

**Hitaveita Suðurnesja hf.
Suðurnes Regional Heating hf.**

**Interim Financial Statements
1 January – 30 June 2006**

Hitaveita Suðurnesja hf.
Brekkestíg 36
260 Njarðvík

Reg. no. 680475-0169

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Endorsement by the Board of Directors and Management

The Interim Financial Statements of Hitaveita Suðurnesja hf. have in all main respects been prepared in accordance with the same accounting principles as during the previous year.

The departure of the defense force from Keflavik airport at the end of September will affect the Company's operations. The defense force has been the Company's single biggest purchaser of hot water and electric power and its income from this customer amounted to ISK 984 million during the year 2005. According to the current agreement on hot water supply to the defense force, it is stipulated that purchased quantity may not decrease by more than 4% a year. Furthermore, the agreement stipulates that a lump sum payment to Hitaveita Suðurnesja must be agreed upon should the military base be shut down. Negotiations with the defense force are in process but it is still unclear when the results will be available or how much they will affect the Company's operations and financial position during the next years.

Law no. 50/2005 on the Taxability of Power Companies stipulates that power companies that until now have been exempt from taxation shall become taxable as of year 2006. Therefore, income tax is recognized in the income statement for the period. On the one hand income tax for the period to the amount of ISK 99 million is recognized. On the other, income tax is registered for temporary differences between the book value of the Company's assets and liabilities and their tax value. Comparative amounts in the interim financial statements have not been adjusted as the Company was exempt from tax until year-end 2005. The taxability and its effects on the Company's operations and financial standing are further accounted for in notes m and p.

Reykjanes power station was taken into use in May 2006 and thereby direct sale of electric power to large scale industry started, which will lead to a permanent increase of the Company's income derived from electric power sale.

According to the Statement of Earnings, the Company's operational revenues amounted to ISK 2,670 million and net earnings amounted to ISK 1,066 million. According to the Balance Sheet, Company's assets amounted to ISK 29,386 million. Stockholders' equity at the end of June amounted to ISK 14,418 million or 49% of the total capital. This ratio was 56% at the beginning of the year.

The Board of Directors and the Management of Hitaveita Suðurnesja hf. hereby confirm the Company's Financial Statements for the period from 1 January to 30 June 2006 with their signatures.

Njarðvík, 31 August 2006.

Ellert Eiríksson

Árni Sigfússon

Björn H. Guðbjörnsson

Gunnar Svavarsson

Ingimundur Þ. Guðnason

Jón Gunnarsson

Magnús Gunnarsson

Managing Director:

Júlíus Jónsson

Assistant Managing Director:

Albert Albertsson

Auditors' Review Report

To The Board of Directors of Sudurnes Regional Heating hf.

We have reviewed the accompanying Interim Balance Sheet of Hitaveita Suðurnesja hf. as of 30 June 2006, and the related Statement of Earnings, Statement of changes in Equity and Statement of Cash Flows for the six months then ended. The Interim Financial Statements are based on Company data and information from its management.

A review consists principally of a review of the documents on which the Interim Statements are based, inquiries of company personnel and analytical procedures applied to financial data and ratios. It is substantially less in scope than an audit performed in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the Financial Statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any modifications that should be made to the Interim Financial Statements in order for them to conform with generally accepted accounting principles in Iceland.

Njarðvík, 31 August 2006.

Sæmundur Valdimarsson

KPMG Endurskoðun hf.

