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Puerto Rico Facing Debt Risk Beyond Power Utility: Muni Credit.

Governor Alejandro Garcia Padilla's strategy to bolster the Government Development Bank, which lends to the junk-rated commonwealth and its localities, hinges on a planned $2.9 billion bond sale backed by increased petroleum-tax revenue. Lawmakers intend to amend the deal this month to make it more attractive to investors. Without the borrowing, the GDB's cash would drop by almost half by March 31, according to Moody's Investors Service, crimping its ability to serve as a financing backstop.

Puerto Rico and its agencies are staggering under $73 billion of debt, which would rank the territory third among U.S. states. The island needs to meet revenue targets and get its economy to grow to enable it to provide services to its 3.5 million residents and also repay investors, said Municipal Market Analytics Inc.'s Bob Donahue.

"The challenges that are coming down the pike here are greater than they've ever been," said Donahue, managing director of the Concord, Massachusetts-based research firm. There's concern that the commonwealth has to pay short-term bills "at the same time as public-safety responsibilities must be met."

Record Overhaul

The Electric Power Authority, called Prepa, is working on a plan to restructure $8.6 billion of liabilities this year, and commonwealth officials have warned that bondholders may take a loss. The move, which would be the largest restructuring ever in the $3.6 trillion municipal market, became feasible after lawmakers in June passed a measure allowing some public corporations to restructure debt.

"The GDB and the Puerto Rican government continue to execute their plan to strengthen the island's fiscal health and support its economic growth," Melba Acosta, president of the bank, said in an e-mail. "We passed the Recovery Act last year in order to ring-fence our general-obligation debt from that of Puerto Rico's public corporations, which are making progress in resolving their financial difficulties."

Repayment Order

Puerto Rico's borrowings include $13 billion of general-obligation debt, most of which is tax-exempt nationwide and held by individuals, mutual funds and hedge funds. About 54 percent of muni mutual funds own Puerto Rico securities, according to Morningstar Inc.

Debt of other agencies and even general obligations — which the commonwealth's constitution stipulates must be repaid before other bills — may face an overhaul as well unless the economy gains momentum and residents stop leaving, said Bart Mosley, co-president of Trident Municipal Research in New York. The population has dropped each year since 2005, shrinking 7 percent, according to U.S. Census data.

In a bid to balance budgets, lawmakers have raised taxes and boosted utility and transportation fees while also cutting payrolls, raising the retirement age and requiring public workers to contribute more to pensions.

If legislators ask for more changes to retirement benefits and tax increases, residents may push officials to trim the island's debt by negotiating with investors, Mosley said.

Debt Choice

"It would be very hard to assume that they don't choose to go down something that looks like a sovereign-debt restructuring at some point with the general-obligation debt," Mosley said.

Rating companies cut Puerto Rico to junk in February 2014. Moody's scores it five levels below investment grade at B2, while Standard & Poor's assigns a BB, three steps higher.

Financial pressures may intensify if the Infrastructure Financing Authority, called Prifa, is unable to sell the debt repaid with petroleum taxes. A law passed in December capped the average coupon at 8.5 percent, and set a minimum price of 93 cents on the dollar. Legislators plan to change those guidelines this month.

General obligations sold in March 2014 and maturing in July 2035 traded today with an average yield of 9.45 percent, or 87 cents on the dollar, data compiled by Bloomberg show.

Cash Need

The Development Bank needs the sale as proceeds would allow the Highways & Transportation Authority to repay $2.2 billion it owes the bank. That amounts to 21 percent of GDB loans. The bank said it had about $1.5 billion of net liquidity as of Nov. 30. That would drop to $819 million by March 31 if Prifa fails to issue the bonds, Moody's said in October.

"It's very precarious," Donahue said of the bank's liquidity. "A determination by the auditors that it's insolvent almost certainly puts an end to their ability to assist and leaves the commonwealth and the agencies on their own."

The general fund also faces challenges. Revenue collections through November were $32.5 million below projections for this fiscal year, according to the Treasury Department. Principal and interest payments — which consume about 15 percent of the budget — are set to increase by $287 million in the year beginning July 1, according to S&P.

The commonwealth doesn't anticipate another agency debt restructuring beyond Prepa, and the $2.9 billion borrowing plan allows the highways authority to avoid such a move, Natalia Guzman, senior vice president at the GDB, told investors in an October presentation.

'Fixing Prepa'

"Our resolve to do what is right and necessary to preserve our credit and grow the island economy is now stronger than ever," Garcia Padilla said in a July conference call with investors, about three weeks after signing the restructuring measure.

Officials project that reducing the power agency's $1.75 billion of tardy customer bills and shrinking its debt will reduce electricity costs and spark the economy. Residents and businesses pay about twice as much as mainland consumers for power, according to Moody's.

Strengthening Prepa may not shield other agencies or the general obligations, said Philip Fischer, head of muni research at Bank of America Merrill Lynch in New York.

“We certainly would hope that fixing Prepa will fix the economy, Fischer said. ‘‘But it strikes us as unlikely. Prepa is just one of the problems.’’

‘Unsustainable’ Finances

Puerto Rico and its agencies have a history of selling bonds to balance budgets and repay short-term debt. Now that practice comes at a steeper cost as hedge funds and other alternative investors, who target riskier securities for their relatively high yields, have largely replaced traditional muni buyers.

The GDB on Oct. 9 sold tax-exempt notes maturing in June 2015 and priced to yield 7.75 percent. That compared with 0.14 percent on benchmark one-year munis, Bloomberg data show.

‘‘Growing debt and a contracting economy is an unsustainable condition,’’ Alan Schankel, a managing director at Janney Montgomery Scott LLC in Philadelphia, wrote in a Dec. 16 report. ‘‘It seems very unlikely that Prepa will be the last case of restructuring for Puerto Rico issuers.’’

The fiscal 2015 budget assumes economic growth of 0.2 percent, according to S&P. The company has said that isn’t enough to deal with rising debt costs and a retirement system that was 3 percent funded as of June 2013, lower than any U.S. state.

The restructuring bill allows Prepa, the aqueduct and sewer authority and other public corporations to ask investors to take a loss. General obligations, Prifa debt, sales-tax bonds and GDB debt are exempt from the law. Without economic growth, Garcia Padilla may have to expand the measure, Donahue said.

‘‘If the governor finds that he has no option, it’s something that everyone who is involved in Puerto Rico should consider,” he said.

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