POLICY BRIEF

Rethinking the Governance of State-Owned Enterprises in Puerto Rico

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Introduction

The executive branch of the government of Puerto Rico carries out its operations through two distinct sets of administrative structures. On the one hand, there are the agencies and departments, such as the Justice and the Treasury departments, which constitute the "central government" of the Commonwealth. On the other hand, there are the state-owned enterprises, commonly known as "public corporations" in Puerto Rico, which constitute what we may call the "other" central government of Puerto Rico.

Historically, the use of public corporations offered several political advantages. Prior to the enactment of the Commonwealth's constitution in 1952, the public corporation device prevented the Washington-appointed governor from interfering with programs under its jurisdiction. According to Charles Goodsell, public corporations were usually located outside government departments; their boards of directors were appointed by a group and not the governor alone; and their managers were appointed by the boards of directors and not by the governor.[1] Therefore, the Puerto Rico legislature in effect created a whole administrative structure independent of and parallel to the established executive departments.

Public corporations were also used to avoid the restrictive debt limit that Congress had imposed on Puerto Rico. The Jones Act of 1917 limited the borrowing authority of the central government and the three largest municipalities to 10 percent of the assessed property valuation. The debt issued by public corporations, however, was not considered a pledge of the full faith and credit or the taxing power of the Commonwealth. Therefore, public corporation debt was excluded for purposes of calculating the limit under the Jones Act. To this day, in fact, the debt of public corporations is accounted for separately from central government debt and the debt service of public corporations is not counted toward the constitutional debt service limitation currently in effect.

Furthermore, according to former governor Roberto Sánchez Vilella, "it was felt that the red tape and political intervention that often hinders governmental activity could be best avoided by a corporation having its own board of directors, able to finance its expenditures from its income, make its own purchases, with the power to borrow for capital needs, in short possessing the legal powers and flexibility of a private corporation yet subject to control on matters of policy by the legislature."[2]

Since the 1940s, therefore, public corporations have been an important feature of the island's government. The public policy rationale was to create entities that were legally incorporated, financially self-sufficient and administratively apart from the regular departments and agencies of the executive branch bureaucracy. Public corporations, in sum, were conceived as a vehicle for government technocrats to efficiently address some of the most pressing problems facing Puerto Rico.

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[1] Charles T. Goodsell, *Administration of a Revolution: Executive Reform in Puerto Rico Under Governor Tugwell* (Cambridge, MA: Harvard University Press, 1965), p. 185.
[2] Id. at 183.

Today public corporations are a significant component of the machinery of government in Puerto Rico. Currently there are 51 public corporations in operation which generate revenues of $8.9 billion, equivalent to approximately 13 percent of Puerto Rico's GNP. Unfortunately, it appears that notwithstanding early successes, public corporations have failed to live up to the standards set forth by Sánchez Vilella. Instead of reducing red tape, public corporations have added dozens of new bureaucratic layers to government and instead of limiting political intervention in government, public corporations have become important sources of political patronage as they provide ample employment opportunities for loyal party members and generous contracts for politically-connected suppliers.

Financial self-sufficiency has also turned out to be a chimera as many public corporations rely on the central government to help them cover their operational deficits and in some cases the central government has been obligated to assume their debt servicing obligations in order to avoid a default. In addition, most public corporations suffer from a severe lack of accountability, oversight and transparency at all levels. The recent shenanigans at the Puerto Rico Electric Power Authority are a good example of this lack of accountability.

In our opinion, the government of Puerto Rico should undertake a comprehensive analysis of the management and operations of its public corporations and establish a new governance framework and regulatory structure for its state-owned enterprises. In this policy brief we propose that the *OECD Guidelines on Corporate Governance of State-Owned Enterprises*, which were adopted in 2005, be implemented, with certain modifications, in Puerto Rico. In specific, we analyze how they may be applied to the governance and regulation of the Puerto Rico Electric Power Authority ("PREPA").

The Puerto Rico Electric Power Authority

According to PREPA, the first private lighting system in Puerto Rico was installed in 1893 by José Ramón Figueroa in the municipality of Villalba. From that time, up until the inauguration of the Carite #1 Hydroelectric Plant in 1915, all electric power in Puerto Rico was produced and distributed by private companies established in the island's urban centers.[3] By the 1930s, Puerto Rico had 11 "insular" and 11 municipal power plants, while private plants furnished electricity to all but one of the remaining municipalities.[4]

This pattern of multiple, relatively small providers was the norm in the early years of the electric power industry. For example, between 1887 and 1893, twenty-four central station power companies were established within Chicago alone.[5] Competition in this market was brutal and inefficient; with overlapping distribution lines, the battle for customers was fierce and operating costs extremely high.

