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The recent status report on the mediation of the Puerto Rico Electric Power Authority (PREPA) plan of adjustment creates the opportunity for a permanent financial plan for PREPA and the electricity grid. As outlined, however, the mediation and underlying assumptions strongly suggest this new arrangement will fail.

I write to suggest a series of complementary actions that could bring about a restructuring agreement that 1) is consistent with the underlying economic prospects for Puerto Rico's economy, 2) can gain institutional support from the Legislature and Governor, and 3) can be integrated successfully into the rate structure regulated by the Puerto Rico Energy Bureau (PREB) and the budget process overseen by the Financial Oversight and Management Board (FOMB).

Institutional and Financial Gaps in the Mediation Plan Design

The mediation plan includes a set of stakeholders who represent the principal financial interests supporting PREPA and the electric grid.[1] This same group has proposed two failed restructuring support agreements (RSAs). The deliberation processes have been extraordinarily lucrative for the army of financial service providers enlisted to represent the interests of many of the stakeholders, but it has not produced a meaningful exit strategy.

The two rejected proposals reflect a failure on the part of the bondholders to acknowledge that Puerto Rico's economic growth is negative now, has been for the better part of a decade, and is likely to continue to be so for the foreseeable future. Even with significant federal outlays, the economy shows signs of a very fragile future. In a no-growth environment, the conflict is stark: Pay off the legacy debt or use the value created by existing businesses to invest in economic growth. There is no room to do both. Rate increases to cover legacy debt consign future business profits and wage growth to repay expenditures made as long as 20 years ago. Future wage and profit growth will be precious and will need to be used to rebuild Puerto Rico.

This problem could be mitigated with the inclusion of the Legislature and the PREB in the process.[2] The Legislature's political mandate for the public interest was an important reason that the most recent flawed deal was cancelled. The PREB has an institutional mandate to set rates consistent with the service needs and economic conditions of Puerto Rico.

There is another group however that needs to be included in this process. I will refer to them as the "financial services" group. The core of the group are the underwriting teams that supported PREPA's bond issuances and includes certain legal, engineering and accounting firms. The names of the underwriting teams can be found on the face page of PREPA's official statement.

In a mediation process and for the good of Puerto Rico, the kind of settlement proposed here does not require formal findings of culpability. Is not the current financial status of PREPA and the two flawed and failed RSAs to date their own form of *prima facie* evidence of ongoing financial service company culpability? In 2018, the FOMB hired Kobre and Kim to investigate bond issuances in the Commonwealth, including PREPA. The report raised numerous red flags with regard to poor performance by the "financial services" group. Very little has been done to address the issues identified in that report. Along the same lines, when the Puerto Rico Energy Commission took a contemporary look at the issue of the selection and payment of financial services providers in 2016, it also found significant deficiencies.[3]

[1] Puerto Rico Fiscal Agency and Financial Authority (AAFAF), Puerto Rico Electric Power Authority (PREPA), Financial Oversight and Management Board (FOMB), the Ad Hoc Group of PREPA Bondholders, National Public Finance Guarantee Corp. (National), Assured Guaranty Corp. and Assured Guaranty Municipal Corp. (together, Assured), Syncora Guarantee, Inc. (Syncora), La Union de Trabajadores de La Industria Electrica y Riego (UTIER), PREPA's retirement system (SREAEE), the Official Committee of Unsecured Creditors, and PREPA's fuel line lenders.
[2] PREB's authority to approve the RSA was limited. It restricted the Puerto Rico Energy Commission (PREB's predecessor) from ruling on the reasonableness of the rate increase. For a full discussion see: IEEFA. PREPA Debt Restructuring Deal Won't Restore Agency to Financial Health. August 2016.
[3] *Ibid.*

To understand how the abuses occurred and what remedies were available, the Kobre and Kim report identified 100 pages worth of causes of action that could be initiated. For example, insurance companies might have a cause of action against any of the underwriters for providing false or misleading information that induced them to issue insurance protection. If insurance companies can offset their costs in this manner, then there should be no reason why they do not pay out 100% of the coverage to PREPA under existing insurance policies.

In prior publications, IEEFA has identified the value of these investment houses and financial services providers as cumulatively being in the trillions. They can both absorb losses and be available to provide cash where needed to bring this matter to closure.

