Orkuveita Reykjavíkur
Consolidated
Financial Statements 2016*

*These Financial statements are translated from the original which is in Icelandic. Should there be discrepancies between the two versions, the Icelandic version will take priority over the translated version.

Orkuveita Reykjavíkur
Bæjarháls 1
110 Reykjavík

reg no. 551298-3029

Contents

Endorsement by the Board of Directors and the CEO

Orkuveita Reykjavíkur is a partnership that complies with the Icelandic law no.136/2013 on the founding of the partnership Orkuveita Reykjavíkur. The Group provides services through its subsidiaries that operate power plants, distribute electricity, hot water and cold water, operates the sewage systems in its service area as well as a fibre optic system in its service area.

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS´s) as adopted by the European Union and the additional requirements set out in the local rules and regulations regarding Financial statements of companies with listed bonds. The financial consolidated statements comprise the financial statements of Orkuveita Reykjavikur and its subsidiaries.

Profit of operations of the Group for the year was ISK 13.352 million (2015: ISK 4.176 million). Comprehensive income was 6.705 million (2015: 15.025 million). According to the statement of financial position the Group's assets were ISK 300.450 million at the end of the year (31.12.2015: ISK 310.990 million), book value of equity at the end of the year was ISK 121.476 million (31.12.2015: ISK 114.771 million), resulting in equity ratio of 40,4% (31.12.2015: 36,9%).

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

	Share
Reykjavíkurborg	93,539%
Akraneskaupstaður	5,528%
Borgarbyggð	0,933%

Corporate governance

The Board maintains and seeks to improve good corporate governance. Corporate governance is directed by law no. 136/2013, collective ownership contract, owners policy and the Board´s operating procedure. The procedures also take into account the company´s moral guidelines, Guidelines on corporate governance, which were issued by the Icelandic Chamber of Commerce, Nasdaq OMX Iceland ehf. and SA - Business Iceland and a handbook for board members, issued by KPMG. Subsidiaries have their separate company agreements and their Board´s procedures. These documents can be found on the Company´s website, www.or.is. The Board of Orkuveita Reykjavíkur has appointed a Compensation committee and has nominated a representative in Reykjavík City´s Audit committee.

In an appendix to the the Financial Statements further information regarding corporate governance can be found and information on the Company´s risk management is in notes 24-28 to the Financial statements.

Non financial information

The Icelandic Parliament approved amendments on the Icelandic Financial Statements Act no. 3/2006 by mid-2016. The legislation was retroactive since the law took effect as of 1. January, 2016. In Article 66. d. the act requires that the Endorsement by the Board of Directors and the CEO should include information necessary to assess the development, scale position and influence of the company in relation to environmental, social and human resources. It should also report on the company policy on human rights and describe how the company counter corruption and bribery. Furthermore, there should be a short description of the Company´s business model, non-financial indicators and more. If the Company does not have a policy associated with the matter which the Article refers to, then it should make a short and reasoned report on that matter.

Provisions of the non-financial information will take effect for Companies in the EU member states starting in 2017. OR has provided more information regarding Non-financial factor than is stated in Article 66 d. in the Icelandic Financial Statements Act with the publication of reports prepared with regard to international standards of social responsibility, GRI. Non-financial information will be published along with the financial statements for OR in the year 2017, which means that this provision will be fully implemented.

Endorsement by the Board of Directors and the CEO, contd.:

Statement by the Board of Directors

According to the best knowledge of the Board of Directors and the CEO of Orkuveita Reykjavíkur, the consolidated financial statements are in accordance with IFRS´s as they have been approved by EU and the additional requirements set out in the local rules and regulations regarding Financial statements of companies with listed bonds. It is the opinion of the Board of Directors and the CEO that the Financial Statements give a fair view of the Group's assets, liabilities and financial position 31 December 2016 and the Group´s operating return and changes in cash and cash equivalents in the year 2016. The Financial Statements also describe the main risk factors and uncertainties faced by the Group.

The Board of Directors and the CEO of Orkuveita Reykjavíkur hereby confirm the Group´ Financial statements for the year 2016.

Reykjavík, 7 March 2017.

The Board of Directors:
Brynhildur Davíðsdóttir
Gylfi Magnússon
Sigríður Rut Júlíusdóttir
Kjartan Magnússon
Áslaug Friðriksdóttir
Valdís Eyjólfsdóttir

CEO:
Bjarni Bjarnason

Independent auditor's report

To the Board of Directors and Owners of Orkuveitu Reykjavíkur.

Report on the Audit of the Consolidated Financial Statements

Opinion

We have audited the consolidated financial statements of Orkuveita Reykjavíkur (the Group), which comprise the consolidated balance sheet as at December 31, 2016, the consolidated income statement, and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements give a true and fair view of the financial position of the Company as at December 31, 2016, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and additional Icelandic disclosure requirements for companies with listed bonds.

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Consolidated Financial Statements section of our report. We are independent of the Group in accordance with the Code of ethics for Icelandic auditors, which are based on the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code). We have also fulfilled other ethical requirements of that rules. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Key Audit Matters	How the matter was addressed in the audit
Valuation of production systems (power plants)	
Reference is made to note 10 and 36d "Property, plant and equipment". At end of year 2016 the carrying value of property, plant and equipment amounted to ISK 264,8 billion and thereof the carrying value of electricity and hot water production system, valued at fair value, amounted to ISK 135,6 billion. The fair value is determined by discounting future cash flow of the cash generating units within the group where the assets belong to. On regular basis the carrying amount is compared to the fair value or recoverable amount which is calculated by performing an impairment test. When impairment tests show that fair value of production systems are considerable above or below carrying amount then the assets are adjusted to fair value taken into consideration the sensitivity of the impairment test, but never exceeding depreciated replacement cost. Due to the significance to the group's consolidated statement of financial position or 45% of total assets valuation of production systems is a key audit matter in our audit of the financial statements of the group. Also due to inherent uncertainty involved in management forecasting of changes in price level, changes of volume, price changes and other management assumptions used for discounting estimated future cash flow for the production and due to the sensitivity of the impairment tests is for changes in assumptions.	We used the service of our valuation specialists to assess the valuation models and assumptions used by management in their calculation of fair value of production systems. We assessed the management assumptions by comparing them to both internal information from the group and external industry information. We assessed if the design and implementation of the impairment tests used by management was appropriate. We assessed the reasonableness of the discount rates and risk free interest applied. We assessed the reasonableness of general assumptions as population projections, price level and future growth. Management calculation of the impairment test was compared to KPMG calculation and management sensitive analysis done for each cash generating unit where changes in EBITDA, future growth and yield are shown was also tested.

Key Audit Matters	How the matter was addressed in the audit
Timing of revenue recognition from sale and distribution of electricity and hot water.	
Reference is made to note 36k i) "Revenue from sale and distribution of electricity and hot water" and note 3 "Segment reporting". Revenue from sale and distribution of electricity and hot water are invoiced and posted to P&L based on estimated quantity. In subsequent periods the sale is corrected for the difference between measured actual delivered quantity and estimation. At end of each reporting period revenue are corrected for the difference between measured actual delivery to buyers and estimated sale. The process of analysing the difference between estimated and measured delivery of quantity is complex which gives rise to an inherent risk of error in timing of revenue recognition. The timing of revenue recognition from sale and distribution of electricity and hot water is therefore one of the key audit matters of our audit of the consolidated financial statements.	We tested controls over revenue systems. We used the service of our IT specialists to test the appropriate IT controls such as access control, change management control and automated controls of the revenue systems. We also tested non-automated controls. The purpose of the testing was to assess if the design of controls was likely to ensure right timing of the revenue recognition and to test operating effectiveness of controls to see if it was consisted with design of controls. We also evaluated management monitoring of controls. We analysed revenue and used external and internal information to set expectations which were compared to recognised revenue. We used substantive testing where we tested reconciliation between revenue systems and general ledger.

Other information

The Board of Directors and CEO are responsible for the other information. The other information comprises the information included in the annual report, but does not include the consolidated financial statements and our auditor's report thereon. Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the consolidated financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

Responsibilities of the Board of Directors and CEO for the Consolidated Financial Statements

The Board of Directors and CEO are responsible for the preparation and fair presentation of the consolidated financial statements in accordance with IFRSs as adopted by the EU, and for such internal control as they determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the consolidated financial statements, the Board of Directors and CEO are responsible for assessing the Group's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless they either intends to liquidate the Group or to cease operations, or has no realistic alternative but to do so.

The Board of Directors and CEO are responsible for overseeing the Group's financial reporting process.

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit 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 Group’s internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management’s use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group’s ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor’s report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor’s report. However, future events or conditions may cause the Group to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with The Board of Directors regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide The Board of Directors with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with The Board of Directors, we determine those matters that were of most significance in the audit of the consolidated financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor’s report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Report on Other Legal and Regulatory Requirements

Pursuant to the legal requirement under Article 104, Paragraph 2 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 consolidated financial statements includes the information required by the Financial Statement Act if not disclosed elsewhere in the consolidated financial statements.

The engagement partners on the audit resulting in this independent auditor’s report are Kristrún Helga Ingólfsdóttir and Guðný Helga Guðmundsdóttir.

Reykjavik 7 March 2017.

KPMG ehf.
Kristrún H. Ingólfsdóttir
Guðný Helga Guðmundsdóttir

Income Statement 2016

	Notes	2016	2015
Operating revenue		41.420.682	40.312.178
Profit from sale of assets		2.544	44.684
Operating revenues, total	3	41.423.226	40.356.862
Energy purchase		(6.204.799)	(6.400.193)
Salaries and salary related expenses	5	(5.240.591)	(4.424.532)
Other operating expenses		(4.617.027)	(4.357.952)
Operating expenses, total		(16.062.417)	(15.182.677)
EBITDA		25.360.809	25.174.185
Depreciation and impairment	7	(10.392.479)	(10.746.623)
Results from operating activities, EBIT		14.968.330	14.427.561
Interest income		433.252	510.774
Interest expenses		(5.189.598)	(4.582.634)
Other income (expenses) on financial assets and liabilities		7.844.913	(6.770.931)
Total financial income and expenses	8	3.088.567	(10.842.791)
Share in (loss) profit of associated companies	12	(3.413)	3.562
Profit before income tax		18.053.484	3.588.332
Income tax	9	(4.701.673)	587.267
Profit for the year		13.351.811	4.175.600

The notes on pages 13 to 49 are an integral part of these Consolidated Financial Statements.

