STATEMENT OF
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CHAIRMAN, GOVERNING BOARD
PUERTO RICO ELECTRIC POWER AUTHORITY
BEFORE THE
COMMITTEE ON NATURAL RESOURCES
SUBCOMMITTEE ON INDIAN, INSULAR AND ALASKA NATIVE AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

"The Status of the Puerto Rico Electric Power Authority (PREPA) Restructuring Support Agreement"

March 22, 2017 at 10:00 a.m.

Chairman of the House Committee on Natural Resources Bishop, Subcommittee Chairman LaMalfa, Ranking Member Torres, Commissioner González and members of the subcommittee:

My name is Professor Luis Benítez Hernández, and I am the Chairman of the PREPA Governing Board. I have served in this role since November 2016. Prior to becoming Chairman, I served as the Vice Chair and the Chairman of the Finance Committee of the PREPA Governing Board since June 2014. I am also the former President of the Puerto Rico Economists Association, the former Chief Economist and Director of the Economic and Social Planning Program of the Puerto Rico Planning Board, and the former Co-President of the Special Commission for the Fiscal and Tax Reform. I have served as an economics litigation expert witness and an adjunct professor of economics at the University of Puerto Rico.

I want to thank the subcommittee for giving PREPA the opportunity to participate in this hearing. Despite significant progress over the past few years, PREPA continues to face a difficult financial situation and we greatly appreciate the subcommittee's interest in our ongoing restructuring efforts.

PREPA was created for the purpose of conserving, developing and utilizing Puerto Rico's energy resources to promote the general welfare of Puerto Rico's residents and to increase commerce and prosperity. PREPA produces and delivers virtually all of the electric power consumed in Puerto Rico. Its future is central to the economic growth and well-being of Puerto Rico.

Since my appointment to the PREPA Governing Board, I have been a part of PREPA's efforts to address the fundamental operational deficiencies and financial difficulties that have hindered PREPA and the people and businesses it serves. Our efforts to restructure PREPA led to the execution of the Restructuring Support Agreement (RSA) in December 2015 that is the subject matter of today's hearing.

Background

As the subcommittee may recall from prior testimony before the Subcommittee on Energy and Mineral Resources in January 2016, PREPA has experienced financial difficulties for several years. As demand for power declined during the recession, PREPA took on considerable debt to fund its operating expenses rather than raise base rates. By the summer of

2014, PREPA faced a severe financial and liquidity crisis, created by a combination of recurring negative cash flow, the ongoing recession, outdated generation facilities, substantial debt maturities and an inability to access the capital markets. This crisis — magnified by PREPA's inability at that time to access a federal restructuring regime — threatened PREPA's ability to operate and imperiled PREPA's ability to provide energy to Puerto Rico.

PREPA's problems did not arise overnight, or even in a few years — they developed and intensified over a period of decades. During this time, management and other strategic decisions, including rate setting, staffing and capital investment were too often based on political or electoral considerations rather than best practices or business imperatives. As a result of this dynamic, PREPA suffered from regular employee reassignments and had difficulty conducting rational long-term planning, which compounded existing challenges.

These deep-rooted problems demanded a comprehensive solution. First, the PREPA Governing Board and its advisors stabilized the situation by PREPA's signing of long-term forbearance agreements with creditors representing more than 60% of PREPA's debt, including its fuel line lenders. These agreements gave PREPA relief on $700 million of maturing debt, increased the threshold necessary for the exercise of bondholder remedies, provided relief from PREPA's obligation to make over $600 million in annual interest and sinking fund payments, and permitted a reallocation of construction reserves to operating expenses. Second, the PREPA Governing Board retained financial advisors and implemented cash flow forecasting and other operational controls. Lastly, the PREPA Governing Board and its advisors designed a comprehensive business and restructuring plan, based on the principle of burden-sharing across stakeholders, and worked closely with PREPA's creditors to negotiate the RSA and subsequent amendments and supplements.

Key Terms of PREPA's Restructuring Support Agreement

In December 2015, PREPA and creditors holding or controlling approximately 70% of its debt, including bondholders, fuel line credit lenders and bond insurers, signed the RSA to address PREPA's fiscal and operational challenges. The RSA required all of PREPA's stakeholders to contribute to its rehabilitation and transformation. It is the product of good faith negotiations by all parties, particularly considering that when it was signed, PREPA had no access to any legal mechanism like PROMESA to facilitate its restructuring.

- For the uninsured bondholders, the RSA provides for a 15% principal haircut, a fixed interest rate that is lower than the current rates and a five-year principal holiday. Although most of the media attention has been on the 15% principal haircut, the most important financial benefit of the RSA is that it reduces the interest rate from approximately 5.5% to 4.75% per annum and extends principal maturities by 5 years. In exchange, bondholders would receive securitization bonds to be issued by a new, bankruptcy remote entity known as the PREPA Revitalization Corporation that is authorized to impose and collect a non-bypassable transition charge to cover the costs of refinancing at a discount PREPA's legacy bond debt.

