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Puerto Rico Sales Tax Financing Corporation; Sales Tax

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Credit Profile		
US$2,200. mil sales tax rev bnds first subor ser 2010A due 08/01/2045		
Long Term Rating	A+/Stable	New

Rationale

Standard & Poor's Ratings Services assigned its 'A+' rating and stable outlook to Puerto Rico Sales Tax Financing Corporation's (COFINA) approximately $2.2 billion in first subordinate sales tax revenue bonds, series 2010A.

In addition, Standard & Poor's affirmed its 'AA-' rating and stable outlook on the corporation's approximately $5.2 billion in senior lien sales tax revenue bonds outstanding. We also affirmed the 'A+' rating and stable outlook on COFINA's $4.1 billion series 2009A and approximately $500 million series 2009B first subordinate sales tax revenue bonds.

Standard & Poor's also withdrew its 'SP-1+' rating on the corporation's 2009 bond anticipation notes. The notes were retired when the series 2009A first subordinate lien bonds closed.

The 'AA-' rating on the senior bonds and 'A+' rating on the first subordinate lien bonds continue to reflect our opinion of:

- COFINA's strong legal structure that successfully separates the revenue stream securing the bonds from the Commonwealth of Puerto Rico (BBB-/Stable GO rating);
- The resilient performance of the pledged sales tax revenues, which have exhibited only a modest decline despite the prolonged and deep economic recession Puerto Rico has experienced over the past three years; and
- The corporation's access, on a priority basis, to the entire 5.5% sales and use tax (SUT) currently collected by the Commonwealth of Puerto Rico, which provides adequate coverage of all senior and subordinate projected debt service payments, even under severe stress assumptions.

The ratings are constrained by the commonwealth's 'BBB-' GO rating, because the structure securing the bonds cannot completely isolate COFINA's bondholders from the commonwealth's financial and economic condition. The ability to levy and collect sales and use taxes depends directly on the underlying economic activity in Puerto Rico, which can be affected by the government's financial condition, and that dependence cannot be entirely eliminated by the structure supporting the bonds.

The legislative act creating COFINA, Law 91 of 2006, successfully separates and provides a priority interest in the commonwealth's SUT for the bondholders. Law 91 provides that all revenues from the commonwealth's 5.5% SUT go directly to COFINA until a guaranteed base amount of tax collections is met. The statute further grants a statutory lien to bondholders on the commonwealth's SUT revenues once any bonds are issued. In addition, COFINA is not permitted to voluntarily file for bankruptcy protection and cannot be forced into involuntary bankruptcy. Furthermore, Standard & Poor's received multiple legal opinions stating that Act 91 successfully transfers property of the SUT collections to COFINA. This transfer of property effectively excludes the pledged SUT revenues from Puerto Rico's constitutional provision regarding the commonwealth GO debt's first-lien claim on all available revenues (also known as the "claw-back" constitutional provision).

COFINA is a corporate and political entity independent and separate from the Commonwealth of Puerto Rico. COFINA was created with the purpose of issuing bonds and utilizing other financing mechanisms to pay or refinance all or part of the "extra-constitutional" (appropriation) debt of the Commonwealth of Puerto Rico as of June 30, 2006 (totaling $6.8 billion). In early 2009, the Puerto Rico legislature approved an amendment to Law 91 that expanded COFINA's corporate purpose to include the funding of the commonwealth's budget deficit through fiscal 2012; the payment of accrued obligations to suppliers; the establishment of a local stimulus plan; and the creation of an emergency fund to cover expenses related to catastrophic events such as hurricanes and floods. To meet COFINA's expanded corporate purpose, the amendment to Act 91 increased the percentage of sales tax receipts pledged directly to the Dedicated Sales Tax Fund (Fondo de Interés Apremiante, or FIA) to 2.75% from 1%. The FIA will be funded with the first revenues collected by the entire 5.5% commonwealth SUT, until revenues in the FIA reach the collections equivalent to the 2.75% dedicated SUT or an annual guaranteed base amount--whichever is greater. The base amount increases by a 4% annual adjustment factor. Regardless of the sales tax collections based on the 2.75% dedicated sales tax, Act 91 requires that all of the 5.5% commonwealth sales tax be applied to satisfy and fund the base amount before any money can be transferred to the commonwealth's general fund.

