STANDARD & POOR'S

PUBLIC FINANCE

Commonwealth of Puerto Rico

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Credit Profile		
Outstanding General Obligation Bonds, Various Series		
Unenhanced Rating	BBB- (SPUR) / Stable	Affirmed
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Rationale

Standard & Poor's Ratings Services affirmed its 'BBB-' rating on the Commonwealth of ***Puerto Rico***'s general obligation (GO) and appropriation debt outstanding. The rating on the commonwealth's appropriation debt, typically rated one notch below the GO, remains at 'BBB-', reflecting Standard & Poor's opinion that Puerto Rico's appropriation credit profile is not speculative grade. The outlook is stable.

The 'BBB-' ratings are based on Puerto Rico's full faith and credit pledge and reflect our opinion of the commonwealth's:

- Chronic budget deficits—in the past 10 years, the commonwealth's structural budget deficit ballooned to an estimated $3.2 billion in fiscal 2009 (42% of general fund revenues). While Governor Luis Fortuño's fiscal stabilization plan has received broad support from the legislature, Standard & Poor's doesn't anticipate structurally balanced budgets until fiscal 2013, which in our opinion poses a significant implementation risk, particularly given the challenging economic environment.
- High debt levels, with GO, appropriation, and sales tax revenue debt currently at about $21.8 billion or 35.9% of gross national product (GNP) and $5,477 per capita—when about $31 billion in debt from public corporations, agencies, and municipalities is included, the commonwealth's total public sector debt is a very high 83% of GNP; and
- Protracted economic recession, as evidenced by the GNP contraction of 1.9% in fiscal 2007, 2.5% in fiscal 2008, and an estimated 3.4% in fiscal 2009.

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 investment income and income transfers, which according to commonwealth officials account for as much as 22% of GNP; and
- Support from the Government Development Bank for Puerto Rico (GDB), which provides a stabilizing financial and management influence, as well as a source of liquidity and market access for the commonwealth.

In our opinion, Puerto Rico continues to face significant fiscal and economic challenges. However, in the five months since his inauguration, the administration of Governor Luis Fortuño has made fiscal stability a priority. With broad support from the legislature, Gov. Fortuño implemented a fiscal reconstruction plan designed to regain budgetary structural balance by fiscal 2013. The fiscal measures adopted by the Fortuño administration represent, in our opinion, a factor that lends near-term stability to the credit of the commonwealth. However, we expect that Gov. Fortuño's fiscal reconstruction program will remain challenged by a potential further decline in economic growth, and the potential growing political pressure to delay or modify the scope of the identified payroll and expenditure costs.

Gov. Fortuño's proposed fiscal 2010 budget assumes flat revenue growth relative to actual fiscal 2008 recurring revenues, and general fund expenditures of $7.6 billion. However, the proposed fiscal 2010 budget includes $2.5 billion in the Stabilization Fund, which commonwealth officials expect to establish with the proceeds from the sale of the Puerto Rico Sales Tax Financing Corporation's (COFINA) first subordinate lien bonds. The Stabilization Fund will be used primarily to pay for the costs associated with the payroll reductions and buyout plans included in the commonwealth's fiscal reconstruction plan. When the expenditures associated with the Stabilization Fund are included, the commonwealth's structural deficit for fiscal 2010 would reach $2.6 billion, or a high 34.5% of general fund recurring revenues. Commonwealth officials expect that the majority of the expenditures being funded through the Stabilization Fund will be nonrecurring in subsequent fiscal years, gradually closing the structural deficit by fiscal 2013.

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.

Overall debt levels remain high compared with the debt of other state and local governments and similarly rated sovereigns. The commonwealth's GO debt reached $9.7 billion, or approximately 127% of general fund recurring revenues at year-end fiscal 2008. In addition, the commonwealth has $2.66 billion in appropriation debt, $1.4 billion in GDB loans outstanding, and $5.2 billion in senior lien sales tax revenue bonds. Debt service expenditures on the debt supported by the general fund reached $392.9 million in fiscal 2009, or approximately 5.1% of general fund recurring revenues.

Outlook

The stable outlook reflects our expectation that the administration and legislature will remain committed to the goals outlined in the fiscal reconstruction plan, allowing the commonwealth to gradually achieve structurally balanced budgets. In addition, the stable outlook reflects the assumption of continued liquidity and financial and management support from GDB. However, in our view, GDB's stabilizing effect on the commonwealth's rating has its limitations. The rating may be pressured if Puerto Rico's reliance on GDB to fund the deficit increases materially or if the government does not continue to implement measures in the near term to reduce the structural deficit. In our view, the ability of the commonwealth to use GDB only as a temporary source of flexibility to implement meaningful measures to narrow the budget deficit and not as a long-term source of deficit financing may affect the commonwealth's credit stability. We expect, however, that the expanded authority of COFINA to provide interim deficit financing will gradually reduce the commonwealth's reliance on GDB.

