

**STATEMENT
OF
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DEPARTMENT OF THE INTERIOR
BEFORE THE
SENATE COMMITTEE ON ENERGY AND NATURAL RESOURCES
TO
EXAMINE THE UNITED STATES' INTERESTS IN THE FREELY ASSOCIATED
STATES**

July 23, 2019

Chairman Murkowski, Ranking Member Manchin, and members of the Committee, I am Doug Domenech, Assistant Secretary, Insular and International Affairs for the Department of the Interior (Department). Thank you for the opportunity to provide the Department's views on the interests of the United States in the Federated States of Micronesia, the Republic of the Marshall Islands, and the Republic of Palau, referred to collectively as the freely associated states (FAS). Each of these Pacific Island nations shares a unique, bi-lateral relationship with the United States under special agreements known as Compacts of Free Association (Compacts). The Federated States of Micronesia and the Marshall Islands each signed an original Compact with the United States in 1982 and 1983, respectively, and are now operating under amended Compacts, which were concluded in 2003 and entered into force in 2004. In 1986 Palau signed a Compact with the United States which entered into force in 1994. In 2010, pursuant to that Compact, the United States and Palau signed a Compact Review Agreement (CRA), which was amended and brought into force in 2018.

My colleagues from the Departments of State and Defense will discuss the diplomatic and military importance of the U.S. Government's relationship with the FAS governments. I will focus on (1) the financial assistance the Department provides to the Federated States of Micronesia and the Marshall Islands under the 2003 amended Compacts, and to Palau under the 1994 Compact and the 2010 CRA, as amended in 2018, and (2) how this financial assistance provides both short- and long-term benefits to the United States.

I. Original Compacts

In 1947, the United Nations assigned the United States administering authority over the Trust Territory of the Pacific Islands (Trust Territory), which included Federated States of Micronesia (FSM), the Republic of the Marshall Islands (RMI), and the Republic of Palau (Palau), and the Commonwealth of the Northern Mariana Islands. In 1951, the Department of the Navy transferred to the Department of the Interior the civil administration of the Trust Territory thereby creating a long lasting partnership between the Department and the people of the Trust Territory. The Compacts grew out of this trusteeship relationship with the Trust Territory, and the U.S. interest in supporting their economic advancement and self-sufficiency. The Compacts originally entered into force in 1986 for FSM and RMI and in 1994 for Palau. Under the Compacts, which reflected the common desire of the United States and each of the three FAS to

establish a government-to-government relationship, the governments agreed that the United States would be responsible for security and defense matters in and relating to the three FAS and would have special and extensive access to operate in these nations' territories, as well as the authority to deny access to these nations by other countries' militaries and their personnel. The governments also agreed on the provision of U.S. economic assistance to all three FAS.

The Department of the Interior built on its expertise in the civil administration of the Trust Territory, and has since developed many years of expertise, specialized staff, resources, and institutional knowledge in administering Compact assistance.

The Compacts:

- Enabled the end of Trust Territory status of the three Freely Associated States;
- guaranteed the United States the ability to deny access to and use of these three nations by third country militaries;
- established three stable, sovereign, and democratic states in the Pacific; these states, acting through their governments established under their respective constitutions, became self-governing; and
- supported close and mutually beneficial relationships that contribute to regional security, stability, and prosperity.

II. Amended Compacts for the FSM and RMI, and the Palau Compact Review Agreement

At the conclusion of the first fifteen-year funding period, the original Compacts with the FSM and the RMI were reviewed and amended. Following the conclusion of the agreements amending the Compacts in 2003, and the passage of Public Law 108-188, the Compact of Free Association Amendments Act of 2003, the agreements amending the Compacts were brought into force in 2004. The Compacts, as amended, provide mandatory financial assistance in fiscal years 2004 through 2023, still through the Department of the Interior. The amended Compacts require the FSM and the RMI to target funding in six sectors of development: 1) education; 2) health; 3) the environment; 4) public-sector capacity building; 5) private-sector development, and 6) infrastructure, with priority given to education, health, and projects directly affecting health and safety.

