Wealth Management Research
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• Puerto Rico has made scant progress on restoring financial stability since Hurricane Maria wreaked havoc on the island. We expect the economic crisis to persist indefinitely. In the wake of the hurricane, the Financial Oversight and Management Board for Puerto Rico directed the Rosselló Administration to submit a new and revised Fiscal Plan to better account for the additional costs associated with disaster recovery. The government submitted its updated five-year Fiscal Plan on 24 January 2018.

• The Commonwealth’s revised plan proposes to eliminate the payment of all debt service over the forecast period. Many of the underlying assumptions upon which the New Fiscal Plan is predicated strike us as very optimistic. Much will depend on the timing and amount of federal aid allocated to the island. The FOMB responded to the revised plan on 5 February. It required that further changes and clarifications be made by 12 February.

• In another example of the Commonwealth’s inconsistent financial reporting, the government announced on 18 December 2017 that liquid resources had abruptly increased by USD 5bn after reviewing the balances of more than 800 bank accounts. The government updated and reclassified its findings related to cash balances on 19 January. The matter is now the subject of a forensic investigation by Duff & Phelps, LLC.

• Recent court decisions have captured market attention and upended municipal market expectations regarding pledged security liens. If upheld on likely appeal, the probability grows that Puerto Rico’s creditors will be structurally subordinated to pensioners and other expenditures deemed necessary to stimulate economic development.

• Some bond prices have improved since the first of the year. We do not believe the improvement is warranted in light of the fundamental challenges faced by Puerto Rico. The recent improvement in the price of senior and subordinate lien revenue bonds issued by the Puerto Rico Sales Tax Financing Corporation (COFINA) presents an opportunity for individual investors that still own the credit to reduce risk in their portfolios, in our view.

"Puerto Rico faces a unique set of circumstances – the largest municipal bankruptcy and the greatest natural disaster to strike the island in the last 100 years. The devastation affected millions of lives, decimated critical infrastructure, and made revenue collection almost impossible. In light of this new reality, we must work urgently towards revising the certified fiscal plans."

Ms. Natalie Jaresko
Executive Director
Financial Oversight and Management Board

This report has been prepared by UBS Financial Services Inc. (UBS FS). Analyst certification and required disclosures begin on page 14.
Puerto Rico was already in its fourth year of fiscal crisis when Hurricane Maria devastated the island’s physical infrastructure. The territory’s existing challenges, ranging from population decline to economic stagnation to a structural operating deficit, became even more daunting in the wake of destruction from the ferocious windstorm. Economic and physical recovery has been slower than expected, due in part to the island’s distance from the US mainland.

In early January, four months after the arrival of Maria, more than 30% of the electric utility’s customer base still lacked reliable service. The delivery of potable water had been restored to most residents but cellular phone service was still intermittent in many parts of the island. Given the extent of the physical devastation, and barring a surge in financial support from the United States government, we expect that any economic recovery will take more than a decade to complete.

**A new Fiscal Plan**

The Financial Oversight and Management Board for Puerto Rico (the “FOMB” or the “Board”) authorized the Rosselló Administration to use up to USD 1bn of reserves for emergency operations related to hurricane recovery in anticipation of the receipt of federal funds. The Board also postponed employee furloughs for at least a year and initiated a new process for contract execution by government agencies. The latter decision was made in the wake of a controversial contract for reconstruction of the island’s electric transmission grid.

In accordance with the provisions of the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), the Board also is responsible for reviewing and approving a fiscal plan of recovery for the island. The original Fiscal Plan for Puerto Rico was certified by the FOMB on 13 March 2017 and described then as a “transformational and comprehensive roadmap to balance the budget and turn around the economy, structural reforms being key to making this happen.” Unfortunately, little progress was made in subsequent months toward those laudable goals.

In the wake of Hurricane Maria, the FOMB directed the Rosselló Administration to submit a revised Fiscal Plan that would better account for the additional costs associated with disaster recovery. The demand for a new Fiscal Plan was accompanied by a requirement that nine discrete principles be satisfied. A list of those principles is set forth in Fig. 1.

The government submitted its updated New Fiscal Plan for Puerto Rico to the FOMB two weeks ago. Unlike the original ten-year plan certified nine months ago, the new version eliminates the payment of all debt service over the five-year forecast period. By contrast, the earlier plan provided for the payment of about 24% of debt service due over that time.

