



Jorge Irizarry Herrans  
President

April 1, 2008

Hon. Migdalia Padilla, Chairwoman  
Treasury Commission

Hon. Ángel Pérez, Chairman  
Budget Commission

**PUBLIC DEBT REPORT PRESENTED BY THE PRESIDENT OF THE  
GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO BEFORE THE  
TREASURY COMMISSION OF THE SENATE OF PUERTO RICO**

Good morning, Honorable Migdalia Padilla, Chairwoman of the Treasury Commission of the Senate, Honorable Ángel Pérez, Chairman of the Budget Commission of the House, and honorable members of the Commissions.

For the record, my name is Jorge Irizarry, President of the Government Development Bank for Puerto Rico (GDB). I appear before you to present the annual public debt report as required by law. I am accompanied by several GDB officers who are directly related to the subject at hand.

The past year and a half has been full of important achievements for the Government Development Bank and for Puerto Rico. The Bank, together with the Governor's financial team, I am pleased to say, has been a key participant in making these achievements come about.

Among the most significant achievements, which often involved difficult decisions based on thorough analyses, are:

- \$3.7 billion in refinancing that produced significant savings for PRHTA, PREPA and the General Fund.
- The successful refinancing of the first \$4 billion of the appropriation debt through the Puerto Rico Sales Tax Financing Corporation.
- An improvement in the outlook assigned by the credit rating agencies to the Commonwealth credit, which was changed to "stable" from "negative", the outlook they had maintained since 2004.

- Improvement in the credit rating assigned to the Government Development Bank to BBB/A-2.
- Financing \$1.4 billion representing the first part of the \$10 billion in unfunded actuarial liability of the Retirement System.
- Successful placement of \$1.6 billion in PRASA debt based on a rating of BBB-, after a 20-year absence from the market.

After enactment of the Fiscal Reform bill, the credit of Puerto Rico was still affected by two principal factors:

- The level of appropriation debt (extra-constitutional debt) and the financing of budget shortfalls through the GDB.
- The unfunded actuarial liability of the Retirement System

As I noted earlier, over the past year and a half we have begun to take actions to resolve these two issues. The success of the billions of dollars in transactions we have undertaken in this period show that investors have received our bond issues with enthusiasm, and that they have faith in our fiscal plan and our payment capacity. Particularly with regard to the extensive record of Puerto Rico in meeting its debt obligations. Let us examine each accomplishment in detail.

First, market conditions during the first 7 months of the year allowed several Puerto Rico issuers to execute refinancing transactions that resulted in multi-million dollar savings.

- The Puerto Rico Highways and Transportation Authority (PRHTA) refinanced in February 2007 nearly \$1.7 billion of its existing debt at significantly lower rates. This resulted in savings of \$115 million at present value.
- The Puerto Rico Electric Power Authority (PREPA) also had the opportunity of refinancing \$2 billion of its debt, which resulted in savings of \$105 million at present value.
- Finally, a refinancing of approximately \$1.5 billion in Commonwealth General Obligations also generated savings for the General Fund of over \$58 million at present value.

Second, I am pleased to note that last summer we were able to place in the U.S. market and the local market a total of \$4 billion in debt through COFINA, whose source of repayment is the Dedicated Sales Tax Fund. This issue

received an A+ rating and set a record in the market for the amount of zero coupon bonds (\$1,815 million) sold in an exempt issue and for the extended maturity of the bonds, which extended to 50 years. In fact, the 50-year bond was sold with a 4.90% yield, an extremely low interest rate for Puerto Rico, particularly for such a long term.

The proceeds of the issue were used for the refinancing and payment of principal and interest on outstanding appropriation debt, represented by bonds issued by the Puerto Rico Public Financing Corporation (PFC) and by loans from the GDB. This was the first transaction to refinance appropriation debt that had no secure source of payment. Pursuant to the law and the financial plan established, for the next 50 years COFINA will have the capacity to refinance and pay, until it is paid in full, all the corresponding appropriation debt.

This is one of our most significant achievements in terms of public debt management over the past two decades, a time during which we accumulated a debt that we now will be able to pay off. With this transaction we not only identified a source of repayment for financings that for so many years had been incurred by past administrations, but we also liberated the General Fund from an annual contribution of nearly \$600 million previously required to cover service on that debt.

