



PUERTO RICO AQUEDUCT AND SEWER AUTHORITY REVITALIZATION CORPORATION

TO: Executive Director
Puerto Rico Fiscal Agency and Financing Advisory Authority

FROM: Michael Mace¹
Managing Director
Public Financial Management, Inc. ("PFM")

DATE: July 27, 2016

RE: Supporting Memorandum on the Structure and Mechanics of the Proposed
Transactions in the Financing Resolution

Introduction and Summary

This memorandum is prepared on behalf of the Puerto Rico Aqueduct and Sewer Revitalization Corporation (the "Corporation"). PFM is a financial advisor to the Puerto Rico Fiscal Agency and Financial Advisory Authority ("PRFAFAA") and to the public corporations of Puerto Rico. This memorandum is in support of the "Report In Support Of The Proposed Financing Resolution Issued By The Board Of Directors Of The Puerto Rico Aqueduct And Sewer Authority Revitalization Corporation" (the "Report"), presented pursuant to 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").

In this memorandum I address the structure and mechanics of the proposed transactions described in the Financing Resolution and the Report including:

1. The description of the Bonds authorized by the Financing Resolution (the "Bonds") and the terms by which certain Bonds are exchanged for, or otherwise legally or

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economically defease, currently outstanding bonds issued by Puerto Rico Aqueduct and Sewer Authority ("PRASA" or the "Authority").

2. The Upfront (or "one-time") Financing Costs, Ongoing Financing Costs, and other costs estimated to be incurred and recovered; and the consistency of these costs and their recovery with requirements in the Revitalization Act.
3. The Servicing Agreement and the duties of PRASA as the Initial Servicer (as defined herein).

In this connection, I address many of the requirements of the Revitalization Act applicable to the Financing Resolution, and other aspects of the transactions described therein.

I. TRANSACTION BACKGROUND AND FRAMEWORK

The main purpose of the transactions described in the Financing Resolution is to provide a legal mechanism to revitalize the Authority, in order to give it the necessary tools to regain financial stability and be able to continue providing quality water and sewer services for the benefit of the citizens of Puerto Rico. The bond transactions contemplated in the Revitalization Act and the Financing Resolution are aimed to assist the Authority in meeting its payment obligations to its CIP contractors, as well as resuming its CIP commitments, and are integral to PRASA's long-term financial strength. This portion of the Bonds will be referred to herein after as "New Money Bonds".

Additionally, under Article 7(a) of the Revitalization Act, the Corporation may also issue one or more series of Bonds 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 in order to retire, cancel, purchase, 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. The bonds to be retired, canceled, purchased, defeased or refinanced must be done so at a value not greater than eighty-five percent (85%) of their nominal or face value. Features of the Bonds to be issued include: (i) no payment of principal for at least the first five (5) years from the date in which they are issued, and (ii) the interest rate of the Bonds to be issued will be established according to the credit rating conferred to the Bonds at the time of their issuance, as described below. This portion of the Bonds will be referred to hereinafter as the "Tender/Exchange Offer Bonds".

If issued these Tender/Exchange Offer Bonds would reduce near-term debt service costs in order to benefit the citizens of the Commonwealth and revitalize the Authority. In this respect, existing creditors would agree to the above conditions in exchange for receiving Bonds (or the economic equivalent) that, by virtue of the securitization process authorized by the Revitalization Act, will have a lower risk of default. Because those securitized Bonds have a lower risk of default, they are also expected to require a lower interest rate, providing a further benefit to PRASA and the customers who ultimately pay the debt costs through utility rates and Revitalization Charges. As a result, PRASA's outstanding indebtedness will be reduced and its ability to repay its



remaining financial obligations will be improved, an essential step to PRASA's turn-around.

Bonds Authorized by the Financing Resolution

Once PRFAFAA issues its Certification under Article 7 of the Revitalization Act, the issuance of the Bonds is authorized and governed by the Financing Resolution. For the convenience of the PRFAFAA I will summarize key characteristics of the Bonds that the Financing Resolution authorizes. Those Bonds fall into two broad categories: “New Money Bonds” and “Tender/Exchange Offer Bonds”.

A. New Money Bonds - One or more series of Bonds to be issued on the date of sale and delivery of the Bonds in an initial aggregate principal amount not to exceed \$900,000,000; and

B. Tender/Exchange Offer Bonds - One or more series of Bonds to be issued in an aggregate principal amount not to exceed the difference between \$900,000,000 and the maximum amount of Bonds that can be financed with the Revitalization Charge approved under the Act (the “Exchange Offer Bonds”), to cover the costs of retiring, defeasing or refinancing a portion of debt obligations. No agreement is currently in place with Bondholders. The transaction may be pursued as a tender or exchange. A portion of these bonds may be issued to the beneficial holders of Bonds, in exchange for such Bonds (i) at an exchange ratio (principal to principal) which satisfies the requirements of the Securitization Law and (ii) may also be issued in an amount equal to and in satisfaction of any accrued and unpaid interest owing on such Bonds at the time of such exchange. The rest of these bonds may be issued to cover the cost of purchasing outstanding Bonds at similar terms as the exchange offer. Any tender or exchange offer under this authorization will be pursued on the basis of the savings the transaction offers to the Authority and its clients. The Exchange Offer Bonds to be issued to the beneficial owners of PRASA Bonds (i) at an exchange ratio (principal to principal) of 85% and (ii) at the interest rates provided for under the Act depending on the ratings received on the Bonds, as set forth in the following table:



<i>Interest Rate</i>	<p>For Current Interest Bond Payments:</p> <ul style="list-style-type: none"> 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: <p>AAA: 4.00%</p> <p>AA+/AA/AA-: 4.25%</p> <p>A+/A/A-: 4.50%</p> <p>BBB+/BBB/BBB- or less: 4.75%</p>	<p>For Convertible Capital Appreciation Bonds:</p> <ul style="list-style-type: none"> 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: <p>AAA: 4.50%</p> <p>AA+/AA/AA-: 4.75%</p> <p>A+/A/A-: 5.25%</p> <p>BBB+/BBB/BBB- or less: 5.50%</p>
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Terms of the Bonds

The Bonds of any issue (i) may be issued in one or more tranches or series, at one or more times, (ii) may be issued as any combination of serial and term Bonds and as Bonds paying current interest ("Current Interest Bonds") and Bonds accreting interest for a period after their issue date and paying cash interest thereafter ("Convertible Capital Appreciation Bonds" or "Convertible CABs"), (iii) may have (A) a scheduled maturity date or dates (including scheduled mandatory sinking fund redemption dates), which will be a date or dates by which such series or tranche is to be amortized in principal amounts set forth therein for such date or dates and with the Revitalization Charges set at sufficient levels to generate receipts to enable such amortization on such date or dates, and (B) a legal maturity date or dates (including legal mandatory sinking fund redemption dates), which will be a date or dates by which such series or tranche must be amortized in principal amounts set forth therein in order to avoid a default under the transaction documents and which is expected to be two years after the related scheduled maturity date, provided that the legal maturity date for any series or tranche of the Bonds shall be no less than one year and no more than thirty-five years after the date of issuance of the Bonds, and (iv) shall have such other terms and details, consistent with the Financing Resolution and as contained in the applicable Trust Agreement as executed and delivered, subject to the following additional limitations described in the Financing Resolution.

