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November 29, 2010

Puerto Rico; Appropriations; General Obligation; General Obligation Equivalent Security; Joint Criteria; Moral Obligation

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Rationale

Standard & Poor's Ratings Services has revised its outlook on its general obligation (GO) 'BBB-' rating on the Commonwealth of Puerto Rico to positive from stable. At the same time, we affirmed our 'BBB-' rating on the commonwealth's appropriation debt. The outlook on the commonwealth's appropriation rating remains stable because even if the GO rating is raised in the next two years, the appropriation rating would remain one notch below the GO rating.

The outlook revision is based on our view of the commonwealth's recent implementation of significant expenditure controls and revenue enhancement measures that we believe could help restore budget balance within the next two years.

The 'BBB-' ratings continue to reflect our opinion of the commonwealth's:

- History of chronic budget deficits. Governor Luis Fortuño's fiscal stabilization plan, which included an unprecedented 17% reduction in payroll expenditures, along with the recently approved tax measures is aimed at eliminating a decade-long trend of budget imbalances. The implementation of these measures has received broad legislative support. While we view the current administration's measures as an important step toward budget stability, we do not anticipate the achievement of a structurally balanced budget until fiscal 2013.
- High debt levels, with GO, appropriation, and sales tax revenue debt currently at about $29 billion or 46.2% of the estimated $62.8 billion gross national product (GNP) and $7,309 per capita. Approximately $14.2 billion of this debt has been issued by the Puerto Rico Sales Tax Financing Corp. (COFINA) and has a dedicated source of repayment. Total debt, excluding the sales tax revenue bonds, is equivalent to approximately 23.8% of GNP. We consider debt service costs moderate at 8.6% of fiscal 2011 general fund expenditures.
- Protracted economic recession, as evidenced by the contraction in the commonwealth's Economic Activity Index (EAI) of 1.3% in fiscal 2007, 0.9% in fiscal 2008, 4.2% in fiscal 2009, and 5.5% in fiscal 2010. The EAI's year-over-year contraction through October 2010 was lower, at 2.6%. While employment estimates for October 2010 reflect a 1% growth relative to October 2009, the unemployment rate remains high relative to other states at 15.8%.
- High level of retirement liabilities. While Puerto Rico closed its defined benefit system to new participants starting on Jan. 1, 2000, the funded ratio of its defined benefit system is extremely low, in our view, at 9.8% as of June 30, 2009. The actuarial study estimates that without any changes, the defined benefit system's net assets would be exhausted in 2014 and all available assets would be exhausted by 2019, requiring a rapidly increasing amount of supplemental cash from the sponsoring entities, which include the commonwealth, several public enterprises, and

municipalities. We understand that the Fortuño administration is in the process of developing a comprehensive reform to its defined benefit system, and currently plans to increase the employer contribution by 1% annually, among other measures.

Factors that continue to support the ratings include our opinion of the commonwealth's:

- Strong ties to the U.S. economy, resulting in a significant flow of trade and income transfers, with exports to the U.S. accounting for approximately $46.4 billion (76% of GNP) in 2008. According to the U.S. Census Bureau, total income transfers from the U.S. to Puerto Rico totaled $13.5 billion (22% of GNP) in 2008.
- Support from the Government Development Bank for Puerto Rico (BBB/Stable), which in our view provides a stabilizing financial and management influence, as well as a source of liquidity and market access for the commonwealth.
- The current administration's commitment to restore fiscal balance and economic growth and the progress made to date, which has required the passage and implementation of what we view as difficult and sometimes politically unpopular measures.