COFINA's ability to issue senior lien bonds remains limited by statute to the total amount of extra-constitutional debt as of June 30, 2006. In addition, the resolution requires that SUT revenues for the fiscal year prior to the issuance of additional bonds (increased by the adjustment factor) provide at least 3.0x coverage of annual debt service on all existing and proposed senior lien bonds. Consequently, COFINA will not issue additional senior-lien bonds unless it is to refund or to anticipate payment on extra constitutional debt and related obligations and for refundings that provide annual savings. The subordinate-lien bonds have a two-pronged additional bonds test (ABT) that requires 102% of the annual combined senior and subordinate bond principal and interest payments due in each year to be less than the amended base amount for the corresponding year. The base amount equals $550 million for fiscal 2010, escalated by 4% thereafter and is capped at $1.85 billion. In addition, the subordinate lien ABT requires that total sales taxes collected in the year prior to the issuance of additional bonds (increased by an annual factor of 4%) provide at least 2.0x coverage of combined annual senior and subordinate lien bonds in every year bonds are outstanding.

Outlook

The stable outlook reflects Standard & Poor's expectation that the current structural and legal strengths supporting COFINA's bonds will remain unchanged. In addition, the outlook reflects the prospects for strong coverage of debt service from revenues generated by the access to the entire 5.5% commonwealth sales tax to pay the base amount. We believe that the issuance of subordinate lien debt in an amount that results in a potential significant reduction of annual debt service coverage due to an increased reliance on future sales tax growth could result in downward pressure on the subordinate lien rating.

Broad-Based Revenue Source Provides Strong Debt Service Coverage

The Commonwealth of Puerto Rico's sales tax collections have remained relatively stable despite the prolonged economic recession the island has experienced for the past three years. In fiscal 2009, collections for the entire 5.5% SUT averaged approximately $91.5 million per month, which has exceeded the commonwealth's projections when the tax was initially implemented. For the first four months of fiscal 2010, SUT collections totaled $341 million, which is 2.8% below the fiscal 2009 collections for the same period. Commonwealth officials attribute the decline in sales tax collections to the island-wide back-to-school-tax-free holiday in July, which exempted certain items from the sales tax.

In our opinion, the stability of sales tax collections resides primarily in three factors: the broad-range of products and services included in the tax base, which excludes more volatile items such as motor vehicle sales, gasoline sales, and most tourism-related activities; the historically strong growth in personal consumption expenditures; and a large population base (nearly 4 million residents) with very limited options for off-island consumption, which prevents sales tax leakage. In addition, commonwealth officials estimate that there is still a significant portion of small retailers that do not contribute to the tax. In our view, an increase in collection efforts provides some flexibility to mitigate the impact of a decline in taxable sales of existing contributors.

Most of the sales tax collections are derived from large retailers. In fiscal 2009, the leading 20 retailers accounted for 31% of total sales tax collections, and the leading 100 retailers accounted for 51% of total sales tax collections. From a sector perspective, the sales tax is diverse, with retail trade accounting for 50% of fiscal 2008 collections, followed by food services (15%), information and telecommunications (11%), wholesale trade (10%), manufacturing (4%), and other sectors (10%).

In our opinion, debt service coverage of senior lien bonds is very strong. SUT revenues generated from the 1% originally dedicated to COFINA provided an adequate 1.2x coverage of fiscal 2010 debt service. The increase in the base amount to 2.75%, or $550 million in fiscal 2010 (increased by 4% annually thereafter), provides a strong coverage of 3.1x in fiscal 2010, and a minimum coverage of 1.4x for the life of the bonds. Revenues from the entire 5.5% Commonwealth sales tax provided what we consider a very strong 6.1x senior lien debt service coverage in fiscal 2009. Furthermore, if sales tax collections remained flat at fiscal 2009 levels, the 5.5% sales tax would provide sufficient coverage of senior lien debt service through 2053.

Commonwealth officials have developed four different stress scenarios, with varying degrees of projected changes in sales tax collections. These stress scenarios are based on historical patterns of personal consumption expenditures (which have averaged 5.4% annual growth in the past 10 years), gross national product and the assumption of a fully-leveraged senior lien (approximately $6.8 billion in bonds), and a fully-leveraged first subordinate lien (approximately $7.2 billion in bonds). In all of these stress scenarios, coverage of combined senior and first subordinate lien remains at above 1x. Some of the assumptions of the four stress scenarios are listed below.

