



April 25, 2018

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201 South Biscayne  
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Miami, Florida, 33131

Dear PROMESA Investigator,

This letter from the Institute for Energy Economics and Financial Analysis (IEEFA) provides suggested topics of inquiry regarding the debt practices of Puerto Rico in response to your office's request for public input, which was included in the Independent Investigator's Second Interim Report to Puerto Rico's Federal Oversight and Management Board (FOMB) dated April 5, 2018.

The questions we raise are derived from our research over the past three years related to PREPA.<sup>1</sup> Significant portions of our research have been submitted to the Puerto Rico Energy Commission (PREC) as part of its deliberations on PREPA's Integrated Resource Plan, Securitization proposal and rate setting dockets. Some of the topics we raise about PREPA have general applicability to the Federal Oversight and Management Board (FOMB) and its establishment of uniform standards of debt management for the Commonwealth. We make specific recommendations where the data warrants and suggest areas of inquiry where we believe sufficient red flags exist.

While IEEFA encourages the look back identified in the report, we believe the mismanagement and recklessness have not ended.

We have divided this letter into seven sections:

- General Observation
- Unsuccessful Securitization Proposal for PREPA
- Executive Staff, GDB Relationships and Bond Issuances
- Role of the consulting engineer
- Financial Profile of Bondholders
- PREPA's fiscal processes
- PREPA's regulatory and third party oversight

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<sup>1</sup> <http://ieefa.org/category/geography-2/puerto-rico/>

## **I. General Observation**

The Investigator's Second Interim Report restates the purpose of the overall investigative effort:

"The Special Investigation Committee's principal goals for this Investigation are to identify any policies or absent safeguards that contributed to the Puerto Rico debt crisis, including factors that permitted the government and its instrumentalities to issue significant amounts of debt without adequate sources of repayment, so that Puerto Rico can regain access to the capital markets, and so that stakeholders can identify potential claims or matters for regulatory and legislative attention."

The first area of investigative inquiry appears to be devoted to a review and analysis of "policies or absent safeguards" that have led to the kind of materially false, misleading and reckless statements<sup>2</sup> made by the government and its advisors to induce bond investors to purchase Puerto Rico's securities when the Commonwealth did not have a reasonable basis for assuming that it could repay the debt. This backward look is to be used to construct reforms to instill market confidence necessary for Puerto Rico's re-entry into the capital markets.

The second purpose of the Investigation is to support the development of claims by stakeholders and/or regulatory and legislative action. Achieving those two important goals—restoring market access and providing stakeholders with a valid basis for claims—will require formal legal actions that must be supported by firm factual data and documentation. The language of the report raises questions about whether the Investigation will deliver what is needed.

Paragraph 12 of the report previews the Investigators anticipated "final report" and says the findings will include how a list of twelve issues "may have contributed to the fiscal crisis." That suggests a final report that is quite tentative in its outlook as it anticipates supplying information that may or may not have triggered the fiscal crisis. There is \$72 billion at risk for bondholders. Market access will not be enhanced by a report that evades providing answers to tough questions.

What further undermines confidence in this Investigative effort is its failure to state if and how the data collection and analysis will be used for any actions or referrals by the Board or the General Counsel. There is no discussion about the Investigator's expectation that it will offer remedial actions related to its findings that may include referrals to securities regulators and/or prosecutors.

## **II. Unsuccessful Securitization at PREPA**

In February 2016, the Puerto Rico legislature and Governor passed Article 20<sup>3</sup> of the Laws of Puerto Rico to facilitate a bond transaction that would refinance PREPA's indebtedness.<sup>4</sup> The bill reflected a negotiated agreement between PREPA, bondholders and insurance companies. The agreement: bondholders would accept a 15% reduction

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<sup>2</sup> We have tried in this letter to adhere to the working definitions of false, misleading and reckless contained in the SEC's report on the findings of Orange County, California debt crisis in the 1990's, see:

<https://www.sec.gov/litigation/admin/3436761.txt>

<sup>3</sup> <http://www.oslpr.org/download/en/2016/A-004-2016.pdf>

<sup>4</sup> For a full description of the law and subsequent regulatory proceedings that flowed from Article 20 see: <http://energia.pr.gov/en/transition-charge/>

on the face value of approximately \$8 billion in existing bonds. In return, the bondholders would benefit from a new rate design that established a secured, dedicated revenue stream to repay the debt. The revenue would be a separate and discrete charge added to the monthly bills of Puerto Rico's electricity consumers. Pursuant to the statutorily limited oversight conducted by PREC as outlined in Article 20, the transition charge was approved.<sup>5</sup> Subsequently, the transition charge was submitted to the FOMB and rejected because of the negative impact of the deal on electricity rates.

