FITCH DOWNGRADES PUERTO RICO ELECTRIC POWER AUTH'S REV BONDS; MAINTAINS WATCH NEGATIVE

Fitch Ratings-New York-26 June 2014: Fitch Ratings has downgraded the rating on $8.7 billion of Puerto Rico Electric Power Authority (PREPA) power revenue bonds to 'CC' from 'BB'.

The downgrade reflects Fitch's view that, based on its reading of newly proposed legislation, a debt restructuring or default by the Authority is probable in light of the legislation, and given the near-term liquidity demands brought on by maturing bank lines of credit and the required repayment of outstanding loans due in July and August 2014.

Fitch is maintaining the Rating Watch Negative.

SECURITY

The power revenue bonds are secured by a senior lien on net revenues of the electric system.

KEY RATING DRIVERS

INCREASED EXPECTATION OF RESTRUCTURING OR DEFAULT: The further downgrade of PREPA reflects Fitch's view that bondholders now face a probable financial restructuring or default by the Authority in light of newly proposed legislation in Puerto Rico. The Puerto Rico Public Corporation Debt Enforcement and Recovery Act (the Act), expected to be signed into law imminently, would establish a restructuring regime for public corporations that may become insolvent. PREPA faces repayment obligations totaling $671 million through August 2014, which it appears unable to meet.

GOVERNMENTAL SUPPORT DISCOUNTED: Statements within the Act acknowledge that the Government Development Bank of Puerto Rico (GDB) is no longer a viable alternative for interim financing and is unable to provide necessary bridging liquidity support to avoid a PREPA default. With market-based options for addressing repayment of the pending maturities diminishing, Fitch believes that PREPA will likely pursue restructuring alternatives offered under the Act. Existing law would not have supported a debtor controlled restructuring process.

TWO PATHS FOR RESTRUCTURING: The Act contemplates two procedures for addressing debt obligations. While they are intended to restore solvency over the long-term, both procedures entail debt restructuring that would trigger suspension of debt payments and preclude the timely payment of principal and interest during the pendency of the proceedings.

RATING SENSITIVITIES

REQUEST FOR RELIEF: Any request for relief through restructuring by PREPA, or GDB upon the Governor's request, as contemplated in the proposed legislation would result in a further downgrade to 'C'.

NEGOTIATED RESOLUTION TO LIQUIDITY DEMAND: Although unlikely, any negotiated resolution to the near term liquidity demands facing PREPA would be evaluated for commercial reasonableness and sustainability, and could lead to consideration of a higher rating.

CREDIT PROFILE

RESTRUCTURING LEGISLATION INTRODUCED

On June 25, 2014, the Governor of Puerto Rico introduced the Puerto Rico Public Corporation Debt Enforcement and Recovery Act in order to establish a debt enforcement, recovery and restructuring regime for the public corporations and instrumentalities of the Commonwealth of Puerto Rico during an economic emergency. The bill is intended to introduce a bankruptcy-like process and provide an orderly recovery regime for public corporations that may become insolvent. The bill is expected to be signed by June 30, 2014.

HEIGHTENED FINANCIAL AND LIQUIDITY RISK

PREPA has been plagued by weak financial performance in recent years, including through fiscal 2014. For the ten months ended April 30, 2014 PREPA reported earnings before depreciation of $645 million and a net loss of ($204 million). However, the authority currently faces heightened liquidity and market access risk stemming from the maturity of two short-term lines of credit (LOCs) and the required repayment of outstanding borrowings totaling $641 million in July and August 2014.

LIQUIDITY SUPPORT NOT EXPECTED

Fitch noted in its June 10, 2014 release that PREPA's ability to repay these outstanding loans was limited and that the prospects for extending or replacing the LOCs was uncertain, but noted further that the GDB could provide necessary bridging liquidity support to prevent a PREPA default.

It now appears that support will not be forthcoming as the Act states that the GDB 'lacks sufficient financial strength' .. to satisfy the current financing needs of the Government of the Commonwealth and, in particular, of its public corporations', and that GDB's ability to provide interim financing is constrained. In its preamble to the legislation the government states '[g]iven that public corporations no longer can rely on GDB loans, Commonwealth subsidies, or rate increases to cover their operating deficits, they may be unable to pay their debts as they become due'.

With market-based options for addressing repayment of the pending maturities, as well as expectations for governmental assistance, diminishing Fitch believes that PREPA will likely seek to address its current fiscal emergency, and restore its solvency over the long-term, through alternatives presented under the Act.

ALTERNATIVES FOR RESTRUCTURING WOULD PRECLUDE TIMELY PAYMENT

The Act contemplates two types of procedures to address a public corporation's burdensome debt obligations, both of which include debt restructuring and would preclude the timely payment of principal and interest, and reduce recovery.

The first is a consensual debt modification procedure whereby the corporation would adopt a recovery program and a market-led solution for debt relief that binds all debt holders with the consent of a supermajority of debt holders. Discussions with stakeholders would be preceded by a suspension period when all remedies would be suspended.

The second procedure would be court-supervised and would culminate in an orderly debt enforcement plan. Qualifying public corporations would be allowed to defer repayment and decrease interest and principal to continue to fulfill vital public functions. Any action for payment of claims would be stayed during the procedure. Ultimately a debt enforcement plan would be proposed by the petitioner or GDB and confirmed by the court and creditors.

A public corporation could seek relief under either of these alternatives at the same time or sequentially.

For additional information please see Fitch's releases dated Feb. 18, 2014 and June 11, 2014.

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This rating action was informed by the sources of information identified in Fitch's U.S. Public Power Rating Criteria.

Applicable Criteria and Related Research:
--'Fitch Downgrades Puerto Rico GO and Related Debt Ratings to 'BB'; Outlook Negative' (Feb. 11, 2014);
--'U.S. Public Power Peer Study Addendum -- February 2014', (Feb. 7, 2014);
--'U.S. Public Power Peer Study -- June 2013' (June 13, 2013);
--'U.S. Public Power Rating Criteria' (Dec. 18, 2012).

Applicable Criteria and Related Research:
U.S. Public Power Peer Study Addendum -- February 2014
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=735601
U.S. Public Power Peer Study Addendum - June 2014
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=750283

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