HS Orka hf.

Financial statements for the year 2011 ISK

HS Orka hf.
Brekkustígur 36
260 Reykjanesbær

Reg.no. 680475-0169

Contents

Endorsement by the Board of Directors and the Management

The financial statements of HS Orka hf. (the Company) for the year 2011 are prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union (EU) and with additional Icelandic disclosure requirements.

According to the statement of comprehensive (loss) income, the Company's operating revenue amounted to ISK 7,431 million for the year 2011 (2010: ISK 6,994 million) and the loss for year 2011 amounted to ISK 937 million (2010: ISK 865 million profit). Total comprehensive loss amounted to ISK 936 million (2010: ISK 711 million comprehensive income). According to the statement of financial position, the Company's assets amounted to ISK 39,904 million at year end 2011 (2010: ISK 41,536 million). Equity amounted to ISK 16,397 million at the end of the year 2011 (2010: ISK 17,296 million) or 41.1% of total capital (2010: 41.6%).

The operating assets and capitalized development costs were tested for impairment at year-end by estimating their recoverable amounts. The results were that there is not an indication of impairment for these assets. Operating assets under construction were tested for impairment at year-end by calculating the recoverable amount of those assets. There is uncertainty related to future timing of the project due to a delay in receiving operational license and financing of the project, which could affect the recoverability of the assets. Management concluded that the recoverability of the projects is more likely than not.

At the end of the year 2009, the Company signed temporary agreements with its lenders on covenants and interest rates for the years 2009 and 2010. One of these temporary agreements was extended for the year 2011 with European Investment Bank, but further waivers were not needed for the other two banks. This waiver has now been extended for the year 2012. The company has now also amended the loan agreement with Nordic Investment Bank. HS Orka hf. is at year end 2011 in compliance with all covenants.

In 2007, HS Orka hf., entered into a conditional power sale agreement with Nordural (Helguvik) to sell power from a new power plant at Reykjanes, which is currently being prepared, to a new aluminum smelter in Helguvík. The agreement contained a number of conditions, which were not fulfilled by the time set out in the agreement. Accordingly, HS Orka hf. held the view that the agreement had lapsed in accordance with its terms but Nordural disputed this interpretation and maintained that the agreement was in force and that conditions had been met. Nordural initiated, in July 2010, arbitration proceedings according to the agreement to determine the validity of the agreement. The arbitrators gave their final award on 16 December 2011. According to the award the agreement from 2007 is valid but the conditions have not been fulfilled. Nordural and HS Orka hf. continue to work together to determine if the conditions will be fulfilled at some future date or if the agreement can be amended to provide for the delivery of power on agreed terms.

HS Orka hf initiated on 16 December 2011 arbitration proceedings towards Nordural Grundartangi concerning interpretation of clauses in the Power Purchase Agreement for Grundartangi concerning minimum purchase of power. The full amount was accrued in the end of the year. Results are expected late in 2012.

The Company's shareholders numbered two at the end of 2011 compared to five at the beginning of 2011. At the end of 2011 Magma Energy Sweden A.B. held 75% of the shares in HS Orka hf. and Jarðvarmi slhf. held 25% of the shares in HS Orka hf.

The Company's Board of Directors refers to the financial statements for settlement of loss and changes in equity during the year.

Icelandic shareholder Jardvarmi slhf. informed Magma Energy Sweden AB. on 10 February 2012 on their decision to exercise its option to increase its stake in HS Orka from 25.0% to 33.4%, according to agreement between Jardvarmi and Magma Energy Sweden AB. Jardvarmi slhf. will pay ISK 4.7 billion for the new shares that will increase HS Orka hf. equity by the same amount. Nominal value of the share capital increase by ISK 878 million to ISK 7.8 billion.

Statement of good management practices

The Board of Directors of HS Orka hf. emphasizes maintaining good management practices. The Board of Directors has reviewed and approved comprehensive guidelines wherein the competence of the Board is defined and its scope of work vis-à-vis the Managing Director. These rules include i.e. rules regarding order at meetings, comprehensive rules on the competence of Directors to participate in discussions and decisions of issues presented to the Board, rules on secrecy, and rules on information disclosure by the Managing Director to the Board and other issues. The Company's Board of Directors determines the Managing Director's terms of employment and meets regularly with the Company's auditors. The Board of Directors has appointed an Audit Committee. Two members of the Board are independent of the Company and three members of the Board are dependent on the major shareholder according to a definition in Article 2.5 in the Guidelines on Corporate Governance, issued in June 2009, by Iceland Chamber of Commerce, Nasdaq OMX Iceland hf. and Confederation of Icelandic Employers. The Board does not believe it is necessary to appoint a remuneration and appointment committee as the size and extent of the company's operation does not require such committees.

The board had twelve meetings and the Audit committee had four meetings in 2011.

Statement by the Board of Directors and the Management

To the best knowledge of the Board of Directors and the Management, the Company's financial statements are in accordance with International Financial Reporting Standards as adopted by the EU and it is the opinion of the Board of Directors and the Management that the financial statements give a true and fair view of the Company's assets, liabilities and financial position as at 31 December 2011, its financial performance, and the changes in cash flows during the year 2011.

Furthermore, it is the opinion of the Board of Directors and Management that the financial statements and endorsement by the Board of Directors and Management contain a fair overview of the Company's financial development and performance, its position and describe the main risk factors and uncertainties faced by the Company.

The Board of Directors and the Management of HS Orka hf. have today discussed the Company's financial statements for the year 2011 and confirmed by means of their signatures. The Board of Directors and the Management submit the financial statements for approval at the annual general meeting.

Reykjanesbær, 14 February 2012.

The Board of Directors:

Ásgeir Margeirsson
Chairman of the board

Gylfi Árnason

John Carson

Anna Skúladóttir

Ross Beaty

Managing Director:
Júlíus Jónsson

Assistant Managing Director:
Albert Albertsson

Independent Auditors' Report

To the Board of Directors of HS Orka hf.

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

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

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

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

Opinion

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

Report on the Board of Directors report

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

Reykjanesbær, 14 February 2012.

KPMG ehf.

Sæmundur Valdimarsson

Margret G. Flóvenz

Statement of Comprehensive (Loss) Income for the year ended 31 December

	Notes	2011	2010
Operating revenue	5	7.431.384	6.993.773
Production cost and cost of sales	7	(4.972.335)	(4.692.753)
Gross profit		2.459.049	2.301.020
Other operating expenses	8	(756.946)	(405.730)
Results from operating activities		1.702.103	1.895.290
Finance income		195.961	1.163.746
Finance costs		(1.594.689)	(862.409)
Changes in fair value of derivatives		41.136	405.946
Changes in fair value of embedded derivatives in sales contracts		(1.465.215)	(1.395.995)
Net finance costs	11	(2.822.807)	(688.712)
Share of loss of associates	16	(39.213)	(177.467)
(Loss) profit before income tax		(1.159.917)	1.029.111
Income tax	12	223.163	(164.549)
(Loss) profit for the year		(936.754)	864.562
Other comprehensive income (loss)			
Foreign currency translation difference of associates	16	907	(110.749)
Effects of changes in tax rate	12	0	(43.089)
Other comprehensive income (loss) for the year, net of income tax		907	(153.838)
Total comprehensive (loss) income for the year		(935.847)	710.724

Earnings per share

	Notes	2011	2010
Basic and diluted (loss) earnings per share	25	(0,13)	0,13

Notes on pages 10 to 45 are an integral part of these financial statements

Financial Statements 31 December 2011 of HS Orka hf. 6 All amounts are in thousands of ISK

Statement of Financial Position as at 31 December

Assets	Notes	2011	2010
Operating assets	13	25.803.349	24.781.700
Operating assets under construction	14	3.544.465	4.746.587
Intangible assets	15	982.699	981.275
Investments in associates	16	655.608	638.611
Investments in other companies	17	27.075	27.075
Bonds	18	405.201	495.604
Embedded derivatives in power purchase agreements	19	4.294.623	5.096.653
Deferred tax asset	20	499.481	276.318
Prepaid lease and royalty fee	21	454.676	0
Long term receivable	22	200.926	559.221
Total non-current assets		36.868.103	37.603.044
Inventories		368.386	340.926
Bonds	18	70.428	647.793
Trade and other receivables	22	1.125.599	1.070.586
Embedded derivatives in power purchase agreements	19	166.784	829.969
Cash and cash equivalents	23	1.304.713	1.043.250
Total current assets		3.035.910	3.932.524
Total assets		39.904.013	41.535.568
Equity			
Share capital		6.962.919	6.962.919
Share premium		3.218.660	3.218.660
Translation reserve		297.542	296.634
Revaluation reserve		1.647.187	1.723.505
Reserve for shares in associate		0	(37.157)
Retained earnings		4.270.960	5.131.395
Total equity	24	16.397.268	17.295.956
Liabilities			
Loans and borrowings	26	17.476.628	18.570.882
Pension obligations	27	1.576.500	1.400.000
Currency and interest rate swap contracts	28	761.614	886.753
Total non-current liabilities		19.814.742	20.857.635
Loans and borrowings	26	2.101.388	1.951.594
Trade and other payables	29	1.234.276	1.158.045
Currency and interest rate swap contracts	28	356.339	272.338
Total current liabilities		3.692.003	3.381.977
Total liabilities		23.506.745	24.239.612
Total equity and liabilities		39.904.013	41.535.568

Notes on pages 10 to 45 are an integral part of these financial statements

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Statement of Changes in Equity
for the year ended 31 December

