

STATEMENT

of

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Before the

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ALASKA NATIVE AFFAIRS

Of the

COMMITTEE ON NATURAL RESOURCES

Of the

U.S. HOUSE OF REPRESENTATIVES

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OVERSIGHT HEARING ON

“EXAMINING PROCEDURES REGARDING PUERTO RICO’S
POLITICAL STATUS AND ECONOMIC OUTLOOK”

Chairman Young, Ranking Member Ruiz, and members of the subcommittee:

My name is César R. Miranda Rodríguez, and I am the Secretary of Justice of Puerto Rico. I am the chief legal officer of Puerto Rico and the chief executive of the Department of Justice (the “DOJ”). Prior to my appointment as Secretary of Justice in January 2014, I served as Chief of Staff under former Governor Sila M. Calderon and in many other posts as a public servant. I am appearing today before this subcommittee representing the Governor of Puerto Rico.

We have been invited today to discuss an issue over which there is no consensus, but quite the opposite either in Puerto Rico or in Congress. The status of Puerto Rico is a debate in which we have been perpetually immersed for well over the century. It has always been a divisive matter in Puerto Rico as in Congress. Recognizing the importance of such a historical debate but taking into consideration the extreme fiscal and economic crisis that we are facing in Puerto Rico, I honestly prefer to direct my participation to address other matters of the utmost importance for our Island, in which there is a common understanding and consensus.

The first of these issues is the approval of H.R. 870, which was introduced by our Resident Commissioner. H.R. 870 would amend the U.S. Bankruptcy Code to treat Puerto Rico like a “state” for purposes of Chapter 9. Its approval is supported among all political parties in Puerto Rico and among informed experts and intellectuals in the United States. In addition to passing H.R. 870, and as I discuss below, there are other uncontroversial measures Congress can take to assist Puerto Rico, including crafting a limited exemption for Puerto Rico from the Jones Act, fixing the automatic sunset

provisions of health care funding, and providing much-needed certainty on creditability of certain taxes paid in Puerto Rico. These are just a few of the ways in which Congress can assist Puerto Rico.

Economic Crisis in Puerto Rico

I would like to begin by emphasizing that the fiscal and economic situation in Puerto Rico has reached a tipping point. The Legislative Assembly has declared a fiscal emergency, the credit markets have closed their doors, and many of Puerto Rico's public institutions face liquidity crises. The situation is truly dire, and it is important to tell why it is so.

Puerto Rico's economy is closely tied to that of the United States but was disproportionately and adversely impacted by the U.S. financial crisis and the "Great Recession." The Commonwealth has experienced high unemployment rates, steady population decline, loss of industry, consecutive budget deficits, and truly unprecedented levels of debt and unfunded pension obligations. A number of significant economic and legal factors have contributed to this fiscal crisis. An example of this is the repeal and phase-out by Congress of Section 936 of the Internal Revenue Code, which, until its phase-out in 2005, provided tax benefits for certain businesses (including large pharmaceutical companies) operating in Puerto Rico. The elimination of these tax benefits led to a significant loss of employment in Puerto Rico's manufacturing sector, and generated strong headwinds for economic growth. Other factors include the decline in the local housing sector, the failure of a number of local banking entities, and the

doubling in oil prices between 2005 and 2012 (this posed a major problem for the Commonwealth given its dependence on oil for virtually all of its power generation).

The Commonwealth has also been experiencing an unemployment crisis. In fact, unemployment remained above 15% for many years following the financial crisis, suggesting continued weakness in Puerto Rico's economy. Unemployment dropped to a still-elevated rate of 12.1% at the end of 2014 while unemployment in the rest of the United States dropped to 5.6%. The loss of employment opportunities in the Commonwealth has caused an increasing number of residents to seek opportunities in the mainland. Many residents that are leaving are those with the greatest earnings potential, while many who remain strain existing resources at a time when the Commonwealth is least able to meet such demands. In fact, 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.

