

## Ratings

Category	Moody's Rating
Outlook	Negative
Senior Unsecured	Baa3
Other Short Term	(P)P-3

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## Key Indicators

Landsvirkjun[1]	2009	2008	2007
FFO Interest Coverage	2.3x	1.8x	1.5x
CFO / Net Debt	6.2%	4.5%	1.4%
FFO / Net Debt	4.3%	4.7%	2.7%
RCF / Net Debt	4.3%	4.4%	2.5%
FCF / Net Debt	4.7%	-1.4%	-16.8%
RCF / (Capex + Acquisitions - Divestitures)	282.1%	78.1%	13.7%

[1] Standard adjustments in accordance with "Rating Methodology: Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations, Part 1, Part 2 and Part 3." In addition, Moody's adjusts for one-time items.

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

## Opinion

### Corporate Profile

Landsvirkjun (Baa3/P-3/negative outlook) is Iceland's largest electric utility. It owns the majority of the transmission grid and is responsible for 76% of Iceland's total electricity production of 16.8 TWh. It provides energy for domestic users via sales of electricity to public utilities, although the bulk of sales are to power intensive industries (PII) for aluminium smelting. This forms an important source of Iceland's foreign currency earnings.

Landsvirkjun was established on 1 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 remains a partnership and 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 Eignarhlutir hf, an SPV owned by the Republic of Iceland. The ownership changes and the amended Law on Landsvirkjun Nr 42/1983 came into effect on 1 January 2007.

### MARKET STRUCTURE

On the regulatory front, in response to the EU directive on separation of transmission, generation, distribution and sales of electricity, the Icelandic Parliament ratified The Electricity Act, a law that was enforced on 1 July 2003. The market has been progressively liberalised, and there has been some pressure on domestic electricity prices; however, the market is rather small and too isolated for meaningful competition. Landsvirkjun has entered into long-term contracts with local supply companies to protect against this risk, as described under the Hedging Strategy section.

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.

## Recent Developments

### NEW PRICE FORMULA ON ALCAN CONTRACT

In October 2010, Landsvirkjun and Alcan Iceland signed a revised contract for energy delivery. The amended contract provides for a change in the price formula on the sales of energy for the smelter's present production (2,932 GWh) and supply of additional energy (658 GWh) for the smelter's planned production increase in 2014.

The new price formula took effect on 1 October 2010 and is linked to the US Consumer Price Index. Therefore, the link to aluminium prices has been removed. The contract is valid until 2036 and thus involved an almost 12 year extension from the previous contract.

### BOND ISSUANCE

In September 2010, Landsvirkjun issued a US\$150 million bond. The five-year instrument pays a 6.5% coupon, which compares with an average nominal interest on the company's debt of 2.5% in 2009 or 4.5% a year earlier. The issuance has strengthened the company's liquidity as described under the "Liquidity" section.

## Rating Rationale

The debt ratings of Landsvirkjun at Baa3/P-3 with a negative outlook, are in line with the local and foreign currency bond ratings of the sovereign debt of the Republic of Iceland, given the explicit support provided by the state under the Guarantee of Collection to Landsvirkjun, and its strategic role in Iceland.

Landsvirkjun's stand-alone assessment reflects the company's dominant position in the Icelandic energy market, supported by the low-cost renewable generation asset base, albeit in a small and isolated market. The rating is, however, constrained by: (i) Landsvirkjun's high financial leverage; (ii) exposure to aluminium prices in a weak commodity market; (iii) concentration exposure to a comparatively small number of counterparties in the aluminium industry; (iv) currency risk; and (v) vulnerability to increases in funding costs in the event of higher interest rates.

## DETAILED RATING CONSIDERATIONS

Landsvirkjun's rating assessment reflects the application of Moody's Rating Methodology for Government-Related Issuers (GRIs). Landsvirkjun's Baa3 issuer rating incorporates an uplift for potential government support to its stand-alone credit quality. This is expressed by Moody's baseline credit assessment (BCA) of 15 (on a scale of 1 to 21, where 1 represents the lowest risk and 15 is equivalent to B2). The uplift to the BCA, currently at five notches, is a result of the credit quality of the government of Iceland (Baa3, negative), which owns 99.9% of Landsvirkjun, coupled with Moody's assessment of a very high probability of government support in the event of financial distress, as well as high default dependence (i.e. degree of exposure to common drivers of credit quality).

In its assessment of Landsvirkjun's credit profile, Moody's also applies its global Rating Methodology for Unregulated Utilities and Power Companies, published in August 2009. Under this methodology, Landsvirkjun is considered an Unregulated Power Company and the output of the grid maps to B1. In assigning the BCA of 15 (=B2), Moody's gives additional weight to company's exposure to aluminium prices in a weak commodity market, some currency mismatch between revenues and debt service costs, as well as vulnerability to increased funding costs in the event of higher interest rates. New financing costs are also likely to reflect a much lower investment grade rating than it has historically enjoyed.

