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Chairman José B. Carrión III
PROMESA Oversight Board
Jacob Javits Federal Bldg, 26 Federal Plaza
Room 2-128
New York, NY 10278

Governor Ricardo Rosselló
La Fortaleza
P.O. Box 9020082
San Juan, PR 00902-0082

Re: Puerto Rico Electric Power Authority ("PREPA") – Debt Structure, Rates and Fiscal Solvency

Dear Chairman Carrión and Governor Rosselló:

The Institute for Energy Economics and Financial Analysis (IEEFA) has conducted extensive research and analysis on the operational, energy, and financial issues facing the Puerto Rico Electric Power Authority (PREPA) over the past two years.[1] This letter provides further commentary on those issues; responds to the July 21, 2017, letter[2] to you from Dominic Federico, President and Chief Executive Officer of Assured Guaranty (AG), an insurer of PREPA's bonds; and recommends the appointment of an independent inspector general to oversee PREPA'S operations.

Summary

IEEFA's research and analysis has led us to three major conclusions regarding PREPA:

- First, residential electricity prices that are not in the range of 12 cents per kWh are detrimental to Puerto Rico's future growth.
- Second, going forward, PREPA will be able to re-enter the capital markets as a going concern only if it has a \$2-\$3 billion debt level; a structure that tries to support \$8-\$9 billion in debt will fail.

[1] See, for example: IEEFA Testimony, PREPA Aguirre Site Economic Analysis, PREC, June 2017; Puerto Rico (PREPA) Briefing Note, January 2017; IEEFA Filing: Testimony to the Puerto Rico Energy Commission, October 2016; PREPA Debt Restructuring Deal Won't Restore Agency to Financial Health, August 2016; Comments on the Puerto Rico Electric Power Authority's Integrated Resource Plan, April 2016; and Report: Opportunity for a New Direction for Puerto Rico's Electric System, September, 2015.

[2] http://assuredguaranty.com/letter-to-puerto-rico-oversight-board-governor

- Third, PREPA's dysfunctional and probably corrupt management practices prevent it from adopting sound energy plans, operational improvements and a tight system of internal financial controls.

We recommend an Independent Private Sector Inspector General (IPSIG) be appointed to run PREPA. The inspector general's mission would be to institute improvements, root out waste, fraud and abuse, and establish reliable internal controls and reporting that form the basis for sound budget and energy planning.

We contrast this proposed reform to AG's proposal to appointment a receiver for PREPA. The receiver's mission would be to raise electricity rates (to levels that are clearly unsustainable) and to pay bondholders. AG offers no plan for the operational improvement of PREPA or for improvements in its financial reporting. By comparison, governance by an IPSIG can serve as integral part of your administration's solution and support PROMESA's needs for oversight needs of PREPA.

AG's rate-increase arguments lack grounding in Puerto Rico's current economic condition and its likely future growth trajectory.

Our review of the financial disclosures PREPA provided during recent Energy Commission hearings on rates and other issues shows that the island, its residents and its businesses cannot sustain a return to electricity rates of 25 to 30 cents per kilowatt hour. Yet this this is the path that AG is urging you to take. Puerto Rico's economy must compete with those elsewhere in the Caribbean. Economic indicators for Caribbean countries show current and projected growth far above the generally negative GDP growth and growth projections expected in Puerto Rico (despite the high electricity rates in these countries). Puerto Rico's economic future requires a lower electricity cost structure for businesses and residents. I invite you to review our testimony and reports on the relative position of Puerto Rico's economy and the economic status of Puerto Rico's businesses and people.

Contrary to the impression left by AG's letter, electricity prices in Puerto Rico are on the rise again. As AG states, electricity prices have dropped in Puerto Rico over the last few years due to a decrease in global oil prices. This has brought much-needed relief to PREPA's customers. However, real electricity rates and prices are going back up again. During the first 11 months of fiscal year 2017, rates have averaged 20.21 cents/kWh, an increase of 8.7% over last year. This has occurred during a period in which the price of oil has been stable and relatively low for Puerto Rico and the rest of the world. Business profits and the income of households in Puerto Rico have not risen by 8.7% during this time. Further, electricity demand through the first 11 months of the year has dropped by 2.8% below planned levels.

Little or no due diligence has been done on the question of exactly what PREPA owes bondholders.

PREPA is now, and has been for decades, dysfunctional and probably corrupt at the operational, financial and governance levels. Our testimony and the opinion of the Energy Commission took note that PREPA's debt-restructuring proposal did not conduct a past-practices review of the agency. Neither Alix Partners nor PREPA reviewed the history of waste, fraud and abuse in PREPA as part of its diligence connected to the restructuring deal.

