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Orkuveita Reykjavíkur ("Reykjavik Energy")

Corporate Profile

Strong support from its 93.5% ownership by City of Reykjavik boosts the rating of this strategically important multi-utility

Orkuveita Reykjavíkur ("Reykjavik Energy" or "RE"), rated Aa2 with stable outlook, is a small company. Nonetheless, it is Iceland's largest multi-utility, providing electricity, geothermal hot water, cold water and sewage to more than 50% of the Icelandic population. Its principal service area is Reykjavik and the surrounding areas. It is the country's second-largest electric utility after Landsvirkjun (Aaa, stable outlook). Since 2005, the company has also been a fibre-optic service provider, offering Internet access to businesses and households. However, this is expected to remain a limited contributor to the business overall. RE's monopoly or quasi-monopoly businesses today contribute the majority of revenues (around 70% in 2005), although this will gradually fall over time. Reykjavik Energy has recently embarked on a heavy investment programme to expand its production capacity in geothermal and hydro capacity, utilising Iceland's natural resources, in order to sell to energy-intensive companies.

RE is currently owned 93.5% by the City of Reykjavik, which is unrated. Nevertheless, the City is considered of strong credit quality. This assessment, plus Moody's view of the strong likelihood of support and the high dependence between the two entities, are key drivers of RE's overall Aa2 credit rating and give significant uplift to the company's fundamental credit assessment.

Figure 1 - Segmental Operating Performance

	Gross Revenue			Relative contribution		
FY ended 31 December (ISK m)	**2004**	**2005**	***Change***	**2004**	**2005**	**Outlook**
Electricity	6,159	6,643	8%	47%	45%	*Significant growth*
Heating	4,420	4,797	9%	34%	33%	*Steady growth*
Water	1,426	1,518	6%	11%	10%	
Data utility	225	378	68%	2%	3%	*Significant growth but relatively small contributor*
Other	954	1,392	46%	7%	9%	
Total	**13,184**	**14,728**	**12%**	**100%**	**100%**	

Source: Reykjavik Energy AR 2005

Shareholder Structure

The City of Reykjavik is RE's dominant shareholder

RE was created by the merger of Reykjavik City's Electric Power Works and District Heating utility in 1999. In 2000, the company merged with Reykjavik Water Works. Since 1 January 2002, RE has been a partnership owned 93.5% by the City of Reykjavik, 5.5% by the Town of Akranes and 1% by the Municipality of Borgarbyggd.

Key features of the partnership under RE's governing act are:

- Simple proportional responsibility for all the commitments of the partnership based on proportional ownership (explained in more detail in the "Support" section below).
- A partner is not authorised to sell its shares or leave the partnership without the consent of the other partners. The partners are not authorised to pledge their shares in the partnership or to dispose of them in another manner.
- RE has an exclusive licence for operating heating and power utilities in the areas served by RE and the Akranes utilities.
- RE is authorised to take loans for the needs of the partnership and guarantee payments up to 5% of its equity. Over this percentage, it must obtain the prior consent of all partners.

Corporate Governance

The company's owners are closely involved in all key decisions

The Board of Directors of the partnership consists of six people; five elected by the Reykjavik city council (chairman, vice-chairman and three other members) and one by the Akranes town council. The weight of the vote of the Chairman of the Board is double at the Board of Directors meeting. The Chief Executive Officer of the company also holds a seat on the Board. The Board makes all major decisions and commitments. In the case of new commitments and guarantees exceeding 5% of the principal (defined as net assets at the end of the previous year), RE must obtain the prior consent of all the partners. RE pays dividends to its owners in accordance with the proportional share of each municipality in the partnership. Hence, the City of Reykjavik is very closely involved with all decision-making at RE.

Corporate Structure

RE is a holding company of the group and all debt is currently raised at that level. RE has recently decided to spin off its fibre-optic business into a separate subsidiary and may have some separate funding at the level of that entity in due course. However, over 90% of debt is expected to be maintained at the parent company level; Moody's does not therefore factor any structural subordination considerations into the rating.