After a period of intense competition, consolidation became the standard in the industry as it became evident that electricity production, transmission and distribution had the characteristics of what was then called a "natural monopoly." Vertically integrated utilities, which generated the electrical energy, transmitted it from the power plants to the load centers, and distributed it to individual customers, became the industry standard for most of the 20th century. In most instances, these "public utilities" were subject to regulation by state public utility commissions which regulated profits and the rates of return these monopolists were allowed to realize.

In Puerto Rico the same forces pushing for consolidation and integration in the electric industry were at play and converged with the economic development objectives of the Popular Democratic Party (PPD). Indeed, the creation of the Authority was part of a broader economic development agenda pushed by the PPD majority in the Puerto Rico Senate. This agenda included the enactment of legislation in 1941 for the creation of the Minimum Wage Board, the Land Authority, the Food and Supplies Commission and the centralization of all drinking-water systems, which at the time were operated by municipalities.[6]

At the time of the Authority's creation in 1941 the largest of the remaining private concerns owned the distribution system in San Juan, as well as a steam generating plant and two hydroelectric projects. In general terms, however, the central government owned most of the generating capacity, in the form of hydro projects, while private companies

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[3] This information is from the historical sketch posted by PREPA at www.aeepr.com/HISTORIA.ASP.

[4] Victor S. Clark, editor, *Porto Rico and Its Problems*, (Washington, DC: The Brookings Institution, 1930), p. 352. For example, historian Fernando Picó mentions in his book *Amargo Café* that the municipality of Utuado had its own electric generation plant since the mid-1890s. See Fernando Picó, *Amargo Café: los pequeños y medianos caficultores de Utuado en la segunda mitad del siglo xix,* (San Juan, PR: Ediciones Huracán, 1981), p.33.

[5] Steven Stoft, *Power System Economics: Designing Markets for Electricity*, (New York, NY: John Wiley and Sons, Inc., 2002), p. 6.

[6] James Dietz, *Economic History of Puerto Rico: Institutional Change and Capitalist Development*, (Princeton, NJ: Princeton University Press, 1986), p.187.

controlled the distribution for the largest market, which consisted of San Juan and its environs.

The government of Rexford G. Tugwell pushed for the expropriation of the private lines by arguing that at a time when surpluses of electricity were available from public water developments, the private companies "were using precious fuel oil for their Diesel and steam generators."[7] Tugwell, working through the power division of the U.S. Department of the Interior, "persuaded the Federal Works Agency of the necessity to take the private lines and entrust them to our Authority for operation." President Roosevelt signed a seizure order to that effect in 1942.[8]

The private power producers, however, did not go quietly into the night. They challenged the taking in federal courts on grounds that their properties were taken illegally under the federal Lanham Act. The U.S Circuit Court in Boston agreed with the plaintiffs. However, as the Authority was still in possession of the transmission and distribution lines and equipment, a new taking was devised under the broad powers granted to the President under the War Powers Act.[9] The private power companies fought on.

Finally, after close to two years of legal wrangling, the government of Puerto Rico purchased the distribution system in an out of court settlement transaction in 1944. In the poignant words of then Governor Tugwell:

> I felt that the price we paid was outrageous; but we had done our best. That it was a good investment, however, we had the assurance of the New York bankers who loaned us the funds for the purchase as well as for extensions and improvements. The negotiations leading up to this had been long and devious and had to be parallel with those for the purchase. If the Canadian interests [the owners of the San Juan power company] did not lose, neither did the bankers, of course, though we expected that. In fact, when we finally came to the point of paying too much and borrowing under conditions and at rates calculated to please Wall Street, we were suddenly regarded benignly by all the powers that be. I had thought that we ought to be castigated for the deal. But that did not happen. There was not a word of criticism and a good deal of congratulation. The people of Puerto Rico would pay for it over a period of some twenty years in inflated rates; but absolutely no one showed any concern over that.[10]

Thus, the conflict of these disparate, but in the end mutually reinforcing interests—the greed of absentee owners, the grandiose dreams of central planners, the avarice of New York bankers, and the necessities of a nation at war—set the stage for the tumultuous birth of PREPA's monopoly in electricity generation, transmission and distribution in Puerto Rico.

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[7] Rexford G. Tugwell, *The Stricken Land: The Story of Puerto Rico*, (Garden City, NY: Doubleday & Company, Inc., 1946), p. 345.
[8] Id. at 346.
[9] Id. at 458.
[10] Id. at 622.

To be fair in the discussion of this historical record, we note that in the 1940s, Puerto Rico was an extremely poor and rural country, with a per capita income of $146 and with 70% of its population living in rural areas. In addition, the island's economy was predominantly agricultural and private capital was limited and could not satisfy the demand for investment in large infrastructure projects. Therefore, seventy years ago this kind of state intervention in the economy was deemed imperative in order to jumpstart economic growth in Puerto Rico.

