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U.S. Virgin Islands

Credit Profile

US\$18. mil GO Bonds, Series 1999A due 07/01/2010

BBB-

OUTLOOK:

STABLE

Rationale

Standard & Poor's Ratings Services assigned its 'BBB-' rating, and stable outlook, to U.S. Virgin Islands' GO debt outstanding.

The rating reflects the government's:

- Strong political and economic ties to the U.S., which provides monetary, legal, and regulatory stability;
- Broad revenue-raising and budget control authority;
- Improving financial operations; and
- Manageable GO debt burden, which is limited to 10% of the territory's assessed valuation (AV).

Factors that preclude a higher rating include the territory's:

- Limited economy that is centered on tourism and oil-refining facilities;
- Vulnerability to natural disasters, which has hampered economic growth in the past;
- Recent history of severe budget deficits and significant deferral of employee salary increases and other benefits;
- Weak, though improving, history of timely financial reporting, which has been evidenced by late and qualified independent audits over the past few years; and
- High total public sector debt levels, which are measured on a per capita basis and as a portion of gross territorial product.

The U.S. Virgin Islands are an unincorporated territory of the U.S. The islands, which include St. Croix, St. Thomas, and St. John, are in the North Atlantic Ocean in the Caribbean Sea, about 60 miles east of Puerto Rico. The 84-square-mile St. Croix, the largest of the U.S.

Virgin Islands, has two main urban centers: Christiansted and Frederiksted. The 32-square-mile St. Thomas has one urban center: Charlotte Amalie. About two-thirds of the 20-square-mile St. John is preserved as the U.S. Virgin Islands' National Park.

The U.S. Virgin Islands' population has grown steadily over the past 25 years to an estimated 112,128 in 2005 from 96,569 in 1990, an increase of 16%. Gross territorial product has expanded consistently over the past five years; it grew by 3.6% annually to \$2.76 billion in 2005.

The islands' economy is centered on tourism, oil refining, and rum production. After years of lagging growth and economic decline in the 1990s due, in part, to a series of hurricanes that struck the islands, the local economy has recently experienced a steady recovery. From 2001-2005, annual visitor expenditures increased by nearly 21% to \$1.5 billion from \$1.2 billion. Hotel occupancy rates have also increased to 64% in 2005 from about 57% in 2001. Employment growth remains healthy, averaging 1.2% annually over the past five years. Unemployment rates were higher than the national rate at 7.1% in 2005; unemployment, however, compares favorably with other Caribbean issuers, including Puerto Rico.

Despite the recent trend of consistent improvement, the islands' small economy maintains structural limitations and remains vulnerable to a decline in tourism or energy prices, as well as the adverse effect weather-related events might have on the territory. In addition, per capita personal income remains low at just 54% of the national average.

After several years of reserve deficits and overall fiscal strain, the government's financial position has improved. Consistent improvement in tax collections and budget-control measures first implemented in 1999 resulted in improved general fund reserves to \$159.6 million in fiscal 2005, or about 27% of general fund expenditures, from a \$288.0 million deficit in fiscal 1999. Government officials are projecting a \$514,018 general fund surplus for fiscal 2006 and an \$827,621 surplus in fiscal 2007.

The U.S. Virgin Islands' management practices are considered standard under Standard & Poor's financial management assessment (FMA) methodology, indicating the finance department maintains adequate policies in most, but not all, key areas.

The government's total tax-supported debt levels are a high \$1.1 billion, or \$9,755 per capita and 39.9% of gross territorial product. These debt ratios, however, are all encompassing and are not directly comparable with debt ratios for U.S. states because the territory does not have an underlying municipal form of government. The territory's total public sector debt is in-line with the median indicator for Caribbean sovereigns rated in the 'BBB' category.

Outlook

The stable outlook reflects the expectation that economic expansion and private sector employment growth will continue, which should result in sustained tax revenue stability and additional flexibility for officials to adjust personnel and other operating expenditures as necessary to maintain balanced operations. The stable outlook also reflects the expectation that the government will continue to improve its financial management reporting, including the achievement of clean and timely audited financial reports.

Tourism Anchors The Local Economy

The Virgin Islands' economy is centered on tourism, oil refining, and rum production. The local economy has recently experienced a steady recovery after years of lagging growth and economic decline in the 1990s. From 2001-2005, annual visitor expenditures increased by nearly 21% to \$1.5 billion from \$1.2 billion.

Private sector employment growth has been the islands' main driver of recent economic expansion; this sector now accounts for about 71% of total employment, up from 68% in 1990. Despite a significant reduction in territorial government employment and the expansion of the labor force, private employment growth has contributed to a relatively stable unemployment rate.

Tourism and related services fuel private sector employment growth. Most jobs are in the service and trade sectors. About 53% of gross territorial product and 30% of employment are tourism related. Total visitor and cruise ship passenger arrivals have surpassed pre-Sept. 11, 2001, levels. Total visitor arrivals exceeded 2.6 million in 2005, up by 8.7% since 2000. Since 2001, air visitors increased by nearly 50.0% and cruise ship passenger arrivals increased by 1.3%. About 76% of tourists come from the U.S. mainland.

