PREPA's Debt Restructuring – What's Next?

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Summary of the analysis by Sergio M. Marxuach, Policy Director at the Center for a New Economy, on PREPA's debt restructuring

(March 24, 2022) The recently terminated PREPA Restructuring Support Agreement ("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." She also imposed a tight deadline for the Fiscal Oversight and Management Board 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.

In this policy brief, therefore, we offer some recommendations that hopefully will provide a useful framework to thoughtfully analyze any new proposal to restructure PREPA's debt.

These recommendations are:

- Any new plan of adjustment for PREPA has to be comprehensive in nature — This means **the plan of adjustment must take into account the complicated environment in which PREPA operates**, Puerto Rico's weak economy, the fragility of the island's transmission and distribution system, PREPA's aging generation fleet, the politicization of its management, and PREPA's prior history of mismanaged initiatives to reduce costs.

- A restructured PREPA should be a solvent entity — This 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 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. 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.

- Eliminate the securitization structure — Securitization would have guaranteed the repayment of the new PREPA bonds regardless of PREPA's operational situation and would have represented a significant upgrade of the bondholder's collateral package. **The repayment guarantee for any new PREPA bonds**, as is the case with the existing PREPA bonds, **should be a lien against the net revenues** (*after payment* of the operating costs of the issuer) generated by PREPA. 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.

- Any rate increase to pay off debt will have negative economic consequences — Electricity prices affect economic activity and economic activity affects electricity prices. **Any significant rate increases to pay off debt would reduce economic activity and employment, which, in turn, would reduce demand for electricity.** 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.