Contract Between Puerto Rico, LUMA Energy Sets up Full Privatization, Higher Rates for Island Grid

Executive Summary

The recent agreement between LUMA Energy and Puerto Rico’s Public-Private Partnerships (P3) Authority and the Puerto Rico Electric Power Authority (PREPA) for the operation of the transmission and distribution of the island’s electrical system should be rescinded. The overall plan for the transformation of the electrical grid needs to be redesigned to comply with Puerto Rico law and energy policy. Neither the transformation plan nor this contract will achieve a 20 cents per kilowatt-hour (kWh) price of electricity, create a 100% renewable energy system, ensure that a steady and stable workforce continues to serve Puerto Rico, or provide the island’s citizens with strong, independent oversight to protect the public interest.

The contract is billed as a transmission and distribution operation agreement and organized as a public-private partnership. The contract fails from the outset, as it is actually a full privatization of PREPA’s basic functions. The contract is signed with a private company that is not required to put any of its own money at risk. This is not a partnership; it is a contract that guarantees the flow of money to LUMA Energy and leaves a safe, reliable and affordable electricity system for Puerto Rico to luck.

The LUMA contract will:

- **Push Electricity Rates Up**—Puerto Rico’s energy goal is to create a price of electricity of 20 cents/kWh. The structure of the contract will push prices toward the 30 cents/kWh level. One of the first contract tasks for LUMA Energy will be to file for an increase in electricity prices. This request will go before the Puerto Rico Energy Bureau (PREB), which this report shows has been an ineffective watchdog over operational costs and its own ethical conduct. The contract is silent on the hundreds of millions of dollars that annually go to debt service, fuel costs, political patronage and bad contracting. Instead, over the life of the contract, hundreds of millions of dollars in new fees for LUMA Energy will be added to already burdensome
costs imposed by consultants and advisors, fossil fuel interests and bondholders.

Consultant and oversight fees will be increased to $274 million in this fiscal year—more than 22% of PREPA’s current non-fuel budget. This translates into a rate impact of 1.6 cents/kWh.

- **Use Financially Weak Companies**—The rebuilding of Puerto Rico’s grid is estimated to cost more than $20 billion, largely financed with federal dollars. The two companies that sponsor LUMA—Quanta Services and ATCO—are worth about $12 billion. These companies are too small to meet the challenge in Puerto Rico. If federal funds fail to materialize at the level or on the schedule anticipated, these companies are poorly positioned to step in to complete the task. In addition, the contract does not prohibit LUMA Energy from hiring its parent company to perform some or all of the $18 billion in new federal spending projects that LUMA will manage.

- **Promote Expansion of Outdated Natural Gas Plans**—The goal of Puerto Rico energy law is to move toward 100% renewable energy. The actions of PREPA and the contract point LUMA to highly centralized natural gas generation as a priority. The recently implemented San Juan 5 and 6 natural gas project missed its first savings target of $192 million, is not on time, and faces administrative challenges. Recently, PREB has called on PREPA and its successor to maximize renewable energy. The contract permits LUMA Energy to file changes with the PREB to the recently approved Integrated Resource Plan (IRP). The two paths are in conflict. The contract, PREPA’s past practices and PREB’s weak oversight point toward a high-cost, nonrenewable and unreliable energy system dominated by natural gas projects.

- **Pursue Unsound Labor Practices**—Puerto Rico currently has a solid unionized workforce to help rebuild the grid. The contract calls for eliminating labor protections, including existing labor unions, that protect wages and benefits and pensions. This is an unsound management decision. New privatized operators and labor agreements struck in other communities in fiscal distress continue to recognize existing labor rights and build on existing workforce strengths. Overall, the contract provides specific provisions to assist with reducing labor costs but makes no mention of the more costly, wasteful parts of PREPA related to fuel, debt and political patronage.

- **Less Public Input**—The contract gives LUMA Energy responsibility for customer and public relations. Public interest organizations (including IEEFA) have had to sue PREPA, a public agency, to gain access to even the most basic information regarding its operations. LUMA Energy is a private corporation with confidentiality and proprietary obligations that can only further restrict the flow of public information.
The LUMA contract is objectionable on a mix of policy and procedural grounds.

Repeat Past Mistakes—The largest part of LUMA Energy’s fee for running the grid must be paid whether or not the company is performing well. An additional incentive payment is made if they perform in a superior fashion. The three oversight structures designed to protect the public interest have either no history in energy regulation or a history of ineffectiveness with regard to PREPA. The P3 Authority is unqualified to be the administrator of the electrical system, the PREB is, at best, under-resourced to regulate properly, and the Financial Oversight Management Board (FOMB) is an unreliable fiscal monitor.

The LUMA contract is objectionable on a mix of policy and procedural grounds that are so extensive that its execution is unlikely to achieve critical resiliency, affordability, renewable energy, workforce and budgetary goals.
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Background

With an agreement signed on June 22, 2020, PREPA entered into a contract with LUMA Energy, LLC and LUMA Energy ServCo, LLC (LUMA) for the privatization of PREPA's distribution and transmission system.

The PREPA privatization is largely governed by the legal framework of the Public-Private Partnership Act of 2009 that created the Puerto Rico Public-Private Partnerships Authority (P3), with some variances that were incorporated through Act 120-2018, Puerto Rico Electric System Transformation Act.1 This governmental corporation is responsible for determining the functions, services or facilities that should be privatized, as well as outlining the public policies surrounding any privatization. The act also outlines a uniform procurement process under which privatization can occur.

The Puerto Rico Transmission and Distribution System Operation and Maintenance Agreement sets out the following structure:

A. The Stakeholders

The Owner is PREPA, a public corporation and governmental instrument of the Commonwealth of Puerto Rico.

The Administrator of the contract is the Puerto Rico Public-Private Partnerships Authority (P3), a public corporation of the Commonwealth of Puerto Rico.

The Management Company is run by a newly formed consortium, LUMA Energy LLC, a limited liability company organized under the laws of Puerto Rico, and LUMA Energy ServCo LLC.2 This Management Company is composed of:

- ATCO Ltd., a diversified global holding company that operates electric transmission and distribution (T&D) systems. It has 6,500 employees with 2019 revenues of $4.7 billion (CAD). The company is based in Calgary, Canada.3 The company's holdings in power plants, pipelines, ports, and transmission and distribution infrastructure includes a mix of hydroelectric, coal and natural gas sources. The company recently sold a portfolio of coal and natural gas electricity assets in Canada.4 The company has a current market capitalization of $4.5 billion and outstanding long-term debt of $9.3 billion.5

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1 Public-Private Partnerships Authority Act, No. 29-2009
4 Ibid.
• Quanta Services Inc., an infrastructure solutions provider for the utility, pipeline, energy and communications industry. Located in Houston, Quanta had revenues last year of $12.1 billion and more than 40,000 employees. It has a current market capitalization of $7.4 billion.

• Innovative Emergency Management, Inc., an emergency management and disaster recovery firm located in Morrisville, N.C. It is one of the largest women-owned businesses of its kind.

The agreement between PREPA/P3 and LUMA has been deemed a "qualified management contract," ensuring the tax-exempt status of PREPA's legacy and restructured debt, as well as the future eligibility of potential federal funding. This agreement constitutes the complete privatization of the operation of the Island’s electric transmission and distribution and customer service systems, as well as the administrative functions (human resources, finance), rate planning and setting, reconstruction, federal funding, energy policy, power procurement, and integrated resource planning, thus creating monopoly control of the entire energy apparatus of Puerto Rico.

The Regulator is the Puerto Rico Energy Bureau (PREB). It is not a party to the contract but plays a pivotal role. PREB reviews and approves operations and finance. It establishes rates and the island's Integrated Resource Plan, as well as significant operational plan and individual asset transactions.

The Financial Oversight and Management Board (FOMB) is not a party to the agreement but is mentioned in the contract. Its general purpose is to ensure the development of a financial plan for the Commonwealth and covered authorities like PREPA. The FOMB approves PREPA’s annual budget, multi-year financial plan and critical contracts like this one with LUMA. Its relationship to the parties in this contract is to be spelled out in a FOMB Protocol Agreement.

