

April 19, 2017

**John J. Rapisardi**  
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**Re: Response to Letter of Certain General Obligation Bondholders**

Dear Judge Gropper:

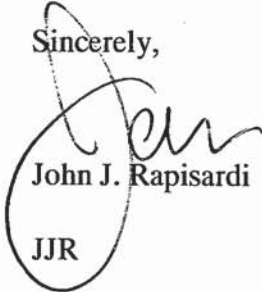
I write on behalf of the Puerto Rico Fiscal Agency and Financial Advisory Authority (“AAFAF”) and the Government of Puerto Rico in response to the letter sent earlier today on behalf of certain General Obligation bondholders regarding the Puerto Rico mediation.

The Government and its officials take seriously, and are in compliance with, the protocol governing the mediation. The comments of Mr. Elías Sánchez and Governor Ricardo Rosselló Nevaes were completely appropriate and did not divulge any confidential information or positions taken by creditors during the mediation. Mr. Sánchez was simply reiterating what has been, and continues to be, the Government’s desire and perspective: to receive constructive proposals from creditors so all parties can move forward in good faith with negotiations that will lead to a consensual agreement. As has been previously stated by the Government, a negotiated resolution under Title VI is the best vehicle to achieve a successful restructuring that both fairly treats creditors and protects the vital needs of the 3.5 million U.S. citizens living in Puerto Rico. Likewise, the Governor's statement that “the ball is in creditors’ court” is nothing more than a restatement of the Government’s views with respect to a consensual restructuring.

Moreover, Mr. Sánchez’s statements regarding creditors’ views on the Fiscal Plan were simply commentary on creditors' public pronouncements—including the GO bondholders who corresponded with you earlier today. Creditors have waged a campaign against the Fiscal Plan via press release and publicly laid out their views on the Fiscal Plan with great specificity. We attach a small sample of those public statements to this letter. *See* Press Release, Ad Hoc Group of Puerto Rico’s General Obligation Bondholders, The Ad Hoc Group of General Obligation Bondholders of Puerto Rico Joins Other Creditors in Letter to Federal Oversight Board (Mar. 27, 2017); Letter from Creditors of Puerto Rico to the Financial Oversight and Management Board (Mar. 27, 2017); Letter from Creditors of Puerto Rico to the Financial Oversight and Management Board (Mar. 30, 2017); *Creditors Detail Wide-Ranging Fiscal Plan Concerns in Letter to PROMESA Board*, Reorg Research (Mar. 27, 2017). It is completely proper for Mr. Sánchez to comment on creditors’ public statements. Nothing in the mediation protocol is to the contrary.

As you know, the Government has participated in this mediation eagerly and has been fully engaged. It intends to continue negotiating and being available to its creditors going forward as it works to attain a consensual resolution to Puerto Rico's debt situation.

Sincerely,



John J. Rapisardi

JJR

## The Ad Hoc Group of General Obligation Bondholders of Puerto Rico Joins Other Creditors in Letter to Federal Oversight Board

### Letter Outlines Violations of PROMESA in Puerto Rico's Fiscal Plan

[27-March-2017]

WASHINGTON, March 27, 2017 /PRNewswire-USNewswire/ -- Today, creditors and insurers representing approximately \$12 billion of bonds issued by the Commonwealth of Puerto Rico and its instrumentalities sent a joint letter to Members of the Federal Oversight Board created by PROMESA. The signers of the letter represent thousands of investors in municipal debt across the United States, many of whom are the very same investors that will be called upon to lend money to Puerto Rico in the future. The letter from these investors, which can be found here, outlines specific concerns and questions the signers have relating to the *Fiscal Plan for Puerto Rico* that was certified by the Board on March 13, 2017.

The signers of the letter have again made clear their willingness to engage the Commonwealth and the Oversight Board in a consensual process. Indeed, they have made many previous attempts to do so.

The letter specifically outlines how the Fiscal Plan certified by the Board violates PROMESA along with its other shortcomings, including:

- The Plan fails to comply with lawful priorities as established by Puerto Rico's Constitution and required by PROMESA.
- The Plan does not differentiate between expenses for essential services and expenses for non-essential services and, in fact, prioritizes all non-debt expenses above debt service.
- The Plan contains rampant expense growth and assumes that the Commonwealth will not adhere to its own budget by requesting a \$600 million annual "cushion" to pay for non-budgeted expenses.
- The Plan contains certain omissions, unexplained numbers and assumptions including those related to tax collection rates and macro-economic assumptions.
- The plan undermines investor confidence in Puerto Rico, making it very unlikely that the Commonwealth will be able to access the capital markets any time soon.

The signers of the letter have respectfully asked for the opportunity to immediately discuss these issues with the Oversight Board and the Commonwealth, with the expressed goal of advancing negotiations and achieving a consensual resolution under Title VI of PROMESA.

For media inquiries, please contact Miriam Warren at [mwarren@dcigroup.com](mailto:mwarren@dcigroup.com).

To view the original version on PR Newswire,  
visit:<http://www.prnewswire.com/news-releases/the-ad-hoc-group-of-general-obligation-bondholders-of-puerto-rico-joins-other-creditors-in-letter-to-federal-oversight-board-300430120.html>

SOURCE Ad Hoc Group of Puerto Rico's General Obligation Bondholders

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March 27, 2017

José B. Carrión III  
Andrew G. Biggs  
Carlos M. García  
Arthur J. González  
José R. González  
Ana J. Matosantos  
David A. Skeel, Jr.

