

**To: The Subcommittee on Indian, Insular, and Alaska Native Affairs**

**Re: Written Testimony of Adam Bergonzi**

### **1. Introduction to National**

National Public Finance Guarantee (“National”) is a municipal-only monoline insurer with over 40 years of experience in the municipal market. Through its municipal bond insurance products, National has delivered savings to municipalities across the United States and provided credit protection to individual investors, thereby facilitating the selling and purchasing of municipal bonds which are critical to finance essential public infrastructure projects.

### **2. National’s Partnership with Puerto Rico**

For over 30 years, National has partnered with Puerto Rico and its bondholders and currently insures approximately \$3.6 billion of Puerto Rico bonds issued for energy, transportation, higher education and general government purposes. A summary of this activity is as follows and notes where National has contributed capital in the form of Claims Paid and Relending Bonds over the past two years:

	Gross Par Outstanding	Claims Paid	Relending Bonds	Total Exposure
Commonwealth GO	\$855	\$192	–	\$1,047
PRHTA	706	5	–	711
PREPA	1,249	–	139	1,388
COFINA <sup>(1)</sup>	684	–	–	684
UPR	86	–	–	86
Inter-American UPR	26	–	–	26
<b>Total</b>	<b>\$3,607</b>	<b>\$197</b>	<b>\$139</b>	<b>\$3,943</b>

Note: As of 9/30/2016

(1) Excludes interest accreted to-date on CABs.

### **3. National and PREPA**

National insures nearly \$1.4 billion of PREPA bonds—making National PREPA’s single-largest creditor. National has worked constructively with PREPA and the Puerto Rico Government toward an optimal consensual outcome for all stakeholders over the past two years. Our objective is the same as Puerto Rico’s: a sustainable, long-term solution. Accordingly, in December 2015, 70% of PREPA’s creditors, including National, reached a voluntary agreement known as the Restructuring Support Agreement or “RSA” that would allow PREPA to restructure its debt on consensual terms.

The RSA is designed to achieve the following objectives:

- a) create a stable financial platform to permit access to the capital markets;
- b) depoliticize PREPA through the creation of an independent board of directors;

- c) position PREPA to reap the benefits of operational and maintenance savings, thereby creating opportunities for further rate reduction;
- d) assure a steady fuel supply for the Island; and
- e) achieve the necessary financial stability to encourage future private investment in generation, transmission, and distribution of electricity.

#### **4. Overview of the PREPA RSA and Creditor Contributions**

The RSA entails the following:

- a) Exchange of **uninsured PREPA Bonds** at 85% of par into a newly-formed bankruptcy-remote entity (“SPE”). The entity would be backed by a special assessment charged by PREPA (the “securitization charge”).
- b) **Fuel line lenders** are repaid ~\$650 million of currently due loans over 6 years. Interest rate on fuel line loans reduced by ~150 basis points.
- c) **Monolines** to provide sureties of up to \$462 million to fund a Debt Service Reserve Fund (“DSRF”) for the securitization bonds which would be used after a \$65 million cash funded DSRF.

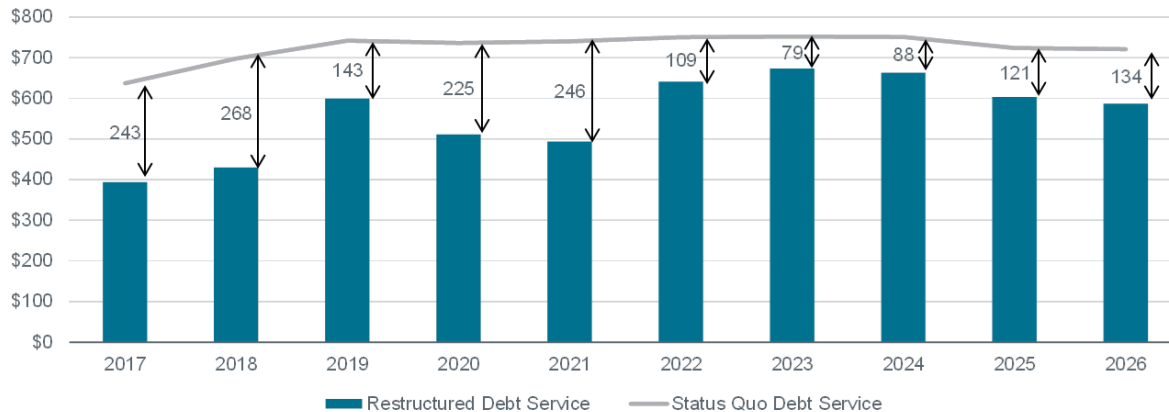
In addition to the concessions made in the RSA, National and other creditors have made important contributions over the past two years that have allowed PREPA to continue operating despite its lack of access to the capital markets:

- a) Purchased \$375 million of new bonds—over a third of which came from National.
- b) Additional bond purchase avoided payment defaults and prevented a contraction of fuel vendor credit terms.
- c) Waived collateral requirements (thereby releasing over \$500 million in needed liquidity to PREPA).
- d) Permitted the use of general fund monies for capital improvements prior to debt service.
- e) Permitted PREPA to use cash in the construction fund, providing further liquidity.

All of the above actions have enabled PREPA to operate at levels of liquidity necessary to serve Puerto Rico.

#### **5. Benefits of the RSA to PREPA and Puerto Rico**

The RSA lowers PREPA’s overall debt burden and provides near-term liquidity for reinvestment. According to PREPA’s petition for a Restructuring Order filed in April 2016, the RSA leads to \$1.7 billion of savings over a 10-year period. To the extent the RSA is enacted through a Title VI proceeding under PROMESA, the savings will be even greater, as uninsured bondholders (including those not currently parties to the RSA) would all take a principal deferral and a 15% principal discount.



The RSA also starts PREPA on a path to restored access to the capital markets and third party investment. The debt restructuring would allow PREPA to achieve a higher credit rating. Closing the RSA would also facilitate integration of P3 investment in PREPA, as 3<sup>rd</sup> party investors would be unlikely to extend credit or provide financing to PREPA absent a resolution of its debt restructuring. The SPV may also provide a go-forward financing vehicle for select capital projects. In sum, closing the RSA provides a bridge for PREPA to access the capital it needs for critical investments that will transform the utility.

Finally, the RSA has contributed to significant business improvements at PREPA. The stability provided by creditor forbearance has restored trade terms with fuel vendors and PREPA currently has payables balances of over \$350 million with terms of up to 60 days. The RSA also requires increased transparency and improved PREPA governance. Closing the RSA will allow management to shift their attention to critical issues facing the business, and allow PREPA to proceed with a much-needed operational transformation to provide cheaper and more stable service to the island.

## 6. Risks of Termination of the RSA

If the RSA is terminated, PREPA would likely default on its over \$450 million bond payment due July 1, 2017. This would in turn lead to bondholder litigation (post-expiration of stay) for receivership and the enforcement of liens for Special Revenue debt. Active litigation with bondholders would deter critical private investment, and delay EPA compliance and renewable integration. In addition, approximately \$730 million in payments for matured fuel lines, which lenders are currently forbearing from exercising remedies due to RSA, would come due and current fuel vendor credit terms (\$342 million of current payables balances) that were enabled by the RSA could be withdrawn—all of which could generate additional litigation and affect PREPA’s operations. Furthermore, a default would undermine PREPA’s creditworthiness and delay PREPA’s re-entry to the capital markets.

Puerto Rico also risks losing credibility with investors—and therefore renewed access to the capital markets—if the RSA falls prey to the vagaries of local politics or to a change of administration. The RSA and its implementing legislation, Act 4-2016, recognized the importance of a nonpolitical, professional board of directors for PREPA as a way to insulate PREPA from political risk and guarantee a competent, expert-driven, and evidence-based stewardship for the utility. The RSA is the only fully negotiated solution that creditors and the Puerto Rico government have reached in the last three years. Abandoning it

at this time bodes ill for future negotiations with creditors on PREPA and other Puerto Rico government entities.