	Share capital	Share premium	Translation reserve	Revaluation reserve	Reserve for shares in associate	Retained earnings	Total
2010							
Equity at 1 January 2010	6.118.387	1.529.597	407.383	1.830.311	0	4.203.116	14.088.794
Total comprehensive income			(110.749)	(43.089)		864.562	710.724
Revaluation reserve transferred to retained earnings				(63.717)		63.717	0
Share capital increase	844.532	1.689.063					2.533.595
Effects of put option on own shares of an associate					(277.354)		(277.354)
Expired put options on own shares of an associate					240.197		240.197
Equity at 31 December 2010	6.962.919	3.218.660	296.634	1.723.505	(37.157)	5.131.395	17.295.956
2011							
Equity at 1 January 2011	6.962.919	3.218.660	296.634	1.723.505	(37.157)	5.131.395	17.295.956
Total comprehensive loss			907			(936.754)	(935.847)
Revaluation reserve transferred to retained earnings				(76.318)		76.318	0
Exercised put option on own shares of an associate					37.157		37.157
Equity at 31 December 2011	6.962.919	3.218.660	297.542	1.647.187	0	4.270.960	16.397.268

Notes on pages 10 to 45 are an integral part of these financial statements

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Statement of Cash Flows
for the year ended 31 December

	Notes	2011	2010
Cash flows from operating activities			
(Loss) profit for the year		(936.754)	864.562
Adjustments:			
Gain on sale of operating assets		(4.649)	0
Increase in pension obligations	27	176.500	24.300
Depreciation and amortization	10	975.633	988.203
Net finance expenses	11	2.822.807	688.712
Share of loss of associates	16	39.214	177.467
Income tax	12	(223.163)	164.549
		2.849.588	2.907.793
Inventories, (increase) decrease		(27.460)	5.445
Receivables, increase		(141.636)	(247.739)
Current liabilities, increase		227.999	16.782
Net cash from operations before interest and taxes		2.908.491	2.682.281
Interest income received		55.203	64.303
Interest and indexation costs paid		(589.451)	(674.261)
Net cash from operating activities		2.374.243	2.072.323
Cash flows from investing activities			
Acquisition of operating assets during the year		(597.024)	(2.133.290)
Payments for operating assets acquired in prior year		(244.142)	0
Proceeds from sale of operating assets		5.700	0
Acquisition of intangible assets		(26.216)	(61.869)
Acquisition of shares in associates		(23.000)	(70.000)
Dividend received		4.854	0
Proceeds from repayment and sale of bonds		734.164	1.354.081
Net cash used in investing activities		(145.664)	(911.078)
Cash flows from financing activities			
Share capital increase		0	2.533.595
Repayment of borrowings		(2.061.143)	(1.813.823)
Repayment of loan from HS Veitur		0	(378.816)
Short-term loans, decrease		0	(549.013)
Net cash used in financing activities		(2.061.143)	(208.057)
Increase in cash and cash equivalents		167.436	953.188
Cash and cash equivalents at 1 January		1.043.250	151.782
Effect of exchange rate fluctuations on cash held		94.027	(61.720)
Cash and cash equivalents at year end		1.304.713	1.043.250
Investing and financing activities not affecting cash flows			
Acquisition of operating assets		(174.394)	(635.538)
Current liabilities		174.394	257.062
Sale of bonds		0	378.476

Notes on pages 10 to 45 are an integral part of these financial statements

Financial Statements 31 December 2011 of HS Orka hf. 9 All amounts are in thousands of ISK

Notes to the Financial Statements

1. Reporting entity

HS Orka hf. is a limited liability company domiciled in Iceland. The Company's registered office address is Brekkustígur 36, Reykjanesbær, Iceland. The Company generates and sells electricity and hot water for heating. The Company is a subsidiary of Magma Energy Sweden AB. The financial statements of the Company are part of the consolidated financial statements of the ultimate parent company Alterra Power Corp., headquartered in Canada.

The financial statements of the Company includes its share of associates accounted for on an equity basis of accounting.

2. Basis of preparation

a. Statement of compliance

The Company's financial statements are prepared according to International Financial Reporting Standards (IFRS) as adopted by the EU and additional Icelandic disclosure requirement in accordance with Icelandic financial statement act nr. 3/2006.

These financial statements were authorized for issue by the Board of Directors on 14 February 2012.

b. Basis of measurement

The financial statements have been prepared on the historical cost, except for the following material items in the statement of financial position:

- the majority of operating assets are recognized at revalued cost, which is their fair value at the revaluation date
- derivative financial instruments are measured at fair value
- embedded derivatives in power purchase agreements are measured at fair value
- financial instruments at fair value through profit or loss are measured at fair value (bonds and shares)
- available for sale financial instruments are measured 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 (ISK), which is the Company's functional currency. All financial information presented in ISK has been rounded to the nearest thousand except where otherwise noted.

d. Use of estimates and judgments

The preparation of financial statements in conformity with IFRS 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 recognized in the period in which the estimate is revised and in any future periods affected.

Information about critical judgements in applying accounting policies that have the most significant effect on the amounts recognized in the financial statements is included in the following notes:

- Note 13 - operating assets
- Note 19 - embedded derivatives in power purhcase agreements
- Note 27 - pension obligations
- Note 28 - currency and interest rate swap contracts

2. Basis of preparation, continued:

Information about assumptions and estimates that have a significant risk of resulting in a material adjustment within the next financial year are included in the following notes:

- Note 13 - operating assets
- Note 14 - operating assets under construction
- Note 15 - intangible assets
- Note 18 - bonds
- Note 19 - embedded derivatives
- Note 20 - deferred taxes
- Note 28 - currency and interest rate swap contracts

3. Significant accounting policies

The accounting policies set out below have been applied consistently to all periods presented in these financial statements.

a. Investment in associates

Associates are those entities in which the Company has significant influence, but not control, over their financial and operating policies. Significant influence is presumed to exist when the Company holds between 20 and 50 percent of the voting power of another entity.

Investments in associates are accounted for using the equity method and are recognized initially at cost. The cost of the investment includes transaction costs.

The financial statements include the Company's share of the profit or loss and other comprehensive income, after adjustments to align the accounting policies with those of the Company, from the date that significant influence or joint control commences until the date that significant influence ceases.

When the Company's share of losses exceeds its interest in an equity-accounted investee, the carrying amount of that interest, including any long-term investments, is reduced to zero, and the recognition of further losses is discontinued except to the extent that the Company has an obligation or has made payments on behalf of the investee.

Unrealized gains arising from transactions with associates are eliminated against the investment to the extent of the Company's interest in the associate. Unrealized losses are eliminated in the same way as unrealized gains, but only to the extent that there is no evidence of impairment.

b. Foreign currency

(i) Foreign currency transactions

Transactions in foreign currencies are translated to the functional currency of the Company at exchange rates at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies at the reporting date are retranslated to the functional currency at the exchange rate at that date. The foreign currency gain or loss on monetary items is the difference between amortized cost in the functional currency at the beginning of the period, adjusted for effective interest and payments during the period, and the amortized cost in foreign currency translated at the exchange rate at the end of the year. Non-monetary assets and liabilities denominated in foreign currencies that are measured at fair value are retranslated to the functional currency at the exchange rate at the date that the fair value was determined. Foreign currency differences arising on retranslation are recognized in profit or loss. Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction.

3. Significant accounting policies, continued:

c. Financial instruments

(i) Non-derivative financial assets

The Company initially recognizes loans and receivables and bank deposits on the date that they are originated. All other financial assets including assets designated at fair value through profit or loss are recognized initially on the trade date, which is the date the Company becomes a party to the contractual provisions of the instrument.

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

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

The Company classifies non-derivative financial assets into the following categories: financial assets at fair value through profit or loss, loans and receivables and available-for-sale financial assets.

Financial assets at fair value through profit or loss

A financial asset is classified at fair value through profit or loss if it is classified as held for trading or is designated as such upon initial recognition. Financial assets are designated at fair value through profit or loss if the Company manages such investments and makes purchase and sale decisions based on their fair value in accordance with the Company's documented risk management or investment strategy. Attributable transaction costs are recognized in profit or loss as incurred. Financial assets at fair value through profit or loss are measured at fair value, and changes therein are recognized in profit or loss.

Financial assets at fair value through profit or loss comprise equity securities and bond asset.

Loans and receivables

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

Loans and receivables comprise cash and cash equivalent and trade and other receivables.

Cash and cash equivalents comprise cash balances and call deposits with original maturities of three months or less.

3. Significant accounting policies, continued:

c. Financial instruments, continued:

(i) Non-derivative financial assets, continued:

Available-for-sale financial assets

Available-for-sale financial assets are non-derivative financial assets that are designated as available-for-sale and that are not classified in any of the previous categories. The Company's investments in 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 and foreign currency differences on available-for-sale equity instruments, are recognized in other comprehensive income and presented within equity in the fair value reserve. When an investment is derecognized, the cumulative gain or loss in other comprehensive income is transferred to profit or loss.

At year end 2011 the Company held no securities classified as available for sale.

(ii) Non-derivative financial liabilities

The Company initially recognizes debt securities issued and subordinated liabilities on the date that they are originated. All other financial liabilities are recognized initially on the trade date at which the Company becomes a party to the contractual provisions of the instrument.

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

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

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

Financial liabilities other than derivatives comprise loans and borrowings and trade and other payables.

(iii) Derivative financial instruments

Derivatives are recognized initially at fair value; attributable transaction costs are recognized in profit or loss as incurred. Subsequent to initial recognition, derivatives are measured at fair value in the statement of financial position and changes in fair value are recognized in profit or loss as part of financial income or cost in the statement of comprehensive income.

Separable embedded derivatives

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.

Changes in the fair value of separable embedded derivatives are recognized in profit or loss as part of financial income or cost in the statement of comprehensive income.