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Statement of Comprehensive Income
for the year ended 31 December 2016

	Notes	2016	2015
Profit for the year		13.351.811	4.175.600
Other comprehensive income			
Items moved to equity that will not be moved later to the income statement			
Revaluation reserve, increase	10	0	10.326.585
Revaluation reserve, decrease	10	0	(28.785)
Income tax effect of revaluation	9	0	(1.187.959)
		0	9.109.841
Items moved to equity that could be moved later to the income statement			
Changes in fair value of assets available for sale	13	377.160	685.000
Translation difference	20	(7.024.272)	1.053.298
		(6.647.112)	1.738.298
Other comprehensive income, after taxes		(6.647.112)	10.848.139
Total comprehensive income for the year		6.704.699	15.023.738

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Statement of Financial Position
31 December 2016

	Notes	31.12.2016	31.12.2015
Assets			
Property, plant and equipment	10	264.822.746	278.311.167
Intangible assets	11	1.503.771	1.366.036
Investments in associated companies	12	59.337	62.750
Investments in other companies	13	3.285.074	2.907.914
Hedge contracts	15	365.333	443.324
Other financial assets	15	4.091.936	0
Deferred tax assets	16	3.714.879	5.458.992
Total non-current assets		277.843.077	288.550.184
Inventories	17	582.934	610.407
Trade receivables	18	4.596.627	4.634.866
Hedge contracts	15	393.183	805.795
Other financial assets	15	0	8.713.156
Other receivables	18	332.229	352.905
Prepaid expenses		213.209	149.855
Marketable securities	19	4.132.427	1.908.275
Cash and cash equivalents	19	12.356.669	5.264.079
Total current assets		22.607.277	22.439.337
Total assets		300.450.354	310.989.521
Equity			
Revaluation reserve		72.918.471	75.808.678
Equity reserve		7.000.139	0
Development reserve		59.759	0
Fair value reserve		2.822.160	2.445.000
Translation reserve		(1.785.611)	5.238.661
Retained earnings		40.460.965	31.278.845
Total equity	20	121.475.883	114.771.184
Liabilities			
Loans and borrowings	21	129.316.964	146.346.901
Pension liability	22	591.905	542.661
Embedded derivatives in electricity sales contracts	14	8.913.368	11.095.112
Hedge contracts	15	2.713.071	2.320.623
Deferred tax liabilities	16	8.345.332	7.619.437
Total non-current liabilities		149.880.640	167.924.734
Accounts payable		2.317.493	2.240.135
Loans and borrowings	21	18.322.481	19.288.436
Embedded derivatives in electricity sales contracts	14	1.405.741	2.097.051
Hedge contracts	15	2.311.883	1.755.978
Current tax liability	9	1.737.164	0
Other current liabilities	23	2.999.068	2.912.003
Total current liabilities		29.093.830	28.293.603
Total liabilities		178.974.471	196.218.337
Total equity and liabilities		300.450.354	310.989.521

The notes on pages 13 to 49 are an integral part of these Consolidated Financial Statements.

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Statement of Changes in Equity for the year 2016

	Revaluation reserve	Equity reserve	Develop-ment reserve	Fair value reserve	Translation reserve	Retained earnings	Total equity
The year 2016							
Equity at 1 January 2016	75.808.678	0	0	2.445.000	5.238.661	31.278.845	114.771.184
Changes in fair value of assets available for sale				377.160			377.160
Translation difference					(7.024.272)		(7.024.272)
Profit for the year						13.351.811	13.351.811
Total comprehensive income	0	0	0	377.160	(7.024.272)	13.351.811	6.704.699
Depreciation transferred to retained earnings	(2.890.207)					2.890.207	0
Share in profit of subsidiaries transferred to equity reserve*		7.000.139				(7.000.139)	0
Transfer to development reserve*			59.759			(59.759)	0
Equity at 31 December 2016	72.918.471	7.000.139	59.759	2.822.160	(1.785.611)	40.460.965	121.475.883
The year 2015							
Equity at 1 January 2015	69.446.324	0	0	1.760.000	4.185.363	24.355.759	99.747.445
Revaluation, increase	10.326.585						10.326.585
Revaluation, decrease	(28.785)						(28.785)
Income tax effect of revaluation	(1.187.959)						(1.187.959)
Changes in fair value of assets available for sale				685.000			685.000
Translation difference					1.053.298		1.053.298
Profit for the year						4.175.600	4.175.600
Total comprehensive income	9.109.841	0	0	685.000	1.053.298	4.175.600	15.023.739
Depreciation transferred to retained earnings	(2.747.487)					2.747.487	0
Equity at 31 December 2015	75.808.678	0	0	2.445.000	5.238.661	31.278.845	114.771.184

* See note 20

The notes on pages 13 to 49 are an integral part of these Consolidated Financial Statements.

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Statement of Cash Flows
for the year 2016

	Notes	2016	2015
Cash flows from operating activities			
Profit for the year		13.351.811	4.175.600
Adjusted for:			
Financial income and expenses	8	(3.088.567)	10.842.791
Share in P/L of associates		3.413	(3.562)
Income tax	9	4.701.673	(587.267)
Depreciation, amortisation and impairment	10	10.392.479	10.746.623
Profit from sale of property, plants and equipment		(2.573)	(44.684)
Pension liability, change		49.244	22.394
Working capital from operation before interest and taxes		25.407.480	25.151.895
Inventories, decrease (increase)		27.072	(196.601)
Current assets, decrease (increase)		11.651	(13.413)
Current liabilities, increase (decrease)		(465.284)	307.285
Cash generated from operations before interests and taxes		24.980.920	25.249.166
Received interest income		460.968	676.516
Paid interest expenses		(4.145.821)	(3.947.737)
Dividend received	8	28.968	9.474
Payments due to other financial income and expenses		(1.116)	(172.436)
Net cash from operating activities		21.323.919	21.814.983
Cash flows from investing activities			
Acquisition of property, plant and equipment	10	(12.200.177)	(10.057.374)
Acquisition of intangible assets	11	(207.833)	(109.212)
Proceeds from sale of property, plant and equipment		20.394	80.544
Proceeds from sale of other companies		0	5.319
Change in deposits		(2.445.619)	2.445.763
Change in marketable securities		375.016	(1.024.668)
Other financial assets		4.008.100	0
Net cash used in investing activities		(10.450.119)	(8.659.628)
Cash flows from financing activities			
Proceeds from new borrowings		8.162.142	0
Repayment of borrowings		(15.631.063)	(14.890.531)
Current liabilities, change		3.958.074	(1.693.456)
Net cash used in financing activities		(3.510.846)	(16.583.986)
Increase (decrease) in cash and cash equivalents		7.362.954	(3.428.631)
Cash and cash equivalents at year beginning		5.264.079	8.817.887
Effect of currency fluctuations on cash and cash equivalents		(270.363)	(125.178)
Cash and cash equivalents at the end of the year	19	12.356.669	5.264.079
Investments and financing without payment effects:			
Acquisition of property, plant and equipment		(555.151)	(379.066)
Current liabilities, change		555.151	379.066
Proceeds from new borrowings		5.816.713	0
Repayment of borrowings		(5.816.713)	0
Other information:			
Working capital from operation		20.240.375	22.563.045

The notes on pages 13 to 49 are an integral part of these Consolidated Financial Statements.

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Notes

1. Reporting entity

Orkuveita Reykjavíkur "OR" is a partnership that complies with the Icelandic law no. 136/2013 on the founding of Orkuveita Reykjavíkur. The Company's headquarters are at Bæjarháls 1 in Reykjavik. The Company's consolidated financial statements include the financial statements of the parent company and its subsidiaries, (together referred to as "the Group") and a share in associated companies. The consolidated financial statements of Orkuveita Reykjavikur is a part of the consolidated financial statements of Reykjavik city.

The Group provides services through its subsidiaries that operate power plants, distribute electricity, hot water and cold water, operates the sewage systems in its service area as well as a fibre optic system in its service area.

2. Basis of preparation

a. *Statement of compliance*

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and the additional requirements set out in the local rules and regulations regarding Financial statements of companies with listed bonds.

The consolidated financial statements were approved by the Board of Directors on 7 March 2017.

Significant accounting policies for the Group are described in note 36.

b. *Functional and presentation currency*

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

c. *Basis of measurement*

The consolidated financial statements have been prepared on the historical cost basis except for a part of property, plant and equipment have been revalued at fair value, derivative agreement, embedded derivatives in electricity sales contracts, assets held for sale and other financial assets and liabilities are stated at fair value. The methods used to measure fair values are discussed further in note 36.

d. *Use of estimates and judgements*

The preparation of the consolidated financial statements in conformity with IFRSs requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the year in which the estimates are revised and in any future periods affected.

In particular, information about significant areas of estimation uncertainty and critical judgements in applying accounting policies that have the most significant effect on the amounts recognised in the financial statements is included in the following notes:

- note 10 - Property, plant and equipment (revaluation of the distribution- and production system and valuation of impairment.)
- note 13 - Investments in other companies (presumptions made when calculating fair value of assets classified as assets held for sale.)
- note 14 - Embedded derivatives in electricity sales contracts (presumptions when calculating fair value)
- note 15 - Other financial assets and other financial liabilities (presumptions when calculating fair value)
- note 16 - Deferred tax assets and liabilities (valuation of future taxable profits against carry forward tax losses)
- note 25 - Market risk
- note 31 - Property leases (classification of property leases)

3. Segment reporting

Business divisions and sectors

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

The subsidiary **ON Power** generate electricity and harness hot water from the power plants, sells electricity to wholesale and retail customers as well as the new construction and operation of street lighting.

The subsidiaries **Utilities** and **OR Water and Sewage** distribute electricity, harnessing hot water from low-temperature fields and the geothermal plants and distribute it for space heating. It also collects and distributes cold water from reservoirs and runs a sewerage system.

Other operations cover the fibre optic system, rental of housing and equipment, incidental sale of specialist consultancy services and more.

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

Sector	**Official obligations**
Hot water	Minister approves utility rates not subject to the open market. These take effect upon publication in the Ministerial Gazette.
Electricity, distribution	Price rates are subject to authorisation from The National Energy Authority. Rates are officially published.
Electricity, production	Energy sales are subject to the open market, electricity rate changes are therefore not subject to government approval.
Cold water	The legal limitation on the upper limit of the rate is 0,5% of the real estate value. Rates are officially published in the Law and Ministerial Gazette.
Sewer system	The Rates for the sewer system shall cover all costs. Rates are officially published in the Ministerial Gazette.
Fibre-optic data system	This is a competitive practice that is supervised by The Post and Telecom Administration.

Customers that have significant effect on the Group´s revenues

One customer of ON Power has significant effect on the Group´s revenues in the year 2016. The Group´s revenues from this customer represents approximately ISK 5.313 million or 12,8% of total revenues. (2015: ISK 5.977 million, or 14,8% of total revenue).

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3. Segment reporting, cont.:

Segment information is presented by the Group's internal reporting. Business segments presented are *Utilities,* that represent licenced operations in hot and cold water, distribution of electricity and sewage*, Our nature*, representing the competitive operations in producing electricity and hot water and *Other Operation,* that represents the activities of the parent company and the fibre optic operations. The parent company's main activites is rental of housing and equipment, incidental sale of specialist consultancy services and more. Reykjavik fiber network represents the fiber optic operations. Segment reporting is conducted by using the same accounting principle as the group uses and is described in note 36.