Third, and based on both these important actions, the rating agencies changed the outlook assigned to Puerto Rico credit to “stable” from the “negative” outlook in place since the beginning of 2004. Also, based on the repayment of approximately \$1.7 billion in loans from the Central Government to the GDB, and the consequent increase in liquidity, GDB’s rating for its long term bonds were upgraded from BBB- to BBB, and the rating of its short term paper increased from A-3 to A2. This represented the first rating upgrade for any government issuer since rating reductions began back in 2005.

Puerto Rico’s credit rating no longer is in danger of falling into the non-investment grade category. In fact, the recent trend of the rating agencies, in light of the credit crisis resulting from the plunge of the U.S. mortgage market, is to improve the ratings of government entities. The financing structure created for the Retirement System has already received an A1 Global Scale Rating from Moody’s for up to \$7 billion of the debt. Thus, we believe it is possible for Puerto Rico issuers to receive a Global Scale Rating of that level or higher within the coming months. Last week Moody’s requested our comments on this matter, which we will be submitting by April 15<sup>th</sup>.

Another significant achievement has been the placement of the first \$1,589 million to cover the actuarial deficit of the Retirement System. This deficit has been one of the negative factors cited for decades by the rating agencies as negatively affecting the credit of the Commonwealth. To deal with this issue, we created a financing structure that will allow the System to raise \$7 billion or more in the capital markets and inject them into the assets of the Retirement System to guarantee its capacity to pay the benefits to which public employees are entitled. The most recent actuarial study of the System reports a deficit in excess of \$10 billion, while assets on hand represented only 19% of the liabilities, the lowest funding ratio in any U.S. state government.

With the new structure the funding ratio is projected to reach 70% this year, and the actuarial deficit could be eliminated in the future with better management of the System's investments, a transformation that is underway, and a possible increase in employer's contributions, for which a bill has already been approved by the Senate. Noteworthy, this structure does not represent an increase in debt, since the \$10 billion liability of the System already exists. Also, the financing structure does not require a single additional dollar be paid by any government entity. That is, it uses the same contribution that employers are required to pay into the System today by law that will go towards paying the entire debt used to provide funding to cover the obligations we have to public employees.

Last January, the System managed to successfully place the first portion of this financing with \$1,589 million in the local market. Demand was such that this issue ended up being more than double the size of the initial proposed offering of \$700 million. It evidenced the confidence of local investors in the government and in the structure we created to solve the actuarial deficit of the Retirement System. We hope to continue implementing our plan to raise a total of \$7 billion in the next months, once market conditions stabilize.

An example of what can be achieved when a business approach is applied to a government agency is the turnaround achieved by the Puerto Rico Aqueduct and Sewer Authority (PRASA). Two years after the government once again took over the control of this public corporation, a program was developed to implement a reengineering of its organizational structure, revise its fee structure, and establish a 5-year financing plan. The credit rating agencies acknowledged these achievements by assigning the Authority an investment grade rating.

The 5-year plan includes a Capital Improvements Program at a cost of approximately \$2 billion. To finance it, PRASA successfully accessed the U.S. bond market and the local market for the first time in 20 years, placing \$1.6 billion to an unprecedented strong demand. Over 40 institutional investors showed interest in the credit, filing orders for a total amount in excess of \$4 billion.

This summarizes some of the more important achievements regarding Puerto Rico's credit and the management of our public debt to generate revenues to ensure the future development of our country.

Allow me to comment on our overview on Puerto Rico's capacity to finance its public work to support economic development, particularly in these times in which our local economy is in recession.

Our public debt has been increasing for a long time because the government is one of the strongest motors of our economy and if it does not actively invest in infrastructure the consequences would be extremely negative. Today I can assure you that the debt is and will continue to be managed within the highest standards of sound financial management. I must point out that each debt issuer of the Commonwealth of Puerto Rico has its own specific parameters to limit debt. What this means is that there are effective controls in place to limit the level of debt based on the payment capacity of each issuer. Nonetheless, we have established mechanisms aimed at immediately beginning a reduction cycle of such debt in absolute and relative terms.

We have the payment capacity to comply with the commitments incurred with our creditors. We have access to the capital markets and this access represents a competitive advantage for Puerto Rico that is essential to our economic development. If we fail to show our will to repay any additional debt we might incur and our capacity to repay all existing debt, the capital markets will close their doors on us, thus affecting the ability of the government to continue investing in infrastructure. Investment in infrastructure is also essential to maintain Puerto Rico's competitiveness to attract new businesses to further economic development. Hence, public debt is a necessary instrument to enable investment in our infrastructure, and it is particularly useful when the cost of the debt incurred is low, as is the case of the most recent bond issue we have placed in the market with maturities of 30 years or more, with an effective cost lower than 4.5%.

