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Policy Brief

PREPA's Debt Restructuring – What's Next?

Sergio M. Marxuach, Policy Director

Center for a New Economy
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INTRODUCTION

On March 8, 2022, the Puerto Rico Fiscal Agency and Financial Advisory Authority ("AAFAF"), issued a notification stating it was terminating the Definitive Restructuring Support Agreement (the "PREPA RSA"), dated as of May 3, 2019, as amended, by and among (1) the Puerto Rico Electric Power Authority ("PREPA"), (2) AAFAF, (3) the Financial Oversight and Management Board for Puerto Rico ("FOMB"), (4) the members of the Ad Hoc Group of PREPA Bondholders, (5) Assured Guaranty Corp. and Assured Guaranty Municipal Corp., (6) Syncora Guarantee Inc., (7) National Public Finance Guarantee Corporation, and (8) any other persons who had joined the PREPA RSA as of that date.

The purpose of the PREPA RSA was to restructure certain bonds issued by PREPA. In our view, the PREPA RSA was not a good transaction for Puerto Rico. Its terms and conditions were overly generous to creditors; it discouraged the transition to distributed renewable generation; there was uncertainty as to whether it provided the debt relief necessary to maintain PREPA as a going concern, while avoiding another restructuring in the short to medium term; and would have, in all likelihood, resulted in a significant rate increase for Puerto Rican ratepayers for decades to come.

In this policy brief, we take a look at the current state of PREPA's debt restructuring process and offer some recommendations about what a good PREPA debt restructuring transaction should (and shouldn't) include.

PROCEDURAL STATUS

Judge Laura Taylor Swain, also on March 8, issued an *Order Denying Urgent Motion of the Ad Hoc Group of PREPA Bondholders to Appoint a Mediator and Impose Deadlines for a PREPA Plan of Adjustment and Directing Additional Consultation and Filings,*[1] (the "March 8 Order").

The March 8 Order denied "the Ad Hoc Group's Motion insofar as it seeks an order requiring the Oversight Board to participate in, and PREPA to provide unlimited financing for, mediation focused on the interests of a particular subset of creditors under the provision of an RSA that AAFAF has purportedly terminated."[2]

The Court, however, encouraged the relevant parties to "continue discussions and pursue a consensual resolution of the outstanding issues" and stated that it would be willing to consider "a prompt consensual revival of a private mediation proposal" if such proposal is "accompanied by a delineation of scope, a timetable, and evidence of the proposal's commercial reasonableness, susceptibility to cost controls, and consistency with any relevant requirements of the Puerto Rico Recovery Accuracy in Disclosures Act ("PRRADA").[3]

[1] PREPA Docket Entry No. 2748.
[2] Id. at p. 10.
[3] Id. at pp. 10-11.

To that end, the Court ordered the FOMB to "promptly meet and confer with AAFAF, the Ad Hoc Group of Bondholders, and all other major stakeholders and interested parties whose collaboration it believes is necessary to construct a viable basis for a plan of adjustment, to consider whether a consensual mediation arrangement can be entered into promptly to resolve key plan-related issues."[4] Any mediation proposal submitted for Court approval must comply with the criteria set forth above. The FOMB and AAFAF have until March 18, 2022 to submit a status report regarding this matter.

In addition, the Court ordered the FOMB to file by May 2, 2022:

- "A proposed plan of adjustment, disclosure statement, and proposed deadlines in connection with consideration of the disclosure statement, plan-related discovery, solicitation and tabulation of votes, objection period in connection with the confirmation hearing, and proposed confirmation hearing schedule for the PREPA Title III case; **or**

- A detailed term sheet for a plan of adjustment, with a proposed timetable for the filing of the plan, consideration and approval of a disclosure statement, voting and confirmation of the plan; **or**

- A proposed schedule for the litigation of significant disputed issues in PREPA's Title III case, including, without limitation, the motion for stay relief to seek appointment of a receiver, the UCC's claim objection (including, if appropriate, litigation of antecedent questions of standing), and the issues raised in Adv. Proc. Nos. 19-396 and 19-405; **or**

