LANDSNET

# ANNUAL REPORT 2011

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# What is Landsnet?

Landsnet is the owner and operator of Iceland's electricity transmission system and operates under laws enacted by Iceland's parliament. We are a public limited company owned by Landsvirkjun, RARIK – Iceland State Electricity, Reykjavik Energy and the Westfjord Power Company.

## Our role

Ensuring and maintaining the transmission system's capacities on a long-term basis
Ensuring the electricity system's operational security
Maintaining a balance between electricity supply and demand
Managing the settlement of electricity flows countrywide
Promoting an active electricity market

## Our values

Our values form the basis of all our activities. They reflect Landsnet's role and vision and provide the foundation for the corporate culture we strive for.

**Reliability**

- We show independence whilst maintaining due confidentiality and equal treatment of our customers
- We show integrity and diligence in our behaviour and work methods

**Progress**

- We take initiative, seek out opportunities and strive for continual improvement
- We are creative in developing methods and solutions that stimulate competition
- We pride ourselves on completing tasks and projects promptly and methodically

**Economy**

- We maintain prudent stewardship of our funds and other resources
- We are guided by profitability targets

**Respect**

- Our customers come first
- We respect the natural environment and seek to minimise any undesirable effects of our operations
- We respect our colleagues and their views

## Owners

| | |
|---|---|
| Landsvirkjun | 64,73% |
| RARIK | 22,51% |
| Orkuveita Reykjavíkur | 6,78% |
| Orkubú Vestfjarða | 5,98% |

# Future vision

Landsnet's future vision is informed by its duties and role under the Electricity Act. The grid plays a vital role in our society as electricity's highway. Crucially, it ensures a secure supply of power for Iceland's general public and companies whatever their location. On this basis, the core of Landsnet's future vision is to be:

> *A reliable transmission system operator, supporting value creation in society whilst operating in harmony with the environment.*

This future vision has three main strands: security of supply, value creation and environmental protection. With electric power playing an ever more pivotal role in modern society, grid disturbances can cause considerable disruption to our country's key infrastructure. Limitations on power transmission can severely impact business development plans, can have a negative effect on electricity pricing and can diminish the value of energy sources. Growing demands for the mitigation of environmental impact from transmission infrastructure will pose challenges for Landsnet. To meet society's expectations, we must build the next generation of the grid on the basis of eco-friendly solutions, whilst at the same time meeting long-term market requirements.

We have formulated a new set of policies that sharpen the focus on the grid's long-term development and reduce the influence of large-scale projects on its overall shape. These policies present a picture of how the grid may look in 2030-2050 and define requirements for its individual components. The requirements for the central grid, which serves the whole of Iceland, are now better defined than previously. Certain steps have also been taken with respect to the long-term development of regional transmission networks. The map diagrams on page 5 show both the current grid and how we envision its future development.

Decisions about the grid's development are based on the power development options set out in the Master Plan for Hydro and Geothermal Energy Resources in Iceland and on projected economic and population development. Environmental considerations also shape our selection of transmission routes. Our guiding principle is to build few, but high-capacity transmission lines, so as to minimise their number in future and thus meet increased environmental standards. A key priority for the future grid will be increased transmission capacity between northern and southern Iceland.

System constraints in the present grid place limitations on power stations' output and may therefore affect their cost-effectiveness. However, the grid development currently on the drawing board will make it possible to better ensure inter-regional parity of access to and increase trade in electricity.

Electricity trading looks set to change substantially in future. Alternative energy sources will come to the fore, including wind and solar power as well as small hydroelectric power stations. Electricity consumption will no doubt change considerably, with rising electricity prices and consumers increasingly opting to deal with price developments by changing their consumption patterns. To meet such challenges, Landsnet has adopted the following strategic aims:

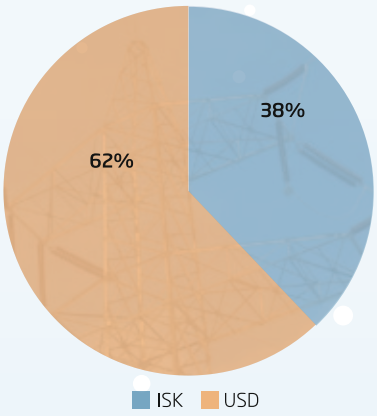
- To be a leader in the introduction of smart grid solutions focusing on renewable energy sources, increased value creation and sustainability
- To be a leader in the development of an information highway for electricity market players
- To foster energy-market innovation that supports value creation in society, including the presentation of such innovation and of Landsnet's plans

High-tech solutions will be at the centre of future electricity systems. Automated systems will no doubt take a prominent place in homes and workplaces. In fact, this development has already started, one example of which is the availability of household appliances that switch automatically between energy sources depending on the conditions. Automated grid systems have been termed "smart grids". These employ an information system covering all aspects of the grid and a powerful electronic communications system, which will eventually revolutionise electricity trading. Hence, our system operations role will change dramatically in the future. To meet such challenges, further development of the current business model for power generation and distribution will be necessary. Development and innovation will therefore be an increasing part of what we do.

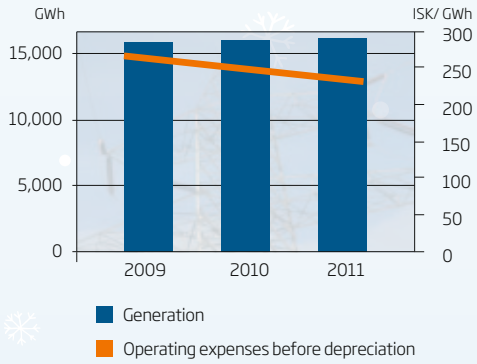
# Key figures

- Total income was ISK 11,903 billion, compared with ISK 12,846 billion in 2010.
- EBITDA was ISK 8,007 billion, against ISK 8,882 billion in 2010.
- Fixed assets amounted to ISK 60,187 billion, compared with ISK 62,156 billion in 2010.
- Total assets stood at ISK 74,679 billion, up from ISK 70,513 billion in 2010.
- Equity at year-end was ISK 12,462 billion, and the equity ratio was 16.7%.
- Return on equity (ROE) 7.2%
- The tariff for power-intensive consumers was reduced by 5% on 1 June 2011.
- The tariff for distribution system operators remained unchanged throughout the year.

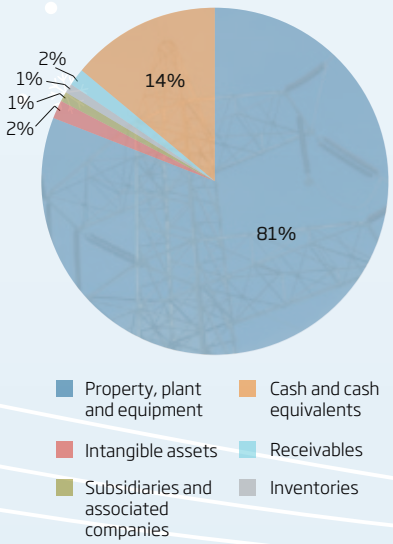
**Revenue**



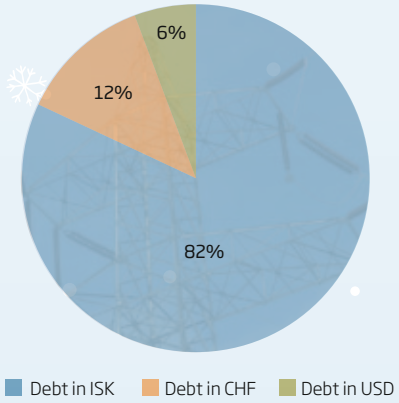

**Transmission volume and operating expenses**
**before depreciation at average 2011 prices**




**Assets**

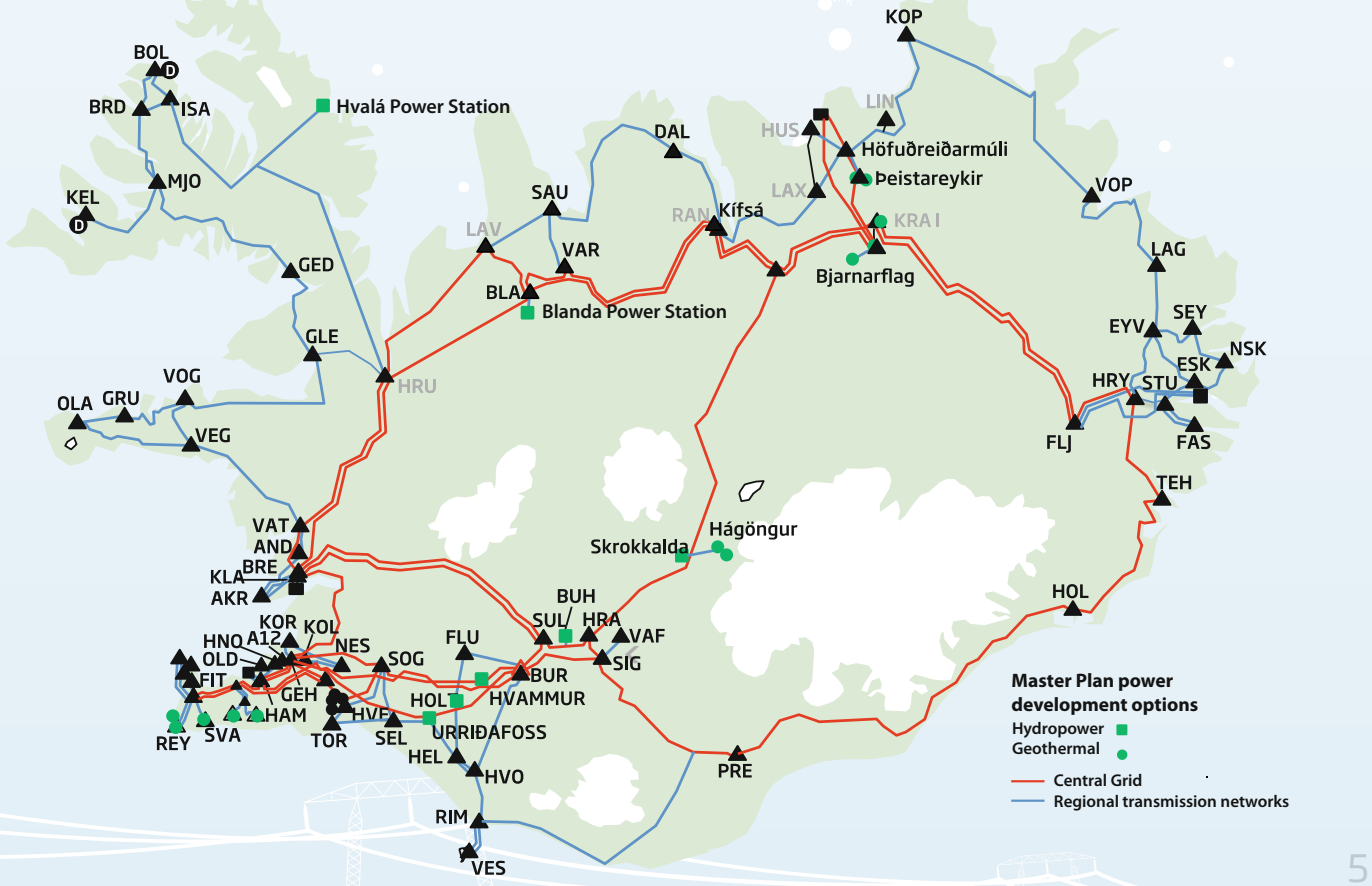



**Total liabilities and obligations**



# Landsnet's grid in 2011


# Next generation of the grid



Landsnet's Board of Directors: Agnar Olsen, Geir A. Gunnlaugsson and Svana Helen Björnsdóttir.

# Landsnet's Board of Directors:

**Geir A. Gunnlaugsson** **Chairman of the Board**

Geir A. Gunnlaugsson studied mechanical engineering at the University of Iceland, earned an MSc degree in mechanical engineering from the Technical University of Denmark and a PhD from Brown University, USA. He was professor of mechanical engineering at the University of Iceland in 1975-1986. He was chief executive of Icelandic Metals in 1983-1987, Marel in 1987-1999 and Hæfi in 2000-2003, chairman of Reyðarál in 2000-2003 and chief executive of Promens in 2003-2006. Mr Gunnlaugsson has served on government negotiating committees on power-intensive industry and on the board of the Marketing Office of the Ministry of Industry and the National Power Company in 1988-1997, including as chairman in 1989-1997. He has sat on the board of numerous businesses, both Icelandic and foreign, as well as other organisations and institutions, and has extensive experience in business management in Iceland and overseas.

**Agnar Olsen** **Director**

Agnar Olsen studied civil engineering at the University of Iceland and took an MSc degree in civil engineering from the Technical University of Denmark. After working at Landsvirkjun for one year, he joined the engineering firm Verkfræðistofa dr. Gunnars Sigurðssonar. He then rejoined Landsvirkjun, starting in the Line Department before becoming chief engineer in the Engineering Department and Director of the Engineering and Construction Division. He was Director of the CEO's Office for three years until retiring in 2011. Mr Olsen has served on various boards and committees for Landsvirkjun and Samorka – Icelandic Energy and Utilities.

**Svana Helen Björnsdóttir** **Director**

Svana Helen Björnsdóttir holds a BSc degree in electrical engineering from the University of Iceland and an MSc in electrical power engineering from the Technische Universität Darmstadt in Germany. In recent years, she has worked mainly in the information technology sector. She is currently CEO of the information security company Stiki ehf. She holds a diploma in operations management from the University of Iceland, is a certified lead auditor of ISO/IEC 27001 information security management systems and has served on various boards and committees in Iceland as well as abroad. She has extensive experience in business management, international co-operation and export activities.

# Executive Committee:

**Þórður Guðmundsson President & CEO**

Born in 1949, Þórður Guðmundsson pursued studies at the Technical School in Reykjavík, the Technical College of Iceland, University of Iceland and the Norwegian University of Science and Technology, from which he graduated with an MSc degree in power systems engineering in 1978. He joined Landsvirkjun in 1978, starting as an electrical engineer and later becoming chief engineer in the Operations department until appointed Director of Operations in 1992. Following organisational changes in 1997, he became Director of the Transmission division until appointed Landsnet's President & CEO on the 1st of January 2005.

**Guðlaug Sigurðardóttir CFO**

Born in Reykjavík in 1966, Guðlaug Sigurðardóttir earned a degree in business administration from the University of Iceland in 1991. After graduation, she worked for KPMG Iceland until 1993, when she joined Meitillinn hf as administrator and financial manager. She worked on special projects for the fisheries company VSV from 1996, later becoming financial manager. She joined the Municipality of Árborg in 1999 as finance director and became managing director of finance and administration at the beginning of 2002. She joined Landsnet as Chief Financial Officer in 2008.

**Guðmundur Ingi Ásmundsson Deputy CEO**

Born in Reykjavík in 1955, Guðmundur Ingi Ásmundsson took a degree in electrical engineering from the University of Iceland in 1980 and a master's degree in electrical power engineering from the Technical University of Denmark in 1982. He joined Landsvirkjun in 1982 as an engineer in the Operations department, later becoming chief engineer and Head of the Systems Operations from 1993. He served as Director of Landsnet's System Operations and Markets from the company's founding on January 1st 2005, and became Deputy CEO in January 2008.

# From the Chairman and the President & CEO

In the 1960s, the electricity grid did not exist in its current form. Smaller power stations operating separately in Iceland's four main regions supplied consumers with electricity, diesel generators were widely used and there were no inter-regional connections. In that same decade, a decision was made to interconnect the transmission systems throughout the entire country in a Regional Ring Network. Once it was constructed, the diesel generators could be taken off stream, buildings could be heated electrically and oil-powered heating was phased out almost completely. The replacement of imported oil with domestic energy sources for heating created value for the Icelandic economy in the tens of billions of Icelandic krónur. The environmental benefit was of at least equal value.

We are now again at a turning point. Substantial investment is needed in the grid where bottlenecks and a high utilisation ratio of infrastructure are restricting further value creation that would benefit society at large. Generating companies are not afforded full scope to make market-based decisions on the output of individual power stations. The location of new consumers, whether large or small, is also widely subject to significant restrictions. This situation needs to be remedied, so it is foreseeable that we will be stepping up our investment in the grid in the coming years, after years of minimal investment. With due reference to the Master Plan for Hydro and Geothermal Energy Resources in Iceland, our Board has adopted a forward-looking policy on the grid's development up until 2025, which involves a major increase in investment in new infrastructure to revamp the grid and accelerate value creation for all stakeholders. The policy's overriding focus is to increase value creation and security of supply, as system disturbances can be very costly for our society. We will also redouble efforts to adapt our infrastructure projects to the environment in the best possible way. As some of the infrastructure development that will be necessary over the coming decades may be controversial, it is important to open a public dialogue on such projects as soon as possible.

The transposition of EU directives on the internal market into Icelandic law aimed to ensure effective competition in the generation and supply of electricity. However, the introduction of market solutions to stimulate the power market has proceeded at a slower pace than originally envisaged. Landsnet operates a balancing energy market and buys regulating power and transmission losses through tenders. Within long, we will take a further step in this direction by launching a wholesale electricity market, which will contribute to more effective pricing in the power market. Preparations for this move started several years ago but the market launch was postponed in the aftermath of the 2008 economic crisis. This electricity market will enable Landsnet to buy the transmission losses on the market, which hopefully will offer interesting solutions of benefit to all stakeholders.

One of Landsnet's roles is to issue certificates of origin to Icelandic generators interested in selling Tradable Green Certificates, Guarantees of Origin, in the market. By confirming that Icelandic power generation is both eco-friendly and

Geir A. Gunnlaugsson Chairman of the Board and Þórður Guðmundsson President & CEO.

renewable, these certificates of origin serve to highlight what Iceland has to offer for businesses committed to green energy. To meet requirements as a provider of such certification, Landsnet has joined the Association of Issuing Bodies (AIB), an international accreditation organisation. Our hope is that Icelandic generating companies will gain substantially from the sale of Tradable Green Certificates in future years.

The environmental footprint of grid infrastructure has come under increased focus in recent years. Most of the discussion has centred on the choice between overhead lines and underground cables, with less attention paid to other important infrastructure, such as substations. Like transmission system operators in other countries, our policy has been to develop the grid mainly with overhead lines, particularly for higher voltages, given the higher costs of more extensive undergrounding and attendant tariff increases. This does not mean that we are opposed to undergrounding per se – in recent years, we have laid approximately 125km of underground cables for voltages of 66kV and 132 kV, as low-voltage cables are less costly. In the past few years, we have stressed the need for a future government policy in this area. We therefore welcome the recently adopted parliamentary resolution to formulate such a policy. This issue is of particular importance, as extensive undergrounding could multiply tariff rates, both for general and power-intensive consumers. Such a decision is not for Landsnet to make.

Of course, overhead lines are usually rather conspicuous in the landscape. The criticism has been made that insufficient attention is given to innovative design of new transmission towers in regards of materials and visibility. We take such criticism fully on board. Work has been ongoing over the past two years to develop

new types of towers, including towers made of carbon fibres, as well as ways of minimising their visibility. Our aim is to use these new designs the next time transmission line structures are built. The same applies to our transformer stations, for which new and interesting solutions to minimise visual intrusion have been under development.

An electricity grid criss-crosses the country like a system of highways. Hence, our infrastructure is to be found throughout Iceland and in most municipalities. New infrastructure development requires extensive preparation and consultation with numerous stakeholders, including local authorities – whose viewpoints and attitudes can differ widely. In some cases, a single local authority may halt an infrastructure project of wider public interest by refusing to include the project in its land-use planning or to grant a construction permit. There have been numerous such examples. Landsnet, on the other hand, has the statutory role of developing Iceland's electricity transmission system. This puts us in something of a difficult position in cases where a satisfactory agreement cannot be reached with the local authority. In this respect, the Icelandic rules are largely divergent from those of other countries, where the wider public interest is afforded a higher priority than individual municipalities.

With the passing of the 2003 Electricity Act, the EU directive on common rules for the internal market in electricity was transposed into Icelandic law. This aimed to ensure a sound operating environment for Landsnet. According to the Act, Landsnet operates under a concession arrangement and is subject to regulation by the National Energy Authority (NEA). The 2003 Act also stipulated a three-year

revenue cap for Landsnet to be reviewed annually. The revenue cap in effect determines the income that the company may collect from its customers in the form of transmission revenue. Because the company had no operating history to build on at the outset, the revenue cap was initially set for a single year at a time for 2005 and for 2006. Subsequently, the cap was set for three years at a time as prescribed by the Act, the first such period being 2007-2009. The revenue cap was again set for a single year in 2010 in anticipation of the Electricity Act's then impending review.

The amendments made to the Act in early 2011 specify in further detail how to determine, review and settle the revenue cap. It must now be set for five years at a time, new profitability criteria must be adopted each time, and the NEA must determine the cap for each upcoming period no later than 15 September of the year prior to the year in which the new cap takes effect. The amended Act also stipulates that, no later than 1 May of each year, the transmission system operator must submit its operating results for the preceding year to the NEA. The NEA must then deliver its decision on the updated revenue cap and settlement for the preceding year, together with appropriate reasoning, to the transmission system operator no later than 1 August. In addition, the revenue-cap-based settlement made at the end of each year must be based on a comparison between real income and the updated revenue cap for the year.

