MOODY'S
INVESTORS SERVICE

CREDIT OPINION
27 June 2016

Update

Rate this Research

RATINGS

Orkuveita Reykjavikur

Domicile	Iceland
Long Term Rating	Ba3 , Possible Upgrade
Type	LT Issuer Rating - Fgn Curr
Outlook	Rating(s) Under Review

Please see the ratings section at the end of this report for more information.The ratings and outlook shown reflect information as of the publication date.

Contacts

Erica Gauto Flesch 44-20-7772-1968
Analyst
erica.gautoflesch@moodys.com

Andrew Blease 44-20-7772-5541
Associate Managing Director
andrew.blease@moodys.com

Orkuveita Reykjavikur

Update following initiation of rating review

Summary Rating Rationale

The Ba3 issuer rating of Orkuveita Reykjavikur (OR) reflects (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) its foreign currency exposure; and (3) its exposure to long-term power purchase agreements with aluminium smelters, which exposes revenues to the price of aluminium.

The assigned Ba3 issuer rating incorporates one notch uplift from the baseline credit assessment (BCA) of b1 to reflect the likelihood of extraordinary support being provided by the company's owners in the event this was needed to avoid a payment default.

The review for upgrade on OR's ratings reflects our view that the strengthening of the Icelandic government's credit profile could translate into a higher ability and willingness to provide financial support to OR. In addition, the potential liberalization of capital controls, the improving macroeconomic environment in Iceland and the strengthening of the sovereign credit profile could have an impact on OR's standalone credit profile.

Exhibit 1
2015 Revenue breakdown by segments

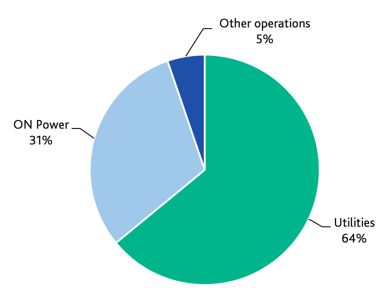
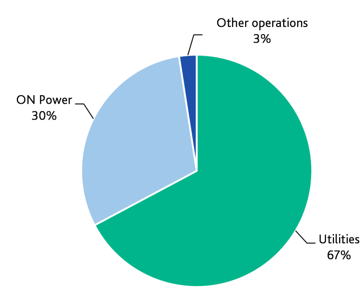


Exhibit 2
2015 EBITDA breakdown by segments



Source: Orkuveita Reykjavikur's 2015 financial statements

Credit Strengths

- » Low business risk profile of regulated activities
- » Strengthened financial profile against the background of an improving macroeconomic environment
- » Support from the owners provides uplift to the standalone credit quality

Credit Challenges

- » Unregulated power sales increase business risk and bring exposure to the aluminium price
- » Significant financial leverage and exposure to foreign currency risk

Rating Outlook

OR's ratings are under review for upgrade, reflecting the current review on Iceland's Baa2 issuer and government bond rating.

Factors that Could Lead to an Upgrade / Rating Confirmation

During the review period, we will consider whether the strengthening of the Icelandic government's credit profile will translate into a higher ability and willingness to provide financial support to OR, directly or indirectly thorough support to the company's shareholders, in case of need. In addition, the review will focus on the potential liberalization of capital controls in Iceland, the improving macroeconomic environment, the strengthening of the sovereign credit profile, and the impact of these on OR's standalone credit profile.

Moody's will endeavour to conclude the rating review within 90 days.

