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San Juan, Puerto Rico  
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# Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund

Basic Financial Statements and  
Required Supplementary Information

June 30, 2017

(With Independent Auditors' Report Thereon)

**PUERTO RICO SAFE DRINKING WATER TREATMENT  
REVOLVING LOAN FUND**

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## **Independent Auditors' Report**

To the Board of Directors of  
Puerto Rico Safe Drinking Water  
Treatment Revolving Loan Fund

### **Report on the Financial Statements**

We have audited the accompanying statement of net position of the Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund ("the Revolving Fund") as of June 30, 2017 and the statements of revenues, expenses and changes in net position and cash flows for the year then ended, and the related notes to the basic financial statements, which collectively comprise the Revolving Fund's basic financial statements as listed in the table of contents.

### **Management's Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these basic financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### **Auditors' Responsibility**

Our responsibility is to express an opinion on these basic financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Revolving Fund's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Revolving Fund's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### **Opinion**

In our opinion, based on our audit, the financial statements referred to above present fairly, in all material respects, the respective financial position of the Revolving Fund, as of June 30, 2017, and the respective changes in financial position and cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

## **Emphasis of Matters**

### *Uncertainty and Liquidity Risk*

As further discussed in Note 3 to the basic financial statements, the Revolving Fund has recognized at June 30, 2017 cumulative custodial credit risk losses of approximately \$47.6 million and loss provisions with respect to its loans to the Puerto Rico Aqueduct and Sewage Authority (PRASA) of approximately \$44.8 million. These loss events have brought a significant reduction in the Revolving Fund's net position and liquidity, as well as temporarily halting the disbursement of funds for the construction of drinking water infrastructure to PRASA, to the point of raising substantial doubt about the Revolving Fund's ability to continue serving the purposes of the safe drinking water treatment revolving loan program, especially as it has been partially inactive since then.

As further disclosed in Note 12 to the basic financial statements, in response to the liquidity concerns referred to the previous paragraph, the Commonwealth recapitalized the Revolving Fund, by making a \$53.3 million contribution to such fund during December 2018, deposited in a separate trust account of new creation, from which the fund would now be able to resume its normal operations for which it was created. With respect to the collectability of the loans, the Commonwealth, PRASA and the Revolving Fund finalized the restructuring of PRASA's obligations, which would permit PRASA to resume its payments, although in a restructured manner, to the Revolving Fund.

Future capitalization grants are dependent on the availability of funds from the Commonwealth to match a required percentage under Federal Law; which in turn depends on budgetary appropriations made by the Legislature and the certification of such allocations by the Financial Oversight and Management Board for Puerto Rico, which actions are beyond the control of the Revolving Fund. Notwithstanding, the aforementioned remediating activities already in effect alleviates the substantial doubt about the Revolving Fund's ability to continue serving the purposes of the safe drinking water treatment revolving loan program.

## **Other Matters**

### *Required Supplementary Information*

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 4 through 8 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

**Other Reporting Required by *Government Auditing Standards***

In accordance with *Government Auditing Standards*, we have also issued our report dated October 23, 2019, on our consideration of the Revolving Fund’s internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Revolving Fund’s internal control over financial reporting and compliance.



San Juan, PR  
October 23, 2019

License No. 90  
Expiration Date: December 1, 2019



# PUERTO RICO SAFE DRINKING WATER TREATMENT REVOLVING LOAN FUND

## MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED) FOR THE YEAR ENDED JUNE 30, 2017

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As financial management of the Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund (the "Revolving Fund"), we offer readers of the Revolving Fund's financial statements this narrative overview and analysis of the Revolving Fund's financial performance during the fiscal year ended June 30, 2017. This discussion and analysis is designed to assist the reader in focusing on the significant financial matters and activities and to identify any significant changes in the net position of the Revolving Fund. We encourage readers to consider the information presented here in conjunction with the basic financial statements as a whole, which follow this section.

### 1. FINANCIAL HIGHLIGHTS

- The Revolving Fund's restricted net position increased approximately by \$142.6 million or 4,172.3% over the course of the year's operations mainly resulting from a reversal in the provision for loan losses of approximately \$140.1 million. Management's analysis of the allowance for loan losses showed a reduction in the required reserves.
- Operating income was approximately \$139.6 million for fiscal year 2017, an increase of approximately \$357 million when compared to prior year. The provisions for loan losses and custodial credit loss on deposits with GDB recorded in 2016 and the release in provision for loan losses during 2017 accounted for the positive variance.
- Grants and contributions received experienced a net decrease of approximately \$19.5 million or 86.5% when compared to prior year. Grants received from the U.S. Environmental Protection Agency ("EPA") were \$686 thousands while contributions from the Commonwealth of Puerto Rico (the "Commonwealth") amounted to approximately \$2.4 million during the year ended June 30, 2017.
- Loan disbursements made by the Revolving Fund to finance capital improvement programs amounted to approximately \$1.5 million, a decrease of approximately \$23.4 million, or 94% from the \$24.9 million disbursed during the previous year.

### 2. OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is intended to serve as an introduction to the Revolving Fund's basic financial statements, which are comprised of the basic financial statements and the notes to the basic financial statements. Since the Revolving Fund is comprised of a single enterprise fund, no fund level financial statements are shown.

**Basic Financial Statements** — The basic financial statements are designed to provide readers with a broad overview of the Revolving Fund's finances, in a manner similar to a private-sector business.

The statement of net position presents information on all of the Revolving Fund's assets and liabilities, with the difference between the two reported as net position. Net position increase when revenues exceed expenses. Increases in assets without a corresponding increase to liabilities result in increased net position, which indicate an improved financial position.

The statement of revenues, expenses, and changes in net position presents information showing how an entity's net position changed during the fiscal year. All changes in net position are reported as soon as the underlying event occurs, regardless of timing of related cash flows.

# PUERTO RICO SAFE DRINKING WATER TREATMENT REVOLVING LOAN FUND

## MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED) FOR THE YEAR ENDED JUNE 30, 2017

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The last of the required financial statements is the statement of cash flows. This statement reports cash receipts, cash payments, and net changes in cash resulting from operating, investing, and capital and non-capital financing activities and provides answers to such questions as where did cash come from, what was cash used for, and what was the change in the cash balance during the reporting period.

*Notes to the Basic Financial Statements* — The notes provide additional information that is essential to a full understanding of the data provided in the basic financial statements.

### 3. FINANCIAL ANALYSIS

Net position may serve, over time, as a useful indicator of whether a governmental entity's financial position is improving or deteriorating. In the case of the Revolving Fund, assets exceeded liabilities by approximately \$146 million as of June 30, 2017. This represents an increase of \$142.6 million or 4172.3% over net position as of June 30, 2016. The total amount of net position is restricted as it only serves the purpose provided by the enabling legislation of providing loans and financing for drinking water infrastructure facilities. As of June 30, 2017, all loans and commitments have been granted to the Puerto Rico Aqueduct and Sewer Authority (PRASA).

For fiscal year 2017, the Revolving Fund's management established an allowance for loan losses based on, among others, the terms and conditions of the PRASA's debt restructuring agreement discussed in Note 12 to the basic financial statements. Management recognized in the 2017 financial statements the effects of these subsequent events based on information available prior to the issuance of the financial statements. The allowance for loan losses on the troubled debt restructuring was based on management best estimate of the present value of expected debt service payments discounted at the loans' original effective interest rate. As part of the PRASA's debt restructuring, the Commonwealth guaranty related to all the original financing agreements was terminated and any future right to the guaranty was waived. The notes are on parity with PRASA's senior bonds and other senior indebtedness.

The operation of the Revolving Fund is subject to the capital financing requirements of PRASA, and/or any other qualifying entity, and therefore, loan origination activity will be determined on an annual basis, depending upon PRASA's and/or any other qualifying entity's needs.

**PUERTO RICO SAFE DRINKING WATER TREATMENT  
REVOLVING LOAN FUND**

**MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)  
FOR THE YEAR ENDED JUNE 30, 2017**

Condensed financial information on assets, liabilities, and restricted net position is presented below (in thousands):

	June 30,		Change	
	2017	2016	Amount	Percent
<b>Assets:</b>				
Cash	\$ 2,446	\$ 1,518	\$ 928	61.1%
Loans	143,793	2,267	141,526	6,242.9%
Total current assets	146,239	3,785	142,454	3,763.6%
<b>Liabilities - Accounts payable</b>	213	367	(154)	(42.0)%
<b>Net Position - Restricted</b>	<u>\$ 146,026</u>	<u>\$ 3,418</u>	<u>\$ 142,608</u>	4,172.3%

Cash at June 30, 2017 was \$2.4 million resulting in an increase of approximately \$928 thousands from approximately \$1.5 million as of June 30, 2016, or an increase of 61.1%, attributed mostly to the escrow deposits in accordance with the forbearance agreements. Loans increased impacted by the reversal in 2017 in the provision for loan losses of approximately \$140.1 million. An allowance for loan losses of \$184.7 million had been recorded during the 2016 because of the significant delay in the receipt of the scheduled debt service payments and the uncertainty over a restructuring agreement on impaired loans that was concluded on July 26, 2019. Consequently, the net position increased by \$142.6 million primarily due to the reversal in the provision for loan losses.

