



Moody's Investors Service

Global Credit Research

New Issue

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New Issue: [Puerto Rico \(Commonwealth of\)](#)

MOODY'S ASSIGNS Baa3 RATING \$101.695 MILLION COMMONWEALTH OF PUERTO RICO PUBLIC IMPROVEMENT REFUNDING BONDS; OUTLOOK IS NEGATIVE

COMMONWEALTH HAS OVER \$16.8 BILLION DEBT OUTSTANDING

State
PR

Moody's Rating

ISSUE	RATING
General Obligation Public Improvement Bonds, Series 2006	Baa3
Sale Amount \$100,000,000	
Expected Sale Date 06/21/06	
Rating Description Public Improvement Refunding Bonds	

Opinion

NEW YORK, Dec 29, 2006 -- Moody's Investors Service has assigned a Baa3 rating and negative outlook to the Commonwealth of Puerto Rico's \$101.695 million Public Improvement Refunding Bonds, Series 2006A. The rating is assigned to a private placement that occurred in June 2006.

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 the next two years, though smaller than the imbalance of over 18% of revenues in 2006.

* Very high government debt level relative to the economy, due in part to financing budget deficits, although growth in debt is expected to decline in coming years.

* 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 Commonwealth's debt ratings at this time reflects the Commonwealth's implementation of a 7% sales tax, 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 continued negative rating outlook reflects the potential for continued fiscal strain and political conflict as these plans are implemented.

REVENUE SHORTFALL INCREASES 2006 BUDGET GAP TO OVER \$1.5 BILLION; Q1 2007 REVENUES ABOVE FORECAST

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 \$325 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.

For the first quarter of fiscal year 2007, actual revenues exceeded budgeted by \$81 million, although they were down \$58 million compared to the first quarter of fiscal

2006. This was expected, however, because revenues in the first quarter of 2006 included a \$125 million extraordinary non-recurring payment from withholding to non-residents. Without this payment, revenues in the first quarter of fiscal 2007 would show an increase of \$67 million.

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 implemented a new retail sales tax of 7%, which went into effect on November 15. The 5% general excise tax on imported goods was repealed, and individual income taxes were modestly reduced. 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 almost twice as large.

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%, some \$250 million of projected revenue from certain one-time tax measures, and a lesser net revenue gain from the new tax legislation. 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.

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?

*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.

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