



# CRA Insights: Financial Markets

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## The Commonwealth of Puerto Rico: The next chapter

### Introduction

In this issue of *Insights* we provide context around efforts by the Commonwealth of Puerto Rico to pursue a plan for long-term fiscal stability and growth.

The Commonwealth of Puerto Rico has a long history of fiscal uncertainty and structural deficits. Responding to decades of general fund deficits in 2014, the rating services lowered the ratings on the Commonwealth's general obligation credit to below investment grade, or junk status. See Table 1.

The rating services downgraded Puerto Rico's general obligation rating to BB (non-investment grade) in February 2014.<sup>2</sup> The rating action had been long anticipated by the municipal market. The yields on the Commonwealth's general obligation bonds exceeded 10% the month prior to the downgrade.<sup>3</sup>

Table 1: Commonwealth General Obligation ratings<sup>1</sup>

Date	Standard & Poor's	Moody's Investors Service
1983 – 2001	A	Baa1
2002 – 2004	A-	Baa1
2005	BBB	Baa1
2006	BBB	Baa3
2007 – 2009	BBB-	Baa3
2010	BBB-	A3
2011	BBB	Baa1
2012	BBB	Baa3
2013	BBB-	Baa3
<b>Feb 2014</b>	<b>BB+</b>	<b>Ba2</b>
<b>July 2014</b>	<b>BB</b>	<b>B2</b>

The Puerto Rico Corporations Debt Enforcement & Recovery Act (the Recovery Act), adopted on June 28, 2014, generated a subsequent wave of downgrades in July 2014. The ratings agencies notched downward Puerto Rico's general obligation rating and Moody's downgraded several public corporations a full rating grade to 'Caa.'<sup>4</sup>

<sup>1</sup> Commonwealth's general obligation rating history provided by the Government Development Bank. The lowest Standard & Poor's and Moody's rating is shown for each calendar year, unless otherwise noted.

<sup>2</sup> The Commonwealth's general obligation credit was downgraded by: Moody's Investors Service to 'Ba2,' Standard & Poor's to 'BB+' and Fitch to 'BB.'

<sup>3</sup> MSRB: Electronic Municipal Market Access, Trading summary, Commonwealth of Puerto Rico general obligation bonds, January 2014.

<sup>4</sup> Moody's municipal ratings include nine categories: Issues rated 'B' and 'Caa' are respectively rated in Moody's 6<sup>th</sup> and 7<sup>th</sup> lowest rating categories.

Moody's cited as the rationale for the second round of downgrades that the Recovery Act signals a "... new preference for shifting fiscal pressures to creditors, which in our view, has implications for all Puerto Rico's debt, including that of the central government."<sup>5</sup>

In response to the ratings services' commentary on the Recovery Act and accompanying downgrades, the Commonwealth released the following statement: "This administration has implemented critical and decisive measures to stabilize Puerto Rico's fiscal situation, promote economic growth, and safeguard and reinforce Puerto Rico's credit. This includes the first balanced budget in 22 years ... We will continue to proceed with determination and focus to successfully guide Puerto Rico on its path to fiscal health and stability."<sup>8</sup>

The Commonwealth is a large economy, with gross domestic product (GDP) exceeding that of 15 US states and population exceeding that of 22 US states. Prior attempts to gain fiscal stability produced minimal results, primarily because of the Commonwealth's policy of providing financial support to underperforming public corporations.

In 2012, the Commonwealth provided \$1.0 billion of support to three public corporations. Governmental aid historically included liquidity, capital financing, and operating subsidies. This time, the Commonwealth's arsenal includes the legislative ability to restructure select public corporations if commercial self-sufficiency is deemed unachievable. Puerto Rico's potential elimination of annual, billion-dollar support to public corporations should materially strengthen the Commonwealth's general obligation and related credits.