Puerto Rico's unprecedented economic difficulties have contributed to rising budget deficits at all levels of government, including at Puerto Rico's public corporations. Historically, these entities have relied on access to the credit markets, interim financing from the Government Development Bank for Puerto Rico (the "GDB"), and private-sector banks to cover budget shortfalls and provide essential services. Today, these entities have been closed out of the credit markets and are unable to refinance any portion of their nearly \$73 billion in outstanding public debt. In addition, Puerto Rico's public pension funds, though subject to a major overhaul during fiscal year 2014 that reduced future annual cash flow needs, still face significant unfunded liabilities, which will require increased governmental contributions in the coming years.

Governor Alejandro García Padilla and has taken unprecedented fiscal measures in an effort to achieve long-term fiscal sustainability in Puerto Rico. Within two years of taking office, for example, the Padilla administration reduced budget deficits, imposed unprecedented cost-control measures at the central government and public corporation levels, established limits on government payroll (as of November 2014, there were 92,842 government employees, compared to 139,640 in 2008), implemented comprehensive pension reform, imposed loan origination discipline at the GDB, reformed rates at certain public corporations, and completed and is actively exploring public-private partnerships.

One critical component of achieving fiscal sustainability is ensuring that Puerto Rico's governmental instrumentalities are self-sufficient. In Puerto Rico, public services, including water and wastewater services, electric power, and transportation are performed by state-owned public corporations. 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, businesses and governmental units 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 fact that Puerto Rico is an island exacerbates its already high cost of providing these services. 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 capital market financings or the central government, which has provided loans through the GDB or private sector banks. These deficits, combined with borrowings for infrastructure projects, have left these three public corporations with over \$20 billion in debt.

PREPA

I would like to provide additional detail on the fiscal crisis at PREPA because it provides an example that illuminates some of the challenges that Puerto Rico faces more generally in the absence of a legal regime like Chapter 9.

PREPA supplies virtually all of the electricity in Puerto Rico and carries a debt burden of over \$9 billion, including approximately over \$1.1 billion that is due on or before July 1, 2015. PREPA has been facing a financial crisis since the summer of 2014 when nearly \$700 million in revolving credit lines was set to expire and PREPA was unable to access the capital markets or secure financing from other sources. In response, the Legislative Assembly adopted the Public Corporation Debt Enforcement and Recovery Act (the “Recovery Act”) to provide a framework for a consensual resolution of PREPA’s liquidity and debt crisis that would have been negotiated between PREPA and its creditors. Because Puerto Rico is precluded from invoking Chapter 9 of the U.S. Bankruptcy Code, such a measure was seen as vital to bringing the necessary parties to the negotiating table. Following enactment of the Recovery Act, PREPA succeeded in

executing forbearance agreements with its revolving credit-line lenders and the insurers and bondholders controlling more than 60 percent of PREPA's \$8.3 billion of outstanding power revenue bonds.

The forbearance agreements enabled PREPA to conserve cash, thereby improving its liquidity and stabilizing its operations, while also providing PREPA with much-needed time to develop a long-term recovery plan. Under those agreements, PREPA was authorized to use funds for ordinary operational expenses that would otherwise have been required to pay debt service and was temporarily excused from making hundreds of millions of dollars in payments into reserve accounts for the payment of debt service. PREPA's ongoing ability to operate today is due in large part to the relaxation of these financial obligations during the forbearance period that may not have been possible but for the existence of the Recovery Act. In fact, the forbearance agreements expire at the end of June 2015, and PREPA faces imminent default and an uncertain future beyond June. As the sole provider of electricity in Puerto Rico, this is really not a tenable situation. Unfortunately, many other government entities in Puerto Rico could find themselves in similar positions in the future.

The Recovery Act

Research and experience makes clear that investors, creditors and anyone doing business in or with Puerto Rico need to have more clarity on how the Commonwealth's financial crisis might be resolved before investing in or transacting business with Puerto Rico. The establishment of an orderly and consensus-based process for addressing outstanding debt at the public corporations is absolutely vital to providing this clarity.