Key Rating Considerations

High credit assessment of City of Reykyavik and strong support provide significant uplift to RE's BCA

Reykjavik Energy is classified as a Government-Related Issuer (GRI) under Moody's Joint-Default Analysis because of its 93.5% ownership by the City of Reykjavik.[1]

In accordance with Moody's GRI methodology, the Aa2 rating reflects the following factors:

- Baseline Credit Assessment (BCA) of 11 (on a scale of 1 to 21, where 1 represents lowest credit risk; an 11 is equivalent to a Ba1);
- Ownership by the City of Reykjavik (unrated);
- High dependence; and
- High support.

1. *Please refer to Moody's Special Comment ("The Application of Joint Default Analysis to Government-Related Issuers") published in April 2005, and its accompanying press release. Please also refer to Moody's Special Comment entitled "Rating Government-Related Issuers in European Corporate Finance" for a detailed discussion of the application of the GRI rating methodology to corporate issuers in Europe and "Government Related Issuers: July 2006 Update". GRIs are entities with full or partial government ownership or control, a special charter, or a public-policy mandate from a national or local government.*
"Support" is the likelihood that the state shareholder will provide an extraordinary "bail-out" to a GRI on the verge of default. The baseline credit assessment of the GRI therefore measures the likelihood that the GRI will require such an extraordinary bail-out. The baseline credit assessment also takes into account all aspects of the GRI's existing (or anticipated) business model, including benefits (such as regular subsidies or credit extension) and/or drags associated with the government relationship.
"Dependence" captures the intrinsic economic link between the GRI's baseline default risk and the default risk of the government. For more detailed discussion of definitions, please see Moody's Special Comments noted earlier.

The City of Reykjavik is unrated but Moody's considers it of high credit quality. This, together with an evaluation of support that is towards the top end of the support category, provides significant uplift to the BCA of 11; these two factors are key in determining the final Aa2 rating. The main drivers of the four inputs into the rating are described more fully in the following sections.

BASELINE CREDIT ASSESSMENT (BCA)

Under "Moody's Rating Methodology: Global Regulated Electric Utilities" (March 2005), RE counts as a low-medium risk utility. This reflects the fact that RE is expected to derive around 70% of revenues and 80% of EBITDA in 2006 from the low-risk monopoly and quasi-monopoly services that it provides to the residents in and around Reykjavik. Over time, however, the proportion of higher-risk, unregulated cash flows will assume much greater importance as RE embarks on a significant debt-funded capex programme to invest in new geothermal power - primarily to sell to the aluminium-smelting industry. This will lead to a weakening of RE's financial profile and, as RE becomes more reliant on cash flows from new investments, the EBITDA contribution from its monopoly activities is expected to drop to around 60%-65% by 2010.

MANAGEMENT STRATEGY

Management targets steady growth in all businesses but significant expansion in electricity production

Management targets "leadership in geothermal heat, further expansion in hydro power, exporting geothermal know-how, the sale of access to new infrastructure in data transfer and increasing market share in waterworks and sewage system."

While the company's strategy is to continue to provide services in its core monopoly businesses, it has significant plans for expansion over the next few years. These are primarily aimed at increasing energy production capacity. The increase is principally designed to meet the needs of heavy industry (aluminium smelters), although some is directed at local Icelandic consumption. Overall, RE plans to increase its installed capacity from 130 MW in 2005 to 683 MW by 2010. Its geothermal plants, Nesjavellir and Hellisheidi, will produce hot water as well as electricity

Figure 2 - Estimated Capex by BU 2006-2011

ISKm	2006		2007		2008		2009		2010		2011		2006-2011 (ISKm)	2006-2001 (EURm)*	Relative Contribution
Power Plants	11,374	74%	12,083	67%	13,474	68%	26,854	82%	30,462	88%	4,245	52%	98,492	1,071	77%
Distribution systems	4,438	29%	5,510	30%	5,767	29%	5,486	17%	3,689	11%	3,717	46%	28,607	311	22%
Other investments	-521	-3%	502	3%	519	3%	544	2%	290	1%	196	2%	1,529	17	1%
TOTAL	**15,291**	100%	**18,095**	100%	**19,760**	100%	**32,883**	100%	**34,441**	100%	**8,158**	100%	128,628	1,398	100%

Source: Reykjavik Energy
**1 ISK = 0.01087 EUR*

Management is also considering small, i.e. ISK2billion-3 billion (€22 million-33 million), acquisitions over the next five years in the water and sewage sectors. The company started some relatively small investments in China and in the USA (approximately US$3million-4 million, equivalent to ISK210 million-280 million). The company's financial targets are: (i) a financial structure with an equity ratio not lower than 30-35%; (ii) revenue growth of 10% each year for the next four years; and (iii) a return on equity of 5%.