Unfortunately, we must express disappointment with the implementation of these provisions of the Act, which are intended to establish a sound operating basis for Landsnet and price certainty for consumers. Landsnet has been faced with uncertainty about its revenue cap almost since the company's founding. The revenue-cap-based settlement for the years 2006-2010 is yet to be fully completed, as the NEA has made certain decisions only later to withdraw them. The 2011-2015 revenue cap also remains to be determined, causing uncertainty about our tariffs for distributors and power-intensive consumers. This presents problems not only for Landsnet but also for our customers. New profitability criteria for the revenue cap were recently proposed on a temporary basis. These proposals are being reviewed by stakeholders, but when the criteria will be finally determined remains unclear. Such operational uncertainty is hardly satisfactory to the company, not least as the Act stipulates clear time limits for the determination of the revenue cap and settlements based on it. We must therefore ask whether this is acceptable government.

Overall, Landsnet has performed well in recent years. However, like other Icelandic businesses, the company was adversely affected by the 2008 economic crisis. Even so, our tariff for utilities has not been raised since 2009. In fact, in real terms it has been reduced by 44% since Landsnet's founding in 2005. The tariff for power-intensive consumers has also been on a downward path in real terms.

Our good performance has been achieved through the concerted efforts of our team of dedicated employees, to whom we extend thanks for their excellent work over the past years.

*Geir A. Gunnlaugsson, Chairman of the Board*
*Þórður Guðmundsson, President & CEO*

# Activities in 2011

The grid's operation and maintenance followed a fairly conventional course in 2011. Focus was placed on preventive maintenance through detailed inspections of transmission infrastructure, followed by repairs and improvements as required. Such work proceeds on a long-term schedule for transmission lines and substations, with regular checks of their condition and operational security.

In addition to routine activities, we worked on special priority projects to improve and strengthen the transmission system. A major project on the Fljótsdalur Lines in East Iceland was completed. Fall protection equipment and safety grids were installed at the top of the line's transmission towers, increasing safety for our staff when carrying out maintenance and repairs. We launched an effort to step up the maintenance of structures and sites where electrical equipment is housed, our asset base having grown considerably since 2007. We revamped the control systems of a number of substations and renewed their electricity feeders and reserve power source, diagnosed and strengthened the Tálknafjörður Line, checked the condition of two submarine cables to the Westman Islands using underwater cameras, renewed protection equipment and undertook numerous smaller projects to increase security of supply.

## Grid development

We undertook a wide range of activities in 2011 devoted to individual projects' system design, checks in response to inquiries by customers and stakeholders, general studies of the transmission grid and analysis of potential future solutions.

The year saw extensive preparations for strengthening the central grid. Particular emphasis was placed on the Regional Ring Network and a possible connection over the highlands coupled with the closure of a 400 kV ring structure in South-West Iceland, involving voltage raising – the Brennimelur Line 1. We prepared an assessment plan for the connections of the Hólmsá and Búland power stations and worked on various other planning projects around the country. Also worth mentioning are the preparation of special web pages on the relative merits of overhead lines versus underground cables and the formulation of a long-term investment strategy, including an assessment of its effects on our tariff.

## New development projects in 2011

Investment in the grid amounted to ISK 1,047 million in 2011, somewhat less than in recent years. However, we anticipate a substantial increase in investment in the next few years.

In the summer of 2011, a 5.9 km 66 kV underground cable was laid to the Lagarfoss Line 1 from the Eyvindará substation in East Iceland, in addition to development on the substation lot. The underground cable was brought into service in December.

Construction for the grid connection of a data centre at Ásbrú in South-West Iceland went into full swing in the spring of 2011. Energy supply to the data centre started in November and work on the connection is due to be completed in early 2012.

The year saw preparations for the construction of a new static VAR compensator (SVC) at Klafastaðir, a new substation lot at the Grundartangi industrial site in Hvalfjörður fjord, South-West Iceland. Tenders were invited for the supply of electrical equipment during the year. The winning tender was submitted by the Swedish-Swiss power and automation technology company ABB AB. The contract involves the design, construction and installation of electrical equipment for a +150/-100 MVAr reactive power compensator, which is due to come into service in the spring of 2013. The reactive power compensator will increase transmission capacity to the Grundartangi site, enabling Landsnet to meet increased energy demand in the area. It will also enhance the grid's voltage control significantly, which will have a positive effect on the operation of the whole grid.

Following a tender for power transformers during the year, we entered a contract with the Turkish manufacturer BEST Transformers Corporation to purchase two 100 MVA, 220/132 kV power transformers, with an option to buy two additional 80 MVA transformers. From the six tenders received from transformer manufacturers, BEST's proved the most economically advantageous. The two transformers will be delivered to Landsnet at the end of 2012.

We prepared the construction of a connection to the Búðarháls Power Station, with the tender design taking place in the second half of the year. A substation is envisaged at Búðarháls and there are plans to build a 6km, 220 kV transmission line, the Búðarháls Line 1, which will connect to the Hrauneyjafoss Line 1 at Langalda. The substation will be constructed as a non-insulated steel-frame structure over air-insulated switchgear, in addition to a concrete structure for support systems. Tenders for this project will be invited in the first half of 2012.

A number of infrastructure projects were completed during the year. The major ones were the Nesjavellir Line 2 (underground cable), the Bolungarvík Line 2


ANDSNET

(underground cable) and the interconnection of cables at the Kolviðarhóll substation from generating units 5 and 6 in the Hellisheiði Power Station. The interconnection brings substantial cost savings, as it eliminates the need to add expensive high-voltage switchgear at the substation. The environmental impact assessment for the Þorlákshöfn Lines 2 and 3 was also completed in 2011.

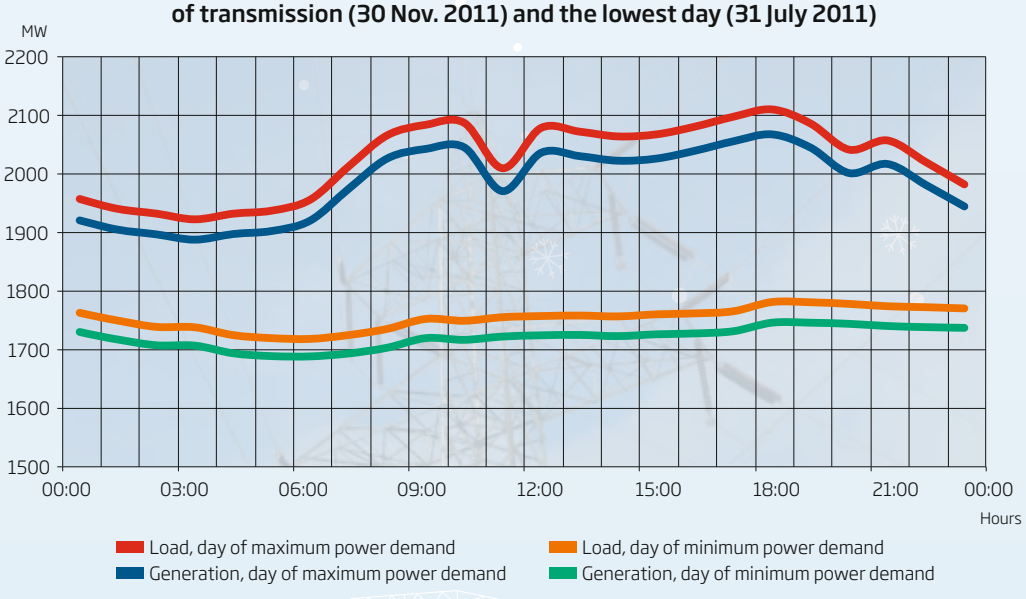
Preparations continued for laying the Blanda Line 3 and the Suðurnes Line 2. These lines are much needed to strengthen the grid, so their construction is envisaged in the next few years. Preparations also continued for the prospective power stations in North-East Iceland.

Due to the construction of protective structures against avalanches, rock fall and mudslides in the slope above Ísafjörður town in the West Fjords, the current substation in that same location Stórurð, needs to be moved. We assessed site options for the new substation in co-operation with the Westfjord Power Company, with preparations for these works set to continue in 2012. In parallel with this project, we have been examining options for a new backup generating station for the area. Its construction is expected to commence in 2012 at Bolungarvík and the backup generating station is scheduled to come into service in the second half of 2013.

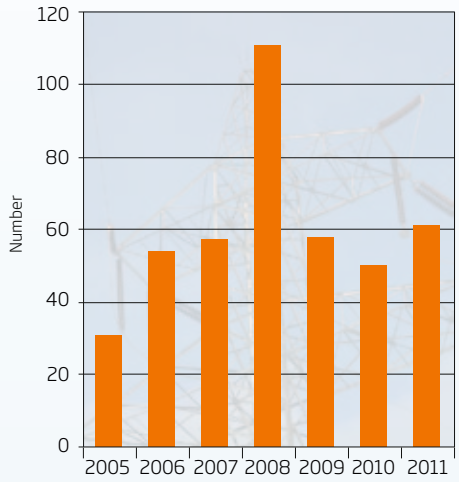
## Operation of the transmission system

The highest peak in power fed into the transmission grid was measured on 7 December at 2,114 MW, a year-on-year increase of 0.3%. Total system demand in 2011 was 16,287 GWh, up 0.68% on the previous year. Transmission losses totalled 324 GWh, or 1.95% of generation, down by 5.6 GWh or approximately 1.7% from the previous year despite increased transmission. This was primarily due to more efficient power flows in the grid.

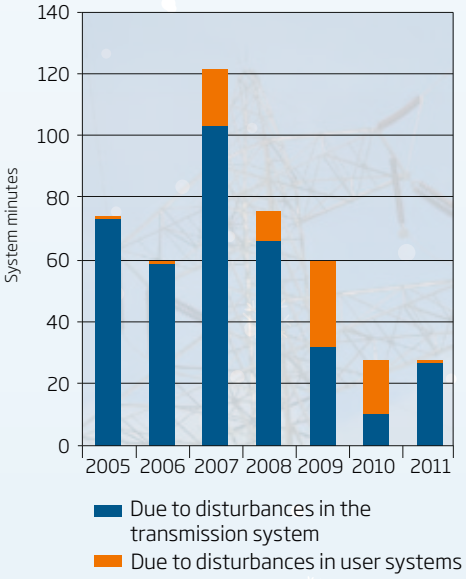
**Intra-day load curves for generation and consumption on the peak day of transmission (30 Nov. 2011) and the lowest day (31 July 2011)**



**Number of disturbances in the transmission system**




**System minutes due to disturbances**




## Grid disturbances

Rapid and accurate functioning of protection equipment is crucial in ensuring security of supply and power quality at the delivery point, as well as in protecting the equipment against faults that may occur over its lifetime. The year 2011 saw continued scheduled improvement and renewal of our protection systems, which have time and again proved their worth by mitigating the impact of grid disturbances. We are now aiming to digitise all system protections, which will among other things enable faster and better diagnostics of disturbances.

Disturbances in the transmission system numbered 53 in the year. Disturbance-related faults numbered 61, which means that more than one fault occurred during some disturbances. Energy not supplied due to grid disturbances totalled 834 GWh, which corresponds to 26.9 outage minutes. Energy not supplied due to disturbances in non-Landsnet systems totalled 8 MWh.

## Summary of main grid disturbances in 2011

The main grid disturbances causing outages and unsupplied energy were as follows:

- **On 6 January**, a major grid disturbance occurred in North-East Iceland when an intense easterly storm hit the country. The Laxá Line 1 tripped, causing extensive disruption to electricity supply in the region. Tripping also occurred on the Krafla Line 2 (Krafla–Fljótsdalur), but did not cause any power outages for consumers. On the same day, tripping on the 132 kV line in the Geiradalur valley left consumers without power in the southern West Fjords. Energy not supplied due to these disturbances was assessed at almost 88 MWh.
- **On 14 March**, the Glerárskógar Line 1 tripped where River Hrútafjarðará had eroded tower foundations. As a result, some consumers in the West Fjords were without power. Energy not supplied was assessed at 195 MWh.
- **On 10 April**, a fierce storm struck the country, causing repeated tripping of the West Line (Vesturlína). This led to extensive outages for consumers in the West Fjords. Both the Geiradalur Line 1 (Glerárskógar–Geiradalur) and the Mjólká Line 1 (Geiradalur–Mjólká) tripped repeatedly. Energy not supplied was assessed at 215 MWh.
- **On 12 April**, a three-phase short circuit occurred at the 220 kV side of transformer 6 at Hellisheiði Power Station when an underground cable and a generator transformer were being energised. The short circuit led to the tripping of both of the potlines at the Norðurál – Century Aluminum plant, potline 3 at the Alcan Iceland aluminium plant, all generating units at the Hellisheiði Power Station, generating unit 3 at the Nesjavellir Power Station, unit 6 at the Svartsengi Power Station and unit 1 at the Lagarfoss Power Station. The generating units at the Reykjanes Power Station scaled down to half-load.
- **On 7 October**, circuit breakers, transformers and a transmission line in Fljótsdalur valley tripped, taking out the Alcoa Fjarðaál aluminium plant's potline and station service power as well as generating units at the Fljótsdalur Power Station. A fault occurred in the DC system at Fljótsdalur. Energy not supplied due to the disturbance was assessed at 275 MWh.

## Market developments

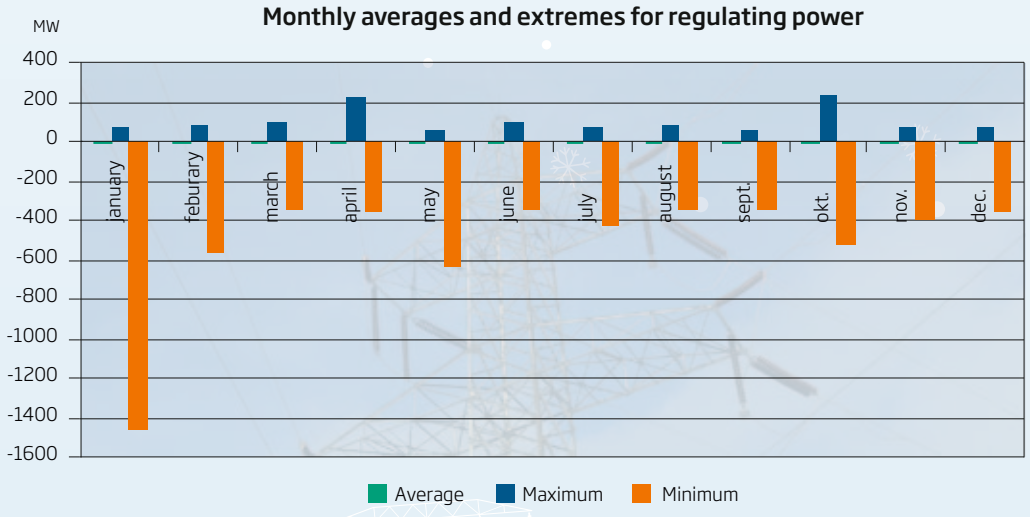
Our client base gained a new power-intensive consumer during the year, bringing the total number of customers meeting the legal conditions for power intensive users to six. We devoted efforts to clarifying our regulatory framework for such clients and making it more accessible by adding two new sets of terms and conditions: the B9 Terms for power-intensive consumers wishing to connect to the grid at a voltage lower than 132 kV; and the B4 Terms, which set out general requirements for power-intensive consumers' connection to the grid. We also issued new Terms for the Design of the Transmission System (E1), which specify Landsnet's design criteria and are of use to those considering connecting to the grid.

Among Landsnet's functions is to ensure the availability of sufficient spinning reserves at any given time, to control frequency and voltage and to ensure a minimum supply of regulating power. For 2011, this was effected through contracts ensuring the availability of 100 MW of spinning reserves.

Landsnet operates a regulating power market to offset imbalances between projected and actual power consumption. In 2011, we experimented with 'telephone bids' in the regulating power market in an aim to stimulate market competition. These experiments helped us to further develop the way in which telephone bids are organised. More experiments will follow in 2012. We are also developing a process to better enable suppliers to offer consumption via the regulating power market, which should step up competition.

## ISBAS - wholesale market in electricity

The year saw increased interest among electricity market players in the opening of an Icelandic energy trading market, whose launch we have repeatedly postponed due to the wider economic situation in the aftermath of October 2008. To meet this renewed interest, we started preparing for the launch of a wholesale market in electricity, now scheduled for late summer 2012. This market will be operated at Landsnet's premises and modelled on the Nordpool exchange, which has several years' experience in operating wholesale markets for energy.



## Information technology

At year-end 2011, the largest part of our IT services had been brought in-house. This includes the operation of central computers, data backup, various networks and e-mail hosting. Many of these services were previously managed by other companies, whilst our policy has been to increase and bolster our internal IT management. We continued to work on the implementation of the ISO 27001 information security standard, aiming for certification in 2012.

The key to secure real-time information systems is secure communications. 2011 was a year of major change in our telecommunications environment, as following amendments to the Electricity Act in March, our telecommunications property was transferred to a new company, Orkufjarskipti ehf, which is 50% owned by Landsnet.

## Environmental management

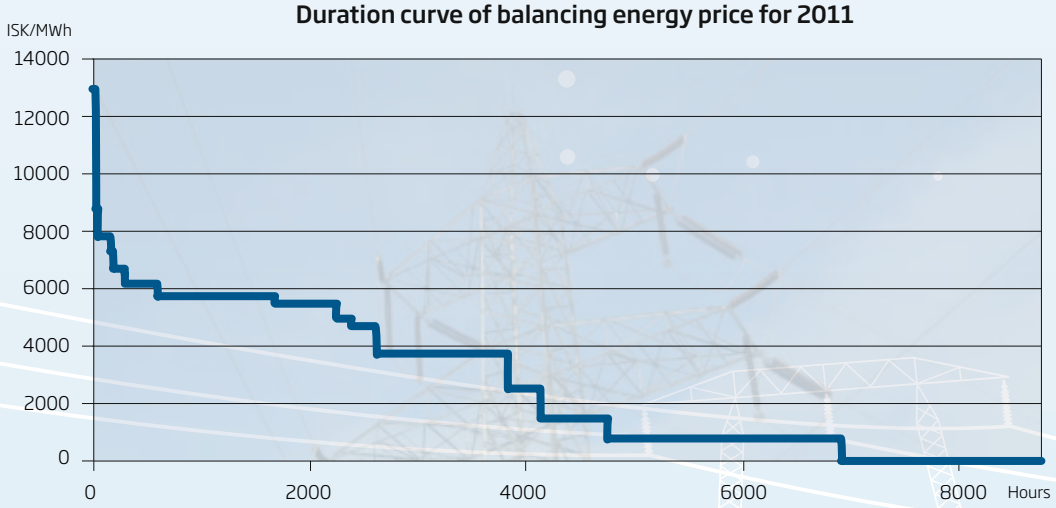
Landsnet is committed to fulfilling its public role of transmitting electricity responsibly whilst operating in harmony with the environment and society. Although all generation, transmission and consumption of electricity has some effect on the environment, this footprint varies depending on the energy source.

The main environmental impact of electricity transmission in Iceland is land disturbance from line construction, greenhouse gas emissions from the construction and operation of the grid and the use of non-renewable resources such as steel in infrastructure. Another factor is the visual impact of infrastructure in the landscape, although the impact of transmission lines is reversible and arguably of an aesthetic nature.

## Minimisation of environmental impact:

We are constantly looking for ways in which to minimise the environmental footprint of the grid's construction and operation. Since the technology behind electricity transmission has remained relatively unchanged for a long time and the grid is not a production unit, the environmental impact of our day-to-day activities is not particularly severe compared with many other types of operations.

**Duration curve of balancing energy price for 2011**



## Certification

To ensure that electricity supply is secure and meets requirements, Landsnet has developed and implemented an accredited management system. An active management system encourages improvements, increases efficiency and effectiveness and promotes trust, transparency, co-operation and staff loyalty.

## ISO 9001 quality management

Landsnet has been certified under the international quality management standard ISO 9001 since 2007. An accredited quality management system serves as a foundation for other management systems adopted by the company. The aim of such systems is to ensure that the products and/or services provided by the organisation in question meet the requirements of clients, laws and regulations and that the organisation's activities are being constantly developed and improved.

## Safety management as per requirements for electric utilities

Landsnet operates in accordance with a safety management system approved by an accreditation agency. The system's processes meet the Icelandic Construction Authority's requirements for electric utilities' safety management. The system is part of Landsnet's ISO 9001 quality management system.

## Management systems being implemented

Landsnet is preparing the certification of its management systems for environmental management in accordance with the ISO 14001 standard, for occupational health and safety management in accordance with the OHSAS 18001 standard and for information security management in accordance with the ISO 27001 standard. All these systems will form part of our overall integrated management system. Organisations that meet the requirements of the environmental management standard ISO 14001 must basically define important environmental factors in their activities and then manage these, as well as continuously work to reduce their environmental footprint. Organisations that operate in accordance with the OHSAS 18001 standard must demonstrate their management of occupational, health and safety risks and work continuously to improve these. As for information technology accreditation, the ISO 27001 standard emphasises the management of data security and information systems to minimise operational risks.

