STANDARD & POOR'S

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March 8, 2012

Puerto Rico; Appropriations; General Obligation; General Obligation Equivalent Security; Moral Obligation; Water/Sewer

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Credit Profile		
US$1500.0 mil pub imp rfdg bnds ser 2012A due 07/01/2041		
Long Term Rating	BBB/Stable	New
US$400.0 mil pub imp rfdg bnds ser 2012B due 07/01/2041		
Long Term Rating	BBB/Stable	New

Rationale

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 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.

For fiscal 2012, Governor Fortuño's $9.26 billion proposed budget includes estimated revenue collections of $8.65 billion, and an overall deficit of approximately $610 million, which commonwealth officials funded in part with the issuance of additional COFINA debt. In the months of July 2011 through January 2012, commonwealth officials report approximately $1.1 billion in collections from the Act 154 tax, which is $176 million (18.6%) higher than the budget estimate. Overall general fund revenues are slightly below estimates ($68 million, or 1.5%), primarily due to a decline in individual and corporate income tax collections, and sales tax collections. While the economy continues to reel from a five-and-a-half-year-long recession, commonwealth officials expect that the continuation of the budget discipline of the past three years and the recently approved tax measures will result in structurally balanced budgets starting in fiscal 2013. Through the first six months of fiscal 2012, commonwealth officials report general fund expenditures of approximately 40.7% of the annual budget. We believe that the achievement of structurally balanced budgets in fiscal 2013 will remain challenged by what remains an uncertain economic recovery. Given the commonwealth's close economic ties with the continental U.S., a steady economic recovery may not take hold in Puerto Rico until a similar trend is observed in the mainland.

Standard & Poor's deems Puerto Rico's financial management practices "standard" under its Financial Management Assessment (FMA) methodology, indicating the commonwealth's finance department maintains adequate policies in most, but not all, key areas.

Based on the analytical factors we evaluate for U.S. states and territories, on a scale of '1' (strongest) to '4' (weakest), we have assigned a composite score of 3.0. Based on our criteria, an overall score of 3.0 is associated with an indicative credit level of 'A-'. Our criteria also specify overriding factors that may result in a rating different from the indicative credit level. In the case of Puerto Rico, we view its system support score and level of unfunded pension liabilities as overriding factors that result in a rating of two notches below its indicative credit level.

Outlook

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.

Government Framework

Puerto Rico's constitution requires the commonwealth to adopt a balanced budget. There is no requirement, however, for the commonwealth to end the fiscal year with a balanced budget. Puerto Rico has broad authority to set and adjust tax rates and other revenues. The commonwealth has frequently exercised this authority because there are no constitutional limitations or other restrictions on major tax sources. While education expenditures and other government assistance programs have a defined disbursement schedule, the commonwealth has flexibility to adjust disbursements for most other government programs. The commonwealth has not had any voter initiatives that substantially constrained revenues.

Puerto Rico has broad authority to issue GO debt for a variety of purposes. The only constitutional limitation on the issuance of debt relates to the amount of interest and principal payment due at the time of issuance, which cannot exceed 15% of the average of the total amount of the annual revenues in the two fiscal years next preceding the then-current fiscal year. The commonwealth's constitution also grants a priority status to the payments of principal and interest on the commonwealth's GO and appropriation debt.

In our view, Puerto Rico shares many of the attributes that govern the fiscal and policy relationship of the 50 states and the federal government. However, we believe that Puerto Rico's relatively limited ability to influence federal legislation through the means available to all states results in a system support framework slightly weaker than the one governing the 50 states.

On a scale ranging from '1' (strongest) to '4' (weakest), we have assigned a '1.8' to Puerto Rico's governmental framework.

Financial Management

Standard & Poor's deems Puerto Rico's financial management practices "standard" under its FMA methodology, indicating the commonwealth's finance department maintains adequate policies in most, but not all, key areas.