In our opinion, Puerto Rico continues to face significant fiscal and economic challenges. However, in the nearly two years since his inauguration, the administration of Gov. Fortuño has made fiscal stability a priority. With broad support from the legislature, the current administration has implemented an aggressive expenditure reduction plan that trimmed nearly $1 billion in recurring payroll expenditures. In addition, the legislature recently approved several tax reform initiatives, including a temporary excise tax on the purchases from affiliates of certain manufacturing companies that is expected to generate about $1.4 billion in 2011. While the economy continues to reel from a four-year long recession, commonwealth officials expect that the continuation of the budget discipline of the past two years and the recently approved tax measures will result in structurally balanced budgets starting in fiscal 2013. The fiscal measures adopted by the Fortuño administration, represent, in our opinion, a factor that lends near-term stability to the credit of the commonwealth, and that could yield the projected results by fiscal 2013 if the economy stabilizes and expenditure discipline is maintained.

Puerto Rico's economy continues to exhibit uneven performance. While recent employment figures point to a slight recovery, the overall economic picture remains mixed at best, in our opinion. The Economic Activity Index (EAI), which is a coincident economic index developed by the Government Development Bank, continues to show lackluster performance, although there are signs of economic stability. In October 2010, the EAI had a lower year-over-year decline than any month since April 2008, but the overall trend for the past year has been uneven. However, other indicators, such as retail sales and hotel occupancy rates continue to show gradual improvement. We believe that given the commonwealth's close economic ties with the continental U.S., a steady economic recovery may not take hold until a similar trend is observed there. Despite the mixed economic news, revenue performance has been relatively stable. Total revenues as of September 2010 are only 2.9% below the estimate, and the total structural deficit at year-end is still projected to reach $1 billion (12.2% of recurring revenues), significantly below the $3.3 billion deficit (43% of recurring revenue) in fiscal 2009.

Despite the lower-than-estimated revenue collections, commonwealth officials project ending fiscal 2011 with approximately $31 million in cash on hand (0.33% of expenditures). These assumptions, however, include the use of about $1.3 billion in funds from the commonwealth's Stabilization Fund, which includes proceeds from the issuance of sales tax revenue bonds and funds from the American Reconstruction and Reinvestment Act. The cash-flow projections, however, do not include the potential impact of the recently approved tax reform, which may improve the commonwealth's overall cash position.

Standard & Poor's deems Puerto Rico's financial management practices "standard" under its Financial Management Assessment (FMA) methodology, indicating the commonwealth's finance department maintains adequate policies in most, but not all, key areas.

Outlook

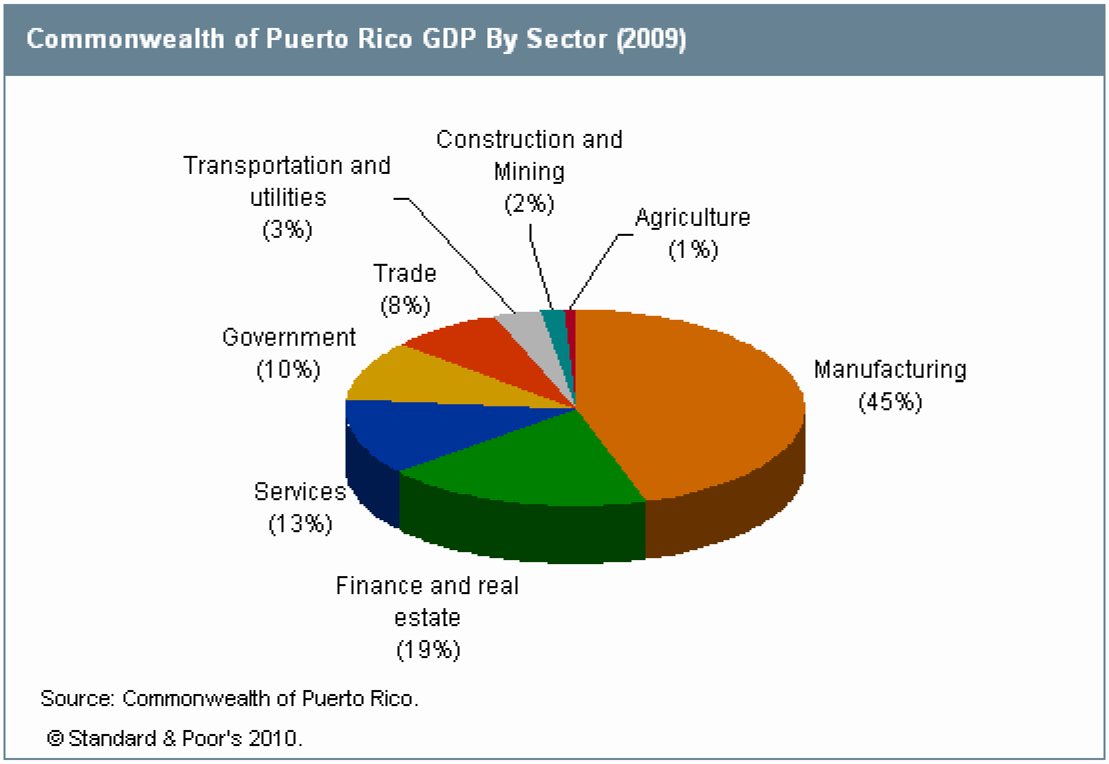
The positive outlook is based on our view of the commonwealth's recent implementation of significant expenditure controls and revenue enhancement measures that we believe could help restore budget balance within the next two years. Standard & Poor's could raise the rating if over the upcoming two years in conjunction with an improvement in the commonwealth's economic performance, budget controls remain in place and we believe there is significant progress toward achieving balance between ongoing revenues and expenditures as well as in addressing its unfunded retirement benefit obligations. We could revise the outlook to stable if the effectiveness of the recently approved tax and budget measures is impeded by either continued economic deterioration or a loosening of the expenditure discipline exhibited to date, and the commonwealth fails to make progress toward addressing its unfunded retirement obligations in the next two years.