At the time of the FOMB rejection, the bonds were valued at 53 cents on the dollar or a discount of 47% from the face value of the original debt.<sup>6</sup> During the negotiating period that ended in December 2015 with the announcement of the agreement between PREPA and its creditors, Puerto Rico bonds were selling with 30% to 40% discounts.<sup>7</sup>

These facts raise a number of questions. Upon what basis did the team of advisors to PREPA determine that repayment of 85% of PREPA's debt was affordable, sustainable or reflected the market price of the bonds, which were selling at discounts as much as 47%? What were the motivations of those who caused the PREPA Board, Governor and Legislature to pursue a new debt arrangement that was plainly unsustainable and contrary to the goal of establishing affordable and competitive electricity rates? Was this proposal that heavily favored the bondholders developed to establish a broader set of policies and practices for recovery rates across the Commonwealth's debt portfolio?

**Fees for the Team of Advisors:** In the process of developing the agreement with the creditors, PREPA hired Alix Partners, a New York based investment advisory firm as the lead negotiator. The company spearheaded the negotiations with the creditors, the Puerto Rico legislature, Puerto Rico's regulators and the press. Before the company resigned in February 2017, it was paid \$45 million.<sup>8</sup> An additional \$41 million in fees to attorneys and financial advisors was identified by PREC in its restructuring order (this list was not a comprehensive summary of all expenses). The PREC Restructuring Order questioned the amount of the fees, consultant selection, administrative structure for paying the fees and conflicts of interest regarding fee approvals. The Commission concluded that further investigation was warranted.<sup>9</sup>

How did Puerto Rico pay upward of \$100 million in fees for a debt deal that was based on misleading assumptions about the electricity system and economy?

IEEFA's view is that the fee payments for PREPA's debt issuances--including the names of the vendors, services provided and amounts paid--should be compiled going back several years. The internal control process for the review of financial services contracts, invoices and final payments on these contracts should be reviewed.

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<sup>5</sup> <http://energia.pr.gov/en/dockets/?docket=cepr-ap-2016-0001> , Restructuring Order, June 21, 2016.

<sup>6</sup> <https://www.bloomberg.com/news/articles/2017-06-28/puerto-rico-board-rejects-power-utility-debt-restructuring>

<sup>7</sup> UBS, Municipal Brief, April 18, 2017, see pages 5 and 7.

<sup>8</sup> <https://www.elnuevodia.com/english/english/nota/thedepartureofalixpartnersisnear-2287053/>

<sup>9</sup> <http://energia.pr.gov/en/dockets/?docket=cepr-ap-2016-0001> , Restructuring Order, paragraphs 257-274.

This issue has general applicability for all Commonwealth debt as one potential set of claims by bondholders could be against the underwriting teams and, to substantiate a claim, detailed accurate information is required from an independent third party such as the Investigator.

**Alix Partners Selection:** It was never made clear how Alix Partners was selected to be the lead negotiator for PREPA. According to published reports, the company's agreement was extended six times. A more complete review of the selection is warranted by the facts available, as is an assessment of the six extensions. What was the role of specific bondholders in the appointment of Alix Partners? Who are Alix Partners clients?<sup>10</sup> Did the company add any customers to its customer base during the term of Alix Partners contract with Puerto Rico? Did the company receive any support from any bondholders related to its placement as an advisor to the Puerto Rico government or for any of the contract extensions?

