Governance and management aspects of the Puerto Rico Oversight Board

August 30, 2016

Introduction

For more than a decade, the Commonwealth of Puerto Rico, an unincorporated territory of the United States (US)[1], has been facing severe economic and fiscal challenges. A stagnant economy, persistent budgetary imbalances, lack of fiscal responsibility, and governance problems have placed Puerto Rico into its current critical state. The territory has also suffered significant reductions in its workforce and tax base due to mass emigration and an aging population.

Public debt levels have increased from $24.2 billion to $69.2 billion over the last 15 years, increasing at a rate higher than revenues and gross national product (GNP)[2]. On June 2015, the Governor of Puerto Rico declared the debt "not payable"[3]. The high debt burden and lack of sufficient liquidity led to a series of defaults, the most recent being a default on almost $1 billion[4] of bonds and general obligations that were due on July 1, 2016.

On June 30, 2016, President Obama signed the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA)[5] which grants the Commonwealth access to an orderly mechanism to resolve creditor claims and restore fiscal stability under the supervision of a seven member Oversight Board. Among its provisions, the law includes an automatic stay on all litigation against the Commonwealth's government[6].

The full impact of these measures is yet to be determined thus presenting Puerto Rico with unprecedented challenges ahead; many stakeholders are yet to obtain a comprehensive understanding of the implications of this bill and its many fronts.

To this end, we would like to offer a series of articles covering the main aspects of PROMESA and its implications on Puerto Rico's unclear future.

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[1] An unincorporated territory in American law is an area controlled by the United States government "where fundamental rights apply as a matter of law, but other constitutional rights are not available". For the purposes of PROMESA, the term "territory" means Puerto Rico, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands and the United States Virgin Islands.

[2] Puerto Rico Manufacturers Association. *Econews*, Issue 2, Volume 39. June 2016.

[3] Michael Corkery, Mary Williams Walsh. "Puerto Rico's Governor Says Island's Debts Are 'Not Payable'". *New York Times. June 28, 2015.* http://www.nytimes.com/2015/06/29/business/dealbook/puerto-ricos-governor-says-islands-debts-are-not-payable.html

[4] On June 30, 2016, the Governor of Puerto Rico declared a moratorium on the payment of principal and interest on obligations issued or guaranteed by the Commonwealth of Puerto Rico. The default was on approximately $911 million of bonds, including $779 million related to general obligation (GO) debt.

[5] H.R. 5278 passed the House on June 9, 2016 and passed to the Senate under S.2328 which was later signed into law by President Obama. Refer to: https://www.congress.gov/bill/114th-congress/senate-bill/2328?q=%7B%22search%22%3A%5B%22promesa%22%5D%7D&resultIndex=1

[6] On June 2014, the Puerto Rico Government enacted Act 71 of 2014 that would allow its public corporations to file for debt restructuring through Puerto Rico's legal system. In February 2015, a US District Court struck down that act, an opinion upheld by the US Court of Appeals for the First Circuit on July 6, 2015. On March 22, 2016, the US Supreme Court heard oral arguments for an appeal. The Supreme Court upheld the lower court's opinion on June 13, 2016, ruling that, although Puerto Rico has no access to chapter 9 of the Bankruptcy Code, the US Constitution preempts Puerto Rico's attempt to establish its own vehicle for restructuring the debts of its instrumentalities.

This first article provides an overview of PROMESA's Oversight Board, its governance and management aspects, and its implications on fiscal and budgetary planning.

Who is going to be part of the Board?

Appointment process

The Financial Oversight and Management Board (the Board) is the principal and overriding authority within PROMESA. The Board will exercise governance over Puerto Rico pursuant to article IV, section 3 of the Constitution of the United States which concedes plenary authority and power to "dispose of and make all needful rules and regulations respecting the Territory."

The Board will be comprised of seven members, six of which will be selected by the President of the United States (the President) from a list of recommendations submitted by the US House and US Senate leadership (see Figure 1).

