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1. INTRODUCTION

On 3 April 2012, the European Commission published the Third Review of the Economic Adjustment Programme for Portugal (the "Programme" and the third review, the "Review").

The Review was undertaken from 15 to 27 February 2012 to assess compliance with the terms of the Programme over the last quarter of 2011 and will pave the way for the next tranche of Programme based financing of around EUR 15 bn. This instalment is the largest of the Programme and will bring EU and IMF financing to around EUR 53 bn, representing more than two thirds of total available financial assistance.

Overall, the Review concludes that the Programme is "on track" as Portugal puts in place the measures required under the Programme to ensure access to funds and to bring the country's economy back to sustainability.

The Programme is reviewed every three months. The last review (i.e. the second review) took place in November 2011 and a copy of the report can be downloaded from: http://ec.europa.eu/economy_finance/publications/occasional_paper/2011/pdf/ocp89_en.pdf

In fact, the Review is quite positive about Portugal's progress so far. While recognising that the current economic downturn throughout the Eurozone, and indeed the world, will potentially make recovery more challenging, the Review confirms that Portugal is facing these challenges and making progress.

The fourth review of the Programme, which took place between May 22 and June 4 has now been completed. According to the initial statement by the EC, ECB and IMF, the Programme is still deemed to be on track. The full report of the fourth review is expected to be published within the next couple of months and will be, once again, summarised by PLMJ for your convenience. In the meantime the present Review provides an interesting birds-eye view of the state of the Portuguese economy[1]. This summary[2] of the 60 page Review, gives a broad overview of its findings on an easy to follow sector-by-sector basis together with some insights and opinions from leading experts in their field at PLMJ and is a must-read for investors in Portugal and those looking to invest in and wanting to understand the current status and future plans for the Portuguese economy.

All the information (including charts and graphs) used in this summary can be found in the Review which is available online (in English only) at: http://ec.europa.eu/economy_finance/publications/occasional_paper/2012/pdf/ocp95_en.pdf

FIRST AND SECOND REVIEWS

The first review of the Programme took place in June 2011 at the time when Portugal's new government had just taken office and full ownership of the programme. According to the first Review, It moved quickly to meet the structural targets for the first review and reacted promptly to evidence of an emerging shortfall in public finances. Structural reforms to open the economy to competition and reduce government involvement in the private sector were underway and measures to strengthen the financial sector as well. In particular, banks were set to working towards meeting the higher capital requirements established under the Programme.

A copy of the first review can be downloaded from: http://ec.europa.eu/economy_finance/publications/occasional_paper/2011/pdf/ocp83_en.pdf

*The **second review** took place in November 2011 and reported that Portugal had made good progress on a number of fronts, but significant challenges still remained. Achieving the fiscal targets to regain full market access within the Programme period was deemed key. The government also needed to focus on reforms that address Portugal's competitiveness challenges. The 2012 budget was reviewed and it was deemed important to rapidly adopt structural reforms in labour and product markets with a view to reducing labour cost, increasing flexibility, lowering entry barriers and tackling rent-seeking. The Programme's projections were deemed to continue to be valid and that financing was sufficient to cater for the needs of the Portuguese government over the Programme period.*

A copy of the second review can be downloaded from: http://ec.europa.eu/economy_finance/publications/occasional_paper/2011/pdf/ocp89_en.pdf

[1] Some dates and references mentioned in the Review may now be out of date since the publication of the Review in April.

[2] This summary does not purport to be complete and should not replace reading the Review in full for a comprehensive understanding of the status of the Programme and the projections set out in the Review. The facts and figures expressed in this summary are taken directly from the Review unless expressly stated otherwise. The projections and opinions set out in the Review and summarised in this summary are not necessarily those of PLMJ.

THE ECONOMIC ADJUSTMENT PROGRAMME FOR MADEIRA

The Review also briefly reports on the financial arrangement concluded with the Autonomous Region of Madeira in January of this year.

It's aim is to restore the region's fiscal situation and contain the fiscal risks that the region has caused on the Portuguese public finances. The arrangement is designed along the same lines as the Programme. Regular reports on Madeira's progress will be made each quarter and the results submitted ahead of each review of the Programme. The report on the first review of the Madeira programme will be made available by the end of April (in time for the fourth Review).

The total volume of the Madeira programme is EUR 1.5 bn (about 25% of the total debt), available in tranches amounting to EUR 1 bn in 2012, EUR 307 million in 2013, EUR 110 million in 2014 and EUR 83 million in 2015. The repayment of the loan will start in 2016 and last until 2033, with interest rates being those set by central government plus 15 basis points. The majority of conditions replicate those of the Programme.

The various revenue and expenditure measures should allow a reduction of the budget deficit down to 3.1% of the regional GDP in 2012, 0.8% in 2013 and a surplus in subsequent years.

A copy of the adjustment for Madeira (in Portuguese) can be downloaded from:http://www.portugal.gov.pt/media/445364/programa_ajustamento_madeira.pdf

THE PROGRAMME

The objectives of the Programme are to restore sound public finances, improve competitiveness and to put Portugal's economy back on the path of sustainable growth and job creation. The Programme was agreed by the Ecofin Council on 17 May 2011 and by the IMF Executive Board on 20 May. The Programme, which covers the period 2011-2014, entails an external financing by the European Union, the euro-area Member States and the IMF of up to **EUR 78 bn**, for possible fiscal financing needs and support to the banking system.

