

Wall Street's Power Grab in Puerto Rico

How the Electric Power Authority's Debt Restructuring Deal Left Puerto Ricans in the Dark

Puerto Rico is embroiled in a dire humanitarian crisis that is being compounded by its unsustainable debt load. The U.S. Congress passed the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) in June 2016, which created a Fiscal Control Board to oversee the Commonwealth's finances. But in order for it to do its job fairly, the Control Board must understand how Puerto Rico came to be so deeply indebted in the first place. The ReFund America Project is releasing a series of reports investigating Puerto Rico's debt. Our previous reports can be found on our website, at refundproject.org/#puerto-rico. This report focuses on debt of the Puerto Rico Electric Power Authority (PREPA) and the disastrous restructuring agreement creditors coerced the agency into in 2015.

When Puerto Rico's new Governor Ricardo Rosselló took office in January 2017, he faced an island in crisis. One aspect of that crisis is the \$9 billion in debt owed by Puerto Rico's Electric Power Authority, or PREPA. In late 2015, PREPA had agreed to a debt restructuring agreement (RSA) that was overly generous to its creditors at the expense of Puerto Rico's residents. When Rosselló took power, he had an opportunity to push for a much better debt restructuring deal for PREPA. Instead, he oversaw a tweaking of the original deal that is not significantly better for the people of Puerto Rico and still overly generous to creditors. The Governor has indicated that the PREPA deal is an example of a successful consensual negotiation process, but PREPA's RSA should be seen as a warning rather than a model.

Key Findings

There are two distinct issues with PREPA's debt restructuring. The first is the issue of the debt itself, much of which may be illegitimate. The second is the terms of the RSA itself.

First, PREPA's debt crisis is the result of a confluence of factors:

- ◆ **Puerto Rico has unique vulnerabilities.** Because of its colonial status and its exclusion from Chapter 9 bankruptcy protection, to which U.S. municipalities have access, the island has less power over its own finances than a U.S. state or city.
- ◆ **PREPA's bonds are triple tax-exempt** and thus in high demand. "Triple tax-exempt" means investors don't pay state, local, or federal taxes on the bonds. These bonds were thus considered a great investment by investors who were counting on PREPA being unable to file bankruptcy. Investors were betting that they'd be able to collect even if that meant austerity for the people of the island, so they kept buying the bonds.
- ◆ **Banks kept pushing PREPA deeper into debt because it benefited them financially.** After it was clear PREPA didn't have the revenues to pay it back, banks kept underwriting new bonds, because these banks wanted to collect fees and because they had a stake in some of the deals.

We examined bond deals between 2007 and 2013 and found that:

- ◆ Banks and legal firms collected more than \$101 million in issuance fees for the bonds.
- ◆ Banks underwrote bonds that pushed the final maturity of the debt beyond the Puerto Rican Constitution's 30-year limit.
- ◆ Banks like JPMorgan Chase and UBS have collected at least \$65 million in termination penalties on interest rate swaps connected to PREPA bonds.
- ◆ Banks such as JPMorgan Chase and UBS also underwrote the original bond deals that included the toxic swaps to which they were counterparties. JPMorgan Chase also was an underwriter on a bond deal that was used to make payments for termination penalties on those same swaps that were held by JPMorgan Chase. Such banks set up deals that gave them multiple paydays.

The second issue is the deeply flawed restructuring agreement:

- ◆ **Wall Street pressured PREPA into an unfair debt restructuring deal that is overly generous to creditors.** When it became clear that Puerto Rico's economy was in crisis and the island and its agencies would soon default on some of its debt, creditors such as hedge funds, some of which bought PREPA debt for 50 or 60 cents on the dollar,¹ then pushed PREPA into a restructuring agreement that is potentially disastrous for PREPA rate-payers and terrible for Puerto Rico's economy.
- ◆ **The RSA guarantees investor paydays at the expense of PREPA ratepayers.** One of the most egregious aspects of the RSA was its use of rate securitization—a mechanism that allows automatic rate increases for PREPA customers when energy use declines due to people being unable to afford their electricity or from people leaving the island entirely.

It is not too late to set this right. Here's how Puerto Rico can move forward:

- ◆ **The Fiscal Control Board and the U.S. District Court in San Juan should reject the current PREPA RSA.** The power to approve restructuring agreements in Puerto Rico lies with the Board and the Court and there is no reason they should approve the RSA.
- ◆ **Governor Rosselló should reinstate the Debt Audit Commission** and ensure that it is fully funded so that it can perform a detailed audit of all of Puerto Rico's debt and determine how much of Puerto Rico's outstanding debt is predatory and therefore illegitimate. Any new restructuring agreement for PREPA or any other entity in Puerto Rico should be informed by the results of a thorough audit of the island's debt.
- ◆ **The Fiscal Control Board should cancel any debt deemed illegitimate by the Debt Audit Commission,** so that Puerto Rico's scarce funds can go toward mitigating the humanitarian crisis that is unfolding on the island and improving the lives of the people of Puerto Rico.

