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AN INDEPENDENT EVALUATION OF PREPA'S FINANCIAL SUSTAINABILITY AND ITS IMPACT ON THE PROPOSED RESTRUCTURING SUPPORT AGREEMENT, PROMESA PROCEEDINGS AND FUNDING SCENARIOS ON PREPA PLANNED CAPITAL INVESTMENTS

EXECUTIVE SUMMARY

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Introduction

The purpose of this report is to evaluate the Puerto Rico Electric Power Authority (PREPA) financial sustainability and its impact on its operations. The report considers PREPA' financial position after Hurricanes Irma and Maria, which became aggravated after the January 2020 seismic events and under the present COVID-19 health crisis. As shown on this report, PREPA's historic deficit and insolvency is impacted by the present environment, creating an even more difficult situation for the utility. Under this complicated scenario the proposed PREPA's Debt Restructuring Agreement (RSA)[1], presented in court as part of the current PROMESA Title III proceedings[2], shows not to be a solution to PREPA's gross insolvency and deficits. Additional and more severe measures are required to bring PREPA to solvency and a sustainable financial position, which is urgently needed within the present scenario.

Available data does not allow to do a detailed analysis the effects of January 2020 tremors and the COVID-19 pandemic on PREPA's finances[3]. However, those events

[1] Definitive Restructuring Support Agreement of Puerto Rico Electric Power Authority. May 3, 2019. Financial Oversight and Management Board.

[2] In addition to the Financial Oversight and Management Board (FOMB), the RSA was also approved by PREPA and the Puerto Rico Fiscal Agency and the Financial Advisory Authority (AAFAF).

[3] Financial data used in the analysis is taken from interim reports published by PREPA on its web page (Monthly Reports to the Governing Board). These reports are not audited financial statements, but they

bring additional pressure on PREPA with expected consequences on all customer classes, in which electricity demand is being directly affected by the closing of business, while the ability of many residential consumers to pay their electricity bill is questionable. Defaults and late payment are part of the consequences that this crisis will have on the utilities. This suggests that the effects of this crisis on PREPA's finances will not be unnoticeable, but rather it will affect its capacity to pay its debt.

Insolvency of PREPA

PREPA is operating an old and unstable system that urgently needs to be modernized. To upgrade the electric power grid, substantial investment is required. Some of these required investments are expected to be financed, in part, by the federal government through FEMA and other federal entities, and the rest of the investments will need to be financed by PREPA issuing new debt. It is therefore relevant to assess whether, after the proposed RSA, PREPA will have the capacity to issue new long-term debt and, if so, the effect of this new debt on the PREPA's financial capacity to maintain a sustainable operation.

Given PREPA's high state of insolvency, with debt of about $17,692 million and a difference between assets and liabilities reflecting a deficit in over $7,750 million[4], the RSA does not solve PREPA's insolvency problem. As a result, in order to improve and resolve the long-term sustainability and future solvency of PREPA, the debt resulting from PREPA bond issuances, after restructuring, should not be considered as a liability of the utility. It appears the RSA tries to achieve that purpose, not by reducing PREPA's debt substantially, but, through the issue of securitization bonds by a separate legal entity that assumes such debt. Through that means, PREPA's restructured long term bonds debt could not be reflected on PREPA. Notwithstanding, the restructured bonds debt will still be paid by PREPA customers, through a special charge in energy bills, known as Transition Charge.

Even if it is considered to fully eliminate, from PREPA liabilities, the $8,300 million debt related to existing bond issuance, PREPA would continue showing insolvency parameters reflecting a debt-to-asset (D/A) ratio of 0.95.

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are more up to date and reliable sources of information available. The last report used on this evaluation is the one for December 2019.

[4] Monthly Report to the Governing Board for December 2019. https://aeepr.com/es-pr/investors/FinancialInformation/Monthly%20Reports/2019/December%202019.pdf

Impact of Federal Funds

Another aspect to consider is the participation of federal reconstruction funds to help alleviate the PREPA insolvency and partially finance necessary investments. The report evaluated eight scenarios that consider the effect of these funds using the information included in the Integrated Resource Plan (IRP) proposed by PREPA and eight other scenarios based on the Grid Modernization Plan. Analysis of the different scenarios shows that, even considering a strong injection of federal funds, ranging from 45% to 90% of reconstruction costs, PREPA would stay showing insolvency parameters. Adequate solvency parameters are only achieved when the restructured debt is not considered as a liability of PREPA and federal government finances 90% of required investment.

In total, 16 scenarios were built and analyzed over a 10-year period to assess the financial sustainability of PREPA, according to the proposed RSA, considering the investment described in the IRP and the "Grid Modernization Plan".

