# TESTIMONY

# OF

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"Puerto Rico's Fiscal Problems: Examining the Source and Exploring the Solution"

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## Introduction

Chairman Grassley, Ranking Member Leahy, and members of the Committee, thank you for allowing me to testify today and to share the benefit of my experience and insight on the source of, and possible solutions to, Puerto Rico's fiscal problems.

My name is Stephen J. Spencer.[1] I represent certain funds managed by Franklin Advisers ("Franklin") and by OppenheimerFunds, Inc. ("Oppenheimer") in connection with their investment in approximately $10 billion of bonds issued by the Commonwealth of Puerto Rico (the "Commonwealth" or "Puerto Rico") and its government agencies.[2] Franklin and Oppenheimer have been for many years two of the largest investors in bonds issued by Puerto Rico and its governmental corporations. Hundreds of thousands of individual retail investors in the U.S. States and Puerto Rico invest in Commonwealth debt through funds managed by Franklin and Oppenheimer alone.[3]

Throughout the past year and a half, I have been on the frontlines in the negotiations between my clients and the government of Puerto Rico, particularly the Puerto Rico Electric Power Authority ("PREPA"), that recently resulted in a consensual restructuring agreement wherein my clients are providing debt relief to support PREPA's revitalization. For the PREPA negotiations, I advise both Franklin and Oppenheimer, along with the investment interests of six separate asset investors. Through this lens, I have developed a deep understanding of the Commonwealth's finances, economy, tax structure, government inefficiencies, and political challenges. In addition, I have represented creditors in other municipal restructurings, including San Bernardino, Detroit, and the Indiana Toll Road, so I have significant related experience on municipal finance.

Mr. Chairman, I agree with the sentiment you expressed in the press release announcing this hearing, stating that "restructuring debt and throwing taxpayer money at the Commonwealth, without ensuring the creation and implementation of structural and fiscal reform, fails to resolve the underlying problems in Puerto Rico required to creating economic growth." I would further submit that enactment of legislation, such as S.1774, that retroactively amends the Bankruptcy Code to authorize Puerto Rico to declare its government corporations eligible for Chapter 9, would be a bailout of Puerto Rican municipal corporations on the backs of hundreds of thousands of individual retail investors throughout the United States, including Puerto Rico: a bailout that would undermine reform efforts needed to foster growth in Puerto Rico by violating the sanctity of contract; undermining the rule of law; and harming the Commonwealth and municipal debt markets throughout the country.

Moreover, Chapter 9 is not needed to solve Puerto Rico's problems. As demonstrated by the recently announced agreement between PREPA and its largest bondholders, whom I represent, debt service issues can be worked-out in a mutually acceptable manner under current law and contracts. While the PREPA

[1] I am a Managing Director at Houlihan Lokey with over 20 years of relevant experience advising both debtors and creditors in large, complex corporate and municipal restructurings. In municipal finance, in addition to advising the largest investors in Puerto Rico, I have advised creditors in the Detroit, San Bernardino, and Indiana Toll Road restructurings. I am a Financial Industry Regulatory Authority ("FINRA") series 7 and series 63 registered financial representative.

[2] Franklin and Oppenheimer are the largest investors in the Commonwealth's General Obligation, Puerto Rico Sales Tax Financing Corporation ("COFINA"), PREPA and a variety of other government agency debt issues.

[3] Franklin and Oppenheimer estimates.

agreement required hard work and shared sacrifice – my clients have agreed to support a significant haircut, and a reduction in interest rate, for all bondholders – the PREPA agreement illustrates that debtor / creditor divisions are not insurmountable and that the current process can work without Congress retroactively changing Chapter 9.

I appreciate the opportunity to provide some additional perspectives on Chapter 9 and on the source of Puerto Rico's fiscal problems.

**Chapter 9 – Commonwealth Spin vs. Fiscal Reality**

Extending Chapter 9 to Puerto Rico has been presented as an issue of fairness and as a simple, non-controversial fix. The argument is that Puerto Rico, like U.S. States, should have access to bankruptcy as an effective tool to manage the Commonwealth's financial challenges, and that opponents are financial opportunists engaging in a form of market predation. These arguments are dangerously misguided. Chapter 9, whether applied to municipalities and governmental corporations in its current form, or in a "Super Chapter 9" format for the Commonwealth itself, is ineffective as a tool for use in addressing the root causes of municipal financial distress, and its use in Puerto Rico would have broad adverse consequences on municipal borrowers and individual retail investors throughout the United States. Contrary to the public spin being put on the issue by the Commonwealth, there is nothing simple, straight forward, or even fair about extending Chapter 9 to Puerto Rico. It is a complex issue with potentially profound negative financial and public policy ramifications and I urge you not to pass S.1774.

**Chapter 9 Impedes Fiscal Reform**

Proponents of Chapter 9 for Puerto Rico assume it would provide an effective and "orderly" tool for the Commonwealth to use in addressing its financial constraints. In reality, Chapter 9 has a proven track record of frustrating the fiscal and structural reforms that are needed for the Commonwealth to achieve a sustainable recovery (notably, 22 U.S. States have not authorized their municipalities to file under Chapter 9 for good reason). This poor track record is rooted in Congress' decision to omit from Chapter 9 many of the creditor protections that are a key part of Chapter 11. Crucially, Congress omitted these protections from Chapter 9 out of concern that federal intervention might interfere with the Tenth Amendment rights of States to control their own municipalities – a concern that does not apply to Puerto Rico, due to its territory status.[4] As a result, Chapter 9 is fundamentally different from Chapter 11.

[4] *See Franklin California Tax-Free Trust v. Commonwealth of Puerto Rico*, 2015 WL 4079422, at *9 (1st Cir. July 6, 2015) (because Puerto Rico is a Territory, "the limitations on Congress's ability to address municipal insolvency in the states . . . are not directly applicable to Puerto Rico. Accordingly, Congress may wish to adopt other – and possibly better – options to address the insolvency of Puerto Rico municipalities that are not available to it when addressing similar problems in the states.") (citations omitted); *id.* at *14 ("The limits of the Tenth Amendment do not apply to Puerto Rico, which is 'constitutionally a territory' . . . .") (citations omitted); *see generally* M. W. McConnell & R. C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. Chi. L. Rev. 425, 427-28 (1993) (describing Tenth Amendment bases of Chapter 9's limitations).

A few examples make clear the enormous practical consequences of Congress' omission from Chapter 9 of creditor protections that are included in Chapter 11:

- Court Powers. In Chapter 11, if a debtor hides assets or cannot (or will not) provide critical financial information, then creditors can petition the judge to install a Chapter 11 trustee to provide a fair and impartial accounting. Not so in Chapter 9. No *federal* judge can usurp the right of a *municipality* to self-govern. Consequently, if a municipality bungles, stalls, or if it cannot even provide basic audited financial information (as is the case with Puerto Rico),[5] there is little a creditor can do.
- Plan Exclusivity. In Chapter 11, the debtor cannot simply remain in bankruptcy indefinitely. Creditors can file their own plans for the corporate debtor after, at most, 18 months – even sooner if the Court allows. Not so in Chapter 9. Only the municipal debtor can file a plan. A municipal debtor can wage a war of attrition against creditors indefinitely if it chooses. The strategy can dramatically escalate creditor costs, as well as administrative costs of debtors,[6] and the mere threat of it conveys incredible leverage to a municipal debtor.
- Sheltering Assets. In Chapter 11, the debtor must sell extraneous assets. Not so in Chapter 9. A municipality can accumulate substantial non-core assets and actually use Chapter 9 bankruptcy protection to shield them.

Detroit's bankruptcy is often erroneously cited as an example of a "successful" Chapter 9. As the advisor to Detroit's single largest unsecured creditor, I can address this misperception from personal experience. The end result was that investors took disproportionately large losses so Detroit could avoid needed reforms. Specifically, the Detroit Plan of Adjustment ("Plan") had a number of major deficiencies including:

*Failure to address pensions* – Although pension costs were the single largest expenditure in Detroit's budget, [7] the city's pension obligations were effectively reinstated in full while bondholders received less

[5] Most recent audited Commonwealth financial statements provided for FY 2013. FY 2014 audited financials originally due on October 30, 2015 have not yet been provided. http://www.bgfpr.com/documents/2013CommonwealthFS-SecuredVersion.pdf

[6] The restructuring advisory expenditures for the City of Detroit's bankruptcy totaled more than $180 million for the 18 months the city spent on bankruptcy equating to approximately 12% of the $1.5 billion in repudiated bond debt.

(i) Karen Pierog, Lisa Lambert, and Matthew Lewis. "Fees, expenses for Detroit bankruptcy hit nearly $178 million." *Reuters* 30 December 2014. http://www.reuters.com/article/2014/12/30/usa-detroit-bankruptcy-fees-idUSL1N0UE1LJ20141230#HxQhBXxyMb8moj5r.97

(ii) "City of Detroit Plan of Adjustment - 40 year projections." http://www.michigan.gov/documents/treasury/Detroit_FRC_Plan_of_Adjust_40_Year_Proj_10-21-14_490442_7.pdf

[7] Fourth Amended Disclosure Statement for the Adjustment of Debts of the City of Detroit, 5 May 2014. Pages 99 and 145 (of 197) and page 12 (of 212). https://www.kccllc.net/detroit/document/1353846140505000000000005

than 10 cent recoveries.[8] Post-bankruptcy, the city recently concluded that the size of the remaining pension obligation may stress cash flow to the point of derailing a recovery.[9]

*Failure to cut costs* – In just one of many examples, Detroit was unable to staunch the bleeding in the Detroit Department of Transportation ("DDOT"). Although millions were spent on outside consulting reports recommending a range of operational efficiency improvements, not a single major strategic suggestion was adopted. Consequently, the city's Plan projected that DDOT would continue to lose hundreds of millions of dollars over the next decade, despite tens of millions in federal and state support annually.[10] Today, DDOT remains inefficient and poorly managed.[11]

*Failure to streamline government infrastructure* – Despite abysmal government service delivery metrics and overlapping operational objectives among multiple government agencies, no structural changes to Detroit's government were made. The city exited bankruptcy with the same 28 government agencies it had when it entered into bankruptcy.[12] I note that Puerto Rico has 120 government agencies, suggesting even greater structural realignment opportunities may exist within the Commonwealth.

