MOODY'S
INVESTORS SERVICE

Rating Update: Moody's downgrades PREPA to Baa3 from Baa2; Outlook is Negative

Global Credit Research - 19 Jun 2013

Approximately $8.2 billion of outstanding rated debt affected

PUERTO RICO ELECTRIC POWER AUTHORITY
Electric Distribution and Generation
PR

Opinion

NEW YORK, June 19, 2013 --Moody's Investors Service downgraded the ratings of $8.2 billion of the Puerto Rico Electric Power Authority's (PREPA, Authority) Power Revenue Bonds to Baa3 from Baa2. This rating action concludes the rating review that Moody's started in December of 2012. The outlook is negative.

RATINGS RATIONALE

The downgrade reflects the current rating and outlook for the Commonwealth of Puerto Rico's general obligation bonds (Baa3; negative) as well as the rating of entities that are based on or capped at the GO rating, including the Government Development Bank of Puerto Rico (GDB) (Baa3; negative), which is an important source of liquidity for PREPA. Moody's believes that the rating of PREPA is closely tied to the rating of the Commonwealth.

The rating action also reflects continued weakness in the economy of Puerto Rico, including the lack of economic growth drivers and the negative demographic trends. In addition, the rating action reflects uncertainty about the execution of a long-term fuel diversification and cost reduction plan that is designed to put the Authority on a sounder financial footing. PREPA also has a sizable Capital Improvement Program (CIP), which contemplates the issuance of additional debt and uncertainty remains in terms of PREPA's ability to execute a complex construction program.

Furthermore, the downgrade reflects credit metrics that have remained weak despite some easing in 2012 as well as weak liquidity. Days cash on hand in 2012 was only slightly higher at 17 days, and PREPAs committed bank lines, which are largely drawn, will need to be renewed at the end of this year.

Outlook

The negative outlook reflects the negative outlook for the Commonwealth and the GDB as well as the liquidity pressures at PREPA that will continue. The negative outlook also considers the uncertainty about the execution of the long-term strategic plan to convert high cost oil-based power generation to lower cost natural gas, which will enable PREPA to control rates and help spur economic growth on the island.

What could change the rating - Up

In light of the negative outlook, the rating is not expected to move upward over the near-to-medium term. The outlook could stabilize if the Commonwealth of Puerto Rico stabilizes and/or PREPA shows progress on the execution of its fuel diversification and cost reduction strategy.

What could change the rating - Down

The rating could be pressured downward if receivables from government entities remain high and unrestricted cash balances decline, debt service coverage ratios fall significantly below projected levels, or the ratings of the Commonwealth and GDB decline. In addition, the rating could move down if PREPA fails to renew its committed bank facilities, which are set to expire this year.

Strengths

*PREPA continues to operate as the monopoly provider of an essential service, historically independent from the

Commonwealth's finances and with liquidity support from the Government Development Bank of Puerto Rico.

*The board has full rate-setting authority. PREPA can automatically pass through to customers higher fuel and energy costs on a monthly basis, and has demonstrated a willingness to do so.

*Sound bond covenants including a requirement that maximum annual debt service is covered 1.20x.

*PREPA has also continued to better position the utility with its power resource diversity plan.

* Diverse customer base with no dependence on small number of large customers.

Challenges

*Deteriorating economic and demographic situation in the Commonwealth creates negative trends in power sales.

*Significant dominance of fuel oil as a percentage of total generation fuel mix has subjected PREPA to price volatility.

*Accounts receivable problem has historically been a pressure on cash flow, though legislative efforts should reduce impact in future periods .

*Debt leverage is above median for major public power utilities that own generation.

*Frequent changes to executive management continue to provide some instability.

*Natural gas conversion plan subject to environmental permitting and construction risk.

*Internal financial liquidity is weak.

PLEDGE: Net revenues of the power system. The bonds are not a debt obligation of the Commonwealth of Puerto Rico or any of its municipalities.