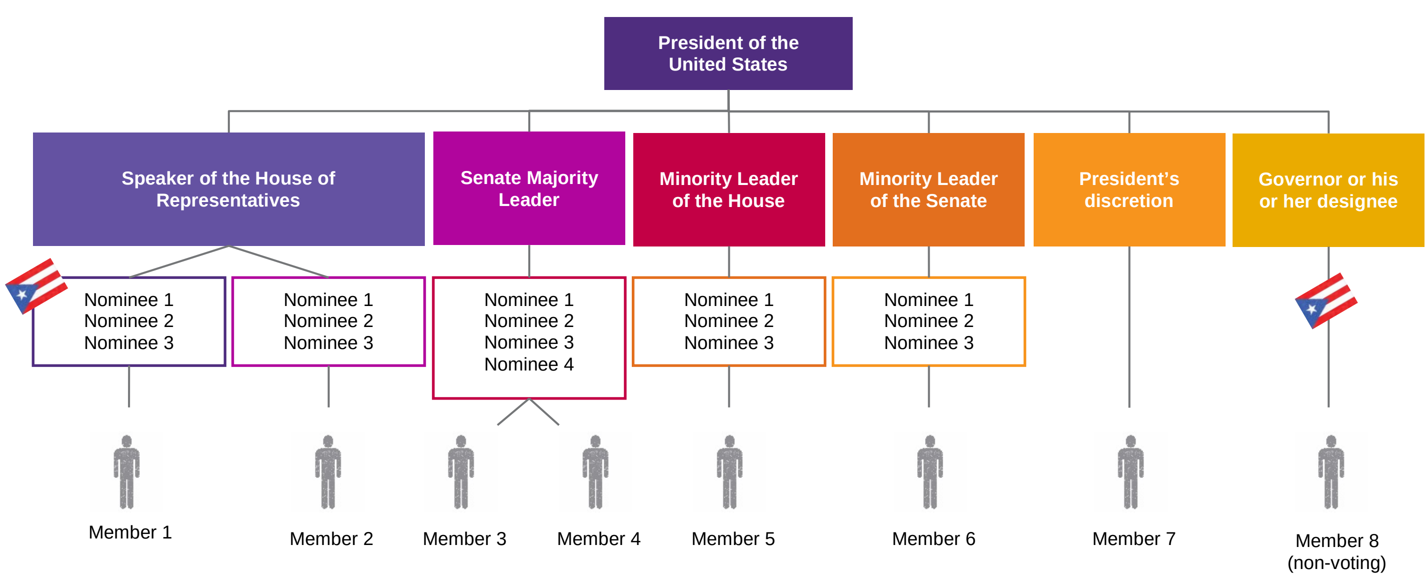
The 7th member will be selected by the President's sole discretion. In addition, the Governor of Puerto Rico or his or her designee shall serve as an 8th non-voting member of the Board; which means the Governor could participate of the Board's deliberation process but he or she would not vote on the Board's decisions.

However, subject to a majority vote of its members, the Board may conduct business in an executive session, meaning that the proceedings would be closed to the Governor or his or her designee and the general public.

Once the full Board has been confirmed, its members must designate a chair within 30 days from among the seven voting members.

Following the confirmation of Board's Chair, the Board shall develop and approve its own bylaws, rules and procedures needed to carry out its responsibilities. Once in place, these documents will be considered public documents. Each of the voting members of the Board may serve up to three (3) years. However, upon expiration of a term of office, a member of the Board may continue to serve until a successor has been appointed.

Fig. 1: Financial Oversight and Management Board appointment process



All the members of the Board shall be appointed by September 1, 2016. In the event that any of the seven members are yet to be appointed by September 1, 2016, the President shall fill the vacant from the corresponding nominee list by September 15, 2016[7].

Eligibility and requirements

PROMESA requires the Board's nominees to meet the following criteria[8]:

- has expertise in finance, municipal bond markets, management, law, or the organization or operation of business or government
- is not a candidate for elected office
- is not an elected or appointed official
- is not an employee of the territorial government
- is not a former elected official of the territorial government

Former voting members of the Board are prohibited from being a candidate for elected office in Puerto Rico as it could be perceived as being in conflict with the provision designating the governor, or his or her designee, as a non-voting member of the Board.

Where will the Board be operating?