*Failure to adopt a strategic plan* – By ignoring calls from urban planners and civic engineers,[13] Detroit failed to rationalize its geographic footprint to serve a much smaller population. Consequently, the city's $1.7 billion pot of revitalization capital is being spent on a far less efficient, largely ad hoc basis to revive a civic infrastructure originally designed to support a population nearly three times as large.[14]

In these and many other ways, the Detroit bankruptcy failed to accomplish critical reforms to help the city achieve a quicker, more efficient, and more secure long-term recovery. According to the bankruptcy court's own expert witness, "th[e] bankruptcy ha[d] been largely focused on deleveraging [Detroit] …often to the exclusion of fixing [Detroit's] broken operations." As a result, "the operational restructuring that often occurs with commercial reorganizations will be left largely to Mayor Duggan and his managers for the post confirmation period."[15]

The problem isn't unique to Detroit. In the handful of other cities that have attempted to use Chapter 9 as a tool to adjust their debts, little has been done to address legacy entitlement expenditures or achieve a more efficient and effective government. While bankruptcy judges have recognized a municipality's

[8] City of Detroit – Expert Witness Report of Stephen J. Spencer. July 2014.

[9] Matthew Dolan, Matt Helms and Joe Guillen. "$195M pension payment might derail Detroit's recovery." *Detroit Free Press* 15 November 2015. http://www.freep.com/story/news/local/detroit-bankruptcy/2015/11/14/detroit-pension-balloon-payment-estimated-195m/75657200/

[10] See source cited in footnote 7.

[11] Stephen Henderson and Kristi Tanner. "Region's transit system can't get many to job centers." *Detroit Free Press* 22 February 2015. http://www.freep.com/story/opinion/columnists/stephen-henderson/2015/02/22/detroit-bus-transit/23775245/

[12] See source cited in footnote 8.

[13] "Detroit Future City – 2012 Detroit Strategic Framework Plan." May 2013. Page 10. http://detroitfuturecity.com/wp-content/uploads/2014/02/DFC_ExecutiveSummary_2ndEd.pdf

[14] See source cited in footnote 7.

[15] Expert Report of Martha E.M. Kopacz Regarding the Feasibility of the City of Detroit Plan of Adjustment. Page 26. http://www.detroitmi.gov/portals/0/docs/em/bankruptcy%20information/m.%20kopacz%20expert%20report%20to%20judge%20rhodes%20071814.pdf

power to abrogate pensions, the municipalities have strongly resisted cuts impacting government workers and none, so far, have meaningfully diminished pension obligations. The difficulty in reducing pension costs has been equally evident in the Vallejo, Stockton, and San Bernardino bankruptcies. In these cases, the same pattern elevating the financial interests of pensions and labor above financial creditors, and even municipal residents, is clear.[16] Because active and retiree labor costs are rapidly growing municipal financial obligations,[17] more widespread use of Chapter 9, including in Puerto Rico, risks relegating municipalities to a serial Chapter 9 filing, which confiscates savings from a diminishing pool of lenders but solves no problems. Indeed, the City of Vallejo, having cut virtually everything but its pension costs, may soon find itself back in bankruptcy to address its biggest problem, and one it used the first Chapter 9 to ignore.[18]

One of the primary reasons this kind of failure to cut costs and achieve greater operational efficiency is uncommon in corporate bankruptcies is that creditors with a vested stake in the corporate entity's long-term survival are given the standing and opportunity to force management to make difficult decisions in the interests of long-term recovery, which is something that has not occurred in Chapter 9 municipal restructurings. Simply put, because creditor rights are lacking in Chapter 9, there is a gaping moral hazard available for municipal debtors to exploit. It is one of the overlooked ironies of Chapter 9 that creditors, who are often misrepresented as working against the interests of citizens, are often aligned with municipal *residents* in achieving long term recovery.

To municipal officials, the message from Detroit and other recent Chapter 9 plans is clear: payment of financial obligations is optional and the hard work of reform can be delayed indefinitely. For these reasons, anybody seriously interested in helping Puerto Rico address the root causes of its financial distress should understand that, in practice, Chapter 9 actually frustrates the fiscal and operational changes that form the base of a longer-term fiscal and economic recovery.

**Chapter 9 Would Hurt Individual Investors and The Broader Municipal Market:**

For individual investors, and there are hundreds of thousands of them throughout the United States and within Puerto Rico itself, there is a basic investor protection issue at stake. They bought Puerto Rican bonds and thus financed critical government infrastructure at a time when the market knew and understood that the Commonwealth and its municipalities were prohibited from filing for Chapter 9 bankruptcy. The language precluding Puerto Rico from access to Chapter 9 is clear and unambiguous.[19] If the Bankruptcy Code had listed all 50 U.S. States as authorized to use Chapter 9, and simply excluded Puerto Rico, there might have been some justifiable confusion. But it did not, and the fact that it did not, is economically significant. Because Puerto Rico was explicitly precluded from using Chapter 9, a significant risk factor relating to the repayment of the Commonwealth's municipal debt was removed and the market priced Puerto Rico municipal bonds at lower interest rates than if that risk had remained.

[16] Houlihan Lokey Chapter 9 Considerations Analysis. *(See Appendix pages 1 & 2)*

[17] Alicia Munnell. "The Funding of State and Local Pensions: 2013-2017." Center for Pension Research June 2014. Page 3. http://crr.bc.edu/wp-content/uploads/2014/06/slp_39.pdf

[18] Hicken, Melanie. "Once bankrupt, Vallejo still can't afford its pricey pensions." *CNN Money* 10 March 2014. http://unionwatch.org/why-pacific-grove-matters-to-pension-reformers/

[19] Administrative Office of the U.S. Courts: Chapter 9 – Bankruptcy Basics. http://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-9-bankruptcy-basics

Securities laws are premised on the markets factoring in available public information. Puerto Rico's lack of access to Chapter 9 was clearly public information and this information was factored into the pricing of Puerto Rico debt. Consequently, for more than 30 years, the markets assumed Puerto Rico was a safer credit risk and the Commonwealth enjoyed lower interest rates on its municipal debt resulting in billions of dollars of interest reductions that investors will never recover.[20] The magnitude of this value transfer underscores the problem with retroactively changing the rules in the middle of the game and it illustrates why so many individual investors would feel justifiably cheated if the legislation is passed.

In addition to the impact on individual investors, extending Chapter 9 to Puerto Rico municipal corporations would hit the broader municipal market at a point of uncertainty. The municipal market is still struggling to understand if Detroit and the handful of other recent municipal bankruptcies are part of a broader trend or are anomalies in a market that has otherwise historically experienced exceedingly low default rates and remarkable stability.[21] That market stability was challenged by Detroit, whose cadre of corporate restructuring advisors advocated for an aggressive corporate restructuring approach to resolving the city's financial distress on the thesis that the causes of and solutions to the distress were singular, and that the overall municipal market would be unaffected.

The thesis has so far proven to be incorrect and Detroit's bankruptcy has had negative consequences for both the city and the broader market. Contrary to the public's perception that Detroit's bankruptcy was an unmitigated success, the city remains a junk-rated municipal credit and has been unable to access the municipal credit markets without support from the State of Michigan.[22] Given Detroit's poor credit profile, the yield on Detroit's B-notes (bonds issued to Detroit's creditors in exchange for their pre-petition claims) currently tops 16% – they trade at less than 30 cents on the dollar. Worse, Detroit's Chapter 9 filing clearly inflicted collateral damage on the broader municipal market. For larger, more liquid municipal credits, such as Chicago, the negative impact of Detroit's bankruptcy was observed almost immediately.[23] During the week of June 10th, the week Detroit presented its first restructuring proposal requiring significant bondholder impairment;[24] yields on the general obligation ("GO") bonds for the City of Chicago widened out 100 basis points and have not returned to pre-Detroit levels.[25] This represents a quantum upward shift in the cost of borrowing for Chicago, amounting to more than $180

[20] Average annual gross public debt over the past 30 years of $30 billion multiplied by 100 basis points (widened yields on GO Bonds for the City of Chicago[23]) equals an illustrative annual potential interest savings of $300 million.
Statistical Appendix (Apéndice Estadístico), Multiple reports.
http://www.jp.gobierno.pr/portal_jp/ActividadEcon%C3%B3micaEconomicActivity/Ap%C3%A9ndice/tabid/184/Default.aspx

[21] Further, general government defaults comprise a minority of total municipal defaults – the majority of municipal defaults have been in the healthcare and local housing project finance sectors. Altogether, the low number of municipal defaults (average of 5 per year from 2008-2013) stands in stark contrast to the thousands of Chapter 11 filings that occur annually.
"US Municipal Bond Defaults and Recoveries, 1970-2013." *Moody's Investor Service* 7 May 2014.