Wall Street's Power Grab in Puerto Rico

In March 2017, the Santa Rosa Hospital in Puerto Rico lost power, jeopardizing the hospital's ability to serve its sick patients. The hospital was \$4 million behind on bills it owed to the Puerto Rico Electric Power Authority (PREPA), the financially struggling electric utility that supplies the vast majority of the island's power.² Mired in debt and facing creditors' demands for austerity policies, PREPA cut the hospital's power in an attempt to get the hospital to pay its bill. The incident highlighted the economic and humanitarian disaster currently unfolding on the island, where residents and vital service providers alike struggle and sometimes fail to afford the most basic

expenses. The incident also highlighted the importance of understanding services like electricity as a social good, something people's lives can quite literally depend on, and the danger that awaits us if we treat it solely as a commodity off of which some people profit and others sacrifice to afford, or suffer without.

Financial firms rigged the system to make sure they get paid even if it costs lives.

To understand how we got to this juncture, in which a public utility will jeopardize the lives of sick U.S. citizens by cutting off electricity to a Puerto Rican hospital, we must look at the role of the debt crisis that has ensnared Puerto Rico, and the financial firms that have rigged the system to make sure they get paid even if it costs lives.

In May 2017, Puerto Rico filed to restructure its debt under Title III of the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), the law Congress enacted in 2016 to enable the island to manage its debt crisis. However, the \$9 billion of PREPA debt was not included in the filing, because PREPA had been forced into a restructuring agreement (RSA) with its creditors in 2015. Although this RSA was deemed “voluntary”, in reality aggressive creditors like Goldman Sachs coerced PREPA into it. The RSA was vastly generous to banks, insurance companies, hedge funds, and other creditors, and pushed the burden, risk, and sacrifice onto vulnerable Puerto Ricans. One of the most egregious aspects of the RSA was its use of rate securitization—a mechanism that allows automatic rate increases for PREPA customers when energy use declines due to people being unable to afford their electricity or from people leaving the island entirely.

Struggling to pay its own bills to its creditors, it was under this context that PREPA felt compelled to cut power to Santa Rosa Hospital in March.

When Governor Ricardo Rosselló took office in January 2017, he had an opportunity to renegotiate the RSA and secure a deal that would prioritize Puerto Ricans over banks and hedge funds, but he failed to do so. He had an opportunity to play hardball with creditors, especially given that he took office after the U.S. government passed PROMESA. Title III of PROMESA established an in-court debt restructuring option modeled after Chapter 9 of the U.S. Bankruptcy Code, which allows municipalities in U.S. states to file bankruptcy. This gave Puerto Rico more leverage with creditors. But instead of pushing back hard against PREPA's creditors, Governor Rosselló doubled down on it.

With minor tweaks to the original RSA, PREPA's new deal is also terrible for residents and businesses on the island. Even though, according to Roselló's own budget plan, Puerto Ricans cannot afford to pay more than about 25% of Puerto Rico's existing public debt, the revised RSA rewards PREPA's creditors with an effective repayment rate close to 90%.³ Rather than serving as a model to be emulated in future restructuring talks, PREPA's RSA stands as a cautionary tale of what can happen when creditors have the upper hand in negotiations.

Moreover, much of the underlying debt PREPA entered into in the run up to the debt crisis was predatory. We looked at bonds PREPA has issued since 2007,⁴ and found that banks pushed PREPA into deals that would provide big paychecks for themselves and investors, while failing to adequately fund PREPA's infrastructure needs. Many of these deals effectively moved money around and pushed debt into the future—potentially in violation of Puerto Rico's Constitution in some cases. We found that:

- ◆ Banks and legal firms collected more than \$101 million in issuance fees for PREPA bonds from 2007 through 2013.

- ◆ More than \$2 billion of the proceeds from PREPA's bonds from 2007 through 2013 was allocated to paying older debt and debt-related fees such as capitalized interest, lines of credit, and swap penalties.
- ◆ Only about 31% of bond revenues between 2007 and 2013 were allocated to PREPA's construction fund, which is used to pay for infrastructure projects.
- ◆ Some banks underwrote new bonds that PREPA used to pay the same banks for lines of credit and for swap penalties.

Even after it became clear that PREPA did not have adequate revenues to pay back all of its debt, credit rating agencies continued giving PREPA's debt investment grade ratings, banks kept underwriting more bonds, and investors kept buying up the debt. All of these parties were complicit in creating PREPA's debt crisis. Banks systematically targeted PREPA with expensive, risky, and possibly illegal deals. These predatory deals are illegitimate and should not be repaid. The existing RSA should be scrapped and there should be a comprehensive audit of PREPA's debt before any new restructuring plan is finalized.

Banks systematically targeted PREPA with expensive, risky, and possibly illegal deals.

How PREPA Came to Be \$9 Billion in Debt

PREPA has been publicly struggling to avoid defaulting on its debt since 2014, when it first signed a forbearance agreement with some of its creditors.⁵ A forbearance agreement is a contract that a borrower negotiates with creditors to avoid defaulting on a bond by modifying some of the original terms of the bond covenant in order to make it easier to make payments on the debt. PREPA simply does not have the revenue to pay its debts, despite the fact that Puerto Ricans already pay twice as much for electricity as the average stateside ratepayer.⁶ Power in Puerto Rico is so pricey because PREPA relies heavily on expensive fuel oil to generate electricity, and ratepayers' bills fluctuate based on the volatile price of fuel. To help address the high cost of power, PREPA has a longstanding practice of subsidizing electricity for some customers, which suppresses its revenues.⁷

To understand how PREPA got here, we have to consider three things: (1) Puerto Rico's colonial status, (2) investors' desire to profiteer off of some unique characteristics of Puerto Rican debt, and (3) banks' incentives to keep pushing PREPA deeper and deeper into debt as they raked in more and more fees.