- One third will be financed by the European Union under the European Financial Stabilisation Mechanism (EFSM).
- One third by the European Financial Stability Facility (EFSF).
- The remaining third by the IMF under an Extended Fund Facility.

So far, EUR 38.2 bn (of which EUR 25.3 bn by the European Union and EUR 12.9 bn by IMF) has already been disbursed.

A copy of the Programme report can be downloaded at: http://ec.europa.eu/economy_finance/publications/occasional_paper/2011/pdf/ocp79_en.pdf

A copy of the Letter of Intent and revised Memorandum of Understanding, dated 9 December 2011 (The MoU), which sets out the (revised) objectives and conditions regarding the Programme financing, can be downloaded from: www.imf.org/external/np/loi/2011/prt/090111.pdf

For more information on the EFSF and other financial stability mechanisms in relation to the Eurozone, please see our Eurozone Update of 30 March: http://www.plmj.com/xms/files/newsletters/2012/Abril/the_mother_of_all_firewalls_ing.pdf.

2. EXECUTIVE SUMMARY

OVERALL, THE PROGRAMME IS DEEMED TO BE ON TRACK. THE FISCAL ADJUSTMENT IN 2011-2012 IS CONSIDERED TO BE QUITE REMARKABLE

According to the Review, contraction of economic activity in 2012 is likely to be more pronounced than foreseen, in spite of a better macro-economic outcome for 2011. Financing conditions remain tight but risks of a credit crunch are contained.

The Programme's 2011 target for the general government deficit of 5.9% of GDP has been overachieved by resorting to a transfer of banks' pension funds to the state amounting to 3.5% of GDP. The Programme's 2012 target for the general government of 4.5% of GDP remains valid.

Noticeable progress has been made in the area of structural reforms. The far-reaching and ambitious market reform agenda is progressing according to plan for the employment market, health care sector, housing market, legal system and the insolvency and regulatory framework, including competition. Also, privatisations so far have been highly successful.

Overall, the programme is deemed to be on track. The fiscal adjustment in 2011-2012 is considered to be quite remarkable. The necessary deleveraging of the financial sector is deemed to be progressing in an orderly manner. According to the Review, reforms in labour and product markets aimed at raising competitiveness, growth and job creation are advancing and framework conditions for doing business are being improved.

But important risks and challenges remain. Amongst others, the Review mentions risks related to a further increase in unemployment beyond current projections and, it suggests that, with regard to the employment market, it may be necessary to go beyond currently planned reform steps in specific areas such as the duration of unemployment benefits or the extension mechanism of collective agreements.

The Review notes that raising the country's attractiveness for foreign investment will be a crucial element for the success of the Programme.

In general, the review finds that the Programme's financing projections remain valid.

◻ Executive Sector Summary of Key Review Points - We have set out a sector by sector summary of the key points from the review including links to any relevant PLMJ newsletters that might be of interest for more in-depth information on the relevant topic.

3. GENERAL ECONOMIC DEVELOPMENT AND OUTLOOK

KEY POINTS

- *Decline in economic activity in 2011 was less pronounced.*
- *Real GDP in 2011 is estimated to have declined by 1.5%, which is 0.7 percentage points better than the initial Programme projection.*
- **But Real GDP in 2012 is now forecast to fall by 3.3% which implies a downward revision by 0.3 percentage points compared with the last review.**
- *Business and consumer confidence indicators reached record lows in Q4-2011.*
- *Labour markets worsened with the unemployment rate reaching 14%, up from 12.6% in Q3-2011.*
- *Financing conditions remain tight, in particular for households and SMEs*
- *Portuguese exports are now expected to increase by only 2% in 2012.*
- *Private investment is now expected to decline by 12% in 2012*
- *Annual growth is projected to be 0.3%, almost 0.5% less than before.*
- **The main driver of growth in 2013 will be an acceleration of exports on the back of a strengthening EU economy and improved cost competitiveness.**
- *Reduction of current account deficit by 3% suggests recovery is underway.*
- *A fiscal gap of 0.5% of GDP for achieving the 2011 budget target has been closed by the transfer of banks' pension funds to the public social security system.*
- *General government arrears complied for the first time with the indicative target of non-accumulation.*
- *Portuguese sovereign spreads have started come down after a sharp increase at the beginning of the year.*
- *The five largest Portuguese banks recorded a cumulated loss of EUR 1.5 bn in 2011.*
- *All but two small banking groups subject to BdP supervision met the 9% Core Tier 1 ratio target.*

The Review takes a look at the Portuguese economy in general and concludes that the decline in economic activity in 2011 was less pronounced than expected. According to the Review, real GDP is estimated to have declined by 1.5% in 2011, which is 0.7% better than the initial Programme projection. The significant reduction of the current account deficit in 2011 by about 3% of GDP suggests that the external rebalancing of the economy is underway.

However, the Review goes on to remind us that the contraction of economic activity intensified in Q4-2011. Business and consumer confidence indicators reached record lows in Q4-2011. The situation in the employment market worsened more than expected in Q4-2011, with employment decreasing by 2.4% compared with the previous quarter and the unemployment rate reaching 14.0%, up from 12.6% in Q3-2011.

Financing conditions in Portugal also remain tight, according to the Review, while the risks of an outright 'credit crunch' are limited. Bank lending to the non-financial sector has been shrinking since mid-2011, in particular for households and SMEs.