The Compact relationship with Palau has operated differently from the Compact relationships with the FSM and the RMI, and requires a formal review of its terms as well as the terms of its related agreements by the United States and Palau upon the fifteenth, thirtieth, and fortieth anniversaries of the effect date of the Compact. In 2010, at the conclusion of the first mandated review, the U.S. and Palau signed an agreement known as the Palau Compact Review Agreement (CRA), which contained provisions to provide additional economic assistance through 2024, or the scheduled date of the next mandated Compact review. It was fully funded on March 26, 2018, when President Trump signed the 2018 Omnibus Funding Agreement, and following the negotiation of amendments to the funding schedule contained in the 2010 CRA, the CRA and its amendments entered into force in September 2018. Funds under the Compact and the CRA, as amended with Palau have been and continue to be available primarily for government operations and infrastructure projects.

These Compacts are unique. The U.S. Government did not intend for any of the Compact agreements to underwrite the entire economies of the FAS or the operations of each government. Rather, the U.S. Government saw the Compacts as an economic springboard, making available the resources to allow the Federated States of Micronesia, the Marshall Islands, and Palau to improve:

- essential government services and infrastructure, while they reform their business climate and fiscal policies, and
- their capacity to govern.

Under the amended Compacts, the United States has provided to the FSM and the RMI approximately \$3 billion of financial assistance in fiscal years 2004 - 2019, primarily supporting the delivery of health and education services and infrastructure development. Of this amount, approximately \$50 million supports the education sector and \$35 million supports the health sector of each country, annually. For both the FSM and the RMI, the health and education sectors rely principally on federal funding under the amended Compacts. By 2023, the Department will have invested approximately \$170 million of assistance under the amended Compacts into new hospitals and health centers for construction, renovation, and maintenance and \$350 million into new school construction. For the FSM's total revenue, approximately 48 percent derives from grants under the amended Compact or from other federal sources. Figures for two of the four states of Micronesia are even higher: 64 percent for Chuuk and 70 percent for Kosrae. Of the Marshall Islands' total revenue, approximately 42 percent derives from grants under the amended Compact or from other federal sources.

From 1994 - 2009, Palau benefited from Compact assistance totaling approximately \$560 million which included a significant infrastructure project, the circumferential road on Babeldaob, also known as the Palau Compact Road. Under the 2010 CRA, brought into force in 2018, an additional \$229 million was made available to Palau, again for government operations, infrastructure projects, and to shore up Palau's Trust Fund, established under the Compact with Palau, Public Law 99-658 as a sinking fund managed solely by the Palau Government .

All funding provided to the FSM and the RMI under the amended Compacts is reviewed semi-annually in two, bilateral, joint economic management committees. These committees are chaired by the Department's Director of the Office of Insular Affairs. Funding under the CRA is provided directly to the Palau government.

Other funding for which the FSM, RMI, and Palau are eligible is through the Department's Office of Insular Affairs Technical Assistance Program (TAP), which manages discretionary funds provided annually to the Department by the Congress. TAP funding is flexible in its use and application in the FSM, RMI, and Palau and can help fill in gaps that the three governments identify. The U.S. territories are the primary recipients of TAP funding.

III. Trust Funds

As provided for under the amended Compacts, Public Law 108-188, jointly managed Trust Funds were established for both the FSM and the RMI. Federal grant funding has generally decreased annually, paired with increasing contributions to the respective Trust Funds. The Trust Funds were incorporated in 2004 as non-profit corporations under the laws of the District of Columbia.

Earnings from the Trust Funds were intended to provide an annual source of revenue for the FSM and RMI Governments after fiscal year 2023 for assistance in education, health care, the environment, public-sector capacity building, private-sector development, and public infrastructure, as described in Section 211 of the amended Compacts, or other sectors as mutually agreed by the United States and the FSM and RMI, respectively, with priorities in education and health.