B. Selection of LUMA as the Contractor

Pursuant to the Puerto Rico Electric System Transformation Act, LUMA was recommended on May 15, 2020, by the Partnership Committee of the P3 Authority to assume responsibility for operation, maintenance, repair, restoration, and

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7 Yahoo! Finance, Quanta Services, Inc. September 5, 2020.
9 PREPA and P3 Authority. Puerto Rico Transmission and Distribution System Operation and Maintenance Agreement. Section 3.9, p. 37.
12 PREPA and P3 Authority, Puerto Rico Transmission and Distribution System Operation and Maintenance Agreement, Section 1.1. Definitions.
replacement of the Puerto Rico electric power transmission and distribution system.\textsuperscript{13}

The privatization process began on Oct. 31, 2018, with P3’s release of a Request for Qualifications for the project. Statements of Qualifications were submitted by five private sector parties. On Jan. 17, 2019, the P3 Partnership Committee, which had responsibility for the overall management of the process for the award of the project, selected four entities to compete in the Request for Proposal (RFP) process. It released the RFP on Feb. 1, 2019. Two parties submitted proposals, LUMA and PSEG. The Partnership Committee unanimously recommended LUMA be awarded the contract. The committee noted LUMA was “uniquely equipped to reinvigorate Puerto Rico’s electricity T&D system... ushering in both a clean and resilient energy future for the people of Puerto Rico, and rapid disaster and emergency response expertise to ensure the safety of the people of Puerto Rico.”\textsuperscript{14}

\textbf{C. Terms of the Contract}

The contract is divided into three distinct periods: The Front-End Transition Services Period, the Operation and Management Services Period, and the Back-End Transition Services Period. Before the contract became effective on June 22, 2020, several conditions had to be satisfied,\textsuperscript{15} most notably acceptance and/or authorizations by the various oversight parties, including the P3, PREB, PREPA, and FOMB, as well as the Governor of the Commonwealth. In addition, it was incumbent on PREPA to deposit at least 4 1/2 months of the estimated front-end transition services fee into a separate account.\textsuperscript{16}

The initial term runs from the effective date through the 15\textsuperscript{th} anniversary of the service commencement date. In addition, the contract can be extended for additional periods to be determined and on terms and conditions “agreed to in good faith.”\textsuperscript{17}

\textbf{D. Front-End Transition Period}

Upon the effective date of the agreement, the front-end transition period commences. The intent of this period is to provide time for LUMA to complete a host of administrative tasks and secure approvals not yet in place. The time is also to be spent by other parties to this contract and vendors working under separate agreements to secure approval of a financial restructuring agreement. The P3 Authority and LUMA is required to accomplish an extensive list of administrative benchmarks that must be secured or waived prior to the commencement of the operations and maintenance services period, also known as the initial term. The list

\begin{itemize}
  \item \textsuperscript{13} Public-Private Partnerships Authority. \textit{Puerto Rico Public-Private Partnership for the Electric Power Transmission and Distribution System.} May 15, 2020, p. 3.
  \item \textsuperscript{14} Public-Private Partnerships Authority, \textit{Puerto Rico Public-Private Partnership for the Electric Power Transmission and Distribution System.} May 15, 2020, p. 4.
  \item \textsuperscript{15} PREPA and Public-Private Partnerships Authority. \textit{Puerto Rico Transmission and Distribution System Operation and Maintenance Agreement.} June 22, 2020, Article 2, Section 2.2(a), p. 34.
  \item \textsuperscript{16} \textit{Ibid}, pp. 34-35.
  \item \textsuperscript{17} \textit{Ibid}, Article 2, Section 2.3, p. 35.
\end{itemize}
includes 22 areas such as: Management, administration and owner responsibilities, compliance with existing governmental prohibitions and any injunctions, pre-existing environmental conditions, initial budgets and rate orders, federal funding, remediation plans, Title III bankruptcy approvals and PREPA’s Reorganization Plan.\(^\text{18}\)

LUMA is entitled to reimbursement for expenses during this period consistent with the completion of activities outlined in the front-end transition plan.\(^\text{19}\)

The contract does not specify whether the list of governmental approvals for the PREPA reorganization includes legislative approval of some or all of the agreement. One area, changing the ownership structure to include new companies—GenCo and GridCo\(^\text{20}\)—would appear to require an alteration of PREPA’s statute.\(^\text{21}\)

The front-end transition fee includes reimbursement for time spent by LUMA employees consistent with the rates bid, as well as a fixed fee in the amount of $60 million annually and “all other reasonable and documented costs and expenses.”\(^\text{22}\)

**E. Operations and Maintenance Services Period**

Upon successful completion of the front-end transition period, the 15-year operations and maintenance service period will commence. LUMA will be responsible for providing “management, operation, maintenance, repair, restoration and replacement and other related services for the T&D System.” It will also “establish policies, programs and procedures” for those services, in accordance with the contract standards.\(^\text{23}\)

**F. Financial Performance**

LUMA will be “entitled to exercise all of the rights and perform the responsibilities of PREPA (the Owner) in providing the O&M Services,” and to “have the autonomy and responsibility to operate and maintain the T&D System” and “establish the related plans, policies, procedures and programs” to operate the entire system.\(^\text{24}\)

In addition to reimbursing LUMA for all T&D pass-through expenditures, generation pass-through expenditures, capital improvements, outage event costs and any other amounts as compensation for the performance of the O&M Services, LUMA will be paid a management service fee consisting of a fixed fee and an incentive fee.\(^\text{25}\) The

\(^{18}\) *Ibid*, Article 4, Section 4.5 (a–v).


\(^{20}\) GridCo is the new company contemplated by the agreement to act as the manager of Puerto Rico’s electrical grid. GenCo is the new company contemplated by the agreement to as the manager of Puerto Rico’s generation assets. See: *Ibid*, Section 1.1.

\(^{21}\) *Ibid*, Section 4.5(q), p. 54.

\(^{22}\) *Ibid*, Section 4.6, page 55.

\(^{23}\) *Ibid*, Article 5, Section 5.1, p. 62.

\(^{24}\) *Ibid*, Article 5, Section 5.1, p. 62.

fixed fee will be paid in 12 equal installments and is expected to range from $70 million to $105 million annually,\textsuperscript{26} possibly increasing to as much as $115 million.\textsuperscript{27}

The incentive fee is based on LUMA achieving or exceeding a number of performance metrics outlined in the agreement. These "performance categories" are: 1) Customer Satisfaction, 2) Technical, Safety & Regulatory, and 3) Financial Performance. The incentive fee is paid based upon the P3 Authority's assessment of LUMA's progress.\textsuperscript{28}

The contract also provides for separate, additional payments to LUMA Energy for: 1) activities that fall outside the scope of services in the contract; 2) costs related to the Title III bankruptcy proceeding; and 3) any fees associated with LUMA assisting PREPA or its successors with management and administrative fees.

In addition to the pass-through costs, the total amount specified in the contract before inflation and assuming performance metrics are met for the operations and maintenance services period are as follows: 1) fixed fee of $\textbf{1.625 billion} (beginning at Year 1 of $70 million and increasing to $105 million by the final year of the initial term) plus, 2) Incentive Fee $\textbf{309 million} (beginning at Year 1 of $13 million and increasing to $20 million by the final year of the initial term).\textsuperscript{29}

\textsuperscript{26} \textit{Ibid}, Management Company Responsibilities, Service Fee, Annex VIII.

\textsuperscript{27} \textit{Ibid}, Puerto Rico Transmission and Distribution System Supplemental Terms Agreement, Section 3.3.

\textsuperscript{28} \textit{Ibid}, Management Company Responsibilities, Calculation of Incentive Fee Annex X.

\textsuperscript{29} PREPA and Public-Private Partnerships Authority. \textit{Puerto Rico Transmission and Distribution System Operation and Maintenance Agreement}, Annex VIII.
Privatization of Puerto Rico’s Grid

A. The T&D Agreement extends beyond a Transmission and Distribution Agreement to a full privatization of PREPA’s operations.

The contract with LUMA is not solely a T&D operation and management agreement. The LUMA contract identifies a scope of services that goes beyond management of PREPA’s transmission and distribution assets and gives LUMA responsibility for planning, rate setting, asset management, budgeting, procurement, collections, public relations and other financial matters. It is a full privatization of PREPA’s operational functions.

The contract provides a scope of services that covers:

- T&D System Operations
- Asset Management and Maintenance Services
- Continuous Improvement Services
- Government Community and Media Relations
- Testing, Reports and Records
- Finance and Accounting Services
- Emergency Response
- Maintenance
- Customer Service

LUMA’s responsibilities are therefore not restricted to the very difficult task of managing the issues of system reliability and resiliency, but extend to difficult policy issues that PREPA has never resolved. The risk of failure is high. This private company, with no experience in Puerto Rico, is expected to provide technical and professional services to rebuild the grid and be the public face of its transformation.

