

## **FITCH AFFIRMS REYKJAVIK ENERGY AT 'BB-'; OUTLOOK STABLE**

Fitch Ratings-London/Warsaw-21 December 2015: Fitch Ratings has affirmed Orkuveita Reykjavíkur's (Reykjavik Energy; RE) Long-term Issuer Default Rating (IDR) at 'BB-'. The Outlook is Stable.

The rating reflects significant EBITDA contribution (expected 68% in 2015; 65% in 2014) from the regulated electricity, hot water, cold water and sewage networks of RE, with tariffs covering costs. The remaining 32% of 2015 EBITDA is from electricity generation (predominantly geothermal), part of which is exposed to commodity prices, and its fibre-optic network.

The rating also reflects the concentrated Icelandic operations of RE, its high exposure to market risk, including foreign exchange risk, aluminium and interest rate price risk, and its high funds from operations (FFO) adjusted net leverage averaging 6.4x for 2015-2017. These constraints are offset by an expected strong FFO interest cover of 5.7x on average for 2015-2017 due to RE's low cost of debt.

The Stable Outlook takes into account the company's strong performance against its existing five-year business plan (2011-2016), and improved economic growth prospects in Iceland (BBB+/Stable).

### **KEY RATING DRIVERS**

#### **Shareholder Support**

The IDR incorporates a single-notch uplift over RE's standalone rating to reflect moderate-to-strong links between the company and its three municipality shareholders, the City of Reykjavik (approx. 93.5%), the Municipality of Akranes (approx. 5.5%) and the Municipality of Borgarbyggð (approx.1%).

Over the business plan period of 2011-2016, the municipalities have provided supportive measures to help improve the financial position of RE. The company's existing agreement with the shareholders, which is valid until 2016, includes no dividend payments, costs and investment reductions, an at least 5% return on investments, and inflation linking of tariffs.

In November 2015, RE's board proposed to revise the company's dividend policy from 2017, and as a result, moderate dividend payments are likely with the maximum pay-out of 50% but a number of financial targets need to be met simultaneously before and after any dividends are paid.

We expect shareholder support and fully cost-reflective tariffs to continue after 2016 given that Iceland has some of the lowest water and electricity tariffs in Europe due to the purity of the available water, and low electricity prices due to the abundance and low running costs of hydro and geothermal power sources. Therefore, it does not face the same energy affordability issues as other European countries.

#### **Regulated Earnings Dominant**

For 2015 we expect the share of regulated networks to increase to 68% of EBITDA from 65% in 2014 as a result of a steep increase in Building Cost Index (BCI), to which some of the regulated tariffs are linked. Fitch estimates the contribution from the regulated networks to decrease to 64% of EBITDA by 2019 as a result of lower expected tariff increases over the forecast period. Our forecast is based on the assumption that RE's tariffs will continue to be index-linked (to the

Consumer Price Index (CPI) or BCI) and will cover all efficiently incurred costs and provide a return on investment at similar levels to the return agreed with shareholders of at least 5% up to 2016.

#### Benign Regulation, Political Risk

Tariffs are monitored and approved by government bodies, rather than a fully independent regulator. In our view the regulatory environment for the different regulated businesses is less robust and transparent than in other European countries. Although, we consider it to be benign, we also believe there is scope for political interference because RE's board is elected by the Reykjavik and Akranes city councils, and tariffs and investment plans are subject to influence from government bodies rather than an independent regulator.

#### Expected Deleverage, Strong Coverage

We forecast FFO net adjusted leverage at 7.2x in 2015, up from 6.9x in 2014, mainly due to a decrease in aluminium prices which affects revenues from electricity generation and the negative impact on the associated aluminium hedges. We expect leverage to decrease to 6.3x in 2016 due to the maturity of the aluminium-linked bond asset in 2016, increasing prices of aluminium on the forward markets, increases in tariffs, and Fitch's assumption that no dividends will be paid. However, the company's ability to continue deleveraging beyond 2016 will be dependent on measures agreed by shareholders following the completion of the 2011- 2016 business plan and dividend payments.

Interest coverage is strong due to RE's access to low-priced funding across a basket of currencies. However, this has exposed the company to significant FX risk, which is managed with RE's US dollar-denominated power generation earnings and hedged over a five-year horizon.

