STANDARD & POOR'S
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Summary:

# Puerto Rico Electric Power Authority; Retail Electric

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## Summary:

# Puerto Rico Electric Power Authority; Retail Electric

| Credit Profile | | |
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| **Puerto Rico Elec Pwr Auth pwr** | | |
| *Unenhanced Rating* | BBB(SPUR)/Stable | Downgraded |
| *Long Term Rating* | BBB/Stable | Downgraded |

## Rationale

Standard & Poor's Ratings Services has lowered its rating on Puerto Rico Electric Power Authority's (PREPA) power revenue bonds to 'BBB' from 'BBB+'. The outlook is stable.

As of fiscal year-end 2012 (June 30), PREPA had $8.2 billion of power revenue bonds outstanding. A pledge of the electric system revenues secures the bonds.

The lower rating better reflects our opinion of both the continuing weakness of the island's economy and the utility's own challenges, including:

- An isolated electric system, which requires the utility to maintain a capacity margin of at least 50%;
- High rates due to dependence on fuel oil for 61% of energy production;
- Large capital requirements to convert generating plants to gas, bury distribution wires, and upgrade and extend the transmission system;
- Weakened debt service coverage in 2012 and 2013; and
- Limited liquidity, exacerbated by delinquency of public corporation receivables.

The rating also takes into account steps PREPA's management is taking to lower the cost of electricity by converting generating plants to gas, reducing operating costs and energy theft, increasing collection of government receivables, and strengthening transmission efficiency. Management also intends to increase the percentage of power provided by renewable sources.

In our opinion, PREPA's credit profile is strongly linked to the economy it serves, although the utility has maintained fairly stable financial metrics through past economic cycles. The authority has also maintained a stable base rate of less than 6.0 cents per kilowatt-hour (kWh). In the next five years, management expects the base rate to be about that amount despite significant investment in the system because of other cost reductions.

During the next five years, PREPA will invest about $1.55 billion in the system, having already invested $2.30 billion in the past five. The investment includes both conversion of most of the generating capacity to natural gas from oil and the upgrade and strengthening of the transmission and distribution system. Dependence on oil raised rates for residential customers, which account for 35% of total revenue, to 24.8 cents per kWh in fiscal 2012, from 17.6 cents in fiscal 2007. In April 2012, the authority began burning natural gas in unit 5 of the Costa Sur plant on the south coast. By April 2013, the unit was fully converted to natural gas. Later in the summer, Costa Sur units 5 and 6 (820 megawatts [MW]) will burn natural gas. Management will invest an estimated $172 million to outfit an additional 1,932 MW of oil-burning units to burn gas by 2017. Once the conversion is complete in 2017, natural gas will account for 72% of electricity generated, coal for 16% and oil for only 2% -- down from 99% in 2000. Also, PREPA will comply with the Mercury and Air Toxics Standards issued by the EPA. It presented the conversion plan to the EPA in April 2013 and requested an extension of the 2015 compliance deadline.

Supplementing PREPA-owned generation, two purchased power contracts, one for gas-fired power from a plant on the southeast coast and the other from a coal-fired plant on the southwest coast, provide about 31% of PREPA's power. The authority has also signed and is taking bids for additional power from renewable resources (wind, solar, waste-to-energy, landfill gas) and expects power from those sources to account for 10% of energy by 2016. Compliance with the government's requirement that renewable energy sources provide 12% of power by 2015 and 15% by 2020 will depend on the ability of the system to absorb intermittent power.

Natural gas for the Costa Sur units comes from the expanded liquid natural gas (LNG) terminal at the gas-fired Ecoelectrica generating station, from which PREPA purchases power. Natural gas for the Aguirre units (900 MW) on the southwest coast will be supplied from a floating LNG platform. PREPA submitted a formal application to the Federal Energy Regulatory Commission in April 2013 and expects permits to be approved within a year. The authority expects to complete conversion of the Aguirre units by 2015. Construction of the LNG platform will cost an estimated $253 million, and will be financed privately. In the north, 4 units at the San Juan generating station (600 MW) and 2 units at the Palo Seco plant (432 MW) will be converted by 2017. PREPA is evaluating recommendations from 25 companies active in the sector for LNG delivery methods. Management expects to have a natural gas delivery system in place for the north coast generating plants by the second quarter of 2017. That structure replaces the north-south gas pipeline plan that was cancelled in October 2012.

In addition, PREPA intends to increase system reliability by investing about $800 million in transmission and distribution facilities in fiscal years 2014-2018. A good part of the distribution system around San Juan is now underground, and this additional investment will increase the underground system, reducing vulnerability to hurricanes. The investment will also add a new 230 kilovolt line from the Costa Sur plant in the south to the north on the western end of the island, and from the Aguirre plant to a point in the middle of the eastern end of the island, providing alternate routes for power.

