PREPA Ex. 2.0

COMMONWEALTH OF PUERTO RICO
PUERTO RICO ENERGY COMMISSION

IN RE: THE PUERTO RICO ELECTRIC POWER AUTHORITY	**No.** CEPR-AP-2015-0001
INITIAL RATE REVIEW	**SUBJECT:** TESTIMONY IN SUPPORT OF PETITION

Direct Testimony of

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AlixPartners, LLP

and

Chief Restructuring Officer,

Puerto Rico Electric Power Authority

on behalf of the

Puerto Rico Electric Power Authority

May 27, 2016

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I. INTRODUCTION

A. Witness Identification

Q. Please state your name, title, employer, and business address.

A. My name is Lisa J. Donahue. I am a Managing Director and the leader of the Turnaround and Restructuring Practice at AlixPartners, LLP, a global business and advisory firm. I have also served as the Chief Restructuring Officer ("CRO") of the Puerto Rico Electric Power Authority ("PREPA" or the "Authority") since September 2014. My business address is 909 3rd Ave, New York, New York 10022.

Q. Please describe your role at PREPA.

A. PREPA's Governing Board selected and appointed me as PREPA's Chief Restructuring Officer in September 2014. I work alongside PREPA's management. I report to the Governing Board and serve at their discretion. I lead a team of approximately 15 colleagues that are working on various cost saving initiatives and also assisting me in carrying out my duties as CRO.

As CRO, my fundamental role is to lead the development and implementation of a holistic recovery plan that allows PREPA to serve the people of Puerto Rico more efficiently, reliably, and at a reasonable cost. The recovery plan, at the highest level, involves two tasks: (1) addressing the fundamental operational problems that have hindered PREPA for decades and (2) financial restructuring in light of PREPA's debt and liquidity crises.

With respect to the first task, my mandates include providing overall leadership to PREPA's restructuring process, which includes:

- developing a business plan;
- implementing revenue improvement and cost reduction plans;
- overseeing cash and liquidity management activities;
- improving PREPA's ability to analyze, track, and collect accounts receivable;
- improving PREPA's capital expenditure plan; and
- developing plans to improve PREPA's generation, transmission, distribution, and other operations.

This task has involved seven workstreams: governance / organization, a new business plan, the capital structure, the rate structure, the legislative / regulatory framework, operational improvements, and communication with stakeholders. Since my appointment as CRO, PREPA has made significant strides to improve its operations, lower its operational costs, and remedy many of its longstanding challenges. PREPA continues and will continue to work on those issues.

With respect to the second task, we have had to focus both on PREPA's significant debt burden and on its serious liquidity issues. In the summer of 2014, negative cash flows, the ongoing recession, outdated generation facilities, and its inability to access capital markets led to debt and liquidity crises that threatened PREPA's ability to operate, including its ability to purchase fuel to run its power plants and thus to keep the lights on in Puerto Rico. At that time, PREPA faced maturity of approximately $735 million in revolving credit lines and $400 million in principal and interest payments due under its power revenue bonds. In August 2014, as a first step in addressing PREPA's severe financial distress, PREPA negotiated forbearance agreements with key financial and fuel line creditors to kept PREPA afloat. The forbearance agreements were not a long-term solution to PREPA's financial problems. Rather, they simply gave PREPA some breathing room and flexibility to negotiate and start implementing a comprehensive recovery plan for PREPA.

As CRO, I have led PREPA's negotiations with creditors holding, in the aggregate, about 70% of PREPA's debt. The negotiations have culminated in a lengthy and detailed Restructuring Support Agreement (as amended or restated from time to time, the "RSA"), which provides for the restructuring of PREPA's financial debt subject to the satisfaction of certain conditions and milestones. The foundation of the RSA is PREPA's recovery plan, which requires equitable burden sharing by all stakeholders, including PREPA's management and employees through labor and operational savings, governments and municipalities through timely payment of energy bills and reform of the CILT system, and PREPA's creditors through creating a sustainable capital structure. Throughout this process, we have been very clear that PREPA's recovery plan cannot be built solely on the backs of ratepayers. It must be an equitable process with shared burdens and shared benefits.

Q. **On whose behalf are you testifying?**

A. I am testifying on behalf of PREPA.

B. <u>Summary of Direct Testimony and Attachments</u>

Q. **What are the purposes and subjects of your direct testimony?**

A. My testimony begins with a discussion of PREPA's financial and liquidity situation and how it must be addressed, particularly how it relates to this rate review. PREPA faces severe debt and liquidity crises. PREPA currently has approximately $550 million in cash, including approximately $146 million held in Government Development Bank accounts that are currently subject to a moratorium. PREPA has debt obligations of approximately $9 billion, including approximately $1.3 billion in principal and interest that will be due on July 1, 2016 under its existing revolving credit lines and power revenue bonds. As a result, absent a successful financial restructuring and addressing the liquidity issues, no version of PREPA, no matter how much its operations are improved, can succeed.

I also discuss the efforts to restructure PREPA's debt, and how this rate review addresses the debt and liquidity issues. Over the long term, the debt crisis can be addressed by consummating the transactions contemplated by the RSA. Implementing these transactions, however, will take several months. For example, the Commission will need to approve the calculation methodology and the adjustment mechanism for the Transition Charge, the validation proceedings contemplated by the Revitalization Act will need to be completed, and the exchange of debt for new securitization bonds will need to be completed successfully, and the new PREPA Revitalization Corporation will need to begin charging and collecting the Transition Charge.

