

FITCH PUBLISHES FIRST-TIME 'BB-' IDR FOR REYKJAVIK ENERGY; OUTLOOK STABLE

Fitch Ratings-London-11 February 2015: Fitch Ratings has published Orkuveita Reykjavikur's (Reykjavik Energy; RE) Long-term Issuer Default Rating (IDR) of 'BB-'. The Outlook is Stable.

RE's rating reflects the regulated nature of the company with 65% of 2014 EBITDA coming from its regulated electricity, hot water, cold water and sewage networks. The remaining 35% of 2014 EBITDA was from electricity generation (predominantly geo-thermal) and its fibre-optic network.

The rating is constrained by its concentrated Icelandic operations, large exposure to currency risk and aluminium price risk, and expected funds from operations (FFO) net adjusted leverage of 7.4x to FYE16. These constraints are offset by the high contribution of regulated earnings, the ability to set an all-in-cost tariff in a benign regulatory environment and a strong FFO interest cover of 4.5x to FYE16.

The Stable Outlook reflects the company's outperformance against its existing five-year business plan (2011-2016), which we expect to be delivered on. The plan has focused on strengthening the company's financial position through the provision of subordinated shareholder loans, asset sales, tariff increases linked to the Consumer Price Index (CPI) or Building Cost Index (BCI) and a cost-efficiency programme. As a result, FFO net adjusted leverage improved to 7.4x at YE13 from 10.8x at YE11.

Our view of the moderate to strong link between the company and its three municipality parents supports a one-notch uplift included in the IDR.

RE is a regional publicly-owned utility operating in Iceland (BBB/Positive). The company operates in 20 communities, which cover 67% of the Icelandic population and has three municipality shareholders: the City of Reykjavik (93.5%), the Municipality of Akranes (5.5%) and the Municipality of Borgarbyggd (1.0%).

KEY RATING DRIVERS

Majority Regulated, Benign Regulation

RE earns 65% of its EBITDA from regulated networks and has the ability to regularly propose index-linked tariff increases (CPI or BCI linked) in order to cover all efficiently incurred costs and provide a return on investment of at least 5%, up to 2016. Tariffs are monitored and approved by government bodies, rather than a fully independent regulator.

We view the regulatory environment for the different regulated businesses as less robust and transparent compared with other European countries. However, it can be considered relatively benign, with some predictability given the company's ability to propose tariffs linked to inflation, and an efficiently incurred full cost-pass-through tariff mechanism including a return on investment.

Generation with Market Risks Exposure

Around half of the 30% of earnings in the electricity generation segment are from retail operations, with the other half coming from long-term contracted generation to aluminium producers. The latter contains take or pay contracts which are linked to the price of aluminium and therefore if the price of aluminium is low, revenues would decrease although costs would remain the same. This introduces price risk, which is only partially offset in the short to medium term by RE's active hedging on the price of aluminium.

High Leverage

FFO net adjusted leverage is forecast to average 7.4x from 2014 to 2016, with a spike to around 8.3x at YE14. The maturity of the aluminium linked bond asset in 2016, an increasing price of aluminium on the forward markets, increases in tariffs, continued dividend freeze and capex restraints are the main drivers of the expected deleveraging to 2016. The company's ability to continue deleveraging beyond 2016 will be dependent on measures agreed by shareholders following the completion of the 2011- 2016 business plan.

Strong Coverage, Significant FX Risk

Interest coverage is strong thanks to RE's access to well-priced funding across a basket of currencies. However, this has exposed the company to significant FX risk, which is managed through RE's US dollar-denominated power generation earnings and hedged over a five-year horizon. We note that the company has significantly reduced balance sheet exposure to FX fluctuations by denominating the generation subsidiary in US dollars, but the cash flow exposure remains a rating risk. We expect that the FX volatility may remain muted by the continuing capital controls in Iceland.

