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FITCH DOWNGRADES PUERTO RICO ELECTRIC POWER AUTHORITY REVS TO 'BBB+'; OUTLOOK STABLE

Fitch Ratings-New York-12 October 2009: Fitch Ratings downgrades the Puerto Rico Electric Power Authority's (PREPA) outstanding power revenue bonds to 'BBB+' from 'A-'. The Rating Outlook is Stable.

The downgrade reflects a declining trend in the utility's financial profile, reduced electric sales, and economic pressures affecting customer delinquencies. As of fiscal year ended 2008 operating margins have declined to 4% from a historical average of 14%; debt service coverage (Fitch's calculation) was 1.23 times (x) down from an average of 1.50x (2004-2007); and liquidity is down to eight days from an already low 19 days in 2007. The deterioration in financial performance continued through fiscal year ended 2009 (fiscal year ends June 30) with PREPA's operating margin declining to negative 4% based upon unaudited results.

The 'BBB+' rating and Stable Outlook take into account management's steps to strengthen the utility's financial profile through material cost reductions ($89 million in controllable expenses in 2009, $154 million in annual pension obligations, and reductions in staffing) and positive signs associated with the government's fiscal stabilization plan. PREPA has reduced the system's capital improvement plan by $400 million to $1.7 billion for 2009-2014 from $2.1 billion for 2008-2012 while still implementing the most needed and key strategic improvements (for system reliability and fuel diversity). The utility is also working with the government and Government Development Bank (GDB) to ensure timely payment of the governmental agencies' electric bills as well as plans to receive payment of their respective delinquent accounts.

Favorably, the GDB is facilitating these plans with positive results to date on the pay-down of past due accounts. Fitch also factored into its analysis PREPA's progress in reducing private customer delinquencies. Consequently, management expects the resulting cash-flow to be used to pay down certain lines of credit for fuel and working capital needs. While improvements are being made and are expected to continue, Fitch believes that PREPA's financial profile given the system's risk characteristics is more in line with other 'BBB+' utilities. Further financial improvements must continue (in operating margins and liquidity) to off-set the system's economic, fuel and receivables concerns, which will take time.

Historically, PREPA's consistent 1.50x debt service coverage and available lines of credit sufficiently met the utility's operating needs and supported the 'A-' rating. However, PREPA's financial stress increased with the depletion of its lines of credit for fuel (during the run up in 2008), working capital (to off-set increasing governmental receivables), and declining energy sales which were key to supporting PREPA's capital plan and financial position. While Fitch views as a concern the basis swap PREPA entered into in 2008 for an expected present value of $81 million, management notes that the utility's collateral posting on this agreement has declined, freeing much of the system's designated $150 million line of credit. Management has stated that the swap is currently performing well and meeting cash-flow targets with minimal to no collateral posting at this time.

As noted above, PREPA's capital improvement plan and targeted financial profile was largely based upon consistent growth in electric energy sales of about 2% per year. This strategy, along with savings achieved from economic refunding bond transactions, provided PREPA with near term financial relief, and allowed the utility to avoid base rate increases since 1989. As PREPA's sales declined in 2008 and 2009, and account receivables increased, the utility experienced notable declines in its financial operating margins. While no base rate has been implemented to date, based upon Fitch's 2008 report, PREPA officials planned for a base rate increase by 2012. Fitch will continue to monitor this issue to see if and when a base rate increase occurs.

Underpinnings to PREPA's rating continue to reflect the utility's position as sole electricity provider on the island and a governance structure that has historically operated independently from the Commonwealth. Other support includes PREPA's automatic fuel cost pass through which allows the system to recover fuel cost on a timely basis. While PREPA has a high dependence on oil-fired generation, exposing PREPA to volatile costs, the utility has a strategy to diversify its fuel portfolio. Although the island economy has weakened, and has below average income and wealth indicators, PREPA benefits from a diverse economy and customer base that is not solely dependent on tourism.

Key Rating Drivers:

--Continue to improve the financial position via system efficiencies and appropriate base rate increases (DSC of above 1.5x, operating margin returning to double-digit range, and available liquidity sufficient to support the system's needs and in line with similarly rated systems).

--Reduce system accounts receivables and increase collections on past due government and residential customers billings.

--Maintain energy reserve margins at or above the 2006 level of 45%, prior to the December 2006 accidental fires at Palo Seco generating facility.

Fitch will continue to follow up with management regarding its progress on these initiatives.

PREPA is one of the largest public power systems in the United States, serving approximately 1.4 million electric customers and a population of about 4.5 million. PREPA is a vertically integrated utility and the sole provider of power to Puerto Rico. The utility system is comprised of over 5,388 megawatts of owned and purchased capacity with a vast transmission and distribution system. PREPA serves a diverse mix of customers: residential (35%), commercial (45%), industrial (17%), and other (3%).

A full rating report will soon be available at 'www.fitchratings.com'.

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