The outlook on the commonwealth's appropriation rating remains stable because even if the GO rating is raised in the next two years, the appropriation rating would remain one notch below the GO rating.

The Prolonged Economic Recession Will Remain The Greatest Challenge To Budget Stability

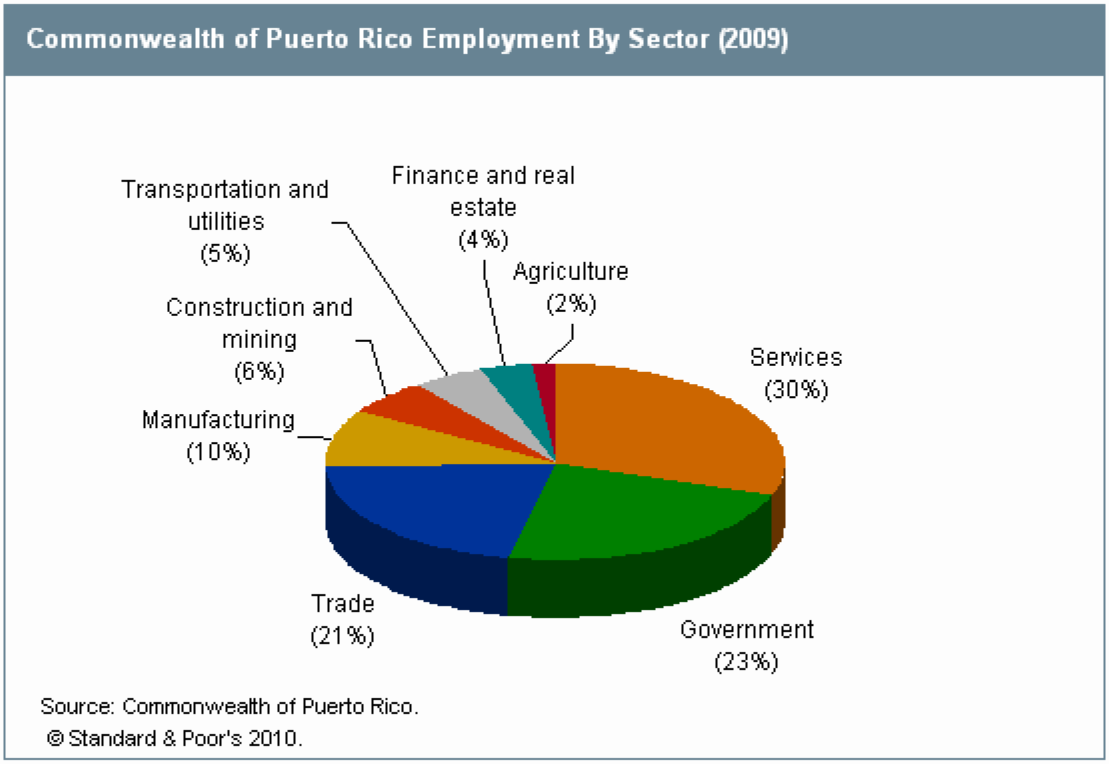
Puerto Rico has been in a recession for the past four years. While the economy in Puerto Rico continues to show a mixed performance overall, we believe that what appears to be an incipient recovery in the U.S. may bode well for the island. Manufacturing and the services sector (of which tourism is an important component), in particular, may be the largest beneficiaries of a potential return of growth in the U.S. economy. In our opinion, however, the biggest long-term economic challenge for Puerto Rico continues be its ability to foster private sector employment growth. For decades, the public sector became the employer of last resort, mitigating the inability of the private sector to generate the jobs demanded by a relatively young and growing population. This imbalance bloated government payroll and set the commonwealth on what we believe was an unsustainable path of recurring budget deficits. In our opinion, the reductions in the government's payroll may result in long-term high unemployment rates (which are currently at a high 15.8%), particularly if private employment growth remains depressed. Furthermore, we believe that the commonwealth's economic performance over the next two years will be a key determinant of its ability to restore fiscal balance and improve its credit quality. In our opinion, the effectiveness of the current administration's aggressive efforts to restore fiscal balance may be limited if the economic recovery does not gain momentum.

