

Orkuveita Reykjavíkur
Consolidated
Financial Statements 2012

Orkuveita Reykjavíkur
Bæjarhálsi 1
110 Reykjavík

reg no. 551298-3029

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Endorsement by the Board of Directors and the Managing Director

Orkuveita Reykjavíkur is a partnership that complies with the Icelandic law no.139/2001 on the founding of the partnership Orkuveita Reykjavíkur. The Company is an independent service company operating its own power plants, producing and selling electricity and hot water. It provides local distribution of electricity, hot water and cold water, operates the sewage systems in its service area as well as a telecom network based on IP and fiber optic technology.

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS's) as adopted by the European Union. The financial statements comprise the consolidated financial statements of Orkuveita Reykjavíkur and subsidiaries.

Loss of operations of Orkuveita Reykjavíkur for the year 2012 was ISK 2.295 million. According to the statement of financial position the Company's assets were ISK 297.202 million at year-end, book value of equity at the end of the year was ISK 60.648 million, resulting in equity ratio of 20.4%

At the beginning of the year and at the end of the year the Company's shareholders were the following three municipalities:

	Share
Reykjavíkurborg	93.539%
Akraneskaupstaður	5.528%
Borgarbyggð	0.933%

The Company's Board of Directors do not propose dividend payments to the Company's shareholders in the year 2013 due to the operating year 2012.

The Icelandic Parliament passed changes to several Acts affecting the energy sector in the year 2008. These changes involve among others things that the Company must be split so that exclusive licence operations and competitive operations will be operated by separate entities. This act will come into effect 1 January 2014. Preparations for these changes are well underway.

Corporate governance

The Board of Directors of Orkuveita Reykjavíkur has implemented a code of procedures, last confirmed 17 February 2012. In them the scope of the Board's work is defined as well as work of the Managing Director. The Company takes into account the owners policy that was approved in the summer of 2012. The Board maintains and seeks to improve good corporate governance. At the beginning of the year the Board appointed an audit committee. In an appendix with the Financial Statements further information regarding corporate governance can be found and further information on corporate governance, owners' policy and the Board's procedures will be discussed in the Company's Annual Statements. The Annual Statement will be published in April 2013 and can then be found on the Company's website, www.or.is

Statement by the Board of Directors

According to the best knowledge of the Board of Directors of Orkuveita Reykjavíkur, the company's consolidated financial statements are in accordance with IFRS's as adopted by the EU. It is the opinion of the Board of Directors that the consolidated financial statements give a fair view of the Company's assets, liabilities and financial position 31 December 2012 and the company's operating return and changes in cash and cash equivalents for the year then ended.

It is the opinion of the Board of Directors that the consolidated financial statements give a fair view of the Company's operating development and results, its standing and describe the main risk factors and uncertainties faced by the Company.

The Board of Directors and the Managing Director of Orkuveita Reykjavíkur hereby confirm the Company's consolidated financial statements for the year 2012.

Reykjavík, 22 March 2013.

The Board of Directors:

Haraldur Flosi Tryggvason

Gylfi Magnússon

Hrönn Ríkharðsdóttir

Sóley Tómasdóttir

Kjartan Magnússon

Managing Director:

Bjarni Bjarnason

Independent Auditor's Report

To the Board of Directors and owners of Orkuveita Reykjavíkur.

We have audited the accompanying financial statements of Orkuveita Reykjavíkur, which comprise the statement of financial position as at December 31, 2012, the income statement, the statement 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 Orkuveita Reykjavíkur 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.

Reykjavík, 22 March 2013.

KPMG ehf.

Auðunn Guðjónsson

Guðný Helga Guðmundsdóttir

Income Statement 2012

	Notes	2012	2011
Operating revenue	5	37.904.545	33.626.215
Energy purchase		(4.865.858)	(5.016.487)
Salaries and salary related expenses	7	(3.701.222)	(3.836.419)
Other operating expenses	8	(4.293.531)	(3.538.078)
Operating expenses, total		<u>(12.860.611)</u>	<u>(12.390.983)</u>
EBITDA		<u>25.043.934</u>	<u>21.235.231</u>
Depreciation and amortisation	9	(10.371.085)	(8.880.736)
Results from operating activities, EBIT		<u>14.672.849</u>	<u>12.354.496</u>
Interest income		146.916	126.924
Interest expenses		(7.092.787)	(5.689.628)
Other (expenses) income on financial assets and liabilities		(11.547.680)	(14.093.609)
Total financial income and expenses	10	<u>(18.493.550)</u>	<u>(19.656.314)</u>
Share in loss of associated companies	15	(9.754)	(5.400)
Loss before income tax		<u>(3.830.455)</u>	<u>(7.307.218)</u>
Income tax	11	1.535.261	6.750.946
Loss for the year		<u>(2.295.194)</u>	<u>(556.272)</u>
Attributable to:			
Equity holders of the Company		(2.294.823)	(556.291)
Minority interest in subsidiaries		(371)	20
Loss for the year		<u>(2.295.194)</u>	<u>(556.272)</u>

The notes on pages 11 to 52 are an integral part of these Consolidated Financial Statements.

Statement of Comprehensive Income for the year ended 31 December 2012

	Notes	2012	2011
Loss for the year		(2.295.194)	(556.272)
Other comprehensive income			
Revaluation reserve, increase	12	0	15.137.813
Revaluation reserve, decrease	12	0	(5.000.000)
Income tax effect of revaluation		0	(1.245.295)
Changes in fair value of assets available for sale	16	1.300.000	460.000
Total comprehensive (loss) profit for the year		<u>(995.194)</u>	<u>8.796.246</u>
Total comprehensive income attributable to:			
Equity holders of the Company		(994.823)	8.796.227
Minority interest in subsidiaries		(371)	20
Total comprehensive (loss) profit for the year		<u>(995.194)</u>	<u>8.796.246</u>

The notes on pages 11 to 52 are an integral part of these Consolidated Financial Statements.

Consolidated Statement of Financial Position

31 December 2012

	Notes	2012	2011
Assets			
Property, plant and equipment	12	246.111.462	258.802.010
Intangible assets	14	1.218.980	1.256.937
Investments in associated companies	15	59.826	118.148
Investments in other companies	16	3.265.182	1.983.269
Embedded derivatives in electricity sales contracts	17	14.150.678	17.168.462
Hedge contracts	18	893.934	0
Other financial assets	18	9.745.440	7.886.188
Deferred tax assets	19	3.467.268	1.932.007
Total non-current assets		<u>278.912.770</u>	<u>289.147.020</u>
Inventories	20	402.872	431.560
Trade receivables	21	4.721.350	4.227.536
Embedded derivatives in electricity sales contracts	17	587.982	514.508
Hedge contracts	18	38.956	0
Other financial assets	18	5.986	569
Properties held for sale	13	5.347.856	0
Other receivables	21	298.181	411.196
Cash and cash equivalents	22	6.885.693	1.652.484
Total current assets		<u>18.288.875</u>	<u>7.237.853</u>
Total assets		<u><u>297.201.645</u></u>	<u><u>296.384.873</u></u>

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Consolidated Statement of Financial Position

31 December 2012

	Notes	2012	2011
Equity			
Revaluation reserve		51.791.161	53.923.091
Fair value reserve		1.760.000	460.000
Retained earnings		7.092.309	7.255.202
Equity attributable to equity holders of the Company		60.643.470	61.638.293
Minority interest		4.353	4.724
Total equity	23	60.647.822	61.643.016
Liabilities			
Loans and borrowings	24	201.546.363	213.838.494
Retirement benefit obligation	25	483.377	460.874
Hedge contracts	18	98.974	2.390
Total non-current liabilities		202.128.714	214.301.758
Accounts payable		1.366.254	1.627.619
Loans and borrowings	24	29.956.923	16.384.762
Hedge contracts	18	150.300	17.389
Other current liabilities	26	2.951.632	2.410.329
Total current liabilities		34.425.109	20.440.099
Total liabilities		236.553.823	234.741.857
Total equity and liabilities		297.201.645	296.384.873

The notes on pages 11 to 52 are an integral part of these Consolidated Financial Statements.

Interim Statement of Changes in Equity for the year 2012

	Revaluation reserve	Fair value reserve	Retained earnings	Attributable to equity holders of the Company	Minority interest	Total equity
The year 2012						
Equity at 1 January 2012	53.923.090	460.000	7.255.201	61.638.291	4.725	61.643.016
Depreciation transferred to retained earnings	(2.131.929)		2.131.929	0		0
Changes in fair value of assets available for sale		1.300.000		1.300.000		1.300.000
Loss for the year			(2.294.823)	(2.294.823)	(371)	(2.295.194)
Total comprehensive income	(2.131.929)	1.300.000	(162.894)	(994.823)	(371)	(995.194)
Equity at 31 December 2012	51.791.161	1.760.000	7.092.307	60.643.468	4.354	60.647.822
The year 2011						
Equity at 1 January 2011	46.882.894	0	5.959.170	52.842.064	4.705	52.846.769
Revaluation, increase	15.137.813			15.137.813		15.137.813
Revaluation, decrease	(5.000.000)			(5.000.000)		(5.000.000)
Income tax on revaluation	(1.245.295)			(1.245.295)		(1.245.295)
Depreciation transferred to retained earnings	(1.852.322)		1.852.322	0		0
Changes in fair value of assets available for sale		460.000		460.000		460.000
Loss for the year			(556.291)	(556.291)	20	(556.271)
Total comprehensive income	7.040.196	460.000	1.296.031	8.796.227	20	8.796.247
Equity at 31 December 2011	53.923.090	460.000	7.255.201	61.638.291	4.725	61.643.016

The notes on pages 11 to 52 are an integral part of these Consolidated Financial Statements.

Interim Statement of Cash Flows for the year 2012

	Notes	2012	2011
Cash flows from operating activities			
Cash generated from operations before interest and taxes	33	24.335.571	20.574.518
Received interest income		137.916	127.147
Paid interest expenses .....	(	5.411.118)	(3.777.307)
Dividend received		54.475	43.840
Paid due to other financial income and expenses .....	(	182.318)	(38.063)
Net cash from operating activities		<u>18.934.526</u>	<u>16.930.135</u>
Cash flows from investing activities			
Acquisition of property, plant and equipment .....	(	3.122.147)	(10.203.833)
Acquisition of intangible assets .....	(	50.383)	(80.258)
Proceeds from sale of property, plant and equipment		226.200	582.268
Proceeds from sale of other companies		197.693	179.000
Acquisition of other financial assets .....	(	28.000)	(16.887)
Proceeds and repayment of other financial assets		29.858	1.036
Net cash used in investing activities		<u>(2.746.779)</u>	<u>(9.538.674)</u>
Cash flows from financing activities			
Proceeds from new borrowings		1.007.996	0
Repayment of borrowings .....	(	12.317.428)	(10.449.874)
Proceeds from new borrowings from the owners		74.640	7.925.360
Credit facility, change .....	(	2.482.638)	(6.771.507)
Current liabilities, change		2.357.358	1.227.863
Net cash from financing activities		<u>(11.360.072)</u>	<u>(8.068.157)</u>
Increase (decrease) in cash and cash equivalents		<u>4.827.676</u>	<u>(676.696)</u>
Cash and cash equivalents at year beginning		1.652.484	2.343.648
Effect of currency fluctuations on cash and cash equivalents		405.534	(14.468)
Cash and cash equivalents at end of the year		<u>6.885.693</u>	<u>1.652.484</u>
Investments and financing without payment effects:			
Acquisition of property, plant and equipment .....	(	195.704)	(302.915)
Proceeds from sale of property, plant and equipment		0	135.000
Proceeds from sale of other companies		0	149.541
Receivables, change		0	(284.541)
Current liabilities, change		195.704	302.915
Other information:			
Working capital from operation		19.880.141	17.231.251

The notes on pages 11 to 52 are an integral part of these Consolidated Financial Statements.

Notes to the Financial Statements

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Notes

1. Reporting entity

Orkuveita Reykjavíkur is a partnership that complies with the Icelandic law no. 139/2001 on the founding of the partnership Orkuveita Reykjavíkur. The Company's headquarters are at Bæjarháls 1 in Reykjavik. The Company's consolidated financial statements include the financial statements of the parent company and its subsidiaries, (together referred to as "the Company") and a share in associated companies. The consolidated financial statements of Orkuveita Reykjavíkur is a part of the interim financial statements of Reykjavik city.

The Company is an independent service company that produces and distributes electricity, distributes geothermal water for heating, cold water for consumptions, sewer systems, and operates fibre-optic cable systems.

