Commonwealth of Puerto Rico's GO 2012A&B Public Improvement Bonds Rated 'BBB'; Existing Ratings Affirmed

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DALLAS (Standard & Poor's) March 8, 2012--Standard & Poor's Ratings Services assigned its 'BBB' rating to the Commonwealth of Puerto Rico Public Improvement Refunding Bonds Series 2012A and Series 2012B. In addition, Standard & Poor's affirmed its 'BBB' rating on the commonwealth's outstanding GO bonds and its 'BBB-' rating and stable outlook on the commonwealth's appropriation debt. The commonwealth's full faith and credit pledge, including a constitutional requirement that provides a first claim on available commonwealth resources, secures the bonds. Commonwealth officials will use the proceeds from the sale of the bonds to refund several lines of credit provided by the Government Development Bank, and to refund other outstanding GO bonds and any potential termination payments associated with investment and interest rate agreements.

While several economic measures tracked by government officials, including retail sales, auto and home sales, and tourism-related activity, appear to be improving, we believe that a steady recovery will be a critical element in the administration's stated goal of achieving structurally balanced budgets by fiscal 2013. In our opinion, the practical and political ability of the administration to rely exclusively on expenditure cuts to balance the budget in fiscal 2013 is relatively limited, given the depth of the cuts already adopted, and the potential for additional expenditure reductions to hamper what remains a relatively anemic economic growth. We believe that the fiscal 2013 budget will be critical to the future of the commonwealth's rating, particularly because the extent to which structurally imbalances persist, may limit the commonwealth's ability to address issues that will require an increasing share of the budget, such as retirement obligations.

The 'BBB' rating on the commonwealth's GO debt continues to reflect our opinion of Puerto Rico's:

- History of chronic budget deficits. Governor Luis Fortuño's fiscal stabilization plan, which included an unprecedented 17% reduction in payroll expenditures, along with the recently approved revenue measures, is aimed at eliminating a decade-long trend of budget imbalances. While we view the current administration's measures as an important step toward budget stability, we believe that a lackluster economic performance and potential slippage in expenditure controls may increasingly challenge the administration's stated goal of achieving structurally balanced budgets by fiscal 2013.
- High debt levels, with GO, appropriation, and sales tax revenue debt currently at about $32.7 billion or 51.7% of the estimated $63.2 billion gross state product and $8,384 per capita. Approximately $13.7 billion of this debt is outstanding and was issued by COFINA and has a dedicated source of repayment. We consider debt service costs moderate, with currently projected maximum annual debt service on the commonwealth's GO bonds at 11.8% of the average revenues for fiscal 2010 and fiscal 2011.
- Protracted economic recession, as evidenced by the contraction in the commonwealth's Economic Activity Index of 1.3% in fiscal 2007, 0.9% in fiscal 2008, 4.2% in fiscal 2009, and 5.5% in fiscal 2010. On its most recent estimate, the Puerto Rico Planning Board forecast a return to growth in 2012, with an increase in inflation-adjusted GNP of 0.7%. Employment trends remain relatively stable with only marginal improvement in total employment levels since 2010, and a persistently high unemployment rate of 15.2% through December 2011.
- High level of retirement liabilities. Although Puerto Rico closed its defined benefit system to new participants starting on Jan. 1, 2000, the funded ratio of its defined benefit system is extremely low, in our view, at 8.5% as of June 30, 2010 (the latest actuarial study available). The actuarial study estimates that without any changes, the defined benefit system's net assets would be exhausted in 2014 and all available assets would be exhausted by 2019, requiring a rapidly increasing amount of supplemental cash from the sponsoring entities, which include the commonwealth, several public corporations, and municipalities. We understand that the Fortuño administration is in the process of developing a comprehensive reform to its defined benefit system in addition to the current legislation that increased the employer contribution annually for the next ten years, among other measures.

Factors that continue to support the ratings include our opinion of the commonwealth's:

- Strong ties to the U.S. economy, resulting in a significant flow of trade and income transfers, with exports to the U.S. accounting for approximately $46.4 billion (76% of GNP) in 2008. According to the U.S. Census Bureau, total income transfers from the U.S. to Puerto Rico totaled $13.5 billion (22% of GNP) in 2008 (the latest figure available).
- Support from the Government Development Bank for Puerto Rico

(BBB/Stable), which in our view provides a source of liquidity and market access for the commonwealth.

The stable outlook is based on our view of the commonwealth's recent implementation of significant expenditure controls and revenue enhancement measures that we believe could help restore budget balance within the next two years. The rating could be negatively pressured if the recently approved tax and budget measures are impeded by either continued economic deterioration or a loosening of the expenditure discipline exhibited to date, and the commonwealth fails to address its unfunded retirement obligations in the next two years. In addition, the rating could be negatively pressured if there are significant reductions in federal funding that currently flows to the commonwealth and its residents.

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USPF Criteria: State Ratings Methodology, Jan. 3, 2011

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