In no event are Bonds to be issued during the pendency of any action brought pursuant to Article 7(c), (d) or (e) of the Act, nor later than five (5) years from the date of adoption of this Financing Resolution.



The final term of the Bonds, consistent with the terms of this Financing Resolution, shall be approved by the Corporation either solely by act of the Corporation Designee, as evidenced by the execution of the Designee Certificate, or in the discretion of the Board, through an award resolution (an “Award Resolution”) which the Board may adopt to approve the final pricing and terms of the Bonds. In either such case, the approval of the final terms of the Bonds shall be conclusively evidenced by the execution and delivery by the Corporation Designee of the Designee Certificate and the applicable Trust Agreement.

Contribution of the Bonds to the Revitalization or Economic Defeasance of Outstanding PRASA Debt

The proceeds of the New Money Bonds are to be used to finance or pay: a) the capital costs related to PRASA's Capital Improvement Program for a period of up to three (3) years from the date of issuance, including those projects of the Capital Improvement Program that had been initiated but not finished before the approval of the Act, detailed in Resolution No. 2984 adopted by the Governing Board of PRASA on June 3, 2016; including all projects that were postponed, halted or stopped because of lack of funds of PRASA; (b) the applicable costs of PRASA's accumulated debt, as of the time of approval of the Act, relating to the CIP's accounts payable, including reimbursement to PRASA of the advances, if any, made from its operational funds for said CIP, as well as the payment of any amount owed to suppliers of goods or services related to the implementation of the CIP that are outstanding; (c) refinancing credit lines or other instruments of short-term debt, such as notes, bonds, promissory notes or other interim financing issued or incurred by PRASA in anticipation of the issuance of Bonds of PRASA or the Bond Anticipation issued to meet the purposes of the Act; (d) the arbitrage rebate, yield reduction payments and any other amount payable to the United States of America to preserve or protect the federal tax exempt status of PRASA or Corporation's outstanding debt obligations; (e) the deposits from proceeds of issuance of the Bonds that are paid to a capitalized interest fund or account, a debt service reserve fund or account, or an operating expense reserve fund or account, established in connection with the Bonds; (f) costs related to the negotiation of legitimate labor debts pending payment by PRASA; and (g) subject to the limitations contained in the Act, the Financing Costs;

The Exchange Offer Bonds will be delivered to the beneficial owners of PRASA bonds who agree to exchange such PRASA bonds for Bonds at a discount equal to 15% of the principal amount of such PRASA bonds. The discounted exchange provides an immediate reduction in the principal amount of bonds that remain outstanding and is a key component of the settlement with PRASA's creditors. The effect of the exchange is to retire more costly PRASA bonds with Bonds having a smaller total principal balance and lower interest rates.

The Trust Agreement

The Corporation will enter into a Trust Agreement (the “Trust Agreement”) with a bank or trust company acceptable to the Corporation Designee (the “Trustee”) pursuant to which the Bonds may be issued and secured. As provided in the Revitalization Act, the Corporation, by its execution and



delivery of a Trust Agreement, will pledge the Financing Property to secure the payment of Bonds, amounts payable to Financing Entities, and other Ongoing Financing Costs. While the Financing Property remains pledged to secure such payments, revenues from the collection of Revitalization Charges shall be applied solely to pay Ongoing Financing Costs. Following the award or pricing of any issuance of Bonds, consistent with this Financing Resolution, the Corporation Designee is authorized to execute and deliver the Trust Agreement, together with any supplements thereto consistent with the terms of the Trust Agreement, with such changes, omissions or alterations, consistent with terms of this Financing Resolution, as the Corporation Designee shall approve upon the advice of financing counsel to the Corporation, his or her execution of the same being conclusive proof of the approval of such changes, omissions or alterations.

The Revitalization Charge

The Revitalization Act defines "Revitalization Charges" as "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." The Revitalization Act also defines "Revitalization Charge Revenues" as "all money and other property received or to be received, directly or indirectly, on account of the Revitalization Charges, and all proceeds of the investment thereof." In simplified terms, Revitalization Charges are the monies that the Corporation collects from PRASA customers that allow the Corporation to pay debt service on the Bonds and cover other Ongoing Financing Costs when they become due and payable.

The Adjustment Mechanism

After the Revitalization Charge is established, it must be periodically adjusted in response to changes in both the cost of meeting the Corporation's obligations and the amount of funds actually collected (e.g., as a result of changes in consumption of water and/or wastewater collection services, number of customers, customer payment patterns, etc.). The Revitalization Act defines "Adjustment Mechanism" as "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."



Target Credit Rating for the Bonds

The objective is to obtain investment-grade rating (at least BBB-/Baa3/BBB). An investment-grade rating would provide for the largest potential pool of investors, which would, in turn, provide for lower yields. Many potential purchasers are not permitted to purchase or hold securities that are not investment-grade rated. The lower yields required by purchasers of investment grade bonds would reduce the costs of financing which would, in turn, reduce the Revitalization Charges customers must pay. It is important to note that at this point in the process no rating has been assigned to any of the Bonds, nor has there been a request for a rating made to any of the major rating agencies. There is no assurance that the Bonds will achieve the desired investment grade rating. It is currently expected that the Bonds will include all of the major credit features and criteria of other highly-rated utility securitization bonds. However, there are several conditions that are unique to PRASA, this securitization transaction, and to the Commonwealth that make it difficult to predict the outcome of the credit rating process.

Legal Protections - The Key Features of the Bonds Designed to Assure Their Full and Timely Payment

Described below are some of the legal protections of the Corporation's Revitalization transaction that I believe will be material to the credit worthiness of the Bonds. Such features are also addressed in the Financing Resolution.

Adjustment Mechanism: A critical credit provision for the Bonds will be the Adjustment Mechanism established in accordance with the Revitalization Act, which is the formulaic Adjustment Mechanism contained in a Financing Resolution, "to be applied by the Corporation periodically, and at least semi-annually, to adjust the Revitalization Charges and ensure the collection of Revitalization Charge Revenues that are sufficient to comply with the timely payment of Ongoing Financing Costs." A formulaic Adjustment Mechanism that responds to changes in Ongoing Financing Costs and Revitalization Charge Revenues is critical to ensuring that the Revitalization Charges provide for full and timely payment of the Bonds and other Ongoing Financing Costs. The Adjustment Mechanism proposed in the Revitalization Resolution would provide for the adjustments to be made not less than semi-annually to provide more certainty regarding the sufficiency of the Revitalization Charge Revenues. Semi-annual applications of the Adjustment Mechanism should also result in less variability in the Revitalization Charge itself.

Irrevocability of Financing Resolution: As provided in the Revitalization Act, upon the issuance of the Bonds, the Financing Resolution, the related Revitalization Charges, including their non-bypassability and the procedures for the Adjustment Mechanism, as provided in the Revitalization Resolution, are irrevocable, final, non-discretionary and effective without further action by the Corporation or any other Person. No adjustment of the Revitalization Charges pursuant to the Adjustment Mechanism shall in any way affect the irrevocability of the Financing Resolution.



