STATEMENT

of

MELBA ACOSTA-FEBO

On behalf of the

GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO

Before the

SUBCOMMITTEE ON REGULATORY REFORM,
COMMERCIAL AND ANTITRUST LAW

Of the

COMMITTEE ON THE JUDICIARY

Of the

U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, D.C.

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FEBRUARY 26, 2015

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H.R. 870

TO AMEND TITLE 11 OF THE UNITED STATES CODE TO TREAT PUERTO RICO AS A STATE FOR PURPOSES OF CHAPTER 9 OF SUCH TITLE RELATING TO THE ADJUSTMENT OF DEBTS OF MUNICIPALITIES

(“PUERTO RICO CHAPTER 9 UNIFORMITY ACT OF 2015”)

Chairman Marino, Ranking Member Johnson, and members of the subcommittee:

My name is Melba Acosta-Febo, and I am the President of the Government Development Bank for Puerto Rico (the "GDB"). Before assuming this position in October 2014, I was the Secretary of Treasury of the Commonwealth of Puerto Rico.

I want to thank the subcommittee for giving the Commonwealth of Puerto Rico ("Puerto Rico") and the GDB the opportunity to participate in this hearing. The GDB is charged with safeguarding the fiscal stability of Puerto Rico and promoting its economic competitiveness. The GDB is also charged with serving as the fiscal agent and financial advisor for Puerto Rico and all of its instrumentalities. The GDB has a significant interest in the subject matter of this hearing, and along with the Commonwealth and the Governor of Puerto Rico, supports H.R. 870, which would treat Puerto Rico as a "State" for the purposes of Chapter 9 eligibility under the U.S. Bankruptcy Code.

Economic Overview of Puerto Rico

The fiscal and economic situation in Puerto Rico has reached a critical moment. The Legislative Assembly has declared a fiscal emergency in Puerto Rico.

Puerto Rico's economy is closely tied to the United States but was disproportionately and adversely impacted by the U.S. financial crisis and the Great Recession. For example, economic growth in Puerto Rico was negative or weak between 2007 and 2014, which is materially worse than in the rest of the United States during the same period. Growth continues to pose a significant challenge as a result of many factors, including some beyond Puerto Rico's control. An example of this was the repeal and phase-out by Congress of Section 936 of the Internal

Revenue Code, which provided tax benefits for certain businesses (including large pharmaceutical companies) operating in Puerto Rico. The elimination of these tax benefits has led to a significant contraction in employment in Puerto Rico's manufacturing sector, leading to a significant adverse impact on economic growth.

Unemployment has remained at elevated levels, suggesting continued weakness in Puerto Rico's economy, exceeding 15% for many years following the financial crisis. Puerto Rico's unemployment rate was approximately 12.1% as of December 2014, while unemployment in the rest of the United States dropped to 5.6%. Nearly half of all residents in Puerto Rico qualify for low-income health insurance subsidies, and the average personal income per capita, including transfer payments, was approximately $17,000 in fiscal year 2013. Moreover, Puerto Rico's population, unlike the rest of the United States, has declined in each of the last five years resulting in part from migration to the mainland United States.

Puerto Rico's unprecedented economic difficulties have contributed to rising budget deficits at all levels of government, including at Puerto Rico's municipal or "public" corporations. To continue providing essential public services, and to close those deficits, these public corporations routinely accessed the market, or relied on interim financing from the GDB or private sector banks, to finance their budget deficits. Today, Puerto Rico's government, including its public agencies, divisions, instrumentalities and public corporations, has approximately $73 billion in public debt outstanding with a total population of less than 3.6 million residents. In addition, Puerto Rico's public pension funds, although subject to a major overhaul during fiscal year 2014 that reduced future annual cash flow needs, still face significant unfunded actuarial accrued liabilities, which will require increased governmental pension contributions in upcoming years.

Governor Alejandro García Padilla took office in 2013 and has forcefully responded to these unprecedented fiscal challenges in an effort to achieve long-term fiscal sustainability. Within two years of taking office, the administration has materially reduced budget deficits by raising revenues and cutting expenses; has imposed unprecedented cost-control measures at the central government and public corporation levels; has established limits on government payroll (as of November 2014, there were 92,842 government employees paid from the General Fund, compared to 139,640 in 2008); has implemented comprehensive pension reform; has imposed loan origination discipline at the GDB; has completed and is actively exploring public-private partnerships; and has reformed rates at certain public corporations. The federal government has shown continued support for the difficult measures that the Garcia Padilla administration has taken to address long-term fiscal sustainability in Puerto Rico, and we look forward to having continued support from all levels of the federal government as we address many of the remaining challenges that lie ahead.

