Puerto Rico Credit & Market Update

- Puerto Rico relies heavily upon the capital markets as a source of liquidity for operations. Interest in Puerto Rico’s bonds among traditional municipal investors has waned and the island has become more dependent on crossover buyers. As the scope of the unfolding fiscal crisis becomes more evident, we believe that the island’s general obligation bonds and sales tax revenue bonds no longer offer the same degree of relative safety as they once did. Excessive leverage, persistent budgetary deficits, a contentious political climate, and fiscally strained public corporations represent serious challenges.

- Assuming Puerto Rico successfully navigates its immediate hurdles, we believe that other obstacles are likely to prevent much improvement in credit quality for the foreseeable future. Absent further employer contributions, the depletion of public pension assets appears inevitable. Escalating health care costs have been financed through accelerated federal aid payments, which are scheduled to expire in three years. Meanwhile, the Commonwealth is poised to undertake a broad tax reform program designed to generate more tax revenue. The introduction of a new tax structure will add an element of budgetary uncertainty.

- Puerto Rico planned to sell approximately USD 2.9 billion of bonds through PRIFA this month but the transaction was delayed after certain amendments to the enabling legislation were deemed problematic by the Government Development Bank (GDB). To the extent the bonds are successfully sold in January, proceeds would be directed in part towards improving the financial position of the GDB, whose own loan portfolio is strained by more than USD 2 billion of loans made to the Highway & Transportation Authority.

- We readily acknowledge the Commonwealth’s stated intention to limit possible debt restructurings to its most stressed public corporations. However, unless economic growth accelerates, this goal may prove more difficult to achieve over time, raising the possibility of a more comprehensive debt restructuring program. We reiterate our recommendation that private clients with a lower risk tolerance diversify their holdings to ensure that exposure to Puerto Rico is limited in light of the mounting credit risk.
The Commonwealth of Puerto Rico enacted the Puerto Rico Public Corporation Debt Enforcement and Recovery Act (the "Recovery Act") on 28 June 2014. The law created a legal framework for certain public corporations to adjust their debts. The Highways and Transportation Authority (HTA), along with the Puerto Rico Electric Power Authority (PREPA) and the Puerto Rico Aqueduct and Sewer Authority (PRASA), are subject to the law and in aggregate have about USD 20 billion of outstanding debt. Governor Alejandro García Padilla contended that the Recovery Act was designed to ring fence other government agencies from the fiscal turmoil besetting some public corporations. Despite these assurances, the investment calculus was altered for many investors. Investors and rating agencies interpreted it as a renunciation of prior assurances that all debt would be paid in full. The strategy was poorly communicated and thus undermined the credibility of the Commonwealth and its fiscal agent, the Government Development Bank, among traditional municipal bond investors.

**Market update**
Puerto Rico bond prices have weakened since our last *Puerto Rico Credit & Market Update* (21 August 2014) and remain volatile. Whereas the credit spread on Puerto Rico general obligation bonds at the 10-year maturity point averaged 627bps in August, according to MMD, it widened to an average of 695bps in November. Over the same period, the Commonwealth’s general obligation bonds at the 30-year spot widened by an average of 25bps from August to November (see Fig. 1).

"The island faces numerous material fiscal and economic challenges that could adversely affect the credit quality of Commonwealth securities and the risk of further deterioration in its financial condition is a real one. There appears to be diminishing political will to support further austerity – a trend that we believe is worth monitoring."

– CIO WMR, Puerto Rico Credit & Market Update, 21 February 2014

**Fig. 1: Credit spreads for Puerto Rico GO bonds**

<table>
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<th>Month</th>
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Source: MMD, UBS CIO WMR, as of 10 December 2014
The prices of other Puerto Rico bonds have fluctuated during the third and fourth quarters of 2014, improving in September before reversing course. For example, according to MSRB trade data, the price of Puerto Rico Electric Power Authority (PREPA) bonds carrying a 5% coupon maturing in 2042 closed at USD 49.125 on 11 December 2014 (10.827% yield) and is down from a recent high of USD 59.5 (8.984% yield) on 17 September 2014. Meanwhile, prices on subordinated lien Sales Tax Financing Corporation (or COFINA, by its Spanish acronym) sales tax revenue bonds with a 5.25% coupon due in 2043 declined from USD 78.425 on 22 September 2014 (7% yield) to USD 69.5 (7.971% yield) on 11 December (see Fig. 2).