Expected Maturity and Legal Final Maturity: Unlike most corporate and municipal bonds with fixed, date-certain maturities, utility securitization bonds are often structured to allow for flexibility with respect to the timing of principal repayment for each bond comprising the bond issue. In lieu of a single, fixed maturity date, the Bonds, and the individual tranches of the Bonds, will have one or more scheduled maturities, or "expected maturity dates," the dates by which principal is scheduled to be repaid. Revitalization Charges will be set based on the scheduled payment dates. The Bonds, and tranches, will also have "legal final" maturities, dates typically two years after the expected maturity dates by which all principal is required to be paid. This concept of a later "legal final" maturity allows for the Bonds to be paid on later dates than their scheduled maturity dates if Revitalization Charge collections are lower than expected and any reserves have been depleted, without triggering a default, upon the scheduled maturity dates. This time differential between the expected maturity date and the legal final maturity date provides a buffer period in which the Corporation can utilize subsequent Revitalization Charge Revenues to repay the Bonds. The Financing Resolution provides that the legal final maturity date for any series or tranche of the Bonds shall be no greater than two (2) years after the date of issuance of the Bonds. The majority of utility securitization bonds have a legal final maturity that is roughly two years after the expected maturity date.

Non-Bypassability: As provided in the Revitalization Act, for so long as the Bonds are outstanding, and the Approved Financing Costs (including any payments that have or are to become due under Ancillary Agreements) have not been paid in full, the Revitalization Charges authorized and imposed by the Revitalization Act shall be obligatory, non-bypassable and apply to all Customers. Effectively, non-bypassability means that the Revitalization Charges will be payable by Customers who remain or become PRASA Customers.

Commonwealth Pledge: As provided in the Revitalization Act there are a number of Commonwealth covenants. In Article 13 of the Revitalization Act, the Commonwealth has covenanted, pledged and agreed with the holders of the Bonds that after the issuance of Bonds, neither the Commonwealth of Puerto Rico nor any agency, public corporation, municipality, or other instrumentality thereof shall take or allow any action to be taken to limit, alter, reduce, impair, postpone, or terminate the rights conferred in any Financing Resolution, including those related to Revitalization Charges and the related Adjustment Mechanism, as the same may be adjusted from time to time pursuant to the applicable Financing Resolution, in a manner that impairs the rights or remedies of the Corporation or the bondholders, parties to any Ancillary Agreement or any Financing Entity or the collateral for the Bonds or Ancillary Agreements, or that impairs the Financing Property or the billing or collection of Revitalization Charge Revenues.

Financing Property: The Financing Property created by the Revitalization Resolution includes the Revitalization Resolution and the property rights and interests created thereby, including the right, title, and interest in and to: (a) the right to create and receive Revitalization Charges in amounts sufficient to pay the Bonds and all related Ongoing Financing costs in full and on a timely basis; (b) the Revitalization Charges, as adjusted from time to time in accordance with the Adjustment Mechanism, including any rights under the Servicing Agreement, the Calculation Agent Agreement, the Depository Agreement(s) (referred to below) or other security agreement assigned pursuant to the Trust Agreement(s); (c) all revenues, collections, claims, payments, money, or proceeds of or arising from the Revitalization Charges or constituting Revitalization



Charges, regardless of whether such revenues, collections, claims, payments, money, or proceeds are billed, received, collected or maintained by PRASA, any other Servicer or by the Corporation, together with or commingled with other revenues, collections, claims, payments, money or proceeds; (d) all rights to obtain adjustments to the Revitalization Charges pursuant to the terms of the Adjustment Mechanism and the Financing Resolution; and (e) all reserves, surety Bonds, or other collateral accounts established in connection with the Bonds or the Revitalization Property and pledged to the payment of the Bonds under the Trust Agreement.

Upon the issuance of any series of Bonds, the Revitalization Property shall constitute a vested, presently existing property right in the Corporation, as initial owner, subject to the transfer, sale, or conveyance as provided in the Trust Agreement, notwithstanding the fact that the value of the property right will depend on further acts that have not yet occurred, including Customers remaining or becoming connected to the System Assets, the imposition and billing of Revitalization Charges, or PRASA performing services.

Validation: Many jurisdictions permit issuers of municipal bonds to "validate" bond issues in a court proceeding. In many instances, validation actions are commenced to settle legal questions particular to the subject bond issue, such as constitutional issues upon which the highest court of such jurisdiction has not ruled. Validation statutes also typically provide for liberal joinder rules, allowing for participation by the broadest range of interested parties and, therefore, the consideration of the broadest range of legal issues. Successful validation actions provide investors with substantial comfort because the legal issues raised and settled by the court, except in very limited instances, and are not subject to collateral attack in any subsequent legal proceedings. The Revitalization Act provides that, after certain approvals by the PRFAFAA and by the Corporation of the Financing Resolution, any Interested Party may commence a validation action relating to the Bonds to determine, among other things, the validity of the Bonds, the Financing Resolution, including the Adjustment Mechanism, that the issuance of the Bonds does not breach any contract or covenant made by the Commonwealth or PRASA, and any or all other matters relating to the transaction that raise issues under the United States or Commonwealth Constitutions.

Legal Opinions: Various legal counsels to the Corporation will render legal opinions that have become customary in utility securitizations. Such opinions may also rely upon the outcome of any validation proceeding in reaching the conclusions set forth therein.

Servicing Arrangements: The Corporation is authorized pursuant to the Revitalization Act to enter into a servicing agreement with PRASA, as the initial Servicer. As Servicer, PRASA will perform such duties of the Servicer as may be required or permitted by the Revitalization Act, including providing for the servicing, billing and collection of the Revitalization Charges. In the event of a default in its obligation under the Servicing Agreement, PRASA can be replaced as Servicer to ensure the timely and full payment of the Bonds and all Ongoing Financing Costs.

Debt Service Reserve Account(s): There may be an initial Debt Service Reserve Account(s), which may be funded with a combination of surety bonds and cash from a portion of the proceeds of the Bonds. Different series of Bonds may have different reserves. The reserve may be larger than reserve accounts in comparable transactions to account for the credit challenges of the Commonwealth and the Servicer, as well as the lack of servicing history. Additionally, other



restricted accounts or subaccounts may be required to be established by the Trust Agreement, and to the extent permitted in the Trust Agreement, any Ancillary Agreement, including without limitation, any additional reserve fund.

Purpose of Reserve Account(s)

The reserve accounts provide liquidity so that payment of debt service and Ongoing Financing Costs will not be interrupted in the event Revitalization Charge collections are insufficient to pay such costs on any payment date. Reserve accounts are typically required by rating agencies in other securitizations in order to receive the highest reasonably attainable credit ratings and the reserves have typically been sized to an amount equal to 0.50% to 2.00% of the initial par amount of the bonds. As noted above, certain challenges particular to this transaction, like the underlying credit of PRASA, are likely to necessitate a larger debt service reserve account. Additionally, debt service reserves (to provide sufficient reserves to account for miscalculations in the collections curve and other short term deficiencies in revenue collection) may also be required by the Trust Agreement. The reserve account may be used to pay all or a portion of the final debt service payment on the Bonds, if funds are otherwise sufficient to meet all remaining outstanding payment obligations under the Trust Agreement.

Advantage of Tax-Exemption of Bonds

Issuing the Bonds with interest that is exempt from federal income taxation will result in lower costs compared to a taxable transaction because the holders of the Bonds will not be required to include interest payments they receive on the Bonds in the calculation of gross income on their federal and state income tax returns. Interest earned on taxable bonds is included in the gross income of the holders and is subject to federal and often state income taxation as well. Investors in tax-exempt bonds should, therefore, be willing to accept a lower yield on their investment.