One critical component of the administration's commitment to fiscal sustainability is ensuring that Puerto Rico's public corporations can become self-sufficient and are no longer dependent on voluntary contributions by the GDB or the central government for their financing needs. The public corporations, which are government-owned municipal instrumentalities, are essential to the wellbeing of residents because they provide basic public services including water and wastewater services, electric power, and transportation. Three of the most critical public corporations in Puerto Rico are: (1) the Puerto Rico Electric Power Authority (often referred to as "PREPA"), which provides substantially all of the electricity to residents and businesses in Puerto Rico; (2) the Puerto Rico Aqueduct and Sewer Authority (often referred to as "PRASA"), which provides 97% of the water and 59% of the wastewater services to residents in Puerto Rico;

and (3) the Puerto Rico Highways and Transportation Authority (often referred to as "PRHTA"), which is responsible for highway construction and maintenance on the island.

The public corporations, like all municipal utilities, charge fees associated with their services. Because Puerto Rico is an island, the cost of providing these services is often much higher than in the mainland United States. In November 2014, for example, utility customers in Puerto Rico paid more than twice the national average per kilowatt hour for electricity. Nonetheless, these public corporations have had chronic budget deficits in recent years resulting, in part, from population and economic decline. In 2012-2013 alone, the combined deficit of PREPA, PRASA, and PRHTA was over $800 million. Public corporations have historically financed their deficits by relying on the central government in Puerto Rico; on loans from GDB or private sector banks; and on capital market financings. These recurring deficits ballooned the debt of these three public corporations. The deficits, when combined with borrowings for infrastructure projects, have left these three public corporations with over $20 billion in debt.

Certain of these public corporations currently lack market access and have been shut out from private bank financing. Neither the central government nor GDB has the liquidity to shore up deficits or finance necessary capital expenditures at these public corporations. Meanwhile, Puerto Rico's infrastructure, including its power generating plants and electricity distribution network, are outdated and inefficient and require substantial capital investment. Addressing fiscal problems associated with Puerto Rico's public corporations is not only a necessity from a public welfare and safety perspective but it is a critical piece of any strategy for long-term economic growth, fiscal sustainability, and prosperity in Puerto Rico. Unlike many island economies, Puerto Rico's manufacturing sector is the largest sector of Puerto Rico's economy. It also pays the highest wages. To retain and grow this sector, Puerto Rico needs to remain competitive including being competitive when it comes to providing basic services such as power, water and transportation. The cost of these essential services are important contributing factors to employers' decisions to come to or remain on the island.

The Debt Enforcement and Recovery Act

Research and experience shows that investors, creditors and others doing business with Puerto Rico and its instrumentalities need to have more certainty in dealing with the island's current financial situation, including the establishment of an orderly and consensus-based process for addressing outstanding debt at the public corporations. Prior to June 2014, there was no legal regime allowing Puerto Rico's public corporations to adjust their debt or handle creditor claims in an orderly manner. Our public corporations are not eligible to reorganize under Chapter 11 of the U.S. Bankruptcy Code because they are governmental instrumentalities, and they are not eligible to adjust their debts under Chapter 9 because Puerto Rico is expressly excluded from the U.S. Bankruptcy Code's definition of "State" for purposes of Chapter 9 eligibility.

In response, the Puerto Rico Legislative Assembly adopted the Puerto Rico Public Corporation Debt Enforcement and Recovery Act (No. 71-2014) (the "Recovery Act") in June 2014 to allow public corporations to address their fiscal problems while protecting the collective interest of all of their constituents, including bondholders and other creditors, as well Puerto Rico's residents and businesses who depend on these corporations for the essential services they provide. The Recovery Act fills a gap left by the U.S. Bankruptcy Code and is designed and intended to permit Puerto Rico's public corporations to adjust their debt in an orderly process—with creditor input and court supervision—much like Chapters 9 and 11 of the U.S. Bankruptcy

Code. The Recovery Act also ensures that provision of essential public services to Puerto Rico's residents will not be interrupted in the event of a fiscal emergency at one of the public corporations. The Recovery Act is designed to protect the collective interests of creditors by including supermajority voting requirements and minimum recovery levels.

Immediately after the passage of the Recovery Act, two groups of PREPA bondholders filed suit, seeking judgments declaring the Recovery Act unconstitutional. On February 6, 2015, the U.S. District Court for the District of Puerto Rico enjoined enforcement of the Recovery Act, holding that the Recovery Act is unconstitutional because it is preempted by section 903 of the U.S. Bankruptcy Code, which the court concluded prevents Puerto Rico from passing a law allowing its public corporations to adjust their debts through a composition. I do not think it is appropriate for me to discuss the specifics of pending litigation, or the reasons for our belief that the Recovery Act is not precluded by section 903 of the U.S. Bankruptcy Code. I note for the record, however, that both the Government of Puerto Rico and the GDB disagree with this decision, which is being appealed to the U.S. Court of Appeals for the First Circuit, and do not agree that section 903 preempts the Recovery Act. Ultimately, we believe we will be successful on appeal, but there would be no need for the Recovery Act if the U.S. Bankruptcy Code is amended so that Chapter 9 applies to Puerto Rico.

