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INVESTORS SERVICE

Rating Update: Moody's downgrades Puerto Rico GOs to B2 from Ba2, COFINA Senior-Sub to Ba3-B1; outlooks negative

Global Credit Research - 01 Jul 2014

Downgrades of Electric Power Authority (PREPA) and other Puerto Rico entities affect over $61 billion total

PUERTO RICO (COMMONWEALTH OF)
State Governments (including Puerto Rico and US Territories)
PR

Opinion

NEW YORK, July 01, 2014 --Moody's Investors Service has downgraded the Commonwealth of Puerto Rico to B2 from Ba2, affecting $14.4 billion of outstanding general obligation (GO) bonds. Concurrently, commonwealth agencies and public corporations have been downgraded, affecting about $46 billion of non-GO bonds, including $15.6 billion of senior- and subordinate-lien bonds issued by the Sales-Tax Financing Corporation (COFINA), which respectively were lowered to Ba3 and B1. The Puerto Rico Electric Power Authority (PREPA) was downgraded to Caa2 from Ba3, while the Puerto Rico Aqueduct and Sewer Authority (PRASA) was downgraded to Caa1 from Ba3. The Puerto Rico Highway and Transportation Authority (PRHTA) was downgraded to Caa1 (senior 1998 resolution and 1968 resolution) from Ba3, and to Caa2 from B1 (subordinate 1998 resolution). For PREPA, PRHTA and PRASA, the newly lowered ratings remain under review for possible further downgrade. The debt of the Government Development Bank (GDB) was downgraded to B3 from Ba2, and the debt of the University of Puerto Rico was downgraded to Caa1 and Caa2. The outlook for the GDB as well as for commonwealth GO and related debt remains negative. All the rating and outlook changes incorporated in this action are listed at the end of this release.

SUMMARY RATING RATIONALE

The downgrades of Puerto Rico and its debt-issuing entities follow the commonwealth's enactment of a law (the Puerto Rico Public Corporation Debt Enforcement and Recovery Act) that will allow public corporations to defer or reduce payments on outstanding bonds. By providing for defaults by certain issuers that the central government has long supported, Puerto Rico's new law marks the end of the commonwealth's long history of taking actions needed to support its debt. It signals a depleted capacity for revenue increases and austerity measures, and a new preference for shifting fiscal pressures to creditors, which, in our view, has implications for all of Puerto Rico's debt, including that of the central government. Application of the law may further limit the commonwealth's market access, leaving it more vulnerable to financial risk and unable to fund capital projects.

The COFINA ratings have now been positioned closer to the GO, reflecting their increased susceptibility to any action that impairs bondholders' claims on sales tax revenues if the commonwealth invokes its police powers and acts to protect the health and safety of the general public ahead of bondholders. The new GO and COFINA bond ratings face heightened risk of default, given the commonwealth's stagnant economic conditions and disproportionately large debt burden.

Ratings now assigned to PREPA, PRASA and PRHTA and the Puerto Rico Convention Center District Authority are under review for further downgrade, reflect the escalating risk that these entities could default voluntarily under the new restructuring law. We have also lowered ratings on certain bonds previously considered as equivalent to the general obligation rating, or "capped" at the GO rating, because of their increased risk of default and potentially lower recovery rates than the GO. The ratings on Puerto Rico's pension funding bonds, as well as debt issued by the GDB and the Municipal Finance Agency, and the Puerto Rico Infrastructure Financing Authority (PRIFA, bonds secured by rum tax remittances from the federal government) were downgraded to B3 from Ba2 and are now rated one notch below the GO bonds due to our view that the expected loss rates on these securities are now higher. GDB has direct exposure to the risks implicit in the restructuring law, given its substantial loans to PRHTA and other public corporations.

DETAILED CREDIT DISCUSSION

DEBT RESTRUCTURING LAW'S PASSAGE SIGNALS LIKELIHOOD OF AUTHORITY DEBT DEFAULT

The governor of Puerto Rico last week signed legislation that we view as a declaration of intent to allow public-corporation debt restructuring. Neither Puerto Rico nor its municipalities (including local governments and public corporations) can seek relief from creditors under the US Bankruptcy Code. The new Debt Enforcement and Recovery Act gives public corporations two ways to reduce their obligations. First, the corporations can negotiate new terms that are binding on all parties. Second, a Puerto Rico court can impose new terms to benefit an authorized governmental organization. This non-consensual approach would allow debt repudiation "to the extent necessary to enable each entity to continue to fulfill its vital public functions." Under the law, a public corporation could initiate this type of restructuring by filing a petition for relief. The entity seeking relief would have to demonstrate it was "at serious risk" of being unable to make timely debt service payments "while performing its public functions" with no central government aid. Initiating the process would also require consent of the commonwealth's fiscal agent, the GDB. The law could be used to reject or modify collective bargaining agreements, but pension and retiree health benefit plan assets could not be affected, and the law would require full payment of wages and salaries.