However, there is one issue that can have negative consequences. The GDB has proposed to liquidate the \$1.151 billion debt that the Public Improvements Fund has had with the GDB, within the next 18 years, at a rate of \$175 million per year. This can only be achieved if the Legislative Assembly authorizes the bond issue that was presented last year before it for consideration and which, regrettably, has not been approved. Not receiving the \$175 million payment could have serious consequences for the GDB since these loans, if not paid in accordance with the proposed schedule, could be classified as defaulting loans by our external auditors; and GDB's credit rating could be affected.

The Legislative Assembly has refused to approve the proposed general obligation bonds issue. This refusal does not protect the credit of the Commonwealth, which is already stable and will continue to improve. It does not prevent an excessive growth of the constitutional debt, since said debt already has a favorable relation to our gross product. This action only denies Puerto Rico a much needed economic stimulus in this time of recession. It also jeopardizes the fiscal health and credit rating of the GDB by denying the funds to pay the loans incurred by the Public Improvements Fund with the GDB. These loans were granted based on legislation approved by the Legislative Assembly authorizing each one and providing for their repayment. The refusal to repay these loans to the GDB challenges the laws approved by the Legislative Assembly. I invite you to reconsider this matter, since there is no gain in refusing to approve the proposed bond issue, rather it will be detrimental for Puerto Rico and, in particular, the GDB.

Let me describe the situation of the public debt in further detail. There are three kinds of entities that issue public debt in Puerto Rico: the Central Government, the municipal governments and the public corporations of the Commonwealth.

First, the total amount of public debt as of December 31, 2007 is \$49.252 billion. From that amount we must subtract \$3.319 billion in debt that does not affect the Commonwealth's coffers because that is paid from external sources. This portion comprises loans payable by certain agencies with funds received from the Federal Government, such as HUD subsidies, bonds payable from funds received from the tobacco settlement agreement, and others.

After subtracting the \$3.319 billion, the total public debt is \$45.933 billion, compared to \$42,540 billion as of December 2006. The \$3,310 million increase is due to debt from the public corporations (\$1,923 million),

appropriation debt financed through COFINA (\$951 million), constitutional debt (\$333 million), and municipalities (\$103 million).

This debt is further subdivided in six categories, as described hereinafter.

First, there are the General Obligation Bonds that have constitutional guarantee because their repayment is protected by the good faith and credit of the Commonwealth of Puerto Rico. This means that the taxing power of the state serves as guarantee to these bonds; i.e., that all resources available to the Commonwealth shall be used to cover the debt services of General Obligations prior to serving any other obligations. As of December 31, 2007 the outstanding constitutional debt is \$8.498 billion.

The capacity to issue General Obligation debt is limited by our Constitution, which establishes that the maximum annual payment for debt service for a certain year shall not exceed 15% of the average of internal revenue for the last two fiscal years. The average revenue for fiscal years 2006 and 2007 was \$8,346 million. The maximum payment requirement for this debt in any future year is \$720 million, for the year 2020, which means that the maximum portion of the average revenue committed for future debt payment for this debt is 8.6%. However, the average payment for future debt service is \$470 million per year, which represents 5.6% of the real average internal revenue. That is, on average, for each dollar received in revenues we are committing only 5.5 cents for debt payment. The use of this constitutional margin has been decreasing since 1999, when it reached 9.7%.

In terms of the General Obligations, we are well under the constitutional limit that we have imposed on ourselves to ensure that we act prudently in managing our public debt. Furthermore, I wish to point out that if we were to place the proposed \$450 million GO bond issue, the amount needed for debt service would still remain under 9% of the average revenues, and the average payment would still be less than 6 cents of every dollar received.

There is also debt that is issued with the solid guarantee of the Commonwealth; that is, that if the debtor does not pay the Commonwealth must pay. Hence, this debt could eventually be considered within the computation of the debt that must remain within the constitutional margin. Even if we added to the General Obligations the debt guaranteed by the Commonwealth, such as the Public Buildings Authority debt of \$3,173.8 million, we are still within the 15% constitutional limit.

