FITCH RATES PUERTO RICO ELECTRIC POWER AUTH'S $453.8M POWER REV BNDS 'BBB+'; OUTLK TO NEGATIVE

Fitch Ratings-New York-28 March 2012: Fitch Ratings assigns a 'BBB+' rating to the following Puerto Rico Electric Power Authority's (PREPA) bonds:

--$461.5 million power revenue bonds, series 2012A;
--$19.7 million power revenue refunding bonds, series 2012B.

Bond proceeds will fund a portion of planned capital expenditures through fiscal 2013, repay short-term borrowings payable to the Government Development Bank (GDB), pay capitalized interest through Jan. 1, 2015 (2012A bonds), and economically refund certain series II outstanding power revenue bonds. Bonds are expected to price via negotiation during the week of April 9, 2012.

Fitch also affirms the 'BBB+' rating on $8.1 billion outstanding parity PREPA power revenue bonds.

The Rating Outlook is revised to Negative from Stable.

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

KEY RATING DRIVERS

SOLE POWER PROVIDER: PREPA is essential to the Commonwealth of Puerto Rico as it is the sole provider of electricity on the island. PREPA is the largest municipal power system in the U.S., in terms of customers (1.47 million) and revenues ($4.4 billion).

TIGHTENED FINANCIAL PERFORMANCE: The Outlook revision to Negative reflects slimmer operating margins and cash flow in fiscal 2011 and prospectively, due to the effects of ongoing economic recession, escalated fuel costs, declining electricity usage, mounting accounts receivable and the authority's reluctance to increase electric base rates.

GDB LIQUIDITY SUPPORT: PREPA had to rely on borrowings from the GDB (fiscal agent for all governmental entities in Puerto Rico) and other banks to adequately meet operating and debt service costs (in 2008 and 2011) given the tightening of operating cash flow. Positively, management and the GDB are working to reduce operating expenses, improve collections, and bolster cash flow.

DIVERSYFING POWER SUPPLY: A key credit positive is management's focus on reducing dependency on oil-fired generation via combination of renewable power purchases and conversion of existing plants to dual fuel (oil and natural gas) generation. Oil generation dependency is projected to decline from 65% currently to 41% by 2016. Further conversions are planned, but subject to challenge.

RECEIVABLES REMAIN HIGH: Total receivables remain high at 26.7% of 2011 revenues, an ongoing negative credit factor. Management has achieved some success in reducing government and municipal receivables the past few years with the support of the GDB, but private customer receivables have grown.

BROAD BUT WEAKENED SERVICE AREA: PREPA's retail customer base is well-diversified, excluding the governmental sector, and not as heavily dependent on tourism as other islands. However, the Commonwealth (GO debt rated 'BBB+': Stable Outlook by Fitch) remains economically weak, with a declining population base and comparatively low income levels.

AVERAGE ELECTRIC RATES: PREPA's average retail revenue per kilo-watt hour (27.5 cents at Dec. 31, 2011) is among the highest for U.S. municipal systems, but in-line with other island systems.

WHAT COULD TRIGGER A RATING ACTION

FAILURE TO STABILIZE CASH FLOW: PREPA's inability to achieve projected cash flow improvements through its current initiatives including power supply diversification, operating cost cuts, and improved revenue billing and collections, or through base rate increases could result in a negative rating action.

DEBT FINANCING OF BUDGET DEFICITS: A continued reliance on borrowings to adequately meet costs (including debt service) could result in further negative rating action.

CREDIT SUMMARY

PREPA is one of the largest public power systems in the U.S., and the sole provider of power to the Commonwealth of Puerto Rico, an island of 4 million people. The authority has historically operated independent from the commonwealth and has been allowed to pass through the costs of fuel and purchase power costs on a monthly basis.

Higher generating reserves are required for PREPA as an island system, which has a total of 5,839 megawatts (MW) of owned and purchased capacity compared with the 2011 peak load of 3,406 MW. Concentration of resources in oil exposes PREPA to volatile fuel costs and environmental mandates.

