# Financial Statements 2012

Landsnet hf.
Gylfaflöt 9
112 Reykjavík

Reg. no. 580804-2410

# Contents

# Endorsement by the Board of Directors and the CEO

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 2012

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 13.3 billion, including share capital in the amount of ISK 5.9 billion.

Share capital at year end 2012 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 4.2 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. Landnet and the National Energy Authority have been unable to agree on the settlement for the years 2006-2009. In addition, a decision is still pending on the revenue cap for the years 2011, 2012 and 2013. This creates some uncertainty with regard to the Company’s operating results. Note 31 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 appendix in 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 2012, its assets, liabilities and financial position as at 31 December 2012 and its cash flows for the financial year 2012.

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 2012 and confirmed them by means of their signatures.

Reykjavik, 14 February 2013

The Board of Directors:

Geir A. Gunnlaugsson
Svana Helen Björnsdóttir
Ómar Benediktsson

CEO:

Þórður Guðmundsson

# 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, 2012, 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, 2012, 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, 14 February 2013.

***KPMG ehf.***

Sæmundur Valdimarsson

# Income Statement for the year 2012

| | Notes | 2012 | 2011 |
|---|---|---|---|
| **Operating revenue** | | | |
| Transmission | 5 | 12.228.758 | 11.804.961 |
| Other income | 7 | 115.704 | 98.259 |
| | | 12.344.462 | 11.903.220 |
| **Operating expenses** | | | |
| Energy procurement costs | 8 | 1.383.844 | 1.346.225 |
| Transmission costs | 9,10 | 3.922.280 | 3.470.765 |
| System operation | 9,10 | 977.253 | 941.087 |
| Other operating expenses | 9,10 | 755.469 | 704.726 |
| | | 7.038.846 | 6.462.803 |
| **Operating profit** | | 5.305.616 | 5.440.417 |
| Financial income | | 67.382 | 84.509 |
| Financial expenses | | ( 4.406.306) | ( 4.480.655) |
| Net financial expenses | 11 | ( 4.338.924) | ( 4.396.146) |
| Share in net earnings of associated company | 16 | 18.580 | 5.516 |
| **Profit before income tax** | | 985.272 | 1.049.787 |
| Income tax | 12 | ( 184.319) | ( 209.957) |
| **Profit** | | 800.953 | 839.830 |
| **Earnings per share:** | | | |
| Basic and diluted earnings per each ISK 1 share | 22 | 0,14 | 0,14 |

Notes no. 1 to 33 are an integral part of these financial statements.

*Financial Statements of Landsnet hf. 2012* 5 *Amounts are in ISK thousand*

# Statement of Comprehensive Income for the year 2012

| | Notes | 2012 | 2011 |
|---|---|---|---|
| **Profit** ........................................................................................ | | 800.953 | 839.830 |
| **Total items under total profit recognised among equity** .................... | | 0 | 0 |
| **Total profit of the year** ........................................................................ | | 800.953 | 839.830 |

Notes no. 1 to 33 are an integral part of these financial statements.

# Balance Sheet as at 31 December 2012

| | Notes | 2012 | 2011 |
|---|---|---|---|
| **Assets** | | | |
| Fixed assets in operation | 13 | 58.625.415 | 60.187.407 |
| Projects under construction | 13 | 1.769.671 | 276.275 |
| Intangible assets | 14 | 1.376.230 | 1.275.937 |
| Investment in subsidiary | 15 | 500 | 500 |
| Investment in associates | 16 | 643.851 | 676.777 |
| Long-term note | | 34.929 | 34.929 |
| Fixed assets | | 62.450.596 | 62.451.825 |
| Inventories | 17 | 522.301 | 490.949 |
| Receivable from parent company | 32 | 648.398 | 578.827 |
| Trade and other receivables | 18 | 690.778 | 646.425 |
| Marketable securities | 19 | 251.027 | 267.750 |
| Cash and cash equivalents | 20 | 10.309.772 | 10.242.916 |
| Current assets | | 12.422.276 | 12.226.867 |
| **Total assets** | | 74.872.872 | 74.678.692 |
| **Equity** | | | |
| Share capital | | 5.902.733 | 5.902.733 |
| Revaluation account | | 11.593.238 | 12.293.653 |
| Accumulated deficit | | ( 4.233.136) | ( 5.734.504) |
| Equity | 21 | 13.262.835 | 12.461.882 |
| **Liabilities** | | | |
| Long term liabilities from parent company | 23 | 42.675.190 | 40.828.055 |
| Other interest bearing long-term liabilities | 23 | 12.141.815 | 12.319.241 |
| Deferred income tax liability | 24 | 1.791.932 | 1.607.613 |
| Deferred income | 25 | 300.678 | 129.008 |
| Provision due to site restoration | 26 | 734.307 | 696.081 |
| Long-term liabilities and obligations | | 57.643.922 | 55.579.998 |
| Loans from parent company | 23 | 1.402.366 | 1.347.270 |
| Current maturities | 23 | 968.844 | 4.073.121 |
| Trade and other payables | 28 | 1.594.905 | 1.216.421 |
| Short-term liabilities | | 3.966.115 | 6.636.812 |
| Total liabilities | | 61.610.037 | 62.216.810 |
| **Total equity and liabilities** | | 74.872.872 | 74.678.692 |

Notes no. 1 to 33 are an integral part of these financial statements.

