HS Orka hf.

Financial Statements
for the year 2012
ISK

HS Orka hf.
Brekkustígur 36
260 Reykjanesbær

Reg.no. 680475-0169

Contents

Endorsement by the Board of Directors and Management

The financial statements of HS Orka hf. (the Company or "HS Orka") for the year 2012 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 income (loss), the Company's operating revenue amounted to ISK 6,881 million for the year 2012 (2011: ISK 7,431 million) and the profit for year 2012 amounted to ISK 600 million (2011: ISK 937 million loss). Total comprehensive income amounted to ISK 5,509 million (2011: ISK 936 million comprehensive loss). According to the statement of financial position, the Company's assets amounted to ISK 49,826 million at year end 2012 (2011: ISK 39,904 million). Equity amounted to ISK 26,605 million at the end of the year 2012 (2011: ISK 16,397 million) or 53.4% of total capital (2011: 41.1%).

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

The Company's power plants were revalued to fair value on 31 December 2012 by calculating the present value of estimated cash flows from the operating assets. Revaluations are performed regularly and this revaluation is a part of normal periodic process. 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 cash-flow was estimated for the next twenty years and expected future value calculated for the years thereafter. The result of the revaluation was an increase in the fair value of the two power plants of 6.1 billion.

The Company's shareholders numbered two at the end of 2012, there was no change in the number of shareholders during the year. At the end of 2012 Magma Energy Sweden A.B. held 66.6% of the shares in HS Orka hf. and Jarðvarmi slhf. held 33.4% of the shares in HS Orka hf.

The Company's Board of Directors proposes that dividends of 150 million ISK (ISK 19.13 pr. share) will be paid to shareholders in the year 2013, and refers to the financial statements for further allocation of profit and changes in equity during the year.

The board had 12 meetings and the Audit committee had 4 meetings in 2012.

Statement of Corporate Governance

The Board of Directors of HS Orka hf. emphasizes maintaining good management practices. The Board of Directors is of the opinion that practicing good corporate governance is vital for the existence of the Company and in best interest of the shareholders, employees and other stakeholders and will in the long run produce satisfactory profits on shareholders investments. The framework on corporate governance is made in accordance with Article 66-c of the Icelandic Financial Statements Act No. 3/2006, as amended. This statement has been approved by the Board of Directors and is also published in the Company’s Annual Report. This statement covers the financial year ended on 31 December 2012. The Board of Directors has prepared a corporate government statement in compliance with the Icelandic Corporate Governance guidelines which are described in full in the corporate governance statement in the appendix to the financial statements.

It is the opinion of the Board of Directors that HS Orka hf. complies with the Icelandic guidelines for Corporate Governance.

Endorsement by the Board of Directors and Management, continued.:

Statement by the Board of Directors and Management

To the best knowledge of the Board of Directors and 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 Management that the financial statements give a true and fair view of the Company's assets, liabilities and financial position as at 31 December 2012, its financial performance, and the changes in cash flows during the year 2012.

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 2012 and confirmed by means of their signatures. The Board of Directors and Management will submit the financial statements for approval at the annual general meeting to be held at 25 March 2013.

Reykjanesbær, 27 February 2013.

The Board of Directors:

Ásgeir Margeirson
Gylfi Árnason
John Carson
Anna Skúladóttir
Ross Beaty

Chief Executive Officer

Júlíus Jónsson

Assistant Chief Executive Officer

Albert Albertsson

Independent Auditors' Report

To the Board of Directors and shareholders 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 2012, the statements of comprehensive income, changes in equity and cash flows for the year then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

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

Auditors´ 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 2012, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the EU.

Report on the Board of Directors Report

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

Reykjanesbær, 27 February 2013.

KPMG ehf.

Sæmundur Valdimarsson

Margret G. Flóvenz

Statement of Comprehensive Income (Loss) for the year ended 31 December 2012

	Note	2012	2011
Operating revenue	5	6,880,577	7,431,384
Production cost and cost of sales	7	(4,592,056)	(4,972,335)
Gross profit		2,288,521	2,459,049
Other operating expenses	8	(433,179)	(756,946)
Results from operating activities		1,855,342	1,702,103
Finance income		326,655	195,961
Finance costs		(1,424,188)	(1,594,689)
Changes in fair value of currency and interest rate swap contracts		(20,018)	41,136
Changes in fair value of embedded derivatives in power sales contracts		(200,736)	(1,465,215)
Net finance expenses	11	(1,318,287)	(2,822,807)
Share of profit (loss) of associates	16	170,274	(39,213)
Profit (loss) before income tax		707,329	(1,159,917)
Income tax	12	(107,411)	223,163
Profit (loss) for the year		599,918	(936,754)
Other comprehensive income			
Revaluation of operating assets	13	6,090,242	0
Income tax effect of revaluation		(1,218,048)	0
Foreign currency translation difference of associates		36,923	907
Other comprehensive income for the year, net of income tax		4,909,117	907
Total comprehensive income (loss) for the year		5,509,035	(935,847)
Earnings (loss) per share			
Basic and diluted earnings (loss) per share	26	0.08	(0.13)

Notes on pages 10 to 44 are an integral part of these financial statements

Financial Statements 31 December 2012 of HS Orka hf. 6 All amounts are in thousands of ISK

Statement of Financial Position
as at 31 December 2012

Assets	Note	2012	2011
Operating assets	13	31,494,192	25,803,349
Operating assets under construction	14	3,664,287	3,544,465
Intangible assets	15	990,063	982,699
Investments in associates	16	740,937	655,608
Investments in other companies	17	27,075	27,075
Bonds	18	363,028	405,201
Embedded derivatives in power sales contracts	19	4,071,213	4,294,623
Deferred tax asset	20	0	499,481
Prepaid lease and royalty fee	21	475,166	454,676
Long term receivable	22	289,646	200,926
Total non-current assets		42,115,607	36,868,103
Inventories		414,088	368,386
Bonds	18	78,740	70,428
Trade and other receivables	22	1,234,576	1,125,599
Embedded derivatives in power sales contracts	19	189,458	166,784
Short term investments	23	565,800	0
Cash and cash equivalents	24	5,227,728	1,304,713
Total current assets		7,710,390	3,035,910
Total assets		49,825,997	39,904,013
Equity			
Share capital		7,841,124	6,962,919
Share premium		7,038,855	3,218,660
Translation reserve		334,465	297,542
Revaluation reserve		6,443,110	1,647,187
Retained earnings		4,947,149	4,270,960
Total equity	25	26,604,703	16,397,268
Liabilities			
Loans and borrowings	27	16,007,219	17,476,628
Pension obligations	28	1,726,700	1,576,500
Deferred tax liability	20	825,978	0
Currency and interest rate swap contracts	29	677,508	761,614
Total non-current liabilities		19,237,405	19,814,742
Loans and borrowings	27	2,381,334	2,101,388
Trade and other payables	30	1,142,086	1,234,276
Currency and interest rate swap contracts	29	460,469	356,339
Total current liabilities		3,983,889	3,692,003
Total liabilities		23,221,294	23,506,745
Total equity and liabilities		49,825,997	39,904,013

