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SPECIAL COMMENT

Puerto Rico's New Governor Faces Continuing Fiscal Challenges

Enactment of Pension Reform Initiatives Are Key to the GO Rating

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Summary

On Tuesday November 6, voters in the Commonwealth of Puerto Rico narrowly elected Alejandro Garcia Padilla of the Popular Democratic Party (PDP), a popular senator at large in the Puerto Rican legislature and prior secretary of the commonwealth's Department of Consumer Affairs and ousted the incumbent Governor Luis Fortuño. The governor-elect will face a difficult fiscal environment that has challenged the Commonwealth for the past six years, , including a lingering recession, high unemployment, a weakened manufacturing sector and significantly increased debt levels. The commonwealth's severely underfunded retirement systems also faces assets that are projected to rapidly decline from an already low level. Enactment of pension reform initiatives to extend the life of plan assets and reduce the cost burden are key to our analysis of the Commonwealth's general obligation rating.

Though a majority of voters also chose statehood in the commonwealth's concurrent, non-binding plebiscite, an actual change in political status will face an uphill battle at this time, including a Governor-Elect who opposes such a change.

Puerto Rico has Been Hampered by Six Years of Recession

Puerto Rico has been in recession for the past six years, in part triggered by the loss of key territorial tax advantages under Section 936 of the Internal Revenue Code, as well as increased global competition in the manufacturing sector. Though there have been some signs of economic stabilization this year, the economy is still struggling with very high unemployment of 13.2%, reduced labor force participation, ongoing losses in its manufacturing sector and population declines.

Puerto Rico's budget deficit has declined from a high of 43% of revenues in 2009 (inclusive of some expenditures deferred from the prior fiscal year) to an expected 4% of revenues for fiscal 2013, not including debt service restructurings. If restructurings are included, the gap is closer to 12% of revenues. Revenue growth is likely to remain uncertain in the near future.

Outgoing governor Luis Fortuño spearheaded a major tax restructuring in the commonwealth that decreased local corporate and individual income taxes and largely replaced them with a highly concentrated temporary excise tax on non-Puerto Rican companies with manufacturing operations in Puerto Rico. The temporary excise tax decreases every year and expires at the end of 2016. The tax is largely paid by fewer than 50 companies. While temporary, it could further undermine the manufacturing sector and introduces the risk of significant revenue loss to the commonwealth if even a few companies decrease their operations in Puerto Rico.

Moreover, since the expiration of Section 936, which granted territorial benefits to companies locating in Puerto Rico, the commonwealth has invested in tourism and agriculture to help replace those losses. It is not clear if those sectors can generate adequate growth to replace the losses in the manufacturing sector.

Over the past six years, the commonwealth has helped close its deficits with debt, including a portion of the sales tax backed revenue bonds issued by the Puerto Rico Sales Tax Financing Corporation (COFINA). As a result, the commonwealth's debt levels are high by every measure and an outlier relative to the U.S. states. Net tax supported debt per capita for 2011 was $14,004 versus a median for U.S. states of $1,117 and a mean of $1,408, as reported in Moody's 2012 State Debt Medians Report. Debt service was approximately 18.7% of revenues, versus a median for U.S. states of 4.9% and a mean of 5.3%.

Retirement Systems Face Asset Depletion without Major Pension Reform

Puerto Rico's severely underfunded pension plans also continue to pressure the rating. The Puerto Rico Employees Retirement System (ERS) had net assets of only $1.7 billion (net of $3 billion of pension bonds recorded on the ERS balance sheet) versus an unfunded liability of $24 billion in fiscal 2011 and projected general fund revenues in fiscal 2013 of $9.1 billion. Previous actuarial studies have projected asset depletion occurring 2021, assuming consistently positive investment performance. The commonwealth has estimated that paying benefits from current revenues would amount to approximately 10 to 11% of the budget, plus another 2% for debt service on outstanding pension bonds. The Puerto Rico Teachers Retirement System (TRS) is also underfunded with an unfunded liability of $9 billion and a funded ratio of 21%. Outgoing governor Luis Fortuño had assembled a bipartisan task force to recommend draft pension reform legislation prior to the end of this term. The governor-elect however, has stated publicly that he does not support any reform that includes reduction of benefits for current retirees. Moody's would view any delay or cessation of pension reform as a serious credit negative.

Puerto Rico's Voters Also Weighed in on their Political Status

Puerto Ricans also cast votes in a non-binding referendum on the political status of the U.S. territory last week. The referendum was structured as a two-part question. The first part asked if voters wanted to continue their current status as a territory of the U.S. As a territory, Puerto Ricans are U.S. citizens, able to move freely between the U.S. and the commonwealth and eligible for a variety of federal programs including social security and needs-based programs. Despite full U.S. citizenship, Puerto Ricans are represented nationally only by a resident commissioner in the U.S. House with limited voting powers and they may not vote in U.S. presidential elections.

The second part of the referendum asked voters to express their preference for one of three alternatives to their current territorial status: statehood, independence or sovereign free association, regardless of how they voted on the first part. Preliminary results indicated that 54% of approximately 1.7 million voters said they did not want to continue as a U.S. territory (and 46% did wish to remain so). On the second part of the referendum, approximately 61% of respondents chose statehood, but significantly fewer responses were tallied (approximately 1.3 million) for the second question, diluting the strength of that majority. If the blank votes for the second part are counted in the total, then the statehood option won less than a majority, with only 45% of the vote. Moreover, Governor-elect Garcia Padilla is not pro-statehood and the PDP, which favors no significant change in status, regained both houses of Puerto Rico's legislature.

Statehood Faces an Uphill Battle

This is the fourth non-binding referendum the commonwealth has held and the first where a majority indicated a desire for a change in political status. In the past, President Obama has indicated support for the will of the Puerto Rican people regarding political status, but it remains to be seen if the referendum's results provide a clear enough indication to give the issue any momentum in Congress. When the residents of Alaska and Hawaii were asked to vote on admission to the United States, statehood received 83% and 94% of the votes respectively. While Puerto Rico's referendum involved consultation with the President's Puerto Rico Task Force, it was not authorized by Congress. The only resulting legal requirement is to report the results to Congress. Any change in status for Puerto Rico would have to be approved by both houses of Congress and then go back to the people of Puerto Rico for a binding vote to accept it.

Puerto Rico's pro-statehood resident commissioner Pedro Pierluisi was re-elected, but he aligns himself with the U.S. Democratic Party, as opposed to outgoing Governor Fortuño who is a Republican and a key champion of statehood. That means Pierluisi would have to argue for statehood to a House of Representatives that is majority Republican and unlikely to be sympathetic to a change in status that would likely involve additional costs for the U.S. government as well as adding Puerto Rico's likely Democratic votes to the U.S. electoral college and additional Democratic members of Congress.

Nevertheless, the referendum has attracted considerable international attention and the governor-elect has already publicly stated his plans to hold another plebiscite referendum, with Congressional support, in 2014.

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