The Prolonged Economic Recession Will Continue To Pressure Revenues

Puerto Rico has been in an economic recession for the past three years. The recession in the continental U.S. doesn't bode well for Puerto Rico, particularly if the recession affects sectors that had until recently performed relatively well, such as tourism and services. According to the Puerto Rico Planning Board, GNP growth projections indicated a 2.5% decline for fiscal 2008; growth is now projected to decline by 3.4% in fiscal 2009 and to stabilize at 0.1% in fiscal 2010. Furthermore, unemployment in Puerto Rico reached 14.7% in April 2009, up from 10.3% from the prior year.

The planned reductions in the government's payroll may further increase unemployment rates, particularly if private employment growth remains depressed. The commonwealth's employment (not including federal government and municipal employees), currently at approximately 213,500, accounts for about 19% of total employment. The actual number of layoffs will likely change, but commonwealth officials have anticipated potential job cuts upward of 30,000. The extent to which the U.S. recession affects tourism and related services will have an impact on tax collections and has the potential to further widen the budget deficit. We believe that given the dominant role that public spending has on the island's economy, the reduction in government spending without an increase in private sector employment could deepen the current recession and widen the budget deficit in fiscal 2010 and beyond.

Commonwealth officials estimate that the economic impact of the expenditure cuts implemented as part of the Fiscal Reconstruction plan will be mitigated by the federal and local economic stimulus programs. Commonwealth officials expect to receive up to $5 billion in funds related to the American Recovery and Reinvestment Act of 2009 (ARRA). In addition to that, the Fortuño administration has developed a $500 million local stimulus program that will dedicate approximately $210 million to capital improvement projects, with the remainder dedicated to various other spending and tax relief programs. The local stimulus program will be funded with proceeds from the sale of sales tax revenue subordinate lien bonds.

Economic And Fiscal Reconstruction Plan

The commonwealth's current administration has made fiscal and economic stability a top priority. While Puerto Rico has a long history of structural budget deficits, the recent trend of overly optimistic revenue assumptions, combined with a prolonged economic recession and a growing payroll, resulted in an unprecedented $3.2 billion structural deficit in fiscal 2009 (equal to a very high 42% of general fund revenues). 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 first five months 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 approved measures include a $500 million local economic stimulus program, tax and revenue enhancements, as well as aggressive budget and personnel cuts.

Some of the highlights of the commonwealth's fiscal recovery plan include:

- Increasing the portion of the sales and use tax (SUT) dedicated to COFINA to 2.75% from 1%. Commonwealth officials estimate that this will provide the commonwealth with up to $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 Act 7 of 2009, which created the Fiscal Restructuring and Stabilization Board, and mandates the reduction of operational and payroll expenses by approximately $2 billion through fiscal 2010, as well as revenue and financial measures to cover the reduction in government payroll; and
- Executive orders that included the reduction of 30% of non-union and temporary employees in the new administration as well as reduction of salaries for agency heads, as well as a government-wide hiring freeze.

The initial phase of government payroll reductions resulted in 2,585 voluntary resignations and 28 furloughs that officials expect to generate approximately $50 million in annual savings. Phase II of the government's plan will include additional layoffs and transition of permanent and temporary employees. As of May 31, 2009, commonwealth officials had identified 7,816 employees that would be laid off, most of them in the education department. Government officials project that Phase III, the temporary freeze in labor economic conditions, will provide $186 million in expense savings. However, in our view, there will be significant credit challenges associated with the implementation of Gov. Fortuño's fiscal stability program. These challenges include:

- Continued economic deterioration that results in lower-than-projected revenues. The Puerto Rico Planning Board estimates that the commonwealth's economy will stabilize at 0.1% growth in fiscal 2010. In addition, commonwealth officials estimate that the ARRA will provide approximately $5 billion in economic stimulus funds. However, a prolonged economic recession in the U.S. may result in continued revenue weakness, which could require budget cuts beyond those currently identified to achieve structurally balanced budgets by fiscal 2013; and
- Growing political pressure to reduce or delay the scope of planned expenditure cuts, particularly if the economy does not recover as anticipated and demand for government services increases beyond what commonwealth officials currently anticipate.

Puerto Rico—Financial Statistics										
	—Fiscal year ended June 30—									
(Mil. $)	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Recurring revenues	6,944	6,962	7,210	7,842	7,985	8,306	8,541	8,621	8,253	7,600
Recurring expenditures	7,083	7,435	7,620	7,956	8,605	9,332	9,964	9,367	9,343	10,833
Structural surplus/(deficit)	(139)	(473)	(410)	(114)	(620)	(1,026)	(1,423)	(746)	(1,090)	(3,233)
% of recurring revenues	(2.0)	(6.8)	(5.7)	(1.5)	(7.8)	(12.4)	(16.7)	(8.7)	(13.2)	(42.5)

Retirement System Liability

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 $9.9 billion unfunded actuarial accrued liability (UAAL), or a 19% funding ratio.

In 2008, the ERS issued $1.5 billion in retirement system bonds (BBB-/Stable/—) secured by the employers' contributions to the system. The system had plans to issue up to $7 billion in retirement system bonds to fund the system's UAAL. However, commonwealth officials do not plan to issue additional retirement system bonds any time soon.

