Fiscal Strategies Group

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June 23, 2008

MEMORANDUM

To: Governor John deJongh

From: Fiscal Strategies Group, Inc.

Re: Agreement Between Diageo USVI and the Government of the U.S. Virgin Islands

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At your request, we have reviewed the Agreement Between Diageo USVI, Inc. and the Government of the U.S. Virgin Islands (the "Agreement"). The purpose of this review was to provide a projection of the potential Cover Over revenue receipts to the Government of the Virgin Islands (the "Government") under the terms of the proposed Agreement should the Government choose to proceed with the project. This review includes (i) an overview of the rum industry and Captain Morgan's position in the industry, (ii) an overview of the impact of the proposed Agreement on the rum industry in the Virgin Islands, (iii) a summary of the terms of the Agreement that affect the economics of the transaction, and (iv) projected Cover Over revenues that will be produced under the terms of the Agreement, and how those revenues would be allocated.

The review of the Agreement provided herein is provided for the purposes of explaining how projected revenues generated by the Project would be allocated over time. It is not, and it is not intended to provide, a complete review or legal review of that document, and should not be considered in that light. Similarly, the revenue projections provided herein are based on production projections provided by Diageo, and on the continued implementation of the Cover Over program at the $13.25 tax rate. Actual revenues in future years will most certainly be either higher or lower than those projected here.

Captain Morgan Rum Market Position

As illustrated in the table below, Captain Morgan is the second largest rum brand sold in the United States market, based on data provided by the IWSR Global Wine and Spirits Database. As this table illustrates, Bacardi and Captain Morgan are the dominant rum brands. Within a market that is growing at a compound annual growth rate of 4.9%, Bacardi is growing at a 3.0% annual rate, while Captain Morgan is the fastest growing major brand, growing at an annual rate of 9.5%.

Leading Rum Brands US Market Sales Volume

9 L Cases in thousands

Brand	Company	2002	2003	2004	2005	2006	CAGR 2002-2006
Bacardi	Bacardi - Martini	7,697	7,775	8,109	8,480	8,672	3.0%
Captain Morgan	Diageo	3,888	4,150	4,655	5,412	5,595	9.5%
Castillo	Bacardi - Martini	1,206	1,223	1,245	1,225	1,222	0.3%
Cruzan	Pernod Ricard*	873	881	888	884	940	1.9%
Ronrico	Beam Global	916	972	897	902	923	0.2%
Myers Rum	Diageo	267	269	340	422	489	16.3%
	Total	14,846	15,268	16,133	17,325	17,841	4.7%
	Total Rum Market	17,740	18,355	19,395	20,765	21,520	4.9%

* Sale pending.
Source: IWSR Global Wine and Spirits Database.

As illustrated in the table below, rum is a highly concentrated market, with the top six brands noted in the table above combining for 83% market share, base on volume shipments. Due to its growth rate that is higher than the market as a whole, Captain Morgan has gained market share, growing from 22% to 26% over the five-year period 2002-2006, the most recent period for which data is available. During the same period, Bacardi lost market share, declining from 43% to 40%.

