

Credit Opinion: Orkuveita Reykjavikur

Global Credit Research - 16 Dec 2013

Reykjavik, Iceland

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	B1

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Key Indicators

Orkuveita Reykjavikur	Dec-2012	Dec-2011	Dec-2010
FFO Interest Cover	3.5x	3.0x	2.9x
FFO / Debt	7.7%	6.2%	4.0%
RCF / Debt	7.7%	6.2%	3.7%
FCF / Debt	6.8%	2.9%	-1.6%
Debt/ Book Capitalisation	79.3%	79.3%	80.1%

Note: For definitions of Moody's most common ratio terms please see the accompanying [User's Guide](#).

Opinion

Rating Drivers

- Low risk of OR's activities as an essential services provider
- Power sales to aluminium smelters bring exposure to aluminium price risk and volatility in cash flows
- Exposure to foreign currency risk
- High debt burden
- Support from the owners provides uplift to the standalone rating

Corporate Profile

Orkuveita Reykjavikur (OR, also known as Reykjavik Energy) is Iceland's largest multi-utility, providing electricity, hot water, heating, cold water and waste services to more than 70% of the Icelandic population. It is Iceland's second-largest electric utility after Landsvirkjun. At present, about 60% of OR's EBITDA is regulated. The majority of the company's revenue is derived from sale of electricity, followed by hot water, sewage services, cold water and other.

OR is a partnership and under its governing act the partners are (1) the city of Reykjavik (unrated), which owns

93.5% of OR; (2) the municipality of Akranes; and (3) the municipality of Borgarbyggd, which have stakes of 5.5% and 1%, respectively.

SUMMARY RATING RATIONALE

OR's rating factors in positively (1) the company's strategic importance to Reykjavik, and Iceland more broadly, given that the company provides essential utility services to more than 70% of the Iceland's population and (2) the high proportion of OR's activities that are regulated, which account for around 60% of the company's EBITDA. The rating is, however, constrained by (1) OR's still high financial leverage; (2) its exchange rate risk; (3) the company's exposure to aluminium prices; and (4) its limited financial flexibility with regard to liquidity, given the company's very substantial debt (ISK207 billion, or EUR1.3 billion, as of end-September 2013).

The assigned B1 rating of OR incorporates an uplift of two notches from its fundamental credit quality, reflecting a view on the likelihood of support from OR's owners.

DETAILED RATING CONSIDERATIONS

LOW RISK OF OR'S ACTIVITIES AS AN ESSENTIAL SERVICES PROVIDER

At present, around 60% of OR's EBITDA is derived from monopoly or quasi-monopoly activities, which are essential utility services to the majority of Iceland's population. According to the regulatory formulas, water and waste tariffs are increased in line with inflation, whilst electricity distribution should allow an overall stable return on its asset base. As such they are fundamentally low risk services with limited cash flow volatility.

The key factor of the assessment of regulated activities is the transparency and predictability of the regulatory framework coupled with its consistent application. In this regard we note that in the past the company did not always adjust tariffs in accordance with the regulatory principles, which had a negative impact on returns. This was, however, rectified in 2011. Since then OR has adjusted tariffs a number of times and aligned them with increases in inflation rate. Whilst the track record remains short, consistent implementation of tariff changes is supportive of OR's business risk profile.

EXPOSURE TO ALUMINIUM PRICES UNDER THE LONG-TERM CONTRACTS WITH ALUMINIUM SMELTERS BRINGS VOLATILITY TO CASH FLOWS, ALTHOUGH SHORT-TERM RISK MITGATED BY HEDGING

OR is active in the generation and supply of power to the aluminium industry in Iceland. The company has two geothermal and two hydropower plants. Its production accounts for some 15% of the generation market and meets close to 90% of OR's supply needs. The remaining balance is supplied by Landsvirkjun under a long-term contract, which provides for coverage of peak demand.

OR has a number of long-term take-or-pay contracts with aluminium smelting companies. Such contracts are indexed to the US dollar and aluminium prices. They provide valuable foreign currency earnings but they also expose the company to volatility in the aluminium price. As such, OR has assumed a commodity risk not seen for other utilities in Europe and outside of Iceland.

The aluminium price underwent a major correction in 2008, when it dropped from over US\$3,000 per tonne in July 2008 to around US\$1,300 per tonne in February 2009. As of mid-December 2013, spot aluminium was around US\$1,760. We believe aluminium prices could remain under pressure for some time, given the weak end-market environment (excluding China), the high inventory position on the London Metal Exchange, potential stockpile sales by China's State Reserve Bureau and the level of aluminium tied up in financing transactions.

Aluminium-linked income represents around 20% of the company's revenues. Whilst the company has entered into derivative contracts aimed at mitigation of this risk (as of mid-December 2013, OR hedged 44% of its aluminium exposure for the year 2014), OR is ultimately exposed to the aluminium price risk, which can lead to material volatility in cash flows.

EXPOSURE TO FOREIGN CURRENCY RISK

OR is exposed to a material exchange rate risk given that majority of its debt is denominated in foreign currency, whilst cash flows are mainly derived in Icelandic krona. This currency exposure resulted in a rise in the company's debt burden from around ISK90 billion at 2007 to ISK206 billion in 2008, when Icelandic krona depreciated rapidly.

As of end-September 2013, some 80% of debt was denominated in foreign currencies including EUR (33% of total

debt), USD (21%), CHF (13%) and other currencies (JPY, SEK and GBP). In comparison, only some 20% of cash flows is derived in foreign currency (and mainly USD) with the majority being in Icelandic krona.

