



Moody's Investors Service

Credit Opinion: Landsvirkjun

Global Credit Research - 18 Nov 2009

Reykjavik, Iceland

Ratings

Category	Moody's Rating
Outlook	Stable
Senior Unsecured	Baa3
Other Short Term	P-3

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Key Indicators

[1]Landsvirkjun	2007	2008
FFO Interest Coverage	1.5x	2.1x
CFO / Net Debt	1.4%	4.5%
FFO / Net Debt	2.7%	6.8%
RCF / Net Debt	2.5%	6.5%
FCF / Net Debt	-16.8%	-1.4%
RCF / (Capex + Acquisitions - Divestitures)	13.7%	115.2%

[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 (Baa3/P-3) is Iceland's largest electric utility. It owns a majority of the transmission grid and is responsible for 75% of Iceland's total electricity production of 16. 47TWh.

It provides energy for domestic users via sales of electricity to public utilities, but the bulk of sales are to power intensive industries (PII) for aluminium smelting. This 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 Eignarhlutir 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.

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 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. LV has entered into long-term contracts with local supply companies to protect against this risk as described under "Hedging Strategy".

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.

Rating Rationale

The debt ratings of Landsvirkjun at Baa3/P-3 stable, 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 and its strategic role in Iceland.

The Baa3/P-3 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 inputs to the rating are:

(i) The Baa3/P-3 local currency ratings of the Icelandic government with a stable outlook are the primary driver of Landsvirkjun's ratings. The government ratings reflect the enduring fiscal, financial and monetary challenges resulting from the current economic crisis set against Iceland's high wealth, economic flexibility and sound institutions. The stable outlook additionally reflects the balance of risks between the divergent trends of an improving economic outlook, severe strains on public finances and the still uncertain exit strategy from capital controls.

(ii) High support reflects the explicit support for Landsvirkjun from its shareholders - in particular 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 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 role in the economy of the aluminium smelting industry which relies on electricity provided by hydro and geothermal power.

(iii) 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 USD-based revenues that the company receives from contracts with aluminium smelters with international parent companies.

(iv) The Baseline Credit Assessment (BCA) of 15 (on a scale of 1 to 21, where 1 represents the lowest credit risk and maps to an "Aaa" and a 15 maps to a B2)

BASELINE CREDIT ASSESSMENT

In deriving the BCA, Moody's applies the methodology for Unregulated Utilities and Power Companies (August 2009).

Under this methodology, Landsvirkjun is considered as an Unregulated Power Company and the output of the grid maps to a B1.

In assigning the BCA of 15 (=B2), Moody's gives additional weight to the leveraged financial position of LV and its exposure to aluminium prices in a weak commodity market, 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.

FACTOR 1: Market Assessment, Scale, and Competitive Position

MARKET AND COMPETITIVE POSITION

Landsvirkjun owns 65% of the national transmission grid, Landsnet, and currently generates over 75% of the country's electricity, mainly from hydro plants.

Landsvirkjun is the dominant producer in an isolated market, it has some competition from regional companies, primarily Reykjavik Energy and Hitaveita Sudurnesja. In scoring the company A on this factor, we recognise its significant market position in Iceland, but we 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.

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

HEDGING STRATEGY

Landsvirkjun is predominantly a wholesale producer with over 90% of revenues coming from power sales. The balance is from transmission activities (spread between local utilities and power intensive industries.)

18% of its 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 Icelandic Krona and linked to the Icelandic CPI. This customer base comprises public utilities including Reykjavik Energy, State Electricity Works and other municipal distribution companies for contracts amounting to 2,100 GWh pa (16% of power produced).

The bulk of sales (75% of total revenues) are to Power Intensive Industry (PII), through contracts directly linked to the aluminium price and based in dollars. Its PII customers, total 11,030 GWh pa, and the contracts are as follows: Alcan Iceland (2800 GWh pa); Nordural (1570 GWh pa); Icelandic Alloys (1055 GWh pa); Alcoa Fjardaal (5040 GWh pa); Becromal (565 GWh pa.). These contracts have maturities of between 15 and 40 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. 9540 GWh of them 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.

Landsvirkjun scores B on this factor. Whilst factoring the long-term nature of its forward sales contracts, Moody's recognises the inherent volatility in much of the cash flows given their linkage to the aluminium price as well as the concentration of contracts with a small number of companies.

FUEL STRATEGY AND MIX

Landsvirkjun scores B on this factor given its limited diversification of fuel source. Moody's does however recognise the value of the renewable nature of its fuel mix.

Landsvirkjun currently operates 11 hydropower plants, two geothermal plants and one fossil fuel plant for back-up. As of end 2008, Landsvirkjun produced 12,345 GWh of electricity; of which 96% was produced from hydrological resources and 4% from geothermal resources. (Overall, Iceland's fuel mix is based off 75% hydro/ 25% geothermal sources.) It bought in some 400GWh (from Hitaveita Sudurnesja) for resale to power intensive industries. Overall production increased by 43% in 2008 due to the coming into operation of Karahnjukar hydropower plant.

Possible further projects include a number of new power projects in Southern Iceland for a total of 345MW. The project at Budarhals for another 80MW of capacity (to produce 585GWH pa) has received all environmental impact assessment and all permits for construction have been obtained. 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.