Market Concentration and Market Share in US Market Rum Sales Volume

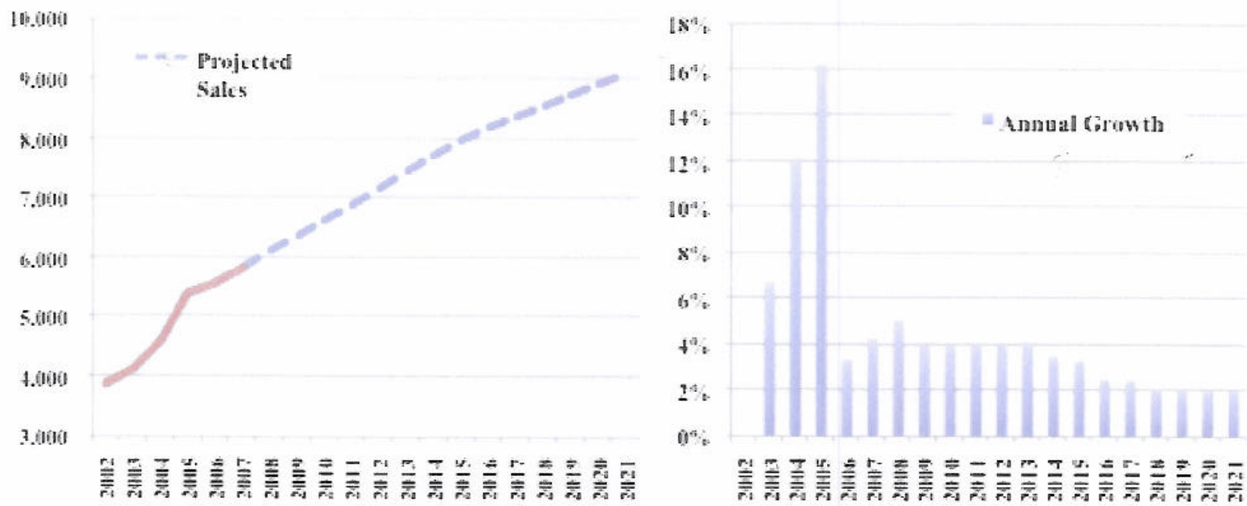
	2002	2003	2004	2005	2006
Total Rum Sales	17,740	18,355	19,395	20,765	21,520
Top Six Brands	14,846	15,268	16,133	17,325	17,841
Top Six Brands % Total Market	84%	83%	83%	83%	83%
Bacardi % Total Market	43%	42%	42%	41%	40%
Captain Morgan % Total Market	22%	23%	24%	26%	26%
Cruzan % Total Market	5%	5%	5%	4%	4%

Source: IWSR Global Wine and Spirits Database.
All volume figures in: 000s 9 LC

Historical and Projected Captain Morgan Rum Sales In the United States

The following graphs presents the historical and projected sales and sales growth of Captain Morgan rum in the United States. Historical data is based on the IWSR data. Projected sales growth is based on medium growth proof gallon projections provided by Diageo.

Historical and Projected US Sales and Sales Growth of Captain Morgan Rum Products
9L Cases, 2002-2019



Projected Excise Tax Receipts Based on Projected Captain Morgan Rum Sales

The following table presents the projected fiscal year sales based on Diageo's medium growth projections from the St. Croix Project that will be subject the Cover Over excise tax, and the excise tax receipts that would be generated by those sales at the Cover Over excise tax rate of $13.25.

Projected Production Subject to Taxation
And Cover Over Revenues Generated

Fiscal Year	Project Production (1)	Cover Over Revenues (2)	Year	Project Production (1)	Cover Over Revenues (2)
2011			2025	16,409,500	$217,425,875
2012	8,980,500	$118,991,625	2026	16,744,000	221,858,000
2013	12,346,750	163,594,438	2027	17,086,000	226,389,500
2014	12,802,500	169,633,125	2028	17,172,000	227,529,000
2015	13,237,750	175,400,188	2029	17,172,000	227,529,000
2016	13,598,750	180,183,438	2030	17,172,000	227,529,000
2017	13,938,750	184,688,438	2031	17,172,000	227,529,000
2018	14,243,750	188,729,688	2032	17,172,000	227,529,000
2019	14,536,000	192,602,000	2033	17,172,000	227,529,000
2020	14,832,500	196,530,625	2034	17,172,000	227,529,000
2021	15,135,000	200,538,750	2035	17,172,000	227,529,000
2022	15,444,250	204,636,313	2036	17,172,000	227,529,000
2023	15,759,000	208,806,750	2037	17,172,000	227,529,000
2024	16,081,000	213,073,250	2038	17,172,000	227,529,000

1) Proof gallon. Production levels subject to tax are internal medium growth projections as provided by Diageo.