Many of the financial services companies are also bondholders, but it is not in that role where they have had the greatest impact. The fees paid to these investment houses as financial advisors is in the hundreds of millions. Their financial advice over decades made a significant contribution to PREPA's downward spiral and bankruptcy.

They should be brought into the mediation process because they were financial advisors who consistently pursued dubious strategies. Some may have even broken the law. In total, Puerto Rico is due recompense.

Setting aside the issue of fairness, we need to look at the issue from a strictly financial perspective. The companies that provided the underwriting for PREPA's 2013 bond issuance, for example, have cumulatively $12 trillion in assets under management. PREPA has assets of $8 billion, but liabilities that create a net negative position of $6.6 billion. It is absurd to assume that either PREPA can pay back the debt or that the financial service providers cannot absorb a loss of most of the $8 billion in Puerto Rico.

From a global market perspective, the efficient course of action is to cancel PREPA's debt, enforce strict fiscal accountability going forward and encourage economic growth strategies. With debt extinguished and a reasonable recovery plan in place, investors (including former bondholders) can put their money in a going concern with the potential for ongoing profitability. The stronger parts of the economy effectively support the weaker parts so that the potential for growth is enhanced across the board. Puerto Rico can then join the stronger growth component of global financial markets and contribute to the resolution of other areas with weaknesses, like Sri Lanka.[4]

Historically, bond markets have responded to unique operating environments with flexibility. In some instances, that has meant accepting recovery rates that are below historical norms. For example, the complex role played by JPMorgan Chase in Jefferson County, Alabama, resulted in a settlement with a lower recovery rate for the company than other bondholders in the context of a settlement with low overall recovery rates.[5] In other distressed situations,

[4] The Week. Sri Lanka on the brink of bankruptcy after worst economic crisis in history. March 24, 2022.
[5] Moody's. Jefferson County, Alabama's Debt Offering has Non-Investment Grade Characteristics, Credit Focus. November 13, 2013. Also see: Moody's. How Moody's Calculates 55%-60% Proposed Recovery Rate for Jefferson

recovery rates have been below historical norms, reflecting the type of instrument, underlying credit pledges and other defining characteristics of the financial profile. The settlement ranges vary from 1% to 50% in such situations.[6]

One of the unique conditions involved in Puerto Rico is the economy. The median household income of the United States was $64,944 in 2020. Mississippi recorded a median income of $46,511,[7] the lowest median income of any state.[8] The Commonwealth of Puerto Rico had a median income in 2020 of $21,058, less than one-half of the poorest state.

The Rationale for a Zero Recovery on Uninsured Bonds

The cornerstone of this proposal is to provide compensation to the bondholders that is consistent with market forces. This would result in bondholders receiving zero recovery on any uninsured bonds. In this type of settlement, bondholders are able to pursue their interests but do so without having catastrophic effects on electricity rates in Puerto Rico.

The rationale for a zero recovery for the bondholders flows from the following:

1. The 20 cents per kilowatt-hour (kWh) goal set by the Legislature and the FOMB would be effectively abandoned if legacy debt is included in the rate structure.
2. Macroeconomic conditions are weak and the population is expected to continue to decline. No debt service can be imposed when the repayment of the debt outpaces the growth rate of the Commonwealth's economy.
3. Urgently needed increases in renewable energy are unlikely to take place, compromising the grid system's affordability and resilience, as well as PREPA's budget stability.
4. PREPA/LUMA have not demonstrated a consistent ability to achieve planned operational savings since the appointment of the FOMB.
5. The current mediation structure is not a path to market access.

1. The 20 cents per kWh goal set by the Legislature and the FOMB would be effectively abandoned if legacy debt is included in the rate structure.

PREPA's most recent certified fiscal plan tells us that even if we assume the successful implementation of the current fiscal plan, it is difficult to achieve the 20 cents per kwh rate established by the Legislature.[9] As the fiscal plan demonstrates (Table 1) it is impossible to achieve the 20-cent goal with unrestructured debt included in the rate. (I also note that current rates in Puerto Rico are far above what was projected in this plan, without any

County Sewer Warrants. August 27, 2013. Also see: Moody's. Jefferson County Demands More Concessions from Creditors, Special Comment. October 21, 2013. (Proprietary)

[6] Moody's. Detroit: How Moody's Calculates 25% overall recovery rate. September 2015. Also see: Moody's. Stockton CA: Pensions prevail over Debt in Franklin Templeton's Appeal of Stockton's Bankruptcy Plan. September 15, 2015. (Proprietary)

[7] For median income levels see: U.S. Census Bureau. Quick Facts.