Chart 1



The commonwealth's per capita wealth and income levels remain low compared with those of the U.S. As of 2008, the latest U.S. Census figure available, per capita disposable personal income was $13,462, or approximately 32% of the U.S. average. As Chart 2 shows, the commonwealth's economic structure and employment base remain centered around manufacturing and tourism and related services. We believe that the recent approval of a temporary excise tax on certain manufacturing companies has the potential to more closely align the commonwealth's revenue sources with its economic structure. In our opinion, manufacturing's significance to the island's economy and the fact that much of its manufacturing output is destined to U.S. markets highlight the influence that a U.S. economic recovery will have on the commonwealth's economic future.

Chart 2



We consider Puerto Rico's employment base diverse, with services (of which tourism is an important component) accounting for 30.2%, followed by government (23.2%), and trade (20.9%). Manufacturing accounts for approximately 9.6% of employment, with construction, transportation, finance, and agriculture each accounting for less than 6% of employment.

Searching For Budget Balance: Fiscal Reconstruction Plan And Tax Reform

The commonwealth's current administration has made fiscal and economic stability a top priority. Although Puerto Rico has a long history of structural budget deficits, the previous trend of overly optimistic revenue assumptions, combined with a prolonged economic recession and a growing payroll, resulted in an unprecedented $3.3 billion structural deficit in fiscal 2009 (equal to a very high, in our view, 43% of general fund recurring revenue). In our opinion, the drastic increase in the size of the structural deficit and the increasingly limited options to fund it presented a new set of circumstances that required the implementation of a fairly drastic set of fiscal and administrative measures to preserve credit stability in the near term.

