STANDARD & POOR'S

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Summary:

Puerto Rico Electric Power Authority; Retail Electric

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Summary:

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Credit Profile		
Puerto Rico Elec Pwr Auth pwr		
Long Term Rating	BBB+/Stable	Affirmed
Puerto Rico Elec Pwr Auth pwr		
Unenhanced Rating	BBB+(SPUR)/Stable	Affirmed

Rationale

Standard & Poor's Ratings Services has affirmed its 'BBB+' underlying rating on Puerto Rico Electric Power Authority's (PREPA or the authority) power revenue bonds. The outlook is stable.

The bonds are secured by a pledge of the electric system revenues. As of June 30, 2009, PREPA has $6.16 billion of power revenue bonds outstanding, and $694 million of notes payable.

In our opinion, the rating reflects:

- An isolated electric system, which requires the utility to maintain a capacity margin of at least 50%;
- Large capital requirements of $2.8 billion in the past five years and $1.7 billion during the next five years to convert generating plants to gas, bury distribution wires, upgrade and extend the transmission system;
- A dependence on oil, although conversion of several generating plants to gas and clean coal technology as well as evaluating offshore liquid natural gas (LNG) supply will help achieve the goal of having gas-fired generation account for 24% of capacity, coal for 15%, renewable sources and others for 12%, and oil for only 49% of total generation by 2013;
- The protracted recession, with real GNP contraction of 1.9% in fiscal 2007, 2.5% in fiscal 2008, and an estimated 3.4% in fiscal 2009;
- High rates, which reached 22.2 cents per kilowatt-hour (kWh) in fiscal 2008 and 21.5 cents in 2009; and
- Limited liquidity, exacerbated by increased delinquency on government receivables. The Government Development Bank (GDB) will provide a guarantee to private banks or lines of credit for operating liquidity structured around the government's budgeted payment plan. The payment of government receivables will help improve operating liquidity and will partially pay down existing bank lines of credit. A dedicated line of credit provides liquidity for fuel purchases.

We believe that adequate capacity; and the ability to pass through fuel costs, which allows the authority to maintain what we view as a stable, if not strong, financial profile, mitigate these weaknesses.

In our opinion, PREPA's credit profile is strongly linked to the island economy it serves (Puerto Rico's general obligation bond rating is BBB-/Stable), although the utility has maintained fairly stable financial metrics in the island's past economic cycles. The authority has maintained a stable base rate of 5.8 cents per kWh, and passes through fuel and purchased power costs as incurred. The dependence on oil raised rates for residential customers, which account for 34% of total revenue, to about 22.0 cents per kWh in fiscal 2008 and 21.0 cents in 2009, up from 17.76 cents in fiscal 2007. (The utility's fiscal year-end is June 30.) Commercial customers account for about 48% of revenue, and industrial and other customers for 18%.

In the past two years, PREPA's financial metrics have weakened, as collections of receivables, primarily from the government and government-related entities, have decreased. At the end of fiscal 2009, government receivables were about 30% of the total, up from 24% in 2005. However, in the five months since his inauguration, the administration of Governor Luis Fortuño has made fiscal stability a priority. With broad support from the legislature, Gov. Fortuño implemented a fiscal reconstruction plan designed to regain budgetary structural balance by fiscal 2013. These fiscal measures represent, in our opinion, a factor that lends near-term stability to the Commonwealth's credit. As part of that plan, amounts owed PREPA will be paid over six years, and the GDB will provide a guarantee of loans provided by banks to make those payments. The Government of Puerto Rico has paid down the $190 million it owed to $110.4 million as of June 30, 2009 and will be paid down to $70 million in the next month. The Public Building Authority will pay down approximately $25 million of its $57 million in the next month.

However, we expect that Gov. Fortuño's fiscal reconstruction program will remain challenged by the recession and the potential growing political pressure to delay or modify the scope of the identified payroll and expenditure costs that the government plans to control. The approved fiscal 2010 budget assumes flat revenue growth relative to actual fiscal 2009 recurring revenues, and general fund expenditures of $7.6 billion. The budget also includes a $2.5 billion stabilization fund, which Commonwealth funded with the proceeds from the sale of the Puerto Rico Sales Tax Financing Corp.'s first subordinate-lien bonds. The stabilization fund will primarily pay for the costs associated with the payroll reductions and buyout plans included in the Commonwealth's fiscal reconstruction plan. Including expenditures associated with the fund, the Commonwealth's structural deficit for fiscal 2010 would reach $2.6 billion, or what we view as a high 34.5% of general fund recurring revenues. Commonwealth officials expect that the majority of the expenditures that the fund is financing will not recur in subsequent fiscal years, gradually closing the structural deficit by fiscal 2013.