3. Significant accounting policies, continued:

c. Financial instruments, continued:

(iii) Share capital

Ordinary shares

Incremental costs directly attributable to issue of ordinary shares are recognized as a deduction from equity, net of any tax effects.

Repurchase of share capital (treasury shares)

When share capital recognized as equity is repurchased, the amount of the consideration paid, which includes directly attributable costs, net of any tax effects, is recognized as a deduction from equity. Repurchased shares are classified as treasury shares and are presented as a deduction from total equity. When treasury shares are sold or reissued subsequently, the amount received is recognized as an increase in equity, and the resulting surplus or deficit on the transaction is presented in share premium.

d. Operating assets

(i) Recognition and measurement

Items of operating assets are measured at cost or revalued 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 assets to a working condition for their intended use and capitalized borrowing costs. Purchased software that is integral to the functionality of the related equipment is capitalized as part of that equipment.

The Company's power plants and real estates are measured at revalued cost in the statement of financial position. The revalued cost is the fair value at the revaluation date less accumulated depreciation. Revaluation is carried out on a regular basis. Any increase in the carrying amount of operating assets as a result of a revaluation is recognized in equity under the heading of revaluation reserve net of income tax. Depreciation of the revalued cost is recognized in profit or loss. In the case of sale or disposal of an asset the part of the revaluation reserve pertaining to the asset is transferred to retained earnings. Depreciation, net of tax, is annually transferred to retained earnings.

When part of an item of operating assets have different useful lives, they are accounted for as separate items of operating assets.

Gains and losses on disposal of an item of operating assets are determined by comparing the proceeds from disposal with the carrying amount of operating assets, and are recognized net within other income or other expenses in profit or loss. When revalued assets are sold, the amounts included in the revaluation reserve are transferred to retained earnings.

(ii) Subsequent costs

Subsequent expenditure is capitalised only when it is probable that the future economic benefits associated with the expenditure will flow to the Company. Ongoing repairs and maintenance are expensed as incurred.

3. Significant accounting policies, continued:

d. Operating assets, continued:

(iii) Depreciation

Depreciation is based on the cost or revalued cost of an asset less its residual value. Significant components of individual assets are assessed and if a component has a useful life that is different from the remainder of that asset, that component is depreciated separately.

Depreciation is recognized in profit or loss on a straight-line basis over the estimated useful lives of each component of an item of operating assets. Land is not depreciated.

Operating assets are depreciated from the date they are installed and are ready for use, or in respect of internally constructed assets, from the date the asset is completed and ready for use.

The estimated useful lives for the current and comparative year are as follows:

Power plants	40 years
Boreholes	20 years
Electrical systems	50 years
Hot water and cold water distribution systems	50 years
Real estate	50 years
Other operating assets	5 - 20 years

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

e. Intangible assets

(i) Research and development

Expenditure on research activities, undertaken with the prospect of surveying geothermal areas where geothermal resource is uncertain, and in order to gain new scientific or technical knowledge, is recognized in profit or loss when incurred.

Development activities involve surveys of geothermal areas where there is probability of future development and power production. Development expenditure is capitalized only if development costs can be measured reliably, the product or process is technically and commercially feasible, future economic benefits are probable, and the Company intends to and has sufficient resources to complete development and to use or sell the asset. The expenditure capitalized includes the cost of materials, direct labour, overhead costs that are directly attributable to preparing the asset for its intended use, and capitalized borrowing costs. Other development expenditure is recognized in profit or loss as incurred.

When a decision on producing power or harnessing of geothermal areas has been made and all required licenses have been obtained the preparation cost due to harnessing or production of power is transferred to operating assets under construction.

Capitalized development expenditure is measured at cost less accumulated impairment losses.

(ii) Other intangible assets

Other intangible assets that are acquired by the Company, which have finite useful lives, are measured at cost less accumulated amortization and accumulated impairment losses.

(iii) Subsequent expenditure

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

3. Significant accounting policies, continued:

e. Intangible assets, continued:

(iv) Amortization

Amortization is based on the cost of an asset less its residual value.

Amortization is recognized 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 years are as follows:

Software .... 5-10 years

Amortization methods, useful lives and residual values are reviewed at each reporting date and adjusted if appropriate.

f. Leased assets

Leases are operating leases and the leased assets are not recognized on the Company's statement of financial position.

g. Inventories

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

h. Impairment

(i) Non-derivative financial assets

A financial asset not carried at fair value through profit or loss is assessed at each reporting date to determine whether there is objective evidence that it is impaired. A financial asset is impaired if objective evidence indicates that a loss event has occurred after the initial recognition of the asset, and that the loss event had a negative effect on the estimated future cash flows of that asset that can be estimated reliably.

In assessing collective impairment the Company uses historical trends of the probability of default, timing of recoveries and the amount of loss incurred, adjusted for management’s judgment as to whether current economic and credit conditions are such that the actual losses are likely to be greater or less than suggested by historical trends.

(ii) Non-financial assets

The carrying amounts of the Company'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. For intangible assets that are not yet available for use, the recoverable amount is estimated each year at the same time.

Impairment is recognized if the carrying amount of an asset exceeds its estimated recoverable amount. Impairment loss of revalued operating assets is recognized in equity under revaluation reserve up to the value of the reserve, after which they are recognized in profit or loss. Impairment losses of other assets are recognized in profit or loss.

The recoverable amount of an asset 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.

3. Significant accounting policies, continued:

i. Employee benefits

(i) Defined contribution plans

A defined contribution plan is a post-employment benefit plan under which an entity pays fixed contributions into a separate entity and will have no legal or constructive obligation to pay further amounts. Obligations for contributions to defined contribution pension plans are recognized as an employee benefit expense in profit or loss in the periods during which services are rendered by employees. Prepaid contributions are recognized as an asset to the extent that a cash refund or a reduction in future payments is available.

(ii) Defined benefit plans

The Company's net obligation in respect of defined benefit pension plans or pension fund commitment 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. That benefit is discounted to determine its present value. The calculation is performed annually by qualified actuaries using a method based on earned benefits. Changes in pension fund obligation are recognized as incurred in profit or loss.

j. Provisions

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

k. Revenue

Revenue from the sale of electricity and hot water along with power transmission and distribution are recognized in profit and loss based on recorded measurement of delivery during the period. Between measurements, usage is estimated based on prior period usage. Other revenues are recognized when the goods or services are delivered.

Service revenues from HS Veitur hf. are based on service contract and recognized in profit or loss when service has been provided.

Lease revenues are recognized in profit or loss on a straight-line basis over the term of the lease.

l. Lease payments

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

m. Net finance income (costs)

Finance income comprises of interest income on funds invested, dividend income, changes in the fair value of financial assets at fair value through profit or loss, foreign currency gains and gains on derivatives that are recognized in profit or loss. Interest income is recognized as it accrues in profit or loss, using the effective interest method. Dividend income is recognized on the date that the Company’s right to receive payment is established.

Finance costs comprise of interest expense on borrowings, unwinding of the discount on provisions, foreign currency losses, losses on derivatives that are recognized in profit or loss, changes in the fair value of financial assets at fair value through profit or loss, and impairment losses recognized on financial assets other than trade receivables. Borrowing costs that are not directly attributable to the acquisition, construction or production of a qualifying asset are recognized in profit or loss using the effective interest method.

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

3. Significant accounting policies, continued:

n. Income tax

Income tax expense comprises current and deferred tax. Current tax and deferred tax are recognized in profit or loss except to the extent that it relates to items recognized directly in equity or in other comprehensive income.

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.

Deferred tax is recognized 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 temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date. Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities and assets, and they relate to income taxes levied by the same tax authority.

A deferred tax asset is recognized for unused tax losses, tax credits and deductible temporary differences, to the extent that it is probable that future taxable profits will be available against which they can be utilized. 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 realized.

o. Earnings per share

The Company presents basic and diluted earnings per share (EPS) data for its ordinary shares. Basic EPS is calculated by dividing the profit or loss attributable to ordinary shareholders of the Company by the weighted average number of ordinary shares outstanding during the period, adjusted for own shares held. Diluted EPS equals to basic EPS as the Company has not issued convertible notes nor granted share options.

p. Segment reporting

An operating segment is a component of the Company that engages in business activities from which it may earn revenues and incur expenses, including revenues and expenses that relate to transactions with any of the Company's other components. All operating segments' operating results are reviewed regularly by the Company's management to make decisions about resources to be allocated to the segment and assess its performance, and for which discrete financial information is available.

q. New standards and interpretations

A number of new standards, amendments to standards and interpretations are effective for annual periods beginning after 1 January 2011, and have not been applied in preparing these financial statements. None of these is expected to have a significant effect on the financial statements of the Company.

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. Operating assets

The fair value of operating assets is calculated using the income approach or cash-flow analysis where the estimated future cash-flow of the related business units which operating assets are a part of is calculated at present value.

The fair value of real estate is its market value according to a value assessment carried out by an authorized real estate agent.

b. Investments in equity and debt securities

The fair value of financial assets at fair value through profit or loss is determined by reference to their market price at the reporting date. If a listed market price is not available then fair value is estimated using accepted valuation techniques.

c. 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.

d. Derivatives

The fair value of derivative contracts is based on their listed market price, if available. If a listed market price is not available, then fair value is estimated using accepted valuation techniques.

Valuation techniques include recent arm's length transactions between knowledgeable, willing parties, if available, reference to the current fair value of other instruments that are substantially the same, the discounted cash flow analysis and option pricing models. Valuation techniques incorporate all factors that market participants would consider in setting a price and are consistent with accepted methodologies for pricing financial instruments.

The most reliable verification of the fair value of derivative agreements at the beginning is the transaction price, unless the fair value of the instrument can be verified by comparison to other listed and recent market transactions of a comparable instrument or based on an evaluation method where variables are solely based on market documents. When such documents are available the Company recognizes profit or loss at the initial registration date of the instruments.