I next discuss PREPA's immediate liquidity crisis that requires immediate action. This cannot wait for the completion of the RSA transactions, or even until approval of a "permanent rate." To address PREPA's liquidity crisis, PREPA is requesting approval of the proposed rates on a provisional basis in accordance with the PREPA Revitalization

Act. I also am submitting a separate piece of direct testimony regarding PREPA's liquidity issues in support of PREPA's request for provisional rates (PREPA Ex. 11.0). Other witnesses testifying for PREPA also discuss and support the proposed provisional rates.

Finally, I discuss PREPA's longstanding challenges and what PREPA and my team are doing to face those challenges, including work on the recovery plan, which includes the Business Plan. The challenges have included, among other things, significant operational deficiencies and the failure to implement best industry practices and the influence of political considerations that have negatively affected PREPA's ability to make effective long-term strategic and management decisions. PREPA and my team have been working for the better part of two years to develop the recovery and business plans, improve PREPA's operations, lower its operational costs, and address those challenges. We have made great progress, but we are far from done. Executing PREPA's transformation will require continued operational improvements, broad organizational change, and a new strategic direction. Our task is to transform PREPA for the benefit of the people and businesses of Puerto Rico and in doing so we must learn from PREPA's historical experiences that led to its state of crisis. Other witnesses for PREPA discuss and support that PREPA's proposed new rates give customers the benefits of the recovery work, including actual and estimated costs savings.

Q. **Does your testimony comply with Sections 2.17(c), 2.02(B) and (E) of the Commission's rules as you understand them?**

A. Yes. I have been advised that the Commission's Regulation No. 8720, Section 2.17(C), requires either PREPA's Chief Executive Officer or its CRO, or both, to submit direct testimony concerning whether PREPA's revenue requirement includes any costs that are not prudently or reasonably incurred. My work as CRO has not involved a formal, in-depth, "prudence investigation" of PREPA's actions over the past decades. Such an investigation would be beyond the scope of the mandate approved by PREPA's governing board and would be an extraordinarily time-consuming and expensive process that would impose demands on personnel who are needed to implement the recovery plan. In addition, because the subject involves a large entity over decades, and the factors that affect its operations are multitudinous and interrelated, it would be very difficult to quantify the total net effects of each of the various challenges that have faced PREPA. That being said, our work has involved recognizing PREPA's challenges, and reviewing in detail how PREPA operates, how those operations can be improved and their costs reduced, and how those challenges can be met, as I indicated above. My testimony on those subjects is intended to comply with Section 2.17(C). I understand that PREPA also is submitting cost "benchmarking" testimony (the direct testimony of Lawrence Kaufmann, Senior Advisor, Navigant Consulting, Inc., PREPA Ex. 6.0) that also sheds light on that subject.

I also understand that the Commission's Regulation No. 8720, Section 2.02(B), contains language regarding the prudence and reasonableness of costs addressed by a witness. My testimony is intended as high level and background testimony, not as detail on the specifics of PREPA's revenue requirement, and is intended to comply with Section 2.17(C) as noted above. Nonetheless, to the extent applicable, I can state from my perspective as CRO that it is my professional view that the costs sought to be incurred through PREPA's proposed rates generally are reasonable and prudently incurred, but that such conclusion must be tempered by my testimony about PREPA's challenges and recovery. I cannot directly quantify the total net effects of if or how each of the challenges faced by PREPA historically has affected its operational costs, or affects its current costs, but it would be unrealistic to believe that there have been no effects. However, we have agreed upon a debt restructuring that, when implemented, would reduce PREPA's costs of debt, and as part of the recovery plan we have estimated significant cost savings in operations that can be achieved. Those cost reductions to some extent may shed light on how past challenges have affected costs, although I do not mean to suggest or imply that they are a measure of past imprudence. They are not. The cost reductions also reflect improved practices and new opportunities. Not every action that is not optimal is imprudent. .

Finally, I also understand that the Commission's Regulation No. 8720, Section 2.02(E), requires separation of testimony supporting provisional rates, although it allows that testimony to refer back to the testimony supporting permanent rates. My direct testimony in PREPA Ex. 2.0 is intended to support the request for new "permanent" rates, but portions of it also may be referenced in support of the request for provisional rates. Also, again, I am submitting a separate piece of direct testimony regarding PREPA's liquidity issues in support of PREPA's request for provisional rates (PREPA Ex. 11.0).

Q. **What are the attachments to your direct testimony?**

A. Attached to my direct testimony is my *curriculum vitae* as Exhibit 2.01.

C. Qualifications and Professional Background

Q. Please describe your educational background and professional experience.

A. In addition to serving as CRO of PREPA and as a Global Head of the Turnaround and Restructuring Practice at AlixPartners, I have served as a senior executive at several energy companies, most recently as Chief Financial Officer at Atlantic Power Corporation, a publicly traded power and infrastructure company. Prior to that, I served as Executive Vice President and Chief Financial Officer at Calpine Corporation, an energy company with operations in several North American countries, and as the Chief Restructuring Officer at SemGroup, L.P., a mid-stream oil & gas, pipeline, storage, and commodity trading company. My professional education includes a Bachelor of Science (B.S.) degree in Finance from Florida State University. My complete *curriculum vitae*, which reviews my education, professional qualifications, and experience in detail, is attached as PREPA Ex. 2.01.

