equity injections or other support from its owners, could add to the very high debt load of this company at a time when cash flows are still very weak. However Moody's expects the company to proceed with great caution and only undertake any such project if funding were secured.

## Liquidity

Given the weak financial profile of the company, appropriate liquidity and treasury management is a prime focus. Landsvirkjun's current liquidity profile is comfortable and sufficient until end 2009 and probably well into 2010 under most scenarios.

As at 30 September 2008 the company had approximately US\$105 million of cash and cash equivalents as well as access to a committed MAC- and covenant- free revolving credit facility (RCF), made available by a number of banks which, together with cash flow, should be sufficient to cover debt repayments of approximately US\$170 million and capital expenditure of approximately US\$100 million in 2009. The liquidity assessment also takes into account the fact that Landsvirkjun is required to pay US\$30million under a collateralised facility. Committed availability under the RCF is assumed to be around US\$288million out of US\$350 million. (The company does not count on the commitments which are made available by Icelandic banks.)

In addition the company has a well-spread maturity profile which mitigates refinancing issues. The company now

also receives 70% of its revenues in US\$ (25% in ISK;5% NOK) which partially offsets its currency risk exposures: Landsvirkjun funds itself mainly through a basket of currencies; today its major currency exposure is EUR/US\$ and the company has been gradually increasing the US\$ funding in its mix. Landsvirkjun does have some exposure to interest rate risk, with only 15% of its portfolio being fixed, although it should benefit from falling interest rates.

## Other Considerations

Incorporation, which would permit a privatisation of Landsvirkjun, has been periodically raised as a topic in Iceland. The recent change in ownership however maintains a partnership structure and hence this suggests that no such change is contemplated in the medium term.

## Rating Outlook

The Baa1 rating has a negative outlook in line with that of the sovereign.

## What Could Change the Rating - Down

(i) A move downwards in the sovereign rating. (ii) A change in legal form and hence withdrawal of the guarantee of collection from future debt - which could happen if the company were incorporated. All existing debt would however be grandfathered and retain the current rating

## What Could Change the Rating - Up

A stabilisation of the government bond rating is likely to lead to a stabilisation of Landsvirkjun's rating. There is no immediate upward pressure on either Landsvirkjun's or the government's rating at this time, but the evolution of Landsvirkjun's rating is likely to remain closely linked to developments in the government bond rating.

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