FLOW OF FUNDS: All power system revenues to the 1974 General Fund to pay current operating expenses and to meet the reserve for current expenses; monthly deposits into Bond Service Account and the 1974 Bond Reserve Account, the Reserve Maintenance Fund, Subordinate Obligations Fund, Self-Insurance Fund, Capital Improvement Fund, remaining funds may be used for all lawful purposes of PREPA.

RATE COVENANT: Rates and charges must be set so that the Revenues of System will be sufficient to pay current expenses and provide an amount at least equal to 120% of aggregate debt service.

DEBT SERVICE RESERVE ACCOUNT: 1974 Agreement requires 1974 Reserve Account to be equal to the interest payable on all outstanding Power Revenue bonds within the next 12 months.

ADDITIONAL BONDS TEST: Under the 1974 agreement, additional bonds can be issued if net revenues for 12 consecutive months out of the past 18 months, adjusted to reflect rates in effect on the date of issuance of bonds, are 120% of maximum annual debt service prior to the issuance of the additional bonds and the average net revenues for the five fiscal years after bond issuance adjusted to reflect any rate schedule covenanted are 120% of maximum debt service after the issuance of the additional bonds.

CONTRIBUTIONS IN LIEU OF TAXES (CILTs) AND GOVERNMENTAL SUBSIDIES: PREPA is required to make a contribution in lieu of taxes of the greater of: 20% of adjusted net revenues (net revenues less the cost of the Commonwealth rate subsidies) or the cost of actual electric power consumption of the municipalities or the prior 5-year moving average of the contributions in lieu of taxes paid to the municipalities collectively. If PREPA does not have sufficient funds in any year to make the payment, then the difference will be accrued and carried forward for a maximum of three years. The contribution in lieu of taxes can be used to offset the accounts receivable balance owed by the municipalities to PREPA. In December 2011, the Governor signed a new law that limits CILT payments to municipalities when the municipality is using a property to generate revenues for the municipality (i.e. ticket sales, parking, etc.).

INTEREST RATE DERIVATIVES/VARIABLE RATE DEBT: PREPA has no un-hedged, long-term variable rate debt. PREPA has two lines of credit for fuel and working capital, which are

indexed to LIBOR.

Effective July 1, 2008, PREPA entered into a basis swap on the notional amount of $1.375 billion with an amortization schedule matching the 2027 to 2037 maturities of previously issued revenue bonds. The current notional amount is $1.0 billion. The original swap counterparty was Goldman Sachs Capital Markets, which makes quarterly payments to PREPA, which began October 1, 2008 equal to 62% of LIBOR plus 29 basis points and a fixed rate payment of 0.4669% per annum. PREPA makes quarterly payments to Goldman based on the SIFMA-Municipal Swap Index, exposing the utility to basis and tax risk. The swap currently provides positive net payments to PREPA. Moody's believes the swap is speculative and relies on the relative performance between SIFMA and LIBOR rates.

When the swap basis swap was reduced, the counterparties were split up among a group of banks. The notional amount of $1.0 billion is now split among Goldman ($500 million), Deutsche Bank ($200 million) and RBC ($300 million).

Despite the positive current cash flow for PREPA, the mark-to-market exposure, which is calculated on forward indices, can be positive or negative. The applicable threshold for collateral posting is negative $30 million MTM at the Baa2 ratings level and $-0- at Baa3. Based upon the current mark-to-market, the aggregate collateral requirement for all the swaps as a result of the downgrade to Baa3 level would be about $31.5 million (as of 6/14/13). To make a collateral requirements posting, PREPA accesses its $100 million credit line with the Government Development Bank of Puerto Rico which currently expires in December of 2013, which has been regularly renewed by GDB. There is currently adequate capacity under the GDB line to cover the posting of the collateral. PREPA is in regular contact with the GDB, and it is PREPA's expectation that the line will continue to be extended. Under the basis swap agreement, an event of default and subsequent termination occurs if PREPA's rating falls below Ba1, which introduces an additional risk to PREPA should its credit quality further deteriorate.