Table 2: Sovereign and state per capita GDP comparison

Country Rankings	Country	Rating (S&P)	Per Capita 2013 GDP <sup>6</sup>
13	United States	AA+	\$53,143
<b>31</b>	<b>Puerto Rico</b>	<b>BB</b>	<b>\$27,795</b>
34	Saudi Arabia	AA-	\$25,852
48	Chile	AA-	\$15,732
69	Mexico	BBB+	\$10,307
118	Guatemala	BB	\$3,478
State Rankings	State	Rating (S&P)	Per Capita 2013 GDP <sup>7</sup>
1	Alaska	AAA	\$70,113
25	Pennsylvania	AA-	\$47,274
50	Mississippi	AA	\$32,421

## Puerto Rico's challenges and progress

Structural deficits have persisted in the Commonwealth's general fund for more than a decade. These deficits are the result of years of masking budgetary imbalances through Commonwealth bond sales and extending internal credit by the Government Development Bank for Puerto Rico.

The cumulative impact of past fiscal actions has resulted in a relatively high debt load coupled with constrained liquidity and market access. Puerto Rico has \$72 billion of outstanding debt and obligations

<sup>5</sup> Moody's Investors Service, Global Credit Research Rating Action, "Moody's downgrades Puerto Rico GOs to B2 from Ba2, COFINA Senior-Sub to Ba3-B1; outlooks negative," July 1, 2014.

<sup>6</sup> World Bank database (Development Indicators, July 2014) provides per capita GDP for 189 countries.

<sup>7</sup> US Department of Commerce website, Bureau of Economic Analysis, 2014.

<sup>8</sup> Commonwealth of Puerto Rico, "GDB Chairman and Treasury Secretary Provide Joint Comments on Recent Statements from Rating Agencies," press release, July 11, 2014, [http://www.gdbpr.com/documents/GDBandTreasuryResponsetoSP\\_71114.pdf](http://www.gdbpr.com/documents/GDBandTreasuryResponsetoSP_71114.pdf)

(see Table 3). The official statement for the Commonwealth's \$3.5 billion general obligation bonds, sold in March of 2014, contains 14 pages of *risk factors*.<sup>9</sup> Issues cited as risk factors include:

- The Commonwealth may be unable to uphold its obligation to pay debt service on the 2014 General Obligation Bonds.
- Actions by the rating agencies, such as the recent downgrade of the Commonwealth's credit ratings to non-investment grade, could raise the cost of borrowing.
- The Commonwealth's very high level of debt may affect the performance of the economy and government revenue.
- The Commonwealth's macroeconomic data may not accurately reflect the performance of the economy of Puerto Rico.

A common theme underlying these risk factors is that market access may become unavailable to the Commonwealth, resulting in an inability to obtain sufficient funds and liquidity from future debt offerings to meet obligations as they become due.

### Cash flow initiatives to improve fiscal stability

While a headline may trumpet "*Puerto Rico's \$72 billion of Debt*," the message skirts the core issue that cash flow, not debt, drives a government's insolvency. The Commonwealth acknowledged the importance of governmental cash flow while developing the four key initiatives that form the foundation to their plan for fiscal stability:<sup>13</sup>

1. **Secure liquidity runway** – Puerto Rico's recent \$3.5 billion general obligation debt offering secured a material liquidity runway for both the Commonwealth and the Government Development Bank. Of equal note, the general obligation credit no longer has any financial obligations that are subject to acceleration.<sup>14</sup>

Table 3: Puerto Rico outstanding obligations<sup>10</sup>

Issuer	Outstanding (\$bn)
<b>Commonwealth</b>	
General Obligation Debt and Guaranties	\$19.0
COFINA Sales Tax Debt <sup>11</sup>	15.2
Annual Appropriation Debt <sup>12</sup>	3.8
Limited Obligations/Non Recourse	2.1
Municipalities	4.2
Pension Obligation Bonds	3.0
Tax Revenue Anticipation Notes (TRANS)	<u>0.5</u>
<b>Total</b>	<b>\$47.8</b>
<b>Public corporations</b>	
Puerto Rico Electric Power Authority (PREPA)	\$9.3
Highway and Transportation Authority (HTA)	7.0
PR Aqueduct and Sewer Authority (PRASA)	3.7
Additional Instrumentalities	<u>4.2</u>
<b>Total</b>	<b>\$24.2</b>
<b>Total obligations</b>	<b>\$72.0</b>

