FINANCIAL OVERSIGHT AND MANAGEMENT BOARD
FOR PUERTO RICO

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BY ELECTRONIC MAIL

August 30, 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 Oversight Board is in receipt of the Commonwealth's Proposed Fiscal Plan as of August 21, 2018 (the "Proposed Plan"), and recognizes the substantial updates that the Commonwealth has made to the existing Fiscal Plan, certified by the Oversight Board on June 29, 2018 (the "June Certified Fiscal Plan"). Nonetheless, the Oversight Board has determined that the Proposed Plan requires certain revisions before the Oversight Board can certify it as compliant with the requirements of PROMESA. The Oversight Board looks forward to continuing to discuss the Proposed Plan, and the violations detailed herein, with the Government in the coming weeks.[1]

The Oversight Board reiterates that Puerto Rico must seize this moment – while it enjoys a short-term stimulus from federal disaster assistance – to fundamentally reform an economy that has been in a long-term recession, and to make the structural reforms needed to restore the Government's access to capital markets. The June Certified Fiscal Plan already identified the structural reforms and fiscal measures that are necessary to comply with PROMESA. Accordingly, the Oversight Board intended this revision to the Fiscal Plan to incorporate the latest material information and certain technical adjustments, not to renegotiate policy initiatives. Unfortunately, the Proposed Plan does not reflect all of the latest information for baseline projections and includes several new policies that are inconsistent with PROMESA's mandate. Below the Oversight Board identifies and details the Proposed Plan's primary points of noncompliance.

[1] This letter serves as the notice of violation pursuant to Section 201(c)(3)(B).

Macroeconomic projections[2]

The Oversight Board requires the following changes to and/or explanations of baseline projections:

- **Disaster pass-through:** The Government's Proposed Plan includes a pass-through rate of 18% across FEMA Public Assistance and HUD CDBG funding, FEMA Individual Assistance, Other Federal Funding, and Private Insurance. However, the Proposed Plan also inputs ~$850 million in Individual Assistance with a pass-through rate of 100% as a negative measure, along with some one-off Federal funding (e.g., RESTART funding and Centros 330 funding), each of which has different pass-through rates assigned. This latter category should be removed so as to avoid double-counting. Further, in order to ensure a more accurate approach that reflects spending on the ground, the Government should segment disaster funding among those which are directed just toward consumption (with a 100% pass-through rate) and those just toward capital investment (with an 18% pass-through rate).
- **Projections for mainland US growth and inflation rates:** The Government's Proposed Plan uses U.S. mainland GDP growth rate and inflation rate estimates from the International Monetary Fund, but also references CBO projections. Considering the importance of the U.S. mainland growth projections on projections for Puerto Rico, and the need for the Fiscal Plan to be anchored in forecasts consistent with those that U.S. policy makers use, the Proposed Plan should be updated to use the CBO forecasts for both U.S. GDP growth and U.S. inflation.
- **Population:** The Government's Proposed Plan includes population numbers that come from the June Certified Fiscal Plan instead of projections that are in line with the Proposed Plan's GNP growth trajectory. The Government Proposed Plan should be updated to adjust population accordingly.
- **Damage assessment:** The Proposed Plan uses the original damage assessment from the Planning Board (using data from October 2017). The Government should share the Planning Board's methodology for reaching this assessment figure, and provide an explanation of why this estimate should not be changed to reflect updated information.

Revenue projections[3]

The Oversight Board requires the following changes to and/or explanations of baseline revenue projections:

- **Major General Fund Categories (income taxes, sales & use taxes):** The Oversight Board appreciates the Government's incorporation of revenue actuals and breakdown between one-time and recurring revenue variance. Please provide additional information on the rationale for incorporating recovery-related revenues into the FY19 tax base that then grows with GNP versus those revenues that relate to a tax base that exists only during the 10-15-year reconstruction period, as the former methodology overstates the impact of