Statement of Earnings for the period from 1 January to 30 June 2006

	Notes	2006 1.1.-30.6.	2005 1.1.-30.6.
Operating revenue			
Electricity		1,692,710	1,386,658
Hot water		688,752	678,458
Cold water		103,876	91,717
Other income		184,656	141,518
Total operating revenue		2,669,994	2,298,351
Operating expenses			
Power generation		171,287	158,640
Operation of electrical systems		118,533	161,018
Electricity purchases and distribution systems		669,274	619,072
Operation of hot water distribution systems		69,370	71,606
Operation of cold water distribution systems		23,749	26,636
General and administrative		177,658	174,946
Depreciation and amortization	1	397,239	333,438
Total operating expenses		1,627,110	1,545,356
Operating profit before financing costs		1,042,884	752,995
Financial income and expenses	2	(1,493,158)	(44,226)
(Loss) profit before tax		(450,274)	708,769
Tax asset at the beginning of taxation		1,417,693	-
Income tax for the period	3	98,988	-
Profit for the period		1,066,407	708,769
Earnings per share	4	0.14	0.10

Balance Sheet as at 30 June 2006

	Notes	30.6.2006	31.12.2005
Assets			
Fixed assets	5	24,609,988	12,276,294
Fixed assets under construction	5	1,001,308	9,819,942
Intangible assets	6	28,124	29,889
Investments in associates		506,574	409,405
Investments in other companies		163,897	164,511
Tax asset	7	1,516,681	0
Total non-current assets		<u>27,826,572</u>	<u>22,700,041</u>
Inventories		312,184	243,624
Trade receivables	8	781,758	866,287
Other receivables		136,477	347,409
Cash and cash equivalents		328,847	476,006
Total current assets		<u>1,559,266</u>	<u>1,933,326</u>
Total assets		<u>29,385,838</u>	<u>24,633,367</u>
Equity			
Issued capital	9	7,454,816	7,454,816
Share premium		1,749,844	1,749,844
Retained earnings		5,212,998	4,566,591
Total equity		<u>14,417,658</u>	<u>13,771,251</u>
Liabilities			
Pension fund commitment	10	906,664	920,080
Interest-bearing loans and borrowings	11	11,378,390	7,201,993
Total non-current liabilities		<u>12,285,054</u>	<u>8,122,073</u>
Interest-bearing loans and borrowings	11	626,151	386,153
Trade payables		1,842,239	2,179,541
Other payables		214,736	174,349
Total current liabilities		<u>2,683,126</u>	<u>2,740,043</u>
Total liabilities		<u>14,968,180</u>	<u>10,862,116</u>
Total equity and liabilities		<u>29,385,838</u>	<u>24,633,367</u>
Commitments	12		

Statement of Changes in Equity for the period from 1 January to 30 June 2006

	Notes	Issued capital	Share premium	Retained earnings	Total
1 January – 30 June 2005					
Equity 1.1.2005		7,454,816	1,749,844	3,320,739	12,525,399
Dividends				(330,000)	(330,000)
Profit for the period				708,769	708,769
Equity 30.6.2005		7,454,816	1,749,844	3,699,508	12,904,168
1 January – 30 June 2006					
Equity 1.1.2006		7,454,816	1,749,844	4,566,591	13,771,251
Dividends				(420,000)	(420,000)
Profit for the period				1,066,407	1,066,407
Equity 30.6.2006		7,454,816	1,749,844	5,212,998	14,417,658

