

Policy Brief

Another Look at the PREPA-LUMA Agreement

Sergio M. Marxuach, Policy Director

Center for a New Economy

San Juan, PR | Washington, DC | Madrid, Spain

September 2022



INTRODUCTION

Puerto Rico's energy system has been in the news again. Rate increases, widespread outages, and generally unreliable service have combined to generate street protests as well as calls by politicians, artists, and other stakeholders for the government of Puerto Rico to cancel or terminate the public-private partnership agreement with LUMA Energy for the operation of the island's electric grid.

As of the date of this Policy Brief, it is clear that LUMA has not performed up to expectations. A [recent analysis](#) by the Puerto Rico Energy Bureau (the "PREB") found that both the duration and frequency of outages had increased during the six months between January and June of the current calendar year. This is a particularly disappointing finding because, while we understand that bringing the performance of the system up to world-class standards will take years, so far we have not seen even nominal progress towards achieving that objective. Indeed, according to the PREB's analysis, the needle is moving in the opposite direction. Instead of seeing modest and continuous progress, say a 3 or 4 percent reduction in the duration of outages, we are, in a sense, in negative territory.

In addition, LUMA has faced difficulties in operating within approved and established budgets, and any savings it may have generated so far from the more efficient operation of the grid appear to be negligible. This is unacceptable.

However, while we fully sympathize with and support the demands for affordable and more reliable electric service in Puerto Rico, the objective reality is that not all of our electric power troubles can be blamed on LUMA. The transmission and distribution system, while functional, has been in a fragile state since the emergency repairs related to the damage caused by Hurricane Maria were finalized in 2018.

In addition, PREPA's generation fleet, with the exception of a handful of units that have been retrofitted to burn natural gas, has not been modernized. It still relies mostly on oil and diesel fuel for the generation of electricity. This means that Puerto Rico is at the mercy of oil and natural gas markets, which have been roiled recently by the unexpectedly rapid economic recovery from the Covid-19 pandemic, the strong post-pandemic shift towards the consumption of manufactured goods (instead of services), other constraints on energy supply, and the invasion of Ukraine by Russia.

Therefore, a share of the outages, at least those related to the patched-up state of the grid, and the rate increases, which are mostly, if not wholly, a function of increases in fuel costs, cannot be properly charged to LUMA.

CNE already published [an extensive analysis of the operation and maintenance agreement](#), back on August 2020. Our objective with this new analysis is to provide a succinct evaluation of the situation today, analyze the options available to the government of Puerto Rico, and hopefully clarify some of the confusion surrounding the operation of this public-private partnership agreement.

WHERE ARE WE TODAY?

In order to understand where we are today, we need to understand the series of events that brought us here and the timeline that was triggered by the execution of the operation and maintenance agreement. This review may be a little tedious but it is absolutely necessary to understand the nature of the transaction Puerto Rico executed in 2020, as well as the options available today. So, let's take it from the top, as music teachers say.

On June 22, 2020, the Puerto Rico Electric Power Authority ("PREPA" or "Owner"), the Puerto Rico Public-Private Partnerships Authority (the "P3 Authority" or the "Administrator"), and LUMA Energy LLC ("LUMA" or "Operator"), entered into an Operation and Maintenance Agreement (the "O&M Agreement").