Dear Members of the Oversight Board:

This letter is being sent by the following holders and insurers of bonds issued by the Commonwealth of Puerto Rico or its territorial instrumentalities (collectively, the “Government of Puerto Rico”):

- The Ad Hoc Group of Puerto Rico General Obligation Bondholders (the “GO Group”), which holds approximately \$3 billion of bonds issued or guaranteed by the Commonwealth of Puerto Rico;
- Certain funds managed by Franklin Advisers Inc., certain funds managed by Oppenheimer Funds, Inc., and certain funds managed by Santander Asset Management, LLC (the “Major COFINA Bondholders”), which hold approximately \$3.65 billion of bonds issued by COFINA and approximately \$1.85 billion of bonds issued or guaranteed by the Commonwealth of Puerto Rico;
- Assured Guaranty Corp. and Assured Guaranty Municipal Corp. (“Assured”) as insurer of approximately \$1.75 billion of bonds issued or guaranteed by the Commonwealth of Puerto Rico, and approximately \$1.675 billion of secured revenue bonds issued by HTA, PRCCDA, and PRIFA<sup>1</sup> (collectively, the “Petitioning Creditors”):<sup>2</sup>

On March 13, 2017, you certified the *Fiscal Plan for Puerto Rico* (the “Fiscal Plan”). We write for the purpose of calling upon you to provide certain additional

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<sup>1</sup> The figures herein include Assured’s gross par exposure for (i) GO and PBA bonds insured by Assured and (ii) HTA, PRCCDA, and PRIFA bonds insured by Assured.

<sup>2</sup> The Petitioning Creditors submit this letter exclusively on their own behalves and do not assume any fiduciary or other duties. The list of issues set forth herein is not intended to be a comprehensive list of all questions and disputes the Petitioning Creditors have concerning the Fiscal Plan (defined below). This letter does not purport to provide a full description of the parties’ rights, claims, and respective positions regarding any rights or remedies with respect to particular resources or the treatment of such under PROMESA. Each party hereto reserves all rights, and statements in this letter do not (and shall not be deemed to) represent each Petitioning Creditor’s comprehensive view on a particular subject matter.

information concerning the Fiscal Plan and to address certain deficiencies pertaining thereto. Although the Petitioning Creditors' interests are diverse, we share an interest in expeditiously resolving the Government of Puerto Rico's financial crisis.

As the Fiscal Plan states, it is "intended to represent the basis upon which the Government and its creditor constituencies can, for the first time, conduct real and meaningful dialogue." (Fiscal Plan at 5.) If the Fiscal Plan is to serve as the basis for dialogue, it must persuade creditors, not dictate to them—and creditors must fully understand the assumptions, analyses and rationales underlying the Fiscal Plan, so that the Government of Puerto Rico can reach an agreement with creditors and regain its desperately needed credibility with the capital markets.

Respectfully, we believe that the Fiscal Plan violates many of the requirements of PROMESA. The Fiscal Plan also contains many unexplained numbers and assumptions that creditors need to understand before meaningful negotiations can occur. These include, but are not limited to:<sup>3</sup>

- \$6.2 billion "Reconciliation Adjustment" in non-budgeted expenses, over a ten-year period;
- \$1.8 billion increase in payroll expenses, over a ten-year period, compared to maintaining a 2017 run rate level;
- \$500 million increase in operational expenses, over a ten-year period, compared to maintaining a 2017 run rate level;
- \$9.3 billion in deficits at component units and other non-General Fund entities, over a ten-year period, with an annual growth rate of 10%;
- Tax collection rates and related assumptions embodied in the Fiscal Plan;
- Macro-economic assumptions, including components of GNP, the fiscal multiplier behind the projections for revenues and expenses, and the models behind the Fiscal Plan; and
- Any sensitivity analyses measuring the impact of recommendations from the Congressional Task Force on Economic Growth in Puerto Rico.

The Petitioning Creditors have separately made prior attempts to engage you on these very topics. Unfortunately, we cannot see any reflection of our prior submissions. What's more, far from restoring the Government of Puerto Rico's access to the capital markets—the first and last goal of PROMESA—the Fiscal Plan seems designed to

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<sup>3</sup> Fiscal Plan numbers cited in this letter do not include the effect of amendments described in the Oversight Board Resolution adopted on March 13, 2017

undermine it. We urge you to engage with us constructively and immediately on the topics that follow. The future of Puerto Rico depends on it.

Accordingly, we highlight herein some of the key aspects of the Fiscal Plan that we believe require further consideration or potential amendment.

