FINANCIAL OVERSIGHT AND MANAGEMENT BOARD
FOR PUERTO RICO

BY ELECTRONIC MAIL

February 5, 2018

The Honorable Ricardo A. Rosselló Nevares
Governor of Puerto Rico
La Fortaleza
P.O. Box 9020082
San Juan, PR 00902-0082

Dear Governor Rosselló Nevares:

The Board is in receipt of the Commonwealth's proposed fiscal plan, dated January 24, 2018 (the "Proposed Plan"), and recognizes the substantial revisions that the Commonwealth has made to the existing fiscal plan, certified by the Board on March 13, 2017 (the "Current Plan"), to adjust for the impact of Hurricanes Maria and Irma. Nonetheless, the Board has determined that the Proposed Plan requires certain revisions before the Board can certify it as compliant with the requirements of the Puerto Rico Oversight, Management, and Economic Stability Act ("PROMESA"). This letter will serve as the notice of violation provided for in Section 201(c)(3)(B)(i) of PROMESA. The Board looks forward to continuing to discuss the Proposed Plan, and the revisions detailed herein, with you in the coming weeks.

It is imperative that Puerto Rico seize this moment to fundamentally reform an economy that has been in a long-term recession, even before Hurricanes Irma and Maria. Our goals of achieving balance and renewing access to the debt markets are only possible if we fundamentally change the underlying economic trends that characterized Puerto Rico's economy prior to the hurricane. To fundamentally change these negative trends, the Proposed Plan must outline the implementation of structural reforms which will change the competitive landscape in Puerto Rico in meaningful ways. In addition, following the hurricanes and the demographic adjustments underway on the Island, it is even more important that the Government continue its efforts to re-design its operations to drive better citizen outcomes at lower cost across a range of services and functions, reflecting the actual demographic situation on the Island. Notwithstanding the fact that the Proposed Plan includes many important proposals needed to move the Island toward fiscal sustainability and economic growth, certain material elements and improvements in the Proposed Plan, laid out herein, are necessary.

Baseline

The Board requires the following changes to baseline projections:

- **Federal funding[1]:** The Proposed Plan should reflect any new public information that has been released regarding federal disaster relief appropriations for the Island. The Board will continue to review and revise disaster spend assumptions.
- **General fund revenue[2]:** The Proposed Plan should include more specific data to backup general fund revenue projections on a line-by-line basis.
- **Capital expenditures[3]:** The Proposed Plan must include sufficient funds for capital expenditures that are necessary to maintain the assets of the Commonwealth. In the Current Plan, the capital expenditure needs were estimated at $400M per year. There has been no project or agency specific analysis that would support a reduction to this amount. It is important to recognize that federal funding will not cover many of the capital expenditures that will be required to preserve and sustain the Commonwealth's capital stock.
- **Emergency reserves[4]:** The Proposed Plan must account for the funding of an emergency reserve based on best practices for states and territories regularly impacted by storms. This is to ensure the sustainability of the recovery over the fiscal plan projection period. The Board believes that contributing $650M over the next five years, and building a total reserve of $1.3B over the next ten years, is prudent. This reserve should build on and encompass already legislated emergency reserves and should be replenished if drawn on in the event of another emergency.

Structural reforms

Structural reforms are crucial to spurring long-term economic growth on the Island. The Board agrees with the Government that structural reforms are at least as important as prudent fiscal policies. Accordingly, the Board requires the following changes to the structural reforms detailed in the Proposed Plan:

- **Ease of Doing Business[5]:** To generate the growth stated in the Proposed Plan, the Proposed Plan must commit to improving specific World Bank Ease of Doing Business measures in the areas in which Puerto Rico most significantly trails the mainland, in particular the categories of Construction Permits, Registering Property, Paying Taxes, and Getting Electricity. The World Bank Ease of Doing Business rankings are watched by companies around the world when making investment decisions and are treated as credible measures of a government's success in improving its business climate. Within each of these areas, the Proposed Plan must outline specific initiatives it will pursue to improve such rankings, and include an implementation plan that outlines when major milestones will be accomplished.