The result is that taxable bonds typically provide a higher pre-tax yield to investors than tax-exempt bonds, in order to provide a comparable after-tax return to the holder, relative to a tax-exempt bond. The result of the more favorable tax-exempt rates would be lower Ongoing Financing Costs and lower Revitalization Charges for PRASA customers.

Approved Financing Costs

The Approved Financing Costs for the New Money Bonds authorized by the financing Resolution are: (a) exclusively the capital expenditures related to the Authority's Capital Improvement Program for a period of up to three (3) years after the date of issuance, including those projects of the Capital Improvement Program that have been begun but have not been completed before the approval of this Act, even though the Corporation has borrowing capacity to issue a larger amount of debt, as provided in Resolution No. 2984 adopted by the Governing Board of the Authority on June 3, 2016; including all projects that were postponed, halted, or stopped due to the lack of funds of the Authority; (b) the payments applicable to the Authority's accumulated debt, as of the date of approval of this Act, related to the accounts payable of the



Capital Improvement Program, including the reimbursement to the Authority of any amounts paid in advance, if any, from its operating funds for said Capital Improvement Program, as well as the payment of any amount owed to goods or services providers related to the implementation of the Capital Improvement Program that are still outstanding; (c) refinancing credit lines or other short-term debt instruments, such as notes, bonds, promissory notes or other type of interim financing issued or incurred by the Authority in anticipation of the issuance of bonds of the Authority or Bond Anticipation Notes (BAN) issued to achieve the purposes of this Act; (d) the costs of retiring, defeasing, or refinancing all or a portion of the Authority's debt obligations or Bonds; (e) rebate, yield reduction payments and any other amounts payable to the United States of America to preserve or protect the federal tax exemption on outstanding debt obligations of the Authority or the Corporation; (f) deposits from proceeds of Bonds made to a capitalized interest fund or account, debt service reserve fund or account, or operating expenses reserve fund or account established in connection with such Bonds; (g) costs related to the negotiation of costs related to legitimate labor negotiations of outstanding debts paid by the Authority; and (h) subject to any limitations provided in this Act, the Financing Costs. The operating expenses of the Authority or the costs, if any, of financing said operating expenses costs shall not be deemed to be Approved Financing Costs under this Act.

Payment of the Bonds

The Bonds will be repaid solely through the imposition of Revitalization Charges and the collection of Revitalization Charge Revenues from Customers of PRASA. Pursuant to the Servicing Agreement, PRASA, as the initial Servicer, will bill and collect the Revitalization Charge and remit the Revitalization Charge Revenues to the Corporation to pay the Ongoing Financing Costs related to the Bonds and their issuance.

PRASA's role as the Initial Servicer.

The Servicer bills and collects the Revitalization Charges on behalf of the Corporation, all in accordance with the terms of the Servicing Agreement. In utility securitizations, whether the utility is public or private, such charges typically appear on the bills rendered by the utility and customers pay those charges through the utility. Practically, the utility is the entity best positioned to perform the functions required. Setting up a parallel servicing function and collecting and maintaining all of the required data would be very costly and time-consuming. The terms of the Servicing Agreement are addressed in additional detail below.

The Calculation Agent

Pursuant to the Revitalization Act the Corporation is authorized to retain the services of a third party Calculation Agent that is independent of the Government of Puerto Rico or PRASA. The Calculation Agent will confirm the calculation of the Revitalization Charges prepared by the Servicer. Under the Servicing Agreement, PRASA, as initial Servicer, will be required to implement the Adjustment Mechanism at least semi-annually. PRASA will provide an initial



calculation of the required adjustment to the Revitalization Charge, which calculation will be confirmed by the third-party Calculation Agent. The Corporation has been advised that the use of an independent Calculation Agent provides investors with greater comfort that the Revitalization Charge will be calculated accurately and, thus, in a manner that assures that the Bonds will be paid in accordance with their terms. In turn, this will enhance the marketability of the Bonds.

The Depository Agreement

The Corporation will enter into a trust or escrow agreement with financial institution or other Person – a “Depository” – providing for the escrowing and allocation of the portion of the collections from PRASA Customers’ bills that will be allocated to the Corporation. The Depository will segregate collections received that constitute PRASA charges and collections that are related to the Revitalization Charge, and remit such collections to the Trustee for the Revitalization Bonds. This provides assurance that, as soon as practicable, the Revitalization Charges will be in the control and possession of the Trustee, and serves to limit the amount of Revitalization Charge Revenues held by or for the account of PRASA at any given time. Such a Depository Agreement is authorized pursuant to the Revitalization Act. As discussed above, the costs of the Depository shall be Ongoing Financing Costs and should be recovered from Revitalization Charge Revenues.

II. UPFRONT AND ONGOING FINANCING COSTS

The costs associated with issuing, supporting, and servicing the Bonds can be placed in two categories: Upfront (or “one-time”) Financing Costs and Ongoing Financing Costs.

Upfront Financing Costs

Upfront Financing Costs² (also referred to as “one-time” costs) are costs incurred in advance of, or in connection with, the issuance of the Bonds, and will be recovered and will be reimbursed from Bond proceeds. These costs may include underwriting and exchange agent’s costs (including fees and expenses), costs related to solicitations to investors for their exchange or sale of PRASA bonds, rating agency fees, costs of obtaining any surety bonds and any additional credit enhancements (if any), fees and expenses of PRASA’s and the Corporation’s legal advisors, fees and expenses of the financial advisors to PRASA and the Corporation, accountants fees, fees and expenses of the Trustee and its counsel, Servicer set-up costs, printing and filing costs, set-up

² The Revitalization Act defines “Upfront Financing Costs” as “the Financing Costs related to the costs of design, marketing, and issuance of Bonds, except to the extent that the Corporation determines to pay said costs as Ongoing Financing Costs payable from Revitalization Charge Revenues. Upfront Financing Costs include, without limitation, Trustee (or similar fiduciary) fees and expenses, legal fees and expenses, accounting fees and expenses, Servicer set-up rates or expenses, calculation agent, depository or other manager or fiduciary placement fees and expenses, underwriting fees and expenses, printing and marketing fees, filing or listing and compliance fees, fees and expenses of the Corporation’s other consultants, if any, credit rating agency fees, collateral fees and expenses, and any other cost approved by the Board of the Corporation as necessary or desirable to achieve the purposes of this Act, and shall include reimbursement to any Person of amounts paid in advance to cover such costs. Within the costs related to the Capital Improvement Program, only costs related to the works and improvements of water and/or sanitary sewer services and facilities providing direct services to Customers shall be included as Approved Financing Costs; 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 meet the requirements of a health, safety or compliance organization and/or those that generate efficiencies or savings as a result of technological improvements or information systems.”



costs related to the Corporation, non-legal securitization proceeding costs and expenses of the Corporation, miscellaneous administrative costs, and others. The estimated Upfront Financing Costs are itemized by category of cost in Attachment #1. This is an estimate of fees provided by PFM. The estimate is based on information provided by various potential parties to the transaction, and PFM's best estimate based on prior experience. There is no assurance that actual, final costs will be similar to these estimates. PFM believes these to be good faith estimates based on what is currently known.

Deposits to reserves are also considered Upfront Financing Costs. However it is important to note that the deposit to the reserve is not the economic equivalent of other Upfront Financing Costs because the Corporation would retain the cash reserve, earn interest on the reserve, replenish reserves if used, and apply any balance in the reserve to offset the debt service requirement of the last debt service payment on the Bonds.

