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INVESTORS SERVICE

ISSUER IN-DEPTH
16 MARCH 2015

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RATINGS

PREPA

Long-Term Rating	Caa3
Outlook	Negative

Source: Moody's Investors Service

KEY METRICS:

PREPA

	2014	2013	2012
Days Cash on Hand	13	11	17
Debt Ratio (%)	100.9	113.0	111.0
DSCR (Net Revenue)	0.94	0.88	1.39

Source: Moody's Investors Service

ANALYST CONTACTS

Richard E. Donner 212-553-7226
VP-Sr Credit Officer
richard.donner@moodys.com

A.J. Sabatelle 212-553-4136
Associate Managing Director
angelo.sabatelle@moodys.com

Chee Mee Hu 212-553-3665
MD-Project Finance
cheemee.hu@moodys.com

Puerto Rico Electric Power Authority

Frequently Asked Questions About PREPA

Summary

» **On September 17, 2014, Moody's downgraded the rating for the Puerto Rico Electric Power Authority (PREPA) to Caa3 from Caa2 with a negative outlook.** At the time of the downgrade, the Caa3 rating and negative outlook considered the uncertainty about the details of the expected restructuring plan, the implementation risk concerning the utility's multi-year fuel conversion plan as well our belief that any such debt restructuring would involve some degree of impairment for bondholders. The rating action further recognized PREPA's financial pressures, which include weak liquidity, a significant debt burden, high electricity rates and the need for a large capital investment program to convert its generation fleet to natural gas from oil.

» **Since the downgrade, several events have occurred that have implications for PREPA.** Fuel oil prices, the primary fuel source for electric generation on the island, have declined substantially, which should reduce working capital requirements for PREPA and should lead to lower electric prices for PREPA customers. Also, last month, a US District Court judge struck down a law passed by the Puerto Rican government in June 2014 that would have allowed PREPA to restructure its debt. In the meantime, PREPA is operating its business under a forbearance agreement with its creditors.

» **We believe PREPA is likely to default within a few months, and this is captured in the Caa3 rating.**[1] The Caa3 rating also incorporates the belief that the expected recovery rate in the event of a default could approximate between 65% and 80%. Although the Recovery Act was recently struck down, we still believe PREPA will default given the challenges it faces. PREPA is currently negotiating a restructuring with its bondholders. We expect PREPA to default on or before July 1, 2015, the next scheduled debt service payment date.

» **PREPA's credit is closely related to the credit of the Commonwealth of Puerto Rico (Commonwealth, Caa1 negative) given their mutual dependence on the same economic base, as well as the close relationship on governance, liquidity and rate design.** This credit and rating relationship remains, but both ratings today incorporate increased default risk.

Q: Is PREPA going to default?

Most likely. The Debt Enforcement and Recovery Act (Recovery Act) that the Commonwealth's legislature passed in June 2014 seemed to provide a clear path to a bankruptcy-like reorganization for public corporations in Puerto Rico, including PREPA. Although a federal court recently struck down the Recovery Act, we still believe PREPA will default given the challenges it faces.

PREPA's next debt service payment of approximately $400 million is due on July 1, 2015, covering scheduled principal and interest. PREPA's last debt service payment of $214 million on January 1, 2015, satisfied six months of interest. Based upon PREPA's December 2014 operating report posted on its website, PREPA ended 2014 with total cash (restricted and unrestricted) of $892 million. After making the January 1 debt service payment of $214 million, we calculate PREPA's restricted and non-restricted cash balance to be approximately $678 million.

However, PREPA's capital requirements are sizeable at approximately $300 million annually. Completing the capital investment program is critical to improving the utility's operating efficiency and converting its generation fleet to natural gas from oil-fired. Without access to the capital markets, we believe PREPA will try to preserve as much cash as possible in order to safely run its business and complete its capital spending program. For these reasons, we believe that PREPA will likely enter into a distressed exchange agreement by the end of June or will default on its July 1 payment.[2]

PREPA is currently in negotiations with its bondholders pursuant to the terms of a forbearance agreement signed on August 14, 2014, which provides a framework for the parties to work on a consensual restructuring plan. PREPA recently missed one of the agreement's milestones – that PREPA file a restructuring plan with its bondholders by March 2, 2015. Bondholders have not taken action following this event, and we understand that PREPA and the bondholders continue to work towards a consensual plan.