We achieved our annual target for greenhouse gas emissions from gas-insulated substations (GIS), which was for the leakage rate of sulphur hexafluoride (SF6) not to exceed 0.5%. One environmental incident occurred when gas leaked into the atmosphere following an explosion in a cable termination at the Nesjavellir Power Station.

We introduced a waste sorting system at all Landsnet premises and prepared the implementation of a certifiable environmental management system.

Two post-construction environmental audits were carried out in collaboration with the representatives of local and environmental authorities. The audits were conducted on Landsnet's initiative to ensure an optimal standard of finish upon project completion.

## Landsnet Emergency Management

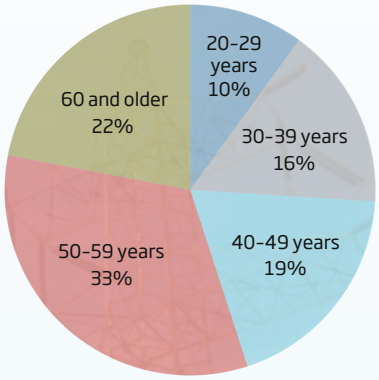
Landsnet Emergency Management (LEM) held an extensive exercise on 10 March 2011, in which many members of the Electricity Sector Emergency Partnership (ESEP) participated. This was the largest such exercise to date since Landsnet was founded. Preparations are already underway for the next major exercise, which is due to take place in 2013. Smaller LEM exercises will be held in the interim. The March 2011 exercise was deemed a great success and spawned numerous other projects aiming to improve emergency preparedness capabilities. The participants were put under heavy stress during the exercise, which went as far as possible without disturbing electricity supply. It included a fully-fledged newsroom with live broadcasts from the field, a meteorologist and several other important external professionals. The Terrestrial Trunked Ratio (TETRA) network was used for telecommunication and more than proved its worth as a very suitable security communications system when the country's infrastructure comes under threat.

## Safety, health and human resources

One of Landsnet's key priorities is to be a sought-after workplace with a strong team of dedicated professionals. Since the appointment of a Human Resources Manager in 2010, systematic work has been ongoing to develop our human resources management. In 2010, HR services were still being handled by our parent company, Landsvirkjun. These have now been transferred to Landsnet, with the exception of payroll management. We will continue to strengthen our HR management in the coming years. Preparations for transferring payroll management in-house will begin in 2012, with completion of the transfer scheduled within three years, after which all HR management will be handled internally. We will take on an additional employee in 2012 to add weight to our HR management.

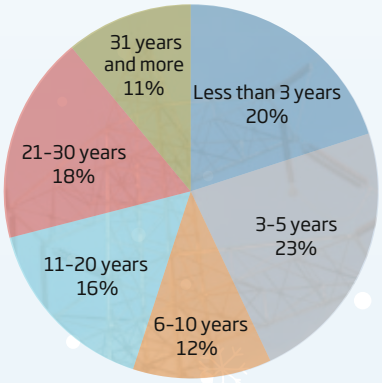
In 2011, we formulated and updated various HR-related quality control documents and procedures. We updated quality control documents and procedures for staff training, staff development and the recruitment process, and devised checklists for recruitment and termination of employment. Job descriptions were replaced with a job analysis for each position. A job analysis includes a job description as well as an analysis of the education, knowledge and capabilities required for the position in

**Employees' age profile**




The figure shows the average age of employees.

**Years of service**




Our employees have a wide range of educational backgrounds. Most commonly, they hold degrees in engineering, in particular electrical engineering, or are certified electricians or powerline technicians.

question. The conversion of job descriptions into job analyses started during the year and will continue into 2012, when all job descriptions will be rendered into a new form. Job analyses will be included in the information packages that employees receive on their respective positions and job requirements, as well as providing a basis for recruitment, training assessment and performance appraisal.

Our employees numbered 100 at year-end 2011, of which 83% were men and 17% women, the number of female employees having dropped slightly during the year. The gender balance among senior management remains unchanged, with women at 33% and men at 67%.

Eight new staff were added in 2011, thereof three for temporary positions. Staff turnover for the year was 7%. Somewhat increased staff turnover is expected in the coming years, since about 22% of our employees are older than 60. We have reacted to this age profile by producing a workforce forecast for the next few years, including an assessment of recruitment and training needs. Given this age distribution, increased recruitment is foreseeable in the coming years.

We employed a record number of upper-secondary school-aged children in summer jobs in 2011, totalling 56 people. All youth-work-related management and procedures were updated during the year. We also opened a special information web for our youth employees. A total of 18 university students were employed in summer jobs, also a record number. We updated our focus areas for the work and projects of university students in our employment over the summer months to ensure that they are afforded opportunities to perform real-world tasks in their respective fields of study. We thereby aim to contribute more to society by providing university students with meaningful work skills and knowledge. In keeping with the nature of our activities, most of the university students we employed in summer jobs were engineering students, although we also hired finance and law students, to name a few other examples.

## Training and development

Landsnet has always placed a high premium on staff training and development. Our staff training reflects the company's specialised activities and took the form both of in-house and external training during the year. Many employees also attended specialised training overseas through participation in courses and conferences. A total of 44 courses were offered during the year, with training hours numbering approximately 1700.

A management training needs analysis was carried out in 2011. This led to the introduction of management capability criteria at the beginning of 2012, to be followed by a 10-month training programme for our management staff. Training this year will focus on management capabilities in need of improvement, which will be evaluated both before and after the programme.

## Staff performance and team cohesion

Our HR objectives and indicators will be formulated and updated in 2012. This includes the introduction of regular management appraisals, assessments of internal services and workplace audits.

At the start of 2012, the joint staff association of Landsnet and Landsvirkjun – STALA – agreed at the annual general meeting to separate into two staff associations. This gives our employees the challenge for 2012 of building a strong staff association within the company. The preparations were already underway in 2011, including the formation of an entertainment committee, which organised various events during the year. Our new staff association received a handsome legacy from its predecessor and its development is keenly supported by Landsnet's executive management.

Our "H factor", which indicates the frequency of injuries, was 1.55 at year-end based on 200,000 hours worked, with two lost-time injuries during the year.

Our workforce was in fairly robust health in 2011 compared with national averages. However, our sickness absence rate has been slowly rising, with no apparent straightforward explanation. The 2011 sickness absence rate was 2.32% of paid working hours, up on the preceding year but still 1.5% lower than the national average. We hope to reduce the rate in 2012 as we do not anticipate any long-term sickness of staff as in 2011.

## Finance

**Revenue cap and profitability criteria**

Act No. 19/2011 introduced a number of major amendments to the Electricity Act with regard to the revenue cap regime for Landsnet. These amendments apply to the setting of the revenue cap as of 2011. The key changes are that the revenue cap

period has been lengthened to five years, profitability is now defined on the basis of weighted average cost of capital (WACC), the asset base for power-intensive consumers has been converted to USD and account is now taken of the return on current assets. Previously, the company's profitability was tied to the yield on five-year non-indexed government bonds and determined as the same for both revenue frameworks, i.e. power-intensive consumers and distribution system operators.

The revenue cap is determined on the basis of operating expenses, depreciation, profitability and taxes. Landsnet is required to conduct its funding and return a profit to its owners on the basis of defined profitability thresholds. Profitability is calculated from the asset base of fixed assets in operation and a valuation of current assets based on the preceding year's revenue cap. The required return is based on the WACC of comparable companies, as determined by the National Energy Authority (NEA). Landsnet's revenue cap is set by the NEA, which also has a regulatory role over the company.

A temporary decision on the profitability criteria was recently submitted by a special committee appointed by the NEA on the basis of the Act and will apply as of 1 January 2011. The profitability criteria are a fundamental determinant of our revenue cap, i.e. the company's allowed revenue. The revenue cap for 2011-2015 is yet to be decided.

**Revenue-cap-based settlement**

In 2007, we changed the currency of our tariff for power-intensive consumers from ISK to USD. However, the currency of the revenue cap was not changed accordingly. On the back of Iceland's economic crisis and the ISK's sharp depreciation in 2008, revenues from power-intensive consumers jumped in line with the USD gain against the ISK. This tipped the balance of the revenue cap regime, whereas account was not taken of Landsnet's increased costs due to exchange-rate movements. To counteract such discrepancy in future, the revenue cap for power-intensive consumers is now based on the same currency as that of the tariff.

Efforts were made throughout 2011 to complete a revenue-cap-based settlement, but Landsnet and the NEA have been unable to agree on various issues, including the interpretation of profitability with regard to distribution system operators, so this matter remains unsolved. After the company's annual financial statements were signed, the NEA sent Landsnet a draft decision on the settlement for 2006–2010, but a difference of opinion remains as regards profitability criteria. In addition, the revenue cap for 2011 remains to be decided. Consequently, the total amount of revenue in excess of the revenue cap for 2006–2011 is uncertain. The situation regarding revenue-cap-based settlements and statutory provisions on repayments is discussed in detail in the notes to the annual financial statements.

## Income statement

According to the income statement, Landsnet generated a profit of ISK 840 million in 2011, compared with a profit of ISK 3,563 million in 2010. Earnings before interest, taxes, depreciation and amortisation (EBITDA) were ISK 8,007 million, against ISK 8,882 million for 2010.

The poorer year-on-year performance was due to lower revenue coupled with changes in financial items, primarily driven by higher inflation and a lower exchange rate gain than in the preceding year.

**Revenue**

Operating revenue amounted to ISK 11,903 million of which transmission income was ISK 10,408 million. Transmission income was down by ISK 935 million year-on-year, mostly owing to the reduced tariff for power-intensive consumers and a lower average exchange rate of the USD.

With Act No. 19/2011, the revenue-cap base for power-intensive consumers was linked to the USD by denominating the asset base that determines profitability and depreciation under the revenue cap regime in that currency. This served to redress the balance between the tariff for power-intensive consumers and the revenue cap. Previously, the revenue cap for power-intensive consumers was linked to an ISK-denominated asset base whereas the tariff was USD-denominated, which led to a discrepancy between revenue and the revenue cap as of the autumn of 2008. Landsnet reacted by reducing the tariff for power-intensive consumers by 5% in June 2011, and will over the next 10 years repay the revenue surplus accumulated during the period in question. This means lower revenue during the repayment period.

**Operating expenses**

Operating expenses before depreciation and amortisation were ISK 3,896 million, down by ISK 68 million year-on-year. Despite the nearly unchanged overall result, some individual operating expense items changed significantly. The main change was the lower cost of electricity purchases (to compensate for transmission losses) and ancillary services, which totalled ISK 195 million. This was counterbalanced by an ISK 107 million increase in payroll expenses. Average full-time position equivalents numbered 109 in 2011, up from 102 in the previous year. The ratio of summer positions was also higher than in 2010. Other operating expenses were also up, by ISK 20 million year-on-year, or 1.55%.

**Financial items**

Net financial expenses were ISK 4,396 million in 2011, up from ISK 2,155 million in 2010. This was mostly due to increased inflation, with indexation for the year at ISK 2,295 million, compared with ISK 1,003 million in 2010. The impact of exchange rate movements was minor during the year, whereas in the preceding year exchange rate differences were positive by ISK 975 million.

## Balance sheet

**Assets**

Total assets stood at ISK 74,679 million at year-end, up from ISK 70,513 million a year before. Of this total, fixed assets accounted for ISK 62,452 million, compared with ISK 64,035 million at year-end 2010. This year-on-year decrease of ISK 1,583 million was due to depreciation exceeding investment. Fixed assets in operation were ISK 60,187 million at year-end, compared with ISK 62,156 million at the end of the previous year. Investment was minimal during the year and loan repayments were insignificant. As a result, almost the entire cash provided by operating

activities went into increasing the cash balance, which stood at ISK 10,511 million at year-end. In 2012, we expect to pay off a revolving credit facility. Repayments of a loan from the Nordic Investment Bank are also due to commence in the year. No payments will be made on Landsnet's largest loan, from the parent company Landsvirkjun, until 2020.

### Liabilities

Long-term liabilities and obligations stood at ISK 55,580 million at year-end and short-term liabilities at ISK 6,637 million. At the end of 2010, in comparison, long-term liabilities and obligations were ISK 56,403 million and short-term liabilities ISK 2,488 million. No new loans were raised during the year; the increase in short-term liabilities is explained by higher repayments in 2012. These are estimated to amount to ISK 4,073 million, whereas repayments in 2011 were ISK 129 million.

### Equity

Equity at year-end 2011 stood at ISK 12,462 million, including share capital of ISK 5,903 million, as stated in the balance sheet. By comparison, equity at the end of 2010 was ISK 11,622 million. The equity ratio was 16.7% at year-end 2011, up from 16.5% at the end of 2010.

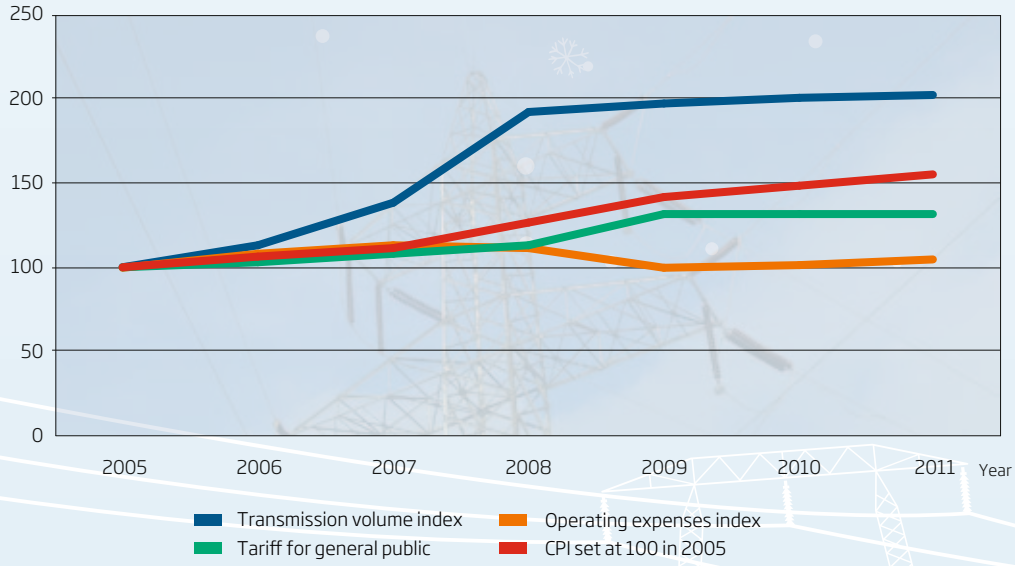
## Cash flow

Net cash from operating activities was ISK 6,279 million, compared with ISK 7,360 million in 2010. Cash at year-end was ISK 10,511 million, up by ISK 6,255 million.

**Financial ratios and key figures**

| | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|
| EBIT margin | 45.70% | 49.40% | 52.30% | 47.60% |
| EBIT interest coverage ratio | 2.65 | 3.25 | 3.55 | 4.30 |
| Return on equity | 7.20% | 42.80% | 20.20% | -107.70% |
| Equity ratio | 16.70% | 16.50% | 11.30% | 10.50% |
| Current ratio | 1.84 | 2.60 | 3.61 | 0.26 |
| Asset turnover ratio | 0.16 | 0.18 | 0.18 | 0.16 |

**Development of selected key figures**



## Efficiency gains

The trend in operating expenses during Landsnet's seven years in operation clearly shows that substantial efficiency savings have been achieved. This is perhaps most apparent in the graph on the opposite page, which shows how operating costs measured at constant 2011 price levels have developed compared with the amount of electricity transmitted, the consumer price index (CPI) and changes to tariffs for distribution system operators. The figures have been converted to an index with the base value of 100 in 2005.

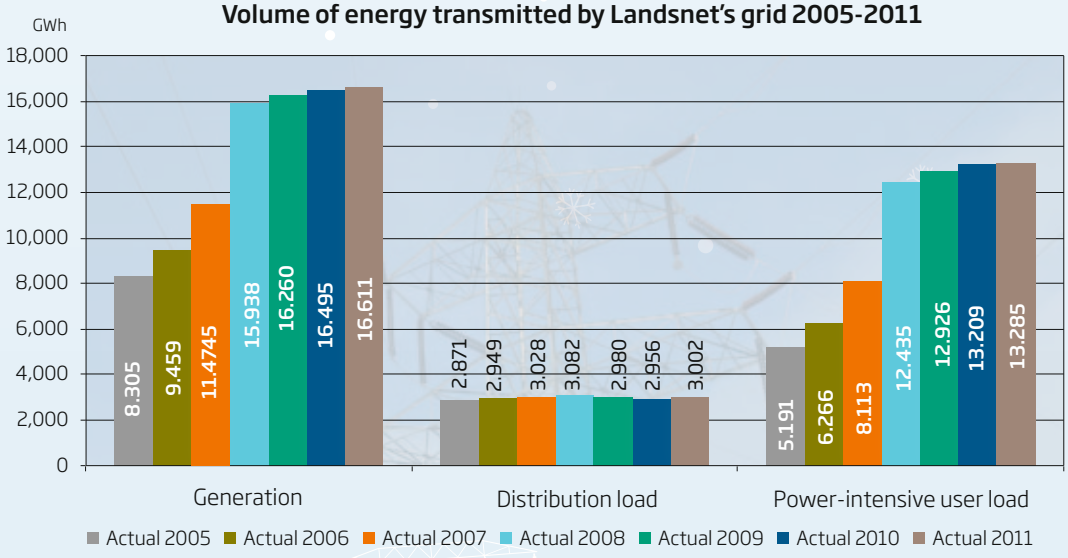
The volume of electricity transmitted by the grid has grown rapidly in the past few years. This has raised the utilisation rate of Landsnet's resources, whether in the form of fixed assets, personnel or other factors. We have thus achieved substantial rationalisation. The transmission volume has grown 102% since the company's founding, with transmission to power-intensive consumers up 155% and transmission to general consumers up by about 4%. Despite this increase in activity, our operating expenses index rose only 5% over the same period, i.e. based on the average annual index. The tariff for utilities rose 32%, but has remained unchanged since August 2009, so has not kept up with real inflation. For comparison with these items, the graph also shows the development of the average CPI since Landsnet's founding, with a base index of 100 set in mid-2005. During this period, the average CPI rose 55%.

## Funding

No new loans were raised during 2011. We have a USD-denominated revolving credit facility from our parent company, which matures in 2012. This facility's total contractual amount in 2011 was USD 50 million. At year-end, USD 29 million had been drawn from the facility, equal to ISK 3,600 million.

Long-term liabilities were 89% of total liabilities at the close of the year. Of interest-bearing debt, ISK-denominated loans now account for 81%, CFH-denominated loans for 13% and USD-denominated loans for 6%. No loan refinancing will be required in 2012, as loan repayments will be made with cash on hand.

**Volume of energy transmitted by Landsnet's grid 2005-2011**



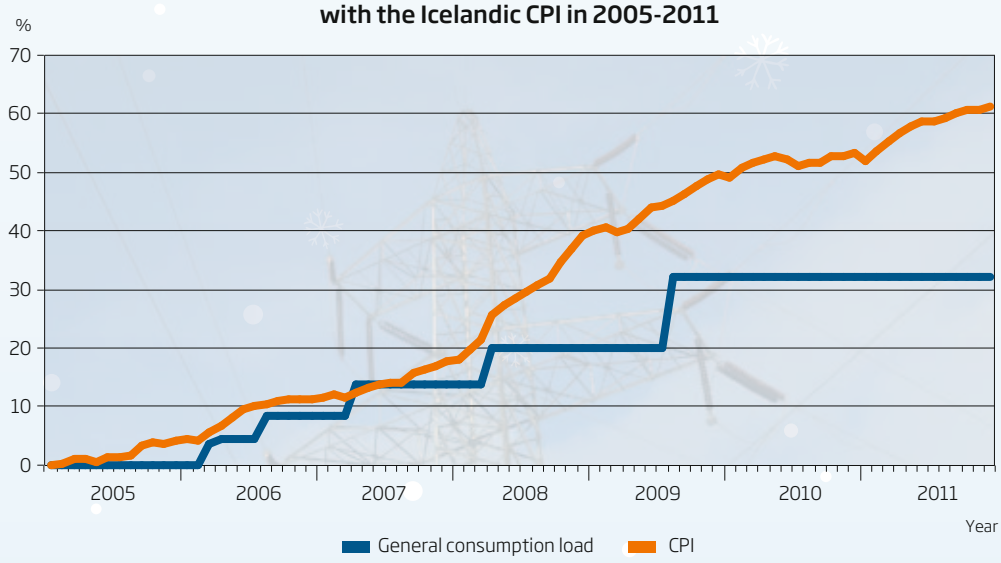
## Treasury Policy

Our Treasury Policy sets out a framework for financial risk management, the segregation of duties, authorisations, limits and other criteria. The Board of Directors regularly receives reports on financial risks. Monitoring of risk management is in the hands of a Risk Committee.