Condensed financial information on revenues, expenses, and change in net position is presented below (in thousands):

	June 30,		Change	
	2017	2016	Amount	Percent
Operating revenues - interest	\$ 399	\$ 1,846	\$ (1,447)	(78.4)%
Operating recovery (expenses) - general and administrative	139,165	(219,291)	358,456	(163.5)%
Operating income (loss) before grants, contributions, and transfers	139,564	(217,445)	357,009	(164.2)%
Grants and contributions	3,044	22,527	(19,483)	(86.5)%
Contributions to PRASA	-	(1,522)	1,522	(100.0)%
Changes in restricted net position	142,608	(196,440)	339,048	(172.6)%
NET POSITION - Beginning of year	3,418	199,858	(196,440)	(98.3)%
NET POSITION - End of year	<u>\$ 146,026</u>	<u>\$ 3,418</u>	<u>\$ 142,608</u>	4,172.3%



# PUERTO RICO SAFE DRINKING WATER TREATMENT REVOLVING LOAN FUND

## MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED) FOR THE YEAR ENDED JUNE 30, 2017

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The change in net position increased by approximately \$339 million when compared to the previous year. The positive variance results principally from the recording during 2016 of a provision for loan losses of \$185 million and a custodial credit loss on deposits with GDB of approximately \$33.7 million. These adjustments had an aggregate effect of approximately \$219 million. During fiscal year 2017, a reversal in the provision for loan losses of approximately \$140.1 million was recorded because a reduction in the need of allowance for loan losses, increasing the positive variance effect to \$359 million. On the other hand, there was a decrease of \$19.5 million in grants and contributions received. Note that grants are received to the extent disbursements are required under outstanding loans commitments.

#### 4. CURRENTLY KNOWN FACTS

##### **Restoration of Funds from the Commonwealth**

The Commonwealth, with the approval of the Oversight Board, included in its budget for fiscal year 2019, \$194.5 million to be transferred to the State Revolving Funds (SRFs) in restitution of the deposits lost because of GDB's insufficient liquidity. The SRFs had approximately \$194.5 million that was on deposit with GDB and frozen during fiscal year 2016.

The EPA requested the transfer of said funds in a lump sum as soon as appropriate since these funds would go a long way in helping to stabilize the SRFs and enable them to provide significant financial assistance to Puerto Rico communities in addressing critical water and waste water infrastructure problems for the maximum benefit to the people. On November 21, 2018 the Oversight Board agreed and authorized the disbursement, on or before December 31, 2018, of the \$194.5 million (\$141.2 million and \$53.3 million on behalf of the Puerto Rico Water Pollution Control Revolving Fund and the Revolving Fund, respectively).

On December 19, 2018, the Fiscal Agency and Financial Advisory Authority (FAFAA) requested to the Treasury Department and the Office of Management and Budget the release and transfer of such funds, which are currently deposited in their respective Trust account in custody of Banco Popular de Puerto Rico. The recorded custodial credit loss on the deposits with GDB will reverse during fiscal year 2019 upon the aforementioned transfer, also consistent with the position adopted by the Commonwealth.

##### **PRASA Debt's Restructuring**

The Commonwealth of Puerto Rico reached an agreement with the Environmental Protection Agency (EPA) to restructure some \$596 million in PRASA debt with the SRF's, of which approximately \$192.5 million pertain to the Revolving Fund. PRASA and the Commonwealth reached an understanding with the federal agency's Water Pollution Control and Drinking Water State Revolving Fund programs (SRF). The agreements modify the economic terms of approximately \$596 million in outstanding SRF loans, eliminate the Commonwealth's guaranty of such debt, and designate the new federal debt as parity senior debt with PRASA's other senior debt pursuant to the terms of PRASA's existing Master Agreement of Trust. The agreement ended the need for continued forbearance agreements related to the federal debt and alleviated certain uncertainties about PRASA's future. Refer to Note 12 to the basic financial statements for further information.

# **PUERTO RICO SAFE DRINKING WATER TREATMENT REVOLVING LOAN FUND**

**MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)  
FOR THE YEAR ENDED JUNE 30, 2017**

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## **Mitigating Factors to Going Concern**

Future capitalization grants are dependent on the availability of funds from the Commonwealth to match a required percentage under Federal Law; which in turn depends on budgetary appropriations made by the Legislature and the certification of such allocations by the Oversight Board (see Notes 4 and 12), which actions are beyond the control of the Revolving Fund. Notwithstanding, the aforementioned remediating activities already in effect alleviates the substantial doubt about the Revolving Fund's ability to continue serving the purposes of the safe drinking water treatment revolving loan program. The Department of Health under the Commonwealth, has always complied with the matching requirement and will continue directing its exertions towards complying with it.

## **5. REQUESTS FOR INFORMATION**

This financial report is designed to provide those interested with a general overview of the Revolving Fund's finances. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund, P.O. Box 42001, San Juan, Puerto Rico, 00940-2001.

**PUERTO RICO SAFE DRINKING WATER TREATMENT  
REVOLVING LOAN FUND**

**STATEMENT OF NET POSITION  
JUNE 30, 2017**

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**ASSETS**

**CURRENT ASSETS**

Cash, net custodial credit loss impairment of \$47.6 million	\$ 2,445,669
Loans receivable from Puerto Rico Aqueduct and Sewer Authority, net of allowance for loan losses of \$16.7 million	<u>333,333</u>
Total current assets	2,779,002

**NON CURRENT ASSETS - Loans receivable from  
Puerto Rico Aqueduct and Sewer Authority, net of  
allowance for loan losses of \$28.1 million**

143,459,540

Total assets

146,238,542

**LIABILITIES - Accounts payable**

212,964

**NET POSITION - Restricted**

\$ 146,025,578

See notes to basic financial statements.

**PUERTO RICO SAFE DRINKING WATER TREATMENT  
REVOLVING LOAN FUND**

**STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET POSITION  
FOR THE YEAR ENDED JUNE 30, 2017**

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**OPERATING REVENUES:**

Interest income on deposits	\$	399,162
Total interest earned		399,162

**OPERATING (RECOVERY) EXPENSES:**

Release of provision for possible loan losses		(140,093,673)
Custodial credit loss on deposits with GDB		396,196
General and administrative		532,551
Total operating recovery, net		(139,164,926)

**OPERATING INCOME**

139,564,088

**NON-OPERATING REVENUES :**

Contributions from Environmental Protection Agency		686,142
Contributions from Commonwealth of Puerto Rico		2,357,400
Total non-operating revenue		3,043,542

**CHANGE IN NET POSITION**

142,607,630

**NET POSITION - Beginning of year**

3,417,948

**NET POSITION - End of year**

\$ 146,025,578

See notes to basic financial statements.

**PUERTO RICO SAFE DRINKING WATER TREATMENT  
REVOLVING LOAN FUND**

**STATEMENT OF CASH FLOWS  
FOR THE YEAR ENDED JUNE 30, 2017**

<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>	
Cash paid for general and administrative expenses	\$ (686,173)
Custodial credit loss on deposit with GDB	(396,196)
Net cash used in operating activities	<u>(1,082,369)</u>
 <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>	
Loan disbursements	(1,517,529)
Forbearance agreement deposits	85,334
Interest collected on deposits	399,162
Net cash used in investing activities	<u>(1,033,033)</u>
 <b>CASH FLOWS FROM NON-CAPITAL FINANCING ACTIVITIES:</b>	
Contributions received from Environmental Protection Agency	686,142
Contributions received from Commonwealth of Puerto Rico	2,357,400
Net cash provided by non-capital financing activities	<u>3,043,542</u>
 <b>NET DECREASE IN CASH</b>	 928,140
CASH - Beginning of year	<u>1,517,529</u>
CASH - End of year	<u>\$ 2,445,669</u>
 <b>RECONCILIATION OF OPERATING INCOME TO NET CASH USED IN OPERATING ACTIVITIES:</b>	
Operating income	\$ 139,564,088
Adjustments to reconcile operating income to net cash used in operating activities:	
Interest income from deposits	(399,162)
Release of provision for possible loan losses	(140,093,673)
Decrease in accounts payable	<u>(153,622)</u>
Net cash used in operating activities	<u>\$ (1,082,369)</u>

See notes to basic financial statements.

# PUERTO RICO SAFE DRINKING WATER TREATMENT REVOLVING LOAN FUND

## NOTES TO BASIC FINANCIAL STATEMENTS FOR THE YEAR ENDED JUNE 30, 2017

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### 1. REPORTING ENTITY

Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund (the “Revolving Fund”) was created by Act 32 of the Legislature of the Commonwealth of Puerto Rico (the “Commonwealth”) on July 7, 1997. The Revolving Fund was constituted separately and independently from any other funds or resources of the Commonwealth. It is presented as an enterprise fund of the Commonwealth.

The Revolving Fund is administered, pursuant to Act 5 of July 21, 1977, as amended (the “Act 5”), by the Puerto Rico Department of Health (the “DOH”). Pursuant to the Act 5, the DOH, on behalf of the Commonwealth, is authorized to enter into operating agreements and capitalization grant agreements with the U.S. Environmental Protection Agency (“EPA”). DOH, Puerto Rico Infrastructure Financing Authority (“PRIFA”), Puerto Rico Aqueduct and Sewer Authority (“PRASA”), and the Fiscal Agency and Financial Advisory Authority (“FAFAA”) entered into a memorandum of understanding under which each party has agreed to assume specific responsibilities in connection with the operations of the Revolving Fund.

### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting and reporting policies of the Revolving Fund conform to Accounting Principles Generally Accepted in the United States of America (“GAAP”), for governments as prescribed by the Governmental Accounting Standards Board (“GASB”).

During fiscal year ended on June 30, 2017, certain governmental accounting pronouncements became effective, none of which had any impact in the results of the operations or in the presentation of the financial statements of the Revolving Fund.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of changes in net position and revenues and expenditures during the reporting period. Actual results could differ from those estimates.

Following is a description of the Revolving Fund’s most significant accounting policies:

***Measurement Focus, Basis of Accounting, and Financial Statements Presentation*** — The Revolving Fund financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when incurred, regardless of the timing of related cash flows.

The statement of net position and the statement of revenues, expenses, and changes in net position report information on all activities of the Revolving Fund. The Revolving Fund’s activities are distinguished as proprietary activities. The Revolving Fund’s activities generally are financed through intergovernmental revenues, other non-exchange revenues and interest income from its loans and deposits. Following is a description of the Revolving Fund’s financial statements.

# PUERTO RICO SAFE DRINKING WATER TREATMENT REVOLVING LOAN FUND

## NOTES TO BASIC FINANCIAL STATEMENTS FOR THE YEAR ENDED JUNE 30, 2017

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The statement of net position presents the Revolving Fund's assets and liabilities, with the difference reported as net position. Net position may be reported as:

- Restricted component of net position consists of restricted assets reduced by liabilities related to those assets. Restricted net assets result when constraints placed on net position use are either externally imposed by creditors, grantors, contributors, and the like, or imposed by law through constitutional provisions or enabling legislation.
- Unrestricted component of net position consists of net amount of the assets and liabilities that do not meet the definition of the preceding category. Unrestricted component of net position often is designated in order to indicate that management does not consider them to be available for general operations. Unrestricted component of net position often has constraints on use that are imposed by management, but such constraints may be removed or modified.

As of June 30, 2017, the Revolving Fund net position is presented as restricted.

The statement of revenues, expenses, and changes in net position demonstrates the degree to which the direct expenses of a given function or segments are offset by program revenues. Direct expenses are those that are clearly identifiable within a specific function. Program revenues include interest income on loans and deposits. Operating expenses are those that relate to the administration of the Revolving Fund. Other items not meeting the definition of program revenues or operating expense are reported as non-operating revenues or expenses.

***Loan Receivable and Allowance for Loan Losses*** – Loans are presented at the outstanding principal balance reduced by allowance for loan losses. The allowance for loan losses is established through a provision recorded in the statement of activities. The allowance for loan losses is based on management's evaluation of the risk characteristic of the loans including such factors as the nature of individual credit outstanding, past loss experience, known and inherent risk in the portfolios' sources of repayment, adverse situation that may affect the borrower's ability to repay, the estimated value of any underlying collateral, and general economic condition. Loan charge-offs are recorded against the allowance when management believes that the collection of the principal is unlikely. Recoveries of amount previously charged off are credited to the respective allowance. Because of uncertainties inherent in the estimation process, management's estimate of credit losses in the outstanding loans receivable portfolios and the related allowance may change if economic and other conditions differ substantially from the assumptions used in making the estimates. Such adjustment to original estimates, as necessary, are made in the period on which these factors and other relevant considerations indicate that loss levels vary from previous estimates. A loan is considered impaired when, based on current information and events, it is probable that the Revolving Fund will be unable to collect the scheduled payments of principal or interest when due according to the contractual term of the loan agreement.

***Allowance for Loan Losses Public Sector*** - The Revolving Fund's principal function was to provide financing to certain public entities and municipalities under the memorandum of understanding guidance described in Note 1. The financing activities include interim financing for capital improvements payable by the aforementioned public entities and municipalities. At June 30, 2017 these loans have not received its otherwise scheduled debt service payments as a result of (i) the deterioration of the fiscal situation and financial condition of the Commonwealth and PRASA, (ii) the

# PUERTO RICO SAFE DRINKING WATER TREATMENT REVOLVING LOAN FUND

## NOTES TO BASIC FINANCIAL STATEMENTS FOR THE YEAR ENDED JUNE 30, 2017

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inability to complete certain financing and liability management transaction due to limited market access and (iii) general market conditions, which in turn have negatively affected the ability of the Commonwealth and PRASA to permanently finance their capital expenditure and operating deficits by issuing bonds and notes.

The Revolving Fund considers loans as impaired based on current information and events, including the significant delay in the receipt of the scheduled debt service payment mentioned above. In management's opinion, it is highly probable that the Revolving Fund will be unable to collect all amounts due according to the loan's original contractual terms. To establish an allowance for loans losses, the Revolving Fund's management used applicable authoritative literature, general background information and recent relevant information included in the Commonwealth and PRASA's fiscal plan including, as further discussed in Note 8, a forbearance agreement ("Forbearance Agreement") that PRIFA, DOH and the Puerto Rico Environmental Quality Board ("EQB") entered into on June 30, 2016 with PRASA, whereby PRIFA, among other things, agreed to a temporary forbearance of its rights and remedies under the Revolving Fund Loan documents against PRASA. In addition, the terms and conditions of the PRASA's debt restructuring agreed to subsequent to year end, as discussed in Notes 3, 6 and 12, were employed for allowance for loan losses determination.

The Revolving Fund established an allowance for losses on the impaired loans based on management's estimate of the present value of expected debt services payment discounted at the loans' effective interest rate. The Revolving Fund determined that major sources of repayment in this portfolio were appropriations from the Commonwealth and operating and rental revenue of the borrowers. To identify loans that must be individually measured for impairment, the population of all loans was segregated into the following risk-based buckets taking into consideration their source of repayment, guaranty and payment history. The risk based buckets included i) loans with a reliable source of repayment, and ii) loans with an unreliable source of repayment that were not performing according to contract terms (as to principal and interest) and did not have any additional source of repayment. For loans identified as those to be individually measured for impairment, the present value of estimated future cash flow was compared with the respective balance of the recorded investment in the loan to determine the impairment amount or required allowance for loan losses.

In relation to income recognition, the Revolving Fund classifies loans as nonaccrual when the management determines if any of the following characteristic are present: (a) a loan was six months past due; (b) it has no current source of repayment; (c) it is not covered by formal commitment from the Commonwealth; and (d) it does not have designated collateral, or such collateral is insufficient. Based on these four elements, when a loan is placed in nonaccrual status interest receivable is reversed from interest income. Interest income on nonaccrual loan is thereafter recognized in income only to the extent actually collected. Nonaccrual loans are returned to accrual status when management has adequate evidence to believe that the loans would perform as contracted.

***Recent Accounting Pronouncements-*** The GASB has issue the following accounting pronouncements that have effective dates after June 30, 2017:

- (a) GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefit Other Than Pension*. This Statement replaces the requirements of Statements No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, as amended, and No. 57, *OPEB Measurements by Agent Employers and Agent*



# PUERTO RICO SAFE DRINKING WATER TREATMENT REVOLVING LOAN FUND

## NOTES TO BASIC FINANCIAL STATEMENTS FOR THE YEAR ENDED JUNE 30, 2017

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*Multiple-Employer Plans*, for OPEB. The primary objective of this Statement is to improve accounting and financial reporting by state and local governments for postemployment benefits other than pensions (other postemployment benefits or OPEB). It also improves information provided by state and local governmental employers about financial support for OPEB that is provided by other entities. This Statement is effective for fiscal years beginning after June 15, 2017.

- (b) GASB Statement No. 81, *Irrevocable Split-Interest Agreements*. The objective of this Statement is to improve accounting and financial reporting for irrevocable split-interest agreements by providing recognition and measurement guidance for situations in which a government is a beneficiary of the agreement. This Statement is not effective until fiscal year 2018.
- (c) GASB Statement No. 83, *Certain Asset Retirement Obligations*. This Statement addresses accounting and financial reporting for certain asset retirement obligations (AROs). An ARO is a legally enforceable liability associated with the retirement of a tangible capital asset. A government that has legal obligations to perform future asset retirement activities related to its tangible capital assets should recognize a liability based on the guidance in this Statement. This Statement establishes criteria for determining the timing and pattern of recognition of a liability and a corresponding deferred outflow of resources for AROs. This Statement requires that recognition occur when the liability is both incurred and reasonably estimable. The requirements of this Statement are effective for reporting periods beginning after June 15, 2018. Earlier application is encouraged.
- (d) GASB Statement No. 84, *Fiduciary Activities*. The objective of this Statement is to improve guidance regarding the identification of fiduciary activities for accounting and financial reporting purposes and how those activities should be reported. The requirements of this Statement are effective for reporting periods beginning after December 15, 2018. Earlier application is encouraged.
- (e) GASB Statement No. 85, *Omnibus 2017*. The objective of this Statement is to address practice issues that have been identified during implementation and application of certain GASB Statements. This Statement addresses a variety of topics including issues related to blending component units, goodwill, fair value measurement and application, and postemployment benefits (pensions and other postemployment benefits [OPEB]). Specifically, this Statement addresses the following topics:
- Blending a component unit in circumstances in which the primary government is a business-type activity that reports in a single column for financial statement presentation.
  - Reporting amounts previously reported as goodwill and “negative” goodwill.
  - Classifying real estate held by insurance entities.
  - Measuring certain money market investments and participating interest earning investment contracts at amortized cost.
  - Timing of the measurement of pension or OPEB liabilities and expenditures recognized in financial statements prepared using the current financial resources measurement focus.
  - Recognizing on-behalf payments for pensions or OPEB in employer financial statements.

