MOODY'S
INVESTORS SERVICE

ISSUER COMMENT

# Puerto Rico adopts major pension reform and proposes sales tax expansion for fiscal 2014 budget

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## Summary


The Commonwealth of Puerto Rico (Baa3, negative) faces a number of significant credit challenges, and has recently been addressing some of those challenges through pension reform, budget adjustments for the current fiscal year, and a proposed budget for fiscal 2014. This issuer comment discusses the commonwealth's recent and proposed actions, the impact of these actions on the commonwealth's credit, our view of the key challenges the commonwealth still faces and what we will be watching as we monitor the commonwealth's general credit rating in the coming months.

Highlights:

» The enacted reforms to the Employee Retirement System (ERS) are intended to provide cash sufficiency through reduced benefits and increased contributions. Although the magnitude of the effect on the large accrued unfunded liability is uncertain, the reform is positive for the commonwealth, which faced rapidly approaching illiquidity of the retirement system without reforms.

» The new pension law does not affect the other large and strained retirement plan, the Teachers' Retirement System (TRS).

» The 2013 budget gap has been reduced through interim deficit-financing transactions, acceleration of certain revenues and other non-recurring solutions, though a gap of nearly $500 million remains to be closed by the end of June.

» The commonwealth's proposed budget for fiscal 2014 relies on increased sales tax revenues through broadening the taxing base to include business-to-business transactions, and includes a reduced but still large component of debt restructuring and deficit financing of $775 million. A number of measures in the budget may prove politically challenging, and what form the final budget will take after legislative debates is uncertain.

» The sales tax expansion, if it passes, it will be positive for both the commonwealth and the Puerto Rico Sales Tax Financing Authority (known by its Spanish acronym COFINA), although uncertainty will remain regarding the forecasted incremental revenue to be raised.

» Economic headwinds will make achieving budget and fiscal goals more difficult.

» Debt and fixed costs remain high.

» The weak financial position of some of the commonwealth's public corporations and their reliance on the Government Development Bank for Puerto Rico (GDB) (Baa3, negative) for liquidity places additional risks and burdens on the commonwealth.

» At this time, the general obligation rating of Baa3/negative reflects our view of the pension reform actions, the proposed budget, and the continuing credit challenges that face the commonwealth.

## ERS Pension Reform Identifies Funding for Reduced Benefits; Credit Impact is Positive

Act 3, enacted on April 4, has several components designed to reduce pressure on ERS cash flows and allow the commonwealth to meet reduced ERS obligations in the near term. The new law includes multiple components which act together to stabilize the system.

The Act freezes ERS's current defined benefit plans and moves all participants to a new hybrid plan where future benefits depend solely on employees' contributions plus a return on investment. Current employees retain benefits accumulated prior to the reform. The act also increases the retirement age for all employees (except certain high risk employees) and increases required employee contributions from 8.275% to a minimum of 10%.

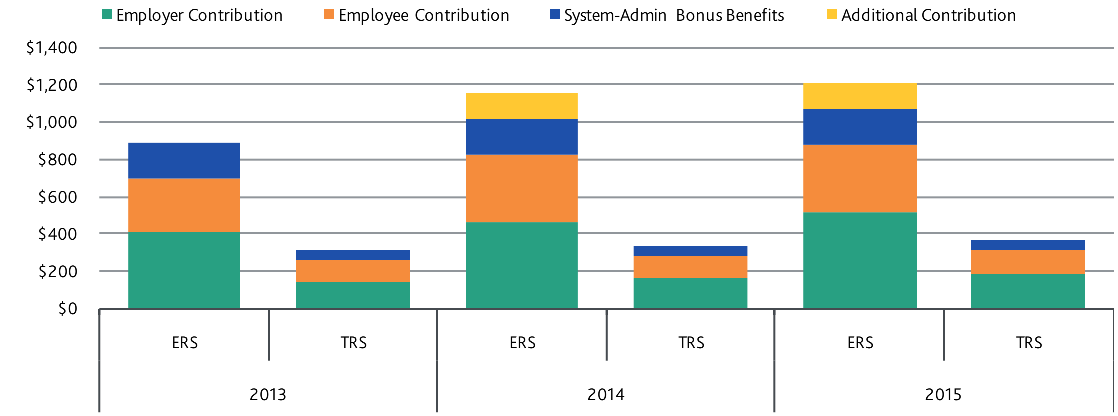
The new law no longer permits participants in ERS's existing hybrid plan, known as System 2000, to take lump-sum payments upon retirement. Accrued balances will be annuitized, decreasing the cash demands from lump-sum payments that otherwise would likely have occurred during the same period as significant debt service requirements from previously issued pension obligation bonds. The new law further reduces a number of special benefits, such as seasonal bonuses for current retirees, and eliminates these bonuses for future retirees. Disability benefits from the system will be replaced with mandatory disability insurance, and certain survivor and death benefits will be modified or eliminated.

