MOODY'S
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Credit Opinion: Orkuveita Reykjavikur

Global Credit Research - 22 Feb 2013

Reykjavik, Iceland

Ratings

Category	Moody's Rating
Outlook	Negative
Issuer Rating	B1

Contacts

Analyst	Phone
Joanna Fic/London	44.20.7772.5454
Niel Bisset/London	
Andrew Blease/London	

Key Indicators

Orkuveita Reykjavikur

	Dec-2011	Dec-2010	Dec-2009	Dec-2008
FFO Interest Cover	**3.0x**	**2.9x**	**1.8x**	**1.5x**
FFO / Debt	**6.2%**	**4.0%**	**2.4%**	**2.1%**
RCF / Debt	**6.2%**	**3.7%**	**2.1%**	**1.4%**
FCF / Debt	**2.9%**	**-1.6%**	**-5.6%**	**-12.2%**
Debt/ Book Capitalisation	**79.3%**	**80.1%**	**85.9%**	**81.7%**

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Corporate Profile

Orkuveita Reykjavíkur ("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 61% of OR's revenues and 68% of its EBITDA are regulated. The majority of the company's revenue is derived from sale of electricity (ISK17.5 billion), followed by hot water (ISK8.7 billion), sewage services (ISK3.4 billion), cold water (ISK2.8 billion) and other. Total revenues of OR amounted to ISK33.6 billion (US$268 million) as of end-2011.

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 Borgabyggd, which have stakes of 5.5% and 1%, respectively.

Recent Developments

--FIVE-YEAR PLAN

On 29 March 2011, OR announced a five-year plan, which 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 the postponement of investments, increases in tariffs, reductions in operational expenses and the 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.

As of end Q3 2012, OR was on track to accomplish the goals laid out in its plan and had even exceeded the target by some ISK937 million in terms of operational performance. In Q3 2012, the company's financial position benefited from higher inflation, which translates into higher revenues through tariff indexation. The positive impact of inflation was, however, offset by negative developments regarding aluminium prices and exchange rates. Overall, OR exceeded the target set for the three quarters by ISK1.2 billion.

--FINANCIAL RISK MANAGEMENT

OR's management has undertaken a number of steps to limit the company's exposure to market risks. In June 2012, the company entered into a currency swap agreement with Arion bank, which will ensure OR's access to foreign currency over the next six years to the amount of ISK15 billion. This contract is a positive development as it will reduce the foreign exchange risk of the company.

In May and June 2012, OR renegotiated the repayment terms of its bank facilities with Dexia Credit Local and Depfa. The agreement with Dexia provided for a postponement of EUR33 million of the 2013 debt amortisation to 2015 with some additional amendments to the debt schedule going forward. In the case of the Depfa agreement, the EUR30 million bullet payment due in 2016 has been postponed and split over a number of years starting from 2023. These agreements are positive for OR as they will relieve pressure on the company's cash flows in the near term, at a time when the company's financial position remains vulnerable to external developments, such as changes in exchange rates, interest rates or aluminium prices.

Rating Rationale

OR's B1 rating reflects the company's strategic importance to Reykjavik and the country, given that it provides essential utility services to more than 70% of Iceland's population. The regulated activities account for around 61% of OR's revenues, although OR's rating also factors in the company's exposure to unregulated operations under long-term take-or-pay contracts with aluminium smelters. The rating is constrained by: (1) OR's high financial leverage; (2) currency risk; (3) vulnerability to increases in funding costs in the event of higher interest rates; (4) exposure to aluminium prices; and (5) limited financial flexibility with regard to liquidity, given the very substantial debt amount (ISK223 billion (US$1.8 billion) as of end Q3 2012) and the lack of depth in the domestic financial market.

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

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 procurement of electricity 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 heightens the company's overall risk profile.

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 Borgarbyggd (1%). These owners provide a guarantee of collection in support of OR. Hence, 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.

--ASSESSMENT OF BUSINESS RISK PROFILE

The majority of OR's core revenues are derived from a strong and diversified base of essential utility services, which the company provides to the residents in the Reykjavik area. Most of these activities (hot and cold water, district heating, waste and electricity distribution) are monopoly or quasi-monopoly services and/or are regulated. Fundamentally, they are low-risk services with limited cash flow volatility. According to the regulatory formulas, water and waste tariffs are increased with inflation, whilst electricity distribution should allow an overall stable return on its asset base.