Secondly, the Central Government incurs debt by issuing short term Tax Revenue Anticipation Notes, which are paid within the same fiscal year. That is, by June 30, 2008 outstanding TRANs, which total \$1.36 billion, will be paid in full.

Third, there are nine public corporations that issue bonds payable from their own income. Their total debt, including bonds and other financings, is \$20,699.6 million. The amount of debt these public corporations can incur is limited by law based on their individual capacity to generate revenues to cover debt payment, a requirement that is strictly established in the trust indentures governing each of these bond issues. In other words, both the debt of the Central Government and that of the public corporations have controls that limit their level based on the payment capacity of each debtor.

Fourth, there is the debt of the municipalities. There are also statutory limitations on how much a municipality can issue in loans to cover operational expenses and finance public works. The total debt of municipalities as of December 31, 2007 was \$2.42 billion. It includes \$2.087 billion for equipment and permanent improvements, and \$333 million for operations. The debt incurred for public works, based on the special additional tax, is limited to 10% of the appraised value of the taxable real estate property. Likewise, the operation debt is limited to 10% of operational income of the municipality. Hence, the municipalities have fiscal controls to keep their levels of debt within their respective payment capacities.

Fifth, we must mention the appropriation debt that amounted to \$7,685 million as of December 31, 2007. This debt is practically frozen and will be paid in full by refinancing through COFINA and the Dedicated Sales Tax Fund, thus, as we said earlier, relieving the General Fund from the burden it had of repayment.

Finally, there is yet another appropriation debt that we already mentioned, which is the \$1,151.4 million debt of the Public Improvements Fund, which we have proposed be paid for the next 18 years at a rate of \$175 million per year from General Obligations bonds issued each year, as stated in the laws authorizing the original loans.

In sum, we have seen how the Government of Puerto Rico has taken effective measures to put its financial house in order regarding public debt management. Today, all public debt is properly identified and taken care of,

with a clearly identified source of repayment, and within our payment capacity. Maintaining this discipline of not approving loans without a properly identified source of repayment or loans that are not within the payment capacity of each public entity, is GDB's mission. These measures guarantee that we will be able to continue using this instrument so essential to our development without jeopardizing the good credit of the public sector and the well being of present and future generations of Puerto Ricans. Said measures include the following:

- We have defined the mechanisms to repay the appropriation debt and we are committed to never incurring this kind of financing again.
- We are committed to never using debt to finance operational expenses again.
- We have defined strategies to limit the growth of public debt.
- We have identified specific goals to control public spending, to avoid the possibilities of unexpected financing pressures, as has happened many times in the past.

Based on this, on March 17, 2008, Standard & Poor's' (S&P) confirmed its BBB- rating for the Commonwealth credit, with stable outlook. In its report S&P acknowledged the efforts and advances made by the Commonwealth of Puerto Rico to control public spending. In particular, S&P recognized that fiscal year 2009 is the third year in a row that, as proposed, the expenditures budget is kept under the fiscal year 2006 budget. It also acknowledged the importance of achieving these public spending measures amidst a recessionary situation that has affected the Government's revenues.

Furthermore, we must mention that last December S&P, in improving the credit rating assigned to the GDB from BBB-/A-3 to BBB/A-2, with a stable outlook, the credit agency acknowledged the significant improvement of GDB's liquidity and capital base. Specifically, they highlighted that the Bank reduced its loans with the central government by \$1.7 billion. This was achieved, as explained earlier, by refinancing the appropriation debt.

As we have restored and improved the credit position of the central government, we have continued to place bond issues in the U.S. and Puerto Rico capital markets, some of which we have mentioned already. Allow me to highlight some of the most outstanding credit aspects of said transactions.

In February, the Puerto Rico Highways and Transportation Authority (PRHTA) successfully placed \$2.194 billion. The bonds corresponding to the 1968

Resolution received an A- rating from S&P and a Baa2 rating from Moody's. The bonds of the 1998 Resolution received a BBB+ rating from S&P and a Baa3 rating from Moody's. This represented a step forward in our efforts to improve the Authority's credit rating.

In April 2007, S&P revised its rating for PREPA and removed it from the credit alert with negative outlook, where it was placed after the Palo Seco fire, granting it a BBB+ rating with stable outlook. In addition, PREPA received a reaffirmation of its A3 rating from Moody's, as well as an improvement of its outlook to stable, and, for the first time, received from Fitch Ratings, a rating of A- with stable outlook.