**Fig. 1: Nine Fiscal Plan principles**

1. Reflect current demographic trends, economic challenges, hurricane damage assessments, federal funding commitments, and a government sized to the post-hurricane reality;
2. Cover five fiscal years (from FYs 18-22);
3. Establish an accurate assessment of the fiscal outlook, where the base case reflects a variety of scenarios of federal recovery funding, including one assuming no additional federal support;
4. Provide sufficient resources to ensure appropriate immediate emergency response and recovery effort in anticipation of the receipt of federal funds to avoid increased out-migration. Include metrics focused on the improvement of living standards in areas such as public safety, healthcare, and education;
5. Prioritize structural reforms needed to improve the business climate, such as pension reform, corporate tax reform, and capital efficiency efforts;
6. Develop a capital expenditure plan that provides the basis for long-term economic recovery, focusing on increased and expedited support for rebuilding energy, water, transportation, and housing;
7. Include resources to complete the Commonwealth’s FY15 comprehensive annual financial report (CAFR) by 31 December 2017 and the FYs 16-17 CAFRs by 30 June 2018. Thereafter, audited financial statements should be issued no later than within six months of year-end;
8. Facilitate structural balance by FY22 at the latest; and
9. Include a long-term debt sustainability analysis and detailed economic projections for the next 30 years.
The revised plan also relies upon myriad assumptions, many of which strike us as very optimistic. For example, the government anticipates aggregate real GNP growth over the forecast horizon of 2.1% despite an estimated population decline of 19.4% over the same time frame. The Rosselló Administration also appears to be relying on a surge of federal financial aid to stimulate economic activity that, at least thus far, has eluded the island.

The government expects to save more than USD 3bn through operational reforms, including departmental consolidation. While such reforms are certainly needed, the Commonwealth has yet to demonstrate an ability to confront entrenched interests and institute reforms that will substantially reduce government employment.

Despite the abrupt increase in forecasted economic growth following a projected 11.2% decline in FY18, and the indefinite suspension of debt service payments for non-enterprise debt, the new plan still anticipates a USD 3.4bn deficit through FY22. The operating deficit will trigger the need for a new liquidity facility to bridge the funding gap. Lacking any reliable capital market access, the Commonwealth presumably will be forced to rely upon the federal government for these operating funds.

The Puerto Rico Aqueduct and Sewer Authority (PRASA) and the Puerto Rico Electric Power Authority (PREPA) also released revised fiscal plans last month. Assuming no receipt of federal aid, PRASA anticipates that it will be able to pay only 17% of debt service through FY22. With federal aid, this figure increases to 47%. PREPA’s plan does not contemplate any debt repayment.

In a press release, bond insurer Assured Guaranty concluded that the revised fiscal plans fail to differentiate essential and non-essential spending, and ignore creditors’ constitutional rights, as well as contractual liens and covenants. We are inclined to agree.

The Oversight Board announced that it had sent letters to Governor Rosselló on 5 February calling for immediate revisions to the new and amended fiscal plans. Among other changes, the FOMB has ordered the government to include provisions for funding a capital improvement program and that the plans be extended to cover another operating year (FY23). Relevant labor market and pension reforms are also mandated. The required changes must be made by the government by 12 February, a deadline that the government may fail to meet. We review the highlights of the FOMB review of the Fiscal Plan in the appendix to this report.

Reliance upon federal assistance
One of the most important factors in the speed with which the island will recover is the size and timing of federal disaster relief. Puerto Rico has requested USD 94.4bn in federal aid, including USD 31.1bn for housing and USD 17.8bn for the power grid. While we remain skeptical that the federal government will provide that level of assistance, some federal support has been forthcoming.

The University of Puerto Rico (UPR), the Puerto Rico Highways and Transportation Authority (HTA), the Government Development Bank of Puerto Rico (GDB), and the Public Corporation for the Supervision and Insurance of Cooperatives of Puerto Rico (COSSEC) are required to submit draft fiscal plans to the FOMB by 9 March 2018 (from 9 February, previously), with review and revision ongoing through the certification date of 20 April 2018 (from 16 March, previously).
On 1 February, the US Housing and Urban Development Department announced that it would provide the territory with a USD 1.5bn community development block grant (CDBG) toward hurricane recovery efforts. The money is dedicated to the rehabilitation of housing and businesses damaged in the storm.