[22] Houlihan Lokey Detroit Ex Post Facto Analysis. *(See Appendix pages 3 & 4)*

[23] Houlihan Lokey Supplemental Analysis. *(See Appendix pages 5-9)*

[24] City Of Detroit Proposal For Creditors – Restructuring Proposal. 14 June 2013.
http://archive.freep.com/assets/freep/pdf/C4206913614.PDF

[25] See source cited in footnote 23.

million annually[26] on the city's GO debt alone. In this way, the treatment of creditors under Chapter 9 in Detroit not only increased borrowing costs in other financially challenged U.S. cities, but it also further stressed cash flows and increased the chances of similar defaults within those same cities.

Because of the comparatively low trading volumes in the municipal market,[27] the collateral damage of Detroit has taken longer to filter down to smaller municipal credits – but its pricing impact was in some cases even more severe. The City of Scranton, Pennsylvania is a good example. With significant unfunded pension and OPEB obligations, deferred capital expenditures, and a lack of financial reporting sophistication, the city bears all the hallmarks of a small to mid-sized distressed municipality.[28] Despite its financial challenges, Scranton had maintained access to the municipal tax revenue anticipation note ("TRAN") market, which it used to fund working capital needs at low, single digit interest rates. In the wake of Detroit, Scranton was forced to issue a private placement note to a local bank with a net interest cost of 9% – nearly twice as high as the 5% net interest cost Scranton paid on its TRANs in the preceding year, in which it faced a similar liquidity crunch.[29]

At bottom, the problem with the Detroit approach to municipal restructuring is that it made inappropriate assumptions about the structure and composition of the municipal market. In contrast to the corporate debt market, the average municipal issuer is much smaller and provides less extensive financial disclosure than the average corporate issuer.[30] On the municipal buy-side, there is far greater "retail" investor participation, with 9.5 million individual participants who invest, directly or indirectly, in municipal bonds primarily for safety and income.[31] Given the risk averse nature of municipal market participants, the market composition skews toward older, often retired investors who are willing to accept lower interest rate debt for perceived safety.[32] For the most part, these investors are not financial experts who pore over municipal comprehensive annual financial reports for signs of distress. They are patient, buy and hold investors who have put their confidence in an implicit pact that state and local governments would honor their full faith and credit commitments and do everything in their power to honor the debt service obligations, no matter how politically challenging the obligations become.

Before Detroit, this faith was rewarded by a market that experienced a very low default rate and almost no bankruptcy activity. Over many decades, the prioritization of willingness to pay above quantitative risk factors was a distinguishing feature of risk assessment within the municipal market, as evidenced by

[26] Average annual total General Obligation and Revenue Bonds over the past 10 years of $18 billion multiplied by 100 basis points equals an illustrative annual potential interest savings of $180 million. "Comprehensive Annual Financial Reports." *City of Chicago, Illinois*. Multiple reports. https://www.cityofchicago.org/city/en/depts/fin/supp_info/comprehensive_annualfinancialstatements.html

[27] See source cited in footnote 23.

[28] City of Scranton, Pennsylvania 2012 Independent Auditors' Report. Page 15 and Note 10. http://www.scrantonpa.gov/business_admin_docs/2012%20Audit%20Report.pdf

[29] HJA Strategies, LLC. – Report on the Budget and Finances of the City of Scranton, page 32. http://www.scrantonpa.gov/business_admin_docs/2014/HJA%20Report%207-2-2014.pdf

[30] See source cited in footnote 23.

[31] In 2012, 5,954,819 tax returns reported tax exempt income, comprised of 3,532,100 tax returns from married couples filing jointly, or 7,064,200 individuals, and 2,422,719 other individual tax returns, for a total of 9,486,919 individuals. Statistics of Income, 2012 Individual Income Tax Returns, Publ. 1304, U.S. Dep't of the Treasury, Internal Revenue Service, Table 1.3 at 36 (2012), http://www.irs.gov/file_source/pub/irs-soi/12inalcr.pdf [hereinafter "IRS Publ. 1304"]

[32] See source cited in footnote 23.

major ratings agencies' primary reliance on legal and contractual assurances in assigning municipal credit ratings.[33] In the post-Detroit world, the municipal market's reaction to cities like Chicago and Scranton shows a certain segment of municipal buyers have lost faith in the market and may have left the market for good. The recent municipal bankruptcies show that for the first time a municipality's willingness to pay back the debts it owes is being questioned. Moreover, the discriminatory outcomes favoring legacy municipal entitlement claims over bond debt obligations has broadcasted to the market that the Chapter 9 playing field is tilted decidedly against municipal bondholders.[34] It simply doesn't make sense for a retiree to buy bonds to help a city build roads and schools when the investor now knows that if the city mismanages its finances, the investor would be left holding the bag.

The central point is that the historical risk paradigm for the municipal bond market is currently at a precarious place. Puerto Rico's debt obligations are approximately 9 times as large as Detroit's.[35] If Chapter 9 is extended to Puerto Rico, the potential collateral damage of a negative market reaction could be far more significant. In such a scenario, because the municipal market provides the vast majority of financing for state and local governments and government infrastructure,[36] the federal government could be called upon, in one manner or another, to fill a potentially major void once filled very efficiently by the municipal finance market.

With respect to Puerto Rico, a final observation is critical: Puerto Rico will need access to the capital markets in the future for vital capital expenditures. PREPA must – by EPA consent decree – spend billions to convert dirty diesel generators to clean natural gas. Puerto Rico Aqueduct and Sewer Authority must raise hundreds of millions to improve the Commonwealth's sewer and water system. Puerto Rico Highways and Transportation Authority needs access to the capital markets to fix the Commonwealth's roads. Giving Puerto Rico access to Chapter 9 would do nothing to persuade investors to risk their capital – again – on an island with the ability to serially default like Argentina.

[33] Rating agencies' presentations.

(i) "US Local Government General Obligation Debt." *Moody's Investor Service* 15 January 2014. http://www.rigfoa.org/media/presentations/wintertraining2014/go-us-local-govts-methodology-1-2014-moodys.pdf

(ii) "U.S. Local Governments General Obligation Ratings: Methodology and Assumptions." *Standard & Poor's Ratings Services, McGRAW HILL FINANCIAL* 12 September 2013. http://www.standardandpoors.com/spf/upload/Events_US/US_PF_logo102014.pdf

[34] See source cited in footnote 19.

[35] As of June 30, 2015, Puerto Rico had $71 billion of debt outstanding compared to $8 billion for Detroit.

(i) "Puerto Rico Fiscal and Economic Growth Plan." *Working Group for the Fiscal and Economic Recovery of Puerto Rico Pursuant to Executive Order 2015-022* 9 September 2015. Pages 12 and 59. http://www.bgfpr.com/documents/PuertoRicoFiscalandEconomicGrowthPlan9.9.15.pdf

(ii) "Comprehensive Annual Financial Report." *City of Detroit, Michigan* 30 June 2014. Page 31. http://www.detroitmi.gov/Portals/0/docs/finance/cafr/Final%20CAFR.pdf

(iii) Diane Bukowski. "LEAVING BANKRUPTCY, DETROIT TAKES ON $1.28 BILLION OF NEW DEBT." *Voice of Detroit* 14 December 2014. http://voiceofdetroit.net/2014/12/14/leaving-bankruptcy-detroit-takes-on-1-28-billion-of-new-debt/

[36] Roughly 75% of the infrastructure in this country was funded with municipal bonds. Comments of the Honorable Stephen K. Benjamin Mayor of Columbia, South Carolina, 15 April 2013. Page 11. *(See Appendix for referenced page)* http://www.munibondsforamerica.org/cms/wp-content/uploads/2013/04/FINAL-MBFA-Tax-Reform-Working-Group-Testimony-April-2013.pdf

## Puerto Rico Doesn't Need Chapter 9 to Recover

The Commonwealth says it cannot pay its debts. That is failure of political will more than a statement of economic necessity. In fact, there are some very effective tools the Commonwealth has at its disposal to address its fiscal and economic challenges, and a number of objective indicators suggest its debt obligations are payable in full over time.

*Puerto Rico is a comparatively low tax jurisdiction* – In a comprehensive analysis of the Commonwealth's tax structure, KPMG, the Commonwealth's own outside tax consultant, found that Puerto Rico's tax as a percent of GDP burden was far lower than comparable sovereign states.[37] Further analysis also reveals the Commonwealth's tax burden as a percent of GDP is far lower than all U.S. States.[38] Puerto Rico's status as a low tax jurisdiction makes it unique when comparing to distressed municipalities that are often already heavily taxed jurisdictions.[39]

*Puerto Rico has a comparatively low debt burden* – In October 2013, the Commonwealth *itself* produced an analysis distributed to its investor base suggesting its debt service obligations are vastly lower than any U.S. State government. According to the Commonwealth's *own* calculations, its debt burden is approximately 70% lower than any U.S. State.[40] These assertions run counter to more recent pronouncements that the Commonwealth's debts are no longer payable. Further analysis suggests the Commonwealth continues to have a comparatively light consolidated debt burden and may now be seeking to expunge debt opportunistically.[41]

It should also be noted that the Commonwealth, its professional advisors, and even the U.S. Treasury continue to reference a highly misleading debt service statistic as a prominent rationale for seeking Chapter 9. More specifically, they have argued that debt service consumes nearly 40% of government revenues.[42] The figure is misleading because it compares apples to oranges; it aggregates debt services across general fund and non-general fund debt obligations and divides the number by a denominator that excludes certain related revenues that would either service such debt obligations or reduce the overall

[37] KPMG's Commonwealth of Puerto Rico Tax Reform Assessment Project. *(See Appendix for select pages)*
(i) "Unified Tax Code of Puerto Rico: Tax Policy Implementation Options Executive Summary." 31 October 2014. Pages 6, 9, and 14. http://www.hacienda.gobierno.pr/sites/default/files/unified_tax_code_of_pr-_executive_summary_0.pdf
(ii) "Unified Tax Code of Puerto Rico: Tax Policy Implementation Options & General Explanation of Principal Options." 31 October 2014. Pages 19, 21, 26, 34, and 61. http://www.hacienda.pr.gov/sites/default/files/unified_tax_code_of_pr-_general_explanation.pdf
(iii) "Unified Tax Code of Puerto Rico: Tax Policy Implementation Options Appendix." 31 October 2014. http://www.hacienda.gobierno.pr/sites/default/files/unified_tax_code_of_pr-_appendix.pdf

[38] See source cited in footnote 23.