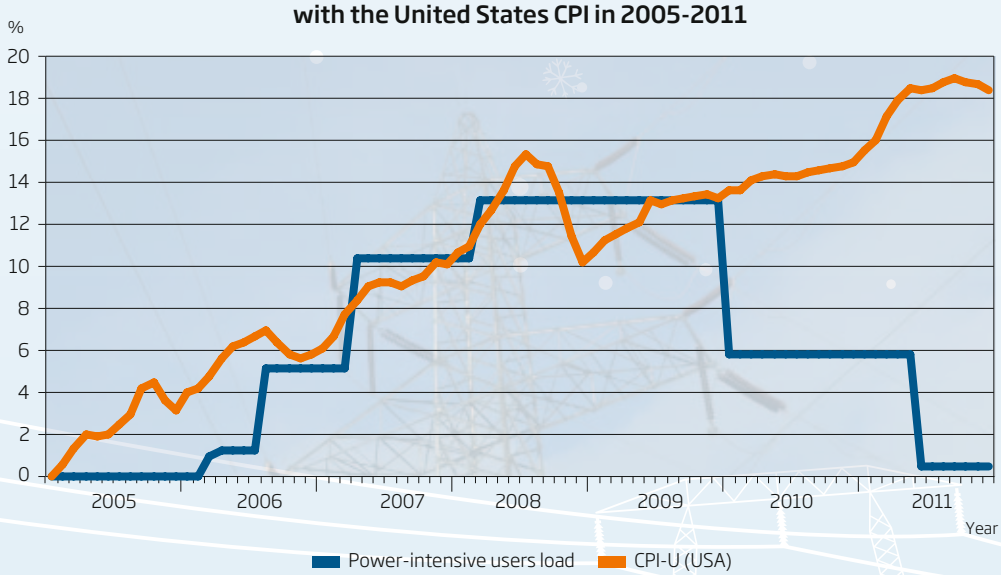
The key financial risk factors have been defined as interest-rate risk, currency risk and liquidity risk. Aluminium prices are not a risk factor as our revenues are determined purely by the amount of power transmitted and the tariff in force, which does not reflect aluminium prices.

*Interest-rate risk* – Interest-bearing liabilities far exceed interest-bearing assets. Current ISK-denominated debts carry fixed interest rates, whereas foreign-denominated debts have variable rates. This entails the risk that variable rates on

**Development of tariff for general consumers compared with the Icelandic CPI in 2005-2011**




**Development of tariff for power-intensive consumers compared with the United States CPI in 2005-2011**



debts may increase. A total of 19.6% of our interest-bearing debts have variable rates.

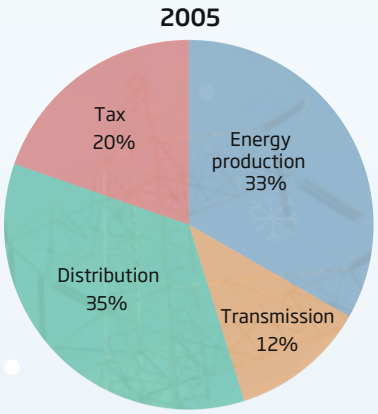
*Currency risk* – The company faces currency risk with respect to revenues, procurement and borrowing in currencies other than its operating currency, i.e. the ISK. Currency risk management with respect to counterparty risk aims to minimise the impact of exchange-rate fluctuations on our financial performance and budgets. Regarding settlement risk, the key principle of the Treasury Policy is to preserve the company's equity. The main currencies posing currency risk are the USD and CHF.

*Liquidity risk* – Liquidity risk is the risk that the company will not be able to meet its financial commitments as they fall due. Landsnet aims to have sufficient liquid assets in the form of cash and/or contractual revolving credit facilities amounting to at least three-months' operating expenses and loan-and-interest repayments. The company has a strong liquidity position. Cash at year-end amounted to ISK 10,511 million.

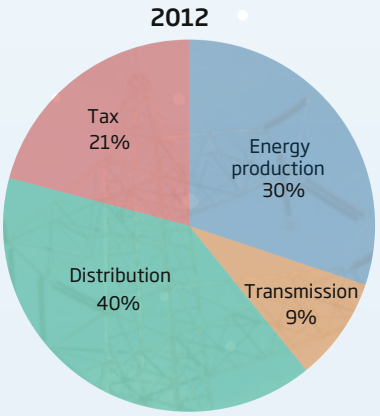
## Transmission tariff

As mentioned above, the transmission tariff rate for power-intensive consumers was reduced by 5% in June 2011. No change was made to the general tariff, which has remained unchanged since August 2009. The diagrams on page 28 show clearly how the company's tariff has been on a downward path in real terms since 2005. The first diagram shows how the general tariff has developed compared with the Icelandic CPI. The second diagram shows the transmission tariff rate for power-intensive consumers compared with the CPI in the United States.

The composition of electricity prices for the typical household in the Greater Reykjavík area has changed significantly since 2005, when transmission cost was 12% of the total price, distribution cost was 35%, the energy price was 33% and taxes were 20%. At year-end 2011, distribution costs had become 40% of the total price, taxes were 21%, the energy price was 30% and transmission costs were down to 9%.




Cost: ISK 43,822/year




Cost: ISK 70,792/year

The pie charts show the total cost of electricity purchases and a breakdown of the total price of electricity at the beginning of 2005 and 2012 for a household in the Greater Reykjavík area consuming 4 MWh per year.

# Landsnet's substations at year-end 2011

| Substation | KKS Code | Co-owner | Voltage [kV] | First year in service |
|---|---|---|---|---|
| **Aðveitustöð 12** | A12 | OR | 132 | 2006 |
| **Akranes** | AKR | OR | 66 | 1987 |
| **Andakíll** | AND | OR | 66 | 1974 |
| **Ásbrú** | ASB | | 33 | 2011 |
| **Bessastaðir** | BES | | 132/33 | 2003 |
| **Blanda** | BLA | LV | 132 | 1991 |
| **Bolungarvík** | BOL | OV | 66/11 | 1977 |
| **Breiðidalur** | BRD | OV | 66/33/19/11 | 1959 |
| **Brennimelur** | BRE | RA | 220/132/66/11 | 1978 |
| **Búrfell** | BUR | | 220/66 | 1999 |
| **Dalvík** | DAL | RA | 66/33/11 | 1981 |
| **Eskifjörður** | ESK | RA | 66/33/11 | 1993 |
| **Eyvindará** | EYV | RA | 132/66/33/11 | 1975 |
| **Fáskrúðsfjörður** | FAS | RA | 66/33/11 | 1998 |
| **Fitjar** | FIT | HS | 132 | 1990 |
| **Fljótsdalur** | FLJ | | 220/132 | 2007 |
| **Flúðir** | FLU | RA | 66/11 | 1995 |
| **Geiradalur** | GED | OV | 132/33/19 | 1983 |
| **Geithális** | GEH | | 220/132 | 1969 |
| **Glerárskógar** | GLE | RA | 132/19 | 1980 |
| **Grundarfjörður** | GRU | RA | 66/19 | 1987 |
| **Hamranes** | HAM | | 220/132/11 | 1989 |
| **Hella** | HLA | RA | 66/11 | 1995 |
| **Hnoðraholt** | HNO | OR | 132 | 1990 |
| **Hólar** | HOL | RA | 132/19/11 | 1984 |
| **Hrauneyjafoss** | HRA | LV | 220 | 1981 |
| **Hrútatunga** | HRU | RA | 132/19 | 1980 |
| **Hryggstekkur** | HRY | RA | 132/66/11 | 1978 |
| **Húsavík** | HUS | RA | 33/11/6 | 1978 |
| **Hveragerði** | HVE | RA | 66/11 | 1983 |
| **Hvolsvöllur** | HVO | RA | 66/11 | 1995 |
| **Írafoss** | IRA | LV | 220/132/66/11 | 1953 |
| **Ísafjörður** | ISA | OV | 66/11 | 1959 |
| **Keldeyri** | KEL | OV | 66/33/11 | 1959 |
| **Kolviðarhóll** | KOL | | 220 | 2006 |
| **Korpa** | KOR | OR | 132/33/11 | 1976 |
| **Kópasker** | KOP | RA | 66/33/11 | 1980 |
| **Krafla** | KRA | LV | 132/11 | 1977 |
| **Lagarfoss** | LAG | RA | 66 | 2007 |
| **Laxá** | LAX | | 66/33/11 | 1937 |
| **Laxárvatn** | LAV | RA | 132/33/11 | 1977 |
| **Lindarbrekka** | LIN | RA | 66/11 | 1985 |
| **Ljósafoss** | LJO | LV | 66/11 | 1937 |
| **Mjólká (lower substation)** | MJO | OV | 66/33/11 | 1980 |
| **Mjólká (upper substation)** | MJO | OV | 132/66 | 1980 |
| **Nesjavellir** | NES | OR | 132 | 1998 |
| **Neskaupstaður** | NKS | RA | 66/11 | 1994 |

| Substation | KKS Code | Co-owner | Voltage [kV] | First year in service |
|---|---|---|---|---|
| **Ólafsvík** | OLA | RA | 66/19 | 1980 |
| **Prestbakki** | PRB | RA | 132/19 | 1984 |
| **Rangárvellir** | RAN | RA | 132/66/11 | 1974 |
| **Rauðimelur** | RAU | | 132 | 2006 |
| **Reykjanes** | REY | HS | 132 | 2006 |
| **Rimakot** | RIM | RA | 66/33/11 | 1990 |
| **Sauðárkrókur** | SAU | RA | 66/33/11 | 1977 |
| **Selfoss** | SEL | RA | 66/11 | 2005 |
| **Seyðisfjörður** | SEY | RA | 66/11 | 1957 |
| **Sigalda** | SIG | LV | 220/132 | 1977 |
| **Silfurstjarnan** | SIL | RA | 66/11 | 1992 |
| **Steingrímsstöð** | STE | LV | 66/11 | 1959 |
| **Stuðlar** | STU | RA | 66/11 | 1980 |
| **Sultartangi** | SUL | | 220/11 | 1999 |
| **Svartsengi** | SVA | HS | 132 | 1997 |
| **Teigarhorn** | TEH | RA | 132/33/11 | 2005 |
| **Varmahlíð** | VAR | RA | 132/66/11 | 1977 |
| **Vatnsfell** | VAF | | 220/11 | 2001 |
| **Vatnshamrar** | VAT | RA | 132/66/19 | 1976 |
| **Vegamót** | VEG | RA | 66/19 | 1975 |
| **Vestmannaeyjar** | VEM | RA | 33 | 2002 |
| **Vogaskeið** | VOG | RA | 66/19 | 1975 |
| **Vopnafjörður** | VOP | RA | 66/11 | 1982 |
| **Þorlákshöfn** | TOR | RA | 66/11 | 1991 |
| **Öldugata** | OLD | | 132 | 1989 |

**RA=Rarik, OV=Westfjord Power Company, HS=Sudurnes Regional Heating, LV=Landsvirkjun, OR=Reykjavik Energy**

# Landsnet's transmission lines at year-end 2011

| Voltage [kV] | Transmission line | KKS Code | First year | Connected substations | Length [km] |
|---|---|---|---|---|---|
| 220 | **Brennimelslína 1** | BR1 | 1977 | Geithals - Brennimelur | 59 |
| | **Búrfellslína 1** | BU1 | 1969 | Búrfell - Írafoss | 61 |
| | **Búrfellslína 2** | BU2 | 1973 | Búrfell - Kolviðarhóll | 86 |
| | **Búrfellslína 3** | BU3 | 1992 | Búrfell - Hamranes | 119 |
| | **Fljótsdalslína 3** | FL3 | 2007 | Fljótsdalur - Reyðarfjörður | 49 |
| | **Fljótsdalslína 4** | FL4 | 2007 | Fljótsdalur - Reyðarfjörður | 53 |
| | **Hamraneslína 1** | HN1 | 1969 | Geithals - Hamranes | 15 |
| | **Hamraneslína 2** | HN2 | 1969 | Geithals - Hamranes | 15 |
| | **Hrauneyjafosslína 1** | HR1 | 1982 | Hrauneyjafoss - Sultartangi | 20 |
| | **Ísallína 1** | IS1 | 1969 | Hamranes - Ísal | 2 |
| | **Ísallína 2** | IS2 | 1969 | Hamranes - Ísal | 2 |
| | **Járnblendilína 1** | JA1 | 1978 | Brennimelur - Járnblendiv. | 5 |
| | **Kolviðarhólslína 1** | KH1 | 1973 | Kolviðarhóll - Geithals | 17 |
| | **Norðurálslína 1** | NA1 | 1998 | Brennimelur - Norðurál | 4 |
| | **Norðurálslína 2** | NA2 | 1998 | Brennimelur - Norðurál | 4 |
| | **Sigöldulína 2** | SI2 | 1982 | Sigalda - Hrauneyjafoss | 9 |
| | **Sigöldulína 3** | SI3 | 1975 | Sigalda - Búrfell | 37 |
| | **Sogslína 3** | SO3 | 1969 | Írafoss - Geithals | 36 |
| | **Sultartangalína 1** | SU1 | 1982 | Sultartangi - Brennimelur | 122 |
| | **Sultartangalína 2** | SU2 | 1999 | Sultartangi - Búrfell | 13 |
| | **Sultartangalína 3** | SU3 | 2006 | Sultartangi - Brennimelur | 119 |
| | **Vatnsfellslína 1** | VF1 | 2001 | Vatnsfell - Sigalda | 6 |
| | | | | **Total 220 kV** | **853** |
| 132 | **Aðveitustöð 7 (line/underground)** | AD7 | 1990 | Hamranes - Hnoðraholt | 10 |
| | **Blöndulína 1** | BL1 | 1977 | Blanda - Laxárvatn | 33 |
| | **Blöndulína 2** | BL2 | 1977 | Blanda - Varmahlíð | 32 |
| | **Eyvindarárlína 1** | EY1 | 1977 | Hryggstekkur - Eyvindará | 28 |
| | **Fitjalína 1** | MF1 | 1991 | Rauðimelur - Fitjar | 7 |
| | **Fljótsdalslína 2 (line/underground cable)** | FL2 | 1978 | Fljótsdalur - Hryggstekkur | 25 |
| | **Geiradalslína 1** | GE1 | 1980 | Glerárskógar - Geiradalur | 47 |
| | **Glerárskógalína 1** | GL1 | 1983 | Hrútatunga - Glerárskógar | 34 |
| | **Hafnarfjörður 1 (underground cable)** | HF1 | 1989 | Hamranes - Hafnarfjörður | 4 |
| | **Hólalína 1** | HO1 | 1981 | Teigarhorn - Hólar | 75 |
| | **Hrútatungulína 1** | HT1 | 1976 | Vatnshamrar - Hrútatunga | 77 |
| | **Korpulína 1** | KO1 | 1974 | Geithals - Korpa | 6 |
| | **Kröflulína 1** | KR1 | 1977 | Krafla-Rangárvellir | 82 |
| | **Kröflulína 2** | KR2 | 1978 | Krafla - Fljótsdalur | 123 |
| | **Laxárvatnslína 1** | LV1 | 1976 | Hrútatunga - Laxárvatn | 73 |
| | **Mjólkárlína 1** | MJ1 | 1981 | Geiradalur - Mjólká | 81 |
| | **Nesjavallalína 1 (line/underground cable)** | NE1 | 1998 | Nesjavellir - Korpa | 32 |
| | **Nesjavallalína 2 (underground cable)** | NE2 | 2010 | Nesjavellir - Geithals | 25 |
| | **Prestbakkalína 1** | PB1 | 1984 | Hólar- Prestbakki | 171 |
| | **Rangárvallalína 1** | RA1 | 1974 | Rangárvellir - Varmahlíð | 88 |
| | **Rangárvallalína 2 (underground cable)** | RA2 | 2009 | Rangárvellir - Krossanes | 5 |
| | **Rauðamelslína 1** | RM1 | 2006 | Reykjanes - Rauðimelur | 15 |
| | **Rauðavatnslína 1 (line/undergr. c.)** | RV1 | 1953 | Geithals - A12 | 3 |
| | **Sigöldulína 4** | SI4 | 1984 | Sigalda - Prestbakki | 78 |
| | **Sogslína 2** | SO2 | 1953 | Írafoss - Geithals | 44 |

| Voltage [kV] | Transmission line | KKS Code | First year | Connected substations | Length [km] |
|---|---|---|---|---|---|
| | **Suðurnesjalína 1** | SN1 | 1991 | Hamranes - Fitjar | 31 |
| | **Svartsengislína 1** | SM1 | 1991 | Svartsengi - Rauðimelur | 5 |
| | **Teigarhornslína 1** | TE1 | 1981 | Hyggstekkur - Teigarhorn | 50 |
| | **Vatnshamralína 1** | VA1 | 1977 | Vatnshamrar - Brennimelur | 20 |
| | | | | **Total 132 kV** | **1304** |
| 66 | **Akraneslína 1 (underground table)** | AK1 | 1996 | Brennimelur - Akranes | 17 |
| | **Andakílslína 1** | AN1 | 1966 | Andakíll - Akranes | 35 |
| | **Bolungarvíkurlína 1** | BV1 | 1979 | Breiðidalur - Bolungarvík | 17 |
| | **Bolungarvíkurlína 2 (underground cable)** | BV2 | 2010 | Ísafjörður - Bolungarvík | 12 |
| | **Breiðadalslína 1** | BD1 | 1975 | Mjólká - Breiðidalur | 36 |
| | **Dalvíkurlína 1** | DA1 | 1982 | Rangárvellir - Dalvík | 39 |
| | **Eskifjarðarlína 1** | ES1 | 2001 | Eyvindará - Eskifjörður | 29 |
| | **Fáskrúðsfjarðarlína 1** | FA1 | 1989 | Stuðlar - Fáskrúðsfjörður | 17 |
| | **Flúðalína 1** | FU1 | 1978 | Búrfell - Flúðir | 27 |
| | **Grundarfjarðarlína 1** | GF1 | 1985 | Vogaskeið - Grundarfjörður | 35 |
| | **Hellulína 1** | HE1 | 1995 | Flúðir - Hella | 34 |
| | **Hellulína 2** | HE2 | 1948 | Hella - Hvolsvöllur | 13 |
| | **Hveragerðislína 1** | HG1 | 1982 | Ljósifoss - Hveragerði | 15 |
| | **Hvolsvallarlína 1** | HV1 | 1972 | Búrfell - Hvolsvöllur | 45 |
| | **Ísafjarðarlína 1 (line/underground cable)** | IF1 | 1959 | Breiðidalur - Ísafjörður | 15 |
| | **Kópaskerslína 1** | KS1 | 1983 | Laxá - Kópasker | 83 |
| | **Lagarfosslína 1 (line/underground cable)** | LF1 | 1971 | Lagarfoss - Eyvindará | 27 |
| | **Laxárlína 1** | LA1 | 1953 | Laxá - Rangárvellir | 58 |
| | **Ljósafosslína 1 (underground cable)** | LJ1 | 2002 | Ljósifoss - Írafoss | 1 |
| | **Neskaupsstaðalína 1** | NK1 | 1985 | Eskifjörður - Neskaupstaður | 18 |
| | **Ólafsvíkurlína 1** | OL1 | 1978 | Vegamót - Ólafsvík | 49 |
| | **Rimakotslína 1** | RI1 | 1988 | Hvolsvöllur - Rimakot | 22 |
| | **Sauðárkrókslína 1** | SA1 | 1974 | Varmahlíð - Sauðárkrókur | 22 |
| | **Selfosslína 1** | SE1 | 1981 | Ljósifoss - Selfoss | 20 |
| | **Selfosslína 2** | SE2 | 1947 | Selfoss - Hella | 32 |
| | **Seyðisfjarðarlína 1** | SF1 | 1996 | Eyvindará - Seyðisfjörður | 20 |
| | **Steingrímsstöðvarlína 1 (line/undergr.c.)** | ST1 | 2003 | Steingrímsstöð - Ljósifoss | 3 |
| | **Stuðlalína 1 (underground cable)** | SR1 | 2005 | Hryggstekkur - Stuðlar | 16 |
| | **Stuðlalína 2** | SR2 | 1983 | Stuðlar - Eskifjörður | 18 |
| | **Tálknafjarðarlína 1** | TA1 | 1985 | Mjólká - Keldeyri | 45 |
| | **Vatnshamralína 2** | VA2 | 1974 | Andakíll - Vatnshamrar | 2 |
| | **Vegamótalína 1** | VE1 | 1974 | Vatnshamrar - Vegamót | 64 |
| | **Vogaskeiðslína 1** | VS1 | 1974 | Vegamót - Vogaskeið | 25 |
| | **Vopnafjarðarlína 1** | VP1 | 1980 | Lagarfoss - Vopnafjörður | 58 |
| | **Þorlákshafnarlína 1** | TO1 | 1991 | Hveragerði - Þorlákhöfn | 19 |
| | | | | **Total 66 kV** | **988** |
| 33 | **Húsavíkurlína 1** | HU1 | 1964 | Laxá - Húsavík | 26 |
| | **Vestmannaeyjalína 1 (submarine cable)** | VM1 | 1978 | Vestmannaeyjar - Rimakot | 15 |
| | **Vestmannaeyjalína 2 (submarine cable)** | VM2 | 1966 | Vestmannaeyjar - Rimakot | 16 |
| | | | | **Total 33 kV** | **57** |
| | | | | **Total** | **3202** |

# Financial Statements

# 2011

# Contents

# Endorsement by the Board of Directors and the CEO

## General

Landsnet hf was established in August 2004 on the basis of the Electricity Act passed by the Icelandic parliament, the Althingi, in the spring of 2003. The role of Landsnet is to administer the transmission of electricity and system operation in accordance with the provisions of Chapter III of the Electricity Act No. 65/2003.

