

September 3, 2008

Summary:

Puerto Rico; Appropriations; General Obligation

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Credit Profile

US\$250. mil pub imp bnds (Go Bnds) ser 2008A due 07/01/2038

Long Term Rating

BBB-/Stable

New

Rationale

Standard & Poor's Ratings Services assigned its 'BBB-' rating to the commonwealth of Puerto Rico's series 2008A general obligation (GO) public improvement bonds.

The commonwealth's full faith and credit pledge secures the bonds. Officials will use bond proceeds to fund a portion of the commonwealth's 2008 capital improvement program.

The rating reflects:

- The commonwealth's chronic budget deficits, although a major new revenue source, a 5.5% sales tax, was added in fiscal 2007, balance remains difficult to achieve, requiring expense cuts and use of onetime revenue sources;
- The current economic recession will further complicate the achievement of balanced operations, as evidenced by the projected \$1 billion revenue gap included in the fiscal 2009 budget;
- High debt levels, currently at about 33.8% of gross national product (GNP) and \$5,789 per capita; and
- Historical tension among the government's different branches concerning cohesive long-term fiscal and economic policies, which provide a greater degree of institutionalization of financial management policies.

Factors that continue to support the rating include:

- The commonwealth's strong ties to the U.S. economy, resulting from a significant flow of trade investment income and a history of favorable federal tax incentives that have stimulated investment in the island economy;
- A greater degree of revenue flexibility following the approval of a 5.5% sales tax with 1.0% dedicated to the repayment of roughly \$6.8 billion of appropriation (extraconstitutional) debt; and
- The Government Development Bank for Puerto Rico's stabilizing financial and management influence on Puerto Rico.

Puerto Rico continues to face significant financial and economic challenges. While the passage of a 5.5% sales and use tax in fiscal 2007 provided additional revenue flexibility, declining economic activity has limited the commonwealth's overall revenue-generating potential. According to the Puerto Rico Planning Board, the commonwealth's GNP experienced a 1.8% decline in real terms in fiscal 2007. We expect the slowdown in the U.S. economy and continued high oil prices to further reduce Puerto Rico's growth prospects in fiscal 2008. The planning board expects GNP to decline by 2.1% in real terms, with economic growth expected to return in fiscal 2009, albeit at a modest 2.1% rate.

The commonwealth's economic recession has inevitably taken its toll on revenue collections. Current fiscal 2008

projections estimate a general fund structural deficit of \$804 million, or about 8% of general fund expenditures. The projected structural deficit is primarily the result of an underperformance in revenues (mostly income tax revenues), which are estimated to have ended fiscal 2008 \$643.6 million below fiscal 2007 levels. The commonwealth closed the budget gap by collecting approximately \$300 million in pending reimbursements from the U.S. Department of Education, and through cash management strategies, which included the deferral of payments to suppliers.

The fiscal 2009 budget includes a \$1 billion structural deficit. This gap can be largely attributed to slower tax revenue growth, particularly in income tax receipts, which are budgeted to be approximately \$464 million lower (9.2%) than the fiscal 2008 budgeted level. The budget shows recurring general fund revenues reaching \$8.8 billion dollars, or roughly 2.7% below the fiscal 2008 budget. Commonwealth officials attribute the economic recession largely to the implementation of the sales and use tax (SUT). However, from a fiscal

perspective, the SUT has performed better than anticipated. For the first six months of the current fiscal year, SUT collections reached \$486.5 million, or approximately 2% above budget. The fiscal 2009 budget estimates SUT collections of \$977 million, 7.2% above estimates for fiscal 2008.

The adopted fiscal 2009 budget includes non-recurring revenue measures to fill the \$1 billion projected gap. The administration is planning to fill this gap from the collection of delinquent tax accounts. The treasury department has identified approximately \$1.3 billion in receivables that are less than five years past due.

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. GO debt reached \$11.5 billion, including \$1.1 billion of short-term debt, or an above-average \$3,524 per capita and 20% of GNP. Total tax-supported debt, including some debt from the commonwealth's public corporations, is a high 33.8% of GNP and \$5,789 per capita. Total public sector debt, including revenue-secured debt issued by underlying agencies and trusts, reached \$43.6 billion, or a high 76% of GNP.

Outlook

The stable outlook reflects our expectation that the current economic recession and revenue shortfall coupled with expenditure rigidity will result in persistent budget imbalance in the next two fiscal years. Should the economy weaken further, pressuring the revenue and expense budgets and overall liquidity, we could lower the rating. If the commonwealth, however, achieves and maintains structural balance and reduces the accumulated deficit, based on either revenue or expenditure actions, we could raise the rating to 'BBB'.

Ratings Detail (As Of September 3, 2008)		
Puerto Rico GO		
<i>Long Term Rating</i>	BBB-/Stable	Affirmed
Puerto Rico GO		
<i>Unenhanced Rating</i>	BBB-(SPUR)/Stable	Affirmed
Puerto Rico Pub Bldgs Auth, Puerto Rico		
Puerto Rico		

Ratings Detail (As Of September 3, 2008) (cont.)		
Puerto Rico Pub Bldgs Auth (Puerto Rico)		
<i>Unenhanced Rating</i>	BBB-(SPUR)/Stable	Affirmed
Puerto Rico Pub Bldgs Auth (Puerto Rico) GO		
<i>Unenhanced Rating</i>	BBB-(SPUR)/Stable	Affirmed
Puerto Rico Pub Fin Corp, Puerto Rico		
Puerto Rico		
Puerto Rico Pub Fin Corp		
<i>Unenhanced Rating</i>	BBB-(SPUR)/Stable	Affirmed
Puerto Rico Pub Fin Corp (Puerto Rico)		
<i>Unenhanced Rating</i>	BBB-(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.

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