

DRAFT FINAL REPORT

ADB TA-4539 (FSM): Legislation for Private Sector Development (SSTA)

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ABBREVIATIONS

ADB	Asian Development Bank (also called “the Bank”)
APA	Administrative Procedures Act
AV	All Venture Trading Ltd.
CCA	Chuuk Coconut Authority
CDA	Coconut Development Authority (FSM)
DEA	Department of Economic Affairs
EDA	Economic Development Authority (Pohnpei)
FIAS	Foreign Investment Advisory Service
FIAS I	first round of FSM foreign investment reform (late 1990’s)
FIAS II	second attempt at FSM foreign investment reform (1999-2000)
FSM	Federated States of Micronesia
IDF	Investment Development Fund
LTFV	Luen Tai Fishing Venture, Inc.
NAC	National Aquaculture Center
OFCF	Overseas Fishery Cooperation Foundation
PCFV	Pohnpei Commercial Fishing Venture
PSD	Private Sector Development
PSDP	Private Sector Development Program
PSE	public sector enterprise
TA	technical assistance

NOTE

In this report, \$ refers to US dollars
and dates given without a year are in 2005

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EXECUTIVE SUMMARY

The focus of this TA was to encourage and assist the national and four state governments of the FSM to meet certain conditions in order to qualify for the second tranche of the PSDP Loan. The current tally, by government and by issue, is as follows:

National Government—on track to qualify

Qualified on transformation. Still on track to qualify on foreign investment reform.

Chuuk State—not qualified

Not qualified on transformation, foreign investment reform, or leasing/mortgaging reform.

Kosrae State—on track to qualify

Qualified on leasing/mortgaging reform. Still on track to qualify on transformation and foreign investment reform.

Pohnpei State—not qualified

Qualified on transformation. Not qualified on foreign investment reform or leasing/mortgaging reform.

Yap State—on track to qualify

Qualified on transformation. Still on track to qualify on foreign investment reform and leasing/mortgaging reform.

Both before and during the consultancy, considerable progress was made. This report highlights the achievements, identifies the shortcomings, and suggests areas for future assistance.

INTRODUCTION

In 2002, the ADB entered into two companion loans—a Policy or Program Loan and an Investment or Project Loan—whereby the Bank lent money to the FSM National Government, which relented most of it to the states, for private sector development (PSD). The Program Loan is disbursable in two tranches. Several conditions are established for each FSM government before the second tranche can be released. Those conditions must be satisfied by the National Government and at least two of the states before any money will be released (and then, of course, it will only be released for the governments that have qualified).

Upon the inception of this consultancy, some of the conditions for second tranche qualification had already been met. Others were the primary focus of the on-site Project Manager. Three of the conditions, however, were the primary focus of this consultancy. They are the conditions relating to public enterprise transformation, foreign investment, and land leasing and mortgaging. As stated in Sections 5, 7 and 8 of Attachment 2 to Schedule 3 of the Policy Loan Agreement, the conditions are as follows:

- The FSM governments “shall have amended their foreign investment laws and/or regulations to streamline the application process and improve the consistency, transparency and fairness of the regulatory environment for foreign direct investment.”
- “The legislative branches of the States shall have passed legislation improving the legal environment for long term leasing of land and for encouraging mortgage-secured commercial lending.”
- The FSM governments “shall have transformed one public enterprise each.”

The deadline for second tranche qualification came and went several times, only to be extended. Early in the consultancy, a final deadline of November 1, 2005, was agreed to by all parties. As the new deadline approached, it became clear that none of the governments would qualify by then, but some would be very close. In particular, each of the governments that was still on track to qualify at all—namely Kosrae, Yap, and the National Government—fell behind schedule in adopting new foreign investment regulations; by November 1 the regulations had been formulated and officially published, but the period for public comment prior to final adoption had not yet run. Also, Kosrae’s PSE transformation was running behind because the first request for proposals failed to yield any sufficiently responsive ones. Finally, the Yap legislature needed another week or two to consider the bills before them.

In response to the first of these grounds for delay, and with the Project Officer’s approval, the consultant informed officials it would suffice if foreign investment regulations were published by November 1 and completed in a timely manner thereafter. Regarding the delays in the Kosrae transformation and Yap legislation, the consultant said he would consider it sufficient if they were completed by the time the regulations should be

completed, but could not commit the Bank. The Project Officer has since agreed with this view. All the outstanding conditions should be met, if they are going to be met at all, by mid-December.

Since the production and proof of finally adopted statutes and regulations is of such importance here, a synopsis of the procedures for accomplishing this is attached as Appendix S.

FOREIGN INVESTMENT LAW REFORM

Background

First Round—“FIAS I”. Until the late 1990’s, control of foreign investment in the FSM was by the National Government pursuant to an outdated law left over from the UN Trust Territory days. The states complained about slow processing, insufficient sensitivity to local concerns, and usurpation of power by the National Government. Except for a few business sectors of undisputed national interest, there was general agreement at all levels in the FSM that decentralizing the control of foreign investment to the states was a good idea.

While the states sought decentralization, development experts and foreign investors were concerned about the restrictiveness and lack of transparency in the existing law. The Foreign Investment Advisory Service (FIAS), a joint facility of the International Finance Corporation and The World Bank, was requested to do a review. FIAS proposed the “stoplight system” of red, amber, and green lists that was subsequently adopted by the National Government in 1997 and three of the states soon thereafter. (Pohnpei already had a foreign investment control regime of its own design and did not wish to adopt the same approach as the other FSM governments.)

Goals of FIAS I. The FIAS proposals had four goals: (1) decentralization, (2) uniformity of structure, (3) making the rules less restrictive, and (4) making the rules more transparent. Only the first of these goals was achieved, and this came at considerable cost. Perhaps the greatest cost was that a foreign investor who wished to engage in business in two or more states—for example, a lawyer representing clients throughout the FSM—could no longer do so by obtaining a single national foreign investment permit, but had to obtain a permit from every state. Apparently this cost was believed to be worthwhile in light of the other expected benefits. For the most part, however, those other benefits never materialized because the other three goals of the reform were not achieved.

Uniformity in the structure of all five laws—although not necessarily in the specific policies expressed through that structure—was seen as important for two reasons. The laws would be more comprehensible to potential investors who had to comply with more than one of the laws. And proper coordination between appropriate authorities would produce better statistics. Pohnpei’s decision to opt out of the proposals probably spelled failure from the beginning, but some other states have also introduced far too much variability into the stoplight system to permit much benefit from the remaining similarity.

Given a history of troubled attempts at cooperation between the five governments, and especially the continuing jurisdictional disputes between the states and the National Government—specifically, whether regulating foreign investment is within the constitutional authority of the states or the National Government—the goal of uniformity is probably a lost cause.

The third goal, making rules less restrictive, refers to eliminating or reducing various restrictions based on minimum local or maximum foreign equity, minimum local employment, minimum investment levels, minimum export requirements, intrusive application or reporting requirements, prohibition of all foreign investment in large numbers of sectors, etc. Some of these were explicit requirements and all were implicit possibilities under the prior law.

The fourth goal, making rules more transparent, aimed at reducing the amount of unbridled discretion afforded to the regulators. The criteria for obtaining and retaining a foreign investment permit should be clearly stated ahead of time and uniformly applied to all applicants. In most cases, a potential investor should be able to predict accurately how he will fare with a particular investment proposal just from reading the act and regulations.

While there was some small improvement in the areas of restrictiveness and transparency in the first round of foreign investment law reform in the 1990's, these goals were mostly subverted by changes that each government made to the FIAS proposals during adoption.

Second Round—“FIAS II”. At the request of the National Government's Department of Economic Affairs (DEA), FIAS returned to the FSM and prepared a September 1999 report entitled “National and State Foreign Investment Legislation Review.” The ADB contracted with this consultant to review that FIAS report and all existing foreign investment legislation, propose specific amendments to that legislation for review by FIAS and the governments, and travel briefly with FIAS through the FSM in 2000 to discuss these changes with interested officials. Some refinements were made to the proposed amendments, generally to reflect ways of addressing local concerns in more transparent ways.

At about the same time, the ADB started putting together the PSDP Loan that is the subject of the current consultancy. The second round reform proposals became the basis for the second tranche condition regarding foreign investment—namely, that the FSM governments “shall have amended their foreign investment laws and/or regulations to streamline the application process and improve the consistency, transparency and fairness of the regulatory environment for foreign direct investment.” Sec. 7, Attachment 2 to Schedule 3, Program Loan Agreement.

Five years on, at inception of the current consultancy, none of the governments had satisfied that condition, and few had even tried. Now, at the end of this consultancy, two and possibly three of the governments are on the verge of complying.

Status Summary

In assessing status, it is important to bear in mind that the FIAS scheme for foreign investment in the FSM is highly dependant upon regulations. In each government, the statute sets forth a framework for regulation, leaving much of the detail to be fleshed out in regulations. Since regulations implement statutes, amendment of regulations is generally required after any significant statutory amendment, thus creating a two-step process with all its timing implications. This is in sharp contrast to the land leasing and mortgaging laws, also involved in the current consultancy, where all relevant provisions are in the proposed statutes and regulations are not necessary.

National Government. The National Government adopted its FIAS I statute in 1997 and regulations thereunder in 1999. FIAS II proposed several changes to both. Bills to amend the statute were introduced in each of the last two Congresses but went nowhere. At inception of this consultancy, no bill to amend the statute had yet been introduced in the Fourteenth Congress (which commenced at the same time as this consultancy), nor had any changes to the regulations been initiated.

After extensive consultations with interested parties, a suitable bill, modeled after the FIAS II proposal, was introduced and passed in the September session of the FSM Congress. It was signed into law as Public Law No. 14-32 on November 2, 2005. Immediately upon legislative passage of the statutory amendments, proposed new Foreign Investment Regulations, also modeled after the FIAS II proposal, were completed and, on or about November 1, published for public comment. There is every expectation that these regulations will be finally adopted in early December under the procedures detailed in Appendix S. Accordingly, **the National Government is on track to comply with its condition on foreign investment reform.**

Attached for the interested reader are documents prepared and used in securing passage of the bill amending the National Foreign Investment Act, including an explanation of the proposed changes (Appendix A), talking points on why the changes are important (Appendix B), and a single page of introductory points summarizing the prior two documents (Appendix C). Comparable documents were prepared for most of the proposed state legislation as well.

Chuuk State. Although it is called the “Chuuk State Foreign Investment Act of 1998”, Chuuk actually enacted its FIAS I statute in 1999. Regulations were never adopted to flesh out the statute. FIAS II proposed numerous changes to the statute and prompt adoption of appropriate regulations. At inception of this consultancy, neither had occurred.

A word on the status of foreign investment regulations in Chuuk is in order. On the consultant’s first two visits to Chuuk, numerous state officials claimed that regulations had indeed been adopted, but were unable to produce a copy. On October 19, late in his third visit, the consultant was given a set of signed regulations from August 2002 which failed to give any indication—nor could anyone provide evidence—that they had been approved by the legislature as required in the existing Act. (This anomaly in the Act will be removed if

the Act is amended as proposed.) Thus the validity of the 2002 regulations is at the very least subject to question. Also, they are full of objectionable provisions.

Despite three visits to Chuuk and considerable effort throughout the consultancy, no bill to amend the statute had even been submitted to the Legislature by November 1. Suitable legislation and regulations, modeled after the FIAS II proposals, were developed with appropriate state officials, preliminary contact was made with key legislators, and there was no indication of any significant opposition to the proposals. But it just seemed impossible to overcome the inertia that has come to plague Chuuk's Government. As a result, **Chuuk State has NOT complied with its condition on foreign investment reform.**

Kosrae State. Along with Chuuk, Kosrae was one of two governments that had not even adopted regulations in 2000. FIAS II proposed improvements to the statute and prompt adoption of complete regulations. At inception of this consultancy, no changes had been made to the statute, but regulations had been adopted in 2003. However, those regulations perpetuated the shortcomings of the FIAS I statute ("Kosrae State Foreign Investment Act of 1998") and changes were needed to both.

Thanks to extensive work with state officials—and especially with a legislature which was far more willing than most to spend substantial, meaningful time with the consultant—desirable amendments to the Kosrae act, modeled after the FIAS II proposals, were passed in September and, on October 31, 2005, signed into law as State Law No. 8-131. Progressive new regulations, also modeled on FIAS II, were published for public comment on or about November 1. There is every expectation that these regulations will be finally adopted in early December under the procedures detailed in Appendix S. Pursuant to Kosrae law, they will become effective 10 days later. Accordingly, **Kosrae State is on track to comply with its condition on foreign investment reform.**

Pohnpei State. Believing that foreign investment was not a proper subject for regulation by the National Government under the National Constitution, Pohnpei jumped the gun on decentralization by enacting its Foreign Investors Permit Act of 1986, several years before FIAS I came to the FSM. Amendments were made to that statute in 1999 as a result of FIAS I, but without adopting the stoplight system or many other features of the FIAS approach. Existing regulations were amended in 1999 to reflect these limited legislative changes.

FIAS II urged a complete overhaul of the Pohnpei statute and regulations in furtherance of all the goals of FIAS I, including uniformity. Nothing had happened as of commencement of this consultancy, and it appeared virtually certain that the complete overhaul urged by FIAS II was not going to happen. Instead, the consultant focused on working with appropriate state officials to devise and enact amendments to the existing scheme that would at least constitute a significant step in the right direction.

Even the watered down approach that this consultant was prepared to approve, however, was not to be. The winds were blowing in completely the wrong direction with respect to

foreign investment reform in Pohnpei. A vociferous faction of the local business community, apparently fearing competition, showed up regularly at Foreign Investment Board hearings to fight virtually every application for a new or modified foreign investment permit. They lobbied the Legislature, as hard as many people can remember ever occurring, to reduce or even eliminate further foreign investment in Pohnpei. Several regressive measures received serious consideration, although as of November 1, the Legislature had managed to avoid passing any new legislation on the matter.

In this atmosphere, it proved impossible even to get a progressive bill introduced into the Legislature, to say nothing of any significant overhaul of the Foreign Investment Regulations. As a result, **Pohnpei State has NOT complied with its condition on foreign investment reform.**

Yap State. Yap's FIAS I statute and regulations contained many of the same problems as in the other governments' efforts. FIAS II proposed changes to both and Yap responded. The statute was repealed and replaced by a new "Yap State Foreign Investment Act" in 2001 (YSL No.5-72), to which some minor amendments were added in 2002 (YSL No. 5-99). This current statute incorporated many but not all of the changes proposed by FIAS II. Further changes to the statute were certainly desirable, but they were not strictly necessary for second tranche qualification.

The same could not be said of new regulations adopted in 2002. While they also drew heavily on the FIAS II suggestions, the Yap regulations repeated the pattern observed in other FSM governments, where the detail is in the regulations and "the devil is in the detail." Yap's regulations clearly needed rethinking if foreign investment were to be encouraged.

At the time of FIAS II, Yap was also thinking about rewriting its general business licensing laws. Many of the fears about foreign investment throughout the FSM are seen, upon reflection, as equally applicable to both foreign-owned and locally owned businesses. With a proper array of generally applicable rules for all investments, the process of permitting foreign investment can be opened up considerably. Encouraging this approach, the FIAS II consultants provided comments on the proposed legislation even after FIAS II was concluded. Partly following and partly rejecting the FIAS II comments, Yap repealed and replaced its "Yap State Business License Act" in 2001 (YSL No. 5-73), then amended it slightly in 2002 (YSL No. 5-98). This statute is much like the Foreign Investment Act in its structure and boilerplate. Among other things, this means that most of the telling detail is be found only in the regulations. And, as with foreign investment, the Business License Regulations are far too restrictive to encourage PSD.

The consultant prepared and distributed comments on the business licensing regime ([Appendix D](#)) urging and offering to assist with reform but making it clear that such reform was not a condition for second tranche qualification. The Executive Branch did submit a few proposed amendments to the act, but the legislature has not yet enacted or rejected the bill. The consultant also recommended a few improvements to the existing Foreign

Investment Act, to which the Legislature is currently giving careful and expedited consideration.

Finally, progressive new regulations were published for public comment on or about November 1. There is every expectation that these regulations will be finally adopted in early December under the procedures detailed in Appendix S. Accordingly, **Yap State is on track to comply with its condition on foreign investment reform.**

LAND LEASING AND MORTGAGE REFORM

Background

The FSM Constitution prohibits ownership of land by noncitizens. The constitutions of two states—Kosrae and Pohnpei—prohibit ownership even by citizens from other states in the FSM. Removing or even loosening these restrictions may never happen, yet availability of land for development and as collateral for financing is critical if there is to be significant PSD.

With this dilemma in mind, the Bank sponsored a TA in 1999 to develop the necessary legal framework and model forms for a system of long-term land leasing and mortgage reform in the FSM. The result was a September, 1999, paper by this consultant entitled “Land Leasing in the FSM: A Report on Long-Term Land Leasing and Leasehold Mortgaging.” That report became the basis for the second tranche requirement that “[t]he legislative branches of the States shall have passed legislation improving the legal environment for long term leasing of land and for encouraging mortgage-secured commercial lending.” Sec. 8, Attachment 2 to Schedule 3, Program Loan Agreement.

This loan condition differs from the one regarding foreign investment in several ways. First, it requires only legislative action. Unlike foreign investment regulation, no implementing regulations are needed.

Second, it does not require action by the National Government. While the 1999 Report included a proposed national leasing policy, this was primarily because the terms of reference called for it. In fact, land is of purely local concern in the FSM and the states alone can take all the action that needs to be taken in this area.

Third, with one exception, it does not require alteration of existing statutes, which can constitute a psychological obstacle to change. The exception is Pohnpei, which has had a “Development Leasehold Act” since 1996. That statute took an approach to long-term leasing that differs substantially from the approach recommended in the 1999 Land Leasing Report. In particular, the Pohnpei Act calls for intrusive and case-by-case intervention by the state government in what should essentially be a private contract between private parties. This and other drawbacks created a fear that the Pohnpei Act was more likely to deter than to attract long-term leasing, a fear arguably borne out by the almost complete lack of activity under the Act since its adoption nearly a decade ago.

A word on the length of lease terms is in order. While the 1999 Land Leasing Report recommended allowing terms of up to 99 years, terms as short as 50 years are adequate in almost all circumstances. In fact, for reasons detailed in [Appendix E](#), 55 years may be better than 50 years in some cases, but either is good enough. Right now, Chuuk is at 99 years, Kosrae is at 55 years, and, for citizens, Yap is considering 99 years. (Yap's Constitution prohibits leases to foreigners of over 50 years, but a proposed amendment to the Constitution increasing this period to 99 years will go before the voters next year). Only Pohnpei presents a problem here. The Pohnpei Constitution prohibits leases in excess of 25 years unless otherwise provided by legislation. The only such provision made by the legislature is the Development Leasehold Act described in the previous paragraph. While that Act permits terms of up to 55 years, it applies only to some commercial leases.

