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Summary:

Puerto Rico Aqueduct & Sewer Authority; General Obligation Equivalent Security; Water/Sewer

Primary Credit Analyst:
Theodore A Chapman, Dallas (1) 214-871-1401; theodore.chapman@standardandpoors.com

Secondary Contact:
Jeffrey M Panger, New York (1) 212-438-2076; jeff.panger@standardandpoors.com

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Credit Profile		
Puerto Rico Aqueduct & Swr Auth (Senior Lien) (RADIAN) (SEC MKT)		
Unenhanced Rating	CCC+(SPUR)/Watch Neg	Downgraded, On CreditWatch Negative
Puerto Rico Aqueduct & Swr Auth		
Long Term Rating	CCC+/Watch Neg	Downgraded, On CreditWatch Negative

Rationale

Standard & Poor's Ratings Services lowered its rating on all Puerto Rico Aqueduct & Sewer Authority (PRASA) debt two notches to 'CCC+' from 'B'. At the same time, we placed the ratings on CreditWatch with negative implications.

The downgrade reflects a similar action Standard & Poor's took on the commonwealth's general obligation (GO) and related ratings on April 24, 2015 (see the article, "Puerto Rico Downgraded To 'CCC+' From 'B' On Weakened Market Access; Placed On CreditWatch Negative", on RatingsDirect). The actions were based on our view that the commonwealth's market access prospects have further weakened and its ability to meet its financial commitments is increasingly tied to favorable business, financial, and economic conditions. Absent economic improvement, GO debt and other financial commitments will be unsustainable. The CreditWatch action reflects the current lack of consensus on key elements of the fiscal 2016 budget, which could exacerbate liquidity and fiscal pressure. We expect to resolve the CreditWatch within three months when there is greater clarity on the budget and overall liquidity. We believe enactment of a credible balanced budget by the start of the new fiscal year (July 1, 2015) could be an important element in regaining external market access. Should passage of a fiscal 2016 budget become significantly delayed, or if the budget is enacted with significant structural flaws, we could lower the rating to 'CCC' or lower. Alternatively, if timely budget adoption translated to stabilized liquidity, we could remove the rating from CreditWatch.

Recent developments highlight what we see as the general government's liquidity risk from diminished external market access. The board of the Puerto Rico Government Development Bank (GDB) recently sent a letter to state legislators indicating significant difficulty in a proposed refinancing of a $2.2 billion Highways and Transportation Authority loan from GDB with a larger $2.95 billion external bond issue backed by petroleum taxes. The purpose of the refinancing would be to improve GDB liquidity. The GDB board cited the extended delay in refinancing this debt as potentially causing liquidity problems that could occur as early as the start of the new fiscal year and which could result in a government shutdown unless legislators enact a budget and the GDB could externally market its debt. It is unclear, in our view, how efforts to attract a nontraditional base of debt investors are affecting budget and fiscal policy negotiations, or exactly where central government liquidity levels will be at the end of the fiscal year. However, in our view, the existence of such a letter indicates credit stress.

It is important to note that we do not currently view PRASA's cash flow or cash reserves as being distressed; both are, in fact, at historic highs. However, we also cannot de-link PRASA from the headwinds created by the commonwealth's budget difficulties and legislative attempts at providing relief. In both the Public Corporation Debt Enforcement and Recovery Act (2014; later invalidated by the courts), as well as Puerto Rico House Bill 2406 introduced in April 2015, PRASA was not explicitly exempted from the legislation. Bill 2406 proposes to require all commonwealth-related entities (including the public corporations) to deposit all funds with the GDB. PRASA's revenues and cash are not subject to claw-back or intercept by the commonwealth. Further, there are certain provisions that may not make the bill applicable to PRASA, such as if the measure impedes bondholder rights. Regardless, the legislature in both cases did not explicitly exempt PRASA despite the authority achieving financial independence in fiscal 2014. In our view, this precludes de-linking the authority from the commonwealth. PRASA also has to address draws on its committed lines of credit by May 2015, either by converting them to long-term debt or reaching some kind of forbearance or extension arrangement. Therefore, even indirect and remote association with the high-profile situations with both the electric authority and the general government could cause PRASA challenges. Earlier in 2015, PRASA negotiated an extension from a March due date, as well as paying down $40 million in outstanding balances.

The actions are applicable to PRASA's series 2008A and B revenue bonds, of which there are about $285 million outstanding. PRASA also has approximately $890 million in other commonwealth-backed obligations, mainly the U.S. Department of Agriculture's Rural Development loans, as well as the Puerto Rico Infrastructure Financing Authority loans, none of which are rated by Standard & Poor's.

The rating actions are also applicable to PRASA's revenue bonds. The senior-lien revenue bonds -- series 2008 and 2012A and B, secured by a gross revenue pledge of PRASA, with about $3.4 billion total outstanding -- are based on the fact that PRASA is, in our view, a governmental-sponsored enterprise. By applying our governmental-related entity (GRE) criteria and because of PRASA's important role and limited link with the commonwealth, a downgrade of Puerto Rico's GO debt could cause a downgrade of PRASA's revenue bonds. The relationship, based on our criteria, caps PRASA's rating at the GO rating of the commonwealth for now.

