Puerto Rico Tax-Backed Debt Downgraded To 'CC' From 'CCC-' Following Release Of Fiscal Commission Report

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NEW YORK (Standard & Poor's) Sept. 10, 2015--Standard & Poor's Ratings Services lowered its ratings on the Commonwealth of Puerto Rico's tax-backed debt to 'CC' from 'CCC-' and removed the ratings from CreditWatch, where they had been placed with negative implications July 20. The outlook is negative.

These rating actions follow the Sept. 9 release by the Working Group for the Fiscal and Economic Recovery of Puerto Rico (a special commission recently appointed by the governor) of a special fiscal commission report (the report) recommending restructuring all tax-backed debt, including general obligation (GO) and Puerto Rico Sales Tax Financing Corp. (COFINA) sales tax debt.

We believe a default or restructuring is highly likely and could take the form of either a missed debt service payment or a distressed exchange that we would characterize as a default. In a follow-up address to the commonwealth, Gov. Alejandro Garcia Padilla stated that if creditors are not willing to partake in restructuring negotiations, the government would have no alternative but to proceed without them even if it involved "years of litigation and defaults."

We rate debt 'CC' when we expect default to be a virtual certainty, regardless of the anticipated time to default. In our view, all of Puerto Rico's tax-backed debt is highly vulnerable to nonpayment.

In his television address, Gov. Padilla announced the appointment of a team of debt restructuring experts to negotiate with creditors. Although at this point

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the report is technically only a recommendation, the report specifically references measures to address all of Puerto Rico's tax-backed debt obligations, including GO and COFINA sales tax debt.

The report projects Puerto Rico's treasury will exhaust its liquidity in November 2015, even after undertaking extraordinary measures to preserve cash, while the Puerto Rico Government Development Bank (GDB) is projected to exhaust its liquidity before the end of calendar 2015. It projects Puerto Rico will not have fully sufficient resources in fiscal 2016 to make payment on its scheduled tax-supported debt, including GO debt. The report further forecasts a total central government deficit as a whole, including the general fund, GDB net revenue, COFINA, federal programs, and Puerto Rico Highways & Transportation Authority (HTA) net revenue, in fiscal 2016 of $3.2 billion, or about 16% of expenditures, including payment of debt service. The report projects only a $924 million surplus available before payment of debt service--insufficient, in our view, to pay $1.8 billion of GO and GO-guaranteed debt service (GO debt service alone is $1.2 billion), much less total central government debt service, including GO debt, of $4.1 billion.

We rate all Puerto Rico tax-backed debt at the same 'CC' level, except for Puerto Rico Public Finance Corp. (PFC) debt, which is currently in default and rated 'D', reflecting the report's projection of limited liquidity to meet all debt service before the end of calendar 2015, including GO debt service, and the report's recommendation to enter restructuring discussions with all tax-backed debt holders.

The report also makes various other revenue and expenditure recommendations, although the governor stated in his follow-up address that he does not expect to make any further reductions to the number of commonwealth employees. In addition, the report recommends that the governor establish a five-member financial control board with oversight authority over most governmental entities, including the commonwealth, GDB, and the public corporations except Puerto Rico Aqueduct & Sewer Authority (PRASA) and Puerto Rico Electric Power Authority. Creating such a board would, however, that would require new legislation. In our view, it may be difficult for the governor to obtain the requisite legislative approval to cede significant fiscal power to a financial control board. The report also anticipates the provision of additional federal health care funding not in current law and other U.S. actions in future years that might not materialize.

Apart from the information and recommendations contained in the report, we believe Puerto Rico's very difficult near-term fiscal situation is demonstrated by:

- A large $703 million fiscal 2015 operating deficit, despite the enactment on paper of a balanced budget;
- Constraints on external market access for needed cash flow financing, which has contributed to what we view as the current precarious liquidity position--in fiscal 2015 the commonwealth was able to sell $1.2 billion of cash flow financing notes, but has been unable to sell external cash flow financing to date in fiscal 2016;

- The recent default on PFC annual appropriation-secured debt as the result of non-appropriation of debt service by the legislature;
- A recent decision to no longer make monthly GO debt service set-asides in advance of the commonwealth's next Jan. 1 GO debt service payment date in order to preserve liquidity;
- The administration's embrace of an earlier report released on June 29 (the Kreuger report), that similarly recommended debt restructuring as part of a comprehensive fiscal solution; and
- A weak long-term fiscal outlook due to pressures from projected rising healthcare costs, pension payments, and debt service, which increases Puerto Rico's incentive to pursue debt restructuring.