We note, however, that OR previously had a history of a lack of consistent tariff changes implementation. Despite approved targets for each segment of operations, OR did not increase tariffs in accordance with inflation in the past few years, which had a negative impact on returns. This was somewhat rectified for the first time in 2010. Since then, the company has increased tariffs a number of times across all segments of operation. Most recent increases in tariffs were effective 1st January 2013 (cold water - 3.5%, sewage - 8.5%, hot water - 0.7% and electricity distribution - 5.35%). Whilst the recent changes indicate a supportive regulatory framework and management commitment to take necessary measures to improve the operational performance of OR, we consider that the track record of consistent application of tariffs providing a fair return on investments remains very short.

OR is active in the generation and supply of electricity. The company, with around 15% of the generation market, currently meets close to 90% of its own supply needs through two geothermal power plants and two hydropower plants. Landsvirkjun, the country's dominant generator, supplies the balance under a long-term contract.

We note that, following the heavy investment programme to expand the geothermal production capacity in order to sell to energy-intensive companies, the business risk profile of the company has been gradually shifting towards a higher reliance on unregulated cash flows from new geothermal power. This is a result of investments in new production facilities to meet contracts with a number of key aluminium-smelting companies, as well as increasing production for its own domestic needs. At present, around 61% of OR's revenues and 68% of EBITDA are regulated. Given high inflation, which benefits OR's revenues, and relatively low aluminium prices, the share of the higher-risk unregulated cash flows is at present not expected to change in the medium term.

--ASSESSMENT OF FINANCIAL RISK PROFILE

OR's financial profile has been significantly impacted by the financial crisis, in particular by its exposure to foreign currency debt, which rose dramatically in krona terms as a result of the currency's depreciation. Additionally, the financial position of the company was adversely impacted by rising inflation, which in the past did not translate into higher tariffs of the company.

We note that management took some actions in 2008, when a decision to finalise Hellisheidi power plants was made, given that the production has already been sold to Nordural under long-term contracts, although some investments in sewerage networks were postponed. In 2009-10, the company cut its operating costs and increased tariffs. Finally, a decision not to pay dividends going forward was taken. All these actions were aimed to minimise the risks and potential losses. However, the steps undertaken were not sufficient and OR found it difficult to procure funding whilst facing sizeable debt maturities. This has led the company's management and owners to approve a five-year plan, which would allow OR 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.

The plan includes a number of measures to be undertaken during this period, including the postponement of investments, increases in tariffs, the reduction of operational expenses and sale of non-core assets. As a part of the plan, OR will delay or save on the investments in utility systems for approximately ISK15 billion and other investments will be cut by ISK1.3 billion during the period through 2016. OR will also seek to sell assets that are not part of the company's core operations and which are expected to bring around ISK10 billion of additional cash flows in total. These measures will be combined with the funding provided by OR's owners in the form of subordinated loans totalling ISK12 billion.

The company has made significant progress in the implementation of its five-year plan. All the operational targets set for the year 2011 were fully met or even exceeded. However, not all the owners were able to meet their obligations under the guarantee of collection. Whilst Reykjavik City and Akranes municipality paid their commitments under the subordinated loans on time (total of ISK7.925 billion), Borgabyggd municipality was not able to deliver their share of ISK75 million at the time. This was, however, rectified in 2012 when the municipality paid its share in full. The second tranche of the subordinated loans in the amount of ISK4 billion will be disbursed in March this year.

We note that the financial result achieved under the plan is dependent on external variables such as exchange rate, aluminium prices and inflation. Such market variables had a negative effect on cash flows of ISK758 million in 2011, thus reducing the overall positive measures taken by management. This indicates the material vulnerability of OR's position on market developments. In this regard we note that in Q3 2012 the company benefited from higher inflation as well as lower interest rates. These positive effects were more than the negative impact of the aluminium price decline over the period.

Regarding contracts with aluminium smelting companies, these are long-term take-or-pay contracts indexed to the US dollar and aluminium prices. They provide valuable foreign currency earnings, although they are also linked to aluminium prices, which are rather volatile. We note that 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 the beginning of February 2013, spot aluminium was around US$2,000. 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. In the case of OR, aluminium-linked income represents around 20% of the company's revenues.

In addition to large investments pushing up debt levels, OR's leverage has been exacerbated by the mismatch between the 81% of OR's cash flows derived in Icelandic krona from domestic operations and the bulk of OR's debt burden funded in a range of foreign currencies (around 83% of OR's debt). At the end of September 2012, around 36% of debt was denominated in EUR, followed by 17% in USD and close to 16% in CHF. Other currencies include JPY, SEK and GBP. 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 the Icelandic krona depreciated rapidly. As of end Q3 2012, the total debt of OR was ISK223 billion (US$1.8 billion).