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.

5. Segment reporting

The Company has three operating segments that are described below:

Power Production

Includes production and sale of electrical energy, heating water and distilled water with subterranean steam.

Electricity Sale

Includes purchases and sale of electricity to other users than mass users and power companies.

Other

Includes sale of service, rent of facilities and equipment, and other sales.

Year 2011	**Power production**	**Electricity sale**	**Other**	**Total**
External revenue	4.095.397	2.387.540	948.447	7.431.384
Inter-segment revenue	947.851			947.851
Total segment revenue	5.043.248	2.387.540	948.447	8.379.235
Segment operating results	1.575.266	110.254	16.583	1.702.103
Unallocated items				
Net finance costs				(2.822.807)
Share of loss of associates				(39.213)
Income tax				223.163
Loss for the year				(936.754)
Segment assets	29.698.633	50.886	580.994	30.330.513
Unallocated assets				9.573.500
Total assets				39.904.013
Unallocated liabilities				23.506.745
Capital expenditures	778.136	10.353	9.145	797.634
Depreciation and amortization	932.200	5.219	38.214	975.633

Year 2010	**Power production**	**Electricity sale**	**Other**	**Total**
External revenue	4.051.003	2.059.966	882.804	6.993.773
Inter-segment revenue	710.416			710.416
Total segment revenue	4.761.419	2.059.966	882.804	7.704.189
Segment operating results	1.814.570	15.469	65.251	1.895.290
Unallocated items				
Net finance costs				(688.712)
Share of loss of associates				(177.467)
Income tax				(164.549)
Profit for the year				864.562
Segment assets	29.846.428	54.871	608.263	30.509.562
Unallocated assets				11.026.006
Total assets				41.535.568
Unallocated liabilities				24.239.612
Capital expenditures	2.802.800	4.635	23.262	2.830.697
Depreciation and amortization	930.682	10.789	46.732	988.203

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5. Segment reporting, contd.:

Power production

Revenues in the power production segment are specified as follows:

Year 2011	Electricity	Hot water	Other	Total
External revenue	3.300.317	625.091	169.989	4.095.397
Inter-segment revenue	947.851			947.851
Total segment revenue	4.248.168	625.091	169.989	5.043.248
Year 2010				
External revenue	3.377.178	592.157	81.668	4.051.003
Inter-segment revenue	710.416			710.416
Total segment revenue	4.087.594	592.157	81.668	4.761.419

6. Major customers

Revenues from one customer of the Company's power production segment amounted to ISK 3,020 million (2010: ISK 3,110 million).

Revenues from HS Veitur hf. were as follows:

	Power production	Electricity sale	Other	Total
Revenues 2011	676.832	204.768	842.981	1.724.581
Revenues 2010	643.480	166.365	808.076	1.617.921

7. Production cost and cost of sales

Production cost and cost of sales are specified as follows:

	2011	2010
Production cost	2.769.758	2.659.229
Cost of sales	1.239.137	1.215.971
Cost of service	963.440	817.553
Total production cost and cost of sales	4.972.335	4.692.753

8. Other operating expenses

Operating expenses specifies as follows:

Salaries and related expenses	145.435	130.517
Increase in pension fund obligation	74.556	8.115
Administrative expenses	520.833	181.066
Depreciation and amortization	16.122	86.032
Total other operating expenses	756.946	405.730

The majority of the increase in administrative expenses in 2011 are related to the arbitration case with Nordural (Helguvik).

Capitalized cost in the amount of ISK 63 million related to new headquarters was written off in the year 2010.

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9. Salaries and related expenses

Salaries and salary related expenses are as follows:

	2011	2010
Salaries	962.669	861.063
Contribution to defined contribution fund	94.011	83.691
Increase in pension obligation	242.065	92.618
Other salary related expenses	145.587	128.292
Total salaries and salary related expenses	1.444.332	1.165.664
Average number of full time employees equivalent	136	136

Salaries and salary related expenses including pension obligations are allocated as follows:

Capitalized on projects	34.729	39.822
Production cost and cost of sale	1.189.612	987.210
Other operating expenses	219.991	138.632
Total salaries and salary related expenses	1.444.332	1.165.664

Salaries paid to the Board of Directors and Management amounted to ISK 48 million in 2011 (2010: ISK 45 million).

10. Depreciation, amortization and impairment

Depreciation, amortization and impairment is specified as follows:

Depreciation of operating assets, see note 13	950.841	954.710
Amortization of intangible assets, see note 15	24.792	33.493
Depreciation and amortization recognized in the income statement	975.633	988.203

Depreciation and amortization is allocated as follows:

Production cost and cost of sales	959.511	902.171
Other operating expenses	16.122	86.032
Depreciation and amortization recognized in the income statement	975.633	988.203

11. Finance income and costs

Finance income and costs specifies as follows:

Interest income on loans and receivables	84.944	54.565
Interest income on available for sale securities	3.429	122.427
Fair value changes on financial assets through profit or loss	107.588	59.032
Net foreign exchange gain	0	927.722
Total finance income	195.961	1.163.746
Interest expense	(575.342)	(674.268)
Indexation	(173.654)	(87.673)
Changes in fair value of financial assets through profit or loss	0	(100.468)
Net foreign exchange loss	(845.693)	0
Total finance costs	(1.594.689)	(862.409)
Fair value changes of currency and interest rate swap	41.136	405.946
Fair value changes of embedded derivatives in electric power sale contracts	(1.465.215)	(1.395.995)
Net finance costs	(2.822.807)	(688.712)

Capitalized interest amounted to ISK 26 million during the year (2010: ISK 0 million)

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Notes, continued:

12. Income tax

Deferred income tax is specified as follows:

	2011	2010
Origination and reversal of temporary difference	223.163	(235.268)
Change in tax rate	0	70.719
Income tax	223.163	(164.549)

Effective tax rate is specified as follows:

	2011		2010	
(Loss) profit for the year		(936.754)		864.562
Income tax		(223.163)		164.549
(Loss) profit before income tax		(1.159.917)		1.029.111
Income tax according to current tax rate	20,0%	231.983	18,0%	(185.240)
Change in tax rate from 18% to 20%	0,0%	0	6,9%	70.719
Effect of associates	0,7%	(7.843)	(3,1%)	(31.944)
Other items	0,1%	(977)	(1,8%)	(18.084)
Effective income tax rate	(19,2%)	223.163	(16,0%)	(164.549)

Deferred income tax recognized directly in equity is specified as follows:

	2011	2010
Effects of change in tax rate	0	43.089
	0	43.089

13. Operating assets

Revaluation of operating assets

The Company's power plants were revalued to fair value on 31 December 2009. In order to calculate the present value of the operating assets, an interest rate which reflects the Weighted Average Cost of Capital (WACC) of the Company, that is the cost of capital and interest-bearing loans, net of income tax, is used. The discount rate was 10.98% for Svartsengi and 8.28% for Reykjanes. The cash-flow was estimated using the operating budget for the next five years and expected future value calculated for the years thereafter. In the cash-flow, it was expected that the increase in revenue for the first year to be 14.9% for Svartengi and 39.2% for Reykjanes due to increase in aluminum prices compared to 2009 and for year two to five between 2.4% to 4.4% and that future increases in revenue would be 2.9%. The calculations were performed by independent experts.

Impairment testing

Management reviewed whether there was an indication of impairment of the Company's operating assets at the year end 2011 and management concluded that there was no indication of impairment.

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13. Operating assets, continued:

Operating assets are specified as follows:

	Power plants	Other operating assets	Total
Cost			
Balance at 1.1.2010	24.916.940	1.785.805	26.702.745
Additions during the year	241.583	2.122	243.705
Disposals	0	(161.816)	(161.816)
Balance at 31.12.2010	25.158.523	1.626.111	26.784.634
Transferred from operating assets under construction	1.821.095	0	1.821.095
Additions during the year	116.627	35.819	152.446
Disposals	0	(10.507)	(10.507)
Balance at 31.12.2011	27.096.245	1.651.423	28.747.668
Depreciation			
Balance at 1.1.2010	981.309	228.731	1.210.040
Depreciation for the year	846.251	108.459	954.710
Disposals	0	(161.816)	(161.816)
Balance at 31.12.2010	1.827.560	175.374	2.002.934
Depreciation for the year	912.086	38.755	950.841
Disposals	0	(9.456)	(9.456)
Balance at 31.12.2011	2.739.646	204.673	2.944.319
Net book value			
1.1.2010	23.935.631	1.557.074	25.492.705
31.12.2010	23.330.963	1.450.737	24.781.700
31.12.2011	24.356.599	1.446.750	25.803.349
Net book value without revaluation			
1.1.2010	21.792.931	1.449.939	23.242.870
31.12.2010	21.279.342	1.347.440	22.626.782
31.12.2011	22.391.779	1.352.587	23.744.366

Other operating assets include capitalized land and buildings with the carrying amount of ISK 1,105 million (2010: ISK 1,121 million).

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13. Operating assets, continued:

Capital commitments

The company anticipates that it will need to invest in a new discharge pipe system for Svartsengi in the next 3 years and that the majority of the investment will be in the years 2012 - 2014. Once the discharge system is designed, built and in full operation additional geothermal fluid can be extracted from the reservoir resulting in increased power generation estimated to be approximately 5 MW from already installed turbine generators.

Pledge of assets

The Company's power plants at Reykjanes and Svartsengi are pledged to secure bank loans in the amount of ISK 16,380 million (2010: ISK 16,926 million).