Based on the Review's assumption of a further slowdown of economic activity in Europe in the first half of 2012, Portuguese exports are now expected to increase by only 2% in 2012, implying a downward revision by 1.8% compared with the second review of the Programme (see Table 1).

	Feb 2012 (3rd review)			Nov 2011 (2nd review)			Difference		
	2011	2012	2013	2011	2012	2013	2011	2012	2013
				year-on-year volume change					
Gross domestic product	**-1.5**	**-3.3**	**0.3**	*-1.6*	*-3.0*	*0.7*	0.1	-0.3	-0.4
Private consumption	**-3.8**	**-5.8**	**-0.9**	*-3.8*	*-5.8*	*-1.1*	0.0	0.0	0.2
Public consumption	**-3.1**	**-2.9**	**-2.6**	*-3.7*	*-4.1*	*-2.4*	0.6	1.2	-0.2
Fixed investment	**-11.3**	**-11.8**	**0.7**	*-11.3*	*-10.3*	*0.6*	0.0	-1.5	0.1
Exports of goods and services	**7.2**	**2.0**	**4.7**	*6.8*	*3.8*	*5.5*	0.4	-1.8	-0.8
Imports of goods and services	**-5.7**	**-6.9**	**1.9**	*-4.8*	*-5.0*	*1.2*	-0.9	-1.9	0.7
				contributions to real GDP growth					
Domestic demand excl. inventories	**-5.4**	**-6.6**	**-0.9**	*-5.5*	*-6.5*	*-1.1*	0.1	-0.1	0.2
Change in inventories	**-0.5**	**-0.1**	**0.2**	*-0.1*	*0.1*	*0.1*	-0.4	-0.2	0.1
Net trade	**4.4**	**3.4**	**1.1**	*3.9*	*3.3*	*1.6*	0.5	0.1	-0.5
Employment (y-o-y change)	**-1.5**	**-2.5**	**0.2**	*-1.0*	*-1.6*	*0.2*	-0.5	-0.9	0.0
Unemployment rate (level)	**12.7**	**14.4**	**13.9**	*12.7*	*13.8*	*13.6*	0.0	0.6	0.3
HICP (y-o-y change)	**3.6**	**3.2**	**1.3**	*3.6*	*3.3*	*1.3*	0.0	-0.1	0.0

Table 1 – Source: European Commission

As a consequence, the Review projects that private investment is now expected to decline by 12% in 2012. Private consumption expenditure is forecast to contract by an unchanged 6% and real GDP is now forecast to fall by 3.3% in 2012, which implies a downward revision by 0.3% compared with the last review.

The Review confirms that, although the economy is still expected to regain traction during 2013, annual growth is now projected to be rather weak at 0.3%, almost 0.5% less than before. According to the Review the main driver of growth in 2013 will be an acceleration of exports on the back of a strengthening EU economy and improved cost competitiveness.

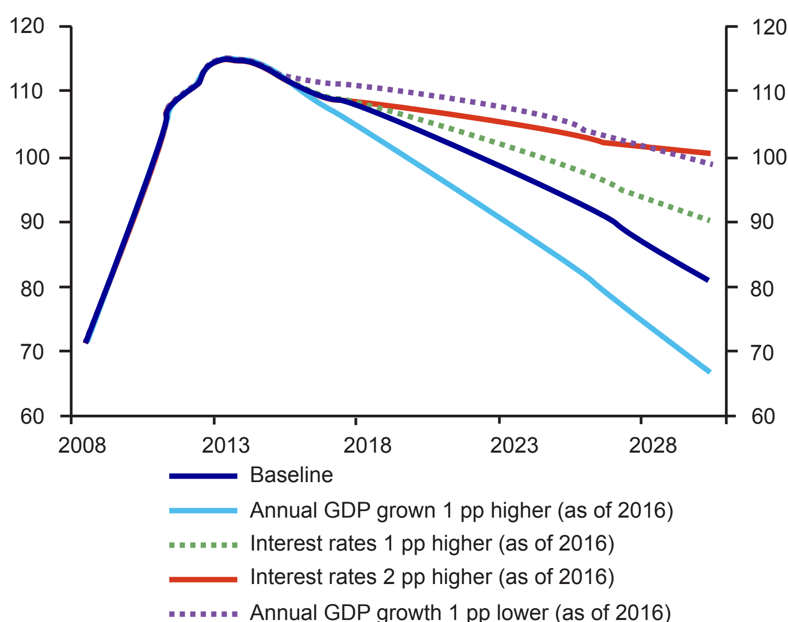
The Review notes that, inflation accelerated in Q4-2011 due to an increase in VAT for natural gas and electricity. Inflation is predicted to stay fairly high in 2012 following further increases in indirect taxes in January 2012. However, the Review suggests that rising unemployment should keep wage increases low while the weak domestic demand should put pressure on price mark-ups.

OVERALL, THE REVIEW CONFIRMS THE SOLID DEBT REDUCTION PATH IS STILL ATTAINABLE IF FISCAL CONSTRAINT IS MAINTAINED AFTER THE END OF THE PROGRAMME PERIOD.

4. DEBT AND FISCAL SUSTAINABILITY

The Review notes that the Programme projects government debt to peak at 115% of GDP in 2013 before starting a gradual decline. After 2015, it is assumed that:

- The structural primary fiscal balance (i.e., the government balance adjusted for interest payments, one-off and temporary measures and for the effect of the cycle) remains unchanged at a surplus of 3.2% of GDP;
- Nominal interest rates are 5%;
- Nominal GDP growth stays close to 4%; and
- Pension cost projections are taken into account[3].