Legislation now pending before Congress includes a supplemental appropriation for disaster assistance. While there is some uncertainty as we go to press as to whether the legislation shall become law, it does contain USD 89.3bn in emergency supplemental appropriations to communities to recover from recent hurricanes, wildfires and other disasters.

Of around USD 6.8bn allocated to disaster relief for Puerto Rico and the US Virgin Islands within this legislation, approximately USD 4.8bn has been earmarked for an increase in Medicaid assistance for Puerto Rico. According to statements made by Governor Rosselló, an additional USD 2bn of CDBG funding would be used to repair the island’s electric utility. The Commonwealth had originally requested USD 46bn of CDBG funding.

Population decline accelerates
While there is widespread agreement that Puerto Rico’s population has declined dramatically due to migration, there is still much debate over precisely how many individuals have already departed and how many are likely to return. The Commonwealth’s New Fiscal Plan estimates that 300,000 individuals left the island over the past decade. This estimate strikes us as low. According to a recent study by the Center for Puerto Rican Studies at Hunter College, the island lost approximately 525,000 residents through net migration from 2006 to 2016. This results in a Puerto Rican population of just 3.3 - 3.4mn before the hurricane.

The absence of basic services on the island has accelerated out-migration. Consider the experience in Florida, which has become the preferred destination for US citizens leaving Puerto Rico for the mainland. According to figures from the state’s own emergency response team, over 230,000 Puerto Ricans have arrived there since early October. The government’s Fiscal Plan does concede that another 600,000 individuals are expected to leave by 2022. In a presentation to the Oversight Board in November, one demographer testified that Puerto Rico’s population is likely to bottom out at 1.9mn by 2060.

Economy continues to falter
Reliable economic data on Puerto Rico remains elusive. For many years, creditors have been obliged to rely upon the Economic Activity Index compiled by the now-defunct Government Development Bank of Puerto Rico. While useful as a trend indicator, the index is a poor substitute for broader measures of economic activity. Unfortunately, inflation-adjusted data on personal consumption and gross domestic product are difficult to come by and arguably meaningless. The poor quality of official data on economic activity presents a challenge in
determining whether remedial actions after the hurricane are proving to be effective in generating economic development.

The New York Federal Reserve Bank does conduct an annual survey of small businesses in Puerto Rico and these surveys provide a snapshot of activity. The most recent survey was undertaken in May 2017, before the hurricane caused extensive damage to the island’s infrastructure. Among other results, the percentage of small businesses reporting profitable operations dropped from 44% in 2015 to 31% in 2016. Not surprisingly, fewer small businesses reported applications for new credit lines.

According to one recent report, approximately 90,000 borrowers became delinquent as a consequence of Hurricane Maria and one-third of Puerto Rico’s 425,000 homeowners are behind on their mortgage payments. The island’s delinquency rate, which is approaching 35%, is now more than twice the national rate recorded in the midst of the US financial crisis a decade ago.

**Tax bill creates new challenges**

We believe the Tax Cuts and Jobs Act will prompt changes in corporate behavior and make Puerto Rico less attractive as a location for manufacturing enterprises. US companies must pay a minimum tax of 10% for profits earned in a “foreign” country, with Puerto Rico treated as a foreign jurisdiction for tax purposes.

The law also includes a 12.5% tax on intangible property imported from “foreign” countries. A patented pharmaceutical produced in Puerto Rico presumably will be subject to this tax. For its part, Puerto Rico believes that the new US tax law will result in a cumulative reduction in Act 154 revenues relative to the FY17 level of around 50%.

To soften the adverse impact from the new US tax law, Puerto Rico lawmakers are considering the enactment of comprehensive tax legislation to spur economic development, lower the cost of doing business, and make the island more competitive. The government proposes reducing maximum individual and corporate income tax rates to no more than 30%, eliminating the business-to-business sales and use tax by FY20, and reducing a prepared food tax.

The proposed tax reductions are designed to stimulate longer term economic activity but the immediate impact is likely to reduce the amount of revenue collected by the government. The revised plan anticipated the loss of USD 2bn through FY22 from reduction in individual and corporate tax rates. Among the revisions to the fiscal plan demanded by the FOMB is a requirement that any tax reform measures be at least revenue neutral.

At the federal level, Puerto Rico is pursuing eligibility for designation as a new “opportunity zone” that would receive more favorable tax treatment. This proposal was included in the Senate version of the tax reform bill and would defer federal capital gains taxes on investments in qualifying low-income communities. Under the framework,
the entire island would be eligible for this designation, with the hope of stemming the rising tide of outmigration.

