Puerto Rico Credit Conference:
The Road to Fiscal and Economic Reconstruction

FEBRUARY 20, 2009
Puerto Rico Government
Tackling the Fiscal Crisis
Puerto Rico Credit Conference 2009

Ms. María Sánchez Brás
Office of Management and Budget
Director

FEBRUARY 20, 2009
Puerto Rico Government
Tackling the fiscal crisis

- National Fiscal Crisis
  - What are we doing now? (1 – 6 months)
  - What are we doing for the future? (1 – 4 years)
- Government Management Accountability and Performance Program (GMAP)
National Fiscal Crisis

- Puerto Rico is one of the many jurisdictions confronting a budget gap.
- At least 46 states faced or are facing shortfalls in their budgets for this and/or next year.
- With the economy on a downslide, Puerto Rico is facing a budget gap of $3.2 billion or higher.

“I found this national debt, doubled, wrapped in a big bow waiting for me as I stepped into the Oval Office.”
Barack Obama
Puerto Rico Government
Tackling the fiscal crisis

• National Fiscal Crisis
• **What are we doing now? (1 – 6 months)**
• What are we doing for the future? (1 – 4 years)
• Government Management Accountability and Performance Program (GMAP)

“It’s time to control Government spending…we have the innate capacity to overcome adversity.”
Hon. Luis G. Fortuño Burset
What are we doing NOW?

• The Governor of Puerto Rico has submitted various Executive Orders to implement measures of austerity, fiscal control and expense reduction.

  • 10 % reduction in budget spending
    • Expected projected savings of $731 million in the next four years.

  • 30 % reduction of confidential / trust personnel (“confianza”)
    • A total of 877 positions have been eliminated.
    • Expected projected savings of $140 million in the next four years.

“Change will not come if we wait for some other person or some other time. We are the ones we've been waiting for. We are the change that we seek.”
Barack Obama
What are we doing NOW?

Other measures:

• Elimination of government credit cards

• Strict control over travel expenses

• Limitations to the following:
  • Cellular phones and PDA’s
  • Agency vehicles
  • Electric power usage

All of these measures are currently being implemented by every Agency and firmly monitored by OMB.

You cannot escape the responsibility of tomorrow by evading it today.

Abraham Lincoln
What are we doing NOW?

Outcome of these measures:

• $100 Million General Fund Estimated Budget Reserve for Fiscal Year 2009.

• End the exponential increase in government payroll

• Increase productivity – do more with less

• Leaner government

• Full Disclosure, Transparency and Accountability

“Prudence, Discipline and Transparency – this is OMB’s North”
M. Sánchez Brás
Puerto Rico Government Tackling the fiscal crisis

• National Fiscal Crisis
• What are we doing now? (1 – 6 months)
• What are we doing for the future? (1 – 4 years)
• Government Management Accountability and Performance Program (GMAP)

“We have accomplished many things on our first 45 days in office, yet we will continue to work towards the achievement of a Full Fiscal Reconstruction accompanied by an economic renewal…”

Hon. Luis G. Fortuño Burset
What are we doing for the future?

• Our path is clear.
• Our Administration has a thorough Economic Recovery Program.
• As it relates to OMB, we will be using proven strategies that are in line with our Administration’s Overall Program
  o Washington State’s Government Management Accountability and Performance Program (GMAP) follows our Government-wide vision

✓ 2008 Winner of Council of State Government’s Governance Transformation Award
Puerto Rico Government Tackling the fiscal crisis

- National Fiscal Crisis
- What are we doing now? (1 – 6 months)
- What are we doing for the future? (1 – 4 years)
- Government Management Accountability and Performance Program (GMAP)
GMAP - Management

- Establish a “Continuous Government Reform Agenda”
  - Recover citizen’s confidence in Government
  - Reduce Government’s size
  - Anticipate and prevent management and fiscal problems
- Create a Multi-Sector Committee for the measurement and evaluation of governmental performance
- Develop a precise and relevant results driven measurement system
- Reorganize and modernize the organizational structures of the agencies and departments to make them more flexible.
- Clarify and redefine their mission and their role with a set goal to eliminate redundancies and duplicities in the processes and functions.
GMAP - Management

Managing for Results Model

Governor’s Platform → Government - Wide Benchmarks

Agency Mission → Agency Strategic Measures

Programs → Program Outcomes

Activities → Inputs → Outputs → Outcomes

Source: Government Accounting Standards Board for Puerto Rico’s OMB – 1996
GMAP - Accountability

• Zero Based Budgeting FY 2010
  ✓ Review programs / activities with a “grass roots” approach
  ✓ Rank activities by priority and social impact
  ✓ Find synergies and efficiencies between programs as we merge activities

• Timeliness of Financial Information
  ✓ Budgets
  ✓ Forecasts
  ✓ Financial Statements

“One thing is sure. We have to do something. We have to do the best we know how at the moment... If it doesn't turn out right, we can modify it as we go along.”

F.D. Roosevelt
GMAP - Accountability

• Creation of the Office for Governmental Integrity and Efficiency

✓ The Office will respond to the OMB with independent and operational autonomy as an added value asset

✓ The Office will be a self-sustainable unit through the savings achieved

✓ Will coordinate and enhance the governmental efforts to promote integrity and efficiency in order to detect and deter fraud, illegal use or misuse of federal and state funds

✓ Identify and liberate funds that were previously wasted in unnecessary inefficient processes to reassign them to the fulfillment of the key priorities of our Government

✓ Evaluate the economic effects of the savings and resources recovered to help in the incorporation of such in future budgets
GMAP - Performance Measure

• Establish Statewide Results
  ✓ Follow our Economic Recovery Program
  ✓ Goals will be set in a four year plan
  ✓ Identify savings and efficiencies

• Establish – key indicators of success
• Measure – examine by performance
• Reassign – allocate future resources based on past and planned results
• Transparency – Inform our citizens
  ✓ OMB’s Website enhancement
It is very clear that what Puerto Rico needs is a Government that motivates but does not burden; …that leads rather than impose, …that listens but does not punish, …a [Government] that keeps its word.”

