

AUSTIN, Texas--([BUSINESS WIRE](#))--Fitch Ratings downgrades the following ratings on Puerto Rico Aqueduct and Sewer Authority, Puerto Rico (PRASA, or the authority):

--Approximately \$3.4 billion of outstanding revenue bonds, series A, B, 2012A and 2012B (senior lien), to 'BB+' from 'BBB-'.

The Rating Outlook remains Negative.

SECURITY

The bonds are secured by a gross lien of all authority revenues related to PRASA's combined water and sewer system (the system), as defined in the amended master agreement of trust (MAT), senior to all other debt or expenses of PRASA. Authority revenues include operating revenues, as defined in the amended MAT (e.g. user charges and impact fees), as well as governmental funds available to pay current expenses; amounts from the Commonwealth of Puerto Rico (the commonwealth) for payment of commonwealth guaranteed indebtedness (CGI) or commonwealth supported obligations (CSO); and any amounts transferred from the budgetary reserve fund, as created in the amended and restated Fiscal Oversight Agreement between PRASA, the commonwealth and the Government Development Bank for Puerto Rico (GDB). The authority revenues received from the commonwealth for CGI and CSO are not subject to lien of the MAT and are not available to pay debt service on the bonds.

KEY RATING DRIVERS

COMMONWEALTH DETERIORATION DRIVES PRASA DOWNGRADE: The credit deterioration and recent downgrade of the commonwealth's general obligation (GO) rating to 'BB' Negative Outlook due to a weak economy and challenges to liquidity and capital markets access pose the same obstacles to PRASA warranting a downgrade to below investment grade. However, PRASA's improving financial and debt profiles currently keep the authority's rating from falling further. The Negative Outlook on the authority's bonds includes possible additional capital and service area pressures that could adversely affect

the authority's financial profile over the long term, particularly in the event further deterioration of the commonwealth's GO occurs.

SELF-SUFFICIENT OPERATIONS FROM RATE HIKE: PRASA enacted a 67% average rate increase for the current fiscal year which has allowed PRASA to become self-sufficient without assistance from the commonwealth and GDB, alleviating a major concern that had developed. Year to date collections are in line with PRASA's projections and annualized figures are expected to produce sound financial results for not only fiscal 2014 but the next several years as well without support of the commonwealth or GDB.

FAVORABLE CAPITAL DEVELOPMENTS: The capital improvement program (CIP) continues to be substantial but negotiations with regulators are expected to lead to a cap in required annual spending by the end of the year. Also, the expected annual cap is expected to be meaningfully less than recent CIP projections.

HIGH UTILITY RATES: The rate hike for fiscal 2014 has pushed residential charges well above Fitch's 2% of median household income (MHI) affordability measure and has increased bad debt levels. However, no additional increases to user charges are forecasted through at least fiscal 2018 and delinquency rates have been within PRASA's budget expectations.

WEAK DEBT PROFILE: Debt levels are high both in terms of absolute dollars as well as the relative percentage of carrying costs to revenues. Costs will also continue to increase as the system pushes forward with its ongoing CIP funding but the rate of growth will slow from previous expectations.

SOLID MANAGEMENT AND COMMONWEALTH/GDB SUPPORT: PRASA management is strong and the system also benefits from GDB advisory support. Unlike recent years where PRASA relied extensively on commonwealth and GDB financial funding, limited to no support is expected over the foreseeable future.

WEAK BUT EXTENSIVE SERVICE AREA: The service territory is diverse, although weak economic conditions have been protracted and customer wealth levels are limited.

ESSENTIAL UTILITY: The system provides an essential service to the residents of Puerto Rico.

RATING SENSITIVITIES

FURTHER COMMONWEALTH CREDIT DECLINE: Continued erosion in the commonwealth's credit quality could heighten concerns regarding PRASA's ongoing market access and long-term service territory fundamentals that are beyond the current rating level.

WEAKENED FINANCIALS: Deterioration in financial results that threatens the authority's expected ongoing self-sufficiency would almost assuredly result in a downgrade given the weakened credit quality of the commonwealth and its constrained ability to provide ongoing support to PRASA.

