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Hedge Funds Ready to Back Puerto Rico Bond Sale Despite Rate Cap.

Dec 9 (Reuters) – Puerto Rico imposed an 8.5 percent interest rate cap on a proposed bond sale of up to \$2.9 billion late on Monday, but hedge funds that hold the U.S. commonwealth's debt still appeared likely to back the deal.

Lawmakers added the rate cap to a bill with a 68 percent oil tax hike needed to raise funds to back the bond sale. They also included other conditions such as tying the hike to comprehensive tax reform and delinking it from inflation.

While the conditions are unlikely to endear Puerto Rico to traditional municipal bond investors, they also seemed unlikely to deter hedge funds that have been major buyers of the U.S. commonwealth's general obligation debt.

"The rate limit does not change the broad view on Puerto Rico or the bond sale itself," said a source close to the hedge funds, who declined to be named as details of the transaction were not public.

The bill provides protection for investors such as pledging general tax revenues and allowing investors to sue under a New York jurisdiction in case of legal disputes.

House Finance Committee Chairman Rafael "Tatito" Hernandez Montanez called the approval of the measure a "gigantic achievement" but expressed concerns that the conditions could dampen investors' enthusiasm.

"Last night was a political transaction, not a financial transaction. This is an extremely positive development for Puerto Rico," said Hernandez.

The tax hike, which raises the tax on a barrel of oil to \$15.50 from \$9.25, is unpopular during an austerity drive that has cut government spending by \$1.4 billion this year. Officials said the tax increase will raise \$178 million annually.

The amendments were an attempt by lawmakers to deflect the political blow of the tax. Puerto Rico will hold elections in 2016.

The \$2.9 billion bond issue would be used to repay a \$2.2 billion loan the Highways and Transportation Authority (HTA) has with Government Development Bank (GDB). The funds would shore up the HTA and the GDB, the U.S. commonwealth's financing arm.

A institutional investor who holds Puerto Rico's general obligation debt said a pledge to back the bonds from the general fund would be enough to get hedge funds to buy.

"Having a dedicated tax stream is good but also having the additional protection of the GO guarantee, which gives you access to all available revenues, should make bondholders feel pretty protected," the investor said.

(Reporting by Edward Krudy in New York and Reuters in San Juan; Editing by James Dalglish and Richard Chang)

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