2. Basis of preparation

a. Statement of compliance

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

The financial statements were approved by the Board of Directors on 22 March 2013.

b. Basis of measurement

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

- A part of property, plant and equipment have been revalued at fair value.
- Derivative agreements are stated at fair value.
- Assets held for sale are stated at fair value.
- Financial instruments at fair value through profit and loss are stated at fair value.

The methods used to measure fair values are discussed further in note 4.

c. Functional and presentation currency

These financial statements are presented in Icelandic kronas, which is the Company's functional currency. All financial information presented in Icelandic kronas has been rounded to the nearest thousand unless otherwise stated.

d. Use of estimates and judgements

The preparation of the financial statements in conformity with IFRSs 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.

In particular, 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 12 - Property, plant and equipment
- note 16 - Investments in other companies
- note 17 - Embedded derivatives in electricity sales contracts
- note 18 - Other financial assets and other financial liabilities
- note 19 - Deferred tax assets and liabilities
- note 25 - Retirement benefit obligations
- note 28 - Market risk

Notes

3. Significant accounting policies

The accounting policies set out below have been applied consistently to all periods presented in these consolidated financial statements, and have been applied consistently by Group entities.

a. Basis of consolidation

i) Subsidiaries

Subsidiaries are entities controlled by the Group. Control exists when the Group has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. In assessing control, potential voting rights that currently are exercisable are taken into account. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases. The accounting policies of subsidiaries have been changed when necessary to align them with the policies adopted by the Group.

ii) Associates

Associates are those entities in which the Group has significant influence, but not control, over the financial and operating policies. Significant influence is presumed to exist when the Group holds between 20 and 50 percent of the voting power of another entity. Associates are entered in the Group's financial statements by using the equity method.

The Group's financial statements include a share in the profit or loss of associates and jointly controlled entities based on the equity method. When the Group's share of losses exceeds its interest in an equity accounted investee, the carrying amount of that interest is reduced to nil and the recognition of further losses is discontinued except to the extent that the Group has an obligation or has made payments on behalf of the investee. In case of a profit on the operation of associates or jointly controlled entities in later periods a share in the profit is not recognised until the recognised share in the loss has been set off.

iii) Transactions eliminated on consolidation

Intra-group balances and transactions, and any unrealised income and expenses arising from intra-group transactions, are eliminated in preparing the consolidated financial statements. Unrealised gains arising from transactions with equity accounted investees are eliminated against the investment to the extent of the Group's interest in the investee. Unrealised losses are eliminated in the same way as unrealised gains, but only to the extent that there is no evidence of impairment.

b. Foreign currency

Transactions in foreign currencies are recognised at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies at the reporting date and the Company uses the mid foreign exchange rate at the end of the day according to the Central Bank of Iceland (2011: Reuters). Other assets and liabilities stated at fair value in foreign currencies are recognised at the exchange rate ruling when their fair value was determined. Exchange difference is recognised in the income statement.

Notes

3. Significant accounting policies, contd.

c. Financial instruments

i) Non-derivative financial assets

Loans, receivables and cash in bank are recognised when received. All other financial instruments are recognised in the financial statements when the Company becomes a party of contractual provisions of the relevant financial instruments.

Financial assets are eliminated from the financial statements if the Company's contractual right to cash flow due to the financial asset expires or if the Group transfers the assets to another party without retaining control or nearly all risk and gain inherent with their ownership. Any interest in transferred financial assets that is created or retained by the group is recognized as a separate asset or liability.

Financial assets and liabilities are netted out and the net amount is entered in the balance sheet when the legal right of off-setting exists and financial assets and liabilities are recognised by off-setting.

Non-derivative financial instruments comprise investments in equity and debt securities, trade and other receivables, cash and cash equivalents, loans and borrowings, and trade and other payables.

Held-to maturity investments

When the Group has both the intention and the ability to hold debt securities to maturity, then they are classified as held-to-maturity. Such investments are recognised in the financial statements at amortised cost using the effective interest method, less any impairment losses.

Available-for sale financial assets

The Group's investments in equity securities and certain debt securities are classified as available-for-sale financial assets. Subsequent to initial recognition, they are measured at fair value and changes therein, other than impairment losses (see note 3.h.i.), and foreign exchange gains and losses on available-for-sale monetary items (see note 3.b.), are recognised directly in equity. When an investment is derecognised, the cumulative gain or loss in equity is transferred to profit or loss. Fair value changes recognised under equity are derecognised when the available-for-sale asset is derecognised.

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 purchase and sale decisions are based on their fair value in accordance with the Company's risk policy or investment plan. Financial instruments at fair value through profit or loss are measured at fair value, and changes therein are recognised in profit or loss. Direct transaction cost is recognised in the income statement as it is incurred.

Loans and receivables

Loans and receivables are financial assets with certain or determinable payments and are not listed in active markets. Such assets are recognised initially at fair value plus, for instruments not at fair value through profit or loss, 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 of receivables and other current assets.

Cash and cash equivalents comprise cash balances and call deposits.

Notes

3. Significant accounting policies, contd.

c. Financial instruments, contd.

ii) Non-derivative financial liabilities

Loans and subordinated loans are recognised when they are incurred. All other financial liabilities, including loans at fair value through profit and loss are initially accounted for on the business day the Company becomes part of the contractual agreement of the financial instrument.

Financial liabilities are eliminated from the financial statements when the contractual agreements of the instrument are no longer valid.

Financial assets and liabilities are netted out and the net amount is entered in the balance sheet when the legal right of off-setting exists and financial assets and liabilities are recognised by off-setting.

The Company classifies non-derivative financial liabilities as other financial liabilities. Such liabilities are recognised initially at fair value plus, for instruments not at fair value through profit or loss, any directly attributable transaction costs. Subsequent to initial recognition financial liabilities are measured at amortised cost using the effective interest method.

Other non-derivative financial liabilities comprise of borrowings, accounts payable and other current liabilities.

iii) Derivative financial instruments

Derivatives are recognised initially at fair value; attributable transaction costs are recognised in profit or loss when incurred. Subsequent to initial recognition, derivatives are measured at fair value in the balance sheet and fair value changes are recognised in the income statement.

iv) Economic hedges

Embedded derivatives are separated from the host contract and accounted for separately if the economic characteristics and risks of the host contract and the embedded derivative are not closely related, a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative, and the combined instrument is not measured at fair value through profit or loss.

Fair value changes in such derivatives are recognised in the income statement.

v) Other embedded derivatives

Fair value changes in separate embedded derivatives are recognised in the income statement.

Notes

3. Significant accounting policies, contd.

d. Property, plant and equipment

i) Recognition and measurement

Items of property, plant and equipment, except distribution, production systems and fibre-optic systems, are measured at cost less accumulated depreciation and accumulated impairment losses.

Cost includes expenditure that is 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 and restoring the site on which they are located. Purchased software that is integral to the functionality of the related equipment is capitalised as part of that equipment.

Interest expenses on loans used to finance cost of buildings in construction are capitalised over the construction period. Interest is not calculated on preparation cost. After the assets have been taken into use interest expenses are expensed in the income statement.

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 and depreciated over their useful lives.

The Group's distribution, production systems and fibre-optic system, are stated at revalued carrying amount in the balance sheet, which is their fair value at the revaluation date less additional depreciation from that date. Revaluation of those assets is made on a regular basis. Value surplus due to the revaluation is recognised in a revaluation reserve among equity after taking the effect on deferred tax liability into consideration. Depreciation on the revalued carrying amount is recognised in the income statement. Upon sale or discontinuance of the asset the part of the revaluation reserve belonging to the asset is transferred from the revaluation reserve to retained earnings after taking tax effect into consideration. No recognition takes place from the revaluation reserve to retained earnings unless the relevant asset is sold or discontinued.

The fair value of these assets is determined on the basis of the depreciated replacement cost. This consists in that an assessment is made on changes in the construction cost of comparable assets and both cost and accumulated depreciations are revaluated in accordance with those changes. The calculation is based on official information and actual statistics from the Company's books on value changes of cost of items and takes into account an estimate on the weight of each cost item in the total cost of construction of comparable assets. Cost items and their proportional weight were determined by experts within and outside of the Company. The impairment test of assets is also taken into consideration and revaluation is not recognised beyond the expected future cash flow of the assets. Distribution systems for hot water, cold water, sewage and electricity are licensed operations and subject to official revenue targets that are based mostly on changes in the construction cost index. This is taken into consideration when revaluating these systems.

Gains and losses on disposal of an item of property, plant and equipment are determined by comparing the proceeds from disposal with the carrying amount of property, plant and equipment and are recognised net within "other income" in the income statement. When revalued assets are sold, the amounts included in the revaluation surplus reserve are transferred to retained earnings.

ii) Subsequent costs

The cost of replacing 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 Group and its cost can be measured reliably. All other cost is expensed in the income statement when incurred.

Notes

3. Significant accounting policies, contd.

d. Property, plant and equipment, contd.

iii) 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 and equipment. Land is not depreciated. Estimated useful lives are specified as follows:

Production system	5-50 years
Electricity distribution systems	10-60 years
Heating distribution systems	10-60 years
Cold water distribution systems	5-80 years
Sewer distribution system	15-60 years
Fibre-optic distribution system	7-41 years
Other real estate	17-50 years
Other equipment	3-25 years

Depreciation methods, useful lives and scrap value are reviewed on the accounting date.

e. Intangible assets

i) Heating rights

Heating rights are recognised in the balance sheet at amortised cost as intangible assets with an indefinite lifetime. Heating rights are separated from land up on purchase.

ii) Preparation costs

A preparation cost is capitalised at cost. This cost arises in the preparation of specific defined projects. Cost due to those projects is only capitalised if it can be measured reliably, the product or process is technically and commercially feasible, future economic benefits are probable and the Company has both the intention and the ability to finish the project and plans to profit from it or sell it. This cost is expensed when the project is discontinued or due to changed premises.

iii) Other intangible assets

Other intangible assets are measured at cost less accumulated depreciation and impairment losses.

iv) Subsequent expenditure

Subsequent expenditure is capitalised only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditure is recognised in profit or loss as incurred.

v) Amortisation

Amortisation is recognised in profit or loss on a straight-line basis over the estimated useful lives of intangible assets from the date that they are available for use. The estimated useful lives for the current and comparative periods are as follows:

Heating rights	100 years
Software	3-7 years

f. Leased assets

Leases in terms of which the Company assumes substantially all the risks and rewards of ownership are classified as finance leases. Upon initial recognition the leased asset is measured at an amount equal to the lower of its fair value and the present value of the minimum lease payments. Subsequent to initial recognition, the asset is accounted for in accordance with the accounting policy applicable to that asset.

Other lease agreements are considered as operating lease agreement and the leased assets are not capitalised.

Notes

3. Significant accounting policies, contd.

g. Inventories

Inventories are measured at the lower of cost and net realisable value. The cost of inventories is based on the first-in first-out principle, and includes expenditure incurred in acquiring the inventories, production or conversion costs and other costs incurred in bringing them to their existing location and condition. Net realisable value is the estimated selling price in the ordinary course of business, less the estimated costs of completion and selling expenses.

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. An impairment loss in respect of an available-for-sale financial asset is calculated by reference to its fair value at each time. The Group defines decrease in fair value below cost as a subjective indication of impairment of available-for-sale financial assets when:

- decrease is 15% below cost or
- fair value decrease lasts for at least six months.

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. Any cumulative loss in respect of an available-for-sale financial asset recognised previously in equity is transferred to profit or loss.

An impairment loss is reversed if the reversal can be related objectively to an event occurring after the impairment loss was recognised. For financial assets measured at amortised cost and available-for-sale financial assets that are debt securities, the reversal is recognised in profit or loss. For available-for-sale financial assets that are equity securities, the reversal is recognised directly in equity.

ii) Non-financial assets

The carrying amounts of the Group's non-financial assets, other than inventories and deferred tax assets, are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, then the asset's recoverable amount is estimated.

Impairment is recognized if the carrying amount of an asset or a cash generating unit exceeds its estimated recoverable amount. A cash generating unit is the smallest separable group of assets that form a cash flow that is mostly independent of other units or groups of units. Impairment loss of revalued operating assets is recognized in equity under revaluation reserve. Impairment losses of other assets are recognized in profit or loss.

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.

An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortization, if no impairment loss had been recognized.