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- Presenting payroll-related measures in required supplementary information for purposes of reporting by OPEB plans and employers that provide OPEB.
- Classifying employer-paid member contributions for OPEB.
- Simplifying certain aspects of the alternative measurement method for OPEB.
- Accounting and financial reporting for OPEB provided through certain multiple-employer defined benefit OPEB plans.

The requirements of this Statement are effective for reporting periods beginning after June 15, 2017. Earlier application is encouraged.

- (f) GASB Statement No. 86, *Certain Debt Extinguishment Issues*. This Statement improves the consistency in accounting and financial reporting for in-substance defeasance of debt by providing guidance for transactions in which cash and other monetary assets acquired with only existing resources—resources other than the proceeds of refunding debt—are placed in an irrevocable trust for the sole purpose of extinguishing debt. This Statement also improves accounting and financial reporting for prepaid insurance on debt that is extinguished and notes to financial statements for debt that is defeased in substance. The requirements of this Statement are effective for fiscal years beginning after June 15, 2017. Earlier application is encouraged.
- (g) GASB Statement No. 87, *Leases*. The objective of this Statement is to better meet the information needs of financial statement users by improving accounting and financial reporting for leases by governments. This Statement increases the usefulness of governments' financial statements by requiring recognition of certain lease assets and liabilities for leases that previously were classified as operating leases and recognized as inflows of resources or outflows of resources based on the payment provisions of the contract. It establishes a single model for lease accounting based on the foundational principle that leases are financings of the right to use an underlying asset. Under this Statement, a lessee is required to recognize a lease liability and an intangible right-to-use lease asset, and a lessor is required to recognize a lease receivable and a deferred inflow of resources, thereby enhancing the relevance and consistency of information about governments' leasing activities. The requirements of this Statement are effective for reporting periods beginning after December 15, 2019. Earlier application is encouraged.
- (h) GASB Statement No. 88, *Certain Disclosures Related to Debt, including Direct Borrowings and Direct Placements*. The primary objective of this Statement is to improve the information that is disclosed in notes to government financial statements related to debt, including direct borrowings and direct placements. It also clarifies which liabilities governments should include when disclosing information related to debt. This Statement defines debt for purposes of disclosure in notes to financial statements as a liability that arises from a contractual obligation to pay cash (or other assets that may be used in lieu of cash) in one or more payments to settle an amount that is fixed at the date the contractual obligation is established. This Statement requires that additional essential information related to debt be disclosed in notes to financial statements, including unused lines of credit; assets pledged as collateral for the debt; and terms specified in debt agreements related to significant events of

# PUERTO RICO SAFE DRINKING WATER TREATMENT REVOLVING LOAN FUND

## NOTES TO BASIC FINANCIAL STATEMENTS FOR THE YEAR ENDED JUNE 30, 2017

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default with finance-related consequences, significant termination events with finance-related consequences, and significant subjective acceleration clauses. For notes to financial statements related to debt, this Statement also requires that existing and additional information be provided for direct borrowings and direct placements of debt separately from other debt. The requirements of this Statement are effective for reporting periods beginning after June 15, 2018. Earlier application is encouraged.

- (i) GASB Statement No. 89, *Accounting for Interest Cost Incurred Before the End of a Construction Period*. This Statement establishes accounting requirements for interest cost incurred before the end of a construction period. Such interest cost includes all interest that previously was accounted for in accordance with the requirements of paragraphs 5–22 of Statement No. 62, Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements, which are superseded by this Statement. This Statement requires that interest cost incurred before the end of a construction period be recognized as an expense in the period in which the cost is incurred for financial statements prepared using the economic resources measurement focus. As a result, interest cost incurred before the end of a construction period will not be included in the historical cost of a capital asset reported in a business-type activity or enterprise fund. This Statement also reiterates that in financial statements prepared using the current financial resources measurement focus, interest cost incurred before the end of a construction period should be recognized as an expenditure on a basis consistent with governmental fund accounting principles. The requirements of this Statement are effective for reporting periods beginning after December 15, 2019. Earlier application is encouraged.
- (j) GASB Statement No. 90, *Majority Equity Interests*. The primary objectives of this Statement are to improve the consistency and comparability of reporting a government's majority equity interest in a legally separate organization and to improve the relevance of financial statement information for certain components units. It defines a majority equity interest and specifies that a majority equity interest in a legally separate organization should be reported as an investment if a government's holding of the equity interest meets the definition of an investment. The requirements of this Statement are effective for reporting periods beginning after December 15, 2018. Earlier application is encouraged.
- (k) GASB Statement No. 91, *Conduit Debt Obligations*. The primary objectives of this Statement are to provide a single method of reporting conduit debt obligations by issuers and eliminate diversity in practice associated with (i) commitments extended by issuers, (ii) arrangements associated with conduit debt obligations, and (iii) related note disclosures. This Statement achieves those objectives by clarifying the existing definition of a conduit debt obligation; establishing that a conduit debt obligation is not a liability of the issuer; establishing standards for accounting and financial reporting of additional commitments and voluntary commitments extended by issuers and arrangements associated with conduit debt obligations; and improving required note disclosures.

This Statement also addresses arrangements—often characterized as leases— that are associated with conduit debt obligations. In those arrangements, capital assets are constructed or acquired with the proceeds of a conduit debt obligation and used by third-party obligors in the course of their activities. Payments from third-party obligors are intended to cover and

# PUERTO RICO SAFE DRINKING WATER TREATMENT REVOLVING LOAN FUND

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coincide with debt service payments. During those arrangements, issuers retain the titles to the capital assets. Those titles may or may not pass to the obligors at the end of the arrangements.

This Statement requires issuers to disclose general information about their conduit debt obligations, organized by type of commitment, including the aggregate outstanding principal amount of the issuers' conduit debt obligations and a description of each type of commitment. The requirements of this Statement are effective for reporting periods beginning after December 15, 2020. Earlier application is encouraged.

Management is evaluating the impact that these statements will have, if any, on the Revolving Fund's basic financial statements.

### 3. UNCERTAINTY AND LIQUIDITY RISK

As of June 30, 2017, the Revolving Fund has recognized significant custodial credit losses and loss provisions in its deposits with GDB and its loans, respectively, as follows:

- The Revolving Fund maintained certain cash and time deposits with GDB. As further discussed in Note 4 below, as a result of the enactment of the Puerto Rico Emergency Moratorium and Financial Rehabilitation Act of April 2016 and a series of subsequent executive orders, deposits held at GDB were subject to strict restrictions and limitations during fiscal year 2017, and subsequent periods. Therefore, GDB currently does not have sufficient liquid financial resources to meet obligations as they become due or honor deposits withdrawals as they are requested. As a result, management determined that a custodial credit loss existed as of June 30, 2017 for the deposits held at GDB in the amount of approximately \$47.6 million.
- As further discussed in Note 6 below, PRASA has not been able to meet in full its scheduled debt service payments on the loans granted by the Revolving Fund. Therefore, management of the Revolving Fund determined that an allowance for such loans was required to be recognized during fiscal year 2017 and estimated it at approximately \$44.8 million.

Both of these loss events have brought a significant reduction in the Revolving Fund's net position and liquidity, as well as temporarily halting the disbursement of funds for the construction of drinking water infrastructure to PRASA, to the point of raising substantial doubt about its ability to continue serving the purposes of the safe drinking water treatment revolving loan program, especially as the Revolving Fund has been partially inactive since then.

#### Remediation Plan

As further described in Note 12, in response to the approved fiscal plan provisions of the Commonwealth as well as the approved General Fund Budget for fiscal year 2019, the Commonwealth recapitalized the Revolving Fund and its sister revolving fund, the Puerto Rico Water Pollution Control Revolving Fund (together known as the State Revolving Fund or SRFs), by making a \$194.5 million contribution (\$141.2 million and \$53.3 million on behalf of the Puerto Rico Water Pollution Control Revolving Fund and the Revolving Fund, respectively) to such funds during December 2018, deposited in separate Trust accounts of new creation, from which both revolving funds would now be able to

# PUERTO RICO SAFE DRINKING WATER TREATMENT REVOLVING LOAN FUND

## NOTES TO BASIC FINANCIAL STATEMENTS FOR THE YEAR ENDED JUNE 30, 2017

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resume or reactivate the operations for which they were created. This recapitalization has also allowed the EPA to authorize disbursements and loans to PRASA in regard to the Revolving Fund.

With respect to the collectability of the Revolving Fund's loans, the Commonwealth reached an agreement with the Environmental Protection Agency (EPA) to restructure some \$596 million in debt with the SRF's. The agreements modify the economic terms of approximately \$596 million in outstanding SRF loans, approximately \$192.5 million pertaining to the Revolving Fund, eliminate the Commonwealth's guaranty of such debt, and designate debt as parity senior debt with PRASA's other senior debt pursuant to the terms of PRASA's existing Master Agreement of Trust. The agreement was approved by the Oversight Board ending the need for continued forbearance agreements related to the federal debt and removing uncertainties about PRASA's future. Refer to Note 12 to the basic financial statements for further information.