Rateable value and insurance value

Rateable value of the Company's buildings amounted to ISK 2,869 million at year-end 2011 (2010: ISK 2,393 million) and land measured at rateable value amounted to ISK 1,193 million (2010: ISK 570 million). Insurance value of the Company's assets amounted to ISK 19,860 million (2010: ISK 23,150 million).

14. Operating assets under constructions

Operating assets under constructions are specified as follows:

	2011	2010
Net book value 1.1.	4.746.587	2.221.463
Additions	618.973	2.525.124
Transferred to operating assets	(1.821.095)	0
Net book value 31.12.	3.544.465	4.746.587

Indication of impairment

Operating assets under construction represents capitalized cost related to a new power plant at Reykjanes, which was planned to supply Nordural with power for a new aluminum smelter in Helguvík. In 2007, HS Orka hf. and Nordural executed a power purchase agreement on power for the new aluminum smelter in Helguvík. The agreement with Nordural was under dispute and Nordural initiated arbitration proceedings to determine the validity of the agreement. A conclusion was reached on 16 December 2011. The conclusion is further explained in note 33. Despite the delay, negotiation with Nordural are ongoing and management's opinion is that the recoverable amount of operating assets under construction is above its carrying value.

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14. Operating assets under constructions, continued:

Impairment test at 31 December 2011

The operating assets under construction were tested for impairment at 31 December 2011 by estimating their recoverable amount. The impairment test was based on several assumptions including delivery of power commencing in 2015. There is some uncertainty related to the future timing of the project (Reykjanes expansion) due to both negotiations with Norðurál and financing of the project, which could affect the recoverability of the assets.

15. Intangible assets

Intangible assets are specified as follows:

	Software	Development cost	Total
Cost			
Balance 1.1.2010	336.403	944.887	1.281.290
Additions during the year	34.523	27.346	61.869
Disposals	(36.716)	0	(36.716)
Balance 31.12.2010	334.210	972.233	1.306.443
Additions during the year	5.755	20.461	26.216
Balance at 31.12.2011	339.965	992.694	1.332.659
Amortization			
Balance at 1.1.2010	182.150	146.241	328.391
Amortization for the year	33.493	0	33.493
Disposals	(36.716)	0	(36.716)
Balance at 31.12.2010	178.927	146.241	325.168
Amortization for the year	24.792	0	24.792
Balance at 31.12.2011	203.719	146.241	349.960
Book value			
1.1.2010	154.253	798.646	952.899
31.12.2010	155.283	825.992	981.275
31.12.2011	136.246	846.453	982.699

Impairment test 2011

Development cost includes the costs for the experimental drilling at Trölladyngja, Krýsuvík and Eldvörp. Relevant costs are capitalized to the extent that it is probable that future benefits are generated in order to recover the investment. HS Orka hf. holds a research permit in these areas and according to management results from recent analysis are positive. If it becomes evident that development cost will not be utilized by the company to generate revenue it must be expensed as an impairment cost. Management confirmed that the above projects are feasible and it is likely that they will generate revenues in the future. At the end of 2011 there has been no material changes to the assumption regarding impairment of intangible assets.

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Notes, continued:

16. Investments in associates

Associates are as follows:

	2011		2010	
	Share	Carrying amount	Share	Carrying amount
Bláa Lónið hf. (The Blue Lagoon), Iceland	31,7%	425.438	24,4%	509.755
Hreyfing Eignarhaldsfélag ehf., Iceland	24,4%	69.264	-	-
Hótel Bláa Lónið ehf., Iceland	24,4%	3.099	-	-
Blue Lagoon International ehf., Iceland	24,4%	5.351	-	-
DMM-lausnir ehf., Iceland	22,6%	17.956	25,3%	17.356
Suðurorka ehf., Iceland	50,0%	134.000	47,9%	111.500
HS Orkurannsóknir ehf., Iceland	100,0%	500		-
Total		655.608		638.611

The Company's share in loss of its associates for the year 2011 was ISK 39 million (2010: loss ISK 177 million). The share in associates loss is based on un-audited financial information. Currency translation difference for the year was positive in the amount of ISK 1 million (2010: negative ISK 111 million).

During the year 2011 the Board of Directors of the Blue Lagoon confirmed a demerger of the Company into four companies; Bláa Lónið hf., Blue Lagoon International ehf., Hótel Bláa Lónið ehf. and Hreyfing Eignarhaldsfélag ehf. When the demerger took place HS Orka hf. held a 24.4% share in all of the companies. In the third quarter the Bláa Lónið hf. purchased own shares, therefore the share of HS Orka hf. increased to 31.7%.

The Company increased its share in Suðurorka ehf. during the year by ISK 23 million.

HS Orkurannsóknir ehf. is not consolidated as the Company had no operations during the year.

17. Investments in other companies

Investments in other companies are as follows:

	2011		2010	
	Share	Carrying amount	Share	Carrying amount
Keilir ehf., Iceland	11.3%	17.500	11.3%	17.500
Vistorka hf., Iceland	11.3%	9.575	11.3%	9.575
Total		27.075		27.075

18. Bonds

	2011	2010
Non-current		
Financial assets at fair value through profit or loss, Reykjanesb. bonds	405.201	495.604
	405.201	495.604
Current		
Financial assets at fair value through profit or loss, Reykjanesb. bonds	70.428	0
Available for sale financial assets, HS Veitur hf. bonds	0	647.793
	70.428	647.793

Interest-bearing financial assets designated through profit or loss, with a carrying amount of ISK 476 million at 31 December 2011 (2010: ISK 496 million) have stated interest rates of 5.0% plus indexation, annual installments and mature in the year 2019. The bond is valued at 5.0% interest rate which is based on a valuation from an external expert.

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18. Bonds, continued:

During the year 2011 an agreement with Reykjanesbær was reached. Reykjanesbær paid an ISK 100 million installment to the bond and the bond now pays annual equal installments until the year 2019.

During the year all HS Veitur hf. bonds were sold.

19. Embedded derivatives in power purchase agreements

The Company signed in 2004 power purchase agreements with Nordural on power supply until the years 2011 and 2026. The Company has also signed in 1999 an agreement with Landsvirkjun on the sale of power until the year 2019. The agreements are all in USD and are partly linked to the price of aluminium.

The long-term power purchase agreements feature embedded derivatives, on which income is contingent upon changes in the future price of aluminium.

In evaluating the value of embedded derivatives, generally accepted valuation methods are applied, as the market value is not available. The fair value of the agreements is calculated on the basis of the forward price of aluminium and experts' projections. The expected present value of cash flows on the reporting date is calculated on the basis of the registered forward price of aluminium with the London Metal Exchange (LME) over the next 10 years after the reporting date and expectations of price trends of aluminium when a forward market ends, and growth applied to the calculation was 2.19% (2010: 0.52%). The expected present value of cash flows, from the agreements, on the agreement date is deducted from this value based on aluminium price presumptions used as the basis for the conclusion of the agreements. The difference is a fair value change of the derivative, which is recognized in profit or loss. Embedded derivatives in power purchase agreements are expected to have no value at the beginning of the agreements.

In addition, the Company has concluded that power purchase agreements with Landsvirkjun where the power price is based on Landsvirkjun's price list, with indexation in ISK, do not include embedded derivatives.

Fair value of embedded derivatives are as follows:	2011	2010
Fair value of embedded derivatives at 1.1.	5.926.622	7.322.617
Changes in fair value	(1.465.215)	(1.395.995)
Fair value of embedded derivatives at 31.12.	4.461.407	5.926.622

20. Deferred tax asset

Deferred tax asset is as follows:

	2011	2010
Deferred tax asset on 1.1.	276.318	483.954
Effect of changes in tax rate	0	27.632
Origination and reversal of temporary difference	223.163	(235.268)
Deferred tax asset on 31.12.	499.481	276.318

In December 2010 the tax rate applicable for the year 2011 increased from 18% to 20%.

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20. Deferred tax asset, continued:

Deferred tax asset is as follows at the year end:

	2011	2010
Operating assets	(35.350)	(38.453)
Derivatives	(668.690)	(953.506)
Long term receivables	(40.185)	(19.797)
Inventories	3.399	3.399
Trade and other receivables	9.328	7.600
Pension obligation	315.300	280.000
Deferred foreign exchange loss (gain)	50.911	(40.690)
Tax losses carried forward	864.768	1.037.765
Deferred tax asset on 31.12.	499.481	276.318

Tax loss carry-forward can be utilized over 10 years from the date that the loss is incurred. Tax loss carry - forward at year end amounted to ISK 4,324 million and is useable to the year 2018 (2009: ISK 5,189 million). Management has concluded, based on their projections, that there will be sufficient taxable profit in the future to use the tax loss carried forward.

21. Prepaid lease and royalty fee

The Board of the company has exercised the right to convert the long term receivable with Grindavíkurbær following the sale of land, into prepaid royalty fee and land lease. The prepaid royalty fee and land lease is classified as a long term receivable and will be expensed over the remaining life of the long term receivable (63 years).

22. Receivables

Long-term receivables

Long term receivables are specified as follows:

	2011	2010
Receivable due to sale of land	0	460.238
Long term receivable from HS veitur hf. due to pension liability	200.926	98.983
Total long term receivables	200.926	559.221

Trade and other receivables

Trade and other receivables are specified as follows:

	2011	2010
Trade receivables	874.445	878.724
Receivable from HS veitur hf.	231.335	175.296
Allowance for bad debt	(46.638)	(38.000)
Total trade receivables	1.059.142	1.016.020
Other receivables	66.457	54.566
Total trade and other receivables	1.125.599	1.070.586

The Company's exposure to credit and currency risks and impairment losses related to trade and other receivables is disclosed in note 30.