In the nearly two years since its inauguration, Gov. Fortuño's administration has received legislative approval for a fairly comprehensive set of fiscal and administrative reforms aimed at bringing structural balance by fiscal 2013. The cornerstone of these reforms was the approval of Act 7 in 2009 (Fiscal Emergency Act), which included the approval of the following measures:

- Increasing the portion of the sales and use tax dedicated to COFINA to 2.75% from 1%. This provided the commonwealth with approximately $7.5 billion in additional bonding capacity to finance the projected deficit

through fiscal 2012, and a $500 million local economic stimulus package;
- The approval of several temporary revenue measures, including surtaxes on individual income, corporations, credit unions, and excise tax increases on cigarettes, alcoholic beverages, and motorcycles; and
- Reduction of $2 billion in recurring expenditures, including a voluntary early retirement and employee layoffs. In the past two years, Puerto Rico has reduced its payroll by nearly 17,000 workers (approximately 11% of total central government employees), through both lay-offs and other initiatives. The reduction has resulted in nearly $1 billion (12% of fiscal 2011 recurring general fund revenues) in the central government's payroll expenditures. In all, the commonwealth's recurring expenditures have been reduced by a considerable $1.8 billion (17%) relative to their fiscal 2009 levels.

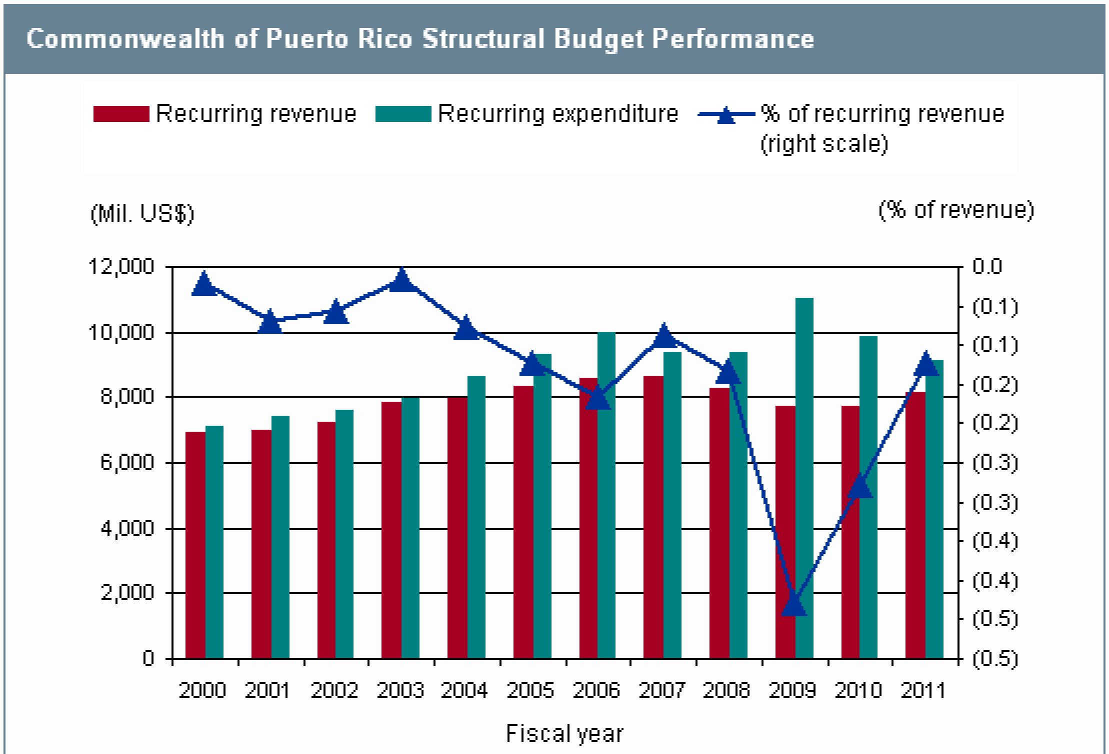
A second phase of reforms that focuses on tax revenues was recently approved. Act 154 of 2010 established a source income rule and enacted a temporary (six years) excise tax on the purchases of affiliates of certain multinational manufacturing corporations that operate in Puerto Rico. In addition, Governor Fortuño recently presented a new tax revenue code bill with a series of tax relief measures that among other things reduces the maximum corporate and individual income tax. Some of the highlights of the commonwealth's tax reform include:

- The introduction of an excise tax on the purchases of affiliates of manufacturing companies that are subject to the source income rule, which in the case of Puerto Rico include the affiliates of many of the pharmaceutical companies that are beneficiaries of specific tax agreements. The excise tax will have an initial tax rate of 4% in 2011, which will gradually decrease to 1% in 2016. Commonwealth officials estimate that this excise tax could generate approximately $1.4 billion in the first full year of implementation.
- Tax relief for individuals and corporations. The tax reform reduces the maximum corporate tax rate from 41% to 30%, as well as several tax credits and deductions. Commonwealth officials expect that the effective corporate tax rate will fall from 34% to about 26% in 2011. In addition, the tax reform expands the tax brackets and provides an increasing level of tax relief for taxpayers at the low end of the income scale, to eventually reach a 0% personal income tax for taxpayers with $20,000 or less of taxable income. The implementation of the gradual expansion of tax exemptions starting in 2014, however, is subject to the achievement of specific revenue and expenditure targets and GDP growth. The reforms also include a reduction in the mortgage interest deduction and more stringent tax collection mechanisms and penalties for tax evasion.

Commonwealth officials expect that the set of tax reforms will represent a net gain in recurring revenues or approximately $35 million in fiscal 2011, $203 million in fiscal 2012, and $105 million in fiscal 2013.

In our opinion, the key measure of the impact of the expenditure cuts and revenue enhancement measures continues to be the extent to which the commonwealth can achieve structurally balanced budgets by fiscal 2013.

Chart 3



Source: Commonwealth of Puerto Rico.

Retirement System Liability

The Employees Retirement System (ERS) is a trust created in 1951 to provide retirement and disability annuities, death benefits, and loans to Puerto Rico's public employees. The system administers two separate retirement plans: a defined benefit plan, which closed to new members on Dec. 31, 1999; and a defined contribution plan, available to employees who entered the system on or after Jan. 1, 2000. System benefits are funded by a combination of monthly or bimonthly employer and employee contributions, and investment earnings. Participating employers are statutorily required to contribute to the defined benefit plan at a rate of 9.275% of payroll. The requirement to make this contribution is not tied to the number of employees participating in the defined benefit plan. Historically, actual employer contributions have been substantially below the annual required contribution, resulting in a $17 billion unfunded actuarial accrued liability, or a 9.8% funding ratio as of June 30, 2009. For the past seven years, employer contributions into the system have ranged between 40.4% (fiscal 2010) and 69.4% (fiscal 2007).

The 2009 actuarial valuation estimates that under current investment return assumption (7.5%) and contribution rates, the ERS' net assets would be exhausted in 2014 and all system's available assets by 2019, which would then require supplemental funding from the sponsoring governments and public corporations. The actuarial study estimates negative cash flow of approximately $440 million in fiscal 2014, which gradually increase to $549 million in fiscal 2020.

The estimated other postemployment benefits (OPEB) (GASB 45) unfunded liability is relatively small compared to the commonwealth's pension obligations. According to the most recent actuarial study, the commonwealth's unfunded OPEB liability as of June 30, 2009, reached $1.6 billion. The annual required contribution (ARC) to amortize the OPEB liability is estimated at $128.3 million, which is relatively small compared with the $1.4 billion ARC to amortize the commonwealth's pension liability.

A special commission appointed by Gov. Fortuño recently submitted a set of recommendations to improve the funding status of the commonwealth's defined benefit system. The commission's recommendations include contribution increases to both employers and employees. In addition, the legislature approved Act 70 of 2010, which provides incentives for early retirements with a lower percentage of final pay for certain qualified employees. The administration also plans to present a comprehensive set of pension reforms in 2011.

