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Puerto Rico Bondholders Share The Pain

By **Bradley Wendt**

Law360, New York (August 4, 2017, 12:40 PM EDT) --
The commonwealth of Puerto Rico has embarked on the first phase of restructuring over $74 billion of debt. The Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) governs the United States' largest municipal restructuring. The U.S. Congress enacted PROMESA in 2016, providing Puerto Rico broad in-court restructuring methods modeled on Chapter 9 of the U.S. Bankruptcy Code.[1]

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PROMESA empowers a seven-member board (oversight board) with ultimate discretion and final authority over Puerto Rico's fiscal plans and budgets. The oversight board designated a preliminary total of 63 commonwealth entities subject to PROMESA oversight. The financially troubled Puerto Rico Electric Power Authority (PREPA) is included among PROMESA's covered entities.[2]

Prior to PROMESA's congressional enactment, PREPA commenced voluntary negotiations with its creditors to restructure its debt and provide a path forward to competitive pricing for power sales. This article provides context around the PREPA creditor negotiations and the decisive role PROMESA will play in determining the concessions borne by all Puerto Rico bondholders.

PROMESA Debt Adjustment

Under a PROMESA debt adjustment proceeding, the oversight board takes the place of the debtor government. The first step in the debt adjustment is for one or more covered entities to provide a fiscal plan to the oversight board for certification. The board-certified plan of debt adjustment is then voted on by the creditors and confirmed by the district court.[3][4]

The first fiscal plan certified by the oversight board were the covered entities underlying the commonwealth's general obligation and sales tax bonds (General Obligation Certified Plan). These covered entitles represented 55 percent of the total debt to be restructured by the commonwealth. The General Obligation Certified Plan used a waterfall approach to determine debt capacity:[5]

Table 1: General Obligation Certified Plan Debt Sustainability Analysis

Commonwealth Certified Plan	2018	2019	2020	2021	2022	'17 – '26 Average
Revenues	$17,511	$16,407	$16,434	$16,494	$16,590	$17,080
Plus Certified Plan Savings	1,875	3,393	3,799	4,515	4,789	3,958
Less Expenses	(18,981)	19,233	19,512	19,950	20,477	20,251
Cash Flow Available for Debt (A)	$404	$567	$722	$1,059	$903	$787
Required Debt Service (B)	$3,283	$3,828	$3,437	$3,347	$3,171	$3,339
Debt Recovery Value (A / B)	**0.12x**	**.15x**	**.21x**	**.32x**	**.28x**	**.24x**

Source: CRA Analysis

Consistent with the debt sustainability analysis, Gov. Ricardo Rosselló committed that over the next decade, the commonwealth will pay no more than 24 percent of the General Obligation Certified Plan's debt.[6]

A Financially Troubled Electric Utility

Created in 1941 as a public corporation and governmental instrumentality, PREPA generates, transmits and distributes substantially all of the electricity in Puerto Rico. PREPA is the largest public power utility in the United States, ranking first in number of clients and revenues. PREPA's average energy cost is 21 cents per kilowatt hour, twice the average cost in the United States.[7][8]

The past decade has been especially burdensome for PREPA. The commonwealth's ongoing recession caused a significant reduction in energy sales, leading to inadequate capital investments and operating deficits. The utility obscured the operating deficits by reallocating funds from municipal bond sales, compounding PREPA's debt burden. Capital plans to modernize the utility and diversify beyond PREPA's high dependence on oil fuel were by necessity, placed on hold. PREPA's debt and obligations total $9 billion.[9]

PREPA's Debt Adjustment

PREPA commenced creditor negotiations in the summer of 2014. During the ensuing three years, the utility negotiated creditor forbearance agreements and hired a chief restructuring officer. Creditor negotiations were memorialized in a restructuring support agreement (RSA), authorized by the commonwealth's legislature and approved by the governor in June 2017.[10]

The RSA proposed exchanging PREPA's existing bonds for new bonds, with the following structural modifications:[11]

1. Face value reduced by 15 percent;
2. Lower interest rate; and
3. Five-year deferral of principal retirement.

In the parlance of the RSA, the creditors proposed taking a 15 percent "haircut," providing the PREPA bondholders an approximate 85 percent recovery rate.

Board Rejects an RSA

The oversight board met in executive session on June 27, 2017, and rejected PREPA's restructuring support agreement, stating:

... the proposed agreement was not in Puerto Rico's best interests because, ultimately, it did not support the structural and operational reforms required to attract additional capital to PREPA that will enable its much-needed transformation.