BUSINESS RISK FACTORS

RE's monopoly/quasi-monopoly activities provide low-risk stable returns

RE has a strong and diversified base of utility services (hot and cold water, sewage and electricity distribution). Most of RE's monopoly or quasi-monopoly activities are low risk, with the bulk of them regulated. This reflects the essential nature of the services and the limited volatility of the cash flows.

Electricity Distribution: The Icelandic electricity market is regulated by the Electricity Act (2003). This act applies to "the generation, transmission, distribution and trade in the Icelandic territory, regardless of the source of energy".[2] Since 2006, the market has been fully liberalised. Hence, generation and supply count as competitive activities whilst distribution and transmission are monopoly regulated activities.

2. *Electricity Act (2003), Article 2.*

Tariffs for regulated activities are set by the *Orkustofnun* (National Energy Authority), in accordance with article 17 of the Electricity Act. Effectively this is a cost-plus system, allowing a stable return on profit[3] that should not exceed the 5-year government bond rate plus 2%. The regulator is currently engaged in a benchmarking study to look at efficiency incentives that they may introduce. RE believes that it is efficient compared with the sector and its peers in other Nordic countries; prices are fairly comparable for distribution, although RE incorporates higher[4] charges for transmission as RE owns part of the high voltage grid with Landsvirkjun.

Hot water heating: RE has monopoly status in its service areas.[5] RE's water comes from low-temperature (70-130ºC) sources in Reykjavik and Mosfellsbaer and from high temperature (over 200ºC) sources in Nesjavellir and Hveragerdi. Tariffs are proposed by the company and need to be approved by the Ministry of Industry. They are generally set on a cost-plus basis (including a 5% real return) and are generally in line with inflation, although occasionally there have been deviations.

Cold water: RE serves around 80% of the City of Reykjavik, with cold water drawn from wells in the various lava field areas around Reykjavik. The maximum tariff is set at 0.5% of property value, which is measured by the Land Registry of Iceland.[6] The company is currently charging much less than the allowed limits – at 0.088% (dwelling houses) and 0.18% (industrial companies), although this is partly explained by the rise in Icelandic property values far outstripping inflation. The charges collected by utilities companies in nearby communities are in the range of 0.14-0.22% for dwelling houses and 0.14-0.44% for industrial companies, so RE's contracts appear to be competitively priced. RE has monopoly status in its service areas.

Sewage: Tariffs are set by municipal authorities. Fees are based on a fixed connection fee and a fee per square metre of housing space. Prices increases are allowed to follow the construction cost index. This is growing faster than the CPI given heavy investment in construction and RE has the flexibility to increase tariffs at a significantly higher rate than it has done to date.

For both cold water and sewage, RE has the right to raise tariffs to higher rates if need be and these rights could be used in the event of stress. However, the City of Reykjavik is likely to balance RE's needs with that of maintaining a stable utility price environment for its citizens. Increases in tariffs for both cold water and sewage in reality have tended to track inflation.

Competitive Activities will be major driver of growth in the future

RE is also active in the generation and supply of electricity. The generation market has been fully liberalized since 2006. However, given the small size of the market, competition has been relatively limited - albeit with some reduction in prices.

The Icelandic Generation and Supply Market

In 2005, total electricity production in Iceland was 8,678 GWh. Heavy industry used 5,191 GWh (60%), retail users 3,234 GWh (37%), with transmission losses at 254 GWh (3%). There are a limited number of players. Landsvirkjun produces nearly 85% of the nation's electricity while RE accounts for about 9% of the market (817.1 GWh in 2005). There are two other main producers: Rarik, which is the Icelandic state power company that produces and sells electricity around the country (mainly to rural communities) and Hitaveita Sudurnesja, a power company in the South West of Iceland that produces, distributes and sells both geothermal hot water and electricity.