- Scenario 1: Assumes 3.8% annual growth in sales tax collections starting in fiscal 2010 (no growth assumed for fiscal 2009). Under this scenario minimum coverage of combined senior and first subordinate lien is 2.0x, average coverage is 2.32x, and maximum coverage is 3.67x;
- Scenario 2: Assumes 1.6% annual growth in sales tax collections starting in 2010 (no growth assumed in fiscal 2009). Under this scenario minimum coverage of combined senior and first subordinate lien is 1.01x, average coverage is 1.38x, and maximum coverage is 2.11x;

- Scenario 3: Assumes 10% reductions in sales tax collections in fiscals 2011, 2012, and 2013, and 3.8% annual growth thereafter. Under this scenario minimum coverage of combined senior and first subordinate lien is 1.32x, average coverage is 1.54x, and maximum coverage is 2.39x; and
- Scenario 4: Assumes no sales tax growth for 15 years- from 2010 to 2024- and 3.8% growth in collections thereafter. Under this scenario minimum coverage of combined senior and first subordinate lien is 1.19x, average coverage is 1.49x, and maximum coverage is 2.16x;

Transaction Overview

Statutory revenues

The senior and first subordinate lien bonds are payable from COFINA's revenues. Act 91 creates a statutory pledge over COFINA's revenues for the benefit of the bondholders. Because this pledge is created by statute, no further action is necessary to perfect the bondholders' interest in COFINA's revenues. COFINA derives its revenues from SUTs collected throughout the island. The SUT is broad based and includes most goods and services. Major items that are exempt include health care services and prescription medications, motor vehicles, non-prepared food, financial services, services provided by designated professionals, hotel room charges, and services provided by the Commonwealth such as water and electricity. The exclusion of motor vehicle sales, gasoline sales, and hotel room charges eliminates some of the volatility associated with these sectors. The current sales and use tax of 7% includes a 1.5% municipal sales tax, a 2.75% general fund sales tax, and a 2.75% dedicated sales tax. The structure securing COFINA's bonds provides bondholders first access to the entire 5.5% SUT to cover the guaranteed base amount allocated to the Dedicated Sales Tax Fund (DSTF). The DSTF is funded with the 2.75% dedicated SUT or a base amount--whichever is greater. Pursuant to Act 91, the base amount for fiscal 2008 was $185 million. This base amount increases each fiscal year thereafter at a statutory rate of 4%. In early 2009, the Puerto Rico legislature amended Act 91 to increase the portion of the sales tax dedicated to COFINA to 2.75%, and increased the base amount to $550 million in fiscal 2010. This base amount will increase at a statutory rate of a 4% unit it reaches a cap of $1.85 billion. On or prior to Oct. 1 of each fiscal year, the Secretary of the Treasury is required to determine whether the amount of Commonwealth sales tax required to be transferred to the DSTF, based on the dedicated 2.75% sales tax, exceeded the applicable base amount; if so, Act 91 and its amendments, require that all Commonwealth sales tax collections of the prior fiscal year representing such excess be transferred to the DSTF (to the extent that they were not previously transferred).

Collection and payment procedures

Sales tax revenues are collected on a monthly basis by First Data Corp., a provider of electronic commerce and payment solutions for businesses and consumers; Banco Popular de Puerto Rico; or any other authorized collector designated by the Secretary of the Treasury. Merchants have until the 10th of every month to remit sales tax collections for the prior month. Collectors transfer sales tax revenues on a daily basis to a bridge account at Banco Popular in the name of the Treasury Department, as paying/receiving agent. Once the funds are deposited in the Banco Popular bridge account, Banco Popular then transfers on a daily basis (with a two-day delay) to the trustee collections from the entire 5.5% SUT until the base amount has been deposited in the DSTF, and thereafter to the Treasury Department all subsequent sales tax collections until the department has received its share (2.75%/5.5%) of the collections received to date in the fiscal year. Thereafter, Banco Popular divides additional sales tax receipts between the FIA and the Commonwealth's Treasury on the basis of the 2.75%/4.5% split.

The structure for the senior and first subordinate bonds does not include a debt service reserve account. However, the indenture requires the trustee to set aside the "Accrued Obligation", which is equivalent to the next 12 months of debt service (15 months for bonds with quarterly interest payments). In our opinion, this requirement provides a source of liquidity similar to a debt service reserve fund. Furthermore, the liquidity provided by the allocation of the first revenues from the full 5.5% sales tax to COFINA and the timing of scheduled debt service payments alleviate concerns over the lack of a funded debt service reserve account. The senior and first subordinate lien bonds pay interest starting on Feb. 1, and interest and principal starting in October. Based on fiscal 2008 collections, the original base amount (1% sales tax) was fully funded in the first two months of the fiscal year. The required amount for the original and additional base (2.75% sales tax) is expected to be fully funded in the first six months of the fiscal year. In our opinion, the legal requirement to set aside the next year's annual debt service on the senior and subordinate lien bonds (accrued obligation) mitigates some of the liquidity concerns that may arise in the event of an unforeseen decline of collections in the early part of the fiscal year, before the base amount is reached.