Key Indicators

Exhibit 3

Orkuveita Reykjavikur

	12/31/2015	12/31/2014	12/31/2013	12/31/2012	12/31/2011
(CFO Pre-W/C + Interest) / Interest	5.2x	5.2x	4.0x	3.5x	3.0x
(CFO Pre-W/C) / Debt	12.3%	10.9%	9.7%	7.7%	6.2%
(CFO Pre-W/C - Dividends) / Debt	12.3%	10.9%	9.7%	7.7%	6.2%
FCF / Debt	7.1%	9.3%	8.7%	7.0%	2.9%
Debt / Book Capitalization	58.0%	64.1%	70.9%	79.3%	79.3%

Note: All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. For definitions of Moody's most common ratio terms please see the accompanying User'sGuide

Source: Moody's Financial Metrics™

Detailed Rating Considerations

Low business risk profile of regulated activities

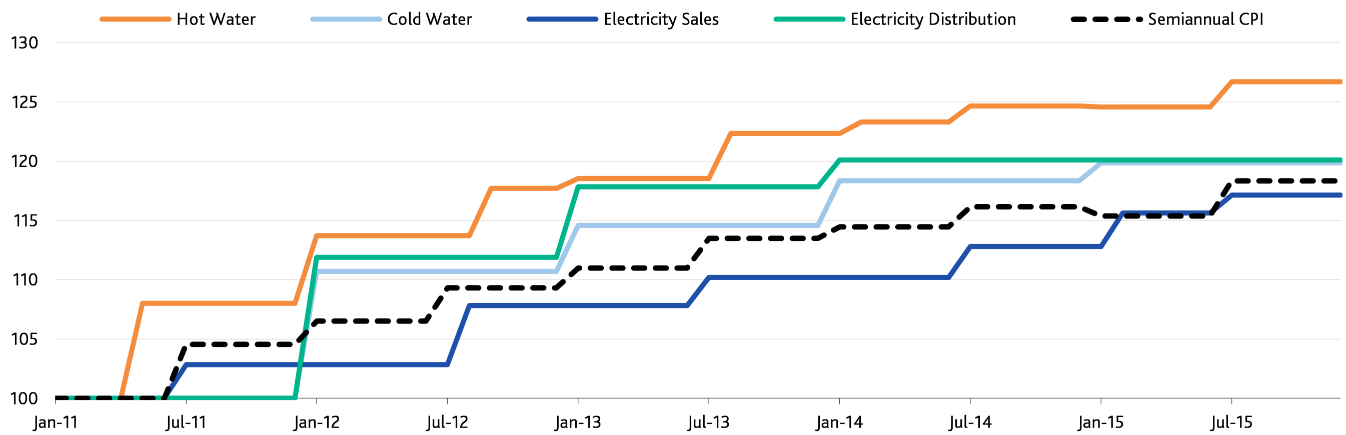
More than 60% of OR's revenues and EBITDA is derived from monopoly or quasi-monopoly activities, which are essential utility services to the majority of Iceland's population. The regulatory regime is relatively supportive and provides a good degree of predictability, albeit it is lacking sophistication and transparency compared with well-established RAB-based models. According to the regulatory framework, tariffs are linked to inflation with a pass-through cost mechanism that should allow the company to recover operating and financial costs, including investment requirements for the provision of the service, and achieve an adequate return.

We note that in the past the company did not always adjust tariffs in accordance with the regulatory principles, which had a negative impact on returns and profitability. However, this was rectified in 2011. Since then, OR has adjusted tariffs a number of times and aligned them with increases in the inflation rate. The recent track record of consistent implementation of tariff changes is supportive of the company's business risk profile.

In addition, utilities in Iceland do not face the same tariff affordability issues as those elsewhere in Europe, due to the very low prices of utility services. Therefore, we consider the risk of political interference to be low.

Exhibit 4

OR's cumulative tariff increases vs average semi-annual CPI evolution (2011=100)



Source: Orkuveita Reykjavikur and Statistics Iceland

Unregulated power sales increase business risk and bring exposure to the aluminium price

OR is active in the generation and supply of power to domestic retail and wholesale customers and the aluminium industry in Iceland. The company currently operates two geothermal and one hydropower plant. Its production accounts for almost 20% of the generation market and meets close to 90% of OR's supply needs. The remaining balance is supplied by Landsvirkjun under a long-term contract, which provides for coverage of peak demand.