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# Statement of Changes in Equity for the year 2012

| | Share capital | Revaluation account | Accumulated deficit | Total |
|---|---|---|---|---|
| **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 |
| **Year 2012:** | | | | |
| Equity at 1 January 2012 | 5.902.733 | 12.293.653 | ( 5.734.504 ) | 12.461.882 |
| Total comprehensive income | | | 800.953 | 800.953 |
| Depreciation on revaluation recognised under accumulated deficit | | ( 700.415 ) | 700.415 | 0 |
| Equity at 31 December 2012 | 5.902.733 | 11.593.238 | ( 4.233.136 ) | 13.262.835 |

Notes no. 1 to 33 are an integral part of these financial statements.

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# Statement of Cash Flows for the year 2012

| | Notes | 2012 | 2011 |
|---|---|---|---|
| **Cash flow from operating activities** | | | |
| Operating profit | | 5.305.616 | 5.440.417 |
| **Adjustments for:** | | | |
| Profit from sales of fixed assets | | ( 1.214) | ( 24.864) |
| Depreciation and amortisation | 10 | 2.467.552 | 2.566.448 |
| Working capital from operation before financial items | | 7.771.954 | 7.982.001 |
| Operating assets, (increase) decrease | | ( 128.552) | 131.604 |
| Operating liabilities, increase | | 149.657 | 131.450 |
| Net Cash from operating activities before financial items | | 7.793.059 | 8.245.055 |
| Interest income received | | 49.839 | 84.509 |
| Interest expenses paid and foreign exchange difference | | ( 2.034.834) | ( 2.050.296) |
| Net cash from operating activities | | 5.808.064 | 6.279.268 |
| **Cash flow from investing activities** | | | |
| Investment in transmission infrastructures | 13 | ( 2.001.415) | ( 672.393) |
| Other investments | 13 | ( 511.729) | ( 374.360) |
| Proceeds from sale of property, plant and equipment | | 82.609 | 460.037 |
| Decrease in shares in an associated company | | 0 | 7.741 |
| Dividend from associated company | | 1.548 | 0 |
| Marketable securities, change | | 0 | ( 267.750) |
| Change in unpaid construction costs, increase | | 217.580 | 16.798 |
| Net cash to investment activities | | ( 2.211.407) | ( 829.927) |
| **Cash flow from financing activities** | | | |
| Change in loans from parent company | | ( 3.657.360) | 0 |
| Payments of long-term liabilities and provisions | | ( 510.278) | ( 129.294) |
| Change in deferred income | | 178.520 | 129.008 |
| Net cash to financing activities | | ( 3.989.118) | ( 286) |
| **(Net decrease) increase in cash and cash equivalents** | | ( 392.461) | 5.449.055 |
| **Effect of exchange rate changes on cash and cash equivalents** | | 459.317 | 537.960 |
| **Cash and cash equivalents at 1 January** | | 10.242.916 | 4.255.901 |
| **Cash and cash equivalents at 31 December** | 18 | 10.309.772 | 10.242.916 |
| **Investment and financing activities without cash flow effect:** | | | |
| Proceeds from the sale of operating assets | | 0 | 662.764 |
| Aquisition of shares in an associated company | | 0 | ( 627.835) |
| Long-term note | | 0 | ( 34.929) |

Notes no. 1 to 33 are an integral part of these financial statements.

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# 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 14 February 2013.

### 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 13 - Fixed assets in operation
- Note 3d and 14 - Intangible assets
- Note 3j (i) and 26 - Estimation of provision due to site restoration
- Note 24 - Income tax

## 3. Significant accounting policies

The following accounting methods have been consistently applied to all disclosed periods in the financial statements.  Marketable securities are now shown separately and are no longer a part of cash and cash equivalents.  Statement of cash flow and comparison figures have been restated accordingly. Cost have also been reclassed between Energy procurement costs and Transmission costs in the income statement and 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 and call deposits.

#### (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) 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 Standards, 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.

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 no 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% (2011: 6.9%) 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 31.

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

**l. 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 2012 and that apply to its operations. The Company has not implemented standards, amendments thereto or interpretations entering into effect after year-end 2012 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:

| | 2012 | 2011 |
|---|---|---|
| Energy transmission | 10.916.642 | 10.325.878 |
| Transmission losses and ancillary services | 1.203.586 | 1.377.923 |
| Service income | 26.497 | 19.127 |
| Input fees | 82.033 | 82.033 |
| Transmission revenue total | 12.228.758 | 11.804.961 |

## 6. Energy transmission

Energy transmission consist of:

| | | |
|---|---|---|
| Energy transmission to power-intensive consumers | 7.660.746 | 7.064.891 |
| Energy transmission to distribution system operators | 3.255.896 | 3.260.987 |
| Energy transmission total | 10.916.642 | 10.325.878 |

## 7. Other income

Other income consist of:

| | | |
|---|---|---|
| Income from work sold | 61.924 | 66.366 |
| Rental income | 11.169 | 7.029 |
| Income from guarantees of origin and certification | 41.397 | 0 |
| Sales profit from fixed assets | 1.214 | 24.864 |
| Other income total | 115.704 | 98.259 |

## 8. Energy procurement costs

Energy procurement costs consist of:

| | | |
|---|---|---|
| Electricity purchases due to transmission losses | 883.967 | 887.062 |
| Purchase of ancillary services | 499.877 | 459.163 |
| Energy procurement costs total | 1.383.844 | 1.346.225 |