## Rating Drivers

The following factors influence Landsvirkjun's rating under the Unregulated Utilities and Power Companies methodology:

### FACTOR 1: MARKET ASSESSMENT, SCALE AND COMPETITIVE POSITION

#### (a) Market and Competitive Position

Landsvirkjun is Iceland's largest electric utility. It owns 65% of the national transmission grid, Landsnet, and currently generates over 75% of the country's electricity production. The company's installed capacity, totalling 1.9 GW, is mainly based on hydro sources, which account for approximately 96% of the total owned capacity, with the remaining represented by geothermal plants. Given the very low marginal costs of production associated with its hydro sources, Landsvirkjun has a very attractive generation portfolio, albeit in a small and isolated market, where there is only some competition from regional companies, primarily Reykjavik Energy and Hitaveita Sudurnesja.

In scoring the company A on this factor, we recognise Landsvirkjun's significant market position in Iceland, but also consider the relatively small size of the overall market, its relative illiquidity and its concentration exposure to a comparatively small number of counterparties in the aluminium industry.

#### (b) Geographic Diversity

Landsvirkjun scores Ba on this factor as it operates within a single economic area with low volatility in demand for its products as much of its power is sold under long-term contracts.

### FACTOR 2: CASH FLOW PREDICTABILITY OF BUSINESS MODEL

#### (a) Effectiveness of Hedging Strategy

Landsvirkjun is predominantly a wholesale producer, with over 85% of revenues coming from power sales. The balance is from transmission activities, spread between local utilities and power intensive industries. Whilst recognising the attractiveness of the cost structure associated with Landsvirkjun's hydro base, Moody's notes that the power price can be very volatile given its linkage to, inter alia, aluminium price, when the costs associated with this generation source are largely fixed, thus affecting cash flow predictability.

Around 18% of Landsvirkjun's revenues are derived from sales to local utilities, which are considered relatively low risk given the number of long term sales contracts in place (3, 5, 7 and 12 year maturities). They are denominated in ISK and linked to the Icelandic CPI. This customer base

comprises public utilities, including Reykjavik Energy, and other municipal distribution companies for contracts amounting to 2,100 GWh per annum.

The bulk of sales (over 80% of total revenues) are to power intensive industries. The majority of sales are through contracts directly linked to the aluminium price and based in dollars. In 2010, the PII customers accounted for around 11,160 GWh of Landsvirkjun's sales under the following contracts: Alcoa Fjarðaál (5,040 GWh), Alcan Iceland (2,930 GWh), Nordural (1,570 GWh), Icelandic Alloys (1,055 GWh) and Becromal (565 GWh). These contracts have maturities of between 19 and 37 years and all of them are "take or pay", where the customers have to pay 85% of the underlying quantity of the agreement, whether or not they use the electricity. Alcoa and Nordural contracts are linked to the LME (without a floor or a ceiling cap), whilst the Icelandic Alloys contract is linked to the NOK CPI and the Becromal contract has a fixed step-up in prices. Until September of last year, the Alcan contract had been linked to LME, but following the revision in October 2010, the price is now linked to US CPI. The amendment of the contract with Alcan was the first step in Landsvirkjun's new strategy for pricing energy in Iceland and resulted in a reduction of the company's exposure to aluminium price volatility, although 58% of sales to PII remain linked to aluminium price.

Despite the long-term nature of the contracts with the aluminium smelters, Landsvirkjun's cash flows are exposed to a high level of volatility, primarily due to a link between the power sale price and aluminium price. The aluminium price tends to vary often and widely. Most recently, for example, the aluminium price underwent a major correction in 2008, when it dropped from over US\$3,000 per tonne in July 2008 to around US\$1,300 per tonne in February 2009. As of the beginning of January 2010, spot aluminium was around US\$2,400 per tonne. Moody's notes that in order to reduce the volatility of cash flows, the company has adopted a hedging strategy, whereby they hedge a certain percentage of their future energy sales. The actual amount hedged is dependent on market conditions and view of expected aluminium prices.

Moody's assigns Landsvirkjun a score of B for the Effectiveness of Hedging Strategy sub-factor, reflecting the inherent volatility in much of the cash flows given their link to the aluminium price, as well as the concentration of contracts with a small number of companies.