Ongoing Financing Costs

Ongoing Financing Costs (including principal and interest on the Bonds and any deposits required to replenish draws on reserves or reimburse draws on surety bonds) are 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. They will be recovered or paid from the Revitalization Charges. The Ongoing Financing Costs include servicing fees, administrative fees, fees and expenses of the Trustee and its counsel, accountants' fees, legal fees, ongoing costs of surety bonds and additional credit enhancements (if any), independent manager or consulting fees, rating agency fees, ongoing disclosure costs, and printing and filing costs, among others. Ongoing Financing Costs also include funds deposited into any additional debt service reserve (such as a rate stabilization or other reserve fund to provide sufficient reserves to account for miscalculations in the collections curve and other short term deficiencies in revenue collection) for the Bonds or otherwise, to the extent provided in the Trust Agreement. The estimated Ongoing Financing Costs for the Corporation are also itemized by category of cost in Attachment #1. This is an estimate of fees provided by PFM. The estimate is based on information provided by various potential parties to the transaction, and PFM's best estimate based on prior experience. There is no assurance that actual, final costs will be similar to these estimates. PFM believes these to be good faith estimates based on what is currently known. Please note that many of these Ongoing Financing Costs can be subject to inflation, which may increase the nominal amount of the Ongoing Financing Costs over time.

Upfront Financing Costs

The actual details and quantification of Upfront Financing Costs related to issuing the Bonds will not be known with certainty until after the Bonds are priced and closed. Certain of the Ongoing Financing Costs relating to the Bonds may not be known until such costs are incurred. Accordingly, it is necessary to estimate the costs of these items. Actual financing costs could be higher (or lower) than the estimates.



Upfront Financing Costs included in the Revitalization Charge

The estimated total Upfront (or one-time) Financing Costs may be funded through the issuance of the Bonds and included in the principal amount of the Bonds. These costs may be funded with Bond proceeds and recovered through the Revitalization Charge over time versus a one-time recovery in a single repayment. If the actual Upfront Financing Costs are eventually determined to have been less than the Upfront Financing Costs that were estimated and included in the principal amount financed, the difference will flow through to customers through the Revitalization Charge and Adjustment Mechanism process discussed below. If the actual Upfront Financing Costs are more than the Upfront Financing Costs that were estimated and included in the principal amount securitized, the Corporation would recover the remaining Upfront Financing Costs through the Revitalization Charge. Actual Ongoing Financing Costs will be recovered through Revitalization Charges, which will be periodically adjusted as appropriate through the Adjustment Mechanism discussed below.

Estimated Upfront and Ongoing Financing Costs

PFM currently estimates that the Corporation will incur approximately \$28.7 million of Upfront Financing Costs, **exclusive of any deposits to reserve funds**. The estimated Upfront Financing Costs of the Corporation are itemized by category of cost in Attachment #1.

PFM currently estimates that for the first year following the issuance of the Bonds, the annual Ongoing Financing Costs (excluding debt service or any deposits required to replenish reserves) will be approximately \$2.4 million. These amounts reflect costs that will be incurred annually to support and service the Bonds after their issuance, including but not limited to, PRASA's Servicer fee, any Administrator's fee, fees of the Trustee and its counsel, the Corporation's out-of-pocket costs for external accounting and legal services, surety bond premiums, annual surveillance fees payable to the rating agencies; most of which will be incurred in satisfaction of obligations of the Corporation under the financing documents and the Financing Resolution.

It is important to note that there are significant portions of these costs that relate directly to the size, structure and rating of the individual components of the Bonds. The Corporation will update the costs with the actual costs when known.

Upfront Financing Costs Recovered Through Revitalization Charge Revenues

Costs Related to the Preparation and Approval of the Financing Resolution, Protecting the Status of the Financing Property and Collecting the Revitalization Charges, and the Administration Costs

These are costs relating to the preparation and approval of the Financing Resolution and PRFAFAA certification thereof legal fees and the fees of other consultants to the Corporation relating to the Financing Resolution, as well as certain fees and expenses associated with the preparation and delivery of the accompanying explanatory report and costs related to the validation process. Specific costs relating to protecting the status of the Financing Property and collecting



the Revitalization Charges are more difficult to identify with certainty at this time. However, such expenses could include legal expenses of counsel to the Corporation and the Trustee of actions undertaken to enforce provisions of the Servicing Agreement or of actions to challenge subsequent actions of the Commonwealth or instrumentalities of the Commonwealth that could potentially conflict with the Commonwealth pledge.

Attorneys' and Advisors' Fees and Expenses Payable by the Corporation

Legal fees are the cost of the considerable legal work necessary to issue the Bonds, much of which is specialized. These fees are based upon the hours individual firms must devote to the bond issuance. This category includes the fees and expenses of counsel to the Corporation and those of counsel to the Trustee, underwriters, and any other parties to the transaction, if paid for by the Corporation. The exact amount of the legal fees will, of course, be affected by events between now and the date of issuance, including the extent to which this proceeding is contested by the parties and the scope of additional work required during the proceeding, the scope of any appeals, the requirements of underwriters, trustees, rating agencies, regulators or financial advisors for any requested revisions to documents, potential changes in federal securities laws and interpretations thereof, use of additional credit enhancements, and other unforeseeable occurrences. The final aggregate amount of legal fees and expenses will not be known until after closing. The amount of legal fees that are estimated or known at the time the Bonds are issued may be included in, and funded by, a portion of the proceeds of the Bonds. Any legal fees that arise after the issuance of the Bonds that are above the Corporation's estimate and not included in the amount of Upfront Financing Costs financed with a portion of the Bonds would be recoverable by the Corporation through future adjustments to the Revitalization Charge as mentioned above.

The advisor fees are the cost of the financial advisory services provided to the Corporation and PRASA in connection with the preliminary structuring and sale of the Bonds. The financial advisors' services include: reviewing the Corporation's and PRASA's financing objectives; reviewing rating agency criteria with the Corporation and PRASA; developing preliminary financing structures; developing the mechanics of properly effecting the securitization; reviewing material submitted to and by the Corporation; and providing supporting information.

Accounting and Auditing Fees and Expenses

The Corporation will require an annual audit of its financial statements, and these financial statements are required to be made available to the public

Costs of Debt Service Reserves or Operating Reserves

The primary cost of reserves are the debt service costs to the extent Bonds are issued to provide cash funding for the debt service or operating reserve funds.

Fees and Expenses Associated with the Structuring, Marketing, and Issuance of the Bonds

The fees may include, without limitation, underwriting fees associated with the issuance of any Bonds, broker-dealer fees associated with the Exchange Offer Bonds, solicitation fees to the broker-dealers that will approach their clients who may sell their existing PRASA bonds, and such



other fees associated with the tender for PRASA Bonds, fees of the investment banks and financial advisors to the Corporation and PRASA associated with the structuring of the new securitization credit, fees of counsel to the Corporation and PRASA, printing fees, and fees relating to the preparation and distribution of the offering and legal documents pursuant to which the Bonds are exchanged and/or sold. The actual fees will depend on the final structure, ratings, and size of the various financing components.

Broker-Dealer Fees

Broker-dealers serve as the dealer-manager for either debt exchanges or tender offers and are compensated based on the par amount of the bonds that are exchanged or tendered. Legal fees and expenses of the broker-dealers are also typically passed on to the bond issuer.

