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COMMONWEALTH OF PUERTO RICO
PUERTO RICO ELECTRIC POWER AUTHORITY

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September 2, 2016

The Honorable Orrin Hatch
Chairman, Congressional Task Force on
Economic Growth in Puerto Rico
104 Hart Office Building
Washington, DC 20510

Re: Puerto Rico Electric Power Authority

Honorable Chairman:

We write to you on behalf of the Puerto Rico Electric Power Authority ("PREPA"), in connection with the request issued by the Congressional Task Force on Economic Growth in Puerto Rico (the "Task Force") for stakeholder input regarding potential impediments to Puerto Rico's economic growth stemming from Federal law and programs, pursuant to the Puerto Rico Oversight, Management, and Economic Stability Act ("PROMESA").

The purpose of this letter is to provide the Task Force with context about PREPA's current situation, identify impediments to PREPA's recovery and respond to certain suggestions of other stakeholders. If helpful, PREPA can provide additional information requested by the Task Force, whether in response to this submission or other stakeholders' submissions.

As the Task Force is undoubtedly aware, over the past few years, PREPA and its advisors have been working with creditors and other stakeholders to develop and implement a comprehensive restructuring process. The goal of the restructuring is to modernize PREPA's operations and improve its balance sheet while providing affordable and reliable electricity to the Commonwealth's 3.5 million American citizens. Through this restructuring process, PREPA has been working to transform itself into a modern utility. To date, much progress has been made, but much more work remains.

Background

For many years, and through successive administrations, PREPA did not operate with the level of efficiency associated with the private sector. PREPA's governing board and management were changed every four years as new gubernatorial administrations were elected. Long term capital planning was nearly impossible as leadership and priorities constantly changed. Too often decisions were made out of political expediency, rather than sound business judgment.

Currently, PREPA owes nearly $9 billion to its bondholders and bank lenders and faces very serious liquidity constraints. PREPA began its restructuring efforts in July 2014, when it faced significant debt maturities and principal payments due under its bond and bank debt. At that time, PREPA entered into forbearance agreements which paved the way toward a consensual restructuring, extended certain maturities and excused PREPA from the obligation to make more than $600 million in sinking fund payments. Absent these hard-fought creditor concessions, PREPA would have run out of money months ago.

In December 2015, after many months of extensive negotiations, PREPA entered into a Restructuring Support Agreement with creditors holding approximately 70% of PREPA's outstanding financial debt (the "RSA"). Broadly, the RSA creates a framework for PREPA's stakeholders to share the burden of its transformation in a fair and lasting manner. The RSA lays out a roadmap for PREPA's transformation into a modern utility, including significant operational improvements to reduce costs, governance reform to minimize political interference, a capital investment plan to update PREPA's deteriorating infrastructure and debt savings and liquidity enhancements to ensure a financially robust utility for the Commonwealth.

PREPA's transformation is occurring at the same time as significant regulatory reform in Puerto Rico. In early 2014, Puerto Rico's Legislative Assembly adopted the Puerto Rico Energy Transformation and RELIEF Act (Act 57-2014), which, among other things, established the Puerto Rico Energy Commission (the "Energy Commission") to oversee and regulate PREPA, creating new processes to review and approve PREPA's electricity rates and long-term capital investment plans, ensure that PREPA's costs are appropriate and promote efficiency and diversification in the electricity market.

Vision for a New PREPA

As part of the RSA, PREPA developed a comprehensive vision for a new, modern and self-sustaining PREPA. This is necessary because PREPA's outdated and inefficient generation fleet and transmission system have contributed to rising costs and decreasing reliability to customers over time.

PREPA's core infrastructure is outdated, and this drives high forced outage rates, poor efficiency, low reliability and high costs. PREPA's generation system is under extreme stress. Generating units are old, and historically PREPA has not made the investments necessary to maintain their reliable service. For example, PREPA's median plant age is 44 years, compared to a U.S. industry average of 18 years. Approximately 80% of PREPA's generating fleet is more than 25 years old, and PREPA's oldest thermal unit is 56 years old.