Notes on pages 10 to 44 are an integral part of these financial statements

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Statement of Changes in Equity
for the year ended 31 December 2012

	Share capital	Share premium	Translation reserve	Revaluation reserve	Reserve for shares in associate	Retained earnings	Total
2011							
Equity at 1 January 2011	6,962,919	3,218,660	296,634	1,723,505	(37,157)	5,131,395	17,295,957
Total comprehensive loss			907	0	0	(936,754)	(935,847)
Revaluation reserve transferred to retained earnings				(76,318)		76,318	0
Excercised put options 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
2012							
Equity at 1 January 2012	6,962,919	3,218,660	297,542	1,647,187	0	4,270,960	16,397,268
Total comprehensive income			36,923	4,872,194		599,918	5,509,035
Revaluation reserve transferred to retained earnings				(76,271)		76,271	0
Share capital increase	878,205	3,820,195					4,698,400
Equity at 31 December 2012	7,841,124	7,038,855	334,465	6,443,110	0	4,947,149	26,604,703

Notes on pages 10 to 44 are an integral part of these financial statements

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Statement of Cash Flows
for the year ended 31 December 2012

	Note	2012	2011
Cash flows from operating activities			
Profit (loss) for the year		599,918	(936,754)
Adjustments:			
Gain on sale of operating assets		(5,203)	(4,649)
Increase in pension obligations	28	150,200	176,500
Depreciation and amortization		1,001,834	975,633
Net finance expenses	11	1,318,287	2,822,807
Share of (profit) loss of associates	16	(170,274)	39,213
Income tax	12	107,411	(223,163)
		3,002,173	2,849,587
Inventories, increase		(45,702)	(27,460)
Receivables, increase		(150,918)	(141,636)
Current liabilities, increase		45,638	227,999
Net cash from operations before interest and taxes		2,851,192	2,908,490
Interest income received		185,976	55,203
Interest and indexation costs paid		(460,978)	(589,451)
Net cash from operating activities		2,576,190	2,374,242
Cash flows from investing activities			
Acquisition of operating assets during the year		(706,634)	(597,024)
Payments for operating assets acquired in prior year		(174,394)	(244,142)
Proceeds from sale of operating assets		6,393	5,700
Acquisition of intangible assets		(24,177)	(26,216)
Acquisition of shares in associates		(43,638)	(23,000)
Dividend received from associate		161,802	4,854
Short term investments		(550,000)	0
Proceeds from repayment and sale of bonds		78,514	734,164
Net cash used in investing activities		(1,252,133)	(145,664)
Cash flows from financing activities			
Share capital increase		4,698,400	0
Repayment of borrowings		(2,149,166)	(2,061,143)
Net cash provided by (used in) financing activities		2,549,234	(2,061,143)
Increase in cash and cash equivalents		3,873,291	167,435
Cash and cash equivalents at 1 January		1,304,713	1,043,250
Effect of exchange rate fluctuations on cash held		49,724	94,027
Cash and cash equivalents at 31 December		5,227,728	1,304,712

Investing and financing activities not affecting cash flows

		2012	2011
Dividend from associate		18,502	0
Acquisition of shares in associate		(14,801)	0
Receivables		(3,701)	0
Current liabilities		0	174,394
Acquisition of operating assets		0	(174,394)

Notes on pages 10 to 44 are an integral part of these financial statements

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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 as well as 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 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 27 February 2013.

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 sales contracts are measured at fair value
- financial instruments at fair value through profit or loss are measured at fair value (bonds and shares)

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 when otherwise indicated.

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 sales agreements
- Note 28 - pension obligations
- Note 29 - 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 in power sales agreements
- Note 20 - deferred tax assets (liabilities)
- Note 22 - provisions for bad debts
- Note 29 - currency and interest rate swap contracts

3. Significant accounting policies

The accounting policies set out herein 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

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 and loans and receivables.

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, bond asset and marketable debt securities.

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 equivalents 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:

(ii) Non-derivative financial liabilities

The Company initially recognizes debt securities issued 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:

(iv) Share capital

Ordinary shares

Incremental costs directly attributable to issuance 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 estate holdings 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 parts of an item of operating assets has 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 on a net basis 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, or 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, including software, 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 classified as at fair value through profit or loss, including an interest in an equity-accounted investee, is assessed at each reporting date to determine whether there is objective evidence that it is impaired. A financial asset is impaired if there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset, and that loss event(s) had an impact 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. In addition, for an investment in an equity security, a significant or prolonged decline in its fair value below its cost is objective evidence of impairment. The Company considers a decline of 20 percent to be significant and a period of 9 months to be prolonged.

(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 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 a 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 is comprised 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 are comprised 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 is comprised of current and deferred tax. Current tax and deferred tax are recognized in profit or loss except to the extent that they relate 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 basic EPS in these statements 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. The operating results of all operating segments for which discrete financial information is available are reviewed regularly by the Company’s management to make decisions about resources to be allocated to the segment and assess its performance.

q. New standards and interpretations

A number of new standards, amendments to standards and interpretations are effective for annual periods beginning after 1 January 2012, 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, 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 contracts at inception 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 a valuation 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 electricity, heating water and fresh water from subterranean steam.

Electricity Sale

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

Other

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

Year 2012	**Power production**	**Electricity sale**	**Other**	**Total**
External revenue	3,157,068	2,714,883	1,008,626	6,880,577
Inter-segment revenue	1,446,708			1,446,708
Total segment revenue	4,603,776	2,714,883	1,008,626	8,327,285
Segment operating results	1,608,577	189,762	57,003	1,855,342
Unallocated items				
Net finance expenses				(1,318,287)
Share of profit of associates				170,274
Income tax				(107,411)
Profit for the year				599,918
Segment assets	35,543,225	47,988	557,329	36,148,542
Unallocated assets				13,677,455
Total assets				49,825,997
Unallocated liabilities				23,221,294
Capital expenditures	718,418	2,880	9,513	730,811
Depreciation and amortization	962,272	6,385	33,177	1,001,834

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 expenses				(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

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5. Segment reporting, continued.:

Power production

Revenues in the power production segment are specified as follows:

Year 2012	Electricity	Hot water	Other	Total
External revenue	2,324,925	659,049	173,094	3,157,068
Inter-segment revenue	1,446,708			1,446,708
Total segment revenue	3,771,633	659,049	173,094	4,603,776
Year 2011				
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

6. Major customers

Revenues from one customer of the Company’s power production segment amounted to ISK 2,065 million (2011: ISK 3,020 million).

