

**COMMONWEALTH OF PUERTO RICO**

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Session

**HOUSE OF REPRESENTATIVES**

**FINAL REPORT**

**H. R. 1049**

**(House of Representatives Resolution 1049)**

**JUNE 24, 2015**

**TO THE PUERTO RICO HOUSE OF REPRESENTATIVES:**

Your Small and Medium Businesses, Commerce, Industry and Telecommunications Commission of the Commonwealth of Puerto Rico House of Representatives, having previously studied and taken into consideration the H.R. 1049, has the honor of presenting before this Legislative Body a Final Report on said Resolution, including findings, recommendations and conclusions.

**SCOPE OF THE MEASURE**

House Resolution 1049 warrants Small and Medium Businesses, Commerce, Industry and Telecommunications Commission to carry out an investigation with regard to the operational energy expenses of several industries, pymes and businesses located in the Island, taking into account recent decisions made by

the Puerto Rico Electric Power Authority (“PREPA”); evaluate different alternatives in the current energy market and would portend to mitigate the economic impact they represent; and analyze the liquidity and financial claims of bondholders, and how decisions made thereof translated into energy rates/tariff increases.

In accordance with provisions stated in the Exposition of Motives of House Resolution 1049, PREPA’s finances management must be part of the study and investigation such that the conclusions arrived at could be made public to the people of Puerto Rico. Likewise, it should investigate prospective effects of the new energy reform implemented thereof to the operational energy costs of diverse industries, pymes and businesses working in the Island, and evaluate alternatives in the energy market.

To achieve the objectives established in Resolution 1049, the Small and Medium Businesses, Commerce, Industry and Telecommunications Commission conducted public hearings and analyzed extensive documentation which allowed it to arrive at the conclusions and recommendations set forth in this document.

## **ANALYSIS OF THE MEASURE**

The Small and Medium Business, Commerce, Industry and Telecommunications Commission of the House of Representatives, in accordance with its ministerial duty of analyzing measures referred by the House of Representatives, carried out an ample process of collecting data and essential documents which PREPA provided during the first investigative phase of this legislative measure. The Commission, after compiling all the information, held public hearings on May 12, 22 and 28 of 2015; and on June 4 and 16 of 2015. In addition, it held an executive meeting on June 4, 2015. The following individuals appeared in those public hearings and executive meetings:

**May 12, 2015:**

1. Eng. Edwin Rivera Serrano, PR Power Authority Executive Director from 2005 to 2007;
2. Mr. Otoniel Crux Carrillo, PR Power Authority Executive Director from 2011 to 2012; and
3. Eng. Josue Colon Ortiz, PR Power Authority Executive Director from 2012 to 2013.

**May 22, 2015:**

1. Eng. Luis Garcia Passalacqua, Ex-President of the PREPA Government Board; and
2. Eng. Jose Del Valle Vazquez, Ex-President of the PREPA Government Board.

**May 28, 2015:**

1. CPA Luis Figueroa Baez, Finance Director of the PREPA; and
2. Eng. Sonia Miranda Vega, PREPA Environmental Protection and Planning Division Director.

**June 4, 2015:**

1. Eng. Luis Garcia Passalacqua, Ex-President of the PRPA Government Board; and
2. Atty. Luis Aviles Pagan, Ex-President of the PRPA Government Board.

**June 4, 2015 (Executive Meeting):**

1. CPA Arturo Ondina, Ernst & Young Consulting Partner.

**June 16, 2015:**

1. Mrs. Lisa Donahue, PRPA Principal Restructuring Officer

**FINDINGS**

According to the Restructuring Officer, Lisa Donahue, PREPA currently has a debt approximating \$8.3 billion. To understand how PREPA incurred in such debt, this Commission analyzed the prospectus and financial statements

regarding bonds issued between the years 2000 and 2012, as well as the engineering reports issued in accordance with the 1974 Trust Agreement, as amended, (from hereon “Trust Agreement”) which regulates PREPA and its relationship with the representatives of the bondholders and, of course, with the latter.

Article 4 of the Trust Agreement establishes the application that would be given to the issued bonds, namely:

“ARTICLE IV

CUSTODY APPLICATION OF PROCEEDS OF BONDS.

Section 401. A special fund is hereby created and designated “Puerto Rico Water Resources Authority Power System Construction Fund” (herein sometimes called the “Construction Fund”), to the credit of which such deposits shall be made as are required by the provisions of Section 208 of this Agreement. There shall also be deposited to the credit of the Construction Fund any moneys received from any other source for paying any portion of the cost of any Improvements. One or more separate accounts may be created for the Construction Fund for use for specific projects.