Compounding this problem is that PREPA's transmission system needs to be repaired and modernized. Unless this occurs, it will be difficult to accommodate unplanned unit outages and to achieve the reduction in generation in the North of the island that is necessary to comply with federal Mercury and Air Toxics Standards ("MATS").

PREPA's energy mix is a legacy of the past. Currently, 65% of total electricity generation in Puerto Rico is powered by fuel oil and coal, with 32% powered by natural gas and only 3% from renewable sources. PREPA's heavy reliance on fuel oil is perhaps most problematic, as it exposes the utility – and, correspondingly, its customers – to significant price volatility while also creating environmental compliance challenges under MATS and other regulations.

To address these issues and facilitate its transformation, PREPA has developed a comprehensive long-term capital plan, composed of $2.4 billion in new investment—funded either through incremental revenue collections, cash resources or new public-private partnership investments (the "Capital Plan"). Our Capital Plan is driven by PREPA's integrated resource plan ("IRP"), which seeks to modernize PREPA's infrastructure through the replacement of the aging generating fleet with a combination of new efficient and highly flexible generation, largely based on the use of natural gas and the maximization of renewable integration, by eliminating inflexibilities in PREPA's fleet. To help develop the IRP, PREPA engaged Siemens Industry, Inc., an industry leader. The IRP was filed with the Energy Commission in July 2015 and was updated in August 2015. The Energy Commission is currently in the final stages of reviewing the IRP with input from other stakeholders.

An important component of the Capital Plan is the construction of the Aguirre Offshore Gas Port ("AOGP"), which will allow PREPA to receive natural gas directly and efficiently at its Aguirre power complex, as well as the conversion of the Aguirre generation facility to burn natural gas. This transition from fuel oil to natural gas will improve fuel diversity, enable the Aguirre steam power generating units to comply with environmental regulations and directly contribute to infrastructure development and economic growth in Puerto Rico. Construction on the AOGP has been delayed given certain permitting issues (mostly Federal) and PREPA's financial situation, but we anticipate that PREPA will be in position to commence construction in the near term.

PREPA is pursuing cost-effective financing for AOGP, including through discussions with the U.S. Department of Energy ("DOE") regarding a potential loan guarantee under DOE's Section 1703 program. At this time, PREPA understands that DOE and other potential financing partners are awaiting a resolution of PREPA's overall financial situation before committing to invest in the project.

Other key near-term projects in the Capital Plan include the construction of new combined cycle units at PREPA's Palo Seco plant, the repowering of the Aguirre combined cycle and the repair and installation of new transmission and distribution equipment throughout PREPA's system. Over the medium-term, PREPA's plan will replace the large steam electric generating units at Aguirre and Costa Sur with new efficient and flexible combined cycle units.

The shift to highly flexible combined cycle generation will eliminate the current restrictions on the fleet and improve PREPA's ability to integrate intermittent renewable energy sources, which are a key component of PREPA's vision for the future. Execution of the Capital Plan will also enable PREPA to comply with Federal environmental regulations for steam power generating units and reduce reliance on fuel oil.

These initiatives will dramatically improve the efficiency of PREPA's system and reduce its environmental impact. The installation of newer and more efficient units will reduce the volume of fuel needed to power Puerto Rico and the increased use of cleaner-burning natural gas will minimize the price volatility that results from relying on heavy fuel oil for so much of Puerto Rico's supply. Under PREPA's Capital Plan, by 2030, 83% of total electricity generation will be powered by natural gas and renewables and only 17% will be powered by fuel oil and coal (with fuel oil driven down to below 1%).

PREPA is also focused on renewables to further diversify energy sources in Puerto Rico while managing costs and contributing to PREPA's ongoing environmental compliance efforts. In Puerto Rico, peak usage occurs in the evening hours. The wind powered resources and the photovoltaic resources are largely coincident, with negligible outputs after sunset, and the night peak needs to be supplied by thermal generation. The entire replacement of the PREPA fleet will allow the turning on and off these units on a daily basis, to better accommodate renewables, which is something that cannot be done with the steam power generating units at Aguirre and Costa Sur, San Juan and Palo Seco.

