Comments on 2020 Fiscal Plan for the Puerto Rico Electric Power Authority, As certified by the Financial Oversight and Management Board for Puerto Rico on June 29,2020.

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Introduction

The purpose of this paper is to evaluate the *2020 Fiscal Plan for the Puerto Rico Electric Power Authority, as certified by the Financial Oversight and Management Board for Puerto Rico on June 29, 2020* (2020 PREPA Fiscal Plan). The approved Fiscal Plan does not fulfill its function of establishing a coherent roadmap for the development of PREPA. It is not consistent, internally or with other official documents. It also ignores the impact of rate increases on the agreement with PREPA's bondholders, currently in court, and the economic effects of said agreement on the economy and PREPA itself. It is an overly optimistic document that hopes for a solution – or a myriad of proposed actions based on hopeful assumptions – to the pitiful condition of PREPA's operation over the last decades, without presenting or considering the impact the proposed solutions – which are mainly based in a price increase to electricity rates – represents to Puerto Rico's economy and to the utility (PREPA).

The document pragmatically recognizes the inefficient and politically constrained operation of the electric company over time, and hopes that measures already taken, or planned to be taken, will transform PREPA into an efficient world class operation, in the not too far future. Such transformation of PREPA is supposed to take place through (1) increasing electricity tariff rates to PREPA customers, (2) reforming PREPA retirement system; (3) federal financing of the modernization of PREPA's generation, transmission and distribution systems; (4) restructuring revenue bonds or "legacy" debt; (5) transforming to positive the presently negative operational net income; (6) gaining again access to the bond markets; (7) breaking PREPA monopoly through privatization, thus creating a competitive environment; and (8) reducing the Contribution in Lieu of Taxes paid to municipalities.[2]

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[1] The author thanks helpful comments and suggestions from Horacio Matos Díaz. All remaining errors and omissions in the paper are the sole responsibility of the author.

[2] During the last two decades there has been enacted various amendments reducing the Contributions in Lieu of Taxes (CELI) that PREPA pays to the municipalities. By law, the municipalities cannot charge property tax or the transaction tax (called Patente Municipal) to PREPA. Originally CELI was designed to compensate municipalities for this special tax treatment that they have to provide to PREPA. When PREPA began to show financial shortcomings, in the late 90's and at the beginning of this century, CELI began to be modified to reduce PREPA's contributions to municipalities, and it was defined as a "subsidy", which it is not. CELI really is a compensation for forfeit taxes, and not a gift of any sort. Notwithstanding, although not the norm, in some instances there has been inadequate used of the CELI by municipalities. Such actions, coupled with other concurrent actions of the state government, have contributed to seriously damage municipal finances, in such a way that the majority of municipal governments have been suffering from recurrent operational deficits. It is urgent to reconsider the role to be played by municipalities in Puerto Rico, as well as their finances, including their tax-handles and the operation of the Municipalities Collection Center (CRIM), but this is the topic for another paper.

Cost Projections, Transmission and Distribution System

As part of this evaluation, it is pertinent to consider some peculiarities in 2020 PREPA Fiscal Plan. The first one to be pointed out is that **the Fiscal Plan includes many figures and projections without providing data sources, or identifying methodologies and assumptions used to reach these figures and projections**. Also, significant inconsistencies are found between figures in this document and other official PREPA or government documents. For example, on Exhibit 10, page 25, of 2020 PREPA Fiscal Plan it is stated that in FY2020 PREPA is expected to end fiscal year 2020 with an operational surplus of $153 million. Such statement is inconsistent with the May 2020 Monthly Report to the Governing Board of PREPA, which states that from July 1, 2019 to May 31, 2020, PREPA accumulated an operational deficit of $456 million.