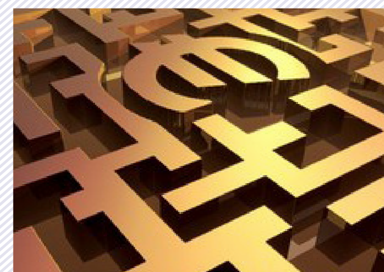


Graph 1 – Macro economic risks-growth and interest rates (debt as % of GDP)

Overall, the Review confirms the solid debt reduction path is still attainable if fiscal constraint is maintained after the end of the Programme period.

[3] According to the projections in the forthcoming Commission's 2012 Ageing Report.

5. PROGRAMME IMPLEMENTATION



5.1 BUDGET

From a fiscal policy perspective, the Review reports that a fiscal gap of 0.5% of GDP in the 2011 budget target has been over-achieved by the transfer of banks' pension funds to the public social security system increasing capital revenues by 3.5% of GDP. The 2011 deficit is now estimated at around 4% of GDP compared to a target of 5.9% of GDP.

The Review notes that additional revenue measures adopted in the summer of 2011 (a one-off surcharge on personal income taxes and bringing forward the increase in VAT on energy, originally planned for 2012), whilst significant, were not sufficient to close the fiscal gap of 0.5% of GDP by the end of the year. The recapitalisation costs of the troubled bank BPN, added a further 0.3% of GDP to that[4].

The 2012 budget, which the Review considers to be ambitious, aims at a government deficit of 4.5% of GDP and includes new consolidation measures worth 5.4% of GDP when compared with 2011. As the Review notes, this is more than originally foreseen at the outset of the Programme and is necessary to compensate the worsened underlying fiscal position in 2011 and the projected sharper contraction of economic activity. Expenditure-reducing measures account for most of the effort (mainly wage and pension cuts), with additional contributions coming from revenue-raising measures (mainly higher indirect taxes).

The Review commends Portugal for making clear progress in strengthening its budgetary framework and notes that the budgetary framework law, approved by the Parliament in 2011, addresses relevant weaknesses of the budgetary process, including a multi-annual framework with expenditure and budget rules over the medium-term and an independent Fiscal Council.

However, it also notes that Portugal still faces challenges in 2012 regarding the implementation of the new budgetary framework, referring, amongst others, to the revision of the regional and local finance laws in particular.

One of the main weaknesses in this respect, according to the Review, is weak budget constraint. Spending at local government level has been increasing at a higher pace than at central government level over the last decade. However, regional and local finance laws revisions are already in the preparation phase.

[4] On an ESA95 basis.

THE TAX MEASURES IN THE 2012 BUDGET CONTRIBUTE TO IMPROVING THE TAX STRUCTURE AND THE OVERALL DESIGN OF THE TAX SYSTEM.

5.2 ARREARS

The Review reports that general government arrears[5] complied, for the first time, with the general indicative target of non-accumulation. At the end of 2011, the combined stock of arrears for the general government sector and State operated enterprises ("SOEs") classified outside the general government, has been estimated at about EUR 5.5 bn or 3% of GDP. The health sector accounts for almost 50% of this. Local and regional governments account for another large share.

5.3 TAX POLICY

Overall, the Review considers tax policy to have significantly improved in Portugal. The recent tax measures, while having substantially contributed to fiscal consolidation, have mainly focused on raising higher revenues from those taxes which are considered less detrimental to growth and competitiveness, i.e. consumption taxes (VAT and excise duties) and recurrent taxes on immovable property. Moreover, according to the Review, the significant reduction in tax credits, tax benefits and tax allowances is going to help reduce the previous distortions caused by the tax system, in particular with regard to the bias towards debt financing in housing taxation.

The Review raises the concern that, in general, a higher overall tax burden leads to higher tax evasion and tax fraud. This renders the measures undertaken to improve tax governance and the revenue administration framework even more relevant. In this respect, the Review notes that a strategic plan to combat tax and customs fraud and evasion for 2012-14 has been completed and the authorities have taken important steps towards its implementation. This will play an important role in 2012, also given also the less favourable macro-economic environment.

The tax measures in the 2012 budget contribute to improving the tax structure and the overall design of the tax system. This should reduce the negative impact of the overall higher tax burden on the economy.

5.4 PUBLIC SECTOR STREAMLINING

5.4.1 Public Administration

According to the Review, important steps have already been initiated to reform the public administration including:

- The creation of a database for public sector employment;
- The reduction of management positions and administrative units;
- Stock-taking and restructuring of foundations and associations;
- Creating shared services regarding human, financial and IT resources;
- The reorganisation of local government administration; and
- The reduction of duplication at central and local levels.

5.4.2 SOEs

The Review notes the restructuring of public transport SOEs and the new round of transport price increases in February 2012 as well as personnel cost reductions. A strategy to deal with the historical debt of transport companies totalling about EUR 17 bn will be prepared for the next review.

[5] Arrears are defined as payables/creditors that have remained unpaid for 90 days or more beyond any specified due date (regardless of any contractual grace period). In case no due date is specified, arrears are defined as payables/creditors that have remained unpaid for 90 days or more after the date of the invoice or contract.

Finally, the Review mentions that the government is preparing a decree law on the governance framework for SOEs which aims at a clearer distinction between commercial and non-commercial SOEs with different implications for their governance.