II. PREPA'S FINANCIAL SITUATION AND THE RELATIONSHIP OF THIS RATE REVIEW TO THE PROPOSED FINANCIAL RESTRUCTURING

Q. Is the restructuring of PREPA's debt before the Energy Commission for approval in the instant review?

A. No. However, the debt restructuring and this rate review are related in several ways, as I will explain below.

Q. What is the genesis of the efforts to restructure PREPA's debt?

A. Utility rates that do not keep up with costs of service are not sustainable. Over time, insufficient rates tend to drive up a utility's costs of capital, and at some point a utility will become unable to access capital at a reasonable cost, if at all. During the past several decades, PREPA's rates did not keep pace with its cost of service. In fact, PREPA's base rates have not been updated since 1989. By 2015, it was estimated that, all else being equal (absent concessions from creditors and operational improvements), the difference between PREPA's costs and what it was charging was between 7.8¢ and 10.99¢ per kilowatt hour ("kWh"). This range depends on whether you examine 2017-2019 averages and assume the fuel line creditors would accept a 3-year amortization schedule, or you examine just 2017 and assume that the entire fuel line would be due in that year.[1] Not surprisingly, therefore, for many years PREPA borrowed to make up for the shortfall in cost recovery through rates. The money to run PREPA had to come from somewhere and there was a market of investors willing and able to invest in PREPA debt.

In addition, the current design of PREPA's rates diverges significantly from PREPA's actual costs of serving its Customers. Fixed and variable charges do not correspond to fixed and variable costs and often chronically under recover costs. For example, Contributions in Lieu of Taxes ("CILT") which is a subsidy to municipalities recovered through the markup of fuel costs (along with other rate subsidies) has left PREPA unable to cover the costs of CILT and subsidies. This problem has been

[1] Please note that I am not suggesting that PREPA's customers should face rates that fail to reflect concessions from creditors and that fail to reflect cost savings resulting from operational improvements. Just the opposite is true. Closing the gap is something that needs to be achieved in an equitable manner by all stakeholders, including PREPA, the creditors, and customers.

exacerbated as fuel costs have dropped. CILT alone has approximately $48 million and $78 million in FY2014 and FY2015 respectively of unrecovered subsidies.

Lacking sufficient rates, PREPA incurred substantial debt to fund capital expenditures and, in the case of the revolving credit lines, certain operating expenses. Over time, PREPA's ability to access the capital markets on reasonable terms dried up. As a consequence, PREPA's ability to fund essential investments was compromised and those investments that were made had to be funded from current operating revenues. This ultimately threatened PREPA's ability to satisfy its obligations to creditors and to provide safe and reliable service to its customers.

As I discussed earlier, although the problems have existed for many years, the crisis really hit PREPA in the summer of 2014. At that time, negative cash flows (reflecting the insufficient rates), the ongoing recession, outdated generation plants, and PREPA's lack of access to capital markets led to financial and liquidity crises that threatened its ability to operate, including its ability to purchase fuel to run its power plants and thus to provide electricity to Puerto Rico.

In August 2014, as a first step in addressing such crisis, PREPA negotiated forbearance agreements with key financial and fuel line creditors. The forbearance agreements were not a long-term solution. Rather, they afforded PREPA necessary breathing room and flexibility to work on real solutions. In fact, given PREPA's severe liquidity position at the time, the forbearance agreements permitted PREPA to use construction reserve funds for operating purposes. That is not a sustainable strategy. An operating entity cannot make a long-term practice of using funds designated for critical capital projects to instead fund operations. In addition, the forbearance agreements excused PREPA from the obligation to make monthly sinking fund payments to the bond debt service reserve fund totaling approximately $600 million annually. Absent this relief, PREPA would have run out of money several months ago. As is customary, the forbearance agreements imposed a number of obligations and milestones on PREPA, including an obligation to retain a CRO to be chosen by the governing board.

The forbearance agreements were extended as we continued to work with all stakeholders to develop a recovery plan to transform PREPA into a modern self-sustaining utility. The continued forbearance allowed us the time required to develop the business plan, generate initial savings and ultimately negotiate the Recovery plan that became part of the Restructuring Support Agreement (RSA) that exists today.

That, in brief, is the situation that led to the creation of the position of CRO, and to my work together with PREPA on the financial crisis and the recovery of PREPA as an operating entity.

Q. **What is the magnitude of the current debt and liquidity issues?**

A. As I previously noted, PREPA has debt obligations of approximately $9 billion, including approximately $1.3 billion in principal and interest that will be due on July 1, 2016 under its existing revolving credit lines and power revenue bonds. PREPA currently has approximately $550 million in cash, including $146 million that is held in GDB accounts subject to a moratorium. PREPA has exhausted all of its debt service reserves because it has not been able to make any monthly sinking fund payments since late 2014. Thus, PREPA faces a liquidity crisis as well as a debt crisis. PREPA cannot meet its immediate financial obligations absent a financial restructuring and transformative change. Indeed, without action to restructure PREPA's debt and reduce its immediate cash flow burdens, PREPA faces a funding gap of more than $700 million as of July 1, 2016. PREPA also faces the need to replenish its self-insurance fund, which helps protect PREPA against unexpected needs, *e.g.*, extraordinary maintenance and repair costs following a hurricane. As the Legislative Assembly concluded in adopting the Revitalization Act, PREPA's financial situation requires immediate action if it is to achieve financial solvency and meet its obligations in a manner that is orderly and satisfactory to all its stakeholders.