<sup>9</sup> Government Development Bank for Puerto Rico, Official Statement, "\$3,500,000,000 Commonwealth of Puerto Rico General Obligation Bonds," March 11, 2014, pp. 5–18.

<sup>10</sup> Commonwealth Report, "Update on Fiscal & Economic Progress," Investor Webcast, July 2014, p. 50.

<sup>11</sup> Moody's and Fitch position COFINA sales tax bonds as susceptible to the Commonwealth's GO credit with ratings of 'Ba3' and 'BB-' respectively; S&P views COFINA as a stand-alone credit and rates 'BBB-.'

<sup>12</sup> Subject to appropriation by the Legislature; failure to appropriate is not deemed a monetary default.

<sup>13</sup> Commonwealth Report, "Update on Fiscal and Economic Progress," Investor Webcast, July 2014, p. 5.

<sup>14</sup> The Commonwealth's general obligation debt structure is currently all fixed rate with the 2014 refinancing of \$460 million variable rate bonds and the termination of \$1.2 billion of interest rate swaps.

2. **Eliminate deficit financings** – The 2015 budget is the first budget in years to be void of deficit financings or include refinancing of maturing debt service. The budget imposes \$1.5 billion of corrective expense measures in lieu of deficit financings.
3. **Grow the economy** – Policy priorities include: (i) restoring Puerto Rico’s reputation as a business-friendly jurisdiction<sup>15</sup> and (ii) offering businesses full advantage of Puerto Rico’s status as a US jurisdiction.<sup>16</sup>
4. **Public corporations self-sufficiency** – Two recent legislative actions are central to making public corporations self-sufficient. The Fiscal Sustainability Act provides Puerto Rico’s public corporations additional tools to reduce public and private personnel expenses.<sup>17</sup> The Recovery Act filled a statutory gap for public corporations to achieve debt relief that is not available under Chapter 9 or Chapter 11 of the Bankruptcy Code.<sup>18</sup>

Governmental cash flow is core to each of these initiatives and provides the foundation to the Commonwealth’s zero budget deficit projected for 2015.<sup>19</sup> Table 4 shows the Commonwealth’s cash flow for 2010 through 2013, along with the impact of pro-forma changes which governmental officials believe will be implemented over the next 18 months:

Table 4: General Fund historic and projected deficits (\$mm)<sup>20, 21</sup>

Fiscal Year	2010	2011	2012	2013	2014 projected	2015 projected
Total Revenues	\$8,032	\$8,343	\$8,783	\$8,697	\$9,037	\$9,565
Total Expenditures	<u>\$10,756</u>	<u>\$10,144</u>	<u>\$11,158</u>	<u>\$10,050</u>	<u>\$9,820</u>	<u>\$9,565</u>
<b>General Fund Deficit</b>	(\$2,724)	(\$1,801)	(\$2,375)	(\$1,353)	(\$783)	<b>\$0</b>

The administration faced a 2012 General Fund budget deficit of more than \$2.3 billion. The 2013 deficit was cut to \$1.4 billion with savings realized through a series of measures including: acceleration of tax receivables, tax amnesty program, sale of tax receivables, and closing agreements with two pharmaceutical companies.