Revenues from HS Veitur hf. were as follows:

	Power production	Electricity sale	Other	Total
Revenues 2012	718,756	249,489	862,067	1,830,312
Revenues 2011	676,832	204,768	842,981	1,724,581

7. Production cost and cost of sales

Production cost and cost of sales are specified as follows:

	2012	2011
Production cost	2,677,541	2,769,758
Cost of sales	962,890	1,239,137
Cost of service	951,625	963,440
Total production cost and cost of sales	4,592,056	4,972,335

8. Other operating expenses

Operating expenses specifies as follows:

	2012	2011
Salaries and related expenses	156,687	145,435
Increase in pension fund obligation	61,480	74,556
Administrative expenses	201,115	520,833
Depreciation and amortization	13,897	16,122
Total other operating expenses	433,179	756,946

The majority of the decrease in administrative expenses in 2012 is related to the arbitration case with Norðurál (Helguvik) in 2011.

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9. Salaries and related expenses

Salaries and salary related expenses are as follows:

	2012	2011
Salaries	993,740	962,669
Contribution to defined contribution fund	104,663	94,011
Increase in pension obligation	150,200	242,065
Other salary related expenses	143,707	145,587
Total salaries and salary related expenses	1,392,310	1,444,332
Average number of full time employees equivalent	135	136

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

	2012	2011
Capitalized on projects	33,737	34,729
Production cost and cost of sale	1,140,406	1,189,612
Other operating expenses	218,167	219,991
Total salaries and salary related expenses	1,392,310	1,444,332

Salaries paid to the Board of Directors and Management amounted to ISK 52 million in 2012 (2011: ISK 48 million).

10. Depreciation, amortization and impairment

Depreciation, amortization and impairment is specified as follows:

	2012	2011
Depreciation of operating assets, see note 13	985,022	950,841
Amortization of intangible assets, see note 15	16,812	24,792
Depreciation and amortization recognized in the income statement	1,001,834	975,633

Depreciation and amortization is allocated as follows:

	2012	2011
Production cost and cost of sales	987,937	959,511
Other operating expenses	13,897	16,122
Depreciation and amortization recognized in the income statement	1,001,834	975,633

11. Finance income and costs

Finance income and costs is specified as follows:

	2012	2011
Interest income on loans and receivables	266,201	84,944
Interest income on available for sale securities	0	3,429
Fair value changes on financial assets through profit or loss	60,454	107,588
Total finance income	326,655	195,961
Interest expense	(518,075)	(575,342)
Indexation	(123,852)	(173,654)
Net foreign exchange loss	(782,261)	(845,693)
Total finance costs	(1,424,188)	(1,594,689)
Fair value changes of currency and interest rate swap	(20,018)	41,136
Fair value changes of embedded derivatives in power sale contracts	(200,736)	(1,465,215)
Net finance expenses	(1,318,287)	(2,822,807)

Capitalized interest amounted to ISK 27 million during the year (2011: ISK 26 million).

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Notes, continued:

12. Income tax

Deferred income tax is specified as follows:

	2012	2011
Origination and reversal of temporary difference	107,411	223,163

Effective tax rate is specified as follows:

	2012	2011
Profit (loss) for the year	599,918	(936,754)
Income tax	107,411	(223,163)
Profit (loss) before income tax	707,329	(1,159,917)

		2012		2011
Income tax according to current tax rate	20.0%	(141,466)	20.0%	231,983
Effect of associates	(4.8%)	34,055	(0.7%)	(7,843)
Other items	0.0%	0	(0.1%)	(977)
Effective income tax rate	15.2%	(107,411)	19.2%	223,163

13. Operating assets

Revaluation of operating assets

The Company's power plants were revalued to fair value on 31 December 2012. In order to calculate the present value of the operating assets, an interest rate which reflects the WACC of the Company. The discount rate was 10.08% for Svartsengi and 8.47% for Reykjanes. Unlevered beta used for Svartsengi was 0.60 and 0.77 for Reykjanes. Both estimates are built on an assumption about future growth of 3% per annum. The cash flow was estimated using estimates for the next twenty years and expected future value calculated for the years thereafter. The calculations were performed by the HS Orka financial department.

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13. Operating assets, continued:

Operating assets are specified as follows:

	Power plants	Other operating assets	Total
Cost			
Balance at 1.1.2011	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
Additions during the year	525,770	61,043	586,813
Disposals	0	(169,972)	(169,972)
Revaluation 31.12.2012	6,090,242	0	6,090,242
Depreciation adjustment	(3,685,167)	0	(3,685,167)
Balance at 31.12.2012	30,027,090	1,542,494	31,569,584
Depreciation			
Balance at 1.1.2011	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
Depreciation for the year	945,521	39,501	985,022
Disposals	0	(168,782)	(168,782)
Depreciation adjustment	(3,685,167)	0	(3,685,167)
Balance at 31.12.2012	0	75,392	75,392
Net book value			
1.1.2011	23,330,963	1,450,737	24,781,700
31.12.2011	24,356,599	1,446,750	25,803,349
31.12.2012	30,027,090	1,467,102	31,494,192
Net book value without revaluation			
1.1.2011	21,279,342	1,347,440	22,626,782
31.12.2011	22,391,779	1,352,587	23,744,366
31.12.2012	22,058,232	1,382,073	23,440,305

Other operating assets include capitalized land and buildings with the carrying amount of ISK 1,108 million (2011: ISK 1,105 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 the majority of the investment will be in the years 2013 - 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.

On 25 September 2012 a contract with Jardboranir hf., for drilling 2 new wells, 1 work over and one new optional well was signed. Work started in November 2012 and is expected to last until late March or early May 2013, assuming the optional well is drillled. Total budget for the drilling program is ISK 1,200 million including the optional well.

Pledge of assets

The Company's power plants at Reykjanes and Svartsengi are pledged to secure bank loans in the amount of ISK 15,581 million (2011: ISK 16,380 million).

Rateable value and insurance value

Rateable value of the Company's buildings amounted to ISK 2,190 million at year-end 2012 (2011: ISK 2,869 million) and land measured at rateable value amounted to ISK 1,442 million (2011: ISK 1,193 million). Insurance value of the Company's assets amounted to ISK 37,985 million (2011: ISK 19,860 million).

