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RESEARCH

Puerto Rico's GO Debt Rating Lowered To 'BBB-' Due To Structural Imbalance

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NEW YORK (Standard & Poor's) May 22, 2007--Standard & Poor's Ratings Services lowered its long-term rating on the Commonwealth of Puerto Rico's GO debt one notch to 'BBB-' from 'BBB', reflecting a long history of structural imbalance and the ongoing difficulties anticipated with further efforts to reduce the accrued deficit. The outlook is stable.

The rating on the appropriation debt, typically rated one notch below the GO, has not been lowered, reflecting the improvements that have been made. Standard & Poor's does not believe that Puerto Rico's appropriation credit is speculative grade.

Standard & Poor's also took the following related ratings actions:

-- The 'BBB/A-2' counterparty credit rating of Government Development Bank of Puerto Rico (GDB Puerto Rico) has been lowered to 'BBB-/A-3' (see more below);

-- The rating on the University of Puerto Rico (UPR) system revenue bonds has been lowered to 'BBB-' from 'BBB'. The outlook is stable. The downgrade reflects the lower rating on the Commonwealth's GO debt and UPR's high and increasing dependence upon the Commonwealth for its revenues. Under Commonwealth Act 2 of 1966, UPR is allocated an amount equal to 9.6% of the average total revenue collected by the Commonwealth Rico during the prior two fiscal years. Appropriations account for about 90% of UPR's operating budget and in fiscal 2006 appropriations from the Commonwealth were $835 million, or nearly $13,000 per student.

-- The 'BBB-' SPUR on the Puerto Rico Industrial, Tourist, Educational, Medical, and Environmental Control Facilities Financing Authority's bonds issued for the Plaza Universitaria is affirmed and the outlook is revised to stable from negative. The rating reflects a junior lien on pledged revenues (including tuition and fees, dormitory rental income, and research-overhead monies) that are securing UPR's senior debt.

The ratings for the Puerto Rico Ports Authority (A-/Stable) and Puerto Rico Highways and Transportation Authority's highway revenue bonds (A-/Stable), transportation revenue bonds (BBB+/Stable), subordinate transportation revenue bonds (BBB/Stable), and special facility revenue refunding bonds, 2003 series A, (BBB-/Stable) will not change, despite the lowering of the Commonwealth's rating. Standard & Poor's considers pledged revenues for these credits as fairly insulated. However, further deterioration in the Commonwealth's credit quality could be a rating concern for these transportation credits.

HIGH DEBT LIKE TO GO HIGHER

Standard & Poor's noted that Puerto Rico's debt, which is already high, is likely to increase. Although a major new revenue source--a 5.5% sales tax--was added in the current fiscal year, balance remains difficult to achieve, requiring expense cuts and use of one-time revenue sources. Gap forecasts suggest that balance will not be achieved until 2010 and those forecasts are based on the expectation of flat expense growth, which Standard

& Poor's believes will be difficult to achieve. It appears that despite the efforts taken to date, accrued structural imbalance will persist. In addition, Puerto Rico's economy is struggling, with unemployment at 10.1% and a projected decline of 1.4% in gross national product (GNP) in 2007.

Although Standard & Poor's has assigned a stable outlook to the GO debt, it expects that the current momentum on expenditure reductions will be difficult to maintain, and that the Commonwealth will continue to find balance elusive. The economic picture will likely strengthen modestly, adding a level of stability to the outlook. Should the economy further weaken, pressuring the revenue and expense bases, the rating could be lowered. If structural balance is achieved, maintained, and the accumulated deficit reduced, based on either revenue or expenditure actions, the rating could be raised to 'BBB'.

In addition, the ratings continue to reflect the Commonwealth's:

-- Historic tension among the different branches of government on a cohesive long-term fiscal and economic policy that provides a greater degree of institutionalization of financial management policies; and

-- High debt levels, currently at approximately 30% of GNP and $5,789 per capita. Including a $9.9 billion unfunded pension liability, the Commonwealth's obligations increase to a very high $9,097 per capita and 48% of GNP

Factors that continue to support the rating include:

-- Puerto Rico's strong ties to the U.S. economy resulting from significant flows of trade investment income and a history of favorable federal tax incentives that have stimulated investment in the island economy;

-- Greater degree of revenue flexibility following the approval of a 5.5% sales tax, which includes a 1% dedicated to the repayment of approximately $6.8 billion in appropriation ("extraconstitutional") debt; and

-- The stabilizing financial and management influence of the Government Development Bank for Puerto Rico (GDB).