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B. LUMA is paid a fee and does not risk any money. This is not a typical partnership agreement.

The agreement also does not meet a basic standard for a public-private partnership arrangement. LUMA Energy is not obligated to invest any equity in the project.

Public-private partnerships can take many forms. Arrangements between public and private sector interests to support public infrastructure and services employ a wide range of financial options related to ownership, construction, operations, maintenance, finance, regulation and reporting.

The Government Accountability Office (GAO) offers a definition that summarizes one critical ingredient usually common to public-private partnerships:

"Under these arrangements, the agency may retain ownership of the public facility or system, but the private party generally invests its own capital to design and develop the properties. Typically, each partner shares in income resulting from the partnership. Such a venture, although a contractual arrangement, differs from typical service contracting in that the private-sector partner usually makes a substantial cash, at-risk, equity investment in the project, and the public sector gains access to new revenue or service delivery capacity without having to pay the private-sector partner."\(^{31}\)

The agreement between P3 and LUMA Energy does not require LUMA to invest any of its own money.\(^ {32}\) The assumption is that most or all of the funds will come from federal sources.\(^ {33}\) If federal funds fail to materialize, there appears to be no backup plan. This is troubling for three reasons:

First, Quanta and ATCO have a combined market capitalization of $11.9 billion. The estimated investment levels needed in Puerto Rico electrical infrastructure are in the $20 billion range. ATCO is heavily leveraged. These companies are poorly positioned to raise additional dollars in the capital markets if the need arises. The

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\(^ {32}\) Center for New Economy. Analysis of a Long-Term Agreement for the Operation and Management of Puerto Rico's Transmission and Distribution System. August 2020, p. 20. See also: Public-Private Partnerships Authority, Puerto Rico Public-Private Partnership for the Electric Power Transmission and Distribution System. May 15, 2020, p. 58. The P3 Committee RFP posed the issue of the operator’s provision of debt as an optional requirement in the RFP. LUMA sent a letter expressing that it could provide financing, but the P3 Committee did not consider the letter of sufficient substance to rate.

inability to attract an operator with resources to invest is a substantial risk to the project.

Second, the contract is also an apparent step backward for the island. The San Juan 5 and 6 agreement with New Fortress Energy (NFE) required the company to provide 100% of the capital necessary, to be paid back through the electricity rate over time. This new contract, with no capital commitment from LUMA, suggests that no investor could be found that would invest its own equity.

Although the NFE deal faces several problems, the company put its own money at risk. PREPA is obligated to pay NFE $50 million during the first five years of the agreement.34 The amount of money in the NFE transaction is considerably smaller than the larger costs anticipated with the broader build-out.

Third, there is no evidence that the federal funds sought by PREPA will arrive on time or be sufficient to complete the work.

The lack of any investment by LUMA makes this a service contract and not a partnership. Although a lack of equity investment increases PREPA’s risks under the agreement it also allows for easier termination of the agreement as is recommended in this report.

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34 PREPA. Fuel Sale and Purchase Agreement, Exhibit D Natural Gas Manufacturing Surcharge Discount of Surcharge Amount. March 5, 2019.
Biased Approval Process

Edison Avilés-Deliz is the current chairman of the Puerto Rico Energy Bureau. He was appointed to and served as a member of the P3 Partnership Committee that reviewed, rated and approved the LUMA contract. Avilés-Deliz’s appointment appears to have been made by the board of the P3 Authority. This selection by the P3 board was discretionary as the provision sets the qualification of this appointment as an official from any government entity.

As a member of the Partnership Committee, Avilés-Deliz submitted a ranking of the submissions made by LUMA and other competitors to the committee. This ranking was included in the scoring of the proposals and served as a critical element in the approval of the LUMA contract. Avilés-Deliz voted for the approval of the project as part of the committee’s unanimous consent.

The preliminary LUMA contract then came before the Puerto Rico Energy Bureau (where Mr. Avilés-Deliz is the chairman) to secure a legally required certificate of energy compliance. On June 17, 2020, the Energy Bureau issued a final order granting the certificate. Avilés-Deliz signed the order, allowing the board to achieve the majority required by law. Given that one member of the board (Commissioner Angel Rivera de la Cruz) dissented, the motion on the resolution was passed and the certificate of energy compliance granted. If Avilés-Deliz had recused himself, under the board’s governing statute, the resolution would have failed for lack of a majority vote. At the time of the vote, the five-member board had one vacancy. Three votes were needed for a majority.

PREB is an independent government entity designed to review decisions related to electricity provision on Puerto Rico based on an objective assessment. The chairman cannot be considered to be objective in this case, as he had already been privy to facts (and undoubtedly ex parte communications) and had expressed approval for the project as a member of the P3 Committee.

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37 Ibid, p. 57.
38 Public-Private Partnership Authority Act, No. 29-2009, Section 8(a)(iv).
40 Ibid.
41 Ibid, p.57.
Internal Controls, Governance Lacking

A. The formal oversight and governance structure is an interlocking set of checks and balances.

LUMA Energy is replacing PREPA as the operator of the island’s electricity grid. The P3 Authority has the responsibility to help develop and approve plans and strategies for implementation, including performance metrics. The P3 Authority will judge LUMA’s performance against these metrics and approve incentive fee payments to LUMA.

PREPA remains the owner, but it is uncertain how it will function. The PREB will approve rates (and the budgets they support), energy planning (the IRP and its implementation) and certain contracts. PREB also reviews, modifies, approves and monitors LUMA’s adherence to the performance metrics.

The FOMB will assess the efforts of the T&D provider and the partnership structure. It will determine if actions taken by LUMA are consistent with the certified financial plan.

B. The oversight and governance structure is poorly designed, and the responsible agencies have weak oversight priorities, poor track records, limited core competencies and resource constraints. They are improperly equipped to monitor and enforce this contract.

The contract concentrates too many public goals—rates, planning, renewable energy, and public participation in a private company with too few oversight mechanisms and poorly prepared oversight agencies.

LUMA is entitled to the fixed fee on a monthly basis (established over time between $70 million and $115 million annually). The P3 Authority processes the fixed fee payments. No provision is made to tie the fixed fee payments to performance.

The P3 Authority makes the final decision to pay LUMA some or all of the incentive fee.44 The PREB approves the performance metric used to judge LUMA’s progress toward its planned objectives, but it lacks the authority to enforce them. The PREB can establish oversight proceedings to review post-expenditure reviews and audits. It is unclear, however, whether PREB hearings, audits, reviews or orders are binding

upon the P3 Authority.\textsuperscript{45} There is no provision to prevent or penalize waste by LUMA or the P3 Authority.\textsuperscript{46} PREB must also agree to the imprudent costs and pass them along to consumers in any rate proceeding, absent penalties or other sanctions.\textsuperscript{47}

The P3 Authority has no experience designing, operating or overseeing a utility operation. The P3 Authority lacks the ability to properly monitor this complex contract and the significant expenditures it will be required to approve. In recognition of the P3 Authority’s limited capacity, the contract allows it to retain consultants to assist with its oversight responsibilities.\textsuperscript{48} The P3 Authority’s planned expenditures of $9.5 million identified in PREPA’s FY 2021 budget appear to cover expenses related to the contract transaction, but not to operations.\textsuperscript{49} The likelihood of cost overruns in this area of the budget for FY2021 is high, and future costs will arise to either pay for additional P3 staff or additional consulting capacity.

In addition to its rate and planning functions, the PREB must also approve the performance metric used to judge LUMA’s progress toward its planned objectives. The current contract contains an outline of performance metrics that focus on customer service (25%), technical/reliability (50%) and finance (25%).\textsuperscript{50} A final set of performance metrics must be developed with P3 Authority and PREB approvals.\textsuperscript{51}

The broad categories offered in the illustrative example of performance metrics do not currently address: 1) the island’s energy goal to move to 100% renewable

\textsuperscript{45} PREPA and Public-Private Partnerships Authority. Puerto Rico Transmission and Distribution System Operation and Maintenance Agreement. June 22, 2020. The contract assumes that the P3 Authority will take actions so as to avoid jurisdictional conflict with PREB (Section 3.9(c). The contract does not intend to conflict with PREB’s jurisdiction over the Operator and Owner (Section 20.17), however jurisdiction disputes appear to be settled by litigation between PREB and the P3 Authority (Section 6.2 (iv) and Article 15.1).