Flow of funds

Dedicated sales tax revenues are deposited in the DSTF account on a daily basis. The bonds benefit from the availability of the first collections of the entire 5.5% Commonwealth sales tax.

Pledged sales taxes are first used to pay scheduled fees of the trustee and operating expenditures not to exceed a $200,000 cap (escalated 2% annually). Sales taxes next flow to the debt service account for the senior bonds, allocated on a pro rated basis between the principal subaccount, the interest subaccount, and the holding account, until the accrued obligation requirement is met. After debt service is paid, sales taxes next fund a senior debt service reserve account (if one is established, which is not anticipated at this point). Next, sales taxes flow to the debt service accounts for the subordinate lien bonds and obligations, debt service on subordinate bonds, and subordinate obligations. Thereafter, sales taxes fund a subordinate debt service reserve account, if one is established. Sales taxes then flow to the debt service account for second subordinate bonds and second subordinate obligations (none issued at this point), and to fund a debt service reserve on those obligations if one is established. Finally, excess sales tax funds can be retained in the revenue account; be transferred to the early redemption account; pay credit facilities, liquidity facilities, and qualified hedges; and be used to pay of operating costs in excess of the operating cap.

Legal Risks

COFINA was established by statute as an instrumentality of the Commonwealth. COFINA is not authorized to file a petition for bankruptcy under Chapter 9 of the Bankruptcy Code. Its assets and liabilities are separate from those of the Commonwealth. In addition, as a public agency or instrumentality of the Commonwealth, COFINA cannot be the subject of an involuntary bankruptcy filing.

In early 2009, the Puerto Rico legislature approved an amendment to Law 91, which expanded COFINA's corporate purpose to include the funding of: the commonwealth's budget deficit through fiscal 2012; the payment of accrued obligations to suppliers; the establishment of a local stimulus plan; and the creation of an emergency fund to cover expenses related to catastrophic events such as hurricanes and floods. To meet COFINA's expanded corporate purpose, the amendment to Act 91 increased the percentage of sales tax receipts pledged directly to the Dedicated Sales Tax Fund (Fondo de Interés Apremiante, or FIA) to 2.75% from 1%. The FIA will be funded with the first revenues collected by the entire 5.5% Commonwealth SUT, until revenues in the FIA reach the collections equivalent to the 2.75% dedicated sales and use tax or an annual guaranteed base amount--whichever is greater.

The base amount increases by a 4% annual adjustment factor. Regardless of the sales tax collections based on the 2.75% dedicated sales tax, Act 91 requires that all of the 5.5% Commonwealth sales tax be applied to satisfy and fund the base amount before any money can be transferred to the Commonwealth's general fund.

Credit Risks

Underlying economic viability of the Commonwealth is key

The ability of COFINA to make payments on the bonds according to the elongated maturity schedule is dependent on the timely generation of sufficient SUT receipts over a 50-year time horizon. This in turn is dependent on Puerto Rico's ability to attract and retain corporations that pay wages in the island and residents and visitors who buy goods and services in the island. Standard & Poor's took into account that, to generate sales tax revenue, the Commonwealth must provide and pay for essential services such as education, police, fire, sewer, and water. It is because of this reliance on the island's economic viability that the rating on COFINA's bonds cannot be completely de-linked from the Commonwealth's GO rating. However, Standard & Poor's believes that Puerto Rico will be able to generate sufficient sales and use tax revenues to cover debt service on the bonds even under stressful conditions. During some of these stressful scenarios, the Commonwealth may be impaired to operate normally because COFINA's bonds have first call on a substantial portion of the Commonwealth's revenues.

During the past decade, Puerto Rico's economy has been characterized by an increasing reliance on the public sector as the employer and economic engine of last resort. Consequently, it is not surprising that a reduction in government spending coupled with the implementation of a SUT and significant increases in public services triggered the island's current economic recession. In addition, the recession in the U.S. mainland has the potential to further aggravate Puerto Rico's economic decline. Commonwealth officials estimate that the American Recovery and Reinvestment Act of 2009 will result in approximately $5.1 billion in stimulus funds, which the Commonwealth plans to leverage with a local $500 million economic stimulus fund. The extent to which stimulus funds provide an increase in economic activity in the island may provide additional stability to sales tax collections, at least in the short term.