Business segments - divisions

The year 2016	Utilities	ON Power	Other Operation	Adjust-ments	Total
External revenue	27.027.091	12.290.176	2.105.959	0	41.423.226
Inter-segment revenue	3.315.594	4.247.844	5.889.117	(13.452.555)	0
Total segment revenue	30.342.686	16.538.021	7.995.075	(13.452.555)	41.423.226
Segment operation expenses	(14.099.606)	(8.327.805)	(7.087.561)	13.452.555	(16.062.417)
Segment profit EBITDA	16.243.079	8.210.215	907.514	0	25.360.809
Depreciation and amortisation	(4.977.064)	(3.496.008)	(929.123)	0	(9.402.195)
Impairment	0	0	(990.284)	0	(990.284)
Segment results, EBIT	11.266.015	4.714.207	(1.011.893)	0	14.968.330
Financial income and expenses	(3.502.964)	(4.553.243)	8.271.720	2.873.054	3.088.567
Share of loss of associated companies	0	0	(3.413)	0	(3.413)
Income tax	(852.904)	(70.693)	(2.743.777)	(1.034.299)	(4.701.673)
Profit for the year	6.910.147	90.273	4.512.637	1.838.754	13.351.811

The year 2015	Utilities	ON Power	Other Operation	Adjust-ments	Total
External revenue	25.850.334	12.387.489	2.119.039	0	40.356.862
Inter-segment revenue	3.006.614	3.408.696	4.873.783	(11.289.093)	0
Total segment revenue	28.856.949	15.796.185	6.992.821	(11.289.093)	40.356.862
Segment operation expenses	(11.927.510)	(8.168.872)	(6.375.387)	11.289.093	(15.182.677)
Segment profit EBITDA	16.929.439	7.627.312	617.434	0	25.174.185
Depreciation and amortisation	(5.050.313)	(3.583.614)	(872.697)	0	(9.506.623)
Impairment	0	0	(1.240.000)		(1.240.000)
Segment results, EBIT	11.879.126	4.043.699	(1.495.263)	0	14.427.561
Financial income and expenses	(5.151.462)	(1.575.392)	6.048.537	(10.164.474)	(10.842.791)
Share of loss of associated companies	0	0	3.562	0	3.562
Income tax	(833.113)	(536.118)	(1.702.713)	3.659.211	587.267
Profit for the year	5.894.550	1.932.189	2.854.123	(6.505.264)	4.175.600

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3. Segment reporting, contd.

Business segments - divisions, contd.

	Utilities	ON Power	Other Operation	Adjust-ments	Total
Balance sheet (31.12.2016)					
Property, plant and equipment and intangible assets	140.907.133	106.661.900	18.757.484	0	266.326.517
Other assets	13.820.838	7.188.531	158.044.763	(144.930.295)	34.123.836
					300.450.354
Loans and borrowings	67.441.448	61.583.102	147.639.446	(129.024.550)	147.639.446
Other liabilities	8.242.316	4.966.732	27.429.313	(9.303.336)	31.335.025
					178.974.471
Investments					
Property, plant and equipment and intangible assets	6.506.192	2.967.163	3.479.974	0	12.953.328
Balance sheet (31.12.2015)					
Property, plant and equipment and intangible assets	139.378.006	123.084.460	17.214.738	0	279.677.203
Other assets	11.343.532	7.541.563	167.050.684	(154.623.462)	31.312.317
					310.989.521
Loans and borrowings	71.229.733	71.363.358	165.635.337	(142.593.091)	165.635.337
Other liabilities	7.357.745	5.028.073	21.784.659	(3.587.478)	30.583.000
					196.218.337
Investments					
Property, plant and equipment and intangible assets	3.989.932	4.509.621	1.878.980	0	10.378.533

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Notes

4. Analysis of geothermal power plant operation

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

	Electricity 2016	Hot water 2016	Electricity 2015	Hot water 2015
Geothermal power plant				
Revenue	9.205.438	3.600.872	8.869.348	3.081.045
Operating expenses	(1.927.328)	(789.570)	(1.616.982)	(686.904)
Depreciation and amortisation	(2.649.013)	(829.947)	(2.652.948)	(891.754)
Profit before financial expenses	4.629.097	1.981.355	4.599.418	1.502.387
Return on investment	5,4%	7,0%	4,9%	4,8%

The power plants at Hellisheiði and Nesjavellir are mixed production plants, where both hot water and energy are produced.
The cost allocation is based on ON Power´s methods, that the National Energy Authority "NEA" has not approved. NEA is obligated to set new cost allocation rules after having disapproved ON Power´s proposal, NEA has not yet carried this out. Until NEA sets new rules for cost allocation, the return of the sectors are reported using ON Power's methods.

5. Salaries and salary related expenses

Salaries and salary related expenses are specified as follows:	2016	2015
Salaries	4.802.257	3.960.733
Defined contribution pension expenses	633.931	526.107
Defined benefit pension expenses	76.744	43.252
Other salary related expenses	463.473	404.055
Total salaries and salary related expenses	5.976.406	4.934.147

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

Expensed in the income statement	5.240.591	4.424.532
Capitalised on projects	735.815	509.615
Total salaries and salary related expenses	5.976.406	4.934.147

Number of employees:

Number of annual working units	503	462

Management's salaries and benefits for the parent company and subsidiaries are specified as follows:

Salaries to the Board of Directors of the Parent Company	15.265	14.704
Salaries of the CEO of the Parent Company	27.657	24.801
Salaries of three Managing Directors of the Parent Company	56.059	48.310
Salaries to the Board of Directors of three subsidiaries	24.101	17.880
Salaries of three Managing Directors of subsidiaries	54.914	58.937
Termination expenses, pension expenses included 1)	20.697	0
	198.694	164.631

Included in salaries are benefits and vehicle subsidy.

1) The manager of Orka náttúrunnar ohf. left his position at year-end 2016. Salaries and salary related expenses were all expensed in P/L upon his departure.

6. Auditors fee

	2016	2015
Audit of financial statements and review of interim financial statements	15.288	18.084
Other services	4.254	2.616
Total auditors fee	19.542	20.700

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7. Depreciation, amortisation and impairment

	2016	2015
Depreciation, amortisation and impairment is specified as follows:		
Depreciation of property, plant and equipment cf. note 10	9.332.096	9.429.720
Impairment of assets under construction cf. note 10	990.284	1.240.000
Amortisation of intangible assets, cf. note 11	70.099	76.903
Depreciation, amortisation and impairment	10.392.479	10.746.623

8. Financial income and expenses

	2016	2015
Financial income and expenses are specified as follows:		
Interest income	433.252	510.774
Interest expense and indexation	(4.108.864)	(3.877.312)
Guarantee fee to owners 1)	(1.080.733)	(705.321)
Total interest expenses	(5.189.598)	(4.582.634)
Fair value changes of embedded derivatives in electricity sales contracts	2.873.054	(10.164.474)
Fair value changes of assets available for sale	0	(7.712)
Fair value changes of financial assets and financial liabilities through P/L	(616.075)	232.605
Fair value changes of hedge contracts	(1.438.956)	(684.016)
Hedge contracts	(1.506.133)	(1.232.298)
Foreign exchange difference	8.504.057	5.075.491
Dividends	28.968	9.474
Total of other income (expenses) on financial assets and liabilities	7.844.913	(6.770.931)
Total financial income and expenses	3.088.567	(10.842.791)

1) The Group paid a guarantee fee to current and former owners of the company for guarantees they have made on the Groups loans and borrowings according to a decision made on the annual meeting of Orkuveita Reykjavikur in 2005. The fee on yearly basis for its licenced operations is 0,95% (2015: 0,375%) and 0,57% (2015: 0,55%) regarding loans due for operations in the open market. The guarantee fee is calculated on total loans quarterly. The guarantee fee amounted to ISK 1.011 million in the year 2016 (2015: ISK 705 million) and is accounted for among interest expenses.

Fair value changes through P/L

Generally accepted valuation methods are used to determine the fair value of certain financial assets and financial liabilities, further discussed in note 36. Change in fair value that is recognized in the income statement amounts to ISK 818 million. (2015: expense ISK 10.624 million). Fair value changes on financial asses and liabilities defined at level 3 amounts to ISK 2.260 million (2015: expense ISK 9.932 million).

Capitalised financing cost

Financing cost has not been capitalized in the year 2016. In the year 2015 financing cost due to construction of a power plant amounting to ISK 222 million was capitalised and was deducted from financial expense. Interest ratio that was used in the calculation of capitalised financing cost in the year 2015 was 4,64%.

	2016	2015
Interest expense is specified as follows:		
Interest expenses, charged in the income statement	(5.189.598)	(4.582.634)
Capitalised finance cost	0	(221.855)
Interest expenses	(5.189.598)	(4.804.489)

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Notes

9. Income tax

The Group´s companies are tax liable according with Article 2 of law no. 90/2003 on income tax. The part of the Group´s operation concerning operation of cold water supply and sewer is though exempt from income tax. The parent Company´s tax rate is 36%, other taxable subsidiaries have a 20% tax rate.

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

	2016	2015
Current income tax	1.737.164	0
Change in deferred income tax	2.964.509	(587.267)
Income tax recognised through P/L	4.701.673	(587.267)

Reconciliation of effective tax rate:

		2016		2015
Profit before income tax		18.053.484		3.588.332
Income tax according to tax ratio of parent	36,0%	6.499.254	36,0%	1.291.800
Effect of tax rates of subsidiaries	(3,9%)	(700.268)	(30,3%)	(1.086.433)
Effect of valuation of impairment of deferred tax losses	0,7%	133.132	2,5%	90.764
Non-taxable operation of water supply and sewer	(7,0%)	(1.259.401)	(25,7%)	(922.440)
Effect of different functional currencies in the Group	0,2%	38.503	1,2%	42.234
Other items	(0,1%)	(9.548)	(0,1%)	(3.193)
Effective income tax	26,0%	4.701.673	(16,4%)	(587.268)

Income tax recognised in other comprehensive income

Deferred tax

Due to income and expenses moved direct to equity	2016	2015
Tax effect of revaluation	0	1.187.959
Defered tax, total	0	1.187.959

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10. Property, plant and equipment

The year 2016	Production system	Utility system	Other real estates	Other equipment	Total
Cost or deemed cost					
Balance at year beginning	242.676.320	264.376.762	1.512.548	1.986.046	510.551.676
Reclassification of assets	(276.822)	(107.740)	81.295	(17.465)	(320.732)
Additions during the year	3.848.583	8.213.874	364.930	317.590	12.744.977
Additions of assets in constr.	518	0	0	0	518
Translation difference	(22.342.020)	0	(1.741)	(8.870)	(22.352.631)
Sold or disposed of	0	0	0	(66.893)	(66.893)
Balance at year end	223.906.578	272.482.897	1.957.032	2.210.408	500.556.916
Depreciation					
Balance at year beginning	89.424.779	141.539.321	292.548	983.861	232.240.509
Reclassification of assets	(301.712)	(44.685)	43.290	(17.625)	(320.732)
Depreciated during the year	4.638.729	4.449.197	20.635	223.536	9.332.096
Impairment of assets in constr.	990.284	0	0	0	990.284
Translation difference	(6.455.987)	0	(621)	(2.309)	(6.458.916)
Sold or disposed of	0	0	0	(49.072)	(49.072)
Balance at year end	88.296.093	145.943.833	355.851	1.138.391	235.734.169
Carrying amounts					
At 1.1. 2016.................................	153.251.540	122.837.442	1.220.000	1.002.185	278.311.167
At 31.12. 2016.............................	135.610.485	126.539.064	1.601.181	1.072.017	264.822.746
Thereof assets under construction at year end...........	346.299	1.790.524	0	0	2.136.823

The year 2015	Production system	Utility system	Other real estates	Other equipment	Total
Cost or deemed cost					
Balance at year beginning	229.949.102	241.679.011	1.664.022	1.683.033	474.975.168
Reclassification of assets	(493.601)	(27.526)	(172.813)	(140.979)	(834.918)
Additions during the year	4.496.859	4.578.892	106.712	475.116	9.657.579
Additions of assets in constr.	596.015	15.728	0	0	611.742
Translation difference	3.385.148	0	279	204	3.385.631
Sold or disposed of	0	0	(85.652)	(31.328)	(116.979)
Revaluation, increase	4.742.797	18.221.921	0	0	22.964.718
Revaluation, decrease	0	(91.264)	0	0	(91.264)
Balance at year end	242.676.320	264.376.762	1.512.548	1.986.046	510.551.676
Depreciation					
Balance at year beginning	80.301.902	127.310.832	514.635	918.390	209.045.759
Reclassification of assets	(493.601)	(27.526)	(172.813)	(140.979)	(834.918)
Depreciated during the year	4.788.113	4.403.737	13.231	224.640	9.429.720
Impairment of assets in constr.	1.240.000	0	0	0	1.240.000
Translation difference	864.989	0	90	335	865.413
Sold or disposed of	0	0	(62.594)	(18.525)	(81.119)
Revaluation, increase	2.723.376	9.914.756	0	0	12.638.133
Revaluation, decrease	0	(62.479)	0	0	(62.479)
Balance at year end	89.424.779	141.539.321	292.548	983.861	232.240.509
Carrying amounts					
At 1.1. 2015.................................	149.647.200	114.368.179	1.149.387	764.643	265.929.409
At 31.12. 2015.............................	153.251.540	122.837.442	1.220.000	1.002.185	278.311.167
Thereof assets under construction at year end...........	7.308.846	1.716.102	0	0	9.024.949

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10. Property, plant and equipment, contd.