Puerto Rico's status as a colony has created particular vulnerabilities for the island. Though residents of Puerto Rico are U.S. citizens, they cannot vote in federal U.S. elections and have no real representation in Congress. Yet Congress has immense power to determine Puerto Rico's future, which it exercised in passing PROMESA. PROMESA created a Fiscal Control Board, known locally in Spanish as "La Junta", with seven federally appointed persons with banking, finance and legal backgrounds, and granted them authority over the island's finances. This means that unelected Fiscal Control Board members can essentially approve or veto decisions made by Puerto Rico's own elected officials.

In addition to its colonial status, Puerto Rico has other unique vulnerabilities that made its debt particularly attractive to investors. First, since 1984, the U.S. Bankruptcy Code has prohibited public authorities and municipalities in Puerto Rico from utilizing Chapter 9 bankruptcy, which

allows financially distressed municipalities in the 50 states to restructure their debt. Puerto Rico's lack of access to Chapter 9 left the island stranded in what Supreme Court justice Ruth Bader Ginsburg famously called a financial "never-neverland", without any clear path to restructure debt prior to the passage of PROMESA. This meant that bondholders believed they did not have to worry about Puerto Rico being unable to pay them back. Investors could buy up these bonds, even while Puerto Rico's economy continued to contract, knowing that Puerto Rico would have to pay the debt even if that meant severe austerity for the island's inhabitants.

Second, Puerto Rico's bonds are triple tax-exempt, meaning bondholders are exempt from paying federal, state, and local taxes on interest income from these bonds. This also made them particularly attractive to investors looking for a safe and steady source of tax-free income.

This combination of factors—that the Puerto Rican bonds were deemed safe from bankruptcy and yielded tax-free returns—allowed the island to become a prime target for predatory banks, hedge funds, and other financial firms looking to exploit the island's unique vulnerabilities.

Wall Street banks continued pushing PREPA to issue more and more debt, including debt that may be unconstitutional, even as the utility struggled to pay its bills. Banks had big financial incentives for doing so as investor demand for the triple tax-exempt bonds was high. For years, banks collected hefty fees to push PREPA's debt into the future by encouraging the utility to issue new bonds to pay off older debt, a practice known as "scoop and toss financing" because it allows borrowers to scoop up current debt payments and toss them into the future (see our August 2016 report, [Scooping and Tossing Puerto Rico's Future](#), for more information). Banks also sold PREPA toxic deals like interest rate swaps that drove up the agency's borrowing costs (see our February 2017 report, [Beware of Bankers Bearing Gifts](#), for more information on interest rate swaps).

Many of the banks serving as underwriters on PREPA's refunding bonds had a financial stake in the deals because the proceeds from the new bonds were going to be used to pay back the same banks for lines of credit or termination penalties on toxic swap deals. In other words, some of these banks helped arrange deals that would pay themselves and keep the debt cycle going. For example, JPMorgan Chase was an underwriter on new bonds that PREPA took out to pay swap termination penalties to JPMorgan Chase. Moreover, JPMorgan Chase and UBS had also been underwriters on the original bonds that the swaps were attached to, which means they had also made money for underwriting services on the deals that would allow them to collect fees on the swaps as well. In other words, the deals were set up in a way that gave the banks multiple paydays.

Despite PREPA's pressing infrastructure needs, a significant number of its bonds were issued to make interest payments on other debt rather than to fund infrastructure improvements. Long-term debt should be used for long-term capital projects, like building and maintaining infrastructure, and not to meet short-term cash flow needs, fill budget holes, or push current payments into the future. Much of the debt PREPA issued in the last decade went toward the latter rather than the former. This was the case even though PREPA had huge infrastructure needs, including the need to modernize outdated, inefficient and even nonfunctional power plants, and the need to shift away from its reliance on expensive and environmentally destructive oil.

Furthermore, some recent bond issuances effectively moved money around such that funds that were intended to pay off previous bonds were instead used to pay capitalized interest (interest that gets tacked onto the principal of a bond, forcing the borrower to pay interest on the interest) and make payments on bank lines of credit. Despite all of this- and despite the clear evidence that

The deals were set up in such a way that gave the banks multiple paydays.

PREPA did not have revenues sufficient to cover its debt, credit rating agencies gave PREPA investment grade ratings for a major bond issuance as recently as 2013. An investment grade rating indicates to investors that the credit rating agencies view the issuer as having a low risk of default.