2) Assumes tax remitted to the USVI of $13.25

Virgin Islands Rum Industry

St. Croix was formerly the home to three rum companies. Since the Brugal distillery was destroyed by Hurricane Hugo, Cruzan VIRIL has been the only remaining rum producer in the Virgin Islands. Cruzan VIRIL was acquired this year by Pernod Ricard, the World's second largest spirits company, when Pernod Ricard acquired V&S Vin and Spirits AB from the Swedish government in order to acquire Absolut Vodka, the premier brand owned by V&S. V&S itself acquired VIRIL from Angostura in 2005. Angostura, in turn, acquired Cruzan when it acquired its former parent company, Todhunter, in 2002. Todhunter had acquired Cruzan eight years earlier, in 1994.

Cruzan VIRIL produces bulk alcohol, branded rum, and vinegar and cooking wine. Over the past several years, the Company has invested in the development of the Cruzan brand, and the Government has supported this effort through the negotiation of a Marketing Support Agreement, dated October 1, 2006 and approved by the Legislature, pursuant to which the Government agreed to pay the Company 35% of the Cover Over revenues generated by new rum sales over an historical baseline. According to information provided by the Government, the Government appropriated $53 million in subsidies and support for Cruzan VIRIL over the period 2003-2007, with annual expenditures increasing from 7.5% to approximately 30% of annual Cover Over receipts during the period. The subsidies and support paid to Cruzan VIRIL during this period included $40 million of molasses subsidies, $13 million for marketing support and rum promotion, and $6 million for costs related at assisting the Company in addressing ongoing environmental mitigation efforts. The Government anticipates further investments will be required as Cruzan VIRIL finally addresses its long-standing environmental issues.

Pernod Ricard has indicated their intention to keep Cruzan VIRIL in St. Croix, and to further develop the Cruzan brand. As a leading spirits company, Pernod Ricard management is interested in growing the Cruzan brand as part of their portfolio, but has little interest in the bulk rum business, other than as a way to keep the Cruzan plant running at full capacity. They are aware, as is the Government, that as international tariffs are reduced, the market for bulk rum production will become increasingly competitive, and increasing Cruzan VIRIL's sales of branded spirits will be important to the Company's long-term profitability and financial health. At the same time, Pernod Ricard owns two brands, Malibu and Havana Club, which may compete with Cruzan within Pernod Ricard's portfolio. Accordingly, Cruzan VIRIL continues to face challenges—including environmental constraints on production, ownership that continues to evolve, and growing competition in the bulk rum market—that will continue to demand Governmental investment and lend uncertainty the stability of the Cover Over revenues that are critical to the Government's finances.

The phase out of import tariffs on rum imports to the United States has and continues to loom as a competitive threat to the Caribbean rum industry in general, and the USVI in particular. This issue has been raised over time by Winston & Strawn LLP, counsel to the Government, who in a 2005 memorandum supporting a marketing agreement with Cruzan VIRIL that would pay that company a percentage of future incremental Cover Over revenues noted:

> *"Incentives for the USVI rum industry to transition from low-value commodity rum to higher-value brand-name rum are particularly important for both the industry and the GVI. The United States maintains significant duties on non-CBI-origin rum in the lower-value market segments in which USVI rum currently competes. While the industry and the GVI strongly support the maintenance of these duties, there is no long-term assurance that these duties will be retained in U.S. trade negotiations with such significant spirits-producing countries such as Brazil and Columbia. Accordingly, as both the industry and the GVI have noted in submissions to the Office of the U.S. Trade Representative and the U.S. Trade Commission, it is critical that the USVI rum industry transition to a higher-value product."*

According to industry sources there are approximately forty-five distillers across the Caribbean and Central America that offer a combined capacity to the rum industry in excess of 220 million proof gallons. This includes thirty-five distillers within the Caribbean with 175 million proof gallons of capacity, of which approximately 65% is currently utilized. As tariff protection is phased out through the implementation of free trade, the preferred access to the U.S. market enjoyed by the USVI, Puerto Rico and CBI countries will be reduced, and it is reasonable to expect that price competition for bulk rum will continue to increase across the region. The countries in the region that currently have production capacity include the following.