Hon. Luis G. Fortuño Burset

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Tax Compliance Program

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Mr. Juan Carlos Puig
Treasury Secretary

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FY 2009 Revenues

- The budget for FY 2009 included a proposed sale of a $1.0 bn of tax receivables, but market conditions have not allowed for the sale to materialize.

- The trend in revenues for 1H of FY2009 reveal a nominal drop of 5.2%

<table>
<thead>
<tr>
<th>Revenue Sources</th>
<th>Actual FY 2008</th>
<th>Budget FY 2009</th>
<th>$ Change</th>
<th>Jul-Dec FY 2008</th>
<th>Jul-Dec FY 2009</th>
<th>$ Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individuals</td>
<td>$2,793.0</td>
<td>$2,770.0</td>
<td>-$23.0</td>
<td>$1,269.5</td>
<td>$1,273.2</td>
<td>$3.7</td>
</tr>
<tr>
<td>Corporations</td>
<td>$1,566.0</td>
<td>$1,751.0</td>
<td>$185.0</td>
<td>$773.9</td>
<td>$687.4</td>
<td>-$86.5</td>
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<tr>
<td>Non-Resident Withholdings</td>
<td>$1,088.0</td>
<td>$1,015.0</td>
<td>-$73.0</td>
<td>$469.3</td>
<td>$422.8</td>
<td>-$46.5</td>
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<tr>
<td>GF Sales and Use Tax</td>
<td>$911.0</td>
<td>$977.0</td>
<td>$66.0</td>
<td>$397.0</td>
<td>$368.7</td>
<td>-$28.3</td>
</tr>
<tr>
<td>Alcoholic Beverages</td>
<td>$268.0</td>
<td>$292.0</td>
<td>$24.0</td>
<td>$129.4</td>
<td>$137.8</td>
<td>$8.4</td>
</tr>
<tr>
<td>Motor Vehicles</td>
<td>$366.0</td>
<td>$414.0</td>
<td>$48.0</td>
<td>$193.2</td>
<td>$176.7</td>
<td>-$16.5</td>
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<tr>
<td>Federal Excise Taxes on Rum</td>
<td>$362.0</td>
<td>$372.0</td>
<td>$10.0</td>
<td>$168.5</td>
<td>$207.3</td>
<td>$38.8</td>
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<tr>
<td>Other</td>
<td>$899.0</td>
<td>$897.0</td>
<td>-$2.0</td>
<td>$488.4</td>
<td>$414.1</td>
<td>$74.3</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>$8,253.0</strong></td>
<td><strong>$8,488.0</strong></td>
<td><strong>$235.0</strong></td>
<td><strong>$3,889.2</strong></td>
<td><strong>$3,688.0</strong></td>
<td><strong>-$201.2</strong></td>
</tr>
</tbody>
</table>
## Revised Revenue Forecast FY 2009

- General Fund revenues are expected to decline by 10.5%
- Sharp decline in corporate revenues mainly due to losses in local banks and slowdown in global sales of pharmaceutical products

<table>
<thead>
<tr>
<th>Revenue Sources</th>
<th>Initial Forecasts FY 09</th>
<th>Revised Forecasts FY 09</th>
<th>$ Change</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual</td>
<td>$2,770</td>
<td>$2,555</td>
<td>($215)</td>
<td>-7.8%</td>
</tr>
<tr>
<td>Corporation</td>
<td>$1,751</td>
<td>$1,432</td>
<td>($319)</td>
<td>-18.2%</td>
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<tr>
<td>Non-Resident Withholdings</td>
<td>$1,015</td>
<td>$879</td>
<td>($136)</td>
<td>-13.4%</td>
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<tr>
<td>Sales And Use Tax</td>
<td>$977</td>
<td>$911</td>
<td>($66)</td>
<td>-6.8%</td>
</tr>
<tr>
<td>Alcoholic Beverages</td>
<td>$292</td>
<td>$282</td>
<td>($10)</td>
<td>-3.4%</td>
</tr>
<tr>
<td>Motor Vehicles</td>
<td>$414</td>
<td>$339</td>
<td>($75)</td>
<td>-18.1%</td>
</tr>
<tr>
<td>Federal Excise Taxes on Rum</td>
<td>$372</td>
<td>$397</td>
<td>$25</td>
<td>6.7%</td>
</tr>
<tr>
<td>Other</td>
<td>$897</td>
<td>$805</td>
<td>($92)</td>
<td>-10.3%</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>$8,488</strong></td>
<td><strong>$7,600</strong></td>
<td><strong>($888)</strong></td>
<td><strong>-10.5%</strong></td>
</tr>
</tbody>
</table>

Revised Revenue Forecast FY 2009

- General Fund revenues are expected to decline by 10.5%
- Sharp decline in corporate revenues mainly due to losses in local banks and slowdown in global sales of pharmaceutical products
• At least 46 states faced or are facing shortfalls in their budgets for this year.
  – Average Mid year FY2009 budgets gaps 10.5%
    • California 15.9%, Illinois 14.8%, Alabama 12.7%, NC 9.3%

• The economy has deteriorated substantially since November, and states have revised their revenue estimate downward since then.
  – Revenue collection declines across a variety of types of taxes

• The there main organizations that track state fiscal conditions – the National Conference of State Legislatures, The National Association of State Budget Officers and the Center on Budget and Policy Priorities – have found large and growing shortfalls in the vast majority of states.