Variable Rate Exposure And Derivatives

Commonwealth officials estimate that approximately 18% of its debt portfolio is in variable rate, and all variable rate debt has swaps in place. Approximately $1 billion in variable rate has liquidity facilities that expire in 2011, about $472.9 million in fiscal 2011, and the remainder in fiscal 2012. Commonwealth officials actively manage Puerto Rico's variable rate portfolio and anticipate having a replacement liquidity provider or terming out the variable rate debt into fixed rate if the lines expire and cannot be replaced. In cases where the commonwealth has not been able to replace its liquidity facility providers, the Government Development Bank has terminated existing credit facilities, effectively preventing a failed remarketing and the payment of a bank bond rate.

Financial Management Assessment: 'Standard'

Standard & Poor's deems Puerto Rico's financial management practices "standard" under its FMA methodology, indicating the commonwealth's finance department maintains adequate policies in most, but not all, key areas.

These policies often lack formal detail and institutionalization and might not include best practices. In particular, the commonwealth does not make comprehensive midyear budget amendments to correct shortfalls that could develop during the budget year. Puerto Rico does not have a formal budget reserve policy, and budget deficits have prevented commonwealth officials from reaching any informal reserve targets that might exist. The commonwealth has a detailed written investment policy and a long-term capital plan. It also has a written policy on variable-rate debt and the use of derivatives.

Related Criteria And Research

- USPF Criteria: GO Debt, Oct. 12, 2006
- USPF Criteria: Appropriation-Backed Obligations, June 13, 2007

Ratings Detail (As Of November 29, 2010)		
Puerto Rico GO		
Long Term Rating	BBB-/Positive	Outlook Revised

Ratings Detail (As Of November 29, 2010) **(cont.)**		
Puerto Rico GO rfd ser 2001 2002 (AGM)		
Unenhanced Rating	BBB-(SPUR)/Positive	Outlook Revised
Puerto Rico GO VRDB ser 2003C-4 & 2003C-5 (AGM)		
Long Term Rating	AA+/A-1/Stable	Downgraded
Unenhanced Rating	BBB-(SPUR)/Positive	Outlook Revised
Puerto Rico GO VRDB ser 2004A & 2004 B-1 thru B-4 (AGM)		
Long Term Rating	AA+/A-1/Stable	Downgraded
Unenhanced Rating	BBB-(SPUR)/Positive	Outlook Revised
Puerto Rico GO (wrap of insured) (CIFG & AGM) (SEC MKT)		
Unenhanced Rating	BBB-(SPUR)/Positive	Outlook Revised
Puerto Rico GO (wrap of insured) (FGIC) (ASSURED GTY) (SEC MKT)		
Unenhanced Rating	BBB-(SPUR)/Positive	Outlook Revised
Puerto Rico GO (wrap of insured) (RADIAN & FGIC) (SEC MKT)		
Unenhanced Rating	BBB-(SPUR)/Positive	Outlook Revised
Puerto Rico GO (wrap of insured) (SYNCORA GTY & AGM) (SEC MKT)		
Unenhanced Rating	BBB-(SPUR)/Positive	Outlook Revised
Puerto Rico GO (AGM)		
Unenhanced Rating	BBB-(SPUR)/Positive	Outlook Revised
Puerto Rico GO (CIFG)		
Long Term Rating	BBB-/Positive	Outlook Revised
Puerto Rico GO (MBIA) (National) (SEC MKT)		
Unenhanced Rating	BBB-(SPUR)/Positive	Outlook Revised
Puerto Rico VRDB ser 2008B		
Long Term Rating	AA+/A-1+	Affirmed
Unenhanced Rating	BBB-(SPUR)/Positive	Outlook Revised
Puerto Rico (wrap of insured) (SYNCORA) (ASSURED GTY) (SEC MKT)		
Unenhanced Rating	BBB-(SPUR)/Positive	Outlook Revised
Puerto Rico		
Unenhanced Rating	BBB-(SPUR)/Positive	Outlook Revised
Puerto Rico GO		
Unenhanced Rating	BBB-(SPUR)/Positive	Outlook Revised
Puerto Rico VRDB subser A-2		
Unenhanced Rating	BBB-(SPUR)/Positive	Outlook Revised
Long Term Rating	AA+/A-1+/Stable	Downgraded
Puerto Rico VRDB subser A-3		
Unenhanced Rating	BBB-(SPUR)/Positive	Outlook Revised
Long Term Rating	AA+/A-1/Stable	Downgraded
Puerto Rico VRDB subser A-4		

