

**FINANCIAL OVERSIGHT AND MANAGEMENT BOARD
FOR PUERTO RICO**



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December 20, 2016

SENT VIA ELECTRONIC MAIL

Honorable Alejandro García Padilla
Governor of Puerto Rico
La Fortaleza
PO Box 9020082
San Juan, PR 00902-0082

Dr. Ricardo Rosselló Nevares
Governor-Elect of Puerto Rico
#36 J Street Urb. Villa Caparra
Guaynabo, PR 00966

Dear Governor García Padilla and Governor-Elect Rosselló Nevares:

We would like to start by thanking you, Governor García Padilla, your team and your advisors for collaborating with the Financial Oversight and Management Board for Puerto Rico (“Oversight Board”) over the past month to help us evaluate the Government of Puerto Rico’s proposed fiscal plan.

We also would like to congratulate you, Governor-elect Rosselló Nevares, on your election. We look forward to developing a productive working relationship with you and your Administration to address Puerto Rico’s fiscal and economic crisis for the benefit of the People of Puerto Rico.

With the passage of the bipartisan Puerto Rico Oversight Management and Economic Stability Act (“PROMESA”), the Federal Government both empowered the Government of Puerto Rico and imposed on it the responsibility to implement an economic turnaround of Puerto Rico on behalf of its people. Through PROMESA and the establishment of the Oversight Board, Congress and the President have given Puerto Rico tools to establish fiscal discipline, restructure its debt and restore opportunity on the Island.

Governor Alejandro García Padilla
Governor-Elect Ricardo Rosselló Nevares
December 20, 2016
Page 2

The Board is committed to carrying out its duties under law in partnership with Puerto Rico's duly elected government. To that end, the Oversight Board has evaluated the Government's proposed Fiscal and Economic Growth Plan ("FEGP" or the "fiscal plan"), initially vetted the magnitude and nature of Puerto Rico's fiscal and economic situation, as well as considered actions required to address this crisis. In this letter, we outline key findings and a framework for an updated fiscal plan.

We are optimistic that working together we can achieve the following:

1. Return Puerto Rico's economic performance to a level consistent with that of a regional economy of the U.S.;
2. Increase the labor participation rate;
3. Transition more parents and other adults from welfare programs to self-sufficiency and work;
4. Improve writing, reading, bilingual and STEM (Science, Technology, Engineering and Mathematics) proficiency of K-12 students, thus charting for them an early path to: (1) jobs available in the labor market or (2) college, and provide affordable public higher education on a financial need-basis;
5. Build a modern, efficient and cost-effective infrastructure that ensures quality utility services are delivered fairly to every Island region;
6. Create a vibrant entrepreneurial sector;
7. Increase the median family income and reduce poverty;
8. Improve vital health statistics and average life expectancy;
9. Improve public safety and reduce crime and violent deaths; and
10. Restore population growth in Puerto Rico.

While we are optimistic, we must also be realistic about where we are today. The Puerto Rican economy is struggling under constraints that make it uncompetitive, including a high burden of long-term obligations. Wide ranging reforms will be required to unlock the economy's true potential. Only through real economic growth will enough opportunities be created to allow the People of Puerto Rico to stay and thrive, thus stemming outmigration and attracting new investment and new residents to the Island.

Governor Alejandro García Padilla
Governor-Elect Ricardo Rosselló Nevares
December 20, 2016
Page 3

As you know, this is a crucial time for Puerto Rico. The tight timeline imposed by the mandatory stay on debt litigation, ending on February 15, 2017 requires us to act urgently. At this critical juncture we would like to:

1. Define the nature and magnitude of Puerto Rico's current fiscal and economic problem;
2. Provide a framework for the Government of Puerto Rico to develop policies and plans to address the current fiscal and economic problem; and
3. Propose a path forward to certify a revised fiscal plan as the immediate next step.

NATURE AND MAGNITUDE OF PUERTO RICO'S CURRENT FISCAL AND ECONOMIC PROBLEM

Puerto Rico has a massive fiscal deficit, a declining economy and no access to capital markets. To understand the magnitude of this problem, the Oversight Board and its advisors have been working diligently with the Government and its advisors to develop a "baseline gap" analysis that answers the following question: "What would happen to Puerto Rico's fiscal situation over the next 10 years if all current obligations remain as they are and no corrective actions are taken?"