Prices have come down somewhat since the onset of liberalisation but there is no significant change expected, given the relatively limited nature of competition and a shortage of electricity production in Iceland available to the wholesale and retail Icelandic community.

RE supplies electricity to the City of Reykyavik and surrounding areas. RE is currently charging a electricity prices of ISK 3.24/KWh.The charges collected by its main competitors are in the range of ISK2.90-3.45/KWh. All in all, RE believes it is competitive. However, overall supply margins are expected to remain tight, with growth in electricity rates coming through growth in volume rather than price increases.

RE is expected to increase production

RE currently meets 50% of its own supply needs through its geothermal power plant in Nesjavellir and two power hydropower plants in Andakilsarvirkjun and Ellioaarstod. Landsvirkjun, the country's dominant generator, supplies the balance.

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3. *Profitability defined as EBIT to the book value of fixed assets.*
4. *Given the topography, population density and weather conditions in Iceland.*
5. *Energy Act no. 58/1967.*
6. *Act on Municipal Waterworks no. 32/2004*

This position is expected to change over time as RE invests further in new production, drawing on Iceland's environmentally-friendly geothermal power sources, to meet contracts with a number of key aluminium-smelting companies. Nonetheless, the contract with Landsvirkjun gives RE a degree of flexibility as it offers more flexible peaking power than the new investments, which will be mainly baseload power (and hence very suitable for industry because of predictable operating power needs).

In 2006, approximately 10% of total revenues will have come from the aluminium-smelter industry and this proportion is expected to increase over the next five years (reaching 20% in 2011). RE has signed contracts with Nordural (subsidiary of Century Aluminium Company (Ba3)) and Alcan Iceland (subsidiary of Alcan Inc. (Baa1)) as well as a letter of intent with Nordural Helguvik (part of Nordural). These long-term take-or-pay contracts (around 20 years) are indexed to the US dollar and aluminium prices. Therefore, whilst cash flow and margins should increase, Moody's expects RE to be increasingly exposed to commodity and currency risks. Once contracts are signed, the capex programme is heavy with limited flexibility as both sides have committed to pay penalties if there is any slippage in meeting target rollout dates or other obligations.

Data contribution is expected to increase but remain relatively small

RE has built and operates the fibre-optic cable network in South West Iceland. The company aims to provide content and service providers to the network. Its principal competitor is Iceland Telecom, which provides all telecommunication services and data services. The latter activity is expected to remain a small contributor in the overall business mix (less than 10% of EBITDA.)

FINANCIAL RISK FACTORS

RE's debt is expected to increase significantly as its capex programme is rolled out

Figure 3 - Key Financial Data [1]

	2004	2005	2004	2005	1H 2006**	
	(in ISKm)		*(in EURm)**		*(in ISKm)*	*(in EURm)**
Revenue	13,184	14,728	158	196	8,524	93
Operating Profit	3,304	1,925	40	26	1,742	19
Interest Expense as adjusted	857	1,159	10	15	12,656	138
FFO as adjusted	4,376	5,518	52	73	3,909	42
RCF as Adjusted	2,926	4,101	35	55	3,207	35
Capex	7,810	11,726	94	156	8,495	92
Total Debt as adjusted	30,255	37,820	362	503	58,797	643
Net Debt as adjusted	30,128	37,192	361	495	57,811	632
Adjusted FFO Interest Coverage	6.1x	5.8x	6.1x	5.8x	-	-
Adjusted FFO / Net Adjusted Debt	14.5%	14.8%	14.5%	14.8%	-	-
Adjusted RCF / Net Adjusted Debt	9.7%	11.0%	9.7%	11.0%	-	-
Adjusted RCF / Adjusted Capex	37.6%	35.0%	37.6%	35.0%	-	-

