

Attachment 1

**STATEMENT MEMORANDUM**

TO: Puerto Rico Aqueduct and Sewer Authority Revitalization Corporation

FROM: Alberto Lázaro Castro, P.E.  
Executive President  
Puerto Rico Aqueduct and Sewer Authority

DATE: July 27, 2016

RE: Statement Memorandum in Support of the Report and Proposed Financing Resolution of the Puerto Rico Aqueduct and Sewer Authority Revitalization Corporation

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On behalf of the Puerto Rico Aqueduct and Sewer Authority (the “Authority”), I submit the present written statement memorandum (the “Statement”) in support of the Report<sup>1</sup> and Proposed Financing Resolution<sup>2</sup> adopted by the Board of Directors of the Puerto Rico Aqueduct and Sewer Authority Revitalization Corporation (the “Corporation”), and issued by the Corporation on July 27, 2016, under the provisions of Chapter I, Article 7(1) of the “Puerto Rico Aqueduct and Sewer Authority Revitalization Act” (the “Revitalization Act”), as may be amended from time to time, created under Chapter II of Act No. 68 of July 12, 2016 (“Act 68-2016”).

This Statement also refers to the interaction between the Authority, the Corporation and the Puerto Rico Fiscal Agency and Financing Advisory Authority (“PRFAFAA”), Commonwealth of Puerto Rico’s (the “Commonwealth”) fiscal agent, during the drafting period and attest as to its to active role in advising the Corporation as mandated under the Revitalization Act.

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<sup>1</sup> The Revitalization Act requires the Corporation to issue a detailed explanatory report with supporting attachments (the “Report”), stating the grounds and circumstances in support of the issued proposed Financing Resolution (“Proposed Financing Resolution”), together with all pertinent information, data, reports, analysis and other required documents.

<sup>2</sup> “Financing Resolution” (“*Resolución de Financiamiento*”) means “a resolution of the Board of the Corporation adopted pursuant to the Revitalization Act, which creates the Financing Property, approves the imposition and collection of Revitalization Charges and the financing of Approved Financing Costs through the issuance of Bonds and which contains the Adjustment Mechanism, as provided for in Article 6 of the Revitalization Act”. Article 3(28) of the Revitalization Act.

After a long process, through the enactment of the Revitalization Act, as detailed below, the Authority is expected to benefit from the proceeds of the proposed issuance of Bonds by the Corporation in the amount of \$900,000,000 for new money to finance certain essential capital investment costs and/or an exchange or tender of its current bonds for the purposes contemplated under the Act, as well as serve as Servicer<sup>3</sup> for the Corporation in such regard.

## I. INTRODUCTION AND BACKGROUND

I am currently the Executive President of the Authority, and as such, have the responsibility of assuring that the Authority is compliant with its statutory, regulatory and financial obligations. Under my purview and direction is that the Authority and its Governing Board have been actively seeking market access to finance certain regulatory compliance projects of the Authority. Attached hereto is my Curriculum Vitae and summary of qualifications and experience, as Appendix A.

Through the drafting process for the authorization by the Corporation of the Report and the Proposed Financing Resolution, my managerial team and the Governing Board have interacted with GBD, PRFAFAA, and the Corporation, to provide them the pertinent information regarding the financial situation, fiscal obligations, liability, debts, senior and subordinated debts, contractual obligations with bondholders, operations, statutory and regulatory obligations requiring capital investments the Authority. These are more particularly described in Attachments 1 hereto, depicting the specifics of the Authority's finances and obligations.

During the process, PRFAFAA had the opportunity to review and comment on the financial aspects of the proposed transactions for the issuance of Bonds as required under the Revitalization Act. In the preparation for the submission of this Statement, as well as in the process of drafting the Report and Proposed Financial Resolution together with the Corporation and PFFAFAA, the Authority has provided for analysis and review the overall details regarding the Authority's historical and current fiscal situation, as well as its proposed future plans as contemplated under the Revitalization Act. We have requested these instrumentalities to take the necessary precautions and to redact if necessary to confidential information intricately related to the Authority.

As provided under Article 7(b)(4) of the Revitalization Act, the attached Report and Proposed Financing Resolution are required to be uploaded to the websites of the GDB, PRFAFAA and the Corporation, respectively, on or before fifteen (15) days following the date

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<sup>3</sup> Article 3(22) "Servicer" - means the Authority's to the extent permitted by this Act and, if the Authority is replaced as Servicer under a Servicing Contract, means a Person or Persons authorized and required, by contract or otherwise, to impose, bill, or collect Revitalization Charges, to the Authority's periodic reports in relation to the billing and collection of Revitalization Charges, to remit collections by or on account of the Corporation or its assignees or creditors, including a Financing Entity, and to provide other related services, which may include the calculation of periodic adjustments to the Revitalization Charges or provide other services to the Corporation relating to the Financing Property; and it shall be understood to include any sub-Servicer, alternate Servicer (backup) (including if it becomes a Servicer under the Servicing Contract), substitute Servicer or the successors of any of the foregoing, authorized to act as such by a Financing Resolution.

of approval of the Act, that is, July 27<sup>th</sup>, 2016.

This Statement is to be taken into consideration together with the statements provided by Arcadis US, Inc. and Public Financing Management, Inc., technical and financial advisors of the Authority, which provide additional supporting aspects, the transaction structure as well as the technical and financial reports attached to the Report and Proposed Financing Resolution (Attachments [-] and [-] to the Report).

We have been advised that in addition to the procedures established in the Revitalization Act, before issuing the Bonds it may become necessary in the future to consult and get the approval from the Federal Oversight Board assisting the Commonwealth and its instrumentalities in managing its public finances, among other purposes, as provided under PROMESA<sup>4</sup>. To that effect, the Authority, together with the Corporation and PRFAFAA will be looking into the applicable requirements which may impact the issuance of the Bonds, if any, and take the corresponding actions.

For convenience and to provide uniformity with other documents related to the same purposes as this document, all capitalized terms used herewith have the meanings given such terms in Article 3 of the Revitalization Act, the Report and Proposed Financing Resolution. Referenced to Articles, Sections and Subsections correspond to those included in the Spanish version of the approved Revitalization Act, since an official English translation was not available at the time this Statement is being rendered.

