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Honorable Doug LaMalfa, Chair
House Subcommittee on Indian, Insular and Alaska Native Affairs
Committee on Natural Resources
1324 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman LaMalfa,

I write to comment on the status of the Puerto Rico Electric Power Authority (PREPA) Restructuring Support Agreement (RSA), the topic of a hearing sponsored by the House Subcommittee on Indian, Insular and Alaska Native Affairs on March 22, 2017.

I am Director of Finance[1] of the Institute for Energy Economics and Financial Analysis (IEEFA), a non-profit organization headquartered in Cleveland, Ohio. IEEFA is made up of a group of energy and finance professionals who conduct research and analyses on financial and economic issues related to energy and the environment. Our mission is to accelerate the transition to a diverse, sustainable and profitable energy economy.

IEEFA has been deeply involved in the debate over PREPA's future. We have published two substantive studies on PREPA's financial condition,[2] provided testimony in formal administrative hearings at the Puerto Rico Energy Commission on PREPA's Integrated Resource Plan[3] and electric rate case,[4] and published several additional commentaries[5] on emerging issues.

Summary

PREPA's proposed Restructuring Support Agreement (RSA) does not reduce PREPA's principal bond indebtedness sufficiently to allow it to continue as a going concern. As a result of this

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1 Prior to my tenure at IEEFA I served in senior management positions at the New York City and New York State Comptroller's Offices. During that time I held various positions including my final job as First Deputy Comptroller for New York State. Among my responsibilities during those years I worked on New York City finances under a control board. My work also involved monitoring control board progress in Yonkers, Troy and Nassau County. I also played a leading role in establishing control boards in the City of Buffalo and Erie County. Upon leaving state government I served as a private citizen on the Long Island Power Authority advisory team involved with reorganizing the Authority's debt. The model proposed for PREPA is similar to LIPA's current structure that grew out of these deliberations. See also The Oxford Handbook of New York State Government and Politics.

2 Kunkel, C., Sanzillo, T. and Schlissel, D. (2015), Opportunity for a New Direction for Puerto Rico's Electric System. and Sanzillo, T. and Kunkel, C. (2016) PREPA Debt Restructuring Deal Won't Restore Agency to Financial Health.

3 Sommer, A. and Kunkel, C. (2016) Comments on the Puerto Rico Electric Authority's Integrated Resource Plan.

4 Sanzillo, T. and Kunkel, C. (2016) IEEFA Filing: Testimony to the Puerto Rico Energy Commission.

5 See http://ieefa.org/category/geography-2/puerto-rico/

and other organizational dysfunction, debt and debt service payments are too high, placing upward pressure on electricity rates. These high rates are burdensome to ratepayers and economically uncompetitive. In addition the high debt burden assumed by the RSA crowds out PREPA's ability to invest responsibly in its future.

The Commonwealth and PREPA are overleveraged. Recent budgetary projections by the Governor and the Board that oversees implementation of the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) demonstrate that the Commonwealth can cover only 25% of existing bond obligations. The RSA assumes that PREPA has revenues that can pay an effective repayment rate of 89% of existing bond obligations.

It is our contention that PREPA does not legitimately owe the full $9.5 billion in outstanding indebtedness. Actions taken by participants in PREPA's situation and the egregious level of indebtedness incurred suggest a pattern of reckless disregard for PREPA's financial condition. The Board of PREPA, elected and appointed officials in various positions within the Puerto Rico government, bondholders, underwriters, credit agencies, attorneys, advisors and accountants should share responsibility.

We offer an outline and rationale to accomplish a more substantial reduction of PREPA's debt. This requires bondholders to incur losses. The losses, however, clearly can be mitigated as part of a new organizational and financial plan for PREPA. A new RSA tied to a more realistic assessment of PREPA's customers' ability to pay and an aggressive reform program to rid the agency of its current dysfunction should put Puerto Rico's electricity system on the right track. These initiatives will provide realistic certainty to PREPA's current bondholders, restore PREPA's access to the capital markets and improve the likelihood of repayment to future PREPA bondholders. The net effect of this scenario provides room for the Commonwealth and its economy to grow again.