\textsuperscript{46} This problem of post expenditure review has been identified as a key flaw in the PREPA regulatory and management structure. Also see: Puerto Rico Energy Commission. Final Resolution and Order, CEPR-AP 2015-002. 2014, paragraph 51, p. 24. That is, once PREPA spends money, ratepayers must reimburse it whether or not the expenditure was prudent. The LUMA contract does nothing to address this fundamental problem—it simply replaces LUMA with PREPA and provides a weak fee structure as an incentive.

\textsuperscript{47} PREB has approval authority over the annual budget proposed by LUMA and the P3 Authority. How that authority will be used is uncertain. As noted in the above captioned PREC Final Resolution and Order the budget approval authority is seen as a less than effective measure to prevent imprudent expenditures. IEEFA has proposed a series of reforms to improve budgeting, expenditures and other critical financial management functions. See: IEEFA Letter to Puerto Rico Legislature, October 2019.

\textsuperscript{48} PREPA and Public-Private Partnerships Authority. Puerto Rico Transmission and Distribution System Operation and Maintenance Agreement, Rights and Responsibilities of Administrator, Section 6.2 (d).


\textsuperscript{50} PREPA and Public-Private Partnerships Authority. Puerto Rico Transmission and Distribution System Operation and Maintenance Agreement, Annex IX.

\textsuperscript{51} PREPA and Public-Private Partnerships Authority. Puerto Rico Transmission and Distribution System Operation and Maintenance Agreement, Management Company Responsibilities, Section 4.2(f), p. 45. See also pp. 52-55 for more complete description of the scope of the illustrative performance measures.
energy; 2) the need for a rate of 20 cents/kWh; 3) specific goals related to workforce productivity initiatives or relations with labor; 4) adoption of budgets that are balanced and provide access to the capital markets; and 5) improving internal controls to prevent political hiring, favoritism in contract awards, excessive payments and to ensure timely, accurate financial reporting.

The FOMB reviews LUMA’s progress to see that it is consistent with the certified fiscal plan, a document with vague goals for which there is no effective penalty if they are not achieved. For example, after four years of existence, FOMB and PREPA have yet to report to the public on progress related to PREPA’s annual program of planned savings.\(^{52}\)

LUMA is responsible for day-to-day operations, but it is not penalized if it fails to meet goals. The only penalty for operational failure in the contract is a smaller incentive fee at the end of a year. The larger fixed fee in the service fee is paid independently of any performance considerations.

The LUMA co-venture between Quanta and ATCO represents two companies with inadequate capitalization to raise private capital if federal funds fail to materialize. This eventuality is not contemplated in the contract at all. The contract also does not prohibit LUMA Energy from awarding contracts to its parent companies, Quanta and ATCO. Quanta has already informed its investors that it sees an opportunity to compete for work under Puerto Rico’s $18 billion plan managed by LUMA Energy.\(^{53}\)

PREPA’s role, function and budgets are poorly defined, even as it remains the owner. A weak governance structure decreases the chances of successful contract execution. The risks associated with each oversight entity stem from known, identifiable and specific oversight performance deficits.

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\(^{52}\) The failure of the FOMB to establish an effective monitoring program to track actual savings in the PREPA budget was first pointed out in May 2018. See: IEEFA. The Puerto Rico Electric Power Authority’s Flawed Fiscal Plan. May 2018. See pp. 11-13 for a discussion of the role of monitoring savings initiatives in the PREPA budget. The problem of a lack of a rigorous monitoring program of savings was raised again in IEEFA. Is Puerto Rico’s Energy Future Rigged? June 2020. This problem was reiterated more recently see: Letter to Natalie Jaresko, Executive Director FOMB from Tom Sanzillo, IEEFA and Ingrid Vila-Biaggi, Re: Response to New Fortress Energy Letter, Sept. 7, 2020.

Renewable Goals Ignored

A. LUMA is not incentivized or required to move the island’s grid from its state of disrepair toward 100% renewable energy.

The principal goals to be achieved by a new electricity grid in Puerto Rico are resilience, accessibility and affordability. The operation agreement, which is the principal contract that governs the deployment of organizational resources to achieve these goals, is silent on how LUMA Energy will be held accountable for achieving the optimal generation mix.

Nowhere is this more obvious than in the area of renewable energy in Puerto Rico. The law in Puerto Rico establishes a goal of 100% renewable energy by 2050 and interim goals for prior years. The recently approved IRP offers a mix of generation resources that, if implemented, will move the grid toward a greater reliance on renewable energy. It calls for the maximization of solar energy in the generation mix. It is uncertain whether the approved IRP by the PREB will be challenged in any follow-up proceedings or undermined through administrative mechanisms, or whether PREPA will seek to modify the approved IRP.

LUMA and the parties to the contract are charged with reviewing the IRP and, if necessary, offering changes to it. PREPA’s substantive approach to the IRP has been to consistently advocate for natural gas solutions for Puerto Rico. The recently approved IRP canceled some of these plans. LUMA and the parties to the agreement have a choice: To adhere to the current approved IRP and to improve on implementation of the legislative goal of 100% renewable energy, or to facilitate the development of natural gas infrastructure at levels of oversupply and cost that are unsustainable. In a status report filed at PREB, PREPA is already indicating it will not be able to meet the renewable and storage capacity requirements set forth in the IRP resolution.

The agreement designates LUMA as the representative of the electricity system to the Puerto Rico Energy Bureau for the purposes of future IRP processes. The contract, for example, directs LUMA to align its planning with the Grid Mod Plan. This plan increases the use of liquefied natural gas (LNG) as a transition fuel that is more efficient and less polluting than the current use of diesel fuel, as well as

55 Ibid, paragraph 855.
56 Puerto Rico Transmission and Distribution System Operation and Maintenance Agreement, Owner and Administrator Responsibilities, Section 4.3(j), pp. 50-51.
59 Ibid, Contract, System Regulatory Matters, Section 5.6 (a), p. 66.
60 PREPA. Grid Modernization Plan for Puerto Rico.
61 Ibid, p. 4.
62 Ibid, p. 5.
63 Ibid, p. 6.
Contract Between Puerto Rico, LUMA Energy Sets up Full Privatization, Higher Rates for Island Grid

placing LNG a long-term, equal footing with solar and storage capacity investments. The plan is PREPA’s centerpiece strategy presented to the federal government. The report identifies $20 billion in new funding required to rebuild the grid. Of this amount, $13.2 billion is dedicated to T&D investments that appear to be dedicated to centralized generation supports, like natural gas. There is $3.9 billion for generation investments that identify clean energy and upgrades to current generation, and another $1.8 billion for microgrid investments.

Investments made along these lines, largely with federal dollars, will ensure the overbuilding of natural gas capacity and provide almost no support for renewable energy, the purported goal of Puerto Rico law.

Much of the responsibility outside of LUMA for the realization of the renewable energy goal rests with the PREB. The bureau and its predecessor, PREC, have approved: The New Fortress Energy contract outside the scope of the Integrated Resource Plan; the failed Restructuring Agreement that was ultimately rejected by the FOMB because it was unsustainable; and a Transmission and Distribution agreement that does not ensure compliance with basic provisions of Puerto Rico law. As noted in this report, the recent participation by the chairman of the PREB in the selection of LUMA is an obvious lapse in judgment.

The main problem with the agreement is that it does not specifically support a path to 100% renewable energy. The laws of Puerto Rico do. Plans have been created for greater participation and cost savings initiatives by energy consumers in Puerto Rico through energy conservation and efficiency, photovoltaic systems on rooftops or close to the point of use, energy storage (battery) systems and other alternatives to centralized generation at fossil fuel plants.

Absent substantial changes to the current contract structures in place, the contract simply anticipates support for highly centralized generation and supportive T&D investments.

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64 Ibid.
66 PREPA. Grid Modernization Plan for Puerto Rico, p. 9.
B. LUMA is not incentivized or required to move the cost structure toward a 20 cents/kWh level.

1. The 20 cents/kWh goal established by the Legislature is designed to grow Puerto Rico’s economy.

The Puerto Rico Legislature passed Act 17-2019, setting 20 cents/kWh as the rate affordability goal of PREPA’s transformation process. The Legislature reached this view after an extensive review of Puerto Rico’s economic, fiscal and energy condition, and after a survey of the energy laws that govern the Commonwealth. Included in that review was Act 120-2018, the law that forms the statutory basis for the LUMA Energy contract.