## II. BACKGROUND ON the Authority AND ITS SECURITIZATION EFFORTS

1. The Authority is a public corporation and governmental instrumentality of the Commonwealth created by Act No. 40 of May 1, 1945, as amended and reenacted (“Act 40”), for the purpose of owning and operating the only public water supply and wastewater collection systems in the Commonwealth.
2. The Authority is currently the sole provider of water and wastewater collection services in Puerto Rico and is subject to federal and local regulatory requirements to ensure that it provides a quality, safe, reliable, and environmentally friendly service at reasonable rates, as required under Act No. 21 of May 31, 1985, as amended.
3. The Authority’s water supply system (the “Water System”) serves most (approximately 97%) of Puerto Rico’s population. The Authority’s wastewater collection system (the “Wastewater System” and, together with the Water System, the “Systems”) serves more than half (approximately 59%) of Puerto Rico’s population. The Authority serves private and public customers, and provides invaluable services for the wellbeing of the Puerto Rican residents and the operation of public and private entities.
4. The Authority is governed by a board comprised of nine (9) directors, including

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<sup>4</sup> The Puerto Rico Oversight, Management, and Economic Stability Act, known as PROMESA. Public Act 5278 enacted on June 30, 2016.

private sector, public sector and consumer representative members (the “Governing Board”).

5. The Authority has been facing unprecedented financial pressures since 2014, primarily as a result of the Commonwealth’s financial condition. As an immediate response to the critical situation, the Authority and its Governing Board have diligently taken affirmative action to ameliorate the stress on the Authority’s finances, and have sought alternatives to obtain funding for its CIP, including reducing operating costs; entering into amendments to collective bargaining agreements to reduce labor costs; obtaining a statutory preferential reduced electricity rate (which was terminated by the Puerto Rico Electric Power Authority (“the Authority”) as of June 30, 2016); restructuring lines of credit and commercial loans; implementing efficiencies and cost reduction initiatives to maintain the system and guarantee a reliable and safe services; as well as unsuccessfully attempting to issue additional revenue bonds last year. These efforts notwithstanding, for reasons outside of its control and despite its best efforts, the Authority has been unable to gain market access, it has been increasingly difficult for it to deal with its accumulated Capital Improvement Program (“CIP”) costs, which at present are upwards of \$150 million and for which the Authority has no source of payment. Additionally, as a direct result of the Authority not being able to access the bond market, the Authority was forced to use surplus operational funds on deposit in the Rate Stabilization Account of the Surplus Fund created by the Master Agreement of Trust, dated as of March 1, 2008, as amended and restated as of February 15, 2012, as further amended and supplemented to date, executed by the Authority and Banco Popular de Puerto Rico, as Trustee (the “MAT”) to cover CIP related costs during the last months of 2013, 2014 and 2015 and to secure the payment of interim financing facilities. Under the Authority’s revised rate structure implemented in July 2013, such surplus funds were necessary to cover projected budgetary deficiencies through fiscal year 2018 without the need for the Authority to revise its rates. The loss of such funds put a significant strain on the Authority’s liquidity.

6. The current strain on the Authority’s finances and the lack of viable options to resolve the above mentioned situation has been a result of a combination of adverse circumstances. Some of the external factors that have aggravated its financial situation include (i) the negative outlook of the Commonwealth’s finances and that of its agencies and instrumentalities; (ii) the downgrade of the Commonwealth’s general bond obligations, which in turn resulted in downgrades to the Authority’s bonds (both currently non-investment grade); (iii) the negative reaction of the investment community to the enactment of certain local legislation and the ensuing filing of judicial action seeking authorization for public corporations of the Commonwealth to request and obtain bankruptcy like relief either through a local statute or through the United States Bankruptcy Code; (iv) the impact of the Government of the Commonwealth’s statements concerning its ability and that of other public corporations to timely pay their debts; and (v) the severe drought conditions experienced in Puerto Rico during 2015, which not only required implementing rationing plans throughout the Island for several months, but also resulted in a significant loss revenues and the incurrence of additional operating costs, for an aggregate negative impact of approximately \$70 million.

7. As a direct result of the above stated circumstances and the delays in the issuance of new revenue bonds, the Authority had to utilize operating funds to cover its CIP projects, given the lack of short term external financing to cover immediate CIP related expenses.

Although the Authority was not among the Commonwealth's instrumentalities in jeopardy of becoming insolvent, it nonetheless received a negative backlash from the investment community, which regarded the Authority as part of the Commonwealth, and expected it to be negatively affected by its fiscal woes. In turn, this raised financing costs for the Authority and eliminated the prospects for obtaining long-term financing from traditional financing sources and ultimately even from other non-traditional sources, such as hedge funds.

8. The Authority's current rate structure, revised in July 2013 with an increase of 65% on average, was designed to provide sufficient funds to cover all its operating expenses and debt service through fiscal year 2018. However, this rate structure was implemented following the Authority's historical rate setting model which assumed that CIP would be financed and accordingly provided funds for debt service on projected bond issuances the proceeds of which would be used to finance the CIP and except for a small portion identified as the [ ] charge did not include funds to actually pay for the CIP on a cash basis

9. Historically, the Authority has relied on external financing for the implementation of its CIP, both through traditional municipal bond market debt issuance, as well as through federal assistance in the form of low interest State Revolving Funds for Drinking Water and Clean Water loans ("SRF Loans") and bonds ("RD Bonds") issued by the United States Department of Agriculture's the Rural Development Program ("USDA Rural").

10. Pursuant to the MAT, all of the Authority's Revenues are subject to a gross pledge for the benefit of the Senior Bonds, Senior Subordinate Bonds and Subordinate Bonds.

11. As of the date hereof, in addition to its obligations to various senior creditors, which pursuant to its Master Agreement of Trust, dated as of March 1, 2008, as amended and restated, are to be paid with preference over subordinated creditors, including federal agencies such as the Environmental Protection Agency ("EPA") and USDA Rural, and as a direct result of the above stated circumstances and the delays in the issuance of new revenue bonds has an outstanding debt in excess of \$150 million with its CIP contractors and suppliers. Most of these debts are over 365 days past due and in some cases over a year past due.

