Municipal Brief
Puerto Rico Credit and Market Update
9 August 2018

Wealth Management Research
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- The Financial Oversight and Management Board ("FOMB" or "the Board") announced on 8 August that it had reached an agreement in principle with creditors of the Puerto Rico Sales Tax Revenue Corporation (COFINA, by its Spanish acronym). The agreement, which requires court approval, would allocate 53.65% of the revenue derived from the 5.5% sales and use tax to COFINA bondholders, subject to an annual cap. Revenue in excess of the Pledged Sales Tax Base Amount would be directed to the Commonwealth.

- Senior and subordinate COFINA bondholders would both receive senior lien bonds in exchange for existing securities. The Board expects existing senior lien COFINA holders to recover 93-95 cents on the dollar. Subordinate bondholder recoveries are expected to reach 56-58 cents on the dollar. The monoline bond insurers have agreed to the terms of the settlement.

- The Board also reached a tentative agreement with an ad hoc group of investors holding Puerto Rico Electric Power Authority revenue bonds. The agreement, which also still requires court approval, would provide participating utility bondholders with the opportunity to exchange bonds at a rate of 67.5 cents on the dollar. A second series of bonds would be provided by the utility at a rate of 10 cents of the dollar, with payment on the second tranche contingent on economic performance. PREPA bond prices rallied strongly when news of the deal was announced. The monoline bond insurers did not participate in the PREPA agreement.

- The pace of litigation on a variety of other issues has accelerated. One group of institutional investors has argued that certain provisions of the Puerto Rico Oversight Management and Economic Stability Act (PROMESA) violated the appointment clause of Article II of the US Constitution. Other investors have sought compensation from the federal government for interference with their contractual rights to pledged revenue. Meanwhile, the Commonwealth government unsuccessfully sought a court injunction to prohibit the FOMB from mandating expenditure reductions.

COFINA settlement announced
As we discussed in our blog post entitled "Puerto Rico creditors reach a tentative agreement" (8 June 2018), court-appointed agents for general obligation and COFINA creditors had already reached a Settlement in Principle Agreement regarding the allocation of future

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sales tax revenue generated on the island. Yesterday’s announcement by the FOMB honors the terms of that agreement and also appears to resolve the lingering dispute between senior and subordinate sales tax revenue bondholders.

COFINA bondholders would receive 53.65% of the Pledged Sales Tax Base Amount (PSTBA) through 2058. The PSTBA would be limited to USD 783 million for fiscal year 2019, would escalate by 4% each year thereafter, and cap out at USD 1.85 billion in fiscal year 2041. The Commonwealth, meanwhile, would receive 46.35% of the annual sales tax revenue and would also receive any residual amount over and above the PSTBA dedicated to COFINA. The Commonwealth also would retain its interest in revenue derived by any sales and use taxes over and above the 5.5% rate. All cash held on deposit with the Bank of New York Mellon through the end of 2018 would be allocated to COFINA.

The Board’s announcement resolves the dispute between senior and subordinate COFINA bondholders. Under the terms of the agreement, all bondholders, regardless of lien, will receive new fixed rate senior bonds secured by the 5.5% tax in exchange for their existing securities. The senior lien will then be closed, excepting any future refunding bonds that result in debt service savings. After rallying on news of a tentative agreement by the creditors’ agents two months ago, COFINA prices rallied strongly again this morning (see Appendix). We do not expect any rating agency to provide an investment grade rating to the new senior bonds. While the structure of the new senior bonds would merit such a rating in other circumstances, yesterday’s announcement requires subordinate holders to absorb a significant loss in the bond exchange. However, to the extent that the pro forma financial projections are realized over time, the Commonwealth has secured a viable revenue stream of sales tax revenue over and above the PSTBA.

**PREPA settlement announced**

The FOMB announced a tentative restructuring support agreement with a group of investors holding approximately USD 3 billion of outstanding utility revenue bonds. The proposed deal, which still requires court approval, would compel participating investors to exchange their uninsured bonds for new Securitization Bonds to be issued by a bankruptcy-remote entity. The new bonds would be secured by a transition charge ranging from 2.6 cents per kilowatt hour to 2.8 cents per kilowatt hour for the next 11 years. Thereafter, the transition charge would increase by 2.5% per annum until a maximum rate of 4.35 cents per kilowatt hour is reached. The use of a bankruptcy remote entity and a fixed transition charge on utility bills may sound familiar to our readers. Prior restructuring proposals have envisioned a similar structure to reduce the likelihood of political interference.