Notes

3. Significant accounting policies, contd.

i. Employee benefits

i) Defined contribution plans

Obligations for contributions to defined contribution pension plans are recognised in the income statement when they are due.

ii) Defined benefit plans

The Group's net obligation in respect of defined benefit pension plans is calculated separately for each plan by estimating the amount of future benefit that current and former employees have earned in return for their service in the current and prior periods. The benefit is discounted to determine its present value and any unrecognised past service costs and the fair value of any plan assets are deducted. The calculation is performed annually by a qualified actuary using the projected unit credit method. Changes in the obligation are recognised in the income statement as incurred.

j. Obligations

An obligation is recognised in the balance sheet when the Company has the legal right or has entered into an obligation due to previous events and it is likely that it will incur cost upon settling the obligation. The obligation is measured on the basis of the estimated future cash flow, discounted based on interests reflecting market interests, and the risk inherent with the obligation.

k. Revenue

i) Revenues from sale and distribution of electricity and hot water

Revenue from the sale and distribution of electricity and hot water is recognised in the income statement according to measured delivery to purchasers during the year plus a fixed fee.

The rate for the distribution of electricity has a revenue cap set by the National Energy Authority in accordance with laws on energy number 65/2003. The revenue cap is based on actual figures from prior years from the operation of distribution utilities, the depreciation of assets, real losses in the distribution system and return on equity. When setting the revenue cap financial income and expenses are not taken into account. The rate is decided from the revenue cap and projections of sale of electricity in the Company's utilities area.

ii) Revenues from sale of cold water and sewage

Revenue from the sale of cold water and sewer are based on the size of properties plus a fixed fee and are set forth linearly in the income statement. In addition revenue is stated for cold water according to measurement from specific industries.

iii) Connection revenues

Upon connection of new users to distribution systems of electricity, water and sewer or upon renewal of connection an initial fee is charged. The initial fee meets cost due to new distribution systems or their renewal. Income on connection fees is recognised in the income statement upon delivery of the service.

iv) Other revenues

Other revenue is recognised when generated or upon delivery of goods or services.

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. Lease incentives received are recognised as an integral part of the total lease expense, over the term of the lease.

Minimum lease payments made under finance leases are apportioned between the finance expense and the reduction of the outstanding liability. Interest expenses are distributed over the lease term based on effective interests.

Notes

3. Significant accounting policies, contd.

m. *Financial income and expenses*

Finance income comprises interest income on funds invested, dividend income, changes in the fair value of financial assets at fair value through profit or loss, foreign exchange gain and gains on hedging instruments that are recognised in the income statement. Interest income is recognised as it accrues in the income statement, using the effective interest method. Dividend income is recognised in the income statement on the date that the Group's right to receive payment is established.

Finance expenses comprise interest expense on borrowings, unwinding of the discount on provisions, foreign exchange losses, impairment losses recognised on financial assets, and losses on hedging instruments that are recognised in the income statement. Borrowing cost is recognised in the income statement based on effective interests.

Effective interest is the required rate of return used when discounting estimated cash flow over the estimated useful life of a financial instrument or a shorter period when applicable, so that it equals to the book value of the financial asset or liability in the balance sheet.

Foreign currency gains and losses are reported on a net basis as either finance income or finance cost depending on whether foreign currency movements are in a net gain or net loss position.

n. *Income tax*

Income tax expense comprises current and deferred tax. Income tax expense is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years. The income tax ratio for the parent company is 36.0% and the tax ratio for the subsidiaries is 20.0%. Cold water supply and sewer is exempt from tax.

Deferred tax is recognised using the balance sheet method, providing for temporary differences between the carrying amounts 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. Deferred tax was measured in accordance with the current tax rate, which is 36.0% for the parent company that is a partnership and 20.0% for the subsidiaries that are companies with limited liability.

A deferred tax asset is only 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.

Notes

3. Significant accounting policies, contd.

o. Segment reporting

A segment is a distinguishable component of the Company that is engaged in business and is capable to earn revenues and accept cost, both within and outside of the Company. The return of all segments is overviewed by management to value their performance.

Segment results and their assets include items directly attributable to a segment as well as those that can be allocated on a reasonable basis.

Segment investments are investments in property, plant and equipment and intangible assets.

Inter-segment pricing is determined on an arm's length basis.

p. New standards and interpretations

The Company has implemented all international accounting standards, their interpretation and changes on existing standards that were effective at year end 2012 and are related to the Company's operation. The Group has not beforehand implemented international accounting standards, their interpretation and changes which are effective after 31 December 2012. Adoption of these standards are not considered to have a significant effect on the preparation of the Group's financial statements.

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. Property, plant and equipment

The fair value of production systems that have undergone a revaluation is determined on the basis of the depreciated replacement cost, which consists in the assessment of changes in construction cost of comparable assets and both cost and accumulated depreciation are re-measured in accordance with those changes. The results of the impairment tests are also taken into consideration and revaluation is not recognised beyond the expected future cash flow of those assets.

The same method is applied in the determination of the fair value of distribution systems, accounted at fair value. Revalued distribution systems are used in an operation subject to exclusive licence and income limits are mainly based on changes in the building cost index. This is taken into account when determining the fair value.

The fair value of property, plant and equipment taken over upon a merger is based on the market value. The market value is the amount that can be obtain in transactions between unrelated, willing and informed parties. The fair value of other assets among property, plant and equipment is based on the market value of comparable assets.

b. Investments in equity and debt securities

The fair value of financial assets at fair value through profit or loss is determined on the basis of their market value at the reporting date. If the market value is not known the valuation is based on generally accepted valuation methods. Valuation methods can be based on known recent financial transactions between unrelated parties. In applying these valuation methods factors are considered which would be used in the respective market concerning calculation of fair value and the methods are in accordance with generally accepted methods concerning valuation of financial assets.

Notes

4. Determination of fair values, contd.

c. Derivatives

The fair value of derivatives is based on their market value, if available. If the market value is not available the fair value is determined on the basis of generally accepted valuation methods.

Valuation methods may be based on prices in recent transactions between unrelated parties. The measurement is based on the value of other financial instruments comparable to the instrument in question, methods in order to evaluate the present value of cash flow or other valuation methods, which may be applied in order to reliably assess the real market value. When valuation methods are applied all factors are used, which market parties would use in price evaluations, and the methods are in accordance with generally accepted methods for the price evaluation of financial instruments. The Company verifies on a regular basis its valuation methods and tests them by using a price obtained in a transaction on an active market with the same instrument, without adjustments and changes, or are based on information from an active market.

The fair value of derivative agreements not listed in active markets is determined by use of valuation methods, which are regularly reviewed by qualified employees. All valuation models used must be approved and tested in order to ensure that the results reflect the data used.

The most reliable indication of the fair value of derivative agreements at the beginning is the purchase value, unless the fair value of the instruments is verifiable in comparison with other listed and recent market transactions with the same financial instrument or based on a valuation method where variables are only based on market data. When such data is available the Company recognises profit or loss at the initial registration date of the instruments.

The fair value of interest rate swaps is based on broker quotes. Those quotes are tested for reasonableness by discounting estimated future cash flows based on the terms and maturity of each contract and using market interest rates for a similar instrument at the measurement date.

d. Trade and other receivables

The fair value of trade and other receivables, is estimated at the present value of future cash flows, discounted at the market rate of interest at the reporting date if applicable. This fair value is determined for disclosure purposes.

e. 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 interest at the reporting date.

Notes

5. Segment reporting

Business divisions and sectors

Orkuveita Reykjavíkur's service area is mainly in the Reykjavík city area, but it also extends to the southern and western parts of Iceland. The Company is divided into three separate divisions: Production and Sales, Utilities and Other Operation.

Production and Sales generate electricity and harness hot water from the power plants as well as selling electricity to wholesale and retail customers.

Utilities distribute electricity, harnessing hot water from low-temperature fields and the geothermal plants and distribute it for space heating. It also collects and distributes cold water from reservoirs, runs a sewerage system and operates a fiber-optic system.

Other operations cover the new construction and operation of street lighting, rental of housing and equipment, incidental sale of specialist consultancy services and more.

The Company is also divided by its sectors, **Electricity, Hot water, Cold water, Sewer** and **Fibre-optic system**. The sectors operate in different legal environments, both regarding income tax and value added tax, revenue targets as set forth in the electricity and earnings law. The sectors hot water, cold water, sewerage and the distribution of electricity are exclusively licensed by law, however the generation of electricity, sale of power and sale of data transfer is subject to the open market.

The Company is income taxed and collects value added tax, except for operations regarding cold water and sewer but they are regulated by law no. 33/2004 concerning cold water suppliers of municipalities and law no. 9/2009 concerning the operations of sewer. The provision of hot water supply is subject to law no. 58/1967, concerning earnings from hot water. The distribution of electricity is subject to law no. 65/2003, which stipulates revenue caps that are decided by the National Energy Authority.

Sector	Official obligations
Hot water	Minister approves utility rates not subject to the open market. These take effect upon publication in the Ministerial Gazette.
Electricity, distribution	The National Energy Authority is sent a rate list for authorisation. Rates are officially published.
Electricity, production	Energy sales are subject to the open market, electricity rate changes are therefore not subject to government approval.
Cold water	The legal limitation on the upper limit of the rate is 0.5% of the real estate value. Rates are officially published in the Law and Ministerial Gazette.
Sewer system	The Rates for the sewer system shall cover all costs. Rates are officially published in the Ministerial Gazette.
Fibre-optic data system	This is a competitive practice that is supervised by The Post and Telecom Administration.

Customers that have significant effect on the Company's revenues

One customer has significant effect on the Company's revenues in the year 2012, i.e. Norðurál Grundartangi ehf.

Revenues from Norðurál Grundartangi ehf., a customer of the Company's Production and Sale's division, represents approximately ISK 6.943 million or 18.3% of total revenues. (2011: ISK 5.652 million, or 16.8% of total revenue.)

Notes

3. Segment reporting

Segment information is presented by the Group's business segments according to the Group's organisation and internal reporting. Business segments consist of *Utilities*, *Production and Sale*, and *Other Operation*. In addition, information is provided on the Group's sectors, which are *Electricity*, *Hot water*, *Cold water*, *Sewer* and *Fibre-optic cable systems*.

Business segments - divisions					
The year 2012	Utilities	Production and sale	Other Operation	Adjustments	Total
External revenue	24.536.839	12.928.173	439.533	0	37.904.545
Inter-segment revenue	239.150	11.249.187	382.497	(11.870.834)	0
Total segment revenue	24.775.989	24.177.360	822.030	(11.870.834)	37.904.545
Segment result	11.352.117	4.586.527	(7.002)	0	15.931.642
Unallocated expenses					(1.258.793)
Results from operating activities					14.672.849
Financial income and expenses					(18.493.550)
Share of loss of associated companies					(9.754)
Income tax					1.535.261
Loss for the year					(2.295.194)
The year 2011					
External revenue	21.439.485	11.956.289	230.441	0	33.626.215
Inter-segment revenue	317.170	4.061.665	482.184	(4.861.019)	0
Total segment revenue	21.756.655	16.017.954	712.625	(4.861.019)	33.626.215
Segment result	8.829.471	5.122.206	(131.009)	0	13.820.668
Unallocated expenses					(1.466.172)
Results from operating activities					12.354.496
Financial income and expenses					(19.656.314)
Share of loss of associated companies					(5.400)
Income tax					6.750.946
Loss for the year					(556.272)

Notes

3. Segment reporting, contd.

Business segments - divisions, contd.

The year 2012

Balance sheet (31.12. 2012)

	Utilities	Production and sale	Other Operation	Adjustments	Total
Property, plant and equipment and properties held for sale	134.028.592	110.594.420	9.286	6.827.021	251.459.319
Intangible assets	0	0	0	1.218.980	1.218.980
Shares in associates					59.826
Other unallocated assets					44.463.520
Total assets					297.201.645
Unallocated liabilities					236.553.823
Investments:					
Property, plant and equipment	2.170.195	697.863	0	146.877	3.014.935
Intangible assets	0	0	0	50.383	50.383
Depreciation, amortization:					
Property, plant and equipment	5.024.089	4.443.127	0	815.529	10.282.745
Intangible assets	0	0	0	88.340	88.340

The year 2011

Balance sheet (31.12. 2011)

Property, plant and equipment	133.688.631	117.555.164	36.109	7.522.107	258.802.011
Intangible assets				1.256.937	1.256.937
Shares in associates					118.148
Other unallocated assets					36.207.778
Total assets					296.384.874
Unallocated liabilities					234.741.857
Investments:					
Property, plant and equipment	2.208.279	7.382.796	0	154.095	9.745.170
Intangible assets	0	0	0	80.258	80.258
Depreciation, amortization:					
Property, plant and equipment	4.781.813	3.401.467	20.544	379.853	8.583.677
Intangible assets	0	0	171.862	125.198	297.060

Notes

3. Segment reporting, contd.

Business segments - sectors

The year 2012

	Electricity	Hot water	Cold water	Sewer	Fibre-optic cable system	Adjustments	Total
Income							
External revenue	19.252.841	9.904.780	3.176.966	4.184.368	1.385.590	0	37.904.545
Inter-segment revenue	824.308	137.839	33.275	43.827	0	(1.039.249)	0
Total segment revenue	20.077.149	10.042.619	3.210.241	4.228.195	1.385.590	(1.039.249)	37.904.545
Balance sheet (31.12. 2012)							
Properties, current and non-current	112.712.357	70.343.547	18.699.324	38.864.090	10.840.001	0	251.459.319
Intangible assets	570.483	355.942	96.299	196.256	0	0	1.218.980
Unallocated assets	0	0	0	0	0	0	44.523.346
Total assets	113.282.840	70.699.489	18.795.623	39.060.346	10.840.001	0	297.201.645
Investments							
Property, plant and equipments	984.378	573.471	216.723	302.763	937.599	0	3.014.934
Intangible assets	23.579	14.813	3.930	8.061	0	0	50.383
Depreciation, amortization							
Property, plant and equipments	4.563.001	3.379.335	536.353	1.281.570	522.485	0	10.282.744
Intangible assets	33.750	27.525	8.479	18.586	0	0	88.340

Notes

3. Segment reporting, contd.

Business segments - sectors, contd.

