

New Issue: Puerto Rico (Commonwealth of)

MOODY'S ASSIGNS Baa3 RATING AND NEGATIVE OUTLOOK TO \$893,000,000 MILLION COMMONWEALTH OF PUERTO RICO G.O. BONDS

Ratings on \$25 billion of outstanding government debt confirmed and removed from Watchlist

State
 PR

Moody's Rating

ISSUE	RATING
Public Improvement Bonds of 2006, Series A, and Public Improvement Refunding Bonds, Series 2006B	Baa3
Sale Amount	\$893,000,000
Expected Sale Date	08/01/06
Rating Description	General Obligation Bonds

Moody's Outlook Negative

Opinion

NEW YORK, Jul 21, 2006 -- Moody's Investors Service assigned a Baa3 rating and negative outlook to the Commonwealth of Puerto Rico's planned August 1 sale of \$893,000,000 million of general obligation bonds to fund capital improvements and refinance existing debt. At this time, we have also confirmed and removed from watch the ratings on some \$25 billion of outstanding Puerto Rico government debt, as listed at the end of this report. The rating outlook for all of this debt also remains negative.

The Commonwealth's G.O. rating reflects the following credit strengths and challenges:

Credit Strengths

"Politically and economically linked to the U.S., with benefit of the nation's strong financial, legal, and regulatory systems.

"Large economy, with gross product exceeding those of ten states and population exceeding those of 24 states.

"Growing and diversifying private sector, which generated faster job growth than the U.S. during the 1990s. Private sector jobs have been flat since 2000 due to manufacturing losses (similar to the mainland U.S. pattern).

"Wide legal powers to raise revenues, adjust spending programs, and employ borrowing in order to maintain fiscal solvency.

Credit Challenges

"High unemployment, low workforce participation, and high poverty levels compared to the U.S. Average income levels remain below 50% relative to the U.S. mainland.

"Deeply polarized political system impedes consensus on economic development and fiscal issues. Large size of Commonwealth government relative to the economy also reduces practical flexibility on fiscal issues.

"Multi-year trend of large General Fund operating deficits, primarily due to overspending, and financed by deficit borrowing. Deficits are expected to continue in coming years, though smaller than the imbalance of over 18% of revenues in 2006.

"Very high and rapidly growing government debt level relative to the economy, due in part to financing budget deficits.

"Seriously under-funded pension system, also plagued by reporting lags and intra-governmental disputes over payment responsibilities; system has had difficulty meeting benefit payments in recent years.

The confirmation of the Commonwealth's government debt ratings at this time reflects the Commonwealth's recent passage of legislation authorizing a 7% sales tax (with an optional 1% after January 2007 if certain one-time tax measures do not produce the expected amount), as well as general legislation mandating spending process controls and a restrained specific budget plan for fiscal 2007. Together, these actions represent a positive effort to address the government's multi-year trend of large budget deficits and deficit borrowings. The revenue yield of the sales tax is lower than previously expected, however, due to significant tax exemptions included in the legislation. In addition, the government's near-term spending reduction plans are heavily dependent on debt restructuring and health and education cuts that are still in a relatively early stage of development. The continued negative rating outlook reflects the potential for continued fiscal strain and political conflict as these plans, and the new sales tax, are implemented.

REVENUE SHORTFALL INCREASES 2006 BUDGET GAP TO OVER \$1.5 BILLION

Due to local economic slowing, the Commonwealth experienced tax revenue shortfalls in the last several months of fiscal 2006. As a result, the revenue estimates for fiscal 2006 and fiscal 2007 were reduced by \$350 and \$200 million respectively. The revenue loss in 2006 increases the estimated budget gap to more than \$1.5 billion including recurring and non recurring revenues, representing over 18% of revenues for the year. The gap was financed with \$1.2 billion of loans from the Government Development Bank (including \$368 million that is being refinanced with the current bond issue), a \$100 million G.O. sale to an institutional investor just before the close of the year, and other cash-management measures.

