MOODY'S
PUBLIC SECTOR EUROPE

ISSUER IN-DEPTH
6 March 2017

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**RATINGS**

**Faroe Islands, Government of**

| | |
|---|---|
| Domicile | Denmark |
| Long Term Rating | Aa3 |
| Type | LT Issuer Rating |
| Outlook | Stable |

**KEY METRICS:**

| | 2014 | 2015 | 2016F |
|---|---|---|---|
| Gross Operating Balance / Operating Revenue (%) | 1.4 | 4.1 | 7.5 |
| Financing surplus / Total Revenue (%)) | -3.8 | -1.2 | 3.7 |
| Net Direct and Indirect Debt / Operating Revenue (%) | 104.6 | 107.2 | 100.2 |
| Real GDP growth (%) | 6.9 | 8.1 | 8.8 |

*Source: Moody's*

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# Faroe Islands, Government of

## Frequently Asked Questions About the Sub-Sea Tunnel Plans, Minimum Traffic Guarantee

On 7 February 2017, we affirmed the Government of the Faroe Islands' Aa3 rating with a stable outlook, outlining our view that the Faroe Islands' rating and credit strengths are sufficient to withstand the challenges associated with the government's exposure to an infrastructure project comprising of two major sub-sea tunnels (Eysturoy and Sandoy).

This report complements the update to the credit opinion published 21 February 2017 and answers a series of questions on the new tunnels, which represent the biggest infrastructure investment in the history of the Faroe Islands. The tunnels have an expected cost of approximately DKK2.64 billion and benefit from a minimum traffic guarantee from the Faroese national government.

## Frequently Asked Questions:

1. **How does the minimum traffic guarantee work?** Starting from Jan 2022, any difference between actual revenues generated by the project and forecasted revenues will be covered via direct payment from the Faroese Ministry of Transportation, Infrastructure & Labour (MoTIL) to the government-owned Project Company.

2. **What are the risks associated with this project?** Sub-sea tunnels have a riskier profile relative to other PPP projects. The highest risk pertains to the construction phase, where elements of variable pricing and severe delays could lead to cost overruns. While MoTIL has some exposure to cost overruns, it also has the option to opt out of the construction of the second tunnel with a one-off payment of DKK35 million.

3. **What is the impact of the infrastructure project on our debt projections?** As a result of the guarantee, we project the Faroes' debt in our base case to remain high but stable over the next five years, a trend we had elsewise expected to reverse. Nevertheless, we view that the Faroe Islands' current Aa3 stable rating can sufficiently absorb the additional debt from the tunnel as outlined in our rating action on 7 Feb 2017.

4. **What would be the impact of additional sizeable guarantees?** Any additional guarantee will be evaluated on a case-by-case basis and its impact will depend on the exposure that it places on the Government of the Faroe Islands.

5. **Do the Faroe Islands need to seek approval from Denmark for such a major infrastructure project?** The Faroe Islands are a self-governing nation within the Danish realm and so have independent revenue and expenditure setting powers. The Faroese Parliament unanimously approved the construction of the Eysturoy and Sandoy sub-sea tunnels. Involvement of the Danish sovereign is not required.

## PROJECT OVERVIEW

The planning, construction and operations of the two sub-sea tunnels are carried out by Eysturoyar-og Sandoyartunnilin project company (the Project Company), which is 100% owned by the Faroese government, and benefits from a minimum revenue guarantee provided by the government. The Eysturoy tunnel will be 11.3km in total, connecting both sides of the bay of Skálafjørður using two tunnels that connect to a roundabout under the seabed. The Sandoy tunnel will be 10.8km long from Gamlarætt on the island of Streymoy to Traoardalur in Sandoy. Once operational, the project will shorten travel time and distances for local users with only limited competition from alternative routes. In particular, with the first sub-sea tunnel, travel time to Runavik from the capital Torshavn will take around 16 minutes instead of the current time of 64 minutes. The travel time between Streymoy and Sandoy will be also shortened significantly, liberating travellers from ferry schedules and variable weather conditions.