[1] Source: Reykjavik Energy, Annual Report 2005
Please refer to "Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations - Part II, Rating Methodology, Feb-06 (#96729).
**1 ISK= 0.01198(31/12/04); 1 ISK=0.01330(31/12/05); 1 ISK = 0.01087 EUR*
***Unadjusted figures*

RE is only a small company, with revenues totalling approximately €196 million as at FYE 2005. Its significant capex programme of €1.5 billion over the 2006-12 period means that debt is expected to almost triple over the next few years from 2005 levels, peaking in 2012. As a result, credit metrics are expected to deteriorate significantly from the moderate FFO/debt of 14.8% in 2005 and the company will be significantly free cash flow negative for a number of years.

RE will become increasing exposed to commodity and foreign exchange risk, although there are some mitigants

The BCA also factors RE's exposure to foreign exchange and aluminium price risk. Today, RE's revenues are principally in Icelandic Krona but its debt burden is in a range of currencies. This significantly lowers cash interest costs but, from an accounting perspective, leaves RE's balance sheet and income statement exposed to foreign exchange movements.

Figure 4 - Debt breakdown by currency

(ISKm)	2004		2005		1H 2006	
CHF	4,816	16%	7,326	20%	12,899	21%
EUR	8,668	29%	7,291	20%	14,783	24%
GBP	2,646	9%	2,367	6%	4,033	7%
JPY	1,213	4%	3,150	8%	5,694	9%
SEK	1,490	5%	3,432	9%	5,072	8%
USD	7,361	25%	7,506	20%	12,592	20%
ISK	3,264	11%	6,037	16%	6,836	11%
Total	29,458	100%	37,109	100%	61,908	100%

Source: Reykjavik Energy AR 2005, 1H 2006

The aluminium contracts are paid in US dollars, which will increasingly provide some natural currency hedging to RE's debt position. Nevertheless, RE is still exposed to a devaluation or a drop in the price of aluminium. This could mean that, in a low commodity price and/or devaluation scenario, the company's financial profile would weaken further while it continues to carry a very heavy debt burden.

Moody's notes that, on a cash basis, RE will get stronger cash flows in the event of ISK depreciation against the US dollar - more than offseting increased interest expense. Debt would nonetheless increase on a marked-to-market value basis (and hence cash flow/debt metrics would be affected), although any losses caused by currency weakening will only be realised in principal (and interest) repayments as they fall due. These amounts are expected to be relatively small on an annual basis compared to the debt burden, given the long maturity schedules of the loans.

Aluminium prices have been well over US$2000/tonne in the recent past, although they were as low as US$1300 or US$1400 in the early part of the decade. However, long-term forecasts are unpredictable and RE could be particularly negatively affected if prices were to fall at a time when its debt was high. Moody's notes that the company believes that, in the more negative scenarios outlined, it has some flexibility to raise tariffs in regulated businesses and that it will also enter into hedging as appropriate.

Moody's expects the financial profile of the company to weaken from its current FFO/debt of 15% and could, in some of the more negative scenarios outlined above, decline to below FFO/debt of 10% as debt increases. In the event that Funds from Operations were to be severely affected, Moody's believes that is more likely that the company would reduce dividends. Retained Cash Flow would thus be much closer to Funds from Operation, bringing these two ratios (FFO/debt and RCF/debt) closer in line. FFO/interest is expected to remain strong for the current BCA for, despite paying a guarantee fee, (which Moody's factors into the interest expense ratio) the company should benefit from lower interest cost related to its final rating.

Liquidity

RE is in the process of expanding and diversifying its funding sources. It currently has an undrawn €100 million revolving facility with Fortis Bank and a €50 million facility with Dexia Bank. It expects to sign a line with investment banks for a further ISK10 billion (eq. €108 million). RE has uncommitted lines with Icelandic banks totalling €60 million. For the next 12 months, RE's liquidity should be satisfactory. In addition, RE is negotiating additional lines with investment banks, so that overall it can secure half the funding needed for its current capex programme. The balance it would hope to access through the capital markets.