Interestingly, on the first page of Chapter 7, Exhibit 30 presents a composite graph, where at its left side reports the forecasts for fiscal years 2021 to 2025 of total expenses to be incurred by PREPA in generation and transmission and distribution , based in its current structure, while at the right side there are two graphs that break down the annual totals (for FY22 to FY25) in GenCo and GridCo[3] expenses. As can be seen on Table 1, below, projected expenses for the transmission and distribution system (GridCo as per the Fiscal Plan) increases from $898 million in FY2022 to $909 million in FY2025. The selected transition and distribution system operator (LUMA Energy) is going to be on charge of GridCo operation since Fiscal 2022. PREPA 2020 Fiscal Plan repeatedly states that this private company is going to be highly successful in reducing costs and increasing efficiency. In many sections of this fiscal plan, it congratulates AAFAF, P3A, FOMB, PREB and PREPA for the wise decision of selecting LUMA Energy as the new operator for the transmission and distribution system. However, if we check Exhibit 30 on page 53, we can find that forecasted GridCo costs in FY2025 are going to be $12 million or 1.3% higher than those forecasted for FY2022.[1] **In consequence, the entrance of LUMA Energy as the operator for the transmission and distribution system should not be expected to have a significant effect on PREPA operational deficits.**

[3]Defining GenCo as the successor company that will own PREPA's generation assets and GridCo as the successor company that will own PREPA's transmission and distribution assets.

Table 1

PREPA Forecasted Annual Expenses in GridCo

Fiscal Years	T&D Expenses ($ million)[4]
2022	898
2023	879
2024	890
2025	909
Change FY22-FY25	11
%Change FY22-FY25	1.3%

Source: PREPA 2020 Fiscal Plan
Exhibit 30, p. 53.

Impacts on Electricity Rates

With regard to electricity rates, Exhibit 19 in page 43 presents two graphs: one that shows electricity rates over time if full prevailing debt is to be paid, and another graph showing projected rates **excluding debt service and <u>not including</u> the Transition Change**[5]. This is an intentional attempt to be non-transparent. The valid presentation would had been to include the Transition Charge to be paid by electricity customers under the proposed debt restructuring agreement.

Notwithstanding, **Exhibit19 includes a surcharge for pension reform.** The charge is estimated by FY2025 on 1.5 ¢/Kwh. However, on Exhibit 37 this charge is estimated on 1.8 ¢/Kwh, after a pension freeze and a reduction of 8.5%.[6] Exhibit 19 also lacks to include the impact on electricity rates if the federal government does not fund 90% of reconstruction cost. This impact was estimated on a cost increase of 2.82 ¢/Kwh by 2024 in PREPA 2019 Fiscal Plan.[7]

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[4] PREPA 2020 Fiscal Plan is not specific about if fees to be paid to LUMA are included in forecasted T&D expenses.

[5] The Transition Charge is the obligation that will be imposed to electricity consumers to recover restructured debt service.

[6] PREPA 2020 Fiscal Plan assumes as an accomplished fact that "the pension plan is going to be frozen and current pensions reduced by 8.5%." This author is not aware that any of the required formal procedures required to reform PREPA Pension Plan have been initiated. It should be expected that any proposal to reduced pension benefits is going to face opposition from Labor Unions in PREPA.

[7] PREPA Fiscal Plan 2019, as certified by the FPMB for Puerto on June 27, 2019, p. 62.

If the Transition Charge – estimated on the 2019 Fiscal Plan in 3 ¢/Kwh for year 2024 – and the rate impact due to lack in federal funding are added to the forecasted rate in Exhibit 19 of PREPA 2020 Fiscal Plan, then electricity tariff rates in FY2025 would increase by 5.82 ¢/Kwh, to 28.62¢/Kwh a 25.5% increase. It should also be noted that the Fiscal Plan does not consider the impact of such rate increase on the Puerto Rican economy and society.

Federal Reconstruction Financing and Debt Restructuring

It should be noted that PREPA 2020 Fiscal Plan does not say a thing about how much, of the required capital investments, is going to be financed by the federal government. It only says, on page 52, that:

> "The timing of potential expenditure and disbursement is still uncertain and therefore omitted by the financial projections. Puerto Rico has requested a cost-share adjustment for future FEMA program amounts under the Stafford Act. The projections in this Fiscal Plan assume that Community Development Block Grant-Disaster Recovery (CDBG-DR) program funding will be available to cover any PREPA-related matching requirements under the Stafford Act."

