



New Issue: Puerto Rico (Commonwealth of)

**MOODY'S ASSIGNS Baa3 RATING TO \$250 MILLION PUERTO RICO GENERAL OBLIGATION BONDS; OUTLOOK IS STABLE**

**COMMONWEALTH HAS OVER \$30 BILLION NET TAX-SUPPORTED DEBT OUTSTANDING**

State  
PR

Moody's Rating ISSUE	RATING
Public Improvement Bonds of 2008, Series A	Baa3
Sale Amount	\$250,000,000
Expected Sale Date	09/04/08
Rating Description	General Obligation

**Opinion**

NEW YORK, Sep 3, 2008 -- Moody's Investors Service has assigned a rating of Baa3 to \$250 million Commonwealth of Puerto Rico Public Improvement Bonds of 2008, Series A (General Obligation Bonds). The outlook is stable. Puerto Rico's Baa3 debt rating reflects the commonwealth's tax reform policies, including the implementation of a 7% sales tax, general legislation mandating spending process controls, spending restraint in fiscal 2007 and 2008, a 2009 budget which shows a return to increased structural imbalance, and the recessionary environment within which the commonwealth is operating.

**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.

**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.

\* Under-funded pension system.

\* Local economy, highly dependent on oil, in recession since 2006.

\* Economy that tends to follow the U.S., and could therefore decline further if the U.S. economy declines further.

#### VARIABLE RATE DEBT

At the beginning of 2008, the commonwealth had \$643 million of Auction Rate Securities (ARS) outstanding, equivalent to 7.5% of total debt. The commonwealth has refunded or converted all of it, and now has no auction rate exposure. As part of an overall financing plan to reduce exposure to variable rate debt, the commonwealth has reduced its floating rate exposure from 19% to 13% of its total debt portfolio.

#### GAAP DEFICITS HIGH; FISCAL 2007 CAFR RELEASED

The consolidated annual financial report for fiscal year 2007 reports a GAAP-basis General Fund balance of negative \$511 million, compared to negative \$384 million for fiscal 2006. The General Fund showed an operating deficit (revenues minus expenditures) of \$872 million, compared to an operating deficit of \$740 million in the previous year.

#### FISCAL 2008 REVENUES AND EXPENDITURES BOTH BELOW BUDGET

Fiscal 2008 expenditures for the commonwealth were slightly below budgeted amounts, at \$9.05 billion (preliminary estimates) compared to a budgeted \$9.23 billion. Revenues were well below budgeted amounts; collections were reported at \$8.2 billion, almost \$800 million below budgeted revenues of \$9 billion. The gap was closed with one-time measures including: Federal funds recovery (\$287 million); debt service reduction through refinancings (\$100 million); cash management measures including holding back payments to vendors (\$300 million); and the sale of government properties (\$150 million). Revenues were approximately \$600 million, or 7%, below 2007 levels. Structural balance is now expected in 2010, one year later than previously expected.

#### FISCAL 2009 BUDGET STRUCTURALLY IMBALANCED

On July 20, 2008, the governor signed the fiscal year 2009 budget into law. The budget for fiscal year 2009 includes General Fund total resources and appropriations of \$9.484 billion, an increase of \$257 million over approved expenditures for fiscal 2008. General Fund revenue projections for fiscal year 2009 total \$8.484 billion, a decrease of \$183 million, or 2.1%, from estimated net revenues for fiscal year 2008 of \$8.671 billion. This leaves a shortfall of \$1 billion. Legislation was signed authorizing the commonwealth, as an exception to the general prohibition against budget balancing borrowing, to issue limited special obligations of the commonwealth payable from tax receivables. Support from the Government Development Bank may have to be secured.

Fiscal 2009 budgeted appropriations represent the third consecutive year in which budgeted expenditures are below the fiscal year 2006 level. The increase in appropriations for fiscal 2009 is largely due to election-year spending and collective bargaining agreements.

#### ECONOMY REMAINS A WEAKNESS

The commonwealth is currently in a recession, and has been since March 2006. The risks associated with the economy are heightened by the national slowdown. The housing market has been sluggish in the commonwealth for the past three years, with housing permits, number of new dwelling units, and the value of new dwelling units all showing declines in recent years. It appears, however, that the poor performance of the housing market in the commonwealth is a result of the general economic weakness of the commonwealth, and is not connected to the housing downturn caused by the sub-prime mortgage crisis in the U.S.

Total employment in the commonwealth declined in fiscal 2008 by 1.5% compared to fiscal 2007. Private sector employment was down 0.7%, with construction employment down 1.9%, employment in services down 1.4%, and employment in manufacturing down 3.6%. Hotel registrations for the fiscal year through April 2008 were down 2.7%, perhaps showing weakness in the tourism industry, although air passenger traffic through February 2008 was up 3.1%.

#### DEBT CONTINUES TO BE HIGH, ALTHOUGH DEBT SERVICE COSTS ARE BEING MANAGED

Debt ratios for the commonwealth are very high, with net tax-supported debt at over \$8,000 per capita and more than 63% of personal income. The commonwealth has made efforts to reduce its debt service costs, including issuing sales tax revenue bonds, which are secured by a portion of sales tax revenues, not appropriations from the General Fund. The commonwealth used the proceeds of the sales tax revenue

bonds to refund much lower-rated appropriation debt, thereby reducing annual debt service.

The commonwealth's pension system was severely underfunded, at only 19% in 2005. On January 31, 2008 the Employees Retirement System issued \$1.5 billion of pension funding bonds, adding the proceeds to assets held in trust for benefit payments, bringing such funds to approximately \$4.5 billion and the funding ratio to an estimated 32%. On June 2, 2008 the system issued an additional \$1.06 billion and on June 30, 2008 an additional \$300 million. An updated actuarial report as of June 30, 2007, is expected to be delivered in the next 60 days. The bonds are secured by a pledged of contributions to be made into the system by all of the participating government employers, including the commonwealth, its municipalities, and certain public corporations. The system anticipates issuing additional pension funding bonds for the same purpose later this year and targets a funding ratio of 70-80%. Current OPEB costs were approximately \$49 million in 2006 and the commonwealth expects to report its actuarial liability, as required, in its 2008 audit.

## **Outlook**

The rating outlook for the commonwealth is stable at this time, reflecting the stability the commonwealth showed in 2007, meeting budget targets and progressing toward structural balance even while in a recessionary period. Although budget targets are not likely to be met in 2008, and structural balance is looking more difficult as the commonwealth's recession continues, Moody's believes that the commonwealth has not yet returned to the high-stress situation of 2006, with a government shutdown and the need for massive deficit borrowing.

What could move the rating--UP

- Strong rebound in economic growth leading to improved revenue results.
- Spending controls that lead to long-term improved budgetary results and outlook
- Significant improvement in the condition of the commonwealth's pension system, including greater recurring budgetary contributions.
- Reversal of General Fund's deficit position.

What could move the rating--DOWN

- Growth in structural budget gap and an increase in GAAP deficits.
- Prolonged recession, resulting in declining revenues and a return to deficit financing.

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