**Financial reporting remains inadequate**

According to an 18 December 2017 filing by its Fiscal Agency and Financial Advisory Authority (FAFAA), Puerto Rico had USD 6.875bn in cash at the end of November 2017, up from a previous estimate of USD 1.73bn as of 1 December. The new estimate was provided at a December meeting of the FOMB after the FAFAA scoured more than 800 government bank accounts in search of available funds. The discovery led to renewed accusations of inadequate disclosure and sloppy accounting practices.

Gerardo Portela Franco, Executive Director of FAFAA, reportedly denied allegations that the government had more liquidity to share with creditors, citing legal restrictions on the cash and pending litigation. Almost USD 1bn of the newly identified funds was held by the Puerto Rico Sales Tax Financing Corporation (COFINA) bond trustee. Another USD 813mn was located in restricted Title III accounts. The remainder was held in conjunction with bonded debt of the Puerto Rico Employees Retirement System (ERS), the general obligation (GO) redemption fund, and revenue claw-backs from other Puerto Rico agencies. The FOMB subsequently announced that it would commission an independent forensic investigation into the government’s accounts from 1 July 2014. On 6 February, the FOMB reported that Duff & Phelps, LLC had been retained for this purpose.

The discrepancy in cash balances undermined confidence among creditors and other stakeholders in the territory’s recovery. The Federal Emergency Management Agency (FEMA) and the US Treasury Department informed FAFAA last month that they would withhold a USD 1bn disaster recovery loan in light of the additional cash on deposit, for example.

FAFAA provided another estimate of its aggregate cash balance in a presentation on 19 January. Revising its findings from the 18 December presentation to the FOMB, the government now reports that it had a balance of USD 6.943bn at the end of November 2017 and USD 6.882bn at the end of December.

We are obliged to remind investors that the Commonwealth has failed to produce a full set of audited financial statements for several years. The most recent set available, for FY14, was not issued until 30 June 2016. To the best of our knowledge, the FY15 CAFR had not been filed as of 8 February 2018. In the revised Fiscal Plan, the government now targets the release of audited financial statements for FYs 16-18 by 30 June 2018. There is no mention of the FY15 report.

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**Restoring the power grid**

Given the substantial damage caused to the **Puerto Rico Electric Power Authority’s** (PREPA’s) assets as a result of Hurricanes Irma and Maria, the US Army Corps of Engineers expects the power grid will not be fully restored until May. In our view, rebuilding the grid is essential to restoring fiscal and economic stability for the island.

Moody’s, which assigns a Ca rating to PREPA’s bonded debt, now believes that recovery will be closer to the lower end of its previously stated range of 35-65%. That rating is accompanied by a negative outlook. Legacy challenges for the power utility leading up to the storm included its advanced age and the poor condition of its infrastructure. The corresponding need for significant capital investment was made all the more difficult by a weak liquidity position and lack of market access.

The power utility has not made debt service payments since PREPA’s Title III proceeding commenced on 2 July 2017. Moody’s warns of the “significant uncertainty for bondholders, given the novelty of Title III proceedings for all parties, the complexity of those proceedings and the likelihood of delays owing to the numerous debtors seeking debt relief under the legislation, coupled with the weak economy.”

It is unknown at this time how, or if, the power grid will be reconstructed with longer-term sustainability in mind. The FOMB authorized USD 5bn of public-private partnerships, including USD 2bn for energy projects, at the end of last month.

Puerto Rico Governor Ricardo Rosselló has stated that he believes that PREPA’s assets could fetch as much as USD 4bn. In light of the massive amount of investment required to restore system reliability, and the expectation that Puerto Rico will constrain any private operator from raising rates significantly, we have our doubts. In any event, with the power utility subject to Title III, any decision regarding the disposition of the utility rests with the court, as opposed to the Governor.
Litigation flourishes
District Court Judge Laura Taylor Swain ruled on 30 January 2018 that special revenue bonds issued by the Puerto Rico Highways and Transportation Authority (HTA), Convention Center District Authority (CCDA), and the Puerto Rico Infrastructure Financing Authority (PRIFA) are subject to an automatic stay, meaning that they do not need to be paid during the pendency of the Title III bankruptcy proceeding. In rejecting the arguments set forth by Assured Guaranty and other bond insurers, she also found that a special reserve fund held in trust may be withheld from bondholders.