Today, PREPA operates as a vertically integrated, self-regulated monopoly with the capacity to fully pass all operating costs to its customers, with absolutely no incentives whatsoever to streamline its operations. Notwithstanding this legally privileged status, PREPA currently faces a difficult financial situation. According to note 14 to its audited financial statements for fiscal year 2010:

> As of June 30, 2010, the Authority is in a net deficit position. The Authority faces a number of business challenges that have been exacerbated by the Commonwealth's economic recession, the volatility in oil prices, and the fact that the Authority has not increased rates to its customers at sufficient levels to offset the effects of its rising costs. Its principal challenges, some of which are interrelated, are: (i) addressing the decline in electric energy sales; (ii) addressing the volatility of oil costs; (iii) addressing high customer electric power rates; (iv) reducing government accounts receivables; and (v) improving its liquidity.

In addition to these financial challenges, PREPA faces significant regulatory risks at the federal level. Currently, about 99% of electricity generation in Puerto Rico, including the generating capacity of two private independent power producers that sell only to PREPA, is based on fossil fuels. Recently the U.S. Environmental Protection Agency ("EPA") approved new regulations under the Clean Air Act that set forth detailed annual reporting requirements for emissions of greenhouse gases ("GHGs") by power producers.

Unless these requirements are pre-empted or modified by Congressional legislation, PREPA will need to incur significant capital expenses to implement a comprehensive GHGs emissions monitoring system. According to a recent analysis published by the Government Development for Puerto Rico, PREPA will need to (1) invest $4.6 billion over three years and (2) incur in a recurring annual expense of $196 million, to comply with these new regulatory requirements.[11]

While it is difficult at this time to forecast the final form of the environmental laws, rules and regulations that may eventually be enacted or adopted by the federal government, it is reasonable to assume that any such regulatory action will have a material adverse effect on PREPA's operations. Thus, PREPA would be well advised to (1) reduce its dependence on fuel oil; (2) decrease its overall carbon footprint; and (3) move towards and adopt renewable fuel technology for the generation of electricity.

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[11] Government Development Bank for Puerto Rico, *Natural Gas Diversification Strategy for PREPA,* dated October 13, 2011, p.7.

PREPA is also subject to other constraints that severely limit its operational flexibility. Among these we note that PREPA: (1) is required to grant several credits, subsidies and special rates to some of its clients; (2) is subject to a rate covenant under a 1974 Trust Agreement, which requires PREPA to fix, charge and collect reasonable rates and charges so that revenues of the system will be sufficient (a) to pay current expenses and (b) to provide an amount at least equal to 120% of the aggregate principal and interest requirements for the next fiscal year; (3) is required to make substantial contributions in lieu of taxes; (4) loses, or otherwise cannot account for, close to 15% of the electricity it transmits, mostly due to theft; and (5) has significantly higher administrative, accounting, and customer support costs relative to its peers.

In sum, PREPA needs to undergo a significant restructuring if it is to become a positive net contributor, instead of a hindrance, to Puerto Rico's economic growth over the next few years. In our opinion, a radical reorganization of PREPA's governance framework and regulatory structure should be the first step of this complicated restructuring process.

The OECD Guidelines

The OECD adopted its Guidelines on Corporate Governance of State-Owned Enterprises in 2005, in recognition of the significant role that these enterprises play in the economies of the member states. In addition, the OECD member states recognized that state-owned enterprises ("SOEs") face some distinct "governance challenges." First, "SOEs may suffer just as much from undue hands-on and politically motivated ownership interference as from totally passive or distant ownership by the state."[12]

Second, accountability could also be a problem, given that in most countries SOEs are often protected "from two major threats that are essential for policing management in private sector corporations, *i.e.*, takeover and bankruptcy."

Third, and perhaps more important, "corporate governance difficulties derive from the fact that the accountability for the performance of SOEs involves a complex chain of agents (management, board, ownership entities, ministries, the government), without clearly and easily identifiable, or in some cases remote, principals. To structure this complex web of accountabilities in order to ensure efficient decisions and good corporate governance is a challenge."

The OECD Guidelines cover six broad areas: (1) ensuring an effective legal regulatory framework for state-owned enterprises; (2) the state acting as owner; (3) the equitable treatment of shareholders; (4) relations with stakeholders; (5) transparency and disclosure; and (6) the responsibilities of the boards of state-owned enterprises. The guidelines for each one of these areas are presented next. After that, we proceed to evaluate their application to the Puerto Rico Electric Power Authority ("PREPA").

[12] *OECD Guidelines on Corporate Governance of State-Owned Enterprises* (2005), p. 10

I. Ensuring an Effective Legal and Regulatory Framework for State-Owned Enterprises

The legal and regulatory framework for state-owned enterprises should ensure a level-playing field in markets where state-owned enterprises and private sector companies compete in order to avoid market distortions. The framework should build on, and be fully compatible with, the OECD Principles of Corporate Governance.

A. There should be a clear separation between the state's *ownership function* and other state functions that may influence the conditions for state-owned enterprises, particularly with regard to *market regulation*.