#### Outperformance of Five-year Business Plan

We view positively management's stance to achieve operational efficiencies, which have significantly contributed to deleveraging since the business plan was implemented. The company has outperformed most of its targets under the 2011-2016 business plan a year and a half ahead of its completion in December 2016.

The business plan was agreed in March 2011 between the company and its shareholders to improve the company's cash balance by ISK50bn by end-2016 and repay large debt maturities from 2013. This included sales of assets, reduction of investments, tariff corrections and reductions in operational costs. We believe management should be able to continue to achieve cost efficiencies beyond 2016 given their track record although we expect these to be considerably less than those achieved in the plan.

#### Hedging Mitigates Market Risk

RE's cash flows are exposed to currency fluctuations (largest exposures being to USD and EUR), interest rates and to aluminium prices to which some of the company's generation contracts are linked. In our view, this exposure, though mitigated through hedging, may affect the pace at which RE will deleverage as the fluctuations can be substantial. RE has significantly reduced balance-sheet exposure to FX fluctuations by denominating the generation subsidiary in USD, but its cash flow exposure remains a rating risk. The company manages exposure to other currencies through currency hedges to smooth volatility. Cash flow risk is also mitigated by the company maintaining enough liquidity to meet cash outflow in each currency six months in advance.

At 30 September 2015, the company's total debt was ISK169.8bn, of which 73.6% was denominated in foreign currencies compared with 83% of the company's revenues in krona. Variable-rate debt was 76.6% and interest rate hedges covered on average 65% of the variable-rate debt for 2016-2019 and on average 51% for 2017-2021. The company has also hedged 51% of

its exposure to aluminium prices a year ahead and some of its exposure up to 2018. RE has also hedged some of its foreign currency exposure up to 2020.

### Lifting Capital Controls in Iceland

In June 2015, the Icelandic government announced its strategy for the liberalisation of capital controls that have been in place since 2008. We believe there is a risk of exchange rate volatility as a result, the magnitude of which may depend on the speed of implementation and resulting effect on the country's economic activities.

A weakening of the krona is possible after capital controls are lifted, via a rise in inflation as prices of imported goods increase. We expect the government to implement its strategy over the next few months, followed by the lifting of capital controls at a later date. A related uncertainty is the extent to which Iceland's balance of payments will be affected by capital flows in a post-capital controls environment. A substantial weakening of the krona could have a negative impact on RE's debt in local currency equivalent and the scope for deleveraging.

### KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer include:

- Majority of wholesale electricity generation earnings are linked to aluminium forward prices. Retail earnings, including earnings from the regulated business, are inflation-linked throughout the rating horizon.
- EBITDA on average of ISK26bn for 2015-2018
- Capex is forecast to average ISK12bn a year for 2015-2018 following capex deferrals since 2012.
- Positive free cash flow (FCF) of ISK9.8bn on average for 2015-2018
- An inflow of ISK8.9bn is forecast in 2016 due to the maturity of the bond asset that RE owns.
- No dividends in 2015-2016, dividend payout of 30% in 2017-2018.

### RATING SENSITIVITIES

Positive: Future developments that could, individually or collectively, lead to positive rating action include:

- Continued tariff increases and operational outperformance leading to FFO net adjusted leverage below 6x and FFO interest cover over 5x on a sustained basis.
- Increased parent support including unconditional guarantees.

Negative: Future developments that could, individually or collectively, lead to negative rating action include:

- Restrictions on tariff increases and higher investments, or no proceeds on the 2016 bond asset, leading to FFO net adjusted leverage above 7x from FY16 and FFO interest cover under 4x on a sustained basis.
- Weaker parent support, including de-linkage of tariffs to inflation or withdrawal of other support.

### LIQUIDITY

As of 30 September 2015, the company had ISK10.86bn in cash and cash equivalents and ISK8.3bn of undrawn committed facilities against short-term debt maturities of ISK14.3bn. Fitch assesses the company's liquidity as adequate to cover operational requirements over the next 24 months due to our expectation that it will remain significantly FCF positive over the rating horizon. Fitch considers 24 months of available liquidity as appropriate due to the high market volatility RE faces on its aluminium, interest rate and foreign exchange exposures.

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#### Applicable Criteria

Corporate Rating Methodology - Including Short-Term Ratings and Parent and Subsidiary Linkage  
(pub. 17 Aug 2015)  
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