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Puerto Rico Seen Trying to Avert Defaults One Bond at a Time.

Puerto Rico may have to begin taking revenue that repays highway debt to help the struggling commonwealth pay for its general-obligation bonds as soon as this budget year, according to Height Securities.

The Caribbean island, which says it's short $13 billion needed for bond payments in the next five years, must pay investors $1.1 billion this year on general-obligation debt guaranteed by its constitution. That pledge has been increasingly called into question. Standard & Poor's dropped Puerto Rico's rating to CC, the third-worst grade, saying in a report late Thursday that all of its tax-backed debt is highly vulnerable to default.

Facing potential cash shortfalls as soon as November, Puerto Rico may use petroleum and gasoline taxes that fund its highway-agency's debt, raising the risk of a default on the securities, Daniel Hanson, an analyst at Height, a Washington-based broker dealer, said Thursday on a conference call with clients.

"It seems reasonable to expect that considerable amounts of cash are about to be clawed back from corporations to help cover general-obligation debt service," Hanson said.

Governor Alejandro Garcia Padilla on Wednesday released a report showing that Puerto Rico has only $5 billion available to cover $18 billion of principal and interest payments in the next five years. The government also projected that it may run out of cash by the end of 2015 and will have a $500 million shortfall when the fiscal year ends in June, right before an $805 million payment to general obligation bondholders is due July 1.

Puerto Rico said in a May 7 quarterly report that it could resort to emergency measures to cover its debt bills, including taking "taxes or other revenues previously assigned by law to certain public corporations to secure their indebtedness." Its Public Finance Corp. defaulted on debt-service payments in August and September after lawmakers failed to allocated funds.

Puerto Rico's highway bonds carry higher yields than other commonwealth securities, reflecting the risk. Debt maturing in 2028 last traded for an average of 13 cents on the dollar on Aug. 28 to yield 42 percent. That's almost four times the yield on Puerto Rico's most frequently traded general obligations.

Taxes on gasoline and petroleum products that Puerto Rico allocates to its highways agency for debt service are considered "available commonwealth resources," according to bond documents. The island's constitution requires that the government use such revenue to pay general obligations if needed. The island has about $4.7 billion of highway bonds outstanding, according to the May 7 report.

Puerto Rico has about $541 million of mostly petroleum and gas taxes dedicated to highway bonds that it could use in the fiscal year ending June 30, Hanson said. Another $290 million from a petroleum-tax increase implemented last year and not currently pegged to specific debt is also available.

“In accordance with the constitution of Puerto Rico, the proceeds of such taxes and license fees are subject to being applied first to the payment of general obligation debt of and debt guaranteed by the commonwealth,” according to bond documents.

Tolls and other fees from the authority aren’t subject to a so-called clawback. Documents from Puerto Rico’s most recent highway bond sale in 2010 highlighted that it never had to use appropriated money to pay general obligations.

Investors who bought debt knowing they have priority over other bondholders will probably assert their rights in court, Moody’s Investors Service said Thursday in a report. The credit rater maintained its projected recovery rate of 65 percent to 80 percent for general obligations. Highway securities may recoup just 35 percent to 65 percent.

To ease the budget shortfall, the administration may consolidate 135 schools, reduce public-worker overtime, cut government subsidies and end corporate-tax loopholes, according to the report Wednesday. Puerto Rico lawmakers may also want to use the $680 million of annual sales-tax revenue that goes straight to repaying other bonds, called Cofina by their Spanish acronym, Hanson said.

“That may make Cofina much more at risk than people think,” Hanson said.

Puerto Rico’s $15 billion of Cofina bonds have stronger protections than the highway debt. The first $680 million of sales-tax collections are sent to a trustee to pay bondholders, with the rest put into the general fund, Hanson said. Puerto Rico law protects the portion that’s sent to the trustee from being used by the government, according to bond documents.

General obligation investors are likely to challenge that law in court by claiming that their payments have priority under the constitution, Howard Sitzer, senior municipal analyst at CreditSights Inc., said in a conference call with clients on Thursday.

“We think that the legal opinions behind the sales-tax financing corporation debt are subject to dispute and likely to be the subject of litigation going forward,” Sitzer said. General obligations “are to be paid by the first revenues received by the government, which implies that any tax revenues would be available.”

Bloomberg News

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September 10, 2015 — 11:45 AM PDT Updated on September 10, 2015 — 2:58 PM PDT