

**Subject:** News & Research of Interest to GDB

**Global Credit Research**

**New Issue**

10 JUN 2008

**New Issue:** [Puerto Rico Electric Power Authority](#)

**MOODY'S ASSIGNS A3 TO PUERTO RICO ELECTRIC POWER  
AUTHORITY REVENUE BONDS; STABLE OUTLOOK**

**PREPA TO ISSUE \$800 MILLION REVENUE BONDS JUNE, 17  
2008**

Electric Utilities  
PR

**Moody's Rating**

<b>ISSUE</b>	<b>RATING</b>
Power Revenue Refunding Bonds Series WW	A3
<b>Sale Amount</b>	\$700,000,000
<b>Expected Sale Date</b>	06/17/08
<b>Rating Description</b>	Revenue
Power Revenue Refunding Bonds Series XX	A3
<b>Sale Amount</b>	\$100,000,000
<b>Expected Sale Date</b>	06/17/08
<b>Rating Description</b>	Revenue

**Moody's Outlook** Stable

**Opinion**

NEW YORK, Jun 10, 2008 -- Moody's Investors Service has assigned an A3 credit

rating to the fixed rate \$700,000,000 Series WW and \$100,000,000 XX Power Revenue Bonds of the Puerto Rico Electric Power Authority's (PREPA) expected to price on June 17. Moody's has also affirmed the A3 rating on PREPA's outstanding \$5.4 billion revenue bonds. The rating outlook is stable.

The credit rating incorporates the strong management of PREPA which has successfully been managing through the recent economic slowdown and rising fuel prices. PREPA continues to operate as the sole provider of an essential service, independent from the Commonwealth's finances. PREPA has maintained a stable debt service coverage trend which has demonstrated management's willingness to raise rates to maintain the utility's financial position despite fuel price pressures. PREPA has also continued to better position the utility with its power resource diversity plan.

PREPA's sound risk management program has served it well thus far in mitigating the loss of the Palo Seco power plant. Moody's believes PREPA has done a credible job of bringing the Palo Seco generating units back on line in the timeframe and near the cost that was expected. While PREPA has only satisfactory internal liquidity compared to other major public power utilities, the authority has external lines of credit which have provided some flexibility. Also considered in the rating are rising fuel oil prices which have taken their toll on rate stability and are becoming a pressure on ratepayers.

For additional credit information please refer to Moody's High Profile New Issue report to be published during the week of June 9.

**USE OF PROCEEDS:** The bond proceeds will fund PREPA's ongoing capital improvement program including generation and transmission projects and repay certain outstanding lines of credit. PREPA will also be refunding various outstanding bond maturities depending on whether the 3% net present value savings target is met.

**BOND SECURITY PROVISIONS:**

**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:** Fix charges and collect rates and charges so that 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, with certain modifications to that requirement.

**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 and the average net revenues for five fiscal years after bond issuance adjusted to reflect any rate schedule covenanted are 120% of maximum debt service.

**CONTRIBUTIONS IN LIEU OF TAXES AND GOVERNMENTAL SUBSIDIES:** PREPA is required to make a contribution in lieu of taxes to all municipalities 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 balances owed by the municipalities to PREPA.

**INTEREST RATE DERIVATIVES:**

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 swap is with Goldman Sachs Capital Markets and PREPA will receive quarterly payments beginning October 1, 2008 equal to a floating amount applied to the notional amount at a rate equal to 62% of the taxable LIBOR reset each week plus 29 basis points and a fixed rate payment of 0.4669% per annum, in return from PREPA quarterly payments based on SIFMA. PREPA will be exposed to basis and tax risk. The business purpose of this swap, to provide positive net payments to PREPA, is speculative and relies on the relative performance between SIFMA and LIBOR rates. While the net present value of the expected payments under the swap is \$81 million, in PREPA's favor, the basis risk in any given year could result in net payments by PREPA. Additionally if PREPA's rating fell below Ba1, an event of default under the agreement, the swap is subject to termination, which introduces additional risk to PREPA should its credit substantially deteriorate.