The three major credit ratings agencies—Standard & Poor’s, Moody’s, and Fitch—kept providing PREPA investment grade ratings on its debt, banks continued to underwrite the bonds, and hedge funds and mutual funds kept lining up to buy them. Banks collected millions in issuance fees while

...would force PREPA to find a way to pay investors, even if it meant drastic austerity measures for the people of Puerto Rico.

helping grow PREPA’s debt burdens to unmanageable levels. Investors were effectively betting that once PREPA reached the breaking point, its lack of legal bankruptcy options or any other clear path to restructuring (prior to the passage of PROMESA in 2016, which created a new pathway for debt restructuring under Title III of the Act) would force PREPA to find a way to pay investors, even if it meant drastic austerity measures for the people of Puerto Rico. And wealthy and powerful investors were confident they could use their power—including their power to influence the U.S. government—to secure a favorable outcome for themselves.

Digging a Debt Hole for Puerto Rico

In our examination of bonds PREPA issued between 2007 and 2013, we found numerous examples of deals that generated income for banks while worsening PREPA’s debt burden.

Kicking the Can Down the Road: Issuing New Debt to Pay Old Debt

One of the problematic practices that PREPA engaged in to manage its unsustainable debt load was capitalizing interest, which is when a borrower takes out new debt to pay interest on older debt, effectively converting interest from one bond into the principal of another. Here’s the problem with issuing new bonds to pay interest on older debt: The principal on a bond is debt that is owed to creditors, whereas the interest is the creditors’ profit. By borrowing new money to pay interest on older bonds, Puerto Rico borrowed money to *pay profits* to its other creditors. It did not borrow to build infrastructure or provide services for residents; it borrowed to pay investor profit. It is like using one credit card to pay the interest on another. Because capitalized interest gets converted to principal, the borrower ends up paying interest on the interest. This drives up borrowing costs and pushes the ultimate payoff of the debt farther into the future while generating fee income for the banks that underwrite the bonds.⁸

In our analysis of PREPA’s debt, we found that the utility has often paid old debt—including capitalized interest—with new bonds. We looked at bonds issued from 2007 through 2013 and found:

Puerto Rico borrowed money to pay profits to its other creditors.

- ◆ Banks and legal firms collected more than \$101 million in bond issuance fees.
- ◆ More than \$2 billion in proceeds from PREPA's bonds was allocated to paying debt and fees such as capitalized interest, lines of credit, and swap penalties.
- ◆ Only about 31% of bond revenues since 2007 were allocated to PREPA's construction fund.

Banks and legal firms collected more than \$101 million in bond issuance fees.

We examined \$7.3 billion in bonds PREPA issued from 2007 to 2013 and found that about one of every four dollars in bond revenue went towards paying capitalized interest or lines of credit.⁹

Our analysis lines up with the findings of an investigation by the Puerto Rico House of Representatives Small and Medium Businesses, Commerce, Industry and Telecommunications Commission.¹⁰ In June 2015, the Commission published a report on bonds PREPA issued between 2000 and 2012. It found that out of more than \$11 billion in bonds, only \$2.7 billion was dedicated to capital projects. Nearly \$165 million went to "financial advisors". The rest, more than \$8.5 billion, went to interest payments and refinancing of earlier debt, "thereby circularly refinancing its debts and interests, with complete disregard for the amortization of the original debt."¹¹

This is classic "scoop and toss" financing. As we explained in [Scoping and Tossing Puerto Rico's Future](#), the fees and capitalized interest on these scoop and toss deals are not legitimate debt. Wall Street banks and wealthy investors pushed much of this debt onto Puerto Rico to safeguard their own profits. They knew that Puerto Rico's debt load was unsustainable, but they convinced public officials to borrow even more money to enable them to collect interest and fees. This had the combined effect of extracting billions of dollars out of the island and putting it in the hands of wealthy investors and big banks.

More than \$8.5 billion went to interest payments and refinancing of earlier debt.

Wall Street Banks Sold PREPA Toxic Swaps

In our February 2017 report, [Beware of Bankers Bearing Gifts](#), we described the way that, as Puerto Rico's financial situation worsened, banks engaged in predatory lending behavior. Banks targeted Puerto Rico with complex, risky deals that generated fee income for Wall Street but became incredibly costly for Puerto Rican taxpayers. One of the products banks peddled to Puerto Rico was the interest rate swap.¹²

Since 2007, banks like JPMorgan Chase and UBS have collected at least \$65 million in termination penalties on interest rate swaps connected to PREPA bonds. The same banks also underwrote the original bond deals that included the toxic swaps to which they were counterparties, as well as the bond deals that were used to make payments for swap termination penalties. They set up deals that gave them multiple paydays.

In 2007, PREPA entered into nine swaps with JPMorgan Chase and UBS on its \$1.3 billion 2007 Series UU Refunding Bonds. Since the Federal Reserve slashed interest rates to near zero in light of the financial crash in 2008, these deals have been very lucrative for the banks and very costly for PREPA. JPMorgan Chase was also lead underwriter on the UU bonds, with UBS also providing

underwriting services. Just a few years later, in 2010, JPMorgan Chase was an underwriter on bonds that included a \$44.5 million payment to JPMorgan Chase for termination penalties on some of the 2007 swaps. What this means is that JPMorgan Chase collected fees for its underwriting services, made millions on the related swaps, and then made even more money for underwriting the bonds that PREPA used to pay the swap termination fees. Moreover, because PREPA is paying termination fees with borrowed money, PREPA ratepayers will be paying not just for swap termination payments but also for interest on those fees.