The moneys in the Construction Fund shall be held by the Authority in trust, separate and apart from all other funds of the Authority, and shall be applied to the payment of the cost of any Improvements and, except for any moneys in separate accounts, in the Construction Fund received from the United States Government or any agency thereof or from the Commonwealth of Puerto Rico or any agency thereof, pending such application, shall be subject to a lien and charge in favor of the holders of the bonds issued and outstanding under this Agreement and for the further security of such holders until paid out or transferred as herein provided”

Section 402. Payment of the cost of any Improvements shall be made from the Construction Fund as herein provided. Moneys in the Construction Fund shall be disbursed by check, voucher, order, draft, certificate or warrant signed

by the Executive Director or by any officer of the Authority designated by him for such purpose.”

On the other hand, Section 208 of the Trust Agreement establishes that the issued bonds would finance the Capital Improvement Plan, including repayment of moneys advanced for paying refinancing costs, together with their accrued interest:

“Section 208. Revenue bonds of the Authority may be issued under and secured by this Agreement, subject to the conditions hereafter provided in this Section, from time to time for the purpose of paying all or any part of the cost of any Improvements, including the repayment of moneys advanced for paying such cost and, if deemed necessary by the Board, the payment of the interest to accrue on such money advances to the day of such payment and for the providing moneys for deposit to the credit of the Reserve Account.

Before any bonds shall be issued under the provisions of this Section, the Board shall adopt a resolution or resolutions authorizing the issuance of such bonds, fixing the amount and the details thereof, describing in brief and general terms Improvements which are to be acquired or constructed or which were acquired or constructed from any moneys to be repaid from the proceeds of such bonds, and specifying the amount, if any, of the proceeds of such bonds to be deposited to the credit of the Reserve Account.”

According to the Trust Agreement and to statements from former Executive Directors and Government Board Presidents, financing for PREPA operations has to come from money collected from the rates imposed to the public corporation subscribers. After having been asked some questions, these former functionaries indicated that the operations of the corporation could never be

financed through issuance of debt as long as said practice would constitute an ultra vires action against the Trust Agreement itself.

Likewise, the Trust Agreement stipulates in Section 702 of Article 7 that consulting engineers, as said term is defined in Section 101, page 15, shall approve the improvements to be carried out with the bonds issued by PREPA:

“Section 702.

The authority further covenants that it will construct all Improvements for the construction for which bonds shall be issued under the provisions of this Agreement, or for which moneys repairable from the proceeds of bonds issued under the provisions of this Agreement shall have been advanced to the Authority, in accordance with plans theretofore adopted by the Board and approved by the Consulting Engineers and that upon the completion of such Improvements, it will operate and maintain the same as a part of the System...”

Likewise, and in accordance with Section 706, Article 7 of the Trust Agreement, the consulting engineers appointed by PREPA have the duty to recommend to the Board the need to revise rates/tariffs, yet it has not been done since 1989:

“Section 706.

It shall be the duty of the Consulting Engineers to prepare and file with the Authority and with the Trustees on or before the 1<sup>st</sup> day of May in each year a report setting forth the recommendations as to any necessary or advisable revisions of rates and changes and such other advices and recommendations as they may deem desirable. After the outstanding 1947 Indentured Bonds have been paid or provision has been made for their payment and the release

of the 1947 Indenture, it shall be the duty of the Consulting Engineers to include in such report their recommendations as to the amount that should be deposited monthly during the ensuing fiscal year to the credit of the Reserve Maintenance Fund for the purposes set forth in Section 512 of this Agreement.”

This Commission did not find a single instance from 1989 to the present whereby the consulting engineers recommended a revision of the rates, as required in Section 706.

Between the years of 2000 and 2012, PREPA Government Board authorized an issuance of bonds that raised said corporation the sum of \$11,449,840,000, of which \$2,720,441,711 were used for capital works while \$164,649,287 were used to pay financial consultants and advisors who worked for PREPA. The remaining \$8,564,749,002 was used for the prepayment of interests, as well as to refinance previous capital investments, and to capitalize their respective interests, thereby circularly refinancing its debts and interests, with complete disregard for the amortization of the original debt.