## Results of the year 2011

According to the income statement, profit and total profit for the year amounted to ISK 0.8 billion. According to the balance sheet, the Company's equity at year end amounted to ISK 12.5 billion, including share capital in the amount of ISK 5.9 billion.

Share capital at year end 2011 is divided between four shareholders as at the beginning of the year:

| | Share |
|---|---|
| Landsvirkjun | 64.73% |
| Rarik ohf. | 22.51% |
| Orkuveita Reykjavíkur | 6.78% |
| Orkubú Vestfjarða ohf. | 5.98% |

Accumulated deficit amounts to ISK 5.7 billion at year end and therefore not permitted to pay dividend to shareholders.

Under the current Electricity Act, the National Energy Authority is charged with setting a revenue cap for Landsnet hf. At year-end 2011, no confirmation had been received from the Authority regarding the revenue-cap-based settlement for the period 2006-2010. In addition, a decision is still pending on the revenue cap for the years 2011-2015. This creates some uncertainty with regard to the Company's operating results. It is clear that the Company's revenue exceeded its revenue cap in the past few years, which must be taken into account when setting tariff rates. Note 29 provides a detailed account of the status of this issue, including the uncertainty it generates.

## Corporate governance

The Board of Directors of Landsnet hf. emphasizes maintaining good management practices. The Board of Directors has laid down comprehensive guidelines wherein the competence of the Board is defined and its scope of work vis-à vis the CEO. These rules include i.e. rules regarding order at meetings, comprehensive rules on the competence of Directors to participate in the discussion and decision of issues presented to the Board, rules on secrecy, rules on information disclosure by the CEO to the Board and other issues. The Coporate Governance Statement, which is a part of the Financial Statements, provides further information.

## Statement of the Board of Directors and the CEO

According to the best of our knowledge, the financial statements are in accordance with the International Financial Reporting Standards as adopted by the EU and it is our opinion that the annual financial statements give a true and fair view of the financial performance of the Company for the financial year 2011, its assets, liabilities and financial position as at 31 December 2011 and its cash flows for the financial year 2011.

Further, in our opinion the financial statements and the endorsement by the Board of Directors and the CEO give a fair view of the development and performance of the Company's operations and its position and describes the principal risks and uncertainties faced by the Company.

The Board of Directors and the CEO have today discussed the annual financial statements of Landsnet hf. for the year 2011 and confirmed them by means of their signatures.

Reykjavik, 23 February 2012.

The Board of Directors: CEO:

# Independent Auditor's Report

To the Board of Directors and Shareholders of Landsnet hf.

We have audited the accompanying financial statements of Landsnet hf., which comprise the statement of financial position as at December 31, 2011, the statements of comprehensive income, changes in equity and cash flows for the year then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

### Management's responsibility for the financial statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards as adopted by the EU, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

### Auditor's responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting principles used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### Opinion

In our opinion, the financial statements give a true and fair view of the financial position of Landsnet hf. as at December 31, 2011, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the EU.

### Report on the Board of Directors report

Pursuant to the legal requirement under Article 106, Paragraph 1, Item 5 of the Icelandic Financial Statement Act No. 3/2006, we confirm that, to the best of our knowledge, the report of the Board of Directors accompanying the financial statements includes the information required by the Financial Statement Act if not disclosed elsewhere in the Financial Statements.

Reykjavik, 23 February 2012.

***KPMG ehf.***

# Income Statement for the year 2011

| | Notes | 2011 | 2010 |
|---|---|---|---|
| **Operating revenue** | | | |
| Transmission | 5 | 11,804,961 | 12,781,452 |
| Other income | 6 | 98,259 | 65,009 |
| | | 11,903,220 | 12,846,461 |
| **Operating expenses** | | | |
| Energy procurement costs | 7 | 1,369,140 | 1,563,765 |
| Transmission costs | 8,9 | 3,447,850 | 3,377,678 |
| System operation | 8,9 | 941,087 | 815,552 |
| Other operating expenses | 8,9 | 704,726 | 748,794 |
| | | 6,462,803 | 6,505,789 |
| **Operating profit** | | 5,440,417 | 6,340,672 |
| Financial income | | 84,509 | 1,121,405 |
| Financial expenses | | ( 4,480,655) | ( 3,276,008) |
| Net financial expenses | 10 | ( 4,396,146) | ( 2,154,603) |
| Share in net earnings of associated company | 15 | 5,516 | 8,851 |
| **Profit before income tax** | | 1,049,787 | 4,194,920 |
| Income tax | 11 | ( 209,957) | ( 632,336) |
| **Profit** | | 839,830 | 3,562,584 |
| **Earnings per share:** | | | |
| Basic and diluted earnings per each ISK 1 share | 20 | 0.14 | 0.60 |

Notes no. 1 to 31 are an integral part of these financial statements.

# Statement of Comprehensive Income for the year 2011

| | Notes | 2011 | 2010 |
|---|---|---|---|
| **Profit** | | 839,830 | 3,562,584 |
| **Items under total profit recognised among equity:** | | | |
| Effect of changed tax rate on the revaluation of transmission | | 0 | ( 262,515) |
| **Total items under total profit recognised among equity** | | 0 | ( 262,515) |
| **Total profit of the year** | | 839,830 | 3,300,069 |

Notes no. 1 to 31 are an integral part of these financial statements.

# Balance Sheet as at 31 December 2011

| | Notes | 2011 | 2010 |
|---|---|---|---|
| **Assets** | | | |
| Fixed assets in operation | 12 | 60,187,407 | 62,155,955 |
| Projects under construction | 12 | 276,275 | 425,541 |
| Intangible assets | 13 | 1,275,937 | 1,401,758 |
| Investment in subsidiary | 14 | 500 | 500 |
| Investment in associates | 15 | 676,777 | 51,167 |
| Long-term note | 15 | 34,929 | 0 |
| Fixed assets | | 62,451,825 | 64,034,921 |
| Inventories | 16 | 490,949 | 499,251 |
| Assets available for sale | 12 | 0 | 374,000 |
| Receivable from parent company | 30 | 578,827 | 498,720 |
| Trade and other receivables | 17 | 646,425 | 849,833 |
| Cash and cash equivalents | 18 | 10,510,666 | 4,255,901 |
| Current assets | | 12,226,867 | 6,477,705 |
| **Total assets** | | 74,678,692 | 70,512,626 |
| **Equity** | | | |
| Share capital | | 5,902,733 | 5,902,733 |
| Revaluation account | | 12,293,653 | 12,863,228 |
| Accumulated deficit | | ( 5,734,504) | ( 7,143,909) |
| Equity | 19 | 12,461,882 | 11,622,052 |
| **Liabilities** | | | |
| Long term liabilities from parent company | 21 | 40,828,055 | 42,136,902 |
| Other long-term liabilities | 21 | 12,319,241 | 12,115,701 |
| Deferred income tax liability | 22 | 1,607,613 | 1,397,656 |
| Deferred income | 23 | 129,008 | 0 |
| Provision due to site restoration | 24 | 696,081 | 752,523 |
| Long-term liabilities and obligations | | 55,579,998 | 56,402,782 |
| Loans from parent company | 21 | 1,347,270 | 1,297,882 |
| Current maturities | 21 | 4,073,121 | 119,067 |
| Trade and other payables | 26 | 1,216,421 | 1,070,843 |
| Short-term liabilities | | 6,636,812 | 2,487,792 |
| Total liabilities | | 62,216,810 | 58,890,574 |
| **Total equity and liabilities** | | 74,678,692 | 70,512,626 |

Notes no. 1 to 31 are an integral part of these financial statements.

# Statement of Changes in Equity for the year 2011

| | Share capital | Revaluation account | Accumulated deficit | Total |
|---|---|---|---|---|
| **Year 2010:** | | | | |
| Equity at 1 January 2010 | 5,902,733 | 13,709,886 | ( 11,290,636 ) | 8,321,983 |
| Total comprehensive income | | ( 262,515 ) | 3,562,584 | 3,300,069 |
| Depreciation on revaluation recognised under accumulated deficit | | ( 584,143 ) | 584,143 | 0 |
| Equity at 31 December 2010 | 5,902,733 | 12,863,228 | ( 7,143,909 ) | 11,622,052 |
| **Year 2011:** | | | | |
| Equity at 1 January 2011 | 5,902,733 | 12,863,228 | ( 7,143,909 ) | 11,622,052 |
| Total comprehensive income | | | 839,830 | 839,830 |
| Depreciation on revaluation recognised under accumulated deficit | | ( 569,575 ) | 569,575 | 0 |
| Equity at 31 December 2011 | 5,902,733 | 12,293,653 | ( 5,734,504 ) | 12,461,882 |

Notes no. 1 to 31 are an integral part of these financial statements.

# Statement of Cash Flows for the year 2011

| | Notes | 2011 | 2010 |
|---|---|---|---|
| **Cash flow from operating activities** | | | |
| Operating profit | | 5,440,417 | 6,340,672 |
| **Adjustments for:** | | | |
| (Profit) loss from sales of fixed assets | | ( 24,864) | ( 1,016) |
| Depreciation and amortisation | | 2,566,448 | 2,541,336 |
| Impairment of assets available for sale | | 0 | 44,597 |
| Working capital from operation before financial items | | 7,982,001 | 8,925,589 |
| Operating assets, decrease | | 131,604 | 95,438 |
| Operating liabilities, increase | | 131,450 | 142,315 |
| Net Cash from operating activities before financial items | | 8,245,055 | 9,163,342 |
| Interest income received | | 84,509 | 146,880 |
| Interest expenses paid and foreign exchange difference | | ( 2,050,296) | ( 1,949,853) |
| Net cash from operating activities | | 6,279,268 | 7,360,369 |
| **Cash flow from investing activities** | | | |
| Investment in transmission infrastructures | 12 | ( 672,393) | ( 1,015,273) |
| Other investments | 12 | ( 374,360) | ( 271,214) |
| Proceeds from sale of property, plant and equipment | | 460,037 | 1,373 |
| Decrease in shares in an associated company | | 7,741 | 7,742 |
| Change in unpaid construction costs, increase (decrease) | | 16,798 | ( 60,358) |
| Net cash to investment activities | | ( 562,177) | ( 1,337,730) |
| **Cash flow from financing activities** | | | |
| Change in loans from parent company | | 0 | ( 5,756,880) |
| Payments of long-term liabilities and provisions | | ( 129,294) | ( 1,749,333) |
| Change in deferred income | | 129,008 | 0 |
| Net cash to financing activities | | ( 286) | ( 7,506,213) |
| **Net increase (decrease) in cash and cash equivalents** | | 5,716,805 | ( 1,483,574) |
| **Effect of exchange rate changes on cash and cash equivalents** | | 537,960 | ( 124,399) |
| **Cash and cash equivalents at 1 January** | | 4,255,901 | 5,863,874 |
| **Cash and cash equivalents at 31 December** | | 10,510,666 | 4,255,901 |
| **Investment and financing activities without cash flow effect:** | | | |
| Proceeds from the sale of operating assets | 15 | 662,764 | 0 |
| Aquisition of shares in an associated company | 15 | ( 627,835) | 0 |
| Long-term note | 15 | ( 34,929) | 0 |

Notes no. 1 to 31 are an integral part of these financial statements.

# Notes to the Financial Statements

# Notes to the Financial Statements

## 1. Reporting entity

Landsnet hf has its headquarters in Iceland and is domiciled at Gylfaflöt 9 in Reykjavik, Iceland. The Company is a subsidiary of Landsvirkjun, and the financial statement of Landsnet hf. is included in the consolidated financial statements of Landsvirkjun. Landsnet was established in 2004 on the basis of the Electricity Act passed by the Icelandic parliament, the Althingi, in the spring of 2003. The role of Landsnet is to administer the transmission of electricity and system operation in accordance with the provisions of Chapter III of the Electricity Act No. 65/2003, which stipulates that the Company must not engage in any activities other than necessary to perform its duties under the Act.

## 2. Basis of preparation

### a. Statement of compliance

The financial statements have been prepared in accordance with the International Financial Reporting Standards (IFRS) as adopted by the EU.

The financial statements were approved by the Board of Directors on 23 February 2012.

### b. Basis of measurement

The financial statements have been prepared on the historical cost basis, except for:

- The Company's transmission system is recognised at a revalued amount.
- Financial assets at fair value through profit and loss are recognised at fair value.

The methods to measure fair value are discussed further in Note 4.

### c. Functional and presentational currency

These financial statements are presented in Icelandic krónur (ISK), which is the Company's functional currency. All financial information presented in ISK has been rounded to the nearest thousand.

### d. Use of estimates and judgements

The preparation of the financial statements in conformity with IFRS standards requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimates are revised and in any future periods affected.

Information about significant areas of estimation uncertainty and critical judgements in applying accounting policies that have the most significant effect on the amounts recognised in the financial statements is included in the following notes:

- Note 3c and 12 - Fixed assets in operation
- Note 3d and 13 - Intangible assets
- Note 3j (i) and 24 - Estimation of provision due to site restoration
- Note 22 - Income tax

## 3. Significant accounting policies

The following accounting methods have been consistently applied to all disclosed periods in the financial statements, except for changes in provision due to site restoration is disclosed in financial expenses instead of operating expenses. Comparison figures have been restated accordingly.

### a. Foreign currency

Transactions in foreign currencies are translated to the functional currency of the Company at the exchange rates on the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies on the reporting date are retranslated to the functional currency at the exchange rate on that date. Non-monetary assets and liabilities denominated in foreign currencies that are measured at fair value are retranslated to the functional currency at the exchange rate on the date that the fair value was determined. Foreign currency differences arising on retranslation are recognised in profit or loss.

## 3. Significant accounting policies, contd.:

## b. Financial instruments

### (i) Non-derivative financial instruments

The Company initially recognises loans, receivables and cash and cash equivalents on the date that they are originated. All other financial assets (including assets designanted as at fair value through profit or loss) are recognised initially on the trade date, which is the date that the Company becomes a party to the contractual

The Company derecognises a financial asset when the contractual rights to the cash flows from the asset expire, or it transfers the rights to receive the contractual cash flows in a transaction in which substantially all the risks and rewards of ownership of the financial asset are transferred. Any interest is such transferred financial assets that is created or retained by the Company is recognised as a separate asset or liability.

Financial assets and liabilities are offset and the net amount presented in the statement of financial position when, and only when, the Company has a legal right to offset the amounts and intends either to settle on a net basis or to realise the asset and settle the liability simultaneously.

The Company classifes non-deravative financial assets into the following catagories: financial assets at fair value through profit or loss and loans and receivables.

#### Financial assets at fair value through profit or loss

An instrument is classified at fair value through profit or loss if it is held for trading or is designated as such upon initial recognition. Financial instruments are designated at fair value through profit or loss if the Company manages such investments and makes purchase and sale decisions based on their fair value. Upon initial recognition, attributable transaction costs are recognised in profit or loss when incurred. Financial instruments at fair value through profit or loss are measured at fair value, and changes therein are recognised in profit or loss.

#### Loans and receivables

Loans and receivables are financial assets with fixed or determinable payments that are not quoted in an active market. Such assets are recognised initially at fair value plus any directly attributable transaction costs. Subsequent to initial recognition, loans and receivables are measured at amortised cost using the effective interest method, less any impairment losses.

Loans and receivables comprise trade and other receivables.

Cash and cash equivalents comprise cash balances, call deposits and market securities.

### (ii) Non-derivative financial liabilities

The Company initially recognises debt securities issued and subordinated liabilities on the date that they are originated. All other financial liabilities (including liabilities designated as at fari valure through profit or loss) are recognised initially on the trade date, which is the date that the Company becomes a party to the contractual provisions of the instrument.

The Company derecognises a financial liability when its contractual obligations are discharged, cancelled or expire.

The Company classifies non-derivative financial liabilities into the other financial liabilities category. Such financial liabilities are recognised initially at fair value less any directly attributable transaction costs. Subsequent to initial recognition, these financial liabilities are measured at amortised cost using the effective interest method.

Other financial liabilities comprise loans and borrowings and trade and other payables.

### (iii) Derivative financial instruments

Derivatives are recognised initially at fair value. Subsequent to initial recognition, derivatives are measured at fair value. Fair value changes on such derivatives are recognised among net income and expenses on financial assets and liabilities in the statement of comprehensive income.

### (iv) Share capital

Share capital is classified as equity. Incremental costs directly attributable to the issue of shares are recognised as a deduction from equity.

**3. Significant accounting policies, contd.:**

**c. Property, plant and equipment**

**(i) Fixed assets in operation**

Items of fixed assets in operation other than transmission lines and substations are measured at cost less accumulated depreciation and impairment losses.

The cost includes expenditures directly attributable to the acquisition of the asset. The cost of self-constructed assets includes the cost of materials and direct labour, any other costs directly attributable to bringing the asset to a working condition for its intended use and the costs of dismantling and removing the items as well as restoring the site on which they are located.

When parts of an item of property, plant and equipment have different useful lives, they are accounted for as separate items (major components) of property, plant and equipment.

In accordance with the provisions of the International Accounting Standard IAS 16, the Company's transmission lines and substations are recognised on the basis of the revaluation method. The Company's transmission lines and substations are thus stated at a revalued cost in the balance sheet, which is their fair value on the revaluation date less revalued depreciation from the assets' acquisition date. The revaluation of those assets will be performed on a regular basis and when the management believes that their fair value has changed significantly, among other things due to external factors. All value increases due to the revaluation are entered in a revaluation account among equity after income tax. Depreciation of the revalued price is recognised in the income statement. Upon sale or disposal of an asset, the part of the revaluation account pertaining to that asset is recognised in retained earnings.

The most recent revaluation of transmission lines and substations was carried out at year-end 2008.

Any gain on disposal of an item of fixed assets in operating (calculated as the difference between the net proceeds from disposal and the carrying amount of the item) is recognised in profit or loss as other income but any loss on disposal of an item of fixed assets in operation is recognised in profit or loss as other operating expenses.

**(ii) Transmission structures under construction**

Projects under construction are capitalised on the basis of the cost of purchased services, materials, direct wages and other costs directly attributable to the property. Assets that have not been put to use are not depreciated. Cost of capital for financing the cost of projects under construction is capitalised in the period that the asset is being constructed and is considered a part of the cost of the asset. Capitalised cost of capital is the Company's weighted average cost of capital.

**(iii) Leased assets**

The leases the Company holds are operating leases. Leased assets are not recognised in the Company's balance sheet.

**(iv) Subsequent costs**

The cost of replacing a part of an item of property, plant and equipment is recognised in the carrying amount of the item if it is probable that the future economic benefits embodied within the part will flow to the Company and its cost can be measured reliably. The costs of day-to-day servicing of fixed assets in operation are recognised in profit or loss when incurred.

**(v) Depreciation**

Depreciation is recognised in profit or loss on a straight-line basis over the estimated useful lives of each part of an item of property, plant or equipment until the salvage value is reached. The estimated useful lives are as follows:

| | |
|---|---|
| Substations | 20 - 40 years |
| Transmission lines | 20 - 50 years |
| Fibre-optic cables | 20 years |
| Buildings | 50 years |
| Other assets | 4 - 10 years |

Depreciation methods, useful lives and residual values are reviewed at each reporting date.

### 3. Significant accounting policies, contd.:

### d. Intangible assets

#### (i) Developement cost

Developement cost is capitalised within fixed assets. This cost consists largely of expenses relating to exploration for transmission line sites, preparation for transmission structures and environmental impact assessments of proposed projects. The Company has concluded agreements whereby the prospective buyers of electricity shall bear all expenses of the project if it is cancelled. Cost of capital attributable to developement costs is capitalised except when there is a extended delay on the projects. Developement cost is not depreciated at this stage, but possible impairment losses have been considered, as discussed in Note 3h.

When the decision to construct a transmission structure has been made and all neccessary approvals have been obtained, the development cost of the transmission structure is capitalised in fixed assets as a project under construction.
At each accounting date, capitalised development cost is reviewed by management and impairment is recognised if premises for the recognition of development cost no longer exist.
Expenditure on research activities is recognised in profit or loss when incurred.

#### (ii) Software and other intangible assets

Software and other intangible assets are measured at cost less accumulated amortisation and accumulated impairment losses.

#### (iii) Amortisation

Amortisation is recognised in profit or loss on a straight-line basis over the estimated useful lives of intangible assets. The estimated useful lives of software for the current and comparative periods are 4 years.