Revaluation

When revaluating, the relevant asset groups are measured at fair value. The aforementioned revaluation is recognised in a revaluation reserve among equity taken into account effects of deferred income tax as further explained in note 36 d. The revaluation is carried out by experts within the Group.

No revaluation was accounted for in the year 2016.
Revaluation was last conducted according to the following table:

	Date of Revaluation
Production systems	
Hot water	31.12.2013
Cold water	31.12.2015
Electricity	31.12.2014
Distribution systems	
Hot water	31.12.2015
Cold water	31.12.2015
Sewage	31.12.2015
Electricity	31.12.2015
Fibre-optic cable system	31.12.2015

The fair value of these assets is determined on the basis of the depreciated replacement cost. This consists in that an assessment is made on changes in the construction cost of comparable assets and both cost and accumulated depreciations are revaluated in accordance with those changes. The calculation is based on official information and actual statistics from the Group's books on value changes of cost of items and takes into account an estimate on the weight of each cost item in the total cost of construction of comparable assets. Cost items and their proportional weight were determined by experts within the Group. The impairment test of assets is also taken into consideration and revaluation is not recognised beyond the expected future cash flow of the assets. Distribution systems for hot water, cold water, sewage and electricity are licensed operations and subject to official revenue targets that are based mostly on changes in the construction cost index. This is taken into consideration when revaluating these systems. Revaluation is classified as level 3 of the hierarchy of fair value, further explained in note 29.

Information on revalued assets at year end

31.12.2016	Production system	Distribution system	Total
Revalued carrying amount	135.610.485	126.539.064	262.149.549
Thereof effect of revaluation	(35.532.280)	(48.341.332)	(83.873.612)
Carrying amount before effect of revaluation	100.078.205	78.197.731	178.275.936
31.12.2015			
Revalued carrying amount	153.251.540	122.837.442	276.088.982
Thereof effect of revaluation	(39.264.621)	(50.466.177)	(89.730.798)
Carrying amount before effect of revaluation	113.986.919	72.371.264	186.358.184

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10. Property, plant and equipment, contd.

Impairment tests

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

The recoverable amount of each sector was evaluated based on value in use. The value in use was determined by discounting the expected future cash flows at the continued use in each sector. Cash flows were based on the future cash flow of the next five years. In assessing value in use, management make the plan for business development, based on both internal and external information.

The following criteria was used in assessing the value in use:

	Year 2016				
	Distribution system				Prod. systems
	Hot water	Electricity	Cold water	Sewage	Power plants
Revenue CAGR 2016-2021	2,0%	0,8%	-0,1%	1,7%	3,7%
CAGR w.r.t. to price changes	1,2%	0,9%	0,9%	0,9%	0%-6,8%
EBITDA CARG 2016-2021	2,6%	1,8%	-0,5%	1,5%	4,0%
WACC	5,4%	5,2%	6,3%	5,7%	5,3%-8,8%

	Year 2015				
	Distribution system				Prod. systems
	Hot water	Electricity	Cold water	Sewage	Power plants
Revenue CAGR 2016-2020	1,4%	1,8%	2,2%	2,8%	2,8%
CAGR w.r.t. to price changes	1,0%	1,0%	0,7%	0,7%	0,0% til 4,9%
EBITDA CARG 2016-2020	1,5%	1,7%	2,3%	3,2%	2,3%
WACC	4,8%	5,4%	5,0%	5,0%	4,8%- 7,5%

Impairment for distribution system for utilities or hot water production is unlikely because of considerable additional value. However the test for electricity in power plants is sensitive to changes in key assumptions. If the required rate of ROCE by 0,35 percentage points, and other criteria are kept unchanged the calculated impairment in electricity for power plants would be ISK 1,3 billion. If the projected EBITDA is 6% lower during the planning period and other terms are unchanged, calculated impairment would be ISK 0,7 billion.

Assets under construction

Assets under construction have been impaired by ISK 990,3 billion (2015: 1.200 billion) due to uncertainty about a contract for the purchase of two 45 MW turbines. After the impairment the book value of those assets is ISK 0. There is no indication for further impairment for other assets under constructions for the book value of ISK 2,1 billion at year-end 2016 (2015: 9,0 billion)

Further explanation on impairment test is in note 36 h.

Rateable value and insurance value

The rateable value of the Group's assets measured in the rateable value assessment amounted to ISK 22.808 million at year end 2016 (2015: ISK 21.485 million). The fire insurance value of the company's assets amounted to ISK 30.175 million at the same time (2015: ISK 30.064 million). Among those assets are real estates capitalised among production and distribution systems. The insurance value of the Group's assets amounted to ISK 356.225 million at year end 2016 (2015: ISK 370.013 million).

Obligations

The Group notified in the year 2016 that there would be no additional purchase of turbines according the contract with producers from the year 2008. Negotiations on the cancellation of the last two 45MW turbines are ongoing, the balance of the contract is valued at ISK 6,3 billion (31.12.2015: ISK 6,6 billion). The cost, if the contract is terminated, is unsignificant. Furthermore, the Group has entered into contracts and placed purchase orders with suppliers and developers concerning work on production and distribution systems. The balance of these contracts and purchase orders at year end is estimated at ISK 2,1 billion (31.12.2015: ISK 0,9 billion).

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11. Intangible assets

Intangible assets are specified as follows:

The year 2016	**Heating rights**	**Software**	**Total**
Cost			
Balance at year beginning	1.427.031	1.284.666	2.711.697
Additions during the year	0	207.833	207.833
Balance at end of the year	1.427.031	1.492.499	2.919.530
Amortisation			
Balance at year beginning	457.768	887.892	1.345.660
Amortisation during the year	0	70.099	70.099
Balance at end of the year	457.768	957.990	1.415.759
Carrying amounts			
At 1.1. 2016	969.263	396.774	1.366.037
At 31.12. 2016	969.263	534.509	1.503.771
The year 2015			
Cost			
Balance at year beginning	1.427.031	1.575.650	3.002.681
Reclassification of assets	0	(400.196)	(400.196)
Additions during the year	0	109.212	109.212
Balance at year end	1.427.031	1.284.666	2.711.697
Amortisation			
Balance at year beginning	457.768	1.211.184	1.668.953
Reclassification of assets	0	(400.196)	(400.196)
Amortisation during the year	0	76.903	76.903
Balance at year end	457.768	887.892	1.345.660
Carrying amounts			
At 1.1. 2015	969.263	364.466	1.333.728
At 31.12. 2015	969.263	396.774	1.366.037

12. Investments in associated companies

	2016		**2015**	
	Share	**Carrying amount**	**Share**	**Carrying amount**
Íslensk Nýorka ehf.	28,95%	27.670	28,95%	28.357
Netorka hf.	38,41%	25.521	38,41%	28.204
Reykjavik Energy Grad. School hf.	45,00%	6.146	45,00%	6.190
Total		59.337		62.750

The Group's share in the loss of its associated companies amounted to ISK 3,4 million in the year 2016 (2015: profit of ISK 3,6 million).

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13. Investments in other companies

Investments in other companies are specified as follows:	Share	2016	2015
Landsnet hf. 1)	6,8%	3.222.160	2.845.000
Other shares in companies		62.914	62.914
Other shares in companies, total		3.285.074	2.907.914

Fair value of financial assets available for sale is based on generally accepted valuation methods performed by independent experts and internal experts. Fair value change of Landsnet hf. amounted to ISK 377 million and the increase was transferred to a fair value reserve among equity. See further discussion in note 29.

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

14. Embedded derivatives in electricity sales contracts

	2016	2015
Fair value of embedded derivatives at the beginning of the year	(13.192.163)	(3.027.689)
Fair value changes during the year, expensed	2.873.054	(10.164.474)
Fair value of embedded derivatives at year-end (liability)/asset	(10.319.109)	(13.192.163)

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

	2016	2015
Non-current embedded derivatives (liability)/asset	(8.913.368)	(11.095.112)
Current embedded derivatives, (liability)/asset	(1.405.741)	(2.097.051)
Total embedded derivatives at year-end	(10.319.109)	(13.192.163)

Further discussion regarding embedded derivatives can be found in note 25 c.

15. Other financial assets and financial liabilities

Financial assets at fair value through profit or loss:	2016	2015
Non-current assets		
Bonds	4.091.936	0
Hedge contracts	365.333	443.324
	4.457.269	443.324
Current assets		
Bonds	0	8.713.156
Hedge contracts	393.183	805.795
	393.183	9.518.951
Non current liabilities		
Hedge contracts	(2.713.071)	(2.320.623)
Current liabilities		
Hedge contracts	(2.311.883)	(1.755.978)

In September 2016 an agreement was signed between Orkuveita Reykjavíkur and Magma Energy Sweden, the parent company of HS Orka, to reschedule payments on the bond which was to fully mature in December 2016. According to the agreement, half of the bond´s amount was paid when the agreement was confirmed and the other half will be paid in early 2018. Shares in HS Orka will continue to be pledged to secure payments and the interest rate will increase from 1,5% to 5%. Derivatives are not separated from the bond. The fair value of the bond is measured from future prices of aluminium, discounted by the interest rate of the relevant currency, plus premium due to counter-party risk. All of the Group´s bonds are determined to be third level in the fair value hierarchy as further is explained in note 29.

Hedge contracts are measured by discounted future cash flow and market observable data is used in the price determination.