To answer this question, we requested the current Administration to make certain modifications to its models, including an economic forecast based on current law and policy, updated pension assumptions, and spending projections that reflect existing obligations and current spending levels. These changes, based on the latest information available as well as updates to other assumptions, result in a fiscal gap of \$67.5 billion over the next 10 years. The implications of this situation are dire:

- The \$67.5 billion projected budget gap is equivalent to approximately \$54,000 per Puerto Rican family, or 2.8 times the average Puerto Rico median annual family income. In other words, unless action is taken, covering the enormous deficit would require the equivalent of EVERY Puerto Rican family having to pay \$5,400 EVERY year over the next 10 years, for a total of \$54,000 per family.
- The Government would have to reduce expenses, increase revenues or both to close an average annual budget shortfall of \$7 billion (out of about \$20 billion in annual spending) to meet its current legal obligations.
- Even if the Government made no debt payments (which is legally and equitably not an option), Puerto Rico would face an average annual budget shortfall of more than \$3.2 billion.

Governor Alejandro García Padilla
Governor-Elect Ricardo Rosselló Nevares
December 20, 2016
Page 4

- A decline in the gross national product (GNP), likely larger than what has occurred over the past years, is expected.
- Puerto Rico has limited or no ability to finance such a deficit through additional borrowing.

We will continue to evaluate the baseline numbers in the FEGP as part of the certification process. Specifically, the Oversight Board is seeking an independent third party validation of the starting point of the Baseline Projection and the bridge from the last available audited financial statements of fiscal year 2014.

FRAMEWORK FOR THE GOVERNMENT OF PUERTO RICO TO DEVELOP POLICIES AND PLANS TO ADDRESS THE CURRENT FISCAL AND ECONOMIC PROBLEM

Puerto Rico's economy has been studied extensively since the early 1970's. The conclusions from prior studies and lessons from jurisdictions managing similar critical economic situations suggest that Puerto Rico should take immediate action on several fronts. The aim of such actions should be to restore economic growth, achieve fiscal balance, and allow for the wind-down of the Oversight Board as set forth in PROMESA. Puerto Rico will need a very clear plan and a commitment to enact and implement major changes to:

1. Restore economic growth and opportunity through fundamental structural reforms that create a more competitive economy. In the short-term, the focus of structural reforms should be liberalizing the labor market, lowering the cost of reliable energy, rationalizing and optimizing taxation and streamlining the permitting processes to enable investment.
2. Achieve sustainable, balanced fiscal budgets by substantially restructuring the Government while preserving essential services for the People of Puerto Rico.
3. Restructure Puerto Rico's to a sustainable level and reform pensions, in each case respecting the process and requirements established under PROMESA, and re-establish access to the capital markets.

These critical actions will require commitment and sacrifices from all stakeholders, but they are the key to restoring economic growth and opportunity for all. Every month we wait represents lost opportunity for economic growth and Puerto Rico's ability to recover.

1. Restoring economic growth through structural reforms.

Economic growth is critical to address Puerto Rico's crisis. For decades, Puerto Rico has focused on attracting investment from outside the Island by providing incentives targeted at specific industries. While the model worked to spark different industries, it did not address the fundamental structural problems that have been building within the Puerto Rican economy and

Governor Alejandro García Padilla
Governor-Elect Ricardo Rosselló Nevares
December 20, 2016
Page 5

are impeding growth. To address this challenge to economic growth, several major reforms will need to be implemented immediately:

Comprehensive labor and welfare reform. Structural reform should focus on increasing Puerto Rico's labor force participation rate which stands at 40% (compared with 63% in the rest of the U.S. and 60% in Florida) and lowering its unemployment rate (currently at 13% compared with 4.5% in the rest of the U.S. and 4.8% in Florida). To encourage businesses to create job opportunities, a comprehensive review of labor regulations, including Act 80 and pension benefits, should be completed. Today, regulations related to severance pay, flexible scheduling, employee retention and mandatory vacation days and pensions, for example, are not consistent with those in the U.S. states with whom Puerto Rico competes for investment and talent.