At 30 September 2014, the company's total debt amounted to ISK187.9bn (USD1.55bn) of which 76% was denominated in foreign currencies (ISK194.9bn; 78% at FY13), whilst variable rate debt stood at 76.5% and interest rate hedges covered around 82% of the loans one year ahead (77.6% at FY13 and interest rate hedges covering 94% of loans for one year ahead).

Standalone Credit Profile and Moderate-to-Strong Parent Linkage

RE's rating is based on our view of its standalone credit profile, which we assess as weaker than its majority shareholder, the City of Reykjavik. Our moderate to strong linkage assessment reflects conditional parent guarantees of over 75% of outstanding debt (expected to decrease in future) and subordinated shareholder loans from its municipality shareholders representing a further 7% of outstanding debt. There is also strong operational control from RE's shareholders and high strategic importance as Reykjavik's foremost public utility.

Risk of Political Interference

There is scope for political interference due to RE's board being elected by the Reykjavik and Akranes City Councils, and due to tariffs and investment plans being subject to influence from government bodies rather than an independent regulator. Although the risk is currently benign, it may increase after 2016 when approvals by the shareholders lapse and which include no dividend payments, costs and investment reductions, a 5%-7% minimum allowed return on investment, and inflation linking of tariffs. In addition, capital repayments are due to start on shareholder loans after 2016.

Iceland benefits from some of the lowest water and electricity tariffs in Europe due to the purity of water, as well as low electricity prices due to the abundance and low running costs of hydro and geothermal power sources. Therefore, it does not face the same energy affordability issues that other European countries face, which could make parental support and continuation of fully cost reflective tariffs after 2016 a more tenable proposition.

Strong Progress Against Five-year Business Plan

The company has over-performed against its targets set under the 2011-2016 business plan, which was agreed in March 2011 between the company and its shareholders as an effort to improve the company's cash balance by ISK50bn until the end of 2016, as well as helping with large debt maturities from 2013 onwards. Fitch forecasts RE will continue to de-leverage by end-2016 and beyond. However, we note that this will also depend on market movements on the aluminium price and currency exchange that are outside the company's control.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer include:

- Wholesale electricity generation earnings are linked to the aluminium forward curve. Retail earnings, including earnings from the regulated business, are inflation linked throughout the rating horizon.
- Over the rating horizon, capex is forecast to average ISK9bn a year following capex deferrals in 2012 and 2013. This capex programme restricts the level at which RE can de-leverage.
- An inflow of ISK8.9bn is forecast in 2016 due to the maturity of the bond asset that RE owns.
- No dividends are assumed over the rating horizon.

RATING SENSITIVITIES

Positive: Future developments that could lead to positive rating action include:

- Continued tariff increases and operational outperformance leading to FFO net adjusted leverage below 6x and FFO interest cover over 5x on a sustained basis.
- Increased support from the parent including unconditional guarantees or prolonged restrictions on dividends.

Negative: Future developments that could lead to negative rating action include:

- Restrictions on tariff increases and higher investments, or lack of proceeds on the 2016 bond asset, leading to FFO net adjusted leverage above 7x from YE16 and FFO interest cover under 4x on a sustained basis.
- Weaker parent support, including reinstatement of dividend payments or withdrawal of other support.

LIQUIDITY AND DEBT STRUCTURE

As of 30 September 2014, the company had ISK16.6bn in cash and cash equivalents and ISK8.3bn of undrawn committed facilities against short-term debt maturities of ISK16.4bn. Fitch assesses the company's current liquidity as adequate to cover operational requirements over the next 24 months due to our expectation that it will remain significantly free cash flow positive over the rating horizon. Fitch considers 24 months available liquidity as appropriate due to the high market volatility RE faces on its aluminium, interest rate and foreign exchange exposures.

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Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable criteria, Corporate Rating Methodology Including Short-Term Ratings and Parent and Subsidiary Linkage', dated 28 May 2014, are available at www.fitchratings.com.

Applicable Criteria and Related Research:

Corporate Rating Methodology - Including Short-Term Ratings and Parent and Subsidiary Linkage
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=749393

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