Future capitalization grants are dependent on the availability of funds from the Commonwealth to match a required percentage under Federal Law; which in turn depends on budgetary appropriations made by the Legislature and the certification of such allocations by the Oversight Board, which actions are beyond the control of the Revolving Fund (see Notes 4 and 12). Notwithstanding, the aforementioned remediating activities already in effect alleviates the substantial doubt about the Revolving Fund's ability to continue serving the purposes of the safe drinking water treatment revolving loan program.

#### 4. CUSTODIAL CREDIT RISK

Custodial credit risk is the risk that in the event of a bank failure of a depository financial institution, the entity will not be able to recover its deposits. The Revolving Fund does not have a custodial credit policy. At June 30, 2017, the Revolving Fund maintains approximately \$47.6 million of cash and time deposits balances with GDB, which are not covered by federal depository insurance. Such amounts are uninsured and uncollateralized. In response to the significant risks and uncertainties being faced by GDB and the Commonwealth, on April 6, 2016, the Commonwealth approved Act No. 21 "Puerto Rico Emergency Moratorium and Financial Rehabilitation" ("Act No. 21"), which among several provisions, authorized the Governor to declare a moratorium on debt service payments for a temporary period for the Commonwealth and the GDB, or any of the remaining government instrumentalities of Puerto Rico, and stay creditor remedies that may result from the moratorium.

On April 8, 2016, the Governor signed Executive Order No. 2016-010 ("EO No. 2016-010"), declaring GDB to be in a state of emergency pursuant to Act No. 21. In accordance with the emergency powers provided for in Act No. 21, EO No. 2016-010 implemented a regulatory framework governing GDB's operations and liquidity, including prohibiting loan disbursements by GDB and establishing a procedure with respect to governmental withdrawals, payments, and transfer requests with respect to funds held on deposit at GDB. To that effect, EO No. 2016-010 restricted the withdrawal, payment and transfer of funds held on deposit at GDB to those reasonable and necessary to ensure the provision of essential services and authorized GDB to establish weekly limits on the aggregate amount of such disbursements. Moreover, EO No. 2016-010 prohibited GDB depositors from printing or writing checks creditable against their accounts at GDB, unless they obtain a temporary waiver from GDB.

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On June 30, 2016, the U.S. President signed the Puerto Rico Oversight, Management, and Economic Stability Act (“PROMESA”), which granted the Commonwealth and its component units’ access to an orderly mechanism to restructure their debts in exchange for significant federal oversight over the Commonwealth’s finances. In broad strokes, PROMESA seeks to provide Puerto Rico with fiscal and economic discipline through the creation of a control board (the Oversight Board), relief from creditors and lawsuits through the enactment of a temporary stay on litigation, and two alternative methods to adjust unsustainable debt.

On June 30, 2016, the Governor signed an Executive Order No. EO-2016-030 (“No. EO-2016-030”), declaring the Commonwealth to be in state of emergency and declaring a moratorium on the Commonwealth’s obligation to make payments on bonds, and notes issued or guaranteed by the Commonwealth. EO No.2016-30 suspends any obligation of the Office of Management and Budget of the Commonwealth (OMB) to include an appropriation in the proposed budget submitted to the Legislative Assembly for the payments of bonds issued by the Public Finance Corporation.

On March 23, 2018, GDB ceased its operations and it has been since then winding down in an orderly fashion under title VI of PROMESA. As GDB serves as the depository of most of the Revolving Fund’s funds, the Revolving Fund’s cash, time deposits and accrued interest receivable on deposits continue to be subject to strict restrictions and limitations. Based on an evaluation of the availability and recoverability of such deposits, a custodial credit loss on deposits and related accrued interest at GDB has been recorded in an aggregate amount of \$47.6 million on the Revolving Fund’s financial statements as follows:

<u>Type of Deposit</u>	<b>Deposits Held at June 30, 2017</b>		
	<b>Deposits Balance</b>	<b>Custodial Credit Loss</b>	<b>Book Balance</b>
Cash deposit at GDB	\$ 1,123,874	\$ (1,122,440)	\$ 1,434
Time deposit at GDB	46,512,597	(46,512,597)	-
Cash and escrow deposit at BPPR	2,444,235	-	2,444,235
	<b>\$ 50,080,706</b>	<b>\$ (47,635,037)</b>	<b>\$ 2,445,669</b>

Pursuant Title VI of PROMESA, GDB has been restructuring its obligations. Such restructuring requires the offset between financial instruments assets and liabilities held by GDB. Upon the restructuring of the GDB’s obligations noted in the GDB Restructuring Support Agreement (GDB RSA), the recorded custodial credit loss on the interest-bearing deposits disclosed above will reverse at that moment, consistent with the position established by the Commonwealth. Refer to Note 12 for a description of subsequent events regarding the status of the GDB RSA and recapitalization of the Revolving Fund.

**5. TRANSACTIONS WITH GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO**

Since GDB had certain responsibilities with the Revolving Fund, GDB provided certain management services to the Revolving Fund at no cost during the year ended June 30, 2017.

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The Act. No 21 of 2016, known as the Puerto Rico Emergency Moratorium and Rehabilitation Act, as amended, created the Puerto Rico Fiscal Agency and Financial Advisory (FAFAA) as an independent public corporation to assume GDB's role as fiscal agent, financial advisor and reporting agent for the Commonwealth and its instrumentalities.

**6. LOANS RECEIVABLE**

Loans receivable, net of allowance for loans losses as, of June 30, 2017 consist of:

<b>Description</b>	<b>Amount</b>
Permanent loans, net	\$ 105,346,868
Construction loans, net	38,446,005
Total loans receivable	<u>\$ 143,792,873</u>

**Reconciliation to the statement of net position**

Current portion, net	\$ 333,333
Noncurrent portion, net	143,459,540
Total loans receivable, net	<u>\$ 143,792,873</u>

Permanent loans are due in semiannual installments bearing interest at 2% per annum, maturing on various dates through January 1, 2033. Permanent loans receivable as of June 30, 2017, mature as follows:

<b>Years Ending June 30,</b>	<b>Amount</b>
2018	\$ 17,070,390
2019	8,793,385
2020	8,970,132
2021	9,150,431
2022	9,334,355
Thereafter	84,882,202
	<u>\$ 138,200,895</u>

Construction loans bear interest at 2% per annum and principal will be payable semiannually commencing no later than one year after construction completion date. All loans are required to be paid in full in a period not to exceed 20 years. For construction loans, such period commences after the construction loan is converted to a permanent loan. Interest on construction loans are payable semiannually since inception of loan.

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The Revolving Fund is operated as a direct loan program, whereby most of the loans made to PRASA are funded by capitalization grants from the EPA and a Commonwealth match equaling 20% of the EPA capitalization grant. All of the outstanding loans were 100% funded with EPA capitalization grants or with funds from the results of the operations of the Revolving Fund.

Pursuant to Act 96 of June 30, 2015 (the "Act 96"), the Commonwealth guarantees the payment of principal and interest on most of the outstanding Revolving Fund loans granted to PRASA on or before June 30, 2020. Loans covered by Act 96 include a statement of such guarantee in the loan agreement.

Notwithstanding that a guaranty from the Commonwealth exists, the current financial situation of the Commonwealth is precarious and the possibility that available resources will be insufficient to cover the guaranty in its entirety prevails. PRASA is also experiencing a challenging financial scenario, with its ability to fulfill all of its financial commitments currently impaired, including those obligations incurred under the Revolving Fund loans. As a result, PRASA is seeking relief through the modification of its debt obligations.

The Commonwealth's guaranty related to all the original financing agreements, and the bonds and loans issued was terminated on July 26, 2019, and the new loans are not subject to the guaranty and the obligations of PRASA under the new loan agreements and the notes will not constitute Commonwealth guaranteed indebtedness under the trust agreement. Any future right to the Commonwealth guaranty was waived.

Loans are considered impaired based on current information and events, including a letter to the Electronic Municipal Market Access System (EMMA) dated March 16, 2016 and the eventual significant delays in the receipt of the scheduled debt service payments.

The letter to EMMA disclosed the situation that caused a backlog of unpaid obligations to contractors on PRASA's capital improvement program (CIP). In summary, as a result of the recent obstacles faced by PRASA in gaining access to the bond market for the issuance of its revenue bonds to cover the cost of its CIP, it has been unable to pay certain outstanding contractor receivables and had to suspend its ongoing CIP projects. The action plan proposed in this letter to face the situation included the following: (1) rate increases (currently in implementation stage), (2) set aside certain funds within the master agreement trust in order to make payments to its contractors, which did not include any payment to the Revolving Fund, (3) the approval by the Senate of Puerto Rico of the legislation to create a special purpose entity for a bond issuance (the creation of such entity never materialized), (4) PRASA had a \$180 million credit line from GDB (no longer available due to the wind down and restructuring of GDB in November 2018) and (5) obtaining financing from a willing investor, with or without the approval of legislation.

Considering that the action plan has had no significant development and that beginning on June 30 2016, a series of debt forbearance agreements were entered with PRASA (see Note 8), the Revolving Fund established an allowance for loan losses on identified impaired loans based on management's estimate of the present value of expected debt service payments discounted at the loans' effective interest rate.