Hovensa LLC is at the top of the islands' leading private employer list. Hovensa operates the third-largest oil refinery in the Western Hemisphere with about 1,200 employees and about 800 contractors, accounting for about 5% of the territory's labor force. Additional leading employers include hotel, resorts, and construction companies.

Manufacturing is concentrated on St. Croix, which has space for industrial development. Manufacturing is focused primarily on the petroleum refining industry and a set of small pharmaceutical, electronics, and assembly businesses. The petroleum industry continues to expand in St. Croix; Hovensa recently spent \$400 million to expand its facility on the island. Petroleum exports have increased substantially due to higher energy prices; exports reached \$9.4 billion in 2005. Manufacturing is declining as a whole due to the continual reduction in U.S. import tariffs, which was the original reason for attracting industrial processing and assembly businesses to the territory. Manufacturing employment has contracted by 11.6% since 1995.

Rum production employs relatively few people but is important to the islands' economy because it is a major source of government revenues through the U.S. excise tax on rum. Exporters shipped about 6.6 million gallons of rum to the U.S. in 2005, which resulted in more than \$75 million of matching fund revenues to the government in fiscal 2005, an increase of 75% since 1996.

In 2004, the U.S. Congress tightened the eligibility requirements for qualifying as a bona fide resident of the islands and the type and amount of income that might qualify for tax incentives, which could also reduce the islands' attractiveness to investors and developers.

Spending Controls Are Key To Improved Financial Position

Chronic overspending, lax budgetary controls, and deficit borrowing have historically characterized the government's financial performance. In April 2000, however, government officials issued a comprehensive five-year operating and strategic financial plan to bring its finances back in balance. These measures include several revenue enhancements that are designed to expand the property tax base and improve collection rates, as well as increase personnel reduction and other expenditure cuts.

From fiscals 1999-2005, the government reduced its workforce by nearly 9% to 11,445 from 12,570. In addition, officials are currently implementing a new financial management system that is expected to improve budget controls and the government's ability to produce timely audits, which have been several years late in the past. Officials expect the fiscal 2005 audit to be complete by December 2006. Furthermore, the number of qualifications and findings in the audited financial statements were reduced to 35 in 2004 from 126 in 1999.

Personal income taxes, the islands' largest revenue source, accounted for 44.5% of fiscal 2005 general fund revenues, followed by gross receipt taxes at 15.3%, corporate income taxes at 14.3%, rum excise tax matching funds at 8.7%, and property taxes at 4.6%. The revenue mix has remained relatively unchanged over the past few years. Moderate concentration exists in the individual and corporate income taxpayers and the leading gross receipt tax generators. Current projections reflect a continued trend of operating surpluses through 2010. In addition, starting in fiscal 2007, the government plans to establish a new rainy day fund that will have annual appropriations of not less than \$5 million to fund a cumulative 10% of annual revenue projections. Officials will only use money in the rainy day fund when forecast general fund revenues decline by more than 15%.

Debt/Unfunded Pension Liabilities

Debt: reassessment ongoing to increase percent of AV cap

The government's GO debt is limited to 10% of taxable AV. Government officials are currently reassessing properties within the territory to increase bonding capacity; litigation over the government's assessment systems and procedures, however, has delayed this process. The current taxable AV of \$7.89 billion provides a debt ceiling of \$789.3 million, or roughly \$250.0 million of additional bonding capacity.

Unfunded pension liabilities: officials are evaluating several options

The government is evaluating several options to address its pension liability, including the potential issuance of up to \$600 million of pension obligation bonds and amendments to the existing contribution scheme and vesting periods. According to a 2003 actuarial study, the government's unfunded actuarial pension liability reached \$921.6 million, which equated to the pension being 59.4% funded.

Financial Management Assessment: 'Standard'

The U.S. Virgin Islands' management practices are considered standard under Standard & Poor's FMA methodology, indicating the finance department maintains adequate policies in most, but not all, key areas.

As is the case with states on the U.S. mainland and other territories, the government's budget is subject to the approval of a 15-member territorial Legislature. If a budget is not approved by the beginning of the fiscal year, appropriations for the preceding fiscal year are automatically deemed reappropriated item by item. Once the legislature approves the budget, the governor exercises fiscal control over expenditures through the allotment process by the director of the office of management and budget. Management prepares quarterly revenue projections and allotments to determine

whether or not its available resources are sufficient for the appropriated expenditures. The office of management and budget director has authority to reduce expenditures as needed.

While the government has a rolling five-year financial plan, it does not have a long-term capital improvement program. An investment policy exists and reports are prepared at least quarterly. While there is no established general fund reserve policy, the fiscal 2007 proposed budget includes the establishment of a rainy day fund requirement at 10% of projected revenues. The government does not have formal debt or swap management policies, so management issues debt based on constitutional and statute limitations.

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