We note that the capital controls implemented in Iceland limit the fluctuations in the exchange rate, which is beneficial for the company. Whilst at present we do not expect an adjustment in the exchange rate like that seen in 2008, we consider the exchange rate risk to be high. Given the highly leveraged position of OR, even modest changes in the exchange rate can have a material impact on the company's debt burden. More positively, we note the company's hedging arrangements which mitigate some of the cash flow risks.

HIGH DEBT BURDEN AND THE ABILITY TO DELEVERAGE IS DEPENDENT ON EXTERNAL VARIABLES

OR's credit profile has improved owing to the company's strict implementation of a five-year plan approved by the board of directors in March 2011 but the debt burden still remains very high.

The five-year plan aims to turn around the company's operations so that it can continue to provide its services as a public utility. Owing to a very strong management commitment, the company has outperformed on its targets regarding items controllable by management, which include reducing costs and investments as well as postponing certain investments. The biggest challenge for OR has been around executing asset sales given that these are not directly under management control. Albeit with a delay, OR has now managed to complete the sale of assets for a total of ISK7.4 billion (EUR46 million), which is close to the company's target of ISK8.1 billion (EUR50 million) set for the years 2011-13.

The company's financial profile has strengthened as a result of the consistent implementation of tariff increases and cost discipline. Whilst the exchange rate risk remains high due to a significant mismatch between OR's revenues and debt, the company managed to reduce its debt burden to ISK207 billion (EUR1.3 billion) as of end-September 2013 from ISK231 billion (EUR1.4 billion) at end-2012.

Management forecasts a considerable improvement in OR's financial metrics over the next few years owing to the initiatives to be undertaken in accordance with the five-year plan. However, we highlight that OR's financial profile remains very leveraged and its 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. In this regard, we acknowledge the progress made with regards to management of financial risks and adoption of hedging to the extent available to the company.

SUPPORT FROM THE OWNERS PROVIDES AN UPLIFT TO OR'S STANDALONE RATING

OR is considered a government-related issuer (GRI) because of its ownership by sub-sovereign entities, which include the city of Reykjavik (93.5%) and its Icelandic municipal partners, the town of Akranes (5.5%) and the municipality of Borgarbyggð (1%). These owners provide a guarantee of collection in support of OR. Whilst the guarantee of collection 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. Under Icelandic law, if there is any delay in the payments, penalty rates of interest and cost of collection are imposed.

The B1 rating of OR incorporates two notches of uplift from its standalone credit quality, as expressed by OR's baseline credit assessment (BCA) of b3.

UNBUNDLING DOES NOT IMPACT OR'S RATING

We consider that the unbundling process, which is to be completed by 1 January 2014, does not affect OR's rating. Separation of the competitive and regulated activities will not result in the group exhibiting a different business or financial risk profile. OR will remain a parent company for the group and the main borrower. Future funding will be raised at the parent company with the only exception related to OR's fibre optic business, which is, however, very small in the context of the group's finances. Given that virtually all of OR's debt will be raised by the parent company and down-streamed to the operating companies via intercompany loans, there should be no issue of structural subordination for OR's debt creditors.

Liquidity Profile

OR's liquidity has improved owing to the company's execution of a number of medium-term bank facilities and hedging agreements. These agreements give the company greater visibility over funding and help to protect it from volatility in commodity and financial markets.

As of end-September 2013, OR's liquidity was supported by around ISK8 billion of cash and ISK8.9 billion of

committed and available bank lines provided by Icelandic banks. Of the committed lines, ISK4 billion has a final maturity in December 2016 and ISK4 billion in February 2017.

The company's cash flow generation has improved but remains fairly weak in the context of the scheduled debt maturities. OR's annual debt maturities amount to around ISK20 billion in 2014-16. These amounts could be higher or lower in ISK terms depending on the exchange rate and actual cash flows achieved. The adequate medium-term liquidity is further predicated on successful execution of asset sales and timely receipt of the loan granted by OR to Magma Energy Sweden, due in 2016.

Rating Outlook

The stable rating outlook reflects our expectation that OR will continue to prudently manage its financial and liquidity position within the constraints of its financial profile.

What Could Change the Rating - Up

We could consider an upgrade if (1) OR continued to demonstrate its access to debt markets and ability to withstand significant volatility in commodity and financial markets, and (2) the company's funds from operations (FFO) debt ratio was above 10% on a sustainable basis. This would also assume no changes to the support assumption from the owners incorporated into OR's rating.

What Could Change the Rating - Down

We could downgrade OR's rating if it appears likely that the company's currently available bank lines are not sufficient to insulate it from market risks, particularly in relation to exchange rates, interest rates or aluminium prices. The rating would also come under downward pressure if (1) there were delays in the execution of the five-year plan, which would result in increased funding requirements; and (2) the company were not able to raise debt in the domestic or international markets.

Other Considerations

As a multi-utility OR does not fall directly under one of Moody's electricity and gas utility methodologies published in August 2009, although these are helpful in benchmarking the company's business and financial risks. We consider OR to be a low-medium risk utility with respect to its core cash flows and business operations in the regulated segments of operations but high risk with regard to the sale of electricity to aluminium smelters under long-term contracts. Furthermore, OR's financial risk, given its foreign currency exposure via its debt composition and leveraged financial position, considerably increases the company's overall risk.

The rating of OR incorporates a moderate support assumption as the city of Reykjavik's ability to provide further support may be constrained, given OR's very significant debt burden relative to the city's financial resources. Whilst in general, we would expect the central government to coordinate with the local governments to arrange timely intervention, if necessary, and given the critical nature of essential utility services that it provides to the city of Reykjavik, the instances of default by municipalities in Iceland indicate that there is low probability that direct extraordinary support would be forthcoming from the central government in the event that OR were to face financial distress.

Very high dependence reflects our assumption that the likely cause of a city of Reykjavik or a government default, namely severe economic distress, would affect the revenues of both local and central government revenues as well as OR.

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