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March 26, 2012

Summary:
Puerto Rico Electric Power Authority; Retail Electric

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Table Of Contents

950806 | 301835958

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(Editor's Note: The original version of this analysis, published March 23, misstated the rating on Puerto Rico's general oblligation bonds. A corrected version follows.)

Credit Profile		
US$461.525 mil pwr rev bnds ser 2012 A due 07/01/2041		
Long Term Rating	BBB+/Stable	New
US$19.555 mil pwr rev rfdg bnds ser 2012 B due 07/01/2041		
Long Term Rating	BBB+/Stable	New
Puerto Rico Elec Pwr Auth pwr		
Unenhanced Rating	BBB+(SPUR)/Stable	Affirmed
Long Term Rating	BBB+/Stable	Affirmed

Rationale

Standard & Poor's Ratings Services has assigned its 'BBB+' long-term rating to Puerto Rico Electric Power Authority's (PREPA) $481 million power revenue bonds, series 2012 A and B. At the same time, Standard & Poor's affirmed its 'BBB+' rating on the utility's parity debt. The outlook is stable. A pledge of the electric system revenues secures the bonds.

As of fiscal year-end 2011 (June 30), PREPA had $7.5 billion of power revenue bonds outstanding. Series 2012 proceeds will fund a portion of its planned capital investment.

The rating reflects our opinion of the following weaknesses:

- 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 65% of energy production;
- Large capital requirements to convert generating plants to gas, bury distribution wires, and upgrade and extend the transmission system; 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 (we rate Puerto Rico's general obligation bonds 'BBB' with a stable outlook), 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 5.75 cents per kilowatt-hour (kWh), which management expects to maintain despite significant investment in the system because of other cost reductions.

During the next five years, PREPA will invest about $1.7 billion in the system, having already invested $2.5 billion in the past five. The conversion of the generating units to gas from oil will account for the largest component of cost reduction. Dependence on oil raised rates for residential customers, which account for 35% of total revenue, to 23.5 cents per kWh in fiscal 2011, from 17.6 cents in fiscal 2007. In April 2012, the authority expects to begin burning natural gas in 820 MW of the 990 MW of dependable generating capacity at the Costa Sur plant in the south. By April 2013, PREPA expects the full 820 MW to be operating on natural gas. Management will invest an estimated $742.3 million to outfit an additional 2,420 MW of oil-burning units to burn gas. In the next five years, management intends to build the Via Verde pipeline to bring has from the liquefied natural gas (LNG) terminal in the south to units in the north, and to build an offshore LNG terminal in the south to provide gas to the Aguirre units nearby. The authority expects that construction for the Via Verde project will take 14-16 months, and for the Aguirre offshore LNG terminal to be approximately 12 months. Management is reviewing financing options for the pipeline and offshore LNG terminal, so these costs are not included in the $1.7 billion construction budget. Management estimates the pipeline construction cost at $450 million and the offshore LNG terminal $173 million.

To supplement PREPA-owned generation, two purchased power contracts, one for gas-fired power from the Ecoelectrica 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.

PREPA intends to increase system reliability by investing about $814 million in transmission and distribution facilities. 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 Costa Sur plant to a point in the middle of the eastern end of the island, providing alternate routes for power.

Another important target of cost reduction is the timely recovery of payment from government departments and agencies. Legislation passed recently 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. Lines of credit from the Government Development Bank (GDB) allow government departments (notably education and health) to pay past due amounts. Revenue from government and municipal customers in fiscal 2011 accounted for about 16% of revenue and about 45% 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, which is 97% complete, allows PREPA to implement load control and helps eliminate theft, which accounted for about 8% of produced electricity in fiscal 2010. Management has been successful in identifying and eliminating electricity theft, and recovering past-due amounts. Legislation passed recently 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.

950806 | 301835958

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 $30 million of additional annual savings.

Management expects these cost reductions will help it maintain at least 1.2x debt service coverage despite the additional debt issued to fund capital investment. Debt reduction of about $1.0 billion will partially offset the $2.3 billion management expects to issue in the next five years--which includes the 2012 issues. 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 operation costs. However, the utility's ability to pass fuel costs directly through to customers monthly helps limit operating liquidity requirements. In addition, PREPA has access to a $235 million line of credit for fuel purchases ($85 million available as of Jan. 31, 2012) and $150 million for working capital ($30 million available). However, the GDB is now authorized to procure fuel for the authority. GDB will contract directly with oil supply companies and refineries, can assure payment to providers in less than 60 days, and will implement a commodities hedging program to protect ratepayers from sudden increases in oil prices.

GDB also provides a $150 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 $1,150 million. At its current ratings, a collateral threshold of $50 million is effective on the basis swap. The interest rate swaps have an infinite threshold. If we lower our rating on PREPA to 'BBB' or if Moody does to Baa2 or below, both the basis swap and the uninsured interest rate swaps would have a $30 million threshold. The basis swap has generated $33 million of to the authority since its inception through December 2011. There were no collateral posting requirements as of January 2012.

Outlook

The stable outlook reflects our opinion of PREPA's ability to maintain a sufficiently strong financial risk profile 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.

Related Criteria And Research

USPF Criteria: Electric Utility Ratings, June 15, 2007

Ratings Detail (As Of March 26, 2012)		
Puerto Rico Elec Pwr Auth pwr		
Unenhanced Rating	BBB+(SPUR)/Stable	Affirmed

Ratings Detail (As Of March 26, 2012) **(cont.)**
Many issues are enhanced by bond insurance.

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