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Puerto Rico GO Rating Lowered One Notch To 'BB' Following Debt Legislation; Outlook Negative

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NEW YORK (Standard & Poor's) July 11, 2014--Standard & Poor's Ratings Services has lowered its general obligation (GO) rating on the Commonwealth of Puerto Rico to 'BB' from 'BB+'. Standard & Poor's has also lowered the following : its rating on the Puerto Rico Sales Tax Financing Corporation (COFINA) first lien sales tax bonds to 'BBB' from 'AA-'; its second lien COFINA sales tax underlying rating (SPUR) to 'BBB-' from 'A+'; its rating on the Puerto Rico Highways and Transportation Authority (HTA) to 'B' from 'BB+; its ratings on the Puerto Rico Municipal Finance Agency, the Puerto Rico Employees Retirement System, and general fund-supported appropriation and moral obligation bonds to 'BB-' from 'BB'; and its ratings on the Puerto Rico Infrastructure Financing Authority (rum tax) and the Puerto Rico Convention Center District Authority (hotel tax) ratings to 'BB' from 'BB+'. All ratings have been removed from CreditWatch and assigned a negative outlook.

GO AND APPROPRIATION SECURED RATINGS

The rating actions follow the enactment of the Puerto Rico Public Corporation Debt Enforcement Act (the Act), which allows certain Puerto Rican public corporations and other instrumentalities of the commonwealth to seek protection from creditors through a debt restructuring. Although the Act specifically excludes GO, general fund appropriation secured, and COFINA secured debt, we believe it could potentially limit the demand for liquidity and budgetary support to the public corporations from the commonwealth and the Government Development Bank. We also believe that the enactment of the bill is indicative of the mounting economic and fiscal challenges for the commonwealth as a whole, which could lead to additional liquidity pressures in the long term, and enactment of the legislation itself signals a potential shift in the commonwealth's historically strong willingness to continue to meet its obligations to bondholders, particularly in the event of constrained market access.

Although from a credit standpoint we view the recent enactment of a budget for fiscal 2015 that significantly improves structural alignment for fiscal 2015 as favorable, we nevertheless continue to view the commonwealth's fiscal situation as precarious. We believe there will be spending pressure from escalating GO and COFINA related debt service in future years and—absent implementation of reform measures currently under judicial stay—potential for rising costs related to the commonwealth's teacher retirement system.

HIGHWAYS AND TRANSPORTATION AUTHORITY

We have lowered the rating on HTA multiple notches below that of the commonwealth's GO bonds because we believe the new law facilitates Puerto Rico's eventual restructuring of HTA operations and debt obligations, including approximately $2 billion in loans payable to GDB, as well as outstanding toll and gas and petroleum tax secured bonds.

COFINA

We have also lowered the rating on COFINA multiple notches, bringing the COFINA sales tax rating closer to that of the commonwealth's GO, as a result of our view that the Act raises the risk that the commonwealth may seek additional changes in statutory law that could potentially reduce the separation in credit quality of COFINA's sales tax pledge from the commonwealth's finances should financial stress on the general fund increase significantly. However, we continue to maintain an investment grade rating on the COFINA bonds due to the strong statutory provisions that still remain in place giving COFINA a first lien on pledged sales taxes, before transfer of excess revenues to the general fund after payment of COFINA debt service. The rating reduction on COFINA also reflects continued weak economic trends over the past year. COFINA debt has an escalating annual debt service schedule, and while we believe current annual debt service coverage is strong by pledged sales and use taxes, weak economic and revenue performance could translate to lower annual coverage coverage in the future. The commonwealth released unaudited fiscal 2014 pledged revenues today, with an annual increase, partly as the result of a one-time expansion of the sales tax base to business services, but less than what was projected at the time of 2014 budget adoption. We calculate fiscal 2014 pledged sales and use tax (SUT) would provide 1.83x annual debt service coverage on combined first and second lien in 2014, at a level that could cover annual debt service through 2031, but provide only 0.68x coverage of maximum annual debt service occurring in 2041 without future revenue growth.

ENACTED 2015 BUDGET

The enacted general fund budget for fiscal 2015 projects no new deficit financing, although we believe that there are still implementation risks to the achievement of budget projections. These include a history of revenues coming in below budget and difficulty in reducing expenditures. The 2015 budget assumes new revenue measures of $370 million, plus $170 million of additional revenue from collecting SUT at ports of entry, which we understand the commonwealth believes will reduce tax evasion, plus $112 million of additional revenue from rum sales and other adjustments. The commonwealth recently announced general fund net revenues were $488 million short of fiscal 2014 budgeted amounts, on budgeted fiscal 2014 revenues of $9.5 billion. The fiscal 2014 budget had originally targeted a deficit of $650 million, or 6% of appropriations, and now has an estimated fiscal 2014 deficit of $783 million, or 8% of amended budgeted appropriations. The commonwealth attributes some of the shortfall to taxpayers who postponed tax filings, which may result in increased deferred revenue as extended filing deadlines are reached shortly after fiscal year end. The executive budget proposal for fiscal 2015 projects expenditures reductions of about $130 million from fiscal 2014, the result of cost escalators of $1.2 billion offset by corrective measures of $1.4 billion. Lawmakers also made additional spending-side adjustments in the fiscal 2015 budget, with an additional $82 million in net spending cuts, as we understand it, that were included in the enacted budget. Corrective expenditure reductions include certain freezes in funding formula increases, and the redirection of certain recurring revenues from public corporations to related expenses, among other measures.

The negative outlook on the GO debt reflects our view of implementation risk in achieving progress toward structural budget alignment in fiscal 2015, potential limitations on capital market access, and continued weak economic conditions that we believe show recent signs of stabilization, but not yet meaningful growth. Should fiscal 2015 develop a material general fund deficit as the fiscal year progresses, to the extent general fund liquidity is affected during our one-year rating outlook horizon, or economic conditions deteriorate substantially, we could lower the rating. If, in our view, financial, liquidity and economic conditions improve significantly the outlook could be returned to stable. We do not see upside rating potential at this time due to the uncertainty surrounding the potential restructuring of public corporation debt and its impact on the central government and the Government Development Bank. The negative outlook on related appropriation secured and other debt and debt subject to prioritization after payment of GO debt under the Puerto Rican constitution is based on our GO rating outlook.

The negative outlook on COFINA debt reflects the possibility over the next two years we could lower COFINA's rating should we lower the commonwealth's GO rating, and our view that a smaller rating separation between COFINA and the GO rating is appropriate following passage of the Debt Enforcement Act. In addition, should the commonwealth make statutory changes that affect the level of pledged sales tax revenues, or there should be a significant decline in pledged revenues for economic reasons, we could lower the rating.

RELATED CRITERIA AND RESEARCH

Related Criteria

- 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: Moral Obligation Bonds, June 27, 2006

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