### **Failure to Respect Lawful Priorities and Liens**

The Fiscal Plan simply ignores one of the enumerated *requirements* that Congress imposed on any fiscal plan, namely, that it “respect the relative lawful priorities or lawful liens, as may be applicable, in the constitution, other laws, or agreements of a covered territory or covered territorial instrumentality in effect prior to the date of enactment of this Act.” (PROMESA § 201(b)(1)(N).) Congress authorized the Oversight Board to certify a fiscal plan that “satisfies such *requirements*.” (*Id.* §201(c)(3) (emphasis added).) If a fiscal plan “does not satisfy such *requirements*” then the “Board *shall* provide to the Governor a *notice of violation*.” (*Id.* (emphasis added).) Here, the Commonwealth acknowledged that the Fiscal Plan did not comply with Section 201(b)(1)(N), and the Oversight Board stated that it did not have enough information to determine the Fiscal Plan’s compliance with Sections 201(b)(1) (N). Instead of requiring correction, the Oversight Board certified the Fiscal Plan.<sup>4</sup>

### ***The Constitutional Debt***

Puerto Rico’s Constitution—expressly referenced in Section 201(b)(1)(N)—clearly provides that, when available resources are insufficient to cover all of the Commonwealth’s obligations, Constitutional Debt shall be paid first. (P.R. Const. Art. VI, Sec. 8.) Moreover, Puerto Rico’s Management and Budget Office Organic Act, 23 L.P.R.A. 104(c), recognizes the constitutional requirement that payment on Constitutional Debt shall come first, and specifies that payments or disbursements related to certain contracts, public health, safety, education, welfare, pensions, and capital works and improvements shall only be made after payments on Constitutional Debt.

By providing that payment on Constitutional Debt comes *after* all of the Commonwealth’s expenditures, the Fiscal Plan violates Puerto Rico’s Constitution and Section 201(b)(1)(N). We call upon you to correct this error or to explain why you believe this is not an error.<sup>5</sup>

<sup>4</sup> See Commonwealth Fiscal Plan, dated February 28, 2017 (the “[February 28<sup>th</sup> Fiscal Plan](#)”) (noting that compliance with Section 201(b)(1)(N) was “ongoing.”); Letter from Oversight Board to Gov. Rosselló Nevares, at 1, fn. 1, dated March 9, 2017.

<sup>5</sup> Contrary to the testimony Chairman Carrión gave in Congress on March 22, 2017, this issue is *not* the issue raised in the litigation brought by the GO Group with regard to the COFINA structure. See *Oversight Hearing on the Status of the P.R. Elec. Power Auth. (PREPA) Restructuring Support Agreement Before the Subcomm. on Indian, Insular and Alaska Native Affairs of the H. Comm. on Nat. Res.*, 115th Cong. (2017). Regardless of the outcome of that dispute, the Constitutional Debt is entitled



### ***The Major COFINA Bondholders' and Assured's Positions***<sup>6</sup>

The Major COFINA Bondholders and Assured assert that the Fiscal Plan also violates Sections 201(b)(1)(M) and 201(b)(1)(N) in its treatment of COFINA, HTA, PRCCDA, and PRIFA.<sup>7</sup>

The Major COFINA Bondholders maintain that the COFINA structure is valid and therefore the Fiscal Plan violates Section 201(b)(1)(M) by transferring COFINA's property to the Commonwealth's General Fund and violates Section 201(b)(1)(N) by failing to respect the COFINA bondholders' lien on the assigned revenues granted to COFINA.

Similarly, Assured has brought litigation challenging the Commonwealth's diversion of collateral that secures bonds issued by HTA, PRCCDA and PRIFA (each, an "Authority"). Assured and other Authority bondholders contend that the diversion of collateral securing bonds issued by the Authorities is illegal and therefore the Fiscal Plan violates Sections 201(b)(1)(M) and (N) by transferring such revenues to the Commonwealth and failing to respect the lawful liens and priorities relating thereto.

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The Oversight Board has repeatedly stated that it takes no position on these disputes, but such indecision does not constitute compliance with Congress' requirements under PROMESA. The Fiscal Plan takes all revenues and uses them for the payment of general expenses, without any regard to lawful priorities or liens. Regardless of how the above disputes may be resolved, that approach is plainly inconsistent with sections 201(b)(1)(M) or (N) of PROMESA.

### **Identification of Essential Services**

The Fiscal Plan does not attempt to differentiate between expenses for essential services and expenses for non-essential services. While the Fiscal Plan lists this issue as one of the "legal and contractual issues not determined by the Fiscal Plan," it is also a key *economic* issue. (Fiscal Plan at 6.)

As certified, the Fiscal Plan presumes that *all* non-debt expenses are paid before *any* payments are made on debt service, yet the Oversight Board and the Government of

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to be paid before all other Commonwealth expenditures. And regardless of the outcome of that dispute, the Fiscal Plan violates Section 201(b)(1)(N) of PROMESA.

<sup>6</sup> For the avoidance of doubt, the GO Group has not signed on to any portion of this letter stating or implying that the COFINA structure is valid and the Major COFINA Bondholders have not signed on to any portion of this letter implying that the COFINA structure is not valid.

<sup>7</sup> As you know, the GO Group has brought litigation challenging the transfer of sales and use tax revenues to COFINA.



Puerto Rico have never explained the legal or commercial basis for such a waterfall in the Fiscal Plan. We therefore ask you to address the following questions:

1. What is the legal basis for that waterfall?
2. Does this basis depend, in your view, on whether the expenses are for essential services?
3. If the answer to question 2 above is yes, what portion of the projected annual expenses are for essential services and what are those services? If the Fiscal Plan does not distinguish between essential and non-essential services, how can it meet the requirements of PROMESA?