14. Operating assets under constructions

Operating assets under constructions are specified as follows:

	2012	2011
Net book value 1.1.	3,544,465	4,746,587
Additions	119,822	618,973
Transferred to operating assets	0	(1,821,095)
Net book value 31.12.	3,664,287	3,544,465

Indication of impairment

Operating assets under construction represents capitalized cost related to an expansion to the power plant at Reykjanes, which is planned to supply Norðurál (subsidiary of Century Aluminum) with power for a new aluminum smelter in Helguvík (located in Reykjanesbær, Iceland). In 2007, HS Orka hf. and Norðurál executed a power purchase agreement on power for a new aluminum smelter in Helguvík. The agreement with Norðurál was under dispute and Norðurál 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 34. Despite the delay, negotiations with Norðurál 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 2012

The operating assets under construction were tested for impairment at 31 December 2012 by estimating their recoverable amount. The impairment test was based on several assumptions including delivery of power commencing in 2016. There is some uncertainty related to the future timing of the project (Reykjanes expansion) due to both negotiations with Norðurál and the form of financing for 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 1.1.2011	334,210	972,233	1,306,443
Additions during the year	5,755	20,461	26,216
Balance 31.12.2011	339,965	992,694	1,332,659
Additions during the year	509	23,667	24,176
Disposals	(48,265)	0	(48,265)
Balance at 31.12.2012	292,209	1,016,361	1,308,570
Amortization			
Balance at 1.1.2011	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
Amortization for the year	16,812	0	16,812
Disposals	(48,265)	0	(48,265)
Balance at 31.12.2012	172,266	146,241	318,507
Book value			
1.1.2011	155,283	825,992	981,275
31.12.2011	136,246	846,453	982,699
31.12.2012	119,943	870,120	990,063

Impairment test 2012

Development cost includes the costs for 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 analysis to date are positive. If it becomes evident that the development cost will not be utilized by the Company to generate revenue it must be expensed as an impairment cost. Management has confirmed that the above projects are feasible and it is likely that they will generate revenues in the future. At the end of 2012 there has been no material changes to the assumption regarding impairment of intangible assets.

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Notes, continued:

16. Investments in associates

Investments in associates are as follows:

	2012		2011	
	Share	Carrying amount	Share	Carrying amount
Bláa Lónið hf. (the Blue Lagoon), Iceland	33.2%	461,793	31.7%	425,438
Hreyfing Eignarhaldsfélag ehf., Iceland	23.9%	79,914	24.4%	69,264
Hótel Bláa Lónið ehf., Iceland	24.4%	472	24.4%	3,099
Blue Lagoon International ehf., Iceland	24.4%	3,139	24.4%	5,351
DMM-lausnir ehf., Iceland	22.9%	17,482	22.6%	17,956
Suðurorka ehf., Iceland	50.0%	177,637	50.0%	134,000
HS Orkurannsóknir ehf., Iceland	100.0%	500	100.0%	500
Total		740,937		655,608

The Company's share in profit of its associates for the year 2012 was ISK 170 million (2011: loss ISK 39 million). The share in associates profit or loss is based on un-audited financial information. Currency translation difference for the year was positive in the amount of ISK 37 million (2011: positive ISK 1 million).

In the third quarter the Blue Lagoon purchased a portion of its own shares, resulting in an increase of the share of HS Orka hf. to 33.2%.

The Company made investments in Suðurorka ehf. In a joint venture for Bulandsvirkjun Hydro development asset during the year for ISK 44 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:

	2012		2011	
	Share	Carrying amount	Share	Carrying amount
Keilir ehf., Iceland	10.2%	17,500	10.2%	17,500
Íslensk nýorka hf., Iceland	8.1%	9,575	8.5%	9,575
Total		27,075		27,075

18. Bonds

	2012	2011
Non-current		
Financial assets at fair value through profit or loss, Reykjanesb. bonds	363,028	405,201
	363,028	405,201
Current		
Financial assets at fair value through profit or loss, Reykjanesb. bonds	78,740	70,428
	78,740	70,428
Total	441,768	475,629

Interest-bearing financial assets designated at fair value through profit or loss, with a carrying amount of ISK 442 million at 31 December 2012 (2011: ISK 476 million) have stated interest rates of 5.0% plus indexation,are paid annual installments and mature in 2019. The bond is valued at 5.0% interest rate which is based on a valuation from an external expert.

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19. Embedded derivatives in power sales agreements

I n 2004 The Company signed power sales agreements with Norðurál on power supply until the year 2026. In 1999 The Company has also signed an agreement with Landsvirkjun for the sale of power until the year 2019. Payments under the agreements are made in USD and are partly linked to the price of aluminium.

These long-term power sales agreements feature embedded derivatives, the value of which is adjusted 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 power purchase agreements is calculated on the basis of the forward price of aluminium and experts' projections. The expected present value of cash flows based on the reporting date is calculated on the basis of the registered forward price of aluminium on 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 1.99% (2011: 2.19%). The expected present value of cash flows, from the agreements, on the agreement date is deducted from this value based on aluminium price assumptions used 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 sale agreements that the Comapny holds 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:

	2012	2011
Fair value of embedded derivatives at 1.1.	4,461,407	5,926,622
Changes in fair value	(200,736)	(1,465,215)
Fair value of embedded derivatives at 31.12.	4,260,671	4,461,407

20. Deferred tax asset (liabilty)

Deferred tax asset (liability) is as follows:

	2012	2011
Deferred tax asset (liability) on 1.1.	499,481	276,318
Origination and reversal of temporary difference	(107,411)	223,163
Income tax on revaluation	(1,218,048)	0
Deferred tax (liability) asset on 31.12.	(825,978)	499,481

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20. Deferred tax asset (liability), continued:

Deferred tax asset is as follows at the year end:

	2012	2011
Operating assets	(1,250,750)	(35,350)
Derivatives	(648,996)	(668,690)
Long term receivables	0	(40,185)
Inventories	3,398	3,399
Trade and other receivables	7,555	9,328
Pension obligation	287,411	315,300
Deferred foreign exchange loss	160,681	50,911
Tax losses carried forward	614,723	864,768
Deferred tax asset (liability) on 31.12.	(825,978)	499,481

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 3,074 million (2011: ISK 4,324 million) and is useable until 2018. Management has concluded, based on its projections, that there will be sufficient taxable profit in the future to use the tax loss currently carried forward.

21. Prepaid lease and royalty fee

The Board of the Company 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 (62 years).

22. Receivables

Long-term receivables

Long term receivables are specified as follows:

	2012	2011
Long term receivable from HS veitur hf. due to pension liability	289,647	200,926
Total long term receivables	289,647	200,926

Trade and other receivables

Trade and other receivables are specified as follows:

	2012	2011
Trade receivables	821,206	874,445
Receivable from HS veitur hf.	222,404	231,335
Allowance for bad debt	(37,775)	(46,638)
Total trade receivables	1,005,835	1,059,142
Other receivables	228,741	66,457
Total trade and other receivables	1,234,576	1,125,599

The Company's exposure to credit and currency risks and impairment losses related to trade and other receivables is disclosed in note 31.