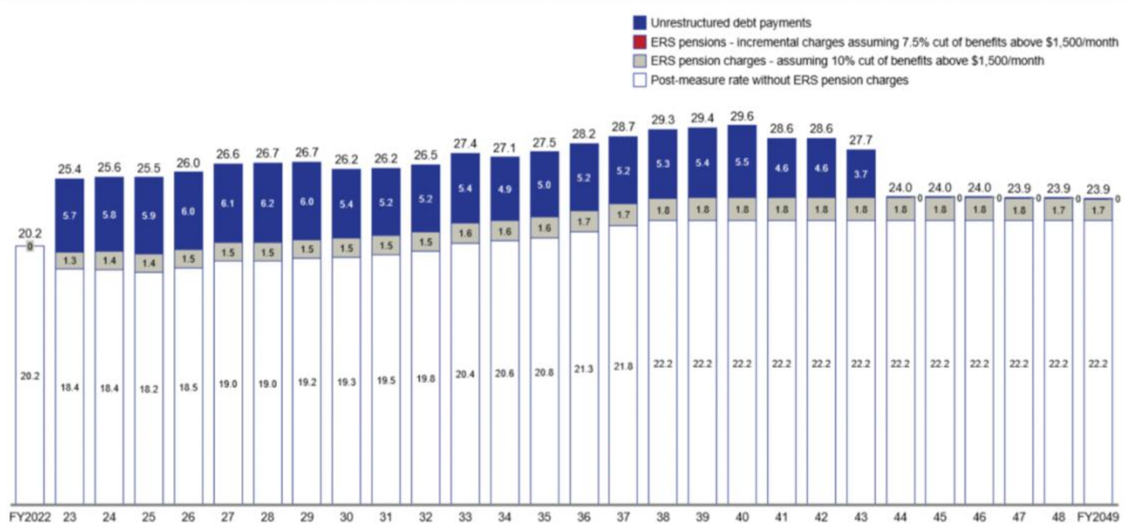
[8] St. Louis Federal Reserve. Real Median Income.

[9] The term 'post measure' is described: PREPA. 2021 Fiscal Plan for the Puerto Rico Electric Power Authority. May 27, 2021, p. 94. (Fiscal Plan)

inclusion of debt service). Two restructuring proposals have been made and both have been rejected. To date, bankruptcy negotiations have not found a level of debt that can be supported by the economy and ratepayers of Puerto Rico.

Table 1: Certified Financial Plan Rate Projections Under a Post-measure, Unrestructured Debt Scenario[10]

EXHIBIT 70: POST-MEASURE RATE WITH UNRESTRUCTURED DEBT ADDED (IN REAL 2021 C/KWH)



The 20 cents per kwh goal is not an ill-considered construct. It sends a signal that businesses can plan their budgets with certainty and the electricity price and future increases will be within manageable levels. Practically speaking, the benchmark allows businesses to look at new investment with far more confidence than a rate that is approaching or above 30 cents per kwh. Does a business invest its profits back into Puerto Rico or must it plan to set aside an unknown portion of future profits to pay an unknown but rising electricity bill? Residential users must make the same decisions with regard to their wages and the all-important decision of living in Puerto Rico or somewhere else.

A forward-looking analysis that conscientiously considers the economy, operational capabilities, political agendas, use of federal funds and commodity market volatility with a sober eye toward the ability to pay debt service would conclude that the imposition of any legacy debt is prohibitive. There must be sufficient space within the rate to consider the very real likelihood that investments beyond the current levels anticipated may be necessary for the transformation and ongoing maintenance of the system.

[10] Fiscal Plan, *op. cit.*, p. 170.

