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Puerto Rico (PREPA) Briefing Note

- *Fiscal Oversight Board Sends Signal: Bondholders Must Share in Financial Sacrifice.*
- *Recent Puerto Rico Energy Commission Order Paints a Picture of PREPA Awash in Mismanagement.*
- *If the Oversight Board Applies the Same Standards to PREPA as it does to the Commonwealth, than PREPA's flawed debt refinancing deal should not be approved.*

By Tom Sanzillo, Director of Finance and Cathy Kunkel, Energy Finance Analyst

INTRODUCTION

The Puerto Rico Oversight Board (PROMESA) issued a letter on Jan. 18[1] that sketches the outlines of a broad path to fiscal stability for the Commonwealth. We key in on the point that in the fiscal year 2019 Puerto Rico's taxpayers can potentially afford only $800 million for debt service. The commonwealth actually owes $3.9 billion under contractual obligations on approximately $64 billion of outstanding debt. That means Puerto Rico's taxpayers can afford only 21 percent of the government's current debt obligation. This is the first real clear acknowledgement of this reality by the board.

The oversight board also extended the deadline for Puerto Rico's governor to submit a 10-year financial plan consistent with the broad fiscal outlined in the letter. The significant reduction in debt service for 2019 outlined in the letter sends a signal to bondholders that they will face a substantial reduction in the value of their holdings as part of Puerto Rico's financial solution. We note that in his Jan. 18 response to the Oversight Board,[2] the governor acknowledged that an average 79 percent haircut for bondholders was in play as a real budget consideration. Puerto Rico's economy is expected to decline by 1.1% annually over the next decade, driven by substantial contraction in 2018 and 2019.

[1] https://juntasupervision.pr.gov/index.php/en/documents/
[2] https://juntasupervision.pr.gov/wp-content/uploads/wpfd/50/587fea840f998.pdf

This budgetary revelation by the board holds important implications for the assessment of the Puerto Rico Electric Power Authority (PREPA)'s pending deal to restructure its debt. PREPA's proposed debt deal assumes that Puerto Rico's ratepayers can afford to pay nearly $940 million in annual debt service on a debt load of just over $8 billion. PREPA's proposed debt restructuring would have PREPA ratepayers paying more than 85 percent of the outstanding debt burden. PREPA's ratepayers, who also happen to be Puerto Rico taxpayers, are being told they have to shoulder this debt burden while the Oversight Board states that the Commonwealth as a whole can afford only 21 percent.

BUDGET METHODS

Two radically different budget methods are being employed here—one by the Oversight Board and one by PREPA.

The Oversight Board has looked at Puerto Rico's baseline needs for schools, hospitals and other public services, as well as its revenues (a combination of taxes and federal revenue). The deficit for operations is $3.7 billion. After the board applies a series of savings and revenue increases worth $4.5 billion, it produces the $800 million in an "implied surplus" for debt service. The board also notes that the $800 million may be overstated.

The Oversight Board assumes that money available for debt service is what the Commonwealth has left after it has taken care of its budget needs, albeit with a quite austere spending plan.

PREPA, on the other hand, has decided its first priority is to pay bondholders. PREPA took $940 billion out of its $3.7 billion budget for debt service. That was done first. The Puerto Rico Energy Commission's Jan. 10 order[3] granting PREPA a rate increase shows that PREPA has done very little to determine its actual budget needs. The commission states flat out that the information that PREPA provided to it is largely unsupported by documentation. For example, the order states that PREPA's claims that the system is in good working order are simply "wrong." The level of mismanagement spelled out in 239 pages is astounding.

PREPA took the exact opposite approach to budgeting from the Oversight Board. It gave short shrift to the needs of the electricity system in favor of an outsize payment to the bondholders.

DEBT METHODS

PREPA has offered in its defense that it was able to wring all the concessions it possibly could out of the agency's bondholders.