PREPA MOST LIKELY TO MAKE USE OF RESTRUCTURING PROCESS IN THE NEAR TERM

We view PREPA as most likely to make immediate use of the new law, given its financial pressures, a view that is reflected in the lower rating now assigned to PREPA (Caa2). PREPA not only has immediate cash needs to repay maturing bank lines and procure oil, but it also suffers from existing high leverage, negative free cash flow, sizeable capital investment needs as it converts generation facilities to natural gas from oil. On its two main bank lines maturing in July and August, PREPA owes approximately $671 million combined. If the commercial banks do not extend their lines, and they demand repayment, PREPA will not be able to repay the advances from its own available funds. PREPA also faces other significant challenges, in the form of high electricity rates and growing accounts receivable balances.

LAW AFFECTS GENERAL OBLIGATION BONDS, RELATED CREDIT STRUCTURES

The text of the new legislation emphasizes that its debt restructuring framework will not be available for all of the commonwealth's public debt. The law specifically does not apply to the commonwealth itself, its municipalities, or to the GDB, COFINA, or public pension systems. However, the commonwealth may be challenged to maintain market access and investor confidence if its largest public corporations negotiate new debt terms or otherwise impair bondholder rights and remedies. A restructuring that involves an extension of maturities with the same or lower coupons, or reduces the security of the bonds is a default by Moody's definition.

The law signals an end to the commonwealth's long history of providing liquidity, capital financing and operating subsidies, often through the GDB, to various public corporations. PRHTA has accumulated $2 billion of fully drawn bank lines owed to GDB with interest only payable and no scheduled repayment terms. Most recently, GDB purchased $200 million of variable-rate demand obligation bonds for which the supporting bank facility expired on May 27.

PRHTA and PRASA are closely aligned with the central government from a governance and management perspective. Puerto Rico's governor appoints five of PRASA's nine board members and also appoints PRHTA's executive director, and PRHTA is overseen by the commonwealth's Department of Transportation and Public Works. The governor likewise names a majority of PREPA's nine board members (the governor's Secretary of the Department of Transportation and Public Works serves on the board ex officio, and the governor also appoints another four board members).

UNIVERSITY OF PUERTO RICO'S DOWNGRADE TO Caa1 REFLECTS COMMONWEALTH RATING AND HEIGHTENED PRESSURE ON MOST REVENUE

University of Puerto Rico (UPR) is not eligible to restructure debt under the new law. We have nevertheless lowered ratings on its University System Revenue Bonds and lease-backed Educational Facilities Revenue Bonds, 2000 Series A, to Caa1 and Caa2, respectively, from Ba3 and B1. The University System Revenue Bonds are now rated two notches lower than the B2 commonwealth rating. The ratings' outlook is negative. These actions for UPR reflect heightened downward pressure on the university's funding sources, notably on its commonwealth funding and tuition. The ratings incorporate the university's high reliance on commonwealth appropriations, plus its constrained ability and willingness to raise tuition and other auxiliary revenues sufficient to mitigate cuts. Statutorily mandated Commonwealth funding represents an extraordinarily high 72% of fiscal year 2013 operating revenues. Other factors expressed in the university's ratings and negative outlook include its historical reliance on GDB (B3 negative) for liquidity and the close governance oversight from the commonwealth that can affect operations and cash flow, as shown by the governor's replacement of both the board of trustees and president in 2013.

COMMONWEALTH'S WILLINGNESS TO IMPOSE REVENUE INCREASES, AUSTERITY MEASURES IS DEPLETED

While not applying directly to Puerto Rico's GO debt, the law makes the legal case for a "state of fiscal emergency" affecting the central government as a potential justification for debt restructuring by authorized public corporations. Immediate challenges, the law states, constitute a "real and palpable threat to the government's ability to protect and promote the general welfare of the people of Puerto Rico." The law reasons that while public corporations must now end reliance on the central government, their self-sufficiency "may not be achieved through increases in basic rates, which are already excessively high, [and] hinder and depress economic activity and development." This invocation of police powers effectively ends a long period in which the commonwealth was willing to shore up the financial position of its public corporations through new revenue and austerity measures. By declaring its intent to contemplate public corporation debt restructurings, the commonwealth is indicating that it lacks economic or political capacity for further revenue increases or austerity measures.