The Commonwealth’s deficit for 2014 is projected to be \$570 million lower than the 2013 deficit. The lower deficit was realized through enhanced General Fund revenues while simultaneously reducing reliance on deficit financings. Of note, the 4% excise tax scheduled to decline 1% per year to 1% in

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<sup>15</sup> Jobs Act Now was adopted in February 2013 to promote small and medium enterprises through an expedited permitting process, capital access and tax incentives. To date, 587 businesses have been granted incentive decrees resulting in an aggregate commitment of 9,684 jobs.

<sup>16</sup> As a US jurisdiction, Puerto Rico’s complies with “US soil” requirements, making it eligible for US government and defense contracts, which are closed to all other Latin American economies.

<sup>17</sup> The Fiscal Sustainability Act declares a state of emergency, provides greater budgetary flexibility, and is in place until July 1, 2017, or when certain fiscal conditions are met, including an investment grade rating.

<sup>18</sup> The Administration’s stated purpose of the Recovery Act is to provide orderly restructuring alternatives and emphasizes that the Recovery Act will be used only as a last resort emergency measure with a strong preference for consensual, negotiated solutions.

<sup>19</sup> Puerto Rico’s economy is projected to provide \$6 to \$7 billion of incremental GDP by 2016 and \$10 to \$12 billion of incremental GDP by 2018.

<sup>20</sup> Official Statement, “\$3,500,000,000 Commonwealth of Puerto Rico General Obligation Bonds,” March 11, 2014.

<sup>21</sup> Commonwealth Report, “Update on Fiscal and Economic Progress,” Investor Webcast, July 2014.

2016 and then expire, was extended through 2017 and reset at a fixed rate of 4%. Excise tax revenues totaled \$2.6 billion in 2013. Expense reductions, including a 9% public sector headcount reduction and limits on benefit increases from collective bargaining, resulted in a decrease in the Commonwealth's projected expenditures for 2014 and 2015.

### Public corporations

The Recovery Act, adopted on June 28, 2014, enables designated public corporations to restructure their debt in the event of financial distress. The goal of the law is to balance the interest of all creditors and stakeholders with the Commonwealth's ability to provide essential services delivered via public corporations during periods of fiscal stress. The Commonwealth's general obligation and related credits are not eligible for restructuring pursuant to the Recovery Act. Also excluded from the Recovery Act are 78 municipalities and Puerto Rico's Government Development Bank. Therefore, all Commonwealth general obligation securities are required to be paid in full, while certain debt of Puerto Rico's government corporations are eligible to be restructured.

The three largest public corporations that may be restructured pursuant to the Recovery Act have outstanding indebtedness totaling \$20 billion:<sup>22</sup>

**Puerto Rico Electric Power Authority (PREPA)** - is the government-owned electric power company exclusively responsible for electricity generation, power transmission, and power distribution in Puerto Rico.

**Puerto Rico Aqueduct and Sewer Authority (PRASA)** – owns and operates Puerto Rico's water and waste water system, servicing 97% and 57% of the Commonwealth's population, respectively.

**Puerto Rico Highways and Transportation Authority (PRHTA)** – is responsible for constructing and financing highways in Puerto Rico. Construction is financed through PRHTA's revenues and debt issuances along with federal and Commonwealth grants.

The Recovery Act's mandate for self-supporting public corporations is designed to eliminate the Commonwealth's historical role of providing aid to underperforming instrumentalities. Table 5 details current obligations and operating deficits in 2012 associated with these three public corporations.

Table 5: Public corporations 2012 operating deficits<sup>23</sup>

Public Corporation	PREPA	PRASA	PRHTA	Total
Outstanding obligations (\$bn)	\$9.3	\$7.0	\$3.7	\$20.0 bn
2012 Operating deficit (\$mm)	\$346	\$137	\$517	\$1.0 bn

<sup>22</sup> In addition to PREPA, PRASA and PRHTA, instrumentalities eligible for the Recovery Act include Puerto Rico Infrastructure Finance Authority and Puerto Rico Ports Authority. Public corporations specifically excluded from the Recovery Act include Puerto Rico Sales Tax Financing Corporation (COFINA), The Puerto Rico Infrastructure Finance Authority (PRIFA), and the Puerto Rico Industrial Development Company.