Underwriting Fees and Expenses

As is the case for the fees for debt exchanges and tender offers, underwriter compensation is typically based on the par amount of bonds sold, and can vary according to the type and maturity of bonds. The exact amount, structure, and maturity of the Bonds that may be underwritten will not be known with certainty until the Bonds are about to be priced. To the extent the actual principal amount of each of the tranches is different from the estimated principal amounts, underwriters' fees may vary. In addition to the purchase or placement of the Bonds, underwriters typically assist with the preparation of the rating agency presentations and investor presentations and the structuring and marketing of the Bonds.

Original Issue Discount (“OID”) or Original Issue Premium (“OIP”)

OID arises when buyers pay less than face value to acquire a bond (*i.e.*, when the original buyers of a bond pay less than \$1,000 per \$1,000 principal amount of bonds). One common reason for an OID is that investors prefer a bond that has an original issue price that is less than par, and a coupon that is less than the yield to maturity. An investor may be willing to accept a lower yield to maturity for the OID structure than it would otherwise require if the bonds were sold at par. Conversely, some investors prefer bonds that are priced at a premium, or above par. Those bonds have an OIP and would have a coupon rate that exceeded their yield and a price above par. The amount of original issue discount or premium will depend upon, among other things, market conditions at the time of issuance that cannot now be known. For purposes of estimating financing costs and debt service, we have assumed that Bonds will be sold at par. However, the Corporation retains the flexibility to sell the Bonds with OID or OIP if doing so is found to be more advantageous to the Corporation.

Rating Agency Fees

The rating agencies charge fees for the service of providing a credit rating at the time bonds are issued. These fees are typically calculated by applying a charge to the initial principal balance, plus the annual fee payable for the first year. For purposes of estimating rating agency fees, the fees of two of the three major rating agencies have been included.



While the Bonds are outstanding, the rating agencies typically charge annual surveillance fees. The Corporation will not have any effective control over the future fees charged by the rating agencies and the agencies can increase their fees or otherwise change their fee structure, causing the amount charged by the agencies to exceed the Corporation's current estimate. However, the Corporation, in cooperation with its advisors, will negotiate with the rating agencies in good faith to secure the lowest practicable rating agency costs.

Depository Fees and Expenses

The Corporation will be required to engage a Depository that takes legal possession of all revenues and Revitalization Charges that are billed by PRASA to its customers. The presence of a Depository assures securitization bond investors that their share of customer remittances will be delivered promptly and wholly to the Trustee.

Trustee Fees and Expenses

The Trustee is responsible for holding and disbursing all funds associated with the Bond issue, including Revitalization Charge Revenues. The Trustee also represents the interests of the Bondholders. Investors will require that there is a Trustee for the Bonds, as is the case for virtually all securitization bond issues.

Calculation Agent Fees and Expenses

In order to provide comfort to Bondholders that the Revitalization Charge is being calculated accurately, an independent, third-party Calculation Agent will be appointed to verify the accuracy of the Revitalization Charges initially calculated by PRASA in accordance with the provisions of the Financing Resolution, the Servicing Agreement, and the Trust Agreement.

Servicer Initial Fees and Expenses

The role of the Servicer and fees and expenses of the Servicer are discussed in detail later in this report.

Printing and Marketing Expenses.

There are several public documents that will be required to fully disclose the relevant information that will enable investors to make decisions related to the purchase of Bonds or their sale or exchange of outstanding PRASA bonds. There may also be expense related to organizing and attending various meetings with investors. These meetings are typically conducted in major cities where there are a substantial number of potential investors.

Consistency of the Upfront Financing Costs with the Requirements of the Revitalization Act

In my professional opinion, the Upfront Financing Costs proposed to be recovered from the Bond proceeds or the Revitalization Charge Revenues are consistent with the Revitalization



Act. The Upfront Financing Costs are reasonable and necessary to issue, support, and service the Bonds.

Ongoing Financing Costs Recovered Through Revitalization Charge Revenues

Payments to Fund or Replenish any Reserves or other Accounts

To the extent future Revitalization Charge Revenues are less than those expected and required to meet periodic payments on the Bonds, the reserves established upon initial issuance of the Bonds would be available to supplement any deficiency in Revitalization Charge Revenues prior to their further adjustment via the Adjustment Mechanism. The Adjustment Mechanism is also designed to, and will be calculated to, reimburse the reserves for any required draws, and bring the reserve balances up to their requirements and make repayments required under any surety reimbursement agreements.

Federal or State Taxes and Charges

It is not expected that any funds received by the Corporation would trigger a tax liability of any kind for the Corporation. Under the Act, Revitalization Charge Revenues are exempt from Commonwealth of Puerto Rico or local taxation.

Administration Fees and Expenses

Administration fees compensate for the costs of administrative functions of the Corporation performed by itself or the Administrator under any Administration Agreement.

Surety Policy Fees

It may be advantageous to obtain a surety policy that would serve to meet all or a portion of the debt service reserve fund requirement. The cost of the surety policy may be paid as a portion of up-front costs, or over time.

Ongoing Compliance Costs for the Bonds.

The Bonds are not expected to be subject to United States Securities and Exchange Commission registration requirements due to their status as tax-exempt municipal bonds. During the time when the Bonds are outstanding, there may be limited fees associated with making routine filings associated with ongoing disclosure requirements, or other governmental filing requirements.

Potential Indemnity Claims or Payments Required to be Paid from Revitalization Charges or by the Corporation

The financing documents are expected to provide, as they must, that the Trustee will be entitled to indemnity for certain actions undertaken in connection with its duties under the Trust Agreement, including actions to defend the Financing Property. In addition, the Corporation will



make various representations and covenants in the financing documents which, if ultimately proven to be materially inaccurate, could give rise to liability on the part of the Corporation for which the parties to the financing documents may be entitled to indemnity. Further, the Corporation will make statements of fact in the disclosure document which may give rise to liability under applicable securities law, which may trigger indemnity provisions in the underwriting agreement(s) and broker-dealer agreement(s) relating to the Bonds. It is difficult to identify the universe of potential indemnity claims or payments that could arise as a result. But, those are potential costs that must be addressed and managed, typically with insurance. Satisfaction of indemnity claims and any insurance premiums are an appropriate Ongoing Financing Cost.

Expected Principal and Interest on the Bonds

The expected principal and interest on Bonds will not be known until such terms are finalized. The Corporation will provide a report detailing the final terms of the Bonds and setting forth a final estimate of the Upfront Financing Costs and the estimated Ongoing Financing Costs during the term of the Revitalization Bonds.

Consistency of Ongoing Financing Costs with the Requirements of the Revitalization Act

In my professional opinion, the Ongoing Financing Costs proposed to be recovered through the Revitalization Charge Revenues are consistent with the Revitalization Act. The Ongoing Financing Costs are reasonable and necessary to issue, support, and service the Bonds.