- The execution of the O&M Agreement started the clock on a transition period (the "Front-End Transition Period"), defined in the O&M Agreement as the period between the **Effective Date of the O&M Agreement** (June 22, 2020) and the "**Service Commencement Date.**"
- The Service Commencement Date, in turn, is defined in Section 4.7(b) of the O&M Agreement as the date on "which a handover to Operator of the O&M Services occurs, which shall be (i) the first (1st) Business Day of a calendar month that is at least three (3) Business Days following the date on which Administrator delivers a certificate to Operator confirming that all Service Commencement Date Conditions have been met or (ii) such other date as the Parties may agree. The satisfaction or waiver of all the Service Commencement Date Conditions is required for the achievement of the Service Commencement Date."
- So, in theory, the Service Commencement Date under the O&M Agreement should have been June 1, 2021.
- But that is not the entire story. The parties also executed on June 22, 2020 a **Supplemental Agreement**, at the behest of the Fiscal Oversight and Management Board ("FOMB"). The Supplemental Agreement amended parts of the O&M Agreement and entered into effect on June 1, 2021 (the "Supplemental Agreement Effective Date").
- Among the most significant of those amendments, we find the following in Section 6.1 of the Supplemental Agreement: "**in addition** to the Service Commencement Date Conditions set forth in the O&M Agreement, **it shall be** a Service Commencement Date Condition **that the Title III Exit shall have occurred and that the Title III Plan and order of the Title III Court confirming same shall be reasonably acceptable to Operator.** The Parties shall follow the process set forth in the O&M Agreement for establishing the Service Commencement Date, upon which date this Supplemental Agreement shall terminate and be null and void."
- Thus, the Supplemental Agreement changed the Service Commencement Date under the O&M Agreement, added a key condition to the Service Commencement Date under the O&M Agreement (the Title III Exit,) and partially substituted the timeline set forth in the O&M Agreement by creating an "Interim Period" of operation.

- Pursuant to Section 2.3 of the Supplemental Agreement the “Interim Period Service Commencement Date” shall be the first (1st) Business Day of a calendar month that is at least three (3) Business Days following the date on which the Administrator delivers a certificate to the Operator” confirming that certain conditions set forth in the Supplemental Agreement have been satisfied. That date was June 1, 2021.
- In turn, Section 2.4 of the Supplemental Agreement defines the “Interim Period” of operation as the period between the effective date of the Supplemental Agreement and “the earlier of (a) the Service Commencement Date [under the O&M Agreement] and (b) the Interim Period Termination Date [under the Supplemental Agreement].”
- The “Interim Period Termination Date” occurs automatically in the event that the Service Commencement Date under the O&M Agreement does not occur on or prior to the date that is eighteen (18) months after the Supplemental Agreement Effective Date (June 1, 2021). In that case, “the Supplemental Agreement and the O&M Agreement shall automatically terminate without further action by Operator, and without need for a court decision or arbitral award confirming such termination.”
- However, “the Interim Period Termination Date **may, if requested by Administrator,** be extended by the mutual agreement of the Parties prior to the then-current Interim Period Termination Date.”

So, where does that leave us? First, LUMA has been operating the Puerto Rico transmission and distribution system (the “T&D System”) for approximately 15 months now pursuant to the terms and conditions of the O&M Agreement **as amended** by the Supplemental Agreement.

Second, this means that the clock has not started running on the 15-year term of the O&M Agreement, as Section 2.4 of the Supplemental Agreement clearly states “the occurrence of the Interim Period shall not in any way reduce or be applied against the Initial Term.” Thus, assuming the Title III Exit occurs by December 31, 2022, the first full year of the O&M Agreement’s 15-year term would be 2023.

Third, the fixed Service Fee payable to LUMA in accordance with the Supplemental Agreement is significantly higher than the fixed fee it would receive under the O&M Agreement. According to Section 3.3 the “Interim Period Service Fee” shall be \$115,000,000 in 2020 dollars, adjusted for inflation in accordance with Annex VIII of the O&M Agreement, in contrast with the Service Fee payable under the O&M Agreement which is \$70,000,000 in 2020 dollars, adjusted for inflation in the same manner, for the first year of the contract. The same pattern prevails during the entire Interim Period.

This higher fee could be interpreted in two ways. First, it could be construed as a pressure mechanism on bondholders to reach a Title III agreement as soon as possible because the Interim Period Service Fee is considered an “administrative expense” that has priority over payments to bondholders. In theory, the sooner the Interim Period ends, the more cash available to bondholders as the obligation to pay the higher Interim Period Fee ends.