B. Governments should strive to *simplify and streamline* the operational practices and the legal form under which SOEs operate. Their legal form should allow creditors to press their claims and to initiate insolvency procedures.

C. Any obligations and responsibilities that an SOE is required to undertake in terms of public services *beyond the generally accepted norm* should be clearly mandated by laws or regulations. Such obligations and responsibilities should also be *disclosed* to the general public and related costs should be covered in a *transparent* manner.

D. SOEs should not be exempt from the application of general laws and regulations. Stakeholders, including competitors, should have access to efficient redress and an even-handed ruling when they consider that their rights have been violated.

E. The legal and regulatory framework should allow sufficient flexibility for adjustments in the capital structure of SOEs when this is necessary for achieving company objectives.

F. SOEs should face competitive conditions regarding access to finance. Their relations with state-owned banks, state-owned financial institutions and other state-owned companies should be based on purely commercial grounds.

II. The State Acting as an Owner

The state should act as an informed and active owner and establish a clear and consistent ownership policy, ensuring that the governance of state-owned enterprises is carried out in a transparent and accountable manner, with the necessary degree of professionalism and effectiveness.

A. The government should develop and issue an *ownership policy* that defines the overall objectives of state ownership, the state's role in the corporate governance of SOEs, and how it will implement its ownership policy.

B. The government *should not* be involved in the day-to-day management of SOEs and allow them full operational autonomy to achieve their defined objectives.

C. The state should let SOE boards exercise their responsibilities and respect their independence.

D. The exercise of ownership rights should be clearly identified within the state administration. This may be facilitated by setting up a *co-ordinating entity* or, more appropriately, by the centralization of the ownership function.

E. The co-ordinating or ownership entity should be *held accountable* to representative bodies such as the Parliament and have clearly defined relationships with relevant public bodies, including the state supreme audit institutions.

F. The state as an active owner should exercise its ownership rights according to the legal structure of each company. Its prime responsibilities include:

1. Being represented at the general shareholders meetings and voting the state shares.

2. Establishing *well structured and transparent* board nomination processes in fully or majority owned SOEs, and actively participating in the nomination of all SOEs' boards.

3. Setting up reporting systems allowing regular monitoring and assessment of SOE performance.

4. When permitted by the legal system and the state's level of ownership, maintaining continuous dialogue with external auditors and specific state control organs.

5. Ensuring that remuneration schemes for SOE board members foster the long term interest of the company and can attract and motivate qualified professionals.

III. Equitable Treatment of Shareholders

The state and state-owned enterprises should recognize the rights of all shareholders and in accordance with the OECD Principles of Corporate Governance ensure their equitable treatment and equal access to corporate information.

A. The co-ordinating or ownership entity and SOEs should ensure that all shareholders are treated equitably.

B. SOEs should observe a high degree of transparency towards all shareholders.

C. SOEs should develop an active policy of communication and consultation with all shareholders.

D. The participation of minority shareholders in shareholder meetings should be facilitated in order to allow them to take part in fundamental corporate decisions such as board election.

IV. Relations with Stakeholders

The state ownership policy should fully recognize the state-owned enterprises' responsibilities towards stakeholders and request that they report on their relations with stakeholders.

A. Governments, the co-ordinating or ownership entity and SOEs themselves should recognize and respect stakeholders' rights established by law or through mutual agreements, and refer to the OECD Principles of Corporate Governance in this regard.

B. Listed or large SOEs, as well as SOEs pursuing important public policy objectives, *should report* on stakeholder relations.

C. The board of SOEs should be required to *develop, implement and communicate compliance programmes for internal codes of ethics*. These codes of ethics should be based on country norms, in conformity with international commitments and apply to the company and its subsidiaries.

V. Transparency and Disclosure

State-owned enterprises should observe high standards of transparency in accordance with the OECD Principles of Corporate Governance.

A. The co-ordinating or ownership entity should develop consistent and aggregate reporting on state-owned enterprises and publish annually an aggregate report on SOEs.

B. SOEs should develop efficient internal audit procedures and establish an internal audit function that is monitored by and reports directly to the board and to the audit committee or the equivalent company organ.

C. SOEs, especially large ones, should be subject to an annual independent external audit based on international standards. The existence of specific state control procedures does not substitute for an independent external audit.

D. SOEs should be subject to the same high quality accounting and auditing standards as listed companies. Large or listed SOEs should disclose financial and non-financial information according to high quality internationally recognized standards.

E. SOEs should disclose *material information* on all matters described in the OECD Principles of Corporate Governance and in addition focus on areas of significant concern for the state as an owner and the general public.

Examples of such information include:

1. A clear statement to the public of the company objectives and their fulfillment.

2. The ownership and voting structure of the company.

3. Any material risk factors and measures taken to manage such risks.

4. Any *financial assistance*, including guarantees, received from the state and commitments made on behalf of the SOE.

5. Any material transactions with related entities

VI. The Responsibilities of the Boards of State-Owned Enterprises

The boards of state-owned enterprises should have the necessary authority, competencies and objectivity to carry out their function of strategic guidance and monitoring of management. They should act with integrity and be held accountable for their actions.