OPERATIONAL CHARACTERISTICS AND CAPITAL REQUIREMENTS

Landsvirkjun recently completed the construction of a major project in the East of Iceland - the 690MW Karahnjukar 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 overall to USD1.1 billion. The project is fully operational with all capex-related costs completed. Overall Landsvirkjun's capex is estimated to be around USD75 million in 2009 and should drop to around USD10 million p.a. thereafter.

Landsvirkjun scores A on this factor. Overall, moderate levels of capex are required for maintenance and for environmental related expenditures and availability at Landsvirkjun's plants is generally high. Availability was around 94.5% in 2008 due to a malfunction at one of the stations although Landsvirkjun targets 99% availability not including scheduled maintenance agreements.

FINANCIAL RISK PROFILE

FINANCIAL POLICY

Landsvirkjun scores a B on this factor, given the very stretched financial profile of the company and its reliance on debt funding, albeit under the Guarantee of Collection of its owner, rather than fresh equity to fund its historically very high capex programme.

FINANCIAL STRENGTH METRICS

The company scores weakly on financial metrics. Given the capital intensive nature of its investments, the financial flexibility of Landsvirkjun is constrained by high leverage, weak profitability and significant exposure to movements in aluminium prices and interest rates, as well as a more limited exposure to currency risk, although Landsvirkjun does enter into hedging contracts to mitigate these risks.

Spot aluminium prices are currently around USD2030-2040 per tonne (significantly down from the peaks of early 2008) and have experienced significant volatility in recent months. Moody's believes aluminium prices will remain under pressure for some time given the current overcapacity in the industry. In addition a large proportion of the company's debt is subject to variable rates, and hence whilst the company has benefited from the recent drop in interest rates, the company is vulnerable to a rise in rates. The company is also likely to be exposed to a higher cost of debt going forward given a much lower than historic rating.

Landsvirkjun now accounts in US dollars, the currency in which most of its revenues are derived (70% in USD; 25% in ISK; 5% in NOK) and a substantial proportion of its debt, hence it has limited exposure to the weak Krona. It has some sensitivity to adverse movements in the US dollar against the Euro given the weighting towards the latter currency in its funding base.

With CFO/net debt of 4.5% at 2008, Moody's expects debt coverage metrics to remain in the low single digits for some time. They could experience some volatility, and may even weaken in the case of higher funding costs and/or continuing low, or lower aluminium prices. The company does not however expect to pay a dividend going forward and therefore RCF/net debt should be in line with FFO/net debt.

Moody's notes that debt has now passed its peak (assuming no further investments) of USD2.8 billion on completion of the very capital-intensive Karahnjukar project and is now expected to gradually reduce as cash flows from the project came fully on stream in March 2008. Assuming no further investments for large projects are undertaken, capex is likely to reduce to a minimal level in 2010. On this basis, in a reasonably benign environment, metrics should improve gradually over time.

Further investments could nonetheless take place - the expansion of the plant at Budarhals could cost around USD200-250 million if it goes ahead. Moody's expects the company to proceed with great caution and only undertake any such project if funding were secured.

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.

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 for 2010 and sufficient to carry it well into 2011.

As at 30 September 2009, the company had approximately USD63 million of cash and cash equivalents as well as access to USD280 million under a committed MAC- and covenant- free revolving credit facility (RCF). This facility is available until December 2012. Additionally the Government has put in place a USD300 million credit facility for LV until 1 July 2011 which would ensure timely payment under its guarantee of collection.

Landsvirkjun estimates that it requires access to over USD300 million in order to meet its financing needs in 2010-12. Cash flow could however be negatively affected by low aluminium prices and increasing interest rates, which would raise this requirement. After 2012, the company could be able to repay its debt from cash flow but that would assume a continuing benign interest rate environment and higher aluminium prices than at present. Therefore the company is expected to be covered well into 2011 by existing facilities, but will need to raise fresh funding if these facilities are not extended. Moody's notes also that the company has a well-spread maturity profile which mitigates refinancing issues.

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.

Recent Events

The EFTA Surveillance Committee has recently indicated to the Government that the current Guarantee of Collection constitutes State Aid. Discussions 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, all existing debt liabilities would be grandfathered.

Rating Outlook

The outlook is stable reflecting the stable outlook of the sovereign.

What Could Change the Rating - Down

(i) A move downwards 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 and retain the current rating; (iii) should Moody's believe that the likelihood of timely support is weakened; this is not envisaged at the current time given the sovereign's low, but stable, positioning within investment grade.

What Could Change the Rating - Up

This rating is likely to move in line with the sovereign rating and no immediate upgrade is envisaged.

Rating Factors

Landsvirkjun

Unregulated Utilities and Power Companies	Aaa	Aa	A	Baa	Ba	B	Caa
Factor 1: MARKET ASSESSMENT, SCALE AND COMPETITIVE POSITION (20%)							
a) Market and Competitive Position			X				
b) Geographic Diversification					x		
Factor 2: CASH FLOW PREDICTABILITY OF BUSINESS MODEL (20%)							
a) Hedging Strategy						x	
b) Fuel Strategy and Mix						x	
c) Capital Requirements and Operating Performance			x				
Factor 3: FINANCIAL POLICY (10%)						x	
Factor 4: FINANCIAL STRENGTH METRICS (50%)*							

a) FFO + Interest / Interest						1.6x	
b) FFO/Net Debt							4.75%
c) RCF/Net Debt						4.47%	
d) FCF/Net Debt						-	
						9.18%	
Rating:							
a) Indicated Rating from Methodology						B1	
b) Actual BCAAssigned						15 (B2)	

* 2-year historical average

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



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