## 9. Personnel expenses

Salaries and other personnel expenses consist of:

| | | |
|---|---|---|
| Salaries | 1.042.459 | 973.906 |
| Defined contribution plan payments | 125.613 | 114.182 |
| Defined benefit plan payments | 11.909 | 16.215 |
| Other payroll expenses | 114.749 | 113.359 |
| Personnell expenses total | 1.294.730 | 1.217.662 |

Personnel expenses are specified as follows:

| | | |
|---|---|---|
| Transmission costs | 555.661 | 477.104 |
| System operation | 454.480 | 436.362 |
| Other operating expenses | 284.589 | 304.196 |
| | 1.294.730 | 1.217.662 |

| | | |
|---|---|---|
| Average number of employees | 117 | 109 |
| Full-time equivalent units at year-end | 106 | 94 |

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# Notes, continued

## 9. Personnel expenses, contd.:

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

| | 2012 | 2011 |
|---|---|---|
| Remuneration of the Board of Directors | 5.975 | 5.040 |
| Remuneration and benefits of the CEO | 13.225 | 21.181 |
| Remuneration of two Excecutive Directors | 34.688 | 33.892 |

## 10. Depreciation and amortisation

Depreciation and amortisation are specified as follows:

| | | |
|---|---|---|
| Depreciation of fixed assets in operation, see Note 13 | 2.427.328 | 2.428.630 |
| Amortisation and impairment losses, see Note 14 | 40.224 | 137.818 |
| Depreciation and amortisation recognised in the income statement | 2.467.552 | 2.566.448 |

Depreciation and amortisation are allocated as follows to operating items:

| | | |
|---|---|---|
| Transmission costs | 2.298.882 | 2.398.162 |
| System operation | 56.541 | 40.149 |
| Other operating expenses | 112.129 | 128.137 |
| Depreciation and amortisation recognised in the income statement | 2.467.552 | 2.566.448 |

## 11. Financial income and expenses

Financial income and expenses are specified as follows:

| | | |
|---|---|---|
| Interest income | 40.318 | 27.079 |
| Net gain in fair value of marketable securities | 9.521 | 57.430 |
| Gain on sale of shares in associate | 17.543 | 0 |
| Total financial income | 67.382 | 84.509 |
| | | |
| Interest expenses | ( 2.216.696) | ( 2.202.114) |
| Indexation | ( 2.078.598) | ( 2.294.596) |
| Exchange rate difference | ( 152.823) | ( 98.623) |
| Change in present value of the provision due to site restoration | ( 38.226) | 56.442 |
| Capitalised interest expense due to projects under construction | 80.037 | 58.236 |
| Total financial expenses | ( 4.406.306) | ( 4.480.655) |
| | | |
| Net financial expenses | ( 4.338.924) | ( 4.396.146) |

Net financial expenses due to the construction of a transmission infrastructure amounting to ISK 80 million (2011: 58 million) is capitalised and has been reported as a reduction in financial expenses.

Capitalised financial expenses were 7.6% of capital tied in transmission structures under construction during the year (2011: 8.0%). This is the Company's average finance cost in the year 2012.

## 12. Income tax

Income tax recognised in the income statement is specified as follows:

| | | |
|---|---|---|
| Calculated income tax for the year | ( 184.319) | ( 209.957) |
| Income tax recognised in the income statement | ( 184.319) | ( 209.957) |

**Change in deferred income tax liability is specified as follows:**

| | | |
|---|---|---|
| Change in temporary differences | 308.482 | 211.626 |
| Change in carry-forward losses | ( 492.801) | ( 421.583) |
| Change in deferred tax assets | ( 184.319) | ( 209.957) |

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## Notes, continued

### 12. Income tax, contd.:

**Reconciliation of effective tax rate**

| | | 2012 | | 2011 |
|---|---|---|---|---|
| Profit before income tax ................................... | | 985.272 | | 1.049.787 |
| Income tax according to the current tax rate ........................................................ | 20,0% | ( 197.054) | 20,0% | ( 209.957) |
| Effects of associates ........................................ | ( 1,2%) | 12.297 | 0,0% | 0 |
| Other ................................................................ | ( 0,0%) | 438 | 0,0% | 0 |
| Effective tax rate .............................................. | 18,7% | ( 184.319) | 20,0% | ( 209.957) |

### 13. Fixed assets in operation:

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

In accordance with the International Accounting Standard, 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 2012.

**Fixed assets in operation:**

| | Substations | Transmission lines | Other | Total |
|---|---|---|---|---|
| **Cost** | | | | |
| Balance at 1.1.2011 ......................................... | 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 |
| Additions .......................................................... | 418.645 | 75.827 | 372.035 | 866.507 |
| Sold and disposed of ....................................... | 0 | 0 | ( 4.790) | ( 4.790) |
| Balance at 31.12.2012 ..................................... | 23.084.752 | 47.408.117 | 3.489.245 | 73.982.114 |
| **Depreciation** | | | | |
| Balance at 1.1.2011 ......................................... | 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 at 31.12.2011 ..................................... | 4.008.157 | 8.194.034 | 730.798 | 12.932.989 |
| Depreciation ..................................................... | 766.203 | 1.505.057 | 156.068 | 2.427.328 |
| Sold and disposed of ....................................... | 0 | 0 | ( 3.619) | ( 3.619) |
| Balance 31.12.2012 .......................................... | 4.774.360 | 9.699.091 | 883.247 | 15.356.698 |