These policies often lack formal detail and institutionalization and might not include best practices. In particular, the commonwealth does not make comprehensive midyear budget amendments to correct shortfalls that could develop during the budget year. While the commonwealth has not historically maintained a budget reserve, the recently enacted tax reform requires mandatory reserves of 1% of the general fund budget in fiscal 2014 and 1.5% in each of fiscals 2015 and 2016. The commonwealth has a detailed written investment policy and a long-term capital plan. It also has a written policy on variable-rate debt and the use of derivatives.

In our opinion, the commonwealth's budget management framework has improved over the past two years. However, the ability of the commonwealth to provide comprehensive revenue and expenditure forecast updates remains challenged by the inability to track and consolidate some of its largest expenditure items, such as education, on a timely basis. In our view, this limits the commonwealth's ability to identify and implement corrective budget actions on a timely basis.

On a scale ranging from '1' (strongest) to '4' (weakest), Standard & Poor's has assigned a '3.0' to Puerto Rico's financial management.

Economy

According to the 2011 U.S. Census Bureau Statistical Abstract, Puerto Rico's population has reached nearly 4 million. The commonwealth's average annual population growth rate of 0.3% is lower than the national average of approximately 1%. Puerto Rico's demographic profile is also weaker than the average for the nation, in our opinion. The commonwealth's age dependency ratio of 62.3% is higher than the 59.2% national average.

Although the economy in Puerto Rico continues to show a mixed performance overall, we believe that what appears to be an incipient recovery in the U.S. may bode well for the island. Manufacturing and the services sector (of which tourism is an important component), in particular, may be the largest beneficiaries of a potential return of growth in the U.S. economy. In our opinion, however, the biggest long-term economic challenge for Puerto Rico continues to be its ability to foster private-sector employment growth. For decades, the public sector became the employer of last resort, mitigating the inability of the private sector to generate the jobs demanded by a relatively young and growing population. This imbalance bloated government payroll and set the commonwealth on what we believe was an unsustainable path of recurring budget deficits. In our opinion, the reductions in the government's payroll may result in long-term high unemployment rates (which are currently at a high 15.1%), particularly if private-sector employment growth remains depressed. Furthermore, we believe that the commonwealth's economic performance over the next two years will be a key determinant of its ability to restore fiscal balance and improve its credit quality. In our opinion, the effectiveness of the current administration's aggressive efforts to restore fiscal balance may be limited if the economic recovery does not gain momentum.

The commonwealth's per capita wealth and income levels remain low compared with those of the U.S. As of 2008, the latest U.S. Census figure available, per capita disposable personal income was $13,462, or approximately 32% of the U.S. average. The commonwealth's economic structure and employment base remain centered around manufacturing and tourism and related services. We believe that the recent approval of a temporary excise tax on certain manufacturing companies has the potential to more closely align the commonwealth's revenue sources with its economic structure. In our opinion, manufacturing's significance to the island's economy (see chart 1) and the fact that much of its manufacturing output is destined to U.S. markets highlight the influence that a U.S. recovery will have on the commonwealth's economic future.

We consider Puerto Rico's employment base diverse (see chart 2), with services (of which tourism is an important component) accounting for 30.2%, followed by government (23.2%), and trade (20.9%). Manufacturing accounts for approximately 9.6% of employment, with construction, transportation, finance, and agriculture each accounting for less than 6% of employment.

On a scale ranging from '1' (strongest) to '4' (weakest), Standard & Poor's has assigned a '3.4' to Puerto Rico's economy.

Budgetary Performance

The commonwealth's current administration has made fiscal and economic stability a top priority. Although Puerto Rico has a long history of structural budget deficits (see chart 3), the previous trend of overly optimistic revenue assumptions, combined with a prolonged economic recession and a growing payroll, resulted in an unprecedented $3.3 billion structural deficit in fiscal 2009 (equal to a very high, in our view, 43% of general fund recurring revenue). In our opinion, the drastic increase in the size of the structural deficit and the increasingly limited options to fund it presented a new set of circumstances that required the implementation of a fairly drastic set of fiscal and administrative measures to preserve credit stability in the near term.

