Global Credit Research
Rating Update
24 AUG 2006

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Rating Update: Puerto Rico Electric Power Authority

MOODY'S CONFIRMS PUERTO RICO ELECTRIC POWER AUTHORITY'S A3 RATING

Negative outlook assigned to $5.2 billion of outstanding power revenue bonds

Electric Utilities
PR
Opinion
NEW YORK, Aug 24, 2006 -- Moody's Investors Service has confirmed the Puerto Rico Electric Power Authority's A3 power revenue bond rating, and removed the rating from the agency's watch-list. At the same time, a negative rating outlook has been assigned to the utility's approximately $5.2 billion of outstanding long-term revenue bonds.
The rating confirmation reflects the utility's continued good overall business performance in the fiscal year ended June 30, 2006 - despite rising fuel costs and a slowdown in electric payments by the Commonwealth of Puerto Rico government - as well as the recent confirmation of the Commonwealth's own bond rating at Baa3 (see our report on the Commonwealth dated July 2, 2006). On the other hand, the utility's negative outlook reflects a continued negative outlook assigned to the Commonwealth due to its ongoing budgetary and fiscal strains, and a slowing of the Puerto Rico economy that is expected to persist over the coming year.
The utility's A3 rating reflects the following fundamental credit strengths and challenges:
Credit Strengths
* Sole provider of electric power in Puerto Rico, with no appreciable deregulation or competition-related risks.
* Diversified customer base including residential (35% of revenue), commercial (30%), industrial (20%) and government (15%).
* Increased generating capacity, with improved reliability (85% average availability) and diversity by fuel source (65% oil, 16% LNG, 16% coal).
* Long track record of demand growth in face of volatile fuel costs, which are passed on to customers through monthly adjustments.
* Long track record of stable financial performance and moderate coverage of increasing annual debt service.
* Positive recovery from very severe 1998 hurricane demonstrates adequacy of self-

insurance and FEMA support.
* Good structural protections for bondholders, including 1.2x rate covenant (supported by the utility's legal ability to raise rates without legislative or regulatory approval), monthly sinking fund deposits for debt service, and a dedicated debt service reserve fund.

Credit Challenges

* Very narrow balance sheet liquidity, due to narrow cash operating margins and high government-sector receivable balances.
* High financial leverage, including bond requirements and capacity payments to private cogeneration plant operators.
* Close to 15% of reported revenue comes from inter-related government sector clients who have experienced significant credit stress - with Commonwealth downgraded twice in past 15 months to Baa3 with a continued negative outlook.
* Growth of government receivables has required draws on a $100M working capital line established this year.
* Weakened near-term outlook for the Puerto Rico economy, due in part to the government's continuing fiscal strain, is expected to lead to a modest decline in power demand over the next year.

FISCALLY STRAINED COMMONWEALTH GOVERNMENT ACCOUNTS FOR 10% OF UTILITY'S REVENUE

The Commonwealth and its public corporations account for about 10% of the utility's annual revenue, and have historically been slower-paying than other customers. Preliminary statements from the utility for fiscal 2006 (ended June 30) indicate that related government receivables have increased to $250 million, or about 67% of annual billed revenue, compared to a more usual level of about 50% of billed revenue. The government payment slowdown has put pressure on the utility's already narrow cash flow and balance sheet liquidity measures, and increased the need for working capital borrowing. The government payment slowdown during the last quarter of the year was somewhat less than had been expected, however.

NEW CREDIT FACILITES ESTABLISHED TO REDUCE RELIANCE ON GDB

Reflecting the reduction in cash flow from the government, the utility currently has drawn some $45 million under a $100 million revolving working capital facility that it established earlier in the year with the Government Development Bank for Puerto Rico (GDB, which is rated Baa3/negative). Given the GDB's own financial pressures, this facility is in the process of being replaced by a similar facility the utility has obtained from JP Morgan. There is currently no plan to increase the size of the facility, based on an expectation that the government payment slowdown will not get appreciably worse in the coming year. The facility is also supplemented by a longstanding fuel purchase credit facility from a local bank group, currently sized at $175 million. In a further effort to lighten the demands on GDB, PREPA also intends to shift its interim capital borrowing to new facilities established by JP Morgan and Citibank.

CONTINUED GOOD OVERALL UTILITY PERFORMANCE IN FISCAL 2006

Apart from the government receivables trend and related working capital borrowing, PREPA's financial performance in fiscal 2006 has been consistent with its long historical trend of net revenue growth and moderate coverage of debt service requirements. This is impressive given the steep increase in fuel costs and customer charges over the past year. Despite fuel costs being passed on to customers through a monthly adjustment process, fiscal 2006 power demand was relatively stable vs. 2005 for commercial and industrial customers, and down modestly for residential customers. Reflecting increased fuel charges, total power revenues were up 22% for the year, net revenues were up 11%, and reported debt service coverage was 1.5 times. Adjusted for contributions in lieu of taxes to municipalities - which offset

about 4% of reported gross revenues - debt service coverage was 1.2 times, also consistent with the historic trend on this basis.
Following a slight decline in fourth-quarter power demand, PREPA is now forecasting a modest overall demand decline in fiscal 2007 due to a weakened local economic outlook for Puerto Rico. However, the utility does not currently expect the demand decline will negatively affect its net revenues or debt service coverage.

Outlook

The rating outlook for PREPA's power revenue bonds is negative, reflecting the negative outlook assigned to the Commonwealth, and a weakened outlook for the Puerto Rican economy and related power demand.

What could change the rating down?

* substantial decline in power demand, net revenues, and debt service coverage, either as a result of a significant general economic downturn or a problem recovering increased fuel costs.
* actions by the Commonwealth government that weaken the utility, such as a significant further slowdown of public sector power payments or other interference in the utility's ability to recover its costs.
* downgrade of the Commonwealth's G.O. rating below Baa3.

What could change the rating up?

* Trend of materially higher (cash) debt service coverage levels, improved balance sheet liquidity measures, and reduced reliance on public sector customers as a percent of total power sales

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