Proposals to increase to a target renewable portfolio standard ("RPS") of 50% by 2035 are unfortunately not workable given the reality of PREPA's electric system. Given the energy production profile of photovoltaics and wind resources, satisfying a 50% RPS target would require the shift of over 70% of the renewable energy output from the hour it was produced to be stored in a yet-to-be-developed energy-intensive (and likely currently uneconomical) battery storage system for such energy output to be used during other hours.

In the future, these systems could possibly be developed, but considering current prices, the combination of renewables plus the necessary storage to meet energy requirements would be prohibitively expensive. Even so, PREPA remains committed to expanding renewables and the IRP forecasts renewable capacity growth of almost 600%, from 207 MW in 2016 to 1,193 MW in 2030. Power produced from renewable sources is expected to increase by an average of 9% annually, which will displace traditional thermal generation.

PREPA's Capital Plan is comprehensive and achievable. We intend to fund the plan with a combination of enhanced liquidity from operational savings, creditor concessions and incremental revenues through a new transparent rate structure. PREPA will also pursue bids from third parties to finance and build new power generating units through an open and competitive RFP process to ensure that we are attracting the most efficient capital (public and/or private) and expertise to help us execute the plan. PREPA has already reached agreement with the Energy Commission on the terms of a joint regulation to conduct the RFP for soliciting private capital in PREPA's transformation.

Another critical element of PREPA's vision for the future is governance reform. PREPA's employees and leaders are critical to ensuring that PREPA is able to execute on its capital and business plans. Governance reforms embedded in the RSA and the PREPA Revitalization Act (Act 4-2016), which was enacted by Puerto Rico's Legislative Assembly in February 2016, provide for the appointment of an independent board to promote independence and meritocracy to ensure that the changes we are implementing and planning are sustainable. Consistent with these requirements, PREPA has completed an extensive search for new independent directors with assistance from an internationally recognized search firm. In parallel, PREPA works daily to instill a culture of meritocracy, and as discussed above, implement concrete policies in line with that culture, including rewarding employees based on performance.

PREPA's Restructuring Support Agreement

As discussed above, in late December 2015, PREPA reached agreement with creditors holding or controlling approximately 70% of its debt, including bondholders, fuel line credit lenders and bond insurers, regarding a comprehensive restructuring plan. Along with a principal reduction of more than $1 billion, PREPA's restructuring maximizes debt service savings – approximately $1.13 billion over 5 years and $1.66 billion over 10 years, based on projections included in recent Energy Commission filings – while providing near-term relief to facilitate needed infrastructure improvements.

The key economic terms of the RSA include the following:

Bondholder Agreement. All holders of uninsured PREPA bonds will have the option to exchange their outstanding bonds for new securitization bonds at 85% of the current face amount of their bonds. The new securitization bonds will be interest-only bonds for the first five years, with an interest rate that is lower than the current rate on PREPA's existing debt based on a pricing grid. Formal discussions with the rating agencies have not yet begun, but the RSA requires that the new securitization bonds receive an investment grade rating (meaning a rating of at least BBB- or Baa3, based on the S&P and Moody scales, respectively). An ad hoc group of bondholders representing more than a majority of the outstanding uninsured bonds has agreed to exchange all uninsured bonds held by the group for new securitization bonds.

Fuel Line Agreement. PREPA's fuel line credit lenders (which no longer provide fuel line credit) will have two treatment options. The fuel line credit lenders may convert their existing credit agreements into term loans, with a fixed interest rate that is lower than the annual interest rate PREPA is currently paying on its fuel line credit, to be repaid over a period of six years from the consummation of the restructuring transactions. Alternatively, PREPA's fuel line credit lenders may exchange all or part of the principal due under the existing fuel line credit agreements for securitization bonds to be issued on the same terms as those issued and exchanged for the uninsured bonds.

Bond Insurers. To finance the restructuring transactions, PREPA's bond insurers will issue surety insurance policies that will support a portion of the debt service reserve fund for the securitization bonds.