Fitch views the authority's efforts to diversify its energy mix as positive and believes the generation conversions to natural gas should alleviate some of the pressure on future financial margins. Fitch will be monitoring PREPA's progress over the next 24 months to stabilize its financial position and achieve projected stronger operating cash flow levels - sufficient to cover total costs, including debt service.

FINANCIAL PERFORMANCE HAS WEAKENED

PREPA's financial performance has weakened since 2007 due to the protracted and deep economic recession in the Commonwealth, exceptionally high fuel oil costs and declining customer usage. In addition, substantial customer receivables persist (in excess of 23% of total revenues each year) resulting in considerable operating cash flow shortfalls. For fiscals 2008 and 2011, Fitch-adjusted cash flow was not sufficient to cover operating and debt service costs. For the first six months of fiscal 2012, PREPA's fiscal challenges have not abated as fuel prices remain high (average of $117/barrel) and electricity sales are down 2.6% from the same period in the prior year.

Positively, management is taking increasingly aggressive steps to strengthen the utility's financial profile via a combination of cost reduction efforts and improved collection of government account receivables. The cost cutting efforts have included reducing staff positions, lowering healthcare benefits, and reducing overtime expense. PREPA also reduced the system's capital improvement plan to $1.75 billion (or $893.6 million less than originally planned in fiscal 2006), while still implementing the most needed and key strategic improvements for system reliability and fuel diversity.

PROSPECTIVE OPERATING COST REDUCTIONS UNCERTAIN

Prospectively, PREPA plans to cut operating expenses (non-fuel) more than $100 million through fiscal 2016. Additionally, through the use of more natural gas fired generation (33% of energy mix by 2016) and the new fuel procurement model, PREPA anticipates more than $660 million in annual fuel cost savings by 2016.

Assuming PREPA can continue to improve collections of government and municipal receivables, PREPA projects debt service coverage, from operating cash flow, of 1.42 times (x)-2.24x, through fiscal 2016 with no base rate increases. Coverage of full obligations, which offsets net revenues by the amounts contributed in lieu of taxes and municipal subsidies, brings debt service coverage closer to 1.0x, a slim margin of coverage but acceptable for the rating category, if achieved.

RATE RELIEF UNLIKELY

Fitch's Negative Outlook takes into account that PREPA is facing a confluence of fiscal and operational challenges that could jeopardize forecast cost reductions. Fitch believes that there is a low likelihood that base rate increases would be implemented to improve financial performance.

HISTORICALLY HIGH ACCOUNTS RECEIVABLE

Puerto Rico's economy is weak and wealth and income indicators are well below those of the mainland U.S., which contributes to PREPA's high level of accounts receivables (A/R). Since 2007, net A/R have been greater than 23% of total revenues, one of the highest percentages of any Fitch-rated public power utility and twice the median for all retail systems.

The size of the net A/R balance is a credit concern, although progress is being made with respect to government and municipal receivables in particular. The total net A/R balance is at $1.18 billion for fiscal 2011, which is 21% higher than the prior year balance. This significant jump in receivables for fiscal 2011 directly correlates to the substantial increase in oil prices (from average of $76.6/barrel in 2010 up to $95.9/barrel in 2011), which is automatically passed-through to customers via the fuel surcharge.

Contact:

Primary Analyst
Dennis Pidherny
Senior Director
+1-212-908-0738
Fitch, Inc.
One State Street Plaza
New York, NY 10004

Secondary Analyst
Lina Santoro
+1-212-908-0522

Committee Chairperson
Alan Spen
Senior Director
+1-212-908-0594

Media Relations: Sandro Scenga, New York, Tel: +1 212-908-0278, Email: sandro.scenga@fitchratings.com.

Additional information is available at 'www.fitchratings.com'. The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.

Applicable Criteria and Related Research:
--'Revenue-Supported Rating Criteria', June 20, 2011;
--'U.S. Public Power Rating Criteria', Jan. 11, 2012.

INTEREST, AFFILIATE FIREWALL, COMPLIANCE AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE 'CODE OF CONDUCT' SECTION OF THIS SITE.