• Each of these surveys clearly indicates that states are facing a fiscal crisis of historic proportions that will continue for number of years.
Sales and Use Tax Collections

• Exemption of 4 1/2 days in Sep. 2008 - due to declaration of emergency
Compliance Program

Main Objective: Increase Revenues

Compliance
- Effective Tax Administration
- Broaden The Tax Base

Burden Reduction
- Facilitate the services to compliant taxpayers
Compliance Program (Cont.)

Change in Service’s Image

• Service Oriented organization
  – Reinforcement of taxpayers rights.
  – Increased Authority and Visibility of the Taxpayer’s Ombudsman.
  – Increased level of service to compliant taxpayers.
  – Tax Education to the taxpaying Community
Compliance Program (Cont.)
Hacienda’s obligation with Compliant Taxpayers

• Facilitate the compliance with the tax laws is one of Hacienda’s main responsibilities with the taxpaying community.

• Hacienda will reinforce their commitment with the honest and law-abiding citizens who meet their obligation on a timely and accurate fashion.
Compliance Program (Cont.)

Window of Opportunity

• Cases in Process (Non criminal)
  – Establish settlement procedures to bring unresolved cases in Appeals, to a closure.

• Allow taxpayers the opportunity to come forward and get in full compliance.
  – Consider non assertion of discretionary penalties.
Compliance Program (Cont.)

Initiatives

• Voluntary Disclosure Program
• Closing Agreements as an alternative to solve cases
• Offer In Compromise Program
• Streamlined lien filing procedures
• Delinquent taxpayers to be reported to the Credit Reporting Agencies
Compliance Program (cont.)

Initiatives

• Use of artificial intelligence to identify high yield cases
  – Use technology to improve quality service and compliance efforts
  – Information matching to identify non-compliant taxpayers

• Improved coordination with Federal and Local Agencies
  • Exchange of information agreements
  • Law Enforcement Task Forces

• Expedited collection procedures on audit assessments
• Initiatives to improve "IVU" collections
  – Unannounced visits to business taxpayers to ensure full compliance
  – New legislation
  – Use of technology to record transactions
  – Lottery system to attract customers to ask for receipts
Compliance Program (Cont.)

Call Center

- Compliance Call Center
  - Provide assistance to compliant taxpayers
  - Increased collection activity
    - Follow up on collection actions
      - Systemic notices
      - Installment agreements
        » Promote Payroll deductions and ACH procedures
      - Levies against third parties (salaries and banks)
      - Lien filing
    - Follow up to non-compliant taxpayers
Compliance Program (cont.)

- Emphasis on withheld taxes
- Ensure criminal prosecution against tax evaders, including withholding agents, non filers, and under reporters
- Ease on payment agreement procedures
- Targeted audits
Staff Projections

- Resources Redistribution
- Increased Staff
  - 100 Auditors
  - 200 Collection Officers
  - 40 Special Agents
- Administrative Reorganization Internal Revenue Area oriented to collection
## COMPLIANCE ECONOMIC PLAN

### CHART OF IMPLEMENTATION

<table>
<thead>
<tr>
<th>Compliance Initiative</th>
<th>Jan</th>
<th>Feb</th>
<th>Mar</th>
<th>Apr</th>
<th>May</th>
<th>Jun</th>
<th>Jul</th>
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<tr>
<td>Employment Tax (Audit)</td>
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<tr>
<td>Employment Tax (Collection)</td>
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<tr>
<td>Reduce Burden (Payment Plans)</td>
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<tr>
<td>Reduce Burden (Offer in Compromise)</td>
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<tr>
<td>Reduce Burden (Closing Agreement)</td>
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<tr>
<td>Reduce Burden (Voluntary Disclosure)</td>
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<tr>
<td>Enforced Collection</td>
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<tr>
<td>Revenue Increase The Sales &amp; Use Tax</td>
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<tr>
<td>Sales &amp; Use Tax Compliance</td>
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<td>9</td>
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<tr>
<td>Sales &amp; Use Tax &amp; PRITAS Systems Integration</td>
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<tr>
<td>Targeted Audits</td>
<td></td>
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<tr>
<td>Tax Evasion Project</td>
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<td>Correspondence Audits</td>
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<td>Tax Intelligence &amp; Equity Project (PIT)</td>
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<tr>
<td>Military Store Sales &amp; Use Tax Implementation</td>
<td></td>
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<td></td>
<td>15</td>
<td></td>
</tr>
</tbody>
</table>
Tax Compliance Program

Puerto Rico Credit Conference 2009

Mr. Juan Carlos Puig
Treasury Secretary

FEBRUARY 20, 2009
Credit Challenges:
Safeguarding Puerto Rico’s Investment Grade Ratings

Mr. Dennis Farrell

FEBRUARY 20, 2009
Rating Agency Panel

**Dennis Farrell**
Executive Director, Morgan Stanley, Ratings Specialist, Panel Moderator

**Horacio Aldrete**
Director, Public Finance Ratings, Standard & Poor’s

**Robert Kurtter**
Managing Director, State and Regional Ratings, Moody’s Investors Service
A “One-Notch” Rating Downgrade Would Limit Market Access on the GO Credit

Commonwealth GO Ratings and Outlook Changes

Minimum Investment Grade Rating
The Loss of Investment Grade Ratings Could Result In Loss of Control Over Financial Affairs

Overview of Selected Financial Control Boards

<table>
<thead>
<tr>
<th>Control Board: New York State Municipal Assistance Corporation</th>
<th>District of Columbia Financial Responsibility and Management Assistance Authority</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issuer: City of New York</td>
<td>Washington, D.C.</td>
</tr>
<tr>
<td>Oversight Entity: State of New York</td>
<td>Federal Government</td>
</tr>
<tr>
<td>Board: Nine Directors appointed by the Governor; four of the nine recommended by Mayor; No State or City employees</td>
<td>Five members appointed by President of the United States</td>
</tr>
</tbody>
</table>