- PREPA's fuel line credit lenders were given the option of converting their existing credit agreements into term loans, with a fixed interest rate of 5.75% per annum, to be repaid over a period of six years in accordance with an agreed amortization schedule, or exchanging all or part of the principal due under the existing fuel line credit agreements for securitization bonds to be issued on the same terms as those issued and exchanged for the uninsured bonds, including the 15% principal haircut.

- PREPA's bond insurers agreed to issue approximately $460 million in surety insurance policies to support a significant portion of the debt service reserve fund requirement for the securitization bonds.

The RSA, however, is not just about a financial restructuring. The RSA is the heart of PREPA's overall strategy to transform into a modern and reliable utility.

As part of the RSA, PREPA agreed to seek reasonable rate increases, given that PREPA's base rates had not been increased since 1989 and that its current rate structure did not fully cover its costs. At the time we executed the RSA, our financial advisors estimated that there was an 8-cent-per-kilowatt-hour gap between the existing base rate and the rate needed to cover PREPA's costs including capital improvements and debt service. Consistent with the RSA, PREPA sought and obtained the approval from the Puerto Rico Energy Commission to implement a rate increase of approximately 4 cents per kilowatt hour (including both the new transition charge and a PREPA rate increase).

Pursuant to the RSA, PREPA obtained more than $400 million in short term "relending" financings from the creditors who had signed the RSA. Under these financings, RSA creditors agreed to purchase new PREPA bonds in the same amount they received in debt service payments from PREPA on various principal and interest payment dates. These relending arrangements allowed PREPA to continue making debt service payments while conserving liquidity in an uncertain time. Without these relending arrangements, PREPA would have run out of money.

In addition, the RSA contemplates important operational improvements with a goal of increasing efficiencies, reducing costs and implementing best industry practices. PREPA had long been plagued by inadequate procedures and controls for managing fuel supply, inventory, and collection efforts. During this time, we worked with our advisors to achieve $267 million in one-time savings and $212 million in recurring annual operating expense savings.

The RSA also provides a framework for the modernization of PREPA's outdated and inefficient generation fleet and transmission system, which have been responsible for rising costs and decreasing reliability to customers over time. It was also necessary to overcome limitations on diversifying PREPA's fuel mix, and to implement necessary safety procedures and compliance measures.

The long-term capital plan that was developed as part of the RSA and PREPA's Integrated Resource Plan calls for approximately $2.4 billion of investment in new infrastructure — including sustainable renewable energy initiatives — over the next 10-15 years. Phase 1 of the investment plan calls for upgrades at the Palo Seco plant and construction of the Aguirre Offshore Gasport to improve fuel diversity, meet federal Mercury and Air Toxics Standards (MATS), and increase system reliability. Phase 2 comprehends improvements in energy efficiency and upgrades to the existing the fleet through repowerings or public-private partnerships (P3).

While PREPA presently could use the savings achieved through operational improvements and the debt restructuring to fund this capital improvement plan, our goal has been to provide a platform for third-party investment through a competitive bidding process. We believe there is substantial interest by the private sector in making new infrastructure investments as demonstrated by a successful Request of Expressions of Interest process we ran in Fall 2015. At that time, 31 proposals were received from 16 participants, which included many major market players. All participants expressed an interest in helping PREPA modernize its infrastructure, whether through P3s or other approaches. Importantly, all of the participating investors said that PREPA must fix its balance sheet before the investors would make any investments.

The RSA also required the creation of an independent governing board comprised of non-political appointees with substantial private sector experience. Pursuant to the RSA and the PREPA Revitalization Act (Act 4-2016), PREPA retained an independent, internationally recognized search firm (Russell Reynolds) to identify and interview qualified candidates. Governor Padilla then appointed a slate of candidates from the list of nominees prepared by the search firm, and the Puerto Rico Senate confirmed the governor's appointments in December 2016.

Implementation of the RSA has required significant effort. For example, PREPA obtained passage of the PREPA Revitalization Act in February 2016. Among other things, this law authorized the issuance of the securitization bonds in exchange for PREPA's legacy bonds. In June 2016, PREPA obtained Energy Commission approval of the transition charge to support the securitization bonds and also obtained provisional approval of a 1.3 cents per kilowatt hour rate increase. In January 2017, PREPA obtained final approval of a 1.03 cents per kilowatt hour permanent rate increase. This rate increase has to be seen in the context of the rate saving contributions from creditors (so far in the range of approximately 5 cents per kilowatt hour) and the operational improvements of approximately 1.4 cents per kilowatt hour (the equivalent of $250 million). In addition, in the summer of 2016, PREPA received Energy Commission approval of a modified Integrated Resource Plan that permits PREPA to implement substantially all of the capital plan envisioned by the RSA, except for the Aguirre Offshore Gasport Project (AOGP). We continue to pursue approval of the AOGP project, which is also included in Governor Ricardo Roselló Nevares's energy reform plan.

