



**Testimony of Tom Sanzillo
Director of Financial Analysis
Institute for Energy Economics and Financial Analysis**

**Before the Puerto Rico House of Representatives Commission on Economic Development,
Planning, Telecommunications, Public-Private Partnerships and Energy
October 26, 2022**

Chairman Torres and members of the committee:

Thank you for the opportunity to testify today. My name is Tom Sanzillo, and I am the Director of Financial Analysis for the Institute for Energy Economics and Financial Analysis. IEEFA has been closely following and analyzing Puerto Rico electrical system issues since 2015. Our publications have focused on the physical and financial condition of the Puerto Rico Electric Power Authority (PREPA), specifically pre- and post-hurricane energy planning and priorities, debt management, consultant hiring and fee structures, renewable energy opportunities, management challenges, political interference, budget and fiscal plan, federal oversight, fuel oil contracting and other procurement issues and irregularities.

Prior to my tenure at IEEFA, I spent 17 years at senior management levels at the New York City and New York State Comptroller's Offices. I left state service in 2007 as the First Deputy Comptroller of New York State (and served for a short period as the State Comptroller due to an early resignation). In those positions, I had responsibility for the oversight of a \$150 billion pension fund; a 1 million-member retirement system; a \$250 billion state and local bond portfolio; 40,000 annual contracts valued at \$85 billion; the audit program for all public authorities (including the state's largest energy authorities, the Long Island Power Authority and the New York State Power Authority) and state and local governments; monitoring of the state budget and expenditures (including payrolls); and review of the finances of 1,400 units of local government. My work on state government finances has appeared in the New York State Oxford Handbook on Politics and Government.

During my tenure with New York City the City was operating under a financial control board. The City Comptroller is a voting member of the Board. During my tenure the State Comptroller of New York had oversight responsibilities for control boards at Nassau and Erie County and other local government entities at New York, Buffalo, Troy, Yonkers. The oversight responsibilities vary but require ongoing monitoring and often review and approval of critical decisions including debt relief, major asset transactions and savings initiatives.

Thank you for the opportunity to testify today on House Bill 1429. I applaud the Legislature's initiative to ensure that any forthcoming Puerto Rico Electric Power Authority plan of adjustment is in the public interest.



My testimony today will focus on a strategy for reaching a restructuring agreement that is consistent with the underlying economic prospects for Puerto Rico's economy. My testimony is based on an updated version of a letter IEEFA sent to the Financial Oversight and Management Board in April of this year regarding the mediation process.¹

As you know, over the past seven years, PREPA debt restructuring negotiations have produced two failed restructuring agreements and a failed mediation process. 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 rejected proposals reflect a failure on the part of the bondholders to acknowledge that Puerto Rico's economy has not experienced growth for the better part of a decade and, even with significant federal outlays, the economy shows signs of a very fragile future.² 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.

Rather than insist that a debt restructuring agreement be based on rate increases, another group of stakeholders must 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 "financial services" group has assets under management valued in the trillions. They can both absorb losses and be available to provide cash where needed to bring this matter to closure.

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.

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

¹ https://ieefa.org/wp-content/uploads/2022/04/Sanzillo-Puerto-Rico-Debt-Letter_Spanish_April-2022.pdf

² See <https://www.bea.gov/data/gdp/gdp-puerto-rico> and 2022 Commonwealth Certified Fiscal Plan (Exhibit 9).



The fees paid to these financial advisors is in the hundreds of millions. Their financial advice over decades made a significant contribution to PREPA's downward spiral and bankruptcy. Some may have even broken the law. In total, Puerto Rico is due recompense.

But 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 \$10.6 billion, but liabilities that create a net negative position of \$6.8 billion.³ 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. 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.⁴

In other distressed situations 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.⁵

One of the unique conditions involved in Puerto Rico is the economy. The median household income of the United States was \$64,944 in 2020.⁶ The Commonwealth of Puerto Rico had a median income in 2020 of \$21,058, less than one-half of the poorest state.

³ [https://aeepr.com/es-pr/investors/FinancialInformation/Annual%20Reports/Financial%20Statements%2C%20Required%20Supplementary%20Information%20and%20Supplemental%20Schedules%20\(2019\).pdf](https://aeepr.com/es-pr/investors/FinancialInformation/Annual%20Reports/Financial%20Statements%2C%20Required%20Supplementary%20Information%20and%20Supplemental%20Schedules%20(2019).pdf)

⁴ 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 County Sewer Warrants. August 27, 2013. Also see: Moody's. Jefferson County Demands More Concessions from Creditors, Special Comment. October 21, 2013. (Proprietary)

⁵ 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)

⁶ St. Louis Federal Reserve. [Real Median Income](#).



The Rationale for a Zero Recovery on Uninsured Bonds

The cornerstone of IEEFA's 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. As discussed in my written testimony, it is important to understand that this does not mean that bondholders would receive no compensation; rather, a settlement pool would be constructed making use of other assets, including from insurance companies and the financial services group. 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 debt restructuring negotiations are not a path to market access.

In my written testimony I consider each of these five points. For the purposes of my testimony today I will cover only the first point related to rates.

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 the successful implementation of the current fiscal plan will not achieve the 20 cents per kwh rate established by the Legislature, even if no money is included for debt service.⁷ 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.

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 near or above 30 cents per kWh. Does a

⁷ PREPA 2022 Certified Fiscal Plan, Exhibit 48.



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.

Puerto Rico's electrical system is in dire condition, a situation that has cost literally thousands of lives, and the transformation pathway to a resilient, reliable and affordable grid would be difficult even in the best of circumstances. Layering on additional fees to pay legacy debt threatens to make this transformation all but impossible.