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16. Deferred tax assets and liabilities

Deferred tax assets and liabilities is specified as follows:

2016	Tax assets	Tax liabilities	Net amount
Deferred tax assets/liabilities at the beginning of the year	5.458.992	7.619.438	(2.160.445)
Calculated income tax for the year	(3.654.661)	1.047.012	(4.701.673)
Current tax liability	1.621.717	(115.446)	1.737.164
Other changes	288.831	(205.670)	494.501
Deferred tax assets/liabilities at end of the year	3.714.880	8.345.332	(4.630.453)
2015			
Deferred tax assets/liabilities at the beginning of the year	3.546.925	5.063.468	(1.516.542)
Calculated income tax for the year	1.956.428	1.369.161	587.267
Other changes	93.971	137.182	(43.212)
Tax effect on the revaluation account	(138.332)	1.049.627	(1.187.959)
Deferred tax assets/liabilities at end of the year	5.458.992	7.619.438	(2.160.445)

Deferred tax assets and liabilities are attributable to the following:

	31.12.2016		31.12.2015	
	Tax assets	Tax liabilities	Tax assets	Tax liabilities
Property, plant and equipment	0	8.495.648	714.653	10.521.628
Embedded derivatives	3.714.879	0	4.749.179	0
Other items	0	897.554	(430.890)	131.931
Effect of carry forward taxable loss	0	(1.365.758)	426.050	(3.218.877)
Effect of write-down of taxable loss	0	317.889	0	184.757
Deferred tax assets/liabilities at year end	3.714.879	8.345.332	5.458.992	7.619.437

Carry forward taxable loss

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

	2016	2015
Unadjusted taxable loss for the year 2008, usable until year 2018	4.147.939	12.446.443
Unadjusted taxable loss for the year 2009, usable until year 2019	2.475.484	4.831.415
Unadjusted taxable loss for the year 2016, usable until year 2026	205.368	0
Carry forwards taxable loss at year end	6.623.423	17.277.859
Unadjusted taxable loss for the year 2008, write-down	1.589.445	923.783

Management has evaluated the utilization of income tax losses and made plans for taxable profit for the next years. Deferred tax assets due to the loss carried forward is recognized to the extent that it is believed to be useful. Loss carried forward in the amount of ISK 1,6 billion is not credited at the end of 2016, but at the beginning of the year it was ISK 0,9 billion due to uncertainty of utilization of the tax losses. The tax effect is ISK 0,1 billion.

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17. Inventories

	2016	2015
Inventory of materials	582.934	610.407

The Group's material inventories consist of material for maintenance, renewal and construction of the Group's production and distribution systems. A part of the inventories is defined as safety inventories, i.e. inventories that are necessary to have on hand in case of malfunction or maintenance even though their turnover is low. The value of inventories is estimated regularly. Inventories for renewal and new constructions are accounted for among property, plant and equipment as part of building cost of assets under construction.

18. Receivables

Trade receivables is specified as follows at year end:	2016	2015
Trade receivables, industrial consumers	670.120	733.062
Trade receivables, retail	4.075.708	4.064.615
Trade receivables, total	4.745.828	4.797.677
Allowance for doubtful accounts	(149.201)	(162.811)
	4.596.627	4.634.866

Other current receivables are specified as follows at year end:

	2016	2015
Capital income tax	102.606	127.880
Accrued interest income	47.617	43.664
Receivables from employees	3.807	4.630
Other receivables	178.199	176.731
	332.229	352.905

19. Cash and cash equivalents, deposits and marketable securities

Cash and cash equivalents and deposits at year end are specified as follows:	2016	2015
Bank deposits, available from three to twelve months	3.000.000	554.381
Marketable securities	1.132.427	1.353.894
Bank balances available within three months	12.356.669	5.264.079
	16.489.096	7.172.354

20. Equity

Equity ratio of the Group at year end 2016 is 40,4% (2015: 36,9%). Return on equity was positive by 12% in the year 2016 (2015: positive by 4,0%).

Revaluation reserve

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

Translation reserve

The translation reserve comprises all foreign currency differences arising from the translation of financial statements of operations with other functional currency than ISK.

Fair value reserve

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

Equity reserve

According to recently accepted amendments on the Financial Statements Act no. 3/2006, share in profit of subsidiaries ans associates, which exceeds the dividends received or the dividend decided of retained earnings, is accounted for on a restricted reserve account among equity.

Development reserve

According to the law no. 3/2006 companies that capitalize developmental cost should account for the same amount on a restricted reserve account among equity.

Retained earnings

Dividend was not paid to the owners of the parent Company in the year 2016. (2015: No payment of dividend).
The Company's Board of Directors do not propose dividend to be paid to the owners of the parent company in the year 2017 due to the operating year 2016. The owners of the parent company decide on dividend payments.

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21. Loans and borrowings

Interest bearing loans are recorded using the method of amortised cost. Further information on the Group´s exposure to interest rate, foreign currency and liquidity risk, see note 25. Loans and borrowings are detailed as follows:

Non-current liabilities	31.12.2016	31.12.2015
Bank loans	106.326.779	130.929.982
Subordinated loan from owners of the Company	13.293.025	13.711.809
Bond issuance	25.159.658	20.993.546
	144.779.461	165.635.337
Current portion on non-current liabilities	(15.462.497)	(19.288.436)
	129.316.964	146.346.901
Current liabilities		
Current portion on non-current liabilities	15.462.497	19.288.436
Short-term bank loans	2.859.984	0
	18.322.481	19.288.436
Total interest bearing loans and borrowings	147.639.446	165.635.337

Terms of interest-bearing loans and borrowings

Liabilities in foreign currencies:		31.12.2016		31.12.2015	
	Date of maturity	Average interest rate	Carrying amount	Average interest rate	Carrying amount
Liabilities in CHF	5.10.2027	0,00%	12.148.428	0,00%	15.858.990
Liabilities in EUR	19.12.2027	0,65%	37.619.335	0,79%	49.424.015
Liabilities in USD	15.11.2038	2,18%	30.554.614	1,62%	39.472.704
Liabilities in JPY	10.5.2027	0,00%	5.868.767	0,13%	7.550.385
Liabilities in GBP	26.2.2024	1,53%	2.544.687	1,74%	4.031.464
Liabilities in SEK	5.10.2027	0,00%	3.747.424	0,00%	5.155.106
			92.483.255		121.492.664
Liabilities in Icelandic kronas:					
Indexed	9.5.2046	4,13%	45.696.207	4,03%	42.907.674
Non-indexed	5.12.2018	6,90%	9.459.984	7,40%	1.235.000
			55.156.191		44.142.674
Total interest-bearing loans and borrowings			147.639.446		165.635.337

Repayment on non-current liabilities are specified as follows on the next years:

31.12.2016	
The year 2017	18.322.481
The year 2018	14.605.156
The year 2019	13.467.078
The year 2020	13.224.740
The year 2021	12.160.142
Later	75.859.849
Total non-current liabilities, including next year's repayment	147.639.446

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21. Loans and borrowings, contd.,

31.12.2015

The year 2016	19.288.436
The year 2017	15.001.564
The year 2018	15.928.982
The year 2019	14.275.206
The year 2020	13.976.808
Later	87.164.340
Total non-current liabilities, including next year's repayment	165.635.337

Guarantees and pledges

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

Covenants

Loans for the amount of ISK 23.443 million have certain covenants that regard repayment time as a proportion of EBITDA and as interests as a proportion of EBITDA as well as reviewing that budgets are within set limits (2015: ISK 13.909 million). Management regularly evaluate the covenants and in their view there is not risk of them being breached. At the end of the year 2016 the Group measured up to all financial covenants of loan agreements.

22. Retirement benefit obligation

The Group has retirement benefit obligation due to benefits of current and former employees in pension benefit plans.

The Group's accrued retirement benefit obligation amounted to ISK 617 million at year end 2016, discounted based on 2% interests and taken into account the share in the net asset of the pension fund (2015: ISK 568 million). The Group updates the obligation according to an assessment from an actuary each year when that assessment is available. Premises for life expectancy are in accordance with provisions of Regulation no. 391/1998 on obligatory insurance of pension benefits and operation of pension funds. The estimated increase in the obligation in the year is based on general increase in salaries taken into account interests. The increase of the obligation during the year is expensed in the income statement among salaries and salary related expenses. The part of the obligation that is estimated to be payable in the year 2017 is recognised among current liabilities.

	2016	2015
Retirement benefit obligation at the beginning of the year	567.661	545.264
Contribution due to pension payments during the year	(27.500)	(20.855)
Increase in the pension fund obligation during the year	76.744	43.252
Retirement benefit obligation at year end	616.905	567.661
Non-current component of retirement benefit obligation	591.905	542.661
Current component of retirement benefit obligation	25.000	25.000
Retirement benefit obligation at year end	616.905	567.661

23. Current liabilities

Other current liabilities is specified as follows:	2016	2015
Unpaid taxes	497.163	513.479
Unpaid salaries and salary related items	1.029.443	934.141
Accrued interest expenses	554.415	585.862
Current component of retirement benefit obligation	25.000	25.000
Derivative contracts in default*	740.000	740.000
Other liabilities	153.047	113.521
	2.999.068	2.912.003

* See note 34

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24. Risk management and financial instruments

The risk policy was updated and approved by the Board of Directors of Orkuveita Reykjavík at the end of the year 2016. The Board´s policy is that in all of the Group´s operations, risks are to be considered and by that implementing efficient decision making and governance. The risk policy explains the overview and main targets of the Board in this matter. The risk policy also defines the main risk factors, measurement indicators, objectives and risk limits in the daily risk management. One of the main foundations in the risk policy is to define the risk factors which are of relevance, measure their impact and define acceptable limits when controlling them.

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

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

The department of risk oversees and controls risk. The objective of the department is to monitor, analyse and control the financial risks of the Group.
Financial risk is divided into:

• Market risk, further discussed in note 25
• Liquidity risk, further discussed in note 26
• Credit risk, further discussed in note 27
• Operational risk, further discussed in note 28

25. Market risk

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

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

a. *Currency risk*

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

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

Approx. 62,6% of the Group's interest bearing loans are in foreign currencies. The Group has entered into long term electricity sales contracts in foreign currency (USD). The expected future revenues from these contracts on the accounting date amount to approx. ISK 81.059 million (2015: ISK 98.698 million). That amount is based on the future price of aluminium on LME (London Metal Exchange) and expectations of price development of aluminium for the next 25 years according to, an independent evaluation party CRU, as available on the accounting date.

	2016	2015	31.12.2016	31.12.2015
	Average exchange rate		Exchange rate at year end	
CHF	122,504	137,077	110,810	130,500
EUR	133,591	146,296	119,130	141,320
USD	120,673	131,847	112,820	129,590
JPY	1,112	1,089	0,966	1,076
GBP	163,803	201,576	138,910	192,060
SEK	14,128	15,642	12,432	15,395
TWI	179,629	200,993	161,668	191,495

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25. Market risk, contd.

a. *Currency risk, contd.*

Balance sheet currency risk

The Group's exposure to currency risk is specified as follows:

31.12.2016	CHF	EUR	USD	JPY	SEK	ISK	Other currencies	Total
Loans and borrowings	(12.148.428)	(37.619.335)	(30.554.614)	(5.868.767)	(3.747.424)		(2.544.687)	(92.483.255)
Trade receivables (accounts payables)	(102)	7.230	457.005	67	3	734.618	43	1.198.865
Bank deposits	200.958	228.385	462.009	50.957	32.841	57.926	31.952	1.065.027
Embedded derivatives			(10.319.109)					(10.319.109)
Hedge contracts	951.952	6.511.505	(5.301.761)	1.084.754	901.206		1.049.601	5.197.257
Financial assets at fair value through P/L			4.091.936					4.091.936
Receivables/(payables) for related parties*		(71.497)	(825.633)			(4.072.957)		(4.970.087)
Loans and borrowings to related parties*			47.596.551			13.986.551		61.583.102
Risk of Financial instruments	(10.995.619)	(30.943.712)	5.606.384	(4.732.990)	(2.813.374)	10.706.138	(1.463.090)	(34.636.264)
Subsidiaries equity in USD**			47.300.597					47.300.597
Total risk in equity	(10.995.619)	(30.943.712)	52.906.981	(4.732.990)	(2.813.374)	10.706.138	(1.463.090)	12.664.333

(*) The functional currency of ON Power is in USD and translational differences are accounted for over P/L of assets and liabilities in ISK. In addition the translational differences are accounted over P/L for foreign assets and liabilities of the parent company towards it´s subsidiary, ON Power.

