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Summary:

Puerto Rico Aqueduct & Sewer Authority; General Obligation Equivalent Security; Water/Sewer

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Summary:

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Credit Profile		
Puerto Rico Aqueduct & Swr Auth rev bnds (sr lien)		
Long Term Rating	BB-/Negative	Downgraded
Puerto Rico Aqueduct & Swr Auth (Commonwealth Guaranteed)		
Long Term Rating	BB/Negative	Downgraded
Puerto Rico Aqueduct & Swr Auth (Commonwealth Guaranteed) ser 2008A		
Long Term Rating	BB/Negative	Downgraded
Puerto Rico Aqueduct & Swr Auth (Senior Lien)		
Long Term Rating	BB-/Negative	Downgraded
Puerto Rico Aqueduct & Swr Auth (Senior Lien) (ASSURED GTY)		
Unenhanced Rating	BB-(SPUR)/Negative	Downgraded

Many issues are enhanced by bond insurance.

Rationale

Standard & Poor's Ratings Services has lowered its ratings on Puerto Rico Aqueduct & Sewer Authority's (PRASA) revenue bonds, guaranteed by the Commonwealth of Puerto Rico, by one notch to 'BB'. At the same time, Standard & Poor's lowered its rating on PRASA's revenue bonds to 'BB-' from 'BB+'. The outlook is negative.

The actions reflect our our downgrade of the commonwealth's general obligation (GO) debt (for more information, see "Puerto Rico GO Rating Lowered One Notch To 'BB' Following Debt Legislation; Outlook Negative," published July 11, 2014, on RatingsDirect).

The negative outlook affects PRASA's series 2008A and 2008B revenue bonds, of which $285 million are outstanding. The authority also has approximately $874.3 million in other commonwealth-backed obligations, mainly U.S. Department of Agriculture's Rural Development loans, as well as the Puerto Rico Infrastructure Financing Authority loans (we don't rate these bonds). Those bonds are first secured by a pledge of net revenues of PRASA's system. Should the net revenues be insufficient, the commonwealth backstops the bonds.

The 'BB-' rating on the senior-lien revenue bonds -- series 2008 and 2012A and B, secured by a gross revenue pledge of the authority, with about $3.4 billion total outstanding -- reflects PRASA's stand-alone credit profile. The authority is, in our view, a governmental-sponsored enterprise. By applying our governmental-related entity criteria, and because of PRASA's important role and strong link with the commonwealth, a further downgrade to Puerto Rico's GO debt could cause a downgrade to the authority's revenue bonds.

We have also lowered PRASA's stand-alone credit profile (SACP) to 'bb-', from 'bb+'. The SACP reflects our view of the authority's general creditworthiness based solely on its own fundamentals, absent any uplift or headwinds associated with its relationship with the general government. The lower SACP is because we view the current climate surrounding all Puerto Rico obligations as creating adverse business conditions for PRASA. Its liquidity has no immediate challenges because of a 2012 bond restructuring that included the injection of temporary working capital, as well as a 60% rate increase in 2013. However, we view the authority's ability to extend its lines of credit (LOCs; expiring in March 2015) or convert them to long-term debt as now being more difficult. PRASA has little discretion in its capital improvement program given the large share of regulatory-ordered, date-certain mandates as a share of total projects. Although an SACP does not carry an outlook, the outlook on the revenue bonds is negative because we believe there is at least a one-in-three chance that the adverse business conditions could worsen for the authority within our two-year outlook horizon.

The extremely large rate increase in 2013 established financial independence from the commonwealth by making up for the loss of a debt subsidy, and created financial capacity for PRASA to more aggressively fund its myriad projects. Management has also taken a number of other steps to improve operations and control costs -- mainly toward personnel and energy -- that we view as credit positive. Furthermore, the forecast includes conservative assumptions such as declining demand and the exclusion of any potential cost savings from the fiscal emergency Act 66, making it more realistic that cash from operations could cover all revenue requirements regardless of lien priority. The credit lines' capacity of $350 million provides the authority with interim working capital, but our opinion of this financing tool has always been predicated on refunding that capacity via an ability to issue long-term debt at reasonable borrowing costs.

