

Subcommittee on Indian, Insular and Alaska Native Affairs

Don Young, Chairman

Hearing Memorandum

January 29, 2016

To: All, Subcommittee on Indian, Insular and Alaska Native Affairs Committee Members

From: Majority Committee Staff, 6-7925
Subcommittee on Indian, Insular and Alaska Native Affairs

Hearing: Oversight hearing on “*The Need for the Establishment of a Puerto Rico Financial Stability and Economic Growth Authority*”

The Subcommittee will hold an oversight hearing on **Tuesday, February 2, 2016 at 11:00 a.m. in room 1334 Longworth** titled: “*The Need for the Establishment of a Puerto Rico Financial Stability and Economic Growth Authority.*” The purpose of this hearing is to provide commentary on a possible solution to the Puerto Rican debt crisis, which will emphasize improved management policies and long-term sustainability.

Policy Overview

- Puerto Rico’s mounting debt is expected to grow by \$27 billion over the next five years, adding onto the already \$70 billion owed by the Commonwealth. Debt restructuring alone will not be sufficient to ensure Puerto Rico’s future financial security.
- The Puerto Rico legislature has had the opportunity to enact a number of financial and structural reforms that would assist in alleviating the growing debt crisis. However, as demonstrated by the legislature’s failure to pass a deal that would restructure Puerto Rico’s public utility’s debt, such legislative action is in serious doubt.
- Any United States involvement in Puerto Rico’s crisis must specifically address Puerto Rico’s creditworthiness, the lack of labor participation and employment on the island, and the myriad of regulatory and infrastructure barriers that hinder renewed business development.

Invited Witnesses

The Honorable Anthony A. Williams
Senior Advisor, Dentons US LLP
(Former Mayor of Washington, D.C., 1999-2007)
Washington, DC

Mr. James E. Spiotto
Managing Director
Chapman Strategic Advisors LLC
Chicago, IL

Mr. Carlos M. Garcia
Chief Executive Officer
BayBoston Managers LLC
(Former Chairman and President of the Government Development Bank of Puerto Rico)
Newton Center, MA

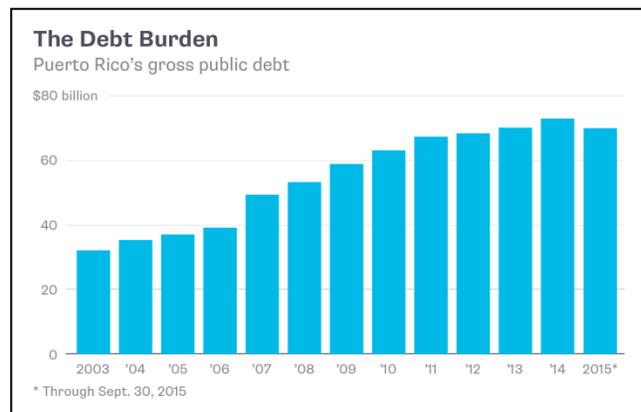
Professor Simon Johnson
Professor of Global Economics and Management
MIT Sloan School of Management
Cambridge, MA

Mr. Thomas Moers Mayer
Partner, Kramer Levin Naftalis & Frankel, LLP
New York, NY

Background

Today, the Commonwealth of Puerto Rico finds itself in dire economic circumstances. As of the end of 2015, it had over \$70 billion of debt – excluding pension obligations, which exceed \$40 billion. The debt is expected to grow by another \$27 billion over the next 5 years.¹ Puerto Rico’s fiscal situation was further compromised on January 4, 2016 when Puerto Rico defaulted on \$174 million owed to holders of municipal debt in order to cover higher-priority general obligation debt payments.²

Many observers on and off the island have called for U.S. federal intervention. If such federal involvement is to occur, it must provide a comprehensive plan to mitigate the debt crisis and jumpstart growth – specifically, it must address 1) Puerto Rico’s creditworthiness; 2) lack of labor participation; and 3) regulatory and infrastructure barriers that impede business development.