The Debt Level as Proposed by the RSA Is Too Burdensome

PREPA currently has an outstanding debt obligation of $9.5 billion including all bond indebtedness and other long term obligations. The RSA addresses only a portion of the debt held by uninsured bondholders. It does not cover the total universe of all PREPA debt. In total, the RSA reduces the $9.5 obligation to $8.4 billion, a net reduction of $1.1 billion or 89% of the total current principal balance of all obligations.[6]

Both the PROMESA Board and Governor Ricardo Rosselló (in his budget and financial plan submission) have recently stated that the Commonwealth as a whole (excluding PREPA) can afford debt on its current outstanding obligations in the 25% range. That is, the amount of revenues available to pay debt service from all existing operations can cover only 25% of the island's existing bond indebtedness. If Commonwealth officials agree to a financial plan that exceeds these levels the government is at risk of continued budget deficits and will be in violation of the PROMESA statute. Such a scenario would, in short, simply force a repetition of past mistakes.

PREPA's ratepayers are also taxpayers. They are residents of Puerto Rico and are part of the same troubled economy that the PROMESA Board and the Governor know can only afford

[6]Sanzillo, T. and Kunkel, C. (2016) PREPA Debt Restructuring Deal Won't Restore Agency to Financial Health

25% of its current Commonwealth debt. There is no rationale as a matter of sound debt policy for PREPA and its ratepayers to sustain an 89% debt burden.

We understand that PREPA's bondholders will be treated differently than some other issuers in Puerto Rico. A July 2015 Moody's report[7] rated the potential recovery rates of all of the issuers on the island and treated PREPA bonds on parity with recovery rates for General Obligation and COFINA bonds, for which Moody's projected recovery rates of 65% to 80%. All of these bonds are tied to direct revenues.

Puerto Rico's dire financial circumstance require a rethinking of Moody's estimates. The Governor and the PROMESA Board estimate revenues that can afford to pay only 25% of Puerto Rico's existing debt obligations. At this level, we estimate that Puerto Rico's budgetary resources would not cover COFINA and General Obligation debt even if they were reduced consistent with the standards used in the RSA. By our estimate, if COFINA and General Obligation bonds were financed at an 85% repayment ratio, all other bondholders in possession of debt from Puerto Rico's 12 other issuing authorities identified by Moody's would receive zero in any bond settlement.

An 85% recovery ratio for COFINA, General Obligation debt or PREPA is unsupportable if Puerto Rico is to adopt debt management policies that are affordable, uniform and consistent with a financial plan that provides for structural budget balance.

For PREPA to sustain the projected debt levels under the RSA, ratepayers would be forced to bear excessively high rates. According to documents provided in the Puerto Rico Energy Commission's Transition and Rate Case proceedings, PREPA's initial rates with the RSA charges will be 20 cents per kilowatt hour. To place this in context, the Long Island Power Authority has rates of 18.1 cents per kilowatt hour for a population (Nassau and Suffolk County) with income that is four times higher than Puerto Rico's. PREPA anticipates that rates will rise to 25.8 cents per kilowatt hour by 2021 under the plan. (This projection has already fallen apart. Today, Puerto Rico's residents pay 20 cents per kilowatt hour without the full transition charge in PREPA's FY 2017 budget.)

PREPA's Estimated Future Indebtedness Will Make Matters Worse If RSA Goes Forward

The RSA assumes a five-year principal holiday on the indebtedness covered in the agreement. For those five years the remaining debt owed by PREPA and not covered under the RSA would see some principal reduction. Over the following 10 years the Governor's recent plan assumes that PREPA will incur at least $2.2 billion in new borrowings. IEEFA estimates that over the next five years PREPA will see a net increase of indebtedness from the RSA baseline of $8.4 billion to as much as $10 billion. The additional $2.2 billion of additional indebtedness is not included in the current rate calculations assumed in the plans that have been the subject of rate hearings in Puerto Rico.