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Notes, continued:

23. Short term investments

The Company has invested in short term debt securities amounting to ISK 566 million at the end of the year.

24. Cash and cash equivalents

Cash and cash equivalents are as follows:

	2012	2011
Bank balances	5,227,728	1,304,713
Cash and cash equivalents	5,227,728	1,304,713

At year end 2012 cash in the amount of ISK 578 million (USD 4.5 million) (2011: ISK 554 million) is classified 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 31.

25. Equity

Issued capital

Issued share capital, as stipulated in the Company’s Articles of Association, amounted to ISK 7,841 million (2011: 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

	2012	2011
Outstanding shares on 1 January	6,962,919	6,962,919
Share capital increase	878,205	0
Outstanding shares on 31 December	7,841,124	6,962,919

Icelandic shareholder Jarðvarmi slhf. informed Magma Energy Sweden AB, on 10 February 2012 of its decision to exercise its option to increase its stake in HS Orka from 25.0% to 33.4%, according to an agreement between Jarðvarmi and Magma Energy Sweden AB. Jarðvarmi slhf. payed ISK 4.7 billion for the new shares at the end of February 2012 which increased HS Orka hf. equity by the same amount.

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 the 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 2011 comprised of HS Orka hf. share in a put option regarding own shares in an associate.

Dividends

No dividend was paid during 2012 or 2011.

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Notes, continued:

26. Earnings per share

Basic and diluted earnings (loss) per share

	2012	2011
Profit (loss) for the year	599,918	(936,754)

Weighted average number of ordinary shares

	2012	2011
Shares on 1 January	6,962,919	6,962,919
Effect of share capital increase	731,838	0
Weighted average number of ordinary shares	7,694,757	6,962,919
Basic and diluted earnings (loss) per share	0.08	(0.13)

27. 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 31.

	2012	2011
Non-current debt		
Unsecured bank loans	424,306	470,792
Secured bank loans with covenants	15,581,345	16,379,996
Unsecured bond issue	2,382,902	2,727,228
Current maturities	(2,381,334)	(2,101,388)
Non-current debt	16,007,219	17,476,628
Current debt		
Current maturities	2,381,334	2,101,388
Current loans and borrowings	2,381,334	2,101,388
Total interest-bearing loans and borrowing	18,388,553	19,578,016

Terms of loans and borrowings

Loans in foreign currency:		2012		2011	
	Final due date	Weighted average interest rate	Carrying amount	Weighted average interest rate	Carrying amount
Loans in CHF	2019-2021	2.2%	4,731,696	2.2%	4,884,749
Loans in EUR	2019-2021	3.0%	3,243,444	3.7%	3,401,620
Loans in USD	2019-2023	2.3%	3,173,652	2.7%	3,358,273
Loans in JPY	2019-2023	1.5%	1,798,494	1.7%	2,089,799
Loans in CAD	2021-2023	1.8%	1,375,244	1.8%	1,399,400
Loans in SEK	2021	4.8%	836,173	5.4%	818,776
Loans in GBP	2017-2019	1.1%	422,642	1.4%	427,379
			15,581,345		16,379,996
Loans in ISK:					
Indexed loans in ISK	2016-2017	4.7%	2,382,902	4.0%	2,890,530
Other loans in ISK	2031	5.0%	424,306	5.3%	307,490
			2,807,208		3,198,020
Total interest-bearing loans and borrowings			18,388,553		19,578,016

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27. Loans and borrowings, continued:

Annual maturities of loans and borrowings are as follows:

	2012	2011
Year 2013/2012	2,381,334	2,101,388
Year 2014/2013	2,402,384	2,262,302
Year 2015/2014	2,424,394	2,282,475
Year 2016/2015	2,447,121	2,303,458
Year 2017/2016	2,141,786	2,325,283
Subsequent	6,591,534	8,303,110
Total interest-bearing loans and borrowings	18,388,553	19,578,016

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 through 2011 and 2012 by one of the banks (European Investment Bank) but further waivers were not required by the other two banks. This waiver has now changed slightly and extended for 2013. In early 2012, the Company amended and restated its loan agreement with Nordic Investment Bank, which amended certain covenants and reset interest rates. All covenants were fulfilled by the Company in 2012.

28. Pension obligations

According to actuaries' assessment, the Company's accrued pension obligations amounted at year end 2012 to ISK1,727 million (2011: ISK 1,577 million), discounted based on an interest rate of 2.0%, (taking into account the net assets of part 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 unclear increase in the obligation in 2012 is based on general salary increase taking 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 obligations. HS Veitur hf.'s share in the increase in the pension obligations during the year amounted to ISK 89 million (2011: ISK 102 million) and is recognized as a long term receivable from HS Veitur hf.

	2012	2011
Pension commitment at 1.1.	1,576,500	1,400,000
Contribution during the year	(72,328)	(65,565)
Increase in obligation due to interests, salaries and change in fund's net assets	222,528	242,065
Pension obligation at 31.12.	1,726,700	1,576,500

Pension obligations are as follows:

	2012	2011
The pension fund for State employees	879,400	839,200
The pension fund for Municipality of Hafnarfjörður employees	527,800	442,000
The pension fund for Municipality of Westman Islands employees	319,500	295,300
Pension fund obligation at 31.12.	1,726,700	1,576,500

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29. 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.

A foreign currency swap agreement entered into between Glitnir Bank hf. and HS Orka hf. on 19 November 2006 is in dispute. HS Orka claims the agreement was annulled in November 2008 when Glitnir stated in a communication to HS Orka that they did not intend to fulfill their part of the contract. Glitnir now claims the contract is still valid and demands payments from HS Orka. The parties have had discussions to seek a compromise and explore whether there is a possibility for negotiations to settle the agreement. Glitnir has made an offer to HS Orka where they claim an amount identical to the amount HS Orka has calculated, based on the original contract. However, they further claim a penalty interest assessment for the whole amount. The penalty interest is considered unacceptable by HS Orka in light of the facts, and if further negotiations will not lead to a result acceptable to HS Orka, it will be up to the courts to decide on the matter. HS Orka will claim principally that the agreement was terminated in November 2008 and therefore HS Orka has no obligations thereunder, but at the same time and alternatively, that net present calculations of obligations pursuant to the agreement should be substantially lower than those claimed by Glitnir. HS Orka's calculation of the contract value is ISK 1,138 million and is shown at that value in the Statement of Financial Position. on February 20, 2013 Glitnir's attempted to terminate the swap agreement, as stipulated in a letter issued by the Winding up Board of Glitnir. In HS Orka´s managements opinion the attempted termination is based on weak legal grounds and that it is unlikely that Glitnir's claim in that respect will be upheld.