The year 2011

	Electricity	Hot water	Cold water	Sewer	Fibre-optic cable system	Adjustments	Total
Income							
External revenue	17.515.064	8.732.030	2.818.304	3.390.673	1.170.144	0	33.626.215
Inter-segment revenue	1.171.938	155.271	41.870	50.374	0	(1.419.453)	0
Total segment revenue	18.687.002	8.887.301	2.860.174	3.441.047	1.170.144	(1.419.453)	33.626.215
Balance sheet (31.12. 2011)							
Properties	119.559.252	70.123.187	18.696.299	39.998.384	10.424.888	0	258.802.010
Intangible assets	664.920	291.609	95.527	204.881	0	0	1.256.937
Unallocated assets	0	0	0	0	0	0	36.325.925
Total assets	120.224.172	70.414.796	18.791.826	40.203.265	10.424.888	0	296.384.872
Investments							
Property, plant and equipments	7.231.993	901.350	186.932	247.147	1.177.749	0	9.745.171
Intangible assets	42.457	19.101	5.939	12.761	0	0	80.258
Depreciation, amortization							
Property, plant and equipments	3.829.908	2.386.919	494.645	1.416.898	455.306	0	8.583.676
Intangible assets	47.833	210.871	12.015	26.340	0	0	297.059

Notes

6. Analysis of geothermal power plant operation

Return analysis of production of electricity and hot water, cf. Article 41, paragraph 5 of law no. 65/2003:

	Electricity 2012	Hot water 2012	Electricity 2011	Hot water 2011
Power plant at Nesjavellir				
Revenue	8.663.959	1.915.000	8.575.389	1.520.000
Operating expenses	(1.419.692)	(525.679)	(984.606)	(500.517)
Depreciation	(3.504.326)	(449.152)	(2.794.359)	(406.192)
Profit before financial expenses	<u>3.739.941</u>	<u>940.170</u>	<u>4.796.424</u>	<u>613.291</u>
Return on investment	3.8%	8.0%	4.8%	5.4%

The power plants at Hellisheiði and Nesjavellir are mixed production plants, where both hot water and energy are produced.

7. Salaries and salary related expenses

	2012	2011
Salaries and salary related expenses are specified as follows:		
Salaries	2.988.203	3.278.044
Defined contribution pension expenses	395.860	463.847
Defined benefit pension expenses	55.547	37.721
Other salary related expenses	313.216	406.071
Expensed salaries and salary related expenses due to early retirement plan and laid-off employees 1)	<u>314.271</u>	<u>192.965</u>
Total salaries and salary related expenses	<u>4.067.097</u>	<u>4.378.648</u>

Salaries and salary related expenses are stated in the financial statements as follows:

Expensed in the income statement	3.701.222	3.836.419
Capitalised on projects	365.875	542.228
Total salaries and salary related expenses	<u>4.067.097</u>	<u>4.378.648</u>

Number of employees:

Number of annual working units	476	532
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Management's salaries and benefits for the parent company and subsidiaries are specified as follows:

Salaries to the Board of Directors of the Parent Company	16.695	15.439
Salaries to the Director and five/four Managing Directors of the Parent Company ...	94.037	79.187
Salaries to the Board of Directors and Managing Directors of subsidiaries	21.931	20.771
Defined contribution pension expenses	17.075	14.598
Termination expenses, pension expenses included 2)	<u>9.071</u>	<u>20.034</u>
	<u>158.808</u>	<u>150.029</u>

Included in salaries are car benefits and vehicle subsidy.

1) A part of curtailing in the operations is to decrease the number of employees. This is achieved partly by offering employees that have reached the age of 63, early retirement. Those who accept this offer are not expected to work for the Company during the termination. When employees leave the Company, either due to early retirement or due to lay-offs the termination cost is recognised immediately.

2) In September the manager of Sales and Production left the company. Expenses due to the termination of his employment, salary related expenses included, were all expensed upon his departure from the company. In the year 2011 similar payments were made upon the departure of the former CFO of the company.

Notes

8. Other operating expenses

	2012	2011
Other operating expenses is specified as follows:		
Operational cost of utilities and power plants	1.570.857	1.145.147
Collection cost and other office cost	625.924	603.256
Operation cost of properties	566.098	516.809
Public levies and insurance cost	447.369	206.193
Various cost	1.083.283	1.066.672
Other operating expenses, total	<u>4.293.531</u>	<u>3.538.078</u>

9. Depreciation and amortisation

	2012	2011
Depreciation and amortisation is specified as follows:		
Depreciation of property, plant and equipment	9.052.618	8.583.676
Amortisation of assets in construction	743.431	0
Amortisation of properties held for sale	486.696	0
Depreciation and amortisation, total, cf. note 12	<u>10.282.745</u>	<u>8.583.676</u>
Amortisation of intangible assets, cf. note 14	88.340	297.059
Depreciation and amortisation recognised in the income statement	<u>10.371.085</u>	<u>8.880.736</u>

10. Financial income and expenses

	2012	2011
Financial income and expenses are specified as follows:		
Interest income	146.916	126.924
Interest expense	(6.232.254)	(4.899.197)
Guarantee fee to owners 1)	(860.534)	(790.431)
Total interest expenses	<u>(7.092.787)</u>	<u>(5.689.628)</u>
Fair value changes of embedded derivatives in electricity sales contracts	(2.944.310)	(2.728.135)
Fair value changes of assets available for sale	0	(611.169)
Fair value changes of financial assets and financial liabilities through P/L	1.847.840	679.855
Change in valuation of derivatives in default, cf. note 33	(558.759)	0
Hedge contracts	417.832	62
Foreign exchange difference	(10.364.758)	(11.479.368)
Dividends	54.475	45.145
Total of other income (expenses) on financial assets and liabilities	<u>(11.547.680)</u>	<u>(14.093.609)</u>
Total financial income and expenses	<u>(18.493.550)</u>	<u>(19.656.313)</u>

1) Orkuveita Reykjavíkur paid a guarantee fee to current and former owners of the company for guarantees they have made on the Groups loans and borrowings according to a decision made on the annual meeting of Orkuveita Reykjavíkur in 2005. The fee on yearly basis for its licenced operations is 0.375% and 0.48% regarding loans due for operations in the open market. (2011: The fee was 0.375% on all loans) The calculation of the fee is done at the end of each quarter. The guarantee fee amounted to ISK 861 million in the year 2012 (2011: ISK 790 million) and is accounted for among interest expenses.

Notes

10. Financial income and expenses

Capitalised financing cost

No financing cost due to construction of a power plant was capitalised in the year 2012. Capitalised financing cost for the year 2011 amounted to ISK 1.287 million and was deducted from financial expense. Interest ratio that was used in the calculation of capitalised financing cost for the year 2011 was 7.46%.

	2012	2011
Interest expense is specified as follows:		
Interest expenses, charged in the income statement	(7.092.787)	(5.689.628)
Capitalised finance cost	0	(1.287.642)
Interest expenses	<u>(7.092.787)</u>	<u>(6.977.270)</u>

Fair value changes through P/L

Generally accepted valuation methods are used to determine the fair value of certain financial assets and financial liabilities, further discussed in note 4. Change in fair value that is expensed in the income statement amounts ISK 1.096 million. (2011: expense ISK 2.659 million).

11. Income tax

Orkuveita Reykjavíkur is tax liable in accordance with Article 2 of law no. 90/2003 on income tax. The part of the Company's operation concerning operation of cold water supply and sewer is though exempt from income tax.

	2012	2011
Income tax recognised in the income statement is specified as follows:		
Change in deferred income tax	(1.535.261)	6.750.946
Income tax recognised in the income statement	<u>(1.535.261)</u>	<u>6.750.946</u>

	2012		2011	
Reconciliation of effective tax rate:				
Loss before income tax	(3.830.455)		(7.307.218)	
Income tax according to current tax ratio	36.0%	(1.378.964)	36.0%	(2.630.598)
Effect of various tax rates in the Group	(0.9%)	33.817	(0.7%)	54.575
Effect of valuation of exploitation				
of deferred tax losses	2.6%	(100.000)	63.7%	(4.655.873)
Non-taxable operation of				
water supply and sewer	2.4%	(93.706)	(2.9%)	208.881
Other items	0.1%	3.592	(3.7%)	272.069
Effective income tax	<u>40.1%</u>	<u>(1.535.261)</u>	<u>92.4%</u>	<u>(6.750.946)</u>

Notes

12. Property, plant and equipment

Property, plant and equipment is specified as follows:

The year 2012	Production system	Utility system	Other real estates	Other equipment	Total
Cost or deemed cost					
Balance at year beginning	195.996.921	222.894.519	8.140.245	5.596.352	432.628.037
Reclassification of assets	1.301.287	(884.548)	1.383.128	(3.528.887)	(1.729.019)
Additions during the year	993.880	1.856.200	19.769	145.086	3.014.935
Transferred to properties held for sale	(60.701)	0	(7.390.556)	(869.043)	(8.320.300)
Sold or disposed of	0	(91.361)	(69.054)	(99.219)	(259.634)
Balance at year-end	198.231.387	223.774.810	2.083.533	1.244.289	425.334.019
Depreciation					
Balance at year beginning	58.379.184	111.034.725	1.825.401	2.586.718	173.826.027
Reclassification of assets	491.232	(1.693.391)	580.320	(1.107.180)	(1.729.019)
Depreciated during the year	5.611.392	3.858.468	644.176	168.709	10.282.745
Transferred to properties held for sale	(57.224)	0	(2.156.978)	(758.241)	(2.972.444)
Sold or disposed of	0	(89.570)	(11.624)	(83.559)	(184.752)
Balance at year-end	64.424.583	113.110.231	881.295	806.447	179.222.557
Carrying amounts					
At 1.1. 2012.....	137.617.737	111.859.794	6.314.845	3.009.634	258.802.010
At 31.12. 2012.....	133.806.804	110.664.579	1.202.237	437.842	246.111.462
Thereof assets in construction at year end.....	7.209.960	1.555.018	0	0	8.764.979
The year 2011					
Cost or deemed cost					
Balance at year beginning	191.999.364	193.739.637	8.367.940	5.520.843	399.627.784
Additions during the year	7.571.665	2.043.869	33.191	96.445	9.745.170
Sold or disposed of	(541.385)	0	(260.886)	(20.936)	(823.207)
Revaluation, increase	3.015.875	27.111.013	0	0	30.126.888
Revaluation, decrease	(6.048.598)	0	0	0	(6.048.598)
Balance at year end	195.996.921	222.894.519	8.140.245	5.596.352	432.628.037
Depreciation					
Balance at year beginning	53.917.500	93.547.119	1.691.261	2.440.910	151.596.790
Reclassification of assets	0	0	0	0	0
Depreciated during the year	4.534.610	3.735.613	161.163	152.291	8.583.676
Sold or disposed of	(261.409)	0	(27.023)	(6.482)	(294.915)
Revaluation, increase	1.237.081	13.751.993	0	0	14.989.074
Revaluation, decrease	(1.048.598)	0	0	0	(1.048.598)
Balance at year end	58.379.184	111.034.725	1.825.401	2.586.718	173.826.027
Carrying amounts					
At 1.1. 2011.....	138.081.864	100.192.518	6.676.679	3.079.933	248.030.994
At 31.12. 2011.....	137.617.737	111.859.794	6.314.845	3.009.634	258.802.010
Thereof assets in construction at year end.....	8.225.347	1.529.241	0	0	9.754.588

Notes

12. Property, plant and equipment, contd.

Assets in construction

At year-end 2012 parliament approved a draft on protection and utilisation of natural resources, which is based on a Framework Program on protection and utilisation of hydropower and geothermal power. The area of Bitra is categorised in a protected area and therefore the book value of OR's assets and research in the area, ISK 743 million is amortised in the year 2012.

