Mathematics and the Puerto Rico Conundrum

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"…..It's just math" so says Puerto Rico Governor Alejandro Garcia Padilla. This simple statement, explaining that the U.S. territory would be unable to pay its bills, harkens observers back to their first math classes. Subtracting a big number from a smaller number leaves a negative number and if the numbers reflect cash, negatives are a bad thing. The past few days have brought about numerous references to mathematical concepts and data in an attempt to explain Puerto Rico's conundrum: that confusing, intricate and difficult problem of paying past, current and future obligations, while delivering essential services to citizens and visitors in Puerto Rico. The recently published Krueger Report[1] is full of numbers and measures that explain why Puerto Rico is in the position it is. Retired Bankruptcy Judge Steven Rhodes says "Puerto Rico is insolvent…," the litmus test of mathematics gone awry. Wall Street warns that "millions of American retirees" will be harmed if Puerto Rico defaults. Municipal advisors suggest that the contagion effect on the municipal finance markets will be extraordinary, and on and on. We acknowledge that this is high math, with significant implications, but enough about the math. Math can define the problem but it can't solve the problem.

We view the Krueger Report as an important summary of the problems and a good overview of some of the solutions. We agree a comprehensive approach to change in the territory's government structure and operations is warranted. Scan the Puerto Rico media over the past few days, however, and you would think this is a win-lose situation. The focus is on who is going to get paid what, who is going to feel what pain and how the Puerto Rican predicament could affect the U.S. mainland. Those sentiments may be great for headlines but that is the ***wrong*** focus.

While there is no avoiding discussions regarding who will take short term pain and who will get paid; the real work is analyzing and developing a viable economic model. The Krueger Report notes that trends in migration, energy costs, transportation costs and barriers to competition and business activity all are causing head winds to a recovery. The fact is, without a viable economic model, any deal to pay creditors 80 cents today will quickly morph to 75 cents next year and 50 cents 5 years from now. The time to focus on creating viable, sustainable government services at an effective cost is now. Every delay makes getting to a viable model more difficult.

All mission-based enterprises must operate at a sustainable break even and set aside reserves for the rainy day, if they intend to exist, prosper and grow over the long term. Governments are the poster child for ignoring this fundamental truth; deficits unacknowledged by accounting gimmickry and masked by financial engineering will always be unsustainable in the long term. The intercreditor debate must

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[1] **Published by Anne Krueger with Ranjit Teja and Andrew Wolfe http://recend.apextech.netdna-cdn.com/docs/editor/Informe%20Krueger.pdf**

occur but the more important dialog today is about what Puerto Rico and its stakeholders need to change to create a viable and stable territory and…..what will it cost to get there?

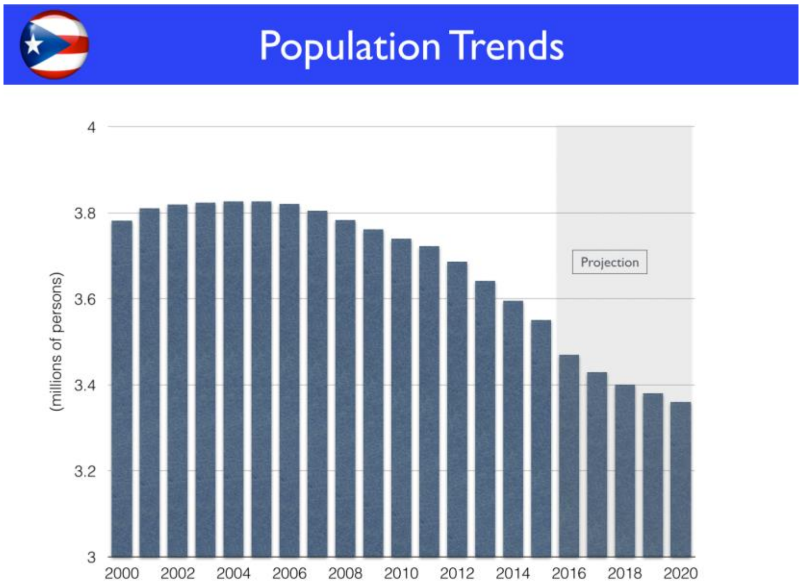
Does Puerto Rico resemble Detroit? Absolutely, including declining population, unsustainable debt burden, no capital market access, essential public service delivery insolvency. Are there important differences? Absolutely, including no external “adult supervision” like Detroit’s Emergency Manager, no strong governmental support from the supervising level of government, no access to a controlled and impartial forum like a Bankruptcy Court, and no existing framework for getting to sustainability. Still, the Detroit approach to fixing the City while fixing the balance sheet does make sense for Puerto Rico. Puerto Rico is advantaged in that its revitalization can proceed on a sensible timetable[i] that can allow for priorities focused on getting the economic model right and undertaking the creditor negotiations in due course.

As is true in many municipalities in this country, past taxpayers have failed to pay the real cost of the services they received over the past decades leaving the bill to future generations. Traditional investors put their money into public sector debt even with a low return, because their principal was “protected.” Citizens went to work for the government because the unions were strong, the benefits were good and even if the pay wasn’t equivalent to the private sector, the employer’s demands were modest and the retirement “guarantees” were solid. Elected officials were motivated by sponsoring programs they thought would bring prosperity and voter happiness near term and their standard practice was to assume that the future good times or some complex financial protocol or “one-shot” activity would allow them to meet the budgetary requirements. Thus presents the other conundrum: no one group of stakeholders is responsible for, nor can one group solve, the problem. Attempts by any group to avoid responsibility or fail to take a proactive role in the revitalization process should be a non-starter for any stakeholder.

As such, the comprehensive approach suggested in the Krueger Report makes sense although a rigorous framework will be required. The connectedness between the central government, governmental agencies, and quasi-governmental entities is so extensive, but for the fact that each of these are separate debtors, there would be little reason to look at their economic profiles separately. While we have not seen a credible analysis of the “due to/due from” accounts amongst these entities, each one touches not only their governmental siblings and cousins but the residents and taxpayers as well. From a restructuring perspective, this is another reason why it is imperative to fix the income statement first before moving on to correcting the balance sheet. Now is not the time for the University of Puerto Rico to argue about its electric bill when it must fundamentally determine how it can deliver its essential services at an effective cost.

Puerto Rico needs a fresh approach to restructuring and revitalization. Although there is value in analyzing reams of historical data and conducting studies of “why” and “how much”, the benefit is marginal to the work that must be done prospectively to stop the downward spiral of distress. Whether the obligations are $72 billion or $100 billion, a population of 3.5 million people and a government system that has lost its ability to “rob Peter to pay Paul” can’t make the math work, today or 5 years from now. Focus on the essential mission-based activities of the Commonwealth and let the capital structure flow from there.

In viewing the chart below from the Krueger Report, one is left with the question: If Puerto Rico doesn’t solve the problem of economic viability, how many people will be left to foot the bill?



[i] The Michigan Emergency Manager statute provides for a fixed 18-month time period to accomplish the stabilization which in turn, forces difficult choices between restructuring the balance sheet and revitalizing government services.