Our public corporations are not eligible to reorganize under Chapter 11 of the U.S. Bankruptcy Code because they are governmental units, and they are not eligible to adjust their debts under Chapter 9 because Puerto Rico is expressly – and inexplicably – excluded from the U.S. Bankruptcy Code’s definition of “State” for purposes of Chapter 9 eligibility. Prior to the enactment of the Recovery Act in June 2014, Puerto Rico was in the unique position of having no means for authorizing a legal regime under which its public corporations could adjust their debt or address creditor claims in an orderly manner.

The Legislative Assembly’s adoption of the Recovery Act in 2014 was a response to the legislative gap in the U.S. Bankruptcy Code. The Recovery Act was designed to allow public corporations to adjust their debt in an orderly process – with creditor input and court supervision – while protecting the collective interest of their constituents, including bondholders and other creditors, as well Puerto Rico’s residents and businesses who depend on them for the essential services they provide. The Recovery Act ensured that the provision of essential public services to Puerto Rico’s residents would not be interrupted in the event of a fiscal emergency.

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. Specifically, the court concluded that Puerto Rico cannot pass a law allowing its public corporations to adjust their debts through a method of composition. The Commonwealth and the GDB

have appealed the ruling and the matter is under advisement. It is not appropriate for me to comment on the specifics of the appeal, or the reasons why we believe the Recovery Act is lawful, but I can say that we are hopeful that the court will uphold the legality of the Recovery Act as a means of addressing Puerto Rico's fiscal crisis.

More recently, the Commonwealth's Resident Commissioner, the Hon. Pedro Pierluisi, who joins me on the panel, introduced legislation that would amend the U.S. Bankruptcy Code's definition of "State" to include Puerto Rico for purposes of Chapter 9. *See* H.R. 870, 114th Cong. § 2 (2015). If enacted, the Commonwealth's political subdivisions, public agencies, and instrumentalities would be treated like every other municipality in the United States. There would no longer be a need for the Recovery Act.

In the end, the practical and unfortunate result of the District Court's decision enjoining enforcement of the Recovery Act 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. In this respect, Puerto Rico is treated differently than every state in the nation.

The Consequences of Treating Puerto Rico Differently Under the Bankruptcy Code are Significant, But Extending Chapter 9 to Puerto Rico Provides Significant Benefits

The absence of any legislative tools to adjust the debts of Puerto Rico's public corporations has exacerbated Puerto Rico's fiscal challenges by creating an environment of uncertainty that makes it more difficult to address these challenges. It has increased Puerto Rico's cost of borrowing; it may require Puerto Rico to take extraordinary liquidity measures to ensure the continued performance of essential public services; it may encourage creditors to race to the courthouse and exercise remedies that include

attempting to appoint a receiver; and it will ultimately depress economic growth in Puerto Rico, making long-term investment and capital expenditure plans at the public corporations impossible.

Extending Chapter 9 to Puerto Rico, however, would provide significant benefits to all stakeholders.

First, Chapter 9 provides an orderly process for debt adjustment that is understood by the capital markets, creditors, prospective lenders, and suppliers. Specifically, it provides a framework that requires the public corporation to negotiate in good faith, creating an ideal environment to reach consensus under the supervision of an experienced court. Chapter 9 has also been tested many times, including, most recently, in Detroit, Michigan, Stockton, California, and Jefferson County, Alabama, to name a few. These municipalities are now on their way to recovery and renewed prosperity.

Second, 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. Third, oversight by a U.S. Bankruptcy Judge with expertise in insolvency matters will also ensure that all parties in interest have recourse to an independent arbiter and no party is denied its rights.

In short, the virtue of Chapter 9 can be seen in the successes of its most recent graduates, including the City of Detroit, whose adjustment proceedings lasted less than 18 months, and Stockton, whose adjustment proceedings lasted less than two years.