Toward a Solution

It is our contention that PREPA does not legitimately owe all of the $9.5 billion in debt carried on its books. The actions of financial participants in PREPA's situation and the egregious level

[7] Moody's Investor Services, *Frequently Asked Questions About Puerto Rico's Fiscal and Debt Crisis*, Issuer In Depth, July 22, 2015.

of indebtedness suggest a pattern of reckless disregard for PREPA's financial condition. The board of PREPA, elected and appointed officials in various positions within the Puerto Rico government, bondholders, underwriters, credit agencies, attorneys, advisors and accountants all share responsibility.

- **Participants Need to Share liability**

The Puerto Rico Commission for the Comprehensive Audit of the Public Credit issued a report in August 2016 covering a 2013 PREPA bond issuance.[8] The report's findings raise questions about the role of some of the most prominent companies in the public finance community. It identifies red flags regarding the role of J.P. Morgan, Morgan Stanley, Wells Fargo, Citigroup, Ernst and Young, Sidley Austin, Standard and Poors, Moody's, and Fitch.

The audit makes clear that Puerto Rico's financial distress was well known when these bonds were issued. It also says that representations made in the Official Statement to the market were materially flawed. The audit criticizes actions taken by PREPA officials and the Puerto Rico Government Development Bank,[9] and singles out PREPA's consulting engineer, URS. URS issued reports that certified PREPA's physical plant was in a state of good repair. This was plainly wrong. The Puerto Rico Energy Commission leveled the same criticism of URS.

The audit establishes culpability among a wide set of participants in the 2013 issuance. No other entity has conducted an independent assessment of any other bond issuance in the Commonwealth. While I am not an attorney, it is apparent to me that the bondholders and PREPA and perhaps some of the underwriting team have claims against other participants in the process. As a result, a series of long, expensive, complex court battles could ensue, and may result in a reduction of PREPA's bond indebtedness and considerable reputational harm to those involved.

On the other hand, the PROMESA board represents the kind of forum that can bring parties together, perhaps along with the Securities and Exchange Commission.[10] This leverage needs to be brought to bear in order to settle out the liabilities and reduce PREPA's outstanding indebtedness. There is precedent for underwriters, insurers and investors reducing or eliminating financial claims including bond indebtedness rather than facing litigation or protracted investigation.[11]

- **Bondholder Losses Need to Be Put in Proper Context**

Several kinds of bondholders own PREPA's debt. They all seek to maximize recovery from Puerto Rico. They are not all similarly situated and thus will experience the implications of any settlement differently.

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8 http://sptpr.net/wp-content/uploads/2016/10/Second-Interim-Pre-Audit-Report-on-2013-PREPA-debt-emission-con-anejos.pdf

9 For a discussion of how the Securities and Exchange Commission views the "reckless disregard" standard for public officials see: https://www.sec.gov/litigation/admin/3436761.txt

10 http://www.bondbuyer.com/news/washington-enforcement/white-sec-focused-on-possible-puerto-rico-bond-related-violations-1106175-1.html

11 http://blog.al.com/spotnews/2013/06/jefferson_county_reaches_deal_1.html and https://www.sec.gov/news/press/2009/2009-232.htm

First, Franklin, Oppenheimer and other large firms hold PREPA bonds.[12] Taken in the aggregate, these companies possess trillions of dollars in assets under management. Company portfolios are hedged against the global economy, which is expected to grow by 3.1% in 2017, according to the International Monetary Fund.[13] Puerto Rico's economy is expected to continue to contract in 2017 and then to grow very slowly thereafter. The strength of global markets and the companies that invest in them lies precisely in how they manage risk when one segment of the economy weakens. Puerto Rico's bond losses should be seen against this backdrop of economic activity and considered as a way to bring its economy back as a contributing component of the global economy.

Second, bond insurers play a significant role with PREPA and appear to be receiving special treatment. PREPA paid the insurers a premium over the years to provide financial security if ever the agency needed it. Yet, under the RSA, PREPA's insurers are not expected to make any bond and principal payments. Instead, they are providing some reserve guarantees for a short period and then will, presumably, reissue insurance for future issuances. PREPA receives no relief from principal and interest payments, which is of course a major reason for purchasing bond insurance.