The other way to interpret this clause could be as a pressure mechanism on the government of Puerto Rico, specifically PREPA, to exit the Title III process as soon as possible, again to save money on the Service Fee payable to LUMA.

Whichever way it cuts, however, it does not appear to have had much of an effect on the Title III negotiations. It has certainly benefitted LUMA.

Finally, the Supplemental Agreement sets forth additional causes for termination that could be invoked by either the P3 Authority or LUMA.

WHAT ARE SOME OF THE MOST LIKELY SCENARIOS?

Given the current state of play and the growing dissatisfaction with LUMA's performance, what are some of the most likely scenarios and their consequences?

Scenario 1: Run Out the Clock

Section 7.1(a) of the Supplemental Agreement provides for the automatic termination of both the O&M Agreement and the Supplemental Agreement in the event that the Service Commencement Date under the O&M Agreement does not occur within 18 months of the Supplemental Agreement Effective Date. Given that the Supplemental Agreement Effective Date is June 1, 2021, the Section 7.1(a) term expires on **November 30, 2022**.

In addition, since it is likely that at least one condition precedent to the Supplemental Agreement Effective Date, namely a Title III Exit — which requires that a Title III Plan be approved by creditors and the issuance of an order of the Title III Court confirming the same — will NOT occur on or prior to November 30, 2022, the government of Puerto Rico will have to make a policy decision regarding the extension of the Interim Period Termination Date under the Supplemental Agreement.

The language of Section 7.1(a) is quite clear:

This Supplemental Agreement and the O&M Agreement shall automatically terminate without further action by Operator, and without need for a court decision or arbitral award confirming such termination, in the event that the Service Commencement Date does not occur on or prior to the date that is eighteen (18) months after the Supplemental Agreement Effective Date (such date, the "Interim Period Termination Date"), which Interim Period Termination Date may, if requested by Administrator, be extended by the mutual agreement of the Parties prior to the then-current Interim Period Termination Date.

From a reading of the plain language of the agreement, we can reach the following conclusions:

- First, the termination of both agreements is automatic on the Interim Period Termination Date.
- Second, a close reading of the relevant language shows that it is within the discretion of the government of Puerto Rico to let the clock run out on both agreements. The Supplemental Agreement clearly states that the Interim Period Termination Date *may* (instead of “shall”), *if requested* by the P3 Authority (as Administrator of the O&M Agreement), *be extended by mutual agreement*. If the government of Puerto Rico does not request the extension of the Interim Period, then the automatic termination language becomes effective.
- Third, contrary to popular belief, there is no requirement to obtain the prior approval of the FOMB to let both contracts expire pursuant to Section 7.1(a) of the Supplemental Agreement.

The termination of both the O&M Agreement and the Supplemental Agreement would have at least two consequences. First, pursuant to Section 7.2(c)(i) of the Supplemental Agreement, PREPA would be required to pay LUMA the Operator Termination Fee, which in this case would be equal to the Interim Period Service Fee (see Section 4.2(d) of the Supplemental Agreement). As we explained above, the Interim Period Service Fee is \$115,000,000 in 2020 dollars, adjusted for inflation.

Second, the termination of both agreements would trigger the clock on the Back-End Transition period, which could last up to twelve months and during which LUMA would wind up its operations and transfer them to a successor operator. PREPA would be responsible for paying a Back-End Transition Fee to cover the cost of LUMA's operations during this period. The problem with this scenario is that it appears there are no candidates to be a successor operator in the event of termination. That is, there appears to be no Plan B.

Scenario 2: Go the Long Way

In the alternative, the government of Puerto Rico could seek to declare the occurrence of an Operator Event of Default under section 14.1 of the O&M Agreement. That section describes several events any one of which would constitute an Event of Default under the O&M Agreement. In all likelihood, the government would probably seek to declare an Event of Default pursuant to Section 14.1(d), for the failure of the Operator to perform a material obligation under the O&M Agreement.