JPMorgan Chase collected bond underwriting fees, made millions on related swaps, and then made even more money underwriting new bonds that PREPA used to pay the swap termination fees.

Because one of the swap counterparties—JPMorgan—was also the lead underwriter for the bonds, this presents a potential conflict of interest. The lead underwriters on any given bond deal are the architects of the entire deal and serve as *de facto* advisers to the borrower. When the lead underwriter steers a borrower toward a more complex debt structure that requires the borrower to buy add-on products and then the same bank ends up providing those products, it is important to ask whether that structure was really in the borrower's best interest.

JPMorgan Chase and UBS (along with other banks) were also manipulating the interest rates that some of these swaps were linked to, which means they illegally colluded to enrich themselves by driving up the cost of these deals to ratepayers.¹³ Furthermore, it was standard industry practice for the underwriters that structured these variable-rate bond deals with interest rate swaps to misrepresent how risky these deals were, in violation of the federal government's fair dealing rule, which requires banks to treat municipal borrowers fairly. Because of the myriad illegal and legally questionable practices undertaken by the banks that sold these deals to PREPA, the agency should petition the federal Securities and Exchange Commission (SEC) to take legal actions against the banks to disgorge them of their ill-gotten gains on the backs of ratepayers.

However, instead of playing hardball with the banks and getting out from under the swaps, PREPA agreed in the March 2015 RSA to pay UBS and JPMorgan Chase penalties to terminate the toxic swaps.¹⁴ As of PREPA's 2014 annual financial report (AFR), the most recent available, these swap penalties would have cost nearly \$49 million.¹⁵

PREPA Used Lines of Credit to Pay Bills and Used Bonds to Pay Lines of Credit

Because PREPA didn't have adequate revenues, it paid its bills by tapping its lines of credit, which is akin to a struggling family using a credit card for basic expenses. It's okay to do it if you have enough money coming in the near future to pay back the line of credit, but if you don't have a pathway for paying it back, it can trap you in a cycle of debt. Because PREPA didn't have the revenues to pay back these lines of credit, it ended up taking out new debt to pay off the lines of credit. Banks obliged in continuing to underwrite new debt to refinance old debt, because they knew that as long as they kept pushing PREPA to issue more bonds, they could keep collecting interest on the lines of credit.

Many banks also underwrote bonds for PREPA that would allow the agency to pay them back on their own credit lines. For example, the 2010 Series XX Power Revenue Bonds, which had a principal of \$822 million, allocated about \$191 million for paying back lines of credit with the bond's lead underwriters, Citigroup and JPMorgan Chase. That means nearly a quarter of the bond proceeds were going to pay back the same banks that were underwriting the new deal. PREPA had \$500 million in outstanding principal on lines of credit with the two banks at the time.¹⁶

In addition to JPMorgan Chase and Citigroup, Banco Bilbao Vizcaya Argentaria (BBVA), Banco Popular, Banco Santander, and FirstBank Puerto Rico all underwrote bonds that were used to pay back their own lines of credit and/or syndicated lines of credit in which they had an interest.¹⁷

Banks Underwrote Debt With Terms Exceeding Constitutional Limits

Puerto Rico's constitution sets a limit on debt maturity time to 30 years, which means the Commonwealth and its agencies must pay back all debt within 30 years and may not enter into deals that have longer terms. However, some of PREPA's debt has been refinanced so many times that the final maturity has been extended past this 30-year constitutional limit. For example, in 2010, PREPA issued more than \$1.3 billion in bonds, most of which was dedicated to refunding existing bonds and making payments on lines of credit. Some of the debt these bonds refunded can be traced back through multiple previous refundings, all the way back to at least the 1989 Series N bonds, which is where the available records end.

However, even without knowing whether the 1989 Series N bonds had also refinanced even older debt, we do know that the bonds issued in 1989 were refunded multiple times over a period of decades, including a 2010 refunding that would not mature until 2021. That's a 32-year stretch, which means it violates Puerto Rico's constitutional limit of 30 years for debt maturity.

The underwriting banks were able to keep making a profit by preying on Puerto Rico's financial crisis, but this is debt that should have been challenged in the restructuring negotiations. PREPA should not have signed off on any restructuring agreement that privileges—or even permits—the repayment of illegal debt.

Wall Street Banks Enabled Black Hole of Circular Refinancing

It would have been clear to underwriters and investors that PREPA was digging itself deeper into a debt hole by using new bonds to pay older debt—debt from bonds, lines of credit, and bank loans—to push its debt farther into the future while failing to adequately invest in necessary infrastructure projects. It should also have been clear that PREPA had been using its lines of credit as a source of permanent funding rather than a source of liquidity¹⁸—and then using bond proceeds to pay the lines of credit when they were maxed out or nearly maxed out. Some of PREPA's shifting around of funds likely constituted a violation of the utility's governing Trust Agreement, which requires that financing for PREPA operations come from revenues collected from ratepayers. PREPA was instead funding operations at least in part by issuing debt. It was thus irresponsible at best for these banks to convince PREPA to keep borrowing at obviously unsustainable levels, so they could keep collecting fees and payments.