The PRASA's debt restructuring agreements (Both SRF and Rural Development), referred to in Notes 2, 3 and 12, were executed July 26, 2019 and publicly disclosed through the Municipal Securities



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Rulemaking Board’s Electronic Municipal Market Access, on August 9, 2019, in accordance with the Securities and Exchange Commission timelines. As a result of this restructuring, management was able to release some allowance for loan losses that was provided in prior year.

At June 30, 2017, loans, all to PRASA, consist of the outstanding balances as following:

<b>Type of loan</b>	<b>Loans at June 30, 2017</b>		
	<b>Loans Balance</b>	<b>Allowance for Loans Losses</b>	<b>Book Balance</b>
Permanent loan (PRASA)	\$ 138,200,895	\$ (32,854,027)	\$ 105,346,868
Construction loan	50,435,978	(11,989,973)	38,446,005
Total	\$ 188,636,873	\$ (44,844,000)	\$ 143,792,873

**7. CAPITALIZATION GRANTS**

The Safe Drinking Water Act (the “SDWA”), as amended, is the main federal law that ensures the quality of the United States' drinking water. Under the SDWA, EPA sets standards for drinking water quality and oversees different localities, and water suppliers who implement those standards. The SDWA created the federal Drinking Water State Revolving Fund to make funds available to public water systems to finance infrastructure construction and improvements needed to comply with the SDWA water quality requirements. The SDWA authorizes the EPA to award capitalization grants to state which, in turn, provide low interest loans and other types of financial assistance to eligible systems. These grants are routinely subject to financial and compliance audits in accordance with the provisions of the *Title 2, U.S. Code of Federal Regulation Part 200, Uniform Administration Requirements, Cost Principles and Audit Requirements for Federal Award* (Uniform Guidance) and compliance audits by EPA. The latter has the authority to determine liabilities as well as to limit, suspend, or terminate the federal assistance. All funds drawn from EPA and the matching funds from the Commonwealth are recorded as non-operating revenues. As of June 30, 2017, EPA has awarded capitalization grants of \$217,849,000 to the Revolving Fund of which \$194,912,976 has been drawn for loans and administrative expenses.

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The following summarizes the capitalization grants awarded, amounts drawn on each grant as of the statement of net position date, and balances available for future draws:

<u>June 30,</u>	<u>Grant amount</u>	<u>Total draws at June 30, 2016</u>	<u>Draws during 2017</u>	<u>Total draws at June 30, 2017</u>	<u>Available at June 30, 2017</u>
1998	\$ 22,783,800	\$ 22,783,800	\$ -	\$ 22,783,800	\$ -
1999	10,716,700	10,716,700	-	10,716,700	-
2000	11,137,800	11,137,800	-	11,137,800	-
2001	11,183,800	11,183,800	-	11,183,800	-
2002	10,741,300	10,741,300	-	10,741,300	-
2003	10,676,700	10,676,700	-	10,676,700	-
2004	11,075,500	11,075,500	-	11,075,500	-
2005	11,052,100	11,052,100	-	11,052,100	-
2006	8,229,300	8,229,300	-	8,229,300	-
2007	8,229,000	8,229,000	-	8,229,000	-
2008	8,146,000	8,146,000	-	8,146,000	-
ARRA	19,500,000	19,500,000	-	19,500,000	-
2009	8,146,000	8,146,000	-	8,146,000	-
2010	13,573,000	13,573,000	-	13,573,000	-
2011	9,418,000	9,418,000	-	9,418,000	-
2012	8,975,000	8,437,304	96,009	8,533,313	441,687
2013	8,421,000	5,314,075	590,133	5,904,208	2,516,792
2014	8,845,000	5,866,455	-	5,866,455	2,978,545
2015	8,687,000	-	-	-	8,687,000
2016	8,312,000	-	-	-	8,312,000
	<u>\$ 217,849,000</u>	<u>\$ 194,226,834</u>	<u>\$ 686,142</u>	<u>\$ 194,912,976</u>	<u>\$ 22,936,024</u>

At June 30, 2017, the Revolving Fund has \$8,312,000 and \$8,687,000 from the grants awarded by EPA for the federal fiscal years ended September 30, 2016 and 2015, respectively, that are available to be drawn for loan commitments and/or administrative expenses once all the EPA requirements have been met. As of June 30, 2017, PRIFA, PRASA and other parties have not executed financial agreements related to these awards.

**8. REVOLVING FUNDS LOAN FORBEARANCE**

On June 30, 2016, in light of PRASA's liquidity constraints, PRIFA, DOH, and the Puerto Rico Environmental Quality Board ("EQB") entered into a forbearance agreement with PRASA (the "Forbearance Agreement"), under which PRIFA, among other things, agreed to a temporary forbearance of its rights and remedies under the Revolving Fund Loan documents against PRASA and under the Commonwealth Guaranty through December 30, 2016. The Forbearance Agreement was reached in order to facilitate a reasonable due diligence and negotiation period necessary to achieve definitive agreements for the restructuring of PRASA's obligations related to such Revolving Fund Loan facilities.

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At different dates between December 14, 2016 through July 26, 2019, PRIFA, EQB, DOH and PRASA have entered into nine additional amendment agreements, the last one expiring on July 31, 2019, to amend certain provisions of the forbearance and to provide for an additional temporary forbearance of potential defaults and events of default that may arise under the Forbearance Agreement and the Revolving Loan documents.

On July 26, 2019, the forbearance agreements were terminated and escrowed funds applied to the SRF loans as part of the PRASA's debt restructuring agreement, described in Notes 3, 6 and 12.

### 9. NOTICE OF NONCOMPLIANCE

Following meetings with the directors or representatives of PRIFA, the DOH and GDB between September 12 and 15 of 2016, the EPA, concerned with the continuing delays in processing payments for drinking water treatment projects funded by the Revolving Fund, issued on October 3, 2016 to these agencies, a Notice of Noncompliance with their obligations and federal requirements for the management of the Revolving Fund.

Based on information received by PRIFA, DOH and GDB, the EPA determined that these agencies, with particular reference to GDB, did not comply with the federal requirements to (1) establish, maintain, invest and credit the Revolving Fund with repayments, such that the fund balance will be available in perpetuity for authorized and eligible water pollution control activities, (2) maintain the Revolving Fund in a manner that ensures the funds are used for authorized purposes and (3) maintain a separate account or series of accounts for the Revolving Fund that are dedicated solely to providing loans and financial assistance for the purpose authorized by the Safe Drinking Water Act.

The Notice of Noncompliance identified steps that the aforementioned agencies had to take to be in full compliance with the requirements of the Safe Drinking Water Act and remain eligible for federal drinking water funding. The Notice of Noncompliance also required the submittal of a corrective action plan to the EPA. The Notice of Noncompliance was referred to the EPA's Office of Inspector General (OIG).

The recapitalization discussed in Note 12 has also allowed the EPA to authorize disbursements and loans to PRASA in regard to the Revolving Fund. Also, the finalization of the restructuring agreement discussed in Note 12 will ensure the repayment of PRASA's SRF loans and PRASA will be eligible to apply for financial assistance from the SRF funds which help ensure the continued protection of public health and the environment for the residents of Puerto Rico.

### 10. FINANCIAL MANAGEMENT AUDIT BY EPA'S OIG

On September 16, 2016, the EPA's OIG received a hotline complaint from the EPA identifying financial irregularities with the SRFs. The complaint reported of a combined balance of approximately \$194.5 million for the SRFs (\$53.3 million for the Revolving Fund) at GDB but that GDB did not have the assets to honor such balances. Pursuant the receipt of the hotline complaint, the OIG conducted an audit to accomplish the following objectives:

- Identify the source of the funds that made up the \$194.5 million in question.
- Determine the current status of the \$194.5 million and the potential for recovery.

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- Identify the causes for the alleged financial irregularities.
- Determine when the agencies responsible for administering the SRFs knew or should have known about the financial crisis and GDB's failure, and determine what actions or measures, if any, these agencies could have taken to secure the funds in question.
- Determine if the EPA performed adequate oversight.

The audit was conducted from October 31, 2016 to February 15, 2017, in accordance with generally accepted auditing standards issued by the Comptroller General of the U.S.

The OIG audit confirmed that the \$194.5 million in question (\$53.3 million for the Revolving Fund) was not available because GDB did not have the assets to honor the balance, as a result from the severe and ongoing financial crisis faced by the Commonwealth and GDB. However, although the EPA and the SRFs managing agencies (PRIFA, the EQB and DOH) were all aware of the financial crisis of Puerto Rico, they had no reason to believe and received no early indications prior to March 31, 2016 that the SRFs funds at GDB would ultimately be impaired. The OIG audit report went further by stating that the EPA could not have predicted or prevented this situation.

The audit also revealed that there were no indications that the SRFs managing agencies commingled or misused the funds held with GDB and as soon as the irregularities were discovered. The EPA provided adequate oversight to address the issues and worked with the managing agencies to safeguard the future revolving fund transactions. The Commonwealth recognized its obligation and has included restoration of the SRFs funds in its 10-year fiscal plan for fiscal year 2019 (see related disclosure of this restoration further below); nonetheless, withdrawals of any significance in the near future were determined to be highly unlikely.

