STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

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Summary:

Puerto Rico; General Obligation; General Obligation Equivalent Security

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Summary:

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Credit Profile		
Puerto Rico pub imp rfdg bnds		
Long Term Rating	BB+/Watch Neg	Downgraded
Puerto Rico pub imp rfdg bnds ser 2003 C-5-1		
Long Term Rating	BB+/Watch Neg	Downgraded
Unenhanced Rating	NR(SPUR)	
Puerto Rico pub imp (AGM)		
Unenhanced Rating	BB+(SPUR)/Watch Neg	Downgraded
Puerto Rico GO		
Long Term Rating	BB+/Watch Neg	Downgraded
Unenhanced Rating	NR(SPUR)	
Puerto Rico GO (wrap of insured) (CIFG & AGM) (SEC MKT)		
Unenhanced Rating	BB+(SPUR)/Watch Neg	Downgraded
Puerto Rico GO (wrap of insured) (FGIC) (ASSURED GTY) (SEC MKT)		
Unenhanced Rating	BB+(SPUR)/Watch Neg	Downgraded
Puerto Rico GO (wrap of insured) (RADIAN & FGIC) (SEC MKT)		
Unenhanced Rating	BB+(SPUR)/Watch Neg	Downgraded
Puerto Rico GO (wrap of insured) (SYNCORA) (ASSURED GTY) (SEC MKT)		
Unenhanced Rating	BB+(SPUR)/Watch Neg	Downgraded
Puerto Rico GO (AGM)		
Unenhanced Rating	BB+(SPUR)/Watch Neg	Downgraded
Puerto Rico GO (MBIA) (National) (SEC MKT)		
Unenhanced Rating	BB+(SPUR)/Watch Neg	Downgraded
Puerto Rico GO		
Unenhanced Rating	BB+(SPUR)/Watch Neg	Downgraded
Long Term Rating	BB+/Watch Neg	Downgraded
Puerto Rico GO (AGM)		
Unenhanced Rating	BB+(SPUR)/Watch Neg	Downgraded
Long Term Rating	AA-/NR/Stable	Affirmed
Puerto Rico VRDB subser A-2		
Unenhanced Rating	BB+(SPUR)/Watch Neg	Downgraded
Long Term Rating	AA-/A-1/Stable	Affirmed
Puerto Rico Pub Bldgs Auth, Puerto Rico		
Puerto Rico		
Puerto Rico Pub Bldgs Auth (Puerto Rico)		

Credit Profile (cont.)		
Unenhanced Rating	BB+(SPUR)/Watch Neg	Downgraded
Puerto Rico Pub Bldgs Auth (Puerto Rico) GO		
Long Term Rating	BB+/Watch Neg	Downgraded
Puerto Rico Pub Bldgs Auth (Puerto Rico) (wrap of insured) (RADIAN & FGIC) (SEC MKT)		
Unenhanced Rating	BB+(SPUR)/Watch Neg	Downgraded
Puerto Rico Pub Bldgs Auth govt fac subseries M-2		
Unenhanced Rating	BB+(SPUR)/Watch Neg	Downgraded
Puerto Rico Pub Bldgs Auth VRDB subser M-3		
Unenhanced Rating	BB+(SPUR)/Watch Neg	Downgraded
Puerto Rico Pub Bldgs Auth (Puerto Rico)		
Long Term Rating	BB+/Watch Neg	Downgraded
Puerto Rico Pub Bldgs Auth (Puerto Rico) GO		
Unenhanced Rating	BB+(SPUR)/Watch Neg	Downgraded

Many issues are enhanced by bond insurance.

Rationale

Standard & Poor's Ratings Services has lowered its rating on the Commonwealth of Puerto Rico's general obligation (GO) debt to 'BB+' from 'BBB-'. At the same time, we have downgraded Commonwealth appropriation secured debt and Employee Retirement System (ERS) debt to 'BB'. All of our ratings remain on CreditWatch with negative implications.