Puerto Rico’s Lack of Creditworthiness has Hastened the Fiscal Crisis

Since 2000, public sector debt has grown each year – reaching 100% of gross national product (GNP) at the end of Fiscal Year (FY) 2014.³ Such a dramatic rise in public sector debt

¹ Working Group for the Fiscal and Economic Recovery of Puerto Rico, Puerto Rico Fiscal and Economic Growth Plan Update Presentation, at 4, 13, Jan. 18, 2016, available at <http://www.bgfpr.com/documents/PRFEGPUupdatePresentation1.18.16-2.pdf>.

² Mary Walsh, “Puerto Rico Defaults on Debt Payments”, Jan. 4, 2016 available at http://www.nytimes.com/2016/01/05/business/dealbook/puerto-rico-defaults-on-debt-payments.html?_r=0.

³ Krueger, Teja, and Wolfe, “Puerto Rico – A Way Forward”, at 9, June 29, 2015, available at <http://www.bgfpr.com/documents/puertoricoawayforward.pdf>.

carried adverse market views, and as such, Puerto Rico saw its credit ratings collapse to below investment grade.⁴ Without confidence from traditional municipal bond investors, Puerto Rico turned towards new investors that demanded “higher risk premia, shorter maturities, and greater seniority.”⁵ For instance, in 2006 general obligation bonds were priced to yield 4.8%, whereas bonds issued in March 2014 were to yield 8.7%.⁶ Essentially, the fall to below investment grade helped exacerbate Puerto Rico’s financial crisis.

The new reality for Puerto Rico is that credit agencies view its economic health on par, if not worse, than Venezuela’s.⁷ Credit rating service Standard & Poor’s (S&P) cited the Commonwealth’s “very weak liquidity and difficulty in obtaining external market access” and “delay in enacting a budget” as justification when downgrading Puerto Rico to CCC-, a rating that is indicative of a substantial risk of default.⁸ Furthermore, S&P viewed Puerto Rico’s forthcoming fiscal gaps for years 2016 through 2018 as “unmanageable.” These concerns were similarly echoed by Moody’s.⁹ Both agencies agreed the restoration of a sufficient liquidity position to prevent defaults, and the enactment of a sustainable fiscal plan would help mitigate the negative trend and revise the ratings upwards.

One avenue available to Puerto Rico to obtain debt relief and increased liquidity is via “voluntary exchange[s] of old bonds for new ones with a [modified] debt service profile.”¹⁰ Demonstrating this, the Puerto Rico Electric Power Authority (PREPA), which holds the highest portion of public debt at approximately \$8 billion, reached a consensual agreement with creditors on December 22, 2015.¹¹ Approximately 70% of PREPA’s bondholders agreed to the restructuring agreement, which would provide debt-service relief of \$700 million to PREPA over five years.¹² Furthermore, the deal encouraged necessary structural reforms within PREPA to be made. However, the agreement was contingent on the passage of authorizing legislation by the Puerto Rican legislature before January 22, 2016. The legislature failed to do so, yet per further negotiations between PREPA and the creditors the deadline has been moved to February 16.¹³

⁴ *Id.*, at 3.

⁵ *Id.*

⁶ Working Group for the Fiscal and Economic Recovery of Puerto Rico, Puerto Rico Fiscal and Economic Growth Plan, September 9, 2015, *available at* <http://www.bgfpr.com/documents/PuertoRicoFiscalandEconomicGrowthPlan9.9.15.pdf>.

⁷ See Trading Economics, Puerto Rico | Credit Rating, *available at* <http://www.tradingeconomics.com/puerto-rico/rating>.

⁸ Standard & Poor’s Ratings Services, Ratings Direct: Puerto Rico GO Rating Lowered To ‘CCC-’ From ‘CCC+’, June 29, 2015, *available at* http://www.bgfpr.com/investors_resources/documents/InformeSPDowngrade29junio2015.pdf.