During the next five years, PREPA will invest about $1.7 billion in the system, having invested $2.8 billion in the past five years. The goal of the investment plan is to reduce oil dependence and increase fuel efficiency. By 2013, the authority expects to reduce its dependence on oil to 49% from 100%, and use gas-fired units to provide 24% of electricity with coal, renewable sources, and other sources providing the remaining 27%. In addition to converting plants to gas or dual-fuel capability, PREPA will build two high-voltage transmission lines to transfer power across the island, and is considering privately owned generating facilities. The utility has also transferred some distribution wires underground, most notably the system that serves San Juan. In addition, of the completed fiber optic telecommunications network has allowed the authority to modernize its internal communications systems, which provide operations, load management, system protection and security, and other controls.

One-year contracts cover PREPA's fuel requirements for its generation facilities, expire at various times, and are usually renewable at the authority's option. The utility contracted fuel oil prices consist of an escalation factor plus a fixed price differential. The escalation factor reflects the fuel oil price at the New York market at the time of purchase. The fixed price differential compensates for the fuel oil being delivered in the Commonwealth and not New York. It also takes into account other aspects of the delivery such as maximum cargo volume and draft restrictions. PREPA does not expect any difficulty in renewing its contracts at price differentials similar to those currently in effect. Also, it has the right to buy up to 50% of its oil supply at government-to-government rates, helps lower the all-in cost of electricity.

Although the capital investment will increase the system's debt obligation, PREPA expects to maintain a debt service coverage level of about 1.5x, which is consistent with past performance, without raising base rates. Management expects that annual demand growth of about 2%, plus stringent operating cost controls and greater fuel efficiency, will provide margins that cover increasing debt service at a level that exceeds the 1.2x required minimum. The fixed charge coverage ratio will also continue to be slightly more than 1.0x. This ratio measures coverage of debt service and other long-term fixed obligations by net funds from operations after the annual transfer of funds to the municipalities. For PREPA, the transfer ranges from about $140-$150 million each year. Fixed obligations include 50% of purchased power as a proxy for capacity payments. This level of coverage does not allow the authority to set aside significant reserves to help fund the capital spending program. Less than 5% of the $1.7 billion program will come from internally generated funds.

For these reasons, we believe PREPA's liquidity has always been weak. Cash and investments normally on hand are equal to just a few days of operation costs. However, a $275 million line of credit provides financing for fuel purchases, and a $200 million credit facility provides operating liquidity, although this facility is fully used. GDB has provided lines of credit in the interim and is willing to provide guarantees to banks to back the delinquent receivable repayment plan by the Puerto Rico government and governmental agencies

Outlook

The stable outlook indicates, in our opinion, PREPA's ability to maintain the current level of financial strength despite the effects of the recession on the economy of Puerto Rico. Supporting this is both the authority's commitment to reduce its own operating costs and to the Puerto Rico government's commitment to honor its financial obligations to PREPA. Progress in both of these endeavors will be important factors in maintaining the rating. Moreover, the utility's goal of reducing its oil dependence and improving the overall reliability and efficiency of the electricity delivery system will be an important component of Puerto Rico's economic growth.

Related Research

USPF Criteria: "Electric Utility Ratings," June 15, 2007

Ratings Detail (As Of July 31, 2009)		
Puerto Rico Elec Pwr Auth elec		
Long Term Rating	BBB+/Stable	Affirmed
Puerto Rico Elec Pwr Auth pwr		
Unenhanced Rating	BBB+(SPUR)/Stable	Affirmed
Puerto Rico Elec Pwr Auth pwr		
Unenhanced Rating	BBB+(SPUR)/Stable	Affirmed
Puerto Rico Elec Pwr Auth pwr rev bnds ser AA dtd 05/01/1997 due 07/01/1999-2017 2022-2023 2027		
Unenhanced Rating	BBB+(SPUR)/Stable	Affirmed
Puerto Rico Elec Pwr Auth pwr rev rfdg bnds ser V V dtd 05/30/2007 due 07/01/2020 2024-2027 2029-2035		
Unenhanced Rating	BBB+(SPUR)/Stable	Affirmed

Ratings Detail (As Of July 31, 2009) **(cont.)**		
Puerto Rico Elec Pwr Auth pwr (wrap of insured) (FSA & BHAC) (SEC MKT)		
Unenhanced Rating	BBB+(SPUR)/Stable	Affirmed
Puerto Rico Elec Pwr Auth pwr		
Unenhanced Rating	BBB+(SPUR)/Stable	Affirmed
Many issues are enhanced by bond insurance.		

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