OR benefits from low interest rates on its debt, although its sensitivity to interest rate fluctuations remains very high. Potentially, a 100 basis point increase in interest rates would lead to a ISK2 billion cash flow reduction. The impact of such increase would be, however, mitigated by the hedging instruments put in place by OR.

Overall, OR's financial metrics demonstrated a noticeable improvement in 2011 and 9M 2012 thanks to the implemented measures in terms of tariff increases, cost cutting and lower interest rates. As of end-September 2012, FFO/debt was 7.5% compared with an average of 2.9% in years 2008-10. As the company cut its investment, free cash flow (FCF) generation turned positive in 2011.

OR has just completed the expansion of the geothermal plant at Hellisheidi. Overall, the capex will be significantly lower going forward. In 2013 the company plans to spend around ISK4.75 billion on minor upgrades and the maintenance of existing assets.

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 stretched 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.

We caution 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. While we acknowledge management focus on delivery of the plan, we caution that an execution risk remains as some of its elements are dependent on the market conditions (e.g., sale of non-core assets).

Liquidity

OR's liquidity has improved over the recent months and as of end-December 2012 was supported by ISK6.9 billion of cash and ISK6.3 billion of committed and available bank lines provided by Icelandic banks.

The company's debt due in 2013 totals ISK25.5 billion. Thereafter and over the medium term, debt maturities range from ISK17 billion in 2014 to ISK20 billion in 2015 and 2016. These amounts could be higher or lower in ISK terms depending on the exchange rate and actual cash flows achieved. Whilst the current five-year plan assumes that no additional funding will be needed until 2016 and all debt repayments will be met with the internal cash flow generation and subordinated loans from owners (ISK8 billion disbursed as of end Q1 2012 and the remaining ISK4 billion will be made available in Q1 2013), OR's liquidity remains exposed to fluctuations in exchange rates, interest rates and aluminium prices. The adequate liquidity position is further predicated on successful execution of asset sales. In this regard we note that OR was not able to deliver asset sales in the amounts planned. In particular, the company managed to realise only ISK186 million in asset sales proceeds as compared with ISK1.5 billion plan for 9M 2012. The 2013 plan assumes sale proceeds of ISK5.1 billion. This element of the plan has presented the biggest challenge so far to OR.

OR's indebtedness is primarily bank debt, with the European Investment Bank being the largest creditor (30% of total outstanding debt). We note that OR has successfully renegotiated a debt repayment schedule with Dexia and Depfa and has been actively engaged in discussions with domestic and international financial institutions on additional funding and derivative contracts, which should somewhat reduce exposure to market risks.

Other Considerations

OR is supported by a `guarantee of collection' from its owners. The liability of the partners gives the creditors a direct claim against the partners after the remedies against the borrower have been exhausted. Whilst this type of guarantee 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.

We note changes to the availability of guarantees of collection implemented through an amending Act that was made in response to criticisms by the European Surveillance Authority in 2011. According to the amended Act, each owner is only proportionally liable for the financial obligations of OR. The owners' liability does not extend to other obligations of the company and it cannot exceed an amount higher than 80% of the financial requirements of a project which benefits from such a guarantee. OR must now apply for a guarantee from its owners on a case-by-case basis, although it may also choose to borrow amounts for the operational needs of the company without the guarantee of its owners. We note that the company's financial liabilities and long-term power contracts entered into before the amendment are unaffected.

The uplift to OR's rating is primarily driven by the guarantee of collection from its owners as we would expect that, in the first instance, the city of Reykjavik and other municipal owners would support the company in case of extraordinary need to pay any shortfall in interest and principal. We note that the recent actions of the company's owners are a very strong indicator of their commitment and support for OR. Whilst the guarantee is a several guarantee, we view the city of Reykjavik as the most important shareholder, given its dominant shareholding and decision-making importance.

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 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.

Rating Outlook

The negative outlook on OR's rating reflects risks pertaining to the execution of the five-year plan and associated liquidity of the company.

What Could Change the Rating - Up

The outlook could be stabilised if OR's financial position becomes more resilient to market risks that may arise from changes in aluminium prices, interest rates or exchange rates. In particular, a successful delivery of the asset sales programme, which would help OR to address its refinancing needs in April 2013, could lead to a change in the outlook to stable.

A material improvement in the financial position of the company would be necessary before we would consider any upgrade. In particular, OR would need to demonstrate its continued access to debt markets and consistent track record of tariff implementation allowing a fair return on investment.

What Could Change the Rating - Down

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 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.