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Puerto Rico Debt Ratings Placed On CreditWatch Negative; Persistent Structural Imbalance Cited

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WASHINGTON D.C. (Standard & Poor's) March 22, 2006--Standard & Poor's Ratings Services has placed its 'BBB' GO and related debt ratings on the Commonwealth of Puerto Rico's debt on CreditWatch with negative implications.

"The CreditWatch placement reflects a persistent annual structural imbalance exceeding $1 billion, created by a trend of budgetary performance that has not met targets, due in part to weak expenditure controls, leading to an increasingly weak liquidity position. Of particular concern is the increasing reliance on financing from the Government Development Bank for Puerto Rico, which totaled about $1 billion in direct loans to the central government for deficit financing and about a cumulative $5.6 billion for all government agencies, including capital purposes, as of Dec. 31, 2005," said Standard & Poor's credit analyst Kenneth Gear.

The magnitude of the liquidity needs necessitate balanced operations during fiscal 2007. Credit quality is expected to weaken without passage and effective timely implementation of a combined tax reform and spending reform package as part of the fiscal 2007 budget, which needs to be enacted by the start of the new fiscal year on July 1. Passage of a new sales tax is critical to the effort to provide additional revenues and a broader revenue stream that could close most of the existing budget gap. Equally critical to restoration of long-term fiscal stability is the need to reform chronic overspending, particularly in the department of education.

The political difficulty of attacking the imbalance solely through headcount reduction makes the need for a broader revenue stream more critical. However, a significant degree of uncertainty surrounds the political process necessary to approve a new consumption-based tax, whether at the administration's proposed level of 7%, or even at the 4% level suggested by some members of the legislature, in time for the start of the fiscal 2007 budget. Standard & Poor's will continue to closely monitor the commonwealth's progress toward adoption of a balanced budget and expects to reevaluate its CreditWatch designation within the next 90 days.

A structural imbalance of $989 million occurred in fiscal 2005, with $550 million of deficit financing, $329 million of one-time measures, and $88 million of other non-recurring revenues. In addition, deficit loans from GDB of $233 million in fiscal 2004 and $250 million in 2003 have also reflected the need to access the GDB for liquidity. The late release of audited financial results for fiscal 2005 creates some uncertainty about the report of an unaudited $1 billion operating deficit for the fiscal year ended June 30, 2005. Interim results for fiscal 2006 project an operating deficit of $569 million and growth in the long-term structural imbalance to more than $1.1 billion, with expenditures estimated at near $10.0 billion and revenues projected at $8.8 billion.

The commonwealth restructured $368 million of debt in fiscal 2006 for budget relief and used reserves and plans to use a proposed $100 million basis swap to close $531 million of the structural gap. Spending pressure accounts for most of the fiscal 2006 operating deficit. Approximately 59% of spending pressure is associated with education spending. Of ongoing concern is a trend of increases in GDB loans to the commonwealth to fund operations, and the GDB's weakened balance sheet, which held $5.6 billion of cumulative commonwealth and agency loans as of Dec. 31, 2005. GDB loans to the commonwealth and agencies increased by $3 billion, or 117%, between fiscals 2005 and 2003.

While the economy has demonstrated relative stability in some sectors such as capital-intensive manufacturing and pharmaceuticals and tourism and services, overall, private employment continues to decline. Bloated government employment of more than 200,000, representing almost 30% of the employment base, is a likely target for future reductions. A "right sizing" of government headcount is necessary to bring expenditures in-line with revenues. Early retirement initiatives were proposed as a partial solution, but were discarded because of the potential adverse impact on a grossly underfunded (less than 18% funded) retirement system. Headcount reductions, while providing short-term savings, must be understood in terms of the long-term costs associated with increased unemployment, already high at 12%. The future cost of social programs to address unemployment is difficult to quantify.

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