Statement of Cash Flows

for the period from 1 January to 30 June 2006

	Notes	2006 1.1.-30.6.	2005 1.1.-30.6.
Operating activities			
Net earnings		1,066,407	708,769
Items not affecting working capital:			
Gain on sale of fixed assets .....	(	12,436	(2,093)
Depreciation and amortization	1	397,239	333,438
Currency fluctuation and indexation		1,635,715	89,319
Provision for investments in companies		0	36,596
Income tax .....	(	1,516,681	0
Working capital provided by operating activities		1,570,244	1,166,029
Change in non-cash working capital balances:			
Inventories, (increase) decrease .....	(	68,560	18,047
Receivables, decrease (increase)		295,461	(155,444)
Current liabilities, decrease .....	(	716,915	(65,393)
Change in non-cash working capital balances		(490,014)	(202,790)
Net cash provided by operating activities		1,080,230	963,239
Investing activities			
Paid investment in fixed assets .....	(	3,939,538	(3,023,913)
Proceeds from sale of fixed assets		41,440	4,840
Paid investment in subsidiary, net of cash acquired		0	1,577
Paid investment in shares in other companies .....	(	96,555	(39,701)
Net cash used in investing activities		(3,994,653)	(3,057,197)
Financing activities			
Proceeds from new long-term debts		2,996,451	4,519,586
Repayment of long-term debts .....	(	229,187	(224,939)
Net cash provided by financing activities		2,767,264	4,294,647
(Decrease) increase in cash and cash equivalents .....	(	147,159	2,200,689
Cash and cash equivalents at beginning of the year		476,006	867,995
Cash and cash equivalents at end of the period		328,847	3,068,684
Supplemental disclosure of cash flow information			
Paid interest on long-term debt		163,782	52,107
Financing activities not effecting cash flow			
Dividends .....	(	420,000	(330,000)

Notes to Financial Statements

Significant accounting policies

Hitaveita Suðurnesja hf. („HS hf.”) is a company domiciled in Njardvík, Iceland. The interim financial statements were authorized for issue on 31 August 2006 by the Company’s board of directors.

a) *Basis of Preparation*

The Interim Financial Statement is prepared in accordance with the same accounting principles as the Company's Financial Statement of 2005. The Financial Statements are prepared in Icelandic currency and amounts are presented in thousands of Icelandic krona.

b) *Foreign Currency*

Assets and liabilities in foreign currency are converted to Icelandic currency at the exchange rate at 30 June. Operational revenue and operational expenses in foreign currency are converted at the exchange rate on the date of transaction.

c) *Revenue Recognition*

Electricity and hot water revenues are recognized when the invoices are issued. Other revenues are recognized when the goods or services are delivered.

d) *Financial income and expenses*

Financial income and expenses comprise interest payable on borrowings calculated using the effective interest rate method, interest receivable on funds invested, dividend income, foreign exchange gains and losses.

Interest income is recognized in profit or loss as it accrues, using the effective interest method. Dividend income is recognized in profit or loss on the date the entity’s right to receive payments is established. A part of financial expenses are capitalized as power plants under constructions (see note e).

e) *Fixed assets*

Fixed assets are capitalized at historical cost, less depreciation. Power plants under construction by the Company are capitalized based on the services, materials purchased, direct payroll expenses and other direct expenses.

Assets the use of which has not commenced are not depreciated. Financial expenses in relation to the financing of a power plant under construction are capitalized and considered a part of the cost of the asset. Capitalized financial expenses are interests on loans taken in relation to the project and incurred until the time the use of the asset commences and exchange difference due to foreign currency loans corresponding to the difference between interest terms of such loans and interest terms of domestic loans. Interest income of bank deposit for the part of the loan not utilized is stated to the reduction of cost of capital

Depreciation

Depreciation is calculated as a fixed annual percentage based on the estimated useful life of the property and equipment until a scrap value is reached. Estimated useful life is specified as follows:

Power plants	10-50 years
Electrical systems	5-30 years
Hot water and cold water distribution systems	7-20 years
Other fixed assets	3-50 years

Notes, cont.:

f) *Intangible assets*

Costs related to research and development on geothermal areas are capitalized when it is likely to generate income in the future. The costs will be amortized on a systematic basis over the estimated productive life. The amortization is expensed among depreciation.

g) *Associated companies and other companies*

Shares in associate companies and other companies are entered at historical cost less provision when the estimated value of the total shares is lower than their historical cost.

h) *Inventories*

Inventories are valued at the last purchase price, less provision.

i) *Accounts receivable and notes*

Allowance has been made for doubtful receivables and notes to meet the estimated risk attached to these assets but do not represent a final write-off. On the one hand there is a specific allowance for certain receivables and notes and on the other hand a general allowance to meet the general risk. The allowance is deducted from the appropriate Balance Sheet items.