Another target of cost reduction is the timely recovery of payment from government departments and agencies. Legislation passed in 2010 requires the government's Office of Management and Budget to estimate the future cost of electricity for agencies whose operation depends on the government's general fund and to coordinate with the Treasury Department to make payments directly to PREPA at the beginning of each month. Revenue from state and federal agencies and public corporations in fiscal 2012 accounted for about 11% of revenue and about 33% of accounts receivable.

Completion of a fiber optic telecommunications network has allowed PREPA to modernize its internal communications systems, which provide operations, load management, system protection and security, and other controls. The upgraded remote metering system allows PREPA to implement load control and helps eliminate theft, which accounted for about 6% of electricity produced in fiscal 2012 -- down from 8% in previous years. Management has identified and eliminated some electricity theft, and is recovering past-due amounts. Legislation passed in late 2011 assigns primary responsibility for reducing theft to the Special Investigations Bureau of the Department of Justice, changes the criminal charge for tampering with a meter to a felony, and authorizes PREPA to impose administrative penalties or sanctions on anyone involved with tampering with the electric utility system. Using its own resources, management is also identifying potential billing irregularities for major customers. It expects to increase revenue about $30 million as a result of these efforts. Management has also reduced its own operating expenses. It expects staff reductions, changes to retiree health care benefits, and other initiatives such as reduced overtime to result in about $50 million of additional annual savings. In addition, management expects to reduce payments to municipalities by about $30 million by enforcing a law passed in 2011 that eliminates from the calculation of contributions in lieu of taxes the electricity consumption associated with those properties that the municipalities currently run as for-profit operations.

Management expects these cost reductions will help it maintain at least 1.2x debt service coverage, which is the minimum required by the trust indenture, despite the additional debt issued to fund capital investment. Management also expects to issue $1.4 billion of debt in the next five years, and projects debt service to rise to $626 million in 2017 from $485 million in fiscal 2012. Maximum annual debt service on the revenue bonds is projected to be about $680 million. Our calculation of fixed charge coverage, which includes payment in lieu of taxes as an operating cost and the capacity payment included in purchased power (about one-third of total cost) as a debt equivalent, indicates probable cash coverage of all costs of at least 1.0x.

This level does not allow the authority to set aside significant reserves to help fund the capital spending program. For these reasons, PREPA's liquidity has always been weak, in our view. Cash and investments normally on hand equal just a few days of cash operating costs. However, the utility's ability to pass fuel costs directly through to customers monthly helps limit operating liquidity requirements. However, from December 2011 through October 2012, the former governor requested PREPA to under-recover fuel costs, which reduced net income by $79.4 million in fiscal 2012 and by about $53.0 million in fiscal 2013. Proceeds of the 2012 bond issue covered the deficit. The termination of that program allowed PREPA to once again fully recover the cost of fuel in rates and achieve the level of DSC required to issue bonds to fund the remainder of the capital investment program.

To provide liquidity, the authority has credit lines that total $750 million. A $250 million line with Citibank N.A. expires in January 2014, and a $500 million line arranged by The Bank of Nova Scotia, which matures June 2013, is in renewal negotiations. PREPA's lines of credit are usually fully outstanding, and used primarily for oil purchases. As the power is sold, revenue repays the debt and then the lines are used to purchase additional oil. We expect the lower cost of gas to provide some additional availability on these lines once the generating units are converted to gas-fired capability.

Puerto Rico's Government Development Bank (GDB) provides a $100 million line of credit for collateral requirements associated with floating rate note related swaps that have a notional value of $412 million ($253 million of which Assured Guaranty Municipal Corp. insures) and a basis swap that has a notional value of $1 billion. At the current ratings, the collateral threshold on both the floating rate swaps and the basis swap is zero and $31 million of collateral will be posted using a draw on the GDB line. Lowering the rating to speculative-grade status would permit the basis swap counterparty to terminate the swap. The basis swap has generated $45.2 million for the authority since its inception.

## Outlook

The stable outlook reflects our opinion of PREPA's ability to maintain adequate credit metrics while continuing to fund its capital investment program with substantial amounts of debt. The authority's commitment to reduce its own operating costs and the Puerto Rico government's commitment to honor its financial obligations to PREPA support this. Progress in both of these endeavors will be important factors in maintaining the rating during our two-year outlook horizon. Moreover, the authority's goal of reducing its dependence on oil and improving the electricity system's overall reliability and efficiency will be an important component of Puerto Rico's economic growth, and successful execution of the planned conversion and upgrade will also be important factors in maintaining the rating. We do not expect to raise the rating during the outlook period.

## Related Criteria And Research

USPF Criteria: Electric Utility Ratings, June 15, 2007

| Ratings Detail (As Of June 21, 2013) | | |
|---|---|---|
| Puerto Rico Elec Pwr Auth pwr rev bnds ser 2012 A due 07/01/2041 | | |
| *Long Term Rating* | BBB/Stable | Downgraded |
| **Puerto Rico Elec Pwr Auth pwr** | | |
| *Unenhanced Rating* | BBB(SPUR)/Stable | Downgraded |
| Many issues are enhanced by bond insurance. | | |

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