

Executive Summary

Analysis of a Long-Term Agreement for the Operation and Management for Puerto Rico's Transmission and Distribution System

August 2020

INTRODUCTION

The service provided by Puerto Rico's state-owned utility is unreliable, highly polluting, and expensive. The Puerto Rico Electric and Power Authority ("PREPA") has been a source of private and public corruption in the island. For decades, diverse interests have organized in order to extract undeserved benefits from PREPA at the expense of the rest of the population of Puerto Rico. Thus, PREPA's transformation is imperative for the future development of the island's economy.

On June 22, 2020 PREPA and the Puerto Rico Public-Private Partnerships Authority (the "P3A" or "Administrator") entered into an agreement for the Operation and Maintenance ("O&M" Agreement) of PREPA's Transmission and Distribution System ("T&D System") with LUMA Energy, LLC, ("ManagementCo") and LUMA Energy Servco, LLC ("ServCo", and together with ManagementCo, the "Operator"). The Operator, in turn, is a consortium formed by (1) ATCO Ltd., a Canadian operator of electric systems and (2) Quanta Services, Inc., a Texas-based provider of "infrastructure solutions" for the electric power industry.

This policy brief analyzes important aspects of this agreement; highlights some risks associated with the performance of that agreement; identifies some serious concerns regarding the transaction; and offers some recommendations for its improvement.

ASPECT OF THE AGREEMENT	BACKGROUND	RISK/CONCERN	RECOMMENDATION
<p>POWER SUPPLY DISPATCH AND MANAGEMENT</p>	<p>Operator is required to use “economic dispatch” to run the T&D System, but that term is ambiguously defined in the O&M Agreement.</p>	<p>The combination of an ambiguous definition of “economic dispatch” and an oligopolistic market structure means that strategic interactions among and between market players, including price fixing via market signals, could take place and result in rent-seeking behavior and the extraction of rents.</p>	<p>The PREB should clarify, by regulation if necessary, the meaning of “economic dispatch” in the Puerto Rico power market.</p> <p>The PREB should also develop a process to investigate allegations of price fixing or market collusion. The PR Department of Justice should also train lawyers from its anti-trust division to investigate these cases and file charges against power producers, if necessary. PREPA and all large IPPs should be required by law to disclose all pricing-related information at the request of the PREB.</p>
<p>AUDITING AND TRACKING PROJECTED SAVINGS</p>	<p>The savings analyses provided by the government show, at first glance, that the O&M Agreement, if executed in accordance with its terms, would pay for itself. But PREPA is notorious for overestimating savings from various reform efforts undertaken in the past.</p>	<p>The forecast of cost reductions to be generated by the Operator could be significantly overestimated.</p>	<p>The P3A should hire an independent auditing firm to perform yearly audits and keep track of cost reductions allegedly generated by the Operator. The PREB should also be allowed to review and analyze those findings. The O&M Agreement should be adjusted as necessary if the Operator fails to deliver the requisite cost reductions.</p>

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METRICS/ BENCHMARKS	<p>To collect the annual Incentive Fee, the Operator has to achieve certain performance benchmarks. A significant number of the benchmarks has not been determined yet and are subject to further negotiation among the parties.</p> <p>Almost all of the benchmarks are set against PREPA's prior performance, which sets a low bar.</p>	<p>The payment of the Incentive Fee depends on the Operator achieving certain performance benchmarks that have not been determined yet. Using PREPA's prior performance to measure progress could set a standard that is too low to justify the transaction.</p>	<p>Performance metrics should be developed in consultation with the PREB and the P3A using best practices and benchmarks from similarly situated utilities in the United States.</p>
CAPITAL EXPENDITURES	<p>The Grid Modernization Plan prepared by PREPA estimates that approximately \$21 billion in capital expenditures are necessary to bring the Puerto Rico power system to "industry standard levels."</p> <p>The Agreement does not require the Operator to make any capital expenditures using its own funding.</p>	<p>The financing for the entire modernization of Puerto Rico's T&D system is predicated on obtaining federal reconstruction funding for such purposes, which may be delayed or not materialize at all.</p>	<p>Operator, PREPA, and the PREB should prepare a "Plan B" setting forth capital spending priorities for Puerto Rico's T&D System in case federal funds to finance the Grid Modernization Plan are insufficient or unavailable.</p>

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<p>OPERATOR-OWNED CAPITAL IMPROVEMENTS</p>	<p>The Operator has the option to propose to the PREB Operator-owned capital improvements to the T&D System. The PREB shall evaluate any such proposal on its merits and allow for the Operator “to earn a reasonable rate of return thereon consistent with the returns permitted to be earned by companies operating in the United States electric transmission and distribution business on similar investments.”</p>	<p>Bidding on capital improvements by the Operator, or any of its affiliates, would be a related-party transaction and such transactions are prone to generate rent-seeking opportunities.</p>	<p>First, the PREB should develop a special administrative process to conduct a strict scrutiny of any such proposed transactions.</p> <p>Second, those transactions should also be subject to review and approval by the P3A, as Administrator of the O&M Agreement.</p>
<p>LIABILITY LIMITATIONS</p>	<p>The liability waiver provisions in the Agreement include ordinary negligence, gross negligence or willful misconduct of Owner, ManagementCo or ServCo, or their respective employees, agents or contractors.</p>	<p>The liability waiver provisions proposed in the O&M Agreement are too broad and favorable to the Operator, creating a perverse incentive for the Operator to execute its duties and obligations without following the requisite standard of care.</p>	<p>The PREB should not grant the broad liability waiver set forth in the O&M Agreement. Instead, it should provide for a limited waiver consistent with the dangerousness intrinsic to the operation and management of a large power system.</p>

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<p>THE O&M AGREEMENT IS ONLY ONE PART OF A LARGER PROCESS</p>	<p>In addition to completing the transition to the Operator as per the Agreement, the following key initiatives must be implemented: improving operations, modernizing the transmission and distribution system, upgrading the generation fleet, improving workforce and public safety, restructuring legacy debt obligations, and pension reform.</p>	<p>Failure to coordinate the multiple actions required to modernize Puerto Rico power system could lead a catastrophic failure of the entire transformation process.</p>	<p>The processes to transform PREPA should be coordinated by the PREB pursuant to a duly adopted Integrated Resource Plan that sets forth a logical sequence for PREPA's modernization and transformation. The PREB should exercise its legal authority to compel PREPA to comply with this requirement.</p> <p>With respect to the PREB, we recommend that the next administration restore its legal standing and powers as a truly independent regulator. In addition, the FOMB should ensure that the PREB has adequate budgetary resources to effectively execute its mission.</p>

In addition to these critical flaws in the O&M Agreement, **we are concerned that Puerto Rico's government may not have the required capacity to successfully manage this complex multilayered process, with several dimensions that intersect and reinforce each other.** Thus, there are no guarantees that the process to modernize and transform PREPA will be successful. A lot depends on the effective execution and implementation of other initiatives, exogenous to the O&M Agreement.

In the end, we cannot advocate in favor of keeping this utterly corrupt, environmentally harmful, and economically unsustainable government-owned enterprise in charge of our power system. Yet, while we strongly favor the thorough transformation of the PREPA, the proposed O&M Agreement is critically deficient in several key areas. If that agreement cannot be corrected in a timely manner, then we can only recommend the parties return to the negotiating table. And try again.



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