

Memorandum to Qualified Respondents re: Updated O&M Agreement

Dear Qualified Respondents –

The Puerto Rico Public-Private Partnerships Authority (the “Authority”) would like to thank you for your continued participation in the process for the transformation of the Puerto Rico Transmission and Distribution System (the “T&D Transformation”). We appreciate the time and effort that you, your teams and your advisors have devoted – and continue to devote – to the process, the level of engagement you have demonstrated and the thoughtfulness of the feedback you have provided to date. In particular, the Authority thanks you for the detailed comments we received to the initial draft of the O&M Agreement and your participation in the meetings to discuss these comments (the “Contract Meetings”). The Contract Meetings were extremely helpful in terms of both providing an opportunity for the parties to hear each other out and allowing the Authority and its advisors to better understand the concerns of Qualified Respondents.

Over the past couple of months, the Authority and its advisors have carefully considered the Qualified Respondents’ feedback to the initial draft of the O&M Agreement and the concerns raised by Qualified Respondents in the Contract Meetings. Taking into account these concerns and the goals of the Authority in pursuing the T&D Transformation, the Authority and its advisors have prepared a revised draft of the O&M Agreement, which is being shared with Qualified Respondents together with Addendum No. 5 to the RFP for the T&D Transformation. The revised O&M Agreement seeks to address various issues raised by Qualified Respondents while promoting an efficient, enduring and successful transformation of the T&D System for the benefit of the people of Puerto Rico.

To assist Qualified Respondents in reviewing the revised O&M Agreement, we have summarized below a number of key changes to the O&M Agreement and, where relevant, included the Authority’s rationale for the changes. Capitalized terms used but not defined in the summary below generally have the same meaning as in the revised O&M Agreement.

1. Conditions Precedent

- a. *Conditions to Effective Date* – To provide comfort to Qualified Respondents as from the date of contract execution with respect to the status of PREPA’s Title III process, the available amount of Federal Funding for Capital Improvements and security for payment of amounts payable to Operator, the revised O&M Agreement includes the following additional conditions precedent to the Effective Date: (i) receipt of Title III Approvals from the Title III Court acceptable to Owner and Operator, including an order approving of Owner’s entry into the O&M Agreement; (ii) receipt of (A) a list of the project worksheets related to the T&D System prepared by FEMA to date or (B) a summary of the

cost estimates or preliminary cost estimates for Federally Funded Capital Improvements established to date; and (iii) evidence that an amount equal to the Front-End Transition Service Fee for four and a half months has been pre-funded into an account that will be replenished on a monthly basis. (See §2.2(b).) The Authority believes that these conditions represent what is (x) realistic to achieve within the time frame contemplated for execution of the O&M Agreement and (y) necessary for Operator to have an understanding of before it commences the work related to the Front-End Transition Period.

- b. *Conditions to Service Commencement Date* – The revised O&M Agreement includes the following additional conditions precedent to the Service Commencement Date (*i.e.*, the date on which the T&D System is turned over to Operator): (i) evidence that the funding contemplated for Capital Costs – Federally Funded for the first three years of the Term is available; (ii) receipt of the Servicing Contract executed as part of the Title III process; and (iii) pre-funding of all the Service Accounts as described in 1.c below. (See §4.5(g), §4.5(h) and §4.5(j).) With funding available for the initial three years of Capital Costs – Federally Funded, Operator should have comfort that it will be able to immediately start on the Federally Funded Capital Improvements that will lead to both improvements in the T&D System and Operator’s ability to meet the Performance Metrics and earn the Incentive Fee.
- c. *Pre-Funding of Accounts* – To provide Operator with assurance that funds will be available to make the required payments to Operator under the O&M Agreement, the revised O&M Agreement: (i) provides for pre-funding of amounts due under all Budgets – *i.e.*, not only T&D Pass-Through Expenditures (as in the previous draft) but also the Service Fee and capital expenditures; and (ii) increases the amount of pre-funding from three months to four and a half months (except that in the case of Capital Costs – Federally Funded, the amount of pre-funding is still under consideration given the need to ensure compliance with Federal Funding requirements). In addition, the revised O&M Agreement includes an Owner Event of Default in the event that funding of any Service Account falls below three-months’ worth of pre-funding. (See §7.5 and §14.3(f).) The lower threshold to trigger an Event of Default is intended to provide a grace period within which Owner can address any funding deficiencies that are not otherwise resulting in payment default on amounts owed to Operator.