The 20 cents/kWh price of electricity goal is reflected in PREPA’s FY 2020 Fiscal Plan as operationally achievable under certain circumstances, most notably a heavy reliance on renewable energy and no debt service. This financial goal reflects several enduring realities of the economy of Puerto Rico.

The economy is currently in a negative growth phase and is likely to remain as such for the foreseeable future. The Commonwealth and PREPA have been filing annual budgets and updated financial plans since FY 2017 with the Financial Oversight Management Board. The economic outlooks expressed in those documents have deteriorated over this period. For example, in the Commonwealth’s FY 2017 Certified Financial Plan, the economic outlook through 2016 projected steady but modest progress in a low-growth environment. In its most recent, FY 2020 growth is largely negative through the same period.

Continued negative growth brings persistent poverty, an unstable job market, and sporadic and low household income. From an energy perspective, negative growth reduces consumption of electricity, lowering annual revenues. Negative economic growth also undermines the ability of PREPA or its successors to borrow money and rebuild the system. PREPA’s current financial plan recognizes this problem and

Families face life-threatening conditions when they have no or severely limited access to electricity.

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73 Ibid, p. 49.
75 Ibid, p. 19.
assumes a high degree of federal funds that will be used to reconstruct the island’s electricity grid.

Higher rates will mean less electricity consumption by Puerto Rico households. Families face life-threatening conditions when they have no or severely limited access to electricity. The hurricanes of 2017 shut down Puerto Rico’s electricity system and killed at least 2,975 people. Less well-understood are the impacts of a prolonged period without electricity on the well-being and mortality of Puerto Rico’s people.

Higher rates will mean Puerto Rico’s businesses will be faced with a cost structure that has direct negative impacts on Puerto Rico’s gross domestic product, its businesses and its entire population.

2. **The structure of the contract pushes prices toward 30 cents/kWh.**

The agreement sets no particular operational goals for the price of electricity charged by the new system and no specific savings targets. It is unclear how LUMA Energy’s contract requirements are aligned with the current financial plan and price of electricity it assumes.

The contract gives LUMA Energy broad authority to seek increases, and it’s expected to seek an increase soon. LUMA is appointed as the owner’s representative before the PREB.

> “From the Service Commencement Date and during the duration of the Term thereafter, Operator shall function as agent of Owner, and Owner hereby irrevocably authorizes Operator to (i) represent Owner before PREB with respect to any matter related to the performance of any of the O&M Services provided by Operator under this Agreement, (ii) prepare all related filings and other submissions before PREB and (iii) represent Owner before any Governmental Body and any other similar industry or regulatory institutions or organizations having regulatory jurisdiction.”

The contract also assumes that LUMA Energy will collect the transition charge that is ultimately approved by the Bankruptcy Court to settle PREPA’s legacy debt

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81 *Ibid*, Section 5.6(a). p. 66.
LUMA Energy is also charged with the responsibility of preparing and submitting the annual budget for the operation of the grid.\textsuperscript{83}

Table 1: IEEFA Estimate of Rate Impact of Selected Cost Drivers Using Current Rate as Baseline (Current to FY 2023) (in C/KWH)

<table>
<thead>
<tr>
<th>Item</th>
<th>Current (May 2020)</th>
<th>FY 21</th>
<th>FY 22</th>
<th>FY 23</th>
</tr>
</thead>
<tbody>
<tr>
<td>Load (Gwh)</td>
<td>16.0</td>
<td>15.7</td>
<td>14.9</td>
<td>13.9</td>
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<tr>
<td>Rates</td>
<td>22.5</td>
<td>24</td>
<td>26</td>
<td>30.2</td>
</tr>
<tr>
<td>Added Expenses</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt\textsuperscript{84}</td>
<td>0</td>
<td>0</td>
<td>3.6</td>
<td></td>
</tr>
<tr>
<td>Fuel \textsuperscript{85}</td>
<td>1.0</td>
<td>2.0</td>
<td>2.0</td>
<td></td>
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<tr>
<td>Fees\textsuperscript{86}</td>
<td>0.5</td>
<td>1.5</td>
<td>2.1</td>
<td></td>
</tr>
</tbody>
</table>


\textsuperscript{83} PREPA and Public-Private Partnerships Authority, \textit{Puerto Rico Transmission and Distribution System Operation and Maintenance Agreement}, Section 7.3(a), pp. 88-89.

\textsuperscript{84} PREPA. \textit{2020 Fiscal Plan for the Puerto Rico Electric Power Authority}. June 29, 2020. The plan estimates that under PREPA’s current debt obligations that it would owe approximately $900 million in annual debt service payments on an outstanding legacy debt obligation of $9 billion (see pages 72-75 for full debt discussion). Full payment of this legacy debt under current market conditions increase rates between 6 cents and 7 cents per kwh. PREPA offers a scenario in their Fiscal Plan with varying coupon rates assuming the availability of $300 million per year in debt services. PREPA assumes that this level of debt service could pay approximately half of the current legacy debt. The Fiscal Plan also notes that there is uncertainty as to the outcome of debt negotiations. For the purposes of this paper IEEFA has assumed a debt service payment of $500 million per year assuming a closing by end of year FY 2022. IEEFA estimates a 3.6 cents/kwh rate impact in FY 2023 assuming a straight line debt amortization.

\textsuperscript{85} PREPA. \textit{2020 Fiscal Plan for the Puerto Rico Electric Power Authority}. June 29, 2020. The plan anticipates fuel savings from Costa Sur and San Juan 5 and 6. The Plan also notes that San Juan 5 and 6 missed its first year savings target. Fuel savings is calculated by PREPA and the FOMB as the difference between using LNG and the more expensive diesel fuel. The cost savings is calculated against a hypothetical diesel price and hypothetical natural gas price. The proper method for calculating savings is to use prior year expenditures and to compare them with current year and expected expenditures in the future. This creates a facility-based, real-time calculation. In the absence of a sound method for calculating savings we assume that the estimates provided by PREPA for Costa Sur and San Juan are invalid and we add back the “savings” into the baseline costs of fuel. IEEFA assumes that during FY 2022 and FY 2023, normal pricing and price increases will occur consistent with Henry Hub Futures and NY Harbor Diesel Futures pricing. For a discussion of various fuel savings initiatives and fuel outlook in FY 2020 Fiscal Plan see: Section 6.2 Other Assumptions (pp. 51-52) and Overview of FY 2021 Measures, p. 62-63.

\textsuperscript{86} IEEFA assumes that in year FY 2022 and 2023 Fees (including P3, FOMB, Bankruptcy, LUMA fees and added expenses) will amount to $390 and $400 million. It is anticipated that a new round of negotiations with bondholders will occur and that adding to the burden will be PREPA’s absorption of LUMA’s costs of participating in bankruptcy negotiations. It is anticipated that the P3 Authority will require more than $40 million to cover its costs and that of any consultants it
This broad structure is likely to result in upward pressure on PREPA’s current price of electricity of 22.5 cents/kWh. Table I shows the impact on the price of electricity of IEEFA’s estimates of fees, fuel and debt costs not included in PREPA’s annual budget or fiscal plan. The combined impact of all the factors is likely to drive the price of electricity toward 30 cents/kWh. During the review process of the LUMA contract by the Puerto Rico Energy Bureau, Commissioner Cruz stated he could not approve the contract because the record did not contain a cost benefit or other impact assessment.

IEEFA’s conclusion is that the contract supports a working environment that will exert upward rate pressure, based on the following:

1. Existing high fee arrangements for professionals will rise under the contract and push rates up.

The FY 2021 budget for PREPA includes $119 million in fees for the FOMB, bankruptcy consultants and P3 Authority. There is also a $20 million fee for the support of the PREB budget. LUMA Energy’s $135 million in fees is added to this list. LUMA Energy’s expense adds costs of approximately 1 cent/kWh to the FY 2021 price of electricity. The combination of consultant fees (including LUMA Energy) amounts to 1.6 cents/kWh in FY 2021. Stated another way, the $274 million price tag for consultant’s equals 22% of PREPA’s non-fuel budget.