Revaluation

Revaluation was last executed as specified in the following table:

	Date of Revaluation
Production systems	
Hot water	31.12.2011
Cold water	31.12.2011
Electricity	31.12.2011
Distribution systems	
Hot water	31.12.2011
Cold water	30.9.2011
Sewage	30.9.2011
Electricity	31.12.2011
Fibre-optic cable system	30.9.2010

When revaluating, the relevant asset groups are measured at fair value. The aforementioned revaluation is recognised in a revaluation reserve among equity taken into account effects of deferred income tax as further explained in note 3. d.

Impairment tests

Impairment tests were performed at year end in order to confirm both carrying amounts of assets and main assets under construction would meet estimated future cash flows of these assets. The impairment tests are carried out for every sector in the utilities and production systems. The impairment are based on several assumptions, the main assumptions are:

- i) weighted average cost of capital (WACC) is 3.64% to 6.31%,
- ii) the future growth is between 0% to 2.5%
- iii) weighted probability of different results regarding negotiations with buyers of power.

Further explanation on impairment test is in note 3. h.

Uncertainty is about when construction projects will be commenced due to unsettled energy sale contracts and financing of the projects.

All sectors of the distribution systems and the production system stood the impairment test.

Information on revalued assets at year end

	Production system	Distribution system	Total
The year 2012			
Revalued carrying amount	133.806.804	110.664.579	244.471.382
Thereof effect of revaluation	(27.206.629)	(40.048.340)	(67.254.969)
carrying amount before effect of revaluation	<u>106.600.175</u>	<u>70.616.238</u>	<u>177.216.413</u>
The year 2011			
Revalued carrying amount	137.617.737	111.859.794	249.477.531
Thereof effect of revaluation	(28.117.996)	(42.097.167)	(70.215.163)
carrying amount before effect of revaluation	<u>109.499.741</u>	<u>69.762.627</u>	<u>179.262.369</u>

Rateable value and insurance value

The rateable value of the Company's assets measured in the rateable value assessment amounted to ISK 31.390 million at year end 2012 (2011: ISK 24.879 million). The fire insurance value of the company's assets amounted to ISK 38.499 million at the same time (2011: ISK 37.046 million). Among those assets are real estates capitalised among production and distribution systems as well as properties held for sale.

Notes

12. Property, plant and equipment, contd.

Obligations

In May 2008 the Company entered into a contract concerning purchase of equipment for power plants. The equipment will be delivered in the year 2016. The contract and other contracts regarding developments at Hellisheiði amount to ISK 12.3 billion as per exchange rate at end of the year (2011: ISK 12.4 billion). More information regarding these contracts can be found in note 36. Furthermore, the Company has entered into contracts and placed purchase orders with suppliers and developers concerning work on production and distribution systems. The balance of these contracts and purchase orders at the end of the year is estimated at ISK 1.2 billion (2011: ISK 1.2 billion).

13. Properties held for sale

Properties held for sale are specified as follows:

	2012	2011
Orkuveita Reykjavíkur, headquarters at Bæjar- and Réttarháls, 110 Reykjavík	4.397.856	0
Perlan, Öskjuhlíð, 105 Reykjavík	950.000	0
Properties held for sale, total	<u>5.347.856</u>	<u>0</u>

At year-end 2012 Reykjavík City purchased Perlan from the Company, negotiated price amounting to ISK 950 million. The sale was finalised at the beginning of the year 2013. In the beginning of 2013 the Company sold its headquarters at Bæjar- and Réttarháls for ISK 5.100 million. Because of these transactions these assets are reclassified among current assets in the financial statements for the year 2012.

14. Intangible assets

Intangible assets are specified as follows:

	Heating rights	Preparation cost	Software	Total
The year 2012				
Cost				
Balance at year beginning	1.427.031	0	3.045.194	4.472.225
Reclassification of assets	0	0	(1.723.761)	(1.723.761)
Additions during the year	0	0	50.383	50.383
Balance at end of the year	<u>1.427.031</u>	<u>0</u>	<u>1.371.816</u>	<u>2.798.847</u>
Amortisation				
Balance at year beginning	491.550	0	2.723.738	3.215.288
Reclassification of assets	0	0	(1.723.761)	(1.723.761)
Amortisation during the year	11.974	0	76.366	88.340
Balance at end of the year	<u>503.524</u>	<u>0</u>	<u>1.076.343</u>	<u>1.579.867</u>
Carrying amounts				
At 1.1. 2012.....	935.481	0	321.456	1.256.937
At 31.12. 2012.....	<u>923.507</u>	<u>0</u>	<u>295.473</u>	<u>1.218.980</u>
The year 2011				
Cost				
Balance at year beginning	1.427.031	261.864	2.964.934	4.653.829
Additions during the year	0	0	80.258	80.258
Sold or disposed of	0	(261.864)	2	(261.862)
Balance at year end	<u>1.427.031</u>	<u>0</u>	<u>3.045.194</u>	<u>4.472.225</u>
Amortisation				
Balance at year beginning	438.570	90.000	2.611.134	3.139.704
Amortisation during the year	12.594	171.862	112.604	297.060
Sold or disposed of	40.386	(261.862)	0	(221.476)
Balance at year end	<u>491.550</u>	<u>0</u>	<u>2.723.738</u>	<u>3.215.288</u>
Carrying amounts				
At 1.1. 2011.....	988.461	171.864	353.800	1.514.125
At 31.12. 2011.....	<u>935.481</u>	<u>0</u>	<u>321.456</u>	<u>1.256.936</u>

Notes

15. Investments in associated companies

Investments in associated companies are specified as follows:

	2012		2011	
	Share	Carrying amount	Share	Carrying amount
Envent Holdings ehf.	0.0%	0	24.5%	45.000
Iceland American Energy Inc.	83.7%	0	83.7%	0
Vistorka ehf.	0.0%	0	29.0%	42.591
Íslensk Nýorka ehf.	27.6%	29.339	0.0%	0
Metan hf.	0.0%	0	35.4%	3.568
Netorka hf.	23.5%	29.207	21.9%	25.708
Reykjavik Energy Grad. School hf.	45.0%	1.281	50.0%	1.281
Total		<u>59.827</u>		<u>118.148</u>

The Company's share in the loss of its associated companies amounted to ISK 10 million in the year 2012 (2011: loss of ISK 5 million).

Vistorka ehf. and Íslensk Nýorka ehf. were merged in the year 2012 under the name of Íslensk Nýorka ehf. Recompence in the merger were shares in Íslensk Nýorka ehf.

16. Investments in other companies

Investments in other companies are specified as follows:

	Share	2012	2011
HS Veitur hf.	16.6%	957.000	957.000
Landsnet hf. 1)	6.8%	2.160.000	860.000
Other shares in companies		<u>148.182</u>	<u>166.269</u>
Other shares in companies, total		<u>3.265.182</u>	<u>1.983.269</u>

The value of financial assets at fair value through profit or loss is based on market value. Fair value of financial assets available for sale is based on generally accepted valuation methods of independent experts, unless where it is possible to base it on recent commercial transactions.

1) According to provisions in the Energy laws no. 65/2003 only current owners of shares in Landsnet are allowed to assign their shares to other owners of Landsnet and are not allowed to sell their shares to other parties.

17. Embedded derivatives in electricity sales contracts

The fair value of embedded derivatives in electricity sales contracts is specified as follows:

	2012	2011
Fair value of embedded derivatives at the beginning of the year	17.682.970	20.411.105
Fair value changes during the year	<u>(2.944.310)</u>	<u>(2.728.135)</u>
Fair value of embedded derivatives at year-end	<u>14.738.660</u>	<u>17.682.970</u>

The allocation of embedded derivatives in electricity sales contracts is specified as follows:

Non-current embedded derivatives	14.150.678	17.168.462
Current embedded derivatives	<u>587.982</u>	<u>514.508</u>
Total embedded derivatives at year-end	<u>14.738.660</u>	<u>17.682.970</u>

Further discussion regarding embedded derivatives can be found in note 28 c.

Notes

18. Other financial assets and financial liabilities

Non-current assets	2012	2011
Financial assets at fair value through profit or loss:		
Bonds	9.744.861	7.868.334
Hedge contracts	893.934	0
	<u>10.638.795</u>	<u>7.868.334</u>
Bonds and other receivables:		
Bonds	579	17.853
	<u>579</u>	<u>17.853</u>
Total among non-current assets	<u>10.639.373</u>	<u>7.868.334</u>
Current assets		
Financial assets at fair value through profit or loss:		
Hedge contracts	38.956	0
	<u>38.956</u>	<u>0</u>
Bonds and other receivables:		
Bonds	5.986	569
	<u>5.986</u>	<u>569</u>
Total among current assets	<u>44.942</u>	<u>569</u>
Non current liabilities		
Financial liabilities at fair value through profit or loss:		
Hedge contracts	(98.974)	(2.390)
	<u>(98.974)</u>	<u>(2.390)</u>
Current liabilities		
Financial liabilities at fair value through profit or loss:		
Hedge contracts	(150.300)	(17.389)
	<u>(150.300)</u>	<u>(17.389)</u>

The bond among non-current assets is issued in USD and carries 1.5% interest. It has one settlement date in the year 2016. The bond is linked to aluminium prices to certain extent and is pledged with shares in HS Orka hf. The bond is stated at fair value through P/L and derivatives are not separated from the bond. All of the Company's bonds are determined to be third level in the fair value hierarchy as further is explained in note 31.

19. Deferred tax assets and liabilities

Deferred tax assets and liabilities is specified as follows:

2012	Tax assets	Tax liabilities	Net amount
Deferred tax assets/liabilities at the beginning of the year	1.932.006	0	1.932.006
Calculated income tax for the year	1.535.261	0	1.535.261
Deferred tax assets/liabilities at end of the year	<u>3.467.267</u>	<u>0</u>	<u>3.467.267</u>
2011			
Deferred tax assets/liabilities at the beginning of the year	206.741	3.780.403	(3.573.662)
Calculated income tax for the year	2.970.543	(3.780.403)	6.750.946
Income tax, due	17	0	17
Effect of change in income tax rate on revaluation account	(1.245.295)	0	(1.245.295)
Deferred tax assets/liabilities at year end	<u>1.932.006</u>	<u>0</u>	<u>1.932.007</u>

Notes

19. Deferred tax assets and liabilities, contd.,

Deferred tax assets and liabilities are attributable to the following:

	31.12. 2012		31.12. 2011	
	Tax assets	Tax liabilities	Tax assets	Tax liabilities
Property, plant and equipment	(15.063.674)	0	(17.056.401)	0
Embedded derivatives	(5.305.918)	0	(6.365.869)	0
Other items	2.599.893	0	888.700	0
Effect of carry forward taxable loss	21.236.966	0	24.465.576	0
Deferred tax assets/liabilities at year end	3.467.268	0	1.932.006	0

Carry forward taxable loss

Based on current tax law, a carry forwards taxable loss can be used against taxable profit within 10 years from when it was incurred. Carryforwards taxable loss at year end can be used as follows:

	2012	2011
Unadjusted taxable loss for the year 2008, usable until year 2018	56.383.614	65.631.854
Unadjusted taxable loss for the year 2009, usable until year 2019	4.953.017	4.953.017
Carry forwards taxable loss at year end 2012	61.336.631	70.584.871

Management has concluded based on their projections that there will be sufficient taxable profit in the future to use the stated deferred taxable asset.

20. Inventories

Inventories are specified as follows at year end:

	2012	2011
Inventory of materials	402.872	431.560

The Company's material inventories consist of material for maintenance, renewal and construction of the Company's production and distribution systems. Inventories for renewal and new constructions are accounted for among property, plant and equipment as part of building cost of assets under construction.

21. Receivables

Trade receivables is specified as follows at year end:

	2012	2011
Trade receivables, industrial consumers	917.120	537.146
Trade receivables, retail	4.122.730	3.969.640
Trade receivables, total	5.039.850	4.506.786
Allowance for doubtful accounts	(318.500)	(279.250)
	4.721.350	4.227.536

Other current receivables are specified as follows at year end:

Value added tax	0	23.617
Pre-paid expenses	199.480	185.715
Capital income tax	34.832	35.382
Accrued interest income	32.035	23.035
Receivables from employees	6.529	8.275
Other receivables	25.305	135.172
	298.181	411.196

Notes

22. Cash and cash equivalents

Cash and cash equivalents at year end are specified as follows:	2012	2011
Bank balances	6.885.693	1.652.484

23. Equity

Equity ratio of the Company at year end 2012 is 20.4% (2011: 20.8%). Return on equity was negative by 3.7% in the year (2011: negative by 1.0%).