Unlike Puerto Rico Electric Power Authority (PREPA), PRASA's current cash reserves are what we consider adequate, even if mostly attributed to some of the proceeds from a 2012 bond sale that established several years of working capital. Management intended that cash infusion to last until cash from operations is consistently positive. Although it is therefore possible for the SACP to actually improve, the rating's uppermost bound would not be higher than the GO debt rating based on our criteria. In our view, an improvement to the SACP over our two-year outlook horizon would be based on a number of factors, including:

- Cash from operations consistently being at least sufficient to fund all revenue requirements, regardless of where they fall in the flow of funds and irrespective of whether the commonwealth ultimately backstops them;
- Continued progress toward addressing the capital improvement program, both for projects established in the consent decrees -- which alone could exceed $3.4 billion by the end of the next decade -- as well as those key to system integrity; and
- Maintaining the recent momentum of apolitical decision-making. Regardless of the frequency or magnitude of rate increases, the current management team has shown a willingness to make decisions that benefit the system despite the difficult political environment in which those decisions have occurred.

On June 30, 2014, we revised our opinion of PRASA's role and link to the commonwealth's general government as a government-related entity. In our view, there is a moderately high likelihood -- compared with a high likelihood previously -- of extraordinary government support if needed. The reasons for this revision included:

- The general government's own well-documented budgetary challenges, making it less likely it would even have the financial capacity to intervene if the authority were to be in extraordinary distress;

- The commonwealth's recent signal to PRASA of its intent to cease appropriations to support commonwealth-backed debt. Although this austerity measure is actually a long-term credit positive for the authority by forcing it to become self-sufficient -- and it did spur a 60% utility rate adjustment -- it indicates the commonwealth might be less inclined to throw PRASA a lifeline; and
- The government's clear position in light of the Puerto Rico Public Corporation Debt Enforcement and Recovery Act. The law, which the governor signed June 28, 2014, allows public corporations, including PRASA, to restructure existing debt and permits "postponing or reducing debt service with the consent of a supermajority of [75% of] the creditors as part of a recovery program."

We understand creditors would have nine months to negotiate a restructuring, after which the matter would revert to Puerto Rican courts. We believe this legislation introduces the potential for selective default by the commonwealth, including the gross revenue portion of the authority's debt. The legislation, however, explicitly excludes GO debt to be considered for restructuring, which we understand would also include PRASA's debt that the commonwealth backstops. Authority management recently stated it has no intentions to pursue a restructuring.

Given our view of the role, link, and moderately high likelihood of support, should the rating on Puerto Rico's GO debt fall one notch, we would also downgrade all PRASA debt one notch. (For more information, see table 7 of our article, "Rating Government-Related Entities: Methodology And Assumptions," published Dec. 9, 2010).

Factors that preclude a higher stand-alone credit profile include:

- The authority's relatively fragmented water and wastewater system, which coupled with significant deferred capital needs, has resulted in a high level of operational deficiencies and regulatory citations;
- An extremely high nonrevenue water percentage and customer accounts receivables that perpetually constrain finances, making it more difficult for the utility to generate consistent operating surpluses. PRASA has, however, made significant strides in the past two years to restore the system's financial operations, targeting personnel and energy cost reductions in addition to the aforementioned rate increase; and
- The estimated $1.4 billion in identified capital improvements through fiscal 2018, stemming primarily from compliance-related mandatory projects and other critical system improvements. Management might fund as much as $1.2 billion of the identified projects with external sources.

The key factor in supporting the SACP is PRASA's commitment to structural budgetary stability through a number of financial and operational initiatives to not only increase operating revenues but control expenses, as it proceeds from general government subsidization. Although we understand the 2013 rate increase was one of the authority's most significant (even if the implementation plan was adjusted somewhat in December 2013), it remains to be seen how the newfound financial capacity will be used. Currently, PRASA management does not expect further rate adjustments until fiscal 2018 -- and the ability to raise rates incrementally each year thereafter -- with no additional long-term borrowing until it needs to convert draws on its LOCs to long-term debt. Also unlike PREPA, there is no immediate need to renegotiate or replace the committed lines. They provide PRASA with interim funding for capital expenditures, secured on a senior lien (gross pledge), on parity with the 2008, 2012A and 2012B bonds. The authority also has about $90 million drawn on a $180 million LOC with the Government Development Bank of Puerto Rico (GDB); that line exists through June 2016.

