Puerto Rico Electric Power Authority's rate burden to face renewed scrutiny
By Andrew Scurria and Xavira Neggers Crescioni
August 19, 2016

The structure of the **Puerto Rico Electric Power Authority**'s (PREPA) proposed bond exchange will go under the microscope along with its requested rate hikes, said Joseph Fichera, CEO of financial advisory firm Saber Partners.

After the Puerto Rico Energy Commission's (PREC) approval of a 3.1 cents per kilowatt hour (kWh) transition charge to PREPA customer bills, its decision-making will now be subject to review by the Court of First Instance in San Juan. Nonprofit groups critical of PREPA's restructuring proposal have filed suit to contest PREC's approval of the workout, calling it a bad deal for island ratepayers.

The restructuring accord couples the transition charge with a quarterly true-up mechanism designed to ensure that enough is collected to meet ongoing debt service requirements. Those collections are to be dedicated to the **Corporation for PREPA's Revitalization** (CPR), a special-purpose vehicle (SPV) that would issue exchange bonds, as reported.

Forbearing investors would then tender existing PREPA bonds at a 15% discount and take back some USD 6.8bn in exchange bonds.

Trading haircuts for security

Investors are willing to trade away some value for the credit enhancement features of the securitization, Fichera said. The key enhancement for the PREPA bonds is the true-up — an automatic quarterly adjustment of the debt charge to ensure adequate coverage of debt service.

Once the true-up goes effective, "the ratepayer checkbook is now open," said Fichera, a securitization expert who has advised seven different utility commissions on 13 corporate offerings. If the ratepayer base contracts from business closures or outmigration, the charge must go up on those that are still paying. If one customer fails to pay the charge, that liability is automatically redistributed to paying customers.

Normally a ratemaking body like the PREC cannot bind its successors to a particular rate determination method, Fichera said. But the true-up is designed to be unreviewable by subsequent regulators.

"You need to be very careful how you structure the deal once you open the ratepayer checkbook to make sure you get the best deal possible up front at the lowest cost at the time of pricing," Fichera said. "Otherwise you're never going to get the chance to review it again."

Puerto Rico needs sustainable energy costs of between 16 cents to 18 cents per kWh for its economy to grow, said economist Gustavo Velez, a restructuring advisor and former **Government Development Bank for Puerto Rico** attorney. Otherwise the island's economy will remain stagnant and the territorial government will not generate revenues to repay its own debt load, Velez said.

The current all-in cost of providing power is roughly 21 cents per kWh, according to PREPA CRO Lisa Donahue's January testimony before Congress, while the utility's current rate deficit is around 8 cents per kWh.

Litigation risk

The "blank check rate hikes" are unsustainable for an already weakened economy, said Tom Sanzillo, director of finance at the Institute for Energy Economics and Financial Analysis, one of the groups behind the rate challenge, on a conference call yesterday (18 August).

"We do not agree that a plan that creates unstable electricity rates at a time when even fossil fuel prices are dropping is a good plan," Sanzillo said. The proposal assumes that electricity sales will remain flat but the evidence allegedly shows a likelihood that the number of power payers is likely to shrink.

"Both PREPA and the commission disregard the fact that Puerto Rico is in a declining electricity sales market," Sanzillo said.

The true-up will create unstable rates and make it difficult for businesses to develop budgets, undercutting business investment on the island, according to the legal challenge. The groups are also critical of the imposition of the charge on ratepayers producing their own energy through renewable power sources or co-generation.

The ad hoc group of forbearing bondholders responded yesterday that the litigation "is misguided and based on various flawed assumptions."

"Essentially the plan objectors are proposing that PREPA dissolve its debt restructuring plan, which would raise costs for consumers, cause further delay in reforming PREPA and would fail to move Puerto Rico any closer to greater use of renewable energy," the bondholders said. "The fact remains that the PREPA deal provides a dramatic financial benefit to both the company and its customers."

A source close to PREPA was harsher, calling the litigation "a form of blackmail."

The PROMESA factor

Utility securitizations have been extensive in the private sector, a favorite of issuers like **Entergy Corporation** and **Duke Energy**. The process made a prominent appearance in municipal finance starting in 2013 when the **State of New York** created a new public authority to restructure certain of the **Long Island Power Authority**'s

(LIPA) debts. Empire State lawmakers later authorized the new **Utility Debt Securitization Authority** to issue up to USD 4.5bn in securitization bonds for refinancing legacy LIPA debt.

Virtually all of those securitization deals have earned Aaa ratings because of their strong legal protections, Fichera said. PREPA may not earn an investment-grade rating because of the unprecedented nature of Puerto Rico's crisis, as bank and insurance executives have acknowledged on recent earnings calls.

The proposed exchange involves structuring the new bonds as typical munis, with the same complex mixture of serials, cash flows and CUSIPs as before the deal, Fichera said. He said that simplifying the capital structure into several large CUSIPs or a simplified corporate-style sinking bond fund would lower the burden on ratepayers and produce a more liquid, saleable bond in the institutional market, he said.

The Puerto Rico Oversight, Management and Economic Stability Act mandates that the commonwealth's yet-to-be appointed federal control board show some deference toward tentative restructuring deals like PREPA's, as reported. The workout appears headed for the law's Title III or Title VI restructuring processes, Assured Guaranty CEO Dominic Federico recently said.

But the board retains the right to override the current RSA if it is deemed a threat to the commonwealth's recovery prospects, said Velez, as well as an island-based corporate attorney and two other sources close to the Puerto Rico workout. It is unclear if the board would tread into this territory since the market views PREPA as a test case for Puerto Rico's broader workout, they said.

A USD 110.6m tranche of 5.75% Series XX power revenue bonds maturing in 2036 last priced in a block trade today at 64.25 yielding 9.895%, according to *Electronic Municipal Market Access*.