Q. **Has PREPA negotiated with its creditors in an effort to gain concessions and arrive at a plan that could allow for PREPA's revitalization?**

A. Yes. In light of its financial situation, PREPA negotiated with major creditors to arrive at a broad, consensual financial settlement that addresses both PREPA's financial and operational challenges. The Legislative Assembly also has played a role in the debt restructuring through the passage of the Revitalization Act.

Since entering into the forbearance agreements with its key creditors in August 2014, PREPA has negotiated extensively with its creditors with the ultimate goal of reaching agreement on a comprehensive restructuring plan that addresses both PREPA's financial and operational challenges. The lack of an available legal framework within which to restructure its debts has complicated and extended PREPA's negotiation process. At this point, PREPA has no ability to compel anyone to agree or even participate in the process. Therefore, the overall solution, which must be consensual, has to be fair, balanced and holistic.

In particular, PREPA has negotiated with major creditors and entered into the Restructuring Support Agreement (RSA) with creditors holding or insuring approximately 70% of the face amount of PREPA's outstanding financial indebtedness including the Government Development Bank for Puerto Rico ("GDB"), beneficial owners and insurers of existing PREPA bonds, banks (and their transferees) that had provided revolving lines of credit used to pay for fuel and other expenses (collectively, the "Supporting Creditors"), and others. In the RSA, an *ad hoc* group of PREPA's bondholders and insurers, PREPA's fuel line credit lenders, and the GDB have agreed to support a revitalization plan for PREPA that includes significant financial concessions for the benefit of PREPA specifically and Puerto Rico generally.

The Revitalization Act, as I noted earlier, created the Revitalization Corporation to help implement the restructuring. The Revitalization Corporation now also is a party to the RSA, and is to be the issuer of the new securitization bonds that are essential to accomplishing the debt restructuring. A copy of the RSA is attached hereto as PREPA Ex. 2.02.

Q. **What are the economic terms of the RSA?**

A. This is an over-simplification, but, in brief, the key economic terms of the RSA involve: (1) holders of uninsured bonds exchanging their existing outstanding bonds for new securitization bonds at 85% of the face value of their existing bonds, with a 5-year principal holiday and a fixed interest rate that is lower than the rates of the existing bonds; (2) fuel line credit lenders agreeing to one of two options, either converting their existing credit agreements into term loans, with a fixed interest rate, to be repaid over six years, or exchanging some or all of the principal due to them for securitization bonds on the same terms as those for holders of uninsured bonds; and (3) bond insurers agreeing to issue surety insurance policies to support a portion of the debt service reserve fund for the securitization bonds.

Those economic terms, however, are not the end of the story under the RSA. There are many noneconomic contingencies that must be met under the RSA, most of which are not a part of the instant rate review. Those contingencies include, among others, consent by holders of $2 billion of the $2.7 billion in bonds that are not currently parties to the RSA, the appointment of a new independent board for PREPA, approval of the calculation methodology and true-up mechanism for the Transition Charge, obtaining an investment grade rating for the new securitization bonds, successful completion of the validation proceedings with respect to the Revitalization Act and the issuance of the new securitization bonds, and the continuing implementation of operational reforms leading to cost savings. All of those contingencies are works in progress. Failure to meet any of the milestone and other conditions precedent could result in termination of the RSA and the loss of nearly $1.4 billion in liquidity savings and debt reductions embodied by the RSA.

Several important contingencies, however, have already been satisfied. For example, the enactment of the PREPA Revitalization Act, Act 4-2016 (the "Revitalization Act") is a condition to the obligations under the RSA that has been satisfied. The legislation includes, among other things, the creation of the PREPA Revitalization Corporation (the "Revitalization Corporation") to issue the securitization bonds, and provisions for the payment of those bonds through Transition Charges to be collected by PREPA (as a servicer), and for an associated Adjustment Mechanism (a reconciliation mechanism). The revenues collected by PREPA under the Transition Charges are the property of the Revitalization Corporation, not of PREPA. On April 7, 2016, the Revitalization Corporation filed a petition with the Puerto Rico Energy Commission (the "Commission") to approve the calculation methodology for the Transition Charges and the Adjustment Mechanism. The filing of the Petition, which is now pending in a docket that is separate from the instant rate review, *i.e.*, docket No. CEPR-AP-2016-0001, is also a condition to the RSA.[2] Similarly, the filing of this rate review case, including the approval of the provisional, is a condition to the parties' obligations under the RSA.