j) *Cash and cash equivalents*

Cash and cash equivalents consist of cash and bank deposits.

k) *Share capital*

Dividends

Dividends to shareholders are recognized to the reduction of equity subsequent to the Shareholders' Meetings approval of its payment.

l) *Interest bearing borrowings*

Interest bearing borrowings are recognized initially at fair value less attributable transaction costs. Subsequent to initial recognition, interest-bearing borrowings are stated at amortised cost with any difference between cost and redemption value being recognized in profit or loss over the period of the borrowings on an effective interest basis.

m) *Obligations*

An obligation is recognized in the balance sheet when HS hf. has a present legal or constructive obligation as a result of a past event, and it is probable that an outflow of economic benefits will be required to settle the obligation. If the effect is material, 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, where appropriate, the risks specific to the liability.

n) *Payables and other short-term liabilities*

Payables and other short-term liabilities are recognized at cost.

Income tax expense

o) Income tax expense

Income tax on the profit of the year consists of current income tax and deferred income tax. Income tax is recognized in the income statement except when pertaining to items under equity, in which cases income tax is recognized under equity.

Current income tax is the estimated income tax payable due to taxable income of the year, in accordance with the current tax rate on the balance sheet date and all adjustments on current income tax for the previous year.

Deferred income tax is recognized according to the balance sheet liability method due to temporary differences between the book value of assets and liabilities in the interim financial statements on the one hand and their tax value on the other. The deferred income tax amount is based on the estimated redemption or adjustment of the book value of assets and liabilities by applying the current tax rate on the accounting date.

Tax asset is only recognized to the extent that it is likely that future profits can be used against the asset. The tax asset is reduced to the extent that it is considered likely that it can not be used.

p) Taxability of power companies

Law no. 50/2005 on The Taxability of Power Companies stipulates that power companies that until now have been exempt from income tax shall be taxable as of year 2006.

According to the law, all operating assets owned by the Company at the beginning of the year 2006 and that were acquired before year-end 2001, must be revalued. Operating assets, which the Company acquired during the years from 2002 to year-end 2005, were not revalued as the revaluation according to the Tax Law was at that point discontinued. Restatement of cost generates the taxable depreciation base, on which taxable depreciation will be calculated. Yearly depreciation is calculated for the deduction of the restated value of assets. Depreciation ratio is lower than the Company has been using until now, thus the tax asset generates. Furthermore, there is a difference between the book value of shares in other companies, accounts receivables and pension obligations and the tax value of those assets and liabilities. The composition of tax asset is further accounted for in note 7.

The operation of a water supply company does not fall under provisions of the Income Tax Law or the Law on The Taxability of Power Companies. The Company's income from water supply, which is being operated on a part of the operating area, is therefore not taxable and operating expenses, including depreciation, are not deductible in the calculation of income tax.

Due to the taxability, income tax is recognized in the income statement for the period. On the one hand 18% income tax revenue for the period is recognized to the amount of ISK 99 million. On the other, estimated income tax revenue to the amount of ISK 1,418 million is recognized due to the temporary differences between the book value of the Company's assets and liabilities and their tax value. Comparative amounts in the interim financial statements have not been adjusted as the Company was exempt from tax until year-end 2005

The tax asset is capitalized in full.

Notes, cont.:

1. Operating expenses

Depreciation and amortization is summarized as follows:

Depreciation of fixed assets, see note 5	394,772
Depreciation of power plant under construction, see note 5	702
Amortization of intangible assets, see note 6	1,765
Transferred to the Statement of Earnings as depreciation	<u>397,239</u>

2. Financial income and expenses

	2006 1.1.-30.6.	2005 1.1.-30.6.
<i>Financial income and expenses specifies as follows:</i>		
Interest earned	19,774	44,225
Dividends earned	21,476	9,033
Provision for investments in companies	0 (	32,942)
Interest expenses	(363,283 ) (	111,132)
Currency fluctuation	(1,574,405 ) (	41,814)
Tax on financial income	0 (	4,997)
	(1,896,438 ) (	137,627)
Capitalized financial expense due to constructing power plants	403,280	93,401
Total financial income and expenses	(1,493,158 ) (	44,226)

Financial expenses due to constructing power plants is capitalized.