Key Powers:

- Levy 4% sales and stock transfer tax in City in place of City taxes
- **Control Board approves contracts (including debt issues and collective bargaining) and four-year financial plans during Control Period**
- Control Board reviews compliance with financial plan quarterly
- Issue bonds until 1980 with max term of 15 years
- Purchase short-term bonds of the City to fund the repayment of maturing short-term bonds
- Purchase short-term bonds of the City to fund intra-year cash needs and a capped amount of deficit

- Review 4-year financial plan; if recommendations not incorporated, submit own plan to Congress
- **Review contracts and leases, including collective bargaining agreements**
- Direct access to records; power of subpoena
- **If District fails to implement recommendations, ability to take actions directly in consultation with Congress**
- Approve appointment of CFO and Inspector General
- Approve long and short-term borrowings

Source of Aid:

- Bonds sold by MAC and repaid with sales tax and stock transfer tax (in place of prior City taxes)

- None; Limited ability to take cash advances against next year’s Federal payment if no access to public credit markets; 1997 Act revised Federal funding formula, providing a modest benefit of 1.1% growing to 4% of expenses in year four
# Regaining Financial Control and Investment

## Grade Ratings Required Difficult Decisions for New York City and Washington, D.C.

### Major Initiatives to Balance Budget

<table>
<thead>
<tr>
<th>Control Board:</th>
<th>New York State Municipal Assistance Corporation</th>
<th>District of Columbia Financial Responsibility and Management Assistance Authority</th>
</tr>
</thead>
<tbody>
<tr>
<td>City G.O. Ratings at Inception:</td>
<td>Caa (Moody's)</td>
<td>Ba / B / BB (M / S / F)</td>
</tr>
</tbody>
</table>
| Significant Initiatives in First Multi-Year Financial Plan: | • 25,000 layoffs and wage freeze for all employees  
• Cap expenditures at current levels for three years  
• No tax increases due to high tax burden  
• **42% mass transit fare increase**  
• Eliminate operating expenses improperly included in capital budget over time  
• **Require City to balance GAAP rather than cash budget** | • Layoffs (4.2%)  
• Management initiatives (1.7%)  
• Update financial and management systems  
• Implement pilot performance programs  
• **Prioritize capital projects, which are limited by available funds**  
• Cashflow estimates added to Budget |
| Fiscal Years Until Balanced Budget | 7 years (GAAP)  
FY1976 to FY1983 | 2 years  
(FY1995 to FY1997) |
| Time Until Regained Investment Grade Rating | ~ 8 years  
(October 1975 to November 1983) | ~ 4 years  
(February 1995 to June 1999) |
| Termination of Oversight: | Financial Control Board Permanent; Control Period ended in 1986 after three GAAP balanced budgets; Control Period can be reinstated if deficit exceeds $100 million in any fiscal year | After (i) District has access to credit markets at reasonable rates; and (ii) four consecutive balanced budgets according to GAAP; can be reinstated (September 2001) |
State and Local Government Ratings

Puerto Rico Credit Conference
February 19-20, 2009

Horacio Aldrete, Director
214 871 1426
horacio_alderete@sandp.com
Investment Grade Ratings

AAA
• An obligation rated 'AAA' has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.

AA
• An obligation rated 'AA' differs from the highest-rated obligations only to a small degree. The obligor's capacity to meet its financial commitment on the obligation is very strong.

A
• An obligation rated 'A' is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher-rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still strong.

BBB
• An obligation rated 'BBB' exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.

Plus (+) or minus (-)
The ratings from 'AA' to 'CCC' may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the major rating categories.
Municipal Ratings on a Global Scale

• Credit ratings facilitate the process of issuing and purchasing bonds and other debt issues by providing an efficient, widely recognized, and long-standing measure of credit risk. Investors and other market participants can use the ratings as a screening device to match the relative credit risk of an issuer or individual debt issue with their own risk tolerance or credit risk guidelines in making investment and business decisions.

• The global credit markets benefit from standards and benchmarks that are understood by all, *which is why we use the same scale across all sectors.*
Puerto Rico GO Credit Rating History

‘A’ to ‘A-’  May 2002

‘A-’ to ‘BBB’  May 2005

‘BBB’ to ‘BBB-’  May 2007
S&P’s Rationale for 2007 Rating Action

The Commonwealth’s GO rating was lowered to ‘BBB-’ based on our opinion of the Commonwealth’s:

• **Long history of structural imbalance** and the ongoing difficulties anticipated with further efforts to reduce the accrued deficit;

• Standard & Poor's noted that Puerto Rico's debt, which is already high, is likely to increase. Although a major new revenue source--a 5.5% sales tax--was added in the current fiscal year, balance remains difficult to achieve, requiring expense cuts and use of onetime revenue sources. Gap forecasts suggest that balance will not be achieved until 2010 and those forecasts are based on the expectation of flat expense growth, which Standard & Poor's believes will be difficult to achieve. **It appears that** despite the efforts taken to date, accrued structural imbalance will persist. In addition, Puerto Rico's economy is struggling, with unemployment at 10.1% and a projected decline of 1.4% in gross national product (GNP) in 2007.
Credit Implications of Current Deficit

In our opinion, there are four main factors that we will continue to consider in our assessment of the stability of the Commonwealth’s GO credit rating in the near term:

• Fiscal and Budget Measures to Narrow the Gap

• The Government Development Bank Provides an Element of Stability

• Continued Market Access

• The Economic Recession will Continue to Pressure Revenues
Fiscal and Budget Measures to Narrow the Gap

- $3.2 billion projected deficit for fiscal 2009 (nearly 38% of budget) is significantly higher than originally budgeted.