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[1] Section 201(b)(1)(A), (L)
[2] Section 201(b)(1)(A), (G), (H)
[3] Section 201(b)(1)(G), (J)
[4] Section 201(b)(1)(F), (G)
[5] Section 201(b)(1)(A), (D), (G)

- **Labor market and welfare reforms**[6]**:** Puerto Rico's labor force participation rate has for many years been roughly 20 percentage points lower than either the mainland U.S. or other Caribbean islands. Despite recent reforms, Puerto Rico's labor market remains far more rigid and regulated than that of any U.S. state. Increasing labor force participation is crucial to the fiscal health and long-run economic success of Puerto Rico. The Board agrees with the Government that a local Earned Income Tax Credit program is needed to improve labor force participation. However, the Proposed Plan must also include a series of additional labor market and benefit reforms to increase participation in the formal labor market, lower the cost of hiring new employees, and drive a more flexible and competitive labor market. These reforms are critical to increasing opportunity and prosperity for all residents of Puerto Rico.
    - Based on our review of other jurisdictions, examples of such reforms include:
        - Becoming an at-will employment jurisdiction, similar to 49 of 50 mainland states, in order to reduce the cost and risk of hiring new employees;
        - Make employer provision of severance pay and a Christmas bonus optional, as under the Federal Fair Labor Standards Act. To the Board's knowledge, no mainland state requires either severance pay or the payment of a Christmas bonus;
        - Reducing requirements for vacation and sick leave to mainland levels. Current requirements for paid leave causes employers to reduce wages and hire fewer employees. No state requires that employers provide vacation pay. Only nine of the 50 mainland states require any paid sick leave, and none of the nine who do mandate paid sick leave require as much leave as does Puerto Rico; and
        - Instituting a work requirement for NAP for able-bodied adults, as required under the food stamps program in the mainland states.
    - In addition, the Proposed Plan must include a specific implementation plan that would sequence such reforms, with labor market reforms to improve access to jobs preceding a work requirement for NAP.
- **Tax reform**[7]**:** Tax policy should focus on improving tax compliance, simplicity and economic growth, rather than perpetuating a tax system that has distorted economic activity and failed to generate long-term growth. Tax policy reforms included in the Proposed Plan must be at least revenue neutral (relative to the baseline) and exemptions and incentives should be phased out before reducing rates. Tax incentives, credits and other related tax-related subsidies must be shown as an expense, rather than net of revenues, requiring a comprehensive tax expenditure report. The Proposed Plan must clearly articulate the link between the proposed tax reforms and any economic growth projected. Finally, the Proposed Plan must provide a timeline for implementation.
- **Infrastructure reform and capital investment**[8]**:** The need to re-build and modernize Puerto Rico's infrastructure has never been more urgent, but the Proposed Plan does not include a specific plan for capital investment that is tied to the Government's broader

[6] Section 201(b)(1)(A), (D), (G)
[7] Section 201(b)(1)(A), (D), (G)
[8] Section 201(b)(1)(A), (D), (J), (G)

economic strategy. The Proposed Plan also needs to ensure a new and more effective system of capital investment is backed by appropriate institutional organization and Key Performance Indicators (KPIs).

- Specifically, the Proposed Plan must outline a specific capital investment plan at a greater level of specificity than what is currently outlined. This should include:
  - A prioritized list of investments, beyond the reconstruction plan, that addresses key bottlenecks to generate economic growth;
  - A framework for reconstruction that does not just build back what existed, but instead incorporates resiliency measures to build to a risk adjusted level; and
  - Sources of funding for all investments.
- In addition, the plan should address:
  - Infrastructure priorities to guide investment with clear, systematic cost-benefit analysis and quantitative scoring to prioritize projects;
  - Environmental review and permitting with opportunities for accelerated review processes, where appropriate;
  - Sustainable funding models, including external capital, foreign direct investment, and PPP structures; and
  - Procurement and delivery best practices.

- **Human capital**[9]**:** We appreciate the inclusion of specific human capital targets in the Proposed Plan, such as improvements in test scores related to Spanish, Math and English proficiency and a target for retention of new employees. We believe these goals will help drive improvements in human capital on the Island. We also appreciate the specific initiatives the Department of Education has outlined to improve student test scores and other outcomes. However, the Proposed Plan should also include specific initiatives to reduce youth unemployment and the transition into the workforce, such as partnerships with private employers to implement education-to-employment reskilling programs, or the creation of a Youth Unemployment agency to coordinate tying curricula and workforce initiatives to local market opportunities. It should further include an implementation plan that outlines when such programs will be launched and how they will be held accountable for success.
- **Power sector reform**[10]**:** A strong and independent regulator is crucial to a successful transformation of the power sector, which itself is critical to the Island's economic recovery. The Board requires that the Proposed Plan contain a plan for a robust and independent energy regulator. Legislation to create this regulatory model should be introduced by this summer.
  - The energy regulator required to make this transformed power sector a success should be an independent stand-alone agency and should have, at a minimum, the following attributes:
    - Commissioners serve staggered 6-year terms and may only be removed for cause;

[9] Section 201(b)(1)(D), (G)
[10] Section 201(b)(1)(A), (D), (J), (G)

  - At least three but preferably five commissioners, who are selected by the Governor from a candidate list developed by an independent expert panel;
  - Adequate protections and oversight in place for Commission staff;
  - Funding should be generated through a surcharge on electricity rates, with a budget in line with mainland utility commissions; and
  - Authority to approve IRP and rate cases, as well as determine whether utility operator has met requirements for operational performance incentives.