OR has a strong market position on the domestic retail and business market, providing electricity to the most populated areas of the country. However, due to competitive pressures, over the recent past tariffs adjustments for this segment has been slightly below increases in the inflation rate.

Additionally, OR has a number of long-term take-or-pay contracts with aluminium smelting companies. Such contracts are denominated in US dollars and indexed to aluminium prices. They provide valuable foreign currency earnings, but also expose the company to aluminium price volatility. OR's aluminium-linked income represented around 16% of 2015 revenues, although the contribution varies depending on aluminium prices. During 2015, aluminium prices have materially fallen, with a decline of around 20%. We believe that aluminium prices will remain under pressure with no catalyst seen for a material price improvement through 2016, as the market still faces oversupply and a slow global economic recovery.

OR has entered into derivative contracts aimed at mitigation of this risk. The company's aluminium hedging policy provides some visibility in cash flows of up to 3 years, but does not fully eliminate the aluminium price risk, which can lead to some unpredictability to cash flows.

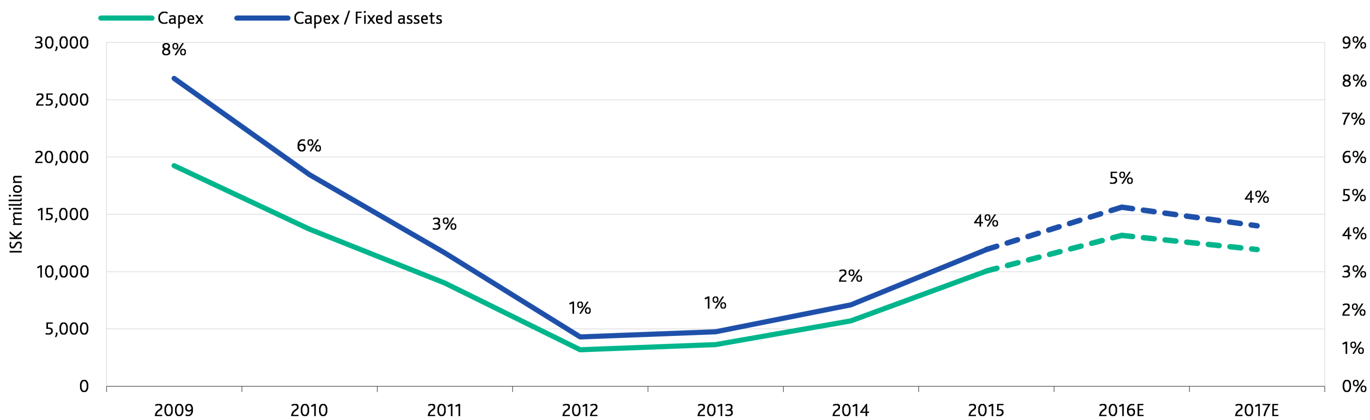
More positively, OR has recently signed a new electricity supply contract for 40 MW with Silicor Materials, a US producer of solar-grade silicon. The contract is for 15 years with a possibility of extension and the power delivery commences in 2018. The power price under the contract is more aligned with current retail prices and it is linked to US inflation.

Strengthened financial profile against the background of an improving macroeconomic environment

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. As at December 2015, the company has outperformed against almost all targets and exceeded the overall plan's goal more than one year ahead of its scheduled completion date in December 2016. The company's credit profile has strengthened due to the consistent implementation of tariff increases, cost discipline and the streamlining of capital investments. We expect OR to maintain the overall business strategy and improved operational performance beyond the five-year plan.

Exhibit 5

Rationalization of investments in utility systems and postponements in sewage investments was one of the milestones in OR's 5-years Plan



Note: Estimates represent Moody's forward view; not the view of the issuer.
Source: Orkuveita Reykjavikur and Moody's Investor Service

Furthermore, 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 5% in 2016 and 3.5% in 2017, 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 higher inflation will have a positive impact on the tariffs of OR's regulated utility services.