The oversight board expressed the additional concern that "affordable and reliable electricity is central to Puerto Rico's economic turnaround" and barring these conditions, customers will seek alternative energy sources, thereby placing rate pressure on the remaining customer base. The oversight board stated that PREPA is best served through the Title III restructuring provision of PROMESA, as opposed to the Title VI consensual negotiations that were used for the RSA.[12]

On July 3, 2017, the oversight board unanimously voted to file a Title III voluntary petition on behalf of PREPA to protect the utility and creditor interests.[13]

Voluntary Creditor Negotiations Encouraged

The oversight board recognizes that PROMESA's covered entities have distinct characteristics that necessitate a broad range of restructuring solutions and metrics. An openness to negotiated settlements is a consistent oversight board refrain.

On July 12, 2017, the oversight board granted conditional approval of an RSA for the Puerto Rico Government Development Bank (GDB). The proposed GDB liability restructuring was attained pursuant to PROMESA Title VI providing for consensual negotiations.[14] The RSA term sheet provides for a restructuring exchange ratio ranging from 55 percent to 75 percent.[15]

Puerto Rico Bondholder Recovery

The recent actions by the oversight board create a relatively broad band of recovery levels for Puerto Rico bondholders.

Table 2: Oversight Board Actions on Proposed Bondholder Recovery Levels

Covered Entity	Debt and Liabilities	Board Disposition	Proposed Recovery
General Obligation and Sales Tax Bonds	$41.1 bn	Fiscal Plan: Certified	**22%**
Government Development Bank (GDB)	$4.1 bn	RSA: Conditional approval	**55% - 75%**
Puerto Rico Electric Power Authority (PREPA)	$9.0 bn	RSA: Rejected	**85%**

Source: CRA Analysis

Proposed recovery levels for Puerto Rico bondholders are still too few in number to draw meaningful conclusions. Investor uncertainty will likely persist for the near and medium terms.

However, there is one area of certainty that continues to emerge: The oversight board's commitment to the legislative mandate that bondholder concessions adequately support and nurture permanent economic growth for the commonwealth of Puerto Rico.

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[1] Once a PROMESA Title III petition is filed, the court is empowered to issue a broad confirmation order that definitively discharges, upon confirmation, all obligations and provides a clean slate for the debtor to re-enter the market place. The court's tools underlying the universal discharge include: (1) cramdown power for nonconsenting classes of claims allowing a qualified plan of adjustment to be approved by a single impaired class and (2) debtor-in-possession financing, providing lenders a superpriority lien.

[2] Sept. 20, 2016, meeting, The Financial Oversight and Management Board for Puerto Rico: Designation of 63 initial covered entities pursuant to Attachment B. PROMESA-covered entities include all entities referenced in the 2014 Commonwealth Annual Financial Report.

[3] Congressional Research Service, The Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA: HR 5278, S. 2328), p. 15.

[4] Adjustments to the certified plan must be approved by the oversight board and cannot be unilaterally modified by the district court.

[5] Fiscal Plan for Puerto Rico, Government of Puerto Rico, Puerto Rico Fiscal Agency and Financial Advisory Authority,
March 13, 2017.

[6] Fidelity, Puerto Rico governor insists judge cannot revise next 10 years of debt payments, May 5, 2017.

[7] PREPA Fiscal Plan, August 28, 2017, p. 15.

[8] U.S. Energy Information Administration, Data for April 2017.

[9] See supra note 7 at 20.

[10] Motion of Ad Hoc Group of PREPA Bondholders et al., In re: The Financial Oversight and Management Board for Puerto Rico, United States District Court for the District of Puerto Rico, July 18, 2017.

[11] National Public Finance Guarantee, Demystifying the PREPA Transaction, March 24, 2016.

[12] Press Release: Financial Oversight and Management Board for Puerto Rico, Oversight Board Does Not Approve PREPA's RSA, June 27, 2017.

[13] Press Release: Financial Oversight and Management Board for Puerto Rico, Oversight Board Files Title III Petition for PREPA, July 2, 2017.

[14] Press Release: Financial Oversight and Management Board for Puerto Rico, Oversight Board Authorizes Government Development Bank to Restructure Debts under Title VI of PROMESA, July 14, 2017.

[15] The proposed restructuring exchange ratio is the recovery rate for the GDB bondholders. Tranche A: 55 percent recovery, 7.5 percent interest rate; Tranche B: 60 percent recovery, 5.5 percent interest rate; Tranche C: 75 percent recovery, 3.5 percent interest rate.