In any event, the practical and unfortunate result of the District Court's decision is that there is currently no available legal regime for Puerto Rico's public corporations to adjust their debts through a consensus-based, court-supervised process—either under the U.S. Bankruptcy Code or Puerto Rico law. In this respect, Puerto Rico is treated differently from every state in the United States, each of which may utilize Chapter 9 if the respective state legislature so authorizes. Puerto Rico's exclusion from Chapter 9 is the result of an amendment adopted by

Congress in 1984. There is very little legislative history regarding that amendment and nothing that would suggest an intent to deprive Puerto Rico's public corporations of the ability to reorganize and adjust their debts under court supervision.

Leading bankruptcy academics, such as Professors David Skeel of the University of Pennsylvania and Stephen J. Lubben of Seton Hall University, have noted that there is no justification for this exclusion and have suggested that Congress fill the legislative gap in the U.S. Bankruptcy Code to dispel the uncertainty that Puerto Rico faces by permitting Puerto Rico—like each of the 50 states—to opt into Chapter 9. In fact, Professor Lubben wrote last fall in an American Bankruptcy Law Journal article that: "The logic behind excluding Puerto Rico from chapter 9, to the extent it did, no longer makes sense. In a perfect world, Congress would quickly allow Puerto Rico's public corporations to file chapter 9 bankruptcy petitions."

Consequences of Having No Legal Regime to Adjust Debts

The unavailability of any feasible legislative option other than the Recovery Act to adjust debts of Puerto Rico's public corporations—such as under Chapter 9 of the U.S. Bankruptcy Code—has created an environment of uncertainty that makes it more difficult to address Puerto Rico's fiscal challenges and threatens Puerto Rico's economic future. I would like to share with the subcommittee some of the unfortunate consequences of this predicament.

First, the credit markets require a risk premium to compensate for uncertainty in the market. This in turn will make it more expensive for all Puerto Rico issuers—particularly at the Commonwealth level—to borrow money in the future at a time that Puerto Rico seeks to contain costs and lower expenses (some of Puerto Rico's general obligation bonds currently yield over 10%). This consequence has already been evidenced by credit downgrades that followed the invalidation of the Recovery Act. Standard & Poor's downgraded Puerto Rico's general obligation and appropriation debt to three notches below investment grade (from 'BB' to 'B'), and it downgraded GDB's long- and short-term credit ratings even further into speculative grade territory ('BB-/B' to 'B-/C'). Standard & Poor's also put GDB on negative outlook and even stated in a report published on February 12, 2015 that "Puerto Rico has experienced and will continue to face a major reduction in its ability to obtain external liquidity at a reasonable cost, as evidenced by GO bond yields topping 10%, following a lower court decision invalidating its debt restructuring law. As a result, Puerto Rico's access to cash flow financing necessary for the next fiscal year could be severely constrained in our opinion." Other ratings agencies have followed suit, having recently downgraded various Puerto Rico issuers further into speculative grade territory.

Moreover, and perhaps most critically today, the lack of a clear debt adjustment mechanism negatively affects investor appetite for Puerto Rico's upcoming bond issuance, which the GDB views as necessary to provide the central government and GDB with liquidity. Indeed, the failure to complete a financing transaction could severely impact GDB's ability to support the central government's fiscal adjustment plan and continue acting as its lender of last resort. By way of background, Puerto Rico has not accessed the credit markets for long-term debt in twelve months and will need to do so in the near future. Accordingly, Puerto Rico's Legislative Assembly approved legislation in December 2014 authorizing the Puerto Rico Infrastructure Finance Authority, which is sometimes referred to as "PRIFA," to issue up to $2.95 billion in secured, Commonwealth-guaranteed bonds that would be collateralized by new taxes on oil. The proceeds of that bond issuance would be used, in part, to refinance $2.2 billion that the Puerto Rico Highway Transportation Authority owes to GDB. The invalidation of the Recovery Act may reduce investor appetite for these new bonds or require a risk premium that makes the issuance materially more expensive or prohibitive.

Second, the lack of a clear debt adjustment mechanism undermines the Administration's objective of making public corporations self-sufficient and financially independent from the central government. This objective, which was announced one year ago as part of the administration's plan to promote long-term fiscal sustainability, provided confidence to the capital markets that Puerto Rico had a plan to address the fiscal health of its public corporations while also ensuring investors that the public corporations would not jeopardize the fiscal health of the central government. This policy played an integral role in allowing Puerto Rico to raise $3.5 billion in the capital markets in March 2014. But the GDB has already seen signs that confidence in this objective has begun to erode as bond prices for the public corporations increased and bond prices for Puerto Rico's general obligation bonds decreased upon the invalidation of the Recovery Act.