During the rating review period, we will consider the impact of the potential liberalization of capital controls and related further improvements in the macroeconomic environment on OR's standalone credit profile.

Significant financial leverage and exposure to foreign currency risk

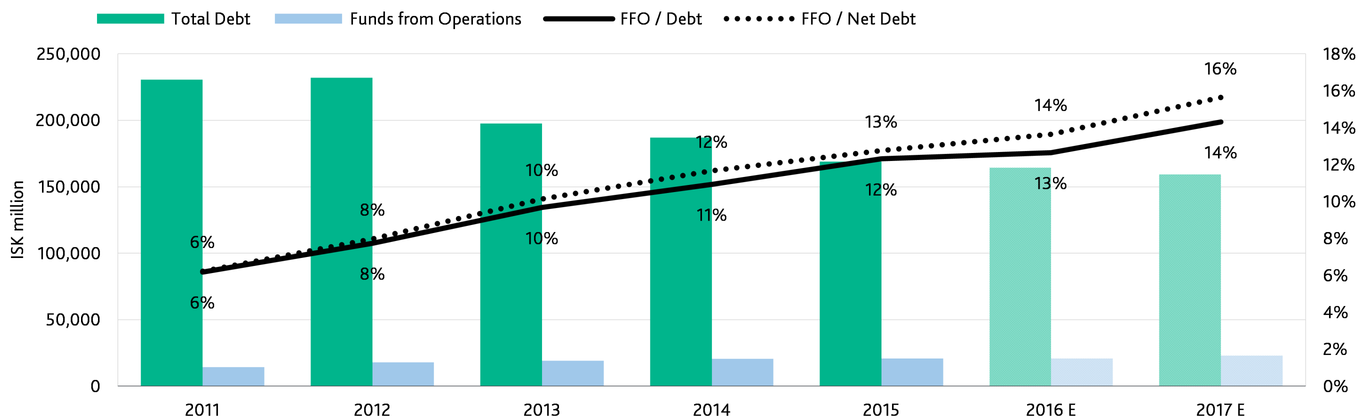
Owing to OR's improved operational performance and strong cash flow generation, the company managed to reduce its debt burden to ISK166 billion (ca. USD1.27 billion) as at December 2015 from ISK183 billion (USD1.44 billion) at December 2014, but debt leverage still remains high.

In addition, OR is exposed to a material exchange rate risk given the mismatch between foreign currency income and its debt servicing obligations. As at December 2015, around 74% of debt was denominated in foreign currencies including EUR (31% of total debt), USD (24%), CHF (10%) and other currencies (JPY, SEK and GBP). In contrast, only around 16% of revenues are derived in foreign currency (USD) with the remaining being in Icelandic krona.

As a result of its leveraged position, changes in the exchange rate can have a material impact on the company's debt burden. However, we note the company's foreign currency deposits and hedging policy mitigate some of the cash flow risk in the short term. Moreover, we note that the Central Bank of Iceland has engaged in purchases of foreign currency in order to smooth the exchange rate volatility, which is beneficial for the company. Whilst we do not expect material adjustments in the exchange rate due to the government strategy for capital account liberalization, OR's foreign currency risk will remain high although in the context of lower exchange rate volatility.

Overall, the pace of improvement in OR's financial position will be dependent on market variables, such as foreign exchange rates, the aluminium price and funding costs, but also on shareholder policy regarding investment plans and dividend distributions.

Exhibit 6
OR's debt leverage
Historical evolution and forward looking view



Note: figures presented are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. Estimates represent Moody's forward view; not the view of the issuer.
Source: Orkuveita Reykjavikur and Moody's Investor Service

Support from the owners provides an uplift to OR's standalone credit quality

OR is considered a government-related issuer 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%). The owners provide a guarantee of collection in support of OR, which currently covers more than 95% of the total outstanding debt. Whilst the guarantee of collection does not offer lenders the same degree of protection as a standard guarantee, given the potential for non-timely payment, there are very strong incentives for timeliness of payment if the guarantee were to be called. Under Icelandic law, if there is any delay in the payments, penalty rates of interest and cost of collection are imposed.