Exhibit 1

**Faroese Sub-Sea Tunnels - Key Project Details**

| | Eysturoy | Sandoy |
|---|---|---|
| Cost | DKK 1.46 billion | DKK 1.18 billion |
| Start date | 2016 | 2018 |
| Completion date | 2020 | 2023 |
| Income start year | 2021 | 2023 |
| 40-year income projection | DKK 5.29 billion | DKK 0.49 billion |
| Length | 11.24 km | 10.9km |
| *Project Equity injection* | *DKK 400 million* | |
| *Senior Secured Notes raised* | *DKK 2.68 billion at 2.73% fixed* | |

*Source: Moody's, Eysturoyar-og Sandoyartunnilin, Landsbankin*

**Credit Strengths.** The project benefits from standard PPP structural features, including fully-amortizing debt, 12-month debt service reserve account, maintenance reserve account and distribution lock-up agreed with the lenders at 1.20x average debt service coverage ratio (ADSCR).

**Credit Weaknesses.** The vast scale of the project vis-à-vis the size of the Faroese economy and the extremely low total traffic transactions, which leave little room for significant upsides in future revenue streams, offset the credit strengths of the project.

During operations, the Project Company's highly-leveraged structure limits its ability to withstand unexpected stress. The forecast debt service coverage ratios (DSCRs) under our base case are comparatively weak relative to rated toll roads with minimum and average DSCRs of 1.04x and 1.08x, respectively. However, considering the positive track record of tolled traffic at the existing tunnels, we believe that the Project Company should be able to meet its obligation on a stand-alone basis with a limited amount of claims under the minimum traffic guarantee.

QUESTION 1

## How does the minimum traffic guarantee work?

The Faroese government, through MoTIL, provides the minimum traffic guarantee to the 100% government-owned Eysturoyar-og Sandoyartunnilin project company (the Project Company). Under the guarantee, any difference between the actual revenues generated by the project and the revenues forecast in the long-term financial budget will be covered via a direct payment from the MoTIL to the Project Company. From the information received, the Project Company will have the right to begin making claims in respect of any revenue shortfalls starting from January 2022.

We note the MoTIL undertakes to compensate the Project Company for any shortfall in traffic income or increase in the operating and management costs. Under the current draft of the guarantee, construction overruns are not explicitly covered. However, this scenario should not impact the project's ability to repay the debt service as we understand the guarantee is effective irrespective of whether the tunnels completion will actually be achieved. In addition, should the guarantee be triggered, MoTIL has the option to change toll prices in order to bring operational revenues in line with required debt service.

The long-term financial budget has been signed by the various project parties and cannot be amended without the previous consent of creditors. In addition, the Project Company is obligated to submit semi-annual operating budgets which must periodically prove that it is able to meet all of its financial obligations, including among others, operating costs and debt service payments under the project's debt. Importantly, the Project Company's right to make claims under the guarantee is not conditioned to any external factor, thus we expect the Project Company to be always entitled to make claims in an amount sufficient to service all regularly scheduled due payments.

QUESTION 2

**What are the risks associated with this project?**

We view sub-sea tunnels as maintaining a riskier profile relative to rated PPP peers with the assets generally exposed to the risk of natural gaseous settlements, unstable geology and water inflows. However, the site preparation requirements as well as the construction techniques for these tunnels are well known to the construction contractor NCC Norge AS, the engingeering, procurement and construction (EPC) contractor, which is relatively experienced in the area. In particular, the drill-and-blast technique during construction is deemed standard for this type of ground and the initial estimates for completion schedule (2.5 years per tunnel excluding buffers) and costs (approx. DKK2 billion) were based on the knowledge acquired with the two existing sub-sea tunnels.

We view that the highest risk pertains to the construction phase. The Project Company's responsibilities during the construction phase are passed down to the EPC contractor via a quasi-fixed price EPC contract. Although a common feature of sub-sea asset contracts, this exposes the Project Company to some elements of variable pricing. This risk, albeit only accounting for around 12% of the total EPC contract price, could result in unforeseeable cost increases. We note any delay by the EPC contractor shall give rise to delay liquidated damages payable under the Concession Agreement with an aggregate liability cap set at 15% of the EPC contract price. We assessed the adequacy of the construction liquidity package and concluded that the liquidity in place is sufficient to cover the equivalent of 12 months of delay damages.

In the event of an EPC contractor replacement, the project's exposure to cash shortfalls will depend on the amount of extra costs required to complete the outstanding works at that date, on which there is little visibility at this stage. However, with the Project Company being entitled to make claims under the minimum traffic guarantee irrespective of the final project completion, we expect lenders to be protected during the construction phase with the government bearing the risk of cost overruns and severe delays.

The MoTIL has the option to opt out from the construction of the second tunnel with the payment of a DKK35 million penalty. However, projected revenues from the Eysturoy tunnel alone would cover the interest and principal instalments due until debt maturity. In line with this, we see the completion of the first tunnel as the major milestone during construction with a possible abandonment of the second tunnel having only a minor impact on the project's overall financial sustainability.