12. In 2015, after expending all of its surplus operating income and reserves to cover a portion of its unfunded CIP, the Authority was forced to postpone or terminate virtually all of its active construction projects. The Authority had to stop the execution of \$352 million in fifty-five (55) projects that were under construction, in addition to stopping its CIP process, which was expected to start eighty-six (86) projects with an investment of an additional \$247 million. As stated before, to date the Authority owes its suppliers and contractors over \$150 million.

13. These postponements and cancellations could eventually result in the Authority's non-compliance with its obligations under its existing Consent Decree with the EPA<sup>5</sup> and the

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<sup>5</sup> On May 23, 2016 the United States District Court for the District of Puerto Rico entered judgment approving the 2015 EPA Consent Decree, as presented on May 10, 2016, dismissing with prejudice and closing civil case number 15-2283. The 2015 EPA Consent Decree is the result of an arduous negotiation process undertaken by the Authority, EPA and the United State Department of Justice aimed, among other things, at resolving the claims addressed in the civil case number 15-2283 and the requirements of previous consent decrees, specifically with the

amended settlement agreement with Puerto Rico Department of Health (“PRDOH”) (collectively, the “Existing Consent Decrees”) leading to potential civil lawsuits by federal prosecutors against Authority officials and the Commonwealth, as well as a negative impact on the island’s economy.

14. The cessation of CIP projects due to lack of funding reduced the Authority’s continued investment in infrastructure, which in turn supports over 5,000 construction jobs and is expected to lead to contractor and supplier bankruptcies and lawsuits, most of which are small and medium sized local companies. Furthermore, CIP funds not only cover major infrastructure projects, but also renewal and replacement, emergency repairs and major maintenance works. At this point, these portions of the CIP have also been essentially discontinued and are being addressed on a “critical for service” priority basis through operating funds reprogramming. At some point, this will become unsustainable and if the required funding to comply with its Existing Consent Decrees and maintain the system is not available, the Authority’s infrastructure is at risk of deteriorating and even failing. The lack of maintenance and compliance with the Existing Consent Decrees, in turn, would potentially jeopardize the health of the Puerto Rican people.

15. The Authority’s situation is challenging, and the facts are extraordinary. Until now, the Authority had never had to face the extreme hardship it is experiencing now. The livelihood of thousands of families depends on the ability of the Authority to pay over \$150 million dollars owed in connection with its CIP projects. The decision to halt all ongoing CIP projects and postpone all future infrastructure work has been the toughest action the Authority has had to make. Accelerating the downfall of the local economy, withholding money from contractors and suppliers, and in turn Puerto Rican workers, was a tough choice, but a necessary one in order to be able to continue providing services. However, it is not a sustainable option. Furthermore, to the extent the Authority is required to allocate funding to repay senior creditors before subordinated creditors, there is a possibility that the economic pressure and the impact of disbursing all its available funds to pay the senior creditors and the contractors, would deplete the funding that would otherwise be available to repay subordinated creditors. This, together with the provisions of Act 68-2016, benefits the Authority by allowing it to continue to carry out its essential public function of providing safe drinking water in the Commonwealth in compliance with its existing regulatory obligations and give some relief to the Authority to then pay outstanding debts with its CIP’s contractors and suppliers. The Authority is in dire need of an immediate influx of funds to be able to continue its operations and repay its current obligations.

16. Recently, in an effort to prevent the worsening of its financing obligations with its subordinated creditors, and the enforcement of the Commonwealth’s guarantee on these obligations, the Authority entered into temporary short term forbearance agreements with two

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goal of implementing system-wide National Pollutant Discharge Elimination System permits compliance plan, continue the implementation of operational and maintenance plans in all of the Authority’s facilities, implementing remedial measures to address discharges and the alleged violations to the Clean Water Act occurring within the Puerto Nuevo Sewer System in the municipality of San Juan. The Authority expects that with the final approval of the 2015 EPA Consent Decree, it will be able to finalize the proposed amendment to the 2006 Drinking Water Settlement Agreement between the Authority and PRDOH under terms substantially similar to those currently being negotiated.

of its subordinated creditors, providing a limited negotiation period for the renegotiation of its existing related debt and guarantee the continued availability of State Revolving Fund loans and USDA Rural funding in the future. The aforementioned forbearance agreements were entered into with the Puerto Rico Infrastructure Financing Authority, PRDOH, the Puerto Rico Environmental Quality Board, and the USDA Rural with respect to the SRF Loans and RD Bonds, respectively. It is expected that before the end of the current calendar year the Authority will be able to agree on the terms of restructuring agreement with its aforementioned federal and state public creditors to facilitate the repayment of its obligations thereunder

17. The Authority needs time to carry out its current financing plan and to comply with its obligations to suppliers of goods and services for its CIP in order to prevent actions against the Authority which may significantly and negatively impact it, and to be able to retake the construction of infrastructure projects required under its Consent Decree. If the Authority were unable to stabilize its situation in this manner, the potential degradation of the Authority's financial condition could lead to more adverse consequences which would impact all of its creditors, but more particularly it would jeopardize the health of the population of the Commonwealth.

18. The Authority has been actively looking into potential viable options and legal scenarios which would permit some short term relief to it. As a result, following an extensive legislative process, in which the Authority actively participated, the initially proposed enrolled bill to enable the authorization of the Puerto Rico Aqueduct and Sewer Authority Revitalization Act, HB 2786, was withdrawn by the Senate after it had been approved after the two duly constituted Legislative Conference Committees, but before it was remitted to the Governor of the Commonwealth. In its stead, the House of Representatives of Puerto Rico presented a new bill, HB 2864, which was later approved by both the Senate and the House of Representatives on June 30, 2016 and enacted into law as Chapter 2 and 3 of Act 68-2016.

19. The Authority endorsed HB 2786 and later its substitute bill HB 2864, now Act 68-2016, because the Revitalization Act that is now included as part of Act 68-2016 permits the securitization of a new charge to be imposed by the Corporation, a bankruptcy remote governmental entity, to guarantee bonds to be issued by it, a the proceeds of which would be provided to the Authority for the payment of the costs of its CIP. It would, as well, potentially allow the Authority to exchange and/or refinance some of its outstanding senior debt. This alternative, however, even if approved would not provide short term relief for its current problems, nor resolve the immediate situation.