There was some modest improvement in the wake of the Commonwealth’s investor webcast held on 30 October 2014, which offered a fiscal and economic update through the first quarter of FY15. Going into the call, spreads on the 10-year and 30-year maturities stood at 700bps and 475bps, respectively. Spreads on the same maturities had declined to 695bps and 455bps, respectively, by 11 December. On the same date, Puerto Rico GO bonds carrying an 8% coupon maturing in 2035 closed at a price of USD 86.25 (9.538% yield), down from a recent high of USD 94.375 (8.583% yield) on 11 September 2014 (see Fig. 3). The bond was issued at a price of USD 93.00 on 11 March 2014.
Source: MSRB trade data, Bloomberg, UBS CIO WMR, as of 11 December 2014
Note: Puerto Rico GO 8.00% 2035 were issued at USD 93.00 on 11 March 2014

PRIFA bond issue postponed
The Commonwealth intends to sell up to USD 2.95bn of debt in the coming weeks through the Puerto Rico Infrastructure Financing Authority (PRIFA). As envisioned by the Government Development Bank, the bond issue will be secured by a 68% increase in the petroleum excise tax (from USD 9.25 to USD 15.50 per barrel), coupled with a pledge of the Commonwealth’s general fund resources in the event of any insufficiency. A portion of the bond proceeds will permanently finance more than USD 2bn of outstanding loans previously extended by the GDB to HTA. These loans represent over 20% of the bank’s loan portfolio. We expressed concern over concentration risk posed by these loans in May 2013.2

If the PRIFA bond issue is successful, Puerto Rico bond prices may rally briefly, based on a sense of relief that the Commonwealth was able to secure financing for another large bond issue. We would expect any such rally to be short-lived, however, as investors refocus their attention on the scale of the island’s acute fiscal and economic challenges. To the extent the sale is unsuccessful, investors should anticipate an abrupt sell-off of Puerto Rico securities given the historic reliance of the Commonwealth and related public entities on the GDB for short-term financing needs.

The GDB reported a total net liquidity position of USD 1.717bn on 31 October 2014 following the syndication of USD 900mn of Senior Notes, 2015 Series B, to a group of financial institutions.3 This cash infusion was not unusual in and of itself, as proceeds of short-term notes are often used to accommodate normal cash flow cycles. However, the Commonwealth also sold a USD 3.5bn GO bond offering just nine months ago and used USD 1.9bn of proceeds to repay an equivalent amount of GDB lines of credit. An additional USD 900mn was directed towards the repayment of liabilities that were subject to acceleration due to rating downgrades. Collectively, these actions bolstered the GDB’s liquidity position and reduced its contingent liabilities but additional funding is now needed.

The bank’s reported net liquidity position appears to have weakened faster than anticipated. While the GDB’s liquidity projections provided
in March included a contingency amount of USD 1bn, the contingency balance had declined to USD 500mn in an October forecast. The smaller contingency followed the purchase of USD 200mn of HTA variable rate demand obligations in May, the Commonwealth’s deferral of USD 247mn of principal and interest payments on outstanding GDB lines of credit, and the extension of an incremental USD 50mn line to the Commonwealth to finance extraordinary liquidations of vacation and sick leave at the Department of Education.  

The GDB’s liquidity position could deteriorate rapidly if the PRIFA financing is not consummated. Based on the GDB’s last liquidity update (adjusted to include GDB’s higher projection of total net liquidity as of 31 October 2014 as our beginning balance), we estimate that the bank’s ending liquidity position could become negative by the quarter ending 30 September 2015, net of any contingency. In making this calculation, we assume that GDB is called upon to repay the outstanding principal balance due on the HTA bond anticipation note on 1 September 2015. Beyond this period, the outlook is less clear. The GDB is obliged to repay USD 876 million of senior notes in FY2016, a large increase in comparison to USD 481mn in FY15.  

We believe the credit quality of the Government Development Bank and other Puerto Rico obligations will be substantially weakened if the Commonwealth fails to sell the PRIFA bonds. The GDB has been a longstanding source of liquidity for the Commonwealth, its public corporations, and municipalities across the island. As such, the credit worthiness of the Commonwealth and its agencies is inextricably linked to the GDB’s ability to function effectively.  