#### (b) Fuel Strategy and Mix

Landsvirkjun currently operates 11 hydropower plants, two geothermal plants and one fossil fuel plant for back-up. In 2010, it is estimated that Landsvirkjun produced 13,100 GWh of electricity, of which 96% was produced from hydrological resources and 4% from geothermal resources. Overall, Iceland's fuel mix is based on 75% hydro and 25% geothermal sources. The company bought in some 400 GWh (from Hitaveita Sudurnesja) for resale to power intensive industries.

A score of single-B is assigned for Fuel Strategy and Mix, reflecting the limited diversification of fuel source, recognising nevertheless the value of the renewable nature of its fuel mix.

#### (c) Capital Requirements and Operating Performance

Landsvirkjun recently completed the construction of a major project in the East of Iceland, the 690 MW Karahnjúkar hydropower plant. This plant remains wholly owned and operated by Landsvirkjun and its purpose is to supply the newly constructed aluminium plant owned by Alcoa. Overall costs amounted to US\$1.1 billion. The project is fully operational, with all capex-related costs completed.

Following the completion of this project, capital investments are significantly reduced. Overall Landsvirkjun's capex is estimated to have been at around US\$50-60 million in 2010. Looking ahead, the investments will be mainly related to maintenance, with some investment in developing the transmission grid. Possible further projects include a number of new power projects in Southern Iceland for a total of 345 MW. The project at Budarhals for another 80 MW of capacity (to produce 585 GWh) has received all construction permits. Geothermal power plants in the North-East of Iceland could also be possibilities in the future. Landsvirkjun has however, not undertaken any obligations regarding new projects.

The Capital Requirements and Operating Performance sub-factor is scored A. Operating performance has been solid and future output is considered to be relatively predictable. Overall, moderate levels of capex are required for maintenance and for environment-related expenditure and availability at Landsvirkjun's plants is generally high (historical average of 96%, not including scheduled maintenance agreements).

### FACTOR 3: FINANCIAL POLICY

Landsvirkjun scores single-B on this factor, given the company's historical reliance on debt funding to finance a large investment programme, albeit under the Guarantee of Collection of its owner, without any equity support. The past financial policies have resulted in the company's leveraged financial profile and refinancing risk.

Moody's notes that Landsvirkjun has strengthened its liquidity position in recent months and expects the company to continue to follow its prudent financial policies in terms of maintaining adequate amounts of committed facilities to manage refinancing risks in the potentially volatile financial markets.

### FACTOR 4: FINANCIAL STRENGTH METRICS

Landsvirkjun scores weakly on financial metrics. The company's financial profile remains highly leveraged, with CFO/ Net Debt of 6.2% in 2009, following completion of a very sizeable capital investment programme. Furthermore, the company's financial flexibility is constrained by significant exposure to movement in aluminium prices and interest rates, as well as more limited exposure to currency risk, although Landsvirkjun does enter into hedging contracts to mitigate these risks.

Spot aluminium prices are currently around US\$2,400 per tonne or over, down from the peaks of early 2008, but nonetheless, an improvement on the lows seen in late 2008 and 2009. Moody's believes aluminium prices could remain under pressure for some time, given the weak end market environment, excluding China, the high inventory position on the London Metal Exchange, potential stockpile sales by China's State Reserve Bureau and the level of aluminium tied up in financing transactions.

A large portion of Landsvirkjun's debt is subject to variable rates, and hence although the company has benefited from the recent drop in interest rates, it is also vulnerable to a rise in rates. The company is also likely to be exposed to a higher cost of debt given a much lower-than-historic rating.

Landsvirkjun's reporting currency is US dollar, the currency in which most of its revenues are derived (74% in US\$, 18.5% in ISK, 7.5% in NOK). As also substantial proportion of its debt is denominated in this currency, the company has limited exposure to the weak Icelandic krona. It has, however, some sensitivity to adverse movements in the US dollar against the euro given the weighting towards the latter currency in its funding

base (around 50% of debt as of end-2009 was denominated in EUR).

With the completion of the very capital-intensive Karaknjukar project in 2008/09, Moody's expects the debt coverage metrics to improve gradually over time, although remain in the mid- to high-single digits in the medium term. Whilst these could also improve further, were the aluminium prices at current levels or higher, they could also experience some volatility and may even weaken in the case of higher funding costs or lower aluminium prices. The pace of improvement in Landsvirkjun's credit metrics will be, however, also dependent on the company's willingness to undertake any further investment projects. The expansion of the plant at Budarhals could cost around US\$200-250 million, if it goes ahead. Nonetheless, Moody's expects the company to proceed with caution and only undertake any such project, if funding is secured.

#### OTHER GRI FACTORS

Moody's assumption of very high support reflects the explicit support for Landsvirkjun from its shareholder - the Icelandic State - through the Guarantee of Collection. 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 Landsvirkjun's obligations.