The bill requires the Board to have an office in Puerto Rico and additional offices as it deems necessary. In addition, the Board may request, at any time, the use of any US federal agency's facilities. During these cases, the head of the corresponding US federal agency would set the terms and conditions allowing the use of their facilities by the Board.

Who will pay for the Board?

PROMESA states that members of the Board would serve without compensation, although they may be reimbursed for reasonable and necessary expenses incurred in the performance of their duties.

Nevertheless, the Congressional Budget Office (CBO) estimated that operating the Oversight Board for Puerto Rico would cost approximately $370 million over a period of five years (FY2017 to FY 2022), $200 million of which shall be disbursed during the first year. The bill requires the Government of Puerto Rico "to establish a dedicated source of funding to fully cover anticipated direct spending for the board's expenses."[9]

Operating costs estimated at $370 million over a period of five years

For these matters, the bill would require the Board to submit an annual budget to the President, the House Committee on Natural Resources, the Senate Committee on Energy and Natural Resources, and the legislature and Governor of Puerto Rico.

The Governor of Puerto Rico would be obliged to designate a dedicated funding source within 30 days of enactment of the bill. Once initially approved, the legislature would not be able to subsequently retire the funding source by means of appropriations. In the case no funding source is designated, PROMESA allows the Board to use its powers with respect to Puerto Rico's fiscal budget to ensure that there are sufficient funds to cover its operations.

[7] Provided that such list includes at least two (2) individuals per vacancy who meet the established requirements and are willing to serve on the Board.
[8] Section 101

[9] CBO, "H.R. 5278: Puerto Rico Oversight, Management, and Economic Stability Act, as ordered reported by the House Committee on Natural Resources on May 25, 2016," June 3, 2016; https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/costestimate/hr5278.pdf.

How powerful the Board will be?

Section 104 of PROMESA describes the Board's broad powers. The Board will have the power to:

- hold hearings and seek testimony
- obtain information, including written and electronic documents and data, from federal agencies (with the consent of the agency head) and agencies and entities of the government of Puerto Rico
- obtain creditor information on the nature and aggregate amount of claims or other economic interests held by each creditor or organized group of creditors seeking to participate in voluntary negotiations
- accept, use, and dispose gifts, bequests, and donations of real and personal property for the purpose of aiding or facilitating the work of the Board[10]
- issue subpoenas
- request administrative support services from the US General Services Administration (GSA)
- enter into contracts
- enforce laws of Puerto Rico prohibiting public sector employees from participate in a labor strike or lockout
- initiate civil actions to carry out its responsibilities
- investigate how Puerto Rico government bonds were sold to small investors
- certify voluntary debt restructuring agreements entered with bondholders as long as it provides a sustainable level of debt and is in accordance with the approved fiscal plan
- in consultation with the Governor, the Board may "ensure the prompt and efficient payment and administration of taxes through the adoption of electronic reporting, payment and auditing technologies[11]

What does the Board's fiscal plan entails?

Responsibilities of the Board

In broad terms, the main purpose of the Board is to provide a method for Puerto Rico to achieve "fiscal responsibility" and "access to capital markets". One method the Board has to achieve this objective is through the enforcement of balanced budgets and the development and certification of a fiscal plan.

Covering a minimum of five (5) fiscal years, the fiscal plan would initially be developed by the Governor of Puerto Rico and formally submitted to the Board for review, approval and certification. PROMESA outlines three (3) ways by which a fiscal plan may be certified as "compliant" with the 14 requirements outlined in Section 201(b) of the bill, which includes:

1. A fiscal plan submitted by the governor and approved by the Board: If the submitted fiscal plan meets the requirements outlined in the bill, the Board shall determine the fiscal plan as approved. If the plan is found to be deficient then the Board could issue a "notice of violation" which includes recommendations to correct the deficiencies.

2. A fiscal plan developed and approved by the Board: If the governor fails to take corrective actions based on the items outlined on the notice of violation, then the Board, at its sole discretion, could develop and submit a fiscal plan together with a compliance certificate to the governor and legislature and the plan would be considered approved.

3. A fiscal plan jointly developed by the Board and the Governor: The bill allows the Board and Governor to work collaboratively to develop a consensus fiscal plan.