Third, several hedge funds invested in PREPA, [14] purchasing bonds from other holders at a significant discount from the face value of the bonds. The hedge funds then collected interest payments according to the original terms of the bond. This means that a bond with an original face value of $100, purchased by a hedge fund at $50, now pays to the bondholder an effective interest rate twice the size of the note purchased. The settlement anticipated by the RSA also assumes a repayment ratio of 85% of face value of the bonds. This creates a considerable windfall on top of the outsize interest rate. The hedge funds took a risk and are due a return, but the combined interest payments and substantial gain on the RSA settlement constitutes undue enrichment.

Fourth, smaller investors, generally those who have purchased bonds in smaller denominations as part of personal savings or retirement plans, are exposed. A fair and equitable way can be devised to make these bondholders whole. These bondholders, who may have bought Puerto Rico's bonds as part of their loyalty to the Commonwealth, were misled and they do not usually have the resources to create sophisticated hedging programs.

If Puerto Rico's Economy Is to Recover, Bondholders Must Take a Loss and PREPA Must Be Fundamentally Reformed

The Puerto Rico Energy Commission's hearings into PREPA's finances and organizational capacity have documented how PREPA is a severely dysfunctional organization. The commission has made clear that it is pursuing a reform agenda. It is also clear that the type of bond reorganization that IEEFA is recommending will require a thorough organizational overhaul.

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[12] Kunkel, C., Sanzillo, T. and Schlissel, D. (2015), Opportunity for a New Direction for Puerto Rico's Electric System

[13] http://www.imf.org/en/Publications/WEO/Issues/2016/12/27/A-Shifting-Global-Economic-Landscape

[14] http://www.bondbuyer.com/news/regionalnews/prepa-forbearing-bondholders-reach-agreement-on-restructuring-1083637-1.html

It is worth noting that PREPA has made a number of decisions to pursue investment strategies that will prevent the Commonwealth and its citizens from benefiting from advances in solar and wind energy generation technologies. PREPA's capital investment plan devotes $2.2 billion in new investment in a garbage incinerator and two new natural gas facilities, with only a 5% set-aside for renewable energy. These priorities ignore current best practices in energy generation in favor of retaining fossil fuels and other highly polluting sources of electricity.

Several bondholders and their spokespersons have threatened retaliation against Puerto Rico in the bond markets if it pursues a strategy of steeply discounting its bonds.[15] These threats are disturbing. PREPA's financial condition suffers from overstated revenues, understated expenses, misleading debt service calculations, a flawed budget process that conceals looming deficits, questionable financial audits and statements, poor diligence attributed to almost every participant, and unreliable characterizations of PREPA's physical plant condition.

The fiscal plans for a reformed PREPA going forward, including substantial debt reduction, put the agency on a sound financial path. By necessity, PREPA's finances must contain realistic estimates of revenue and expenses; a transparent system of internal controls; budget and financial plan processes that are known, uniform and based on objective standards; timely financial reporting; internal accountability for meeting budget targets; improved oversight over capital expenditure; clear, affordable debt management practices; an oversight board to enforce fiscal discipline. Those offering punitive market outlooks send a peculiar message in which they asset in essence that they would rather invest in a profoundly flawed status quo than in forward-looking plans for realistic, steady progress. It is inconceivable that a reformed PREPA with a cleaned-up balance sheet and an enforceable program of fiscal discipline would be denied access to the capital markets. The experience of most control boards attests to this outcome. Detroit, for example, is an example of a government with renewed and robust market access after a period of turmoil.[16]

If members of the committee or staff have any questions I would be glad to assist.

Sincerely,

Tom Sanzillo
Director of Finance

CC: Members of the House Subcommittee on Indian, Insular and Alaska Native Affairs

[15] Robert Slavin, *Why Puerto Rico's Fiscal Plan Debt Allotment May be Negotiated*, Bond Buyer, March 14, 2017.
[16] http://www.bondbuyer.com/news/regionalnews/pricing-shows-strong-demand-for-detroit-bonds-1109646-1.html