Fiscal measures

The Board requires the following changes to the revenues and expenses measures:

- **Municipal subsidies and county structure**[11]**:** Any plan to consolidate municipal services and create new structures at the regional level must be supported by sufficient detail to ensure such actions will drive operating efficiencies, cost reduction, and improve local administration and citizen outcomes. These plans must also include details for how the Commonwealth will support local administrations in executing such changes. More specifically, the Proposed Plan should contain the following:
  - Reduction of municipal subsidies by 80% of current levels by FY22. The Commonwealth should retain 20% of current subsidies to incentivize municipalities to achieve these operating model changes and avoid further fiscal imbalance. Any municipality's receipt of a Commonwealth subsidy should increasingly be tied to meaningful, structural reforms to the way municipalities and local administrations operate so as to ensure long-term fiscal stability and continuity of services.
  - Policy language, models, and other documentation behind the county proposal, including which services will be performed by counties instead of by the Government or municipalities, a list of territorial government departments that will be moved and their cost and headcount, a proposed timeline of consolidation, the assumed savings and implementation costs from instituting the proposed county structure, and the Government's proposed approach to supporting such consolidation. Plans should include specific services or administrative units within Commonwealth agencies that will be shifted into county administrative functions, such as the regional health and education oversight bodies that currently report to the Government. The transfer of administration should be coupled with meaningful efficiency measures consistent with the goals of agency right-sizing.
  - Plans for revenue streams that will be sufficient to support the proposed county governments.
  - Clear actions, beyond financial incentives, that the Commonwealth will take to support improved local administration. Examples include sharing best practices, centrally resourced service provision collectives, and streamlined legal frameworks to facilitate consolidations and shared services, particularly with regard to labor.

[11] Section 201(b)(1)(A), (D), (F), (G)

- **Pensions[12]:** The Proposed Plan must include specific actions the Government will take to ensure long-term reductions in pension liabilities. Progressive reductions in pensions, with protections against beneficiaries falling into poverty, are consistent with the Board's principle of shared sacrifice and recognize that unfunded pension liabilities are a key driver in the Island's overall fiscal crisis. In particular, the Board requires that:
    - The Board agrees with the Government's proposal to freeze the Employees Retirement Systems (ERS) and shift employees to a true defined contribution retirement plan in which employee contributions are segregated in individually-owned and administered retirement accounts. However, there must be a similar freeze and conversion to defined contribution accounts of the Teachers Retirement System (TRS) and the Judicial Retirement System (JRS). The Government should set clear, immediate deadlines to have all employees enrolled in a defined contribution plan with segregated and self-directed accounts.
    - Any retiree with a combined pension and Social Security benefit below the federal poverty threshold of $1,000 per month be exempt from any reduction to their pension. Pension benefits above that combined $1,000 amount would be reduced by 25%. This formula is designed to reduce total pension benefit outlays by roughly 10%.
    - Police, teachers and judges *under the age of 40* should be enrolled in Social Security. We believe this can be accomplished by reducing pension contributions for government employees under the age of 40 by roughly the amount of the Social Security employee contribution payroll tax. This reduction in employee pension contributions would trigger coverage by Social Security and ensure that employees' take-home pay is not reduced. The Proposed Plan should address policies that at a later stage give police, teachers and judges *over the age of 40* the option enroll in Social Security.
- **Healthcare[13]:** Currently, over 90% of the Proposed Plan's savings for healthcare is driven by a comprehensive "New Healthcare Model." The Proposed Plan must break down projected savings by initiative so that the Board can properly evaluate and score the proposed transformation of Mi Salud. Specifically, the Board asks to see values attached to, at a minimum, the following initiatives: improvements in enrollment and eligibility verification; reductions in fraud, waste, and abuse (including the proposed expansion of Medicaid Fraud Control Unit); formulary and prescription drug reform; value-based payment and care delivery initiatives; competitive bidding of a single MCO region; standardized fee schedules; increased cost sharing; and optional benefit reductions.
- **Agency efficiencies[14]:** The Proposed Plan for reduction in costs across government agencies relies on an assumption that savings will be driven solely by employee attrition as a result of the Single Employer Model and the Voluntary Transition Program (VTP). Without greater detail on agency-level service eliminations, the Board believes that the Proposed Plan's attrition-based model overstates the fiscal impact that such an approach will achieve and does not ensure the permanency of fiscal impact. Further, it will not lead