It is not plausible that 100% of the approximately \$18 billion in average annual expenses projected under the Fiscal Plan are for essential services. The persistent refusal of the Oversight Board and the Government of Puerto Rico to address this obvious question is telling.

### **Reconciliation Adjustment**

As certified, the Fiscal Plan includes an incremental \$6.2 billion “Reconciliation Adjustment” based upon the assumption that the Government of Puerto Rico will not adhere to its budget, which will be approved by the Oversight Board. Moreover, and notwithstanding the reforms proposed by the Oversight Board and the Government of Puerto Rico, the Fiscal Plan actually projects that this cushion will grow steadily over the next decade. (Fiscal Plan at 14 (noting “steady increase until 2026.”).)

In other words, the Fiscal Plan asks creditors—in addition to subordinating themselves to all government expenses, whether essential or not—to further assume that the Government of Puerto Rico will need an annual “cushion” of approximately \$600 million to pay for non-budgeted expenses. To reach such an expense level, the Government of Puerto Rico must not only miss this fiscal year’s cost-reduction targets, but also reverse last year’s expense reductions and then grow expenses from fiscal year 2015 levels. Creditors are asked to make this assumption despite the Government of Puerto Rico’s recent efforts to implement zero-based budgeting for each department.<sup>8</sup>

Incorporating this significant contingency reserve is contrary to the express language of PROMESA. First, Section 202 requires that the Oversight Board, the Governor, and the Legislature develop annual budgets for certain covered entities through an iterative process. To be approved, such budgets must be “compliant budgets,” *i.e.*, consistent with the Fiscal Plan. (PROMESA § 202(e).) One of the key requirements for

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<sup>8</sup> The E&Y Report does not explain or necessitate this contingency reserve. The E&Y Report is based primarily on projections from fiscal years 2014 and 2015 and de-emphasizes figures from fiscal year 2016 that reduce the impact of its conclusions.

any fiscal plan is to eliminate “structural deficits,” which is contrary to the very inclusion of a Reconciliation Adjustment. (PROMESA § 201(b)(1)(D).) Second, Section 203 requires the Government of Puerto Rico to submit quarterly reports to the Oversight Board detailing whether the Government of Puerto Rico is in compliance with its approved budget. In the event that the Government of Puerto Rico is not in compliance with its approved budget, the Oversight Board *shall* “make appropriate reductions in *nondebt expenditures* to ensure that the actual quarterly revenues and expenditures for the territorial government are in compliance with the applicable certified Territory Budget.” (PROMESA § 203(d)(1) (emphasis added).) The Fiscal Plan ignores these requirements and instead permits (i) structural deficits to persist into perpetuity, and (ii) the Government of Puerto Rico to build in a significant cushion upfront (a reserve nearly equal to the annual amount dedicated to debt service), and thereby reduce funds available for debt service. Congress clearly stated that structural deficits were to be eliminated and that if interim revenue/expense gaps arose, budgetary adjustments should be made from “nondebt expenditures.” The net result of affording a \$6.2 billion budgetary cushion would appear to defeat one of PROMESA’s primary goals, *i.e.*, fiscal discipline.

Further, the assertion that the contingency reserve and non-essential services should lawfully come before all debt service creates an environment that requires an examination of limits arising under the United States and Commonwealth constitutions and will certainly impact the broader municipal bond market.

### **Other Expense Assumptions**

The Fiscal Plan contains billions of dollars in other expenses that require further detail for the Petitioning Creditors to understand.

In contrast to the February 28<sup>th</sup> Fiscal Plan, the Fiscal Plan that the Oversight Board certified *increased* payroll expenses by more than \$1.5 billion and *increased* operational expenses by more than \$400 million over a ten-year period. Neither the Oversight Board nor the Government of Puerto Rico has explained why the growth rate for expenses increased so significantly between February 28<sup>th</sup> and March 13<sup>th</sup>. Instead of instilling the necessary discipline to maintain fiscal year 2017 run rate expense levels, the Fiscal Plan allows payroll expenses and operational expenses to grow, which increases expenses by over \$2.3 billion over a ten-year period. The Petitioning Creditors are entitled to understand the analysis that led to revising these amounts.

The Fiscal Plan also includes expenditures that are not related to the General Fund or services provided by the central government of Puerto Rico. In particular, the Fiscal Plan includes \$7.4 billion over a ten-year period in component unit expenses including ASEM, ASES, ADEA, PRIDCO, PRITA, Tourism, and UPR deficits. (Fiscal Plan at 14.) In all, deficits at component units and other non-General Fund entities have likewise increased—without explanation—by \$715 million compared to the February 28<sup>th</sup> Fiscal Plan over a ten-year period. Moreover, the Fiscal Plan assumes a **compound annual growth rate of approximately 10%** for such expenses. **This rampant expense growth**

**leads to a \$3.2 billion incremental deficit at these component units and non-General Fund entities, above the fiscal year 2017 run rate levels.**

To facilitate meaningful negotiations of a potential restructuring, the Petitioning Creditors must understand why the Government of Puerto Rico is forecasting \$9.3 billion in expenses over a ten-year period to component units and other non-General Fund entities, and why those expenses, together with the General Fund’s payroll and operating expenses, increased by more than \$2.6 billion over a ten-year period compared to the February 28<sup>th</sup> Fiscal Plan.