5.4.3 PPPs

The Review notes that the government is preparing a decree-law on a legal framework for PPPs which defines the role of the technical unit in the Ministry of Finance, the identification of the economic and fiscal impact, and the scope for its application.

5.4.4 Privatisations

The government's privatisation programme is ongoing. The Review reports on the EUR 3.3 bn of proceeds resulting from the sale of its stakes in the national energy company (EDP) and the national energy network company (REN), and notes that the target of EUR 5 bn is likely to be exceeded by the end of the Programme. The planned sale of the small remaining stakes in Galp and REN have been delayed until market conditions have improved.

The privatisation agenda for 2012 includes:

- The national air carrier (TAP);
- The airport operator Aeroportos de Portugal (ANA);
- The cargo handling subsidiary of the railway company (CP Carga);
- The postal service *Correios de Portugal* (CTT); and
- The insurance arm of *Caixa Geral de Depositos (Caixa Seguros*).

Jorge Brito Pereira
Partner Head of Banking & Finance and Capital Markets Practice Area

PLMJ INSIGHTS - PRIVATISATIONS

"In the MoU signed with the Troika, the Portuguese Government undertook to accelerate its privatisation programme which is expected to generate around EUR 5.5 bn of revenue. As a result, the MoU established, from the outset, that all of the shares in REN, EDP and TAP should be sold by the end of 2011. Of these three companies, EDP was the only one to complete the privatisation process in late 2011. REN was already in the middle of its privatisation process by the end of 2011 and around 11% of its capital will be sold by the Portuguese state in July this year; only six months late. Just TAP's privatisation, which should take the first steps in the process in the beginning of June of this year, has prevented the Portuguese state from complying with its obligations under the MoU. However, as part of the second review of the Programme, the Portuguese Government undertook to identify two additional large companies to be privatised by the end of 2012. It has already identified ANA, which privatisation process should take place parallel to that of TAP. We are now eagerly waiting to know which company will be selected next. Many think this may be RTP. In conclusion, even though the commitments regarding privatisation outlined in the MoU have not been fulfilled to the letter, in respect of the challenge of "financing the Portuguese state" the outcome has been more than positive."

HEALTH SECTOR ARREARS

The Review notes that the Portuguese government has given priority to arrears resulting from the chronic underfunding of the health sector over the past years (about EUR 1.5 bn). Arrears in the health sector amount to about EUR 2.5 bn, out of which about EUR 1.5 bn are deemed to have been caused by underfunding as result of the state budget since 2005. The remaining amount of EUR 1 bn is deemed to be the result of inefficient management of hospitals.

5.5 HEALTHCARE SECTOR

The Review reports on the extensive revision that the Portuguese national health system is undergoing in order to be able to control expenditure, raise the efficiency and cost effectiveness of the system, and improve equity of financing. Throughout 2011 and especially during the last quarter, the Review notes that large numbers of regulatory changes were put in motion including:

- The revision, increase and exemptions of National Health System (NHS) fees;
- The revision of the reference countries for pricing medicines;
- The reduction in the maximum price of the first generic and the removal of barriers to the entry of generics;
- changes to the pharmacies' profit margins;
- The introduction of compulsory e-prescription; and
- The implementation of enhanced/regular monitoring of 29 prescription behaviour and regular feedback to physicians, and the strengthening of centralised procurement.

In addition, a large number of guidelines for the prescription of medicines and diagnostics have been published and there is improvement in the development of electronic medical records for patients.

Hospitals are starting to be compared along a number of indicators which include financial and activity performance. There has been a reduction in costs with contracted services and in operational costs of hospitals.

However, the Review also notes that a number of important measures such as the compulsory prescription by substance (INN) and an update of the legislation on pharmacies, await implementation. While a number of policies have been introduced to reduce the expenditure of the public health system, there are no plans to ensure its independence from public funding. Also, downsizing, concentrating and redefining NHS hospitals has not yet taken full effect. Finally, there remains a substantial amount of arrears by NHS hospitals to private providers for which a strategy is yet to be fully defined.

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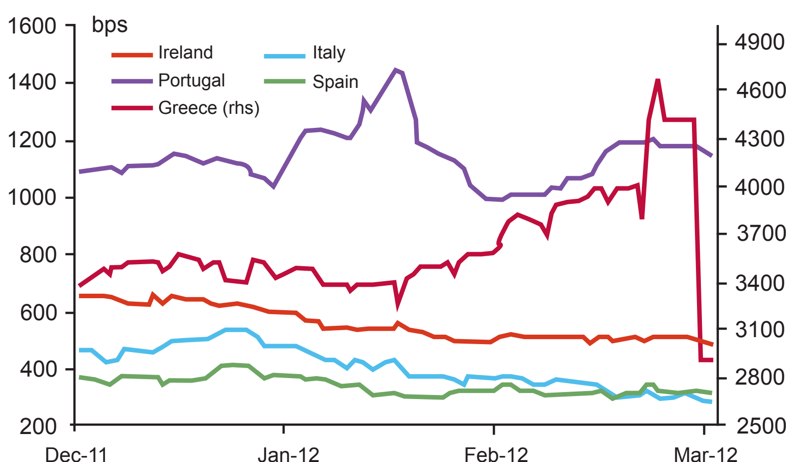
PLMJ INSIGHTS - HEALTHCARE

"In order to implement new intellectual property rules, the Portuguese Government has introduced two important changes to Portuguese legislation: (i) the creation of a National Intellectual Property Court; and (ii) a mandatory arbitration requirement regarding reference and generic medicines. The latter (Law 62/2011 of 12 December) requires that litigation arising from disputes related to reference and generic medicine industrial property rights, is subject to compulsory arbitration (regardless of whether patent validity is at issue). The application of this piece of legislation is a matter of some controversy. The fact that arbitration has been made compulsory stumbles on three main problems: (i) its compulsory nature, (ii) inconsistency regarding the Enforcement Directive and (iii) its practical effects. One of the problems currently being discussed, is whether the new legislation applies only to pending cases, or whether it will be changed in all cases which will also be decided by the new Intellectual Property Court."