20. The main purpose of the Revitalization Act approved under 68-2016 is to provide a legal mechanism to promote the Authority's fiscal sustainability, in order to give it the necessary tools for it to be able to continue providing quality water and sewer services for the benefit of the citizens of Puerto Rico.

21. Since inception of the initial legislative process, the purpose of the Act now known as Act 68-2016, has been to enable the enactment of the Puerto Rico Aqueduct and Sewer Authority Revitalization Act, which among other provisions creates a new public corporation, known as the Puerto Rico Aqueduct and Sewer Authority Revitalization

Corporation, as a single purpose, bankruptcy remote entity authorized to issue bonds for the benefit of the Authority by fixing and collecting a new securitization charge, the proceeds of which may be used for its Capital Improvement Program (“CIP”), refinancing bond anticipation notes and for the cancelation, defeasance and refinancing of its Bonds, among other approved financing costs, within certain parameters and conditions, therefore providing for the financing and development of the Authority through its provisions.

22. Act 68-2016 not only establishes the required process for the authorization and issuance of debt through the Revitalization Act, but also amends various portions of the Authority’s Enabling Statute, Act No. 40 of May 1, 1945, as amended, mostly with respect to its governance and its obligations under the Revitalization Act.

23. As provided in more detail in the Statement submitted on behalf of the Corporation and PRFAAF by Ricardo Fishman Koffman. (Attachment 2 to the Report), the Revitalization Act allows for the creation of the Corporation, which is a bankruptcy remote, single purpose entity, totally separate and independent from the Authority with the authorization to issue Bonds to assist the Authority in meeting its obligations to its CIP contractors, as well as resuming its CIP commitments. Moreover, the legal protections set forth in the Act are intended to permit the Corporation to access the capital markets. These legal protections include, inter alia, provisions which authorized (a) an Adjustment Mechanism, to be applied by the Corporation (or by a Servicer on behalf of the Corporation) to adjust the Revitalization Charge, no less often than semi-annually, to ensure that Revitalization Charge revenues are sufficient to provide for the timely payment of the Bonds and related Ongoing Financing Costs, (b) provisions to make the Revitalization Charge non-bypassable to Customers, and (c) the statutory agreements, covenants and pledges of the Commonwealth including, inter alia, providing that the Commonwealth shall not limit, alter, reduce, impair, postpone or terminate the rights conferred in the Act, any Financing Resolution and related agreements. The Revitalization Act provides for the issuance of up to \$900 million (the “New Money Bonds”) to fund the development of the Authority’s CIP, bond anticipation notes and other permitted uses. Additionally, under Article 7(a) of the Revitalization Act, the Corporation may also issue one or more series of Bonds to be issued in an aggregate principal amount not to exceed the difference between \$900 million and the maximum amount of the Bonds that can be financed with the Revitalization Charge (the “Tender/Exchange”) in order to retire, cancel (defease) or refinance all or part of the debt issued by the Authority , upon meeting the conditions, if any, established for it in any then existing Trust Agreement, and additionally subject to compliance with the following conditions:

- (1) that the bonds to be redeemed, canceled (defeased) or refinanced are at a value not greater than eighty-five percent (85%) of their nominal or face value;
- (2) that the Bonds to be issued for the redemption, cancellation (defeasance), or refinancing do not require payment of principal for at least the first five (5) years from the date in which they are issued; and
- (3) that the interest rate of the Bonds to be issued fluctuate according to the credit rating conferred to the Bonds, consistent with the following table:

<i>Interest Rate</i>	For Current Interest Bond Payments:	For Convertible Capital Appreciation Bonds:
	the weighted average interest rates across maturities (based on the yield curve) be set at specified rates, subject to the final classification of investment grade as follows:	the weighted average interest rates/ appreciation through the maturities (based on the yield curve) be set at specified rates, subject to the final classification of investment grade as follows:
	AAA:	AAA:
	4.00%	4.50%
	AA+/AA/AA-:	AA+/AA/AA-:
	4.25%	4.75%
	A+/A/A-:	A+/A/A-:
	4.50%	5.25%
	BBB+/BBB/BBB-	BBB+/BBB/BBB-
	or less:	or less:
	4.75%	5.50%

### III. PURPOSE OF the AUTHORITY'S SECURITIZATION STATUTE

1. The Report and the Proposed Financing Resolution, as per Articles 7(a) and (b) of the Revitalization Act, describe the Corporation's proposed issuance of the Bonds and present the documents required to initiate the public hearing process prior to the approval by the Corporation of the Initial Financing Resolution and later the approval by PRFAFAA of the final Financing Resolution. Once the latter becomes final, the Revitalization Act provides a 60 day term of repose for the validation process of the Revitalization Act itself, as well as the Financing Resolution and related claims. Thereafter, upon a 10 prior notice to PRFAFAA, the Corporation may issue and sell the Bonds.

2. As stated in the Proposed Financing Resolution, the Revitalization Act creates the Financing Property<sup>6</sup>, provides for financing of Approved

<sup>6</sup> Article 7(27) "Financing Property" - means a Financing Resolution and the property rights and interests created thereby, including the right, title, and interest in: (a) the right to create and receive Revitalization Charges; (b) the Revitalization Charges, as adjusted from time to time in accordance with the Adjustment Mechanism, including any rights under a Servicing Contract assigned pursuant to the related Trust Agreement or other security interest agreement; (c) all revenues, collections, claims, payments, money or profits arising from the Revitalization Charges or that constitute Revitalization Charges, regardless that such revenues, collections, claims, payments, money or profits are billed, received, collected, or maintained by the Authority or the Corporation together with or commingled with other revenues, collections, claims, payments, money or profits; (d) all rights to receive Revitalization Charge adjustments in accordance with the terms of the Financing Resolution related thereto; and (e)

Financing Costs and other approved costs through the issuance of Bonds, imposes and provides for the collection of Revitalization Charges to fund Initial Financing Costs, Upfront Financing Costs<sup>7</sup>; and other Financing Costs<sup>8</sup>, and describes how the Revitalization Charges will be calculated and adjusted

all reserves established in relation to the Bonds or the Financing Property. Once the Bonds are issued, the Financing Property shall constitute a property right acquired and existing in the estate of the Corporation, as the initial owner, subject to Article 8 and any pledge of Financing Property pursuant to this Act, notwithstanding that the value of the property right shall depend on future actions that have not yet occurred, including that Customers remain connected or be connected to the System Assets and that they take or receive water and sewer service, the imposition and billing of the Revitalization Charges, or the providing of services by the Authority. The term "Financing Property" shall not include real estate property of the Authority nor real property rights created on such real estate.