**RECENT DEVELOPMENTS:**

PREPA maintained debt service coverage at 1.48 times at year-end 2007 despite rising fuel oil prices. Forecast for 2008 indicates over 1.50 times coverage as well. Retail sales for the eight-month period ending February 28, 2008, fell 4.1% but net revenues were maintained at the same level as the prior year, since fuel costs were passed through to customers. Receivables as of April 2008 (unaudited) were slightly higher than 2007 levels. While the receivable level remains a pressure and will continue to be an issue, PREPA management continues to work on mitigation measures. PREPA expects full operation of all four Palo Seco generating units by the Fall 2008. The reconstruction project at Palo Seco also modernized the control room and switchyard confirming PREPA's belief that this generation site is critical to voltage control and area generation for San Juan. More than one-half of the \$300 million in insurance claims related to Palo Seco have been received or approved with the balance still under review by insurance providers. No agreements have been reached with major labor unions on their contracts. Recent legislation signed into law includes an industrial tax credit to be funded by the Commonwealth and PREPA and phased in over 10 years. Estimated total cost to PREPA is \$24 million in 2018. A new

provision was enacted for a wheeling system to permit eligible companies to generate and sell renewable energy resources was approved. A feasibility study is required before implementation.

## CREDIT FUNDAMENTALS

### STRENGTHS:

- \*PREPA is a monopoly provider of essential electric service to Puerto Rico
- \*Management has done a credible job at bringing Palo Seco back online
- \* PREPA board has full rate-setting control. PREPA can automatically pass through to customers higher fuel and energy costs on a monthly basis
- \*PREPA has maintained satisfactory debt service coverage despite prior Commonwealth economic down cycles and fuel price spikes
- \*Sound bond covenants including a requirement that maximum annual debt service is covered 1.20x
- \*A well-established and effective record of improving generating unit reliability and implementation of a strategy to diversify fuel mix to lessen impact of oil price volatility
- \*Strong power reserve margin which helped to mitigate the impact of the unplanned outage at Palo Seco due to fire
- \*Limited customer concentration

### CHALLENGES:

- \*Significant dominance of fuel oil as percent of total generation fuel mix has subjected PREPA to price volatility
- \*Accounts receivable problem remains a pressure on cash flow
- \*Debt leverage is above median for major public power utilities that own generation
- \*Financial pressure for PREPA has been caused by Commonwealth's slowness in payment of its electricity bills. Commonwealth and its municipalities represent about 15% of total energy sales
- \*Internal financial liquidity is only weak but it is bolstered by lines of credit with major banks
- \*PREPA has a basis swap which adds additional risk to PREPA's debt structure

## **Outlook**

The rating outlook for PREPA's power revenue bonds is stable given its essential role and record of satisfactory financial operations.

#### What Could Change the Rating - DOWN

Actions by the Commonwealth government that weaken the utility, such as a significant slowdown of public sector power payments or interference in the utility's ability to recover its costs could result in a downgrade. A downgrade of the Commonwealth's G.O. rating below Baa3 would result in pressure on PREPA's rating. Ratepayer resistance to higher electricity rates should fuel oil prices continue to increase significantly could impact revenues and place downward pressure on the rating.

#### What Could Change the Rating - UP

The rating could be upgraded if there were a 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.

#### KEY FACTS:

Debt Service Coverage, 2007: 1.48 x

Debt Service Coverage, 2009: (Budget): 1.76 x

Debt Service Coverage After In-Lieu of Tax Payments, 2007: 1.21x

Fuel Expense, 2003: \$888,425,000

2007: \$1,716,965,000

Debt Ratio, 2007: 97.9%

Debt Outstanding, 2007: \$6,544,757,000 (including short-term debt)

Number of Customers, 2003: 1,401,301

2007: 1,452,529

Average Residential Revenue, cents per Kwh, 2007: 17.57 cents/kwh

Puerto Rico GO Rating: Baa3

Debt Outstanding as of April 30, 2008 (\$000)

Fixed Rate Power Revenue Bonds: \$5,470,435

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