The major risk for Puerto Rico's long-term economic growth remains a continued pattern of laggard private sector job creation, which will limit the Commonwealth's ability to reduce its dominant presence in the local employment base. High energy costs, which have historically constrained the island's competitiveness, also remain a concern for the island's prospects for future growth.

Puerto Rico has a relatively short history of consumption-based taxation. However, sales tax collections have remained relatively stable despite the prolonged economic recession. As mentioned before, there are three main factors that support the stability of sales tax collections: the broad-range of products and services included in the tax base, which excludes more volatile items such as motor vehicle sales, gasoline sales, and most tourism-related activities; the historically strong growth in personal consumption expenditures; and a large population base (nearly 4 million residents) with very limited options for off-island consumption, which prevents sales tax leakage.

Personal income and personal consumption data are perhaps the best evidence of what the historical trend of the SUT would have been, and are the closest indicators to evaluate the vulnerability of sales tax collections to economic cycles. Total personal consumption expenditures have steadily increased over the past 10 years at an average annual rate of 5.4%. Moreover, since the local recession began in 2006, personal consumption expenditures have grown by 3.1%. One factor that contributes to the stability of personal consumption expenditures is the significance of federal transfers on the local economy. Commonwealth officials estimate that federal transfers to individuals (which include social security payments, nutritional assistance programs, veteran's benefits and U.S. civil service pensions) account for approximately 22% of personal income and about 23% of personal consumption expenditures. Federal transfers have increased 5.5% annually over the past five years.

Debt Derivative Profile: Low Risk

Standard & Poor's assigned a Debt Derivative Profile (DDP) score of '2' on a scale of '1'-'4', with '1' representing the lowest risk and '4' the highest risk, to COFINA, indicating the swap portfolio's low-risk nature. The corporation entered into two forward starting swaps effective Feb. 1, 2012, with DEPFA BANK PLC (BBB/Watch Pos/A-2) and Morgan Stanley (A/Negative/A-1) that requires the corporation to make payments based on a fixed 3.95% interest rate and receive payments from the counterparties at 67.00% of the three-month LIBOR. The swaps synthetically fixed $907 million of the corporation's series 2007A sales tax revenue bonds. Given the termination events of the swaps, which would a trigger a termination if the corporation's or the counterparty's ratings fall below 'BBB+' (an event that would have occurred given DEPFAs current rating), Commonwealth officials plan to terminate the swaps prior to their effective date of Feb. 1, 2012. Based on current interest rates, the mark-to-market on the swaps is approximately $85 million against COFINA. If the mark-to-market on the swaps in 2012 remains adverse to COFINA, Commonwealth officials plan to issue senior refunding bonds to meet the required termination payment. The potential issuance of approximately $200 million in senior bonds has already been incorporated in our debt service coverage calculations.

Our DDP score also reflects the corporation's formally adopted swap management policy, the swap's long 30-year duration, and ensuing basis risk increase vulnerability to stressful economic cycles.

Related Research

- USPF Criteria: Short-Term Debt, June 15, 2007
- USPF Criteria: Special Tax Bonds, June 13, 2007

Ratings Detail (As Of January 14, 2010)		
Puerto Rico Sales Tax Fin Corp sales tax rev bnds first subord 2009 BANs ser 2009		
Short Term Rating	NR	Withdrawn
Puerto Rico Sales Tax Fin Corp sales tax rev bnds ser 2008A dtd 08/01/2008 due 08/01/2057		
Long Term Rating	AA-/Stable	Affirmed
Puerto Rico Sales Tax Fin Corp sales tax rev bnds, first subord ser 2009A		
Long Term Rating	A+/Stable	Affirmed
Puerto Rico Sales Tax Fin Corp sales tax rev		
Long Term Rating	AA-/Stable	Affirmed
Puerto Rico Sales Tax Fin Corp sales tax (wrap of insured) (AMBAC & BHAC) (SEC MKT)		
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed
Puerto Rico Sales Tax Fin Corp sales tax (wrap of insured) (FGIC & BHAC) (SEC MKT)		
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed
Puerto Rico Sales Tax Fin Corp sales tax		
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed

Ratings Detail (As Of January 14, 2010) **(cont.)**

Many issues are enhanced by bond insurance.