There is simply no good reason to deny the residents and creditors of Puerto Rico what has proven time and again to be a vital tool for recovering from dire economic straits.

Congress Can Take Other Measures to Assist
Puerto Rico in Navigating Through this Crisis

There are a number of other measures Congress can take to assist Puerto Rico during this financial crisis. For example, Congress could provide Puerto Rico with a limited exemption from the Merchant Marine Act of 1920, which is more commonly known as the “Jones Act,” to significantly reduce the cost of doing business and delivery services in Puerto Rico. The Jones Act imposes significant restrictions on shipping between United States ports, thereby significantly driving up the cost of all goods in Puerto Rico and depressing the Puerto Rican economy. The Jones Act requires that all goods shipped, or passengers conveyed, by water between ports in the United States, including ports in Puerto Rico, be carried in U.S.-flagged ships, which are primarily constructed in the United States and owned and crewed by U.S. Citizens and permanent residents. Because Puerto Rico is an island economy, the Jones Act disproportionately harms the local economy. Specifically, the Jones Act severely limits the supply and increases the costs of shipping services, imposing a substantial burden on local productivity (this is particularly pronounced in Puerto Rico’s energy sector – including PREPA – because nearly all of the electricity is generated by oil that is shipped to Puerto Rico). Congress could even grant a temporary exemption from the Jones Act in order to evaluate its impact on Puerto Rico’s economy and assess the costs and benefits of a permanent exemption.

Moreover, Congress needs to fix the significant reductions in federal healthcare funding that will harm Puerto Rico's residents in the near future. Puerto Rico has begun experiencing significant reductions in federal healthcare funding. These reductions are not in line with funding treatment received by the 50 States and they threaten the health and welfare of Puerto Ricans, as well as Puerto Rico's financial and economic stability. I understand that a further reduction will occur when the 2016 Center for Medicaid and Medicare Services rate structure becomes effective and cuts Medicare Advantage funding by 11% in Puerto Rico while increasing it by 3% on the mainland. This cut compounds the difficulties that Puerto Ricans – who pay the same Social Security and Medicare taxes as mainland residents, but receive significantly lower reimbursement rates – face. It also threatens the viability of Medicare Advantage on a going-forward basis, and should Medicare Advantage collapse, patients may move to Mi Salud, Puerto Rico's Medicaid program, which already receives 70% lower reimbursement rates than any mainland state and faces a funding shortfall within the next few years, when a grant provided under the Affordable Care Act is exhausted.

Finally, Congress and the U.S. Department of the Treasury can provide clarity on the creditability of certain taxes paid in Puerto Rico pursuant to a local law known as Act 154 on federal income tax returns. Act 154, which was enacted in 2010, imposed a special temporary excise tax and has become one of Puerto Rico's principal sources of tax revenue. Act 154 revenues accounted for approximately 20% of Puerto Rico's General Fund revenues in 2012, 2013, and 2014. The Act 154 tax base is very small (only 27 groups of affiliated taxpayers paid the special temporary excise tax in fiscal year 2015), and six of these groups accounted for approximately 75% of collections. The

GDB has noted that any action the U.S. Department of the Treasury to reduce or eliminate the federal income tax credit available with respect to the Act 154 temporary excise tax is likely to reduce Act 154 revenues.

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In conclusion, I believe that we should focus our attention to these matters of critical importance to our Island, around which there is common understanding and consensus. There is widespread consensus on the approval of H.R. 870, which was introduced by our Resident Commissioner, to amend the U.S. Bankruptcy Code to treat Puerto Rico like a “state” for purposes of Chapter 9. In addition, Congress can take other measures, including crafting an exemption from the Jones Act, amending the automatic sunset provisions of much-needed health care funding, and providing certainty on creditability of certain taxes paid in Puerto Rico. Of course, these are just a few of the ways in which Congress can assist Puerto Rico, but they would be a good start.