In the three years since its inauguration, Gov. Fortuño's administration has received legislative approval for a fairly comprehensive set of fiscal and administrative reforms aimed at bringing structural balance by fiscal 2013. The cornerstone of these reforms was the approval of Act 7 in 2009 (Fiscal Emergency Act), which included the following measures:

- Increasing the portion of the sales and use tax dedicated to COFINA to 2.75% from 1%. This provided the commonwealth with approximately $7.5 billion in additional bonding capacity to finance the projected deficit through fiscal 2012, and a $500 million local economic stimulus package;
- The approval of several temporary revenue measures, including surtaxes on individual income, corporations, credit unions, and excise tax increases on cigarettes, alcoholic beverages, and motorcycles; and reduction of $2 billion in recurring expenditures, including voluntary early retirement and employee layoffs.

A second phase of reforms that focuses on tax revenues was approved in 2010. Act 154 of 2010 established a source income rule and enacted a temporary (six years) excise tax on the purchases of affiliates of certain multinational manufacturing corporations that operate in Puerto Rico. In addition, Governor Fortuño signed into law a new tax revenue code that includes a series of tax relief measures that among other things reduces the maximum corporate and individual income tax. Some of the highlights of the commonwealth's tax reform include:

- The introduction of an excise tax on the purchases of affiliates of manufacturing companies that are subject to the source income rule, which in the case of Puerto Rico include the affiliates of many of the pharmaceutical, electronic, and medical devices companies that are beneficiaries of specific tax agreements. The excise tax has an initial tax rate of 4% in 2011, which will gradually decrease to 1% in 2016.
- The tax reform reduces the maximum corporate tax rate from 41% to 30%, as well as several tax credits and deductions. In addition, the tax reform expanded the tax brackets and provided an increasing level of tax relief for taxpayers at the low end of the income scale, to eventually reach a 0% personal income tax for taxpayers with $20,000 or less of taxable income. The implementation of the gradual expansion of tax exemptions starting in 2014, however, is subject to the achievement of specific revenue and expenditure targets and GSP growth. The

reforms also include a reduction in the mortgage interest deduction and more stringent tax collection mechanisms and penalties for tax evasion.

In our opinion, the key measure of the impact of the expenditure cuts and revenue enhancement measures continues to be the extent to which the commonwealth can achieve structurally balanced budgets by fiscal 2013.

On a scale ranging from '1' (strongest) to '4' (weakest), Standard & Poor's has assigned a '3.0' to Puerto Rico's budgetary performance.

Debt And Liability Profile

Puerto Rico's tax-supported debt levels are very high, in our view. The commonwealth's GO, appropriation, and sales tax revenue debt is 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.

Commonwealth officials estimate that approximately 7% of its debt portfolio is in variable rate, and all variable rate debt has swaps in place. The total notional amount of GO swaps currently outstanding is $2.7 billion, which represents a $1.39 billion decrease since 2009. As of September 2011, the swaps had a negative mark-to-market of $302 million. Commonwealth officials expect to continue to reduce their swap exposure by taking advantage of refunding opportunities. Approximately $288 million of variable rate debt is subject to mandatory tender upon the expiration of credit/liquidity facilities in March and April 2013. Commonwealth officials actively manage Puerto Rico's variable rate debt portfolio and anticipate having a replacement liquidity provider or terming out the variable rate debt into fixed rate if the lines expire and cannot be replaced. In cases where the commonwealth has not been able to replace its liquidity facility providers, the Government Development Bank has terminated existing credit facilities, effectively preventing a failed remarketing and the payment of a bank bond rate.