But such statement does not refer to the critical issue. A new study recently made for the Consumers Representative at the PREPA Governing Board[8] concluded that PREPA will not attain financial solvency with the current debt restructuring agreement, even if 90% of required capital investments – using IRP[9] and Grid Modernization Plan costs – are financed by the federal government. The study shows that PREPA would only attain financial solvency if all the long-term debt in bankruptcy Title III proceedings ceases to be a liability for PREPA, within a federal funding scenario of 90% of total costs. The previous 2019 PREPA Fiscal Plan assumes that the federal government is going to finance between 45% and 90% of required capital investments. Given known public information available, it is uncertain how much of the required capital improvement can be funded by the federal government, so PREPA's financial solvency, after Title III proceedings, is uncertain.

This open the question of PREPA's debt. At the very beginning of the 2020 Fiscal Plan it is stated:

> **"PREPA's operational shortcomings and failure to adjust rates to cover its rising costs led to the accumulation of significant legacy debt and pension obligations.** As of May 2017, PREPA held approximately $9 billion in debt obligations, while PREPA's current unfunded pension liability exceeds $4.9 billion, of which $3.8 billion is unfunded. These liabilities led PREPA to seek a restructuring of its legacy obligations through a voluntary petition under Title III of the Puerto Rico Oversight, Management, and Economic Stability Act."[10]

[8]Ramón J. Cao García, *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*, May 19, 2020.

[9] Puerto Rico Integrated Resource Plan 2018-2019. Prepared for the Puerto Rico Electric Power Authority by: Siemens Industry. June 2019.

[10] 2020 PREPA Fiscal Plan, p. 9. It is noted that legacy obligations and legacy debt is never defined in the document.

This statement is somewhat misleading. It is true that, as of May 2017, PREPA's total liabilities and net position were $9.3 billion, but its total liabilities were $13.4 billion.[11] **And the document also forgets to tell that PREPA total liabilities at December 31, 2019 were $17,692 billion.[12]** Moreover, Title III case filed by the FOMB, as part of the PROMESA proceeding, includes debt from Power Revenue Bonds amounts to $8.3 billion[13]. This leaves a $9.4 billion debt that it is not address by the debt restructuring agreement. It should be noted that, even if the complete Power Revenue bond debt is discarded during court bankruptcy proceedings or not considered as PREPA's debt,[14] PREPA remains with insolvency parameters reflecting a Debt to Asset Ratio (D/A) of 0.95.[15]

PREPA total liabilities at December 31, 2019	$ 17,692	million
Power Revenue Bond Debt	$ 8,259	million
Total PREPA Debt after RSA (assuming all long-term debt is discarded)	$ 9,433	million
PREPA total assets at December 31,2019	$ 9,889	million
Debt to Assets Ratio (D/A)	0.95	

In consequence, 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 a previous report, the PREPA debt-to-asset ratio (D/A) should be reduced to national parameters of 0.56.[16] This requires substantial changes and adjustments to debt, beyond those considered in the RSA. Hence, 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's 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.

This brings us to the issue of PREPA's future access to the bond market. Such access is essential to finance required capital investments. PREPA 2020 Fiscal Plan recognizes the

[11] PREPA monthly Report to the Governing Board for May 2017, p.15.

[12] PREPA monthly Report to the Governing Board for December 2019, p.15, quoted in R. Cao García (2020), *op. cit.*, p. 6.

[13] The Financial Oversight and Management Board for Puerto Rico, *Notice of Filing of Statement of Oversight Board Regarding PREPA's Title III Case,* Case No. 17-04780-LTS, July 2, 2017, p.3.

[14] Under the proposed RSA, the remaining Revenue Bond Debt will be owned by a third-party entity, financed through a Transition Charge to PREPA customers, and could not be considered as PREPA's debt.

[15] R. Cao García (2020), *op. cit.*, p. 7.