<sup>7</sup> Article 3(14) "Upfront Financing Costs" - means the Financing Costs related to the costs of design, marketing and issuance of the Bonds, except to the extent that the Corporation determines to pay such costs as Ongoing Financing Costs payable from the Revitalization Charge Revenues. The Upfront Financing Costs include, without limitation, costs and expenses of the Trustee (or similar trustee), legal costs and expenses, accounting costs and expenses, initial (or set-up) costs or rates of the servicer, calculation agent, depository or other administrator or trustee, placement costs and expenses, underwriting costs and expenses, printing and marketing costs, filing or listing and compliance costs, costs and expenses of the Corporation's other consultants, if any, rating agency costs, costs and expenses of the guaranty provider and any other costs approved by the Board of the Corporation as necessary or desirable for the accomplishment of the objectives of the Revitalization Act and shall include reimbursement to any Person of amounts advanced for the payment of such costs. Within the costs related to the Capital Improvement Program only those Approved Financing Costs related to the works and improvements of services of water and/or sanitary sewer and installations providing direct service to Customers shall be included; no type of construction or improvements to the Authority's management offices or headquarters shall be included, except those constructions, investments or improvements that are strictly necessary to comply with a requirement of a health, safety or compliance organization and/or those that result in efficiencies or savings that are product of technological improvements or information systems.

<sup>8</sup> Article 3(13) "Financing Costs" - means the costs of issuing, meeting with, repaying or refinancing the Bonds, whether incurred at the time of the issuance of such Bonds or during the life of the Bonds, the recovery of which is authorized in a Financing Resolution. Without necessarily being limited to, "Financing Costs" may include, as applicable, any of the following: a. principal, interest and redemption premiums of the Bonds; b. any payment required under the terms of an Ancillary Agreement and any amount required to fund or replenish funds (or to reimburse third parties for replenishing said funds) of a debt service reserve fund or account, an operating expenses reserve fund or account, or any other account or fund established pursuant to a Trust Agreement, any Ancillary Agreement, resolution or other financing document relating to the Bonds; c. any federal or state tax or charge, including federal or state payments or contributions made in lieu of taxes, franchise fees or license fees applied to the Revitalization Charge Revenues (but excluding any tax, fee or contribution, or payment in lieu of taxes that are local or that originate in the Commonwealth of Puerto Rico); d. any cost related to the administration of the Corporation, Bonds or the Financing Property, including costs for implementing the Adjustment Mechanisms, of the Trustee (and other similar trustee), legal, accounting and other consultants, depository, calculation agent, administrator, rating agencies fees and expenses, and Servicing Fees and servicing expenses, in each case subject to the provisions of this Act; e. any costs related to the protection of the status of the Financing Property and collection of Revitalization Charges, including any costs related to any judicial proceedings or similar proceedings that the Corporation or the Trustee or any owner of all or a portion of the Financing Property considers necessary to demand payment or to collect the Revitalization Charge Revenues or to protect the Financing Property or any other costs referred to in Article 10 of this Act, in each case subject to the provisions of this Act; and f. any other costs related to issuing Bonds, or the administration and servicing of the Financing Property and Bonds, including the costs of calculating adjustments to the Revitalization Charges, the Servicing Fees and servicing expenses, costs and expenses of the Trustee (or similar trustee), legal costs and expenses, accounting costs and expenses, administrative costs and expenses, placement costs and expenses, underwriting costs and expenses, printing and marketing costs, marketing or listing costs, costs and expenses of the Corporation's other consultants, if any, costs of rating agencies and any other costs approved by the Board of the Corporation, as necessary or desirable to achieve the purposes of this Act.

through the Adjustment Mechanism.

3. As required, the Report and Proposed Financing Resolution also include the supporting information, data and financial documents, and in compliance with Article 7(b), the Corporation submits the Report, the Proposed Financing Resolutions, the attachments hereto and the statements and other documents in support thereof and states that the Report includes the following:

- a. A description of the Ongoing Financing Costs<sup>9</sup>;
- b. The determination of the Customer<sup>10</sup> categories among which the Ongoing Financing Costs shall be distributed and the distribution of the Ongoing Financing Costs among Customer categories;
- c. The calculation of the Revitalization Charges<sup>11</sup> for Customers, by category;
- d. A provision that any delinquency in the payments of any category of Customers shall be distributed among all categories of Customers, as provided in Articles 7(b)(1) and 7(b)(2) and are to be included in the Adjustment Mechanism<sup>12</sup>. As well, the allocation of distribution of any excess or surplus of the estimated revenues for the prompt payment of any category of Customers among all categories of Customers for the next period or cycle of the Revitalization Charge;
- e. A determination by the Corporation of the following:
  - (i) That the distributions of established in Article 7(b)(2), subsections (B), (C) and (D) are practical to manage and that they ensure the full and timely payment of Ongoing Financing Costs during the term of the Bonds;

<sup>9</sup> Article 3(19) "Ongoing Financing Costs" - means the Financing Costs other than Upfront Financing Costs and any excess of Upfront Financing Costs incurred over the Corporation's estimate of Upfront Financing Costs that are payable from the proceeds of the issuance of Bonds .

<sup>10</sup> Article 3 (18) "Customer" - means any Person who is connected to or takes or receives water and/or sewer services within the Commonwealth of Puerto Rico by means of the facilities that constitute part of System Assets. The Authority shall not be considered a Customer.

<sup>11</sup> Article 3(7) " Revitalization Charges" - means those charges and rates that are independent of the Authority's charges and rates and that are imposed on Customers by the Corporation pursuant to a Financing Resolution to recover Ongoing Financing Costs, and shall include a pro rata share of any late payment fee imposed with respect to any past-due bill for water and/or sewer service and that includes in said bill an amount for Revitalization Charges.