In order to implement the restructuring contemplated by the RSA and the recovery plan, this rate review focuses on four major items: (1) establishing new PREPA base rates[3] for electric service that allow PREPA the opportunity to recover its "revenue requirement", *i.e.*, the cost of offering and providing its services covered by its base rates; (2) conforming PREPA's new rates with the Transition Charges and the Adjustment Mechanism, which for practical purposes primarily means that the new rates are reduced to reflect the amounts collected under the Transition Charges; (3) making sure that the new rates reflect the benefits of the debt restructuring to PREPA's customers; and (4) establishing a formula rate mechanism that will update PREPA's rates on an annual basis, so that PREPA neither over- nor under-recovers its costs of service from its

[2] The Revitalization Corporation's petition is complicated and has many attachments, as required by Article 6.25 of the Revitalization Act. Describing that petition and its subject matter in full in my direct testimony is not required and it would be inappropriate and inefficient. The descriptions in my testimony are only a very brief high level summary intended to give background information and context.

[3] An electric utility's basic rates for electric service, not including charges that are passed through or fluctuate through a tariff rider or other mechanism, often are referred to by the general term "base rates".

customers. These steps will allow PREPA to maintain rates at stable levels significantly below historical highs, and to bring down the cost of energy and reduce rates over time, which are the primary goals of PREPA's restructuring. Other witnesses testifying for PREPA discuss and support that the proposed new rates are designed to meet those four objectives.

Q. **What are the cost savings to PREPA customers associated with these financial concessions?**

A. The creditors' concessions include a permanent deleveraging of more than $600 million of debt principal owed by PREPA, five year liquidity relief of PREPA's debt service obligations of nearly $800 million, and liquidity relief and interest rate savings with respect to fuel line credit facilities.

The debt restructuring involves the issuance of certain securitization bonds by the Revitalization Corporation, as I noted above. Under the Revitalization Act, the Revitalization Corporation may issue those bonds only if, as a result of the issuance of such bonds, the present value of the debt service in respect of all such bonds is at least $725 million lower than the present value of the debt service of all of such PREPA bonds refinanced by such issue of bonds (this is called the "savings test"). The Revitalization Corporation has consulted with its financial advisors and their calculations demonstrate that the present value of the expected debt service in respect to the issuance of the bonds pursuant to the terms of the RSA is at least $725 million lower than the present value of the debt service of all PREPA bonds refinanced by such issue of bonds.

If PREPA had not made any operational improvements, or secured any of these concessions from its creditors, the gap between PREPA's existing rates and the rates the

Authority would need to charge consumers to cover all these costs (*i.e.*, the "rate deficit"), would be would be between 7.8 and 10.99 cents per kilowatt hour ("kWh") and would need to be paid for by the ratepayers. Again, this range depends on whether you examine 2017-2019 averages and assume that fuel lines will accept a 3 year amortization, or whether you just examine 2017 and assume that the fuel lines are due in that year. Our consistent goal has been to share the burden so that no one constituent is unduly impacted by this large existing gap. To the extent that the financial concessions from creditors will be taken into account in PREPA's new rates, they will greatly benefit PREPA's customers as their rates would be lower than the rates that would be applicable if the creditors had not agreed to this debt restructuring.

Q. **What is the status of the debt restructuring as of the time of your direct testimony in this rate review?**

A. The parties have entered into the RSA, which remains in effect. To implement the restructuring contemplated in the RSA requires certain additional actions are required by the Revitalization Corporation and the Energy Commission, including, among other things, the Commission's approval of the calculation methodology for the Transition Charges and the Adjustment Mechanism, which the Corporation has proposed in compliance with the Revitalization Act when it filed the Petition on April 7, 2016, In addition to having filed this Petition, PREPA is continuing to work to implement all aspects of the agreed upon recovery plan, including, by way of example, engaging a search firm to select new independent directors, implementing operational improvements, dealing with credit agencies with respect to the rating of the securitization bonds, participating in the validation proceedings described above and seeking agreement with additional creditors who are not parties to the RSA.

Q. **Why do you state that the restructuring of PREPA's debt is not before the Commission for approval purposes in this rate review?**

A. The specific jurisdiction that the Revitalization Act vests in the Commission with respect to the debt restructuring is prescribed in detail in the statute and that jurisdiction is to be exercised by the Commission in docket No. CEPR-AP-2016-0001 and not in this rate review.

Q. **Why is the debt restructuring relevant to this rate review?**

A. While the debt restructuring is not subject to the Commission's approval as part of this rate review, and many other contingencies needed to implement the debt restructuring do not involve the rate review, the rates to be set here need to "sync up" (be coordinated) with the applicable requirements in the RSA.

In brief, PREPA's new rates must help to effectuate the recovery plan agreed upon in the RSA in four ways. Consistent with Schedule VI to the RSA, PREPA is seeking approval of new rates that will: (1) allow PREPA the opportunity to recover its revenue requirement; (2) conform PREPA's new rates with the Transition Charges and the Adjustment Mechanism, which primarily means that the new rates are reduced by the amounts collected under the Transition Charges; (3) make sure that the new rates reflect the benefits to PREPA's customers of the debt restructuring; and (4) establish a formula rate mechanism that will update PREPA's rates on an annual basis, so that PREPA neither over- nor under-recovers its costs of service from its customers. Again, other witnesses discuss and support that PREPA's proposed new rates are designed to meet those four objectives.