No contingency plans have been proffered by Commonwealth officials in the event the bond sale is not completed. At least one news source reports that Governor García is trying to determine if there are other ways to ensure the financial viability of the GDB if he chooses not to sign the amended bill. According to GDB President Melba Acosta Febo, the bank’s unencumbered cash has been reduced to a point where a major unexpected expense for the government could cause it to come up short. This, in turn, would have the potential to lead to even more serious liquidity challenges across the island given the historic reliance of the public sector on the bank for short-term financing needs. If unaddressed, the need for debt relief beyond the entities targeted under the Puerto Rico Public Corporation Debt Enforcement and Recovery Act becomes greater.

**Legislative update**  
The proposal to increase the petroleum excise tax and use it to secure a new bond issue was the subject of contentious debate in the legislature. Governor Alejandro García Padilla convened a special legislative session in the last week of November for this purpose. As originally envisioned, revenue from the USD 15.50 per barrel petroleum excise tax would be shared between HTA, PRIFA, and a new Integrated Transit Authority (which would assume responsibility for mass transit service on the island). The aggregate revenue would be divided among the three agencies as follows: USD 6.00 (HTA), USD 8.25 (PRIFA), and USD 1.25 (ATI).

The House of Representatives approved the bill on 2 December by a narrow margin, with amendments calling for the repeal of the gross profits tax (patente nacional) on businesses with annual gross
income of more than USD 1 million (the unpopular tax was enacted in 2013). An alternative version was approved by the Senate the following day. A conference committee was convened to resolve differences between the two bills. The final bill (HB 2212) was passed on 8 December 2014 with significant amendments to Governor García’s original proposal. The governor has not signed the legislation as we go to print. According to a press release, the GDB is discussing “certain shortcomings” of the approved version of the bill with the Senate and House leadership.10

Media reports suggest that some of the amendments included in the final version of the bill have proven to be problematic. The conference committee eliminated a provision which would automatically increase the petroleum tax every four years to cover the cost of inflation plus 1.5% and included language that caps the interest rate on debt secured by the levy at 8.5% (along with a provision that the original price for the bonds may not be less than 93% of face value). The final bill also included a stipulation that the tax increase take place along with planned broader tax reform before 15 March 2014 and imposed a requirement that a joint executive-legislative committee be established to identify operating efficiencies at the HTA within 30 days or otherwise appoint an emergency officer.11

GDB President Melba Acosta Febo stated that dropping the automatic future petroleum tax increase would downsize the proposed bond deal to USD 1.7bn from USD 2.95bn.12 The provision requiring an interest rate cap and price threshold could be similarly problematic based on recent valuations of Commonwealth general fund-supported debt. Popular support for Governor García appears to be waning and that sentiment may constrain his ability to garner legislative support. With the holidays rapidly approaching, the likelihood of the legislature arriving at an agreement on an amended version of the bill prior to 7 January is low. Meanwhile, some legislators have already threatened legal action against HB 2212 on grounds that it unconstitutionally commits the legislature to pass future bills.

Talking tax reform
Beyond the petroleum tax, market observers are highly attuned to any details related to the long-awaited tax reform proposal. The centerpiece is expected to be a calculated shift towards consumption taxes. The Commonwealth appears intent on replacing the current sales and use tax (which secures over USD 17bn of outstanding debt issued by the Sales Tax Financing Corporation) with a broad-based value added tax on goods and services.

The Commonwealth has advised bondholders that it is committed to “ensuring protection of (the) COFINA revenue pledge” in this process and expects COFINA to remain an important source of financing for the island.13 As we go to print, we are still awaiting the public release of a formal proposal. While we anticipate that the tax reform package will be structured with a sensitivity to its impact on outstanding sales tax revenue bonds, investors should be mindful of the high level of implementation risk that accompanies any tax reform initiative. The introduction of a new - and untested - tax structure adds an element of uncertainty to future budgets given Puerto Rico’s history of optimistic revenue forecasts and the intention to implement the program on an expedited basis.
Economic update
The GDB’s Economic Activity Index (EAI), a coincident index of economic activity on the island, recently posted its largest year-over-year percentage decline in the last eight months. The EAI took a turn for the worse in the second half of fiscal year 2013 and has continued to deteriorate into FY15 (see Fig. 4). The October result represents the 22nd consecutive month of year-over-year percentage declines for this metric.