<sup>23</sup> Official Statement, "\$3,500,000,000 Commonwealth of Puerto Rico General Obligation Bonds," March 11, 2014, pp. II-76 through II-86.

## Puerto Rico's frameworks for debt enforcement

The Commonwealth enacted the Recovery Act to provide an orderly framework for debt enforcement. The law can be applied to reject or modify collective bargaining agreements, but pensions and retiree health benefits may not be impacted. The Commonwealth publicly positions the Recovery Act as a gap-filling measure with a stated strong preference for consensual resolution. Open dialogue with all creditors and stakeholders is a key principle of the Recovery Act.

## Recovery Act settlement paths

The Recovery Act provides two distinct settlement paths:

### Path # 1 - Chapter 2: Market based path *whereby*:

1. Public corporation designates the debt to be renegotiated,
2. Suspension period of 9 – 12 months during which consensual agreement is sought,
3. “Recovery Program” requires 50% of the creditors to vote and 75% of those voters to agree, and
4. Special judge approves and declares binding consensual debt relief.

### Path # 2 - Chapter 3: Judicially supervised path *whereby*:

1. Public corporation files petition to initiate the process,
2. Affected creditors are stayed from exercising remedies during the proceeding,
3. Public corporation's proposed recovery plan must make creditors better off than they would be if all creditors immediately enforced their claims, and
4. Upon one class of creditors' approval, judge declares plan binding on all creditors.<sup>24</sup>

## Recovery Act legal challenge

Certain holders of PREPA bonds have challenged the constitutionality of the Recovery Act on multiple US Constitutional grounds. The bondholders' Constitutional challenges and the Commonwealth's response include:<sup>25, 26</sup>

- **Preemption**  
**Challenge:** The US Congress' Bankruptcy Code already applies to Puerto Rico.  
**Commonwealth response:** US Supreme Court rejected the argument that federal Bankruptcy Code precludes states and territories from passing restructuring laws when no conflicts exist.
- **Impairment of contracts**  
**Challenge:** The US Constitution prohibits states from impairing contracts.  
**Commonwealth response:** US Supreme Court held contractual impairment is permitted to achieve an important governmental purpose.

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<sup>24</sup> Orrick Restructuring Alert, “Summary of Puerto Rico Public Corporation Debt Enforcement & Recovery Act,” July 2014.

<sup>25</sup> *Franklin California Tax-Free Trust et al., v. The Commonwealth of Puerto Rico, et al.*, United States District Court for the District of Puerto Rico, Case No. 14-1518, *Declaratory Judgment*.

<sup>26</sup> *Franklin California Tax-Free Trust et al., v. The Commonwealth of Puerto Rico, et al.*, United States District Court for the District of Puerto Rico, Case No. 14-1518, *Motion to Dismiss*.

- **Unconstitutional taking**

**Challenge:** The US Constitution forbids public taking of private property.

**Commonwealth response:** US Supreme Court precedent that economic regulations rarely result in an economic deprivation, which rises to an unconstitutional taking.

Supporting the Recovery Act, Puerto Rico's Secretary of Justice, César R. Miranda Rodríguez, stated: "The U.S. Supreme Court has clearly established a sovereign's right to pass debt enforcement laws when such relief does not conflict with the federal law ... We stand behind the Act and will defend it as a reasonable and necessary measure to protect the interests of everyone associated with our public corporations and the Island as a whole."<sup>27</sup>

At this time, any future action taken or decision made by the United States District Court is difficult to predict.