It is highly likely that the payment to LUMA will exceed $135 million for FY 2021. LUMA Energy’s initial payments, which appear as $135 million in PREPA’s budget, are described in the contract as a “front end transition fee.” This fee commences on the effective date of the contract (contract signing) but before the service commencement date (the first day of the service period tolls the 15-year operations contract). During this period, LUMA is compensated with an hourly rate schedule, a $60 million fixed fee, and all other reasonable and documented expenses.

IEEFA assumes that LUMA’s costs under these provisions will rise to $160 million and that at least $30 million in additional expenditures will be needed to pay for LUMA’s costs for participation in future bankruptcy proceedings.

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92 Assuming a FY 2021 load of 15,789 GWh, per 2020 Fiscal Plan for the Puerto Rico Electric Power Authority, p. 43.
94 Ibid, Article 2, Section 2.2 Effective Date, p. 34.
95 Ibid, Annex V.
There are at least three other provisions in the contract that provide a justification for LUMA to receive additional expenditures to carry out its functions. The administrator may request that LUMA perform services outside of the activities covered by the contract. LUMA has the right to enter into subcontracts, and any expenses incurred by LUMA from the Title III bankruptcy case must also be reimbursed (see discussion below in Transition Charge section).

The net impact of LUMA's contract on the price of electricity—that is, the amount already included in PREPA's budget and IEEFA's estimates of additional expenditures—amounts to:

### Table 2: Impact of Cost of LUMA Contract on Price of Electricity (FY 2021 through 2023)

<table>
<thead>
<tr>
<th>FY 2021</th>
<th>FY 2022</th>
<th>FY 2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>LUMA Impact on Price of Electricity</td>
<td>1.2 cents/Kwh</td>
<td>1.3 cents/Kwh</td>
</tr>
</tbody>
</table>

The FY 2021 FOMB certified budgeted amount of $135 million for payment to LUMA Energy stands in stark contrast to the $76 million first-year, front-end transition fee published by the P3 Authority as part of its public report on the awarding of the contract.

It is also almost certain that the service fee schedule provided in the contract will be exceeded and upward pressure will be placed on the price of electricity. The service commencement date occurs when LUMA informs the P3 Authority that it has completed an extensive list of preparatory functions and secured all necessary approvals for operation. The service date launches another payment structure. A service fee is established that is a fixed fee ($70 million for the first year, rising to $105 million in year four) plus an incentive fee ($13 million in first year, rising to $20 million in year four), as well as any pass-through expenditures. It was reported in the media that the annual cost would rise to $125 million.

The contract also contemplates an “interim service” period, defined as the period when all service commencement requirements have been met with the exception of

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96 *Ibid*, Additional Services, Section 5.2(b).
97 *Ibid*, Right to Engage Subcontractors, Section 4.9(a).
101 *Ibid*, Service Fee, Annex VIII.
102 *Ibid*, Annex XI.
**a final order from the Title III court and a tax opinion.**\(^{105}\) It is anticipated this period could last up to 18 months with a potential for extension.

Section 3.3 of the supplemental agreement provides for a fixed fee of $115 million paid to the operator during this period.\(^{106}\) This is compared to an estimated first-year fee under the Service Fee in Annex VIII of $70 million. Apparently, this increase of $45 million in fee payments to LUMA is at the direction of the FOMB.\(^{107}\)

The service fee structure presented in the contract and reported in the media is likely to bear little relationship to actual expenditures given additional generous contract provisions to LUMA.\(^{108}\) In the first year, LUMA’s proposal stated that the front-end transition fee would be $76 million, but PREPA’s FY 2021 budget puts initial amount at $135 million, not including any contractually detailed additional expenditures.

The service fee in the contract states that in the first full year of service operation (perhaps beyond FY 2022), the fee would be $70 million and the incentive pool another $13 million. This $83 million would constitute a reduction from the budgeted $135 million in FY 2021. A supplemental agreement, however, has been signed by the parties. In the likely event that the Title III proceeding extends beyond a transition period, LUMA is entitled to a fixed fee of $115 million—$45 million more than represented in the contract.

**b. The transition charge to repay PREPA’s legacy debt remains a budget priority that LUMA is likely to support.**

LUMA’s role in the settlement of PREPA’s legacy debt is likely to be significant. The company has no experience in municipal bond bankruptcy and so there is a risk that LUMA Energy—like Alix Partners, Filsinger and the FOMB—will accept another financially unsustainable plan. The contract mentions that LUMA will collect the transition fee as part of its scope of services. Expenses associated with its participation in the Title III bankruptcy are not included in the service fee, so any involvement by LUMA will be an added expense.

The current proposed restructuring agreement calls for an initial rate increase of 2.8 cents/kWh and increases to over 4 cents/kWh.\(^{109}\) This proposal is proving

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\(^{106}\) *Ibid*, Section 3.3.


\(^{109}\) PREPA. *2019 Fiscal Plan for the Puerto Rico Electric Power Authority*, June 27, 2019, pp. 55 and 62. The FY 2020 Fiscal Plan makes no mention of the Restructuring Agreement that was carried as a projected expense in prior year fiscal plans.
unsustainable and is on the precipice of rejection.\textsuperscript{110}

As noted above, several involved parties have found the current proposed Restructuring Agreement (RSA) financially unsustainable. Recently, the unsecured creditors committee, a party to the bankruptcy proceeding, has asked the bankruptcy court to set the agreement aside.\textsuperscript{111}

Based on that disclosure and comments by former CEO Jose Ortiz and the FOMB,\textsuperscript{112,113} LUMA will have a significant role in the formulation of the next phase of the restructuring agreement.\textsuperscript{114} The FOMB has called for some unspecified form of debt restructuring similar to the currently proposed deal that is heading toward rejection.\textsuperscript{115}

In the likely event that a new round of negotiations starts and the parties decide to pursue a third restructuring agreement, there is a risk that LUMA will simply agree to another restructuring agreement that establishes an unsustainable debt burden. LUMA is not required under the contract to achieve an all-in price of electricity of 20 cents/kWh. It has been made clear during the debates on the first two agreements that the island’s economy in negative growth or very low growth cannot afford a large debt service legacy charge in the rate.\textsuperscript{116}

A price of electricity structure that purports to retire PREPA’s legacy debt during this period of negative economic growth is unrealistic.\textsuperscript{117} This view has been stated by the lead economic consultant for the FOMB:

\textit{“According to my extensive study of the experience of countries with excessive debt burdens, no sovereign jurisdiction has ever escaped a debt crisis without

\textsuperscript{110}The current Restructuring Agreement was a central component of the FY 2020 Fiscal Plan and is not included in the FY 2021 Plan.
\textsuperscript{112}Ibid, Exhibit B.
\textsuperscript{113}Ibid, Exhibit C.
\textsuperscript{114}Ibid, Exhibits B and C.
\textsuperscript{115}Ibid, Exhibit C.
\textsuperscript{116}The FOMB rejected the initial Restructuring Agreement. See: Puerto Rico Report. Puerto Rico Board Rejects Budget and PREPA deal. June 28, 2017. The current one also fails to meet financial sustainability standards even before the pandemic. Also see: IEEFA. Letter to Puerto Rico’s Legislative Assembly: Secure more viable PREPA debt deal. October 29, 2019.
\textsuperscript{117}London Economics Institute. Critique of Government Parties’ Assertions that the 9019 Settlement Will Not Affect Non-settling Creditors and Will Avoid a Subsequent Title III Filing by PREPA. October 30, 2019.
positive growth. Jurisdictions with territorial status such as Puerto Rico face even greater odds as they have fewer financing options than a sovereign. Current and prior U.S. administrations made it clear that a federal bailout was not an option, placing the full cost of the adjustment on the Commonwealth.”

LUMA’s inclusion into the Title III process also all but guarantees increased payments to the company. The contract specifically identifies that costs related to the Title II proceeding are outside the service fee and will have to be paid separately (see discussion above).

For the purposes of this paper (see Table I), IEEFA assumes that a new restructuring agreement will be closed on by the end of FY 2022. The first full year of impact on the price of electricity will be in FY 2023. IEEFA anticipates that the new agreement will be as unrealistic and unsustainable as the first two agreements. The new round of negotiations will, however, support and extend additional fees for bankruptcy advisors, FOMB, and in this new round of negotiations, the P3 Authority and LUMA.

c. Savings promises made by LUMA and PREPA are not contractual obligations.

The goal of the new professional LUMA Energy team is to improve on PREPA’s historic inability to execute a program of operational reform and budget savings. Continued failure to implement cost savings mechanisms will make it impossible for Puerto Rico’s electricity system to recover and to return to the capital markets.