The ruling was a surprise to many municipal market observers because the bonds in question are secured by liens on specific sources of pledged revenue. Bankruptcy courts elsewhere in the United States have ruled that insolvent governmental borrowers are still required to remit special revenues pledged to the repayment of revenue bonds.15 In this instance, Judge Swain concluded that PROMESA constrained the court’s ability to interfere with Puerto Rico’s unfettered right to revenue otherwise pledged to bondholders without the consent of the Oversight Board.

Judge Swain’s decision is another example, if one were needed, of how difficult it has become to anticipate judicial rulings from the bench in municipal bankruptcies. Fitch Ratings added to the industry chorus of consternation by publishing a critique of Judge Swain’s ruling. In the rating agency’s view, “a final court ruling that payment of special revenue obligations during bankruptcy is optional would create uncertainty … and remove the basis for rating special revenue bonds any higher than the municipality’s own issuer default rating.”16 The court’s decision will be appealed to the US Court of Appeals for the First Circuit in Boston.

In a separate legal matter raised by a group of hedge fund creditors, Judge Swain found that she did not have jurisdiction over whether GO and Commonwealth-guaranteed bonds could be granted any special protection by virtue of the priority of payment provisions set forth in the Puerto Rico Constitution. She argued that PROMESA did not empower her court to grant relief and that the consent of the FOMB would be required to make any such determination.

Meanwhile, holders of Employees Retirement System pension bonds fared better in court. In December, Judge Swain approved an order which directed that interest payments on the obligations continue to be made until she makes a final determination as to the validity of the pledged security lien. The timing for that decision is unknown.

As we have discussed in other reports, municipal debtors may be more inclined to view bankruptcy as a tool to restructure liabilities in the future if it allows for the targeted impairment of certain creditor classes.17 Recent legal decisions suggest that Puerto Rico’s creditors will be structurally subordinated to pensioners and other expenditures deemed necessary to stimulate economic development.

Restoring the power grid (continued)
Meanwhile, the Puerto Rico legislature has passed a bill authorizing the government to loan money to PREPA and PRASA to avert projected upcoming cash shortfalls, with a cap of USD 550mn for the power utility and USD 80mn for the water system. The disbursement may take place up until 30 June.

Additionally, the FOMB asked Judge Swain to allow PREPA to borrow up to USD 1.3bn from the Commonwealth’s general fund. The Ad Hoc Group of GO bondholders and a PREPA subcontractor have already objected to the proposed loan, calling it a raid of Commonwealth funds. A final hearing on the matter is schedule for 15 February in New York.

As noted earlier in this report, subject to Congressional approval, the US Housing and Urban Development Department plans to direct USD 2bn of federal community development block grant funding toward the repair of the island’s battered electric grid.

1 Moody’s, Issuer In-Depth, Puerto Rico Electric Power Authority, FAQ: Recovery prospects for bondholders, 13 December 2017.
2 Ibid.
Legal fees continue to mount
Thus far, over two dozen entities have asked federal judge Laura Taylor Swain to authorize payment for legal services rendered during the first interim period, which ran from 3 May to 30 September 2017. These requests were made in connection with the island’s debt restructuring proceedings under Title III of PROMESA. The requested amount exceeds USD 77mn.

Despite the fact that the territory is likely to be in litigation with its creditors for at least another year, its legal fees are already over 40% of the aggregate cost billed to Detroit in connection with its Chapter 9 proceeding in 2013-14 (USD 178mn). All of which compels us to remind our readers that the principal beneficiaries in a Chapter 9 (or Title III) proceeding are restructuring consultants and bankruptcy attorneys.

The Commonwealth and its public entities that have entered Title III are obliged to pay for all Title III-related professionals retained by the government, the financial control board, and any statutory committees. The US District Court for the District of Puerto Rico is handling the various Title III cases.

Bond prices decline … and then rebound
Puerto Rico bond prices declined abruptly after Hurricane Maria devastated the island’s infrastructure and made an economic recovery more challenging. While bond prices for most of the island’s borrowers have improved since mid-December, the degree of improvement has varied. Uninsured COFINA senior and subordinate lien bonds have improved markedly in the wake of court decisions that imply that general obligation bonds do not have a priority lien on all revenue, including sales taxes.

While the court’s decision in the Assured case, discussed earlier in this report, also might be interpreted as a negative development for COFINA bondholders, recent trade activity suggests that investors have placed higher importance on the court’s conclusion that it lacked the jurisdiction to grant a higher priority to GO bonds.