As Chief Restructuring Officer, did Alix Partners agree to an analytical scope of work that avoided questions related to past mismanagement, which would result in recommendations based on a faulty diligence review?<sup>11</sup> Did the company adopt and use financial assumptions in the Securitization docket and related representations before PREC that the company would not use for other clients?<sup>12</sup>

**Treatment of Bond Insurers:** On many of PREPA's bond issuances, the authority purchased bond insurance. PREPA paid bond insurance premiums to secure coverage for bondholders in the event of default or interruption of payments. According to published reports, PREPA's bond insurers hold about \$2 billion in exposure to PREPA debt.<sup>13</sup>

But instead of using the bond insurers to lower costs for PREPA and the ratepayers, the Securitization Plan was designed to forestall a formal default by PREPA on its bond obligations, even though the Authority was unable to make the necessary payments, which would have triggered the bond insurance. The Plan even included taking loans from the bond insurers so PREPA could maintain liquidity and firm up its ability to meet its debt obligations. This protected the insurers from having to make principle and interest payments that would occur in the event of further fiscal distress or a bankruptcy filing. But since the bond insurers were lending the money to PREPA, it also increased the authority's already overwhelming debt burden.

This questionable measure turned out to provide only a temporary delay. The combination of the hurricanes<sup>14</sup> and already existing risk exposure has now resulted in payments being

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<sup>10</sup> The company website does not offer a comprehensive list of its client base. <https://www.alixpartners.com/>

<sup>11</sup> <http://ieefa.org/wp-content/uploads/2017/12/PREPA-Debt-Restructuring-Deal-Wont-Restore-Agency-to-Financial-Health-August-2016.pdf>, See page 10.

<sup>12</sup> See the discussion on the misleading representations regarding fuel costs submitted to PREC by PREPA and Alix Partners: <http://ieefa.org/ieefa-puerto-rico-electric-company-off-mark-house-outlook-spending-twice-much-fuel-projected/>

<sup>13</sup> <https://ihsmarkit.com/research-analysis/12102017-Municipal-Market-Puerto-Rico-bonds-and-bond-insurer-CDS-come-under-pressure-post-Maria.html>

<sup>14</sup> <https://ihsmarkit.com/research-analysis/12102017-Municipal-Market-Puerto-Rico-bonds-and-bond-insurer-CDS-come-under-pressure-post-Maria.html>

made by the insurers. Despite public criticisms made by the insurers<sup>15</sup> regarding the direction of the Commonwealth's budget negotiations, Assured Guaranty continues to tell investors and the market that it is capable of handling the principal and interest exposure.<sup>16</sup>

Who made the decision that the best interest of Puerto Rico was served by foregoing its legal right to use its bond insurance policies as part of the securitization plan to lower costs for PREPA and Puerto Rico's ratepayers? Why did the advisors on the original deal fail to simply reduce PREPA's long-term indebtedness by \$2 billion and require the insurers to take on the principal and interest payments as they now appear to be doing? If PREPA's financial disclosures to the insurers were defective, why are the insurers paying bondholders under the tainted policies?

### **III. Executive Staff and GDB Relationship**

The report characterizes the current investigation process as voluntary. Various stakeholders and Commonwealth public agencies are cooperating with the investigation reducing the need for subpoenas.

Given the significant amount of money in bond issuances over the past decade, the Puerto Rico government and its executives and the leadership at the Government Development Bank of Puerto Rico (GDB) (the prime issuer of debt for PREPA) should be investigated as potential recipients of improper payments from a host of stakeholders that are identified generally in the Investigator's report.

Is the investigation looking into the personal bank accounts of key high-level staff? Is there any investigation into the potential for inappropriate individual gain from revolving door deal making related to members of the GDB Board (or the elected leaders who appointed them), underwriting participants or issuing entities that gained from diligence or transaction related contract revenues?

A similar set of questions needs to be asked regarding FOMB Board members who were or are now serving on the FOMB Board, and who have other relationships with banks and other financial institutions with an interest in the outcome of Puerto Rico's fiscal crisis.

Did the fee structures and remuneration to transaction stakeholders drive these unsustainable bond issuances separate and apart from the financial merits of the official offering?