[39] "50-State Property Tax Comparison Study." *Lincoln Institute of Land Policy and Minnesota Center for Fiscal Excellence* May 2013. Pages 1, 15, 18, 19 and 21. http://www.lincolninst.edu/subcenters/significant-features-property-tax/upload/sources/ContentPages/documents/Pay_2012_PT_%20Report_National.pdf

[40] "Update on Fiscal and Economic Progress." *The Commonwealth of Puerto Rico* 15 October 2013. Page 57. *(See Appendix for referenced page)* http://www.bgfpr.com/documents/UpdateonFiscalandEconomicProgressWebcast-Final.pdf

[41] See source cited in footnote 23.

[42] "Testimony Of Counselor Antonio Weiss Before The Senate Committee On Energy And Natural Resources" 22 October 2015. https://www.treasury.gov/press-center/press-releases/Pages/jl0230.aspx

expenditure burden on the general fund. In other words, the representation uses either an inflated numerator or a deflated denominator to produce an inflated debt service burden ratio. Making the appropriate adjustments, the debt service ratio is actually much lower – about 20%.[43]

*Puerto Rico can significantly improve revenue collections* – Crucially, the analysis undertaken by the Commonwealth's tax consultant, KPMG, concluded that by improving tax collections and simplifying the Commonwealth's tax structure, net revenue collections could be improved by more than $3.6 billion annually. The size of the incremental revenue collections opportunity stems from a system of taxation that KPMG found is plagued by "…structural complexity, instability, internal inconsistency, inefficient administration and inadequate enforcement." KPMG also noted that revenue collections were hindered by a "culture of tax evasion." Further highlighting the extent of the incremental revenue opportunity, the Commonwealth was found to collect less than 60% of sales taxes owed, to have a large number of high income filers who pay no income tax at all, and to be collecting property taxes off a base that was in some cases last assessed in the 1950s.[44] Implementing KPMG's recommended tax code changes would close the $14.0 billion 5-year budget gap estimated in the Fiscal and Economic Growth Plan ("FEGP"),[45] leaving the Commonwealth with a surplus of several billion dollars at the end of the period.

*Puerto Rico can reduce costs* –Although Puerto Rico has recently attempted to limit the growth in government spending, consolidated government expenditures have still increased 47% over the past 10 years.[46] The governor's recent FEPG identifies a number of sensible cost reduction opportunities, but fails to identify a detailed execution plan explaining how the measures will be implemented. Given the government's historical inability to reduce costs, the lack of implementation detail is concerning. Moreover, while there have been calls by some to focus on a more significant realignment of government structure to achieve greater operational efficiencies, these calls do not yet appear to be widely embraced.[47]

One advantage Puerto Rico has that will help it achieve greater governmental efficiency is progressive public private partnership ("P3") legislation. Puerto Rico has a record of leveraging its P3 model successfully to facilitate significant private investment in key infrastructure assets, such as its airport and highways. There appears to be many more transactional opportunities available to enhance the operating efficiency of Puerto Rico's infrastructure assets, and potentially achieve significant monetization proceeds.

**Can These Remedies Be Implemented Absent Chapter 9?**

Real world experience suggests the answer is "yes". The case of the City of Harrisburg, Pennsylvania is instructive. After having its Chapter 9 petition denied, the city executed real reforms that were previously

[43] Illustrative example for 2016: Total projected Debt Service of $4.1 billion divided by total projected Revenue of $17.4 billion equals 24%. Total Revenue (for 2016) includes General Fund and Other Select Revenues ($8,503 million), GDB Net Operating Revenues (($96) million), COFINA Revenue ($696 million), Federal Transfers ($6,477 million), and Revenue Measures ($1,121 million). Data obtained from the FEGP.[35]

[44] See source cited in footnote 37.

[45] See source cited in footnote 35.

[46] See source cited in footnote 23.

[47] Ricardo Rosselló. "A New Path For Puerto Rico--Which Doesn't Include A Washington Bailout." *Forbes* 22 October 2015. http://www.forbes.com/sites/realspin/2015/10/22/a-new-path-for-puerto-rico-which-doesnt-include-a-washington-bailout/

assumed to be impossible. The city rationalized its infrastructure and improved fiscal control to cut city government expenditures. Beyond Harrisburg, larger and more complicated municipal restructurings such as New York City and Washington, D.C. were effectuated outside Chapter 9. Indeed, the comparatively few number of Chapter 9 cases overall shows the overwhelming majority of municipalities manage their fiscal challenges and constraints effectively outside of bankruptcy.

Finally, the PREPA restructuring agreement also illustrates that out-of-court consensual negotiations can produce a positive outcome. The PREPA negotiations worked because both PREPA creditors and the Commonwealth were able to embrace a dialogue focused on solutions that involved give and take from all parties – which is the essence of financial restructuring. Under the terms of the deal, PREPA creditors were able to minimize impairment by providing debt service relief that PREPA will use to improve operational efficiency and lower electricity costs in the Commonwealth. Beyond PREPA, there are other opportunities within the Commonwealth's government agencies, and for the Commonwealth as a whole, where these types of "win-win-win" solutions can be structured and implemented. The Commonwealth's key creditors are organized and a critical mass of them are already involved in a restructuring dialogue with the Commonwealth.

## Conclusions and Recommendations

While there are no easy solutions to restoring Puerto Rico's fiscal and economic health, I can nonetheless offer the Committee the following conclusions and recommendations:

1. Chapter 9 Should Be Avoided – The remedy of Chapter 9 is an illusion. In reality, Chapter 9 merely relieves municipalities of the pressure to effect operational and governance reforms necessary for long-term fiscal and economic recovery. It would also unfairly harm hundreds of thousands of retail investors throughout the country and have adverse consequences for the U.S. municipal markets.
2. Puerto Rico Needs to Maintain the Confidence of its Traditional Investor Base – Puerto Rico's financial creditors are not the source of its fiscal problems. Puerto Rico's investor base is still overwhelmingly comprised of individual municipal investors (many through mutual funds), hundreds of thousands of them in both the Commonwealth and United States. Puerto Rico must ultimately win back this core creditor constituency as an important source of long-term, low cost capital.
3. Puerto Rico Can Effect Essential Remedies – Puerto Rico has recently started to make progress in key areas such as revenue collections, but much more needs to be done. Additionally, very little significant effort has been made to reduce government costs and much more attention should be given to implementation of sensible cost reduction initiatives. There is reason to expect both revenue increases and cost reductions can be achieved without damage to the economy.
4. The Commonwealth Must Work With Congress – Puerto Rico's recovery is dependent on a complex interrelationship between federal and Commonwealth officials, as well as its major capital providers. Flexibility will be required from all parties, but real world examples suggest such flexibility will be critical to a positive outcome.
5. The Ultimate Solution Lies With Puerto Rico – Chapter 9 is rarely used by the U.S. States (even those who have authorized it) because they know ***it can poison their financial reputation while allowing*** municipalities to avoid undertaking the real reforms needed for long-term success. As a

beautiful island with an educated populace and a comparatively diverse economy supported by the rule of law, Puerto Rico has tremendous competitive advantages that will allow its economy to recover over time, provided it executes critical fiscal and economic reforms (like many U.S. States and municipalities), rather than seeking a quick fix through Chapter 9. Puerto Rico can work through its current problems and establish a foundation for economic growth and job creation for decades to come.