[10] Subject to public disclosure of the identity of donor(s) within 30 days of the receipt of a gift.
[11] Section 104(m)

Requirements of the fiscal plan

Section 201(b) of PROMESA establishes the requirements for the fiscal plan:

a) provide for estimates of revenues and expenditures
b) ensure the funding of essential public services
c) provide adequate funding for public pension systems
d) provide for the elimination of structural deficits
e) provide for a debt burden that is sustainable
f) improve fiscal governance, accountability, and internal controls
g) enable the achievement of fiscal targets
h) create independent forecasts of revenue for the period covered by the Fiscal Plan
i) include a debt sustainability analysis
j) provide for capital expenditures and investments necessary to promote economic growth
k) adopt appropriate recommendations submitted by the Board
l) include additional information as the Board deems necessary
m) ensure that assets, funds, or resources are not loaned to, transferred to, or otherwise used for the benefit of another territorial instrumentality, unless permitted
n) respect the lawful priorities or lawful liens with respect to a territorial instrumentality

Ensuring compliance with the fiscal plan

To ensure compliance with the approved fiscal plan, the Board may, at any time, submit recommendations to the Governor or the Legislature on measures the government shall adapt to ensure compliance with the fiscal plan. These actions (see Table 1[12]) are based on four (4) main platforms: promoting financial stability, economic growth, management responsibility, and efficiency in the delivery of services.

The Governor or Legislature will have 90 days to incorporate such recommendations. If the Government rejects the recommendations of the Board, then the Governor or the Legislature would be required to submit a statement to the President and Congress explaining why the recommendations were rejected .

[12] Section 205(a)

Table 1: Oversight Board recommendations to ensure compliance with approved

	Board deliverables	Financial stability	Economic Growth	Management responsibility	Service delivery efficiency
1.	management of financial affairs, including economic forecasting and multiyear fiscal forecasting capabilities, information technology, placing controls of expenditures for personnel, reducing benefit costs, reforming procurement practices, and placing other controls on expenditures	x		x	x
2.	the modification of existing revenue structures, or the establishment of additional revenue structures	x	x		x
3.	the privatization and commercialization of entities within the territorial government		x	x	x
4.	the establishment of alternatives for meeting obligations to pay for the pensions of government employees	x		x	
5.	the effects of the territory's law and court orders on the operations of the territorial government	x		x	x
6.	the establishment of a personnel system for government employees based on employee performance standards			x	x
7.	the improvement of personnel training and proficiency, the adjustment of staffing levels (layoffs), and the improvement of training and performance management for supervisory personnel			x	x
8.	modification of structural relationship of departments, agencies, and independent agencies			x	x
9.	modifications or transfers of the types of services that are the responsibility of, and are delivered by the government	x		x	x
10.	modifications of the type of services that are delivered by entities other than the government under alternative service delivery mechanisms	x		x	x

Annual and quarterly budgets

Once a fiscal plan is approved, the governor shall submit annual and quarterly budgets which must be in full compliance with the approved fiscal plan.

Initially, the Board would facilitate the Governor a notice delineating a schedule for the development, submission, approval, and certification of the budget. Within this schedule, the Board will be determining the number of fiscal years to be covered in the budget. In addition, the Board will be submitting revenue estimates for the period covered by the budget for use by the Governor.

Similar to the Fiscal Plan process, the bill provides various methods the Governor could use to develop such budget:

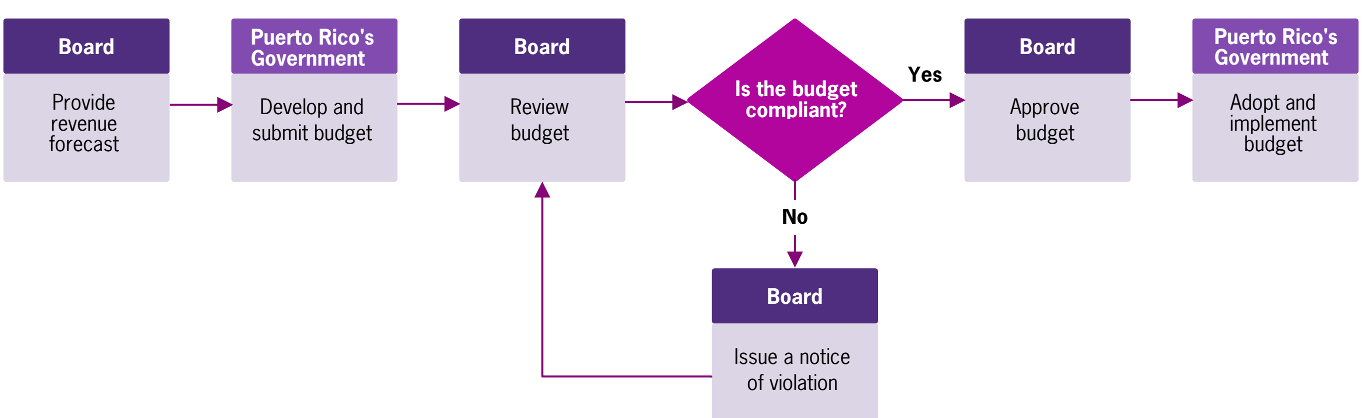
Budget submission by governor: If the proposed budget is certified as compliant, the Board would approve it and submit it to the legislature for approval. If inconsistencies are found, a notice of violation would be issued.

Oversight Board budget: If the governor fails to submit a compliant budget, then the Board would develop a compliant budget and submit it to the governor and legislature.

Budget adopted by legislature: The bill allows Puerto Rico's legislature to develop a compliant budget. In the same way as submitted by the Governor, if the Board finds inconsistencies, a notice of violation would be issued.

Figure 2 illustrates the approval process for the development and submission of budgets. The bill would require the Governor to submit quarterly "budget vs actual" reports in the areas of revenues, expenditures, and cash flows. Inconsistencies identified within these reports would require explanation and corrective action by the Governor. If the Governor fails to take corrective action, the Board would be required to notify the US House Committee on Natural Resources and the US Senate Committee of Energy and Natural Resources. PROMESA allows the Board to direct the territorial government to take corrective action. In addition, if the government fails to do so, the Board has the powers to address the inconsistencies directly by reducing non-debt expenditures, instituting hiring freezes and prohibiting the government from entering into any contract or financial transaction not previously approved by the Board.

Fig. 2: Budget approval process



Review of enacted laws and contracts

Section 204 of PROMESA expands further the Board's powers by granting it the ability to review any proposed legislation and all enacted laws passed by the Government for consistency with the budget and the fiscal plan. Any new laws enacted under the Board's effectiveness period shall be accompanied by a formal cost estimate describing the impact the law will have on revenues and expenditures. If the enacted law is found to be inconsistent with the Board's fiscal efforts, the Board could take action to prevent the enforcement or application of the law.

The approval of the fiscal plan also has a direct effect on all contracts, rules and regulations executed by the government.

In the first place, PROMESA requires the Government to prepare and maintain a public registry of all contracts executed, including amendments thereto.

The Board has the power to review and approve certain contracts with a governmental entity or corporation in order to "promote market competition" and ensure such contracts are not "inconsistent with the approved fiscal plan".

Finally, the Board will have the authority to take any necessary action to ensure that any contract will not adversely affect compliance with the fiscal plan, including preventing its execution or enforcement. These review and revocation powers expand to rules, executive orders and regulations enacted by the governor or the legislature.

However, the Board shall not interfere with any administrative order or settlement with a federal agency regarding federal programs.

Reporting requirements for the Board

In order to promote the Board's accountability, PROMESA's Section 208 declares that the Board shall submit an annual report to the President of the US, Congress, the Governor and the legislature describing:

1. the progress made in meeting the objectives of the act
2. the assistance provided to the territorial government
3. recommendations that would assist the territorial government in complying with the fiscal plan for the year

The Board would also issue quarterly reports on cash flows available to pay debt service affected by a stay or moratorium, if feasible.

Tax abatements

In addition to the financial and budgetary reporting requirements, PROMESA requires the Governor to submit to the Board, within six months of its establishment, a report documenting all existing tax abatement or similar tax relief agreements. The Board reserves the power to execute or modify any tax abatement or relief agreement without limits to what constitutes the limit of power.

This report would not be disclosed to the public in order to comply with all applicable territorial and federal laws and regulation regarding the handling of confidential taxpayer information.