### **IV. Consulting Engineers**

According to the Puerto Rico Energy Commission, PREPA's Consulting Engineers URS<sup>17</sup> failed to call attention to the fact that the Authority was underfunded and continued to declare that the physical system was in a state of good repair. The Commission said URS was wrong going back perhaps as long as a decade. And, in 2013, URS' attestation to PREPA's fiscal solvency and state of good repair was particularly egregious. An audit

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<sup>15</sup> <http://assuredguaranty.newshq.businesswire.com/press-release/assured-guaranty-comments-governors-announcement-regarding-prepa>

<sup>16</sup> <https://assuredguaranty.com/ag-protects-insured-bondholders-from-pr-defaults-no-action-required-of-assu>

<sup>17</sup> [http://energia.pr.gov/numero\\_orden/cepr-ap-2015-0001](http://energia.pr.gov/numero_orden/cepr-ap-2015-0001), Final Resolution and Order, January 10, 2017, paragraphs 12-15

performed by the Puerto Rico Commission on the Audit of the Debt<sup>18</sup> had similar conclusions.

In 2017, URS was awarded a FEMA contract for \$122 million to perform post hurricane services in Puerto Rico.<sup>19</sup> Did PREPA officials or any representative of the Puerto Rico government bring to FEMA's attention the issues related to URS' unacceptable performance as PREPA's consulting engineer? Has FEMA been questioned regarding its award of this contract? What is URS' current status regarding its role as PREPA's consulting engineer?

## **V. Profile of PREPA Bondholders**

The report identifies a series of stakeholders who are being talked with regarding the debt practices of Puerto Rico. The report does not directly state that investigators are similarly engaged with the myriad of bondholders. Puerto Rico's bonds are held by a group of bondholders with a diverse set of interests. Large-scale bond houses like Oppenheimer and Franklin have one or more sets of interests. Hedge funds that bought distressed debt long after the initial issuances will have another set of interests. Small on Island bondholders who purchased bonds to support the local economy will have another set of interests and motivations.

If the purpose of this exercise is, in part, to provide information that may be useful in the initiation of claims, then the largest stakeholder, the bondholders, should be included in the scope of the investigation. A well-documented profile of bondholders prepared by this Investigation would provide an important public service. Such a report should identify the current bondholders, when they purchased the bonds, how much they purchased the bonds for, what is the stated interest rate and what has been the actual collected interest rate by type of investor, how big are the holdings and, where available, the size of assets under management by parent corporations. Paragraph 10(xi) of the Second Interim Report suggests there may be some investigation of the selling practices, presumably by the underwriting team and PREPA officials.

## **VI. PREPA's Fiscal Processes**

Paragraph 10(i) of the report speaks to "legislative, political and regulatory frameworks" as a potential contributing cause to Puerto Rico's fiscal crisis. Another area is the Commonwealth's actual fiscal policies and practices. The in-depth review of PREPA conducted by PREC exposed fiscal policies that were extraordinary, perhaps even reckless. The review found poor controls over revenues, fuel and other expenses, contract monitoring, capital expenditures and labor costs.<sup>20</sup> One example will suffice.<sup>21</sup> PREPA under budgeted for fuel by \$461 million in its original submission for a rate increase to the public service commission. The discovery of the under budgeting by Commission

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<sup>18</sup> <http://sptpr.net/wp-content/uploads/2016/10/Second-Interim-Pre-Audit-Report-on-2013-PREPA-debt-emission-con-anejos.pdf>

<sup>19</sup> [http://www.pogo.org/blog/2017/10/harvey-irma-and-maria-hurricane-recovery-contract-spending-by-the-numbers.html?utm\\_content=buffercccd1&utm\\_medium=social&utm\\_source=twitter.com&utm\\_campaign=buffer](http://www.pogo.org/blog/2017/10/harvey-irma-and-maria-hurricane-recovery-contract-spending-by-the-numbers.html?utm_content=buffercccd1&utm_medium=social&utm_source=twitter.com&utm_campaign=buffer)

<sup>20</sup> <http://energia.pr.gov/wp-content/uploads/2016/11/Expert-Report-Revenue-Requirements-Fisher-and-Horowitz-Revised-20161123.pdf>, pps. 186-204.