The information contained in the paragraph above arises from the content of the issued bond prospectus for the time period indicated above. However, the information with regard to the capital improvements for which the financing by way of the issuance of bonds was being solicited was not defined in each particular work. This Commission could only obtain detailed evidence of works



for the 2013-1014 fiscal year from PREPA personnel, which included only energy transmission and fuel distribution projects, but not energy generating projects which certainly comprise a considerably larger expense with amounts, as estimated by this Commission, falling in the millions. With regard to previous years, this Commission's President visited PREPA's headquarters, and despite requesting that same data for the years between 2000 and 2012, it was never provided. However, with the evidence at hand, we detected that PREPA repeatedly underestimated the costs of these improvements and capital investments for each project, which amount to 200% in excess from the budgeted amount, without reaching a 100% project completion. There are instances within the 12-month period evaluated, where PREPA incurred in costs exceeding the budget, construction was not finished and the project was abandoned.

A sample of this economic imbalance and disaster, which should have been denounced by the consulting engineers and the bondholders themselves before agreeing to their loans is as follows, based on 22 out of 265 projects analyzed for the 2013-1014 fiscal year, that is, a sample of 8% of projects analyzed:

## 2013-2014 FISCAL YEAR

Project	Region	Estimate	Spent	Percentage of Incurred Costs	Percentage of Completion
9793	San Juan	\$ 4,692,684	\$ 5,721,299	122%	76%
16987	San Juan	38,054,201	36,145,082	95%	65%
18653	San Juan	250,000	509,753	204%	100%
19647	Carolina	200,000	435,176	218%	100%
9793	Carolina	4,692,684	5,721,299	122%	76%
36701	Carolina	200,000	182,123	91%	Cancelled
19647	Carolina	2,000,000	435,176	218%	100%
14897	Bayamon	22,317	102,974	461.42%	95%
8581	Bayamon	18,225,000	25,548,043	140.18%	27%
17118	Bayamon	4,633,000	8,494,949	183.36%	?
14896	Bayamon	22,317	102,974	461.42%	95%
19455	Caguas	175,000	350,665	200.38%	?
17072	Caguas	455,841	875,590	192.00%	?
07885	Caguas	530,000	690,271	130.24%	100%
19445	Caguas	175,000	350,665	200.38%	?
17072	Caguas	455,841	875,590	192.00%	?
13536	Ponce	450,000	761,107	169.13%	70%
16515	Ponce	15,592,087	21,733,319	139.39%	90%
18609	Mayaguez	200,000	434,819	217.41%	27%
18630	Arecibo	225,000	513,879	228.39%	100%
15636	Arecibo	325,000	280,719	86.38%	15%
786	Arecibo	2,485,197	3,309,174	133.16%	only purchased equipment
<b>TOTALS</b>		<b>\$94,061,169</b>	<b>\$113,574,646</b>	<b>120.75%</b>	

PREPA, in one year, as seen in the table above, has had a deficit in its estimates of 22 of approximately 265 projects, excluding power generating costs, which are the most costly. It is this Commission's understanding that these alarming instances should have been registered several years ago. But as previously pointed out, PREPA did not provide the information requested.

Errors calculating estimated costs versus actual costs incurred may be attributed to flaws in project estimates; excessive equipment, goods and materials purchasing costs; and excesses in the required labor work forces in charge. But it must be undoubtedly attributed to a faulty and unhealthy administration of public funds. Bondholders must have been aware of the above because in their determination analysis made prior to decide on the issuance of bonds to the PREPA, this information was available and no false representations were made. The numbers were available and, more importantly, the consulting engineer, appointed by the bondholders and PREPA, had to personally approve any such investment with his signature. No engineering report informing about or denouncing the excessive costs being annually registered for fuel distribution and energy transmission infrastructure projects were included in any of the issued bonds.

With regard to this matter, this Commission also analyzed how PREPA capital improvement plans decreased following the 2000-2004 year period when 46% of the moneys, that is almost half of what was issued in the debt, was spent either in the Construction Fund or to finance the Capital Improvement Plan. During 2004-2008 only 15% of the capital raised by the issuance of debt was used to finance the Capital Improvement Plan, the rest was used to refinance the debt, according to Mr. Luis Figueroa Baez, PREPA Finance Director. However, from 2009 to 2012 only 18% of the debt was used to finance the Capital Improvement Plan, while the remainder was used to refinance the existing debt, capitalize interest and issue advanced notes to pay future interest.

With regard to Article 7 and the performance of the consulting engineers, this Commission found that for the last 20 years the same person has been executing or subscribing the Engineer Report, which has to be submitted pursuant to the Trust Agreement. The subscriber is Eng. George Romano Jr., who has worked for different firms. This Commission believes this is not synonymous to a healthy administration, and that it should have been questioned by PREPA's highest administrative body, something that did not happen until this Commission brought forth the anomaly to the attention of the current PREPA officials.

