STATEMENT
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BEFORE THE
SENATE COMMITTEE ON ENERGY AND NATURAL RESOURCES

REGARDING
S. 343
AND
THE AGREEMENT BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE REPUBLIC OF PALAU FOLLOWING THE COMPACT OF FREE ASSOCIATION SECTION 432 REVIEW

JUNE 16, 2011

Chairman Bingaman and members of the Committee on Energy and Natural Resources, I am pleased to be here today to discuss S. 343, a bill that would amend Public Law 99-658 and approve the results of the review of fifteen-years of the Compact of Free Association between the Government of the United States and the Government of the Republic of Palau (ROP). My colleagues from the Departments of State and Defense will discuss the importance of the United States - Palau relationship as it relates to national security and our policies in the Pacific. My statement today will focus on the financial assistance components of the new agreement with Palau for which the Department of the Interior will be responsible.

THE UNITED STATES – PALAU RELATIONSHIP

The Department of the Interior and the Government of Palau have been partners since 1951, when the Navy transferred to the Department of the Interior the administration of the United Nations Trust Territory of the Pacific Islands. Since the end of World War II, Palau has emerged from its status as a war-ravaged protectorate to become a sovereign nation and member of the world community. Consistent with the provisions of the 1994 Compact of Free Association, Palau has exercised its sovereignty in accordance with the principles of democracy and in a firm alliance with the United States.

The Compact of Free Association has proven to be a very successful framework for United States – Palau relations. The goals of the first fifteen years of the Compact have been met: the trusteeship was terminated; Palau's self-government was restored; a stable democratic state was established; third countries were denied military influence in the region of Palau; and with United States financial assistance, a base for economic growth has been provided.

The original financial terms and conditions of the Compact have been fully implemented by the United States and Palau. The United States, through the Department of the Interior, has provided over $600 million of assistance including $149 million used to construct the 53-mile road system on the island of Babeldoab and $38.7 million for health care and education block grants. Most of the funding, $400 million, was expended on activities defined under Title Two of the Compact, which included general government operations, energy production, communications, capital improvements, health and education programs and establishment of the Compact Trust Fund.

The Compact Trust Fund was an important feature of U.S. assistance. Capitalized with $70 million during the first three years of the agreement in the 1990s, the objective of the trust fund was to produce an average annual amount of $15 million as revenue for Palau government operations for the thirty-five year period fiscal year 2010 through fiscal year 2044. The fund also generated $5 million in annual operational revenue for Palau since the fourth year of the agreement, totaling $60 million for the years 1998 through 2009.

Palau has made strong economic gains under the Compact of Free Association. Its growth, in real terms, has averaged just over 2 percent per year. Palau's governmental services are meeting the needs of its community. Palau has taken control of its destiny and is moving in the right direction.

COMPACT REVIEW

As both the United States and Palau began the required Compact section 432 review several years ago, each side took pride in the growth evident in Palau. However, the review, which examined the terms of the Compact and its related agreements and the overall nature of the bilateral relationship, also focused attention on several important issues. The United States and Palau agreed that prospects for continued economic growth relied on four key factors: 1) the viability of the Compact trust fund and its ability to return $15 million a year; 2) the implementation of fiscal reforms to close the gap between Palau's revenues and expenditures by shrinking its public sector and raising revenue; 3) the promotion of increased foreign investment and private sector growth, and, 4) the continuation of certain United States assistance, including access to United States Federal domestic programs and services.

From the perspective of the United States, the viability of the Compact Trust Fund was of paramount concern. The economies of Pacific islands are always fragile; their size, distance from markets and relative lack of resources make growth a perennial problem. Although Palau has some relative advantages in contrast to other Pacific island countries, the Compact Trust Fund was established with the intention of providing a relatively secure revenue base for Palau's government through fiscal year 2044. As the 15-year review began, Palau's trust fund, which had earned roughly 9 percent annually since its inception, had suffered significant losses. As GAO reported in 2008, it was uncertain that the trust fund could pay $15 million annually to the Government of Palau through fiscal year 2044.

COMPACT AGREEMENT

The condition of the Compact Trust Fund, the need for fiscal and economic reforms, and the goal of strengthening conditions for private sector growth became the focus of the bilateral review. I believe that the *Agreement Between the Government of the United States of America and the Government of the Republic of Palau Following the Compact of Free Association Section 432 Review* (Agreement) that arose from the 15-year review, and which is embodied in S. 343 will address these concerns, maintain stability, promote economic growth and increase the progress already made under the Compact of Free Association.

The Agreement extends United States assistance, in declining annual amounts, through fiscal year 2024. The total of direct financial assistance to Palau under the Agreement is $229 million, although $13.1 million of that amount has already been appropriated for direct economic assistance by congressional action in fiscal year 2010 and $13 million in fiscal year 2011.