The PREPA Revitalization Act enacted into law in February 2016 authorized the legal framework for the implementation of the RSA, including the issuance of the new securitization bonds and significant governance reforms to depoliticize PREPA, with a goal of allowing PREPA to function like a modern utility and implement long-term operational savings and reforms. Importantly, in keeping with the RSA, the law also authorizes a transparent process to allow third-party investors to submit competitive bids to invest in PREPA's infrastructure. We are currently evaluating, and having discussions with our creditors, about the possibility of using PROMESA to implement the debt restructuring contemplated by the RSA.

Completion of the RSA transactions remain subject to various conditions and contingencies. For example, the RSA requires the new securitization bonds to receive an investment grade rating from a recognized rating agency. While the restructuring transactions are designed to maximize the new securitization bonds' rating, achievement of an investment grade rating will likely depend at least in part on the rating agencies' views of the overall financial situation of Puerto Rico. In addition, the new securitization bonds must be validated by a Commonwealth court pursuant to a newly established process that is underway.

Operational Reform

As mentioned above, a fundamental principle of PREPA's recovery plan and the RSA is burden sharing among all stakeholders. Burden sharing requires PREPA to make important changes to improve its own operations and transform PREPA into a modern utility that serves its customers efficiently.

When PREPA's restructuring advisors, Alix Partners, arrived in September 2014, they encountered a large and complex organization facing a range of challenges that had been decades in the making. Like many companies experiencing financial distress, PREPA needed outside assistance to help restructure its operations and finances and create a plan to assure long-term sustainability.

PREPA has focused its operational improvement efforts on core business functions to improve organizational efficiency, increase revenue generation and instill a culture of safety in the workplace. With respect to PREPA's support functions, the emphasis has been on improving operational efficiency, eliminating waste, and renegotiating sourcing agreements to reduce costs. Putting all this together, by comprehensively addressing shortcomings – including accounts receivable and collections, fuel inventory, procurement, inventory management and safety, as well as labor costs – PREPA has begun the process to transform into a modern utility.

PREPA has made great strides in its accounts receivable and collections processes with respect to government and private customers alike. PREPA has directly engaged with the central Commonwealth government and its agencies to set appropriate Fiscal Year 2016 budgets and has implemented payment plans for past due government accounts. Given the current financial situation within the Commonwealth, these efforts have become even more important. To address private customers' receivables, PREPA has launched successful collection programs targeting specific segments such as wholesale customers and public housing. In addition, PREPA has retained specialized third party collection agencies to pursue uncollected balances in inactive accounts. As a result of these programs, past due accounts receivable from government customers have decreased by approximately $30 million over the last 12 months, while past due accounts receivable from general customers have decreased by $70 million approximately over the same period.

PREPA has also used sophisticated data analysis and streamlined procedures to reduce energy theft and other non-technical losses, improved the service levels in its call center and implemented customer care, billing and field operations improvements. Taken together, these reforms create a platform for PREPA to work collaboratively with customers to reduce past due accounts and improve customer service.

We have also reduced labor costs by capitalizing on organic attrition to significantly lower headcount and thus payroll costs. In addition, since June 30, 2014, PREPA has reduced headcount by about 850 full time employees, generating annual payroll savings of approximately $124 million. The sustainability of reduced headcount is supported through the ongoing transformation initiatives. In addition, PREPA has implemented changes to its medical benefits plans for active and retired employees, resulting in substantial cost savings while maintaining competitive coverage relative to market norms.

PREPA has also worked to improve fuel inventory controls and fuel costs by adopting and implementing industry standards to forecast its fuel requirements uniformly, better synchronize generation, dispatch, and fuel scheduling to deliver power at the lowest possible cost. PREPA is implementing an integrated process that measures and tracks fuel inventory, improves inventory controls and optimizes inventory levels with respect to all inventory. In addition, we have implemented a Request for Proposal ("RFP") process and negotiated with fuel suppliers to secure more favorable fuel purchase terms. In parallel, we are reducing the frequency and duration of forced outages that previously resulted in less efficient units running more to compensate for those outages. Implementation of RFPs for other supply categories – including electrical distribution equipment, maintenance repair and operations parts, business essentials, structures, meters, and fleet parts – is projected to generate additional recurring savings of $25 million annually.

