FINANCIAL OVERSIGHT AND MANAGEMENT BOARD
FOR PUERTO RICO

BY ELECTRONIC MAIL

March 28, 2018

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

RE: Commonwealth Fiscal Plan

Dear Governor Rosselló Nevares:

The problems Puerto Rico faces are serious, yet addressable. Years of negative growth and fiscal irresponsibility long before Hurricane Maria produced a debt crisis with over $70 billion in outstanding obligations. Hurricane Maria then devastated core infrastructure and impacted the lives of millions of Puerto Ricans. We have the chance now, with the support of the Federal government and the stimulus effect of federal funding, to launch a truly sustainable recovery, correct the terrible fiscal mistakes of the past, and benefit the lives of everyone living on the Island.

It is by acting now, making the structural changes required to improve competitiveness, the budgetary changes to achieve balance, and investments in education and the fight against poverty, that we can revive and restore Puerto Rico's economy. Without taking meaningful and urgent action now, we face continued contractual obligations that exceed our means. Worse, without change we face a future of poverty and outmigration as Puerto Rico residents move to the mainland to support their families and achieve their aspirations. These are the changes we need to make to honor our pensioners, to honor all of our Island's residents – those working and those not yet working – to attain a better reality for all.

Since the Board sent its Notice of Violation for the Proposed Fiscal Plan for the Commonwealth, dated February 5, 2018, we have worked cooperatively and collaboratively with you and your advisors to address the violations detailed therein, as well as additional requirements that we have outlined in oral and written correspondence with you and your advisors. Significant progress with respect to the Commonwealth Fiscal Plan has been made over that period, and we genuinely appreciate your and your team's willingness to work together with the Board in the interest of Puerto Rico.

After carefully reviewing the most recent draft Fiscal Plan for the Commonwealth, dated March 23, 2018 (the "Latest Fiscal Plan"), the Board notes a number of items that it supports. First, the Government's commitment to transforming the Mi Salud program to deliver quality healthcare at lower cost is laudable. Similarly, the transformations proposed for the Departments of Education and Health will ultimately improve overall services at lower cost. Likewise, we welcome the Latest Fiscal Plan's stated commitment to structural reforms in key areas like labor, ease of doing business improvements, and electricity reform. We recognize the significant efforts of your team and your advisors throughout the process.

Despite many areas of alignment, the Board has identified the following areas and items that must be addressed through revisions to the Latest Fiscal Plan before the Board can certify that the Latest Fiscal Plan satisfies the requirements set forth in Section 201(b)(1) of PROMESA. The Board is also sending, under separate cover, a technical appendix that provides additional details on these issues.

Baseline

The Board and the Government have worked closely to align our respective baseline projections. While the Latest Fiscal Plan comes close to the Board's perspective on macroeconomic projections and revenue and expenditure assumptions, the following additional adjustments are needed:

- CDBG funds are projected as being spent 10% per year for 10 years beginning in FY19 and 12% passthrough to on Island businesses. Given recent information regarding requirements around FEMA funding, these funds should be projected to roll out over 10 years as well (14% in FY18, 13.5% in FY19, 13% in FY20, 12.5% in FY21, 12% in FY22, 9.5% in FY23, 8% in FY24, 6% in FY25, 5% in FY26, 4% in FY27 and 2.5% in FY28).
- The private insurance funding estimates should be revised downward to approximately 75% of submitted amount. This more accurately reflects the split between business interruption/ property damage, and taking into account historical information about regional/non-regional splits.
- Municipal Recovery Fund should have $78 million budgeted in FY18 and zero in all other years, rather than $100 million a year for each year.
- The $300M PREPA loan should be provided in FY18 and repaid by FY20, with associated interest received between FY18 and FY20.
- Federal Funds (on revenue and expense sides) should be grown by the appropriate, program-specific growth rates provided to the Government by the Board, rather than by Puerto Rico's inflation rate.
- Costs associated with Title III and the Board should be updated to reflect the Board's latest estimates.
- The 46% incentive payment to rum producers should apply to the $2.75 cover over, which would reduce the amount of revenue going to the Commonwealth.
- Motor vehicle license fees should be grown with real GNP from FY19-23.

- Corrections adjustment for General Fund payroll should be $12 million per year and utility costs should be grown with base case PREPA and PRASA increases.
- Non-personnel operating expenditure costs should be constant in FY18 and FY19 and grown by inflation thereafter.
- Medicaid expenditure projections should reflect FY18 base previously agreed upon and revenue projections should reflect assumptions previously agreed upon until the Board receives a copy of formal guidance from CMS regarding the parameters for spending supplemental Medicaid funds.

Structural Reforms

The Latest Fiscal Plan's commitment to structural reforms is critical because they are essential to the future of Puerto Rico. Implementing structural reforms around labor laws, improving ease of doing business, traffic relief, and the energy sector are critical to long-term growth. We cannot rely permanently on the benefits that Puerto Rico will receive from a temporary boost in federal funds and a temporary reprieve from paying debt service because they will soon subside. However, we can use the temporary economic stimulus provided by federal funds to smooth the transition to an economic model of more flexible labor markets and greater availability of good-paying jobs.