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."⁸

The latest proposals in the mediation proposes adding a flat fixed charge to electric rates to pay back the PREPA debt. Yet the current Commonwealth Fiscal Plan projects net negative economic growth from FY23 through FY31 and continued negative real GDP growth through FY51.⁹ Imposing a flat debt service fee on a negative growth economy violates the Board's own principles.

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.

⁸ 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")

⁹ 2022 Commonwealth Fiscal Plan. Exhibit 9 and Exhibit 26.



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

At the same time, plans for renewable energy have yet to materialize. The only significant generation project undertaken in the last five years was the conversion of two units of the San Juan plant to natural gas. It was not until this summer that contracts for renewable energy and storage will approved by the Energy Bureau, more than a year behind schedule.

The only progress in transitioning towards renewable energy has been at the level of individual customer investment in rooftop solar and storage. Indeed, rooftop solar now provides more of Puerto Rico's electricity consumption than utility-scale solar. Yet this progress would be undermined by the most recent PREPA Fiscal Plan which proposes to weaken the net metering program that ensures a fair compensation to rooftop solar owners for the excess electricity they produce.¹⁰

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 2022 closed posting \$4.1 billion in total consolidated electrical system revenue and expenses of \$4.1 billion. Fuel and purchased power equaled \$2.9 billion.¹¹ The most recent cash flow statement through July 13, 2022, is posting a 13-week deficit of \$174 million.

The Authority remains crippled by volatility in oil and gas prices. 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. The fuel estimates year after year continue to lack credibility. Budget plans going

¹⁰ 2022 PREPA Fiscal Plan, p. 125.

¹¹ <https://aafaf.pr.gov/wp-content/uploads/prepa-b2a-fy2022-q4-aug-15-2022.pdf>, <https://aafaf.pr.gov/wp-content/uploads/13-week-cash-flow-update-07-13-2022.pdf>



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.

5. The current debt restructuring negotiations are 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. It is difficult to see how any bonds that would have been issued under past proposals would have received favorable credit ratings. The standards used by Moody's to rate public utility bonds, for example, are forward-looking.¹² The standards look to the status of the assets in the system, and the ability of the economy to support the rate base.

PREPA's assets are in poor condition. A favorable credit rating would require 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.¹³

Puerto Rico's economy is weak and, while the introduction of \$14.4 billion in federal funds unencumbered by commensurate debt service increases could be a substantial credit enhancement, the adoption of a legacy debt charge would eviscerate the positive credit benefits by diverting substantial revenue for the next decades to pay past liabilities.¹⁴

In short, 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 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.

¹² 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.

¹³ IEEFA. [Letter to Legislative Assembly](#). December 2020.

¹⁴ IEEFA. [PREPA debt plan—new gimmick uses federal money to pay off old electric authority debt](#). March 7, 2022.



Essentially the plan proposes a 0% recovery rate to bondholders, 50% to fuel line lenders and 0% to unsecured creditors. This does not mean that bondholders would receive no compensation. Rather a compensation pool would be constructed from other available assets, including insurance recoveries and the financial services group.

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.¹⁵

The liabilities 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.

Table 2: Liabilities (\$ billions)¹⁶

Liabilities	Amount	Estimated Settlement
Outstanding Bond Indebtedness	8.3	2.30
Fuel and Unsecured Creditors	0.7	0.35
Pensions	3.0	3.00
Subtotal	12.0+	5.65
Pool for Small Investors	1.0	1.00
Total	13.0+	6.65

The following table proposes the assets that could be used for the \$6.65 billion settlement shown above.

Assets	Amount
Insurance	2.30
Advisors	4.35
Total	6.65

¹⁵ Workable and fair criteria can be developed to ensure that all are treated fairly.

¹⁶ As per PREPA's most recent Annual Audited Financial Statement for year ending in June 2019 (dated February 2022) PREPA's long term outstanding bonds payable is \$7.0 billion (p. 24). There is a current bond liability of \$1.3 billion. Note 10 long term liabilities aggregates the bonds payable to \$8.3 billion) p. 54). [https://aeep.com/es-pr/investors/FinancialInformation/Annual%20Reports/Financial%20Statements%2C%20Required%20Supplementary%20Information%20and%20Supplemental%20Schedules%20\(2019\).pdf](https://aeep.com/es-pr/investors/FinancialInformation/Annual%20Reports/Financial%20Statements%2C%20Required%20Supplementary%20Information%20and%20Supplemental%20Schedules%20(2019).pdf)



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.

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 \$12 trillion 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 from bankruptcy. 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.

Recommendations

Puerto Rico desperately needs to transform its unreliable and expensive power grid. The federal funds available provide a debt-free way to do that. This financial benefit is extraordinary and cannot be overstated. As the current revenue 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.

This plan at first may seem unrealistic since there is no law compelling the financial services group to act in a responsible manner. 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 the Legislature wishes to support this concept, or something similar, I urge you to include specific conditions in House Bill 1429 to prevent rates from being raised to pay off the PREPA bond debt (or, as an alternative, only make rate dollars available for debt service if and when rates below 20 cents per kWh are achieved in the future).

I conclude by emphasizing the critical role that the Legislature has in this process. Bond markets will not look favorably on a debt deal that does not have the support of the Puerto Rico legislature, even if such support is not legally required. Bonds are less likely to receive a favorable rating if they are not seen as backed by the full faith of the issuing government. I thank you for your interest in structuring a debt agreement that is in the interests of the people of Puerto Rico.