(**) The functional currency of ON Power is in USD and translational differences are accounted for over equity due to changes in currency USD/ISK.

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25. Market risk, contd.

a. *Currency risk, contd.*

Balance sheet currency risk, contd.

31.12.2015	CHF	EUR	USD	JPY	SEK	ISK	Other currencies	
Loans and borrowings	(15.858.990)	(49.424.015)	(39.472.704)	(7.550.385)	(5.155.106)		(4.031.464)	(121.492.664)
Trade receivables (accounts payables)		(37.488)	351		(194)	(58.216)	(978)	(96.525)
Bank deposits	902.484	1.261.058	994.254	204.102	4.031	40.979	125.703	3.532.612
Embedded derivatives			(13.192.163)					(13.192.163)
Hedge contracts	1.436.433	11.104.069	(7.296.281)	1.615.459	1.480.798		2.003.206	10.343.684
Financial assets at fair value through P/L			8.713.156					8.713.156
Receivables/(payables) for related parties*			(559.336)			(3.617.692)		(4.177.028)
Loans and borrowings to related parties*			57.156.554			14.206.804		71.363.358
Risk of Financial instruments	(13.520.073)	(37.096.376)	6.343.831	(5.730.824)	(3.670.470)	10.571.876	(1.903.533)	(45.005.569)
Subsidiaries equity in USD**			54.234.592					54.234.592
Total risk in equity	(13.520.073)	(37.096.376)	60.578.423	(5.730.824)	(3.670.470)	10.571.876	(1.903.533)	9.229.023

Sensitivity analysis

Strengthening by 10% of the Icelandic krona against the following currencies at year-end would have increased (decreased) equity and profit or (loss) by the amounts shown below, taking into account tax effects. This analysis assumes that all other variables, in particular interest rates and aluminium prices, remain constant. Weakening by 10% of the Icelandic krona against the above currencies would have had the equivalent, but opposite effect on the above currencies to the amounts shown above, on the basis that all other variables remain constant.

	CHF	EUR	USD	JPY	SEK	ISK	Other currencies	Total
				Profit or (loss)				
The year 2016	1.099.562	3.094.371	(560.638)	473.299	281.337	(1.070.614)	146.309	3.463.626
The year 2015	1.352.007	3.709.638	(634.383)	573.082	367.047	(1.057.188)	190.353	4.500.557
				Equity				
The year 2016	1.099.562	3.094.371	(5.290.698)	473.299	281.337	(1.070.614)	146.309	(1.266.433)
The year 2015	1.352.007	3.709.638	(6.057.842)	573.082	367.047	(1.057.188)	190.354	(922.902)

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25. Market risk, contd.

b. *Interest rate risk*

Interest rate risk is the risk of changes in interest rates having a negative effect on the Group's income. The Group is exposed to interest rate risk due to interest bearing assets, liabilities and financial instruments measured at fair value. The Group´s liabilities both have fixed and variable interest rates, majority being subject to variable interest rates. The department of risk monitors that interest rate risk is within preset limits and has permission to control interest rate risk with derivatives. On the accounting date hedges covered 87% of loans, taking into account hedges, with fixed interest rates 1 year ahead.

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

	31.12.2016	31.12.2015
Fixed rate instruments		
Financial liabilities	(48.978.590)	(43.336.268)
Variable rate instruments		
Financial liabilities	(98.660.856)	(122.299.069)
Financial instruments at fair value		
Bonds	4.091.936	8.713.156
Marketable securities	1.132.427	0
Hedge contracts	(4.266.438)	(2.827.482)
	957.925	5.885.674

In the following table, calculated effect of changes in interest on one year cash flow and on financial instruments at fair value is set forth, taken into account the effect of taxes. The analysis was done in the same way for the year 2015.

	Cash flow sensitivity analysis		Fair value sensitivity analysis	
31.12.2016	**100 p increase**	**100 p decrease**	**100 p increase**	**100 p decrease**
Embedded derivatives	0	0	333.163	(356.307)
Other financial assets	0	0	(31.822)	32.526
Investments in other companies	0	0	(1.095.344)	1.721.984
Hedge contracts	213.621	(213.621)	733.475	(765.307)
Interest bearing loans	(624.389)	624.389	0	0
	(410.769)	410.769	(60.528)	632.896
31.12.2015	**100 p increase**	**100 p decrease**	**100 p increase**	**100 p decrease**
Embedded derivatives	0	0	385.732	(409.342)
Other financial assets	0	0	(49.119)	50.020
Hedge contracts	291.378	(291.378)	1.296.185	(1.347.632)
Interest bearing loans	(410.595)	410.595	0	0
	(119.218)	119.218	1.632.798	(1.706.954)

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25. Market risk, contd.

c. *Aluminium risk*

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

Four electricity sales contracts have been made, originally to the next 20 years. One with Landsvirkjun in regards of Norðurál and three with Norðurál in regards of the aluminium plant at Grundartangi, in addition contracts have been made with Landsnet hf. on distribution of electricity. Orkuveita Reykjavíkur and Norðurál have also made an electricity sales contract due to sale of electricity to a pending aluminium plant in Helguvík, where delivery of electricity has begun, but the contract is for the next 25 years. These electricity sales contracts are denominated in USD and the price of the electricity is connected to the world market price of aluminium. Income of electricity contracts that is effected by price of aluminium is 13,8% of total revenue in the reporting year 2016 (2015: 15,8%)

To reduce risk due to aluminium prices the Group has entered into derivative contracts to reduce the fluctuation of income effected by aluminium prices. The department of risk has permission to hedge this risk for the next five years. At the accounting date hedges amounted to 50% of expected income effected by aluminium price until 31 December 2017 (31.12 2015: 43,0%).

Embedded derivatives in electricity sales contracts

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

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

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

Among embedded electricity sales contracts is a contract with Norðurál Helguvík ehf. (NH), stated at negative book value of ISK 2,4 billion (31.12.2015: negative by ISK 2,7 billion). The constructions of the aluminium plant at Helguvík have been delayed and there is uncertainty regarding continuance of the project. It was scheduled to begin delivery of power to the aluminium plant 1 September 2011 and NH was obliged to begin payments from that date. NH has used an option in the contract that allows NH to use the power at the aluminium plant at Grundartangi.

25. Market risk, contd.

c. *Aluminium risk, contd.*

In the following table shows the calculated effect on financial instruments due to change in aluminium price booked at fair value, taking tax effect into account.

Sensitivity analysis on the price of aluminium

31.12.2016	**Sensitivity of Fair value** 10% decrease	10% increase
Embedded derivatives	(3.911.703)	3.911.701
Aluminium hedges	219.732	(210.218)
Financial assets at fair value through P/L	0	100.188
Total	(3.691.971)	3.801.671

31.12.2015	**Sensitivity of Fair value** 10% decrease	10% increase
Embedded derivatives	(4.074.684)	4.074.684
Aluminium hedges	225.324	(218.473)
Total	(3.849.360)	3.856.212

d. *Other market risk*

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

26. Liquidity risk

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

The Group's cash and cash equivalents at end of the year amounted to ISK 12,4 billion and deposits available in three to twelve months amounting to ISK 3,0 billion as well as marketable securities amounting to 1,1 billion. Therefore the Group owned ISK 16,4 billion in bank deposits. Furthermore, the Group had unused loan authorisations and a open credit line to the total amount of approx. ISK 9,0 billion. The Group had thus in total ensured capital at year-end to the amount of approx. ISK 25,5 billion. The corresponding amount at year end 2015 amounted to ISK 16,0 billion.

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26. Liquidity risk, contd.

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

31.12.2016

	Carrying amount	Contractual cash flows	Less than 1 year	After 1 - 2 years	After 2 - 5 years	More than 5 years
Non-derivative financial instruments						
Other financial assets	4.091.936	4.370.083	205.897	4.164.186	0	0
Trade receivables	4.596.627	4.596.627	4.596.627	0	0	0
Other receivables	332.229	332.229	332.229	0	0	0
Deposits	3.000.000	3.000.000	3.000.000	0	0	0
Marketable securities	1.132.427	1.132.427	1.132.427	0	0	0
Cash and cash equivalents	12.356.669	12.356.669	12.356.669	0	0	0
Interest-bearing liabilities	(147.639.446)	(171.312.426)	(20.972.291)	(17.260.769)	(45.971.194)	(87.108.172)
Accounts payable	(2.317.493)	(2.317.493)	(2.317.493)	0	0	0
Other liabilities	(2.999.068)	(2.999.068)	(2.999.068)	0	0	0
	(127.446.119)	(150.840.952)	(4.665.003)	(13.096.583)	(45.971.194)	(87.108.172)
Derivative financial instruments, net financial assets and financial liabilities						
Embedded derivatives	(10.319.109)	81.059.017	5.650.004	5.737.529	16.972.067	52.699.416
Hedge contracts	(4.266.438)	(4.608.745)	(1.838.156)	(2.167.519)	(603.069)	0
	(14.585.547)	76.450.272	3.811.848	3.570.010	16.368.998	52.699.416

31.12.2015

	Carrying amount	Contractual cash flows	Less than 1 year	After 1 - 2 years	After 2 - 5 years	More than 5 years
Non-derivative financial instruments						
Other financial assets	8.713.156	9.337.072	9.337.072	0	0	0
Trade receivables	4.634.866	4.634.866	4.634.866	0	0	0
Other receivables	352.905	352.905	352.905	0	0	0
Deposits	554.381	554.381	554.381	0	0	
Marketable securities	1.353.894	1.353.894	1.353.894	0	0	0
Cash and cash equivalents	5.264.079	5.264.079	5.264.079	0	0	0
Interest-bearing liabilities	(165.635.337)	(187.673.123)	(21.699.952)	(17.077.167)	(50.641.126)	(98.254.878)
Accounts payable	(2.240.135)	(2.240.135)	(2.240.135)	0	0	0
Other liabilities	(2.912.003)	(2.912.003)	(2.912.003)	0	0	0
	(149.914.195)	(171.328.065)	(5.354.894)	(17.077.167)	(50.641.126)	(98.254.878)
Derivative financial instruments, net financial assets and financial liabilities						
Embedded derivatives	(13.192.163)	98.697.830	5.834.881	6.002.527	18.631.266	68.229.157
Hedge contracts	(2.827.482)	(3.194.475)	(1.028.752)	(994.301)	(1.171.422)	0
	(16.019.645)	95.503.355	4.806.129	5.008.226	17.459.844	68.229.157

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

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27. Credit risk

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

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

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

	31.12.2016	31.12.2015
Trade receivables	4.596.627	4.634.866
Other current receivables	332.229	502.759
Other financial assets	4.091.936	8.713.156
Hedge contracts	758.516	1.249.119
Deposits	3.000.000	554.381
Marketable securities	1.132.427	1.353.894
Cash and cash equivalents	12.356.669	5.264.079
Total	26.268.404	22.272.254

Financial assets as stated above are categorised as *loans and receivables* except for a part of *other financial assets* and *hedge contracts*. Their categorisation can be seen in note 30.