Q: Are the commonwealth and PREPA's ratings linked?

PREPA's Caa3 rating has been closely related to the Commonwealth's Caa1 rating because of PREPA's reliance on the Puerto Rican economy and the close relationship between the two entities around governance, liquidity and rate design. As such, the ratings tended to be no more than one notch from each other. In fact, PREPA's rating had indeed been higher than that of the Commonwealth, reflecting PREPA's historical strengths, including:

» the sole provider of an essential service to the island

» full rate setting authority

» willingness to raise rates through the fuel adjustment clause

» the existence of a debt service reserve

» a rate covenant in its bond documentation.

The Recovery Act in June 2014 raised default risk substantially for public corporations, like PREPA, and indirectly for the Commonwealth. Our two rating actions on PREPA following passage of the Recovery Act (in June and September 2014) resulted in a four-notch difference between PREPA and the Commonwealth because of the very high default prospects for the utility. Our current Caa3 rating at PREPA captures the high likelihood of default, but also speaks to PREPA's stand alone prospects for recovery.

On February 19, 2015, we downgraded the Commonwealth's rating to Caa1 from B2 along with other Puerto Rico entities owing to continued sluggish economic growth that may accelerate the depletion of Puerto Rico's already very narrow liquidity. The outlook is negative. However, we did not change PREPA's Caa3 rating. Today, there is a two-notch difference between the ratings of the Commonwealth and PREPA, reflecting the increasing probability of default for each entity. We foresee that over time the ratings have the potential to be de-linked, because PREPA faces a near-term default, which could be followed by a restructuring, while the Commonwealth's default prospects, while elevated, do not appear to be as imminent.

Q: What assumptions and analysis did Moody's undertake that support the Caa3 rating?

Our ratings provide opinions about the probability of default and the expected recovery prospects in the event of a default. This is particularly the case for securities rated in the Caa rating category or below. PREPA's Caa3 rating incorporates a high probability of default and a belief that the expected bondholder recovery rate in the event of a default is between 65% and 80%.

We considered several factors in reaching this view. For one, we expect PREPA to continue operating with a monopoly position as the electric utility for Puerto Rico. As such, PREPA will continue to generate revenues and operating cash flow, which we believe enhances long-term recovery prospects. We also recognize that the economy and local politics cannot tolerate a base rate increase at this point and that capital will need to be invested at PREPA in order for the utility's operating efficiency to improve and for it to become less reliant on oil as a primary fuel for electric generation.[3]

PREPA is unlikely to be able to access the capital markets and will need to rely upon internal sources to satisfy these capital requirements. Like most public power entities, PREPA has an amortizing debt schedule. Over the next five years, PREPA has approximately $1.2 billion of scheduled principal maturing, and over the next 10 years, PREPA has approximately $2.8 billion of scheduled principal maturing. Deferring principal payments for some period of time can provide PREPA with a source of capital that will help finance its capital spending program without accessing the debt markets and will defer the need for an electric base rate increase until the economy is on stronger footing.

With the deferral of principal, PREPA could use existing operating cash flow as well as its cash reserves to fund its fuel conversion program to switch from oil-based generation to lower cost natural gas generation and to pay current interest to bondholders. The principal deferment gives PREPA time to complete the conversion and to do so in a rate neutral manner.

Assuming this hypothetical scenario played out, we examined the potential impairment for bondholders under three cases (see Exhibit 1). In each case, we performed a net present value analysis (NPV) and compared each of the outcomes to the NPV of the existing stream of debt service payments without any deferment. For example, under Scenario 1, we examined a hypothetical case whereby principal is deferred for five years, and interest payments remain exactly the same as originally scheduled. The NPV of this stream of payments discounted at 5% is approximately $7.4 billion, as compared to the NPV of the existing stream of debt service payments without any deferment of approximately $8.4 billion (also discounted at 5%). This 12% difference in value suggests a recovery on the deferred bonds of 88%. [4]

Exhibit 1
Potential Impairment for Bondholders Under Three Scenarios

Scenario	Description	Impairment	Expected Recovery
Scenario 1	Defer Principal for 5 years; Remaining current on Interest	12%	88%
Scenario 2	Defer Principal for 10 years; Remaining current on Interest	20%	80%
Scenario 3	Defer Principal and Interest for 5 years. Resumed in year six	23%	77%

Source: Moody's Investors Service

While these hypothetical examples are not intended to represent what may or may not occur in the restructuring currently being negotiated with bondholders, they do provide some transparency into our thinking in arriving at the 65%-80% recovery range, and help provide some information about potential outcomes should a restructuring occur along these lines.