CREDIT SUMMARY

PRASA provides water service to virtually the entire island, including the roughly 4 million residents and 5 million annual tourists; sewer service is limited to around 60% of the island. After a decade of privatization, operations were transitioned back to the public side in 2004 and the commonwealth reorganized PRASA's board and executive management with the goals of limiting political interference, improving the organizational structure, and returning the authority to financial viability without commonwealth subsidization. Since this change, operating, financial, and regulatory performance have improved overall although challenges persist.

MARKET ACCESS ENVIRONMENT CHALLENGED

The authority has meaningful market access risk exposure stemming from certain lines of credit (LOCs) with local banks that come due over the course of the next year and will

need to be refinanced with long-term debt or renegotiated for an extended term. The LOCs total \$350 million and are expected to be fully drawn for fiscal 2014 and 2015 capital projects leading up to the termination of the agreements in March 2015.

The recent deterioration in the credit quality of both the commonwealth and PRASA is expected to lead to higher borrowing costs for the authority at a minimum when PRASA seeks to take out the LOCs, which may in turn reduce the authority's financial results from current expectations. There is also the possibility, albeit considered relatively unlikely by Fitch, that (a) PRASA would be unable to either access the capital markets to take out the LOCs or (b) that PRASA's current LOC bank consortium would be unwilling to extend the LOCs for a period of time until market access became feasible, either of which situation would lead to an event of default on the LOCs and consequently the senior lien bonds; the LOCs are senior lien obligations that are on parity with the bonds. The higher capital cost structure and the existence of market access risk are better reflected at the current 'BB+' level considering PRASA's other credit factors.

RATE HIKE LEADS TO MODEST BUT SELF-SUFFICIENT OPERATIONS

Apart from recent market access and rising cost structure concerns, the most pressing weakness for PRASA over the last few years has been a significant budget gap that had developed and was growing from lack of rate action. The gap had required commonwealth and GDB support as well as deficit financing. For fiscal 2013, a \$145 million budget gap was met from 2012 bond proceeds. But starting with fiscal 2014, projections pointed to the budget gap widening to \$342 million and escalating annually thereafter. PRASA had received both direct and indirect commonwealth support in prior years to balance operations, but the commonwealth determined not to provide an appropriation for PRASA for fiscal 2014, requiring PRASA's governing board to begin the process of revising its rate structure in accordance with the rate covenant under the MAT securing the bonds.

The approved rate hike, which became effective at the beginning of fiscal 2014, resulted in an average increase in user charges of 67%. The adjustment as enacted was designed to provide self-sufficient operations not only for fiscal 2014 but also for each year through fiscal 2018. The anticipated positive financial performance helps to address the concern of self-sufficiency over an extended period of time. Also, there is some positive consideration from the rate adjustment being implemented at once as opposed to piecemeal over multiple years where future political interference could have derailed one or more annual rate hikes.

On the negative side, residential charges which were already on the high side (2.2% of MHI) have now jumped to around 3.3% of MHI as a result of the rate increase. The escalation in user charges has correlated to a spike in bad debt expenses (to around 10% from roughly 3% in fiscal 2013) and reduced user flows somewhat. However, PRASA's budget estimates for bad debt and consumption are in line with actual results.

Overall, the rate adjustment has improved PRASA's recurring revenue base to the point that total debt service coverage (DSC) for fiscal 2014 is expected at 1.12x without consideration of any possible transfers to the rate stabilization fund (RSF); any transfer to or from the RSF would result in an offsetting change in pledged revenues in the year of the transfer. Senior lien DSC for fiscal 2014 is expected at 4.47x in accordance with the MAT's calculation. Using the more traditional net revenue method that Fitch applies to all utility credits, senior lien DSC for the year is expected at 1.51x.