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**13. Fixed assets in operation, contd.:**

**Fixed assets in operation:**

| | Substations | Transmission lines | Other | Total |
|---|---|---|---|---|
| **Carrying amount** | | | | |
| 1.1.2011 | 19.002.250 | 40.850.324 | 2.303.382 | 62.155.956 |
| 31.12.2011 | 18.657.950 | 39.138.256 | 2.391.202 | 60.187.407 |
| 31.12.2012 | 18.310.392 | 37.709.026 | 2.605.998 | 58.625.415 |
| **Carrying amount without revaluation** | | | | |
| 1.1.2011 | 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 |
| 31.12.2012 | 15.794.313 | 25.733.557 | 2.605.998 | 44.133.868 |

**Rateable value and insurance value**

The rateable value of the Company's real property amounts to upwards of ISK 2.7 billion (2011: ISK 2.5 billion). Assessed value for the same property's fire insurance amounts to ISK 5.2 billion (2011: ISK 4.6 billion) and book value amounts to ISK 3.7 billion (2011: ISK 3.9 billion). The insurance value of the Company's assets amounts to ISK 42.2 billion (2011: ISK 37.3 billion), excluding transmission lines and cables, which are insured by an emergency insurance fund. The Company's emergency insurance amounts to ISK 103.4 billion (2011: ISK 99.8 billion).

**Projects under construction:**

| | 2012 | 2011 |
|---|---|---|
| Balance at 1.1. | 276.275 | 425.541 |
| Additions | 1.506.943 | 518.809 |
| Transferred to intangible assets / fixed assets in operation | ( 8.075) | ( 668.075) |
| Sold and disposed of | ( 5.472) | 0 |
| Balance at 31.12. | 1.769.671 | 276.275 |

**14. Intangible assets:**

| | Capitalised development cost | Software | Total |
|---|---|---|---|
| **Cost** | | | |
| Balance at 1.1.2011 | 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 |
| Additions | 134.114 | 5.580 | 139.694 |
| Transferred to projects under construction | 8.075 | 0 | 8.075 |
| Sold and disposed of | ( 7.252) | 0 | ( 7.252) |
| Balance at 31.12.2012 | 1.482.113 | 391.844 | 1.873.957 |

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**14. Intangible assets, contd.:**

**Amortisation and impairment losses**

| | | | |
|---|---|---|---|
| Balance at 1.1.2011 | 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 |
| Amortisation and impairment losses | 8.075 | 32.149 | 40.224 |
| Balance at 31.12.2012 | 220.489 | 277.238 | 497.727 |

**Carrying amount**

| | | | |
|---|---|---|---|
| 1.1.2011 | 1.212.719 | 189.039 | 1.401.758 |
| 31.12.2011 | 1.134.762 | 141.175 | 1.275.937 |
| 31.12.2012 | 1.261.624 | 114.606 | 1.376.230 |

**15. Investment in subsidiary**

The breakdown of investment in subsidiary is as follows:

| | 2012 Share | 2012 Carrying amount | 2011 Share | 2011 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.

**16. Investment in associates**

The breakdown of investment in associates is as follows:

| | 2012 Share in net earnings | 2011 Share in net earnings | 2012 Carrying amount | 2011 Carrying amount |
|---|---|---|---|---|
| Orkufjarskipti hf. 50% / 50% | 16.015 | 0 | 643.851 | 627.835 |
| Netorka ehf. 0% / 38,71% | 2.565 | 5.516 | 0 | 48.942 |
| Total investment in other companies | 18.580 | 5.516 | 643.851 | 676.777 |

In October the Company sold its 38.71% share in Netorka ehf.

**17. Inventories**

Inventories are spare parts and material inventories. No write-down due to the Company's inventories is recognised in the financial statements (2011: ISK 10 million write-down).

**18. Trade and other receivables**

Trade and other receivables:

| | 2012 | 2011 |
|---|---|---|
| Trade receivables | 557.242 | 500.695 |
| Other receivables | 133.536 | 145.730 |
| Trade and other receivables total | 690.778 | 646.425 |

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# Notes, continued

## 19. Marketable securities

Marketable securities held by the Company are listed on a stock exchange. They are liquid but cannot be classed as cash because their maturity is more than three months.

## 20. Cash and cash equivalents

Cash and cash equivalent is specified as follows:

| | 2012 | 2011 |
|---|---|---|
| Bank balances | 10.309.772 | 10.242.916 |
| Cash and cash equivalent total | 10.309.772 | 10.242.916 |

## 21. 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 2012 for the financial year 2011, nor in the year 2011 for the financial year 2010. Accumulated deficit amounts to ISK 4.2 billion at year end and therefore not permitted to pay dividend to shareholders.