5.6 FINANCIAL SECTOR

The Review reports that Portuguese sovereign spreads have started come down after a sharp increase at the beginning of the year. The ECB's 36-month long-term refinancing operation ("LTRO") had little effect on Portuguese interest rates. However, the Review notes that it did improve the bank's liquidity situation considerably. The Review shows borrowing levels in January 2012 around EUR 46.5 bn[6], equivalent to 9% of total liabilities and reminds us that Portuguese banks have also been hit by the sovereign downgrades. Portugal is currently rated Ba3 (negative) by Moody's, BBB- (negative) by Fitch and BB (negative) by S&P[7].

The Review confirms that low turnover coupled with market speculations about a second adjustment Programme containing private sector involvement, have led to widening yield spreads in early 2012. At around 13% and 1,000 basis points above the German Bund, long-term interest rates are around the peaks observed in July 2011. See the graph below which sets out different countries' 10-year bond yield spreads versus those of Germany.



Graph 2: 10-year bond yield spreads versus Germany – Source: Reuters

The Review reports that the five largest Portuguese banks recorded a cumulated loss of EUR 1.5 bn in 2011. According to the Review, this was mainly due to the recessionary environment, the situation in Greece, the impact of the Special onsite Inspections Program (SIP) and the partial transfer of pension funds. However, it also notes that all but two small banking groups subject to BdP supervision met the 9% Core Tier 1 ratio target set under the Programme for end-2011, including the eight largest banking groups (accounting for 83% of banking system's assets). According to the Review, banks will need to raise high-quality Core Tier 1 capital in 2012.

[6] Statistics from the Bank of Portugal website showed that ECB lending to Portugal under the LTRO programme increased in March 2012 to EUR 56.3 bn from EUR 47.5 bn in February 2012: http://www.bportugal.pt/EstatisticasWeb/(S(cvek4y45imrk1z45evh3st45))/SeriesCronologicas.aspx

[7] Ratings last updated on 28 February 2012.

THE PORTUGUESE GOVERNMENT AND THE RELEVANT WORKERS UNIONS CONCLUDED A TRIPARTITE AGREEMENT, WHICH COVERS MOST OF THE LABOUR MARKET REFORMS IN THE MOU.

5.7 EMPLOYMENT MARKET

The Review notes that the Portuguese government and the relevant workers unions concluded a tripartite agreement[8], which covers most of the labour market reforms in the MoU. Draft laws to reform the employment code were sent to parliament, and will substantially reduce rigidities. The Review reports on the following main elements:

- **Severance pay rules of current employees are aligned with those of new hires.** Following the reduction of severance payments to 20 days per year of work for hires after 1 November 2011, the draft law applies the new severance pay rules to current employees, while preserving accrued-to-date rights.
- **Definition of individual fair dismissals is eased.** Individual dismissals based on the extinction of the job on grounds of economic structural or technological reasons will no longer need to obey to a tenure rule when more than one worker is involved. Instead, the employer will need to present an objective reason for the selection of employees. Individual dismissals based on unsuitability of the work will become possible also when no new technology or other changes to the work place had occurred. The employer has to justify the dismissal based on substantial changes in worker's performance. In both types of dismissals, the employer is no longer obliged to look for a suitable alternative position for the employee within the firm. The Government will carry out an analysis of the impact of these measures on relevant labour market variables by the second quarter of 2013.
- **Working time flexibility is increased.** Overtime pay is reduced by 50%, and the mandatory 15 minute extra time off for each overtime hour worked is abolished. The scope for working time flexibility is increased with a 150-hour bank of hours that can be activated by agreement between employer and employees. Short-time working schemes during industrial crisis are streamlined. The number of working days is increased by cutting four national holidays and by eliminating the possibility for workers accumulating three additional annual leave days based on their record of absences.
- **The possibility for works councils to conclude firm-level collective agreements is enhanced**. The firm-level threshold for unions to delegate to works councils the conclusion of collective agreements was reduced from 500 to 150 workers. Simultaneously, the draft law includes the possibility that sector-level collective agreements contain clauses under which works councils can negotiate at firm level functional and geographical mobility, working time and remuneration. The proposal is in line with the MoU but it is less ambitious than a proposal discussed during the second review mission.

The Review also reports on the review of the unemployment insurance benefits system which is being revised to reduce unemployment traps while better protecting workers with short contributory careers and the self-employed. Two draft-decree laws revising the system to bring it into line with EU averages, have been approved by the Council of Ministers in this respect.

The hiring incentives programme Estímulo 2012, which entered into force on 14 February 2012, is also mentioned by the Review. Under this programme employees registered for more than 6 months with the Public Employment Services (PES) are subsidised for 50% of the wage of the employee up to a ceiling equal to the social support index for a period of 6 months. The firms benefiting from the scheme must provide training and offer a contract of at least six months. The Government estimates that more than 56,000 unemployed will benefit from the measure.