- A declaration and memorandum of law showing cause as to why the court should not consider dismissal of PREPA's Title III case for failure to demonstrate that a confirmable plan of adjustment can be formulated and filed within a time period consistent with the best interests of PREPA, the parties-in-interest and the people of Puerto Rico."[5]

On March 9, 2022, the Honorable Rafael Hernández, Speaker of the House of Representatives of Puerto Rico, sent a letter to the FOMB "expressing the House's interest in participating in the mediation process regarding PREPA's plan of adjustment."[6]

On March 14, 2022, the FOMB replied that the "Oversight Board does not anticipate developing or negotiating a PREPA plan of adjustment requiring legislation. But, if that changes, the Oversight Board would welcome the Legislature's participation in mediation if such a restructuring proposal is developed."[7]

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[4] Id. at p. 12.
[5] Id. at p. 13.
[6] FOMB – Letter – Legislative Leaders – PREPA Regarding Mediation – March 14, 2022.
[7] Id.

On March 16, 2022, the Court entered another Order (the "March 16 Order") amending the March 8 Order, indicating "[t]he Court is exploring whether a judicial mediator or mediation team can be made available to facilitate development of a plan of adjustment for PREPA and the resolution of related litigation."[8]

ANALYSIS OF THE PROCEDURAL OPTIONS

In our view, it is clear from the language of the March 8 Order that Judge Taylor Swain favors a consensual resolution of the major pending issues prior to the FOMB submitting a plan of adjustment for PREPA. Hence her order that the FOMB determine the feasibility of setting up a mediation process in consultation with AAFAF, the Ad Hoc Group of Bondholders, and "all other major stakeholders and interested parties whose collaboration it believes is necessary" to develop a plan of adjustment.

In theory, the group of "major stakeholders and interested parties" would include, at a minimum, the following parties: (1) PREPA; (2) AAFAF; (3) the FOMB; (4) the Ad Hoc Group of PREPA Bondholders; (5) Assured Guaranty Corp. and Assured Guaranty Municipal Corp.; (6) Syncora Guarantee Inc.; (7) National Public Finance Guarantee Corporation; (8) PREPA's Fuel Line Lenders; (9) a representative of PREPA's current retirees and future beneficiaries of PREPA's pension plan; and (10) a representative of PREPA's unsecured creditors.

Who else might be deemed a "necessary party" seems to be up to the FOMB to decide. Based on its letter to Speaker Hernández it appears the FOMB will apply a narrow definition to determine who is a "necessary" party to the mediation proceedings. That is, it appears the FOMB would be limiting participation in any mediation process only to those parties strictly required to develop a plan of adjustment.

That would be a pity, for while we understand that there is a negative tradeoff between expediency and the number of parties at the negotiating table, there are also some advantages to integrating a broader set of stakeholders and interested parties into the negotiating process. To the extent any proposed plan of adjustment has significant support among civic society organizations, NGOs, and the various trade guilds, the easier it would be to implement. While, on the other hand, presenting PREPA's clients, essentially everybody in Puerto Rico, with a plan they don't understand as a *fait accompli*, on a take it or leave it basis, is likely to generate resistance and opposition.

Mediation is also preferable to the available alternatives to a negotiated settlement. In the instant case, those alternatives are the litigation of complex issues of law and fact, which could take literally years when appeals are factored in, or the dismissal of the Title III case, in which case bondholders and other creditors would seek to exercise their rights pursuant to the terms and conditions of the relevant credit documents. PREPA's bondholders, for example, would be entitled to request the appointment of a receiver to manage and operate PREPA and to require the enforcement of the rate covenant of the

[8] Docket Entry No. 20357 at p. 2.

1974 Trust Agreement, pursuant to which PREPA's rates would have to be set at a level that generates sufficient revenues to cover all operating expenses plus 120% of annual debt service.

