STANDARD & POOR'S RATINGS SERVICES

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Summary:

Puerto Rico Aqueduct & Sewer Authority; Water/Sewer

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Summary:

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Credit Profile		
Puerto Rico Aqueduct & Swr Auth (Senior Lien) ser B		
Long Term Rating	BBB-/Negative	Downgraded
Puerto Rico Aqueduct & Swr Auth (Senior Lien) (ASSURED GTY)		
Unenhanced Rating	BB+(SPUR)/Stable	Downgraded

Rationale

Standard & Poor's Ratings Services lowered by one notch, to 'BB+', its rating on Puerto Rico Aqueduct & Sewer Authority's (PRASA) senior-lien revenue bonds. We also lowered by one notch, to 'BBB-' our rating on the authority's bonds guaranteed by the full faith and credit pledge of the commonwealth of Puerto Rico.

The downgrades reflect Standard & Poor's lowering of its rating on the commonwealth's general obligation (GO) debt on March 13, 2013 (see "Commonwealth of Puerto Rico GO Rating Lowered To 'BBB-' From 'BBB' On Fiscal 2013 Budget Gap"). We lowered that rating by one notch, based primarily on a larger-than-expected budgetary gap and the potential difficulty for the general government to achieve structural fiscal stability in the near term.

PRASA's stand-alone credit profile (SACP) is unchanged at 'bb+,' reflecting our view of the authority's general creditworthiness solely on its own credit characteristics. The ratings on PRASA's senior-lien bonds had previously received a one-notch uplift from the authority's SACP of 'bb+', based on the application of our criteria for government-related entities (GREs). We consider PRASA a GRE of the central government, given the history of support by the Government Development Bank of Puerto Rico (BBB-/Negative/A-3) in guaranteeing or, in some cases, at least supporting certain financing obligations of PRASA. In our view, there is a high likelihood of extraordinary government support given what we deem an important role and very strong link to the central government and PRASA's function as the drinking water and sanitary sewer provider of the commonwealth.

Factors that constrain the rating include the authority's:

- Relatively fragmented water and wastewater system, which, coupled with significant deferred capital needs, has resulted in high operational deficiencies;
- Historically poor financial performance, stemming from unwillingness to raise rates, deficient billing and collection systems, and low liquidity, all of which historically constrained the utility from generating consistent operating surpluses, though PRASA has made significant strides over the past two years to restore the system's financial operations;
- The estimated $1.5 billion in identified capital improvements over the next five years, stemming primarily from compliance-related mandatory projects, as well as other critical system improvements. As much as $1.2 billion of the identified projects may be funded with external financing sources.

Factors that moderate these credit limitations include:

- Continued liquidity support from the commonwealth of Puerto Rico through lines of credit provided by the Government Development Bank for Puerto Rico (GDB); these revolving credit lines totaled approximately $110 million at the end of fiscal 2012; and
- A supportive regulatory environment in which PRASA does not require legislative action to implement rate adjustments, and has full authority to cut off service to delinquent accounts.

The senior-lien bonds are secured by a first lien on the gross revenues of the authority. The master trust agreement governing the issuance of the senior-lien bonds was amended as of March 1, 2012, to provide for a gross lien on the authority's operating revenues to secure the payments of debt service on senior indebtedness and bonds. Although payment of debt service with a gross revenue pledge represents a prior claim on revenues from an ordinal perspective, our ratings do not reflect this payment order. Revenues diverted for debt service could effectively shut down the entity if operations and maintenance went unpaid for more than a short time. In our view, such an event could risk operations, including revenue collections, and the ability to continue to produce revenues for debt service.

As part of this issuance, the authority has entered into an amended fiscal oversight and support agreement with GDB and the commonwealth of Puerto Rico. This agreement outlines, among other covenants, the requirement for the authority to maintain a budgetary reserve fund equivalent to the anticipated operating support the authority would require from the commonwealth of Puerto Rico. For fiscal years 2012 and 2013, this budgetary reserve requirement (estimated at $240 million) will be funded with proceeds from the series 2012A bonds. Beyond fiscal 2013, the authority's need for continued support from the commonwealth will be determined on an annual basis, and will consider the effects of potential rate adjustments on the authority's revenues. Other legal provisions include a covenant to maintain rates sufficient to cover annual debt service on the senior bonds by 2.5x, senior subordinate debt by 2.0x, and on all of PRASA's obligations (including commonwealth-supported debt) by 1.0x. In addition, the indenture establishes an additional bonds test that requires debt service coverage (DSC) of 2.5x annual debt service on senior-lien debt, 2.0x annual DSC on senior subordinate-lien bonds, and 1.5x annual DSC on subordinate-lien bonds.