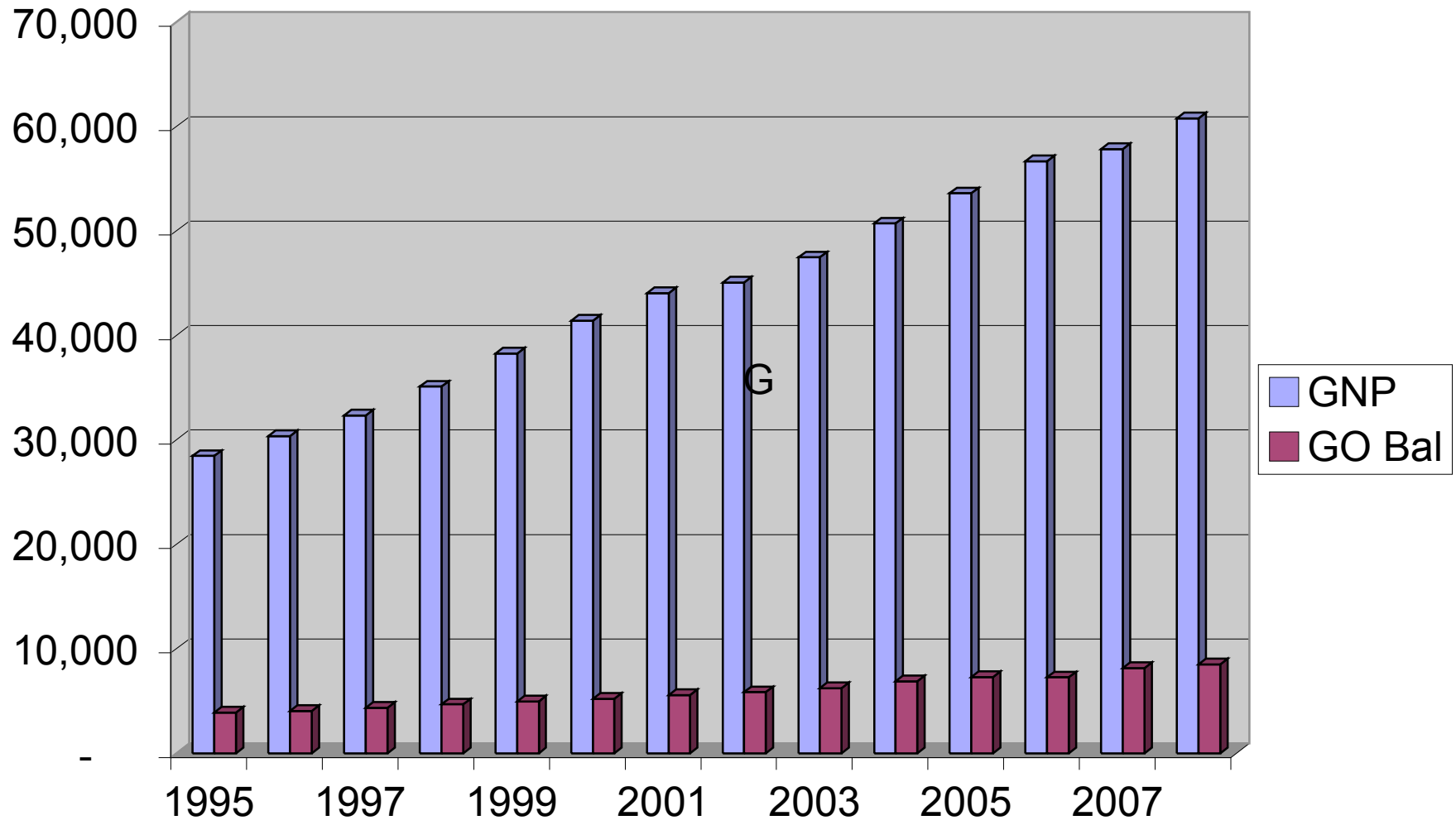
All this made it possible for us to obtain a total interest cost of 4.46%, one of the lowest ever in PREPA's history.

In conclusion, we have shown that Puerto Rico's public debt is currently under control, and our payment capacity is substantially above the amount necessary to cover debt service. In addition, we anticipate a significant reduction of the debt, both in terms of its total amount and of its relationship to the future economic activity of Puerto Rico.