While the Commonwealth’s budget for FY15 is built on nominal GNP growth of 2.6% (equivalent to real GNP growth of 0.2%), the EAI was 2.2% lower in October 2015 than in the same month the prior year. While the EAI is not a direct measure of GNP, it is highly correlated.

For its part, S&P has noted that it would consider lowering its general obligation bond rating of the Commonwealth within the coming year if economic decline leads to another significant budget deficit, in the absence of significant offsetting credit factors.

Fig. 4: Average EAI and yoy difference, FY 06-14 and FY15, first four months
Left hand side is average yoy difference, right hand side is average EAI

Source: Government Development Bank, UBS CIO WMR, as of 10 December 2014

Changing investor base
Puerto Rico has experienced general fund budget deficits for more than a decade (see Fig. 5). The structural deficit has been accommodated through the sale of long term bonds by COFINA and by refinancing general obligation and Commonwealth guaranteed debt issued by the Puerto Rico Public Buildings Authority. Market access has diminished and Puerto Rico’s ability to continue this practice indefinitely will depend upon the degree of interest in new debt from crossover investors, such as hedge funds.

We have expressed concern about the Commonwealth’s reliance on market access as far back as January 2012 when we opined that “the Commonwealth’s reliance on regular access to the capital markets constitutes the most pronounced credit risk for investors….” Traditional municipal bond investors are disinclined to regard their municipal bond investments as risk assets. As price volatility increases, the traditional investor base retreats, reinforcing “the degree to which Puerto Rico relies upon a concentrated investor base to cover annual operating deficits. When investor confidence wavers, the Commonwealth finds itself in uncharted territory.” In the last edition of our Puerto Rico Credit & Market Update (21 August 2014), we took a closer look at this issue.

Fig. 5: General fund budget deficit
In USD mn, fiscal years ended 30 June

Note: Based on preliminary, unaudited results for FY14
Source: Commonwealth of Puerto Rico, UBS CIO WMR, as of 10 December 2014
Citing data compiled by Fitch Ratings, we observed that traditional mutual fund ownership of Puerto Rico bonds had declined to about 30%, with most of that held by two fund managers. The rating agency reported that US municipal bond funds had reduced their Puerto Rico exposure by approximately 65% on average since May 2013. At the same time, ownership of Puerto Rico securities by hedge funds had increased to approximately 25% across the various credits on the island (see Fig. 6). Fitch’s data also shows that hedge fund ownership of some issuers, such as PREPA, PRASA, and HTA, is higher. The Commonwealth’s increased reliance on non-traditional investors that tend to have a shorter-term investment strategy heightens our level of concern.

Budget update
The FY15 budget was balanced without the sale of new bonds to finance the deficit but did rely on USD 344mn of capitalized interest borrowed in FYs 12 and 14, along with reductions to the planned contribution to the Employees Retirement System and the deferral of loan repayments to the Government Development Bank, among other measures. To the extent the Commonwealth is successful in selling new debt by PRIFA with proceeds going to the GDB, one can make a reasonably good argument that Puerto Rico has resorted once again to deficit financing.

Thus far into the fiscal year, the Commonwealth appears to be close to its budgeted forecast. It announced on 12 December 2014 that general fund revenues for the first five months are running only 1.1% below estimates. This is equal to an aggregate miss of USD 32.5mn. While general fund revenues are lagging budgeted estimates by a modest amount, the most significant months for collections are April and June, which represent 15% and 13% of the total, respectively. The economy has been struggling and does not engender much confidence that forecast tax collections will be achieved as the fiscal year progresses.

The Commonwealth also reported that expenses for the first quarter of FY15 (July – September), exclusive of the effect of subsidized public corporations such as the Health Insurance Administration, were 4% below expectations due to corrective measures. With that said, certain areas of cost pressure are evident. As of 30 October 2014, interest costs were higher than anticipated by an estimated USD 25-30mn, the Department of Education (DoE) had overspent by at least USD 32mn, and new health insurance contracts contributed to over USD 60mn of higher costs than originally planned. The Commonwealth has indicated that overspending by the DoE is expected to be addressed by tapping carry-forward surplus reserve balances from FYs 13 and 14.