The Employees Retirement System (ERS) is a trust created in 1951 to provide retirement and disability annuities, death benefits, and loans to Puerto Rico's public employees. The system administers two separate retirement plans: a defined benefit plan, which closed to new members on Dec. 31, 1999; and a defined contribution plan, available to employees who entered the system on or after Jan. 1, 2000. System benefits are funded by a combination of monthly or bimonthly employer and employee contributions, and investment earnings. Participating employers are statutorily required to contribute to the defined benefit plan at a rate of 9.275% of payroll. The requirement to make this contribution is not tied to the number of employees participating in the defined benefit plan. Historically, actual employer contributions have been substantially below the annual required contribution, resulting in a $17.8 billion unfunded actuarial accrued liability, or a 8.5% funding ratio as of June 30, 2010, based on a preliminary actuarial valuation. For the past seven years, employer contributions into the system have ranged between 40.4% (fiscal 2010) and 69.4% (fiscal 2007).

The 2010 preliminary valuation estimates that under current investment return assumption (7.5%) and contribution rates, the ERS' net assets would be exhausted in 2014 and all of the system's available assets by 2019, which would then require supplemental funding from the sponsoring governments and public corporations. The actuarial study estimates negative cash flow of approximately $588 million in fiscal 2014, which gradually increases to $687 million in fiscal 2020.

The estimated other postemployment benefits (OPEB) (GASB 45) unfunded liability is relatively small compared to the commonwealth's pension obligations. According to the most recent actuarial study, the commonwealth's unfunded OPEB liability as of June 30, 2009, reached $1.6 billion. The annual required contribution (ARC) to amortize the OPEB liability is estimated at $128.3 million, which is relatively small compared with the $1.4 billion ARC to amortize the commonwealth's pension liability.

A special commission appointed by Gov. Fortuño recently submitted a set of recommendations to improve the funding status of the commonwealth's defined benefit system. The commission's recommendations include contribution increases to both employers and employees. In addition, the legislature approved Act 70 of 2010, which provides incentives for early retirements with a lower percentage of final pay for certain qualified employees. According to commonwealth officials, approximately 2,400 employees have elected to retire through this program, generating annual savings of approximately $30 million.

On a scale ranging from '1' (strongest) to '4' (weakest), Standard & Poor's has assigned a '3.9' to Puerto Rico's debt and liability profile.

Related Criteria And Research

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

Ratings Detail (As Of March 8, 2012)		
Puerto Rico pub imp rfdg bnds ser 2003C-5-2		
Long Term Rating	AA+/A-1	Affirmed
Unenhanced Rating	BBB(SPUR)/Stable	Affirmed
Puerto Rico pub imp rfdg bnds ser 2003 C-5-1		
Long Term Rating	BBB/NR/Stable	Affirmed
Unenhanced Rating	BBB(SPUR)/Stable	Affirmed
Puerto Rico Aqueduct & Swr Auth		
Long Term Rating	BBB/Stable	Affirmed
Puerto Rico Aqueduct & Swr Auth (Commonwealth Guaranteed)		
Long Term Rating	BBB/Stable	Affirmed
Puerto Rico Aqueduct & Swr Auth (Senior Lien) ser B		
Long Term Rating	BBB/Stable	Affirmed
Puerto Rico GO		
Long Term Rating	BBB/NR/Stable	Affirmed
Unenhanced Rating	BBB(SPUR)/Stable	Affirmed
Puerto Rico GO (wrap of insured) (CIFG & AGM) (SEC MKT)		
Unenhanced Rating	BBB(SPUR)/Stable	Affirmed
Puerto Rico GO (wrap of insured) (FGIC) (ASSURED GTY) (SEC MKT)		
Unenhanced Rating	BBB(SPUR)/Stable	Affirmed
Puerto Rico GO (wrap of insured) (RADIAN & FGIC) (SEC MKT)		
Unenhanced Rating	BBB(SPUR)/Stable	Affirmed