Additionally, welfare programs require comprehensive reforms to strengthen incentives for work. A 2006 Brookings Institution/Center for a New Economy study found that minimum wage earners lost between 80 cents and \$1.25 for each additional \$1 they earned, meaning that beneficiaries who chose to work often ended up with lower incomes. Moving the needle on the labor force participation rate requires reform to eradicate these disincentives.

Puerto Rico could also benefit from an Earned Income Tax Credit which can reduce hardship for low-wage workers, stimulate formal employment and offset sales tax regressivity.

Energy reform. The cost of electricity in Puerto Rico is high compared with competing economies. Power prices are also highly variable over time due to Puerto Rico's dependence on oil-fired power plants and link to the volatile global oil markets. Furthermore, the supply of electricity is also increasingly unreliable due to aging infrastructure. Lowering the cost of energy and increasing system reliability are key priorities to lower the cost of living and doing business in Puerto Rico. Low energy prices are spurring economic activity and new investments across the rest of the U.S. Unfortunately, Puerto Rico has largely missed out on the low-cost energy boom. Getting there will require a fundamental reevaluation of energy policy and the way the Puerto Rico Electric Power Authority ("PREPA") delivers its services today.

There is a pressing need to stabilize the situation at PREPA and accelerate critical capital projects that can bring new and cheaper energy resources to Puerto Rico. We believe that a process should be established for interested stakeholders to weigh in on the pros and cons of the current proposed PREPA restructuring and more generally on the options for energy reform. The Board will work with the Government and with PREPA on an expedited basis to assess the PREPA restructuring in light of the goals of delivering lower cost, reliable power to Puerto Rico as soon as possible.

Governor Alejandro García Padilla
Governor-Elect Ricardo Rosselló Nevares
December 20, 2016
Page 6

Tax reform. Puerto Rico has a tax structure that is onerous on employees and small businesses and disproportionately benefits certain businesses instead of providing a level playing field for all enterprises. In addition, there is a history and habit of negotiated tax agreements, amnesties and other short-term oriented approaches that end up undermining the Government's credibility and ability to collect.

Puerto Rico needs a simpler and fairer tax structure, particularly for corporate tax, that eliminates giveaways and spreads the tax burden over a broader tax base. The Government should complete a comprehensive review of tax inequities and act quickly to put in place new legislation, regulation and capabilities to reduce inconsistencies and improve collections. Specific proposals should include reviewing and considering replacing the soon-to-sunset Act 154 excise tax with proposed legislation. Puerto Rico should also consider property tax reform, including a revaluation of properties that could increase tax receipts, incentivize real estate investment and enable Puerto Rico's central government to decrease subsidies to municipalities.

Puerto Rico also needs to collect more actively and effectively the taxes it is owed. Current tax compliance rates in Puerto Rico are around 65%, versus a benchmark of over 85% nationally. In order to address this gap, Puerto Rico can enhance compliance through increased audit effectiveness and use of technology, advanced analytics and training to increase capture rates and administration. We encourage the incoming administration to pursue a long-term collaboration or agreement with the U.S. Internal Revenue Service to guide, monitor and accelerate the enhancement of tax compliance.

Economic competitiveness measures. Puerto Rico is plagued with an array of regulations that slow economic growth and opportunity. Additionally, there are numerous regulations that unreasonably protect certain businesses or result in higher costs for consumers. Overall, the Government should evaluate the costs and benefits of barriers limiting competition in certain economic sectors with the aim of making distribution of goods more competitive and reducing costs of local goods to promote fair competition. In addition, real property markets are distorted by a variety of regulatory requirements and fees that are not consistent with what is seen on the mainland.

Government permitting processes are also slow, uncertain and sometimes duplicative. These impediments stall much-needed capital projects and prevent a variety of other projects from even being considered (an opportunity cost that is impossible to measure, but likely significant). Current regulations should be re-assessed with a simple lens: "Does the regulation enhance or hinder growth and job creation" and if the latter, "Do the benefits far outweigh the costs?" Today, we have the chance to "clean sheet" Puerto Rico's regulatory regime and start over with a set of regulations that advance Puerto Rico's economic and fiscal strategies. The result will be a lower cost of living for the People of Puerto Rico and a more open competitive economy where entrepreneurs are rewarded for delivering the best product or service.

