

Summary:

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

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Credit Profile

US\$1879.675 mil rev bnds 2012A (senior lien) ser 2012A due 07/01/2047

Long Term Rating

BBB-/Stable

New

US\$270.6 mil rev bnds (senior lien) ser 2012B due 07/01/2023

Long Term Rating

BBB-/Stable

New

Rationale

Standard & Poor's Ratings Services assigned its 'BBB-' rating to Puerto Rico Aqueduct & Sewer Authority's (PRASA) series 2012A and series 2012B senior-lien revenue bonds. The outlook is stable. In addition, Standard & Poor's affirmed its 'BBB-' rating and stable outlook on the authority's senior-lien obligations currently outstanding. We are also affirming our 'BBB' rating and stable outlook on the authority's bonds guaranteed by the full faith and credit pledge of the commonwealth of Puerto Rico (BBB/Stable).

The ratings on the senior-lien bonds include a one-notch lift from the authority's 'bb+' stand-alone credit profile, based on the application of our criteria for government-related entities (GREs). In accordance with our criteria for GREs, our view of a high likelihood of extraordinary government support reflects our assessment of PRASA's very strong link with the government of Puerto Rico, and our assessment of PRASA's important role as the provider of water and sewer services in the island. The assessment also reflects the history of support Government Development Bank for Puerto Rico provides, and its stated intentions to continue to support the authority as required.

Factors that constrain the rating 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;
- Historically poor financial performance, stemming from unwillingness to raise rates, deficient billing and collection systems, and low levels of liquidity, all of which historically constrained the utility from generating consistent operating surpluses. PRASA has, however, made significant strides over the past two years to restore the system's financial operations;
- Estimated \$1.5 billion in identified capital improvements over the next five years, stemming primarily from compliance-related mandatory projects, as well as other critical system improvements. As much as \$1.2 billion of the identified projects may be funded with external financing sources.

Factors that moderate these credit limitations include:

- Continued liquidity support from the Commonwealth of Puerto Rico through lines of credit provided by the Government Development Bank for Puerto Rico (GDB). These revolving credit lines totaled approximately \$1.1

billion at the end of fiscal 2011; and

- A supportive regulatory environment in which PRASA does not require legislative action to implement rate adjustments, and has full authority to cut off service to delinquent accounts.

The authority plans to use the proceeds from the approximately \$1.8 billion in series 2012A bonds to refund approximately \$1.1 billion in credit lines supported by GDB, to fund approximately \$361.1 million in capital improvement projects, and \$240 million in a budgetary reserve fund, as well as other costs of issuance. The approximately \$270 million in series 2012B bonds will primarily fund the repayment of a bond anticipation note and a credit line with GDB.

The senior-lien bonds are secured by a first lien on the gross revenues of the authority. The master trust agreement governing the issuance of the senior-lien 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 an ordinal perspective, our ratings do not reflect this payment order. Revenues diverted for debt service could effectively shut down the entity if operations and maintenance went unpaid for more than a short time. In our view, such an event could risk operations, including revenue collections, and the ability to continue to produce revenues for debt service.

As part of this issuance, the authority has entered into an amended fiscal oversight and support agreement with GDB and the commonwealth of Puerto Rico. This agreement outlines, among other covenants, the requirement for the authority to maintain a budgetary reserve fund equivalent to the anticipated operating support the authority would require from the commonwealth of Puerto Rico. For fiscals 2012 and 2013, this budgetary reserve requirement (estimated at \$240 million) will be funded with proceeds from the series 2012A bonds. Beyond fiscal 2013, the authority's need for continued support from the commonwealth will be determined on an annual basis, and will consider the impact of potential rate adjustments on the authority's revenues. Other legal provisions include a covenant to maintain rates sufficient to cover annual debt service on the senior bonds by 2.5x, senior subordinate debt by 2.0x, and on all of PRASA's obligations (including general obligation [GO] supported debt) by 1.0x. In addition, the indenture establishes an additional bonds test that requires debt service coverage (DSC) of 2.5x annual debt service on senior-lien debt, 2.0x annual DSC on senior subordinate-lien bonds, and 1.5x annual DSC on subordinate-lien bonds.