Ratings Detail (As Of March 8, 2012) **(cont.)**		
Puerto Rico GO (wrap of insured) (SYNCORA) (ASSURED GTY) (SEC MKT)		
Unenhanced Rating	BBB(SPUR)/Stable	Affirmed
Puerto Rico GO (AGM)		
Unenhanced Rating	BBB(SPUR)/Stable	Affirmed
Puerto Rico GO (MBIA) (National) (SEC MKT)		
Unenhanced Rating	BBB(SPUR)/Stable	Affirmed
Puerto Rico Indl Tour Ed Med & Environ Ctrl Fac Fin Auth (Costa Caribe Resort Proj)		
Long Term Rating	BBB-/Stable	Affirmed
Puerto Rico GO		
Unenhanced Rating	BBB(SPUR)/Stable	Affirmed
Long Term Rating	BBB/Stable	Affirmed
Puerto Rico GO (AGM)		
Unenhanced Rating	BBB(SPUR)/Stable	Affirmed
Long Term Rating	AA-/NR/Stable	Affirmed
Puerto Rico VRDB subser A-2		
Unenhanced Rating	BBB(SPUR)/Stable	Affirmed
Long Term Rating	AA-/A-1/Stable	Downgraded
DBR Dorado Owner LLC, Puerto Rico		
Puerto Rico		
DBR Dorado Owner LLC (Puerto Rico) (Tourism Dev Fund) (Ritz-Carlton Reserve Proj)		
Long Term Rating	BBB-/Stable	Affirmed
Puerto Rico Aqueduct & Swr Auth, Puerto Rico		
Puerto Rico		
Puerto Rico Aqueduct & Swr Auth (Puerto Rico)		
Long Term Rating	BBB/Stable	Affirmed
Puerto Rico Indl Tour Ed Med & Environ Ctrl Fac Fin Auth, Puerto Rico		
Puerto Rico		
Puerto Rico Indl Tour Ed Med & Environ Ctrl Fac Fin Auth (Puerto Rico) (Trump International Golf Club Proj)		
Long Term Rating	BBB-/Stable	Affirmed
Puerto Rico Pub Bldgs Auth, Puerto Rico		
Puerto Rico		
Puerto Rico Pub Bldgs Auth (Puerto Rico)		
Long Term Rating	BBB/Stable	Upgraded
Puerto Rico Pub Bldgs Auth (Puerto Rico)		
Unenhanced Rating	BBB(SPUR)/Stable	Upgraded
Puerto Rico Pub Bldgs Auth (Puerto Rico)		
Long Term Rating	BBB/Stable	Upgraded
Puerto Rico Pub Bldgs Auth (Puerto Rico)		
Long Term Rating	BBB/Stable	Upgraded
Puerto Rico Pub Bldgs Auth (Puerto Rico) GO		

Ratings Detail (As Of March 8, 2012) **(cont.)**		
Long Term Rating	BBB/Stable	Affirmed
Puerto Rico Pub Bldgs Auth (Puerto Rico) (wrap of insured) (RADIAN & FGIC) (SEC MKT)		
Unenhanced Rating	BBB(SPUR)/Stable	Upgraded
Puerto Rico Pub Bldgs Auth govt fac subseries M-2		
Unenhanced Rating	BBB(SPUR)/Stable	Upgraded
Puerto Rico Pub Bldgs Auth VRDB subser M-3		
Unenhanced Rating	BBB(SPUR)/Stable	Upgraded
Puerto Rico Pub Bldgs Auth (Puerto Rico)		
Unenhanced Rating	BBB(SPUR)/Stable	Affirmed
Long Term Rating	BBB/Stable	Affirmed
Puerto Rico Pub Bldgs Auth (Puerto Rico) GO		
Unenhanced Rating	BBB(SPUR)/Stable	Upgraded
Puerto Rico Pub Fin Corp, Puerto Rico		
Puerto Rico		
Puerto Rico Pub Fin Corp (Puerto Rico)		
Long Term Rating	BBB-/Stable	Affirmed
Puerto Rico Pub Fin Corp (Puerto Rico)		
Long Term Rating	BBB-/Stable	Affirmed

Many issues are enhanced by bond insurance.