Revaluation reserve

Revaluation reserve comprises of increase in the value of properties, plant and equipment after taking tax effects into account. Depreciation of the revaluated price are expensed in the income statement and transferred at the same time from the revaluation reserve account to retained earnings.

Fair value reserve

Fair value reserve comprises increase of the value of assets categorised as available for sale after taking tax effects into account.

Retained earnings

Dividend was not paid to the owners of the parent Company in the year 2012. (2011: No payment of dividend).

The Company's Board of Directors do not propose dividend to be paid to the owners of the parent company in the year 2013 due to the operating year 2012. The owners of the parent company decide on dividend payments.

24. Loans and borrowings

This note provides information about the contractual terms of the Group's interest-bearing loans and borrowings, which are measured at amortised cost. For more information about the Group's exposure to interest rate, foreign currency and liquidity risk, see note 28.

Non-current liabilities	2012	2011
Bank loans	195.721.276	195.380.948
Subordinated loan from owners of the Company	8.849.752	8.211.459
Credit facilities	0	2.381.700
Bond issuance	22.515.068	22.191.286
	<u>227.086.096</u>	<u>228.165.393</u>
Current portion on non-current liabilities	(25.539.733)	(14.326.899)
	<u>201.546.363</u>	<u>213.838.494</u>
 Current liabilities		
Current portion on non-current liabilities	25.539.733	14.326.899
Short-term bank loans	4.417.190	2.057.863
	<u>29.956.923</u>	<u>16.384.762</u>
Total interest bearing loans and borrowings	<u>231.503.286</u>	<u>230.223.256</u>

Notes

24. Loans and borrowings, contd.,

Terms of interest-bearing loans and borrowings

Liabilities in foreign currencies:

	Date of maturity	2012		2011	
		Average interest rate	Carrying amount	Average interest rate	Carrying amount
Liabilities in CHF	5.10.2027	0.56%	33.989.877	0.47%	43.999.890
Liabilities in EUR	6.12.2032	0.98%	84.800.019	2.04%	67.075.409
Liabilities in USD	8.11.2030	1.81%	41.956.344	1.61%	39.089.748
Liabilities in JPY	5.10.2027	0.47%	16.304.551	0.50%	23.450.772
Liabilities in GBP	26.2.2024	1.85%	5.084.266	1.86%	7.372.326
Liabilities in SEK	5.10.2027	2.06%	8.891.712	2.75%	11.923.887
			191.026.769		192.912.031

Liabilities in Icelandic kronas:

Indexed	10.1.2037	4.67%	36.059.327	4.76%	35.253.362
Non-indexed	31.1.2013	7.53%	4.417.190	7.5%	2.057.863
			40.476.517		37.311.225

Total interest-bearing loans and borrowings			231.503.286		230.223.256
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Repayment on non-current liabilities are specified as follows on the next years:

	2012	2011
The year 2012.....	-	14.326.899
The year 2013.....	25.539.733	29.277.537
The year 2014.....	16.747.099	15.883.347
The year 2015.....	19.625.714	13.141.900
The year 2016.....	19.697.595	22.652.881
The year 2017.....	15.625.559	13.976.357
Later	129.850.396	118.906.472
Total non-current liabilities, including next year's repayment	227.086.096	228.165.393

Next years repayment

In the year 2012 repayments of certain loans were re-negotiated that explains the change in the distribution between years. If non-current loans are refinanced in order to prolonge the loan terms, it can be assumed that the distribution of the repayments will be different from the above.

Guarantees and pledges

The owners of the parent company are responsible, pro rata, for all of the Parent company's liabilities and obligations. The Company has not pledged its assets as guarantee for its liabilities.

Covenants

Loans for the amount of ISK 16.856 million have certain covenants that regard repayment time as a proportion of EBITDA and as interests as a proportion of EBITDA as well as reviewing that budgets are within set limits. (2011: ISK 14.933 million). Management regularly evaluate the covenants and in their view there is not danger of them being breached.

Notes

25. Retirement benefit obligation

Upon the establishment of Orkuveita Reykjavíkur, an accrued retirement benefit obligation due to employees at that time was settled. The Company has retirement benefit obligation due to benefits of current and former employees in pension benefit plans. This obligation is due to companies merged with Orkuveita Reykjavíkur and due pension fund obligation has been taken over in relation to the merger.

The Company's accrued retirement benefit obligation amounted to ISK 508 million at year end 2012, discounted based on 2% interests and taken into account the share in the net asset of the pension fund (2011: ISK 477 million). The Company updates the obligation according to an assessment from an actuary each year when that assessment is available. Premises for life expectancy are in accordance with provisions of Regulation no. 391/1998 on obligatory insurance of pension benefits and operation of pension funds. The estimated increase in the obligation in the year is based on general increase in salaries taken into account interests. The increase of the obligation during the year is expensed in the income statement among salaries and salary related expenses. The part of the obligation that is estimated to be payable in the year 2013 is recognised among current liabilities.

Retirement benefit obligation is specified as follows:	2012	2011
Retirement benefit obligation at the beginning of the year	476.694	457.307
Contribution due to pension payments during the year ..... (	23.864)	(18.334)
Increase in the pension fund obligation during the year	55.547	37.721
Retirement benefit obligation at year end	<u>508.377</u>	<u>476.694</u>
Non-current component of retirement benefit obligation	483.377	460.874
Current component of retirement benefit obligation	25.000	15.820
Retirement benefit obligation at year end	<u>508.377</u>	<u>476.694</u>

26. Current liabilities

Other current liabilities is specified as follows:	2012	2011
Unpaid taxes	860.745	560.809
Unpaid salaries and salary related items	463.324	681.513
Accrued interest expenses	799.631	909.373
Current component of retirement benefit obligation	25.000	15.820
Derivative contracts in default, cf. note 36	740.000	181.241
Other liabilities	62.933	61.573
	<u>2.951.632</u>	<u>2.410.329</u>

27. Risk management and financial instruments

Overview

On the 20th. of January 2012 a risk policy was approved by the Board of Directors of Orkuveita Reykjavík. The Board's policy is that in all of the Company's operations, risks are to be considered and thereby the policy implements a mindset of responsible and efficient decisions as well as good corporate governance. The risk policy explains the overview and main targets of the Board in this matter. The risk policy also defines the main risk factors, measurement indicators, objectives and risk limits in the daily risk management. One of the main foundations in the risk policy is to define the risk factors which are of relevance, measure their impact and define acceptable limits when controlling them.

Decision making and control on the execution of the risk management is in the hands of a risk council. The risk council consists of the Managing Director, Managing Director of finance, Head of treasury and risk and Head of the financial department. It overviews for instance:

- that suitable methods are used to recognise and measure risk
- that risk monitoring systems are in place and efficient
- that the risk policy of the Board is complied with in the operations of the Company

Notes

27. Risk management and financial instruments, contd.,

The department of treasury and risk oversees and controls risk. The objective of the department is to monitor, analyse and control the financial risks of the Company.

Financial risk is divided into:

- Market risk, further discussed in note 28
- Liquidity risk, further discussed in note 29
- Credit risk, further discussed in note 30

28. Market risk

Market risk is the risk that changes in the market price of foreign currencies, aluminium price and interests will affect the Company's income or the value of its financial instruments. In regard of the current Balance Sheet the market risk is mainly due to changes in interest, currency, index and aluminium price but risk regarding portfolio assets such as shares in companies and bonds is minimum. This is the risk that weighs the most in the Company is divided into:

- a. Currency risk due to liabilities in the balance sheet and cash flow in foreign currencies.
- b. Interest rate risk due to loans and contracts made by the Company.
- c. Risk due to changes in the world market price of aluminium.

a. Currency risk

Currency risk is the risk of changes in currency prices having a negative effect on the Company's income. Currency risk is measured in the difference between assets and liabilities in each currency where taken into consideration all assets, liabilities and derivatives. The department of treasury and risk is permitted to use forward contracts and currency swaps to mitigate risk due to currency fluctuations.

The Company is exposed to currency risk on sales, purchases and borrowings that are denominated in a currency other than Icelandic kronas (ISK). Currencies mainly creating risk are Euro (EUR), Swiss Francs (CHF), Japanese Yens (JPY), United States dollar (USD) and Swedish kronas (SEK).

Approx. 84.1% of the Company's non-current loans are in foreign currencies. The Company has entered into long term electricity sales contracts in foreign currency (USD). The expected future revenues from these contracts on the accounting date amount to approx. ISK 160.383 million. That amount is based on the future price of aluminium on LME (London Metal Exchange) on the accounting date and expectations of price development of aluminium for the next 25 years according to the assessment of CRU, an independent evaluation party, as available on the accounting date.

Foreign exchange rate of the main currencies during the year is specified as follows:

	2012	2011	31.12. 2012	31.12. 2011
	Average exchange rate		Exchange rate at year end	
CHF	133,352	131,188	140,640	130,795
EUR	160,733	161,416	169,800	158,780
USD	125,052	116,067	128,740	122,320
JPY	1,570	1,458	1,495	1,590
GBP	198,155	186,005	208,150	190,140
SEK	18,4684	17,876	19,758	17,843
CAD	125,110	117,309	129,360	120,095
TWI	221,796	216,843	232,686	217,195

Notes

28. Market risk, contd.

a. Currency risk, contd.

Exposure to currency risk

The Company's exposure to currency risk based on the nominal amounts is specified as follows:

2012	CHF	EUR	USD	JPY	GBP	CAD	SEK	DKK	Total
Loans and borrowings	(33.989.877)	(84.800.019)	(41.956.344)	(16.304.551)	(5.084.266)		(8.891.712)		(191.026.769)
Accounts payables		(37.253)	(299.766)						(337.019)
Trade receivables			658.285		47				658.332
Bank deposits	1.709	6.226.479	492.598	135	131	2.530	1.263	90	6.724.936
Embedded derivatives			14.738.660						14.738.660
Hedge contracts	(217.681)	14.874.347	2.754	156.497	(10.985)		(18.706)		14.786.226
Other financial assets			9.744.861						9.744.861
Balance sheet risk	(34.205.849)	(63.736.446)	(16.618.951)	(16.147.919)	(5.095.073)	2.530	(8.909.154)	90	(144.710.772)
Estimated sale in 2013			8.116.661						8.116.661
Estimated purchase in 2013		(155.915)	(25.849)	(290.034)	(154)				(471.952)
Balance sheet risk	0	(155.915)	8.090.812	(290.034)	(154)	0	0	0	7.644.709
Net risk	(34.205.849)	(63.892.361)	(8.528.139)	(16.437.953)	(5.095.227)	2.530	(8.909.154)	90	(137.066.063)

Notes

28. Market risk, contd.

a. Currency risk, contd.

Exposure to currency risk, contd.

2011	CHF	EUR	USD	JPY	GBP	CAD	SEK	DKK	Total
Loans and borrowings	(43.999.890)	(67.075.409)	(39.089.748)	(23.450.772)	(7.372.326)		(11.923.887)		(192.912.031)
Accounts payables			(293.119)		(782)			(5.515)	(299.416)
Trade receivables		27.324	588.749	10.696					626.769
Bank deposits	470	711.445	638.435	212	183	3.338	3.039	85	1.357.207
Embedded derivatives			17.682.970						17.682.970
Hedge contracts	(377.996)		(12.372)	370.589					(19.779)
Other financial assets			7.868.334						7.868.334
Balance sheet risk	(44.377.416)	(66.336.640)	(12.616.752)	(23.069.275)	(7.372.924)	3.338	(11.920.847)	(5.430)	(165.695.947)
Estimated sale in 2011			7.539.896						7.539.896
Estim. Purch. in 2011		(1.210.284)	0	(1.254)					(1.211.538)
Balance sheet risk	0	(1.210.284)	7.539.896	(1.254)	0	0	0	0	6.328.358
Net risk	(44.377.416)	(67.546.924)	(5.076.856)	(23.070.529)	(7.372.924)	3.338	(11.920.847)	(5.430)	(159.367.589)

Sensitivity analysis

Strengthening by 10% of the Icelandic krona against the following currencies at year-end would have increased (decreased) equity and profit or loss by the amounts shown below, taking into account tax effects.

	Profit or (loss)								
	CHF	EUR	USD	JPY	GBP	CAD	SEK	DKK	Total
The year 2012	2.189.174	4.079.133	1.063.613	1.033.467	326.085	(162)	570.186	(6)	9.261.489
The year 2011	2.840.155	4.245.545	807.472	1.476.434	471.867	(214)	762.934	348	10.604.541

This analysis assumes that all other variables, in particular interest rates, remain constant. The analysis was performed on the same basis for the year 2011.