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

30. Trade and other payables

Trade and other payables are as follows:	2012	2011
Trade payables	482,996	453,776
Debt related to assets under construction	0	174,394
Other payables	659,090	606,106
Total trade and other payables	1,142,086	1,234,276

The Company's exposure to currency and liquidity risk related to trade and other payables is disclosed in note 31.

31. Financial instruments

Overview

The Company's activitiesare exposed to financial risk consisting of credit risk, liquidity risk and market risk. Market risk consists of currency risk and interest rate 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 process is carried out by 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 risk management program focuses on addressing 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 such derivatives 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.

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31. Financial instruments, continued:

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 its customer. Approximately 56% (2011: 64%) of the Company's revenue is attributable to sales transactions with its two largest 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 are not permitted to make further transactions with the Company until 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 2012, shorter times are now given to non-paying customers before delivery to such customer is cancelled.

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 companies 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	2012	2011
Bonds		441,768	475,629
Long term receivables		289,646	200,926
Trade and other receivables	22	1,234,576	1,125,599
Short term investment	23	565,800	0
Cash and cash equivalents	24	5,227,728	1,304,713
		7,759,518	3,106,867

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

Large users and power companies	383,705	401,245
Receivables from HS Veitur	222,404	231,335
Other customers	437,501	473,200
	1,043,610	1,105,780

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31. Financial instruments, continued:
Credit risk, continued

Impairment

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

	2012 Gross value	Impairment	2011 Gross value	Impairment
Not past due	974,402	3,241	1,013,649	1,962
Past due 0 - 30 days	14,033	1,310	14,240	1,134
Past due 31 - 60 days	10,223	1,078	6,704	967
Past due 61 - 90 days	7,464	2,638	6,520	1,630
Past due more than 90 days	37,488	29,508	64,667	40,945
	1,043,610	37,775	1,105,780	46,638

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

	2012	2011
Balance at 1.1.	46,638	38,000
Final write off	(34,177)	(17,827)
Impairment losses recognized	25,314	26,465
Balance at 31.12.	37,775	46,638

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Notes, continued:

31. 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 new loan facilities and had no unused loan facilities at year end 2012 and 2011.

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 2012						
Loans and borrowing	18,388,553	20,787,184	2,935,771	2,872,064	7,912,225	7,067,124
Trade and other payables	1,142,086	1,142,086	1,142,086			
Derivatives	1,137,977	1,082,307	459,220	133,520	489,567	
31 December 2011						
Loans and borrowings	19,578,016	23,045,866	2,834,592	2,860,536	8,138,254	9,212,484
Trade and other payables	1,234,276	1,234,277	1,234,277			
Derivatives	1,117,953	1,079,906	354,259	102,882	511,700	111,065

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. Market risk for the Company consists of currency risk and interest rate risk.

Currency risk

The Company is exposed to currency risk on sales, purchases and borrowings that are denominated in a currencies other than ISK. The currencies in which these transactions primarily are denominated are US Dollar (USD), Swiss Franc (CHF), Euro (EUR), Canadian Dollar (CAD), Swedish Krona (SEK), British Pound (GBP) 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 827 million (2011: ISK 1,115 million) for repayments of loans in foreign currencies.

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31. 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
2012						
Derivatives	(1,508,292)	(457,761)	3,685,958	(546,171)	0	(236,826)
Receivables			282,447			
Cash and cash equivalents	93	10,926	826,874	6	5	431
Loans and borrowings	(4,731,696)	(3,243,444)	(3,173,652)	(1,798,494)	(1,375,244)	(1,258,815)
Balance sheet risk	(6,239,895)	(3,690,279)	1,621,627	(2,344,659)	(1,375,239)	(1,495,210)
Estimated sale 2013			2,537,011			
Estimated purchases 2013			(535,111)			
Gross foreign exchange rate risk	0	0	2,001,900	0	0	0
Net foreign exchange rate risk	(6,239,895)	(3,690,279)	3,623,527	(2,344,659)	(1,375,239)	(1,495,210)

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31. Financial instruments, continued:

Currency risk, continued:

2011	CHF	EUR	USD	JPY	CAD	Other currencies
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)

The following exchange rates were used during the year:

	Average exchange rate		End of year exchange rate	
	2012	2011	2012	2011
CHF	133.72	131.56	141.03	131.02
EUR	161.18	161.87	170.27	159.28
USD	125.35	116.35	129.05	123.00
JPY	1.57	1.46	1.50	1.59
CAD	125.48	117.65	127.74	120.56

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 2011.

	Profit or (loss)	
	2012	2011
CHF	499,192	524,668
EUR	295,222	312,690
USD	(129,730)	(137,756)
JPY	187,573	222,535
CAD	110,019	112,163
Other currencies	119,617	120,311

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 2011.

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31. 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:

	2012	2011
Financial instruments with fixed interest rate		
Financial assets	441,768	475,629
Financial liabilities	(2,515,097)	(2,890,530)
	(2,073,329)	(2,414,901)
Financial instruments with floating interest rate		
Financial assets	5,793,528	1,304,713
Financial liabilities	(15,873,457)	(16,687,486)
	(10,079,929)	(15,382,773)
Derivatives		
Embedded derivatives	4,260,671	4,461,407
Currency and interest rate swap	(1,137,977)	(1,117,953)
	3,122,694	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 2011.

	Equity		Profit or loss	
	100 bp increase	100 bp decrease	100 bp increase	100 bp decrease
2012				
Financial assets	(13,147)	15,899	(13,147)	15,899
Fair value sensitivity analysis, net	(13,147)	15,899	(13,147)	15,899
2011				
Financial assets	(13,355)	14,226	(13,355)	14,226
Fair value sensitivity analysis, net	(13,355)	14,226	(13,355)	14,226

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 2011.

	Profit or loss	
	100 bp increase	100 bp decrease
2012		
Embedded derivatives	(220,438)	242,602
Currency and interest rate swap	(42,163)	39,347
Fair value sensitivity analysis, net	(262,601)	281,949

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31. Financial instruments, continued:

Interest rate risk continued:

	Profit or loss 100 bp increase	Profit or loss 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

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 the assumption that all other variables, in particular foreign currency rates, remain constant. The analysis was performed on the same basis for the year 2011.

	Profit or loss 100 bp increase	Profit or loss 100 bp decrease
2012		
Financial instruments with floating interest rates	(80,640)	80,640
Cash flow sensitivity analysis, net	(80,640)	80,640
2011		
Financial instruments with floating interest rates	(123,062)	123,062
Cash flow sensitivity analysis, net	(123,062)	123,062

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 2011.