### e. Investment in subsidiaries

The Company has one subsidiary, Landsnet ehf. The financial statements of the two companies are not consolidated and the holding is recognised at historical cost. The subsidiary has had insubstantial activity since its establishment. The share capital of the subsidiary is ISK 500 thousand.

### f. Investment in associates

Associates are those entities in which the Company has significant influence, but not control, over financial and operating policies. Significant influence is presumed to exist when the Company holds between 20 and 50 percent of the voting power of another entity. Associates are accounted for using the equity method and are initially recognised at cost. The financial statements include the Company's share of the total recognised gains and losses of equity movements of associates on an equity-accounted basis from the date that significant influence commences until the date that the significant influence ceases. When the Company's share of losses exceeds its interest in an associate, the Company's carrying amount, including any long-term investments, is reduced to nil and recognition of further losses is discontinued except to the extent that the Company has undertaken an obligation for or made payments on behalf of the investee.

### g. Inventories

Inventories are measured at the lower of cost and net realisable value. Net realisable value is the expected sales price in normal operation net of any cost of selling the product. The cost of inventories is based on the first-in-first-out (FIFO) principle of inventory valuation and includes cost incurred in acquiring the inventories and bringing them to their existing location and condition.

### h. Impairment

#### (i) Financial assets

A financial asset is assessed at each reporting date to determine whether there is any objective evidence that it is impaired. A financial asset is considered to be impaired if objective evidence indicates that one or more events have had a negative effect on the estimated future cash flows of that asset.

An impairment loss in respect of a financial asset measured at amortised cost is calculated as the difference between its carrying amount and the present value of the estimated future cash flows discounted at the original effective interest rate.
Individually significant financial assets are tested for impairment on an individual basis. The remaining financial assets are assessed collectively in groups that share similar credit risk characteristics.

All impairment losses are recognised in profit or loss.

### 3. Significant accounting policies, contd.:

#### (ii) Other assets

The carrying amount of the Company's other assets, except for inventories and deferred tax assets, is reviewed at each reporting date to determine whether there is any indication of an impairment loss. If any such indication exists, the asset's recoverable amount is estimated.
An impairment loss is recognised if the carrying amount of an asset or its cash-generating unit exceeds its estimated recoverable amount. For the purpose of impairment testing, assets are grouped together into the smallest group of assets that generates cash inflows of other assets or groups of assets (the "cash-generating unit"). Impairment losses are recognised in profit or loss. Impairment losses recognised in respect of cash-generating units are allocated first to reduce the carrying amount of any goodwill allocated to the units and then to reduce the carrying amount of the other assets in the unit (group of units) on a pro rata basis. An impairment loss of revalued assets is recognised in revaluation account amongst retained earnings.

The recoverable amount of an asset or cash-generating unit is the greater of its value in use and its fair value less costs to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

### i. Employee benefits

#### (i) Defined contribution plans

The Company pays a contribution for part of its employees to defined contribution pension funds. The Company has no responsibility regarding the obligations of the pension funds. The contributions are recognised as an expense under salary and salary related expenses as incurred.

#### (ii) Defined benefit plans

Under an agreement between the Company and the Pension Fund for State Employees (LSR), the Company's obligations regarding employees who are members of LSR shall be settled yearly. LSR estimates specifically at year-end the present value of the pension obligation accrued during the year and deducts from that amount the contributions paid by employees and the Company to LSR due to pension rights accrued during the year. The difference is recognised in profit or loss and settled on a yearly basis. The actuarial estimation shall assume that the obligation accrued for the year is calculated to the present value at year-end using the interest rate normally used to estimate the obligations of pension funds, which is currently 3.5% per annum.

### j. Provisions

A provision is recognised if, as a result of a past event, the Company has a present legal or constructive obligation that can be estimated reliably, and it is probable that an outflow of economic benefits will be required to settle the obligation. Provisions are estimated by discounting the expected future cash flows at a pre-tax rate that reflects the current market assessment of the time value of money and the risks specific to the liability.

#### (i) Site restoration

The Company has estimated the cost of demolition of current line lots. The estimation is based on expert assessment. The demolition cost has been discounted based on the estimated useful life of the Company's power transmission lines. The discounted value is entered, on the one hand, as an increase for the relevant asset and, on the other hand, as an obligation in the balance sheet. Estimated demolition cost is discounted by the nominal yield of state-guaranteed securities, which is currently 6.9% (2010: 5.9%) and is recognised as financial expenses.

### k. Revenue

Income from the transmission of electricity is recognised in the income statement on the basis of measured delivery during the period. Other revenue is recognised as earned or delivered.

The Company's tariff is subject to the National Energy Authority's opinion. On the basis of Article 12 of the Electricity Act No. 65/2003, the National Energy Authority sets an annual limit on the Company's revenue from transmission of electricity to distribution system operators on the one hand and industrial users on the other hand. Article 12 of the Electricity Act states, among other things, the following:

**3. Significant accounting policies, contd.:**

The National Energy Authority must establish an income possibility curve (revenue cap) for the transmission system operator with regard to the expense of transmitting electricity to distribution system operators, on the one hand, and to large-scale (industrial) users, on the other hand. In the establishment of an income possibility curve, account shall be taken of whether the connection of large-scale users will lead to, or has led to, increased efficiency in the development and use of the system.

The income possibility curve shall be determined based on the following criteria:

1. Expenses relating to the company's operation, including expenses relating to maintenance, leasing costs relating to transmission facilities, general operating expenses and expenses incurred by system management.
2. The profitability of the transmission system operator shall be as close as possible to weighted average cost of capital (WACC), after allowing for income tax and excluding any price index effects. Profitability is calculated as the ratio of earnings before financial income, financial expenses and taxes (EBIT) to the carrying value of fixed assets plus 20% of the preceding year's revenue cap to cover expenses of current assets.
3. Depreciation of fixed assets, cf. to paragraph 2.
4. Taxes.

The revenue cap must be decided for a five-year period at a time, but reviewed annually. Each review must include consideration of whether any of the premises on which the revenue cap decision was based have changed. Over- or under-collected revenue with reference to the revenue cap may be transferred between years when the annual revenue-cap-based settlement is made. However, accumulated over- or under-collected revenue shall never exceed more than 10% of the updated revenue cap for each settlement year. Should it transpire upon the revenue-cap-based settlement that the accumulated over-collection of revenue has exceeded this limit, measures shall be taken to lower the percentage below the specified limit no later than by the end of the following year. Under-collected revenue in excess of the limit specified above is not allowed to be carried over between years.

The transmission company shall establish tariffs for its service in accordance with the revenue cap pursuant to paragraph 2. The tariff shall apply to distribution system operators on the one hand and industrial users on the other hand.

No later than six weeks before the tariff enters into force, it shall be submitted to the National Energy Authority. If the National Energy Authority believes that the presented tariff is in breach of the provisions of this Act or the of regulations, it shall send comments thereon to the transmission company within three weeks from the date it received the tariff. The tariff does not become valid until it has been adjusted on the basis of the National Energy Authority's assessment. The transmission company shall publish the tariff publicly.

Act No. 19/2011 contains a transitional provision on the treatment of accumulated over-collected revenue from previous years, which reads as follows: “In the event that accumulated over-collected revenue exceeds 10% of the updated revenue cap at year-end 2010, the transmission system operator or distribution system operator, as applicable, shall set its tariff each year, as of 2011, at a level reducing the percentage of accumulated over-collected revenue until it is lower than 10%. Accumulated over-collected revenue shall not exceed 10% of the updated revenue cap at year-end 2020. In the event that accumulated under-collected revenue exceeds 10% of the updated revenue cap at year-end 2010, the tariff may be set at a level reducing the percentage below 10% by year-end 2020, whilst ensuring that each year’s revenue does not exceed the updated revenue cap for that year by more than 3% as a result. Accumulated over-collected revenue at year-end 2010 shall be converted to USD at the exchange rate on the date when the total amount of over-collected revenue becomes known.”
Landsnet will be obliged to repay the difference between its revenue and the revenue cap for previous years in accordance with this provision, cf. Note 29.

The Company's tariff is denominated partly in ISK and partly in USD.

**I. Lease payments**

Payments made under operating leases are recognised in profit or loss on a straight-line basis over the term of the lease.

An asset lease is expensed in the financial statements, the amount of which corresponds to financing cost and depreciation during the year, in relation to the use of electricity companies' transmission structures. The lease charge is regulated by the National Energy Authority.

## 3. Significant accounting policies, contd.:

### m. Finance income and expenses

Finance income comprises interest income on funds invested, changes in the fair value of financial assets at fair value through profit or loss and foreign exchange rate differences recognised in profit or loss. Interest income is recognised as it accrues in profit or loss, using the effective interest method.

Finance expenses comprise interest expense on borrowings, reversal of discounting of obligations, foreign exchange losses, changes in the fair value of financial assets at fair value through profit or loss and impairment losses recognised on financial assets.

Foreign currency gains and losses are reported on a net basis.

### n. Income tax

Income tax on the profit for the year is deferred income tax. Income tax is recognised in profit or loss except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.

Deferred tax is recognised using the balance sheet method, providing for temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is measured at the tax rates that are expected to be applied to the temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date.

A deferred tax asset is recognised to the extent that it is probable that future taxable profits will be available against which the temporary difference can be utilised. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realised. The income tax rate is 20%.

### o. Earnings per share

The Company presents basic and diluted earnings per share (EPS) data for its ordinary shares. Basic EPS is calculated by dividing the profit or loss attributable to ordinary shareholders of the Company by the weighted average number of ordinary shares outstanding during the period. Diluted EPS is the same as basic EPS, as the Company has not issued any call options or convertible bonds.

### p. Segment reporting

Under the Electricity Act, the Company may only administer the transmission of electricity and system management in Iceland and operate an electricity trading market. The Company has not begun operating an electricity trading market and considers its present operation as one single segment, for which reason it does not provide segment reporting.

### q. New standards and interpretations thereof

The Company has implemented all International Financial Reporting Standards, amendments thereto and interpretations confirmed by the EU at year-end 2011 and that apply to its operations. The Company has not implemented standards, amendments thereto or interpretations entering into effect after year-end 2011 but allowed to be implemented sooner. The effect thereof on the Company's financial statements has not been fully determined but is considered to be insubstantial.

## 4. Determination of fair values

A number of the Company's accounting policies and disclosures require the determination of fair value, for both financial and non-financial assets and liabilities. Fair values have been determined for measurement and/or disclosure purposes based on the following methods. When applicable, further information about the assumptions made in determining fair values is disclosed in the notes specific to that asset or liability.

### a. Trade and other receivables

The fair value of trade and other receivables is measured at the estimated discounted cash flow, based on market interests on the reporting date.

### b. Non-derivative financial liabilities

Fair value, which is determined for disclosure purposes, is calculated based on the present value of future principal and interest cash flows, discounted at the market rate of intest at the reporting date.

## 5. Revenue

Transmission revenue consist of:

| | 2011 | 2010 |
|---|---|---|
| Energy transmission | 10,325,878 | 11,261,469 |
| Transmission losses and ancillary services | 1,377,923 | 1,419,108 |
| Service income | 19,127 | 18,842 |
| Input fees | 82,033 | 82,033 |
| Transmission revenue total | 11,804,961 | 12,781,452 |

## 6. Other income

Other income consist of:

| | | |
|---|---|---|
| Income from work sold | 66,366 | 54,239 |
| Rental income | 7,029 | 9,754 |
| Sales profit from fixed assets | 24,864 | 1,016 |
| Other income total | 98,259 | 65,009 |

## 7. Energy procurement costs

Energy procurement costs consist of:

| | | |
|---|---|---|
| Electricity purchases due to transmission losses | 887,062 | 1,101,812 |
| Purchase of ancillary services | 459,163 | 445,350 |
| Other energy purchases | 22,915 | 16,603 |
| Energy procurement costs total | 1,369,140 | 1,563,765 |

## 8. Personnel expenses

Salaries and other personnel expenses consist of:

| | | |
|---|---|---|
| Salaries | 973,906 | 892,422 |
| Defined contribution plan payments | 114,182 | 97,922 |
| Defined benefit plan payments | 16,215 | 17,902 |
| Other payroll expenses | 113,359 | 102,835 |
| Personnell expenses total | 1,217,662 | 1,111,081 |

Personnel expenses are specified as follows:

| | | |
|---|---|---|
| Transmission costs | 477,104 | 431,502 |
| System operation | 436,362 | 388,926 |
| Other operating expenses | 304,196 | 290,653 |
| | 1,217,662 | 1,111,081 |

| | | |
|---|---|---|
| Average number of employees | 109 | 102 |
| Full-time equivalent units at year-end | 94 | 95 |

Remuneration of the Board of Directors, CEO and two Executive Directors were as follows:

| | | |
|---|---|---|
| Remuneration of the Board of Directors | 5,040 | 5,066 |
| Remuneration and benefits of the CEO | 21,181 | 15,145 |
| Remuneration of two Excecutive Directors | 33,892 | 32,728 |

## 9. Depreciation and amortisation

| | 2011 | 2010 |
|---|---|---|
| Depreciation and amortisation are specified as follows: | | |
| Depreciation of fixed assets in operation, see Note 12 | 2,428,630 | 2,395,282 |
| Amortisation and impairment losses, see Note 13 | 137,818 | 146,054 |
| Depreciation and amortisation recognised in the income statement | 2,566,448 | 2,541,336 |
| Depreciation and amortisation are allocated as follows to operating items: | | |
| Transmission costs | 2,398,162 | 2,352,942 |
| System operation | 40,149 | 44,024 |
| Other operating expenses | 128,137 | 144,370 |
| Depreciation and amortisation recognised in the income statement | 2,566,448 | 2,541,336 |

## 10. Financial income and expenses

| | | |
|---|---|---|
| Financial income and expenses are specified as follows: | | |
| Interest income | 27,079 | 129,061 |
| Net gain in fair value of market securities | 57,430 | 17,819 |
| Exchange rate difference | 0 | 974,525 |
| Total financial income | 84,509 | 1,121,405 |
| Interest expenses | ( 2,202,114) | ( 2,334,422) |
| Indexation | ( 2,294,596) | ( 1,002,536) |
| Exchange rate difference | ( 98,623) | 0 |
| Changes in fair values of derivatives | 0 | 236,644 |
| Change in present value of the provision due to site restoration | 56,442 | ( 203,622) |
| Capitalised interest expense due to projects under construction | 58,236 | 27,928 |
| Total financial expenses | ( 4,480,655) | ( 3,276,008) |
| Net financial expenses | ( 4,396,146) | ( 2,154,603) |

Net financial expenses due to the construction of a transmission infrastructure amounting to ISK 58 million (2010: 28 million) is capitalised and has been reported as a reduction in financial expenses.

Capitalised financial expenses were 8.0% of capital tied in transmission structures under construction during the year (2010: 5.3%). This is the Company's average finance cost in the year 2011.

## 11. Income tax

| | | |
|---|---|---|
| Income tax recognised in the income statement is specified as follows: | | |
| Calculated income tax for the year | ( 209,957) | ( 755,086) |
| Effect of changed tax rate | 0 | 122,750 |
| Income tax recognised in the income statement | ( 209,957) | ( 632,336) |
| **Income tax recognised in equity:** | | |
| Effect of increased tax rate on income tax liability due to revaluation | 0 | ( 262,515) |
| Change in income tax liability | ( 209,957) | ( 894,851) |
| **Change in deferred income tax liability is specified as follows:** | | |
| Change in temporary differences | 211,626 | 122,306 |
| Change in carry-forward losses | ( 421,583) | ( 877,391) |
| Effect of changed income tax rate | 0 | ( 139,766) |
| Change in deferred tax assets | ( 209,957) | ( 894,851) |

## 11. Income tax, contd.:

| | | 2011 | | 2010 |
|---|---|---|---|---|
| **Reconciliation of effective tax rate** | | | | |
| Profit before income tax | | 1,049,787 | | 4,194,920 |
| Income tax according to the current tax rate | 18.0% | ( 209,957) | 18.0% | ( 755,086) |
| Difference due to change in tax rate | 0.0% | 0 | ( 2.9%) | 122,750 |
| Effective tax rate | 18.0% | ( 209,957) | 15.1% | ( 632,336) |

## 12. Fixed assets in operation:

**Basis of revaluation of fixed assets in operation**

In accordance with the International Accounting Standard IAS 16, the Company's lines and substations are recognised according to the revaluation method. A revaluation was conducted on those assets in the year 2008. The revaluation was based on two methods. First, it was based on the estimated reconstruction cost of the transmission system, which was calculated by independent experts at the beginning of year and projected to year-end 2008. Second, the operating value was measured using a cash flow analysis. The valuation period was from 2009 to 2013, with the future operating value calculated thereafter. The year's revaluation was based on the operating value, the main premises of which were the Company's operating budgets for the years 2009-2013, a 30% equity ratio and that Landsnet's tariff for transmission to distributors would reflect price developments in Iceland while the tariff for industrial users would reflect price level changes in the United States. The estimation of weighted-average cost of capital (WACC) was based on comparable companies abroad. It is the opinion of the Company's management that nothing gives reason for a revaluation in the year 2011.

**Fixed assets in operation:**

| | Substations | Transmission lines | Other | Total |
|---|---|---|---|---|
| **Cost** | | | | |
| Balance at 1.1.2010 | 21,829,651 | 45,793,896 | 2,753,105 | 70,376,652 |
| Additions | 201,071 | 240,960 | 141,221 | 583,252 |
| Transferred from projects under construction and intangible assets | 235,504 | 1,552,384 | 0 | 1,787,888 |
| Sold and disposed of | 0 | 0 | ( 986) | ( 986) |
| Effects of assets available for sale | 0 | 0 | 9,095 | 9,095 |
| Balance at 31.12.2010 | 22,266,226 | 47,587,240 | 2,902,435 | 72,755,901 |
| Additions | 108,022 | 101,794 | 220,552 | 430,368 |
| Transfer | ( 196,372) | 196,372 | 0 | 0 |
| Transferred from projects under construction and intangible assets | 488,231 | 179,844 | 0 | 668,075 |
| Sold and disposed of | 0 | ( 732,960) | ( 987) | ( 733,947) |
| Balance at 31.12.2011 | 22,666,107 | 47,332,290 | 3,122,000 | 73,120,397 |
| **Depreciation** | | | | |
| Balance at 1.1.2010 | 2,517,384 | 5,226,940 | 460,967 | 8,205,291 |
| Depreciation | 746,592 | 1,509,976 | 138,714 | 2,395,282 |
| Sold and disposed of | 0 | 0 | ( 628) | ( 628) |
| Balance at 31.12.2010 | 3,263,976 | 6,736,916 | 599,053 | 10,599,945 |
| Depreciation | 751,760 | 1,544,455 | 132,415 | 2,428,630 |
| Transfer | ( 7,579) | 7,579 | 0 | 0 |
| Sold and disposed of | 0 | ( 94,916) | ( 670) | ( 95,586) |
| Balance 31.12.2011 | 4,008,157 | 8,194,034 | 730,798 | 12,932,989 |

## 12. Fixed assets in operation, contd.:

**Fixed assets in operation:**

| | Substations | Transmission lines | Other | Total |
|---|---|---|---|---|
| **Carrying amount** | | | | |
| 1.1.2010 | 19,312,267 | 40,566,956 | 2,292,138 | 62,171,361 |
| 31.12.2010 | 19,002,250 | 40,850,324 | 2,303,382 | 62,155,955 |
| 31.12.2011 | 18,657,950 | 39,138,256 | 2,391,202 | 60,187,407 |
| **Carrying amount without revaluation** | | | | |
| 1.1.2010 | 16,448,685 | 26,802,708 | 2,292,138 | 45,543,531 |
| 31.12.2010 | 16,254,195 | 27,682,918 | 2,303,382 | 46,240,495 |
| 31.12.2011 | 16,025,423 | 26,567,291 | 2,391,202 | 44,983,916 |

**Assets available for sale**

In the year 2011 the Company sold its property at Bústaðavegur. The property previously housed, among other things, the Company's Control Centre. At year-end 2010 the property was recognised as asset available for sale.

**Rateable value and insurance value**

The rateable value of the Company's real property amounts to upwards of ISK 2.5 billion (2010: ISK 3.0 billion). Assessed value for the same property's fire insurance amounts to ISK 4.6 billion (2010: ISK 5.1 billion) and book value amounts to ISK 3.9 billion (2010: ISK 4.5 billion). The insurance value of the Company's assets amounts to ISK 37.3 billion (2010: ISK 36.2 billion), excluding transmission lines and cables, which are insured by an emergency insurance fund. The Company's emergency insurance amounts to ISK 99.8 billion (2010: ISK 91.3 billion).