We revised PRASA's stand-alone credit profile (SACP) to 'ccc+', which reflects our view of the authority's general creditworthiness solely on its own fundamentals, absent any uplift or headwinds associated with its relationship with the general government. We view the current climate surrounding all Puerto Rico obligations as creating adverse business conditions for PRASA. Its liquidity has no immediate challenges because of a 2012 bond restructuring that included the injection of temporary working capital, as well as a 60% rate increase implemented in 2013. PRASA also has not had to touch a $180 million operating reserve, established by way of a separate line with the GDB. However, we view PRASA's ability to extend its lines of credit – which expire May 29, 2015, and are essentially used as a bond anticipation note (BAN) – or to convert them to long-term debt as now being more difficult. PRASA has little discretion in its capital improvement program given the large share of regulatory ordered, date-certain unfunded mandates as a percentage of total projects, although we believe it is possible PRASA may be granted an extension in the timelines of the projects..

The extremely large rate increase implemented in 2013 did establish financial independence from the commonwealth by making up for the loss of a debt subsidy, and created financial capacity for PRASA to more aggressively fund its myriad of projects. PRASA management has also taken a number of other actions to improve operations and control costs that we view as credit positive, and the forecast includes conservative assumptions, making it more realistic that cash from operations could be sufficient to cover all revenue requirements regardless of lien priority. The credit lines' aggregate draws of $155 million provided PRASA with interim working capital, but our opinion of this financing option has always been predicated on refunding that capacity with an ability to economically issue long-term debt. While market access could still be a possibility, and other options such as a new syndicated bank line of credit cannot be ruled out, it is possible that any such arrangement could come at a higher cost that it ekes away at PRASA's newfound positive net revenues.

Unlike Puerto Rico Electric Power Authority (PREPA), PRASA's current cash reserves are adequate, and rate-raising flexibility is a less sensitive topic for PRASA management. While it is therefore possible for the SACP to actually improve over time, the uppermost bound of the rating at this point would not be higher than the GO debt rating based on our criteria, absent a complete de-linkage from the commonwealth. In our view, an improvement to the SACP over our two-year outlook horizon would be based on a number of factors, including:

- Cash from operations consistently being at least sufficient to fund all revenue requirements, regardless of where they fall in the flow of funds and irrespective of whether or not they are ultimately back-stopped by the commonwealth. A restructuring at PREPA, however, could come with PREPA revoking a favorable electric rate to PRASA, which would increase PRASA's operating expenses. Electricity represents over 20% of PRASA's operating expenses;
- Continued progress toward addressing the capital improvement program, both for projects established in the consent decrees - which alone could exceed $3.4 billion by the end of the next decade - as well as those key to system integrity; and
- Maintaining the recent momentum of apolitical decision-making. Regardless of the frequency or magnitude of rate increases, the current management team has shown a willingness to make decisions that benefit the system despite the difficult political environment in which those decisions have occurred.

On June 30, 2014, we revised our opinion of PRASA's role and link to the commonwealth's general government as a GRE. In our view, there is a moderately high likelihood -- compared with a high likelihood previously -- of extraordinary government support in a situation of extraordinary distress. The reasons for this revision include:

- The general government's own well-documented budgetary challenges, making it less likely it would even have the financial capacity to intervene (save, perhaps, for the commonwealth-backed debt of PRASA, given the commonwealth's explicit statements to support GO debt) if PRASA were to be in a situation of extraordinary distress.
- The commonwealth's recent signal to PRASA of its intent to cease appropriations to support commonwealth-backed debt. While this austerity measure is actually a long-term credit positive for PRASA by forcing it to become self-sufficient - and did spur a 60% utility rate adjustment - it indicates the commonwealth may be less inclined to throw PRASA a lifeline. The government's position is clear in light of the Puerto Rico Public Corporation Debt Enforcement and Recovery Act. Although the courts later struck down the law, and the U.S. Congress has not yet created modified the bankruptcy code to allow Puerto Rico or its related entities to file for protection, we understand PRASA had no intention of restructuring its debt.

Related Criteria And Research

Related Criteria

- USPF Criteria: Standard & Poor's Revises Criteria For Rating Water, Sewer, And Drainage Utility Revenue Bonds, Sept. 15, 2008
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings, Oct. 1, 2012

Ratings Detail (As Of April 27, 2015)		
Puerto Rico Aqueduct & Swr Auth		
Unenhanced Rating	CCC+(SPUR)/Watch Neg	Downgraded, On CreditWatch Negative
Long Term Rating	CCC+/Watch Neg	Downgraded, On CreditWatch Negative
Puerto Rico Aqueduct & Swr Auth GO Equiv		
Long Term Rating	CCC+/Watch Neg	Downgraded, On CreditWatch Negative
Many issues are enhanced by bond insurance.		

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