Thus, except for Pohnpei, the length of lease terms is not a problem. But the model leasing act addresses many other issues of concern. A discussion of those concerns, as well as the concerns addressed by the model mortgage act, may be found in the 1999 Land Leasing Report, portions of which are attached hereto as [Appendix F](#) for the convenience of the reader.

Status Summary

Chuuk State. At inception of the consultancy, Chuuk was the only state to have adopted new legislation in this area. Known as the “Chuuk State Land Leasing and Lease-based Mortgage Act”, it became law in 2003. Unfortunately, it contains numerous shortcomings compared to the 1999 model acts upon which it is based. It combines into one statute what were originally two model acts—one for leasing and one for mortgaging (which covers more than just lease-based mortgages). In the process of consolidation, significant provisions of each model act were deleted or diluted. A more detailed critique of the existing statute is attached as [Appendix G](#).

The consultant focused on urging reinstatement of the missing or altered provisions through amendment of the 2003 Act. That might have been difficult, as the consultant had already been afforded an opportunity to comment on an early draft of the Act in May of 2000 and most of the recommendations from that comment, including all the most important ones, were ignored in the Act as eventually passed.

As it turned out, no opposition to correcting the Act ever materialized. Instead, the proposal fell victim to the same inertia that doomed foreign investment reform in Chuuk. The specific leasing and mortgage bills worked out in the first visit to Chuuk never even got submitted to the Legislature. If Chuuk had otherwise met its second tranche conditions, the consultant might have been inclined to view the existing Chuuk Act as sufficient, but that difficult decision need not be made now. **Chuuk State has NOT complied with its condition on land leasing and mortgage reform.**

Kosrae State. Early in the consultancy, the Kosrae Legislature passed bills to establish a Kosrae Leasehold Act (L.B. No. 8-116) and a Kosrae State Mortgage Act (L.B. No.8-66).

Both were clearly based on the 1999 model acts, but the leasing bill incorporated some unfortunate changes to the model, and the mortgage bill contained numerous clerical errors, some potentially significant.

While the mortgage act and probably the leasing act would have been acceptable without change, the consultant along with state lawyers urged correction. The Legislature was amenable, and suitable amendments were enacted in September and signed into law on October 31 as State Laws No. 8-130 (land leasing) and 8-132 (mortgaging). As a result, **Kosrae State has complied with its condition on land leasing and mortgage reform.**

Pohnpei State. From the beginning, Pohnpei had no intention of changing its current leasing approach to something more in line with the model leasing act. Accordingly, the consultant focused on whatever improvements might be possible to the existing Pohnpei Act. Legislative Counsel had prepared a bill, designed to satisfy the second tranche condition, for the state legislative session that began at the same time as this consultancy. It appeared to be a positive step but needed to go farther if it was to have any significant impact.

The situation regarding mortgaging was more promising. Here, too, a bill had been drafted with the second tranche in mind, but it, unlike the leasing bill, was similar to the model act.

Consultations to seek more improvement to both the leasing and mortgage bills went well, and bills sufficient to satisfy the second tranche condition were introduced on June 29, 2005. However, they never advanced within the Legislature. While they did not appear to have any real opposition, neither did they have any indigenous champions. According to several observers, once the government realized it was unwilling to qualify on foreign investment reform, it lost interest in the other reforms as well. As a result, **Pohnpei State has NOT complied with its condition on land leasing and mortgage reform.**

Yap State. At inception of this consultancy, Yap had yet to take any action on either land leasing or mortgage reform. The consultant urged enactment of the two model acts, revised as appropriate for Yap. The executive branch was supportive but took a long time vetting the bills through its PSD Steering Committee and getting them sent over to the legislature. The latter did not happen until October 25, only days before the November 1 deadline. The Legislature urged that they be given a few extra weeks in which to consider the bills properly. The consultant said he would consider it sufficient if they were adopted by the time the foreign investment regulations should be adopted, but could not commit the Bank. The Project Officer has since agreed with this view. Accordingly, **Yap State is on track to comply with its condition on land leasing and mortgage reform.**

PUBLIC ENTERPRISE REFORMS

Background

The term “privatization” has different meanings to different people. As noted in Swimming Against the Tide? An Assessment of the Private Sector in the Pacific (ADB, 2004, p.103, n.50):

Privatization in its purest form refers to the shifting of the production and ownership of a good or the provision of a service from the government to the private sector by selling government-owned assets. Most definitions of privatization are more expansive, covering virtually any action that involves exposing the operations of government to the pressures of the commercial marketplace.

Perhaps recognizing the tension between these pure and more expansive views of privatization, the drafters of the PSDP Loan chose to use the word “transformation” instead.

In order to qualify for the second tranche, each of the FSM national and state governments must have transformed at least one public sector enterprise (PSE). Key to determining compliance is the meaning of “transformation”, which is never actually defined in the loan documents. The consultant’s terms of reference (footnote 3, page 2) said that the term “comprises measures that reduce (i) the burden of nonperforming public enterprises on the government budget, and (ii) crowding out of the private sector.” According to the Project Manager’s regular status report, “ADB has said that transformations should show improved service and/or cost saving to the respective government.”

These standards obviously differ. While government cost saving is probably the same as reducing burdens on the government budget, improved service and not crowding out the private sector certainly are not the same thing. Moreover, use of “and” in one formulation and “and/or” in the other leaves doubt as to whether only one of the standards need be met or more than one. The consultant proposed at the outset, and the Bank agreed, to assess particular transformations against all three standards—reducing government costs, improving service, and not crowding out the private sector—at least two of which must be implicated unless only one is implicated but dramatically so.

Much of the groundwork for current PSE reform in the FSM comes from ADB TA 3201-FSM: Privatization of Public Enterprises and Corporate Governance Reform. The final report in 2001—commonly called the “Aries Report”—identifies a variety of activities that can constitute PSE reform, including liquidation, divestiture, corporatization, commercialization, governance reform, and outsourcing of goods or services. Moreover, a PSE can be any commercial activity conducted by a public entity, whether lodged in a government department or a separate legal entity owned by the government. Thus the opportunities for PSE transformations are many, and reforms falling far short of classic

privatization can potentially qualify as transformations. All beneficial possibilities were considered.

Status Summary

National Government.

The **National Capital water system** has been transferred from a National Government department to a Pohnpei State-owned utility corporation resulting in clear improvement of service, clear cost savings to the National Government, and lesser overall cost savings to the utility company that have yet to be quantified. (See [Appendix H](#) for more details.) As a result, **the National Government has complied with its condition on PSE transformation.**

Good faith efforts continue on other possible transformations—to the **National Aquaculture Center** (see [Appendix I](#)) and the **Coconut Development Authority** (see [Appendix J](#)) in particular—but with unlikely success by the end of this year.

Chuuk State.

Chuuk originally proposed contracting out management of its ice-making plant (see [Appendix K](#)) or the catering of meals at its public high school (see [Appendix L](#)). The consultant also examined a failed past attempt at transforming the Chuuk Coconut Authority (CCA) processing plant (see [Appendix M](#)) and referred a capable Chuukese business person to appropriate authorities about possibly reviving it. As of November 1, however, no qualifying transformation even appeared ready to go. Accordingly, **Chuuk State has NOT complied with its condition on PSE transformation.**

Kosrae State.

Of all the FSM governments, Kosrae probably has the least real appreciation of the need for privatization. It pursues fairly trivial transformations while simultaneously undertaking a new public enterprise (harvest and sale of mangrove crabs to Guam) that actually conflicts with one of the National Government's transformation efforts (National Aquaculture Center). A proposal to transform the Kosrae Port Authority (KPA) has stalled because the administration does not wish to give up existing revenues from the air and seaports. Possibly the most promising of the options now underway in Kosrae involves transferring water supply to the state utility authority, in effect corporatizing and commercializing it, but this will not happen soon.

Given Kosrae's ready cooperation on all the other conditions, however, the consultant went to some lengths to identify a completed or nearly completed transformation that, like Pohnpei's, might fortuitously qualify even though never intended to do so. Hospital outsourcing of equipment maintenance, outsourcing of school custodians and grounds maintenance, divesting the Public Works construction arm, outsourcing school bus service, arrangements for mortuary services, and the strange history of something called Kosrae

Hotel Corporation—all these and more were studied and rejected for one reason or another. Some had occurred before the inception of the PSDP Loan, some were going nowhere at the moment, some were not transformations at all.

Thus all hope for Kosrae second tranche qualification came to rest on their original proposal to outsource hospital food service. This transformation is problematic both because it is of borderline significance and because it was not completed by the November 1 deadline. However, the delay was deemed excusable since Kosrae had published its original request for proposals in a timely manner but received only one, insufficiently responsive response. (See [Appendix N](#) for more details.) The State requested more time and the consultant responded that he would consider it sufficient if they were completed by the time the regulations should be completed, but could not commit the Bank. The Project Officer has since agreed with this view. Accordingly, **Kosrae is on track to comply with its condition on PSE transformation.**

Pohnpei State.

Early this year, Pohnpei’s Economic Development Authority (EDA) sold three fishing vessels to a private company, resulting in significant financial benefit to the public and less crowding out of the private sector (see [Appendix O](#)). While there is no evidence that the transaction was intended to satisfy a loan condition, it nonetheless turns out that **Pohnpei State has complied with its condition on PSE transformation.**

Throughout much of the consultancy, the Governor pursued controversial efforts to outsource the operation of Pohnpei Fishing Company’s (PFC) fish processing plant to an affiliate of the same private company. The consultant was not invited to take part in either negotiations or the subsequent legislative fight over ratification of the Governor’s deal. At this writing, the outcome remains unclear, but if it were to be approved and properly evaluated, there might well be a qualifying transformation here as well.

The loan-related transformation actually proposed by the state was completing the corporatization of its radio station that had been mandated by law over ten years earlier. The consultant spent a substantial amount of time, particularly during the first half of the consultancy, pursuing this transformation. Limitations of capacity and will at the station ultimately torpedoed the idea. There is obviously a reason why this project remains uncompleted despite at least three prior consultancies that focused on it.

Yap State.

As described in [Appendix P](#), Yap has transferred its TV service from within a state department to FSM Telecom, in effect corporatizing and commercializing it. A subsidized, free service has been upgraded and placed on a fee-for-service basis. The improvement in service is substantial. Savings to the government are small and perhaps being used unwisely, but they are real. And there is arguably less crowding out of the private sector. As a result, **Yap has complied with its condition on PSE transformation.**

Good faith efforts also continue to corporatize public transportation in Yap. Legislation to accomplish this was submitted to the legislature in October along with all the other PSD-related legislation.

PROSPECTS FOR FUTURE PSD ASSISTANCE

The current environment in the FSM is not particularly conducive to private sector development. This is surprising given the nation's dependency on a dwindling flow of aid from the US and the frequency of statements supporting PSD. But too many of the things that outsiders deem critical to PSD remain anathema to Micronesians. Foreign investment, competition, use of land by noncitizens, reducing government employment, cultural invasion, and many other real or imagined concomitants of PSD are widely feared. Even during this consultancy, the prospects for true development inherent in the reforms required for second tranche qualification seemed far less motivating to the FSM governments than the desire just to receive another disbursement of funds.

It is evident to most observers that meaningful development of the FSM will require significant influx of direct and indirect foreign investment. Yet widespread hostility to foreign investment is why Pohnpei failed to qualify and why foreign investment reform was everywhere the most controversial of the conditions. In addition to the matters discussed in the foregoing text, at least two issues that bear directly on foreign investment were current and controversial during the period of this consultancy. One involves avoidable restrictions on American foreign investment in the FSM (see [Appendix Q](#)), the other a new corporate tax law designed to create a tax haven for certain Japanese corporations (see [Appendix R](#)). Neither demonstrates a positive attitude toward foreign investment.

It is probably time to give the issue of foreign investment a rest in the FSM. People in the FSM are tired of talking about it. Moreover, the next big step in foreign investment reforms will probably need to be undoing the decentralization of control that was introduced in the late 1990s. Among the biggest problems with the current system are the conflict between National and State authority, with the investor often caught in the middle, and the multiplicity of permits necessary for most multi-state businesses. These will only be resolved by re-centralizing control at the national level—something that is politically impossible right now. Thus, a period of benign neglect is recommended.

There are other areas, however, where continued assistance could be useful. The new land leasing and mortgaging laws, for example, will have little benefit unless progress continues on a variety of other land-related fronts—title determinations, registration systems, surveying, valuation, etc. Land is critical for PSD but it takes a plethora of reforms to have a meaningful impact in this area. The land reform team that is currently working in the FSM under the PSD Project Loan is concentrating on the right things and deserves continued support.

One benefit of comprehensive land reform will be enhanced ability to use land as collateral for credit. But this goal is also served—and more readily served—by the secured transactions legislation recently enacted at the national level. Plenty of assistance can and should be provided to make the FSM Secured Transactions Act a success. Registration hardware and software must be chosen, acquired, and installed. Forms must be developed and registrars educated in their use. Bankers, business owners, attorneys, and judges will also require education in how the law works. Some support is undoubtedly still coming under the PSD Project Loan, but more will be necessary. Because the law is (necessarily) complex and the concept new to Micronesians, it will succeed only with careful nurturing.

There also seems to be some momentum for PSE transformation, despite severe capacity limitations and the universal concern with laying off public employees. Expert assistance could make a difference, however, on a project-by-project basis if the donor thought that potential gains (often small) justified the cost of aid (often high). A coconut expert, for example, might well have some success transforming CDA at the national level or CCA in Chuuk. The Chuuk ice plant is ripe for transformation, but it will not happen without focused assistance. Similar possibilities exist in most of the governments.

Perhaps the most important consideration in any future support for PSD in the FSM will be securing true acceptance by the stakeholders. Too many projects—including this one to a considerable extent—have been donor driven with only nominal local buy-in. Finding the right balance will be difficult because what the Micronesians want (e.g., development funds for government to lend out, support for programs and incentives to attract certain industries) and what the donor community wants rarely coincide. Where projects within that rare zone of coincidence cannot be identified, the benign neglect option may remain the best option. At least it would help to cure the chronic case of “consultant fatigue” suffered by these beautiful islands of few people and many governments.

**EXPLANATION OF BILL TO AMEND THE
FSM FOREIGN INVESTMENT ACT**

Following is a brief explanation of the more significant and less self-evident changes being proposed to the current FSM Foreign Investment Act. It may be read with the Talking Points on National Foreign Investment Reform, which focuses on why the bill is important to the FSM.

The bill begins by introducing the concept of “character criteria” to be specified in the foreign investment regulations. **Section 203(2)**. This change is part of a series of changes designed to clarify the existing uncertainty as to whether and when the ownership of a noncitizen business entity is relevant to the issuing and retaining of a foreign investment permit. The proposed scheme is that both a foreign investor and any foreign owner of a substantial interest in that foreign investor, as defined in section **203(20)**, must meet certain character-related criteria at the time of permit issuance and at all times thereafter. This will allow for the character screening of key individuals that is of such concern to many FSM policy makers while not otherwise interfering with ownership changes. To the extent that a foreign owner is not free to sell his interest in a business, he is less likely to start that business in the first place.

Existing section **203(5)(a)(x)** is deleted because it is one source of the present uncertainty as to whether and when a noncitizen owner of a business entity is himself required to get a foreign investment permit, even though the business entity also has one. There should only have to be one permit for each foreign investment. The present uncertainty is resolved by the deletion, and the problem of paying closer attention to substantial owners is now addressed in the proposal described in the prior paragraph.

Existing section **203(12)** contains several changes. The first change makes it clearer that fiduciary arrangements—for example, placing ownership in a citizen trustee on behalf of a noncitizen beneficiary—cannot be used to get around the permit requirements of the act. The change to (12)(a) expands the scope of the exception for legitimate security interests but provides a way to ignore ones created to get around the act. The change to (12)(b) follows language devised by Yap to make it clear that a noncitizen will not be deemed to own a foreign investment just because his spouse owns it. The citizen spouse’s ownership interest will be imputed to the noncitizen spouse only if the latter already has some ownership interest in the enterprise.

New section **203(20)**, which defines “substantial ownership interest,” relates to the first comment above. The ownership percentage in a business entity is relevant only when it entails effective control of the enterprise. This occurs somewhere in the 20% to 50% range. The new language suggests 30%. The goal should be to keep the number of people requiring character screening as low as possible consistent with adequate screening.

Section **205(1)(b)** is changed to shift the focus from criteria for getting a foreign investment permit to those that must be met to keep the permit. Other than the new

character criteria, there should not be any front-end criteria, and primary reliance should be placed on conditions attached to the permit.

New section **205(3)** establishes the rule that permit applicants and holders, as well as their major owners, must meet the character criteria.

Section **207** is changed in several ways to streamline the application process in accordance with the precepts discussed above.

Section **209(3)** is changed to dispense with annual permit renewals. The original plan was to have annual permits that were automatically renewable upon payment of the annual permit fee. However, this has become a nuisance with the annual repermitting and its effects on EWAs and the entry permits issued thereunder. Also, some observers believe that annual relicensing invites annual reapproval, despite the specific language of the law. Such reapproval is anathema to foreign investors, and any suggestion that it might happen is best removed from the law entirely. Thus the proposal is to make the foreign investment permit last for the life of the investment unless it is terminated earlier. (One ground for early termination, of course, is nonpayment of the annual permit fee. See section **209(7)(a)**.)

In section **209(5)**, the first change replaces an undefined term with a defined term. The second change deletes a provision which is no longer appropriate in light of the other changes to the act that place special requirements upon holders of substantial ownership interests in a permittee and otherwise seek to avoid interfering with ownership changes (see comments under sections **203(2)** and **205(3)** above).

Section **209(7)** lists the grounds for canceling a foreign investment permit. Subsection (g) is amended to replace one reason with another. The deleted reason (any violation of any law) is overreaching. Only major law violations should result in loss of a permit, and these will now be covered by the character criteria. Lesser violations should carry no greater penalties for a foreign investor than they carry for a domestic one. The replacement reason for cancellation is ownership of a substantial ownership interest by someone who does not meet the character criteria.

New section **209(10)** corrects an oversight in the original legislation, which failed to indicate the effect of suspending (as opposed to canceling) a foreign investment permit.

In section **210**, the different kinds of EWAs (expatriate worker permits) currently provided for are too numerous and have not produced useful regulations. Simplicity is promoted by eliminating the subsection (4) kind of EWA and relying instead on the regular alien worker laws with respect to the kind of workers described therein. Since the criteria for obtaining an EWA may not be continuously satisfied following issuance of the EWA, the regulations should be free to restrict the usability of the EWA when certain criteria are not being met.

