

Rating Action: Moody's upgrades Orkuveita Reykjavikur's rating to Ba3; stable outlook

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London, 02 December 2015 -- Moody's Investors Service, ("Moody's") has today upgraded to Ba3 from B1 the issuer rating of Orkuveita Reykjavikur (OR). Concurrently, the outlook has been changed to stable.

RATINGS RATIONALE

The upgrade of OR's issuer rating to Ba3 reflects the progress the company has made with regard to improving its operational performance, strengthening its liquidity position and reducing financial leverage against the background of an improving macroeconomic environment and market conditions in Iceland. It also takes into account of Moody's expectation that OR should be able to maintain its improved financial profile and better withstand adverse aluminium, foreign exchange and interest rate movements.

OR's financial profile has improved as a result of the company's successful execution of a five-year plan approved by the board of directors in March 2011. The company has outperformed against almost all targets, including those to increase revenues, reduce costs, and postpone certain investments. Overall, OR has already exceeded the Plan's goals more than one year ahead of its intended completion date in December 2016.

The rating upgrade takes account of the fact that the Icelandic economy has been on an improving trend over the last few years, which is expected to continue. Moody's forecasts GDP growth in Iceland of 4.7% in 2015 and 3.9% in 2016, underpinned by increasingly robust domestic demand from business investments and private consumption, which should be supportive of demand growth for utility services. Moreover, we expect that higher inflation will have a positive impact on the tariffs of OR's regulated services.

Nevertheless, foreign currency exposure remains substantial owing to a significant mismatch between the majority of OR's revenues being generated in Icelandic krona and the majority of debt being denominated in foreign currency. OR has a number of long-term take-or-pay US dollar-denominated contracts with aluminium smelting companies that provide valuable foreign currency earnings, but these contracts are indexed to aluminium prices and therefore expose the company to an additional source of volatility.

OR's liquidity has improved owing to the company's effective cash management and implementation of hedging agreements, which provides greater visibility of cash flow and helps to partially reduce its interest rate, exchange rate and commodity risks in the shorter term.

OR is a partnership and under its governing act the partners -- the City of Reykjavik, which owns 93.5% of OR, the Town of Akranes and the Municipality of Borgabyggd, which have shares for 5.5% and 1% respectively -- are responsible for the company's financial liabilities in proportion to their shareholding (a guarantee of collection). The company's Ba3 rating incorporates one notch of uplift for potential extraordinary support to the company's baseline credit assessment (BCA, a measure of standalone credit strength) of b1.

OR's rating factors in positively (1) the company's strong market position and strategic importance to Reykjavik, and Iceland more broadly, as the provider of essential utility services to more than 70% of Iceland's population; (2) the low business risk profile associated with regulated activities, which account for more than 60% of the company's EBITDA and provide a good degree of cash flow predictability; and (3) its asset base with predictable and low levels of capital expenditure requirements. However, the rating also takes account of (1) OR's still significant financial leverage; (2) the foreign currency risk; and (3) the company's exposure to unregulated business and long-term power purchase agreements with aluminium smelters, which expose revenues to volatility in the price of aluminium.

RATIONALE FOR STABLE OUTLOOK

The stable outlook reflects Moody's expectation that OR will continue to prudently manage its liquidity and improve its financial position, such that credit metrics will be comfortably positioned within the ratio guidance for a b1 BCA, namely the maintenance of an FFO/ Net debt ratio in the low to mid-teens in percentage terms.

WHAT COULD CHANGE THE RATING UP/ DOWN

Moody's could consider an upgrade if the company's credit metrics were to improve above ratio guidance on a sustainable basis in conjunction with a reduction in the company's foreign exchange exposure. This would also assume no change to the assumption of support from the owner incorporated into OR's rating.

Conversely, downward pressure on OR's rating could develop (1) as consequence of a weakening in the company's financial profile, such that FFO/ Net debt in percentage terms was expected to remain consistently below the low teens in percentage terms; or (2) it would appear likely that the company's liquidity was not sufficient to insulate it from market risks, particularly in relation to exchange rates, aluminium prices or interest rates, and OR were unable to raise debt in the domestic or international markets.

PRINCIPAL METHODOLOGY

The principal methodology used in this rating was Government-Related Issuers published in October 2014. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

OR is the largest multi-utility in Iceland providing electricity, hot water heating, cold water and sewage services to more than 70% of the Icelandic population. As at fiscal year ending 2014, the company had revenues of ISK38.5 billion (c. USD300 million) and EBITDA of ISK24.8 billion (c. USD194 million).

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