## 22. Earnings per share

### Basic and diluted earnings per share:

| | 2012 | 2011 |
|---|---|---|
| Profit to shareholders | 800.953 | 839.830 |
| Weighted average number of ordinary shares at 31 December | 5.902.733 | 5.902.733 |
| Basic and diluted earnings per share | 0,14 | 0,14 |

## 23. 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

| | 2012 | 2011 |
|---|---|---|
| Indexed bond loan from parent company in ISK, fixed interest | 42.675.190 | 40.828.055 |
| Loan agreement with parent company in USD, LIBOR + margin | 0 | 3.558.590 |
| Loan agreement in CHF, LIBOR + margin | 7.830.765 | 7.657.983 |
| Indexed bond loan in ISK, fixed interest | 5.279.894 | 5.175.789 |
| | 55.785.849 | 57.220.417 |
| Current maturities on long-term liabilities | ( 968.844) | ( 4.073.121) |
| | 54.817.005 | 53.147.296 |

### Short-term liabilities

| | 2012 | 2011 |
|---|---|---|
| Short-term loans from parent company specifies as follows: | | |
| Accrued interest of long-term liabilities with parent company | 1.402.366 | 1.347.270 |
| Loan agreement with the parent company | | |
| in USD as part of current maturities on long-term liabilities | 0 | 3.558.590 |
| Total interest-bearing short-term liabilities | 1.402.366 | 4.905.860 |
| Current maturities on long-term liabilities | 0 | ( 3.558.590) |
| Short-term loans from parent company total | 1.402.366 | 1.347.270 |

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## 23. 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. In the beginning of the year the Company had a revolving credit facility with the parent company, Landsvirkjun, in the amount of USD 50 million. Credit drawn under the facility amounted to USD 29 million but in June 2012 the Company repaid the USD 29 million in credit drawn under the facility and the facility was terminated.

### Terms of interest-bearing loans and borrowings

Debts in foreign currencies:

| | | 2012 | | 2011 | |
|---|---|---|---|---|---|
| | Final maturity | Weighted avg. rate | Carrying amount | Weighted avg. rate | Carrying amount |
| Debt in CHF ............................ | 2022 | 0,39% | 7.830.765 | 0,46% | 7.657.983 |
| Debt in USD ............................ | 2012 | - | 0 | 3,79% | 3.558.590 |
| | | | 7.830.765 | | 11.216.573 |
| Debt in ISK: | | | | | |
| Indexed .................................. | 2020 - 2034 | 4,30% | 47.955.084 | 4.30% | 46.003.844 |
| Total interest-bearing loans and borrowings ............................ | | | 55.785.849 | | 57.220.417 |

Maturities by year of interest-bearing loans and borrowings:

| | 2012 | 2011 |
|---|---|---|
| Árið 2013/2012 ............................................................ | 968.844 | 4.073.121 |
| Árið 2014/2013 ............................................................ | 976.162 | 904.094 |
| Árið 2015/2014 ............................................................ | 983.850 | 911.096 |
| Árið 2016/2015 ............................................................ | 991.928 | 918.451 |
| Árið 2017/2016 ............................................................ | 1.000.415 | 926.179 |
| Later ............................................................ | 50.864.650 | 49.487.476 |
| | 55.785.849 | 57.220.417 |

## 24. Deferred tax liability

The breakdown of deferred tax liability is as follows:

| | 2012 | 2011 |
|---|---|---|
| Deferred tax liability at 1 January ............................................ | 1.607.613 | 1.397.656 |
| Calculated income tax for the year ............................................ | 184.319 | 209.957 |
| Deferred tax liability at 31 December ............................................ | 1.791.932 | 1.607.613 |

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

| | 2012 | 2011 |
|---|---|---|
| Fixed assets in operation ............................................ | 2.756.995 | 2.945.402 |
| Intangible assets ............................................ | 197.008 | 154.274 |
| Investment in companies ............................................ | 0 | 5.072 |
| Provision due to site restoration ............................................ | ( 146.861) | ( 139.216) |
| Other obligations ............................................ | ( 137.342) | ( 66.020) |
| Unrealized exchange rate difference ............................................ | ( 26.951) | 51.819 |
| Tax losses carried forward ............................................ | ( 850.917) | ( 1.343.718) |
| Deferred tax liability at 31 December ............................................ | 1.791.932 | 1.607.613 |

The carry-forward taxable loss amounted to ISK 4.3 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 2012 will be utilisable until the year 2018.

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**25. 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 308 millon (2011:136 million). 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 2012 amounted to ISK 7 million (2011: 1 million).

**26. Provision due to site restoration**

| Change in the provision due to site restoration is specified as follows: | 2012 | 2011 |
|---|---|---|
| Balance at 1.1. | 696.081 | 752.523 |
| Present value for the year reversed | 38.226 | ( 56.442) |
| Balance at year-end | 734.307 | 696.081 |

In accordance with the International Accounting Standard, 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.

**27. 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 12 million is expensed in relation thereto for 2012 (2011: 16 million).

**28. Trade and other payables**

| Trade and other payables are specified as follows: | 2012 | 2011 |
|---|---|---|
| Trade payables | 949.683 | 770.410 |
| Other payables | 645.222 | 446.011 |
| Trade and other payables total | 1.594.905 | 1.216.421 |

**29. 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 and is dependant on the financial condition and operations of each customer.