**Macro-Economic Assumptions**

The Fiscal Plan is built on a number of key macro-economic assumptions that are not sufficiently explained. In particular, the Fiscal Plan fails to disclose the components of GNP and the fiscal multiplier that drive the revenue and expense projections.

The Petitioning Creditors need access to this critical information, including access to the underlying models on which the Fiscal Plan is built, to perform necessary diligence on the Fiscal Plan. This would enable the Petitioning Creditors to better understand, for example, why certain expenses appear to grow at a higher rate than revenues and overall inflation, and why the Government of Puerto Rico’s proposed structural reforms are not projected to have a more significant positive effect on GNP. Full access to these models and assumptions is critical to advancing negotiations.

**Privatization**

The Fiscal Plan fails to take into account any potential privatization of government assets, or the reductions in expenses that would accompany such privatization. On December 20, 2016, the Oversight Board stated that “[b]y privatizing a number of government assets, such as real estate, the state insurance fund and ports, for example, Puerto Rico could fund near-term initiatives on a one-time basis, and potentially achieve better service levels at a lower cost. Government assets should be monetized with the specific aim of funding one-time investments in infrastructure development, like upgrading to broadband internet connections, and not funding continuous operations.”<sup>9</sup> Similarly, when seeking proposals from advisors, the Government of Puerto Rico has twice sought an advisor with expertise in “asset valuations, sales and privatizations.”<sup>10</sup>

Despite the Oversight Board’s and the Government of Puerto Rico’s recent interest in such measures, the Fiscal Plan ignores the possibility of privatizing

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<sup>9</sup> Letter from Oversight Board to Gov. García Padilla and Gov. Elect Rosselló Nevaes, dated December 20, 2016.

<sup>10</sup> Request for Qualifications for Omnibus Infrastructure Public-Private Partnership Advisor, dated March 21, 2017; Request For Proposals for Role of Strategic and Financial Advisor, Puerto Rico Fiscal Agency and Financial Advisory Authority, dated January 3, 2017.

government assets and the attendant fiscal benefits. If executed effectively, privatization should produce measurable economic benefits through one-time cash infusions, a reduction in public capital funding requirements, and significant decreases in operational expenditures—none of which appear in the Fiscal Plan.

### **Tax Collection Rates**

The Fiscal Plan fails to account for potentially significant additional revenues generated from improved tax collection and compliance reforms. It is widely understood that the Government of Puerto Rico’s historical collection rates are low (for example, collection of sales and use tax (“SUT”) was estimated to be no more than 67.9% in fiscal year 2016).<sup>11</sup> During his recent State of the Commonwealth Address, Governor Rosselló Nevares stated that improved tax collection would be a focus of his administration and would significantly increase the Government of Puerto Rico’s revenues.<sup>12</sup> However, the Fiscal Plan contemplates only modest improvements in tax collection rates.

Given the impact that improved tax collection rates would have on the Government of Puerto Rico’s revenues, we expect that the Oversight Board is supportive of these proposed compliance reforms. For example, based on 2016 SUT collections, each 1% improvement in collection rates represents an incremental \$35 million in revenues. The Department of Hacienda under the prior administration projected a sustained 12%-17% improvement in SUT collections over the coming ten years, representing an incremental \$420 million to \$595 million annually on SUT revenues alone.<sup>13</sup> Accordingly, the Oversight Board should provide the Petitioning Creditors with the collection rates that are implied in the Fiscal Plan and allow the Petitioning Creditors to test such assumptions in light of the Government of Puerto Rico’s proposed reforms.

Understanding the Oversight Board’s assumptions regarding collection rates is also critical in light of recent data demonstrating that the Government of Puerto Rico is surpassing prior estimates. In particular, through February of fiscal year 2017, General Fund net revenues are approximately 3.5% higher than initially forecast, representing a \$184 million increase over projections (\$5.41 billion vs. \$5.22 billion).<sup>14</sup> Similarly, through February 28, 2017, Government of Puerto Rico revenues are approximately 1.7% higher than revenues over the same period in 2016, and revenues for fiscal year 2016

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<sup>11</sup> Puerto Rico Departamento de Hacienda, “Secretario de Hacienda anuncia alza de 4.2 puntos porcentuales en la tasa de captación del Impuesto sobre Ventas y Uso (IVU) en el año fiscal 2016,” *Press Release*, Nov. 15, 2016.

<sup>12</sup> *Rossello’s Fiscal Plan Falls Short by \$800M*, REORG RESEARCH, Feb. 28, 2017.

<sup>13</sup> Puerto Rico Departamento de Hacienda, “Índice de Captación del Impuesto sobre Ventas y Uso (IVU),” *Executive Summary*, Apr. 2016.

<sup>14</sup> Puerto Rico Departamento de Hacienda, “Hacienda recauda \$776.6 millones en febrero, \$9.0 millones más que el año anterior y \$7.4 millones menos que la proyección,” *Press Release*, Mar. 21, 2017.

were 2.4% higher than revenues in fiscal year 2015.<sup>15</sup> Given these recent trends, the Petitioning Creditors should understand why the Oversight Board adopted more pessimistic assumptions than initially proposed by the Government of Puerto Rico.