**Projects under construction:**

| | Projects under construction |
|---|---|
| **Cost** | |
| Balance at 1.1.2010 | 1,612,158 |
| Additions | 539,741 |
| Transferred to fixed assets in operation | ( 1,726,358) |
| Balance at 31.12.2009 | 425,541 |
| Additions | 518,809 |
| Transferred to fixed assets in operation | ( 668,075) |
| Balance at 31.12.2010 | 276,275 |

## 13. Intangible assets:

| | Capitalised development cost | Software | Total |
|---|---|---|---|
| **Cost** | | | |
| Balance at 1.1.2010 | 1,277,786 | 375,195 | 1,652,981 |
| Additions | 123,412 | 6,579 | 129,991 |
| Transferred to projects under construction | ( 61,529) | 0 | ( 61,529) |
| Balance at 31.12.2010 | 1,339,669 | 381,774 | 1,721,443 |
| Additions | 149,317 | 4,490 | 153,807 |
| Transferred to projects under construction | ( 56,233) | 0 | ( 56,233) |
| Sold and disposed of | ( 85,577) | 0 | ( 85,577) |
| Balance at 31.12.2011 | 1,347,176 | 386,264 | 1,733,440 |

## 13. Intangible assets, contd.:

### Amortisation and impairment losses

| | | | |
|---|---|---|---|
| Balance at 1.1.2010 | 45,324 | 128,307 | 173,631 |
| Amortisation and impairment losses | 81,626 | 64,428 | 146,054 |
| Balance at 31.12.2010 | 126,950 | 192,735 | 319,685 |
| Amortisation and impairment losses | 85,464 | 52,354 | 137,818 |
| Balance at 31.12.2011 | 212,414 | 245,089 | 457,503 |

### Carrying amount

| | | | |
|---|---|---|---|
| 1.1.2010 | 1,232,462 | 246,888 | 1,479,350 |
| 31.12.2010 | 1,212,719 | 189,039 | 1,401,758 |
| 31.12.2011 | 1,134,762 | 141,175 | 1,275,937 |

## 14. Investment in subsidiary

The breakdown of investment in subsidiary is as follows:

| | 2011 | | 2010 | |
|---|---|---|---|---|
| | Share | Carrying amount | Share | Carrying amount |
| Landsnet ehf | 100.00% | 500 | 100.00% | 500 |

The Company's share in Landsnet ehf is stated at cost as the firm has not conducted any operations from its establishment.

## 15. Investment in associates

The breakdown of investment in associates is as follows:

| | 2011 | | 2010 | |
|---|---|---|---|---|
| | Share | Carrying amount | Share | Carrying amount |
| Orkufjarskipti hf. | 50.00% | 627,835 | - | - |
| Netorka ehf | 38.71% | 48,942 | 36.58% | 51,167 |
| Total investment in other companies | | 676,777 | | 51,167 |

At year-end, the Company took part in a share capital increase of Orkufjarskipti hf. (previously Fjarski ehf.). Landsnet hf. acquired a 50% stake in Orkufjarskipti; another 50% stake is held by Landsvirkjun. The payment for the shares was in the form of delivery of the Company’s telecommunications property. The assets delivered were valuated at a total of ISK 662.8 billion, whereas the share capital increase amounted to ISK 627.8 billion at purchase price. Orkufjarskipti paid the ISK 34.9 billion difference with a bond issued to Landsnet.

At the time of preparing Landsnet hf's financial statements, the financial statements of Netorka ehf were not available. However, the estimated share in Netorka's profit amounts to ISK 6 million for the year 2011 (2010: ISK 9 million).

## 16. Inventories

Inventories are spare parts and material inventories. The expensed write-down of inventories amounted to ISK 10 million (2010: ISK 0).

## 17. Trade and other receivables

Trade and other receivables:

| | 2011 | 2010 |
|---|---|---|
| Trade receivables | 500,695 | 807,150 |
| Other receivables | 145,730 | 42,683 |
| Trade and other receivables total | 646,425 | 849,833 |

## 18. Cash and cash equivalents

| Cash and cash equivalent is specified as follows: | 2011 | 2010 |
|---|---|---|
| Bank balances | 10,242,916 | 3,658,587 |
| Market securities | 267,750 | 597,314 |
| Cash and cash equivalent total | 10,510,666 | 4,255,901 |

## 19. Equity

### Share capital

The Company's total share capital according to its Articles of Association was ISK 5,903 million at year-end. The Company holds no treasury shares. Each share of ISK in the Company carries one vote. All share capital has been paid.

### Revaluation account

The Company's revaluation account consists of the revaluation increase of the Company's fixed assets after income tax effects. Depreciation of the revalued price is entered in the income statement and transferred from the revaluation account to unadjusted loss.

### Dividends

The Company paid no dividends in 2011 for the financial year 2010, nor in the year 2010 for the financial year 2009. Accumulated deficit amounts to ISK 5.7 billion at year end and therefore not permitted to pay dividend to shareholders.

## 20. Earnings per share

| Basic and diluted earnings per share: | 2011 | 2010 |
|---|---|---|
| Profit to shareholders | 839,830 | 3,562,584 |
| Weighted average number of ordinary shares at 31 December | 5,902,733 | 5,902,733 |
| Basic and diluted earnings per share | 0.14 | 0.60 |

## 21. Interest-bearing loans and borrowings

This Note provides information on the contractual terms of the Company's interest-bearing loans and borrowings, which are measured at amortised cost.

### Long-term liabilities

| | | |
|---|---|---|
| Indexed bond loan from parent company in ISK, fixed interest of 4.21% | 40,828,055 | 38,800,453 |
| Loan agreement with parent company in USD, LIBOR + margin | 3,558,590 | 3,336,450 |
| Loan agreement in CHF, LIBOR + margin | 7,657,983 | 7,203,755 |
| Indexed bond loan in ISK, fixed interest of 5% | 5,175,789 | 5,031,012 |
| | 57,220,417 | 54,371,670 |
| Current maturities on long-term liabilities | ( 4,073,121) | ( 119,067) |
| | 53,147,296 | 54,252,603 |

### Short-term liabilities

| Short-term loans from parent company specifies as follows: | | |
|---|---|---|
| Accrued interest of long-term liabilities with parent company | 1,347,270 | 1,297,882 |
| Loan agreement with the parent company in USD as part of current maturities on long-term liabilities | 3,558,590 | 0 |
| Total interest-bearing short-term liabilities | 4,905,860 | 1,297,882 |
| Current maturities on long-term liabilities | ( 3,558,590) | 0 |
| Short-term loans from parent company total | 1,347,270 | 1,297,882 |

## 21. Loans and borrowings, contd.:

The bond from the parent company is an inflation-indexed bullet bond maturing in 2020 with interest payable once per year. Indexed bond loans from third parties consist of a 25-year superannuation loan. The loan agreement with the parent company is denominated in USD amounted to ISK 3.6 billion and will be fully paid in October 2012.

### Terms of interest-bearing loans and borrowings

Debts in foreign currencies:

| | | 2011 | | 2010 | |
|---|---|---|---|---|---|
| | Final maturity | Interest rate | Carrying amount | Interest rate | Carrying amount |
| Debt in CHF | 2022 | 0.28% | 7,657,983 | 0.46% | 7,203,755 |
| Debt in USD | 2012 | 4.07% | 3,558,590 | 3.79% | 3,336,450 |
| | | | 11,216,573 | | 10,540,205 |
| Debt in ISK: | | | | | |
| Indexed | 2020 - 2034 | 4.21 - 5% | 46,003,844 | 4.21 - 5% | 43,831,465 |
| Total interest-bearing loans and borrowings | | | 57,220,417 | | 54,371,670 |

| Maturities by year of interest-bearing loans and borrowings: | 2011 | 2010 |
|---|---|---|
| Year 2012/2011 | 4,073,121 | 119,067 |
| Year 2013/2012 | 904,094 | 3,821,733 |
| Year 2014/2013 | 911,096 | 851,804 |
| Year 2015/2014 | 918,451 | 858,457 |
| Year 2016/2015 | 926,179 | 865,448 |
| Later | 49,487,476 | 47,855,161 |
| | 57,220,417 | 54,371,670 |

## 22. Deferred tax liability

The breakdown of deferred tax liability is as follows:

| | | |
|---|---|---|
| Deferred tax liability at 1 January | 1,397,656 | 502,804 |
| Calculated income tax for the year | 209,957 | 632,336 |
| Effect of changed tax rate on previous revaluation on transmission | 0 | 262,515 |
| Deferred tax liability at 31 December | 1,607,613 | 1,397,656 |

The breakdown of deferred tax liability was as follows at year-end:

| | | |
|---|---|---|
| Fixed assets in operation | 2,945,402 | 3,130,833 |
| Intangible assets | 154,274 | 131,702 |
| Investment in companies | 5,072 | 3,969 |
| Other obligations | ( 153,417) | ( 103,547) |
| Tax losses carried forward | ( 1,343,718) | ( 1,765,301) |
| Deferred tax liability at 31 December | 1,607,613 | 1,397,656 |

The carry-forward taxable loss amounted to ISK 6.7 billion. The loss is utilisable against taxable income over ten years from when the loss is incurred. The management believes that the Company's operation over the next years will generate taxable income and that the accumulated carry-forward taxable loss will be fully utilised. Carry-forward taxable loss at year-end 2011 will be utilisable as follows:

| | | |
|---|---|---|
| Loss for the year 2008, applicable until year 2018 | 6,718,590 | 8,826,507 |
| Total unadjusted taxable loss | 6,718,590 | 8,826,507 |

## 23. Deferred income

Deferred income is recognised with regard to connection charges paid by electricity buyers to the Company during the year. At year-end, deferred income amounted to ISK 136 millon (2010:0). The part of deferred income that will be recognised in the income statement next year is recognised in current liabilities. Connection charges recognised in profit or loss for 2011 amounted to ISK 1 million (2010: 0).

## 24. Provision due to site restoration

Change in the provision due to site restoration is specified as follows:

| | | |
|---|---|---|
| Balance at 1.1. | 752,523 | 582,404 |
| Present value for the year reversed | ( 56,442) | 203,622 |
| (Decrease) increase in provision | 0 | ( 33,503) |
| Balance at year-end | 696,081 | 752,523 |

Under IAS 16, the initial value of property, plant and equipment shall include their estimated cost of demolition after use. The estimated cost of demolition of lines has been assessed and then discounted based on assessed useful life. In return, an obligation has been written up under long-term liabilities. An increase in the obligation due to the discounting in addition to depreciation of demolition cost is expensed in the income statement.

## 25. Pension fund obligation

The Pension Fund for State Employees calculates at the end of each year the benefit plan obligation accrued for the year. Actuary assessment is based on the accrued obligation for the year being discounted at year-end on the basis of the annual interest rate generally used to assess pension fund obligations. The present annual rate is 3.5%. A total of ISK 16 million is expensed in relation thereto for 2011 (2010: 18 million).

## 26. Trade and other payables

Trade and other payables are specified as follows:

| | 2011 | 2010 |
|---|---|---|
| Trade payables | 770,410 | 843,715 |
| Other payables | 446,011 | 227,128 |
| Trade and other payables total | 1,216,421 | 1,070,843 |

## 27. Financial instruments

### Overview

The Company has exposure to the following risks from its use of financial instruments:

- Credit risk
- Liquidity risk
- Market risk

This Note presents information about the Company's exposure to each of the above risks, the Company's objectives, policies and processes for measuring and managing risk and its management of capital. Further quantitative disclosures are included throughout these financial statements.

The Board of Directors has overall responsibility for the establishment and oversight of the Company's risk management framework. The Board of Directors seeks consultation regarding financial risk both from its employees and external consultants and discusses it regularly at Board meetings.

The Company's objective is to discover and analyse the risks it faces, set a benchmark for risk exposure and control it. The Company's risk management policy is regularily reviewed to analyse market changes and changes within the Company.

### Credit risk

Credit risk is the risk of financial loss of the Company owing to the failure of a customer or counterparty to a financial instrument to meet its contractual obligations. The Company's credit risk is mainly due to trade receivables.

## 27. Financial instruments, contd.:

### Trade and other receivables

In general, the Company's customers are financially strong energy companies, which have conducted business with the Company since its establishment. The Company's largest customers are also shareholders in the Company. Approximately 85% (2010: 85%) of the Company's transmission income derives from the Company's shareholders.

### Highest possible loss due to credit risk

The Company's highest possible loss due to financial assets is their book value, which was as follows at year-end:

| | 2011 | 2010 |
|---|---|---|
| Receivables from parent company | 578,827 | 498,720 |
| Trade and other receivables | 646,425 | 849,833 |
| Cash and cash equivalents | 10,510,666 | 4,255,901 |
| Highest possible loss due to credit risk total | 11,735,918 | 5,604,454 |

***Impairment losses***

No impairment loss has been recognised in relation to accounts receivable at year-end; nor has loss on receivables been expensed during the year, which is based on the management's experience. As of its establishment, the Company has not incurred losses on accounts receivable and its representatives have assessed its credit risk as insubstantial based on current operations. The Company's collection issues are reviewed on a regular basis.

### Liquidity risk

Liquidity risk is the risk that the company will not be able to meet its financial obligations as they will fall due. The Company endeavours to ensure, to the extent possible, that it always has sufficient liquidity to meet its liabilities when due, without incurring unacceptable losses or risking damage to the Company's reputation.

The Company has a revolving credit facility with the parent company, Landsvirkjun, in the amount of USD 50 million. At year-end, credit drawn under the facility amounted to USD 29 million. In 2012 the Company will repay the USD 29 million in credit drawn under the facility, which will then terminate.

The following are the contractual maturities of financial liabilities, including future interest payments:

**2011**

| | Carrying amount | Contractual cash flow | Within 12 months | 1-2 years | 2-5 years | After 5 years |
|---|---|---|---|---|---|---|
| **Non-derivative financial liabilities:** | | | | | | |
| Long-term liabilities from parent comp. | 45,733,915 | 60,031,225 | 5,452,282 | 1,718,861 | 5,156,583 | 47,703,499 |
| Long-term liabilities ..... | 12,833,772 | 17,012,224 | 805,305 | 1,190,909 | 3,632,129 | 11,383,881 |
| Trade and other payables ..... | 1,216,421 | 1,216,421 | 1,216,421 | 0 | 0 | 0 |
| | 59,784,108 | 78,259,870 | 7,474,008 | 2,909,770 | 8,788,712 | 59,087,380 |

**2010**

| | | | | | | |
|---|---|---|---|---|---|---|
| Long-term liabilities from parent comp. | 43,434,784 | 58,882,712 | 1,848,071 | 5,166,196 | 4,900,497 | 46,967,948 |
| Long-term liabilities ..... | 12,234,768 | 16,252,621 | 409,083 | 769,457 | 3,370,997 | 11,703,084 |
| Trade and other payables ..... | 1,070,843 | 1,070,843 | 1,070,843 | 0 | 0 | 0 |
| | 56,740,395 | 76,206,176 | 3,327,997 | 5,935,653 | 8,271,494 | 58,671,032 |

## 27. Financial instruments, contd.:

### Market risk

Market risk is the risk that changes in the market prices of foreign exchange rates and interest rates will affect the Company's income or the value of its holdings of financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable parameters, while optimising return.

**Currency risk**

The Company is exposed to currency risk on sales, purchases and borrowings that are denominated in a currency other than the Company's functional currency. The Company's functional currency is the Icelandic króna (ISK). However, the Company derives substantial part of its income in US dollars. In 2011, 62.1% (2010: 64.5%) of the Company's total revenue was in USD while purchases were mainly in ISK but a portion of its purchases is made in other currencies than Icelandic króna (ISK), mainly in euro (EUR) and USD. The main currencies posing a foreign exchange risk are the USD and the Swiss Francs (CHF). In 2011, it is estimated that 63.6% of the Company's total revenue will be in USD.

The Company does in general not hedge against foreign exchange risk but reviews on a regular basis the currency combination of its liabilities against the currency combination of its income.

The Company's currency risk on borrowings denominated in foreign currencies, USD and CHF, is partly hedged against its revenues. The interest rates on these borrowings are on average lower than those on the Company's ISK-denominated borrowings.

The Company's exposure to foreign currency risk, based on nominal amounts, was as follows:

| | EUR | CHF | USD |
|---|---|---|---|
| **2011** | | | |
| Trade and other receivables | 963 | 0 | 225,536 |
| Long term liabilities from parent company | 0 | 0 | ( 3,558,590) |
| Other long-term liabilities | 0 | ( 7,657,983) | 0 |
| Trade and other payables | ( 72,975) | ( 6,945) | ( 2,497) |
| Net currency risk | ( 72,012) | ( 7,664,928) | ( 3,335,551) |
| **2010** | | | |
| Trade and other receivables | 0 | 23,867 | 931,145 |
| Long term liabilities from parent company | 0 | 0 | ( 3,336,450) |
| Other long-term liabilities | 0 | ( 7,203,755) | 0 |
| Trade and other payables | ( 35,196) | ( 35,224) | ( 1,977) |
| Net currency risk | ( 35,196) | ( 7,215,112) | ( 2,407,282) |

| | Av. exch. rate for the year | | Year-end exch. rate | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| **Currency risk** | | | | |
| EUR | 161.42 | 161.89 | 158.84 | 153.80 |
| CHF | 131.20 | 117.24 | 130.66 | 122.91 |
| USD | 116.07 | 122.04 | 122.71 | 115.05 |

**Sensitivity analysis**

A 10% strengthening of the ISK against the following currencies at 31 December would have increased (decreased) after-tax profit or loss by the amounts shown below. This analysis assumes that all other variables, in particular interest rates, remain constant. The analysis is performed on the same basis for 2010.

| | 2011 | 2010 |
|---|---|---|
| EUR | 5,761 | 2,886 |
| CHF | 613,194 | 591,639 |
| USD | 266,844 | 197,397 |

## 27. Financial instruments, contd.:

A 10% weakening of the ISK against the above currencies at 31 December would have had the equal but opposite effect on profit or loss after tax to the amounts shown above, given that all other variables remain constant.

**Interest rate risk**

The Company's borrowings bear both variable and fixed interest. The majority of the Company's borrowings bear fixed interest, cf. Note 21.

The breakdown of the Company's interest-bearing financial instruments at year-end was as follows:

| | Carrying amount | |
|---|---|---|
| | 2011 | 2010 |
| **Financial instruments with floating interest rate** | | |
| Financial liabilities | 11,216,573 | 10,540,205 |
| **Financial instruments with fixed interest rate** | | |
| Financial liabilities | 46,003,844 | 43,831,465 |

**Cash-flow sensitivity analysis for fixed-interest-rate instruments**

The Company's liabilities carrying fixed interest rates are, on the one hand, an indexed bullet bond repayable in a single payment in 2020 to its parent company and, on the other, a 25-year superannuation bond loan. These liabilities are not recognised at fair value. Therefore, interest changes on the settlement date should not affect the Company's income statement.

**Cash-flow sensitivity analysis for floating interest rate instruments**

An increase in interest rates of 100 basis points at the reporting date would have increased (decreased) equity and profit or loss after tax by the amounts stated below. If interest rates had decreased by 100 basis points, the effect would have had the equal but opposite effect on profit or loss after tax. This analysis assumes that all other variables, in particular the exchange rates, remain constant. The analysis was performed in the same manner for the year 2010.

| | Earnings | |
|---|---|---|
| | 100bp increase | 100bp decrease |
| **31 December 2011** | | |
| Financial instruments with floating interest rates | ( 87,027) | 53,988 |
| Cash flow sensitivy (net) | ( 87,027) | 53,988 |
| **31 December 2010** | | |
| Financial instruments with floating interest rates | ( 110,760) | 83,255 |
| Cash flow sensitivy (net) | ( 110,760) | 83,255 |

**Fair value**

**Fair value versus carrying amounts**

The fair values and carrying amounts of financial assets and liabilities as reported in the balance sheet are specified as follows:

| | 2011 | | 2010 | |
|---|---|---|---|---|
| | Carrying amount | Fair value | Carrying amount | Fair value |
| Loans and receivables | 1,225,252 | 1,225,252 | 1,348,553 | 1,348,553 |
| Cash and cash equivalents | 10,510,666 | 10,510,666 | 4,255,901 | 4,255,901 |
| Long-term liabilities from parent company | 44,386,645 | 49,935,197 | 42,136,902 | 47,892,715 |
| Other long-term liabilities | 12,833,772 | 13,282,842 | 12,115,701 | 12,937,796 |
| Loans from parent company, short-term | 1,347,270 | 1,347,270 | 1,297,882 | 1,297,882 |
| Trade and other payables | 1,216,421 | 1,216,421 | 1,070,843 | 1,070,843 |
| | 71,520,026 | 77,517,648 | 62,225,782 | 68,803,690 |

## 27. Financial instruments, contd.:

**Interest rate in valuation of fair value**

Where applicable, expected contractual cash flow is discounted using the interest rate on government bonds plus a 0.4% margin on the reporting date.