⁹ Moody’s, Moody’s Downgrades Puerto Rico GDB notes to Ca from Caa1, GOs to Caa2 from Caa1; outlook negative, May 21, 2015, *available at* https://www.moodys.com/research/Moodys-downgrades-Puerto-Rico-GDB-notes-to-Ca-from-Caa1--PR_325985.

¹⁰ Krueger, at 21.

¹¹ Lisa Donahue, Testimony before the Subcommittee on Energy and Mineral Resources Oversight Hearing: Exploring Energy Challenges and Opportunities Facing Puerto Rico, Jan. 12, 2016, *available at* http://naturalresources.house.gov/uploadedfiles/testimony_donahue.pdf.

¹² *Id.*

¹³ Nick Brown, Puerto Rico’s PREPA, creditors revive restructuring deal, *available at* <http://www.reuters.com/article/usa-puertorico-prepa-idUSL2N15C08K>.

Despite PREPA's efforts, recent events, including the Puerto Rican legislature's failure to pass debt relief legislation, have demonstrated Puerto Rico is unlikely to achieve the needed results that would result in positive credit ratings. On January 18, 2016 the Government Development Bank (GDB) of Puerto Rico released an update to the Fiscal and Economic Growth Plan. This update reiterated "that the Commonwealth does not have a sufficient projected surplus to pay existing contractual debt service" and decreased the forecast General Revenue funds from \$9.46 billion to \$9.21 billion for FY 2016.¹⁴ In turn, the estimated five-year projected fiscal gap has increased from approximately \$14 billion to \$16.1 billion.¹⁵

Labor Laws and Welfare have Hindered the Development of the Puerto Rican Labor Force

The Commonwealth of Puerto Rico has a population of 3.5 million residents, yet "only 40% of the adult population – versus 63% on the [United States] mainland – is employed or looking for work."¹⁶ Furthermore, nearly a quarter of those in the workforce work for the Puerto Rican government, which makes it the largest employment sector on the island.¹⁷ A GDB funded study, entitled "Puerto Rico – A Way Forward" (Krueger Report), diagnosed these symptoms as being the consequences of two realities to doing business within Puerto Rico: 1) the high cost to employers, and 2) the generous welfare system.¹⁸

Employers find it costly to hire in Puerto Rico due to a comparatively high minimum wage, and "local regulations" that permit "more onerous" benefits, such as overtime and paid vacation, than on the continental United States.¹⁹ These benefits have assisted in the promotion of an illegitimate "grey economy," which exists outside of the tax system of Puerto Rico.²⁰ In turn, some estimates suggest the Puerto Rican government only collects about 56 cents of every dollar its due from sales tax.²¹

Second, many within Puerto Rico are disincentivized from participating in the economy due to available welfare benefits. The Krueger Report detailed that "a household of three eligible for food stamps, [Aid to Families with Dependent Children], Medicaid and utilities subsidies could receive \$1,743 per month – as compared to a minimum wage earner's take-home earnings of \$1,159."²²

¹⁴ Working Group for the Fiscal and Economic Recovery of Puerto Rico, Puerto Rico Fiscal and Economic Growth Plan Update Presentation, at 4, 13, Jan. 18, 2016, *available at* <http://www.bgfpr.com/documents/PRFEGPUpdatePresentation1.18.16-2.pdf>.

¹⁵ *Id.* at 4.

¹⁶ Krueger, at 6.

¹⁷ See Bureau of Labor Statistics, Economy at a Glance: Puerto Rico, *available at* <http://www.bls.gov/eag/eag.pr.htm>.

¹⁸ Krueger, at 6-7.

¹⁹ Krueger, at 6.

²⁰ Luciana Lopez, "Desperate for taxes, Puerto Rico tries to get grip on underground economy," April 9, 2014, *available at* <http://www.reuters.com/article/us-usa-puertorico-economy-insight-idUSBREA380BS20140409>.

²¹ *Id.*

²² Krueger, at 7.

To address these issues, the GDB has proposed private sector labor reform, as well as measures that would stimulate employment and labor force participation.²³ However, any such reforms are contingent on federal assistance, and action by the Puerto Rican legislature. Thus, it is unclear whether Puerto Rico will be able to stimulate the labor force and economy if left alone.