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## 29. 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 89% (2011: 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:

| | 2012 | 2011 |
|---|---|---|
| Long-term note ..................................................................................... | 34.929 | 34.929 |
| Receivables from parent company ..................................................................... | 648.398 | 578.827 |
| Trade and other receivables ............................................................................. | 690.778 | 646.425 |
| Market securities .................................................................................... | 251.027 | 267.750 |
| Cash and cash equivalents ................................................................................ | 10.309.772 | 10.242.916 |
| Highest possible loss due to credit risk total ..................................................... | 11.934.904 | 11.770.847 |

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

**2012**

| | 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. | 44.077.556 | 56.474.945 | 1.796.625 | 3.593.251 | 5.389.876 | 45.695.193 |
| Long-term liabilities ........ | 13.110.659 | 16.541.910 | 1.233.020 | 2.456.820 | 3.661.658 | 9.190.412 |
| Trade and other payables ....... | 1.594.905 | 1.594.905 | 1.594.905 | 0 | 0 | 0 |
| | 58.783.120 | 74.611.760 | 4.624.550 | 6.050.071 | 9.051.534 | 54.885.605 |

**2011**

| | Carrying amount | Contractual cash flow | Within 12 months | 1-2 years | 2-5 years | After 5 years |
|---|---|---|---|---|---|---|
| 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 |

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**29. 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**

Currency risk is the risk of a loss because of unfavorable changes in the rate of currencies. 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) and therefore a currency risk arises from the net cash flow and opening balance in currencies other than ISK. Supstantial part of the Company's income derives from US dollars. In 2012, 64.8% (2011: 62.1%) 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 2013, it is estimated that 68.9% 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 Swiss Francs (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 |
|---|---|---|---|
| **2012** | | | |
| Cash and cash equivalent | 190.826 | 50.782 | 9.348.845 |
| Trade and other receivables | 0 | 0 | 255.691 |
| Other long-term liabilities | 0 | ( 7.830.765) | 0 |
| Trade and other payables | ( 104.605) | 0 | ( 45.078) |
| Net currency risk | 86.221 | ( 7.779.983) | 9.559.458 |
| **2011** | | | |
| Cash and cash equivalent | 132 | 51.788 | 9.497.126 |
| 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 | ( 71.880) | ( 7.613.140) | 6.161.575 |

| | Av. exch. rate for the year | | Year-end exch. rate | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| **Currency risk** | | | | |
| EUR | 160,73 | 161,42 | 169,80 | 158,84 |
| CHF | 133,35 | 131,20 | 140,64 | 130,66 |
| USD | 125,05 | 116,07 | 128,74 | 122,71 |

**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 2011.

| | 2012 | 2011 |
|---|---|---|
| EUR | ( 6.898) | 5.750 |
| CHF | 622.399 | 609.051 |
| USD | ( 764.757) | ( 492.926) |

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**29. 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 interest rate risk arises from interest bearing assets and liabilities. The Company's borrowings bear both floating and fixed interest. The majority of the Company's borrowings bear fixed interest, cf. Note 23. At year end 2012, the proportion of liabilities with floating interest rates was 14% compared to 20% at year end 2011.

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

| | Carrying amount | |
|---|---|---|
| | 2012 | 2011 |
| **Financial instruments with floating interest rate** | | |
| Financial assets | 34.929 | 34.929 |
| Financial liabilities | ( 7.830.765) | ( 11.216.573) |
| | ( 7.795.836) | ( 11.181.644) |
| **Financial instruments with fixed interest rate** | | |
| Financial liabilities | ( 47.955.084) | ( 46.003.844) |

**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 2011.

| | Earnings | |
|---|---|---|
| | 100bp increase | 100bp decrease |
| **31 December 2012** | | |
| Financial instruments with floating interest rates | ( 62.234) | 23.386 |
| Cash flow sensitivy (net) | ( 62.234) | 23.386 |
| **31 December 2011** | | |
| Financial instruments with floating interest rates | ( 87.027) | 53.988 |
| Cash flow sensitivy (net) | ( 87.027) | 53.988 |

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**29. Financial instruments, contd.:**

**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:

| | 2012 Carrying amount | 2012 Fair value | 2011 Carrying amount | 2011 Fair value |
|---|---|---|---|---|
| Long-term note | 34.929 | 34.929 | 34.929 | 34.929 |
| Loans and receivables | 1.339.176 | 1.339.176 | 1.225.252 | 1.225.252 |
| Marketable securities | 251.027 | 251.027 | 267.750 | 267.750 |
| Cash and cash equivalents | 10.309.772 | 10.309.772 | 10.242.916 | 10.242.916 |
| Long-term liabilities from parent company | ( 42.675.190) | ( 49.613.500) | ( 44.386.645) | ( 49.935.197) |
| Other long-term liabilities | ( 13.110.659) | ( 14.398.193) | ( 12.833.772) | ( 13.282.842) |
| Loans from parent company, short-term | ( 1.402.366) | ( 1.402.366) | ( 1.347.270) | ( 1.347.270) |
| Trade and other payables | ( 1.594.905) | ( 1.594.905) | ( 1.216.421) | ( 1.216.421) |
| | ( 46.848.216) | ( 55.074.060) | ( 48.013.261) | ( 54.010.883) |