Weakening by 10% of the Icelandic krona against the above currencies would have had the equivalent, but opposite effect on the above currencies to the amounts shown above, on the basis that all other variables remain constant.

Notes

28. Market risk, contd.

b. Interest rate risk

Interest rate risk is the risk of changes in interest rates having a negative effect on the Company's income. The Company is exposed to interest rate risk due to interest bearing assets, liabilities and financial instruments measured at fair value. The Company's liabilities both have fixed and variable interest rates, majority being subject to variable interest rates. The department of treasury and risk monitors that interest rate risk is within preset limits and has permission to control interest rate risk with derivatives.

Interest-bearing financial assets and liabilities are specified as follows:

Fixed rate instruments	2012	2011
Financial assets	6.564	18.423
Financial liabilities	42.553.480	41.570.434
	42.560.044	41.588.857
 Variable rate instruments		
Financial liabilities	188.949.806	188.672.600
	188.949.806	188.672.600
 Financial instruments at fair value		
Other financial assets	9.744.861	7.868.334
Hedge contracts	683.616 (	19.779)
	10.428.477	7.848.555

In the following table, effect of changes on financial instruments at fair value is set forth, taken into account the effect of taxes. The analysis was done in the same way for the previous year.

	Cash flow sensitivity analysis		Fair value sensitivity analysis	
	100 p increase	100 p decrease	100 p increase	100 p decrease
31.12. 2012				
Embedded derivatives	0	0 (	725.573)	811.329
Other financial assets	0	0 (	226.081)	237.008
Hedge contracts	284.502 (	284.502)	699.815 (	717.916)
Interest bearing loans	(633.244)	633.244	0	0
	(348.742)	348.742 (	251.839)	330.420
 31.12. 2011				
Embedded derivatives	0	0 (	976.334)	1.102.158
Other financial assets	0	0 (	222.413)	235.021
Hedge contracts	0	0	70 (	71)
Interest bearing loans	(661.878)	661.878		
	(661.878)	661.878 (	1.198.677)	1.337.108

Notes

28. Market risk, contd.

c. Aluminium risk

Aluminium risk is the risk that changes in the price of aluminium has a negative effect on the income of the Company.

Four electricity sales contracts have been made, originally to the next 20 years. One with Landsvirkjun in regards of Norðurál and three with Norðurál in regards of the aluminium plant at Grundartangi, in addition contracts have been done with Landsnet hf. on distribution of electricity. Orkuveita Reykjavíkur and Norðurál have also made an electricity sales contract due to sale of electricity to a pending aluminium plant in Helgúvík, where delivery of electricity has begun, but the contract is for the next 25 years. These electricity sales contracts are denominated in USD and the price of the electricity is connected to the world market price of aluminium. Income of electricity contracts that are effected by price of aluminium is 20.0% of total revenue for the year 2012 (2011: 19.1%)

To reduce risk due to aluminium prices the Company has entered into derivative contracts to reduce the fluctuation of income effected by aluminium prices. The department of treasury and risk has permission to hedge 100% of the aluminium risk of next year and proportionally less in the next two years. At the accounting date hedges amounted to 22.16% of expected income effected by aluminium in the years 2013 to 2014 (2011: 7.5%).

Embedded derivatives in electricity sales contracts

The aforementioned electricity sales contracts include embedded derivatives as income thereon is subject to changes in the future world market price of aluminium. In accordance with provisions of IAS 39 on financial instruments, the fair value of embedded derivatives for Grundartangi has been measured and recognised in the financial statements and partly for the contracts with Helgúvík.

As the market value of the embedded derivatives is not available their fair value has been measured with generally accepted evaluation methods. The expected net present value of the cash flow of a contract on the accounting date has been measured, based on the future price of aluminium on LME (London Metal Exchange) on the accounting date and expectations of price development of aluminium for the next 25 years according to the assessment of CRU, an independent evaluation party, as available on the accounting date. From the expected net present value of cash flow of the contract on the accounting date the expected net present value based on premises on aluminium price on the initial date of the contract is deducted. The difference is the fair value change of the derivative. The valuation is based on the premises that the derivative has no value at the initial date of the contract.

Embedded derivatives of the electricity sales contracts recognised in the financial statements are capitalised in the balance sheet at fair value at the accounting date and fair value changes during the year are recognised in the income statement among income on financial assets.

Among embedded electricity sales contracts is a contract with Norðurál Helgúvík ehf. (NH), stated at the book value of ISK 1.9 billion. The constructions of the aluminium plant at Helgúvík have been delayed and there is uncertainty regarding continuance of the project. It was scheduled to begin delivery of power to the aluminium plant 1 September 2011 and NH was obliged to begin payments from that date. NH has used a option in the contract that allows NH to use the power at the aluminium plant at Grundartangi. Counter party risk is valued by the management as considerable and the risk is reflected in the stated book value of the derivative.

If the contract will be terminated or renegotiated on other terms, the book value of the embedded derivative would be fully expensed through the income statement.

Notes

28. Market risk, contd.

c. Aluminium risk, contd.

Sensitivity analysis on the price of aluminium

31.12. 2012	Sensitivity of Fair value	
	10% decrease	10% increase
Embedded derivatives	(6.483.469)	6.471.310
Aluminium hedges	275.762 (	197.940)
Financial assets at fair value through P/L	(353.902)	353.902
Total	(6.561.608)	6.627.271

31.12. 2011

31.12. 2011	Sensitivity of Fair value	
	10% decrease	10% increase
Embedded derivatives	(6.698.980)	6.673.253
Aluminium hedges	36.796 (	36.796)
Financial assets at fair value through P/L	(276.459)	276.459
Total	(6.938.643)	6.912.916

d. Other market risk

Other market risk such as interest spread and risk in shares in other companies is limited, as investments in such securities is an insubstantial part of the Company's operation.

29. Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Group's approach to managing liquidity is to ensure, as far as possible, that it will always have sufficient liquidity to meet its liabilities when due.

The Company's cash and cash equivalents at the end of the period amounted to ISK 6.9 billion. Furthermore, the Company had unused loan authorisations and a open credit line to the total amount of approx. ISK 6.8 billion. The Company had thus in total ensured capital at the end of the period to the amount of approx. ISK 13.7 billion. The corresponding amount at year end 2011 amounted to ISK 7.8 billion.

In an agreement made between the Company and its owners in March 2011, the owners obliged themselves to grant a loan to the Company, amounting to ISK 12 billion. ISK 8 billion were granted at the time of the agreement and ISK 4 billion were granted in March 2013.

Notes

29. Liquidity risk, contd.

c. Liquidity risk, contd.

Contractual payments due to financial liabilities, including estimated interest payments, are specified as follows:

31.12. 2012

Non-derivative financial instruments

	Carrying amount	Contractual cash flows	Less than 1 year	1 - 2 years	2 - 5 years	More than 5 years
Interest-bearing liabilities	231.503.285	(260.057.715)	(33.352.320)	(19.281.902)	(62.068.130)	(145.355.362)
Accounts payable	1.366.254	(1.366.254)	(1.366.254)	0	0	0
Other liabilities ...	2.951.632	(2.951.632)	(2.951.632)	0	0	0

Derivative financial instruments

Hedge

contracts	(249.274)	(1.233.289)	(631.390)	(553.736)	(103.455)	55.292
	<u>235.571.897</u>	<u>(265.608.890)</u>	<u>(38.301.596)</u>	<u>(19.835.638)</u>	<u>(62.171.585)</u>	<u>(145.300.070)</u>

31.12. 2011

Non-derivative financial instruments

Interest-bearing liabilities	230.223.256	(266.244.117)	(20.623.894)	(32.346.083)	(61.363.182)	(151.910.958)
Accounts payable	1.627.619	(1.627.619)	(1.627.619)	0	0	0
Other liabilities ...	2.410.329	(2.410.329)	(2.410.329)	0	0	0

Derivative financial instruments

Hedge

contracts	19.779	(19.216)	(17.261)	(1.955)	0	0
	<u>234.280.983</u>	<u>(270.301.281)</u>	<u>(24.679.103)</u>	<u>(32.348.038)</u>	<u>(61.363.182)</u>	<u>(151.910.958)</u>

If non-current loans are refinanced in order to prolong the loan terms, it can be assumed that the distribution of the repayments will be different from the above.

Notes

30. Credit risk

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations, and arises principally from the Company's receivables from customers. Credit risk is mainly due to whole sale electricity contracts and derivatives that the Company has entered into for hedging purposes. Losses due to unpaid receivables are insubstantial and have limited effect on the Company's return.

When entering into contracts it shall be insured, as possible, that the counterparty is trustworthy and settlement with large counterparties shall be looked into regularly as well as their credit rating.

The carrying amount of financial assets represents the maximum credit exposure, which is specified as follows:

	2012	2011
Trade receivable	4.721.350	4.227.536
Other current receivables	298.181	411.196
Other financial assets	9.751.425	7.886.757
Hedge contracts	932.890	0
Cash and cash equivalents	6.885.693	1.652.484
Total	22.589.539	14.177.972

Financial assets as stated above are categorised as *loans and receivables* except for a part of *other financial assets* and *hedge contracts*. Their categorisation can be seen in note 32.

The maximum exposure to credit risk for trade receivables at the reporting date by type of customer was:

Trade receivable, industrial consumers	917.120	537.146
Trade receivable, retail	3.804.230	3.690.390
	4.721.350	4.227.536

Impairment

The aging of trade receivables and allowance for doubtful accounts at the reporting date was:

	2012		2011	
	Gross balance	Allowance	Gross balance	Allowance
Not past due receivables	4.081.898	102.884	3.167.551	73.317
Past due, 1 to 30 days	316.652	12.263	870.132	30.514
Past due, 31 to 90 days	108.612	24.581	67.067	2.721
Past due, 91 days and older	532.688	178.772	402.036	172.698
Total	5.039.850	318.500	4.506.786	279.250

Allowance due to receivables is valued at each reporting date by management. Collectability is valued both in general using historic evidence and also specifically for receivables that are in default.

Receivables due to sewage and cold water have statutory lien in properties and therefore allowance is not considered for those claims.

The Customer Services department governs the collection of receivables and supplies customers with information regarding claims. Collection is done in a well defined process where among other things, consistency in procedures is maintained as much as possible.

Notes

31. Fair value

Fair values versus carrying amounts

The carrying amounts of financial assets and financial liabilities is equal to their fair value with the exception that interest bearing loans are stated at amortised cost. The fair values of interest bearing liabilities, together with the carrying amounts are specified as follows:

	2012		2011	
	Carrying amount	Fair value	Carrying amount	Fair value
Interest-bearing liabilities	(231.503.285)	(223.412.705)	(230.223.256)	(224.628.071)

The fair value of interest-bearing liabilities are based on the present value of future principal and interest payments, discounted with the market rate of interest and an appropriate risk premium on the accounting date.

Interest rates used for determining fair value

Where applicable, the interest yield curve at the reporting date is used in discounting estimated cash flow. The interests are specified as follows:

	2012	2011
Embedded derivatives in electr. sales contr.	2.37% to 11.56%	1.94% to 10.12%
Other financial assets	3.99% to 4.39%	6.63% to 7.11%
Interest bearing loans	1.05% to 4.76%	1.87% to 4.99%

Fair value hierarchy

The table below analysis financial instruments carried at fair value, by valuation method. The different levels have been defined as follows:

Level 1: Quoted prices (unadjusted) in active markets for identical assets og liabilities.

Level 2: Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e., as prices) or indirectly (i.e., derived from prices).

Level 3: Inputs for the asset or liability that are not based on observable market data (unobservable inputs).

2012	Level 2	Level 3	Total
Shares in companies	0	3.265.182	3.265.182
Embedded derivatives in sales contracts	0	14.738.660	14.738.660
Other financial assets	0	10.684.315	10.684.315
Other financial liabilities	(249.274)	0	(249.274)
	(249.274)	28.688.157	28.438.883
2011			
Shares in companies	0	1.983.269	1.983.269
Embedded derivatives in sales contracts	0	17.682.970	17.682.970
Other financial assets	0	7.868.334	7.868.334
Other financial liabilities	(19.779)	0	(19.779)
	(19.779)	27.534.573	27.514.794

Embedded derivatives in electric sales contracts that have more than ten year duration er classified under level 3 due to the fact that the forward market for aluminium only reaches maximum of ten years.