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 would intervene in a timely fashion and provide financial or other assistance.

Moody's assessment of high default dependence balances Landsvirkjun's strategic importance to the Icelandic economy due to its position as the country's dominant electric utility with the company's high level of US\$-based revenues from contracts with aluminium smelters with international parent companies.

#### Liquidity

Landsvirkjun's current liquidity profile is comfortable for 2011 and sufficient to carry it into 2012. The 2011 debt amortisation of US\$364 million and planned investments are fully covered by around US\$550 million of cash and revolving credit facilities with commercial banks. Additionally, solid cash flow generation - estimated by the company to be around US\$220 million for 2010 - is expected to support liquidity.

As of the beginning of 2011, Landsvirkjun had approximately US\$250 million of cash and cash equivalents, as well as access to US\$306 million under committed long-term revolving credit facilities. Of this US\$306 million, US\$282 million relate to a committed MAC- and covenant-free revolving facility maturing in December 2012 and the remaining US\$24 million (ISK3 billion equivalent) relate to a new long-term revolving credit facility with Islandsbanki, maturing in April 2013.

Additionally the government has put in place a US\$300 million credit facility for Landsvirkjun until 1 July 2011, which would ensure timely payment under its Guarantee of Collection. However, under the conditions of this facility, Landsvirkjun would be required to use the bank RCF first. Given the company's good liquidity position beyond July 2011, this facility is unlikely to be utilised.

Based on current aluminium price and interest rate assumptions, Landsvirkjun estimates that it will require access to around US\$50 million in order to maintain a cash position of US\$100 million and meet its refinancing needs until 2012. Moody's notes also that the company has a relatively well-spread maturity profile, which mitigates refinancing issues. Cash flow could, however, be challenged by low aluminium prices and increasing interest rates, which could impact negatively these assumptions.

In 2010, Landsvirkjun managed to access the debt capital market, placing a US\$150 million 6.5% bond with a five year maturity. Along with the newly negotiated credit facilities, this bond issuance indicates improvement in the company's ability to access debt funding in the current difficult economic environment for Iceland.

#### Other Considerations

Incorporation, which would permit a privatisation of Landsvirkjun, has been periodically raised as a topic in Iceland. However, the current partnership structure suggests that no such change is contemplated in the medium term.

The EFTA Surveillance Committee has recently indicated to the Government that the current Guarantee of Collection constitutes State Aid. Discussions are taking place to resolve this issue and the most likely solution is that a higher guarantee fee will be paid by Landsvirkjun to the government. There are no plans to withdraw the guarantee, but in this unlikely event, Moody's understands that all existing debt liabilities would be grandfathered.

#### Rating Outlook

The outlook is negative, reflecting the negative outlook on the Icelandic government's ratings.

#### What Could Change the Rating - Down

A downward revision in the rating could be expected following: (i) a downwards move in the sovereign rating; (ii) a withdrawal of the Guarantee of Collection, possibly triggered by the incorporation of the company. This is not currently under consideration. Were this to happen, all existing debt would be grandfathered; or (iii) should Moody's believe that the likelihood of timely support is weakened, which is also not currently envisaged.

#### What Could Change the Rating - Up

An upward change in the sovereign rating, although this is not currently envisaged given the negative outlook.

#### Rating Factors

Landsvirkjun

Unregulated Utilities and Power Companies	Aaa	Aa	A	Baa	Ba	B	Caa
<b>Factor 1: MARKET ASSESSMENT, SCALE AND COMPETITIVE POSITION (20%)</b>							
a) Market and Competitive Position			X				
b) Geographic Diversification					X		
<b>Factor 2: CASH FLOW PREDICTABILITY OF BUSINESS MODEL (20%)</b>							
a) Hedging Strategy						X	
b) Fuel Strategy and Mix						X	
c) Capital Requirements and Operating Performance			X				
<b>Factor 3: FINANCIAL POLICY (10%)</b>						X	
<b>Factor 4: FINANCIAL STRENGTH METRICS (50%) [1][2]</b>							
a) FFO + Interest / Interest						1.8x	3.9%
b) FFO/Net Debt							
c) RCF/Net Debt						3.7%	
d) FCF/Net Debt						-4.6%	
<b>Rating:</b>							
a) Indicated Rating from Grid						B1	
b) Actual BCA Assigned						15 (B2)	

Government Related Issuer	Factor
a) Baseline Credit Assessment	15
b) Government Local Currency Rating	Baa3
c) Default Dependence	High
d) Support	Very High

[1] Standard adjustments in accordance with "Rating Methodology: Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations, Part 1, Part 2 and Part 3." In addition, Moody's adjusts for one-time items. [2] 3-year (2007-2009) historical average



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