

Rating Action: Moody's changes outlook to stable on Orkuveita Reykjavíkur's B1 rating

Global Credit Research - 16 Dec 2013

London, 16 December 2013 -- Moody's Investors Service has today affirmed the B1 issuer rating of Orkuveita Reykjavíkur (OR, also known as Reykjavik Energy) and changed the rating outlook to stable from negative.

RATINGS RATIONALE

Moody's rating affirmation and stabilisation of the outlook recognises OR's improved access to liquidity and the progress the company has made with regard to strengthening its financial profile over the past two years.

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. The 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. As previously cautioned by Moody's, 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.

OR's liquidity has also 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.

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.

Moody's notes 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 downstreamed to the operating companies via intercompany loans, there should be no issue of structural subordination to OR's creditors.

OR is a partnership and under its governing act the partners -- the City of Reykjavik, which owns 93.5% of OR, and two other municipalities, the Municipality of Akranes and the Municipality of Borgabyggd, which have stakes of 5.5% and 1% respectively -- are responsible for all the company's liabilities in proportion to their shareholding (a "guarantee of collection"). The company's B1 rating incorporates two notches of uplift for potential extraordinary support to the company's baseline credit assessment (BCA) -- a measure of standalone credit strength -- of b3.

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).

RATIONALE FOR STABLE OUTLOOK

The stable rating outlook reflects Moody's expectation that OR will continue to prudently manage its financial and liquidity position.

WHAT COULD CHANGE THE RATING UP/ DOWN

Moody's 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 operation (FFO) debt ratio was above 10% on a sustainable basis. This would also assume no changes to the support from the owners assumption incorporated into OR's rating.

Conversely, Moody's 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.

PRINCIPAL METHODOLOGY

The principal methodology used in this rating was Government-Related Issuers: Methodology Update published in July 2010. 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 waste services to more than 70% of the Icelandic population. It is Iceland's second-largest electric utility after Landsvirkjun. As at fiscal year ending 2012, the company had revenues of ISK38 billion (EUR235 million).

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