In the event a defensive Title III proceeding was filed, such a proceeding would not create stability for PREPA. Title III-related creditor litigation would still occur and liquidity and trade contraction could remain obstacles to PREPA's recovery.

Termination of the RSA would also lead to the loss of voluntary creditor concessions. PREPA's former CRO, Lisa Donahue, has stated in testimony to the Puerto Rico Energy Commission, that bondholders would likely receive 100% recovery in litigation. In the interim, PREPA would be unable to access capital markets or public-private partnerships until any litigation is resolved, which could take [years]. This is all compared to the current RSA, which contemplates a 15% principal haircut, interest rate reduction, five-year principal deferral, and extension of up to \$462 million of credit by the monolines.

Puerto Rico has benefitted in the past few years from a significant decrease in electricity rates thanks in large part to historically low oil prices. PREPA chose to pass on all of those savings to consumers, while creditors were not being paid full debt service. PREPA needs to, and is statutorily and contractually obligated to, increase rates to account for debt service. However, it had not (until last year) increased its base rate since 1989, despite having expenses that exceeded revenues. The required increase is limited to 3.3 cents/kwh under the RSA, compared to an increase of an average of 4.6 cents/kwh from FY2017-FY2020 if PREPA had to pay its status quo projected debt service (see Exhibit A for a detailed breakdown of PREPA's rate).

## **7. Current Status of the PREPA RSA**

The PREPA RSA has received support and approval from key stakeholders. Approximately 70% of PREPA's legacy bond creditors and all of PREPA's bank creditors support the restructuring. Under Governor Padilla's administration, the Puerto Rico government put in place the legislative and regulatory framework needed to implement the RSA. In February 2016, the Legislature enacted Act 4-2016, which carried out central provisions of the agreement, most notably the securitization structure and transition charge necessary for PREPA's transformation into a financially stable utility. In June 2016, PREPA's regulator, the Energy Commission, approved a transition charge methodology. The Puerto Rico courts, meanwhile, are in the process of validating the securitization structure (see further below). Additionally, both the Puerto Rico Legislature and Congress expressed their support for the RSA by carving out PREPA from the Moratorium Act and PROMESA.

PREPA is in the midst of validation proceedings, where challengers are questioning both the validity of Act 4-2016 and the validity of the Energy Commission's 2016 PREPA Restructuring Order (both of which must be upheld as a condition to the RSA). The first decision recently came out in favor of validity of Act 4 and other Phase I cases were voluntarily dismissed (the decision in the *UTIER* case is being appealed). The Phase II cases have been consolidated.

In January 2017, National participated in discussions with PREPA's advisors regarding adjustments to the RSA needed to close the restructuring under PROMESA. Near the end of the month, however, Governor Rosselló appointed AAFAP to take over the negotiations on behalf of PREPA, and creditors agreed to

extend the RSA from January 31, 2017 to March 31, 2017. Since then, no one from AAFAF has shared any proposal with National to close the restructuring.

## **8. Opportunities for PREPA Post-Restructuring**

According to PREPA's most recent business plan, chronic underinvestment and inconsistent management have led PREPA's facilities to fall significantly behind industry standards. For example, PREPA's median plant age is 44 years (compared to an industry average of 18 years), and PREPA's facilities experience significant forced outages (16%, compared to industry average of 11%). Once the restructuring has closed, PREPA will be able to pursue the investments needed to achieve cheaper, cleaner and more reliable energy.

PREPA's long-term investment program seeking compliance with environmental requirements totals over \$4.5 billion from FY2016-2035 (\$2.4 billion in first 10 years). Significant projects include:

- a) AOGP (\$517mm): Facility is expected to be built in 18 months (post-permitting). AOGP would improve fuel diversity, as needed to achieve environmental compliance, and would allow for construction of new units that rely on gas rather than diesel
- b) New Units/Fleet Upgrade (\$1.7bn): Investment in new fleet would reduce costs and enhance system reliability (reduce outages). Average PREPA thermal unit is 30% less efficient than a new combined cycle gas unit
- c) Transmission and Distribution (\$250mm): Improve distribution system reliability (reduce energy losses)
- d) Increasing share of Renewable Energy from 2% to 17%

Besides achieving regulatory compliance, improved reliability and improved efficiency, these investments will create jobs in Puerto Rico and attract new third-party capital investment. PREPA conducted a Request for Expressions of Interest in Sept/Oct 2015 for the development of new generation assets to gauge interest from third parties on modernization solutions for PREPA. 31 proposals were received from 16 participants, demonstrating robust interest in P3s from the private sector.

