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**Testimony by  
Tom Sanzillo  
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Before the Permanent Senate Commission for Strategic Projects and Energy  
of the Puerto Rico Senate  
January 25, 2022**

My name is Tom Sanzillo, Director of Financial Analysis for the Institute for Energy Economics and Financial Analysis.

Thank you allowing me to testify on the question of how to retire the PREPA debt without a significant rate impact. This testimony is a summary and update of a letter I sent to the Legislative Assembly in October 2019.<sup>1</sup> I also attach a more detailed listing of my research on the Puerto Rico energy and debt crisis dating back to 2014 for your reference.

I endorse the comments and testimony of Cathy Kunkel from CAMBIO. We have worked together for many years on the problems in Puerto Rico.

I limit my comments to solutions. However, I want to make one observation before outlining my suggestions:

In the Commonwealth's current fiscal plan, Puerto Rico's economy will post marginally positive economic growth through 2025 and then turn negative again. The positive numbers are due to anticipated large infusions of federal revenue that will stimulate spending on the island.

PREPA cannot afford any debt service payments when annual growth is negative.

Reducing PREPA's debt by 80% would be a good place to start. The current PREPA restructuring support agreement (RSA) may reduce PREPA's debt by 15%. I do not believe that either of these is sufficient for PREPA's ratepayers, but the current RSA proposal is far worse for them and the island's economy. The only solid numbers I have seen for the RSA are the electricity price increases that will hit the island's businesses and consumers.

It does not have to be this way.

### **How to Rework the Debt Deal**

The outstanding principal of PREPA's debt is reportedly \$8.26 billion.

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<sup>1</sup> IEEFA. [IEEFA letter to Puerto Rico's Legislative Assembly: Secure more viable PREPA debt deal](#). October 29, 2019.

A careful review of the issues makes clear three things:

- Ratepayers do not have to bear the burden of this debt alone.
- Bondholders do not have to absorb all losses, but have recourse beyond the ratepayer.
- There is also ample money available to ensure that small bondholders who are island residents can be compensated for their bonds. They stand as the principal victims of the fraud that has been committed.

### 1. **At least \$5 billion may be illegal debt.**

PREPA and its ratepayers may not actually owe \$8.26 billion. I have demonstrated in my October 2019 letter that fully \$5 billion had been identified by insurers and FOMB as questionable indebtedness. Why is the Legislature going to assume that Puerto Rico's people should pay for debt that they may not owe?

The Legislature should also consider more fully the Kobre and Kim study that uses more than 100 pages of a 600-page report to challenge the validity of Puerto Rico's debt.

Those advisors who provide information to the Legislature that the \$8.26 billion in outstanding principal of PREPA debt is actually owed are negligent.

### 2. **Bondholders should accept a principal reduction between 70 percent and 90 percent of debt paid by PREPA ratepayers.**

Any new debt arrangement should be consistent with Puerto Rico's ability to pay. Even after Puerto Rico institutes years of financial reforms, its economy will remain in flat or negative growth, and its fiscal condition will be out of balance. Any promise by the Legislature to pay back 60 percent or 70 percent of the face value of PREPA's outstanding indebtedness out of the ratepayer's pocket is reckless.<sup>2</sup>

Bondholders took a risk on Puerto Rico, and the risk did not pan out. We emphasize that the original trust agreement does not guarantee repayment to bondholders. The substantial losses need to be accepted.

On the other hand, bondholders who accept less from PREPA and the Commonwealth need to preserve their rights to move against other stakeholders. Clearly, bondholders have been harmed by illegally issued debt, negligent due diligence and political corruption.

As noted in a prior 2014 report by IEEFA, bondholders that held PREPA debt had an estimated \$7 trillion in assets.<sup>3</sup> For its large bondholders, Puerto Rico's debt constitutes a negligible percentage of their overall holdings. These investment houses, including the hedge funds that bought Puerto Rico's distressed debt, were appropriately hedged against losses incurred.

It is quite common to read newspaper articles that the bond market has shrugged off the losses in Puerto Rico. Eight billion dollars is a lot of money, but it is insignificant against the worldwide \$119 trillion value of the bond market. That market remains stable and capable of absorbing Puerto Rico's problem.<sup>4</sup>

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<sup>2</sup> Securities and Exchange Commission. [Report of Investigation in the Matter of County of Orange, California, As It Relates to the Conduct of the Members of the Board of Supervisors](#). January 24, 1996.

<sup>3</sup> IEEFA. [Opportunity for a New Direction in Puerto Rico's Electric System](#). August 2015.

<sup>4</sup> Wikipedia. [The Bond Market](#).

The bondholders who were hurt the most were small bondholders— island residents relying on the income for basic needs.

If necessary, the Legislature should require that bondholders be accorded no more than 10% of the face value of existing bonds. A third party should be identified to provide proper, accurate and transparent certifications. The Legislature should also, to the degree possible (see below), provide support for bondholder remedies against those who were negligent in the issuance of the debt.

### **3. Bond insurers should pay the full amount of claims.**

The bond insurers were paid premiums by PREPA to insure debt payments in case of default. They should make good on the payments to bondholders for the remaining principal and interest. Instead, the RSA absolves them of their responsibility to pay claims on the debt.<sup>5</sup>

The Legislature should not allow any part of the insured debt to be repaid as part of the transition charge. To do otherwise is tantamount to paying twice for the insurance coverage.