It was also found that consulting engineers signed for approval, under different names, and have carried out construction work for PREPA, which is contradictory per se with Section 706 of the Trust Agreement. Said provision of the agreement demands that those external consultants, chosen between the bondholders and the public corporation itself, must be independent contractors. Within that parallel appointment practice process, they ceased to be independent because they had to evaluate the same infrastructure projects they were supposed to build.

This Commission also found that the consulting engineers were negligent and failed in the obligation imposed to them by the Trust Agreement (Section 706) when they allowed PREPA's energy-generating stations and the whole system in general to become obsolete; in violation of federal regulation established by the Mercury and Airborne Toxic Emissions Standards (MATS).

Another finding was that the consulting engineers were not impartial to PREPA's refinancing scheme; because while knowing that the electric power authority did not have sufficient income to comply with its financial obligations, they allowed the use of funds allocated for capital improvements

to be used in the maintenance of an infrastructure they knew was soon to become obsolete.

PREPA's current economic insolvency was the product of, among other factors, negligent acts on the part of its creditors, who in spite of knowing that PREPA's financial and competitive situation was weak, and knowing that its infrastructure was obsolete, they negligently granted PREPA a good credit rating; disregarding that by 2010, PREPA was technically bankrupt. This fact was corroborated by Arturo Ondina, CPA and consulting partner of Ernst & Young, firm who has audited PREPA for the past 12 years. This occurred while the financial consultants and consulting engineers indicated in their reports that the PREPA financial condition allowed it to issue more bonds, when the fiscal reality was that PREPA was not generating sufficient income to repay the debt.

Those individuals and/or consulting firms knew that any funds granted to PREPA would be used to pay fees, underwriters and commissions to the financial intermediaries who issued the debt, from \$40 to \$60 million dollars per four-year period, as well as to refinance the outstanding debt, and not for

any works plans and improvements to generator plants. Mr. Figueroa Baez mentioned this fact in one of the hearings this Commission conducted.

This Commission realized that PREPA paid previous bondholders with capital received from new investors, to the point that owed interests were capitalized and re-grouped whenever a new debt was issued. The abovementioned was done to benefit the financial community that issued the debt and who today is collecting same, without any moneys having been invested in improvements to infrastructure, all to the detriment of the best interest of the people of Puerto Rico. We believe that the actions and circumstances mentioned above caused the economic insolvency which has plagued PREPA in the past years. Said debt was sold at discount, a large quantity of it between .60 to less than .50 cents to the dollar with the agreement to pay to the dollar in full upon its maturity. Plus, the annual return yield was agreed to set high interest rates, and the principal and return are three-fold exempt from payment of local and federal taxes, in accordance with the Jones Act. When Mrs. Lisa Donahue was asked whether she knew of any other issuances of debt with characteristics so benefitting to investors, she replied that she did not know of any other investment tool or instrument that is three-fold tax exempt. This goes to show that the financial intermediaries and the institutional holders, despite being fully aware of

PREPA's fiscal situation, had no qualms with Unjustly Enriching themselves and with having the consequences of their negligent acts be paid for by the people of Puerto Rico.

Meanwhile, and fully aware that PREPA did not have the resources to repay the debt, investment firms, banks, credit houses, consulting engineers, and PREPA itself failed to bring out into public light the need to make adjustments to the rates charged by PREPA, an act contrary to what the holders were bound to do pursuant to the last paragraph of Section 502 of the Trust Agreement. Bondholders had the contractual obligation to commit PREPA to increase tariffs and rates in an adequate and timely manner in order to avoid the situation this public corporation has to bear today. This act is known as a laches or negligent act ("acto de incuria"). They did not act in time, yet now they demand strict compliance.

PREPA, in an act out of the scope of its own standard procedure of annual issuance of debt, which usually occurred no more than twice a year, in 2010 carried out 8 issuances in a row whereby it reduced its capital improvement plans in order to justify the issuances and then were used for prepayment of interests and to finance PREPA operations without ever recommending a rate



increase to the Board. Officials called to appear at the hearings coincided that the aforementioned issuances were carried out with the bondholders' consent every time presentations were held in New York with the financial intermediaries, underwriters and others, with the consulting engineer's endorsement, prior to the issuance of said debts. Therefore, the institutional bondholders bought this debt with the knowledge and with consent of what was going on financially in the corporation, which was ailed with technical insolvency or bankruptcy.