	Profit or (loss) 2012	Profit or (loss) 2011
Increase of 10%	2,433,445	2,364,782
Decrease of 10%	(2,433,445)	(2,364,782)

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Notes, continued:

31. 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:

	2012 Carrying amount	2012 Fair value	2011 Carrying amount	2011 Fair value
Interest-bearing long-term debts	(18,388,553)	(18,138,840)	(19,578,016)	(19,543,205)
	(18,388,553)	(18,138,840)	(19,578,016)	(19,543,205)

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:

	2012	2011
Embedded derivatives in power purchase agreements (USD)	1.90- 3.94%	2.25 - 4.61%
Bonds	5.0%	5.0%
Interest bearing long term liabilities	Libor + 250 bp	Libor + 250 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 lags.

Fair value hierarchy:

The table below analyses financial instruments carried at fair value, sorted 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 1	Level 2	Level 3	Total
31 December 2012				
Embedded derivatives		227,412	4,033,259	4,260,671
Bonds		441,768		441,768
Other derivatives		(788,365)		(788,365)
Investments in other companies			27,075	27,075
Short term investments	565,800			565,800
Total	565,800	(119,185)	4,060,334	4,506,949
31 December 2011				
Embedded derivatives		256,415	4,204,992	4,461,407
Bonds		475,629		475,629
Other derivatives		(850,610)		(850,610)
Investments in other companies			27,075	27,075
Total	0	(118,566)	4,232,067	4,113,501

Embedded derivatives that expire in the year 2026 are classified in level 3 due to the fact that the forward market for aluminium only extends to maximum of ten years.

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Notes, continued:

31. 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:

	Loans and receivables	Financial assets designated at fair value through profit and loss	Financial assets and liabilities held for trading	Financial liabilities measured at amortized cost	Carrying amount
2012					
Shares		27,075			27,075
Bonds		441,768			441,768
Derivatives			4,260,671		4,260,671
Trade receivables	1,005,835				1,005,835
Other receivables	518,387				518,387
Short term investments		565,800			565,800
Cash and cash equivalent	5,227,728				5,227,728
Total assets	6,751,950	1,034,643	4,260,671	0	12,047,264
Loans and borrowings				18,788,553	18,788,553
Derivatives			1,137,977		1,137,977
Trade payables				482,996	482,996
Other payables				659,090	659,090
Total liabilities	0	0	1,137,977	19,930,639	21,068,616
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 and cash equivalent	1,304,713				1,304,713
Total assets	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				606,106	606,106
Total liabilities	0	0	1,117,953	20,812,292	21,930,245

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Notes, continued:

32. 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 lower levels of borrowings. The equity ratio was 53.4% at year end 2012 (2011: 41.4%).

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 required pursuant to covenants in its loan agreements.

33. Guarantees

Due to the division of Hitaveita Suðurnesja hf. into HS Orka hf. and HS Veitur hf. in 2008 the Company is liable for certain liabilities of HS veitur hf. whom existed at division date. This Guarantee amounts to a maximum of ISK 1 million at year end 2012 (2011: ISK 37 million).

34. Other matters

Litigations and claims

In 2007, HS Orka hf entered into a conditional power sale agreement with Norðurál (Helguvik) to sell power from a new power plant at Reykjanes, which is currently under construction, 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 Norðurál disputed this interpretation and maintained that the agreement remained in force and that the relevant conditions had been met. Norðurál 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 some of the conditions have not been fulfilled. Norðurál 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 revised terms.

HS Orka hf. initiated on 16 December 2011 arbitration proceedings towards Norðurál Grundartangi concerning interpretation of certain clauses in the power purchase agreement for Grundartangi concerning minimum purchase of power. The full amount of revenue that should have been received under the agreement had been accrued at the end of the year. Hearings in the arbitration case took place in Madrid in February 2013. Results are expected in mid 2013.

Trölladyngja

In 2012 The Icelandic parliament accepted “Rammaáætlun II” (a national Energy development plan), which categorized existing hydro and geothermal power sites into three groups: protected sites, pending sites and power developing sites. The Trölladyngja area is categorized as a pending site meaning more information, research and data is required. The carrying amount of Trölladyngja was at year end 2012 ISK 676.

35. 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 did not make any sales or provide any services to shareholders in the year 2012 (2011: ISK 6 million) The Company bought services from shareholders for the amount of ISK 11 million (2011: ISK 0 million)

The Company purchased goods and services from associate companies in the amount of ISK 17 million in the year 2012 (2011: ISK 19 million).

The Company sold goods to an associate company in the amount of ISK 40 million (2011: ISK 36 million).

The Company purchased services from fellow subsidiaries in the amount of ISK 23 million in the year 2012 (2011: ISK 18 million). At year end there were no trade payables to fellow subsidiaries (2011: ISK 4 million).

Sales to HS Veitur hf. amounted to ISK 1,830 million during the year (2011: ISK 1,725 million). Purchases from HS Veitur hf. amounted to ISK 23 million (2011: ISK 18 million). At year end the receivables from HS Veitur hf. amounted to ISK 222 million (2011: ISK 231 million).

Unaudited financial information

36. Quarterly Statements

Summary of the Company´s results by quarters:

2012	Q1	Q2	Q3	Q4	Total
Operating revenue	1,841,469	1,624,361	1,488,393	1,926,354	6,880,577
Production cost and cost of sales	(1,192,847)	(1,131,387)	(1,008,260)	(1,259,562)	(4,592,056)
Gross profit	648,622	492,974	480,133	666,792	2,288,521
Other operating expenses	(111,122)	(137,017)	(86,666)	(98,374)	(433,179)
Results from operating activities	537,500	355,957	393,467	568,418	1,855,342
Finance income	48,137	663,906	85,462	(470,850)	326,655
Finance costs	(913,194)	(171,336)	(222,906)	(116,752)	(1,424,188)
Changes in fair value of derivatives	(94,204)	158,011	21,062	(104,887)	(20,018)
Changes in fair value of embedded derivatives in power sales contracts	461,861	(1,989,779)	1,790,198	(463,016)	(200,736)
Net finance income (expenses)	(497,400)	(1,339,198)	1,673,816	(1,155,505)	(1,318,287)
Share of (loss) profit of associates	(40,462)	93,932	117,826	(1,022)	170,274
Profit (loss) before income tax	(362)	(889,309)	2,185,109	(588,109)	707,329
Income tax	(8,020)	196,648	(413,456)	117,417	(107,411)
Profit (loss) for the period	(8,382)	(692,661)	1,771,653	(470,692)	599,918
Other comprehensive income:					
Revaluation of operating assets				6,090,242	6,090,242
Income tax effect of revaluation				(1,218,048)	(1,218,048)
Foreign currency translation difference of associates	25,228	(24,579)	9,464	26,810	36,923
Tax effects of revaluation					
Other comprehensive income (loss)	25,228	(24,579)	9,464	4,899,004	4,909,117
Total comprehensive income (loss)	16,846	(717,240)	1,781,117	4,428,312	5,509,035

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Unaudited financial information, contd.:

Quarterly Statements, contd.:

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 swap	118,259	(95,143)	127,138	(109,118)	41,136
Changes in fair value of embedded derivatives in power sales contracts	2,607,744	(1,481,875)	(2,938,843)	347,759	(1,465,215)
Net finance income (expenses)	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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Appendix: Corporate Governance Statement, unaudited

This statutory statement on corporate governance is made in accordance with Article 66-c of the Icelandic Financial Statements Act No. 3/2006, as amended. This statement has been approved by the Board of Directors of HS Orka hf. and is also published in the Company's Annual Report. This statement covers the financial year ended on 31 December 2012.