IMPLEMENTATION MAY DECREASE MARKET ACCESS, SPUR BONDHOLDER LITIGATION

A debt restructuring or default by one or more authorities probably will exacerbate the commonwealth's market-access challenges, affecting its ability to raise money through the sale of GO or other bonds. This would leave the commonwealth increasingly vulnerable to financial risk and unable to finance capital projects. The law also will provoke litigation. Some bondholder lawsuits, questioning whether the law violates the US Constitution, have reportedly been filed already.

RATING REVIEWS WILL FOCUS ON AUTHORITIES THAT MAY MAKE USE OF RESTRUCTURING LAW

Last week we downgraded PREPA, PRHTA and PRASA, and put the authorities' ratings under review for possible further downgrade. Our review of PREPA will continue to focus on near-term liquidity demands from maturing bank lines of credit, with $671 million of debt outstanding, as well as long-term pressures such as chronic negative free-cash flow, high non-payment rates, and growing accounts receivable. Our actions on PREPA, PRASA and PRHTA - including the review for further downgrade - incorporate our view that one or more of these entities may make use of the new restructuring law, leading to defaults on their bonds. During the review period, we expect to assess the likelihood of such an event, as well as the fundamental credit positions of the authorities, including short-term liquidity needs and long-term economic viability of the enterprises. Given the varying circumstances of the authorities, it is possible that the length of review will not be uniform. We will provide additional analysis and commentary on these actions in the next week.

SUMMARY OF DEBT AFFECTED BY LEGISLATION

Downgraded to Ba3 from Baa1; outlook negative

--COFINA Senior

-- Industrial Development (PRIDCO)

Downgraded to B1 from Baa2; outlook negative

--COFINA Subordinate

Downgraded to B2 from Ba2; outlook negative

--General Obligation

Downgraded to B3 from Ba2; outlook negative

--GDB notes

--Infrastructure Financing Authority (PRIFA)

--Municipal Finance Agency

--Pension funding bonds

Downgraded to B3 from Ba3; outlook negative

--Appropriation debt of commonwealth

Downgraded to Caa1 from Ba3; ratings under review

-- Aqueduct & Sewer Authority(PRASA)

-- Highway & Transportation (PRHTA)

Downgraded to Caa1 from Ba2; outlook under review

Convention Ctr (Hotel Occupancy Tax)

Downgraded to Caa2 from Ba3; ratings under review

-- Electric Power Authority (PREPA)

Downgraded to Caa2 from B1; ratings under review

-- PRHTA Subordinate-lien

Downgraded to Caa1 from Ba3; outlook negative

--University of Puerto Rico (System)

Downgraded to Caa2 from B1; outlook negative

--University of Puerto Rico (Facilities)

RATING METHODOLOGIES

The principal methodology used in rating the Commonwealth of Puerto Rico, Puerto Rico Municipal Finance Agency, Puerto Rico Public Buildings Authority, Puerto Rico Highway & Transportation Authority, Puerto Rico Aqueduct and Sewer Authority, Puerto Rico Infrastructure Financing Authority, Government Development Bank for Puerto Rico, Puerto Rico Public Finance Corporation, Puerto Rico Convention Center District Authority and Puerto Rico Employees Retirement System debt was US States Rating Methodology published in April 2013.

The additional methodology used in rating the Puerto Rico Highway & Transportation Authority debt, the Puerto Rico Infrastructure Financing Authority debt, and the Puerto Rico Convention Center District Authority debt was US Public Finance Special Tax Methodology published in January 2014.

The additional methodology used in rating the Puerto Rico Aqueduct and Sewer Authority debt was Analytical Framework For Water And Sewer System Ratings published in August 1999.

The additional methodology used in rating the Government Development Bank for Puerto Rico debt was Rating Transactions Based on the Credit Substitution Approach: Letter of Credit backed, Insured and Guaranteed Debts published in March 2013.

The additional methodology used in rating the appropriation debt was The Fundamentals of Credit Analysis for Lease-Backed Municipal Obligations published in December 2011.

The principal methodology used in rating the Puerto Rico Sales Tax Financing Corporation debt and the Puerto Rico Industrial Development Company debt was US Public Finance Special Tax Methodology published in January 2014. An additional methodology used in this rating was US States Rating Methodology published in April 2013.

The principal methodology used in rating the Puerto Rico Electric Power Authority debt was U.S. Public Power Electric Utilities with Generation Ownership Exposure published in November 2011.

The principal methodology used in rating the University of Puerto Rico debt was U.S. Not-for-Profit Private and Public Higher Education published in August 2011. The additional methodology used in rating the lease debt was The Fundamentals of Credit Analysis for Lease-Backed Municipal Obligations published in December 2011.

Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.

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