This process would begin with the government of Puerto Rico sending a notification to LUMA describing what it deems to be at least one Operator Event of Default. Delivery of the notification then triggers a long and winding process to terminate the O&M Agreement:

- First, the Operator would have 60 days to “cure” the default and an additional 30 days if it is “diligently attempting in good faith to cure such failure and it is reasonably expected that such failure is curable”.

- If the default is not cured within the 90-day period, then the Administrator may terminate the O&M Agreement upon not less than one hundred twenty (120) days prior written notice to Operator, subject, to the extent required by law, **to the prior approval of the PREB or the FOMB** (if then in existence). Notice that in this scenario, in contrast with termination pursuant to the Supplemental Agreement, obtaining prior approval from the FOMB may be necessary to the extent required by applicable law.
- At this point, however, LUMA has the right to contest, pursuant to a Dispute Resolution mechanism set forth in Article 15 of the O&M Agreement, whether an Event of Default has actually occurred.
- The Article 15 Dispute Resolution Process begins with a Notice of Dispute setting forth the subject of the Dispute Resolution Process. Once the Notice of Dispute is delivered, the Designated Persons of the parties have 30 days to negotiate in good faith a solution to the dispute.
- If after 30 days of negotiations the dispute is still unresolved, then the parties have two options: (1) if it is a “Technical Dispute”, they must submit it to an independent expert who shall have 60 days to make his determination, which shall be binding upon the parties; or (2) if it is a dispute other than a Technical Dispute, then the dispute could be referred to Mediation by either the Administrator or the Operator.
- If the parties choose Mediation, then the parties shall appoint a mediator, who shall have 90 days to mediate the dispute. If the dispute is not resolved within 90 days, then the Mediation process shall be terminated.
- At this point, either party may file a civil lawsuit seeking relief in the courts of the Commonwealth of Puerto Rico.
- If the government of Puerto Rico obtains a decision in its favor, subject to any appeals, then it could proceed to terminate the O&M Agreement.

If the government of Puerto Rico successfully terminates the O&M Agreement due to an Operator Event of Default it is entitled, depending on the reason for the termination, to receive payment from the Operator of the Owner Termination Fee, which is equal to \$20,000,000 in 2020 dollars, adjusted for inflation, if the termination occurs during the first five years of the term of the contract, or \$10,000,000 in 2020 dollars, adjusted for inflation, if the termination occurs on any other year thereafter.

The termination of the O&M Agreement pursuant to Article 14 would also trigger the clock on the Back-End Transition period, which could last up to twelve months and during which LUMA would wind up its operations and transfer them to a successor operator. PREPA would also be responsible for paying the Back-End Transition Fee to cover the cost of LUMA’s operations during this period.

But the same problem remains, who would take over the operation and maintenance of the Puerto Rico T&D System?

Scenario 3: Play Hardball

Under this scenario, the objective would not be to terminate the O&M Agreement but to turn up the heat on LUMA to get it to improve its performance. The government of Puerto Rico could do this in any number of ways, but the most effective probably would be by withholding a portion of the Interim Period Service Fee payable to LUMA. In that event, LUMA would probably argue that such withholding constitutes an Owner Event of Default under Section 14.3 of the O&M Agreement.

At that point, however, the government of Puerto Rico could invoke the provisions of the Dispute Resolution mechanism pursuant to Article 15, which would set in motion the same dispute resolution process described in Scenario 2. The idea is that the tedious negotiation and mediation process will force the parties to the table and agree on a set of actions to be undertaken by LUMA to improve its performance. It remains to be seen, however, whether the government of Puerto Rico has the backbone and the resolve to execute this Scenario.