Not surprisingly, prices on the island’s general obligation bonds remain subdued and close to their historic lows. The Commonwealth’s most actively traded security, the benchmark 8s of ‘35, traded at an all-time low of USD 20.8 on 19 December 2017 (see Fig. 2). The bonds had declined by more than 60% since the time that Hurricane Maria struck the island on 20 September, having traded at a price of USD 56.7 cents before the storm. The average price of the benchmark GO bond stood at USD 25.125 on 8 February 2018, having declined in value from USD 27.1 cents previously.

Fig. 2: Price trends, Puerto Rico GO 8.00% due 1 July 2035
Last price, in USD

Source: MSRB trade data, Bloomberg, UBS, as of 5 February 2018 3:00PM
Note: Puerto Rico GO 8.00% 2035 were issued at USD 93.00 on 11 March 2014
PRASA bonds also exhibited abrupt improvement through mid-January as investors appeared to take some solace in the utility’s recent record of debt service payments (see Fig. 3). However, while the utility’s bond prices remain higher than most other uninsured bonds, prices slipped in the last two weeks after PRASA admitted it does not have the revenue necessary to pay most of its annual debt service and must rely on federal assistance to pay even half of what it owes.

Conclusions and outlook
Puerto Rico has adopted a more adversarial approach in its negotiations with creditors. Bondholder recoveries will depend upon the outcome of litigation contested by a diverse group of creditors. The Commonwealth government is preoccupied with igniting economic growth and appears to view most debt service payments as a less optimal use of precious capital. Puerto Rico’s access to the capital markets also is nonexistent, which creates another incentive to impose larger losses on creditors.18

Creditors, of course, will contest any effort to curtail their rights to pledged revenue. To the extent that revenue bond holders win their appeal and restore their rights to special revenues and reserve funds, we would expect revenue bond recoveries to be higher than the recoveries available to general obligation creditors.

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Source: MSRB trade data, Bloomberg, UBS, as of 7 February 2018 5:00PM EST
However, while the recoveries may be higher on a relative basis, the depth of economic recession on the island will act as a severe headwind to a full recovery. We reiterate our long-held view that private clients should take the opportunity to reduce their exposure to Puerto Rico. Recent improvement in the price of COFINA bonds provides such an occasion.

End notes

1 Debt service estimate is based on disclosure in the Governor's proposed fiscal plan, as of 10 January 2018.
2 Mr. José B. Carrión, Chair of the Financial Oversight and Management Board for Puerto Rico, as quoted in the minutes of the Eleventh Meeting of the Board, 5 December 2017.
3 The Financial Oversight & Management Board for Puerto Rico, The importance of structural reforms in the updated Fiscal Plan, 5 December 2017
4 Assured Guaranty, Press release, Assured Guaranty responds to Puerto Rico’s revised fiscal plan proposals, 25 January 2018
5 The FOMB addressed three fiscal plans. These included the new fiscal plan for the Commonwealth, the Puerto Rico Electric Power Authority and the Puerto Rico Aqueduct and Sewer Authority.
7 New Fiscal Plan for Puerto Rico, 24 January 2018
8 Jonathan Levin and Yalixa Rivera, "We made it up: Trying in Vain to Count the Puerto Rico exodus" 30 January 2018
13 Robert Slavin, Puerto Rico, after finding $6.9B in bank accounts, says money is still short”, Bond Buyer, 22 January 2018.
15 James Spiotto, "Puerto Rico's 'Assured' Decision Should be Reconsidered or Reversed", 5 February 2018.
18 Notwithstanding the requirement for a bridge loan to finance operations through FY22, the source of which is unidentified.
Appendix: Oversight Board response to revised fiscal plans

For each entity, the FOMB is requiring that its respective fiscal plan include:

**Government of Puerto Rico**

- An outline of the structural reforms that will change the competitive landscape in a meaningful way;
- Any new public information regarding federal disaster relief appropriations for the island;
- More specifics to support general fund revenue projections;
- Non-federal funding sources for identified capital expenditures needs (currently estimated at USD 400mn per year);
- Funding for an emergency reserve at a recommended USD 650mn over the next five years, building to USD 1.3bn over ten years, that would be replenished if drawn upon in the event of another storm emergency;
- An outline of specific initiatives to improve World Bank Ease of Doing Business measures in categories such as construction permits, registering property, paying taxes, and getting electricity, with an implementation plan and timeline for the same.
- 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 might include becoming an at-will employment jurisdiction, making employer provision of severance pay and a Christmas bonus optional, reducing requirements for vacation and sick leave to mainland levels, and requiring that there be a job requirement for the food-stamp program.
- Tax policy reforms that are at least revenue neutral and are better articulated relative to projected economic growth. A timeline for implementation should be provided.
- A specific plan for capital investment that is tied to the Administration’s broader economic strategy, prioritizes investments, incorporates resiliency measures, and identifies sources of funding.
- Specific initiatives to reduce youth unemployment;
- The creation of an independent, stand-alone agency to regulate the energy sector funded through a surcharge on electricity rates;
- A reduction in municipal subsidies by 80% of current levels by FY22;
- More detail on how the transition to the county structure is envisioned and on planned revenue streams to support the proposed county governments;
- Specific actions to reduce pension liabilities over the long-term consistent with the Oversight Board’s principle of shared sacrifice:
I. In addition to freezing the Employees Retirement System and shifting employees to a true defined contribution plan, the Teachers Retirement System and Judicial Retirement System should also be frozen and converted to defined contribution accounts.

II. Reduce total pension benefit outlays by roughly 10% by targeting retirees with a combined pension and Social Security benefit in excess of the federal poverty threshold of USD 1,000 per month.

III. Enroll police, teachers, and judges under age 40 in Social Security (the Oversight Board believes this can be accomplished by reducing pension contributions for this group by roughly the amount of the Social Security employee contribution payroll tax).

- A break down of projected savings initiatives for the proposed transformation of the Mi Salud healthcare program;
- Better substantiation of the fiscal impact generated by proposed agency efficiency initiatives;
- An expanded role and further discussion of the proposed Office of the CFO;
- A more specific analysis of 30-year debt sustainability projections;
- An extension through FY23 (versus FY22 currently); and
- The incorporation of each component unit and subsidiary.

**PRASA**

- More detail on water quality initiatives and infrastructure investment plans;
- A review of the cash management program through December 2018 to show all anticipated cash flows, including an aggressive government collections program, an operating cost reduction program, and an accurate projection of incoming and outgoing funds;
- A break down of and revision to the capital improvement plan (CIP), properly accounting for costs of pre-existing capital projects that were superseded or made obsolete by emergency repair projects;
- An exception whereby uncertain federal funding sources, such as the USD 200mn community disaster loan and state revolving fund / rural development fund requests, are excluded;
- A description of damage assessment efforts to date and a mandate to accelerate the same, coupled with a reflection of the resulting increase in certainty and clarity to the CIP;
- Additional measures to reduce operational costs to narrow the projected deficit;
- A vision of potential actions to achieve long-term fiscal sustainability, improved water quality, and greater infrastructure resiliency, with proposed funding sources for the latter including (but not limited to) federal, additional P3s, and concessions;
- A more specific analysis of 30-year debt sustainability projections;
• An extension through FY23 (versus FY22 currently); and
• The incorporation of each component unit and subsidiary.

PREPA

• A provision for a financially sustainable utility as a baseline, regardless of future transformation plans, by including financial projections for the full term of the plan and a realistic estimate of federal funding;
• Solutions to reduce long-term costs, strengthen liquidity, and improve fiscal governance and accountability;
• Measures to increase collections, manage fuel and purchased power costs, and efficiently allocate labor;
• A more thorough review of operational savings initiatives;
• Support for the privatization of the power generation business and long-term concession of the transmission and distribution segment by providing a set of targets for a potential bidder to meet or exceed during the bidding process and by outlining the path, timeline, and parameters of the transactions;
• A more specific analysis of 30-year debt sustainability projections;
• An extension through FY23 (versus FY22 currently); and
• The incorporation of each component unit and subsidiary.
Appendix

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Terms and Abbreviations

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<th>Term / Abbreviation</th>
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<td>GO</td>
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- AA+: Issuers have very strong credit quality.
- AA: Issuers have strong credit quality.
- AA-: Issuers have high credit quality.
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- BB+: Issuers have weak credit quality. This is the highest Speculative Grade category.
- BB: Issuers have very weak credit quality.
- BB-: Issuers have extremely weak credit quality.
- CC+: Issuers have very high risk of default.
- C: Obligor failed to make payment on one or more of its financial commitments. This is the lowest quality of the Speculative Grade category.
Appendix

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