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23. Cash and cash equivalents

Cash and cash equivalents are as follows:

	2011	2010
Bank balances	1.304.713	1.043.250
Cash and cash equivalents	1.304.713	1.043.250

At year end 2011 cash in the amount of ISK 554 million (USD 4.5 million) (2010: ISK 517 million) is defined as restricted. The cash is dedicated to secure loan payments in accordance with a collateral agreement concluded in March 2010 with the Company's lenders.

The Company's exposure to interest rate risk and sensitivity analysis for financial assets and liabilities is disclosed in note 30.

24. Equity

Issued capital

Issued share capital, as stipulated in the Company's Articles of Association, amounted to ISK 6,963 million. One vote is attached to each share of one ISK in the Company in addition to rights to receive dividends. All issued capital has been paid for.

Outstanding number of ordinary shares	2011	2010
Outstanding shares on 1 January	6.962.919	6.118.387
Share capital increase	0	844.532
Outstanding shares on 31 December	6.962.919	6.962.919

Share premium

Share premium represents excess of payment above nominal value (ISK 1 per share) that shareholders have paid for shares sold by the Company. According to Icelandic Companies Act, 25% of the nominal value of share capital must be held in reserve which can not be paid out as dividend to shareholders.

Translation reserve

The translation reserve comprises of all foreign currency differences arising from the translation of the company's proportionate share in certain associates.

Revaluation reserve

The revaluation reserve relates to the revaluation of operating assets, net of income tax. The revaluation reserve may not be distributed as dividends to the Company's shareholders.

Reserve for shares in associate

The reserve for shares in associate in 2010 and 2011 comprised of HS Orka hf. share in a put option regarding its own shares in an associate.

Dividends

No dividend was paid during the years 2011 and 2010.

25. Earnings per share

Basic and diluted (loss) earnings per share	2011	2010
(Loss) profit for the year	(936.754)	864.562

Weighted average number of ordinary shares		
Shares on 1 January	6.962.919	6.118.387
Effect of share capital increase	0	640.156
Weighted average number of ordinary shares	6.962.919	6.758.543
Basic and diluted (loss) earnings per share	(0,13)	0,13

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26. Loans and borrowings

This note provides information about the contractual terms of the Company's interest-bearing loans and borrowings, which are measured at amortized cost. For more information about the Company's exposure to interest rate, foreign currency and liquidity risk, see note 30.

	2011	2010
Non-current debt		
Unsecured bank loans	470.792	590.865
Secured bank loans with covenants	16.379.996	16.926.577
Unsecured bond issue	2.727.228	3.005.034
Current maturities	(2.101.388)	(1.951.594)
Non-current debt	17.476.628	18.570.882
Current debt		
Current maturities	2.101.388	1.951.594
Current loans and borrowings	2.101.388	1.951.594
Total interest-bearing loans and borrowing	19.578.016	20.522.476

Terms of Loans and borrowings

Debt in foreign currency:		2011		2010	
	Final due date	Weighted average interest rate	Carrying amount	Weighted average interest rate	Carrying amount
Loans in CHF	2019-2021	2,2%	4.884.749	2,3%	5.115.667
Loans in EUR	2019-2021	3,7%	3.401.620	3,5%	3.881.076
Loans in USD	2019-2023	2,7%	3.358.273	2,5%	3.545.391
Loans in JPY	2019-2023	1,7%	2.089.799	1,7%	2.035.249
Loans in CAD	2021-2023	1,8%	1.399.400	1,8%	1.397.604
Loans in SEK	2021	5,4%	818.776	4,4%	911.210
Loans in GBP	2017-2019	1,4%	427.379	1,2%	442.909
			16.379.996		17.329.106
Loans in ISK:					
Indexed loans in ISK	2016-2017	4,0%	2.890.530	4,0%	3.193.370
Other loans in ISK	2031	5,3%	307.490		0
			3.198.020		3.193.370
Total interest-bearing loans and borrowings			19.578.016		20.522.476

Annual maturities of loans and borrowings are as follows:	2011	2010
Year 2012/2011	2.101.388	1.951.594
Year 2013/2012	2.262.302	2.128.825
Year 2014/2013	2.282.475	2.147.502
Year 2015/2014	2.303.458	2.166.931
Year 2016/2015	2.325.283	2.187.145
Subsequent	8.303.110	9.940.479
Total interest-bearing loans and borrowings	19.578.016	20.522.476

During the year a foreign exchange loan with Landsbankinn was recalculated into ISK, resulting in an exchange gain amounting to ISK 103 million. The exchange gain is recognised among net foreign exchange difference. The loan is now dominated in Icelandic krona.

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26. Loans and borrowings, continued:

Covenants

At the end of the year 2009, the Company signed temporary agreements with its lenders with revised covenants and interest rates for the years 2009 and 2010. One of these temporary agreements was extended for the year 2011 by one of the banks (European Investment Bank) but further waivers were not needed for the other two banks. This waiver has now been extended for 2012. In early 2012, the Company amended the loan agreement with Nordic Investment Bank. At year end 2011 the Company complies with all applicable covenants.

27. Pension obligations

According to actuaries' assessment, the Company's accrued pension obligation amounted to ISK 1,577 million at year end 2011 (2010: ISK 1,400 million), discounted based on an interest rate of 2%, taken into account its share in the net asset of the pension funds. Presumptions on life expectancy, mortality rate and discount rate are in accordance with provisions of Regulation no. 391/1998 on obligatory pension right insurance and pension funds' operation. The estimated increase in the obligation in the year is based on general salary increase taken into account interests. The Company's pension obligation is uncapitalized.

A part of the pension obligation pertains to the Company's employees providing services to HS Veitur hf. and HS Veitur hf. participates in the cost of the increase in these employees' pension obligation. HS Veitur hf.'s share in the increase in the pension obligations during the year amounted to ISK 102 million (2010: ISK 16 million) and is recognized as long term receivable from HS Veitur hf.

	2011	2010
Pension commitment at 1.1.	1.400.000	1.375.700
Contribution during the year	(65.565)	(68.318)
Increase in obligation due to interests, salaries and change in fund's net assets	242.065	92.618
Pension obligation at 31.12.	1.576.500	1.400.000

Pension obligations are as follows:

	2011	2010
The pension fund for State employees	839.200	773.755
The pension fund for Municipality of Hafnarfjörður employees	442.000	372.645
The pension fund for Municipality of Westman Islands employees	295.300	253.600
Pension fund obligation at 31.12.	1.576.500	1.400.000

28. Currency and interest rate swap contracts

The Company held long term currency and interest rate swaps contracts with Glitnir hf., which was taken over by the Financial Supervisory Authority (FSA) in October 2008.

The swaps are recognized as a liability in the Company's financial statements based on the exchange rate ruling at year end 2011, amounting to ISK 1,118 million (2010: ISK 1,159 million) including due payments. It is uncertain whether the Company is obliged to settle the swap or not. There is uncertainty regarding the date and exchange rate that will be applied on settlement of the swaps.

The swaps at year end 2011 were classified as current and long term based on the term of the swaps.

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29. Trade and other payables

Trade and other payables are as follows:

	2011	2010
Trade payables	453.776	339.475
Debt related to assets under construction	174.394	252.398
Other payables	606.107	566.172
Total trade and other payables	1.234.277	1.158.045

The Company's exposure to currency and liquidity risk related to trade and other payables is disclosed in note 30.

30. Financial instruments

Overview

The Company's activities exposed to financial risk consists of market risk, credit risk and liquidity risk. Market risk consists of interest rate risk and currency risk.

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

Risk management framework

The risk management is carried out by the management under policies approved by the Board of Directors. Management identifies, evaluates and manages financial risk in close co-operation with the Board of Directors. The Company's overall risk management program focuses on the unpredictability of financial markets and seeks to minimize potential adverse effects on the Company's financial performance. The Company determines whether or not to use derivative financial instruments to hedge certain risk exposures if they are available. The Company does not currently hedge its risk exposure except for part of its currency risk where revenues in USD are hedged against loans in USD.

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.

The Company's exposure to credit risk is influenced mainly by the individual characteristics of each customer. Approximately 64% (2010: 68%) of the Company's revenue is attributable to sales transactions with the two customers. Trade and other receivables are receivables from retail customers, companies, large consumers and power companies.

The Company has set a credit policy where all new significant customers are evaluated for credit risk. Payment history of those customers is checked.

Most of the Company's customers have been customers for many years and loss on receivables has been insignificant in proportion to turnover. Credit risk management includes taking into account the age of the receivables and financial standing of each customer. The list of aged receivables is reviewed on a regular basis by the credit controller. Customers that are behind in payments can not make further transactions with the Company unless they settle their debt or the Company's collection department approves further transactions based on an agreement. As a result of the deteriorating economic circumstances in 2008 through 2011, a shorter time is given to a non-payment customer before delivery to the customer is cancelled.

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30. Financial instruments, continued:

Credit risk, continued:

The Company establishes an allowance for impairment that represents an estimate of expected losses of trade and other receivables. The main components of this allowance are a specific loss component that relates to individually significant exposures, and a collective loss component established for Company's with similar receivables in respect of losses that have been incurred but not yet identified. The collective loss allowance is determined based on historical data of payment statistics for similar receivables.