In addition, we consider the fixed rate and amortising nature of the loan as credit positive as this structure limits exposure to both interest rate and refinancing risk. The interest rate for the DKK2.68 billion senior secured notes raised is fixed at 2.73%, with an amortisation schedule starting in 2023 and maturing in 2040. However, should the Project Company opt out from the construction of Sandoy tunnel, it will have to invest the available funds, as all of the project-related debt has been drawn upfront at a fixed interest rate of 2.73%.

QUESTION 3

**What is the impact of the infrastructure project on our debt projections?**

As a result of the guarantee, we project the Faroes' debt in our base case to remain high but stable over the next five years, a trend we had previously expected to reverse over the coming years. We previously anticipated that the realisation of secondary budget surpluses[1] would support the government's repayment of outstanding debt, reducing net direct and indirect debt (NDID) to 74% by

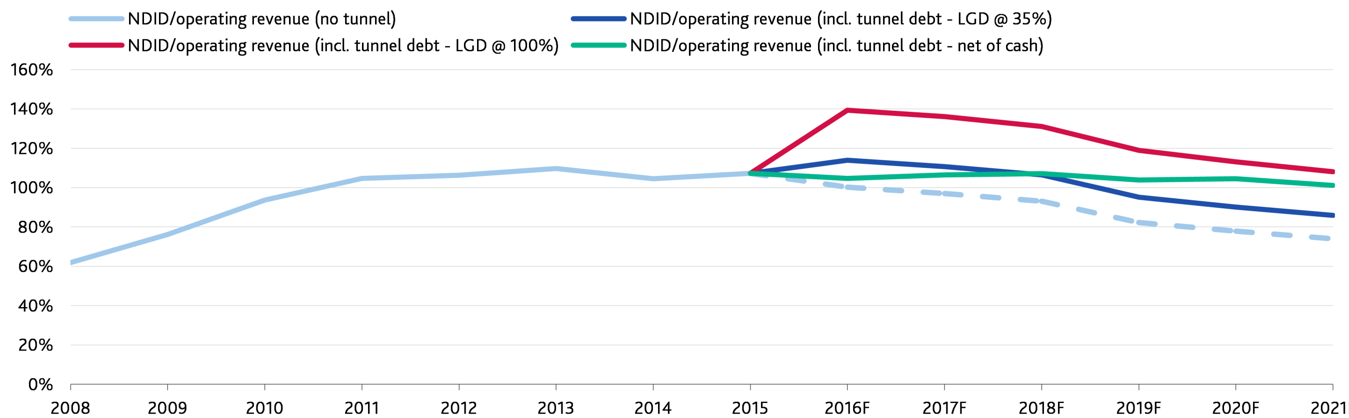
2021 after peaking at 107% in 2015. This would have had a positive impact on the Faroe Islands' baseline credit assessment (BCA) because this decrease to 74% would have placed it in a lower bucket for *Sub-Factor 3.4 Debt Burden* in the Moody's Regional and Local Governments Methodology.

However, the Faroese government's minimum traffic guarantee provided to the Project Company will offset the otherwise positive rating pressure from our previously assumed reduced debt projections. As the senior secured notes were issued by a 100% government-owned project company, we classify the debt from the project as indirect debt of the Faroese government. Exhibit 2 shows the various scenarios we have modelled, with our base case (see green line) being the net of project cash scenario. Our previous base case forecast debt to fall, while our new base case expects debt to remain high but flat.

Exhibit 2

**While all treatments of the contingent liability increases the government's total debt, the increase relative to operating revenues is modest**

**Net direct and indirect debt (NDID) as a % of operating revenues, by scenario and by year**




*Source: Moody's*

In all of these cases, the additional debt burden would not cause a change in the scorecard-suggested BCA of the Faroe Islands. Our new base case, which uses project debt net of project cash, does not anticipate any adverse impact on the Faroe Islands' current scorecard as debt to operating revenues will remain within its current scorecard bucket, which is at the higher end of our range. Other scenarios considered include the assignment of a loss given default (LGD) of 35%, which is our standard assumption for these types of infrastructure projects. We also analysed the worst-case scenario where the LGD would be 100%. Despite taking on this additional debt, the Faroe Island's current Aa3, stable rating can sufficiently absorb this change in debt for all scenarios considered. As a result, we affirmed the Aa3 long-term issuer rating of the Faroe Islands with a stable outlook on 7 February 2017.