Whether the IRP or the "Grid Modernization Plan" is implemented, the only scenarios in which the PREPA remains financially viable after the proposed restructuring in the RSA are those that meet two conditions:

1. Restructured Revenue Bonds debt is not considered a liability for PREPA [5].
2. FEMA and other federal government agencies finance 90% of the required investments. It is unclear how much investment will eventually be provided by federal agencies. However, if federal agencies only finance 45% of the total investment, the PREPA's financial position after RSA would reflect a debt-to-asset (D/A) ratio, much higher than the U.S. national average for comparable electricity companies and close to insolvency parameters.

On the scenarios that the PREPA Restructured Revenue Bonds debt is considered, even when including massive amounts of FEMA restructuring funds ranging from 45% to 90% of reconstruction cost, PREPA remained with insolvency or near insolvency parameters in all cases, Scenarios I trough VIII.

The issuance of securitized bonds is a common practice that, when used appropriately, brings benefits to a public utility. However, this is not the case with the proposed RSA. What is striking is that PREPA consumers will continue to pay the restructured debt on

[5] This is by presuming that Restructured Revenue Bond debt will be assumed by a new legal entity through the issue of securitized bonds, or, for analysis purposes, other reasons such as that within the bankruptcy proceedings, and under current circumstances, PREPA's Restructured Revenue Bonds debt would be discarded.

their monthly bills through a Transition Charge, even if that debt is not reflected in PREPA and its financial and insolvency problems continue.

Additional Findings

Another interesting finding of the analysis in the report is that scenarios in which the PREPA retains the ownership of generation assets tend to be financially better than those in which these assets are privatized. Therefore, there is no financial justification for privatizing assets, i.e. PREPA's finances are no more sustainable under privatization. This also points to the possibility of retaining ownership and hiring the management of generation assets, if some form of privatization is desired.

This report also considered the PREPA's financial performance from fiscal year 2008,[6] finding the existence of annual operational deficits from that year to the present. These deficits began long before the extraordinary expenses caused by Hurricanes Irma and Maria, and even after the PREPA stopped paying off its debt service. This raises a warning signal, in terms that PREPA is not only having a financial problem, but also an operational one. Analysis, public discussion and government policies should be expanded to include an evaluation of PREPA's performance and how to improve it, as well as its administrative practices.

The report briefly assessed the bond issues considered within the RSA and its financial position at the date of issuance of different emissions. All RSA related debt was found to have been issued between fiscal years 2002 and 2016. As a result, according to the PREPA's audited financial statements, in all years after 2006, at the time of issuing debt, PREPA was on the verge of financial insolvency or already insolvent, and since FY 2011 always showed an operational deficit, which means that PREPA did not have the capacity to cover its operating costs and debt service. This suggests that PREPA bond issues should be audited before proposing any debt restructuring.

Conclusions

PREPA's financial and insolvency problems, with a deficit between assets and liabilities of more than $7,750 million, go beyond the solution proposed in the RSA. As proposed in the previous report, the PREPA debt-to-asset ratio (D/A) should be reduced to national parameters of 0.56. This requires substantial changes and adjustments to debt, beyond those considered in the RSA.

[6] Fiscal year 2008 is the earliest information provided in PREPA's web page.

As shown in this report, if all debt considered in the RSA is presumed to be eliminated from PREPA, the utility would still have a debt of $9,433 million, and the D/A ratio would still show insolvency parameters of 0.95. If a D/A ratio of 0.56 is applied to PREPA's total assets, considering their current values, PREPA could pay up to $5,567 million in restructured debt, without compromising its finances and operations. The restructuring of the PREPA's debt must be realistic to be sustainable. This means that the proposed RSA must be rejected and a new debt restructuring plan must be developed. The new plan must guarantee that the electric power utility must be able to attain financing for its required capital investments and operate in an efficient way. To reach this necessary targets it is required: (1) in the short run PREPA D/A ratio must be equal or less than the national norm of comparable electric power utilities; (2) electricity rates to be paid by PREPA's costumers – after covering restructured debt service, operational costs and service of debt to be incurred in financing new required capital investment – do not exceed a threshold that will induce reductions in electricity consumption that will bring PREPA to a new bankruptcy situation.

PREPA should also take advantage from federal reconstruction funds to refurbish and modernize its infrastructure, but at the same time it should also consider a comprehensive debt restructuring process. Existing PREPA debt levels require both efforts to achieve a sustainable operation. The analysis on this report also points out that PREPA's struggles are not limited to its finances, but it also has serious operational problems. Hence, it is necessary to examine and reform its administration and operational practices.

Finally, the consequences of the world health crisis of the Coronavirus are not expected to be short lived, because necessary social isolation measures are going to have long term effects on economic activity, and, probably, even on the structure of the economy, depending upon the final extend of social isolation and the policies that government finally adopts to promote growth, efficiency and equity in the economy. In consequence, it is clear that the effects of this crisis, on PREPA's finances and its capacity to pay its debt, should be considered before a final decision is reached in terms its debt restructuring process.