PREPA
The Puerto Rico Electric Power Authority continues to operate under the terms of forbearance agreements executed with certain bond insurers, beneficial owners of power revenue bonds, commercial bank line of credit providers, and the GDB. These agreements expire on 31 March 2015 unless terminated earlier. In terms of more immediate deadlines, PREPA must deliver a five-year business plan by 15 December 2015 and a restructuring plan that is reasonably acceptable to forbearing creditors by 2 March 2015. The utility has over USD 8bn of power revenue bonds outstanding.
Although PREPA is expected to make the debt service payment due on 1 January 2015 from draws on its reserve account, it continues to suffer from acute liquidity challenges and significant capital needs. While the forbearance agreements increase the likelihood that the Authority will not default on its January 2015 debt service payment, the bias is in favor of a debt restructuring in the first half of calendar year 2015 that involves a material reduction in principal. While the forbearance agreements increase the likelihood that such a restructuring will occur on a negotiated basis, a court-ordered resolution via the Recovery Act remains a possibility.

Challenges ahead
Assuming the island succeeds in navigating its more immediate challenges, we believe that a multitude of variables could weaken the tenuous financial position of the Commonwealth over the longer term. The highly partisan political environment in Puerto Rico makes the challenge of addressing these issues even greater. As we noted in the past, reductions in operating expenditures “run the risk of further slowing the economy.”

Areas of concern include:

Weak economic and demographic trends
The challenge of sustaining a high and growing debt burden becomes all the more difficult against the backdrop of a contracting economy. Austerity measures, while arguably necessary from a budget perspective, have likely exacerbated the situation. The US Census Bureau reports that population across the island declined by 3% from 2010 to 2013 as more residents migrate to the mainland. This pattern is even more pronounced in the working-age segment. This leaves the Commonwealth with a smaller population more heavily weighted towards older residents that will have a greater need for health and other public services. As we discussed in January 2012, after aggressively cutting expenditures in the face of large deficits, “Puerto Rico now lacks a degree of financial flexibility and must rely more heavily on economic recovery to drive higher revenues.”

Asset depletion in pension plans
The Commonwealth contributes to three principal pension plans – the Employees Retirement System (ERS), the Teachers Retirement System (TRS), and the Judiciary Retirement System (JRS). As of 30 June 2013, the funded ratios of the ERS and TRS plans were 3.1% and 15.6%, respectively, while the funded ratio of the smaller JRS plan was 14.2%.

Reforms to the ERS enacted in 2013 provided for larger annual contributions by the Commonwealth and other participating employers beginning in FY14 in order to avoid the projected depletion of its assets. Unfortunately, the required contribution was not made in either FY14 or thus far in FY15. Net assets of the pension plan were on pace to be depleted by FY 2014 (with net assets defined as total assets less proceeds of pension bonds and other liabilities) in the absence of the reform package. And, while most state and local governments have been engaged in lowering the interest rate assumptions accompanying public pension plans in recent years, the 2013 valuation for the ERS assumed an increase in that metric from 6% per year to 6.4%. That change lowered the actuarially required contribution.

Turning to the Teachers Retirement System, reforms enacted by law in 2013 were largely struck down by the Puerto Rico Supreme Court. Without corrective measures, gross assets of the pension plan are
positioned to be exhausted by FY 2020. Upon asset exhaustion, annual pension contributions would need to be funded on a pay-as-you-go basis. The 2013 actuarial valuation for the Teachers’ plan was based on an interest rate assumption of 6.25% per year, in contrast to 5.95% in 2012.

While a spike in the number of individuals taking early retirement in the wake of these reforms may be a longer term positive for the pension plans, in the near-term it translates into higher recommended annual contributions by the Commonwealth and other employers on the island, which contributes to greater budgetary stress.