New section **211(5)** corrects an oversight in the original legislation, which failed to specify the effect of EWAs, and the entry permits based thereon, upon the entry permits which

existing immigration law already provides for foreign investors. The suggested language allows but places a limit on the number of foreign investor entry permits allocable to any particular foreign investor.

New section **211(6)** addresses situations, such as Americans under the Compact, where an entry permit may not be required at all. Whether or not such a foreign investor must get a foreign investment permit is, of course, different from whether or not he must get an entry permit.

Section **212(1)** relates to the duration of entry permits issued under EWAs. Under existing law, the period of validity of an EWA has been interpreted to be one year, since an EWA is good for the term of the underlying foreign investment permit, which is one year. This has created more work for Immigration than is necessary. On the other hand, Immigration needs to take a fresh look at every alien from time to time, so allowing the entry permit to last for the entire life of the investment is too long. Five years (or shorter if specified by Immigration) is a suitable compromise which has been supported by Immigration. As provided in new section **212(3)**, a section **211** entry permit is automatically renewable unless grounds exist under which it could be canceled.

New section **212(2)** assures that the effect will be the similar for entry permits issued under state foreign investment permits (some of which are still subject to annual renewal) as for those issued under national foreign investment permits (which are now proposed to last for the lifetime of the investment).

The purpose of new section **212(5)** is to prevent abuse of the system of foreign investment permits as a vehicle for gaining entry to the FSM without a bona fide intention of engaging in business. The “minimum value standards” envisioned by several of the state foreign investment acts are intended to serve the same purpose, but will not do so as effectively.

A change in section **213(2)** limits the effect of this section to those cases of substantial foreign ownership change that are relevant under the proposal explained under section **203(2)** above. Lesser cases of ownership change are of concern only for statistical purposes and can be included in the annual report required of all foreign investors.

Changes to section **216(4)** and the beginning of **216(1)** have been requested by the Attorney General’s Office in order to limit and clarify the National Government’s liability in certain situations.

Prior notification of certain capital repatriations has been deleted from section **217(2)**. The requirement serves no purpose by itself. Existing regulations add a purpose by prohibiting such large repatriations of capital without the Secretary’s prior permission. But this will just scare away the honest potential investors and be unenforceable against the dishonest ones, who will simply move their funds out of the FSM without bothering to get permission. A secondary (though more easily fixed) problem with the deleted language is that, contrary to the general scheme envisioned by the statute, it restricts the holders of all foreign investment permits, not just national ones.

Language added to section **219** is necessary to allow for the existing and possible future laws—for example, those governing telecommunications, banking, fishing in the EEZ, and insurance—that have different rules or procedures for foreigners than for citizens. Every effort should be made, however, to minimize the number of such laws.

**FOREIGN INVESTMENT TALKING POINTS
(NATIONAL)**

1. Reform of foreign investment (FI) laws is required by each of the FSM governments in order to qualify for release of the second tranche funds under the PSD Program Loan.

In 2002 the FSM and the Asian Development Bank (ADB) agreed to two companion loans, a Policy or Program Loan and an Investment or Project Loan, whereby the FSM borrowed money from the Bank, and relented most of it to the states, for private sector development (PSD). The Program Loan is disbursed in two tranches or draws. Conditions are set forth for each FSM government before the second tranche can be released. Those conditions must be satisfied by the National Government and at least two of the states before any further money will be released—and then, of course, it will only be released for the governments that have qualified. The deadline for qualification, which has been extended several times already, is now November 1, 2005, and very unlikely to be further extended.

2. Timing is critical because of the sequencing issue.

FI reform requires changes to both the FI Act and the FI Regulations. The Act must be amended before the Regulations since details in the latter depend on details in the former. It takes over a month to amend regulations, so the Act really needs to be amended during the next session of Congress if the Regulations are to be adopted by the November 1 deadline.

3. Qualification at the national level is particularly important.

If the National Government doesn't qualify for the second tranche, none of the governments can qualify. This would be very disappointing to any states that did go to the effort of qualifying but found themselves unable to access the second tranche because of the National Government's failure to qualify.

4. Qualification at the national level should be particularly easy.

There are two reasons for this. First, unlike any of the states, the National Government has now essentially satisfied all of its second tranche conditions except for FI reform. Adopt FI reform and qualification is virtually assured. Second, national FI law controls only a handful of economic sectors—such as banking, international transport, fishing in the EEZ—which are already heavily regulated by other national laws. The fears of competition with local businesses, cultural inundation by foreigners, and other perceived risks of FI are more commonly raised at the state level, where FI law controls the bulk of economic activity by foreign investors and regulation of many economic sectors is weak.

5. The FI reforms which will qualify the National Government for the second tranche are well known.

A word on the recent background of FI reform in the FSM is in order here. Control of FI used to be at the national level. The states complained about slow processing, insufficient sensitivity to local concerns, and usurpation of power by the National Government. The National Government did not particularly care to hold on to the responsibility but was unsure how to decentralize and simplify it properly.

The Foreign Investment Advisory Service (FIAS), a joint facility of the International Financial Corporation and the World Bank, was requested to do a review (FIAS I). They proposed the “stoplight system” of red, amber, and green lists that was subsequently adopted by the National Government in 1997 and three of the states soon thereafter (Pohnpei already had a new FI regime and did not wish to adopt the same approach as the others). The goal of decentralization was thus achieved. However, the goals of making the rules less restrictive and more transparent were mainly subverted by changes which each government made to the proposals during adoption.

At the request of the FSM Department of Economic Affairs (DEA), FIAS revisited the FSM and prepared a September 1999 “National and State Foreign Investment Legislation Review.” The ADB contracted with a legal consultant named Rick Caldwell to review that FIAS report and all the existing FI legislation, propose specific changes to that legislation for review by FIAS and the governments, then travel briefly with FIAS through the FSM in 2000 to discuss those changes with interested officials (FIAS II).

Policy dialogue at the national level resulted in some refinements to the national legislation. The result was a 6/2000 draft amendment to the national law, with commentary explaining the changes. Bills based on that draft were introduced by request in both the 12th Congress and the 13th (C.B. No. 13-42).

At about the same time as the FI proposed changes were being finalized, ADB was putting together what we now know as the PSD Program Loan. One of the conditions for 2nd tranche qualification is that the FSM governments “shall have amended their foreign investment laws and/or regulations to streamline the application process and improve the consistency, transparency and fairness of the regulatory environment for foreign direct investment.” (Sec. 7, Attachment 2 to Schedule 3, Program Loan Agreement.) That condition was clearly written with the 2000 draft amendments in mind.

6. The international push for FI reform has been remarkably persistent and consistent in the FSM.

FSM leaders sometimes ask, “Why does foreign investment reform keep coming up? I thought we did that in the 1990s.” As discussed under the prior talking point, the FIAS I reforms were gutted in several key ways during their enactment. The subsequent FIAS II urge for reform was essentially an effort to restore the original intent of the FIAS I proposals. FIAS, ADB, and the rest of the donor community have been consistent over the years in their prescriptions for a more open and investor-friendly FI regime. This is not a case of multiple consultants making inconsistent recommendations.

7. FI is a critical component of private sector development.

Foreign investment is important to a developing economy for a number of reasons. It increases the availability of capital, as foreigners invest their own funds or funds from lenders abroad with whom they have established a relationship. These represent new sources of financing that would otherwise not be available to the local economy.

Foreigners also bring needed skills, attitudes, and expectations. This is usually seen in terms of specific occupational skills, such as legal counseling or computer programming, which are in short supply locally. Less often appreciated are the benefits of successful examples. These benefits are particularly needed in the FSM, where entrepreneurial and workforce abilities are, for historical and cultural reasons, quite limited. Risk taking, good work habits, seeking success even if it means rising above one's peers—these are notoriously difficult things to teach. Often the best or only way to learn them is slowly, over time, through the force of example. Foreigners do not set out to improve the domestic business environment—and they should not be required to so in any way that would distract from their proper goal, as businessmen, of making a lawful profit—but inevitably they will improve the domestic business environment.

8. The costs of increased competition are often emphasized to the exclusion of the benefits.

To be sure, the process of private sector development through the spur and example of foreign investment can have its painful moments. Competition has both winners and losers. Sometimes a local business will fail because it cannot compete effectively with a foreign business. The failed business is certainly a loser, but the surviving foreigner is not the only winner. It survived because it provided better service or lower prices to its customers, who are thus winners. And it probably did so, at least in part, by enhancing the productivity of its employees, who are thus also winners. Focusing solely on the failed business skews the calculus of benefits from the foreign investment. Over time, a growing and vibrant economy benefits everyone, local and foreigner alike, compared to a protected economy such as the FSM has today.

9. FI does not mean losing control over one's own economy.

Fear of foreign investment is bound up with the fear of losing control of the economy. One needs to look no further than Guam or Hawaii to see the justification for this fear. Yet foreign investment is not the culprit. The real risks are loss of land ownership and too many foreign workers. These are separate issues, capable of being (and in fact being) addressed in separate ways.

10. FI does not mean losing control over land.

Land is protected through constitution prohibitions on foreign ownership. While limited tinkering with those prohibitions might be desirable, nobody seriously contemplates

eliminating them. And recent proposals for development of a system of long-term land leasing and leasehold mortgaging will facilitate more ready access to land for development purposes while retaining the benefits of land ownership in Micronesian hands. Enactment of such proposals at the state level is also a condition of 2nd tranche qualification.

11. FI is separate from the issue of foreign workers in the FSM.

Many Micronesians fear that more FI means more foreigners living and working in the FSM. But the vast majority of foreigners here are employees of local businesses or governments, not investors. Control of foreign labor is a function of immigration law—in this case, the national Protection of Resident Workers Act. There may be more efficient ways to provide this control in the future, but there is no question that the number of foreign workers can be controlled independently of the number of foreign investors. In this regard, it is important to recognize that the number of resident foreign investors and the limited number of EWAs (expatriate worker authorizations) allotted to each investment will never amount to a substantial proportion of all foreigners in the nation. As a practical matter, most foreigners working in the FSM will continue to be subject to the Protection of Resident Workers Act or its successor.

12. The present FI regime deters FI in ways that are not always clear.

Some people say, “Why bother changing the foreign investment laws? Most people who seek a foreign investment permit end up getting one anyway.” But not many people even try to get a permit, especially not the established and solvent businesses which have the most to contribute. Legitimate companies are loath to provide all the confidential information called for on many FI permit application and annual report forms. Nor do they want to do all the planning for a business before even knowing if they will be permitted to undertake that business. Instead, in a world full of countries that actively seek their investment, they simply go elsewhere. And the FSM is left with a disproportionate number of applicants who are not deterred by the FI law either because they have no real choice or they have political connections that will smooth the way for them. The real measure of the FI regime is all the potential investors who never apply at all.

13. While intimidating FI laws are not the only barrier to more FI, we must tackle one problem at a time.

“Well,” continue the cynics, “even a more welcoming FI regime will not make much difference in light of all the other obstacles to foreign investment.” There is truth in this. The FSM offers small markets, far from other markets, with high transportation costs. The work force is not well educated, and the work ethic is lax. Infrastructure and governance are weak. But every major problem has multiple causes and must be addressed with multiple solutions. Removing the barrier of overly intrusive and nontransparent FI laws may not make much difference today, but someday it will. And if the reforms are not already in place when that day comes, it will be too late to do it then. Legitimate foreign investors will find other opportunities rather than wait around for the FSM governments to change their laws.

INTRODUCTORY POINTS ON NATIONAL FOREIGN INVESTMENT REFORM

The problem is to make the law more inviting to legitimate investors while addressing shortcomings of the existing system.

The bill addresses this problem by:

1. **Increasing transparency** (including related goals of consistency and fairness).
 - Reduces discretion in determining who gets a permit by shifting the focus from obtaining the permit to retaining it. Conditions for retaining permit to be specified in regulations. Even the few remaining front-end conditions—the new “character criteria”—are more specific.
 - Eliminates discretionary ability to prohibit repatriation of capital.
 - Less discretion means more consistency, transparency, and fairness.

2. **Streamlining procedures.**
 - Simpler application and processing due to increased transparency.
 - Fewer permits required per investment.
 - Reporting of ownership changes reduced.
 - Yearly permit renewal eliminated.

3. **Tightening loopholes.**
 - Effect of permit suspension clarified.
 - Number and kinds of EWAs rationalized.
 - Employment outside scope of entry permit includes same employer.
 - Ability to cancel permit if not really engaging in business.
 - Faster and more certain penalty for failure to file reports.
 - Limits National Government liability for state misbehavior.
 - Fiduciary arrangements for benefit of foreigners, especially spouses, included.
 - Beefs up enforcement by requiring annual compliance review and publication of aggregate statistics on compliance with law by foreign investors.

Emphasize limited list of economic sectors controlled by national foreign investment act (banking, insurance, telecommunications, fishing in the EEZ, and international transport). All are regulated under national law already. None is a “mom-and-pop” type of industry. Most concerns about foreign investment arise under state laws, not the national one.

COMMENTS ON YAP BUSINESS LICENSE ACT

Introduction

The Yap State Business License Act is YSL No. 5-73 (2001), as amended by YSL No. 9-98 (2002). It constitutes Chapter 1 (“Yap State Business Licenses”) of Title 22 (“Business and Professions”) of the Yap State Code and is hereinafter referred to as the “**Licensing Act.**” Regulations adopted thereunder in 2002, as subsequently amended, are the “**Licensing Regulations.**”

The Yap State Foreign Investment Act is YSL No. 5-72 (2001), as amended by YSL No. 5-99 (2002). It constitutes Chapter 3 (“Yap State Foreign Investment”) of Title 22 (“Business and Professions”) of the Yap State Code and is hereinafter referred to as the “**FI Act.**” Regulations adopted thereunder in 2002, as subsequently amended, are the “**FI Regulations.**”

From their structure and “boilerplate” provisions, it is obvious that the Licensing Act and FI Act were written, considered, and adopted in tandem with one another, as were the Licensing Regulations and FI Regulations. In both cases, the act contains only a few provisions that are of serious concern from a private sector development (PSD) point of view, but the regulations contain many. In both cases, amendment of the act will ideally precede amendment of the regulations.

With respect to foreign investment, legal reform is a condition for disbursement of the second tranche of the PSDP Loan from the Asian Development Bank (ADB). Thus I have proposed detailed (though blessedly few) amendments to the FI Act and plan to return later to assist in amending the FI Regulations.

As I understand it, legal reform of business licensing is not a second tranche condition. But it hardly seems sensible to open things up when it comes to obtaining a foreign investment permit while retaining tight reigns on the general business licenses that every business, foreign or domestic, must obtain. An entry barrier is a problem whether it affects just foreigners or everybody.

Therefore I have taken the liberty of providing these comments on the Licensing Act for consideration by the leadership in Yap. If and when there is genuine movement towards amendment of the Licensing Act, I will be happy to assist in formulating more specific proposals for changing the Licensing Act and, in due course, replacing the Licensing Regulations.

Specific Comments

1. License duration. Sections 108 and 109 of the Licensing Act say business licenses expire at the end of every fiscal year (September 30) and must be renewed. Why can't they

be good for the life of the business, as is being proposed for foreign investment permits, or at least for some period of time considerably longer than one year? You can still require annual fees and reports if you wish, as well as cancellation procedures if fees are not paid or reports not filed. Investors, especially foreign ones, are very hesitant to invest much in a place where their right to continue doing business is, or even appears to be, subject to reexamination every year. And such reexamination certainly does look likely under the elaboration of this license renewal requirement in the Licensing Regulations.

2. Ownership transfers. Section 110 requires all transfers of a substantial ownership interest in a business to be reported to the government. Why is it necessary? If the purpose is to facilitate learning of crooks (i.e. owners who don't meet certain character criteria) moving into a business, why not just rely on the annual report to indicate ownership changes?

3. Geographic limitations. Why must a business license be limited to a particular location, with multiple licenses required for multiple locations (sections 111 and 112 as amended)? This looks like a penalty on success.

4. Multiple administrators. The regulatory scheme established by the Licensing Act envisions two apparently co-equal administrators—the state Registrar of Corporations and a designated Business License Officer, both located in the Department of R&D. This unusual approach is overly complicated at a number of points in the Act, especially where it comes to enforcement procedures. One person should be in charge.

5. Multiple licenses. Section 106(g) implies there are locations where a municipal business license will also be required. How does one know which locations these are? Are there many of them in the state? If so, can the multiplicity of licenses be eliminated? Surely there is no value added by letting every level of government take its own bite at the business apple.

6. What is the real purpose for this entire regulatory scheme? If it is to raise revenue, the fees are too low, and anyway, this is a poor substitute for a proper tax. If it is to keep track of who is doing business in the state for statistical or tax monitoring purposes, mere notification and regular reporting requirements would suffice. If it is to protect against criminal activity, environmental damage, or some other perceived ill, the criminal, environmental, or other such laws should be the prime source of restrictions and enforcement, not this unfocused, general business licensing law. To a business person, this law might well suggest a government that sees business not as the backbone of a civil society separate from the government but as a necessary evil that must be kept under close watch. So long as the private sector is allowed to operate only at the sufferance of the government, there will be no proper counterbalance to the power of the government.

**USDA-RURAL DEVELOPMENT
50-YEAR LEASE TERM REQUIREMENT**

Probably the single most specific lender requirement regarding length of lease terms in the FSM comes from the Rural Development Agency of the US Department of Agriculture. Rural Development, previously known as Farmers Home Administration, has been making loans for residential construction and renovation in the FSM for decades, starting in Trust Territory times and continuing under the Compact of Free Association. A substantial percentage of home loans in the FSM come from Rural Development.

Long ago, Rural Development realized that it could not take meaningful collateral rights in real property it was lending against in the FSM, so it worked out an arrangement with each of the FSM states whereby the state effectively guarantees repayment of the loan. When that guarantee is called, the state buys the loan from Rural Development and attempts to collect the loan itself. The State is only required to buy the loan if it was made pursuant to Rural Development's normal lending standards.

Those standards include taking a mortgage or deed of trust on the property that can be foreclosed non-judicially. A complying deed of trust statute is thus on the books in each of the states, although its use is limited to Rural Development in most cases. In theory, a state that has made good on its guarantee could itself foreclose the deed of trust given in connection with the defaulted loan, but this has never happened. Mostly, the state just suffers the loss itself, and Rural Development is forced to be very careful about how many guarantees it actually calls for fear of bankrupting the states.

Rural Development's normal lending standards now also require that where the subject home is on a leasehold, there must normally be at least 50 years remaining in the lease term when the loan is made. This works comfortably with the 55-year term limit which seems to be catching on in the FSM, but the 50-year limit on certain leases in Yap can be problematic: Unless the lease term is carefully timed not to begin until the loan is actually made, there will always be less than 50 years remaining on the term by the time the loan is made.