The OIG audit also determined that approximately \$580 million in repayments to the SRFs owed by PRASA was at risk; however, that there was no indication that such repayments were at risk until February 26, 2016.

As discussed in Note 12, the Commonwealth, with the approval of the Oversight Board, included in its budget for fiscal year 2019, \$194.5 million to be transferred to the SRFs (\$53.3 million for the Revolving Fund) in restitution of the deposits lost because of GDB's insufficient liquidity.

### **11. ADMINISTRATIVE EXPENSES**

As provided by federal laws and regulations, reasonable costs of administering the Revolving Fund are reimbursable under federal programs up to a maximum of 6% of the capitalization grant awarded each year. The federal government also reimburses expenses incurred in training and certifying personnel as well as technical matters. During the year ended June 30, 2017, total reimbursement of administrative expenses amounted to \$517,521.

### **12. SUBSEQUENT EVENTS**

Subsequent events were evaluated through October 23, 2019, the date the financial statements were available to be issued, to determine if any such events should either be recognized or disclosed in the 2017 financial statements. Management believes that the subsequent events disclosed below are intrinsically related to the financial statements of the Revolving Fund. These might have been

# PUERTO RICO SAFE DRINKING WATER TREATMENT REVOLVING LOAN FUND

## NOTES TO BASIC FINANCIAL STATEMENTS FOR THE YEAR ENDED JUNE 30, 2017

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disclosed elsewhere in these financial statements, but management believes they require specific mentioning based on their relevance and materiality as a whole.

### **Government Development Bank**

With the establishment of the Puerto Rico Fiscal Agency and Financial Advisory Authority (the “FAFAA”) through Act 21, as subsequently amended by Act No. 2 of 2017, GDB’s role has been reduced solely to act as an agent in (i) collecting on its loan portfolio and (ii) disbursing funds pursuant to strict priority guidelines. Therefore, taking into consideration the scenario described in Note 3, given the reduced services that the GDB was providing and given that no appropriations were assigned to GDB for fiscal year 2018, on March 23, 2018, GDB ceased its operations after having substantially wound down its operations in an orderly fashion under Title VI of PROMESA. This process was implemented to mitigate the impact on its stakeholders (municipalities, depositors, and other creditors). This wind down process consisted of the GDB RSA entered into by FAFAA and GDB, as described below, with a significant portion of GDB’s major stakeholders, subject to different milestones, and was ultimately consummated on November 29, 2018.

On May 15, 2017, the Governor announced that FAFAA and GDB entered into the GDB RSA, with a significant portion of GDB’s major stakeholders holding more than \$2.45 billion in claims against GDB, including more than 300 on island bondholders, 50 on island credit unions, and an ad hoc group of the GDB’s bondholders, which held more than \$1 billion of the GDB’s public bonds. The GDB RSA contemplated a consensual restructuring of certain of GDB’s financial indebtedness through a Title VI proceeding under PROMESA. On April 6, 2018, FAFAA, GDB and certain of GDB’s financial creditors entered into a fourth amendment to the GDB RSA. The GDB RSA, as amended, was consistent with the underlying strategy of the New GDB Fiscal Plan, namely providing for a transaction resulting in an orderly wind-down of GDB’s operations. The GDB RSA also sets forth the parameters for a proposed GDB Title VI Plan under which distributable cash flow would be allocated among GDB’s various financial creditors and provided greater clarity as to how GDB’s operations would be wound down (the GDB Title VI Plan).

The proposed GDB Title VI Plan contemplated by the GDB RSA provides for certain of GDB’s creditors—consisting primarily of holders of GDB public bonds and deposit claims held by certain municipalities of the Commonwealth and certain municipal and nonpublic entities—to exchange their claims against GDB at a discount for new bonds (the New Bonds). Upon approval of the GDB Title VI Plan, such GDB’s creditors would receive New Bonds, and their claims, valued at full face value plus accrued interest, would be exchanged for New Bonds at an “Upfront Exchange Ratio” of 55%. The New Bonds would be issued by a newly formed special purpose instrumentality created pursuant to Act No. 109 of 2017, as amended (“Act 109-2017”) (the Issuer). The GDB Title VI Plan was consummated on November 29, 2018, following entry of the District Court order by Federal Judge Laura Taylor Swain approving the Qualifying Modification and after satisfaction of conditions set forth in the GDB RSA.

As a condition to closing the Qualifying Modification, the claims held by and against the GDB, on the one hand, and the Commonwealth and its agencies, instrumentalities and affiliates, on the other, were resolved pursuant to a settlement. The settlement released all of the GDB’s non-loan claims against the Commonwealth and certain agencies, instrumentalities, and affiliates of the Commonwealth, as identified in the GDB RSA, and allow each of these entities to receive their pro rata share of the beneficial interests in a trust (the “Public Entity Trust”) in exchange for releasing

# PUERTO RICO SAFE DRINKING WATER TREATMENT REVOLVING LOAN FUND

## NOTES TO BASIC FINANCIAL STATEMENTS FOR THE YEAR ENDED JUNE 30, 2017

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their claims against GDB. The assets of the Public Entity Trust include loans made to certain public entities by GDB, including the Commonwealth.

Pursuant to Act 109-2017, effective as of the closing date of the Qualifying Modification, the balance of liabilities owed between any government entity and GDB would be automatically determined by applying the outstanding balance of any deposit of such entity against the outstanding balance of any loan of such entity with GDB in a manner consistent with the Qualifying Modification. Furthermore, Act 109-2017 provides that all transactions effected pursuant thereto are valid and binding with respect to all government entities and that, other than as expressly provided therein or in the transaction documents, no government entity has any further rights or claims against GDB, the new issuer or the Public Entity Trust based, in whole or in part, on facts existing or occurring on or prior to the closing of the Qualifying Modification. Upon the closing of the Qualifying Modification, government entities are deemed to forever waive, release and discharge GDB, the new issuer and the Public Entity Trust from any and all such claims.

The assets of the Public Entity Trust include claims against the Commonwealth for loans with an outstanding principal balance of approximately \$890 million to be asserted by the Public Entity Trust in the Commonwealth's Title III cases. The GDB RSA also requires the Commonwealth's governmental and business-type entities to net their debts with GDB against their deposits and investments also held by GDB. Approved and certified the fiscal plan of GDB that recommended the winding down of its operations.

### **Escrow Deposit Agreement**

On June 30, 2017, PRASA, PRIFA, EQB and the Puerto Rico Department of Health (DOH), entered into an Escrow Deposit Agreement (Escrow Agreement) with the Banco Popular de Puerto Rico ("BPPR" or "Escrow Agent"). The Escrow Agreement was established, among others things, (1) to account for irrevocable escrow accounts, (2) hold deposit of the escrowed assets and (3) to apply such escrowed assets solely in accordance with the escrow agreement.

The Escrow Agreement emerged as part of and as a condition to the second amendment to the Forbearance Agreement as PRASA agreed to execute certain minimum payments to PRIFA for the sole benefit of the Revolving Fund. However, as a result of the uncertainty surrounding the impact of the Hurricanes Irma and Maria on PRASA's revenues and expenditures and the timing of receipt of federal grants or other funding, PRASA needed to preserve sufficient liquidity for operations and expenditures related to restoring its infrastructure, and therefore requested that PRIFA, EQB, DOH and the EPA agree to waive the requirement of the payments due on November 1, 2017 and December 1, 2017, included in the Second Amendment.

Pursuant the operating agreements with EPA, PRIFA is required to establish trust fund accounts to hold separate and apart from its assets or those of any of the agencies of the Commonwealth, in which it will deposit all funds received from borrowers of the Revolving Fund funds. PRASA will not have and will not exercise any dominion or control over the escrowed assets until the date that the Escrow Agent receives a certificate of compliance with the operating agreements with EPA and duly constituted in accordance with the laws of the Commonwealth. The negotiations of the definitive agreements for the restructuring of PRASA obligations under the Revolving Fund loan facilities were concluded on July 26, 2019, as further described in Notes 3, 6 and 12.

# PUERTO RICO SAFE DRINKING WATER TREATMENT REVOLVING LOAN FUND

## NOTES TO BASIC FINANCIAL STATEMENTS FOR THE YEAR ENDED JUNE 30, 2017

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### **Amendments to the Operating Agreements and Memorandum of Understanding-Incorporation into Trust Agreement**

Effective September 18, 2018, DOH and EPA entered into a revised Drinking Water State Revolving Fund Operating Agreement (the “Revolving Fund Operating Agreement”). On September 18, 2018, PRIFA and DOH entered into an amendment to the December 27, 2016 memorandum of understanding between PRIFA and DOH attached to and referenced in the Revolving Fund Operating Agreement.

DOH, PRIFA and FAFAA, with the consent of EPA, have agreed to incorporate into the Revolving Fund Operating Agreement, The Trust Agreement (the “Trust Agreement”) with BPPR, as Trustee (the “Trustee”), pursuant to which the Trustee shall receive all capitalization grant funds, investment earnings and funds recovered under the Commonwealth Fiscal Plan related to the Revolving Fund, and set them aside in a Trust separate and apart from any and all proprietary funds of PRIFA, DOH, and the Commonwealth, its agencies and instrumentalities, all in accordance with the further terms and conditions provided in the Trust Agreement. The Trust Agreement between DOH, PRIFA and Banco Popular of Puerto Rico was executed on December 18, 2018.