Under the Agreement, in 2011 the United States is to provide Palau $28 million (of which $13 million is the aforementioned direct assistance), and the amount will decline every year thereafter. The declining amount of assistance is intended to provide an incentive for Palau to develop other sources of local revenue and serves notice that the Palauan government has agreed that it will need to make systemic adjustments to its government in order to live within those same resources.

The Agreement contains five categories of financial assistance to Palau.

Direct economic assistance. The Agreement provides for direct assistance for education, health, administration of justice and public safety, in amounts starting at $13 million in 2011, declining to $2 million, the last payment, in 2023. The timing of direct assistance payments is conditioned on Palau's making certain fiscal reform efforts. If the United States government determines that Palau has not made meaningful progress in implementing meaningful reforms, direct assistance payments may be delayed until the United States Government determines that Palau has made sufficient progress on the reforms.

Infrastructure projects. Under the Agreement the United States is to provide grants to Palau for mutually agreed infrastructure projects—$8 million in 2011 through 2013, $6 million in 2014, and $5 million in both 2015 and 2016. The Agreement does not name any projects.

Infrastructure maintenance fund. Under the Agreement, a trust fund will be established to be used for maintenance of capital projects previously financed by the United States, including the existing Compact Road. From 2011 through 2024, the United States government will contribute $2 million annually and the Palau government will contribute $600,000 annually to the fund. This will protect crucial United States investments in Palau that significantly contribute to economic development.

Fiscal consolidation fund. The United States will provide grants of $5 million each in 2011 and 2012 to help the Palau government reduce its debt. United States creditors must receive priority, and the government of Palau must report quarterly on the use of the grants until they are expended. This fund will also simplify needed economic adjustments to Palau's fiscal policies.

Trust fund. The Agreement increases the size of Palau's trust fund directly and indirectly to bolster the likelihood that the trust fund will yield payments of up to $15 million annually through 2044. First, the United States will contribute $3 million annually from 2013 through 2022 and contribute $250,000 in 2023. Second, the government of Palau will delay withdrawals from the fund, drawing $5 million annually through 2013 and gradually increasing its withdrawal ceiling from $5.25 million in 2014 to $13 million in 2023. From 2024 through 2044, Palau is expected to withdraw up to $15 million annually, as originally scheduled. Under the Agreement, withdrawals from the trust fund may only be used for education, health, administration of justice and public safety.

CONTINUING COOPERATION

The United States and Palau will work cooperatively on economic reform. The Agreement requires the two governments to establish an advisory group to recommend economic, financial and management reforms. Palau is committed to adopting and implementing reforms. Palau will be judged on its progress in such reforms as the elimination of operating deficits, reduction in its annual budgets, reducing the number of government employees, implementing meaningful tax reform and reducing subsidies to public utilities.

Palau's progress in implementing reforms will be addressed at annual bilateral economic consultations. If the government of the United States determines that Palau has not made significant progress on reforms, the United States may delay payment of economic assistance under the Agreement.

The Agreement also continues to provide other United States services and grant programs, including the United States Postal Service, the National Weather Service, and the Federal Aviation Administration. The Postal Service moves mail between the United States and Palau, and offers other related services. Palau maintains its own postal service for internal mail delivery. The National Weather Service reimburses Palau for the cost of operating its weather station in Palau, which performs upper air observations twice daily, as requested, for the purpose of Palau's airport operations and the tracking of cyclones that may affect other United States territories, such as Guam. The Federal Aviation Administration provides aviation services to Palau, including en-route air traffic control from the mainland United States, flight inspection of airport navigation aids, and technical assistance and training.

The proposed legislation will also allow the continuance of other Federal program services currently available to Palau under separate authorizing legislation, including programs of the Departments of Education and Health and Human Services. The general authorization for Palau to receive such services was created by the Compact, but individual program eligibility has been created by specific laws that include Palau as an eligible recipient.

The Palau Compact legislative proposal does have PAYGO costs. These costs are included in the President's Budget along with a number of legislative proposals with PAYGO savings. Some proposals that fall under this Committee's jurisdiction include:

- Net Receipt Sharing, which takes into account the costs of managing Federal oil and gas leases before revenues are shared with the States;
- Terminate payments for reclaiming abandoned coal mines to states that are already certified as having cleaned up all of their priority sites; and
- Production incentive fees on non-producing Federal oil and gas leases.

Each example by itself could provide more than enough savings to offset the costs of the Palau Compact. These proposals are also viable; Net Receipt Sharing, for example, has been enacted for four years through annual appropriations language.

The Administration looks forward to continuing our partnership with Palau. The Department of the Interior is proud of the positive advancements our assistance to Palau has provided over the last fifteen years and looks forward to the progress that we anticipate will be made over the next fifteen years.