III. SERVICING AGREEMENT

The Role and Function of the Servicer

The Revitalization Act defines the Servicer and its role and the Servicing Agreement as follows: “Servicer” means the Authority, to the extent allowed by this Act, and if the Authority is replaced as Servicer, under a Servicing Contract, shall mean a Person or Persons authorized and required, by contract or otherwise, to impose, bill, or collect Revitalization Charges, to draft periodic reports on the billing and collection of Revitalization Charges, to remit collections by or on behalf of the Corporation or the assignees or creditors thereof, including a Financing Entity, and to render other related services to the Corporation, which may include the calculation of periodic adjustments to the Revitalization Charges or the rendering of other services related to the Financing Property; and it shall be understood to include any subservicer, backup servicer (including if it becomes a Servicer under a Servicing Contract), replacement servicer, or any of the successors thereof, authorized to act as such under a Financing Resolution.

The Revitalization act also defines “Servicing Agreement” as “the contract or contracts between the Corporation and the Servicer providing for the administration and servicing of Financing Property, as the same may be modified from time to time by the parties thereto in a manner not prohibited by the Revitalization Act.”



The Servicing Agreement

The Servicing Agreement is an agreement between the Corporation, as the issuer of the Revitalization Bonds and the owner of the Financing Property created by the Financing Resolution, on the one hand, and PRASA, as the servicer of the Financing Property created by the Financing Resolution, on the other. The Servicing Agreement sets forth the responsibilities and obligations of the Servicer, including in regard to the billing and collection of Revitalization Charges. The Servicer's duties, as described below, also include implementing periodic adjustments to the Revitalization Charges. Additionally, pursuant to the Revitalization Act, the Servicing Agreement provides for the deposit of all collections from Customers, as soon as possible after receipt by PRASA, with a Depository, and the allocation and distribution of such collections, on a daily basis, to the Corporation and its assigns (*i.e.*, the Trustee) and to PRASA or its assigns in accordance with their respective interests. A draft form of the Servicing Agreement is attached hereto as Appendix 4 to the Financing Resolution. The Servicing Agreement are generally consistent with the utility securitizations that have been issued to date, and are appropriate for this transaction.

Changes to the Form of the Servicing Agreement after PRFAFAA Certification

The terms of the Servicing Agreement are critical to the Rating Agency analysis of the Bonds and the ability to achieve the highest possible credit ratings. The terms of the Servicing Agreement are also critical to PRASA's creditors and investors. Accordingly, the terms of the Servicing Agreement will be subject to change to reflect the input from the Rating Agencies, as well as input from creditors and investors. However, we expect that the final Servicing Agreement will be largely as described in the draft presented with the proposed Financing Resolution and report.

Servicer Duties and Functions

The Key Duties of the Servicer

The Servicing Agreement provides that the Servicer, will manage, service, administer and make collections in respect of the Revitalization Charges. The Servicer's duties will be to and the Servicer shall:

- (i) impose the Revitalization Charges on all Customers and adjust them;
- (ii) exercise all the collection rights of the holders or pledgees of the Financing Property for the benefit of such holders or pledgees;
- (iii) transfer any Revitalization Charge Revenues to the holders or pledgees of Financing Property;
- (iv) obtain meter reads, calculate water and sewer usage, maintain records of service agreements, calculate the periodic adjustments to the Revitalization Charges, bill the Revitalization Charges to the Customers as a separate line item on PRASA's Bills, separate from all PRASA Charges, and collect (from Customers and Third Party Billers, as applicable) all Revitalization Charge Collections;
- (v) estimate the water and sewer use of Customers for the purpose of calculating Revitalization Charges;
- (vi) respond to inquiries by Customers, Third Party Billers, the Trustee, the Bondholders, any party to an Ancillary Agreement or inquiries by any federal, local or other Commonwealth governmental authority, with respect to the Revitalization Charges;



(vii) deliver Bills to Customers and Third Party Billers, account for Revitalization Charge Collections, investigate and resolve delinquencies, process and deposit collections, make periodic remittances and furnish periodic reports to the Issuer, the Calculation Agent, the Trustee and the Rating Agencies;

(viii) sell, as the agent for the Issuer, as its interest may appear, defaulted or written off accounts in accordance with the Servicer's usual and customary practices for accounts of Customers for Rates;

(ix) take action in connection with True-Up Adjustments;

(x) take any action necessary to direct (a) all Customers that do not pay their Bills in person, and (b) Third Party Billers or any other Person that hold Revitalization Charge Collections and PRASA Charges, to remit their payments or turn over all such Revitalization Charge Collections and PRASA Charges directly to the Depository for deposit into the Allocation Account;

(xi) promptly, and in any event as soon as reasonably possible after receipt of the same, cause all Revitalization Charge Collections and all PRASA Charges not otherwise deposited with or paid to the Depository to be paid to the Depository for deposit into the Allocation Account;

(xii) take any actions permitted by the law to collect unpaid bills and terminate service to Customers who are delinquent in the payment of their Revitalization Charge on the same basis as termination of service is permitted for nonpayment of water and sewer or other rates by PRASA, and which would otherwise be consistent with Best Efforts, but none of the Issuer, the Trustee, the Bondholders or any party to an Ancillary Agreement may directly terminate service to any Customer; and

(xiii) administer Revitalization Charge Revenues mingled with other funds of the Servicer in a manner that allows for the distinct identification of the Revitalization Charge Revenues and such other funds, respectively.

In addition, the Servicer will have certain other duties and responsibilities set forth in the Servicing Agreement, including those relating to data acquisition, usage and bill calculation, billing, customer service functions, collections, payment processing and remittance, notification of laws or regulations that have a material adverse effect on the Servicer's ability to perform its duties, and the provision of certain information to relevant parties.

Servicer Compensation

The Servicer is entitled to an annual servicing fee (the "Servicing Fee") payable as an Ongoing Financing Cost from Revitalization Charge Revenues. The Servicer will also be entitled to recover its out-of-pocket expenses. It is important to the rating agencies and separate corporate identity of the Corporation that the Servicer receives an arm's-length fee as servicer of the Financing Property. Further, the Revitalization Act requires that the Servicing Fees are necessary, reasonable, and sufficient to compensate PRASA for the incremental costs of performing its functions as Servicer.



PRASA's Servicer Fee Compared to Other Utility Securitizations

Annual servicing fees for utility securitization transactions can typically range from 0.03% to 0.25% of the principal amount of the Bonds. PRASA expects to charge an annual servicing fee of 0.05% of the principal amount of the Bonds, which is toward the lower end of this fee range, but PRASA's fee will be subject to annual escalation in accordance with the CPI-U.

Replacement of PRASA as the Servicer

In the event that PRASA defaults in the performance of its obligation under the Servicing Agreement, the Corporation, upon the direction of the Trustee, as and to the extent provided in the Servicing Agreement, and/or any Trust Agreement, is authorized to replace PRASA as Servicer. In such a circumstance, the Corporation would be directed to enter into such other servicing, billing, and collection agreements as the Corporation deems appropriate to ensure the timely and full payment of the Bonds and all Ongoing Financing Costs.

Increase of Successor Servicer Costs

Any successor Servicer's costs will most likely be substantially greater because of its lack of a pre-existing servicing relationship with Customers and the need to recreate PRASA's billing and collection infrastructure. A successor Servicer will require an additional inducement to do this. For this reason, utility securitizations typically permit an increase in the servicing fee should a successor Servicer, which is not part of the utility's business and who decouples the Revitalization Charge bill from other billed amounts, assumes the Servicer obligations.