Finally, the FOMB has the option to develop a plan of adjustment with the support of only one class of creditors and seek a court order to "cramdown" all the other creditors, pursuant to section 314(c) of PROMESA. This option, while theoretically possible, is highly unlikely to be endorsed by Judge Taylor Swain, who has demonstrated a clear preference for consensual solutions throughout all Title III proceedings.

In sum, then, an inclusive mediation process would be the best path forward to "construct the basis for a confirmable plan of adjustment for PREPA". No doubt, it would be a complicated and tough negotiating process and the timeline set by the Judge is rather tight. Nonetheless, if all the parties act in "good faith and in a focused manner", it should be possible to present the Court with at least a detailed term sheet for a plan of adjustment by May 2, as requested by Judge Taylor Swain.

SUBSTANTIVE RECOMMENDATIONS

The FOMB has usually defended prior proposals for PREPA's debt restructuring in narrow terms. Perhaps it is legally required to do so. It has stated in the past that its main objective is to ensure any plan of adjustment for PREPA meets the requirements for confirmation set forth in PROMESA. However, any transaction that affects a sector as important as electricity is to the Puerto Rican economy needs to be evaluated in a thorough manner.

Therefore, any plan of adjustment for PREPA has to be comprehensive in nature and take into account the economic and social environment in which PREPA operates. This means that any plan of adjustment must take the following factors into account: (1) PREPA operates in an economy that has shown little or no growth for 15 years; (2) it operates in an island with a declining population and a shrinking industrial base; (3) high fuel costs and general inflationary pressures are expected to prevail in the short to medium term due to the aftermath of the COVID-19 epidemic and the war in Ukraine; (5) interest rates are expected to rise as central banks seek to lower inflation around the globe; (6) Puerto Rico has a fragile transmission and distribution system that needs, essentially, to be entirely rebuilt; (7) PREPA operates an aging fossil fuel generation fleet, with an average age of 40 years and some units approaching 60 years, which is close to the end of their useful life; (8) PREPA is run by a largely ineffective management team, which has been tainted by corruption in the past, and traditionally has been led by political appointees; and (9) PREPA is currently a bankrupt utility without access to the capital markets.

These operational risks translate into financial risks such as the following, which should be taken into account when restructuring PREPA's debt:

- Pension liabilities, if not restructured, could result in a 3.4 cent/kWh increase by 2034.[9]

[9] London Economics International LLC, *Critique of Government Parties' Assertion that the 9019 Settlement will Not Affect Non-settling Creditors and Will Avoid a Subsequent Tittle III Filing by PREPA*, October 30, 2019, (the "LEI Report"), p. 22.

- Inefficient dispatch of generation could raise rates by 1.08 cents/kWh to 1.28 [10] cents/kWh a year.
- PREPA has not been fully transparent about the full extent of T&D investment required over the long term to achieve both its resiliency and renewable generation goals. PREPA's certified 2019 Fiscal Plan states it will need to make capital expenditures on the T&D system of $8.2 billion between 2020 and 2024 plus an additional $8.2 billion between 2025 and 2030. But that is only for resilience, in order to incorporate large amounts of distributed generation it will need to make an additional investment of $13.6 billion between 2030 and 2035. London Economics International ("LEI"), a consulting firm, estimates the federal government will pay 90% of the first $16.4 billion, but that the other $13.6 billion would have to be recuperated through higher customer rates. [11]
- Finally, according to its FY2019 Fiscal Plan, PREPA needs to make a series of capital investments in order to reduce its dependency on oil and reduce its operating costs, and those investments will have to be financed and repaid in some way. PREPA's poor financial condition will raise the cost of financing investments in new renewable generation. This means that ratepayers will have to pay for those costs through long-term power purchase and operating agreements ("PPOAs"), which will need to be included in customer rates. According to LEI, it is possible that the costs of the PPOAs may not be completely offset by reduced use of fossil fuels. [12]

Second, a restructured PREPA should be a solvent entity, at least on paper. As Professor Ramón Cao has stated the "restructured debt is sustainable if, and only if, PREPA is able to effectively operate as an electric utility after the implementation" of the plan of adjustment.[13] This issue is more than a mere accounting technicality. If PREPA is still insolvent, even after exiting the negotiation process, then it is questionable whether the plan of adjustment would be confirmable by the Court. While PROMESA does not require that solvency be established to confirm a plan of adjustment, it does require that it be "viable" and certainly solvency is at least one component of any "viability" analysis.

