STANDARD & POOR'S

PUBLIC FINANCE

Puerto Rico's Incoming Administration Will Face A Challenging 2009

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DALLAS (Standard & Poor's) Dec. 22, 2008—Standard & Poor's Ratings Services said that its 'BBB-' rating, and stable outlook, on the general obligation (GO) debt of the Commonwealth of Puerto Rico are not immediately affected by Governor-elect Luis Fortuño's Advisory Council announcement of an estimated structural deficit of approximately $3.2 billion for fiscal 2009, which is more than three times the initial budgeted deficit of $1 billion. In our downgrade of the commonwealth's GO rating to 'BBB-' from 'BBB' in May 2007 we cited the continuing difficulties with reducing the accrued deficit, and our expectation that the commonwealth's goal of a structurally balanced budget by fiscal 2010 would be difficult to achieve. We anticipated structural imbalance persisting. However, in our opinion, the drastic increase in the size of the structural deficit for fiscal 2009 may require the implementation of an even stronger set of fiscal and administrative measures to preserve credit stability in the near term.

According to the governor-elect's Advisory Council, the widening budget deficit is the result of both an underperformance of revenues and identified budget deficits in several of the commonwealth's agencies and departments. On the revenue side, the deficit includes a downward revision of roughly $687 million (8% of budgeted revenues), attributable to a decline of $487 million in projected tax revenue, and an additional $200 million in tax credits. On the expenditure side, the revised estimates included a deficit of $500 million in health care expenses, $100 million in deficit in other agencies, $165 million in increased debt service payments from the commonwealth's corporations to the Government Development Bank (GDB), and an estimated $750 million in accounts payable.

CREDIT IMPLICATIONS

In our view, there are four main factors that we will continue to consider in our assessment of the stability of the commonwealth's credit rating in the near term:

— Fiscal and budget measures to narrow the gap. In our view, the Fortuño administration will face a challenging economic and budget environment when it is sworn in on Jan. 2, 2009. We believe that the growing size of the budget deficit makes the timely implementation of revenue enhancement and more-aggressive cost-cutting measures crucial to maintaining credit stability in the near-term. While Governor-elect Fortuño will enjoy a considerable majority in the legislature, we expect that narrowing the budget deficit will require sweeping revenue and expenditure measures, some of which may be politically unpopular.

— The GDB provides an element of stability. We believe that the challenging revenue environment may require the commonwealth to rely, at least temporarily, on increased support from GDB to fund the budget gap. However, in our view, the stabilizing effect of GDB on the commonwealth's rating has its limitations. The commonwealth's rating may be pressured if its reliance on GDB to fund the deficit increases materially or if the government does not implement measures in the near term to reduce the structural deficit. In our view, the ability of the commonwealth to use GDB only as a temporary source of flexibility to implement meaningful measures to narrow the budget deficit and not as a long-term source of deficit financing will affect the commonwealth's credit stability.

— Continued market access. In our opinion, Puerto Rico will continue to rely on market access to fund its cash-flow needs to cover the budget deficit. We believe that a lack of sufficient market access to meet its funding needs could forestall one avenue that Puerto Rico has used in the past to solve cash shortfalls. On the other hand, we believe that despite potential cash pressure, constitutional provisions that give priority payments to the commonwealth's GO debt service help support the GO rating.

— The economic recession will continue to pressure revenues**.** Puerto Rico has been in an economic recession for nearly three years. The recession in the continental U.S. doesn't bode well for Puerto Rico, particularly if the recession affects sectors that had until recently performed relatively well, such as tourism and services. According to the Puerto Rico Planning Board, Gross National Product (GNP) growth projections, which indicated a 2.3% decline for 2008, are now projected to decline by 2.4% in 2009. Further, unemployment in Puerto Rico reached 12.6% in August 2008, up 0.6% from the prior year. The extent to which the U.S. recession impacts tourism and related services will have an impact on tax collections and has the potential to further widen the budget deficit. We believe that given the dominant role that public spending has on the island's economy, the reduction in government spending without an increase in private sector employment could deepen the current recession and widen the budget deficit in fiscal 2009 and potentially fiscal 2010.