QUESTION 4

## What would be the impact of additional sizeable guarantees?

Any additional guarantees will be evaluated on a case-by-case basis and its impact will depend on the exposure that it places on the support provider. In the case of the guarantee given to the Eysturoy and Sandoy tunnels, we view the reversal of their long-term debt reduction strategy as a credit negative. We also note the political motivation behind the Sandoy tunnel: financing was secured in 2016 for both tunnels, despite construction of the Sandoy tunnel only set to begin in 2018. This is due to the Sandoy tunnel being financially unviable (on an expected EBITDA generation basis) and the government may not have been able to raise sufficient funds for construction if it had been treated as a stand-alone project.

The guarantee given to the Eysturoy and Sandoy sub-sea tunnel project is the first given to sub-sea tunnels or other road-building projects in the Faroe Islands. Infrastructure projects of this nature are usually part of the capital expenditure appropriated in the government's budgets. While the two previous sub-sea tunnels in the Faroe Islands (Nordoya and Vagar tunnels) were also built through a public company as Eysturoy and Sandoy, the Faroese government instead injected sufficient capital throughout the projects, as well as provided cheap loans through the government's development fund. This ensured that toll revenues and government equity could cover the debt service of the loans[2] (as opposed to providing a minimum traffic guarantee).

The Faroese government has in the past given guarantees to private companies but has stopped this practice since the 1980s after companies under guarantees went bankrupt. In the late 1970s and 1980s, the government provided guarantees to private fishing firms for their vessels and fish factories. This allowed the industry to lower the cost of capital as well encouraged economic activity to relocate to smaller villages. However, the guarantees played a role in the build-up of substantial overcapacity in these locations and as fish stocks decreased considerably in the late 1980s and early 1990s, many fish factories and fishing vessels went bankrupt, triggering the guarantees provided by the government. The resulting liability contributed to the Faroe Islands' fiscal crisis in the early 1990s, and many politicians in the Faroese parliament at that time were not re-elected in the 1994 Faroese general election. Due to the political embarrassment and association with political irresponsibility, the Faroese government has since abolished guarantees to private companies.

The minimum revenue guarantee given to the government-owned Project Company for the Eysturoy and Sandoy tunnels is the first guarantee given by the government since the 1980s.

QUESTION 5

### Do the Faroe Islands need to seek approval from Denmark for such a major infrastructure project?

No, the Faroe Islands are a self-governing nation within the Danish realm. This means that they are responsible for their own finances and are able to independently set revenue and expenditure levels, as well as raise debt on the capital markets. With regards to the major infrastructure project, the Faroese Parliament unanimously agreed to begin work to construct the sub-sea tunnels in 2014. Involvement of the Danish sovereign was not required despite this project being the biggest single infrastructure expansion in the history of the Faroe Islands.

The autonomous constitutional status of the Faroe Islands was established in the Home Rule Act of 1948, which set out the division of responsibilities[3] between the Faroe Islands and Denmark. The areas in which the Faroese government does not have jurisdiction over include: the Danish constitution and citizenship, the judicial system and Supreme Court, banking supervision and currency, and foreign and security policy. We do not expect Denmark to amend the constitutional basis in the medium term as the autonomous governance of the Faroe Islands was recently supplemented by the additional transfer of competencies to the Faroese authorities in the Takeover Act of 2005.

We feel that there is currently a strong relationship with Denmark. The incumbent Faroese government consists of a coalition of various political parties and has representation in the Danish Parliament, resulting in strong political linkages. Although deemed unlikely, any push for independence would assume a referendum and would exert negative pressure on the credit.

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» Moody's changes outlook on Faroe Islands' Aa3 rating to stable from negative; affirms Aa3 rating - 31 July 2015

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» Faroe Islands: Delivery of Faroe Islands' Fiscal Plan Supports Creditworthiness - 1 September 2015

### Sector In-Depth:

» Nordic Local Governments: Credit quality boosted by support expectation and inherent strengths - 20 May 2016

### Rating Methodology:

» Regional and Local Governments - 18 January 2013

## Endnotes

1 See Government of the Faroe Islands - Credit opinion, published 21 February 2017.

2 The provided equity capital by the Faroese government to the Nordoya and Vagar tunnels has been sufficient at covering the debt service of the tunnels. The Vagar tunnel loan has since been paid back, while the Nordoya tunnel loan will be fully amortised by 2019.

3 See Appendix of Delivery of Faroe Islands' Fiscal Plan Supports Creditworthiness, published 1 September 2015.

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