The downgrades follow our evaluation of liquidity for the Commonwealth, including what we believe is a reduced capacity to access liquidity from the Government Development Bank (GDB) of Puerto Rico. In a related action, we downgraded the GDB to 'BB', and the rating remains on CreditWatch with negative implications. We also believe that the Commonwealth's access to liquidity either through GDB or other means will remain constrained in the medium term, even in the event of a potential issuance of debt planned next month. We believe that these liquidity constraints do not warrant an investment-grade rating.

The negative CreditWatch reflects uncertainties relating to the Commonwealth's constrained access to the market, as well as our assessment of the size and timing of potential additional contingent liquidity needs.

That the rating is not lower is due to the progress the current administration has made in reducing operating deficits, and what we view as recent success with reform of the public employee and teacher pension systems, which had been elusive in recent years. We view the reform as significant and could contribute to a sustainable path to fiscal stability. We view the current administration's recently announced intent to further reduce appropriations in fiscal 2014 by $170 million and budget for balanced operations in fiscal 2015 as potentially leading to credit improvement in the long run, but subject to near-term implementation risk that could lead to further liquidity pressure to the extent deficits continued. We also note the sustained commitment through a range of financial and economic cycles to funding debt obligations and providing what we view as strong bondholder security provisions.

In our view, Puerto Rico has limited liquidity without access to the debt market by either GDB or directly by the Commonwealth for sizeable amounts of debt, and may also need further market access to finance a potential fiscal 2015 operating deficit, notwithstanding current efforts to close the deficit. The planned near-term sale of sizeable Commonwealth tax-backed debt will refinance existing GDB loans into long term debt at potentially high interest costs, adding to an already high debt service burden. While we believe such a sale would provide temporary liquidity into fiscal 2015 and could be an important stabilizing factor, we believe there remain implementation risks over the next year in light of continued economic weakness. In our view, there is little margin for error over the next two years in its plan to reduce operating deficits, and potential difficulty financing future deficits larger than currently projected by the Commonwealth. Pending legislation would also raise the authorization of GDB to sell debt with a Commonwealth GO guarantee to $2.0 billion from $500 million, although the GDB has said that it plans to make only limited use of this option.

We have lowered the appropriation and ERS-secured bond ratings further than the GO rating to reflect our view that liquidity and market access risk have been heightened following our downgrade of the Commonwealth, making it less likely that the Commonwealth would prioritize appropriation debt payments in order to preserve market access for GO debt.

We have also lowered various ratings on the Puerto Rico Highways and Transportation Authority (HTA) to the same rating as the Commonwealth GO at 'BB+', and kept it on CreditWatch with negative implications, to reflect the potential diversion of gas tax-derived revenue to pay GO debt service under the Puerto Rico constitution. We have not taken a rating action on sales tax-secured debt of the Puerto Rico Sales Tax Financing Corp. (COFINA), but have retained our negative outlook on our COFINA ratings reflecting our view of the economic outlook and that COFINA sales tax is not subject to the prior diversion of revenue for GO debt service payments.

In our view, contingent liquidity risks totaling $940 million in the event of a downgrade include $257 million of potential GO variable rate demand obligation (VRDO) debt acceleration, $39 million of additional GO interest rate swap collateral posting, $575 million of HTA debt acceleration, and $69 million of additional swap collateral posting. Puerto Rico calculates that $375 million of HTA bond anticipation notes currently outstanding in the amount of $400 million would remain outstanding following a 180-day acceleration provision, while the remaining debt accelerations would need to be paid within 30 days of a downgrade. We understand that the GDB is currently negotiating to have certain debt holders waive acceleration provisions and arranging for new multi-year external bank credit lines that could mitigate near-term liquidity risks. The $940 million total includes only the current additional capital requirements in the event of a one-notch downgrade.

