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## 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 the monopoly transmission system operator.

### Weaknesses:

- Aggressive financial profile owing to sizable debt-financed expansion of power generation capacity.
- Customer concentration in the small and isolated Icelandic power market.
- Significant exposure to aluminum prices for revenues.

### Corporate Credit Rating

BB/Stable/B-1

## Rationale

The 'BB' ratings on Iceland-based 100% state-owned utility Landsvirkjun reflect Standard & Poor's Ratings Services' opinion that there is a "very high" likelihood that 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. Standard & Poor's assesses Landsvirkjun's stand-alone credit profile (SACP) at 'B-'.

In accordance with our criteria for government-related entities (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, 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 Landsvirkjun's 100% ownership by the state and our expectation that Landsvirkjun will not be privatized in the medium term, the provision of ultimate state guarantee for the collection of all of Landsvirkjun's debt and a two-year \$300 million contingent credit facility with the Central Bank of Iceland, and the risk to the sovereign's reputation if Landsvirkjun were to default.

The rating reflects the assumed "very high" likelihood of support, together with Landsvirkjun's weak SACP, which reflects a highly leveraged financial risk profile due to high debt leverage, weak cash flow coverage of debt, and weak liquidity position. It also reflects a weak business risk profile due to customer concentration risks and exposure to inherently volatile aluminum prices and foreign exchange fluctuations.

### Key business and profitability developments

Sales to power-intensive industries account for more than 80% of Landsvirkjun's total power sales, and the price of aluminum drives the price of electricity in Landsvirkjun's power sale agreements with the aluminum plants. This business structure results in a lack of diversification and exposes the company to commodity risks. That said,

following the sharp drop in aluminum prices in the second half of 2008, prices have gradually improved, with the result that Landsvirkjun posted stronger revenues and EBITDA for the first half of 2009 than we had anticipated.

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

Landsvirkjun's financial risk profile is highly leveraged, in our view, due to debt-funded capital investments that the company made in the \$1.1 billion Kárahnjúkar hydropower plant. Landsvirkjun's adjusted debt dropped slightly to \$2.9 billion by June 30, 2009 (from \$3.0 billion at year-end 2008), resulting in a debt-to-capital ratio of 67% (from 69%). Landsvirkjun's ratio of adjusted funds from operations (FFO) to debt (on a rolling 12-month basis) improved to 8.1% (from 6.9%) and the FFO interest coverage (on a rolling 12-month basis) rose to 2.7x (from 1.8x). While we believe that Landsvirkjun's financial risk profile will continue to improve, the improvement starts from a very weak position and is likely to be gradual.

### **Liquidity**

Landsvirkjun's immediate liquidity strengthened significantly with the provision of a two-year, \$300 million contingent credit facility with the Central Bank of Iceland, expiring July 1, 2011. However, the company's liquidity position remains weak, in our opinion, due to limited financial flexibility and dependency on solidly improving operating cash flows and minimum capital expenditures to cover its debt service requirements. On Sept. 30, 2009, Landsvirkjun had \$63 million in freely available cash and \$282 million available under a committed line, compared with about \$250 million of short-term debt.

Landsvirkjun's free operating cash flow (FOCF) has been negative over the past six years, due to the large investments the company made in the Kárahnjúkar power plant. The company funded the negative cash flow with external debt, resulting in high debt leverage and a large amount of short-term debt. The power plant project is now complete and we understand from the company that its capital expenditures will fall sharply in 2010 and cover mainly maintenance expenditures over the near to medium term.

We believe that Landsvirkjun's FOCF will strengthen in the near to medium term. This view is based on our expectation that capital expenditures will be significantly lower in 2010, and on the fact that Landsvirkjun's FOCF totaled \$70 million during the first half of 2009. That said, Landsvirkjun has up to \$700 million of debt to refinance through 2012.