OUTLOOK

If any specific debt issues fell into default, we would lower our rating on the debt to 'D'. Although we do not expect it to occur, if liquidity improved to the extent we believe likely for the commonwealth to avoid near-term default, we could potentially raise our rating back to the 'CCC' category.

DEBT AND LIABILITY UPDATE

New debt figures were released with this report. Using these figures, we calculate Puerto Rico's total tax-backed debt as of June 30, 2015, at $48.5 billion, which includes $13.1 billion GO debt; $5.5 billion commonwealth-guaranteed debt, including $1.1 billion of PRASA debt guaranteed by the commonwealth; $4.1 billion appropriation of Public Building Authority lease supported debt; $2.9 billion Employees Retirement System debt secured by the commonwealth and local employer contributions, but in our view ultimately paid by the general fund; $15.2 billion COFINA sales tax bonds; $554 million Puerto Rico Convention Center District Authority hotel tax bonds; $6.5 billion HTA transportation tax-secured bonds; a $246 million petroleum tax-backed note held by GDB; and $300 million of cash flow notes; but excludes Puerto Rico Infrastructure Financing Authority debt secured by federal rum excise taxes on product sold in the U.S., as well as local municipal debt, and nonguaranteed debt secured by electric and water and sewer utilities. Our calculation of total tax-backed debt equals a very high $13,714 per capita, 76.0% of personal income, and 46.7% of gross domestic product.

We also view Puerto Rico's unfunded pension obligations as very high. Puerto Rico has disclosed a preliminary actuarial valuation of its multi-employer Employees Retirement System as of June 30, 2014, with a net pension liability of $30.0 billion, and a 0.7% funded ratio. The system's net assets were projected to be exhausted in fiscal 2015, but due to the $2.9 billion of pension obligation bonds outstanding, its gross assets were not projected to be depleted until fiscal 2021. However, because a significant amount of the system's assets are loaned to its members, and Puerto Rico funded less than its actuarial recommendation in fiscal 2015, we believe the system's assets will likely be exhausted before then. Puerto Rico's Teachers Retirement System had a preliminary June 30, 2014 valuation showing a $13.1 billion net pension liability and an 11.5% funded ratio. The commonwealth's Judiciary Retirement System had a preliminary $62.1 million net pension liability and a 12.3% funded ratio.

Puerto Rico also projects that without additional federal funding under the Affordable Care Act its health care insurance program deficit could rise to $2.0 billion by fiscal 2019, up from $59 million in fiscal 2014, which could potentially require general fund subsidies.

The commonwealth's tax-backed debt rated 'CC' with a negative outlook includes:
- Puerto Rico GO bonds;
- COFINA first-lien and second-lien sales tax bonds;
- Puerto Rico Municipal Finance Agency's, the Puerto Rico Employees Retirement System's, and the commonwealth's general fund-supported appropriation and moral obligation bonds (excluding PFC debt, which is currently in default and rated 'D');
- Puerto Rico Infrastructure Financing Authority's (rum tax);
- Puerto Rico Convention Center District Authority's (hotel tax) debt; and
- Puerto Rico HTA's rated debt.

RELATED CRITERIA AND RESEARCH

Related Criteria
- USPF Criteria: Assigning Issue Credit Ratings Of Operating Entities, May 20, 2015
- Criteria: Toll Road And Bridge Revenue Bonds In The U.S. And Canada, Feb. 25, 2014
- Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings, Oct. 1, 2012
- USPF Criteria: Methodology: Definitions And Related Analytic Practices For Covenant And Payment Provisions In U.S. Public Finance Revenue Obligations, Nov. 29, 2011
- USPF Criteria: Methodology: Rating Approach To Obligations With Multiple Revenue Streams, Nov. 29, 2011
- Criteria: Use of CreditWatch And Outlooks, Sept. 14, 2009
- USPF Criteria: State Ratings Methodology, Jan. 3, 2011
- USPF Criteria: Appropriation-Backed Obligations, June 13, 2007
- USPF Criteria: Special Tax Bonds, June 13, 2007
- USPF Criteria: Debt Statement Analysis, Aug. 22, 2006
- USPF Criteria: Moral Obligation Bonds, June 27, 2006
- USPF Criteria: Financial Management Assessment, June 27, 2006

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