Rating Action: Moody’s changes outlook to positive on Orkuveita Reykjavikur’s B1 rating

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London, 08 December 2014 -- Moody’s Investors Service, (Moody’s) has today revised the outlook on Orkuveita Reykjavikur’s (Reykjavik Energy) B1 issuer rating to positive from stable. Concurrently, Moody’s has affirmed this rating.

RATINGS RATIONALE

The positive outlook acknowledges the progress Reykjavik Energy has made with regard to strengthening its financial and liquidity profile over recent years and the increased likelihood that the company will meet Moody’s ratio guidance for a rating's upgrade.

Reykjavik Energy’s financial profile has improved as a result of the company's strict implementation of a five-year plan approved by the board of directors in March 2011. Owing to a very strong commitment from management, the company has outperformed all targets, including increasing revenues, reducing costs, as well as postponing certain investments. The main challenge for Reykjavik Energy has been executing asset sales, as these are not directly under management control. Recently, Reykjavik Energy managed to complete the sale of assets for a total of ISK9 billion (EUR58.8 million), which is close to the company’s target of ISK10 billion (EUR65.5 million) set for 2011-16.

Nevertheless, the exchange rate risk remains high owing to a significant mismatch between the majority of Reykjavik Energy’s revenues being generated in Icelandic krona and the majority of debt being denominated in foreign currency. Reykjavik Energy 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.

Reykjavik Energy’s liquidity has improved owing to the company’s accurate cash management and hedging agreements, which provides greater visibility over funding and help to partially reduce its interest rate, exchange rate and commodity risks.

Reykjavik Energy is a partnership and under its governing act the partners -- the City of Reykjavik, which owns 93.5% of Reykjavik Energy, the Town of Akranes and the Municipality of Borgabjorgg, which have shares for 5.5% and 1% respectively -- are responsible for all the company’s financial 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.

Reykjavik Energy’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 almost 70% of the Iceland's population; and (2) the high proportion of Reykjavik Energy’s activities that are regulated, which account for around 60% of the company’s EBITDA. The rating is however, constrained by (1) Reykjavik Energy's still high financial leverage; (2) its exchange rate risk; (3) the company’s exposure to aluminium prices; and (4) its modest financial flexibility with regard to liquidity, given the company’s very substantial debt (ISK188 billion, or EUR1.2 billion, as at end-September 2014).

RATIONALE FOR POSITIVE OUTLOOK

The positive rating outlook reflects Moody's expectation that Reykjavik Energy will continue to prudently manage its liquidity and improve its financial position.

WHAT COULD CHANGE THE RATING UP/ DOWN

Moody’s could consider an upgrade if (1) Reykjavik Energy continued to demonstrate the ability to withstand significant volatility in commodity and financial markets and maintain its access to debt markets; and (2) the company’s funds from operation (FFO)/debt ratio was expected to be above 10% on a sustainable basis. This would also assume no changes to the support from the owner's assumption incorporated into Reykjavik Energy’s
Conversely, Moody's could stabilize the outlook or downgrade Reykjavik Energy’s rating if it appears likely that the company’s currently available liquidity and bank lines are not sufficient to insulate it from market risks, particularly in relation to exchange rates, aluminium prices or interest rates. The rating would also come under downward pressure if (1) there were delays in the execution of the five-year plan or unexpected operational costs, which would result in increased funding requirements; and (2) the company were unable to raise debt in the domestic or international markets.

PRINCIPAL METHODOLOGY

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

Reykjavik Energy is the largest multi-utility in Iceland providing electricity, hot water, heating, cold water and waste services to almost 70% of the Icelandic population. It is Iceland's second-largest electric utility after Landsvirkjun. As at fiscal year ending 2013, the company had revenues of ISK38 billion (EUR240 million).

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