The amended Compacts set forth the funding to be contributed by FSM and RMI until 2023. Trust Fund Agreements outline the organizational structures, policies and procedures for most aspects of the Trust Fund's start-up and ongoing operations. Investment Policy Statements provide investment guidance and are reviewed quarterly and, if required, revised annually.

The U.S. Government maintains a majority of voting members on both Trust Funds, including the Chairman, who is the Director of the Department of the Interior's Office of Insular Affairs. The Marshall Islands Committee consists of seven members: four U.S. members, including the Chairman; two Marshall Islands members, including the Vice Chairman; and one member appointed by the subsequent contributor, Taiwan. The Federated States of Micronesia Committee has five members: three U.S. members, including the Chairman, and two Federated States of Micronesia members. Committee meetings are held quarterly throughout the fiscal year.

Under the Compact with Palau, Public Law 99-658, a Trust Fund was also established for Palau. Unlike the Trust Funds for the FSM and the RMI, Palau's Trust Fund was established as a sinking fund and is managed solely by the Palau Government. Under the Compact Review Agreement, the Palau Government is currently restricted to annual withdrawal amounts of no more than \$15 million. As of February 2019, the Palau Trust Fund was valued roughly at \$286 million.

Performance of the FSM and RMI Trust Funds

Federated States of Micronesia

The total net position of the Federated States of Micronesia Trust Fund for fiscal year 2018 was \$636.09 million. For fiscal year 2018, the last audited financial year, the FSM Trust Fund had a dollar-weighted annual investment return of 6.77 percent. Since its inception in 2004, the FSM Trust Fund has had a net return of 5.2 percent. As of the end of fiscal year 2018, the investment of contributions earned \$265.4 million or 71.6 percent of the value of the contributions. No contributor's capital investment has diminished since its inception.

The U.S. Government was obligated to contribute \$16 million annually in fiscal years 2004-2006 and is obligated in fiscal years 2007-2023 to contribute \$16 million annually, plus a cumulative amount that increases by \$800,000 annually. The U.S. contribution is \$30.8 million for fiscal year 2019. The U.S. Government contributed a total of \$372.7 million since inception. In fiscal year 2005, the Federated States of Micronesia contributed \$30.3 million, as required under the amended Compact.

The Republic of the Marshall Islands

The total net position of the RMI Trust Fund for fiscal year 2018 was \$402.43million. For fiscal year 2018, the last audited financial year, the RMI Trust Fund had a dollar-weighted annual investment return of 7 percent. Since inception in 2004, it has had a net return of 5.7 percent. As of the end of fiscal year 2018, the investment of contributions earned \$163.7 million or 68.6 percent of the value of the contributions. No contributor's capital investment has diminished since its inception.

The U.S. Government is obligated to contribute \$7 million each fiscal year plus a cumulative \$500,000 annually and a partial inflation adjustment. The U.S. contribution has been \$17.7 million for fiscal year 2019. The U.S. Government has contributed a total of \$195.5 million since inception. In accord with the amended Compact, the RMI Government contributed \$30 million in fiscal years 2004-2006. They also contributed an additional \$3.2 million for a total of \$33.2 million. Through fiscal year 2023, Taiwan will contribute to the RMI Trust Fund \$2.4 million per year until 2023 and to date has contributed \$30.4 million.

Issues Leading to Fiscal Year 2023 and Beyond

Palau's Trust Fund, established as a sinking fund, has been managed solely by the Palau Government and does not have the same management or funding structure that characterizes both the FSM and RMI Trust Funds.