- Commonwealth officials project a growing deficit unless measures to contain expenditures and increase revenues are implemented.

- Standard & Poor’s believes 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.
GDB Provides An Element of Stability

• The Commonwealth will need to rely, at least temporarily, on increased support from GDB to fund the budget gap

• The stabilizing effect of GDB on the Commonwealth’s credit rating has its limitations. Pressure on the Commonwealth’s GO rating will increase if:
  – Reliance on GDB increases significantly
  – The Commonwealth does not implement measures in the near term to reduce the structural deficit
  – Reliance on GDB becomes a long-term and growing source of deficit financing for the Commonwealth
Continued Market Access

• In our opinion, Puerto Rico (and its agencies and instrumentalities, including GDB) will continue to rely on market access to fund its cash-flow needs to cover the deficit. 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.

• Constitutional provisions that give priority payments to the Commonwealth’s GO debt service support the current GO rating
Economic Recession

• The economic recession will continue to pressure revenues

• Puerto Rico has been in an economic recession for nearly three years

• The Puerto Rico Planning Board projects that the economy will contract by 3.4% in fiscal 2009, and 2.0% in fiscal 2010

• A deepening of the recession has the potential to widen the deficit and mitigate the impact of the Commonwealth’s revenue and expenditure measures to address the deficit
Contents

- Overview
- Puerto Rico Economy
- Puerto Rico Finances
- Recent Achievements
- Challenges Ahead
- Rating Considerations
- Conclusion
Overview
Overview

- Commonwealth still in recession
- National recession makes Commonwealth recovery more difficult
- Commonwealth faces significant challenges in coming years
- Some important achievements have already been made
- More difficult decisions need to be made to move toward economic stability and structural balance
- Ratings will reflect challenges and solutions
Puerto Rico Economy
Puerto Rico Economy

- Puerto Rico downturn started earlier than U.S. downturn
- Puerto Rico downturn expected to be deeper and longer than U.S. downturn

Source: Moody's Economy.com
Puerto Rico Economy

- Puerto Rico’s unemployment rate is almost 12%
  - Tends to be about 6 percentage points higher than the U.S. unemployment rate
Puerto Rico Economy

- Like the nation, Puerto Rico is expected to see employment declines continue until 2010

Source: Moody’s Economy.com

Moody’s Investors Service
Puerto Rico Economy

- Per capita personal income is $13,500, one-third of the U.S. average
  - Mississippi, the poorest state, has a per capita personal income of $28,500
Puerto Rico Economy

- Tourism is down in Puerto Rico
  - Continued national and global downturn will affect tourism, sales taxes, etc.
Puerto Rico Finances
Puerto Rico Finances

- Financial position is very weak

Unreserved, Undesignated Fund Balance

Fiscal Year

$000s, GAAP-basis
Puerto Rico Finances

- Debt has been increasing

Puerto Rico Net Tax-Supported Debt

* Estimate

Moody’s Investors Service
Puerto Rico Finances

- Revenues so far this year are down 5% on a year-over-year basis compared to last year
- Almost every category is down in both tax revenues and non-tax revenues

Puerto Rico Revenue Collections

<table>
<thead>
<tr>
<th>Fiscal Year to Date</th>
<th>July-Dec 2007</th>
<th>July-Dec 2008</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Revenues</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Personal Income Taxes</td>
<td>1,269,525</td>
<td>1,273,224</td>
<td>0.3%</td>
</tr>
<tr>
<td>Corporate Income Taxes</td>
<td>773,931</td>
<td>687,380</td>
<td>-11.2%</td>
</tr>
<tr>
<td>Sales and Use Tax</td>
<td>396,996</td>
<td>368,736</td>
<td>-7.1%</td>
</tr>
<tr>
<td>Non-Tax Revenues</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Traditional Lottery</td>
<td>20,605</td>
<td>11,358</td>
<td>-44.9%</td>
</tr>
<tr>
<td>Electronic Lottery</td>
<td>68,132</td>
<td>41,911</td>
<td>-38.5%</td>
</tr>
<tr>
<td>General Fund Revenues, Total</td>
<td>3,889,185</td>
<td>3,688,017</td>
<td>-5.2%</td>
</tr>
</tbody>
</table>
Puerto Rico Finances

- Sales tax revenues have performed relatively well

PR Sales Tax Collections

Moody's Investors Service
Recent Achievements
Recent Achievements

Recent achievements include:

- Revision of revenue and spending estimates
- Declaration of fiscal emergency
- Speedy passage of legislation
  - Allowing deficit borrowing
  - Pledging additional 1% of sales tax to allow more revenue bonds
- Restructuring of PRIFA corpus account
- Local stimulus package
Challenges Ahead
Challenges Ahead

- **Economy**
  - Commonwealth government employment has been reduced, but still represents a disproportionately large sector of employment
  - Local and federal stimulus money may help
  - Can local economy rebound if national economy is still struggling?
Challenges Ahead

- **Financial stability**
  - Continued use of deficit borrowing demonstrates chronic fiscal weakness
  - Expenditure control necessary

- **Bond Market**
  - Limited market access presents challenges
  - Option to access local market
Rating Considerations

Rating considerations going forward will include:

- Revenue performance
- Liquidity position
- Spending pressures
- Deficit financings

Offsetting these risks are:

- Federal fiscal stimulus
- Management response
Rating Considerations

- Federal stimulus aid to Puerto Rico
  - Puerto Rico has the option of a 30% increase in their cap or a 6.2 percentage point increase in their FMAP plus a 15% increase in their cap
  - Puerto Rico will get more than $255 million in additional infrastructure investment funding
  - Stabilization aid of several hundred million dollars
## Rating Considerations