**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 |
|---|---|---|---|---|
| **2012** | | | | |
| Long-term note | | 34.929 | | 34.929 |
| Receivables from parent company | | 648.398 | | 648.398 |
| Trade and other receivables | | 690.778 | | 690.778 |
| Marketable securities | 251.027 | | | 251.027 |
| Cash and cash equivalents | | 10.309.772 | | 10.309.772 |
| | 251.027 | 11.683.877 | 0 | 11.934.904 |
| Loans from parent company | | | 42.675.190 | 42.675.190 |
| Other long-term liabilities | | | 13.110.659 | 13.110.659 |
| Trade and other payables | | 1.594.905 | | 1.594.905 |
| | 0 | 1.594.905 | 55.785.849 | 57.380.754 |
| **2011** | | | | |
| Long-term note | | 34.929 | | 34.929 |
| Receivables from parent company | | 578.827 | | 578.827 |
| Trade and other receivables | | 646.425 | | 646.425 |
| Marketable securities | 267.750 | | | 267.750 |
| Cash and cash equivalents | | 10.242.916 | | 10.242.916 |
| | 267.750 | 11.503.097 | 0 | 11.770.847 |
| 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 |

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**29. Financial instruments, contd.:**

**Indexation risk**

Indexation risk derives from changes in the Consumer Price Index, which affect the financial position and cash flows of inflation-indexed financial instruments. The majority of the company's loans are denominated in inflation-indexed ISK, while the majority of its revenue is USD-denominated

**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**

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

**30. 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 2012 amounted to ISK 131 million (2011: ISK 74 million).

**31. Uncertainty**

Under the Electricity Act No. 65/2003, Landsnet is obliged to set the tariff for its services in accordance with a revenue cap. 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, the latter of which shall be determined in United States dollars. The National Energy Authority is yet to set the revenue cap for the Company for the years 2011-2015. Under the Electricity Act, the 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. The Authority and Landsnet have been unable to agree on the settlement for the years 2006-2009 owing to different interpretations of the profitability criteria for distribution system operators; there is no disagreement about the revenue cap for power-intensive consumers.

Landsnet has twice appealed the National Energy Authority's decision regarding the settlement for the years 2006-2009 to the Appeals Committee on Electricity, which overturned both of the Authority's decisions and referred the case back to it for a reassessment. The Authority issued a third decision on the settlement for the said period on 20 December 2012, which has also been appealed. On 12 April 2012, the Authority issued a decision on the revenue cap settlement for 2010. This decision is not in dispute. The delays in effecting a settlement for the years 2006-2009 have caused some uncertainty with regard to the Company's performance measurement and financial position.

With Act No. 19/2011, amending the Electricity Act, 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 exchange rate at 31 July 2007. The amending Act took effect at the beginning of 2011, but a revenue cap in accordance therewith remains to be established. Estimates of the awaited revenue cap were of limited accuracy until recently as information on the required rate of return was not available until 1 October 2012. Only from that date onwards has Landsnet been able to make projections of the anticipated revenue cap and determine tariff changes on that basis; two years after the entry into effect of the amending Act, it has thus become possible to deliver a reasoned decision on tariff changes based on the amended Electricity Act. Stakeholders have appealed the National Energy Authority's decision regarding the required rate of return to the Appeals Committee on Electricity.

*Power-intensive consumers*

Between 2005 and August 2007, Landsnet's revenue and revenue cap for 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, without changing the revenue cap accordingly.

## 31. Uncertainty, contd.:

Following the sharp ISK depreciation in 2008, Landsnet's USD-denominated revenue from power-intensive consumers increased substantially in ISK. The government authorities showed willingness to address the problem that this presented for the revenue cap regime and to amend legislation in order that the revenue cap for power-intensive consumers would be denominated in the same currency as the tariff. With Act No. 19/2011, amending the Electricity Act, 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 exchange rate at 31 July 2007, thereby redressing the balance between the revenue cap and the tariff. Since 2011, Landsnet has accrued a credit balance vis-à-vis power-intensive consumers, and the Company estimates that obligations due to over-collected revenue in previous years have been mostly paid off.

*Distribution system operators*

At year-end 2012, 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 on this matter. 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. According to Landsnet's calculations, obligations resulting from over-collected revenue may amount to between ISK 0.1 billion and up to ISK 1.5 billion

In response to decisions by the National Energy Authority, 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, but this case is pending until the Appeals Committee on Electricity delivers its decision.

*Provisions of law concerning repayments*

A transitional provision of Act No. 19/2011, amending the Electricity Act, provides that, in the event of the transmission system operator's over-collection of revenue for previous years, the Company shall set its tariff at a level ensuring that over-collected revenue does not exceed 10% of the revenue cap at year-end 2020. Over-collected revenue is not subject to interest calculation or inflation-indexation.

The provisions of the Act do not require Landsnet to deliver cash or other assets in repayment of over-collected revenue, nor to provide additional services without charge. Instead, the over-collection of revenue shall be corrected through general changes to the transmission tariff in the following years. Landsnet bases its tariff decisions on the revenue cap and the repayment provision.

On the basis of the provisions of law governing the repayment of over-collected revenue and the provisions of the International Financial Reporting Standards, no effects of revenue-cap-based settlements for 2006-2012 are recognised in the annual financial statements.

## 32. 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 9.

# Notes, continued

### 32. Related parties, contd.:

**Other transactions with related parties**

| | 2012 | 2011 |
|---|---|---|
| **Sale of goods and services:** | | |
| Landsnet's parent company and its subsidiaries | 6.747.318 | 6.425.860 |
| Landsnet's other shareholders | 4.390.775 | 3.876.713 |
| Sale of goods and services to related parties total | 11.138.093 | 10.302.573 |
| **Cost:** | | |
| Landsnet's parent company and its subsidiaries | 1.130.216 | 1.162.453 |
| Landsnet's other shareholders | 665.616 | 573.704 |
| Landsnet's associate | 0 | 471 |
| Cost of goods and services to related parties total | 1.795.832 | 1.736.628 |

In addition the costs outlined above, the Company paid ISK 1,815 million (2011: ISK 1,855 million) in interest to its parent company.