# Appendix

# Discriminatory Aspects of Chapter 9

- The comparative lack of creditor protections in Chapter 9 has proven to be uniquely disadvantageous to financial creditors (specifically municipal bond investors) in recent Chapter 9 proceedings
- Pensions in all recent Chapter 9 proceedings have generated significantly higher recoveries on their claims than financial creditors, even in jurisdictions like Detroit, where pension and financial claims were deemed by the bankruptcy court to be pari passu, or of equal standing

| City | Recovery | |
|---|---|---|
| | Pension | Financial Creditors |
| **Central Falls, RI** | 75-100%[1] | **GO:** NA[2] |
| **Detroit, MI**[3] | 59% - 60% | **LTGO:** 41%<br>**COP:** 3%[6] |
| **Jefferson County, AL** | N/A | **Secured Sewer Bonds:** 56% |
| **Stockton, CA** | 100% | **Lease Revenue:** 1%+[4] |
| **Vallejo, CA** | 100% | **COP:** 53%[5] |

[1] *Reflects approximate cut in actual retiree pension distributions*

[2] *State passed legislation specifically elevating the priority of municipal debt obligations before the city filed for chapter 9 bankruptcy protection*

[3] *Excludes 74% UTGO recovery due to the bonds' secured status relative to LTGO and COP debt*

[4] *One creditor received a 1% recovery on their unsecured claim or a 12% recovery on their secured plus unsecured claim*

[5] *Reflects estimated NPV reduction of Vallejo's costs with respect to approximately $50 million of COP claims held by Union Bank*

[6] *Reflects market value of New B Notes consideration as of October 2015*

# Discriminatory Aspects of Chapter 9 (cont.)

- Beyond the objective metrics highlighting vastly divergent pensioner and financial creditor Chapter 9 recovery outcomes, the lack of creditor protections in Chapter 9 has had a negative impact on municipal restructurings in a number of key respects

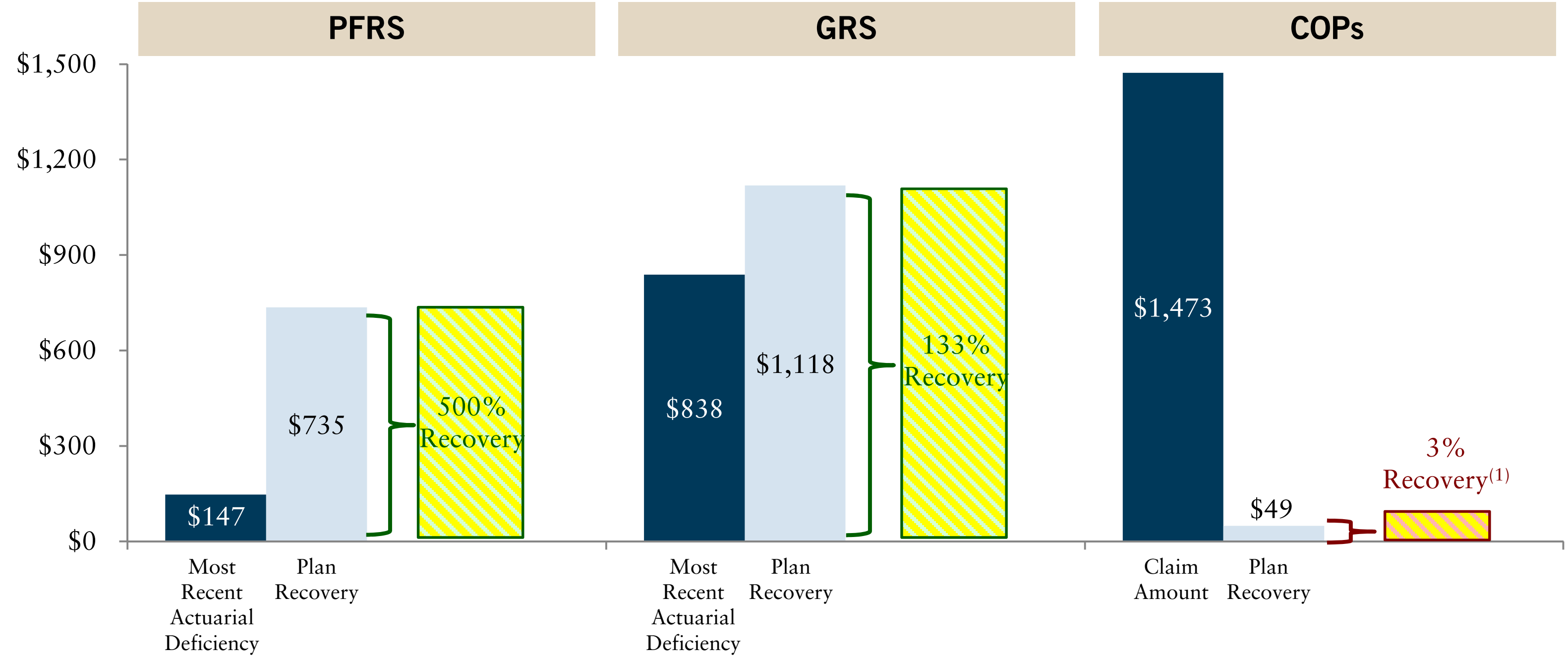
| Restructuring Objective | Outcome |
|---|---|
| **Operational Restructuring Initiatives** | ■ Despite profound city government dysfunction, no recent Chapter 9 municipal debtors have effected significant operational improvements under Chapter 9 bankruptcy protection<br>■ According to the court appointed expert in Detroit's bankruptcy, "the majority of the operational restructuring initiatives have been laid in the lap of the mayor and are expected to be executed after the City emerges from bankruptcy"<br>■ This outcome stands in stark contrast to corporate restructurings, where exigent circumstances are customarily used to effect otherwise challenging institutional changes for the benefit of all stakeholders |
| **Municipal Asset Monetization Strategies** | ■ Recent Chapter 9 debtors have largely ignored transactional opportunities for City assets as a means of generating capital to catalyze municipal recovery and increase creditor recoveries<br>■ In unique circumstances such as the partial monetization of Detroit's city-owned art collection, the monetization process was flawed and generated sub-optimal outcomes<br>■ In the case of Detroit's art collection, the transaction executed in bankruptcy realized a mere $455 million in value for a city asset appraised at $8.1 billion[1] |
| **City / Creditor Recovery Alignment** | ■ In nearly all recent Chapter 9 bankruptcies, financial creditor losses have been set or crystalized with creditors receiving no contingent value recovery mechanisms to allow for incremental creditor recoveries as the city's financial condition improves<br>■ The "heads I win, tales you lose" outcome stands in stark contrast to the corporate restructuring model which seeks to align creditor and corporate recovery interests<br>■ The asymmetric risk dynamic acts as a substantial deterrent to new municipal investment capital from either existing or outside creditors as is the norm in the corporate context |

[1] *City of Detroit – Expert Witness Report of Victor Wiener. July 2014.*

# COP Recoveries vs. Pension Recoveries

- If the City's prior actuarial pension deficiency assumptions had been used to calculate pension recoveries, the recovery differential between pension and COPs would have been even more skewed
- Under the City's pre-petition actuarial calculations, the pensions would be receiving well in excess of 100% recoveries on their calculated deficiency amounts
- In comparison to COP recoveries, this produces more than a 100% recovery differential

## Pension Recoveries as % of Most Recent Actuarial Deficiencies ($ in millions)



*Note: PFRS – Police and Fire Retirement System; GRS – General Retirement System; COP – Certificate of Participation*

*[1] COP recoveries reflect (i) a 16% discount rate to value the New B Notes Consideration and (ii) COP claims asserted at 100% of principal value*

# Michigan Finance Authority Bond Issuance

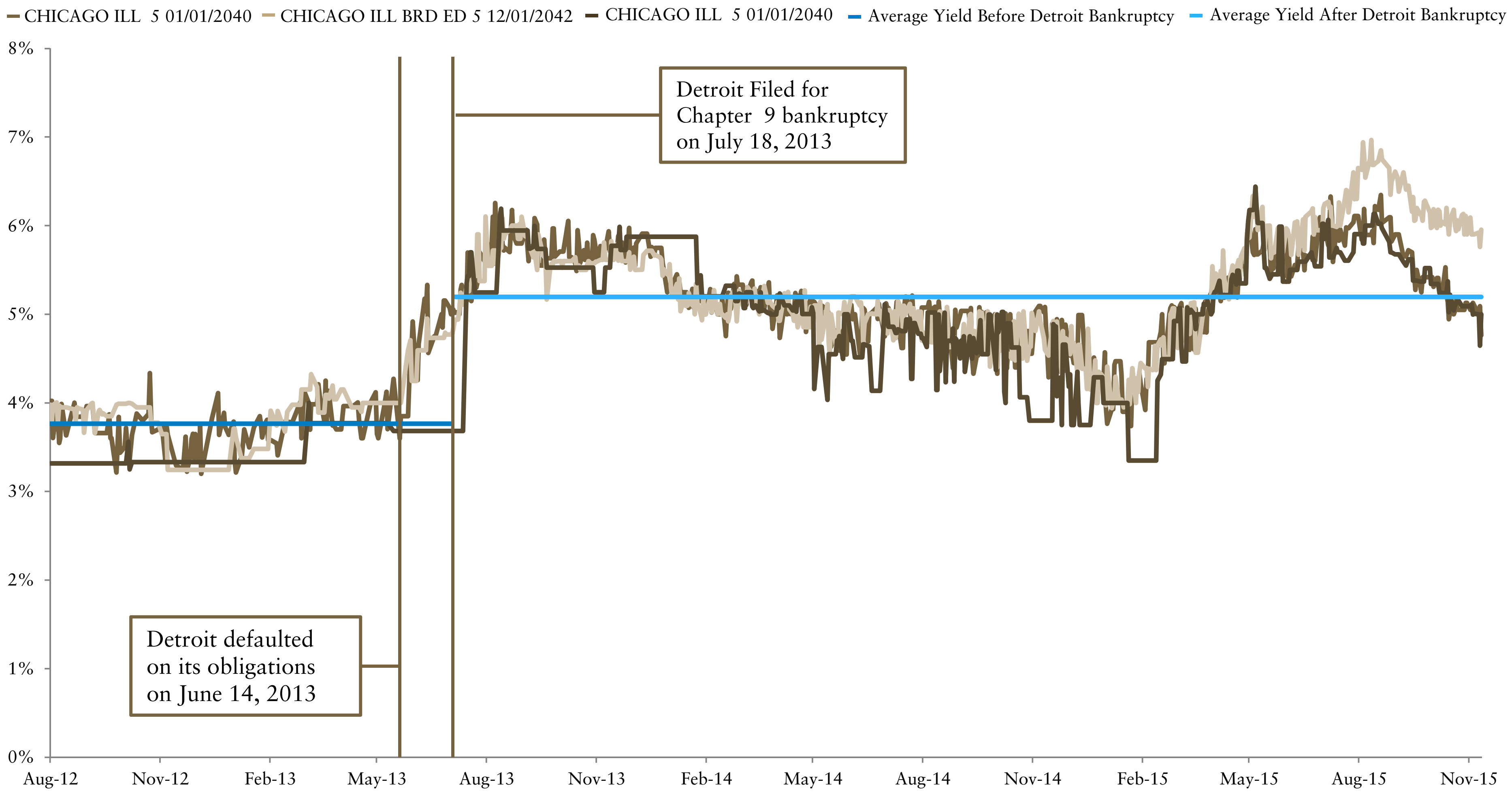
- On July 29, 2015, defenders of Detroit's Plan, including prominent City bankruptcy advisors promoting the outcome as a model for other distressed municipalities, seized on the investment grade rating the City received for the refinancing of its Barclays exit financing facility as evidence that the approach taken by the City in Chapter 9 had worked
- A further examination of the terms of the new financing reveal these assertions to be disingenuous at best
- While the $245 million refinancing did indeed receive an "A" rating with a current yield of approximately 4% on the 9 year maturity bonds, the new issue required Michigan to pass legislation giving the Michigan Finance Authority permission to issue the bonds on behalf of Detroit with a first-lien pledge of the City's income tax revenues coupled with a limited-tax general obligation pledge
- In response to assertions that the refinancing had signaled the City's return to investment grade status, Standard & Poor's issued a clarifying statement stressing it was maintaining a "B" rating for the City's overall credit — five grades below the lowest invest-grade rating
- According to Jane Ridley, an S&P analyst:
  - "The 'A' rating isn't based on the credit of the City itself. It's based on the strength of the revenue pledge and the income stream. It doesn't really stay in the City's hands at all. It's designed to be immediately taken by the trustee for the benefit of bondholders"
- For advisors to City financial creditors during the Chapter 9, the refinancing media campaign was a painful reminder of disinformation tactics used by the City during the bankruptcy