For how long would the Board operate?

The Board would be operating until it determines and certifies that Puerto Rico has achieved the following:

- obtained access to short-term and long-term credit markets at reasonable rates of interest, and
- balanced budgets for four (4) consecutive fiscal years.

Summary: Puerto Rican Government vs. Fiscal Oversight Board responsibilities

Area	Oversight Board	Puerto Rican government
Membership	Seven members will be appointed by the President of the United States	Governor or his or her designee may participate as an 8th non-voting member
Board funding	Ensure that there are sufficient funds to cover its operation	Designate a dedicated funding source within 30 days of the enactment of the bill
Fiscal plans	• Review and approve fiscal plan[13] developed by the government • If the government fails to develop a compliant fiscal plan, the Board shall develop and certify a fiscal plan • Oversee the approved fiscal plan's compliance over its effective period	• Develop a compliant five-year fiscal plan • Submit fiscal plan for review (the government will only have an additional chance to submit a compliant fiscal plan incorporating Board's recommendations) • If the government fails to develop a compliant fiscal plan, the government shall accept the plan developed by the Board
Budgets	• Review and approve budget[14] developed by the government • If the government fails to develop a compliant budget, the Board shall develop and certify a budget	• Develop a compliant annual and quarterly budgets • Submit budgets for review (the government will only have an additional chance to submit a compliant budget incorporating Board's recommendations) • If the government fails to develop compliant budgets, the government shall accept the budgets developed by the Board
Financial reporting	• Review quarterly "budget vs actual" reports for compliance with fiscal plan • If inconsistent, direct the government to take corrective action. If government fails to do so, address inconsistencies directly • Notify the US House Committee on Natural Resources and the US Senate Committee of Energy and Natural Resources	• Submit quarterly "budget vs actual" reports in the areas of revenues, expenditures and cash flows • Take corrective action for variations, if necessary
Austerity measures	• Implement austerity measures, for example: - reduce government's non-debt expenditures, - implement hiring freezes - prohibit contracts or financial transactions - layoffs in the public sector	Adopt proposed measures
Contracts	• Enter into new contracts without Governor's approval • Review and approve new contracts • Revoke any existing contract	• Required to prepare and maintain a public registry of all contracts executed • Required to submit contracts for review by the Board
Legislation and enacted laws	• Certify and amend any proposed or new law • Revoke or amend any existing law, regulation or executive order	For any newly enacted law, submit a formal cost estimate
Financial stability and management responsibility	Submit recommendations to address fiscal and management matters, e.g. - privatization of public entities - alternatives for paying employee pension - performance-based personnel systems - modification or transfers of the type of services delivered by governmental entities	Adopt recommendations within 90 days. If rejected, the governor or legislature must submit a statement to the President of the US and to US Congress explaining why the recommendations were rejected
Debt issuance	• Authorize debt issuance and other transactions • Investigate how Puerto Rico government bonds were sold to small investors	Prohibited to issue debt or enter into related transactions as long as the Board remains in place without the Board's approval
Reporting	Develop an annual progress report directed to the US Congress, the president and the Puerto Rico governor	Report on any tax relief agreements or abatements
Tax abatements and relief agreements	Execute or modify any tax abatement or relief agreement(s)	Prepare a report documenting all existing tax abatement or tax relief agreements within six months of the establishment of the Board
Termination of Board	The Board will operate until it determines and certifies that Puerto Rico has achieved the following: • obtained access to short-term and long-term credit markets at reasonable rates of interest • balanced budgets for four (4) consecutive fiscal years	Prohibited from enacting any laws or taking any actions that would interfere with or attempt to nullify the actions or activities of the Board[15]

[13] Subject to a majority vote
[14] Subject to a majority vote
[15] Section 108

Closing remarks

It's long been accepted that knowledge is power, but in the complex fiscal and political landscape we face, the equation faces its own limitations.

As Puerto Rico stands on the verge of what possibly could be a new form of government, it is crucial for citizens and stakeholders alike to be informed of PROMESA's diverse implications, especially when most of these measures haven't been tested before.

We invite you to continue to explore with us the many aspects of this piece of legislation in our future articles.

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