The closing of the debt restructuring also enables management to refocus on improving the business in several areas. In terms of receivables collection, the past due balance from government customers remains above \$150 million, the equivalent of \$113 per residential client. PREPA can also work to decrease energy losses. Energy losses not due to technical issues (primarily theft) totaled 5% of net generated energy in October 2016, according to the Donahue Handover Report. Total energy losses as a percentage of total power generated/sourced was 14% for PREPA in 2015, compared to U.S. municipal average of 4.6%, according to EIA data. Finally, PREPA must continue to focus on improving safety for employees. DuPont performed a safety analysis showing PREPA performs below "fundamental" levels (the lowest designation) on each of the 12 metrics they analyzed.

## **9. Path Forward Through Title VI**

The RSA parties believe that implementation of the PREPA transaction through Title VI of PROMESA would be advantageous as it would, among other things, (a) increase the speed and certainty of process and outcome and (b) demonstrate that consensual deals are achievable and build momentum for the remaining issuers.

The RSA is a “preexisting voluntary agreement” under PROMESA §104(i)(3) and is therefore deemed to be in conformance with the section of PROMESA concerning certification of Preexisting Voluntary Agreements. As such, certification and approval of the RSA is subject to a streamlined process. Once the RSA/Qualifying Modification is approved and binding under Title VI, the PREPA deal will “go effective” upon satisfaction by PREPA of the closing conditions under the RSA.

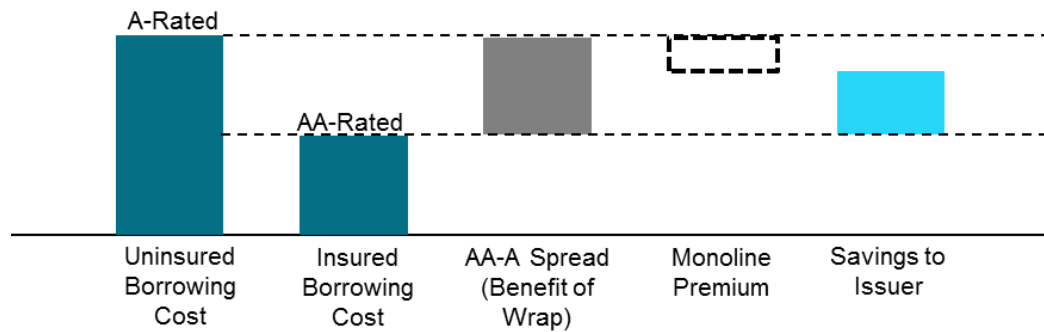
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*Background Note on Monoline Insurers*

Monoline insurance companies insure investors against the risk of a bond defaulting – i.e., guarantee the scheduled payment of principal and interest for the duration of the life of a bond (often up to 30 years). Insurance on bonds is often called a “credit wrap,” or simply a “wrap.” Monolines are akin to the issuer of a bond, and it is their obligation to make full principal and interest payments even if an agreement calls for investors to receive a discount to par.

A wrapped bond has the same credit rating as the insuring monoline, which is generally higher than the credit rating of the issuer. The guarantee and higher credit rating allows the issuer to obtain a lower cost of financing than it may have otherwise received (with the spread in cost being shared between the monoline and the issuer). In addition to lowering financing costs for issuers, monolines enhance capital markets access by attracting a larger group of investors and facilitating greater trading / liquidity.

**Illustrative Example Demonstrating Benefit of Wrap**



**Exhibit A: Breakdown of PREPA Rates**