EXCERPTS FROM 1999 LAND LEASING REPORT

EXECUTIVE SUMMARY

This report contains the recommendations from a two-month consultancy ending in September of 1999. It is based on meetings with government, business, and banking leaders in all four states of the Federated States of Micronesia and with bankers in Guam.

The objectives are to make land in the FSM more readily available for development and to make financing for such development more accessible by permitting at least some of its value to be used as collateral.

The approach is to develop a system of long-term land leasing and leasehold mortgaging as an alternative to the use of freeholds, which can only be owned by citizens in the FSM. Since the ownership of leaseholds is not so restricted, such a lease-based system will allow foreign investors to have access to land for economic development projects while leaving ownership in Micronesian hands.

A lease-based system will also allow lenders, virtually all of whom have at least some noncitizen ownership, to acquire meaningful interests in land through foreclosure. As long as foreigners are precluded from bidding at a foreclosure sale, the likelihood of obtaining a fair price at that sale is greatly reduced, to the disadvantage of both the lender and the borrower. Lease-based mortgaging must be distinguished from the so-called CNMI model, whereby a foreign lender is permitted to actually own the land and, if he can, sell it for a period of time after foreclosure. While this report does favor adoption of the CNMI model, its main focus is on lending in which only a leasehold is conveyed upon foreclosure, leaving the underlying citizen ownership intact.

There are not many legal obstacles to development of a lease-based conveyancing and financing system in the FSM today. To be sure, a few such obstacles are identified, particularly in Pohnpei and Yap, and recommendations are advanced for overcoming them. Also, a revamping of existing mortgage laws is recommended for all the states in order to make them more modern and user friendly.

But for the most part, the problem seems to be lack of awareness of the possibilities and of how to achieve them fairly. If it is not done properly, long-term land leasing can be as unpalatable to owners as outright sale. Add the desire to use a leasehold as collateral for development financing and there are three parties--lessor, lessee/borrower, and lender--whose interests must be carefully balanced if investment and economic development are to be facilitated. Thus the major thrust of this report is to offer and urge adoption of the following:

- a National Policy on Long-Term Land Leasing by the FSM Congress (Appendix A);
- Model Land Leasing and Mortgage Acts by each state (Appendices B and D); and

- Model Long-Term Land Lease, Leasehold Mortgage, and Springing Lease Mortgage forms by the business and lending communities (Appendices C, D, and E).

INTRODUCTION

The Goal

The ultimate goal of this consultancy and report, as with so many others, is to facilitate economic development of the Federated States of Micronesia (“FSM”). Many changes are necessary to achieve this goal, of course, but this report focuses on making land more readily available for development and permitting at least some of its value to be tapped for development financing.

The Problem

Foreigners cannot become landowners in the FSM. The national constitution (Art. XIII, §4) states that “[a] noncitizen, or a corporation not wholly owned by citizens, may not acquire title to land or waters in Micronesia.” The constitutions of two of the states further limit ownership to, in effect, the citizens of those states. *Kosrae Const.* Art. XI, §7; *Pohnpei Const.* Art. 12, §2.

Yet land is critical to many forms of economic development, as is foreign investment. If noncitizens--including entities with even the slightest amount of noncitizen ownership--cannot obtain secure land tenure of some sort, development of the private sector in the FSM will continue to be hampered.

Moreover, economic development by citizens and noncitizens alike requires capital, which usually must be borrowed. Most potential lenders, including all three commercial banks in the FSM, have at least some foreign ownership and are thus prohibited from acquiring ownership of land. This prohibition inhibits lending in the FSM because lenders require a secondary source of repayment, something above and beyond the borrower’s promise to repay. Almost always this involves collateral, or some property which the borrower or his guarantor stands to lose if the loan is not repaid. Land is often the only suitable collateral.

Of course, land can be used as collateral even though the lender may be prohibited from owning it. In the event of nonpayment, the property is sold through a controlled procedure called foreclosure, and the price obtained at the sale is applied against the loan. If the sale price exceeds what is due on the loan, the borrower gets the excess. If the sale price is not enough to repay the loan, the borrower still owes the shortfall, but this “deficiency”, as it is called, can be very hard to collect once the collateral has been exhausted. Thus a high sale price is beneficial to both the borrower and the lender. The lender has greater assurance of repayment in full, and the borrower has greater assurance that he will not continue to owe money and may even receive some excess sale proceeds.

A high sale price requires the broadest possible universe of potential buyers. If that universe is limited to citizens, because only they can acquire title to land, the likelihood of getting top dollar at a foreclosure sale is greatly reduced. Moreover, persons interested in buying the property may not be able to come up with the cash quickly enough to do so at a foreclosure sale, or they want more time to consider the purchase, or the property needs some repair before it will sell well.

For these reasons, the lender will almost always be the highest bidder at a foreclosure sale if he is legally permitted to acquire the interest which is being sold. The lender does not want to own the land--that is not his line of business--but neither does he want the land to be sold for too little. The typical lender bid at a foreclosure sale (called a "credit bid" because the lender pays with debt reduction instead of cash) is the lesser of what he is owed or what he thinks the property is worth. Usually this will be the highest bid and the lender will take over the property, fix it up, and market it in a more orderly fashion than is possible in a foreclosure. Even then, his ability to sell the property for a good price will depend on whether the lender is free to sell to anyone or only to citizens.

Collateral is worth much more to a lender when anyone, including and in particular the lender himself, can acquire the property given as collateral. Right now that is impossible in the FSM with respect to ownership of land and problematic with respect to leaseholds, the major alternative to ownership. The result is that lending and development are inhibited.

The Solution

One solution would be to repeal the constitutional prohibitions on noncitizen ownership of land. This is very unpopular and unlikely to happen anytime soon. Even the more limited reform of adopting the so-called "CNMI model"--whereby a noncitizen lender could take title to land in a foreclosure and thereafter hold it for a limited period (such as 10 years) before having to sell it to a citizen--requires difficult constitutional amendments in Kosrae, Pohnpei, and at the national level.

This report joins prior reports in urging adoption of the CNMI model. Once it is adopted, however, it will not be a panacea. It will complement, but not eliminate the need for, an alternative solution. Noncitizens will still need access to land for development quite apart from their financing needs, and some landowners will still be unwilling to put their entire ownership interest at risk in exchange for financing. These concerns require an alternative.

The alternative solution is to develop a system of long-term leaseholds and leasehold mortgages. A leasehold is the interest of the tenant (lessee) under a lease, and a leasehold mortgage is the collateral in a leasehold. Instead of selling his land, the citizen owner leases it to a person who wishes to develop it. That person, the lessee, may be either a citizen or a noncitizen, although it is most likely to be the latter. When the prospective developer is another citizen, he would probably prefer to buy the land.

The developer, in turn, mortgages--that is, gives a collateral or security interest in--his leasehold interest in the land. If he fails to repay the loan and there is a foreclosure, it is the leasehold interest, not the freehold (ownership) interest, which is sold at the foreclosure sale.

Where the developer is himself a citizen who owns the land to be developed, he may choose to mortgage either the freehold interest or a leasehold interest. The leasehold interest is created by a "springing lease" which is secured under a "springing lease mortgage." The springing lease is negotiated at the beginning of the loan but does not go into effect unless and until there is a foreclosure. Upon foreclosure, the lease springs into effect and the purchaser at the foreclosure sale gets a leasehold rather than a freehold interest. This permits the landowner to tap some (though not all) of the value in his land for financing purposes without risking loss of ownership.

Variations under a springing lease mortgage include offering both the freehold and the leasehold for sale simultaneously, then selling whichever one draws the higher bid. The freehold may draw the higher bid because it is a fuller interest in the land, or the leasehold may draw the higher bid because both citizens and noncitizens are permitted to bid on it. The more the owner is willing to put at risk, and the more potential purchasers there are at a foreclosure sale or thereafter, the more likely it is that a lender will be willing to lend.

Thus a leasehold system provides a means for opening up the land system to better serve the twin objectives of making land more readily available for development and permitting some of its value to be tapped for financing, while at the same time avoiding the possibility that the borrower could actually lose ownership of his land. Such a system is the focus of this report, but first we must acknowledge the existence of other barriers to the achievement of our objectives.

Other Problems and Solutions

Prior consultancies and conferences have identified a wide range of barriers to opening up the land system. These include problems in the areas of land surveying, title registration, determination of disputed titles, title insurance, valuation, regulation of land uses, and inconsistencies between statutory and traditional systems of ownership and conveyancing. Many believe that the courts, especially at the state level, are biased in favor of squatters as against owners, citizens as against noncitizens, debtors as against creditors. Traditional reverence towards the land and cultural aversion to confrontation combine to make it almost impossible to dispossess a Micronesian of his land.

The system proposed in this report will not solve all of these problems. Some of them will require further assistance from abroad. Others will only be overcome gradually over time, as attitudes change from generation to generation. All must be substantially resolved before land can play as full a role in developing the economy here as it does in many other countries.

But one must start somewhere, and each reform will both suffice to open up land in some specific cases and facilitate further reform in general. Miracles do not happen overnight, but take one positive step at a time and positive change will gradually appear. It is hoped that the system proposed herein will be seen as one such positive step.

LONG-TERM LAND LEASES

Definitions.

A land lease, sometimes also called a ground lease, is any lease of improved or unimproved land for any purpose--residential, agricultural, industrial, commercial, etc. It is to be distinguished from a premises lease, which primarily covers space within a building, such as an apartment or office suite. While a premises lease generally has a fairly short term, a land lease can have a term of almost any length.

There is no fixed point at which a term becomes a long term. For purposes of this report and the proposed lease law, a somewhat arbitrary cutoff point of 20 years has been selected. A long-term land lease is thus any land lease with a term of at least 20 years.

The concept of "term" requires further consideration. A lease always has an initial fixed term, often accompanied by one or more options to renew or extend that initial term. (Technically, a renewal is a new lease and an extension is a lengthening of the original lease, but over time "renewal option" has come to have the same meaning as "extension option" for most people. Since the words are practically interchangeable now, and since the effect of either a true renewal or a true extension is the same for our purposes, the more correct "extension" will be used to refer to either a renewal or an extension option or to the term which results from the exercise of such an option.)

Should extension terms be counted when determining whether a lease is a "long-term" lease? Yes, if the exercise of the option to extend is entirely within the lessee's control. No, if the landowner must agree to the extension or to some provision (such as renegotiated rent) applicable during the extension. The former is a true option, and the key difference is how long the lessee can hold on to the land, if he wants to and complies with his obligations, even though the landowner may want the land back. As we shall see, this concept is important when it comes to applying statutory or constitutional term limitations to a specific situation.

Length of Lease Terms.

For certain kinds of development--for example, a major resort hotel complex--it may take a long time to recover the huge investment involved, together with a return on that investment which is sufficiently large to induce the initial risk taking. Acquiring secure land tenure, financing, and development permits may take years. Construction will add more years, during which interest is accumulating and no offsetting revenues are coming

in. Once completed, the project may operate in the red for some time while it builds up a clientele. Often the big profits--the ones that made the project attractive in the first place--do not start appearing until many years down the line. Of course, some projects “turn the corner” more quickly than others. But nobody invests huge sums on the assumption that everything will go perfectly--especially not in markets, like the FSM, which are still relatively remote and untested.

Nor does this calculus change if we assume that the original developer, as is often the case, will sell out soon after the project is completed or profitability is achieved. The amount of time remaining on the lease term at the time of sale will directly affect the sale price. A buyer will pay less for a project that he can operate for only 10 more years than for one with 50 years left on the term. The estimated sell-out value will, in turn, affect the willingness of the original developer to undertake the project in the first place.

In short, the longer the term, the more valuable the leasehold and the more likely it is that the numbers will work out in favor of investment. In many places, a term of 99 years has been common in the past. There is nothing magical about this number. Certainly it represents the maximum term that anyone could reasonably need, and lesser terms will suffice in most instances. Still, if we are designing the ideal system, we should allow for those few cases, often disproportionately important from a development perspective, which truly do need a very long term.

Existing laws do not always allow this. In two of the states (Chuuk and Kosrae), there are no legal limitations on lease terms. However, Yap’s constitution prohibits any lease (“agreement for the use of land”) to a noncitizen of the FSM for more than 50 years (Art. XIII, §2). It is recommended that Yap amend its constitution to repeal this provision or change the 50 years to 99 years.

Pohnpei’s constitution prohibits leases, except from the government, for more than 25 years but authorizes the legislature to permit longer terms (Art. 12, §§1 and 4). The legislature has done this in the Development Leasehold Act of 1996 (S.L. No. 4L-21-96), which allows up to 55 years if various requirements are met. As discussed in the next section, the Act assumes a leasing model which this report rejects. It is recommended that Pohnpei enact the Model Leasing Law included in this report, if not as a replacement for, then at least as an alternative to, the Development Leasehold Act.

The national constitution prohibits leases to noncitizens of the FSM for an “indefinite term” (Art. XIII, §5). This clause was amended into the constitution in the early 1990’s and has never been tested in the courts. Debate at the time suggests that the intent was to ban leases with unlimited or unstated terms, not those with what might be deemed excessive terms. Almost certainly, a lease with a term which is definite, no matter how long, will not violate this clause. But is a term “definite” if it consists of an initial term and one or more optional extensions which may or may not ever be exercised? Surely it is; otherwise a common and useful commercial practice, applicable to both land and premises leases of any length, would be inadvertently banned.

In short, the “indefinite lease term” clause of the national constitution probably does not bar leases of up to 99 years, including extension options. However, just to be safe (or at least safer), the proposed National Policy on Long-Term Land Leasing includes a declaration by Congress to that effect. Courts typically defer to explicit legislative interpretations of unclear constitutional provisions.

Two Models for Landowner Protection.

More than anything else, what a landowner expects from a land lease is a fair rent. While there are many variations in between, it is useful to consider two polar models of how rent can be paid. In the lump sum model, all the rent is paid in one large payment at the beginning of the lease term. In the periodic payment model, rent is paid--and adjusted to reflect inflation and market changes--throughout the term.

The lump sum model is popular with some foreign developers, particularly those familiar with practices in CNMI, because it fixes their land costs for the entire term. Since land almost always increases in value over a long enough time, the rent negotiated at the beginning will eventually come to be seen as a bargain for the lessee/developer. The landowner rarely looks that far into the future and is attracted instead by the prospect of a single large payment immediately. Why get many small payments over a long time when you can get one really big one now?

Years later, however, the lump sum payment is spent. The owner sees land values all around him rising and a successful project on his own land. He realizes that he “sold cheap” and thinks that, as the owner of the land, he is entitled to more. His heirs are even more prone to such thoughts. They look for ways to break or renegotiate the lease. A lawyer tells them that a lump sum lease with a long enough term is tantamount to a sale of the land, and since the foreign lessee could not have bought the land outright, a court may be willing to invalidate a lease that accomplished essentially the same end. They sue, lose, and feel cheated. Or they sue, win, and the lessee feels cheated. Neither outcome is desirable.

The periodic payment model avoids this. By spreading rent payments throughout the lease term, it keeps the present owner from denying his heirs the benefits of their inheritance. By adjusting for land value increases, it insures that the current owner of the land, at any point in time, is receiving a fair rent. Of course it is less attractive to the lessee who seeks a bargain, and the uncertainties of how much the rent will increase in the future create legitimate concerns for the lessee and his lender alike. These concerns, together with our inability to adjust rent perfectly and the impracticality of trying to do so too often, require some retreat from the ideal form of the model. But even in imperfect form, the periodic payment model is far better for the landowner and no worse for many lessees than the lump sum model.

If we assume that the landowner is receiving a fair rent, that his land is not being abused, that he or his successors will get the land back someday, possibly with improvements of

considerable value still on it, then the major legitimate concerns of the landowner have been met. He does not need to have final say on everything that the lessee does with the land. He does not need to exact some of the gains when the lessee assigns the lease and sells his project. He does not need to submit his lease for government review before it becomes effective. He does not need to insist upon new construction of a certain value. He does not need a whole panoply of protections designed to compensate for a fundamentally unfair deal because the deal will not be fundamentally unfair.

This is the problem with the Pohnpei Development Leasehold Act, which is premised on the lump sum model. The problem is not that it attempts to protect the Micronesian landowner--any acceptable system must do that--but that it does so by addressing peripheral instead of core concerns. And it does so in a way that makes the whole process too objectionable to lessees. That is why virtually all advisors who have looked at it favor repeal of the Act.

But even if the lump sum model is acceptable, surely the periodic rent model, without all the peripheral protections, should be a permitted alternative. Pohnpei could adopt the system advocated in this report without repealing the Development Leasehold Act and let lessees and landowners choose which approach better suits their needs.

Paying and Adjusting Rent.

If the periodic payment model is the best guaranty of fairness to the Micronesian landowner, its implementation must be partly through legislation and partly through education. Legislation must strike an appropriate balance between protectionism and recognition of the variety of situations which may call for an exception to the general rule. Education must then assure that landowners understand the importance of following the general rule whenever possible.

For example, the Model State Land Leasing Act (Appendix B) allows advance payment of rent by up to 10 years. Except perhaps at the very beginning of a lease term, and then only for perhaps 5 years, this is not ideal. But it is felt to be appropriate in order to avoid excessive interference with the freedom to contract. While one cannot go too far wrong by paying only 10 years in advance, one year is preferable as a general rule. Thus the Model Long-Term Land Lease (Appendix C) provides for annual payments of rent. Landowners need to be educated to go with the provisions of the Model Lease rather than the more permissive ones of the Model Act unless there is a good reason for not doing so.

Another example involves the frequency of adjusting rent. Adjustments should be frequently enough to keep fair market rent from diverging significantly from actual rent. On the other hand, the process of adjustment entails disruption and costs which make it undesirable to resort to the process too often. Experience has shown, and prior advisors have recommended, that 10 years is an appropriate interval between rent adjustments. Yet the Model Act would permit 25 years to elapse before the first rent adjustment under a new lease.

The reason is that lenders will generally not loan against a leasehold for a term longer than the period during which rent payments are predictable in amount. Rent can escalate during that period, but it must do so in predetermined increments. The possibility of an unexpectedly high increase can affect the borrower's ability to repay the loan and thus the lender's willingness to make the loan in the first place. Since one of our goals is to facilitate leasehold mortgaging, we must be careful not to permit rent adjustments from getting in the way.

It appears that, for the foreseeable future, 25 years is about the longest term that will be available on a leasehold mortgage in the FSM. A land lease for development purposes is most likely to need leasehold financing at the beginning of its term, so the Model Act permits, at the beginning of the term only, a 25 year exception to the general rule that rent is to be adjusted every 10 years. But in situations where a long-term leasehold mortgage is not anticipated, landowners should be educated to insist upon adherence to the 10 year rule from the beginning.