The company has covered recent debt repayments with cash and by issuing new debt and drawing on the credit facility. If Landsvirkjun's access to the debt capital markets were limited, existing bank lines were fully drawn, and Landsvirkjun had no access to other funding sources, then the Central Bank would provide Landsvirkjun with foreign currency via a drawdown on the contingent credit facility in exchange for Icelandic krona or bonds. This is to ensure that all of Landsvirkjun's obligations are met on a full and timely basis.

## **Outlook**

The stable outlook reflects our opinion that Landsvirkjun's SACP is unlikely to improve in the near to medium term. This is because of the downturn in the domestic and global economy, the generally low (albeit slowly increasing) aluminum prices, and Landsvirkjun's dependency on the aluminum sector to improve its earnings and strengthen its cash flow coverage of debt ratios. At the same time, Landsvirkjun's liquidity position remains weak due to low (albeit gradually improving) cash flow generation and significant short-term debt service requirements. That said, the contingent credit facility mitigates our immediate concerns in this respect.

The stable outlook also reflects our view that--given Landsvirkjun's 'B-' SACP--a lower or higher local currency rating on the Republic of Iceland would not necessarily lead to a change in the rating on Landsvirkjun.

## Business Description

Landsvirkjun produces, distributes, and sells wholesale electricity to public utilities and distribution companies and provides power-intensive industry (predominantly aluminum) producers with power under long-term take-or-pay contracts. The company generated 12,345 gigawatt-hours (GWh) in 2008, corresponding to about 75% of Iceland's power generation, using low marginal cost and environmentally friendly hydropower (96%) and geothermal power (4%). Landsvirkjun's sales of 12,748 GWh were split between sales to the general market (19%) and sales to power-intensive industries (81%) and were sourced from its own production (97%) and market purchases (3%).

Landsvirkjun's 64.73% owned subsidiary Landsnet owns and operates the national transmission grid. Landsnet's other owners are RARIK (Iceland State Electricity; 22.51%), Orkureita Reykjavíkur (Reykjavík Energy; 6.78%), and Orkubú Vestfjarda (Westfjord Power Co.; 5.98%).

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.

## Rating Methodology

The 'BB' rating on Landsvirkjun is based on the company's SACP, which we assess at 'B-', as well as on our opinion that there is a "very high" likelihood the government of the Republic of Iceland would provide timely and sufficient extraordinary support to Landsvirkjun in the event of financial distress.

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

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

- A lack of diversification, given that over 80% of the power produced is sold to the power-intensive industries, predominantly aluminum smelters.
- Exposure to inherently volatile commodity prices and foreign exchange fluctuations, given that 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.
- 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.

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

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 67% on June 30, 2009.
- Very weak cash flow protection of debt. Landsvirkjun's FFO to debt (on a rolling 12-month basis) was 8.1% on June 30, 2009, and we anticipate only a gradual improvement in the near to medium term. FFO interest coverage (on a rolling 12-month basis) was 2.7x on June 30, 2009.
- A weak liquidity position due to a material amount of short-term debt and limited funding sources. On Sept. 30, 2009, Landsvirkjun had \$63 million in freely available cash and \$282 million available in short-term committed credit lines, compared with \$250 million of short-term debt.

These weaknesses are partially mitigated by:

- The provision of a \$300 million contingent credit facility with the Central Bank of Iceland, expiring on July 1, 2011.
- 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.

Standard & Poor's makes adjustments to Landsvirkjun's reported income, balance sheet, and cash flow statement (see table 1). The company capitalizes \$7.3 million of its interest expenses incurred in construction, which we add back to Landsvirkjun's interest expense. We adjust reported debt to include \$35.9 million in accrued interest and post-tax postretirement benefit obligations of \$16.4 million.