Antigua & Barbuda	El Salvador	Mexico
Bahamas	French Guiana	Nicaragua
Barbados	Grenada	Panama
Belize	Guadaloupe/ Marie Galante	Puerto Rico
Brazil	Guatemala	Saint Kitts & Nevis
British Virgin Isles	Guyana	Saint Vincent & the Grenadines
Colombia	Haiti	St Lucia
Cuba	Jamaica	Trinidad & Tobago
Dominican Republic	Martinique	Venezuela

The competitive environment facing the USVI rum industry includes countries with existing excess distillery capacity, low labor costs and access to sugar cane, and the continuing long-term threat of declining tariff protection. These competitive factors will be exacerbated as the European Union implements its *Integrated Development Programme for the Caribbean Rum Sector,* which is designed to inject new capital investment into the Caribbean rum industry for facility modernization through the European Development Fund.

In this environment, the proposed Agreement offers the opportunity for the US Virgin Islands to stabilize and grow its position as a rum producing community for the next thirty years. The proposed project would make St. Croix the home of the second largest rum brand in the US market, and a brand that is enjoying significant sales growth in the US market. As the home of Captain Morgan rum products, the Virgin Islands share of the US rum market would increase from 4% to 30%, based on the IWSR data. Brand leadership is an important factor in long-term stability and success—as evidenced by the premium price paid by Pernod Ricard itself for Absolut Vodka—and for the Government the value of the Captain Morgan brand is the stability it can provide to the Government's Cover Over revenues, in addition to the substantial additional new net revenues that will be realized by the Government under the proposed Agreement.

Terms of the Proposed Agreement

The essence of the proposed Agreement is that it provides that Diageo agrees to move all of the production of Captain Morgan rum products to a new facility on St. Croix and commits to maintain all production there so long as the Cover Over program under which the excise taxes on rum imports into the United States are remitted back to the United States Virgin Islands remains in place at a tax rate no less than the historic permanent rate. In exchange, the Government agrees to provide economic development incentives, and to provide subsidies and support for the production of Captain Morgan rum that will be funded by the Cover Over revenues generated by the Captain Morgan rum sales. The subsidies and support payments provided under the Agreement are in lieu of Diageo's participation in any other Government funded support. The Agreement places no obligation on the Government that would require funds appropriated from the General Fund other than the designation of a Project Coordinator.

Specifically, the proposed Agreement provides that Diageo will design, develop, construct, equip and operate a state-of-the area facility for the annual production and storage of up to 20 million proof gallons of rum (the "Project"). Under the terms of the Agreement, the Government agrees to provide financing for the Project, which financing will be repaid through the Matching Fund Receipts generated from the sale of Captain Morgan rum produced at the Project and sold in the United States. Diageo has agreed that so long as the tax rate on the excise taxes levied by the U.S. Treasury under the Cover Over program is not reduced below its $10.50 permanent rate, and if reduced below that level not restored to the $10.50 level within a defined cure period, Diageo shall produce all Captain Morgan rum at the Project.

To finance the Project, the Government will provide financing through the Public Finance Authority to fund the costs of the Project. The financing will be provided through the issuance of Matching Fund Bonds (the "Diageo Project Bonds") that will be issued on subordinated basis to the Government's outstanding bonds. The debt service on the Diageo Project Bonds will be paid from the revenues generated through the sale of Captain Morgan rum produced by the Project. Ownership of the facility would vest with Diageo, who is committed under the Agreement to produce all Captain Morgan rum at the facility for the thirty-year life of the Agreement. Should Diageo fail to fully perform its obligations, it would be obligated to pay damages sufficient to pay the costs of any bonds that remain outstanding.

The proposed Agreement provides a range of economic development incentives similar to those granted by the Economic Development Commission. In addition, the Agreement provides for specific subsidies and incentives to support the production and marketing of Captain Morgan rum in the United States. These subsidies and incentives include the following.

- **Molasses Subsidy Payments.** The Government, to support and promote the development and operation of the Project and Diageo's production of bulk rum at the Project, agrees to make molasses subsidy payments in accordance with the provisions of 33 Virgin Islands Code §3036 (2007), which amount shall never be less than the difference between (a) 16 cents (U.S.) per gallon of molasses purchased by Diageo for use in the production of bulk rum at the Project and (2) the total cost per gallon of such molasses to Diageo.