The methods for adjusting rent, if the parties cannot agree to an adjustment on their own, are too complicated and variable to be spelled out in legislation. Thus the Model Act merely requires that the lessor and lessee provided for their own chosen method in the lease. The Model Lease, in turn, contains alternate suggestions under both of the two general approaches.

One approach is by reference to a standard, such as the consumer price index (CPI). This is simple, but it may approximate land value changes in only the roughest of ways.

The other approach is appraisal, in which case an appraisal mechanism must be specified. The Model Lease suggests a mechanism that does not require professional appraisers (since there presently are none in the FSM) and gives each party an incentive to appoint a fair-minded person to represent him in the appraisal process (since the more biased of the representatives is likely to have his opinion disregarded in the final determination). Over time, data on which to base determinations of fair market rental value should become more available in the FSM, as will persons with some specialized knowledge of appraising. And a large enough project will justify bringing in experts from Guam or elsewhere outside the FSM.

The standard for appraisal must be the fair market rental value of the land without any improvements except for those which were there at the outset of the lease and are still there at the time of appraisal. The land value properly belongs to the landowner, but the value of the improvements he has made and the business(es) he operates on the land belong to the lessee. If they are taken into account in fixing his rent, the lessee will end up paying for them twice--once when he built them, and then again over time through higher rent payments.

A way of benefiting the landowner between rent adjustments is to structure the rent as a minimum base rent plus a percentage of the gross or net income that the lessee derives

from the property. The minimum will be adjusted periodically, probably by reference to something like the CPI rather than appraisal, while the percentage allows the landowner to share in the success (if any) of the lessee. This can increase the owner's rental return while gaining his support for a business which he might otherwise resent, but it is not always suitable and is thus inappropriate for inclusion in the Model Act. Landowners should be educated to think of percentage rent whenever appropriate, however.

The Model Lease includes an optional percentage rent clause for consideration. It is based on the lessee's gross income. Net income can be very difficult to define and monitor, and the unsophisticated landowner may find that net income is consistently too low for his percentage to kick in. Unless they have good legal and accounting representation in negotiating the percentage lease clause, landowners are better off insisting on gross income as the base for any percentage rent.

A long-term land lease can take many forms, depending on the purpose of the lease, its term, the need for new construction, the need for mortgage financing, the relationship between the lessor and lessee, and many other factors. No piece of legislation and no single lease form can adequately provide for all the legitimate possibilities. The challenge is to close as few doors as possible while maintaining a core of minimum requirements to prevent the worst abuses. It is believed that the Model Act and Model Lease attached to this report strike the right balance in this regard.

MORTGAGES

Introduction.

Inducing lenders to lend against real property is partly a matter of assuring that there is a large group of permissible buyers--including the lenders themselves--should a foreclosure ever become necessary. But it is also a matter of assuring that a foreclosure can occur at all. As this report is being written, it appears that there has never been a successfully completed foreclosure anywhere in the FSM. A few are in progress right now, and there has been at least one successful (though unopposed) execution on land to satisfy an unrelated judgment. But the picture is clear: lenders are justifiably concerned that when push comes to shove, they will be denied the benefits of their security.

Discussions with bankers in the FSM and Guam revealed a remarkably consistent fear of going to court in the FSM. The courts are seen as slow, relatively unknowledgable in creditors' rights, and inclined to favor Micronesians over foreigners, individuals over corporations, and debtors over creditors. The single most useful reform would be to permit nonjudicial foreclosure, as is already the case in Guam, Hawaii, and many other places. Also very useful is reduction of the lengthy statutory periods before a foreclosure sale can be held and any redemption rights lapse, removal of the arbitrary limit on attorneys' fee recovery, and simplification of notification procedures.

These and similar changes are attractive to lenders regardless of whether the mortgage encumbers a freehold or just a leasehold. The Model State Mortgage Act makes these changes in a way which leaves the landowner with more protections than the states now give him under their own deed of trust laws. The Model Act also contains provisions of special relevance to leasehold and springing lease mortgages. Before looking at the Model Act, however, we should take stock of what is already on the books.

Existing Laws.

All four states have a deed of trust statute, and all but Kosrae have a mortgage statute. What is the difference? Both are ways of borrowing against real property, but the mortgage involves two parties and the deed of trust involves three. Under a mortgage, the owner (“mortgagor”) transfers an interest in the subject property to the lender (“mortgagee”) to secure repayment of the loan. Under a deed of trust, the owner (“trustor”) transfers an interest in the subject property to a third party (the “trustee”) for the benefit of the lender (“beneficiary”).

Depending on the time and place, the interest transferred under either instrument might have been actual title to the property or only a lien upon that title, but deeds of trust tended to the former and mortgages tended to the latter. Nowadays, however, both instruments are usually viewed as creating only a lien, and such is the case under all of the FSM mortgage and deed of trust statutes.

Another common (though not universal) distinction has been more durable and does apply to the FSM state statutes: the trustee under a deed of trust has the power to sell the property in foreclosure (a “power of sale”) without going to court, while a mortgagee may only foreclose through a court action. Since the former is more expedited and less vulnerable to judicial bias, it is preferred by lenders. In many other ways as well, the FSM deed of trust statutes are more lender oriented than the mortgage statutes.

There is a reason for this. The FSM state deed of trust statutes were designed to accommodate U.S. Rural Development (formerly known as Farmers Home Administration). In each case, the trustee is a state governmental official entity which, in the event of a default and foreclosure, is required to pay Rural Development the difference between the amount due on the loan and the amount obtained at the foreclosure sale. In effect, the public is guarantying repayment of the deficiency. The government shares the lender’s interest in facilitating foreclosure.

In fact, the situation is worse than it appears from the statutes alone. Memoranda of understanding between Rural Development and the states call for the trustee to make good on its guaranty even before foreclosure by paying Rural Development the entire amount due and accepting an assignment of the note and deed of trust. The trustee may then attempt to recover its loss by foreclosing on the property, but it is unlikely to do so: a state government would find it politically difficult to take land away from one of its own citizens.

Thus, the state government is guarantying the whole of the amount due. The state also has a statute which is at odds with its contractual commitment to Rural Development. If push comes to shove, which would control? The states would be well advised to resolve this situation promptly. Kosrae and Yap, which do not limit who can be beneficiary, should also look carefully at whether a lender whose loans the state does not wish to guaranty can utilize the deed of trust without the state even knowing it. Most likely, amendment of the existing deed of trust statutes will be needed to limit their application to Rural Development loans and conform them to Rural Development's expectations. Such amendments are beyond the scope of this consultancy.

Because of these problems, it was decided not to use the existing deed of trust statutes as the basis for reform. And if the choice is one between a new deed of trust law which requires a third party trustee and a new mortgage law which does not, the latter is preferable. Not only is it simpler, but it also avoids leaving the control of foreclosures in the hands of a government official who may have no idea of what to do and personal qualms about doing it.

The three existing state mortgage laws, like the deed of trust laws, all appear to have derived from the same original proposed law. They contain many good provisions which lenders, lawyers, and other concerned parties are already familiar. While this counsels revising rather than replacing the existing laws, the desired changes are so extensive, dispersed throughout the statute, and variable from state to state, that a single set of model amendments was felt to be impractical. Thus the decision was made to propose an entire new mortgage statute, but one which is based on the existing ones. It is recommended that the states enact the Model State Mortgage Act (Appendix D) and repeal their existing mortgage statutes.

A word about Kosrae is in order here. Instead of a mortgage statute, Kosrae tried to do it all in their deed of trust statute. Where the other states' deed of trust statutes end, Kosrae's goes on to add provisions for judicial foreclosure and redemption rights as an alternative to the power of sale. The result is confusing. Among other things, it is often unclear whether certain rights or duties belong to the trustee or the beneficiary. Moreover, the deed of trust statute cannot function properly as a foreclosure law of general application as long as it remains oriented to the special needs of Rural Development. Kosrae would benefit perhaps even more than the other states from enacting the Model State Mortgage Act. And repealing the confusing language on judicial foreclosure contained in the deed of trust statute (§§11.412 through 11.415) would simplify that law.

Model State Mortgage Act.

The Model State Mortgage Act is based on the existing mortgage laws in Pohnpei, Chuuk, and Yap. It incorporates what is felt to be the best of each state's variations, while removing or toning down overly protective provisions most likely to hinder mortgage lending. The major changes are as follows:

1. Nonjudicial foreclosure is added as an option for certain lenders when they foreclose on a leasehold interest. The same notices, publications, postings, waiting periods, etc. apply as in a judicial foreclosure, and the mortgagor can seek court protection if he believes the foreclosure is not being done right. But for the lender who is willing to play by rules assuring fairness to the mortgagor, many of the frustrating delays and obstacles to foreclosure under existing law can be avoided.

Eventually, nonjudicial foreclosure should be available regardless of whether the foreclosure is on a leasehold or freehold interest. This is not felt to be acceptable at present, however, because the fear of losing title to land remains so high. Loss of a leasehold, on the other hand, is less wrenching, does not disturb the underlying ownership, and will often involve a noncitizen mortgagor. Thus leaseholds are an ideal place to start with new provisions.

2. Redemption periods are shortened in all cases and eliminated entirely when the interest sold is a leasehold. The right of redemption occurs after a foreclosure sale. The owner of the land just before the sale has the right to buy the land back for the amount paid at the sale. This redemption right is rarely exercised: if the mortgagor could not find the funds to cure his default shortly before the foreclosure, he is unlikely to find the funds (often greater in amount) necessary to redeem the property shortly after foreclosure. Nevertheless, the mere possibility of a redemption prevents the purchaser at the foreclosure sale from making any significant expenditures on the property or selling it to someone else. As a practical matter, the property is frozen during the period in which a redemption is possible.

For reasons similar to those discussed in connection with nonjudicial foreclosure, leaseholds are a good place to start in resolving this problem. Where a leasehold is sold at foreclosure, the right of redemption is eliminated. Where a freehold interest is sold, the right of redemption is retained but shortened to 6 months. Presently, it is one year in Kosrae and Pohnpei, while Chuuk and Yap have no redemption right at all. (Yap, however, gives the mortgagor the excessively long period of up to one year in which to cure the default before foreclosure. The Model Act reduces this to the more reasonable period of 3 months already found in the other states.)

3. Recovery of attorneys' fees is made easier. All but Kosrae presently put a dollar limit on how much can be recovered, but a lender should be able to recover all his fees resulting from a mortgagor's default, so long as they are reasonable in the circumstances. The lender will have to pay his attorney, no matter what, and to the extent that he cannot charge it to the defaulting mortgagor, it becomes just another cost of doing business which must be recovered through higher interest rates. Since all borrowers must pay more, the good ones end up subsidizing the bad ones. This is unfair and weakens the incentive to avoid defaults.

4. Springing leases and mortgages thereon are expressly authorized and regulated. Present laws make no mention of springing leases. A few local lawyers have put them in

their security documents but never actually had to invoke them. These documents may not be enforceable because existing law (like section 5 of the Model Act) often provides that any transfer of an interest in real property made for security purposes is governed by the mortgage law, that law requires foreclosure to realize upon the security, and the existing springing lease arrangements circumvent foreclosure procedures.

The Model Act resolves this by providing for the enforceability of springing lease mortgages, while protecting the mortgagor by requiring that foreclosure procedures be utilized. It also establishes rules for handling a foreclosure where both a springing lease and the entire freehold interest have been mortgaged. Whether to mortgage just a springing lease or to include the freehold as well is up to the mortgagor at the time the loan is made. As noted elsewhere in this report, the loan amount and terms that a lender is willing to offer will depend on the value of the collateral, and a freehold may be worth more than a springing lease.

The Model Act provision on springing leases (§23) refers to a conveyance in lieu of foreclosure. Such a conveyance is used where the mortgagor is willing to forego the protections of a formal foreclosure in order to avoid delay and expense and thus reduce the amount of interest and costs that are added to the indebtedness. Often it will include other benefits to the mortgagor, such as waiver of a deficiency judgment. It must be negotiated at the time of default, and an agreement in advance to convey in lieu of foreclosure (such as in the original mortgage) will not be enforceable against the mortgagor.

5. Foreclosure sale procedures are specified in the Model Act. Existing laws refer the reader to other laws governing sales under executions generally. These laws are often ill-suited to sales of real property. They are confusing and even circular: in at least one state, the executions statute says that when it comes to real property, the rules applicable to mortgages shall apply. Pohnpei State Judiciary Act of 1999, §11-26. Clarity of the law and uniformity among the states are better served by specifying mortgage foreclosure sale procedures in the mortgage law.

6. Notices to the mortgagor are simplified. The present process for notifying the mortgagor of defaults and other matters is too cumbersome. No notice is deemed given until actually received. If the mortgagor cannot be found, an effort must be made to serve a personal representative whom the mortgagor should have (but in many cases will not have) identified in the mortgage. If this too fails, the notice must be filed with the clerk of courts, posted in the municipality where the land is located, and (in some states) announced on the radio and published in a newspaper for 4 weeks. Thus a mortgagor who chooses to make himself unavailable can substantially delay the process and increase its costs at several points in the process. The mortgagor is required to keep the lender notified as to his current address at all times. He should not be rewarded for failing to do so.

Thus §13 of the Model Act provides for a more commercially reasonable system of notifying the mortgagor. Note, however, that where it is important for other people also to receive notice, the additional mailings, recordings, postings, and radio announcements may

also come to the attention of the mortgagor. And when a judicial foreclosure is commenced, the normal rules for service of process will apply.

7. The Model Act clarifies provisions on the right to possession after default, recording, and numerous other matters. Court jurisdiction is no longer limited to state courts where a national court would have jurisdiction under the national constitution. Newspaper publications are dispensed with because there are no newspapers of general circulation in the states, nor has there ever been one published with sufficient frequency (at least once a week) to meet the requirements of existing statutes. If radio announcements and postings on the property and in the municipality are not enough, a state may wish to consider adding television announcements.

**COMMENTS ON THE EXISTING
CHUUK STATE LAND LEASING AND LEASE-BASED MORTGAGE ACT**

Introduction

1. Reference is made to the Model State Land Leasing Act and the Model State Mortgage Act (the “Model Acts”) contained in “Land Leasing in the FSM: A Report on Long-Term Land Leasing and Leasehold Mortgaging” by this writer, dated September 1999 (the “Leasing & Mortgaging Report”). A copy of that report, without all the appendices, is attached to these comments.
2. The Chuuk State Land Leasing and Lease-Based Mortgage Act, CSL No. 6-03-18, Act No.6-33 (the “Existing Act”) was clearly enacted in response to the recommendations of the Leasing & Mortgaging Report, but with variations which significantly reduce its potential for having a positive impact on private sector development (“PSD”).
3. The purpose of these comments is to highlight some of the shortcomings of the Existing Act and propose its repeal and replacement by two new acts more in line with the original Model Acts. Updated versions of those Model Acts, geared specifically to Chuuk, are attached to these comments.

General Comments

4. The Existing Act combines both Model Acts into one law and makes the new mortgage provisions applicable only to leasehold mortgages. The existing Chuuk mortgage law remains in place (and unimproved) for all other purposes, thus reducing the benefits to be gained from complete replacement of that existing law. Also, when the Chuuk Code is finally created, leasing and mortgaging will probably fit better into separate chapters rather than being jammed together as one.
5. The Existing Act drops the concept of springing leases. This makes no difference to foreign developers, who must get a lease from the outset anyway since they are prohibited from owning the land. But it greatly reduces the potential value of the system to domestic developers who already own the land they wish to develop. Commercial banks will still balk at taking a mortgage from such an owner because of their inability to sell the collateral to themselves or other foreigners at or after a foreclosure sale.
6. The Existing Act and the Model Acts each require leases, leasehold mortgages, and related documents to be recorded, but unlike the Model Acts, the Existing Act says they are void unless recorded. (The Model Acts just say that failure to record risks loss of priority pursuant to the general recording law.) This is a tough rule which can lead to unfair results, especially with related documents—such as assignments, amendments, extensions, rent adjustments, terminations, etc.—and short term land leases. It is also at odds with the rest of the state law on recording, thus adding complexity and the potential for conflicts when

both laws must be applied to decide a single dispute. (This issue arises in sections 6(2), 9, and 21.)

6. The Existing Act deletes any right of redemption, which is OK so long as the act relates only to leasehold mortgages, but it may be desirable to reinstate a right of redemption with respect to freehold mortgages, as suggested in the Model Act, if, as strongly recommended, the act is replaced by something more like the Model Act, which would cover all types of mortgaging.

7. The Existing Act contains numerous spelling and formatting errors, some of which may produce significant ambiguity.

Section-by-Section Comments (Leasing)

Section 3. Defining “standard land lease” as a type of lease separate from a “long-term land lease” is unnecessary and leads to confusion and some awkward usage elsewhere in the Existing Act. The Model Act simply makes a “long-term land lease” a subset of “land lease,” which is simpler and less confusing.

Section 6(1). The last two sentences are unnecessary. The first of those two is also confusing, since the 10 year period at the beginning of the lease term might in fact be 25 years pursuant to the first sentence of this section.

Section 8(1). The Model Act refers here to a “land lease or memorandum thereof,” which permits use of a common and useful short form that puts key lease data on the public record while permitting the parties to hold back potentially confidential detail and the recording process to be simplified. Unfortunately, the Existing Act eliminates the reference to such a memorandum. The only things that really need to be recorded are things that the parties to a transaction want the rest of the world to have notice of, not every little detail.

Section 8(3). Requiring acknowledgement to be before a Chuukese or FSM Supreme Court judge is far too restrictive, especially for parties residing elsewhere—for example, a landowner living in Fiji or the US. The Model Act permits the use of other appropriate officials as well.

Section 10. This is an entirely new section compared to the Model Act. What it attempts to accomplish—a kind of quieting of title in the lessor and thus his new lessee—is admirable but very incomplete. It requires either extensive elaboration—regarding the solicitation and filing of adverse claims, the procedures for hearing and deciding them, rights of appeal, the effect of a final determination, etc.—or removal from this act. The latter is recommended, since the matter of formally determining or quieting land titles is best left to another law of general application—a law which, in fact, may itself be amended as part of the ongoing land registration component of the PSD project.

Section 11. This section of the Existing Act is full of problems. First, the free transferability by lessee in subsection (1) and by lessor in subsection (2) should be subject

to variation by agreement of the parties as provided in the Model Act. Second, the reference to subsection (4) in those first two subsections should be eliminated because the notice required from a transferring lessor does not affect the ability of the transfer, just its ability to bind a lessee before he has been notified of it. Third, the reference to subsection (5)—and subsection (5) itself—should be eliminated because is too tough and likely to cause problems. (For example, it is unclear whether there even is such a thing as a “Notarized Certificate of Mailing from the FSM post office”). The notice provisions elsewhere in the act and in the general land recording law are sufficient.