**Table 1**

Reconciliation Of Landsvirkjun Reported Amounts With Standard & Poor's Adjusted Amounts*							
--Fiscal year ended Dec. 31, 2008--							
Landsvirkjun reported amounts							
(Mil. \$)	Debt	Shareholders' equity	Operating income (after D&A)	Interest expense	Cash flow from operations	Cash flow from operations	Capital expenditures
Reported	2,975.3	1,355.5	246.0	177.7	184.4	184.4	271.9
Standard & Poor's adjustments							
Postretirement benefit obligations	16.4	--	--	--	--	--	--
Capitalized interest	--	--	--	7.3	(7.3)	(7.3)	(7.3)
Reclassification of nonoperating income (expenses)	--	--	11.3	--	--	--	--

Table 1

Reconciliation Of Landsvirkjun Reported Amounts With Standard & Poor's Adjusted Amounts* (cont.)							
Reclassification of working-capital cash flow changes	--	--	--	--	--	31.9	--
Minority interests	--	21.3	--	--	--	--	--
Accrued interest	35.9	--	--	--	--	--	--
Total adjustments	52.2	21.3	11.3	7.3	(7.3)	24.6	(7.3)
Standard & Poor's adjusted amounts							
	Debt	Equity	EBIT	Interest expense	Cash flow from operations	Funds from operations	Capital expenditures
Adjusted	3,027.5	1,376.8	257.3	185.0	177.1	209.0	264.6

\*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. \$)	2008	2007	2006	2005	2004	
Rating history	BBB-/Negative/A-3	AA/Negative/A-1+	AA/Negative/A-1+	AA+/Negative/A-1+	AA+/Stable/A-1+	
Revenues	441.6	362.0	284.6	242.9	219.9	
Net income from continuing operations	(293.4)	463.8	155.0	99.4	116.9	
Funds from operations (FFO)	209.0	86.6	94.5	79.9	59.2	
Capital expenditures	264.6	573.3	558.0	466.4	320.9	
Cash and short-term investments	125.0	179.6	65.1	48.4	55.2	
Debt	3,027.5	3,211.8	2,458.5	1,845.5	1,621.0	
Equity	1,376.8	1,600.1	993.5	943.6	834.4	
Debt and equity	4,404.3	4,812.0	3,452.0	2,789.1	2,455.4	
Adjusted ratios						
EBIT interest coverage (x)	1.4	1.2	1.2	1.3	1.0	
FFO interest coverage (x)	1.8	0.9	1.1	2.1	2.2	
FFO/debt (%)	6.9	2.7	3.8	4.3	3.7	
Discretionary cash flow/debt (%)	(3.2)	(16.0)	(19.4)	(21.9)	(16.2)	
Net cash flow/capex (%)	76.0	13.7	15.9	15.8	16.6	
Debt/debt and equity (%)	68.7	66.7	71.2	66.2	66.0	
Return on common equity (%)	(20.5)	31.0	12.1	8.4	15.1	
Common dividend payout ratio (unadjusted) (%)	0.0	1.7	4.5	6.8	5.0	

\*Fully adjusted (including postretirement obligations).

## Related Research

General Criteria: Enhanced Methodology And Assumptions For Rating Government-Related Entities, June 29, 2009

**Ratings Detail** (As Of October 23, 2009)\***Landsvirkjun**

Corporate Credit Rating	BB/Stable/B-1
Senior Unsecured (1 Issue)	BB
Short-Term Debt (1 Issue)	B-1

**Corporate Credit Ratings History**

30-Jun-2009	<i>Foreign Currency</i>	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
22-Feb-2005		AA-/Negative/A-1+
10-Feb-2005		AA-/Stable/A-1+
30-Jun-2009	<i>Local Currency</i>	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+
22-Feb-2005		AA+/Negative/A-1+

<b>Business Risk Profile</b>	Weak
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<b>Financial Risk Profile</b>	Highly leveraged
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**Debt Maturities**

As of Dec. 31, 2008  
2009: \$186 mil.  
2010: \$198 mil.  
2011: \$286 mil.  
2012: \$198 mil.  
2013: \$147 mil.  
Thereafter: \$1,961 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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