### **Federal Health Care Funds**

As set forth in the February 28<sup>th</sup> Fiscal Plan, the expiration or continuation of funding under the Affordable Care Act has a significant effect on the Government of Puerto Rico's revenues and expenses. Although the outcome is undetermined at this time, it seems likely that Congress may act before December 31, 2017.

It is difficult to assess the Fiscal Plan without considering the significant effect that federal health care funding has on the Government of Puerto Rico's budget and long-term fiscal outlook. To avoid informational asymmetries or other strategic impediments, we believe that the Oversight Board, acting together with the Government of Puerto Rico and the Congressional Task Force on Economic Growth in Puerto Rico (the "Task Force"), should immediately seek assistance from Congress (and other applicable agencies and departments) to restore federal health care funding and bring certainty to the Government of Puerto Rico.

The future of federal health care funding is critical to the Government of Puerto Rico because of the spillover effect that it may have on population migration and therefore virtually every aspect of the Fiscal Plan. The Task Force announced its federal health care recommendations on December 20, 2016. Implementing the Task Force's recommendation should be an immediate concern of the Oversight Board, and cannot wait until after creditor negotiations.

### **Task Force Report**

The Fiscal Plan does not incorporate the numerous recommendations contained in the Task Force's December 20, 2016 Report to the House and Senate (the "Task Force Report"). Many of the Task Force's recommendations address economic development initiatives and ways in which the Government of Puerto Rico can better utilize federal resources. At a minimum, creditors should have access to any sensitivities analyses measuring the impact of the Task Force's recommendations so they can understand the determination not to include those recommendations.

### **Access to the Capital Markets**

Congress said that the purpose of any fiscal plan is to provide Puerto Rico "a method to achieve fiscal responsibility and access to the capital markets." (PROMESA

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<sup>15</sup> *Id.*; Puerto Rico Departamento de Hacienda, "Hacienda informa que los ingresos netos al Fondo General del año fiscal 2015-16 totalizaron \$9,175.3 millones; \$214.4 millones o 2.4% más que el año fiscal anterior y 98.7% del estimado total revisado," *Press Release*, July 28, 2016.

§ 201(b)(1).) Indeed, the Government of Puerto Rico's ability to access the capital markets goes hand-in-hand with its ability to implement pro-growth measures, and therefore successfully implement the Fiscal Plan.

Unfortunately, the Fiscal Plan undermines investor confidence in Puerto Rico's commitment to paying debts, making Puerto Rico unlikely to be able to regain access to the credit markets at reasonable interest rates. After the Oversight Board certified the Fiscal Plan, trading prices of the Government of Puerto Rico's bonds fell. This indicates that investors have reduced confidence in the Commonwealth's and Oversight Board's willingness to pursue consensual settlements as favored by PROMESA and portends protracted and expensive litigation that will inhibit the Government of Puerto Rico's access to capital sorely needed to spark economic recovery on the island. Moreover, the Oversight Board's assumptions in the Fiscal Plan regarding, among other things, required amortization of principal in the debt sustainability analysis are inconsistent with the assumption that the Government of Puerto Rico regains capital market access. The inability to access capital markets will only exacerbate the Government of Puerto Rico's fiscal crisis by preventing it from refinancing its indebtedness at lower interest rates at maturity.

### **Treatment of Claw-back Revenues**

The Government of Puerto Rico and the Oversight Board also suggest that the Fiscal Plan does not determine "the scope, timing, or specific use of revenues to be frozen or redirected as 'claw back' revenue." (Fiscal Plan at 6.) In fact, the Fiscal Plan does determine, in clear violation of PROMESA, the use of some claw back revenues that are assumed to be clawed back.

While the Petitioning Creditors may have differing views as to the nature of their rights regarding these funds,<sup>16</sup> they are unanimous in agreeing that the Fiscal Plan improperly assumes that revenues generated by a valid claw back may be disposed of at the Commonwealth's discretion. There is no basis upon which to explain the Fiscal Plan's treatment of these funds, other than a complete disregard for the rule of law. In no sense does the Fiscal Plan show the *respect* for lawful liens and priorities as required by PROMESA with respect to these monies.

The enabling statutes, authorizing resolutions, and offering circulars for each of the claw back bonds expressly provide that the pledged revenues, which include taxes on gasoline, petroleum, cigarettes, rum, and hotel rooms, and vehicle license and registration fees, may *only* be clawed back (upon satisfaction of certain conditions) to pay

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<sup>16</sup> It bears repeating that this letter does not purport to encompass the full scope of any Petitioning Creditor's legal position, and each Petitioning Creditor hereby reserves all rights regarding these and other issues.



