

RatingsDirect®

Summary:

Commonwealth of Puerto Rico; Appropriations; General Obligation; General Obligation Equivalent Security; Moral Obligation

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Summary:

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Credit Profile

Puerto Rico GO

Unenhanced Rating

BBB-(SPUR)/Negative

Downgraded

Long Term Rating

BBB-/Negative

Downgraded

Rationale

Standard & Poor's Ratings Services lowered its general obligation (GO) rating on the Commonwealth of Puerto Rico to 'BBB-' from 'BBB'. The outlook is negative.

We base the downgrade on the result of an estimated fiscal 2013 budget gap, which we view as significantly larger than originally budgeted, absent corrective action. We believe the shortfalls against budget in fiscal 2013 will make it difficult for the commonwealth to achieve structural balance in the next two years. If, in that time frame, only limited progress is made to reduce what we consider large structural budget gaps, we could lower the rating further. The incoming administration of Governor Alejandro Garcia Padilla is considering a number of corrective budget actions, and has proposed what we view as major reform of Puerto Rico's poorly funded pension system. However, we feel that the size of the potential fiscal 2013 budget gap and potential future years' structural deficits warrant a rating action at this time.

We have not lowered the rating on the appropriation debt, which we typically rate one notch below the GO, reflecting current law that allows the governor or budget director to first, prioritize the payment of principal and interest corresponding to public debt, and second, to bind obligations to safeguard the credit, reputation, and good name of the government, when available funds for a specific fiscal year are not sufficient to cover the appropriations approved for that year. Given this structural feature, Standard & Poor's does not believe at this time that Puerto Rico's appropriation credit is speculative-grade.

In January 2013, the Commonwealth of Puerto Rico released a new preliminary estimate of its budget gap for the fiscal year ending June 30, 2013. At the time of original fiscal 2013 budget adoption, the commonwealth budgeted for a fiscal 2013 operating deficit of \$332 million, or 3.7% on budgeted expenses of \$9,082 million, and what we calculate as a structural budget gap of about 10% of expenditures, excluding \$775 million of budgeted debt refinancing and the \$332 million budgeted deficit.

The new preliminary commonwealth estimate is for a much larger \$2.157 billion structural operating deficit, absent corrective action, which would produce what we calculate as structural gap of about 22% against a new higher

estimate of expenditures. The actual 2013 deficit will be lower due to a \$775 million credit line drawn from the Government Development Bank of Puerto Rico (GDB), and to the extent that midyear budget actions are taken, or there is additional deficit financing.

The higher projected operating deficit is the result of expenses estimated at \$140 million above budget; revenues \$910 million below budget mainly due to non-recurring revenues during fiscal 2012 that were included in the base, and additional anticipated revenues from certain administrative measures, such as special tax audits and implementation of a sales and use tax lottery, which did not materialize; \$775 million of debt service refinancing in fiscal 2013 that has not occurred, but instead taken as a credit line draw from GDB; plus the originally budgeted operating deficit of \$332 million. Absent corrective actions, the commonwealth projected budgetary basis revenues of \$7.840 billion and expenses of \$9.997 billion.

We believe that it will still be difficult for the Puerto Rico to achieve structural balance before fiscal 2016, even with potential corrective actions, due to the size of the current budget gap.

The administration is exploring revenue enhancement measures, including the elimination of several exemptions from the sales and use tax, as well as changes to the collection mechanism at point of sale. Other potential fiscal actions the administration is considering, besides those related to sales and use taxes, have not yet been announced publicly. However, the administration has released a proposal for what we view as significant pension reform.

The commonwealth's two retirement systems are running cash flow deficits and are projected to run out of assets without pension reform. Under current actuarial assumptions, Puerto Rico's multi-employer Employees Retirement System (ERS) will run out of assets to pay retirees in fiscal 2019, and its Teachers Retirement System (TRS) would run out of assets in 2022. The commonwealth's actuaries project that ERS then will run an average annual cash flow shortfall of \$905 million per year from fiscal 2022 through fiscal 2051, absent corrective action, and the TRS would run an average annual cash flow shortfall of \$590 million per year from fiscal 2022 through 2051, absent corrective action. ERS had what we consider to be a very low actuarial funded ratio of 6.8% at June 30, 2011. In fiscal 2011, ERS employer and employee contributions totaled 61% of its actuarial annual required contribution (ARC), with a contribution shortfall of \$1.4 billion against ARC, including both local municipal, and commonwealth and commonwealth agency participants. The commonwealth projects that ERS will have negative net assets next year without reform, although the cash flow shortfall would not manifest itself until 2019.