Total DSC in almost all other years through the fiscal 2018 forecast is scheduled to be lower than fiscal 2014 results and be near sum-sufficient operations without taking into consideration any potential RSF transfers for the year. Senior lien DSC will also be lower but should remain favorable given around 30% of debt service costs are related to liens subordinate in payment to PRASA's senior lien bonds. The slimmer out-year DSC margins are the result of generally annual moderate increases to operating expenses and costs related to additional planned borrowings.

Fitch believes PRASA's projections are reasonable and achievable given revenue collections for the first one-half of fiscal 2014 have largely mirrored budget expectations (less than a 1% difference overall) and PRASA has significant certainty with regards to its two largest operating costs for much if not all of the forecast period. In essence, PRASA has labor agreements with the majority of its workers that extend into fiscal 2016, with contractual salary adjustments programmed into the cash flows. Also, PRASA now receives a preferential power rate from Puerto Rico Electric Power Authority and this rate will drop in fiscal 2017, generating savings for the authority which are required by law to be used for the authority's capital needs. Consequently, PRASA's future borrowing demands will be reduced from prior estimates, helping to alleviate pressure on PRASA's already weak debt profile.

ELEVATED DEBT BURDEN BUT FAVORABLE CAPITAL DEVELOPMENTS

Central to PRASA's challenges has been the scope of needed capital investment to maintain regulatory compliance and renew system assets given the limited historical investment in the system's infrastructure and the resulting pressure this places on operations. The system traditionally has relied on borrowable resources to meet its capital demands and this has resulted in an elevated debt profile. For fiscal 2013, the authority's debt per customer of \$2,555 was over 60% higher than Fitch's 'AAA'-'A' category medians. Similarly, PRASA debt to net plant for the same period was 1.6x greater than the same rating group median.

For the five-year period covering fiscals 2014-2018, CIP costs remain elevated at \$1.4 billion, which will lead to an additional weakening in PRASA's debt profile. However, forecasted capital expenditures are down around \$100 million from last year's CIP. More importantly, PRASA is in the final stages of renegotiating its consent decree (CD) with regulators that should have a significant positive effect on PRASA's ongoing operations and its ability to plan and deploy capital assets.

Unlike other traditional CDs that detail specific projects and set out strict milestones, PRASA's proposed CD will be groundbreaking in that it will institute a cap on PRASA's required annual spending based on the authority's overall financial capacity to support the capital program. This spending cap, while still a significant amount, is expected at around \$200 million to \$250 million annually or around a 10%-30% reduction in ongoing CIP levels.

PRASA will work with regulators to identify and prioritize projects that address system regulatory issues within the annual spending cap. On the negative side, this will mean that there will be no definitive termination date of the proposed CD, providing regulators the ability to add or delete projects from the priority list indefinitely. However, because the proposed CD would be all-encompassing it would protect PRASA from infractions associated with current and future regulations and would also require that any projects to address future regulations would only be funded if it was within PRASA's approved annual spending level. PRASA expects the proposed CD to be filed with the court and become final before the end of the year.

For more information on the commonwealth, see Fitch press release 'Fitch Downgrades Puerto Rico GO and Related Debt Ratings to 'BB'; Outlook Negative', Feb. 11, 2014.

Additional information is available at ' www.fitchratings.com '.

In addition to the sources of information identified in the U.S. Municipal Revenue-Supported Rating Criteria, this action was additionally informed by information from Creditscope.

Applicable Criteria and Related Research:

--'Revenue-Supported Rating Criteria', June 2013;

--'U.S. Water and Sewer Revenue Bond Rating Criteria', July 2013;

--'2014 Water and Sewer Medians', December 2013;

--'2014 Outlook: Water and Sewer Sector', December 2013.

Applicable Criteria and Related Research:

Revenue-Supported Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=709499

U.S. Water and Sewer Revenue Bond Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=715275

2014 Water and Sewer Medians

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=724358

2014 Outlook: Water and Sewer Sector

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=724357

Additional Disclosure

Solicitation Status

http://www.fitchratings.com/gws/en/disclosure/solicitation?pr_id=820922

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Written by Australian Business

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BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY
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