Section 12. The clause “including consent by joint resolution from the State Legislature” should be eliminated. It is either redundant as a law “generally applicable to the leasing of public land” or it should be made so. Also, if and when that generally applicable law is ever amended, it should not be necessary that someone remembers this law also needs to be amended.

Section-by-Section Comments (Mortgaging)

Section 14. The Existing Act added a sentence limiting ownership of land to FSM citizens. This is unnecessary because the FSM Constitution already so provides. It is also out of place in this section which is about rights of possession, not ownership.

Section 18. “Except as otherwise provided by statute” has been deleted from the beginning of the first sentence. The effect is to prevent use of the Chuuk State Deed of Trust Act (used by Rural Development to make home loans in Chuuk) where the Existing Act applies. This is bound to create unnecessary problems with Rural Development financing of new homes or home improvements.

Section 20(1). Lease terms (as opposed to just identification of the lease and affected land) should not have to be included in a leasehold mortgage. This results in over-recording, disclosure of potentially confidential deal terms, and a need to amend the mortgage (and record that amendment) every time the lease is amended (and recorded). The simpler requirements of the Model Act are sufficient.

Section 20(3). Same comment as under section 8(3) above.

Section 22. Deletions from the Model Act in this section of the Existing Act inexplicably deny other encumbrancers the benefit of this provision.

Section 23. Mere changes of address in subsection (1) or representative in subsection (2) should not have to be recorded, and parties to a mortgage should not have to consult the records before sending notices to each other. This should be deal with in the mortgage itself as between the parties to that mortgage.

Section 29. Consensual waivers with respect to a particular default should be permitted after that default has occurred. Otherwise, tools which are useful to both parties, such as the conveyance in lieu of foreclosure, will be prohibited.

Section 35(2). It is the property actually subject to the mortgage and to foreclosure (“a leasehold interest in Blackacre”), not just Blackacre itself, which must be legally described. The problem here also affects sections 34(2)(a) and 37(2)(a) and is resolved by using the language of the Model Act.

Section 49(1). Requiring full compliance with the Existing Act (as opposed to substantial compliance, which is otherwise implied) can result in harsh consequences for a minor technical error, and thus reduces the attractiveness of the act to lessees and lenders.

Attachments: Leasing & Mortgaging Report (w/o appendices)
Proposed Chuuk Land Leasing Act
Proposed Chuuk Mortgage Act

TRANSFORMATION OF NATIONAL CAPITAL WATER SYSTEM

For many years the National Government owned and operated a water system serving the National Capital complex at Palikir, the College of Micronesia-FSM main campus, and nearby communities. The system eventually consisted of three water wells at the Capital, one well at COM-FSM, a 500,000 gallon storage tank, distribution lines, pumps, easements, etc. Closely related to the water system—and considered a part of it for the remainder of this narrative—are a sewer system serving the Capital (lines, septic tank, and leeching field) and power lines traversing the Capital from east to west. Although the initial capital investment was substantially higher, by 2005 the system had deteriorated to an estimated as-is value of \$1 million.

The water system was operated by the FSM Department of Transportation, Communications and Infrastructure (DTC&I), which never really had a water system expert on its staff. Maintenance was deferred time and again while demands on the system grew. Frequent weekend or nighttime service problems resulted in the accumulation of large overtime obligations, some of which were paid and others of which remain unresolved. Much water was being lost from pipes that were in poor condition and through lack of basic conservation by users for whom the water was free. No cost recovery system existed.

When the need for a particular repair or replacement could no longer be postponed, DTC&I contracted the work out to Pohnpei Utilities Corporation (PUC), the primary provider of water, sewer, and power service to Pohnpei. While owned by the State Government, PUC is essentially self-supporting except when it comes to funding major capital additions to its systems.

In 2002, DTC&I produced a study of alternatives for dealing with the growing problem. The leading contender was to transfer the capital water system to PUC. Always the logical alternative, this solution had for years been opposed by politicians whose constituents within the service area of the system stood to lose free water service. Nevertheless, on February 11, 2005, DTC&I and PUC both signed a self-executing Agreement for the Transfer of the FSM Capital Water and Sewer Systems and Power Line from the FSM National Government to the Pohnpei Utilities Corporation.

Under the Agreement, which is barely longer than its title, the National Government transfers ownership of the system to PUC and PUC agrees to provide service to the National Government, COM-FSM, and other Palikir area customers (about 400 households) under its standard rates and connection policies. No money changed hands on the system transfer, a compromise between those who thought the National Government should contribute to the substantial cost of needed upgrading and those who thought the National Government should be paid for the value of the system assets.

PUC has undertaken a program to upgrade the system and install water meters before it actually begins charging for the water. This program has gone more slowly than first anticipated, in part because PUC discovered that some of the water lines consisted of sewer-grade pipe. For health reasons, those pipes are being replaced with pipes suitable for drinking water. However, the upgrade is now nearing completion and PUC expects to start charging for water in January 2006. Preliminary readings on most water meters have already been taken and PUC personnel are meeting with customers to point out the possibilities for conserving water and thus lower their charges once billing begins.

Financially, the transformation has been very beneficial to the National Government. The government (1) saved itself the substantial cost (at least \$300,000) of necessary system upgrading, (2) expects to reduce its annual overtime by about \$15,000, and (3) expects to reduce its power costs (for water pumping) by \$90,000-100,000 per year. Once PUC begins charging for water in the area, DTC&I predicts an annual cost to the National Capital complex of less than \$2,000. PUC concurs in these estimates.

Obviously, the flip side is not so rosy. PUC has taken on a significant project. However, it has access to funding sources and expertise not available to the National Government. It has been able to upgrade the system more efficiently than the National Government could have. It adds a missing link to its growing system that will facilitate future provision of quality water service to other areas of the island. And it has the capacity to install cost recovery systems (especially metering) to support future operation of the system. This latter point is especially significant because the existence of an area on Pohnpei where water was provided without charge was making it much more difficult for PUC to charge for water elsewhere. In short, savings to the National Government should far outweigh additional costs to PUC.

There are non-monetary benefits as well. Service has already improved to the non-national users of the system who were often given second shrift in the past—for example, 24-hour service versus just a few hours per day—while service to the national users has remained level. As PUC completes the upgrading and integrates the still separate water system into its own, further service improvements are certain to follow. To be sure, a public service has merely been transferred from the National Government to a state government entity, but now it is located within an appropriate corporation that is increasingly being run on a commercial basis.

In short, the transformation has resulted in both reduced costs to government and improved service levels. It satisfies the criteria for second tranche qualification.

TRANSFORMATION OF NATIONAL AQUACULTURE CENTER

The National Aquaculture Center (NAC) consists of a single facility in Kosrae, which has historically focused only on the growing of giant clams. Although it sells some product, it has required a subsidy from the National Government throughout its life. The transformation proposal is to allow a private company to operate the facility at a profit upon payment to the National Government of a fee based upon the number of clams and other organisms sold. Most of the product would be exported for use in aquariums in Europe.

Martin Selch, of a German company called IMTRONA GbR, is the proposed operator. In addition to giant clams, which can be bred entirely in the NAC facility, Mr. Selch wants to add three other products eventually: corals, tropical fish, and so-called “live rocks” (rocks from the reef which contain natural bacteria and algae beneficial to aquariums). The rocks and fish would necessarily be harvested from the wild, while only fragments of wild coral would be taken for growth and reproduction in the NAC facility.

There are a number of obstacles to the proposal. Perhaps the major one involves the uncertainty of transportation out of Kosrae. The only viable carrier is Continental Airlines, which refuses to commit to carrying freight until just before a flight leaves and it has had a chance to maximize its income from the far more lucrative passenger segment of its market. Passengers and their baggage set weight limitations on the amount of freight Continental will carry, and loads are at constant risk of being bumped at the last minute. For a live cargo in seawater, this is unacceptable and may well spell the ultimate demise of this transformation proposal. There was not much the consultant could do to solve this problem.

The other problem area is several Kosrae State laws that prohibit the harvesting, sale, or export of marine life by foreigners under any circumstances and by anyone else except under strict limitations and with a permit. These laws need to be changed. While there may be little resistance to a change that is limited to marine life entirely grown in the NAC facility, there is widespread objection to making it easier for people—especially foreigners—to exploit the fragile reef around Kosrae. Mr. Selch argues that what he proposes can be done in an environmentally sensitive and even enhancing way, and no doubt it can. But given the justified concern for environmental protection and the current lack of enforcement capacity in Kosrae, it appears that Mr. Selch faces an uphill battle.

The situation is complicated by the Governor’s hope that the State itself can obtain the NAC facility for use in hatching mangrove crabs, which it has started to grow elsewhere on the island for export to Guam. Never mind that this new venture may be just another example of government invading the domain of private enterprise. Never mind that Kosrae seeks a windfall on the NAC facility from the National Government. Such things have happened before in the FSM. For present purposes, it is enough to recognize that the State’s

interest in the facility could make it less willing to assist Mr. Selch in pursuing his interest in the facility.

The consultant analyzed the legal obstacles in Kosrae and prepared draft legislation to permit export of giant clams that have been bred in captivity. However, Mr. Selch will probably just have to go through the same review and permit process, which anyone else, local or foreign, must go through before dealing with marine resources taken from the reef. Whether he will succeed in obtaining that right, what conditions it might be subject to, and whether that will be enough to make his plans economically viable remains to be seen. But the problem is that he simply wants to do a lot more than just take over the operation of NAC.

TRANSFORMATION OF NATIONAL COCONUT DEVELOPMENT AUTHORITY

The FSM Coconut Development Authority (CDA) was created in 1981 by statute. 22 FSMC 201-217. Its purpose was to promote the coconut industry in the FSM by buying copra from the outer islands and selling it or its products, primarily abroad but also domestically. When the world demand for copra fell and small isolated producers could no longer compete effectively with the major Asian mainland producers, the government paid above-market prices to the FSM copra producers in order to provide them with some income and discourage emigration from outer islands to the more crowded main islands. Despite efforts to develop value-added processing and new markets, CDA has never succeeded in recovering either the amount of that government subsidy or any significant portion of the Authority's operating cost, both of which have remained as a significant annual drain on the national budget.

The amount of that drain in recent years has trended downward from \$333,000 in FY2001 (\$200,000 of which was subsidy) to \$215,000 in FY 2004 (\$100,000 of which was subsidy). Thanks to a supplemental appropriation of \$25,000 in subsidy money, FY 2005 rose a bit to \$235,000 overall (\$125,000 total for the subsidy element). For the new fiscal year, at least initially, the subsidy is only \$75,000 and the first six months of the operating budget is \$62,801.

Today, CDA operates mostly in Pohnpei. It is available to assist the Chuuk Coconut Authority, which supposedly runs a similar operation in Chuuk but in fact is moribund now. Yap has a coconut operation of its own, and Kosrae has none.

CDA's copra operation is presently limited to buying copra at subsidized prices, storing it, and reselling it at market prices, mostly abroad but also to Pohnpei Coconut Products, Inc. (PCPI), which makes various coconut oils, soaps, and shampoo. PCPI began as a nonprofit effort of the Pohnpei Agriculture and Trade School (PATS), received assistance over the years from CDA, and was corporatized in 1989. In the 90's it was supposedly privatized, but the new owners did not pay anything to the government for the business and have since received sporadic assistance from both the state and National Governments. Despite the assistance, PCPI is now on the verge of failure and may soon cease buying copra from CDA.

In recent years CDA has switched its focus from dried copra to fresh foods made from young coconut. It is important to appreciate the differences. Copra is the traditional form of raw or unprocessed coconut used in international trade. The meat of old nuts is removed, dried, and bagged on the outer islands, then shipped to a central facility for processing or onward bulk shipment. The process requires a lot of hard work and yields, even at the presently subsidized price, relatively little money per nut, per unit of weight, and per unit of effort. It also requires waiting longer for each nut as it matures on the tree.

By contrast, young coconut is ready to harvest sooner and has significantly more value. The main product is so-called virgin coconut oil, which is healthier than regular coconut oil (made from copra) and rapidly gaining acceptance abroad. But CDA has also developed and is marketing coconut milk, jelly, ice cones, pig feed (from processing residue), shell charcoal, and other valuable products or by-products. The operating costs (including depreciation) of this effort so far have roughly equaled the operating revenues, which derive from sales at relatively low prices in Pohnpei. Thus the operation shows a great deal of promise if the far higher prices available in the more metropolitan markets can be tapped.

The initial proposal was to sell off the fresh coconut operation while retaining the copra operation. The hope is that fresh coconut will gradually replace copra—and the need for a copra subsidy—eventually allowing CDA to dissolve or trim back substantially. For this to happen, a number of issues need to be addressed.

To start with, the government's desire to support outer islanders can be met only if the copra subsidy continues or fresh coconut replaces it on those outer islands. So far, all of CDA's fresh coconut production has been from nuts gathered on Pohnpei proper. This is fortuitous because the handling of young coconut is critical if spoilage is to be avoided. In particular, the fresh meat must be processed within a few hours of cracking the nut, and shipping whole nuts from outer islands to a central processing point is not viable due to high shipping costs and risk of spoilage even to uncracked nuts. Thus, if outer islanders are to supply useful young coconut, they must harvest it, crack the nut, remove and grate the meat, cook or sun dry the meat, squeeze it to extract the virgin coconut oil, and put the oil into large containers. If this is all done properly, the oil will then keep for up to three months on the outer island and aboard ship before further processing is required at the central plant.

All this raises numerous questions regarding the viability of fresh coconut as a long-term replacement for copra production, at least on the outer islands:

- It looks like more work for the outer islanders to process fresh coconut than copra, although the Manager of CDA ("Manager") says that such is not the case. Producing copra is apparently a very tedious and unpleasant task by comparison.
- Special equipment and training will be required on the outer islands. The Manager believes that such equipment—probably 2 graters, 1-2 presses, trays, and containers—will cost about \$2,000 per satellite processing point. He proposes that the islanders would pay for the equipment themselves and CDA would provide the relatively simple training in its use. Just how these actual startup costs are to be funded, and how many outer islands will be able to participate as a practical matter, remain open questions.
- Transportation to and from the outer islands is highly irregular. This means that the loss of product by spoilage would probably be greater with fresh

coconut than with copra, which degrades much more slowly. It would also increase the difficulty of assuring a steady supply of product to any offshore buyers, which has been a significant problem in the past with other local commodities such as pepper and shell buttons.

- The only available mode of transportation to and from the outer islands is owned by the state government and expensive. Right now, CDA pays the cost of bringing copra from those islands to Pohnpei at a rate that is nominally uniform but may reflect the state government's desire to assist the National Government in its support of outer islanders. If fresh coconut production were to be transformed, the private operator might have to pay higher rates. On the other hand, the product is worth much more than copra per unit weight or volume, so perhaps it could bear a higher transportation rate.
- Of all the products available from fresh coconut, only virgin coconut oil can be realistically produced on an outer island and shipped to Pohnpei. However, the Manager believes this is the major future for the industry, and outer islanders can continue to make coconut milk, pig feed, and other byproducts for their own use as they always have.
- Presumably, a private owner of the fresh coconut operation would be free—he certainly ought to be free—to make his own choices as to the size of the operation and sources of its raw product. The owner might well decide that the additional costs and difficulties of getting virgin oil from outer islands were not worth the additional revenues it generated and decide just to work with high value products derived from coconuts grown only on Pohnpei. If so, the problem of supporting outer islanders would remain unsolved.

In addition to the special difficulties of sourcing fresh coconut products on the outer islands, there is a relocation problem. The central processing plant is currently integrated with the CDA's other operations (primarily copra and research) in such a way that physical separation will be highly desirable if the plant is to be under separate ownership and control. Moreover, the underlying land is owned by Pohnpei State and controlled by its Port Authority, which wants operations such as this to move elsewhere so the port itself can grow. It is very unlikely to allow a private operator, especially one who looking to grow, to stay on the present site.

Relocation would entail not just the capital cost of constructing a new building and moving the equipment to the new location, but also incurring a real or opportunity cost of land that is not now incurred by CDA. A private owner will either have to pay rent for land owned by someone else or put the facility on his own land, thus losing the opportunity to do something else valuable with that land. CDA, on the other hand, uses its present site without charge from the state, presumably as a contribution to the support for outer islanders that CDA provides.

Thus if fresh coconut were to be privatized now, it is difficult to see just what the government would have to sell beyond the equipment and possibly some know-how. Both present problems. Existing equipment used in the fresh coconut operation has an original cost basis of \$137,000, but now it is probably not worth much more than \$60,000. New equipment worth \$50,000, a gift from India, is on order. Resale of that equipment, at least before using it for a decent interval, would likely produce diplomatic difficulties, yet retaining the new equipment without also retaining the fresh coconut operation would be senseless.

The know-how exists to some extent in records but primarily in the heads of the few CDA employees who would be rendered redundant by the transformation—and who will have to be let go if the transformation is to make any sense at all from the government’s point of view. The buyer of the fresh coconut operation could hire those people if he wished—though he should not be obligated to do so—but if he did so he would reap the benefit of their know-how by paying them wages, not as part of any purchase price paid to the government.

Finally, sale of the fresh coconut operation now would require the buyer to set up his own satellite operations on the outer islands if he wanted to enlarge the business in any major way.

The Manager wants to delay any transformation for one or two years until he can further develop markets for the product and address these problems—first, by setting up the satellite operations on selected outer islands and, second, by building a new plant somewhere else. This might indeed make a more attractive package for privatization, but first the government must spend more money that it might or might not ever get back. What if a potential buyer wants to locate the business on his own land? What if he is not interested in the satellite operations?

Regardless of whether the fresh coconut operation is sold now or later, at least two more issues must be confronted. First, a private buyer presumably would—and certainly should—lose the exemption from taxes currently afforded CDA. This is a normal and generally beneficial consequence of privatizations, but it represents another cost of doing business that will serve to depress whatever price a buyer is willing to pay for the operation.

Second, the law establishing CDA should be amended. Presently it authorizes (though apparently does not require) CDA to “fix all prices to be paid to producers or sellers of products derived from the coconut tree in the Federated States of Micronesia.” 22 FSMC 202(4). A private party buying fresh coconut must be able to negotiate his own prices. Perhaps this could be accomplished in the purchase and sale agreement, with CDA promising not to set prices applicable to the buyer, but a prudent buyer may want this protection written into the statute itself.