- Rating considerations will include the following:

<table>
<thead>
<tr>
<th></th>
<th>Stronger</th>
<th>Weaker</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Liquidity</strong></td>
<td>Smaller cash flow borrowing</td>
<td>Larger cash-flow borrowing</td>
</tr>
<tr>
<td></td>
<td>Improved cash position</td>
<td>Severely constrained liquidity</td>
</tr>
<tr>
<td><strong>Economy</strong></td>
<td>Economy shows signs of recovery</td>
<td>Recession continues</td>
</tr>
<tr>
<td><strong>Financial</strong></td>
<td>Less deficit borrowing</td>
<td>More reliance on deficit borrowing</td>
</tr>
<tr>
<td></td>
<td>Restrained spending</td>
<td>Spending growth</td>
</tr>
<tr>
<td></td>
<td>Structural balance achieved within three years</td>
<td>Structural balance not achieved</td>
</tr>
</tbody>
</table>
# Rating Considerations

## Puerto Rico ratings

<table>
<thead>
<tr>
<th>Category</th>
<th>Moody's Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Obligation Bonds</td>
<td>Baa3/S</td>
</tr>
<tr>
<td>Appropriation Bonds</td>
<td>Ba1/S</td>
</tr>
<tr>
<td>Hotel Occupancy Tax Revenue Bonds</td>
<td>Baa3/S</td>
</tr>
<tr>
<td>PRIFA Special Tax Revenue Bonds</td>
<td>Baa3/S</td>
</tr>
<tr>
<td>Pension Funding Bonds</td>
<td>Baa3/S</td>
</tr>
<tr>
<td>PRASA Commonwealth Guaranteed</td>
<td>Baa3/S</td>
</tr>
<tr>
<td>PR MFA bonds</td>
<td>Baa3/S</td>
</tr>
<tr>
<td>PRHTA Transportation Revenue Bonds</td>
<td>Baa3/S</td>
</tr>
<tr>
<td>PRHTA Highway Revenue Bonds</td>
<td>Baa2/S</td>
</tr>
<tr>
<td>Sales Tax Revenue Bonds</td>
<td>A1/S</td>
</tr>
<tr>
<td>Conservation Trust Fund Secured Notes</td>
<td>B2/S</td>
</tr>
</tbody>
</table>
Rating Considerations

- Ratings that “pierce” the G.O.
  - Sales tax revenue bonds (A1)
  - PREPA revenue bonds (A3)
  - Highway Revenue Bonds (Baa2)

- Conditions required to “pierce the G.O. ceiling”
  - Economic strength of entity is overpowered by other factors in the G.O. rating
  - Separation from host government
Conclusion
Conclusion

- The economic environment of the current and next fiscal year will present significant challenges to the Commonwealth.

- In order to strengthen its credit, Puerto Rico will need to:
  - move toward structural balance by implementing solutions are recurring, rather than one-time
  - and reduce or eliminate deficit borrowing

- Federal stimulus aid will be a positive factor.
Credit Challenges: Safeguarding PR’s Investment Credit Rating

Rating Agencies Panel

FEBRUARY 20, 2009
Financial Measures and Reconstruction Plan

Mr. Carlos M. García

Chairman and President
Government Development Bank

FEBRUARY 20, 2009
<table>
<thead>
<tr>
<th></th>
<th>Section</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Assessment of Fiscal Situation</td>
</tr>
<tr>
<td>2</td>
<td>Financial Measures</td>
</tr>
<tr>
<td>3</td>
<td>Reconstruction Plan Blueprint</td>
</tr>
</tbody>
</table>
Economic Outlook

A prolonged recession continues to profoundly affect all economic activity in Puerto Rico.

Annual Growth in Real Puerto Rico GNP (fiscal years)

<table>
<thead>
<tr>
<th>Year</th>
<th>Official Base Case Forecasts</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>2.1%</td>
</tr>
<tr>
<td>2004</td>
<td>2.7%</td>
</tr>
<tr>
<td>2005</td>
<td>1.9%</td>
</tr>
<tr>
<td>2006</td>
<td>0.5%</td>
</tr>
<tr>
<td>2007r</td>
<td>-1.9%</td>
</tr>
<tr>
<td>2008r</td>
<td>-2.5%</td>
</tr>
<tr>
<td>2009 E*</td>
<td>-3.4%</td>
</tr>
<tr>
<td>2010 E*</td>
<td>-2.0%</td>
</tr>
</tbody>
</table>

Source: Puerto Rico Planning Board. Puerto Rico fiscal years consist of the twelve month period ending on June 30 of every year.

Fiscal shortcomings:

1. Continuous over-estimations of tax revenues provided the “basis” for not reducing expenses
   - Increases in deficit every year…

2. Consequences of decisions were postponed by taking short-term solutions
   - No long-term strategic solutions

3. A Government that grows despite overall economic contraction
Frequent over-estimation contributed to recurrent deficits

- Over-optimistic forecasts of the local economy led to unrealistic growth projections in tax revenues

Comparison of 2-Yr. Projections and Actual GNP (% Growth)

Source: Puerto Rico Planning Board. Puerto Rico fiscal years consist of the twelve month period ending on June 30 of every year.

* E = Estimates. Estimates correspond to the Base Case Scenarios.
Tax revenues were consistently over-estimated throughout the last four fiscal years

$3,765 million over-estimation

Source: Puerto Rico Budgets, Office of Management and Budget and PR Treasury Dept.
Tax revenue over-estimations have resulted in over-budgeting

$3,293 million from 2005 to 2008

$1,888 million* in 2009

Source: Puerto Rico Budgets, Office of Management and Budget and PR Treasury Dept.