A. The boards of SOEs should be assigned a clear mandate and ultimate responsibility for the company's performance. The board should be fully accountable to the owners, act in the best interest of the company and treat all shareholders equitably.

B. SOE boards should carry out their functions of monitoring of management and strategic guidance, subject to the objectives set by the government and the ownership entity. *They should have the power to appoint and remove the CEO.*

C. The boards of SOEs should be composed so that they can exercise objective and independent judgment. Good practice calls for the Chair to be separate from the CEO.

D. If employee representation on the board is mandated, mechanisms should be developed to guarantee that this representation is exercised effectively and contributes to the enhancement of the board skills, information and independence.

E. When necessary, SOE boards should set up specialized committees to support the full board in performing its functions, particularly in respect to audit, risk management and remuneration.

F. SOE boards should carry out an annual evaluation to appraise their performance.

Applying the OECD Guidelines to PREPA

I. Ensuring an Effective Legal and Regulatory Framework for State-Owned Enterprises – Currently the PREPA board of directors has the power to fix, alter, and collect "reasonable rates" for its services and to enact the regulations governing the electricity market in Puerto Rico. Therefore, there is no separation between the state's *ownership* function and the state's *market regulation* function.

Indeed, Puerto Rico has *never* developed an ownership policy much less organized or centralized its holdings of SOE assets under an umbrella ownership entity. In France, for example, these functions are carried out by the *Agence des Participations d'Etat*, which is charged with developing policy objectives for SOEs; giving specific mandates to SOEs in furtherance of the established policy goals; and monitoring the performance the SOEs, among other things.

In many OECD countries the ownership function of the state with respect to SOEs is carried out by the Ministry of Economics or the Ministry of Finance, and these agencies, in turn, report to the national parliaments or to the national controller. In Puerto Rico there is no economics ministry. The finance function has been entrusted to the Treasury Department, which could a candidate for exercising the government's ownership function with respect to public corporations in Puerto Rico. The Government Development Bank ('GDB") is another agency that could potentially exercise these functions. However, in order to avoid potential conflicts, the implementation of certain safeguards would be necessary to separate the GDB's lending functions from its SOE corporate governance functions.

Under this rubric we note that OECD Guideline I.C. states that "*any obligations and responsibilities that an SOE is required to undertake in terms of public services beyond the generally accepted norm should be clearly mandated by laws or regulations. Such obligations and responsibilities should also be disclosed to the general public and related costs should be covered in a transparent manner.*"

PREPA is currently required to grant credits, subsidies and special rates to some of its clients and make substantial contributions in lieu of taxes. While these requirements are usually mandated by laws or regulations, such obligations are usually not fully disclosed to the general public nor are their related costs accounted for in a transparent manner. Improving disclosure with regard to these matters could be a good first step to improve SOE accountability and transparency in Puerto Rico.

Regarding *market regulation*, the creation of an independent regulatory commission is one of the most important steps to improve PREPA's performance. This commission would, among other things: (1) safeguard the best interests of the Puerto Rican consumer; (2) establish, review, and revise electricity tariffs at least on an annual basis; (3) approve PREPA's capital investment plans; (4) promote the transition to renewable energy technologies at PREPA; and (5) oversee the overall operation of the electricity market in Puerto Rico, in accordance with independently determined rules and regulations.

In Puerto Rico opposition to the creation of an independent regulator for PREPA traditionally has been based on a superficial reading of the case law concerning the prohibition against the impairment of contracts set forth in Section 7, Article II of the Puerto Rico Constitution.

In general, legislative meddling with contracts is limited by the U.S. constitution, which asserts that no state shall pass any law impairing the obligation of contracts, and by the Puerto Rico constitution, which states in its bill of rights that no laws impairing contractual obligations shall be enacted.

The leading modern federal case on contractual impairment is *Home Building & Loan Association v. Blaisdell* (1934), where the U.S. Supreme Court upheld a Minnesota law enacted during the Great Depression that authorized state courts, for the duration of the economic emergency declared to exist by the state legislature, to suspend mortgage foreclosures on homes and farms.

However, the 1977 case of *United States Trust Co. of New York v. New Jersey* limits the applicability of *Blaisdell*. In the *U.S. Trust* case, the U.S. Supreme Court invalidated a state law as violating the contracts clause for the first time in nearly 40 years. Justice Blackmun, writing for the majority, suggested that a law impairing the state's own obligations was subject to less deference than legislation interfering with private contracts.

Cases where the government's own obligations are being impaired are to be subject to something approaching "strict scrutiny"; according to Blackmun such laws must be "reasonable and necessary to serve an important public purpose" in order to pass muster under the contracts clause. However, in applying this standard, "complete deference to a legislative assessment of reasonableness and necessity is not appropriate because the State's self-interest is at stake." So the Courts have substantial discretion to determine what is reasonable and necessary and what constitutes an important public purpose or state interest in cases where the government's own obligations are being impaired.