There is an alternative to selling just the fresh coconut operation: sell CDA as a whole to a private party, subject to restrictions, and terminate it as a government entity. This would be

the simplest way to get the government completely out of a business it can no longer afford to be in. In order to meet its social goal of supporting outer islanders, the government could require that the buyer continue buying coconut from the outer islands at no less than current prices and volumes, either as copra or an economically equivalent amount of virgin oil. This purchase requirement would diminish each year and end after, say, five years. By then, virgin oil should have replaced copra if it is ever going to do so, and the islanders will be earning more than they are now from copra. If virgin oil does not succeed as expected, the islanders will be left with no subsidy, but surely this would have been the case in any event. How much longer can the government continue to give money away to outer islanders? Virgin oil is the great hope, and it can be developed much more efficiently by the private sector than by the public sector.

Of course, the government will have to pay for the phasing out of the subsidy, either in a reduced sale price for the whole operation or with appropriations over the course of the phase-out period. But at least the amount of government expenditure will be declining predictably and the end will be in sight.

Following is a listing of the pros and cons for each of these options. To this writer, option 3 seems by far the best.

Option 1: Sell fresh coconut operation now.

Pros:

1. Frees up space at present site for CDA to pursue development of other possible coconut products.
2. Instead of government, private sector takes risk of fresh coconut not turning out as well as expected.
3. Allows government to continue support of outer islanders separately.
4. Converts a non-taxpaying enterprise to a taxpaying one.

Cons:

1. No or low price expected because buyer must (a) find and pay for new location, (b) pay for new building, (c) establish satellite processing points at his own expense if he wants them
2. Problem with new equipment donated by India.
3. May require simple legislation.
4. Does not save the government any money, because appropriations for the subsidy and for CDA operations will still be required as long as government wants to keep supporting outer islanders. Reduction of CDA budget by expenses related to fresh coconut operation will be offset by the loss of associated revenues.

Option 2: Sell fresh coconut operation in 1-2 years.

Pros:

1. After some delay, frees up space at present site for CDA to pursue development of other possible coconut products.
2. Allows government to continue support of outer islanders separately.

3. Allows for time to build up markets and production capacity, thus enhancing sale price.
4. Converts (though not as soon) a non-taxpaying enterprise to a taxpaying one.

Cons:

1. Government will incur addition costs of (a) relocating to new site and (b) setting up satellite processing points. These costs may or may not be fully recovered in the final sale price.
2. Same diplomatic problem with India, although it may be reduced by not reselling the new equipment so soon after its receipt.
3. May require simple legislation.
4. Government bears most of risk regarding development of fresh coconut business.

Option 3: Sell entire CDA operation now with restrictions.

Pros:

1. Gets government out of coconut entirely.
2. Temporarily continues support of outer islanders, gradually reducing government outlays for the coconut subsidy.
3. Immediately saves government the cost of supporting CDA's operating budget.
4. Instead of government, private sector takes risk of fresh coconut not turning out as well as expected.
5. Converts a non-taxpaying enterprise to a taxpaying one.

Cons:

1. Will require legislation (authorization to sell initially, repeal of CDA organic act eventually).
2. Same diplomatic problem with India, although it may be minimized in this option because of continued use of the new equipment to support outer islanders for several years.
3. Probably spells end to government support for development of coconut products (although government could subsidize private companies to do this if it wished).

The foregoing was presented to the FSM Privatization Committee on October 12, 2005. The group leaned toward option 3 with transfer of CDA's research functions to the Department of Economic Affairs and possible elimination of the subsidy to outer islanders immediately rather than gradually. However, no firm decisions were made.

**TRANSFORMATION OF
CHUUK ICE PLANT**

This is a commercial operation within the Department of Marine Resources designed to make non-potable ice available to artisanal fishermen at an affordable price. The equipment for two plants—one in Weno and a smaller one in Tonoas—was donated by Japan’s Overseas Fisheries Cooperative Foundation (OFCF), which continues to assist with maintenance of the plants. OFCF has indicated that it does not object to a transformation, which keeps plant ownership in government hands, but it is unclear under what scenarios, if any, the ongoing assistance would continue. OFCF has informally suggested that the assistance would probably continue, especially if the support for artisanal fishing were to be continued, but there has been no formal statement yet. It is important to find out for sure, since the ongoing assistance, including potentially costly replacement parts, may be necessary to keep the operation financially viable.

One would hope that, at most, Japan will insist only upon retaining the current, below-cost prices to fishermen, thus preserving the social benefits of the program. If so, it is possible to imagine a transformation in which the management and operation of the ice plant(s) is turned over to a private person who promises to maintain low prices, possibly in return for a subsidy from the government (which would be well below the government’s current net costs of operating the facilities). The subsidy could be phased out over time, and the prices to fishermen could be gradually raised with inflation or perhaps even faster until they reach market equilibrium.

It is very difficult to get complete and accurate figures on either the costs or revenues of existing operations. Some rough annual numbers, however, are as follows:

Costs:	Personnel (13 employees)	72,300
	Electricity	36,000
	Water	2,800
	Fuel for backup generator	10,000
	<u>Miscellaneous</u>	<u>5,000</u>
	TOTAL	126,100

Revenues for the 12-month period ending September 2005 were \$21,875, meaning that the loss to the government—that is, the government subsidy—is over \$100,000 per year.

Ice is sold by the bucket-full (\$1) or half-bucket (\$0.50), which is about half the price of non-potable ice sold on Faichuk. A bucket is about 10 pounds, or \$0.10 per pound. Based on the revenue range above, this means that somewhere in the area of 120,000 and 260,000 pounds of ice are actually sold per year. Yet Marine Resources claims to be producing about 750,000 pounds of ice per year. Some is obviously lost to melting, but surely not 65-80% of the total production! Where is it going?

Elsewhere on Weno, various merchants make potable ice, which is presumably more expensive than non-potable ice, and sell it for about \$0.25-.30 per pound. If the government were to cover all its costs of production (not counting cost of capital and assuming no reduction of demand at the higher price), it would have to charge between \$0.48 and \$1.05 per pound. Why should dirty ice be so much more costly to produce than clean ice?

A recent OFCF report on the plant reached similar results and asked similar questions. Clearly, there are real opportunities for a more entrepreneurial operator to reduce the cost per unit sold significantly. Moreover, the plants are suitable for making either dirty or clean ice with just a simple flushing of the equipment before switching from the former to the latter. Thus, there are opportunities for expansion of the product type and customer base beyond just meeting the demand of the artisanal fishermen. It is not at all unreasonable to suppose that the current low price of dirty ice can be retained in the context of a profitable operation, which requires no government subsidy at all. But a declining, transitional subsidy may be desirable to maximize the likelihood of long-term success.

Such a subsidy could and surely should be much less than the present amount. This would result in savings to the government, but only if the existing personnel are laid off rather than transferred to some other government operation or department. Presumably some of those workers would find work with the new private sector operator of the plant(s). Others could perhaps have been given severance payments, out of the PSDP Loan proceeds or otherwise. But one way or the other, the government would have to get past the mindset that its primary function is to employ as many people as possible.

The outline of a CCA transformation might look like this:

1. Operation of the plants is turned over to a private party.
2. Government retains ownership of the land rights, plant, and equipment.
3. Operator maintains all of same in good condition at operator's expense, hopefully with the continued assistance of OFCF.
4. Operator hires its own employees and pays all expenses of operating the plants.
5. Operator is required to meet the demand for dirty ice at the current price, subject perhaps to CPI-based inflationary increases. Operator may also serve any other ice market at whatever prices operator chooses.
6. Government pays operator a subsidy of maybe \$5,000 per month during the first year of the contract, \$4,000 during the second year, \$3,000 during the third, etc., declining to zero at the end of the first five years.
7. The initial operator is chosen from among those bidding in an open process. The contract is awarded to the responsible bidder offering the highest price to the government or requiring the lowest subsidy from the government.
8. Every five years the contract is put out to bid again.
9. On the day the initial contract goes into effect, all government personnel currently working on the ice plants are laid off by the government.

A transformation along the foregoing lines would have been a qualifying transformation for purposes of the PSDP 2nd tranche. It would have saved the government money and reduced crowding out of the private sector by government. It might also have resulted in improved service to the public.

Chuuk had taken no steps toward implementing such a transformation when, in October, it became clear that part of the land underlying the Weno plant is owned by a private party named Midasy Aisek, a local lawyer and businessman from whom the government had no lease. The consultant visited Aisek and learned that, while he was unwilling to sell the land or commit at this time to a rental amount, he was interested in taking over operation of the ice plant himself. The government will now attempt to negotiate an acceptable deal with Aisek.

**TRANSFORMATION OF
CHUUK HIGH SCHOOL CAFETERIA**

The Chuuk High School is on land owned by the State. However, the cafeteria and dormitories are on land owned by one Julita Aisek or her family. The State would like to buy the land, but Aisek will not sell it at what the State views as a reasonable price. Aisek's lease of the land to the State has expired and negotiations are stalled on a new lease. Apparently Aisek wishes to be paid not just rent for land but also a fee for managing the cafeteria.

Against this backdrop, a Management Services Contract was negotiated with Aisek. Because of funding considerations, it was initially entered into for only one month beginning on January 7, 2005. It was expected that by the end of that month the necessary reprogramming of funds could be accomplished to allow extension of the contract. The reprogramming was in fact completed on time, but the funds themselves suddenly ceased to be available. Their source is the U.S., which terminated funding for the Chuuk school lunch program while it looks into questionable use of the funds in the past. Thus there is no money for school lunches right now and no idea if and when there ever will be.

Even without the funding problem, the contract with Aisek would not suffice as a legitimate transformation for purposes of qualifying for the PSDP Loan 2nd tranche. It is simply too lopsided against the interest of the State. Aisek receives \$10,324 per month just for "managing" the cafeteria. The State still supplies all the personnel (who apparently remain in the public service), food, supplies, equipment, maintenance, transportation, "and other necessities for the operation." Surely this will cost the government much more money overall than if it had never done the transformation in the first place.

Undoubtedly the underlying land dispute figures into this deal in ways not apparent on the face of the Management Services Contract or to the consultant. It may or may not be a good way to kill two birds with one stone, but it is not the right way to privatize a public enterprise.

TRANSFORMATION OF CHUUK COCONUT AUTHORITY

In September 2003, Chuuk State acting by and through its Chuuk Coconut Authority (CCA) signed a Coconut Processing Plant Agreement with Korea A&W, a local firm run by a Korean man residing in Chuuk named World Park, who apparently fronts for other Korean businesses as well. The contract has the strange premise that Korea A&W would serve as a “partner...on an independent contractor basis.” In fact it appears to be a management contract with respect to the construction and operation of a coconut processing plant, along with 50/50 cost sharing. Presumably there was also to be 50/50 profit sharing, but the contract never really says. All this was to last 20 years, with an option to renew for 20 more; it does not specify which party can exercise the option. Had this contract lasted, the legal questions under it would have been legion.

But it has not lasted. From the beginning, Mr. Park and the government were like oil and water. Park complained about the poor skill levels and work ethic of the government employees (about 15) he was trying to manage, the unclear lines of authority with the existing CCA Board members, the poor condition of the plant, the costs of renovating it, and the government’s failure to come up with its share of those costs. The government says Park is the one who did not want to pay his share and whose insensitive management style caused all the problems.

Park walked off the job and has since started to put together his own coconut processing operation. He says he has had it with government, considers the 2003 contract dead, and would not want the government operation if they gave it to him. The consultant suggested to the government that it should probably get a short termination agreement signed by Park just in case he has second thoughts later on.

During the consultancy, the consultant became aware of a Chuukese woman who is interested in using the CCA facility for production of fresh coconut products (see Appendix D on CDA transformation at the national level). Attempts to get the government and this woman together have yet to yield results.

TRANSFORMATION OF KOSRAE HOSPITAL FOOD SERVICE

Before the transformation, the Kosrae Department of Health Services provided food service to an average of 39 patients per day in the state hospital. It employed three full time employees—two cooks and one nutritionist. The nutritionist will remain after the transformation; the cooks will be laid off. The cooks, who had to do everything to keep the cafeteria going, not just the cooking, were overstretched, but a state government hiring freeze precluded staffing up more appropriately. The annual cost to the state was about \$30,000 just for the food. The two cooks cost about \$6,000 including benefits. Power added substantial but unknown costs every year—unknown because until the transformation, there was only one meter and billing for the entire hospital.

The transformation involves splitting the utility meters and contracting out for operation of the hospital food service by a private enterprise that will pay for its own utilities, personnel, food, supplies, maintenance, and other inputs according to general or patient-specific dietary guidelines provided by the nutritionist and doctors. The operator would also be permitted and encouraged to run a small restaurant/snack bar in the hospital dining area. In addition to serving staff and visitors, this would provide a much-needed service to others in an employment center (Tofol) chronically underserved and currently without any restaurant. It would also provide the operator with a potential new profit center to help cover the costs of the mandatory meals for patients.

The transformation will not save the state any money, but it is expected to result in better service. Partly this relates to the new restaurant mentioned above. But mostly it comes from avoiding the restraints on management efficiency imposed by current laws applicable to state personnel and procurement. Obviously, the transformation will also result in less crowding out of the private sector.

In June or early July, the Governor issued a Request for Proposals (RFP) to be submitted within 30 days. It called for a per-meal price and a 2-year contract, after which the contract would be subject to re-tendering. Only one proposal was received and it failed to address all the items asked for in the RFP.

The proposed transformation was reevaluated within the government, the RFP was reformulated, and the Director of Health Services communicated with a variety of potential operators to stimulate new interest in the transformation. For reasons unclear to the consultant, the new RFP has not yet been republished, but reportedly it is about to be. Assuming a response period of less than the original 30-days and prompt follow-up thereafter, it is reasonable to suppose that an outsourcing contract can be in place by mid-December.

TRANSFORMATION OF POHNPEI EDA FISHING BOATS

Although its core mission is to serve as the business development arm of Pohnpei State, the Economic Development Authority (EDA) primarily sells ice, cold storage, and, most importantly, transshipment services to all commercial fishing vessels that put into Pohnpei. It operates somewhat autonomously—keeping its own accounts and revenues, for example, and borrowing from outside sources—but still requires a regular subsidy from the state.

On December 10, 2002, South Korea and the FSM Department of Foreign Affairs signed an MOU (Memorandum of Agreement) for the donation of seven used longline fishing vessels to the FSM National Government. The MOU stipulated that the surplus vessels must be removed from Korea, flagged in the FSM, used in FSM waters, and not “exported or taken out of the country to the Republic of Korea or a third nation.” If these restrictions were violated, Korea could request the return of the vessels. The restrictions did not, however, include a prohibition on selling the vessels, which apparently is typical when a donor cares about that possibility.

On December 27, 2002, the National Government formally agreed to pass three of the vessels along to EDA, and EDA assumed the National Government’s responsibilities regarding those three. Two months later, EDA entered into a partnership agreement with Luan Thai Fishing Venture, Inc. (LTFV), a private company under Chinese ownership, to form a joint venture named Pohnpei Commercial Fishing Venture (PCFV). PCFV assumed EDA’s obligations with respect to the vessels. The partnership agreement had been anticipated since at least as far back as October 2002, when EDA and LTFV signed an MOU of their own regarding the impending gift from Korea. Pursuant to that MOU, both parties had visited Korea to inspect the vessels.

The February 2003 partnership agreement was for a two-year term, after which it would either be renewed by mutual agreement or terminated. EDA contributed the vessels, although apparently retaining title, and received a 40% interest in profits and losses. For its 60% interest in profits and losses (plus a management fee) LTFV agreed to bring the vessels from Korea, refit them, supply navigational equipment and fishing gear, retain the captains and crew (but with limited training of FSM citizens as well), operate the vessels, and market the catch. Upon termination of the partnership, each party was entitled to the return of its capital contribution. Each party was also granted a right of first refusal on transfers of the other’s interest in the partnership, which may have been intended to fulfill a provision of the earlier MOU saying that LTFV would have the right to negotiate for purchase of the vessels at a “favorable price.”

Before the end of the two-year term, PCFV had run up sizable operating losses and EDA wanted out. Negotiations began at least as far back as September 2004 for early termination of the partnership and sale of the boats to an LTFV subsidiary named All Venture Trading Ltd. (AV). An initial deal for a very low price was derailed by the Pohnpei Governor. For reasons that may or may not be related, the Executive Director of

EDA was also replaced. On January 4, 2005, a new deal was consummated under which EDA received \$200,000 cash plus forgiveness of all its debts to the partnership in exchange for the three vessels. At the time those debts consisted of \$306,726.62, including EDA's 40% share of both the operating losses (\$533,959) and return of LTFV's capital contributions (\$232,857.55 net of amortization).

In effect, LTFV/AV paid \$506,726.62 for three eight or nine-year old longliners. Unproductive assets in the hands of a public enterprise have been converted to presumably productive assets in the hands of a private company. The transformation qualifies for the second tranche because it benefits the public financially and there is less crowding out of the private sector.

Nevertheless, this is less than an ideal transformation for many reasons. First, there are reasons to suspect that PCFV's operating losses were inflated, thus increasing the pressure on EDA to sell and diminishing the real value of the consideration paid. Second, there was never any valuation of the boats to support the price paid for them by LTFV/AV, and their true value may have been higher than the price paid. Third, the deal was negotiated with only the one buyer who expressed interest rather than being advertised and put out to bid. (On the other hand, the market here is limited, there is something to be said for an expedited transaction with no significant transaction costs, and LTFV arguably had a right to buy the boats at a "favorable price" as further consideration for its efforts on behalf of the partnership.) Fourth, this is the kind of transaction that could be objectionable to the original donor, though in this case there is no indication that Korea has in fact objected. Fifth, EDA and the closely related Pohnpei Fisheries Corporation (PFC) have been the subject of many studies and recommendations for far more radical transformations, making this divestiture seem paltry compared to the possibilities.

Perhaps LTFV was less than scrupulous in its dealings with EDA. Perhaps the way it all played out was planned from the beginning. Perhaps EDA (under a former Executive Director) was even complicit. But potential for mischief is one of the many reasons why public enterprises are disfavored, and Pohnpei is to be applauded for getting out sooner rather than later. The perfect should not become the enemy of the good. What has happened here is positive in its own right, and it meets the standards by which transformations are to be judged.

TRANSFORMATION OF YAP TV

Waab Television Station began in 1979 with an initial capitalization of \$80,000. Located within the Department of Youth and Civic Affairs, Division of Media, the station had a dual purpose of creating local cultural and educational programs and providing general broadcast television service on Yap proper. By 2004, it was operating a single station for part of each day (1 pm to 11:30 pm). The programming was on Super VHS tapes, purchased from a company in California, which contained shows from a variety of American broadcasters and were replayed in Yap at least a month after they appeared on American TV. In April of 2004, Typhoon Sudal caused extensive damage to the transmission equipment and the station was shut down. It never resumed TV service.

Meanwhile, a transformation of the station had been contemplated for some time. The Aries Report in 2000 recommended corporatizing Yap TV, possibly with FSM Telecommunications Corporation as a co-venturer. Telecom is a self-supporting, publicly owned corporation that supplies cable TV service in other parts of the FSM. It had been thinking of undertaking similar service in Yap, with or without transformation of Yap TV.