2. Front-End Transition

- a. *System Remediation* – In response to Qualified Respondent feedback, the revised O&M Agreement includes the new concept of a System Remediation Plan that will be established by the Parties during the Front-End Transition Period. This plan will set out (i) the elements of the T&D System that need to be remediated in order for Operator to provide the O&M Services in accordance with the Contract Standards and (ii) the agreed costs and time frame for such remediation. All Budgets approved from time to time will take into account the costs of the

System Remediation Plan until such time as the plan has been completed.
(See §4.1(c), §5.4 and §18.6.)

- b. *Federal Funding Procurement Manual* – The revised O&M Agreement includes the new concept of a Federal Funding Procurement Manual, which is to be prepared by the Parties during the Front-End Transition Period and finalized as a condition precedent to the Service Commencement Date. This manual will establish and govern the manner in which all matters related to Federal Funding will be handled and will be updated as necessary to reflect any changes in Applicable Law affecting Federal Funding. (See §4.1(d) and §4.5(i).)

3. Budget-Related Matters and Revenue Protection

- a. *Interim Rate Increases* – The Authority understands the concern expressed by Qualified Respondents that there should be a mechanism for rates to be adjusted to address budget gaps. The Authority is therefore currently discussing with PREB the possibility of PREB approving a rate order that would authorize Operator to implement interim rate adjustments within a certain range without PREB’s *prior* approval but which would require PREB’s *subsequent* approval for the rate adjustments to continue in effect. (See footnote to §4.5(g).)
- b. *Amendments to Budgets* – The revised O&M Agreement provides that if Operator projects that it will exceed the Operating Budget or Capital Budget by more than the 2% cushion included in such Budget, Operator may prepare a new Budget and submit it to PREB for approval. (See §7.3(e).) The Authority believes that this provides Operator with a mechanism to proactively address unforeseen Budget deficiencies but maintains control and oversight over Operator overspending beyond the 2% cushion without justification.
- c. *Flexibility to Reallocate Budgets* – The revised O&M Agreement provides Operator with the flexibility to reallocate amounts *within* each of the Operating Budget and Capital Budgets with notice to Administrator and subject to (i) a cap of 5% of the relevant Budget for the Contract Year and (ii) expenditures not being postponed for more than one year (which restrictions are intended to ensure the O&M Agreement complies with the “qualified management agreement” (“QMA”) requirements). The revised O&M Agreement does not permit reallocation of amounts *between* the Operating Budget and the Capital Budgets given that (x) such reallocation would potentially jeopardize the status of the O&M Agreement being QMA-compliant and (y) Federal Funding may not be used for operating expenses. (See §7.3(c).)

4. Risk Allocation

- a. *Change in Law* – The revised O&M Agreement includes the concept of Change in Law and provides that any costs associated with a Change in Law are T&D Pass-Through Expenditures and may potentially result in an amendment to the Budgets and/or the Performance Metrics where appropriate. (See §1.1, §7.4 and

§17.2(a)-(b).) As discussed during the Contract Meetings, the Authority does not believe there should be protection from changes in Tax law of general applicability as these are a function of the cost of doing business in a given jurisdiction. As a result, non-discriminatory changes in Tax law have been excluded from the definition of Change in Law.