Q. **Will the debt restructuring, if it is achieved, solve PREPA's short-term liquidity crisis?**

A. No. PREPA also needs to address separately its summer 2016 liquidity crisis, because the debt restructuring is not designed to and will not completely solve that problem. The liquidity crisis can be managed only by the Commission also establishing provisional rates for PREPA that are in effect until the new rates begin to be recovered. Again, I also am submitting a separate piece of direct testimony regarding PREPA's liquidity issues in support of PREPA's request for provisional rates (PREPA Ex. 11.0).

III. PREPA'S LONGSTANDING CHALLENGES, AND ITS EFFORTS TO IMPROVE ITS OPERATIONS, REDUCE ITS COSTS, AND ADDRESS THOSE CHALLENGES

Q. **To what extent has your role as CRO of PREPA involved assessing and working on plans to address PREPA's fundamental challenges?**

A. Although negotiating with creditors and working with other stakeholders on PREPA's financial issues has been an essential part of my work as CRO, , the primary focus of my work, and most of my time has been spent on identifying and tackling the fundamental operational problems that have hindered PREPA for decades. This work has involved the development of a recovery plan, and, within that, a business plan, among other steps.

As noted above, our work to develop and implement a recovery plan for PREPA has not involved a formal, in-depth, prudence investigation of PREPA's actions over the past decades. That type of investigation would take a great deal of time, cost the company and the rate payers a great deal of money, and impose very significant burdens on PREPA when its priorities at the moment are to stabilize its operations through addressing its financial issues and making operational improvements. Moreover, even such an investigation would have difficulty producing reliable figures on if and how any specific challenge has affected PREPA's operations. As discussed previously, the issues with PREPA did not materialize overnight or as a result of any one significant decision; but rather through decades of mismanagement and poor decision making. Nonetheless, our recovery work has involved recognizing and working to tackle PREPA's current challenges, and my testimony should be understood as being based on that work.

Q. **Has PREPA faced significant challenges at the governance and strategic levels in recent decades?**

A. Yes. For many years, PREPA has been run by successive Governing Boards and senior management teams that have been subject to the changing direction and policies of different administrations. Management and other strategic decisions, including staffing and capital investment, too often have been based on political considerations rather than best practices or sound business judgment. There have been frequent changes of positions and responsibilities with each electoral cycle. Staffing decisions have been made often without regard for prior experience or expertise given the nature of PREPA's role in the political process. This pattern has made it difficult for PREPA to tackle critical multi-year projects such as environmental and capital investment. In the past, scarce capital has been spent on multi-year expensive projects that later administrations have determined not to pursue – losing the value of prior investments and at times incurring costs to remove partially constructed projects. I cannot quantify the total net effects of how decisions such as these have impacted PREPA. Yet, they are very real issues that we have had to recognize as we worked on the recovery plan, and they are issues that must continue to be addressed going forward.

Q. **Have improvements been made in PREPA's governance structure?**

A. Yes. The government of Puerto Rico itself has taken some significant statutory steps to improve the governance and strategic decisions of PREPA. The Puerto Rico Energy Transformation and RELIEF Act, Act 57- 2014 (the "RELIEF Act"), contained a number of provisions intended to improve PREPA's governance. For example, Article 2.3 of the RELIEF Act amended Section 4 of Act 83-1941 with respect to PREPA's Governing Board, while Article 2.4 amends Section 5 of Act 83-1941 with respect to PREPA's Executive Director.

The Revitalization Act included further provisions on governance. The Revitalization Act (in its Articles 5 and 6) made further amendments in Sections 4 and 5 of Act 83-1941, including provisions on the appointment, performance, and conduct of the Governing Board; a new provision intended to enhance the independence of the Governing Board from political pressures; and new provisions on the appointment, performance, and conduct of PREPA's executive officers. The recovery plan contemplates governance and legislative reforms to ensure that changes made at PREPA take hold and remain in place. PREPA's board will be composed of a majority of experienced independent directors identified by a nationally recognized search firm who will serve in staggered terms to ensure continuity past the four-year election cycle. This will ensure that PREPA's board and management remains independent from political interference and able to plan for the long term.

Q. **What other serious operational challenges have faced PREPA in recent decades?**

A. I will not attempt to provide an exhaustive catalog, but PREPA's serious operational challenges in recent decades have included the items listed below. I should note that my team and I have worked, and we continue to work, with PREPA on these items. So, the status of these items is evolving, and they have been addressed to varying degrees. Accordingly, the list should be understood as characterizing PREPA's operational challenges in recent decades, but with the additional understanding that the work to implement the recovery plan has made progress (to varying degrees) on these items.

- A lack of institutionalized processes and procedures.
- Outdated systems and information technology ("IT"). Information systems that are not integrated, resulting in duplicate data, poor data utilization, and poor data quality. Underfunding of these systems, and frequent outages. Inadequate training to effectively use and improve IT. This is a major cause of delays when customers are waiting for help from the call center or are disconnected.
- Government agencies, corporations, and other public institutions, and even for-profit entities operating in public facilities, that fail to pay their electric bills, either because PREPA's billing systems are unreliable and outdated, or because PREPA does not take sufficient actions to collect its bills.

Non-technical losses – by which I mainly mean theft of power – also are considerable and costly.