3. Effective tax rate is specified as follows:

Loss before tax .....	(	450,274)
Income tax according to current tax rate, 18%	18.0%	81,049
Tax-exempt dividend income	0.9%	3,866
Non-taxable water supply operation	3.1%	14,073
Effective income tax	<u>22.0%</u>	<u>98,988</u>

4. Earnings per share

Earnings per share is calculated by dividing the net profit by the weighted average outstanding number of shares during the year and shows the earnings per each share.

	2006 1.1.-30.6.	2005 1.1.-30.6.
Profit for the period	1,066,407	708,769
Weighted average outstanding number of shares	7,454,816	7,454,816
Earnings per share of ISK 1	0.14	0.10

Notes, cont.:

5. Fixed assets

	Power plants	Electrical systems	Hot and cold water distribution systems	Other fixed assets	Total
Fixed assets					
Total value 1.1.2006	5,980,365	5,625,930	2,388,945	1,270,513	15,265,753
Previously depreciated 1.1.2006	(1,353,228)	(792,476)	(493,902)	(349,853)	(2,989,459)
Net book value 1.1.2006	4,627,137	4,833,454	1,895,043	920,660	12,276,294
Additions during the period	2,772,674	530,388	116,171	27,612	3,446,845
Transferred from fixed assets under constructions	9,310,625	0	0	0	9,310,625
Disposal during the period	0	0	0	(29,004)	(29,004)
Depreciation during the period	(193,085)	(102,873)	(66,204)	(32,610)	(394,772)
Net book value 30.6.2006	16,517,351	5,260,969	1,945,010	886,658	24,609,988
Total value 30.6.2006	18,063,664	6,156,318	2,505,116	1,269,121	27,994,219
Accumulated depreciation 30.6.2006	(1,546,313)	(895,349)	(560,106)	(382,463)	(3,384,231)
Net book value 30.6.2006	16,517,351	5,260,969	1,945,010	886,658	24,609,988
Annual depreciation ratio	2-10%	3-20%	5-15%	2-30%	

	Power plant under construction in Svartsengi	Power plant under construction in Reykjanes	Drilling wells and other power plants under constructions	Total
Fixed assets under constructions				
Total value 1.1.2006	73,483	9,387,780	437,238	9,898,501
Previously depreciated 1.1.2006	0	(77,155)	(1,404)	(78,559)
Net book value 1.1.2006	73,483	9,310,625	435,834	9,819,942
Additions during the period	138,018	0	354,675	492,693
Transferred to fixed assets	0	(9,310,625)	0	(9,310,625)
Depreciation during the period	0	0	(702)	(702)
Net book value 30.6.2006	211,501	0	789,807	1,001,308
Total value 30.6.2006	211,501	0	791,913	1,003,414
Accumulated depreciation 30.6.2006	0	0	(2,106)	(2,106)
Net book value 30.6.2006	211,501	0	789,807	1,001,308

Power plants under constructions are not depreciated as utilization has not commenced. The Power plant in Reykjanes started operation in May 2006 and the net book value was then transferred to fixed assets. Included in power plants under construction are equipments the use of which has already commenced and it is depreciated by 5% annually.

Notes, cont.:

6. Intangible assets

	Research and development Rosmhvalanes
<i>The Company's researches, are as follows:</i>	
Book value 1.1.2006	29,889
Amortization	(1,765)
Book value 30.6.2006	<u>28,124</u>
Annual amortization ratio	10%

7. Tax asset is specified as follows:

Fixed assets	1,210,307
Intangible assets	3,060
Investments in other companies	(5,338)
Inventories	7,844
Trade receivables	21,240
Pension fund commitment	<u>163,200</u>
	1,400,313
Carry-forward tax loss	<u>116,368</u>
Tax asset at the end of June	<u>1,516,681</u>

8. Provision for accounts receivable

The provision for accounts receivable and notes in the balance sheet amounted to ISK 118 million.