Governor Alejandro García Padilla
 Governor-Elect Ricardo Rosselló Nevares
 December 20, 2016
 Page 7

Infrastructure and Public Private Partnerships. Puerto Rico's infrastructure is in need of significant upgrade and repair. The Island is ranked 51st among U.S. states and territories on road roughness (an indicator of road quality) and 45th in traffic congestion. Much of Puerto Rico's core infrastructure could be built and more efficiently provided by putting in place programs to attract private financing and expertise into capital delivery and infrastructure operations. Puerto Rico has a successful track record of attracting private sector investment in roads and airports (such as roads PR-22 and PR-5 and the Luis Muñoz Marín International Airport), but it has been hampered by a low-growth economy and lack of aggressive execution.

The fiscal plan should include a broad-based program to support growth in Puerto Rico by investing in infrastructure and partnering with the private sector. These partnerships can unlock new sources of capital, accelerate the delivery of projects and ensure ongoing operations and maintenance needs are addressed. The Government should build on its existing expertise and past successes to create a more centralized and efficient end-to-end project development program. A capital delivery program focused on prioritizing projects that support near-term economic growth and that can attract private capital will allow the Government to deliver more infrastructure and better services with less taxpayer funding. Through Title V of PROMESA and the Revitalization Coordinator the Board will provide support to the Government on expediting local and federal permitting process and supporting priority projects.

2. Achieving sustainable fiscal balance.

Structural reforms, as described above, are a necessary part of the Puerto Rico turnaround strategy. However, to eliminate the Island's massive budget gap, a comprehensive restructuring of the way the Government delivers services will also be necessary.

While Government spending will have to be reduced, essential services must be preserved for the People of Puerto Rico. Governments that run fiscal surpluses and have a thriving private sector can afford services beyond those that are essential. Puerto Rico is not in that situation. Puerto Rico's government can no longer afford to provide non-essential services. The Government should focus on improving the quality of government services by delivering them more efficiently, as well as on improving the efficiency of revenue collection without imposing new taxes or fees. Despite significant potential gains from making government more efficient, the Government will need to make substantial, necessary cuts and revenue changes to balance its budget.

Right sizing Government. Puerto Rico has had a public sector-led economy since the 1940s. As the economy modernized, Puerto Rico continued to grow its public sector infrastructure and made its processes increasingly complex. Today's Government is fragmented, complex and duplicative. For example:

- There are 70 treasury units with no centralized accounting system;

Governor Alejandro García Padilla
Governor-Elect Ricardo Rosselló Nevares
December 20, 2016
Page 8

- There is no central office to manage federal funds and optimize use of proceeds;
- Central procurement manages purchases for only some of the Government not all of its instrumentalities.

This complexity makes it challenging for the Government to deliver the services citizens need as efficiently and cost effectively as possible. Puerto Rico needs to transform its Government to be better positioned to deliver only essential services (such as public safety, education, healthcare and welfare) more efficiently. We will work in the coming days and weeks to identify non-essential services, opportunities to consolidate agencies and to centralize functions.

Education and healthcare are two of the largest areas of expenditure for the Government. While both areas are essential, the fiscal condition requires they be reduced substantially. A similar adjustment should be considered for the correctional system.

In education, Puerto Rico needs major out-of-the-box thinking and comprehensive reforms to achieve the dual objectives of improving K-12 outcomes across the board and right-sizing the public school footprint to better fit a declining student population. This alone would unlock potential savings of more than \$1 billion over 10 years.

For higher education, Puerto Rico should implement a means-tested tuition policy that aims to improve graduation rates and time to degree and supports the elimination of the current funding formula. Additionally, today there are exciting innovations in education that could reduce costs materially while improving education. Their applicability and benefits should be explored.

On healthcare, Puerto Rico should focus on determining the amount of resources it can afford to invest on a long-term sustainable basis and the most efficient allocation of those resources. In the near term, to reduce the current expenditure on healthcare, the Government should look to reduce healthcare operational costs (e.g., procurement and delivery structure) and the scope of insurance coverage (e.g., eligibility, scope of benefits and cost sharing). In the long-term Puerto Rico should pursue value-based care opportunities to improve patient outcomes while lowering total cost of care.

Many of these needed changes are well understood and in some cases progress has already been made. We must, without distraction or delay, design and implement these necessary changes. Temporary fixes like furloughs and freezes may be necessary bridges to capture savings in the short-term as the long-term foundation is built. All of these steps will require political leadership and the support of the People of Puerto Rico.