<sup>12</sup> Article 3(23) "Adjustment Mechanism" - means the formulaic adjustment mechanism contained and approved in a Financing Resolution that is to be applied by the Corporation periodically, and at least semi-annually, to adjust the Revitalization Charges to ensure the collection of Revitalization Charge Revenues sufficient to meet the timely payment of Ongoing Financing Costs. The establishment and adjustment of the Revitalization Charges carried out by the Corporation in relation to the Adjustment Mechanism shall not be subject to legislative review or any other government review or approval, except as provided in Article 6 of the Revitalization Act regarding the correction of mathematical errors and Article 7 of the Revitalization Act with respect to the approval of the Adjustment Mechanism.

- (ii) The historical consumption data of each Customer category that serves as the basis of the distributions established in Article 7(b)(2), subsections (B), (C) and (D), and are certified by an officer of the Authority; and
  - (iii) That the Proposed Financing Resolution meets the requirements established in Article (7)(b)(1) and (b)(2) and other applicable requirements established in the Revitalization Act.
4. The Proposed Financing Resolution as per Article 6, contains in addition to other matters required to be included in accordance with the Revitalization Act:
- (i) specifies the maximum amount of Bonds<sup>13</sup> authorized to be issued, including parameters or limitations for their maturities, scheduled maturities, interest rates and interest rates determination methods and other Bond details as the Board deems appropriate;
  - (ii) describes the Approved Financing Costs to be paid through the issuance of Bonds and to be recovered through the Revitalization Charges;
  - (iii) specifies the qualitative or quantitative limitations of the Financing Costs to be recovered (which shall not adversely affect the ability to pay and to service the Bonds in accordance with their terms);
  - (iv) specifies the methodology to determine the amount of Revitalization Charges;
  - (v) describes the Adjustment Mechanism<sup>14</sup> that shall apply, based on the methodology for the allocation of Revitalization Charges, to reconcile the actual collections with projected collections at least semi-annually, to ensure that the collection of the Revitalization Charges are adequate to pay on their due date the principal and

<sup>13</sup> Article 7(4) "Bonds" - means the Bonds or other evidences of long-term indebtedness issued by the Corporation pursuant to the Revitalization Act, any Financing Resolution and Trust Agreement related thereto: (a) the proceeds of which are used, directly or indirectly, to finance or refinance Approved Financing Costs; (b) which are directly or indirectly guaranteed by, or payable from, the Financing Property; and (c) which duration does not exceed thirty-five (35) years.

<sup>14</sup> Article 3(23) "Adjustment Mechanism" - means the formulaic adjustment mechanism contained and approved in a Financing Resolution that is to be applied by the Corporation periodically, and at least semi-annually, to adjust the Revitalization Charges to ensure the collection of Revitalization Charge Revenues sufficient to meet the timely payment of Ongoing Financing Costs. The establishment and adjustment of the Revitalization Charges carried out by the Corporation in relation to the Adjustment Mechanism shall not be subject to legislative review or any other government review or approval, except as provided in Article 6 of the Revitalization Act regarding the correction of mathematical errors and Article 7 of the Revitalization Act with respect to the approval of the Adjustment Mechanism.

interest of the associated Bonds, pursuant to the expected amortization schedule, to finance at the required levels all debt service reserve funds or accounts, and to pay, when appropriate, all Ongoing Financing Costs;

- (vi) describes the benefit for Customers and for the Authority that are expected to result from the issuance of the Bonds;
- (vii) concludes that the calculation methodology in accordance with clause (iv) and the Adjustment Mechanism in accordance with clause (v) are practicable to administer and shall assure the full and punctual payment of the Bonds;
- (viii) authorizes the creation of the Financing Property and specifying that it shall be created and vested into the Corporation after the issuance of the Bonds, and addressing other matters, as may be necessary or desirable for the marketing or servicing of the Bonds or the servicing of the Financing Property;
- (ix) authorizes the imposition, billing and collection of Revitalization Charges to pay debt service on the Bonds and other Ongoing Financing Costs;
- (x) describes the Financing Property that shall be created pursuant to the Financing Resolution and vested upon the issuance of the Bonds to the Corporation and that may be used to pay and secure the payment of the Bonds;
- (xi) authorizes the execution and delivery by the Corporation of one or more servicing, billing or collection contracts with one or more Servicers and other agents and permit the designation of co-Servicers or sub-Servicers upon the occurrence of the events that the Corporation, being advised by its consultants, determines enhances the marketability of the Bonds;
- (xii) authorizes the execution and delivery by the Corporation of one or more depository, trust or escrow agreements with financial institutions or other Persons providing for the deposit (escrowing) and allocation of the collections of Customer bills between the Authority and the Corporation, as the Corporation, in consultation with its advisers deems appropriate, and determines that enhances the probability of sale of the Bonds;
- (xiii) requires the filing of billing and collection reports relating to the Revitalization Charges as the Corporation may require of a

Servicer<sup>15</sup> (at least on a monthly basis);

- (xiv) approves and authorizes the form, execution and delivery of a Trust Agreement;
- (xv) details other conclusions, determinations and authorizations that the Corporation, being advised by its consultants, deems appropriate; and,
- (xvi) certifies that the Revitalization Charges related to the Bonds issued and to be issued shall not exceed, in the aggregate, twenty percent (20%) of the charges billed by the Authority;
- (xvii) itemizes which projects within the Authority's CIP shall be financed with such issuance, which as of the date of the approval of the Revitalization Act, must include all infrastructure projects that were postponed, halted or stopped because of the Authority's lack of funds, as itemized in Resolution No. 2984 approved by the Authority's Governing Board on June 3, 2016<sup>16</sup>:

<sup>15</sup> Article 3(22) "Servicer" - means the Authority, to the extent permitted by this Act and, if the Authority is replaced as Servicer under a Servicing Contract, means a Person or Persons authorized and required, by contract or otherwise, to impose, bill, or collect Revitalization Charges, to the Authority's periodic reports in relation to the billing and collection of Revitalization Charges, to remit collections by or on account of the Corporation or its assignees or creditors, including a Financing Entity, and to provide other related services, which may include the calculation of periodic adjustments to the Revitalization Charges or provide other services to the Corporation relating to the Financing Property; and it shall be understood to include any sub-Servicer, alternate Servicer (backup) (including if it becomes a Servicer under the Servicing Contract), substitute Servicer or the successors of any of the foregoing, authorized to act as such by a Financing Resolution.