In addition to using increased operating revenue to displace commonwealth appropriations, PRASA must also still fund a capital improvement plan that is driven heavily by mandates from environmental regulators. From fiscal years 2011-2012, the commonwealth made about $175 million in direct subsidization to support the authority's bonds because of insufficient net revenues. A budgetary reserve established from some of the 2012 bond proceeds covered the fiscal 2013 budget gap. Management is working to gain some flexibility for date-certain timelines as well as the scope and magnitude of a number of these projects; discussions regulators are ongoing.

A first lien on PRASA gross revenues secures the senior-lien bonds. The master trust agreement governing the bonds was amended as of March 1, 2012, to provide for a gross lien on the authority's operating revenues to secure the payments of debt service on senior indebtedness and bonds. Although payment of debt service with a gross revenue pledge represents a prior claim on revenues from a covenant perspective, our ratings take into account the entirety of the system's revenue requirements, including operating expenses. Thus, an evaluation on a net revenue basis provides insight into the enterprise's ongoing viability. Neither PRASA's operating revenues or cash are subject to a claw-back or transfers for the purposes of paying certain other commonwealth obligations. The intent of the 2013 rate increase, however, indirectly served the same purpose as it moves the authority toward paying commonwealth-supported debt issued on its behalf from its own surplus net revenues. This effectively frees up that appropriation for other commonwealth general government needs.

Concurrent with the 2012 indenture, PRASA entered an amended fiscal oversight and support agreement with GDB and the commonwealth. This agreement outlines, among other covenants, the requirement for the authority to maintain a budgetary reserve fund equivalent to the expected operating support the authority would require from the commonwealth. Series 2012A bond proceeds funded the budgetary reserve requirement, filling that gap partially in fiscal 2012 and completely in fiscal 2013.

In fiscal 2014, the commonwealth did not make a direct appropriation to PRASA for debt support, with the intent that the authority will fully support all of its financing obligations every year, even if by practice that ability would be reviewed every budget cycle. Other bond provisions include a covenant to maintain rates sufficient to cover annual debt service on the senior bonds 2.5x, senior subordinate debt 2.0x, and on all of PRASA's obligations (including GO-supported debt) 1.0x. In addition, the indenture establishes an additional bonds test that requires annual debt service coverage (DSC) of 2.5x on senior-lien debt, 2x on senior subordinate-lien bonds, and 1.5x on subordinate-lien bonds.

PRASA is the sole water and sewer service provider in Puerto Rico, serving approximately 1.25 million customers. The system consists of a relatively fragmented series of water and wastewater facilities divided into five regional service areas. The primarily residential base has seen little customer growth, given the island's economic profile and population trend. Due to the system's noncontiguous nature and condition, the authority has a very high level of nonrevenue water (slightly less than 60% of total water produced) as well as multiple regulatory violations. Steps to remediate these problems include large-scale meter replacements, more aggressive collections, staffing reductions, and aggressive efforts to reduce energy demand.

Fiscal 2013 operations generated sufficient coverage of all financing obligations of PRASA only after giving credit for the budgetary reserve fund. However, it also does not reflect the full impact of the 60% rate increase. Although we do not expect operating revenues to grow by an identical amount, we do think that PRASA has moved toward being fully cash flow-positive by the end of fiscal 2014. The most recent forecast indicates all-in DSC of 1x on a net revenue basis on all financing obligations through fiscal 2018. It may be several more years, however, before liquidity can begin to increase appreciably, given system reinvestment needs. No further draws on the budgetary reserve are forecast in 2014 or 2015. We believe that the overall financial risk profile could continue to improve, even if at a measured pace.

Outlook

The negative outlook on the Puerto Rico-backed bond reflects Standard & Poor's outlook on its GO debt. The negative outlook on PRASA's gross-lien revenue bond reflects our view that the climate surrounding all commonwealth obligations is furthering the adverse business conditions in which the authority is operating. A further downgrade to Puerto Rico's GO debt would lead to a downgrade on the guaranteed revenue bonds. An outlook revision to stable would be mainly predicated on what we view as unimpeded, apolitical access to working capital sufficient in nature to support ongoing operations and address the highest priority capital projects.

Related Criteria And Research

Related Criteria

- USPF Criteria: Standard & Poor’s Revises Criteria For Rating Water, Sewer, And Drainage Utility Revenue Bonds, Sept. 15, 2008
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

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