Had they looked, a troubling picture would probably have emerged. One audit performed by the Puerto Rico Commission for the Comprehensive Audit of the Public Credit raised this concern quite vividly. The Commission reviewed one bond offering and found that the due diligence for the issuance took poor account of PREPA's physical condition, consumer services, internal controls, financial disclosures and governance. The financial oversight structure put in place for PREPA and paid for with ratepayer dollars failed to perform its diligence functions. The Energy Commission has raised questions about the broader conduct of PREPA's financial advisors, lawyers, accountants, underwriters and credit agencies. We are uncertain as to the role the insurers play in the process but note that AG and other insurers became parties to the Restructuring Support Agreement (RSA)discussions shortly after these bonds were issued.

PREPA's financial problems did not come about overnight. We have in noted in various reports and commentaries that when problems of this magnitude have occurred in other jurisdictions, underwriters have borne some financial liability for inadequate diligence. From what we see, PREPA's actual liability could be substantially diminished if accountability were demanded by all parties in the underwriting of its bonds. We also note the SEC's interest in these issues.

Only an aggressive assertion of PREPA's legal interests in what is clearly an unacceptable quagmire of financial oversight will help the authority reduce its obligations and compel accountability from those responsible.

PREPA should not settle for paying $8-$9 billion in debt.

AG's solution demonstrates that AG has its financial-planning priorities backward.

PREPA needs an operational overhaul to improve personnel deployment, contracting, physical plant assessment, investment prioritization and energy planning. An operational overhaul needs to be accompanied by a wholesale shake-up of the governance structure so as to eliminate political interference and entrenched dysfunctional management.

Even under ideal circumstances and with stringent financial controls, PREPA cannot sustain the $8-$9 billion debt load contemplated by the restructuring agreement and assumed by the Transition Charge. Our research suggests that PREPA can sustain a $2-$3 billion debt load, but only if it is to adopt a financial plan that is worthy of the term "going concern." PREPA must be able to cover its operational expenses, it debt service and its investment in upgrades. Saddling PREPA with obligations to pay old debt that was not used to create revenue-producing assets will fail.

I have attached for your reference a copy of Moody's Investment Services' most recent annual study of municipal debt defaults. Since 1970, recovery rates for municipal utility defaults have been 54%. Recovery rates overall for general government debt are 50%.

At this level, PREPA's debt recovery would be somewhere in the $4 billion range. However, given the severely weakened state of the Puerto Rico economy and the massive financial investment needed to return PREPA to a state of good repair, IEEFA would reduce the manageable target level of PREPA debt to the $2-$3 billion range.

PREPA can and should finance a modernization program for Puerto Rico's electricity grid. The euphemism that PREPA's grid "is not in a state of good repair" masks a starker reality. The grid is dangerous and outdated and is seriously mismanaged. The agency's energy-planning apparatus is equally bereft.

We argue—based on our in-depth work on the problem—for an objective, rational, financially-driven set of proposals to integrate renewable energy into Puerto Rico's system as a least-cost option. All that has emerged from PREPA's energy-planning processes thus far are financially volatile fossil fuel proposals. The answer is not to choose only one or the other (fossil fuel or renewables), the answer is to incorporate both. Right now, PREPA lacks both the will to produce renewable energy projects and the ability to execute its own misguided fossil-fuel strategy. AG ignores the fact that most Caribbean nations are involved in renewable energy investments to improve their grids and to reduce the high cost of electricity.

The assertion by AG and others that PREPA will lose access to the capital markets if it demands more significant debt reduction is baseless.

AG and others have warned you that the imposition of steep principal reductions will prevent PREPA from re-entering the capital markets. This position is baseless, for the following reasons:

- The proponents of the RSA have no clear idea when PREPA could re-enter the bond market even if the current restructuring deal is approved.
- Historical precedent shows that a leaner PREPA with less debt can indeed re-enter the market.
- AG's position defies and distorts the purpose of bankruptcy and fiscal-distress planning.
- Large institutional investors are already hedged against losses by larger market forces and would actually benefit from the elimination of the PREPA problem.

We have noted in our testimony that the proponents of the RSA plan have presented no clear path back to the capital markets. We have analyzed the statements of PREPA's consultants (who have been paid over $40 million) and their spreadsheets and financial assumptions. These consultants have provided no clear date to the Energy Commission as to when PREPA could re-access the markets. They have provided only the vaguest of standards to be met for this to occur.