Exposure to credit risk

The carrying amount of financial assets represents the maximum credit exposure. The maximum exposure to credit risk at the reporting date was:

	Notes	2011	2010
Bonds		475.629	1.143.397
Long term receivables		200.926	559.221
Trade and other receivables	22	1.125.599	1.070.586
Cash and cash equivalents	23	1.304.713	1.043.250
		3.106.867	3.816.454

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

	2011	2010
Large users and power companies	401.245	502.423
Receivable from HS Veitur	231.335	175.296
Other customers	473.200	376.301
	1.105.780	1.054.020

Impairment

The aging of trade receivables and impairment at the reporting date was:

	2011		2010	
	Gross value	Impairment	Gross value	Impairment
Not past due	1.013.649	1.962	914.379	0
Past due 0 - 30 days	14.240	1.134	48.257	603
Past due 31 - 60 days	6.704	967	20.935	314
Past due 61 - 90 days	6.520	1.630	8.627	431
Past due more than 91 days	64.667	40.945	61.822	36.652
	1.105.780	46.638	1.054.020	38.000

The movement in the allowance for impairment in respect of trade receivables during the year was as follows:

	2011	2010
Balance at 1.1.	38.000	28.000
Impairment losses recognized	8.638	10.000
Balance at 31.12.	46.638	38.000

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30. Financial instruments, continued:

Liquidity risk:

Liquidity risk is the risk that the Company will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset. The Company'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, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the Company's reputation.

The Company has not made agreements for loan facilities and had no unused loan facilities at year end 2011 and 2010.

Exposure to liquidity risk

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

	Carrying amount	Contractual cash flows	Less than one year	1 - 2 years	2- 5 years	After 5 years
31 December 2011						
Loans and borrowing	19.578.016	23.045.866	2.834.592	2.860.536	8.138.254	9.212.484
Trade and other payables	1.234.277	1.234.277	1.234.277			
Derivatives	1.117.953	1.079.906	354.259	102.882	511.700	111.065
31 December 2010						
Loans and borrowings	20.522.476	23.758.420	2.538.836	2.692.576	8.117.846	10.409.162
Trade and other payables	1.158.045	1.158.045	1.158.045			
Derivatives	1.159.091	1.072.839	268.698	73.014	440.173	290.954

Market risk

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

Currency risk

The Company is exposed to currency risk on sales, purchases and borrowings that are denominated in a currency other than ISK. The currencies in which these transactions primarily are denominated are US Dollar (USD), Swiss Francs (CHF), Euro (EUR), Canadian Dollar (CAD), Swedish Kronas (SEK) and Japanese Yen (JPY).

Due to market conditions in Iceland the Company is currently not able to hedge against foreign exchange rate risk as there is no counterparty for forward contracts or other derivatives available in Iceland. The Company does hedge a portion of its revenue in USD with borrowings in USD. The company holds USD cash at year end amounting to ISK 1,115 million (2010: ISK 776 million) for repayments of loans in foreign currencies.

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30. Financial instruments, continued:

Exposure to currency risk

The Company's exposure to foreign currency risk is as follows:

	CHF	EUR	USD	JPY	CAD	Other currencies
2011						
Derivatives	(1.673.603)	(513.616)	3.807.147	(691.888)	0	(257.730)
Receivables		3.922	190.514			
Cash and cash equivalents		2.685	1.115.208			
Loans and borrowings	(4.884.748)	(3.401.620)	(3.358.273)	(2.089.799)	(1.399.400)	(1.246.155)
Payables			(32.648)		(2.635)	
Balance sheet risk	(6.558.351)	(3.908.629)	1.721.948	(2.781.687)	(1.402.035)	(1.503.885)
Estimated sale 2012			2.447.843			
Estimated purchases 2012			(379.200)			
Gross foreign exchange rate risk	0	0	2.068.643	0	0	0
Net foreign exchange rate risk	(6.558.351)	(3.908.629)	3.790.591	(2.781.687)	(1.402.035)	(1.503.885)

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30. Financial instruments, continued:
Currency risk, continued:
Exposure to currency risk, continued:

	CHF	EUR	USD	JPY	CAD	Other currencies
2010						
Derivatives	(1.820.496)	(574.276)	5.217.275	(713.385)	0	(280.618)
Receivables			300.602			
Cash and cash equivalents		14.134	776.193			
Loans and borrowings	(5.115.667)	(3.881.076)	(3.545.391)	(2.035.249)	(1.397.604)	(1.354.119)
Payables		(43.184)	(47.449)	(209.214)	(5.544)	
Balance sheet risk	(6.936.163)	(4.484.402)	2.701.230	(2.957.848)	(1.403.148)	(1.634.737)
Estimated sale 2011			3.101.127			
Estimated purchases 2011			(552.000)			
Gross foreign exchange rate risk	0	0	2.549.127	0	0	0
Net foreign exchange rate risk	(6.936.163)	(4.484.402)	5.250.357	(2.957.848)	(1.403.148)	(1.634.737)

The following exchange rates were used during the year:

	Average exchange rate		End of year exchange rate	
	2011	2010	2011	2010
CHF	131,56	117,56	131,02	123,25
EUR	161,87	162,34	159,28	154,23
USD	116,35	122,33	123,00	115,60
JPY	1,46	1,40	1,59	1,42
CAD	117,65	118,80	120,56	115,60

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

	Profit or (loss)	
	2011	2010
CHF	524.668	568.765
EUR	312.690	367.721
USD	(137.756)	(221.501)
JPY	222.535	242.544
CAD	112.163	115.058
Other	120.311	134.048

A 10 percent weakening of the ISK against the above currencies at 31 December would have had the equal but opposite effect on profit or loss after tax to the amounts shown above, on the basis that all other variables remain constant. The analysis is performed on the same basis for the year 2010.

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30. Financial instruments, continued:
Interest rate risk

The majority of the Company's long term borrowings are subject to variable interest rates. Due to current market conditions in Iceland the Company does not currently hedge its interest rate risk as there is no counterparty for forward contracts or other derivatives available in Iceland.

Exposure to interest rate risk

Interest-bearing financial assets and liabilities are as follows at the year end:	2011	2010
Financial instruments with fixed interest rate		
Financial assets	475.629	1.603.635
Financial liabilities	(2.890.530)	(3.193.370)
	(2.414.901)	(1.589.735)
Financial instruments with floating interest rate		
Financial assets	1.304.713	1.043.250
Financial liabilities	(16.687.486)	(17.329.106)
	(15.382.773)	(16.285.856)
Derivatives		
Embedded derivatives	4.461.407	5.926.622
Currency and interest rate swap	(1.117.953)	(1.159.091)
	3.343.454	4.767.531

Fair value sensitivity analysis for fixed rate instruments:

An increase or decrease of 100 basis points in interest rates at the reporting date would have increased (decreased) profit or loss and equity after tax by the amounts shown below. This analysis assumes that all other variables, in particular foreign currency rates, remain constant. The analysis was performed on the same basis for the year 2010.

	Equity		Profit or loss	
	100 bp increase	100 bp decrease	100 bp increase	100 bp decrease
2011				
Financial assets	(13.355)	14.226	(13.355)	14.226
Fair value sensitivity analysis, net	(13.355)	14.226	(13.355)	14.226
2010				
Financial assets	(41.055)	44.448	(33.179)	36.265
Fair value sensitivity analysis, net	(41.055)	44.448	(33.179)	36.265

Fair value sensitivity analysis for derivatives

An increase or decrease in interest rates of 100 basis points at the reporting date would have increased (decreased) the return after tax by the following amounts. This analysis is based on that all other variables, in particular foreign currency rates, remain constant. The analysis was performed on the same basis for the year 2010.

	Profit or loss	
	100 bp increase	100 bp decrease
2011		
Embedded derivatives	(228.068)	272.300
Currency and interest rate swap	(55.819)	58.445
Fair value sensitivity analysis, net	(283.887)	330.745

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30. Financial instruments, continued:

	Profit or loss	
	100 bp increase	100 bp decrease
2010		
Embedded derivatives	(245.387)	268.519
Currency and interest rate swap	(72.238)	76.042
Fair value sensitivity analysis, net	(317.625)	344.561

Cash flow sensitivity analysis for floating interest rate instruments

An increase or decrease in interest rates of 100 basis points at the reporting date would have increased (decreased) the return after tax by the following amounts. This analysis is based on that all other variables, in particular foreign currency rates, remain constant. The analysis was performed on the same basis for the year 2010.

	Profit or loss	
	100 bp increase	100 bp decrease
2011		
Financial instruments with floating interest rates	(133.576)	133.576
Cash flow sensitivity analysis, net	(133.576)	133.576
2010		
Financial instruments with floating interest rates	(137.578)	137.578
Cash flow sensitivity analysis, net	(137.578)	137.578

Aluminium price risk

The Company has entered into power purchase agreements with Norðurál on power supply until the year 2026. The Company has also entered into an agreement with Landsvirkjun on the sale of power until the year 2019. The agreements are in USD and the contract price of power is based on the world market value of aluminum. The Company does not currently hedge against aluminum price change.

Sensitivity analysis

A 10 percent increase or decrease of aluminium prices at 31 December would have increased (decreased) profit or loss after tax by the amounts shown below. The analysis was performed on the same basis for 2010.

	Profit or (loss)	
	2011	2010
Increase of 10%	2.364.782	2.441.117
Decrease of 10%	(2.364.782)	(2.441.117)

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30. Financial instruments, continued:

Fair value

Fair value versus carrying amounts

The fair values of financial assets and liabilities, together with the carrying amounts shown in the statement of financial position, are as follows:

	2011		2010	
	Carrying amount	Fair value	Carrying amount	Fair value
Interest-bearing long-term debts	(19.578.016)	(19.543.205)	(20.522.476)	(19.883.342)
	(19.578.016)	(19.543.205)	(20.522.476)	(19.883.342)

The basis for determining fair values is disclosed in note 4.

Interest rates used for determining fair value

The interest rates used to discount estimated cash flows, where applicable, are based on the government yield curve at the reporting date in the case of ISK denominated debt, embedded derivatives and bonds. For foreign denominated debt the discount rates are based on interbank rates. All discount rates include an adequate credit spread, and were as follows:

Interest rates used for determining fair value:

	2011	2010
Embedded derivatives in power purchase agreements (USD)	2.25 - 4.61%	1.79 - 5.59%
Bonds	5.0%	5.3 - 6.5%
Interest bearing long term liabilities	Libor + 250 bp	Libor + 275 bp

Currency and interest rate swaps are discounted at swap rates for foreign currency denominated legs and the Housing Finance Fund curve for ISK CPI indexed legs.