PREPA is required by its 1974 Trust Agreement to have revenues that are at least 120% of the aggregate principal and interest requirements for the next fiscal year.¹⁹ In supporting documents for PREPA's 2013 bond issuance, the \$673 million Power Revenue Bonds Series 2013A, the agency revealed that it did not have enough revenue coming in to cover its debt. According to PREPA's calculations, the ratio of net revenues to principal and interest requirements was 1.38 or 138%, but its adjusted net revenues to principal and interest requirements, "net of municipalities' consumption and subsidies", was 0.82, or 82%.²⁰ In other words, once they factored in the revenue *not* actually coming in from the municipalities receiving subsidized electricity, PREPA was falling well short of being able to cover its debt with its revenues. And yet, all three ratings agencies gave these bonds investment grade ratings—just a few months before these same agencies abruptly downgraded PREPA's bonds to junk.

The Puerto Rico Commission for the Comprehensive Audit of the Public Credit issued a pre-audit report of the 2013 bonds in September 2016 in which it identified multiple irregularities. The

Commission found that PREPA had met the 120% the requirement only once in the previous ten years. Because any debt issued in violation of the Trust Agreement may be illegitimate, the Commission's report raises a serious question about how much of this debt PREPA should be held responsible for. Detroit, Michigan's bankruptcy case may be instructive here. In that case, when the bankruptcy judge ruled that the city had issued debt that violated the city's state-imposed debt limit, he instructed the state-appointed Emergency Manager to sue the banks to declare the debt illegitimate. This gave the city the leverage to force the creditors and bond insurers to take major concessions as part of a settlement.²¹

The pre-audit report also raises serious questions about whether PREPA, its advisors, and its underwriters took "sufficient measures to protect the investing public". For example, they identify a possible conflict of interest with PREPA's performance auditors, URS Corporation, noting, "Income earned by the URS Corporation may have been directly tied to the outcome of the sale of the financial instruments of the corporation (PREPA) that it was contracted to analyze."²² In addition, the Commission noted that the

terms PREPA got on its 2013A bonds appear notably less favorable than similar investment grade bonds issued at the same time. This could indicate that the credit rating agencies' investment grade ratings were improper.²³ These and numerous other red flags the Commission raised in their preliminary analysis make it clear that the current RSA must be abandoned and that there must be a full audit of PREPA's debt. Any new restructuring negotiations must be informed by the findings of such an audit.

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How Investors Backed PREPA Into a Corner and Forced it Into an Unfair Debt Restructuring Agreement

Moody's and Fitch first downgraded PREPA's power revenue bonds to junk in February 2014, just a few months after rating the 2013 Power Revenue Bonds at investment grade.²⁴ In September 2014, after several more downgrades deeper into junk status, PREPA entered into a forbearance agreement with a majority of its bondholders, to avoid defaulting on debt payments. Ultimately negotiations with creditors produced a Restructuring Support Agreement (RSA), which PREPA first presented to its creditors in June 2015. Rather than an equitable solution to PREPA's debt crisis, though, the RSA represented a victory for banks and wealthy investors such as hedge funds.

How Creditors Killed the Recovery Act

Before we discuss the specifics of the RSA, we should understand the circumstances that pushed PREPA into agreeing to a plan that guarantees investor profits at the expense of ordinary Puerto Ricans.

First, as we have discussed, the U.S. Bankruptcy Code has excluded Puerto Rico from restructuring debt under Chapter 9 since 1984. On June 28, 2014, Puerto Rico passed its own law—called the Recovery Act—as an attempt to create a pathway to restructure its public utility debt. The intention of the Recovery Act was to establish a process for Puerto Rico's public utilities that would enable them to restructure their debt in a way that would not disrupt vital public services, such as water and electricity, and to do so without having to seek permission from creditors

whose primary concern is their own return on investment.

In other words, the Recovery Act was an attempt, absent the option of Chapter 9, to create a debt restructuring process that allowed the government of Puerto Rico to prioritize the basic needs of Puerto Rico and its residents and avoid deep austerity measures. The Act would have allowed Puerto Rico to restructure debt without the full consent of creditors in the event that a consensual restructuring agreement process failed. Bondholders immediately mounted legal challenges to the Act. Hedge fund Blue Mountain Capital filed suit first, followed by Oppenheimer Funds Inc. and Franklin Resources Inc.²⁵ The two suits were merged together into *Franklin California Tax-Free Trust v. Commonwealth of Puerto Rico*, which ultimately went all the way to the Supreme Court. The Court ruled in favor of lenders 5-2 in June 2016, saying that the Recovery Act was in violation of federal U.S. Bankruptcy Code.²⁶

In direct response to the island's attempt to govern in the interest of its residents and the subsequent lawsuits, the credit ratings agencies helped ramp up pressure on PREPA by lowering PREPA's credit rating. As then-Governor Alejandro García Padilla signed the Recovery Act into law, Fitch downgraded PREPA's credit rating several notches.²⁷ A few days after the law was signed, Moody's similarly downgraded PREPA several levels.²⁸ Both agencies explicitly cited the Recovery Act in their downgrades further into junk status.