[2] Sections 201(b)(1)(D),(G),(H)
[3] Sections 201(b)(1)(B),(D),(G),(H)

such short-term revenues. Additionally, please provide the source and methodology used to update the following actuals:
- For rum tax actuals, particularly the bridge inserted in February of FY18
- For cigarettes, the source of the monthly actuals adjustment of $(65.8) million to base cigarettes revenues in FY19
- For NRW, the source of the monthly actuals adjustment of $(100.9) million to base NRW revenues in FY19

- **SUT and motor vehicles forecasting methodology:** The Government's Proposed Plan forecasts SUT using both GNP growth and population decline. Given that the largest component of GNP is consumption, which is in turn influenced by population, it would appear population is already factored in to the forecast. Please explain why the approach in the proposed plan does not essentially double count population effects. This point also applies to the motor vehicles forecasting methodology.
- **Act 154:** The Proposed Plan includes $5.9 billion in incremental Act 154 revenues relative to the June Certified Fiscal Plan over 40 years. Please provide specific details supporting the revised forecast, including what specific assumptions have changed since the agreed upon forecast from the June Certified Fiscal Plan, and what data the Government has received to support such assumptions.
- **IFCUs:** The Oversight Board understands that IFCU revenues have been updated to reflect FY18 actuals among other changes. Please provide details on revenue updates resulting in the observed variance of $107M relative to the June Certified Fiscal Plan.

***Expenditure projections*[4]**

The Oversight Board requires the following changes to and/or explanations of baseline expenditure projections:

- **Medicaid long-term projections:** The Proposed Plan contains several new assumptions in the baseline per capita inflation rates. Please provide any documentation not already provided by ASES or its advisors to support these revisions.
- **Pensions:** Pension expenses must incorporate the contribution from municipalities of $11.2 million in ERS administration costs (which flows in as an offset to Commonwealth pension expenses and should be grown by inflation), rather than assuming the Commonwealth will cover municipal pensions costs.
- **Payroll expenditures:** The Proposed Plan assumes $4.09 billion in necessary baseline payroll expenditures (including all fund types and IFCUs), which overstates needed payroll based on recent actuals. These expenditures must be reduced to reflect actual expenses by agency as of FY18, inclusive of reapportionments, and should be an adjustment to the baseline that is projected forward permanently, rather than as a one-time reduction.
- **Non-payroll opex:** The Proposed Plan only includes opex reapportionments listed in the June Certified Fiscal Plan. These expenditures must reflect all non-payroll opex

[4] Sections 201(b)(1)(B),(C),(D),(G),(J)

reapportionments submitted and approved by the Oversight Board for FY18, rather than only those included in the June Certified Fiscal Plan.

- **Disaster recovery cost match:** The Proposed Plan assumes that CDBG will cover a portion (but not all) of Commonwealth cost match each year for the length of disaster roll out. This likely misstates the time period within which CDBG can be used, and how it will be used. As a result, the Oversight Board requires that the Government assume that CDBG fully cover cost match (calculated based on the weighted average cost share, based on percent cost share per disaster relief funding category as well as relevant cost match for each) for the first seven years of roll out (e.g., FY18 to FY26), then that this cost share be borne by the Government.
- **Other adjustments**:
  - **Emergency reserve fund:** The reserve for emergency fund of $130M should begin in FY19 and run through FY28.
  - **Title III fees:** Fees need to be adjusted going forward in FY19 to reflect expenses incurred in FY18, but not paid. Please also provide the latest information regarding Title III expenditure projections (versus standard consulting fees).
  - **Capex:** Please provide information to explain all adjustments to capex in FY19.
  - **Intragovernmental transfers:** Please explain adjustments to ASEM and PBA intragovernmental eliminations.
  - **Consistency across plans:** Please revise projection for the Commonwealth loan to PREPA and HTA claw back to reflect latest information.