Financial Management Assessment: 'Standard'

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. Puerto Rico does not have a formal budget reserve policy, and budget deficits have prevented commonwealth officials from reaching any informal reserve targets that might exist. The commonwealth has a detailed written investment policy and a long-term capital plan. Puerto Rico also has a written policy on variable-rate debt and the use of derivatives.

Related Research

- USPF Criteria: "GO Debt," Oct. 12, 2006
- USPF Criteria: "Appropriation-Backed Obligations," June 13, 2007

Ratings Detail (As Of 05-Jun-2009)		
Puerto Rico pub imp rfdg bnds ser 2003 C-4 & C-5 & sub-series C-7 cusip#745145Z21		
Unenhanced Rating	BBB-(SPUR)/Stable	Affirmed

Ratings Detail (As Of 05-Jun-2009) (cont.'d)		
Puerto Rico pub imp rfdg bnds ser 2007A subser A-6-A-9 RMKT		
Long Term Rating	AA+/A-1+	Affirmed
Unenhanced Rating	BBB-(SPUR)/Stable	Affirmed
Puerto Rico pub imp rfdg var rate bnds ser 2008B		
Long Term Rating	AAA/A-1+/Watch Neg	On CreditWatch Negative
Unenhanced Rating	BBB-(SPUR)/Stable	Affirmed
Puerto Rico GO		
Long Term Rating	BBB-/Stable	Affirmed
Puerto Rico GO		
Long Term Rating	BBB-/Stable	Affirmed
Puerto Rico GO		
Long Term Rating	BBB-/Stable	Affirmed
Puerto Rico GO		
Long Term Rating	BBB-/Stable	Affirmed
Puerto Rico GO VRDB ser 2004 B-1 thru B-4 (FSA)		
Long Term Rating	AAA/A-1/Watch Neg	On CreditWatch Negative
Unenhanced Rating	BBB-(SPUR)/Stable	Affirmed
Puerto Rico GO ser 2003 C-4 & C5 (FSA)		
Long Term Rating	AAA/A-1/Watch Neg	On CreditWatch Negative
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
Puerto Rico GO (wrap of insured) (SYNCORA GTY) & (FSA - SEC MKT)		
Unenhanced Rating	BBB-(SPUR)/Stable	Affirmed
Puerto Rico GO 2003 C dtd 05/06/2003 due 07/01/2028 (MBIA of Illinois)		
Unenhanced Rating	BBB-(SPUR)/Stable	Affirmed
Puerto Rico		
Puerto Rico pub imp Puerto Rico pub imp bnds ser 2000 dtd 03/15/2000 due 07/01/2002-2021 2026 (MBIA of Illinois) Puerto Rico pub imp bnds ser 2000 dtd 03/15/2000 due 07/01/2019 2020 (MBIA of Illinois) Puerto Rico pub imp go bnds ser A dtd 08/08/2002 due 07/01/2008-2022 2032 Puerto Rico pub imp rfdg bnds ser 2002 A dtd 10/25/2001 due 07/01/2016 2016 2020 2021 (MBIA of Illinois) Puerto Rico (AMBAC)		
Unenhanced Rating	BBB-(SPUR)/Stable	Affirmed
Puerto Rico GO		
Puerto Rico GO (ASSURED GTY) Puerto Rico GO (FSA) Puerto Rico GO (MBIA) (MBIA of Illinois) Puerto Rico GO (MBIA) (MBIA of Illinois)		
Unenhanced Rating	BBB-(SPUR)/Stable	Affirmed
Puerto Rico VRDB subser A-2		
Puerto Rico VRDB ser 2007A subser A-2 (FSA)		
Unenhanced Rating	BBB-(SPUR)/Stable	Affirmed

Ratings Detail (As Of 05-Jun-2009) (cont.'d)		
Long Term Rating	AAA/A-1+/Watch Neg	Affirmed
Puerto Rico VRDB subser A-3		
Puerto Rico VRDB ser 2007A subser A-3 (FSA)		
Unenhanced Rating	BBB-(SPUR)/Stable	Affirmed
Long Term Rating	AAA/A-1/Watch Neg	On CreditWatch Negative
Puerto Rico VRDB subser A-4		
Puerto Rico VRDB ser 2007A subser A-4 (FSA)		
Unenhanced Rating	BBB-(SPUR)/Stable	Affirmed
Long Term Rating	AAA/A-1+/Watch Neg	Affirmed
Puerto Rico Pub Bldgs Auth, Puerto Rico		
Puerto Rico		
Puerto Rico Pub Bldgs Auth (Puerto Rico) govt fac rev rfdg bnds ser I & J		
Long Term Rating	BBB-/Stable	Affirmed
Puerto Rico Pub Bldgs Auth (Puerto Rico)		
Puerto Rico Pub Bldgs Auth (Puerto Rico) (AMBAC) Puerto Rico Pub Bldgs Auth (Puerto Rico) (MBIA) (MBIA of Illinois)		
Unenhanced Rating	BBB-(SPUR)/Stable	Affirmed
Puerto Rico Pub Bldgs Auth (Puerto Rico) GO		
Puerto Rico Pub Bldgs Auth (Puerto Rico) GO (FSA)		
Unenhanced Rating	BBB-(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.