- **Marketing Activities and Support Payments.** The Government, to support and promote Diageo's performance of the Marketing Activities, agrees to make marketing support payments in annual amounts equal to thirty-five percent (35%) of the Incremental Cover Over Revenues generated in such Fiscal Year.

- **Production Incentive Payments.** The Government, to support and promote the continued production of rum by Diageo at the Project, agrees to make annual production incentive payments in the amount of eight percent (8%) of the Incremental Cover Over Revenues in respect of such Fiscal Year. However, for years in which the Incremental Cover Over Revenues exceeds \$200 million, the Production Incentive Payment amount shall be increased to nine and one half percent (9.5%) of the Incremental Cover Over Revenues in respect of such Fiscal Year.

Notwithstanding the subsidy and incentive payments described above, the Agreement provides for minimum set aside distributions to the Government and to a trust by the Agreement for the development, operations and maintenance of community facilities and urban redevelopment projects (the "Community Facilities Trust"). The set aside distributions for the Government and the Community Facilities Trust are as follows.

- **Government Distributions.** As long as annual sales subject to excise taxation under the Cover Over program are less than 11 million proof gallons, the Government will receive a priority distribution equal to fifty-seven percent (57%) of the Annual Gross Cover Over Receipts. The level is fifty-one percent (51%) above that level, and in years where Annual Gross Cover Over Receipts exceed \$200 million, it is forty-nine and one-half percent (49.5%).

- **Community Facilities Trust Distributions.** In each year, three percent (3%) of the Annual Gross Cover Over Receipts will be deposited in the Community Facilities Trust.

In addition to these two minimum distributions, the subsidy and incentive payments are further limited by the amount of any debt service due on bonds issued by the PFA to fund the Project. Accordingly, in any year, the maximum amount payable to Diageo for the subsidy and incentive payments created under that agreement may be no greater than the amount of the Annual Gross Cover Over Receipts *less* the total amount of distributions due to the Government and the Community Facilities Trust, *less* the amount of debt service paid or payable for such year on Diageo Project bonds. The subsidy and incentive payments due to Diageo are only obligations of the funds and accounts created by the Agreement, and do not carry forward as obligations of the Government.

Projected GVI Matching Fund Receipts and Application of Funds

The following table sets forth the projected Annual Gross Cover Over Receipts from the sales of Captain Morgan rum produced by the Project, based on the medium growth proof gallon data presented above, and the distribution of payments as indicated by the Agreement. Total payments to Diageo are projected to rise from 31% to 39% of the Cover Over revenues generated by the Project. These amounts are higher than the 30% paid to Cruzan VIRIL during the most recent fiscal year, but less than the 46.5% of Incremental Cover Over Revenues payable to Cruzan VIRIL on new rum production, as projected by PriceWaterhouseCoopers in its 2006 Analysis of Proposed Marketing Support Agreement.