- b. *Force Majeure Event* – The revised O&M Agreement generally expands what constitutes a Force Majeure Event in response to Qualified Respondent feedback. As with a Change in Law, any costs associated with Force Majeure Events are considered T&D Pass-Through Expenditures and may result in an amendment to the Budgets and/or the Performance Metrics where appropriate. (See §1.1, §7.4 and §17.2(a)-(b).) As was discussed in some of the Contract Meetings, strikes and similar labor disturbances by Operator’s employees have not been included in the expanded definition of Force Majeure Event given that Operator should be responsible for managing its labor force and ensuring that such strikes and labor disturbances do not occur.
- c. *Owner Related Fault* – The concept of Owner Fault has been added to the revised O&M Agreement. Consistent with Qualified Respondent feedback, the cost of any such Owner Fault is considered a T&D Pass-Through Expenditure and may result in an amendment to the Budgets and/or the Performance Metrics where appropriate. (See §1.1, §7.4, §7.6 and §18.1.)
- d. *Subcontractors* – The revised O&M Agreement provides that Operator is allowed to subcontract any of the O&M Services (subject to certain requirements) and maintains the construct that Operator is responsible for the performance of its Subcontractors. Although Operator should be free to subcontract the O&M Services, the Authority does not believe that Operator should avoid responsibility as a result of doing so. The revised O&M Agreement, however, now provides that any Operator liability with respect to its Subcontractors is subject to Operator’s indemnity cap. (See §11.2.) This should provide comfort to Qualified Respondents that although Operator is responsible for its Subcontractors, Operator will never be liable for more than it would have been otherwise had it not engaged any Subcontractors.
- e. *Pre-Existing Environmental Conditions* – The revised O&M Agreement includes (i) a new condition precedent to the Service Commencement Date that Owner will identify known Pre-Existing Environmental Conditions that present a risk of material liability and (ii) a gross negligence/willful misconduct standard with respect to both (A) the exacerbation by Operator of Pre-Existing Environmental Conditions and (B) new environmental issues caused by Operator. These changes are intended to address the concerns raised by certain Qualified Respondents that there has been limited information provided to Qualified Respondents regarding environmental matters and the fact that environmental liability could be significant. (See §4.5(f) and §5.10(b).) The Authority is working with PREPA and its environmental advisors to determine the scope of an environmental study that could be prepared during the Front-End Transition

Period and delivered as a condition precedent to the Service Commencement Date. As discussed during the Contract Meetings, the scope of any study must be reasonable taking into account the nature and extent of the T&D System, as well as cost and timing considerations.

5. Front-End Transition

- a. *Front-End Transition Service Fee* – In response to Qualified Respondent feedback, the revised O&M Agreement includes as part of the Front-End Transition Service Fee the reimbursement of incidental costs and expenses in connection with Operator’s provision of the Front-End Transition Services. (See §4.6(b).)
- b. *Consequences of Failure of Service Commencement Date* – In order to ensure the Authority’s critical objective that transition of the T&D System occur within the timeframe specified by the Selected Proponent in its bid, the revised O&M Agreement maintains the concepts of both liquidated damages and eventual termination for delays in achieving the Service Commencement Date that are attributable to Operator. However, to provide some cushion in the event of unanticipated delays, there is a three-month grace period before liquidated damages apply and a six-month grace period before Owner may terminate the O&M Agreement. (See §4.8(a)-(b).)

6. Events of Default and Termination

- a. *Owner Events of Default* – In response to Qualified Respondent feedback, the Owner Events of Default have been expanded to include (i) involuntary bankruptcy, (ii) voluntary bankruptcy, (iii) covenant default under the O&M Agreement or the Servicing Contract and (iv) failure to fund the Service Accounts with at least 2/3 of the requisite pre-funding amounts (*i.e.*, three months of funding for the Operating Account and Capital Account – Non-Federally Funded). Upon an Owner Event of Default, Operator may terminate the O&M Agreement upon 120 days’ notice (or, with respect to failure to fund the Operating Account, the earlier of (x) 120 days’ notice and (y) the date on which no funds remain in the Operating Account). (See §14.3 and §14.4.) The 120-day termination period is needed to allow Owner to make plans for continuity of services taking into account that the intent is to significantly reduce the size of PREPA and, as a result, PREPA will not be in a position to take back over operation of the T&D System.
- b. *Failure of Operator to Achieve Performance Metrics* – The initial draft of the O&M Agreement included the concept of penalties for failure to meet the Performance Metrics. Certain Qualified Respondents objected to this and noted that the failure to achieve the Performance Metrics would result in Operator not earning the Incentive Fee, which would be incentive enough for Operator to ensure that the Performance Metrics are met. The Authority considered this point and these penalties have been omitted from the revised O&M Agreement.

However, the Authority believes that the O&M Agreement needs to include some mechanism to ensure reliability and consistency of service, even if Operator has foregone its Incentive Fee by failing to meet the Performance Metrics. A key objective of the T&D Transformation is a material improvement in the quality, efficiency and reliability of the T&D System, not merely a continuation of the status quo. The revised O&M Agreement therefore includes (i) a new concept of Minimum Performance Thresholds (*i.e.*, Baseline Performance Levels for each Performance Metric below which performance should not fall) and (ii) an Operator Event of Default for failure by Operator to meet the Minimum Performance Threshold for any three Performance Metrics during three or more consecutive Contract Years. (See §14.1(k) and Annex IX.)