The ERS reform plan also assumes an estimated $140 million incremental contribution from the general fund (1.4% of general fund expenses for fiscal year 2014), in addition to previously scheduled increases. The commonwealth projects that the combined impact of these measures will allow the retirement system to maintain total assets above the $1 billion level in all years and meet the revised future obligations. Compared to $33 billion in unfunded pension liabilities, the asset base is nearly completely exhausted, but the reforms are an important step in preventing annual cash outlays from the general fund that were previously estimated by the commonwealth to reach 33% on a pay-as-you-go basis by fiscal year 2023.

EXHIBIT 1

**Projected Contributions for ERS & TRS**

(in millions)




*Source: Government Development Bank for Puerto Rico*

The total annual cost of the new ERS contributions will be $794 million for fiscal 2014, including employer contributions, system benefits contributions and the additional $140 million budgeted contribution. Approximately 65% of the employer contribution and the system benefits contributions will be covered by the general fund, resulting in a total general fund contribution of 5.4% of the projected $10.4 billion fiscal 2014 budget, or 8.4% with TRS contributions. This is higher than fiscal 2013 (6.1% and 7.5% respectively), and employer contributions will continue to increase in absolute terms over the long term. Debt service from previously issued pension obligation bonds will be $167 million, or an additional 1.6% of the fiscal 2014 budget.

The actuarial unfunded ratio will remain low for a long time as assets are not expected to begin to accumulate for another 25 years. The reported UAAL was $23.7 billion in fiscal 2011 for the ERS and $9.1 billion for the TRS. Based on our calculations, the combined adjusted net pension liability was $36.6 billion, or 237% of the commonwealth's all governmental fund revenues.[1] Together with net tax-supported debt of $54.5 billion, the Commonwealth's combined debt and adjusted pension liabilities are roughly $87.3 billion, or almost 11 times general fund revenues in fiscal year 2011.

EXHIBIT 2

**Combined Debt and Pension Burden**

| | |
|---|---|
| Net Tax Supported Debt (2012) | $54.5 billion |
| As-Reported Unfunded Actuarial Liability (UAAL) – (ERS, TRS) | $32.6 billion |
| Moody's Adjusted Net Pension Liability (ANPL) | $36.6 billion |
| Debt plus Moody's NPL as % of All Governmental Revenues | 565% |

[1] For full details of our adjustments to pension liabilities, see our recent cross sector rating methodology "Adjustments to U.S. State and Local Government Reported Pension Data."

## Fiscal 2013 Budget Remedies Concentrated in One-Time Measures

In our issuer comment of March 18, 2013, Puerto Rico Faces Large Mid-Year Budget Gap, we noted that full year revenues for fiscal 2013 were likely to be $910 million or10.4% below initial estimates of $8.750 billion and 9.3% below fiscal 2012 revenues. Revised estimates showed the shortfall to be slightly larger at $965 million as of January 31, 2013. In response, the commonwealth has implemented a number of corrective measures, including modest expense reductions.