<sup>16</sup> Included CIP projects: i. Construction of the Valenciano Filter Plant Phase I and the Improvements of the Ceiba Sur Take; ii. Improvements to the Filtration Plant of Isabela and the Distribution System for the Elimination of the Filtration Plant Rocha; iii. Extension of the System of the Sanitary Sewer System in the Northeast of the Añasco Municipality of the Quebrada Larga Neighborhood, Caracol, Piñales, Hatillo & La Playa (Termination of Project); iv. Ponce Sanitary Trunk Sewer Rehabilitation; v. Sanitary Sewer Plant (Termination); vi. New Control Access Gates Installation for Urb. Golden Hills; vii. Sanitary Sewer System for the Communities Las Brumas, La Ley, Marginal La Ley, Pepe Hoyos and Santa María; viii. Design and Construction for the Improvements of the Filtration Plant of Guajataca – Rehabilitation and Installation of Two Modules of Paquete Plants; ix. Sanitary Sewer System Termination of the Community Sandín; x. New Pre-sedimentary Tank for the Filtration Plant Toa Vaca; xi. Sanitary Sewer System Termination of the Community Sammy Vélez; xiii. Improvements to the Sanitary Sewer Plant; xiv. Sanitary Trunk Relocation PR-111 & PR-125; xv. Improvements to the Sanitary Sewer Plant Bayamon Phase I; xvi. New Offices Construction ("Site Works")- Phase II; xvii. Quebrada Water Treatment Plant LT2 Compliance Improvements; xviii. Electrical and Mechanical Improvements and Installation of a Generator of Emergencies in the Take of Raw Water of the Filtration Plant; xix. New Tank CT/Distribution of the Filtration Plant Corozal Urbana; xx. Puerto Nuevo WWTP Grit Collection Facility/New Septage Receiving Stations and Roadway Improvements"; xxi. Improvements to the Filtration Plant Ponce Vieja and Construction of a New Tank of 4 MG; xxii. Rehabilitation Lago Cidra Dam; xxiii. Rehabilitation Candelas Pump Station; xxiv. Non-Revenue water reduction program, large and small meters; xxv. (Group 10) Rehabilitation of Filtration Plants Program Group 10; xxvi. Replacement of Penstock Plant Carite III for supply PF Guayama; xxvii. Stabilization of floors in the Pump Station the 300, PR-128; xxviii. Replacement of Las Americas Residence Extramural Sanitary Sewer System; xxix. Villalba Regional Aqueduct Water Transmission Line from Juana Díaz to Coamo, Los Llanos & El Encanto Chlorination Rooms; xxx. Improvements to the filters system at Cayey WWTP; xxxi. Interconnection of Arecibo Urbano System to the North Coast Aqueduct; xxxii.

Since the Revitalization Charge is a new charge, we have been asked if that means it increases the costs of utility service to the Customers. The Authority regards that if successful, the issuance of the Bonds will result in savings through expected debt service reductions for the benefit of the Customers. This is discussed in more detail in Attachment 3 to the Report.

The Revitalization Act, in its amendments to Act 40, clearly state that Customers will benefit from the proposed transactions.

#### IV. EXPECTED BENEFITS FOR THE AUTHORITY

The final approval and validation of the Financing Resolution will undoubtedly provide significant benefits to the citizens of Puerto Rico, and serve as a successful mechanism to alleviate the [current] debt burdens of the Authority.

- A. If successfully implemented the expected benefits to the Authority and for the Commonwealth from the issuance of the Bonds would include:
- a. Providing a new vehicle to access the capital markets with the purpose of giving PRASA access to the necessary funds to pay the approximately \$150 million dollars due to its contractors, as well as a new source of financing for its CIP;
  - b. Providing the opportunity, subject to compliance with the conditions hereinbefore stated for PRASA to refinance, cancel or defease, whether through an exchange of bonds or otherwise, its existing indebtedness, and accrue substantial net debt service savings. Although the total potential net savings to PRASA cannot be precisely anticipated in advance of an actual transaction, since it is dependent on external factors and uncertainties, the Corporation estimates that compliance with the provisions of the Act, including

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Elimination Filtration Plant La Máquina; xxxiii. Design and Construction for the Rehabilitation of the Plant of Sanitary Sewer; xxxiv. Vega Baja Water Treatment Plant LT2 Compliance Improvements; xxxv. Improvements to the Filtration Plant – Compliance; xxxvi. Elimination Sanitary Sewer Sector Alturas of Orocovis and Sanitary Sewer Com. El Gato Phase 1; xxxvii. (Group 16) Filtration Plant Rehabilitation Program (Group 16); xxxviii. (Group 12) Filtration Plant Rehabilitation Program (Group 12); xxxix. Improvements to the distribution system of potable water in Camarones Centro Bo. Santa Rosa I, Phase II”; xl. Cedro Arriba WTP Compliance Upgrade; xli.

Design – Build for the Construction of new Distribution Tank at Cerro Marquez and Pipeline; xlii. Morovis Sur WTP Compliance Improvements; xliii. Repair, Replacement and Renovation – Minor Construction Work; xliv. Improvements to the Aguas Buenas Treatment Plant LT2 Compliance; xlv. Improvements to the Filtration Plant Morovis Urbana; xlvi. Improvements to the Water Filter System at Guilarte Filter Plant; xlvii. Structural Improvements in the Pump Stations of Sanitary Sewer Levittown; xlvi. Water hammer Arrest System for La Plata Raw Water Pipe; xlix. Improvements to the Filtration Plant Luquilla Urbana LT2; l. WTP La Plata (Reservoir) – Phase I Correction of Security Issues at Dam (Drainage and Recess); li. Elimination of Sanitary Sewer Plant Villa Taina (Phase II) – Improvements at the Station Palmarejo; lii. Improvements to the PF Gurabo liii Repair, Replacement and Renovation – Minor Construction Work; liv. Improvements to the Filtration Plant Urbana Iv. Design and Construction of Administrative Offices in the Central Operations of the Area de Manati; lvi. Sanitary Trunk Rio Grande Estates or detour Coco Beach, Rio Grande; lvii. Jimenez WTP (STC), Rio Grande; lviii. Improvements to the take of raw water of the PF Guzmán Arriba, Rio Grande; lix. Study and rehabilitation of the sanitary sewer system in Rio Grande Estates, Rio Grande.

haircut, interest rates and other terms specified therein, will provide sufficient present value savings, for the benefit of PRASA, the Commonwealth and its residents.