2. **Macroeconomic conditions are weak and the population is expected to continue to decline. No debt service can be imposed when the repayment of the debt outpaces the growth rate of the Commonwealth's economy.**

As part of the deliberation process for the most recent restructuring agreement, David Brownstein, Managing Director, Citigroup filed his assessment of the RSA to the bankruptcy court. In that assessment, he said:

> "First, any recovery by PREPA's creditors had to be secondary to the Commonwealth's overall economic recovery, for which the recovery of PREPA plays an important role. That meant any agreed repayment of legacy debt could not outpace revitalization of the island's overall economy, and in particular the ability of PREPA's customers to pay any increased rates or additional charges required to service restructured PREPA debt."[11]

Mr. Brownstein's filing then proceeded to outline the transition rate increase. The transition rate for the second proposal supported a debt service recovery rate that ranged between 67.5% and 77.5%, depending on of the tranche of debt.[12] Mr. Brownstein then identifies the transition charge, a graduated rate increase implemented over a 47-year period from 2.768 cents per kwh in the first year and increasing to 4.55 cents in year 24. The increase would stay in the rate for the duration of the bonds.[13]

In July 2019, the date of the Brownstein filing, the rate paid by PREPA customers was 21.8 cents per kwh.[14] The RSA would have phased in the rate increase over 24 years. The average rate of increase in the transition charge over that period was 2.3%, according to IEEFA's calculations. The 2019 fiscal plan showed annual nominal GDP growth for the next 24 years at less than 1.5% and the 2021 fiscal plan shows it at less than 1.3%.[15]

The RSA proved completely unsustainable, according to the Brownstein principles. With flat or negative growth, the rates in Puerto Rico cannot carry debt service—*any debt service.*

3. **Urgently needed increases in renewable energy are unlikely to take place, compromising the grid system's affordability and resilience and PREPA's budget stability.**

The most recent certified fiscal plan for PREPA is unequivocal. For PREPA to achieve budget balance, it must invest heavily in renewable energy.[16] The fuel costs for PREPA annually are directly related to the volatile price of oil and gas. The system is unsustainable. After five years

[11] United States District Court for the District of Puerto Rico, Declaration of David Brownstein In support of Joint Motion of Puerto Rico Electric Power Authority and AAFAR Pursuant to Bankruptcy Code Sections 362, 202,922 and 928 and Bankruptcy Rules 30212(A(1) and 9019 for Order approving Settlements embodied in the, Case No. 17 BK 4780-LTS, July 2, 2019, p. para. 25, p. 9. ("Brownstein")
[12] Brownstein, *op. cit.*, p. 13-17.
[13] Brownstein, *op. cit.*, p. 17.
[14] PREPA. Monthly Report. July 2019, p. 24.
[15] Fiscal Plan, *op. cit.*, p. 61.
[16] Fiscal Plan, *op. cit.*, pp. 17, 21-22, 44, 68, 81,93, 94, 97.

under a control board, PREPA has failed to find a manageable system to control fuel costs. In December 2021, the FOMB required PREPA to provide a plan that would achieve this goal. Reforms of the fuel procurement process have been impervious to charges of corruption, a Senate investigation, and regulatory oversight of the PREB and its predecessor, the Puerto Rico Energy Commission (PREC).

Equally clear is a pattern of resistance by what appears to be PREPA management's opposition to renewable energy.[17] The recent certified plan documents how the regulator-approved integrated resource plan (IRP) that calls for more renewable energy has been resisted by PREPA's management, requiring additional special orders by the PREB to be filed. Similarly, a federally required infrastructure plan that is to guide the $14.4 billion when filed by PREPA was inconsistent with the statutory and regulatory goals related to renewable energy.

Despite the fact that LUMA has been brought on board as the new manager and purportedly supporting the goals of the modified IRP and the goals for the federal plan, the recent certified budget contains a scant half-page description of LUMA's planned activities with regard to renewable energy.[18]

4. **PREPA/LUMA have not demonstrated a consistent ability to achieve planned operational savings since the appointment of the Financial Oversight and Management Board.**

FY 2021 closed posting $2.9 billion in total consolidated revenue and an enterprise-wide spend of $3.3 billion.[19] The most recent cash flow statement through April 8, 2022, is posting a 13-week deficit of $141 million.

The Authority remains crippled by volatility in oil and gas prices.[20] The Authority is now looking for another revenue enhancement to make up for the rising price of oil and gas. Last year's budget imbalances were in large measure also tied to volatile fossil fuel prices.