### **4. Underwriters should bear a considerable part of the burden.**

PREPA and its ratepayers have paid hundreds of millions of dollars to attorneys, accountants, financial advisors, investment banks, credit agencies, insurance companies, engineers and a host of consultants to ensure that its debt issuances complied with applicable laws and regulations.

Major studies by credible third-party reviewers contained examples of negligent, if not reckless and perhaps fraudulent diligence performed by these experts.<sup>6</sup> Both reports make it clear that there are probable courses of action against these companies.<sup>7</sup> Many of these advisors are still under contract with PREPA and other Commonwealth agencies. Six of the underwriters on the 2013 bonds that were issued illegally hold assets under management of \$11 trillion;<sup>8</sup> the average household income in Puerto Rico is \$20,539.<sup>9</sup>

If the Legislature ignores the potential for substantial cash payments by these advisers as a resource to help settle PREPA's debt,<sup>10</sup> it too will be guilty of a level of negligence that is hard to understand. The underwriters should be compelled to form a pool for PREPA's debt of between \$3 billion and \$5 billion in cash payments to settle claims related to their negligence.

### **5. Criminal prosecution must be considered.**

A series of grave offenses has been committed against the people of Puerto Rico and against those who invested in PREPA. One of the most unfortunate outcomes from constant political interference with

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<sup>5</sup> Bloomberg. [Bond Insurers Soar After Puerto Rico Strikes Debt Deal](#). August 9, 2018.

<sup>6</sup> Kobre & Kim LLP. [Final Investigative Report to The Financial Oversight & Management Board of Puerto Rico](#). August 20, 2018.

<sup>7</sup> IEEFA. [IEEFA update: Accountability for the banks, law firms, accountants and credit agencies that orchestrated Puerto Rico's \\$72 billion debt crisis](#). September 4, 2018. This update analyzes the Kobre & Kim report.

<sup>8</sup> Current Assets Under Management in the aggregate for Morgan Securities, Citigroup, Bank of America, Wells Fargo, Barclays and Goldman Sachs (last visited websites January 22, 2022).

<sup>9</sup> Census Bureau. [American Community Survey, 2015-19](#). 2020.

<sup>10</sup> Securities and Exchange Commission. [JP Morgan Settlement](#), November 2009. Also see: Business Insider, [Story of Jefferson County Bankruptcy](#), October 2011.

effective oversight of the agency is that no responsibility has ever been assigned for the instances of fraud that have been perpetrated.

Puerto Rico cannot pay back its debt, but any future claim to integrity by the Commonwealth and PREPA must demonstrate a willingness to take strong action against those who broke the law.

#### **6. Re-pay small island bondholders 100% of principal on their bonds.**

It has been reported that many small bondholders who live in Puerto Rico on limited incomes have invested in PREPA and Commonwealth bonds.<sup>11</sup> Large institutional bondholders are the principal bondholders,<sup>57</sup> and they have many remedies to secure their interests that do not require increased ratepayer costs.

If part or all of the steps I outline are taken, the amount of insurance coverage, investor losses and cash payments from underwriters involved should exceed the \$8.26 billion of outstanding bonds. An ample amount can be set aside to assess the size of the liability for smaller investors and the distribution of benefits. Any bill drafted by the Legislature related to PREPA's debt should make provision for reimbursing these bondholders.

Island resident bondholders were encouraged to invest in Puerto Rico under false pretenses. It is a fact in the bond market that individuals do not stand a chance against large institutional investors.<sup>12</sup> Small investors are largely inexperienced in bonds, and most do not have other savings and resources that can hedge their losses like large institutional funds.

#### **7. Whatever is decided on the debt deal, PREPA needs ongoing effective oversight. It needs the imposition of an Independent Private Sector Inspector General.**

Since 2016, IEEFA has been calling for the installation of an Independent Private Sector Inspector General (IPSIG) to act as an independent corruption monitor within PREPA. The IPSIG would work with the governor and agency heads; it would not replace the legitimate leadership of Puerto Rico. An IPSIG would be empowered to investigate PREPA's operations, implement reforms to eliminate wasteful and/or illegal activity, and report violations of law to enforcement authorities.

With all of the talk about exiting bankruptcy and envisioning the sunset of the FOMB, there will still be the need for oversight of PREPA and the private corporations that manage the system in the future.

### **Conclusion**

The Legislature has asked the most important question: Is there a way to provide a fair recovery for the bondholder while not burdening the ratepayer with electricity price increases? The answer is yes.

The basic elements of the bond market are global and work in a self-correcting manner. There are many ways to distribute the losses that occurred in Puerto Rico across the stakeholders in the process. The

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<sup>11</sup> CNBC. [Broken bonds: The role Wall Street played in wiping out Puerto Ricans' savings](#). December 18, 2017. Also see: Center for the Abolition of Illegitimate Debt. [Who Owns Puerto Rico's Debt, Exactly? We've Tracked Down 10 of the Biggest Vulture Firms](#). December 3, 2018.

<sup>12</sup> Annette Thau, [The Bond Book 3rd Edition](#), McGraw Hill Education, 2010, p. 8.

watchdogs of the market – the army of due diligence providers failed the investment community in this instance. The matter should be settled largely between these parties.

These parties, however, are very powerful and they are choosing to push the burden they have created with their negligence onto the ratepayers because they can. The more burden the ratepayer is asked to bear, the less likely it is that the new bonds will be paid off.

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