Investors allowed PREPA to issue bonds, then, PREPA borrowed from private banks to pay the bond's interests; then, borrowed from the Government Development Bank (from herein "GDB") to pay back the private bank loans, and the GDB, in turn, issued more bonds to refinance all. Afterwards, PREPA would issue a new debt to pay GDB's outstanding interests, pay principal and pre-pay the new bonds' interests for several years -a cycle that is repeated over and over- and in which the original debt is never paid. This practice could constitute a fraud scheme for which the federal agencies that regulate financial instruments and the Security Exchange Commission could take action against and/or pursue civil suits against these institutions. That is the reason why we

are referring this Report and its findings to those entities, so that they may assume the appropriate jurisdiction over these acts.

PREPA's current administration has recognized that it does not know of any corporation who has issued this type of debt and maintained good Investment Credit Rating before credit institutions, while issuing, as PREPA did, a \$4,000,000,000 debt in one year.

All surmised herein has been occurring for years and has proven to be an excessive and onerous burden on the operational costs of thousands of small and medium businesses throughout the Island. Due to rates that have gone unrevised for decades and a fuel adjustment clause questioned by many, hundreds of businesses have already closed and others are in the process of doing so faced with the lack of capital to invest in energy generating mechanisms which would allow them total independence from the system PREPA provides. That is why this Commission has determined its own recommendations and conclusions, and they are the following:

## RECOMMENDATIONS

In order to prevent what we have described in this Report from happening again, and to keep control of PREPA's treasury and its operations, we recommend:

1. That this Report be forwarded to the Justice Department of the Commonwealth of Puerto Rico and the United States of America for their corresponding actions;
2. That this Report be forwarded to the United States Securities Exchange Commission for its corresponding action;
3. The annulment of the current agreement with the consulting engineers firm and initiation of a claim against its underwriters of the last 20 years and request restitution of the moneys paid to them;
4. An investigation of PREPA projects estimates department for possible judgement flaws in the past years;
5. An investigation of purchasing costs for equipment, goods, and other services from PREPA's suppliers, under a presumption of possible overbilling for construction works in the past years;
6. An investigation of costs incurred for construction projects work-force in the past years;

7. Adoption of a rate adjustment process that no longer has the detrimental effect it has had until now for small and medium business owners in Puerto Rico; and
8. That the necessary guidelines and norms be defined by an audit so that events that led PREPA to its current economic situation are not allowed to happen again.

## **CONCLUSION**

The people of Puerto Rico shall not be held responsible for nor be guarantors of inadequate, negligent and/or speculative financial decisions taken by professionals, investors and financial groups on behalf of PREPA. Our fellow citizens granted that group the terms and conditions they needed to benefit from the production of energy in Puerto Rico in order to safeguard their investment, namely, the following:

- A prospectus under SEC regulations;
- Intervention from external auditors
- A Trust Agreement that provided said professionals the tools they needed, including the right to name a contractor to foresee and monitor PREPA, requesting, if necessary, rate adjustments, and

giving him access to PREPA's records and facilities, as well as soliciting funds to create capital improvements;

- Unequaled tax exemptions;
- Contracts with credit house financed by our government;
- Recurrent issuance of bonds;
- Legal opinions for every issuance;
- A stable, democratic government;
- Shut down of the government during a particular four-year period where payment of the debt continued over payroll and other obligations, just as our Constitution demands; and
- A just, accessible and expeditious state and federal judicial system.

Investors and administrators' unilateral decision not to use the aforementioned tools adequately to safeguard their own interest is the reason why PREPA arrived at the deep technical insolvency ailing it today, which, in 2010 was eliminated for accounting purposes and which a year later was confirmed, when a two hundred million dollar debt was already in existence. The public corporation's financing by way of 8 simultaneous issuances of debt of over

\$4,000 million with the consent of the financing intermediaries and consulting engineering firm had the effect of plunging the corporation into deep insolvency.

Noteworthy is the fact that the aforementioned took place in the face of the credit houses, whom, knowing this, and therefore PRPA's technical insolvency, allowed this public corporation, and thus the people of Puerto Rico, to continue running into debt.

It is necessary for the PREPA to expunge itself from the fiscal situation it is in and adopt the recommendations expressed herein, as well as those made by PREPA's current administration. All without it translating into additional costs to the people of Puerto Rico and putting forth the aforementioned findings for the consideration of the Puerto Rico Justice Department to conduct an investigation with regard to the matter.

Based on all the findings included in this Report, the Small and Medium Businesses, Commerce, Industry and Telecommunications Commission of the House of Representatives of the Commonwealth of Puerto Rico, having previously studied and taken into consideration House Chamber Resolution

1049, is honored to submit before this Honorable Legislative Body the Final Report on this measure, including findings, recommendations, and conclusions.

Respectfully submitted,

(Illegible signature)

Hon. Javier Aponte Dalmau

President

Small and Medium Businesses, Commerce,  
Industry and Telecommunications Commission