PRASA is the sole water and sewer service provider in Puerto Rico, serving approximately 4 million residents and 5 million tourists that annually visit the island. The system consists of a relatively fragmented series of water and wastewater facilities divided into five regional service areas. The primarily residential customer base, currently composed of 1.29 million combined water and sewer million water accounts, has exhibited a relatively steady 0.6% annual customer growth. Due to its fragmented nature and the lack of adequate capital investment, the authority has a very high level of unaccounted-for water (approximately 64% of total water produced) as well as multiple regulatory violations, which management is currently addressing by improving its collection efforts and aggressively pursuing its meter-replacement program.

Historically, PRASA has required operating and capital subsidies from the commonwealth's general fund. The authority's poor financial condition stemmed primarily from an unwillingness to raise rates for nearly 20 years, which depleted the system's liquidity and limited its ability to maintain and improve its facilities. While PRASA has the authority to increase rates subject to a public hearing, it has not done so given economic conditions on the island. Based on the oversight agreement signed by the authority, GDB, and commonwealth, the funding of the budget reserve with proceeds from the issuance of the series 2012A bonds replaced the operating support from the commonwealth in fiscal year 2012 and was budgeted to do the same in fiscal 2013. On Feb. 21, 2013, PRASA's board of directors approved a new rate structure with rate increases that will be effective starting on July 1, 2013. In the past four years, management has chosen to boost revenue by improving the operational efficiency and collection systems instead of raising rates. In addition, the current administration has focused on expenditure-reduction initiatives, including the elimination of 928 positions since 2008, which has generated an estimated $37 million in annual savings. The combined average residential monthly bill of approximately $35.57 (for about 4,491 gallons or 17 cubic meters of use) remains affordable, which should provide the authority with additional flexibility to implement the authorized rate adjustments.

Fiscal 2011 net available revenues (excluding commonwealth appropriations) provided 1.6x coverage of annual senior debt service, which we consider good. The authority's financial projections for the next five years specify annual gross revenue DSC of at least 2.65x on the senior-lien bonds, and 1.02x annual DSC on all of the authority's debt, including bonds guaranteed by the commonwealth of Puerto Rico. Calculated on a net revenue basis, the authority's projections result in annual DSC of at least 1.3x on its senior-lien debt and approximately 1.02x on all of the authority's obligations. These projections, however, are based on the assumption that the authority will generate additional revenues of $335 million in fiscal 2014, $390 million in fiscal 2015, and $425 million in fiscal 2016 either through rate adjustments or continued replenishment of the budgetary reserve fund with contributions from the commonwealth of Puerto Rico. System liquidity, not including the operating reserve required by the 2008 ordinance, was adequate at 31 days of operations at the end of fiscal 2012. However, the system's liquidity has been consistently boosted by credit support from GDB and contributions from the commonwealth.

The downgrade affects approximately $3.45 billion of revenue bonds and $159 million of guaranteed debt, net of current maturities.

Outlook

The stable outlook on the senior-lien bonds reflects Standard & Poor's GRE criteria given the current correlation between PRASA and the general government, and that PRASA's rating on those bonds would be unaffected by an additional one-notch downgrade to the general government despite our current negative outlook. While the 2012 amendments to the revenue bond legal provisions could provide PRASA the necessary financial capacity to add significant amounts of debt to fund critical improvements, mainly to address the ongoing regulatory mandates and unaccounted-for water problems, an improvement to the stand-alone credit profile would be predicated mainly on consistently providing sufficient net revenues to address all of PRASA's financing obligations and minimize, if not eliminate, outside support.

The negative outlook on the guaranteed bonds reflects the rating outlook on Puerto Rico's GO debt, indicating our view that we could lower the rating within our two-year outlook horizon.

Related Criteria And Research

- 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
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Ratings Detail (As Of March 26, 2013)		
Puerto Rico Aqueduct & Swr Auth rev bnds (sr lien)		
Long Term Rating	BB+/Stable	Downgraded
Puerto Rico Aqueduct & Swr Auth (Senior Lien)		
Long Term Rating	BB+/Stable	Downgraded
Many issues are enhanced by bond insurance.		

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