Constitutional Debt, and not for any other purpose.<sup>17</sup> Former Governor García Padilla acknowledged this in Administrative Bulletin No. OE-2015-046, which stated that any funds clawed back and “retained by the Department of Treasury *shall be held in a segregated account and shall only be used*” for the payment of Constitutional Debt.<sup>18</sup> The current administration recognized the same thing when it recently announced that it would segregate claw back revenues in a trust for the payment of “constitutionally guaranteed general obligation bonds.”<sup>19</sup>

The Fiscal Plan, however, assumes that the revenues may be clawed back (without discussing the stated conditions therefore), but does not segregate claw back revenues for the payment of Constitutional Debt. Instead, the Fiscal Plan allows such revenues to apparently be used for any and all purposes at the Commonwealth’s discretion. For example, the Government of Puerto Rico has identified \$978 million<sup>20</sup> of claw back and other pledged funds in fiscal year 2017 alone, but the Fiscal Plan does not segregate these revenues for the payment of Constitutional Debt. Even more, the Fiscal Plan provides only \$404 million and \$567 million in total debt service for fiscal years 2018 and 2019, respectively, thereby guaranteeing that the Government of Puerto Rico—with the Oversight Board’s blessing—will in fact use claw back revenues for purposes other than debt service on Constitutional Debt.

Because the Fiscal Plan ignores that, assuming claw back revenues are appropriately clawed back, such revenues should be used to pay Constitutional Debt, it violates PROMESA Section 201(b)(1)(A)(i), which requires that all revenue projections be “based on applicable laws.”

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The Petitioning Creditors respectfully request the opportunity to immediately discuss these specific issues with the Oversight Board and the Government of Puerto Rico in a constructive and cooperative manner. We believe that these discussions will significantly help advance negotiations and our shared goal of reaching an expeditious and consensual resolution under Title VI of PROMESA.

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<sup>17</sup> For example, these provisions provide that pledged revenues are “subject to being applied first to the payment and amortization of the public debt in accordance with the provisions of Section 8 of Article VI of the Constitution of Puerto Rico if needed therefor.”

<sup>18</sup> Indeed, in the second half of fiscal year 2016, the García Padilla administration did segregate at least \$146 million in a Banco Popular account and deposited an additional \$143 million at the Government Development Bank. During fiscal year 2017, however, the Commonwealth has failed to segregate any claw back revenues and instead appears to be using such revenues to fund other Commonwealth expenses.

<sup>19</sup> *Sánchez Provides Update on \$146M GO Payment Trust Fund*, REORG RESEARCH, Feb. 15, 2017.

<sup>20</sup> This amount is inclusive of the \$115 million in special property tax to be levied to support Constitutional Debt pursuant to Act 83-1991.



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## Puerto Rico

# Creditors Detail Wide-Ranging Fiscal Plan Concerns in Letter to PROMESA Board

### Relevant Documents:

[Creditor Letter To PROMESA Board](#)  
[GO Bondholders Press Release](#)

Creditors with a \$12 billion investment in Puerto Rico government bonds wrote to the PROMESA oversight board Monday evening asking to discuss a series of concerns they have with the commonwealth's certified fiscal plan with the goal of advancing negotiations towards achieving a consensual resolution under Title VI of PROMESA.

The letter was signed by the ad hoc group of GO bondholders, which holds approximately \$3 billion of commonwealth bonds; certain funds managed by Franklin Advisers Inc., Oppenheimer Funds, Inc., and Santander Asset Management, LLC (the "Major COFINA Bondholders"), which hold approximately \$3.65 billion of bonds issued by COFINA and approximately \$1.85 billion of bonds issued or guaranteed by the Commonwealth of Puerto Rico; and Assured Guaranty Corp. and Assured Guaranty Municipal Corp, an insurer of approximately \$1.75 billion of bonds issued or guaranteed by the Commonwealth of Puerto Rico, and approximately \$1.675 billion of secured revenue bonds issued by commonwealth public corporations.

The letter lists several concerns with the board certified commonwealth fiscal plan, which under PROMESA is intended to be the primary framework for negotiations. The press release issued by the ad hoc GO bondholder group in conjunction with the letter highlights the following concerns:

- "The Plan fails to comply with lawful priorities as established by Puerto Rico's Constitution and required by PROMESA.
- The Plan does not differentiate between expenses for essential services and expenses for non-essential services and, in fact, prioritizes all non-debt expenses above debt service.
- The Plan contains rampant expense growth and assumes that the Commonwealth will not adhere to its own budget by requesting a \$600 million annual "cushion" to pay for non-budgeted expenses.
- The Plan contains certain omissions, unexplained numbers and assumptions including those related to tax collection rates and macro-economic assumptions.
- The plan undermines investor confidence in Puerto Rico, making it very unlikely that the Commonwealth will be able to access the capital markets any time soon."

PROMESA and commonwealth officials have repeatedly stated that the fiscal plan will serve as the basis of creditor negotiations moving forward, but the letter points to what creditors see as several shortcomings of the plan, which they say could prove an impediment in debt talks.

"If the Fiscal Plan is to serve as the basis for dialogue, it must persuade creditors, not dictate to them—and creditors must fully understand the assumptions, analyses and rationales underlying the Fiscal Plan, so that the Government of Puerto Rico can reach an agreement with creditors and regain its desperately needed credibility with the capital markets," the letter states. "Respectfully, we believe that the Fiscal Plan violates many of the requirements of PROMESA. The Fiscal Plan also contains many unexplained numbers and assumptions that creditors need to understand before meaningful negotiations can occur."