In its announcement of the partnership agreement, the P3 Authority made specific reference to the operational savings that will be achieved from the partnership with LUMA:

“LUMA estimates that it will generate cumulative net savings of $323 million during the first half of the 15-year term. LUMA’s projected average annual operating savings over the first half of the term are 27% greater than the average annual service fee payable to LUMA, and thus the projected savings will more than offset the service fee.”

There are no provisions in LUMA’s contract that require it to actually achieve $323 million in performance savings. There are also no specific provisions that require LUMA to successfully execute the current specific menu of savings initiatives assumed in the FY 2021 annual budget and identified in the FY 2021 certified financial plan. The contract simply sets the broad parameter that LUMA must stay within the existing budget and specifies how this is defined in relation to budget modifications. In its four years of existence, the FOMB agency charged with

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enforcing financial plan compliance has failed to establish publicly available budget standards and ongoing reports that demonstrate how savings initiatives of PREPA are then translated into actual budget and financial plan savings. This contract, approved by the FOMB, does nothing to cure this fundamental defect of financial management. In fact, the FOMB’s approval actually validates PREPA’s claims to budget savings based upon an announcement of an initiative with no mechanism to further report to the public whether the actual savings ever took place.

There are also no provisions that incentivize LUMA to provide and achieve ongoing savings from specific, measurable initiatives as part of its budget-making responsibilities that are shared with FOMB and the P3 Authority.\footnote{PREPA and Public-Private Partnerships Authority. \textit{Puerto Rico Transmission and Distribution System Operation and Maintenance Agreement}, Financial Performance, Annex IX, p. IX-19-IX-21.} \footnote{\textit{Ibid}, Annex IX, p. IX-5.}

PREPA’s current fiscal plan relies heavily on fuel savings to achieve its short- and long-term fiscal goals.\footnote{\textit{PREPA, 2020 Fiscal Plan for the Puerto Rico Electric Power Authority}, June 29, 2020, p.51.} The first major generation project, New Fortress Energy’s San Juan 5 and 6, “lost savings” of an estimated $192 million last fiscal year.\footnote{\textit{Ibid}, p. 24.} Despite an announcement that the project is complete, the project has encountered additional business headwinds.\footnote{FERC. \textit{Order to Show Cause, Docket CP 20-466-000}, June 18, 2020.} In FY 2021, PREPA anticipates a fuel savings of between 2 cents and 3 cents per kWh—approximately $200 to $300 million annually.\footnote{Jose Ortiz. \textit{Letter to FERC}, July 2020.} If the authority continues to fail to execute on its initiatives, additional “lost savings” will push rates up faster and further. Despite the promises of former CEO Jose Ortiz that electricity bills will go down due to PREPA’s savings initiatives, the new interim chief executive has said he is less certain that electricity bills will decrease.\footnote{\textit{PREPA, 2020 Fiscal Plan for the Puerto Rico Electric Power Authority}, June 29, 2020, p. 43.}

The structure of incentives now in place in this contract push LUMA toward greater cost reductions in areas where the electricity system can least afford them. With no commitment to lower debt costs, a marginal commitment to fuel cost savings, and continued profligate spending on consultants, labor has become the target for cost savings.\footnote{It is possible under the Agreement that LUMA could adopt plans that reduce services to certain classes of Puerto Rico residents in rural areas. How new plans are developed regarding future electricity service will require careful monitoring.} This is one area where new investment will be essential to transform the
current organization, and it is one area where the cuts are likely to focus.\textsuperscript{131}

LUMA is faced with a series of structural cost problems that have gone unacknowledged in this contract. They have also gone unaddressed in PREPA’s budgets, fiscal plan and financial performance since the inception of the FOMB. Additional ratepayer dollars under the current business design use additional income to pay for more consultants, legacy debt under a now-unspecified third restructuring agreement and greater spending on fossil fuels. None of these funds are reinvested in the grid and its employees or for the benefit of ratepayers. The rebuilding effort is being left up to the vagaries of federal funding.

\textsuperscript{131} The issue of unnecessary, unreasonable and arbitrary reductions in PREPA’s labor force is currently before the courts. See: \textit{Unión de Trabajadores de la Industria Eléctrica y Riego, Inc. (UTIER) v. Puerto Rico Electric Power Authority (PREPA), et al.}, No. 17-00229-LTS. March 28, 2018.
Public Participation Jeopardized

The contract assumes a wholesale change in the character of how electricity is provided to the people of Puerto Rico. PREPA is a public corporation. It is supposed to conduct business in an open, transparent manner; it has not. LUMA now assumes the public and governmental relations obligations for the electricity grid. It has immediate challenges.

The principal disclosure that PREPA made as a result of litigation was that it had not prepared basic financial analysis necessary to support privatization of PREPA and deals like the LUMA agreement.132,133 The information sought in the proceedings formed the basis for the overall rationale for privatization of PREPA, its transmission, distribution and other assets.134 Under court supervision, PREPA provided information regarding its privatization efforts that proved relevant to the LUMA contract and to certain unfair procurement practices related to the New Fortress Energy contract.135

PREPA has a long history of non-compliance with requests for information from governmental oversight organizations. It has been cited throughout regulatory hearings as unprofessional and showing poor capability.136

On July 7, 2020, CAMBIO, a Puerto Rico-based nonprofit, requested information regarding the LUMA Energy T&D operating contract.137 Although the P3 Authority began providing some documentation two months later through a very difficult-to-manage format, Law 29-2009 imposes on the P3 Authority the duty of disclosing all public documents related to the LUMA–PREPA transaction upon approval of the

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133 Testimony of Ingrid M. Vila-Biaggi, P.E. and Luis E. Rodríguez-Rivera, Esq., Transformation of Puerto Rico Electricity Power Authority, Before the House Natural Resources Committee, August 6, 2020. (“Vila-Rodríguez Testimony”).
134 Ibid.
137 Testimony of Ingrid M. Vila-Biaggi, P.E. and Luis E. Rodríguez-Rivera, Esq., Transformation of Puerto Rico Electricity Power Authority, Before the House Natural Resources Committee, August 6, 2020.
partnership contract.\textsuperscript{138} To its credit, the P3 Authority produced a procurement report. However, the request for information and the law supports the agency releasing all of the procurement documents involved with the selection of the vendor.

LUMA is a private corporation. The reporting culture and obligations of the two venture partners have some familiarity with the public nature of an electricity system. There are, however, unique transparency issues in Puerto Rico due to the severely distressed financial situation and challenging weather and climate conditions. These are specific to the regulatory environment in Puerto Rico. If LUMA is to adhere to public standards of transparency, those requirements will have to come through the T&D Agreement. There are no provisions related to LUMA’s responsibilities for openness to the electricity grid’s stakeholders.

\textsuperscript{138} OMB Puerto Rico, Public-Private Partnerships Authority Act, Procedure for the Selection of Proponent and Award of Partnerships, Section 9 (j) Publicity.
Unqualified Regulator

The Puerto Rico Energy Bureau is charged under the contract with approving rates, planning (including the IRP and performance metrics) and major procurements. The PREB has not demonstrated that it is prepared to handle a robust regulatory program. In its first review of a major contract, the bureau approved the New Fortress Energy contract for San Juan 5 and 6. The project is more than a year late in meeting its goals of delivering natural gas to a newly upgraded plant. The contract is now the subject of an administrative action related to NFE’s questionable contention during the contract procurement process that it did not have or need a Federal Energy Regulatory Commission permit for the operation of its natural gas terminal. This item was overlooked by the PREB.

Similarly, NFE was unable to achieve the savings it projected for the first year of the contract and is unlikely to ever achieve the planned savings of its original proposal or any of the subsequent downward revisions of savings. The PREB and the FOMB handled the key element of fiscal savings in this matter without attention to actually achieving the savings, and now they will not achieve those savings and have no recourse to take enforcement action on the matter.

IEEFA and Cambio have summarized the failure the FOMB to address the issue of fiscal savings in the matter of the NFE contract.