We do believe that PREPA will remain a going concern operating with a monopoly position on the island, and we do believe that it is critical for PREPA's financial recovery to complete the capital investment program in some fashion. For that reason, it is plausible that some form of restructuring along these lines may surface. In the end, it could take longer for PREPA to complete the fuel conversion program and to reach a firm financial footing. Moreover, its ability to secure a firm financial footing is highly dependent on the strength of the Puerto Rican economy, which remains a big uncertainty, and on the supportiveness and predictability of the regulatory framework in which PREPA will operate.

While this analysis suggests that a potential recovery may be in the range of 77%-88%, the actual recovery could be higher or lower depending upon the outcome of a variety of assumptions and factors, many of which are beyond the control of PREPA. However, as indicated by our negative outlook, there are material uncertainties and obstacles to executing on a complex restructuring plan and the fuel conversion program in light of a weak Puerto Rican economy as well as regulatory and political issues that could delay or prevent either a settlement or execution of the capital program. Thus, we think there is greater downside risk than upside potential.

Q: What does the market say about recovery prospects for bondholders?

The market is highly sensitive to news stories related to PREPA, which can be seen in the recent trading history of PREPA's bonds (see Exhibit 2).

Exhibit 2

Trading History Indicates Sensitivity to Developments

Puerto Rico Electric Power Authority (PREPA) Rev 5.05% 01-JUL-2042 (CUSIP: 74526QZY1)

Source: Bloomberg

Over the past year, the bonds have traded as low as 37 cents to as high as 66 cents. As shown above, the bonds traded up to about 60 cents on the dollar at the time of the announcement of Lisa Donahue's appointment as Chief Restructuring Officer of PREPA on September 8, 2014. Bond prices subsequently declined, but moved back towards 60 cents after the Recovery Act was struck down on February 6, 2015.

We anticipate the bonds' prices to continue to fluctuate as information and details concerning a PREPA restructuring are announced, which we expect to occur on or before July 1.

Q: What does the District Court's striking down of the Recovery Act mean for bondholders?

PREPA is still likely to default because its financial position and liquidity remain very weak. On June 28, 2014, the Commonwealth enacted the Recovery Act, which provided a path for public corporations to restructure their debt. PREPA bondholders challenged the Recovery Act, which was subsequently struck down by a US federal judge in February 2015. Judge Francisco Besosa struck down the law, siding with investors on key points of US constitutional and bankruptcy law. The ruling is subject to appeal and does not change the ability of PREPA or other public corporations to restructure their debt or default outside of bankruptcy.

We believe that the ruling does not change the prospects for a PREPA default. We also believe the ruling strengthens the bargaining position of its creditors and may have a positive effect on their recovery prospects. If the restructuring law had been upheld and utilized by PREPA, it would have allowed the utility to unilaterally eliminate or greatly reduce the rights of its creditors. With the judge's ruling, PREPA's options are more limited.

Currently, there is a bill being considered in Washington that, if approved by Congress and passed into law, would allow the Puerto Rican public corporations to file for bankruptcy under Chapter 9 of the bankruptcy code (under jurisdiction of a US federal court).

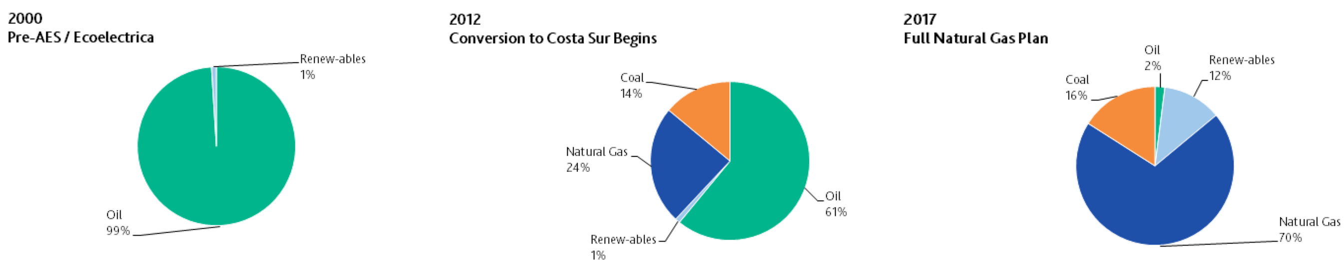
With the bankruptcy option not currently on the table and if parties are unable to reach a consensual restructuring, remedies for a payment default under the PREPA indenture include the appointment of a receiver that has the ability to enforce rights under the indenture.