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

Trade receivables, industrial consumers	670.120	733.062
Trade receivable, retail	3.926.507	3.901.804
	4.596.627	4.634.866

Impairment of accounts receivables

	31.12.2016		31.12.2015	
	Gross balance	Allowance	Gross balance	Allowance
Not past due receivables	4.413.268	97.551	4.229.210	94.483
Past due, 1 to 30 days	77.876	6.459	251.963	18.199
Past due, 31 to 90 days	77.010	19.308	103.278	17.814
Past due, 91 days and older	177.674	25.883	213.226	32.315
Total	4.745.828	149.201	4.797.677	162.811

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

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

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

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28. *Operational risk*

Operational risk is the risk of negative effects on the result of natural disasters, weather, sabotage, terrorism, riots, war, poisoning, pollution, breakdowns, fires, accidents, inadequate information systems, administrative error, inadequate controls, prosecutions, fraud and human error. Risk Management assesses operational risk and monitors known operational risks of the Group and measures on a regular basis, if possible.

29. *Fair value*

Comparison of fair value versus carrying amounts

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

	31.12.2016		31.12.2015	
	Carrying amount	Fair value	Carrying amount	Fair value
Interest-bearing liabilities	147.639.446	140.043.421	165.635.337	145.180.453

The fair value of interest bearing liabilities is calculated based on present value of future principal and interest cash flows, discounted at the interest rate plus appropriate interest rate risk premium at the reporting date. The fair value of interest bearing liabilities is defined at Level 2.

Interest rates used for determining fair value

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

	31.12.2016	31.12.2015
Embedded derivatives in electr. sales contr.	2,34% to 8,11%	3,35% to 10,13%
Financial assets at fair value through P/L	5,16% to 5,22%	7,51% to 7,51%
Hedge contracts	-0,8% to 7,0%	-0,8% to 6,8%
Interest bearing loans	2,20% to 9,77%	2,61% to 7,99%

Fair value hierarchy

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

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

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

Level 3: Inputs for the asset or liability that are not based on observable market data (unobservable inputs). Valuation of shares in other companies is prepared by specialists within the company and other specialists and based on the results and official data on future earnings and investments in underlying assets

31.12.2016	Level 2	Level 3	Total
Shares in companies	0	3.285.074	3.285.074
Embedded derivatives in sales contracts	0	(10.319.109)	(10.319.109)
Other financial assets	758.516	4.091.936	4.850.452
Other financial liabilities	(5.024.954)	0	(5.024.954)
	(4.266.438)	(2.942.100)	(7.208.538)
31.12.2015			
Shares in companies	0	2.907.914	2.907.914
Embedded derivatives in sales contracts	0	(13.192.163)	(13.192.163)
Other financial assets	9.962.275	0	9.962.275
Other financial liabilities	(4.076.600)	0	(4.076.600)
	5.885.674	(10.284.249)	(4.398.575)

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

Fair value measurement

A part of the Group´s financial assets and financial liabilities are measured at fair value. Fair value of these assets and liabilities are determined by market data or price in recent transactions if that is available. Otherwise, accepted valuation methods are used. Further information on fair value calculations can be found in the discussion of the relevant assets and liabilities in notes 13, 14 and 15.

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Notes

30. Overview of financial instruments

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

	31.12.2016			31.12.2015		
	Loans and receivables	Financial asset/ financial liability at fair value through P/L	Available for sale	Loans and receivables	Financial asset/ financial liability at fair value through P/L	Available for sale
Shares in other companies			3.285.074			2.907.914
Embedd. contr. ...		(10.319.109)			(13.192.163)	
Bonds		4.091.936			8.713.156	
Hedge contr.		758.516			1.249.119	
Trade receivabl. .	4.596.627			4.634.866		
Other receivabl. ..	332.229			352.905		
Prepaid exp.	213.209			149.855		
Marketable securities	4.132.427	1.132.427		1.908.275	1.353.894	
Cash	12.356.669			5.264.079		
Interest-bearing .. liabilities	(147.639.446)			(165.635.337)		
Hedge contr.		(5.024.954)			(4.076.600)	
Account payabl. ..	(2.317.493)			(2.240.135)		
Other current liabilities	(2.999.068)			(2.912.003)		
	(131.324.846)	(9.361.184)	3.285.074	(158.477.497)	(5.952.594)	2.907.914

31. Property leases

The Company as a lessee, factors of the lease agreement

The Company entered into a 20 year lease agreement with Foss fasteignafelag inc. leasing the headquarters at Bæjarháls 1 and Réttarháls at year end 2013. In the agreement there is a purchase option that the Company can exercised after 10 and 20 years. The lease minimum payments the first 10 years is ISK 223,9 million pr year, indexed. If the purchase option is not exercised after 10 years the lease payments the next 10 years thereafter are ISK 290,2 million pr. year, indexed. Lease payments do not include any expenses and are expensed over 20 years. Figures below are not discounted.

Lease payments and income	2016	2015
Minimum lease payments, expensed	257.040	257.040
Conditional rent	10.106	6.084
Income from subleases	(41.172)	(48.048)
	225.974	215.077

Commitment in unresignable lease agreements		
Within a year	257.040	257.040
After 1 to 5 years	1.028.160	1.028.160
After 5 years	3.146.615	3.370.505
	4.431.815	4.655.705
Expected future income from subleases	137.986	197.442

The Company as a lessor

The Company has made lease agreements on part of the leased properties of the headquarters with five year terms and possible extension to ten years.

Expected future income from leases due to unresignable lease contracts	2016	2015
Within a year	44.848	48.437
After 1 to 5 years	93.137	140.535
After 5 years	0	8.470
	137.986	197.442

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32. Related parties

Definition of related parties

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

Transactions with related parties

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

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

Sale to related parties:	**2016**	**2015**
Reykjavik City	1.216.136	1.321.599
Institutions and companies controlled by Reykjavik City	559.789	471.402
	1.775.925	1.793.001
Purchases from related parties:		
Reykjavik City	39.986	17.527
Institutions and companies controlled by Reykjavik City	14.607	6.393
Associates	161.499	55.737
	216.092	79.658
Receivables for related parties:		
Reykjavik City	117.763	41.062
Institutions and companies controlled by Reykjavik City	43.585	1.475
	161.349	42.536
Payables for related parties:		
Reykjavik City	208.716	156.164
Institutions and companies controlled by Reykjavik City	360	612
	209.076	156.776
Interest bearing loans from owners of the parent Company:		
Reykjavik City	12.434.163	12.825.889
Akranes town	734.838	757.989
Borgarbyggð, municipality	124.024	127.931
	13.293.025	13.711.809
Interest expense on loans from owners of the parent Company:		
Reykjavik City	1.138.036	1.153.440
Akranes town	66.849	67.633
Borgarbyggð, municipality	11.283	11.415
	1.216.168	1.232.488

Guarantee fee to owners

Orkuveita Reykjavíkur paid a guarantee fee to Reykjavík City and other owners of the company for guarantees they have granted on the Groups loans and borrowings. For further information regarding amounts and the guarantee fee, see note 8. Management´s salaries and benefits are listed in note 5

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33. Group entities

Subsidiaries	Main operation	Share 31.12.2016	Share 31.12.2015
Gagnaveita Reykjavíkur ehf.	Data transfer	100,0%	100,0%
OR Eignir ohf.	Holding company	100,0%	100,0%
Veitur ohf.	Distribution of electricity and hot water	100,0%	100,0%
Orka náttúrunnar ohf.	Sale of electricity	100,0%	100,0%
OR vatns- og fráveita sf.	Cold water and sewage	100,0%	100,0%
Reykjavík Energy Invest ehf.	Investments	100,0%	100,0%
Úlfljótsvatn frítímabyggð ehf.	Preparation company	100,0%	100,0%

34. Other matters

Energy sale contracts with Norðurál Helguvík ehf.

Orkuveita Reykjavíkur will keep to the first part of the power purchase agreement with Norðurál Helguvík ehf. (NH) but there has been a disagreement since 2009 on weather Orkuveita Reykjavíkur needs to deliver more energy than has already been done. NH has not taken any legal action, but reserves the right to require Orkuveita Reykjavíkur for the supply of additional energy and/or compensation for alleged loss for energy that has not been delivered. Orkuveita Reykjavíkur has completely rejected such claims against the company. Possible amounts or consequences for a potential court case are unknown, but management evaluate decreasing risk for potential proceedings. The arbitration court has reached a conclusion in the case between HS Orka and NH, which is a similar case. The conclusion of the arbitrary court, according to notifications of the parties, is that there is no obligation on HS Orka´s part. Also the claims against HS Orka have been rejected by the court. Management believe there is no reason to book an obligation in the financial statements due to this situation.

Derivative contracts in default

Among other current liabilities are derivative contracts accounted for that are in default. The contracts have not been settled and Orkuveita Reykjavíkur has recently been sued regarding the claims. Great uncertainties is on how to settle them. In previous periods ISK 740 million have been expensed. This action is in no way an admittance of the debt on Orkuveita Reykjavikur´s behalf and the amount can either increase or decrease when the contracts are settled. The contracts are accounted for among other current liabilities. See in note 23.

35. Subsequent events

No subsequent events have significant impact on the financial statements.

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36. Significant accounting policies

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

a. *Basis of consolidation*

i) Subsidiaries

Subsidiaries are entities controlled by the Group. Control exists when the Group has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases.

ii) Associates

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

Associates are entered in the Group's financial statements by using the equity method.
Associated companies are reported at original cost, including business cost. After the original transaction the share of the Company is reported until significant influence ceases or joint control is concluded.

iii) Transactions eliminated on consolidation

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

b. *Foreign currency*

i Trade in foreign currencies

Trade in foreign currencies is reported into each consolidation company at the rate of the business day. Monetary assets and debts in foreign currencies are reported in the rate of the reporting date. Other assets and debts reported at fair value in foreign currency are reported at the rate of the day the fair value was set. Exchange difference due to foreign trade is reported through P/L.

ii Subsidiary with other currencies than the Icelandic krona

Assets and debts in the operations of a company of the consolidated financial statements that has USD as its functional currency are calculated into Icelandic kronas at the rate of the reporting date. Income and expenses of this companies operation is calculated into Icelandic kronas at the average exchange rate of the year. The exchange difference due to this is reported in a special account in the statement of comprehensive income. When operations with another functional currency than the Icelandic krona are sold, partly or in full, the accommodating exchange difference is recognised in P/L.

36. Significant accounting policies, contd.

c. *Financial instruments*

i) Non-derivative financial assets

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

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

Non-derivative financial instruments comprise of; available for sale, financial instruments at fair value through P/L and loans and receivables.

Available-for sale financial assets

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

Financial assets at fair value through profit or loss

An instrument is classified at fair value through profit or loss if it is held for trading or is designated as such upon initial recognition. Financial instruments are designated at fair value through profit or loss if purchase and sale decisions are based on their fair value in accordance with the Company´s risk policy or investment plan. Financial instruments at fair value through profit or loss are measured at fair value, and changes therein are recognised in profit or loss. Direct transaction cost is recognised in the income statement as it is incurred.

Loans and receivables

Loans and receivables are financial assets with certain or determinable payments and are not listed in active markets. Such assets are recognised initially at fair value plus, for instruments not at fair value through profit or loss, any directly attributable transaction costs. Subsequent to initial recognition loans and receivables are measured at amortised cost using the effective interest method, less any impairment losses.

Loans and receivables comprise of receivables and other current assets.