**Balance:**

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

| | 2012 | | 2011 | |
|---|---|---|---|---|
| | **Receivables** | **Payables** | **Receivables** | **Payables** |
| Landsnet's parent company and its subsidiaries | 648.398 | 0 | 578.827 | 0 |
| Landsnet's other shareholders | 401.646 | (53.624) | 313.717 | (6.491) |
| | 1.050.044 | (53.624) | 892.544 | (6.491) |

Other receivables and payables with related parties are as follows:

| | 2012 | 2011 |
|---|---|---|
| Interest-bearing liabilities to parent company, see note 23 | 42.675.190 | 44.386.645 |
| Accrued interest payable to parent company | 1.402.366 | 1.347.270 |
| | 44.077.556 | 45.733.915 |

### 33. Financial ratios

The company's key financial ratios:

| | 2012 | 2011 |
|---|---|---|
| **Financial performance:** | | |
| EBIT | 5.305.616 | 5.440.417 |
| EBITDA | 7.773.168 | 8.006.865 |
| **Financial position:** | | |
| Current ratio – current assets/current liabilities | 3,13 | 1,84 |
| Equity ratio – equity/total assets | 17,7% | 16,7% |
| Return on equity | 6,4% | 7,2% |

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# 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 in March 2012. 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 29 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..

# Corporate Governance Statement, contd.:

### 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, Iceland. 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 1987-1999 and Hæfi, chairman of Reyðarál in 2000-2002 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. Mr Gunnlaugsson 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 pursued studies in electrical engineering at the University of Iceland. She read electrical engineering at the Technische Universität Darmstadt in Germany, from which she earned a Dipl.-Ing./MSc degree in electrical power engineering in 1987. Ms Björnsdóttir also holds a diploma in operations management from the University of Iceland and is an IRCA-certified lead auditor of corporate information security management systems based on international standards. She founded the information security company Stiki in 1992 and the subsidiary Stiki Ltd in the United Kingdom in 1996. Ms Björnsdóttir is CEO of Stiki and has worked as an IT and software engineering consultant on various projects for companies and organisations. She has served as a government supervisor on various projects. She has extensive experience in business management, international co-operation and export activities. Her board memberships include Hagar hf, the Icelandic Data Protection Authority, the Association of Chartered Engineers in Iceland, the Seed Company Association in Iceland and the Icelandic Society for Information Processing. She has sat on the Expert Panels of the Technology Development Fund and Research Fund of the Icelandic Centre for Research (RANNÍS). For several years she was Iceland's representative on the Council of European Professional Informatics Societies. She was elected chairman of the Federation of Icelandic Industries in March 2012. Ms Björnsdóttir is also chairman of Akkur SI. In addition, she is a board member of the Confederation of Icelandic Employers, the General Pension Fund, the Association of Small Investors, the Science and Technology Council and the High Tech and Seed Forum, a consultative forum between government and business. Ms Björnsdóttir was elected to Landsnet's Board at the Annual General Meeting of the Company on 31 March 2009.

*Ómar Benediktsson, Director*

Ómar Benediktsson was born on 22 October 1959 and lives in Reykjavík, Iceland. He holds a cand. oecon. degree in business administration from the University of Iceland. He served in managerial positions in tourism and aviation for 30 years, including at Island Tours, Íslandsflug and Air Atlanta. He has sat on numerous boards and committees in these fields, including the Civil Aviation Board and the Icelandic Tourist Board, the Committee on Iceland's Future Policy on Tourism and as vice-chairman of Icelandair Group hf. Mr Benediktsson has been active in promoting Iceland as a tourist destination and has sat on a number of committees devoted to this end, including as chairman of the Icelandic Tourist Board Marketing Committee and chairman of Iceland Naturally, a co-operative marketing organisation. He founded the first Icelandic-owned specialised travel wholesaler offering trips to Iceland in Germany and later in other continental European countries. He sat on the preparatory committee for the founding of the Icelandic Travel Industry Association and on its nominations committee for the first few years. He has led the launch of a number of tourist industry companies, including Fosshótel. He was the first chairman of the Icelandic National Broadcasting Service after its conversion into a state-owned public limited company and sat on the boards of Blue Bird Cargo and Penninn for a number of years. Mr Benediktsson has long-standing experience in international business and relations. At the beginning of 2012, he became CEO of Farice ehf, which operates the submarine telecommunications network linking Iceland with the rest of the world. Farice is also a key player in developing Iceland's emerging data centre industry. Mr Benediktsson was elected to Landsnet's Board at the Annual General Meeting of the Company on 29 March 2012.

The Alternate Director is Guðrún Ragnarsdóttir.

A total of 14 meetings of the Board of Directors were held in 2012, which were attended by all Board members.

**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. 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.

Other members of th Executive Committee are:
Guðmundur Ingi Ásmundsson, Deputy CEO
Guðlaug Sigurðardóttir, CFO

# Corporate Governance Statement, contd.:

### 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.
A total of 5 meetings were held in 2012, all of which were attended by all Committee members.

### 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.