At the local level, it appears a contracts clause was included in the Puerto Rico constitution as an afterthought. José Trías Monge, in the third volume of his constitutional history of Puerto Rico, states that the clause was included despite of its "scant judicial value" because (1) it was deemed to have a positive psychological effect on the investment climate in the island; (2) its elimination would require "providing complicated explanations to Congress"; and (3) the "minorities" participating in the convention had repeatedly and strongly insisted on its inclusion. Thus, according to Trías, "it was decided, as in many other occasions, to choose the less risky alternative and include a clause whose true utility it is difficult to discern, but which in unskilled hands had the potential for inflicting damage on social justice programs."

The Supreme Court of Puerto Rico addressed the impairment clause issue in its recent opinion (2 February 2010) in the case of *Dominguez v. Government of the Commonwealth of Puerto Rico*, which upheld the constitutionality of Act 7 of March 9,

2009, declaring a fiscal emergency in Puerto Rico. In that case the Puerto Rico Supreme Court essentially adopted the contract impairment analysis developed by Justice Blackmun in the *U.S. Trust* case:

(a) First, the Court needs to determine whether a valid contractual obligation exists;

(b) Second, if a valid contractual obligation exists, then the Court has to determine whether the contractual obligation *is or will be* impaired by the legislative action;

(c) Third, if an impairment exists, then the Court has to determine whether it is *substantial*; and

(d) Fourth, if the impairment is found to be substantial, then the Court must analyze its validity under one of two possible standards:

(i) If the contractual obligation involves two private parties, the Court must determine if the government intervention is *rationally related* to the furtherance of a *legitimate* state interest; or

(ii) If the contractual obligation involves the government or a public agency, then the legislation is subject to more careful judicial scrutiny and the Court must determine whether the government's intervention is *reasonable and necessary* (instead of merely rationally related) to further an *important* (instead of a simply legitimate) state interest.

In Puerto Rico we have simply taken for granted PREPA's argument that a regulatory board, with powers to set rates and tariffs, would *ipso facto* constitute a substantial impairment of PREPA bondholders' rights and that such impairment would, implicitly, not be reasonable and necessary to further the clearly important state interest in promoting economic development.

In our view, this is a specious argument because the legislation establishing an independent regulator can be drafted to avoid the impairment issue. To eliminate this issue, it is only necessary to include a clause in the bill to require the regulatory board to take into account and safeguard the interests of the bondholders in carrying out its regulatory powers pursuant to the law. If drafted this way, the impairment clause protection would not be triggered because the board *would be required by law* to act in conformity with existing bondholder rights. Thus, the threshold issue of whether the contractual obligation is or will be impaired by the legislative action never arises.

Furthermore, even if we take PREPA's analysis at face value for purposes of argument, it is not clear to us why an independent regulatory board would not be a reasonable and necessary means to further the clearly important state interest in economic development.

Given that this "problem" has a relatively simple solution; it seems to us the real underlying issue here is the lack of political will to establish an independent regulator over PREPA. We note, however, that as long as PREPA's board of directors has absolute power to regulate the electricity sector in Puerto Rico there will be no progress in

achieving such important policy objectives as (1) significantly lowering the cost of energy in Puerto Rico; (2) reducing Puerto Rico's dependence on oil; (3) promoting investment in alternative sources of energy; and (4) generating economic growth from developing green technologies.

Other stakeholders argue that an independent regulatory commission to oversee the electricity market in Puerto Rico may be ineffective in regulating PREPA because any such agency could be "captured" by the regulatee. A significant amount of research has been carried by economists and political scientists to document this phenomenon, through which a regulatory agency ends up issuing regulations that are highly beneficial to the regulated industry and not necessarily in the public or general interest.

However, the empirical evidence about regulatory capture is far from robust, shows significant variance, and suggests that interest group competition to influence regulation is a complex phenomenon, especially where multiple interest groups, each with different organization costs, interests, and power, interact with each other. The usual result is that, "like vectors in a physics model, the interest group pressure will act on politicians from different directions and with differential force."[13] In the case of electricity regulation, a study of electricity rate structures in forty-six states over the period 1973-1995 found that legislative ideology and the selection method of regulatory commissioners were the two most important factors in explaining rate changes over time, not interest group pressure.[14]

In the case of Puerto Rico, as we will demonstrate in the following section, it could be argued that PREPA has *already* been captured by special interest groups. Therefore, the establishment of an independent regulatory agency would actually correct existing policy biases in favor of particular groups and reduce inefficiencies generated by the intervention of those groups. In addition, by virtue of being a late mover in this area, Puerto Rico can benefit from the experience in other jurisdictions, avoid regulatory mistakes, and implement a set of best practices that already have been proved effective in the field of electricity regulation.