9. Stockholder's equity

Share capital

Issued capital stock, as stipulated in the Company's Articles of Association, amounted to ISK 7,455 million and remains unvaried from the beginning of the year. One vote is attached to each share of one ISK in the Company.

10. Pension fund commitment

HS hf.'s pension obligation due to pension rights of existent and former employees amounted to ISK 907 million at June 30, 2006, based on a real interest rate of 2.0% per annum. The provision is posted to non-current liabilities on the balance sheet. The Company paid an additional contribution of ISK 13 million to pension funds in the six month period.

Notes, cont.:

11. Interest-bearing loans and borrowings

Interest-bearing loans and borrowings consist of the following:

Debt in foreign currency:

Loans in EUR, interest rate 2.9%	2,937,917
Loans in CHF, interest rate 1.3%	2,342,178
Loans in USD, interest rate 5.5%	1,937,415
Loans in SEK, interest rate 3.0%	643,947
Loans in JPY, interest rate 0.7%	563,958
Loans in GBP, interest rate 4.9%	15,266
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	8,440,681
Loans in ISK, interest rate 4.2%	3,563,860
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Total interest-bearing loans and borrowings, including current maturities	12,004,541
Current maturities	(626,151)
	<hr/>
Total interest-bearing loans and borrowings	11,378,390

Aggregate annual maturities of interest-bearing loans and borrowings are as follows:

1 July 2006 – 30 June 2007	626,151
1 July 2007 – 30 June 2008	584,743
1 July 2008 – 30 June 2009	999,558
1 July 2009 – 30 June 2010	1,075,320
1 July 2010 – 30 June 2011	1,050,557
Subsequent	7,668,212
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Total interest-bearing loans and borrowings, including current maturities	12,004,541

Loan commitments

HS hf. has made a loan agreement with the Council of Europe Development Bank, CEB, to finance the construction of new power plant in Svartsengi. The loan agreement amounted to EUR 20 million. The Company used EUR 10 million of the agreement at 25 August 2006.

12. Commitments

In accordance with contract from 1985 between the Government of Iceland and HS hf. in respect to the purchase of RARIK's assets in the Sudurnes area, HS hf. signed an obligation to be paid over the next thirty years as a percentage of electricity sales.

HS hf. has been negotiating the debt with the State Treasury because of new electrical energy legislation which has changed the electrical energy market substantially from the time when the agreement was concluded. Changes in the criterion of the agreement calculation have been agreed upon but not formally signed, and according to those calculations there are no due payments during the period.

13. Uncertainty

The departure of the defense force from Keflavik airport at the end of September will affect the Company's operations. The defense force has been the Company's single biggest purchaser of hot water and electric power and its income from this customer amounted to ISK 984 million during the year 2005. According to the current agreement on hot water supply to the defense force, it is stipulated that purchased quantity may not decrease by more than 4% a year. Furthermore, the agreement stipulates that a lump sum payment to Hitaveita Suðurnesja must be agreed upon should the military base be shut down.

The lump sum is intended to meet cost that Hitaveita Suðurnesja incurred for investments in power stations and distribution systems, which has only been depreciated in part. Furthermore, substantial technical adjustment will have to be made to the production of hot water if the sale of hot water to the defense force decreases considerably. Information on the estimated cost due to the adjustments is not available.

Negotiations with the defense force are in process but it is still unclear when the results will be available or how much they will affect the Company's operations and financial standing during the next years.

14. Financial ratios

	30.6.2006	31.12.2005
Current ratio - Current assets/current liabilities	0.58	0.71
Equity ratio - Capital/total assets	0.49	0.56