7% SALES TAX IMPROVES COMMONWEALTH'S TAX SYSTEM, THOUGH NET REVENUE EFFECT IS LIMITED

Culminating a long and torturous political debate on fiscal and tax reform, the Commonwealth recently enacted legislation authorizing a new retail sales tax of 7%. An additional 1% may be instituted by the Governor after January 2007 if certain one-time tax measures relating to capital gains, dividends, and stock options do not produce \$1 billion by December 2006. This additional 1% will remain in effect until it has produced, along with the one-time measures, a total of \$1 billion. The legislation also repeals the existing 5% general excise tax on imported goods and modestly reduces individual income taxes. The sales tax is expected to be more efficient and less prone to evasion than the previous excise tax system. It is also expected to be less prone to evasion than the income tax system. In addition to these benefits, the tax reforms are projected to result in a net revenue gain for the Commonwealth of \$370 million on an annualized basis (first year will be less). This represents a net revenue increment of slightly more than 4% over base revenues before the reform, and at best addresses some one-third of the Commonwealth's structural budget gap. Significant tax exemptions (groceries, gasoline, etc.) were included in the final sales tax legislation, materially reducing the revenue gain compared to earlier expectations of a net revenue gain at least twice as large.

The 7% sales tax is composed of a 1.5% municipal tax, as well as a 5.5% central government tax scheduled to begin collection on November 15 (barring any litigation or additional political delays). There is an additional 1% central government tax which may come into effect in January 2007. The central government will also receive 0.2% from the municipal portion of the tax. The central government has dedicated 1% of its overall 6.7% tax to a new trust fund to be used for specified debt service obligations. Each 1% of the central government's tax is projected to initially yield \$190 million on an annualized basis. The municipal tax yield is greater due to fewer exemptions.

FISCAL 2007 BUDGET RELIES ON SIGNIFICANT DEBT RESTRUCTURING AND PLANNED CUTS IN HEALTH AND EDUCATION

The Commonwealth has also enacted general "fiscal reform" legislation that intends to improve numerous budgetary control processes, and a Commonwealth budget for fiscal 2007. The latter represents an improvement over fiscal 2006, which saw no legislatively-approved budget for the year. As enacted, the 2007 budget plan calls for a significant reduction in debt service due to the 1% of sales tax dedicated to debt service and planned debt restructuring transactions, as well as a roughly \$200 million reduction in non-debt service spending based on planned savings in the health and K-12 education areas. Total authorized spending, including the debt service trust, is \$9.6 billion, compared to actual total spending of \$10.1 billion in 2006.

Total projected revenue for the year, again including the debt service trust, is close to \$9.3 billion. This includes assumed base revenue growth of about 3%. There is potential forecast risk on the spending side of the budget, however. The plan to reduce non-debt service spending on an absolute basis from the previous year is unprecedented for the Commonwealth. At the same time, the planned savings in health and education are still in an early stage of development, making evaluation difficult.

Based on the Treasury department's revenue estimates, which are more conservative than those of the legislature, the enacted 2007 budget contains an unresolved shortfall of \$325 million. If this shortfall is not subsequently resolved, and especially if it grows in size due to the various forecast risks discussed above, Moody's is concerned that the Commonwealth could potentially face another budget crisis in the spring of 2007, similar to the crisis this spring that led to the battle over a GDB budget loan and the partial shutdown of the government. The plan at present is to avoid a shortfall through a 10% restriction imposed by the executive branch on agency spending which represents about \$540 million during the year and quarterly budget reviews. The Governor has recently appointed a new Chief of Staff and a new Director of OMB to assist with this process as well as the broader fiscal reform processes.

Outlook

The rating outlook for the Commonwealth remains negative at this time. Although the Commonwealth has enacted legislation on several fronts to improve its finances, the scope of the measures is nonetheless moderate compared to the size of the structural budget imbalance experienced in 2006 and otherwise projected for 2007. The enacted tax reform legislation, for example, is projected to barely cover one-third of the structural deficit (not including the debt service reduction of \$532 million for the General Fund). And, after the political battle to enact the sales tax, there is little prospect of additional tax increases in the next two years. The aggressive plan to reduce spending in key areas is unprecedented and still in an early developmental stage. Any shortfall in these plans will add to the \$325 million unresolved shortfall already included in this year's budget.