On July 26, 2019, PRASA and the Trustee entered into a seventh supplemental Agreement of trust, dated as of July 26, 2019, in order to clarify and amend certain provisions in the trust agreement, including, among other things, that the loans provided by the SRF to PRASA are not Commonwealth guaranteed indebtedness (as defined in the trust agreement).

### **Transfer of Funds from the Commonwealth**

The Commonwealth, with the approval of the Oversight Board, included in its budget for fiscal year 2019, \$194.5 million to be transferred to the SRFs in restitution of the deposits lost because of GDB’s insufficient liquidity. The SRFs had approximately \$194.5M that was on deposit with the GDB and frozen during fiscal year 2016.

The EPA requested the transfer of said funds in a lump sum as soon as appropriate since these funds would go a long way in helping to stabilize the SRFs and enable them to provide significant financial assistance to Puerto Rico communities to address critical water and waste water infrastructure problems for the maximum benefit to the people. On November 21, 2018, the Oversight Board agreed and authorized the disbursement, on or before December 31, 2018, of the \$194.5 million (\$141.2 million and \$53.3 million on behalf of the Puerto Rico Water Pollution Revolving Fund and the Revolving Fund, respectively).

On December 19, 2018, FAFAA requested to the Treasury Department and the Office of Management and Budget the release and transfer of such funds, which are currently deposited in their respective Trust account in custody of BPPR. As discussed in Note 4, the recorded custodial credit loss on the deposits with GDB disclosed therein will reverse during fiscal year 2019 upon the aforementioned transfer, consistent with the position established at the Commonwealth.

# PUERTO RICO SAFE DRINKING WATER TREATMENT REVOLVING LOAN FUND

## NOTES TO BASIC FINANCIAL STATEMENTS FOR THE YEAR ENDED JUNE 30, 2017

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### **Fiscal Plans for the Commonwealth and PRASA**

#### *The Commonwealth Fiscal Plan*

On May 9, 2019, the Oversight Board approved and certified its own 5-year fiscal plan for the Commonwealth (the “Commonwealth Fiscal Plan”). The Commonwealth Fiscal plan reflects various structural reforms and fiscal measures pursuing a more effective and efficient public sector and positioning Puerto Rico in the path to meet the objectives laid out in PROMESA of restoring fiscal responsibility, balance revenues and expenditures within five years and regaining access to the capital markets. Detailed information about the Commonwealth Fiscal Plan is disclosed in the notes to the Commonwealth’s 2016 fiscal year audited financial statements and in the portal page of the Oversight Board.

#### *The PRASA Fiscal Plan*

On June 25, 2019, the Oversight Board approved and certified a 5-year fiscal plan for PRASA (the “PRASA Fiscal Plan”) amended due to impact of hurricanes Irma and Maria. The PRASA Fiscal Plan has the objective to become a self-sustainable utility with an efficient and resilient system to allow for a reliable and affordable water service implementing operational improvements and funding a capital improvement program through five (5) key initiatives (i) public-private partnerships; (ii) federal funding and insurance; (iii) debt restructuring relief; (iv) sustainable rate adjustments; (v) efficiency of spending. The PRASA fiscal plan presents funding projections that reflects a negative gap, excluding any debt service relief and additional insurance/federal proceeds, but a gradual reduction in the annual financial need is expected showing a path to long term financial sustainability. Detailed information about the PRASA Fiscal Plan is disclosed in the notes to PRASA’s 2016 fiscal year audited financial statements and in the portal page of the Oversight Board.

### **PRASA’s Debt Restructuring**

On July 26, 2019, the U.S. Environmental Protection Agency (EPA) and Puerto Rico Aqueduct and Sewer Authority (PRASA) restructured certain delinquent loans – amounting to approximately \$596 million in principal – owed to Puerto Rico’s Water Pollution Control (WP) and Drinking Water (DW) State Revolving Fund (SRF) programs. PRASA entered into the loan agreements in order to restructure certain existing loans from the SRF funds and the notes issued by PRASA under the new loan agreements superseded and replaced all outstanding obligations with the SRF funds. The SRF also waived all accrued and unpaid interest with respect to the old debt. The new loan agreements each have a term of thirty years commencing on the January 1, 2016 (effective date) and bear interest at 0.0% for the first 10 years and 1% for the next 20 years. The loans and notes issued by PRASA to the applicable SRF were incurred by PRASA as other system indebtedness and have been designated as senior indebtedness under the master agreement of trust, between PRASA and Banco Popular de Puerto Rico, as trustee, and as amended by the seventh supplemental agreement of trust. The new loans provided by the SRF to PRASA are not Commonwealth guaranteed indebtedness, as defined in the trust agreement and the Commonwealth guaranty related to all the original financing agreements was terminated.

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**INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS**

To the Board of Directors of  
Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards issued by the Comptroller General of the United States, the financial statements of the Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund ("the Revolving Fund"), as of and for the year ended June 30, 2017, and the related notes to the financial statements, which collectively comprise the Revolving Fund's basic financial statements and have issued our report thereon dated October 23, 2019.

**Internal Control over Financial Reporting**

In planning and performing our audit of the financial statements, we considered the Revolving Fund's internal control over financial reporting to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Revolving Fund's internal control. Accordingly, we do not express an opinion on the effectiveness of the Revolving Fund's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weakness. However, material weaknesses may exist that have not been identified.

## Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Revolving Fund's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and which are described in the accompanying schedule of findings and responses as finding No. 2017-01.

## The Revolving Fund's Response to Findings

The Revolving Fund's response to the findings identified in our audit is described in the accompanying schedule of findings and responses. The Revolving Fund's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

## Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with Government Auditing Standards in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

San Juan, PR  
October 23, 2019



License No. 90  
Expiration Date: December 1, 2019



# PUERTO RICO SAFE DRINKING WATER TREATMENT REVOLVING LOAN FUND

## SCHEDULE OF FINDINGS AND RESPONSES FOR THE YEAR ENDED JUNE 30, 2017

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### **Finding No. 2017-001 Noncompliance with Memorandum of Understanding**

#### **Criteria**

The Memorandum of Understanding (“MOU”) between the FAFAA, PRIFA, DOH, and PRASA establishes the responsibilities of each party under the Safe Drinking Water Act. The responsibilities in the MOU require the managing agencies to maintain financial and cash management policies and procedures to ensure the adequate flow of funds, assess the financial health of the Revolving Fund and revise procedures as necessary to promote the perpetuity of the fund.

#### **Condition and Context**

Executive Order No.2016-10, signed by the Governor on April 8, 2016, declared GDB in a state of emergency and, among other things, restricted the withdrawal, payment and transfers of funds held on deposit with GDB. These executive order and subsequently discovered facts came to confirm a situation that already existed at June 30, 2015, where GDB did not have sufficient cash to cover the balance of funds in the Revolving Fund’s account, therefore delaying the water infrastructure projects financed by the Revolving Fund.

#### **Cause and effect**

As a result of the concerns raised by GDB’s insufficient liquidity to honor its obligations with the Revolving Fund’s deposits, the EPA issued a Notice of Noncompliance which established the actions that the Revolving Fund needed to take to be in compliance with the Safe Drinking Water Act and remain eligible for federal funding. Also, due to the deteriorating liquidity of GDB, the Revolving Fund had to restate its beginning net position at July 1, 2015 to recognize a custodial credit loss of \$106.5 million and recognized an additional custodial credit loss of \$33.7 million for the year ended June 30, 2016.

#### **Recommendation**

The Revolving Fund and the Commonwealth agencies in the MOU must take action to address the requirements specified in EPA’s Notice of Noncompliance in order to allow the flow of funds for infrastructure of drinking water.

#### **Views of responsible officials and Corrective Action Plan**

As further discussed in Note 12, management executed a corrective action plan to address the noncompliance referred to in the previous paragraph, including the following remediation steps:

- Established an account in a Trust with Banco Popular de Puerto Rico as Trustee, pursuant to which the Trustee shall receive all capitalization grant funds, investment earnings, loan repayments and any funds to be recovered under the Commonwealth Fiscal Plan; and set this account separate and apart from any and all proprietary funds of PRIFA, DOH, GDB and the Commonwealth, its agencies and instrumentalities.

# PUERTO RICO SAFE DRINKING WATER TREATMENT REVOLVING LOAN FUND

## SCHEDULE OF FINDINGS AND RESPONSES FOR THE YEAR ENDED JUNE 30, 2017

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- Amended the operating agreements and MOU between PRIFA and DOH in order to incorporate the roles of the Fiscal Agency and Financial Advisory Authority (FAFAA).
- Through a transfer from the Commonwealth, pursuant to its fiscal plan and budgetary process for fiscal year 2019, restored to the Revolving Fund the deposits with GDB that had been frozen during fiscal year 2016 as a result of GDB's insolvency."

**Responsible Person:**

Francisco Parés, *Secretary of the Treasury Department/OMB*, Eduardo Rivera Cruz, *Executive Director Puerto Rico Infrastructure Financing Authority* and Rafael Rodriguez Mercado, *Secretary Puerto Rico Department of Health*

**Implementation Date:**

Various dates for each action: June 30, 2017, September 18, 2018 and December 21, 2018