Projected Cover Over Revenues Generated and Allocation of Annual Receipts

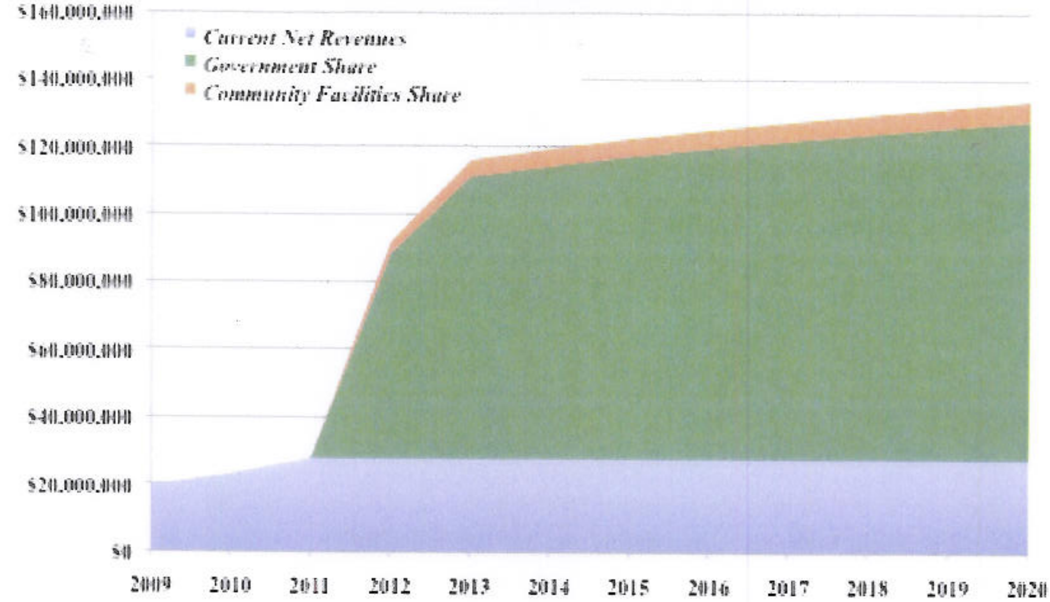
Fiscal Year	Cover Over Revenues (1)	Government Share	Community Trust Share	Project Debt Service	Maximum Total Company Support/ Molasses Subsidy
2012	$118,991,625	$60,685,729	$3,569,749	$18,411,744	$36,324,404
2013	163,594,438	83,433,163	4,907,833	18,411,744	56,841,697
2014	169,633,125	86,512,894	5,088,994	18,411,744	59,619,494
2015	175,400,188	89,454,096	5,262,006	18,411,744	62,272,342
2016	180,183,438	91,893,553	5,405,503	18,411,744	64,472,637
2017	184,688,438	94,191,103	5,540,653	18,411,744	66,544,937
2018	188,729,688	96,252,141	5,661,891	18,411,744	68,403,912
2019	192,602,000	98,227,020	5,778,060	18,411,744	70,185,176
2020	196,530,625	100,230,619	5,895,919	18,411,744	71,992,344
2021	200,538,750	99,266,681	6,016,163	18,411,744	76,844,162
2022	204,636,313	101,294,975	6,139,089	18,411,744	78,790,505
2023	208,806,750	103,359,341	6,264,203	18,411,744	80,771,462
2024	213,073,250	105,471,259	6,392,198	18,411,744	82,798,050
2025	217,425,875	107,625,808	6,522,776	18,411,744	84,865,547
2026	221,858,000	109,819,710	6,655,740	18,411,744	86,970,806
2027-2038	226,389,500	112,062,803	6,791,685	18,411,744	89,123,269

1) Revenues based on medium growth data as provided by Diageo.
Assumes tax remitted to the USVI of $13.25

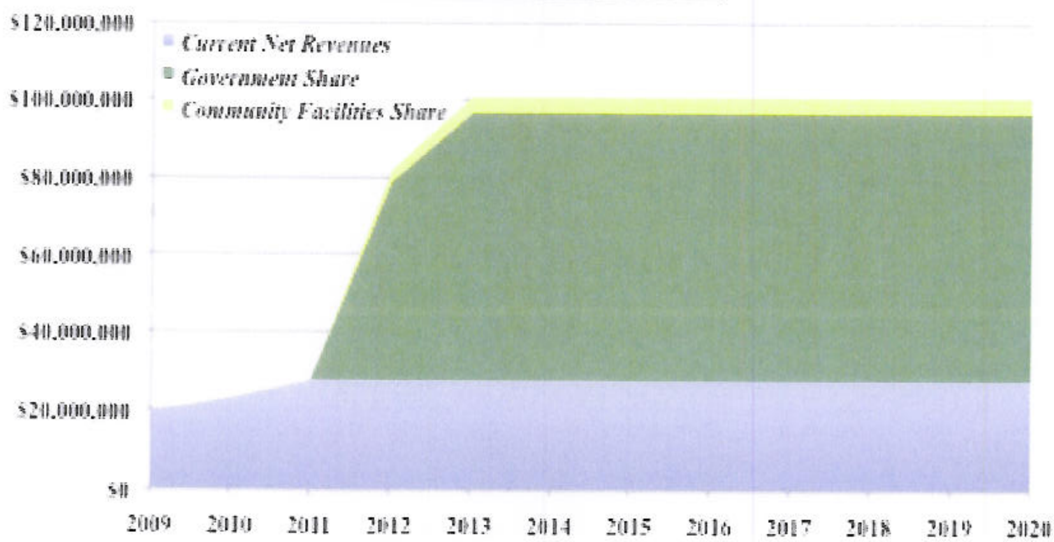
Impact on Virgin Islands General Fund and Resources