- c. *Additional Termination Rights* – To address Qualified Respondent feedback, the revised O&M Agreement expands the circumstances under which Operator has the right to terminate the O&M Agreement. In particular, the revised O&M Agreement now includes termination (i) by either party in the event of the occurrence of a Force Majeure Event that lasts more than 18 months and that materially interferes with either party’s performance, (ii) by Operator if it has performed the O&M Services under a Default Budget in respect of an Operating Budget for three or more consecutive Contract Years and (iii) by Operator if a Change in Regulatory Law has a material adverse effect on Operator’s ability to perform the O&M Services or earn its Incentive Fee. Finally, to ensure that Operator is managing the T&D System within the approved Operating Budgets, the revised O&M Agreement also provides for termination by Owner in the event that Operator overruns the Operating Budget (other than as a result of a Force Majeure Event, Owner Fault, a Storm Event or similar events) for three or more consecutive Contract Years. (See §14.5.)

7. Remedies Upon Early Termination

- a. *All Cases* – In all cases of early termination of the revised O&M Agreement, Operator receives: (i) the accrued and unpaid Service Fee; (ii) the accrued and unpaid T&D Pass-Through Expenditures and Generation Pass-Through Expenditures; and (iii) the Back-End Transition Service Fee. (See §14.6(a)-(b).)
- b. *Termination Fee Upon Early Termination Due to Operator Fault* – In order to protect the T&D System from persistent underperformance or the inability of Operator and Administrator to agree on the Operating Budget for a sustained period, the revised O&M Agreement provides that if Operator (i) fails to meet the Minimum Performance Threshold for any three Performance Metrics for three consecutive Contract Years or (ii) has overrun the Operating Budget (other than as a result of a Force Majeure Event, Owner Fault, a Storm Event or similar events) for three or more consecutive Contract Years, Operator must pay Owner a termination fee to be bid by Qualified Respondents as liquidated damages and Owner’s sole remedy. For all other matters, Owner’s sole remedy for breach by Operator is a damage claim subject to a cap to be bid by Qualified Respondents. (See §14.6(c)-(d).) Providing for a damage claim in the context of termination

events (other than a failure to meet the Minimum Performance Thresholds or where Operator overruns the Operating Budget) reflects feedback from Qualified Respondents. Failure to meet Minimum Performance Thresholds and Operator overrunning the Operating Budget have been addressed differently given the importance the Authority places on maintaining a consistent and reliable level of service for customers at reasonable rates.

- c. *Termination Fee Upon Early Termination Due to Owner Fault* – The revised O&M Agreement provides that if the O&M Agreement is terminated as a result of Contract Nullification or Cancellation (this is a new concept that occurs if the O&M Agreement is terminated, revoked, nullified, cancelled or otherwise rendered invalid by any duly enacted law of Puerto Rico, as determined by a final non-appealable judgment by a court of competent jurisdiction), Owner must pay Operator a fee to be bid by Qualified Respondents as liquidated damages and Operator’s sole remedy. For all other matters, Operator’s sole remedy for breach by Owner is a damage claim capped at the amount of the Fixed Fee over the prior 12 months. (See §14.6(c)-(d).) The damage construct tracks what Qualified Respondents proposed in the case of termination for Operator fault. The cap is intended to reflect the fact that – unlike in a concession arrangement where the concessionaire makes significant upfront and/or periodic payments to the owner – the damages in a “fee for service” contract should be (i) limited, especially in this case where all costs are treated as pass-through expenditures, and (ii) tied to the actual damages experienced by Operator, which Operator will have the opportunity to demonstrate subject to the specified cap.