Debt reduction, therefore, has to be drastic. According to PREPA's Monthly Report to its Governing Board for the Month of December 2021, PREPA's liabilities totaled $18.1 billion, while its assets added to $10.1 billion, a difference of $8 billion. In theory, then, that is the minimum amount — **$8 billion or 44% of all liabilities** — by which all of PREPA's obligations would have to be reduced in order to keep it as a minimally sustainable going concern post-restructuring.

Again, PROMESA does not require that solvency be established in order to confirm a plan of adjustment, but it would be extremely ironic, not to say utterly irrational, to finish this expensive five-year process with an entity that is still technically insolvent. On the other hand, the approach proposed

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The LEI Report was prepared for the Official Committee of Unsecured Creditors of the Puerto Rico Electric Power Authority.

[10] Id.

[11] Id. at p. 97. With respect to the first $16.4 billion we note that as of the date of this Policy Brief, FEMA and HUD have committed to fund only approximately $12 billion of the required T&D capital expenditures.

[12] Id. at p. 4.

[13] Ramón J. Cao García, *An Independent Evaluation of PREPA's Financial Sustainability and its Impact on Proposed Restructuring Support Agreement, PROMESA Proceedings and Funding Scenarios on PREPA Planned Capital Investments*, May 19, 2020, (the "Cao Report 2"), p. 4 and p. 7.

by Professor Cao appears to be reasonable. It seeks the answer to one question: would PREPA be solvent on a balance sheet and cash flow basis after giving effect to the proposed transaction? Doing that analysis for a stand-alone entity such as PREPA is relatively easy, especially in comparison with the complex nature of Puerto Rico's central government finances.

For the sake of clarity, we are not arguing in favor of reducing every single creditor's claim against PREPA by 44%. Instead, our point is, based on Professor Cao's methodology, that PREPA's total obligations should be reduced *on average* by 44%. The amount of the actual impairment of each creditor's claim would be the subject of negotiation or litigation among the parties.

Fourth, eliminate the securitization structure. Under the terms of recently terminated RSA, the parties to the agreement would have exchanged their existing bonds for new bonds (the "New Bonds") to be issued by a "special purpose public corporation and instrumentality of the Government of Puerto Rico, constituting a corporate and political entity independent and separate from the Government of Puerto Rico, PREPA and any other Government Entity."[14]

The repayment of the New Bonds would have been secured by a lien on the future cash flow generated by PREPA through the imposition of a **Transition Charge**. This was a special charge that would have been added to the amount billed to PREPA's customers and used solely to pay the New Bonds. The Transition Charge was designed to increase over time, from 2.768 c/kWh during the first fiscal year after the issuance of the New Bonds up to a cap of 4.552 c/kWh during fiscal year 2044 and thereafter.

This so-called "securitization structure" would have guaranteed the repayment of the New Bonds regardless of PREPA's operational situation and would have represented a significant upgrade of the bondholder's collateral package. PREPA legacy bonds are "special revenue bonds" which are commonly issued by governmental agencies that provide such basic services as transportation, water, sewers, electricity, gas for heating, and so on. The repayment guarantee for these bonds, as is the case with the existing PREPA bonds, is a lien against the **net revenues** (*after payment* of the operating costs of the issuer) generated by the issuer. We see no reason for upgrading this security structure or for substantially modifying PREPA's current relative repayment priorities, *unless* creditors provide an infusion of new money, something analogous to a debtor in possession financing, or some other similar consideration.

