**New Issue: Puerto Rico (Commonwealth of)**

## MOODY'S ASSIGNS Baa3 RATING TO APPROXIMATELY $1.5 BILLON COMMONWEALTH OF PUERTO RICO PUBLIC IMPROVEMENT REFUNDING BONDS; OUTLOOK IS NEGATIVE

### COMMONWEALTH HAS OVER APPROXIMATELY $8 BILLION GENERAL OBLIGATION DEBT OUTSTANDING

State
PR

**Moody's Rating**

| ISSUE | RATING |
|---|---|
| Public Improvement Refunding Bonds, Series 2007A | Baa3 |

| | |
|---|---|
| **Sale Amount** | $1,500,000,000 |
| **Expected Sale Date** | 05/29/07 |
| **Rating Description** | General Obligation |

**Opinion**

NEW YORK, May 22, 2007 -- Moody's Investors Service has assigned a Baa3 rating and negative outlook to the Commonwealth of Puerto Rico's $1.5 billion Public Improvement Refunding Bonds, Series 2007A.

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.

* Strong management dedication to tax and fiscal reform, including strengthening the Commonwealth's general obligation and other credits.

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.

The Commonwealth's debt rating 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 and 2008. Together, these actions represent a significant 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, particularly in the recessionary economy the Commonwealth is experiencing.

SIGNIFICANT STEPS TAKEN TO STRENGTHEN GO AND OTHER CREDITS

The Commonwealth last year enacted general fiscal reform legislation that is intended to improve numerous budgetary control processes. The Commonwealth is now statutorily required to come to structural balance by 2010, putting pressure on the Commonwealth to restrict government spending, which had been growing at rapid rates. As a result, the 2007 budget called for expenditures to be held flat. While fiscal 2007 year-end figures are not yet available, the Commonwealth has indicated that final spending figures will be below the budgeted numbers. The governor's proposed fiscal year 2008 budget totals $9.22 billion, or $261 million less than the fiscal 2007 budget and $369M less than FY05 budget. As well as instituting tax and fiscal reform, Moody's believes that the Commonwealth has taken important steps to make the many other Puerto Rico credits less dependent on the Commonwealth.

2007 REVENUES REVISED DOWN; YEAR-END DEFICIT EXPECTED

At the time of the fiscal 2007 budget, it was anticipated that the Commonwealth would end the fiscal year with a $325 million deficit. Revenues have since been revised downward by $280 million, bringing the expected deficit to $605 million. The Commonwealth anticipates expenditure savings of $160 million, a saving of $107 million due to renegotiating health program rates, and a transfer from the GDB of $240 million (in escrow from last year's collection of a special 5% "tax window"). If these measures come to pass, the Commonwealth will be left with a much more manageable deficit of approximately $96 million.

7% SALES TAX IMPROVES COMMONWEALTH'S TAX SYSTEM, THOUGH REVENUES HAVE NOT REACHED EXPECTATIONS

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.

Sales tax receipts for fiscal 2007 were budgeted at $643 million. It is now expected that the Commonwealth will take in $576 million, or $67 million less than budgeted. Some of the decline is due to the fact that the Commonwealth did not get to add an additional 1% to the sales tax as it originally thought it would. With only six months of sales tax revenues to analyze, it is as yet unclear how the tax will perform, although it is already clear that it will outperform the excise tax it replaces.

FISCAL 2008 PROPOSED BUDGET CUTS SPENDING AGAIN

The governor's proposed fiscal year 2008 budget totals $9.22 billion, or $261 million less than the fiscal 2007 budget and $369M less than FY05 budget. Declines in spending are expected in many agencies. The budget proposal also shows a decrease in debt service costs in 2008, in part because refunding savings will be taken in 2008. The budget proposal also includes an additional $24 million to cover the governor's 3% increase in pension benefits.

**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 actual results of those reforms are not yet known. The aggressive plan to reduce spending in key areas is unprecedented and results of the efforts for fiscal 2007 are not yet in.

What could move the rating down?

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

"Prolonged and severe recession, resulting in declining revenues and deficit increases.

What could move the rating up?

"Strong rebound in economic growth leading to improved revenue results.

"Spending control results that lead to improved budgetary results and outlook

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

**Analysts**


Emily Raimes
Analyst
Public Finance Group
Moody's Investors Service

Mark Tenenhaus
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


---