**Classification and fair value of financial assets and liabilities**

The following table shows the Company's classification of financial assets and liabilities and their fair value (before accrued interest).

| | Financial assets and liabilities designated at fair value | Loans and receivables | Financial liabilities at amortised cost | Carrying amount |
|---|---|---|---|---|
| **2011** | | | | |
| Receivables from parent company | | 578,827 | | 578,827 |
| Trade and other receivables | | 646,425 | | 646,425 |
| Cash and cash equivalents | 267,750 | 10,242,916 | | 10,510,666 |
| | 267,750 | 11,468,168 | 0 | 11,735,918 |
| Loans from parent company | | | 44,386,645 | 44,386,645 |
| Other long-term liabilities | | | 12,833,772 | 12,833,772 |
| Trade and other payables | | 1,216,421 | | 1,216,421 |
| | 0 | 1,216,421 | 57,220,417 | 58,436,838 |
| **2010** | | | | |
| Receivables from parent company | | 498,720 | | 498,720 |
| Trade and other receivables | | 849,833 | | 849,833 |
| Cash and cash equivalents | 597,314 | 3,658,587 | | 4,255,901 |
| | 597,314 | 5,007,140 | 0 | 5,604,454 |
| Loans from parent company | | | 42,136,902 | 42,136,902 |
| Other long-term liabilities | | | 12,115,701 | 12,115,701 |
| Trade and other payables | | 1,070,843 | | 1,070,843 |
| | 0 | 1,070,843 | 54,252,603 | 55,323,446 |

**Other market price risk**

Other market price risk is limited because investment in bonds and shares is an insubstantial part of the Company's operations.

### Capital management

Under Act No. 65/2003, the Company's profitability must be determined on the basis of weighted average cost of capital (WACC). The National Energy Authority appointed three experts in a committee to determine the WACC for the transmission system operator. The committee has delivered a temporary decision with a target of a 45% equity ratio for the framework for power-intensive consumers and 30% for the framework for distribution system operators (the general public).

The Company is not subject to external rules on minimum capital requirements.

## 28. Operating leases

### The Company as lessee

The Company leases a part of the transmission structures it uses from domestic energy companies. The lease agreements have an indeterminate lease term and the lease price is determined by the National Energy Authority. Expensed lease payments in 2011 amounted to ISK 74 million (2010: ISK 150 million).

## 29. Pending revenue-cap-based settlement

Under the Electricity Act No. 65/2003, the National Energy Authority shall set a revenue cap for Landsnet hf in advance and for specified periods. The revenue cap was initially set for only a single year at a time for 2005 and 2006. In 2006, the revenue cap was set for a three-year period, 2007-2009, for the first time as prescribed by the then current Act. The 2010 revenue cap was not set by the Authority until August 2011, and for only a single year owing to amendments made to the Electricity Act in the latter year.

Act No. 19/2011 introduced a number of major amendments to the Electricity Act with respect to the revenue cap regime. These amendments apply to the setting of the revenue cap as of 2011. The most important changes are that the revenue cap period has been lengthened to five years, profitability is now defined on the basis of weighted average cost of capital (WACC), the asset base for power-intensive consumers has been converted to USD and account is now taken of the return on current assets. Previously, the company's profitability was tied to the yield on five-year non-indexed government bonds and determined as the same for both revenue frameworks, i.e. power-intensive consumers and distribution system operators. Under the current Act, different profitability limits apply to the revenue cap for power-intensive consumers and distribution system operators. The revenue cap must be set no later than 15 September of the year prior to the year in which the new revenue cap takes effect.

A temporary decision on the profitability criteria was recently submitted by a special committee appointed by the National Energy Authority on the basis of the Act, and will apply as of 1 January 2011. The profitability criteria are a fundamental determinant of the revenue cap, i.e. the Company's allowed revenue.

Article 12a of the Electricity Act states that: "The transmission system operator shall establish a tariff for its services in accordance with the income possibility curve [revenue cap] pursuant to Article 12. The tariff shall apply to, on the one hand, the consumption of distribution system operators from the transmission system and, on the other hand, the consumption of power-intensive consumers, which shall be determined in United States dollars." The Company's revenue cap has yet to be set for the period 2011-2015. As a result of this and owing to delays in determining the profitability criteria, uncertainty has surrounded the Company's tariffs for 2011 and, consequently, the revenue-cap balance at year-end 2011. The same applies to the 2012 revenue cap and tariff to date. This creates some uncertainty as regards the year's operating results.

*Settlement for 2006-2010*

Under the Electricity Act, the National Energy Authority's decision on the updated revenue cap and the settlement for the preceding year must be submitted no later than 1 August each year, together with reasoning for any changes. Despite this provision, no confirmation of the settlements for the period 2006-2010 had been received on the signing date of the Company's 2011 annual financial statements. The delays in effecting a settlement for this period have caused some uncertainty with regard to the Company's performance measurement for 2011 and previous years.

*Revenue in excess of revenue cap*

Between 2005 and August 2007, Landsnet's revenue and revenue cap for distribution system operators and power-intensive consumers were denominated in ISK. In August 2007, after obtaining the National Energy Authority's approval, the tariff currency for power-intensive consumers was changed to USD, in accordance with the interests of consumers operating mostly in that currency. At the time, the decision was made not to change the revenue cap for power-intensive consumers to reflect the changed tariff base.

In May 2011, the National Energy Authority sent Landsnet its decisions regarding the setting and settlement of the revenue cap for the period 2006-2009. In November 2011, the Authority again sent Landsnet its decisions regarding the revenue-cap-based settlement for the years 2006-2010, without withdrawing the previous decisions from May. Landsnet objected to the latter settlement and appealed the decisions regarding the period 2006-2009 to the Appeals Committee on Electricity. Negotiations have since been ongoing between Landsnet and the Authority in an aim to reach a conclusion on the revenue cap settlement.

*Power-intensive consumers*

Following the 2008 economic collapse and the ISK depreciation, Landsnet's USD-denominated revenue from power-intensive consumers increased substantially in ISK. The legislator showed willingness to address the problem that this presented regarding the revenue cap regime and to amend the legal framework so that the revenue cap for power-intensive consumers would be denominated in the same currency as the tariff. With Act No. 19/2011, the asset base from which profitability and depreciation are derived as determinants of the revenue cap for power-intensive consumers was converted to USD. Based on the available information, Landsnet's debt relating to the revenue-cap framework for power-intensive consumers amounts to ISK 3.5 billion.

## 29. Pending revenue-cap-based settlement, contd.:

*Distribution system operators*

At year-end 2011, a dispute remained to be resolved between Landsnet and the National Energy Authority regarding the profitability criteria used to determine the revenue cap for distribution system operators for the period 2006-2009 and the interpretation of a transitional provision of the Electricity Act in this respect. Since the final decision in this matter is still pending, the level of the revenue cap for distribution system operators during this period remains unclear. Based on the available information, the amount ranges between no liability to a debt of ISK 1.5 billion. Landsnet has initiated legal proceedings before the Reykjavík District Court to determine the interpretation of the said transitional provision, which applies to the period 2006-2009.

*Amounts*

A transitional provision of Act No. 19/2011 provides that, in the event of over-collection of revenue for previous years, Landsnet shall set its tariff at a level ensuring that over-collected revenue does not exceed 10% of the revenue cap at year-end 2020. The balance in question is not subject to interest calculation or inflation-indexation. On the basis of the above, Landsnet reduced its tariff rates for power-intensive consumers at the beginning of June 2011 by 5%.

As mentioned, the total amount of revenues in excess of the revenue cap for 2006-2011 remains uncertain. Based on the available information, it ranges between ISK 3.5 billion and ISK 5.0 billion, excluding discounting, which would reduce the liability to some extent. Adjusting for the profitability criteria put forward, the amount of the corresponding liability discounted to present value, based on a 10-year linear repayment profile, ranges between ISK 2.4 billion and ISK 3.3 billion. There are a number of uncertainties, such as the settlement of amounts for 2006-2010, the amount of the revenue cap for 2011, the effects of discounting and the method of tariff reduction, i.e. linear or otherwise. The provisions of Act No. 19/2011 do not require Landsnet to deliver cash or other assets in repayment of over-collected revenue, nor does the legislator require the Company to provide

On the basis of the above information, the provisions of law concerning the repayment of over-collected revenue and the provisions of the International Financial Reporting Standards, no effects of revenue-cap-based settlements for 2006-2011 are recognised in Landsnet's 2011 annual financial statements.

## 30. Related parties

### Definition of related parties

The Company has a related-party relationship with its shareholders, subsidiary, associates, directors, excecutive officers and companies in their possession.

### Transactions with senior management

#### (i) Payments to senior management

In addition to receiving salaries, the Chief Executive Officer and Managing Directors (Vice Presidents) of the Company enjoy various benefits and a contribution to a defined benefit pension fund. Management's salaries are accounted for in Note 8.

### Other transactions with related parties

| | 2011 | 2010 |
|---|---|---|
| **Sale of goods and services:** | | |
| Landsnet's parent company and its subsidiaries | 6,425,860 | 7,029,305 |
| Landsnet's other shareholders | 3,876,713 | 3,875,086 |
| Sale of goods and services to related parties total | 10,302,573 | 10,904,391 |
| **Cost:** | | |
| Landsnet's parent company and its subsidiaries | 1,162,453 | 1,391,220 |
| Landsnet's other shareholders | 573,704 | 741,964 |
| Landsnet's associate | 471 | 649 |
| | 1,736,628 | 2,133,833 |

In addition the costs outlined above, the Company paid ISK 1,855 million (2010: ISK 1,980 million) in interest to its parent company.

## 30. Related parties, contd.:

**Balance:**

Trade receivables and trade payables with related parties are as follows:

| | 2011 | | 2010 | |
|---|---|---|---|---|
| | **Receivables** | **Payables** | **Receivables** | **Payables** |
| Landsnet's parent company and its subsidiaries | 578,827 | 0 | 498,720 | 0 |
| Landsnet's other shareholders | 313,717 | ( 6,491) | 477,237 | ( 204,507) |
| | 892,544 | ( 6,491) | 975,957 | ( 204,507) |

Other receivables and payables with related parties are as follows:

| | **2011** | **2010** |
|---|---|---|
| Interest-bearing liabilities to parent company, see note 21 | 44,386,645 | 42,136,903 |
| Accrued interest payable to parent company | 1,347,270 | 1,297,882 |
| | 45,733,915 | 43,434,785 |

## 31. Financial ratios

The company's key financial ratios:

| | | |
|---|---|---|
| **Financial performance:** | | |
| EBITDA | 8,006,865 | 8,882,008 |
| **Financial position:** | | |
| Current ratio – current assets/current liabilities | 1.84 | 2.60 |
| Equity ratio – equity/total assets | 16.7% | 16.5% |
| Return on equity | 7.2% | 42.8% |

# Corporate Governance Statement

## Role of Landsnet hf.

Under the Electricity Act No. 65/2003, Landsnet's role is to operate an electricity transmission system and administer its system management. The Company must ensure and maintain the capabilities of the transmission system on a long-term basis and ensure the electricity system's operational security. Landsnet's role is also to maintain a balance between electricity supply and demand at all times and manage the settlement of electricity flows countrywide. In addition, the Company is charged with promoting an efficient electricity market.

## Corporate governance

The Board of Directors of Landsnet hf is committed to maintaining good corporate governance and complying with the Guidelines on Corporate Governance issued by the Icelandic Chamber of Commerce, NASDAQ OMX Iceland and the Confederation of Icelandic Employers on 18 June 2009. The Board adopts Rules of Procedure defining the scope of its powers and duties vis-à-vis the President & CEO. The current Rules of Procedure were confirmed at the Annual General Meeting of Landsnet held on 31 March 2010 and are available for inspection at the Company's head office.

## Internal control and risk management

To ensure that Landsnet's financial statements accord with generally accepted accounting practice, the Company has emphasised well-defined areas of responsibility, proper segregation of duties, regular reporting and transparency in its activities. The process of monthly reporting and reviews for individual departments is an important part of monitoring financial performance and other key performance indicators. Monthly financial results are produced and submitted to the Company's Board of Directors. The Board of Directors monitors the Company's financial risk and receives regular reports thereon. Information on risk management is provided in Note 27 to the annual financial statements.

## Corporate values and Code of Ethics

Landsnet's employees are obliged to abide by the Company's values in all their activities. Its corporate values are informed by its role and future vision and provide the foundation for the corporate culture for which the Company strives. Landsnet's values are: reliability, progress, economy and respect. These values are further defined as follows:

• Reliability. We show independence whilst maintaining due confidentiality and equal treatment of our customers. We show integrity and diligence in our behaviour and work methods.

• Progress. We take initiative, seek out opportunities and strive for continual improvement. We are creative and develop methods and solutions that stimulate competition. We pride ourselves on completing tasks and projects promptly and methodically.

• Economy. We maintain prudent stewardship of our funds and other resources and are guided by profitability targets.

• Respect. Our customers come first. We respect the natural environment and seek to minimise any undesirable effects of our operations. We respect our colleagues and their views and do not compromise on personal safety.

Landsnet's Code of Conduct was approved at a meeting of the Board of Directors on 25 July 2005 and is designed to encourage honesty, justice and fairness among staff towards each other, the Company and its customers. The Code is also intended to promote the trust and confidence of customers and the general public in Landsnet, as well as to limit the risk of reputational damage. The Board of Directors is of the view that a clear Code of Conduct that is duly observed in the Company's day-to-day activities forms the basis of its success and future growth. Landsnet's Code of Conduct applies to all its employees, including the Directors and the President & CEO. The Code of Conduct is available for inspection at Landsnet's head office.

Landsnet is committed to a strong community awareness. The Company's policies include that the development of the transmission system aims to deliver macroeconomic benefits and minimise any undesirable environmental impact of its operations. They also include that Landsnet honours its obligations and supports projects that are of relevance to its activities and benefit society.

## Landsnet's management structure

The main units of Landsnet's management structure are the Board of Directors and the Executive Committee. Key roles are also performed by two committees appointed by the Board of Directors: the Audit Committee and the Remuneration Committee..

### Relations between shareholders and the Board of Directors/management

Under the provisions of Act No. 75/2004 on the Establishment of Landsnet and the Electricity Act No. 65/2003, the Company's Directors shall be independent in all respects from other companies engaging in the generation, distribution or sale of electricity, whether these companies are owners of the Company or not. The purpose of these provisions is to meet the statutory requirement that the transmission system operator maintains utmost impartiality and non-discrimination in its activities.

With respect to the Company's special status under Chapter III of the Electricity Act and its strict duties to maintain impartiality and non-discrimination, it should be reiterated that shareholders are not permitted to interfere in individual affairs relating to Landsnet's activities.

As a rule, the shareholders' involvement must be limited to general policy decisions taken at regular shareholders' meetings, e.g. on financial targets.

### Board of Directors

The Board of Directors of Landsnet hf is the supreme authority in the Company's affairs between Annual General Meetings. The Board is responsible for the Company's policy-making and major decisions between shareholders' meetings, as specified in, e.g., the Rules of Procedure of the Board of Directors. The Board supervises all Company operations, and works to ensure that its activities are in proper and good order at all times. The Board ensures sufficient supervision of the Company's financial management and that its accounts and financial statements are in good order. The Board engages the Chief Executive Officer of the Company, whose salary and employment terms are decided by the Remuneration Committee.

Landsnet's Board of Directors consists of the following three members:

*Geir A. Gunnlaugsson, Chairman of the Board*

Geir A. Gunnlaugsson was born on 30 July 1943 and lives in Reykjavík. He read mechanical engineering at the University of Iceland, earned an MSc degree in mechanical engineering from the Technical University of Denmark and a PhD from Brown University, USA. He was professor of mechanical engineering at the University of Iceland in 1975-1986. He was chief executive of Icelandic Metals in 1983-1987, Marel in 1987-2002 and Hæfi in 2000-2006, chairman of Reyðarál in 2000-2003 and chief executive of Promens in 2003-2006. Mr Gunnlaugsson has served on government negotiating committees on power-intensive industry and on the board of the Marketing Office of the Ministry of Industry and the National Power Company in 1988-1997, including as chairman in 1989-1997. He has sat on the board of numerous businesses, both Icelandic and foreign, as well as other organisations and institutions, and has extensive experience in business management in Iceland and overseas. He is a member of the board of directors of the following companies: Polyform AS, Norway, chairman, 3X Technology ehf, chairman, Fálkinn hf, chairman, and Jarðboranir hf (Iceland Drilling), chairman. Mr Gunnlaugsson was elected to Landsnet's Board of Directors at the Annual General Meeting of the Company on 31 March 2011.

*Agnar Olsen, Director*

Agnar Olsen was born on 9 March 1943 and lives in Garðabær, Iceland. He read civil engineering at the University of Iceland and took an MSc degree in civil engineering from the Technical University of Denmark. After working at Landsvirkjun for one year, he joined the engineering firm Verkfræðistofa dr. Gunnars Sigurðssonar. He then rejoined Landsvirkjun, starting in the Line Department before becoming chief engineer in the Engineering Department and head of the Engineering and Construction Division. He was Director of the CEO's Office for three years until retiring in 2011. Mr Olsen has served on various boards and committees for Landsvirkjun and Samorka – Icelandic Energy and Utilities. Mr Olsen was elected to Landsnet's Board of Directors at the Annual General Meeting of the Company on 31 March 2011.

*Svana Helen Björnsdóttir, Director*

Svana Helen Björnsdóttir was born on 20 December 1960 and lives in Seltjarnarnes, Iceland. She holds a BSc degree in electrical engineering from the University of Iceland and an MSc in electrical power engineering from the Technische Universität Darmstadt in Germany. In recent years, she has worked mainly in the information technology sector. She is currently CEO of the information security company Stiki ehf. She also holds a diploma in operations management from the University of Iceland, is an IRCA-certified lead auditor of ISO/IEC 27001 information security management systems and has served on various boards and committees in Iceland and abroad. Ms Björnsdóttir is a member of the board of directors of Stiki ehf. She has extensive experience in business management, international co-operation and export activities. She was elected to Landsnet's Board of Directors at the Annual General Meeting of the Company on 31 March 2009.

The Alternate Director is Guðrún Ragnarsdóttir.

A total of 18 meetings of the Board of Directors were held in 2011, with one absence at a single meeting.

### Landsnet´s Executive Committee

*Þórður Guðmundsson, President & CEO, is a member of the Executive Committee.*

Mr Guðmundsson was born on 2 October 1949 and lives in Garðabær, Iceland. Born in 1949, he pursued studies at the Industrial Vocational School in Reykjavík, the Technical College of Iceland and the Norwegian University of Science and Technology, from which he graduated with an MSc degree in electrical engineering in 1978. He joined Landsvirkjun in 1978, starting as an engineer and later becoming chief engineer in the Operations department until appointed managing director of Operations in 1992. Following organisational changes in 1997, he became managing director of the Transmission division until appointed Landsnet's President & CEO on 1 January 2005.

The President & CEO is responsible for the Company's day-to-day activities. He/she is empowered to make decisions on all Company affairs not entrusted to others under Act No. 2/1995 and/or the Company's Articles of Association. The President & CEO conducts the operations of the Company in accordance with rules and/or decisions of the Board of Directors, the Articles of Association and the law. The President & CEO's signature constitutes an obligation on the Company's part. He/she is an authorised signatory of the Company ("procuration holder"). The President & CEO may grant power of attorney to other employees of the Company to exercise designated powers of his/her duties of office, provided that prior approval is obtained from the Board of Directors. The President & CEO is responsible for detecting, measuring, monitoring and controlling risks relating to the Company's operations. The President & CEO must maintain an organisation chart of the Company that clearly delineates areas of responsibility, employees' powers and communication channels within the Company. The President & CEO shall set internal control targets in consultation with the Board and monitor the effectiveness of internal control mechanisms. The President & CEO prepares meetings of the Board of Directors together with its Chairman and reports regularly to the Board on the Company's activities and position. The President & CEO is the chairman of the board of Landsnet ehf and a director of Samorka.

### Audit Committee

The current Audit Committee of Landsnet hf was appointed on 10 November 2011 and consists of:
Ólafur Nilsson, accountant, Chairman
Geir A. Gunnlaugsson, Chairman of the Board of Landsnet hf
Svana Helen Björnsdóttir, Director of Landsnet hf

The Audit Committee has adopted Rules of Procedure, which define the Committee's role as follows:
The Audit Committee shall, among other things, have the following role, regardless of the responsibilities of the Board of Directors, management staff or others in this area:

- Oversight of procedures for the preparation of financial statements.
- Oversight of the structures and functioning of the Company's internal controls, internal auditing, if applicable, and risk management.
- Oversight of the auditing of the annual financial statements and consolidated financial statements.
- Assessment of the independence of the Company's auditor or audit firm; monitoring of the work of the auditor or audit firm.

The Audit Committee also makes proposals for improvements and deliberates on matters at the Board's request.
The Audit Committee held two formal meetings in 2011 and one preparatory meeting in the autumn. The majority of Landsnet's Directors at the time were present at the Committee's meeting held in March 2011. A new Audit Committee was appointed at a Board meeting held on 10 November 2011. This newly appointed Committee held two meetings in 2011, which were attended by all Committee members, with one exception. The current Audit Committee has met regularly since its appointment, with four formal meetings and one preparatory meeting held between December 2011 and March 2012, all of which were attended by all Committee members, with one exception.

### Remuneration Committee

The Board of Directors of Landsnet hf performs the role of the Company's Remuneration Committee. Landsnet hf has formulated a Remuneration Policy, which was approved at the Company's Annual General Meeting on 31 March 2011. The Remuneration Policy can be viewed on the Company's website. The business of the Remuneration Committee is transacted at meetings of the Board of Directors when applicable.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