[16] 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 27, 2019.

relevance of such access, and assumes that it will somewhat be reached. Indeed, this fiscal plan devotes Chapter 10 to the topic.[17] The problem with this chapter is that it is superficial, and does not even attempt to answer the real issue: **Which conditions are required for PREPA to finance its share of required capital investments and be financially sustainable, and how PREPA is going to be able to fulfill these conditions?** This chapter only argues, without presenting any assessment or study that evaluates the proposed debt restructuring agreement (RSA) - and in a non-transparent way - that: (1) under the RSA the required rate increase to customers is going to be lower than the one required without the RSA, and (2) if PREPA somehow manages to have sizeable yearly operational net income in the future, and if the rate of interest to be paid by future PREPA's Revenue Bond is low enough, the Authority will be able to issue substantial amounts of debt to finance required investments.

This is further explained in Section 10.3 of the Chapter, titled Debt Sustainability Analysis. The argument on this section not only is simplistic, but also misleading, because it does not include any serious analysis and does not consider adequate information to determine if PREPA will be able to access the bond market to finance required capital investments.

In accordance with the PREPA Integrated Resource Plan (IRP) the capital investments required for the reconstruction of the electrical system is $14.7 billion. If the federal government finances 90% of that cost, PREPA will have to raise $1.5 billion through long-term credit to finance these investments[18]. According to Table 16 of Section 10.3, Illustrative Sustainable Debt Capacity Sizing, PREPA would be able to emit new Revenue Bonds in that amount if it is able to show consistent annual positive net income (operational surplus) of $150 million.[19] However, if the federal government only finances 45% of the cost of capital investments, specified in the IRP, then PREPA would have to raise $8.1 billion in financing[20]. According to the same table in Section 10.3, if PREPA, after restructuring, even have positive annual net income in the amount of $375 million, it would not be able to raise enough funds in the bond market to finance its share of the costs required by the IRP.[21,22] **In consequence,**

[17] See Chapter 10 of the PREPA 2020 Fiscal Plan.

[18] *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.* Ramón J. Cao García, May 2020.

[19] It is, of course, an open question (not adequately answered in PREPA 2020 Fiscal Plan) how the Authority is going to show net income from operations, since it has ended every year, since FY 2008, with operational deficits. At this regard, see Ramón Cao García (2020), *op. cit.,* p. 12.

[20] R. Cao García *Ibid.*

[21] In such highly optimistic scenario (yearly operational surplus of $375 million and 4.0% interest rate) PREPA would be able to issue debt in a total amount of $6.5 billion, an amount $1.6 billion short of the required $8.1 billion.

[22] PREPA 2020 Fiscal Plan does not provide annual values for net revenues, but reports a line graph on Exhibit 22 (Chapter 5) for yearly net revenues, without indicating numeric values. A visual comparison of this graph with the one reported on Exhibit 24, on forecast annual expenses excluding debt service, tend to indicate that assumed surpluses on Chapter 10 are out of bounds with the forecasts on Chapter 5. Hence, it is reasonable to

it is reasonable to conclude that PREPA will not be financially sustainable under the RSA and other assumptions on its 2020 Fiscal Plan.

The above confirms conclusions reached by a recent independent study[23] that PREPA would only have access to the bond market to finance required capital investments if: (1) U.S. federal agencies finance 90% of required capital investments, (2) Restructured "Legacy Debt" is discarded or not considered as PREPA's debt[24], and (3) PREPA becomes capable of showing operational net income in the future – instead of the operational deficits it systematically had for at least the last 18 years up to the present. **If these three conditions are not simultaneously satisfied, PREPA would be forced to go bankrupt in the near future[25].**

Competition and the "Breaking" PREPA's Monopoly

Another topic included in PREPA 2020 Fiscal Plan is competition within the system. The document repeatedly congratulates PREPA and all public entities concerned for "breaking" PREPA's monopoly. Unfortunately, this is not correct. There is no doubt that PREPA has operated as a vertically integrated monopoly since its creation. It is also true that it has already selected an operator for the transmission and distribution system through a PPP with LUMA Energy, and it plans to privatize electricity generation. But such actions do not break PREPA's monopoly; indeed, they do not even diminish its monopoly power.