II. The State Acting as an Owner – Concerning the exercise of the state's power as an owner of SOEs, Puerto Rico has never developed or issued an ownership policy that defines (1) the overall objectives of state ownership, (2) the state's role in the corporate governance of SOEs, and (3) how it will implement its ownership policy.

PREPA was created as a statutory corporation in 1941. Management powers are vested in a nine-person board of directors. *No entity* explicitly exercises the shareholder or ownership function with respect to PREPA. In 1941, the prevailing assumption was that PREPA as a "natural" state-owned monopoly would *always act* in furtherance of the general welfare.

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[13] Paul Teske, *Regulation in the States*, (Washington, DC: Brookings Institution Press, 2004), p. 38.
[14] Id. at chapter 5.

The problem is that utility networks are classic monopolies and they generate rents that are fought over by different interest groups. According to the interest group theory of regulation, these interest groups have different bargaining power, depending on their costs of organizing and the benefits of manipulating outcomes and they will intervene to redistribute benefits to their group at some additional inefficiency cost. Groups that are likely to be favored are those with benefits that are large relative to organizational costs, particularly those organized around production (managers, workers, labor unions, and suppliers) rather than consumers.

Policy interventions in this environment are likely to be biased in favor of some groups at the expense of others, and at some extra costs in deadweight losses. Therefore, policy outcomes may bear little relationship to the best possible outcome that a benevolent dictator might choose in the "public interest" and they certainly need not minimize efficiency losses.

PREPA, as a government-owned monopoly, generates significant rents, which are not distributed to shareholders *because there are none*. How are these rents apportioned in Puerto Rico? Well, just as predicted by the interest group theory of regulation that we describe above, it is clear that several different special interest groups have benefited at the expense of the general population:

- Bondholders are the first discrete special interest group. PREPA has over $7 billion in outstanding debt and its bondholders have a senior claim on its assets and revenues.
- Second, it is clear that some PREPA workers have benefited disproportionably, as demonstrated by the high ratios of general and administrative expenses to customers served.
- Third, it is clear that some suppliers also benefit from the current arrangement. For example, PREPA spent in excess of $2 billion in capital improvements during the 2000 – 2004 period. Of that amount, $651.7 million were spent in production plant, generally retrofitting generation plants built forty or fifty years ago. What criteria were used to analyze these investments?
- Fourth, the Authority provides a significant subsidy to a large segment of the Puerto Rican population. We should note, however, that this characteristic is not unique to Puerto Rico, as a common component in the function of state-owned electricity firms is to provide basic electric service to as many individuals as possible at prices that may be below the incremental cost incurred, especially for residential consumers.

The people of Puerto Rico are the great loser in all of this, as it has witnessed the capture of the state-owned public power company by special interest groups which use their relative power to appropriate for themselves the monopoly rents generated by PREPA. In addition, PREPA has generated large deadweight losses, which are the product of high electricity prices and high operating costs, that are passed on to consumers and which they would not otherwise have to incur if PREPA were properly regulated.

Therefore, it is imperative that the government of Puerto Rico exercise vigorously its ownership function with respect to PREPA in furtherance of the public interest and in accordance with a clear ownership policy. At a minimum, the ownership policy should set forth: (1) the government's objectives for state ownership; (2) the state's expectations of companies; (3) the efficiency and operational requirements for state-owned companies; (4) the government's policy on the remuneration of senior management/personnel; (5) the framework for the state's administration of its ownership, including the division of roles in the state administration; and (6) the rules governing the relationship between the board of directors, the management and the state as shareholder.

Under this rubric we note that OECD Guideline II.F.2. states that one of the principal responsibilities of the state as an owner consists of "*establishing well structured and transparent board nomination processes in fully or majority-owned SOEs, and actively participating in the nomination of all SOEs' boards.*" Currently, the PREPA board of directors consists of nine members: the Puerto Rico Secretary of Transportation and Public Works, who serves as an *ex officio* member of the board; six other members that are appointed by the Governor of Puerto Rico with the advice and consent of the Puerto Rico Senate; and two other members, who are elected by the Authority's clients. It should not be surprising then that political considerations tend to play a significant role in the appointment process.

In order to address this issue, we recommend that membership in the PREPA board of directors be apportioned according to the French model: one third of the members should be elected and appointed by PREPA employees; one third should be representatives of the state shareholder, and one third should be independent directors, elected by PREPA's clients.

III. Equitable Treatment of Shareholders – The guidelines under this rubric are not applicable to PREPA because there are no shareholders other than the government of Puerto Rico.

IV. Relations with Stakeholders – PREPA has multiple relationships with, and obligations to, several stakeholder groups. Among these we find consumers, PREPA employees, bondholders, other creditors, suppliers, and the island's natural environment and wildlife.