The issuer rating of OR does not represent a credit view of debt subject to a guarantee of collection, but it does incorporate an assumption of a moderate level of support to avoid a payment default if this were required. This recognises that the ability of the owners to provide support may be constrained, given OR's very significant debt burden relative to the financial resources of its shareholders. Considering the critical nature of utility services that OR provides to the City of Reykjavik and the surrounding communities, we would expect the central government to try and coordinate with the local governments to arrange timely intervention, if necessary. However, instances of default by municipalities in Iceland during the 2008 crisis indicate a low probability of extraordinary support could be forthcoming directly from the central government in the event that OR were to face financial distress.

Additionally, the rating of OR incorporates an assumption of very high default dependence between OR and its owners, which reflects our view that the likely cause of a default by the City of Reykjavik or the central government, namely severe economic distress, would also affect the revenues and financial profile of OR.

Overall, the Ba3 rating of OR incorporates one notch of uplift for potential extraordinary support to its standalone credit quality, as expressed by OR's baseline credit assessment (BCA) of b1.

During the rating review period, we will consider the extent to which the potential strengthening of the Icelandic government's credit profile, as captured by Moody's review for possible upgrade of Iceland's Baa2 issuer and government bond ratings initiated on 10 June 2016, will translate into a higher ability and willingness to provide financial support to OR, directly or indirectly thorough support to the company's shareholders, in case of need.

Liquidity Analysis

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.

As at December 2015, OR's liquidity was supported by around ISK7 billion of cash and cash equivalents and ISK8 billion of committed and available bank lines provided by Icelandic banks, maturing in 2020.

The company's cash flow generation has improved considerably but still remains moderate in the context of the scheduled debt maturities. OR's annual debt maturities amount to around ISK19 billion in 2016 and ISK15 billion in 2017. These amounts could be higher or lower in ISK terms depending on the exchange rate. Based on the company's cash flow generation and its committed undrawn facilities, we estimate that OR's liquidity is sufficient for at least the next 18 months.

Corporate Profile

Orkuveita Reykjavikur (OR) is Iceland's largest multi-utility, operating its own power plants, electricity distribution system, geothermal district heating system and providing cold water and waste services in 20 communities in the southwest of the country, covering more than 70% of the Icelandic population. The company is also a fibre-optic service provider, although this is expected to remain a limited contributor to cash flows.

OR is a partnership and under its governing act the partners are (1) the City of Reykjavik, which owns 93.5% of OR; (2) the Town of Akranes; and (3) the Municipality of Borgarbyggd, which have shares of 5.5% and 1% respectively.

Rating Methodology

As a multi-utility OR does not fall directly under one of Moody's utilities methodologies, although these are helpful in benchmarking the company's business and financial risks. We consider OR to be a low risk utility with respect to its core cash flows and business operations in the regulated segments but high risk with regard to the unregulated business and sale of electricity to aluminium smelters under long-term contracts. Furthermore, OR's financial risk, due to foreign currency exposure and leveraged profile, considerably increases the company's overall risk.

The principal methodology used in rating OR was Government Related Issuers, published in October 2014.

Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

Ratings

Exhibit 7

Category	Moody's Rating
ORKUVEITA REYKJAVIKUR	
Outlook	Rating(s) Under Review
Issuer Rating	Ba3

Source: Moody's Investors Service

REPORT NUMBER 1031470

Contacts

Erica Gauto Flesch 44-20-7772-1968
Analyst
erica.gautoflesch@moodys.com

Niel Bisset 44-20-7772-5344
Senior Vice President
niel.bisset@moodys.com

Andrew Blease 44-20-7772-5541
Associate Managing Director
andrew.blease@moodys.com

Przemyslaw Pietraszek 44 20 7772-5652
Associate Analyst
przemyslaw.pietraszek@moodys.com

CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

Moody's
INVESTORS SERVICE