These budgetary realities should be a five-alarm warning. These facts are evidence that after five years under a control board, PREPA has not made sufficient progress on the reform of its operations. Budget plans going forward assume the successful completion of an array of savings initiatives. LUMA must make these reforms work, but the record is clear that the chances of success are slim.[21]

PREPA's bankruptcy was partly driven by the discovery of a pattern of misleading revenue and expense presentations. Although it appears that some progress has been made on the revenue estimation side, the continued reliance on future savings in the face of the last five years is not credible.

[17] Fiscal Plan, *op. cit.*, pp. 115-121.
[18] Fiscal Plan, *op. cit.*, pp. 159-160.
[19] AAFAF. Budget to Actuals Quarterly. September 2021, p. 2, 4.
[20] Bond Buyer. PREPA seeks rate increases amid restructuring negotiations. March 23, 2022.
[21] Payments to LUMA in FY 2021 exceeded budgeted amounts by 34%. See: AAFAF, *op. cit.*, p. 4.

5. The current mediation structure is not a path to market access.

A critical goal of PROMESA is to re-establish market access for PREPA. The proposed restructuring agreements thus far would have created serious impairments to market access. Recent statements regarding the parameters of this new round of mediation suggest that the lessons from those failures are not being applied to the next phase of negotiations.

The standards used by Moody's to rate public utility bonds, for example, are forward-looking.[22] The standards look to the status of the assets in the system. PREPA's assets are in poor condition. This requires capital planning to be carried out according to professional best practices. The ongoing disputes between PREPA and the regulator over renewable energy strongly suggests that existing capital plans will not be followed. The failure to institute any kind of special oversight that might provide support for new planning and new expenditures has been soundly rejected by the constant refusal of PREPA and the FOMB to entertain the use of third-party independent oversight.[23]

Puerto Rico's economy is weak and Moody's looks at the ability of the surrounding economic environment to support the rate base. The introduction of $14.4 billion in federal funds unencumbered by commensurate debt service increases is a substantial credit enhancement. The adoption of a legacy debt charge eviscerates the positive credit benefits by attempting to divert substantial revenue for the next 47 years to past liabilities.[24]

The recent decision to not seek legislative support for the next debt deal means that the rates and underlying governance structure that are put in place do not have the buy-in of the political leadership of Puerto Rico.[25] The likelihood of future support from the Legislature is plainly at risk when problems arise.

There are also several idiosyncratic factors that are troublesome. LUMA is working with what is effectively a fee-for-service contract. It has no equity participation in the PREPA transformation plan. It is also plain that LUMA is not a company with substantial cash or credit reserves.[26] The company will have to bring in additional professional support to maintain proper project management discipline.

Broad macro-economic indicators—population decline and flat or negative economic growth—are stark. They do not support the imposition of a rate increase to pay legacy debt service. The apparatus to deliver much-needed reforms in capital planning and operations is weak. Prior restructuring agreements failed, but it is uncertain that the lessons from those

[22] Moody's. U.S. Municipal Utility Revenue Debt. October 2017. (Proprietary). It is unclear what methodology Moody's might use if it were called upon to issue a credit opinion. Various aspects of past RSA proposals suggested the use of a special vehicle. With recent statements by the FOMB suggesting there will be no need for legislation going forward, it may have taken the special vehicle concept off the table.
[23] IEEFA. Letter to Legislative Assembly. December 2020.
[24] IEEFA. PREPA debt plan—new gimmick uses federal money to pay off old electric authority debt. March 7, 2022.
[25] FOMB. Letter to Puerto Rico Senate and House of Representatives. March 14, 2022.
[26] IEEFA. Contract with LUMA Energy Sets Up Full Privatization, Higher Rates. October 2020.

failures are being appropriately applied to create a path for PREPA from bankruptcy to market access.

A Plan That Can Work

The plan explained below accounts for the major liabilities facing PREPA and suggests a course of action that has one purpose: To provide PREPA with a budget outlook that is realistic and feasible in both the short and long-term.