We ask you to review the attached Moody's report carefully. Of the 70 municipalities that have submitted to a fiscal workout, it appears that all eventually re-entered the capital markets on manageable terms. In large measure, market access was regained because the fiscal workouts included concessions from all financial stakeholders, reliable financial reporting, and realistic budget assumptions that brought recurring revenues in line with recurring expenses, including new debt service arrangements.

According to Moody's, municipal bankruptcies, while still rare, are unfortunately occurring with more frequency. The solutions for financial stakeholders and people affected by the consequent fiscal belt-tightening are real and difficult. We acknowledge the difficult set of choices facing all parties. That said, history shows that communities can emerge successfully from such difficulties when they face up to their problems in a transparent and assertive way.

The purpose of a fiscal workout is to establish a structural balance between recurring revenues and recurring expenses, including debt service. Economic assumptions must be realistic, as they are the foundation of revenue estimates and expenditures. Spending estimates must be reliable and based on verifiable measures.

AG's desire for immediate, aggressive electricity rate increases is in direct conflict with Puerto Rico's low and negative economic growth rates. If rates are increased as proposed by AG, PREPA's internal finances would be grossly distorted, allowing for debt service to absorb an extraordinary level of annual revenues and leaving little or nothing left to finance operational improvements or new capital spending.

The public discussion in Puerto Rico now, along with the structural rebalancing of the budget worked out between your offices, sends the right signals to the capital markets. The two most critical immediate questions in the debt debate are: how much can PREPA afford to pay, and how will its financial partners participate in PREPA's rebirth?

Bond markets are global in scope. Most of the larger bondholders in Puerto Rico (with hundreds of billions of dollars—even trillions—in asset bases) are invested worldwide and benefit from hedges across global markets. The global economy is likely to grow in the range of by 2 percent per year over the next several years. Puerto Rico's economy will grow at a much slower rate, if it grows at all. Large institutional investors use economic growth and portfolio size as hedges to offset losses that inevitably occur across the global economy. When one part of the global economy falters, the strength of the rest of it absorbs the losses in a process that turns failing local economies into newly-minted contributing pieces of the larger economy.

That said, it will be necessary to take steps to protect smaller investors, particularly those who live in Puerto Rico and have invested in Puerto Rico as a matter of pride and commitment. A program can be designed to ensure that small investors who do not possess the resources of large investors do not have to absorb large losses.

A financial workout would take the realities of the debt market and PREPA's operational and managerial problems into account. The result would be a plan based on reliable financial disclosures that bring PREPA's finances into structural balance. Such a financial plan, presuming PREPA follows it, would reinstate a bankable credit rating and access to the credit markets. This would allow capital markets to continue to finance PREPA's upgrade needs. It would also create new opportunities for credit transactions to be carried out in a transparent manner supported by rigorous due diligence. If Puerto Rico remains fiscally disciplined, PROMESA's role will shift from what is now seen as a contentious one to one that documents and champions Puerto Rico's path back to fiscal solvency.

The problems identified by AG were not caused by low electricity rates nor will they be solved by raising rates. PREPA's financial problems were caused by poor operational oversight and governance, exacerbated by a reckless disregard of PREPA's bond issuance authority.

The history of fiscal workouts shows that AG and other financial stakeholders can and should spend their time more efficiently by facilitating a realistic debt reduction package as part of overall fiscal reform of PREPA. If AG and other insurers and stakeholders do not participate in a serious debt-reduction process, they risk prolonging a highly public, fractious process and the imposition of even deeper principal discounts.

Appointing an IPSIG would put PREPA onto a responsible recovery path that will lead to fiscal solvency.

The appointment of an IPSIG is strong medicine. In my professional experience with the New York State Comptroller I was part of the oversight process when the New York Racing Association was facing criminal liabilities. The process was not without short-term trade-offs, but it produced real financial savings, new organizational options, staff and board accountability, and renewed commitment to internal controls and integrity in the organization's financial disclosures. It created an upward cycle of accountability and innovation against the downward cycle of deficits and self-dealing.

The time is long overdue for the various financial stakeholders in PREPA to stop highly destructive self-pleadings. It is time now to adopt options that solve PREPA and Puerto Rico's problems and bring those responsible for its current situation to task.

We strongly believe that any outside independent entity with knowledge of the energy issues facing Puerto Rico would support IEEFA's recommendation to make renewable energy a priority. It is the least-cost option and a technologically sound method for improving the grid and placing downward pressure on the costs of running the system—and ultimately on rates.

We appreciate your taking the time to consider these points and we would welcome an opportunity for further discussion.

Sincerely,

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