Possibly material deficit in the Commonwealth’s health insurance program

Puerto Rico provides health insurance coverage to about 1.6 million qualifying residents annually through its Health Insurance Administration (HIA). This costly program currently is being funded principally with non-recurring funds provided through the federal Affordable Care Act (ACA). In FY15, USD 1.03bn of non-recurring ACA federal funds supported approximately 39% of the HIA’s USD 2.647bn budget for the year. Non-recurring ACA funds are expected to expire in 2018. Unless renewed by the US Congress, the Commonwealth will have to make up the difference. Given that federal regulations may prohibit a reduction in coverage or a limitation on eligibility, the Commonwealth may be hard-pressed to identify and implement sufficient cost savings that would preclude a substantial increase in operating expenditures in this event.

The potential impact on Puerto Rico’s financial position is staggering. The HIA’s deficit could increase from USD 59mn in FY14 to over USD 2 billion by FY19 if the non-recurring funds are not renewed (see Fig. 7). To put this number into perspective, the Commonwealth’s peak general fund deficit in the past six years was in FY 2009 when it reached USD 2.864 billion. By FY 2014, that operating deficit had been reduced to USD 664 million. But even at that level, fiscal and economic pressure remains elevated.

Puerto Rico recently shifted its public health insurance model from a “third-party administrator” structure, where it was ultimately responsible for the cost of healthcare services provided, to a managed care organization (MCO) model where the HIA pays insurers a fixed premium for each insured beneficiary. The Commonwealth reports that the monthly premiums for members under the new contracts are 10% higher than what it had owed under the third party administrator model, an increase attributed to the expanded benefit coverage required by the ACA. The Commonwealth also cites the transition to the MCO model and increases in the cost of providing medical services. The budget forecast for FY15 incorporated a 5% increase.

Fig. 7: Puerto Rico Health Insurance Administration projected deficit

In USD mn

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Note: Assumes no Congressional renewal of ACA funds or other waiver of the Commonwealth’s Medicaid cap. Does not consider the effect of new health insurance contracts beyond FY15.

Source: Commonwealth of Puerto Rico, UBS CIO WMR, as of 10 December 2014

Premiums paid by the Commonwealth under the new contracts in FY15 have exceeded the budgeted amount by over USD 60mn which, when added to an originally estimated deficit for the HIA of USD 53mn, results in a gap of USD 115mn for the fiscal year. The projection of a potential deficit in excess of USD 2bn by FY19 does not take into account the effect of the MCO. The Commonwealth warns that the projected deficit could be materially higher as a result. 26
Department of Education spending
The Department of Education (DoE) represents 25% of the general fund budget and historically has experienced a high level of expenditure volatility. The Commonwealth attributes this in part to deficiencies in its own accounting, payroll and fiscal oversight information systems. Another factor has been a 20% increase in special education enrollment between FYs 12 and 14 as corrective measures are implemented in response to a legal judgment related to a class action complaint (the legal contingency associated with the pending individual claims on this matter is USD 650mn).

Meanwhile, student enrollment has declined and federal funding for some educational grants is provided on a per capita basis. It can be difficult to implement cost reductions at the same rate as federal aid is decreasing. The Commonwealth’s ability to keep its own budget in balance is largely tied to the ability of the DoE to do the same, given its proportional relevance. Budgetary reform of the DoE is now underway. Corrective measures discussed in the FY15 First Quarter Investor Webcast included reducing teacher headcount by an estimated 2,300, consolidating schools, and reducing transportation expenses.

Rising costs elsewhere
The Commonwealth’s borrowing costs have increased along with its deep rating downgrades. Capitalized interest mitigated the budgetary impact in FYs 14 and 15, but payments on total GO, guaranteed and appropriated debt are scheduled to increase by 43% from approximately USD 1.366bn in the current fiscal year to USD 1.95bn in FY16. Based on the number of advisors and consultants the Commonwealth has retained during this turbulent period, we also expect that its legal & advisory costs are now higher.

Expiration of the Fiscal Sustainability Act
The Fiscal Sustainability Act was enacted in June 2014 as a temporary fiscal emergency law authorizing measures which faced a high level of public opposition, such as freezing benefits under collective bargaining agreements and formula appropriations to the University of Puerto Rico, municipalities and other entities. The law sunsets at the end of FY17, at which time “cost escalators” are triggered unless the law is extended. Another possible area of concern is that the savings associated with the Fiscal Sustainability Act achieved to date could be overturned in court given that the law authorizes the modification of certain contractual rights that could be subject to legal challenge.