8. Indemnification

- a. *Operator Indemnity* – The revised O&M Agreement provides for Operator to indemnify for any losses caused by (i) its negligence in performing its obligations under the O&M Agreement subject to a cap and (ii) its gross negligence or willful misconduct without a cap. (See §18.1.) As was discussed in the Contract Meetings, the Authority does not expect Operator to engage in gross negligence or willful misconduct and therefore does not believe (x) that this is an appropriate standard for performance under the O&M Agreement or (y) that liability for gross negligence/willful misconduct should be capped.
- b. *Owner Indemnity* – In response to Qualified Respondent feedback, the revised O&M Agreement expands the circumstances under which Owner would indemnify Operator. (See §18.2.)

9. Dispute Resolution

- a. *PREB Role in Disputes* – Given that certain Qualified Respondents objected to the construct whereby certain disputes between Operator and Administrator would be subject to PREB review (including, among others, disputes related to (i) Service Fees, Budgets and Disallowed Costs, (ii) proposed Capital Improvements, (iii) Administrator’s rights and obligations and (iv) extended

Force Majeure Events), the revised O&M Agreement treats these disputes as all other disputes and subjects them to the dispute resolution provisions.

- b. *Dispute Resolution* – In response to Qualified Respondents’ preference for resolution of disputes by means of arbitration, the revised O&M Agreement includes a dispute resolution provision under which the Parties (i) agree to attempt to resolve any dispute through good faith negotiations, and (ii) if disputes are not resolved through such negotiations, then (A) Technical Disputes are referred to arbitration by an Independent Expert and (B) all other disputes are referred to mediation followed by litigation. In addition, the list of disputes that constitute Technical Disputes to be resolved by Independent Expert has been expanded. (See §15.3, §15.4, §15.5 and §15.6.)

10. Generation-Related Provisions:

- a. *Post-Reorganization Structure* – The revised O&M Agreement includes new generation-related provisions drafted to provide more clarity on the role of Operator with respect to PREPA’s generation assets, as requested by Qualified Respondents. The additions reflect a developing understanding of the post-reorganization structure of PREPA that envisions two successor entities: (i) GenCo, a successor to PREPA that acquires or obtains ownership of the Legacy Generation Assets; and (ii) GridCo, a successor to PREPA that acquires or obtains legal ownership of the T&D System, and which will be the counterparty to the O&M Agreement. (See §1.1, §4.3(d), §5.5, §5.13, Article 7, System Operator Principles Schedule to Annex II, and Annex VII.)
- b. *Summary of Generation Provisions* – To address Qualified Respondent feedback, the revised O&M Agreement provides more clarity on the scope of Operator’s responsibilities vis-a-vis GenCo and other Independent Power Producers, including with regards to (i) electricity dispatch and system operations, (ii) capacity planning, (iii) the management of Generation Supply Contracts and the GridCo-GenCo PPOA and (iv) the provision of Shared Services to GenCo (on GridCo’s behalf), including administrative, managerial and operational functions. The revisions also lay out Operator’s role with respect to the treatment of the Generation Budget, which will be prepared by Owner, and define Generation Pass-Through Expenditures. Lastly, the revisions outline Operator’s role in the procurement of new generation, including related interactions with the Administrator and PREB. (See §1.1, §4.3(d), §5.5, §5.13, Article 7, System Operator Principles Schedule to Annex II, and Annex VII.)

11. Miscellaneous

- a. *Contract Standards* – The revised O&M Agreement accepts Qualified Respondents’ proposal to delete the reference to Performance Metrics from the definition of Contract Standards. (See §1.1.)

- b. *Prudent Utility Practice* – The revised O&M Agreement generally accepts Qualified Respondents’ proposal to modify the definition of Prudent Utility Practice so that Operator is held to standards engaged in or approved by a significant portion of the electrical utility industry for use in systems similar to the T&D System. (See §1.1.)
- c. *Parties to the O&M Agreement* – The revised O&M Agreement includes both Administrator and ServCo as parties.

We hope that this summary of the key changes to the O&M Agreement, the vast majority of which are in response to specific comments of Qualified Respondents, will be helpful to you and your advisors in reviewing the revised O&M Agreement. We also hope that the changes will demonstrate that the Authority is committed to making the T&D Transformation process fair and equitable for all parties while protecting the interest of rate payers.

If you have any questions on the above items or any other elements of the revised O&M Agreement, please let the Authority know by replying to this message via the PowerAdvocate platform.

This communication is subject to confidentiality undertakings and all other terms of the RFP

Thank you.

The Puerto Rico Public-Private Partnerships Authority