Proposed Successor Servicer Fee

In the Financing Resolution, the Corporation proposed to authorize the payment of a fee to a successor Servicer in an amount not to exceed 1% of the initial aggregate initial principal amount of all series of Bonds outstanding at the time of the initial issuance of the Bonds. Any fee in excess of 1% of the aggregate initial principal amount of the Bonds shall be subject to the prior written approval of the Corporation (so long as the Corporation, is not in default under the Trust Agreement). PFM reviewed the successor servicing fees provided for in several large utility securitization transactions. The large majority of such transactions provided for maximum successor Servicer fees of 0.6% of the initial principal amount of the bonds or greater. I believe that the 1.0% maximum successor servicer fee contained in the Revitalization Order is reasonable. While this successor servicing fee cap is higher than in prior utility securitizations, the situation in Puerto Rico is unique and requires greater flexibility to attract as successor servicer in the event of a PRASA default. Based upon the lack of regulatory precedent, investors and credit rating agencies are likely to insist that the successor servicer fee be sufficient to induce qualified third-party collection agents to assume the role of successor Servicer. To my knowledge, no successor servicer has been appointed in any utility securitization and, therefore, the replacement servicing fees have never been charged or collected.



Recovery of Expenses by the Servicer

The Servicer will be entitled to be reimbursed for all initial expenses incurred by the Servicer in connection with its activities under the Servicing Agreement (including any fees to and disbursements by accountants, counsel or any other Person, any taxes or payments in lieu of taxes imposed on the Servicer (other than taxes based on the Servicer's net income) and any expenses incurred in connection with reports to Bond holders, subject to the priorities set forth in the Trust Agreement). There will be, for example, certain costs associated with setting up the technology systems modifications to bill, collect, and remit the Revitalization Charges. The Servicer will also earn a periodic fee compensating it for its ongoing costs.

Resignation

The initial Servicer, PRASA, can resign only under very limited circumstances. The Servicing Agreement prohibits the initial Servicer, PRASA, from resigning unless it is unlawful for PRASA to continue in such a capacity. In the event that PRASA defaults in its obligation under the Servicing Agreement, the Corporation shall replace the Servicer. In addition, the Corporation, upon the direction of the Trustee, as and to the extent provided in any Trust Agreement, will be authorized to replace PRASA, and to direct the Corporation to enter into such other servicing, billing and collection agreements deemed appropriate by such requesting party to ensure the timely and full payment of the Bonds and all Ongoing Financing Costs. No servicer in a utility securitization has ever been replaced. The process for replacing PRASA as servicer would be the first instance of a utility securitization servicer replacement.

Conflict between Servicer and Trustee

The Corporation's rights to replace the Servicer cannot diminish the rights of the Trustee, the Bondholders, or any credit enhancer of the Bonds to replace the Servicer under the terms of the Trust Agreement or any Ancillary Agreement. Accordingly, any action taken by the Corporation with respect to the Servicer, including the replacement of the Servicer, is subject to the prior consent of, or contrary direction of, the Trustee if the Trustee, in its sole discretion or at the direction of Bondholders, determines that any such action would impair the rights of the Bondholders.

Adjustment Process.

The review by the Corporation of the periodic adjustment of Revitalization Charges pursuant to the Adjustment Mechanism shall be limited solely to the mathematical accuracy of the calculations of the amount of such adjustments, and in connection to each such review by the Corporation, it shall retain the services of one or more Persons with the necessary experience to review the mathematical accuracy of such periodic adjustments. If the Corporation determines that the calculation of any adjustment to the Revitalization Charges are mathematically inaccurate, such adjustment shall be modified on or before the following application of the Adjustment Mechanism and the over or under estimation of collections resulting from such mathematical inaccuracy shall be credited to or added in the following application of the Adjustment Mechanism, as the case may be, but no Customer shall be entitled to a refund of Revitalization Charges or the



retroactive application thereof by reason of mathematical inaccuracies in such periodic adjustments. No adjustment of Revitalization Charges pursuant to the Adjustment Mechanism shall in any way affect the irrevocability or non-bypassable nature of the Financing Resolution related thereto. The Corporation is hereby authorized to hire one or more persons to review the calculation of Revitalization Charges prepared by the Servicer. The Authority is hereby authorized and directed to provide the Corporation and the agents thereof with any information required by the Corporation and by any calculation agent to review the calculation of all such periodic adjustments. PRFAFAA or its successor, as fiscal agent of the Commonwealth of Puerto Rico, is hereby authorized and directed to assist and provide support and financial advice to the Corporation, so that the purposes of this Act may be achieved diligently, effectively, and in accordance with the provisions of this Act.

Cap on the Revitalization Charge

Under the Revitalization Act there is no cap on the Revitalization Charges or any Adjustment Mechanism.

Effect of Revitalization Act and Revitalization Charge on Customer Collections

The Revitalization Act requires, and the Servicing Agreement provides, that all collections from Customers (whether PRASA charges or Revitalization Charges) must be deposited as soon as practical following receipt with the Depository for deposit into an Allocation Account held by the Depository. Under the Revitalization Act, the Depository is required to be a bank or other financial institution unrelated to and not under the control of PRASA or the Commonwealth. Once in the hands of the Depository, the Customer collections will be allocated to the Corporation (and its assigns) on a daily basis and in accordance with their respective interests.

Need for Depository

The Depository ensures that Customer collections, which will include both PRASA charges (pledged to the payment of PRASA obligations, including the payment of the PRASA revenue bonds) and Revitalization Charges (pledged to the payment of the Bonds and related costs), are accurately allocated and promptly distributed to PRASA (and its assigns) and the Corporation (and its assigns), in accordance with their respective interests. In addition, the use of a Depository is necessary to enhance the marketability of the Bonds. The Revitalization Act requires that all payments made on or behalf of Customers, including all Revitalization Charge Revenues (collectively, "Customer Revenues"), received by PRASA must be paid or deposited by PRASA to a special collection account at a depository bank. In addition, PRASA has agreed to direct its Customers to make their bill payments directly to a depository bank. The depository bank will then allocate the Customer Revenues on a daily basis between the Corporation or its assigns or pledgees (including the Trustee), and to PRASA or its assigns, in accordance with their respective interests. The daily deposit by PRASA of all Customer Revenues into a single consolidated account will better assure securitization bondholders that Revitalization Charges are being properly allocated and distributed to the Trustee on a daily basis, while at the same time protecting the interests in Customer Revenues of PRASA Bondholders and other PRASA creditors.



The Revitalization Act provides that the Depository will be selected by the Corporation. The Revitalization Act further requires that the Depository be organized under the laws and regulations of the United States or any state, and licensed to operate in the Commonwealth. Under the Revitalization Act, the Depository cannot be related to PRASA or the Commonwealth or under the control of PRASA.

Transfer and Distribution of Customer Revenues

Under the Servicing Agreement, PRASA is required to transfer all Customer Revenues, including all Revitalization Charges, to the Depository on a daily basis, and in any event within two Business Days of receipt of such revenues.

Also on a daily basis, PRASA is required to instruct the Depository to transfer (i) the amount of such Customer Revenues held by the Depository which constitute “estimated Revitalization Charges” deemed to have been received on such day and which must be paid to the Trustee, and (ii) the amount of the remaining Customer Revenues which must be paid to PRASA. Upon receipt of such daily instructions, the Depository is required to make transfers to the Trustee and to or for the benefit of PRASA (as the case may be) within one Business Day.

Summary of the Servicing Agreement

PFM believes that the terms of the Servicing Agreement are consistent with other large securitization transactions.