Regulatory and Infrastructure Barriers have Curtailed Business Development

The World Bank found that Puerto Rico ranked 57th out of 189 countries for “ease of doing business,” whereas the United States was ranked 7th.²⁴ This poor ranking for Puerto Rico reflects the difficulties businesses encounter when – among other issues – “registering property” (ranked 164th), “dealing with construction permits” (ranked 135th), and “getting electricity” (ranked 57th).²⁵ As such, business development within the Commonwealth has been obstructed by poor infrastructure and various regulatory barriers.

One of the primary hindrances to economic growth is the poor state of infrastructure on the island. For instance, as of 2012, over 80% of PREPA’s electric generation capacity was “installed in 1977 or earlier.”²⁶ This outdated infrastructure is inefficient and costly, relying on oil for generation – by comparison only 1% of the United States electric generation was from petroleum.²⁷ The decades of neglect have led to a modernization cost estimated at \$4.67 billion to \$5.72 billion over the next 20 years, of which nearly \$2 billion is comprised of crucial and recommended transmission upgrades.²⁸ Similar to electrical infrastructure, much of the Commonwealth’s ports, roads, and bridges are in “need of substantial capital investments,” which are estimated to cost approximately \$3.3 billion.²⁹

Additionally, doing business in Puerto Rico is difficult because of costs and “barriers to competition and business activity.”³⁰ The GDB recognized that Puerto Rico’s loss in business competitiveness must be addressed by equipping Puerto Rico “with a business-friendly environment that is conducive to sustained economic growth.”³¹ To do so, the GDB recommended legislation be introduced in Puerto Rico that centralize permit applications, update how local agencies interact with the federal permitting process, and require municipalities to adopt simplified, uniform general permitting regulations.³²

²³ Working Group for the Fiscal and Economic Recovery of Puerto Rico, Puerto Rico Fiscal and Economic Growth Plan, at 21-23, Sept. 9, 2015, *available at* <http://www.bgfpr.com/documents/PuertoRicoFiscalandEconomicGrowthPlan9.9.15.pdf>.

²⁴ World Bank Group, “Economy Rankings,” <http://www.doingbusiness.org/rankings>.

²⁵ World Bank Group, “Ease of Doing Business in Puerto Rico”, <http://www.doingbusiness.org/data/exploreeconomies/puerto-rico/>

²⁶ Alvarez & Marsal, Presentation to the Government Development Bank of Puerto Rico, at 20 (2012).

²⁷ U.S. Energy Information Administration, FAQ: What is U.S. electricity generation by energy source?, <https://www.eia.gov/tools/faqs/faq.cfm?id=427&t=3>.

²⁸ Siemens, Integrated Resources Plan *prepared for* Puerto Rico Electric Power Authority, Volume I, 6-10, 7-13 (2015).

²⁹ Puerto Rico Fiscal and Economic Growth Plan, at 29.

³⁰ Krueger, at 8.

³¹ Puerto Rico Fiscal and Economic Growth Plan, at 27.

³² *Id.*

Furthermore, the GDB encouraged the adoption of a “pro-growth tax regime” that “lowers nominal tax rates and eliminates loopholes and unnecessary complexity.”³³ In enacting these changes, Puerto Rico would remove the requirement for businesses and employers to navigate the complex and confusing bureaucratic maze that currently exists within the Commonwealth.

With \$23.1 billion of debt held by PREPA and other municipal entities tasked with constructing and improving infrastructure, making the requisite financial upgrades to key infrastructure is daunting, as it remains unclear how Puerto Rico will gain access to financial avenues necessary to fund it. As with many other necessary structural reforms required on the island to promote sustainability and growth, the Puerto Rican legislature must act.

Given the depth of its financial crisis, Puerto Rico’s political will to remove barriers for business development on its own is questionable at best. Witnesses will testify at this hearing about the serious immediate challenges facing Puerto Rico and explore possible short-term and long-term solutions.

³³ *Id.*, at 25.