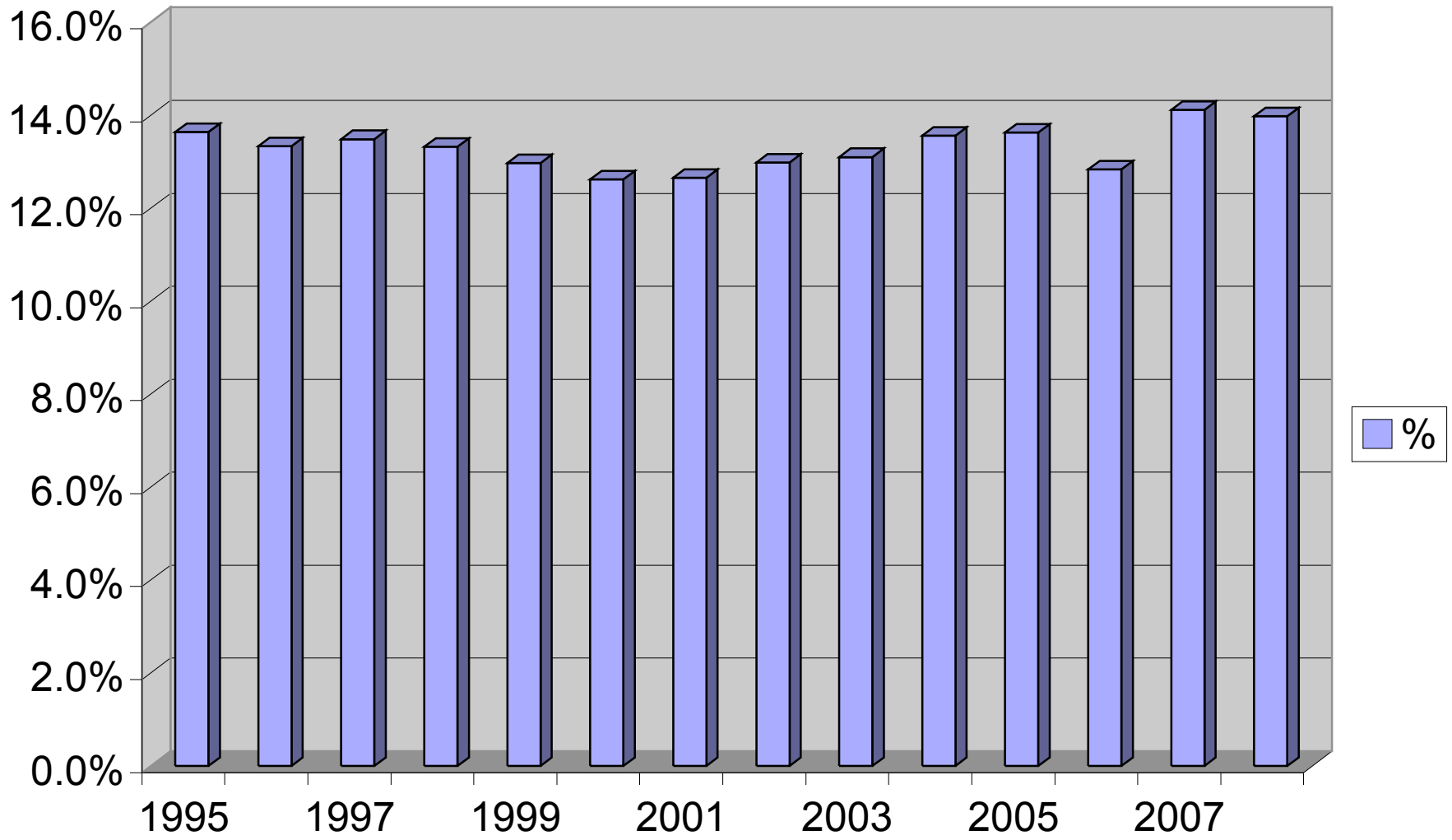
The rating agencies and investors who buy our debt, who at the end of the day are in effect the judges of the quality of our debt, have shown their confidence in our payment capacity and in the way we are managing the fiscal resources of Puerto Rico, as well as in the fact that our position will continue to improve.

Thank you and we are available to answer your questions.

# GDP and GO Balance



## GO Balance as a percentage of GNP



## GO Debt Balance as percent of GNP