Also not included in the $940 million total is the need to finance the remaining portion of the fiscal 2014 Commonwealth operating deficit not already financed by GDB, or a potential 2015 deficit, if one were to develop. We believe the Puerto Rico Electric Power Authority would not have to post additional collateral in the event of a one-notch downgrade. The Commonwealth has reported that general fund revenues and expenses are performing better than originally budgeted in the first half of fiscal 2014, with revenues $93 million better than budgeted through December 2013, and expenses $19 million under budget through November. However, we believe this may not fully reflect sales taxes that are under budget, since sales taxes do not flow into the general fund in the first part of the year until COFINA annual debt service is fully paid.

The Commonwealth may also potentially need monthly cash flow financing in fiscal 2015, following use of $1.2 billion of credit line draws for cash flow purposes in fiscal 2014. We could see some inflows of public-sector deposits to GDB in the coming months as a result of a proposed bill authorizing GDB to require certain public-sector entities to transfer their deposits, which are currently held at private local banks, to GDB.

The Commonwealth GO rating is also based on our view of:

- The Commonwealth's substantial economy of 3.62 million people, whose gross product is centered on manufacturing, and the government sector contributing to significant employment. Tourism is a growing sector, although still a modest part of the overall economy, which we see as having weak economic trends that began in fiscal 2007, including population declines and economic contraction in real terms in every year except one since 2006;
- Puerto Rico's strong ties to the U.S. economy, resulting in a significant flow of trade and income transfers;
- Structural deficits in the Commonwealth's general fund for more than a decade;
- Recent willingness to tackle long-term structural issues, as indicated by enactment of substantial pension reform, elimination of subsidies for the water and sewer authority, and large recent tax increases. The current administration just announced an intention to take additional mid-year actions to reduce the current-year deficit and to introduce a balanced budget in April for fiscal 2015, which would be the first balanced budget in many years;
- The high level of debt and retirement liabilities; and
- A governmental framework that constitutionally places repayment of GO debt ahead of other expenses, and broad legal authority to adjust revenues and expenditures.

We understand that the Commonwealth has sharply reduced its estimate of its fiscal 2013 budget operating deficit from an initial $2.2 billion. The Commonwealth has budgeted for an $820 million operating deficit in fiscal 2014, or about 8% of budgetary expenses. However, the current administration has just announced an intention to take additional budget actions which would reduce the 2014 budget deficit by an additional $170 million, to a $650 million deficit, and also to pass a balanced budget for fiscal 2015. The 2014 operating deficit follows a long string of operating deficits for over a decade.

Economic profile

We believe the economy is moderately diverse in terms of employment. While manufacturing represented 45.6% of GDP in 2012, it was only 9.0% of nonfarm employment. The largest nonfarm employment sector was government at 27.8%, followed by education and health at 12.6%. Net payments abroad accounted for approximately $31.6 billion (31.2% of GNP) in 2012, on a preliminary basis. According to the GDB, income transfers from the U.S. government to the Commonwealth total about 25% of Puerto Rico income. Non-farm wage and salary employment was down 4.2% as of November 2013 from a year earlier.

Recent economic news is mixed. The U.S. Bureau of Labor Statistics released preliminary data showing December 2013 total employment was down slightly, nonfarm wage and salary employment was up slightly, and the preliminary December unemployment rate had risen to 15.4%. The GDB economic activity index was up for three consecutive months through November 2013, although down year over year. On a yearly basis, the Commonwealth has suffered economic contraction for every year except one since 2006. Income levels are well below U.S. state averages, although good compared to some Caribbean island nations.