In addition, PREPA has been working to resolve pending challenges to the RSA transactions. As part of the PREPA Revitalization Act, Puerto Rico established a process allowing all interested parties to challenge the PREPA Revitalization Act and the RSA transactions before the expiration of two statutes of repose. In total, 7 different lawsuits were filed challenging the RSA transactions. Three of these lawsuits have been dismissed, leaving four remaining. PREPA won summary judgment in one of the remaining 4 cases, and that case is now on appeal before the Puerto Rico Supreme Court. The remaining three cases are administrative law cases, which have been consolidated into one proceeding by the courts, and we hope to resolve them in the next three or four months. PREPA will need to continue to vigorously defend against these lawsuits and remains confident that the courts should rule in PREPA's favor.

Enactment of PROMESA

As this subcommittee knows, Congress passed the Puerto Rico Oversight, Management and Economic Stability Act ("PROMESA") in June 2016. Following its passage, PREPA immediately began discussions with creditors about potential changes to the RSA in light of PROMESA. For example, the RSA assumed that approximately $700 million in PREPA legacy bonds would remain obligations of PREPA after consummation of the restructuring because we assumed that some creditors would not voluntarily participate in the exchange. PROMESA gave us the opportunity to bind all bondholders to the exchange into securitization bonds, as long as we met the requisite voting threshold, but we needed to adjust parts of the deal (particularly the size of the debt service reserve or the amount of the monoline surety). In addition, after executing the RSA, it became clear that the rating agencies were not in position to immediately assign an investment grade rating. At the same time, to make the deal work for PREPA, we needed to fix the interest rates at the lowest interest rate contemplated by the RSA, even without an investment grade rating.

As PREPA and its advisors were thinking about ways to adjust the RSA in light of PROMESA, we were also hearing heightened concerns from the public, the Oversight Board and the Congressional Task Force on Economic Growth in Puerto Rico about the costs of electricity in Puerto Rico and the potential negative impact such costs could have on Puerto Rico's economy. With that in mind, the current Governing Board instructed PREPA's advisors to seek additional creditor concessions that maintained the key economics of the RSA but also provided rate relief over the next five years.

As we approached an RSA automatic termination date of December 15, 2016, our management and advisory teams held intensive discussions with our creditors. We believed, and continue to believe, that maintaining the RSA was critical to PREPA's future. Then, as now, if the RSA were terminated, $700 million in fuel line debt and more than $375 million in relending bonds would become immediately due. In addition, termination would trigger potential disputes with fuel suppliers and other counterparties who may seek to terminate contracts or otherwise reduce credit. At the same time, we were (and continue to be) keenly aware that many people in Puerto Rico are expecting improvements to the deal in light of the availability of the restructuring regime provided under PROMESA.

Not surprisingly, PREPA's creditors were hesitant to address any changes in December given the uncertain political situation and the possibility that the incoming governor and his new administration would have different views about the RSA and PREPA's restructuring. As a result, the creditors and PREPA agreed to extend the RSA until January 31, 2017 to give PREPA and its creditors more time to finalize adjustments in light of PROMESA and to allow the new administration to weigh in with its views.

In the face of this deadline, in late January 2017, PREPA and its creditors reached an agreement in principle to modify certain terms of the RSA, subject to approval by the Puerto Rico Fiscal Agency & Financial Advisory Authority (AAFAF). Among other things, these modifications included eliminating the investment grade rating requirement on the securitization bonds and increasing the amount of the surety to be posted by the monoline insurers. In total, these modifications would have reduced the electricity rates contemplated by the RSA for each of the next five years by approximately 1 cent per kilowatt hour. The agreement in principle, however, was not executed because AAFAF assumed responsibility for creditor negotiations on January 27, 2017.

Current Status of RSA Discussions

The enactment of Act 2-2017 by the Legislature of Puerto Rico in January of this year granted AAFAF the sole responsibility to renegotiate, restructure and reach agreement with PREPA's creditors. As a result, PREPA and its Governing Board have not been involved with the restructuring discussions since January 27, 2017, when AAFAF assumed this role. Of course, PREPA's Governing Board continues to support the transformation and modernization of PREPA, especially efforts to improve PREPA's infrastructure and obtain third-party investment through P3 projects and otherwise. In addition, PREPA's Governing Board — whose members have significant experience working with distressed companies such as General Motors —– supports ongoing efforts to improve the terms of the RSA for the benefit of the people and businesses of Puerto Rico. The enactment of PROMESA presents a once-in-a-lifetime opportunity to address PREPA's financial situation and to obtain the best deal possible from the creditors, and Puerto Rico's economic and fiscal situation demand that PREPA succeeds in doing so. We therefore stand ready to implement any agreement that is reached with the creditors to improve the terms of the RSA.

I would like to thank the subcommittee for giving me the opportunity to participate in this hearing on behalf of PREPA and its Governing Board.