It is therefore essential that these structural reforms be implemented as soon as possible, so that when these temporary benefits do pass, Puerto Rico has already implemented the structural reforms that will generate economic growth, opportunity, and prosperity. Accordingly, the Board requires that the Latest Fiscal Plan include mechanisms to ensure that the structural reforms are in fact implemented and include an implementation schedule, with specific milestones and timelines, based on previously agreed upon templates, for each reform. Moreover, the Board requires the following specific changes to the structural reforms:

Labor reform: The Board shares the Governor's stated goal of increasing the labor force participation rate from its current rate of about 40%, which is the lowest in the U.S. and the Caribbean and one of the very lowest in to world, to 55%. To accomplish this, however, will require dramatic changes to Puerto Rico's labor market and business environment. To this end, the labor reform in the Latest Fiscal Plan must provide that at-will employment is effective no later than January 1, 2019; Christmas bonus is made voluntary by no later than January 1, 2019; mandatory vacation and sick leave are reduced to a total of 14 days per year effective immediately; an Earned Income Tax Credit is introduced by the beginning of FY19; and a work requirement is added for the Nutritional Assistance Program effective by no later than January 1, 2021, with any savings from the work requirement used to increase take-home pay for NAP beneficiaries who work. An hourly minimum wage of $8.25 is achievable but, to avoid hurting employment for less-skilled workers, the minimum wage increase must be phased in as labor force participation rises. The Board is willing to endorse an increase in the hourly minimum wage under the following conditions:

- For workers 25 years old and over, and with an exemption for small employers as defined in Act 120-2014, an hourly increase of $0.25 per hour only if and when the Christmas bonus is phased out;
- For all workers 25 years old and over, of an additional $0.25 per hour if Puerto Rico's labor participation rate exceeds 45%;
- For all workers 25 years old and over, of $0.25 per hour if Puerto Rico's labor participation rate exceeds 50% as measured by BLS; and
- For all workers 25 years old and over, of $0.25 per hour if Puerto Rico's labor participation rate exceeds 55% as measured by BLS.

- **Workforce development:** In the workforce development section of the Latest Fiscal Plan, the Government includes reference to a HIRE program that is intended to provide employer subsidies to incentivize hiring. The Latest Fiscal Plan shall not include such section until or unless federal funds are properly defined and identified.
- **Traffic relief:** The Latest Fiscal Plan shall include specific initiatives to support efforts, including at HTA, to reduce transportation delays and unreliability in Puerto Rico's major metropolitan areas and between major areas. These delays depress productivity, hurt quality of life, and increase the costs of goods and services. Using a variety of readily available operational and technology solutions, as well as targeted capital investments, Puerto Rico could achieve a 0.25% additional uptick on the growth rate.
- **Tax initiatives:** Tax policy initiatives section should include the specific list of offsetting reductions in incentives and expenditures to ensure the new rate reductions are revenue neutral.

Fiscal Measures

The Board and the Government have worked closely to reach alignment on the amount and types of fiscal measures. While the Latest Fiscal Plan makes significant progress toward reaching the Board's position, the following additional adjustments are needed:

- **Agency efficiencies measures:** The Latest Fiscal Plan must target: achieving $5,661M in total agency efficiency savings through FY23, with $1,582M in agency efficiency savings in FY23, from: (1) achieving $69.9 million in annual savings from the elimination of the Christmas bonus; (2) achieving $56 million in annual savings from uniform healthcare (by moving to a benefit of $100/month per employee across the Commonwealth and public corporations, except for PREPA and PRASA); (3) adopting the targets of: 45% for back-office consolidations and 30% for non-personnel spend optimization; (4) adopting the Board's proposal for the Department of Public Safety, which accounts for implementation costs of civilianization of the workforce, and includes higher savings targets for non-personnel and overtime spend; and (5) right sizing additional independent agencies (Office of the Comptroller, Citizen's Advocate Office (Ombudsman), Office of Government Ethics, Special Independent Prosecutor Panel, and the National Guard).