Debt and liabilities

Deficit financing has been the primary reason for the recent increase in Puerto Rico's tax-supported debt levels in our view. We calculate that since 2009, the Commonwealth's tax-supported debt has risen by $12.7 billion, or 49.2% at fiscal end 2013. Our calculation of tax-supported debt includes $10.6 billion of GO debt, $4.0 billion of appropriation and tax-supported debt, $2.9 billion of pension bonds, $15.2 billion COFINA sales tax debt, and $5.6 billion of guaranteed debt, totaling $38.4 billion of total tax-supported debt at June 30, 2013. The majority of this increase ($8.9 billion) is attributable to debt issued by COFINA, whose corporate purpose was to fund the identified accumulated deficits through fiscal 2012, but whose authority to issue debt has just been expanded for fiscal 2014.

Our calculation of the Commonwealth's current tax-supported debt level of approximately $38.4 billion at fiscal year end June 30, 2013, or $10,635 per capita and 38% of GDP, are significantly higher than the median for the states of $1,036 per capita and 2.3% of gross state product. Total public sector debt is much larger, and includes $25.6 billion of revenue debt issued by the Commonwealth's public corporations and agencies (some of which previously received support from the general fund). This debt calculation does not include the potential for additional tax-backed debt expected to be sold shortly, or the pending expansion of a Commonwealth GO guarantee to GDB debt to $2.0 billion from $500 million.

Puerto Rico recently enacted various reforms to the Teachers Retirement System similar to the ERS reforms. This sparked a two-day teacher strike and a court stay of implementation while union litigation is resolved. Puerto Rico expects the Teachers Retirement System litigation to be resolved by the end of February, well before implementation of the important part of the legislation on July 1, which would be positive from a credit standpoint. The ERS reform significantly reduced future benefit disbursements, but requires a $140 million higher general fund contribution in fiscal 2014 and afterward to forestall much higher contributions that were projected by 2020 when the pension system would otherwise have exhausted its cash and reverted to a pay-as-you-go system. All active employees are now in a defined contribution retirement system

Combined, the employees, teachers, and judicial pension systems had what we consider a large unfunded actuarial liability of $37.0 billion, and a combined funded ratio of 8.4% at their June 30, 2012, actuarial valuation date. The ERS alone had a 4.5% funded ratio. The unfunded pension liability amounts to about $10,240 per capita. The Commonwealth's unfunded other postemployment liability is not as large, but also significant in our opinion at $2.9 billion, or about $809 per capita.

Based on the analytical factors we evaluate for U.S. states and territories, on a scale of '1.0' (strongest) to '4.0' (weakest), we have assigned a composite score of '3.2'. Based on our criteria, an overall score of '3.2' is associated with an indicative credit level in the 'BBB' category. Our criteria also specify overriding factors that may result in a rating different from the indicative credit level. In the case of the Commonwealth, we view the system support score, level of unfunded pension liabilities, liquidity, and market access as overriding factors that result in a rating below the indicative credit level.

CreditWatch

The ratings remain on CreditWatch with negative implications. The current pressures on funding access heighten our concern about the Commonwealth's overall liquidity profile and the timing and magnitude of potential contingent liquidity requirements that may develop. Our ratings reflect an expectation that either the Commonwealth or GDB will access the market in the near future, while the CreditWatch reflects the risk Puerto Rico may not be able to access the market in a manner to maintain sufficient liquidity on a timely basis. We would view a debt placement by either GDB or the Commonwealth sufficient to cover potential near-term liquidity and contingent risks, currently estimated around $1 billion or more, as an important credit stabilizing factor—the Commonwealth is currently contemplating a sizeable bond sale in the near future. The ratings could be further lowered if there is an inability to raise funding in the next few months or to otherwise improve cash flows. We expect to resolve or address the CreditWatch within the next couple of months.

Related Criteria And Research

Related Criteria

- USPF Criteria: State Ratings Methodology, Jan. 3, 2011
- USPF Criteria: Appropriation-Backed Obligations, June
- USPF Criteria: Special Tax Bonds, June 13, 2007
- USPF Criteria: Toll Road And Bridge Revenue Bonds, June 13, 2007
- USPF Criteria: Contingent Liquidity Risks, March 5, 2012
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010

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