<sup>21</sup> <http://energia.pr.gov/wp-content/uploads/2016/11/Expert-Report-Revenue-Requirements-Fisher-and-Horowitz-Revised-20161123.pdf>

examiners resulted in shifts of capital expenditures away from PREPA's physical plant and into the fuel budget, placing upward pressure on an already over stressed electricity rate and depriving the physical plant of needed repairs.

Such a significant failure in budgeting would normally cause significant mid-year budget adjustments and, in the past, demands for borrowings to cover operational expenses. The lack of any analytical investigatory oversight of PREPA's budget means that any reforms in legislation, political or regulatory frameworks must include fundamental reforms of PREPA's budget discipline.

Additionally, the Energy Commission's detailed review of PREPA's capital budgets and expenditures raises questions about whether PREPA bond proceeds were spent for the purposes described in bond issuances. Red flags raised by the Energy Commission in the 2016 rate case include:

- Politically-driven cuts to capital expenditures in order to avoid raising rates and maintain adequate cash flow.<sup>22</sup>
- Inappropriate prioritization of capital expenditures: "We were told by PREPA that the practice, with some exceptions, has been to allocate to each department the lower of that department's historic [capital] budget or its prior year's actual spending. This approach assumes, incorrectly, that the weighting of priorities among departments does not change. It also encourages each department to spend its budget fully to avoid a reduction in the next year. Neither result substitutes for an annual rethinking of priorities, performed rigorously."<sup>23</sup>
- Lack of transparency with respect to capital expenditures. The Commission's consultants found that PREPA was often "unable to provide basic explanations, work-plans, or other due diligence documentation" for specific projects.<sup>24</sup>

## **VII. Regulatory and Third Party Oversight**

Although the report lists a number of key stakeholders involved with Puerto Rico's financial status as it concerns PREPA, the Investigation does not appear to rely upon the voluminous reporting prepared by PREC experts. The record of its orders and findings is a road map to the kind of fundamental dysfunction that plagues one of the most important governmental agencies in the Commonwealth structure. Is the Investigative team using the documents prepared by PREC? Are they interviewing PREC staff and consultants?

Similarly there has been announcement of an SEC investigation into PREPA that is ongoing despite the agency's recent decision to end its investigation of Puerto Rico's general obligation bonds.<sup>25</sup> Have the Investigators been briefed by staff and representatives of the SEC on both investigations?

During the height of the scandal related to the Whitefish contract, Governor Rosselló announced he had appointed the Comptroller of Puerto Rico to investigate the

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<sup>22</sup> Puerto Rico Energy Commission case no. CEPR-AP-2015-0001, Final Resolution and Order, January 10, 2017, paragraph 168.

<sup>23</sup> Puerto Rico Energy Commission case no. CEPR-AP-2015-0001, Final Resolution and Order, January 10, 2017, paragraph 170.

<sup>24</sup> <http://energia.pr.gov/wp-content/uploads/2016/11/Expert-Report-Revenue-Requirements-Fisher-and-Horowitz-Revised-20161123.pdf>, page 81.

<sup>25</sup> <https://www.bondbuyer.com/news/sec-drops-investigation-into-2014-puerto-rico-go-bond>

circumstances surrounding the award of the contract.<sup>26</sup> In addition, published reports stated that the United States Federal Bureau of Investigation has opened an inquiry of the matter.<sup>27</sup> Neither organization has reported back to the public directly or indirectly regarding the results of their now six-month investigation. The report makes no mention of whether the Investigative team has been in communication with either oversight entity.

We thank you for your effort on this matter and are available to answer any questions that might arise from this letter.

Sincerely,

A handwritten signature in cursive script that reads "Tom Sanzillo".

Tom Sanzillo  
Director of Finance, IEEFA

cc: Ana J. Matosantos, David A. Skeel, and Judge Arthur J. Gonzalez (Ret.), Members,  
Special Investigations Committee of the Oversight Board

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<sup>26</sup> <http://abcnews.go.com/US/puerto-ricos-governor-whitefish-power-agreement/story?id=50795922>

<sup>27</sup> <http://fortune.com/2017/10/30/puerto-rico-cancels-whitefish-fbi-investigate/>