- c. Promoting the financial recovery of PRASA and the continuation of its regulatory capital investment projects for the modernization, efficiency and regulatory requirement compliance, as more particularly set forth in the 2015 Consent Decree entered into by PRASA and the United States Environmental Protection Agency (“EPA”) and in the Settlement Agreement entered into by PRASA with the Department of Health (“DOH”) of the Commonwealth
- d. Permitting the restoration of PRASA’s prior fiscal self-sufficiency, end the financial burden of past due accounts and enable an influx of capital for its CIP program, for at least the next three (3) years, which requires funds to be invested in order to modernize, foster efficiency and comply with regulatory requirements, as well as potentially reduce its current debt burden. These actions would benefit not only PRASA, but also the Commonwealth and all its citizens.
- e. If PRASA were unable to receive the benefits availed to it under the Revitalization Act it would be impossible for PRASA to continue operating without having to modify its current rate structure and substantially increasing Customers charges.
- f. The implementation of the CIP is among the highest priorities for PRASA and its Governing Board, and without access to the proceeds of the Bonds, it would not be able to continue its projects and plan for future CIP projects. As stated in this Report, PRASA is currently unable to access capital markets independently from the Revitalization Act. It is expected that by providing the funds for its CIP and potentially reducing its debt burden, the issuance of the Revitalization Bonds will reestablish PRASA’s financial health and place it in a position to make or attract new investments in infrastructure and to meet the future needs of its Customers at a reasonable cost.
- g. In turn, PRASA’s revitalization is expected to promote capital investment and stimulate economic activity in the Commonwealth and its economic growth, giving gainful employment to thousands of Puerto Ricans and their families, providing also for the continued operation of local businesses, allowing them to continue or regain financial stability.

- h. Even if the Corporation were unable to carry out the simultaneous defeasance, cancellation or exchange of PRASA's bonds, it is still convenient to seek the approval of the Financing Resolution since it is of the outmost importance for PRASA to raise new money in the maximum amount authorized under the Revitalization Act, \$900,000,000 to be able to continue its CIP projects. [MORE TO COME]

## V. OBLIGATIONS UNDER THE SERVICING AGREEMENT

Although the Corporation is the entity entitled under the Revitalization Act to collect and receive the Revitalization Charges, it is almost impossible to carry out this function without the assistance of a Servicer. The Authority is in the best position to carry out said services for the Corporation, since it has in place the billing structure that will be necessary to charge and collect the Revitalization Charges to the Customers and has the historical information data necessary to calculate all formulas required under the Revitalization Act and the Proposed Financing Resolution, including the calculation of the Revitalization Charge and the Adjustment Mechanism. By entering into a Servicing Agreement with the Corporation, the latter would not have to recreate the Customers' records, service centers, payment processing systems, reports, and others. The Authority is the best provider of these services at this time.

The Corporation and the Authority have drafted a preliminary Servicing Agreement, which is attached to the Proposed Financing Resolution, providing that the Authority will act as an agent for the Corporation in performing the aforementioned functions, while at the same time maintaining complete legal separation between the Corporation and the Authority and protecting the Corporation's ownership of Revitalization Charge revenues.

The Authority has the resources and can perform such functions, for which services the Corporation will compensate the Authority. Attachment 3 to the Report prepared by PFM. discusses the obligations the Authority would undertake as Servicer and confirms that they are reasonable and customary in the industry. It also states the operational adjustments that the Authority will have to undertake to meet its obligations under the Servicing Agreement and analyzes the incremental cost to the Authority of doing so. The final Initial Servicing Agreement may vary from this form, but not as to the fees to compensate the Authority for its incremental costs.

Pursuant to the aforementioned report, the payment to be made by the Corporation to the Authority is set based on the scope and cost of the work the Authority will perform and is calculated to compensate the Authority for the reasonable incremental costs of acting as the Servicer. The Corporation has determined that the payments to be made to the Authority as Servicer are sufficient to compensate the Authority for the reasonable incremental costs of performing the servicing functions as set out in the proposed Servicing Agreement. The Authority's advisors agree with such conclusion. The analysis supporting that determination is presented in the Statement from PFM, Attachment 3 to the Report.

## VII. AUTHORITY'S OBLIGATIONS TO MAINTAIN AND PROVIDE ACCURATE

## CUSTOMER RECORDS

The collection and retention of Authority's collection and retention of historic Customer's consumptions and related data is collected and maintained by the Authority as described in Appendix [-] to the Proposed Financing Resolution, which data is collected monthly by the Authority on an aggregate basis, as per its internal customary formalities, which included in Attachment \_\_\_ to the Report.

Prior to this date, during the various working sessions with PRFAFAA, the Corporation, and their respective advisors, the Authority provided accurate historical residential and non-residential Customer consumption data and residential Customer accounts from its records, which are necessary and essential in the calculation of the Revitalization Charges. It includes such data for the most recent 18 month period for which such information is reasonably available.

## VIII. CLOSING COMMENTS

The Authority understands that with the presentation of the Report and the Proposed Financial Resolution, together with their respective attachments, the Corporation has fully complied with the requirements that will permit the initiation of the public hearing process and subsequent validation described in the Revitalization Act, after the conclusion of which, the Financing Resolution will become final and approved, and the Corporation may issue the Revitalization Bonds for the Authority's benefit.

The Authority is of the opinion that the Financing Resolution, once finally approved and validated as per the procedures established in the Revitalization Act, will undoubtedly provide significant benefits to the citizens of Puerto Rico, and serve as a successful mechanism to provide the Authority with access to funds to finance its CIP and potentially alleviate the Authority's debt burdens. The Authority is also of the opinion that the benefits to the itself and for the Commonwealth contained herein are true and correct, and are reasonable taking into consideration the Authority's operations, rate structure, financial obligations and CIP related regulatory compliance.