THE CONSEQUENCES OF HAVING NO PLAN B

As we have mentioned above, Scenarios 1 and 2 both suffer from the same fatal defect: there is no obvious candidate to take over the operation of the T&D System in the event the O&M Agreement is terminated.

Devolving the operation of the T&D System to PREPA, a criminally corrupt and extremely inefficient corporation, would be a regression, instead of progress towards meeting Puerto Rico's energy objectives. In addition, most of PREPA's employees with experience in T&D have either retired or moved to other government agencies. Thus, even if it were desirable to return the operation of the grid to PREPA it may be unable to do so.

In the alternative, seeking a new operator pursuant to the Puerto Rico P3 law would be a cumbersome process that could take up to two years. Given the experience with LUMA, it seems highly unlikely to us that many world-class companies will be lining up to take up its place as operator under the same terms and conditions granted to LUMA. If anything, any such interested company would probably seek even more favorable terms than the ones currently set forth in the O&M Agreement. There is also the risk that a hastily put together fly-by-night operator with political connections may obtain the new contract, leaving Puerto Rico with the worst of both worlds: a fragile T&D System and an incompetent, corrupt operator. A scenario that would be absurd in almost any other country, but which cannot be categorically ruled out in Puerto Rico today.

In addition, we have to take into account the impact that terminating the O&M Agreement now could have on the disbursement of the FEMA and CDBG-DR funds allocated for the reconstruction of the grid. The likely scenario is that both agencies would adopt a wait-and-see attitude with respect to such

disbursement as legal and operational wrinkles are worked out. This means that the reconstruction of the grid would take even longer than the currently projected 10 years.

All of the above leads us to conclude that the most practical scenario is Scenario 3 or a variation thereof. After 15 months of operation, it is clear that LUMA is not measuring up to expectations. Both the PREB and the P3 Authority have been critical of various aspects of LUMA's performance. So far LUMA: has incurred budget overruns; has failed to meet key performance metrics regarding the duration and frequency of outages; is behind schedule in meeting certain maintenance goals (for example, controlling vegetation growth around important lines); and has shown little evidence that it is achieving the savings it represented it would generate from more efficient management of the T&D System. It is up to the government of Puerto Rico, then, to defend the interests of the Puerto Rican people.

WHEN CAN I EXPECT MY ELECTRICITY BILL TO DECREASE SIGNIFICANTLY?

This is a difficult question to answer both honestly and with any accuracy due to several reasons. There are many factors that could affect the cost per kWh in Puerto Rico, some of which are within our control and some that are not. Some of these factors are, for example:

- The restructuring of PREPA's debts in a court-supervised process pursuant to Title III of PROMESA, the settlement of which may require an increase in rates to pay creditors;
- The privatization of PREPA's generation fleet, which probably will require the payment of a service fee to a private operator and thus perhaps result in another rate increase;
- The modernization and reconstruction of the grid, which is necessary to maximize the interconnection of renewable energy generation resources;
- The transition to large-scale renewable generation resources, which is taking longer than expected and is being opposed by special interests from the oil and natural gas sector;
- The war in Ukraine, which has generated a spike in the price of both oil and natural gas;
- The increased world demand for and high cost of rare earth metals, which are necessary for manufacturing batteries, certain kinds of solar panels, and wind turbines;
- Puerto Rico's government lack of capacity to successfully execute complex policies and, unfortunately, complex problems oftentimes, not to say almost always, require complex solutions; and

- Perhaps related to the prior point, the multiplicity of federal and state agencies with partial jurisdiction over Puerto Rico’s energy sector — among others we can name the DOE, FEMA, HUD, the PREB, PREPA, LUMA, the P3 Authority, COR3, the Puerto Rico Department of Housing, the Puerto Rico Energy Policy Office in the Department of Economic Development and Commerce, a recently appointed Deputy Chief of Staff to the Governor in charge of energy issues, and the FOMB — means that no entity is really in charge, no agency is actually looking at the entire puzzle.