What could move the rating down?

"Failure to begin collection of the central government sales tax in November of this year due to potential litigation or renewed political opposition.

"Growth of the structural budget gap back to double digits as a percentage of annual revenue.

What could move the rating up?

"Strong rebound in economic growth coupled with successful spending controls that lead to significantly improved budgetary results and outlook

"Significant improvement in the condition of the Commonwealth's pension system, including greater recurring budgetary contributions.

LIST OF AFFECTED RATINGS - Confirmed at Baa3:

- * Commonwealth of Puerto Rico, General Obligation Bonds
- * Puerto Rico Aqueduct and Sewer Authority, Revenue Bonds (Commonwealth guaranteed)
- * Puerto Rico Public Building Authority, Government Facilities Revenue Bonds (Commonwealth guaranteed)
- * Puerto Rico Highway and Transportation Authority, Highway Revenue Bonds
- * Puerto Rico Highway and Transportation Authority, Transportation Revenue Bonds
- * Puerto Rico Highway and Transportation Authority, Subordinated Transportation Revenue Bonds (PR State Infrastructure Bank)
- * Puerto Rico Infrastructure Finance Authority, Special Tax Revenue Bonds
- * Puerto Rico Convention Center District Authority, Hotel Occupancy Tax Revenue Bonds
- * Puerto Rico Municipal Finance Agency, 1997 Bonds, 1999 Bonds, 2002 Bonds, and 2005 Bonds

LIST OF AFFECTED RATINGS - Confirmed at Ba1:

- * Puerto Rico Public Finance Authority, Commonwealth Appropriation Bonds
- * Puerto Rico Housing Bank and Finance Agency, Commonwealth Appropriation Bonds
- * Puerto Rico Highway and Transportation Authority, Subordinated Transportation Revenue Bonds

* Puerto Rico Highway and Transportation Authority, Special Facility Revenue Refunding Bonds (Teodoro Moscoso Bridge)

Analysts

Emily Raimes
Analyst
Public Finance Group
Moody's Investors Service

Timothy Blake
Backup Analyst
Public Finance Group
Moody's Investors Service

Robert A. Kurtter
Senior Credit Officer
Public Finance Group
Moody's Investors Service

Contacts

Journalists: (212) 553-0376
Research Clients: (212) 553-1653

© Copyright 2006, Moody's Investors Service, Inc. and/or its licensors including Moody's Assurance Company, Inc. (together, "MOODY'S"). All rights reserved.

ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY COPYRIGHT LAW AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT. All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, such information is provided "as is" without warranty of any kind and MOODY'S, in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such information. Under no circumstances shall MOODY'S have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of MOODY'S or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if MOODY'S is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The credit ratings and financial reporting analysis observations, if any, constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER. Each rating or other opinion must be weighed solely as one factor in any investment decision made by or on behalf of any user of the information contained herein, and each such user must accordingly make its own study and evaluation of each security and of each issuer and guarantor of, and each provider of credit support for, each security that it may consider purchasing, holding or selling.

MOODY'S hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MOODY'S have, prior to assignment of any rating, agreed to pay to MOODY'S for appraisal and rating services rendered by it fees ranging from \$1,500 to \$2,400,000. Moody's Corporation (MCO) and its wholly-owned credit rating agency subsidiary, Moody's Investors Service (MIS), also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually on Moody's website at www.moody.com under the heading "Shareholder Relations - Corporate Governance - Director and Shareholder Affiliation Policy."

This credit rating opinion has been prepared without taking into account any of your objectives, financial situation or needs. You should, before acting on the opinion, consider the appropriateness of the opinion having regard to your own objectives, financial situation and needs.