Q: What are PREPA's fuel diversification plans and how does completion of the plan affect credit quality?

PREPA has historically been highly dependent on fuel oil for electric generation. PREPA's long-term plan is to diversify the fuel mix and to lessen dependence on fuel oil by converting its oil-based power generation to cheaper and cleaner natural gas. We expect the lower fuel costs to enable PREPA to lower rates and help spur economic growth on the island. PREPA introduced natural gas fired generation at PREPA-owned plants with the conversion of a Costa Sur plant in 2012. By 2017, PREPA expects natural gas to represent 70% of its generation mix with fuel oil representing only 2% of the generation output, but this timing is likely to be delayed (see Exhibit 3).

Exhibit 3

PREPA's Generation Fuel Mix



Source: PREPA

While the plan looks promising, there have been delays in plant conversions as well as receiving Federal Energy Regulatory Commission (FERC) approval for a floating offshore terminal on the southern coast intended to bring liquefied natural gas (LNG) to the island to be used by the power plants once they are converted. FERC issued its final Environmental Impact Statement (EIS) on February 24, 2015. The FERC EIS, while coming later than expected, is an encouraging development. That said, we expect additional delays to occur given PREPA's fragile financial situation.

Q: How does the drop in oil prices affect the restructuring or the fuel diversification plan?

It may be counterintuitive, but lower oil prices will not provide material near-term uplift to PREPA. However, the decline may provide longer term benefits if the lower oil price is sustainable. Thus far, PREPA has been passing on the savings from the lower oil price to its rate payers; so PREPA's only benefit is a reduction in working capital needs.

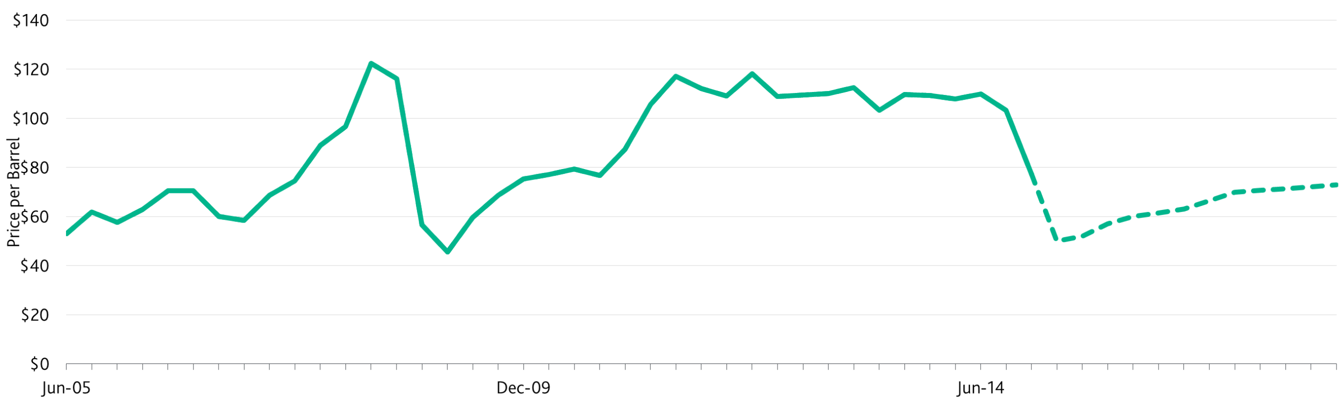
PREPA currently generates about 61% of its electricity from oil. The current price per barrel of Brent crude oil is about $60, down from a high of $115 in June 2014. As of the latest operating report from PREPA, dated December 2014, its average cost per barrel was still high at $86.42, although down from an average of $103.26 per barrel in December 2013.