The letter to the board points to the following specific concerns:

- \$6.2 billion "Reconciliation Adjustment" in non-budgeted expenses, over a ten-year period;
- \$1.8 billion increase in payroll expenses, over a ten-year period, compared to maintaining a 2017 run rate level;
- \$500 million increase in operational expenses, over a ten-year period, compared to maintaining a 2017 run rate level;
- \$9.3 billion in deficits at component units and other non-General Fund entities, over a ten-year period, with an annual growth rate of 10%;
- Tax collection rates and related assumptions embodied in the Fiscal Plan;
- Macro-economic assumptions, including components of GNP, the fiscal multiplier behind the projections for revenues and expenses, and the models behind the Fiscal Plan; and
- Any sensitivity analyses measuring the impact of recommendations from the Congressional Task Force on Economic Growth in Puerto Rico

The creditors signing the letter say that they have attempted to engage the board previously but see no reflection of their concerns in the final plan. "Far from restoring the government of Puerto Rico's access to the capital markets—the first and last goal of PROMESA—the Fiscal Plan seems designed to undermine it. We urge you to engage with us constructively and immediately on the topics that follow. The future of Puerto Rico depends on it," the letter states.

The letter then details specific aspects of the fiscal plan the creditors believe will require renewed board consideration and possible amendments.

The creditors state that the fiscal plan "simply ignores" the PROMESA requirement that it "respect the relative lawful priorities or lawful liens, as may be applicable, in the constitution, other laws, or agreements of a covered territory or covered territorial instrumentality."

The letter notes that Puerto Rico's constitution requires that when available resources are insufficient to cover all of the Commonwealth's obligations, constitutional debt shall be paid first. "By providing that payment on Constitutional Debt comes after all of the Commonwealth's expenditures, the Fiscal Plan violates Puerto Rico's Constitution and Section 201(b)(1)(N). We call upon you to correct this error or to explain why you believe this is not an error," the letter states.

**In a footnote, the letter states that contrary to PROMESA Board Chairman José Carrión's testimony in a Congressional hearing last week, this issue is distinct from the issue raised in the litigation brought by the GO Group with regard to the COFINA structure. "Regardless of the outcome of that dispute, the Constitutional Debt is entitled be paid before all other Commonwealth expenditure," the letter states**

(emphasis added).

The letter also indicates that the major COFINA holders and Assured believe the fiscal plan violates PROMESA in its failure to acknowledge existing liens and collateral in other debt.

The letter further states that the fiscal plan “improperly assumes that revenues generated by a valid claw back may be disposed of at the Commonwealth’s discretion” adding “[t]here is no basis upon which to explain the Fiscal Plan’s treatment of these funds, other than a complete disregard for the rule of law. In no sense does the Fiscal Plan show the respect for lawful liens and priorities as required by PROMESA with respect to these monies,” the letter states.

The letter also says the fiscal plan fails to differentiate between essential and non-essential service expenditures and “presumes that all non-debt expenses are paid before any payments are made on debt service.”

**“It is not plausible that 100% of the approximately \$18 billion in average annual expenses projected under the Fiscal Plan are for essential services. The persistent refusal of the Oversight Board and the Government of Puerto Rico to address this obvious question is telling,” the letter states** (emphasis added).

The creditors also slam the \$6.2 billion “Reconciliation Adjustment” in the fiscal plan, which the letter states is for any spending incurred by Puerto Rico government beyond its budget.

“The Fiscal Plan asks creditors—in addition to subordinating themselves to all government expenses, whether essential or not—to further assume that the government of Puerto Rico will need an annual ‘cushion’ of approximately \$600 million to pay for non-budgeted expenses,” the letter states, saying this would assume that Puerto Rico not only misses this fiscal year’s cost-reduction targets, but also reverses last year’s expense reductions. The letter also points to the current administration of Gov. Ricardo Rosselló’s pledge to begin using zero-based budgeting.

The letter argues that Congress clearly stated in PROMESA that structural deficits were to be eliminated and that if interim revenue/expense gaps arose, budgetary adjustments should be made from “nondebt expenditures.” It adds that affording the commonwealth a \$6.2 billion budgetary cushion defeats a primary PROMESA goal of establishing fiscal discipline.

“Further, the assertion that the contingency reserve and non-essential services should lawfully come before all debt service creates an environment that requires an examination of limits arising under the United States and Commonwealth constitutions and will certainly impact the broader municipal bond market,” the letter says.

The creditors also object that the board certified plan contains nearly \$2 billion more of government expenses over the 10-year period that the initial draft presented by the commonwealth. They also criticize that under the plan the central government will pay some \$7.4 billion in expenses incurred by non-central government entities, including the University of Puerto Rico and for health services.

The creditors also note the hit to Puerto Rico bond prices since the fiscal plan was certified to argue that it won’t lead to Puerto Rico’s return to the capital markets.

“Unfortunately, the Fiscal Plan undermines investor confidence in Puerto Rico’s commitment to paying debts, making Puerto Rico unlikely to be able to regain access to the credit markets at reasonable interest rates,” the letter states.

The creditors close their letter asking for an opportunity to immediately discuss these issues with the board and the commonwealth. “We believe that these discussions will significantly help advance negotiations and our shared goal of reaching an expeditious and consensual resolution under Title VI of PROMESA,” the letter states.

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