Participating investors would receive new bonds at a ratio of 77.5 cents to the dollar for each bond surrendered, divided into two separate tranches. Tranche A bonds would be exchanged at a ratio of 67.5% and would mature in 40 years. These bonds would pay a 5.25% coupon and would be subject to mandatory redemption from excess cash flow. They would remain outstanding until fully paid.
Tranche B bonds, meanwhile, would be exchanged at a ratio of 10%, would receive 100% of the excess cash flow after repayment of the Tranche A bonds. They would mature in 45 years regardless of whether accrued interest was paid in full.

FOMB chair Jose Carrion hailed the PREPA deal as "an important milestone and a big step forward" towards a final resolution of the utility’s insolvency.[ii] Bond insurers were among the majority of creditors who elected not to participate. Their absence suggests that the court may be unable to impose (i.e. cram down) the same settlement on all utility investors, pending further negotiations.

Prices on uninsured PREPA bonds rallied strongly on news of the tentative agreement. Prices have returned to levels last seen in the summer of 2017, offering investors another opportunity to reduce their exposure to the troubled utility. The appointment of five different executive directors in less than 18 months has failed to restore market confidence. The utility’s physical infrastructure is highly inefficient and lacks the redundancy necessary to withstand recurring tropical storms. Power outages are common with scheduled interruptions necessary to prevent systemic failure.

Governor Ricardo Rosselló Nevares has floated the idea of privatization in recent months. In conjunction with the execution of the proposed settlement between PREPA bondholders and the FOMB, the governor expressed his support for private management of the transmission and distribution system via concession contracts.[iii] The utility’s most recent fiscal plan also envisions the sale of power generation assets but lacks much detail as to how asset sales will affect existing bondholders or the means by which the restructuring will be accomplished. Newly installed CEO Jose Ortiz characterized the privatization of generating assets as a "mid-term goal."[iii]

Privatization took center stage in Washington two weeks ago when Rep. Rob Bishop (R-UT) convened a hearing entitled Management Crisis at the Puerto Rico Electric Power Authority and Implications for Recovery. Governor Rosselló was invited to attend but declined to do so. US Department of Energy Assistant Secretary Bruce Walker expressed support at the hearing for a structure that would allow the utility to exert more independence from elected officials. From our perspective, we believe the assumption of responsibility by the private sector for the provision of electricity on the island is essential and inevitable. Unfortunately, the prospect of inconsistent regulatory oversight may dissuade many parties from bidding aggressively on the assets.

Other litigation persists

In previous reports, we have professed a belief that municipal insolvency declarations inevitably result in time-consuming litigation as capital market creditors and other stakeholders vigorously defend their myriad interests. The decision by the Puerto Rico Financial Oversight and Management Board (“FOMC" or the "Board") to commence a debt adjustment proceeding under Title III of PROMESA has proven to be no exception. The Board sought court protection on

The prospect of inconsistent regulatory oversight may dissuade many parties from bidding aggressively on the assets.
behalf of the Commonwealth more than a year ago and the validity of its actions is still under debate.

Look no further than the motion brought by one creditor, Aurelius Investment, over the constitutionality of the Board. Aurelius has argued that Congress violated the appointments clause of Article II of the US Constitution when it selected individuals to serve on the Board without Senate confirmation. As a result, the private investment firm believes that subsequent actions taken by the Board, including the Title III petition seeking court protection, are inherently invalid and should be set aside.

US District Court Judge Laura Taylor Swain rejected the argument and dismissed the legal challenge on 13 July. She cited Congress’ plenary power over the affairs of US territories. In doing so, she affirmed the distinction between "Officers of the United States", who require Senate confirmation, and territorial officers appointed by Congress. That would seem to have settled the matter but plaintiffs have chosen to appeal the District Court ruling. Judge Swain has certified the issue for further argument, which now heads to the First Circuit Court of Appeals in Boston.

In another case where institutional investors were contesting the disposition of pledged revenue, the Chief Judge of the US Court of Claims concluded that the Oversight Board was, in fact, a federal entity. Altair Global Credit Opportunities Fund and a group of other investors brought a lawsuit in that venue seeking continued payment of debt service on Retirement System bonds. The plaintiffs allege that the federal government is now responsible for the payment of debt service because the Financial Oversight and Management Board was a federal entity. In their view, the federal government assumed responsibility for the payment of debt service when the FOMB took effective control of the Commonwealth’s financial management.

Judge Susan G. Braden based her decision, in part, on the legislative history accompanying the enactment of PROMESA. She cited a House of Representatives report directing the Office of Management & Budget to treat the FOMB as a federal entity. She rejected the US government’s motion to dismiss the case and granted legal standing to the plaintiffs to seek just compensation from the US government. However, she also stayed her decision pending a final resolution of the cases being argued in Judge Swain’s courtroom. The net result is a jurisdictional conflict.