Notes

32. Overview of financial instruments

Financial assets and financial liabilities are specified in the following financial groups:

	31.12. 2012			31.12. 2011		
	Loans and receivables	Financial asset/ financial liability at fair value through P/L	Available for sale	Loans and receivables	Financial asset/ financial liability at fair value through P/L	Available for sale
Shares in other companies			3.265.182			1.983.269
Embedd. electr. sales contracts ..		14.738.660			17.682.970	
Other financial assets	939.454	9.744.861		18.423	7.868.334	
Trade receivabl. .	4.721.350			4.227.536		
Other receivabl. ..	298.181			411.196		
Cash	6.885.693			1.652.484		
Interest-bearing .. liabilities	(231.503.285)		(230.223.256)			
Other financial liabilities		(249.274)			(19.779)	
Account payabl. . (	1.366.254)		(1.627.619)			
Other current liabilities	(2.951.632)		(2.410.329)			
	(222.976.493)	24.234.247	3.265.182	(227.951.565)	25.531.525	1.983.269

33. Statement of cash flows, details

Cash from operations before interests and taxes according to the statement of cash flows is specified as follows:

	2012	2011
Loss for the year	(2.295.194)	(556.272)
Adjusted for:		
Financial income and expenses	18.493.550	19.656.314
Share of loss of associated companies	9.754	5.400
Income tax	(1.535.261)	(6.750.946)
Depreciation and amortisation	10.371.085	8.880.736
Profit from sale of assets and other changes	(41.318)	(143.338)
Retirement benefit obligation, change	31.683	19.387
Working capital from operation before interest and taxes	25.034.299	21.111.281
Inventories, decrease	28.688	135.236
Trade and other receivables, change	(702.520)	(899.899)
Payables and other current liabilities, change	(24.897)	227.900
Cash generated from operations before interests and taxes	24.335.571	20.574.518

Notes

34. Related parties

Definition of related parties

Reykjavik city, institutions and companies ruled by the city, subsidiaries of Orkuveita Reykjavíkur, associated companies, Board members, Directors and key management of Orkuveita Reykjavíkur are considered as the Group's related parties. Spouses of the before mentioned and financially dependent children are also considered as related parties as well as companies owned by or directed by those in question.

Transactions with related parties

The parties mentioned here above have had transactions with the Group within the last year. Terms and conditions of these transactions were equivalent with transactions with unrelated parties.

The following gives an overview of the transactions with related parties during the last two years as well as a statement of receivables and payables. Transactions and positions with subsidiaries are eliminated in the financial statements but that information is provided here. This information does not include sale of conventional household supplies to the related parties.

	2012	2011
Sale to related parties:		
Reykjavik City	1.235.886	898.467
Institutions and companies controlled by Reykjavik City	431.868	256.930
Subsidiaries	367.253	470.432
Associates	0	12.534
	2.035.007	1.638.363
Purchases from related parties:		
Reykjavik City	5.246	22.050
Institutions and companies controlled by Reykjavik City	6.841	5.797
Subsidiaries	15.028	14.808
Associates	42.949	54.038
	70.064	96.694
Receivables for related parties:		
Reykjavik City	284.843	316.143
Institutions and companies controlled by Reykjavik City	39.505	34.094
Subsidiaries	90.636	76.930
Subsidiaries, interest bearing loans	6.988.862	6.623.659
	7.403.846	7.050.825
Payables for related parties:		
Reykjavik City	77.141	2.650
Institutions and companies controlled by Reykjavik City	305	120
Subsidiaries	0	339.156
Subsidiaries, interest bearing	0	0
	485.758	341.927
Interest bearing loans from owners of the parent Company:		
Reykjavik City	8.277.970	7.753.254
Akranes town	489.214	458.204
Borgarbyggð, municipality	82.568	0
	8.849.752	8.211.459
Interest expense on loans from owners of the parent Company:		
Reykjavik City	429.649	234.042
Akranes town	25.392	13.831
Borgarbyggð, municipality	2.824	0
	457.864	247.873

Guarantee fee to owners

Orkuveita Reykjavíkur paid a guarantee fee to Reykjavik City and other present and former owners of the company for guarantees they have granted on the Groups loans and borrowings. For further information regarding amounts and the guarantee fee, see note 10.

Notes

35. Group entities

Shares in subsidiaries included in the consolidated financial statements are specified as follows:

Subsidiaries	Main operation	Share	
		31.12. 2012	31.12. 2011
Gagnaveita Reykjavíkur ehf.	Data transfer	100.0%	100.0%
Reykjavík Energy Invest ehf.	Investments	100.0%	100.0%
Úlfjótsvatn frítímabyggð ehf.	Preperation company	100.0%	100.0%
Hrafnabjargavirkjun hf.	Preperation company	60.0%	60.0%

Main changes in the Group during the year

At year-end 2012 shares in were decreased by approx. ISK 225 million or from ISK 225 million to ISK 500 thousand. The decrease was was on one hand to level out Úlfjótsvatn frítímabyggð ehf. deficit that amounted to ISK 41 million and on the other hand to repay a claim the Company had on the mother company.

36. Other issues

Reducted payments from Norðurál

From 1 October 2011 Norðurál has reduced contractual payments of electricity from Orkuveita Reykjavíkur and HS Orka. Orkuveita Reykjavíkur does not accept Norðurál's interpretation regarding this matter and a claim due to this, amounts to ISK 691 million. A conclusion from the Tribunal is expected during the next months in an Arbitration, where HS Orka is the claimant and has made its claims against Norðurál on the grounds of the reduction af contractual payments. As OR is also a party to the trilateral contract the company is also a respondant to the arbitration. If the Tribunal accepts HS Orkas arguments, OR will claim Norðurál for the total amount. The claim is among trade receivables, taken into account an allowance due to uncertainty in the matter.

Possible sale of financial assets

Among other financial assets in the balance sheet is a bond issued by Magma Energy Sweden A.B. Orkuveita Reykjavíkur has mandated Straumur Investment Bank Inc. to act as an advisor in relations to a potential sale of the bond, but a final decision regarding the sale of the bond has not been taken.

The bond is classified as a financial asset for sale through P/L and its book value at year end 2012 is ISK 9.7 billion.

If a decision is made to sell the bond it can effect the presentation of the bond in the financial statements.

Delays of power plant constructions

The continuation of energy production projects has been called into question due to delays in meeting contractual conditions of energy sales contracts between Orkuveita Reykjavíkur and Norðurál Helguvík ehf. (NH). A review of energy sales contracts is ongoing with NH. It is OR's opinion that some of the contractual conditions have been breached and OR is in dispute with NH on this matter. As a result, there have also been delays in the fulfilling of contracts with other parties such as machine producers and contractors. Negotiations have been conducted concerning compensation due to these delays. The largest contracts are with Mitsubishi Heavy Industries (MHI) and Balcke Dürr (BD) regarding the delivery of machinery, Orkuveita Reykjavíkur's obligation regarding those contracts is discussed in note 12. Settlement has been reached with MHI and BD regarding delay of delivery of this machinery. Uncertainty still remains regarding investments of Hverahlíðarvirkjun, the amount of compensation to MHI and BD is unknown, but could be considerable if realised. It is the view of the management that there is no reason to make provisions in the financial statements regarding the matter at this point. The management is confident that solutions which should lower these costs considerably will be realised.

Notes

36. Other issues, contd.

Effect of fluctuations in foreign exchange rates and aluminium prices on the Company's standing

22 March 2013, the day Orkuveita Reykjavíkur's financial statements for the year 2012 were authorised for issue, the TWI is 221,1783 but was 232,6864 at the reporting date 31 December 2012. If interest bearing loans and borrowings would be accounted for according to the foreign exchange rates on the reporting date they would have amounted to ISK 217.6 billion or ISK 9.5 billion lower than accounted for at the end of the accounting period. Embedded derivatives in sales contracts, when taken into consideration changes in aluminium price and currency exchange rates, would have amounted to ISK 8.7 billion on the reporting date or 6.0 billion lower than on the accounting date. Further information about the effect of changes in the exchange rates and aluminium prices can be found in note 28.

Derivative contracts in default

After the collapse of the Icelandic banks in 2008 trading in the foreign exchange market in Iceland has been little and it can hardly be stated that the foreign exchange market is active. Due to the collapse, the Central Bank of Iceland issued rules on foreign exchange based on authority contained in the Act amending the Foreign Exchange Act No. 87/1992, which imposed restrictions on investment and transactions in foreign exchange.

Among other current liabilities are derivative contracts accounted for that are in default. The contracts have not been settled due to uncertainties, both with Orkuveita Reykjavíkur and the Receivership Committees of the fallen banks concerning how to settle them. As a measure of precaution it has been decided to expense ISK 559 million in the year 2012 in addition to the ISK 181 million expensed in earlier accounting periods. In total ISK 740 million have been expensed due to these defaulted contracts. This action is in no way an admittance of the debt on Orkuveita Reykjavíkur's behalf and the amount can either increase or decrease when the contracts are settled. The contracts are accounted for among other current liabilities.

Corporate governance statement (unaudited)

Corporate governance

Orkuveita Reykjavíkur's (OR) main operations are governed by the provisions of Act No.139/2001 (as amended). The owners of OR have outlined an 'Ownership Policy', whereby the Board of OR is expected to set out the 'Board Operation Procedures', with regard to further fulfilling legal requirements. The Ownership Policy can be accessed via the OR website: www.or.is.

Orkuveita Reykjavíkur values

Our values are integrity, foresight and efficiency. These are the principles that guide us in all our business endeavours.

Board of Directors

The Board of Directors at OR is appointed by six individuals; five are appointed by the Reykjavík City Council and one is appointed by the Akranes Council. The Borgarbyggð Council appoints a special representative and Reykjavík appoints the Chairman and the Vice Chairman, from the representatives in the Reykjavík City Council. The Board is responsible for the financial and operational matters of OR. The Board of Directors include, Haraldur Flosi Tryggvson, Chairman of the Board, District Court Attorney and a lawyer at LMB, Brynhildur Davíðsdóttir, Vice Chairman and Docent at the Department of Environment and Natural Sources, at the University of Iceland, Gylfi Magnússon, Docent at the Institute for Economic Studies, at the University of Iceland, Kjartan Magnússon, City Council Representative, Sóley Tómasdóttir, City Council Representative and Hrönn Ríkharðsdóttir Akranes Town Council Representative. Thirteen Board meetings were held in 2012 and the majority of the Members of the Board were present.

Audit Committee

The OR Audit Committee is governed by Chapter IX. Act No. 3/2006 on annual financial statements Act no. 80/2008. The Committee's rules of procedure are devised by the Board of Directors, in accordance with the law.

The Auditing Committee acts as a consultant to the Board of Directors and acts on its behalf. The Committee does not have executive powers. There are three members of the Audit Committee. Gylfi Magnússon is the only Board Member and he works in cooperation with Sigríður Ármannsdóttir, Chairman of the Committee and Ingvar Garðarsson; both State Authorized Public Accountants. Thirty five meetings were held in the year 2012.

The Internal Auditor for OR is Guðmundur I. Bergþórsson and he works under the auspices of the Audit Committee.

The CEO and Executive Directors

The Board of Directors appoints the CEO; Bjarni Bjarnason is OR's CEO. The Board and the CEO are responsible for the operations of OR. The five Executive Directors at OR and the CEO, form the Executive Board and they convene on a weekly basis.

The Chief Financial Officer is Ingvar Stefánsson. He is responsible for the Treasury and Risk, Accounting, Management Information, Procurement and Information technology.

The Director of Utilities is Inga Dóra Hrólfsdóttir. The Utilities is divided into Technology, Operations, Maintenance and Control Room.

The Director of Power Plants and Sales is Páll Erland. He is responsible for the power plants, Sales and Marketing Division and the policy making decisions for the power plants and Sales Division.

The Director of Customer Services is Skúli Skúlason. The Customer Services is divided into the Service Centre, Metering and Installations, Billing and Credit Management.

The Director of Research and Development is Hildigunnur H. Thorsteinsson. Research and Development is divided into Natural resources, Systems and Design and Project Management.

Corporate governance statement (unaudited)

Corporate governance statement, contd.,

Orkuveita Reykjavíkur - Risk management

A new OR risk management policy was approved by the Board of Directors 20 January 2012. It is the policy of the Company board that all of the Company's operations are low risk by promoting responsible and effective decision making and management. The risk management policy provides an overview of the Board's strategy in this regard. It also defines the main types of risk, a risk measurement scale, basic strategies, objectives and goals regarding daily risk management within the Company.

Internal monitoring and risk management

OR prepares its financial statements in accordance with the International Financial Reporting Standards (IFRS's) and focuses on well-defined areas of responsibility, including job descriptions, alongside regular reporting and transparency in all activities. Monthly operational meetings are an important part of the internal monitoring of profits, operating costs and investments, as well as regular meetings of the 'Risk Committee' of the Company. The Board monitors the financial risk of the company and receives regular reports on the issue. For more information on risk management, please see the explanatory notes on the Financial Statements.

Further discussion of corporate governance can be found in the Annual Report, released in April, 2013 and available on the website: www.or.is.