* FY 2009 proposed budget included the sale of $1.0 billion of accounts receivables from the Treasury Department. Adverse market conditions have not allowed for the sale of such account payables portfolio.
Government payroll has grown at an accelerated rate

- Government payroll expenses have increased at an average annual rate of 6% for the last 10 fiscal years versus revenues at 1%
- Payroll expenses increased 10% annually between 2000 and 2005

An increase of $2.3 billion or 6% annually in the last 10 years

STATE OF FISCAL EMERGENCY: has resulted from the structural imbalance between revenues and expenses

The General Fund since FY 2000
(ingresos y gastos recurrentes)

Recurrent Revenues
Recurrent Expenses

Deficit $3,400

One-time transactions were frequent and postponed the consequences of the dealing with the deficit

$M = \text{million}$

<table>
<thead>
<tr>
<th>2005 (F05)</th>
<th>2006 (F06)</th>
<th>2007 (F07)</th>
<th>2008 (F08)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue Forwards</strong> $83 M</td>
<td><strong>Basis Swap</strong> $100 M</td>
<td><strong>Savings from Health Reform</strong> $107 M</td>
<td><strong>Taxes Receivables</strong> $60 M</td>
</tr>
<tr>
<td><strong>PRIFA Bonds</strong> (Rum Taxes) $317 M</td>
<td><strong>Refinance of extra-constitutional debt</strong> $368 M</td>
<td><strong>SUT revenues</strong> $137 M</td>
<td><strong>Real estate sales</strong> $150 M</td>
</tr>
<tr>
<td><strong>Tobacco Bonds</strong> $317 M</td>
<td><strong>Cash Flow Transaction</strong> $150 M</td>
<td><strong>Cash Flow Transaction</strong> $100 M</td>
<td><strong>General Obligations Refinancing</strong> $207 M</td>
</tr>
<tr>
<td><strong>GDB Loans</strong> $550 M</td>
<td><strong>GDB Loan with the SUT as re-payment source</strong> $741 M</td>
<td><strong>Loan from FSE</strong> $180 M</td>
<td><strong>Cash Flow Transactions</strong> $100 M</td>
</tr>
<tr>
<td><strong>Retained Earnings AFICA</strong> $30 M</td>
<td></td>
<td><strong>Relief from debt service on extra-constitutional debt</strong> $522 M</td>
<td><strong>Tobacco Bonds</strong> $175 M</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td><strong>Reimbursement Federal Funds Cash Flow</strong> $287 M</td>
</tr>
</tbody>
</table>

Source: Fiscal and Economic Reconstruction Advisory Board Report, Jan-08-09.
## Index

1. Assessment of Fiscal Situation
2. Financial Measures
3. Reconstruction Plan Blueprint
Financial Measures

In January 2009, the Legislature approved four measures that stabilized the fiscal situation and provided time for the implementation of fiscal and economic stimulus measures.

Summary of Measures

1. Increase in the assignment to COFINA*

2. Optimization of the Corpus Account in the Infrastructure Development Fund of PRIFA**

3. Amendment to the Fiscal Reform Act of 2006 allows for deficit financing through FY 2011 until fiscal measures are implemented and Government finances are stabilized

4. Amendment to Act 164 of 2001 increases from $100 million to $200 million GDB loans to the Central Government to be repaid from future legislative appropriations

* Corporación del Fondo de Interés Apremiante.
** *PRIFA = Puerto Rico Infrastructure Financing Authority.
Increase in the assignment to COFINA

**Act 1 of 2009:**

- Act 1 of 2009, increases to 2% the assignment to COFINA*. The assignment to COFINA comes from the Sales & Use Tax (SUT).

**Benefits of this Financial Measure:**

- Increases the capacity to issue bonds up to $4 billion*.
- Over 50% of this bond issue will be used to provide a re-payment source to existing debt and will not increase public debt outstanding.
- Allowable uses:
  1. Cover operational expenses between F2009-F2012
  2. Cover certain debts with no repayment source granted by GDB to the Government and pay account payables to suppliers
  3. Provide funds for the Economic Stimulus Fund (at GDB) and the Emergency Fund (if necessary).

* Estimate based on current market conditions and subject to changes and market fluctuations.
Other Benefits of COFINA Act Amendments

- COFINA Act amendments also protect GO bondholders:
  - Total COFINA Base Rents will not exceed $1.85 billion, limiting the amount of debt that can be issued and protecting GO bondholders.

- The Act provides for the substitution of the SUT **ONLY** if the substitute revenue stream is equivalent or greater to the debt service and coverage requirements of the outstanding bonds.
Increase in the assignment to COFINA


a. Pledges an additional 1% of the SUT to the Dedicated Sales Tax Fund (2% in total)
b. Enhances access to the bond market through a “single-A” credit
c. Existing COFINA bonds will not be affected by new COFINA bonds

How does it works?

<table>
<thead>
<tr>
<th>SUT*</th>
</tr>
</thead>
<tbody>
<tr>
<td>7% Revenue</td>
</tr>
</tbody>
</table>

- 5.5% Other Revenue
- 1.5% Municipalities

Structure Previous to Act 1 2009

- COFINA (BGF)
  - 1.0% or Basic Amount
- General Fund
  - 4.5% of revenue

Approved change Act 1 of 2009

- 2% of assignment in lieu of 1%
- 3.5% assignment in lieu of 4.5%

It allows for the issuance of bonds to stabilize the fiscal situation and support economic stimulus.