The governor's proposed pension reforms include moving existing ERS employees to a hybrid retirement plan, consisting of a defined benefit plan for already earned benefits and a defined contribution plan for benefits earned after July 1, 2013. The plan also includes raising the retirement age on a staggered basis, increasing the employee retirement contribution from 8.275% to a minimum of 10%, reducing non-required Christmas "bonuses" to retirees and eliminating the summer "bonus," and reducing employer contributions to the retiree medical plan. If the ERS reform proposals were adopted as proposed, the commonwealth would still have to contribute approximately an extra \$140 million per year to the pension system, but would be able to avoid the higher \$905 million pay-as-you-go contribution that would be otherwise required after fiscal 2019. Other pension reform proposals may be introduced shortly.

Based on overall factors we use under our state rating criteria, we have changed our overall score for the

commonwealth to '3.2' from '3.0'.

(For more information on the Commonwealth of Puerto Rico, please refer to our most recent full analysis published June 12, 2012, on RatingsDirect on the Global Credit Portal.)

Outlook

The negative outlook is the result of projections of what we view as large shortfalls against budget in fiscal 2013, absent corrective action, that will make it difficult for the commonwealth to achieve structural balance in the two-year outlook horizon. If only limited progress is made in upcoming budget cycles in significantly reducing large structural budget gaps, we could lower the rating further. The incoming administration of Governor Padilla is considering a number of corrective budget actions, and has proposed what we view as major pension reform of the commonwealth's poorly funded pension system. Standard & Poor's will evaluate the fiscal effect of potential fiscal and pension reforms in determining future credit trends.

Related Criteria And Research

USPF Criteria: State Ratings Methodology, Jan. 3, 2011

Ratings Detail (As Of March 13, 2013)		
Puerto Rico pub imp rfdg bnds ser 2003 C-5-1		
<i>Long Term Rating</i>	BBB-/NR/Negative	Downgraded
<i>Unenhanced Rating</i>	BBB-(SPUR)/Negative	Downgraded
Puerto Rico pub imp rfdg bnds ser 2012A due 07/01/2041		
<i>Long Term Rating</i>	BBB-/Negative	Downgraded
Puerto Rico pub imp (AGM)		
<i>Unenhanced Rating</i>	BBB-(SPUR)/Negative	Downgraded
Puerto Rico GO		
<i>Long Term Rating</i>	BBB-/NR/Negative	Downgraded
<i>Unenhanced Rating</i>	BBB-(SPUR)/Negative	Downgraded
Puerto Rico GO (wrap of insured) (CIFG & AGM) (SEC MKT)		
<i>Unenhanced Rating</i>	BBB-(SPUR)/Negative	Downgraded
Puerto Rico GO (wrap of insured) (FGIC) (ASSURED GTY) (SEC MKT)		
<i>Unenhanced Rating</i>	BBB-(SPUR)/Negative	Downgraded
Puerto Rico GO (wrap of insured) (RADIAN & FGIC) (SEC MKT)		
<i>Unenhanced Rating</i>	BBB-(SPUR)/Negative	Downgraded
Puerto Rico GO (wrap of insured) (SYNCORA) (ASSURED GTY) (SEC MKT)		
<i>Unenhanced Rating</i>	BBB-(SPUR)/Negative	Downgraded
Puerto Rico GO (AGM)		
<i>Unenhanced Rating</i>	BBB-(SPUR)/Negative	Downgraded

Ratings Detail (As Of March 13, 2013) (cont.)