An additional termination event occurs should PREPA's debt service coverage fall below 1.20 times. PREPA is projected to remain in 1.35 times to 1.45 times range.

Recent Developments

The economy of Puerto Rico continues to be under stress which resulted in Moody's downgrading the rating of the Commonwealth by two notches in December of 2012 to Baa3 from Baa1. The island has been experiencing population loss mainly due to emigration caused by lack of economic growth and opportunities. The unemployment rate of about 15% is significantly higher than the average rate for the rest of the U.S. The economic weakness manifests itself in a negative trend of energy sales on the island. This trend, started in 2007, resulted in the aggregate drop of 9.57% in energy sales between 2007 and 2012. Energy sales were down in fiscal year (FY) 2012 by -2.1% and are projected to drop by another -0.8% in FY2013. After FY2012, the forecast calls for annual growth of 1.4% through 2017; however, given the current economic and demographic trends, there is a degree of uncertainty whether this forecasted growth will materialize.

Despite a drop in the number of megawatt hours sold, revenue were up 14% in FY2012 due to a 23% increase in cost of fuel which the Authority passed through to consumers through the fuel charge.

DETAILED RATINGS DISCUSSION

FUEL COSTS PRESSURING ELECTRICITY SALES AND LIQUIDITY

While PREPA continues to work on its resource diversification plan, the Authority remains heavily reliant on fuel oil (61% in FY2012) as an energy source. As oil prices have increased steadily, PREPA has chosen to pursue rate stabilization as a public policy to lessen the economic impact of high energy costs. The Rate Stabilization program provided a temporary reduction in the fuel adjustment charge to residential clients in good standing who did not otherwise benefit from any subsidy. Cost to the authority in 2012 was $79.4 million funded. Approximately $53 million of the fund was utilized in 2013. This exhausted the fund, and PREPA has said that it will no longer provide this subsidy. This removal of the subsidy is effectively a rate increase, which Moody's view positively, and should result in an increase in revenues going forward.

SHORT TERMS OF LIQUIDITY LINES AND HEAVY DRAWING ON THE LINES LIMITS AVAILABLE LIQUIDITY AND INTRODUCES UNCERTAINTY

PREPA's low internal liquidity has historically been supported by lines of credit provided by private banks and the GDB. Two of its major lines, with Scotiabank (Aa2; stable) and Citibank (A3; stable), are being renewed on an annual basis thus introducing uncertainty regarding future availability and cost of funds. The lines are for $500 million and $250 million, respectively, and are almost fully drawn. Moody's has been told that PREPA has extended the Citibank facility and is in active discussions with Scotia about extending its facility.

The authority benefits from a close relationship with the GDB. GDB provides a $100 million line of credit with PREPA. It backstops the collateral posting requirements associated with the basis swap and is still active. It is set to expire in December 2013. It is Moody's expectation that the GDB will continue to provide support to PREPA through bank lines as needed.

Internal liquidity includes unrestricted cash, construction fund balances, sinking fund, debt service reserve account, self insurance fund and reserve maintenance fund, which together totaled $940 million as of end of Q1 2013.

DEBT SERVICE COVERAGE PROJECTED TO REMAIN BELOW HISTORIC AVERAGES AND EARLIER PROJECTIONS

The Debt Service Coverage Ratio in FY 2012 was unusually high owning to the repayment schedule of the Series 2012 A and B financing in which capitalized interest and low early-year principal and interest payments resulted in the debt service being significantly below the obligation of FY2013.

On the bond ordinance basis, DSCR was 1.97 times in FY2012 and is forecasted to be 1.36 times in FY2013. Moody's calculated debt service coverage on net revenue basis (after adjusting for CILTs) for FY 2012 at 1.39 times, however, as noted earlier, this jump from 0.95 times in FY2011 is due to lower debt service because of refinancing activities in FY2012.