Third, the lack of a clear adjustment option depresses economic growth in Puerto Rico generally, and it makes long-term investment and capital expenditure plans at the public corporations nearly impossible. In fact, the International Monetary Fund, the World Bank, and the Organisation for Economic Co-operation and Development have acknowledged that insolvency regimes promote financial stability, investment, and growth. In its publication entitled *Orderly & Effective Insolvency Procedures* (1999), the International Monetary Fund articulates that there is no reason to exclude municipalities:

> [I]t is universally recognized that sovereign nations are not subject to any insolvency law, international or national. Local government entities, such as municipalities, may be excluded from the scope of the insolvency law altogether or the law may establish a special regime for them. While the treatment of government-owned entities may also vary, there appears to be no reason why such an enterprise operating in the market place

> as a distinct entity should be excluded from the coverage of the general insolvency law unless the government has extended an explicit guarantee with respect to all its liabilities. [T]he inclusion of a government-owned enterprise within the scope of the insolvency law has the advantage of both subjecting the enterprise to the discipline of the market place and sending a clear signal that government financial support will not be unlimited.

Debt-adjustment tools, like those found in Chapter 9, provide significant economic benefits to public instrumentalities but also to creditors because legal regimes provide predictability. The uncertainty surrounding the high level of debt held by Puerto Rico governmental entities is an impediment to the very sort of economic activity that is fundamental to Puerto Rico's economic recovery, namely private investment. Until a legal regime for adjusting Puerto Rico's debt is available, this uncertainty will loom large and investors will be hesitant to invest capital.

Finally, if the public corporations default on their obligations and there is no clear legal regime, creditors may attempt to engage in a race to the courthouse and exercise remedies that include attempting to appoint a receiver and, in PREPA's case, filing a rate case before Puerto Rico's Energy Commission seeking to raise utility rates beyond their current levels. This could trigger years of litigation, exacerbate liquidity pressures at these public entities and have adverse consequence on economic growth, which only exacerbates Puerto Rico's overall fiscal situation. Creditors would be in a worse position than they would be in under an orderly, consensual process. Suppliers could refuse to deliver critical supplies as a result of the legal uncertainty surrounding a public corporation's default – this is particularly true in the case of PREPA, which relies on fuel as the primary source of energy to generate electricity on the island. This scenario would certainly be value-destructive for all stakeholders, including creditors, the residents of Puerto Rico, and the public corporations themselves.

Extending Chapter 9 to Puerto Rico Will Provide Measured Benefits

I would like to stress to the subcommittee that no decision has been made as to whether any public corporation intends to file under Chapter 9 were it to become available and the Commonwealth of Puerto Rico and the GDB see Chapter 9 only as an option of last resort. In any event, Chapter 9 would not apply to debt issued directly by the Commonwealth of Puerto Rico. This is because "States," which would include Puerto Rico if H.R. 870 passes, are not eligible for protection under Chapter 9.

Chapter 9 establishes a legal regime that is already understood by the capital markets, creditors, prospective lenders, and suppliers. It would provide an orderly process, requires the public corporation to negotiate in good faith, creates an environment to reach consensus and allows the process to be supervised by an experienced court. Chapter 9 has also been tested on many occasions, including in Detroit, Michigan, Stockton, California, and Jefferson County, Alabama, just to name a few. The National Bankruptcy Conference, comprised of leading bankruptcy scholars as well as current and former judges throughout the country, has stated that extending Chapter 9 to Puerto Rico would provide courts and parties with importance guidance. Fitch Rating has said that extending Chapter 9 to Puerto Rico would offer benefits, including the avoidance of protracted litigation and uncertainty, and would put Puerto Rico on equal footing with the 50 states. Legal precedent under Chapter 9 will give debtors and creditors a useful roadmap that offers more certainty as to their substantive rights and expected procedures. Public corporations in Chapter 9 would be permitted to obtain debtor-in-possession financing and use cash collateral under well-tested procedures, permitting the continuation of normal operations and the provision of essential public services to Puerto Rico's residents. Finally, any Chapter 9 proceeding would be overseen by a U.S. Bankruptcy Judge that has expertise in insolvency matters and that would be approached as an independent arbiter to all parties in interest. The virtue of Chapter 9 can be seen in the Chapter 9 cases of Detroit, whose adjustment proceedings lasted less than 18 months, and Stockton, whose adjustment proceedings lasted less than two years.

Accordingly, Commonwealth of Puerto Rico and the GDB believe that passage of H.R. 870 will prove to be a useful tool for Puerto Rico's long-term economic success, whether or not it is actually invoked.

I would like to thank the subcommittee for giving the Commonwealth of Puerto Rico and the GDB the opportunity to participate in this hearing.