Puerto Rico GO (MBIA) (National) (SEC MKT)		
<i>Unenhanced Rating</i>	BBB-(SPUR)/Negative	Downgraded
Puerto Rico Indl Tour Ed Med & Environ Ctrl Fac Fin Auth (Costa Caribe Resort Proj)		
<i>Long Term Rating</i>	BBB-/Negative	Downgraded
Puerto Rico GO		
<i>Unenhanced Rating</i>	BBB-(SPUR)/Negative	Downgraded
Puerto Rico GO (AGM)		
<i>Unenhanced Rating</i>	BBB-(SPUR)/Negative	Downgraded
<i>Long Term Rating</i>	AA-/NR/Stable	Affirmed
Puerto Rico VRDB subser A-2		
<i>Unenhanced Rating</i>	BBB-(SPUR)/Negative	Downgraded
<i>Long Term Rating</i>	AA-/A-1/Stable	Affirmed
DBR Dorado Owner LLC, Puerto Rico		
Puerto Rico		
DBR Dorado Owner LLC (Puerto Rico) (Tourism Dev Fund) (Ritz-Carlton Reserve Proj)		
<i>Long Term Rating</i>	BBB-/Negative	Downgraded
Puerto Rico Aqueduct & Swr Auth, Puerto Rico		
Puerto Rico		
Puerto Rico Aqueduct & Swr Auth (Puerto Rico)		
<i>Long Term Rating</i>	BBB-/Negative	Downgraded
Puerto Rico Indl Tourist Educl Med Environ Cntl Facs Fincg Auth, Puerto Rico		
Puerto Rico		
Puerto Rico Indl Tour Ed Med & Environ Ctrl Fac Fin Auth (Puerto Rico) (Cayo Largo Inter-Continental Beach Resort Proj)		
<i>Long Term Rating</i>	BBB-/Negative	Downgraded
Puerto Rico Indl Tour Ed Med & Environ Ctrl Fac Fin Auth (Puerto Rico) (Coco Beach Golf & Ctry Club Resort Proj)		
<i>Long Term Rating</i>	BBB-/Negative	Downgraded
Puerto Rico Indl Tour Ed Med & Environ Ctrl Fac Fin Auth (Puerto Rico) (Trump International Golf Club Proj)		
<i>Long Term Rating</i>	BBB-/Negative	Downgraded
Puerto Rico Pub Bldgs Auth, Puerto Rico		
Puerto Rico		
Puerto Rico Pub Bldgs Auth (Puerto Rico)		
<i>Unenhanced Rating</i>	BBB-(SPUR)/Negative	Downgraded
Puerto Rico Pub Bldgs Auth (Puerto Rico) GO		
<i>Long Term Rating</i>	BBB-/Negative	Downgraded
Puerto Rico Pub Bldgs Auth (Puerto Rico) (wrap of insured) (RADIAN & FGIC) (SEC MKT)		
<i>Unenhanced Rating</i>	BBB-(SPUR)/Negative	Downgraded
Puerto Rico Pub Bldgs Auth govt fac subseries M-2		
<i>Unenhanced Rating</i>	BBB-(SPUR)/Negative	Downgraded
Puerto Rico Pub Bldgs Auth VRDB subser M-3		

Ratings Detail (As Of March 13, 2013) (cont.)		
<i>Unenhanced Rating</i>	BBB-(SPUR)/Negative	Downgraded
Puerto Rico Pub Bldgs Auth (Puerto Rico)		
<i>Long Term Rating</i>	BBB-/Negative	Downgraded
Puerto Rico Pub Bldgs Auth (Puerto Rico) GO		
<i>Unenhanced Rating</i>	BBB-(SPUR)/Negative	Downgraded
Puerto Rico Pub Fin Corp, Puerto Rico		
Puerto Rico		
Puerto Rico Pub Fin Corp (Puerto Rico)		
<i>Long Term Rating</i>	BBB-/Negative	Downgraded
Puerto Rico Pub Fin Corp (Puerto Rico)		
<i>Long Term Rating</i>	BBB-/Negative	Downgraded
Puerto Rico Pub Fin Corp (Puerto Rico)		
<i>Long Term Rating</i>	BBB-/Negative	Downgraded
Puerto Rico Pub Fin Corp (Puerto Rico) bnds (Commonwealth Approp Bnds)		
<i>Long Term Rating</i>	BBB-/Negative	Downgraded
Puerto Rico Pub Fin Corp (Puerto Rico) (Commonwealth Approp Bnds)		
<i>Unenhanced Rating</i>	BBB-(SPUR)/Negative	Downgraded

Many issues are enhanced by bond insurance.

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