Against this backdrop, the Commonwealth is embarking upon an ambitious tax reform program. In addition, a special temporary excise tax imposed by Act 154-2010 that is levied upon only 27 taxpayer groups (of which six account for about 75% of collections) was responsible for over 20% of general fund revenue in FY14. It will be replaced with collection under the “modified source of income rule” referenced under the same Act beginning in 2018. There are no assurances that collections under this approach will be equivalent to those achieved through the special excise tax.
Practical considerations
The relationship between the Commonwealth and its various agencies and public corporations is complex. In an environment in which Puerto Rico is still seeking economic growth after seven years of relative inertia, the ability to generate new revenue is constrained. Higher taxes are recessionary in their impact but operating costs are rising and must be accommodated. The structural deficit persists, borrowing for operations is necessary, and the cost of capital is rising. All too often, Puerto Rico has resorted to restructuring its debt or reallocating responsibilities among various agencies. The decision to raise the petroleum tax rate and redirect some of the resulting revenue to PRIFA to repay debt originally incurred by HTA is just one example.

While general obligation bonds and bonds issued by the Puerto Rico Sales Tax Financing Corporation (COFINA) are better positioned than most credits on the island, credit risk is elevated for these securities as well. As we have cautioned in the past, "the risks of holding even these securities have become asymmetrical". While they may "conceivably exhibit some future improvement in price, there is a far greater risk that the bonds decline further in value."  

The Puerto Rico Constitution provides that public debt of the Commonwealth has a first claim over available resources and that the taxing power of the Commonwealth is pledged to repayment. Public policy considerations and procedural matters could delay or limit the judicial enforcement of the priority of payment provision. At the same time, the Puerto Rico Supreme Court has never ruled on whether bondholders have the right to compel the legislature to increase taxes since no debt service payments have ever been missed. There similarly is no basis for how a bondholder’s remedy to increase taxes could be enforced.

As the Commonwealth’s credit ratings deteriorated and its market access eroded, the legal protections it offered on new issues grew more accommodative in order to attract investor interest. For the USD 3.5 billion March 2014 general obligation bond offering, the legal venue for resolution of legal disputes is New York State and the Commonwealth also agreed to waive its sovereign immunity. Whether or not this makes some general obligation bonds more credit worthy than others is uncertain. Similar concerns may be raised regarding the short-term and privately-placed notes it has executed with various bank lenders. The same protections are contemplated for the proposed PRIFA bond issue.

Turning to COFINA, the determination that revenues dedicated to COFINA may not be "clawed back" for the payment of GO debt has been the foundation upon which higher ratings have been awarded over time. Any contrary ruling by a court of competent jurisdiction would diminish the appeal of the bonds (and particularly the subordinate lien bonds) substantially. Historically, the Puerto Rico Supreme Court has deferred to the Secretary of Justice and acts of the Puerto Rico legislature, particularly as it relates to the use of public funds.

The Court’s decision to overturn reforms enacted to the Teachers Retirement System marked a departure on this front that bears further consideration. While we have no reason to believe that COFINA’s bond security would not withstand judicial scrutiny, the implications of an adverse decision are serious. On any such reversal by the Puerto Rico Supreme Court, the appeal of COFINA bonds would diminish. Moreover, the Commonwealth has the option to modify or restructure the plan of reorganization without the necessity of court approval.

"A large borrowing program to bail-out the HTA does not appear to be a fiscally responsible solution."
– CIO WMR, Municipal Market Guide, 22 May 2013

"Competing spending priorities leave little room for discretionary purposes. Pension contributions and debt service pose an increasing burden, of course. But employee payroll...public safety; ... the government’s health insurance program for qualifying residents... and education costs all appear to be rising as well. We believe the ability to support targeted economic development/job creation initiatives will be challenging in light of the competing demands on a budget constrained by slow economic growth."
– CIO WMR, Municipal Market Guide, 22 May 2013

The Court’s decision to overturn reforms enacted to the Teachers Retirement System marked a departure on this front that bears further consideration.
Rico Supreme Court, COFINA bonds would be evaluated on parity with other obligations whose pledged revenues are subject to claw back. In that event, we would expect credit spreads to widen.