Table 2: Liabilities ($ billions)

Liabilities	Amount	Estimated Settlement
Outstanding Bond Indebtedness	8.0	2.30
Fuel and Unsecured Creditors	0.7	0.35
Pensions	3.0	3.00
Subtotal	11.7+	5.65
Pool for Small Investors	1.0	1.00
Total	12.7+	6.65

The liabilities recently categorized in the report to the court on mediation identify what it would take to set PREPA on sound financial footing. The $1 billion IEEFA has inserted into the equation is to ensure that small investors who are residents of Puerto Rico receive 100% of the face value of their bonds.

The liabilities need to be analyzed with regard to a proper recovery rate. For the purposes of this example, the outstanding bondholders would receive 0% recovery rate (only that recovered through insurance), fuel line providers 50%, and unsecured creditors nothing. The resources from the plan should support the pensions and small investors at full face value. Priority to the pension fund is given consistent with the trust agreement. A small investor fund is created as a matter of simple justice. Unlike most of the other bondholders, on-island investors do not have substantial assets that can cushion the loss.[27]

Assets

There are three resources that can be drawn from to settle the bankruptcy case. The primary goal of the bankruptcy is to provide a reasonable outcome for the creditors. This can only be achieved if there is also a reasonable outcome for Puerto Rico.

Table 3: Assets ($ billions)

Assets	Amount
Insurance	2.30
Advisors	4.35
Total	6.65

[27] Workable and fair criteria can be developed to ensure that all are treated fairly.

With the zeroing out of the bondholder claim (and insurance payment), a substantial resource of $8 billion is generated. The insurers need only support the debt covered by policies taken out by PREPA. To better understand how the $4.35 billion can be achieved, consider the following example. The 2013 PREPA bond issuance identified the following companies as part of the underwriting team.

Table 4: Assets Under Management ($ trillions)

Company	Amount
J.P. Morgan	3.1
Morgan Stanley	1.6
Wells Fargo	0.6
Citigroup	0.3
Bank of America	1.5
RBC Capital	0.2
Goldman Sachs	2.1
UBS	2.6
Total	12.0

The assets under management of these companies create a financial base for this settlement. It does not include $2.6 billion in annual revenue for the law firm of Sidley Austin; $40 billion in annual revenue for Ernst & Young auditors; or $4 billion for consulting engineer URS Corporation. They should be included.

There is no question that this group could create a $4.35 billion pool to settle the PREPA matter. The group could contribute even more if a different set of options were amenable to all the parties. Since there were additional bond issuances and a host of new financial service providers that benefited from the two failed rounds of RSA negotiations, this figure should only increase in size.

The use of the assets of the companies, coupled with the insurance payments and bondholder haircut, covers the liabilities. It is not the specifics that matter here, it is the approach—a broader framework that allows for a realistic exit strategy.

Should bondholders or any of the other parties with interest wish to proceed with claims like those identified by Kobre and Kim, they should be free to do so. This might result in additional litigation, but a well-designed settlement should protect PREPA and its ratepayers.

A Broader Picture

PREPA is in line to receive more than $14 billion from the federal government to rebuild its grid.[28] The amount of money provided would be in the form of grants. This federal allocation would allow the rebuilding without any commensurate debt service load factored into the rate base. This financial benefit is extraordinary and cannot be overstated. As the current revenue

[28] Fiscal Plan, *op. cit.*, p. 132.

base of PREPA and the projections all suggest, the authority can barely cover operating expenses under current economic conditions.

Under the two failed RSAs, PREPA would be accepting rate increases to pay back legacy debt at a time when the federal dollars allow the authority a debt service holiday as it transforms the grid system. Layering on past debt is counterproductive. At worst, IEEFA's plan might require some acceptance of long-term costs into the rate base, but the amount would be *de minimus* and it would not defeat the financial impact of the federal grant dollars.

This plan at first may seem unrealistic since there is no law compelling the financial services group to act in a fair and just manner. Right now, the financial process has created a stalemate within a quagmire. However, all the stakeholders might be better off understanding this approach as an investment in Puerto Rico that can provide a sound basis for an exit from bankruptcy. It is also the basis for a sound rationale to achieve market access, obtain legislative support and create recurring budget balance.

If you give this idea some consideration, you will see that it can be quite flexible as a framework for a mediation. I believe that the good that would come from this formulation is only surpassed by the harm that will be inflicted if something like it is not adopted.

Sincerely,

Tom Sanzillo
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