We are also focusing on the safety of employees, which should be at the heart of every well-run utility. In the past 10 years, PREPA has had 15 fatalities and approximately 14,000 safety incidents. Its incident rate is higher than that of its industry peers. In September 2014, we ran an RFP process and engaged industry leader DuPont to conduct an analysis of safety practices and procedures. PREPA is currently implementing the short- and long-term recommendations made by DuPont and tracking its performance in those areas. During 2015, PREPA reduced its incident rate by 15%, which represents a productive first step, but falls short of our ultimate goal.

PREPA is also working to improve its organizational culture and instill a focus on excellence. Many of PREPA's employees have embraced this effort and the board and management have also committed to these critical changes. Work is underway to introduce carefully selected key performance indicators ("KPIs") to heighten the visibility of key priorities within the organization and focus process improvements where they will have the greatest possible impact. PREPA's workforce and organizational structure is being evaluated to reduce overlapping roles, streamline cross-divisional work and clarify job descriptions. PREPA is also undertaking succession planning for key positions to address potential retirements and other retention pressures.

One Federal law issue of importance to PREPA that PREPA urges the Task Force to review is the Jones Act. A core driver of PREPA's costs is the cost of fuel. Complying with the Jones Act, which increases the cost of transporting that fuel from the mainland to Puerto Rico, currently impacts PREPA's operations in the range of $3 to $5 million per year, due to the required use of Jones Act-compliant barges to distribute fuel oil between PREPA's operating units. Based on current operational assumptions, this impact could increase by approximately $20 to $30 million per year if the AOGP is constructed and PREPA elects to source liquefied natural gas from the mainland. Relief from the Jones Act's stringent requirements could allow PREPA to save these amounts over time, and those savings would be passed along to its customers.

All of these efforts have already had a significant financial impact, and show that PREPA can take actions to reduce costs, improve efficiency and apply industry standards. PREPA has achieved approximately $212 million in one-time cash generation savings and approximately $202 million in recurring annual savings. As new operational initiatives are phased in, we expect additional one-time savings of approximately $73 million and recurring annual savings of up to $318 million. These savings are important because they contribute to closing the rate deficit and because we are asking creditors and other stakeholders to contribute to PREPA's transformation.

Rate and Regulatory Reform

One contributing factor to PREPA's financial situation is that its existing rate structure has not captured its operating costs and debt service. PREPA's base rates – which must cover the costs of its transmission and distribution system, the maintenance of its generation facilities, plus any capital investments needed to modernize PREPA's systems, have not changed since 1989 despite increases in costs and debt service obligations. PREPA separately collects charges intended to recover the cost of fuels and purchased power, as well as other costs that vary over time. Those charges vary as those costs vary. Thus, the average "all-in" charges fluctuate based on the cost of fuel and purchased power, and reached highs of approximately 28 cents per kilowatt hour ("kWh") in August 2014. Today, the all-in charges have fallen with oil prices to approximately 17.75 cents per kWh, which is higher compared to the U.S. mainland (though lower than, or similar to, comparable island systems) and has a disproportionate impact on Puerto Rico residents given their income levels and other economic factors.

The RSA shares the burden of closing the rate deficit amongst PREPA's stakeholders. Absent any operational reforms, creditor concessions or rate adjustments, the rate deficit – that is, the difference between PREPA's rates and the costs of providing service – would be approximately 11 cents per kWh. PREPA's operational improvements and efficiencies, in combination with the debt savings contemplated by the RSA and the rate adjustment contemplated by the rate case, will close the gap. To achieve that rate adjustment, PREPA has filed a request with the Puerto Rico Energy Commission to increase electricity rates by approximately 1.3 cents per kWh and adopt a modern rate structure. The Energy Commission has approved this request on a temporary basis, pending its final review which is expected to be completed in the first quarter of 2017 following a public hearing process.