## Chapter 9 Congressional Uniformity Act

Subsequent to the enactment of the Recovery Act, Pedro Pierluisi, Puerto Rico's sole non-voting member of Congress, introduced the Puerto Rico Chapter 9 Uniformity Act of 2014 (the Uniformity Act) that would authorize Commonwealth-designated public corporations to enter Chapter 9 municipal bankruptcy.<sup>28</sup> The Act does not change the fact that Puerto Rico, like all 50 states, is not eligible for bankruptcy.<sup>29</sup>

Congressman Pierluisi advanced the legislation with his belief that the Uniformity Act is a more direct and predictable pathway, relative to the Recovery Act, for fiscal restructuring. With the introduction of the Uniformity Act, the Commonwealth is now pursuing parallel paths to acquire the sovereign right, currently held by all 50 states, to restructure local municipal obligations.

## The next chapter

The Administration, Legislature, and Congressional representatives have all acted upon the urgent need to restructure Puerto Rico's public corporations that cannot stand on their own. Management of PREPA, one of Puerto Rico's three largest public corporations, is in conversations with creditors on "a consensual path forward to improve its operations and financial situation."<sup>30</sup> How the Commonwealth ultimately avails itself of the equivalent of Chapter 9 municipal bankruptcy is still an open issue. What no longer appears to be a question is the political will to balance the General Fund, even at the expense of the Commonwealth's favored private corporations and instrumentalities.

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<sup>27</sup> Government Development Bank, "Puerto Rico and PREPA vigorously defend the constitutionality of the Recovery Act in the motion to Dismiss Bondholder's Complaint," press release, July 22, 2014, <http://www.gdbpr.com/documents/prandprepavigorouslydefendtheconstitutionalityoftherecoveryact.pdf>

<sup>28</sup> The National Bankruptcy Conference, a group of bankruptcy experts, issued a letter endorsing Pierluisi's bill: "*The Conference sees no bankruptcy policy reason why Puerto Rico's municipalities should not have the same access as municipalities in the states to Chapter 9 ... Enactment of the bill, allowing Puerto Rico to authorize its municipalities to file for Chapter 9 relief, would ensure immediate access to debt adjustment for Puerto Rico on a less constitutionally-contested basis than the [Recovery] Act.*"

<sup>29</sup> Kyle Glazer, "Pierluisi Offers Bill to Include Puerto Rico Under Muni Bankruptcy Law," *The Bond Buyer*, July 31, 2014, <http://www.bondbuyer.com/news/washington-budget-finance/pierluisi-offers-bill-to-include-puerto-rico-under-muni-bankruptcy-law-1064876-1.html>

<sup>30</sup> Puerto Rico Electric Power Authority, "PREPA Reaches Agreement with Creditors," press release, August 14, 2014, [http://www.gdbpr.com/documents/PREPA\\_Aug14Forbearance\\_PressRelease\\_081414\\_FINAL.pdf](http://www.gdbpr.com/documents/PREPA_Aug14Forbearance_PressRelease_081414_FINAL.pdf)

Regardless of the path taken to secure Chapter 9 equivalent rights, once acquired, time becomes the new uncertainty for Puerto Rico's inventive fiscal paradigm. Specifically, if commitment remains steadfast and the new programs have the planned effect, how long will it take for:

- Rating agencies to restore Puerto Rico's investment grade rating?
- Municipal bond market participants to recalibrate Puerto Rico's value perception?

The Commonwealth's focused and decisive actions should drive the narrative, but only time will tell if *the next chapter* narrative for Puerto Rico is one of fiscal stability.

### About the author

**Bradley Wendt** has more than 25 years of financial markets experience including fixed income capital markets, credit analyses, electronic trading, regulatory compliance, bond insurance, and securities pricing. His municipal securities expertise includes creating and running Goldman Sachs' Municipal Capital Markets Group and managing Goldman Sachs' \$40 billion short-term municipal remarketing desk. Mr. Wendt was the founding member of the broker-dealer committee that created the SIFMA municipal swap index and was honored by *Institutional Investor* with its "Deal of the Year Award" for an innovative municipal securities transaction.

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