Right pricing services. For decades, Puerto Rican citizens have paid virtually the same price for all sorts of Government-provided services, whether it be heavily subsidized

Governor Alejandro García Padilla
Governor-Elect Ricardo Rosselló Nevares
December 20, 2016
Page 9

ferry trips to Vieques where passengers pay a tiny fraction of the true trip costs, or a University of Puerto Rico tuition level that requires substantial subsidies from the central government.

Right-pricing does not mean a regressive system that punishes low-income students and working families; instead it means thoughtful economic strategies, such as means-based university tuition, supplemented with Pell Grants, or mechanisms to protect prices, such as charging tourists higher prices more aligned with the real price of improved ferry services. In the current environment, all Government fees and subsidies need to be reevaluated and right-priced based on the true cost of delivery and the ability to pay.

Monetizing assets. By privatizing a number of government assets, such as real estate, the state insurance fund and ports, for example, Puerto Rico could fund near-term initiatives on a one-time basis, and potentially achieve better service levels at a lower cost. Government assets should be monetized with the specific aim of funding one-time investments in infrastructure development, like upgrading to broadband internet connections, and not funding continuous operations.

3. Restructuring long-term liabilities

Given the budget gap, long-term liabilities will need to be restructured under a fiscal plan in compliance with PROMESA. Structural reforms will not be sufficient to allow Puerto Rico to fund its long-term liabilities as they currently stand. The Government budget is simply not large enough to allow it to provide essential services and pay debt service as currently structured, even if it implements extensive fiscal initiatives.

The restructuring must greatly simplify the complex debt structure currently in place, which will serve to improve debt management and enhance transparency to assure investors about Puerto Rico's fiscal health going forward. Our efforts to update the current fiscal gap, as well as define a framework for analysis and various potential initiatives, should lay the groundwork to evaluate the best approach to address the debt burden, while ensuring continued access to capital markets for the Government of Puerto Rico and hundreds of Puerto Rican companies. Change is also needed to ensure the pension costs are sustainable and to address the massive pension liabilities built up over decades. We will work closely with the Government to establish a transparent and orderly restructuring process in compliance with PROMESA and where high quality information is clearly communicated to all stakeholders and the legal tools available are used as necessary to implement equitable solutions.

As the Oversight Board had anticipated in its November meeting, it will start coordinating good faith conversations with creditors this week.

Governor Alejandro García Padilla
Governor-Elect Ricardo Rosselló Nevares
December 20, 2016
Page 10

PATH FORWARD TO CERTIFY A FISCAL PLAN AS IMMEDIATE NEXT STEP

Puerto Rico's fiscal and economic problems are severe and could have dire consequences to its people and society if left unattended. However, there are a number of policies and actions that can help address the situation. Their timing and sequence will be critical to the success of the fiscal and economic growth plan. We have outlined a fiscal and economic framework within which we can work jointly with the duly elected Government of Puerto Rico to develop a certifiable fiscal plan. The fiscal plan is not a mere exercise of achieving a balanced budget, but a living and dynamic document that provides a framework for achieving concrete goals that make a difference in improving the lives of everyone in Puerto Rico.

To that end, we will be contacting Governor-Elect Rosselló Nevares shortly to discuss his proposed government initiatives and the next steps necessary to achieve a certifiable fiscal plan by no later than January 31, 2017.

Specifically, we will request that the incoming administration establish a high-level task force during its first week in office dedicated to working on the fiscal plan. We will also request that a package of legislation and administrative reforms implementing some priority measures identified in the fiscal plan be developed immediately and considered by the Puerto Rico Legislature by February 15, 2017. Such priority measures should be the subject of discussion with Governor Rosselló Nevares in the coming weeks.

We strongly recommend that the incoming administration make the fiscal plan and implementing the reforms and initiatives included in the fiscal plan a stated priority for all new appointees and Government employees by incorporating them in their performance evaluation. We trust the incoming Administration shares the Oversight Board's sense of urgency to collaborate swiftly and boldly on this effort.

Please know that the Oversight Board stands ready to assist the Government of Puerto Rico in defining the necessary structural reforms, responsibly managing its long-term obligations and restoring economic growth and opportunity for the People of Puerto Rico.



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