Fair value hierarchy:

The table below analyses 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 or 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).

	Level 2	Level 3	Total
31 December 2011			
Embedded derivatives	256.415	4.204.992	4.461.407
Bonds	475.628		475.628
Other derivatives	(850.610)		(850.610)
Investment in other companies		27.075	27.075
Total	(118.567)	4.232.067	4.113.500
31 December 2010			
Embedded derivatives	664.934	5.261.688	5.926.622
Bonds	647.793	495.604	1.143.397
Other derivatives	(934.950)	0	(934.950)
Investment in other companies	0	27.075	27.075
Total	377.777	5.784.367	6.162.144

No financial assets or liabilities are classified as level 1.

Embedded derivatives that expire in the year 2026 are classified in level three due to the fact that the forward market for aluminium only reaches maximum of ten years.

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30. Financial instruments, continued:

Other market risk

Other market value risk is related to investments in bonds and shares.

Classification of financial instruments

Financial assets and liabilities are classified as follows:

	Financial liabilities measured at amortized cost	Loans and receivables	Financial assets designated at fair value through profit and loss	Financial assets and liabilities held for trading	Financial assets available for sale	Carrying amount
2011						
Shares			27.075			27.075
Bonds			475.629			475.629
Derivatives				4.461.407		4.461.407
Trade receivables		1.059.142				1.059.142
Other receivables		267.383				267.383
Cash		1.304.713				1.304.713
Total assets	0	2.631.238	502.704	4.461.407	0	7.595.349
Loans and borrowings	19.578.016					19.578.016
Derivatives				1.117.953		1.117.953
Trade payables	628.170					628.170
Other payables	606.107					606.107
Total liabilities	20.812.293	0	0	1.117.953	0	21.930.246
2010						
Shares			27.075			27.075
Bonds			495.604		647.793	1.143.397
Derivatives				5.926.622		5.926.622
Trade receivables		1.016.020				1.016.020
Other receivables		613.787				613.787
Cash		1.043.250				1.043.250
Total assets	0	2.673.057	522.679	5.926.622	647.793	9.770.151
Loans and borrowings	20.522.476					20.522.476
Derivatives				1.159.091		1.159.091
Trade payables	591.873					591.873
Other payables	566.172					566.172
Total liabilities	21.680.521	0	0	1.159.091	0	22.839.612

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31. Capital management

The Board's policy is to maintain a strong capital base to sustain future development of the business.

The Company's Board of Directors seeks to maintain a balance between the higher returns that might be possible with higher levels of borrowings and the advantages and security afforded by a sound capital position. The equity ratio was 41.4% at year end 2011 (2010: 41.6%).

There were no changes in the Company's approach to capital management during the year and the Company is not obliged to comply with external rules on minimum equity other than those related to covenants in its loan agreements.

32. Guarantees

Due to the division of Hitaveita Suðurnesja hf. into HS Orka hf. and HS Veitur hf. in 2008 the Company is liable for the liabilities of HS veitur hf. at division date. The Guarantee amounts to a maximum of ISK 37 million at year end 2011.

33. Other matters

Litigations and claims

In 2007, HS Orka hf., entered into a conditional power sale agreement with Nordural (Helguvik) to sell power from a new power plant at Reykjanes, which is currently being prepared, to a new aluminum smelter in Helguvík. The agreement contained a number of conditions, which were not fulfilled by the time set out in the agreement. Accordingly, HS Orka hf. held the view that the agreement had lapsed in accordance with its terms but Nordural disputed this interpretation and maintained that the agreement was in force and that conditions had been met. Nordural initiated, in July 2010, arbitration proceedings according to the agreement to determine the validity of the agreement. The arbitrators gave their final award on 16 December 2011. According to the award the agreement from 2007 is valid but the conditions have not been fulfilled. Nordural and HS Orka hf. continue to work together to determine if the conditions will be fulfilled at some future date or if the agreement can be amnded to provide for the delivery of power on agreed terms.

HS Orka hf initiated on 16 December 2011 arbitration proceedings towards Nordural Grundartangi concerning interpretation of clauses in the Power Purchase Agreement for Grundartangi concerning minimum purchase of power. The full amount was accrued in the end of the year. Results are expected late in 2012.

Trölladyngja

According to the first recommendation of the steering committee of “Rammaáætlun II” to the parliament, regarding categorizing the potential hydro and geothermal power sites in three groups: protected site, pending site and power developing site, the Trölladyngja area is categorized as a pending site where more information and data is required. The recommendation is now for dictums at all stake holders. HS Orka hf. has formerly opposed the recommendation with respect to Trölladyngja. If the recommendation is adopted HS Orka hf. would immediately assess the impact on the carrying value of Trölladyngja. The carrying amount of those assets is ISK 675 million.

34. Related parties

Identity of related parties

The Company has a related party relationship with its shareholders, associates, fellow subsidiaries, HS Veitur hf., its directors and executive officers and other companies owned by them.

The Company sold to one shareholder services in the amount of ISK 6 million in the year 2011 (2010: ISK 1 million).

The Company purchased goods and services from an associate company in the amount of ISK 19 million in the year 2011 (2010: ISK 14 million).

The Company sold goods to an associate company in the amount of ISK 36 million (2010: ISK 28 million).

The Company purchased services from fellow subsidiary in the amount of ISK 18 million in the year 2011 (2010: ISK 25 million). At year end trade payables to fellow subsidiaries amounted to ISK 4 million (2010: ISK 4 million).

Sales to HS Veitur hf. amounted to ISK 1,725 million during the year (2010: ISK 1,618 million). Purchases from HS Veitur hf. amounted to ISK 18 million (2010: ISK 18 million). At year end the receivables from HS Veitur hf. amounted to ISK 231 million to HS Veitur (2010: ISK 163 million).

Unaudited financial information

35. Quarterly Statements

Summary of the Company´s results by quarters:

2011	Q1	Q2	Q3	Q4	Total
Operating revenue	1.952.953	1.849.929	1.747.765	1.880.737	7.431.384
Production cost and cost of sales	(1.282.087)	(1.148.883)	(1.236.003)	(1.305.362)	(4.972.335)
Gross profit	670.866	701.046	511.762	575.375	2.459.049
Other operating expenses	(164.880)	(188.528)	(134.443)	(269.095)	(756.946)
Results from operating activities	505.986	512.518	377.319	306.280	1.702.103
Finance income	27.363	45.206	384.714	(261.322)	195.961
Finance costs	(469.922)	(907.407)	(184.326)	(33.034)	(1.594.689)
Changes in fair value of derivatives	118.259	(95.143)	127.138	(109.118)	41.136
Changes in fair value of embedded derivatives in power purchase agreements	2.607.744	(1.481.875)	(2.938.843)	347.759	(1.465.215)
Net finance income (costs)	2.283.444	(2.439.219)	(2.611.317)	(55.715)	(2.822.807)
Share of (loss) profit of associates	(683)	64.423	101.100	(204.053)	(39.213)
Profit (loss) before income tax	2.788.747	(1.862.278)	(2.132.898)	46.512	(1.159.917)
Income tax	(557.749)	385.203	446.793	(51.084)	223.163
Profit (loss) for the period	2.230.998	(1.477.075)	(1.686.105)	(4.572)	(936.754)
Other comprehensive income:					
Foreign currency translation difference of associates	18.401	7.644	(22.826)	(2.312)	907
Other comprehensive income (loss)	18.401	7.644	(22.826)	(2.312)	907
Total comprehensive income (loss)	2.249.399	(1.469.431)	(1.708.931)	(6.884)	(935.847)

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Unaudited financial information, contd.:

Quarterly Statements, contd.:

2010	**Q1**	**Q2**	**Q3**	**Q4**	**Total**
Operating revenue	1.812.280	1.731.587	1.599.726	1.850.180	6.993.773
Production cost and cost of sales ...	(1.257.949)	(1.102.659)	(1.090.908)	(1.241.237)	(4.692.753)
Gross profit	554.331	628.928	508.818	608.943	2.301.020
Other operating expenses	(55.716)	(177.365)	(75.794)	(96.855)	(405.730)
Results from operating activities .	498.615	451.563	433.024	512.088	1.895.290
Finance income	83.880	717.637	783.162	(420.933)	1.163.746
Finance costs	(316.856)	(247.239)	(186.252)	(112.062)	(862.409)
Changes in fair value of derivatives	46.362	169.609	254.494	(64.519)	405.946
Changes in fair value of embedded derivatives in power purchase agreements	1.210.597	(5.315.017)	3.075.726	(367.301)	(1.395.995)
Net finance income (costs)	1.023.983	(4.675.010)	3.927.130	(964.815)	(688.712)
Share of (loss) profit of associates .	(58.544)	(104.860)	59.192	(73.255)	(177.467)
Profit (loss) before income tax	1.464.054	(4.328.307)	4.419.346	(525.982)	1.029.111
Income tax	(274.068)	742.137	(784.828)	152.210	(164.549)
Profit (loss) for the period	1.189.986	(3.586.170)	3.634.518	(373.772)	864.562
Other comprehensive income:					
Foreign currency translation difference of associates	(26.134)	(41.449)	(3.875)	(39.291)	(110.749)
Effects of changes in tax rate				(43.089)	(43.089)
Other comprehensive loss	(26.134)	(41.449)	(3.875)	(82.380)	(153.838)
Total comprehensive income (loss)............................	1.163.852	(3.627.619)	3.630.643	(456.152)	710.724

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