While both the FSM and the RMI Trust Funds have performed up to market standards, there is significant concern about the volatility and the size of the distributions to support post-2023 budgets of the FSM and the RMI. As shown in the May 17, 2018, General Accounting Office (GAO) report, [GAO-18-415](#), distribution policies that are consistent with both Trust Fund Agreements' current distribution provisions have a high likelihood of resulting in years of limited or zero distributions. While both Trust Funds have grown, based on market performance, that growth has not been significant enough to continue levels of funding similar to fiscal year 2023's annual grant assistance – estimated for the FSM at \$82 million and for the RMI at \$26.9 million.

The Trust Fund Committees are analyzing and discussing different distribution policy options to provide more consistent distributions with less volatility and no zero-year distributions; however, as the Trust Fund Committees can only establish distribution policies that are consistent with the Trust Fund Agreement, these options are limited unless the Trust Fund Agreements are amended. However, there are implications *vis-à-vis* preserving both Trust Funds for the long term.

Additional time and funding would help to achieve the right balance between preserving the Trust Funds for decades to come and providing consistent and stable distributions without taking on additional risk.

Certain changes to the distribution policy would require amending the respective Trust Fund Agreements. Such changes will require the approval of the respective national governments, including, on the United States' part, an Act of Congress. Other potential changes discussed in the GAO's report are the timing of the distributions, the accountability framework to monitor the distributed funds, and the payment of Trust Fund expenses beyond 2023.

IV. CONCLUSION

If grant assistance under the amended Compacts and the CRA is allowed to expire by the end of 2023 and 2024 respectively, and is not extended, there is the risk of damaging the respective bilateral relationships of free association between the United States and these Pacific Island nations.

The year 2024 marks the 30th anniversary of the Compact agreement between the United States and Palau. Upon this anniversary, the U.S.-Palau Compact requires the U.S. and Palau to again formally review the terms of the Compact and consider the overall nature and development of the relationship. Funding provisions under the 2010 CRA will expire in 2024 and the U.S. Government and Congress must carefully weigh its strategic interests to determine the continued level of funding, if any, it wants dedicated to the relationship. The U.S.-Palau Compact relationship, though handled differently from the relationship with the Federated States of Micronesia and the Marshall Islands, should be considered in conjunction with FSM and RMI Compacts.

As GAO has identified, uncertainty exists as to the continuity of the range and level of the programs and services provided by federal departments and agencies other than the Department of the Interior such as the U.S. Postal Service, Supplemental Education Grants through the Department of Education, Federal Deposit Insurance Corporation, Federal Emergency Management Agency, various programs through the Department of Health and Human Services, and other federal agencies. However, two principal provisions of the amended Compacts will continue in force beyond 2023:

- the U.S. military will, as it does now, have responsibility and authority for defense and security matters of or relating to the Federated States of Micronesia, the Marshall Islands, and Palau; and
- as legal non-immigrants, eligible citizens of the Federated States of Micronesia, the Marshall Islands, and Palau will retain the right to enter the United States visa-free and to live, to work, or to study here for an unlimited period of time.

Fulfilling all three Compact of Free Association agreements is critical to sustaining the U.S. Government's commitment to these nations and their respective efforts to advance their own economic self-sufficiency. The U.S. can be proud of the historic relationships and the legacy it has with these three Pacific Island nations. Maintaining the close relationships we have

developed through all three Compacts will continue to be an important part of the overall U.S. policy of a free and open Indo-Pacific.

An expiration of federal financial assistance in just four years could carry dire consequences for the well-being for the people of three of the United States' closest partners. People from these nations have also offered the United States unequalled numbers in the blood and sweat of their own youth in service to our Armed Forces.

The United States relationships in the Indo-Pacific, particularly with the Federated States of Micronesia, the Marshall Islands, and Palau, are part of the legacy that the United States holds in the Pacific. The relationships are mutually beneficial, and are an important part of our shared heritage. Our identity as a "Pacific power" was, in many ways, forged on the beaches of the Pacific during the Second World War, and the United States and the people of the Pacific have fought side-by-side since. Our relationship is founded upon respect for human rights and fundamental freedoms for all. It is important that we continue to maintain these key relationships.