It was determined that right-of-way acquisitions costs would make a cable TV system economically unviable, so Telecom set about installing a wireless system that dispenses with the need for rights-of-way and operates on a line-of-sight basis much like cellular telephones (which Telecom was also installing). To date it has invested over \$600,000. In May 2005 Telecom announced the availability of their new Wireless TV, and by October 2005 they had signed up about 500 subscribers, 300 of which are already receiving service at \$25 per month each. The number of subscribers is expected to grow as TV signals are extended further out from the Colonia base station.

Already the quality of service has improved considerably. Subscribers are receiving 21 channels, including many of the leading cable channels, with more to come. The service is available 24 hours per day. And it is real time, satellite downlinked broadcasting. This certainly beats one channel, for a few hours every day, showing taped material broadcast a month or more earlier. Moreover, the service is now being provided on a fee basis instead of being government subsidized, which arguably reduces any crowding out of the private sector.

However, it remains difficult to say just whether reducing the costs of government, perhaps the key criterion for evaluating transformations, has been satisfied. Imputed savings are small and actual savings are nonexistent. Let's start with imputed savings. Depending on the source, the number of government employees has dropped from 3 to 1 or (more likely) from 2 to 1. The personnel costs saved are on the order of only \$2,600. Add to this the saved cost of buying the video tapes from California (\$13,500) and possibly as much as \$2,500 in power and other avoided costs, and the total savings are no more than \$18,600 per year.

But these savings have not in fact materialized because, apparently, the government has elected to spend more money on the program-creation part of the station's original charge. Total budgets for the station in recent years are as follows:

1999	\$24,990
2000	\$28,990
2001	\$25,290
2002	\$37,130
2003	\$26,290
2004	\$25,830
2005	\$44,170
2006 (recommended)	\$28,910

Fiscal Year 2006 will be the first year without the cost of buying videotapes, but for the year fixed assets would go up by \$5,000 and personnel costs by \$10,760 (for a new position of TV Program Producer). The government hopes that the additional expenditures will yield more locally produced programs aimed not only at education in the local language but also cultural preservation, especially in light of the increased exposure to Western-style television which the Yapese are about to experience. If they succeed, it will be possible to say that funds have merely been diverted from one (possibly) public purpose to another, more compelling one. But it remains to be seen whether there will be any noticeable increase in either the quality or the quantity of productions by Waab Television.

Granting Yap the benefit of the doubt, and recognizing that even small steps in the right direction are worth taking, the Yap TV transformation can be said to qualify for the second tranche.

AMERICAN FOREIGN INVESTMENT IN THE FSM

Two current issues under the Compact of Free Association between the FSM and the US involve foreign investment. The first relates to the Investment Development Fund (IDF) provided for in Compact I. As originally negotiated, the Compact included a provision granting American companies favorable treatment under US tax law to the extent they invested in the FSM. The US Congress failed to approve this tax provision and offered instead a fund of \$20 million to be available to the FSM for use in supporting the development of businesses in the FSM that had some American involvement. When and if the FSM could show that removal of the tax provision had harmed the FSM by more than this amount, an additional sum of up to \$40 million could be added to the fund. Compact II preserved this possibility, and FSM leaders are again talking about trying to make the necessary showing and claim the additional money.

The second issue relates to the need for American foreign investors to obtain foreign investment permits in the FSM. Currently they must do so, just like foreign investors from any other country, but there is a debate over whether this is allowed under Compact II. There is no doubt that Compact II strengthened the original provisions designed to give Americans in the FSM treatment comparable to that given FSM citizens in the US. It is now the case, for example, that Americans can enter the FSM for the purpose of residing, working, and even investing there without having to get an entry permit from FSM Immigration as in the past. It is less clear whether this Compact-mandated reciprocity of “immigration related procedures” exempts American investors from having to obtain a foreign investment permit. (There is no similar requirement on FSM investors in the US.)

The FSM Attorney General has opined that the foreign investment laws of the FSM governments are business related, not immigration related, and therefore unaffected by the revised Compact language. Many Americans, reportedly including the US Ambassador, think the intent was otherwise. It is possible that the FSM interpretation will be challenged in court by some prospective American investor, but the process of seeing such a suit through to completion would be time consuming, expensive, and uncertain of outcome. More likely the issue will be resolved politically or not at all.

Lost in the debate so far is the possible inconsistency of making it harder for Americans to do business in the FSM while seeking to show that the FSM has been damaged by a shortage of American investment to the tune of up to \$40 million dollars. One may wonder how much more American investment there could have been in the FSM—and could still be—if the FSM gave Americans the same freedom to invest in the FSM that FSM citizens have to invest in the US.

The consultant assiduously avoided taking a position on the foregoing issue in the belief that true foreign investment reform should not depend on the nationality of the foreign investor. In assessing the current attitudes toward such investment reform, however, the foregoing situation could hardly be ignored.

NEW CORPORATE TAX SCHEME

Early in 2005 the FSM Congress overrode a Presidential veto and two companion acts became law. Congressional Act No. 13-70 (now Public Law No. 13-71) establishes a 25.5% income tax on certain “Major Corporations.” Congressional Act No. 13-74 (now Public Law No. 13-70) expands the duties of the FSM Registrar of Corporations with respect to administering Major Corporations and related matters. It is evident from all the surrounding circumstances that the intent is to take advantage of a loophole in the Japanese tax laws whereby corporations doing business in Japan can pay a substantial tax to the FSM in order to avoid an even larger tax in Japan. A private company from Hawaii stands to make up to 50% of the revenue collected by the FSM for devising and helping to implement this scheme.

As pointed out in the President’s veto and related documents, there are many good reasons for opposing the scheme, not the least of which is its potential for negative impact on new foreign investment in the FSM. Such an effect could come from the perception that the FSM, having elected to become a tax haven of sorts, may now be open to other, even less savory forms of offshore financial services. But the most obvious connection is that many potential foreign investors are corporations which might fear a substantial corporate income tax if they are or become too big.

The new tax law defines “Major Corporation” as any corporation that is not exempt from the act under section 313. Section 313 applies to all corporations incorporated in the FSM except those which meet at least one of the following four conditions: (1) the corporation’s capital is less than \$1,000,000, (2) the capitalization of the corporation’s “control group” (defined below) is less than \$10,000,000, (3) the corporation is a bank, or (4) the corporation was formed before 2005. For the remainder of this narrative, we will set aside banks and preexisting corporations, concentrating instead on capitalization of the corporation or its control group.

“Control Group” is defined as “a corporation and its 80% or greater owned subsidiaries, its parent companies that own directly or indirectly 80% or more of the corporation, and the 80% or greater owned subsidiaries of such parent companies.” It would seem that a corporation that wanted to avoid Major Corporation status could probably do so by arranging its control group to be capitalized at less than \$10,000,000—assuming, of course, that the corporation itself was worth less than \$10,000,000. One strongly suspects, however, that the intent was to treat as “major” any corporation capitalized at \$1,000,000 regardless of what its control group looks like (this is the interpretation provided in the Request for Proposals from prospective management agents for the scheme). If so, correction to the law is likely to occur and the scheme will effectively apply to any FSM corporation capitalized at \$1,000,000 or more. For now, it effectively applies to any FSM corporation capitalized at \$10,000,000 or more.

Further confusion is created by circularity in the definition of Major Corporation. Public Law No. 13-70 (the registrar act) says that every Major Corporation is required to be

incorporated by the FSM National Government. But the definition of Major Corporation in P.L. No. 13-71 (the tax act) says that it is a corporation which is incorporated in the FSM unless it meets at least one of the four conditions listed above. You must be incorporated in the FSM to be considered a Major Corporation, and if you are a Major Corporation you must incorporate in the FSM. It is unclear whether being a Major Corporation is optional or mandatory for corporations that are large enough.

The size thresholds, particularly the smaller \$1,000,000 one, and other uncertainties are important because legitimate foreign investors in the future might well be large enough to qualify as Major Corporations when they seek to do business in the FSM. Even if they do not start out that large, many will surely hope to be sufficiently successful that they grow that large. If so, they will face a potentially high and poorly conceived income tax that was designed for a completely different set of companies.

Congress now has before it a bill to amend this scheme so that any corporation that actually engages in business in the FSM, as opposed to just registering there for tax purposes, will be excluded from the definition of Major Corporation. If passed, this would eliminate the major objection to the scheme from a foreign investment point of view. But there is no assurance that Congress will pass the amendment. Even if it does, the other negative perceptions that could be generated by the scheme might still deter quality foreign investors.

PROCEDURES FOR ADOPTING STATUTES AND REGULATIONS IN THE FSM

Following are the procedures for adopting statutes (or “acts”) and regulations in the National Government. Procedures in each of the States are very similar.

Statutes. A bill is introduced to Congress (or the Legislature at the state level), studied, debated, and voted upon. If Congress passes the bill, it must be engrossed by legislative counsel to incorporate any amendments made, then transmitted officially to the President (Governor at the state level) by the Speaker. Such transmittal often follows completion of the Congress Session by days or even weeks. Once he receives this Congressional Act, as it is now called, the President has 30 days in which to veto it, sign it into law, or allow it to become law without signature. Even when the President originally proposed the bill, he generally solicits and considers comments from key Cabinet members before acting on it. If and when it becomes law, it must be assigned a Public Law number. Such a numbered Public Law, either signed by the President or annotated to state that it became law without signature, is the best evidence that enactment has been completed. Obviously it can follow passage of the original bill in Congress by considerable time.

Regulations. Regulations interpret and elaborate upon statutes. They are promulgated pursuant to a separate statute generally called the Administrative Procedures Act (APA). Promulgation is the primary responsibility of the department charged with implementing the applicable statute. Promulgation begins with publishing the proposed regulations within the affected jurisdiction (single state or entire nation). APAs vary in just what this involves (posting in public places, announcements on the radio or TV, publication in newspapers, etc.) For a period of time after publication, generally 30 days, any interested person may comment on the proposed regulations. When the public comment period is over, the promulgating department must consider any comments received and make any changes to the regulations it deems appropriate. Adoption is then completed when the regulations are signed by the head of the promulgating department, President (Governor at the state level), and Attorney General. As with a recently adopted Public Law, it is this signed and dated copy which constitutes the best evidence that the regulations have been adopted.

PERSONS MET

National Government

Redley Killion, Vice-President

Department of Justice

Marstella Jack, Attorney General (AG)

Emilio Musrasrik, Assistant AG and former Acting AG

Douglas Hastings, Assistant AG

Janhabi Nandy, Assistant AG

Matthew Olmstead, Assistant AG

Department of Economic Affairs

Akillino Susaia, Secretary

Roger S. Mori, Assistant Secretary, Division of Sectoral Development

Valerio Hallens, Registrar of Corporations (includes Foreign Investment)

William Ladore, Business Development Officer

Jesse Giltamag, Program Director, Public Sector Enterprise Unit

Marion Henry, Program Manager (Fisheries)

Maderson Ramon, Acting Assistant Secretary, Trade & Commerce

Ishmael Lehben, Program Manager (Agriculture) and former Acting Secretary

John Mooteb, SD Coordinator, Environmental & Sustainable Development Unit

Sancherina Salle, Economist

Department of Finance & Administration

Nick Andon, Secretary

Vince Pangelinen, International Finance Coordinator

Lam Dam, Tax & Customs Advisor

Mark Sturton, Macroeconomics Consultant

Department of Foreign Affairs

Lorin Robert, Deputy Secretary, Department of Foreign Affairs

Carl D. Apis, Deputy Assistant Secretary, Department of Foreign Affairs

Coconut Development Authority

Namio O. Nanpei, Manager

Catalino Sam, Chairman, Board of Directors

FSM Banking Board

Wilson Waguk, Banking Commissioner

David Press, Bank Supervision Consultant

Congress

Peter Christian, Speaker
Manny Mori, Chairman, Resources & Development (R&D) Committee
Alik L. Alik, Vice Chairman, R&D Committee
Ramon Peyal, Member, R&D Committee
Simiram Sipenuk, Member, R&D Committee
Several Other Senators in Committee Hearings
John Ehsa, Director of Budget & Administration
Brad Stam, Legislative Counsel
Jennifer Burnett, Asst. Legislative Counsel

Other

Anna Mendiola, President, FSM Development Bank
Robert Hadley, Assistant Secretary for Infrastructure, Department of Transportation,
Communications & Infrastructure

Chuuk State

Wesley Simina, Governor

Division of Commerce & Industry, Department of Administrative Services

Joe Suka, Chief
Manny Sonis, Deputy Chief
Nowell Petrus, Privatization Supervisor
Inson Namper, Foreign Investment Supervisor
Kaster Sisam, Land Management Supervisor
Kusto Edmund, Economist

Attorney General's Office

Joses Gallen, Assistant AG
Johnny Meippen, Acting AG

Legislature

Alonso Cholymay, Senate Floor Leader
Arno Kony, Senator
Jack Fritz, Legislative Counsel

Department of Marine Resources

Romio Osiena, Director
Bernie Killian, Chief, Division of Operations & Technical Support
Emil Peter, Diesel Engine Supervisor

Other

Hentrick Eveluck, CEO/General Manager, Chuuk Public Utilities Corporation

Dennis Yamase, Justice, FSM Supreme Court (Chuuk)
Larry Wentworth, Staff Attorney, FSM Supreme Court (Chuuk)
Camillo Noket, Director, Micronesian Legal Services Corporation (Chuuk)

Kosrae State

Rensley Sigrah, Governor
Gerson Jackson, Lieutenant Governor

Department of Commerce & Industry

Singkitchy P. George, Director
Rinson Edmond, Administrator
Kalis Opet, Administrator, Foreign Investment Division
Semeai Mongkeya, Foreign Investment Specialist

Department of Health Services

Arthy G. Nena, Director
Dr. Taulung
Kun Mongkeya

Legislature

Gibson T. Siba, Chairman, Resources & Development (R&D) Committee
Hiteo S. Shrew, Vice Chairman, R&D Committee
Albert T. Welly, Vice Speaker and Member, R&D Committee
John Martin, Member, R&D Committee
Ilai D. Abraham, Member, R&D Committee
Josaiiah H Saimon, Member R&D Committee
Semeon J. Phillip, Senator
Most Other Senators in Session
John McKenzie, Legislative Counsel
Lipar George, R&D Committee Staff
Steven George, Economist

Other

J.D. Lee, Attorney General
Nora Sigrah, Legal Counsel to State Court
Likiak Wesley, Administrator, Division of Planning & Statistics
Likiak Phillip, Acting Manager, National Aquaculture Center
Bruce Howell, Director, Department of Public Works
Henry Robert, Director, Department of Education

Pohnpei State

Johnny P. David, Governor

Jack Yakana, Lieutenant Governor

Legislature

Sailas J. Henry, Chairman, Resources & Development (R&D) Committee

Tom Beckmann, Legislative Counsel

Scott G. Garvey, Staff Attorney

Huddy Lucas, Staff Attorney

Dave Jennings, Financial Advisor

Foreign Investment Board

Quirino F. Loyola, Administrator

Radio Station V6AH

Joseph C.P. Alannzo, Commissioner

Paulino David, Chairman, Board of Directors

Henry Saimon, Vice Chairman, Board of Directors

Augustine Darmalane, Secretary, Board of Directors

Dakio Solomon, Member, Board of Directors

Ioanis Sahn, Member, Board of Directors

Pensile Enicar, Member, Board of Directors

Other

Hubert Yamada, State Planner

Kikuo L. Apis, Administrator, Office of Economic Affairs

Adalino Lorenz, former Acting Administrator, Office of Economic Affairs

Marcelino Actouka, General Manager, Pohnpei Utilities Corporation

Yosuo Phillip, Executive Director, Economic Development Authority

Yap State

Robert A. Ruecho', Governor

Joe J. Habuchmai, Lieutenant Governor

Department of Resources & Development

Joeseeph Giliko, Director

Jessee Gajdusek, Deputy Director

Mark B. Mathow, Chief, Division of Commerce & Industry

Office of Attorney General

Cyprian Manmaw, AG

Ronald K. Ledgerwood, Assistant AG

Legislature

Tony Ganngiyan, Speaker

James Mangefel, Vice Speaker

Ted Rutun, Chairman, Resources, Education & Development (RE&D) Committee
John J. Masiwemai, Vice Chairman, RE&D Committee
Charles S. Chieng, Member, RE&D Committee
Stan D. Kensof, Chairman, Government, Health & Welfare (GH&W) Committee
Antony M. Tareg, Vice Chairman, GH&W Committee
Leelkan Dabchuren Mulalap, Legislative Counsel
Jesse Raglmar Subolmar, Administrative Officer

Other

Jeffrey Adalbai, General Manager, Public Transportation System
Peter Garamfel, Managing Director, FSM Telecommunications Corporation
Peter J. Stelzer, Chief Public Defender

Miscellaneous

Private Sector Development Project

Matthew Abel, PSDP Project Manager, Department of Economic Affairs
Philip Woodcock, Team Leader, Land Registration Project (BGSI)
Bob Eddington, Member, Land Registration Project (BGSI)
Edwin Hyde, Member, Land Registration Project (BGSI)
Kevin Rainsford, Member, Land Registration Project (BGSI)
Greg Danz, Legal Expert, Land Registration Project (BGSI)
Mark McLoughlan, Valuation Specialist, Land Registration Project (BGSI)
Christopher M. Auricht, Planner, Land Registration Project (BGSI)

Asian Development Bank

Adam Bruun, Country Program Specialist/Economist
Meeja Hamm, Principal Project Specialist and FSM Desk Officer
Nenette S. Salvador, Associate Project Analyst
Edy Broisworo, Senior Environmental Specialist
Ophelia C.A. Iriberry, Senior Programs Officer

Other

Larry Adams, business leader
Andrea Hillyer, Private Attorney and Local Legal Advisor, Secured Transactions Project
Fred Ramp, Private Attorney
Cheryl Burkindine, Executive Director, USDA Rural Development
Tina Takeshy, NGO Leader and Businessperson
Steve Hambalek, Disaster Closeout/Environmental Specialist, FEMA
Bob De Courteney, President & CEO, Bank of the FSM
Patrick Mackenzie, Vice President, Bank of the FSM
Francis Hezel, S.J., Director, Micronesian Seminar
Corrine Tomkinson, Australian Ambassador
World Park, President, Korea A&W

APPENDIX T

Naomichi Suzuki, FSM Resident Representative, Japanese Overseas Fisheries Cooperative Association (OFCE)

Nobuo Lopez, Secretary, OFCE FSM Office

Martin Selch, Imtrona GbR

Midasy O. Aisek, Attorney, Businessman, and Landowner (Chuuk)