The Oversight Board shows us that PREPA's approach to negotiating its bond obligations was deficient in another way. The Oversight Board has opened the negotiations with Puerto Rico's bondholders by telling them Puerto Rico is broke and can maybe afford 21% of what it owes. That is a good opening position, and the key

[3] http://energia.pr.gov/wp-content/uploads/2017/01/Final-Resolution-and-Order.pdf

here is that the settlement of Puerto Rico and PREPA's debt obligation is a ***negotiation.*** It is not driven by jurisprudence, fears of future bond market access, pride or morality.

PREPA did not start with a budget that made any assumption about the upper limits of its customers' ability to pay or the needs of the system. It simply went into negotiations with its bondholders and, with no known leverage, received some minor concessions. We have pointed out that PREPA will now be paying debt levels that by its own admission are higher than the market value of the debt. PREPA acknowledged that the market value of its debt was 65% of the face value of the bonds. We have pointed out that Moody's is showing that PREPA bondholder debt recovery should be in the range of 65% to 80%. IEEFA thinks it should be lower.

The Oversight Board's budget method and opening negotiating gambit show that there were and are better ways to relieve PREPA's debt burden.

QUESTIONS AND IMPLICATIONS

1. How is the Commonwealth going to tell its bondholders, particularly the holders of its General Obligation and revenue backed COFINA bonds, that they are to take a substantial loss, far beyond those of PREPA's bondholders?
2. The ratepayers of Puerto Rico and the taxpayers of Puerto Rico are the same people participating in the same economy that for the next decade faces declining GDP, and the same people being asked to shoulder inordinate burdens. Where is the financial, economic and mathematical logic?
3. How is PREPA going to justify to the bond community during a diligence process that it is asking PREPA ratepayers to support debt that exceeds its market value?
4. Bondholders are obligated to care about whether PREPA's underlying assets are in sound condition and that management is supportive of improvement. How can PREPA make assurances to its bondholders that its current budget can bring the underlying assets of the electric system into a state of good repair or that management supports change? It is clear that the Puerto Rico Energy Commission does not believe this is the case.
5. The Oversight Board has been provided with a blueprint for PREPA's operational improvement by the Commission. It contains significant red-flag warnings about the budget and operational culture at the agency. The Commission has offered no opinion on the refinancing deal. In IEEFA's view, the debt deal suffers from the same defects that are so abundantly documented by the Puerto Rico Energy Commission. How will the Board and the new governor handle the diligence review with such defective information and data?

PARTING OBSERVATIONS

The Oversight Board letter points out that it has not taken a position on the PREPA refinancing deal in deference to the new governor's review. The Oversight Board is also now obtaining its own independent accounting of Puerto Rico's actual debt burden. These are prudent steps upon which a meeting of the minds can occur on a uniform debt strategy for the Commonwealth that actually helps it recover. The out years of the Commonwealth economic projections are optimistic because the board is assuming improved fiscal conditions. This optimism will prove false if the Commonwealth and PREPA are saddled with debt. Economic growth will also be meaningless if every penny of it goes to pay bondholders and nothing is reinvested in businesses, jobs and communities in Puerto Rico.

Finally, the Puerto Rico Energy Commission has kicked this debt deal over to the Oversight Board. Its members have followed the law as they see it and not judged the deal. When we and others in the recent PREPA rate case hearings raised these issues, we were ruled to have been outside the envelope of the commission's administrative authority.

How much debt Puerto Rico and PREPA ultimately pay is a political matter. The Board's job is to objectively structure the terms of the debate. They are doing so. The PREPA deal was put together by fee-driven consultants, an inattentive board, overwhelmed staff, and a Public Service Commission hamstrung by legislation.[4] This issue will only be resolved at the highest level of Puerto Rico's government, the federal government and the CEOs of the major investment houses with the highest stakes.

[4] It is perhaps axiomatic that when a legislature passes a bill on a serious matter and does not solve the underlying problem that the problem will come back through the political process in one form or another. In this instance, PREPA's debt burden was not fixed by the Recovery Act passed in early 2016. It now falls to the Oversight Board and the Governor for action. The nature of Puerto Rico's fiscal and economic emergency is such that this issue will not go away.