In some OECD countries, "legal status, regulations, or mutual agreements/contracts grant certain stakeholders specific rights in SOEs. Some SOEs might even be characterized by distinct governance structures as regard the rights granted to stakeholders, principally employee board level representation, or other consultation/decision making rights to employees' representatives and consumer organizations, for example through advisory councils."[15]

In Puerto Rico there is no public policy regulating the relationships between SOEs and their stakeholders. In the case of PREPA specifically we recommend that PREPA (1) issue a clear policy recognizing and respecting stakeholder rights; (2) publish an annual

[15] *OECD Guidelines on Corporate Governance of State-Owned Enterprises* (2005), p. 37

report on outreach efforts and stakeholder relations; and (3) develop, implement, and communicate compliance programs with internal codes of ethics, especially in the case of procurement, bids, and the award of construction and/or professional services contracts.

V. Transparency and Disclosure – According to the OECD Guidelines "State-owned enterprises should observe high standards of transparency", especially "on all matters and areas of significant concern for the state as an owner and the general public." Examples of such matters include: (1) a clear statement to the public of the company objectives and their fulfillment; (2) any material risk factors and measures taken to manage such risks; (3) any financial assistance, including guarantees, received from the state and commitments made on behalf of the SOE and (4) any material transactions with related entities.

PREPA traditionally has been one of the least transparent and accountable agencies of the Puerto Rican government. Too much of what happens at PREPA is conducted behind closed doors. Management should be required to open to public scrutiny the Authority's capital investment plans, its technology selection processes, and its strategic planning. In addition, PREPA should be subject to public disclosure rules, such as publishing a quarterly report on its operations and financial performance as well as complying with OECD-like requirements regarding the disclosure of "all matters and areas of significant concern for the state as an owner and the general public."

In addition it is imperative that PREPA be subject to a rigorous set of performance benchmarks in areas such as generation costs per kWh; availability and forced outage rates; and client service (time to process and address complaints), among others, and that its performance with respect to these benchmarks be disclosed on a periodic basis.

VI. *The Responsibilities of the Boards of State-Owned Enterprises* – The OECD Guidelines with respect to the responsibilities of the boards of SOEs state that "the boards of SOEs should be assigned a clear mandate and ultimate responsibility for the company's performance. The board should be fully accountable to the owners, act in the best interest of the company and treat all shareholders equitably." In addition, "SOE boards should carry out their functions of monitoring of management and strategic guidance, subject to the objectives set by the government and the ownership entity [and] they should have the power to appoint and remove the CEO."

The problem in some OECD countries is that

> SOE boards may see their roles and responsibilities encroached from two ends; by the ownership entities and by management. The co-ordinating or ownership entity, if not the government itself, may be tempted to become too involved in strategic issues, although it is their responsibility to define the overall objectives of the company, particularly since the difference between defining objectives and setting strategies can be rather unclear. SOE boards may also encounter difficulties in monitoring management as they do not always have the legitimacy, or even the authority, to do so.[16]

[16] *OECD Guidelines on Corporate Governance of State-Owned Enterprises* (2005), p. 48.

There is evidence to support the assertion that the independence of PREPA's board of directors is repeatedly encroached by both the executive branch of the government and by senior management. Strategic financial and operational questions are sometimes decided by the governor in order to further his or her political objectives. On the other hand, senior management at the Authority has also been known to disregard policy guidance from the board in order to further their own objectives.

In order to effectively carry out its role, the PREPA board should actively (1) formulate, monitor and review corporate strategy, within the framework of the overall corporate objectives set by the state; (2) establish appropriate performance indicators and identify key risks; (3) monitor the disclosure and communication processes, ensuring that the financial statements fairly present the affairs of the company and reflect the risks incurred; (4) assess and follow management performance; and (5) develop effective succession plans for key executives.

Conclusion

Public corporations have served the people of Puerto Rico well since their initial establishment in Puerto Rico during the 1940s. In the case of PREPA in specific, it successfully executed its original mandate to provide electric service to all Puerto Ricans, regardless of the geographical conditions where they lived. However, the world is quite different today and both technology and economic theory have evolved significantly since the 1940s. Yet, Puerto Rico's framework for governing and regulating public corporations, including PREPA, has remained stuck in time. It is perhaps high time then to rethink this outdated framework.

In addition, given the direction the international community is moving with respect to the issue of climate change, it appears that PREPA's business model is unsustainable. Over the next ten years or so, it will face significant political and financial pressure to: (1) reduce its dependence on oil; (2) cut back on its consumption of other non-renewable fossil fuels, such as coal and natural gas; (3) decrease its overall carbon footprint; and (4) move towards and adopt renewable fuels for the generation of electricity.

In this process of (1) modernizing the framework that governs and regulates public corporations in Puerto Rico and (2) restructuring PREPA's business model, the *OECD Guidelines on Corporate Governance of State-Owned Enterprises* provide a good paradigm that could be easily adopted in Puerto Rico.

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