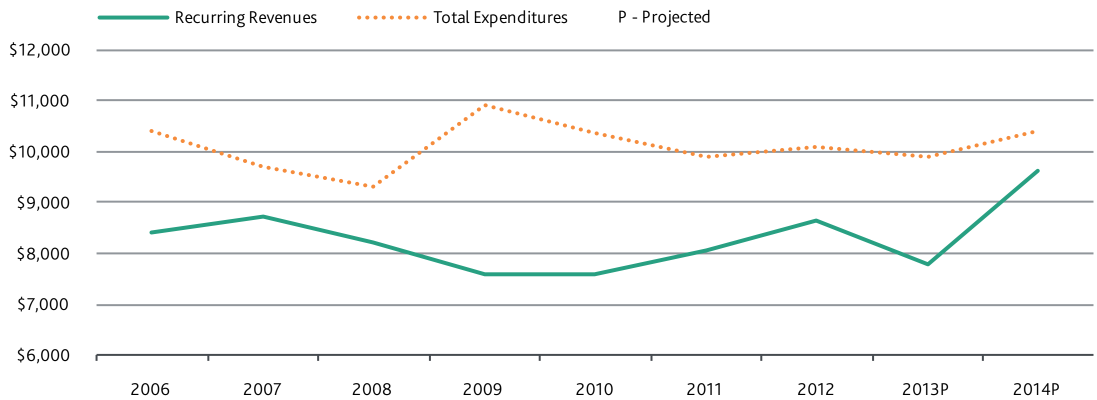
The commonwealth also executed a number of deficit financing measures, as originally contemplated in the fiscal year 2013 budget. It executed a $333 million deficit financing via a bond anticipation note (BAN) with a private bank that it expects to take out with a future COFINA bond issue, and as of June 30, 2013 will have paid $775 million of debt service payments with a GDB line of credit that it expects to take out with a future G.O. bond issue. The commonwealth further identified approximately $240 million in swap collateral reserve funds that could be released given the significant reduction in the commonwealth's general obligation variable rate debt and swap portfolio and $280 million in advance payments by companies subject to the non-resident withholding tax. Including an estimated expense overrun of $50 million identified by the Office of Management and Budget (OMB) as of March 31, 2013, that leaves an estimated remaining budget gap of $495 million, which the commonwealth hopes to close before the end of fiscal 2013 with a variety of measures, including a tax amnesty program and the potential sale of certain performing income tax payment plans.

The credit impact of the fiscal 2013 budget measures is mixed. The budget fixes are virtually all of a non-recurring nature and there is still uncertainty around the remaining $495 million gap, although the new administration has acted quickly to address the revenue shortfall. And, as noted in the March 18 comment, the commonwealth has demonstrated access to the capital market and can access additional financing from the GDB, if necessary.

## Fiscal 2014 Budget Proposal Includes Sales Tax Expansion

At $10.4 billion, the fiscal 2014 proposed budget is about 5% larger than fiscal 2013 budget, incorporates a significant sales tax revenue expansion, and relies on additional deficit financing through the planned restructuring of $575 million of current GO debt service payments and $200 million of other financing. Most of the $500 million increase in spending is due to necessary increases including the costs associated with the new pension law and higher budgeted debt service payments compared to fiscal 2013. Fiscal 2014 recurring revenues are expected to exceed pre-recession levels, reflecting several tax law changes.

EXHIBIT 3
**Recurring Revenues vs. Expenditures**
(in millions)