Supplemental Analysis

# Chicago General Obligation Debt Yields

**From August 15, 2012 to July 18, 2013, or when Detroit filed for Chapter 9, Chicago's average GO yield was 3.8%, representing a 140 basis point increase compared to the average yield after the filing**

## Historical Yields for Chicago's General Obligation Bonds



Detroit Filed for Chapter 9 bankruptcy on July 18, 2013

Detroit defaulted on its obligations on June 14, 2013

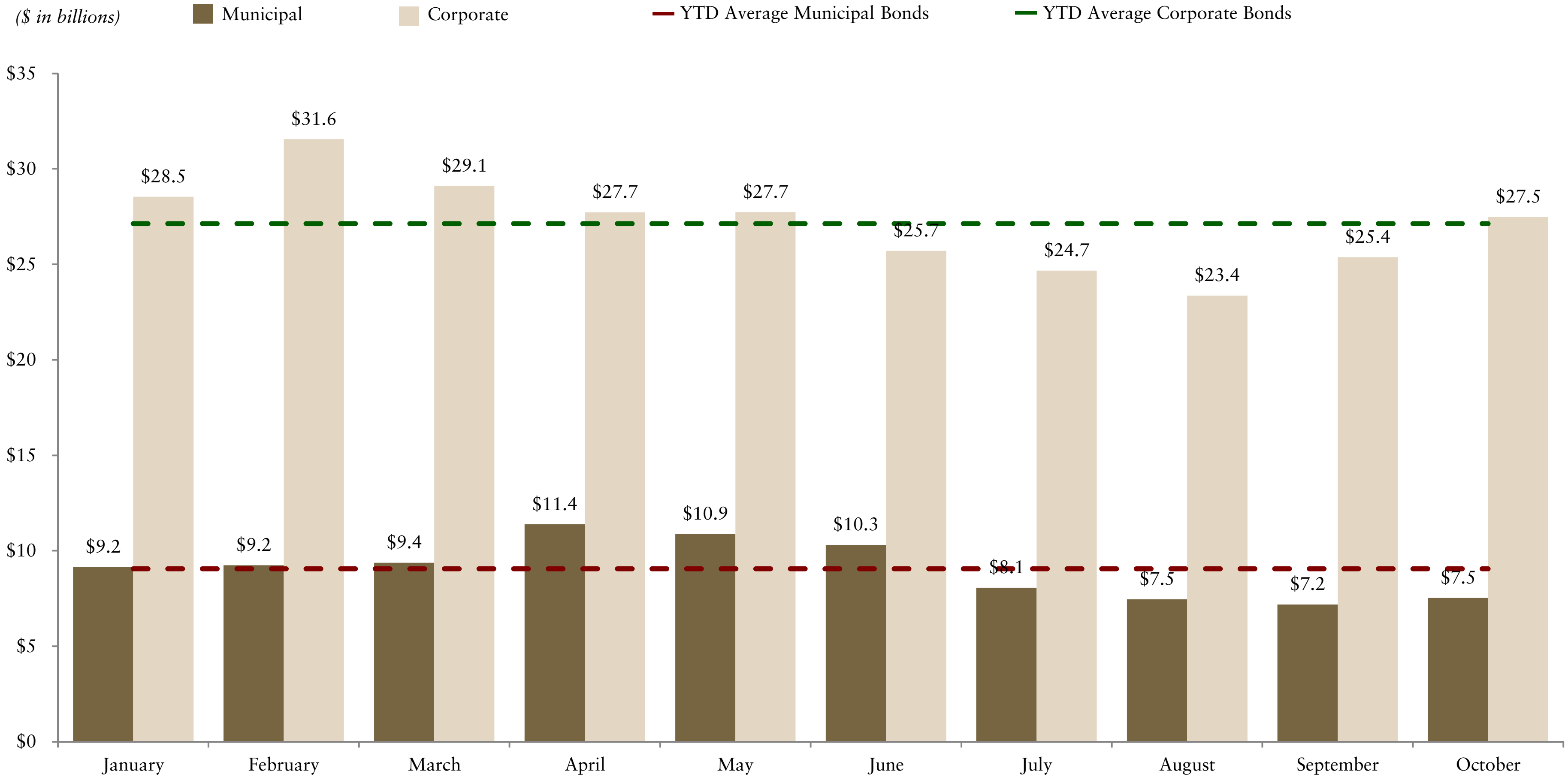
*Source: Public Filings, Bloomberg*
*Referenced on page 6 on testimony of Stephen J. Spencer*

HOULIHAN LOKEY

# Trading Volume Comparison

**Year-to-date average daily trading volumes for corporate bonds is $18.1 billion higher than municipal bonds**

## 2015 Municipal and Corporate Average Daily Trading Volume(1)



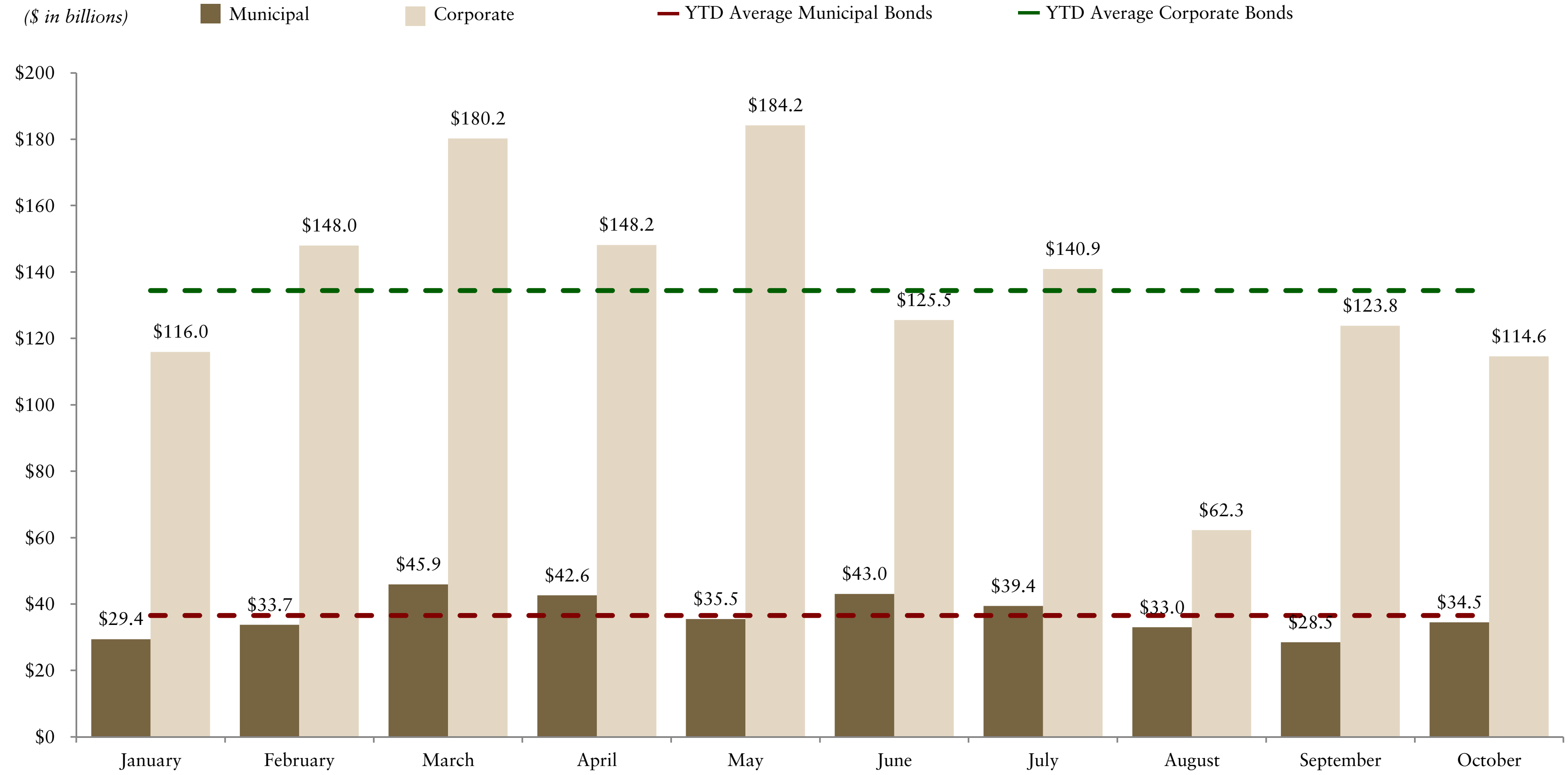
*Source: Securities Industry and Financial Markets Association*
*Note: Referenced on page 7 on Testimony of Stephen J. Spencer*
*(1) Year-to-date as of October 31, 2015*