Structural reforms[5]

The Oversight Board requires the following changes to and/or explanations of in the scoring of structural reforms in the Proposed Plan:

- **Labor reform scoring:** The Government's Proposed Plan assumes 0.30% uptick in GNP in FY21 due to labor reform. While this scoring is consistent with the June Certified Fiscal Plan, several recent decisions by the Government will undermine the growth effects of labor reform as projected in the June Certified Fiscal Plan: first, the decision to increase the publicly funded unemployment insurance compensation, and second, the executive order that all construction projects provide a $15 minimum hourly wage and use Puerto Rican cement. As a result, the uptick from labor reform should be revised down to 0.15%. Additionally, full and timely implementation of EITC and the NAP work requirement are necessary to stimulate the 0.15% growth. Please provide evidence indicating both why the Government's recent decisions will not undermine the projected growth from labor reform as well as how EITC and NAP will be implemented within the June Certified Fiscal Plan-designated timelines.
- **EITC:** The Government Proposed Plan maintains $203.9M of EITC implementation cost beginning in FY19 in anticipation of the proposed EITC being effective as of calendar year 2018. Given the delay in the legislation, and therefore the lack of ability for the EITC to be effective in the coming months (in terms of stimulating employment this year), the

[5] Sections 201(b)(1)(B),(D),(G)

Government should make the EITC effective as of calendar year 2019. This would mean the annual cost of EITC would not be incurred by the Government until FY20.

- **Ease of Doing Business Reform:** The Government's Proposed Plan assumes a 0.65% uptick in GNP due to Ease of Doing Business reform, comprised of 0.25% each year in FY20-FY21 and 0.15% in FY23. The additional 0.15% growth uptick resulting from the Trading Across Borders reform should only be included if accompanied by clear evidence of a path to full implementation within the June Certified Fiscal Plan-designated timelines.
- **Energy reform:** In the Energy and Power Regulatory Reform chapter, the Government Proposed Plan diluted the strength of language indicating that the regulator needs to be strong and independent. This is a nonnegotiable element of a successful transformation of Puerto Rico's energy sector.

Fiscal measures[6]

The Oversight Board requires the following changes to and/or explanations of the application of fiscal measures in the Proposed Plan:

- **Agency efficiencies:** The Government's Proposed Plan includes a number of deviations within the agency efficiency measures from the June Certified Fiscal Plan, mostly in the personnel category of spend. In particular, there has been a 28% reduction in the total savings to be achieved via agency efficiencies between FY19 and FY23, in part because the Government includes (a) $99 million in reinvestment funding in PRITS, procurement, and PPP and CRRO, which was contingent on the repeal of Law 80 as part of the May accommodation (and therefore should not be included), and (b) $725 million in additional implementation costs. While the Government may make changes to the groupings they originally proposed during the formulation of the Fiscal Plan, **all agencies must still achieve the savings specified in the June Certified Fiscal Plan and in the same concept of spend**. Specific areas for revision are detailed below:
  - **Implementation costs:** Recognizing that there will be substantial implementation costs associated with Governmental rightsizing, the June Certified Fiscal Plan included a 3-year implementation ramp for the Government to achieve full run-rate savings from agency efficiencies (e.g., the Government need only achieve ~33% of run-rate savings in FY19). If additional implementation costs are to be included, then savings must be increased commensurately so that agency efficiency savings from the June Certified Fiscal Plan are maintained.
  - **Reinvestments:** The investment in procurement reform, PPP and CRRO, and digital reform (e.g., PRITS) were agreed only if Law 80 was repealed so as to implement comprehensive labor reform. Because that did not happen, the reinvestments detailed in Exhibit 32 should not be included. If these new investments are to be added, then equivalent savings must be increased so that total agency efficiency savings from the June Certified Fiscal Plan are maintained.
  - **Uniform healthcare:** The Government's submission removes savings to be achieved from implementing uniform healthcare in FY19. If these savings cannot

[6] Sections 201(b)(1)(B),(C),(D),(F),(G)

be achieved in FY19 due to delayed implementation on behalf of the Government, then other savings must be increased so that overall FY19 agency efficiencies savings from the June Certified Fiscal Plan are maintained. In addition, for every year after FY19, savings to be achieved from uniform healthcare in the Government's Proposed Plan are lower than savings the Oversight Board had projected to achieve through the measure. Please revise the savings in the submission so that they reflect the total savings to be achieved as if all eligible Commonwealth entities were to reduce employee health contributions to $125 per employee per month as agreed.