This statement includes information on the following items:

- A reference to the corporate governance recommendations the Company follows and how the Company addresses the recommendations, including any deviations and explanations thereto.
- A description of the main aspects of internal controls and risk management systems used in connection with preparation of financial statements.
- A description of the Company´s organizational structure and the role and composition of each function.

1. Corporate Governance

The Company complies in all main respect to the laws mentioned above. The Board of Directors of HS Orka hf. emphasizes maintaining good management practices. The articles of association for the Company lay the framework for the governance of the Company.

The Audit Committee, which is the only Board committee at present, consists of one member of the Board of Directors, Alterra's chief financial officer and an independent member.

The Company's Board of Directors determines the CEO's terms of employment and meets regularly with the Company's auditors. Two members of the Board are independent of the Company and three members of the Board are associated with the major shareholder according to Article 2.5 in the Guidelines on Corporate Governance, issued in March 2012, by Iceland Chamber of Commerce, Nasdaq OMX Iceland hf. and Confederation of Icelandic Employers.

No remuneration or appointment committees have been established and the Board does not believe it is necessary to appoint such committees as the size and extent of the Company's operation does not require such committees. The Board believes it has balanced and relevant expertise and experience within the current members of the Board. The Board has the role and responsibilities such committees would otherwise have.

The preparation of financial statements in conformity with IFRS requires management to make judgments, 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.

2. Main aspects of internal controls and risk management systems in connection with preparation of financial statements.

The Company implemented key provisions of the Sarbanes-Oxley Act (SOX) in 2011. Work regarding SOD (Segregation of Duties) had then already started and was finished in 2012. The Company was already acting according to SOX in most cases but needed some refining with filing and documentation

The Board of Directors has an ongoing dialogue with the CEO on the identification, description and handling of the business risks to which the Company may be exposed. Material risks and risk management are discussed in the Annual Report.

The Company´s risk management and internal control, in relation to financial processes, are designed to control the risk of material misstatements. The Company designs its processes to ensure that there are no material weaknesses with internal controls that could lead to a material misstatement in the financial reporting.

The Company goes through a detailed strategic and budget process each year and a budget report is prepared. The Board approves the Company´s budget each year. Deviations from the budget are carefully monitored on a monthly basis. A year over year comparison is also performed on a monthly basis and deviations explained. The Company´s overall business is fairly stable and past budgets have been reliable and therefore deviations become visible quickly.

- To ensure quality in the Company's financial reporting systems the following policies, procedures and guidelines for financial reporting and internal control have been adopted:
- Continuous analysis of year over year comparison.
- Annual tests to ensure if internal controls are working properly.
- Continuous analysis of results achieved compared to the approved budget
- Policies for IT use, insurance, cash management, segregation of duties, procurement etc.

The responsibility for maintaining sufficient and effective internal control and risk management in connection with financial reporting lies with the CEO.

An auditing firm is elected at the Annual General Meeting for a term of one year. The external auditors are not allowed to own shares in the Company. The external auditors shall examine the Company´s annual financial statements in accordance with international standards on auditing, and shall, for this purpose, inspect account records and other material relating to the operation and financial position of the Company. The external auditors shall have access to all of the Company´s books and documents at all times. The external auditors report any significant findings regarding accounting matters via the Audit Committee to the Board of Directors in the auditors report.

3. Organizational structure and the role and composition of each function

According to the Company´s Articles of Association the Company is managed by

- Shareholders meetings
- The Board of Directors
- The Chief Executive Officer

Shareholders´ Meetings

The ultimate authority in all affairs of the Company, within the limits established by the Company´s Articles of Association and statutory law, is in the hands of lawful shareholders meetings.

The controlling shareholder Alterra Power Corp, through its subsidiary Magma Energy Sweden holds 66.6% of the shares and voting rights of HS Orka hf. The other shareholder Jarðvarmi slhf holds 33.4% of the shares and voting rights.

The Board of Directors

According to the Company´s Articles of Association the Board of Directors is responsible for the affairs of the Company between the Shareholders´ Meetings. The Board shall operate in accordance with the Company´s Articles of Association and the Board´s Rules of Procedure. The Principal duties of the Board are as follows:

- Appoint a CEO and decide the CEO´s salary and terms of employment, establish terms of reference and supervise the CEO´s work.
- Supervise continuously and precisely all aspects of the Company´s operations and ensure that the Company´s organization and activities are always in order. In particular, the Board of Directors shall ensure adequate supervision of the financial control and accurate reporting and disposal of the Company´s financial assets, and at least once a year confirm the Company´s operating plan and budget.
- Establish the Company´s goals in accordance with the Company´s objectives pursuant to the Articles of Association, and formulate the policy and strategy required to achieve these goals.

All Board Members have considered the Board´s procedures and considered them to be efficient. The Board Members also found the Board materials and presentations were good and well prepared. They also confirm the Board has been well informed and all matters have been discussed in an open and constructive way. When evaluating its size and composition, the Board takes into account the Company´s operations, policies and practices and the knowledge, experience and expertise of each Board member. The Board considers its size and composition to be in line with the Board's aim to discharge its duties in an efficient manner with integrity in the best interest of the Company.

Further information on the Board can be found in the Annual Report and on the Company's website.

The Audit Committee

The Audit Committee shall operate in accordance with its Rules of Procedure. The principal duty of the Audit Committee is to ensure the quality of the Company´s financial statements and other financial information, and the independence of the Company's auditors.

The Chief Executive Officer

According to the Company´s Articles of Association the Board of Directors appoints a CEO to manage the Company´s daily operations.

The principal duties of the CEO are as follows:

- He is responsible for daily operations and is obliged to follow the Boards' policy and instructions in that regard. The daily operations do not include measures that are unusual or extraordinary. The CEO may only take such measures if specially authorized by the Board, unless it is impossible to wait for the Board´s decision without substantial disadvantage to the Company´s operations. In such event the CEO shall inform the Board of any action taken without delay.
- He is responsible for the work and results of executive management.
- He shall ensure that the financial statements of the Company conform to the law and accepted practices and that the treatment of the Company´s assets is secure. The CEO shall provide any information that may be requested by the Company´s auditors.

Further information on the CEO can be found in the Annual Report and on the Company´s website.