Cash and cash equivalents comprise cash balances and call deposits.

ii) Non-derivative financial liabilities

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

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

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

36. Significant accounting policies, contd.

c. *Financial instruments, contd.*

iii) Derivative financial instruments

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

iv) 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.

d. *Property, plant and equipment*

i) Recognition and measurement

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

Cost includes expenditure that is directly attributable to the acquisition of the asset. The cost of self-constructed assets includes the cost of materials and direct labour, any other costs directly attributable to bringing the asset to a working condition for its intended use, and the costs of dismantling and removing the items and restoring the site on which they are located. Purchased software that is integral to the functionality of the related equipment is capitalised as part of that equipment.

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

When parts of an item of property, plant and equipment have different useful lives, they are accounted for as separate items (major components) of property, plant and equipment and depreciated over their useful lives.

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

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

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

36. Significant accounting policies, contd.

d. *Property, plant and equipment, contd.*

ii) Subsequent costs
The cost of replacing part of an item of property, plant and equipment is recognised in the carrying amount of the item if it is probable that the future economic benefits embodied within the part will flow to the Group and its cost can be measured reliably. All other cost is expensed in the income statement when incurred.

iii) Depreciation
Depreciation is recognised in profit or loss on a straight-line basis over the estimated useful lives of each part of an item of property, plant and equipment. Land is not depreciated. Estimated useful lives are specified as follows:

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

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

e. *Intangible assets*

i) Heating rights
Heating rights are recognised in the balance sheet at amortised cost as intangible assets. Heating rights are separated from land up on purchase.

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

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

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

Heating rights	100 years
Software	3-7 years

f. *Leased assets*

i) The Company as a lessee
Payments of leases are expensed on straight-line basis in the lease term period unless another systematic method describes the usage of the leased item better. Uncertain lease payments from lease agreements are expensed in the period they occur.

ii) The Company as a lessor
Payments received from leases, both own property as well as lease-back properties, are booked on straight-line basis in the lease term period.

36. Significant accounting policies, contd.

g. *Inventories*

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

h. *Impairment*

i) Financial assets

A financial asset is assessed at each reporting date to determine whether there is any objective evidence that it is impaired. A financial asset is considered to be impaired if objective evidence indicates that one or more events have had a negative effect on the estimated future cash flows of that asset.

An impairment loss in respect of a financial asset measured at amortised cost is calculated as the difference between its carrying amount, and the present value of the estimated future cash flows discounted at the original effective interest rate. An impairment loss in respect of an available-for-sale financial asset is calculated by reference to its fair value at each time. The Group defines decrease in fair value below cost as a subjective indication of impairment of available-for-sale financial assets when:

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

Individually significant financial assets are tested for impairment on an individual basis. The remaining financial assets are assessed collectively in groups that share similar credit risk characteristics.

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

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

ii) Non-financial assets

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

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

The recoverable amount of an asset or cash-generating unit is the greater of its value in use and its fair value less costs to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

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

36. Significant accounting policies, contd.

i. *Employee benefits*

i) Defined contribution plans

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

ii) Defined benefit plans

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

j. *Obligations*

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

k. *Revenue*

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

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

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

ii) Revenues from sale of cold water and sewage

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

iii) Connection revenues

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

iv) Rental income

Rental income is recorded as income in the income statement linearly over the lease term.

v) Other revenues

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

36. Significant accounting policies, contd.

l. *Financial income and expenses*

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

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

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

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

m. *Income tax*

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

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years. The income tax ratio for the parent company is 36,0% and the tax ratio for the subsidiaries is 20,0%. Cold water supply and sewage is exempt from tax.

Deferred tax is recognised using the balance sheet method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is measured at the tax rates that are expected to be applied to the temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date. Deferred tax was measured in accordance with the current tax rate, which is 36,0% for the parent company that is a partnership and 20,0% for the subsidiaries that are companies with limited liability.

A deferred tax asset is only recognised to the extent that it is probable that future taxable profits will be available against which the temporary difference can be utilised. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

n. *Segment reporting*

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

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

Segment investments are investments in property, plant and equipment and intangible assets.
Inter-segment pricing is determined on an arm's length basis.

36. Determination of fair values

o. *Determination of fair value*

A number of the Group’s accounting policies and disclosures require the determination of fair value, for both financial and non-financial assets and liabilities.
The Group´s CFO is responsible for overseeing all significant fair value measurements, including Level 3 fair values. Risk management, led by the CFO, regularly reviews significant unobservable inputs and valuation adjustments. If third party information, such as broker quotes or pricing services, is used to measure fair values, then that information is used to support the conclusion that such valuations meet the requirements of IFRS, including the level in the fair value hierarchy in which such valuations should be classified.
When measuring the fair value of an asset or a liability, the Group uses market observable data as far as possible.

Fair values are categorised into different levels in a fair value hierarchy based on the inputs used in the valuation techniques as follows.
Level 1: quoted prices (unadjusted) in active markets for identical assets or liabilities.
Level 2: inputs other than quoted prices included in 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).

If the inputs used to measure the fair value of an asset or a liability might be categorised in different levels of the fair value hierarch, then the fair value measurement is categorised in its entirety in the same level of the fair value hierarchy as the lowest level input that is significant to the entire measurement.

The Group recognises transfers between levels of the fair value hierarchy at the end of the reporting period during which the change has occurred.

Further information about the assumptions made in measuring fair values can be found in relevant notes and in note 29 regarding fair value.

p. *Property, plant and equipment*

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

q. *Investments in equity and debt securities*

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

36. Determination of fair values, contd.

r. *Derivatives*

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

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

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

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

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

s. *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.

t. *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.

37. New accounting standards not yet adopted

Several new international accounting standards and improvement of the standards applicable to accounting year beginning after 1 January 2016 and are permissible for early adoption The company has not utilized the permission for early adoption in preparing these annual accounts. Management believes that the adoption of these standards will not have a significant impact on the consolidated financial statements excluding the effects of the transition to IFRS 15 effective for annual periods beginning 1 January 2018 and IFRS 16 effective for fiscal year beginning January 1, 2019. Possible effect of the implementation of the standards have not yet been evaluated. The application of IFRS 15 is scheduled in the year 2017 and IFRS 16 will apply to financial statements of the company if it will be adopted by the EU.

Corporate governance statement (unaudited)

Corporate governance

The principal operations of Orkuveita Reykjavíkur (OR) are governed by Act no.136/2013. In 2014 the owners of the company renewed a partnership agreement on operations. The ownership policy was also revised. The policy contains stipulations regarding corporate governance. The corporate governance of OR should ensure professionalism, efficiency, cost effectiveness, transparency and responsible management. The partnership agreement and ownership policy can be viewed on OR's website www.or.is. Moreover, the Board of Directors of OR and the boards of directors of the subsidiaries in the Group have established precise working rules and a code of conduct, which can also be found on the company's website. The code of conduct describes the practices the personnel of OR and its subsidiaries are expected to abide by in their work. An emphasis is placed on integrity, mutual respect and trust and ensuring that work is guided by the principle of guarding the interests of the company, irrespective of personal interests or personal views. At OR there is a policy of not accepting complimentary trips, gifts or other benefits which are connected to the business of companies or individuals with OR, if the gifts can be perceived as compensation for favours or special services. OR does not support political organisations or individual politicians.

At OR there are registered work procedures for the processing of issues when a staff member is alleged to have violated company rules or committed fraud at work. The rules of procedure are accessible to all employees on the company's intranet. These specify what are considered to be deviations or violations at work. If an employee becomes aware of possible breaches committed by another employee(s) at work or there are grounds to suspect fraudulent activities or incidents, the immediate superior must be notified. It is also possible to notify the company's internal auditor of any potential breaches or frauds. Those who receive indications of possible violations or fraud have a duty to report it, but to treat the information with complete confidentiality. OR's lawyer can also provide legal advice or assistance as the case may be. The management of OR, managing directors and directors are responsible for the internal supervision of their specific divisions. Quality Control is responsible for ensuring that OR's internal monitoring system is effective. OR's quality control system is independently certified by external entities.

The Internal Audit Division, which comes under the Board of Directors of OR, performs the function of confirming that the corporate governance, risk management and supervision of the company work cost-effectively and efficiently. In conducting its risk assessment, the internal audit takes into account the risk of corruption and this is reflected in the examination of monitoring functions. There were no cases of corruption in 2016.

In addition to these financial statements OR publishes an annual report and an environmental report in relation to the company's general meeting, which is normally held in April each year. The reports are prepared with regard to international standards of social responsibility, GRI. The standards call for information related to more than a hundred sustainability aspects of economy, environment, employment and working conditions, human rights, society, product responsibility, governance and ethics and integrity. The company strives to provide information on all these factors and provide even more information regarding non-financial factors that are stated in Article 66 d. in the Icelandic Financial Statements Act no 3/2006. Non-financial information will be published along with the financial statements for OR in the year 2017

Board of Directors

In accordance with the law on undertakings, the Board of Directors of OR comprises six members, five elected by the City Council of Reykjavik and one elected by the town council of Akranes. Borgarbyggd has an observer on the board. The City Council of Reykjavik elects a chairperson and vice-chairperson to the board from a group of members of the City Council of Reykjavik. The Board of Directors is responsible for the finances and operations of Reykjavik Energy. The Board of Directors comprises: Brynhildur Davídsdóttir, professor of Environment and Natural Resources Studies at the University of Iceland, who is also the chairperson, Gylfi Magnússon, lecturer in Economics at the University of Iceland who is vice-chairperson, and the other board members are , Sigríður Rut Júlíusdóttir, District Court Attorney at Réttur, Kjartan Magnússon, member of the City Council, Áslaug Fridriksdóttir, city councillor, and Valdís Eyjólfsdóttir, member of the town council of Akranes. Björn Bjarki Thorsteinsson sits as an observer from Borgarbyggd.

13 Board meetings were held in 2016. Absence was insignificant and all meetings legal.

Values

The values of OR are foresight, efficiency and integrity and serve as the guiding principles of all of the activities of the company.

Audit Committee

OR is also considered to be within the City of Reykjavik group pursuant to Article 108 of Act no. 3/2006 on Annual Accounts. The City Council appoints an Audit Committee for the City of Reykjavik group and one member of the Audit Committee is nominated by the Board of Directors of OR. The function of the Audit Committee is discussed in the Act on Annual Accounts and the eligibility of committee members is subject to the provisions of the Act on Annual Accounts regarding the Audit Committee. The Audit Committee comprises Ólafur B. Kristinsson, authorised public accountant, who is chairperson, Ingvar Gardarsson, authorised public accountant, Inga Björg Hjaltadóttir, lawyer, and Sunna Jóhannsdóttir, graduate in Business Administration, who is nominated by the Board of Directors of Reykjavik Energy. Further information on the work of the Audit Committee can be found on the City of Reykjavik's website: http://reykjavik.is/radognefndir/endurskodunarnefnd. The internal auditor of OR is Gudmundur I. Bergthórsson.

Compensation Committee

The Compensation Committee was established in January 2013. It was established in accordance with the ownership policy of OR which stipulates that the company must form a remuneration policy. The committee comprises board members Sigríður Rut Júlíusdóttir, who is chairperson and Kjartan Magnússon, in addition to Ásta Bjarnadóttir, doctor in Industrial and Organizational Psychology.

Organisation

The structure of the OR is shown in the organisation chart with its designated managers in each section. The Board of Directors of Reykjavik Energy and the boards of its subsidiaries bear ultimate responsibility for the activities and operations of the company.