Of all the factors mentioned above, perhaps the most important in terms of lowering the cost of electricity in Puerto Rico is the transition to large-scale renewable sources of generation. According to [unaudited financial information available from PREPA’s website](#), during the period between July 2021 and May 2022, PREPA spent \$1.85 billion on fuel and \$758 million on purchased power, which is equivalent to 73% of total expenditures of \$3.568 billion incurred during that period. This means that your monthly bill will not significantly decrease in the short term unless (1) the world price of oil and natural gas suddenly plunges; or (2) Puerto Rico significantly increases its capacity to generate electricity from large-scale renewable sources.

To put the situation in perspective, even if we assume that terminating the O&M Agreement would immediately generate \$115,000,000 in savings, which is not necessarily true because, as we have seen, PREPA would still have to cover LUMA’s costs of operation during the Back-End Transition Period, the savings per client would amount to \$6.42 per month, or 21 cents per day, on average.

That is why we emphasize and underscore the need to start rolling out large-scale renewable energy projects. Rooftop solar systems can be a part of the solution but it is unlikely that building an island-wide reliable “grid of grids” consisting solely of interconnected rooftop solar systems can be accomplished in Puerto Rico in a financially feasible manner. Puerto Rico’s relatively large-scale industrial sector calls into question the reliability of such a grid, while its high poverty rates and low wages cast a shadow on its financial viability.

CONCLUSION

As we stated at the beginning, we empathize with those who are advocating for a more reliable, affordable, and dependable electric power system in Puerto Rico. Unfortunately, the public debate on this issue has devolved into a silly shouting match between those who support LUMA and those who are against it. But to paraphrase Pope Francis, reducing complex reality to simple binaries is the result of mediocre thinking and when faced with such a reductive, partial mental scheme we must try to transcend it.

The current public debate is a circus sideshow because both sides are wrong: it is equally irresponsible to grant LUMA a blank check as it is to terminate the O&M Agreement without identifying a viable successor operator. In our view, the key questions are (1) why has LUMA been unable to meet basic performance objectives during the past 15 months?; (2) what is the government willing and able to do about it?; (3) what are the consequences of terminating the O&M Agreement?; and (4) what are

the viable alternatives to LUMA, that is what is Plan B? These are the questions we should be asking and analyzing.

As we have seen, it is possible to terminate the agreement with LUMA but there will be some severely adverse consequences, especially if there is no Plan B. Under current circumstances, we would counsel against that course of action. That does not mean, however, that there is nothing that the government can do. Scenario 3 described above is one possible alternative.

At a minimum, though, we recommend that the P3 Authority hire an independent firm of world-class engineers, preferably from the mainland or from Europe, with no business or political connections to Puerto Rico, to relentlessly and unwaveringly supervise LUMA's performance of its obligations pursuant to the O&M Agreement.

Finally, we warn our readers against believing those who are already peddling easy fixes and trafficking in false hopes with the expectation of financial or political gains, or both. There are no effortless solutions to Puerto Rico's energy problems. It will take several years of steadfast hard work to rebuild the system and decrease energy rates. There are no shortcuts, no easy answers, and no straightforward ways out. The only option is to work through it. Otherwise, we face the unpleasant prospect of several more years of economic decline and social stagnation that would entail.



The Center for a New Economy (CNE) is Puerto Rico's first and foremost policy think tank, an independent, nonpartisan group that advocates for the development of a new economy for Puerto Rico. For more than 20 years, CNE has championed the cause of a more productive and stable Puerto Rico through its offices in San Juan, Puerto Rico, Washington, D.C., and Madrid, Spain. We seek to inform current policy debates and find solutions to today's most pressing and complex economic development problems by rigorously analyzing hard data and producing robust empirical research. CNE is organized as a 501(c)(3) nonprofit that does not solicit or accept government funding. It relies solely on funding by individuals, private institutions, and philanthropic organizations.