Under PREPA's credit agreements, if its credit rating fell below a certain threshold, it would be in default on its debt. This happened when the credit rating agencies slashed PREPA's rating in light of the Recovery Act.²⁹ This allowed PREPA's creditors to force the agency to renegotiate the terms of the debt to avoid having to repay all of the debt right away, giving creditors powerful leverage to push Puerto Rico into negotiating with them. As a result, PREPA and the creditor group signed the first of what would become many forbearance agreements on August 14, 2014.³⁰ The forbearance agreement required PREPA to present its creditors with a recovery plan. Before it had a chance to do so, just a month later, Moody's once again downgraded PREPA's rating. The ratings agency said that a default was "highly likely" and speculated that investors would take a 20-35% haircut. It wrote, "While the recently entered Forbearance Agreement provides time for parties to work on a consensual restructuring plan, we believe that any restructuring proposal will be influenced, to some degree, by the Commonwealth's politics."³¹ That's a reference to the Commonwealth's interest in protecting its residents from austerity measures that bondholders would prefer. PREPA was under increasing pressure from credit ratings agencies and its creditors to hammer out a deal that, creditors hoped, would be immune from any bankruptcy protections that the U.S. Congress might later enact.

Some of the hedge funds, mutual funds, and bond insurers who stood to gain so much from PREPA's restructuring also used their political influence to secure a favorable outcome from debt restructuring legislation considered by the U.S. Congress. These stakeholders wanted to ensure that the outcome of this legislation benefited them, even if it meant massive suffering for the people of Puerto Rico. They very much wanted to prevent Puerto Rico or any of its utilities from being able to declare Chapter 9 bankruptcy or to otherwise be able to prioritize the basic needs of Puerto Ricans over the financial preferences of wealthy bondholders.

Mass Mutual Life Insurance Company, whose holdings include major PREPA bondholder Oppenheimer Funds, spent more than \$3 million in 2015 lobbying, including lobbying against amending the federal bankruptcy code to allow Puerto to declare Chapter 9.³² Assured Guaranty, one of the insurers of PREPA bonds, spent \$385,000 lobbying against Chapter 9 protection for Puerto Rico.³³ Hedge fund BlueMountain Capital, another member of the PREPA Ad Hoc group, also registered to lobby against the Chapter 9 option.³⁴

Many of PREPA's creditors filed amicus briefs against the Recovery Act, including Scotia Bank and the insurer Financial Guaranty. Financial Guaranty's amicus brief is particularly callous,

“entirely imagined... parade of horrors.”

dismissively characterizing fears about an impending humanitarian crisis in Puerto Rico as an “entirely imagined...parade of horrors.”³⁵ At this point, the crisis unfolding on the island was well documented, but Financial dismissed the concerns expressed by observers as a kind of hysteria rather than legitimate, well-grounded fears about the consequences of the emergency already unfolding on the island.

In February 2015, a U.S. District Court ruled that U.S. Bankruptcy Code preempted the Recovery Act. Backed into a corner and facing intense pressure from creditors, PREPA submitted a restructuring proposal to its creditors in June 2015 from a position of weakness.³⁶

The Restructuring Agreement Is Deeply Flawed

The RSA is an expensive deal for PREPA that is overly generous to investors, at the expense of ordinary Puerto Ricans, who will see significant increases in their electric bills. It lets investors collect 85% of the face value of the debt, including on illegitimate debt. It also fails to shift PREPA away from fossil fuels as the primary source of fuel for conversion to electricity. The process that produced the RSA was not transparent, from the selection of the firm to oversee the process, to the details of the process itself. And finally, the RSA rests on faulty and unrealistic assumptions about PREPA’s financial future. The RSA should be scrapped and PREPA should negotiate a new deal that prioritizes human need and is informed by the results of a comprehensive audit of PREPA’s debt.

PREPA and the Government Development Bank of Puerto Rico, which is the main investment officer for the Puerto Rican government and the fiscal manager of the island’s debt, negotiated the RSA with a group of bondholders and other creditors, overseen by “Chief Restructuring Officer” Lisa Donahue of the corporate “turnaround” firm, Alix Partners. The creditors involved in the negotiations included bond insurers, banks, hedge funds, mutual funds, and other bondholders. The negotiations were secretive,³⁷ and creditors involved in bargaining had access to information not available to other creditors.³⁸ The first iteration of the RSA was signed in November 2015. A subsequent version signed in March 2016 pertained to nearly \$9 billion in total debt, including bonds and loans. The agreement’s signatories were in control of more than 60% of the total outstanding principal of bonds covered by the agreement.³⁹

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The Restructuring Agreement Puts an Unsustainable Burden on Ratepayers

The RSA called for the creation of a new special purpose vehicle (“SPV”) to issue new bonds, which holders of PREPA debt can exchange for their bonds for 85% of the bonds’ original value. This means that investors would take only a 15% haircut on the bonds. The RSA also gives the newly created PREPA Revitalization Corp the power to levy charges on PREPA customers to ensure that creditors are able to collect the returns they were guaranteed by the RSA.⁴⁰ This is called rate securitization. This means that PREPA customers’ already high electric bills will rise whenever PREPA needs more revenue to pay bondholders. As Puerto Ricans permanently leave the island to escape the economic crisis, and the number of ratepayers decreases, the electric bills of those who remain will automatically jump to make up the difference. Similarly, as the number of delinquent accounts increases amidst the economic crisis, electricity rates will automatically adjust upward.

