

Rating Action: Moody's upgrades Orkuveita Reykjavíkur to Baa3

08 Sep 2021

London, 08 September 2021 -- Moody's Investors Service (Moody's) has today assigned a Baa3 long-term issuer rating to Orkuveita Reykjavíkur (OR) and concurrently withdrawn the Ba1 corporate family rating (CFR), following the rating agency's practice for corporates transitioning to investment grade. The outlook on the rating remains stable.

The upgrade to Baa3 principally reflects an improvement in the company's underlying credit quality, as represented by a ba1 baseline credit assessment (BCA), upgraded from ba2, which in turn reflects the company's strong operating performance, significant improvements in aluminium prices, and an improved balance between earnings and liabilities denominated in foreign currencies. Financial strategy and risk management, including the management of foreign exchange risks, is a governance consideration under Moody's methodology for assessing ESG risks.

RATINGS RATIONALE

OR's ba1 BCA reflects (1) the company's strong market position and strategic importance to Reykjavik and Iceland (A2 stable) as the provider of essential utility services to around 75% of Iceland's population; (2) the low business risk profile associated with regulated activities, which account for around 55% of the company's EBITDA and provide a good degree of cash flow predictability; and (3) low and predictable levels of capital expenditure.

The company achieved resilient operating performance in 2020, despite headwinds associated with the coronavirus pandemic, and strong cash flow in the twelve months to June 2021 attributable to lower borrowing costs and a 7% reduction in operating expenditures compared to the prior year. OR has also benefited from significant improvements in aluminium prices since the start of 2020, which directly benefit revenues through aluminium-linked contracts. As a result, OR's ratio of Funds From Operations (FFO) to net debt increased to 19.2% in the twelve months to June 2021. Stronger aluminium prices have also contributed to an improvement in the credit quality of Century Aluminum Company (B3 stable), which owns Nordural, OR's largest single customer.

OR has significantly improved its exposure to foreign exchange risks by reducing its debt denominated in foreign currencies relative to US dollar-denominated earnings. Borrowings in foreign currencies, mainly the US dollar, have declined from 63% of debt in December 2016 to around 40%, and Moody's expects this to continue to fall. US dollar revenue was equivalent to 21% of 2020 EBITDA.

OR benefits from a transparent and supportive regulatory framework in its electricity distribution segment. Iceland's National Energy Authority (NEA) followed a well-established methodology to set allowed revenues for the 2021-26 regulatory period, which includes a post-tax real allowed return of 5.21% in 2021 that will decline gradually over the period. The real allowed equity return, 7.25% in 2021, is higher than comparable regimes in Europe and globally, in part reflecting high interest rates following Iceland's financial crisis. The regulatory framework for the hot water segment, which is significantly larger than electricity distribution, is less developed, but tariff-setting in recent years has followed the NEA's analytical approach. Tariffs for cold water and sewage have increased steadily in recent years, and in Moody's opinion allow OR to achieve a reasonable return on invested capital.

Liquidity is very strong, with ISK 36.0 billion of cash and equivalents and access to ISK 10.0 billion of undrawn credit facilities as of June 2021.

OR is considered a government-related issuer under Moody's methodology because of its ownership by municipal authorities, which include the City of Reykjavik (93.5%), the Town of Akranes (5.5%) and the Municipality of Borgarbyggð (1%). OR's Baa3 rating incorporates one notch of uplift for potential extraordinary support to the company's ba1 BCA. This recognises that, despite strong incentives for the owners to provide timely financial support to OR, their ability to do so may be constrained by OR's significant debt burden relative to the financial resources of its shareholders. Moody's would expect the central government to coordinate with the local governments to arrange timely intervention, if necessary. On 20 August Moody's affirmed the A2

rating and stable outlook of the Government of Iceland, reflecting expectations of a solid economic recovery and significantly stronger and more credible institutions, offset by limited diversification of the economy.

ESG CONSIDERATIONS

Orkuveita Reykjavíkur's ESG Credit Impact Score is low/neutral (CIS-2), an improvement from its previous score of moderately negative (CIS-3), reflecting improved financial risk management. The effect of ESG risks to the rating is mitigated by the expectation that its government shareholder would support the company, if this were to become necessary.

OR's low/neutral environmental risk (E-2 issuer profile score) reflects the company's fully renewable generation portfolio. Heat and electricity from geothermal energy, which accounts for substantially all of OR's output, is highly reliable and dispatchable, and is unaffected by climactic variability that affects other renewable technologies. Despite Iceland's extreme weather, which creates risk of physical damage to OR's assets and those of Landsnet, the transmission network owner, OR has maintained consistently high network reliability since 2015 and has not faced material storm-related costs. Emissions of carbon and hydrogen sulphide from OR's geothermal plants are within permitted limits and have fallen over time as OR has reinjected an increasing share of these gases. In 2019, the company established a subsidiary to commercialise its carbon capture technology.

OR's social risk is moderately negative (S-3), reflecting the risk, common to all regulated utilities, that public concern over environmental, social or affordability issues could lead to adverse regulatory or political intervention. These risks are balanced by neutral to low risks to health and safety, human capital, customer relationships and responsible production.

Governance risks are low/neutral (G-2), a change from the previous score of moderately negative (G-3), reflecting reductions in OR's foreign exchange risk. Because Reykjavik City owns the company and appoints five of six directors, we view the independence of OR's board as relatively weak. However, a published "ownership strategy" and well-defined financial policies, and the shareholders' track record of appointing non-political external experts to the board, moderate the risk of political interference in the company's operations.

RATIONALE FOR STABLE OUTLOOK

The stable outlook on the rating reflects Moody's expectation that OR will maintain FFO/net debt in the high teens, in percentage terms, with prudent liquidity.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

There could be upward pressure on the rating if OR demonstrated further reductions in foreign currency risk, further improvement in the predictability of its key regulatory frameworks, or FFO/net debt trending toward the mid-20s in percentage terms.

These ratings could be downgraded if OR's FFO/net debt falls persistently below the high teens, if liquidity is insufficient to insulate the company from market risks (particularly in relation to exchange rates or aluminium prices), or if the supportiveness of OR's regulatory frameworks diminishes.

The methodologies used in these ratings were Regulated Electric and Gas Utilities published in June 2017 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1072530 and Government-Related Issuers Methodology published in February 2020 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1186207. Alternatively, please see the Rating Methodologies page on www.moodys.com for a copy of these methodologies.

Orkuveita Reykjavíkur (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 22 communities in the southwest of the country, covering approximately 75% of the Icelandic population. The company is also a fibre-optic service provider, offering internet access to businesses and households. More than 95% of the company's installed generation capacity is based on geothermal sources, while the remainder comes from hydro. OR is the second largest electricity producer in Iceland, with a share of around 18% in total electricity output. The company services mainly the Reykjavik city area, but is also present in southern and western parts of Iceland.

Orkuveita Reykjavíkur is a partnership between three municipalities: the City of Reykjavik (93.5%), the Town of Akranes (5.5%) and the Municipality of Borgabyggd (1%).

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

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Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at http://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_1288435.

At least one ESG consideration was material to the credit rating action(s) announced and described above.

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