PREPA's rate request also contemplates the implementation of a formula rate mechanism, which provides for a three-year review cycle with annual adjustments during the interim period. This mechanism is designed to provide for stable rates that cover all costs, and to put the rate setting process in synch with the three-year capital planning cycle now in place. As part of this, PREPA will implement a new more transparent bill process to give consumers a complete picture of the costs of service.

Closing this rate deficit is critical to PREPA's sustainability. But PREPA's customers cannot carry this burden alone. Even the creditors who are party to the RSA agree with this point. To help close the rate deficit, PREPA is implementing operational reforms to improve efficiency and has reached agreement with its creditors to provide significant debt savings and liquidity relief over the short and long term.

Responding to Puerto Rico Private Sector Recommendations

Recently, the Coalición del Sector Privado (the "PSC") has suggested a number of PREPA-related recommendations. Although PREPA agrees with some of the concepts and points raised by the PSC, it disagrees with certain of the recommendations.

For example, PREPA agrees that modernization of PREPA's facilities is critical to Puerto Rico's economy. PREPA has proposed a $2.4 billion Capital Plan and intends to initiate an RFP process to solicit competitive bids for infrastructure development. Similarly, PREPA agrees that decoupling could be beneficial. Decoupling refers to regulatory mechanisms that are put in place to ensure correct and full recovery of utility revenue requirements and costs, with adjustments if actual sales deviate from projected or historical sales on which base rates were set. PREPA has proposed a form of decoupling in its proposed formula rate mechanism, which would true up previous years' cost and sale deviations, with prospective adjustments to future years' rates, which would also rely on annually re-forecasted sales estimates.

However, PREPA disagrees with the PSC's proposal to expand the jurisdiction of the Federal Energy Regulatory Commission ("FERC") to encompass Puerto Rico. PSC's suggestions rely on a flawed premise that increased Federal regulation and review will lower PREPA's operational costs. The absence of Federal regulation is not the cause of PREPA's costs. PREPA's higher operational costs relative to the U.S. mainland are caused primarily by the simple fact that it serves an island nearly 1,000 miles offshore from the U.S. mainland and fuel supplies must be transported to Puerto Rico from faraway places. There are no neighboring utilities with which to share generation reserved. The lack of past capital investments further adds to operation costs, as well as the need for new capital investment. Extending FERC jurisdiction will not change these realities, nor lower PREPA's costs. Indeed, imposing a second regulatory regime on PREPA will create additional regulatory and administrative costs and burdens. Moreover, even if FERC jurisdiction were extended to Puerto Rico, PREPA would still need to recover its higher operational costs, mitigating any alleged reduction in rates alluded to by the PSC.

In short, FERC regulation is not appropriate and will not result in lower consumer costs. Puerto Rico is a relatively small island market with only 3.5 million inhabitants. FERC regulation and oversight is designed for interstate markets where there is competition flowing from multiple sources across state lines. Where FERC has jurisdiction, it regulates utilities' inter-state transmission and wholesale market functions. FERC does not regulate retail service or utilities' distribution operations. The rates that it sets are transmission and wholesale rates, not rates for retail business and residential users. Responding to such a dual regulatory system would, at a minimum, require PREPA to separately designate those portions of its systems more akin to the interstate system on the mainland from distribution facilities from its other facilities and would force the PREPA and the Energy Commission to wrestle with how to include what would be the FERC-regulated rates for use of the former into the retail rates that are never set by FERC. Mainland utilities must face these costs and burdens because they are integrated with and operate in interstate networks and markets. Imposing that regulation on Puerto Rico does not make sense and will only add to the hurdles PREPA faces.

Conclusion

A successful completion of this restructuring will alleviate PREPA's existing debt burden and spur economic growth across Puerto Rico as PREPA is able to invest in and develop new infrastructure projects across Puerto Rico. PREPA remains focused on effectuating its proposed restructuring, which will achieve tangible results for the citizens of Puerto Rico and spur economic growth.

We are certainly available to provide you with additional information about PREPA and our efforts to the extent helpful to the Task Force.

Sincerely,

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Lisa J. Donahue
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