Ratings Detail (As Of November 29, 2010) **(cont.)**		
Unenhanced Rating	BBB-(SPUR)/Positive	Outlook Revised
DBR Dorado Owner LLC, Puerto Rico		
Puerto Rico		
DBR Dorado Owner LLC (Tourism Dev Fund) tourism notes (Puerto Rico) (Ritz-Carlton Reserve Project) ser 2010 due 08/01/2		
Long Term Rating	BBB-/Stable	Affirmed
Puerto Rico Aqueduct & Swr Auth, Puerto Rico		
Puerto Rico		
Puerto Rico Aque & Swr Auth (Puerto Rico) rfdg bnds (Gtd By Commonwealth of Puerto Rico)		
Long Term Rating	BBB-/Positive	Outlook Revised
Puerto Rico Aque & Swr Auth (Puerto Rico) rfdg ser 95		
Long Term Rating	BBB-/Positive	Outlook Revised
Puerto Rico Indl Tour Ed Med & Environ Ctrl Fac Fin Auth, Puerto Rico		
Puerto Rico		
Puerto Rico Indl Tour Ed Med & Environ Ctrl Fac Fin Auth tourism rev bnds ser 2002A (Puerto Rico) (Cayo Largo Inter-Continental Beach Resort Proj)		
Long Term Rating	BBB-/Stable	Affirmed
Puerto Rico Indl Tour Ed Med & Environ Ctrl Fac Fin Auth (Puerto Rico) tourism rev bnds (Coco Beach Golf & Country Club Proj) ser 2004		
Long Term Rating	BBB-/Stable	Affirmed
Puerto Rico Infrastructure Fing Auth, Puerto Rico		
Puerto Rico		
Puerto Rico Infrastructure Fing Auth (Puerto Rico) spl tax rev rfdg bnds ser 2005A-C		
Long Term Rating	BBB-/Stable	Affirmed
Puerto Rico Pub Bldgs Auth, Puerto Rico		
Puerto Rico		
Puerto Rico Pub Bldgs Auth GO		
Long Term Rating	BBB-/Stable	Affirmed
Puerto Rico Pub Bldgs Auth GO (Puerto Rico) ser I &J, K&L, Q		
Long Term Rating	BBB-/Positive	Outlook Revised
Puerto Rico Pub Bldgs Auth (Puerto Rico)		
Unenhanced Rating	BBB-(SPUR)/Positive	Outlook Revised
Puerto Rico Pub Bldgs Auth (Puerto Rico) GO		
Unenhanced Rating	BBB-(SPUR)/Positive	Outlook Revised
Puerto Rico Pub Fin Corp, Puerto Rico		
Puerto Rico		
Puerto Rico Pub Fin Corp (Puerto Rico) approp		
Unenhanced Rating	BBB-(SPUR)/Stable	Affirmed
Puerto Rico Pub Fin Corp (Puerto Rico) commonwealth approp bnds ser 2004A&B		
Long Term Rating	BBB-/Stable	Affirmed
Puerto Rico Pub Fin Corp		
Unenhanced Rating	BBB-(SPUR)/Stable	Affirmed
Puerto Rico Pub Fin Corp (Commonwealth Appropriation Bnds)		
Unenhanced Rating	BBB-(SPUR)/Stable	Affirmed

Ratings Detail (As Of November 29, 2010) **(cont.)**		
Puerto Rico Pub Fin Corp (Puerto Rico)		
Unenhanced Rating	BBB-(SPUR)/Stable	Affirmed
Many issues are enhanced by bond insurance.		