

# **Bond Case Briefs**

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## **Puerto Rico Commission Raises Red Flags on PREPA's 2013 Bond.**

A Puerto Rico government commission report raised concerns over debt-service coverage, illegalities, disclosures and accounting issues regarding \$673 million of bonds issued by the island's power utility in 2013.

Puerto Rico Commission for the Comprehensive Audit of the Public Credit raised concerns over the 2013 Puerto Rico Electric Power Authority bonds in its second report under its mandate to look into the legality of the island's \$70 billion of public debt. The report focused on the Aug. 7, 2013 sale of 2013A power revenue bonds. It also looked at the role of Morgan Stanley, Ernst & Young, and URS Corp. in the sale and the period leading up to the sale.

The bonds have several maturities, with the longest, 2043, having sold with a 7.15% yield to maturity. The bonds were sold as callable at par in 2023.

Reports from the commission will "be the base for negotiating with the bondholders," said David Rodriguez Ortiz, president of the Puerto Rico Chamber of Commerce and a certified public accountant. The commission will find invalid debt, he said. The work of the commission may also let bond holders file claims against those that prepared official statements or others involved with the bond issues.

The commission released its first report in June, a review of documents connected with the commonwealth's \$3.5 billion general obligation bond sale and \$1.2 billion tax and revenue anticipation note in 2014. Through the earlier review it raised doubts on the legality of much of Puerto Rico's bond debt, now due to be restructured under the supervision of a federally appointed control board that had its first meeting last week.

In the commission's latest report, released at the end of September, the commission looked at the next-most-recent Puerto Rico municipal bonds. Since the commission didn't have funding to hire auditors, it couldn't determine if the sale met with U.S. General Accounting Standards, and dubbed the document a pre-audit survey report.

The pre-audit raises six groups of questions about PREPA and the others involved in the sale.

Puerto Rico covenanted in its trust agreement to adjust electrical rates so that net revenues would provide at least 120% of the aggregate principal and interest due in the following fiscal year. During some years PREPA included uncollected electricity charges in net revenues. This practice helped make the authority's debt service coverage appear higher than it was.

If one excluded uncollected revenues, the authority met or would meet the 120% requirement only once in the five years prior and five years following the 2013 bond sale.

The report says an auditor would be needed to determine with certainty if the uncollected revenues should have been included in PREPA's debt service calculations.

The pre-audit states that SEC Rule 15c2-12 bars underwriters from selling bonds unless they know that the issuer will provide the Municipal Securities Rulemaking Board with annual financial statements in a timely fashion. Yet PREPA repeatedly published financial statements after the due date. The commission asked if the underwriter, Morgan Stanley, should have known that the authority was unlikely to have met its disclosure obligations.

PREPA's performance auditor, URS Corp., was involved with the sale of the bonds. The report says that the Sarbanes-Oxley Act "provides that it is unlawful for auditors to provide services outside the scope of practice of auditors."

The report says that PREPA may have used unrealistically optimistic assumptions in the sale. For example, the authority projected sales increases for all the following five years, without describing the assumptions for this forecast. The projection may have been unrealistic given the island's prolonged economic contraction and population decline.

The bond's official statement also projected that PREPA could sell an additional \$1.1 billion worth of bonds for its five year capital improvement program.

Finally, the report raises questions about the performance of PREPA's auditor, Ernst & Young. The authority's 2012 Audited Finance Statement prepared by Ernst & Young didn't adjust the authority's \$6.5 billion plant property and equipment for the effects of environmental regulations. The report states that the Government Accounting Standards Board Pronouncement 42 appears to require the value to be offset by the roughly \$1 billion regulatory impact.

Additionally, the Ernst & Young opinion failed to include a "going concern" warning "despite recurring severe liquidity stress that PREPA was encountering at the time the 2012 audit report was issued."

"Less than six months after [Ernest & Young] issued its opinion on PREPA's 2012 financial statements, PREPA was technically in default of its bond covenant," the report states. Yet in Ernest & Young's 2013 audit report on PREPA, released in January 2014, Ernst & Young continued to not include a "going concern" statement, the report notes.

PREPA, Ernst & Young, and URS, through its new parent company AECOM, didn't respond to requests for comments. Morgan Stanley declined to comment.

## **The Bond Buyer**

By Robert Slavin

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