SIGNIFICANT CHELLENGES AHEAD

Puerto Rico continues to face significant financial and economic challenges. While the passage of a 5.5% sales and use tax in fiscal 2007 provided additional revenue flexibility, the revenue generating potential of this tax has been limited by declining economic activity. According to the Puerto Rico Planning Board (PRPB), the Commonwealth's GNP will experience a decline of 1.4% in real terms in fiscal 2007, while personal income is expected to drop by 1.2%. The PRPB expects economic activity to rebound in fiscal 2008, albeit modestly, with a projected 0.8% increase in real GNP.

Several factors have contributed to Puerto Rico's current economic recession: in addition to the implementation of the sales and use tax, several public enterprises adopted significant increases to basic services, including water, sewer, and electricity. The combination of increased costs for basic goods and services, high energy prices, and a substantial reduction in government spending (which is a major driver of the island's economic activity) triggered the recession. In addition, employment growth remains stagnant, with a 0.1% reduction in employment levels in March 2007 relative to March 2006. The Commonwealth's unemployment rate remains high at 10.1%, or about 1% higher than in 2006.

In March 2007, Commonwealth officials revised their revenue estimate downward by $280 million, which widened the expected general fund deficit to $602 million from the budgeted $325 million. While the projected deficit is greater than budgeted, the Commonwealth has made progress in its expenditure control measures, reducing general fund budgeted expenditures by $267 million (2.8%) relative to the fiscal 2007 budget and $375 million (3.9%) relative to actual fiscal 2006 expenditures. Commonwealth officials plan to bridge the fiscal 2007 budget gap with the use of $265 million in one-time special taxes, the transfer of $240 million originally dedicated to the repayment of a $741 million loan to GDB (subject to legislative approval), and the delay of approximately $96 million in payments to suppliers, which will be rolled over to fiscal 2008. If approved by the legislature, the $741 million loan from GDB (which was used to balance the fiscal 2006 budget) will be repaid from a dedicated 1% sales tax.

The proposed fiscal 2008 budget includes ambitious expenditure targets. On the revenue side, total general fund revenues are projected to increase 5.3% relative to fiscal 2007. Sales and use tax revenues, which will be collected for the first full year in fiscal 2008, are projected to increase

58% relative to fiscal 2007. At a first glance, the substantial increase in sales tax collections can be misleading given the fact that fiscal 2007 only includes seven months of collections. On a monthly basis, sales tax collections in fiscal 2008 are budgeted fairly conservatively, indicating a slight decline of 0.8% relative to monthly fiscal 2007 collections.

However, the biggest challenge for Commonwealth officials will remain the maintenance of expenditure controls. The proposed $9.2 billion fiscal 2008 budget includes a $261 million reduction in general fund expenditures relative to the fiscal 2007 budget, and a $101 million reduction compared to expected actual year-end expenditures. The projected $150 million budget deficit is expected to be covered with proceeds from the sale of real estate assets. To meet their budget targets, officials plan to continue the expenditure control measures implemented in fiscal 2007. These measures resulted in approximately $160 million in budget savings, and the reduction of 13,687 in employee headcount. While expenditure controls have improved in fiscal 2007, the ability of the Commonwealth to further reduce its operating expenditures in the next two years will be limited without broader reductions in headcount and benefit programs. Moreover, the political pressure to loosen expenditure controls is expected to mount--particularly if the economic recession lasts longer than anticipated--the closer the Commonwealth gets to the 2008 election cycle.

Puerto Rico's overall debt levels remain high relative to other state and local governments and similarly rated sovereigns. As of December 2006, the Commonwealth's GO debt reached $10.6 billion (including $1.2 billion in short-term debt), or an above-average $3,524 per capita and 13% of GNP. Total tax supported debt, which includes $6.8 billion in appropriation debt, is high at 5,789 per capita and 30% of GNP. Total public sector debt, including revenue-secured debt issued by underlying agencies and trusts, reached $42.5 billion, or a high 70% of GNP .

GDB PUERTO RICO

Despite recent actions taken to reduce the dependency of loans from GDB Puerto Rico to the Commonwealth, GDB's business ties and financial support remain closely linked to that of the Commonwealth. GDB's liquidity and capital position are at risk due to the Commonwealth's structural deficit. The government's and municipal entities' reliance on longer term financing in the form of loans from GDB Puerto Rico continues to be a rating concern and supports the equalization of its ratings to those of the Commonwealth.

GDB Puerto Rico was created in 1948 as a public corporation of the Commonwealth and is governed by a seven-member board of directors appointed by the governor. The bank's primary business is acting as fiscal agent for the Commonwealth and aiding economic development. In line with this mandate, the bank acts as fiscal agent and advisor in connection with all borrowings and bond issues of the Commonwealth as well as its public corporations, municipalities, and instrumentalities. GDB Puerto Rico also makes loans to the Commonwealth, purchases and guarantees obligations of the Commonwealth and related entities, accepts Commonwealth deposits, and makes loans to the private sector on a very limited basis.

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