  - **Department of Corrections and Rehabilitation**: Unless and until the Government can explain how the externalization/prisoner outsourcing program will lead to the required net savings, all references to it must be removed.
  - **Elimination of the Christmas Bonus:** The Government's submission does not include savings associated with the elimination of the public Christmas bonus. If these savings will not be achieved, then agency efficiency personnel savings must be increased so that total annual savings from the June Certified Fiscal Plan are maintained.
  - **Rightsizing addressable baseline:** The Government currently maintains the addressable baseline in the rightsizing model that was used in the June Certified Fiscal Plan. However, since certification it has become clear that not all utility costs were included in the addressable baseline of the rightsizing model. Therefore, the Government should increase the addressable baseline for each agency based on the size of its utility costs included in the OMB Custody budget, and increase the expected non-personnel spend reductions proportionally. The Government should also adjust the baseline to incorporate all recurring reapportionments (e.g., between two agencies, or between personnel and non-personnel funds within individual agencies).
  - **Payroll freeze:** The Government Proposed Plan includes language in the payroll freeze section that states the savings that would be achieved by the payroll freeze "if continued." The June Certified Fiscal Plan includes the payroll freeze as a measure through FY23 and therefore the "if continued" language should be deleted.

- **Medicaid**: The Proposed Plan only includes pay-for-value savings of $81 million in FY19. Please provide information explaining this reduction in savings from $91 million.
- **Pensions:** Not only does the Proposed Plan not mention any pension reform, but it now includes implementation of Social Security in a manner that is more costly and inconsistent with the June Certified Fiscal Plan. The Oversight Board's position on pension reform remains. Additionally, the Proposed Plan cannot budget to pay the Social Security contribution costs of its employees; rather, the budget only provides for the employer contribution.
- **Tax law initiatives:** The Proposed Plan reinstates the tax law initiatives that had been included in prior fiscal plans, but were not enacted. Any tax law initiatives that are enacted must be tax revenue neutral. Moreover, references to specific proposed tax initiatives must be deleted until enacted.
- **UPR scholarship fund:** The Government's Proposed Plan removes the endowed UPR scholarship to be funded by budget reductions to General Court of Justice, the Legislative

Assembly, AAFAF, and the Oversight Board. Given that these budget reductions are unchanged, the Proposed Plan should include this fund.

- **Power utility measures:** Based on the change described above in the "Rightsizing addressable baseline" paragraph, the Government should remove the power utility measure to avoid any potential overlap of savings between the two measures.

***Other*[7]**

- **OCFO:** Within the chapter on the OCFO, the Proposed Plan makes several eliminations which have important implications for the OCFO's role and responsibility (e.g., removal of compliance with Oversight Board budget guidelines, ensuring that all other public entities maintain zero balance sweet accounts, removal of responsibility for reforming personnel policies, removal of responsibility for supervising property tax assessment and other tax-related roles such as publishing an annual Tax Expenditure Report). The Proposed Plan also removes the call for all SRF revenue streams to first have their funds deposited into the TSA. Finally, the Government also removed all language under the "Enforcement of the budget" section. This language should all be reinstated.
- **Implementation timelines**: The Government's Proposed Plan removed all implementation plan exhibits. The next submission must reinstate these exhibits with timelines that match the required milestones stated in the June Fiscal Plan.
- **Quarterly performance report**: The Proposed Plan removed the expectation that the Government produces a quarterly performance report on agency efficiencies. This must be reinstated.
- **Statehood:** The Government Proposed Plan includes numerous references to the need for Puerto Rico to become a state. The Oversight Board will not certify a fiscal plan with such references as it is not a political entity.

Conclusion

The Oversight 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 Oversight Board specifies 12:00pm AST on September 7, 2018 as the deadline for submitting a revised, proposed fiscal plan, including all financial and rightsizing models.

Sincerely,

Natalie A. Jaresko

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[7] Sections 201(b)(1)(F)

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