PRASA is the sole water and sewer service provider in Puerto Rico, serving approximately 4 million residents and 5 million tourists that annually visit the island. The system consists of a relatively fragmented series of water and wastewater facilities divided into five regional service areas. The primarily residential customer base, currently composed of 1.29 million combined water and sewer million water accounts, has exhibited a relatively steady 0.6% annual customer growth. Due to its fragmented nature and the lack of adequate capital investment, the authority has a very high level of unaccounted-for water (approximately 64% of total water produced) as well as multiple regulatory violations, which management is currently addressing by improving its collection efforts and aggressively pursuing its meter replacement program.

Historically, PRASA has required operating and capital subsidies from the Commonwealth's general fund. The authority's poor financial condition stemmed primarily from an unwillingness to raise rates for nearly 20 years, which depleted the system's liquidity and limited its ability to maintain and improve its facilities. While PRASA has the authority to increase rates subject to a public hearing, it has not done in the past four years given economic conditions in the island. Based on the oversight agreement signed between the authority, GDB, and commonwealth,

the funding of the budget reserve with proceeds from the issuance of the series 2012A bonds is expected to replace the operating support from the commonwealth in fiscal years 2012 and 2013. However, continued operating support from the commonwealth may be required beyond fiscal 2013, particularly if the authority does not pursue rate adjustments. In the past four years, management has chosen to boost revenue by improving the operational efficiency and collection systems instead of raising rates. In addition, the current administration has focused on expenditure reduction initiatives including the elimination of 928 positions since 2008, which has generated an estimated \$37 million in annual savings. The combined average residential monthly bill of approximately \$35.57 (for about 4,491 gallons or 17 cubic meters of use) remains below average, which should provide the authority with additional flexibility to implement the authorized rate adjustments.

Fiscal 2011 net available revenues (excluding commonwealth appropriations) provided 1.6x coverage of annual senior debt service, which we consider good. The authority's financial projections for the next five years specify annual gross revenue DSC of at least 2.65x on the senior-lien bonds, and 1.02x annual DSC on all of the authority's debt, including bonds guaranteed by the commonwealth of Puerto Rico. Calculated on a net revenue basis, the authority's projections result in annual DSC of at least 1.3x on its senior-lien debt and approximately 1.02x on all of the authority's obligations. These projections, however, are based on the assumption that the authority will generate additional revenues of \$335 million in fiscal 2014, \$390 million in fiscal 2015, and \$425 million in fiscal 2016 either through rate adjustments, or continued replenishment of the budgetary reserve fund with contributions from the commonwealth of Puerto Rico. System liquidity, not including the operating reserve required by the 2008 ordinance, was adequate at 35 days of operations at the end of fiscal 2011. However, the system's liquidity has been consistently boosted by credit support from GDB and contributions from the commonwealth.

Outlook

The stable outlook on the senior bonds reflects Standard & Poor's expectation that management will continue to demonstrate a willingness to address the identified operational, financial, and capital challenges currently facing PRASA. The stable outlook on the guaranteed bonds reflects the rating outlook on Puerto Rico's GO debt. The outlook on both the senior bonds and the guaranteed bonds also reflects our view of PRASA's very strong link with the government of Puerto Rico, and our expectation of the government's continued strong liquidity support. The adoption of legislation that limits PRASA's ability to implement the necessary rate increases to address its capital and operational needs would cause downward pressure on the rating. Conversely, consistently positive financial operations could result in upward pressure on the rating.

Related Criteria And Research

- 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

Ratings Detail (As Of February 7, 2012)

Puerto Rico Aqueduct & Swr Auth		
<i>Long Term Rating</i>	BBB/Stable	Affirmed
Puerto Rico Aqueduct & Swr Auth rev rfdg bnds (Commonwealth Guaranteed) ser 2008B dtd 03/18/2008 due 07/01/2023 2028 2047		
<i>Long Term Rating</i>	BBB/Stable	Affirmed

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

Ratings Detail (As Of February 7, 2012) (cont.)

Puerto Rico Aqueduct & Swr Auth (Senior Lien)

Long Term Rating

BBB-/Stable

Affirmed

Puerto Rico Aqueduct & Swr Auth (Senior Lien) ser B

Long Term Rating

BBB/Stable

Affirmed

Puerto Rico Aqueduct & Swr Auth (Senior Lien) (ASSURED GTY)

Unenhanced Rating

BBB-(SPUR)/Stable

Affirmed

Many issues are enhanced by bond insurance.

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