PREPA's rates remain among the highest in the US, which has been a drag on the Puerto Rican economy and on PREPA's demand growth. According to the same December 2014 operating report, PREPA's average rates were 23.52 cents per kilowatt-hour (kWh). This compares with the average US residential rate of 12.14 cents/kWh, according to the US Energy Information Administration (EIA).

Approximately 50% of PREPA's total rate is made up of the fuel component. Over the long term, however, lower fuel prices will provide benefits to everyone, including PREPA, if the decline helps spur economic growth on the island. Over time, the overall economy should benefit as power bills come down, freeing up disposable income, which could provide some stimulus to the economy.

The expectation of any economic benefit assumes, of course, that low oil prices will continue for the foreseeable future, and as we have seen in the past, prices can be quite volatile. Exhibit 4 depicts Moody's Macroeconomic Board outlook for Brent oil through 2016.

Exhibit 4
Oil Prices Expected To Remain Below Recent Highs Through 2016



Source: Bloomberg, Moody's Investors Service

We expect that oil prices for 2015 will average $55/barrel and increase to $65/barrel during 2016. This view reflects an assumption that cuts in US oil production will diminish oil inventories during the second half of 2015 and into 2016 consistent with already announced capital expenditure cuts. On the demand side, we expect oil demand will increase by around 1 million barrels per day in 2015.

We continue to believe that the fuel diversification plan and cost reduction strategy are key to PREPA's long-term fiscal stability. That said, the lower fuel costs may cause certain capital spending projects to be delayed, which from a capital preservation standpoint is a positive.

Q: What is the timeline and what happens next?

Under the terms of the forbearance agreement, PREPA was required to provide a structuring plan to its bondholders by March 2, 2015. PREPA missed that deadline, but forbearing creditors have not taken any adverse actions. We understand that negotiations are continuing. This is a complex restructuring, and certainly a possibility exists that a consensual agreement cannot be reached. The next debt service payment of principal and interest is due on July 1, 2015. We believe that should a consensual restructuring plan surface, it will be announced on or before the July 1 payment date, because the failure to make a principal payment on July 1 triggers an event of default. Furthermore, we believe that creditors will not be willing to allow PREPA to provide a principal reduction payment to bondholders, since not all creditors would benefit equally, and the payment would have a negative impact on PREPA's liquidity.

Moody's Related Research

Moody's Rating Symbols & Definitions Research Guide, August 2014

PREPA related research:

Issuer Comments:

» Commonwealth of Puerto Rico and PREPA: Debt Restructuring Law's Rejection: Does Not Change Fundamental Credit Risk

» Puerto Rico Electric Power Authority and Commonwealth of Puerto Rico: Low Oil Prices Won't Provide Material Near-Term Uplift to Puerto Rico or PREPA, But May Help Longer Term

» PREPA Extends Bank Lines to Early 2015, but Longer-Term Liquidity and Structural Issues Remain

» PREPA Buys Time with Lenders, but Liquidity and Structural Issues Remain

» Puerto Rico Adopts Debt Restructuring Law, Increasing Default Risk for Public Corporations

Rating Action:

» Moody's downgrades PREPA's ratings to Caa3 from Caa2; outlook negative

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

» Moody's downgrades PREPA's ratings to Ba3 from Ba2; Remains under review for further downgrade

» Moody's downgrades PREPA's ratings to Ba2 from Baa3; outlook negative

Rating Update:

» Moody's downgrades PREPA's ratings to Caa3 from Caa2; outlook negative

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

» Moody's downgrades PREPA's ratings to Ba3 from Ba2; Remains under review for further downgrade

» Moody's downgrades PREPA's ratings to Ba2 from Baa3; outlook negative

Sector Comment:

» Judge's Rejection of Puerto Rico Debt Restructuring Law Does Not Change Credit Risk

Commonwealth of Puerto Rico related research:

Credit Focus:

» Puerto Rican Banks Show Varying Resilience to Economic and Fiscal Stress

» Puerto Rico's Liquidity Remains at Risk Despite Recent Borrowing and Restructuring Law

» Puerto Rico Restructuring Law Drives Ratings Deeper Into Speculative Territory

» Puerto Rico Budget Proposal Targets Improved Finances, But Comes With Risks

» Key Drivers: Commonwealth of Puerto Rico Downgrade

Issuer Comments:

- Commonwealth of Puerto Rico and PREPA: Debt Restructuring Law's Rejection Does Not Change Fundamental Credit Risk
- Puerto Rico Electric Power Authority and Commonwealth of Puerto Rico: Low Oil Prices Won't Provide Material Near-Term Uplift to Puerto Rico or PREPA, But May Help Longer Term
- Puerto Rico (Commonwealth of): Declining Liquidity Underscores Government Development Bank and Puerto Rico's Financial Stress
- Puerto Rico Legislation Imperils Bond Issuance that Would Boost Development Bank Liquidity
- Puerto Rico Government Development Bank: Commonwealth Faces Narrowed Liquidity, Continued Reliance on Bond Market Access
- Puerto Rico: Court Affirms Doral Tax Pact, Potentially Adding to Puerto Rico's Fiscal Stress

New Issue:

- Moody's assigns provisional (P) Ba2 to Puerto Rico's planned $3.5B GO Ser 2014 A; outlook negative

Précis State:

- Puerto Rico Précis

Rating Action :

- Moody's downgrades Puerto Rico GO bonds to Caa1 from B2, COFINA to B3/Caa1 from Ba3/B1
- Moody's confirms Puerto Rico water, highway, and convention center ratings at Caa1; revises outlook to negative
- Moody's downgrades PREPA's ratings to Caa3 from Caa2; outlook negative
- Moody's downgrades Puerto Rico GOs to B2 from Ba2, COFINA Senior-Sub to Ba3-B1; outlooks negative
- Moody's downgrades Puerto Rico Aqueduct & Sewer, Highway & Transportation authorities to Ba3; ratings under review
- Moody's removes 'provisional' designation from Ba2 on Puerto Rico's GO sale; outlook negative

Rating Update :

- Moody's downgrades Puerto Rico GO bonds to Caa1 from B2, COFINA to B3/Caa1 from Ba3/B1
- Moody's downgrades PREPA's ratings to Caa3 from Caa2; outlook negative
- Moody's downgrades Puerto Rico GOs to B2 from Ba2, COFINA Senior-Sub to Ba3-B1; outlooks negative
- Moody's downgrades Puerto Rico Aqueduct & Sewer, Highway & Transportation authorities to Ba3; ratings under review
- Moody's removes 'provisional' designation from Ba2 on Puerto Rico's GO sale; outlook negative
- MOODY'S DOWNGRADES TO A1 PUERTO RICO`S LOC-BACKED PUBLIC IMPROVEMENT REFUNDING BONDS SER. 2003 C-5-2

Sector Comments:

» Puerto Rico's Debt Restructuring Law Raises Default Risk for Public Corporations and the Commonwealth

» Puerto Rican Court Rejects Teachers Pension Reforms, a Negative for the Commonwealth

Sector Insights:

» Puerto Rico's Default Risk Jumps, Argentina's Slumps (Capital Markets Research)

» Puerto Rico's Credit Risk Measures Reach a Five-Year High (Capital Markets Research)

» Puerto Rico's Credit Risk Measures Worsen as Economy Continues to Stumble; Russia Unstable (Capital Markets Research)

» Puerto Rico: Market Signals More Worry (Capital Markets Research)

Endnotes

1 Please see Moody's Rating Symbols and Definitions for our definition of default, which differs somewhat from the typical definition of a default in most loan agreements and bond indentures. Notably, the Moody's definition excludes technical defaults, but it generally includes missed interest or principal payments (after grace periods), even if waived, as well as distressed exchanges, even if they were consensual – e.g., the issuer received a waiver from its creditors for any contractual defaults under financing agreements in conjunction with the exchange.

2 Per Moody's definition, a missed payment default occurs after any grace period permitted in the financing agreement has lapsed.

3 In the longer term, lower oil prices, if sustained, may provide an eventual opportunity to increase base rates, since overall rates are lower when the fuel costs are low.

4 These illustrative recovery percentages may not be representative of bond prices upon restructuring. The 5% rate in the illustrative examples is based upon PREPA's approximate weighted average cost of debt. The 5% discount rate would indicate that bond investors have a high degree of confidence that they will receive the restructured payment stream. If there were more uncertainty about PREPA's ability to service restructured debt, the discount rate would rise and recoveries would be lower.

AUTHOR
Rick Donner