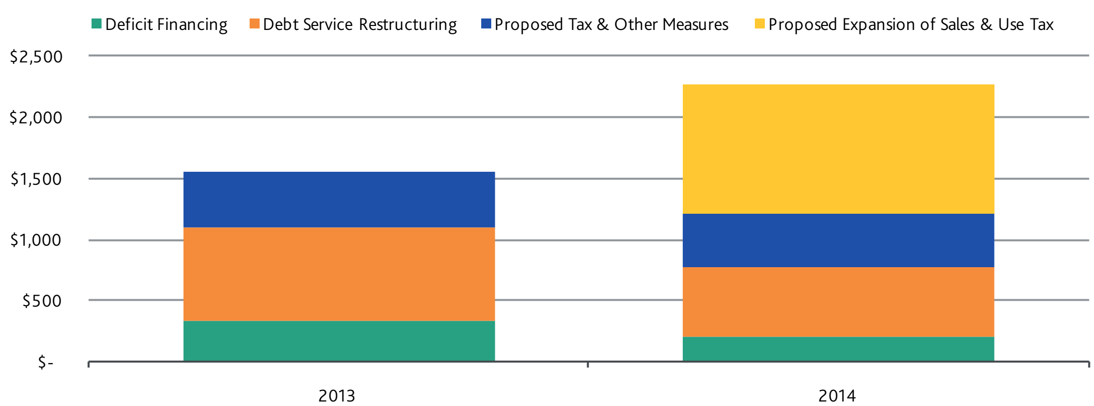



*Source: Government Development Bank for Puerto Rico*

The commonwealth has proposed expanding the existing sales and use tax base to capture more business-to-business services while at the same time reducing the tax rate to 6.5% from 7.0%. This will result in a smaller share of the revenue going to municipalities – from 1.5% to 1.0%. We note that the portion of the tax rate dedicated to supporting the COFINA bonds will remain the same at 5.5%. The sales tax expansion still must pass the legislature and, if enacted, could still fail to reach the $1 billion in projected revenue. If it passes, the broadening of the tax base would be credit positive for COFINA.

Apart from the sales tax expansion, the commonwealth is projecting revenue growth of $360 million or 4.6% primarily derived from the increase in Act 154 excise tax rates passed earlier this year. This revenue estimate incorporates projections for very low economic growth from the Puerto Rico Planning Board of 0.2%. In addition, there are several new taxes proposed on corporations and insurance companies.

EXHIBIT 4
**Fiscal Years 2013 & 2014 Budget Measures**
(in millions)




*Source: Government Development Bank for Puerto Rico*

The credit impact of the fiscal 2014 budget is also mixed due to uncertainty arising from both legislative risk and forecasting risk. The proposed budget does attempt to minimize non-recurring solutions in the budget by raising additional recurring revenue. If enacted, this would be credit positive as a step towards a sustainable budget. The sales and use tax revenues have outperformed other general fund revenue sources consistently over the past four years despite a sluggish economy, which we attribute to the high proportion of transfer payments from the federal government to Puerto Rico residents and to ongoing sales tax collection and enforcement improvements.

## Economy, Debt and Public Corporations Still Pressure the Commonwealth

Puerto Rico's economy is still lackluster. As noted in the report Key Drivers of Puerto Rico's G.O. Bond Downgrade to Baa3, published December 13, 2012, Puerto Rico's economic growth direction no longer tracks that of the US. Modest improvements in certain economic indicators in 2012 have not been sustained and the economy lacks clear growth drivers. The Government Development Bank for Puerto Rico's Economic Activity Index was negative in both January and February, though the tourism sector continues to show growth. The unemployment rate remains high at 14.2% as of March 31, 2013, almost double the U.S. rate and based on a labor force participation rate much lower than that of the U.S. Income levels have shown some improvement, however, with a 3 year compound annual growth rate of 1.9%.

As noted earlier, fiscal 2014 projections from the Puerto Rico Planning Board are for very low economic growth of 0.2%. While funding losses from sequestration have hit education- and housing-related spending, the governor does not expect widespread job losses. Job creation has been a top priority for the new governor, with legislation that grants business energy credits and other incentives for creating jobs, though it isn't clear these initiatives will be enough to reduce unemployment significantly. Tourism continues to be a bright spot in the economy and has grown over the past few years. It is a strategic sector that the commonwealth hopes can replace some of the long-term losses in the manufacturing sector. The new administration is not expected to reverse the widespread public sector layoffs implemented by the previous governor. Economic conditions therefore remain challenging, but employment initiatives and the tourism sector should help the commonwealth meet its modest growth estimates. Lagging economic conditions in the US, however, could put a damper on Puerto Rican tourism, as stateside visitors remain the most critical segment of the sector.