The SUT is a resilient revenue source separate from the Commonwealth’s finances

- Over two years of strong performance in spite of recessionary environment. SUT is an “island of stability”
- The gross revenues of the SUT for the first 6-months of FY 2009 remain in line with the historical average monthly revenues
- Excluding the effect of the “Rainy Tax-Holiday” the monthly average collection would have been $96 million

Source: Puerto Rico Treasury Department.
* Gross without excluding the assignment to COFINA.
The SUT is a resilient revenue source

- The SUT is a highly diversified revenue source that covers over 20 economic sectors islandwide

Source: Puerto Rico Treasury Department, (Revenues collection by NAICS).
* Gross without excluding the assignment to COFINA.
Governor Fortuño’s Administration commitment to the SUT

• SUT is a key revenue source **THAT WILL NOT BE REDUCED OR ELIMINATED.**

• Enhancement of collection and enforcement of SUT will further strengthen revenue stream
COFINA Comparison

- COFINA I has a stronger coverage than comparable programs

<table>
<thead>
<tr>
<th>Pgm.</th>
<th>Coverage</th>
<th>Rating</th>
<th>ABT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Massachusetts Bay TA Sales Tax Bonds</td>
<td>2.0x</td>
<td>Aa2 / AAA</td>
<td>No ABT</td>
</tr>
<tr>
<td>Massachusetts School Building Authority Bonds</td>
<td>2.0x</td>
<td>Aa2 / AA / AA</td>
<td>1.4x</td>
</tr>
<tr>
<td>California Economic Recovery Bonds</td>
<td>1.1x</td>
<td>A1 / A+ / A+</td>
<td>1.5x</td>
</tr>
<tr>
<td>Nassau County Interim Finance Authority Sales Tax Secured Bonds</td>
<td>4.5x</td>
<td>Aa2 / AAA</td>
<td>3.0x</td>
</tr>
<tr>
<td>Jacksonville, FL Better Jacksonville Sales Tax Bonds</td>
<td>1.45x</td>
<td>Aa3 / A A-</td>
<td>1.35x</td>
</tr>
<tr>
<td><strong>COFINA I</strong></td>
<td><strong>5.5x</strong></td>
<td><strong>A+</strong></td>
<td><strong>3.0x</strong></td>
</tr>
</tbody>
</table>
## COFINA II - A Strong Credit

<table>
<thead>
<tr>
<th>Deal Component</th>
<th>Comments*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preliminary Deal Size</td>
<td>$4,000,000,000</td>
</tr>
<tr>
<td>Team selection</td>
<td>To be finalized next week</td>
</tr>
<tr>
<td>Timing of initial financing</td>
<td>To be determined based on market conditions</td>
</tr>
<tr>
<td>Structuring alternatives</td>
<td>Currently under review</td>
</tr>
<tr>
<td>Market access</td>
<td>103 &amp; Local</td>
</tr>
</tbody>
</table>

* Subject to change.
## COFINA II Proposed Uses of Funds

<table>
<thead>
<tr>
<th>Use</th>
<th>Amount*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Expenses and Repayment of GDB Loans</td>
<td>$2.75 billion</td>
</tr>
<tr>
<td>Economic Stimulus Plan</td>
<td>$0.50 billion</td>
</tr>
<tr>
<td>Payment of supplier debts</td>
<td>$0.75 billion</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$4.00 billion</strong></td>
</tr>
</tbody>
</table>

* Preliminary, subject to change.
1. Assessment of Fiscal Situation

2. Financial Measures

3. Reconstruction Plan Blueprint
Framework of the Reconstruction Plan

Economic Reconstruction

1. Federal and Local Stimulus Packages
2. Public-Private Partnerships (PPPs)
3. GDB Supplemental Stimulus
4. Diversification of economy and Biosciences focus

Fiscal Reconstruction

1. Expense Reduction and Government Efficiency
2. Increase Tax Compliance
3. Revenue Measures
4. Temporary Financial Measures

Gross National Product ($)

STRATEGIC PROJECTS

TAX REFORM
A Balanced Reconstruction Plan

**Economic Impact**

- Recessive Effects
  - Expense Reduction Measures
  - Revenue Increase Measures
- Growth Effects
  - Infrastructure Investment
  - Federal Transfers
  - Government Spending
  - Entrepreneurship Investment

**Fiscal Impact**

- Regressive Effects
- Progressive Effects
  - Transfers to Individuals
  - Income Tax Measures
  - Wealth Tax Measures

**GDB Supplemental Stimulus**
Economic Reconstruction

11% of GNP in Total Stimulus

PHASE Ia
$5.0 Federal Stimulus
- Capital Imp. $0.9
- Tax Relief $1.3
- Aid Relief $1.9
- Budgetary Relief, $0.8

PHASE Ib
$0.5 Local Stimulus
- Aid Relief
- Capital Imp.

PHASE II
$1.0-$1.5 Supplemental Stimulus
- Capital Improvements

Public-Private Partnerships

($ billions)

Jun-09 → Dec-10 → 2011

≈ $6.5-$7.0 BN

104
<table>
<thead>
<tr>
<th>Objective</th>
<th>Target date</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Stabilization Period</td>
<td>2009-2010</td>
</tr>
<tr>
<td>2 Restore Economic Growth</td>
<td>2011</td>
</tr>
<tr>
<td>3 Balanced Budget</td>
<td>On or before 2013</td>
</tr>
</tbody>
</table>

**FINAL PLAN ADOPTION: MARCH-APRIL ‘09**
Financial Measures and Reconstruction Plan

Mr. Carlos M. García

Chairman and President
Government Development Bank

FEBRUARY 20, 2009
What Investors Expect from Puerto Rico?

Investors’ Panel

Mr. Carlos Marquez, Caribbean Business (Moderator)
Mr. Terry Trim, Investor
Mr. Joe Rosenblum, Alliance Bernstein
Mr. Rafael Costas, Franklin Templeton

FEBRUARY 20, 2009
Puerto Rico Credit Conference: The Road to Fiscal and Economic Reconstruction

FEBRUARY 20, 2009