“On March 4, 2019, the FOMB sent its approval of the NFE contract to PREPA. In the approval letter, it stated that the project could save between $36 million and $56 million on an annual basis. Since FOMB staff apparently reviewed the procurement record, they might have noticed that NFE claimed annual savings of $260 million. And on March 15, 2019, it was reported in the papers that PREPA and then-Governor Rossello put the savings at $150 million per year. With the FOMB’s estimate at significant variance from NFE’s and PREPA’s, we fail to see the basis of your reasonableness determination. Further to the point, on June 27, 2019, the FOMB certified the FY 2020 Fiscal Plan for PREPA that included an FY 2020 annual savings of $192 million (see page 91). Why, if the FOMB staff concluded that the savings were $36 to $56 million per year, would it certify three months later a savings that was conservatively almost four times higher? With the FOMB’s estimate at significant variance of PREPA’s fiscal plan assumption, we fail to see the basis that the NFE contract was consistent with certified fiscal plan. In short, the FY 2020 savings assumptions offered by NFE and PREPA are unsupported by the FOMB’s own analysis. As you know, in the recently approved 2020 Fiscal Plan, the FOMB inserted its March 2019 (p. 62) savings number, but did not include it in any chart or table. In fact, it reported (page 24) that NFE failed to produce any FY2020 savings and referred to them as “lost savings”—not $192 million in savings, but zero savings. Since then, PREPA CEO Efran Paredes- Maisonet has stated that he

does not expect rate savings deriving from the San Juan 5,6 natural gas conversion.”\textsuperscript{140}
Collective Bargaining Scrapped

The agreement also excludes PREPA's unions from the partnership. The management agreement does not recognize UTIER (the largest union) or any other union. LUMA will not be required to recognize the existing collective bargaining agreement with UTIER. The agreement makes it clear that existing seniority and certain benefits will not be honored.

The agreement appears to be contrary to the P3 Authority's statute,\(^{141}\) where certain labor protections are included. Section 15 of Act 120-2018 contains provisions that generally protect the existing workforce. Any agreement under the P3 Authority statutes would be in accordance with existing laws, rules and collective bargaining agreements. The law also provides that no employee will lose their job. More specifically, job security, pension benefits and other vested rights are protected under this statute.

The agreement,\(^{142}\) however, specifically excludes the existing collective bargaining agreement. This provision appears to contradict Act 120-2018.

Partnership arrangements between existing labor organizations and new utility managers are quite common. LUMA Energy, LLC is a joint venture between Texas-based Quanta Services, Inc. and Calgary-based ATCO Ltd. Approximately 35% of Quanta’s 30,500 employees are covered by collective bargaining agreements that require payments to employees for wages, salaries, benefits and pensions.\(^{143}\)

As new operators in other locations have taken on new assignments, existing collective bargaining agreements and union representation have been integrated into the new contracts. For example, the Long Island Power Authority (LIPA) entered an agreement with Public Service Enterprise Group (PSEG) in 2013.\(^{144}\) The agreement identifies the International Brotherhood of Electric Workers (IBEW) as the local union covering the workers, aligns the contract with the existing collective bargaining agreement, further details employee rights under the transition, and enforces existing salaries, health plan and pension agreements.\(^{145}\)

The failure to include labor in the partnership arrangement sets LUMA Energy on a collision course with PREPA’s union staff.\(^{146}\)

Labor/management cooperation has been at the core of strategies adopted by fiscally distressed communities. The turnaround of New York City in the 1970s stands as arguably the most prominent of all such fiscal recovery efforts:

\(^{143}\) Quanta Services. 2019 Form 10-K. February 28, 2020, p. 5.
\(^{144}\) Long Island Power Authority. Amended and Restated Operations Agreement between Long Island Lighting Company (LILCO) d/b/a LIPA and PSEG Long Island LLC. December 31, 2013.
\(^{145}\) Ibid, Section 4.5 (C,D).
“The survival of the city as well as the collective bargaining process necessitated compromise and conciliation and an abandonment of the traditionally adversarial relationship between the city and the unions. For example, the unions agreed to wage increase deferrals and accepted new cost saving programs for increasing productivity and the efficient delivery of public services. Most significantly, the unions agreed to commit employee pension fund contributions to the purchase of Municipal Assistance Corporation securities when no one else would buy the city’s bonds. In exchange, the city agreed to give labor a share in the savings it would realize from productivity-enhancing measures, including cost of living adjustments. As a result of the cooperation among government, labor and private enterprise, the city has survived the fiscal crisis. Collective bargaining too has survived—but with significant changes.”

PREPA’s exclusion of its union from the partnership agreement represents yet another poor management decision. PREPA has hired LUMA, an established company with credentials to manage PREPA’s transition according to professional standards. LUMA has long-term relations with existing unions in other countries, knowledge of collective bargaining agreements and uses its union relationships as a selling point to potential customers.

PREPA and the FOMB have, however, chosen to ignore this professional capacity and instead decided on a conflict-oriented approach with labor organizations. Such an approach is a poor management decision. UTIER and the professional staffs of PREPA have served the authority well, particularly during periods of acute stress from weather events. While Puerto Rico’s political leadership failed, PREPA’s leadership failed and PREPA’s generation system failed, UTIER’s employees showed up for work. Union jobs with good salaries and benefits also are scarce on Puerto Rico and represent an important element of the island’s shrinking middle class. Employees live on the island, raise families and spend money in Puerto Rico. The elimination of UTIER and its collective bargaining

agreement is another self-inflicted wound to the Puerto Rico economy.

This decision is not only corrosive to the establishment of the management partnership required at PREPA but also of the need by the FOMB (particularly in the absence of responsible gubernatorial leadership) to include all representatives of Puerto Rico’s community in the solution to the fiscal problem. The most common complaint against control boards is a certain high-handedness that comes with the imposition of their authority, an attitude that inherently diminishes the electoral franchise and weakens the control of local elected leaders. This temporary diminution of democratic institutions is done, in theory, to support the restoration of new fiscal and economic practices and to restore the authority of democratic leaders and local institutions.

The antidote for a board confronted with the pressing dilemmas in Puerto Rico can be found in the experience of several control boards. It is not confrontation with labor. Ultimately, a time of austerity and conflict can also be a time of education, trust-building and negotiated agreements that help a government move from fiscal and political distress toward a new plan that includes a growing economy and a responsible level of service provision. In this instance, the first major public-private partnership agreement for PREPA, the FOMB has ignored these central tenets of sound control board practice and opted for open hostility toward labor.
Unethical Practices

PREPA has a long history of hiring unqualified political appointees in technical and professional fields.\textsuperscript{150} PREPA has awarded contracts with vendors without adequate documentation, lacking in competitive bidding and with poorly supervised oversight.\textsuperscript{151} PREPA has a system of weak internal controls that allows for payments that cannot be justified.\textsuperscript{152}

Kobre and Kim, a law firm hired by the FOMB to investigate the Commonwealth’s debt practices, found that the excessive hiring of political employees had a direct impact on customer rates. The FOMB has raised the issue but then failed to require PREPA to take necessary corrective actions to correct it.

Similarly, the contract does not acknowledge this problem and does not require any action. A private corporation alone cannot be expected to address this type of issue if it is unacknowledged and not considered a priority.

\textsuperscript{150} Kobre and Kim. \textit{Final Investigative Report}. August 2018. The report was originally prepared to clarify potential avenues that bondholders might have to file claims related to Commonwealth debt issuances. The report is also a highly significant compendium of management abuses that should be the source of remedial action by the FOMB. There has been no public follow-up related to the management abuses or how they are being addressed.


Conclusion

It will take concerted action over a long period of time to achieve the commonwealth’s goal of a resilient, affordable, renewable grid. Every resource used by the island to affect the outcome of its grid transformation needs to be focused on these goals.

This contract transfers rights and responsibilities for the electricity system that are currently housed in a public authority—PREPA. A considerable amount of policy and operational authority is moved to a private corporation—LUMA Energy. Since LUMA Energy and its parent companies are not required to put any of their own money into this contract, it is a fee-for-service transaction and not a typical partnership where gains and losses are shared.

Aside from the high fees that will be guaranteed to LUMA (independent of performance), meeting the requirements to deliver to Puerto Rico a resilient, affordable grid that meets statutory goals is a matter of chance. The requirements in the contract to meet policy and statutory goals are weak. The external oversight structure envisioned in the contract of the P3 Authority, PREB and FOMB are ill-equipped, and in the instance of P3 and FOMB, not designed to handle the operational policy imperatives that require constant attention.

Taken separately, the menu of issues outlined in this paper would be difficult to manage. Taken together, which is how they will occur over time, suggests a high order of operational failure as mistakes of the past are repeated and incentives within the contract structure are misaligned. The contract should be rescinded and a new process put in place to determine the direction of PREPA’s transformation.
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