[8] The agreement was subscribed by the General Worker's Union (UGT), the Confederation of Portuguese Industry (CIP), the Confederation of Trade and Services of Portugal (CCP), the Confederation of Farmers of Portugal (CAP), the Confederation of Portuguese Tourism (CTP) and the Government. The largest trade union confederation - the General Portuguese Workers' Confederation (CGTP) – has not signed the agreement.

SOME FACTS AND FIGURES ON THE CURRENT STATUS OF THE PORTUGUESE JUDICIAL SYSTEM [9]

- *Portugal currently has about 1.5 million civil and commercial cases pending.*
- *Approx. 1.18 million are enforcement cases.*
- *Approximately 634 000 cases (of those 1.18 million) are claims not exceeding EUR 3 000, out of which 311 000 do not exceed EUR 1 000.*
- *Council of Europe statistics show that average disposition time in first-instance civil and commercial cases in Portugal is 925 days compared with 53 in Austria and 91 in Denmark.*
- *Council of Europe statistics show that the number of first-instance courts in Portugal is relatively high: there are 2.2 courts per 100 000 inhabitants (compared with, for example, 0.1 in the Netherlands, 0.3 in Belgium, 1.1 in the UK and 3.9 in Greece).*

Under the Programme, Portugal is taking the necessary measures to streamline its judicial process, increase efficiency and lower costs.

Nuno Líbano Monteiro
Partner, Head of Litigation and Arbitration Practice Area

[9] All statistics are based on those included in the Review and have not been verified by PLMJ

5.8 JUDICIAL SYSTEM

The Review concludes that the judicial system reform is progressing largely ahead of schedule:

- The first 50,000 backlog cases in the courts have been cleared.
- Quarterly milestones have been identified to reduce the number of court districts and close down underutilised courts. Ten court sections have been closed since November 2011.
- Court management assessment and a new personnel management plan to support judicial specialisation and mobility of court officials have both been completed.
- On 4 November 2011 a law on arbitration was adopted and the authorities have taken the necessary legal, administrative and other steps to make arbitration fully operational ahead of the February 2012 deadline.
- Specialised courts and judges on competition and on intellectual property rights matters are set to become operational.
- A task force of tax judges has been established to facilitate the resolution of outstanding tax cases.
- The government has prepared a bold proposal to speed up the judicial process.

PLMJ INSIGHTS - LITIGATION

"On 13 February 2012, a new regulation was published on court costs, which provides a derogatory regime for the withdrawal of judicial proceedings without payment of court fees. This regime will run until March 2013 and it is expected to resolve a substantial part of the backlog. On 20 April 2012 a new insolvency regime was introduced, which provides for special conciliation prior to the declaration of insolvency, granting guarantees to lenders who invest in the company at this stage which, hopefully, will allow the revitalisation of companies that have financial problems but are sound in economic terms. An amendment to the code of civil procedure is being prepared to expedite civil and commercial proceedings. The amendment focuses more strongly on the oral handling of cases and the simplification of procedures. A comprehensive reform of the organisational law of the courts is also being discussed. Courts will be organised so they are located closer to the population and businesses, instead of being distributed throughout the country. Specialisation is also featured. Specialised courts and judges on commerce, competition and intellectual property rights matters are set to become operational."

5.9 ENERGY MARKET

In general, the Review deems the measures taken to contain the debt relating to the electricity system (the so-called tariff debt) to be insufficient. The Review suggests that substantial further action will be necessary to get it on a sustainable path by correcting the excessive rents associated to the production of energy. The following specific measures are mentioned in the revised MoU:

- Rates of return granting excessive rents to producers under the ordinary regime (CMECs)is being negotiated to bring them close to the cost of capital plus a possible risk premium.
- The government has revised the investment incentives for future installed capacity under the power guarantee mechanism. Investment incentives granted retroactively (i.e. prior to 2007, when the concept of a mechanism was first legislated) will be withdrawn.
- A revision of the support-scheme for co-generation (under special regime) is underway. Tariff revision by end of April 2012 with the objective to reduce implicit subsidies by annual amounts raising from EUR 25 million in the first years to EUR 80 million by 2020 (the adoption of revised tariffs was already foreseen in a 2010 decree law).
- Look at support schemes for renewables and support schemes for capacity not granted by tender procedures.

According to the Review, the liberalisation of the energy sector in Portugal progressed with the adoption of decree-laws phasing out the remaining regulated tariffs for smaller and retail end-users of electricity and natural gas by 1 January 2013. This follows the earlier decreed tariff deregulation for larger and industrial customers by 1 July 2012.

The Review notes that the lack of a common tariff system for the use of gas networks in Portugal and Spain, remains a major impediment to the development of the Iberian gas market (MIBGAS). On the basis of a report analysing the cross-border transmission gas tariffs between Portugal and Spain, the Review confirms that the two countries will prepare a joint proposal for harmonising the cross-border tariffs.

Other recent energy policy measures the Review considers include the increase in the excise tax for electricity to EUR 1 per MWh as of 1 January 2012 and the removal of tax incentives for investment in renewable energy equipment and energy efficiency in buildings overlapping with other policy instruments in the 2012 budget. The procedures relating to licensing renewable energy projects are being simplified.