The Restructuring Agreement Is Overly Generous to Vulture Hedge Fund and Other Bondholders

The RSA guaranteed bondholders 85% of the original face value of the bonds, regardless of what they actually paid for the bonds. Though some bondholders may have to take a 15% haircut on their bonds, others may make huge profits. Many bondholders bought the debt on the secondary market at bargain prices, after credit ratings agencies downgraded PREPA bonds to junk. These investors took a gamble on the risky debt because they were confident that Puerto Rico would be forced to pay the debt back in full, likely while implementing severe austerity measures. In fact, 34 hedge funds even commissioned a report calling for Puerto Rico to prioritize paying creditors by laying off teachers and closing schools.⁴¹

***34 hedge funds
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Oppenheimer and Goldman Sachs, for example—both members of PREPA’s Ad Hoc Bondholders Group—upped their holdings of Puerto Rico’s bonds after the downgrade to junk. Goldman increased its holdings from \$351 million to \$1.3 billion in February 2014, just after the first downgrade to junk. Many of PREPA’s bonds were trading at 60 or 50 cents on the dollar. This is, obviously, well below the recovery rate of 85%.⁴²

The RSA also specifies that swap counterparties will get to collect penalties on PREPA’s toxic swaps. It is absurd for any restructuring agreement to promise future swap payments to counterparty banks in the face of so much evidence that at least some of these deals may not be legitimate, especially because the swaps are not even real debt.

The original restructuring agreement was widely criticized as too generous to creditors. After taking office in January, Governor Rosselló oversaw new negotiations intended to get additional concessions from creditors.⁴³ Rosselló has said that the resulting revised RSA will lead to lower bills, but an independent analysis by the Institute for Energy Economics and Financial Analysis (IEEFA) has projected lower rates only on a short term basis, with increases down the road.⁴⁴ With electricity prices going up, it’s likely that even more customers will be unable to pay their bills, and may fall behind or stop paying entirely. It is likely that these higher bills will contribute to people leaving the island for the mainland. With the rate securitization mechanism of the new bonds, the remaining customers will see their bills increase even further, creating a destructive and unsustainable cycle of bill increases, bill defaults and population decreases, followed by further rate hikes.

Affordable electricity is fundamental to a functioning society, and this deal seems likely to make electricity prohibitively expensive for large numbers of people, small businesses, and manufacturing. Any new restructuring agreement must take into account Puerto Rican ratepayers’ ability to pay.

The Restructuring Agreement Has Dangerously Unrealistic Assumptions for PREPA’s Financial Future

The original restructuring agreement’s assumptions about PREPA’s future revenues, and customers’ ability to pay rising bills, are not based on reality. For example, the RSA assumes no net population loss (and thus steady demand for electricity), at a time when large number of Puerto Ricans are being driven off the island by the economic crisis and demand for electricity is likely to

contract with the economy and with sharply rising prices under the plan. The plan also assumes steady natural gas prices, when in fact this is unpredictable.

IEEFA has also pointed out that the fees PREPA paid to various firms involved in the restructuring, including to Alix Partners, were excessive, totaling \$93 million as of August 2016. They identify these fees as “well over the norm and twice the original estimate.”⁴⁶ Even in the restructuring process, there’s an excessive payday for financial firms who, in the end, are not doing work that actually helps PREPA move forward.

A Path Forward

Puerto Rico is already in the throes of a humanitarian crisis that is likely to get worse before it gets better. Any debt restructuring must put the interests of the Puerto Rican people first and must ensure that creditors are not able to profiteer off the suffering on the island. This is particularly important with respect to PREPA’s debt. There is a way forward:

- ◆ **The Fiscal Control Board and the U.S. District Court in San Juan should reject the current PREPA RSA.** The RSA must be replaced with a plan that will restore PREPA to fiscal health in a sustainable way that is affordable for Puerto Ricans and is based on realistic financial projects.
- ◆ **Governor Rosselló should reinstate the Debt Audit Commission** and ensure that it is fully funded so that it can perform a detailed audit of all of Puerto Rico’s debt, calculate the true cost of these variable-rate deals, and determine how much of Puerto Rico’s outstanding debt is predatory and therefore illegitimate. Any new restructuring agreement for PREPA or any other entity in Puerto Rico should be informed by the results of a thorough audit of the island’s debt.
- ◆ **The Fiscal Control Board should cancel any debt deemed illegitimate by the Debt Audit Commission,** so that Puerto Rico’s scarce funds can go toward mitigating the humanitarian crisis that is unfolding on the island and improving the lives of the people of Puerto Rico.

About the Authors

Carrie Sloan and **Saqib Bhatti** are with the **ReFund America Project** (RAP) of the **Action Center on Race & the Economy** (ACRE). RAP tackles the structural problems in the municipal finance system that cost governments across the United States billions of dollars each year at the expense of public services. Bhatti and Sloan research the role of financial deals in contributing to public budget distress and work with policy experts, community leaders, and public officials to develop, advocate for, and implement solutions to save taxpayer dollars.

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