Competition happens when consumers are able to choose the seller from which to purchase the good or service they want to buy. It must be realized that, even after LUMA Energy, each consumer is connected to the same electric system controlled by a single electric utility[26].

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conclude that operational annual net incomes assumed on Chapter 10 are inconsistent with previous forecasts in the same PREPA 2020 Fiscal Plan.

[23] R. Cao García (2020), *op. cit.*, pp. 25-28.

[24] In the case PREPA's debt is not discarded as part of the bankruptcy proceedings, and in the event the resulting restructured debt is not considered PREPAS's debt, it will have still to be paid by PREPA's consumers through a Transition Charge.

[25] This will be the result of PREPA not be able to finance required capital investments, then requiring to raise electricity rates - to be higher than those forecasted in the 2020 Fiscal Plan - and the demand for purchased electricity would decline more than expected in the document.

[26] This is a technological constrain. This is one of the reasons why electric companies are natural monopolies. It is also a policy decision to maintain PREPA's monopoly power. It is technologically feasible for an electric company to allow consumers to subscribe to different competing electric energy generation companies and charge them a fee for transmitting and distributing the electricity of different providers to customers of these competing suppliers. Another possibility is to indirectly promote competition in the electricity market, allowing and promoting local entities (cooperatives or otherwise) to generate energy (through micro-grids, or otherwise) and distribute electricity to its customers within a bounded local area, without any intervention from PREPA. This alternative results in an indirect promotion of competition because customers in the area served by the local entity would only choose among two providers: the local entity or PREPA, changing the local industrial structure form monopoly to duopoly. This last alternative will also create a Tiebout type of competition among local electricity providers and will impact land rents in the real estate market. (See, Charles

Moreover, the plan presented in the 2020 Fiscal Plan to privatize the electric energy generation is to follow the model presently followed with EcoElectrica and AES, i.e.; that each private electric energy generator sells its production, under contracted prices and terms of supply, to PREPA, who then distributes it among its customers (now through the system operator) under PREPA's determined rates and conditions. Such an operating model means that PREPA will be not just a monopoly, but also a monopsony[27] with regard to energy purchase. Hence, the argument that PREPA 2020 Fiscal Plan is aimed to break its monopoly is just a sophism.

Conclusion

In summary, PREPA 2020 Fiscal Plan appears to be based on optimistic and unrealistic assumptions, with significative internal inconsistencies, as well as incongruencies with other official and public PREPA documents. It has a limited value as roadmap to necessary and urgent PREPA's transformation, not answering how to deal with present uncertainties about the timing and amount of funds that the federal government are going to contribute to finance required capital investments, much less providing any clue about how PREPA is going to obtain financial resources to finance its share of required capital investments. The financial limitations faced by PREPA, under the RSA and PREPA 2019 Fiscal Plan, to finance its required share in necessary capital investment are evaluated, in more detail, in a previous report of May 2020.[28] It is also worth to note that this Fiscal Plan alert all PREPA customer that we should expect an increase in electricity rates, as result on the projected deficit of $132 million that results from the cost of the transmission and distribution operator's agreement.

Beyond the 2020 Fiscal Plan, what is really needed to transform PREPA from its present inefficient condition and transform it into an engine for the progress and welfare of the people on this island, is good regulatory processes, with broad public participation. There should be no restriction on the regulator when addressing transformational regulatory proceedings, including restructuring the *legacy debt*, as well the implementation of performance metrics and audits.

Tiebout, "A Pure Theory of Local Expenditures", *Journal of Political Economy*, Vol. 64, October 1956, pp. 416-424.) It is noted that none of these alternatives are included in PREPA 2020 Fiscal Plan.
[27] Monopsony in general terms means a market situation in which there is only one buyer.

[28] See, Ramón J. Cao García, *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*. May 2020.