- **Regionalization and county model:** The Latest Fiscal Plan must remove the regionalization section proposing a county structure, along with the accompanying $100 million county support fund.
- **Corrections:** The Latest Fiscal Plan's proposal for the Department of Corrections and Rehabilitation does not demonstrate a viable path for achieving its claimed savings and must be amended to show how the targeted savings will be realized.
- **DDEC:** The Latest Fiscal Plan must make clear that DDEC's budget will include carve outs for the Destination Marketing Office and Invest Puerto Rico (or, those funds should come from other areas in the budget) – as these are performing complementary functions to DDEC.
- **Revenue measures:** The Latest Fiscal Plan must project a 5% increase in revenues from compliance measures (rather than 6%) and must keep proposed revenues from right-rating taxes and fees at the levels reflected in the current Certified Fiscal Plan ($951 million in savings over 6 years).
- **UPR appropriation:** The Latest Fiscal Plan must keep the targets for appropriations to UPR at the levels reflected in the current Certified Fiscal Plan, less net cuts to appropriations made in FY18. Moreover, the amount of appropriations to UPR should reach a run rate in FY23 rather than FY22.
- **PREC:** The Latest Fiscal Plan must include a commitment to and definition of the powers of a strong and independent regulatory authority for the power sector, including describing the respective roles of the regulator and the Oversight Board both during the transition period (before the PREPA Transaction) and the end state (after the PREPA Transaction). In all cases, the Public Service Commission shall not have authority to hear appeals of the Energy Bureau nor to engage in any substantive area of its work.
- **PRIS**: The Latest Fiscal Plan must provide that the Institute of Statistics remains an independent standalone entity to ensure impartial collection, production and communication of statistical data.
- **Office of the CFO:** The Latest Fiscal Plan must provide that the OCFO will be created by the beginning of FY19 and fully implemented and consolidated by the beginning of FY20, and operate co-extensively with Hacienda to consolidate the following agencies: Hacienda, OMB, Office of Administration and Transformation of HR, General Services Administration, and AAFAF. The OCFO will be responsible for all matters related to revenues and expenditures, procurement, and HR, and will serve as the primary financial management agent for the Commonwealth. Moreover, the Latest Fiscal Plan shall provide that all revenues be directed and flow through the General Fund, rather than to Special Revenue Funds. Budget management best practices suggest that budget systems should be designed whereby all resources are directed into a common fund (in Puerto Rico's case, the General Fund). These funds are then allocated for expenditure as deemed by the priorities of the Government. This transition shall be in place before the beginning of FY20, and the Latest Fiscal Plan model needs to show this new practice.
- **Accountability and internal controls:** The Latest Fiscal Plan must include a commitment to publish publicly certain key reports, including, but not limited to: TSA liquidity, component unit liquidity, budget to actuals for General Fund, Federal Funds, and Special Revenue Funds, PayGo balances, and public employee payroll, headcount, and attendance.

Moreover, government contracts and change orders in their entirety shall be publicly available online on a schedule as provided in the technical appendix.

- **Pension savings measures:** The Latest Fiscal Plan must provide that, by July 1, 2019, benefit accruals under TRS and JRS are frozen and all employees will be enrolled in defined contribution plans with segregated, self-directed accounts. The Latest Fiscal Plan must provide that benefits are reduced progressively so that, on average, the reduction is 10% for the entire group of retirement system members but there is no reduction for those with combined retirement plan and Social Security benefits below the poverty level of $1,000 per month. The Latest Fiscal Plan must provide that police, teachers, and judges under the age of 40 be enrolled in Social Security and that these employees' mandatory pension contributions be lowered by the amount of the Social Security employee contribution payroll tax. The Latest Fiscal Plan should also provide that police, teachers, and judges over the age of 40 may be able to enroll in Social Security at a later date.
- **Fiscal impact of power structural reforms:** The Latest Fiscal Plan should incorporate the fiscal impact on the Commonwealth of the reduction in electricity and water prices as projected in PREPA's and PRASA's fiscal plans.
- **Crudita:** Currently, the Crudita gasoline tax for the Commonwealth is capped at $470 million per year, and rates are adjusted yearly to target this amount irrespective of demand. The original policy rationale for capping the revenue generated is no longer applicable. Therefore, the Board requires that the Latest Fiscal Plan include, beginning in FY20, a waiver of the cap, that the current excise tax rate be held constant, and that the Crudita be calculated based on the volume of gasoline sold so that revenues will grow as the economy grows.

Other

- **Implementation plan and mechanisms for enforcement:** The Latest Fiscal Plan must include standardized implementation plans for each measure and structural reform, including major milestones and metrics for success. The Government will have up to one month post-certification to submit completed templates, as previously agreed with the Board, detailing implementation plans for each measure. Further, it should demonstrate for each measure and structural reform the mechanisms by which the Government will ensure implementation (e.g., to reach agency efficiencies savings, if attrition does not provide the necessary savings then intentional workforce reductions would need to occur).
- **Long-term projections for Debt Sustainability Analysis:** The Latest Fiscal Plan must include its core assumptions for the 30-year projections, on a line item basis, for macroeconomic indicators, revenues, expenditures, and measures. Detailed assumptions are included in the technical appendix.

The Board requires that the Commonwealth submit a revised version of the Latest Fiscal Plan, in .pdf and .ppt, that addresses the foregoing issues, along with accompanying six-year and 30-year financial models, debt sustainability analysis, and all supporting materials, by April 5, 2018 at 5:00 p.m. AST.

Sincerely,

José B. Carrión III

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