Debt ratios for the commonwealth are very high, with net tax-supported debt at over $14,735 per capita and approximately 92% of personal income, significantly higher than any U.S. state and also reflective of the relatively low per capita incomes in the commonwealth. Net tax-supported debt as of December 31, 2012 was $54.5 billion. Debt measures are also relatively high for similarly rated sovereigns and regional governments outside the US. General fund related debt service expenses from general obligations, the Public Buildings Authority and the Public Finance Corporation will be approximately $1.1 billion (including $575 million of debt service restructuring) or 11% of the fiscal 2014 budget.

Puerto Rico has more than a dozen public corporations that issue debt in the capital markets, including the Puerto Rico Aqueduct and Sewer Authority (PRASA) (Ba1, negative), the Puerto Rico Highways and Transportation Authority (PRHTA) (Baa2, negative; Baa3, negative; Ba1, negative), and the Puerto Rico Infrastructure Financing Authority (PRIFA) (Baa3, negative), as well as the GDB, the commonwealth's fiscal agent. These corporations rely to varying degrees on financial support from the commonwealth and/or the GDB. In some cases, such as PRASA, a lack of willingness to raise rates in the past caused the need for multiple years of government operating subsidies. Other issuers, as well as local municipalities and private entities, maintain lines of credit with the GDB. During the long economic downturn, the debt levels of the corporations rose in tandem with the commonwealth's, causing heavy debt service burdens in some cases, while the weak economy put pressure on their revenues. Our primary ratings on the public corporations and the GDB are linked to and capped at the commonwealth's own rating in light of the interdependency among the entities.

The commonwealth has recently implemented several measures to assist its struggling public corporations and make them more independent, including privatizing toll roads and the international airport and advancing a plan to raise water rates this year. Despite the reduction of $992.4 million of debt through toll road privatizations intended to reduce the authority's operational expenses as a result of reduced debt service payments, PRHTA has indicated that it will need $90 million in additional funds for the remainder of fiscal 2013 in addition to GDB support of $120 million already granted. As of December 31, 2012 PRHTA has more than $7 billion in outstanding public debt and loans from the GDB. PRHTA is the GDB's largest borrower at over $2 billion, representing approximately 24% of GDB's total loan portfolio. The GDB has recently stated publicly that it has discussed with the legislature a variety of measures to restructure PRHTA and increase its revenues. None have been approved yet. While fiscal-year-to-date revenues as of March 31, 2013 are down slightly, PRHTA's bonds are supported by a gross revenue pledge and aggregate debt service coverage is adequate at about 1.3 times (excluding subordinated interest payments to GDB). PRHTA also maintains access to additional credit support via private banks and the GDB.

The commonwealth has endeavored to maintain GDB's capital and liquidity position as weaker corporations, such as PRHTA, lean on it for support.

The GDB's net assets totaled $2.1 billion in fiscal 2012, up from $1.8 billion in fiscal 2011, and an investment portfolio of $5.3 billion, up slightly from $5.2 billion in fiscal 2011. As of March 31, 2013, preliminary and unaudited figures indicate net assets at $2.14 billion and an investment portfolio of $3.6 billion, 45% of which is invested in U.S. Agencies and Treasuries and 28% in money market securities. The change in the investment portfolio balance from 2012 primarily reflects the net change in loans to public corporations and the commonwealth.

EXHIBIT 5

**GDB Total Investment Portfolio**

(in billions)


*Source: Government Development Bank for Puerto Rico*

The credit impact of the weak economy, high debt levels and struggling corporations remain negative for the commonwealth and are reflected in our Baa3 rating and negative outlook at this time.

## Moody's Related Research

Issuer Comments:

» Puerto Rico Faces Large Mid-Year Budget Gap, March 2013 (151570)

» Key Drivers of Puerto Rico's G.O. Bond Downgrade to Baa3, December 2012 (148165)

Request for Comment:

» Adjustments to US State and Local Government Reported Pension Data, July 2012 (143254)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Report Number: 153896

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