The Board’s communications with investors whose bonds have declined in value was bound to be contentious. Unfortunately, its relationship with the Commonwealth government also appears strained despite yesterday’s news regarding COFINA. Governor Rosselló and the Puerto Rico Fiscal Agency and Financial Advisory Authority sought a court injunction in July to prevent the FOMB from requiring the enactment of certain policies that were explicitly rejected by the governor and legislature. Governor Rosselló believed the Board usurped power from elected officials, in contravention of Congressional intent, by mandating certain labor reforms and by demanding expenditure reductions and the elimination of compulsory Christmas bonuses.
Judge Swain reaffirmed the FOMB’s ultimate authority over the Commonwealth budget on 7 August. According to the court’s written opinion, FOMB retains exclusive authority to certify a fiscal plan and thereby determine the aggregate amount of expenditures by the Commonwealth government. However, the Board does not have the power to enact new laws or mandate the repeal existing statutes. The FOMB has “only budgetary tools and negotiations” and neither the Commonwealth government nor the Board “hold all of the cards.”[iv] The net effect is to create dynamic tension between the governor and the Oversight Board. Neither can operate unilaterally.

Puerto Rico economy remains exceptionally fragile
Emigration from the island continues to pose a serious challenge to economic recovery. According to Moody’s Investors Service, approximately 200,000 individuals departed Puerto Rico for the US mainland in the wake of hurricanes Irma and Maria.[v] The exodus has resulted in a population imbalance. Puerto Rico is now third in the nation with the highest percentage of individuals over the age of 65 (behind Florida and Maine) and a labor force participation rate hovering around 40%. The scarcity of qualified physicians poses a longer-term problem that will restrain economic development and prolong the distress of residents still recovering from the devastating storm.

Conclusions
The COFINA settlement holds out the prospect of an accelerated resolution to the numerous disputes between the Commonwealth and its creditors. While we believe the litigation associated with Puerto Rico’s Article III proceedings will continue for some time, COFINA bond prices should remain elevated. Prices on other bonds are expected to remain more volatile.

The agreement announced yesterday is a very positive development for subordinate COFINA bondholders. The junior lien securities were exposed to far greater losses. The COFINA senior lien bondholders' losses will be limited, reinforcing our long-held view that investors holding enterprise revenue bonds are in a better position to withstand insolvency petitions by municipal borrowers than GO bondholders. In this case, market pricing for Puerto Rico GO bonds reflects substantial uncertainty over the Commonwealth’s future budgetary priorities.

General obligation bondholders will benefit from the 46.35% of sales taxes allocated to the territory government. However, unlike COFINA bondholders, the GO creditors must still lay claim to the cash in competition with other general creditors of the Commonwealth. GO bond prices did improve overnight but their lagging performance reflects the absence of a direct lien on the sales taxes for general obligation bondholders.

Bond insurer participation is a critical component to the COFINA settlement and increases the likelihood of a final resolution in accordance with the draft settlement announced yesterday. Their absence from the PREPA settlement introduces greater uncertainty regarding the terms of a final resolution for the electric utility credit. However, with that said, the COFINA announcement does have the potential to hasten the resolution of other creditor disputes.

"PROMESA is an awkward power-sharing arrangement and … is fraught with potential for mutual sabotage."

Hon. Laura Taylor Swain
US District Court Judge

Note: Puerto Rico GO 8.00% 2035 were issued at USD 93.00 on 11 March 2014

Source: MSRB trade data, Bloomberg, UBS, as of 9 August 2018 1:12PM ET
Michelle Kaske, “Puerto Rico Power Utility Bonds Soar on Restructuring Deal, Bloomberg, 1 August 2018.

The statement from La Fortaleza states that the proposed agreement will attract "new private investment through the concession of the T+ D systems and privatization of the current generation fleet."

Caribbean Business, Puerto Rico power company officials hold meetings in DC, 6 August 2018

United States District Court for the District of Puerto Rico, Opinion and Order Granting in Part Defendants Motion to Dismiss, Case No. 17-3283, 7 August 2018.

Moody’s Investors Service, Weak economic recovery weighs on issuers as new hurricane season looms, 11 June 2018.

Appendix

Fig. 2: Select credits and price trends of Puerto Rico municipal bonds
Last price, in USD

Source: MSRB trade data, Bloomberg, UBS, as of 9 August 2018 1:12PM ET
Appendix

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<td>GO</td>
<td>General Obligation Bond</td>
<td>TEY</td>
<td>Taxable Equivalent Yield (tax free yield divided by 100 minus the marginal tax rate)</td>
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Rating Agencies | Credit Ratings

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<td>Issuers have very high risk of default.</td>
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