As a result of the numerous operational and legal changes taking place at PREPA, projections of operating results are heavily based on assumptions. Coverage is projected to stabilize in the 1.35-1.45x range on a bond ordinance basis. In the short term, Moody's notes that effective remediation measures to improve collections of accounts receivable and control expenses may help stabilize the coverage. Over the long-term, PREPA will benefit from conversion to natural gas. There is, however, uncertainty about the execution of this fuel diversification plan.

CAPITAL IMPROVEMENT PROGRAM

The current Capital Improvement Program includes the conversion of PREPA's owned generating plants to natural gas from oil fuel which requires an estimated $172 million of investment. The fuel diversification plan contemplates that by 2017 the fuel mix will change. The share of oil will shrink from the current 61% to only 2%, largely replaced by natural gas whose share will grow from the current 24% to 72% by 2017. Additionally, the share of renewable sources is projected to grow from only 1% in 2012 to 12% by 2017. Those changes will allow PREPA to comply with EPA's Mercury and Air Toxic Standards (MATS) Rule and to lower the cost of fuel. The conversion to gas fuel is estimated to produce about 15% of savings on electric bills in 2013-2014 and even higher savings going forward.

PREPA has made some progress on its fuel diversification plan. Conversion of one of the units at the Costa Sur plant on the south side of the island began in 2012, and full conversion is to be completed this summer. PREPA is already seeing some benefit for the conversion to lower cost gas because the fuel adjustment in its rates has come down for the 10 months ended April 2013.

The Capital Improvement Plan also calls for the construction of a floating liquefied natural gas (LNG) terminal near the Aguirre plant in the south of the island projected to be completed by 2015. The terminal will most probably be constructed and operated by a public-private partnership and is estimated to cost $253 million. The Authority wants to have LNG infrastructure for most of Puerto Rico in place and ready for commercial service by 2017. The Aguirre plant conversion is scheduled to be operation in 2015 and the remaining plants for 2017.

In the face of strong local opposition, projected cost escalations and regulatory uncertainty, during fiscal year 2012 the Authority stopped work on the proposed 92 mile pipeline from the south coast to three plants sites in the north. Various ways to transport the fuel from the south to the plants located in the north of the island are currently under consideration. These include the possibility of barging the natural gas from the LNG terminal in the south to the plants in the north.

The Capital Improvement Program through FY2017 includes budgets to complete the fuel conversion work at all large steam-electric units, a three unit combustion turbine plant and a two unit combined cycle plant. After the conversion of Costa Sur units, the Authority's priority is the gas conversion of Aguirre Units 1 and 2, PREPA's largest (each 450 MW) steam -electric units on the south coast of the island. In FY 2012, the Authority spent $351 million on CIP, 7.5% over budget. The five year $ $1.550 billion CIP calls for an average annual investment of $310 M. This is expected to be financed with a combination of internal sources and additional borrowings (used the CIP amounts from last week's presentation to Moody's).

METHODOLOGY SCORECARD FACTORS:

Factor 1 - Cost Recovery Framework within Service Territory: Baa

Factor 2 - Willingness to Recover Costs with Sound Financial Metrics: Baa

Factor 3 - Management of Generation Risks: Ba

Factor 4 - Competitiveness: Ba

Factor 5 - Financial Strength - Debt Service Coverage (3 year average): 1.25x (Baa)

Factor 5 - Financial Strength - Days liquidity on hand (3 year average): 10.7 days (Ba)

Factor 5 - Financial Strength - Debt Ratio (3 year average): 102.9% (Ba)

Grid Indicated Rating: Baa2

Notching: -1

Scorecard Indicated Rating: Baa3

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RATING METHODOLOGY

The principal methodology used in this rating was U.S. Public Power Electric Utilities with Generation Ownership Exposure published in November 2011. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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