Supplemental Analysis

# Debt Issuance Comparison

**Year-to-date average monthly debt issuance for corporate bonds is $97.8 billion higher than municipal bonds**

## 2015 Municipal and Corporate Monthly Debt Issuance[1]



*Source: Electronic Municipal Market Access; Securities Industry and Financial Markets Association*

*Note: Referenced on page 7 on Testimony of Stephen J. Spencer*

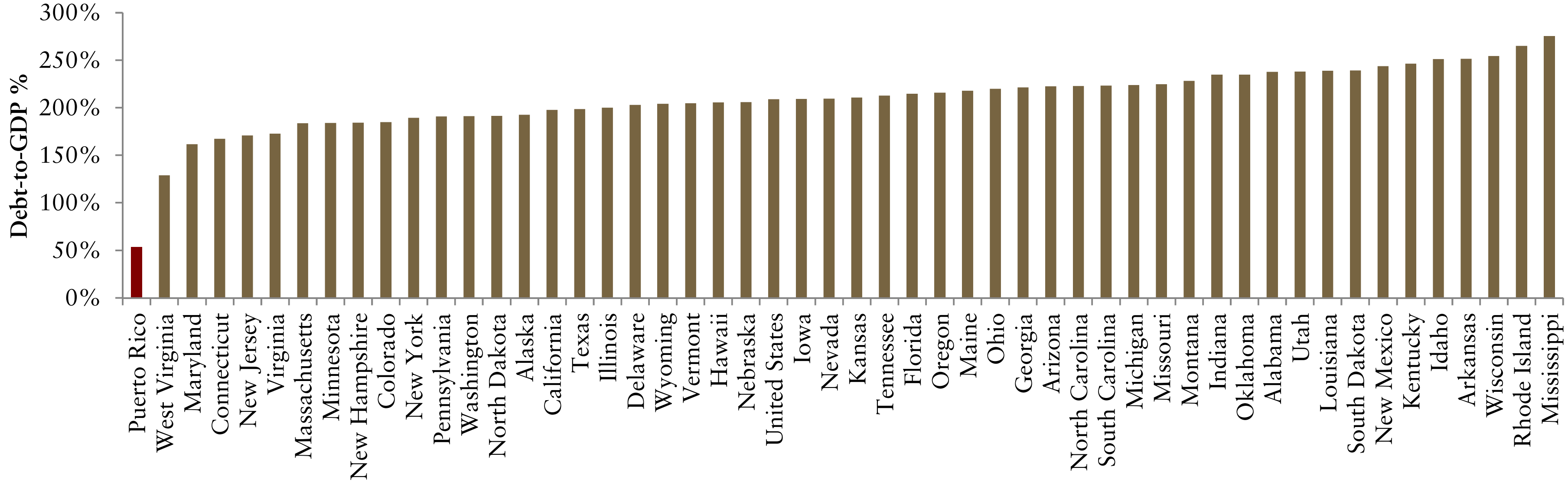
*(1) Year-to-date as of October 31, 2015*

Supplemental Analysis

# Comprehensive Debt to GDP is More Appropriate

- Appropriately comparing Puerto Rican debt levels to that of U.S. states requires consolidating local and state government debt
- As most Puerto Rican residents do not pay federal income tax, the average federal income tax burden should also be added to states on a per capita basis
- After reflecting these adjustments, Puerto Rico's actual tax burden is comparatively lower than all U.S. states

## Debt Per Capita / Income Per Capita for U.S. States and Puerto Rico[1]



*Source: Treasury Direct, US Census Bureau, Bureau of Economic Analysis, Federal Bank of New York, Center for a New Economy*

*Note: Referenced on page 9 on Testimony of Stephen J. Spencer*

*(1) PREPA, PRASA, PRHTA and Tobacco bonds have been stripped from this calculation*

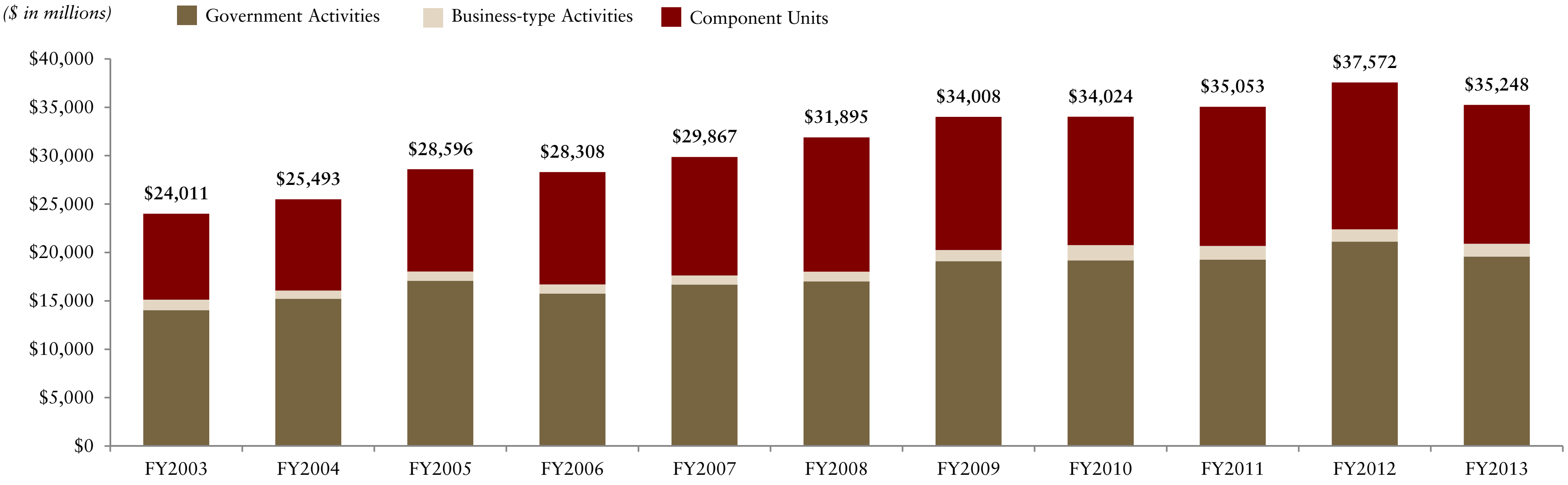
HOULIHAN LOKEY

# Commonwealth Expenditures

**Despite the government's claims that it has implemented austerity measures, total government expenditures have increased by 47% over the past 10 years**

- Government Activities: Majority of services associated with the Commonwealth, including general government, education, public housing and welfare, health, public safety, and economic development
- Business-type Activities: Activities are normally intended to recover all of a significant portion of their costs through user fees and charges to eternal users of goods and services
- Component Units: Comprises of Government Development Bank for Puerto Rico ("GDB"), Puerto Rico Highways and Transportation Authority ("PRHTA"), Puerto Rico Electric Power Authority ("PREPA"), Puerto Rico Aqueduct and Sewer Authority ("PRASA"), University of Puerto Rico ("UPR"), Puerto Rico Health Insurance Administration ("PRHIA") and non-major component units

## Commonwealth Expenditures



*Source: Commonwealth of Puerto Rico Audited Annual Financial Reports*
*Note: Referenced on page 11 on Testimony of Stephen J. Spencer*