Other securities subject to claw back include HTA’s debt (excepting pledged toll revenue which is not subject to claw back), PRIFA rum tax bonds, and Puerto Rico Convention Center District Authority hotel occupancy tax bonds. Bonds subject to the claw back provision tend to be viewed on parity with obligations where the source of repayment is a Commonwealth pledge to appropriate. It is uncertain if exercising the claw back is even a remedy that ultimately would be available to bondholders. The Commonwealth recently stated that

"it is not certain what steps a … bondholder would be required to take or what proof such bondholder would be required to produce to compel the diversion of such funds from any such instrumentality to the payment of public debt, or how the necessary available Commonwealth resources would be thereafter allocated to each such instrumentality."

Providing essential services and assuring the safety of residents is a top priority of any government. The Commonwealth is no different. It has historically provided financial support to its public corporations tasked with the supply of water, power and other necessary goods in order to protect the health and safety of its citizens. Puerto Rico might choose to prioritize its obligations due to retirees under the public pension plans or to ensure the continuity of its healthcare and social services programs over its obligations to capital markets creditors in a worst case scenario. Unfortunately, for municipal bondholders, the practical precedents established by Detroit and Stockton are not encouraging. The outlook for the Government Development Bank under such a scenario is similarly uncertain.

Conclusion
We will continue to monitor the economic outlook for the Commonwealth, the outcome of legislative initiatives, and progress against budget targets in the months ahead. The market’s appetite for large bonds from the Puerto Rico Infrastructure Financing Authority and the Puerto Rico Aqueduct and Sewer Authority will be informative. As was the case with the general obligation bond sale in March, we expect that future bond sales will require substantial support from crossover investors in order to be successful. In the meantime, we advise conservative-minded investors to diversify their holdings and rebalance their municipal bond portfolios to minimize exposure to Puerto Rico credits.
End Notes

1 The Convention Center District Authority is also eligible to restructure its debt under the Recovery Act.

2 "We are concerned that the bank's ability to continue to provide liquidity to Puerto Rico's operating agencies may be jeopardized unless a reliable stream of revenue is identified for this purpose," CIO WMR, Municipal Market Guide, 22 May 2013.


5 ibid


8 ibid

9 According to the article dated 11 December 2014 referenced in The Puerto Rico Report, the amended bill altered this, removing the ATI's allocation and replacing it with USD 36mn of cigarette tax revenue from the Commonwealth’s general fund instead.

10 Joint Statement from the President and the Chairman of the Board of Directors of the Government Development Bank for Puerto Rico, 9 December 2014.


19 Office of the Secretary, Press Release, 11 December 2014.


22 ibid


Commonwealth of Puerto Rico, Financial Information and Operating Data Report, 30 October 2014. This meant that benefits were expected to be paid from the proceeds of pension bonds from FYs 14-19.


UBS CIO WMR, "Puerto Rico Credit & Market Update," 2 July 2014

See UBS CIO WMR, "Puerto Rico Credit & Market Update," 7 November 2013 for more information.

ibid

Examples of dedicated revenues subject to claw back include rum taxes, hotel occupancy taxes, fuel and petroleum products taxes, and employer contributions to the pension plan made after 30 January 2008 securing outstanding pension obligation bonds.

Commonwealth of Puerto Rico, Financial Information and Operating Data Report, 30 October 2014
Appendix

Statement of Risk

Although historical default rates are very low, all municipal bonds carry credit risk, with the degree of risk largely following the particular bond’s sector. Additionally, all municipal bonds feature valuation, return, and liquidity risk. Valuation tends to follow internal and external factors, including the level of interest rates, bond ratings, supply factors, and media reporting. These can be difficult or impossible to project accurately. Also, most municipal bonds are callable and/or subject to earlier than expected redemption, which can reduce an investor’s total return. Because of the large number of municipal issuers and credit structures, not all bonds can be easily or quickly sold on the open market.

Terms and Abbreviations

<table>
<thead>
<tr>
<th>Term / Abbreviation</th>
<th>Description / Definition</th>
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<tbody>
<tr>
<td>GO</td>
<td>General Obligation Bond</td>
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<tr>
<td>TEY</td>
<td>Taxable Equivalent Yield (tax free yield divided by 100 minus the marginal tax rate)</td>
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<th>Rating Agencies</th>
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