

Rating Action: Moody's downgrades Orkuveita Reykjavikur to B1; negative outlook

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London, 08 July 2011 -- Moody's Investors Service has today downgraded to B1 from Ba1 the long-term senior unsecured issuer rating of Orkuveita Reykjavikur ("OR", also known as "Reykjavik Energy"), the Icelandic utility 93.5% owned by the City of Reykjavik, Iceland's capital and principal municipality. The outlook on the rating remains negative.

RATINGS RATIONALE

The downgrade to B1 was prompted by the reduction in the level of support that Moody's incorporates in OR's rating, which follows instances of default by municipalities in Iceland. Moody's continues to recognise the strategic importance of OR -- which provides essential utility services to more than 50% of Iceland's population -- not only to its owners but also to the Government of Iceland (rated Baa3, negative outlook). However, Moody's has considered that in light of municipal defaults, there is now a lower probability that extraordinary support would be forthcoming from the central government in the event that OR were to face financial distress.

Moody's notes the five-year plan announced by OR on 24 March 2011. This has been designed by management to allow the company to continue to provide its services as a public utility without the need to seek additional funding from the capital markets or credit institutions until 2016. In broad terms, the plan includes a number of measures to be undertaken during this period, including postponement of investments, increase in tariffs, reduction of operational expenses and sale of non-core assets. These measures will be combined with the funding provided by OR's owners in the form of subordinated loans totalling ISK12 billion. Moody's notes that ISK8 billion has been already disbursed and the remaining amount will be made available in 2013. However, Moody's highlights that OR's ability to achieve the financial position envisaged under its five-year plan remains exposed to a number of key risks, including interest rate, currency and commodity price risks. Moody's cautions that if any of the aforementioned risks were to materialise, the company may not be able to obtain further support either directly from its owners or ultimately from the central government, should the funds available to it in the financial markets be insufficient. There is also some execution risk with regard to the management plan as some of its elements are dependent on the market conditions (e.g. sale of non-core assets).

OR is a partnership and under its governing act the partners -- the City of Reykjavik, which owns 93.5% of OR as well as two other municipalities, the Municipality of Akranes and the Municipality of Borgabbyggd, which have stakes of 5.5% and 1% respectively -- are responsible for all the liabilities of OR in proportion to their shareholding ("guarantee of collection"). OR's rating is assigned under Moody's rating methodology for Government Related Issuers (GRI). OR's baseline credit assessment (BCA) remains unchanged at 16 (equivalent to B3) reflecting the highly leveraged financial profile of the company (funds from operations (FFO)/debt was 4% at FYE 2010), areas of potential volatility in its operational performance and its limited access to liquidity. Whilst at present about 60% of OR's revenues and 66% of EBITDA are regulated, the share of the higher-risk unregulated cash flows will increase as the new generation capacity fully comes on stream in 2012. Moody's highlights the risks associated with OR's operations and its exposure to increase in the cost of debt, weakening of the Icelandic krona that would raise the cost of servicing the company's foreign currency debt. Furthermore, the company has an exposure to volatility in aluminium prices under its long-term take-or-pay contracts with the aluminium smelters.

The negative outlook on OR's rating reflects the negative outlook on the Government of Iceland, which is based on the high level of uncertainty over the economic, financial and banking sector outlook and still existing legal risks.

OR's rating could be downgraded if it appears likely that the currently available bank lines are not sufficient to cover the market risks in particular in relation to exchange rate, interest rates or aluminium price. The rating would also come under downward pressure if there were delays in the execution of the five-year plan, which would result in increased funding requirements and the company were not able to raise debt in the domestic or international markets.

The principal methodology used in rating OR was "Government Related Issuers: Methodology Update", published July 2010.

OR is the largest multi-utility in Iceland providing electricity, hot water, heating, cold water and waste services to more than 50% of the Icelandic population. It is Iceland's second-largest electric utility after Landsvirkjun. As at FYE 2010, the company had revenues of ISK28 billion.

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