# Commonwealth of Puerto Rico

# Tax Reform Assessment Project

*Unified Tax Code of Puerto Rico:*

*Tax Policy Implementation Options*

*Executive Summary*

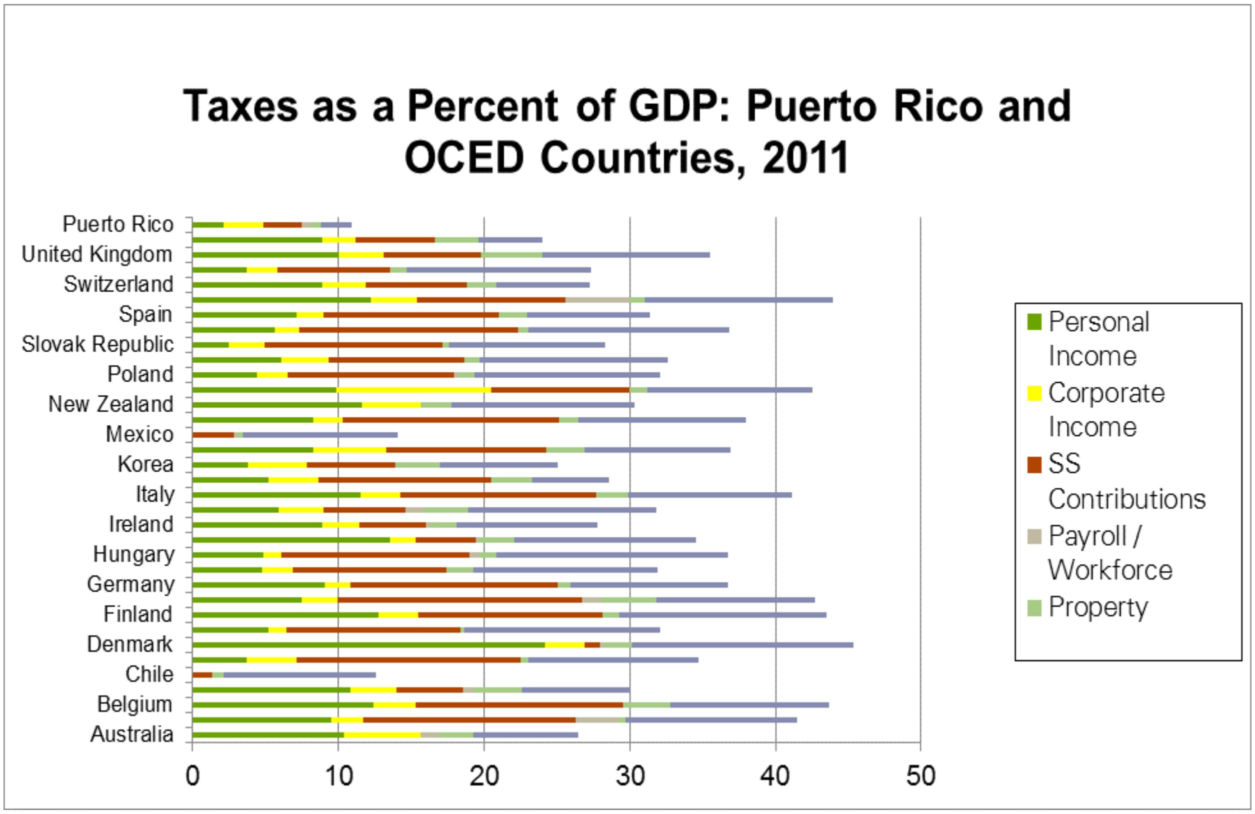
*October 31, 2014*

## 1.3 Summary of Principal Findings

### 1.3.1 High Level Observations

The current income and consumption tax structures are inordinately complex, due principally to a plethora of special provisions that for the most part were adopted in a haphazard manner over time generally to provide incentives for particular forms of economic activity. These special provisions have never been subjected to a cost benefit analysis. As shown in Tables 1 and 2, revenue from consumption and income taxes are below peer jurisdictions.

**Table 1: Taxes as a Percentage of GDP in Puerto Rico Compared to Selected Jurisdictions[4]**



[4] (*) While Table 1 uses GDP as the measure of comparison across countries, the results are similar when using GNP as the measure of comparison. Puerto Rico taxes as a percentage of GNP is closer to 15% but still substantially lower than the tax liability of the peer countries shown.

- Could be reduced if specified economic and revenue goals are attained.

## 1.5 Summary of Projections

The following tables illustrate the revenue, distributional and macroeconomic consequences of the options outlined above, individually and in combination. The parameters of any of the options may be altered and these results will change. The results of other options are set out in the Attached General Explanation.

Table 7 compares the current General Fund receipts with receipts under the above parameters.

**Table 7**

| | Current Law | | Proposed Law (1) | | | |
|---|---|---|---|---|---|---|
| | 2014 General Fund Tax Receipts (in $ millions) | General Fund Tax Receipts as a % of Total GF Receipts | General Fund Tax Receipts (in $ millions) | General Fund Tax Receipts as a % of Total GF Receipts | Difference<br>($) | Difference<br>(%) |
| Individual Income Tax | $1,979 | 21.91% | $1,409 | 12.21% | ($570) | -28.80% |
| Corporate Income Tax - Regular Companies | $1,435 | 15.88% | $996 | 8.63% | ($439) | -30.59% |
| Corporate Income Tax - Exempt Companies | $479 | 5.30% | $479 | 4.15% | $0 | 0 |
| Withholding Tax Receipts | $900 | 9.96% | $900 | 7.80% | $0 | 0 |
| Law 154 Receipts | $1,902 | 21.05% | $1,902 | 16.48% | $0 | 0 |
| Sales and Use Tax | $595 | 6.59% | $0 | 0.00% | ($595) | -100% |
| Excise Tax | $919 | 10.17% | $482 | 4.18% | ($437) | -47.55% |
| Property Tax Receipts | $20 | 0.22% | $20 | 0.17% | $0 | 0 |
| Licenses | $20 | 0.22% | $20 | 0.17% | $0 | 0 |
| GST | $0 | 0.00% | $4,545 | 39.39% | $4,545 | - |
| Other Taxes | $52 | 0.58% | $52 | 0.45% | $0 | 0 |
| Non-tax and external | $733 | 8.11% | $733 | 6.35% | $0 | 0 |
| Total | $9,034 | 100.00% | $11,538 | 100.00% | $2,504 | 27.72% |

# The Commonwealth of Puerto Rico

## Update on Fiscal and Economic Progress

*FY 2014 Q1 Investor Webcast - October 15, 2013*

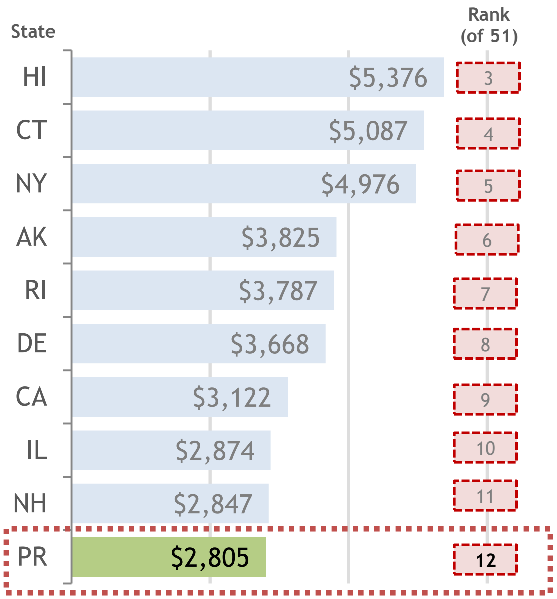
# GDB believes that any comparison of the public debt levels of Puerto Rico with the states should include state, local and federal debt

If one factors in the federal debt load, PR would rank last in outstanding debt per capita amongst all US jurisdictions*

## Puerto Rico Debt Per Capita vs the USA Comparison Analysis as of June 30, 2011
(in millions)

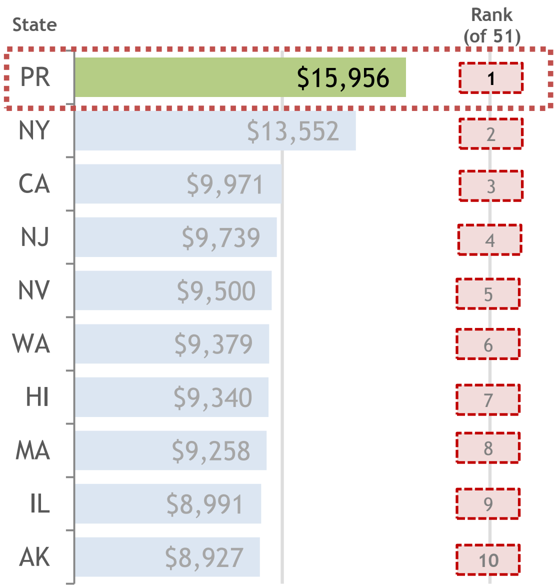
### State Level Debt(1)

US Avg: $2,390 per capita
PR: $2,805 per capita
**Rank: #12 of 51**



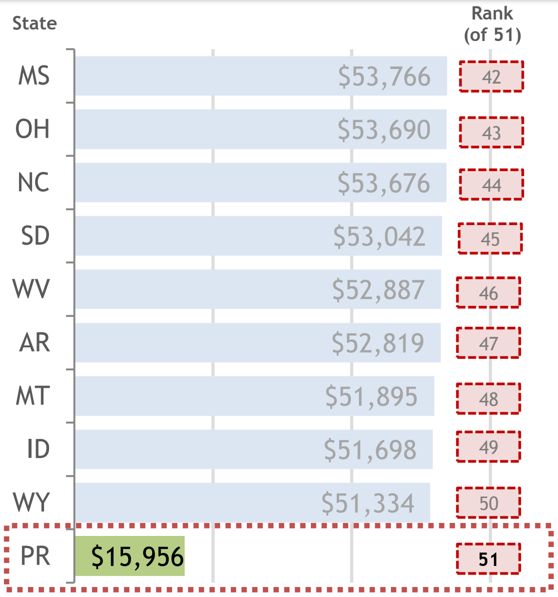
### State & Local Level Debt(2)

US Avg: $7,355 per capita
PR: $15,956 per capita
**Rank: #1 of 51**



### State, Local, Federal Level Debt(3)

US Avg: $57,024 per capita
PR: $15,956 per capita
**Rank: #51 of 51**



*Source: US Bureau of the Census and the Government Development Bank for Puerto Rico
(1) For Puerto Rico State Debt includes GO debt.
(2) For Puerto Rico local debt includes debt of Municipalities and Public Corporations.
(3) US Federal Debt per capita is $49,669