- PREPA's generation structure predominately consists of old and outdated systems. This results in a high rate of forced outages, which prevents optimal, and therefore least cost, dispatch of the fleet. Also, much of the fleet is outdated such that it relies on expensive fuel.
- Inventory controls that are below industry standards. (PREPA had no fuel inventory controls when I arrived, but now it does.)
- Procurement practices that focus on a very large number of small vendors. A lack of product standardization leads to vendor management issues, delays, and higher costs.
- PREPA's deteriorated financial situation and vessel requirements under the federal Jones Act compound PREPA's purchasing challenges, by limiting the vendors that are able and willing to supply fuel.
- The vehicle fleet is too large and the vast majority of it is technically obsolete, making them very expensive to maintain. Limited visibility into fleet movements because of a lack of central tracking makes optimizing vehicles and implementing performance measures very difficult. Maintenance and repair shops that had to focus on repairs and therefore fell behind on preventive maintenance.
- A disorganized and ineffective customer service infrastructure. As indicated above, collection efforts are incomplete. Service disconnection

processes are ineffective and costly. As also indicated above, the call center has unacceptably long wait times for response.

- Safety issues arising from a lack of training, lack of compliance and a lack of appropriate protocols, and a physically deteriorated infrastructure.

Q. **What significant improvements in PREPA's operations have been made or are underway?**

A. The Business Plan is addressed primarily and in more detail in the panel testimony of Sonia Miranda of PREPA, Antonio Pérez Sales and Virgilio Sosa of AlixPartners, ("Business Plan Panel Testimony") in PREPA Ex. 3.0. I will answer this question at a high level. PREPA has focused on operational improvements to core business functions that increase efficiency, improve customer service, centralize controls and decision-making utilizing industry best practices, increase revenue generation, and instill a culture of safety in the workplace. By addressing shortcomings in accounts receivable and collections, fuel inventory, procurement, inventory management, and safety, PREPA has begun the process to transform into a modern self-sustaining utility.

PREPA has made great strides in its accounts receivable and collections processes with respect to government and private customers alike. PREPA has directly engaged with the central Commonwealth government and its agencies to set appropriate Fiscal Year 2016 budgets and has implemented payment plans for past due government accounts. Given the current financial situation within the Commonwealth, these efforts have become even more important.

Benefits from improved receivables processes are already clear. Since August 2015, government Corporations and Agencies accounts receivable more than 30 days overdue have been reduced by $11 million. PREPA has also worked to reduce outstanding receivable balances from PREPA's general customers by implementing new service suspension processes, addressing a large balance of disputed invoices (through the Act 33 process) and also has conducted an RFP process to select and retain collections agencies for inactive accounts. Overdue general customer accounts receivable have been reduced by over $50 million since August 2015. Overall, PREPA projects that the general customer initiatives being undertaken will result in one-time value of as much as $96 million, and as much as $10 million in annual value.

PREPA has also implemented new information technology tools to identify cases of energy theft and decrease other non-technical losses, delivered workforce training in several customer service areas, increased the use of a 3rd party call center and implemented other customer care and billing improvements, that will reduce the number of estimated billings thereby reducing billing errors. Going forward, PREPA is adding more field investigators and administrative personnel to pursue and prevent theft and improve customer interaction in this area, taken together, all these reforms create a platform for PREPA to work collaboratively with customers to reduce past due accounts, energy theft and non-technical losses as well as improve customer service.

PREPA has also worked to improve fuel inventory controls. In September 2014, PREPA's controls were sporadic at best. PREPA did not consistently measure fuel based on industry standards or test for variations in consumption. Additionally, PREPA lacked a uniform process to forecast its fuel requirements based on optimized dispatch and deliver power at the lowest possible cost, leading to unnecessarily high fuel inventory levels and limitations on PREPA's ability to negotiate better terms. Our team has worked with PREPA to implement an integrated process that addresses these issues. We measure and track fuel inventory and investigate variances point to point. We have also improved inventory controls and reduced inventory levels with respect to all inventory. In addition, we have implemented a Request for Proposal ("RFP") process and negotiated with fuel suppliers to secure more favorable fuel purchase terms.

One issue of importance to PREPA, especially as it transitions to burning a significantly higher percentage of natural gas, is the Jones Act, which increases the cost of transporting fuel from the mainland to Puerto Rico. The impact of the Jones Act on PREPA's operations today is in the range of $3 to $5 million per year, due to the required use of Jones Act-compliant barges to distribute fuel oil between units. Based on current operational assumptions, this impact could increase by approximately $20 to $30 million per year if the Aguirre Offshore Gas Port ("AOGP") is constructed and PREPA elects to source liquefied natural gas from the mainland. If Puerto Rico were to get any relief from the Jones Act's stringent requirements, this could allow PREPA to save these amounts over time, and those savings would be passed along to its customers.

The safety of employees should be at the heart of every well-run utility. In the past 10 years, PREPA has had 15 fatalities and approximately 14,000 safety incidents. Its incident rate is significantly higher, in fact more than double, than that of its industry peers. In September 2014, we ran an RFP process and selected and engaged industry leader DuPont to conduct an analysis of safety practices and procedures. PREPA is currently implementing the short- and long-term recommendations made by DuPont and tracking its performance in those areas. PREPA is undertaking these safety initiatives to save lives and make PREPA a safe workplace. PREPA owes this to its employees and their families. From 2014 to 2015, PREPA reduced its incident rate from 16.1 to 12.6 (approximately 21%), which represents a productive first step, but still falls short of our ultimate goal.