Manuel Santos Vítor
Co-Managing Partner, Co-head of Energy and Natural Resources Team

Ana Oliveira Rocha
Senior Associate, Co-head of Energy and Natural Resources Team

PLMJ INSIGHTS - ENERGY

"The measures are cross-sector and are having an impact from the generation to the consumption of energy. On top of the VAT increase from 6% to 23% applicable to electricity and gas, electricity consumption by companies and households is now subject to taxation at € 1.00/Mw. Renewables' feed-in tariffs are being revised for closer to market tariff. But, even with these measures, the energy bill is estimated to increase at least until 2030."

5.10 COMPETITION AND REGULATION

The Review notes that a new competition law was submitted to Parliament at the beginning of February 2012 and is expected to be adopted by June 2012. This law is meant to ensure that the Portuguese Competition Authority (PCA) is able to effectively enforce competition rules and is equipped with adequate investigation powers, in line with other competition authorities in the EU. This involves, in particular, the power to effectively carry out unannounced inspections in business premises, including the power to search, examine and copy or seize all types of business records and communications independent of the medium on which they are stored.

The Review also mentions that a significant revision of the public procurement code is about to be adopted which will address in particular the regime for the award of additional works and services, errors and omissions, as well as the elimination of exemptions permitting direct awards and of the requirement to invest in R&D projects on contracts above EUR 25 million.

A new bylaw, extending the competences of the court of auditors to enforce compliance with public procurement law, has recently been adopted. The public procurement portal "Base" has improved, which, according to the review, increases the overall transparency of the system.

The Review states that, as the Portuguese government has decided to delay the sale of CGD's 1% share in Galp, maintaining the special rights situation, this Programme requirement has not been met and the European Court Ruling of 10 November 2011 has not been respected.

Ricardo Oliveira
Partner, Head of EU and Competition Practice Area

PLMJ INSIGHTS - COMPETITION LAW

"The amendment of the Competition Act carried out within the framework of the bailout programme, has further harmonised national law with EU law and has handed the PCA a number of extra tools to carry out its enforcement mission. Implementation by the PCA of a strong competition policy will now be key"

5.11 HOUSING MARKET

The Review notes that a draft decree law, amending urban rental legislation, was submitted to Parliament. This new legislation phases out open-ended leases, provides for more flexibility in contract duration and updating rent, sets incentives for renovation, and provides for extrajudicial procedures, all in line with the MoU's main objectives.

5.12 GENERAL BUSINESS ENVIRONMENT

First steps have been taken to reduce the administrative burden on exporting companies and to improve effectiveness of existing instruments dealing with access to finance, export promotion, and competitiveness for SMEs. The 'Simple export' programme[10] is well on track. The first steps towards making an overall assessment of consistency, effectiveness, and impact of support measures for SME's are being made.

[10] This governmental programme is designed to give easier access to external trade statistics. It's main purpose is to Its purpose is to provide free statistical information on exports and imports of goods, broken down by product and the target market or market of origin on the Official website of the INE (Institute of National Statistics for Portugal).

6. PROGRAMME FINANCING

The next tranche of EUR 14.9 bn for Q2-2012 was confirmed during the Review. Successful completion of the third review will allow the release of EUR 9.7 bn from EFSF/EFSM and EUR 5.2 bn from the IMF. The forthcoming instalment is the second largest of the programme and will bring EU and IMF financing to around EUR 53 bn, representing more than two thirds of total available financial assistance.

	EU	IMF	Total
Programme mission	12.4	6.1	18.5
1rst review	7.6	4.0	11.6
2nd review	5.3	2.8	8.1
Total disbursed	25.3	12.9	38.2
Total undisbursed	26.7	14.2	40.9

Note: Total disbursements do not add up to EUR 78 bn due to changes in EUR-SDR rate.

Table 2 Disbursements to Portugal (in EUR)

The Review confirms that financing needs for the rest of the Programme period remain broadly in line with previous expectations. Additional financing needs result from:

- The Economic Adjustment programme for Madeira;
- Capital contributions to the ESM;
- Accelerated redemption of saving certificates; and
- The financing of SOEs.

However, as the Review notes, this is largely already compensated for in various financial measures and wind-falls.

The Review also notes that recent funding operations by the Portuguese sovereign have been successful. The downgrade of the Portuguese sovereign long-term debt by S&P to non-investment grade in January did not affected the government's potential for raising short-term funds on the market for the period under review. According to the Review, the stock of treasury bills at the end of February amounted to EUR 14.7 bn. The roll-over risk has been lowered somewhat by the increasing maturity of latest auctions. The Review also notes that, on January 18, Portugal sold EUR 500 million of 11-month T-Bills at a yield below 5%, which is 90 basis points less than at the last 12-month T-Bill auction in April 201l.

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IFLR1000 2011 Top Tier Firm

"Portuguese Law Firm of the Year"
Chambers European Excellence Awards, 2009,2012; / Who`s Who Legal Awards, 2006, 2008, 2009, 2010, 2011/The Lawyer European Awards-Shortlisted,2010, 2011

"Best Portuguese Law Firm for Client Service"
Clients Choice Award - International Law Office, 2008, 2010

"5ª Most Innovative Law Firm in Continental Europe"
Financial Times – Innovative Lawyers Awards, 2011

"Corporate Law Firm of the Year - Southern Europe"
ACQ Finance Magazine, 2009

"Best Portuguese Tax Firm of the Year"
International Tax Review - Tax Awards 2006, 2008

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