The revenues to the Government and the Community Facilities Trust will represent available new revenues to the Government, net of all debt service obligations related to the Project, and subsidy and incentive payment to Diageo. The first graph on the following page presents these new receipts, based on the Diageo medium growth scenario as provided by the Company, in addition to a projection of the Current Net Cover Over revenue stream available to the Government generated by rum production at Cruzan VIRIL. For comparison purposes, the second graph adjusts the Diageo Project receipts to reflect the Company's "Worst Case" scenario, where Captain Morgan sales is flat for the projection period. The Current Cover Over revenues is based upon production and sales projections provided by Cruzan VIRIL to the Government, and reflects flat production growth as Cruzan reaches its production capacity. The Current Net Cover Over revenue stream available to the Government is presented after the funding of outstanding Matching Fund bond debt service ($47.0 million), and annual projected expenditures by the Government for Molasses Subsidy ($12.8-14.0 million), MSA payments ($3.5-6.1 million), and environmental mitigation ($3.0 million).

Current Cover Over Revenue Contribution to Government and Impact of USVI-Diageo Project
Net of Subsidy, Support and Debt Service Payments
<u>Medium Growth Scenario 2009-2020</u>



Current Cover Over Revenue Contribution to Government and Impact of USVI-Diageo Project
Net of Subsidy, Support and Debt Service Payments
<u>Low Growth Case 2009-2020</u>



Note: Graphic analysis above based on medium growth and low/no growth volume projections provided by Diageo, and information from Cruzan VIRIL provided to the Government. In each case, projected revenues available to the Government are net of debt service, estimated molasses subsidy and other support costs. These are projections only, and actual production levels and revenues received by the Government will be higher or lower than projected here.

Conclusion

> *"It is inevitable that tariffs on even low-value bulk rum will phase-out over time. It is for this reason, that it is essential that the Virgin Islands industry shift, as rapidly as possible (and as encouraged by the U.S. Government), to the non-price sensitive premium segment of the U.S. market, while maintaining, as long as possible (for purposes of maximizing its rum excise tax revenues), its current position in the bulk or commodity segment."*
>
> *Winston & Strawn LLP. Letter to Governor John P. deJongh, Jr. June 19, 2008*

The proposed Agreement presents a significant opportunity for the Government to expand its presence in the Caribbean rum industry, and to provide long-term stability to rum production and Government revenues derived from the Cover Over revenues. The Agreement brings to St. Croix a market-leading and growing rum brand that offers long-term revenue stability at a time when market competition threatens the long-term competitiveness the bulk rum sales that continue to produce much of the Government's Cover Over receipts.

Under the production and sales projections provided by Diageo for their Medium Growth scenario, net new revenues to the Government and for community facilities—after the funding of project debt service, and all subsidy and support costs—are projected to grow from $88 to $119 million, beginning in the first full fiscal year of operations in 2013. This level of funding contribution will be lower if the Medium Growth sales targets are not achieved, or if the Cover Over tax rate is reduced below the $13.25 level.

The proposed Agreement does not entail any annual funding commitment from Government resources, and as such is fully self-supporting. The level of funding to Diageo for marketing support and molasses subsidies under the terms of the Agreement range from 31% to 39% of the new Cover Over revenues that are generated. These costs are paid from the Cover Over receipts, and are not obligations of the Government General Fund. These costs are higher than the historic level of payments to Cruzan VIRIL, though lower than the level of subsidy suggested by the Marketing Support Agreement according to the PriceWaterhouseCoopers on new Cover Over revenues generated by the MSA. However, in return for the payments and benefits provided to Diageo, the Government receives (i) the long-term stability and growth potential of a market-leading brand, (ii) substantial new revenues, after all costs, and (iii) protection against market competition that threatens to undermine the competitiveness of St. Croix's traditional position as a bulk rum producer.