Fifth, keep in mind that any rate increase to pay off debt will have negative economic consequences. Electricity prices affect economic activity and economic activity affects electricity prices. Under the 2019 RSA, PREPA would have started billing the Transition Charge in the near term, while any savings from switching to cheaper fuel sources and other cost-saving measures would probably have taken several years to materialize.

In theory, as some FOMB have representatives have argued, it is possible that the imposition of the Transition Charge or a similar special charge to pay off debt would not necessarily have entailed a rate increase for customers, so long as PREPA reduced its system-wide operating costs by an amount

[14] *Definitive Restructuring Support Agreement*, Exhibit C (Recovery Plan Term Sheet), Annex A (Securitization Term Sheet), Schedule I-B (Securitization Protections), p. I-B-1.

equal to or greater than the Transition Charge. In practice, achieving that amount of cost reduction would be very difficult, given the state of PREPA's operations, and PREPA's prior history of mismanaged initiatives to reduce costs certainly casts a shadow on its ability to reduce costs by an amount that would offset any such special charge.

Therefore, it is highly probable that rates would have increased significantly under the old RSA due to the Transition Charge. Professor Cao estimated that increasing rates by the amount of the Transition Charge would have reduced GNP in Puerto Rico by 8.1% in real terms by 2024 relative to actual GNP at constant prices in FY2017 and induced a reduction in total employment of 33,382 jobs by 2024, equivalent to 3.4% of total employment in FY2018.[15]

Lower economic activity and employment would, in turn, reduce the demand for electricity. According to estimates by Professor Cao, demand for electricity by residential, commercial, and industrial consumers would have declined by 21.8%, 7.8%, and 34.2%, respectively by fiscal year 2024 relative to electricity consumption in fiscal year 2017.[16]

Lower demand for electricity would force PREPA to further increase its rates to cover operating costs and meet its obligations. Failure to do so would result in the deferment of capital investments and/or maintenance costs, which would adversely affect the quality of service. And under that scenario, we could expect an increase in "grid defection." That is, we could expect an increase in the number of customers switching to their own generation sources or connecting "informally" to the PREPA grid, "leaving only the customers that cannot afford to leave the PREPA service franchise; those are the customers that are least likely to be able to afford to pay for the rising electricity rates."[17]

CONCLUSION

The recently terminated PREPA RSA was the third failed attempt to restructure at least a portion of PREPA's debt. Judge Taylor Swain in her March 8 Order expressed her concern that "the termination announcement presents the risk of a major setback in progress toward readjustment of PREPA's liabilities."[18] She also imposed a tight deadline for the FOMB to commence a mediation process and file a plan of adjustment, or a term sheet thereof; submit a schedule for the litigation of pending issues; or show cause as to why the Court should not dismiss the Title III case. Time, therefore, is of the essence.

However, while we fully understand the desire to expeditiously conclude this process after five years of expensive and drawn-out negotiations, it is just as important to get right both the process and the substance of the debt restructuring.

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[15] Ramón J. Cao García, *An Independent Economic Evaluation of the Definitive Restructuring Support Agreement for Outstanding PREPA's Debt, of PREPA Fiscal Plan and a Modest Proposal*, August 30, 2019, (the "Cao Report 1"), p. 20 and p. 24.
[16] Id. at p. 27, p. 28, and p. 30.
[17] *LEI Report*, p. 65.
[18] March 8 Order at p. 10.

In procedural terms, we believe an inclusive mediation process is the best alternative to achieve a viable agreement among the parties, especially in contrast with the alternatives of prolonged litigation or the dismissal of the Title III case.

In terms of the substance of the transaction, our view is that any proposed plan of adjustment to restructure PREPA's liabilities has to (1) take into account the complicated environment in which PREPA operates; (2) result in a restructured PREPA that is solvent; (3) reduce PREPA's total obligations by at least 44%; (4) be based on a net revenue lien on PREPA's revenues, and (5) minimize any rate increases to pay off debt.

Anything less would probably result in a defective debt restructuring, raising the specter of a new bankruptcy within the next five years.

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