PREPA is also working to improve its organizational culture and instill a focus on excellence. Many of PREPA's employees have embraced this effort and the board and management have also committed to these critical changes. Work is underway to introduce selected key performance indicators ("KPI's") to heighten the visibility of key priorities within the organization and focus process improvements where they will have the greatest possible impact. PREPA's workforce and organizational structure is being evaluated to reduce overlapping roles, streamline cross-divisional work and clarify job descriptions. PREPA is also undertaking succession planning for key positions to address potential retirements and other retention pressures.

All of these efforts have already had a significant financial impact, and demonstrate that PREPA has taken actions to reduce costs, improve efficiency and apply industry standards. PREPA has achieved approximately $165 million in one-time cash generation savings and approximately $200 million in recurring annual savings. As new operational initiatives are phased in, we expect additional onetime savings of approximately $100 million and recurring annual savings of approximately $120 million. These savings are important because they contribute to closing the rate deficit and because as part of the recovery plan, all stakeholders need to contribute to PREPA's transformation, including PREPA's management and employees.

Q. **You have mentioned PREPA's Business Plan, its capital expenditure plan, plans to improve PREPA's generation, transmission, distribution, and other operations, and, in particular, PREPA's Integrated Resource Plan. What is the nature of the IRP?**

A. PREPA, with the assistance of outside independent experts Siemens Industry, Inc., has developed a proposed Integrated Resource Plan ("IRP"), which, in revised form, is pending before the Commission in another docket, No. CEPR-AP,2015-0002. At the highest level, the IRP is intended to allow PREPA to comply with applicable law, especially the United States Environmental Protection Agency's Mercury and Air Toxics Standards and CO_2 regulation; reduce the long term cost of electricity supply to PREPA's customers by replacing inefficient generating units; address reliability, *i.e.*, maintain system security and adequacy of supply; achieve the statutory Renewable Portfolio Standard; and give flexibility to make the plan adaptable to deal with Puerto Rico's many unknowns and future developments.

Q. **Why is the IRP needed?**

A. With respect to generation and the grid and their operations, PREPA's IRP is vital to whether PREPA will become a utility that operates in a modern manner and meets its Customers' needs, including but not limited to providing basic reliable electric service. PREPA will invest at least $2.3 billion in new infrastructure in two phases over the next 15 years. Phase 1 will cover infrastructure investments PREPA is required to make to comply with environmental regulations and improve system reliability. Phase 2 will cover additional investments to improve energy efficiency.

The IRP is pending before the Commission in a separate proceeding, docket no. CEPR-IN-2015-0002. The results of that case are to be determined. PREPA clearly cannot meet its environmental law requirements, or provide reliable and low cost service over time, without the approval and implementation of a sound IRP. I discuss the IRP further later in my testimony.

Overall, the IRP is needed in order to comply with legal requirements, specifically Act 57. Beyond that, PREPA's generation fleet is outdated and inefficient, and its transmission system needs extensive reconstruction even apart from building, replacing, or repowering any generation. These systems also make it difficult to accommodate unplanned outages and to integrate renewables. The current states of these systems are key causes of high forced outage rates, poor efficiency, low reliability, and high costs that are ultimately borne by PREPA's customers. PREPA's capital expenditure plan is driven largely by the need to make the investments contemplated by the IRP.

I should add a little more information about the IRP being flexible. While the IRP covers the required 20 year planning period, it is designed to afford flexibility in the event of, for example, significant changes in demand. Moreover, the plan is not just a plan to build, replace, or reconstruct. The plan also enables greater use and implementation of energy efficiency and demand response efforts, as well as other innovations and improvements besides construction.

Q. **Are the costs of the IRP included in PREPA's revenue requirement in this rate review?**

A. I am not one of PREPA's witnesses on the specifics of the revenue requirement or the proposed rates, as I have indicated earlier. That said, my understanding is that the amount of spending contemplated in the Revenue Requirement aligns with the assumed timing of the capital spend that is outlined in the IRP. The Revenue Requirement includes known and measureable adjustments through the date of June 2017.

IV. CONCLUSION

Q. Does this complete your direct testimony?

A. Yes.

No. CEPR-AP-2015-0001
PREPA Ex. 2.0

ATTESTATION

Affiant, Lisa J. Donahue, being first duly sworn, states the following:

The prepared pre-filed Direct Testimony and the Schedules and Exhibits attached thereto and the Schedules I am sponsoring constitute the direct testimony of Affiant in the above-styled case. Affiant states that she would give the answers set forth in the pre-filed Direct Testimony if asked the questions propounded therein at the time of the filing. Affiant further states that, to the best of her knowledge, her statements made are true and correct.

____
Lisa J. Donahue

Affidavit No. 3,569

Acknowledged and subscribed before me by Lisa J. Donahue, of the personal circumstances above mentioned, in her capacity as a Managing Director of AlixPartners, LLP, and Chief Restructuring Officer of the Puerto Rico Electric Power Authority, who is personally known to me or whom I have identified by means of her driver's license number ____________________, in San Juan, Puerto Rico, this __th day of May 2016.

____
Public Notary

JAIME J. ORTIZ RODRIGUEZ
PUERTO RICO
NOTARIO PUBLICO

EXENTO PAGO ARANCEL
LEY 47
4 DE JUNIO DE 1982