OTHER GRI FACTORS

City of Reykyavik (unrated)

The strong credit quality of the City is underpinned by the robust operating environment and the predictable and supportive institutional framework for Icelandic local governments. Stable financial operations with improving - albeit narrow - margins, supported by solid, own sources of revenues (including income and property taxes), also support the credit risk profile, as does the city's moderate and declining direct debt. However, Moody's credit quality assessment also incorporates the City's considerable exposure to debt guarantees provided to RE.

High Support

Moody's factors support towards the top end of the high category for RE. In 2002, the company, which had been 100% city-owned, became a joint partnership owned 93.5% by the City of Reykjavik, 5.5% by the Town of Akranes and 1% by the Municipality of Borgarbyggd. Under RE's governing act, the partners are responsible for all the liabilities of RE in proportion to their shareholding. This constitutes a "guarantee of collection". The liability of the partners gives the creditors a direct claim against the partners once the remedies against the borrower have been exhausted. Whilst this type of guarantee, which is common in Nordic countries, does not offer bondholders the same degree of protection as a standard guarantee given the potential for non-timely payment, there are very strong incentives for timeliness:

- (i)The close relationship between the company and the City and the very close control it operates over company activities including dividends, tariffs and investments. The Board of Directors consists of five representatives elected by the Reykjavik city council and one by Akranes town council. The City is therefore well aware of the company's extensive borrowing plans and default would severely damage the City's reputation.
- (ii)The critical nature of the company's services, and therefore the importance of the company to the City's economic existence, indicates that any risk to continued provision of service is very unlikely to be tolerated by City officials.
- (iii)Finally, under Icelandic law, if there is any delay in the payments, penalty rates of interest and cost of collection are imposed. Moody's believes that the City would be very unlikely to undergo the unnecessary damage to its reputation given that it would be required to pay eventually.

Moody's notes that, under the current guarantee structure, the City of Reykjavik is only legally responsible for the liabilities of RE linked to its pro-rata shareholding. However, given its dominance in the shareholding (over 93%) and decision-making, Moody's believes it is most improbable that the City would not ensure timely repayment. However, a dilution of shareholding that called into question the commitment of the City of Reykjavik towards extraordinary support for RE could have a negative impact.

High Dependence. This reflects that the likely cause of a City default - severe economic distress - would likely affect both City tax revenues and utility revenues, supporting a strong default correlation between the two entities.

SUMMARY OF FACTORS THAT COULD MOVE THE RATING

Outlook

The outlook on the Aa2 issuer rating is currently stable. The company is comfortably positioned at its current BCA, which factors the expectation that the company's financial profile will weaken over the next few years as it embarks on its heavy investment plan. This could lead to FFO/debt dropping into single digits for a period of time.

What could move the rating up

- RE would need to show a reduction in execution risk as the company rolls out its investment plan and that it can achieve and sustain at least FFO/debt of 10% and RCF/debt of 7%, during and after this investment period, in order to achieve an upgrade in the BCA. However, it would require a two-notch shift upwards in the BCA, assuming all the other rating inputs remain the same, to have a one-notch impact on the final rating.
- A shift upwards in the assessment of the City of Reykjavik would not affect the rating unless accompanied by a further shift upwards in support factors.

Given the above factors, it seems unlikely that the rating will move up in the medium term.

What could move the rating down

- Moody's believes that the company's BCA is comfortably positioned at its current level. A prolonged deterioration in the Icelandic Krona, weakness in aluminium prices or a step-up in RE's investment programme could lead to a one-notch downgrade in the BCA - which could lead to a downgrade in the final rating - but this is not currently expected. FFO/debt continually below 7% could trigger such a movement.
- The rating is sensitive to a reduction in the level of support attributed to the City and any dilution of shareholding that would call into question the commitment of the City of Reykjavik towards extraordinary support for RE could have a negative impact.
- A more negative credit assessment of the City could also have a negative impact.

Related Research

Analysis:

Iceland, Government of (August 2006), 98550

Rating Methodology:

Global Regulated Electric Utilities (March 2005), 91730

Special Comment:

Icelandic Local Government System -- Consolidation Continues (August 2005), 93609

The Application of Joint Default Analysis to Government-Related Issuers (April 2005), 92432

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