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Research Update:

Landsvirkjun Local Currency Rating Cut To 'BBB-' On Weaker Sovereign; Outlook Negative

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Rationale

On Dec. 18, 2008, Standard & Poor's Ratings Services lowered its long-term and short-term local currency ratings on Iceland-based electricity generation and transmission company Landsvirkjun to 'BBB-' and 'A-3', respectively, from 'BBB+' and 'A-2'. At the same time, Standard & Poor's affirmed its long-term 'BBB-' and short-term 'A-3' foreign currency ratings on Landsvirkjun. The outlook remains negative.

The rating actions reflect our view that Landsvirkjun's owner, the Republic of Iceland (foreign currency: BBB-/Negative/A-3; local currency: BBB+/Negative/A-2), has less ability than previously assumed to provide timely financial support to Landsvirkjun.

The state owns 100% of Landsvirkjun. Together with the company's previous owners--the City of Reykjavik and the town of Akureyri--the state provides guarantees for the collection of debt. The guarantees are ultimate, and in view of the deterioration in the credit rating on the Republic of Iceland, we consider that the sovereign's ability to provide support to Landsvirkjun, if needed, has reduced.

Standard & Poor's analyzes Landsvirkjun using its criteria for government-related entities. The ratings on Landsvirkjun are now based on a top-down methodology--compared with the previous approach of ratings equalization--which reflects: Landsvirkjun's 100% ownership by the state; the fact that there is no medium-term prospect that Landsvirkjun will be incorporated and privatized; its strategic importance to the Icelandic economy; its central role in the promotion of power-intensive industries; and the risk to the sovereign's reputation if Landsvirkjun were to default. We expect that existing and new debt obligations will continue to benefit from the government guarantee and be grandfathered if the company's status changes.

The stand-alone credit quality on Landsvirkjun is assessed to be in the 'B' category and reflects an extremely weak and highly leveraged financial risk profile; customer concentration risks; and exposure to inherently volatile aluminum prices. The stand-alone credit quality also reflects Landsvirkjun's dominant position in the Icelandic electricity market, ownership of the transmission grid, and its modern asset base.

Liquidity

Landsvirkjun's liquidity position is currently adequate, but could weaken depending on how the fair value of its derivative positions changes, and whether Landsvirkjun could be required to post collateral.

Landsvirkjun currently has \$80 million in cash and \$290 million available under a \$400 million credit facility (excluding the Icelandic banks' participation in the facility). This compares with short-term debt of \$171 million.

Outlook

The negative outlook on the local and foreign currency corporate credit ratings on Landsvirkjun reflects the negative outlook on the sovereign ratings, as well as Landsvirkjun's weak financial risk profile. Given that incorporation and privatization appear unlikely in the near to medium term, we expect the ratings and outlook on Landsvirkjun to be linked to the sovereign rating as long as we deem the company to be of high strategic importance to Iceland.

Ratings List

Downgraded

	To	From
Landsvirkjun		
Corporate Credit Rating		
Local Currency	BBB-/Negative/A-3	BBB+/Negative/A-2

Ratings Affirmed

Landsvirkjun		
Corporate Credit Rating		
Foreign Currency	BBB-/Negative/A-3	
Landsvirkjun		
Senior Unsecured	BBB-/Negative	

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