[12] Section 201(b)(1)(A), (C), (D), (F), (G)
[13] Section 201(b)(1)(A), (D), (F), (G)
[14] Section 201(b)(1)(A), (D), (F), (G)

to a Government that is rightsized to efficiently meet the key needs of citizens and reflect demographic realities. The Board requires that the Proposed Plan include specific reference to services that can be reduced, eliminated, externalized, or taken over by other entities, as well as which types of employees are currently fulfilling those services. Further, the Proposed Plan must include a specific implementation plan and timeline for such agency rightsizing. Finally, the Board requires further detail and justification with regard to proposed privatization or externalization of prisons, and requests that savings be considered through consolidations and workforce reductions where there is overstaffing.

- **Tax compliance**[15]**:** The Proposed Plan should restore the compliance target in the Current Plan of a five percent run rate increase in revenue. As compliance increases, and to the extent that revenues increase beyond this run rate as a result, the fiscal plan can be amended for those facts.
- **Office of the CFO**[16]**:** The proposal for the Office of the CFO ("OCFO") in the Proposed Plan, while welcome, does not sufficiently ensure an improvement in fiscal governance, accountability, and internal controls. The Board requires that the proposal:
    - Have strong, explicit, centralized authority and accountability that consolidates management and operational control over all central government fiscal agencies, economic agencies, statistical agencies, human resource offices, and procurement operations for all entities that receive financial support from the General Fund or otherwise depend on the Government's taxing authority.
    - Have clear responsibility for: revenue forecasting, economic forecasting, spending controls, cash management, financial reporting, fiscal plan and budget implementation, and debt issuance.
    - Provide more detail on the policies, procedures, and responsibilities of the OCFO and of agencies and departments that will be affected by the OCFO's creation.
    - Include a detailed roadmap for the implementation of the OCFO which outlines critical details, produces a timeline for the office's creation, and identifies key milestones and individuals responsible for implementing each reform element.
    - More explicitly define cash, budget, and other management roles and integrate fiscal governance reforms from the Government's agency consolidation plan.
    - Be established through a comprehensive statutory overhaul that creates a new structure that ensures permanent long-term reform.

Other

The Board requires the following other change to the Proposed Plan:

- **Debt sustainability analysis**[17]**:** The Proposed Plan must include a more specific analysis of the Commonwealth's 30-year debt sustainability projections, including specific assumptions related to macroeconomic projections and the projected costs of pension

[15] Section 201(b)(1)(A), (D), (F), (G)
[16] Section 201(b)(1)(F)
[17] Section 201(b)(1)(I)

liabilities. In addition to the provided range of potential debt service, the plan should also outline specific debt capacity year-on-year for the 30-year period.

- **Time horizon**[18]**:** Upon further reflection, the Board has determined that the Proposed Plan must extend through FY23.
- **Political status**[19]**:** The Board is a non-political entity, and therefore it cannot certify a fiscal plan that includes positions on the political status of Puerto Rico.
- **Included entities**[20]**:** The Proposed Plan must specify each government entity, component unit, and agency covered by the Proposed Plan, including subsidiaries thereof, and in line with the official list of covered entities under PROMESA.[21]

Conclusion

The Board recognizes the difficulties implicit in these policy decisions, as well as the long path to return the Commonwealth to fiscal stability. Reaching this goal will take time, enormous effort and the full commitment of the Government's leadership, but done properly and in a sustained manner it will put the Commonwealth on the path to a better future. The Board specifies 6:00pm AST on February 12, 2018 as the deadline for submitting a revised, proposed fiscal plan, including all financial models.

Sincerely,

José B. Carrión III
Chair

Andrew G. Biggs
Carlos M. García
Arthur J. González
José R. González
Ana J. Matosantos
David A. Skeel, Jr.

CC: Natalie A. Jaresko
Christian Sobrino Vega
Gerardo Portela Franco

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[18] Section 201(b)(2)
[19] Section 402
[20] Section 201(b)(1)(A), (F), (L)
[21] "Covered entities" are those identified by the Board in its list of "Initial covered entities subject to oversight under the PROMESA Act" posted on November 18, 2016 on the Board's website (https://juntasupervision.pr.gov/wp-content/uploads/wpfd/50/58345e7a9bd5a.pdf).